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Buttonwood

Different this time?

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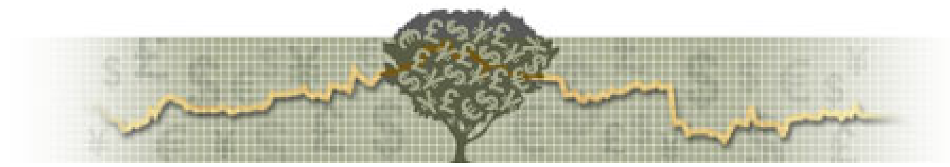
Foreigners are again pouring cash into emerging markets. What will happen when they stop?



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BUTTONWOOD was in the wilds of Guadalajara (Spain's, not Mexico's) last week, trying to keep teenage bikinis within the bounds of decency, when the latest twist in Brazil's long-running corruption tale hit the press. The Spanish have more than a passing interest in Latin America, even the Portuguese-speaking bits. So coverage of allegations that Antonio Palocci, Brazil's finance minister, had been on the take in a previous political incarnation was full and frank.

The resulting sell-off of the Brazilian market hit assets all around Latin America. Brazilian bonds have the heaviest weighting in J.P. Morgan's Emerging Market Bond Index Plus (EMBI+)—the benchmark for many money managers—and any problem Brazil has makes itself felt. The spread on the index—ie, the premium that investors demand for holding an allegedly riskier security than American Treasuries—had fallen from 3.6 percentage points at the beginning of the year to 2.9. On August 19th, it widened back out to 2.95 points. But Mr Palocci effectively denied the charges over the weekend and appeared to have the confidence of his president. Brazil bounced back, and by close of play on August 22nd the spread on the EMBI+ was down to 2.92 percentage points.

The speed of the rebound in Brazil is a sign of just how keen investors are to see the upside in emerging markets. This is borne out by the latest figures from Emerging Portfolio Fund Research, which tracks funds with assets totalling more than $4 trillion. Between the beginning of June and the week ending August 17th, emerging-market equity funds took in a net $6.94 billion. That brings the year's total to $8.74 billion, nearly three times 2004's level and more than the previous high of $8.6 billion for all of 2003. Bond funds tell the same story, with total net inflows this year of $4.74 billion, a record.

Emerging assets have been making more money for their owners than developed countries' for a while. The return on emerging-market debt so far this year has been 5.6%, higher than on Treasuries, for example. Equities in weird and wonderful places have done better, too: the Morgan Stanley Capital International index of share prices in emerging markets is up by almost 13% so far this year, compared with less than 3% for markets in rich countries. Many emerging countries' currencies are strengthening or expected to do so soon.

All well and good. But Buttonwood had a formative experience when she moved to Jakarta in 1997 to live the Asian Miracle and caught instead the Thai baht in freefall, soon followed by the rest of South-East Asia. And one has to say that the global environment has been exceptionally kind to emerging markets lately. Interest and inflation rates are low; demand (in America, parts of Europe and the developing world) has been strong; commodity prices have been booming; risk aversion is in retreat. If any of the above stops, or if investors decide that they have run up emerging-asset prices far enough, will we see a repeat of the 1997-98 crisis?

In theory, no. Most of the important emerging countries have gone straight, we are told, and are thus better able to withstand a sharp reduction in foreign investment than before. Current-account deficits have been reduced or converted to surpluses. Fiscal policy is more prudent. Net new borrowing has been limited and the outstanding stock of debt in most places is dwindling. Inflation has fallen.

In a study released last week, Christian Stracke of CreditSights, a research firm, compares emerging economies' dependence on portfolio inflows now and eight years ago. (Portfolio investment—as opposed to foreign direct investment—is generally fast and easy to liquidate, and so includes the sort of "hot money" that travels fast and upsettingly.) Looking at 25 countries, he finds that dependence is generally much lower, but patchily so.

As the table shows, portfolio liabilities in the 18 months to June 2005 for the group as a whole were $118.5 billion, far less than the $170.7 billion that came in before June 1997. This averages out some very different experiences: both Argentina and Brazil have seen liabilities decrease sharply, while India, Poland and Hungary have had just the reverse. What is more, the "hotter" sort of portfolio investment—debt securities—has fallen most (from $116.6 billion to $66.7 billion) while equity investment has stayed almost the same.

Flowing again

Net increase in portfolio liabilities, $bn

	18 months to June 1997	18 months to June 2005*
Argentina	18.4	-12.7
Brazil	30.8	3.3
Chile	2.9	2.2
Colombia	3.5	1.6
Mexico	22.5	15.8
Peru	0.7	1.7
Venezuela	1.9	1.6
Czech Republic	0.5	6.5
Hungary	-0.9	8.9
Poland	-	12.4
Russia	18.5	6.9
Turkey†	2.7	16.3
India	5.5	14.4
Indonesia	7.1	5.1
Philippines	6.8	-1.1
South Korea	30.9	29.4
Thailand	5.3	0.3
South Africa	11.5	5.6
Other	2.1	0.3
Total	170.7	118.5

*Or latest available †Includes errors and omissions
Source: CreditSights

On another measure, the ratio of foreign-exchange reserves to recent inflows, things look sturdier still. In June 2005, the median emerging country had enough reserves to cover 529% of the past 18 months' portfolio inflows, compared with just 222% in June 1997. This average again masks some big differences: oil-rich Russia's reserves are a staggering 2,093% of flows, while Turkey has either 161% or 249%, depending on how one treats the bulky "errors and omissions" category of its current-account figures.

One can quibble with these figures. Most of the 2005 numbers go up only to the first quarter, for instance, and portfolio flows picked up sharply from June. And while it makes sense to look at foreign portfolio liabilities in isolation—as this is the footloose stuff that leaves—the parallel existence of foreign portfolio assets is not totally irrelevant, nor is the size and trend in foreign direct investment. The broad picture is nonetheless revealing, and, within limits, encouraging: a sell-off rather than a rout may be the worst that happens if foreign investors turn tail.

But it would not take much to produce that—higher real interest rates in America, for a start (and rate rises look likely to continue). The impact of dearer oil is harder to judge. High oil prices should be a plus for emerging producers such as Russia and Venezuela, while heavy importers such as South Korea have enough other attractions to get away with it. But money managers are beginning to look askance at emerging-market guzzlers who have subsidised energy use and may no longer be able to afford it.

Paradoxically, globalisation may also dim the appeal of emerging markets by increasing the correlation between developed and developing assets. Mexico, some say, is beginning to pay the price for its lockstep with the United States. A sharp increase in risk aversion would make that matter more: at the moment, investors ask only to be led to the next frontier, but a few more terrorist attacks in big financial centres could change that.

At the end of the day, a bare-knuckled corruption scandal bringing an important government to its knees—Brazil?—might not be the *pase de la muerte* that we holidaying hackettes would have seen had we spent more time at the bullring and less on the beach. But it could well do the weakening work of the *picadores*.

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