Economic Brief

Global Uncertainty

Potential Effects on Capital Inflows into the CAREC Region

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Global Uncertainty and Potential Effects on Capital Inflows into CAREC

Global uncertainty about economic prospects has increased substantially. Stock market and bond yields tanked. It is yet too early to know how long the turbulences will last and what the final impact on the world economy and on the CAREC region will be. There are several channels through which the CAREC economies will be affected, including forgone earnings from transportation and travel. The largest impact on CAREC economies comes however from the slump in commodity prices, which might have substantial consequences for GDP growth and the exchange rates. Lower oil prices slow the Russian economy, to which a number of CAREC countries has close ties. CAREC authorities have already begun to take measures. Kazakhstan's central bank, for example, raised its base rate by 175bp on 10 March to support the currency. Governments, central banks and international organizations are preparing financial support to help businesses.

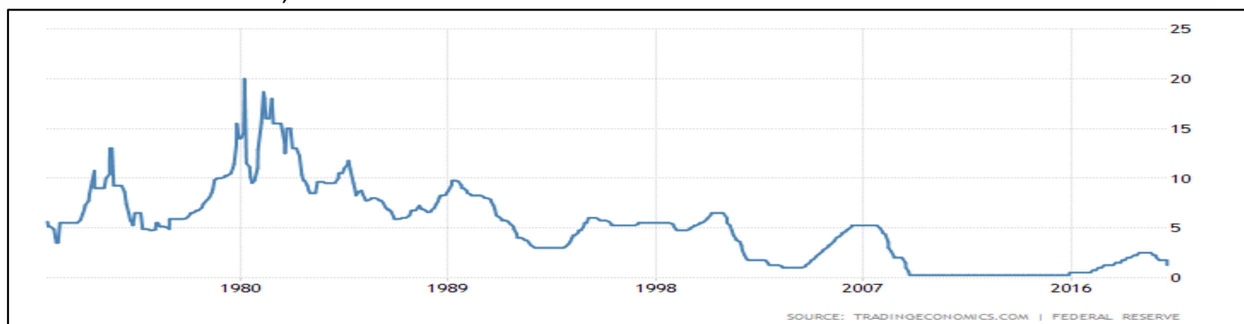
The current global uncertainty has short-term consequences for the CAREC economies, but it also accelerates more fundamental trends. The CAREC Institute's February 2020 comment on the impact of the Covid-19 on the CAREC economies analyzed the potential effect of lower commodity prices on CAREC's foreign trade. In this month's Economic Brief, the focus is on the impact of the global uncertainty on capital inflows into the CAREC countries. The CAREC members have fallen behind other developing countries in attracting foreign investment since 2012. The current uncertainty, increased rivalry of oil producers and decarbonization strategies re-enforce this trend. The CAREC countries need to strengthen their efforts to modernize their economies and to invite technologically advanced foreign investment into the region. Tighter regional integration offers potential investors a larger market. A better coordination of industrialization and digitalization strategies among CAREC countries should help as well.

Flight to safe havens

Global uncertainty about economic prospects have sent shockwaves through global stock markets. All major stock market indices fell sharply on 9 March and have rebounded only slightly since. The stock markets slump happened even though the US Federal Reserve had cut the Fed-funds rate[1] on 3 March 2020, lowering the target range by 50bps to 1-1.25% (Chart 1) citing the Covid-19 as a reason. The Bank of England followed and cut its key interest rate by 50bps to 0.25% on 11 March.

[1] "The federal funds rate refers to the interest rate that banks charge other banks for lending them money from their reserve balances on an overnight basis… The Federal Open Market Committee (FOMC), the monetary policy-making body of the Federal Reserve System, meets eight times a year to set the federal funds rate…. While the FOMC can't mandate a particular federal funds rate, the Federal Reserve System can adjust the money supply so that interest rates will move toward the target rate." https://www.investopedia.com/terms/f/federalfundsrate.asp

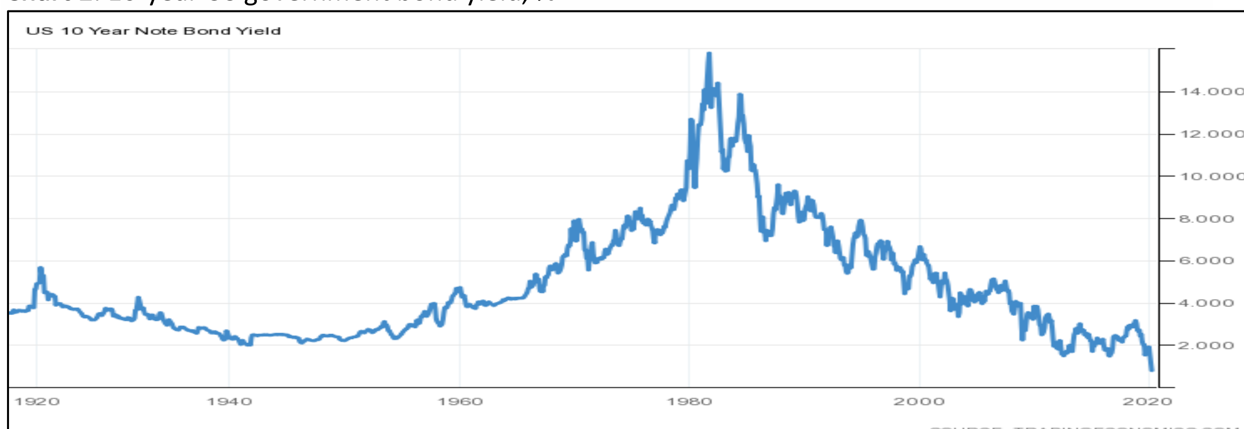
Chart 1: FED funds rate, %



Source: TradingEconomics

Moreover, the flight of nervous investors to relatively risk-free bonds let the US 10-year government bond yield fall to an all-time low. At 0.69% on 6 March, 0.50% on 9 March and 0.69% again on 10 March 2020 it decreased even below the FED-fund rate (Chart 2). Government bonds yields of other major issuing countries fell as well and were as low on 6 March 2020 as 0.23% for UK's 10-year bond, minus 0.10% for Japan's, minus 0.73% for Germany's, minus 0.84% for Switzerland's 10-year bond and have recovered on marginally since.

Chart 2: 10-year US government bond yield, %



Source: TradingEconomics

The direct impact of this flight to security on capital flows to the CAREC region (ex PRC) will probably not be very big, given the shallowness of the capital markets in the region. However, to some extent, money holders in CAREC countries might join the global crowd, particularly the local treasury departments of big international companies. Later, the final reversal of the global easy money policies and the related strengthening of the major currencies might lead to renewed outflows, which could put CAREC exchange rates under additional pressure.

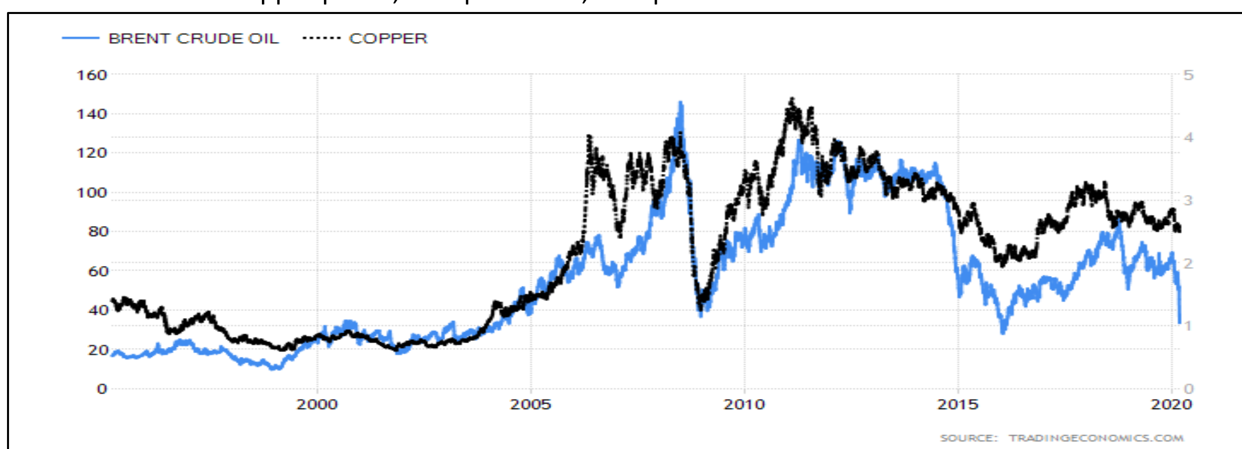
Initially, the global uncertainty was triggered by the Covid-19 outbreak. However, there are also much deeper, structural issues at work. One of them is trade wars, very likely only temporarily calmed by the US-China "phase one" deal. Another one is the increasing rivalry among major global oil producers.

Commodity prices slump

Diverging interests, mostly between Russia and Saudi Arabia, resulted in the failure to reach an OPEC+ agreement, which caused oil prices tumble. On 6 March, OPEC-Russia negotiations on oil output cuts, held in Vienna, Austria, failed. *Investor.com* reported: "Crude oil prices plunged as talks at the OPEC+ meeting Friday collapsed without a deal, meaning all prior agreements to curb production will end next month. Not only did OPEC and key partner Russia not agree to additional output curbs, but starting in April, current limits of 2.1 million barrels per day will no longer continue…OPEC members doubled down on their calls for output cuts late Thursday. After the formal OPEC meeting concluded, the cartel released a statement saying that members are now recommending that an additional production cut of 1.5 million barrels per day be extended to the rest of the year vs. an earlier proposal for Q2 only. OPEC countries would be responsible for 1 million bpd of the new cut, with Russia and other non-OPEC members accounting for the last 500,000 bpd. The latest OPEC proposal comes on top of the current reduction of 2.1 million bpd, which are set to expire this month."[2]

As a result, the Brent oil price fell to 30 USD per barrel on 9 March and recovered only slightly to 34 USD per barrel on 10 March. Such readings were last time seen in early 2016 (Chart 3). Copper prices fell already in the second half of January 2020 but have remained above 2016 levels.

Chart 3: Brent and copper prices, USD per barrel, USD per Lbs



Source: TradingEconomics

CAREC net oil exporters will be confronted with worsening trade balances, less income and economic growth, a fall in tax revenues, and currency pressures. In Kazakhstan, for example, the oil and gas sector accounts for more than 20% of GDP, according to the Statistics Committee of the Republic of Kazakhstan. The correlation of Kazakhstan's exchange rate with the oil price is high, directly and also via its close relationship with the Russian ruble. The ruble weakened by almost 8% against the USD on 9 March, recovering by only 4.3% on 10 March to 71.4, the weakest reading since January 2016. The Kazakhstani tenge followed by weakening 2.4% to the USD on 10 March (markets were closed on 9 March in Kazakhstan) to 395, a value that hasn't been reached ever before. The National Bank of Kazakhstan reacted by increasing its base rate by 175 bp to 12.00% and issued a

[2] https://www.investors.com/news/crude-oil-prices-saudi-arabia-russia-agreement-opec-meeting-march-2020/

press release saying that it keeps the free float but has the possibility to execute foreign exchange interventions to secure the stability of the financial system[3].

The impact of lower commodity prices will also be felt indirectly via the Russian economy, in part because of a significant export share for some of the CAREC economies (16% for Kazakhstan, 5-7% for Azerbaijan, Uzbekistan, Turkmenistan, Georgia, and the Kyrgyz Republic), but also via remittances and possibly also by less lending by such funds as the Russian-Kyrgyz Development Fund.

Net importers such as Pakistan, for which mineral fuel imports accounted for almost 30% of the total goods import in 2018, might profit from lower oil prices in trade balance terms. The financial account might however be affected to some extent, in case the Middle Eastern countries are less willing to extend loans.

A special case in this situation is the Kyrgyz Republic, a major gold exporter. Gold is regarded a safe haven investment. Gold prices peaked at 1700 USD/t.oz on 9 March, readings last seen in 2013.

Until the end of February 2020, the fall in oil prices was related to the Covid-19 outbreak. However, issues are much more fundamental. The prospects that oil demand could perhaps peak in a decade or two due to the fight against the climate change, and the rise in the US shale oil and gas production alters market dynamics and intensifies competition (see in the footnote the quote from BP's "Peak oil demand and long-run oil prices" report)[4]. The big Middle Eastern low-cost oil producers can't lower prices for an extended period of time to production costs because they need higher prices to finance their budgets and related social expenditures. However, they can reduce prices for some time in order to keep their market position and drive out rival companies or at least reduce the rival's investment potential. They did so in 2015-16 and they can do it again with harsher consequences for, meanwhile, more indebted companies. To the extent they diversify their economies also their power will increase to sustain such policies for a longer period.

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[3] https://nationalbank.kz/cont/%D0%9F%D1%80%D0%B5%D1%81%D1%81-%D1%80%D0%B5%D0%BB%D0%B8%D0%B7%20%D0%BF%D0%BE%20%D0%91%D0%A1%20100320%2011.pdf

[4] "Over the past few decades – during the age of (perceived) scarcity – the oil market hasn't behaved like a normal market. In particular, high-cost producers have been able to exist and compete alongside low-cost producers, even though high-cost oil is many times more expensive to produce. The laws of competitive markets, in which high-cost producers are driven out of the market, haven't applied….

The reason is because owners of large, low-cost resources have until now effectively rationed their supplies of oil: rather than using their competitive advantage to maximise market share, they have preserved their resources for the future. This made sense during the age of scarcity, since concerns about peak supply suggested the value of these oil resources was likely to increase over time. Moreover, rationing supplies in this way provided a clear and transparent way of managing a country's oil such that it was distributed fairly across future generations. A high reserves-to-production ratio – implying a country could continue producing oil at the same rate for 80, 90, 100+ years – was a sign of both strength and intergenerational fairness.

But the shift to an age of abundance changes all that. Faced with the possibility that significant amounts of recoverable oil may never be extracted, low-cost producers have a strong incentive to use their comparative advantage to squeeze out high-cost producers and gain market share – just as with any other competitive market. Moreover, if some oil may never be extracted, a high reserves-to-production ratio is no longer such a sign of strength. Better to have money in the bank than oil in the ground."

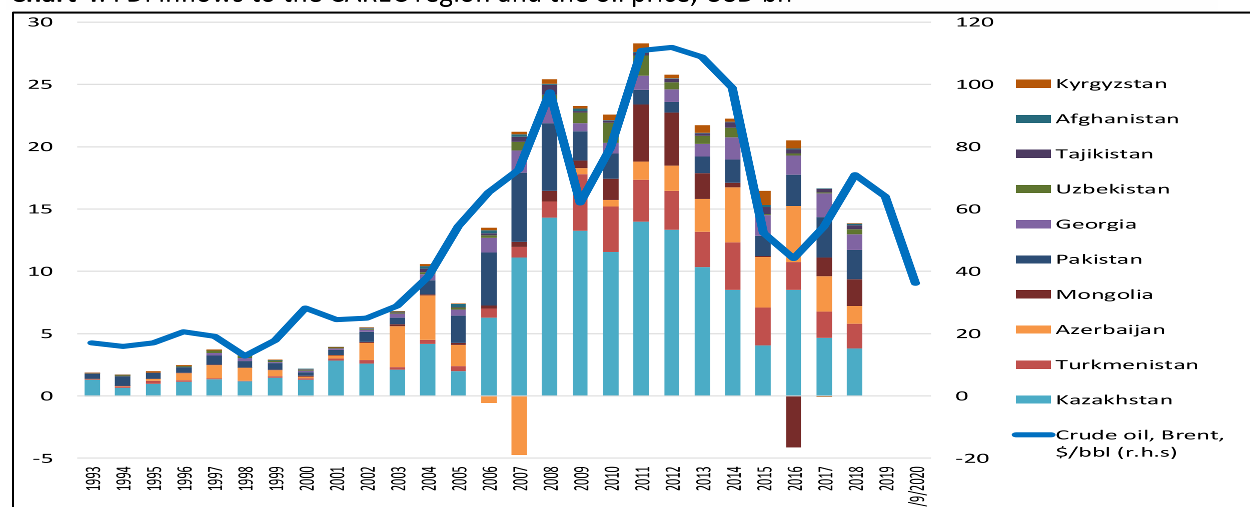
https://www.bp.com/en/global/corporate/energy-economics/spencer-dale-group-chief-economist/peak-oil-demand-and-long-run-oil-prices.html

CAREC falls behind other developing countries in attracting Foreign Direct Investments (FDI)

Direct investment inflows in the CAREC region are strongly related to oil and other commodity prices (Chart 4). Investment went mostly into the resources sector. In Kazakhstan, for example, 72% of inward FDI stock was in the oil and gas sector in 2019 and another 3% in ore mining, according to central bank data.

Since 2001, inflows rose fast, but they peaked in 2011. There are still projects underway such as Chevron's Future Growth and Wellhead Pressure Management Oil Project in Kazakhstan and Rio Tinto's Oyu Tolgoi copper mine project in Mongolia. However, for both projects, where output production should start in 2022, large investments have already been made. The prospect of a period of heightened global uncertainty and possibly lower commodity prices will hardly encourage the management of big international resource companies to put more investment in the CAREC region than planned. Louder calls for decarbonization, currently heard, might affect oil, gas and coal companies in particular.

Chart 4: FDI inflows to the CAREC region and the oil price, USD bn



Source: UNCTAD World Investment Report 2019[5], Annex table 1, WB pink sheets, author's calculations

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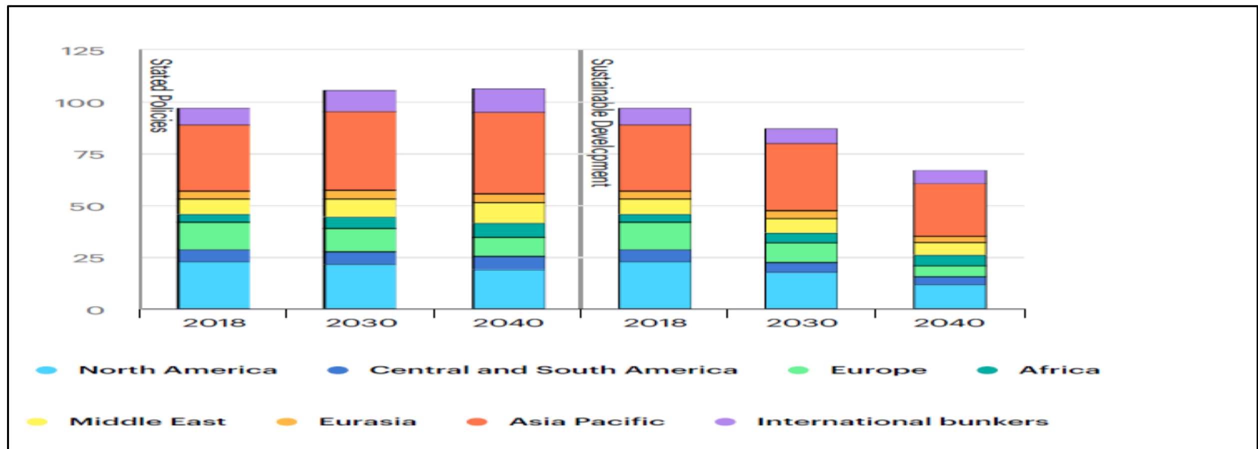
[5] The UNCTAD WIR uses the directional principle for calculating FDI flows, therefore they might differ somewhat from national and IMF statistics. "Flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor. FDI has three components: equity capital, reinvested earnings and intracompany loans.
In 2014, many countries adopted the new guidelines for the compilation of FDI data as part of balance of payments and international investment position statistics based on the sixth edition of IMF's Balance of Payments and International Investment Position Manual (BPM6) and the fourth edition of OECD's Benchmark Definition of Foreign Direct Investment (BD4). A major change introduced is the presentation of FDI statistics on an asset/liability basis instead of the directional principle that had been recommended by the previous editions of these international guidelines. On an asset/liability basis, direct investment statistics are organized according to whether the investment relates to an asset or a liability for the reporting country (for example, a country's assets include not only equity investments by MNEs resident in that country in their foreign affiliates abroad, but also loans made by the resident affiliates to their foreign parents abroad). As a result, the asset/liability presentation does not show the direction of influence while the directional presentation does. Under the directional principle, the direct investment flows and positions are organized according to the direction of the investment for the reporting economy – either inward or outward (i.e. all flows and positions of MNEs in an economy are shown under outward investment and all flows and positions for foreign affiliates resident in that economy are shown under inward investment). The two presentations differ in their treatment

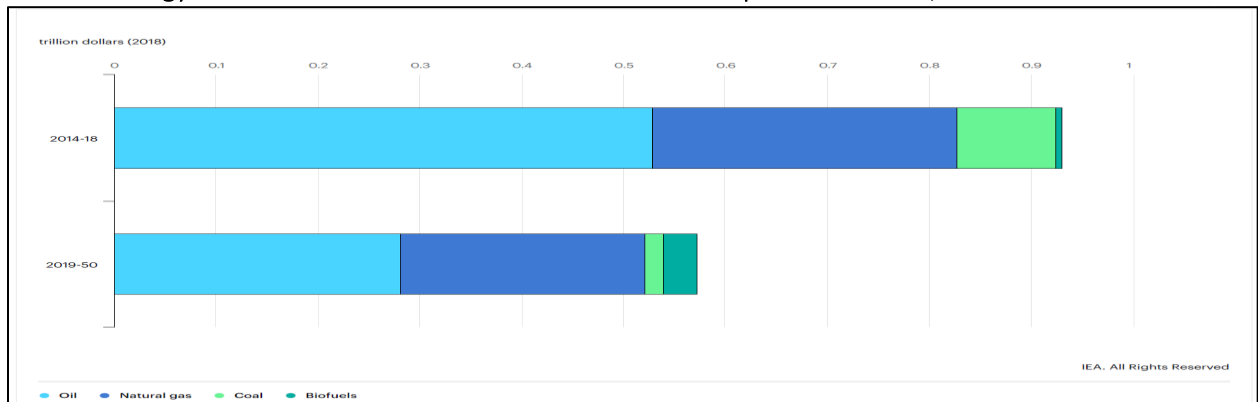
The International Energy Agency (IEA) developed two scenarios of global oil demand (Chart 5). While in the "Stated policies" scenario, oil demand in 2040 is higher than currently, and especially Asian demand is rising substantially, in a low CO2 emission scenario, called "sustainability" scenario, demand is shrinking, including in Asia. This scenario could lead to a substantial reduction in oil, gas and coal investment, according to the IEA (Chart 6).

Chart 5: IEA Oil demand scenarios, mb/d



Source: IEA, "Oil demand by region and scenario, 2018-2040", IEA, Paris https://www.iea.org/data-and-statistics/charts/oil-demand-by-region-and-scenario-2018-2040

Chart 6: Energy investments in fuels in the Sustainable Development Scenario, 2014-2050

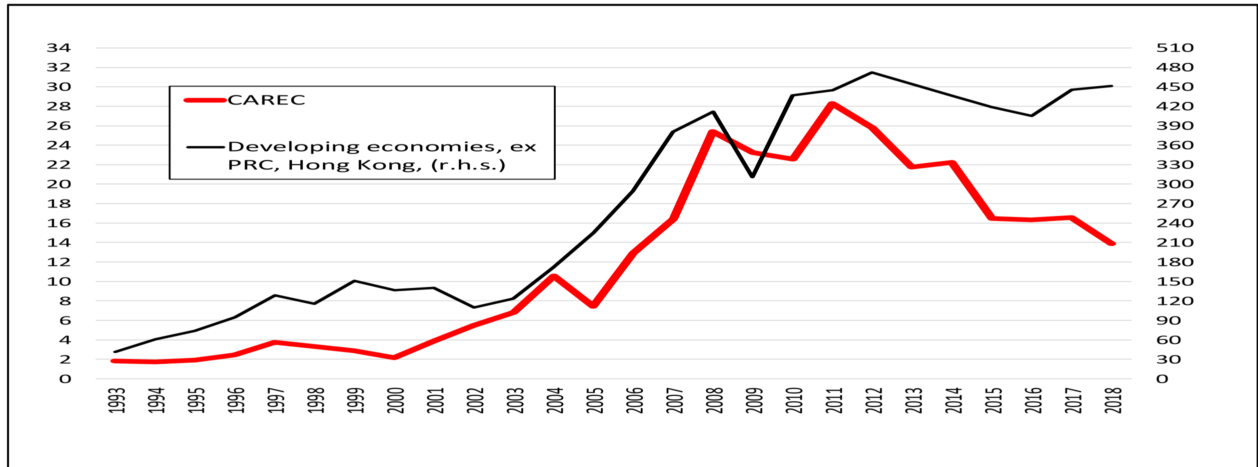


Source: IEA, "Energy investments in fuels in the Sustainable Development Scenario, 2014-2050", IEA, Paris https://www.iea.org/data-and-statistics/charts/energy-investments-in-fuels-in-the-sustainable-development-scenario-2014-2050

of reverse investment (reverse investment is when an affiliate provides loans or acquires less than 10 per cent equity in its parents). Under the directional presentation, reverse investment is subtracted to derive the total outward or inward investment of the reporting economy. Therefore, FDI statistics on an asset/liability basis tends to be higher than those under the directional principle, but such is not always the case.
While the presentation on an asset/liability basis is appropriate for macroeconomic analysis (i.e. the impact on the balance of payments), the directional principle is more appropriate for analyzing FDI in the context of parent-affiliate relationship. These data will better assist policymakers and government officials to formulate investment policies. This is because this presentation captures the direction and degree of influence and is useful for identifying the source or destination countries of direct investment in a particular reporting country or for assessing the access to specific markets by direct investors in that country."
https://unctad.org/en/PublicationChapters/wir2017chMethodNote_en.pdf

Last decade was not a great period for FDI in developing countries, it was stagnating. However, CAREC countries performed even worse and the gap to developing countries (even when excluding the PRC and Hong Kong) has substantially widened since 2012 (Chart 7).

Chart 7: CAREC region and developing economies FDI inflows, USD bn

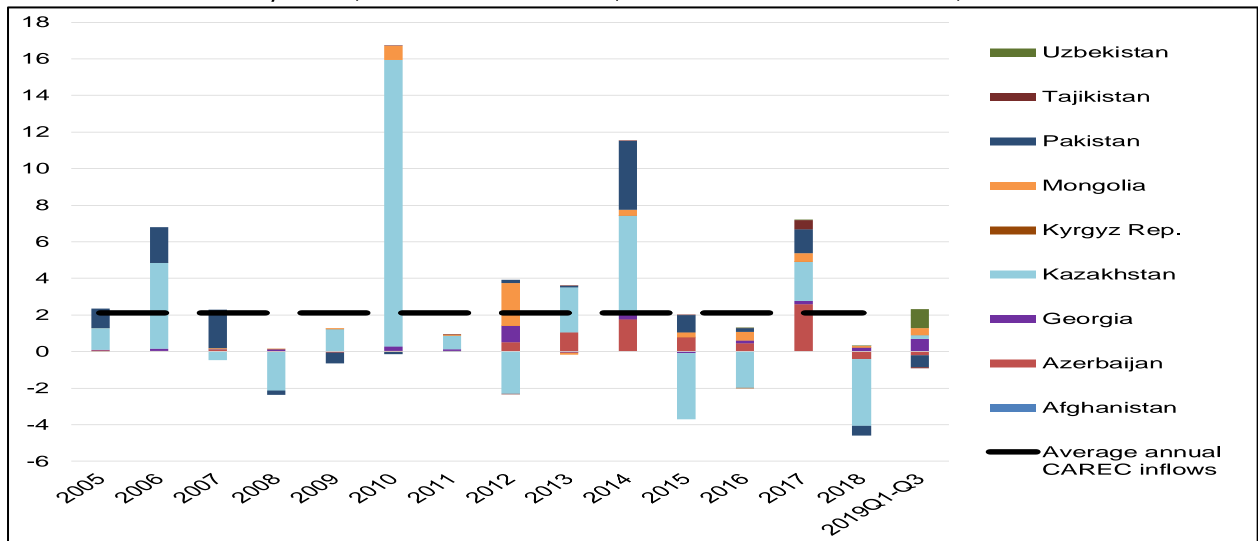


Source: UNCTAD World Investment Report 2019, Annex table 1, author's calculations

Other capital inflows are also rather meagre currently

Capital inflows beside FDI had been weak as well, if borrowing by Pakistan had not increased substantially.

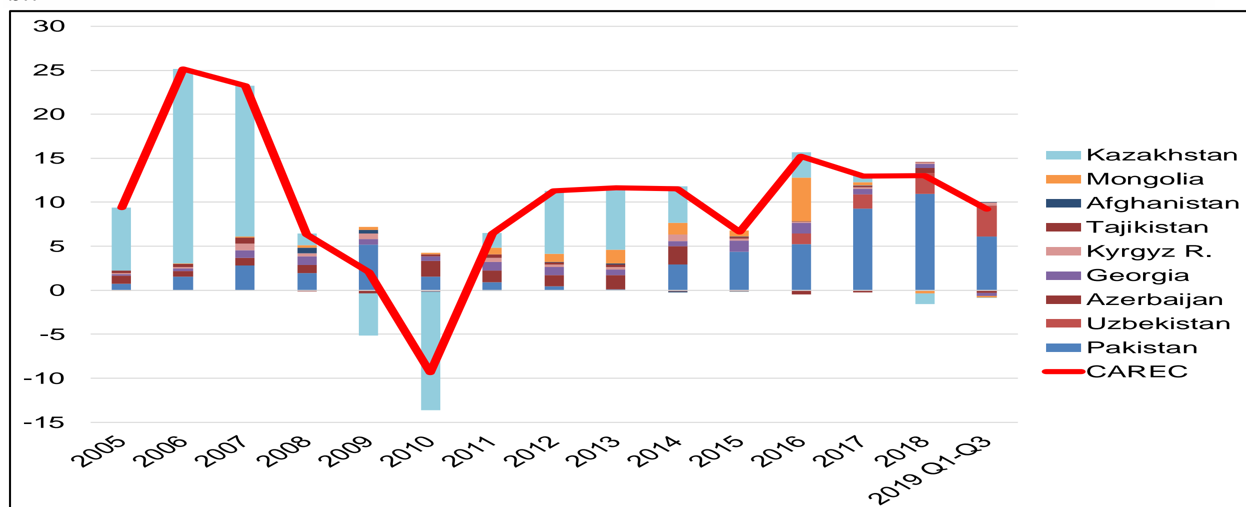
Chart 8: Balance of Payments; Portfolio Investment, Net Incurrence of Liabilities, USD bn



The spike for Kazakhstan in 2010 was due to a loan/bond swap related to the 2009 banking crisis and doesn't reflect actual capital inflows. The annual average of CAREC inflows is therefore calculated without this number.
Source: IMF Balance of Payment statistics, author's calculations

Despite some important bond issues, e.g. by Mongolia, Tajikistan, and Pakistan in 2017, Uzbekistan's recent issue, Pakistan's intended Panda bond issue in the People's Republic of China (PRC), portfolio investment in the CAREC region is not very large compared with FDI and bank loans at some USD 2bn annually on average, and it is highly volatile (Chart 8).

Chart 9: Balance of Payments; Other Investment: net Incurrence of Liabilities, debt Instruments, USD bn



Source: IMF Balance of Payment statistics, author's calculations

"Other investment", mostly cross-border loans, is more important (Chart 9). Before the 2008-2009 great recession there was a strong inflow of foreign loans particularly to Kazakhstan, mostly to the banking system, which in turn used a large part of these inflows as funding for domestic real estate loans. After the resulting real estate bubble collapsed in Kazakhstan in 2008-2009, there was a large reduction in cross-border liabilities (although the 2010 figure greatly overstates the outflow because of the loan/bond swap seen in chart 8 in the opposite way). It took the Kazakhstani banking system very long to recover from these events despite substantial government intervention and support, and only in February 2020 a report of the final Asset Quality Review (AQR) was published. Mongolia also had to go through AQRs (and the country had to get some bridge financing in late 2016, which is visible as inflows in Chart 9). Strong renewed inflows of foreign loans are thus unlikely for some time.

Pakistan's borrowing has increased substantially but has been to a large part government borrowing (see Table 1) to finance the current account deficit and could not be used to upgrade the economy. Pakistan's central bank is complaining in its Annual Report 2018-2019 (State of the Economy) about the low investment ratio and too little FDI: "The investment rate in Pakistan, however, has remained chronically low both in absolute terms and in comparison to other emerging and developing economies, and worryingly has been declining over the past decades …According to the World Bank's estimate, the persistence of current investment growth rates will make it extremely challenging for the country to reach middle-income status in the coming three decades – the required rate is at least 25 percent, as against the current rate of around 15 percent. The fact that other countries are growing faster than Pakistan makes the task more uphill than it may appear otherwise, especially with regards to attracting foreign investments."[6]

[6] http://www.sbp.org.pk/reports/annual/arFY19/Anul-index-eng-19.htm, p 100

Table 1: Balance of Payments of Pakistan, USD mn

	FY17	FY18	FY19
CA balance	**-12,621**	**-19,897**	**-13,508**
Trade balance	-26,680	-31,824	-28,164
Exports	22,003	24,768	24,224
Imports	48,683	56,592	52,388
Services balance	-4,339	-6,068	-4,288
Primary income balance	-5,048	-5,484	-5,697
Sec. income balance	23,446	23,479	24,641
Workers' remittances	19,351	19,914	21,841
Capital acc. balance	**375**	**376**	**253**
Financial acc. balance	**-10,198**	**-14,300**	**-11,989**
FDI in Pakistan	2,749	3,471	1,667
FPI in Pakistan	-251	2,209	-1,419
Net incur. of liabilities	8,965	8,855	11,734
Government	5,040	4,894	3,909
Private (excl. banks)	2,298	2,522	2,110
Banks	1,631	-109	220
SBP's reserves	**16,144**	**9,766**	**7,281**

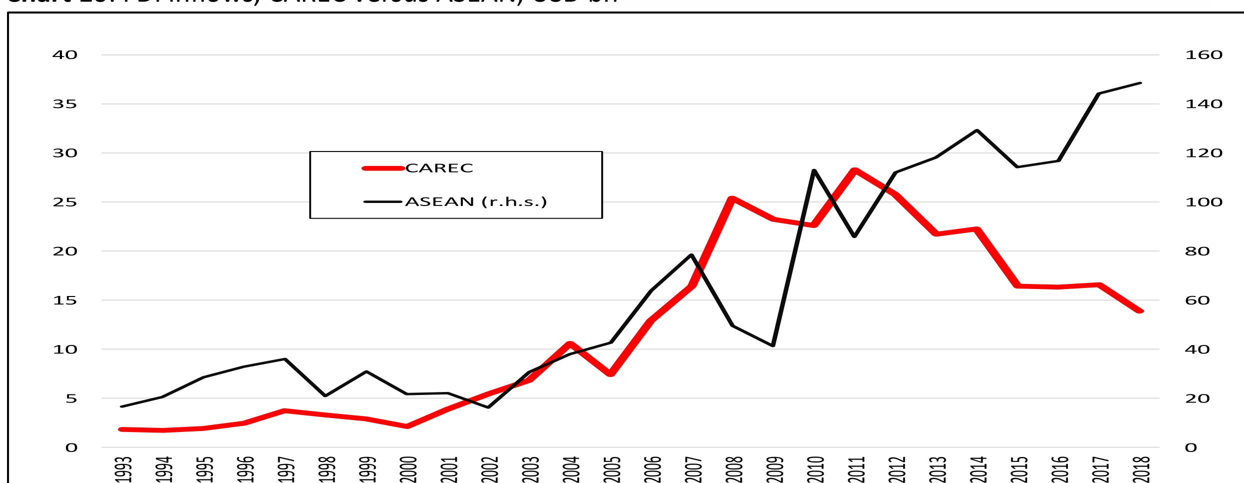
Source: State Bank of Pakistan

The CAREC region needs technological upgrading and more investment

The last month's paper on the Covid-19 economic impact on CAREC mentioned that the CAREC region (ex PRC) had 52% of ASEAN's population in 2018, 23% of ASEAN's GDP, but less than 10% of ASEAN's global exports.

The CAREC region falls back against ASEAN also with regard to FDI (Chart 10).

Chart 10: FDI inflows, CAREC versus ASEAN, USD bn

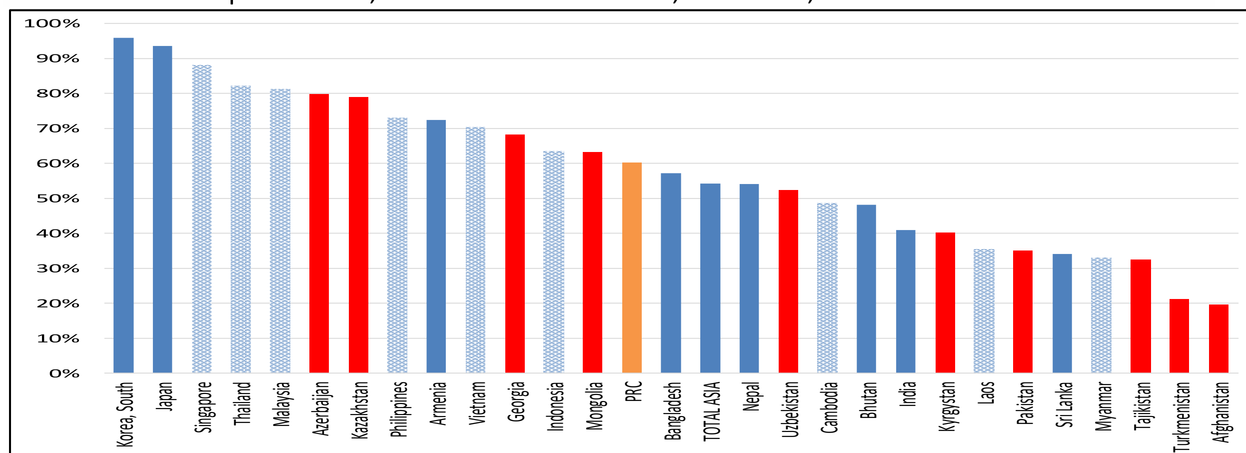


Source: UNCTAD World Investment Report 2019, Annex table 1, author's calculations

One reason for the FDI gap is that CAREC countries are technologically less advanced than the leading ASEAN countries. At the same time, they are less technologically advanced exactly because of less FDI, especially in the non-resources sectors. An indicator for the technological level is the degree of internet penetration (Chart 11). While Azerbaijan, Kazakhstan, Georgia, and Mongolia don't do bad, Singapore, Thailand and Malaysia do better. More striking is however the share of

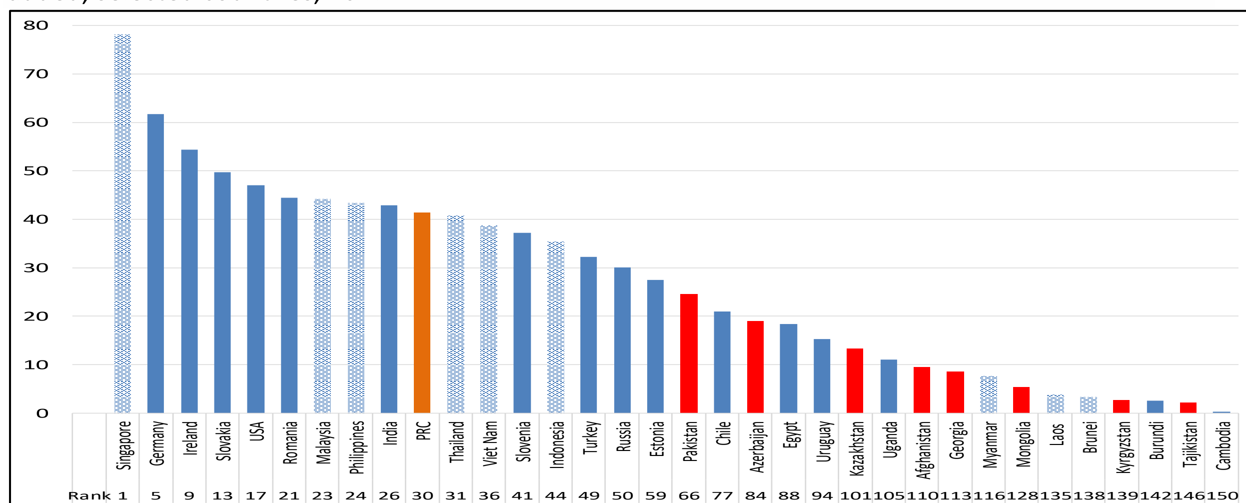
medium- and high-tech manufacturing value added in % of total manufacturing value added, were most CAREC countries score well below most ASEAN countries (Chart 12).

Chart 11: Internet penetration, selected Asian countries, June 2019, %



Source: Internet World Stats, author's calculations

Chart 12: Medium- and high-tech manufacturing value added in % of total manufacturing value added, selected countries, 2017



Source: UNIDO, Competitive Industrial Performance Index, author's calculations

This is not to say that CAREC countries should only focus on manufacturing. The CAREC countries have comparative advantages in resources, agriculture, services, such as tourism, and others. But it is to say that these countries need to be part of the current technological revolution. More FDI is needed to facilitate the transfer of modern technology and management.

CAREC countries act to attract more investment

There is progress in attracting FDI outside the resources sector. One example is the recent signing of an investment agreement by US company Tyson food for Kazakhstan[7] (interestingly triggered by the

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[7] "December 9, 2019 —Tyson Fresh Meats, Inc., the beef and pork subsidiary of TYSON FOODS, INC. (NYSE: TSN), today signed an agreement with the Republic of Kazakhstan and private holding company KUSTO GROUP to collaborate on a project that, in its initial phase could lead to the construction of a modern beef processing plant in Kazakhstan, with an anticipated harvest capacity of 2,000 head per day. As presently conceived, the

US-China trade war to circumvent Chinese counter-tariffs). Another example is the signing between the Ministry of Investment and Foreign Trade of Uzbekistan and Saudi ACWA Power a 25-year Power Purchase Agreement (PPA) and Investment Agreement – with a total investment value of USD1.2 bn - for the development/construction/operation of a 1500 MW Combined Cycle Gas-Turbine (CCGT) power plant as recent as on 8 March 2020[8]. A second agreement, worth USD 0.5-1.1 bn, has been signed with the Uzbek Ministry of Energy for a 500-1000 MW wind farm.

The authorities in the CAREC countries, investment agencies, businesses and organizations make big efforts to bring more foreign investment into their countries. Investment and other business laws are being improved, procedures are being simplified, investment protection is being enhanced, infrastructure is built and digitalization advanced. However, it is difficult to compete with other regions in the world, and efforts need to be further strengthened.

The CAREC countries could benefit from closer coordination. Tighter regional integration, easier cross-border trade, the opening up of Uzbekistan provide opportunities to make the region as a whole more interesting for foreign investors as they can utilize better economies of scale. There is competition among CAREC countries, of course, but more coordination and joint efforts, including in strategic fields such as industrial policy, might benefit all.

Conclusions

The current heightened global uncertainty goes along with the threat of less demand for CAREC export goods, and weaker GDP growth and tax revenues. Especially oil and gas exporters might suffer from lower commodity prices and feel pressures on the exchange rates. The authorities of the CAREC countries are considering measures to mitigate the consequences of the difficult environment, and some have already taken steps.

An extended period of global uncertainty and of lower commodity prices can accelerate the falling behind of the CAREC region in attracting foreign investment needed to modernize the CAREC economies. CAREC countries, therefore, need to step up efforts to attract foreign investment, especially also outside the resource sector. Closer CAREC integration, coordination, and cooperation could help in this respect.

investment is projected to help provide an annual agricultural economic benefit to the country well in excess of one billion dollars (USD)." https://www.tysonfoods.com/news/news-releases/2019/12/tyson-looks-expand-beef-operations-internationally

[8] https://www.acwapower.com/news/acwa-power-signs-milestone-agreements-with-ministry-of-energy-of-uzbekistan/