Capital Inflows and Emerging Markets

Eugenio Cerutti (IMF)

Session 1 - G-24 TECHNICAL GROUP MEETING
March 14, 2019 – Lima, Peru

Disclaimer. The views presented here are those of the authors and do NOT necessarily reflect the views of the IMF or IMF policy
Presentation outline:

I) EMs as Recipient of Capital Inflows
Q1 - Do we observe co-movement in gross capital inflows?
Q2- Substitution or complementarity relationships across asset type?
Q3- What is driving this Global Financial Cycle (GFCy)?
Q4- Which EMs are more sensitive to changes in the GFCy? And Why?
Q5- Is the GFCy the main culprit of the variation in capital inflows to EMs?

II) EMs as Lenders (The case of cross-border banking flows)
Q6- Do EM banks play a significant role?
Q7- How do EM banks lend to EMDEs?
Q8- How important is EM bank lending for EMDEs?

III) Policy conclusions
Q1: Do we observe co-movement in gross capital inflows?

- YES. Co-movement among capital inflows occurs largely among EMs. Not much across AEs
- Mostly on Equity, Bond, and Bank inflows, but not FDI

Source: Cerutti, Claessens, Puy (Forthcoming JIE)
Q2: Substitution or complementarity relationships across asset type?

- There is evidence of substitution between banking inflows and portfolio debt for AEs’ corporates, AEs’ sovereigns, as well as EMs sovereigns (before 2008).
- Complementarity relationships for EMs’ corporates and EMs sovereigns (after 2008)

Source: Cerutti and Hong (2018, IMF WP/18/29)
Q3: What is driving this Global Financial Cycle (GFCy) for EMs?

- EM common dynamic explained mostly by push factors in core countries
- The relative importance of push factors varies across type of flows
- Pull variables somewhat more important for bond and bank flows (but as function of commodity prices, so not really an EM internal driver)

Source: Cerutti, Claessens, Puy (2015, IMF WP/15/267)
Q4: Which EMs are more sensitive to changes in the GFCy? Why?

- Much heterogeneity. Some countries very sensitive across all assets (e.g. Brazil, Turkey)
- Why? Market characteristics rather than institutional/macro fundamentals
- Why? Composition of the foreign investor base (reliance on global investor funds) plays a key role in the case of bond and equity flows

Source: Cerutti and Obstfeld (2018, IMF WP/18/253) based on Cerutti, Claessens, Puy (Forthcoming JIE)
Q5: Is the GFCy the main culprit of all the variation in capital inflows?

- Not really. GFCy not that important in understanding capital flows
- Potential impact of the GFCy present in other variables (e.g. domestic asset prices and credit)

Source: Cerutti, Claessens, Rose (2019, IMF Economic Review) and work in progress
Presentation outline:

I) EMs as Recipient of Capital Inflows
Q1 - Do we observe co-movement in gross capital inflows?
Q2- Substitution or complementarity relationships across asset type?
Q3- What is driving this Global Financial Cycle (GFCy)?
Q4- Which EMs are more sensitive to changes in the GFCy? And Why?
Q5- Is the GFCy the main culprit of the variation in capital inflows to EMs?

II) EMs as Lenders (The case of cross-border banking flows)
Q6- Do EM banks play a significant role?
Q7- How do EM banks lend to EMDEs?
Q8- How important is EM bank lending for EMDEs?

III) Policy conclusions
Q6: Do EM banks play a significant role?

- Increasing role of EM banks in the international banking system
- Chinese banks represent 64% of total EM bank-to-EMDE borrower activity

Cross-border claims by EME reporters
Share in % of total (excl. BH, BS and JE)

**Residency basis:** From 1.5% to 7.7%

**Nationality basis:** From 3.2% to 13.3%

Source: Cerutti, Koch and Pradhan (2018, December 2018 BIS Quarterly Review)
Q7: How do EM banks lend to EMDEs?

- EM banks book the majority of their cross-border lending to EMDEs at their foreign affiliates.
- This is not followed by AE bank peers, or EM bank lending to AE borrowers.

Source: Cerutti, Koch and Pradhan (2018, December 2018 BIS Quarterly Review)
Q8: How important is EM bank lending for EMDEs?

- EM banks are the major providers of cross-border credit to non-bank EMDE borrowers in Asia and Africa.

<table>
<thead>
<tr>
<th>Borrowing region</th>
<th>Share of borrowing counterparty countries (as % of number of countries in respective region)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EME credit &gt;25%</td>
</tr>
<tr>
<td>Europe</td>
<td>56.3%</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>55.6%</td>
</tr>
<tr>
<td>Africa and Middle East</td>
<td>63.5%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>74.4%</td>
</tr>
</tbody>
</table>

1 Banks with controlling parents in EME countries.  2 Numbers of counterparty countries included in each counterparty group: 16 for emerging Europe; 26 for Latin America and the Caribbean; 60 for Africa and the Middle East; and 36 for Asia-Pacific.  3 Individual counterparty countries in different regions borrow from different bank nationalities (advanced, emerging and offshore). Taking, as an example, the 16 counterparty countries in emerging Europe (all sectors, all currencies): 56.3% of these borrower countries (i.e. nine out of 16 countries in the region) receive more than 25% of their total credit from EME banks, and 18.8% (or three out of 16 countries) receive more than 50% of their total credit from EME banks.

Source: Cerutti, Koch and Pradhan (2018, December 2018 BIS Quarterly Review)
EMDE countries borrowing more than 25% of their GDP from EM banks are:

- Djibouti (58%)
- Laos (45%)
- Congo (31%)
- Mozambique (25%)
- Cambodia (25%)
- Kyrgyz Republic (25%)
- Tonga (25%)

Sources: IMF, *World Economic Outlook*, October 2018; BIS locational banking statistics (by nationality).
Conclusions

- Summary of key findings:
  • Disaggregated BOP data is important to better understand capital inflows to EMs
  • Interlinkages among EMDEs have grown rapidly in recent years and have given rise to extensive interdependencies

- Policy implications:
  • A better understanding of the relative differences in the impact of the GFCy into quantities (e.g., capital flows) and prices (e.g., asset prices), as well as the transmission channels (e.g. investor base) is necessary before reaching final policy conclusions on the potential reach of, and remedies to, the GFCy
  • Even though the growing footprint of EM banks has lessened EMDEs’ dependence on AE banks, EM banks are now new sources of contagion and propagator of stress