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PRESS RELEASE

Global imbalances and gross capital flows

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The current account balance has long been an established indicator of an economy's external vulnerability. Countries with a current account deficit and an accumulated net debt position are considered vulnerable to a reversal in capital flows (sudden stop) which could lead to a painful adjustment for the economy as a whole. The steep rise in global imbalances apparent before the financial crisis – and due mainly to the steadily expanding deficits in the United States combined with growing surpluses in China and the commodity-exporting countries – was therefore watched with some concern. According to the excess savings theory, the American deficits were financed by Asian countries with a current account surplus, whereas the euro area, whose external account was more or less in balance, seemed to play no role in this analysis.

However, the outcome of the financial crisis – no sudden stop in the United States, heavy losses for the European banking sector owing to their exposure to the United States, and the relatively unscathed financial position of the Asian surplus countries – revealed the defects of this analysis framework. In addition, since the eruption of the financial crisis global imbalances and hence also the associated vulnerabilities have declined sharply, which is one reason why the attention of the international policy forums has shifted to the construction of a more secure financial framework. In the recent economic literature there are also signs of growing interest in the pattern and structure of gross international capital flows and positions.

Since the mid-1990s there has been a strong rise in gross international capital flows, leading to an unprecedented expansion of gross international asset and liability positions. The escalation of gross international capital flows brings not only advantages but also additional risks relating to currency, maturity and liquidity mismatches which net concepts do not always pick up. For instance, the United States balance of payments statistics show that the foreign capital inflows came mainly from Europe and only to a limited extent from Asian countries with a current account surplus. The analysis of the gross capital flows therefore enables to detect sources of vulnerability other than those identified from the current account balance.

Nonetheless, net flows and positions still have an essential role to play in the analysis of a country's external vulnerability. For instance, the European sovereign debt crisis showed that banks in core countries such as Germany, France, Belgium and the Netherlands built up substantial assets in the peripheral countries but did not raise finance there, so that the peripheral countries were net capital importers and were thus vulnerable to a sudden stop, as became apparent.

A similar analysis of the recent period of volatility on the financial markets of emerging economies likewise points to the importance of using both gross and net concepts to assess an economy's vulnerability. During the past decade the financial markets of emerging economies have also become much deeper. The stronger interest among foreign investors played a key role here: for instance, their participation stimulated the development of new asset classes. At the same time, however, the increased presence of foreign investors could make the financial markets of emerging economies more volatile, especially in times of stress when investors increasingly take into account country-specific economic and financial vulnerabilities. The analysis shows that the variables which determined the recent financial market volatility changed over time. While investors initially withdrew their capital from emerging economies with large and volatile gross debt positions or inflows, at a later stage they differentiated to a greater degree between emerging economies with strong and weak fundamentals (such as the current account balance).

In the future, the continuing compilation and availability of statistics on the composition and size of gross capital flows and positions will undoubtedly help to speed up the identification of potential balance sheet mismatches. That in turn could help policy makers to define and implement targeted measures to tackle these vulnerabilities.