

Assessing the 'Sudden Stop' Risks for EM

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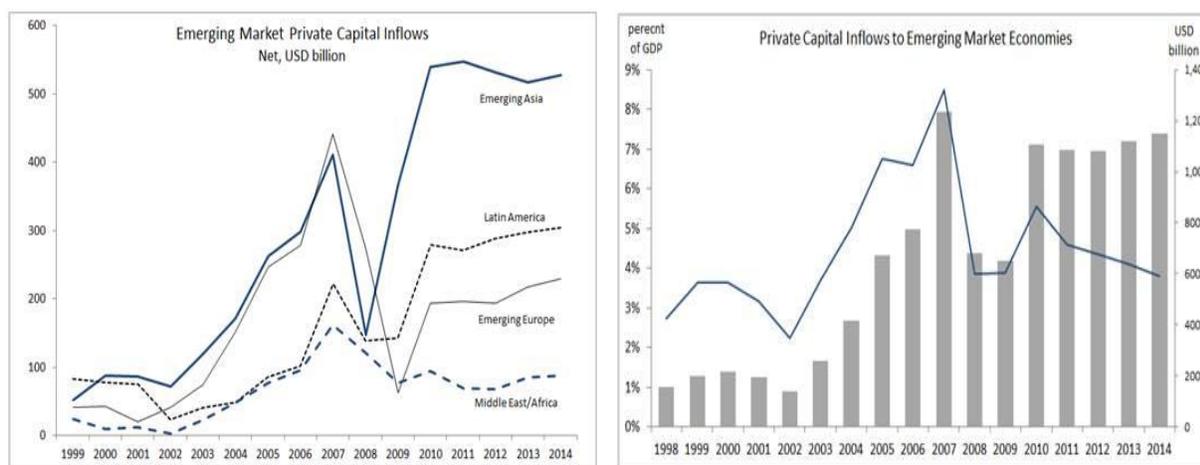
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***Bottom line:** We are likely to be at least several months too earlier/premature in writing about the risk of a 'sudden stop' undermining some EM currencies and assets. Capital continues to flow into EM, in size, pushing up many of the EM currencies. But we are increasingly worried about the risks of a 'sudden stop' in these capital flows. In recent years, the cumulative capital flows into EM have been so large (the cumulative stock of foreign inflows to EM are more than twice as large as that on the eve of the Lehman Crisis) and low in quality that the longer the developed central banks maintain exceptionally aggressive monetary policies, the bigger the risk of an ultimate unwind of these cumulative flows into EM. The potential triggers of such an unwind, in our view, could be (1) an inflection point in the Fed's policies and (2) a sustained rally in the dollar. This risk may not be imminent, but will become more significant over time. The scope for further downside for USDEM is limited. If anything, over the coming months, the risks are skewed to the upside, in our view.*

Massive cumulative capital flows into EM. Capital flows into EM in the last decade has been substantial in size, in absolute terms, relative to past history, as well as in percent of the GDP of the recipient countries. The chart on the left below shows the profile of capital flows into the various parts of EM. Here are some summary figures. In the four years leading up to the Lehman Crisis in 2007 (2004-07), cumulative capital flows into EM totaled some USD3.1 trillion. This amount was substantially higher than the cumulative total of USD800 billion registered during the prior four years, 2000-2003. During the GFC (Global Financial Crisis), capital flows heading to EM collapsed, though they did not turn negative. The mere decline in the capital flows, however, led to some very sharp movements in EM currencies. For example, during the GFC, USDKRW surged by

57%, EURPLN rose by 51%, and MXN depreciated by 55% against the dollar. There was no crisis in any of these countries. But their currencies exhibited crisis-like trajectories.

In the four years since the GFC (2009-2012), the cumulative capital flows into EM totaled USD3.9 trillion – even larger than the four years leading up to the GFC. Thus, the cumulative *stock* of foreign capital flows into EM is more than twice as large now than it was prior to the GFC.



Source: Institute for International Finance and SLJ Macro Partners

In terms of capital flows by region, Emerging Asia has received by far the largest inflows (USD2 trillion during 2009-12), followed by LatAm (USD980 billion), and Emerging Europe (USD646 billion). While, in absolute dollar terms, capital flows into EM have been huge in recent years, in percent of the GDP of the recipient countries, the size of these inflows has been less than that during 2006-07, but more than during the early 2000s. Inflows have been declining in proportionate terms, due to the buoyancy of nominal GDP (in dollar terms) in emerging economies.

History of ‘sudden stops’. A ‘sudden stop’ is an abrupt reversal or stoppage in capital flows that may lead to sharp currency depreciations in the recipient countries. These events can be very disruptive for the recipient countries mainly because (i) economic activities funded by these capital inflows would suddenly need to seek alternative funding sources, (ii) the central banks of the recipient countries will be pressured to sell their reserves to meet this demand for foreign currencies, and often central banks are reluctant to fully meet this demand, (iii)

partly because of (ii), interest rates in the recipient countries experiencing sudden stops could spike higher, leading to economic costs.

We assume our readers are familiar with the sudden stop literature and therefore will not review the details. We do think it is useful, however, to recite the experiences of sudden stops during the LatAm Crisis of the 1980s and the Asian Crisis of 1997.¹

The LatAm Crisis. During the 1970's, many Latin American countries were experiencing booming growth, and the routes to borrowing from foreign creditors was open, and easy. However, debt and debt service begin to accumulate at a rapid pace, spiraling out of control by the late 1970's. The bulk of LatAm debt was in USD, and as the Fed hiked US interest rates in the early-1980's (in order to curb the oil-based inflation of the 1970s), the real exchange rates appreciated significantly, which only intensified the situation, and made the debt repayment more difficult. However, as demand was still high in LatAm, US banks continued to increase their lending during the years leading up to the outbreak of the crisis. With Mexico's announcement in 1982 that it was unable to service its debts, this led to the majority of Latin America (including Mexico, Brazil, Venezuela and Argentina) to reschedule their debts as well. The international financial community reacted badly to this news, and pulled out of LatAm as a region.

The Asian Crisis. The 1997 Asia Crisis arose from a combination of dangerous financial and economic conditions: fixed or semi-fixed exchange rates, large current account deficits (which created downward pressure on these currencies), and high domestic interest rates which gave incentive for companies to borrow offshore. On top of this, they borrowed heavily in international markets and currency, leaving their economies prone to the effects of a strengthening dollar. With the rapid appreciation of the US dollar causing the Asian currencies to become overvalued, currencies devalued, and capital flight ensued.

¹ The LatAm and Asian Crises are the episodes more familiar to investors, mainly because of the scale of these crises. However, there are many other examples of sudden stops: 1975 (Singapore), 1981 (Costa Rica, Thailand), 1982 (Mexico, Uruguay), 1983 (Indonesia, Philippines), 1984 (South Africa), 1985 (Columbia), 1986 (Indonesia, Malaysia, Philippines, Venezuela), 1987 (Brazil), 1989 (Argentina, Venezuela), 1994 (Mexico, Turkey, Venezuela), 1997 (Malta, Thailand). Source: EPRU paper by Hutchison and Noy (2002).

What could happen a year from now? Large and fickle capital inflows into EM are problematic because the flows could reverse, and given the immense size of the cumulative flows witnessed in the last decade, we are concerned about the risk of a sudden stop. Here are some thoughts.

- **The ‘Global Currency War.’** There are two broad aspects of the discussion on this subject: prescriptive and descriptive. The *prescription* portion has to do with the G20 consensus on countries not showing the intent of distorting currency values in the conduct of monetary policy, avoiding the rhetoric of referring to specific numerical exchange rate targets, and abstain from actual interventions to influence the exchange rate. However, just because the G20 have reached an agreement on the acceptable conduct of monetary and exchange rate policies, it does not mean that all would be fine if these guidelines are followed. This is the *descriptive* part of the discussion, that there are negative externalities that the G20 consensus does not deal with. As the reserve currency issuing central banks conduct QE, the liquidity exported to EM has made the recipient countries vulnerable to a sudden stop. The money printing central banks say that they are not responsible for these negative side effects on other countries. The problem is that the EM economies aren’t able to absorb these inflows properly. When the Finance Minister of Brazil accused the Fed of having started a Global Currency War, we presume he did not mean that the US manufacturers were gaining an unfair advantage on the Brazilian counterparts, but that the corresponding Fed liquidity would cause bubbles in Brazil, and elsewhere.
- **Capital flows of inferior quality.** We have made this point in our previous write-ups, that, prior to the GFC, most of the capital flowing into EM were ‘pulled’ in by the perceived superior economic fundamentals of the recipient countries. However, post 2008, much of the flows into EM were ‘pushed’ out by the central banks printing money. Because of this change in the underlying motivation for the flows, we believe the flows in recent years are of inferior quality to the flows seen pre-2007.
- **The Federal Reserve.** The unconventional monetary policies are fully reversible and will be fully reversed when the economies normalize. This

means that, the type of capital flows ‘pushed’ out by the money printing central banks – discussed above – are inferior in quality because they will also be fully reversed one day. This is an important distinguishing feature of the types of capital flows into EM pre- and post- the GFC. Further, if this thesis is correct, then when the Fed normalizes its policy, there will likely be a meaningful reversal in capital flows from EM back into the US. As mentioned above, in the 1980s, it was the Fed’s innocent rate hikes that triggered the LatAm Crisis. At the same time, the dollar has been artificially depressed by the multiple rounds of QE by the Fed. It could appreciate sharply in the coming quarters. We recall that, in the mid-1990s, it was the appreciation of the dollar (especially against the JPY) that dragged USDAsia higher, which ultimately led to the Asian Currency Crisis.

- **CA deficits.** Previously, sudden stops tended to be triggered by certain vulnerabilities of the capital recipient countries, e.g., a large CA deficit, an over-levered or otherwise vulnerable banking system. However, since only a few EM economies have relatively large CA deficits (e.g., India, South Africa, and Turkey all have CA deficits in the 5-6% of GDP range), we suspect a prospective sudden stop will likely be triggered by the ‘originator’ of the liquidity (e.g., the US) rather than the recipient, as has normally been the case.² Once there is capital flight, commentators will ex post ‘discover’ the structural flaws that justify these outflows.³

Bottom line. This may or may not be an immediate risk, but we believe the multiple rounds of QE conducted by the major central banks around the world in

² Indeed, exposure to a common ‘creditor’ (the Fed) also puts countries at higher risk. Global banks withdrew capital during both the 1982 Latin American Crisis as well as the 1997 Asian Crisis, and more recently during the 2008 financial crisis. Emerging Economies are heavily reliant on lending from European Banks. According to data from the BIS, 87% of foreign claims going into Eastern Europe come from European Banks (this is 40% for Asian Countries and 59% for LATAM countries).

³ We wrote a piece recently on the consequences of European bank deleveraging, ‘Over-Levered European Banks and the Lending Channel,’ (March 22, 2013). As the European banks have been forced to reduce their loan-to-deposit ratios, flows in to EM, especially Eastern Europe, have taken a large hit as a result. Our calculations suggest that there is a lot more de-leveraging that will need to be done by the European banks. Europe, therefore may pose a threat to trigger a “sudden stop” in capital flows which could have grave consequences to some Eastern European economies.

recent years may have significantly increased the risk of a ‘sudden stop’ in EM countries. Since the unconventional monetary policies will be fully reversed when the respective economies normalize, these capital flows will also likely to fully reverse one day. Given the size of the cumulative flows witnessed in recent years – around USD7 trillion since 2004, we fear that some EM currencies could weaken substantially against the dollar, when the Fed starts to reverse its policy stance. Without an actual crisis, some EM currencies could exhibit crisis-like price action.

Appendix: Which countries are at the most risk?

Many factors determine the probability of a sudden stop. The size of the cumulative capital inflows (hot money) is one key measure.

The table on the left below shows the four-year cumulative total inflows, measured in percent of GDP of the recipient country) before and after the GFC. The table on the right below shows the size of the inflows in 2012.

| | Cumulative | |
|---------------------------|------------|-------------|
| | Pre-Crisis | Post-Crisis |
| Middle East/Africa | 12.0% | 34.8% |
| Nigeria | 6.4% | 25.6% |
| Egypt | 7.5% | 19.9% |
| Morocco | 6.7% | 21.8% |
| South Africa | 12.2% | 34.6% |
| Lebanon | 27.4% | 102.3% |
| Saudi Arabia | 10.2% | 34.5% |
| United Arab Emirates | 22.2% | 48.8% |
| | | |
| Latin America | 5.5% | 24.3% |
| Argentina | 6.2% | 17.7% |
| Brazil | 4.2% | 24.5% |
| Chile | 12.0% | 55.6% |
| Colombia | 6.5% | 26.7% |
| Ecuador | 3.5% | 4.8% |
| Mexico | 6.8% | 22.0% |
| Peru | 7.3% | 35.0% |
| Venezuela | 3.0% | 13.1% |
| | | |
| Emerging Europe | 18.6% | 45.9% |
| Bulgaria | 52.6% | 121.6% |
| Czech Republic | 20.2% | 50.9% |
| Hungary | 51.9% | 91.5% |
| Poland | 22.7% | 65.5% |
| Romania | 31.9% | 69.2% |
| Russia | 13.5% | 33.3% |
| Turkey | 16.4% | 41.0% |
| Ukraine | 27.5% | 76.3% |
| | | |
| Emerging Asia | 5.8% | 21.0% |
| China | 5.0% | 19.2% |
| India | 6.9% | 27.5% |
| Indonesia | 3.5% | 17.2% |
| Korea | 7.5% | 19.3% |
| Malaysia | 11.8% | 39.5% |
| Philippines | 4.5% | 11.7% |
| Thailand | 13.7% | 34.6% |

| | 2012 |
|---------------------------|-------------|
| Middle East/Africa | 3.1% |
| Nigeria | 7.3% |
| Egypt | -3.4% |
| Morocco | 1.0% |
| South Africa | 5.7% |
| Lebanon | 7.2% |
| Saudi Arabia | 2.7% |
| United Arab Emirates | 2.9% |
| | |
| Latin America | 5.4% |
| Argentina | 1.9% |
| Brazil | 5.3% |
| Chile | 15.8% |
| Colombia | 5.5% |
| Ecuador | 0.8% |
| Mexico | 4.9% |
| Peru | 11.0% |
| Venezuela | 2.5% |
| | |
| Emerging Europe | 4.8% |
| Bulgaria | 3.3% |
| Czech Republic | 4.2% |
| Hungary | 0.9% |
| Poland | 3.6% |
| Romania | 2.6% |
| Russia | 4.2% |
| Turkey | 7.7% |
| Ukraine | 7.7% |
| | |
| Emerging Asia | 4.1% |
| China | 3.6% |
| India | 4.9% |
| Indonesia | 4.8% |
| Korea | 4.0% |
| Malaysia | 7.8% |
| Philippines | 2.4% |
| Thailand | 8.1% |

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