Macro Notes – 2020 Capital Flows Outlook for Emerging Markets

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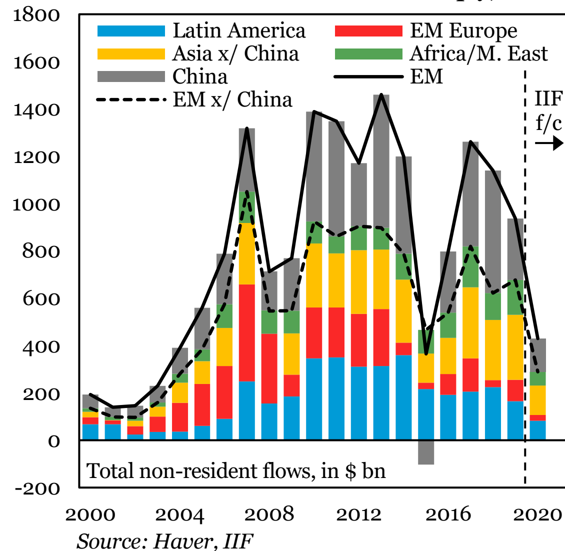
- The COVID-19 shock has led to a pronounced sudden stop in EM.
- Out short-term portfolio tracker shows record outflows in 2020Q1.
- We expect a modest recovery in capital flows in the 2nd half of 2020.
- Nevertheless, capital flows to EMs will be much weaker than in 2019.
- Given uneven EM policy space, multilateral support will be needed.

The COVID-19 shock has caused a pronounced sudden stop in capital flows to emerging markets. Our daily tracking of non-resident portfolio flows shows that EM experienced the largest outflow on record in 2020Q1, exceeding the worst points of the GFC. While we expect a recovery of flows in the second half of 2020, we do not believe that the pickup will be strong enough to bring about a return to 2019 levels. The recovery in flows will most likely follow that of economic activity, with EM Asia leading the way, and Latin America and frontier markets remaining subdued the longest. For many EMs, weaker inflows mean that they will not be able to continue to run large current account deficits and rapid adjustments are imminent. In this context, we expect many countries to turn to multilateral support in coming months due to a lack of policy space to support their economies.

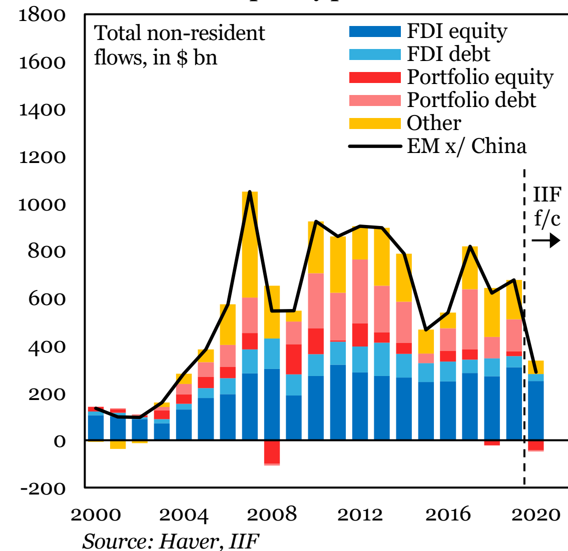
We project total non-resident flows to EM to slow considerably in 2020 (Exhibit 1), driven by the COVID-19 shock to global growth and risk sentiment, as well as the fall in commodity prices. In our forecast, non-resident flows will reach $444 bn, significantly lower than last year ($937 bn). Thus, 2020 will see weaker flows than either the GFC in 2008/09 or the China shock in 2015. Total foreign investments in EM excl. China are expected to come in at $304 bn, the lowest since 2004 (Exhibit 2). In terms of the composition, we expect foreign direct investment in EM excl. China to hold up better, but still fall relative to 2019 levels due to excess capacity (to $294 bn), while portfolio investment for the year will likely be negative at -$41 bn due to the risk-averse sentiment in 2020H1.

Exhibit 1. Non-resident flows will fall sharply, ...



Source: Haver, IIF

Exhibit 2. ... driven in part by portfolio outflows.



Source: Haver, IIF

Since the beginning of the year, EM have experienced record portfolio outflows (Exhibit 3), larger than during any recent crisis episode (Exhibit 4). A combination of the global COVID-19 shock and a substantial drop in oil prices led to outflows of around $83 bn in March alone. Year-to-date, our high-frequency tracker shows portfolio equity outflows of $72 bn and debt outflows of $25 bn. EM Asia was particularly affected, then other EMs began to suffer significant outflows as the pandemic spread. While the COVID-19 shock has led to record outflows for the overall EM complex, China assets suffered less with respect to similar outflow episodes.

Our base scenario assumes that non-resident portfolio flows will begin to recover in 2020H2 as countries emerge from COVID-19-related shutdowns and benefit from accommodative monetary policy in G-3 countries. Nevertheless, we forecast non-resident portfolio flows to EM excl. China to be negative for the whole year (Exhibit 5). The collapse in equity flows is expected to be

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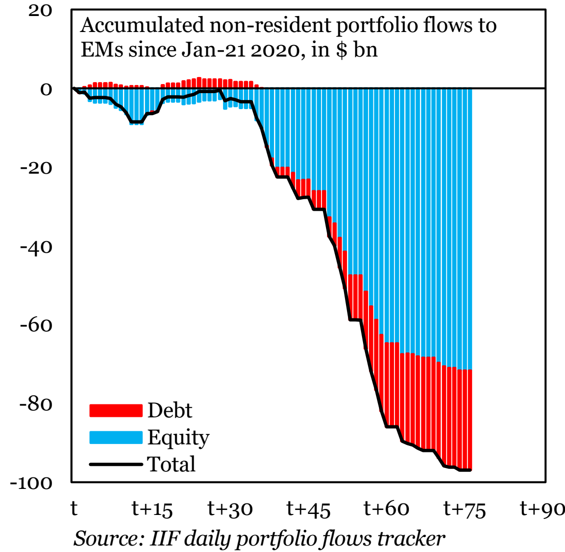
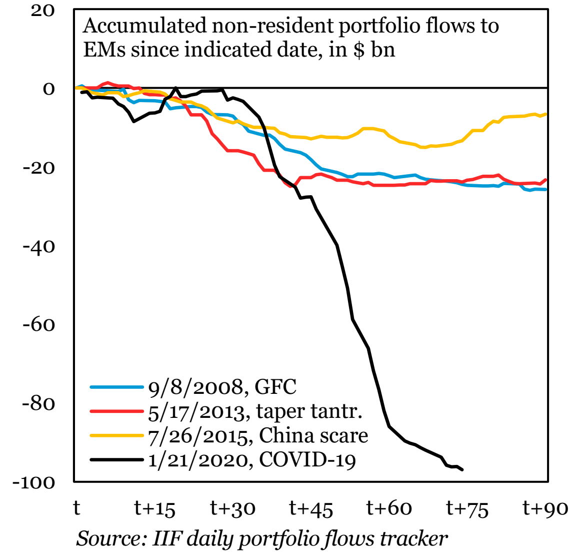
broad-based, with all regions except Africa/Middle East experiencing sizable outflows. Furthermore, we foresee a slow recovery of equity flows due to a sluggish rebound in emerging market growth. We forecast debt flows to be negative in both Latin America and EM Europe, with the former seeing outflows of more than $16 bn and the latter of $5 bn.

Exhibit 3. 2020Q1 saw record portfolio outflows, …



Source: IIF daily portfolio flows tracker

Exhibit 4. … larger than in previous crisis episodes.

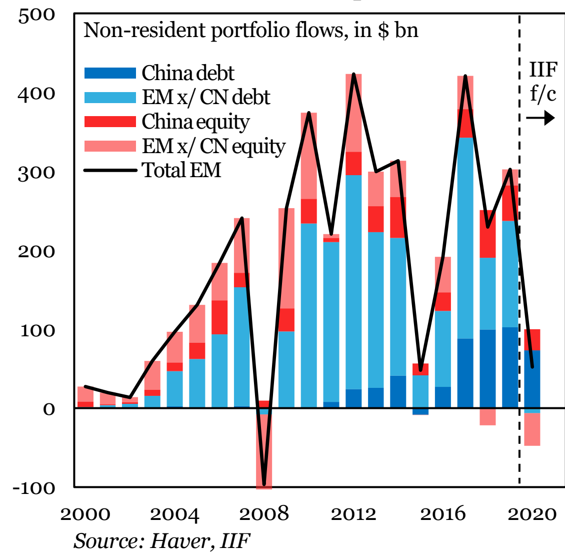


Source: IIF daily portfolio flows tracker

As a result of the sudden stop in capital flows, most emerging markets will not be able to run significant current account deficits and will have to draw down reserves (Exhibit 6). At the same time, commodity exporters will be severely affected by the decline in oil prices. We project Russia's current account surplus to shrink by roughly $50 bn and Saudi Arabia's to turn into a large deficit. Commodity importers will only marginally benefit from lower commodity prices due to shutdowns of economic activity. This, along with significant currency depreciation, will bring current accounts close to balance in many countries—including India and South Africa—while it will lead to sizable surpluses in countries such as Argentina, Chile, and Mexico. As a result of the outlined capital flows dynamics, we expect a significant drawdown of reserves in the EM universe (excl. China).

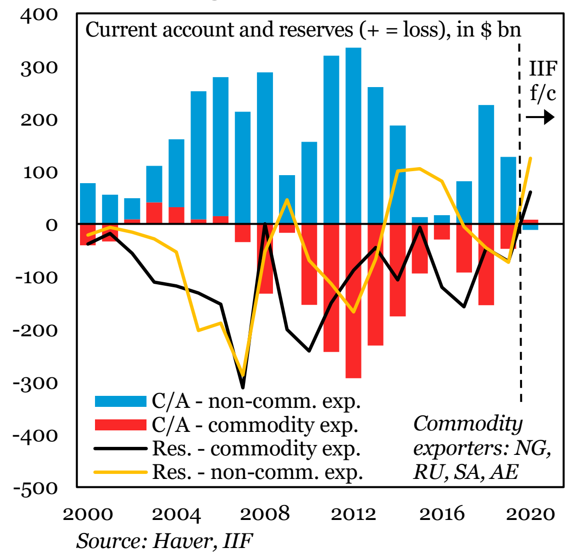
As foreign exchange shortages emerged globally, the Fed has reactivated swap lines to EM. Subsequently, it introduced a facility accessible to many global central banks to repo their treasury holdings for FX liquidity. However, in some cases, the COVID-19 shock, together with pre-existing challenges, will require additional external support.

Exhibit 5. EMs excl. China will see portfolio outflows, …



Source: Haver, IIF

Exhibit 6. … leading to substantial reserve losses.



Source: Haver, IIF