Causalities between Country Risk Scores and International Capital Flows

Ahmet Usta
Recep Tayyip Erdogan University, Turkey
ahmet.usta@erdogan.edu.tr

Abstract

Although international capital flows have positive effects on the performance of emerging market economies, fluctuations in these flows may also have unwanted effects such as currency appreciations, price bubbles, high default risk, overheating in growth, and high inflation which create risky financial and economic environment in emerging economies. Particularly, capital flows have significant impacts especially on the stability of emerging economies. The literature on what drives the capital flows mainly consider the push and pull framework. The push factors can be described as the external conditions such as monetary policy expectations, global interest rates, and risk appetites. The pull factors are related to internal conditions such as domestic growth performance, country specific risk scores and asset returns. Among the pull factors that shape the investment strategies of foreign investors, country specific risk scores, i.e., political, financial, and economic risk can be counted as the most notable ones. On the one hand, changes in the risk scores of countries may cause excessive fluctuations in capital inflows. On the other hand, fluctuations in capital inflows are also likely to affect risk scores. Therefore, it is important to understand the links between risk scores and capital flows because they provide information about the characteristics of an economy with various dimensions including financial stability, credit conditions and sustainability of investment positions. Given the inseparability of risk scores and capital flows, this paper aims to investigate the possible causal relationships between the risk scores and disaggregated capital inflows, i.e., debt-based, and equity-based flows to the emerging economies.

Keywords: Causality, country risk, disaggregated capital flows, emerging economies

JEL Codes: C32, F21, F32, F41