Flood barriers

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Despite the headlines China is not the most aggressive intervener in currency markets

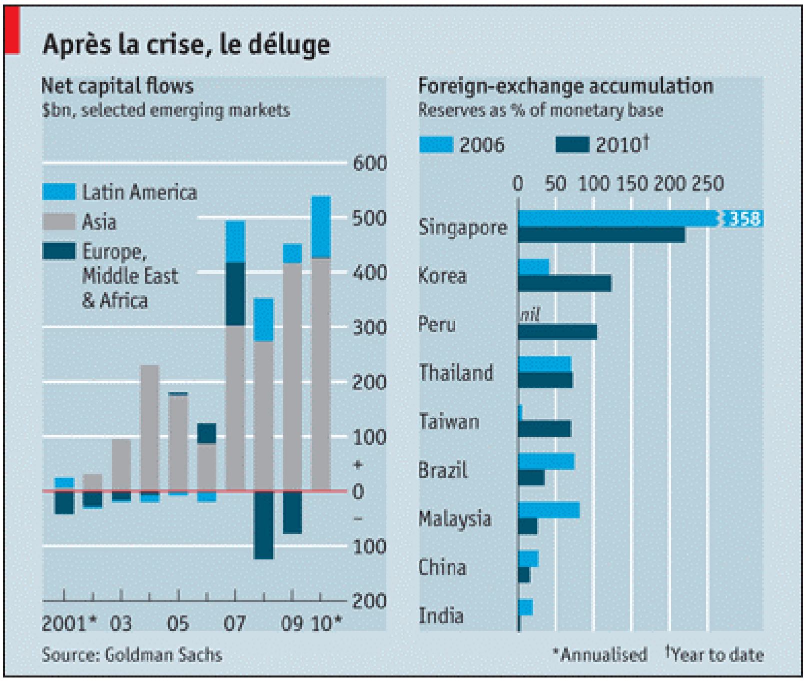
MONSOON rains bring relief after the heat of summer but they can also cause flooding. A flood following a drought is a reasonable description of recent flows of private capital to emerging markets. During the worst of the crisis these flows collapsed, sending at least a few emerging economies into the arms of the IMF. Now, attracted by the developing world's better growth prospects and exceptionally low interest rates in rich countries, money is surging back.

It is hard to know just how much cash is flowing in: complete data on countries' balance-of-payments positions are available only with a long lag. Robin Brooks, an economist at Goldman Sachs, has worked out a measure of net capital inflows from figures on countries' foreign reserves and current-account balances. He reckons that flows into 20 big emerging countries are now running at a faster pace than before the crisis. According to his estimates, net capital inflows to these countries between April 2009 and June this year ran at an annualised pace of $575 billion, well in excess of average annual inflows of $481 billion in the two years prior to September 2008.

As with monsoon rain, so with foreign capital. Policymakers in emerging economies welcome this money but not unreservedly. Many fret that the upward pressure on exchange rates from the surge in foreign capital will cause their currencies to appreciate too much. Critics point out that some appreciation is due: a rise against rich-world currencies is both a natural consequence of the faster growth of emerging economies and a way to correct global imbalances. Emerging-market policymakers would argue that their only concern is to prevent their exchange rates from overshooting. They could cut interest rates to make their economies less attractive to foreign money. But at the moment most are raising rates to curb inflation.

If they do not want their currencies to rise, governments in this position can intervene to try and dampen (or even prevent) the appreciation. Some countries are trying to use capital controls to limit the inflows of foreign money, or at least to discourage the most fickle kinds of capital. China has long applied stringent controls. On October 4th Brazil doubled a tax it charges foreigners on investments in fixed-income securities to 4%. A day later South Korean regulators said that they would soon begin to audit lenders handling foreign-currency derivatives to curb volatility caused by capital inflows. More typically, countries intervene by selling their own currencies and accumulating foreign-exchange reserves. Because fast GDP growth and the capital flows it attracts will eventually spur higher inflation, the authorities' ability to stop a real currency appreciation is limited. Still, analysis by Mr Brooks and his colleagues shows that many countries have been trying to prevent their currencies from rising in nominal terms and that some have dramatically ramped up their interventions from pre-crisis levels. Despite the headlines they find that China is not the only big intervener—and that others have been working much harder to hold their currencies down.

The economists note that the currencies of emerging Asian countries face the strongest upward pressure because of changes in the destination of private capital. As flows to eastern Europe and Africa have shrivelled, Asia's share of the total flow of capital to the emerging world has gone from 61.3% in 2007 to 78.6% in the first half of 2010. Latin America's share has also increased, from 15.2% to 20.9% over the same period. These are rising shares of a growing total, meaning that both regions are now getting more private capital than they were before the crisis. This effect is particularly marked for emerging Asia (see left-hand chart).



A sense of reserves

Mr Brooks and Fiona Lake, one of his colleagues, have looked at annual foreign-exchange interventions by central banks in emerging Asian economies, tracking the pace at which they built up reserves by buying foreign currency. They argue that it is important to scale absolute amounts by the country's base money supply, pointing out that the effect of a $1 billion intervention by Singapore has a much bigger effect on the domestic economy than similar action by China. Comparing 2010 with 2006, the year before the crisis, they find that South Korea and Taiwan have vastly increased their meddling in currency markets (see right-hand chart). Relative to the size of its economy, China's intervention is small in both years, and smaller in 2010 than in 2006.

Not every country's currency is under the same kind of pressure. India, for example, seems not to have intervened much in the foreign-exchange market, but its currency has not moved much over the past year either. Part of the reason is that capital inflows have gone mainly to finance its persistent current-account deficit. By controlling for this kind of thing the analysts find that Malaysia and Thailand have had the most "appreciation-friendly" regimes in Asia. Malaysia has largely been content to let its currency float upwards. The ringgit has risen by over 10% against the dollar since the beginning of the year. Malaysia's reserve accumulation has been much smaller in 2010 than in 2006. South Korea, by contrast, has been absorbing virtually all of the upward pressure on the won by accumulating additional reserves. For Latin America, Mr Brooks and his colleague, Alberto Ramos, conclude that Peru is the country that has been trying the hardest to prevent its currency from rising. Interventions by Brazil look relatively modest once its size is taken into account. Colombia has pretty much allowed its currency to rise.

Currency pressures will be a big theme of the annual meetings of the IMF and World Bank this week and of November's G20 summit in Seoul. The Sino-American spat over the value of the yuan tends to hog attention. But it is only one source of tension among many in the international monetary system.