Capital Flows, Push versus Pull Factors and the Global Financial Crisis

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Non-technical summary

We have witnessed massive fluctuations in global capital flows since 2005. While the 2007-08 global financial crisis triggered strong portfolio capital flows in particular into bonds of some advanced economies, the 2009-10 recovery period has been marked by a surge in capital flows to emerging economies. Yet what has been striking about the crisis as well as the recovery is not only their global reach, but also the high degree of heterogeneity in capital flows, both across advanced economies and across emerging market economies.

The question of what has been driving capital flows in the crisis and the recovery period remains highly controversial. Some have stressed the importance of "push" factors, i.e. in particular monetary and fiscal policies in advanced economies, as the main culprits behind this surge in capital flows. By contrast, others have emphasized "pull" factors, such as real divergences between EMEs and advanced economies (AEs), as the main driver of the current pattern of capital flows. In fact, this controversy has become one of the core issues of debate in international fora, such as the G20 which is considering a code of conduct for capital flow management, including the imposition of capital controls to deal with volatile capital flows.

The paper analyzes the role of different drivers of global capital flows during the crisis and the subsequent recovery. The focus is on two questions: first, how important have been common, global shocks for capital flows? And second, how relevant have been macroeconomic policies, institutions and financial policies in helping countries shield themselves from such global shocks? The first of the questions is informative about the role of push factors, while the second allows gauging the relevance of pull factors. The paper's focus is on portfolio investment flows at the micro level, i.e. at the level of individual investment funds (both mutual funds), across a broad geographic coverage of 50 countries and markets worldwide.

The first part of the paper intends to establish a number of stylized facts about the high-frequency dynamics of capital flows during the crisis and the recovery, which shows remarkably strong divergences in capital flows across countries during the crisis and subsequent recovery. The second part of the paper aims to explain this heterogeneity of global

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capital flows during the financial crisis and the subsequent recovery. A factor model for the determinants of capital flows is formulated, distinguishing between a set of common global shocks – with a specific emphasis on liquidity and risk shocks as well as macro news shocks – as well as a set of idiosyncratic, country-specific shocks on capital flows. The findings show that global factors account for a large share of the global capital flow pattern during the crisis. Importantly, the signs of the model parameters change substantially during the crisis episode. This evidence is consistent with the hypothesis that the dynamics of capital flows was primarily driven by safe-heaven flows during the crisis.

The third part of the paper analyses the role of potential determinants of these differences in sensitivity to common shocks. The findings indicate that it has been the institutional quality, country risk together with the strength of macroeconomic fundamentals and policies that explain a large share of the heterogeneity of capital flows during the crisis. By contrast, countries' external (real and financial) exposure appears to have largely been irrelevant for understanding the global capital flow dynamics, including the retrenchment of capital during the crisis, in particular for emerging economies.

The final part of the paper attempts to quantify and compare the relative importance of common shocks ("push" factors) and country-specific determinants ("pull" factors). The findings indicate that common factors were more important overall as a driver of net capital flows for many countries in 2005-07, as well as in particular during the 2007-08 financial crisis. However, in the recovery period since March 2009, common factors appear to have become less important as drivers of global capital flows, whereas it is domestic pull factors that have come to dominate in explaining capital flows, in particular for countries in Emerging Asia and Latin America.

Putting these findings into perspective, it should be highlight that the period of 2005 to 2010 has been in many ways extraordinary for the dynamics of global capital flows, as a period of a sharp contraction of capital flows, in particular to some EMEs, during the 2007-08 crisis was followed by an equally extraordinary surge in capital flows to EMEs. Hence an important open issue is whether the current dynamics of global capital flows will continue well into the future, and what it implies for the risk of sudden stops and capital flow reversals with all its adverse implications for global growth and financial stability. But in particular because it is so important to understand better the dynamics and risks of periods of financial stress, the findings of the current paper may be instructive about how future crisis may play out.

The paper has a number of implications for economic policy and for policy-makers. On the one hand, financial globalization and the exposure to common global factors have made countries more vulnerable to external and global shocks. Yet, on the other hand, the exposure to domestic risks has also been a relevant factor during the crisis and thereafter, in particular those domestic risks related to poor macroeconomic fundamentals, policies and institutions. This implies that countries are far from innocent bystanders that are powerless in being exposed to volatile global markets, and that indeed they have tools to insulate to some extent their economies from adverse global shocks.

These findings have a bearing in particular on the current debate on how EMEs should deal with volatile capital flows. To the extent that capital flows are driven by global factors, some EME policy-makers have argued that this would justify the use of capital controls as well as policy interventions e.g. in FX markets. However, such policies may be misguided if the drivers of capital flows are mainly found in idiosyncratic, country-specific policies and conditions, which calls for policy-makers to rather focus on making their domestic economies more resilient by improving institutions, deepening financial markets and enhancing macroeconomic and maroprudential policies.