

»» Interest rate reversal – a threat to capital flows to developing and emerging economies?



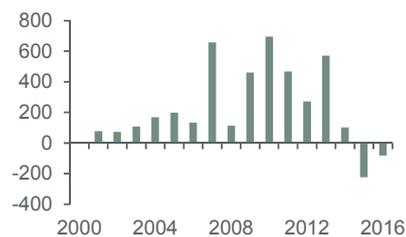
No. 159, 21 March 2018

Author: Dr Tobias Rehbock, phone +49 69 7431-2686, tobias.rehbock@kfw.de

Since the outbreak of the financial and economic crisis, advanced economies (AE) have been characterised by a highly expansionary monetary policy and a pronounced low-interest phase. One of the consequences of this was the 'search for returns' and resulting increases in capital inflows to developing and emerging economies (DE/EE). In the years 2010 to 2014, annual inflows were more than twice as high as in the years preceding the crisis (2000 to 2007, Figure 1).

Figure 1: Capital inflows to DE/EE

Balance on the financial account in USD billions (here and below: without changes in currency reserves, positive means capital inflow)



Sources: IMF, KfW Research

The low-interest phase is slowly coming to an end. The US Federal Reserve leads the way, which has raised the benchmark interest rate by 150 basis points since the end of 2015 and has additionally begun to reduce the size of its securities portfolio. Interest rate increases in AE are raising concern that capital flows into DE/EE will decrease.¹

The level of capital flows to DE/EE does not only depend on the interest rate differential to the advanced economies. Many other factors play a role. Investment decisions are affected not just by investors' level of risk aversion but also by differences in growth expectations and structural factors, such as the currency reserves of the DE/EE and aspects of governance and legal safety.

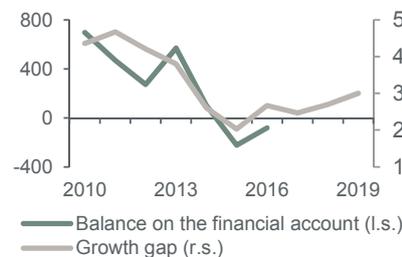
While economic performance is convincing ...

The prospects for the development of capital inflows to DE/EE are thus the result of the expected development of their most important determinants.

1. The growth lead which DE/EE have on the AE will continue or even increase slightly in 2018 and 2019 (Figure 2). The growth momentum in most DE/EE will remain stable or even accelerate (in Brazil, India and South Africa, for example), while the AE probably passed their growth peak in 2017 (for example Japan, the UK) or will reach it in 2018 (e.g. Germany, France, the US).

Figure 2: Capital inflows and growth

Balance on the financial account: USD in billions, growth gap: GDP growth of DE/EE minus growth of AE, in percentage points



Sources: IMF, KfW Research

... risk appetites and reserves are uncertain.

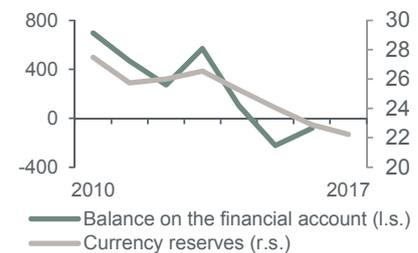
2. Interest differentials by themselves do not necessarily trigger capital flows because in the case of matching maturities a higher return implies higher risk. After the financial crisis, however, the DE/EE benefited from high risk appetite worldwide and risk spreads decreased. It is hard to predict how risk attitudes will evolve in the future. But the current phase of highly dynamic global growth will presumably come to an end after 2019. Lending conditions are tightening and new sources of risk, such as a hard Brexit or trade wars, are currently emerging. In a rising interest

rate environment, more attention will again be paid to the dangers posed by high corporate debt in DE/EE. Investors will therefore tend to be more cautious.

3. Currency reserves play a role in the context of risk. It is easier to achieve a certain stabilisation in crisis situations when the financial system has access to sufficient currency reserves through the central bank. The currency reserve buffer of DE/EE, however, is on a downward trend – not just in relation to GDP (Figure 3) but also calculated in import months, for example.

Figure 3: Capital inflows and reserves

Balance on the financial account: USD in billions; currency reserves: in per cent of GDP



Sources: IMF, KfW Research

Conclusion

The robust economic environment in DE/EE does not suggest that the interest rate reversal will lead to any significant reduction in capital inflows or even massive outflows over the next one to two years. But the climate for capital inflows to the DE/EE will probably become rougher in the years ahead, so that accompanying factors that determine capital flows, such as governance, institutional quality or legal safety, will gain importance. ■

¹ Capital outflows in 2015 and 2016 were not yet caused by the interest rate reversal but resulted exclusively from the specific situation in China.