CHAPTER 2

Some Key Features of Capital Flows

We start this section by arguing that *gross* as well as *net* foreign exposures matter from a financial stability perspective. Next, we differentiate between different types of capital flows and argue that the propensity of banks to make lending decisions that accentuate the business cycle—procyclical behavior—is a destabilizing force that undermines the self-correcting tendencies of the markets. The next section then studies how banks' funding models further accentuate procyclicality. We pay particular attention to wholesale funding, which is the dominant form of funding in the international context. We then consider different organizational forms of cross-border banking in order to understand whether any of them can mitigate these effects. We discuss the roles of valuation effects, international balance sheet effects, flights to safety, and dollar shortages. Finally, we summarize the research on how exchange rates and capital flows interact.

Gross Flows and Net Flows

Capital flows are traditionally viewed as the financial counterpart to savings and investment decisions, in line with the narrative of capital flowing "downhill" from capital-rich countries with lower rates of return to capital-poor countries with higher returns. From this perspective, the focus is typically on *net* capital flows, since that is what counts for funding a country's borrowing requirements.

However, a distinguishing feature of the recent period has been the rapid increase in *gross* flows that do not always show up in the net capital flow statistics. For most countries, net capital flows are small relative to GDP, whereas gross capital flows were above twenty percent of GDP for the advanced economies and about ten percent for emerging economies in the mid-2000s.[6] International banking has been at the heart of the expansion in gross flows, with many cross-border banking activities involving an expansion in the levels of both foreign assets and foreign liabilities.

The distinction between gross and net flows is illustrated by the experience of the United States. Figure 1 shows several categories of capital flows. Positive quantities (and bars) indicate gross capital inflows (the increase in claims of foreigners on the United States), while negative quantities indicate gross capital outflows (the increase in the claims of U.S. residents on foreigners).

[6] A growing recent literature emphasizes gross capital flows, including Borio and Disyatat (2011), Forbes and Warnock (2011), Obstfeld (2012a, 2012b), Lane (2012), Shin (2012), and Shularick and Taylor (2012).