

# **The Great Retrenchment: International Capital Flows During the Global Financial Crisis**

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December 2011

## **Summary**

The current financial crisis has been characterized by striking developments in international capital flows. Financial globalization has led to a sustained and substantial increase in financial flows since the early 1990's. This pattern came to an abrupt halt in the crisis, and especially in the wake of the Lehman Brothers failure in September 2008. Capital flows did not just fall in magnitude, but actually reversed direction as investors that were accumulating foreign assets before the crisis liquidated some of their holdings abroad and retrenched to their domestic market during the crisis. This turnaround was more pronounced than the well documented fall in world trade in the crisis.

The paper proceeds in three stages. We first document the main patterns of capital flows during the crisis and stress a substantial degree of heterogeneity. There is first heterogeneity through time. The first phase of the crisis between the summer 2007 and the fall 2008 was characterized by a mere slowdown of capital flows. By contrast capital flows reversed directions in the acute phase of the crisis in the six months following the fall of Lehman Brothers. Capital flows have gradually recovered in a recovery phase since the spring 2009. The second dimension of heterogeneity is across countries, with advanced economies being more affected. They saw a marked slowdown of flows in the initial phase, followed by a massive retrenchment in the crisis phase, and only a partial recovery in the final stage. Emerging economies by contrast were affected only in the acute phase of the crisis, and recovered faster in subsequent quarters. The final dimension of heterogeneity is related to the various types of capital flows. The collapse of flows was driven by banking flows. As global banks faced large losses in U.S. markets and a more uncertain environment, they reduced their exposure to foreign countries and focused on rebuilding their domestic balance sheets. Our analysis shows that banking flows lead to weakening in the early stage, experienced the most pronounced turnaround in the acute stage, and are characterized by a weak recovery in the final stage.

In the second phase of our analysis we contrast the situation between countries that experienced the largest retrenchment in capital flows and the ones with the smallest retrenchment. We find that countries that were most affected relied more on international banking and debt financing than contingent sources of capital, such as equity and foreign direct investment. These countries also had weaker fundamentals. For instance countries that were large net debtors before the crisis were most affected. We interpret this pattern as a reduction in risk appetite by investors. Whereas capital was abundant before the crisis, the unprecedented disruptions led investors to take a less benign look at countries' fundamental and to reduce their exposure more to the ones with weak fundamental.

In our final step we undertake a formal econometric assessment of capital flows, distinguishing between the acute and recovery phases of the crisis. Our analysis finds strong evidence that countries with larger international integration through banks suffered most. We also find that countries with weaker fundamentals experienced a larger reduction of capital flows as investors became more discriminatory in the crisis.