

## Emerging Markets: Navigating the Rising Tide of Global Liquidity

### Executive Summary

- A wave of liquidity is rushing in the direction of emerging market countries, forcing policy-makers of these countries to protect against inflationary pressures and ensure continued trade competitiveness.
- The factors driving capital inflows this time are structural in nature, which represents a distinct change from past episodes of strong inflows into these countries and creates an acute dilemma for emerging market policy-makers.
- As a result, and in the absence of a consensus at the level of the G20 regarding steps that must be taken to rebalance the global economy, we will continue to see unilateral barriers erected to restrict financial flows, driving an increase in FX volatility and raising the risk of more punitive, politically-driven measures that could eventually lead to an escalation of trade tensions globally.

Capital is pouring into emerging markets. For those who remember the “boom and bust” cycles of the 1980s and 1990s, this is nothing new. However, the catalysts that fostered the gradual build-up and rapid reversal of foreign capital inflows during those periods are markedly different from those driving the wave of liquidity towards emerging markets today. Indeed, it is the very structure of the global economy—which has changed only marginally since the onset of the credit crisis—that is forcing liquidity in the direction of emerging market assets. Any further quantitative easing measures pursued by US monetary policy-makers will only serve to exacerbate this phenomenon. As a consequence, and in the absence of a mutually agreed upon course of action by which to achieve global rebalancing, emerging markets policy-makers will continue to erect unilateral barriers to capital and financial flows in an attempt to protect the competitive position of their trade sectors, and to insulate their economies from inflationary pressures.

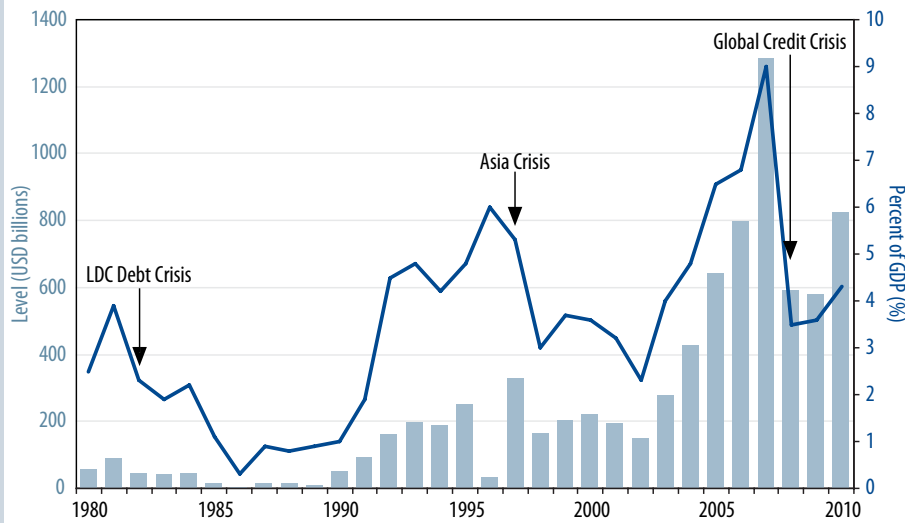
Traditional economics literature explains that capital flows from one country into another as a result of differences in macroeconomic policies and economic performance. By investing internationally, individual and corporate investors are able to diversify their sources of risk and seek better expected returns, while the countries themselves benefit from increased investment, in turn encouraging economic growth. Strong inflows are generally accompanied by booming equity and real estate markets, an accumulation of international reserves, and a decline in the sovereign risk premium, the latter helping to improve a country’s creditworthiness from the perspective of the standard debt sustainability framework.<sup>1</sup> However, this process does not always proceed rationally, and excessive inflows may lead to substantial real exchange rate appreciation, a misallocation of resources, and vulnerability to sudden reversals in capital flows, as witnessed during the Asia crisis of 1997.

While similarities exist between the capital flows in the 1980s and 1990s and capital flows into emerging markets today, the current trend of inflows is unprecedented—both in its size and in its composition.<sup>2</sup> Improved sovereign balance sheets engendered by years of structural reform and fiscal discipline, coupled with higher interest rates and better expected long-term growth prospects have paved the way for this recent surge. As their credit profiles have improved, many emerging markets have been able to extend the maturity profile of their debt (in both domestic and external markets), and to evolve in terms of the types of capital flows they receive. No longer primarily comprised of short-term bank and public sector borrowing, capital inflows today include more stable foreign direct investment (e.g. M&A, joint ventures, targeted development of infrastructure projects, etc.), sizable remittance flows and substantial portfolio flows into local equity markets, most notably in Asia and Latin America.<sup>3</sup>

Sustained over the past decade with only a short period of reversal in the depths of the financial crisis, these inflows have certainly carried with them benefits. Indeed, emerging markets have been able to grow remarkably quickly for much of this period. Furthermore, even in an environment of weaker overall global growth, many of these nations have managed to continue along the path towards development, assisted in a meaningful way by unabated access to capital from both foreign and domestic sources.

Significantly, however, emerging markets are not isolated from financial turmoil in the developed world, and certainly remain vulnerable to any developments in the US or the EU that serve to alter the relative attractiveness (or perceived riskiness) of investments in these countries. To this

Exhibit 1  
**Emerging Market Private Capital Inflows, Net**  
 Historical Cycle and Magnitude



Source: Institute of International Finance

point, it can be argued that the surge in emerging market capital inflows currently underway is largely attributable to the excessively loose US monetary conditions sought after by the Fed. This, in combination with a deteriorating trajectory for the country's fiscal accounts (which in turn has led to serious questions related to the long-term value of the US dollar) has fueled speculative flows out of the US and into emerging markets at an accelerating pace, creating a hyper-charged, one-way trade in emerging market stocks, bonds, and—significantly—currencies.<sup>4</sup>

In an effort to blunt the impact of these flows on their currencies, several emerging market countries (such as Brazil and Thailand) have already implemented some form of capital controls while others (such as Chile, Peru, and South Korea) are

now announcing the possibility of foreign exchange intervention in the near future.<sup>5</sup> However, such measures have historically proven to be costly and ineffective against strong, speculative forces for a variety of reasons.<sup>6</sup> From a political perspective, implementation of measures that lead to additional foreign exchange reserve accumulation will bolster claims made by the developed world that developing countries are intentionally weakening their currencies and, consequently, distorting international trade patterns. From an economic perspective, measures such as sterilized interventions result in “quasi-fiscal” costs which, when sustained over time, can negatively impact countries with sizable public deficits.<sup>7</sup> To the extent that any of these measures lead to a rise in the domestic interest rate (making the domestic/external interest rate differential even more attractive), they will only serve to further aggravate the capital inflow problem.<sup>8</sup>

While concerns of a sudden reversal in capital flows are valid—particularly in light of the past—it is difficult to see today's scenario unraveling quite so quickly absent a sudden escalation of sovereign solvency issues in Europe. Given the outlook for modest growth in the developed world as these countries grapple with fiscal austerity and, at some point, with deleveraging across much of the household sector, the combination of a low developed world interest rate environment coupled with stronger growth prospects for many emerging markets will only fuel additional capital flows into the higher-yielding opportunities these countries present. As a result, the list of countries in emerging markets announcing either foreign exchange interventions or capital controls will continue to grow.

As these events unfold, the absence of a truly global decision-making body—one in which today's balance of economic power is adequately and appropriately reflected—will become an increasingly acute problem. To be sure, the slow unraveling of the G-20's credibility underscores a marked divergence of views between the developed and developing worlds.<sup>9</sup> With the potential for mounting populist sentiment heading into a heavy election cycle globally, the risk of policy error stemming from continued unilateral action (driven by political pressure) is increasing at the worst possible time, leaving open the possibility that interventionist actions will become increasingly more punitive in nature.

While increased foreign capital flows carry with them benefits, the experience of emerging market countries through the volatile periods of the 1980s and 1990s have made these countries very aware of the significant risks also accompanying these flows—particularly short term “hot” money inflows that are prone to rapid reversal in a changing global interest rate environment. In an effort to combat these risks, and to maintain their competitive position in global trade—and in the absence of a consensus at the level of the G20 regarding required steps to achieve global rebalancing—emerging market countries will continue to erect unilateral barriers to financial inflows. While these barriers tend to be ineffective in the medium term, we should expect additional currency pressures and subsequent responses to become increasingly politicized, potentially feeding into global trade tension and likely leading to a marked increase in currency market volatility.

## Footnotes

- <sup>1</sup> For a lengthier discussion, see the recent white paper titled: “Emerging Markets: Revisiting the Investment Thesis in an Era of Debt,” September 2010, available on the Western Asset website: <http://www.westernasset.com/us/en/commentary/filter.cfm>
- <sup>2</sup> Net private capital flows to emerging economies are projected to be \$825 billion in 2010, up from \$581 billion in 2009. See The Institute of International Finance, Inc. ([www.iif.com](http://www.iif.com)).
- <sup>3</sup> Historically speaking, as the size of portfolio flows into equity markets has picked up, it has tended to contribute meaningfully to market volatility—particularly within currency markets—where equity flows in and out of a country amplify any fundamentally driven moves in currencies.
- <sup>4</sup> Alex Frangos and Mark Gongloff, “Yield Hunt Leads to Currency Debt,” Wall Street Journal, October 4, 2010.
- <sup>5</sup> Note that interventionist measures include, but are not limited to: 1) a tax on capital inflows and outflows across various asset classes, 2) sterilized and non-sterilized intervention by the central bank, 3) an increase in marginal reserve requirements on bank deposits, and 4) more regulated banking sector investments in equity and real estate markets.
- <sup>6</sup> Guillermo A. Calvo, “Controls on Cyclical Capital Flows: Some Skeptical Notes,” Columbia University, April 12, 2010. ([www.columbia.edu/~gc2286/documents/capital\\_controls.pdf](http://www.columbia.edu/~gc2286/documents/capital_controls.pdf); accessed October 28, 2010.)
- <sup>7</sup> The quasi-fiscal cost arises because in sterilized intervention—designed to offset the effect of reserve inflows on the monetary base—the central bank typically exchanges high-yielding domestic assets for low-yielding foreign assets. In the consolidated government and central bank portfolio, the public sector ends up paying more on its liabilities than it receives on its assets, as more government debt is held outside of the central bank.
- <sup>8</sup> For a deeper analysis of these issues, see: Guillermo A. Calvo, Leonardo Leiderman and Carmen M. Reinhart, “Capital Inflows and Real Exchange Rate Appreciation in Latin America: The Role of External Factors”, IMF Staff Papers, Vol. 40, No. 1, pgs. 146-149, March 1993.
- <sup>9</sup> For examples highlighting this tension, see: Alan Beattie, “Bric nations grow weary of G20’s rhetoric of co-operation,” Financial Times, October 21, 2010. See also: Takashi Nakamichi, Natasha Brereton, and In-Soo Nam, “G-20 Proposal on Curbing Trade Imbalances Faces Opposition,” Wall Street Journal, October 22, 2010.

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