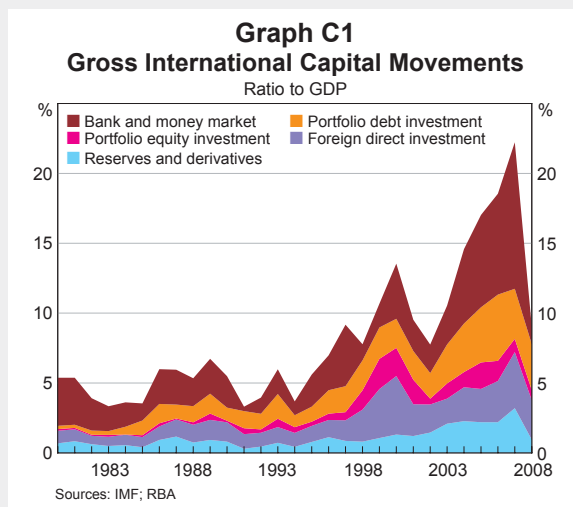
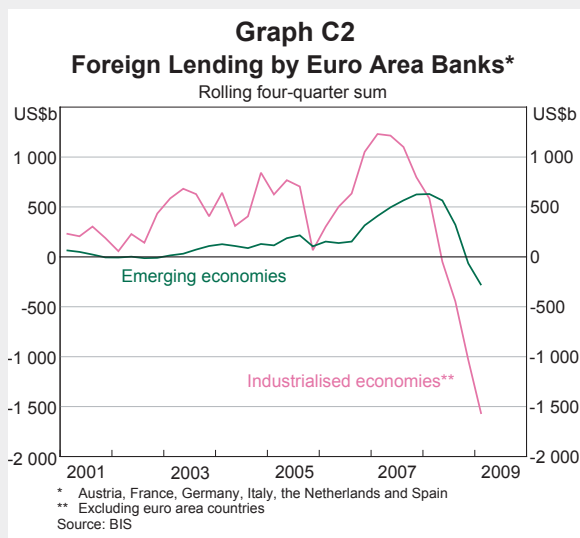


## Box C: Gross International Capital Movements

One of the defining characteristics of the financial crisis has been a sharp rise in risk aversion. One aspect of this has been a reduction in capital flows to emerging markets in Eastern Europe, Asia and Latin America. These regions are generally seen as attractive in times of global macro-financial stability but particularly risky in times of global instability. In previous episodes of global instability, reductions in flows to emerging markets have tended to be associated with increased capital flows between industrialised economies. In the most recent episode, however, this has not been the case and total capital flows have fallen sharply from their peak in 2007.



Capital flows between countries had been rising rapidly since 2002 in an environment of low interest rates, solid economic growth and generally favourable financial conditions (Graph C1). The most notable rise was in cross-border bank lending and the purchase of debt securities. Not surprisingly, given the nature of the financial crisis and the rise in counterparty risk following the failure of several high profile institutions, cross-border bank lending has been sharply curtailed in 2008.



Looking at more detailed data on cross-border bank lending from the Bank for International Settlements, it is evident that cross-border lending by European banks both increased most rapidly going into the crisis and subsequently contracted most sharply. Given that financial stress was concentrated in industrialised economies it is also noteworthy that lending to other industrialised economies peaked earlier than lending to emerging markets, which was curtailed only much later into the financial turbulence (Graph C2). This pattern is also evident in the

sharp reversal of (net) flows between the United States and the United Kingdom as a result of reduced cross-border lending by European banks headquartered in London as institutions sought to unwind their exposures.<sup>1</sup>

The most recent fall in gross capital flows is very sharp by historical standards. However, previous episodes of instability, such as the one around the time of the equity bubble earlier this decade, resulted in reasonably short-lived falls in capital flows. ✎

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<sup>1</sup> For more detail see also *Bank for International Settlements (2009)*, BIS Quarterly Review, June.