The influence of foreign capital flows on long-term interest rates in emerging economies: a comparison with advanced economies*

Masahiro Inoguchi†

Abstract

This study explores how foreign capital inflows affect domestic long-term interest rates. This effect may be more significant in emerging economies than in advanced economies because the financial and bond markets in emerging economies are smaller, which implies that foreign capital flow shocks spread much more quickly. In addition, large fluctuations in long-term interest rates can complicate the operation of monetary policies. Therefore, understanding how foreign capital flows influence long-term interest rates is especially important for emerging economies. We use panel data to infer the yields of 10-year government bonds and three types of capital flows from foreign investors: government debt security liability, debt security liability, and portfolio capital liability. The regressions examine the difference between the effects on emerging and advanced economies, as well as the difference between the period before and after the global financial crisis (GFC). The results suggest that the influence of foreign capital flows on 10-year government bond yields is larger in emerging economies after the GFC than that before the GFC, and the selling of domestic assets by foreign investors resulted in a large increase in the long-term government bond yield in emerging economies. In addition, the shock of foreign capital flows on long-term government bond yields is larger in emerging economies than in advanced economies after the GFC. The regression results imply that massive capital flows from foreign investors during and after the GFC have had a large impact on the long-term interest rates in emerging economies.

Keywords: Capital inflows; Long-term government bond yields; Emerging economies

JEL classification codes: F30; G12; G15; O16

---

* I would like to thank attendees at the 14th Conference of East Asian Economic Association for useful suggestions and discussion. This research was supported in part by the Japanese MEXT KAKENHI Grant Numbers: 25380413.

† Kyoto Sangyo University
E-mail: inoguchi@cc.kyoto-su.ac.jp