

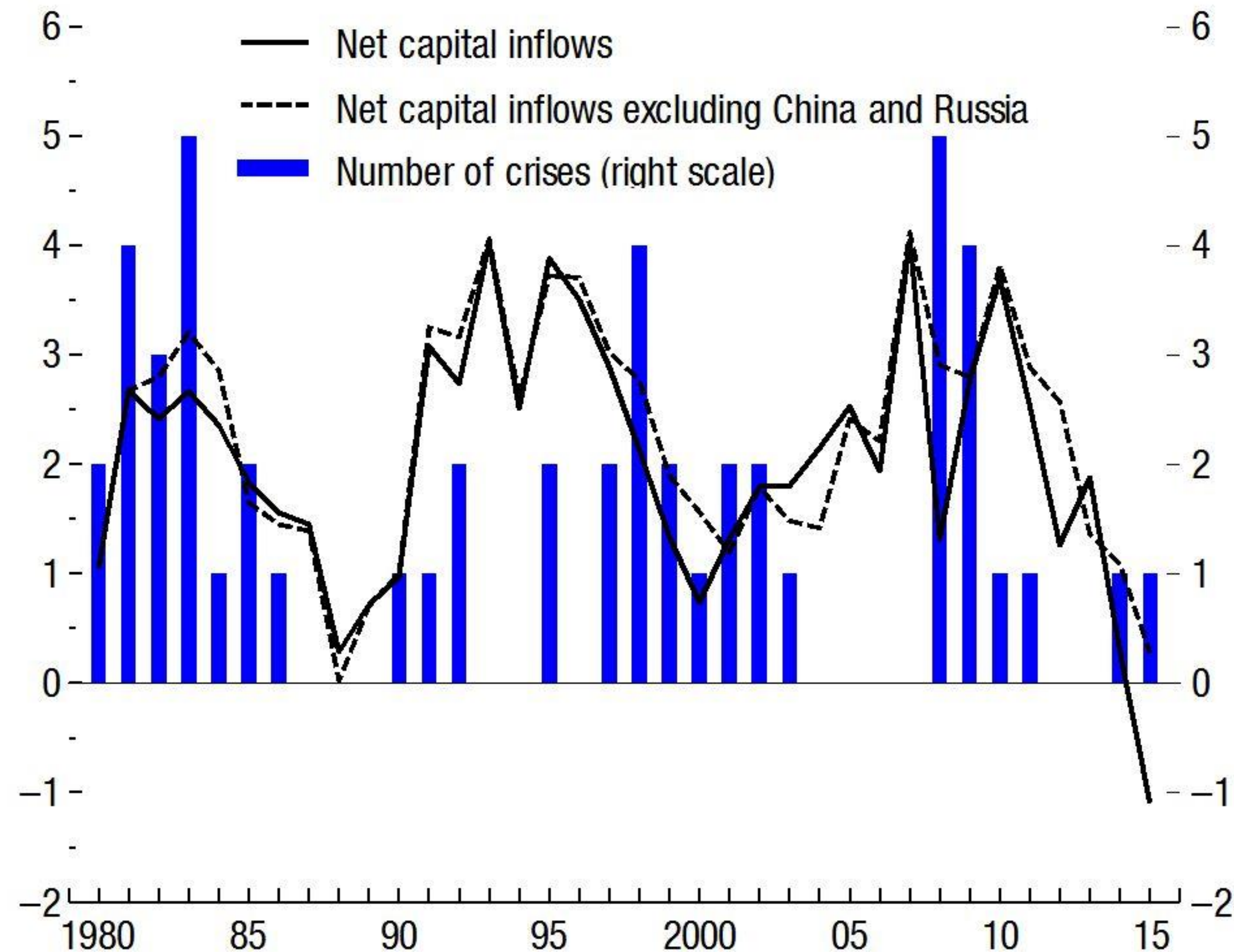


Understanding the Slowdown of Capital Flows to Emerging Markets

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Slowdown in net capital inflows to EMs. Past slowdowns associated with crises.

Net Capital Flows to Emerging Market Economies and Number of Debt Crises
(1980-2015:Q3, percent of GDP unless noted otherwise)



Outline

- The anatomy of the recent net capital inflows slowdown in emerging markets
- Historical comparisons: what is different this time?
- What is driving the recent net capital inflows slowdown in emerging markets?



The Anatomy of Net Capital Inflows Slowdown in 2010-15

Aggregate net k-inflow slowdown of 4.9% of GDP.

Define slowdown relative to the post-GFC peak of 2010

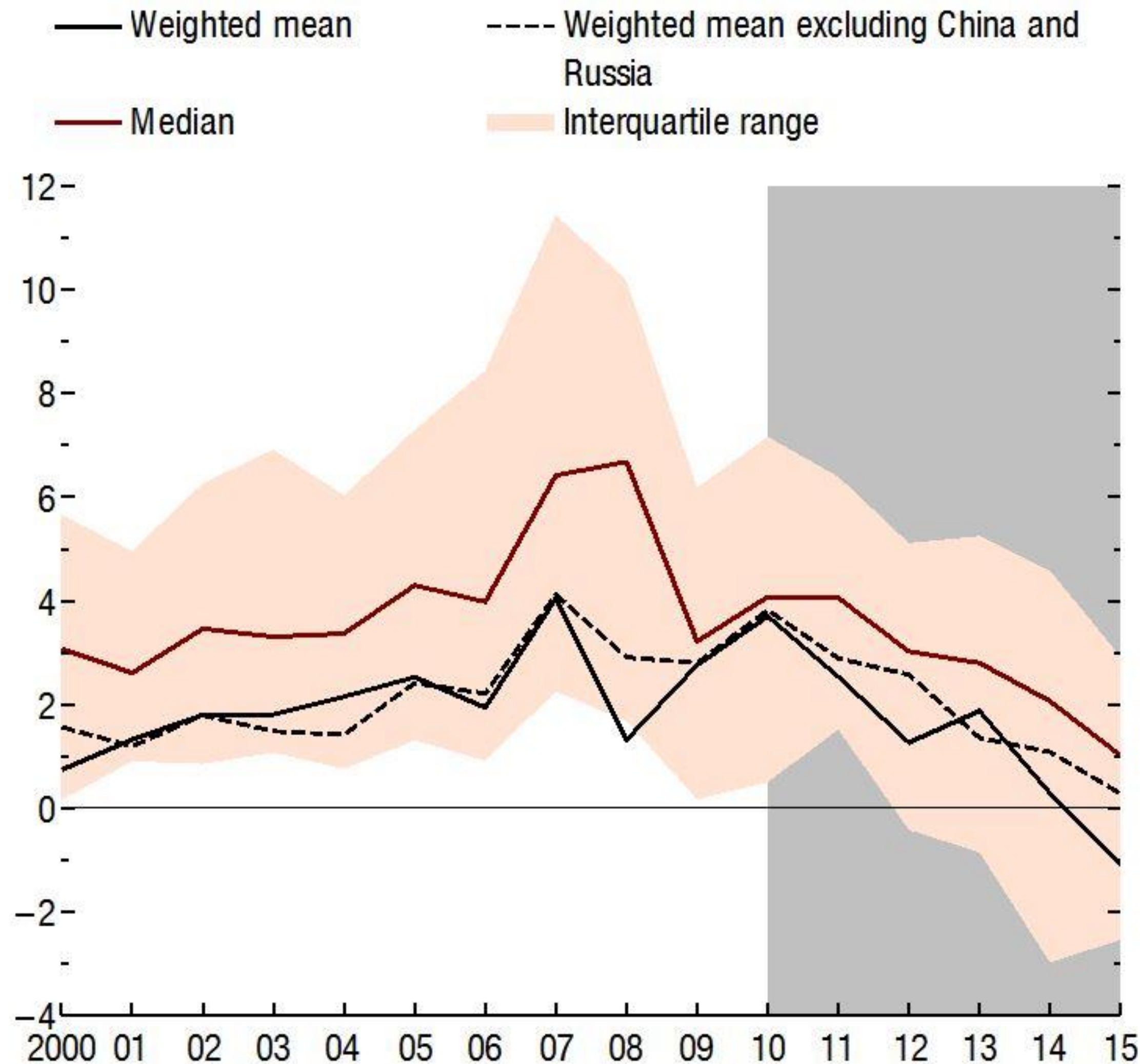
2010Q1-2010Q4: Net k-inflows of **3.9% of GDP**

2014Q4-2015Q3: Net k-inflows of **-1% of GDP**

=> Slowdown: **4.9% of GDP** or \$1.1 trillion

The slowdown is broad based.

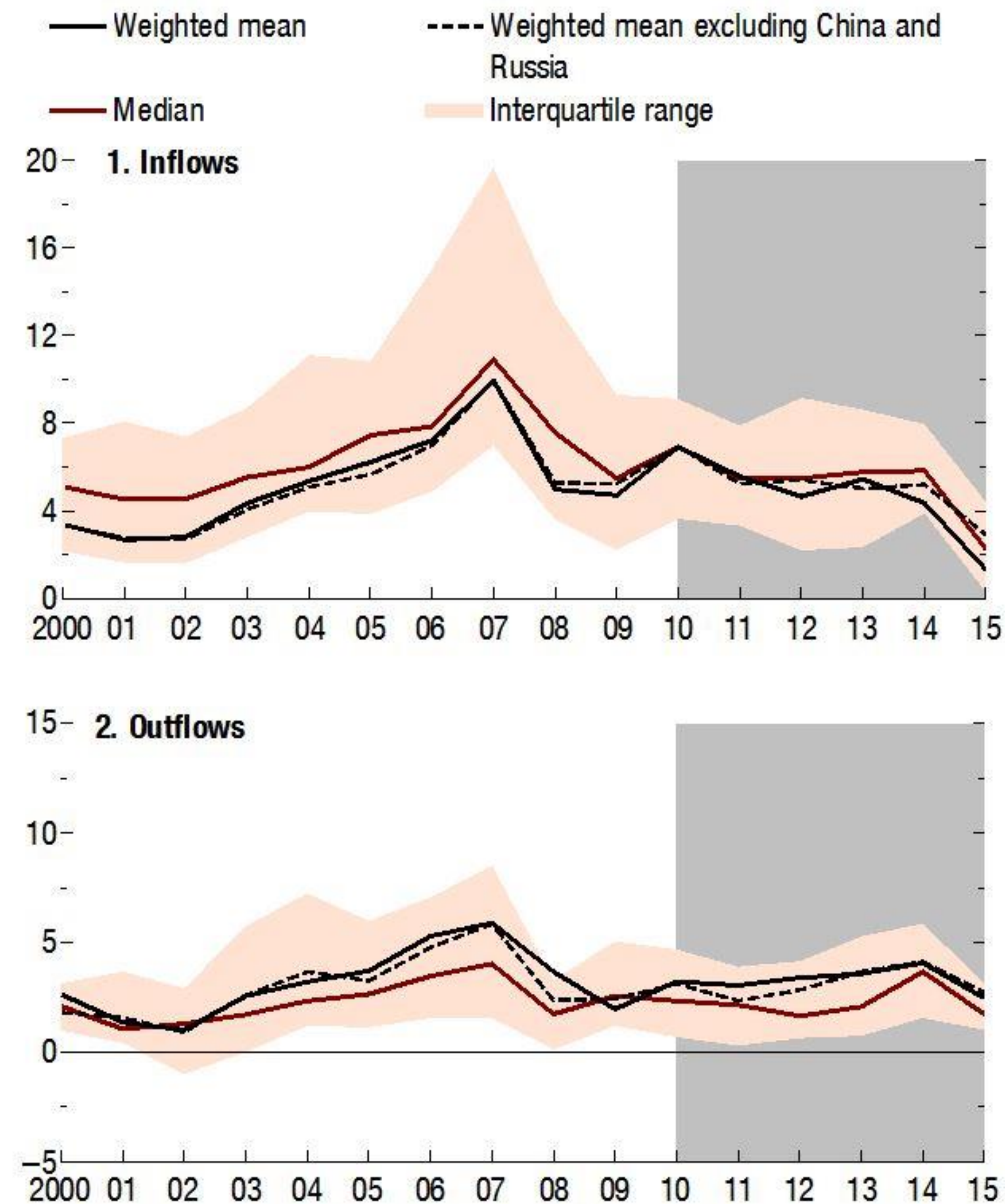
Net Capital Inflows to Emerging Market Economies (2000-2015:Q3, percent of GDP)



- The slowdown is broad-based across asset types and regions (See appendix of the slides)

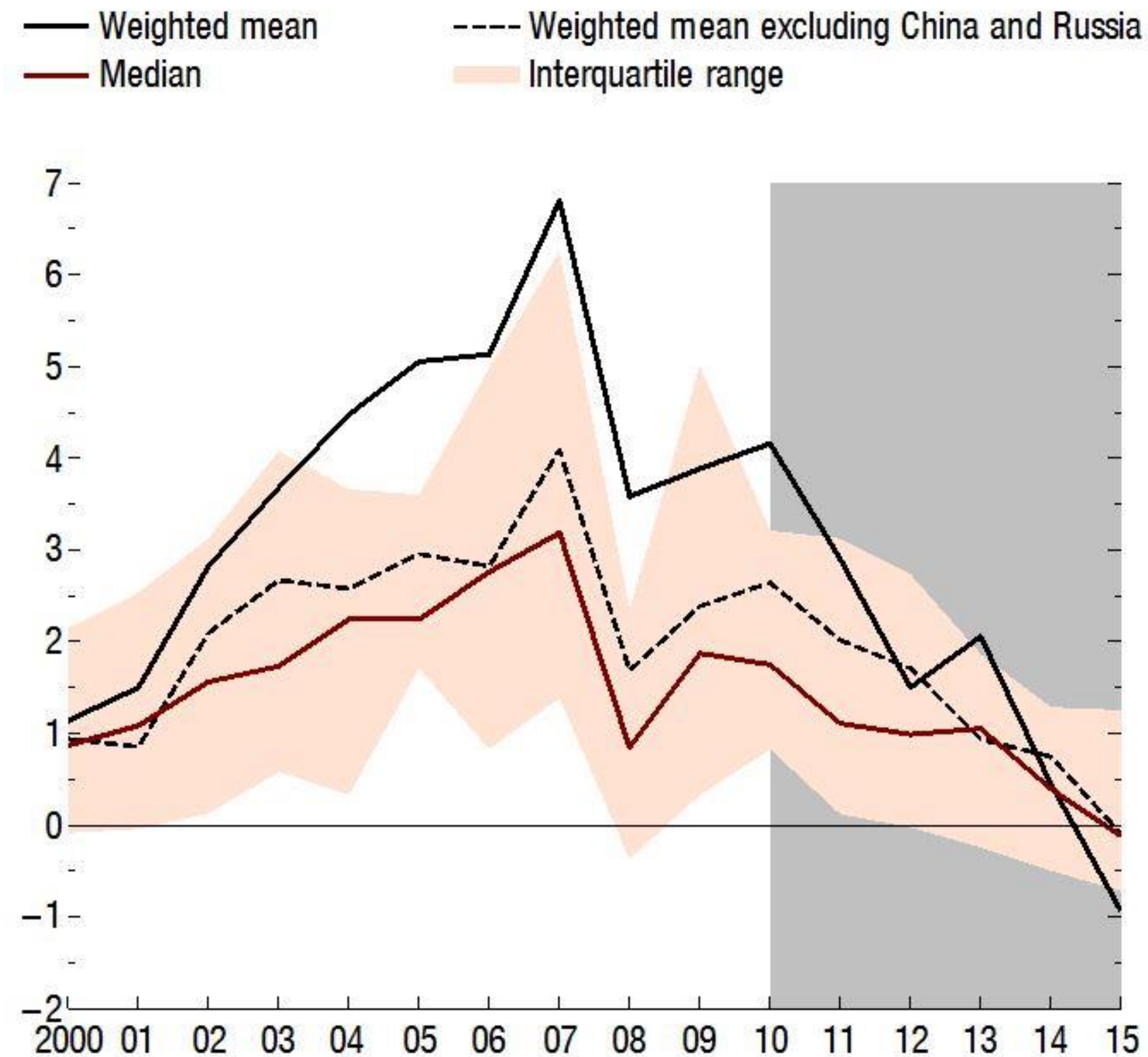
Both inflows and outflows contribute to the slowdown.

Capital Inflows and Outflows for EMEs (Percent of GDP)



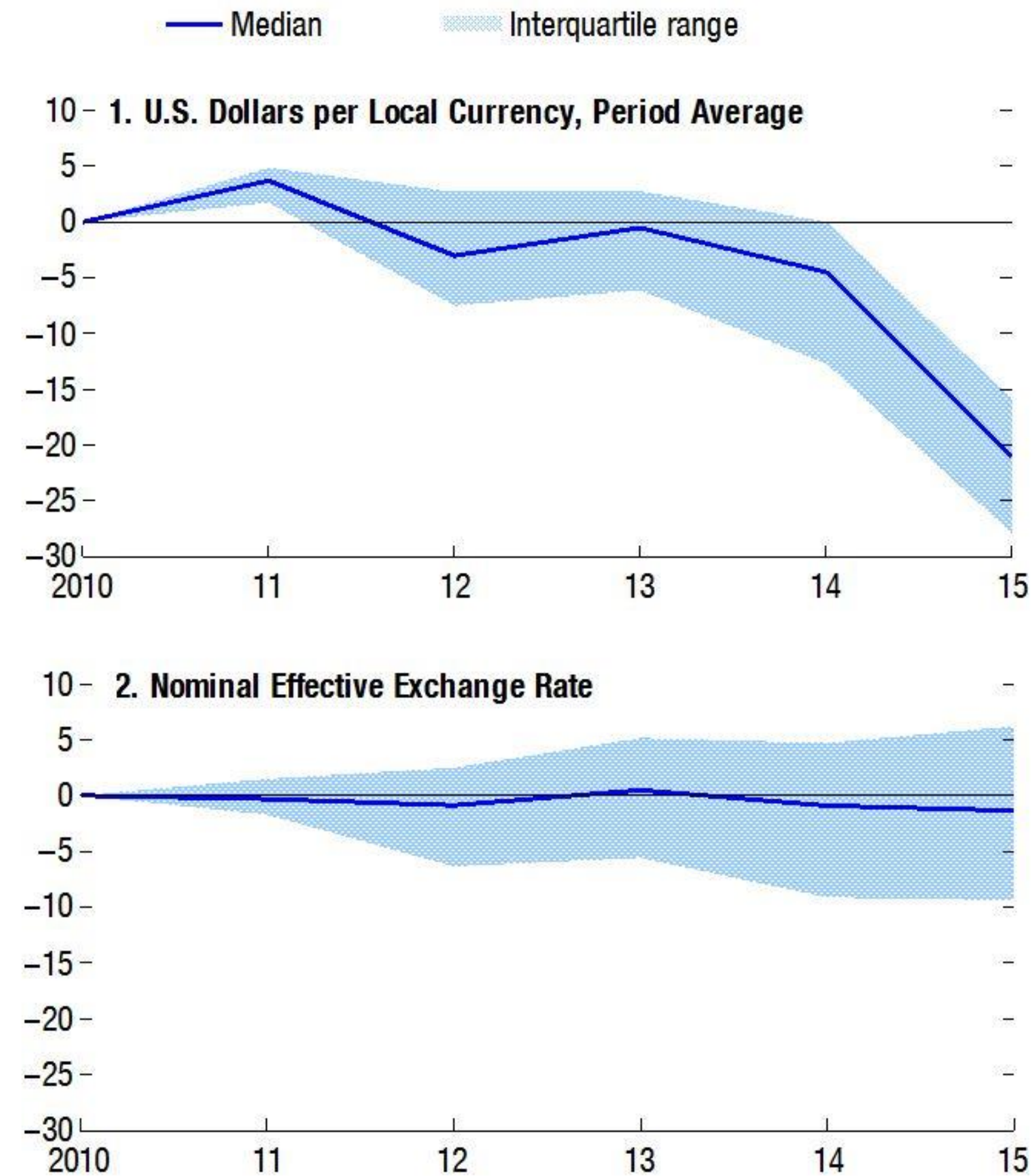
Pace of reserve accumulation decreased in tandem with the slowdown.

Change in Net Reserve Assets of EMEs (Percent of GDP)



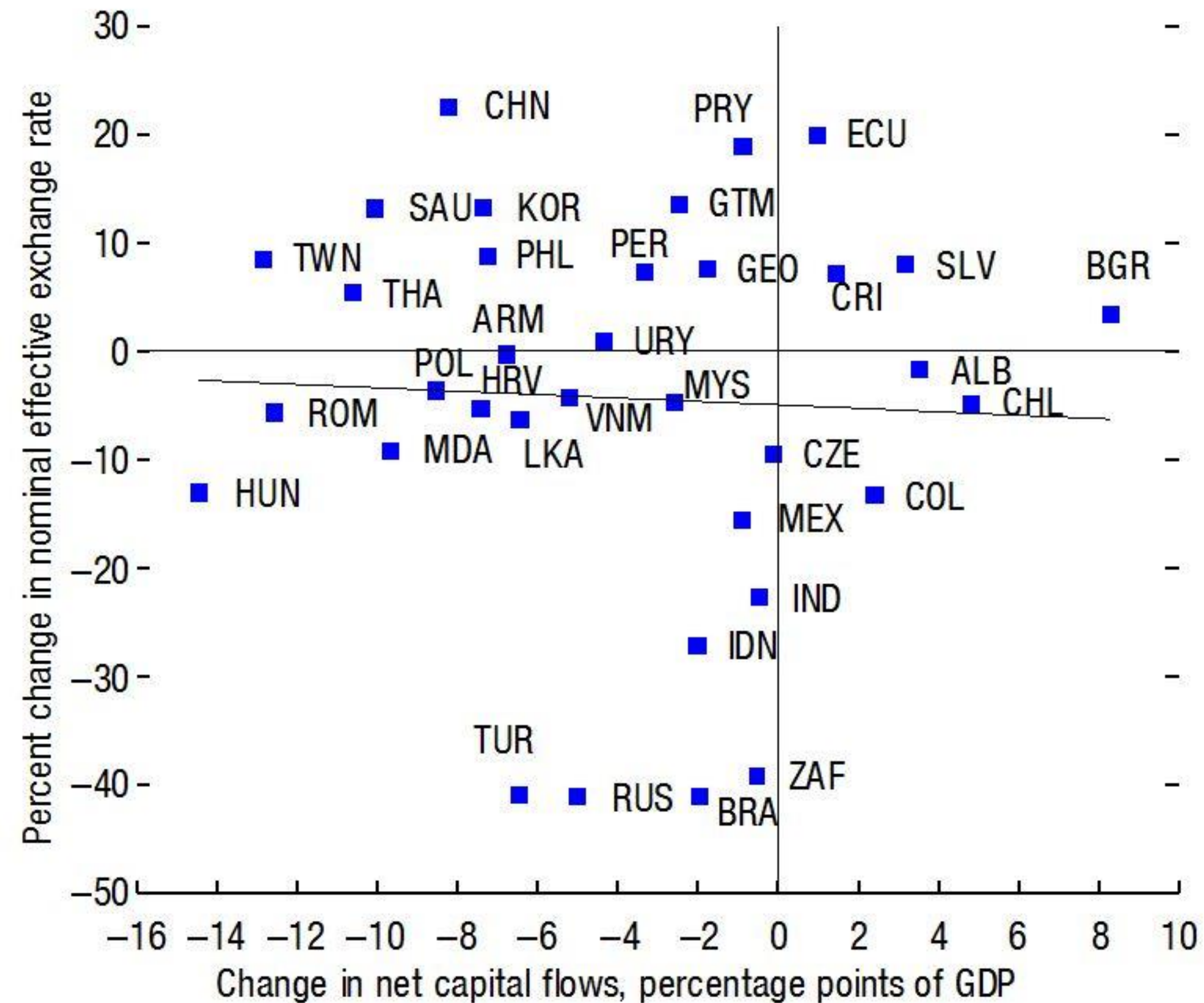
EME exchange rates depreciated against the dollar during the slowdown.

EME Exchange Rates (2010=0)



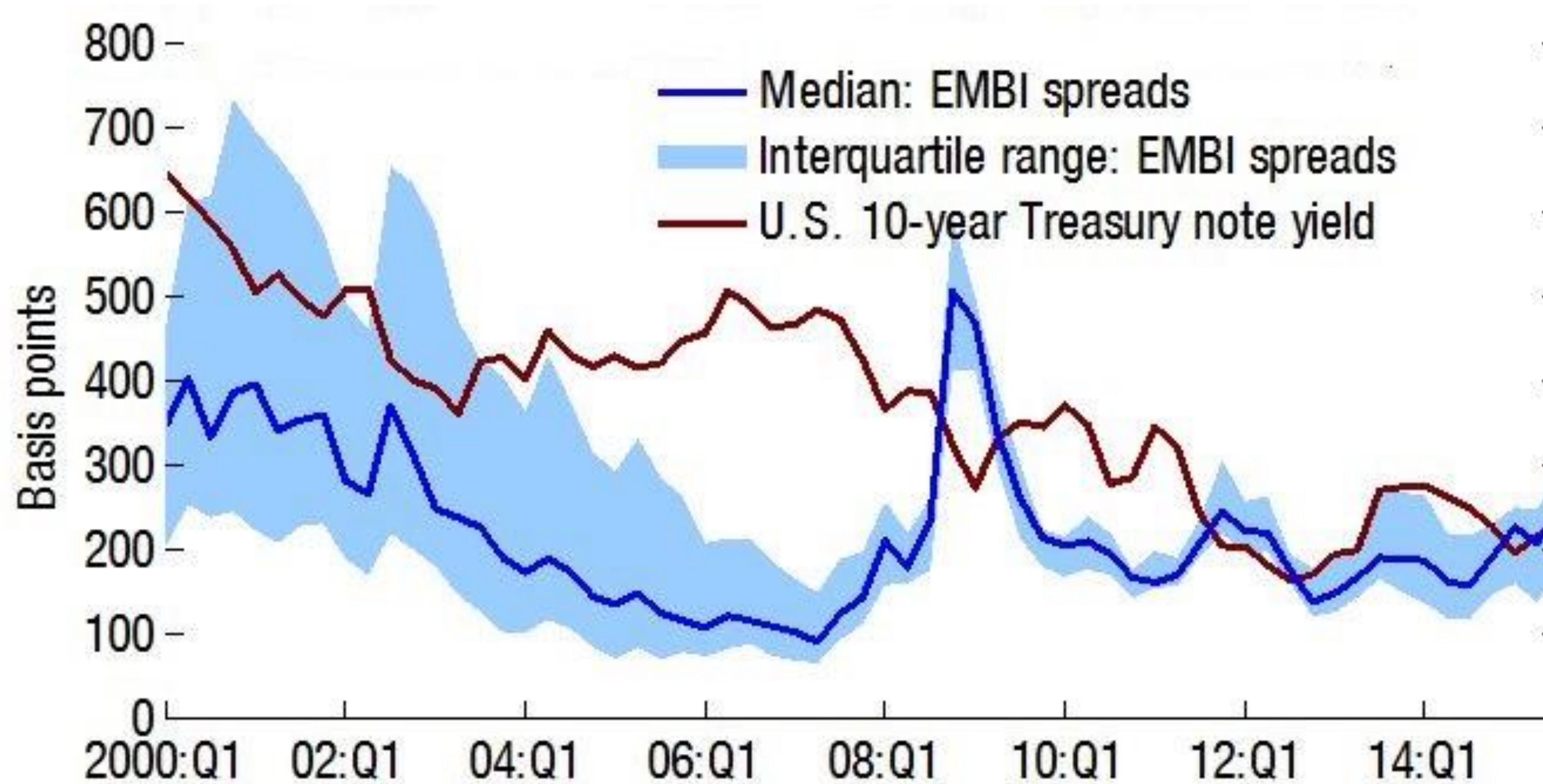
No systematic association between exchange rate changes and the decline in net capital inflows.

Capital Inflow Slowdown and Exchange Rate Changes (2010-2015:Q3)



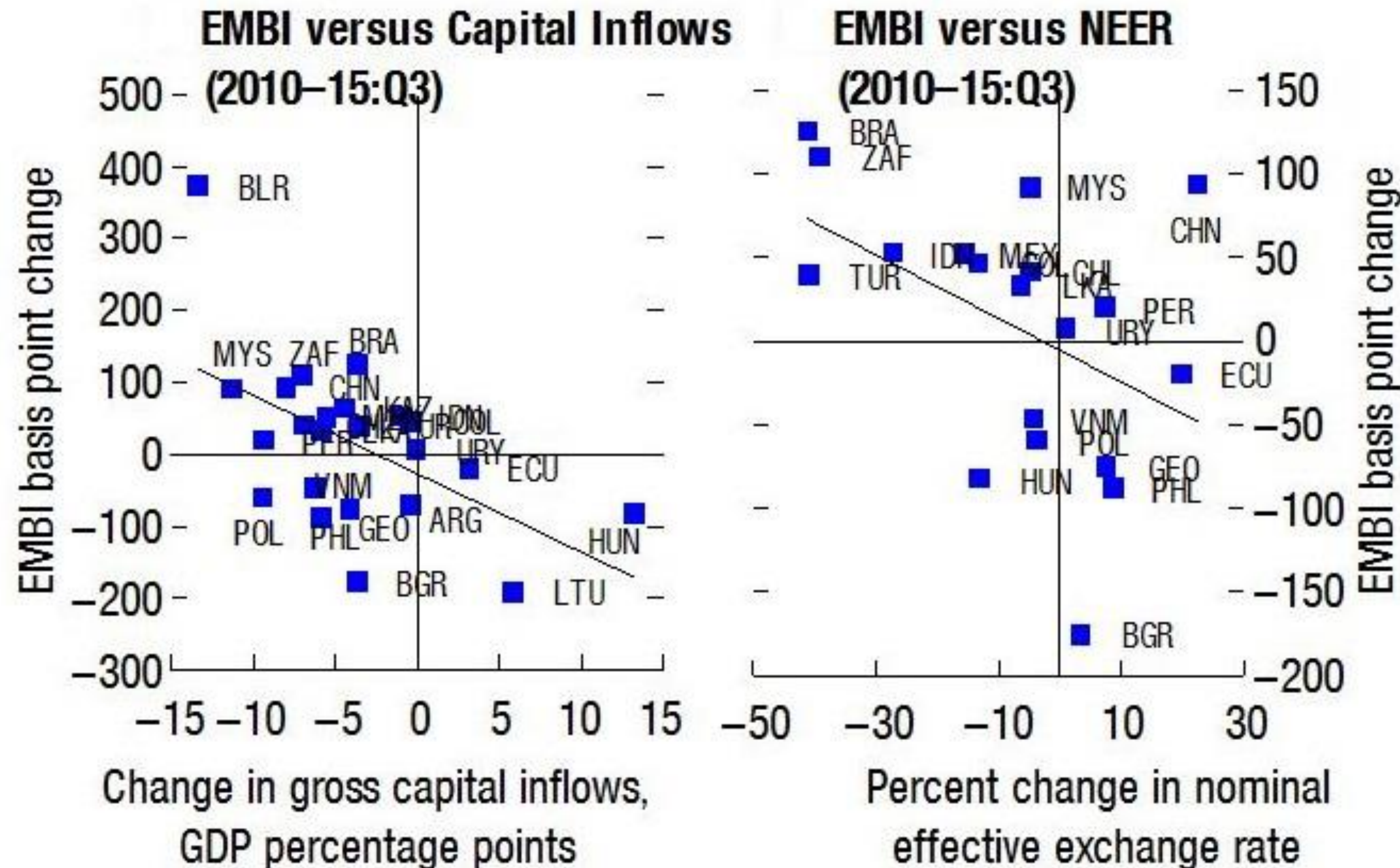
Cost of financing below previous peaks, but increased recently.

Cost of Financing and Sovereign Spreads (2000-2015:Q3)



Increases in spreads positively associated with (i) capital inflow slowdown and (ii) exchange rates changes.

Changes in Spreads, Exchange Rates and Capital Flows (2010-2015:Q3)



Summary of facts

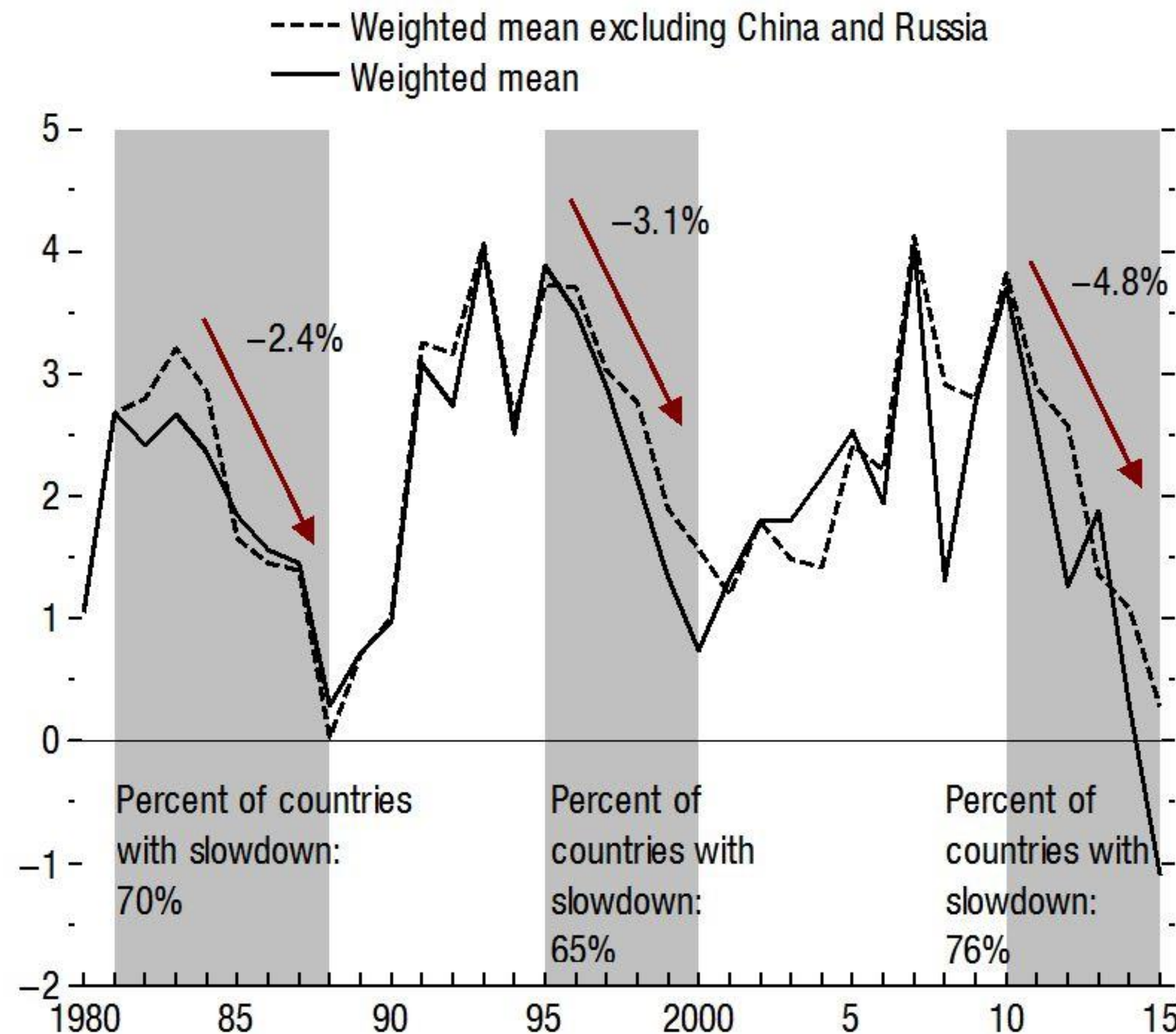
- 4.9% of GDP slowdown in net capital inflows
- Slowdown is broad-based
 - Slowdown in 3/4 of EME sample
 - Both inflows and outflows contribute
- Accompanied by a decreasing pace of reserve accumulation
- Weakness in net inflows continued in 2015Q4
- Exchange rates have depreciated against USD
 - Countries with largest depreciations saw smaller than average slowdowns
- Cost of financing remains historically low, but increasing recently



Historical comparisons: what is different this time?

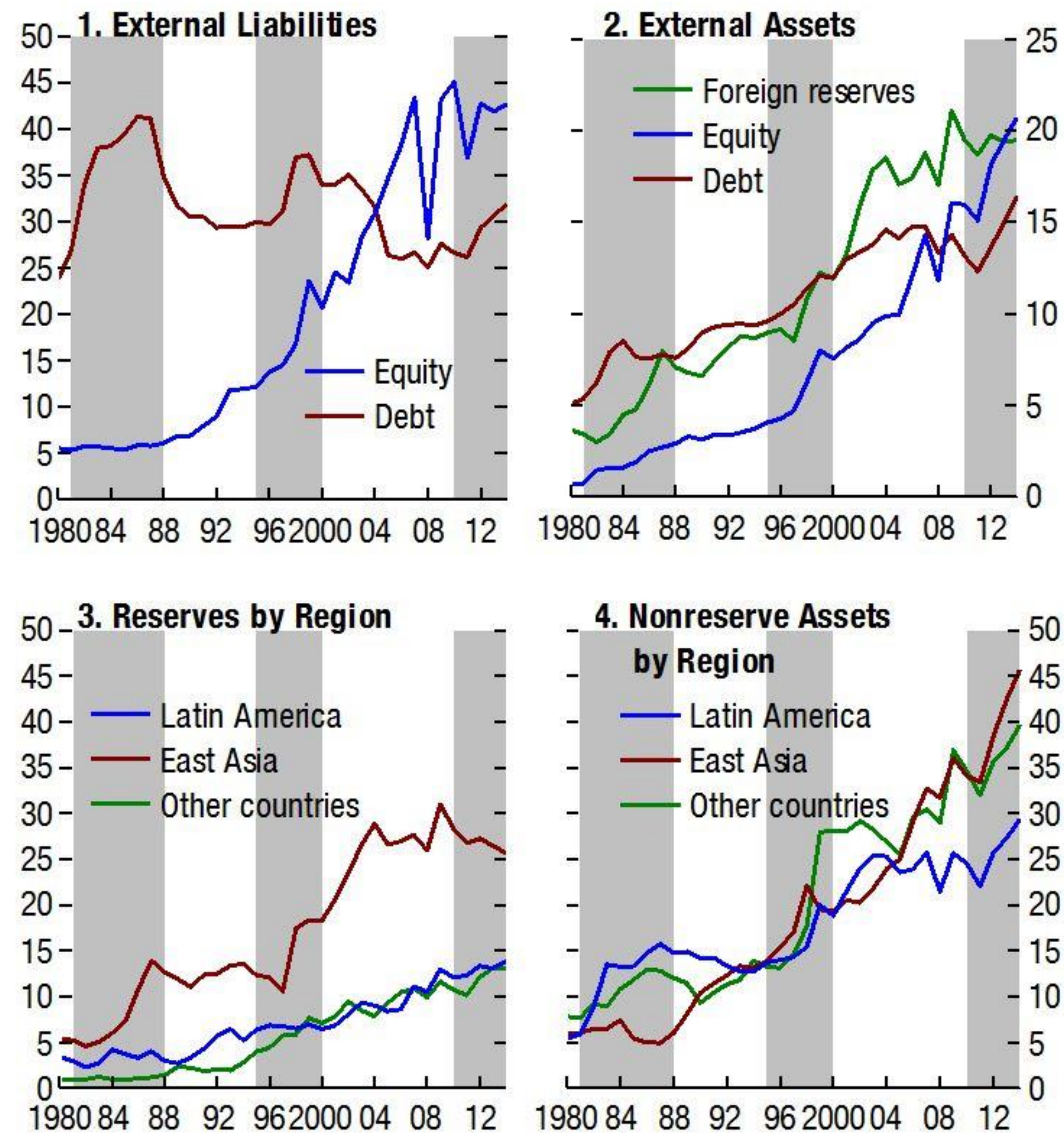
Three episodes have similar magnitude and breadth of the slowdown.

Three Major Net Capital Inflow Slowdown Episodes (Percent of GDP)



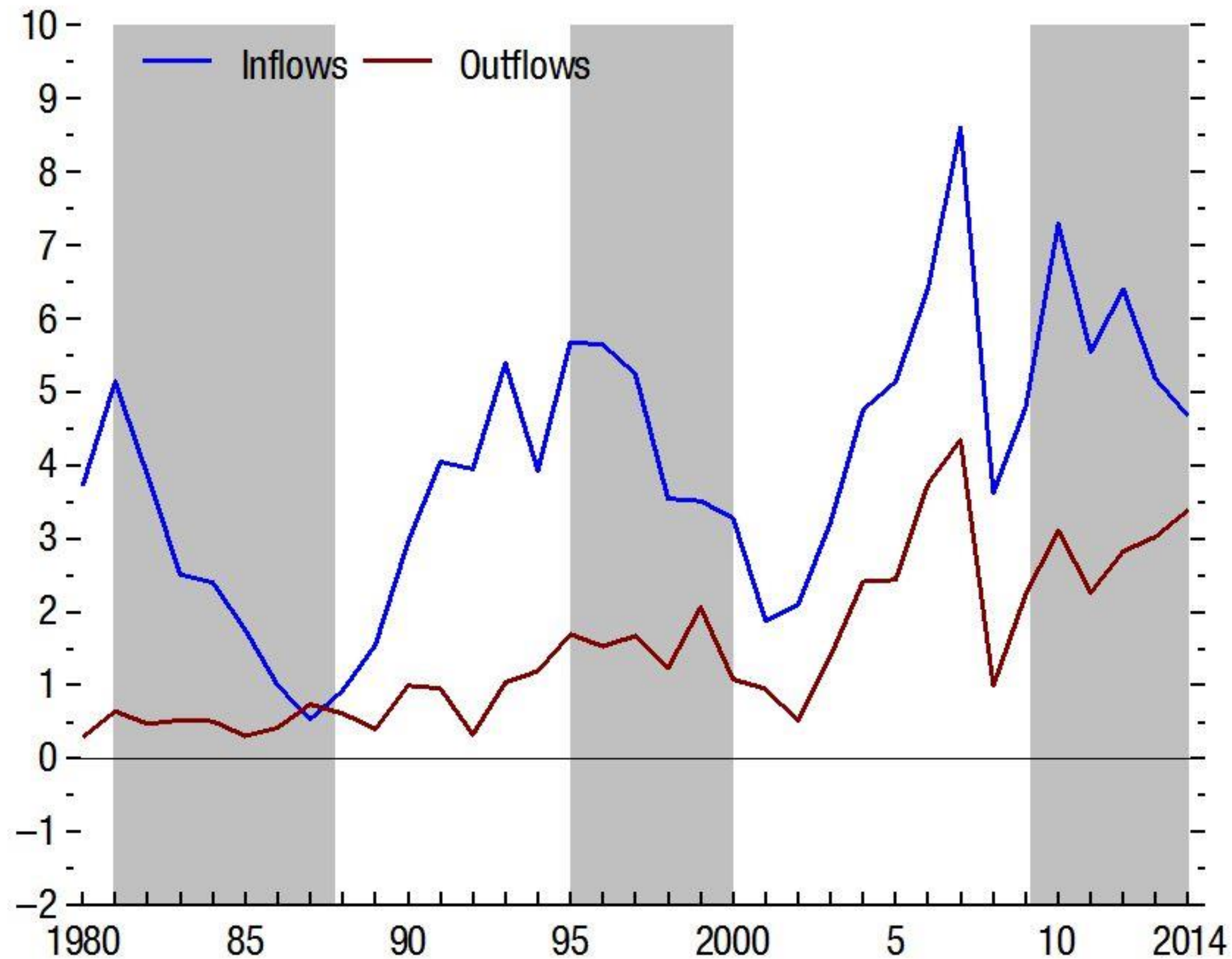
EMEs increasingly integrated into the global financial markets.

External Balance Sheets of EMEs (Percent of GDP)



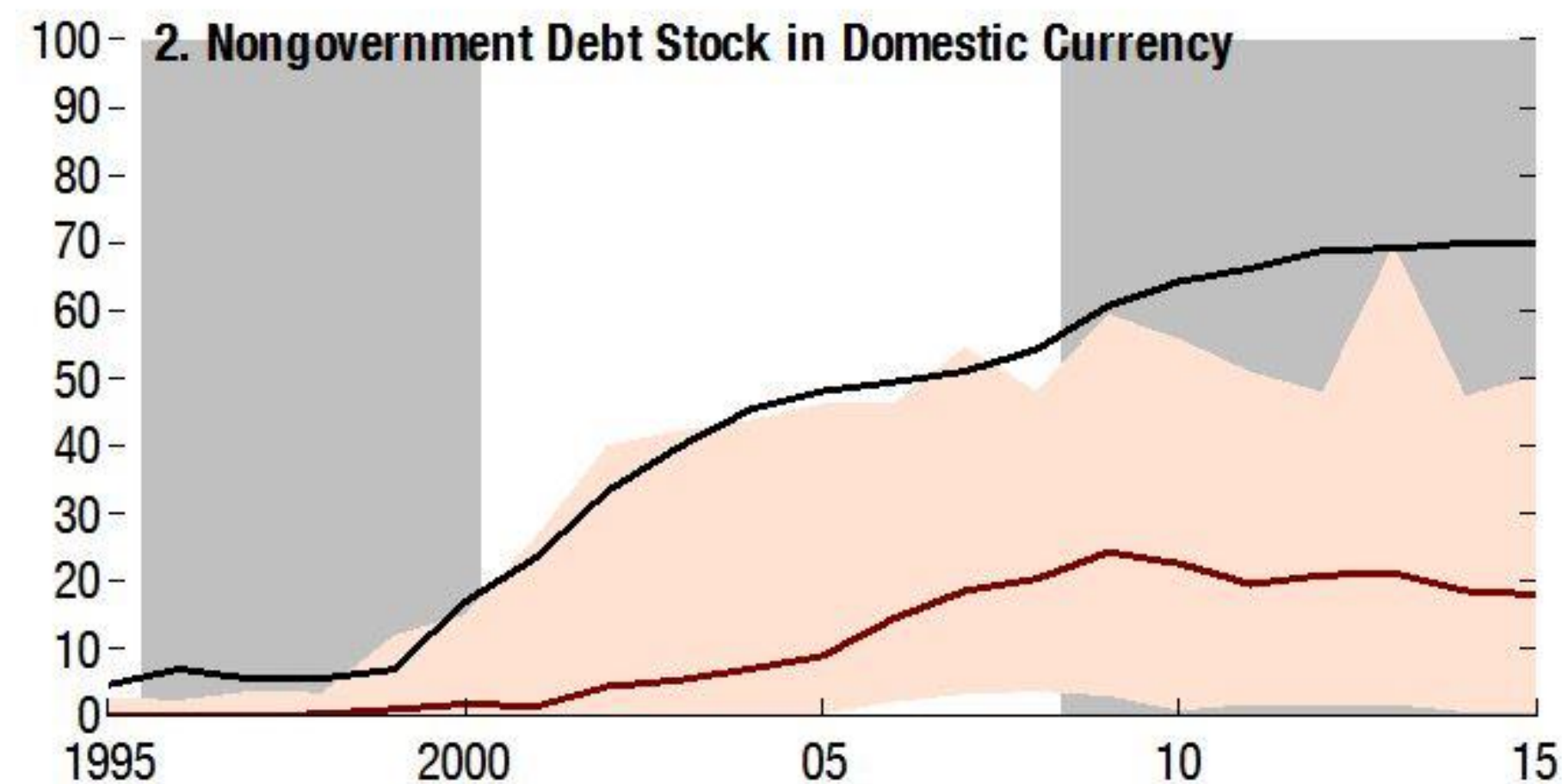
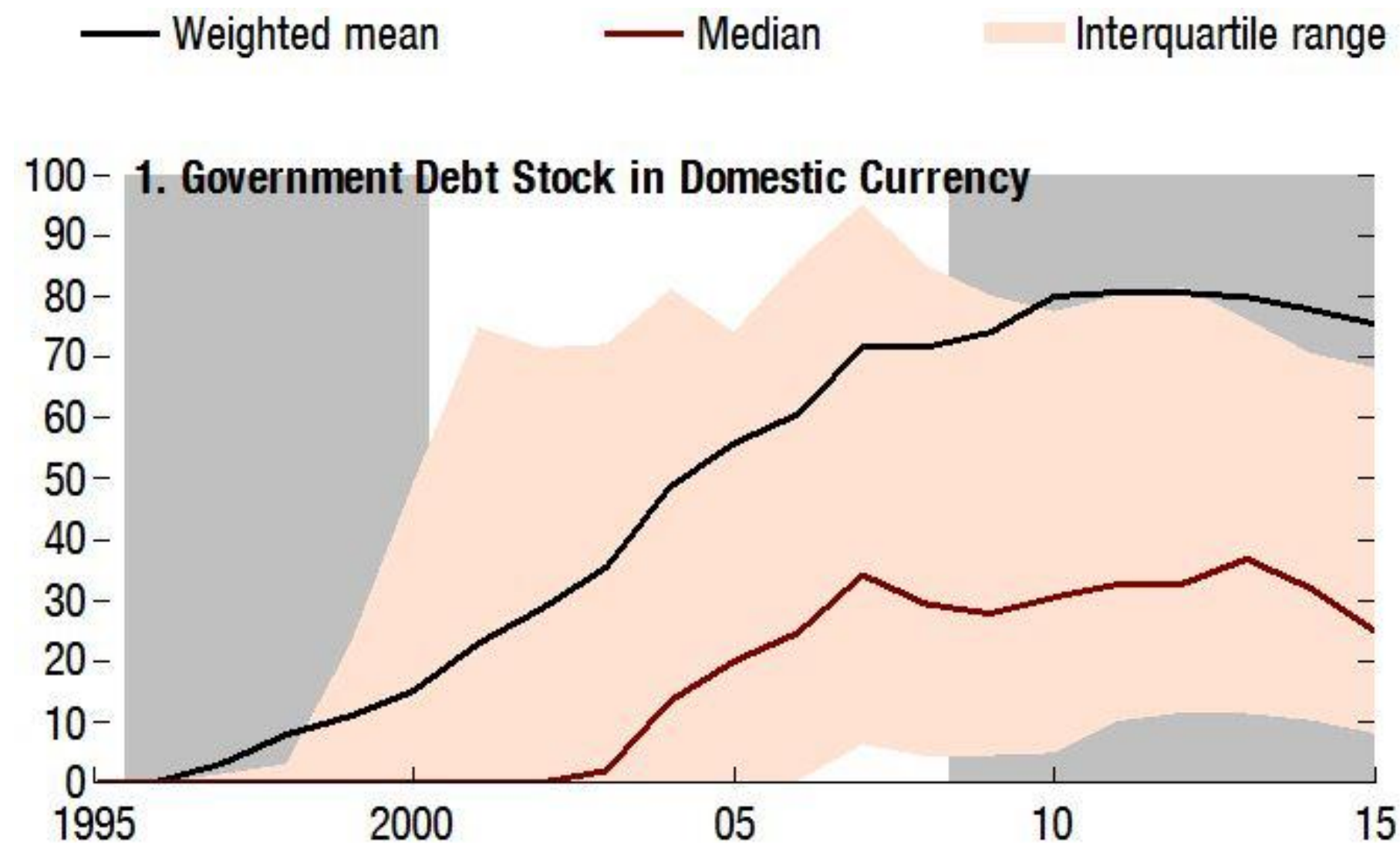
The role of capital outflows increased in the 2010-15 slowdown.

Gross Capital Inflows and Outflows to EMEs (Percent of GDP)



Domestic currency debt issuance contributed to the reduction in currency mismatches.

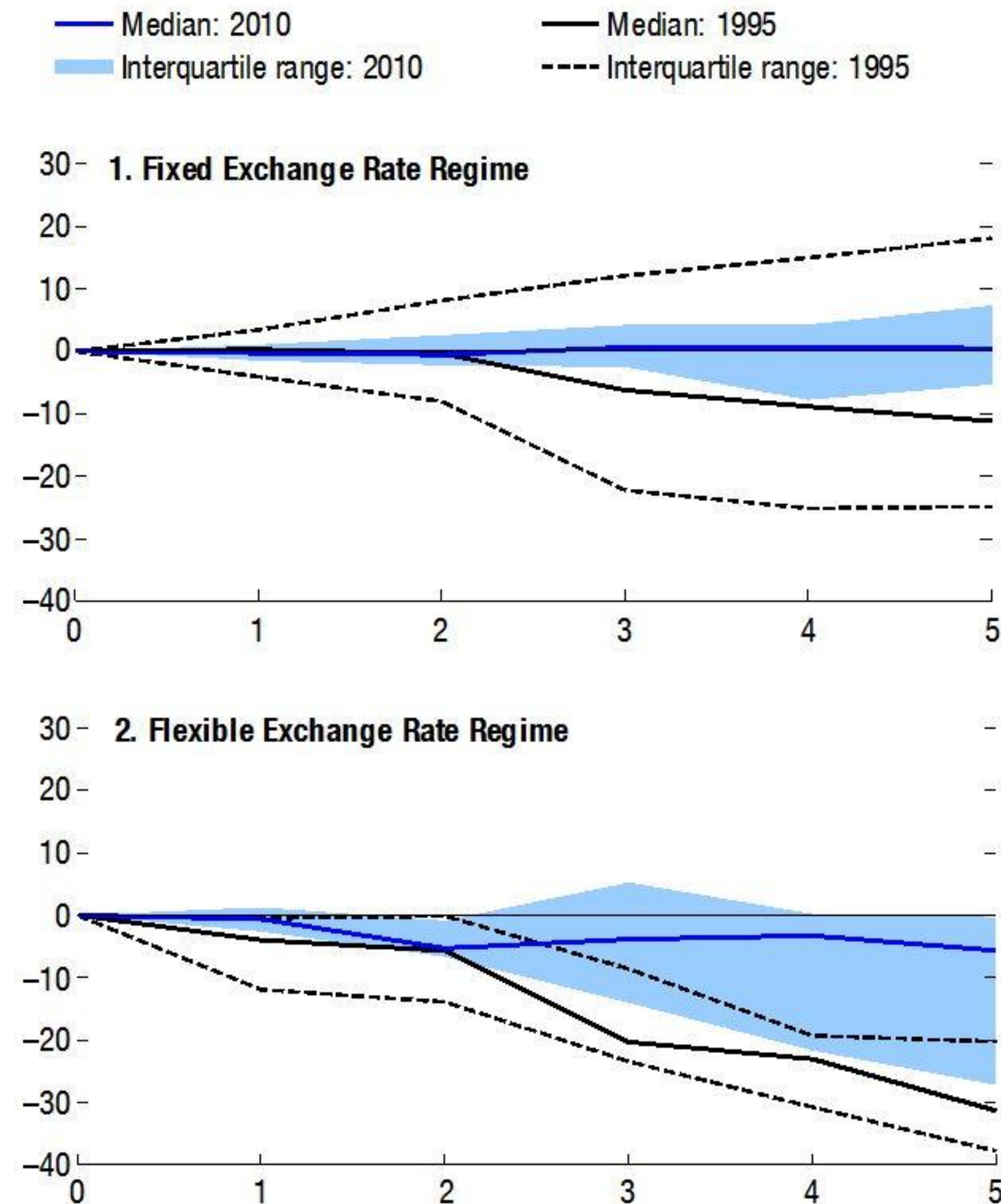
Outstanding Debt of EMEs Denominated in Domestic Currency (Percent of Total Debt)



- Reduction in currency mismatch is also reflected as decline in net external debt.

Exchange rate adjustment were more orderly during the 2010-15 slowdown than in 1995-2000.

EMEs' Exchange Rate Adjustments in 1995-2000 and 2010-2015
(Percent change, year on x-axis)



- Emerging market economies have been moving toward more flexible exchange rate regimes over the past two decades.

Reserves have played a role of a buffer in the 2010-15 slowdown.

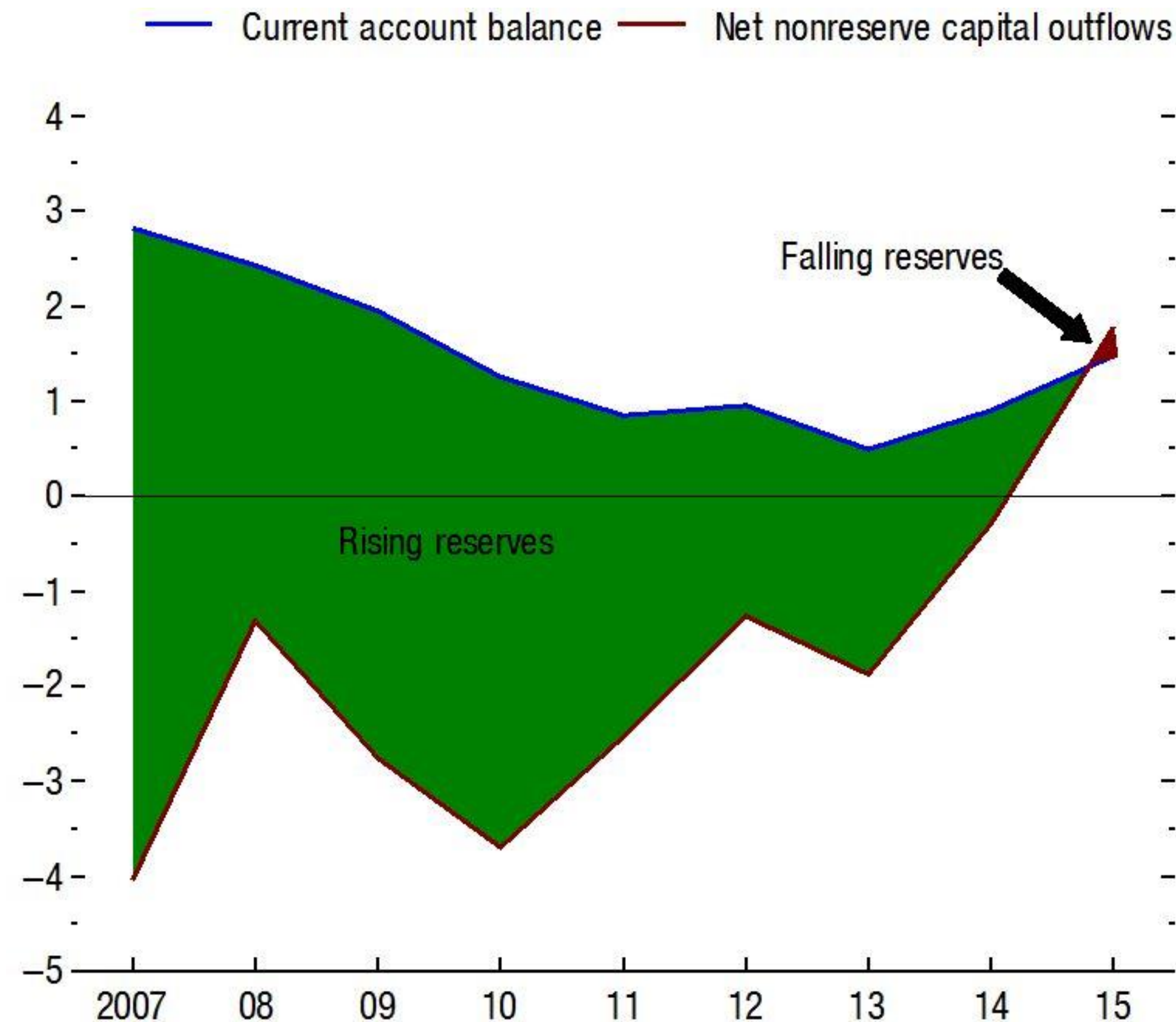
Foreign Reserves and Current Account Balance in Balance of Payments Adjustments
(U.S. dollar per 1 \$ change in net capital inflows)

$$\Delta \text{ Net Nonreserve Inflows} + \Delta \text{ Current Account Balance} + \Delta \text{ Change in Reserves} = 0$$

Episode	Δ Net Nonreserve Inflows	Δ Current Account Balance	Δ Change in Reserves
1995–2000 Net Capital Inflow Slowdown	–1	0.88	0.12
2001–07 Net Capital Inflow Surge	1	0.11	–1.11
2010–15 Net Capital Inflow Slowdown	–1	0.07	0.93
<i>Memorandum</i>			
2013–15 Net Capital Inflow Slowdown	–1	0.18	0.82
2013–15 Net Capital Inflow Slowdown excluding China	–1	0.30	0.70

EMEs continued to accumulate reserves until 2015. CA increased in 2014-15 after a prolonged decline.

Net Capital Outflows and Current Account During the 2010-15 Slowdown(Percent of GDP)



Large depreciations in 2010-15 less prone to banking sector stresses and external crises.

Large Depreciation and Crises during Slowdown Episodes

Episode	Funding Costs (Percent)	G7 Growth (Percent)	Emerging Market Growth (Percent)	Number of Large Depreciations	Number of Large Depreciations Associated with Banking Sector Distresses	Number of External Crises
1995–2000	13.0	3.0	4.7	18	14	11
2010–15	5.8	1.6	5.3	8	3	4

Takeaways from historical comparisons

- Similar size and breadth of slowdown across episodes
- Increased integration into global financial markets
- Decline in “original sin” through lower net external liabilities and increased domestic currency issuance
- Increased role of capital outflows
- Shifts in policy leading to more orderly macro adjustments
 - Foreign reserves as a buffer
 - Increased exchange rate flexibility and more orderly depreciations



**What is driving the recent net capital inflows slowdown
in emerging markets?**

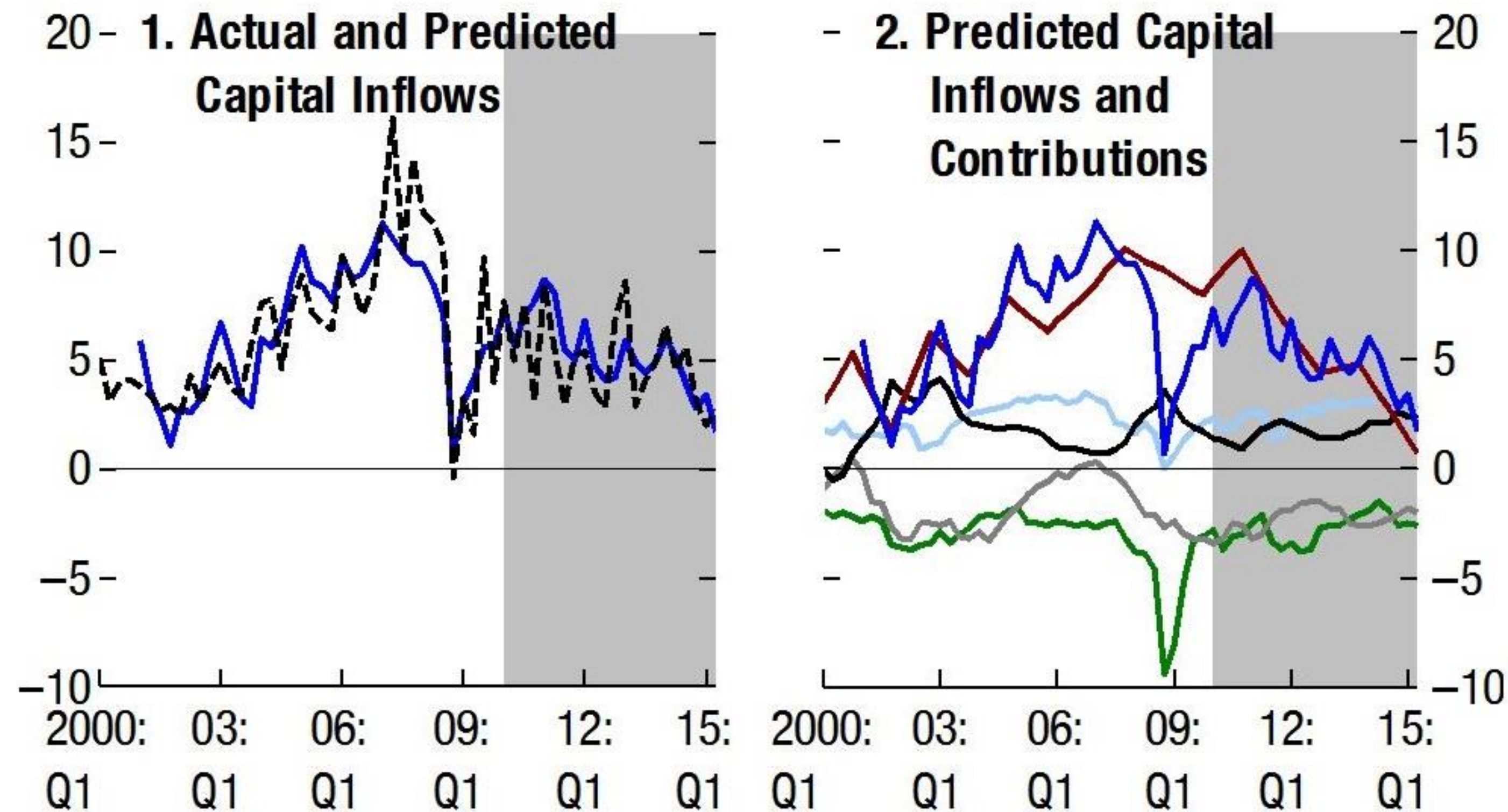
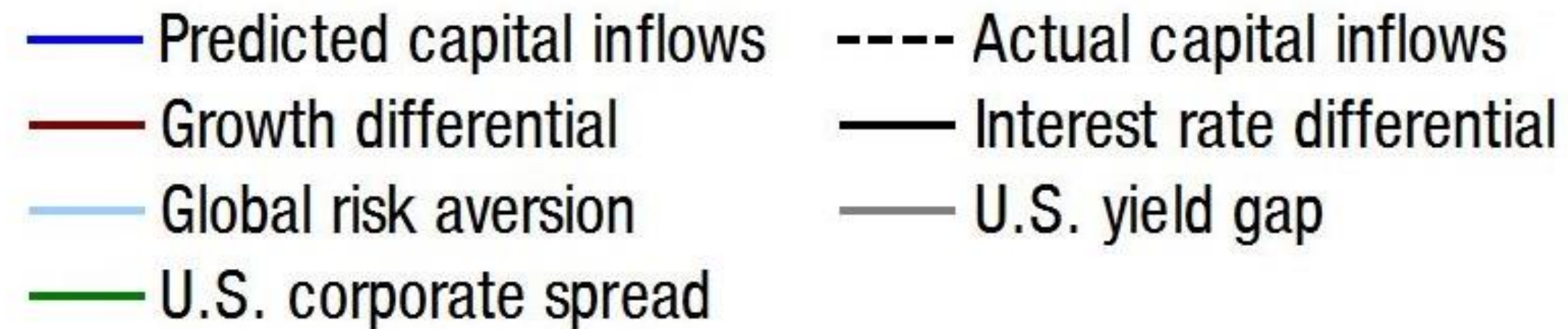
What drives the recent slowdown?

- What drives the slowdown in aggregate flows to EMEs?
 - Growth and interest rate differentials between EMEs and AEs,
 - Investors' risk appetite,
 - U.S. financial conditions,
 - Changes in oil prices
- Are EMEs bystanders to the global financial cycle?
 - Do structural characteristics and policy frameworks matter?
 - Can flexible exchange rates mitigate the slowdown?

The decline in inflows strongly associated with shrinking EM-AE growth differential.

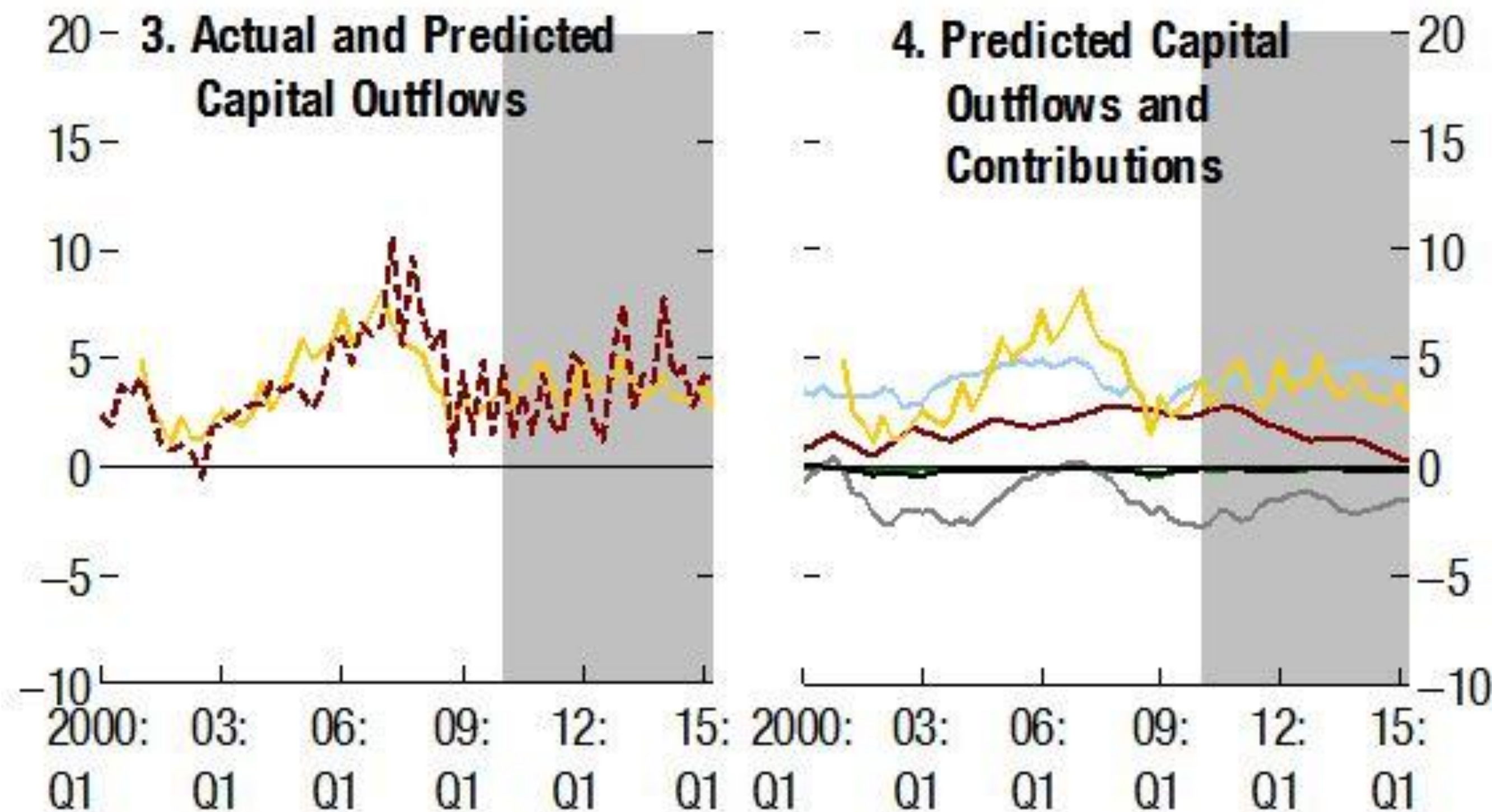
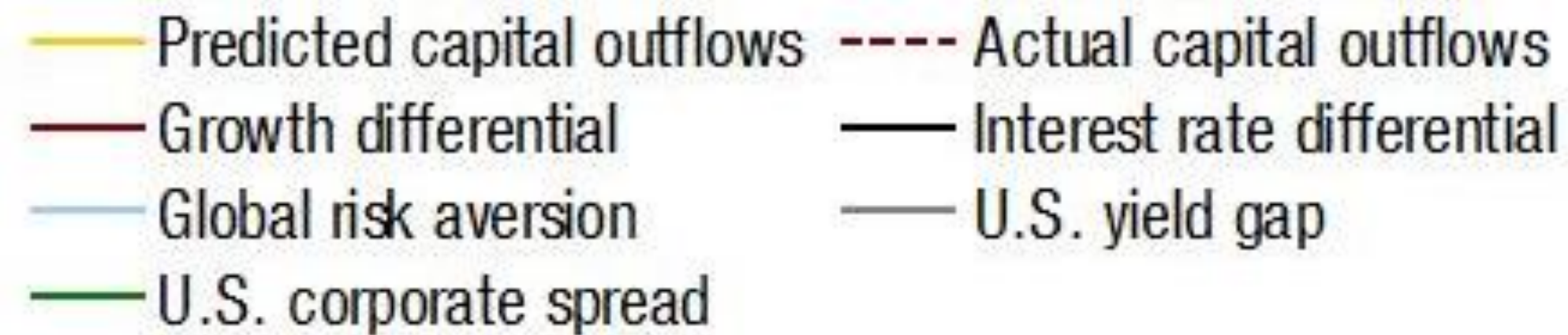
The Role of Global Factors in the Recent Decline in Capital inflows

(2000-15:Q3, percent of GDP)



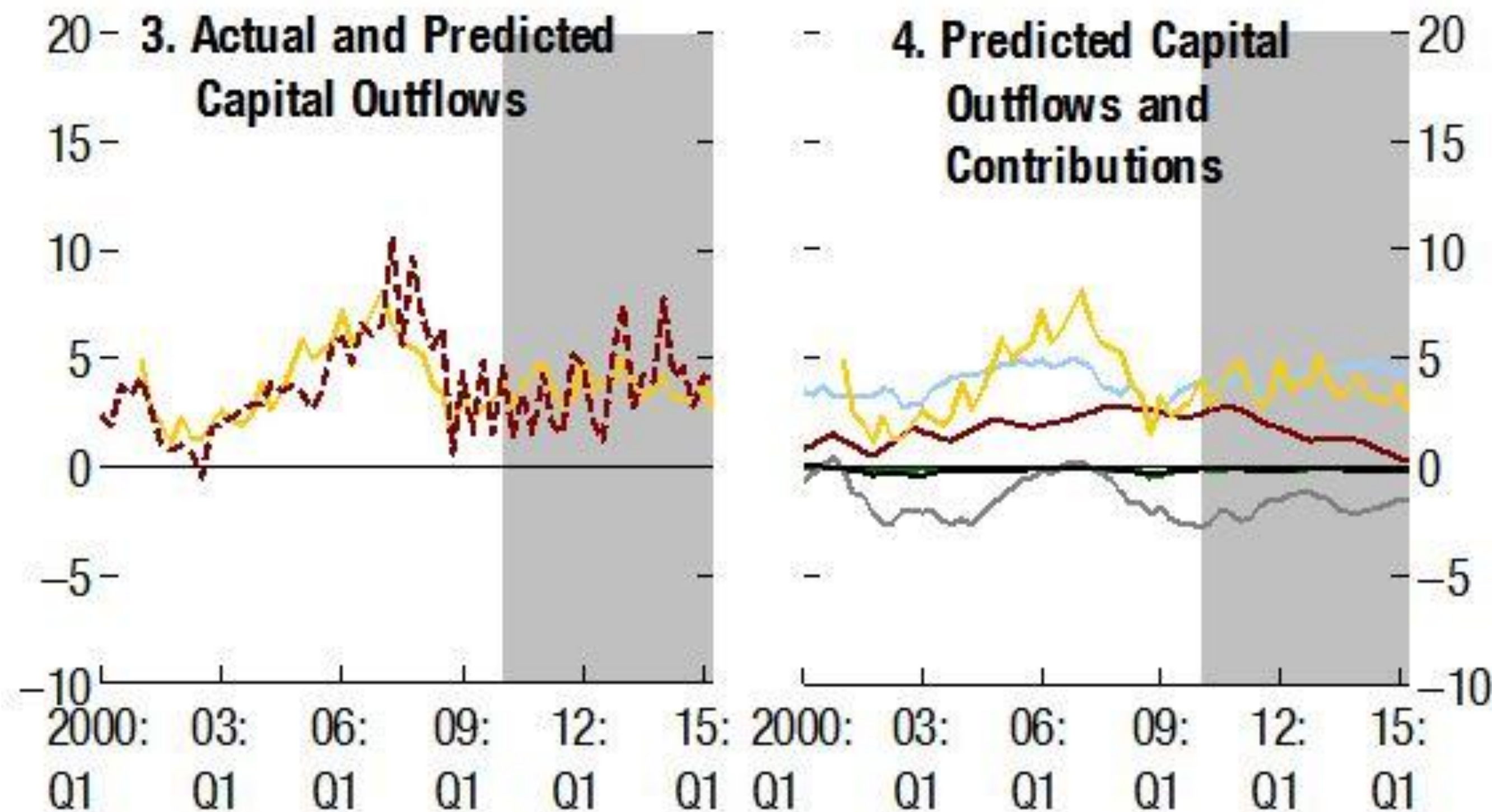
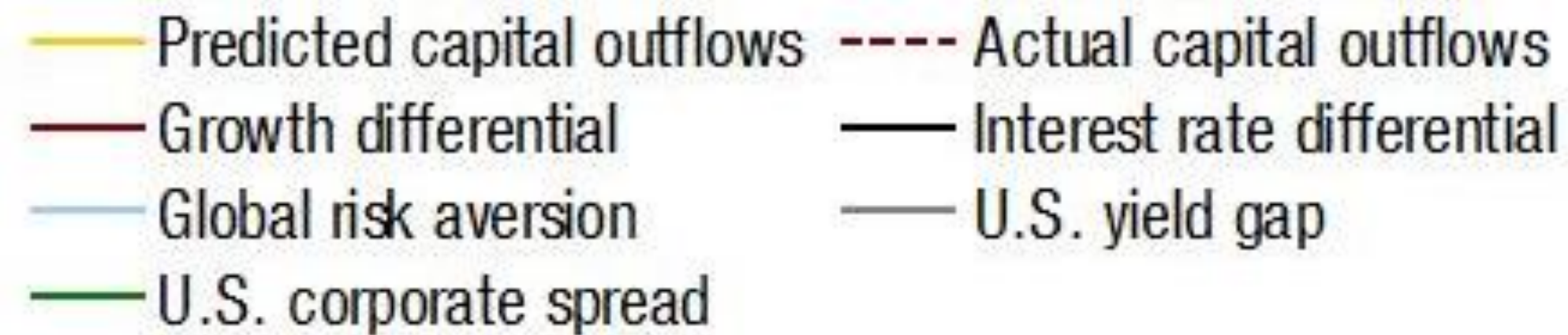
...but outflows remain more difficult to track.

The Role of Global Factors in the Recent Slowdown (Percent of GDP)



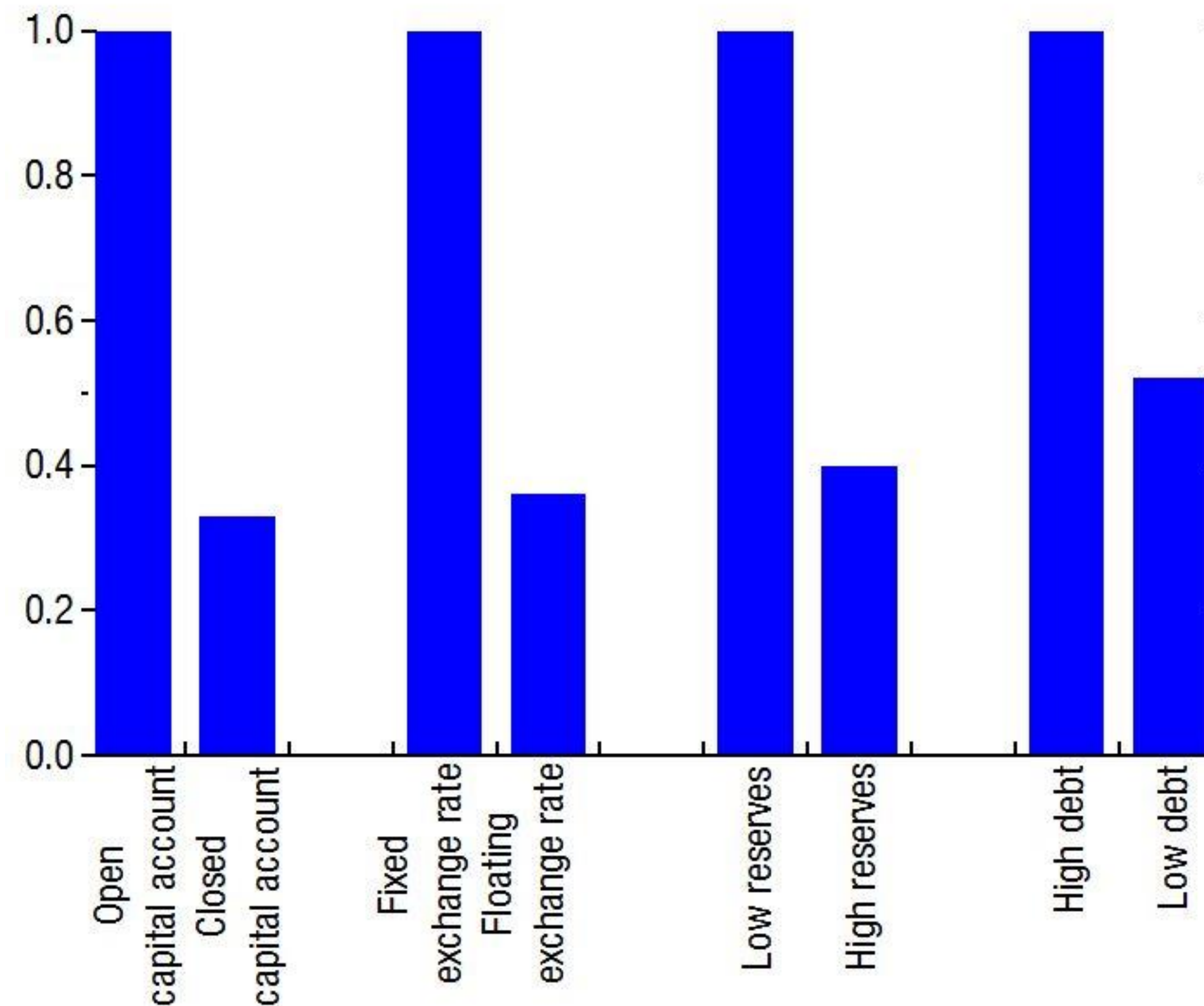
...but outflows remain more difficult to track.

The Role of Global Factors in the Recent Slowdown (Percent of GDP)



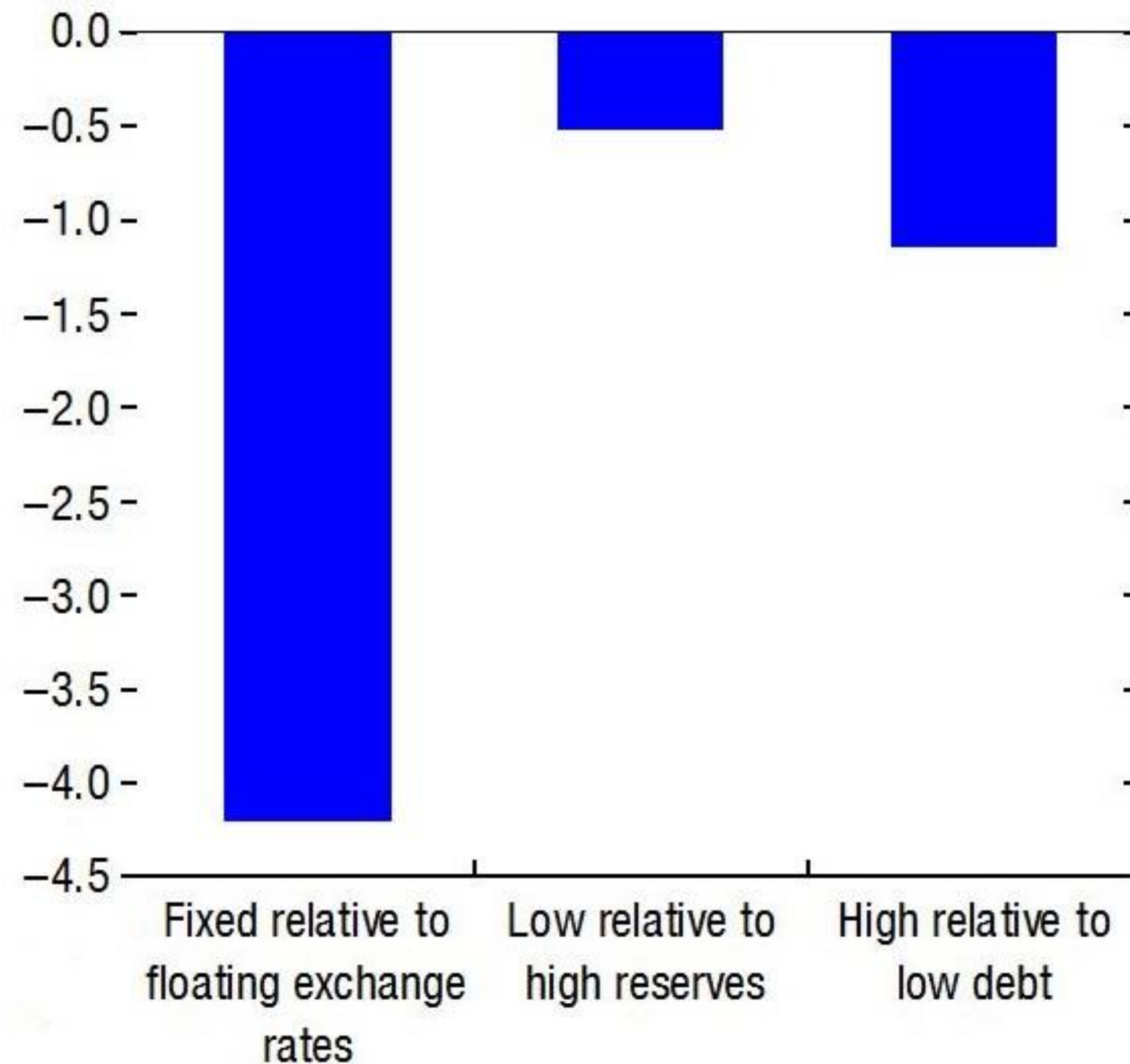
Global factors matter less in countries with floating exchange rates, higher reserves, and lower debt...

Share of Variation in Gross Capital Inflows Explained by Global Factors, 2000-2015



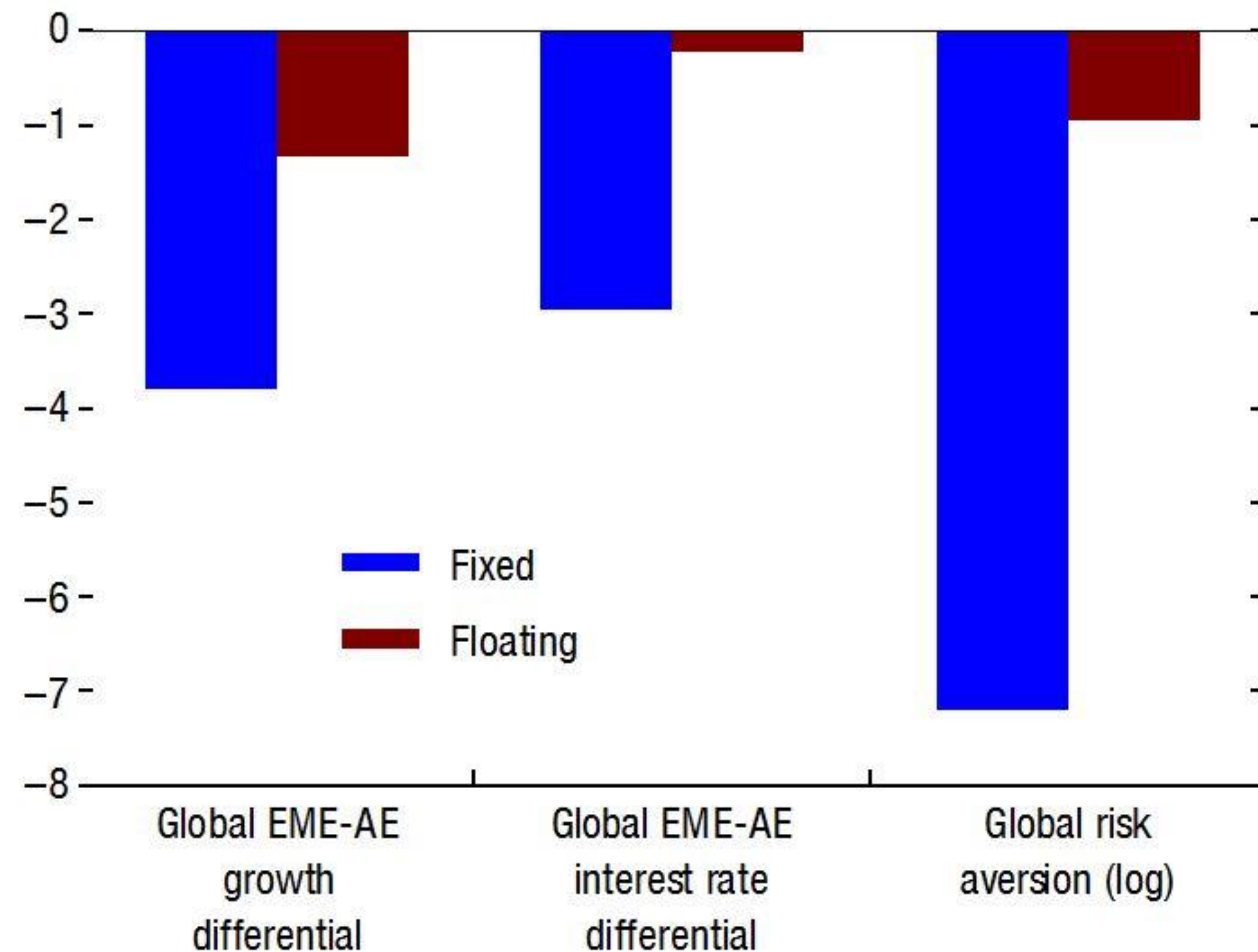
Policy-controlled variables can explain some of the cross-country diversity in experiences during 2010-15.

Differences in the 2010-15 Capital Inflow Slowdown by Country-Specific Characteristics (Percent of GDP)



Exchange rate flexibility also dampened the effects of key global factors.

**Differences in the Contribution of Global Factors
Between More and Less Flexible Exchange Rate Regimes**
(Percent of GDP)



Takeaways

- The EME-AE growth differential shows a close association with capital inflows to EMEs, and can explain the bulk of the 2010-15 slowdown.
- Country characteristics and policy choices also matter:
 - Common factors explain less of the variation in capital inflows in EMEs with more flexible exchange rates, higher reserves and lower debt.
 - Flexible exchange rates have helped mitigate the slowdown associated with a declining growth differential.



Conclusions

Takeaways

- Sizeable slowdown in net capital inflows to EMEs during 2010-15
- In 3/4 of EMEs, broad-based across regions
- Broadly comparable to earlier slowdowns, but...
 - EMEs more financially integrated, bigger role for outflows
 - Higher reserves, used as buffer
 - More flexible exchange rates
 - Lower growth and interest rates in advanced economies
- Slowdown in flows to EMEs strongly associated with shrinking growth differentials
- Flexible exchange rates helped mitigate the slowdown

Policy implications

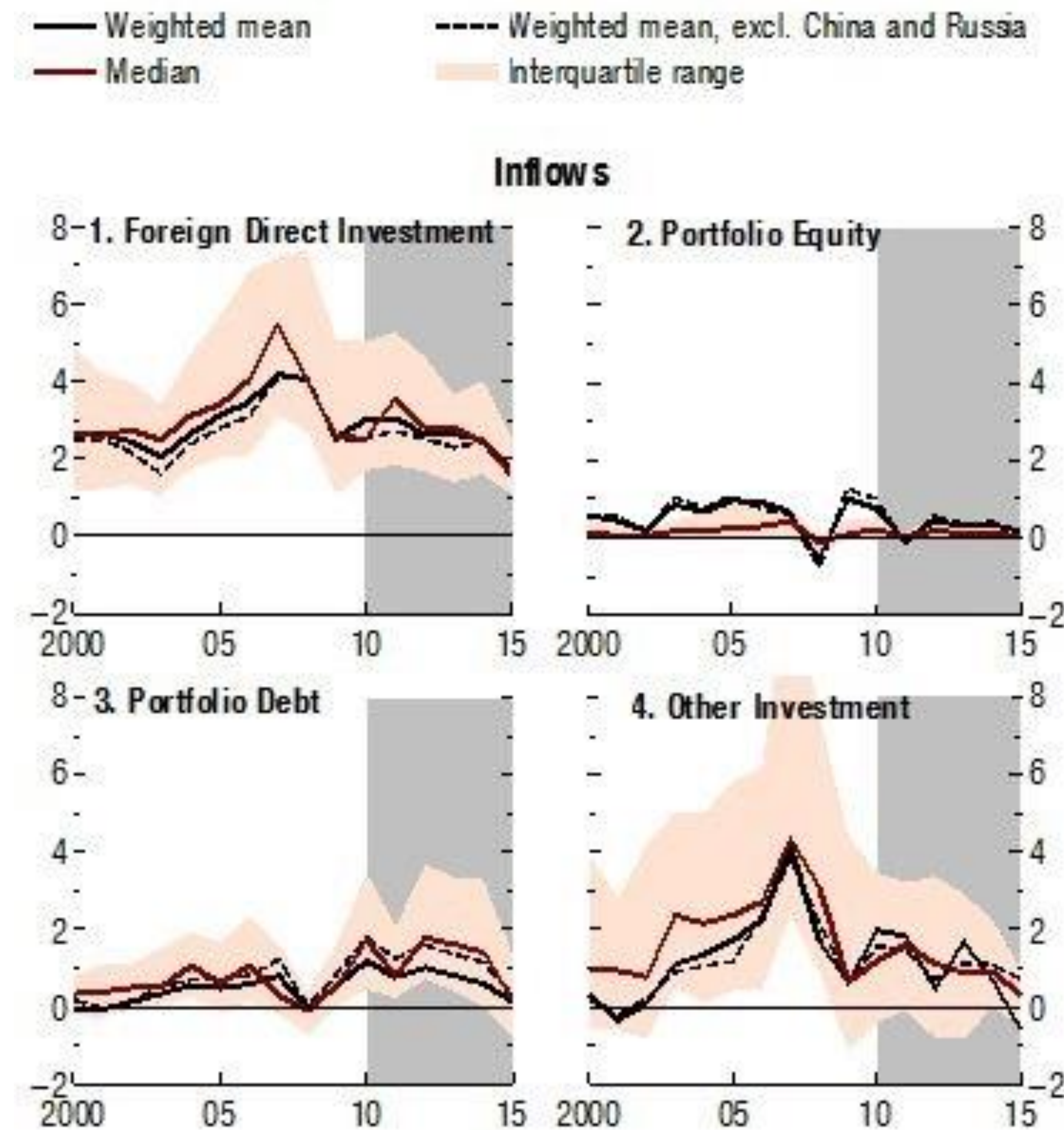
- EME policy frameworks have improved, vulnerabilities reduced
- But persistent narrowing of growth differentials calls for continued policy upgrade
 - Exchange rate flexibility (to cushion shocks)
 - Prudent fiscal policies (to counter higher borrowing costs)
 - Proactive macro-prudential policies (to limit currency mismatches)



Appendix

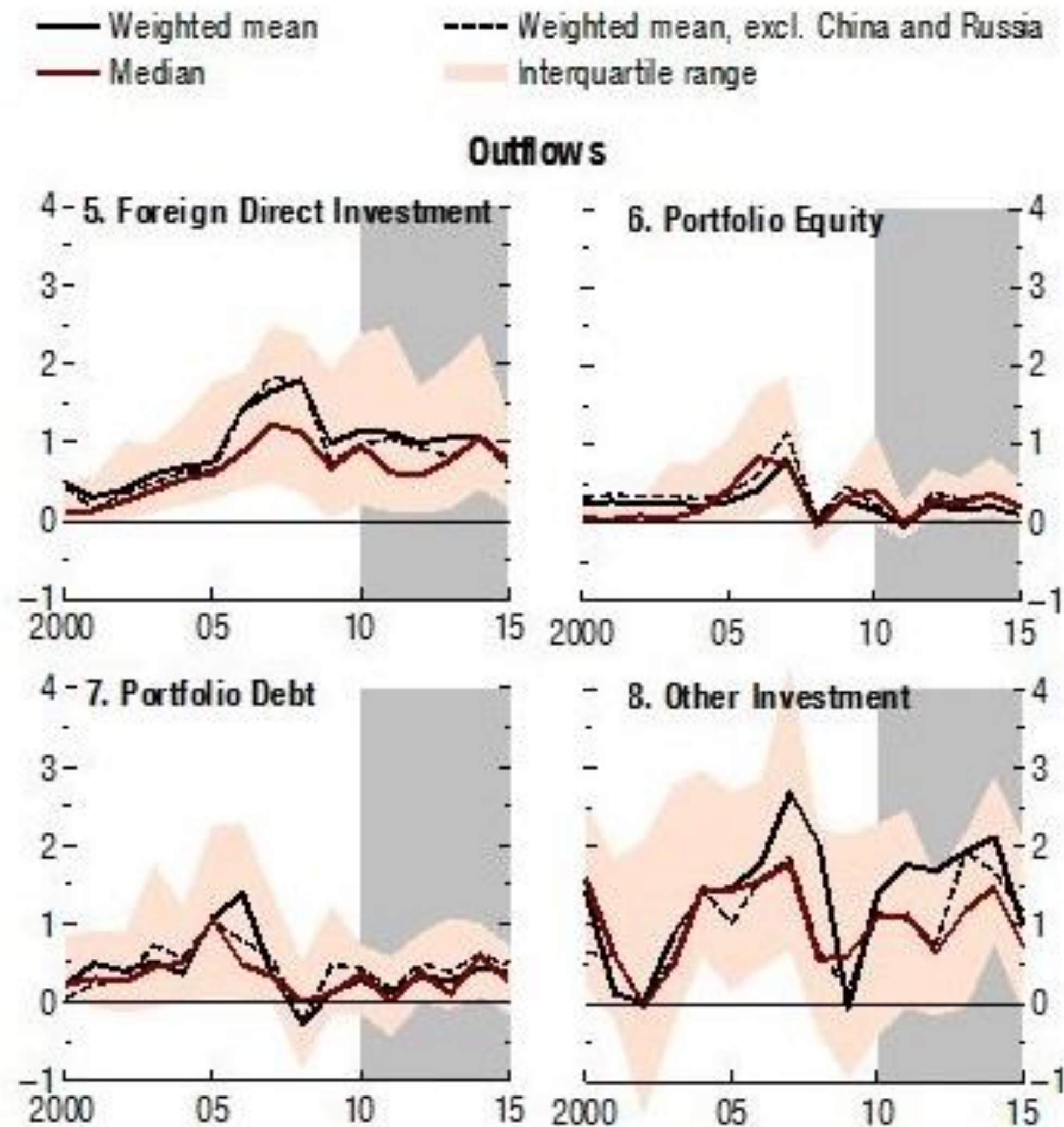
Inflow slowdown broad based across asset types.

Capital Inflows for EMEs by Asset Type (Percent of GDP)



Outflows increased across asset types, except in 2015.

Capital Outflows for EMEs by Asset Type (Percent of GDP)



Slowdown broad-based across regions.

Net capital inflows by Region (Percent of GDP)

