PRESS POINTS FOR CHAPTER 2: UNDERSTANDING THE SLOWDOWN IN CAPITAL FLOWS TO EMERGING MARKETS
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Key Points

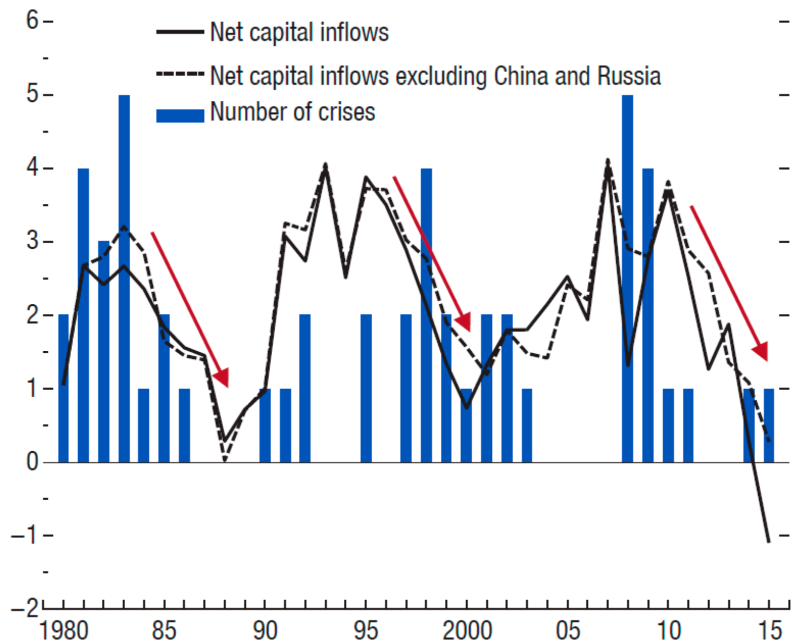
- According to the latest available data (fourth quarter of 2015), capital flows to emerging market economies remain subdued, after five years of a sustained decline.
- This is a matter of concern for policy because (1) capital flows can aid domestic investment and growth and (2) long downswings in the 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.