FOR AGENDA

EBS/11/33
Correction 1

March 11, 2011

To: Members of the Executive Board

From: The Acting Secretary

Subject: **World Economic Outlook—Chapters 3 and 4**

The attached correction to EBS/11/33 (3/7/11) has been provided by the staff:

Typographical Error

Page 67, first paragraph: for ". . . countercyclical nature of portfolio flows to EMEs: higher net flows at the end of strong growth performance may have helped meet recipient economies' larger financing needs. Conversely, FDI generally remained strong even after the end of loose global financing conditions but fell at the end of strong growth episodes in EMEs. Overall, the rise and fall global interest rate and low risk aversion). This could reflect the in FDI during and after alternative events appear less prominent than the rise and fall in other types of flows.[19]"

read ". . . global interest rate and low risk aversion). This could reflect the countercyclical nature of portfolio flows to EMEs: higher net flows at the end of strong growth performance may have helped meet recipient economies' larger financing needs. Conversely, FDI generally remained strong even after the end of loose global financing conditions but fell at the end of strong growth episodes in EMEs. Overall, the rise and fall in FDI during and after alternative events appear less prominent than the rise and fall in other types of flows.[19]"

Questions may be referred to Ms. Koeva Brooks (ext. 39809), Mr. Abiad (ext. 35951), and Ms. Duttagupta (ext. 38583) in RES.

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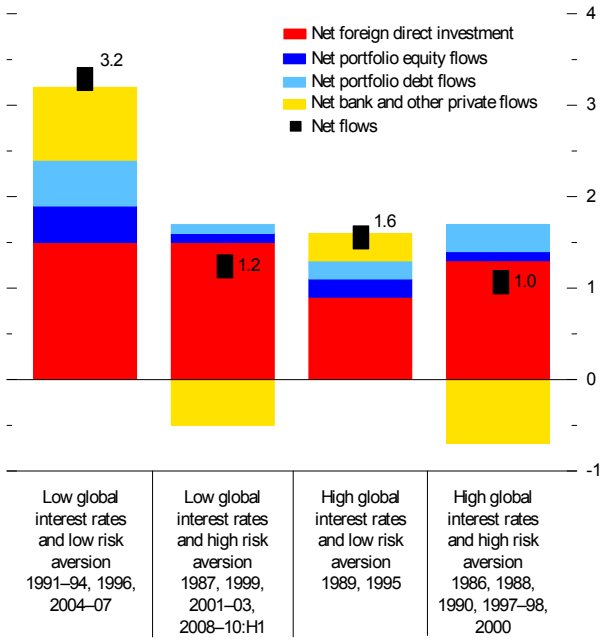
Figure 4.14. Net Private Flows to Emerging Market Economies under Alternative Financing Conditions
(Percent of GDP)

Net capital flows to emerging market economies tended to be strongest when global monetary and risk conditions were both slack, whereas under high risk aversion (but low global interest rates), flows were only marginally above net flows when both conditions were tight.



Sources: IMF, *Balance of Payments Statistics*; national sources; and IMF staff calculations.
Note: Net private capital flows exclude derivative flows. The values for each bar correspond to the average across years for each multiyear period during which the condition prevailed, where the annual data are calculated as the sum of net capital flows across economies divided by the sum of nominal GDP (both in U.S. dollars) across the same group of economies. The group aggregates exclude offshore financial centers.

To summarize, the event studies demonstrate an inverted V-shaped pattern of net capital flows to EMEs around events outside the policymakers' control, underscoring the fickle nature of capital flows from the perspective of the recipient economy. Thus, net flows to EMEs have tended to be temporarily higher during periods with low global interest rates and low risk aversion. Moreover, the rise in net flows to EMEs has been much greater during periods characterized by both low global interest rates and low risk aversion. The dynamics in net flows appear to be driven largely by bank and other private flows. Other types of flows also tended to increase during the events but did not always fall at the end of events.

[19]A number of robustness checks, for example, excluding the 10 largest EMEs or including financial centers, did not change this picture. The similarity in the pattern of net capital flows across all EME regions suggests that the association between global events and capital flows to EMEs is not driven by only a few systemically important economies.

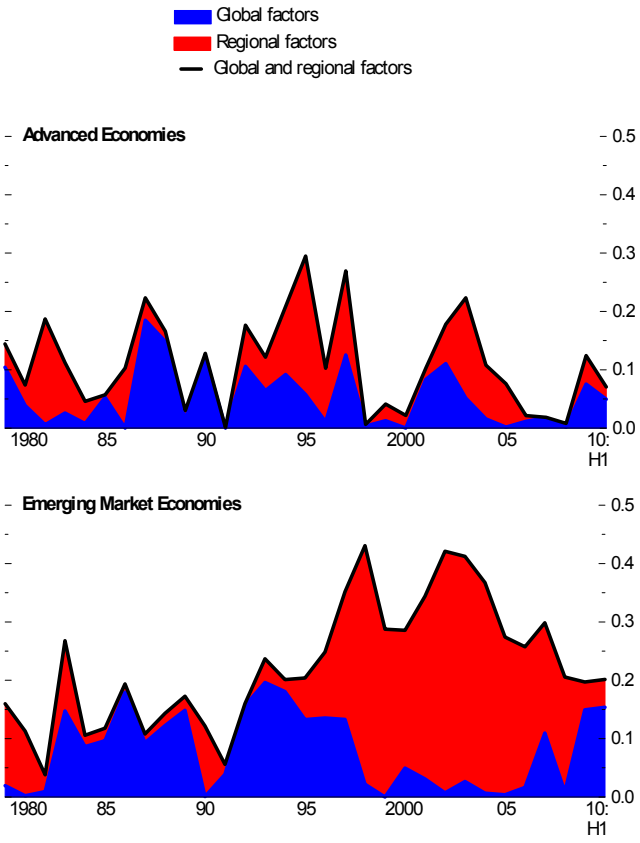
How much of the variation in net capital flows is due to global and regional factors?

A global factor model is used to discern the relative importance of common factors—global and regional—versus economy-specific factors in explaining the variation in net flows to EMEs. A large or growing share of the total variation of net flows explained by common factors would imply that capital flows are increasingly determined outside the domestic economy.

The estimated model underscores the dominance of economy-specific factors, captured by the model residual, in explaining the variation in capital flow movements in EMEs (Figure 4.15).[20] However, it also shows that the share explained by common factors was higher in the past two decades—increasing from less than 15 percent in the 1980s, to about 23 percent in the 1990s, and to more than 30 percent in the 2000s.[21] As a comparison, for AEs, the share explained by common factors is much smaller, hovering at about 10 percent, and lower in the past decade compared with the 1990s.

Figure 4.15. Common Factors Underlying the Variation in Net Private Capital Flows to Advanced and Emerging Market Economies
(R–squared)

Global and regional factors explain only a small share of the variation in net private capital flows to advanced and emerging market economies, underscoring the importance of economy-specific factors. However, the share explained by regional factors in emerging market economies has increased over time, suggesting a greater sensitivity on the part of foreign investors to regional differences among emerging market economies than among advanced economies.



Sources: IMF, *Balance of Payments Statistics*; national sources; and IMF staff calculations.
Note: The blue area corresponds to the share of variation in net flows in percent of GDP across economies within each group that is explained by global factors (time dummies) relative to a specification with only a constant (without time dummies). The red area corresponds to the additional variation of net flows in percent of GDP explained by regional factors (regional time dummies). The black line is the total variation in net flows jointly explained by global and regional factors. Both samples exclude offshore financial centers. For additional information on the estimation procedure, see Appendix 4.3.

Within the set of common factors in EMEs, the relative importance of regional factors appears to have increased since the mid-1990s. This could be related to widespread

[20]Appendix 4.3 describes the specifics of the model.

[21]These estimates are similar to the findings of Levchenko and Mauro (2007) for a diverse group of EMEs but are lower than those of Calvo, Leiderman, and Reinhart (1993) for Latin America.