Should We Worry About Global Capital Flows?

The World Bank Global Economic Prospects report has just been released and highlights a number of key trends over the next few years.

One is that trade flows should start to recover soon. Global trade growth for the last few years has been roughly in line with GDP growth, rather than the more normal rate of twice GDP growth that it was evident during the era of globalization from 1990-2007. This slowdown has largely been due to the shift from import-intensive investment spending, particularly in developed countries, toward government spending that generally has less than half the import content. Trade flows should gradually increase as investment recovers, although they may never return to the intensity of the globalization era as China rebalances toward private consumption which is less import intensive than investment growth, so a rebalancing there will mean less overall import intensity for Chinese growth.

The World Bank also expects a slow recovery in global growth, with significant headwinds from the expected gradual tightening of US monetary policy, and also a shift in capital flows from developing countries to developed ones. They expect these shifting flows to lead to a continued decline in those currencies of developing countries which have appreciated strongly, such as Brazil. Clearly the countries with the most demand for capital, largely those in Eastern Europe and Turkey, and the countries in Latin America will be most affected, not the creditor countries that are running current account surpluses. The World Bank continues to expect China to grow at 7.5% "in line with potential as the economy shifts to slower but more sustainable consumption-led growth." while growth in the rest of East Asia will increase gradually to 5.5%. Contrast this with Turkey where growth is expected to fall in 2014 due to political uncertainty and tighter financing conditions, while they expect Brazil to gradually reach 3.7% growth.

The thesis that investors in developed countries will be less inclined to finance developing debtor countries would have significant implications for the debtors. "Private capital flows to developing countries are also expected to recede in the baseline as asset portfolios are rebalanced, with flows expected to taper off by 0.6 percent of developing-country GDP to about 4.0 percent of GDP by 2016 (about 10 percent relative to current levels)." The worse case scenario would be if this shift in financial flows becomes disorderly as it did in mid-2013: "Those most at risk would include those that are more integrated into the global financial system and those that have large external imbalances. In addition, countries with large amounts of external debt and those that have experienced large credit expansions in recent years could also be at risk." The World Bank particularly highlights the large private sector external debts

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in emerging Europe, Turkey and Ukraine, such as Hungary's 89% of GDP in private sector external debt. Political complacency is also highlighted as a risk.

So far this year, investors apparently have dismissed many of these risks for the time being and EM credit spreads have tightened in general. Absent either more growth or more inflation, these pitfalls for debtor nations will not disappear anytime soon.

For the full report, go to:
http://www.worldbank.org/content/dam/Worldbank/GEP/GEP2014a/GEP2014aFULL%20FINAL.pdf

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