**Economic Blast**

By the Pathfinder Foundation

## Reversal International Capital Flows: Exposes Frailty of Some Emerging Economies

### Impact of Reversal of Capital Flows.

Central Bankers in major economies, particularly the US Federal Reserve and the European Central Bank, always knew that it was extremely risky when they embarked upon quantitative easing. Such a policy has never been tested on such a large scale. However, the Central Bankers have adopted the position that the cost of a prolonged slump across the advanced world would be greater than the threat of inflating unsustainable bubbles in the world's financial markets. This judgment is about to be put to the test.

When the US Federal Reserve launched its QE program, it unleashed a global tidal wave of cheap money which flooded into emerging markets. However, since Ben Bernanke announced, in May 2013, plans to first 'taper' and then 'exit' from QE as the US recovery gathers momentum, capital flows have gone into reverse with money flowing from emerging to advanced economies. A number of emerging economies currently face plunging currencies and stock markets as well as rising cost of borrowing abroad, with foreign institutional investors selling-off their holdings of domestic currency denominated bonds. India, Indonesia and Thailand are three Asian countries which have been affected adversely in this way. Each of these countries has weaknesses in its economic fundamentals.

### India: Looks Dangerously Exposed to Global Capital Swings.

India, with its twin budget and current account of the balance of payments deficits, looks dangerously exposed to sharp swings in global capital flows. Already, the Indian Rupee has plunged to record lows and there has been a sell-off in the stock market. With the sharp depreciation of the Rupee, the authorities are confronted with a difficult balancing act between currency stabilization and growth protection. Furthermore, there is likely to be a surge in inflation as imports become more expensive. If investors lose confidence in India's ability to fund the growing deficit in the current account of the balance of payments they could further

accelerate the selling-off of their holdings of government bonds, thereby pushing-up interest rates and squeezing the already declining growth rate even more. The stalling of economic reforms has left India more exposed to the adverse effects of a reversal in capital flows.

**Indonesia: Vulnerability to 'Sudden-Stop.'**

The Rupiah has depreciated to its lowest level against the US dollar in four years and share prices have declined by over 10% during the week ending 23 August alone. Indonesia is being hit not only by a reversal of capital flows but also by falling commodity prices triggered by concerns that the Chinese economy is slowing. The current account deficit has reached levels last seen in 1996, before the Asian financial crisis. This has raised fears of a balance of payments crisis if the interest rates on foreign borrowing continue to rise. Indonesia, is particularly vulnerable to a 'sudden-stop' (drying-up of access to foreign borrowing) as 1/3 of its government bonds are owned by foreigners. It is worth recalling that the stabilization measures imposed in the wake of the Asian Crisis led to the overthrow of the powerful Suharto Regime, which held power for decades.

**Thailand: Unsustainable Credit Growth**

The Thai economy has slipped into recession (two successful quarters of negative growth). GDP contracted by 1.7% in 1Q 2013 and 0.3% in the subsequent quarter. This marks a significant turnaround from the 6% growth in 2012. The stock market, which rose by 50% between early 2011 and May 2013, has fallen by 15% since then. Doubts have also emerged about the country's economic fundamentals. The sustainability of its economic model, which has become increasingly reliant on credit growth, has created uncertainty among market participants.

**Lessons for Sri Lanka: Drive Towards Greater Resilience.**

There are lessons to be drawn for Sri Lanka from the experience of each of the three countries mentioned above. India's vulnerability stems from its twin budget and current account of the balance of payments deficit. It has become increasingly difficult to protect growth while stabilizing prices and the currency. The risk of a sharp fall in growth has risen. These are challenges, which are familiar to Sri Lankan policymakers. Indonesia is particularly vulnerable to a 'sudden-stop' in capital flows as a third of government bonds are foreign-owned. Sri Lanka is less vulnerable in this regard as it has a cap of 12.5% on foreign ownership of Treasury Instruments. However, a sharp sell-off of the over US$3.5 billion foreign ownership of Rupee denominated Treasury Instruments would be disruptive. It would exert pressure on the currency (and through this on inflation as well) and increase borrowing costs. The lesson from Thailand is the vulnerability of a growth model that is too reliant on domestic credit growth. The demand for credit has been muted in Sri Lanka, though there has been some pick-up in recent months.

The change in the overall global economic landscape means that emerging economies are moving into a world where there will be a reversal of capital flows back to advanced economies.

Analysts at HSBC have argued that a “China Crash” rather than the end of the US Fed’s QE program would trigger a damaging outflow of capital from emerging markets as investors seek “safe heavens” in developed countries, particularly as the US economy is recovering, recession is bottoming out in Europe and Japan is growing again. As argued in previous Pathfinder Foundation (PF) articles, the latter scenario seems less likely. However, under either scenario, external liquidity constraints will tighten for emerging economies.

**Key Messages: The Path to Stable Growth.**

The key message to take away in this more uncertain world for emerging economies, like Sri Lanka, is that countries with weak fundamentals will be most vulnerable to economic disruption. This places an even higher premium on addressing the twin budget and current account deficits as well as ensuring that the external debt dynamics are sustainable.

In the recently published Economic Alert 51, the PF argued that there was some scope for relaxing monetary policy in the context of below trend growth; lower inflation; some improvement in the current account of the balance of payments; and fiscal consolidation. The PF advocated that this should be done very cautiously. However, the timing of any relaxation of monetary policy would have to factor in the impact on international capital flows of the “Feds taper.” It would be very inadvisable to reduce interest rates at a time when foreigners are selling-off their holdings of Rupee denominated Treasury Instruments.

Finally, the best way to insulate Sri Lanka from the adverse effects of a world of reversing capital flows would be to address macroeconomic imbalances and implement structural reforms, which strengthen the growth framework as early as possible. Above all, it is important to become less dependent on debt-creating inflows (government dollar bonds; foreign holdings of Rupee denominated Treasury Instruments; and borrowing abroad by banks and corporates) and be more reliant on non-debt creating flows (earnings from exports of goods and services; remittances; and foreign investment, particularly FDI).

The tightening of external liquidity conditions for an emerging economy, like Sri Lanka, which has been dependent on foreign borrowing, strengthens the case for obtaining a new political mandate as early as possible to create the conditions for a package of reforms to strengthen macroeconomic fundamentals and implement growth enhancing structural reforms.

The seriousness of the implications of the shift in global capital flows is reflected in the remarks made by Christine Lagarde, Managing Director of the IMF. In her remarks at the recent Jackson Hole Central Bank Governors Conference, she anticipated that a number of emerging economies could run into trouble in this new global environment. She indicated that the IMF would need to

ready itself to provide the appropriate support for countries that face external financing problems.

***This is the Fifth in the series of Weekend Economic Blast published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org***

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