Economic Views –The COVID-19 Shock to EM Flows

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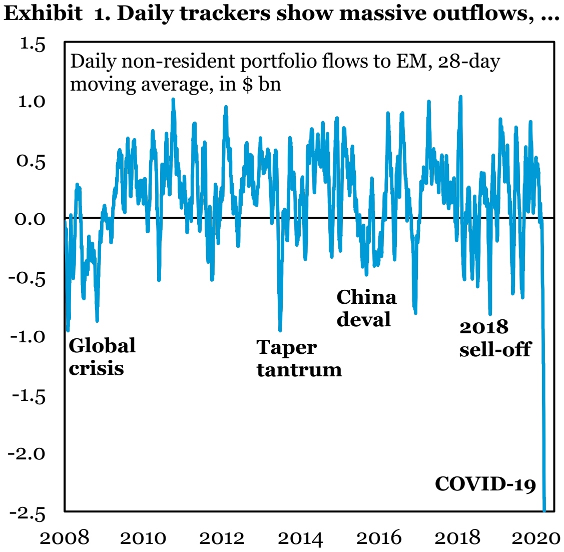
- We see very large capital outflows in our real-time trackers.
- The shock to flows is already more severe than the global crisis, …
- and dwarfs stress episodes such as the Asian crisis of 1997-98.
- As in past global shocks, we will likely see reserve drawdowns.
- Current account deficits will shrink as funding becomes scarce.

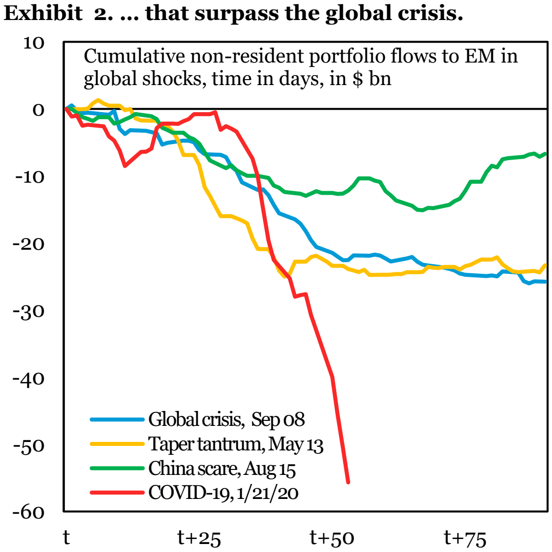
In the last two weeks we have marked down our global growth forecast, highlighted the sudden stop in capital flows emerging markets are experiencing, and identified what countries may have policy space to cushion the shock. It is conceivable that global growth may approach 1% this year, the lowest since the global financial crisis. In this context, our high-frequency capital flows trackers point to a sudden stop in EM due to the combination of uncertainty around the spread of COVID-19, and large oil price and financial shocks. There is policy space in EM to respond to the situation. Some in Europe and Asia have room for fiscal easing but debt in a few major EMs is too high to allow stimulus. As major central banks ease, rate cuts should be feasible where real rates are high. The objective of this ***Economic Views*** is complementing this workstream on the capital flows front. We put the capital outflows our trackers are picking up in historical context and sketch out the implications for EM external accounts. Cumulative outflows since late January have surpassed the levels observed at the peak of the global financial crisis and are an order of magnitude larger relative to the size of the global economy than in stress episodes such as the Asian financial crisis or the taper tantrum. Based on these past global shocks, we can expect reserve losses and substantial current account adjustment across EM as financing dries up.

Exhibit 1. Daily trackers show massive outflows, …



Source: Haver, IIF

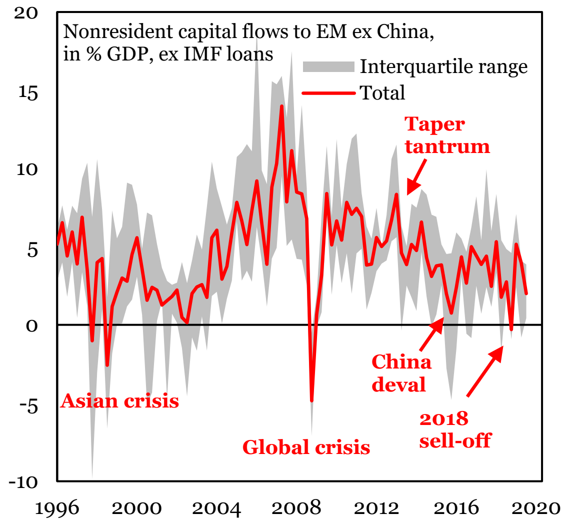
Exhibit 2. … that surpass the global crisis.



Source: Haver, IIF

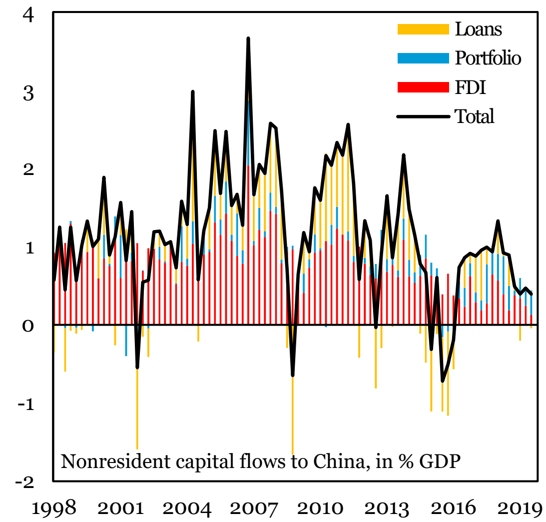
Our capital flows trackers give a daily snapshot of nonresident flows to key emerging markets. We cover more than twenty emerging markets, including China, India, South Africa, and Turkey. Importantly, our trackers are a relevant real-time proxy for balance of payments data, which come out with a significant lag. When aggregated at quarterly frequency, our daily trackers map to official BoP data with a small measurement error. The set of countries we track is also a good proxy for the broader EM universe. The trackers point to an unprecedented shock to nonresident flows to EM since the COVID-19 outbreak became a global concern in late January (Exhibit 1). Cumulative capital outflows since the COVID-19 episode began in late January are already twice as large as in the global financial crisis and dwarf stress events such as the China devaluation scare of 2015 and the taper tantrum in 2014 (Exhibit 2). Even if containment efforts and supportive macroeconomic policies have a positive impact soon, the shock to flows will remain unusually severe. We put the ongoing episode in further historical context using quarterly BoP data as our high-frequency trackers do not span decades. The outflows we are monitoring in real time are very large even by the standards of major events such as the Asian financial crisis (Exhibits 3 and 4).

Exhibit 3. The shock to flows is unprecedented, …



Source: Haver, IIF

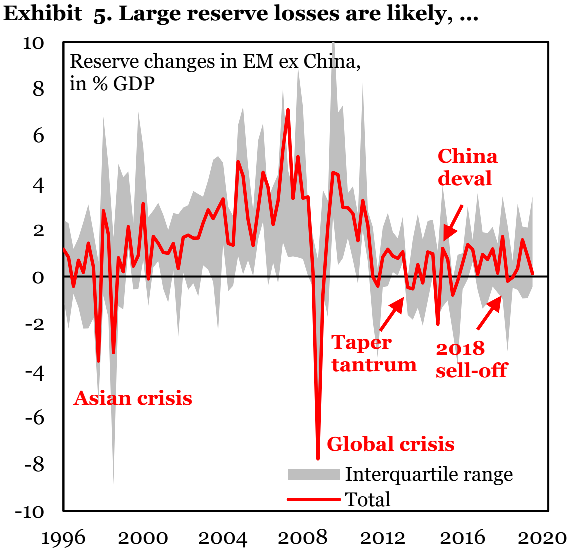
Exhibit 4. … both in China and the rest of EM.



Source: Haver, IIF

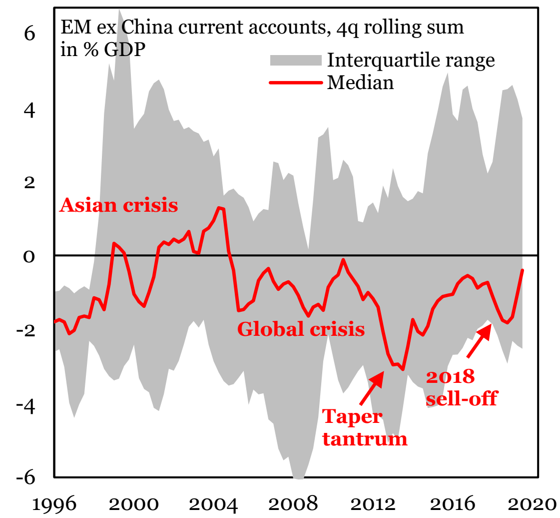
The sudden stop in capital flows puts emerging markets where external financing needs are large at particularly high risk. Last week, we reviewed such vulnerability systematically, highlighting that external debt amortization remains high in some countries despite generally low current account deficits. Relative to reserve buffers, financing needs are especially high in Turkey and South Africa. Vulnerability also exists in Chile and Colombia, where low commodity prices complicate the external financing picture. As in past stress episodes, reserve losses may be unavoidable as central banks step in to fill funding gaps (Exhibit 5). Even after drawing reserves down, funding may still be insufficient for many countries to run current account deficits. The sudden stop in capital flows could force sharp current account adjustment in EM, as was the case in past global shocks (Exhibit 6).

Exhibit 5. Large reserve losses are likely, …



Source: Haver, IIF

Exhibit 6. … as well as sharp current account adjustment.



Source: Haver, IIF