Investment in Emerging Markets
Nicolas E. Magud and Sebastián Sosa

In our working paper on investment in emerging markets (2015) we document that (i) although private investment growth in emerging markets has decelerated in recent years, it came down from cyclical highs and remains close to precrisis trends; and (ii) investment-to-output ratios generally remain close to or above historical averages. Investment is positively related to expected future profitability, cash flows and debt flows, and negatively associated with leverage. Critically, it is also positively related to (country-specific) commodity export prices and capital inflows. The latter help to relax firms’ financial constraints, which tend to be stronger for smaller firms and those less integrated with international financial markets. Lower commodity export prices and expected profitability, a moderation in capital inflows, and an increased leverage account for the bulk of the recent investment deceleration. Looking forward, prospects for a recovery of business investment are not promising.

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Migration: An Attractive Insurance Option in African Countries?
Ahmat Jidoud

Over the last two decades, officially recorded remittances (migrants’ transfers) toward African countries have reached substantial amounts. This paper assesses whether these flows help to cushion the impact of macroeconomic shocks in these countries and explores the channels through which these flows affect macroeconomic volatility. The empirical results show that remittances significantly reduce output and consumption volatilities by absorbing a significant amount of GDP shocks, but their effect on consumption fluctuations is less pronounced. A small, open–economy model augmented with remittances shows that the stabilizing effects of remittances are higher in economies where (i) remittances induce no wealth effect on labor supply, and (ii) help with promoting financial development by lessening financial frictions.

There has been widespread empirical work on the impact of remittances on African countries, both from a microeconomic and macroeconomic perspective in recent years. Although significantly underestimated, officially recorded \( (continued on page 2) \)
remittance flows to Africa have increased from $9.1 billion in 1990 to nearly $40 billion in 2010, outweighing other financial flows (see Figure 1a). In addition, remittances tend to be more stable and persistent than other financial flows (see Figure 1b). An extensive empirical literature has recognized the microeconomic benefits of these financial flows, while a growing number of studies have looked at their macroeconomic effects. More precisely, recent research has extensively examined the impact of migrants’ transfers on growth (Adam Jr. and Page 2005; Gupta, Pattillo, and Wagh 2009). This research found that both international migration and remittances significantly reduce the level, depth, and severity of poverty in developing countries. Remittances reduce poverty through their positive impact on financial development. Remittances give financially constrained households access to credit markets by collateralizing assets they build using their remittances. Hence, they can contribute to an increase in aggregate investment and savings. Another widely explored topic in this literature is the capacity of remittances to reduce macroeconomic volatility. Remittances are thus viewed as automatic stabilizers which buffer shocks and smooth aggregate fluctuations. This insurance role of remittances and migration hinges on the countercyclicality of these financial flows with respect to recipient countries’ fundamentals and their resilience to economic developments within the originating countries.

The present paper fits into the second strand of the literature as it assesses the ability of remittances to stabilize business cycle volatility in a sample of African countries with available relevant data. The paper takes a double approach. First, the paper empirically evaluates the correlation between aggregate fluctuations (output and private consumption volatilities) and the size of remittances as percentage of GDP. From this perspective, our analysis follows the existing work in assessing the correlation between business cycle volatility and remittances by estimating the semi-elasticity of volatility (measured by the standard deviation of GDP or consumption) on cross-section data. The sample comprises 27 African countries with yearly data covering 1980–2005 all from the African Development Indicators (2011) from the World Bank. Data are averaged over this period. The model controls for other relevant determinants for designing appropriate policies to effectively manage these financial flows. This theoretical exercise is the main contribution of the paper that most clearly distinguishes the analysis from similar work, in addition to tentative policy conclusions that may be derived.

Do Remittances Help Stabilize Macroeconomic Fluctuations? How Much of Shocks Are Absorbed by Remittances?

In responding to the first question, our working paper follows the existing work in assessing the correlation between business cycle volatility and remittances by estimating the semi-elasticity of volatility (measured by the standard deviation of GDP or consumption) on cross-section data. The sample comprises 27 African countries with yearly data covering 1980–2005 all from the African Development Indicators (2011) from the World Bank. Data are averaged over this period. The model controls for other relevant determinants.
of volatility identified in the literature such as per capita income, financial development, government size, development aid, and terms of trade volatility. Standard endogeneity tests (Correlation and Nakamura and Nakamura tests) rule out the endogeneity of remittances in the model. The model is estimated using generalized least squares method to account for potential heteroskedasticity in the residuals. The empirical results show that remittances reduce both output and consumption fluctuations. Specifically, an increase in workers’ remittances-to-GDP of one percentage point reduces the log of the standard deviation of per real capita GDP growth by 3.2 percent while the volatility of real per capita consumption decreases by two percent. This small stabilizing effect on consumption seems rather counterintuitive, but at least two arguments can be put forward to explain it. First, households’ consumption in developing economies encompasses both consumption of durables and non-durables. It might be that remittances actually reduce the consumption instability, but only of the non-durable component of aggregate consumption. If this is the case, the inability to disentangle these two components makes it harder to observe a significant effect on aggregate consumption fluctuations. Second, surveys at microeconomic levels in some African countries have brought evidence that more than half of households receiving remittances from outside Africa are in the top two consumption quintiles (Mohapatra and Ratha 2011), minimizing the consumption smoothing effect of remittances may, since these households have access to alternative means (e.g., credit markets), help to smooth out consumption shocks.

Our analysis also quantifies how much of GDP shocks are absorbed by remittances, that is the risk-sharing through migration using a very simple econometric panel framework designed by Asdrubali, Sorensen, and Yoshia (1996). The results suggest that around 4 to 22 percent of GDP shocks are smoothed through remittances channel. In a context where remittances data are severely underestimated due to informal channels, misreporting or misclassification in other revenues (e.g., non resident’s deposits), the stabilizing virtues of remittances are potentially underestimated as well.

**How Do Remittances Affect Macroeconomic Volatility? A DSGE Model Approach**

We present a small open economy dynamic stochastic general equilibrium (DSGE) model to provide a theory consistent with the preceding empirical results. In particular, we probe into the channels through which remittances affect macroeconomic fluctuations. For this purpose we used a small open economy a la Schmitt-Grohe and Uribe (2003) enriched with financial frictions which play a significant role in driving aggregate fluctuations, in particular, the excess volatility of consumption with respect to output. The model is calibrated to replicate the average economy formed in the sample of the economies. The quantitative experiments suggest that the stabilization benefits of remittances depend on two key factors: (i) the size of the wealth effect of remittances on labor supply and (ii) the ability of remittances to promote financial development. The first mechanism is highlighted by comparing the predictions of the model with two types of utility specifications: Greenwood, Hercovitz, and Huffman (1988), or GHH, which induce a zero wealth effect and King, Ploser and Rebelo (1988), or KPR, with a negative wealth effect on labor supply. This channel implies that the impact of remittances on macroeconomic fluctuations is higher in countries where the labor supply does not decrease following an increase in response to an increase in remittances (no wealth effect). In this case, the elasticity of labor supply is constant and irresponsible to changes in households’ income, implying a moderate response of output and consumption in response to shocks. However, in an environment where migrants’ transfers induce a negative wealth effect on the recipients’ labor supply, an increase in remittances deepens the business cycle as macroeconomic variables respond strongly to exogenous shocks. In order to highlight the second channel, we assume that remittances could reduce households’ borrowing costs through a lower risk-premium. This mechanism suggests remittances are more stabilizing in countries with a shallow financial sector while remittances are channeled through this sector. The reason is that remittances help credit-rationed borrowers to access financial services as they build physical assets which they can use as collateral. This finding underscores the need for recipient countries to promote financial development so as to channel remittances through the financial system and to help the poor have greater access to credit.

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Investment in Emerging Markets
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Emerging market economies (EMEs) exhibited strong investment growth in 2003–11, interrupted only temporarily in 2009 by the global financial crisis. After peaking in 2011, however, investment growth has waned in most of these economies. Furthermore, real output growth forecasts have been revised down significantly, to a large extent because of the lower-than-projected actual investment. But what explains this weakness in investment? What is the role of external factors? Is the slowdown a generalized phenomenon across EMEs? Moreover, can recent investment trends be explained by the standard determinants? How concerned should policymakers be about the recent investment disappointment?

We address these questions by first identifying and documenting key trends in private investment across emerging market economies, putting the recent slowdown in historical perspective. Then, we study the determinants of investment using an expanded Q-theory of investment model in panel regressions that combine firm level data for about 16,000 listed firms with country-specific macroeconomic variables—particularly commodity export prices and capital inflows—for 38 emerging market economies over the period 1990–2013. After identifying the key factors driving firms’ investment decisions in EMEs, we shed light on which of these factors have been the main drivers of the recent investment weakness.

The stylized facts show that although investment in EMEs has weakened in the last few years, it came down from cyclical highs and remains broadly at precrisis levels. And although investment-to-output ratios have flattened or declined moderately, they remain close to or above historical averages for most EMEs.

The main results from the panel regressions can be summarized as follows:

- The usual suspects: Emerging market firms’ capital expenditure is positively associated with expected profitability (proxied by Tobin’s Q), cash flows (suggesting the existence of borrowing constraints), and debt flows. It is negatively associated with leverage.
- Commodities matter: Investment is positively associated with changes in (country-specific) commodity export prices.
• Foreign financing and relaxation of financial constraints: Investment by firms in emerging markets is positively influenced by the availability of foreign (international) financing. Moreover, capital inflows help relax firms’ financial constraints, with the sensitivity of investment to cash flow weakening as capital inflows increase. This effect is particularly strong for nontradable sector firms.

• After the boom: Firms’ investment has not been abnormally weak in the past three years, at least not above and beyond what can be explained by the evolution of its main determinants mentioned above.

• Who is to blame? The sharp decline in commodity export prices (especially in Latin America and the Caribbean (LAC)) and the lower expected profitability of firms (which partly reflects the downward revisions to potential growth in many EMEs) have been important factors behind the recent deceleration of investment. A moderation in capital inflows to EMEs and increased leverage (particularly in Asia) have also played a significant role.

Why does this matter? Examining the determinants of private investment is important to understand business cycle fluctuations in EMEs. But the topic is also relevant because capital accumulation is a key driver of potential output growth. The latter is of particular interest at the current juncture given that most emerging markets have been experiencing significant downward revisions to potential growth. Moreover, identifying the main drivers of the recent slowdown in investment is relevant for policymakers in emerging market economies to the extent that it helps with assessing the likely effectiveness of alternative policy measures to foster private investment and boost potential growth.

Our work is related to the extensive empirical literature on the determinants of corporate investment in emerging markets. In particular, it relates to a strand that studies financing constraints, typically relying on Tobin’s Q investment models or Euler investment equations. Most of these studies have documented the importance of internal financing for firms’ investment owing to capital markets imperfections. Based on this framework, for example, Fazzari and others 1988 examine the case of U.S. manufacturing firms, while Love and Zicchino 2006 study emerging market companies. The sensitivity of investment to cash flows is particularly strong for smaller firms (Fazzari and others 2000, and Carpenter and Guariglia 2008) and for firms in less financially developed economies (Love 2003). Criticism of the use of cash flow as a measure of financial frictions (e.g., Kaplan and Zingales 1997, Gomes 2001, and Abel and Eberly 2011) have been addressed by Gilchrist and Himmelberg (1995), who establish the existence of financial constraints by testing the significance of investment-cash flow sensitivities beyond the effect of the “Fundamental Q.”

The study most closely linked to ours is Harrison and others 2004, which documents that foreign direct investment (FDI) flows to emerging markets are associated with a reduction in firms’ financing constraints. Like us, they examine whether—and to what extent—the availability of foreign capital helps to relax financing constraints in emerging market firms by combining firm-level data on cash flows with country-specific capital flows. Forbes 2007 and Gelos and Werner 2002 also find that the latter relax when capital account restrictions are eased.

Policy Implications

The private investment weakening in emerging market economies has not represented a slump, but rather a slowdown after a period of boom. Yet, policymakers should not be complacent. First, prospects for a recovery of business investment are not promising, as the outlook for most of its determinants is generally dim. Commodity prices are expected to remain weak, capital inflows to EMEs are likely to moderate further, and external financial conditions are
Although still a small share of global finance, Islamic finance has grown rapidly over the past decade and is projected to continue to expand. The growth of Islamic finance presents opportunities to improve access to finance for the large underserved Muslim populations, and for small- and medium-sized enterprises, opportunities to facilitate investment in public infrastructures and to promote financial stability. However, for the potential to be realized and to safeguard financial stability, a number of challenges will need to be addressed. In their IMF Staff Discussion Note (SDN 15/05), entitled “Islamic Finance: Opportunities, Challenges and Policy Implications,” the authors discuss the macroeconomic and financial stability implications of Islamic finance and the policy options. This article provides brief answers to seven commonly asked questions about Islamic finance, drawing on the findings of recently completed analytical work.

Question 1. What is Islamic finance and why does it matter?

Islamic Finance refers to the provision of financial services in accordance with Shari’ah Islamic law, principles, and rules. The main tenets of Shari’ah as applied to finance are: the prohibition of interest; excessive uncertainty and gambling; risk sharing; the requirement that finance supports real economic activities; and the adherence to ethical standards.

The Islamic finance industry mainly comprises banking and the Sukuk or Islamic bond market which account for 80 percent and 15 percent of total Islamic financial assets, respectively. The balance is accounted for by equities, investment funds, insurance (Takaful), and microfinance. Islamic finance is growing rapidly in terms of assets and geographical reach, although the assets are concentrated in Southeast Asia and the Middle East, particularly the Gulf Cooperation Countries (GCC). The Islamic banking sector is now systemically important in a dozen countries and Sukuk is increasing its global reach to include issuers from advanced, emerging, and developing economies (Figure 1).

The growth of the Islamic finance industry offers important potential benefits. It can facilitate financial inclusion by increasing access to banking services to underserved Muslim populations; the risk-sharing characteristics of Islamic financial products can facilitate access to finance by small- and medium-sized enterprises (SMEs); and the asset-backed nature of Sukuk makes them suitable for infrastructure financing that can help spur economic development, including creating an enabling environment for private sector investment. Moreover, the requirement to finance real economic activity can reduce leverage while the risk-sharing features enhance the loss absorbency of capital.

However, to realize the potential and to safeguard financial stability, countries need to adapt their regulatory, supervisory, and consumer protection frameworks to the specificities of Islamic finance; to develop Shari’ah-compliant financial markets and monetary instruments; and to build an enabling environment for Sukuk market development.

Question 2. What stability risks are unique to Islamic banking and what changes are needed to regulatory frameworks to safeguard financial stability?

Islamic financial transactions are structured differently from conventional products because of the need to comply with Shari’ah principles. Unlike conventional banks, Islamic banks are funded by current accounts that do not attract interest or by profit-sharing investment accounts (PSIA) where the investment account holder (IAH) receives a return that is determined, after the fact, by the profitability of the underlying financing and the IAH bears losses, if any. On the assets side, transactions include sales with a profit markup and deferred payments, leases, partnerships, or joint ventures. Additionally, to facilitate the investments, Islamic banks are permitted in some jurisdictions to establish subsidiaries of non-financial corporations in their groups, resulting in conglomerate corporate structures.

Consequently, in addition to standard banking risks (such as credit, market, liquidity, and operational risks), Islamic banks also face unique risks such as the displaced commercial risk (DCR) whereby shareholders may forego a part of their profits to provide competitive earnings to IAHs, equity...
investment risk stemming from partnership-like financing, rate of return risk in a context of dual systems where lower earnings may lead to customer flight, and Shari’ah compliance risk. Other standard banking risks such as operational, group risks, concentration, and liquidity risks could also be more heightened because of the complexity of some contracts; corporate structures that include a myriad of non-financial corporations; and underdeveloped liquidity infrastructure and safety nets. PSIAs also raise unique consumer protection issues because of inadequacies in disclosures and the asymmetric treatment of PSIA as investors without shareholder rights.

Therefore, to safeguard financial stability, there is need for further regulatory clarity and consistency, through greater adoption of Islamic standards developed by Islamic standard setting bodies. Countries with Islamic banks need to adopt a cross sectional approach to supervision of Islamic banks, avoid treating profit-sharing investment accounts as pure deposits while enhancing disclosures and corporate governance for the PSIA, strengthen Shari’ah governance structures, and build supervisory capacity. There is also a need to develop supporting financial infrastructures, including Shari’ah-compliant financial safety nets and appropriate resolution frameworks.

**Question 3: How does Islamic banking affect monetary policy conduct given the prohibition on interest and what reforms are needed?**

Monetary policy formulation and implementation are challenging in the presence of Islamic finance because of the scarcity of Shari’ah-compliant monetary policy instruments, the under development of money and interbank markets, and inadequate understanding of the monetary transmission mechanism. Shari’ah-compliant central bank facilities are also limited, reflecting the difficulty in designing market-based instruments for monetary control and limited Sukuk issuance. The shortage of Shari’ah-compliant high-quality liquid assets (HQLA) also reduces the collateral available for liquidity management and may also affect the smooth functioning of the payment systems. Therefore, a key priority

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will be to bolster the supply of Sukuk and develop Shari’ah-compliant monetary policy instruments.

Question 4. What needs to be done to deepen the Sukuk market?

Although the Sukuk market has registered rapid growth in value and the issuer base has broadened, the markets for Sukuk are still neither deep nor liquid, and most issues of Sukuk are asset based and not asset backed. Issuance also takes place without a comprehensive strategy to develop the domestic market.

National authorities should, therefore, develop the necessary infrastructure, including developing securitization and trust laws, promoting true securitization, clarify legally the investor’s rights—particularly in defaults—and promote standardization of contracts. Regular sovereign issuance, and at different maturities, is critical for deepening the market and establishing a yield (or Sukuk) curve that could provide a benchmark for corporate Sukuk. Increased sovereign issuance should also be underpinned by sound public financial management (PFM), and attention should be given to the accounting and statistical treatment of Sukuk instruments, which are currently largely overlooked in existing international standards.

Question 5. What are the tax implications of the growth of Islamic finance?

Islamic finance raises a number of taxation issues that call for policy attention at both national and international levels. The favorable treatment of debt in most tax systems relative to equity can disadvantage Islamic finance. Secondly, Islamic finance involves a series of transactions that could attract value-added, stamp, and other sales taxes that could put Islamic finance at a disadvantage relative to conventional finance. Therefore, particular attention is needed to ensure that tax systems guarantee a level playing field and that the system does not create incentives for international regulatory arbitrage.

Question 6: Does Islamic finance require changes to macroprudential policies?

Most macroprudential policies are applicable to Islamic banks with some modifications. The countercyclical capital buffer framework, conservation buffers, leverage ratio, dynamic provisioning, and sectoral risk weights could help in mitigating credit risks. Also, profit equalization reserves (PER) and investment risk reserve (IRR) can serve as countercyclical reserve buffers. However, given the business model that includes investment, modifications are needed to risk metric and stress tests for identifying and monitoring risks. Sectoral concentrations and liquidity risks also deserve greater attention because of the requirement to underpin all transactions with real economic activity and also the underdeveloped nature of Shari’ah-compliant financial markets and safety nets.

Question 7. What has prompted the IMF to focus on Islamic finance and what is the agenda going forward?

The IMF’s interest in Islamic finance is not new. In the early 1980s, the IMF initiated a program of research on the theoretical underpinnings of an Islamic financial system, the operations of Islamic banking, and the conduct of monetary policy within an Islamic system. The IMF also played a key role in the establishment of the Islamic Financial Services Board in 2002. Where relevant, the IMF has been providing policy advice (Article IV consultations and its FSAP assessment) and technical assistance (TA) to strengthen the regulatory framework and monetary operations and to develop the Sukuk market.

However, with the growth of the industry, demands from member countries for policy advice and technical assistance have increased and the evolution of and innovations in the industry also present new opportunities and challenges. So to ensure coherence and consistency in our policy advice, the IMF formed an interdepartmental working group on Islamic finance to undertake analytical work on the macroeconomic and financial stability implications of Islamic finance. The IMF also established an external advisory group which helped to identify policy challenges facing the Islamic finance industry and facilitated coordination with those international institutions involved in establishing standards for the industry. The findings are summarized in the Staff Discussion Note (SDN 15/05) issued on April 6, 2015, entitled “Islamic Finance: Opportunities, Challenges, and Policy Options.”

To foster policy dialogue on issues raised in the SDN, the IMF and the G20 presidency jointly organized a seminar on Islamic finance during the 2015 IMF-World Bank Spring Meetings entitled “Islamic Finance: Unlocking Its Potential and Supporting Stability.” The seminar was a kickoff event for a global conference on Islamic Finance that will be held in November 2015 in Kuwait. In the interim, a series of working papers that underpinned our policy conclusions will be published and consolidated into a book. The IMF will also continue regular policy dialogue with our member countries, our financial stability assessments, our technical assistance, and training.
set to become tighter because of the impact of the normalization of the U.S. monetary policy. The recent declines in potential growth estimates for most EMEs are also likely to be a drag on business investment going forward. Moreover, investment ratios are still relatively low in some emerging market regions, particularly in Latin America and the Caribbean, so boosting private investment remains a policy priority.

In light of our results on the size and persistence of financing constraints, especially for smaller firms, business investment in EMEs would benefit from further deepening domestic financial systems, strengthening capital market development, and promoting access to finance—of course, subject to sufficient safeguards to ensure financial stability. Strengthening financial infrastructure and legal frameworks, and enhancing capital market access to funding for small and mid-sized firms would be positive measures.

More generally, and beyond the scope of our study, structural reforms to boost productivity could help unlock private investment and output growth. The design of a policy agenda of structural reforms is a difficult task and entails country-specific considerations, but in many emerging markets, the efforts to improve infrastructure and human capital, strengthen the business climate, and foster competition are key priorities.

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