Global Capital Flows and Consumption Booms and Busts

Unbridled capital flows around the world have outgrown the real economy. In this edition of Signature Report, Signature Global Advisors' Chief Investment Officer Eric Bushell examines the powerful pattern of price distortion, economic crisis and recovery that comes with massive global capital flows. In tackling the root cause of the current crisis, global savings imbalances, governments will likely place constraints on capital movements.

Growth in capital flows: the bonanza pattern

Global capital sloshing around in ever greater scale has become a powerful source of price distortions and risk in economies large and small. Carmen and Vincent Reinhart have examined the record of trade and funding imbalances over decades. Their study examined over 150 such "capital bonanzas" where asset markets and economies build up with inflows and collapse upon reversals.[i]

In a typical episode, a new development (such as NAFTA in the Mexico example of the early 1990s) convinces investors that risk has fallen and capital flows into a national economy, seeking higher yields and growth. Over a period of three to four years, equity and housing markets rise, bank lending surges, confidence grows and investment accelerates. Government spending typically expands rapidly. For a period, these foreign capital flows allow the nation to consume more than it saves. But a reckoning inevitably arrives in the form of a "sudden stop" in flows when politics, inflationary bottlenecks, banking losses or deficits draw investors' attention to the current account deficit risk.

Reinhart highlights three preconditions that have driven booms in capital bonanzas:

1. Low real interest rates in developed markets, which force fixed-income investors to seek higher yields in riskier markets.
2. Strong commodity prices, which flood oil-producing nations with surplus cash that must seek out investments, feeding investment booms in resource-rich countries.
3. Low growth in developed economies leaves Western bankers with few lending opportunities, and equity investors chasing growth.

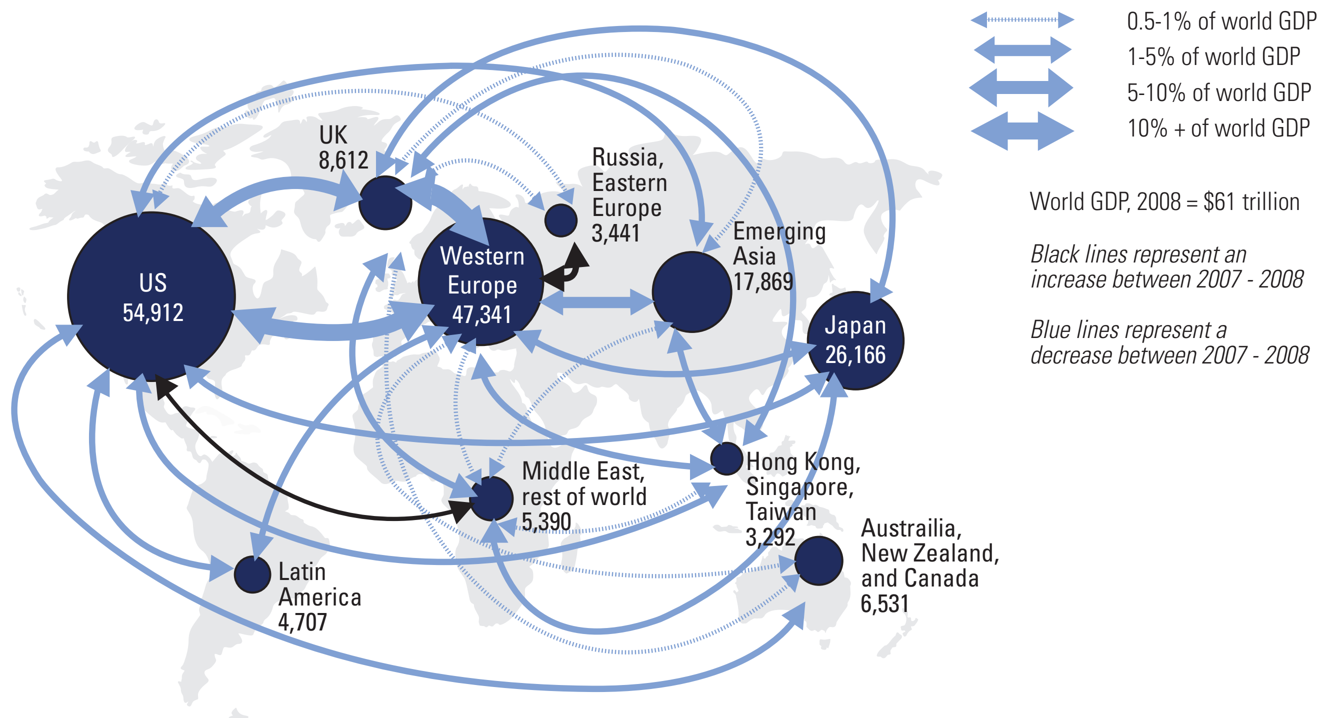
Today, real interest rates are negative, commodity prices are at record highs and developed markets are growing slowly. These circumstances are clearly directing Western capital toward smaller emerging markets – and we are seeing the distortions in their debt, equity and housing markets.

This established pattern of international capital flows in emerging markets has greater relevancy to developed markets today given that roles were reversed in 2003-2008 with current account deficits in Spain, Greece and the U.S. being most pronounced. The reversal took place abruptly with the credit crisis, but the long-term adjustments have only begun.

Evolution of bonanzas

The nature of capital flows has evolved over time. The 1978-82 episodes that affected middle-income countries in Latin America and Africa took the form of syndicated bank loans to sovereign borrowers and local banks. Current account deficits reached as much as 6% of GDP before foreign lenders exited, leaving local borrowers scrambling to refinance maturities – much as we are seeing in Spain and Portugal today.

The Web of Cross-Border Investments Weakened Slightly in 2008



Source: McKinsey Global Institute Cross-Border Investments Database

Chart 1: An analysis of cross-border investment flows show that they declined in almost all regions from 2007-2008, during the global financial crisis. The widths of lines show the size of total value of cross-border investments between regions. (Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment). Figures in bubbles show size of total domestic financial assets, US$ billion, 2008. The 2008 exchange rate is used.

During the Asian crisis of 1997-99, local banks had become reliant on short-term forms of borrowing to support credit growth that had outstripped deposit growth. Lending discipline had withered all around. Ultimately, the exit of capital crushed asset values, triggering bank failures. (The Korean government is still in the process of selling banks that had been nationalized after the 1998 "sudden stop" in Asia). Graciela Kaminsky has contributed substantially to this subject, linking international capital flows and financial stability.[ii]

Foreign direct investment and portfolio investment joined bank lending in contributing to the flow of capital, but banks were still at the core of the contagion in their rush to exit exposures in the Asian crisis. McKinsey reports show that cross-border lending rose from US$900 billion in 2002 to US$6 trillion in 2007, with 65% of this coming in the form of maturities under one year. Short-term funding is clearly a source of instability, as Lehman Brothers came to learn, yet the cycles of inflows and outflows continue

Adjustment phase: emerging or developed markets

Current account adjustments, be they in emerging or developed markets, are generally unhappy times. While the facts can get lost in the haze of time, the pattern is remarkably common. Exchange rates fall, credit becomes scarce and forced deleveraging of governments, corporations and households depresses growth. Savings rates rise as nations are forced to self-finance all borrowing. Asset values of equities and housing often fall or remain depressed for years. Banks recapitalize and consolidate. Imports fall, exports rise. These adjustments can come quickly through external prices in a foreign exchange collapse, or more slowly through internal prices where wages and asset values fall gradually over time, eventually restoring the competitiveness of the country's exports, and dampening imports. Adjustments in a currency union, like the euro, are more painful because the decline must be borne entirely by internal prices, wages and assets. For this reason, the outlook for growth in peripheral European markets will be bleak for some time.

"Watch in 2011 as contentious debates emerge at the World Bank and International Monetary Fund about how to devise fair capital controls to provide a more stable system."

This cycle: current account deficits in developed markets

Looked at in today's context, we can see that all of the policymaking in Basel, the new U.S. financial regulations, etc. are symptoms of a much larger root issue – that of unbridled capital flows distorting economies. Watch in 2011 as contentious debates erupt at the World Bank and IMF about how to devise fair capital controls and a more stable system. Some central bankers, like Mark Carney of the Bank of Canada, who are less distracted by smoldering fires of the crisis, are increasingly focused on this point.[iv] Retrospectively, it may take America to suffer the consequences of a current account adjustment for the new rulebook of global capital controls to be drawn.

A paradox of recent years has been that aging, developed nations have been financed by poorer, younger ones. This savings/investment imbalance broadly measured by current account surpluses and deficits grew at 11% annually from 1990 to 2007, nearly double the pace of global trade growth. By 2007, imbalances had reached 5% of global GDP from a level under 1% before 1990 (See Chart 2). This has been attributable to 1) Asia's adoption of the Japanese/German export-led economic development model; and 2) Following the Asian crisis, the entire region looked to insulate itself from unreliable foreign financing by accumulating massive foreign exchange reserves (See Charts 3 and 4). Devoted to reserve currencies and AAA assets, these reserves worked to depress long-term interest rates and contributed to the credit bubble in housing across Europe and America – and laterally to bank failures and new bank capital regulation.

Past current account adjustments for low or middle-income countries were dealt with rather harshly by developed countries and their agencies. The deficit nations were not systemically important in terms of GDP or banking system assets. When they were (as with Mexico in 1994, because

Current Account Reversals in Emerging Markets

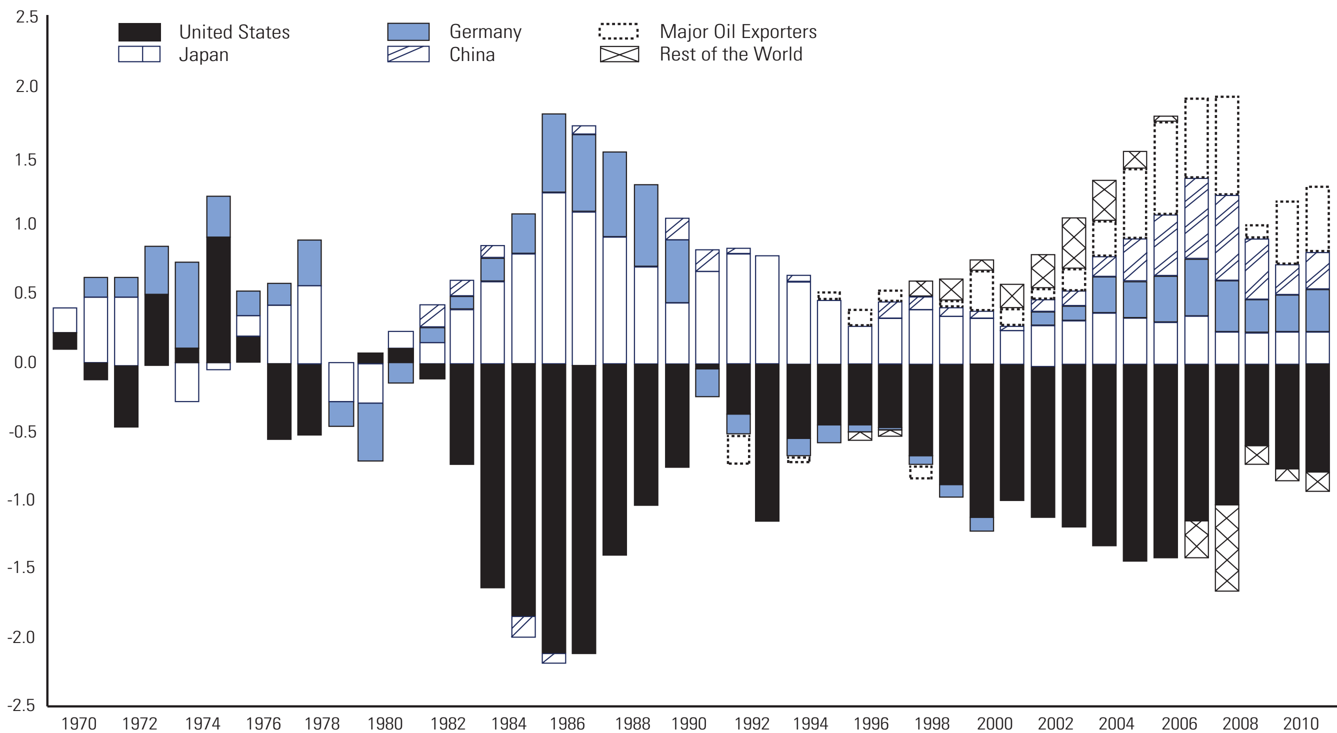
Developing nations like China and India that have insulated themselves from capital flow volatility through restrictions on foreign borrowing fared much better through the financial crisis. While the independent route has appeal, most developing nations lack sufficient savings to financial domestic investment needs and will look to tame the tiger. Brazil's Olympic bid and India's roadways will require foreign capital, for example.

As we write, emerging markets inflows are pressuring domestic growth rates and exchange rates higher. Under attack from local exporters, finance ministers are resisting this pressure through currency interventions and reserve accumulations. But this strategy can be costly and lead to growth in local money supply with related inflation risks. The overheating of emerging markets is a concern, particularly while developed market deflation risks keep financial conditions excessively loose. Protestations in emerging markets over the U.S. Federal Reserve's second round of quantitative easing ("QE2") highlight the policy challenge of operating in a two-speed global economy. There may be a dual motive for the U.S. in QE2. Emerging market pain can be a U.S. gain as higher wages and foreign exchange in developing economies accelerate global current account rebalancing. This may be America's best route to increased competitiveness as it reduces the need for outright deflation in U.S. wages and assets values.

To mitigate distortions and ensure financial stability and growth, the IMF and OECD have undertaken a 180 degree philosophical shift from the pure market ideologies they extolled to Asian economies post-crisis to the more accepting attitude towards capital controls on inflows today. This is also evident in their promotion of more generous, unconditional bridge loan facilities to countries looking to protect against hot money outflows.

There is a new recognition that creditor nations must bear some responsibility and act accordingly to avoid sudden stops. This behaviour was seen in the recent central and eastern European banking crisis of 2009 where restrictions on European banks' capital repatriations were negotiated. Luiz de Mello and Pier Carlo Paduon, looking at the lessons of 160 current account reversals, show impacts can be mitigated through tightening monetary and fiscal policy in the build-up phase, as well as capital controls favouring long-term money over "hot" money.[iii] Global policymakers will be consulting their work in 2011.

Current Account Balances in % of the World GDP, 1970-2010

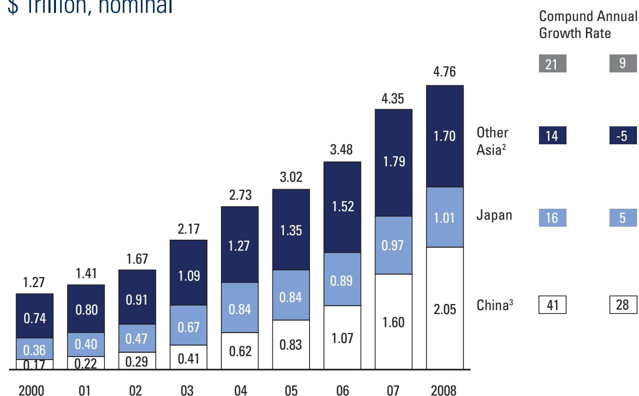


Source: De Mello and Padoan (2010)

Chart 2: Large global imbalances are not necessarily undesirable, so long as they reflect increased financial integration and a more efficient allocation of global savings across countries. But past experience shows that current account reversals following rising global imbalances can be sizeable. The associated disruptive movements in capital flows could pose risks for the global recovery, which remains hesitant and uneven across countries and regions.

Asian Holdings of Sovereign Foreign Assets[1] in 2000-08

$ Trillion, nominal



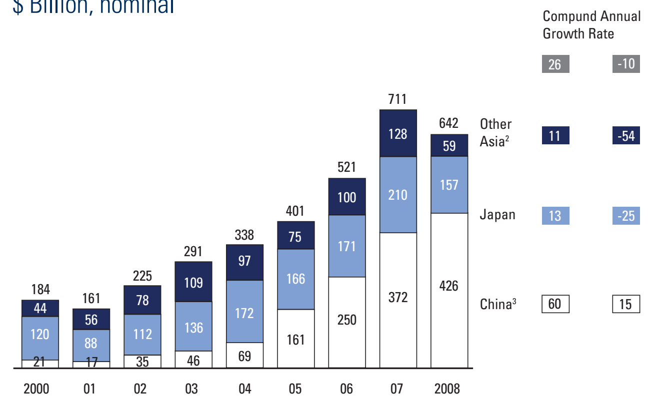
[1] Includes central bank reserve assets and sovereign wealth funds foreign assets.
[2] Other Asia: Bangladesh, Cambodia, Hong Kong, India, Malaysia, Pakistan, Phillipines, Singapore, South Korea, Sri Lanka, Talwan, Thailand, Vietnam.
[3] Does not inlude foriegn assets of state-owned banks or other companies.

Source: Global Insight; People's Bank of China; McKinsey Global Institute Analysis

Chart 3: Asian sovereign investors' foreign assets grew to $4.8 trillion by the end of 2008, up from $4.4 trillion in 2007. While this growth was impressive against the backdrop of the global economic crisis, it is substantially lower than the the 21% annual growth rate from 2002-2007.

Current Account Balance of Asian Exporters in 2000-08

$ Billion, nominal



[1] "Capital Flow Bonanzas: An encompassing view of the past and present." Working Paper 14321, National Bureau of Economic Research, September 2008.

Source: International Monetary Foundation, McKinsey Global Institute Analysis.

Chart 4: The growth in Asian countries' foreign assets has been driven by large current account surpluses in Japan and, especially in recent years, China.

of its proximity to the U.S. and large trade, investment and lending ties), emergency loan guarantees and support have been mobilized. For America, historical current account adjustments were undertaken at a point where foreign holdings of Treasuries and absolute debt were at lower levels and when America was the undisputed global power. In the 1970s, when labour's political leverage peaked, protectionism was the tool that drove down imports and brought balance with Germany and Japan. In the mid-1980s the G7 countries crafted the Plaza Accord to devalue the dollar versus the yen and deutschmark and allow U.S. exports to recover. Japan has yet to recover from the property bubble this created by 1989. This is a point not lost on China, which refuses to be a pawn in America's world.

The current account adjustments taking place today qualify as systemically important and too big to fail. Growth and stability in the European Union and the U.S., the world's two largest consumer economies, are at stake. The adjustments are complicated by the fact that due to the crisis, sovereign debts have risen to limits of solvency, and, if that's not enough, that the solvency of the European banking system hinges on the outcome.

In January 2011, we approach a time of decision for creditor nations. Does one forebear or foreclose? Which is more costly in the end?

Conclusion

The policy prescription today must consider collective interests. Politicians in creditor nations will struggle to persuade national electorates to share the pain of adjustments. Near-term costs like providing subsidized loans to debtor governments (like Germany is doing) or buying more sovereign bonds in a falling currency (like China is doing) are never easy sells. Nor will it be easy for debtor nations to cut services and raise taxes. However, if that's the cost of ensuring economic, social and political stability, it's worth the price.

Germany and China have both experienced hyperinflation in modern times. An over-indebted Germany in the aftermath of the First World War printed money to fund pensions and reparations. The social chaos that ensued led to Nazism. China, after the Second World War, lost funding for its ongoing civil war and destroyed its citizens' savings, which surely influenced the communists' victory in 1949. For those who view this as hyperbole, recognize that financial stability is a prerequisite for productive economies and stable political systems and societies. As Lorenzo Bini Smaghi, executive member of the European Central Bank, has noted, "Europeans have not forgotten the devastating effects that the expropriation of wealth, such as that carried out during the two world wars by way of inflation or defaults, may have on the economic and social fabric.

There is awareness that, in the end, it may be less costly to tackle excessive public debt with the traditional remedies – that is, achieving an adequate level of primary surplus – rather than looking for quick fixes."[v]

Has the financial crisis of 2008 left current account deficit nations indebted to the point that money printing and inflation or default lie ahead? Surely this is the fear that grips creditors. But the weight of vested financial and trade interests, coupled with the lessons of history, argue for those creditors to be patient. Time can heal some of the patients. In Europe, debtor nation patients have faced market medicine. The private sector has abandoned the borrowers, leaving states, the IMF and central banks as lenders of last resort. The Deauville deal between Sarkozy and Merkel in November means that Germany and the broader European community will fund weaker euro members as they have done to date. Conditional bridge loans are the responsible mechanism for incenting fiscal adjustment.

Can America adjust fiscally without pressure from currency and debt markets? The signals I get are that China is a responsible global citizen. The new five-year plan recognizes the need to rebalance the economy toward consumption and away from exports. Already, China has been helpful in supporting peripheral European bond markets. Now, if only China can strike a conditional lending deal with the U.S.: "You tackle your deficits in exchange for stable funding." This would ease the adjustment for the U.S. and restore confidence in U.S. debt markets, but it won't change the fact that for several years, Asian standards of living will rise in relation to American ones – such is the nature of global rebalancing.

After the mess of the G20 meeting in Seoul last November, skepticism is high that global leadership can coordinate solutions. Ian Bremner of the Eurasia Group has dubbed the discordant world system that exists post-G7 and G20 as "G-Zero," arguing that geopolitical and economic turmoil is the world's largest risk.[vi] We are more optimistic that knowledge and history will guide decisions and that leadership will emerge.

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[i] "Capital Flow Bonanzas: An encompassing view of the past and present." Working Paper 14321, National Bureau of Economic Research, September 2008.
[ii] "International Capital Flows, Financial Stability and Growth," Department of Economic and Social Affairs Working Paper No. 10, December 2005.
[iii] "Global imbalances: Lessons from historical reversals," Vox, August 2010.
[iv] "Restoring Faith in the International Monetary System," Remarks by Mark Carney, Spruce Meadows Changing Fortunes Round Table, Calgary, September 10, 2010.
[v] "Europe cannot default its way back to health," Financial Times, December 17, 2010, page 11.
[vi] "Top Risks 2011," Eurasia Group, January 4, 2011.

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