The Macroeconomic Effects of Debt- and Equity-Based Capital Inflows

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Summary

The past decade has witnessed a substantial increase in both the scale and the volatility of international capital flows. Recent experience has shown that large swings in capital flows to many countries, particularly many emerging market economies, tend to be driven less by domestic economic conditions and more by changes in global growth, risk, and monetary conditions. In recent years surges in capital inflows have been blamed for increased inflation and an overheating economy, asset and credit bubbles, and currency appreciation. This in turn has led to efforts by policy makers in many countries to impose capital controls to mitigate these adverse effects of capital inflows.

However, there are many different types of capital inflows. Capital flows can be divided into debt-based capital flows (portfolio debt and bank lending) and equity-based capital flows (portfolio equity and FDI). This paper will ask whether different types of capital inflows have different macroeconomic effects. Using a panel VAR framework, this paper finds the responses of the output gap, inflation, stock prices, credit growth, and the exchange rate to a shock to debt- or equity-based capital inflows. Since capital inflows are driven by both domestic, endogenous factors and foreign, exogenous factors (domestic-pull factors and foreign-push factors) one cannot rely on a simple recursive identification strategy to identify an exogenous shock to capital inflows. Instead, this paper will rely on the method of using external instruments in a structural VAR. With this method, a two-stage procedure is used to identify the exogenous component of shocks to foreign capital inflows with external instruments like measures of global risk aversion.

This paper finds that an exogenous increase in debt inflows leads to a significant increase in GDP, inflation, stock prices and credit growth and an appreciation of the exchange rate. At the same time an exogenous increase in equity-based capital inflows has almost no effect on the same variables. Thus the short-term macroeconomic effects of exogenous capital inflows are almost entirely due to changes in debt, not equity-based, capital inflows.