

MANAGING CAPITAL FLOWS

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*Nonbank Financial Intermediation
and Financial Stability:
A Perfect Storm in the Making?*

G30 report

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STRUCTURAL SHIFT: CAPITAL FLOWS ARE INCREASINGLY NBFI-DRIVEN

There has been **major** transformation in **global capital flows**:

STRUCTURAL CHANGE

- Since the GFC, the current system is increasingly dominated by NBFIs, such as asset managers, hedge funds and pension funds.
- More and more NBFIs now buy and sell sovereign bonds and other financial instruments across borders. In many cases they have become the marginal buyers of government debt.
 - Capital flows are now more market-based, price-sensitive and reactive to changes in financial conditions.

IMPLICATION

Capital flows are less stable and more sensitive to global risk sentiment, interest rates and asset price movements.

INCREASING COMPLEXITY AND OPACITY OF CROSS-BORDER FLOWS

WHY FLOWS ARE HARDER TO TRACK

- Modern capital flows are increasingly mediated through complex instruments such as derivatives, repos and collateralized transactions, often embedded in chains of financial intermediation involving multiple jurisdictions.
- Complexity creates significant challenges for regulators and policy-makers, as it becomes harder to track exposures and identify vulnerabilities. Interconnectedness across markets means that shocks can propagate through multiple channels.

IMPLICATION

Cross-border capital flows are more opaque, harder to measure, and more prone to hidden leverage and systemic risk.

The issue is not only volume, but visibility: where the risks sit and how they move.

GREATER VOLATILITY AND SUDDEN STOPS

MARKET DYNAMICS

- NBFIs can trigger rapid capital movements. Unlike banks, connected with longer-term relationships, NBFIs can quickly reallocate portfolios in response to market conditions.
- Several recent episodes where liquidity quickly evaporated and withdrew from markets. Emerging markets are particularly vulnerable to sudden stops.

IMPLICATION

Capital flows are more procyclical and can reverse abruptly, amplifying financial instability, especially in emerging economies.

CHANGING NATURE OF SOVEREIGN FINANCING

SHIFT IN FINANCING BASE

- As central banks reduce their balance sheets and banks face regulatory constraints, NBFIs have taken a large role in financing governments.
- These investors include both long-term investors (pension funds, insurance companies) and short-term, opportunistic investors (hedge and investment funds).

IMPLICATION

- Sovereign debt markets are increasingly dependent on investors that may withdraw funding quickly, increasing refinancing risks and market volatility.
- Massive and prolonged dysfunction of core government securities markets represents a threat to systemic risk.
- We have seen the increased frequency of central banks acting as “market makers of last resort.”

STRONGER GLOBAL FINANCIAL INTERCONNECTEDNESS

CHANNELS OF INTERCONNECTEDNESS

- NBFIs create dense global networks of financial linkages, interconnected with commercial banks.
- They include direct holdings of foreign assets, as well as indirect exposures through derivatives and funding markets.
- Financial shocks can spread rapidly across countries.

IMPLICATION

The global financial system is more interconnected, increasing the likelihood of contagion and synchronized market stress across countries.

DEPENDENCE ON FOREIGN CURRENCY FUNDING (USD) AND THE NEED FOR INTERNATIONAL COORDINATION

FUNDING DEPENDENCE

- A significant portion of cross-border NBFIs activity relies on forex markets and short-term funding instruments, particularly US dollar funding obtained through FX swaps and repo markets.
- In time of stress, access to dollar liquidity can become constrained, leading to global funding pressures.

IMPLICATION

Effective management of capital flow volatility requires coordinated international policy responses rather than purely domestic ones.

This includes:

- Expanding central bank swap lines
- Enhancing global liquidity facilities
- Improving data sharing across jurisdictions

CAPITAL FLOWS FROM DLT, DEFI AND STABLECOINS

ACCELERATION AND BYPASS RISK

- Digitalization, including DLT-based finance, enables faster runs and increases contagion across markets. Stablecoins for many people and firms are the easiest, cheapest, effective way to have US dollar exposure. Thus financial flows could adjust almost instantaneously, amplifying global synchronization of asset prices and liquidity conditions.
- Capital flows become faster, more synchronized and more prone to sudden reversals, increasing systemic risk.
- DeFi operates mostly through permissionless, peer-to-peer networks that almost do not require participation in national banking systems. This can fundamentally change how capital moves across borders.
- By bypassing traditional financial institutions and regulatory frameworks, these forms of intermediation reduce the effectiveness of capital controls and domestic financial oversight.
- A reality would be that capital flows could be redirected towards less regulated jurisdictions, increasing regulatory arbitrage and fragmentation of global financial markets.

CAPITAL FLOWS FROM DLT, DEFI AND STABLECOINS (CONT.)

RISKS FROM ADOPTION

- Stablecoins denominated in major currencies can lead to substitution away from domestic currencies, especially in smaller EMEs, resulting in digital dollarization, weakening monetary policy effectiveness and increasing vulnerability to capital outflows.
- The pseudonymous and borderless nature of DeFi makes it attractive for illicit activities. Regulators must ensure clear rules at entry and exit points between crypto and fiat systems.
- In the short term, their impact on global capital flows remains limited, but markets could grow very fast as adoption increases.

IMPLICATION

DLT, DeFi and stablecoins have the potential to significantly reshape capital flows by making them faster, more borderless and complex. New risks are introduced related to volatility, regulatory arbitrage, financial oversight and monetary sovereignty. Full impact will depend on evolution of regulation, scalability and integration to the traditional financial system.

The technology may be new, but the policy problem is familiar: confidence, oversight and coordination.

CONCLUDING REMARKS

CAPITAL FLOWS ARE UNDERGOING A PROFOUND TRANSFORMATION

They are increasingly:

- Market-based rather than bank-based
- More volatile and procyclical
- More complex and opaque
- More interconnected globally

Managing these risks will require stronger international coordination, improved data transparency, and updated policy frameworks that reflect the central role of NBFIs in the global financial system.

IMPLICATIONS

- Lower tolerance for macro-financial policy mismatches
- Macroprudential policies, including capital flow management, could be expected to be less effective
- More dependence on higher international reserves, improved global safety nets