



Talking point

Emerging markets capital flows – how are the BRIC countries faring and coping?

November 10, 2010

The last two “super-cycles” in private capital flows to emerging markets lasted almost exactly seven years. This suggests that the current upswing in capital flows may only be in its early stages. The level of capital flows to the BRICs differs markedly, as do their policy responses in terms of currency appreciation, reserve accumulation and capital controls. Brazil will continue to face a far greater temptation to tighten capital controls – and prevent currency appreciation – than the other BRIC countries.

“Behold, there come seven years of great plenty”, according to the book of Genesis. Interestingly, the last two “super-cycles” in private capital flows to emerging markets lasted almost exactly seven years. The first ended with the Asian crisis (1990-1997) and the second with the Lehman collapse (2002-08). In the late 1970s and early 1980s, the EM had experienced a shorter-lived boom (and bust), ending with the Mexican debt moratorium in August 1982. Ominously, economies that suffered a major financial crisis take an average of seven years to complete “deleveraging” during which they tend to suffer from below-average growth (C. Reinhart & V. Reinhart).

All of this seems to suggest that the current upswing in private capital flows to the EM that started in April 2009, following the G20 meeting, may only be in its early stages and may have another five years to run. This sounds plausible considering that high (and rising) EM interest rates, attractive medium-term growth prospects and improved fundamentals will pull capital into EM, while an extended period of unprecedentedly low DM interest rates, sub-par economic growth, exacerbated by an intensifying “demographic drag”, and higher financial risks will push capital out of the DM and into EM.

Capital flows are being underpinned by more than just cyclical and hence reversible factors. The relative “(great) risk shift” in favour of EM would seem to justify a “structurally” higher level of flows. After all, while the DM are being downgraded, EM are being upgraded. Higher EM and lower DM creditworthiness look like they are here to stay. This, in turn, has been behind the greater “strategic” asset allocation to EM by DM institutional investors, which remain heavily under-invested in the EM “space”. The cyclical component is being underpinned by yield differentials and quantitative easing by the Fed, the BoE and, to a far lesser extent, by the BoJ. In practice, it is impossible to disentangle what share of the flows is due to structural versus cyclical factors. For the time being, however, both structural and cyclical factors point to continued strong capital flows.

Another important distinction concerns “asset price busts” and “financial busts”. The former simply refers to a sharp rise and subsequent fall in asset prices. The latter refers to a sharp downward adjustment in asset prices that triggers a wider “systemic” banking sector or balance-of-payments-cum-sovereign-debt crisis. According to this definition, Russia experienced an “asset price bust” in 2008, but a “financial bust” in 1998. Concerns about a “financial bust” in the EM, and certainly in the BRICs, look very much overdone at this stage. The BRICs benefit from strong external solvency and liquidity.



Large FX reserves and/or (more or less) flexible exchange-rate arrangements and favourable foreign-currency mismatches provide them with significant buffers in the event of a “sudden stop” in capital inflows. Current accounts exhibit manageable deficits (Brazil and India) or are even in surplus (China and Russia). The risk profile of the inflows is also more favourable than in the past, from the recipient countries’ point of view. The FDI component of inflows remains significant, and portfolio flows are often biased towards local-currency equity and debt, typically of longer duration. Last but not least, the BRICs continue to increase FX reserves, albeit at different speeds.

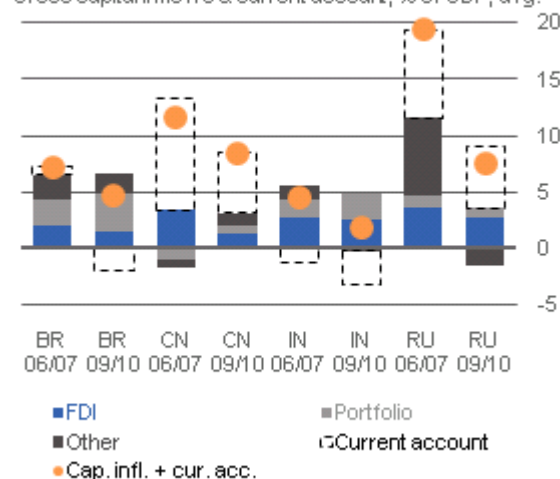
The level of capital flows to the BRICs differs markedly. Brazil has been experiencing the highest level of inflows during 2009-10 due to its more open capital markets (compared to China and India), perceived improvement in post-crisis growth and/or lower “leverage” (compared to Russia) and very high interest rates. At the same time, Brazil has accumulated far less FX reserves (as a share of GDP) than China and Russia, both of which combine small capital account surpluses (China) or deficits (Russia) and large current account surpluses with a more or less aggressive FX intervention policy. Brazil, by comparison, has “absorbed” parts of its overall surplus via currency appreciation (and a widening current account deficit) due to its more flexible exchange rate and, possibly, the significantly higher costs of sterilised intervention. Brazil’s FX reserves do remain well below those of the other BRICs.

Brazil’s current account deficit, combined with larger foreign capital inflows, also means that it is accumulating both larger net and gross foreign liabilities, however favourable their risk features. Concerns over “excess” currency appreciation and rising sensitivity to a “sudden stop” have contributed to Brazil’s decision to incrementally tighten controls on capital inflows. It is noteworthy, however, that - relative to GDP - the level of gross capital inflows is very similar to pre-crisis levels, while the (real effective) exchange rate is only slightly stronger than before the 2008 crisis.

The bottom line is that the degree to which countries – in this case the BRICs – are struggling with capital inflows (and external surpluses, more generally) differs significantly, as they do with respect to their policy responses in terms of currency appreciation, reserve accumulation and capital controls. Both China and Russia are experiencing much lower levels of gross capital inflows (and, indeed, much higher levels of gross private outflows) than Brazil. But large current-account-related inflows contribute to much larger balance-of-payments surpluses in both countries. Their greater capacity and willingness to prevent nominal currency appreciation have resulted in greater official reserve accumulation. As a result, China and Russia perceive much less of a need to tighten controls on capital inflows than Brazil, whose capital account is very open and whose currency has appreciated tangibly, albeit from weak immediate-post-crisis levels. India falls somewhere in between Brazil, on the one hand, and China and Russia, on the other hand, as regards its capacity and the perceived need to absorb (smaller) external surpluses. No doubt, if we are indeed in for “seven years of plenty”, Brazil will continue to face a far greater temptation to further tighten controls in order to stem foreign capital inflows – and prevent currency appreciation – than the other BRIC countries.

Brazil coping with highest level of foreign capital inflows

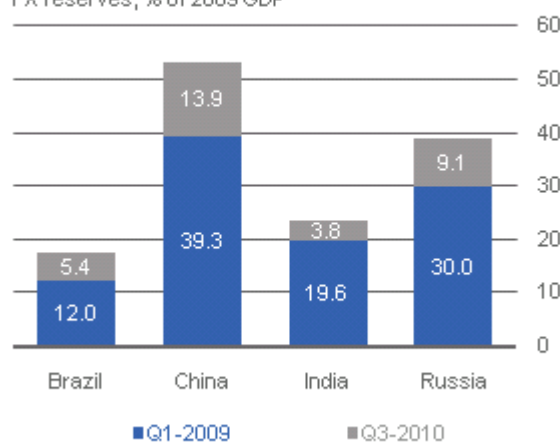
Gross capital inflows & current account, % of GDP, avg.



Sources: IFS, DB Research

Size of FX reserves & pace of accumulation vary

FX reserves, % of 2009 GDP



Sources: IMF, National sources, DB Research



Markus Jaeger +1 212 250 6971

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