The Natural Level of Capital Flows

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Summary

This paper puts forward the notion that capital flows—specifically, gross portfolio flows—fluctuate around some natural level. Our particular measure of the natural level of capital flows, denoted by KF*, is a theory-based time-varying supply-side factor, much like potential GDP is a theory-based time-varying supply-side measure of economic activity. We construct KF* for 184 countries and, for the subset of countries that have quarterly time series data of capital flows, we show that KF* is a level to which flows converge in the medium term. That is, KF* appears to help identify the underlying persistent component in gross portfolio inflows by differentiating between longer-term structural flows and short-term cyclical noise. Overall, we conclude that there is a natural level of capital flows that is well approximated by our measure of KF*. 