Some observations on capital flows in emerging economies

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I. Introduction

I would like to thank the organizers for inviting me to this conference. It is an honor for me to participate in this forum which has brought together influential policy decision-makers and leaders in the financial and business sectors from different regions around the world.

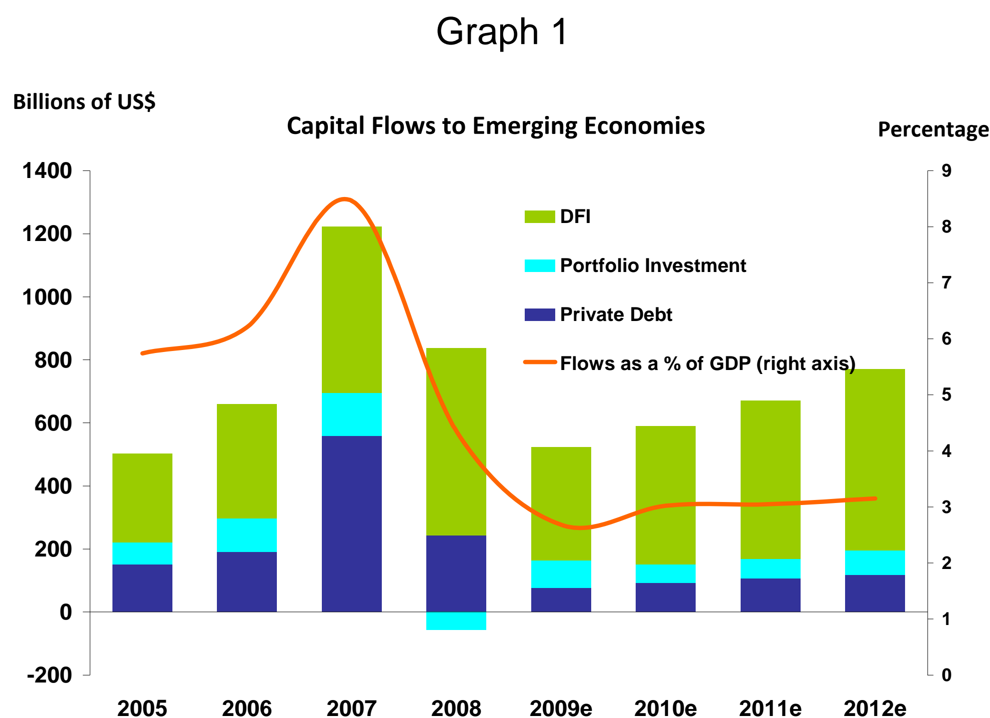
During the last two decades, the discussion of policy on financial flows in emerging economies has been intense. I have no intention of going over the copious literature on this topic here. I will simply make a few general introductory comments on the recent development in these flows and offer a tentative answer to two questions that have been correctly expressed by the organizers. Do large capital flows into emerging economies create the risk of destabilization? How can these risks be reduced without discouraging capital flows? In answering the second question, I will limit myself to speaking about the Colombian experience.

[1] Governor of Banco de la República (Central Bank of Colombia). Chatham House City Series 2010 Conference.

II. **Recent trends in capital flows to emerging economies**

Graph 1 shows the trend of capital flows towards emerging economies for the period that goes from the year 2005 to the year 2009 and a projection for 2010-2012. The values are in billions of dollars and are divided between direct foreign investment and portfolio and loan investment.

Graph 1



Source: The World Bank. Global Economic Prospects, Summer 2010

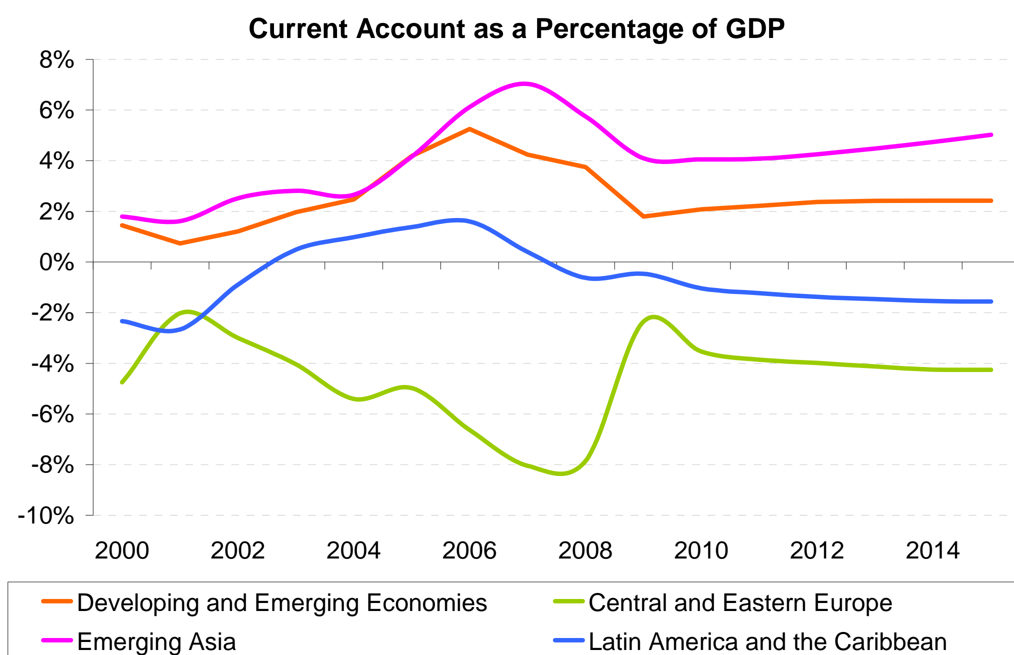
I would like to highlight two aspects of the information provided in Graph 1. The first one is the growth in capital flows during the 2005-2007 period and the significant decline of these flows in 2008 and a large part of 2009. The years of growing flows were largely due to the low interest rates in the United States and other developed countries, the higher rates of return in emerging economies and the high prices for commodities. The collapse, in

turn, had to do with the strangulation of credit in a large number of industrialized countries, a higher overall risk aversion, and the sharp plunge in the prices of commodities in the second half of 2008 and the first half of 2009.

The second one is that the flows of direct foreign investment (DFI) have been less volatile than the portfolio and foreign loan flows. Likewise, when the capital flows are analyzed by regions, it can be seen that in the cases of Eastern Asia and the Pacific as well as of Latin America, the increase in the financial flows was mainly the result of the greater DFI. In contrast, in Europe and Central Asia, the higher flows came from private foreign debt (Appendix 1).

These capital flows to emerging countries have co-existed with current account positions in the balance of payments that show large differences between the various regions around the world. While in Asia the capital inflows have co-existed with large surpluses in the current account and in Latin America with situations that are close to being in equilibrium, they have been accompanied by sharp deficits in the Central and Eastern European countries (Graph 2). This means that while in Asia the gross capital inflows have been lower than the outflows, especially due to the accumulation of international reserves in their central banks, and in Latin America the inflows have not been very different from the outflows, in the Central and Eastern European countries (at least in the great majority) the inflow of foreign capital was much higher than the outflow.

Graph 2



Source: IMF

As of the second half of 2009, capital flows to emerging economies have been recovering. The issuing of corporate bonds and the investments in stock and fixed-income funds have rallied. The flow of interbanking loans has stopped falling and the DFI has been rising, especially in the larger emerging economies and in those that produce commodities which have risen in price.

However, this recovery has been gradual so far and its amount is still far from reaching the levels seen before the outbreak of the international financial crisis. In the case of investments in portfolio and banking loans the flow of capital has been limited by the sharp increase in the prices of assets in some emerging economies and by the interest international

financial institutions have in reducing their degree of leveraging. DFI, in turn, has been recovering largely due to the above mentioned factors but, at the same time, its momentum has been affected by the weakness in the demand for investment around the world.

There are factors that lead us to expect upswings in capital flows to emerging economies in the next few years. First, because the outlook for growth is better for them than for the developed economies. Second, because the international prices for commodities will probably remain high for the next few years and a significant number of the emerging economies are exporters of those types of products. Third, because over a lengthy period of time the interest rates in industrialized countries will remain low in comparison to those in emerging economies. Last of all, for the next two or three years, the financial risks will be higher in developed economies than in the emerging world, especially in Europe.

Therefore, it is not surprising that institutions such as the IMF expect emerging economies to receive strong capital inflows in the near future, especially Asia and Latin America. Of course, this is provided that the public debt problems in Europe are controlled and there is a gradual reduction in the overall risk aversion.

III. **Capital flows and the risk of destabilization**

Do large capital flows into emerging economies create the risk of destabilization?

History has shown that strong and persistent inflows of foreign capital can lead to severe crises in which both those who demand capital and those who offer it lose. These types of crises basically develop by means of two mechanisms. The first is when the capital flows finance the leveraging of households, businesses or governments and this ends up generating a unsustainable growth of domestic expenditure and credit. In this case, the counterpart to the net foreign capital inflows are the deficits in the current account of the balance of payments. Thus, when there is a “sudden stop” in capital inflows (which usually occurs) the economy adjusts through a sharp contraction in expenditure and in economic growth. The economic and social costs of this type of adjustment are enormous.

The second mechanism acts when the leveraging of households or businesses (or both) finances the purchase of assets and creates bubbles in the prices for these. In this case, the higher value of the household and company collateral stimulates their indebtedness, usually with the financial system. Later, when the capital flows reverse, the prices of the assets fall abruptly and the collateral loses value. As a consequence, not only families but also companies face difficulties in renewing or paying their loans and some turn the devalued collateral over to the lenders. If the financial system has not set up enough coverage for their risks, the explosion of the asset price bubble can cause a financial crisis with serious consequences on expenditure and aggregate production.

It is very probable that the two mechanisms that have been described here will act simultaneously. That is to say that pronounced increases in capital flows stimulate an excessive growth in current expenditures and in the

prices of assets at the same time. In both cases, leveraging of companies and households takes off and the economy's financial fragility becomes accentuated.

The history of Latin America offers good examples of the destabilizing effects of foreign capital flows. One of them is the well-known "Latin American debt crisis" of the 80s in the last century. At the end of the 70s and beginning of the 80s, there was a heavy flow of capital into the economies in that region most of which were intended for governments. The counterpart to this phenomenon was the sharp increase in the deficits in the current accounts of the balance of payments. Once capital flows were reversed due to the rise in the interest rate in the United States, a significant number of the governments could not pay their debt and the adjustment of the economies was painful. The Latin America economies, with the exception of Colombia, did not grow in the 80s for all practical purposes.

Another interesting example is that of Colombia in the 90s. Just like other countries in the region, Colombia experienced heavy net inflows of foreign capital during the first half of that decade. These encouraged a sharp growth in expenditure and in indebtedness and contributed to the creation of a bubble in the prices of assets, especially those of real estate. When the Russian debt crisis was unleashed, capital stopped entering and the macroeconomic adjustment occurred through a sharp reduction in the aggregate expenditure. The Colombian economy shrank in 1999 for the first time since 1931, the unemployment rate doubled and the government had to intervene in some financial entities in order to liquidate or manage

them.

These episodes in Latin America have some elements in common with what occurred recently in some countries in Central and Eastern Europe. For example, the existence of heavy deficits in the current account and the excess of debt, both domestic and foreign. They contrast, however, with what has been seen during this decade in a large part of Asia and Latin America. As we saw in Graph 2, the capital flows into Asia have been more than offset by the outflows financed by savings and the current accounts have a surplus. In Latin America, the current accounts of the balance of payments are maintained at close to equilibrium or with a small deficit as is the case for Colombia. This is partly due to the macroeconomic policy actions derived from the lessons extracted from past experience.

IV. **How can capital flows be attracted and their risks be mitigated at the same time?**

Indeed, the experience of Latin America in general and of Colombia in particular illustrates the risks and vulnerabilities that large capital flows can generate. The same thing can be said about the comparison between what occurred recently in Central and Eastern Europe and other regions around the world. From these experiences, at least three lessons have been extracted:

- Avoiding excessive growth in expenditure is fundamental. This is usually reflected in large and persistent imbalances in the

current accounts.

- It is necessary to limit an upsurge in the expansion of loans and an excessive rise in the prices of local assets.

- Unhedged foreign exchange positions and maturity mismatches in the balances of firms, banks and households should be restricted. This facilitates non-traumatic adjustments of economies when faced with negative external shocks.

As a result, in the last decade, we adopted a framework of financial and monetary policy in Colombia with elements derived from the lessons described. First, the monetary policy seeks to maintain price and product stability in the long run. The financial and macroeconomic imbalances that cause excessive and costly economic fluctuations can simmer over long periods and be compatible with controlled inflationary pressures.

For example, in small and open economies a prolonged cycle of capital inflows can stimulate excessive growth in expenditure and loans at the same time that inflation is maintained at low levels through a nominal appreciation of the currency. That is why, the adoption of longer policy horizons implies incorporating financial stability considerations into the decision-making process.

Second, a high degree of flexibility in the exchange rate is allowed. A limited exchange rate flexibility induces monetary policy and the availability of credit to become pro-cyclical in view of capital movements or of export

prices. This takes flexibility away from the policy responses and increases macroeconomic vulnerability. Likewise, under a fixed or semi-fixed exchange rate regime, the private sector incorporates the foreign exchange risk into its decisions incompletely and this can encourage excessive currency mismatches in their balance sheets. In the phase of capital outflows or lower export prices these mismatches accentuate the slowdown or drop in expenditure, compromise the health of the financial system and, therefore, restrict the set of policy responses and make the adjustment of the economy more costly.

When the Banco de la Republica intervenes in the foreign exchange market, we do it to reinforce the country's international liquidity position or to moderate an excessive volatility in the exchange rate. Nevertheless, the foreign exchange intervention does not seek to stabilize the exchange rate around a specific level nor change its trend.

Third, the monetary strategy uses the short term interest rate as its main instrument but complements it with additional tools. Among these I would like to emphasize the reserve requirement on local deposits, permanent macro-prudential regulation and capital controls. The reserve requirements are used to moderate excessive growth of domestic credit and to reinforce the transmission of the policy interest rate movements. The permanent macro-prudential regulation includes limits on the exposure of financial brokers to foreign exchange and liquidity risks in foreign currency as well as boundaries to their exposure to the counterparty risk on the exchange rate derivatives market.

Capital controls consist of a required deposit in the Banco de la Republica on foreign debt transactions carried out by Colombian residents. This requirement is a price-based instrument that seeks to affect the marginal cost of foreign financing (in contrast to restrictions or quantitative prohibitions) and is applied only to capital inflows from foreign indebtedness, not to outflows. Since it consists of a deposit requirement for a fixed period, the control discriminates against short term loans and has a smaller impact on the cost of longer term operations. The control is imposed temporarily in order to complement reserve requirement movements when the intention is to moderate private sector leveraging or to discourage excessive inflows of capital for short term speculation.

Our policy framework, which could be classified within that which is called "Inflation Targeting +" today, has worked satisfactorily over the last decade. In 2009 we reached the long term inflation target (2%-4%) after a gradual process of reduction. Financial stability has not been compromised in spite of the global crisis and the strong negative shock associated with the drop in exports to Venezuela, our second most important trading partner. Colombian banks are solid and profitable, loan availability has not stopped growing in real terms and, in spite of the external shocks mentioned, GDP increased by 0.8% in 2009 and the pace of recovery is picking up fast in 2010.

The deficit in the current account as a proportion of the GDP went from 3.4% in 2007 to 2.8% in 2008 and to 2.2% in 2009. This means that the sharp changes in conditions abroad since the end of 2008 did not show up as a major adjustment of the economy's foreign financing. Colombia kept

its access to the resources from savings abroad at a critical moment in the world economy. Even if this is partly attributable to the fact that the strongest shocks did not occur in the emerging economies, the macroeconomic and financial stability that was reached through out policy framework was a basic and necessary condition to maintain this access. During the same period, other emerging economies with different policy responses experienced serious difficulties in their balance of payments and sharp plunges in expenditure and production.

This indicates that the policies that are conducive to maintaining a sustainable capital flow include measures to mitigate its risks. That is the lesson of our experience from the nineties and from this last decade. Specifically, various studies on the effectiveness of capital controls used in Colombia point out that their impact on the total flows is debatable but their effect on terms and their nature is clear.[2] This is interesting since it suggests that the instrument is useful for discouraging those flows that could compromise financial stability and foreign payments (i.e. short term debt) without substantially affecting those that are more stable or have lower risks for the balance of payments (i.e. DFI).

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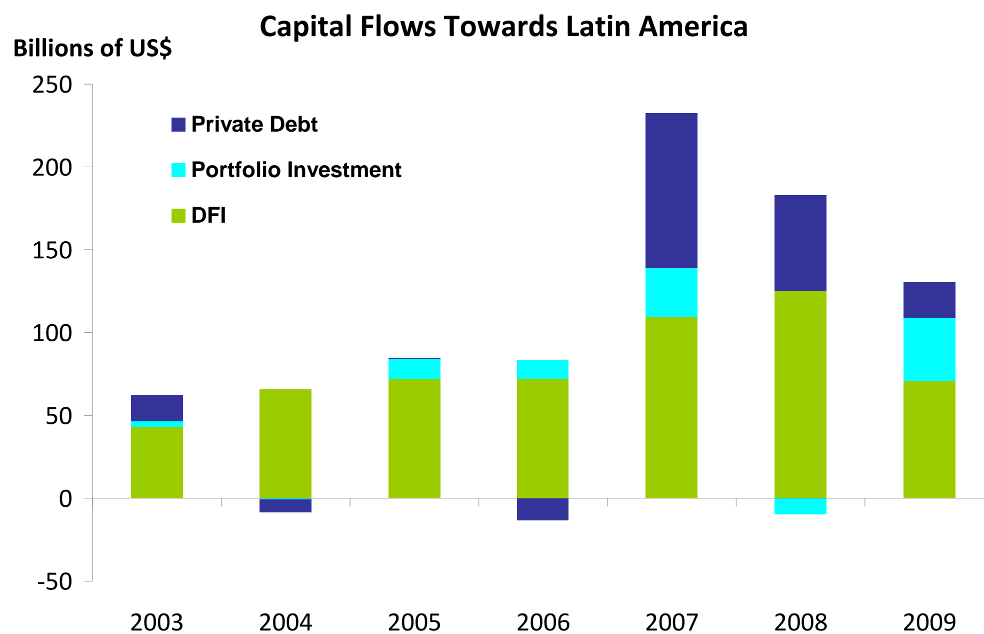
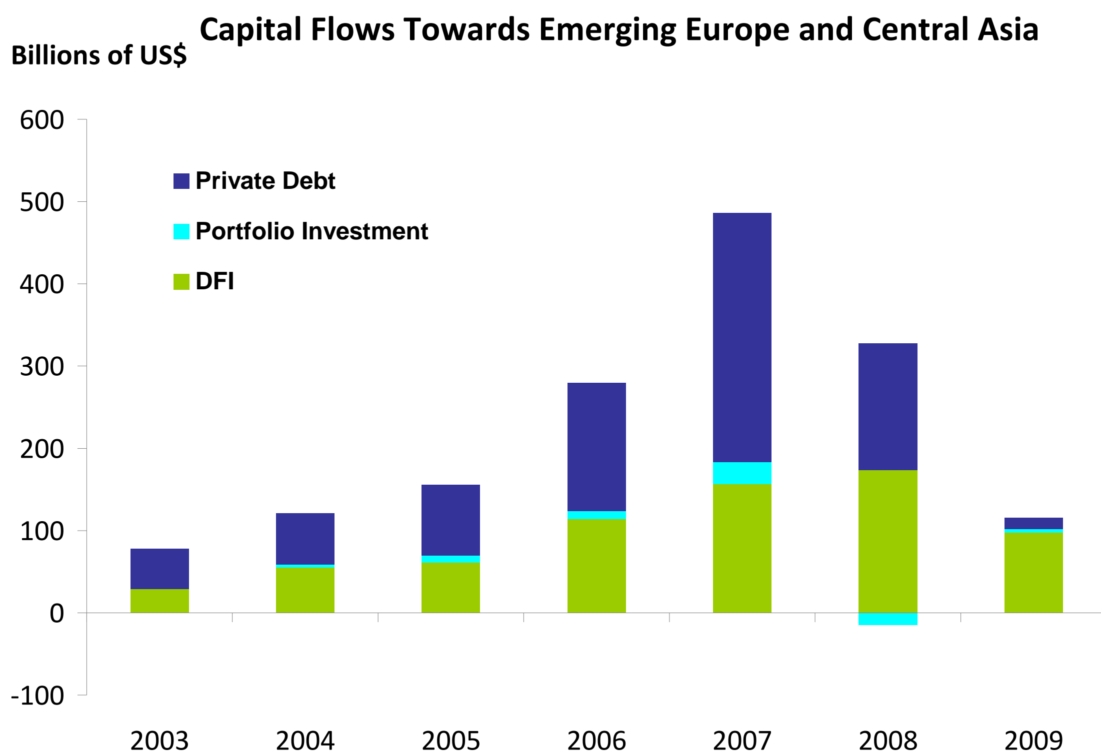
[2] See, for example, Clements and Kamil, "Are Capital Controls Effective in the 21st Century? The Recent Experience of Colombia." For a review of the topic in other countries see Masgud and Reinhart, 2007, "Capital Controls: An Evaluation," in S. Edwards, ed., *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences* (Chicago: The University of Chicago Press).

Appendix 1



Source: The World Bank. Global Economic Prospects, Summer 2010



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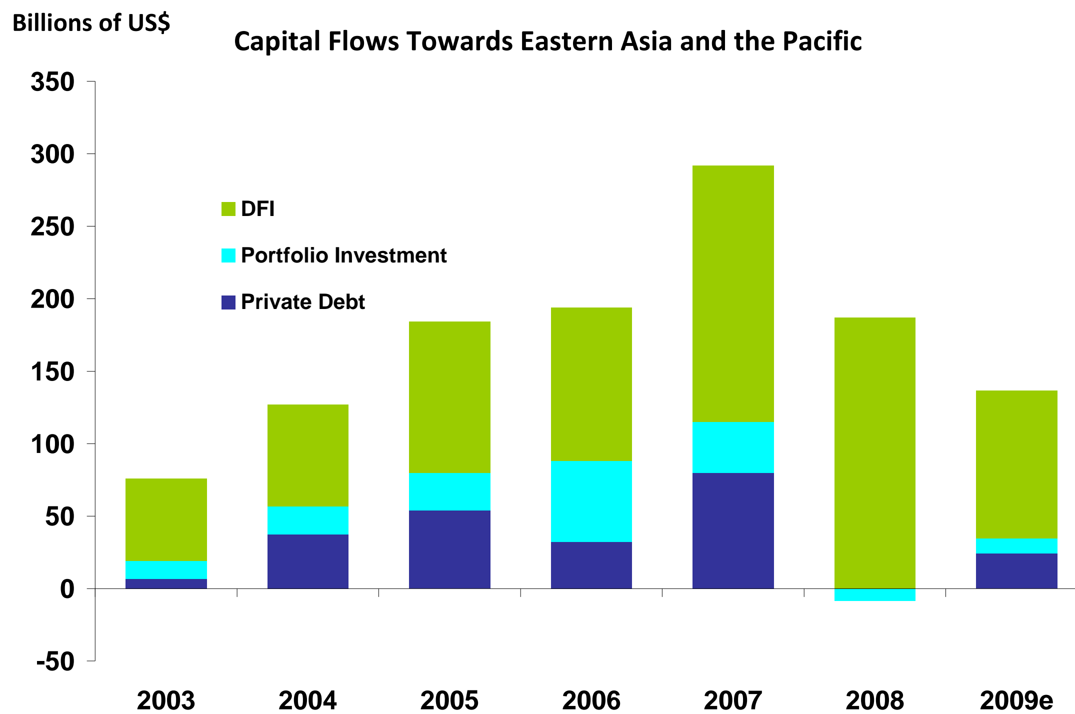

Source: The World Bank. Global Economic Prospects, Summer 2010

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