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Capital Controls – Coming To A Country Near You?

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There are two ways of constructing a software design; one way is to make it so simple that there are obviously no deficiencies, and the other way is to make it so complicated that there are no obvious deficiencies. The first method is far more difficult.

–- C. A. R. Hoare

All about capital controls

Two days ago the investment community was shaken up a bit by the announcement that Brazil intends to re-introduce the IOF levy, its tax on a wide range of foreign financial transactions, as a measure aimed at preventing further appreciation of the real. Keep in mind that this is a pre-existing tax that was abolished only last year, and that while the new rates under consideration are slightly broader (including equities transactions) and slightly higher (2% instead of 1.5% for the highest rate) than in the previous incarnation, this is still more of a mild irritant to financial flows than a full-on barrier. As a result, beyond the initial predictable sell-off in regional currency and equity assets the market seems to have taken the news flow in stride.

On the other hand, in the current environment of buoyant risk appetite, unusually low global interest rates and unprecedented liquidity injections from developed central banks, many clients are clearly concerned that this is an early harbinger of things to come, as more and more EM countries are forced to deal with the effects of large-scale capital inflows.

In this note, co-authored with emerging FX and fixed income strategist **Bhanu Baweja**, we take a closer look at the reasons for the current move, the potential ramifications for other economies and likely scenarios going forward. The analysis that follows generally represents our common views; any individual conclusions or ideas are identified as such in the text.

Our main conclusions are simple. First, despite the visibility of the Brazilian move we do not see strong risks of a widespread adoption of capital controls today or any time in the immediate future. But second, a protracted environment of low global rates, high global liquidity and strong EM growth would raise the likelihood that policymakers will face increasingly uncomfortable choices down the road, and in this scenario capital restrictions could well be a favored solution. And finally, if we were to identify possible candidates in addition to Brazil we would point to Egypt, Colombia, South Africa, India and Korea, and potentially the Asian surplus economies as well.

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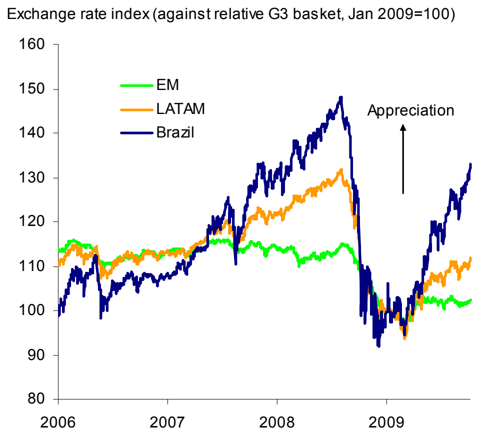
Why Brazil?

The first and most obvious question is "why Brazil"? And the most direct, but also superficial answer is that (according to our rough trade-weighted methodology) the Brazilian real has strengthened more than any other currency in the emerging world since the beginning of the year.[1]

Chart 1: The rise of the real

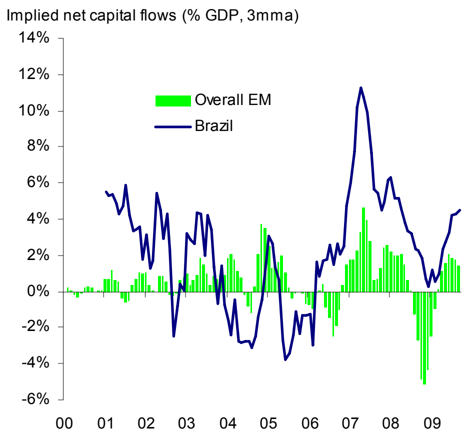


Source: Bloomberg, CEIC, UBS estimates

The rapid rise of the real is very visible from Chart 1 – so what makes this a "superficial" answer? The reason is that it raises a more fundamental question, i.e., that of why exactly the Brazilian currency strengthened so much more than the emerging average.

The natural response would be to posit that perhaps Brazil was facing much stronger capital inflows than the average EM country … and to some extent this is true, as shown in Chart 2.

Chart 2: Net capital flows into EM



Source: Haver, Bloomberg, CEIC, IMF, UBS estimates

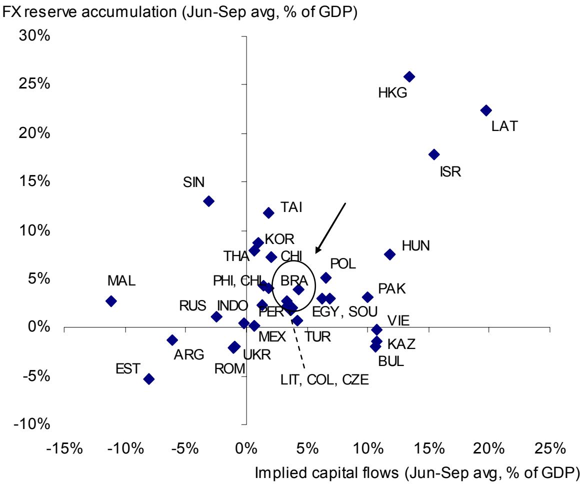
(The chart shows a broad top-down estimate of net capital flows into emerging markets, defined as official valuation-adjusted FX reserve accumulation less the current account balance. Keep in mind that this measure

[1] Chart 1 shows (i) a weighted-average EM currency index against the G3 trade-weighted basket; (ii) a weighted-average Latin America currency index against the US dollar, and (iii) the Brazilian real against the US dollar

includes *all* forms of capital including portfolio flows, FDI and official finance, so it is far from a perfect gauge of pure financial market pressures; on the other hand, it is the only "real-time" indicator we have).

However, this is clearly not the whole story. In Chart 3 we provide a scatter plot of recent implied capital flows and overall FX reserve accumulation as a share of GDP by country, and as you can see, while Brazilian inflows may have been slightly above average over the past quarter or so they were certainly nothing to "write home about"; many other countries saw a higher pace of reserve accumulation, many saw faster implied capital inflows and more than a handful saw both. In nearly all of these cases central banks were happy to continue intervening to maintain pegs or prevent undue appreciation – and virtually none of them applied new capital restrictions.

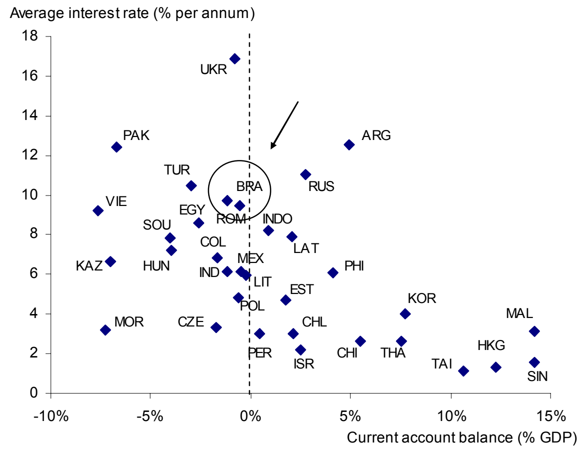
Chart 3: Capital flows and FX reserve growth by country



Source: Haver, Bloomberg, CEIC, IMF, UBS estimates

So if Brazilian policymakers are concerned about the pace of currency appreciation, why didn't they just intervene more aggressively to keep the real stable? And indeed, looking back at Chart 2 above, why react now to net capital inflow pressures of around 5% of GDP with financial transactions taxes that are higher than they were back in 2007, when inflows spiked to nearly 10% of GDP? The short answer is given in Chart 4, which shows the average level of (short term and long term) interest rates:

Chart 4: Interest rates and current account positions



Source: Haver, Bloomberg, CEIC, IMF, UBS estimates

As it turns out, with short-term interest rates at nearly 9% per annum and long-term bond yields of 10% or above, Brazil has some of the highest rates in the emerging world. And this matters a great deal; it's one thing for a country like China, Thailand, Taiwan or Hong Kong to run sizeable current account surpluses and accumulate large reserve positions when interest rates are no higher than those in the US or EU, i.e., when the implied cost of sterilization is essentially zero – and quite another to commit to a stable currency regime and free and open capital flows when there is 700-800 basis points of positive carry on the table. In an environment where global risk appetite is once again strong and implied volatility levels have fallen sharply, this is tantamount to inviting a flood of speculative capital into the country when the implied costs of sterilizing those inflows are very high indeed.

This also helps explain the timing and size of the measures; Brazilian interest rates were higher back in 2007, but then so were US and European rates, and by a more significant margin.

What it means for the rest of us

So far, so good, and we've tried to answer some of the immediate questions on the recent Brazil move. Now we'd like to step back and try put this into a bit broader perspective.

The first point is that, as we have highlighted many times in the past, emerging markets came into the current global crisis with balance sheets in better shape than they have been in nearly four decades. While the recovery in the developed world has largely been producer led, in EM for the most part the consumer has shown clearer signs of life.

And over the course of 2009 this has meant stronger real growth rates in the emerging world, higher average inflation rates in the emerging world – and thus, for the most part, higher financial returns in the form of higher local-currency interest rates and a better nominal corporate earnings outlook.

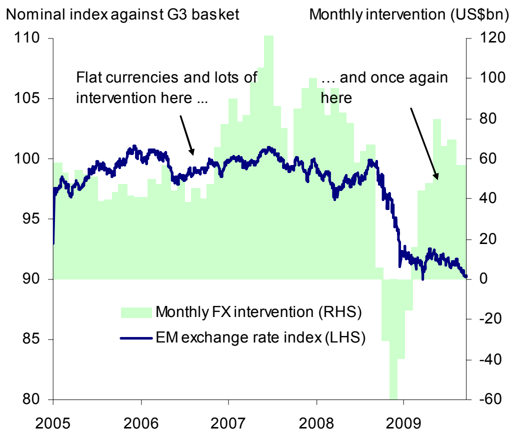
In the early crisis days of Q4 2008 and Q1 2009, of course, this mattered little as virtually all EM economies saw large outflows. However, the subsequent quick return of private capital inflows into emerging equity, debt and currency markets is testament to idea that EM had passed its "stress test" with flying colors, and the combination of a visible recovery in EM and near zero rates in developed markets have meant the emerging central banks' FX reserves are once again increasing in larger clips every month.

Going forward, it's easy to imagine that the amount of capital directed to emerging markets can increase further as developed central banks keep rates lower for longer while rates "normalize" more quickly in EM against the backdrop of a more robust recovery. Indeed, many investors are already actively discussing the possibility of an incipient emerging asset bubble (see for example chief Asian economist **Duncan Wooldridge's** recent report *Asia: Get Ready To Rumble, Asian Economic Perspectives, 16 October 2009*).

And if EM policymakers do end up having to worry about rising amounts of speculative capital and their impact on asset and output volatility, there are essentially four choices at hand. The first is to let currencies appreciate significantly to "let off steam" and avoid liquidity pressures at home; the second is to intervene heavily without sterilization and let asset markets inflate; the third is to intervene and then sterilize the liquidity impact at home – and the fourth, of course, is to try to dampen or derail the process through capital restrictions and controls.

In our view, the first option to let currencies appreciate sharply is *not* a very likely choice. As we showed in *Nothing To See Here, Folks* (*EM Daily, 1 October 2009*), emerging policymakers have a natural preference for nominal currency stability (or to put it in market lingo, for "mercantilist" quasi-pegs with lots of intervention to keep exchange rates from appreciating). This was pretty much the case over the past 50 years of post-war history; it was the case all through the 2003-08 boom despite a combination of record-high current surpluses and very strong capital inflows … and after the one-off devaluation late last year, it remains the case today as markets improve and capital returns to EM once again; as shown in Chart 5, central banks are once again intervening in large amounts to keep currencies flat against a trade-weighted G3 basket.

Chart 5: EM just doesn't like floating currencies



Source: Haver, Bloomberg, CEIC, IMF, UBS estimates

This implies continued strong intervention ahead if capital inflows continue to accelerate; for the time being most central banks are either sterilizing those inflows or simply letting them pushing domestic liquidity, but these options also become increasingly less attractive or even completely untenable as economies recover, output gaps close, inflation picks up, interest rates rise and asset markets continue to rally. And as a result, we do see a risk that policymakers could turn to controls as a preferred means of battling "hot money".

Who's at risk?

So are we going to see countries across the EM world put on capital restrictions in the immediate future? Our answer would be no; it's clear from Chart 2 above that capital is flowing back to the EM world in visibly positive amounts, but we're also still below the peak inflow levels of 2007-08.

However, in our view it's worth taking a hard look now at who the high-risk cases might be. And in our view there are two groups of countries to watch.

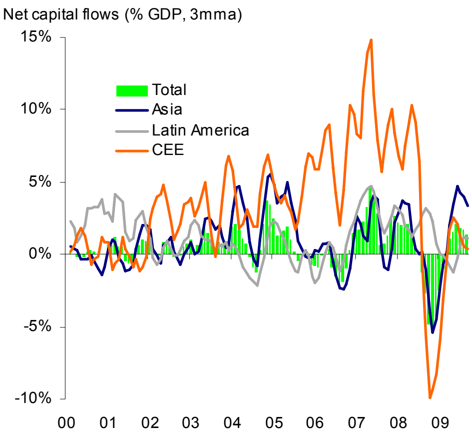
The first, in line with Brazil's experience above, are what we might call the "carry economies", i.e., those countries where interest rates are already significantly above G3 levels and thus where (i) incentives for return-seeking capital inflows are potentially the highest, and (ii) sterilization is already not a sustainable option. Looking back at Chart 4, if we exclude the extreme high-yield risk economies and the more troubled Eastern European balance sheet cases, we are left with a group that includes Brazil, Turkey, Russia, Egypt, Indonesia, Colombia, Mexico, South Africa and India.

Of these, we would highlight Brazil, Egypt, Colombia, South Africa and India as potential candidates here (Turkey is a deficit economy that still faces strong external refinancing constraints and would not want to risk capital disruptions, Russia's commitment to open capital flows is still a cornerstone of ruble support, Mexico would likely welcome some further appreciation pressures in the near term and we see Indonesia as fundamentally more comfortable with currency volatility than most of its peers).

The second group are chronic surplus economies, i.e., those with have very sizeable positive external current account positions. From Chart 4, these are essentially the Asian "tigers": China, Hong Kong, Korea, Taiwan, Singapore, Malaysia and Thailand. These countries tend to be seen as "one-way bets"; large overall surpluses essentially guarantee against downside exchange rate risks, and as a result policymakers have almost no choice but to keep currencies pegged in order to avoid strong upside speculation. One problem is that large current account surpluses generally imply a very high savings rate, which in turn mean very low onshore interest rates (from the chart, this is true today in almost all the above list), so there is little to keep the central bank from just intervening and sterilizing the entire surplus without hurting domestic private investment.

On the other hand, as Duncan discusses in his report, structurally low rates can also help inflate other asset classes such as property and equities, which could sharply increase inflows pressures going forward – and looking at Chart 6 below, Asia is the only region in the EM world where net capital inflows are already pushing against historic highs.

Chart 6: Net capital flows by region



Source: Haver, Bloomberg, CEIC, IMF, UBS estimates

On balance, we would probably highlight Korea as the one Asian country to watch for risk of capital restrictions in the near term, but the situation could change if the risk asset rally continues going forward.

What kind of restrictions?

Capital restrictions come in all shapes and sizes, and can be adopted to tax short term inflows (Chile 1991, Thailand 2006), allow the central bank to exercise independent monetary policy (Malaysia 1998), or prevent currency appreciation (Brazil 2008, 2009). The Malaysian experience was one of the more extreme versions, where the capital account was largely shut to foreign portfolio investors, the ringgit was pegged to the USD and declared illegal tender offshore – but in fact we don't see that kind of full-scale shut-down as remotely likely in the current environment; remember that the Malaysian controls went on at a time when there was significant capital flight from the economy and this had driven local interest rates to levels that threatened the economy with paralysis. On balance, if we do see controls going forward we believe they would be of the Chilean/Thai variety of imposing FX-specific reserve requirements or the Brazilian version of imposing taxes on financial transactions.

Financial de-globalization?

As a final note, for Bhanu this even raises the spectre of financial "de-globalization". As he puts it, global output recovery has been helped in no small measure by significantly higher public debt to GDP ratios, and with government spending now a key driver of growth there is a natural tendency to limit the "import leakage" of the fiscal multiplier, i.e., governments will want to spend the proceeds from their increased issuance of debt on *local* labour and capital and thus will look to limit the proportion of each marginal fiscal dollar expended on imports. So while we could see protectionist measures from developed markets over the coming years aimed at restricting the free flow of goods and perhaps even labor, in this view investors may first be confronted by restrictions and/or taxes on capital flows – and of course, as Brazil's example showed this week, it is much more likely to be emerging countries rather than G10 economies that put up the barriers to capital.

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