International Capital Flows

December 2009

Moderator: *Welcome to the Federal Reserve Bank of Atlanta's* Financial Update Focus *podcast. Today, we'll be speaking with Galina Alexeenko, a senior analyst in the research department at the Atlanta Fed. She'll be speaking about trends in international capital flows in the wake of the recent financial crisis. Thanks for joining us today, Galina.*

Galina Alexeenko: Thanks for having me.

Moderator: *To start, what were the general trends in cross-border U.S. financial flows prior to the crisis? What did things look like?*

Alexeenko: For several years before the financial crisis started in August of 2007, the United States was running a massive current account deficit, which had to be financed by foreign investors. A country runs a current account deficit when it invests more than it saves.

For many years foreign investment has been a major source of financing for the U.S. economy. Foreign investors can be roughly divided into two main categories: private and official investors. Private investors include foreign banks, corporations, investment funds, and individuals who are non-U.S. residents. Foreign official investors are mainly foreign central banks, but also include sovereign wealth funds.

The private sector, which was the dominant foreign investor in U.S. assets going into the crisis, had been acquiring riskier assets—as opposed to U.S. government debt—especially corporate bonds and corporate mortgage-backed securities. Meanwhile, about a half of foreign central banks' purchases of U.S. securities were accounted for by agency debt, which are bonds issued by Fannie Mae and Freddie Mac. Most of the rest were U.S. Treasuries.

Some of the inflows of capital into the United States from abroad were offset by U.S. investors' purchases of foreign securities. These purchases represent an outflow of capital from the United States. U.S. investors had bought increasing amounts of foreign stocks and bonds from 2004 through the first half of 2007. That was in response to declines in the dollar, continued global growth, and desire for diversification.

Moderator: *After the crisis reached its peak in the fall of 2008, what were the major developments with respect to financial flows?*

Alexeenko: Well, in a nutshell, there was a sharp increase in risk aversion in the midst of the crisis that led to outsized "flight-to-safety" flows. Foreign investors were selling all U.S. assets, except for Treasuries, and U.S. investors were selling all types of foreign assets.

Prior to the crisis, most of the foreign financing of U.S. government debt came from central banks, while foreign private investors held relatively little in U.S. Treasuries. As the financial crisis intensified in the fall of 2008, foreign private investors increased their purchases of Treasuries, which reached a record $98 billion in October and remained considerable through the first two quarters of this year. However, this buying was more than offset by foreign private sector sales of other U.S. securities. In the aggregate, the foreign private sector was withdrawing capital from the United States.

Also, foreign central banks as a whole stopped adding to their dollar reserves last fall. Many central banks, including the central banks of South Korea, Brazil, Mexico, and Russia were selling dollars to stem depreciation of their currencies. Despite this selling, central banks' purchases of U.S. government debt increased significantly, funded by the proceeds from their continued selling of agency debt.

With the onset of the financial turmoil, a much larger fraction of both central banks' and foreign private acquisitions of Treasuries has been in short-term Treasury bills. On a rolling three-month basis, foreign investors bought more than $300 billion in Treasury bills at the peak of the crisis.

At the same time, U.S. investors were repatriating capital at a record pace by selling foreign stocks and bonds in the second half of 2008; that was amid increased risk aversion and global recession concerns. As U.S. investors brought their money home, this reduced U.S. reliance on foreign financing.

Moderator: *Now that there has been an easing of tension within global financial markets, what kinds of patterns are emerging?*

Alexeenko: With the easing of financial stress after the first quarter of 2009, foreign private investors resumed buying U.S. equities and then agencies, and again became the net buyers of U.S. assets. As far as central banks, foreign official dollar reserves have begun to grow again rapidly, reflecting foreign central banks' intervention to prevent the appreciation of their currencies as the U.S. dollar weakens. Central banks, however, continue to shy away from agencies and corporate bonds.

Moderator: *What about U.S. investors?*

Alexeenko: As prospects for the global economy are improving, U.S. investors have again started to purchase foreign bonds and equities. As I mentioned earlier, U.S. investor purchases of foreign assets are considered an outflow of capital from the United States, which increases the need for foreign capital in the United States.

Moderator: *So what are the implications of all this for the global economic recovery?*

Alexeenko: Well, financial inflows are returning to emerging markets that saw a sudden flight of capital in the midst of financial crisis. The renewed willingness of both U.S. and foreign investors to redeploy capital to private assets in emerging markets is a welcome development that should facilitate the global economic recovery.

Moderator: *Galina, thank you for your time and for sharing your thoughts with us.*

Alexeenko: Great talking to you.

Moderator: *Again, we've been speaking today with Galina Alexeenko, a senior analyst in the research department at the Atlanta Fed. This concludes our* Financial Update Focus *podcast on international capital flows. For more information, please see the fourth quarter 2009 edition of* Financial Update. *On our Web site, frbatlanta.org, you can read more about international capital flows. Thanks for listening, and please return for more podcasts. If you have comments, please send us e-mail at podcast@frbatlanta.org.*