Factoring Exchange Rate Policy into your Investment Strategy: Risks Facing Andean Countries

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Factoring Exchange Rate Policy into Your Investment Strategy: The Risks Facing Andean Countries

Overview

Capital Inflows Have Reached Pre-Crisis Levels in Latin America

Strong Capital Inflows, High Real Exchange Rates and Fast Credit Growth

Surge in Capital Inflows Requires Difficult Policy Choices to Reduce Risks

Exploring the Current Policy Mix to Curb Currency Appreciation: Where Are We Now?

Should Investors Be Concerned about Wrong Policy Choices?

The Bottom Line

The Sovereign Wealth Fund Initiative
EM Capital Inflows Have Reached Pre-Crisis Levels

EM capital inflows: an upward trend with periods of surges and “sudden stops”

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Rapid recovery of net private capital inflows

Net private capital flows in the first three quarters of 2010 in many emerging market economies already outstripped the averages reached during 2004–07.
A rapid recovery of capital inflows with levels approaching pre-crisis levels in EM Asia and Latin America

Sources: CEIC,Hover Analytics, IMF, Balance of Payments Statistics; national sources; and IMF staff calculations.

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Latam Country Experience with Capital Inflows

Chile, Brazil, Colombia and Peru are all approaching pre-crisis Inflows

Gross Capital Inflows

Gross Capital non-FDI Inflows

(four-quarter cumulative, in percent of GDP)
EM Capital Inflows Continue in 2011

Advanced country sovereign debt problems and greater global risk aversion in 2011 have not stopped the rapid pace of EM capital inflows.
Global External Imbalances Will Support Continued EM Capital Inflows

Sizable global imbalances projected to continue in the medium term

Global Imbalances\(^1\)
(Percent of world GDP)

Source: IMF staff estimates.
\(^1\)CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand; DEU+JPN: Germany and Japan; OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom; OIL: Oil exporters; ROW: rest of the world; US: United States.
We have seen that capital inflows are approaching pre-crisis level in Brazil, Colombia, Peru and Chile.

At the same time we will see that:

- Real effective exchange rate is appreciated outside its 10-year range in Colombia and Brazil.

- Real credit is growing rapidly in Brazil, Colombia and Peru and has reached its pre-crisis levels in Brazil and Colombia.

This points to the need to better understand the required country policy response to maintain sustained economic growth.

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Latin America: Strong Capital Inflows, High Real Exchange Rates and Fast Credit Growth

Capital Inflows in Brazil, Peru, Colombia and Chile are driving fast growth in credit to private sector and appreciation of real exchange rate.

*Includes Brazil, Chile, Colombia, Peru, and Uruguay.

Sources: National authorities; and IMF staff calculations

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Credit growth is above pre-crisis levels in Brazil and Colombia

Per Capita Real Credit
(percent change over five years)

Current (2005–10)  Previous (label indicates year of prior peak)

Credit growth is above pre-crisis levels in Brazil and Colombia

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Surge in Capital Inflows Requires Difficult EM Policy Choices

- **Exchange rate adjustment.** Using the exchange rate as an automatic stabilizer may be the first policy option for countries with an undervalued exchange rate or when capital inflows are considered permanent.

- **Intervention.** Economies may intervene to keep the exchange rate at the current level or to slow appreciation when countries need to increase their reserves or when capital inflows are temporary. However, sterilization of the liquidity injected by interventions can be expensive.

- **Monetary policy.** Monetary easing can narrow the interest rate differential between foreign and domestic interest rates and, thereby, reduce the incentives for investors borrowing in low-yielding currencies and investing in high-yielding ones.

- **Fiscal policy.** Fiscal tightening can support monetary policy by reducing the budget’s financing needs and thus allowing for lower real interest rates.

- **Prudential regulation and supervision.** Prudential ratios in the financial sector, such as liquidity ratios, which differentiate according to currencies, or reserve requirements that vary according to maturity can be used to influence capital inflows.
**Surge in Capital Inflows Requires an Appropriate Policy Mix to Reduce Risks**

*Some policy considerations*

- The surge of capital inflows is likely to subside or even experience a “sudden stop” but Andean countries can expect strong secular capital inflows.

- The “permanent” nature of strong capital inflows calls for these countries to partly absorb these inflows through an appreciation of the exchange rate.

- However, especially for those countries with a significantly overvalued exchange rate, the brunt of the pressure on the exchange rate should be taken up by sterilized currency intervention (giving time for needed structural changes).

- This exchange rate policy should be combined with a mix of tighter fiscal policy and looser monetary policy to reduce incentives for capital inflows; extensive prudential regulations; liberalization of restrictions on capital outflows; and, if necessary, capital controls.

- Once U.S. policy tightening begins, flows could slow abruptly. This is an additional reason for EM countries to ensure that their domestic policies are suitably countercyclical to enable a looser fiscal policy when needed.
Brazil and Colombia have absorbed capital inflows through exchange rate adjustment.
Exploring the Current Policy Mix: Where Are We Now?

Deviations from equilibrium exchange rate estimated by Credit Suisse also indicate that Brazil and Colombia exchange rates are overvalued.

* July 2011 REER was used for Argentina, Israel and Peru
Source: Credit Suisse
Peru, and to a lesser extent Brazil, has also absorbed capital inflows through currency intervention.
Colombia has been more aggressive than Brazil in using macro prudential tools.

<table>
<thead>
<tr>
<th>Tool / Country</th>
<th>Brazil</th>
<th>Chile</th>
<th>Colombia</th>
<th>Mexico</th>
<th>Peru</th>
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<tbody>
<tr>
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<td>Debt to income limit</td>
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<tr>
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<td>Restriction on banks’ profit distribution</td>
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</table>
**Exploring the Current Policy Mix: Where Are We Now?**

- Brazil overheating exceeds that of most other principal emerging markets.
- Peru appears close to overheating with output level above potential while its fiscal position is strong but is not being used as a policy tool to reduce pressures for capital inflows.

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**Sources:** IMF staff estimates and projections.

**Note:** The indicator of cyclical conditions is a composite based upon the following variables: 2011–12 average inflation above 2009–10 average inflation; real economic growth above long-run average; output above potential; and positive net capital inflows. A subindicator for each of these variables is scored 1 if positive, 0 otherwise. The indicator is the sum of the subindicators of these variables. For Hungary and Mexico, the level of the structural deficit is reported.

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**Sources:** IMF staff estimates and projections.

**Note:** The output gap is defined as the difference between actual and potential GDP. If the output gap is deteriorating, there is greater spare capacity in the economy. Circles denote countries with output level above potential in 2011. For Hungary, change in structural balance is reported.
Should Investors Be Concerned about Wrong Policy Choices?

The IMF “overheating indicators” look at pressures on domestic demand and inflation and find Brazil over heating.

<table>
<thead>
<tr>
<th>Overheating Indicators—G20¹</th>
<th>Argentina</th>
<th>Brazil</th>
<th>Indonesia</th>
<th>India</th>
<th>China</th>
<th>Korea</th>
<th>Saudi Arabia</th>
<th>Australia</th>
<th>Germany</th>
<th>South Africa</th>
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<th>United Kingdom</th>
<th>Canada</th>
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<th>Russia</th>
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¹G20 refers to the Group of Twenty, an international forum comprised of 20 countries and international organizations.

²Output relative to trend measures the deviation of actual output from its long-run trend.

³Output gap is the difference between actual output and potential output.

⁴Unemployment indicates the portion of the labor force that is without work.

⁵Fiscal balance is the difference between government revenues and expenditures.

⁶Real interest rate is the nominal interest rate adjusted for inflation.
Should Investors Be Concerned about Wrong Policy Choices?

These indicators show:
- Brazil over-heating without room to allow the exchange rate to absorb pressures from capital inflows
- Colombia has also lost room for additional exchange rate appreciation but is not over-heating
- Peru and Chile are not seen as over-heating and have more room for some additional appreciation of the exchange rate

### Policy Responses to Capital Flows—Selected Economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Capital Flows</th>
<th>Over-heating</th>
<th>FX over-valuation</th>
<th>Macroprudential</th>
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<tbody>
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For the purposes of this figure, policy responses are divided into three categories: (1) domestically focused macroprudential measures are those affecting the domestic activities of banks, such as loan-to-value ratio limits; (2) currency-related measures aim to limit institutions’ and residents’ exposure to currency fluctuations; and (3) capital controls are measures that distinguish between residents and nonresidents.

Gross capital flows over the past year compared with the average during 2000–07. Current flows above 150 percent of the average are assigned a red light, a yellow light denotes flows above 100 percent. Economies are ranked based on this ratio.

Economies with exchange rates higher than warranted by medium-term fundamentals are assigned a red light. Economies with lower-than-warranted exchange rates are assigned a green light.

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An Appropriate Policy Mix is Needed to Reduce Economic and Financial Risks

To prevent economic over heating and asset bubbles, an appropriate policy mix is required that includes:

- Balancing exchange rate appreciation and intervention in combination with
- Tighter fiscal policy, looser monetary policy and prudential regulations to reduce incentives for capital surges and rapid credit expansion
- Liberalization of restrictions on capital outflows

This appropriate policy mix will also help reduce risks in the face of a global economic slowdown or an eventual tightening of U.S. economic policies:

- Latin countries will eventually face another “sudden stop” of capital inflows
- The right policy mix now will allow EM countries to use countercyclical fiscal and monetary policy to offset external shocks
The Andean countries are in a better position than Brazil to manage continued strong capital inflows and increasing private sector activity due to:

- Unlike Brazil, the Andean economies are not at the point of over-heating
- Andean countries face a more manageable surge of capital inflows and growth of private credit
- There is somewhat more room for currency appreciation to absorb pressures
- In general, Andean countries are in a stronger fiscal position

As a result, Andean countries are in a better position to gain from further capital inflows and implement counter-cyclical policies in the face of any negative external shocks.
The Bottom Line

Within the Andean countries:

Colombia
➢ Has surpassed prior peak levels of credit expansion but a still relatively moderate pace
➢ and does not have room for further currency appreciation
➢ but has actively used macro-prudential measures and has room for additional currency intervention

Peru
➢ Has rapid growth of credit to private sector though has not exceeded prior peak levels
➢ but relied on currency intervention and has room for currency appreciation
➢ it has a strong fiscal position but it is deteriorating

Chile
➢ Is furthest away from over-heating and has room for currency appreciation
➢ it also has a strong fiscal position which is improving
➢ in addition, Chile has greater flexibility for capital outflows than Colombia and Peru
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