A brief global outlook and analysis of the factors that will affect capital flows to emerging markets


Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation (COMCEC)
COMCEC Coordination Office

An overview of capital flows in COMCEC Member States:
The state of play and barriers and opportunities for enhancing capital flows in COMCEC countries

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The US, euro zone and Japan will all be growing in 2014

US: Stronger growth; risks to the upside in 2014

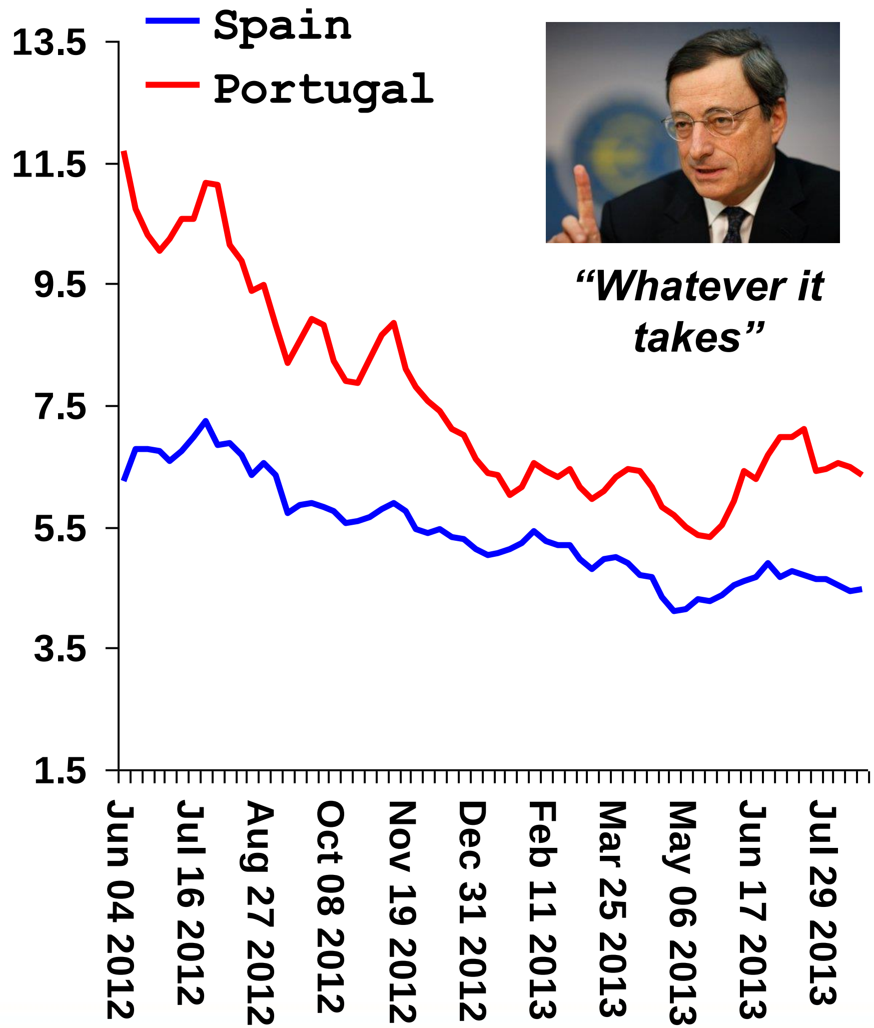
From GDP growth of 1.6% this year to around 2.6% next year.

- US resilient in 2013 to large fiscal drag
- Labour market recovering
- Wages/manufacturing are competitive
- Housing is supporting the recovery
- Energy supply/cost advantages boosting industry

GDP, % change, real terms. Source: Economist Intelligence Unit

Euro zone: Is the worst of the crisis over ?

- ECB´s OMT programme eased peripheral funding markets and cut risk of break-up
- Eurozone emerged from recession in Q2
- Adjustment in external accounts and unit labour costs in periphery but a hard slog to restore competitiveness and solvency
- Structural reforms to consolidate eurozone
  - Little progress on banking union, debt mutualisation
- Greece will need more cash (will IMF agree with EU's debt sustainability analysis?)
- Portugal will need another loan programme

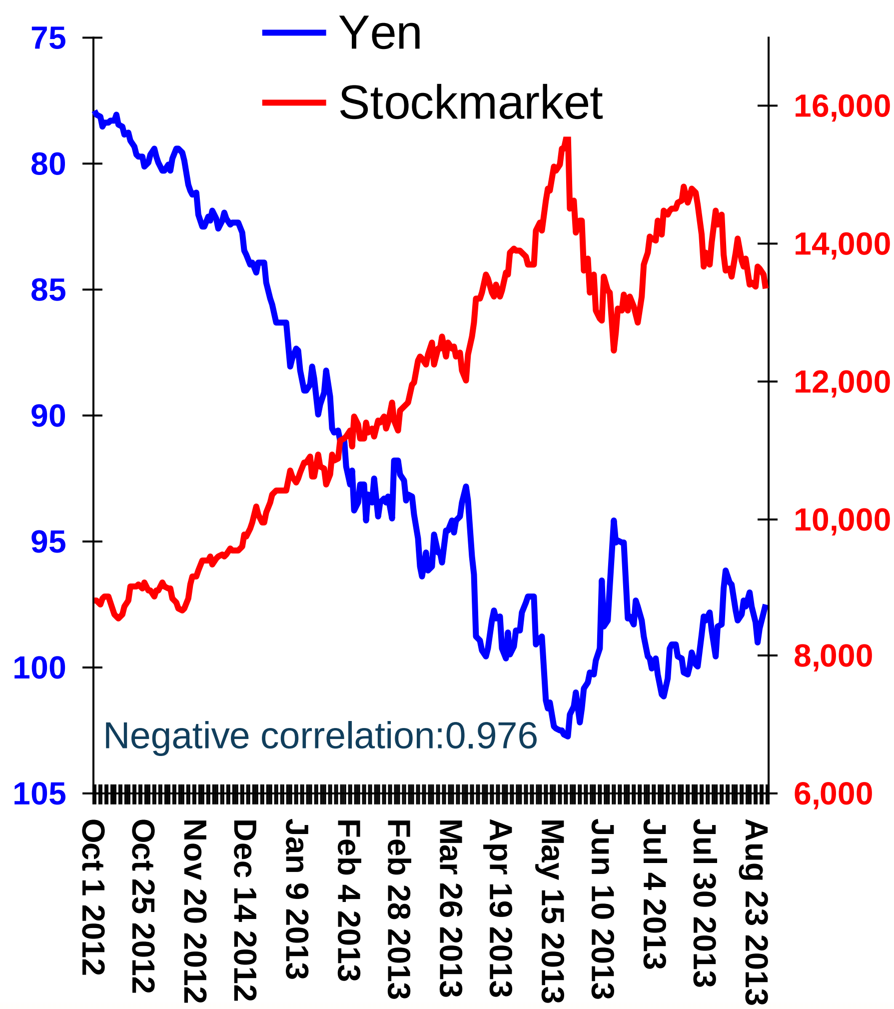


"Whatever it takes"

10-year government bond yield, %. Source: Haver

Japan: A bold policy experiment

- Abe has introduced bold steps to reverse two decades of deflation
- "Abenomics"—fiscal stimulus, structural reforms and central bank money-printing
  - ➢ Double monetary base in 2 years
  - ➢ Twice as much easing as the US Fed, as share of GDP
- Initial results?
  - ➢ Strong GDP growth in 1st half
  - ➢ Depreciation of Yen
  - ➢ Deflationary pressures abating
- Political feasibility of structural reforms ?



Yen:US$1, lh scale; Nikkei 225 stockmarket, rh scale. Source: Haver Analytics

China: slower, more balanced growth

Central forecast

Decline in trend growth rate to 7.7% this year, 6% by 2017

Rebalancing away from fixed asset investment towards consumption

- Entering a less commodity-intensive phase of development

New leadership has announced reforms to address

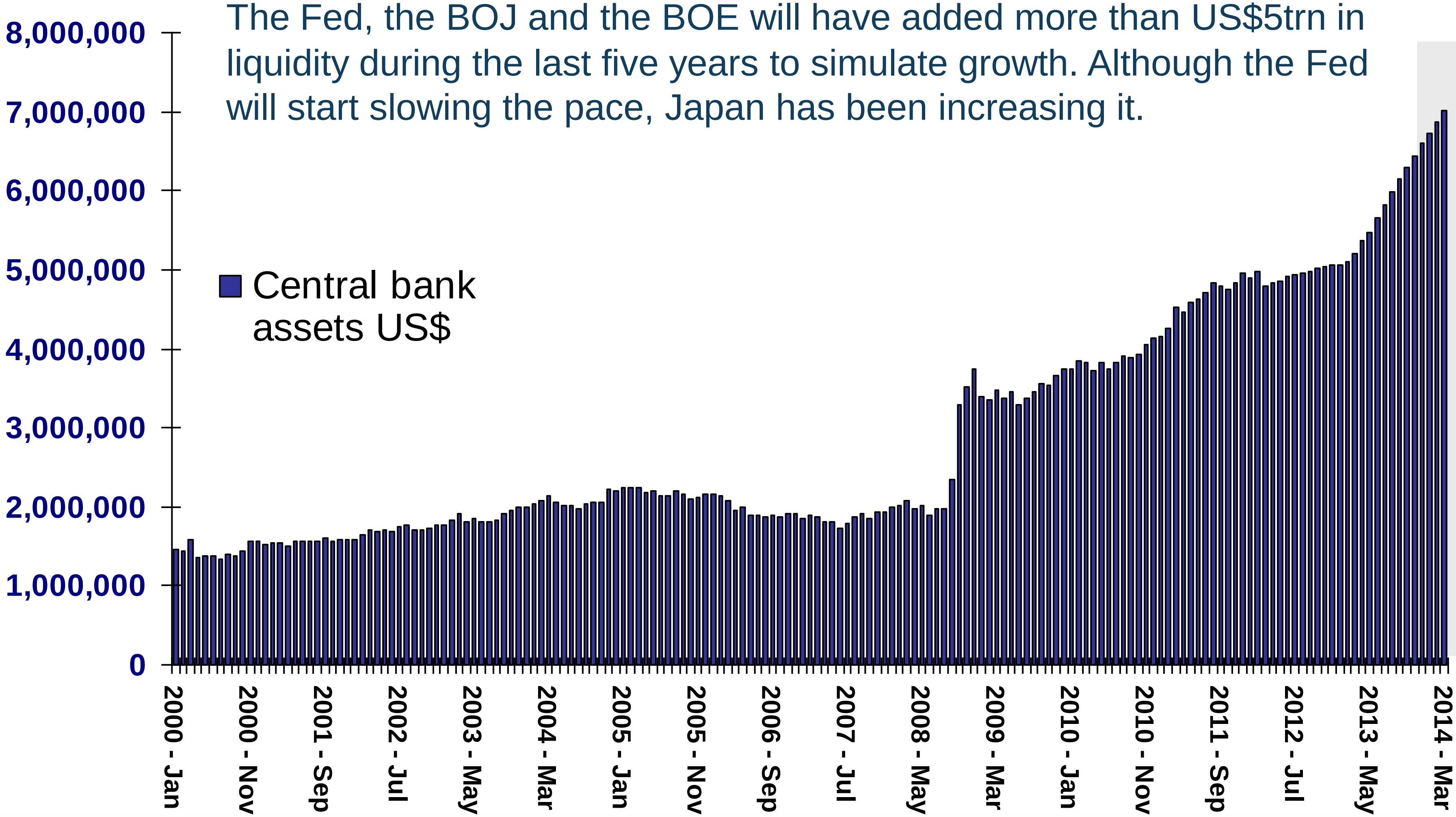
- Wealth, income disparities
- Corruption, abuses by officials
- Environment
- Food standards
- Rights of migrant workers

- High levels of debt in shadow banking system, rise in NPLs as growth slows

Fed ‘tapering’ and capital flows to EMs

Central banks: The era of easy money

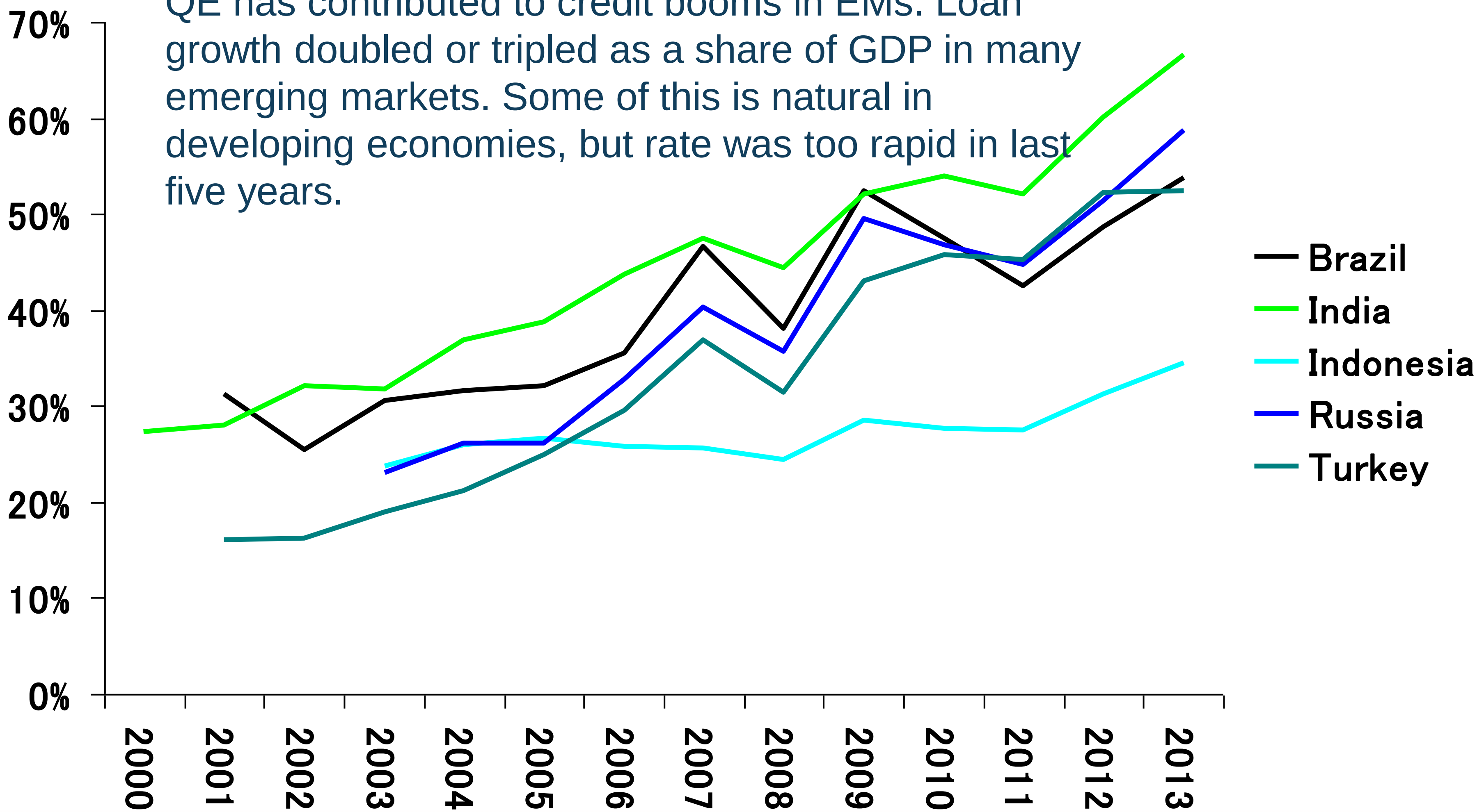
The Fed, the BOJ and the BOE will have added more than US$5trn in liquidity during the last five years to simulate growth. Although the Fed will start slowing the pace, Japan has been increasing it.



Total central bank assets, US$m: US Fed, BOE, BOJ.
Source: National central banks, Haver Analytics

Credit booms in many emerging markets

QE has contributed to credit booms in EMs. Loan growth doubled or tripled as a share of GDP in many emerging markets. Some of this is natural in developing economies, but rate was too rapid in last five years.



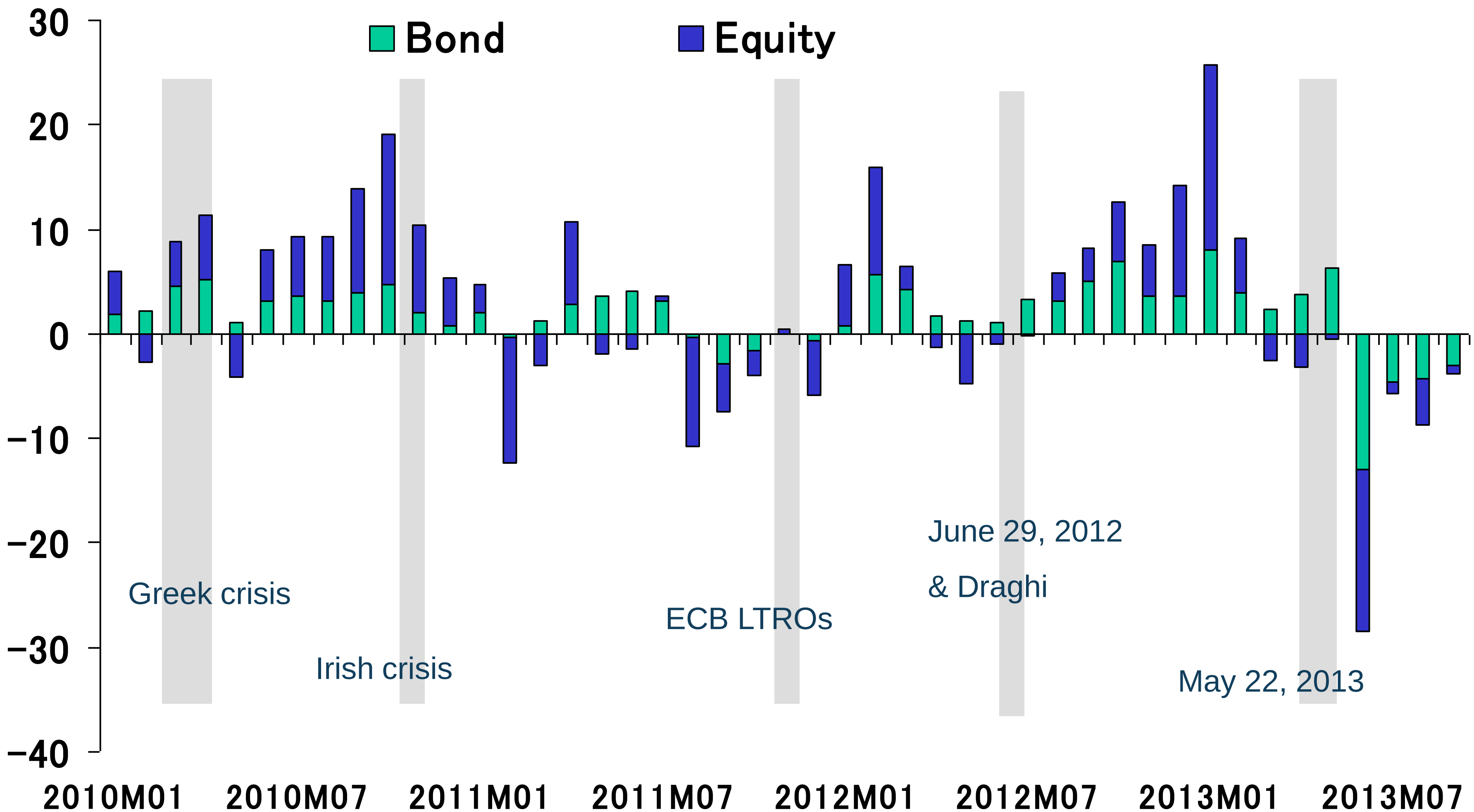
Total loans as a share of nominal GDP, US$. Source: National governments, Economist Intelligence Unit.

Time to taper? The Fed will buy fewer bonds

- The Fed is concerned about instability in asset markets
- The Fed has said it will reduce bond buying if the jobs market continues to improve
  - US jobless rate now down to 7% from 10%

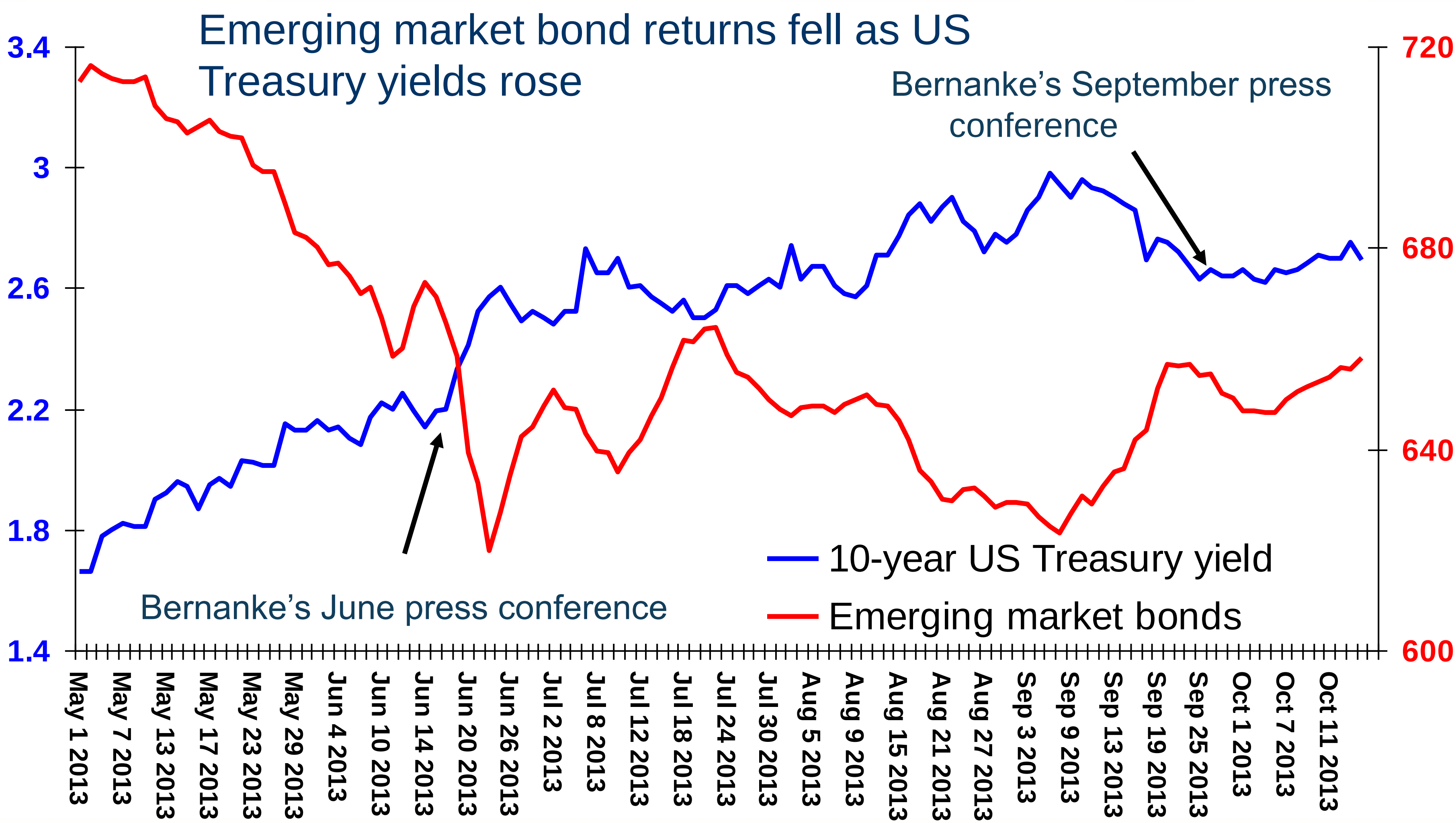
- Tapering could start in January
- Exit strategy was always going to be complicated
  - Search for yield pushed capital into risky assets
  - Markets became addicted to QE
  - Repeat of mid-year EM sell-off?
- Fed will rely on forward guidance to bear down on short term rates
  - Janet Yellen will take over at the Fed in January

Net capital flows to emerging markets



US$ bns; monthly flows; Source: IMF

Negative correlation between UST yields and EMBIG



10-year US Treasury bond, %, lh scale. JP Morgan Emerging Markets Bond Index Plus, index, 1993=100, rh scale. Source: Haver, JP Morgan

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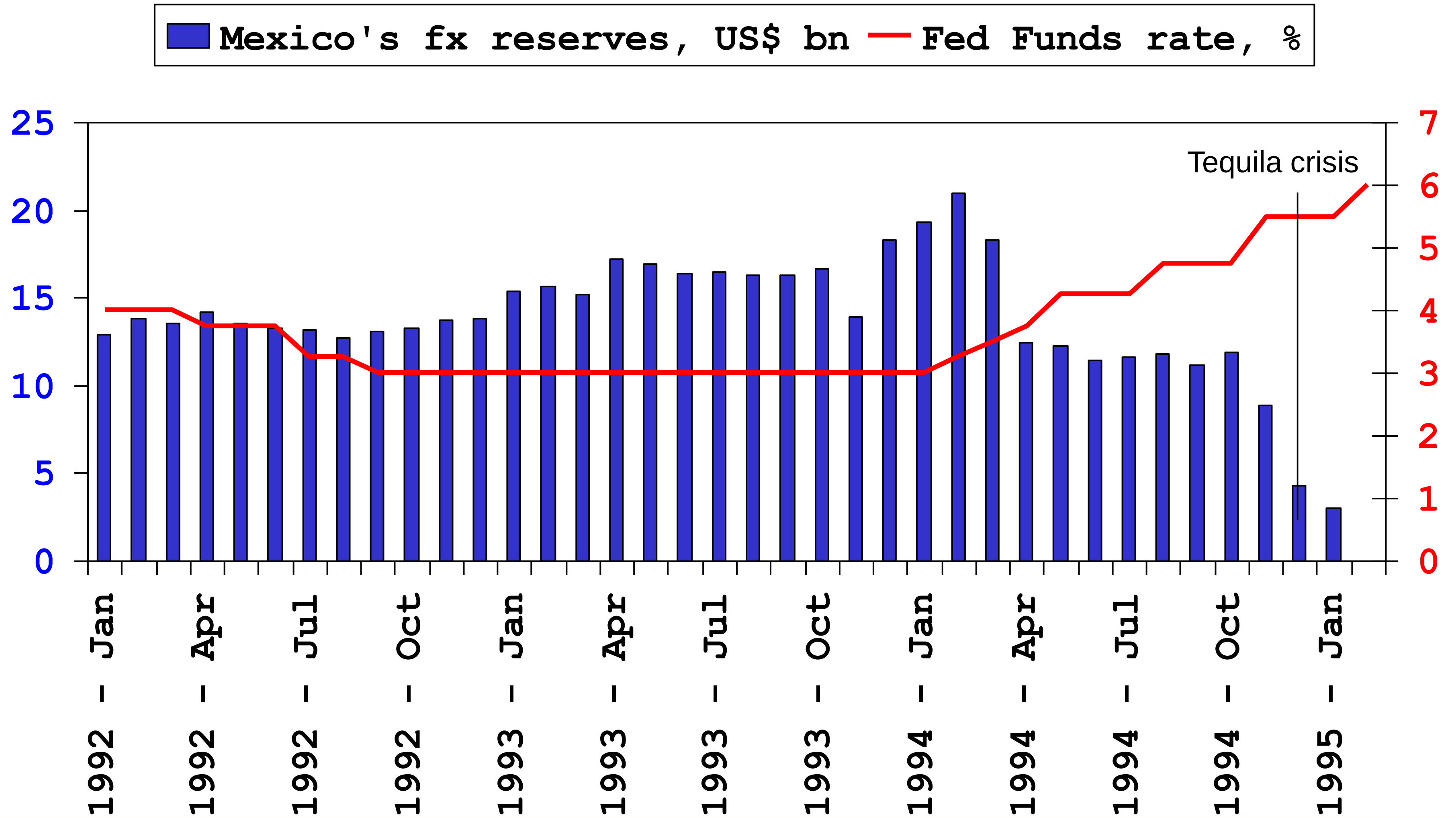
Past US monetary tightening cycles: a worrying precedent ?



•Exchange rate index vs dollar, Jan 7, 2008 = 100
.Source: Haver Analytics.

Why EMs are more resilient this time

Improved solvency ratios

- MENA external debt 47% of GDP in 2002 26% in 2012

Improved liquidity ratios

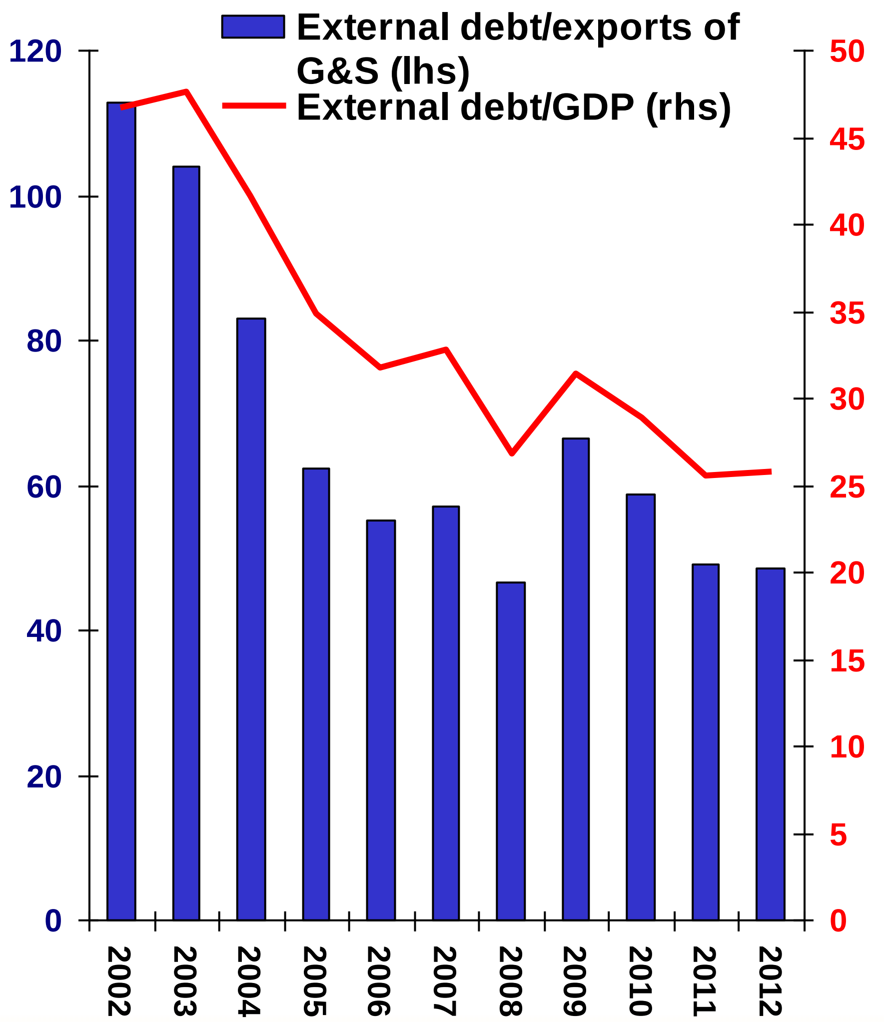
- MENA external debt/exports of goods & services 113% of GDP in 2002 49% in 2012

EMs less tied to the US

- ➢ More integrated with other emerging markets

General shift to floating exchange rates

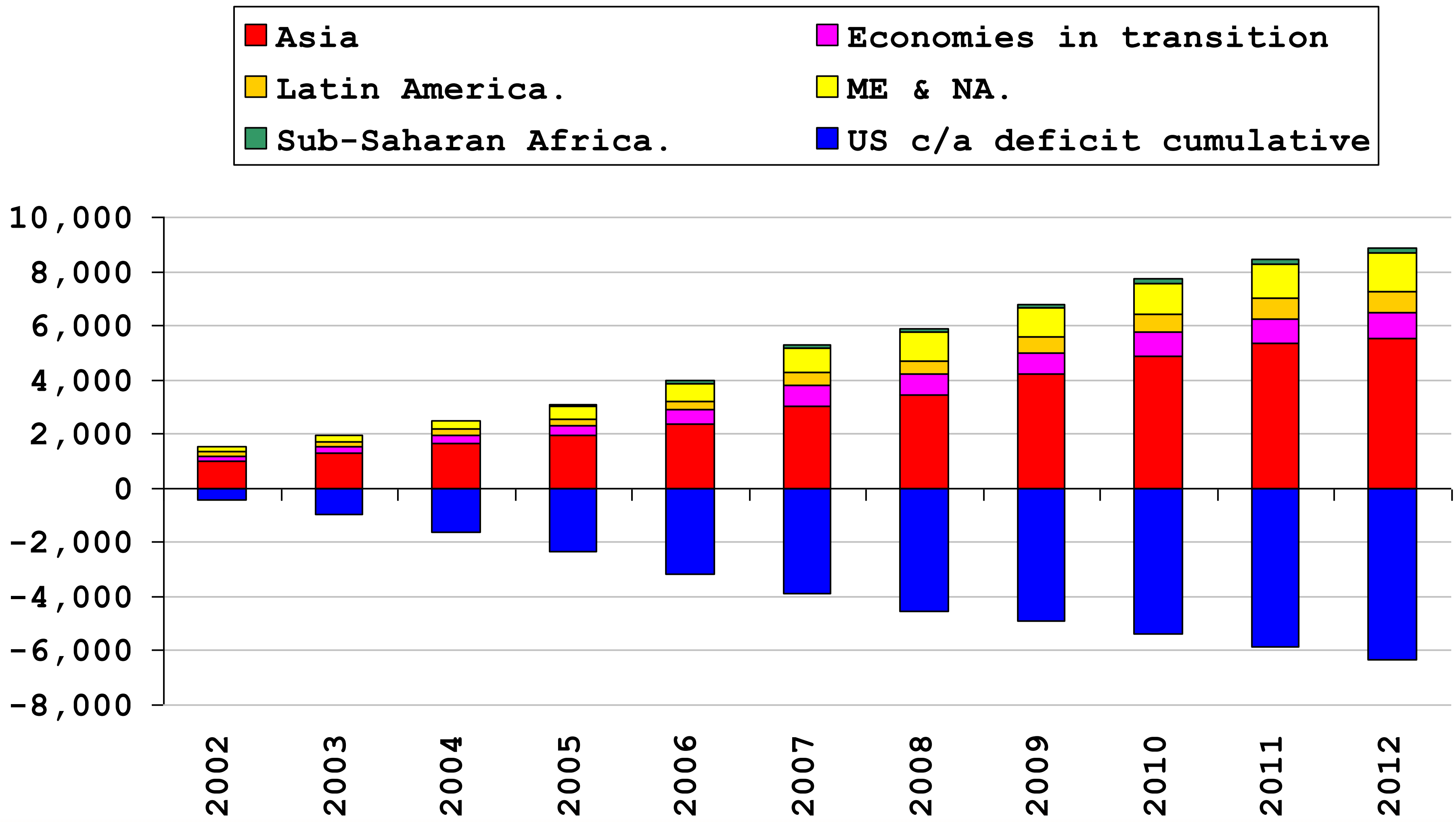
- ➢ Shock absorbers



Middle East and North Africa, Net debt = gross external debt less fx reserves.

Source: EIU Country Data

Record levels of EM fx reserves: an insurance policy



- Fx reserves, US$bn.
- Source: EIU, Country Data.

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Important questions for EMs 1

- Do fx reserves cover short-term external debt, gross external financing needs?
- Do fx reserves reflect accumulated current-account surpluses or footloose capital flows?
- If running a current account deficit, how much is covered by non-debt creating inflows?
- What is the structure of the debt?
  - Foreign or local currency denominated?
  - Average maturity
- Reliance on market funding or other sources (multilaterals, China)
  - Who holds the debt ? Is the investor base wide, stable?

Important questions for EMs 2

- How well is the macroeconomy managed?
  - Sound policies mitigate the risk of sudden outflows
- Is the exchange rate floating or fixed?
  - Floats help to absorb shocks
- Is there an inflationary pass-through from currency depreciation?
  - May require pro-cyclical monetary tightening
- Would financial support be available if needed?
  - Multilaterals, bilaterals
- Will tapering hit commodity prices?

Things to bear in mind

- Fed is aware of risks
  - Will use forward guidance to bear down on short term rates
  - Yellen is a known dove
- Market rates have already tightened
  - US 10-year bond yields at 2.8%, up from 1.6% in May
  - What's a normal rate?
- But scale of Fed intervention this time was unprecedented
- Further volatility in prospect
- But grounds for hope that this cycle of Fed tightening won't be catastrophic for emerging markets
- Beyond the short term, shift in global growth suggests that EMs will attract an increasing share of capital

EMs still attractive to global capital

- Yes, China won't grow as fast now that it's middle-income; no surprise
  - In absolute US$, China will add more to GDP now than when it grew by 14%

- Many EMs, like India, are still under-developed, have young populations and have good growth potential, if they reform
  - Infrastructure need in India, Brazil, Africa, etc is huge

- Recovery in rich countries will boost emerging markets in medium term

- Emerging markets struggling with credit-boom fallout, but this is cyclical

- Shifting to more balanced growth (more consumer spending, less exports) is good thing and should re-set the foundation for better growth