Types of Capital Flows and Procyclicality of Banking Flows

Capital flows differ depending on the nature of the claim (equity, debt), the maturity (short, long), the currency of denomination (domestic, foreign), and the nature or control of the investor (portfolio investment, foreign direct investment, bank). We now ask which kinds of flows cause the greatest concern from a stability perspective.

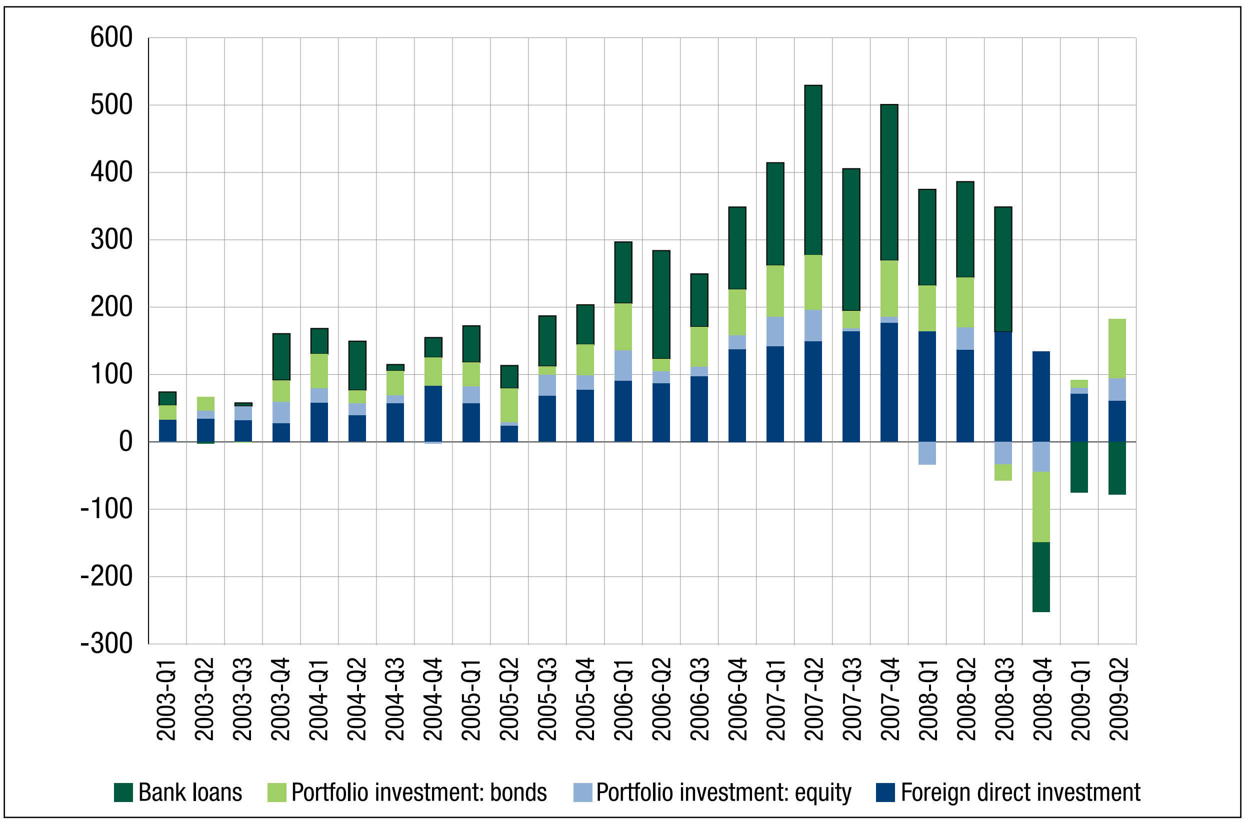
FDI and Equity Portfolio Investments

Typically, aggregate FDI flows are steady, while portfolio equity flows are small in net terms. In principle, equity-type liabilities should be helpful in a crisis, since foreign investors take an automatic hit if the market value of liabilities declines. The typical equity investor (corporation, pension fund, or mutual fund) is not leveraged, so foreign direct investment (FDI) and portfolio equity flows are less likely to reverse abruptly. Even when they do, the impact may be less damaging than a "sudden stop" associated with bank flows. In the case of portfolio equity flows, for example, foreign sellers of stocks in a crisis face the double penalty of lower local currency prices when they sell, as well as a sharply depreciated exchange rate when they exit. The domestic currency-equivalent outflow associated with the repatriation of portfolio equity sales proceeds is small compared to the pre-crisis marked-to-market value of foreign holdings of equity.

Instability of Credit Flows

However, debt-type inflows intermediated by banks can generate adverse dynamics, especially in an environment in which GDP is shrinking, price deflation is occurring, and default risk is rising. Although bank-related flows are just one component of overall capital flows, they are an especially

FIGURE 2: Components of capital flows (billion dollars)



Source: IMF Global Financial Stability Report, April 2010 p. 123