CEE: The virtuous and vicious of capital flows

Gillian Edgeworth, Chief EEMEA economist
The changing composition of capital flows

Since the 2008 crisis there has been a shift in the composition of capital flows from long term to short term in nature. Over the 6 quarters to Q2-11, the region saw capital inflows of EUR116bn, EUR72.3bn of which were portfolio flows, primarily to fixed income markets. Longer term forms of investment such as FDI and long term bank borrowing have shown a very limited recovery.

Source: National central banks, UniCredit Research
Decreasing differentiation across countries

Turkey and Poland account for the majority of portfolio inflows since the 2008 crisis. Over the 8 quarters to Q2-11 portfolio inflows to Poland and Turkey amounted to EUR33.4bn and EUR25.1bn respectively. However over the course of recent quarters 'weaker' economies in the region have also benefitted, in particular Hungary, Romania and Ukraine.

IMF countries refer to the aggregate of inflows to Hungary, Latvia, Romania and Ukraine.

Source: National central banks, UniCredit Research
Governments appreciate financing

A significant chunk of portfolio flows have found their way to domestic fixed income markets, helping to finance governments and prevent crowding out of the private sector. Foreign holdings as a % of the market stand at record highs in Poland and Hungary.

Source: National central banks, UniCredit Research
IMF support coming to an end

The IMF played a crucial role in the region over 2008/09. The majority of funding at this stage has now been disbursed, with repayments for some countries to begin by the end of this year.

Source: IMF, European Commission, UniCredit Research
Foreign banks differentiate across countries

Foreign banks have reduced exposure to some countries much more than others.

Source: BIS, UniCredit Research
Russia is the exception to the rule

Russia is one of the few emerging markets globally not to see a significant recovery in global capital flows while domestic capital outflows have accelerated.

Any recovery in foreign inflows is being neutralised by domestic outflows

Locals continue to lack trust

Source: CBT, NBP, UniCredit Research
Current account balances in most cases have adjusted

Most countries in the region have seen C/A deficits adjust significantly, limiting adjustment pressures this time around.
Despite EMU woes, the region is holding its own in terms of economic activity. GDP growth has softened significantly but remains positive while latest indicators for Q3 (including September) point to slowing growth but not recession.
Capital outflow represents the primary risk

Last week saw the largest outflow on record from emerging market funds, providing clear evidence that EM is no longer a safe haven but is clearly being impacted by weakening global risk appetite.

Source: Bloomberg, EPFR, UniCredit Research
An examination of central bank ability to defend their currencies/smooth capital outflows relative to 2008 reinforces the need for such insurance.

1. We sum portfolio inflows and short term external borrowing (banks, non-bank corporates and governments) between Q1-07 and Q3-08.

2. We then calculate the percentage of these inflows that reversed between Q4-08 and Q2-09, as well as external sovereign debt coming due, all as a % of FX reserves.

3. We repeat step no. 1 for the period Q1-10 to Q2-11 (though for a number of countries Q2 BoP data is still not available). From step 2 we apply the same ratio of outflows to inflows as over Q4-08 – Q2-09. In the event that outflows exceeded 100% of inflows after the 2008 crisis, i.e. all short term borrowing portfolio flows not only fall back to end-06 levels but even further, we capped the outflows at 100%. This is to capture the fact that there has been a more limited time period this time around for accumulate inflows. Finally we add sovereign external debt and IMF repayments coming due until year-end.

Source: National central banks, UniCredit Research
Against a backdrop where the region remains significantly more indebted than other developing regions and FX has not helped in restoring competitiveness, macro performance will be determined to a large extent by government and central bank policy.

Source: IMF World Bank, BIS, National central banks, UniCredit Research
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