

Determinants of Capital Flows to Emerging Market Economies



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Theoretically, capital market integration allows people to share the country-specific risks by holding foreign assets, and contributes to economic growth especially for emerging market economies (hereafter EMEs) at their early stages of development. At the same time, there are also some problems caused by capital market integration. As we experienced during the global financial crisis (GFC), financial shocks originating from the center country can be rapidly transmitted to peripheral countries through the integrated financial market. Volatile cross-border capital inflows and outflows impede efforts to maintain financial stability, which eventually stunts economic growth by incurring financial crises.

Though some monetary authorities in EMEs implemented capital controls or macroprudential policy measures after the GFC to mitigate the procyclicality of credit cycles, the common factors in the global financial market still play a crucial role in determining capital flows to EMEs. In academia, the relationship between common factors in the global financial market and their impact on capital flows to EMEs has been a long-debated issue. This is mainly concerned with the major determinant of capital flows between push and pull factors.

The push factor represents common factors which exist in the global financial market. These are interest rates and GDP growth rates of advanced economies (hereafter AEs), global risk factors such as measured by the S&P 500 Volatility Index (VIX), and commodity price index. The pull factor denotes domestic factors that attract funds from the global financial market to domestic financial markets. These are domestic interest rates, domestic GDP growth rates, and other country-specific characteristics.

Kang and Kim (2018) revisited this issue regarding the push and pull factors of capital inflows. They consider the heterogeneity existing in EMEs by dividing them into four subgroups and then investigate the main driver of capital inflows between push and pull factors across country groups. According to their empirical results, the push and pull factors play a different role in determining capital flows to AEs and EMEs. The major drivers of capital flows to AEs are both push and pull factors, but the push factor turns out to be the main determinant of capital flows to EMEs. When EMEs are divided into four subgroups, there is a sizable heterogeneity across subgroups.

Two policy implications may be derived based on the empirical results in Kang and Kim (2018). First, it might lead to unexpected results if EMEs simply follow uniform policy recommendations suggested by international organizations such as the IMF, because the capital market heterogeneity between EMEs is substantial. Therefore, individual countries need to find effective policy instruments appropriate to the financial market environment of their country.

Second, Korea is classified as an advanced economy by the IMF and a number of other international organizations. However, it should not be overlooked that Korea has the characteristics of a small open economy. Therefore, it is necessary to make efforts to secure the most effective policy instruments while complying with the obligations and agreements required of developed countries. The OECD has opposed to the use of capital flow management measures by its member states. G20 platform needs to discuss ways to activate alternative policy instruments such as macroprudential policy measures to cope with the financial crisis.

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Reference

Kang, Tae Soo and Kyunghun Kim. 2018. "Push vs. Pull Factors of Capital Flows Revisited: A Cross-country Analysis," mimeo.