Emerging markets, awash in cash, are subject to overheating risks
Simon Kennedy and Bill Faries

Emerging markets from the Baltic states to Latin America, awash in overseas capital, are paying a price for their popularity.

The stock market in Vietnam, among the world's top performers this year, is triggering concerns that shares may be in for a fall. Brazilian and Colombian exporters are struggling to compete as the value of their currencies mounts. Residents of Riga, the Latvian capital, have seen house prices jump 67 percent in a year.

Overseas investment will flood emerging markets with $469 billion this year, according to the Institute of International Finance in Washington. That will bring the total since 2005 to almost $1.5 trillion, twice as much as in the previous three years. While fueling growth, all that cash is bringing side effects that threaten to turn booms into busts.

"This is the cost of success," said Claudio Loser, a former International Monetary Fund official now at Inter-American Dialogue in Washington. "It creates problems."

Latvia and Romania may be in for hard landings, and big current account deficits pose a threat to the investment outlook for Bulgaria and Estonia, Standard & Poor's said last month. The International Monetary Fund issued a warning of risks in Vietnam in March.
"There is somewhat of a bubble element to all of this," Desmond Lachman, a resident fellow with the American Enterprise Institute in Washington, said. "The world is fraught with risks right now."

What lies behind the explosion in overseas investment? The strongest global expansion in a generation and the ability to borrow at low interest rates in markets like Japan and Switzerland. Those forces are drawing money into economies whose low labor costs and increasingly valuable commodities offer opportunities for higher returns.

To be sure, foreign capital brings benefits by generating growth, tax revenue, employment and infrastructure improvement. In Turkey, record overseas investment triggered growth of 6.1 percent last year and, by boosting the lira, slowed inflation enough to satisfy the terms of a $10 billion loan agreement with the IMF. Foreign money cushioned the fall in Turkish stocks last month after the army intervened in the presidential election.

"Turkey welcomes and encourages foreign investment," said Inan Demir, an economist at Finansbank, a lender based in Istanbul. "It helps growth, and a strong lira supports the disinflation program."

The challenge comes in managing the flow of money. Let it rip, and so do inflation, asset prices and currency values. Choke it off, and the good times may come to a swift end. "You see an overheating in a number of emerging markets," said William Rhodes, senior vice chairman at Citigroup in New York. "There's a lot more sensitivity to taking steps to avoid a meltdown."

Governments around the world are now trying to strike the right balance as they realize foreign cash can be too much of a good thing.

Last year, Thailand went too far and had to backtrack when its stock index fell the most in 16 years after curbs were imposed on foreign investments. "Capital controls are very drastic because they can have a very negative impact on investment and the economy," said Irene Cheung, an economist at ABN AMRO in Singapore.

"The sheer volume of trade and capital inflows is getting harder to absorb and is causing distortions," said David Hensley, director of global economic coordination at JPMorgan Chase in New York.

China, the biggest emerging market, is struggling to curb overinvestment in factories and real estate projects, while seeking to limit appreciation of the yuan. The governor of the central bank, Zhou Xiaochuan, expressed concern on May 6 that a bubble was building in the nation's stock market, which has already risen more than 80 percent this year.

Concerns extend well beyond China, which will account for roughly a fifth of the private capital flowing into emerging markets this year, according to figures from the Institute of International Finance.

In Latin America, the biggest distortions tend to be in currency values, as rising demand for commodities including copper and soybeans attracts more money from abroad. The Colombian peso has shot up 10 percent this year, and the Brazilian real has risen almost 6 percent.

That is causing pain for exporters in the region, including Colombian banana and flower growers. The Brazilian shoemaker São Paulo Alpargatas has been forced to cut jobs as it's been priced out of export markets.

The Brazilian government has tried to limit the rise of the real by changing tactics to make its sales of the currency less predictable. The central bank of Colombia on May 6 announced lending limits on banks to curb what President Álvaro Uribe called "speculative" capital inflows. Meanwhile, central banks in eastern Europe are grappling with inflation as foreigners invest in building plants and buying property in countries joining the European Union.

Consumer prices in Latvia are accelerating at the fastest pace since 2001, while property prices in Bulgaria have surged 60 percent over the past two years.

"The prospect of increased investment flows brings with it the possibility of economic overheating," Ana Mates, a credit analyst at Standard & Poor's in London, said.

The challenge may be most difficult in Asia, where central banks are wrestling with both inflation and appreciating currencies at the same time.

That puts them "on the horns of a monetary-policy dilemma," David Simmonds, global head of currency research at Royal Bank of Scotland in London, said. While central banks need to tame price pressures, doing so through higher borrowing costs draws more money from abroad and pushes up exchange rates.

In India, where the rupee is near a nine-year high, the price of yellow peas, a staple, has shot up 35 percent in six months. Inflation has exceeded the central bank target of 5 percent since September, even after two and a half years of interest rate increases.

Instead of discouraging lending, those rate increases only raise "the possibility of further capital flows," said Venugopal Reddy, the governor of Yaga Reserve Bank of India who introduced lending curbs.

Elsewhere in the region, the Philippines central bank last week began offering pension funds and some state companies the chance to deposit money in higher yielding accounts in order to curb the money supply. The flood of overseas investment in Vietnamese stocks prompted the country's central bank to consider controls on capital flows.

In such a climate, "there are vulnerabilities out there," said Tim Ash, emerging markets analyst at Bear Stearns in London. "There's no doubt that at some point there will be corrections."

"You don't want to be the last out of the door."

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