CONFIDENTIAL

Changing Patterns of Capital Flows
ADB RCI-POD WEBINAR
29th July, 2021

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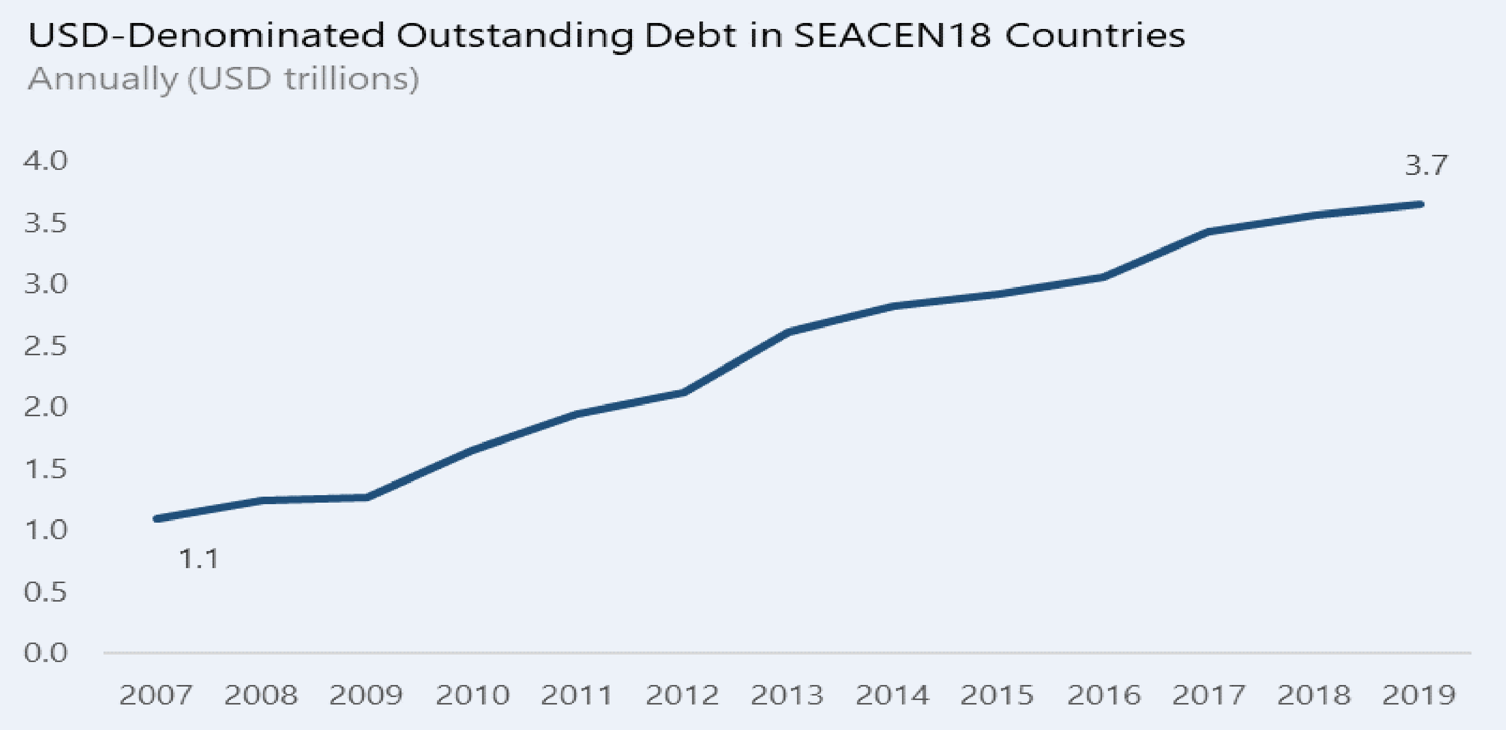
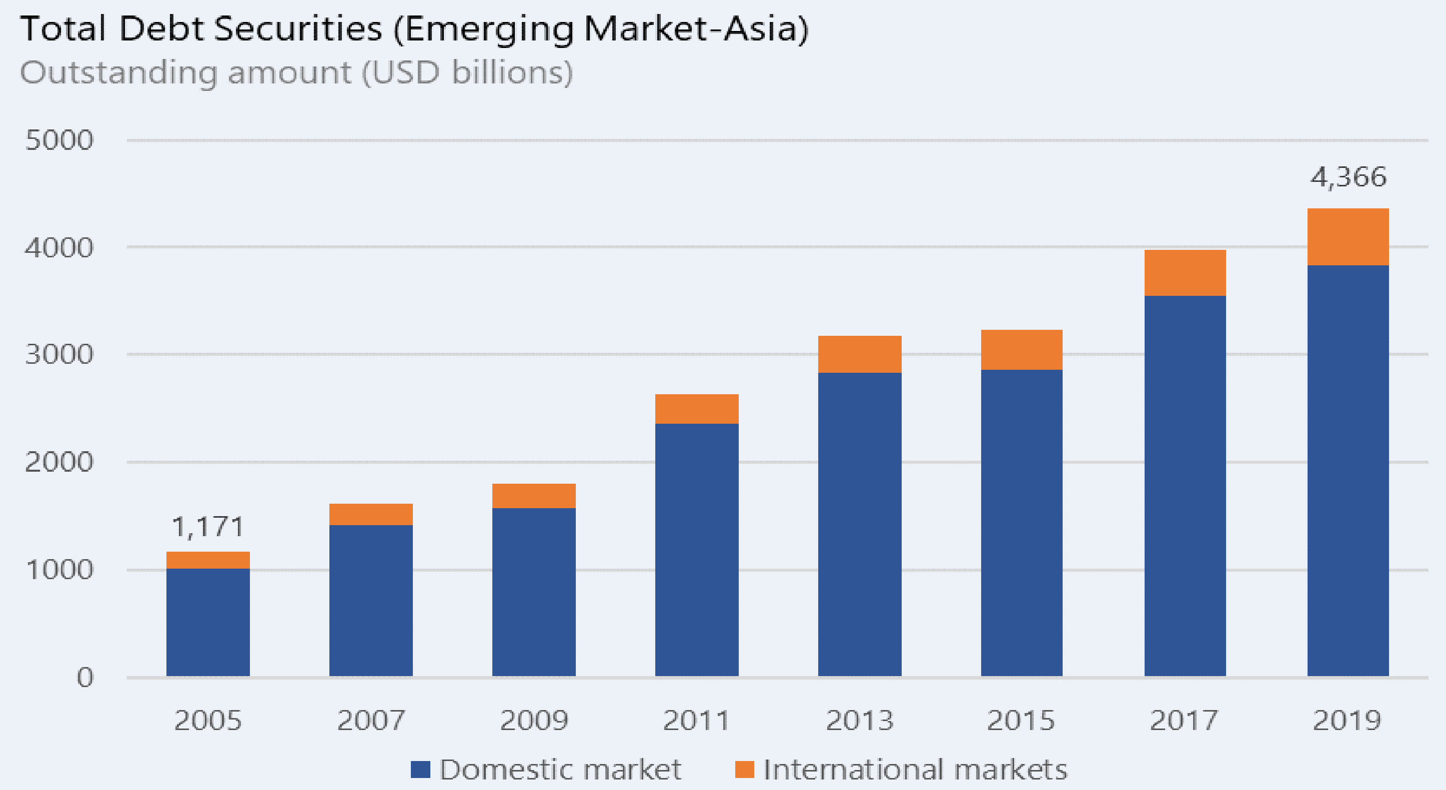
Capital Flows: Key Issues for Emerging Markets (Post GFC)

- US dollar remains a dominant funding currency.
- EM capital flows are more sensitive to changes in global financial conditions.
- EM issuers have had much easier access to financing.
- US Dollar liabilities of EMs in Asia have risen since the GFC.
- US Dollar exposures have shifted to corporates and other non-financial institutions, significantly increasing their vulnerabilities to exchange rate risk.
- Easy external financing has also spilled over to the domestic markets, notably EM local currency bond markets.
- Increase in foreign participation in local currency bond markets can be linked to higher degree of sensitivity of yields to the portfolio bond flows.



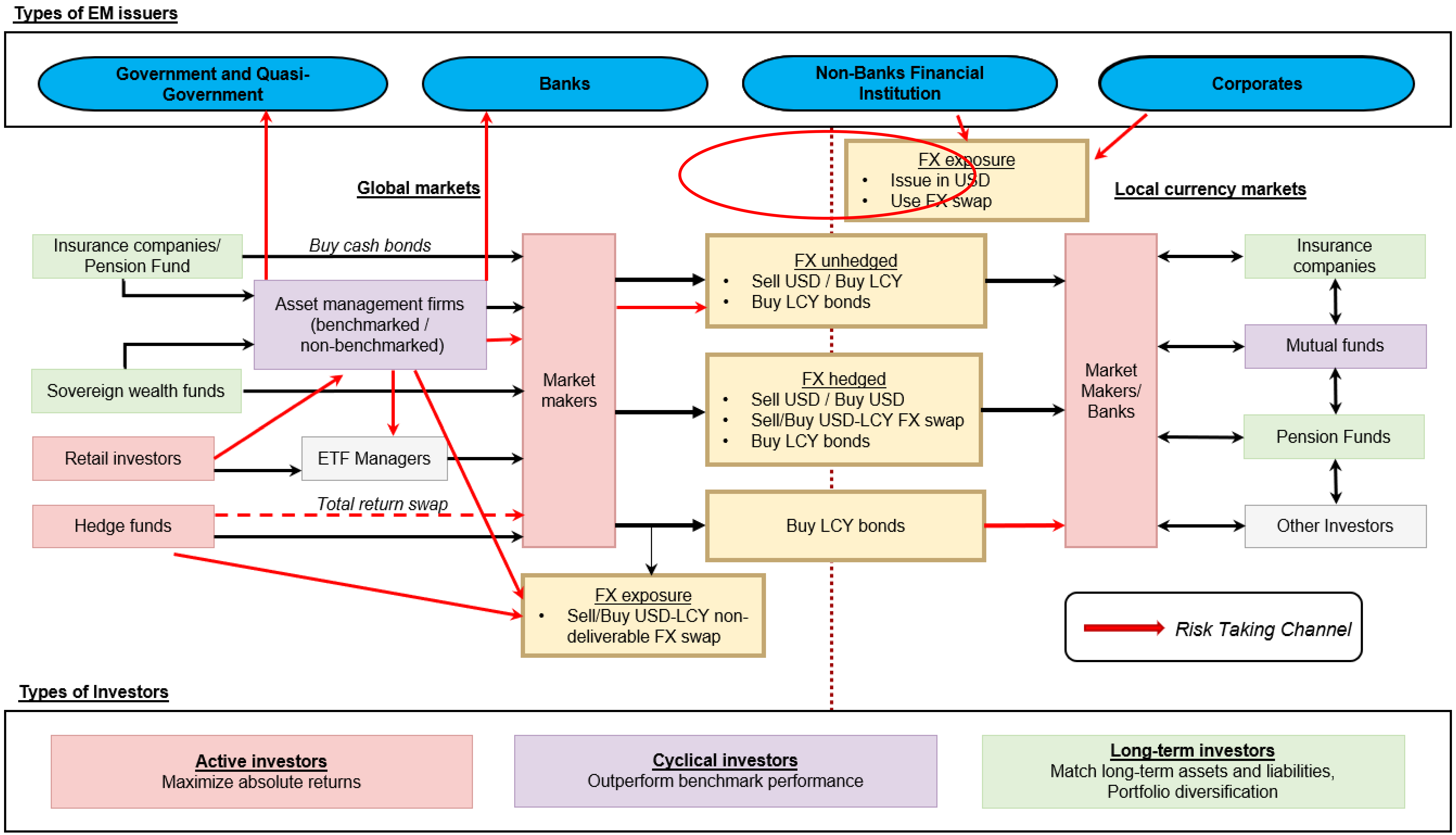
[1]Aggregate of SEACEN18 countries includes Brunei, China, Hong Kong, Cambodia, India, Indonesia, Korea, Laos, Myanmar, Sri Lanka, Mongolia, Malaysia, Nepal, Papua New Guinea, Philippines, Vietnam, Thailand and Singapore.
Source: BIS locational banking statistics by residence, and BIS international debt securities statistics.



EM-Asia includes Korea, Thailand, Indonesia, Malaysia, India and Philippines
Source: BIS

Market Architecture: Investors and Issuers

Managing macro-financial stability risks requires a better mapping of the risk transmission channels - Behavioral pattern of particular classes of global investors affects market volatility in different ways during stress - retail investors (short-term) and hedge funds (leverage) can aggravate market volatility.



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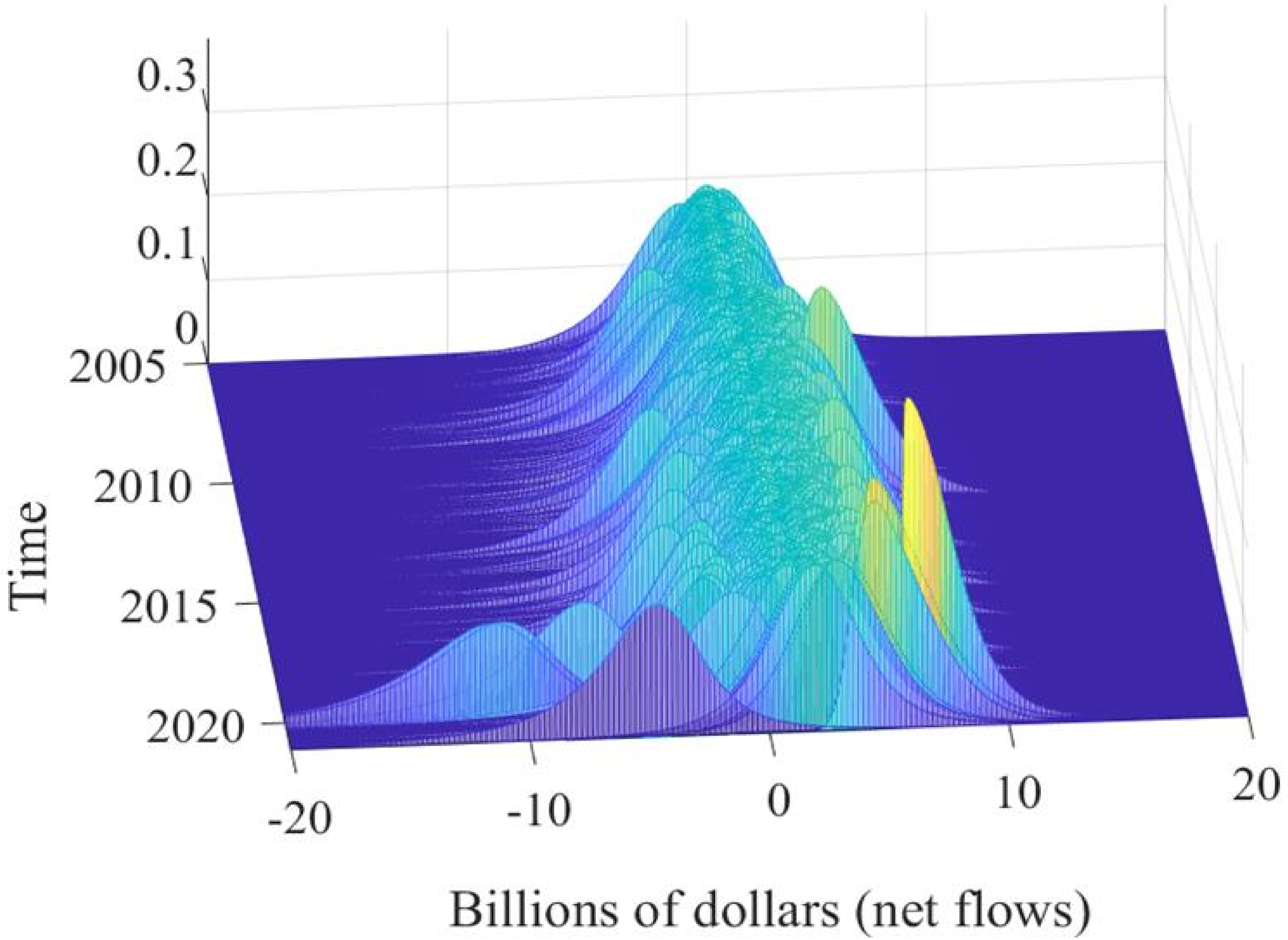
Capital Flows: Key Issues for Emerging Markets (Post GFC)

- Episodes of surges and sudden reversal of capital flows in EMs are best analyzed using frameworks that incorporate regression to the tail and therefore, looking at the entire distribution. Gaussian risk management may give a false sense of security.
- Capital Flow at Risk or similar analytical frameworks indicate that to address the tail risk, ex-ante, policies need to be proactive and holistic so as to cut the tail/shift the distribution to the right/build resilience.
- We find that the tail dependence and asymmetry from sudden stops of EM portfolio flows in reaction to global financial shocks can reflect many market factors:
    - Benchmark-driven investors in the EM universe tend to be more sensitive to changes in global financial conditions.
    - Both investors and issuers seek greater leverage when it is cheap.
    - The complexity and sophistication of portfolio exposures of investors built up during normal times leads to an under-pricing of risk.
    - The exchange rate can amplify external financial shocks: investors and issuers have unhedged forex exposures and risk-off sentiment in financial markets tends to curtail US dollar funding.

Capital Flows and Macro-Financial Vulnerabilities: Tails matter for portfolio flows to EM SOFIES



- Our study finds: NR portfolio debt and equity flows to EMs are characterized by skewed distribution with widening of the downside tail risk strongly affected by changes in global risk sentiment.
- Policy measures based on median forecasts of capital flows can significantly underestimate the potential magnitude of tail flows during stress time.
- Calibrating policies based on the rulebook for normal times will have shortcomings.
- Policies need to take out the tail risk, by building buffers.
- Policies may have to be preemptive to prevent the snowballing effect of capital outflows.