Capital Flows Report
The EM Positioning Overhang

April 5, 2019

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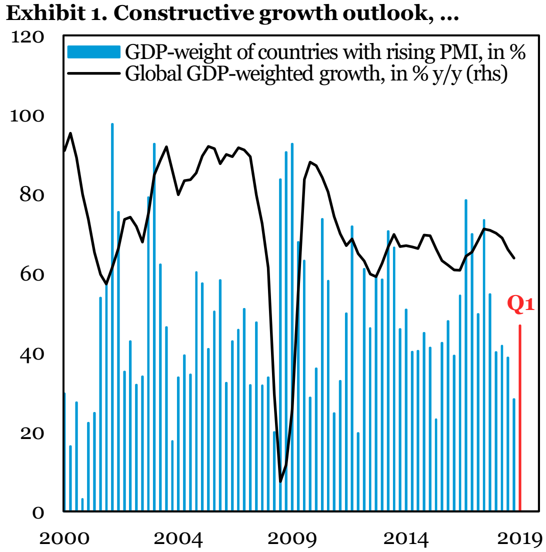
- Our best predictor of global growth has turned a lot more positive.
- Alongside the dovish Fed, this paints a positive picture for risk assets.
- Surprisingly, however, EM currencies have been quite a mixed bag, ...
- and our high frequency tracking of flows shows a mixed rebound in Q1.
- We believe the underlying issue is that investors are over-positioned, ...
- with a positioning overhang after a decade of loose G-3 monetary policy.
- We therefore upgrade our capital flows projection to EM only modestly, ...
- with non-resident flows of $1,260 bn in 2019, after $1,135 bn in 2018.

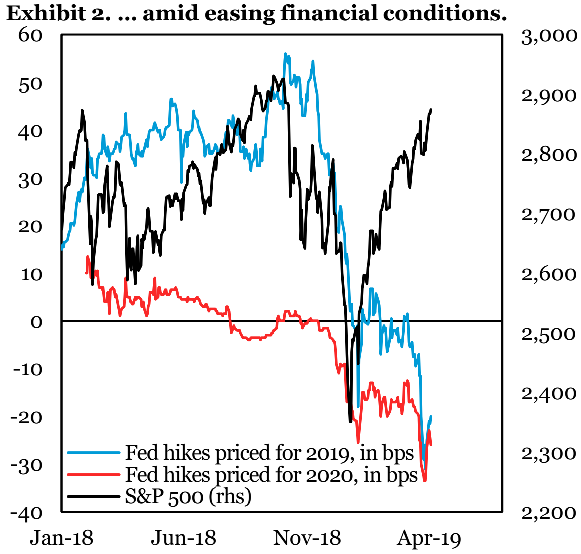
Our high frequency tracking of global growth points to an improving picture. As we have noted previously, the combined weight of global manufacturing PMIs that are rising is a good leading indicator for global growth (Exhibit 1), having correctly anticipated improving growth in 2017 and de-synchronization in 2018. Consistent with mounting trade tensions and tighter financial conditions, this measure fell to its lowest point since 2015 in Q4 2018, but staged a come-back in Q1. Taken together with rapidly easing financial conditions – including in the US where the dovish Fed shift has had a profound impact (Exhibit 2) – this means our global growth outlook remains constructive. We forecast global growth of 2.9 percent this year, down from 3.0 percent in 2018, where the downgrade is due mainly to the Euro zone, which we see as quite idiosyncratic. In particular, we do not see soft German manufacturing data as a signal of weak global growth, as they are heavily influenced by the credit crunch in Turkey. For 2020, we expect global growth to return to 3.0 percent, as the Euro zone and certain EMs recover (Table 1). Idiosyncratic developments will make countries such as Venezuela diverge significantly from global trends (Box 1). Our benign growth view is constructive for risk assets, but emerging markets have not benefitted as much as might have been expected. We believe this relates to what we are calling the *EM Positioning Overhang*, whereby a decade of QE left investors overloaded with EM assets. Because of this overhang, we forecast a relatively modest rebound in non-resident capital flows to EM this year and next. We forecast flows of $1,260 bn in 2019, up somewhat from $1,135 bn in 2018, with a further modest recovery next year. Overall, however, we believe the world is a more difficult place for EMs that depend on foreign capital inflows.

Exhibit 1. Constructive growth outlook, ...



Source: Haver, IIF

Exhibit 2. ... amid easing financial conditions.



Source: Haver, IIF

BOX 1. THE CRISIS IN VENEZUELA

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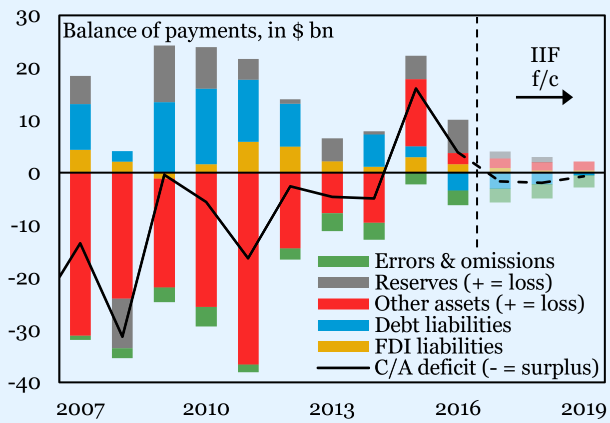
Venezuela's situation is exceptional in many respects, including capital flows. The magnitude of the country's collapse is almost unprecedented in recent history. Real GDP has declined a cumulative 50% since 2013, making the collapses of the Soviet Union and Zimbabwe the only comparable episodes in modern history. Inflation estimates are high, even by the standards of past hyperinflations, but previous stabilization episodes show that hyperinflation can be stopped quickly. External debt more than doubled in the last decade, rising sharply relative to exports.

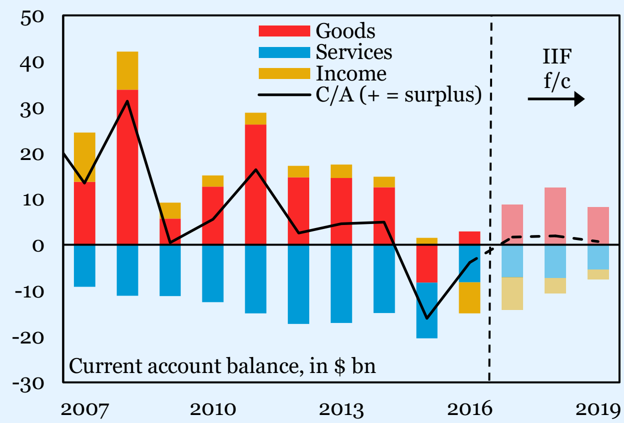
We estimate that Venezuela's current account balance and capital flows have shrunk drastically since official data were last published in 2016. The economic crisis has made it all but impossible to borrow internationally (LHS chart). Modest amounts of bilateral and multilateral loans were extended in 2017, but in net terms Venezuela repaid external debt. Having exhausted liquid reserve assets, the only net source of financing Venezuela has left for imports is modest asset repatriation by the private sector. The mirror image of virtually non-existent foreign financing sources is a current account in rough balance (RHS chart). In the context of rapidly declining oil exports due to crumbling infrastructure and US sanctions, a balanced current account necessarily implies draconian import compression. We estimate imports will be lower this year than in the early 2000s, underscoring the severity of shortages of essential goods.

Foreign funding sources dried up, ...



Source: Haver, IIF

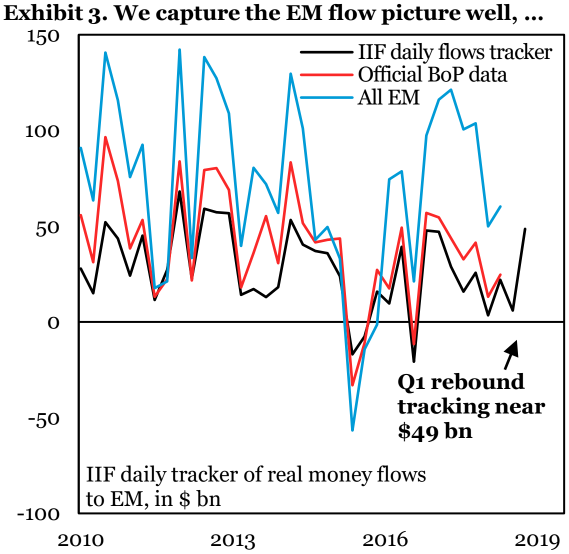
... balancing the current account.



Source: Haver, IIF

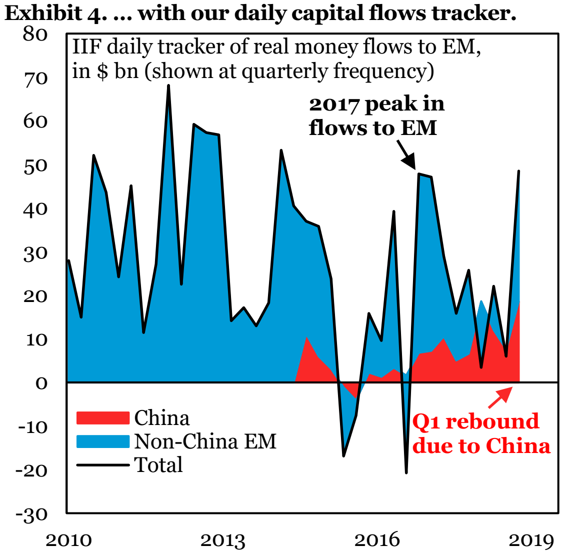
Our capital flows trackers span around twenty of the world's key emerging markets, including China, Brazil, India, as well as Turkey, and provide a daily read on real money flows into EM stocks and bonds. Exhibit 3 shows this tracker (black) aggregated to a quarterly frequency. Importantly, our tracker is a close proxy for official BoP data (red) that are released with a considerable lag, so it can be thought of as an accurate representation for the EM flow picture overall (blue). Although Q1 saw a big rebound, underlying details point to a mixed picture, because China accounts for much of the bounce-back (Exhibit 4).

Exhibit 3. We capture the EM flow picture well, ...



Source: Haver, IIF

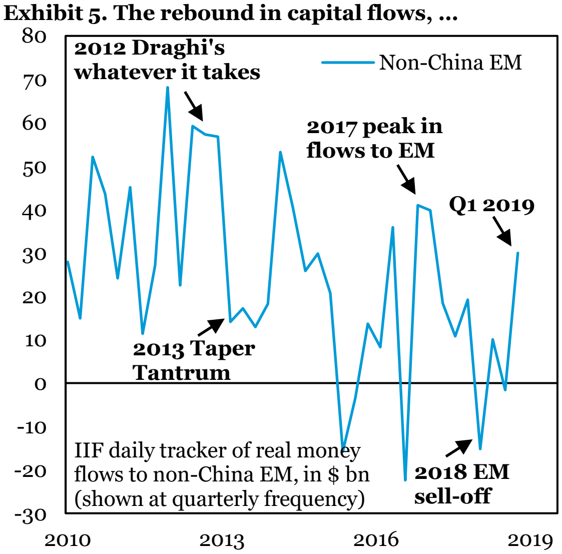
Exhibit 4. ... with our daily capital flows tracker.



Source: Haver, IIF

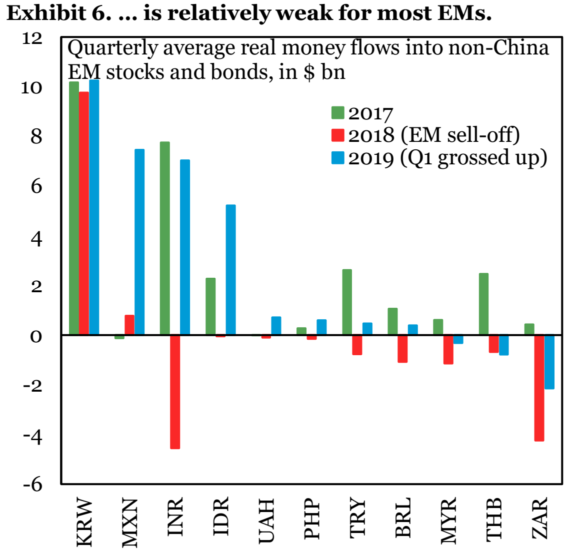
Indeed, if we exclude China from the picture, successive rebounds have been weaker and weaker (Exhibit 5). The Q1 2019 rebound is no exception to this pattern, which is especially notable given that 2018 saw such a pronounced EM sell-off and associated drop in flows. It is also the case that the Q1 rebound was quite idiosyncratic, with only a few places benefitting in a major way. Exhibit 6 gives some perspective on this. It compares the quarterly pace of inflows in 2017 – a good year for EM – to the quarterly pace of flows during the EM sell-off last year and our tracking for Q1 2019. Key emerging markets like South Africa have seen outflows, with Thailand and Malaysia also seeing negative flows, despite the EM sell-off last year. Only a small number of emerging markets have seen a convincing rebound in flows, with Indonesia perhaps the prime example. Part of the explanation for the anemic rebound may be muscle memory from 2018. But we suspect that a continued positioning overhang after years of easy money and record flows to EM is really to blame.

Exhibit 5. The rebound in capital flows, ...



Source: Haver, IIF

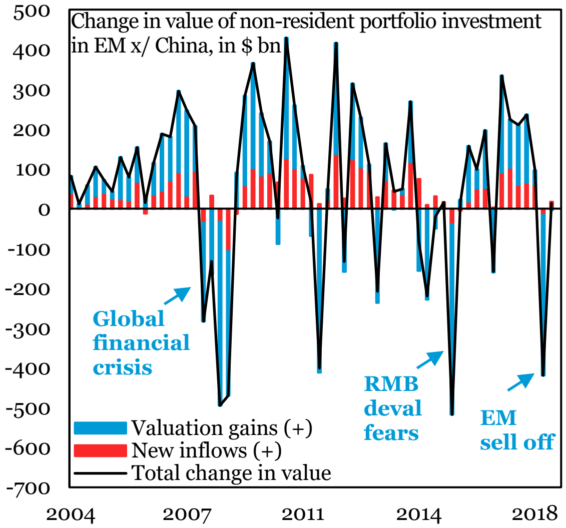
Exhibit 6. ... is relatively weak for most EMs.



Source: Haver, IIF

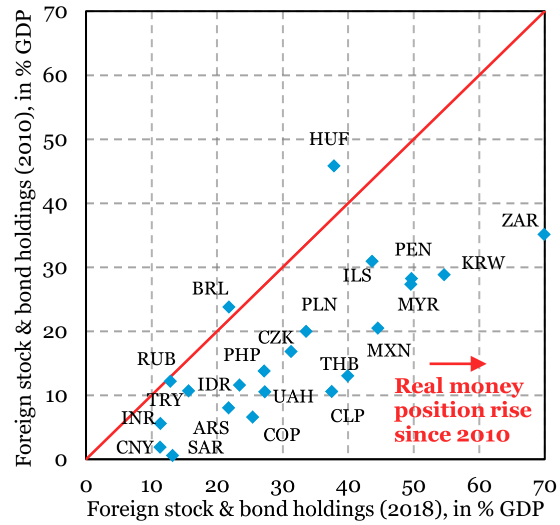
To quantify this positioning overhang, we recently unveiled a new database on EM positioning in a series of ***Global Macro Views***. Our data reflect the *"stock"* of foreign investor holdings in EM equities and debt, while most currently available positioning metrics are really high-frequency trackers of flows, which measure *"sentiment"* rather than *"positioning."* More importantly, many high frequency measures of flows bear little resemblance to official BoP data, i.e. likely capture too small a slice of the market to be representative. We calibrate our flows and positioning estimates to match official BoP data and model historical valuation effects – changes in the Dollar value of past investments that result from currency and stock market fluctuations – so that we can give a real-time estimate of foreign investor holdings. Exhibit 7 shows our tracking of non-resident positioning changes in non-China EM, where red bars show flows and blue bars show valuation changes. It is notable that outflows, i.e. negative red bars, are very rare, which suggests that "true" positioning, even after an EM sell-off as violent as in 2018, rarely changes. Exhibit 8 shows how foreign investor positioning in EM stocks and bonds has evolved relative to GDP since 2010, i.e. in the roughly ten-year window of extraordinarily loose G-3 monetary policy. Across the board, EM positioning has risen, notably so in a few places like South Africa. This is why, despite a positive growth backdrop, we anticipate only a relatively weak rebound in non-resident capital flows to EM. Capital flows to non-China EM are forecast to recover modestly in 2019 to $685 bn and continue improving in 2020, while remaining short of the levels observed in 2017 (Table 2). In MENA, index inclusion will boost non-resident inflows (Box 2). As in past years, China will be a key driver of capital flows to EM. All in all, we forecast non-resident flows to EM of $1,260 and $1,356 bn this year and next (Table 3).

Exhibit 7. Little EM positioning reduction in 2018.



Source: Haver, IIF

Exhibit 8. Foreign positioning in EM is up.



Source: Haver, IIF

BOX 2. MENA ASSET ACCUMULATION CONTINUES

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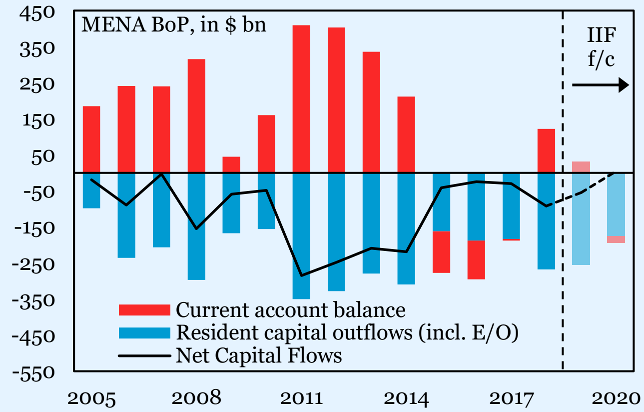
The IIF forecasts Brent oil spot prices to average $65/bbl in 2019 and $60/bbl in 2020. With modestly lower oil prices, the aggregate current account surplus of the six GCC oil exporters will narrow from $147 bn in 2018 to $91 bn in 2019 (exhibit). Non-resident capital inflows are set to rise modestly to $145 bn in 2019, equivalent to 9% of GDP (see MENA Capital Flows Report). Portfolio investment, particularly sovereign bonds, will remain the key driver of capital inflows in 2019.

We expect portfolio debt inflows to increase from $48 bn in 2018 to $60 bn in 2019 as five GCC states are now in J.P. Morgan's EMBI index. During the first quarter of this year, Saudi Arabia and Qatar issued a combined $19.5 bn in sovereign Eurobonds. The pickup in equity inflows in the first three months of 2019 is particularly evident in Saudi Arabia, Kuwait, and the UAE. With an improving EM investment outlook in recent months, we expect healthy equity inflows to continue through the first half of 2019. Resident capital outflows will remain large at $235 bn, far exceeding non-resident capital inflows. As a result, the stock of gross foreign assets is projected to increase to $3.1 tn by 2020, about 70% of which is managed by SWFs with diversified equity and fixed income portfolios. The other 30% is in official reserves.

Asset accumulation continues at lower pace.



Source: Haver, IIF

Table 1. Global Growth Forecasts

Real GDP Growth, change y/y (%)	2011	2012	2013	2014	2015	2016	2017	2018	2019f	2020f
Mature Markets	**1.5**	**1.1**	**1.3**	**1.9**	**2.3**	**1.6**	**2.2**	**2.2**	**1.9**	**1.8**
G3	**1.3**	**0.9**	**1.1**	**1.7**	**2.4**	**1.6**	**2.2**	**2.2**	**1.9**	**1.8**
United States	1.6	2.2	1.8	2.5	2.9	1.6	2.2	2.9	2.5	2.2
Euro Area	1.6	-0.9	-0.2	1.4	2.1	2.0	2.4	1.8	1.1	1.6
Japan	-0.1	1.5	2.0	0.3	1.3	0.6	1.9	0.8	1.1	0.8
Other Mature	**2.4**	**1.9**	**2.1**	**2.8**	**2.2**	**1.9**	**2.2**	**2.1**	**1.8**	**1.9**
Emerging Markets	**6.4**	**4.7**	**4.9**	**4.4**	**3.9**	**4.2**	**4.8**	**4.5**	**4.4**	**4.7**
Latin America	**4.4**	**2.5**	**2.6**	**0.8**	**-0.4**	**-1.2**	**1.2**	**0.7**	**1.1**	**2.2**
Argentina	6.0	-1.0	2.4	-2.5	2.7	-2.1	2.7	-2.5	-1.4	2.3
Brazil	4.0	1.9	3.0	0.5	-3.5	-3.3	1.1	1.1	1.9	2.6
Chile	6.1	5.3	4.0	1.8	2.3	1.7	1.3	4.0	3.4	3.2
Colombia	7.4	3.9	4.6	4.7	3.0	2.1	1.4	2.7	3.2	3.4
Mexico	3.7	3.6	1.4	2.8	3.3	2.9	2.1	2.0	1.7	2.1
Venezuela	4.2	5.6	1.3	-3.9	-5.7	-16.5	-15.5	-19.6	-25.0	-9.0
Emerging Europe	**5.6**	**3.0**	**3.0**	**1.9**	**0.7**	**1.6**	**4.0**	**3.0**	**1.6**	**2.2**
Czech Republic	1.8	-0.8	-0.5	2.7	5.3	2.5	4.4	3.0	2.8	2.6
Hungary	1.7	-1.6	2.1	4.2	3.5	2.3	4.1	4.9	3.7	3.0
Poland	5.0	1.6	1.4	3.2	3.8	3.1	4.8	5.1	3.8	3.4
Russia	4.1	3.6	1.8	0.7	-2.5	-0.2	1.5	2.3	1.6	1.7
Turkey	11.1	4.8	8.5	5.2	6.1	3.2	7.4	2.6	-0.9	2.2
Ukraine	5.5	0.2	0.0	-6.6	-9.8	2.4	2.5	3.3	2.7	3.0
Asia/Pacific	**7.8**	**6.8**	**6.7**	**6.5**	**6.3**	**6.4**	**6.3**	**6.2**	**5.9**	**5.9**
China	9.6	7.9	7.8	7.3	6.9	6.7	6.8	6.6	6.3	6.2
India*	7.0	5.5	6.1	7.0	7.5	8.7	6.9	7.4	6.9	7.4
Indonesia	6.2	6.0	5.6	5.0	4.9	5.0	5.1	5.2	5.1	5.2
Malaysia	5.3	5.5	4.7	6.0	5.1	4.2	5.9	4.7	4.6	4.5
Philippines	3.7	6.7	7.1	6.1	6.1	6.9	6.7	6.2	6.1	6.2
South Korea	3.7	2.3	2.9	3.3	2.8	2.9	3.1	2.7	2.6	2.5
Thailand	0.8	7.2	2.7	1.0	3.1	3.4	4.0	4.1	3.7	3.6
Africa/Middle East	**5.1**	**1.8**	**3.2**	**3.9**	**2.9**	**2.9**	**1.4**	**1.6**	**1.8**	**2.6**
Algeria	2.9	3.4	2.8	3.8	3.7	3.2	1.4	2.2	1.7	2.3
Egypt	1.6	2.6	4.4	3.3	4.3	4.3	4.2	5.3	5.4	5.3
Iran	0.6	-7.7	-0.3	3.2	-1.6	12.5	3.7	-1.6	-2.1	2.1
Lebanon	0.9	2.7	2.6	1.9	0.4	1.6	0.6	0.5	0.9	1.8
Nigeria	4.9	4.3	5.4	6.3	2.7	-1.6	0.8	1.9	2.6	3.2
Qatar	13.4	4.7	4.4	4.0	3.7	2.1	1.6	1.8	1.9	2.8
Saudi Arabia	10.0	5.4	2.7	3.7	4.1	1.7	-0.7	2.2	1.8	2.3
South Africa	3.3	2.2	2.5	1.8	1.2	0.4	1.4	0.8	1.3	1.7
UAE	6.9	4.5	5.1	4.4	5.1	3.0	0.8	1.7	2.4	2.6
World	**3.2**	**2.4**	**2.7**	**2.9**	**3.0**	**2.7**	**3.2**	**3.1**	**2.9**	**3.0**
World (PPP weights)	**4.2**	**3.1**	**3.4**	**3.4**	**3.3**	**3.2**	**3.8**	**3.6**	**3.4**	**3.6**

Source: IIF. Aggregates calculated using previous year's nominal GDP in $ as weights unless otherwise noted.
**India real GDP growth reported in calendar year; country notes and databases report in fiscal year.*

Note: Our country database covering 58 Emerging Markets can be downloaded from our website.

Table 2. Emerging Markets excl. China – Capital Flows

$ bn (+ = inflow of capital, - = outflow of capital)	2015	2016	2017	2018	2019f	2020f
Non-resident Capital Flows	482	547	839	650	685	744
Foreign direct investment	322	329	339	342	343	359
Equity	247	248	281	261	257	272
Debt	75	81	58	81	86	87
Portfolio investment	45	143	300	90	132	171
Equity	-1	45	43	-25	29	42
Debt	46	98	257	115	103	129
Other investment (largely banking related flows)	115	76	201	218	210	214
Resident Capital Flows	-480	-425	-664	-643	-656	-621
Direct investment abroad	-176	-149	-197	-203	-195	-194
Portfolio investment	-100	-72	-180	-115	-124	-119
Other investment (largely banking related flows)	-203	-203	-287	-325	-336	-308
Financial derivatives, net	-3	8	-13	-3	-3	-6
Capital transfers	18	7	10	14	10	12
Reserves (- = increase)	102	-38	-165	-91	-83	-95
Net errors and omissions	-39	-89	-7	-22	-2	-7
Net Capital Flows	0	131	163	3	25	117
Net Capital Flows plus Errors & Omissions	-40	42	155	-19	23	110
Memo:						
Current Account Balance	-81	-11	-1	96	51	-27
Official Flows	18	22	11	46	36	19

Source: IIF. See annexes 1 and 2 for guidance on how to interpret these data and country coverage

Table 3. Emerging Markets – Capital Flows

$ bn (+ = inflow of capital, - = outflow of capital)	2015	2016	2017	2018	2019f	2020f
Non-resident Capital Flows	380	806	1,282	1,135	1,260	1,356
Foreign direct investment	565	504	505	546	543	579
Equity	459	413	422	416	397	416
Debt	106	91	83	130	146	163
Portfolio investment	52	193	424	250	352	403
Equity	14	68	79	35	109	130
Debt	38	125	345	215	243	273
Other investment (largely banking related flows)	-237	109	354	339	365	374
Resident Capital Flows	-810	-1,094	-998	-992	-961	-901
Direct investment abroad	-350	-366	-336	-300	-325	-344
Portfolio investment	-173	-175	-275	-168	-239	-240
Other investment (largely banking related flows)	-286	-553	-387	-524	-396	-317
Financial derivatives, net	-5	3	-12	-10	-11	-14
Capital transfers	19	7	10	13	9	11
Reserves (- = increase)	445	406	-257	-110	-174	-241
Net errors and omissions	-252	-319	-220	-182	-214	-220
Net Capital Flows	-435	-285	272	133	288	441
Net Capital Flows plus Errors & Omissions	-687	-604	52	-49	74	221
Memo:						
Non-resident capital inflows, % of GDP	1.5	3.1	4.5	3.7	4.0	4.0
Current Account Balance	224	191	194	145	91	9
Official Flows	14	22	10	45	35	18

Source: IIF. See annexes 1 and 2 for guidance on how to interpret these data and country coverage

Argentina

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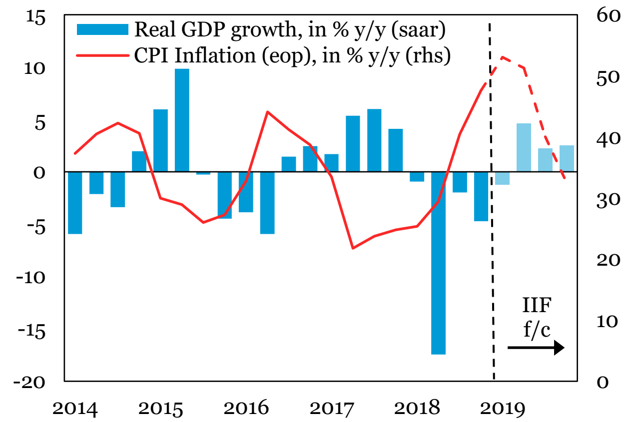
STRUGGLING TO RECOVER

The economy has struggled to recover from financial turmoil and agricultural output losses due to the country's worst drought in decades. Activity declined 4.7% in 2018Q4, down from a contraction of 2.0% in the previous quarter (Exhibit 1). After a decline of 2.5% in 2018, real GDP will likely drop again this year, although a recovery starting in 2019Q2 should set the stage for positive growth in 2020. While some high-frequency activity indicators point to stabilization in 2019Q1, recent downward pressure on the Peso has prompted the central bank to increase interest rates, fueling doubts about the timing and strength of the recovery. Uncertainty over the outcome of the October 27 presidential election also weighs on the outlook. Despite the recession and policy tightening, inflation rose to 51.3% y/y in February from 47.6% y/y in December, driven by still-high inertia and administered price increases. The new monetary policy framework has shown limited ability to control persistent inflation, hindering the projected disinflation path.

Falling economic activity, Peso depreciation, household purchasing power losses, and policy tightening resulted in substantial import compression in 2018Q4 (Exhibit 2). This translated into a decline in the current account deficit to $2.3 bn in 2018Q4 from $7.5 bn in the previous quarter and $9.4 bn in 2017Q4. We project the current account deficit to drop to 2.5% of GDP this year from 5.2% in 2018 due to a recovery in exports and further import contraction, before widening somewhat in 2020. While the acquisition of foreign assets by residents has recently declined, following a surge in 2018, resident outflows normally pick up in the run-up to an election. After the reversal in portfolio inflows in 2018Q2, front-loading of disbursements from the upgraded IMF agreement helped cover external financing needs last year (Exhibit 3). While we expect official debt inflows to continue financing the current account deficit in 2019, we still think financing gaps could emerge in downside scenarios.

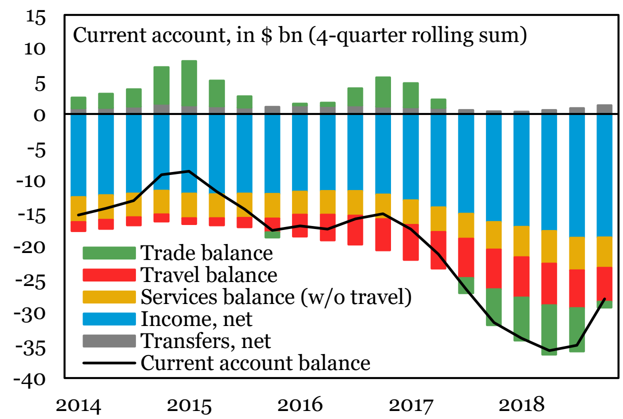
Fiscal policy will be tight, as the authorities bring the primary deficit close to zero this year, a reduction of more than two percent of GDP. Policy options to support the economy are limited, since fiscal consolidation leaves little scope for stimulus spending ahead of the election in a context where high inflation prevents monetary policy easing. While reducing inflation and meeting the ambitious fiscal targets is critical for macro stability, signals given by the presidential candidates in the coming months about policies beyond 2019 will be equally important to set the foundations for a recovery.

Exhibit 1. The economy is in recession.



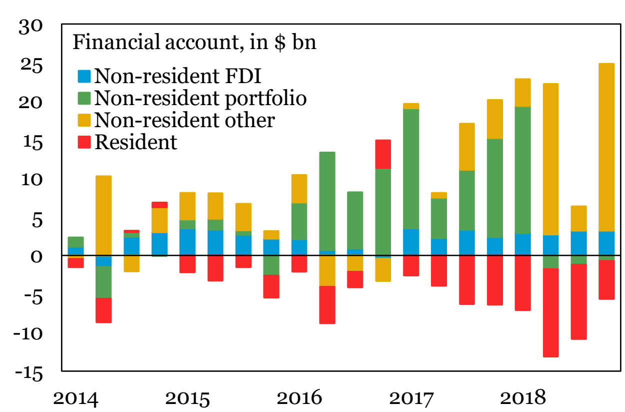
Source: Haver, IIF

Exhibit 2. Narrowing current account deficit.



Source: Haver, IIF

Exhibit 3. Official flows helped ease external pressure.



Source: Haver, IIF

Brazil

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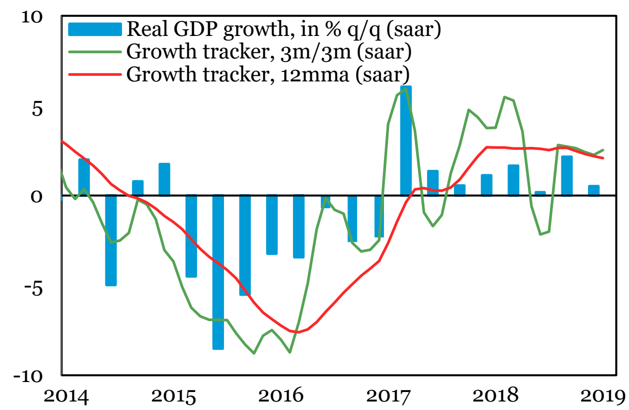
INVESTOR UNDER-POSITIONING

A sluggish cyclical recovery in activity is underway following the deep recession in 2015-16. While political uncertainty has dissipated following last year's presidential election, high-frequency activity indicators suggest progress will remain gradual after lackluster growth in 2018Q4 (Exhibit 1). This is consistent with weak growth observed in EM following deep and long recessions. Inheriting a stable economy, the new administration has aimed to attract foreign capital by quickly improving fragile public finances and adopting productivity-enhancing reforms. However, uncertainty remains high around reform implementation, in particular much-needed pension reform, and the still-unfolding corruption probe. We forecast growth to strengthen from 1.1% last year to 1.9% in 2019 and 2.6% in 2020. Meanwhile, inflation will likely remain within the central bank target of 4.25%±1.5 (2019) and 4%±1.5 (2020) during this period.

A solid external position, including a small current account deficit, large FDI inflows, a sizable stock of foreign reserves, and low non-resident debt holdings should help the economy withstand potential global headwinds such as lower commodity prices (Exhibit 2). The current account deficit expanded in 2018 due to robust import growth but remained below 1% of GDP. While non-resident portfolio outflows and resident capital flight picked up ahead of the presidential election, inward FDI continued to fully finance the current account deficit. We project the current account deficit to hover around a still-manageable level of 1.5% of GDP in 2019 and 2020 amid a gradually worsening trade balance. Non-resident capital inflows are set to rise from 4.6% of GDP in 2018 to 5.7% and 5.9% this year and next, respectively. This would reflect positive portfolio investment flows for the first time since 2015, strengthening FDI amid recovering growth, and low foreign investor positioning (Exhibit 3).

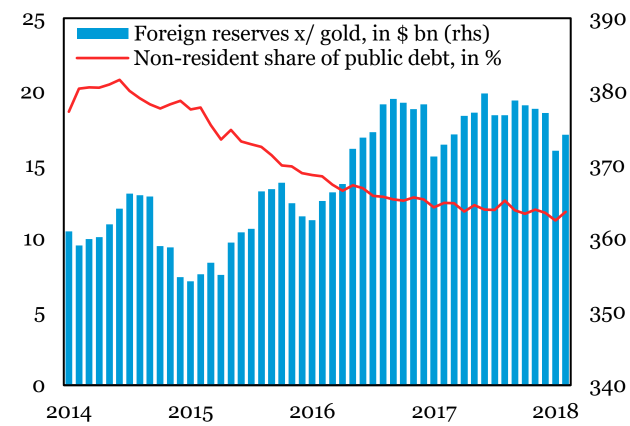
Improved prospects are largely dependent on the government's ability to boost confidence. A fiscal deficit of 7% of GDP, Brazil's Achilles' heel, could drag down growth if not addressed. The administration has proposed long-overdue pension reform to Congress which would generate significant fiscal savings over time. However, approval requires constitutional amendments and, therefore, ample political backing. Reforming the pension system is critical to sustaining investor confidence and unlocking investment. Other government plans, including privatizations and tax and trade reforms, should also help bolster capital inflows, but implementation will be challenging in a context of high political fragmentation.

Exhibit 1. Weak recovery underway.



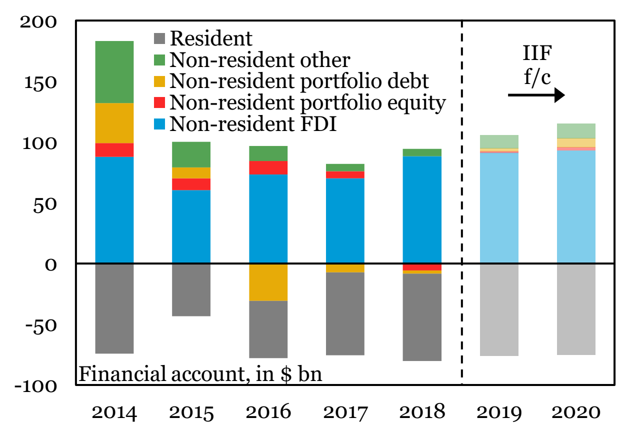
Source: Haver, IIF

Exhibit 2. Low external financing risk.



Source: Haver, IIF

Exhibit 3. Improved capital flows prospects.



Source: Haver, IIF

China

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SLOWER GROWTH, STABLE CAPITAL FLOWS

China's economy and balance of payments are going through profound changes. Real GDP growth slowed to 6.6% in 2018, the lowest in 28 years. Growth is increasingly driven by consumption, which contributed 5.0pp last year, while investment contributed 2.1pp (Exhibit 1). From the production perspective, the services sector accounted for 60% of China's GDP growth. We project growth to slow to 6.3% and 6.2% this year and next.

The current account surplus has dropped steadily, falling from almost 10% of GDP in 2007 to a record low of 0.4% last year. Chinese policymakers are trying to attract capital inflows and tighten controls over outflows. In 2018, resident outflows reached $348 bn, while non-resident flows brought in $485 bn (Exhibit 2). Despite slowing growth and trade concerns, resident outflows did not increase substantially, unlike during the 2015-16 stress episode.

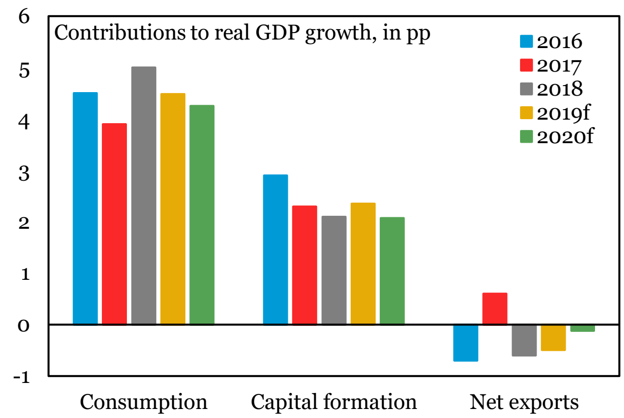
Net FDI bounced back from an outflow of $42 bn in 2016 to an inflow of $107 bn last year, due to smaller ODI in 2017 and greater FDI ($203 bn) in 2018. The Belt & Road Initiative should support Chinese investment in EM, while tighter regulation on both sides will curb FDI flows to the US and EU. We project China's net FDI to be around $70 bn per year in 2019 and 2020 (Exhibit 3).

China attracted large portfolio inflows last year. Its bond market brought in $100 bn in 2018, after drawing $88 bn in 2017. The inclusion of Chinese government bonds into the Bloomberg Barclays Global Aggregate index, to be phased in over 20 months starting in April 2019, will continue to support fixed income inflows going forward. Chinese bonds will represent 6% of the index's $54 tn once fully incorporated.

Furthermore, China attracted $61 bn of equity inflows in 2018, following $36 bn in 2017. At the same time, portfolio investment outflows remain tightly controlled. The Shanghai and Shenzhen Stock Connect with Hong Kong drew in about $44 bn last year, due to both growing north-bound inflows and the reversal of some south-bound positions. The 25% rise of the CSI300 index year-to-date should continue to attract equity flows in the coming months. Consequently, we expect net portfolio flows to reach $105 bn and $111 bn in 2019 and 2020, respectively.

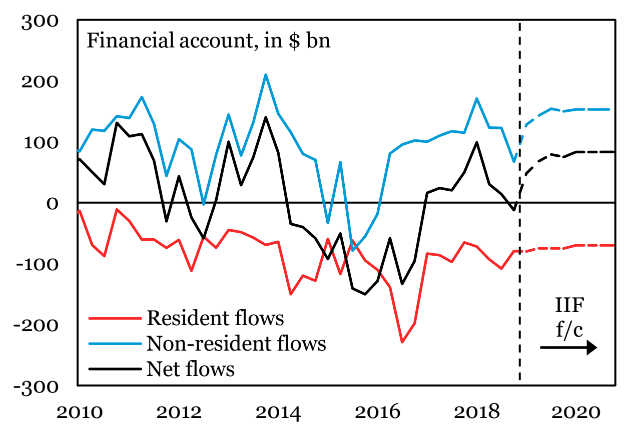
Following massive outflows in 2015-16, other investment banking flows became relatively balanced last year, at $77 bn. As the market expects a steadier RMB over the next year, we forecast positive other investment flows. Total net capital flows are projected to reach $50 bn and $110 bn in 2019 and 2020, respectively.

Exhibit 1. Subdued growth outlook.



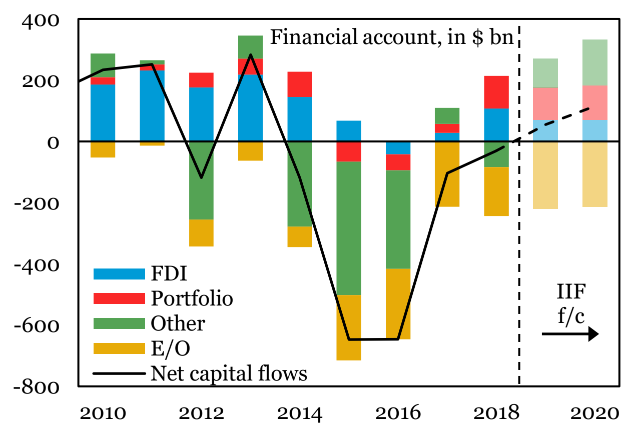
Source: Haver, IIF

Exhibit 2. Growing non-resident flows.



Source: Haver, IIF

Exhibit 3. Net capital flows set to increase.



Source: Haver, IIF

India

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RECOVERING CAPITAL FLOWS

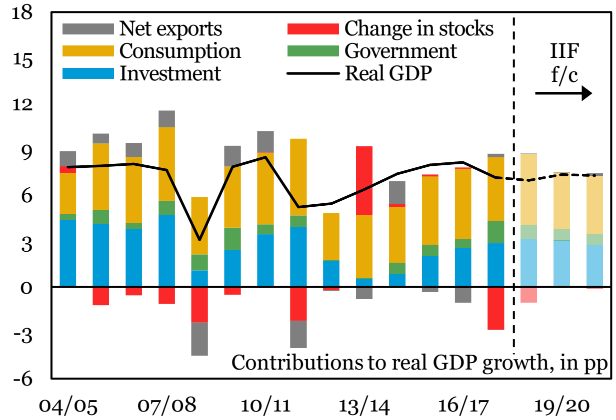
Although India left behind the negative growth effects of demonetization and GST implementation last year, the Indian rupee was the worst-performing currency in Asia. We attributed underperformance to risk from a widening current account deficit, but concluded the external position is stronger today than during the taper tantrum. Even though lower oil prices will reduce external vulnerability in 2019, we think India will remain in focus in the context of a currency that remains somewhat overvalued, changes at the helm of the RBI, the upcoming general election, and restructuring of IL&FS — a large shadow bank in distress. We project growth to increase to 7.4% in FY2019/20, after a period of relative weakness in the second half of last year (Exhibit 1). Inflation should remain well anchored below the 4% RBI target this fiscal year and next. We expect fiscal consolidation by the central government to yield a steady fall in the budget deficit from 3.5% of GDP in FY2018/19 to 3.3% in FY2020/21.

The balance of payments should return to a surplus in FY2020/21 with foreign exchange reserves climbing close to their FY2017/18 peak. We expect a slight decline in the current account deficit in terms of GDP for both FY2019/20 and FY2020/21. Favorable terms of trade will ease import pressures and reduce the trade deficit, particularly oil imports, which make up around 25% of the country's total imports.

As the twin deficits improve, we forecast a noticeable pickup in non-resident capital flows, in line with our daily capital flows tracker through end-March (Exhibit 2). The tax break for non-resident holders of Masala bonds, introduced in September 2018, provided a boost to the bond market. The continuation of this fiscal measure depends on the outcome of the general election in May 2019. The more stable economic and political environment should halt the sustained fall in non-resident FDI since FY2015/2016. Additional support for non-resident flows should come from the newly-introduced RBI policy for non-resident participation in INR interest rate derivatives.

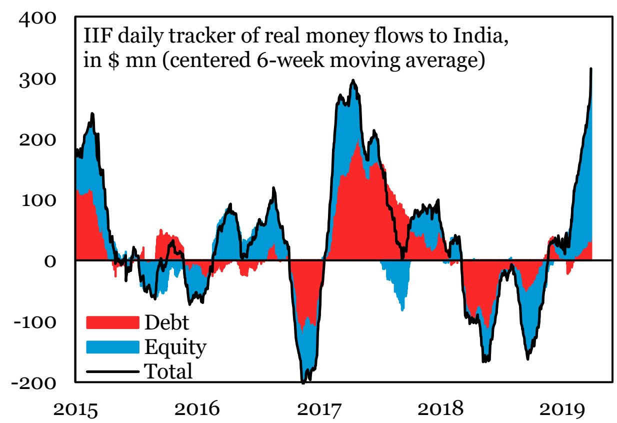
The financial system will remain in the spotlight, especially shadow banks. Data on bond issuance, commercial paper holdings, borrowing from commercial banks, and nonresident capital flows suggest shadow banks still have sources of financing (Exhibit 3). However, lending by shadow banks is slowing, the cost of funding is rising, and asset quality could deteriorate further. We expect a continuation of policies to support shadow banks in the run-up to the election, as part of efforts by the outgoing government to boost growth and access to credit. Near-term risk from shadow banks appears contained, but policymaking in India will be subject to close market scrutiny this year.

Exhibit 1. Growth outlook is stable.



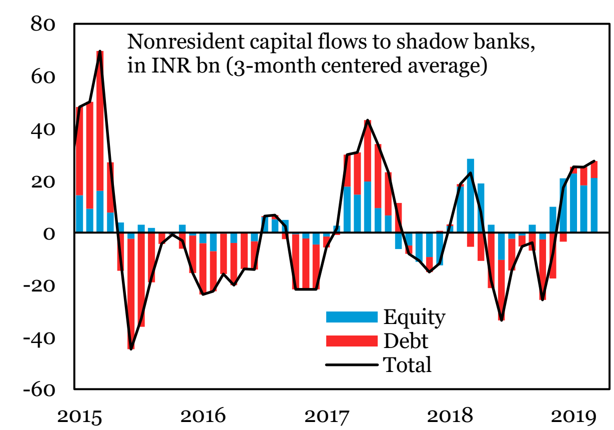
Source: Haver, IIF

Exhibit 2. Capital flows are picking up.



Source: Haver, IIF

Exhibit 3. Flows to shadow banks increase.



Source: Haver, IIF

Indonesia

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STRONG MOMENTUM INTO ELECTIONS

Growth momentum continued as Indonesia's real GDP expanded by 5.2% y/y in 2018, the fastest growth since 2014. The main drivers of last year's growth were manufacturing, construction, power, and telecommunications. The primary challenge for the country continues to be sustaining investment amid a large current account deficit. Real GDP growth should hover around 5.1% in 2019 and 5.2% in 2020 (Exhibit 1).

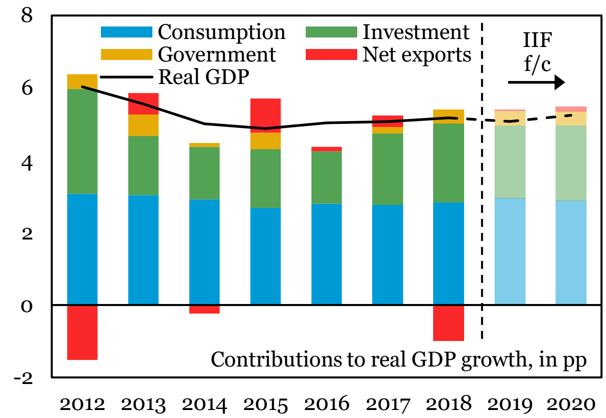
Inflation is projected to remain within the central bank's 2.5-4.5% inflation target range for this year and next. Despite the favorable inflation outlook, the current account deficit will likely force Bank Indonesia to keep its policy rate unchanged in 2019. Fiscal policy should turn expansionary this year for the first time since 2015, albeit only modestly. We forecast a marginal rise in the overall central government budget deficit to 2.1% in 2019 and 2.3% in 2020. Improvements in tax-collection should allow for larger expenditures while adhering to the strict rule capping the budget deficit at 3% of GDP.

We forecast a steady and gradual fall of the current account deficit for this year and next, as import growth slows. Strong imports, partly due to infrastructure projects, were responsible for the goods trade deficit in 2018, the first in over four decades. Except for net transfers, the rest of the current account components are likely to be in deficit for 2019-20 (Exhibit 2).

In 2019, the government plans to issue bonds of around $56 bn, close to 7% more than in 2018. Nearly 60% of the total issuance will be frontloaded in 2019H1. We anticipate foreigners to finance nearly 40% of these sovereign bonds, thus contributing to non-resident portfolio inflows. The government's plan to reduce withholding taxes for bond investors should boost demand further. Portfolio inflows will not be enough to compensate for a fall in foreign direct investment. However, lower resident capital outflows in 2019 will support the balance of payments.

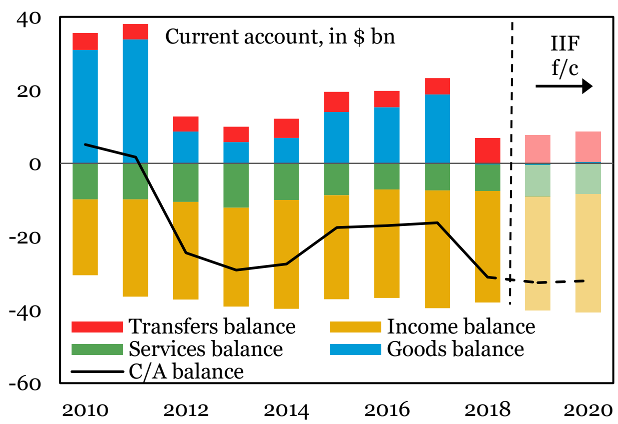
Non-resident capital flows have been strong year to date (Exhibit 3). In our baseline scenario, a stable macroeconomic outlook and targeted policy incentives will continue to attract strong inflows across all categories of non-resident capital flows. The outcome of the Indonesian presidential election later this month will strongly affect Indonesia's outlook in both 2019 and 2020. A wide current account deficit and relatively heavy foreign investor positioning make Indonesia's external accounts potentially sensitive to domestic or foreign shocks.

Exhibit 1. Steady growth continues…



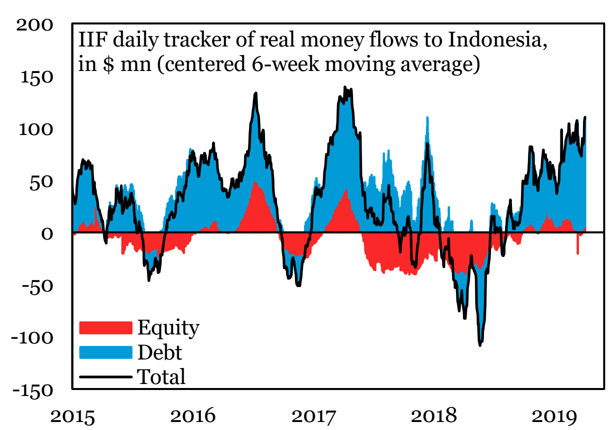
Source: Haver, IIF

Exhibit 2. … amid a sustained current account deficit.



Source: Haver, IIF

Exhibit 3. Strong pick-up in non-resident flows.



Source: Haver, IIF

Mexico

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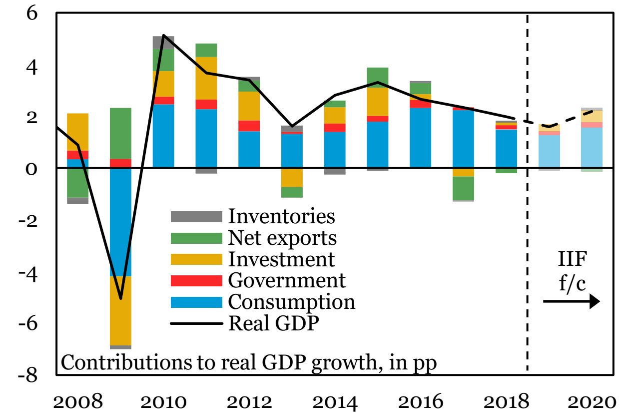
SLOW GROWTH AND HEAVY POSITIONING

Mexico's prospects remain highly dependent on uncertainty around policies by the new administration. Growth slowed down to 1.7% y/y in 2018Q4 due to weaker investment and manufacturing performance. Leading indicators for early 2019 are mixed, amid temporary shocks, including strikes and fuel shortages that followed measures to halt gasoline theft. Mexico's Economic Activity Indicator (IGAE) increased only 1.2% (sa) y/y in January, while industrial production fell 1.1% (sa) y/y, amid a moderate expansion of manufacturing. We forecast real GDP growth to weaken to 1.7% in 2019 from 2.0% last year, before picking up to 2.2% in 2020 (Exhibit 1). While policy uncertainty will continue to dampen investment, consumption should hold up relatively well amid high levels of consumer confidence. We project inflation to moderate within the 3%±1 target range this year, although upside risks persist.

The current account deficit remained contained at 1.8% of GDP last year, as a deterioration in the commodity and income balances was partly offset by positive performance of other goods and services along with strong remittances inflows (Exhibit 2). Despite uncertainty ahead of the presidential election, the economy continued to attract significant FDI and portfolio investment, leading to reserve accumulation. Resident outflows almost halved due to portfolio asset repatriation. We project the current account deficit to widen moderately to 1.9% of GDP in 2019. While weak domestic demand should weigh on imports, the commodity trade deficit is set to deteriorate due to large fuel import needs. We project portfolio inflows to remain subdued amid uncertainty over the direction of economic policies. Meanwhile, FDI should moderate but remain large enough to cover a significant fraction of external financing needs. Heavy positioning could make Mexico comparatively sensitive to unexpected policy developments (Exhibit 3).

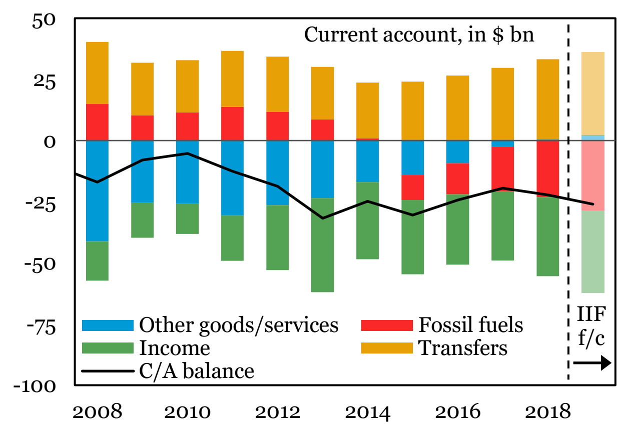
Mexico's prospects will largely depend on the government's capacity to tackle challenges posed by Pemex's steep financial constraints, weak business sentiment, and budget rigidities. Despite efforts to shore up Pemex, a sharp decline in crude oil production, subdued investment, and the firm's rising financing needs have prompted downgrades from credit ratings agencies, casting a shadow over Mexico's investment-grade status. The government's next steps regarding the energy sector, including plans to finance the construction of new refineries, will be key to reassuring investors. Continued uncertainty and potential FX volatility could limit the scope for monetary easing this year, raising the possibility of weaker growth in the context of a tight fiscal stance.

Exhibit 1. Growth dragged down by low investment.



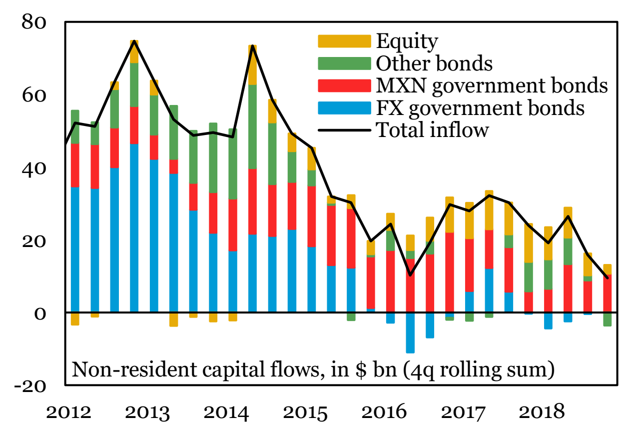
Source: Haver, IIF

Exhibit 2. Current account deficit remains moderate.



Source: Haver, IIF

Exhibit 3. Heavy foreign investor positioning.



Source: Haver, IIF

Russia

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SANCTIONS WEIGH ON CAPITAL FLOWS

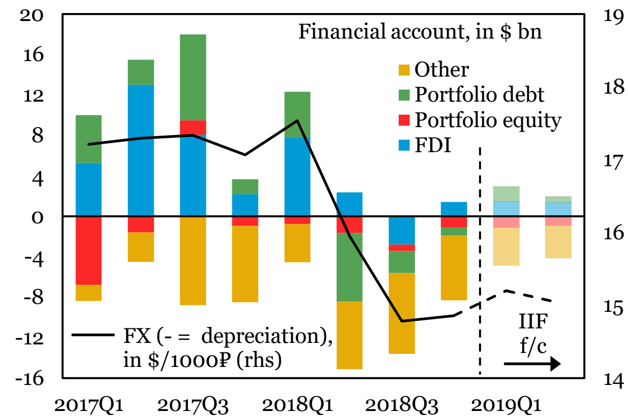
Renewed sanctions pressure weighed heavily on non-resident capital flows last year, turning inflows of $17.0 bn in 2017 into outflows of $25.4 bn in 2018 (Exhibit 1). This was a result of the reversal of portfolio debt inflows as well as continued outflows from other investment. Portfolio debt outflows totaling $9.8 bn over 2018Q2-4 contributed to an 18% depreciation of the Ruble over the same period. Nevertheless, a record current account surplus of $114 bn, primarily driven by higher oil and gas prices, allowed for sizable reserve accumulation to continue (Exhibit 2). At around $380 bn, Russia's FX reserves are sufficiently large to withstand temporary external shocks.

We project the current account surplus to shrink from 6.9% of GDP in 2018 to 5.5% and 4.3% in 2019 and 2020, respectively, as oil prices decline. Non-resident capital outflows should persist over the forecast period but moderate in size as IIP liabilities decline and if sanctions pressures subside, reaching $11.7 bn in 2019 and $3.3 bn in 2020. Foreign holdings of government bonds alone fell by 32% to $42 bn over the course of 2018Q2-4. Resident capital outflows, which had decreased dramatically after 2014, returned in 2018 and are projected to continue at a similar pace. The net result is that further reserve accumulation will likely ensue. Due to the large FX reserves and likely sizable current account surplus, the external financing situation remains comfortable, and the fallout from any additional future sanctions appears manageable. Russia's external sector could absorb an oil price as low as 53 $/bbl in 2019 (49 $/bbl in 2020) without a drawdown of FX reserves.

Real GDP growth reached 2.3% in 2018, the highest reading in six years, driven primarily by private consumption and exports. Growth should slow down to 1.6% in 2019 and 1.7% in 2020, as the recent VAT increase is likely to weigh on consumption, and sluggish Euro area growth may hinder exports. As in the past, we forecast output growth to remain robust through 2020 against continued net capital outflows, and despite likely lower energy prices.

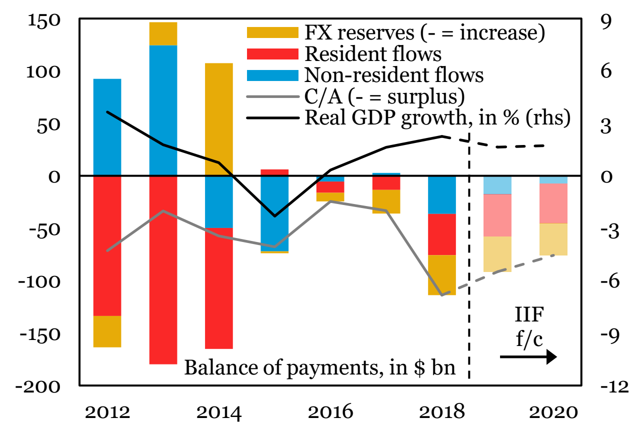
With the large current account surplus insulating the economy from shocks, the fiscal picture has substantially improved as well. Expenditure restraint, combined with significantly higher energy revenue, led to a budget surplus of 2.6% of GDP in 2018 (Exhibit 3). As we expect expenditures to rise more quickly and revenue to grow at a slower pace, the surplus looks likely to narrow through 2020. At the same time, excess energy revenue will be used to add more to FX reserves, which are then transferred to the National Welfare Fund (NWF). We project the fund to grow to ₽7.4 tn by end-2019 and ₽10.6 tn by end-2020, broadly in line with the Finance Ministry's plans, thereby further protecting the economy from external developments.

Exhibit 1. Renewed sanctions pressure weighs on flows.



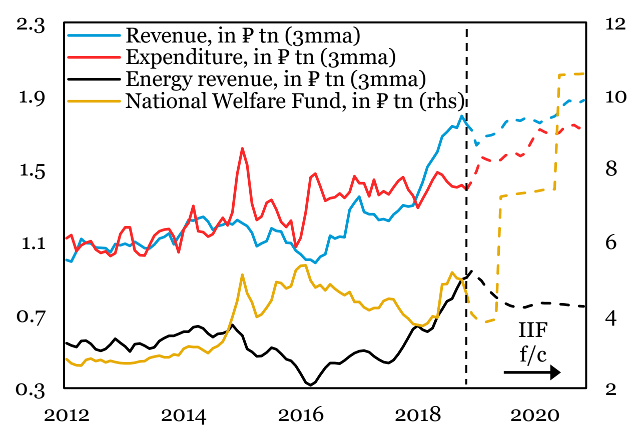
Source: Haver, IIF

Exhibit 2. Capital outflows set to moderate.



Source: Haver, IIF

Exhibit 3. Oil revenue to substantially expand the NWF.



Source: Haver, IIF

Saudi Arabia

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BOND ISSUANCE & UPGRADES DRIVE FLOWS

We see a pickup in non-oil real GDP growth from 2.0% in 2018 to 3.2% in 2019, supported by continued fiscal stimulus and a gradual recovery in private sector growth. Overall growth, however, is set to ease to 1.8% in 2019 due to a stagnation in crude oil production in the context of the December 2018 OPEC+ agreement (Exhibit 1).

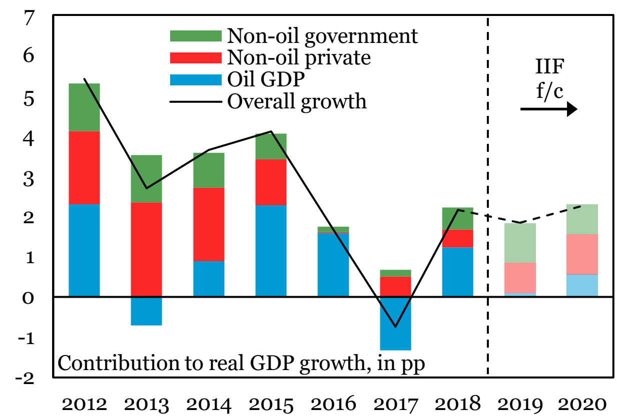
We expect non-resident capital inflows to increase from $28 bn in 2018 to $45 bn in 2019 due to a projected sharp increase in portfolio investment (Exhibit 2). Resident capital outflows will continue to exceed non-resident inflows despite the modest narrowing of the current account surplus due to lower oil prices (Exhibit 3).

Equity inflows are expected to contribute substantially to portfolio flows following the March 18 inclusion of Saudi Arabia to the FTSE index. Saudi stocks will also be added to the MSCI EM index in May, where they will have a 2.6% weight, the eighth largest constituent. These inclusions should boost confidence among investors and attract higher equity inflows, which we conservatively project at $12 bn. However, pre-positioning by investors has been relatively slow due to concerns about policy uncertainty and high valuations for Saudi-listed firms. Foreign net buying has picked up since the start of 2019, hitting $2.3 bn as of March 2018. While we expect this trend to persist throughout the first half of 2019, other countries that joined the MSCI EM index saw their equity indices retract and inflows slow after the official upgrade.

Low public debt and large financial buffers allow for continued borrowing in the international debt market at affordable rates. An average demand of four times the offering for Saudi Arabia's $7.5 bn international bonds issued in January this year suggests that investors have shrugged off regional uncertainties. In addition to raising debt to fund the widening fiscal deficit, state-related entities are also expected to tap international capital markets. As in the past two years, we expect the kingdom to issue sovereign dollar sukuk. Continuous sukuk issuance will serve as a boon to the domestic investor base, which is dominated by Sharia-compliant investors. Although the corporate sector is showing interest in the sukuk market, it is still uncertain whether this will lead to larger issuance of Islamic bonds.

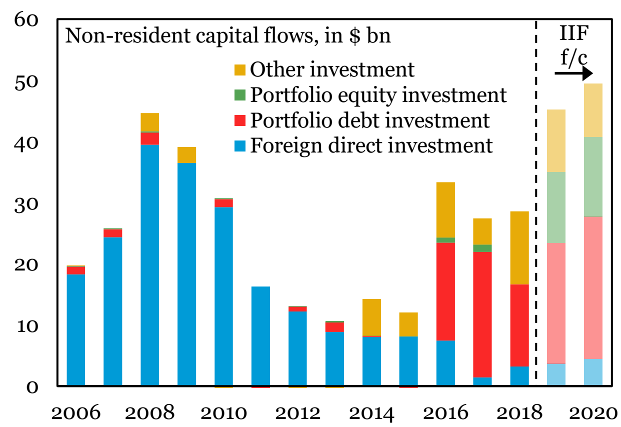
FDI remains low at 0.5% of GDP, far below historic averages. The kingdom needs to attract adequate FDI outside the energy sector to support the authorities' plan to diversify the economy and create a dynamic and expanded private sector.

Exhibit 1. The non-oil sector will drive real growth.



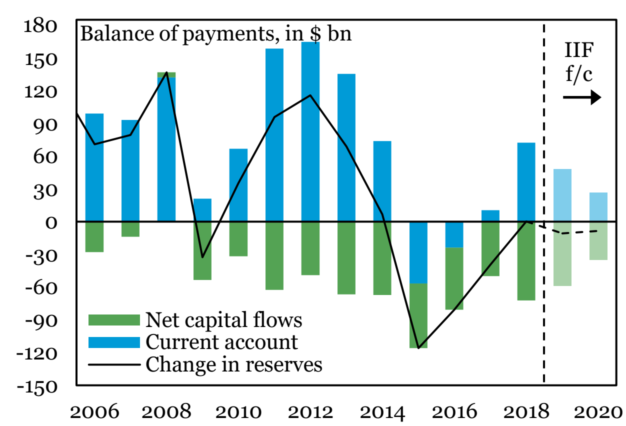
Source: Haver, IIF

Exhibit 2. Non-resident portfolio inflows will increase.



Source: Haver, IIF

Exhibit 3. C/A surpluses are invested abroad.



Source: Haver, IIF

South Africa

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HEAVY DEPENDENCE ON CAPITAL FLOWS

Lower growth and tighter international liquidity reduced non-resident inflows from $28 bn in 2017 to $21 bn in 2018 (Exhibit 1). This decline came from a $14 bn reduction in portfolio inflows, both equity and debt, partially offset by a near doubling in other investment. However, FX reserves still managed to increase as the decline in resident outflows more than offset the lost non-resident capital. Our daily tracker shows that South Africa continues to experience net outflows of non-resident portfolio equity in 2019Q1, while debt flows have recovered only modestly.

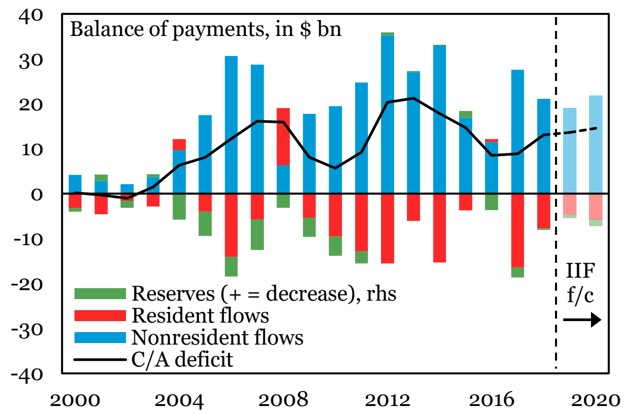
Following years of large non-resident inflows, South Africa has seen a sharp rise in real money positioning since 2009, becoming the most positioned major EM we track. The large overhang places South Africa at significant risk of sudden shifts in investor sentiment. Despite this overhang, South Africa remains a net creditor nation due to its private sector's large external asset holdings. These assets have acted as a buffer in the past, where large declines in non-resident capital flows led to valuation adjustments that enticed resident capital back to South Africa. However, this buffer may weaken if residents grow more uncertain about domestic conditions.

Due to this large overhang, we do not expect a significant rebound in non-resident flows despite the recent dovish turn by the Fed (Exhibit 2). Additionally, we expect increased uncertainty around South Africa's sovereign rating to further reduce capital inflows in 2019. The slowdown in non-resident inflows will be met with a further contraction in resident outflows, as has happened in the past, such that net capital inflows remain relatively stable. Non-resident inflows are expected to pick up again in 2020 as fears of a possible downgrade subside, and South Africa moves past its elections and begins to address high fiscal deficits.

We project real GDP growth to rise from 0.8% in 2018 to 1.3% in 2019 and 1.7% in 2020 as public investment stabilizes and private consumption picks up with relatively low inflation boosting real wages. However, this pickup in demand will prevent a narrowing of the current account deficit, which remains persistently large due to a highly negative income balance from prior external borrowing.

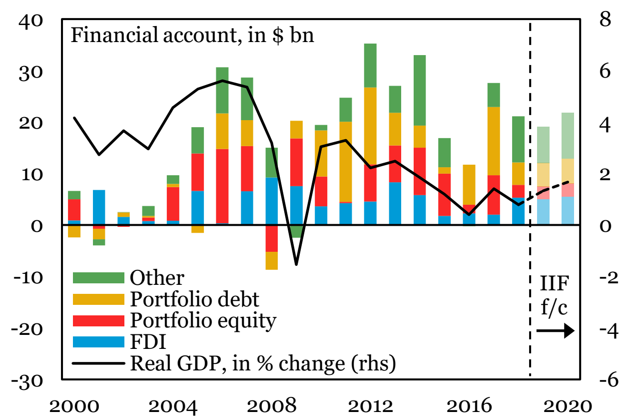
Risks remain skewed toward the downside. South Africa continues to face large external financing needs due to a persistent current account deficit. Large outflows could also materialize if rating agencies place South Africa at junk status which would result in a possible exclusion from several major global capital indices (Exhibit 3).

Exhibit 1. Net capital inflows remain below 2013 highs.



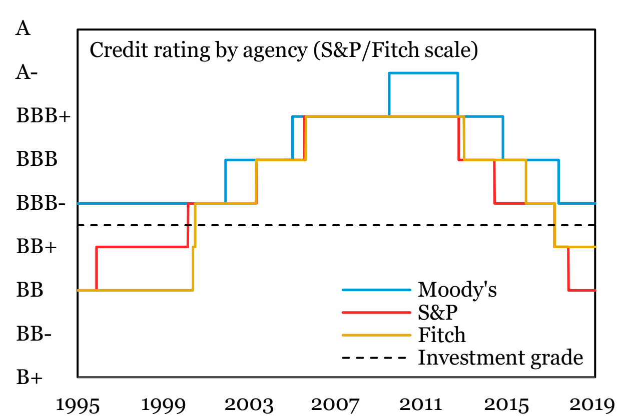
Source: Haver, IIF

Exhibit 2. Non-resident inflows should pick up in 2020.



Source: Haver, IIF

Exhibit 3. Substantial risk from further downgrade.



Source: Haver, IIF

Turkey

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CREDIT-DEPENDENT GROWTH

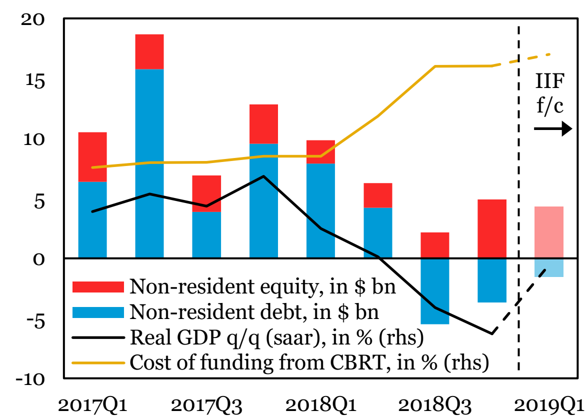
After sharp external adjustment last year, the Lira came under renewed depreciation pressure in late March. In response, the central bank began providing Lira liquidity to the market through its more expensive lending facilities, essentially tightening its stance by 150 bps to 25.5%. Similar market volatility in mid-2018 heightened risk aversion towards Turkey, dampening net inflows of non-resident capital from $49 bn in 2017 to $14 bn in 2018. This decline mainly reflected a reversal in non-resident debt inflows to sizable outflows in 2018H2, causing the Lira to weaken sharply, interest rates to rise, and output to fall (Exhibit 1).

Ongoing strong lending by public banks – which we project will help output to recover in 2019Q2 – should lose momentum after the March 31 local government elections. Stretched corporate balance sheets and a higher unemployment rate will likely constrain private consumption and investment in the near-term. Sluggish demand from the EU will also offset some of the competitiveness gains from the weak Lira, weighing on export growth this year. We project that real GDP will fall by 0.9% this year, a marked reversal from last year's 2.6% increase, before increasing by 2.2% in 2020 as non-resident capital inflows pick up. Risks are to the downside.

With output likely to fall in 2019, we project the current account deficit to narrow further, from $28 bn in 2018 to $5 bn in 2019, before widening to $9 bn in 2020. As in the past, net foreign borrowing will likely be largely channeled through Turkish banks, which continue to have market access. Amounts borrowed have declined due to increasing caution about a further build up in FX indebtedness of Turkish corporates as well as a smaller current account deficit (Exhibit 2).

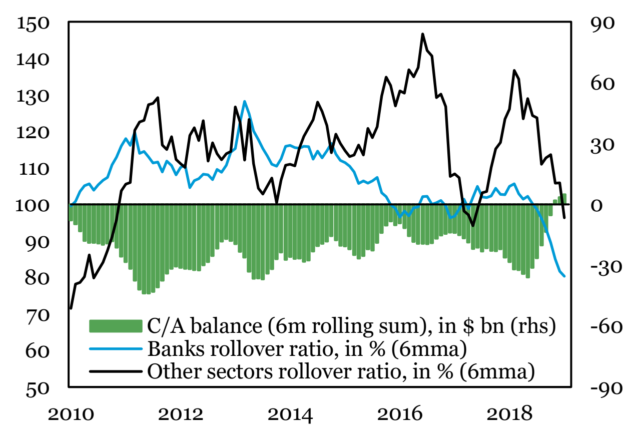
We project a gradual increase in non-resident capital inflows to start in 2019H2, assuming the government puts a credible structural reform framework in place after the March 31 elections, helping improve investor sentiment. Even so, net inflows of non-resident capital will likely moderate further in 2019, in line with the projected fall in output (Exhibit 3). With net outflows of resident capital likely slowing down in 2019, net capital inflows should be sufficiently large to finance a much smaller current account deficit, without major reserve drawdowns. Downside risks remain substantial. External buffers are limited, policies need to change to deliver sustainable growth, and Turkey-US relations remain complex.

Exhibit 1. Non-resident debt outflows weigh on growth.



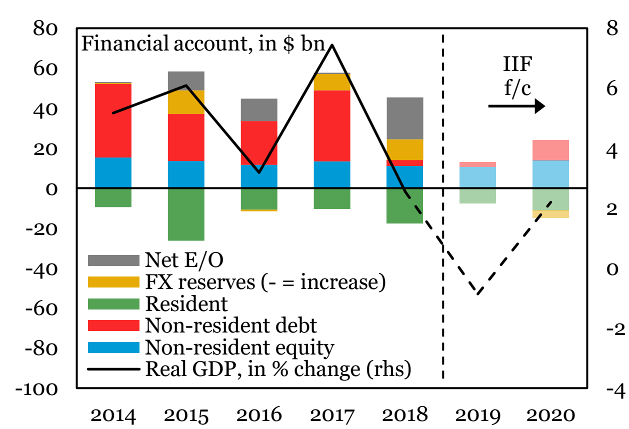
Source: Haver, IIF

Exhibit 2. External debt rollover ratios declined.



Source: Haver, IIF

Exhibit 3. Net capital inflows to remain modest.



Source: Haver, IIF

Annex 1. IIF capital flows data

Capital flows arise through the transfer of ownership of assets from one country to another. When analyzing capital flows, we care about who buys an asset and who sells it. If a foreign investor buys an emerging market asset, we typically refer to this as a non-resident capital flow (or inflow) in our terminology. We report capital flows on a net basis. For example, if foreign investors buy $10 bn of assets in a particular country and sell $2 bn of that country's assets during the same period, we show this as a (net) capital inflow of $8 bn. Note that non-resident capital flows can be negative, namely if foreign investors sell more assets of a country than they buy in a given period.

Correspondingly, if an investor from an emerging market country buys a foreign asset, we call this a resident capital flow (or outflow). Resident capital flows can also be positive or negative.

Annex 2. IIF Capital Flows Report Country Sample (25)

Emerging Europe (6)	***Latin America (6)***	***Africa/Middle East (6)***	***Emerging Asia (7)***
Czech Republic	*Argentina*	*Egypt**	*China*
Hungary	*Brazil*	*Lebanon*	*India**
Poland	*Chile*	*Nigeria*	*Indonesia*
Russia	*Colombia*	*Saudi Arabia*	*Malaysia*
Turkey	*Mexico*	*South Africa*	*Philippines*
Ukraine	*Venezuela*	*United Arab Emirates*	*South Korea*
			Thailand

**For India and Egypt, annual data and forecasts are represented on a fiscal year basis*

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