Emerging Market *Dilemma*

The paradox of global capital flows.

By Kevin P. Gallagher

In 2012, Brazilian President Dilma Roussef scolded Fed Chairman Ben Bernanke's monetary easing policies for creating a tsunami of financial flows to emerging markets that was appreciating currencies, causing asset bubbles, and generally exporting financial instability to the developing world.

Now, as growth increases in the United States and interest rates follow, the tide is turning in emerging markets. Many countries may be facing capital flight and exchange rate depreciation that could lead to financial instability and weak growth for years to come.

The Brazilian president had a point. Until recently, U.S. banks wouldn't lend in the United States despite the unconventionally low interest rates. There was too little demand in the U.S. economy and emerging market prospects seemed more lucrative.

From 2009 to 2013, countries such as Brazil, South Korea, Chile, Colombia, Indonesia, and Taiwan all had wide interest rate differentials with the United States and experienced massive surges of capital flows. The differential between Brazil and the United States was more than 10 percentage points for a while—a much better bet than the slow growth in the United States.

According to the latest estimates by the Bank for International Settlements, emerging markets now hold a staggering $2.6 trillion in

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international debt securities and $3.1 trillion in cross border loans—the majority in dollars.

Official figures put corporate issuance at close to $700 billion since the crisis, but the BIS reckons that the figure is closer to $1.2 trillion when counting offshore transactions designed to evade regulations.

Floating exchange rates and the resulting depreciation can cause the debt burden of firms and fiscal budgets to bloat overnight.

Now the tides are turning. China's economy is undergoing a structural transformation that necessitates slower growth and less reliance on primary commodities. Oil prices and the prices of other major commodities are stabilizing or on the decline. It should be no surprise then that many emerging market growth forecasts are continually being revised downward. Meanwhile, growth and interest rates are picking up in the United States. The dollar gains strength, the value of emerging market currencies falls.

Some analysts predict that emerging market and developing countries can weather the storm through floating exchange rates, the development of local bond markets, interest rate hikes, or by using some of their foreign exchange reserves. These tools are important, but may not be available or enough.

Floating exchange rates and the resulting depreciation can cause the debt burden of firms and fiscal budgets to bloat overnight. Given that most of the capital inflows were in dollars, depreciating currencies mean that nations and firms will need to come up with ever more local currency to pay debt—but in a lower-growth environment.

What is more, most countries didn't properly invest their commodity windfalls into increasing the competitiveness of their industries, and thus exports may not pick up at all. An International Monetary Fund study shows that while Latin America saw one of the biggest commodity windfalls in its history, it has the least to show for it in terms of savings or investment relative to other booms. What is more, the massive exchange rate appreciation that occurred as a result of the tsunami in short-term inflows deemed many industries uncompetitive and pulled them out of key global commodity chains.

Thus, weak currencies and more debt may be apt to lead to falling confidence rather than surges in exports that will help their countries adjust to the new shocks.

Local bond markets help but most debt is indeed in dollars and most local debt is held by foreigners who are always the first to dump such debt for foreign shores. Interest rate hikes can also be dangerous. They are often not enough to reverse the flight to the United States and can choke off what little growth there is to be had in a downturn. Depleting foreign exchange reserves doesn't always work, and non-Asian countries whose reserves are a function of the commodity boom will be reluctant to disperse such reserves in the wake of commodity price declines.

The problem is that too many countries failed to regulate during the boom and instead let capital flows storm into their countries to bloat balance sheets and currency values. They are left with increasing debt as currencies slide, and not enough competitiveness to benefit from currency depreciation. The result could be more financial instability that could further threaten prospects for growth and employment.

Emerging market and developing countries may need to resort to regulating the outflow of capital alongside these other measures. Such moves have traditionally been shunned by international institutions and capital markets alike.

New research on the cutting edge of economics and by the IMF now justifies the regulation of capital outflows to prevent or mitigate a full-blown crisis. The IMF was bold in recommending the regulation of inflows during the surge, but has shied from noting the utility of regulating capital in flight. Worse, new U.S. trade agreements such as the Trans-Pacific Partnership have stripped out balance-of-payment exceptions that allow nations to regulate capital.

Now the tides are turning.

If we have learned anything from the global financial crisis, it is that nations need as many tools at their disposal as possible to prevent and mitigate financial instability. Instability anywhere can lead to instability everywhere, so let's make sure all tools and hands are on deck. ◆