Capital flows to EM: a revival or a dead-cat bounce?

by Lubomir Mitov and Javier Sánchez

After languishing for years, capital inflows into emerging markets (EM) have shown signs of a tenuous recovery recently. In this note, we try to identify its drivers and establish whether it is sustainable.

The flow pattern has changed since the 2009 crisis. While FDI has remained stable, cross-border bank lending has slumped and portfolio debt inflows have risen.

Growth, trade and commodity price developments seem to be the key long-term drivers for capital inflows.

Ultra-low global interest rates and ample liquidity have supported portfolio debt flows until recently, while tighter regulation has restrained bank lending.

Despite diminished EM C/A surpluses and weaker fiscal positions, resident outflows have been on the rise, leaving EM net creditors to the rest of the world. This, if sustained, could hamper growth and spur market volatility in EM.

Stronger FDI and bank lending as the global outlook has improved should result in a sustainable, even if modest, recovery in private inflows. On the other hand, portfolio flows volatility is likely to increase. A return to the pre-2008 levels is unlikely with globalization in reverse.

The withdrawal of global monetary accommodation and the potential rise in protectionism in the US are the key downside risks. Countries with high C/A deficits and dependence on portfolio inflows would be most exposed.

Capital inflows into EM: a roller-coaster ride

Capital flows into EM have undergone major transformations over the last 15-20 years. Cumulative inflows of foreign private capital into EM reached USD 1tn1 over the last decade, more than three times as much as the USD 3.2tn during the preceding decade. However, the magnitude, composition and direction of capital flows varied widely over this period, with major shifts since the global financial crisis. In this note, we analyze these trends and capital flow composition, their drivers, and present the near-term outlook and risks for EM stemming from the anticipated policy changes in the major advanced economies.

Looking back to the turn of the century, we identify three distinct periods of evolution of capital flows into EM. In the run-up to the global financial crisis, from about 2003 until the 2008 crisis, EM experienced a surge to levels never seen before (or after – chart 1). At their peak in 2007, foreign private capital inflows reached USD 1.2tn, or 8.5% of EM aggregate GDP. After a crisis-induced drop by roughly one-half in 2008-2009, private inflows surged again to more than USD 1tn a year during 2010-2013, but remained lower relative to GDP at 5.0-6.5% of GDP. This recovery, however, proved short-lived, with inflows dropping to 2-3% of GDP since 2014, back to their level at the start of the century.

CHART 1: PRIVATE CAPITAL FLOWS INTO EM (% OF WORLD GDP)

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The 2000-2008 boom: driven by fundamentals

Capital-flow developments appear to have been mostly driven by the evolution of certain global trends as well as economic fundamentals. However, since the 2008-2009 crisis, economic policies in the advanced economies and changing risk perceptions have gained in importance. The impact of the various factors on the different components of capital inflows has evolved differently over time as well.

Most of the extraordinary pickup in foreign capital inflows into EM during the previous decade is likely to have reflected the major advances in trade and financial globalization in the years leading to the 2008-09 crisis. During 2000-08, global trade was expanding at an annual average rate of 7%, much faster than the 4.3% world GDP growth. For EM, the expansion in trade was even faster, on the order of 11% p.a. As a result, the degree of openness of the EM economies expanded significantly, with the share of foreign trade in GDP surging to 55% in 2008 from 45% in 2000.

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1 Net incurrence of FDI, portfolio and other investment liabilities to non-residents excluding IMF lending. See the Methodology and Data section.
The expansion in trade flows was accompanied by a major rise in associated capital flows such as FDI, trade credit and commercial bank cross-border lending. However, deepening financial globalization during these years additionally reinforced these flows. Capital accounts liberalization, the opening of local financial markets to foreign investors and the expansion in investable securities led to a marked increase in financial deepening. The share of EM banks’ domestic assets in GDP (excluding China) rose from about 48% in 2002 to a peak of 56% in 2008. In USD terms, banks’ domestic assets rose 2.6 times over the same period.

These developments have been facilitated in part by major political changes. First and most important, the rise of China as the world’s “workshop” was associated with a massive relocation of production capacities, which led to a surge in FDI and other trade-related flows. Second, the completion of the transition in Eastern Europe and the accession to the EU of 10 CEE countries in 2004-2007 was associated with massive FDI inflows as Western European producers shifted production to the region and foreign investors betted on swift convergence. Cross-border bank lending, mainly by EU banks, surged as foreign banks entered the underdeveloped CEE financial markets with new products. Not surprisingly, the pace of the financial deepening in CEE was much faster in 2002-2008 than in any other EM region.

**CHART 2: PRIVATE CAPITAL FLOWS DRIVEN BY EM GROWTH**

Looking at the potential drivers of capital flows, we see significant correlation with economic growth, global trade and commodity prices. These linkages appear to have been strongest for FDI, trade credits and bank lending. While there definitely is also a reverse correlation between financial flows and growth, given the lags associated with the return on investment, it seems that growth prospects have been the key driver behind the 2000-2008 surge in capital flows. On the other hand, we found little evidence during this period of significant correlation with global interest rates, US monetary policy and relative yields.

**The post-crisis adjustment: a structural shift?**

However, the patterns, structure and the driving forces of capital flows seem to have undergone significant changes since the global financial crisis. We observe a sharp decline in cross-border bank lending that is only partly offset by a surge in portfolio debt inflows. FDI has remained largely resilient, and portfolio equity inflows volatile.

Indeed, FDI remains the mainstay of private foreign inflows into EM – both before and after the 2008-09 crisis. FDI inflows have been broadly steady over the last 20 years at 2-4% of GDP, accounting for around two-thirds on average of private capital inflows (chart 3). While FDI inflows have eased somewhat after the global financial crisis, in line with the decrease in global growth and investment demand, they have remained resilient even in downturns, reflecting the long-standing production and technological links between foreign investors and the recipient countries. FDI inflows have been particularly resilient in the CEE EU members, where they have averaged 3% since 2009, thanks in part to their deepening integration in the EA production chains.

**CHART 3: FDI IS THE MAINSTAY OF CAPITAL FLOWS INTO EM (IN USD BN)**

Unlike FDI, other components of capital inflows have been more volatile. Portfolio equity inflows peaked just before the crisis, but have remained subdued, at just 0.2-0.4% of EM GDP since. Part of the post-crisis reduction likely reflects weaker global growth, but it seems that, especially post-2012, relative equity prices played a bigger role. Moreover, the drop in commodity prices since late 2014 has further widened the already sizable gap between the US and EM stock markets performances, further cutting portfolio equity inflows.
The latter have been more significant and stable in Latin America and Asia, both of which have deeper stock markets and larger pools of investible companies. In CEE, by contrast, portfolio equity inflows play a much smaller role given underdeveloped markets, except for Turkey and Russia.

Portfolio debt is the one component of capital flows that has gained momentum since the 2009 crisis. After languishing at less than 0.5% of EM GDP through most of the pre-crisis years, portfolio debt inflows surged to 1.2-1.8% of GDP during 2010-2013, only to fall sharply to less than 0.4% of GDP in 2014-2016 (chart 4). In geographical terms, Latin America reported by far the highest and most stable portfolio debt inflows (some 30-40% of the total), followed by a large margin, by CEE and Emerging Asia.

CHART 4: PORTFOLIO INFLOWS UP BUT VOLATILE (IN USD BN)

With the trend in portfolio debt flows at odds with economic fundamentals, we think the post-2009 increase was driven by the search for yield triggered by the unconventional monetary policy in the advanced economies. There seems to be a correlation between portfolio debt inflows into EM and the size of the combined balance sheets of the major central banks (US, EU and Japan) as a proxy for global liquidity (chart 5). There also appears to be a reverse correlation with the real Fed funds rate (lower real Fed rate is correlated with higher portfolio debt inflows) after 2010. On the other hand, we see no meaningful correlation with actual USD-adjusted returns across foreign and local-currency bonds or stocks.

Policy intentions in the major advanced economies seem to matter as well (even if not resulting in a material change in the policy stance), along with geopolitics. The taper tantrum in 2013 seems to have resulted in sustained reduction in portfolio debt inflows (even though the actual tightening began only in late 2015), as has the drop in commodity prices since 2014, probably due to currency depreciations triggered by it. The imposition of financial sanctions by the EU and the US over Ukraine in 2014 has also resulted in major portfolio debt outflows from Russia that have begun to reverse only recently. Finally, concerns about growth and a weaker RMB have triggered significant outflows also from China since 2014.

On the other hand, bank lending has been the main culprit of the 2009 crisis. After surging to 3-4% of GDP during 2005-2007, at the height of the globalization drive, cross-border bank lending slumped to 1-1.5% of GDP post-2009 and, in 2014, shifted to net outflows (chart 6). While the 2014 outflows seem to have been triggered by geopolitical factors (the Russian sanctions) and worries about China and are likely to reverse, there are also more fundamental factors for the sustained decline in cross-border bank lending. In fact, banks have been hit by a “perfect storm” since the global financial crisis. On one hand, banks’ ability to lend was severely constrained by capital and liquidity problems in the aftermath of the financial crisis, which have just recently begun to ease. More importantly, borrower demand has collapsed, too, as both companies and households deleveraged in an effort to repair balance sheets, while sluggish growth and stagnant trade limited credit demand.
Finally, tighter regulations have made it more difficult and costlier to lend to EM, even to wholly-owned subsidiaries. In Europe, for example, parent banks have to include the sovereign credit risks (measured by the CDS spreads) in what they charge their local affiliates. Given ample liquidity at home, low credit demand and the availability of much cheaper finding sources, foreign-owned banks in CEE made significant net repayments to their parent banks post-2009. Higher capital charges and other risk-mitigating rules have also discouraged lending to high-risk borrowers such as EM.

EM as net creditors – a new normal?

Unlike capital inflows, outflows of private resident capital from EM have followed a completely different trend. After sharply correcting during the financial crisis, these outflows settled at 3% of GDP by 2010 – this is still above their 2000-06 average. Unlike foreign inflows, private resident capital outflows have gradually risen since 2010 both in USD terms and relative to GDP (chart 7). While there was some rise in outward FDI and equity investment (mainly reflecting stepped-up investment abroad by China), the increase was centered on other items (the accumulation of foreign assets by EM banks, trade credits and project financing) as well as unidentified items reported as errors and omissions. At least some of these outflows likely reflected stepped-up capital flight.

The diverging trends between foreign inflows and resident outflows have shifted the EM private sectors’ external position from that of a net debtor to that of a net creditor. In net terms, private flows shifted from inflows averaging roughly 2% of GDP from 2003 through 2012 to outflows of a similar magnitude during 2014-16.

We have been unable to identify a plausible economic reason for this major shift. Growth prospects, interest rates and yields in EM remain significantly higher than those of advanced economies. Moreover, the shift to net private outflows took place at a time when the EM aggregate C/A position shifted from surpluses to the order of 2-4% of GDP through 2012 to broad balances since 2014 – this shift partly reflects the drop in commodity prices but also smaller C/A surpluses in Asia and especially in China.

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\(^2\) Net increase in foreign assets by EM residents
All else being equal, the erosion in the C/A surpluses (and the drop in export revenues that underpinned it) ought to have reduced private capital outflows. However, the EM C/A deterioration has not affected private outflows but has rather led to a sharp drop in reserve accumulation – and even to its reversal in 2015-16.

**CHART 9: EM INTERNATIONAL INVESTMENT POSITIONS AS % OF WORLD GDP BY REGION**

When official outflows such as the accumulation of reserves are included, the EM’s net creditor position has decreased from a peak of 3-4% of GDP in the run-up to the global financial crisis to 1-1.5% of GDP since 2011 (chart 8).

A look at the evolution in the international investment positions by regions (IIP) shows that the main source of the surge in resident capital outflows is China, along with Russia and Latin America, while the other regions have had broadly stable and improving IIP (chart 9). Although in China, the jump in outflows likely reflected growing worries about a potential slowdown in growth and a weaker currency, in Russia and Brazil, it likely reflected political uncertainty. In all three countries, outflows rose despite shrinking C/A surpluses and falling capital inflows, leading to a significant loss of reserves.

Looking forward – a gradual recovery but no rebound

Looking forward, we see conflicting trends that could have opposing impacts on capital flows to EM. On the positive side, global growth looks set to firm somewhat in both advanced and EM economies. The IMF projects global growth will pick up from 3% in 2016 to 3.8% in 2018-20. EM growth is expected to accelerate similarly, from 4.2% to close to 5% over the same period. EM fixed-investment growth should gain momentum as well, from less than 2% in 2015 to close to 5% by 2018 and beyond. Finally, global trade is expected to recover as well, with growth accelerating to 4% by 2018, from 2-2.5% in 2015-16 and commodity prices stabilizing, albeit at moderate levels.

All of these are encouraging signs – however, they are a far cry from their pre-crisis pace. The revival in growth and trade ought to bode well for FDI (both in equity and intercompany lending) as well as trade credit and project financing. We expect FDI inflows to gradually return to the 2.5-3.0% range that prevailed throughout most of the past two decades.

The improving growth and trade outlook, along with the wrapping-up of the post-crisis deleveraging and balance-sheet clean up, ought to provide some upside to cross-border bank lending. However, this upside is likely to be constrained by regulatory restraint. Unless the current regulatory framework is made less restrictive, banks will remain risk-averse, with the potential increase in exposures limited to the countries with the lowest risk perceptions, such as those in CEE and perhaps Latin America. China, by contrast, is likely to remain a drag on cross-border bank lending given its need to slow excessive credit growth. We expect cross-border bank lending to recover somewhat but to remain subdued at 1-1.2% of GDP over the next few years.
The biggest uncertainties are related to portfolio inflows (both equity and debt). Our analysis suggests that both are driven mainly by development and policies in advanced economies. The recent rally in the US equity market has given a lift to EM equities, and the risk-on environment following Donald Trump’s election as US president has led to a recovery in portfolio debt inflows (chart 10). Nevertheless, doubts concerning its sustainability remain. The latest bout of optimism has been driven by expectations surrounding major fiscal stimulus by the Trump administration, which appears less likely to be passed anytime soon in its original form. Therefore, potential disappointment with the US policy agenda might well trigger a major market correction, which would affect EM as well – even though EM equities appear to be fairly valued at present.

With regard to portfolio debt flows, monetary policy developments in the world’s main advanced markets are likely to remain key. With the Fed already in the process of normalizing monetary policy and the ECB likely to announce the onset of tapering, perhaps by September, global liquidity conditions will tighten and core bond rates will rise. Key in this respect would be the pace of US rate hikes and when the Fed will start reducing its balance sheet. The combination of ongoing and prospective monetary tightening and a widening fiscal deficit in the US (assuming fiscal stimulus is eventually passed) could have a significantly adverse impact on EM bond markets. At a minimum, EM costs of borrowing will likely rise, but a reorientation of flows from EM bond markets to core markets cannot be ruled out. However, monetary stimulus appears to have benefitted stocks from developed markets more so than stocks from EM, and the former may be more at risk from a potential liquidity reversal.

The anticipated opening of the Chinese bond market poses another uncertainty. Except for the onshore Chinese bond market, most stocks and bonds worldwide are already investable. The Chinese onshore bond market represents, in this sense, the next frontier in terms of foreign investors’ investing in bonds. Chinese issuers already have USD 120bn of debt outstanding in the international markets, but opening the onshore market may lead to substantial foreign inflows.

According to the Bank for International Settlements (BIS), there is USD 9.2tn of domestic bond debt outstanding in China as of 3Q16. Of this, only Treasury bonds and bonds issued by policy banks would be eligible for inclusion in the major local-currency bond indices. Chinese bonds are already included in several global and EM bond indices, such as those of Bloomberg-Barclays since March 2017, and they are about to be included in the Citigroup local- and EM indices. JPMorgan, the other major index provider, has not officially stated whether these bonds will be included in the GBI-EM indices. These index inclusions could give rise to inflows well in excess of USD 100bn into the Chinese onshore market. This is equivalent to the last decade’s worth of debt portfolio investment into China and about 10% of average annual private flows to EM over the last decade. Estimates reported in the media are as high as USD 250bn, but we expect the adoption of the China indices to be slow, as the market is relatively underdeveloped and yields are not attractive.

CHART 12: CHINESE DOMESTIC SECURITIES OUTSTANDING BY ISSUER TYPE (IN USD BN)

Source: BIS securities statistics and UniCredit Research

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Even after their inclusion, the obstacles these bonds are likely to face with respect to the repatriation of proceeds and the low liquidity of hedging instruments may slow inflows.

**Cautious optimism, beware of the risks**

To summarize, we expect a sustained but only gradual rise in capital flows led by FDI and a tenuous recovery in bank flows. Portfolio equity flows will remain volatile, driven mainly by developments in the advanced economies, while portfolio debt inflows are likely to come under pressure as global liquidity tightens and interest rates rise. In any case, private capital inflows into EM will remain well below the 2005-2008 highs for many years to come. On the other hand, resident capital outflows will remain buoyant with little evidence of the sweeping institutional and structural reforms needed to appreciably improve business environments and geopolitical tensions likely to persist.

Under these circumstances, CEE-EU ought to be in the best position among EM – benefitting from solid FDI and the global rebound in growth and trade while being least vulnerable to external shocks. This resilience is rooted in the region’s large extended basic balances, the availability of some 2-3% of GDP a year in EU fund receipts until 2020, and absent macroeconomic imbalances. While a potential sell-off in the bond markets would have some impact on bond prices, CEE-EU remain among the most resilient EM.

Russia also looks mostly resilient to a potential bond sell-off given large FX reserves, low government debt, only moderate external debt repayments (thanks, in part, to the major debt repayments in the wake of the EU/US financial sanctions imposed in 2014-2016) and prudent economic policies that have enforced a painful but important adjustment to lower oil prices.

On the other hand, countries with large current account deficits, limited FX reserves and heavy reliance on portfolio inflows for financing are likely to be most exposed. Turkey stands out as perhaps the most vulnerable EM, along with South Africa and Brazil. Misplaced policies in all three countries are likely to limit their resilience to external shocks and leave their financial markets vulnerable.

In conclusion, capital inflows generally tend to be positive for EM as they complement domestic savings, helping to boost investment and growth. However, much depends on their composition and use. FDI, in particular, especially if invested in tradables, tends to be most stable and growth-positive as it underpins long-term production links and is rarely subject to reversal.

Cross-border bank lending can play a positive role as well, especially if it is associated with advancing financial deepening in the respective EM. In this respect, capital flows to CEE have been particularly beneficial during the transition by advancing privatization, technological modernization and the creation of modern financial systems.

However, capital inflows may also be a source of significant risk and imbalances. Excessive inflows, if invested in non-tradables or real estate, can lead to asset bubbles (such as Latvia in 2008-2009) or cause an unsustainable currency appreciation. This is particularly relevant for portfolio inflows, given their volatility and ease of reversal. A sudden stop or unwinding of portfolio inflows could lead to sharp market corrections and abrupt depreciations and, in some cases, even threaten financial stability, especially in countries which depend on volatile portfolio inflows for financing large C/A deficits.

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Data sources and methodology

We construct regional aggregations for each of the major components of the Balance of Payments and International Investment Position for 43 major emerging market countries for which there is available data.

We use two main data sources: the IMF Balance of Payments and IIP Statistics data which is reported on annual and quarterly frequencies mostly under BPM6, and the latest updated IIP dataset as of February 2016 compiled by Lane and Milesi-Ferretti (2007) which is reported for most countries on annual frequency starting in 1980.

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6 The sum of the C/A balance, net FDI and net EU funds receipts

In order to construct an as-large-as-possible consistent annual dataset, we extend the IMF annual data in two ways: quarterly data, if available, are used for completing the data for 2016 if the full year has not been reported and the Lane and Milesi-Ferretti dataset is chained for obtaining a longer historical IIP data series after selecting an appropriate chaining year in order to minimize breaks. The main categories we are interested in provide a disaggregated view of the external asset and liability portfolio, FDI, reserves and other investment positions in terms of their stock (IIP) and flow (BOP) values.

We then retain those countries with long historical data for each of the IIP and BOP major categories in order to have a representative and balanced EM aggregate sample. We settle for 45 EM countries (including Korea, Singapore and Hong-Kong) which each have between 15 and 36 years of annual data available for the major IIP and BOP categories. Hong-Kong, China and Singapore are analyzed separately as the size of their flows and external assets and liabilities dwarfs that for other emerging markets and are thus not included in the Emerging Asia category. However, we include South Korea as part of Emerging Asia even if it has transitioned from emerging to industrialized.

As a cross-check, we match our emerging market aggregate with that provided in the IMF WEO database and find an adequate degree of overlap, with the advantage that our dataset extends the data both historically and in terms of the category disaggregation compared to that available in the WEO database.

### Regional aggregates by country ISO3 code

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