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Capital flows to emerging economies - prelude to the next crisis?

By Dr. Ulrich Volz,
German Development Institute /
Deutsches Institut für Entwicklungspolitik (DIE)

The Current Column

of 2 May 2011

Capital flows to emerging economies – prelude to the next crisis?

The money is flowing again. After the withdrawal of massive sums by banks and other financial investors from emerging economies following the Lehman crash in September 2008, investment has again been strong since mid-2009. The Institute of International Finance (IIF) in Washington estimates private net capital flows to emerging economies in 2010 at US$ 908 billion, 50 per cent higher than in 2009. And it anticipates a further rise in private capital movements to emerging economies to US$ 960 billion in 2011 and US$ 1,009 billion in 2012.

While most industrialised countries continue to struggle with the aftermath of the global financial crisis, the economies of many developing and emerging countries are again experiencing strong growth. In the recently published World Economic Outlook the International Monetary Fund (IMF) estimates that the industrialised countries will grow by 2.4 per cent in 2011 and by 2.6 per cent in 2012, whereas the IMF expects the growth rate in developing and emerging countries to be 6.5 per cent in both years. It is even anticipated that the Asian developing and emerging countries will grow by over 8 per cent in 2011 and 2012. These significantly improved growth prospects are attracting investors, as are the strong fundamental data on most emerging economies, positive interest rate differentials and expected revaluations of their currencies. The still expansive monetary policies pursued by most industrialised countries are, moreover, resulting in high global liquidity, which is flowing not only to the international oil, raw materials and food markets but also to the emerging economies in search of returns.

These capital flows pose a major challenge for the emerging economies and entail huge risks - even of financial crises. First and foremost, there is a danger of a "sudden stop" of the capital flows or even of a rapid withdrawal of portfolio investments. The latest example is the withdrawal of capital from the emerging economies despite good fundamental data owing to the liquidity squeeze suffered by international banks and investors during the global financial crisis. Net capital flows to emerging economies fell by 52 per cent to US$ 622 billion in 2008. IMF studies show that capital flows have become more volatile in recent decades – more so for emerging economies than for industrialised countries. Current financial flows to emerging economies are dominated by portfolio investments in bond markets, which have historically been particularly volatile. In contrast, direct investments, which tend to be long-term in nature and to which the greatest development effects are generally ascribed, are again on the decline.

A second problem is that international capital flows may help bubbles to form. In many emerging economies credit allocation fuelled by low real interest rates has already led to a boom in capital markets and the real estate sector. Further external capital flows may encourage the tendency for bubbles to form. The recent experience of such crisis-hit countries as the US, Ireland and Spain, whose investment booms not so long ago were similarly fuelled by external investments, should cause concern.

And thirdly, capital flows increase inflationary pressure in the emerging economies, especially when they are bracing themselves against a revaluation of their currencies, as is currently the case. Intervention in the foreign exchange market aimed at preventing or weakening currency revaluations increases the money supply and complicates the central bank's monetary policy. Although sterilisation is possible, it is not without its costs or, indeed, always effective. In addition, too lax a monetary policy for preventing further capital inflows and the concomitant currency revaluation may exacerbate the risk of inflation. The rise in prices on the international raw materials and food markets has already led to a significant increase in inflationary pressure in emerging economies. For some time now many of these countries, including China and India, have been wrestling with growing rates of inflation and especially with rising food prices.

Emerging economies have a number of policy options for counteracting inflationary pressure and the formation of bubbles on financial and real estate markets. They can, for example, pursue stricter monetary and fiscal policies or impose tighter rules on the financial sector. The problem with a more restrictive monetary policy, however, is that higher interest rates would attract further capital, which would mean even greater pressure for currency revaluation. Although revaluation would ease domestic inflationary pressure, since international purchasing power would be increased and imports - including imports of oil, raw materials and food - would become cheaper, most emerging economies are afraid that revaluation will make their export industries less competitive, especially as China continues to peg its currency closely to the dollar.

Many emerging economies, such as Brazil, Indonesia, South Korea, Thailand and Turkey, have therefore been trying in recent months to limit the inflow of foreign capital with various kinds of capital controls. Even the IMF - long a fierce critic of such controls - has advocated their use (under certain conditions at least) in a recently published report on the management of capital inflows. This is a welcome development, since capital controls should naturally be one of the macroeconomic instruments used by developing and emerging economies - as was, indeed, the case in Europe until the late 1980s.

Rather than relying entirely on capital controls, however, emerging economies should also resort to more restrictive monetary and fiscal policies and stricter regulation of the financial sector. They should not least refrain from resisting an orderly revaluation of their currencies. To maintain relative competitiveness among themselves, major emerging economies, such as Brazil, Russia, India, China and South Africa (BRICS), might agree on a coordinated revaluation, which would also give other developing and emerging countries more breathing space for a revaluation. At the request of the Chinese host, exchange rate policy was omitted from the agenda for the latest BRICS summit meeting held in Sanya on 14 April 2011. Yet it is in their common interest for the subject to appear at the top of the BRICS agenda as soon as possible and not left until the next summit in India in 2012. All the participants in the global economy depend on the major economic nations - which now include the emerging economies - to act cooperatively. Finding cooperative solutions beyond the limits of short-term national interests is clearly becoming even more complicated in this new, “multipolar” global economy.