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The COVID-19 Crisis and Capital Flows

Nicoletta Batini

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Prepared by Nicoletta Batini*

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* Senior Economist, Independent Evaluation Office, IMF.

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ABBREVIATIONS

AE	advanced economy
BIS	Bank for International Settlements
CFM	capital flow management measure
EM	emerging market
EMDE	emerging market and developing economies
EOP	end of period
FCL	Flexible Credit Line
FX	foreign exchange
FXI	foreign exchange intervention
GFC	global financial crisis
<i>GFSR</i>	<i>Global Financial Stability Report</i>
G20	Group of 20
IIF	Institute of International Finance
MCM	Monetary and Capital Markets Department (IMF)
MPM	macroprudential measure
OECD	Organization for Economic Cooperation and Development
QE	quantitative easing
SBA	Stand-By Arrangement
SLL	Short-term Liquidity Line

EXECUTIVE SUMMARY

The COVID-19 outbreak triggered unusually large portfolio outflows from emerging market and developing economies. This abrupt capital flow reversal in March–April 2020 added external financial pressures to the massive economic fallout from the supply and demand shocks following the lockdowns. External financial pressures have eased somewhat since April, helped by aggressive easing measures by major advanced economy central banks. However, the outlook remains quite uncertain as many countries face difficult economic prospects with diminished policy buffers, and further capital flow volatility remains a serious risk at least for individual countries.

Emerging markets and developing economies reacted promptly to the COVID-19 crisis by combining health related actions with bold economic policy measures to contain the outbreak and support economies. In addition to fiscal and monetary policy easing, abundant liquidity support was provided promptly to counter market disruption. Some emerging markets used unconventional measures, including asset purchases, for the first time to help stabilize conditions. Exchange rates were used as an external shock absorber with intervention deployed as needed to avoid disorderly market conditions. Capital flow measures were used parsimoniously, as part of multi-policy packages.

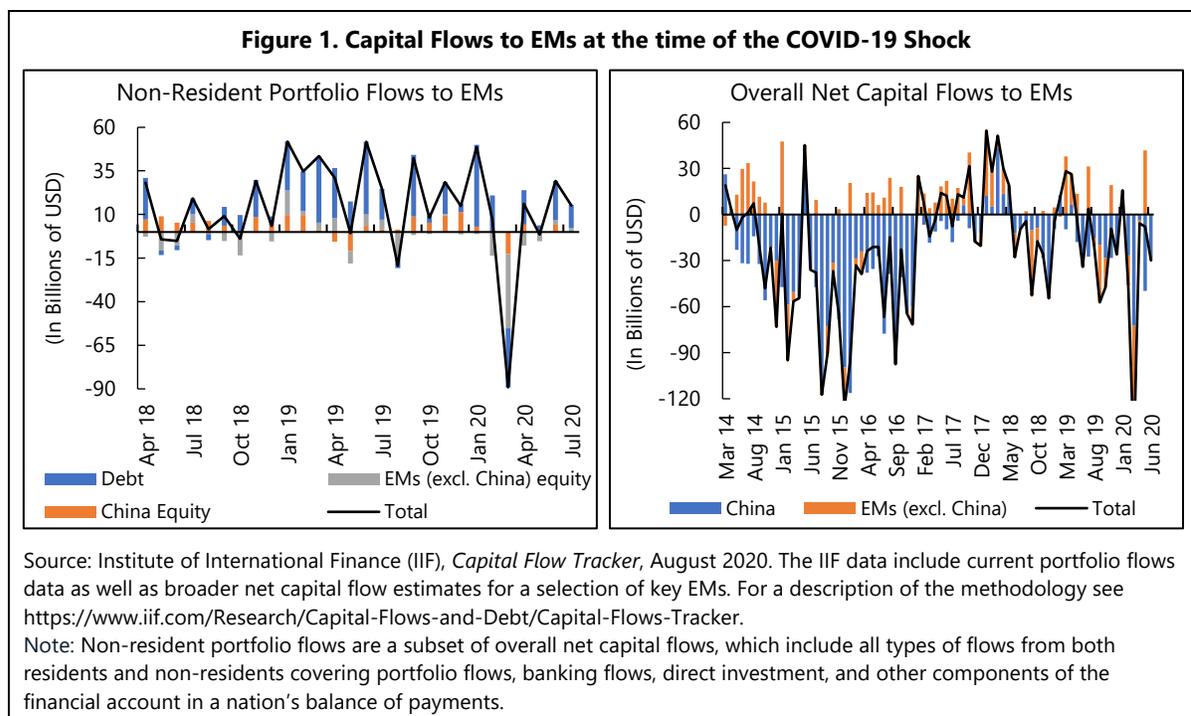
The IMF response to these developments was rapid, focusing on domestic policies and provision of financial support. In addition to tuning up and deploying its instruments to provide emergency and precautionary financial support, the Fund has advocated for wide-ranging and bold domestic policy actions, including deployment of fiscal, monetary, and macroprudential tools to support economies. The Fund has supported the use of flexible exchange rates to handle external strains while providing emergency financing to a wide swath of members. Its advice on use of capital flow measures was in line with the guidance in the Institutional View, to be used only by countries facing a crisis or imminent crisis.

I. INTRODUCTION

1. This background paper provides a factual overview of the recent dramatic sudden stop in capital flows to emerging market and developing economies (EMDEs) in the first half of 2020 in response to the COVID-19 pandemic crisis, and of the IMF's crisis response and policy advice. It is too early to attempt an evaluation of the IMF's crisis response and policy advice, but this stock-taking of what has been a major stress test provides useful background to the overall evaluation of IMF advice on capital flows.

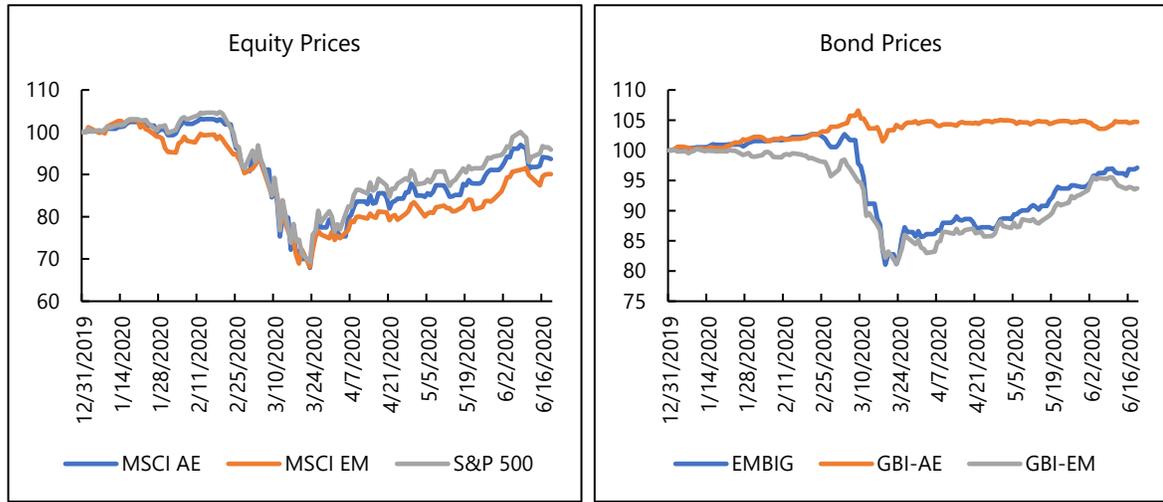
II. THE COVID-19 SUDDEN STOP

2. In early 2020, the health and economic crisis caused by the COVID-19 pandemic triggered a sharp reversal of capital flows to EMDEs.¹ With cases rising fast around the world and financial markets plunging, non-resident portfolio investors quickly rushed to safety, pulling a record US\$83 billion from emerging markets' (EMs) stocks and bonds in March 2020 alone (Figure 1, left panel, and Figure 2). Portfolio outflows were much larger than those seen during the global financial crisis (GFC) and dwarfed those occurring during stress events such as the "taper tantrum" in 2013 or the China risk shock of 2015 (Figure 3). Broader measures of capital flows, based on still incomplete data, suggest substantial outflows through other channels as well, although the magnitude of outflows seems more comparable to previous stress events like the shock of 2015 (Figure 1, right panel).



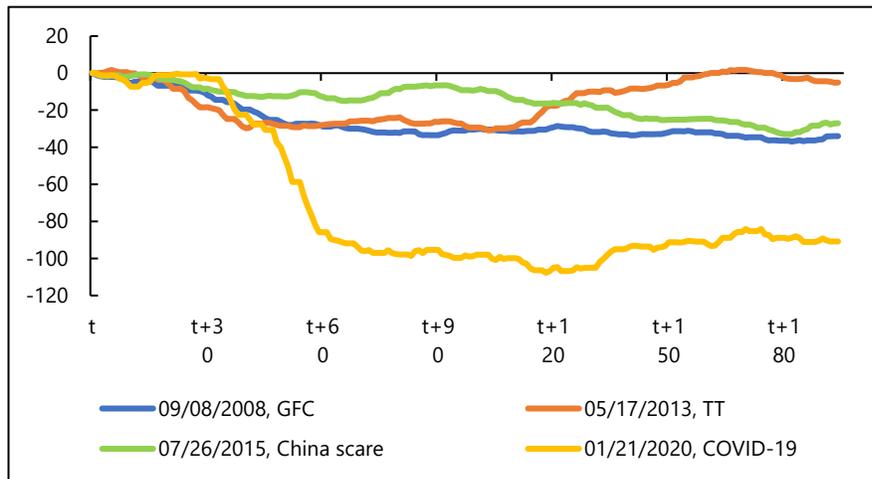
¹ The analysis and discussion here focus on non-resident portfolio flows, as collected by the Institute of International Finance, since complete data on capital flows for the period under analysis were not yet available at the time of writing.

**Figure 2. Financial Price Indexes in AEs and EMs at the time of the COVID-19 Shock
(Index 12/31/2019 = 100)**



Sources: Bloomberg L.P.; and IEO staff calculations.

Figure 3. Cumulative Non-Resident Portfolio Flows to EMs—From the Date of Various Shocks (2008–20)



Sources: Institute of International Finance; and IEO staff calculations.

Note: Covers data for 25 EMs as contained in the IIF Capital Flow Tracker. See <https://www.iif.com/Research/Data> (1) for a list of countries included.

3. Capital flows to EMs began to recover in April and May. With prices starting to turn around, EM equity and bond markets attracted around US\$20 billion in portfolio inflows in two months, focused on bonds and Chinese equities, although investors kept divesting from EM equities elsewhere (see Figure 1). Higher-rated EM sovereigns were also able to launch a substantial volume of new issues. However, this revival has been uneven and remains tentative, with many countries unable to issue or able to issue only at wide spreads.

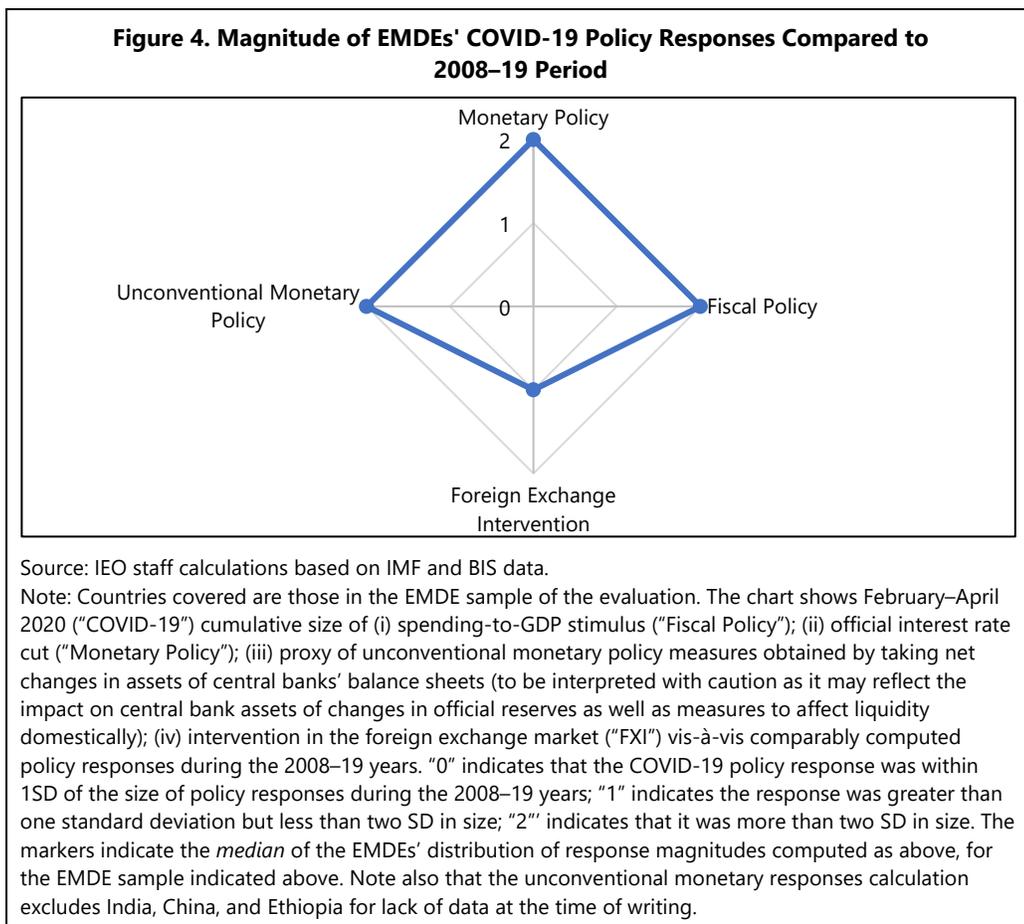
4. Capital flow volatility in EMDEs in recent months was magnified by three factors. First, even if initially the health emergency wreaked havoc primarily on richer nations (about three-quarters of COVID-19-related deaths in March and April 2020 were concentrated in the United States and Europe), expectations were that EMDEs would eventually face stronger outbreaks and deeper economic downturns given the lower quality of their medical facilities, greater constraints in enforcing lockdowns, deep exposure to the downturn in global trade, and overall smaller room for fiscal and financial maneuver. Second, in March 2020, oil prices cratered following a standoff between producing nations about supply cuts, compounding the flight from risk assets. Many EMs depend strongly on oil and commodity exports, while others rely on them indirectly because of regional trade links. Third, the stock of non-resident portfolio investments in EMs has greatly expanded since the GFC, rising from around US\$500 billion in 2008 to US\$3.5 trillion in 2020 and accounting for a rising share of EMs' local markets (IMF, 2020a).

5. Swift and bold monetary policy responses by advanced economies have helped stabilize EM capital flows. Major central banks responded to the crisis by drastically easing monetary conditions and pumping an unprecedented amount of liquidity into the global economy, and EMs benefited from a classic search for yield as investor risk appetite returned. The U.S. Federal Reserve's powerful monetary stimulus in March and April 2020 played a particularly important role since it was both aggressive—including rate cuts and asset purchases measuring more in annualized terms than the combined purchases under QE1, QE2, and QE3—and novel in its promise of unlimited further easing and allowance for purchases of corporate bonds. In addition, the Federal Reserve took a number of steps to safeguard global dollar liquidity. It extended the maturity of its existing swap line agreements with the Bank of Canada, Bank of England, Bank of Japan, European Central Bank, and Swiss National Bank and reintroduced temporary swap line arrangements with some other central banks, including those of Brazil, Korea, Mexico, and Singapore, repeating an action taken during the GFC. It also introduced a new Foreign and International Monetary Authority repo facility to allow the broad range of central banks with accounts at the Federal Reserve Bank of New York to access dollar liquidity through repo operations using their holdings of U.S. Treasuries. The European Central Bank monetary stimulus was also bold, including a EUR 750 billion Pandemic Emergency Purchase Program, the reactivation of swap lines with some other advanced economy central banks, and the extension of new swap lines to the central banks of Bulgaria, Croatia, and Denmark.

6. With risks to the outlook tilted downwards and ongoing uncertainty about both the future course of the pandemic and the global recovery, prospects for capital flows to EMs remain highly fluid. While the commitment by the advanced economy central banks to maintaining global liquidity conditions reduces the risks of a second generalized EM sudden stop, such an event cannot be ruled out, and individual countries with particularly serious vulnerabilities and reduced buffers and policy space may experience further capital flow reversals. The Institute of International Finance projects that in 2020, overall non-resident capital inflows will drop by half—becoming weaker than in 2008/09 or in 2015 during the China risk shock. Excluding China, total foreign investments would come in at around US\$300 billion, the lowest level since 2004.

III. EMDEs' POLICY RESPONSES

7. EMDEs have responded aggressively to the unprecedented economic and capital flow volatility caused by the pandemic.² Like advanced countries, they activated multiple levers at once, both on the health policy front—to slow and address contagion from the pandemic—and on the economic policy front, by using fiscal stimulus and monetary easing to support households, firms, and financial markets distressed by the lockdowns and the sharp contraction in global economic activity (see IMF, 2020a). Overall, the response was somewhat smaller in EMDEs than in advanced economies, given greater constraints on the policy space, particularly the lesser opportunities for fiscal support. Nevertheless, policy actions were considerably bolder than observed in the years going back to the onset of the global financial crisis (Figure 4).

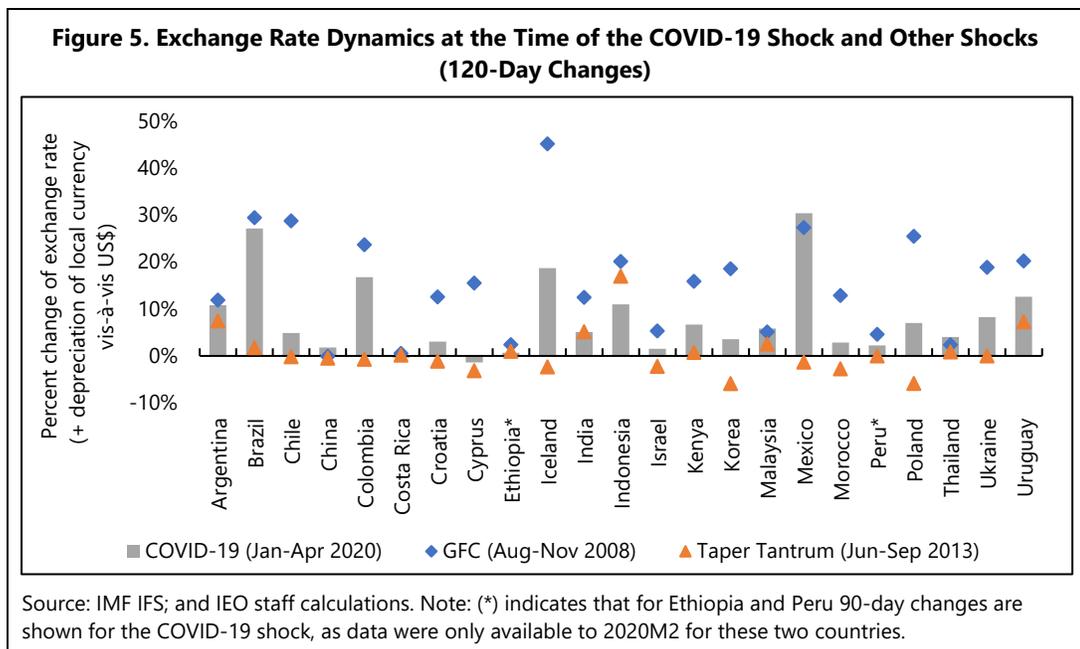


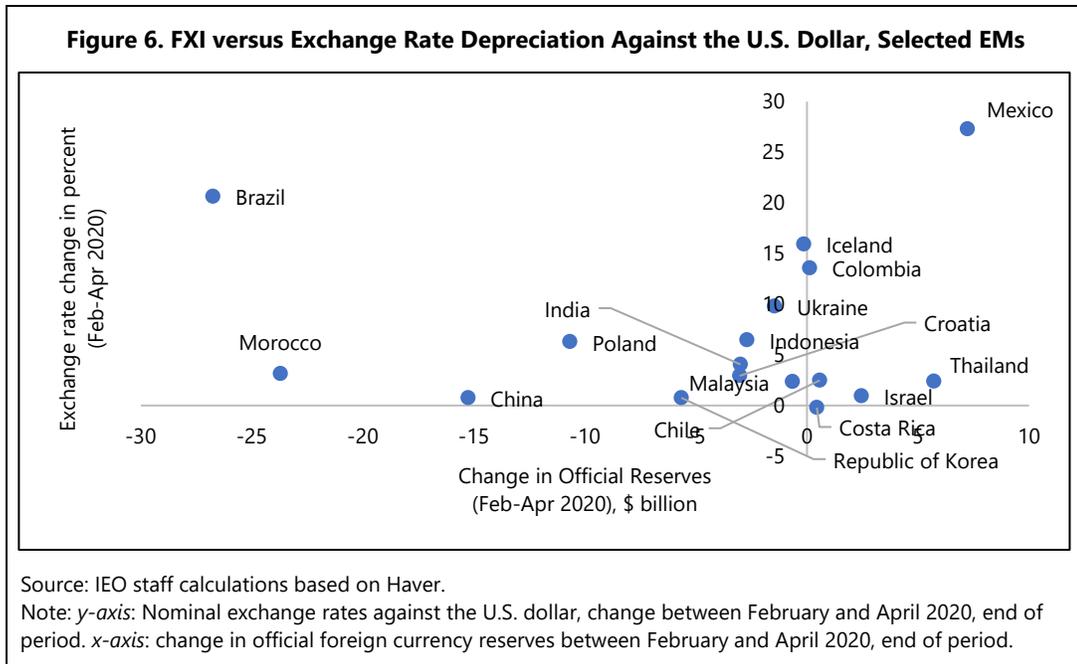
8. The fiscal and monetary policy stimuli were channeled through both conventional and unconventional routes. The pandemic required a rapid deployment of public funds to support health systems, although the bulk of additional public spending was aimed to sustain workers and businesses, including through loans, guarantees, temporary tax breaks, and subsidies for the

² Analysis in this section is based on several policy trackers, including the Fund’s own Policy Tracker, the OECD’s Country Tracker, and the Yale School of Management Policy Tracker.

payment of utility services and other basic necessities. The new fiscal measures were financed through diverse sources including reserve buffers, outright new borrowing, reprioritizing within existing budgets, and extensive multilateral support, including from the IMF. EMDE central banks eased monetary conditions across the board by cutting policy rates, in contrast with previous episodes of capital flow reversals. Central banks also took aggressive actions to support liquidity and prevent an impairment of financial markets, including through an extension of the duration of repo operations, foreign exchange (FX) forwards and swaps, and macroprudential measures (MPMs). Several central banks, for example in Colombia, Indonesia, South Africa, and Turkey, implemented asset purchases, similar to quantitative easing by advanced economy central banks, although such operations seem to have been motivated by a desire to support local currency government bond markets disrupted by heavy foreign investor sales, and to address local market dysfunction, as well as, in some cases, ease the monetary policy stance as policy rates approached the lower bound (Benigno and others, 2020).

9. Countries with flexible exchange rate regimes allowed rates to depreciate sharply in March–April in response to outflow pressures and rising risk aversion. Many central banks, for example those in Brazil, Egypt, Indonesia, Mexico, Peru, Russia, Turkey, and Ukraine, responded to shortages in FX and increased desire for FX cover via measures that included forwards, swaps, and repos, as well as direct intervention in the FX market. For most countries, the overall exchange rate depreciation was somewhat less than at the time of the GFC. This was so even though the scale of direct foreign exchange intervention (FXI) seems to have been quite limited; central banks seemed comfortable allowing currencies to depreciate while relying on inflation-targeting monetary policy regimes to anchor inflation expectations (Figures 5 and 6). In some cases, however—notably in Egypt and Turkey—interventions were particularly heavy and led to a significant loss of FX reserves (see IMF, 2020b).



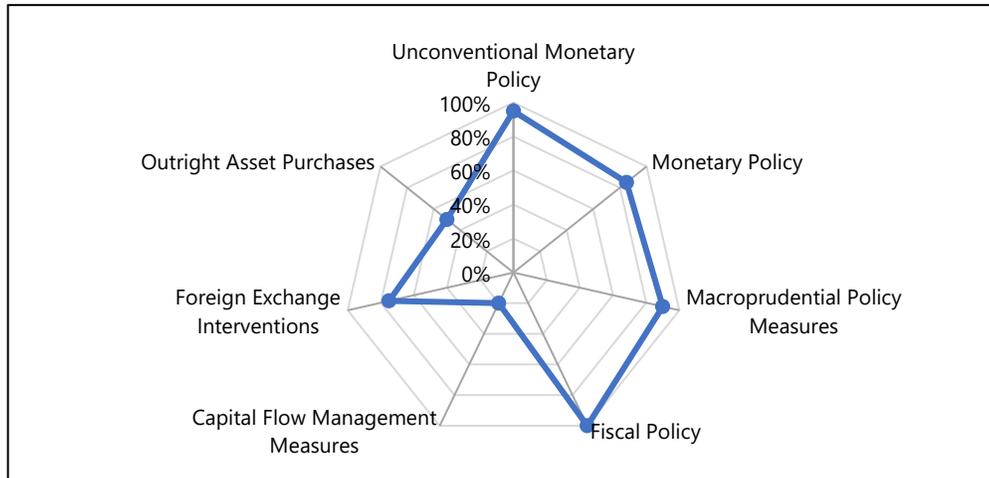


10. Macprudential policy measures were also eased extensively alongside traditional demand policy tools. Regulations on liquidity and loan classification have been adjusted to allow commercial banks to better support the real sector during the pandemic. In addition, some countries including China, Colombia, and Turkey have loosened certain macroprudential restrictions on lending and borrowing that were meant to limit the unwarranted financial leverage that can occur during expansionary phases. Their easing was intended to support lending to households and firms hit hard by the crisis.

11. Capital account measures were used more rarely, if at all. Out of the 20 EMs in our case studies, only four countries—Argentina, China, India, and Peru—deployed capital account measures that have been or could potentially be classified as capital flow management measures (CFMs) or CFMs/MPMs by the Fund under the Institutional View (see IMF, 2012). Among these four, China, India, and Peru eased existing capital account limits on inflows, while Argentina tightened outflows CFMs (Figure 7). A handful of other EMDE countries not in our sample have also introduced controls on capital outflows, namely Aruba, Bahamas, Sri Lanka, Turkey, and Turkmenistan.³

³ The information about capital account measures cited here comes from the authorities' survey of COVID-19 responses available on the Fund's website (as retrieved on June 24, 2020).

Figure 7. Share of EMs in Sample that Adopted Indicated Policies in Response to the COVID-19 Shock



Source: Policy actions are based on the COVID-19 Response Tracker (CFRT) by the Yale School of Management. Capital flow management measures and foreign exchange interventions are from the IMF's Policy Tracker, the IMF COVID-19 Country Survey database. Note: The chart shows the percentage share of countries in the evaluations EMDE country sample that have undertaken policy actions by type out of all countries in the sample (countries included in the chart are Argentina, Brazil, Chile, China, Colombia, Costa Rica, Croatia, Ethiopia, India, Indonesia, Kenya, Malaysia, Mexico, Morocco, Peru, Poland, South Africa, Thailand, Ukraine, and Uruguay).

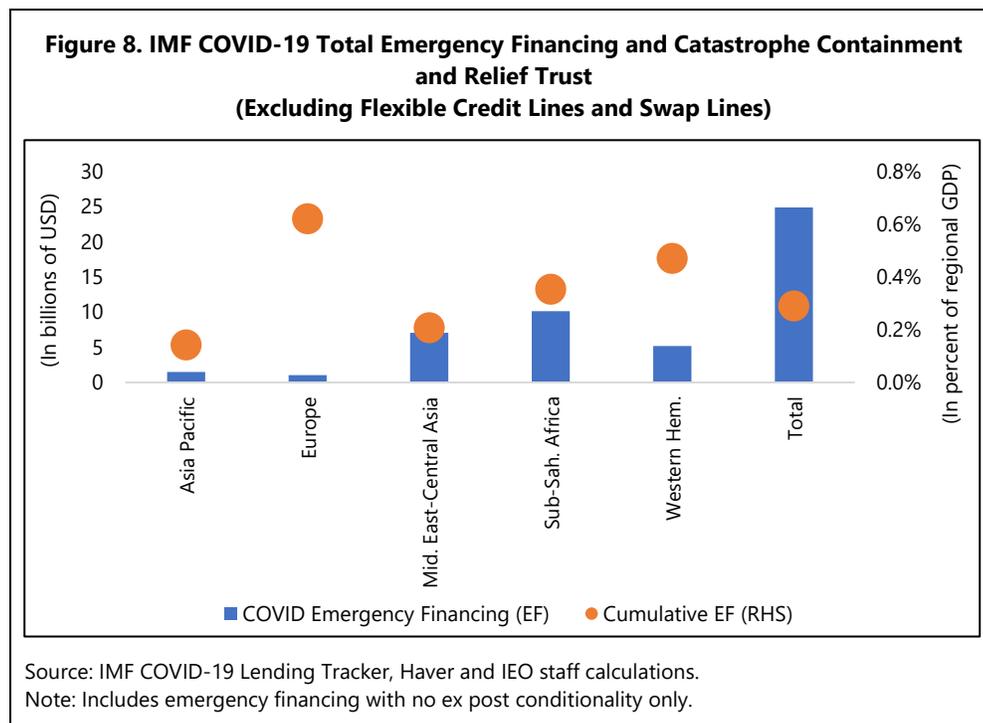
IV. THE IMF'S COVID-19 CRISIS RESPONSE AND POLICY ADVICE

12. The IMF, too, has responded to the crisis on multiple fronts, providing economic assessment, policy advice, and financial support. To provide financial support to countries suffering from external financing needs as a result of the COVID-19 pandemic, it used a range of instruments:

- *Expanded access to emergency financing.* The annual access limits for the Rapid Credit Facility and Rapid Financing Instrument were temporarily doubled and increased by 50 percent of quota on a cumulative basis. As of end-June 2020, more than 100 requests for emergency funds had been received, of which 66 had been approved, providing US\$24 billion in financing (Figure 8). These facilities allowed the Fund to rapidly provide emergency assistance without requiring the recipient to have a full-fledged program in place and without the more traditional IMF ex post conditionality, although countries must satisfy a debt sustainability assessment and meet safeguard requirements.
- *New arrangements or augmentation of existing arrangements.* A number of countries (e.g., Egypt and Ukraine) have received financing under new General Resources Account or Poverty Reduction and Growth Trust arrangements. In some cases (e.g. Armenia,

Barbados, Benin, Georgia, Honduras, and Togo), the Fund has augmented existing arrangements to accommodate urgent new needs arising from the COVID-19 pandemic.

- Precautionary financing.* The Fund approved two new Flexible Credit Line arrangements (US\$11 billion to Peru and US\$23.9 billion to Chile) and renewed the FCL arrangement for Colombia (US\$10.8 billion) to help these countries deal with the crisis by increasing confidence and providing insurance against downside risks. These countries qualified for the FCL by virtue of their very strong fundamentals, institutional policy frameworks, track-record of economic performance and policy implementation, and commitment to maintain such policies in the future. Morocco drew on its existing Precautionary Liquidity Line. A precautionary Stand-By Arrangement (SBA) and a precautionary Stand-By Arrangement (SBA)-Standby Credit Facility (SCF) arrangement were extended to Armenia (US\$0.2 billion) and Honduras (US\$0.2 billion), respectively. The Fund also launched a new Short-term Liquidity Line (SLL). The SLL is a revolving and renewable backstop for member countries with very strong policies and fundamentals; it provides predictable liquidity support to address short-term moderate balance of payments needs resulting specifically from volatility in international capital markets. This new facility has yet to be used.



13. Several additional initiatives were launched in response to the COVID-19 financing needs of the poorest members. In particular, under the enhanced Catastrophe Containment and Relief Trust, the IMF provided debt service relief for six months to 27 of the Fund's poorest and most vulnerable member countries to allow them to direct more of their scarce financial resources

towards relief efforts, and is aiming to raise sufficient contributions to the Catastrophe Containment and Relief Trust to provide up to two years of grant-based debt relief. The Fund has worked closely with the World Bank and the G20 to advance an initiative to suspend debt service on official bilateral credits for up to 73 low-income countries through end-2020, and has joined a call by the World Bank and the G20 to encourage private sector creditors to provide debt relief to these countries on comparable terms.

14. In terms of policy advice to deal with the crisis, the Fund's bilateral and multilateral surveillance has advocated for extraordinary fiscal and monetary accommodation to support lives and livelihoods and to prepare for recovery. The Fund supported aggressive policy responses along four dimensions: first, aggressive healthcare measures to contain the outbreak; second, large targeted fiscal stimulus to help mitigate the economic impact of the health containment measures and the global economic shock; third, strong monetary policy easing to support the economy and reverse deflationary pressures; and fourth, the use of financial policies and macroprudential measures to provide liquidity and market stabilization as necessary (see, for example, IMF 2020a; 2020c; 2020d; 2020e; as well as 2020f). In addition to dealing with the emergency phase of the crisis, the Fund also warned about the need to sustain policy support during the recovery phase—which was likely to be prolonged and difficult—in order to support recovery and minimize scarring by protecting against the risks of bankruptcies, prolonged high unemployment, and rising inequality after the crisis abates. The Fund has prepared and published a special series of policy notes providing more detailed expert advice on how to handle the economic effects of COVID-19.⁴

15. To address external pressures and capital account volatility, the Fund supported exchange rate flexibility with FX intervention to lean against market illiquidity. As laid out in the Spring 2020 *GFSR* (Chapter 3), the exchange rate should be a key shock absorber in countries with flexible exchange rates, credible monetary frameworks, low inflation, deep financial markets, and little or no currency mismatches (IMF, 2020a). For countries with adequate reserves, exchange rate intervention could be used to lean against market illiquidity and tame excessive volatility, particularly where there are large currency mismatches and unhedged foreign currency liabilities (IMF, 2020a) it but should not prevent necessary adjustments of the exchange rate. Countries with fixed or tightly managed regimes may seek to maintain the regime but may need to support FXI by monetary policy tightening and possibly capital flow management measures.

16. IMF advice on the use of capital flow measures to deal with a heavy wave of capital outflows has been more limited and in line with the Institutional View. Chapter 3 of the April 2020 *GFSR*, which is devoted to the challenge of managing volatile portfolio flows, offered a general conceptual template for dealing with capital flow volatility in EMs, concluding that in the “face of an imminent crisis introducing capital outflow measures could be part of a broad policy package, but these measures cannot substitute or avoid warranted macroeconomic adjustment.”

⁴ See <https://www.imf.org/en/Publications/SPROLLS/covid19-special-notes>.

It also provided specific advice that if non-resident outflows are a significant driver of overall outflows, minimum holding periods and caps and other limits on non-resident transfers abroad could be considered, and should be implemented in a transparent manner, be temporary, and lifted once crisis conditions abate, with due consideration for international obligations. Similarly, macroprudential buffers—such as foreign currency reserve requirements—could be relaxed to mitigate FX funding pressures (as done for example by Peru in response to the COVID-19 crisis; see background paper by Batini, Borensztein, and Ocampo, 2020). An MCM expert policy note provides similar advice on the use of CFMs as part of an overall summary of monetary and fiscal responses for EMDEs (IMF, 2020g).

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