

§166 Training Course

**Bangkok
13.–16. November 2006**

Presentation by

Heiner Flassbeck

Director

**Division on Globalization
and Development Strategies**

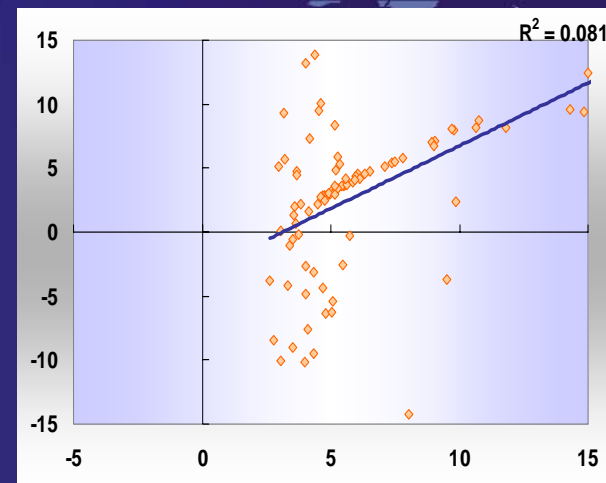
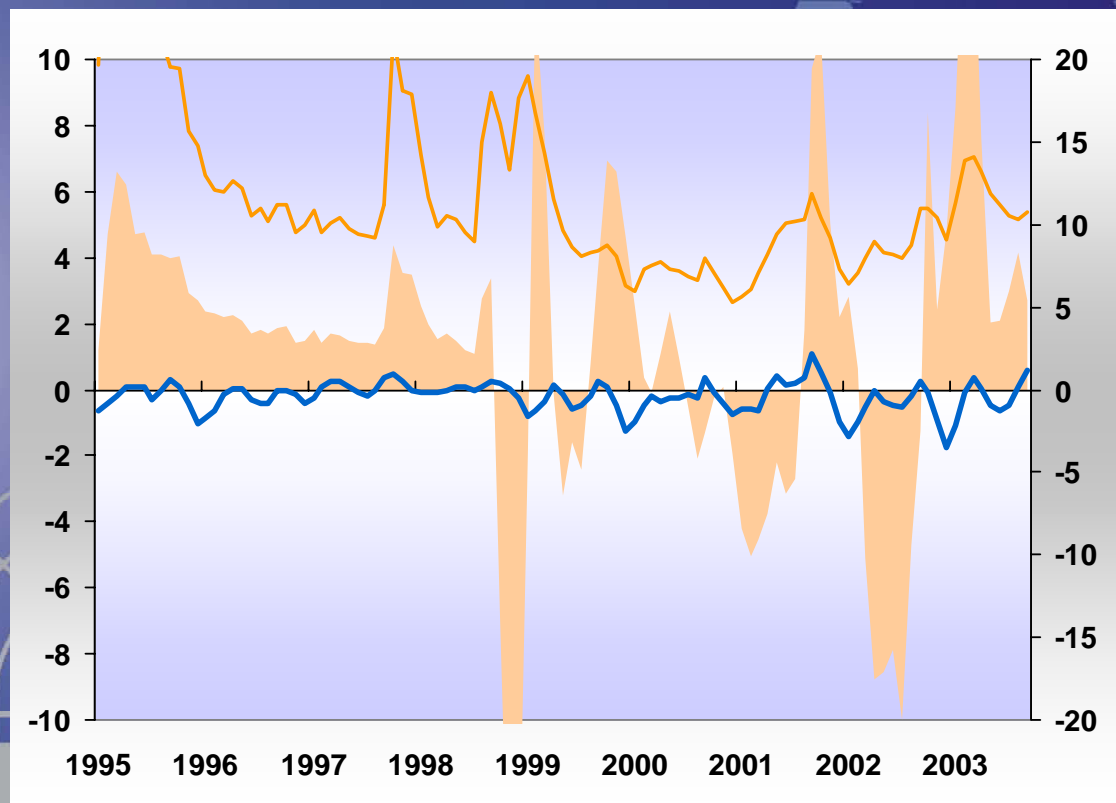
UNCTAD analyzed the impacts of interest rate differentials on short-term capital flows

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

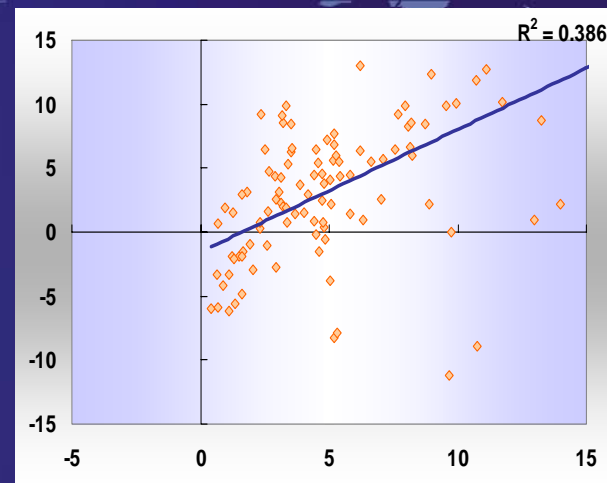
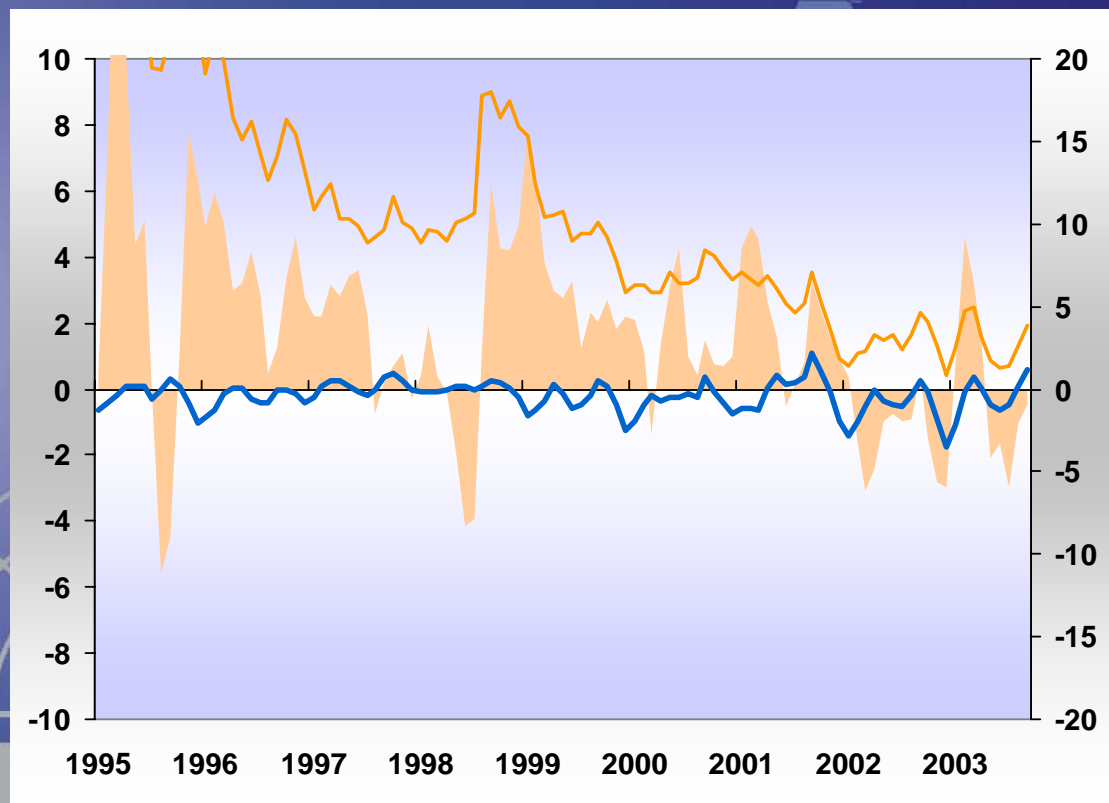
Brazil



- 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)

Mexico also maintained a persistent positive real interest rate differential

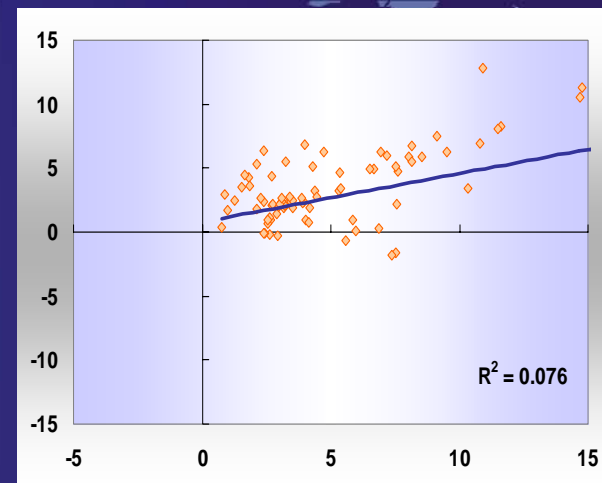
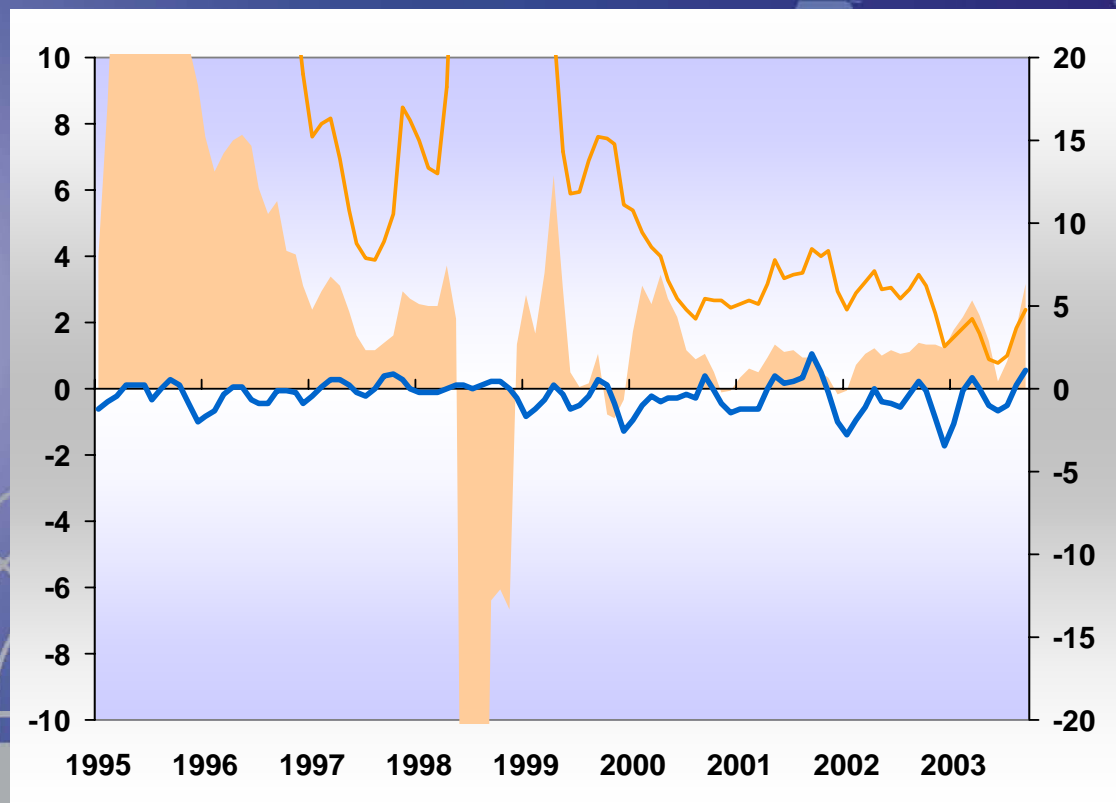
Mexico



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Russia offered very high real interest rates in the

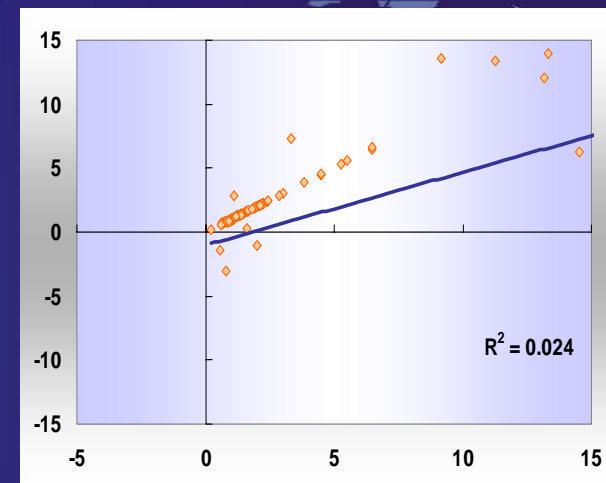
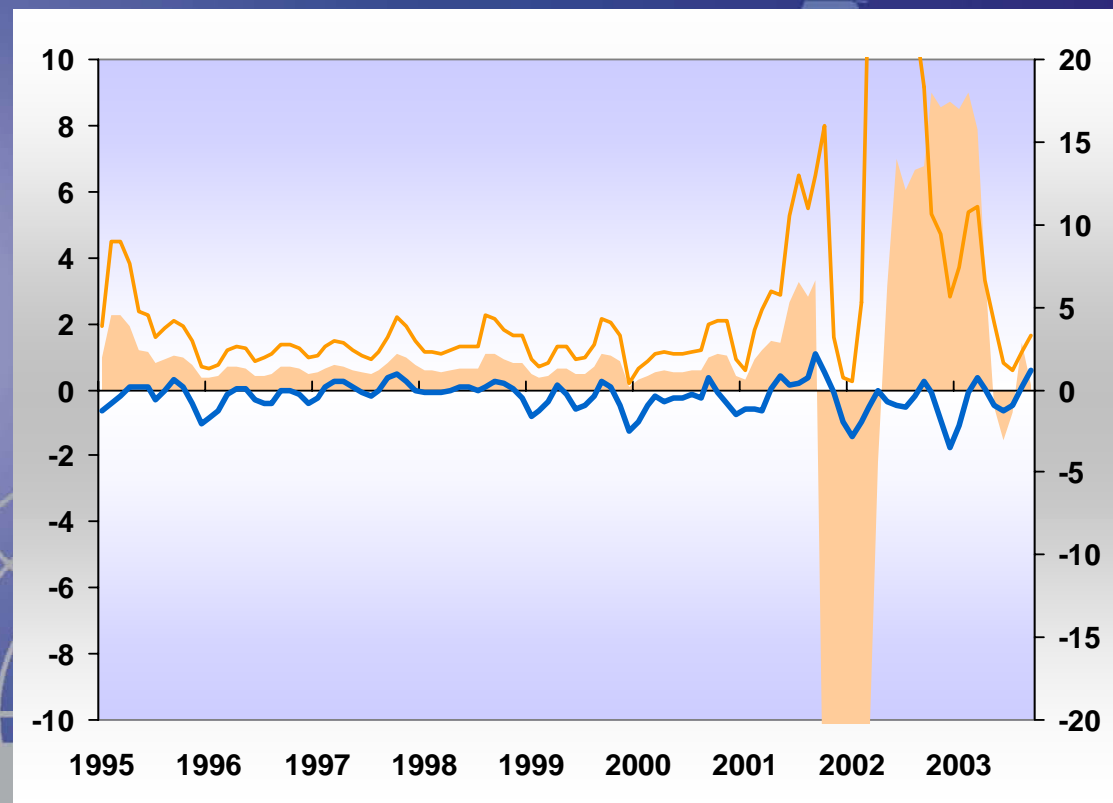
Russian Federation



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Argentina was stable throughout the 90s, but ran

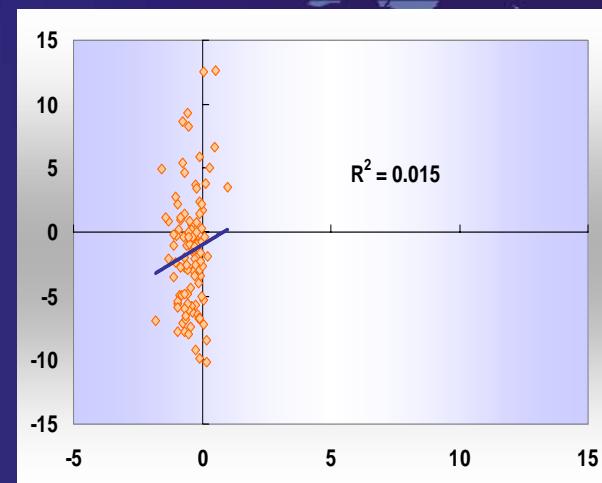
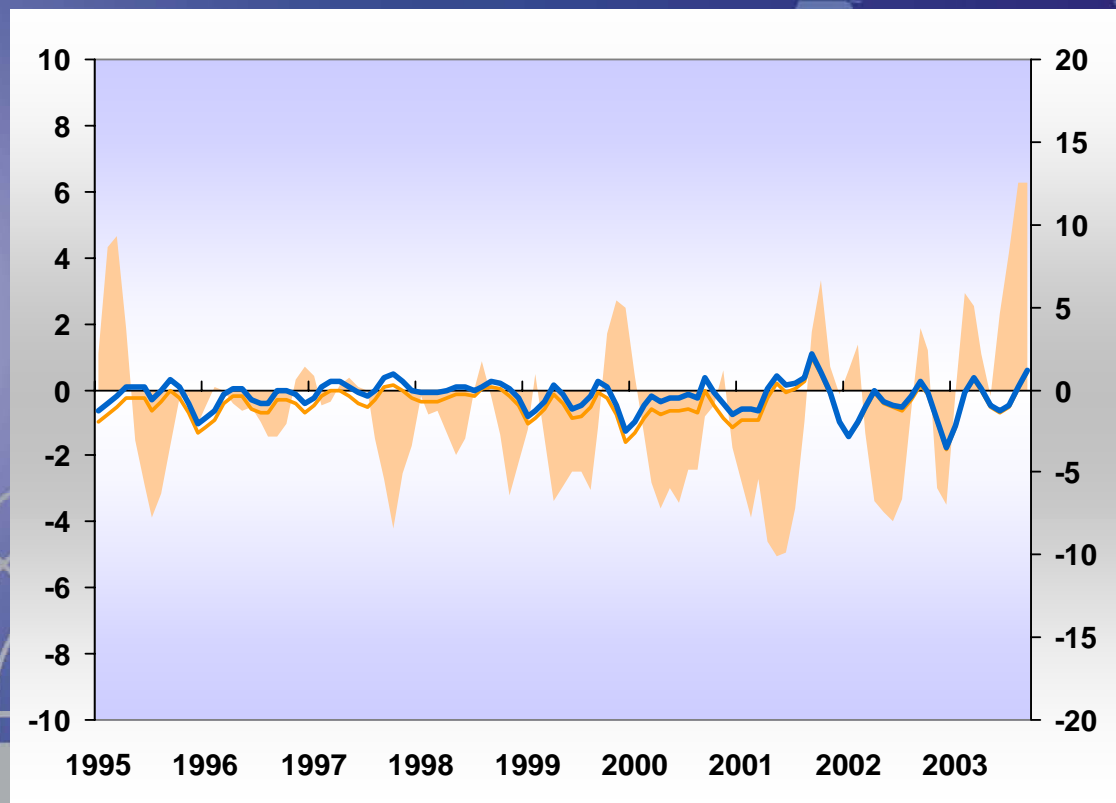
Argentina



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By contrast, Chile was rather unattractive in terms

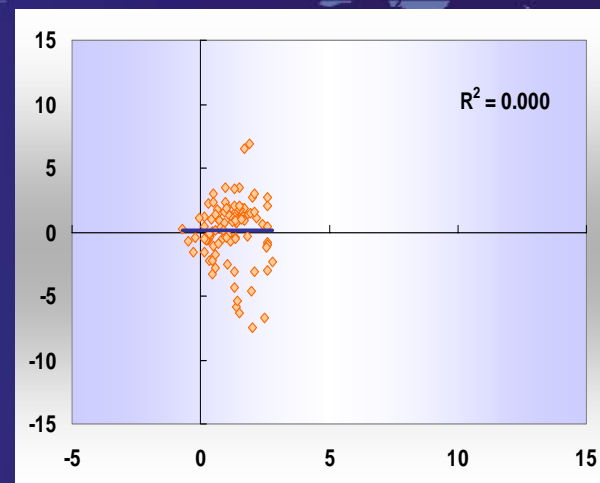
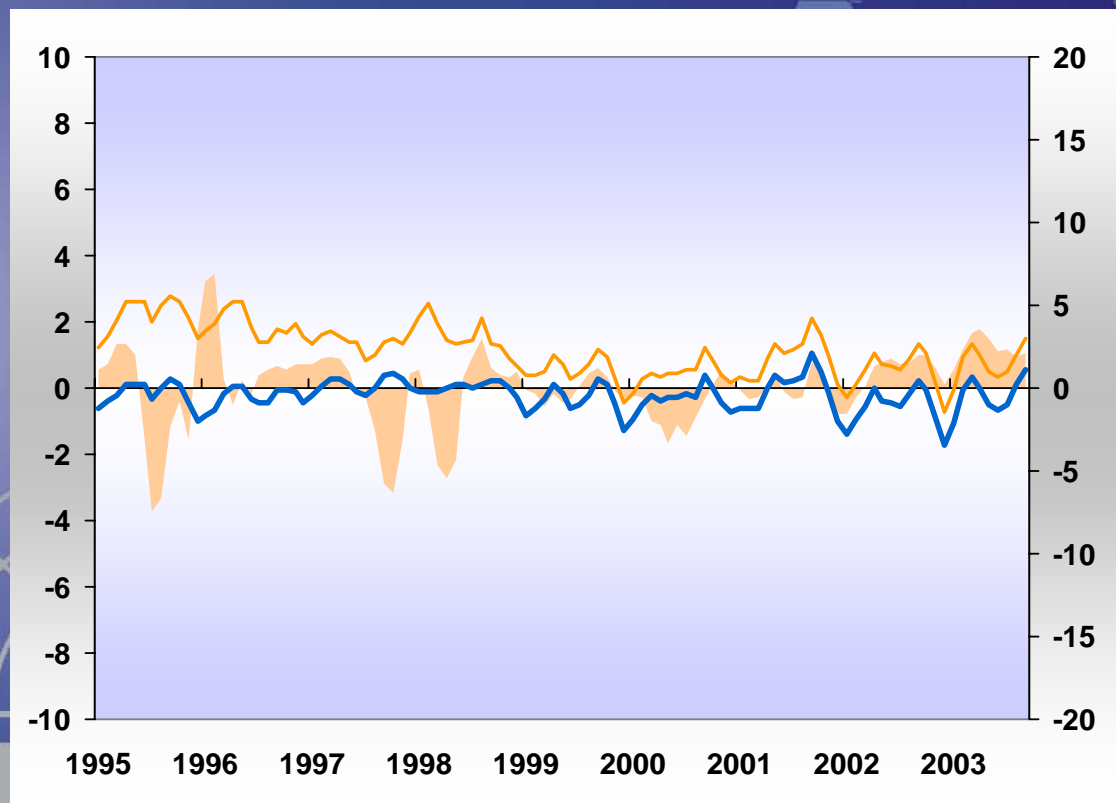
Chile



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India managed to be not too attractive for short-term

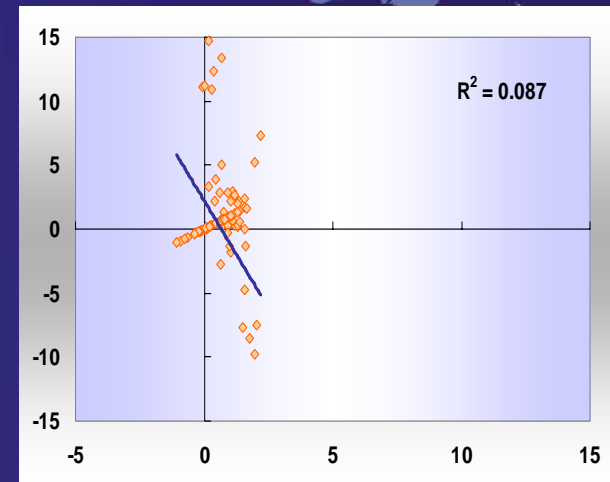
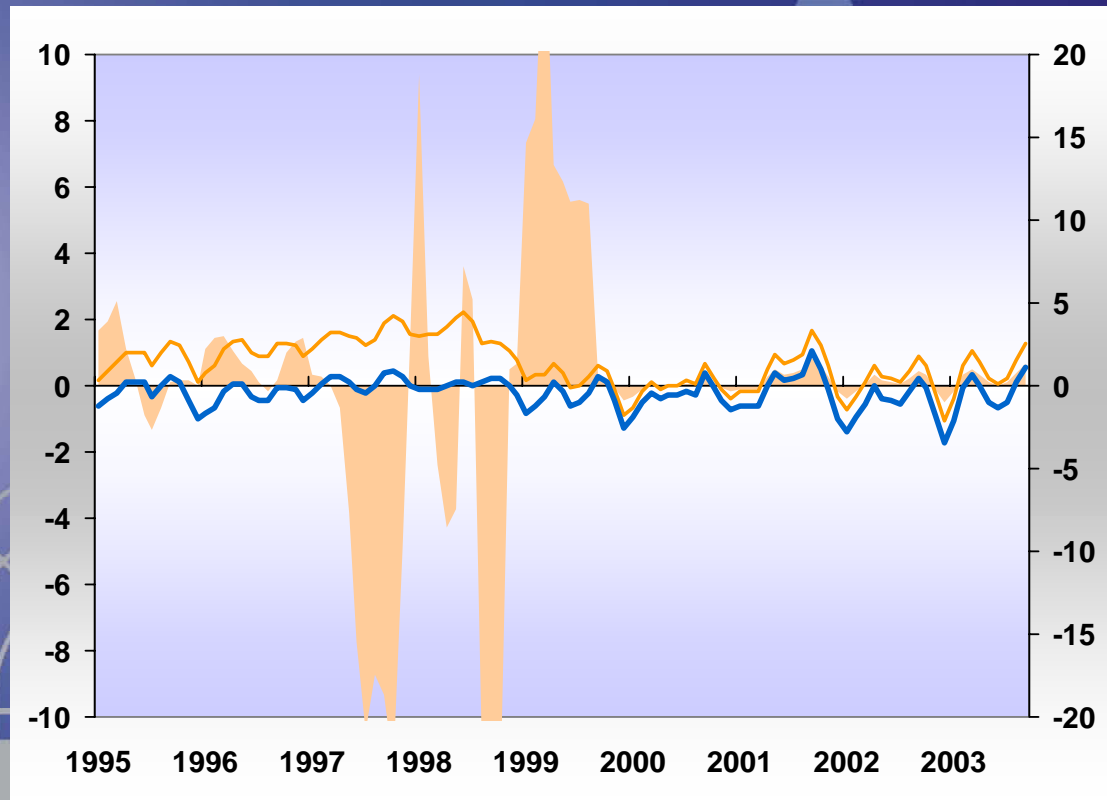
India



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After the turmoil of the Asian crisis Malaysia cut

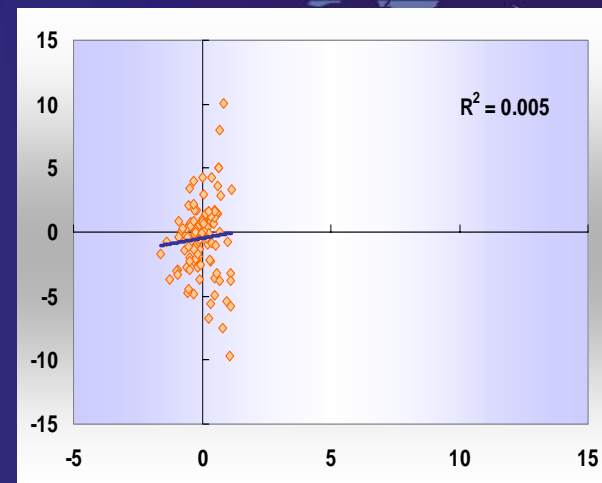
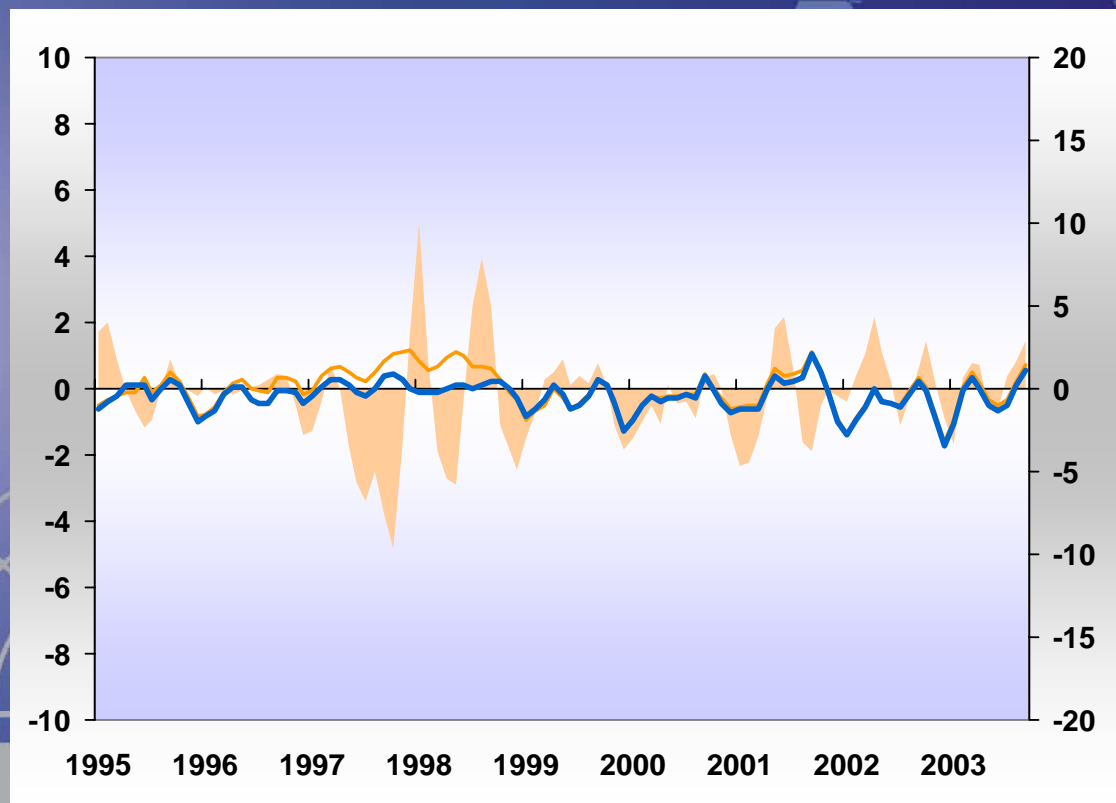
Malaysia



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Singapore was quite unattractive for international investors during the whole period

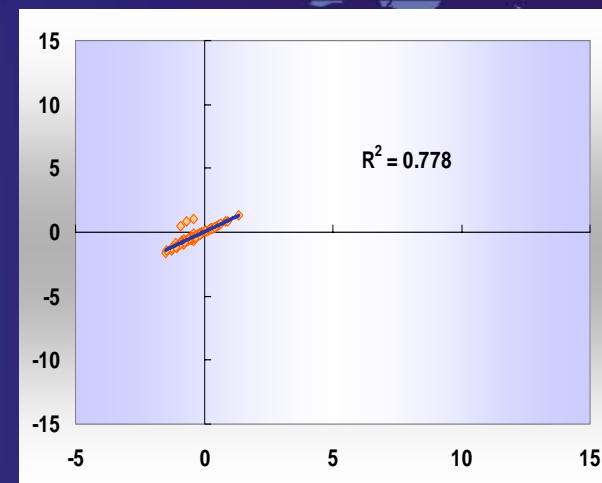
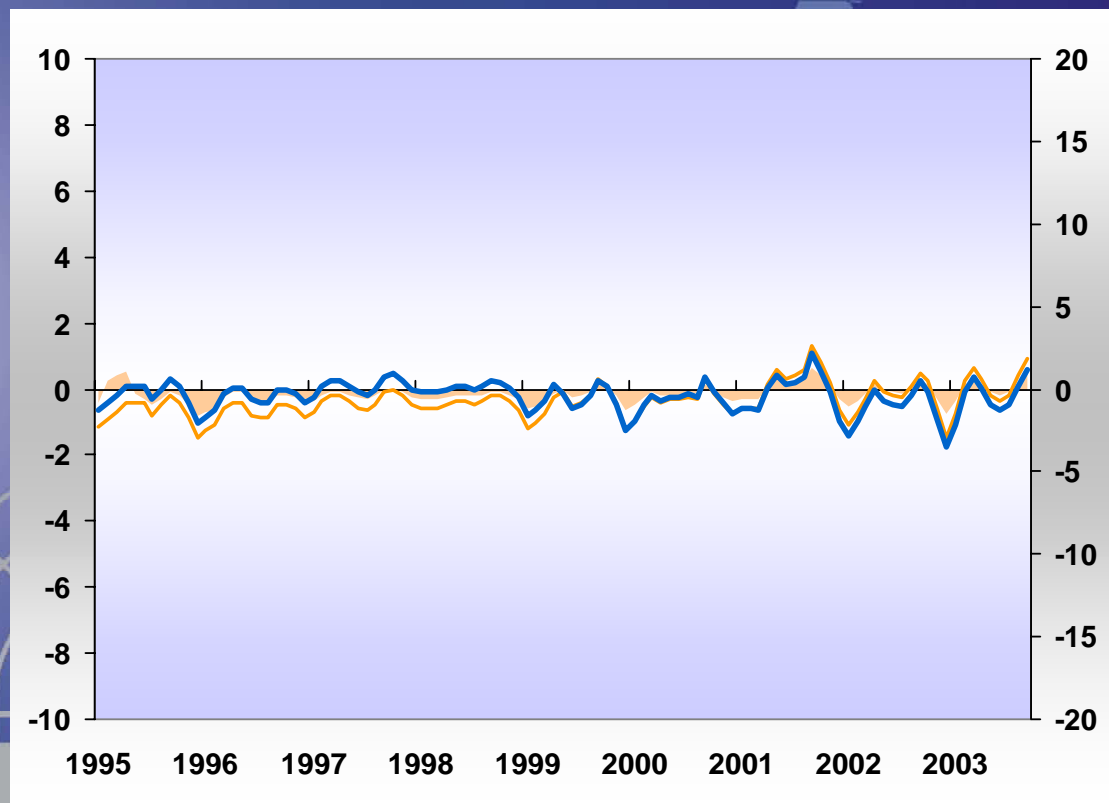
Singapore



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China's de facto peg is sustainable, it does not offer positive real interest rate

China



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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

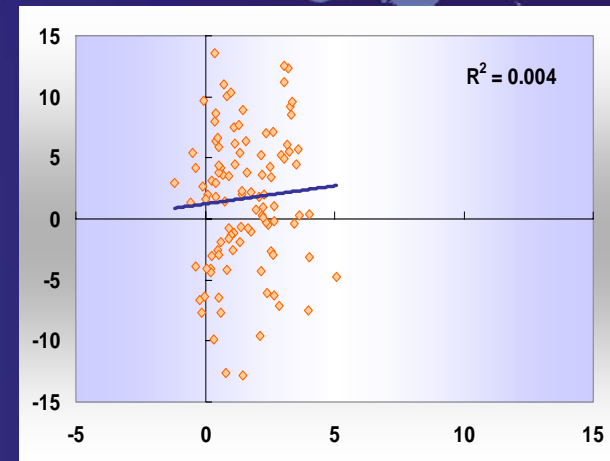
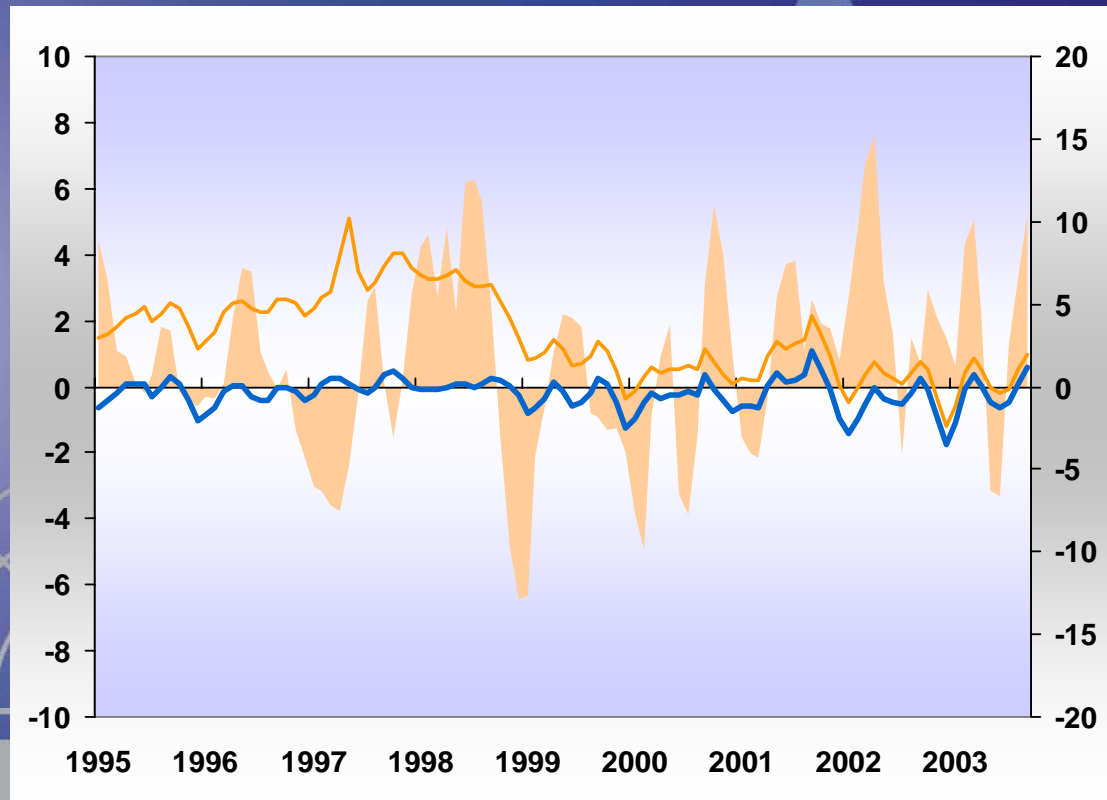
- **If the nominal short-term interest rate in a financially open emerging-market economy exceeds that in a developed country by more than the growth differential, the nominal exchange rate of the emerging- market economy should depreciate at a rate that equals the difference in interest rates**
- **If this condition is not met, combining floating of the 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

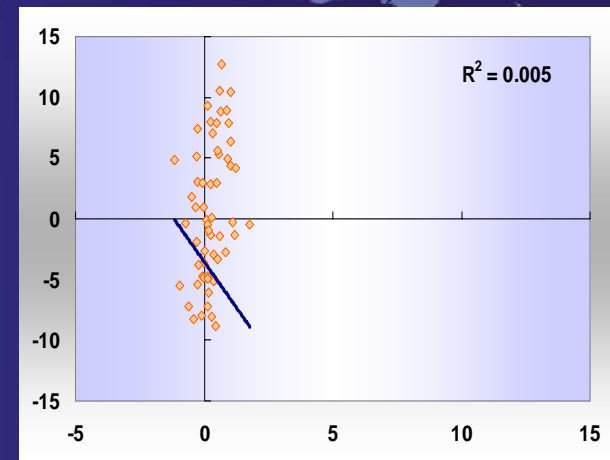
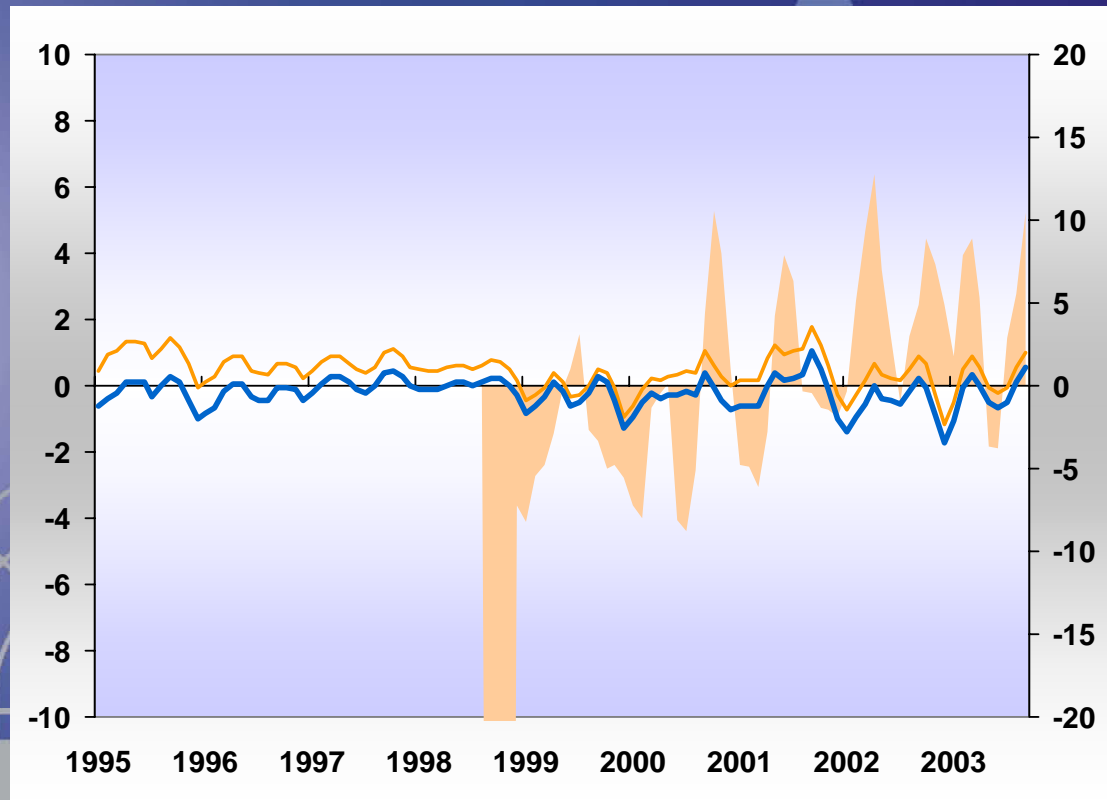
Results: Czech Republic



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UNCTAD's analysis of interest rate differentials on short-term capital flows

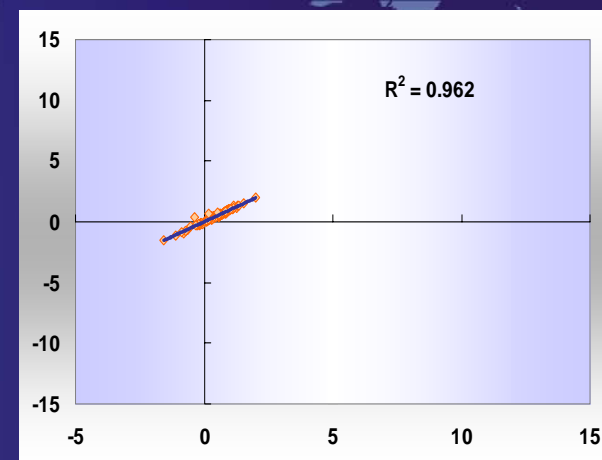
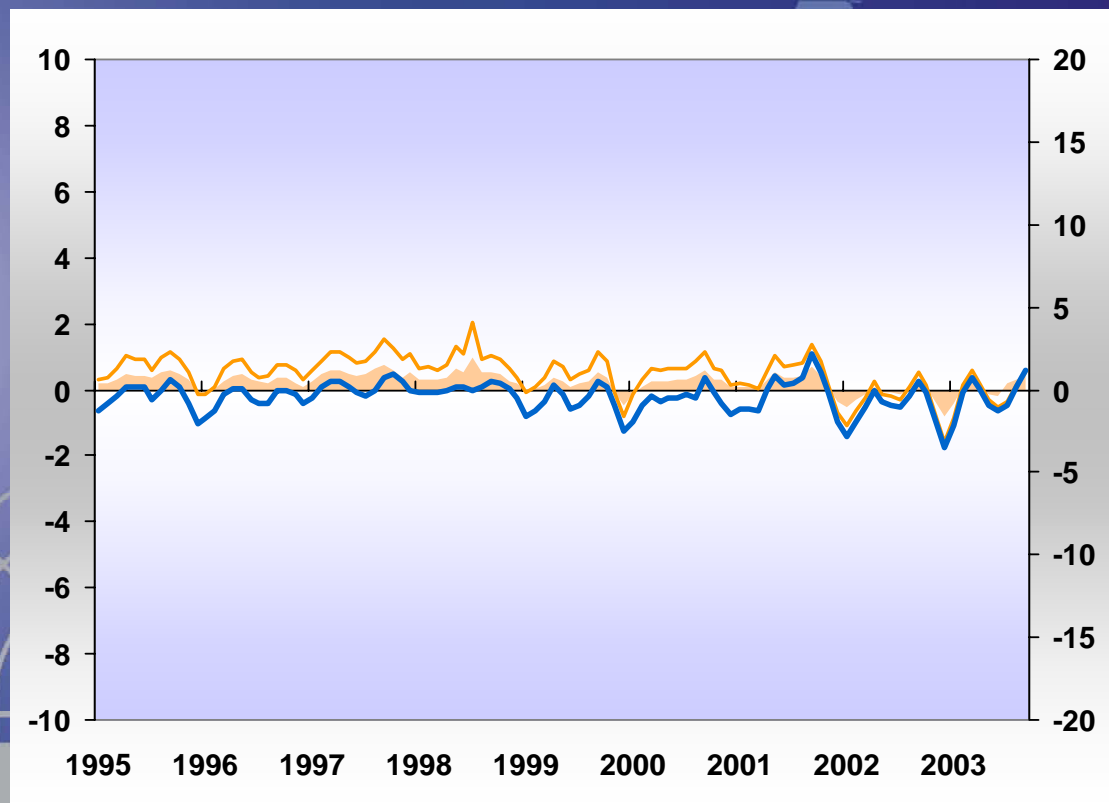
Results: Euro Area



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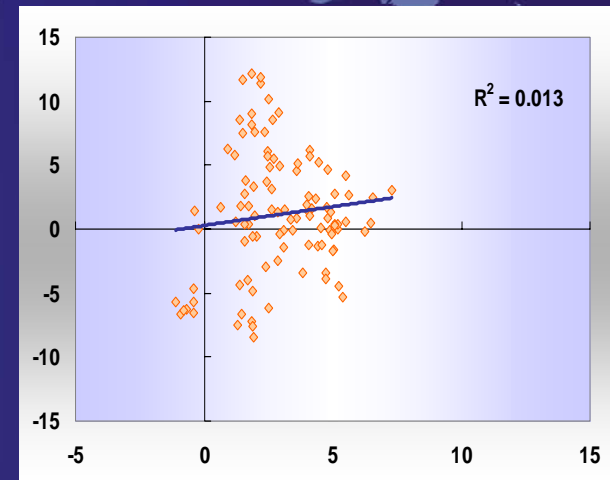
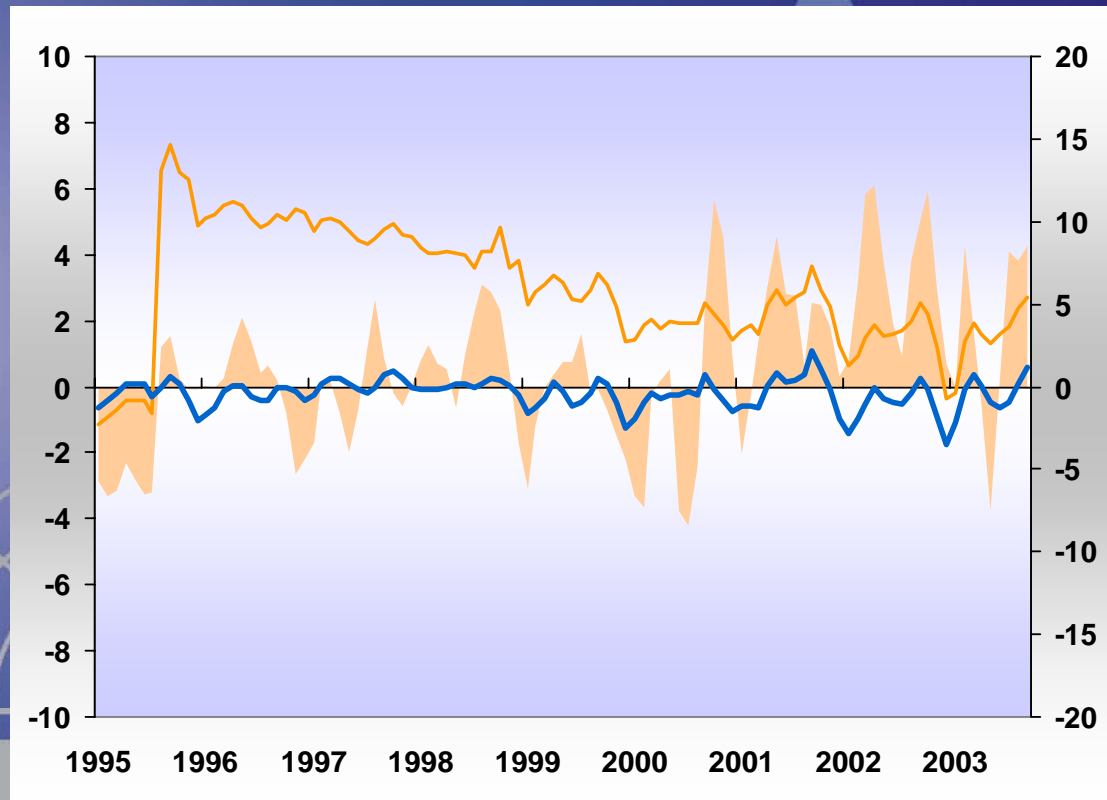
Results: Hong Kong SAR, China



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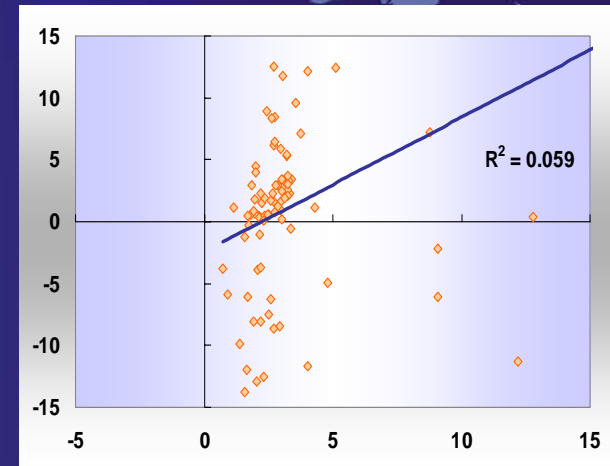
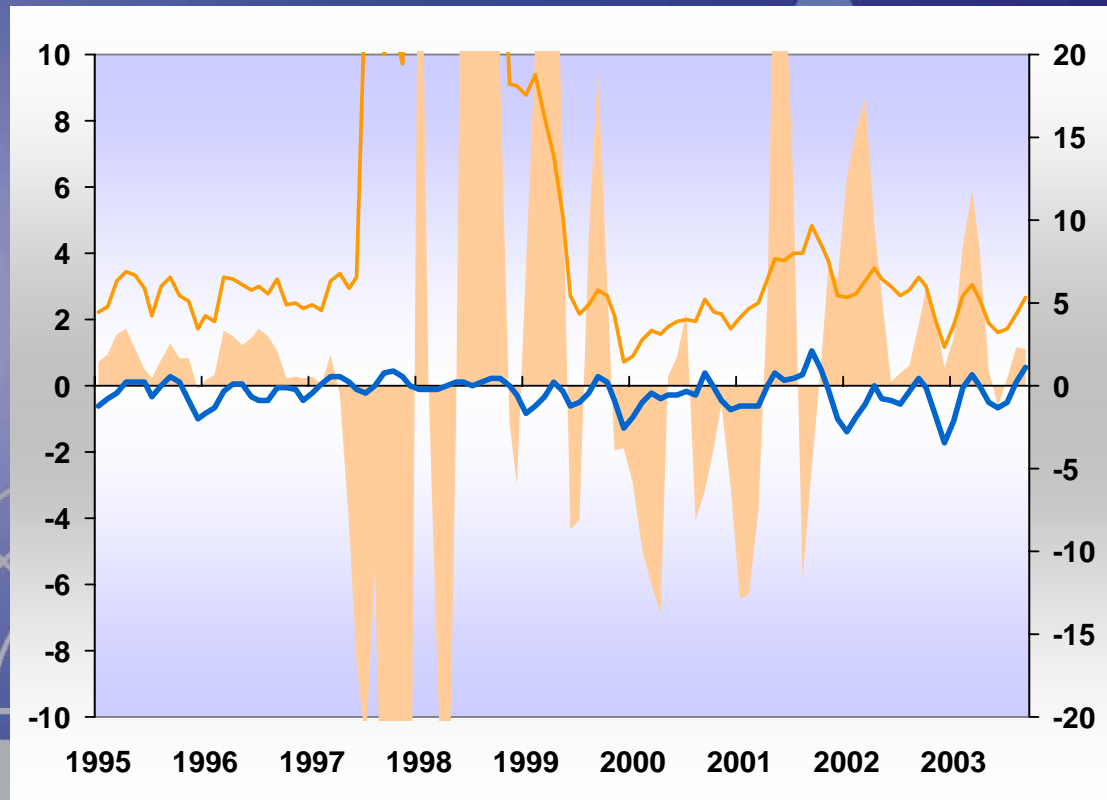
Results: Hungary



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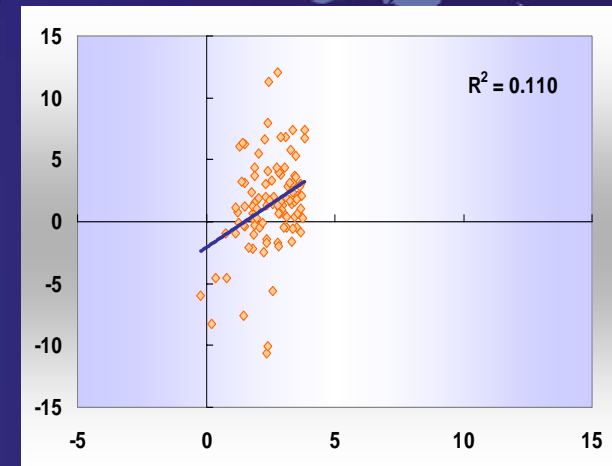
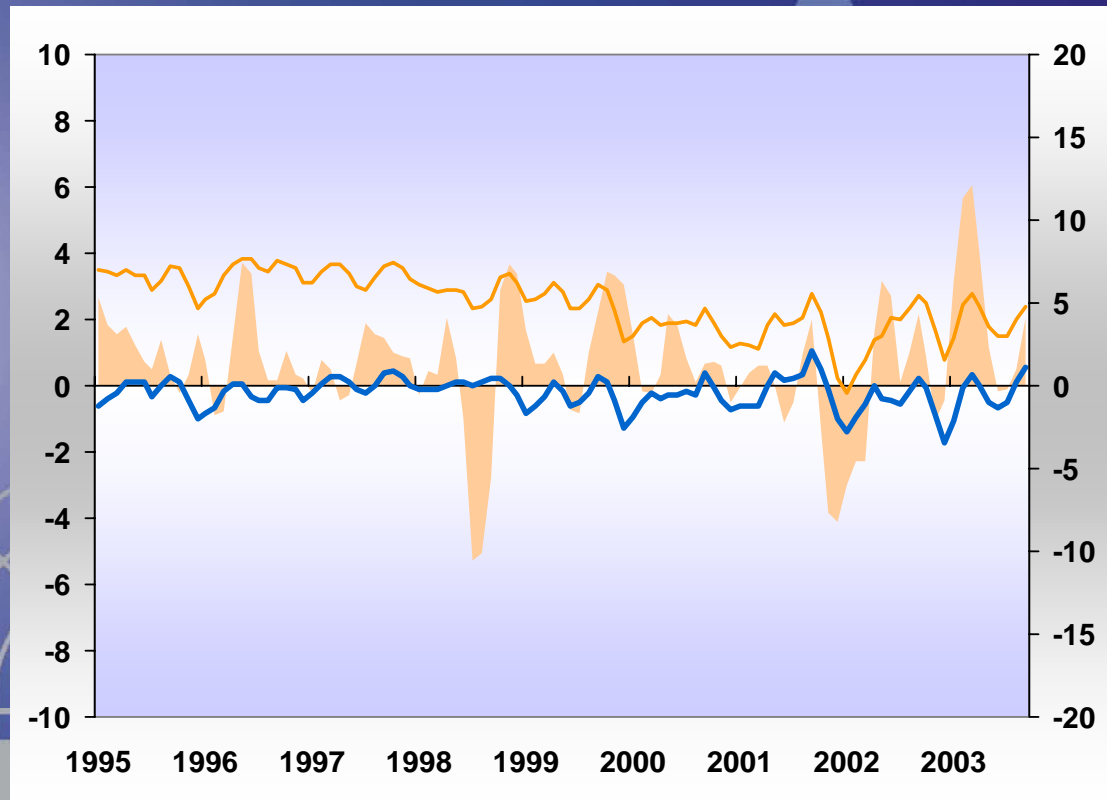
Results: Indonesia



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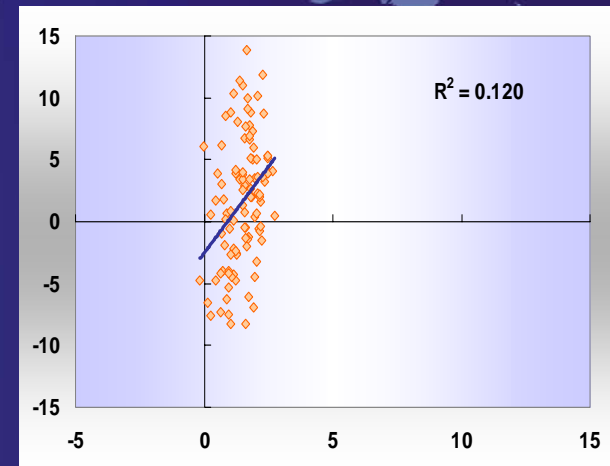
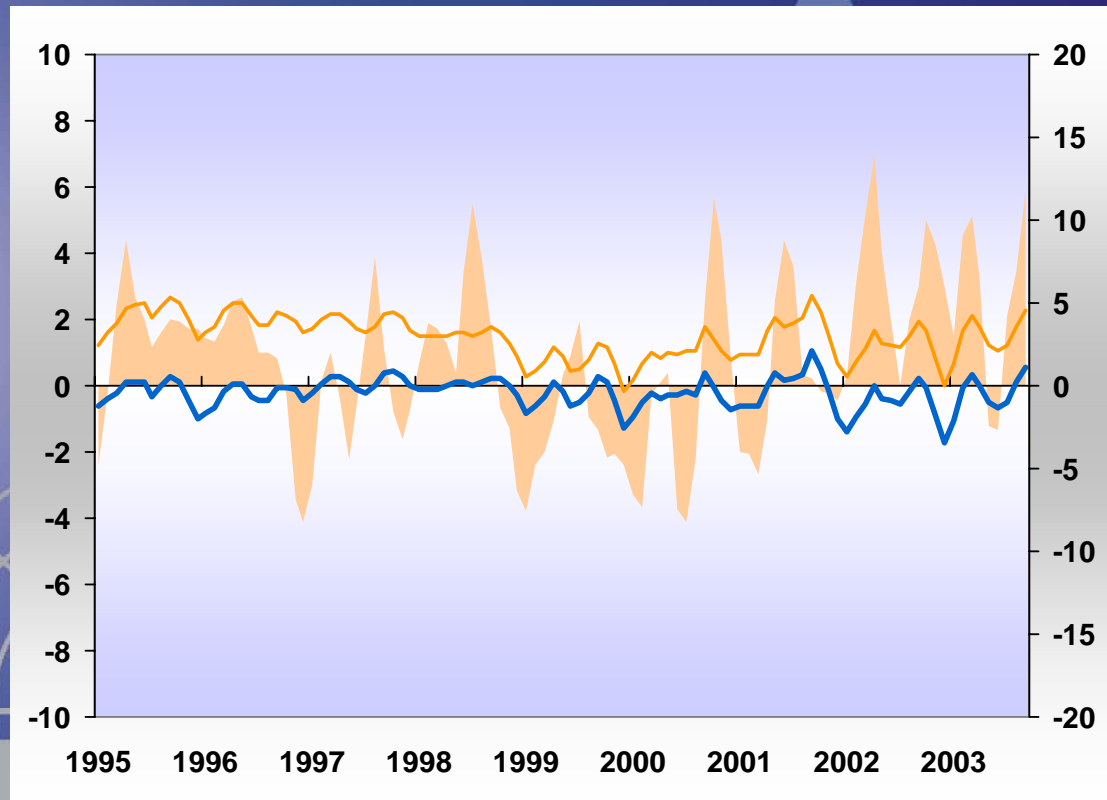
Results: Israel



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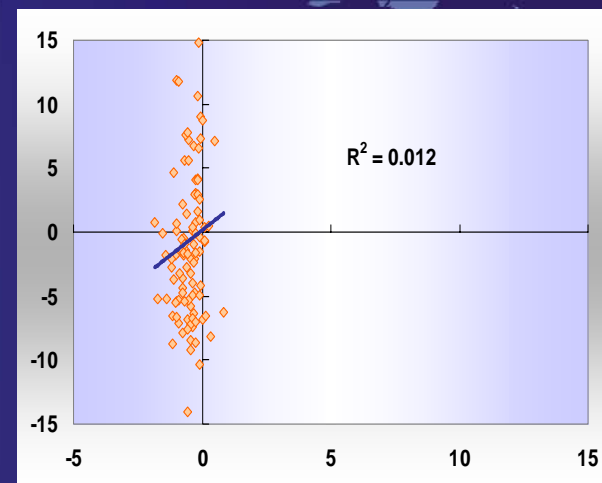
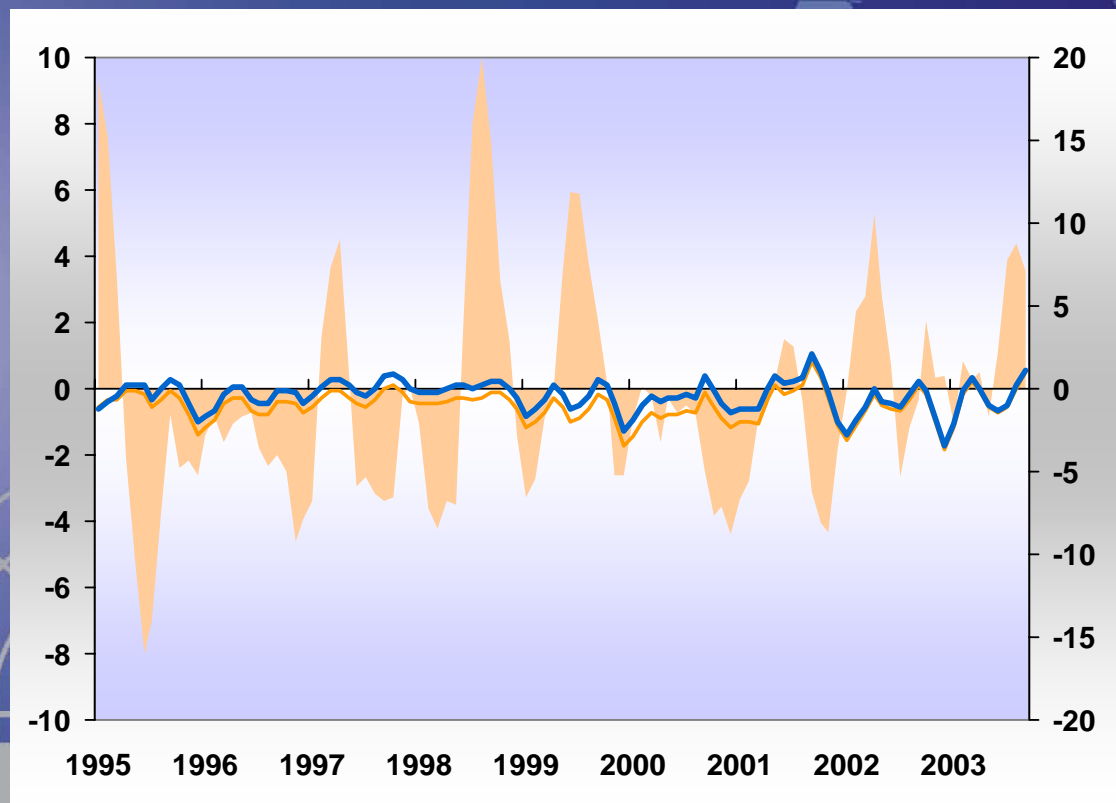
Results: Italy



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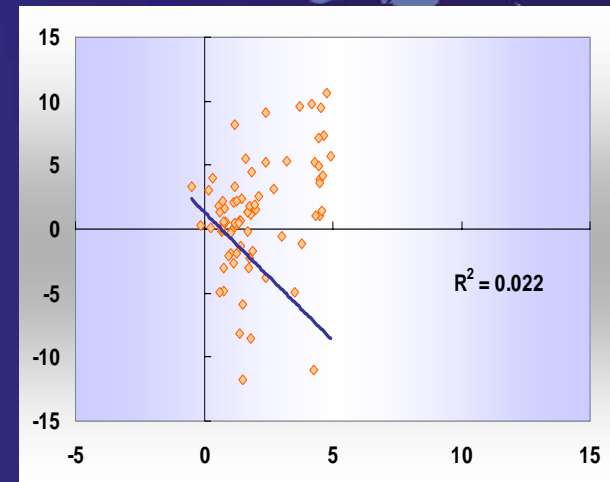
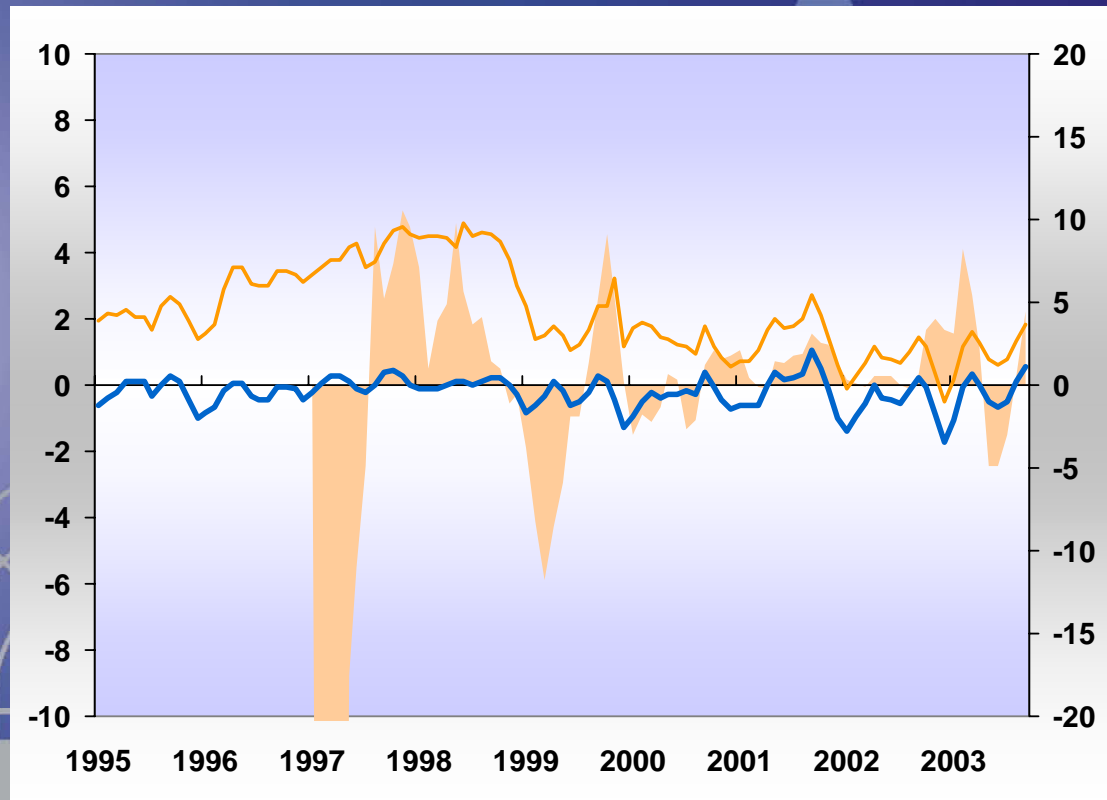
Results: Japan



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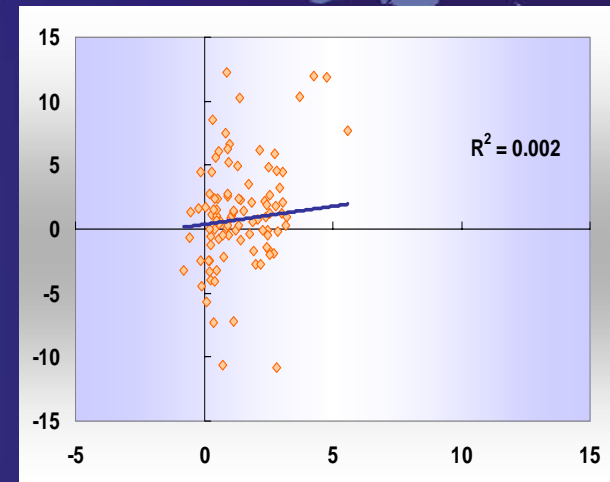
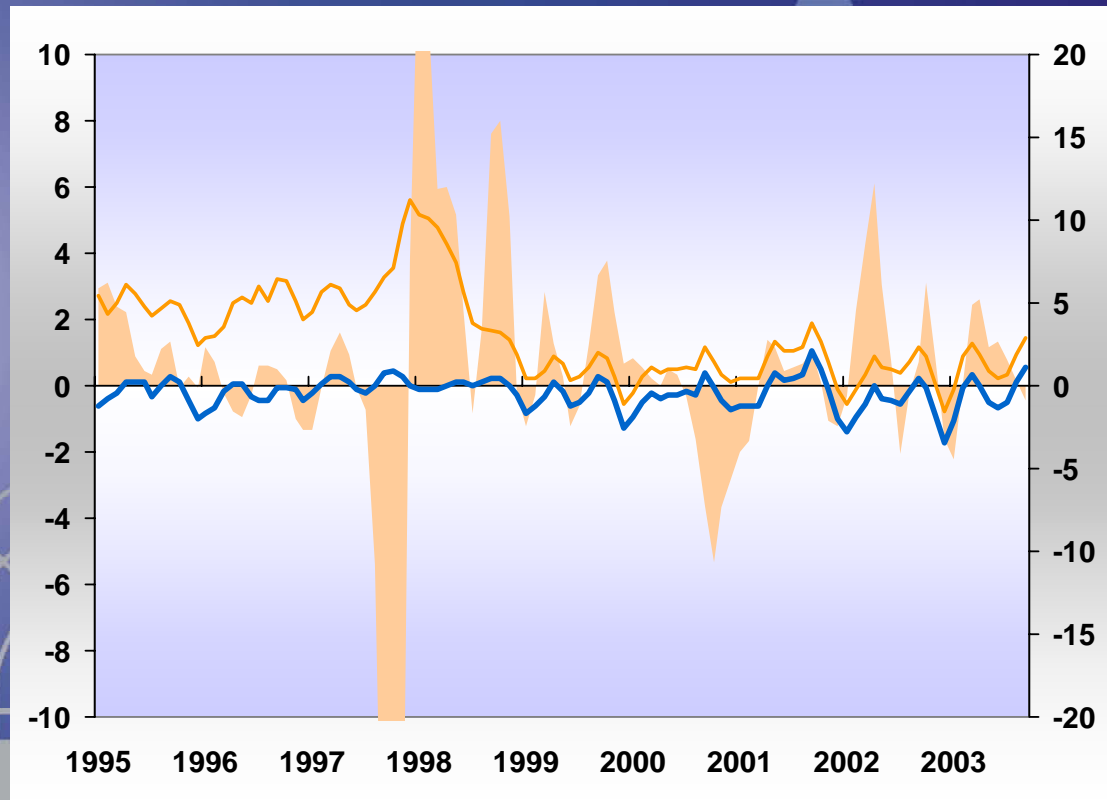
Results: Kenya



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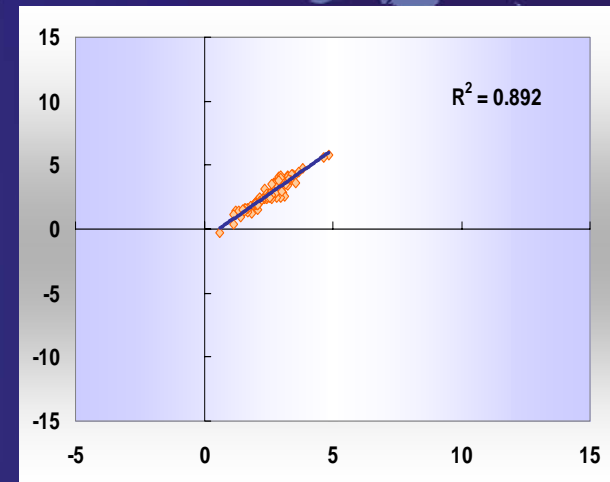
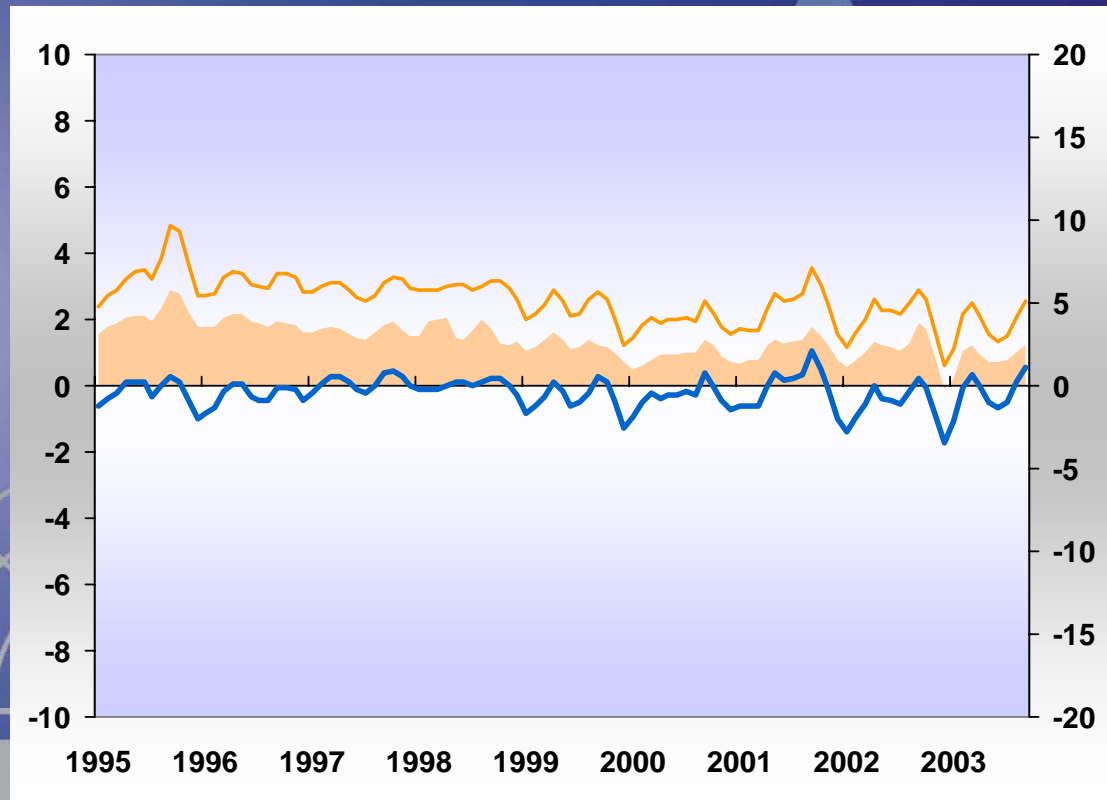
Results: Republic of Korea



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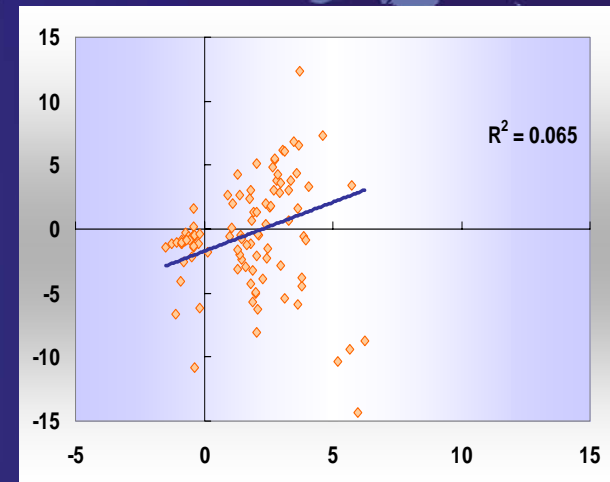
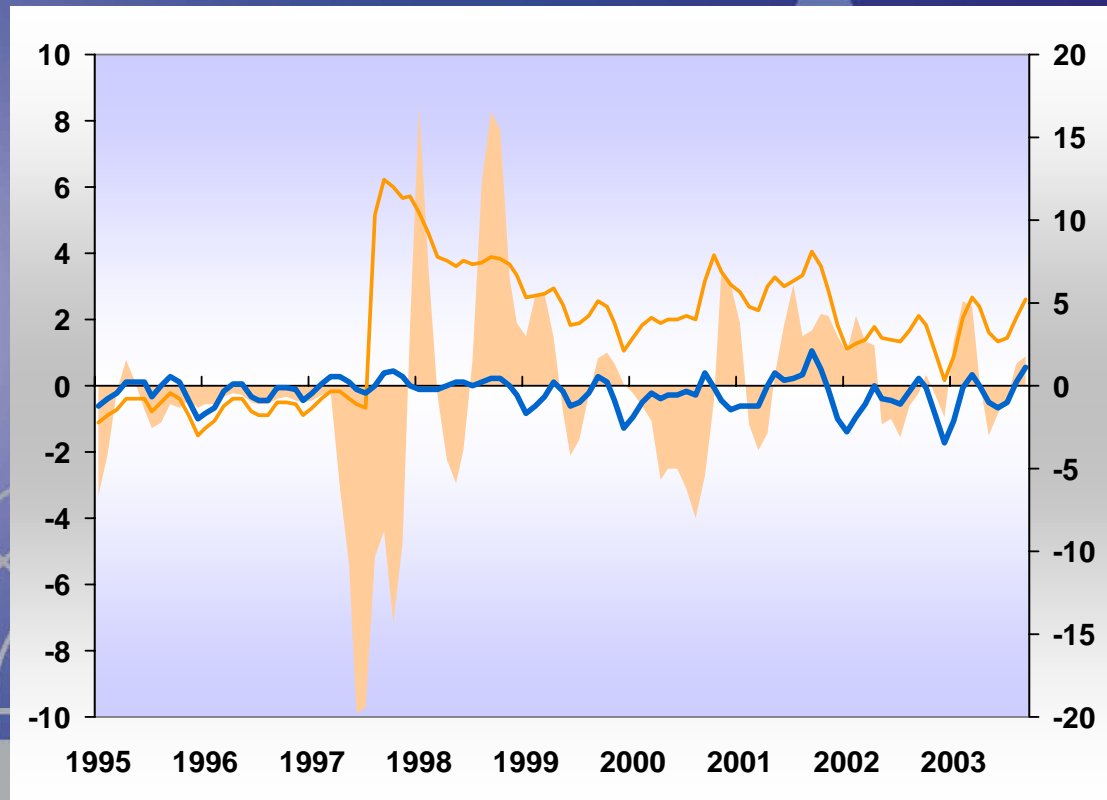
Results: Lebanon



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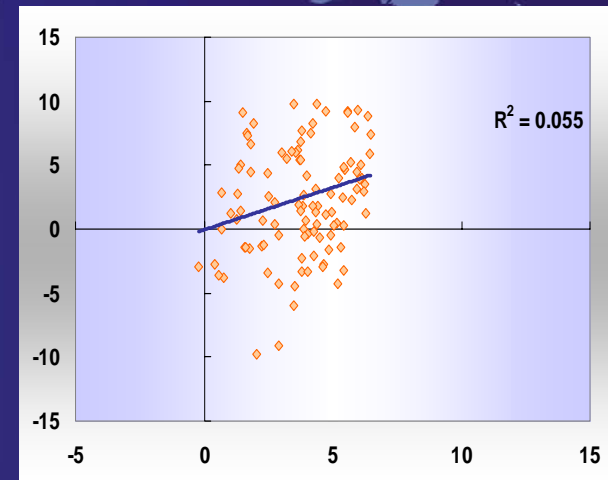
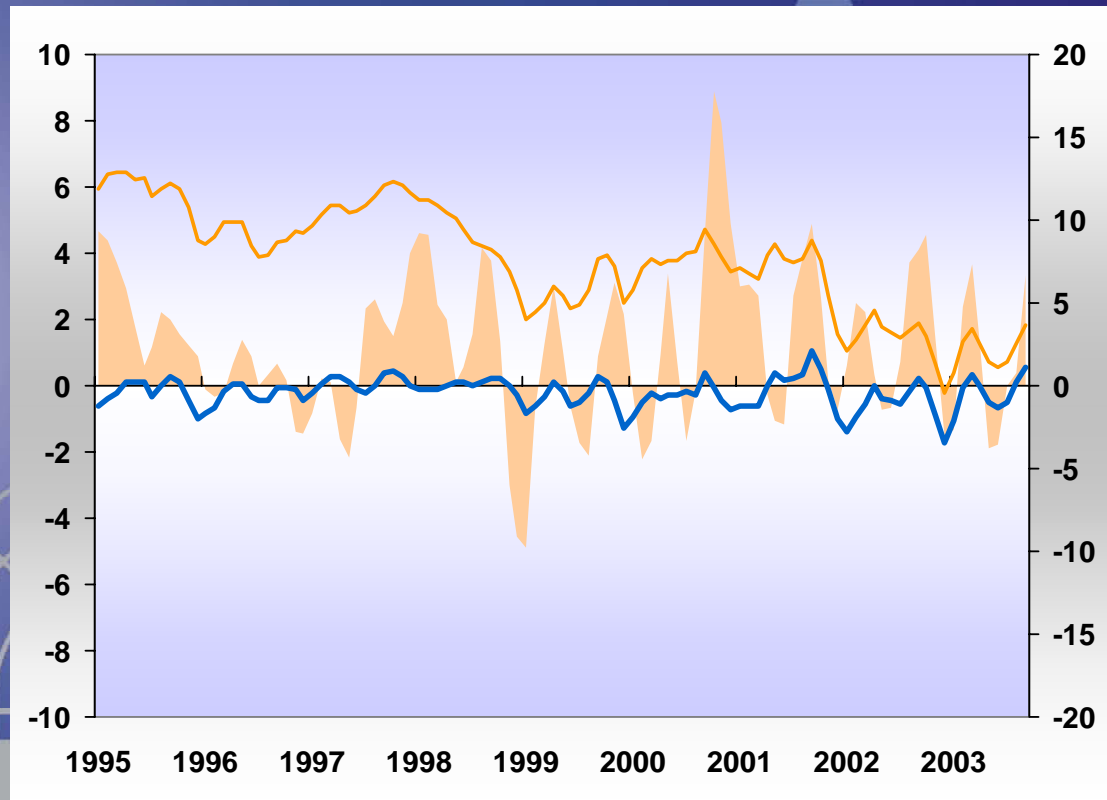
Results: Philippines



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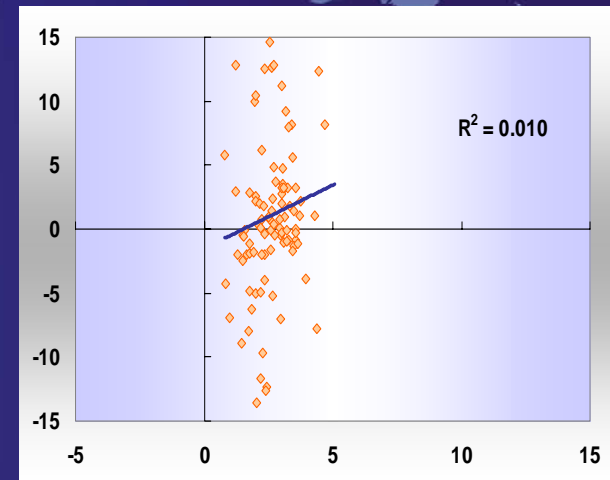
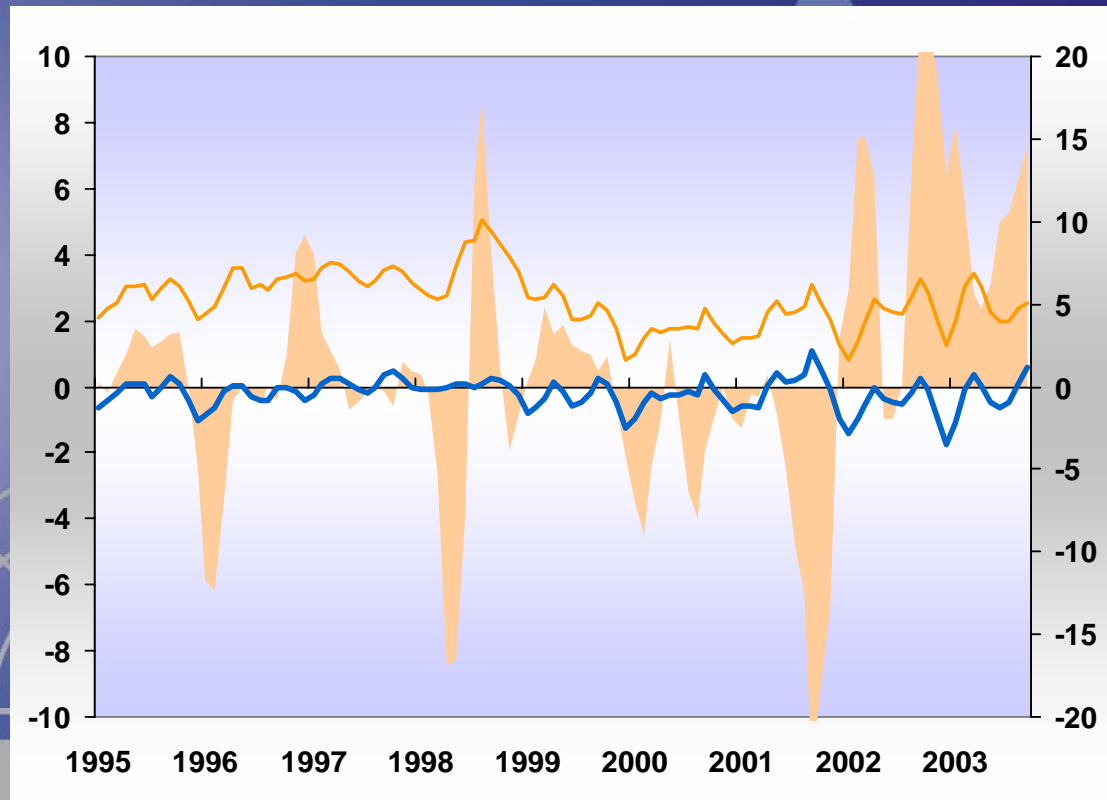
Results: Poland



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UNCTAD's analysis of interest rate differentials on short-term capital flows

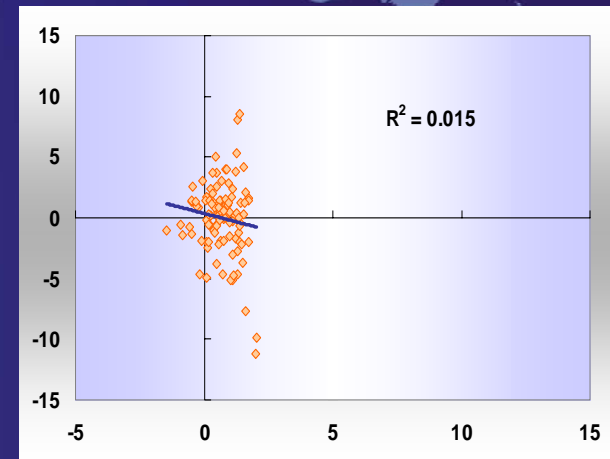
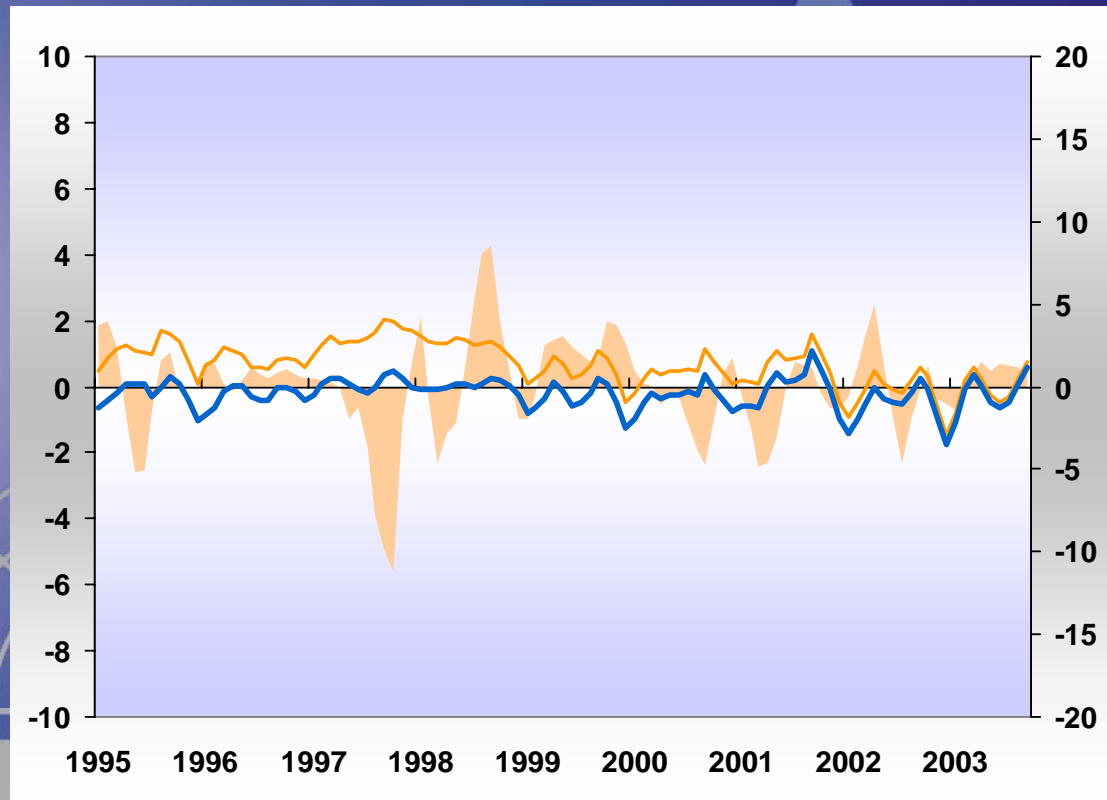
Results: South Africa



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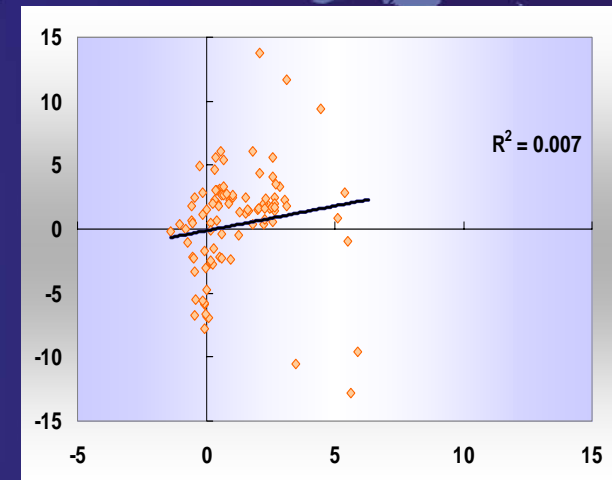
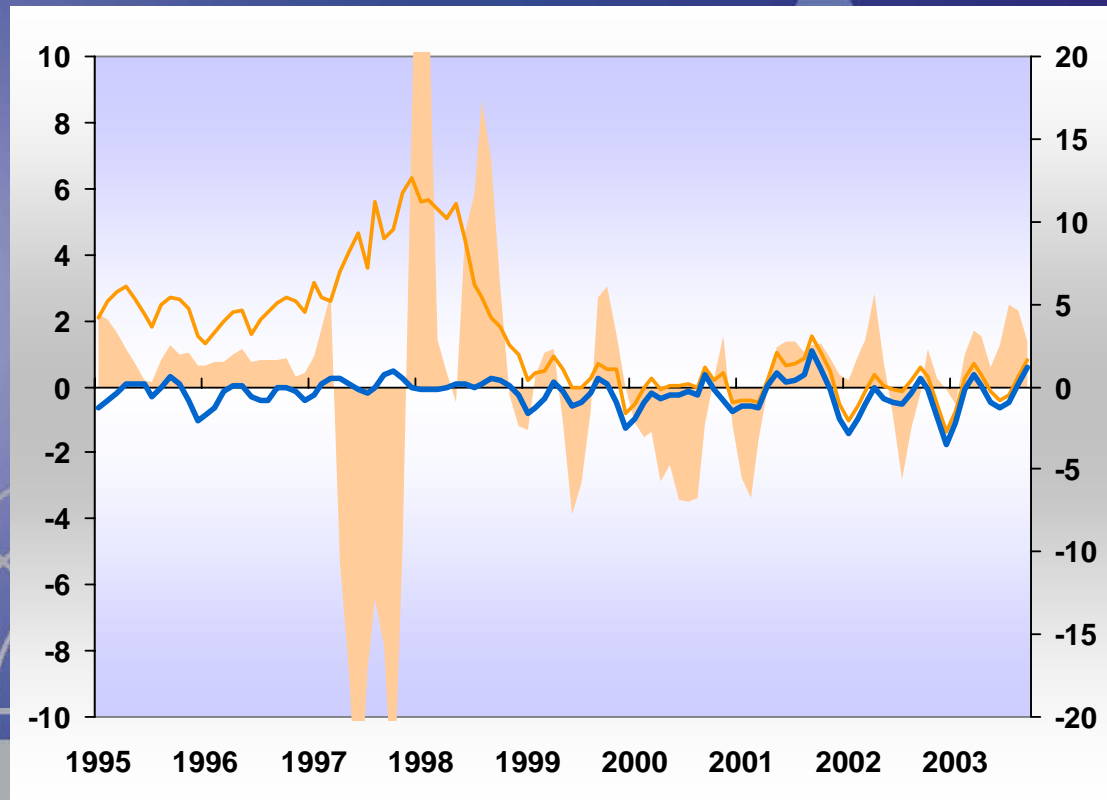
Results: Taiwan, Province of China



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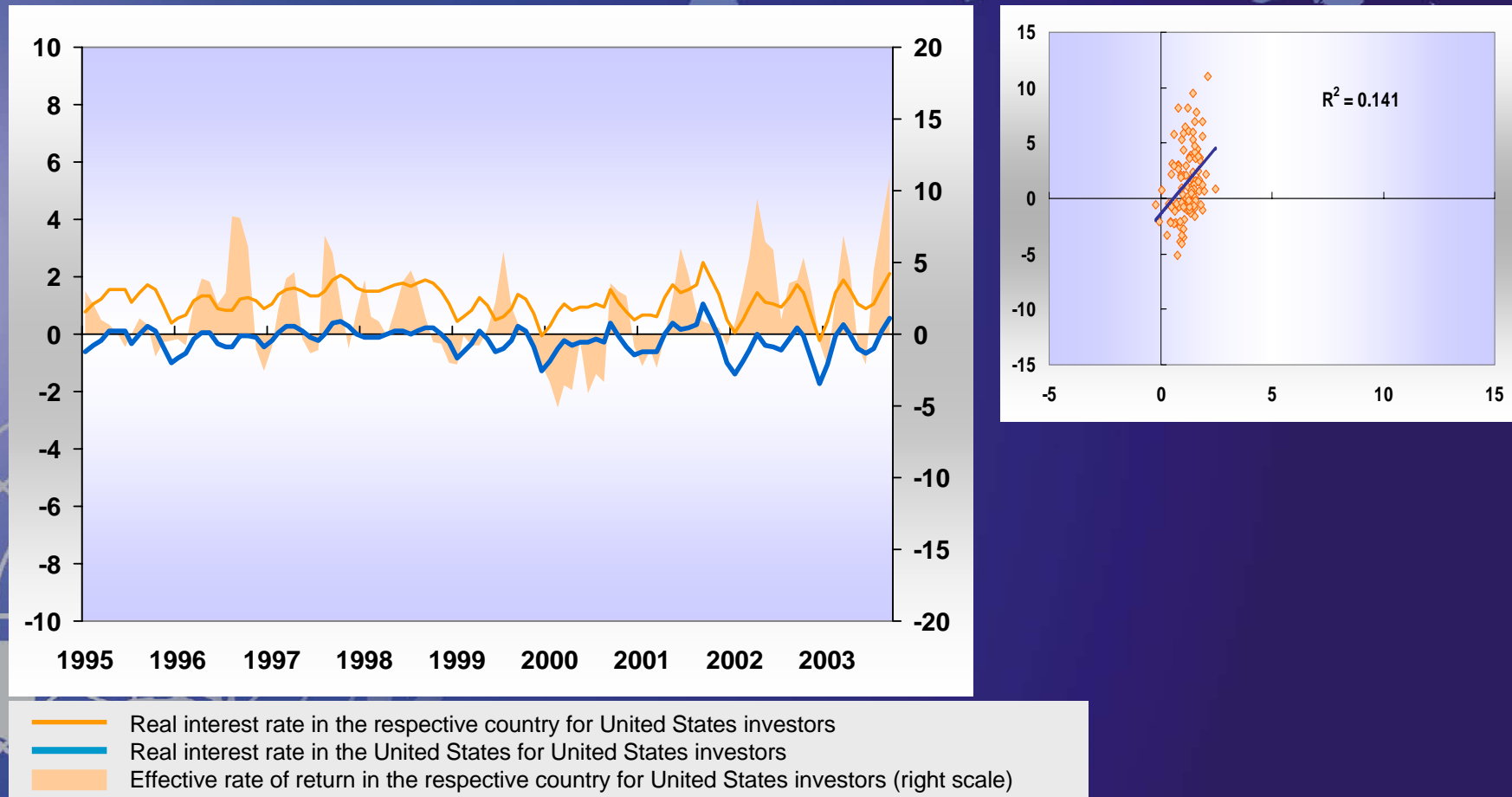
Results: Thailand



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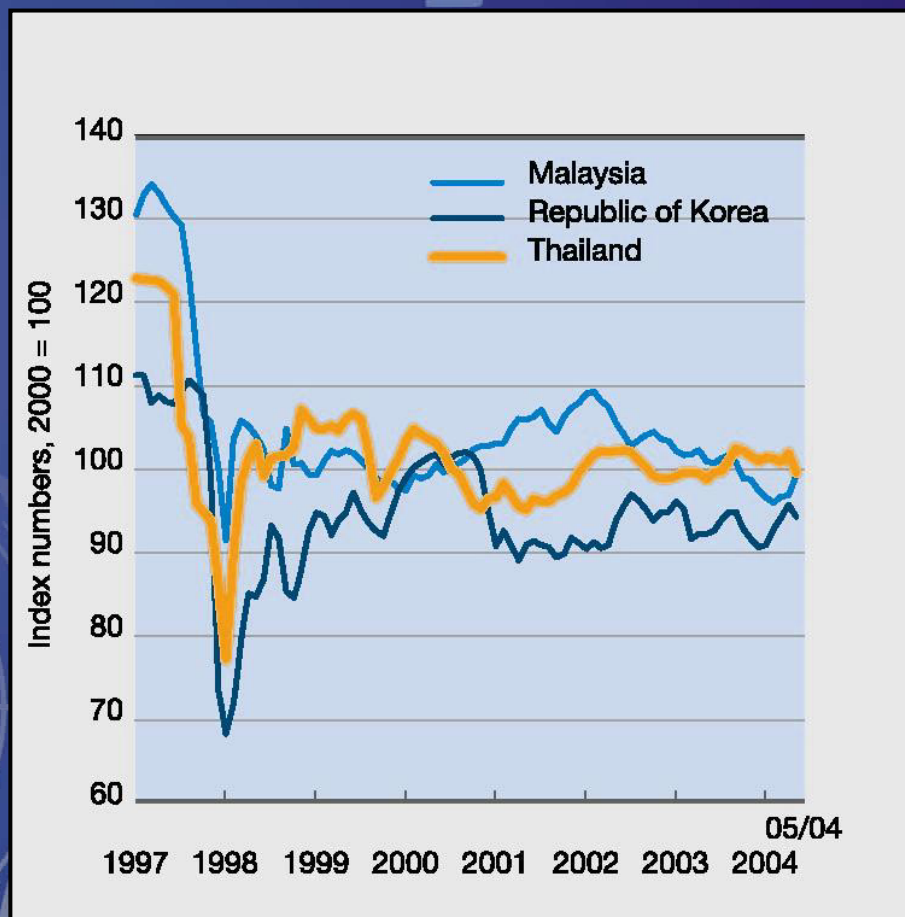
UNCTAD's analysis of interest rate differentials on short-term capital flows

Results: United Kingdom



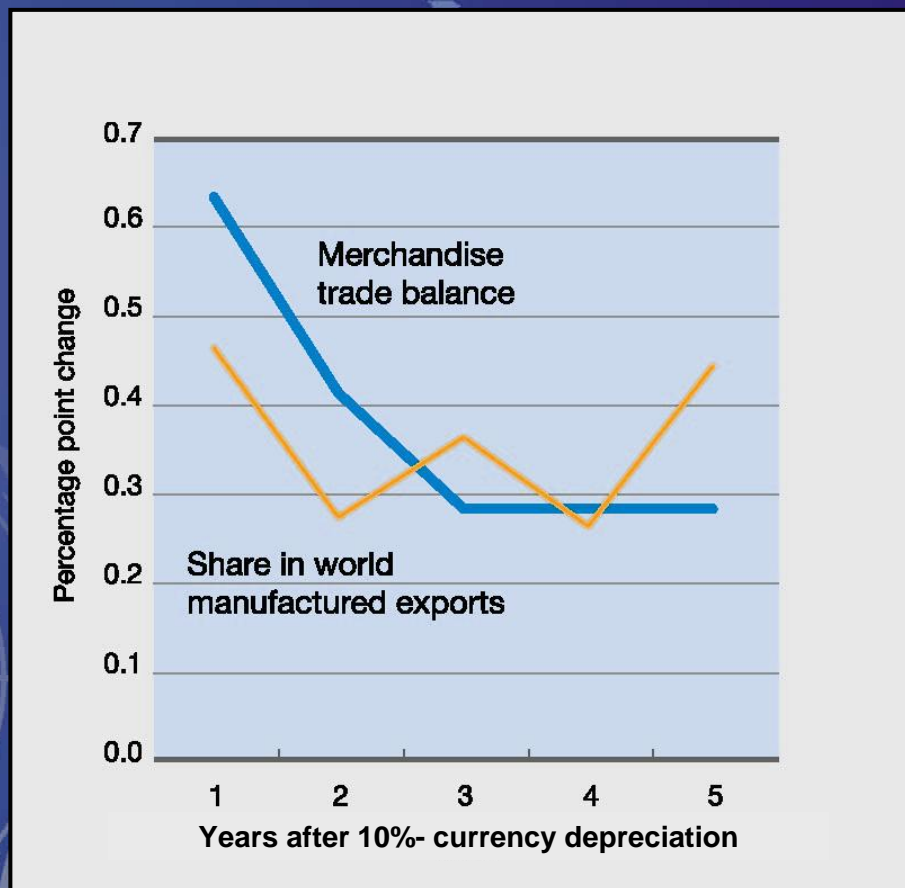
In Asia, fairly stable and competitive exchange rates spurred the trade performances in recent years

Real effective exchange rates (REER) in Asia, 1997 to 2004



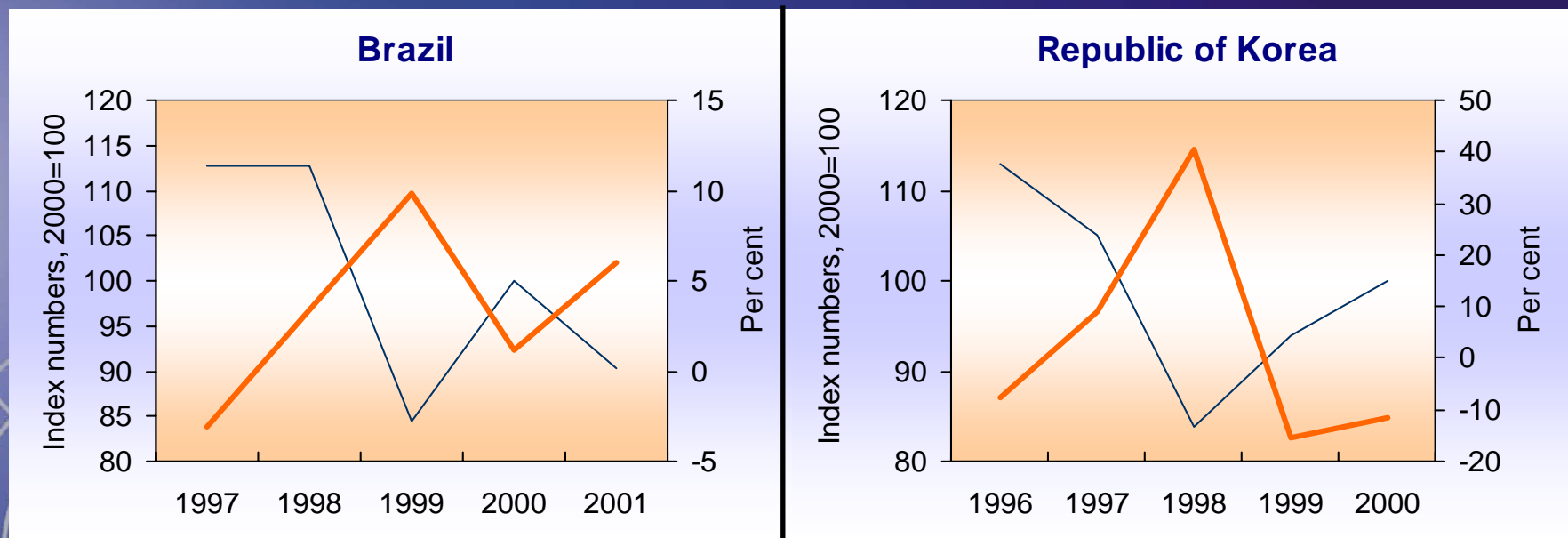
10%-depreciation leads to 0.6% improvement of trade balance in the short- and 0.3% in the medium-term

10%-exchange rate change and trade performance – time path



Sharp currency depreciation in general stimulates the trade balance

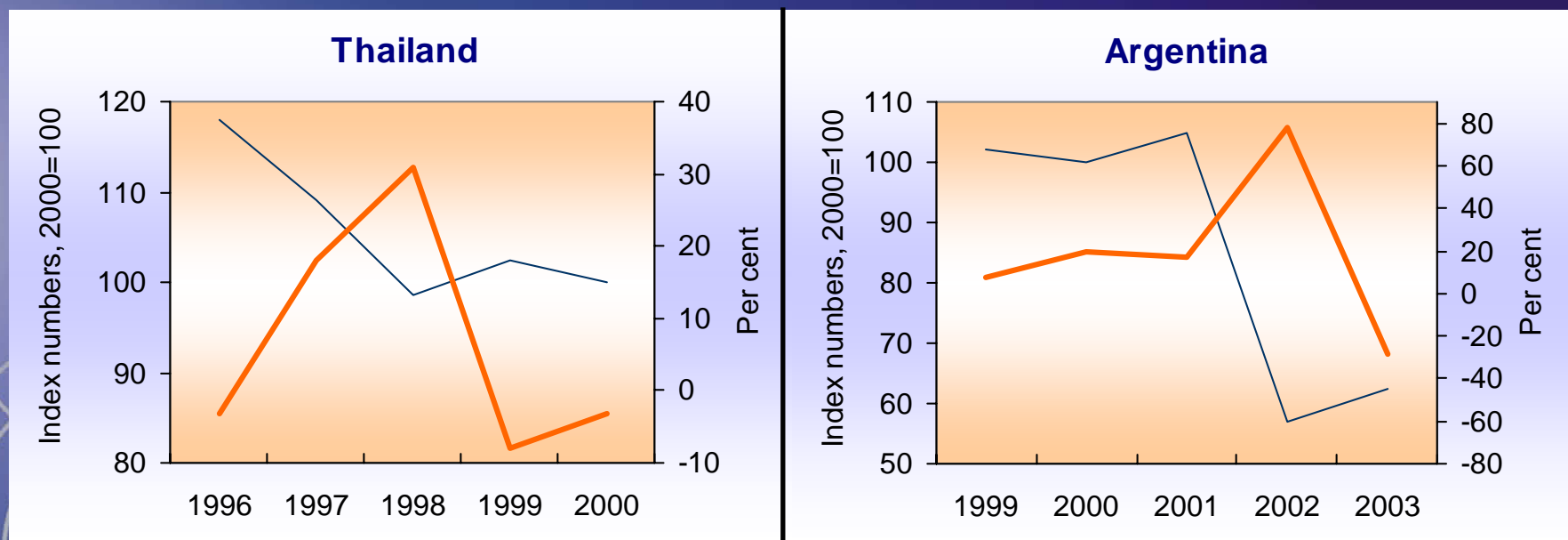
Real exchange rate and trade performance, selected years



- 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

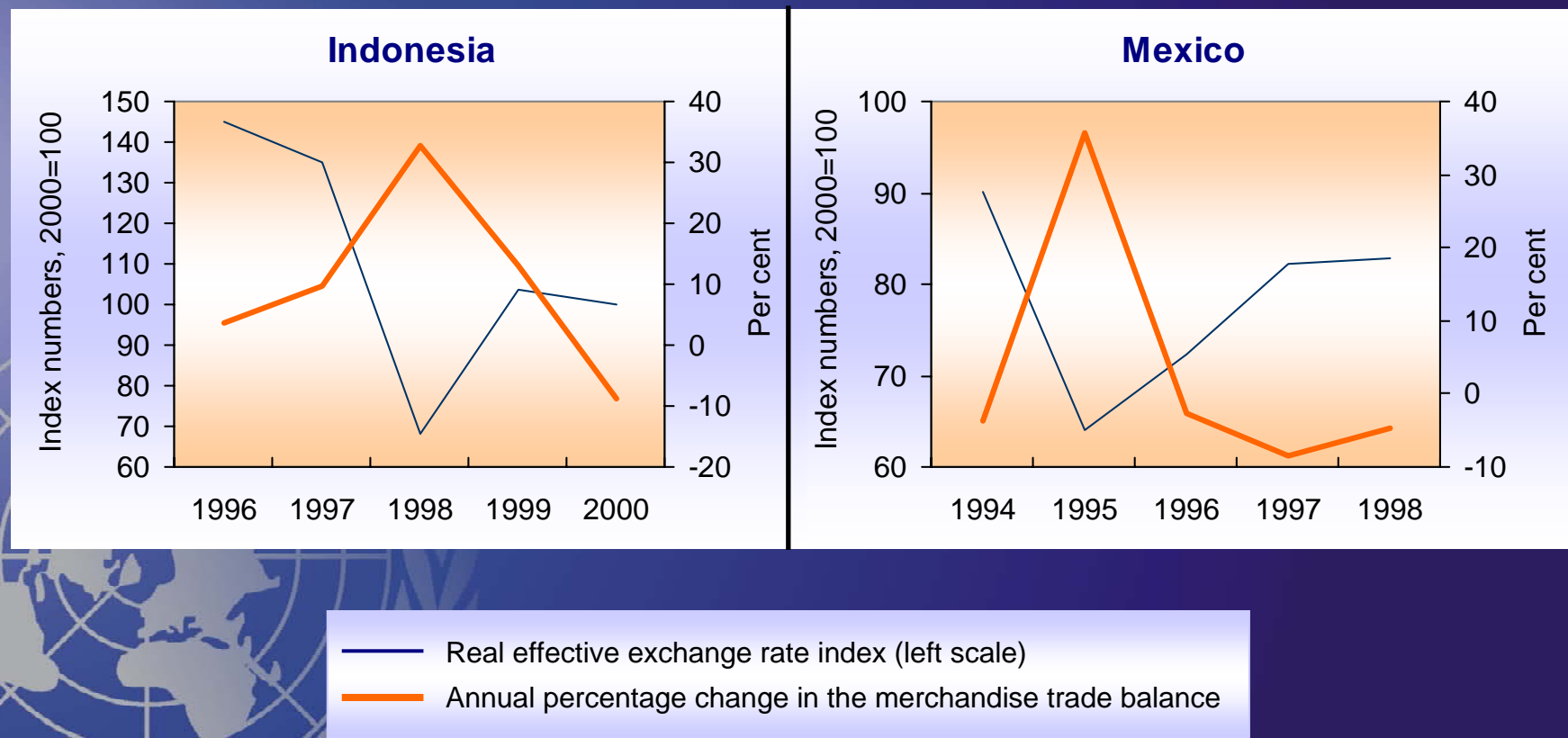
Real exchange rate and trade performance, selected years



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

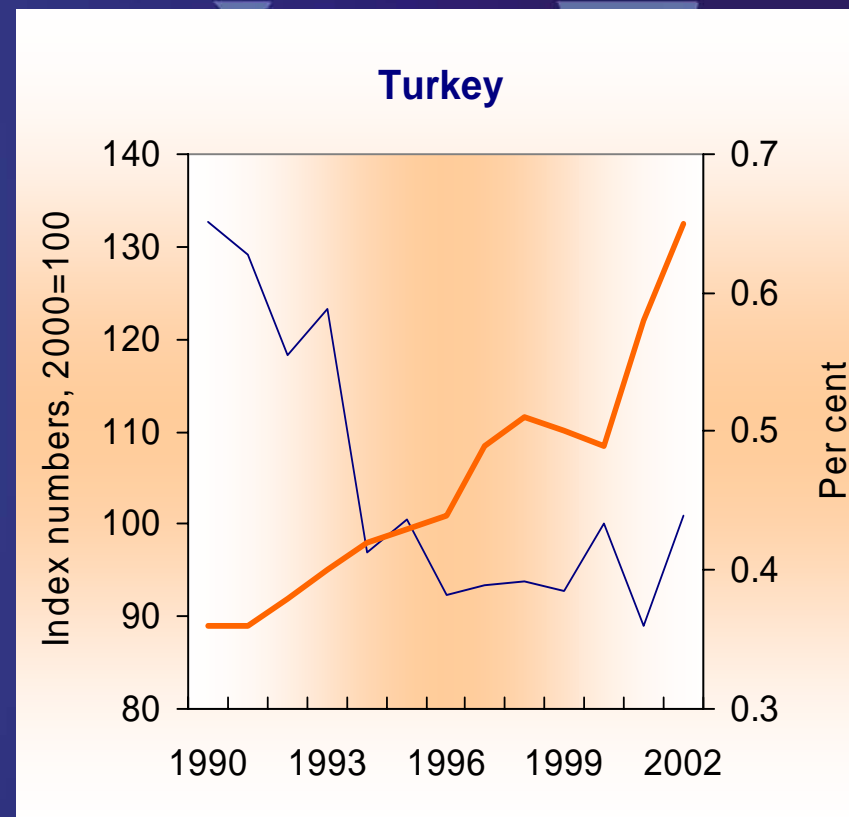
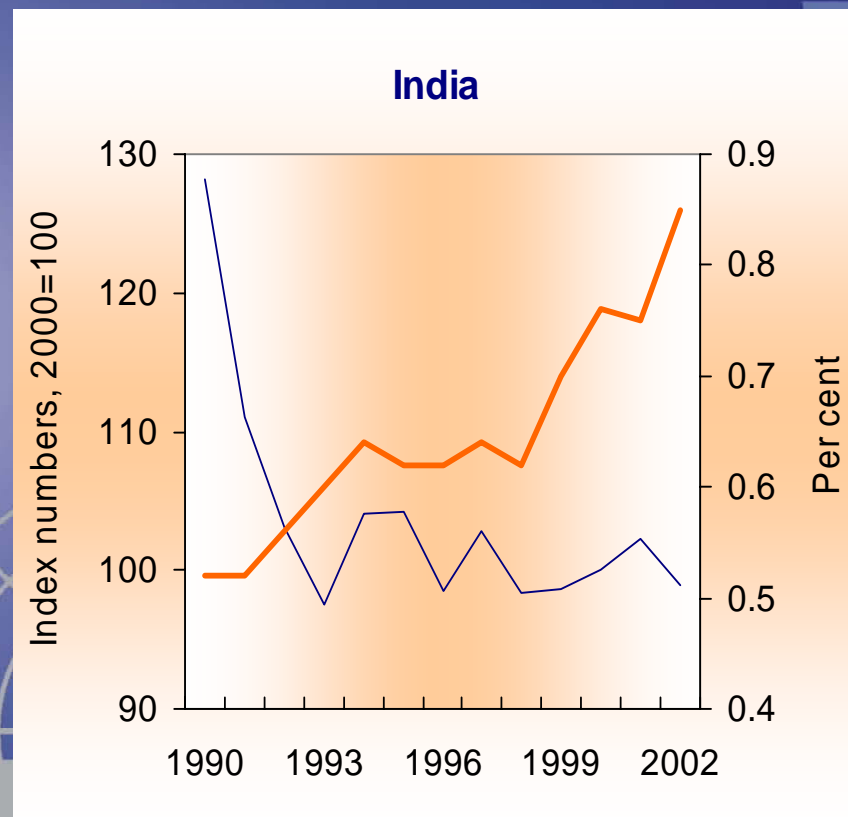
In Indonesia and Mexico, however, the initial stimulus faded as the exchange rate bounced back

Real exchange rate and trade performance, selected years



In a longer perspective some countries benefited from a low valuation of their real exchange rate

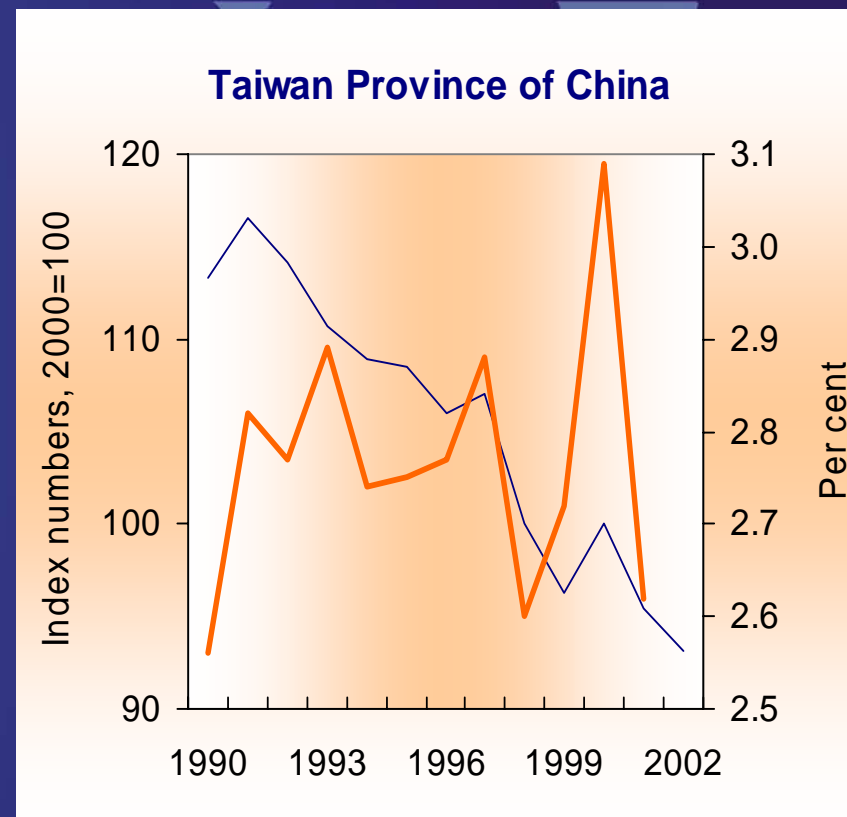
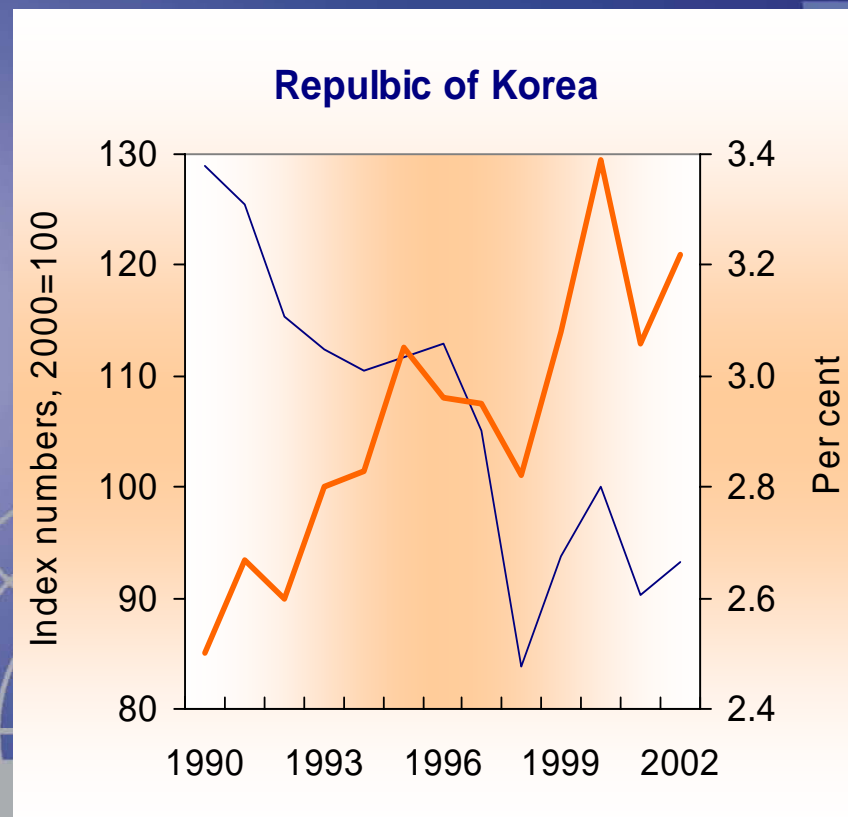
Real exchange rate and export performance, 1990 to 2002



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

While Korea showed a sustained stimulus, in Taiwan's case the effects were not sustainable

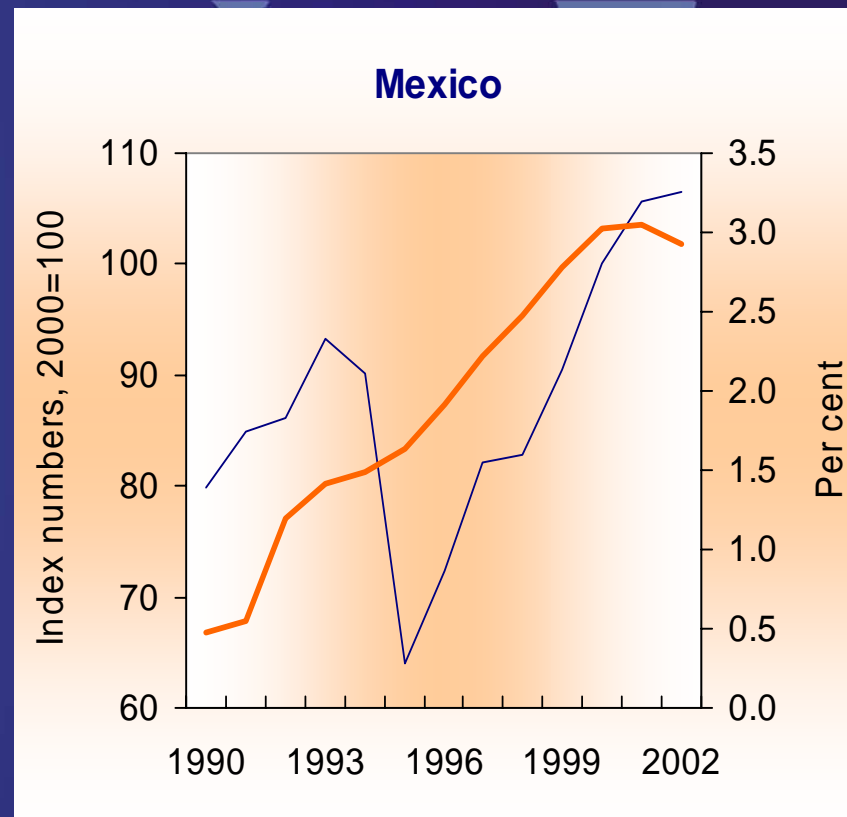
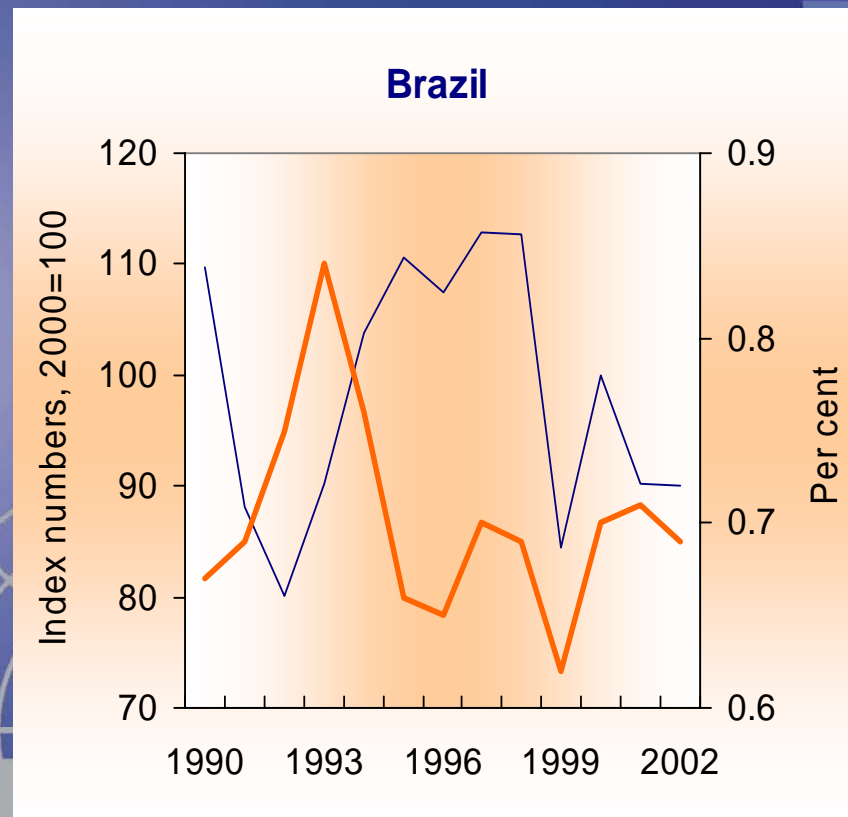
Real exchange rate and export performance, 1990 to 2002



— 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



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