

**PRESS POINTS FOR CHAPTER 2: UNDERSTANDING THE SLOWDOWN IN
CAPITAL FLOWS TO EMERGING MARKETS**
World Economic Outlook, April 2016

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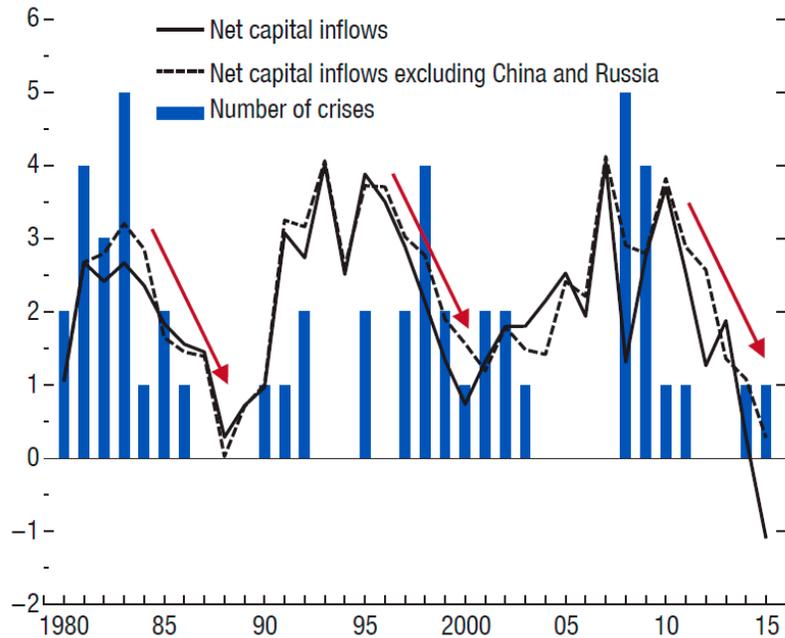
Key Points

- According to the latest available data (fourth quarter of 2015), capital flows to emerging market economies remain subdued, after five years of a sustained decline.
- This is a matter of concern for policy because (1) capital flows can aid domestic investment and growth and (2) long downswings in the global capital flow cycle during the 1980s and 1990s were associated with a high incidence of debt crises.
- Thus, it is important to understand the drivers of the capital flow slowdown since 2010 and the reasons for their less adverse effects now (in the current slowdown) versus then (in the 1980s and 1990s).
- The chapter finds that much of the current slowdown can be explained by the decline in the expected differential in growth in emerging market economies versus advanced economies.
- The less adverse macroeconomic effects can also be attributed to better policy frameworks—mostly through higher foreign exchange reserves, lower shares of debt denominated in foreign currency (that is, less “original sin”), and greater exchange rate flexibility.
- In particular, countries that display greater exchange rate flexibility have insulated themselves better from the global capital flow cycle than in previous slowdowns.

Expanded Discussion

- While net capital flows to emerging market economies as a whole fell markedly in 2015, the slowdown in fact began soon after 2010—a starting point that has not been properly acknowledged in previous work.
- It affected all regions and the majority of emerging market economies regardless of their sizes: it was not restricted to China, Russia, or the BRICS alone.
- Such a prolonged slowdown is not unprecedented: the 2010–15 slowdown was broadly comparable in magnitude and length to major slowdowns in the 1980s and late 1990s (Figure 1).

Figure 1. Net Capital Flows to Emerging Markets and Debt Crises
(1980-2015:Q3, percent of GDP unless noted otherwise)



- As noted, the 2010–15 slowdown was *not* associated with the high incidence of external crises of the past (as shown by the vertical bars in the figure).

These facts raise the following questions, which the chapter addresses:

- To what extent is the current slowdown due to less capital flowing in or more capital flowing out?
- What is driving those flows?
- In particular, to what extent do dimming prospects for emerging market economy growth, diminished global risk appetite, or decreasing commodity prices explain it?
- What is different this time that has made emerging market economies more resilient so far to major financial and debt crises associated with such slowdowns in the past?
- More specifically, have changes in policy frameworks played a role? For instance, have exchange rate flexibility, higher foreign exchange reserve buffers, and lower exposure to foreign-currency debt played a significant role?

To answer these questions, data from more than 40 emerging market economies were analyzed to find that

- Both declining gross inflows and stronger gross outflows (relative to GDP) contributed to the net slowdown in 2010–15.
- Diminished growth prospects in emerging market economies explain most of it.
- Yet structural and domestic policy factors strongly determine the extent to which different countries were affected.
- One major source of resilience for most emerging markets during the 2010–15 slowdown was greater international financial integration in the form of higher foreign assets (including international reserves) and more external debt in domestic currency (less original sin), reducing the effects of lower capital flows on country risk.
- In many emerging market economies, another source of resilience was greater exchange rate flexibility: depreciations make outflows more costly and help attract new inflows.
- At the same time, exchange rate depreciations—when they are orderly and do not take the form of abrupt adjustments, as in several crises of the past—can act as more effective shock absorbers for consumption and employment, mitigating growth slowdowns and the risk of debt crises.
- In general, the econometric analysis provided in the chapter finds that the importance of global (“push”) factors in driving capital flows was lessened in emerging market economies with lower public debt, higher foreign exchange reserves, and greater exchange rate flexibility.

The *main policy implications* are as follows:

- Countries are not simple bystanders to the global financial cycle.
- Specifically, *prudent fiscal policies* (which help lower public debt), *macroprudential policies* (which help limit currency mismatches), *exchange rate flexibility* (which can work as a shock absorber), and *prudent foreign exchange reserve management* (which can help smooth bouts of investors’ risk aversion) help mitigate the contraction and the domestic spillovers of the global capital flow cycle in individual emerging market economies.
- So the less dramatic macro effects of the recent global capital flow slowdown versus those in the past has been a *payoff of sounder policy frameworks*—even if more still needs to be done to upgrade these frameworks further.

PRESS POINTS FOR CHAPTER 3: TIME FOR A SUPPLY-SIDE BOOST? THE MACROECONOMIC EFFECTS OF LABOR AND PRODUCT MARKET REFORMS IN ADVANCED ECONOMIES
World Economic Outlook, April 2016

Prepared by Romain Duval and Davide Furceri

Key Points

- Now is an opportune time to push for additional product and labor market reforms in many advanced economies: there is a strong need and substantial scope for reform, the political environment is conducive, and such reforms can raise potential output and employment levels over the medium term.
- Product market reforms deliver gains in the short term, while the impact of labor market reforms varies across types of reforms and depends on economic conditions. Reductions in labor taxes and increases in spending on active labor market policies have larger effects during periods of economic slack, while reforms to employment protection arrangements and unemployment benefit systems are beneficial in economic good times but can have detrimental effects when the economy is weak.
- Careful prioritization and sequencing of reforms, as well as supportive macroeconomic policies, are needed to maximize the short-term payoff of reforms in the current environment of persistent slack in most advanced economies. Reforms that entail fiscal stimulus will be the most valuable, including reducing labor tax wedges and increasing public spending on active labor market policies. Product market reforms should also be prioritized.

The continued weakness of growth and shrinking macroeconomic policy space in many advanced economies have led policymakers to emphasize structural reforms. High on the agenda are several reforms designed to strengthen the functioning of product and labor markets—including, depending on countries' specific circumstances, reducing barriers to entry in services sectors, strengthening active labor market policies and/or revising unemployment benefit provisions, streamlining and harmonizing employment protection legislation for permanent and temporary workers, cutting labor taxes, and implementing targeted policies to boost the labor market participation of youth, women, and older workers.

These product and labor market reforms have the potential to boost growth and jobs in many advanced economies over the medium term. They therefore warrant further effort. Their contributions are likely to be modest in the short term, however, because it takes time for the benefits to materialize, particularly where economic conditions remain weak.

Product market reforms have some expansionary effect even in the short term, and this effect does not depend markedly on overall economic conditions. For example, the

widespread deregulation of air transport and telecommunications that took place in many advanced economies mostly during the 1990s led to large increases in output, productivity, and quality of services.

In contrast, the impact of labor market reforms depends on overall economic conditions:

- Fiscal structural reforms in the labor market area, such as reduced labor taxes and increased public spending on active labor market policies, have larger effects under weak macroeconomic conditions, in part because they usually entail some degree of fiscal stimulus.
- In contrast, reforms to employment protection arrangements and unemployment benefit systems have positive effects in good times, but can weaken aggregate demand and become contractionary in bad times.

Table 3.1. Effect of Product and Labor Market Reforms on Macroeconomic Outcomes

The effects of structural reforms depend on the type of reform, overall economic conditions, and the horizon considered.

Area of Reforms	Normal Economic Conditions		Weak Economic Conditions		Strong Economic Conditions	
	Short Term	Medium Term	Short Term	Medium Term	Short Term	Medium Term
Product Market	+	++		+	+	++
Employment Protection Legislation			-	--	+	++
Unemployment Benefits	+	++	-		+	++
Labor Taxes	++	++	++	++		
Active Labor Market Policies	++	++	++	++		

Source: IMF staff estimates.

Note: The macroeconomic outcomes are output and/or employment; + (-) indicates positive (negative) effect; the number of "+" ("–") signs denotes the strength of the effect. The effect of labor tax cuts and increases in spending on active labor market policies is smaller but remains positive when these measures are implemented in a budget-neutral way.

Complementary policies can enhance the short-term payoff from structural reforms.

Supportive macroeconomic policies—including fiscal stimulus where space is available and a strong medium-term fiscal framework is in place—can offset the short-term costs of some labor market reforms. Intensified efforts to address weaknesses in bank and corporate balance sheets can strengthen the impact of product market deregulation on private investment.

Prioritizing and sequencing reforms can also strengthen their impact in the current environment of persistent slack in most advanced economies. Reforms that entail fiscal stimulus will be the most valuable, including reducing labor tax wedges and increasing public spending on active labor market policies. Product market reforms should also be prioritized because they boost output regardless of overall economic conditions.