

Seppo Honkapohja

Member of the Board, Bank of Finland

## Macroeconomic policies and capital flows from the perspective of EMEs

WIDER Conference, Helsinki,  
September 18, 2015





# *Background*



- The basic growth theory: countries enjoying higher productivity growth should receive more net capital inflows.
- Data do not support this prediction (e.g. Gourinchas – Jeanne, 2013)
  - The cross country correlation (among non-OECD countries) between productivity growth and net capital inflows is often negative or at best zero.
    - This is called the “allocation puzzle”.
  - Solving the puzzle requires a saving distortion with negative correlation with productivity growth.
  - The puzzle mostly involves public flows, i.e. accumulation of international reserves.
- Empirical relation between growth and saving is induced by domestic frictions:
  - precautionary savings, low domestic financial development, limited investment opportunities,...



- Role of government: countries with take-off in trade resist real appreciation of the currency.
  - Restrictions on capital inflows, accumulation of foreign reserves by government.
- Further observations:
  - General productivity growth may be more important than capital accumulation.
    - Small long-run effects from capital account liberalization.
  - Empirically difficult to find positive correlation between financial integration and GDP growth (Kose et al. 2006)
  - Countries that invest a lot (China, India) do not seem to rely on foreign capital.
    - Institutional improvements can also enhance savings.



# ***Benefits from Financial Liberalization***



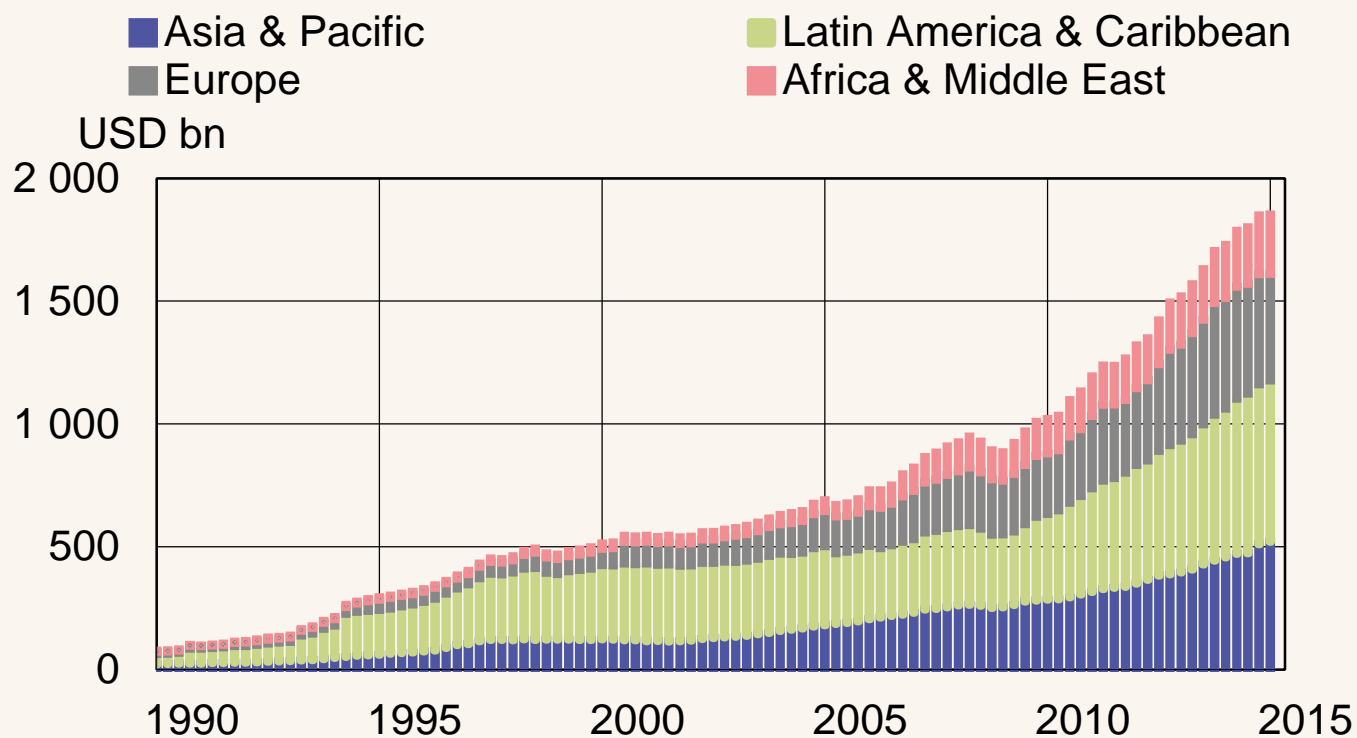
- Financial openness creates "collateral benefits" (Kose et al 2006):
  - Financial sector development: banking, equity markets etc.
  - Improved corporate governance
  - Improved macroeconomic policies
- Evidence is mixed, are there thresholds? (Prasad et al 2007)
  - Foreign investors are not able to improve very weak property rights and other institutions.
- Better institutional quality may change the nature of foreign investment more into FDI and portfolio investment, away from debt flows.



## ***Some Data***



# CHART 1: Developing Economies International Debt Securities

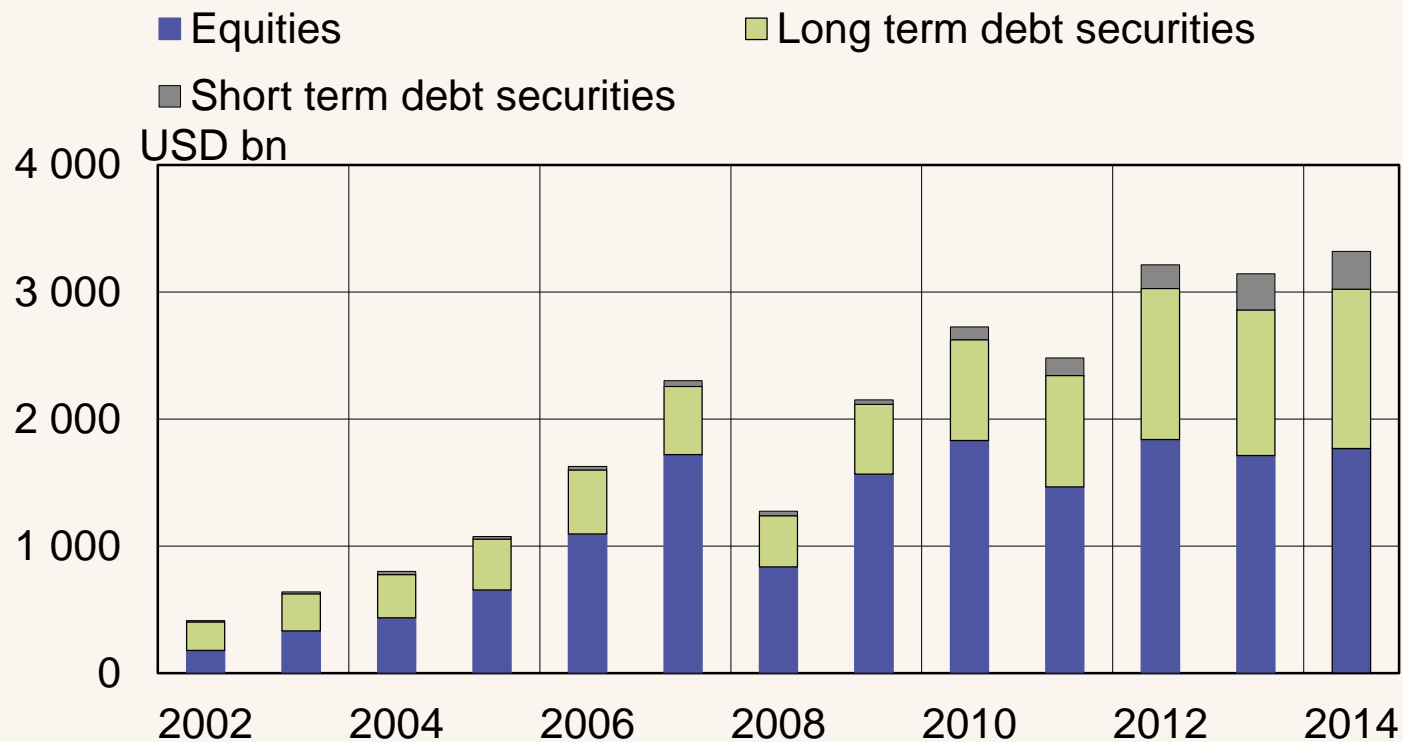


Source: BIS International Debt Securities Statistics





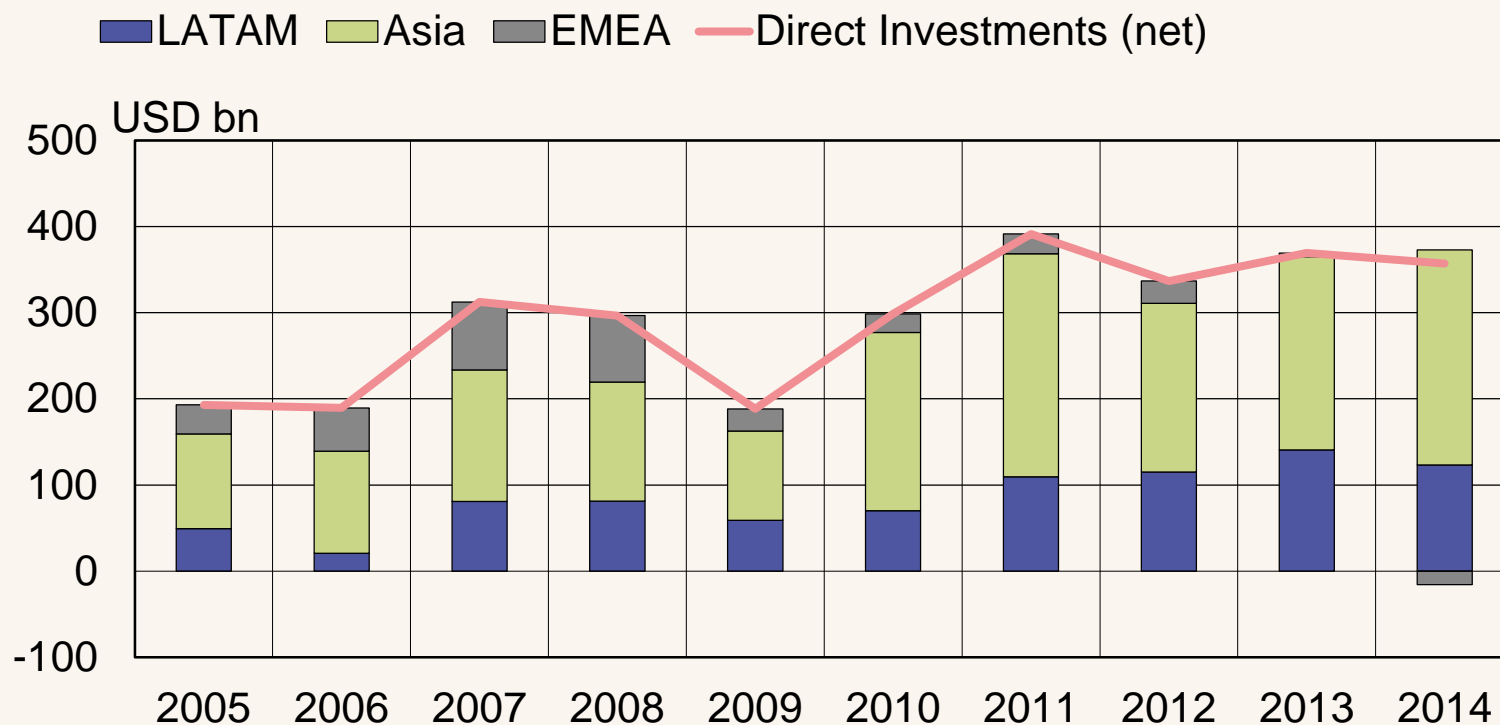
## CHART 2: Developing Economies Portfolio Investment Liabilities



Source: IMF



## CHART 3: Developing Economies Direct Investment Flows (net)



Source: IMF



## Comments on data

- Build-up of debt securities accelerated after the financial crisis in advanced market economies.
- Portfolio investment growth decelerated somewhat after the financial crisis.
- Before the crisis FDI share rose a lot (e.g. Prasad-Rajan 2008). This continued in the crisis years but FDI has levelled off since 2011.



# *Discussion*



- Forces of globalization, e.g. internalization of major companies, make it harder to maintain closed capital accounts.
  - This is a potentially key issue for EMEs and the same phenomenon appeared e.g. in Finland and other Nordic countries in 1980's.
- The literature suggest that, on balance, capital account liberalization is a good thing, but there are various caveats and difficulties.
  - Proceeding carefully is important.
- High foreign exchange reserves strengthen the economy and reduce risks from capital account liberalization.
  - But domestic distortions can provide political economy reasons for delaying the liberalization.



- High domestic savings due to distortions can lead to major capital outflows after liberalization.
  - This may be a good thing but within limits (if there have been earlier problems in sterilizing inflows).
- Changing monetary policy regime from fixed to more flexible exchange rates reduces risks *ceteris paribus*.
  - But the risk of surges in capital inflows remains.
- Higher trade openness of a country reduces risks from capital account liberalization.
  - Less risk of a sudden stop, smaller real exchange rate changes from given CA adjustment



## ***Concluding remarks***



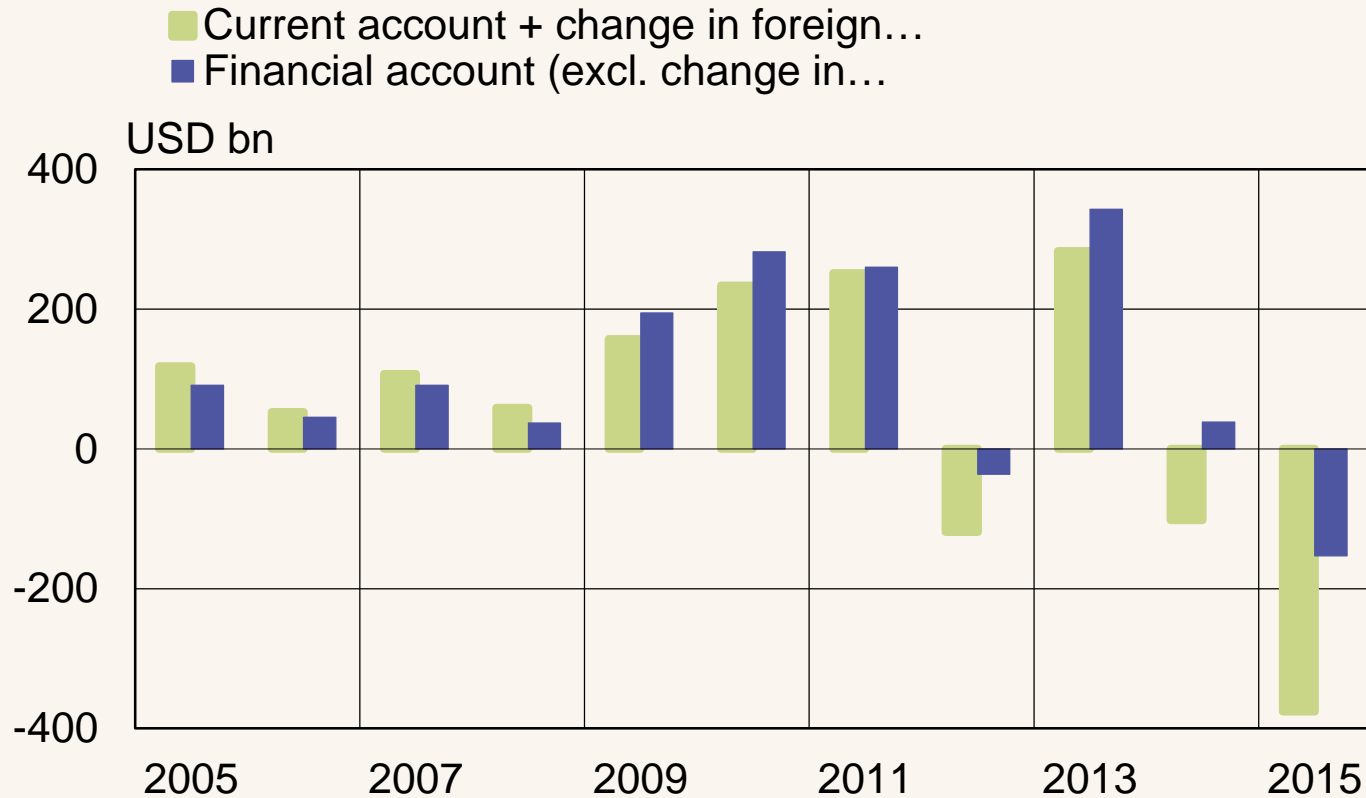
- Current situation:

- After the financial crisis debt flows to EMEs have gone up while FDI has slowed down.
- This changing composition of foreign investment into EMEs has increased the risks from financial liberalization in the form of large outflows.
- We are now seeing reversals on capital flows (data on China).





## CHART 4: Capital flows to China



Source: IMF, China SAFE



- Monetary policy in major currency areas is geared toward domestic objectives, but there is need to increase the resilience of the global financial system.
- Improving resilience should go toward more equity- and security-based international finance and away from bank centered finance.



***Thank you!***