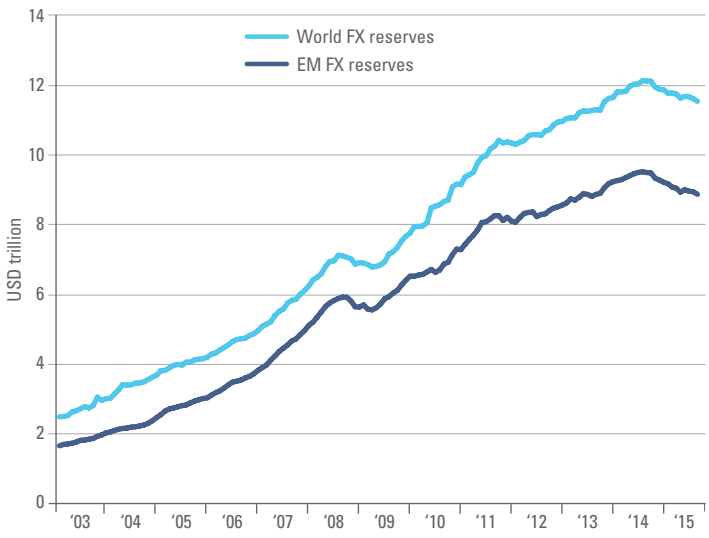
Ashmore

Emerging Markets capital flows

By Jan Dehn

Emerging Markets (EM) foreign exchange reserves have dropped about USD 650bn (7% of total reserves) since reaching a peak of USD 9.4trn in June 2014. The decline in reserves is a concern, because reserves matter to investor confidence, while EM policy-makers regard reserves as pivotal in ameliorating currency volatility. On the other hand, EM controls nearly 80% of the world's FX reserves as insurance, which is meant to be used precisely at times such as these. This report seeks to determine whether there are valid grounds for worrying about the recent decline in EM reserves by establishing why they are declining.

Fig 1: **World and EM foreign exchange reserves (ex-gold)**



Source: Bloomberg, Ashmore.

It is not just about flows

The financial press has been quick to attribute the entire decline in EM reserves to capital outflows.[1] This interpretation, it turns out, is entirely misleading. Currency movements are the big determinant of reserve levels. Huge shifts in exchange rates, particularly in the value of the USD have impacted central bank reserves in unprecedented ways since mid-2014. Currency movements do this by:

- Changing the value of the existing stock of reserves independently of what happens to flows through the current and capital accounts
- Impacting competitiveness and thereby the current account, albeit with a lag
- Changing commodity prices

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These relationships are not always linear. The relationship between currency movements and reserves is complicated by differences in reserve composition (in some cases not fully known), J-curve effects and lags as well as differences in the overall quality of macroeconomic management across countries. A broad variety of currency regimes and different methods of currency intervention as variations in composition of trade also complicate the relationship between currencies and reserves.

To begin to unpack the relationship between currencies and reserves, this paper uses data on reserves, external flows and currency valuation effects for 54 of the most traded EM countries from 2001 to 2014. Higher frequency data is used for the past twelve months for as many EM countries as possible in order to throw further light on more recent developments.

Three results

The analysis arrives at three central conclusions:

- Firstly, the main reason for the drop in reserves since mid-2014 has been a sudden spike in currency valuation effects due to the extraordinary rally in the USD against most other currencies in the world. This is an important insight for two reasons. One is that capital outflows are materially smaller than feared. The other is that reserve depletion in EM is likely to be contained going forward if USD appreciation is contained.
- Secondly, EM current account balances are now beginning to respond positively to EM currency weakness. If so, the benefits of currency weakness are clearly providing significant positive offset for the negative impact of lower commodities.

[1] *"Surge in Emerging Markets capital outflows hits growth and currencies"*, Financial Times, 18 August 2015.

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• Thirdly, capital outflows have picked up, but they are not grossly out of line with outflows during previous periods of uncertainty. Besides, a very large part of EM's capital outflows are directly attributable to China, where domestic corporates have recently covered short USD positions. The good news is that China's Net International Investment Position (NIIP) is now balanced, which means that capital flows will moderate from here.

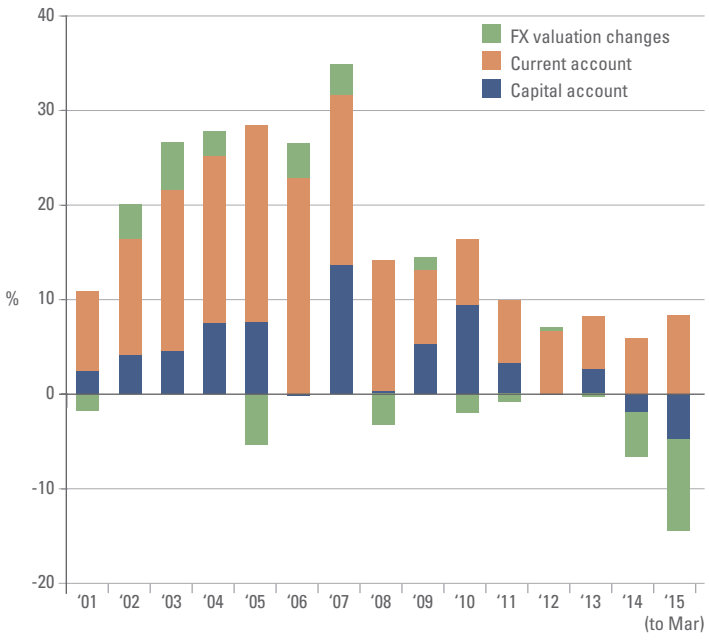
These three findings should offer some reassurance to investors and EM policy-makers that the big reserve cushions are (a) doing their job and (b) unlikely to be depleted to a problematic extent.

Indeed, the far bigger risk facing EM central banks is that roughly 97% of their reserves are invested in the four major QE currencies, i.e. USD, EUR, JPY and GBP. Unless basic laws of economics have suddenly and irrevocably changed – which is not our view – it is only a question of time before QE currencies begin to weaken in earnest. Japan has reached this stage already. Europe is trying to emulate Japan. The only way to guard against the risk of currency debasement from QE is to rotate into non-QE currencies. They provide excellent insurance and they happen to be cheap.

Determinants of changes in EM central bank reserves

Figure 2 shows how the changes in reserves in the 54 most traded EM countries have evolved between 2001 and March 2015. Changes in reserves are expressed in terms of FX valuation effects, current account changes and flows via the capital account from 2001 to March 2015. We discuss the contribution of each below.

Fig 2: **Breakdown of changes in EM reserves**



Source: Bloomberg, Ashmore.

Rotation into non-QE currencies acts as an insurance policy against the risk of currency debasement in the QE economies

(a) FX valuation effects

As the chart illustrates, FX valuation changes began to emerge as a major determinant of EM FX reserves in 2014 and the effect became even more pronounced in Q1 2015. Indeed, the magnitude of currency valuation changes was unprecedented.[2]

In terms of Dollars and Cents, exchange rate movements alone reduced EM currency reserves by USD 412bn, or 5% of total reserves in 2014. The currency valuation effects in 2014 were more than twice as large as any currency valuation effect recorded in any previous period in the sample period. For example, in the period 2001-2013, annual FX valuation impacts averaged just 1% of reserves (USD -1bn).

Using higher frequency data for a smaller sample of 43 EM countries, we estimate that FX valuation effects had increased to 9% of EM reserves by the end of March 2015 (a whopping USD 840bn). FX valuation effects continued to be important in Q2 and Q3 2015, albeit marginally less so. Initial indications using monthly data for a yet smaller sample up to and including June 2015 suggests that FX valuation effects still dominated both current account and capital account flows (Figure 3 below).[3]

Fig 3: **Determinants of changes in EM reserves**

	June 2014 – June 2015		June 2014 – March 2015		2014		2001 – 2013 average	
	USD bn	% of reserves	USD bn	% of reserves	USD bn	% of reserves	USD bn	% of reserves
Capital flow	-51	-1%	-412	-5%	-170	-2%	173	5%
Current account	173	2%	723	8%	521	6%	417	13%
FX valuation	-287	-4%	-840	-9%	-412	-5%	-1	1%
Sample size	17		43		54			

Source: Bloomberg, Ashmore.

[2] For discussion of data and methodology see the appendix.

[3] The sample size drops to 43 countries for the period June 2014 to March 2015 and drops further to just 17 countries for the period from June 2014 to June 2015 due to data constraints.

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Why did FX valuation effects suddenly assume such importance from mid-2014 onwards? The answer is that the USD rose sharply against virtually all currencies in the world, including other reserve currencies such as JPY, CAD, AUD and EUR. Without a doubt, the most powerful and popular narrative of the past half a decade has been that the US will grow faster and the Fed will hike rates sooner than policymakers in Europe. QE flows to the US have therefore tended to favour US stocks and especially the USD, which is now up around 40% over the past four years.[4]

Currencies have also generally gained more importance compared to other types of assets. Zero interest-rate policy (ZIRP) and QE have gradually erased more and more of the yield differential between currencies and bonds with the effect that currencies have grown more attractive relative to securities. After all, currencies are both more liquid and carry no credit risk.

It is likely that the importance of currencies will continue to grow in the future. Indeed, the global imbalances will eventually be resolved through massive global currency realignments, in our view.

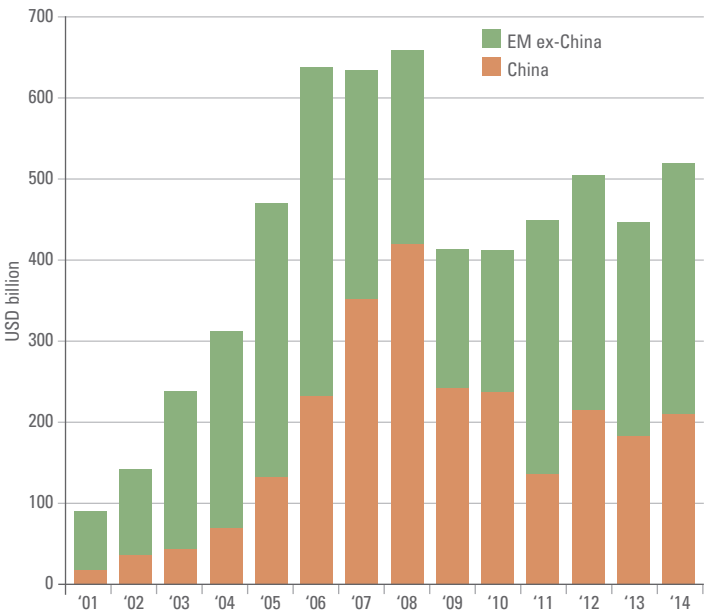
(b) Current account flows

The second observation from the decomposing reserves is that current account balances in EM countries are now making increasing (positive) contributions to the level of reserves.

Figure 4 shows the contribution to reserves from current account balances. Between 2001 and 2013, the current account contributed on average of USD 417bn to reserves per annum across the sample of 54 EM countries. By contrast, in 2014, this contribution increased by around 20% to USD 521bn.

There is some evidence that the current account contribution to reserves grew even stronger between June 2014 and June 2015, where early indications suggest that this increased to USD 723bn. That would mean that the current account contributed nearly twice as much to reserves as was lost in capital outflows over the same period (USD 412bn).[5]

Fig 4: **Contribution of current account to reserves in 54 EM countries**



Source: Bloomberg, Ashmore.

The importance of currencies will continue to grow. We expect global imbalances to be resolved through massive global currency realignment

Why are EM current accounts improving? The single most important reason is probably weaker EM currencies. It is noticeable, for example, that contribution of the current account has been bigger in EM ex-China than in China. Many EM countries have benefitted from substantial currency weakness in recent years, while China's currency has been quasi-pegged to the USD. Note also that the magnitude of the current account effect is such that it has offset much of the FX valuation effects discussed in the previous section.

Of course, there is not a straight-forward positive relationship between currency weakness and net trade. Lags and J-curve effects can produce perverse effects on the current account in the short term. The main threat to harvesting gains from currency weakness is that domestic demand pressures create inflation that in turn undermines the competitiveness gains arising from a weaker currency.

Fortunately, inflation remains contained in most EM countries. Indeed, many EM countries are experiencing outright deflation. The absence of inflation is testament to the credibility of macroeconomic policies in general and central bank policies in particular across the EM space.

A few countries have experienced very violent currency weakness, such as Brazil (largely for self-inflicted reasons) and Russia (due to a major fall in oil prices), but they have not shied away from hiking rates strongly in order to contain domestic demand.

The magnitude of EM outflows is substantially lower than the numbers reported in the media. Most capital outflows from EM have been due to China

(c) Capital account

Capital outflows from EM increased sharply in 2014 and continued into 2015. Analysis of these outflows points to two interesting observations.

The first observation is that the magnitude of outflows is substantially lower than the numbers reported in the media. The reason why the actual numbers are lower is that the numbers in the media did not control for FX valuation effects.

The second observation is that almost all the capital outflows from EM have been due to China. Chinese corporates borrowed heavily in USD in the last few years, but the recent adoption of a more flexible approach to the currency has triggered a significant portfolio shift as corporates have sought to close their net short USD positions.

[4] For further details, see *"The Dollar Bubble"*, Weekly Investment Research, 26 January 2015.

[5] Some caution has to be exercised with respect to the June 2014 - June 2015 numbers due to the smaller sample size.

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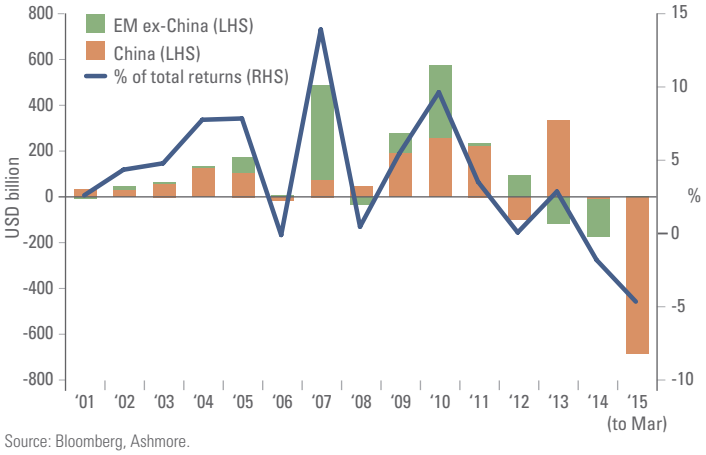
Figure 5 shows the size of capital flows as a percentage of EM reserves and distinguishes between Chinese and EM ex-China flows. Clearly, net of China, the EM outflow story has been one of relatively modest net outflows in 2014 and 2015. There is some anecdotal evidence that outflows have picked up marginally going into Q3 2015, but there is also plenty of circumstantial evidence to suggest that these flows are nowhere near the size discussed in the media.

For example, local bond yields and sovereign and corporate debt spreads in EM remain far below the levels reached during the 2008/2009 crisis.

Fig 5: **Capital flows for the 54 EM countries (2001 – March 2015)**



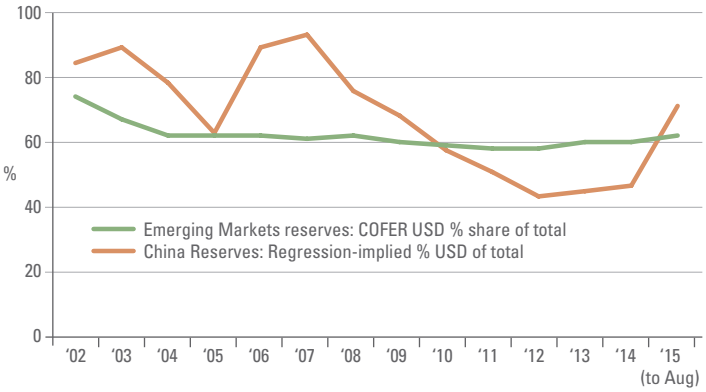
Source: Bloomberg, Ashmore.

Other issues

(a) Active reserve management

If EM central banks actively manage the non-disclosed part of their foreign exchange reserves, then this introduces a new source of change in the valuation of reserves. China is one country that does not fully disclose the allocation of its FX reserves. A simple regression of the USD index on reserves suggests that China increased the USD share of its reserves in late 2014/early 2015 – perhaps contributing to the rally in the USD over this period.[6] Active management means that at various points countries with undisclosed FX reserves may have had lower or higher exposures to the USD assets than those implied by IMF's COFER data for Emerging Markets as a whole (Figure 6).

Fig 6: **USD share of central bank reserves in China and Emerging Markets**



Source: Bloomberg, IMF, Standard Chartered Bank, Ashmore.

(b) Swaps

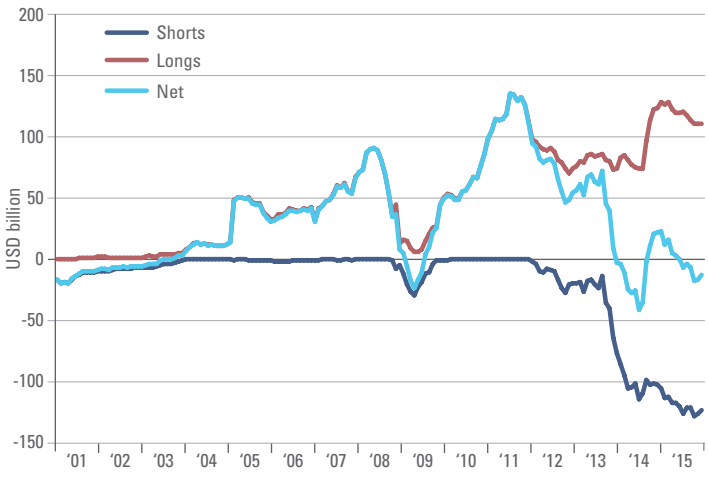
Currency swaps are becoming more common for intervention purposes. They act as de facto currency overlays, enabling central banks to offer foreign currency denominated liquidity without selling underlying securities. This is advantageous when liquidity in the underlying securities is falling due to bad regulation in the aftermath of the subprime crisis.

Is the omission of swaps important for our analysis? Despite their undoubted importance as instruments of FX intervention, they remain small relative to the size of overall reserves.

Standard Chartered Bank, which has the most sophisticated analysis of FX intervention, has compiled data on the use of swaps by central banks dating back to 2001.[7]

Based on their sample of the largest 24 EM countries, they estimate the combined long and short USD swaps positions today to be about USD 237bn. Across EM, positions are roughly evenly balanced between long and short USD positions with a net short position of about USD 13bn (Figure 7).

Fig 7: **Use of swaps by EM central banks**



Source: Standard Chartered Bank.

(c) Exchange rate regimes

Exchange rate regimes can impact the evolution of reserves. Roughly 20% of all EM countries are major oil producers. Fixed exchange rate regimes made sense to many oil producers in the boom times as a way to avoid excessive real exchange rate appreciation. Now that prices have fallen, floating currencies are more appropriate. One of the obvious benefits is that an oil producer's public finances, including the level of reserves, are far better insulated against oil price changes. Russia adopted more flexible exchange rates after 2008/2009. Others, such as Saudi Arabia, maintain pegs with the USD, while Kazakhstan, for example, has recently changed from fixed to floating. Others yet, such as Nigeria and Venezuela, are still trying to avoid devaluation of their official exchange rates by rationing Dollars and introducing de facto capital controls with the result that parallel exchange rates emerge and depreciate.

[6] The simple regression result that forms the basis for the USD allocation in Figure 6 should be viewed with considerable caution due to relatively short time series, possible structural breaks and possible omitted variables that can bias the coefficient on the USD share of reserves. Simple regression models work best if there are no underlying changes in flows into and out of reserves. This condition has obviously not been satisfied. In general, the estimated USD share is likely to be overestimated by simple regression analysis, which does not take account of the effects of flows in the capital and current accounts as well as FX valuation effects. A proper multivariable regression analysis is complicated by lack of high frequency data and short time series.

[7] Standard Chartered Bank, *"REM – Pressure rising on Asia Reserves"*, 10 September 2015.

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Conclusion

EM countries have so many reserves that USD appreciation is unlikely to pose a major risk to their overall reserve position. Indeed, the USD is rapidly becoming a victim of its own success. The USD is now so strong that it is hurting US growth and USD strength has become the most important factor influencing the Fed's decisions on rates. This means that the two most compelling reasons for the USD to continue to rally – higher growth and higher rates – are losing steam.

Global investors still fear capital outflows from EM even though the vast majority of assets are held locally. An EM wide contagion has not happened since the late 1990s. For the most part, EM countries maintain sound macroeconomic policies and the strong USD is beginning to translate into stronger current account positions in EM (the lagged response to the FX weakness of the last few years).

Episodes of global risk aversion create major gulfs between market perceptions about riskiness in EM and the reality on the ground. The likelihood of systemic EM balance of payments crises due to USD strength and capital outflows is extremely small. EM asset prices have now priced in scenarios that are unlikely to materialise and hence offer very good value.

That is not to say there are no risks in EM. EM central banks remain extremely exposed to QE currencies, which make up around 97% of global foreign currency reserves. Exposure to these currencies (as opposed to non-QE currencies) has benefitted EM central banks over the past four years, but these benefits will be reversed when inflation returns in the QE countries.

A 50% fall in the USD – similar to what happened under far less imbalanced conditions in the 1970s – could wipe out at least 30% of EM reserves. If the EUR, JPY and GBP also fall, the damage could easily exceed 50% of EM reserves. All these are QE currencies that are being printed in unprecedented volumes. The way to protect against such a calamity is to allocate more to non-QE currencies.

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Appendix

In order to determine the role of currency movements on reserves, it is necessary to control for other potential factors that can affect the level of reserves, including flows via the current and capital accounts.

Unfortunately, this introduces data requirements which limit the sample of countries significantly. In the end, it was possible to compile complete annual data sets for the full period from 2001-2014 for all the 54 most traded EM countries.

The sample comprises countries which account for some USD 8.7trn or 76% of global FX reserves. The average level of reserves across the 54 countries in the sample is USD 160bn per country, but the median is only USD 37bn and a standard deviation of USD 531bn, which illustrates the variation in reserve holdings across the sample.

The average current account balance in the sample is a surplus of USD 10bn per year with a median of zero and a standard deviation of USD 42bn.The combined current account surplus across the sample was USD 521bn in 2014, of which China accounted for USD 210bn.

The composition of reserves is based on disclosed currency allocations as per IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) database. The COFER data shows allocations to USD, EUR, GBP, JPY, CHF, AUD, CAD and others.

As of end-2014, roughly 62% of EM central bank's disclosed reserves were allocated to USD with 21% to the EUR and most of the balance allocated to the remaining established reserve currencies. We have assumed that the undisclosed part of FX reserves is allocated in the same way as the disclosed reserves. This will undoubtedly not always be correct.

The data set breaks changes in reserves into their constituent parts, namely current account and capital account flows as well as FX valuation effects as follows:

Change in reserves = Change in current account + change in capital account + FX valuation effects in central bank reserves

This method is incomplete. The private sector also has stocks of external assets and external liabilities and hence FX valuation effects, but we do not capture those.

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