Special Report 2011/19

The risk of sudden reversal of capital flows from Emerging Markets

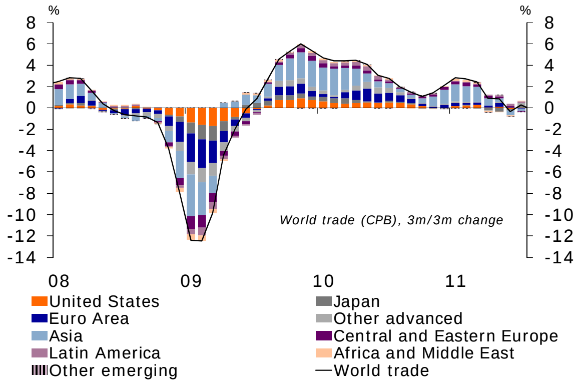
This article is part of a series of Special Reports that discuss the downside risks to the global economic outlook. In this piece, we take a closer look at the risks stemming from Emerging Markets, especially in light of the risk of a sudden reversal of capital flows.

Don't forget the Emerging Markets

Given all the bad news emanating from the Western world, one can be forgiven for not paying attention to the vulnerabilities in the rest of the world. Without doubt, the periphery in the eurozone is in a much more acute position, but this does not entail that the emerging markets (EMs) are just the safe havens and growth drivers often portrayed. Are we not missing a known unknown (a crisis in EMs) by solely focusing on the West? Can a crisis in a single EM or a group of countries also negatively impact the global economy? It sure can! While the economic heavyweights in the world are largely located in the West, much of global economic growth is generated in the booming emerging markets, such as China and India. In the near- to medium-term, as growth rates in the West remain sluggish, a crisis in EMs would eat into global growth. Moreover, emerging economies account for about half of the global imports and exports. In the aftermath of the financial crisis in 2008-09, the EMs turned out to be major contributors to the recovery in world trade (figure 1).

Another reason to keep a close eye on EMs are the well-known contagion channels – but in reverse direction. Losses in the banking sectors in EMs will put a burden on the profit of the already battered banks in continental Europe. Moreover, sovereign wealth funds from China and the Middle East are major investors across the globe. If governments need to draw from these funds, e.g. to recapitalise their domestic banks, this could lead to heavy sell-off of Western assets.

Figure 1: Trade growth supported by EMs

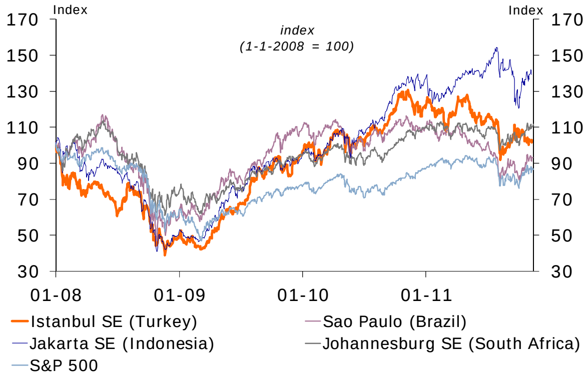


Source: CPB

Capital flows are the thing to watch

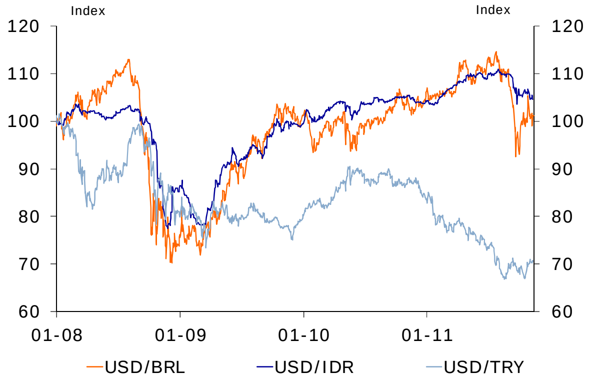
Looking for a higher return, foreign investors poured money into EM assets such as stocks, bonds, and real estate. Capital inflows can have great benefits for an emerging economy through investment in productive capacity or by deepening the local financial market. In Indonesia, for example, about a third of government bonds are in the hands of foreign investors, which has brought down the yield substantially in the past years thereby enforcing debt sustainability. However, there are also some downside risks to short-term foreign capital (hot money) given that it tends to be volatile and bubble-prone. By nature hot money can quickly be withdrawn from a country and is generally invested in the local stock market, government bonds and other relatively liquid assets. A change in investor sentiment or, as is likely in the current situation, the need to recapitalise at home can trigger the reversal of capital flows, with adverse effects on the price of local assets as well as domestic economic growth. Below we give several scenarios that could prompt a rush for exit. However, whether the shock is locally generated or stems from industrialised world, the risk of contagion is high. As investors rush out of one country, herd behaviour may result in many other countries also experiencing sudden reversal of capital flows. This will push some of the most vulnerable countries towards a financial crisis. In the 1997 Asian crisis, the reversal of capital flows indeed was the main route through which the crisis spread from one country to the next.

Figure 2: Foreign capital flows boosted local stock exchanges and …



Source: Ecowin

Figure 3: … pushed up exchange rates.



Source: Ecowin

Indonesia, Brazil, Turkey and South Africa are the EMs that have received the bulk of foreign capital since early 2009 – but they are by no means the only recipients. The mostly short-term portfolio investments boosted their stock exchanges to outperform the S&P 500 by a substantial margin (figure 2). In Brazil and Indonesia, hot money also brought about a strong appreciation of their currencies (figure 3). The Turkish lira initially appreciated in 2009, but has since suffered from the fear of overheating. Despite the rapid rise of stock markets and other indicators, it remains very difficult to assess if bubbles are being/have been created in these economies. Nor is it clear if (and if so, when) investor sentiment towards emerging economies changes. Nevertheless, these are risks that cannot be ignored, making a crisis in EMs a perfect example of a known unknown.

From the inside

A change in investor sentiment could come from within a single EM country. We discuss the risk of domestic policies gone wrong, overheating and export dependency. Admittedly, the latter two can also be seen as failing domestic policy, but for the sake of clarity we discuss them separately.

How not to run a country

When thinking about unsustainable domestic policies, the examples that immediately come to mind are Argentina and Hungary. The government of the former follows a so-called heterodox policy framework. In less euphemistic terms, it completely denies having macroeconomic problems, such as high inflation, while acting to correct these 'non-existent' problems. On the one hand, official inflation is not considered a major issue at about 10% (independent analysts estimate the figure to be in the 20-30% range). On the other hand, the government tries to stem price increases via price controls, lavish subsidies and controlled exchange rate depreciation. Meanwhile, it granted a public sector wage increase of more than 20% in the past year. As a result, the subsidy and public wage bill are ballooning and Argentina's competitive position is deteriorating. All this reminds us of the run-up to the 2001 crisis and could well be a recipe for disaster going forward.

In Hungary, although the government takes a different approach, the final outcome might be just the same. Since the overwhelming victory of Fidesz in the 2010 elections, the government has shown complete insensitivity to the impact of their measures in the international arena. It drew strong parallels between itself and Greece (good thinking at the height of the

Greek crisis!), it offered Hungarians the option to transfer their pension back to the government (basically nationalising the pension funds) and recently it has announced a plan to protect homeowners with foreign currency loans against fluctuations in the Hungarian forint (leaving the banking sector with a huge burden, a year after imposing a hefty bank tax). Early December, Moody's downgraded Hungarian government bonds to junk status, while the country is just one notch away from this level at the other major rating agencies. Word has it that the IMF and Hungary are talking again about a stand-by package, which would be the best case scenario. In the worst case, Hungary would be the next crisis country in Europe.

These issues may seem contained to individual countries, but history has shown that an event in one country can quickly spread to other countries, especially to the ones in the same region due to trade and financial interlinkages. Ending the currency peg of the Thai baht in 1997 was a local event, but is generally seen as the trigger for the Asian crisis[1]. Once the Thai baht was de-pegged, investor confidence dropped sharply and many started worrying that other countries in the region could be as vulnerable as Thailand. Hence, they decided to withdraw their money from Indonesia, Philippines, etc. The rest is, obviously, history.

Overheating in a cool world

Paradoxically, while much of Europe and the US are struggling to get economic growth back on its feet, several EMs have been at risk of overheating (see table 1). An excessive flow of foreign capital combined with strong domestic credit growth and a solid recovery in domestic demand pushed some countries to the danger zone. As a consequence, inflation was more of a concern to many central bankers in the 'South' than stimulating growth. In Brazil, the central bank was very proactive in addressing inflation. The fear of hyperinflation in Brazil, witnessed during the 1980s, is still much stronger than the worry about a slowing economy. In most of emerging Asia, policy rates were hiked in the past year as central banks tried to curtail inflation amid strong capital inflows. Unfortunately, the higher policy rates needed to curb inflation made these countries an even more attractive destination for foreign investors searching for higher return on their investment. Additional capital inflows further increases the risk of overheating, but, public discontent over rising prices, especially of food, can be dangerous as well. Rising food prices is seen as one of the catalysts of the Arab Spring. In India, the popularity of the government has been hit by high inflation too (of course, the numerous corruption scandals did not really help either). Brazil aimed to slowdown hot money by imposing a special tax on gains from short-term investments. Turkey's central bank tried a very unorthodox way to address the issue of buoyant credit growth and a rapidly widening current account deficit. It lowered its policy rate to stem capital flows, but attempted to curb domestic credit growth via the backdoor by raising reserve requirements and later by ending the 7-day repo auctions, forcing banks to use the much more expensive overnight lending facility. The jury is still out on whether this approach was effective, but so far credit growth is still above trend and the current account deficit is yawning.

If an overheating-induced hard landing materialises in one of the major EMs or inflation pushes public support for the government in the wrong direction, this could be a trigger for changing sentiment. That said, with the expected slowdown in the global economy and the resulting lower commodity prices, the risk of overheating and inflationary pressures are waning quickly.

[1] Corsetti, G., P. Pesenti and N. Roubini, *What caused the Asian currency and financial crisis?,* December 1998. NBER Working Paper No. 6833.

Missed the wake-up call

Recently, an article in The Economist started with the positive note that 'as the rich world lurches from one crises to the next, a consolation has been that emerging economies [.] have been growing quickly'. Implied is the idea of reduced dependence of EMs on the West. However, *decoupling*, the magic word used since the global financial crisis, is more myth than fact. Not to say that the domestic markets in, say, China and India provide some cushion for the global economy, but final demand is still largely determined by the Western economies – not to mention the strong financial market linkages. This leaves export-dependent countries at risk of another slowdown in the major consumer markets. Especially emerging Asia and Central and Eastern Europe (CEE) would be hit hard. The manufacturing industries in these countries largely produce for the consumer markets in the West. Even India, which is often seen as less linked, delivers many (semi-finished) products that eventually end up in the West. Indian annual export growth already dropped from 44% in August 2011 to 11% in October.

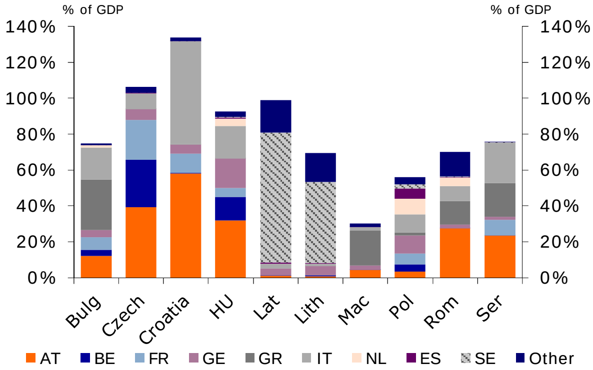
Similarly vulnerable are the commodity exporters. With a global downturn, commodity prices are expected to decline, just as the price developments seen in late 2008/early 2009. As commodities are the primary export product in many countries, e.g. Chile, Russia, Zambia, Nigeria, Mongolia, plunging commodity prices will have great repercussions for government revenues and economic growth. For instance, the 8% shrinkage in Russia's economy in 2009 was induced by the sharp drop in oil prices. The commodity-dependent exporters present a nice catch-22 for EMs. A drop in commodity prices is a blessing for those struggling with inflation and overheating, but a problem for exporters. And vice versa.

How can export-dependency trigger a loss of investor confidence? A sudden realisation that decoupling is a myth and that EMs are still very sensitive to what happens in Europe and the US. Honestly, the 2008/09 global crisis already showed this interconnectedness. So investors that act surprised about a major downturn of emerging economies have definitively missed the previous wake-up calls. By the way, recent developments are also a wake-up call for EMs. Basing your growth primarily on exports to developed economies (or mainly on Germany in the case of CEE) has seen better days.

From the outside

For a number of reasons outside EMs, which we won't discuss here as they are extensively described in the other Special Reports of this series, investors can be spooked and withdraw their money from EMs. However, there is another important channel to consider when thinking about reasons to withdraw capital from EMs, i.e. the strong linkages in the banking sector.

Figure 4: Origins of bank loans



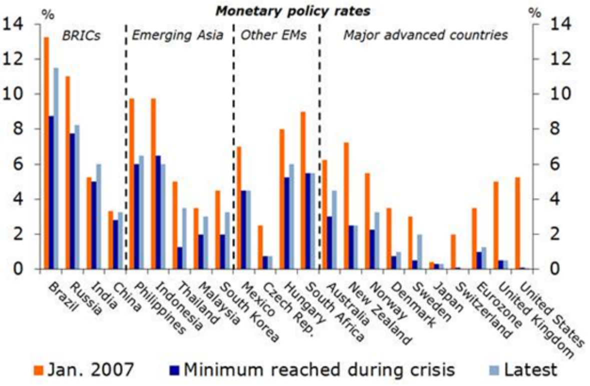
Source: BIS, end-June 2011

Issues in home markets and higher tier-1 capital demand from Basel III are triggering banks to reconsider their foreign strategy – even though much of the profit growth has come from EMs in the past years. This creates the risk that banks withdraw their investments and/or credit lines from EMs. This is particularly of concern for banks in CEE with their Western European parents in need for cash. The European Banking Authority (EBA) recently decided that European banks need to polish up their tier-1 ratio to 9% by mid-2012. As raising equity might be difficult in the current market conditions (and perhaps also unwanted by existing shareholders as this would weaken their position), cutting back on loans seems the easier way out. Given that banks tend to have a home bias, it is likely that Western European banks will cut back on their operations in CEE. In some cases, the home bias is less of a free choice (see Rabo Special Report: The risk of financial repression). End November, for example, Austrian banks were instructed by the central bank to restrict lending in CEE, in an attempt to defend the country's AAA-rating. Several Italian and German banks had earlier already announced to limit their geofigureic focus in CEE. Poland seems to be on the safe side, while the rest of the countries can fear the nomination list. With three quarters of the CEE banks owned by Western European banks, the effects of frozen credit lines or withdrawal of Western banks due to deleveraging could be substantial (figure 4) [2].

Some soothing words

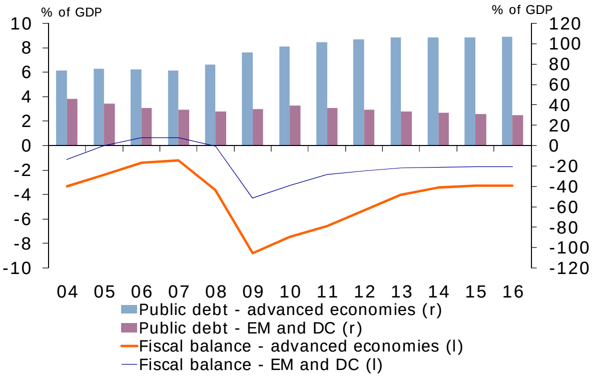
Mind you that the scenarios presented above are the doom and gloom versions of the array of options. Not to say that a locally-started or a eurozone-induced crisis would not hit EMs, but thankfully EMs' governments are not without options. Monetary policy rates are still high enough that central banks have room to stimulate the economy should the need arise (figure 5). A country like Brazil hiked its policy rates substantially, leaving much space to go down again. But even those who haven't tightened as aggressively, such as Indonesia, Philippines, Mexico and South Africa, have ample room if needed. The Czech Republic is probably the only country where the central bank's rate is below the rate of the ECB. Furthermore, fiscal stimulus is still an option in most countries, contrary to Europe and the US (figure 6). On average, the fiscal deficit in advanced economies is expected to be above 5% of GDP, while it is estimated to be around 2% of GDP for EMs and Developing Countries (DC). The difference is even larger if looking at public debt, 105% of GDP vs. 35% of GDP. Within each group there are large differences, with for example many countries in the Middle East and China having more room than CEE countries. But in general EMs have more leeway than advanced economies.

Figure 5: Monetary room and …



Source: Ecowin

Figure 6: … fiscal room is larger in EMs



Source: IMF World Economic Outlook September 2011

Bottom line

Considering the variety of reasons that could trigger a change of heart with investors, the chances are that foreign capital will flow less lavishly towards EMs in the coming year. For those few still struggling with overheating this might even be good news. The risk of an outright, massive reversal of foreign capital flows is rather limited, although not impossible. A break-up of the eurozone, a hard landing of China, or a balance-of-payment crisis in Argentina could push investors' nerves. This is, however, not our baseline scenario. A

[2] More on CEE can be found in Special Report SR1121aru *Emerging Europe: caught without an umbrella.*

comforting factor is that if push comes to shove, many EMs have room to spare to stimulate the economy through monetary or fiscal policy. Unfortunately, this doesn't hold for all EMs, especially the ones hit on multiple fronts – export dependency, retreating bank lines, and limited fiscal room. The countries in CEE and some emerging Asian countries therefore seem most likely to face difficult times ahead.

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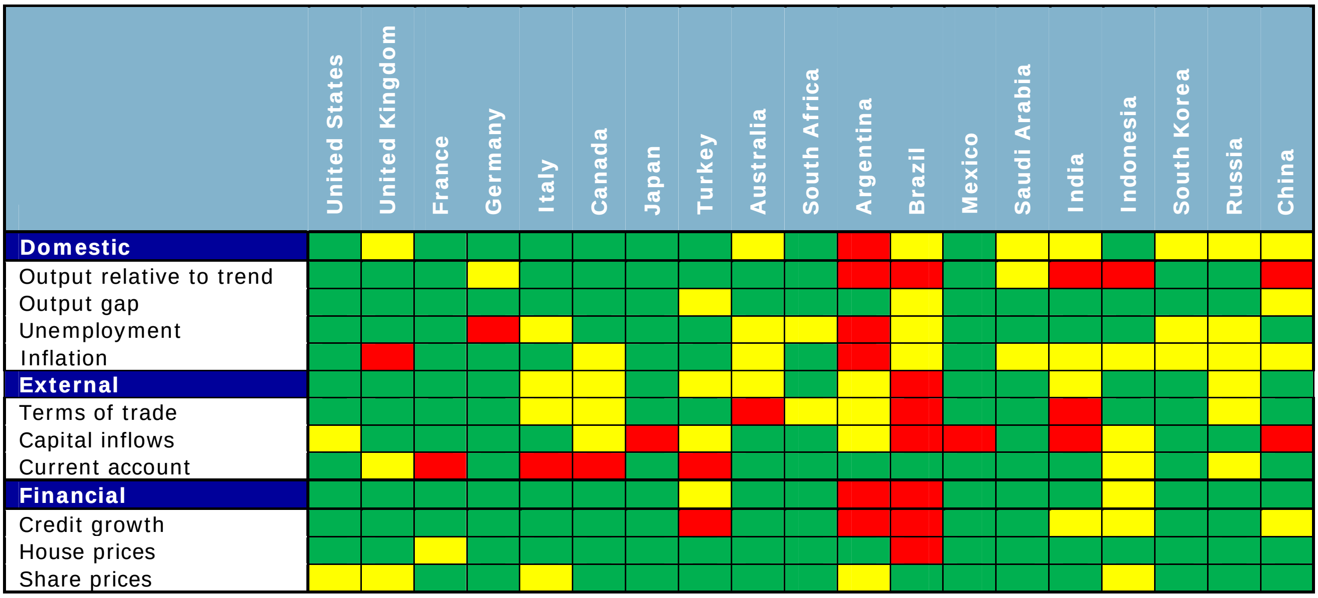
Table 1: Overheating indicators of IMF



Source: IMF World Economic Outlook September 2011