

Capital Flows into EMs: How Real Is the Threat of “Currency Wars”?

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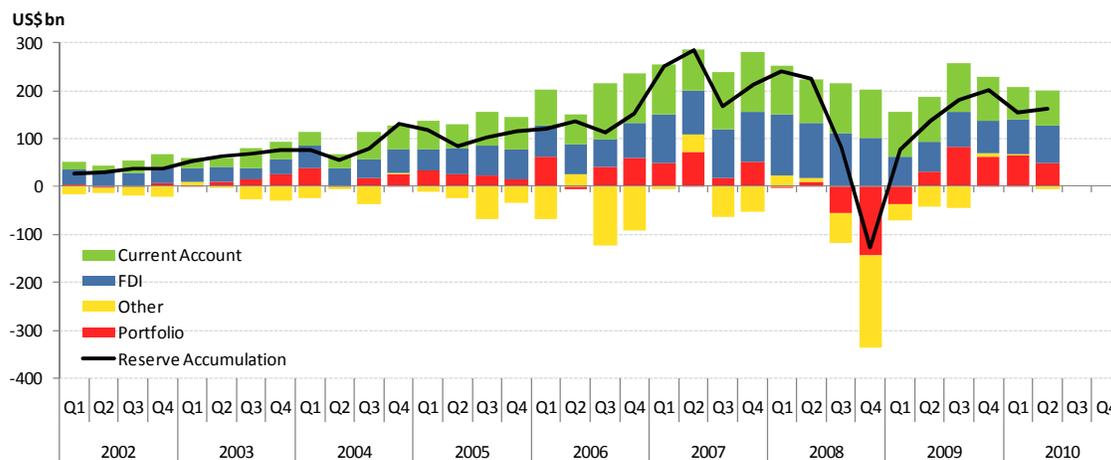
- *Concerns about the global consequences of exceptionally loose monetary policy in the US and other developed markets continue as capital flows to EMs have been picking up and fears of “currency wars” remain a key theme.*
- *We find that portfolio capital inflows to EMs are more structural and less cyclical than often portrayed. As long as growth fundamentals in EMs exceed those in DMs by a wide margin, strong portfolio inflows should continue, providing structural support for EM assets and pressure for EM currencies to appreciate.*
- *Most EMs have been able to cope very well with rising capital inflows. We have seen little evidence of significant external imbalances or over-heating domestic economies, except in some individual cases.*
- *We believe most EM policy makers want to slow the currency appreciation rather than prevent it. Allowing some appreciation also helps contain inflation pressures, which remains an important objective in light of rising commodity prices. And China’s expected gradual appreciation should slowly ease some of the competitive pressures faced by other EMs.*
- *In our view, FX intervention will likely continue to absorb a significant share of capital inflows. We believe this strategy is sustainable in most EMs given the recent pace of capital inflows.*
- *So unless capital inflows surge dramatically, which we do not expect at this point, a wave of disruptive capital controls should be avoided. In our view, the bigger risk is that some countries with a dovish attitude towards monetary policy keep rates too low out of fear of appreciation pressures.*

Since the Fed has embarked on the second round of quantitative easing (generally referred to as QE2), concerns about the global implications of this policy have been growing, especially for EMs. The basic logic behind these concerns is straightforward: excess liquidity and exceptionally low rates in the US trigger increasing portfolio capital flows to higher-yielding EMs. This puts pressure on EM currencies to appreciate, fuels assets bubbles, and creates inflationary pressures, while efforts by EM policy makers to limit those inflows through FX intervention or some kind of capital controls risk creating more volatility and could escalate in global “currency wars”—a term coined recently by Brazil’s finance minister. Some countries have already started to impose measures aimed at slowing capital inflows,

especially debt portfolio inflows. Brazil raised the IOF tax on such flows from 2% to 6% and Thailand and Korea eliminated exemptions from withholding tax for foreign holders of local debt securities. A few countries (e.g. Korea and Brazil) have also taken “macro prudential” measures aimed at limiting banks’ FX positions. Meanwhile, efforts at the G20 level to agree on a coordinated strategy have been unsuccessful so far.

We believe there is some truth to the basic argument behind these concerns but, as usual, the reality is a lot more complex. We see two key issues: (1) what exactly should we expect regarding capital flows into EMs and (2) what are the economic and policy implications?

Figure 1: Capital Flows to EMs*, 2002-2010



*/ Argentina, Brazil, Chile, Mexico, Peru, Hungary, Poland, Russia, Turkey, South Africa, Ukraine, China, India, Indonesia, Malaysia, Philippines, South Korea, Thailand.

Source: Haver Analytics, Stone Harbor calculations

Strong but volatile inflows

This is mainly a story about capital flows to EMs, so we'll start by taking a closer look at these flows. Figure 1 shows the evolution of current and capital account flows to EMs since 2002. The two most important sources of inflows were current account surpluses and foreign direct investment (FDI)¹, both roughly comparable in size. These flows dramatically increased in the second half of the 2000s. Portfolio inflows were smaller but also more volatile. Other flows were negative on average, reflecting accumulation of external assets (beyond official reserve accumulation).

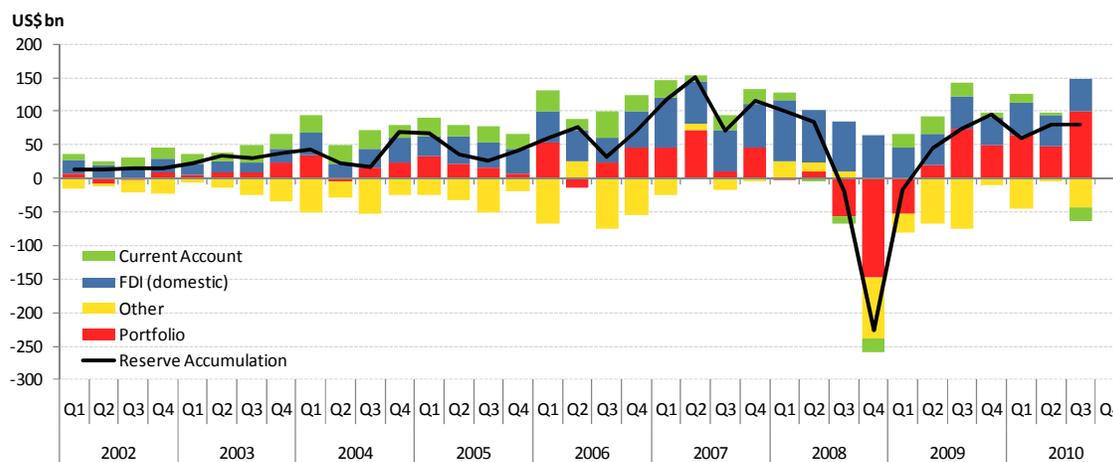
The picture that emerges actually looks rather positive. Inflows from relatively stable sources—FDI and current account surpluses—remain large and

dominate the balance of payments (BOP). Portfolio inflows have recovered to previous highs but remain smaller in total size. Meanwhile, the outflows during the crisis could be financed through continued FDI inflows, current account inflows, and by dipping into FX reserves.

However, it is important to keep in mind that most of the consolidated EM current account surplus is due China. Figure 2 shows the same data, but now excluding China. The result looks similar but with two key differences. First, the combined current account of the remaining EM countries has been close to balance. We have seen cyclical variations during the past decade but there was no major trend. The most recent reading is actually very close to balance. The second key difference after excluding China is that portfolio flows are a much larger share of total inflows. This is basically the result of China's closed capital account that prevents significant portfolio inflows. So, in a nutshell, inflows to China are mainly current account surpluses and to a smaller extent FDI inflows, while inflows to the remaining EMs are in about equal shares FDI inflows and portfolio inflows.

¹ The FDI numbers presented here refer to inward FDI, i.e. foreign FDI investment in the EM country. Outward FDI is not netted out. Portfolio investment is defined to be flows related foreign ownership of domestic debt or equity securities. All other flows, in particular domestic ownership of foreign assets and direct loans, are summarized in the category "other".

Figure 2: Capital Flows to EM ex-China*, 2002-2010



*/ Argentina, Brazil, Chile, Mexico, Peru, Hungary, Poland, Russia, Turkey, South Africa, Ukraine, India, Indonesia, Malaysia, Philippines, South Korea, Thailand.

Source: Haver Analytics, Stone Harbor calculations

These portfolio inflows picked up in the mid 2000s, peaked in 2007, and sharply reversed in late 2008. We then saw a very strong rebound in 2009 and inflows have reached a new all-time high in Q3 2010—the latest available data point. Meanwhile, FDI flows have fallen by about 40% compared to pre-crisis levels and are only recovering slowly. The combined effect, however, is that total inflows have almost recovered to pre-crisis peaks and, as a consequence, the pace of reserve accumulation is also close to the pre-crisis level.

Portfolio flows driven by growth fundamentals—not rate differentials

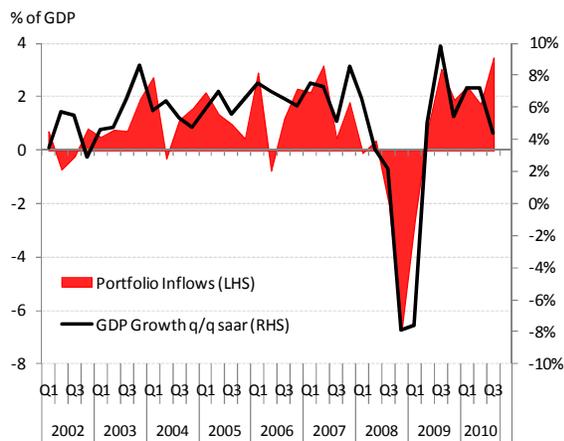
The critical question, however, is how these flows are going to evolve in the future. We believe FDI flows are poised to pick up after having lagged in the rebound so far. The EM growth outlook remains strong and the current level of commodity prices is supportive of further investment in natural resources. However, we do expect this increase to happen gradually as excess capacity in developed economies and in some EMs is still slowing down companies'

plans to expand production capacity in certain sectors.

With that in mind, let's look specifically at portfolio flows. This category includes much of the often controversial "hot money" and this is where we have seen most volatility in the past. The current consensus among market commentators seems to be that QE in the US is going to be a decisive driver of new portfolio flows into EM. We are somewhat more skeptical. While we do believe that exceptionally loose monetary policy in advanced economies tends to support flows into EMs, we think that other factors are significantly more important: in particular differences in macro fundamentals and broad risk appetite in the market. The following charts illustrate this point for the period since 2002 for a broad set of EMs excluding China.² We exclude China since its capital account is largely closed to portfolio inflows.

² Brazil, Chile, Mexico, Peru, Hungary, Poland, Russia, Turkey, South Africa, Ukraine, India, Indonesia, Malaysia, Philippines, South Korea, and Thailand

Figure 3: Portfolio Inflows and GDP Growth, EM ex-China, 2002-10



Source: Haver Analytics, Stone Harbor calculations

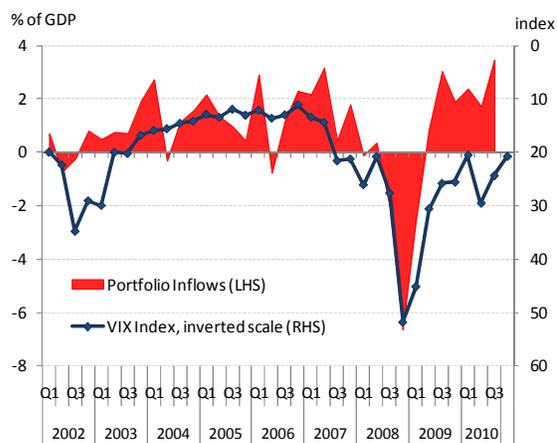
Figure 3 shows portfolio inflows into EMs and the average GDP growth in these countries. We see a strikingly close correlation. Growth peaks tend to coincide with spikes in inflows. And we clearly see the sharp impact of the crisis on both growth and portfolio flows. While the causality likely runs in both directions—i.e. high EM growth triggers capital inflows, but high inflows also support growth—we believe the former effect dominates (especially at shorter time horizons).

Portfolio inflows also depend strongly on broad risk attitudes in financial markets. Figure 4 plots portfolio inflows against the VIX index (the CBOE index of options-implied equity volatility, a commonly used measure of risk aversion). Here too, we also see a significant correlation with periods of low risk aversion coinciding with portfolio inflows into EMs.

However, the more surprising result (that seems to contradict conventional wisdom) is the lack of correlation between portfolio flows and either interest rates in developed markets (DM) or the rate differential between EM and DM (Figure 5). Pre-crisis portfolio inflows peaked in 2007 when the interest rate differential reached a record low. Then, in the year leading up to the Lehman default, the rate differential widened but portfolio flows dried up and then

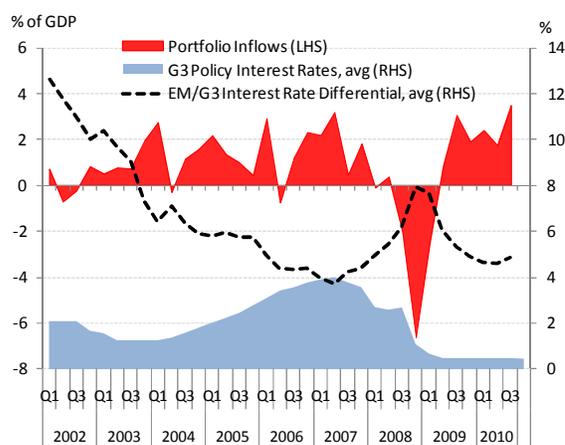
ultimately reversed sharply in Q4 2008. Flows finally resumed in the middle of 2009 when the rate differential had already fallen substantially. Similarly, we do not see much of a relation with the absolute level of rates in DMs. Rates were very low in the early 2000s but most portfolio inflows came later when policy rates in DMs were already much higher.

Figure 4: Portfolio Inflows and Risk Aversion, EM ex-China, 2002-10



Source: Haver Analytics, Bloomberg, Stone Harbor calculations

Figure 5: Portfolio Inflows and Policy Interest Rates, EM ex-China, 2002-10



Source: Haver Analytics, Stone Harbor calculations

This brief look at the stylized facts explains why we are skeptical about the common view that monetary policy in DMs is creating a “wall of money” that inevitably hits EMs in search for yield. Instead, we believe the main drivers are actually EM fundamentals (especially growth opportunities) and the gradual increase in risk taking as the global economy continues the gradual recovery. This has important consequences. In particular, it means that flows are unlikely to diminish much even if quantitative easing came to an end and rates in DMs were to rise again. Instead, we expect sustained inflows over an extended period of time driven by EMs’ strong growth outlook. And we believe these inflows are less sensitive to rate differentials than many observers claim. However, inflows remain sensitive to periodic bouts of heightened market volatility.

Policy reactions to large capital inflows

The prospect of sustained capital inflows has a number of consequences. Most importantly, it provides support for asset prices in EMs, including debt, equities, and FX. But it also creates policy challenges. The immediate concern in many EM countries is currency appreciation and the resulting loss of external competitiveness. Excessive appreciation would dampen demand for exports, thus curbing export-led growth, while excessive inflows could bid up domestic asset prices and ultimately lead to asset bubbles or trigger credit booms with well-known adverse consequences for macro stability. Moreover, both asset and credit booms could result in economic overheating and inflation.

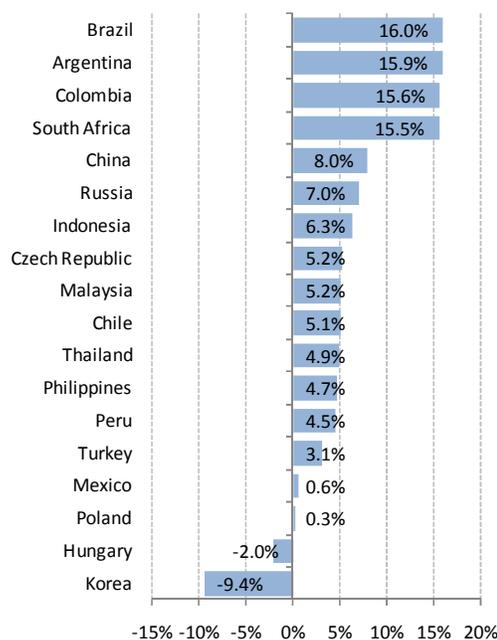
Policy makers face difficult choices. FX intervention can help neutralize appreciation pressures on the exchange rate, but it tends to be difficult to sterilize the impact on domestic liquidity—with potentially inflationary consequences. And keeping policy rates low to discourage inflows also risks higher inflation (and is unlikely to be successful over longer periods of time). This is why “unconventional” measures, in

particular various forms of capital controls, have entered the discussion.

How serious is the problem for EM policy makers?

We believe just looking at the FX appreciation over the past 2 years overstates the problem since a large part of this appreciation was just the reversal of the post-Lehman FX selloff. Instead, we find comparing current valuations to longer-term averages to be more meaningful. Figure 6 shows the latest real effective exchange rates (trade-weighted and inflation adjusted nominal FX rates) relative to the average over the past 5 years for a broad set of EMs. In most countries appreciation has been moderate so far. The real appreciation has exceeded 10% in only in four countries: Argentina, Brazil, Colombia, and South Africa. And those four countries have experienced substantial improvements in their term-of-trade (ToT) during that time—i.e. a substantial improvement in the price of their exports relative to the price of their imports—thus justifying more appreciated FX rates.

Figure 6: Real Effective Exchange Rate Appreciation, Jan 2011 vs. 5 year average



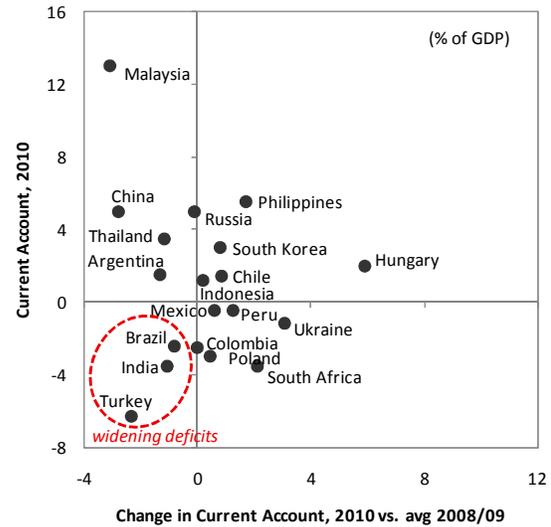
Source: BIS, Bloomberg, Haver Analytics, Stone Harbor calculations

However, the observed improvement in the ToT has been mostly due to higher commodity prices, and the manufacturing sectors (which are usually very important for employment generation) are not benefitting to the same extent in the improvement of the ToT. This explains much of the domestic political pressure that governments and central banks are exposed to as currencies are appreciating.

But pressures from certain sectors that suffer from the appreciation do not necessarily imply problems on a broader macro level. To assess if the appreciation is creating macroeconomic imbalances we need further analysis. The most obvious indicator for developing imbalances is the external current account balance. Figure 7 plots our 2010 current account estimates (as a share of GDP) and the change relative to the 2008/09 average. In the bottom left quadrant we see countries running current account deficits that have been widening (rising surpluses are in the top right, shrinking surpluses in the top left, and narrowing deficits in the bottom right quadrants).

Turkey stands out with the most worrisome current account. It has the largest deficit and it has been deteriorating relatively fast, even though its currency appreciated less than most other EM currencies. Brazil also has a widening deficit but the deficit remains relatively small and it has only been widening slowly despite the sizable appreciation of the Brazilian Real. Most other countries either run surpluses or they run deficits that are improving. This suggests that, so far, capital inflows and currency appreciation have not had a significant negative impact on EMs' external positions—with few exceptions, most notably Turkey.

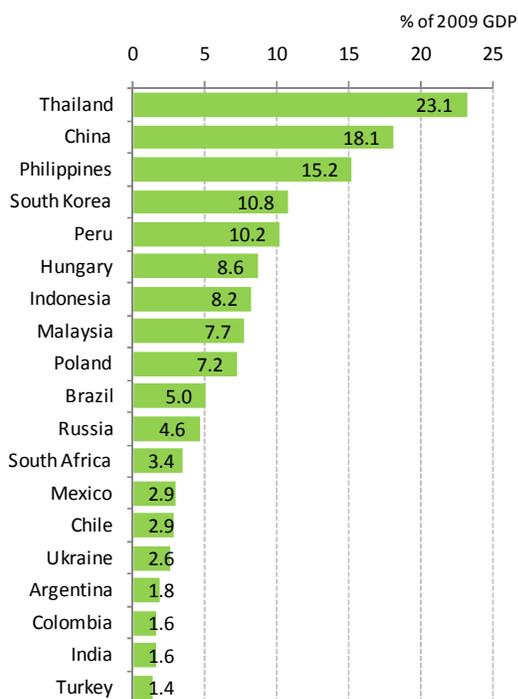
Figure 7: Current Accounts and Change in Current Accounts, 2010 vs. 2008/09 average



Source: Haver Analytics, Stone Harbor estimates

But we need to keep in mind that many central banks have been intervening in the FX market. Reserve accumulation has been very high in some countries over the past 2 years, especially in Asia (Figure 8). This means that the appreciation of some currencies has been muted by this intervention and, accordingly, current accounts show better results than what we would expect without intervention. However, even if countries limit the FX appreciation through intervention, capital inflows can still create domestic imbalances through its impact on domestic demand for goods and assets. In a way, the current problems in Europe's periphery serve as a reminder of this effect. The common currency prevented large real appreciation (though some real appreciation took place through higher inflation rates) but inflows still fueled domestic economic booms that resulted in large imbalances.

Figure 8: Accumulation of FX Reserves, 2009-2010



Source: Haver Analytics

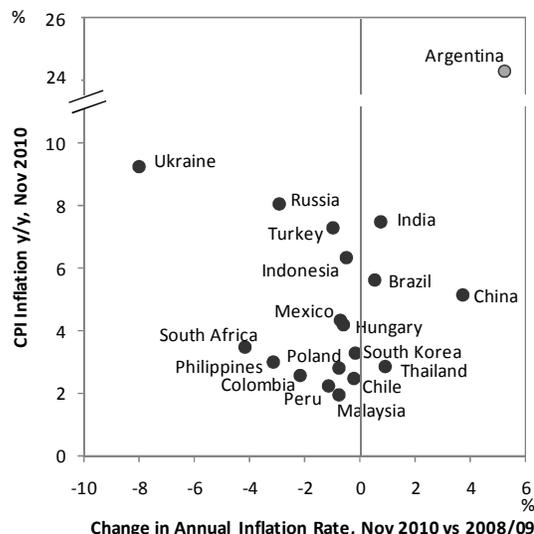
Thus, it is critical to look for signs of developing domestic imbalances, in particular signs of overheating and/or unsustainable credit booms.

Signs of overheating?

The most obvious sign of overheating would be accelerating inflation. Figure 9 shows the latest inflation rate over the past 12 months (vertical axis) and how much inflation increased compared to the average of the preceding two years (horizontal axis). Only two countries show a significant acceleration of inflation: Argentina and China. Argentina is clearly the outlier both in terms of the level of inflation as well as the increase. However, inflation in Argentina has been mostly the result of expansionary monetary and fiscal policies in combination with the commodities boom, while capital inflows have remained relatively low. The other country with a significant acceleration of inflation is China. However, here too, capital inflows are not the source of that acceleration. China's capital controls largely prevent portfolio

inflows and inflation pressures have been mostly the result of rising food prices. In an overheating scenario we would expect broader price pressures, but ex-food inflation remains contained at only 1.9% and services inflation at 2.6%.

Figure 9: Inflation: Recent Level and Change, 2009-2010



Note: Argentina data reflect private estimates from FIEL, not official statistics. For India, the chart shows WPI inflation.

Source: Haver Analytics

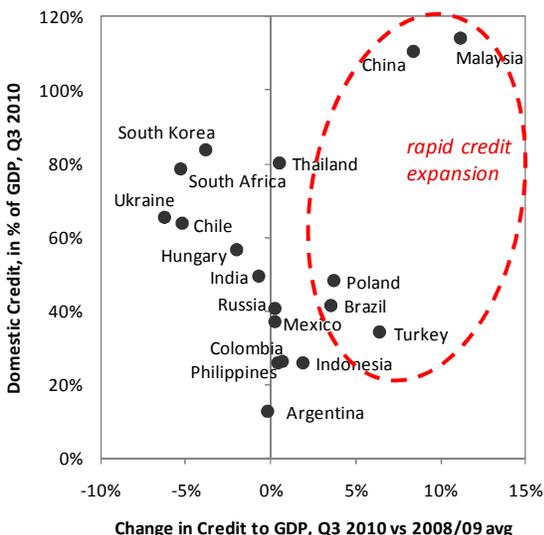
One country to watch closely is Brazil. As in many other EMs, headline inflation is close to the 2008/09 average. However, core inflation has been picking up and is now running at the highest level in several years. Not surprisingly, Brazil's policy makers are among the most concerned about capital inflows.

In the remaining EM countries we have not yet seen a significant acceleration of inflation. What we have seen is a normalization of inflation rates following the sharp deceleration of inflation during the crisis, but compared to the average in 2008/09 inflation remains broadly unchanged or even somewhat lower in most EMs. Nevertheless, the current level of inflation is still relatively high in several EM countries, which means that policy makers in these countries are likely to be reluctant to allow capital inflows to further stir domestic demand, though they might also be more

inclined to allow currency appreciation to help contain imported inflation pressures.

However, the tendency of an appreciating exchange rate to mute inflationary pressures also means that measured inflation might not be the best leading indicator of overheating pressures. That is the reason why we like to look at additional indicators such as domestic credit growth. Sharp credit expansion can often result in over-heating and/or asset bubbles and capital inflows tend to fuel domestic credit booms. Again, the recent experience in peripheral European countries serves as a clear reminder of these links.

Figure 10: Domestic Credit: in % of GDP and Change 2008-2010



Source: Haver Analytics

Figure 10 shows the size of domestic bank credit (as a share of GDP) and the increase compared to the 2008/09 average. While the relative size of domestic bank credit varies widely, a few countries stand out: China and Malaysia both have a very large stock of bank credit which also increased substantially over the past two years. The other countries with significant credit expansion are Turkey, Poland, Brazil, and (to a lesser extent) Indonesia—all countries with strong domestic demand growth. As credit growth tends to be difficult to control (without

heavy-handed measures), we expect these countries to be particularly concerned about further capital inflows. However, Figure 10 also shows that for the majority of EMs, credit growth remains contained and does not suggest that capital inflows have been creating domestic imbalances.

The Bottom Line

So what does this all mean for investors in EM debt? We see several important conclusions:

We believe capital inflows to EMs are more structural and less cyclical than often portrayed. This certainly includes FDI but, more importantly, it also extends to portfolio flows. We also believe that the growth outlook for EMs is far more important than the rate differential, which means that portfolio inflows should continue to remain strong as long as growth fundamentals in EMs exceed those in DMs by a substantial margin. This provides structural support for EM assets including continued pressure for EM currencies to appreciate.

Most EMs have been able to cope very well with rising capital inflows. We have seen little evidence of significant external imbalances or over-heating domestic economies, except in some individual cases, e.g. Turkey (though we keep looking closely for any new signs).

As a result, we believe EM policy makers want to slow the currency appreciation rather than prevent it. Allowing some appreciation also helps contain inflation pressures, which remains an important theme in light of rising commodity prices. Moreover, China's expected gradual appreciation should slowly ease some of the competitive pressures faced by other EMs.

So far, the primary tool to slow currency appreciation pressures has been FX intervention. And despite some of the rhetoric from commentators and policy makers, we believe it will continue to be the primary tool. However, potential capital control measures will likely remain part of the discussion. This includes

prudential regulations on banks aimed at limiting short-term speculative. We believe the introduction of significant capital control will remain the exception, but the fear of more disruptive measures is likely to remain a source of market volatility. Some countries are opting to keep policy rates lower in an effort to limit portfolio inflows (again, Turkey is an example) but we believe this strategy will ultimately be unsuccessful and exacerbate inflation pressures.

With respect to individual countries, conditions vary widely but a few countries stand out: Turkey shows the strongest signs of imbalances, in particular a large and widening current account deficit, relatively high inflation, and rapid credit growth. More capital inflows would likely intensify those imbalances while a reversal of capital flows would create a BOP shortfall due to the large current account deficit. We believe this is a fragile macroeconomic situation and policy makers are running a risky strategy by deliberately keeping rates low.

China is obviously a very special case. Credit growth remains rapid and inflation has picked up. But in contrast to some other EMs, appreciation pressures are not due to portfolio capital inflows. Instead, they arise from the large current account surplus. With heavy capital controls already in place the issue is not the fear of additional controls but rather the pace of

appreciation. And the appreciation of the Chinese Yuan plays a central role for other EMs' willingness to let their currencies appreciate. At this point, we expect a continuation of China's gradual currency appreciation.

Brazil remains an important country to watch, as appreciation has been large, core inflation has been picking up, and the current account deficit has widened somewhat. Moreover, Brazil was one of the few countries to take significant measures (beyond FX intervention). However, we remain confident that Brazil's policy makers will avoid major destabilizing policy measures and continue the proactive monetary policy.

In most other EMs, we see little evidence of significant external imbalances or over-heating domestic economies. In our view, FX intervention will continue to absorb a significant share of capital inflows. We believe this strategy is sustainable in most EMs given the recent pace of capital inflows. So unless capital inflows surge dramatically, which we do not expect at this point, a wave of disruptive capital controls should be avoided. In our view, the bigger risk is that some countries with a dovish attitude towards monetary policy keep rates too low out of fear of appreciation pressures.

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