A new economic crisis is engulfing several developing countries which face sharp currency depreciation and capital outflows. This is caused by the boom-bust cycles in capital flows originating in profit-seeking investor behaviour in developed countries.

Several developing countries are now being engulfed in new economic crises as their currency and stock markets are experiencing sharp falls, and the end is not yet in sight.

The “sell-off” in emerging economies has also spilled over to the American and European stock markets, thus causing global turmoil.

Countries whose currencies were affected in the past week include Argentina, Turkey, Russia, Brazil and Chile.

A hike in interest rates by Turkey and South Africa have so far failed to stem the depreciation of their currencies.

An America market analyst termed it an “emerging market flu” and several global media reports tend to focus on weaknesses in individual developing countries.

However the broad sell off is a general response to the “tapering” of purchase of bonds by the US Federal Reserve, which marks the slowdown of its easy-money policy that has been pumping many hundreds of billions of dollars into the banking system.

On 29 January, the Fed reduced its monthly asset purchase by another $10 billion to $65 billion, following the $10 billion reduction in December. It gave a new boost to the weakening of emerging market currencies.

A lot of the Fed’s money pumping had earlier been taken up by American investors and placed in emerging economies as they searched for higher yield.
With the tapering expected to raise yields in the US, money is flowing out from bonds and stocks in the emerging economies, putting pressure on their currencies. The capital flows have reversed direction.

The current “emerging markets sell-off” thus cannot be explained by ad hoc events. It is a predictable and even inevitable part of a boom-bust cycle in capital flows to and from the developing countries, which originates from the monetary policies of developed countries and the behaviour of their investment funds.

This cycle, which has been very destabilising to the developing economies, has been facilitated by the deregulation of financial markets and the liberalisation of capital flows which in the past had been carefully regulated.

This prompted massive and increasing bouts of speculative international flows by Western investment funds, motivated by the search for higher yields. Emerging economies, having higher economic growth and interest rates, attracted the investors.

Yilmaz Akyuz, chief economist at South Centre, analysed the most recent boom-bust cycles in his paper “Waving or Drowning?”

A boom of private capital flows to developing countries began in the early years of the 2000s but came to an end with the flight to safety triggered by the Lehman collapse in September 2008.

However, the flows recovered quickly. By 2010-12, net flows to Asia and Latin America exceeded the peaks reached before the crisis.

This recovery was largely caused by the easy-money policies and near zero interest rates in the US and Europe.

In the US, the Fed pumped US$85 billion a month into the banking system by buying bonds. It was hoped the banks would lend this to businesses to generate recovery, but in fact investors placed much of the funds in the Western stock markets and in bonds and shares in developing countries.

The surge in capital inflows led to a strong recovery in currency, equity and bond markets of major developing countries. Some of these countries welcomed the new capital inflows and the boom in asset prices.

But others were upset that the inflows caused their currencies to appreciate (thus making their exports less competitive) and that the ultra-easy monetary policies of developed countries were part of a “currency war” to make the latter more competitive.

In 2013, the capital inflows into developing countries weakened due to the European crisis and the prospect of the US Fed “tapering” or reducing its monthly bond purchases.

This weakening took place at a bad time -- just as many of the emerging economies saw their current account deficits widen. Thus, their need for foreign capital increased just as inflows became weaker and unstable.

In May-June 2013 there was a preview of the current sell-off when the Fed announced it could soon start “tapering”. This led to sudden sharp currency falls including in India and Indonesia.
However, the Fed postponed the taper, thus giving a breathing space. But in December, it finally announced the tapering -- a reduction of its monthly bond purchase from $85 billion to $75 billion, with more to come.

There was then no sudden sell off in emerging economies, as the markets had already anticipated it and the Fed also announced that interest rates would be kept at current low levels until the end of 2015.

By now, however, the investment mood had already turned against the emerging economies. Many of them were now termed “fragile”, especially those with current account deficits and dependent on capital inflows.

Many of the so-called fragile countries are in fact members of the BRICS that had been viewed just a few years before as the most powerful emerging economies driving global growth.

In this atmosphere of deepening concerns, it just required a “trigger” to cause a simultaneous sell-off in currencies and markets of developing countries.

Several factors were to emerge which together constituted a trigger. These were a “flash” report indicating contraction of manufacturing in China; the sudden fall in the Argentinian peso; and expectations of further tapering by the US Fed.

For two days last week (23 and 24 January) the currencies and stock markets of several developing countries were in turmoil, which spilled over to the US and European stock markets.

The turmoil continued into the following week, seeming to confirm investor disenchantment with emerging economies, and a reversal of capital flows.

The depreciation in currency and the capital outflows could put strains on the affected countries’ foreign reserves and weaken their balance of payments.

The accompanying fall in currency would have positive effects on export competitiveness, but negative impacts in accelerating inflation (as import prices go up) and debt servicing (as more local currency is needed to repay the same amount of debt denominated in foreign currencies).

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