Global monitoring of international capital flows

Presentation at the Workshop “Financial Stability in Emerging Markets: Dealing with Global Liquidity”

School of Finance, Central University of Finance and Economics, GIZ, DIE

Beijing, 21 October 2011

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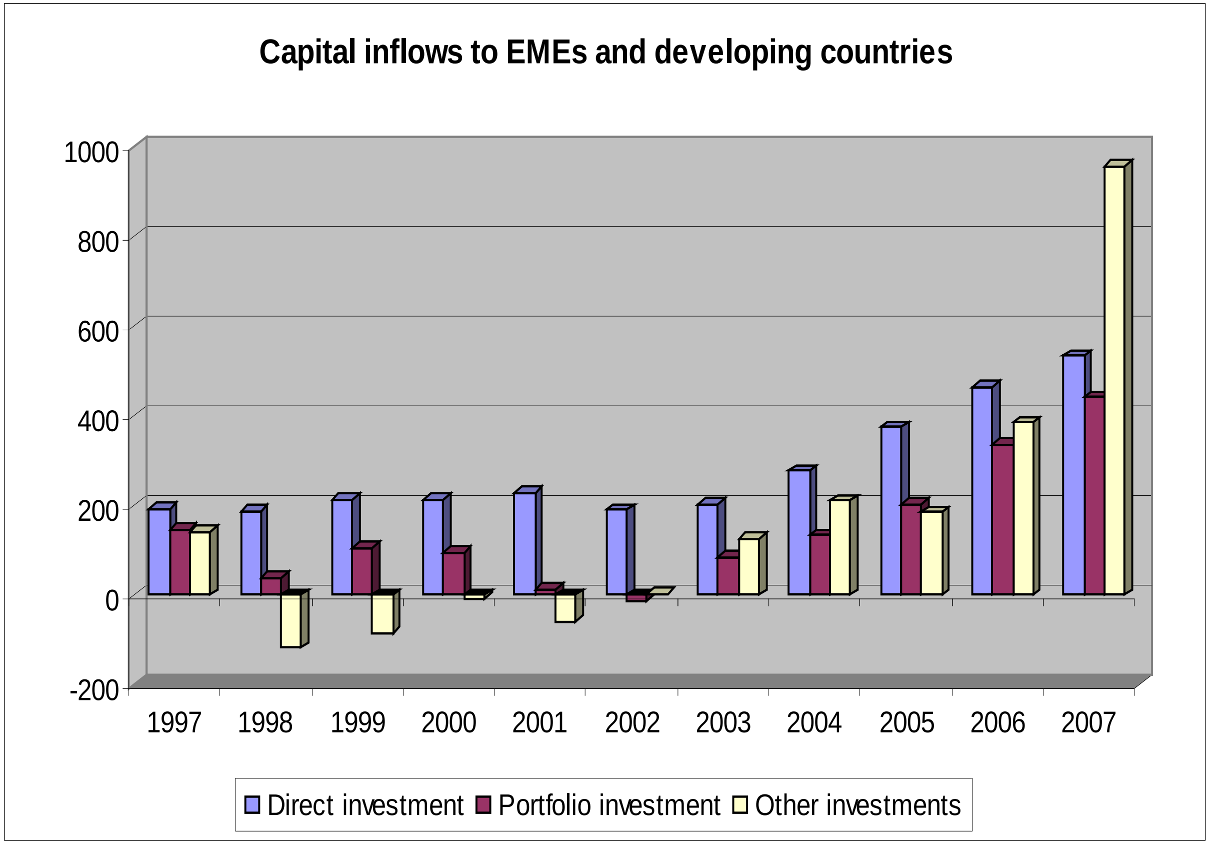
Overview

- **I. Development of global capital flows and underlying trends**
- **II. Why is global monitoring so important?**
- **III. Main objectives of global monitoring**
- **IV. Main implications of increasing global capital flows and its volatility**
- **V. Monitoring – optimal assignment of roles**
- **VI. Capital management measures**
  - I. G20 Discussion
  - II. German experience

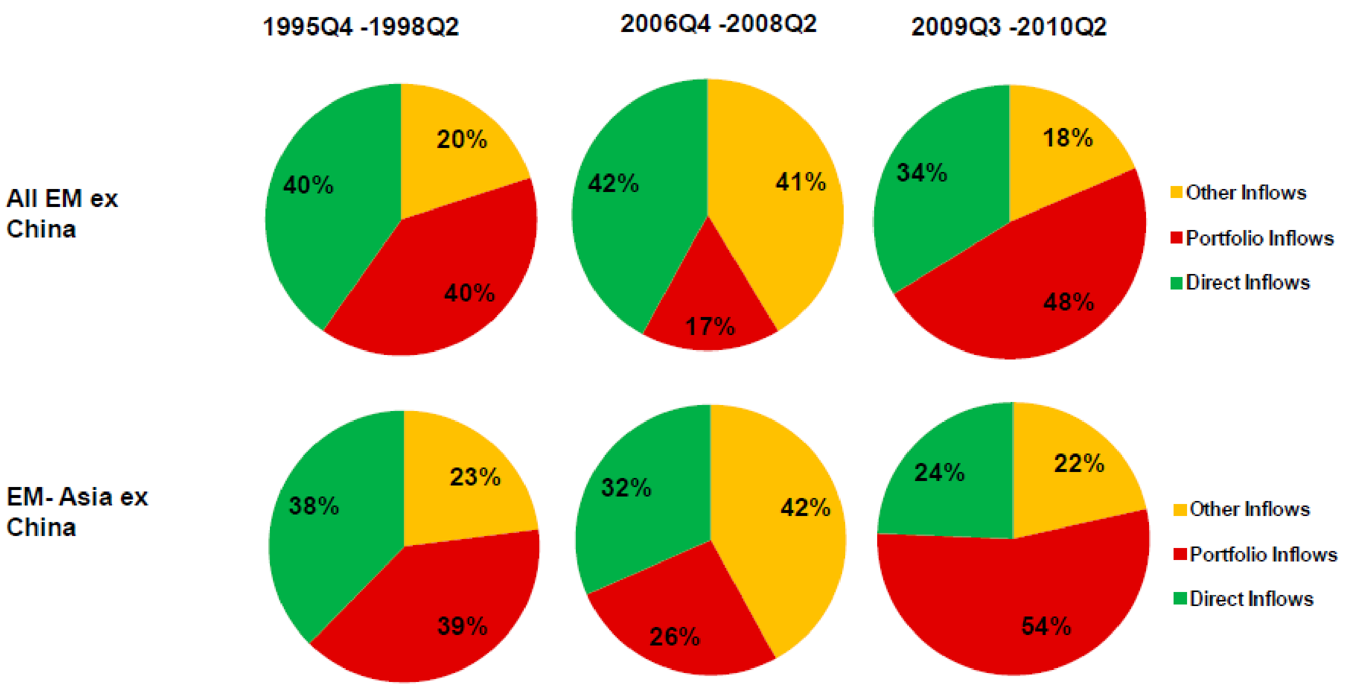
Development of capital flows and underlying trends



- Significant increase in global capital flows before the crisis
- Even more important was a dramatic shift in the structure of capital flows
- Significant increase in “other investments” – as large as foreign direct investments and portfolio flows combined
- This position mainly reflects international credit channel
- Increase of around 420% compared with 2005
- Driven by globally active banks

Dynamically changing composition

Figure 4. Gross Capital Inflows, by Type of Flows for Each Wave (percent share)



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Underlying trends and determinants

- **Institutionalisation of savings**
- **Marketisation of finance**
- **Financial innovations**
- **New Players**
- **With regard to EMEs: no short-term development; new normal**

Elements

Necessary information / Surprises	Phenomenon	Closer analysis needed
Strength of financial crisis	Sub-prime crisis cannot explain the dimension of the crisis Shadow banking system Lack of transparency Financial innovations fuelled transmission	Global financial transmission mechanism Cross border linkages Global risk map Financial innovations and implications for future financial crisis
Vulnerabilities of countries	Macro didn`t matter	Global financial transmission mechanism Portfolio strategies of globally acting banks and investors
Strength of real effects	Underestimated by nearly all macro models	Financial transmission channel into real sphere
Synchrony of effects	Unprecedented shock and partly unexpected response pattern	Changing structures due to financial globalisation
Macro Stress tests	Underestimated strength of financial crisis Often focused on real shocks, but predominance of financial shocks during last two decades	More focus on the whole financial system is needed
Market indicators	Failed to give early and reliable alarms Distorted for example, due to liquidity and risk appetite	Further extract implicit information from market prices

Why is global monitoring so important?

- **Contribute to explaining**
  - Increasing dynamic of contagions across financial markets
  - Changing financial transmission channel
  - Strength of spillover effects into the real sphere of the economy
  - Changing interdependency between the financial and the real sphere of the economy
  - To necessary restructuring of Financial Soundness indicators and early warning systems
  - Enhancing transparency for more effective regulation, determining the best places and institutions

Progress in global monitoring of changing financial factors – why is this so important?

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(i) Global financial factors of increasing importance for national financial markets

- 50% of the variance in the spreads of EMEs influenced by global factors such as global liquidity and institutional investors' risk appetite

(ii) Global financial factors are of increasing importance for national and global business cycles

- For example, an increase of 200 bp in the spread levels of selected EMEs will, in the following year, lead to a drop by around 1% in world economic growth against the baseline
- But models and assessments are mainly focused or based on real sector data

(iii) Global financial factors are of increasing importance for explaining why even EMEs with a stable macroeconomic framework have been hard hit by the financial crisis

- For some markets, empirical studies do not find any significant differentiating effects with regard to different macro stability
- The financial transmission channel explains most of the strength of the economic rebound and the fast spread of the crisis across countries and into the real economy
- Recent empirical work does not find any significance of real channel

Progress in global monitoring of changing financial factors – why is this so important?

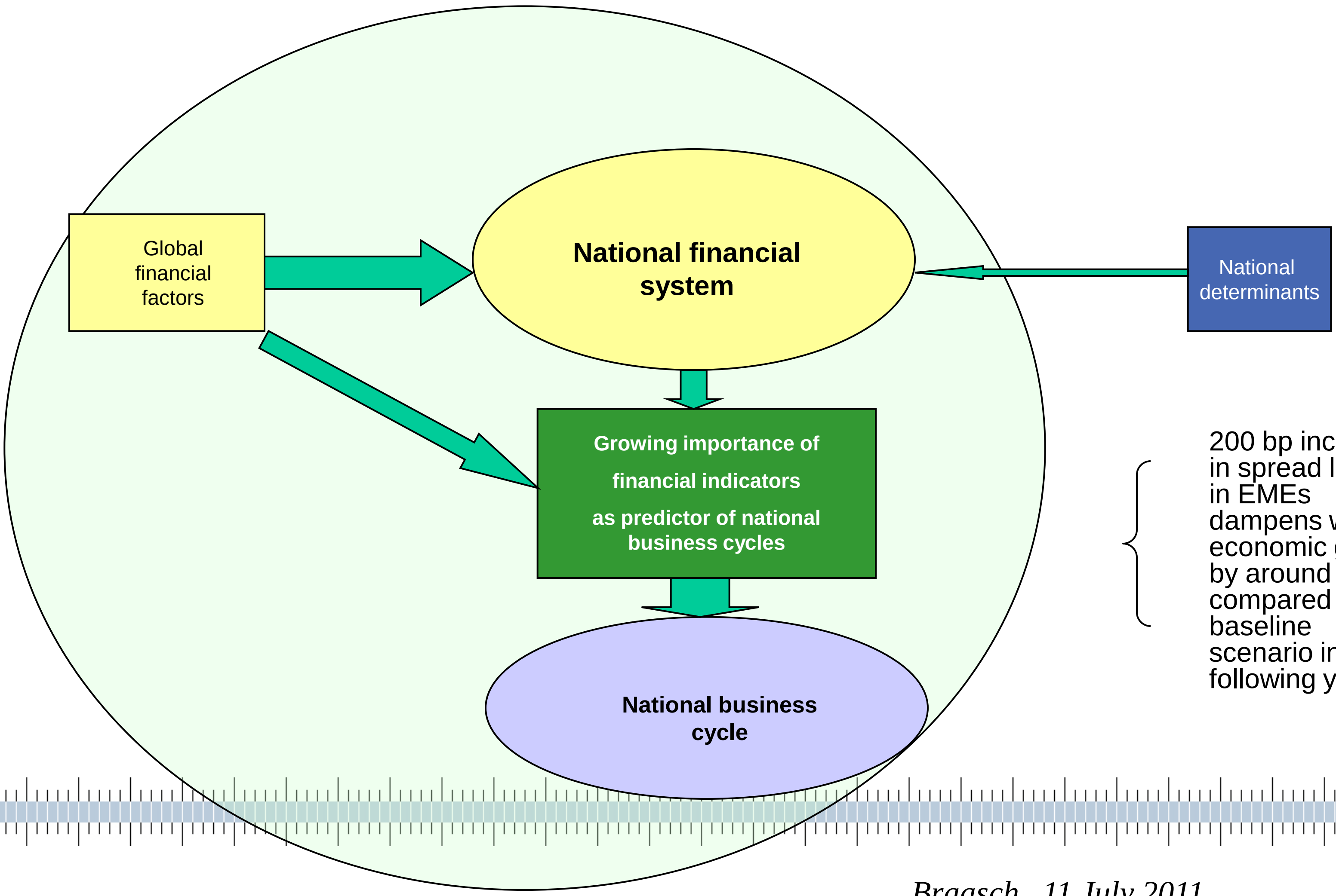
(iv) Global monitoring and analysis supports the necessary restructuring of Financial Soundness Indicators, of early warning systems and necessary changes in surveillance

(v) Supports the development and integration of changing financial structures into macroeconomic models

(vi) Delivers additional valuable information on the most efficient kind of regulation

(vii) Aimed at shortening the lag between recognising build-up of financial distortions, financial crisis and data needs and deciding on a response

Changing interdependencies between financial and real sphere of the economy



200 bp increase in spread levels in EMEs dampens world economic growth by around 0,9 % compared with baseline scenario in the following year

Main objectives and main challenges of global monitoring

- Enhancing national and global financial stability
- Deeper knowledge of main determinants of underlying trends
- Enhancing preventive measures of international financial institutions
- Deeper insight into main drivers of globally acting investors
- Not only explaining the ups and downs of financial markets but in particular changing structures, response patterns to financial crisis.

Main objectives and main main challenges?

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- **Formulating and maintaining a strict stability course for monetary policy**
- **High capital inflows often a predecessor of banking, financial and currency crisis …**
- **… in particular in case of pre-dominance of portfolio flows, as is currently the case with the perspective of EMEs**
- **Contain the dynamic of contagions,**
- **… vunerabilities**
- **… and perhaps most important – spillovers into the real economy**
- **Deeper knowledge about changing global financial transmission channel**

What do strategies of globally acting investors tell us?

- **Behaviour and strategy of globally acting banks and institutional investors**
- **Increasing importance of globally operating institutional investors**
- **Better knowledge of their behaviour and their strategies is key for a better understanding of vulnerabilities, contagions and spillovers**
- **Portfolio strategies and rebalancing activities explain a lot of different vulnerability of countries**
- **… and the transmission of shocks, for example common lender problematic.**
- **Further research of high priority, since their strategies form an essential juncture between the financial and the real sector**

- **Portfolio rebalancing effects are quantitatively of increasing importance**
- **Implications of a low interest rate environment**
- **To what extent are financial flows guided by fundamental indicators and actually play the role of an effective „judge and jury“?**
- **Not influenced but influencing fundamentals across countries?**
- **Assets under management in relation to EMEs market volume**
- **Further research of high priority, since their strategies form an essential juncture between the financial and the real sector**

- **Different size of financial systems**

- **Increasing search for diversification by institutional investors**

- **Assessment of institutional investors: Increasing capital flows are more a reflection of a „new normal“ than due to excess liquidity –**

- **Strong capital inflows to EMEs will continue.**

Optimal assignment of roles in global monitoring

- **IMF have a significant and potential comparative advantage in global monitoring international capital flows, broad country coverage**
- **Bottom up and top down approach**
- **Overcome silo attitude**
- **We will never have the right model – right, but actually the distance between models and reality appears to be too large.**
- **Monitoring not supervision or „umpire“ role**
- **Close cooperation with the BIS, with its comparative advantage on international banking activities.**

Capital flow management measures (CFM) – G20 discussion

- **Main objectives: enhancing national and global financial stability**
- **Protection on the flanks of monetary policy**
- **Strengthening the robustness of the financial system**
- **Long-term: free flow of capital**

- **Some kind of „hierarchy“ of measures:**
  - Macroeconomic stability is the first line of defence, sustainable measures to reduce capital flow volatility.
  - Enhancing the stability and shock absorptive capabilities of financial systems by macroprudential measures
  - Developing and deepening local currency bond markets as medium to long-term strategy
    - G8 and G20 Action Plan
    - Joint Bundesbank, IMF and World Bank conference in local bonds and international capital flows.

Capital flow management measures (CFM) – G20 discussion

- Capital controls as last line of defence, temporary, transparent and targeted
- Capital flow management and in particular capital controls shouldn`t delay necessary macroeconomic measures or try to held exchange rates at unsustainable levels
- Necessity to differentiate between countries with fully liberalised capital accounts, reintroducing capital controls, and those which are still in a process of liberalisation

- **EMEs underline necessity of considering country specific circumstances and different financial structures, therefore non-binding CFM**
- **But very different approaches in countries and its responses to financial shock**
- **Countries are requested to consider potential spillover effects.**

Different country specific policy mixes – stylized matrix

	Macropolicy ; exchange rates	Macroprudential	Developing financial markets	Capital controls
India	No intervent		Yes, LCBM; derivatives	Yes
Chile	Interventions			No
Singapur		Foster fin. systems		
Turkey	Lower interest rates		LCBMs	
Principal non-country specific	First priority	Gaining importance in all countries	Broad interest	Last line of defense

- **Even more important – what is the global outcome of this broad mixture of CFM on country level?**

  - We still need more sharing of country experiences (is this broad variety really reflecting so strong differences in country circumstances?)

  - And in-depth analysis on potential spill-over effects and global repercussions.

- **Consideration of interdependence between global liquidity and capital flow volatility**

German experiences

- **Germany in favour of a free flow of capital and convertibility**
  - ➢ Due to its own experience and
  - ➢ Protection on the flanks of monetary policy
  - ➢ Interdepence of real and financial openness
  - ➢ Not the liberalisation of capital movement as such but macro-economic policy shortcomings and inconsistencies that caused speculative and volatile capital movements
- **Total convertibilty end of 1958**
- **Capital exports by residents and non-residents liberalised end of 1950 th**
- **Liberalisation of capital imports did not proceed as steadily, however.**
- **Unrestricted inflow of capital entailed risk of undermining monetary policy.**
- **Problems virulent in particular in the fixed exchange rate system of Bretton Woods**

German experiences

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- **Between midth 1960 th until 1972 period of introduction, removal and reintroduction of restrictions on capital imports:**
    - Restrictions on purchase of domestic money market paper
    - Ban on the payment of interest on non-residents
- **With transition to flexible exchange rates the problem of high and volatile inflows faded into the background**
- **Majority of controls could again be eliminated until midth of 1970th.**

German experiences

- **In a retrospective analysis of capital account liberalisation, the Bundesbank came to the sobering conclusion that:**

  "… in the final analysis, the administrative attempts to prohibit foreign exchange imports proved unsuccessful" and that "… controls on capital transactions, under the conditions of the last two and a half decades, have proved to be a rather unsuitable means of stabilising exchange rates and safeguarding a primarily domestically-oriented economic policy against external influences".

- **This review was made by the Bundesbank in 1985 – therefore not influenced by current discussion.**