Capital Flows During Covid-19 Pandemic: Insights from KF*, The Natural Level of Capital Flows

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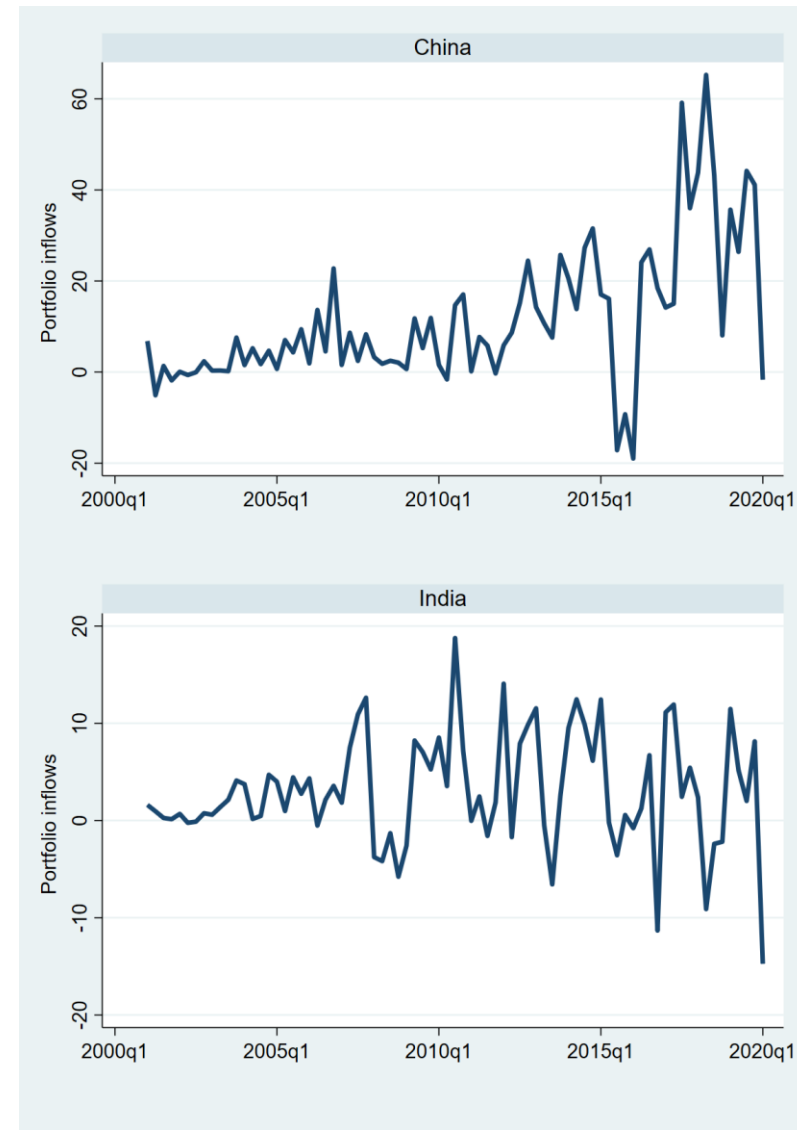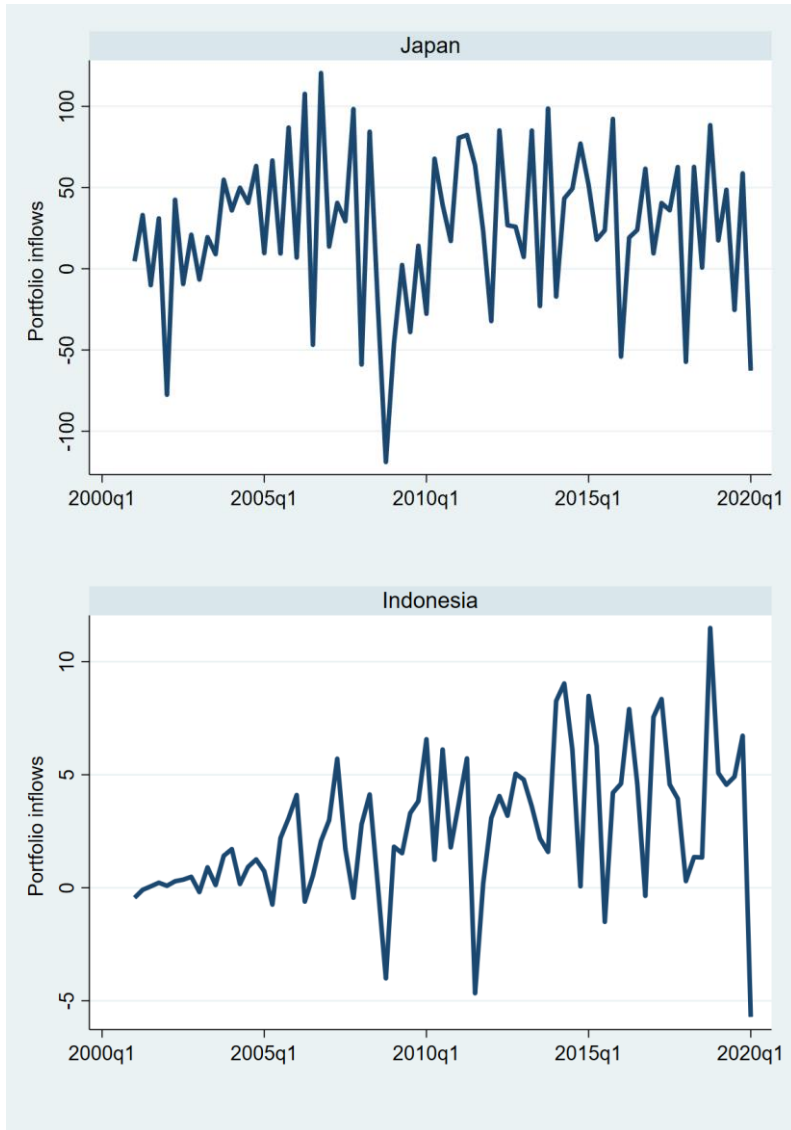**CHARLOTTESVILLE, VA | WASHINGTON, DC | SAN FRANCISCO, CA | SHANGHAI, CHINA**

These comments are based on the following paper:

To be precise, we assess the amount of <u>portfolio (i.e., equity + bond) inflows</u> that a country receives.

KF* is computed as current period ROW private savings times a lagged portfolio weight (5yr moving average).

CAN WE PREDICT FUTURE PORTFOLIO INFLOWS?

Quarterly, billions of USD

F. Warnock, Insights from KF*

KF*, THE NATURAL LEVEL OF CAPITAL FLOWS, IS A STRONG PREDICTOR OF FUTURE FLOWS.

- Portfolio inflows oscillate around KF*.

  - Deviations of actual flows from KF* are transitory.

    - Flows revert strongly to KF* over 1-2 year horizon.

    - The explanatory power of KF* is substantially greater than traditional push/pull factors.

- KF* predicts 6-quarters ahead sudden stops, as well as next year's equity returns.

- Application to crises

  - KF*, at the eve of the GFC, predicted flows during the crisis.

  - KF*, at the eve of the pandemic, suggests sharp decreases in portfolio inflows will be short-lived.
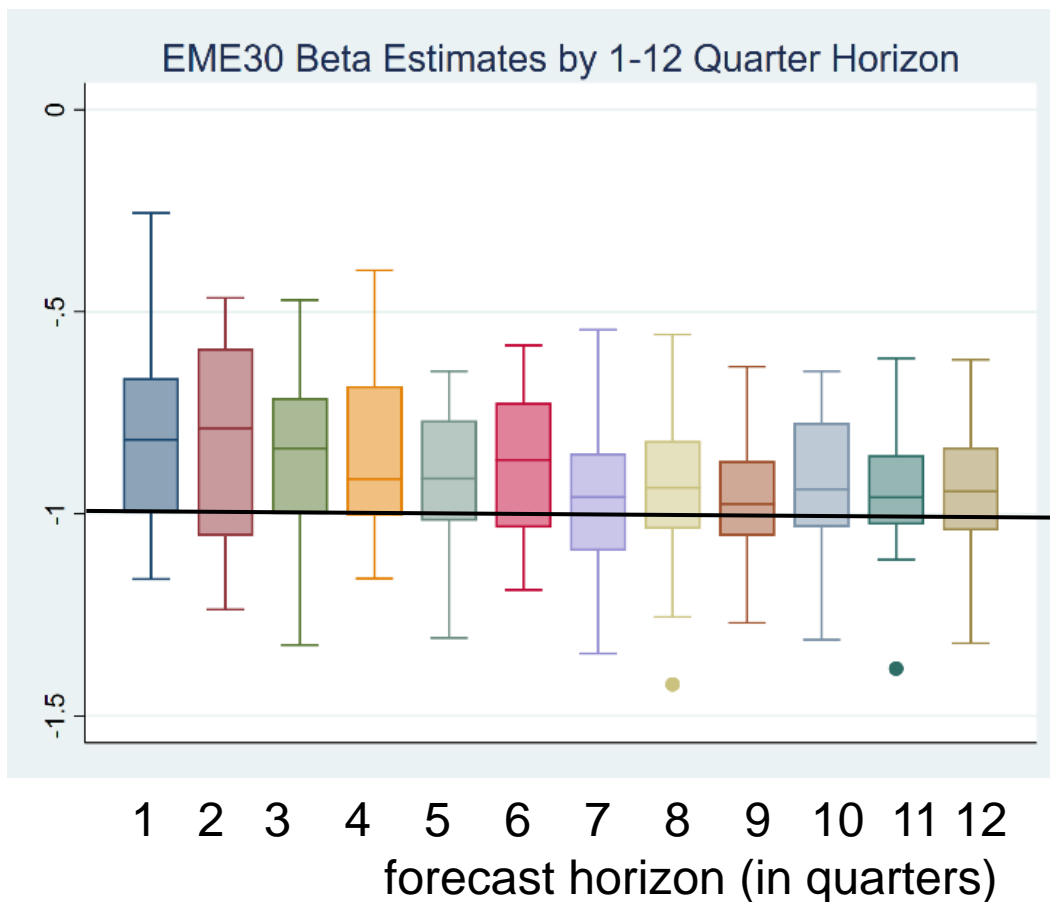
F. Warnock, Insights from KF*

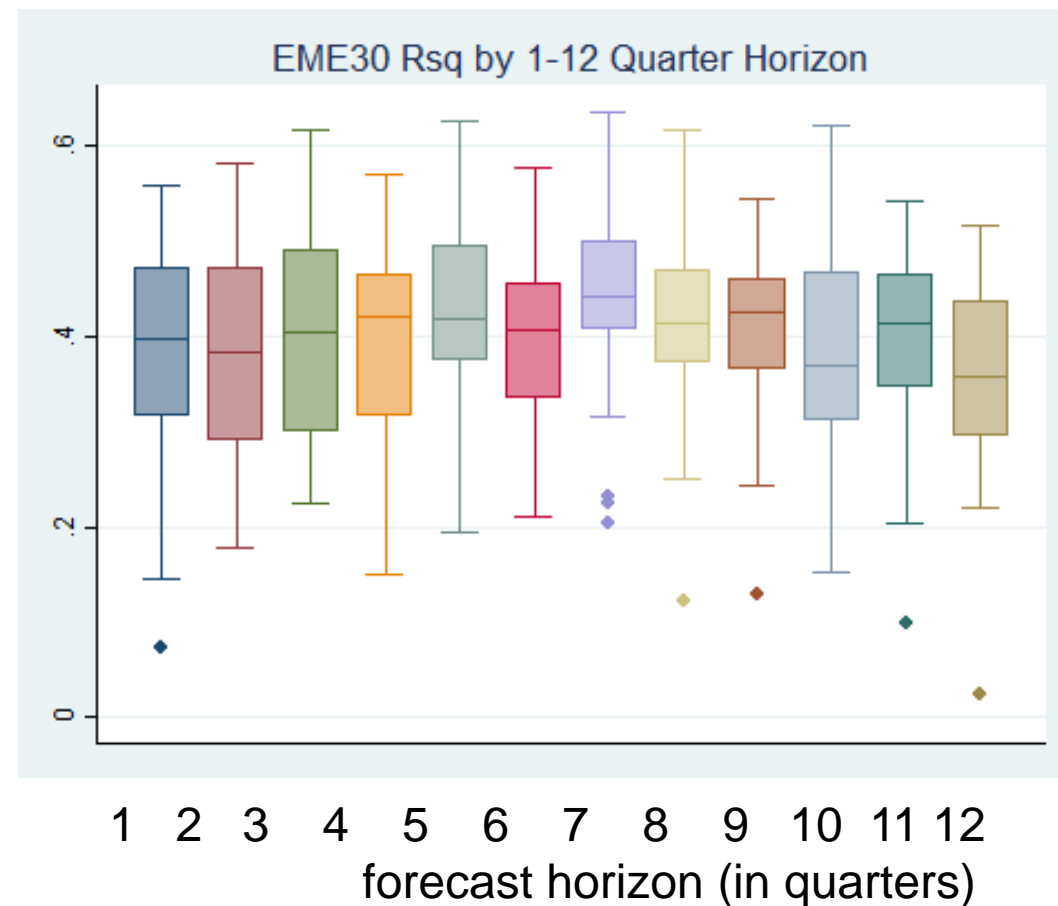# PORTFOLIO INFLOWS OSCILLATE AROUND KF*
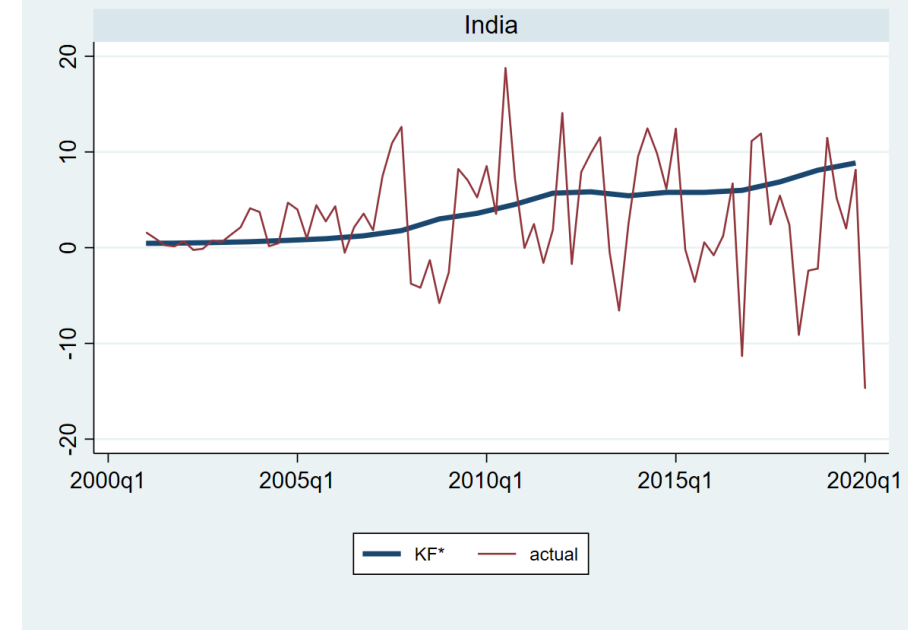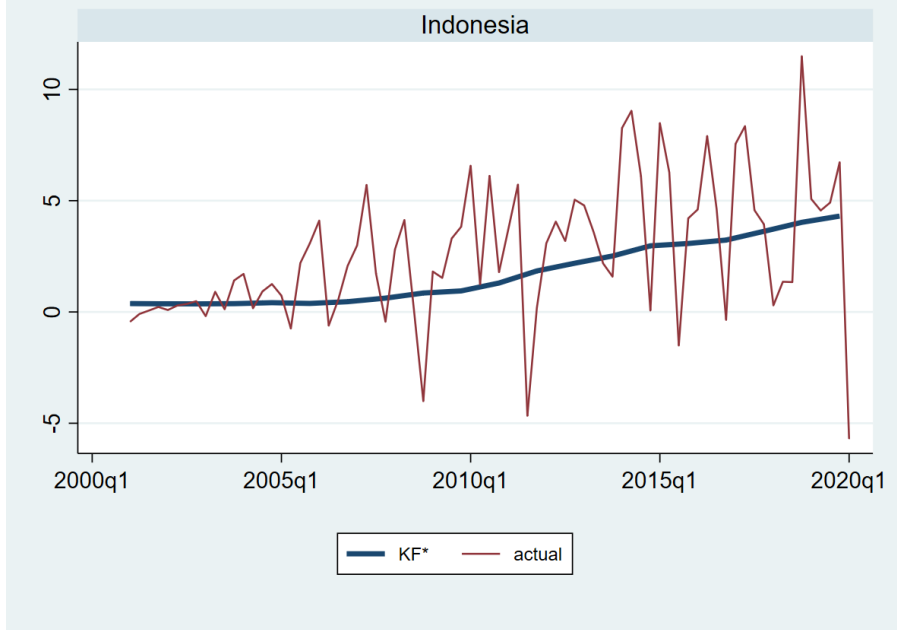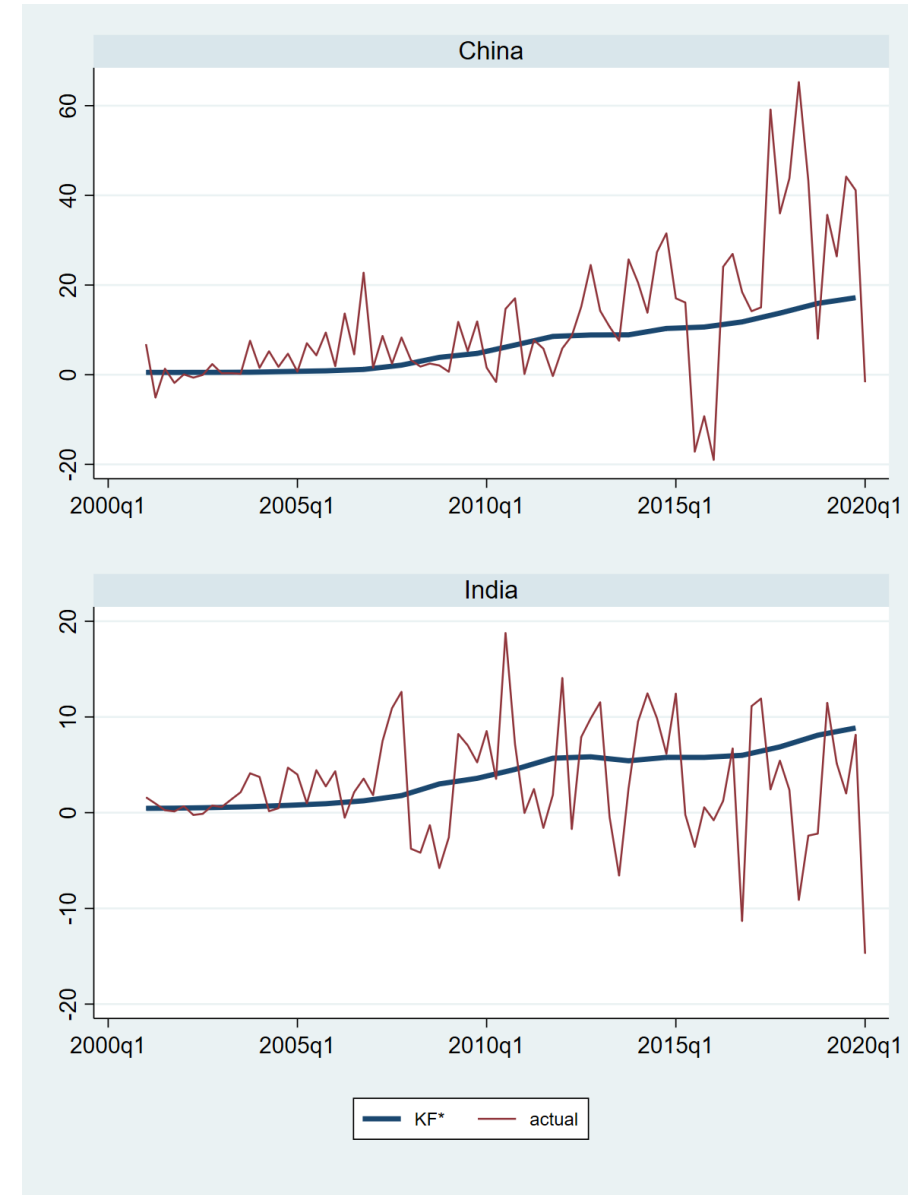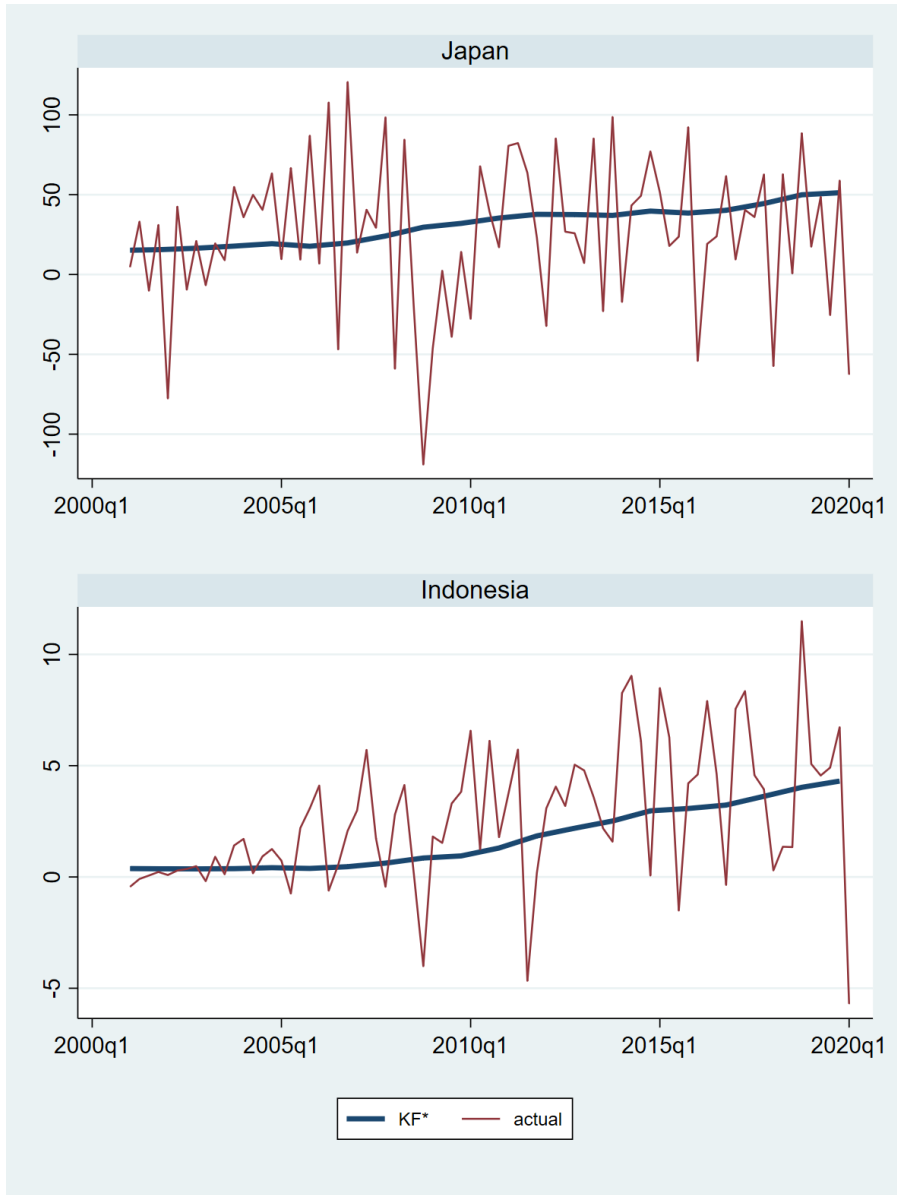
It's apparent from the graphs, and we show empirically too.

FLOWS REVERT STRONGLY TO KF* OVER 1-2 YEAR HORIZON, AND THE EXPLANATORY POWER OF KF* IS SUBSTANTIALLY GREATER THAN TRADITIONAL PUSH/PULL FACTORS.

Beta = -1 means flows fully adjust to KF* in h quarters.

R^2 of 0.15 would be considered good for push/pull factors.

F. Warnock, Insights from KF*

KF* PREDICTS 6-QUARTERS AHEAD SUDDEN STOPS, AS WELL AS NEXT YEAR'S EQUITY RETURNS.

With these conditions

- gap between flows and KF* is large (1 stdev above its mean), and

- global growth is strong (1 stdev above its mean),

Probability of a sudden stop within 6 quarters is **38%.**

> *Intuition: Strong ROW global growth means KF* is increasing. If actual inflows are increasing even more, high probability of a sharp decline in future flows.*

Same conditions (strong inflows relative to KF* and strong global growth) predict **13% decrease** in the country's MSCI equity returns next year.
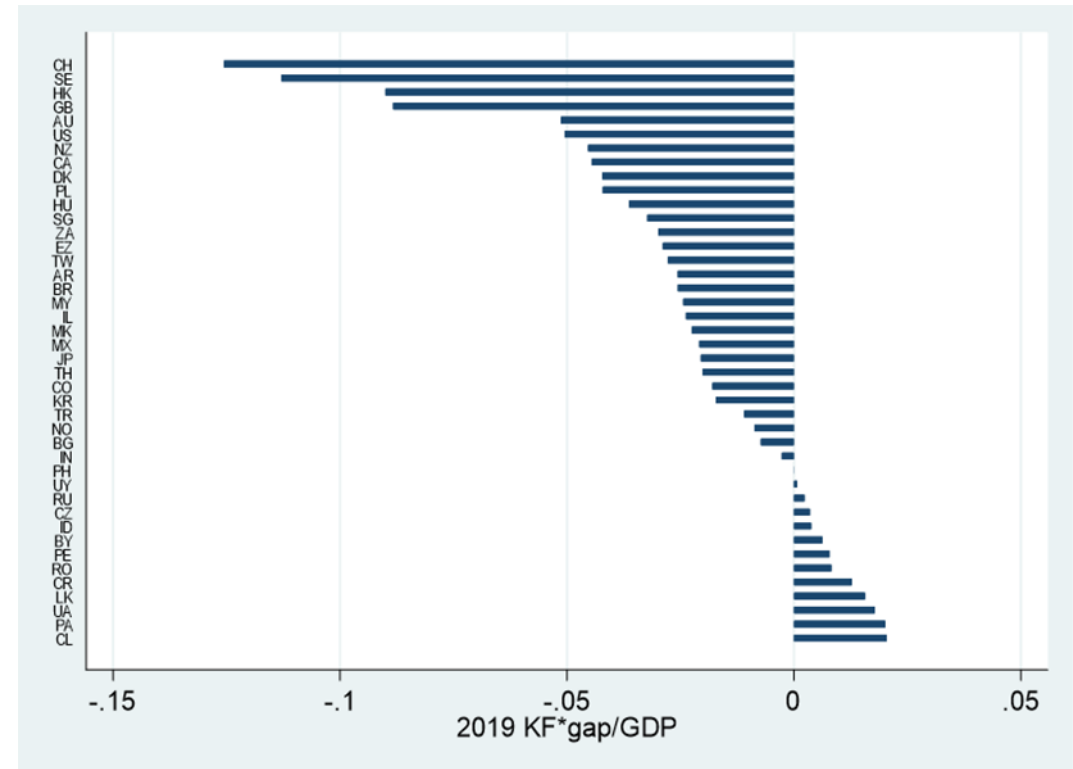
F. Warnock, Insights from KF*

KF* DURING CRISES

Countries with a larger KF*gap/GDP in 2007 had larger declines during the GFC period (2008Q4-2009Q3).
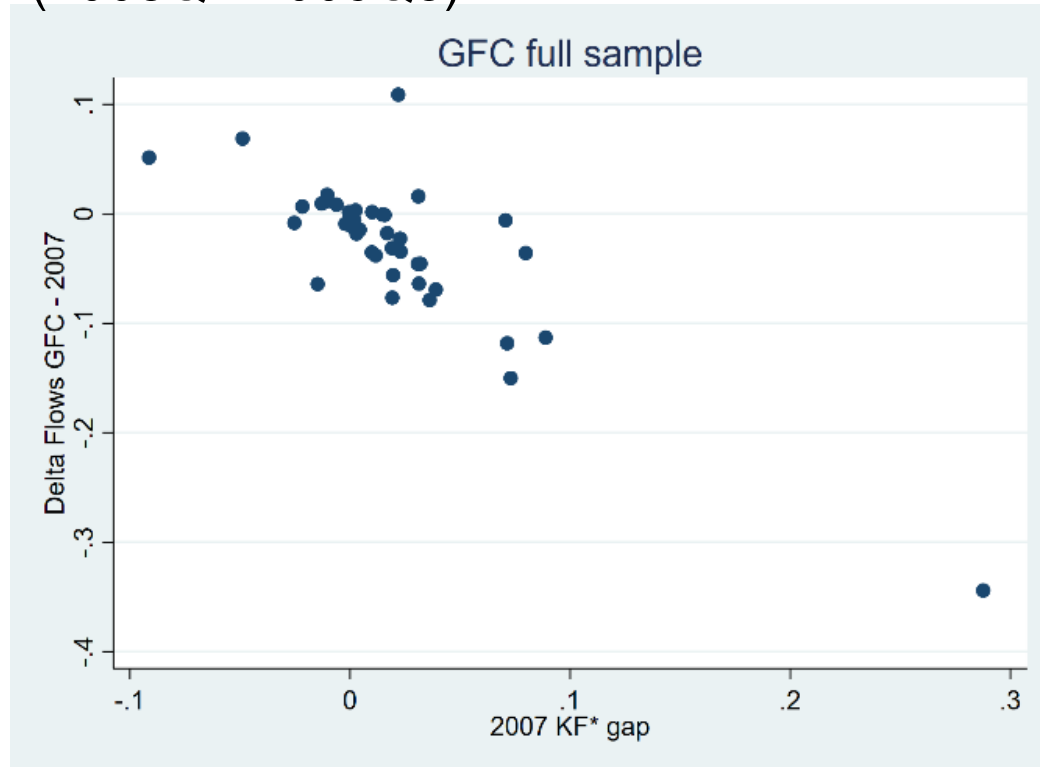
This relationship holds strongly without the one outlier (HK), and in EMEs and nonUMPs.

At the eve of the pandemic, very few countries had positive KF* gaps.

Chile, Panama, Ukraine had the most positive KF* gaps in 2019. In Asia, most positive were Indonesia, China and Philippines (and all were just slightly positive).

KF*, THE NATURAL LEVEL OF CAPITAL FLOWS

- Portfolio inflows oscillate around KF*. Deviations of actual flows from KF* are transitory. Flows revert strongly to KF* over 1-2 year horizon, especially for EMEs and nonUMP AEs.

- KF* predicts 6-quarters ahead sudden stops, as well as next year's equity returns.

- KF*, if applied at the eve of the GFC, predicted flows during the crisis.

- KF*, applied at the eve of the pandemic, suggests sharp decreases in portfolio inflows will be short-lived, because in 2019 very few countries had flows in excess of KF*.