The Other Side October 15, 2015

EMEs and Capital Flows

It is an old journalistic cliché to argue that when the US sneezes, the global economy catches cold. For the last couple of months, global currency, commodity and stock markets have been unusually volatile, the starting point this time being the Chinese devaluation of August 11th, evidencing, once again, that it is the unexpected that moves markets. From that perspective, the US Federal Reserve's decision last month to leave interest rates unchanged was unexpected – and the turmoil has continued. One of the reasons for leaving the rate unchanged given in the policy statement was the *"global economic and financial developments"*: in other words, possible impact a rate rise could have had on capital flows to emerging market economies (EMEs) and exchange rates. Dr. Raghuram Rajan, the Reserve Bank Governor, has been calling for greater international monetary co-operation for some time now, and he should be happy that the US Federal Reserve seems to have heeded his call: or is it a case of co-operation being fine so long as it suits also the domestic agenda?

The International Monetary Fund had expressed concerns about global growth before the last weekend's Annual General Meeting, and reduced its forecast to 3.1%, thanks partly to the slowing Chinese economy. Global growth in the current year, measured in dollar GDPs, could well be negative as currencies and economies of commodity exporters like Brazil have slumped. The Institute of International Finance (IIF) has forecasted that emerging market economies may undergo net capital outflows of as high as $ 500 bn in the current year, which clearly has implications for their exchange rates. The IMF is also worried about capital outflows from EMEs and in its recent Global Financial Stability Report, has expressed concerns about the *"build-up of foreign exchange balance sheet exposures"* of the corporate sector.

As for the prospects of a rise in USD interest rates, frankly, one is getting tired of the "will she, won't she" commentaries in the global media. For what it is worth, my own feeling is that such a long expected event may have little impact – either on capital flows or, therefore, on exchange rates. In fact, in general, I am quite sceptical that a rise in USD interest rates will necessarily attract capital to that country. True, yield on debt paper would go up, but a rise in interest rates could well see outflows from funds in the USD bond and equity markets as investors suffer capital losses: it can as well be argued that, therefore, a rise in interest rate could lead to capital outflows from the US rather than the reverse.

In a recent article in IMF's Finance and Development publication (September 2015), Jiaqian Chen, Tommaso Mancini-Griffoli, and Ratna Sahay have tried to analyse the impact of unexpected changes in US monetary policy on EMEs. For this purpose, the analysts estimated "*the surprise (or the unexpected) component of US monetary policy announcement.*" They believe that "*central banks can only commit to following a course of policy over a period of approximately three years, a period for which they can reasonably forecast the economy."* (One wonders that, given such capabilities, why the US Federal Reserve did not see what was happening in the mortgage market until the crisis occurred.) The analysts then examine the reaction of 21 EMEs to 125 US monetary policy announcements and found that monetary policy surprises did have an impact on capital flows and asset price movements, and that the "*spillover effects "per unit" of US monetary policy surprise were different and stronger during the unconventional phase."* After reading the article twice, I remain as confused as ever by the quantification of the distinction between expected and unexpected changes, the impact per unit of the latter, etc. etc. Or is it another case of over-mathematicisation of economic phenomenon? The ground reality in all asset markets is that greed, fear, herd instinct, feedback loops, liquidity, etc. are far greater influences on participants' actions and hence on market prices.

But to come back to IMF's worries about finance capital outflows from emerging economies and their impact on exchange rates, on corporate balance sheets, etc., the basic question that needs to be debated is the benefits and risks of liberal capital accounts and, their corollary, volatile exchange rates for "*strong, inclusive, job-rich, and more balanced global growth*", goals to which policy makers committed themselves at the end of the last weekend's Annual Meetings.

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