How Resilient Were Capital Flows to GCC Countries to “Taper Talk”?

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Near-zero interest rates in advanced economies have induced yield-seeking investors to pour money into emerging markets, including Gulf Cooperation Council (GCC) countries.[1] The addition of Qatar and the United Arab Emirates to the MSCI Emerging Markets Index in May 2014 heralded the Gulf’s ascendance to emerging market status and boosted capital flows.

The U.S. Federal Reserve has concluded its QE3 stimulus program, and emerging markets are now bracing for increases in U.S. interest rates in the near future. Capital flows into emerging market assets may slow or even reverse with the tightening of monetary policy in the United States, affecting the availability and cost of financing in these countries.

Two taper talk tales

For a sense of how GCC countries might fare in response to normalization of U.S. monetary policy, we looked to two recent episodes of volatility since the Federal Reserve announced plans to taper asset purchases. In particular, we analyzed flows to bond and equity funds exposed to the GCC during two periods of pronounced volatility in emerging markets in 2013 and early 2014. These data measure only a limited share of international capital flows but can serve as a useful indicator of trends.

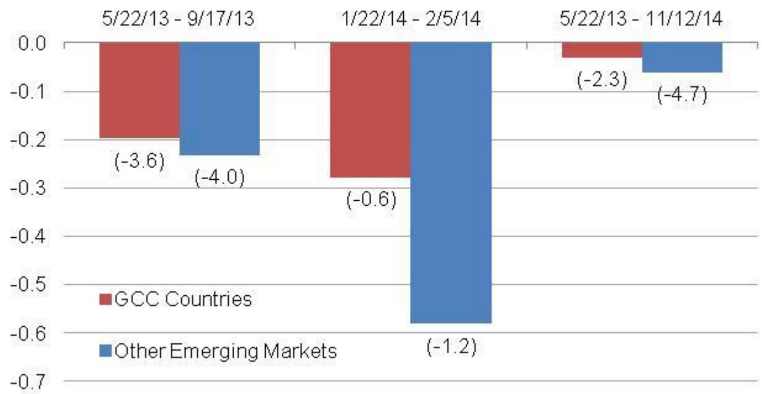
- The sell-off in the first period, May 2013 to September 2013, followed unexpected statements by the Federal Reserve about the possibility of tapering. In this period, weekly bond and equity outflows from GCC countries were generally in line with weekly outflows from other emerging markets, reflecting broad-based deterioration of investor sentiment toward the emerging market asset class (Chart 1). Cumulative outflows amounted to about 3.6 percent of assets under management (AUM) for the GCC, and 4 percent of AUM for other emerging markets.

- Pressures eased in September 2013 when the Federal Reserve surprised markets by delaying tapering, yet volatility spiked again in early 2014 on concerns about vulnerabilities in specific emerging market countries, which might be exacerbated by higher interest rates. GCC

[1] GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

countries were markedly less affected than other emerging markets during this period: the data suggest that portfolio outflows were only half of those from other emerging markets, or 0.6 percent of AUM for the GCC compared to 1.2 percent of AUM for other emerging markets.

Chart 1
Net Portfolio Flows[1]
(One-week equivalent flows, percent of assets under management; cumulative flows in parentheses)



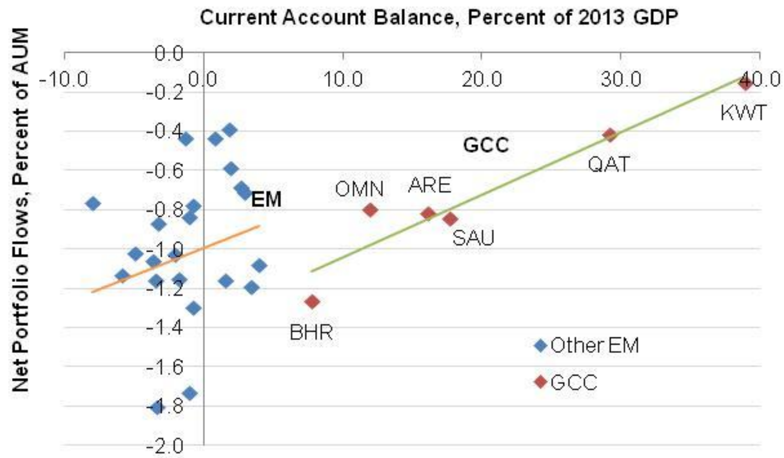
Sources: EPFR Global; and IMF staff calculations.
[1]Portfolio flows are represented by EPFR equity and bond fund flows, a proxy for international capital flows. Assets under management (AUM) refers to the total USD allocation by EPFR-covered funds.

Flows and fundamentals

Although there was no clear relationship between economic fundamentals and outflows in the first episode, investors tended to differentiate among emerging market countries in the second period.

Conducting a similar analysis to the IMF *Global Financial Stability Report* for April 2014, we find that countries with stronger fiscal or external positions saw milder outflows in the second period. The GCC countries stand out from other emerging markets, as they simultaneously exhibit higher external surpluses and smaller outflows of foreign capital (Chart 2). Within the GCC group, outflows tended to be lower in countries where surpluses were higher. As noted in the October 2014 *Regional Economic Outlook* for the Middle East and Central Asia, the presence of sizeable external buffers appears to have been an important factor in explaining the limited capital outflows from GCC countries during the second period of volatility.

Chart 2
Second Period (1/22/14 - 2/5/14): Net Portfolio Flows[1] and Current Account Balance



Sources: EPFR Global; national authorities; and IMF staff calculations.
[1]Portfolio flows are represented by EPFR bond and equity fund flows.

More recently, during the period of rapidly falling oil prices from September through November, flows to GCC countries were relatively flat, similar to other emerging markets. And looking at the whole period from the first mention of tapering in May 2013 to the present, cumulative outflows from GCC countries have totaled slightly less than half of those from other emerging markets (Chart 1).

In sum, despite an uncertain global economic outlook and the prospect of rising interest rates, foreign capital flows to GCC countries have remained fairly resilient, and their dynamics have broadly followed developments in other EMs. Although it is too early to say how capital flows to GCC countries might react in response to the recent decline in oil prices, especially if it is sustained, our analysis provides some comfort that the large external surpluses GCC countries have accumulated during periods of high oil prices appear to have been an important factor that has helped them withstand shifts in investor sentiment.

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