UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

No. 40
DECEMBER 2015

POLICY BRIEF

WHEN THE TIDE GOES OUT: CAPITAL FLOWS AND FINANCIAL SHOCKS IN EMERGING MARKETS

Key points

- Developing countries are currently experiencing their fourth dip in capital flows since the financial crisis of 2008
- Currency swap arrangements offer an immediate option for alleviating liquidity shortages
- Regional monetary arrangements to provide countercyclical financing can offer a promising avenue
- Another option is the creation of a common regional fund with a periodic increase in paid-in capital

UNITED NATIONS
UNCTAD

Capital ebbs and flows

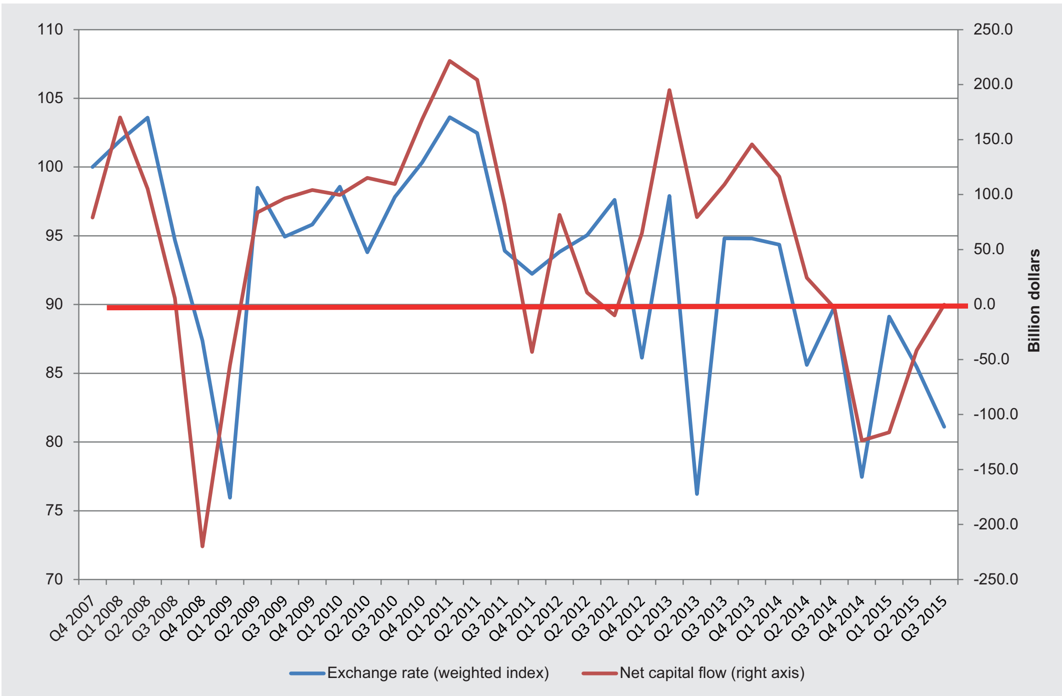
Developing countries are currently experiencing their fourth dip in capital flows since the financial crisis of 2008 (figure 1). The first occurred at the end of 2008 during the global meltdown, but the drop was as short as it was steep, and inflows rebounded almost immediately. The second dip took place in the first half of 2011 when contagion from the Greek crisis again sent net flows into negative territory, albeit less severely, followed by a swift recovery. The dips in early 2012 and early 2013 were short, the latter when the Federal Reserve of the United States of America hinted at a tightening of its monetary policy. The Federal Reserve kept interest rates on hold, however, and calm was quickly restored. The current dip is significantly more worrying; net flows have been declining since late 2013 and have been in negative territory for at least 12 months.

Arguably, the second dip should have acted as a warning about possible cracks in the financial system of some emerging markets. However, lingering talk of decoupling and the aggressive search for yield by investors attempting to profit from the quantitative easing experiments in advanced countries contributed to maintaining confidence and encouraged the further build-up of debt, with an increasingly heavy focus on private sector lending.

Since the beginning of 2015, the cracks have appeared to widen in a number of emerging markets as the prospects for robust global growth have receded and the decoupling euphoria has worn off. Indeed, a combination of weak

Figure 1

Aggregate net capital flow and weighted exchange rate index for selected emerging markets



Source: Thomson Reuters Eikon and national central banks.
Notes: Partial estimates of net capital flow are given for the third quarter of 2015. Countries included are Brazil, China, India, Indonesia, Malaysia, Mexico, the Russian Federation, South Africa, Thailand, Turkey and Ukraine. 100 = fourth quarter of 2007.
Abbreviations: Q1, first quarter; Q2, second quarter; Q3, third quarter; Q4, fourth quarter.

global trade numbers and falling commodity prices would have created problems in several emerging markets, but vulnerabilities have become much more evident and widespread, with capital outflows preceding an interest rate hike in the United States.

Dangerous liaisons

The liberalization of financial markets and services was expected to create more opportunities for investment and growth in developing economies. However, such moves, particularly involving an opening of the capital account, should have carried an economic health warning about possible destabilizing effects from surges and sudden stops in capital flows and the potential serious economic damage these can cause. Years of cheap capital following the dot-com crisis of 2000 encouraged the private and public sectors in many developing countries to load up on debt, which rose in those countries by $8.1 trillion between 2000 and 2007.[1] This build-up was from a relatively low base, and signs of financial fragility were masked by strong growth performances and debt relief for poor developing countries. However, between 2007 and 2014, debt rose by a further $23 trillion, with the average aggregate debt-to-gross domestic product ratio reaching over 120 per cent and, in a number of cases, considerably higher.[2]

Once a crisis hits, the normal response is to devalue or let the domestic currency depreciate. This will help to rebalance the external account, averting a stampede of investors while reducing the pressure on existing debt stock through a return to faster growth. For a few economies after the Asian crisis in the late 1990s, this option worked partially, but not without serious social and economic disruptions. However, given the current health of the global economy, this appears a less plausible option. Moreover, financialization pressures in many emerging economies have complicated the situation as foreign investors have been able to take larger positions in domestically dominated asset classes, and foreign bank presence has expanded.

The danger of capital outflows triggering a crisis in emerging markets now seems more likely as mutually reinforcing deflationary trends combine capital outflows with declining stock markets, falling bond prices and depreciating currencies, pulling down growth, lowering fiscal revenues and adding to debt woes (figure 2). But the potentially damaging consequences of liberalizing financial markets and the capital account are not restricted to external shocks and imbalances. When domestic assets – typically real estate, equities and other financial assets – are collateralized, margin trading can quickly lead to excessive leveraging. This is familiar from advanced economy crises, but the recent turmoil on the Chinese Shanghai and Shenzhen stock exchanges also seems closely associated with margin debt.[3] The potential for problems in developing markets is compounded by the growing share of equities held by overseas residents and the consequent likelihood of a rapid exit as prices decline.

The reversal of fortunes and loss of market capitalization in the Chinese case induced a likely decrease in domestic demand as other collateralized loans faced margin calls with tumbling asset prices. In addition, this had spillover effects in neighbouring countries and around the world as other equity markets fell in turn. Furthermore, the moves towards liberalizing the foreign exchange market in China and the subsequent depreciation of the renminbi prompted depreciation of other currencies in the region, including in developed countries such as Australia and New Zealand. The instability of foreign exchange and asset markets is also related to continuing downward pressures on international commodity prices, on which many developing countries still depend.

Policy recommendations

What does this suggest about the economic prospects in emerging economies? With economic activity slowing sharply and surveys of private sector companies now indicating contraction even for manufacturing sectors,[4] the omens are not good. Predicting where the next crisis will be is best left to those with a more speculative bent, but the emerging corporate debt market, where there are already strong indications that the leverage ratio in several countries has reached the peak seen in developed countries just before the 2008 crisis, needs to be carefully monitored. If history is any guide, and as the current situation in Europe illustrates, a prolonged shock to that market could quickly lead to sovereign debt crises.

In the medium run, much will depend on whether or not the advanced economies can find the right policy mix to return to their growth potential. In the shorter run, much will depend on how much fiscal and policy space a particular developing economy has available to counter a deflationary debt spiral. China's direct intervention helped

1. The figures quoted in this paragraph do not include the financial sector debt.
2. McKinsey Global Institute, 2015, Debt and (not much) deleveraging, McKinsey and Company, February, available at http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging, accessed 4 December 2015.
3. Bank for International Settlements, 2015, EME vulnerabilities take centre stage, *BIS Quarterly Review*, 13 September, available at http://www.bis.org/publ/qtrpdf/r_qt1509a.htm, accessed 4 December 2015.
4. Ibid.

stabilize the situation triggered by the stock market collapse. However, its massive reserve cushion is a luxury that few countries possess. Most countries can still employ an array of controls to stem capital haemorrhaging before it can exert undue influence on exchange rates and destabilize domestic financial markets. The International Monetary Fund has already signalled its willingness to endorse such measures, although more active guidance on their use, including during capital bonanza periods, would be welcome.

In the absence of sufficient fiscal and policy space to fend off a more prolonged crisis, future economic prospects lie outside the remit of domestic policy alone.

Providing sufficient liquidity to counter a deflationary spiral runs up against the dysfunctionality of the existing international monetary system, which provides too much when least needed and too little when most needed. Expanding the role of special drawing rights could offer one way of rebalancing the system, delinking the provision of international liquidity from its current reliance on the dollar. Expanding loan facilities of the International Monetary Fund could also help. However, this does not look likely at present and would require reform of its governance and policy orientation to be made attractive to developing countries.

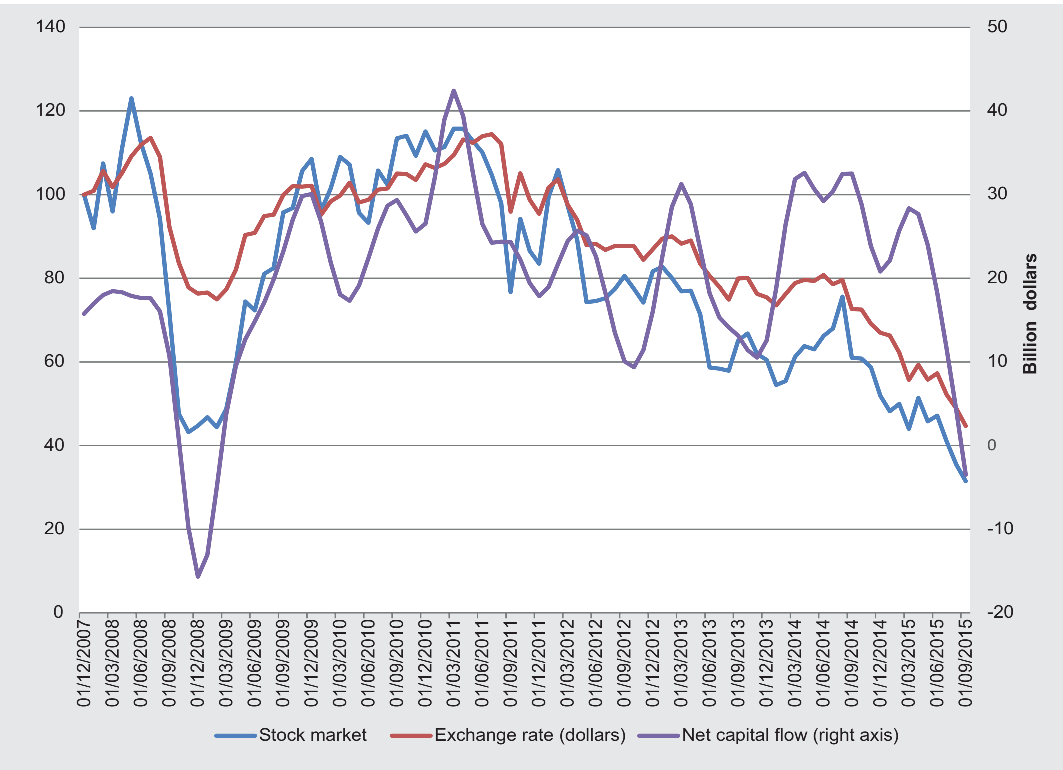
Currency swap arrangements, including among central banks in the South, offer a more immediate option for alleviating liquidity shortages. To date these arrangements have been centred on the United States Federal Reserve, and only one such arrangement with other systemically important central banks from advanced economies remains permanently in place. However, the recently established New Development Bank has established a contingent reserve arrangement among its founding members, and the Peoples Bank of China entered into a swap arrangement with Argentina in July 2014. Scaling up and widening the scope of these types of initiatives could help obviate the need for self-insurance in the form of large, but costly, foreign exchange earnings.

Regional monetary arrangements to provide countercyclical financing can also offer a promising avenue. Several are already operational, although none as yet on a sufficient scale. Again, interregional swap arrangements, such as the Chiang Mai Initiative, would help in scaling up. Regional payments systems, such as those already in use in parts of Latin America, can help to mitigate exchange rate uncertainty and risk, as well as promote interregional trade by cutting transaction costs. Another option worth exploring is the creation of a common regional fund with a periodic increase in paid-in capital, which could be used to increase liquidity provision and credit support among its members. The Latin American Reserve Fund and the Arab Monetary Fund provide working, albeit tentative, examples.

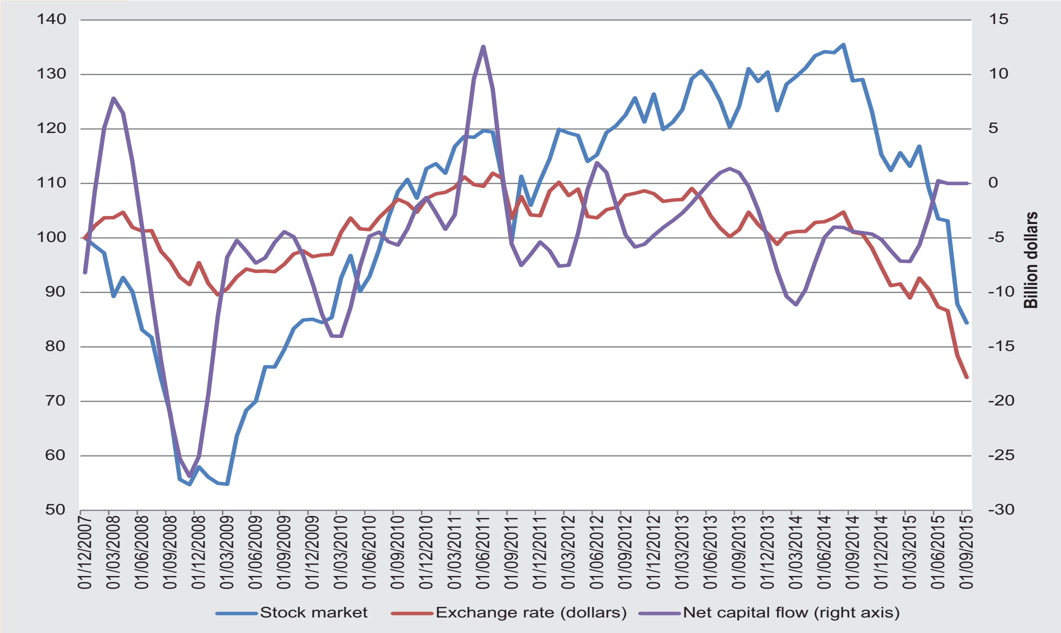
Figure 2

Capital flows, exchange rates and stock markets in selected emerging economies, December 2007–September 2015

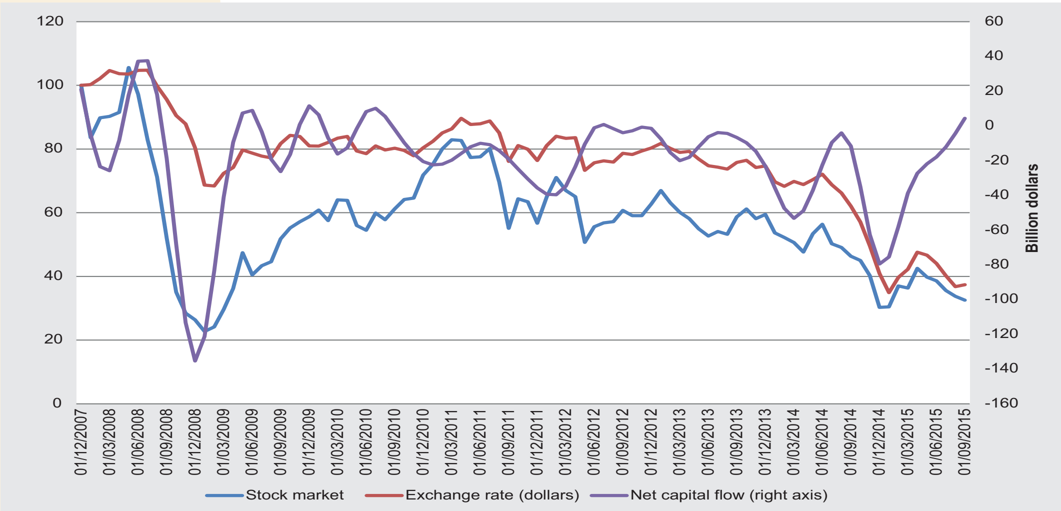
a) Brazil



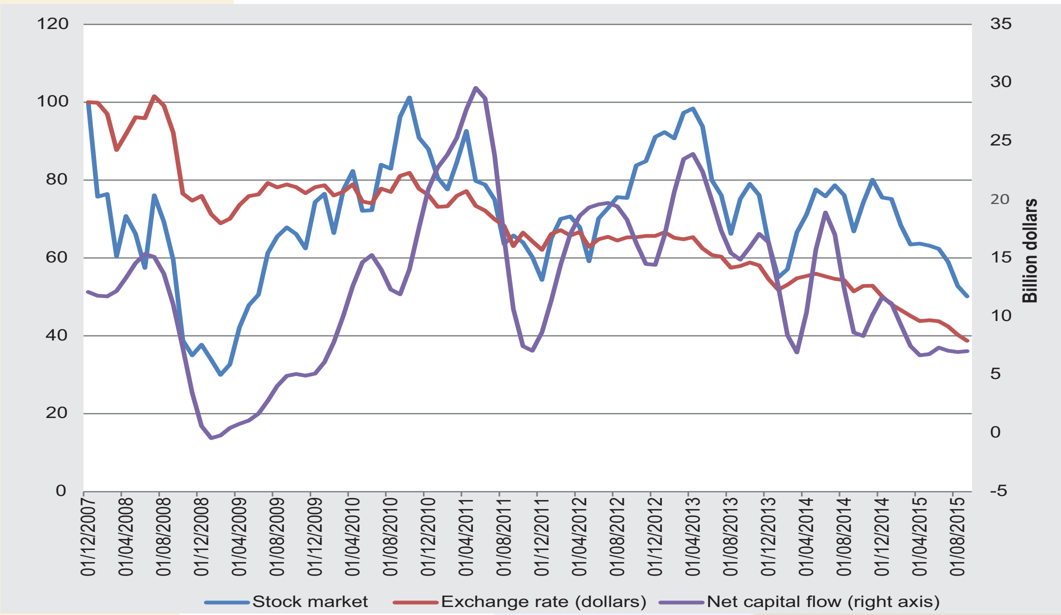
b) Malaysia



c) Russian Federation



d) Turkey



Source: Thomson Reuters Eikon and national central banks.
Notes: Net capital flow data is extrapolated through a cubic spline function to the monthly frequency. Net capital flow for July–September 2015 is partially estimated. 100 = December 2007.

Contact

Richard Kozul-Wright
Director
Division on Globalization and Development Strategies
Tel. 41 22 917 5615
richard.kozul-wright@unctad.org

Press Office
41 22 917 58 28
unctadpress@unctad.org
www.unctad.org

UNITED NATIONS
UNCTAD

UNCTAD/PRESS/PB/2015/14 (No. 40)