G-24 Policy Brief No. 75
04/06/2012

Roberto Frenkel

Managing Capital Flows in Emerging Markets

The current wave of capital inflows to emerging markets is influenced by the higher returns that assets from these countries offer in comparison with advanced countries. The low rates of growth and interest rates in advanced countries are most likely a transitory phenomenon. Their real and financial yields will probably both rise in the near future. In any case, the high growth that emerging markets have been experiencing since the early 2000s should persist. Although the growth rates of emerging markets and advanced countries had shown a high correlation since the 1950s, they diverged in the 1970s, and then more recently in the period of financial globalization (IMF, 2010)[1]. This trend has persisted during and after the global financial crisis of 2007 to 2008.

Besides the yield differentials, current capital inflows are determined by the reduction of perceived risks in emerging markets. These economies have participated differently in international financial markets since the Asian and Russian crises in 1997 to 1998. One key change has been the switch from current account deficits to surpluses in the balance of payments of many emerging markets, which also involved a change in the direction of net capital flows between advanced countries and emerging markets.

Other relevant changes that have reduced the perception of risks are the substantial accumulation of foreign exchange reserves and more flexible exchange rate regimes. These changes helped reduce the segregation of emerging market assets and the risks of contagion and herd behaviour within this class of assets. As a result, the reduction in perceived risks also spread to those emerging market economies that kept running current account deficits or did not move towards more flexible exchange rate regimes.

The global financial crisis was like a stress-test for emerging markets. With the exception of a few European countries, none suffered external or financial crises, and there was no sovereign debt default. Moreover, international financial integration has continued after the crisis. The increase in IMF financial resources and the greater flexibility in the implementation of its programs have also helped prevent crises in emerging markets. These new features seem to be durable. Overall, the crisis and the changes in the IMF have reinforced the previous perception of emerging markets. Thus, the low risks associated with emerging markets will continue in the foreseeable future.

Between 2003 and 2007, Latin America ran a current account surplus. In 2008, it turned into a deficit that widened until 2010. In fact, Mexico, Colombia, and most Central American and Caribbean countries ran current account deficits during most of the last decade. Thus, the dynamics described are mostly due to the other South American countries. Without changes in current economic policies, forecasts – including those of the IMF (2011)[2] – indicate that current

account deficits in these economies will widen.

Does this tendency of increasing current account deficits represent a threat of crisis, as in the past? The answer is probably not in the foreseeable future, due to the changes in the composition of current accounts in the last decade. Foreign debt in these countries has shrunk substantially in this period. Thus, unlike the last three decades of financial globalization, the share of interest payments in the factor income account is significantly lower and most of the deficit is explained by dividends to foreign direct investment. Hence, for a given current account deficit, the external fragility of its current composition is substantially lower than in the past. Current account deficits are now financed with foreign direct investment, with a high proportion of retained utilities.

This is more optimistic than the IMF Regional Economic Outlook for the Western Hemisphere of April 2011 – which warned of increasing current account deficits and the potential risks of a capital inflows reversal. Implementation of policies that reduce capital inflows and offset and mitigate their effects is crucial and urgent.

The main reason is because of the effects that capital inflows have on the real exchange rate, which threaten economic activity, employment and, more generally, economic development in these countries. These real effects take time to become visible and are largely irreversible. The current wave of capital inflows into Latin America will probably lead to Dutch Disease-like phenomena, rather than to external and financial crises. Furthermore, mitigating policies should be promoted, precisely because the reduced threat of crisis reduces the incentive for governments to implement them.

The future is uncertain. Conjectures about the future necessarily have to deal with uncertainty. Will the more favorable terms currently seen in trade persist? Will the current external financial conditions persist? No one can be sure. Economic authorities should be especially cautious in the face of uncertainty.

In this regard, the design of economic policy should stick to two principles. First, it should include all elements to ensure that the proposed goal is achieved in all foreseeable scenarios. The second is to minimize the potential damage that an economic policy could cause if the conjectures on which it is based are wrong.

Following these principles, a prudential attitude would suggest implementing measures to offset or mitigate the effects of capital inflows. These measures should be adopted, not only to avoid domestic asset bubbles and to control inflation, but also because not adopting them could lead to external and financial crises, and consequently, considerable damage, if the terms of trade deteriorate or international financial conditions change.

Prudential economic policy design should broaden consideration of the potential negative effects of capital inflows and include those associated with Dutch Disease. These effects should be taken as seriously as those associated with the risks of external and financial crises because they are largely irreversible. It is well documented, both theoretically and empirically, that a transitory real exchange rate appreciation can have long-lasting effects on the manufacturing sector in the form of permanent destruction of physical, organizational and human resources. Furthermore, prudent management of the real exchange rate is a sound strategy, even when favorable terms of trade and international

financial conditions endure, as the long-term effects of Dutch Disease are also uncertain.

Magud and Sosa (2010; cited by the REO for the Western Hemisphere, April 2011)[3] argue that studies on the effects of the Dutch Disease (meaning an equilibrium appreciation of the real exchange rate) on economic growth are inconclusive. But the same survey acknowledges the existence of substantial evidence that the Dutch Disease leads to a contraction of employment and activity levels in manufacturing. It also acknowledges robust evidence that real exchange rate overvaluation, however defined, hurts growth.

Clearly, the Dutch Disease is likely to undermine the industrial sector. Should a developing country follow this strategy, even if favorable external conditions last? A prudent approach would advice against such a strategy, not only because the empirical evidence is weak, but also because we now face a new, uncertain and still fast-changing global context that we are still trying to understand.

What criteria should guide the choice of measures and degree of intervention to offset or mitigate capital inflows and their effects? Which indicators should be used to gauge interventions in the foreign exchange market, the fiscal policy stance, the interest rate and implementation of capital controls? Recent documents of the IMF focus mostly on financial system and current account indicators and largely ignore the real exchange rate. This orientation prioritizes the reduction of risk of external and financial crises, but neglects Dutch Disease risks.

The arguments for such prioritization are not strong. First, the "equilibrium" real exchange rate is invoked without a precise definition of the term. Definition of the equilibrium real exchange rate has always been controversial in economics. In today's context of high capital mobility, significant current account surpluses and deficits may last for very long periods, thus weakening the empirical and policy relevance of the equilibrium real exchange rate notion.

Besides, the real exchange rate involves several currencies. Thus, if the real exchange rate of some economies are misaligned (as IMF documents emphasize), those of the rest of the world should also be. Recent references to the equilibrium real exchange rate do not go beyond the imprecise notion that current rates should be higher than in the past because the terms of trade, international financial conditions and other fundamentals have improved for emerging markets.

Beyond the theoretical difficulties in defining the equilibrium real exchange rate, there are others associated with their calculation and the contrast with observed real exchange rates. Berg and Miao (2010)[4] estimate equilibrium real exchange rates using a Fundamental Equilibrium Exchange Rate Model with income per capita and the other usual variables (terms of trade, openness, investment and public spending) as regressors for a panel of 181 countries during 1950 to 2004. The residual of the regressions estimates the degree of misalignment (either undervaluation or overvaluation relative to the equilibrium exchange rate). The authors compare these estimates with those obtained using the same sample with an equilibrium real exchange rate model defined as the purchasing power parity adjusted by income per capita as a measure of the Balassa-Samuelson effect (Rodrik, 2008).[5] The correlation coefficient between the two estimations is 0.96.

Because the degree of overvaluation and undervaluation is estimated from the residuals of the regressions, the periods and degrees of undervaluation and overvaluation tend to be

very similar for different methodologies. There is a clear empirical explanation for this result: regardless of the particular variables included in the Fundamental Equilibrium Exchange Rate Model, the explanatory power of the regressions rests on the income per capita variable.

As income per capita is mostly a time-trend variable, the estimated equilibrium real exchange rates move around the time trend of observed real exchange rate series. As a result, estimated over- and under-valuations are essentially deviations from the time trend of the observed real exchange rate series. Based on this, for whatever econometric model, the estimated values for all countries in South America would be very similar to the time trends of the series, and this would suggest that the observed real exchange rates for almost all of them were overvalued in 2010.

Would this information be enough to inform the exchange rate policies of these countries? Probably not, because identifying the most appropriate real exchange rate levels for different economic policy goals should be priority. Past observation of the economy evaluated using different econometric models only provide a rough indication of the degree of overvaluation. For instance, current real exchange rates in most Latin American countries are similar to the highest levels in the last three decades. To assess whether these levels are appropriate or not for particular policy objectives, this information needs to be complemented with other indicators.

Evaluating whether a certain degree of real exchange rate appreciation is enough to avoid the Dutch Disease is more complicated. The negative effects of real exchange rate appreciation on the real economy become manifest gradually over time, and when they become apparent, they may be hard to reverse. To begin with, the short-run effects of appreciation on aggregate demand are usually expansive.

At the same time, gradual substitution effects reduce demand for domestic industrial production. At the firm level, there are incentives to substitute labour and domestic value added to protect competitiveness. The reduction of industrial employment occurs due to the closure of firms – mostly SMEs – and the reduction of personnel in surviving ones. All these effects typically take time. Several studies of lasting real exchange rate appreciations in Latin America have shown that the negative employment effects became evident after a two-year lag.

For these reasons, the authorities in a country that seeks to offset or mitigate the effects of the Dutch Disease have to anticipate its manifestations. To do this, they should have detailed information about industrial sector competitiveness to assess the appropriateness of the real exchange rate level.

The large capital inflows vis-à-vis the size of the foreign exchange and domestic financial markets in emerging market economies limits the ability to sterilize foreign exchange interventions. Similarly, the volume of capital inflows is typically too large compared to the fiscal space of governments to influence the exchange rate using fiscal policy. Regulation of capital inflows, on the other hand, is not very effective, especially in economies that have completely opened their capital accounts.

Given these limitations, it seems reasonable to implement fiscal, monetary and capital control policies simultaneously in a coordinated way. In particular, coordination between the economic authorities and central banks – absent in many Latin American

economies – seems crucial to make them more effective.

Recent IMF documents are sceptical regarding the effects of buying interventions by central banks in foreign exchange markets. They disregard "early interventions" and suggest only intervening when the exchange rate has substantially appreciated so as to dissipate expectations of further appreciation. The underlying rationale seems to be that agents "know" the equilibrium exchange rate and believe that markets will take the exchange rate in that direction. However, recent IMF documents acknowledge the possibility of domestic price asset bubbles including the domestic currency, i.e. exchange rate appreciation can be the result of a bubble in the foreign exchange market.

The observed lack of effectiveness of recent official interventions in the foreign exchange market may be the result of the inability to change agents' expectations about future evolution of the exchange rate. Strong interventions by the central bank – making clear the authorities' will to manage the exchange rate – could influence private sector expectations and thus reduce selling positions and capital inflows. Thus, a key goal of central bank interventions in the foreign exchange market should be to change market expectations. Interventions should make clear the power of central banks and their desire to influence the exchange rate over the medium run.

Roberto Frenkel *is Senior Research Associate at the Center for Economic and Policy Research (CEPR).*

[1] IMF (2010). *Regional Economic Outlook, Western Hemisphere*, October 2010. International Monetary Fund, Washington, DC.

[2] IMF (2011). *World Economic Outlook*, April 2011. International Monetary Fund, Washington, DC.

[3] Magud, Nicolás, and Sebastián Sosa (2010). When and Why Worry About Real Exchange Rate Appreciations? The Missing Link between Dutch Disease and Growth. IMF Working Papers 10/27.

[4] Berg, Andrew, and Yanling Miao (2010). The Real Exchange Rate and Growth Revisited: The Washington Consensus Strikes Back? IMF Working Paper 10/58.

[5] Rodrik, Dani, (2008). The Real Exchange Rate and Economic Growth. *Brookings Papers on Economic Activity*, 2.