Box 1.1

Risks of capital flow reversals in emerging market economies from the eventual normalisation of US interest rates

The weakening of emerging market economies (EMEs)' currencies over the course of 2014, alongside the end of the Federal Reserve (Fed)'s quantitative easing programme and the anticipated Fed's interest rate hike, has reignited concerns about capital flight in EMEs. There were worries about whether higher volatility in the asset and foreign exchange markets would threaten their economic and financial stability. This note attempts to examine some indicators related to the exposure of foreign capital in selected EMEs(1) amid the eventual normalisation of the US' interest rates.

EMEs saw massive capital inflows since the 2008-09 Global Financial Crisis, as investors around the world searched for higher yields after the bold monetary easing policies by major central banks brought the world interest rates to extremely low levels. These capital inflows, particularly those that are short-term, can be quite volatile and prone to sudden reversals, as evidenced by the global sell-off of emerging market assets following the Fed's monetary tapering talks in mid-2013.

The exposure to risks of capital outflows in EMEs can be assessed based on their economic fundamentals, including (1) the current account balance; (2) fiscal strength; (3) external debt; and (4) the degree of leveraging as reflected in the asset markets. These indicators are useful in providing some pointers on the external and internal balances of an economy and its dependence on external funding.

Economies with current account deficits will have to rely on foreign capital inflows, be it in the form of foreign direct investments, portfolio investments and/or loans. Those with higher proportions of short-term foreign capital will be more susceptible to the repatriation of funds by overseas investors. A sustained widening of current account deficit is usually associated with an excessive build-up of external indebtedness and hence warrants a close look-out ***(Chart 1)***.

Chart 1 : Current account and fiscal balances are useful for assessing risks of capital flow reversals

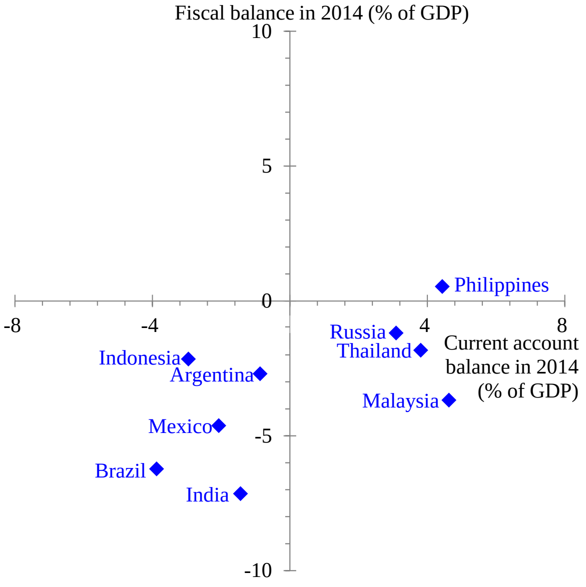
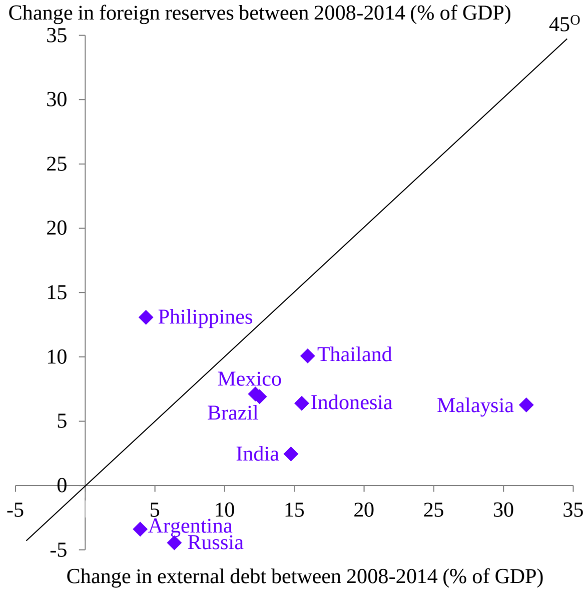


Chart 2 : Economies with visible external debt build-up would also face more severe pressures from abrupt capital outflows



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(1) The EMEs covered in this box article include Argentina, Brazil, India, Indonesia, Malaysia, Mexico, the Philippines, Russia and Thailand.

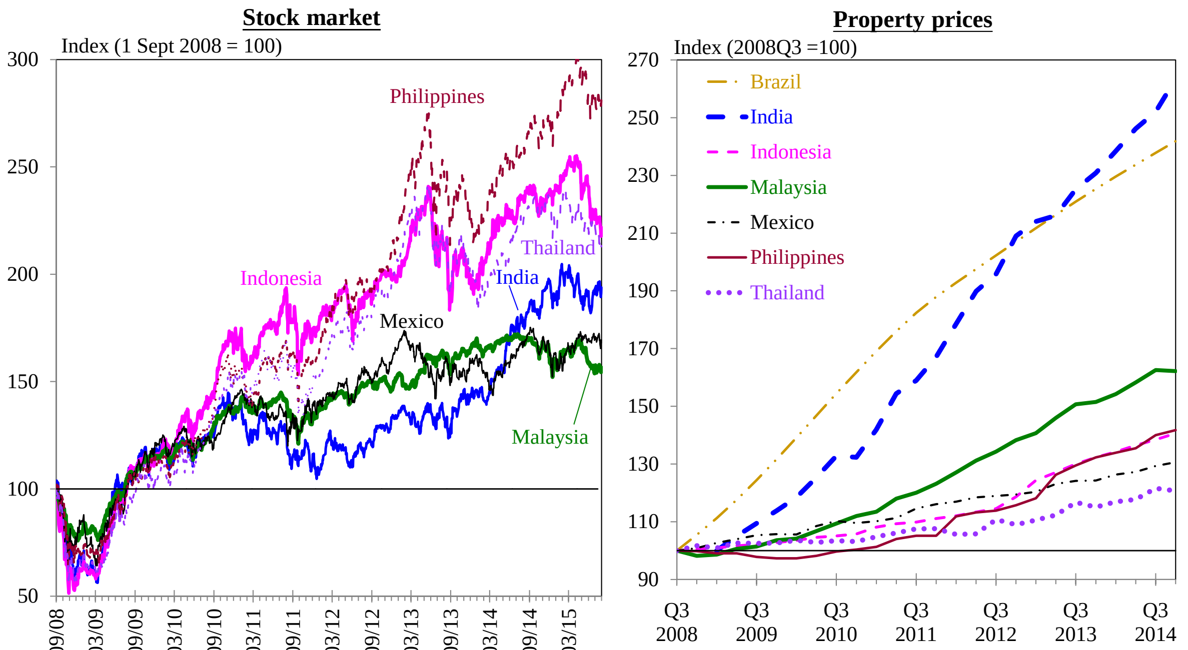
Box 1.1 (Cont'd)

Besides the current account balance, it is also useful to examine the fiscal health, which is an important indicator of an economy's internal balance. Not only do economies with persistent or deteriorating fiscal deficits suggest an underlying structural problem, but unfavourable fiscal positions could also limit policy tools in cushioning external shocks. Twin deficits, i.e. current account and fiscal deficits, are usually more worrying signs of vulnerability and imbalances for an economy.

The third indicator is the reliance on external debt as a source of funding, which can be measured by an economy's total external debt as a ratio of GDP. Over the past years, many EMEs saw varying degrees of build-up in external debt. Those denominated in US dollars may face more difficulties in debt servicing if the eventual US interest rate hikes were to be accompanied by a stronger US dollar and thereby inflating their debt burden. Nevertheless, how well these economies can cope with sudden reversals of capital flows will again hinge on their economic fundamentals, including, for example, the extent of fiscal space. In particular, sizeable foreign reserves(2) should also render some cushion to such impacts and stabilise their currencies against massive capital outflows (***Chart 2***).

The risks of asset market corrections in EMEs alongside an abrupt change in capital flows should not be taken lightly. The equity and property prices of many EMEs saw sharp appreciations over the past years. Those with weaker economic fundamentals and less robust financial systems are likely to be harder hit. The escalation of Greece's debt situation in mid-June has heightened global financial market volatility, and some EMEs' equity markets have already seen corrections of varying degrees (***Chart 3***).

Chart 3 : Asset markets in many EMEs saw exceptional performance



Note: Due to data limitations, India's property prices are indexed to 100 for 2009Q1.

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(2) The foreign reserves of selected EMEs ranged from 10-40% of their respective GDPs in 2014. It is, however, noted that the balance of payments of some EMEs have worsened and their foreign reserves have dropped in recent quarters. The foreign reserves of Russia, Malaysia and Thailand declined by 31%, 17% and 13% respectively during 2013-2014. The Philippines' foreign reserves fell by 5% during 2014.

Box 1.1 (Cont'd)

A persistent moderation in growth could add to the risks of capital flow reversals. Fortunately, many EMEs maintained steady growth in the first half of 2015, albeit at slower paces. Also, lower inflationary pressures since 2014 have allowed room for their central banks to adopt more accommodative monetary policies to bolster growth. Besides, many EMEs have stepped up efforts to improve business and investment confidence, helping to put their economies on a firmer footing. Granting that the Fed's interest rate increases are to be slow and gradual, the stand-alone impact on the EMEs would hopefully be more manageable.

While the timing of the Fed's first interest rate hike remains data-dependent, any untimely or unexpected action by the Fed could pose a severe threat to global financial and macroeconomic stability. As the world's financial markets are increasingly interlinked, the Hong Kong economy will inevitably be affected. While our sound economic fundamentals and robust financial system are well-equipped to cope with massive capital flows, we still need to stay vigilant and closely monitor these developments and their potential impacts on short-term economic growth and outlook.