Box 1

Explaining the slowdown in portfolio flows to EMEs

Prepared by Maurizio Habib and Thomas Kostka

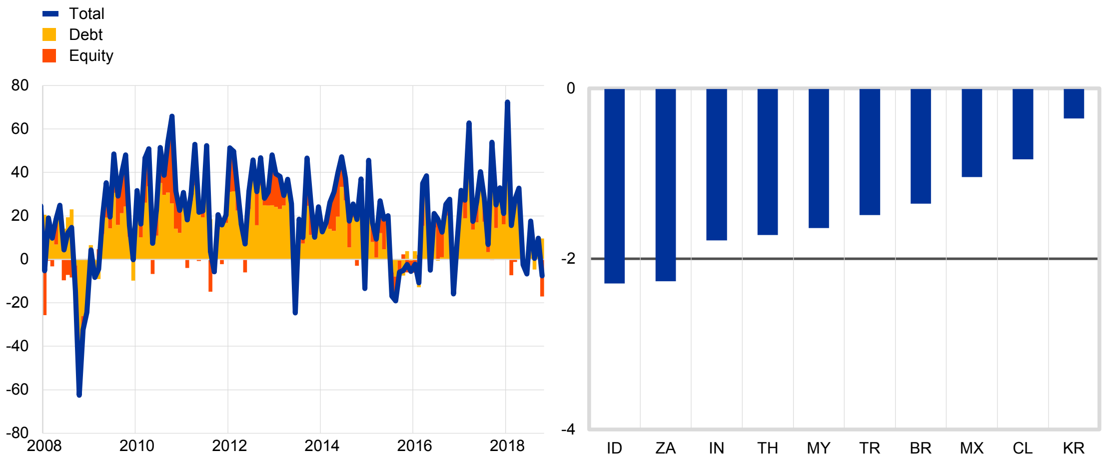
Portfolio flows to EMEs have declined significantly in the course of 2018, largely as a result of increased investor sensitivity towards EME asset markets and rising protectionist pressures. After a spell of strong and stable foreign purchases of debt and equity instruments issued by sovereigns and corporates in EMEs throughout 2017, aggregate portfolio flows to EMEs have dipped notably since February 2018 (see **Chart A,** left panel). Global investors started to reassess the potential negative effects of a tighter US monetary policy and a stronger dollar on financial conditions in EMEs and the downside risks to global growth stemming from mounting protectionist pressures. EMEs appear to be particularly exposed to these risks. Several EMEs borrow heavily in international markets and are affected by the tightening of US dollar funding conditions. Moreover, EMEs are generally more open to trade than advanced economies, relying on policies geared towards free trade to support economic growth. This box aims to disentangle the role of these global factors in driving the recent slowdown in portfolio flows to EMEs from country-specific vulnerabilities, which may have exacerbated the impact of global risks.

Chart A

EME portfolio outflows are still moderate compared with previous episodes of EME turmoil, but flows to several large EMEs came close to a sudden stop in the course of 2018

Non-resident portfolio flows to EMEs by asset class (left panel) and standardised flows to selected EMEs in 2018 (right panel)

(left panel: Jan. 2008-Oct. 2018, USD billions; right panel: minimum value for Jan. 2018-Sep. 2018)



Sources: Institute of International Finance (IIF) and ECB staff calculations.
Notes: Left panel: the aggregate is based on monthly data for 20 countries: Brazil, Bulgaria, Chile, China, the Czech Republic, Hungary, India, Indonesia, Korea, Lebanon, Malaysia, Mexico, the Philippines, Poland, South Africa, Taiwan, Thailand, Turkey, Ukraine and Vietnam. Right panel: a sudden stop is defined as a situation in which total portfolio flows are less than two standard deviations below their mean. See Forbes, K.J. and Warnock, F.E., "Capital flow waves: Surges, stops, flight, and retrenchment", *Journal of International Economics*, Vol. 88(2), 2012, pp. 235-251. The mean and standard deviation of portfolio flows are estimated over a five-year rolling sample of three-month averages. The bars show the minimum estimates for January to October 2018. ID: Indonesia, ZA: South Africa, IN: India, TH: Thailand, MY: Malaysia, TR: Turkey, BR: Brazil, MX: Mexico, CL: Chile, KR: South Korea.

On aggregate, the slowdown in portfolio flows so far has been less abrupt compared with previous periods of market tensions in EMEs. In particular, non-resident purchases of EME portfolio instruments turned negative in May and June, but these outflows did not reach the intensity of previous similar episodes, such as the global financial crisis, the "taper tantrum" episode in 2013 and the correction in global commodity markets and Chinese equity markets in 2015. At the same time, the slowdown has been relatively sustained over time, marking the start of a new period of lower global appetite for the risky asset class of emerging market equity and debt.

While on aggregate portfolio flows to EMEs have shown some resilience to rising volatility, some large EMEs have experienced outflows approaching "sudden stop" levels. Notably, some of the largest EMEs have experienced sizeable portfolio outflows in the course of this year. Foreign flows out of bond and equity markets in Indonesia and South Africa, and to a lesser extent in India, Thailand, Malaysia, Turkey and Brazil, have been in a range from slightly above to somewhat below a threshold that defines a sudden stop according to popular metrics in the international finance literature (see **Chart A**, right panel).

From an aggregate viewpoint, the slowdown in flows to EMEs can be explained by a tightening in global financial conditions as well as by domestic factors. There are two broad categories of factors explaining portfolio flows into EMEs.[2] Push factors comprise popular indicators of global risk and financial conditions, coming in particular from the United States, which are deemed

[2] For an overview, see Koepke, R., "What Drives Capital Flows to Emerging Markets? A Survey of the Empirical Literature", MPRA Paper 62770, University Library of Munich, 2015.

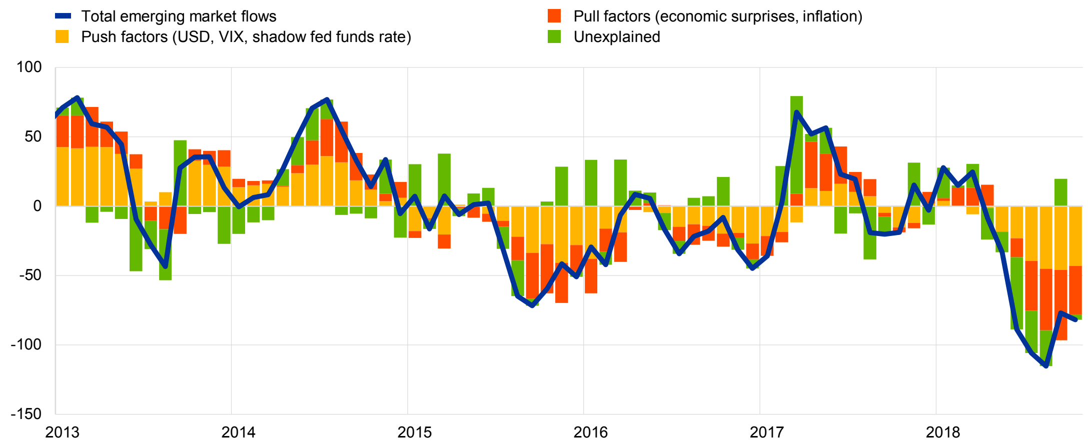
key determinants of investors' liquidity and risk appetite towards EMEs.[3] Pull factors, such as the strength of domestic growth and macroeconomic fundamentals, are also important factors in explaining investments in EMEs, beyond global financial conditions. A simple econometric model that decomposes recent dynamics in aggregate portfolio flows to EMEs into these two broad factors attributes the bulk of the recent slowdown to a stronger negative contribution from a set of push factors (see **Chart B**), notably the strengthening of the US dollar in 2018, several further US monetary policy rate hikes and, to a lesser extent, increases in equity market volatility from the extremely low levels observed in previous years.[4] Moreover, domestic factors have also increasingly contributed to the outflows. In particular, economic surprises have recently been on the downside and inflation rates have increased.

Chart B

The recent slowdown in aggregate portfolio flows was mainly driven by tighter global financial conditions, but also by waning domestic support

Total portfolio flows to EMEs decomposed into push and pull factors – deviations from sample means

(Jan. 2013-Oct. 2018, USD billions)



Sources: IIF, Citigroup, sentix, Federal Reserve Board, Haver and ECB calculations.
Notes: Total EME flows are de-meaned three-month moving sums of non-resident equity and bond flows to a set of EMEs listed in the notes of Chart A. Push and pull factors are derived from a univariate autoregressive distributed lag (ARDL(1)) model of total EME flows explained by five indicators: EME inflation (pull), EME economic surprise index (pull), narrow US dollar nominal exchange rate (push), VIX index (push) and the shadow US federal funds rate (push).

In sum, the slowdown in foreign portfolio flows to EMEs was driven by both push and pull factors. Higher interest rates for US dollar-denominated bonds and a stronger dollar have tightened financial conditions for a number of EMEs, exacerbating external vulnerabilities for corporate and sovereign borrowers that rely on dollar funding without sufficient hedges. Also, the news flow about the economic situation in EMEs has generated selling pressure for global portfolio investors. Finally, it should be noted that the aggregate analysis, presented here, masks important cross-country heterogeneity in respect of country-specific vulnerabilities, such as political uncertainty or the extent of external imbalances (see **Chart 3** in the **Overview**).

[3] In the light of the importance of the US dollar for the majority of EMEs, US financial conditions are a key determinant of financial conditions in EMEs and hence of capital flows; see for instance Rey, H., "Dilemma not trilemma: the global cycle and monetary policy independence", *Proceedings - Economic Policy Symposium - Jackson Hole*, Federal Reserve Bank of Kansas City, 2013, pp. 1-2.

[4] As the strengthening of the dollar and the increase in US policy rates had already commenced in previous years, the model is not fully capable of explaining the full extent of the recent slowdown, nor can it fully explain the strong inflows observed in 2017.