

# Espe 104: Global Financial Cycle, Capital Flows, and Policy Responses

## Espe 104: Global Financial Cycle, Capital Flows, and Policy Responses Approach

The Global Financial Cycle (GFC) is a common movement of financial variables transmitted to emerging economies through various channels. During periods of GFC expansion, emerging economies tend to exhibit higher capital inflows, increased asset prices, and better conditions for accessing external credit (i.e., low-interest rates and greater supply of external credit). On the other hand, the contraction of the GFC translates into sudden capital outflows, lower asset prices, and more expensive external credit. This can affect monetary policy transmission and financial stability in emerging economies, an effect that is accentuated by changes in the monetary policy stance of central economies. To curb these effects, economic authorities mainly employ macroprudential policies and capital management measures.

This paper reviews the literature on the GFC and explains its measurement, transmission channels to emerging economies, and its policy implications. First, the common asset price factor, one of the main measures of the GFC, is estimated using daily data for 57 countries over the period 1991-2021. Then, the effects of the GFC on financial intermediation and external credit flows in Colombia are studied using different methodological approaches and microdata for the 2004-2019 period. Likewise, the effect of the GFC and the Fed's unconventional monetary policy announcements on foreign portfolio investment in Colombia between 2010 and 2018 is analyzed. Finally, a structural model (VAR) is used for a sample of 24 emerging economies with data for the period 2004-2019 to identify the influence of the GFC on portfolio flows and international credit, as well as the differences associated with the use of macroprudential policies and the exchange rate regime.

## Contribution

This paper expands the literature on the transmission of the GFC to emerging economies. Evidence is provided on the influence of the GFC on financial intermediation and the role of global banks. The effects of the use of capital controls on the transmission of the GFC to the local credit supply are shown, and results are provided on the impact of the GFC on the behavior of portfolio flows in Colombia and the influence of the Federal Reserve's unconventional policy measures. Finally, the importance of flexible exchange rates, countercyclical monetary policy, and macroprudential policy as policy tools to face the adverse effects of the GFC in emerging economies is shown.

In periods of expansion of the Global Financial Cycle, emerging economies exhibit higher capital inflows, increased asset prices, and better access to external credit.

## Results

This paper presents three main results. First, the GFC has an important influence on financial intermediation in Colombia. Specifically, a contraction of the GFC is associated with reductions in the foreign credit supply to banks and firms in Colombia. These effects are accentuated by the degree of exposure of local banks and firms to global banks. In addition, the incidence of the GFC on financial intermediation is reduced with the implementation of temporary controls on capital flows. Second, the GFC affects the behavior of foreign portfolio investment in Colombia and the Federal Reserve's unconventional monetary policy announcements accentuate this effect. Third, the GFC affects the dynamics of portfolio and international credit flows in emerging economies. Countries with greater use of macroprudential policies and those with a flexible exchange rate regime experience a lower influence of the GFC on the dynamics of capital flows and a less procyclical monetary policy response.