

# **FINANCIAL MARKETS OUTLOOK**





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## About the report

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The Financial Markets Outlook is a semi-annual review of financial market developments and prospects for capital flows across developing countries. The report is published in February and July and can be accessed at : [www.worldbank.org/globaloutlook](http://www.worldbank.org/globaloutlook).

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## Overview

Financial markets are undergoing a significant transition as strengthening growth in high-income economies is prompting an end to the extraordinary stimulus measures taken in the wake of the global financial crisis.

During the spring and summer of 2013, long-term interest rates on U.S. sovereign debt nearly doubled as financial markets reacted to the prospect of a tapering-off of the Federal Reserve's quantitative easing policies. The sharp increase in U.S. yields sparked a sudden portfolio adjustment by international investors away from developing country assets, leading to a significant decline in capital flows. Most of this adjustment had played itself out by end-August 2013, with equity, bond and foreign exchange markets recovering or stabilizing in the final months of the year. Gross capital inflows also recovered during the fourth quarter of 2013, with the volume of foreign capital raised through new bond, equity and syndicated bank lending up 13.6 percent from a year earlier.

In contrast to the summer, financial markets did not react when the U.S. Federal Reserve actually announced on December 18 and began reducing the extent of its quantitative easing policies (early January 2014). Long-term U.S. Treasury yields remained stable and volatility on currency markets was low, suggesting that a large part of the tapering impact had already been priced in.

However, this period of relative market calm was broken towards the end of January, when the Argentine peso devalued by 16 percent, which, amid concerns about slowing growth in China, led to a sudden shift in market sentiment. While not entirely unexpected, global equity markets weakened sharply. The sell-off was initially concentrated among developing countries, including several that were already hard hit in the summer of 2013. However, stock-market losses in high-income countries were nearly as heavy, pointing toward a broadly-based equity market correction rather than a targeted pullback from developing-country assets. As of February 14 (the cut-off date of this publication), markets appeared to have stabilized and recouped some of their earlier losses, with stock-market indices in both developing and high-income countries down around 3 percent since January 22.

Although the turmoil coincided with the further unwinding of the Federal Reserve's quantitative easing program, it does not appear to have been caused by it. The actual decision to continue tapering asset purchases was made on January 29, after the sell-off began and in line with market expectations.

Unlike the mid-2013 episode, when U.S. long term interest rates increased by 130 basis points, they have actually declined by 20 basis points since the start of 2014. These developments suggest a modest flight to quality and general rotation from equity markets into highly rated sovereign bonds.

Although, developing country spreads have increased by about 35 basis points, the decline in U.S. rates means that yields and borrowing costs have risen only marginally. A somewhat larger number of developing-country currencies depreciated this January when compared with last summer, with new pockets of vulnerabilities observed, in particular in Eastern Europe and Central Asia.

Responding to currency and domestic inflationary pressures, monetary policy was tightened in several developing countries since January 22. In particular, an aggressive increase in policy rates in Turkey helped stabilize its currency, and was soon followed by a period of relative calm in foreign exchange markets. Policy rates do not appear to be too tight given domestic conditions.

Looking forward, prospects are mixed. Financing conditions are likely to tighten further in the coming months as monetary policies continue to normalize. This, combined with a shrinking growth differential between developing and high-income countries, should translate into weaker capital inflows to developing countries this year. Overall, net private capital inflows are projected to slow from \$1.078 trillion (4.6 percent of developing-country GDP) in 2013 to \$1.065 trillion (4.2 percent of GDP) in 2014.

Should global interest rates increase more abruptly than currently expected or market volatility becomes the new norm, more disorderly adjustments could not be ruled out. Simulations suggest that a sudden and sustained 100 basis points increase in U.S. bond yields could dent capital inflows to developing countries by around 50 percent for several months while a persistent 10 point rise in the VIX index, a common measure of market risk aversion, could reduce them by around 30 percent over a similar horizon.

## A bumpy road for financial markets since mid-2013

Developments in global financial markets during 2013 were dominated by signs of a gradual normalization of activity and policy in high-income countries. Improving growth prospects in the U.S., Japan, and Euro Area narrowed

prospective growth differentials between high-income and developing countries, and prompted speculation and the eventual initiation of a gradual withdrawal of the extraordinary monetary policies that were put in place following the 2008 financial crisis.

### Developing countries experienced a substantial drop in portfolio inflows during the summer

In May last year, the Federal Reserve’s announcement that it might start tapering its quantitative easing (QE) policy earlier than expected provoked a rapid rise in long-term U.S. Treasury yields. This led to significant portfolio adjustments among international investors (see Box 1).

During the spring and summer of 2013, gross capital flows to developing countries declined by 45 percent. After averaging \$54 billion during the first five months of the year, the combined volume of international bond issuance, cross-border syndicated bank lending, and equity placement fell to \$30 billion. Bond and equity issuances were especially weak over the summer, reflecting market uncertainty and the more direct portfolio effect of a near doubling of U.S. long term interest rates, from about 160 to more than 290 basis points. At an average of \$22 billion over the June to August 2013 period, bond issuances were down 39 percent from a year earlier, while new equity placement totaled only \$900 million in August, the lowest monthly level since November 2008.

On secondary markets, overseas investors withdrew out about \$67 billion from emerging-market fixed-income and equity funds between June and August, an amount exceeding

the cumulative inflows during the first five months of 2013 (figure 1). The retrenchment was less acute for equity than for bond funds, which posted the largest and longest consecutive months of outflows since 2008. This partly reflected rotation out of emerging-market bonds into other markets, including emerging-market equities.

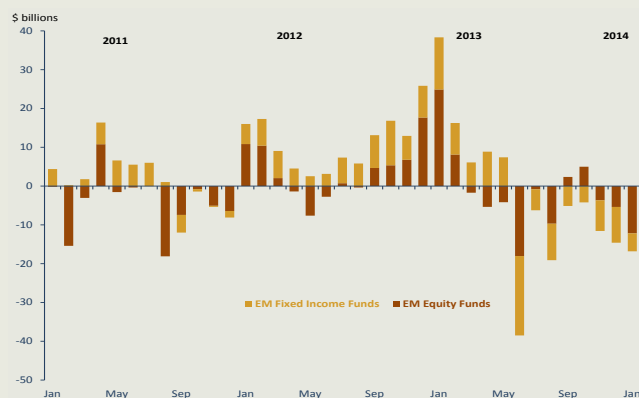
### Asset price adjustments were significant, but losses were mostly pared by summer-end

The rapid unwinding of positions during the summer weakened developing-country asset prices. Between late May and August, developing-country currency, bond and stock market indices had fallen by 3.8, 10.8, and 13.2 percent respectively -- one of their worst performance in the past decade.

Developing countries facing external and domestic imbalances and a relatively high dependence on foreign capital inflows—such as Brazil, India, Indonesia, Malaysia, Turkey, and South Africa—were particularly hard hit (figure 2). In part, the larger impacts on these countries reflected the depth and liquidity of their financial markets. In so far as the sell-off represented a portfolio adjustment, money could only leave those economies where it had previously been invested.

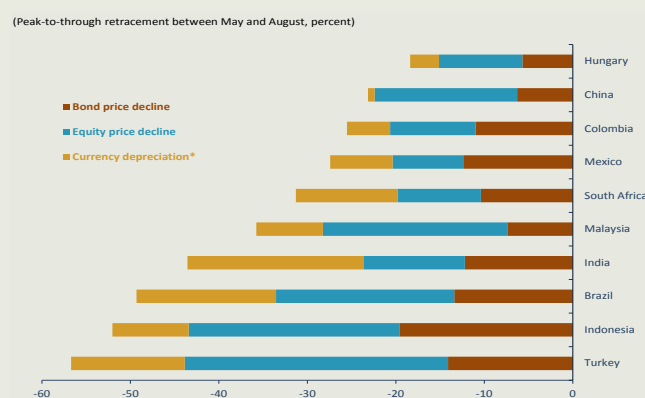
However, not all liquid developing-country markets were equally hit. Several middle-income countries that had received large foreign inflows in the past, including Peru and Mexico, were only moderately affected as investors mainly withdrew funds from countries characterized by high current account deficits, inflation, excessive indebtedness or political vulnerabilities. Overall, the currencies of

**Figure 1** Investors withdrew large sums of money from emerging-market funds in 2013



Source: EPFR Global and World Bank.

**Figure 2** Market performances of selective developing countries during the summer volatility



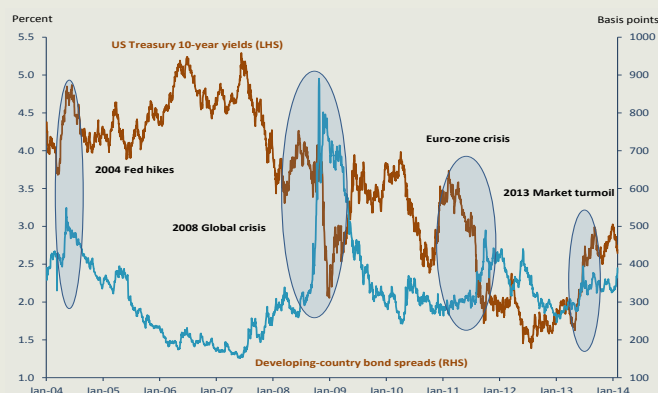
Source: Bloomberg and World Bank.  
Note: \*Nominal Effective Exchange Rates.

**Box 1** The rise in U.S. Treasury yields triggered a significant portfolio readjustment.

Expectations of an imminent withdrawal of the U.S. monetary stimulus pushed up the yield on 10-year U.S. Treasury notes by more than 130 basis points. Yields on developing-country bonds rose by close to 210 basis points as their spreads increased by some 80 basis points between early May and end-August (see figure B1.1).

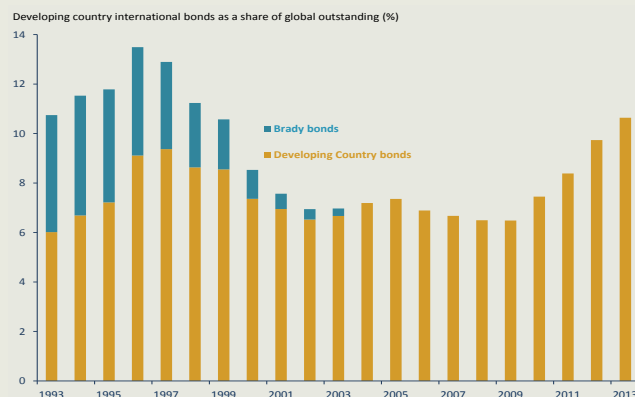
Higher U.S. returns served to reverse some of the inflows into developing countries that ultra-low U.S. interest rates had prompted in the post-crisis period. Since 2009, the share of developing country bond markets in global fixed-income allocations rose from 7 percent in the last decade to more than 10 percent in the first half of 2013, the highest level seen in the past two decades (excluding Brady bonds, figure B1.2). The steady rise in flows partly reflected the low returns in high-income countries on assets with similar risk profiles, but was also prompted by rising credit ratings among developing-country assets (and declining ratings for high-income assets).

**Figure B1.1** U.S. Treasury yield has been a key driver for developing-country financial markets



Source: Bloomberg, JP Morgan Chase, and World Bank.

**Figure B1.2** The share of developing-country bonds\* in global bond outstanding is at a record high



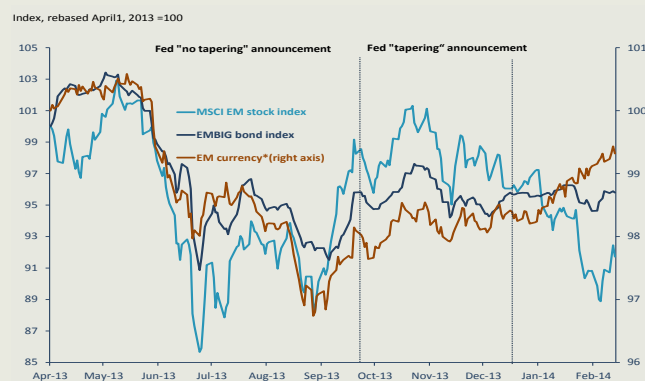
Source: World Bank.  
Note: \*Net of Brady Bonds.

around 65 percent of developing countries were broadly stable or actually appreciated during the May through September period.

The financial market losses of the summer of 2013 were partially recouped later in the year, as the initial portfolio rebalancing came to an end and the Fed decided, in September, to postpone the tapering of its asset purchase program (figure 3). Credit-default swap spreads and borrowing costs for developing countries declined from their June peaks and stock markets regained some of the lost ground. Nevertheless, none of the indicators fully recovered their pre-summer levels.

The eventual tapering decision by these Fed in December 2013 was greeted with calm and had, overall, a limited direct impact on financial markets, reflecting the fact that investors had mostly priced in the initial impact.

**Figure 3** Downward pressure on emerging markets began to ease in mid-August as portfolio adjustment drew to close



Source: Bloomberg and World Bank.  
Note: \*Nominal Effective Exchange Rate.

Despite the ups and downs, developing-country stock market volatility was lower in 2013 than in any other post-crisis year, following a decline in market uncertainty and financial stability concerns in high income countries.

### Gross capital flows recovered after September and ended the year on a high note

Gross capital flows to developing countries recovered in September and remained robust during the fourth quarter of 2013 (figure 4). The rebound reflected relatively stable U.S. Treasury yields, improvement in global economic prospects, and the attempt by some developing-country borrowers to lock in lower financing costs prior to actual QE tapering.

International bond flows were sustained over that period, albeit less than in the first five months of the year. Corporate borrowers continued to dominate bond market issuances during the final months of 2013 (accounting for about 70 percent) as many developing-country companies took advantage of still low interest rates and calmer market conditions. While overall flows were strong, market access for high-risk corporate borrowers was tighter, reflecting more discriminating and risk-averse markets (figure 5).

Several non-investment grade sovereign borrowers (including Hungary, Gabon, Macedonia, Ukraine, Honduras, and Laos) came to the international bond market in 2013, restructuring older, more expensive debt and locking in current rates by extending maturities to insure against possible additional increase in borrowing costs.

Equity flows (a combination of initial public offerings [IPOs] and follow-on issuance) were subdued up to November last year, but got a boost in December from the end of a 14-month ban on IPOs by the Chinese government. This drove up equity placement in China by \$5 billion, more than 70 percent of the total developing-country equity flows for that month.

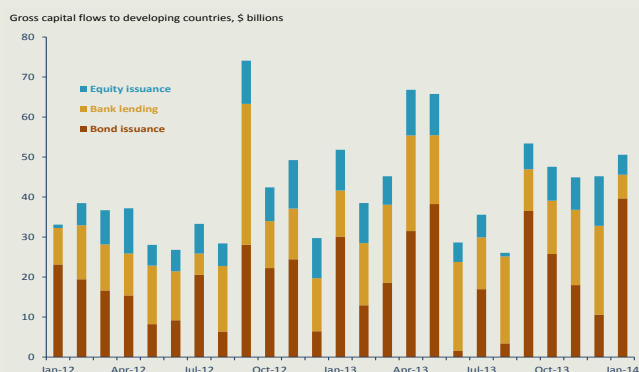
After being broadly unaffected by rising borrowing costs during the summer, cross-border syndicated bank lending to developing countries slowed slightly in September and October, reflecting lagged adjustments as loan transactions take several months to be completed. Following the 2008 financial crisis, the subsequent drop in bank lending was also much more gradual compared with bond and equity flows. Nevertheless, bank flows bounced back during the last two months of 2013, averaging about \$21 billion compared to January-September average of \$18 billion.

### Net private capital flows fell slightly in 2013, recording the first decline since 2009

Despite international bond issuance and syndicated bank lending flows reaching record levels of \$245 billion and \$216 billion respectively in 2013, total net private capital inflows to developing countries were down slightly for the year as a whole, to \$1.08 trillion (4.6 percent of developing-country GDP) from \$1.09 trillion in 2012 (5 percent of GDP) (figure 6).

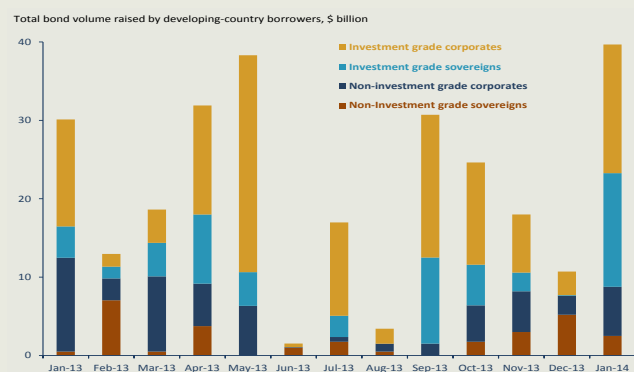
The main factor driving the deceleration in overall financial flows to developing countries – the first one since 2009 – was the retrenchment of portfolio investments

**Figure 4** Capital flows to developing countries remain strong in 2013 despite sharp declines over the summer



Source: Dealogic and World Bank.

**Figure 5** Market access for high-risk corporate borrowers became more difficult following the market turmoil



Source: Dealogic and World Bank.

and, in particular, sharp outflows of retail investors from emerging market equity and bond funds.

The marked volatility mid-year caused portfolio equity inflows to decline by 41 percent to about \$58 billion. Net bonds flows slowed as well in 2013, while both bank flows and short-term debt flows picked up, responding to a sharp drop in loan funding costs, reduced deleveraging pressure on European banks and a pick-up in global trade in 2013. The recovery in short-term debt flows follows a significant decline of this form of financing in 2012.

Foreign direct investment (FDI) to developing countries was broadly stable in 2013 at \$624 billion (2.6 percent of GDP), rising only 2 percent in nominal terms and declining as a percent of GDP. FDI was still dynamic in the first half of the year, with flows slowing modestly in the third quarter amid heightened volatility in global capital markets. However, the share of developing economies in global FDI climbed to a record high of about 52 percent in 2013 (figure 7). This was mainly explained by a 27 percent contraction in FDI to high income countries in 2013, largely reflecting the continued decline in FDI inflows to the United States.

Sub-Saharan Africa and East Asia and the Pacific regions weathered the mid-2013 market turmoil better than other developing regions in terms of net private capital inflows.

Flows to Sub-Saharan Africa continued to rise, reaching an estimated 5.3 percent of regional GDP in 2013 (table 1)--significantly above the developing-country average of 3.9 percent of GDP. Strong inflows partly reflect a much delayed increase in regional intermediation, but are also

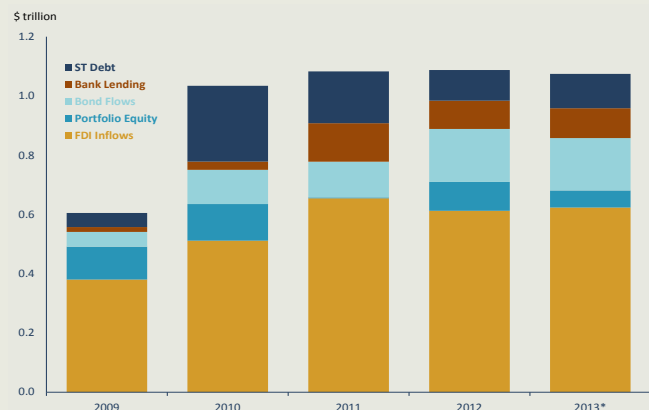
the result of a period of rapid growth, in excess of 5 percent since 2009. Importantly, the majority (70 percent) of these inflows are in the form of less volatile FDI. While much of the FDI has focused on the region's burgeoning resource sector, some 30 percent of it is focused on the domestic market. Furthermore, while FDI is dominant, the region is also a leading recipient of portfolio inflows. At 1.2 percent of GDP, equity and bond financing to Sub-Saharan Africa is among the highest in all regions when measured as a percent of regional GDP.

Private flows to East Asia and the Pacific also rose in 2013 with the increase in bank and bond flows offsetting a sharp drop in portfolio equity inflows. Meanwhile, private capital inflows declined in other regions with the 29 percent decline in the Middle East and North Africa being the largest.

The regional trend for FDI flows was somewhat mixed. The largest percentage increase was in South Asia where FDI increased by about 17 percent after posting a sharp 32 percent drop a year earlier. The rebound was led mostly by India as policy in the country continued to become more welcoming of FDI. Similarly, FDI inflows to Latin American countries increased by 5 percent, helped by the Belgian beer company AB InBEv's mega acquisition of Mexican beer maker Grupo Modelo for \$20.1 billion. Meanwhile, FDI inflows to East Asia and the Pacific economies registered a modest growth of 3 percent, reflecting slowing growth in FDI flows to China, Indonesia, and Thailand.

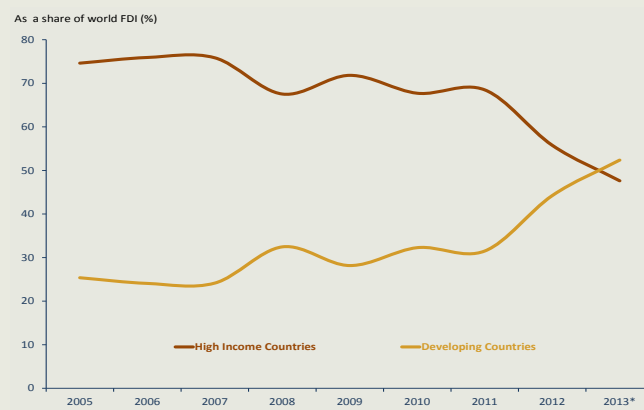
In contrast, FDI inflows to Europe and Central Asia (excluding Russia from the region's aggregate due to its reclassification as a high-income country) fell by about 15 percent with countries that have significant external

**Figure 6** Net private capital flows to developing countries



Source: World Bank.  
Note: \*World Bank staff estimates.

**Figure 7** Developing economies take the biggest share of global foreign direct investment in 2013



Source: World Bank.  
Note: \*World Bank staff estimates.

**Table 1** Net private capital inflows to developing countries by region

\$ billion	2009	2010	2011	2012	2013*
Developing countries	604.2	1,035.9	1,077.3	1,093.6	1,078.4
East Asia and Pacific	255.1	525.6	546.8	482.5	495.3
Europe and Central Asia	52.3	57.3	130.4	128.1	114.2
Latin America and Caribbean	143.2	280.8	262.8	300.3	289.9
Middle East and N. Africa	28.4	30.1	9.0	27.9	19.8
South Asia	79.0	96.1	78.1	92.1	84.7
Sub-Saharan Africa	46.3	46.0	50.1	62.6	74.5
<b>Percent of GDP</b>					
Developing countries	4.1	5.8	5.2	5.0	4.6
East Asia and Pacific	4.1	7.0	6.0	4.7	4.4
Europe and Central Asia	4.2	4.0	8.2	7.8	6.6
Latin America and Caribbean	3.8	6.1	5.0	5.7	5.3
Middle East and N. Africa	2.9	2.7	0.7	2.1	1.5
South Asia	4.9	4.8	3.5	4.1	3.7
Sub-Saharan Africa	5.0	4.1	4.0	4.8	5.3

Source: World Bank.  
Note: \* World Bank estimates.

vulnerabilities experiencing the largest drops, including Turkey and Ukraine. At the same time, inflows to the Middle East and North Africa also suffered a sharp drop, affected by intensified political and economic turmoil.

## Renewed turbulence at the start of 2014

After the relatively calm response to the initial tapering of U.S. Federal Reserve's quantitative easing policies around the turn of the year, market conditions deteriorated at the end of January, following the sudden depreciation of Argentina's official peso and against the background of market concerns over slowing growth in China.

Stock-market volatility increased significant from January 22 to February 5, reflected in a 5 point (35 percent) increase in the VIX index for the U.S. and 10 point (45 percent) jump in the emerging market VIX index (figure 8). The VIX index measures the cost of hedging against stock-market volatility, and is a commonly used gauge of

investors' aversion to risk. Since then both measures have declined significantly while global equity markets have regained some of their initial losses.

As of February 14 (the cut-off date of this publication), developing-country stock-markets were 2.5 percent below January 21 levels, broadly in line with the average drop observed across high-income countries (see Figure 9). As in the summer of 2013, hard hit economies included India, South Africa and Brazil. This time around, a growing number of central and eastern European economies, including Hungary, Kazakhstan and Ukraine were also particularly exposed to sell-off.

In contrast with high-income countries, whose stock-markets strengthened throughout much of last year, the January 2014 unrest came on top of an earlier downward trend in developing countries. Overall, stock-markets are currently 10 percent lower than in January 2013 in developing countries, versus 15 to 25 percent gains in high-income countries. In part, the different trajectories reflect developing countries' out-performance in the immediate aftermath of the 2008 financial crisis, giving way to an extended period of consolidation and relatively low returns since 2012 (see Figure 10).

The pace of outflows from developing-country bond and equity funds accelerated at the start of 2014. Emerging-market equity funds saw \$12.2 billion being pulled out by international investors in January, the biggest retrenchment since August 2011 and only somewhat lower than the cumulative \$15 billion outflow recorded for the whole of last year. Emerging-market bond funds also suffered outflows of \$4.6 billion. However, activity on primary markets was little affected. Bond issuances across developing countries were still running strong in January, posting their highest monthly volume on record. Sovereign borrowers were able to issue large volumes of bonds and lock in relatively favorable financing conditions before the start of the market unrest. Data indicate that corporate bond issuances continued at a sustained pace despite the market unrest after 22 January. As in recent months, activity was concentrated among investment-grade borrowers, while riskier issuers continued to be sidelined.

If a return to more stable market conditions is confirmed, the recent period of market volatility will have been short-lived. Nevertheless, it serves as an additional reminder of the risk of sudden shifts in market sentiment as monetary policy normalizes in the U.S. and global financing conditions tighten (see Box 2).

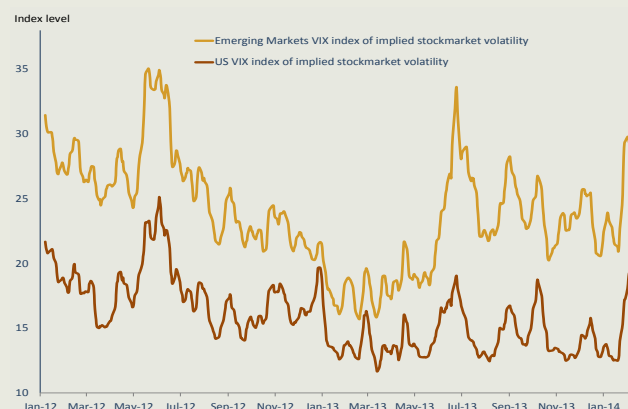
### How do the January 2014 and summer 2013 episodes compare?

The recent period of market volatility was different in nature from that observed during the summer of 2013, but there are similarities as well.

Differences:

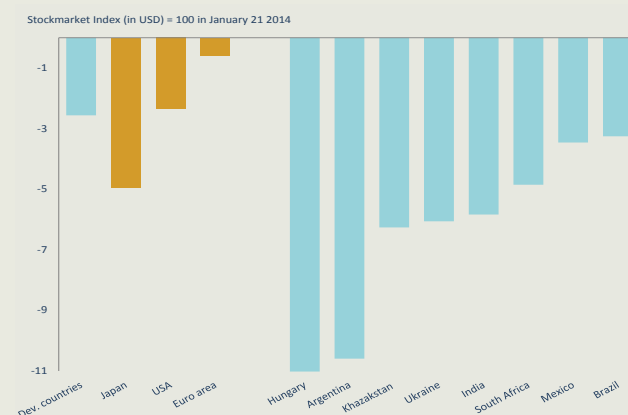
- The January 2014 episode was driven by specific developments in a number of developing countries, impacting global risk aversion through contagion fears, and encouraging a flight to safety. This resulted in a broadly based sell-off of riskier asset classes. U.S. long-term interest rates declined by around 20 basis points since the start of the year, driven by money flowing from global equity markets into highly rated sovereign bonds in a typical flight to safety episode.
- In contrast, the volatility in the summer of 2013 was prompted by a sudden increase in U.S. bond yields, from 160 to 290bp, on prospects of an earlier-than-anticipated end to U.S. quantitative easing.

**Figure 8** Risk aversion back to September 2013 levels



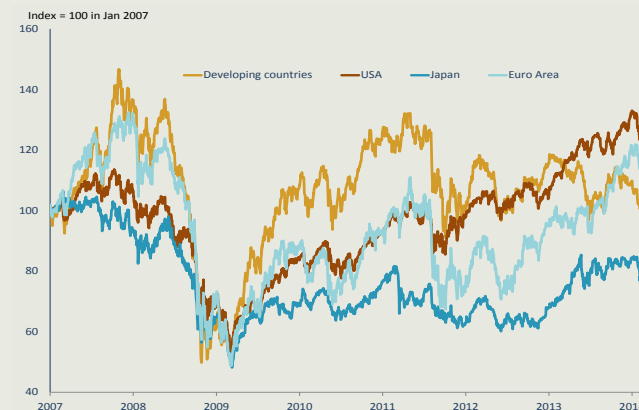
Source: Bloomberg and World Bank.

**Figure 9** A broad-based stockmarket sell-off



Source: Datastream and World Bank.

**Figure 10** Developing country stock-markets trading in a range since 2012



Source: Datastream and World Bank.

**Box 2****U.S. Federal Reserve policy: tapering, forward guidance and initial market reaction**

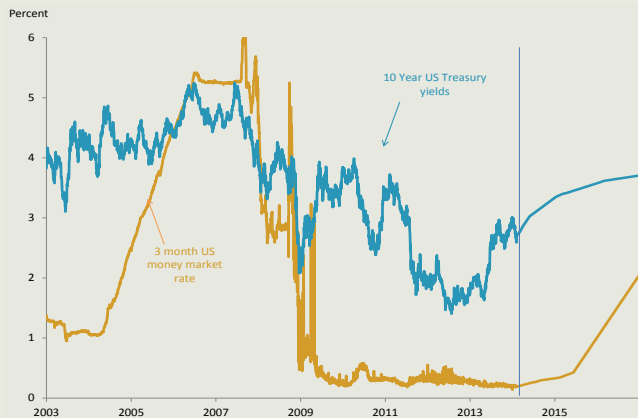
With a stream of strong U.S. economic and labor market data in recent months, below target inflation and positive developments in U.S. budget negotiations, the U.S. Fed decided in December last year to start tapering its asset purchase program (initially from \$85bn to \$75bn/month in January and then further down to \$65bn in February).

Together with the December announcement, the Fed also committed to keeping policy rates close to zero “well past the time that the unemployment rate declines below 6.5 percent”, which according the Fed’s own forecasts should not happen before mid-2015. This reinforced commitment (forward guidance) provided an important anchor and alleviated risks of rapid increases in long term interest rates, as had been seen during the “taper tantrum” last summer, therefore reassuring markets.

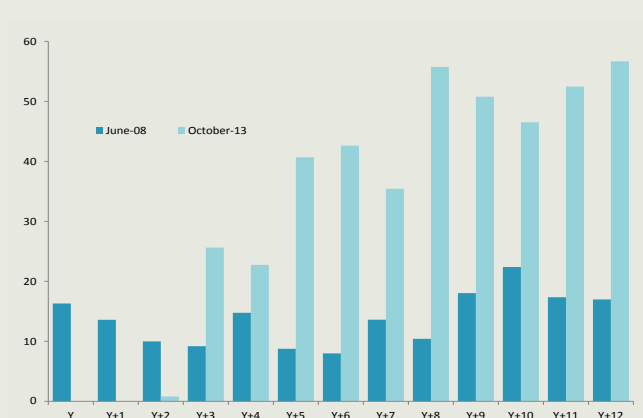
Communication on the new Fed strategy seems to have worked well, with U.S. stock market (S&P 500) gaining around 4 percent during the last two weeks of December, reaching a five-year high, while U.S. ten-year bond yields hovered around the 2.9-3 percent mark. In developing countries, stock markets initially moved sideways or modestly down after the announcement, with the exception of Turkey, Thailand and Argentina, where losses in excess of 10 percent were registered from mid to end December 2013 (largely due to domestic factors).

The calm with which markets greeted the actual taper suggests the baseline projections presented in the January 2014 Global Economic Prospects report of an orderly adjustment in global interest rates and limited disruption in capital flows to developing countries remains the most likely scenario (see figure B2.1). However, the more recent market turmoil stands as a reminder that the road to normalization could be bumpy for financial markets, particularly in developing countries.

Given the dominant role that the Federal Reserve has come to play in U.S. Treasury markets in recent years (holding at present more than 50 percent of outstanding 8-10 Treasuries, see figure B2.2), its gradual pull back from direct bond market interventions throughout 2014 may be met with higher volatility and sudden changes in expectations. To the extent that developing-country assets have benefited from the very low interest rates of the post-crisis period, they will be impacted by the tightening of financial conditions. As outlined in Chapter 3 of the January 2014 Global Economic Prospects report, under a smooth adjustment scenario these impacts should be modest and offset to a large degree by stronger high-income country growth and import demand. However, should the tightening process be bumpy, impacts could be much more severe. How things will play out is unclear, but policy-makers in developing countries should continue to look closely at domestic conditions, prepare contingency plans and seek to reduce vulnerabilities.

**Figure B2.1** U.S. Treasury Yields - baseline projections

Source: Federal Reserve and World Bank.

**Figure B2.2** U.S. Fed holding of U.S. treasuries (% of total by maturity)

Source: Federal Reserve and World Bank.

Similarities:

- In both cases, emerging market bond spreads rose (although yields were stable in January 2014) and developing country stock markets declined significantly (Figure 11).
- Impacts across developing countries were concentrated among middle-income countries with liquid financial markets and significant external financing needs.

Overall effect:

- The adjustment in developing-country spreads and equity prices since the start of the year was about half that observed during the summer 2013.

### Developing-country currencies and foreign exchange reserves under pressure, but not everywhere

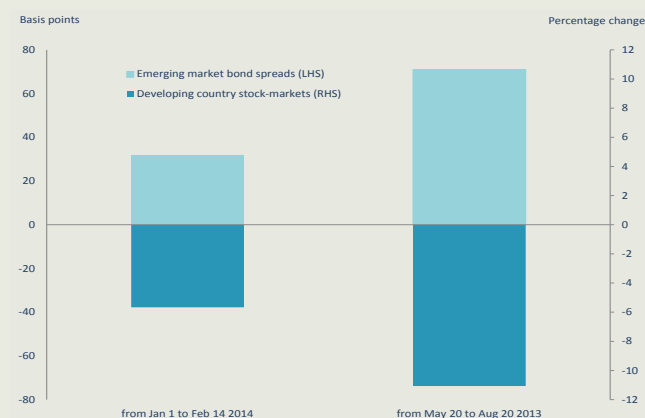
Around 45 percent of developing currencies initially declined by more than 1 percent against the U.S. dollar after the start of the January turmoil, against 35 percent in the month following the May 2013 tapering announcement. However, this left a majority of developing-country currencies broadly stable or slightly appreciating during both episodes.

Compared with previous periods of significant U.S. dollar appreciation (more than 1.8 percent in effective exchange rate terms, see figure 12), currency pressures across developing countries appeared somewhat less pronounced during both June 2013 and January 2014 events: the median depreciation and the proportion of extreme developments were generally larger in past episodes (see Figure 13).

On a trade weighted basis, the sharpest currency declines were found since the start of this year in Argentina, Kazakhstan, Ghana, Ukraine and Hungary (see Figure 14). Emerging European currencies were the focus of intense market pressures this time, driven by concerns about Russia and Ukraine, but also excessively loose monetary policy in some cases. This contrasts with the summer events, when these currencies were relatively stable.

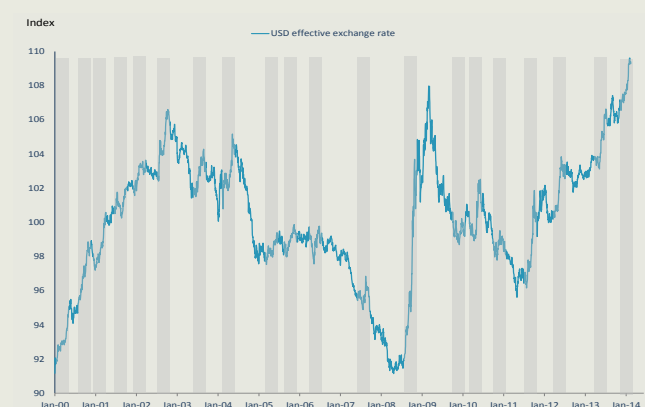
As central banks attempted to offset or slow depreciation pressures, some isolated concerns about low or declining levels of foreign reserves re-emerged around the turn of the year. This was notably the case in Argentina, Venezuela, Ukraine or Kazakhstan (see Figure 15).

**Figure 11** Comparing summer 2013 and January 2014 turmoil



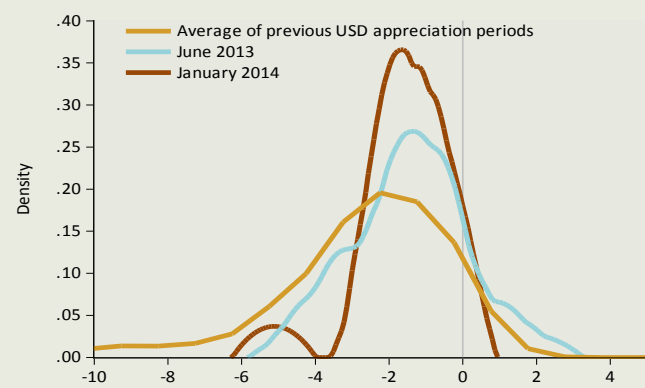
Source: World Bank.

**Figure 12** Previous episodes of U.S. dollar appreciation



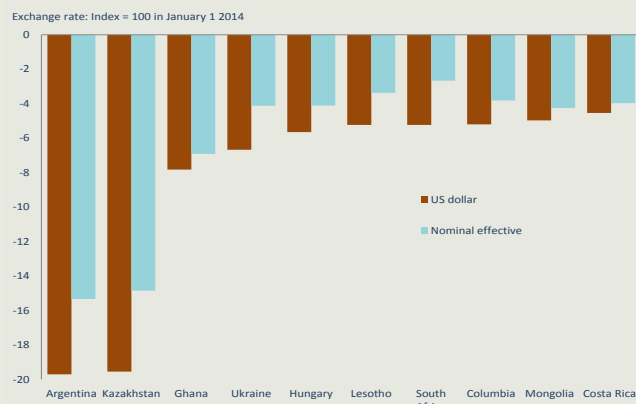
Source: Datastream and World Bank.

**Figure 13** Distribution of changes in developing country bilateral exchange rates with the U.S. dollar



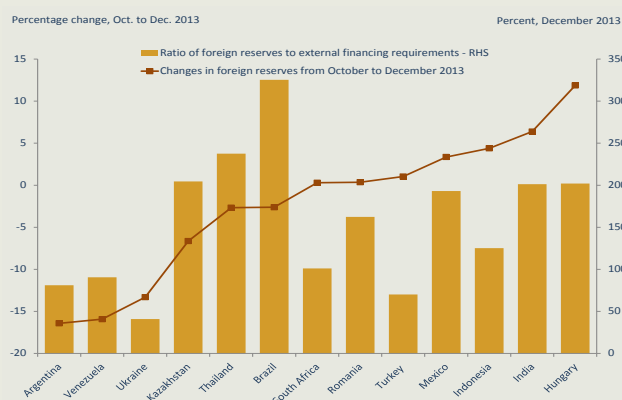
Source: World Bank.

**Figure 14** Largest depreciation of effective exchange rates from January 22 to January 27



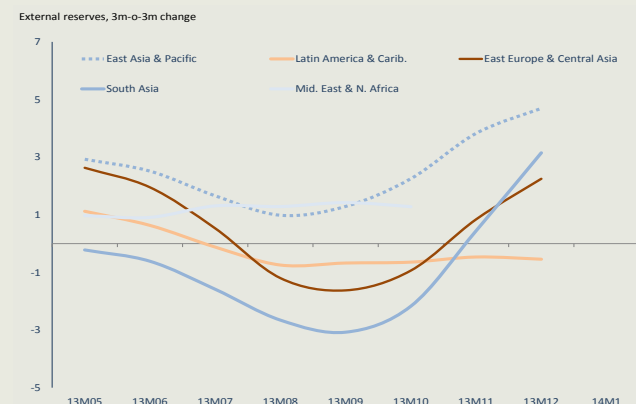
Source: Datastream and World Bank.

**Figure 15** Countries with relatively low or declining currency reserves



Source: World Bank.

**Figure 16** Foreign reserve developments across regions



Source: Datastream and World Bank.

However, foreign-exchange reserves remain abundant across developing countries and are not, in most cases, an immediate source of vulnerability. Following a dip amidst foreign exchange pressures in the summer of 2013, reserves were replenished in following months across most regions, increasing at a sustained pace by year end (see Figure 16). China in particular continued to add to its stockpile of foreign reserves in December, increasing it to a record high of \$3.7 trillion.

### Monetary policy on a tightening cycle in a growing number of developing countries

Market pressures in the course of 2013 already created challenges for a number of developing-country central banks, forcing several of them into monetary policy tightening. A normalization of monetary policy was overdue in many cases but the timing has not always been optimal amidst weakening or subdued growth. Brazil has hiked interest rates by about 200 basis points since May, while Indonesia and India increased rates by 100 basis points each (figure 17). A number of other central banks also introduced various new measures, including capital controls and unorthodox monetary policy instruments.

The announcement of the Fed’s tapering decision in December and renewed market tensions in January accelerated the move towards monetary policy tightening, and a shift in some countries towards a more orthodox, inflation-sensitive approach. Further interest rate hikes were decided in Brazil, and India, while the tightening cycle took a more aggressive turn in Argentina and Turkey, where benchmark policy rates more than doubled. This was followed by South Africa’s decision to raise its lending rate for the first time in nearly six years.

Despite these interest rate hikes, monetary policy generally remains accommodative across the developing world. Since November 2011, the number of rate cuts by central banks across developing countries has outnumbered the number of rate increases by a ratio of 1 to 4 (see figure 18). Loose policy translated into rising or persistently high inflation in many countries (even in the face of declining food and stable energy prices), with real interest rates falling to historically low levels in some cases.

Surging capital inflows in the post-crisis period may have contributed to these developments, leading to significant upward pressure on currencies and encouraging central banks to pursue more accommodative monetary policy than otherwise expected.

Evidence shows that policy interest rates across developing countries were held in recent years, significantly below levels predicted by a simple inflation targeting rule (i.e. “Taylor Rule” rates estimated on the basis of the deviation of consumer price inflation from target and the level of slack in the economy, see figure 19). The implication being that marked cycles in capital inflows have a direct bearing on monetary policy in developing countries, complicating considerably the pursuit of domestically oriented objectives.

## Capital inflows: prospects, risks and vulnerabilities

Net private capital flows to developing countries expected to stabilize in 2014, but downward risks dominate

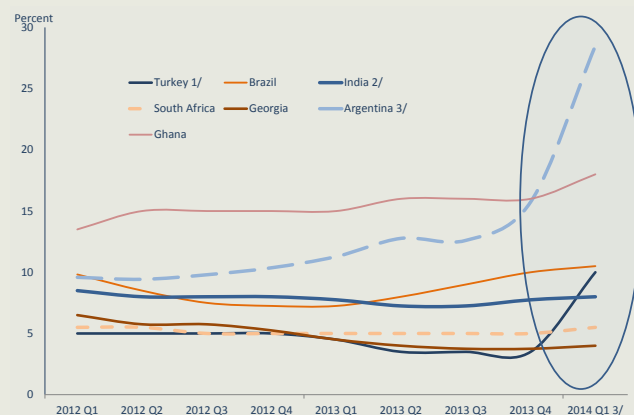
Capital flows to developing countries are likely to face continued headwinds this year as the process of normalization in global financing conditions carries on. The relative risk profile for developing countries changed significantly during 2013, with growth differentials with high income countries at their lowest level in a decade, and credit downgrades in developing countries surpassing upgrades for the first time since 2009 (see Figure 20). With credit rating cycles in high income countries pointing towards a gradual improvement, this suggests that developing countries might find it challenging to attract strong capital flows in an increasingly competitive global financial environment.

As a result, net private capital inflows are projected in the baseline to decline to \$1.065 trillion (4.2 percent of GDP) in 2014, from \$1.078 trillion (4.6 percent of GDP) in 2013 (table 2).

Cross-border debt and bank lending flows are expected to be particularly affected. Even FDI inflows to developing countries are predicted to diminish by 2.1 percent this year as a result of lingering uncertainty in global financial markets and modest growth prospects by post-crisis standards.

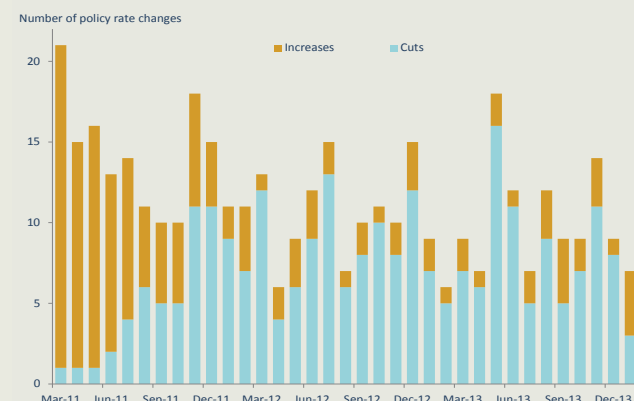
On the other hand, portfolio equity flows are projected to bounce back this year, driven by an expected rise in flows to China and India. Combined with relatively cheaper valuations, China’s decision to lift a 14-month ban on IPOs and India’s recent move to liberalize its financial markets further is expected to attract equity flows into these countries.

**Figure 17** Policy rates in selected developing countries



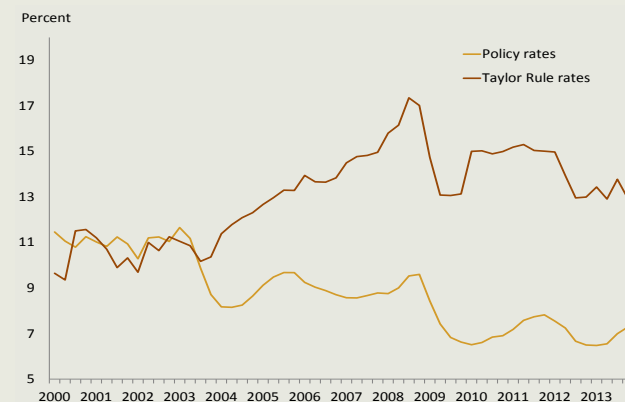
Source: Bloomberg and World Bank.  
 Note: <sup>1</sup>One week repo rate; <sup>2</sup>Benchmark repo rate; <sup>3</sup>Lebac rate

**Figure 18** The monetary policy tightening cycle is accelerating



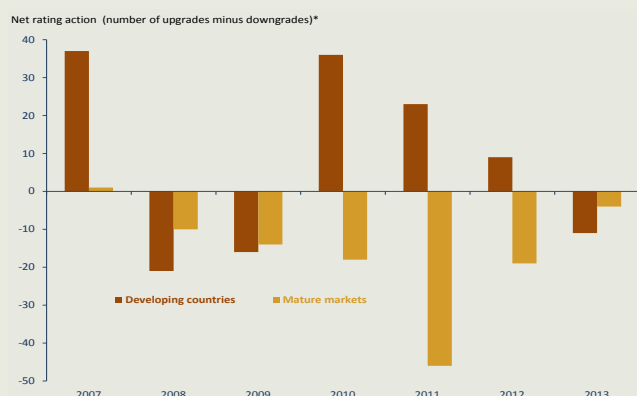
Source: Datastream and World Bank.

**Figure 19** Policy rates and “Taylor Rule” rates in developing countries



Source: World Bank.

**Figure 20** Developing countries' credit cycle turned negative for the first time since 2009



Source: Bloomberg and World Bank.

Note: \*Including rating actions by Moody's S&P and Fitch.

However, the ongoing process of normalization in global financing conditions will necessarily put a lid on expected portfolio flows to developing countries, as these are strongly influenced by global interest rate levels and volatility. The expected impact will vary considerably across regions, depending on past exposures to portfolio flows.

For regions such as East Asia and the Pacific (excluding China) and Europe and Central Asia—where portfolio flows accounted for a lion's share of total flows in recent years (at least 45 percent)—adjustments may be larger than the declines in other regions like Latin America, the Middle East and North Africa, or South Asia where portfolio flows are a much smaller proportion of total capital flows. Meanwhile, Sub-Saharan Africa is estimated to have the third biggest impact of a normalization in global interest rates among developing regions, even though FDI is the dominant type of capital inflows for the region (outside of South Africa) (figure 21).

### Risks of more disorderly adjustments are still present

The modest easing of capital flows projected above is based on the assumption of an orderly normalization of global financing conditions and risk premia. The 2013 summer turmoil and renewed turbulence at the start of 2014 illustrate that more disorderly adjustments in capital flows remain a significant risk in the current environment.

Abrupt increases in global interest rates (as observed during the summer 2013) should be expected to have larger

**Table 2** Net capital flows to developing countries (\$ billions)

	2009	2010	2011	2012	2013e	2014f	2015f	2016f
<b>Current account balance</b>	167.4	112.0	-16.3	-93.4	-173.5	-180.9	-178.2	-154.6
<b>Capital Inflows</b>	698.1	1,116.1	1,109.2	1,121.5	1,116.8	1,088.8	1,176.4	1,249.7
Private inflows, net	604.2	1,035.9	1,077.3	1,093.6	1,078.4	1,065.2	1,149.6	1,226.0
Equity Inflows, net	491.3	634.9	657.4	709.7	681.1	686.2	742.7	794.6
Net FDI inflows	380.3	511.6	654.7	612.2	623.5	610.4	644.7	679.7
Net portfolio equity inflows	110.9	123.4	2.7	97.6	57.6	75.8	98.0	114.9
Private creditors, Net	112.9	401.0	419.9	383.9	397.3	379.0	406.9	431.4
Bonds	49.9	115.5	120.6	178.7	176.7	144.8	132.9	132.0
Banks	16.4	28.1	129.9	95.5	100.9	90.5	117.8	126.1
Other private	-0.8	1.8	-5.7	6.3	3.8	3.3	3.1	5.4
Short-term debt flows	47.4	255.6	175.1	103.4	115.9	140.4	153.1	167.9
<b>Official inflows, net</b>	93.8	80.1	32.0	27.9	38.4	23.6	26.8	23.7
World Bank	18.3	23.0	7.0	12.1	10.3	..	..	..
IMF	31.8	13.4	0.5	-13.3	-2.8	..	..	..
Other official	43.8	43.7	24.5	29.2	30.9	..	..	..

Source: World Bank.

Note: e = estimate, f = forecast.

**Figure 21** Regions will be affected differently in 2014, depending on their exposure to portfolio inflows



Source: World Bank.

effects on capital flows than the type of contagion risks and market volatility observed in January this year.

Drawing from research conducted for the January 2014 Global Economic Prospects Report, the expected disruption to capital flows stemming from both types of market uncertainty can be illustrated.

Simulations suggest in particular that a sudden 100 basis points increase in U.S. bond yields (similar to that observed last summer), could be expected to dent capital inflows to developing countries by around 50 percent for several months. In comparison, a 10 point rise in the VIX index triggered by contagion fears within developing countries could end up reducing aggregate capital flows

to developing countries by around 30 percent (see Figure 22). While in the first case, U.S. bond yields and capital flows to developing countries move in opposite directions during a period of heightened volatility, they are declining in tandem in the second scenario, as observed in January this year.

### Adjusting to the reduction in global liquidity could be a bumpy process for many developing countries

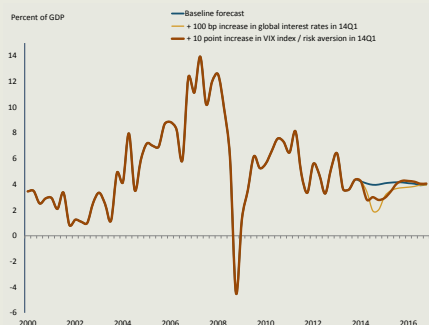
The gradual return of long-term interest rates in both high-income and developing countries to more normal levels should help reduce the excesses and vulnerabilities associated with a persistently low interest rate environment from building up further. In the near term, however, the transition to higher global interest rates could be volatile. Risks of disorderly adjustments would affect in particular countries with larger external financing needs or domestic imbalances, such as overextended credit markets and depleted fiscal buffers. It is no coincidence that middle income countries with a combination of current account and fiscal deficits saw larger corrections during both summer 2013 and January 2014 volatility (figure 23).

Should global financial conditions tighten rapidly and international finance become scarcer, heavily indebted emerging economies may come under renewed risk of sudden capital flow stops.

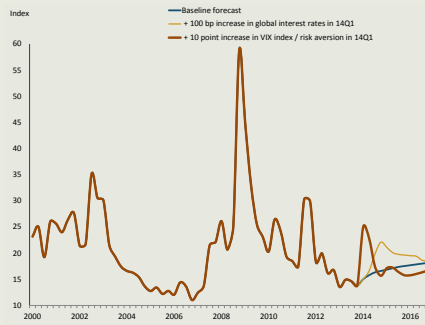
Developing countries require an estimated \$1.4 trillion in 2014 to meet their short-term debt and long-term debt repayment obligations. Private sector external

**Figure 22** Normalization scenarios, overshooting risks, and capital inflow projections

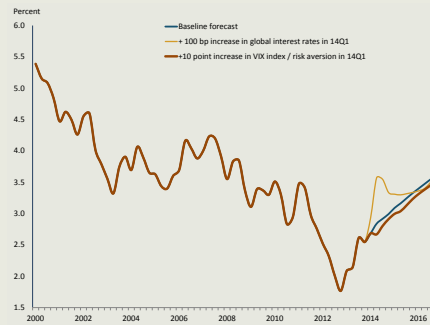
#### Capital inflows in developing countries



#### VIX Index / risk aversion

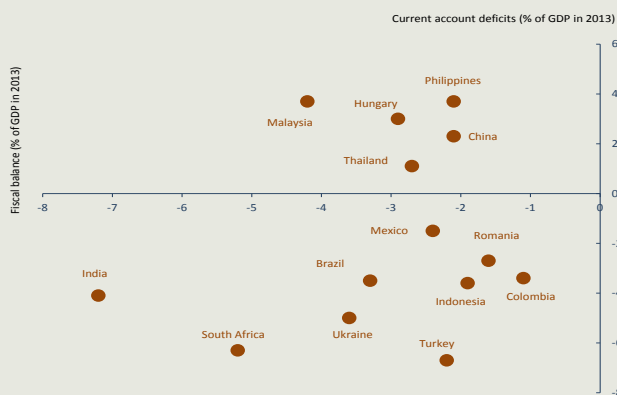


#### G4 long-term interest rates



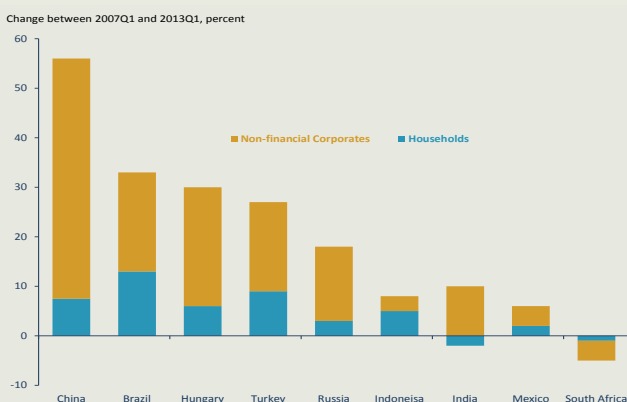
Source: World Bank.

**Figure 23** Many developing countries are exposed to both external and fiscal problems



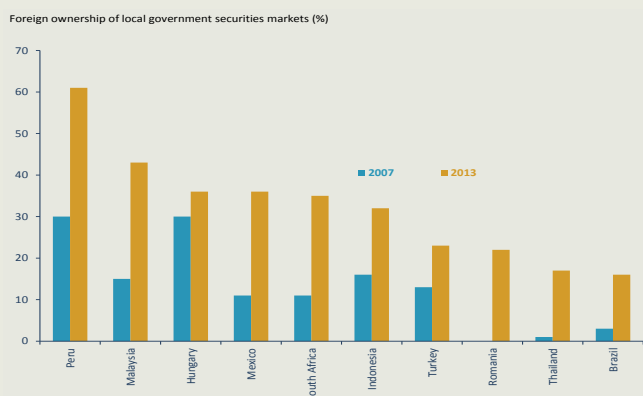
Source: World Bank.

**Figure 24** Private sector debt has risen sharply in some major developing countries



Source: BIS, IIF, IMF, and World Bank.

**Figure 25** Foreign ownership has risen sharply since 2007



Source: IIF, JP Morgan Chase, and World Bank.

debt levels are particularly high in developing Europe, increasing susceptibility to changes in external financing conditions and currency mismatch risks. Added to this, banking sectors remain weak due to the legacy of high levels of non-performing loans from the previous crisis in several economies.

More generally, countries where private-sector lending has increased very rapidly under low interest conditions may be especially vulnerable to a rise in global interest rates (figure 24), with the risk that rising non-performing loans could in some extreme cases threaten banking-sector stability.

### Dynamic local currency debt markets increase resilience but do not provide immunity

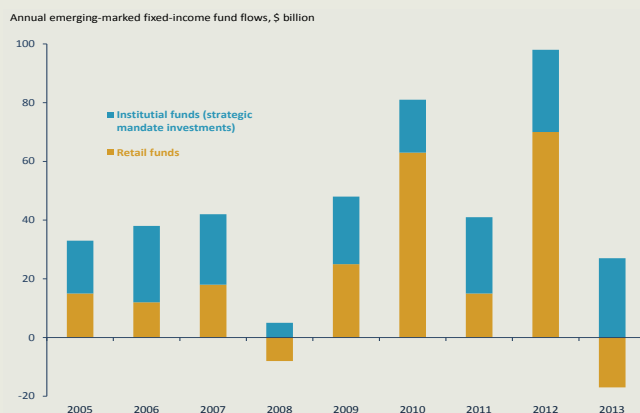
The trend increase in locally issued and denominated debt across developing countries provides an element of resilience and helps reduce risks of currency mismatch, but growing foreign-holding in these markets still expose them to shifts in international investor sentiment. The foreign ownership of domestic government debt has doubled since 2007 for some developing countries (figure 25).

However, foreign positions in developing-country local debt markets did not adjust sharply during last year's turmoil (figure 26), mainly because institutional investors, who hold large stock of local currency debt, generally maintained their exposure steady. While encouraging in the short-term, a further bout of global risk aversion in an environment where the credit ratings of several developing countries are still on a negative outlook could eventually lead to pullbacks from these markets as well.

### Elections to be held in a number of major developing countries add to the uncertainty

Political instability has been a major risk for developing-country markets. Last year a number of countries were battered by large scale protests as general standards that were raised during earlier phase of rapid growth clashed with harsh economic realities and rigid political leaders. With a busy election calendar in 2014, political turmoil could become an even bigger issue for some countries with poor political dynamics. There will be presidential/general elections in 16 developing countries this year. A negative fallout from elections could act as a major restraining factor in terms of policy adjustments in many developing countries.

**Figure 26** Inflows from institutional investors remained resilient in 2013



Source: Bloomberg, EPFR Global, and JP Morgan Chase.

## Facing medium-term challenges while market conditions are still favorable

A return to calmer market conditions after the January 2014 unrest offers an opportunity for policy-makers across developing countries to address vulnerabilities and undertake the necessary confidence-building reforms.

Policy complacency would eventually lead to larger adjustments down the road, and come at greater economic cost given the closer scrutiny of domestic risks by financial markets. Implementing necessary measures—both in the short-term to boost macroeconomic and financial stability during the transition to higher global interest rates and, in the longer term, to raise growth potential—should proceed without delay. Challenges may be made more difficult given upcoming elections in several of those countries that were most tested in recent months.

In any event, policy-makers need to stand ready to respond to financial market pressures if they occur, including through tighter monetary policy and exchange rate adjustment supported by central banks' reserve management policies, macro-prudential policies, and in some cases capital controls. These measures help limit spillovers to domestic activity and remain relevant in the current environment in order to reduce external financing dependencies and bringing down domestic imbalances.



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