LOWY INSTITUTE
FOR INTERNATIONAL POLICY

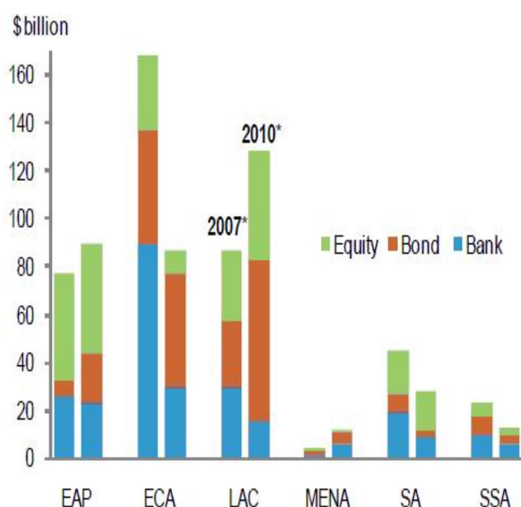
International Economy Comments

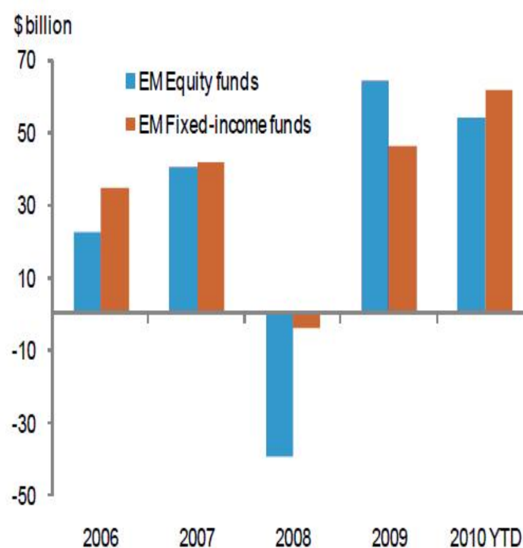
IEC #6, 18 NOVEMBER 2010

HERE WE GO AGAIN . . . ?

Although there are good reasons for large capital inflows into emerging markets right now, there's still a significant risk that this latest surge will end in tears.

Capital is once again pouring into emerging markets. Last month, the Institute of International Finance (IIF) revised up its forecasts for net private capital flows to emerging economies in 2010 by more than US$100 billion. In April, the IIF had forecast net flows of US$709 billion; now it is expecting US$825 billion. That's well up on last year's US$581 billion, and would be the second highest dollar amount since 2007's record US$1,285 billion.[1] The emerging market asset class has been booming: net inflows to emerging market bond funds in the nine months to end-September were more than US$39 billion, or 430 per cent of their best ever full-year totals, while year-to-date inflows into emerging market equity funds have already exceeded 2009's (full year) record of US$44 billion:





Source: World Bank Development Prospects Group, *Developing Trends: October 2010*. *International Finance*. (2010). EAP is East Asia and Pacific; ECA Europe and Central Asia; LAC Latin America and the Caribbean; MENA Middle East and North Africa; SA South Asia, and SSA Sub-Saharan Africa.

The recovery in net inflows resumes a trend that was rudely interrupted by the financial crisis. Between 2003 and 2007, emerging markets had benefitted from a global financial bonanza.[2] Loose monetary policy, low risk aversion and rapid financial innovation together contributed to a quintupling of net capital inflows to emerging markets at the same time as spreads on foreign debt fell from 656 basis points (bp) in 2000 to 168 bp by the end of 2007. Those good times came to an

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abrupt halt in the final quarter of 2008, when investors suddenly decided that they preferred traditional ‘safe’ assets after all. But now, it seems, they are back.

In fact, there are several sensible reasons for investors to be reallocating their portfolios towards emerging markets right now, including:

- The long-term shift in the geography of the world economy driven by the Great Convergence (IEC#4);

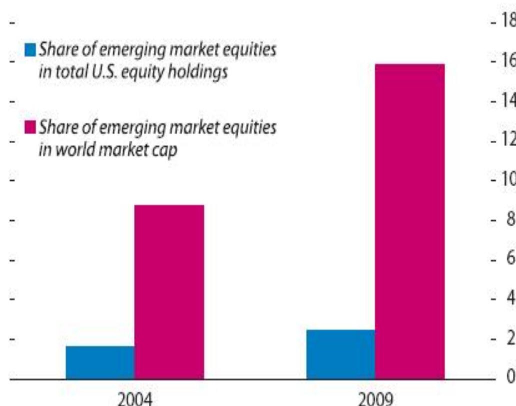
- The trend growth outperformance of emerging markets relative to the developed world in the aftermath of the financial crisis (IEC#2 and IEC#3);

- The changing global profile of sovereign risk (IEC#1); and

- Rock-bottom policy rates combined with quantitative easing targeted at long-term rates in much of the developed world.

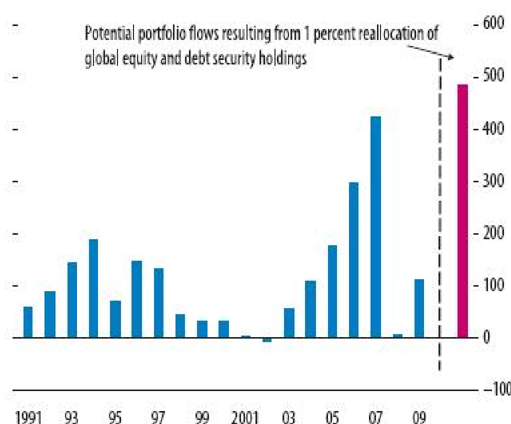
There is also plenty of scope for the current increase in flows to continue.

Figure 1.29a. Emerging Market Equities Market Capitalization and Investor Allocations
(In percent)



Sources: Bloomberg, L.P.; IMF Coordinated Portfolio Investment Survey; Federal Reserve; and IMF staff estimates.

Figure 1.29b. Portfolio Flows to Emerging Markets and Developing Countries
(In billions of U.S. dollars)



Sources: Bloomberg, L.P.; Haver Analytics; IMF World Economic Outlook database; and IMF staff estimates.

Source: International Monetary Fund (IMF), *Global Financial Stability Report: Sovereigns, funding and systemic liquidity*. (2010)

According to the IMF, with rich world investors typically significantly underweight emerging market assets relative to an allocation based on market capitalisation, the reallocation of even a small proportion of financial assets of the advanced economies could have very large effects. For example, the Fund reckons that total emerging market assets only account for around two to seven per cent of real money portfolios

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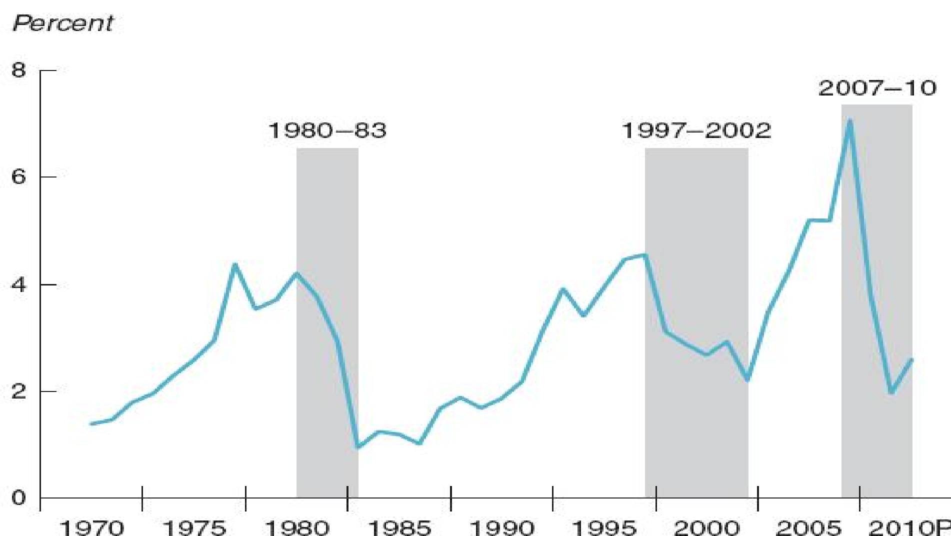
at present. Just a one percentage point reallocation of global equity and debt securities held by G-4 real money investors would result in additional portfolio flows of US$485 billion – larger than the record annual portfolio flows of US$424 billion recorded in 2007.[3]



Source: World Bank, *Global Development Finance 2009: Charting a global recovery*. (2009)

The worry, however, is that we have been here before. A quick look at the last few decades confirms that we have seen repeated surges of private capital into emerging economies, and each time the story has ended in tears.

- In the 1970s, the profits from OPEC-powered oil prices were deposited in developed economy banking systems which then 'recycled' a large chunk of this money to developing country borrowers, typically in the form of syndicated bank loans. While real interest rates stayed low, the recycling process appeared to be a success, but OPEC2, higher inflation, and the Volcker shock pushed up real rates, triggered recession in the developed world, and drove many developing country borrowers into crisis. The result was the infamous 'lost decade'.

- The next wave of capital inflows came in the 1990s. This time the drivers were a fall in global interest rates; recessions in the US, Japan and much of

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Europe encouraging a search for better returns elsewhere; improved actual and perceived creditworthiness in the developing world; and the increasing globalisation of financial markets. There was a brief interruption to inflows following the early warning that was the Mexican crisis in1994/95 before the Asian financial crisis and the Russian default brought this wave to another painful end.

- The third wave began in the early part of this century, and again reflected some familiar drivers: low global interest rates, financial internationalisation and innovation, and the search for yield. The GFC provided what now looks to have been a brief interruption, but capital is flowing once more.

There's an obvious pattern here.[4] Low interest rates and/or growth prospects in the developed world spark a search for yield, prompting investors to turn to emerging markets. For a while, the inflows encourage a self-reinforcing boom in the recipient economies. But then appetites change, capital flows reverse (sometimes in the form of a painful 'sudden stop'), and the borrowers face a process of painful adjustment. Empirical work by Carmen and Vincent Reinhart finds that capital inflow 'bonanza' periods in emerging markets are associated with a higher incidence of banking, currency, and inflation crises, and systematically precede sovereign defaults.[5] Similar work by the IMF finds that more than one-third of episodes of large net private capital inflows ended with a sudden stop or currency crisis.[6]

Will we see a repeat? It's certainly possible. Sure, it's true that there are several important features distinguishing this boom from its predecessors. But betting on 'this time is different' typically hasn't been the best *long-term* strategy.

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[1] Institute of International Finance (IIF), *Capital flows to emerging market economies.* IIF Research Note. Washington DC, Institute of International Finance, 4 October, 2010.
[2] World Bank, *Global economic prospects 2010: Crisis, finance and growth.* Washington DC, World Bank, 2010.
[3] International Monetary Fund (IMF), *Global Financial Stability Report: Sovereigns, funding and systemic liquidity.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2010.
[4] See in particular Carmen M Reinhart and Vincent R Reinhart, Capital flow bonanzas: An encompassing view of the past and present, in *NBER International seminar on macroeconomics 2008*, ed. Jeffrey Frankel and Christopher Pissarides. Chicago, University of Chicago Press, 2009.
[5] Ibid. On sudden stops, the key reference is Guillermo Calvo, Capital flows and capital market crises: The simple economics of sudden stops. *Journal of Applied Economics* 1 (1) 1998.
[6] See Chapter three in International Monetary Fund (IMF), *World Economic Outlook: Globalization and Inequality.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2007.

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