GLOBAL ECONOMIC PROSPECTS

2014 / June

FINANCIAL MARKETS OUTLOOK

WORLD BANK GROUP

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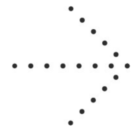

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About the report

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 June and can be accessed at: www.worldbank.org/globaloutlook.

The lead authors of this report are Eung Ju Kim and Marc Stocker, under the guidance of Franziska Ohnsorge. The report updates and reviews some of the analysis presented in the June 2014 edition of Global Economic Prospects.

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Main messages

Goldilocks recovery or calm before the storm?

External financing conditions for developing countries have been remarkably favorable in recent months, reflecting expectations of a more drawn-out period of monetary policy accommodation in high-income countries and some narrowing of external vulnerabilities. Additional easing by the European Central Bank, combined with prospects of modest growth and stable inflation in the United States ("Goldilocks recovery"), helped pull down bond yields and volatility worldwide. These benign conditions currently provide support to capital inflows and activity across developing countries, but could at the same time increase the risk of greater and potentially more abrupt market adjustments ahead. Despite some reduction of current account deficits in several developing countries, many remain vulnerable to sudden shifts in investors' sentiment and capital outflows.

Following a brief period of market turmoil at the start of the year, global financing conditions have eased considerably from March to June. Bond spreads for developing countries (i.e. yield difference with 10-year U.S. Treasury bonds) have narrowed, bringing down average borrowing costs to their lowest level since the Spring of 2013. Stock markets have also recovered rapidly from a significant sell-off in January/February, despite rising geopolitical tensions and evidence of disappointing activity in the first quarter of the year. More favorable financing conditions for developing countries have already had a measurable impact on capital inflows, with international sovereign and corporate bond issuances reaching record levels since March 2014.

These developments appear closely associated with additional easing measures announced by the European Central Bank (ECB) in June, and speculations that policy rates in the United States might stabilize at a lower level over the medium-term due to both persistent slack in the economy and lower equilibrium rates. In this context, long-term interest rates and market volatility declined to unusually low levels, triggering a renewed search for yields which supported the demand for developing-country assets and currencies. Past macroeconomic adjustments, along with improved economic prospects in some middle-income countries, also contributed to positive market sentiment.

As presented in the June 2014 edition of Global Economic Prospects, a more favorable global environment is reflected in upward revisions to capital inflow forecasts for developing countries, now projected to remain broadly stable as a percentage of GDP in 2014 and 2015, at around 5.6 percent, before declining again in 2016, to 5.1 percent. While baseline forecasts assume an orderly increase in long-term interest rates in high-income countries, the risk of more abrupt adjustments from current low levels has recently increased. Escalating geopolitical tensions or financial stress in some developing countries could also potentially trigger a sudden re-pricing of risk. Despite the recent narrowing of current account deficits in some developing countries, many remain vulnerable to a sharp increase in borrowing costs and/or significant currency depreciations, which could put additional strain on corporate and bank balance sheets.

Recent developments

Global financing conditions eased considerably in the second quarter of 2014

A string of adverse economic news from developing countries, including signs of slowing activity in China and a currency devaluation in Argentina, triggered a brief but sudden increase in global risk aversion at the end of January. This led investors to seek the safety of highly rated sovereign bond markets, pushing down long-term interest rates in the United States and other high-income countries, while causing a sell-off on global equity and riskier developing country assets and currencies.

The turmoil subsided mid-February and was followed by a period of rapid easing of global financing conditions. By June, volatility in bond, equity and foreign exchange

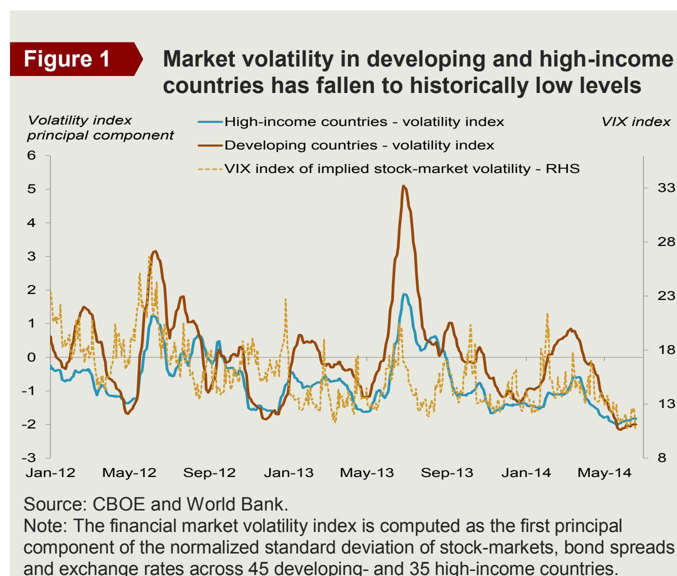


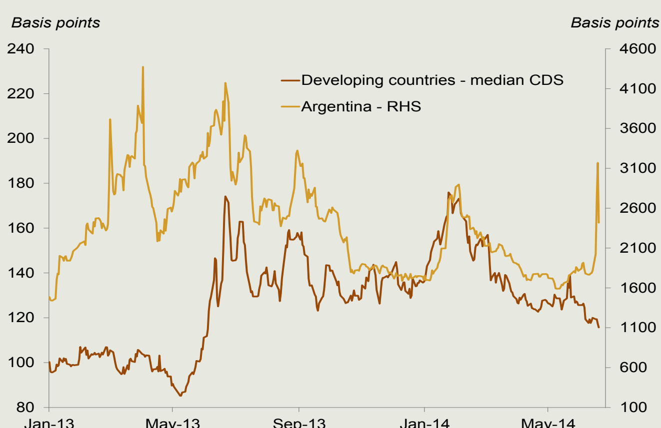
Figure 1 Market volatility in developing and high-income countries has fallen to historically low levels

Source: CBOE and World Bank.
Note: The financial market volatility index is computed as the first principal component of the normalized standard deviation of stock-markets, bond spreads and exchange rates across 45 developing- and 35 high-income countries.

Figure 2 A benign environment increased the appeal of carry-trade investments

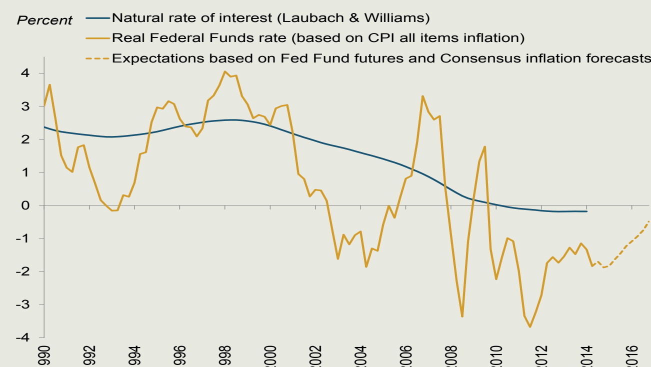
Source: Bloomberg and World Bank.
Note: The proxy index measures the opportunities derived from buying the three highest yielding currencies in the G 10 by shorting the three lowest yielding ones.

Figure 3 Credit default swap spreads have fallen in 2014



Source: Bloomberg and World Bank.

Figure 4 Real interest rates in the United States on a secular downward trend



Source: Fed. Reserve of San Francisco based on Laubach and Williams (2003), CME Group, Consensus Economics and World Bank.
Note: The natural rate of interest is the real Fed. Funds rate level consistent with output equaling potential and stable inflation.

markets had reached historically low levels in both high-income and developing countries (Figure 1).

This benign environment has increased the demand for higher yielding assets and the appeal of so-called carry-trade investments, in which expected returns are boosted by borrowing money in low interest rate / depreciating currencies in order to buy assets in higher yielding / appreciating ones. A proxy index of carry-trade opportunities among G10 currencies climbed 5 percent since the beginning of February (Figure 2).

The general decline in global risk aversion was also reflected in credit-default swap (CDS) spreads dropping in some cases below pre-crisis levels, despite geopolitical tensions in Ukraine, Thailand, Syria and, more recently, Iraq (Figure 3).

Increasing risks of sovereign default in Argentina following a U.S. Supreme Court ruling in favor of a full repayment of "holdout" investors in a dispute over restructured debt obligations was reflected in a sharp increase in CDS spreads for the country, but has had so far limited contagion effects to other developing-country sovereign debt markets (as of June 24, 2014).

Central Bank policy in high-income countries expected to remain highly accommodative

The fall in global bond yields and the exceptionally low levels of volatility since March can be partly attributed to changing expectations about the monetary policy stance of the main high-income central banks.

In the United States, weak activity in the first quarter, signs of a cooling housing market and a benign outlook depicted by the U.S. Federal Reserve contributing to expectations of a first hike in policy rates around mid- to end-2015. At the same time, bond markets increasingly speculated that policy rates might stabilize at a lower level over the medium-term.

This echoed a debate over secular stagnation[1] (persistently weak activity due to deleveraging, fiscal contraction and post-crisis risk aversion) and lower equilibrium real interest rates[2] (due to structural changes in saving and investment patterns). These forces are captured in a

1. See Larry Summers (2014): "US Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound", National Association of Business Economics, February, 2014.

2. See IMF (2014): "Perspective on Global Real Interest Rates", World Economic Outlook, Chapter 3, April 2014.

decline in the so-called natural rate of interest (real interest rate level necessary to stabilize the economy close to full capacity), implying a potentially lower range for policy rates in the future (Figure 4). There is obviously considerable uncertainty on both concepts and measurements, making current market expectations subject to significant readjustments on the basis of new evidence.

In the Euro Area, where credit channels are still impaired, slack in the labor market is abundant and persistently low inflation starts feeding price expectations, the ECB began in April to signal plans for additional policy easing. This drove yields lower and weakened the euro following a trend appreciation since mid-2012. As a result, market-based inflation expectations bottomed out, stabilizing at 1.7 percent over a 10-year horizon but remaining at a low 0.9 percent over a 2-year horizon (Figure 5).

The package of measures announced in June was well received by financial markets. It is expected to provide ongoing support to liquidity and lending, enhance forward guidance on policy rates and result in a renewed expansion of the ECB's balance sheet, partly reversing the drop that followed the repayment by commercial banks of money borrowed under Long Term Refinancing Operations implemented in 2011-12 (Figure 6 and Box 1 for a detailed evaluation).

The Bank of Japan continued to implement its quantitative easing policy, refocussing its bond purchase program in June towards securities of shorter maturities. The program has already inflated the central bank's balance sheet by more than 50 percent of GDP since April 2013. Bond purchases are expected to continue well into 2015, while further measures could be decided if domestic demand fails to recover as currently predicted.

However, beyond the significant depreciation of the Yen, global spillovers of the Japanese QE program have so far been limited, partly stemming from a strong home bias of Japanese institutional investors, banks and households, which hold the bulk of sovereign bonds.

Global bond yields and developing-country spreads declined to low levels

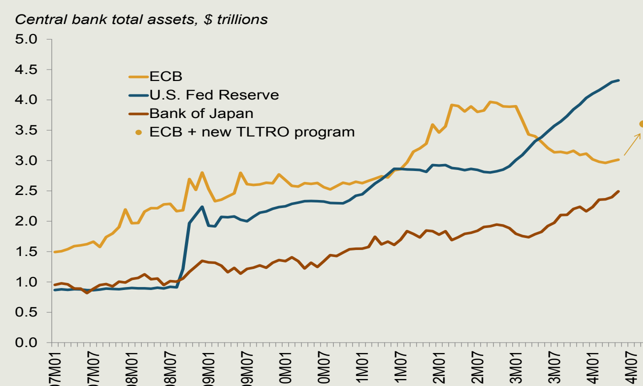
Long-term interest rates have fallen significantly since February 2014 (Figure 7), both in "safe haven" high-income countries and higher-yielding developing countries.

The renewed demand for U.S. Treasuries was initially supported by a period of heightened global risk aversion

Figure 5 Inflation expectations in the Euro Area recently stabilized at a low level

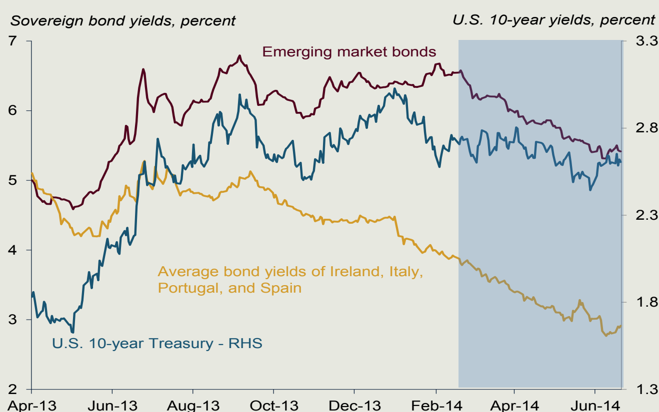
Source: Bloomberg and World Bank.
Note: An inflation-linked swap is a contract involving an exchange of a fixed payment for inflation over a predetermined horizon. Thus, through the construction of the contract, the fixed swap rate provides a direct reading of market's expected inflation rate.

Figure 6 The recently announced TLTRO will only partially reverse the contraction in the ECB balance sheet since 2012



Source: World Bank, ECB, U.S. Federal Reserve, and Bank of Japan.

Figure 7 Government bond yields have fallen significantly this year



Source: Bloomberg and World Bank.

Box 1 Impact of new credit easing measures by the European Central Bank

The ECB presented in June a series of measures aimed at reducing financing costs, improving lending flows and monetary policy transmission channels. The package includes:

- A new €400 billion ($598 billion) Targeted Long Term Refinancing Operations facility (TLTRO), allowing banks to borrow at very low fixed interest rates (benchmark policy rate plus 10bp) from the ECB up to September 2018, conditional on increased net lending to companies
- A 10bp cut in the ECB's main refinancing and deposit rates (bringing the latter to -0.1 percent)
- Suspension of liquidity sterilization injected through previous anti-crisis asset purchase programs
- Preparation of an asset purchase program of "plain" securitization products

In contrast to unconventional monetary policy measures of other major central banks (US Federal Reserve Bank, Bank of Japan, Bank of England), the ECB continues to steer clear of purchases of government bonds.

The credit easing measures announced in June differ from the Long Term Refinancing Operations implemented by the ECB in 2011-12. Rather than expanding commercial banks' access to liquidity in general, the new measures are more specifically designed to encourage lending to the private sector and reinforce forward guidance by locking low interest rates for an extended period of time (through fixed rate refinancing operations until 2018). The eventual success of these measures will primarily depend on banks' uptake of the new conditional refinancing facility and the extent to which firms are currently credit constrained and can be supported by the measures.

Elements of the TLTRO are comparable to the Bank of England's Funding for Lending Scheme (FLS) that started in mid-2012, allowing banks and building societies to borrow from the Bank of England at below-market rates for up to 4 years (the program is in operation in the UK until January 2015). Both the UK Treasury and Bank of England argue that FLS has played a significant role in underpinning the recovery, and provided incentives for banks to boost lending. However, banks participation undershot expectations and there have been concerns that FLS has contributed to rapid rise in housing prices in the UK. In the TLTRO case, however, the incentive structure is different, with lending for house purchases notably excluded from eligibility criteria.

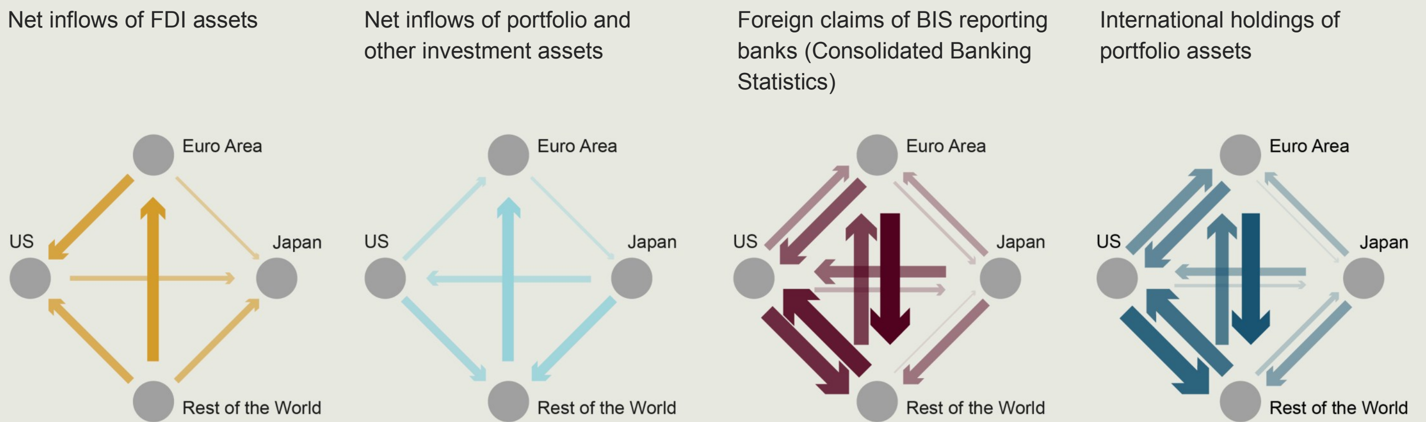
The mere increase in liquidity and the ECB's commitment to keep exceptional levels of policy accommodation through a range of unconventional policies should itself contribute to exerting downward pressure on yields and the euro exchange rate, while encouraging greater risk taking.

This could entail significant spillover effects for developing countries. Euro Area banks are global financial hubs, with their cross-border loans and holdings of foreign securities and deposits about twice as large as those of US and Japanese counterparts (see Figure B1.1).

Increased liquidity and a further reduction in long-term interest rates could prompt Euro Area banks to search for higher yields outside the Euro Area, which would translate into additional cross-border lending and portfolio flows to developing countries.

On the other hand, a depreciation of the euro would exert competitiveness pressures on some trading partners. The effect should be offset by stronger demand from a recovering Euro Area economy, supporting exports and activity especially in neighboring countries in Eastern Europe, Central Asia and North Africa.

Figure B1.1 Net capital flows and financial exposures (width of arrows proportional to amounts in billions of U.S. dollars)



Source: Bilateral balance of payments statistics from BEA, Bank of Japan, and Eurostat. Portfolio and Other Investment Assets could not be separated for lack of bilateral data for the US and the Euro Area. An arrow indicates the direction of net inflows; the darker the arrow, the higher the inflow.

Source: Bilateral foreign claims from the BIS Consolidated Banking Statistics; bilateral international investment positions from the IMF Consolidated Portfolio Investment Survey. An arrow indicates the direction of the claim from the creditor towards a borrower; the darker the arrow, the higher the claim.

in January-February, then reflected in mixed economic data and expectations of lower policy rates over the medium-term.

Rising demand from institutional investors more than compensated the gradual unwinding of the U.S. Federal Reserve bond purchase program since the start of the year, while a fall in gross Treasury issuances in line with reduced deficit financing needs accentuated downward pressure on yields. The decline was especially marked for longer-dated maturities, with 10 and 30-year Treasury yields falling more than 45 basis points since the end of 2013, to 2.61 and 3.43 percent respectively.

In contrast, shorter-dated bond yields were more stable, causing a significant flattening of the yield curve (Figure 8). This suggests that markets were more focused on re-pricing longer-term "equilibrium" rates rather than speculating over the timing of the first interest rate hike by the U.S. Federal Reserve in the course of 2015.

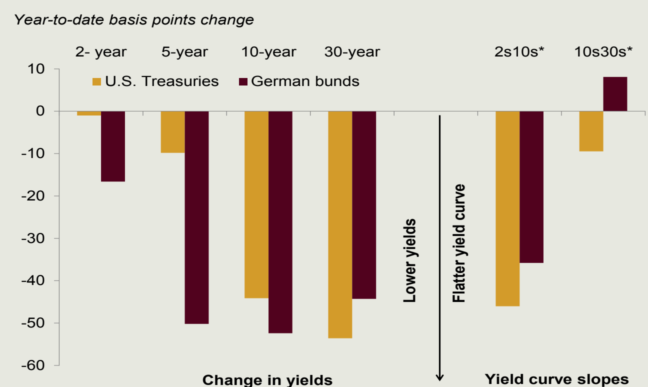
Germany's benchmark bond yields have also fallen to historically low levels, stabilizing around 1.4 percent in June. However, the bond market rally was particularly pronounced in the Euro Area periphery, with average long-term borrowing costs of Ireland, Italy, Portugal, and Spain falling to an average 2.6 percent, after peaking above 10 percent during the height of the crisis. These declines in yields have been fueled by improved fundamentals (including the exit of Ireland and Portugal from their crisis bailout programs), prospects of further stimulus from the ECB, and increased foreign demand.

In developing countries, bond spreads (the yield difference between developing-country sovereign bonds and benchmark 10-year U.S. Treasuries) have narrowed more than 100 basis points since early February, reflecting an easing of financial market tensions, spillovers from a bond market rally in high-income countries and economic and policy adjustments narrowing vulnerabilities in some middle-income countries.

As a result, the implicit borrowing costs of developing countries—proxied by the 10-year U.S. Treasury yield plus emerging market sovereign bond spreads (EMBIG) —fell to 5.4 percent in June from over 6.5 percent in late September last year, unwinding just over half of the increase in international funding costs since May 2013 (Figure 9), and falling well below average costs over the past decade.

Regarding the relative risk profile of developing countries, East Asia continues to maintain the strongest and

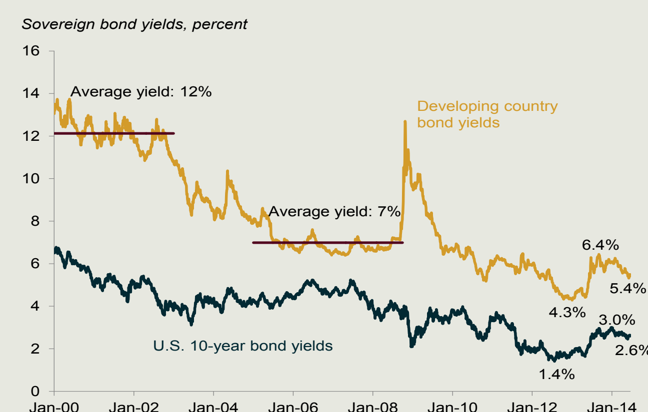
Figure 8 Lower yields in long-dated U.S. Treasuries led to the flattening of the yield curve



* The difference between yields on 2-and 10-year bonds and 10-and 30-year bonds

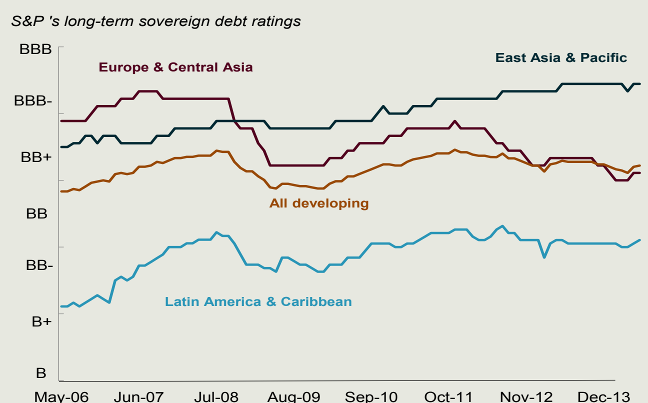
Source: Bloomberg and World Bank.

Figure 9 Developing-country borrowing costs back to Spring 2013 levels



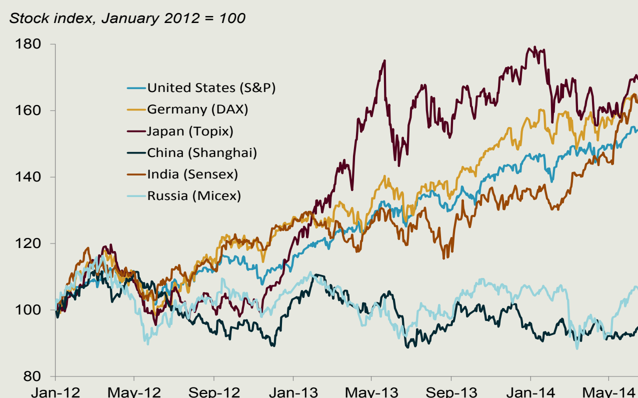
Source: JP Morgan, Bloomberg and World Bank.

Figure 10 Credit ratings have stabilized across developing countries



Source: Bloomberg and World Bank.

Figure 11 U.S. and European equities continued to rally in 2014

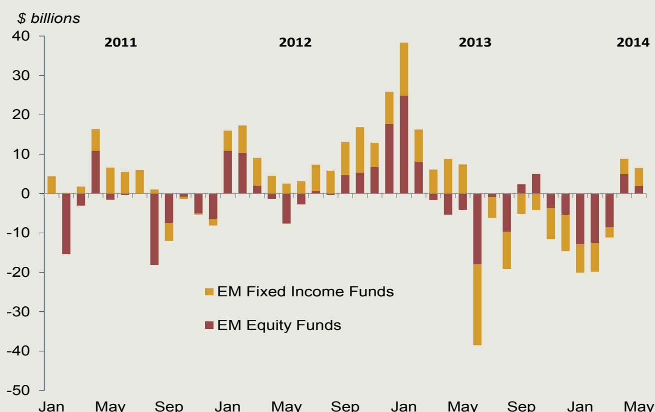


Source: Bloomberg and World Bank.

Figure 12 Developing-country equity markets underperformed since the start of 2013

Source: Bloomberg and World Bank.

Figure 13 Net inflows to developing country funds turned positive since April



Source: EPFR and World Bank.

most stable credit ratings among developing regions (BBB- on an unweighted average basis), despite ongoing concerns about the impact on the region of slowing activity in China (Figure 10). Developing Europe and Latin America have lower average ratings, with the former region having seen a trend deterioration since 2011.

Since the start of 2014, further credit rating downgrades have taken place in Latin America (Argentina, Brazil, Honduras, and Venezuela), developing Europe (Bulgaria, Serbia, and Ukraine) and Sub-Saharan Africa (South Africa, Mozambique, and Uganda).

However, recent indications point to a stabilization in May and June, with no further downgrades and an increasing number of upgrades (Romania, Paraguay, Bolivia, and the Philippines).

Stock markets have recovered from a bumpy start to the year

The S&P 500 for the United States reached new highs in June as data seemed to confirm that the recovery was gaining momentum (Figure 11). Similarly, German stock markets gained nearly 6.2 percent between January and June, reflecting expectations of further monetary stimulus by the ECB, improved economic prospects, and since April, some easing in geopolitical tensions between Russia and Ukraine. In contrast, the Japanese Topix posted year-to-date losses of about 2.6 percent, in a correction following a 51 percent gain in 2013 that had been triggered by combination of fiscal and monetary stimuli.

Many developing-country equity markets also rebounded in March-June. India's Sensex led the developing-country stock market rally, with a year-to-date gain of 19 percent, climbing to a record high on strong foreign capital inflows and market expectations of post-election reforms (Figure 11).

In contrast, the Russian stock market fell sharply on geopolitical tensions and China's index underperformed amid lingering concerns over slowing activity and financial sector troubles.

Despite the broad rebound in developing stock market indices, they remain 1.1 percent below their early-2013 levels, reflecting disappointing growth, weak corporate earnings and concerns about external vulnerabilities in several middle-income countries. This contrasts with gains of 34 percent and 22 percent for U.S. and Euro Area, respectively (Figure 12).

Capital flows to developing countries rebounded, driven by rising demand for fixed-income assets

Low market volatility and a renewed search for yield encouraged a net foreign inflow into developing-country bond and equity funds in April and May (Figure 13). This started to reverse significant outflows from these funds since May 2013.

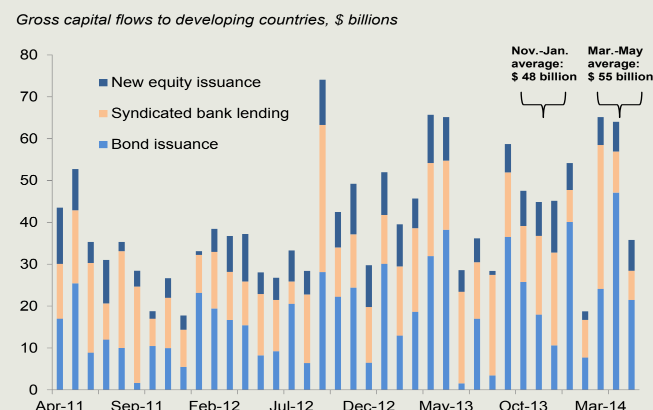
The renewed appetite for emerging market assets convinced many borrowers in developing countries to turn to international markets for financing. Between March and May, gross capital flows averaged a strong $55 billion per month, 14 percent above the three-month average of $48 billion observed prior to the February correction (Figure 14).

The increase was mostly accounted for by vibrant international bond issuances, reaching a record $43 billion in March and April, before moderating again in May to $21 billion. China alone explained a third of these flows, mostly directed to resource-related companies for acquisition and refinancing purposes, as domestic credit constraints amplified. International bond financing was also dynamic in Latin America, particularly in Brazil and Mexico. Investment-grade sovereign and corporate borrowers have dominated primary market activity so far this year, accounting for 77 percent of developing-country bond issuances (Figure 15). However, unrated and low-rated sovereign borrowers also returned to international markets, including Dominican Republic, Lebanon, Pakistan, Sri Lanka, Ukraine (with U.S. government guarantees), Zambia, and Ecuador.

Partly reflecting a tendency of large corporations to increasingly tap into international bond markets for financing, syndicated bank lending has been depressed so far this year, totaling about $70 billion up to May 2014, down 19 percent from a year ago. Flows weakened particularly in developing Europe and Sub-Saharan Africa (Figure 16).

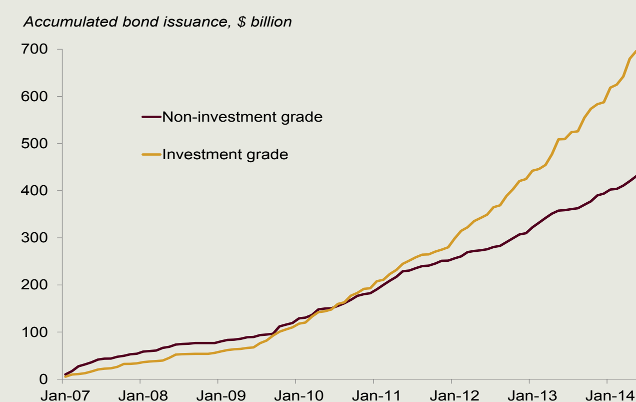
Total equity issuance was also subdued, reaching only $30 billion during the first five months of 2014, 40 percent lower than January-May 2013, with the sharpest drops in Latin America & the Caribbean and East Asia & the Pacific (China, Indonesia, Philippines). Initial Public Offering (IPO) activities remained subdued, mostly due to China's five-month moratorium on IPOs starting in February.

Figure 14 Gross capital flows have recovered strongly after February



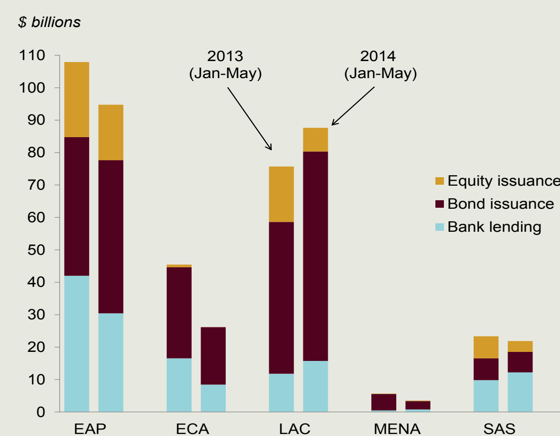
Source: Dealogic and World Bank.

Figure 15 Dynamic bond issuance activity was led by investment grade borrowers



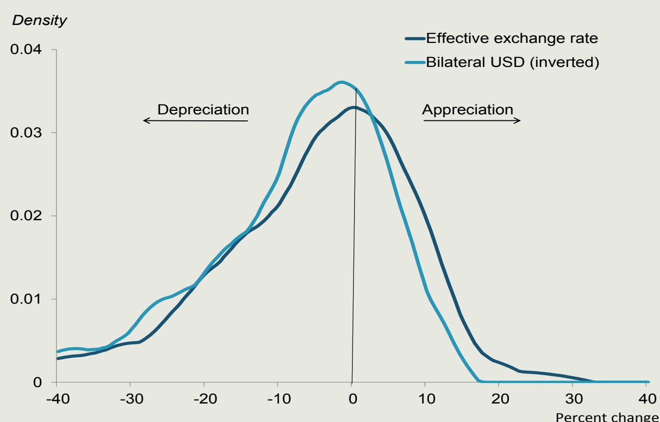
Source: Dealogic and World Bank.

Figure 16 Trends in regional capital flows are varied



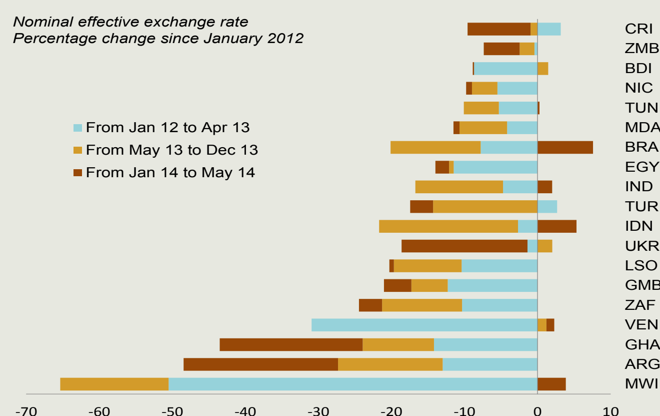
Source: Dealogic and World Bank.

Figure 17 More than 60 percent of developing countries have seen their currency weaken since 2012



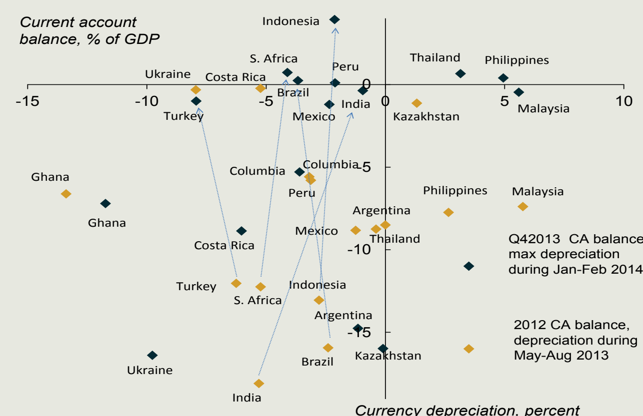
Source: IFS and World Bank.

Figure 18 Countries having seen the largest currency depreciation since 2012



Source: IFS and World Bank.

Figure 19 Recent depreciations were more modest among countries that reduced external imbalances



Source: IFS and World Bank.

Many developing countries are still adjusting to past currency depreciations

Since end-February, foreign exchange markets have stabilized and capital flows have rebounded, but a large number of developing countries are still adjusting to past depreciations.

Overall, 60 percent of developing countries have seen their currencies weaken since 2012 (both against the US dollar and in trade-weighted nominal effective terms, Figure 17), with depreciations remaining in excess of 10 percent in more than 20 countries (Figure 18).

Subsequent to the market turmoil in May-June 2013, several countries (including India and Indonesia) narrowed current account deficits and reduced domestic vulnerabilities through tighter macroeconomic policies or other targeted measures. When market stress recurred in January/February, currencies in those countries came under less pressure than those of peers with macroeconomic imbalances or political strains (Argentina, Ghana, Ukraine, Kazakhstan, Costa Rica or Zambia, Figure 19).

However, past depreciations continue to have broad ranging consequences for the affected countries. On the one hand, a weaker currency provides ongoing support to export competitiveness and current account adjustments. On the other, it strains balance sheets if accompanied by large foreign-denominated liabilities and contributes to rising external price pressures and, in some cases, uncomfortably high levels of inflation (see Special Topic in the June Global Economic Prospects).

The pace of monetary policy tightening has slowed recently

Central banks in developing countries generally responded to strains in currency markets in May-June 2013 and February 2014 by tightening policy or suspending previous easing cycles (Figure 20).

In fact, interest rate hikes observed since mid-2013 across developing countries were essentially concentrated among countries with depreciating currencies, with the January/February episode of financial market turmoil seeing the greatest number and sharpest movements in policy rates (Figure 21). Most significant hikes were implemented in this context in Argentina, Turkey and Ghana, while policy tightening was protracted in Brazil and Indonesia, and measured in South Africa and India.

Interest rate hikes came to a halt in May and June, as exceptionally calm market conditions and recovering capital inflows induced central banks to either hold rates (Brazil, Indonesia) or resume interest rate cuts (Turkey, Mexico, Hungary). At present, real policy rates are positive in most developing countries but remain low or even negative in some cases (Figure 22). This continues to provide ongoing support to activity in the presence of relatively small negative output gaps.

Capital flow prospects

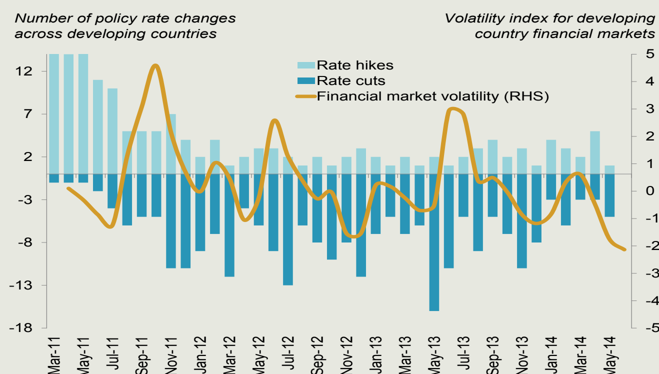
In view of the recent easing of global financing conditions and expectations of a more protracted period of monetary policy accommodation in high-income countries, net private capital inflows to developing countries are now projected to stabilize as a share of their nominal GDP this year and next (at 5.6 percent), before moderating again in 2016 (to 5.1 percent). A rebound in short-term debt flows, steady foreign direct investment (FDI), and a continued shift from bank lending to bond financing across developing countries underpin these forecasts (Table 1).

This contrasts with the scenario outlined in the January Global Economic Prospects, where a modest slowdown in capital flows was predicted this year (by about 0.5 percent of developing-country GDP) based on the assumption that U.S. long-term interest rates would rise above 3 percent by year end, lowering demand of, and increasing risk premia, on developing-country assets.

Prevailing market conditions and expectations that long term Treasury yields will remain below 3 percent until early 2015 have led to upward revisions to capital flow projections across most developing regions and asset classes this year and next (Box 2).

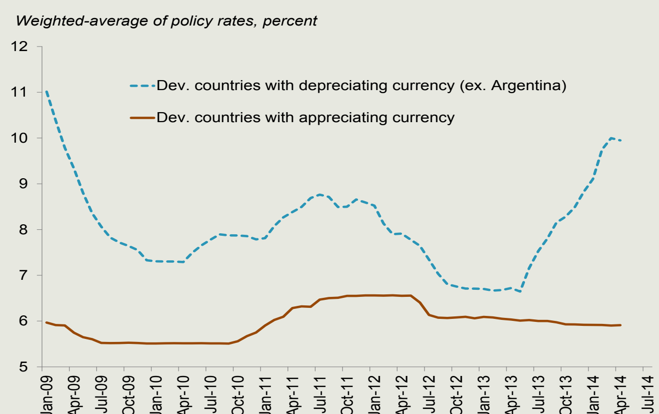
Financial market conditions are now expected to tighten in 2015-2016. The impact of the eventual rise in global interest rates should primarily be felt in slowing portfolio debt flows to developing countries—both international issuance and foreign investment into local currency bond markets. Bank lending on the other hand is expected to recover gradually in 2015 and 2016, following a contraction this year, although the extent of the bounce back may be limited by a tighter regulatory environment putting restrictions on lending to riskier borrowers. Short-term debt flows are also likely to see the gradual increase through 2016 as the demand for trade financing increases in line with a recovery in global trade.

Figure 20 Developing-country central banks gain breathing space as global financing conditions ease



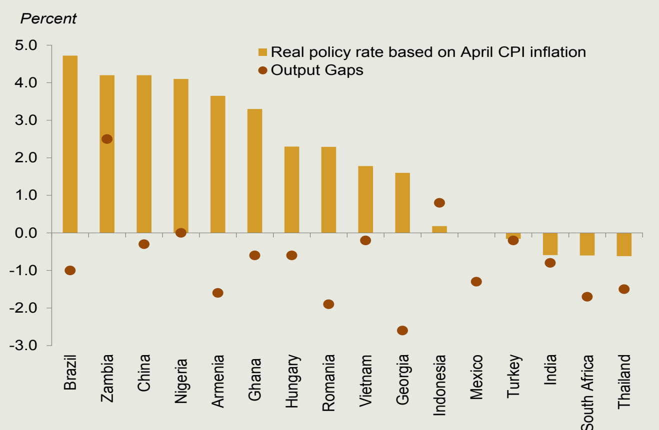
Source: National central banks and World Bank.
Note: The financial market volatility index is computed as the first principal component of the normalized standard deviation of stock-markets, bond spreads and nominal effective exchange rates across 45 developing countries.

Figure 21 Monetary policy tightening essentially concentrated in countries facing currency pressures



Source: World Bank.

Figure 22 Real interest rates still low in many developing countries



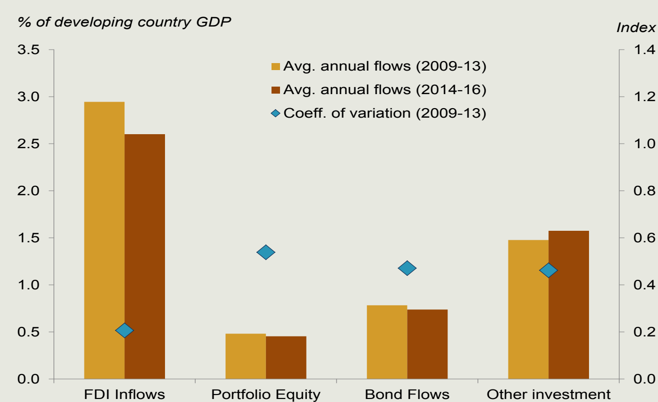
Source: World Bank.

Table 1 Net capital flows to developing countries ($ billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Current account balance	313.5	167.7	111.5	-22.6	-89.8	-184.3	-144.0	-154.7	-170.6
Capital Inflows	765.9	709.2	1,265.3	1,221.6	1,128.3	1,299.2	1,376.2	1,435.3	1,476.1
Foreign direct investment	624.4	400.2	523.9	684.1	650.5	663.7	660.8	691.0	727.3
Portfolio investment	-54.1	151.9	330.4	150.5	344.7	269.3	313.3	320.8	316.4
Equity	-39.8	112.4	134.7	10.0	109.1	82.0	106.8	121.2	136.3
Debt instruments	-14.2	39.6	195.7	140.5	235.6	187.2	206.5	199.6	180.1
Other investment/a	195.5	157.1	411.0	387.0	133.2	366.3	402.1	423.5	432.4
o/w									
Bank lending	194.9	15.7	30.1	124.2	101.7	112.8	106.5	121.2	134.1
Short-term debt flows	2.9	47.3	255.6	175.0	103.4	114.9	149.1	159.1	178.1
Official inflows	42.8	93.8	80.2	32.0	28.0	46.4	40.7	41.9	34.3
World Bank	7.9	18.2	23.0	7.0	12.2	11.2	..	..	..
IMF	16.6	31.7	13.5	0.5	-13.3	-7.3	..	..	..
Other official	18.3	43.8	43.8	24.4	29.0	31.8	..	..	..
Capital outflows	-428.3	-269.9	-531.5	-561.5	-669.3	-574.7	-637.1	-734.6	-794.5
FDI outflows	-244.4	-134.3	-163.0	-202.3	-228.1	-209.4	-235.0	-285	-320
Portfolio investment outflows	16.5	-59.7	-53.1	0.3	-69.3	-55.5	-62.1	-69.6	-74.5
Other investment outflows	-200.4	-75.9	-315.4	-359.5	-372.0	-309.9	-340.0	-380	-400
Net capital flows (inflows + outflows)	337.6	439.3	733.8	660.1	459.0	724.5	739.1	700.7	681.6
Change in reserves	-504.6	-558.0	-673.6	-490.6	-255.1	-517.9	-540.0	-590.0	-610.0
Net unidentified flows/b	-146.4	-49.1	-171.6	-146.8	-114.1	-22.3	-55.1	44.0	99.0
Memo items (as a percentage of GDP):									
Current account balance	2.1	1.1	0.6	-0.1	-0.4	-0.8	-0.6	-0.6	-0.6
Capital inflows	5.1	4.8	7.0	5.8	5.2	5.6	5.6	5.4	5.1
Capital outflows	2.9	1.8	3.0	2.7	3.1	2.5	2.6	2.8	2.7

Source: World Bank.
Note: e = estimate, f = forecast.
/a including short-term and long-term private loans, official loans, other equity and debt instruments, and financial derivatives and employee stock options.
/b Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries, and change in reserves.

Figure 23 FDI has remained the most important and least volatile source of capital flows for developing countries



Source: IMF and World Bank.

Inward FDI, which accounts for more than half of all capital inflows to developing countries, is projected to ease in 2014, before strengthening in subsequent years, reaching $727 billion (2.5 percent of developing-country GDP) by 2016. FDI flows have helped stabilize overall capital flows following the 2008 financial crisis with their larger size and lower volatility (Figure 23). They are projected to remain the most important and stable form of overseas investment for developing countries in the coming years. Despite considerable uncertainties in the short-term, multinational corporations continue to be attracted to developing-country growth prospects, their large and growing consumer base, natural resources, and relatively lower labor costs.

In addition, many developing countries continue to remove barriers to foreign investment in their service sectors. For example, China's latest reform plan states that

Box 2 **Revisions of the World Bank's net capital flows data and projections**

Beginning with the June 2014 edition, capital flow forecasts contained in the Global Economic Prospects reports make full use of the International Monetary Fund's Balance of Payments Manual 6 definitions. Previously, the data combined liability transactions (gross disbursement minus repayments) compiled by the World Bank from various official sources with the IMF's BPM5 definition for FDI and portfolio equity investment. The new approach captures more comprehensively portfolio investments and implies significant upward revisions to FDI flows for some countries. The change in data source and definition has resulted in a significant increase in the level of recorded net capital inflows to developing countries, from 4.7 percent of developing-country GDP under the Bank's previous definition to 5.6 percent under the new methodology.

Changes in interest rate assumptions and prevailing market conditions account for additional upward revisions to capital flow forecasts for 2014 and 2015. Model simulations, in particular, suggest that a lower path for long-term interest rates this year (U.S. 10-year yields 30 basis point lower than previously assumed) and a drop in market volatility (VIX index of implied stock market volatility around 10 percent lower than in January) could increase capital inflows to developing countries by some 0.5 percent of GDP this year and next (when compared with the previous baseline projections). The effect would dissipate by 2016, when capital flows would weaken in line with previous expectations.

Table B2.1 **Simulated impact of improvement in global financing conditions on capital flows to developing countries**

Changes in:	2014	2015	2016
Capital flows to developing countries, % of GDP	0.5	0.4	-0.1
U.S. long term interest rates	-0.3	0	0.2
VIX index of implied stock-market volatility	-9	-4	11

Source: World Bank.
Note: Based on results of the Vector Auto Regression model presented in Chapter 3 of the January 2014 Global Economic Prospects.

the country will lift foreign ownership limits on many service sectors including finance, education and health care among others. With a new government, India is also expected to allow foreign investors greater market access, including to the country's service industries.

Risks and vulnerabilities

While prospects for developing countries remain positive at present, some of the factors that have underlined strong capital flows over the last few years are expected to weaken over time. In particular, while developing countries will continue to grow faster than developed countries, the growth differential is expected to narrow and financing conditions to tighten as high-income countries recover and developing countries face increasing country-specific risks.

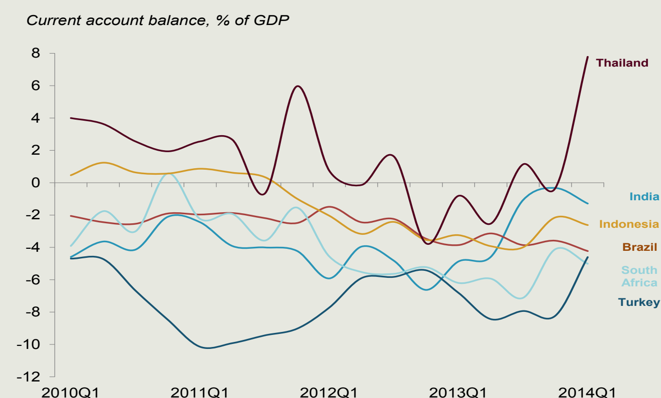
Following years of fast credit growth and rising debt levels, the perceived creditworthiness of developing countries has decreased compared with high-income economies where deleveraging and fiscal consolidation have been ongoing for some time.

A sudden return of financial market volatility remains a key risk

Current market conditions are supportive to developing-country prospects in the short-term, but could encourage investors to underprice risk and borrowers to increase leverage. This might set the ground for sudden spikes in volatility and sharp adjustments to adverse news.

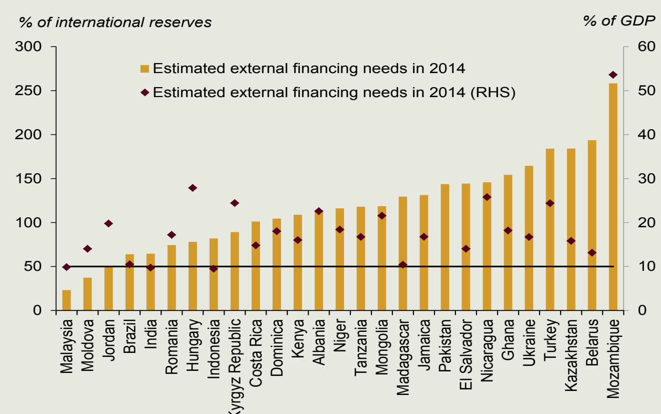
With bond markets currently assuming an extended period of moderate growth and stable inflation in the United States ("Goldilocks recovery"), any sign of increasing price or wage pressures could be met with sudden increases in yields. Such risk remains limited in the short-term, but uncertainty on the actual level of labor market slack could make markets particularly sensitive to incoming data.

Figure 24 Current account deficits started closing since mid-2013



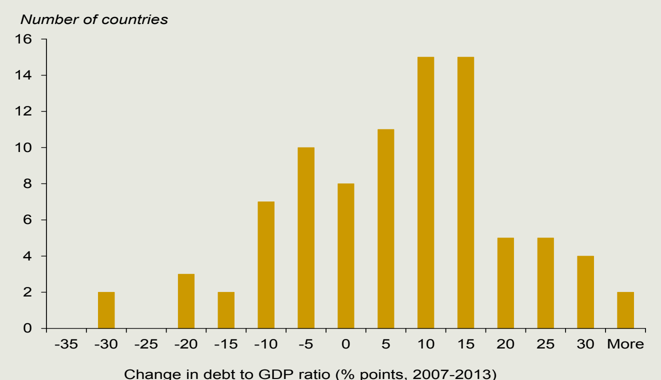
Source: World Bank.

Figure 25 Some developing countries have large financing needs and low reserve cover



Source: World Bank.

Figure 26 Public debt rose by more than 10 percentage points since 2007 in more than half of developing countries



Source: World Bank.

Regarding the potential impact on developing countries, World Bank calculations[3] show that a sudden 100bp uptick in U.S. long term yields (as observed after May 2013) could lead to a 50 percent drop in capital inflows to developing countries for several months, with potentially destabilizing consequences in the most vulnerable economies.

Geopolitical risks remain elevated but the unrest in Ukraine, Syria, and more recently, in Iraq was met so far with relative calm by financial markets. Further escalation could have more severe repercussions, potentially leading to a combination of rising risk aversion and higher oil and gas prices. The latter could add to current account pressures for some large importing countries, contributing to renewed currency depreciations.

Regarding the prospects of sovereign default in Argentina, financial market contagion has not been observed so far but renewed downward pressure on the peso and on economic activity could have significant repercussions for the region.

External financing needs are significant despite current account adjustments

Countries with large external financing needs (defined as the expected current account deficit plus scheduled principal payments on private external debt) and relatively low foreign reserves would be more vulnerable to a reversal of capital inflows and tighter financing conditions. Ongoing current account rebalancing in some middle income countries is helping to reduce these vulnerabilities (Figure 24), but adjustments are incomplete and, so far, have mainly resulted from weakening imports triggered by slow domestic demand or targeted policies.

Among countries with access to international capital markets, projected external financial requirements in 2014 exceed their foreign currency reserves in some 18 developing countries, with funding needs amounting to more than 10 percent of GDP in most cases (Figure 25). For many, external financing needs are unlikely to pose a short-term threat, coming in the relatively stable form of FDI or remittance flows.

However, other countries relying more on volatile financing sources (such as short-term debt and portfolio

3. See World Bank (2014): "Capital flows and risks in developing countries" January 2014 Global Economic Prospects, Chapter 3.

flows) could be more vulnerable in the absence of sufficient foreign reserves to buffer shocks in times of market stress.

Fiscal consolidation is ongoing but incomplete

A tighter fiscal stance would help alleviate external financing pressures and reduce future vulnerabilities. A measured reduction in government deficits was achieved in recent years, but almost half of developing countries have deficits that exceed 3 percent of GDP, while more than half have seen public debt levels increase in excess of 10 percentage points since 2007 (Figure 26).

A growing reliance by governments on local-currency bond issuances helps reduce external vulnerabilities and currency mismatches, but does not alleviate exposure to shifts in investor sentiment and rising external financing costs because much of this locally issued debt is held by overseas investors (Figure 27).

So far, institutional investors, who hold much of this debt, have not cashed in their positions in the face of recent volatility. However, new bouts of global risk aversion could lead to pullbacks from these markets. A sudden exit of foreign investors would test liquidity conditions in local bond markets, heightening downward pressures on the exchange rate.

Private sector indebtedness still rising, exposing banks in a stress situation

Private debt continued to increase as a percentage of GDP in the second half of last year in countries such as China, Malaysia, Thailand, Brazil, Turkey and Mexico (Figure 28). Increased indebtedness over time partly reflects deepening capital markets and growing banking sector intermediation, but also highlights past excesses of credit-fueled growth.

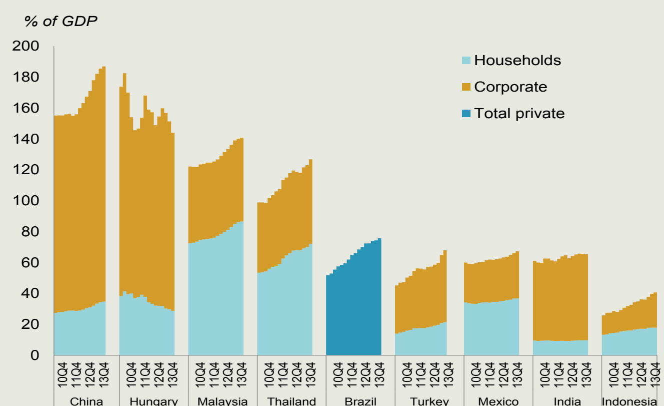
Tighter lending standards and higher costs should eventually translate into a stabilization of leverage ratios, but sharp adjustments in a stress situation cannot be excluded, straining banks' balance sheets with a rapid rise in non-performing loans.

Banks across developing countries continue to maintain sound capital buffers, reporting Tier 1 capital ratios significantly above Basel III requirements in most cases (Figure 29). However, the combination of high domestic leverage and large foreign bank liabilities (notably in certain Eastern and Central Asian economies), could

Figure 27 Foreign ownership of local government bond markets has risen significantly in recent years

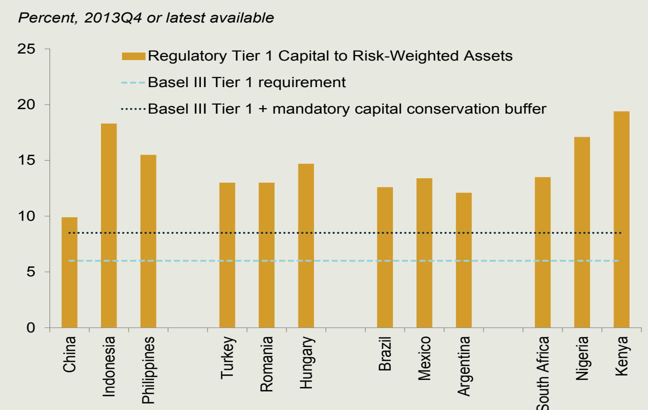
Source: World Bank.

Figure 28 Private indebtedness remained high or increased further in a number of countries



Source: World Bank.

Figure 29 Banks' Tier-1 capital ratios appear adequate in many developing countries



Source: IMF and World Bank.

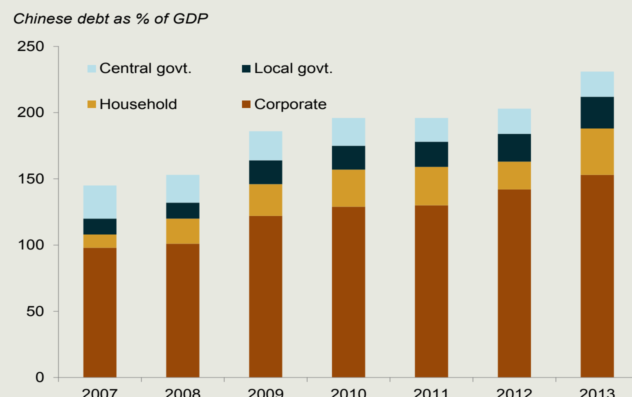
amplify the effect of currency and interest rate shocks on domestic activity and lending.

China's rebalancing effort requires containment of corporate leverage

In China, total debt, at 240 percent of GDP, is one of the highest in the world making companies extremely sensitive to weakening demand or interest rate shocks (Figure 30). Meanwhile, corporate profitability and cash flows are under pressure due to slowing growth and high refinancing needs. In addition, a residential and construction boom—a key driver of growth in recent years, and a major source of revenue for local governments— is cooling and could lead to a sharp correction as credit standards are tightened.

Given large fiscal buffers available to the Chinese government, tight capital controls and limited foreign debt ownership, the country retains significant policy space for crisis mitigation in a stress situation, but the tight interconnection between a highly leveraged corporate sector and financial stability remains a source of concern. Risks of a credit crunch intensifying existing pressures on the corporate, property and financial sectors cannot be excluded.

Figure 30 Chinese corporate debt has increased sharply since 2007



Source: World Bank.

Chinese authorities recommitted in May to a series of capital market reforms aimed at encouraging a more efficient allocation of capital, increasing foreign investment and improving market transparency. If fully implemented, these reforms should help rein in shadow banking activity and help contain the concentration of credit risks.

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