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Global issues

Decline in capital inflows to emerging markets gains pace

Capital inflows to emerging economies continued a gradual but steady decline, amid domestic weaknesses and less favourable external conditions, including lower commodity prices and expectations of monetary tightening in the United States of America. In recent months, portfolio inflows to emerging economies fell markedly, particularly in some Asian countries such as China and Thailand, and also in other countries such as Mexico and Turkey. After reaching $16.5 billion in April, equity inflows dropped to $3.9 billion in June and to $1.6 billion in July, their lowest level in 2015.[1] Bond inflows also remained subdued, averaging only about $2 billion per month in 2015, compared to an average of $15 billion in the previous two years. In addition to a weak economic outlook and potential spillovers effects from the upcoming rise in interest rates in the United States, portfolio inflows in emerging economies have also been rattled recently by the financial uneasiness associated with the ongoing negotiations over the Greek debt and Chinese equity market volatility.

More stable capital inflows, particularly in foreign direct investment (FDI), have also declined in some large emerging markets, including a visible reduction in greenfield projects. For instance, during the first quarter of 2015, FDI into Brazil and Turkey fell by about 38 and 23 per cent year on year, respectively, while FDI into the Russian Federation remains subdued. Similarly, cross-border bank claims on emerging economies have also shown signs of weakness, contracting by $75 billion in the last quarter of 2014, especially in China and some countries in emerging Europe such as Hungary, the Russian Federation and Poland[2].

Overall, the downward trend of capital inflows to emerging markets gained pace recently, casting doubts over the sustainability of current-account deficits in some cases. In the short term, more significant changes in investor sentiment related to the evolution of domestic vulnerabilities and global financial conditions—including unexpected outcomes from the Greek debt crisis and more aggressive actions from the United States Federal Reserve (Fed)—might provoke larger retrenchments of capital inflows. If portfolio liquidity dries up further and external financing costs rise abruptly, macroeconomic fundamentals in emerging economies will face challenges in dealing with additional shocks to exchange rates, equity prices and foreign-exchange reserves, which will be detrimental to private investment.

Summary

- Decline in capital inflows to emerging markets accelerates
- Sluggish investment in developed economies threatens future growth
- Greece and its creditors agree on conditions for new bailout programme
- Chinese stock markets remain volatile in July

Sluggish investment in developed economies threatens future growth prospects

Following the global economic and financial crisis that erupted in 2008, most of the developed economies have witnessed a significant slowdown in investment growth. The share of investment in gross domestic product (GDP) in those countries has dropped in real terms from 22.4 per cent in 2006 to 20.1 per cent in 2013, with even stronger decline in the EU-15; net investment (gross investment minus depreciation) in several cases has become negative.[3] By contrast, the share of investment in GDP in developing economies has been persistently increasing (from 26.5 per cent in 2006 to 30.5 per cent in 2013), bolstered in particular by strong fixed capital accumulation in such large economies as China and India.

Apart from the direct impact on current GDP, sluggish investment in developed countries may have detrimental long-term consequences, curbing potential output and employment and total-factor productivity in the future, and hindering resolution of the post-crisis economic and social problems.

Several factors are responsible for the observed investment slowdown. Although public investment programmes constituted part of the stimulus packages adopted in the direct aftermath of the crisis, most of developed economies have eventually refocused their fiscal policies on rebuilding public finances. In the countries severely hit by the European debt crisis in 2010, austerity measures have led to cuts in public investment; this largely explains the total investment decline in Greece, Portugal and Spain. Business investment also remained feeble, faced with sluggish aggregate demand and a persistently high level of uncertainty as major constraints. However, there are additional explanations, not necessarily related to economic weakness: for most of developed economies, the share

1 Institute of International Finance (2015). July 2015 EM Portfolio Flows Tracker, July 29, 2015.

2 Bank of International Settlements (2015). *BIS Quarterly Review: International banking and financial market developments*, June 2015.

3 Source: UN/DESA.

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of services both in GDP and employment has been increasingly expanding over the recent years. Compared with the industrial sector, services are less capital intensive. The progress in modern technology has allowed for the production of one unit of GDP using less capital stock (especially in services). This effect is, however, partially offset by the higher depreciation rate in certain technological sectors. Also, some share of domestic savings in developed economies has been diverted to FDI in developing countries; for example, a stronger exchange rate in Japan prior to 2012 has facilitated FDI outflows into developing Asian economies.

Nevertheless, the investment slowdown remains a concern that requires comprehensive policy action. Despite the persistently low interest rates in the major economies, business investment was slow to respond; commercial banks remain risk-aversive and practice credit rationing. Therefore, in addition to traditional macroeconomic instruments, other stimulus policies are needed.

Developed economies

North America: monetary policy stances diverge

In July 2015, the Fed released its semi-annual Monetary Policy Report, reiterating its expectations of gradual acceleration of economic growth and decline in the unemployment rate over the coming period. This highlighted the possibility of an interest rate hike by the end of the year. By contrast, the Bank of Canada in mid-July announced the second rate cut in six months, lowering its key policy rate by 25 basis points to 0.5 per cent. The Canadian economy shrank on a monthly basis for five consecutive months through May.

On 30 July, the U.S. Bureau of Economic Analysis released its regular annual revision of national accounts covering the period from 2012 to 2014; the annual GDP growth rates for 2012 and 2013 have been lowered by 0.1 per cent and 0.7 percent, respectively, reducing the GDP level in 2014 by 0.8 per cent. This revision also affected short-term GDP dynamics. The annualized quarterly growth rate for the first quarter of 2015 was revised up from -0.2 per cent to 0.6 per cent; the advanced estimate for the second quarter growth is 2.3 per cent. Contraction in the trade deficit was the most important factor explaining the acceleration in GDP growth. Stronger private consumption also contributed to growth, offsetting the impact of slower fixed capital formation.

Developed Asia: recovery in Japan has weakened

After growing solidly in the first quarter, the Japanese economy has stalled during the second quarter, despite some minor improvements in June. On a quarterly basis, export volume declined by 3.6 per cent and industrial output shrank by 1.8 per cent, while average household consumption expenditure weakened by 3.2 per cent in real terms. However, employment level in second quarter was only slightly lower than for the first one; the unemployment rate has marginally declined due to smaller size of the labour force.

Both headline and core inflation rates began dropping in April; the most recent monthly inflation figures are below 0.5 per cent. However, the Bank of Japan is still expecting inflation to accelerate towards 2 per cent in late 2016 or early 2017.

On 23 July, the Reserve Bank of New Zealand lowered its policy rate by 25 basis points to 3 per cent, after its previous cut of the same size on 11 June, expecting risk for inflation to stay below the target.

Western Europe: Greek euro exit narrowly avoided

Following three weeks of political turmoil, on 12 July 2015, European leaders agreed a broad set of conditions for a third bailout programme that will lend the Greek Government up to €86 billion. While the final details of the programme are still under negotiation, a short-term bridge loan of €7.16 billion was provided through the European Financial Stability Facility on 20 July to meet immediate debt repayment obligations of the Greek Government. This, together with stringent capital controls in place since 29 June, has helped to prevent a sudden collapse of the Greek banking system, and to avoid a withdrawal from the euro area. While the immediate risks of a euro exit are now reduced, they will continue to persist until Greek Government debt is put on a sustainable path.

In the referendum on 5 July, Greek voters demonstrated their fatigue over austerity measures that have been imposed by external creditors since 2010. Outside of Greece, the commitment to austerity is also waning in many other countries. In its 2016 budget, Ireland is considering reversing some of the austerity measures that were imposed to comply with bailout conditions, with a planned fiscal expansion of €1.5 billion. In Italy, the Government has announced plans to cut taxes by €35 billion over the next three years, in an effort to revive the Italian economy after 3 years of recession and stagnation. In the United Kingdom of Great Britain and Northern Ireland, on the other hand, the most recent budget is mildly contractionary; a significant raise in the minimum wage is coupled with cuts in tax credits for low-income working families.

The new EU members: curbing currency appreciation in the Czech Republic

Economic sentiment among the new EU members remained strong in July, with business and consumer confidence mostly exceeding their corresponding 2014 levels. The consumer confidence index in Croatia, subdued for a long period of time, reached its highest level since 2008, bolstered by the improved labour market conditions. The Greek crisis, however, caused some degree of uncertainty, affecting sentiment in the Czech Republic in particular, but that should be a temporary phenomenon. The currencies in Central Europe exhibited some volatility during the negotiations between Greece and its creditors, but as Greek exit from the euro area has been averted, these currencies appreciated against the euro in the second half of July. The Czech National Bank had to intervene on the currency market in the first time since 2013 to maintain the exchange rate ceiling.

Despite some edging up of headline inflation in June, inflationary pressures in the region remain extremely subdued. In late July, the Hungarian National Bank continued its easing cycle, cutting its policy rate by 15 basis points to 1.35 per cent. The labour markets continued to improve: In the Czech Republic, the unemployment rate hit another post-crisis low of 6.2 per cent in June. In Croatia, the unemployment rate, while remaining the highest in the new EU, has been on a declining trend.

Economies in transition

CIS: monetary easing continues in the Russian Federation

In the Russian Federation, industrial output plunged deeper than expected in June—by 4.8 per cent—because of widespread weakness in manufacturing. The retail sector also surprised negatively, with sales dropping by 9.4 per cent. Apparently, the GDP decline accelerated in the second quarter. However, the decline in real wages has tempered, and the turnaround point for the economy may have been reached. In late July, the Central Bank cut its policy rate by 50 basis points to 11 per cent, despite its estimation of acceleration in annual inflation to 15.8 per cent. In Ukraine, industrial output in January-June collapsed by 20.5 per cent; in June, annual inflation reached 57.5 per cent. The currency, however, has stabilized, monthly inflation has been low, and an upturn in industry and the retail is possible; abundant harvest should mitigate the overall GDP contraction. In late July, the IMF approved disbursement of a $1.7 billion tranche of the bailout programme agreed in March.

By contrast, the economy of Azerbaijan expanded by 5.7 per cent in the first half of 2015, defying earlier expectations of a slowdown. In mid-July, the Central Bank of Azerbaijan cut its policy rate by 50 basis points to 3 per cent, aiming to revive bank lending. Despite the sharp contraction in remittance inflows, real GDP in Kyrgyzstan expanded by 7.3 per cent in the first half of 2015, thanks to the flagship gold industry, and by 6.4 per cent in Tajikistan, supported by the textile, clothing and chemicals sectors. In July, the National Bank of Kyrgyzstan cut its policy rate by 150 basis points to 8 per cent, as inflation moderated, while the National Bank of Kazakhstan broadened its currency trading corridor against the dollar, aiming to facilitate a move towards inflation targeting and improve confidence.

South-Eastern Europe: growth strengthens in Albania in the first quarter

The economy of Albania registered acceleration in growth in the first quarter, to 2.8 per cent, despite the fact that domestic demand remained feeble in response to the moderation in public spending. Growth was mostly supported by the industry and financial sectors. In the former Yugoslav Republic of Macedonia, where the first quarter growth was robust and the budget performance in the first half of 2015 was solid, the Government decided in July to adopt a supplementary budget with funds being channelled to infrastructure development, public education, and increases in wages and social spending.

Developing economies

Africa: continued monetary policy tightening amid signs of slowing growth

Several African economies saw slowing growth rates in the first quarter. In Botswana, GDP growth slowed to 4.3 per cent from 5.3 per cent in the previous quarter, owing to weakness in the mining sector. In Kenya, the economy expanded by 4.9 per cent, down from 5.5 per cent in the previous quarter, with tourism and the agricultural sector emerging as a drag on economic activity. At the same time, a number of central banks increased their policy interest rates. The Central Bank of Kenya again, as in the previous month, raised its policy rate by 150 basis points to 11.5 per cent in order to curtail inflationary pressure from currency depreciation and higher food prices. Currency depreciation also drove a policy rate hike by 50 basis points in Angola, to 9.75 per cent. In Namibia, the policy rate increase by 25 basis points to 6.5 per cent aimed to slow domestic credit growth. In debt markets, Zambia issued its third international bond since 2012, a ten-year $1.25 billion issuance at an interest rate of 9.375 per cent. While the country's resource sector has attracted investors over the past years, the higher interest rate stems from risks regarding the use of the funds raised in view of a significant budget deficit and looming elections.

East Asia: serious volatility continues in China's equity markets, amid active government intervention

Stock markets in China remained volatile throughout July. On 27 July, the Shanghai Composite Index suffered an 8.5 per cent drop—the second-largest percentage fall on record. The volatility prevailed amid Government's efforts to stabilize the markets. The People's Bank of China injected liquidity into the China Securities Finance Corporation—a state entity that provides margin financing loan services to brokerages— in supporting its stocks purchases. Other government measures include banning stock sales by large shareholders, restricting opening of new stock index futures contracts, and suspending trade in shares of many listed firms. Effectiveness of these measures has yet to be clearly shown; nevertheless, short-term impacts of the equity price volatility on the real economy should be limited, as stocks account for less than 15 per cent of household financial assets.

Preliminary estimates show that the Republic of Korea and Singapore saw their GDP growth slowing down in the second quarter on a year-on-year basis. The slowdown in the Republic of Korea (to 2.2 per cent from 2.5 per cent in the first quarter) reflects the continuing export weakness and the dampening effect of the Middle East Respiratory Syndrome outbreak on private consumption. Singapore's growth slowed down to 1.7 per cent from 2.8 per cent in the first quarter, largely resulting from the contraction of the export-driven manufacturing sector.

South Asia: nuclear deal expected to boost Iranian economy in the medium term

In mid-July, the Islamic Republic of Iran and the P5+1 countries (China, France, the Russian Federation, United States, United Kingdom and Germany) reached a comprehensive nuclear agreement. Once the International Atomic Energy Agency certifies that the Islamic Republic of Iran has met its commitments under the deal, the economic and financial sanctions imposed by the United Nations, the United States and the European Union will be lifted. While the removal of the sanctions is expected to boost trade (including Iranian oil exports) and foreign direct investment, it will likely take a considerable amount of time before the full effect is felt.

Pakistan's economy grew by 4.2 per cent in the fiscal year 2014/15, slightly up from 4.0 per cent in 2013/14, but well below the Government's target of 5.1 per cent. At the sectoral level, the expansion was mainly driven by the service sector, which experienced robust and broad-based growth. Manufacturing output increased by only 3.2 per cent, held back by severe energy shortages and unstable security conditions. The mild pickup in annual GDP growth was accompanied by improved macroeconomic stability.

Consumer price inflation averaged 4.5 per cent in the fiscal year, the lowest level since 2003. For the fiscal year 2015/16, Pakistan's Government targets growth of 5.5 per cent, while also aiming to raise the country's extraordinarily low tax-to-GDP ratio.

Western Asia: GDP growth remains robust in several GCC economies

In Saudi Arabia, GDP growth has reached 2.4 per cent in the first quarter of 2015, according to recent data. This is an improvement, compared with the fourth quarter of 2014, when GDP had grown by only 1.6 per cent. Although the oil sector expansion slowed down on an annual basis, from 6.9 per cent in the first quarter of 2014 to 1.8 per cent in the first quarter of 2015, it has accelerated compared to the last quarter of 2014. The expansionary fiscal stance has also been a major positive factor on GDP growth. Thus, the fiscal deficit is expected to deteriorate, well above the 2.3 per cent registered in 2014. As a result, and despite the fact that ample financial reserves to cover the national fiscal deficit are still available, the Government decided to issue bonds domestically this year, which hadn't happened since 2007. In Qatar, GDP growth also remains robust, reaching 4.1 per cent in the first quarter of 2015, according to preliminary data. As anticipated earlier this year, growth has been driven mainly by the nonoil sector, particularly by the construction sector with mega infrastructural projects. In Oman, recent data confirms that the economy expanded at a relatively good pace in 2014, 4.6 per cent, despite lower oil prices. The economic expansion was driven by robust domestic demand, supported by high public expenditure and expansionary monetary policy, which will be difficult to replicate again in 2015, given continuous low oil prices and very limited fiscal revenues.

Latin America and the Caribbean: industrial activity continues to be mostly subdued

Against the backdrop of a significant economic slowdown in the region, the industrial sector remains restrained in most countries, especially in South American economies. Moreover, the recent noticeable depreciation of domestic currencies still does not seem to provide a substantial support to industrial exports. In May, industrial output in Brazil fell by 8.8 per cent, the largest decline since 2009 and the fifteenth consecutive negative monthly figure. In the first five months of 2015, the Brazilian industrial output accumulated a fall of almost 7.0 per cent, including an even larger contraction of the manufacturing production. Also in May, the industrial production in Chile shrank by 1.2 per cent, driven by a fall of 3.3 per cent of the manufacturing production, while in Argentina the industrial production decreased by 0.9 per cent. By contrast, the industrial sector in Mexico has shown some positive signs, especially the manufacturing sector, which is slowly benefiting from the improving economic conditions in the United States. In April, Mexican industrial production expanded by 1.1 per cent, mainly owing to the performance of the construction and manufacturing sectors, which expanded by 5.5 and 3.8 per cent, respectively.