§166 Training Course

Bangkok

Presentation by

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UNCTAD analyzed the impacts of interest rate differentials on short-term capital flows

UNCTAD’s analysis

• To examine the evolution of returns on short-term international portfolio investment, UNCTAD conducted a series of calculations

• As a first step, UNCTAD analyzed the impact of a positive real interest rate differential on the capital flows into developing countries

• In a second step, the real interest rate for a United States investor was correlated with the effective rate of return for that investor
Brazil offered very high real interest rates for short-term investors since the mid-90s

Brazil

![Graph showing real interest rates and effective rates of return in Brazil and the United States for US investors, with an R² value of 0.081.]
Mexico also maintained a persistent positive real interest rate differential.

Mexico

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

\[ R^2 = 0.386 \]
Russia offered very high real interest rates in the

Russian Federation

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Argentina was stable throughout the 90s, but ran

Argentina

Real interest rate in the respective country for United States investors
Real interest rate in the United States for United States investors
Effective rate of return in the respective country for United States investors (right scale)

R² = 0.024
By contrast, Chile was rather unattractive in terms of real interest rates and effective rates of return for United States investors.
India managed to be not too attractive for short-term

India

Real interest rate in the respective country for United States investors
Real interest rate in the United States for United States investors
Effective rate of return in the respective country for United States investors (right scale)
After the turmoil of the Asian crisis, Malaysia cut its real interest rate in the respective country for United States investors. The chart shows the real interest rate in the United States and Malaysia, as well as the effective rate of return in the respective country for United States investors over the years 1995 to 2003. The R² value for the regression is 0.087.
Singapore was quite unattractive for international investors during the whole period.
China’s de facto peg is sustainable, it does not offer positive real interest rate

China

Real interest rate in the respective country for United States investors
Real interest rate in the United States for United States investors
Effective rate of return in the respective country for United States investors (right scale)
Trying to avoid currency overvaluation is difficult with an open capital account

**Short-term profit-seeking capital movement**

- Avoiding currency overvaluation is not only a means to preserve or improve macroeconomic competitiveness, but also an insurance against the risk of future financial crises.

- However, a strategy of avoiding currency overvaluation cannot easily be implemented with an open capital account.

- International investors in short-term deposits base their decisions on the expected nominal return rather than the expected real return on investments.

- Countries with an open capital account are vulnerable to international short-term profit-seeking capital movement.
There is need for an international framework to address unilateral competitive devaluations

Conclusions

• If the nominal short-term interest rate in a financially open emerging-market economy exceeds that in a developed country by more than the growth differential, the nominal exchange rate of the emerging-market economy should depreciate at a rate that equals the difference in interest rates.

• If this condition is not met, combining floating of the currency with restrictive domestic monetary policy to bring down inflation will destabilize the external account.

• However, internationally agreed rules to address competitive devaluations need to be in place to avoid a race to the bottom and unfair competitive advantages.
Back UP
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Czech Republic

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

\[ R^2 = 0.004 \]
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Euro Area

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

R² = 0.005
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Hong Kong SAR, China

![Graph showing interest rate differentials over time for Hong Kong SAR, China. The graph includes lines representing real interest rates and effective rates of return for investors, with a linear regression plot on the right showing the correlation (R² = 0.962).]
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Hungary

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

R² = 0.013
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Indonesia

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

Graph showing trends from 1995 to 2003.
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Israel

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

$R^2 = 0.110$
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Italy

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

$R^2 = 0.120$
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Japan

![Graph showing real interest rates and effective rates for Japan and the United States]

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

R² = 0.012
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Kenya

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

R² = 0.022
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Republic of Korea
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Lebanon

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

\[ R^2 = 0.892 \]
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Philippines

Graph showing real interest rates and effective rates of return for the Philippines over the years 1995 to 2003. The graph includes lines for real interest rates in the respective country and in the United States, and an effective rate of return in the respective country for United States investors (right scale).

- R² = 0.065
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Poland

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

R² = 0.055
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: South Africa
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Taiwan, Province of China

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

$R^2 = 0.015$
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: Thailand

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)

R² = 0.007
UNCTAD’s analysis of interest rate differentials on short-term capital flows

Results: United Kingdom

- Real interest rate in the respective country for United States investors
- Real interest rate in the United States for United States investors
- Effective rate of return in the respective country for United States investors (right scale)
In Asia, fairly stable and competitive exchange rates spurred the trade performances in recent years.

Real effective exchange rates (REER) in Asia, 1997 to 2004
10%-depreciation leads to 0.6% improvement of trade balance in the short- and 0.3% in the medium-term

10%-exchange rate change and trade performance – time path
Sharp currency depreciation in general stimulates the trade balance

Real exchange rate and trade performance, selected years

**Brazil**

- Real effective exchange rate index (left scale)
- Annual percentage change in the merchandise trade balance

**Republic of Korea**

- Real effective exchange rate index (left scale)
- Annual percentage change in the merchandise trade balance
Thailand and Argentina serve as examples for cases where the exchange rate remained low after the crisis.

Real exchange rate and trade performance, selected years.
In Indonesia and Mexico, however, the initial stimulus faded as the exchange rate bounced back.

Real exchange rate and trade performance, selected years

**Indonesia**

- Real effective exchange rate index (left scale)
- Annual percentage change in the merchandise trade balance

**Mexico**

- Real effective exchange rate index (left scale)
- Annual percentage change in the merchandise trade balance
In a longer perspective some countries benefited from a low valuation of their real exchange rate.

Real exchange rate and export performance, 1990 to 2002:

- **India**: Real effective exchange rate index (left scale) and share in world manufactured exports (right scale).
- **Turkey**: Similar graph as above.
While Korea showed a sustained stimulus, in Taiwan’s case the effects were not sustainable.

Real exchange rate and export performance, 1990 to 2002

- **Republic of Korea**
  - Real effective exchange rate index (left scale)
  - Share in world manufactured exports (right scale)

- **Taiwan Province of China**
  - Real effective exchange rate index (left scale)
  - Share in world manufactured exports (right scale)
The effects of sharp depreciations on manufactured exports in Brazil and Mexico were uneven, too.

Real exchange rate and export performance, 1990 to 2002

**Brazil**

- Real effective exchange rate index (left scale)
- Share in world manufactured exports (right scale)

**Mexico**

- Real effective exchange rate index (left scale)
- Share in world manufactured exports (right scale)