Special Update

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Is the Fed Really to Blame for Emerging Market Headaches?

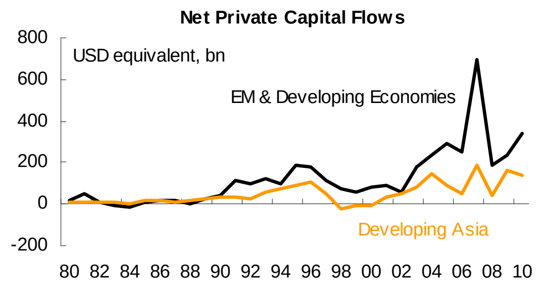
Blaming other countries for one's own problems is usually a winning political strategy, especially when that blame is at least partly justified. In an unusual reversal, however, foreign central banks are accepting the blame, and probably accepting more blame than they should. We are speaking here of the effect of US monetary policies on capital flows to other countries, policies that are drawing considerable ire of some countries in Latin America and Asia, and even motivating significant concern in markets like Canada. Printing US dollars for the purpose of investing in credit and Treasuries has the Fed being tagged as debasing the USD and exporting the woes of the US economy to other markets via unwanted capital inflows and local market currency strength that impedes local competitiveness. Some fear those flows may lead to competitive global currency devaluations, capital controls, competing monetary policy directions, and a wave of protectionism. This week's further policy easing by the Fed not only amplified those concerns for developing countries but also drew critiques from US investors concerned about the capital flow implications. While there is certainly some truth to these accusations, we argue in this article that the impacts are overstated and capital flows to developing countries — and markets like Canada — would likely continue irrespective of US monetary policy.

Flows To Emerging Markets Are Nothing New

Over the period since the Fed first introduced quantitative easing through to the present, there is little evidence to support the thesis that some of these countries have witnessed an acceleration in their net capital flows beyond what was in the process of occurring anyway; the ball was actually set in motion around the middle part of the decade.

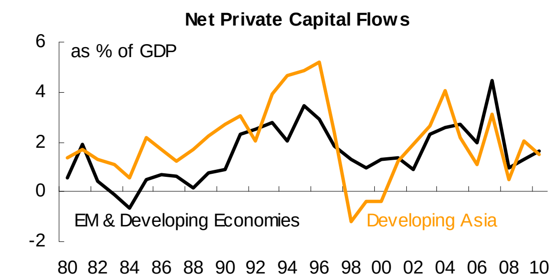
Consider the evidence. As chart 1 shows, the net amounts of private capital flowing into emerging/developing markets as a group and developing Asia as a sub-group through all direct and indirect sources have indeed accelerated to within a record range without adjusting for inflation or economic growth. That said, this acceleration pre-dated Fed policy actions by several years.

Chart 1



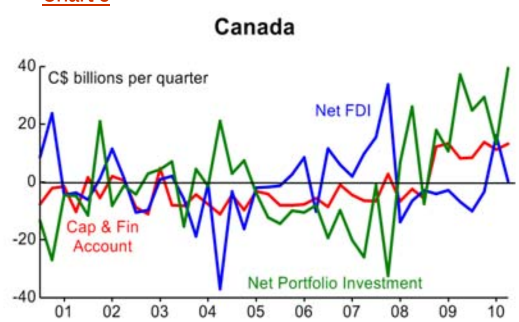
Source: IMF, Scotia Capital Economics

Chart 2



Source: IMF, Scotia Capital Economics

Chart 3



Source: Global Insight, Scotia Capital Economics & Scotia Emerging Markets Strategy.

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Chart 2 makes the additional point that much of this effect is running parallel to domestic economic growth within those economies and is thus not out of line with the strengths in the economies of these countries.

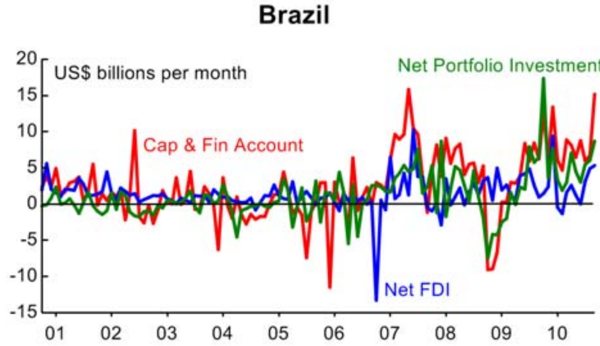
Country-level data also point to the same pattern. Even developed economies like Canada are experiencing accelerated net capital inflows as demonstrated by the movements in broad capital and financial accounts that track net foreign direct investment, net portfolio investment, and other items like net loan and reserve flows (chart 3). But, like emerging markets, the flows into Canada began to accelerate before the US Federal Reserve pursued quantitative easing, and they have more to do with the fact that the Canadian economy has been among the most insulated from the global credit storm sweeping through developed economies. Chart 4 and the accompanying appendix illustrate that these observations also generally hold true — but to varying extents — for a sampling of emerging/developing markets that we examined, including Brazil, Chile, Mexico, Russia, South Korea, and India. Indeed, we have broken apart the broad capital flows for each of these countries in order to show the split between net foreign direct investment and net portfolio flows.

We also have some investor-level evidence on this point based on the flow of new money to investment funds — mutual funds, pension funds, or hedge funds that are mostly based in the US and other developed countries but invest exclusively in emerging markets. Our data here come from EPFR, a firm that specializes in surveying those investment funds about new money flows, and currently covers 929 bond funds with US$149 billion in assets. As chart 5 shows, new flows of client money to emerging market funds have been running at a rate of about 1% of assets starting from 2002 onwards. That period covers both periods of low fed funds rates and high fed funds rates, ranging from 1% to 5.25%. Steady inflows throughout this period suggest that the Fed funds rate is not the primary determinant of these flows.

Comparing the relative flows between emerging market funds that invest in local currency instruments and hard currency instruments is also revealing. We would expect loose monetary policy in the US to drive flows to local currency instruments, as these would allow investors to benefit most from differentials in interest rates and EM currency appreciation. In contrast, hard currency EM bonds are issued at a spread to US Treasuries; as Fed buying of Treasuries drives down Treasury yields, EM bond yields also fall. Thus, the impact of US monetary policy on the demand for those EM bonds is less obvious, and we would not necessarily expect more demand for hard currency EM funds.

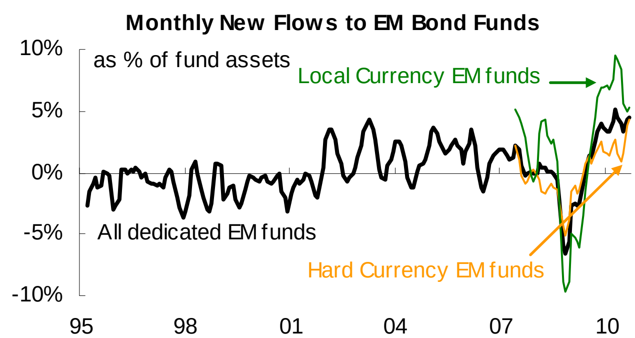
The data show that flows to local currency funds have been running at an average monthly rate of 7% this year; nevertheless, those flows started in the summer of 2007 (we don't have data earlier than that), and were running at around 4% per month then, a time when US interest rates were still at 5.25%. Flows into hard currency funds in 2010 continue at a rate of 2.5% per month, which is higher than flows to dedicated EM funds in any previous year for which we have data.

Chart 4



Source: Global Insight, Soctia Capital Economics & Scotia Emerging Markets Strategy.

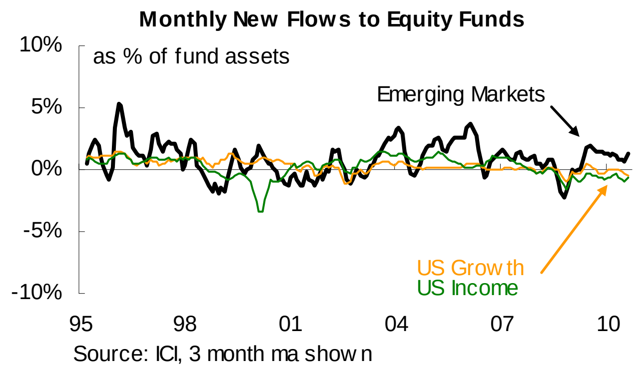
Chart 5



Source: EPFR, 3 month ma shown

This pattern of flows is not what we would have expected theoretically from US quantitative easing. While US monetary policy may well be part of the explanation, we think the evidence suggests something else is going on as well.

Chart 6



Flows Are Driven By Differentials In Growth, Not In Interest Rates

We think the primary factor driving flows to emerging markets is the fact that macroeconomic stabilization and a decade of structural reforms have finally paid off, leading to growth rates much higher than those of developed countries. For example, consensus forecasts are for Latin America to grow at 5.5%, and we expect to see growth rates of up to 7-8% of some of the top performers like Peru.

The data on investor flows support this notion. First, consider that it is not just portfolio flows that are high right now. Foreign direct investment is high as well, and the motivating factor for FDI is normally domestic growth (and high commodity prices); it is not interest rate differentials. To the extent that capital flows are FDI rather than portfolio flows, they work to the advantage of developing country central banks. These types of flows represent long-term commitments which, while prone to cutbacks during downturns, are less likely to suddenly turn into outflows. In addition, they fund capital intensive businesses while allowing the central bank to build up international reserves.

Second, consider the flows to equity investment funds in chart 6, based on data from ICI. Flows to emerging market equity funds are running at 1% per month this year. In contrast, US Growth and US Income funds are recording outflows rather than inflows this year, averaging 0.2% and 0.6%, respectively. US stocks should, at least theoretically, provide protection against US inflation, and we do not think it is US monetary policy that is deterring investors. Instead, we think it is again high growth prospects in emerging markets that are driving flows.

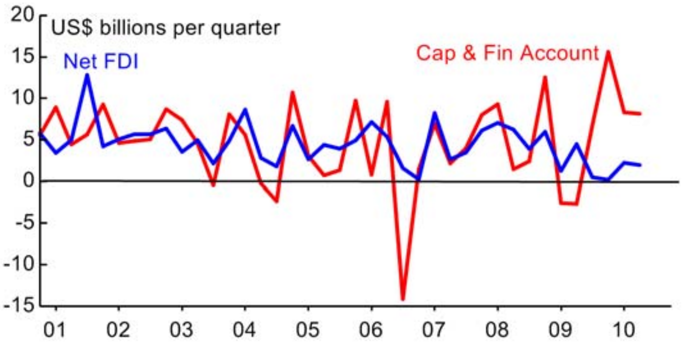
Indeed, concerns over emerging/developing market flows and currency volatility would probably exist even in the absence of what the Fed is doing. In fact, if the Fed didn’t expand its non-sterilized asset purchases, then EM currencies might be even stronger because US growth prospects may well be downgraded further if the pro-QE camp is right on its positive effects.

Capital Flows Are An Opportunity

In conclusion, we view capital inflows into emerging markets as being driven by structural forces more so than by Federal Reserve policies; continued quantitative easing and greater interest rate differentials merely amplify deeper trends that have existed for a number of years. Moreover, we think some of these forces should be embraced by emerging economies as an opportunity. Somehow, despite the longstanding efforts of emerging markets to attract capital flows, these countries now appear to be losing sight of the fact that this represents a nice problem to have. It is the very essence of the global rebalancing argument that is in operation, as capital flows from developed economies that are facing structurally softer growth for some time are being realigned toward other markets with better long-run growth opportunities. That, in turn, represents an opportunity for emerging economies to further pursue supply-side reforms in order to break down bottlenecks within their economies — and enhance market transparency — and thus further facilitate the movement from purely export-led growth toward stronger domestic economies. Indeed, more creative supply side thinking, shifts in monetary policy regimes, and increased development of macroprudential regulation will likely be needed to contain inflation risk in these countries, since we don’t see the forces of capital inflows going away any time soon even if the Federal Reserve reverses course later.

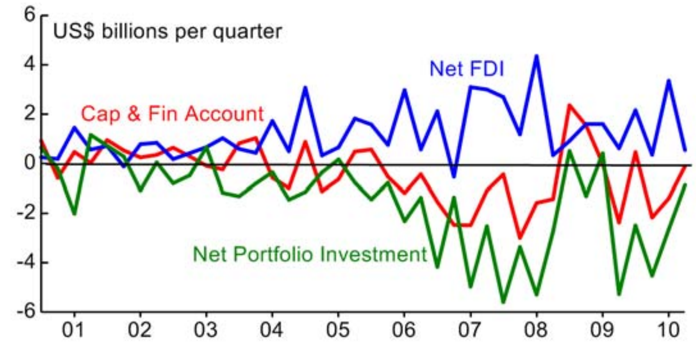
Appendix: Capital Flows in Select Emerging Markets

Mexico



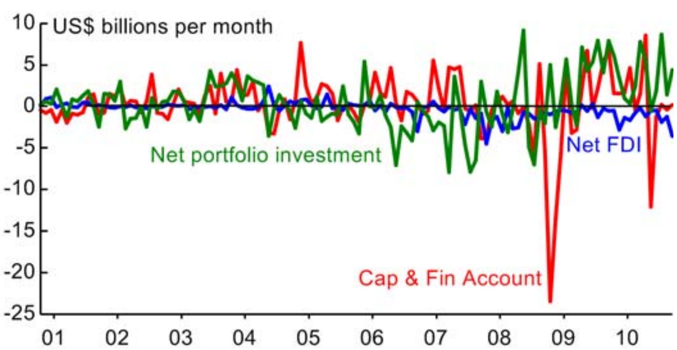
Source: Global insight, Scotia capital Economics & Scotia Emerging Markets Strategy.

Chile



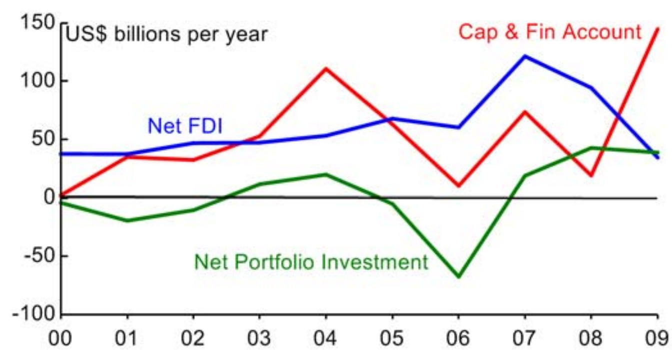
Source: Global Insight, Scotia Capital Economics & Scotia Emerging Markets Strategy.

South Korea



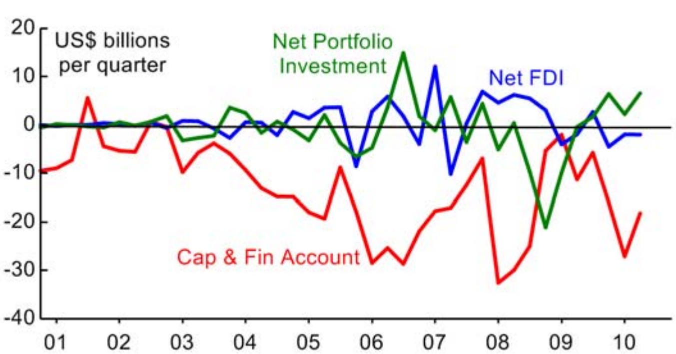
Source: Global Insight, Scotia Capital Economics & Scotia Emerging Markets Strategy.

China



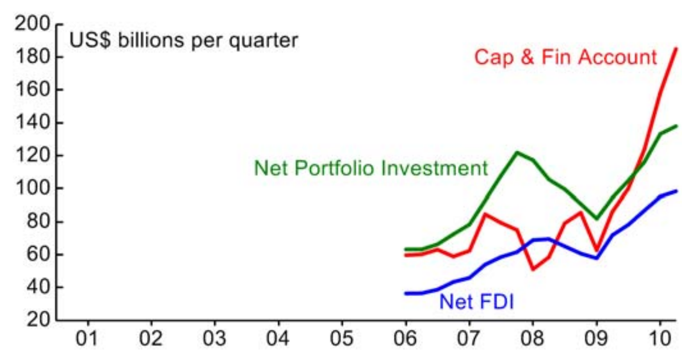
Source: Global Insight, Scotia Capital Economics & Scotia Emerging Markets Strategy.

Russia



Source: Global Insight, Scotia Capital Economics & Scotia Emerging Markets Strategy.

India



Source: Global Insight, Scotia Capital Economics & Scotia Emerging Markets Strategy.