Box 1

CAPITAL FLOWS TO THE EMERGING ECONOMIES DURING THE PANDEMIC

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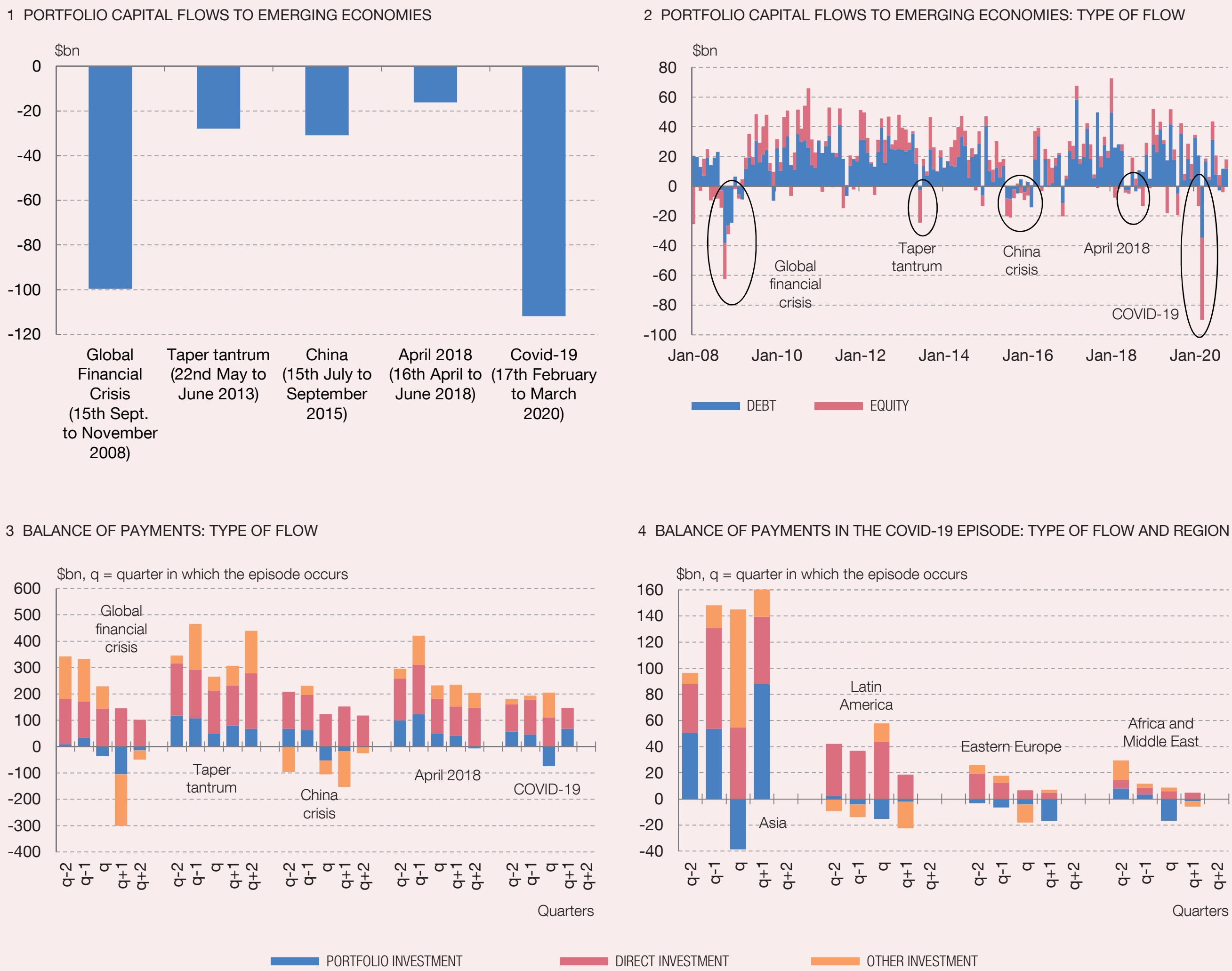
This box analyses the behaviour of net capital flows to the emerging economies since the COVID-19 pandemic broke. A comparison is made with other episodes of capital flows that have occurred in recent years.

As Chart 1.1 shows, the spread of the health crisis beyond Chinese borders in mid-February prompted very significant portfolio capital outflows from the emerging economies. By end-March, and using information from the Institute for International Finance (IIF), these outflows had exceeded $100 billion in cumulative terms. The scale of these outflows was similar to that recorded between mid-September and November 2008, after the global financial crisis broke. But it was far greater than that of other more recent episodes, such as the hike in US long-term interest rates (known as the "taper tantrum") in 2013, the turbulence on the Chinese stock market in 2015 and the financial tensions that particularly affected the emerging economies in 2018 Q2.

In March, the month with the biggest portfolio capital outflows, the volume was very sizeable both in outflows from the stock market (around $55 billion) and in debt outflows (around $35 billion) (see Chart 1.2). Moreover,

Chart 1

CAPITAL FLOWS TO EMERGING ECONOMIES DURING EPISODES OF GLOBAL TURBULENCE



SOURCE: Thomson Reuters and national statistics.

these outflows were across the board in the emerging economies, unlike in previous episodes when they tended to be focused on certain specific areas, with their epicentre in Asia in 2008, 2013 (along with Brazil) and 2015, and in Latin America (Argentina in particular), Eastern Europe and Turkey in 2018.

The various economic policy measures adopted shortly after the outbreak of the pandemic, in the advanced and emerging economies alike,[1] contributed to easing global financial conditions and to stabilising capital flows. In any event, not until September was there a reversal, in the emerging economies as a whole, of the capital outflows recorded between February and March (see Chart 1.2), and, in some regions (in emerging Asia and Latin America in particular), this recovery has not yet concluded.

This analysis of capital flows to the emerging economies, conducted drawing on the information provided by the IIF, can be complemented using balance of payments (BoP) data. Admittedly, BoP figures are published with a lesser frequency and a greater delay than those of the IIF; but they enable not only changes in portfolio flows but also those in direct investment and other investment flows to be evaluated.[2] According to this source, in 2020 Q1 the above-mentioned high portfolio outflows – which were particularly acute in Asia – were accompanied by a reduction in foreign direct investment (FDI) inflows (with the exception of Latin America) (see Charts 1.3 and 1.4). These flows were partly replaced by higher inflows comprising other investment (particularly in Asia and Latin America), essentially bank loans, occasionally at short terms, which was not the case in the other capital outflows episodes considered. In 2020 Q2, the strong recovery in portfolio inflows in Asia more than offset the weakness of these capital movements in the other emerging regions, while the buoyancy of other investment inflows observed in the previous quarter diminished.

When assessing the various factors bearing on the behaviour of these capital flows, the literature has traditionally distinguished between "push" or global factors and "pull" or idiosyncratic factors.[3] Among the former, consideration is usually given to global risk aversion, monetary conditions in the main advanced economies (especially in the United States), the dollar exchange rate and commodities prices. Among the latter, the assessment is usually made on the macroeconomic, financial and institutional fundamentals and vulnerabilities of each emerging economy.[4]

In the current episode, the strong rise in risk aversion (see Chart 2.1), the gloomier economic outlook that led to a fall in commodities prices (see Chart 2.2) and the appreciation of the dollar owing to the search for safe-haven assets (see Chart 2.3) were, as occurred in 2008, the main drivers of the capital outflows observed in the emerging economies. Conversely, US monetary policy – which was the main driver of capital outflows during the aforementioned taper tantrum and in April 2018 (as a strong dollar appreciation ensued) – is not estimated to have contributed to the capital outflows from the emerging economies since the onset of the pandemic (see Chart 2.4).

As regards the influence of local factors, Charts 2.5 and 2.6 show that, in general, those countries with a bigger external imbalance and poorer macroeconomic fundamentals have most seen their capital flows worsen recently. These idiosyncratic factors will have played a relatively similar role to that witnessed in other previous episodes when it comes to mitigating or amplifying the financial turbulence generated by the aforementioned global factors. In any event, it will be vital in the coming quarters to monitor the ongoing increase in macrofinancial vulnerabilities in some of these economies as a result of the prolongation of the health crisis, as these vulnerabilities might prompt a further deterioration in capital flows.

1 See Box 1 of the Report on the Latin American economy. Second half of 2020, Banco de España.

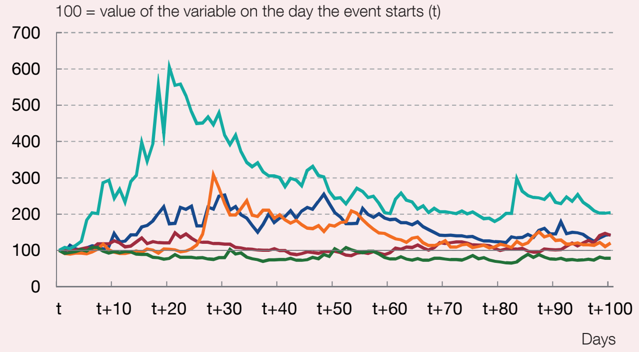
2 The portfolio flows reflected in the IIF and balance of payments statistics are not immediately comparable; among other reasons, because the information provided by the IIF covers fewer countries than that in the balance of payments statistics.

3 See Koepke, Robin (2015), *What Drives Capital Flows to Emerging Markets? A Survey of the Empirical Literature,* Institute of International Finance, University of Wurzburg, and Carney, Mark (2019), *Pull, Push, Pipes: Sustainable Capital Flows for a New World Order,* speech at the Institute of International Finance Spring Membership Meeting, Tokyo.

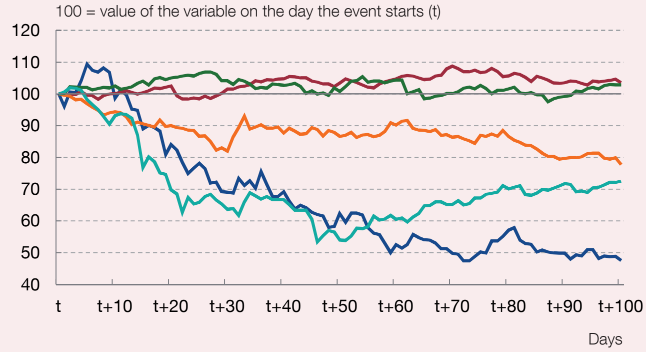
4 For an empirical estimation of the determinants of flows to emerging economies, see Molina and Viani (2019), *Capital flows to emerging economies: recent developments and drivers,* *Economic Bulletin* 2/2019, Banco de España.

Chart 2
PUSH AND PULL FACTORS BEHIND CAPITAL FLOWS TO EMERGING ECONOMIES

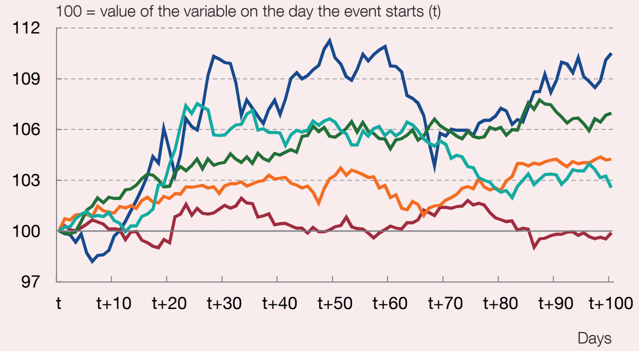
1 PUSH FACTORS: GLOBAL RISK AVERSION (a)



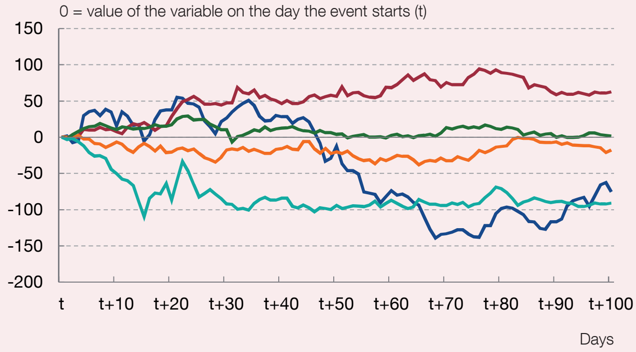
2 PUSH FACTORS: COMMODITIES PRICES



3 PUSH FACTORS: DOLLAR EXCHANGE RATE

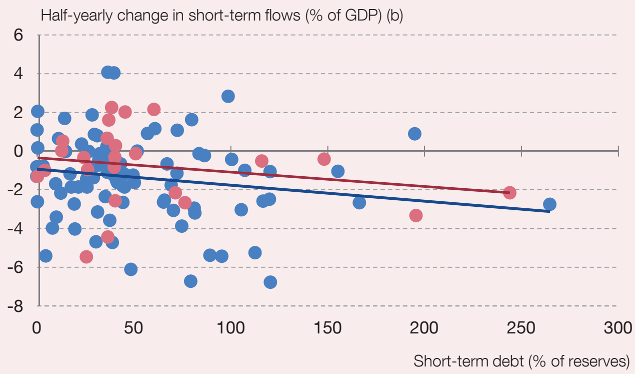


4 PUSH FACTORS: US LONG-TERM RATES (bp)

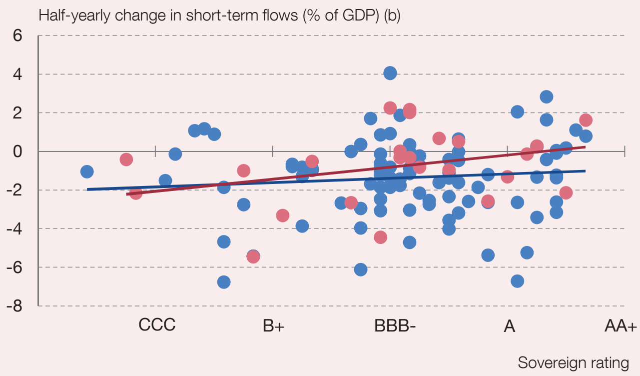


GLOBAL FINANCIAL CRISIS (15-3-2008) TAPER TANTRUM (22-5-2013) CHINA (15-7-2015) APRIL 2018 16-4-2018 COVID-19 (17-02-2020)

5 PULL FACTORS: SHORT-TERM EXTERNAL DEBT



6 PULL FACTORS: SOVEREIGN RATING (c)



PREVIOUS EPISODES COVID19

SOURCES: Thomson Reuters, Standard and Poor's, Fitch, Moody's and national statistics.

a Measured by VIX.
b Sum of half-yearly changes in portfolio inflows and other flows.
c Average of Standard and Poor's, Moody's and Fitch ratings.