

# MANAGING CAPITAL FLOWS TO EMERGING MARKETS COUNTRIES

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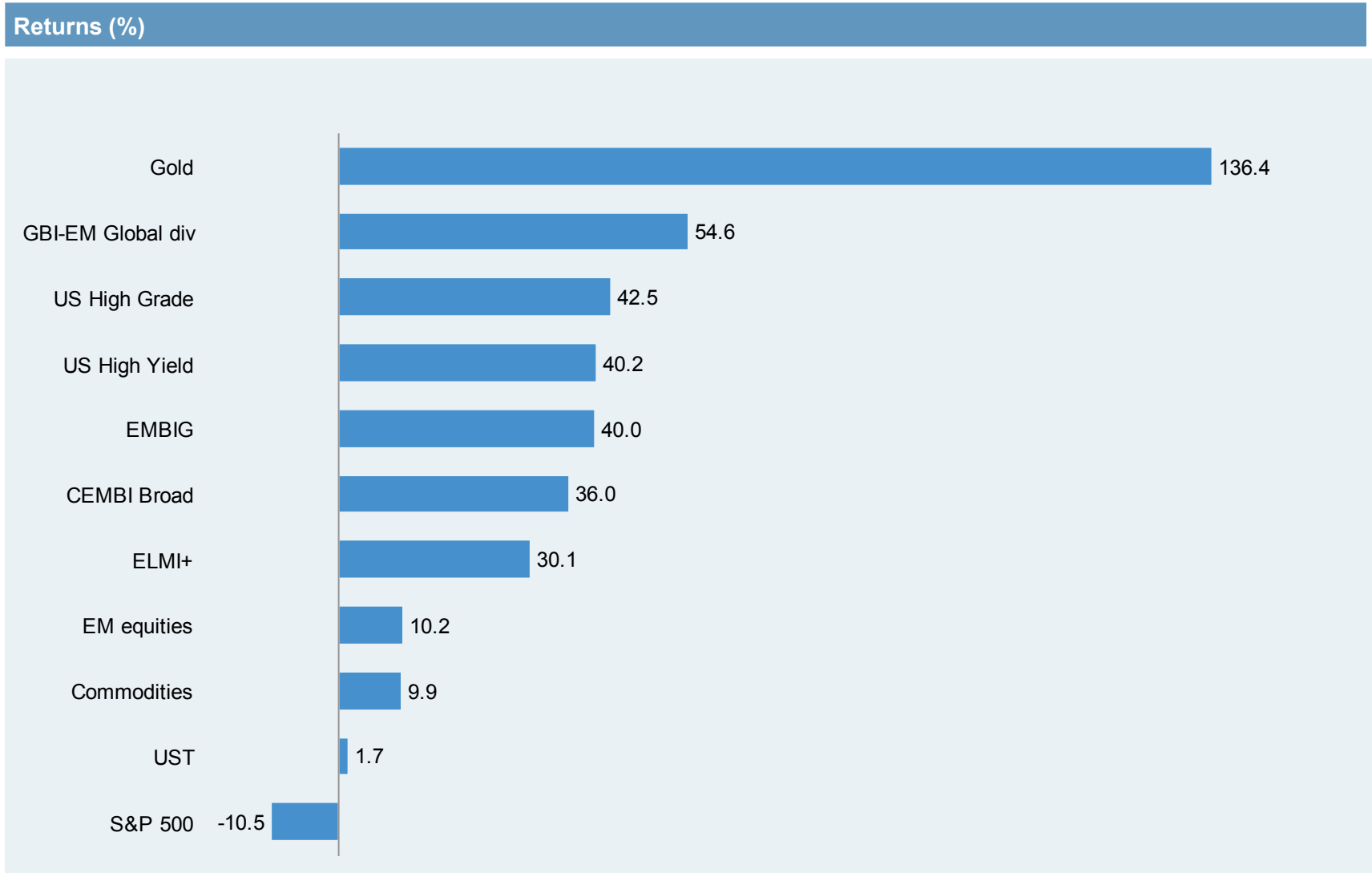
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**J.P.Morgan**

# Agenda

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EM countries have re-rated in the aftermath of the financial crisis	
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Inflows into EM will Persist	

# EM local markets have outperformed other asset classes since the onset of the global financial crisis

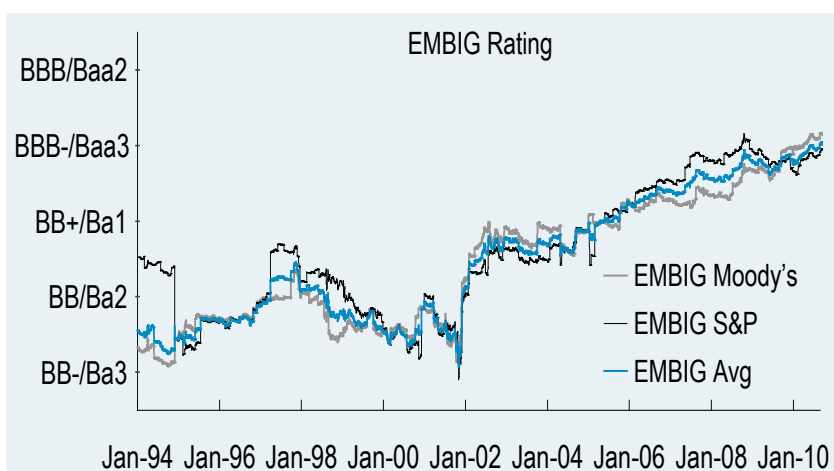


Returns as of June 29, 2007 to May 31, 2011.

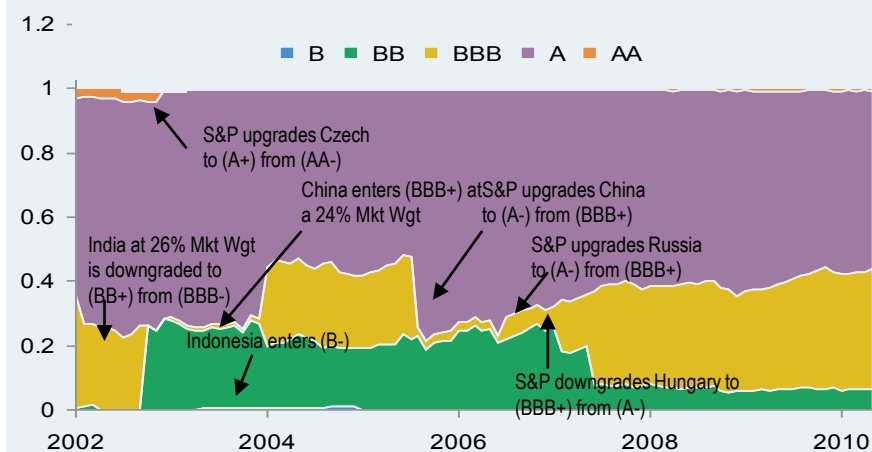
Source: J.P. Morgan

# All EM fixed income indices are now investment grade

EMBI Global average credit rating



Historical rating of GBI-EM Broad by credit buckets



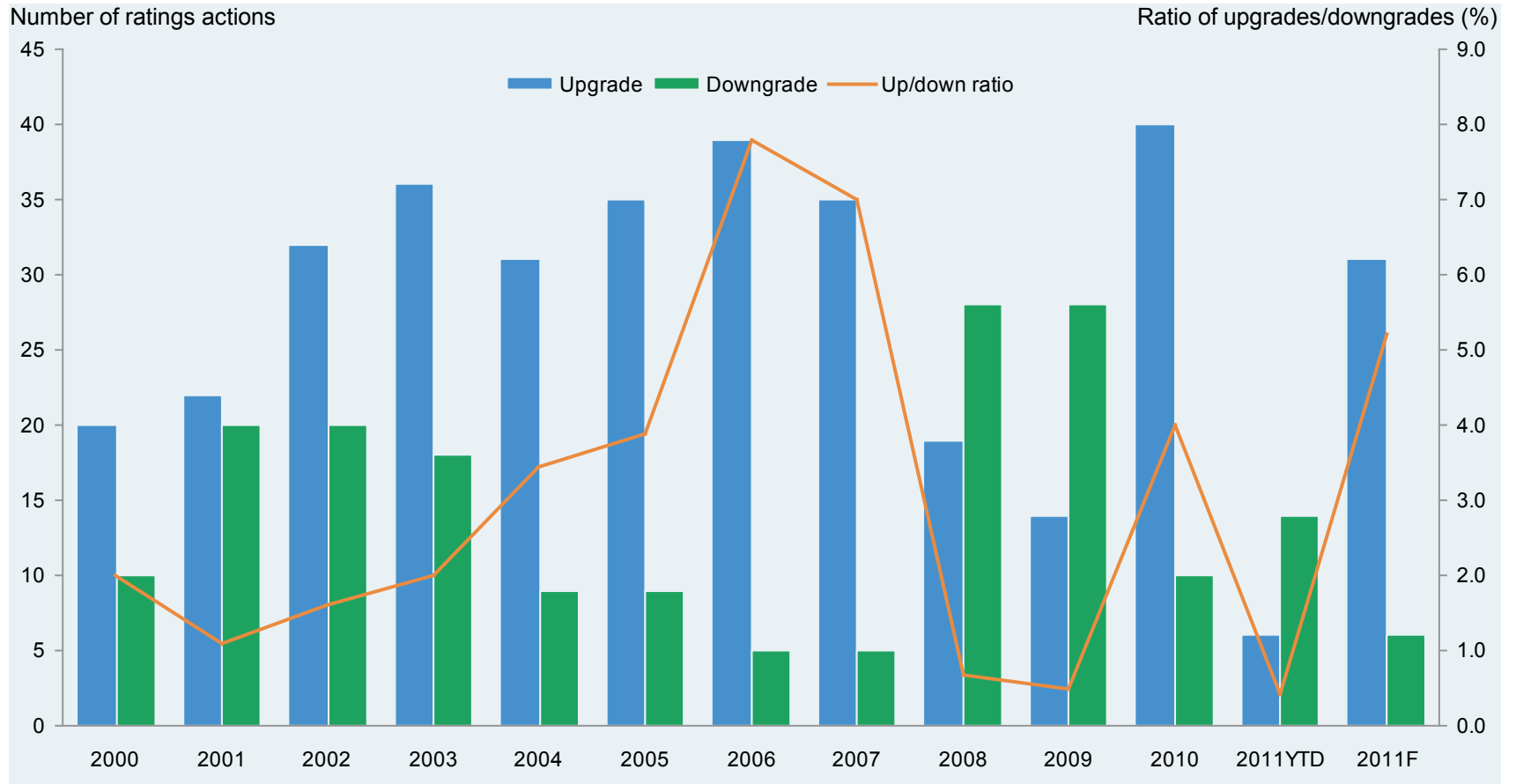
EM Corporates: Historical credit quality

	CEMBI				CEMBI broad			
	Issuers	Issues	Moody's	S&P	Issuers	Issues	Moody's	S&P
2001	10	13	A2	A-	40	58	Baa1	BBB
2002	15	19	A2	A-	51	71	Baa1	BBB
2003	21	28	A2	A-	58	87	Baa1	BBB+
2004	26	37	A3	BBB+	83	134	Baa1	BBB+
2005	46	59	Baa1	BBB+	121	217	Baa1	BBB
2006	50	64	Baa1	BBB+	143	260	Baa1	BBB+
2007	59	79	Baa1	BBB	188	351	Baa1	BBB
2008	60	85	Baa1	BBB	183	349	Baa1	BBB
2009	77	109	Baa1	BBB	193	377	Baa1	BBB
2010	97	129	Baa2	BBB	200	390	Baa1	BBB

Source: J.P. Morgan

# EM sovereign upgrades to exceed downgrades 5:1 this year

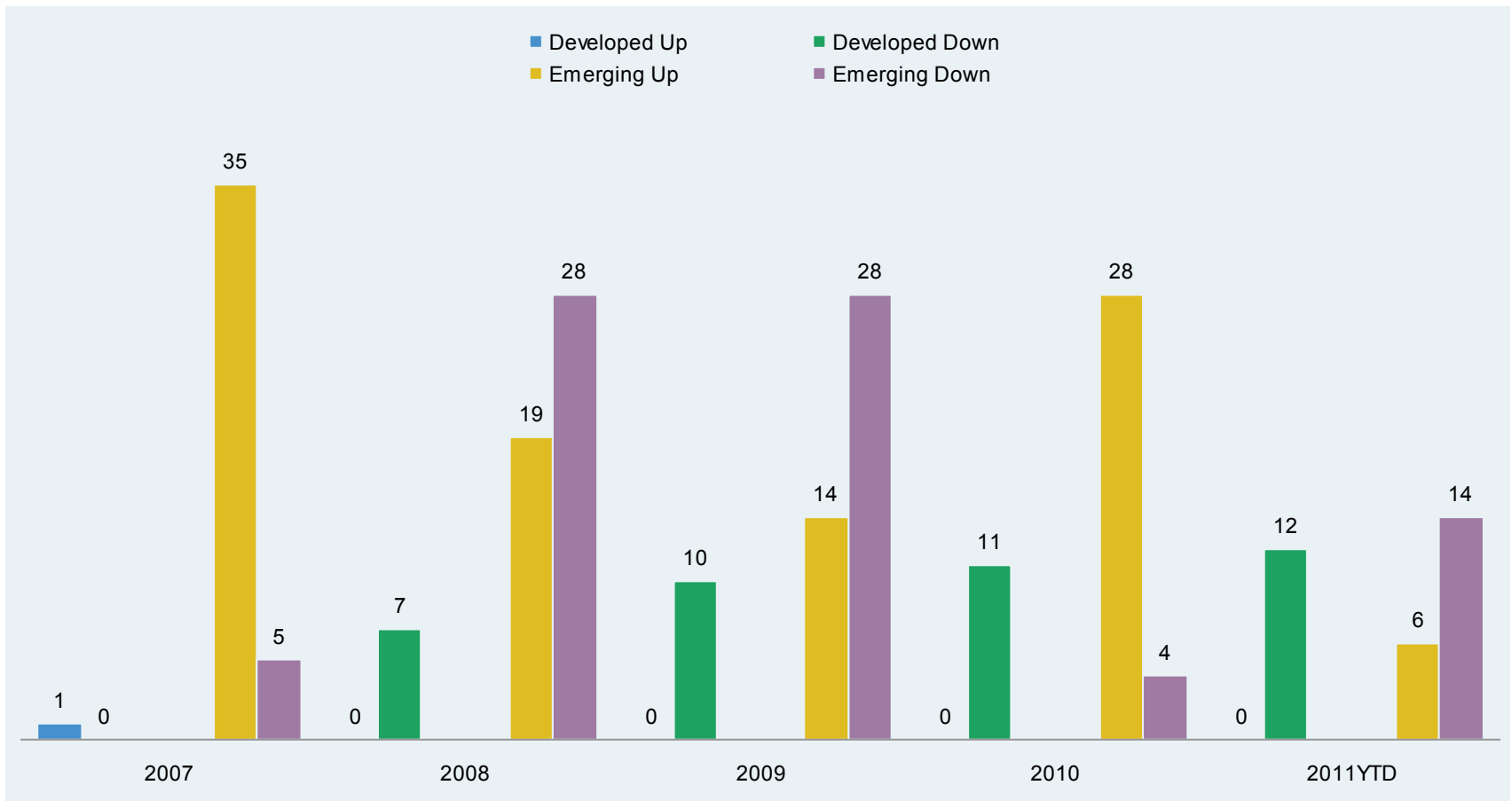
## EM ratings actions



Note: The total number of upgrades and downgrades includes both S&P and Moody's actions  
 Source: S&P, Moody's, and J.P. Morgan

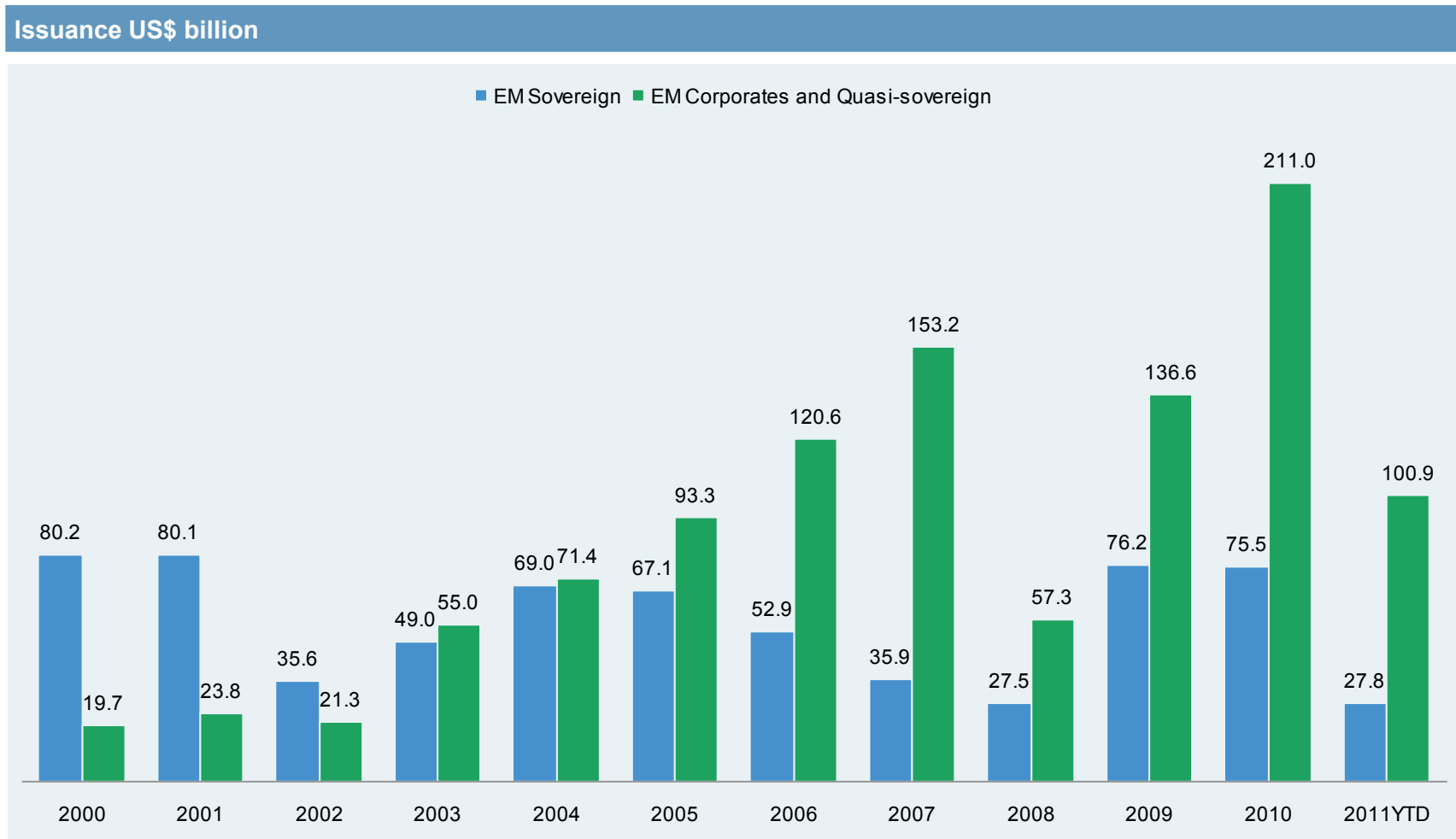
# Last DM sovereign rating upgrade occurred in 2007

## EM vs DM upgrades and downgrades



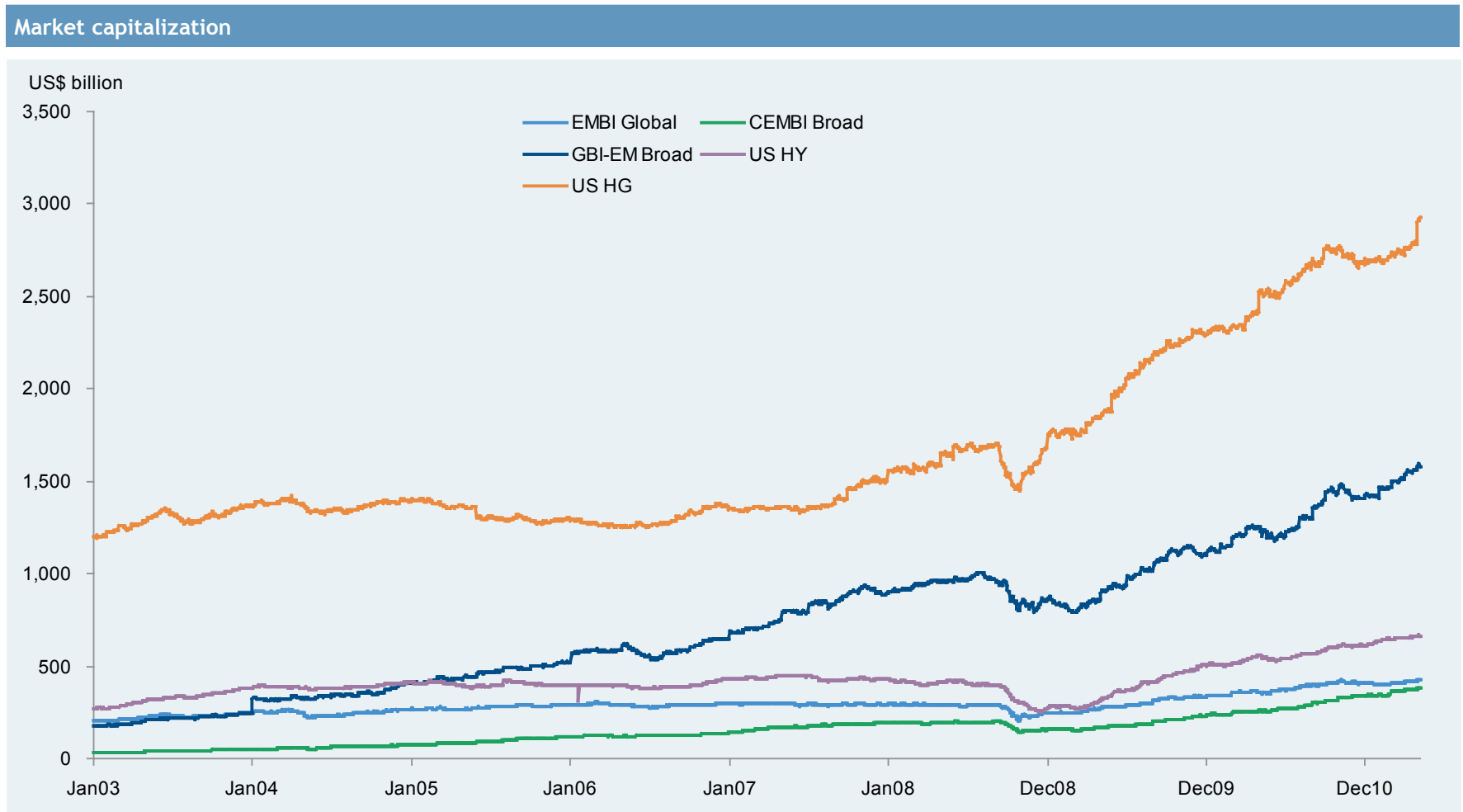
Note: The total number of upgrades and downgrades includes both S&P and Moody's actions  
 Source: S&P, Moody's, and J.P. Morgan

## EM corporate issuance has hit record levels



Source: J.P. Morgan

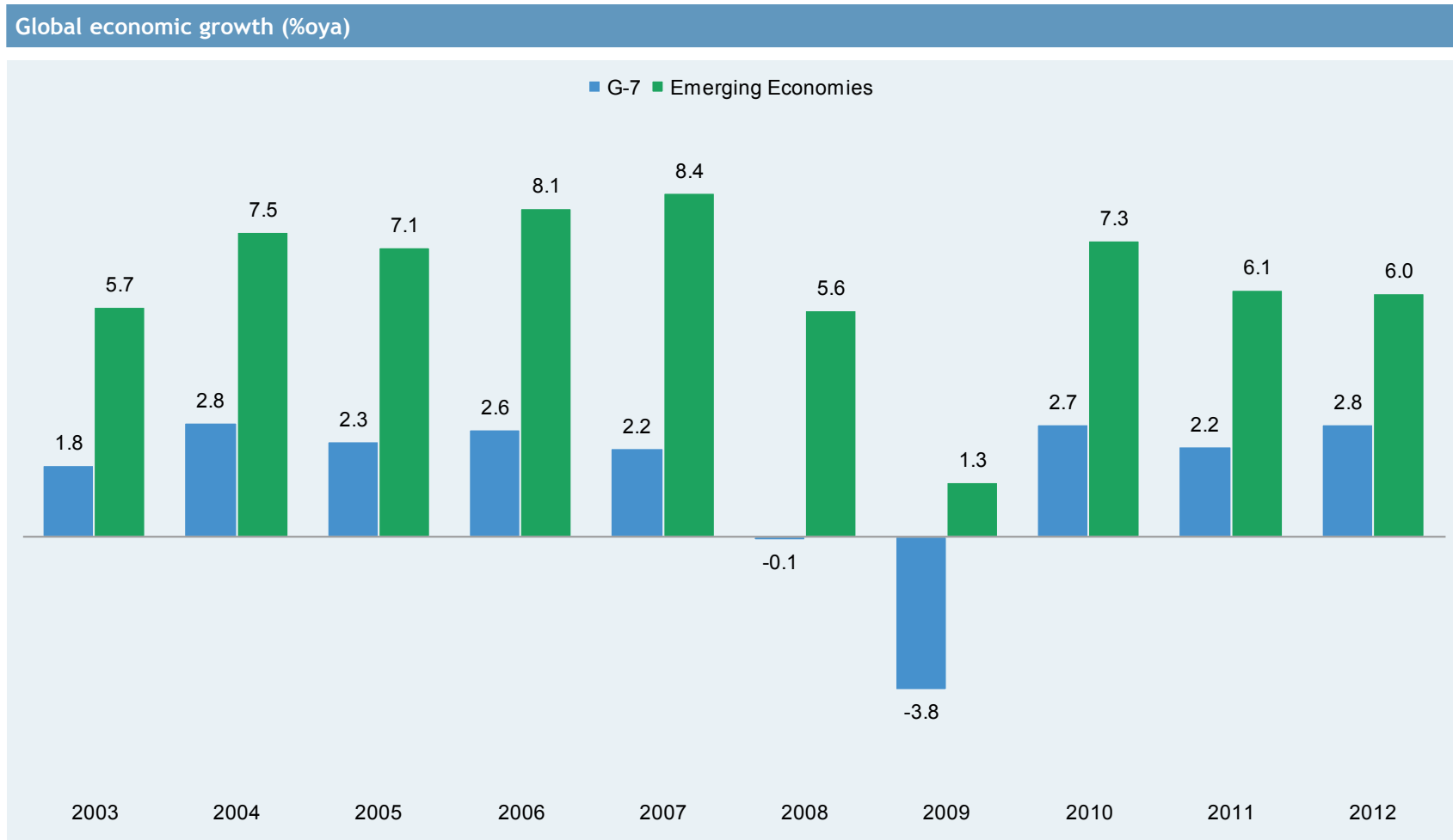
EM fixed income total market capitalization approaching US High Grade and is more than three times higher than US High Yield



Source: J.P. Morgan



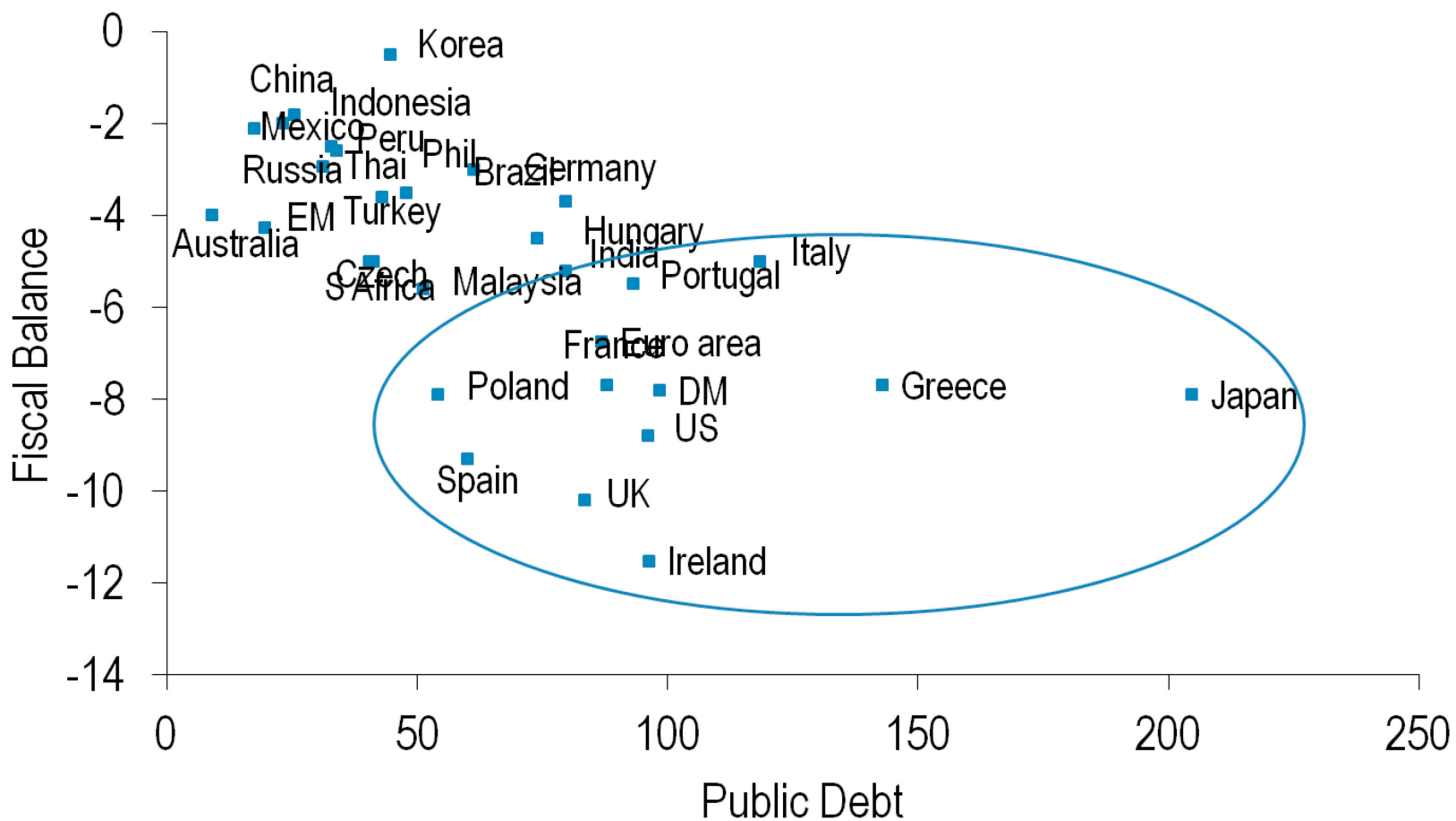
# EM and DM growth differential remains wide



Source: J.P. Morgan

# EM debt and fiscal indicators compare favorably to DM countries

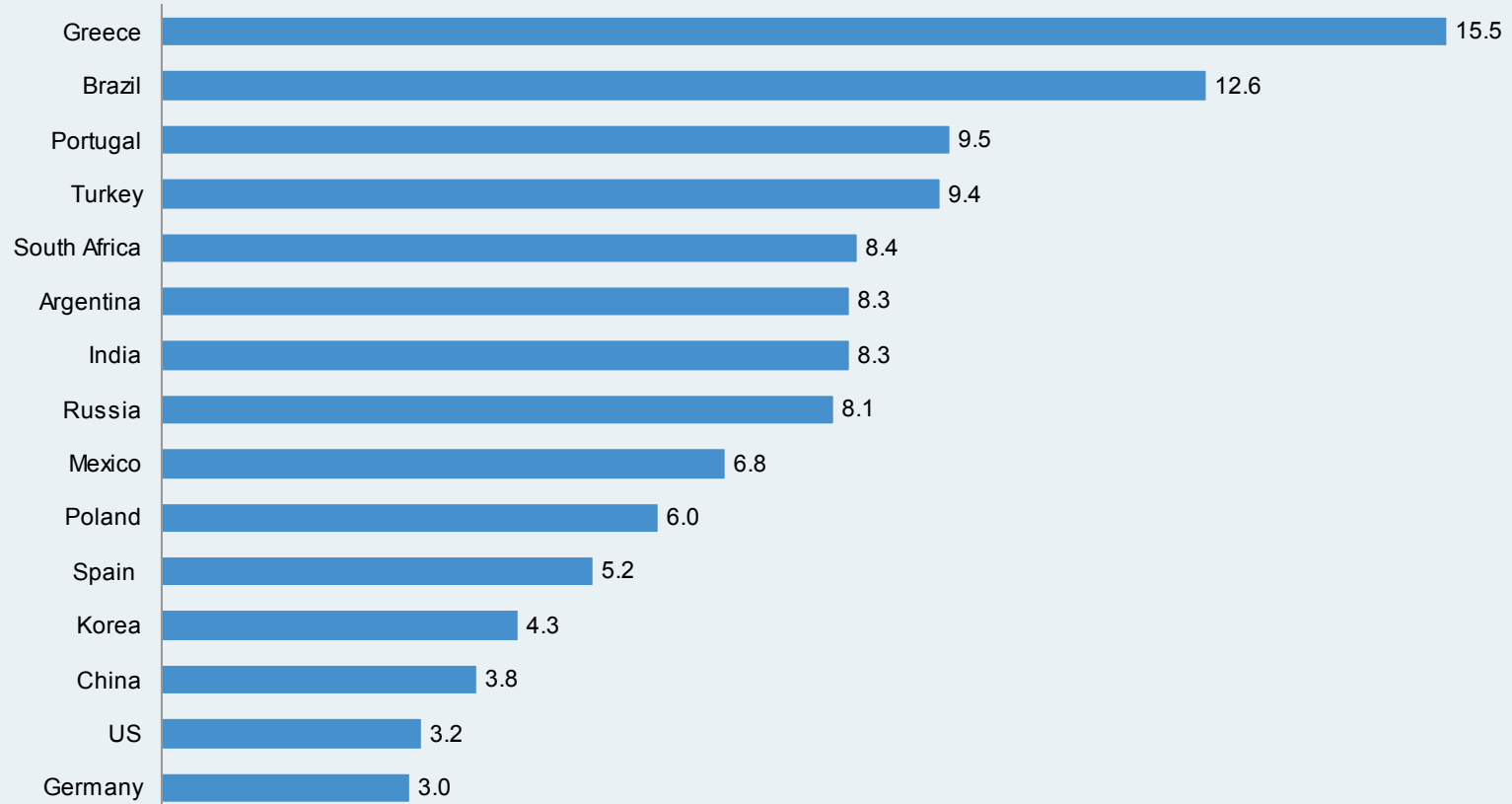
Percent of GDP



Source: J.P. Morgan

## EM interest rate differentials remain wide

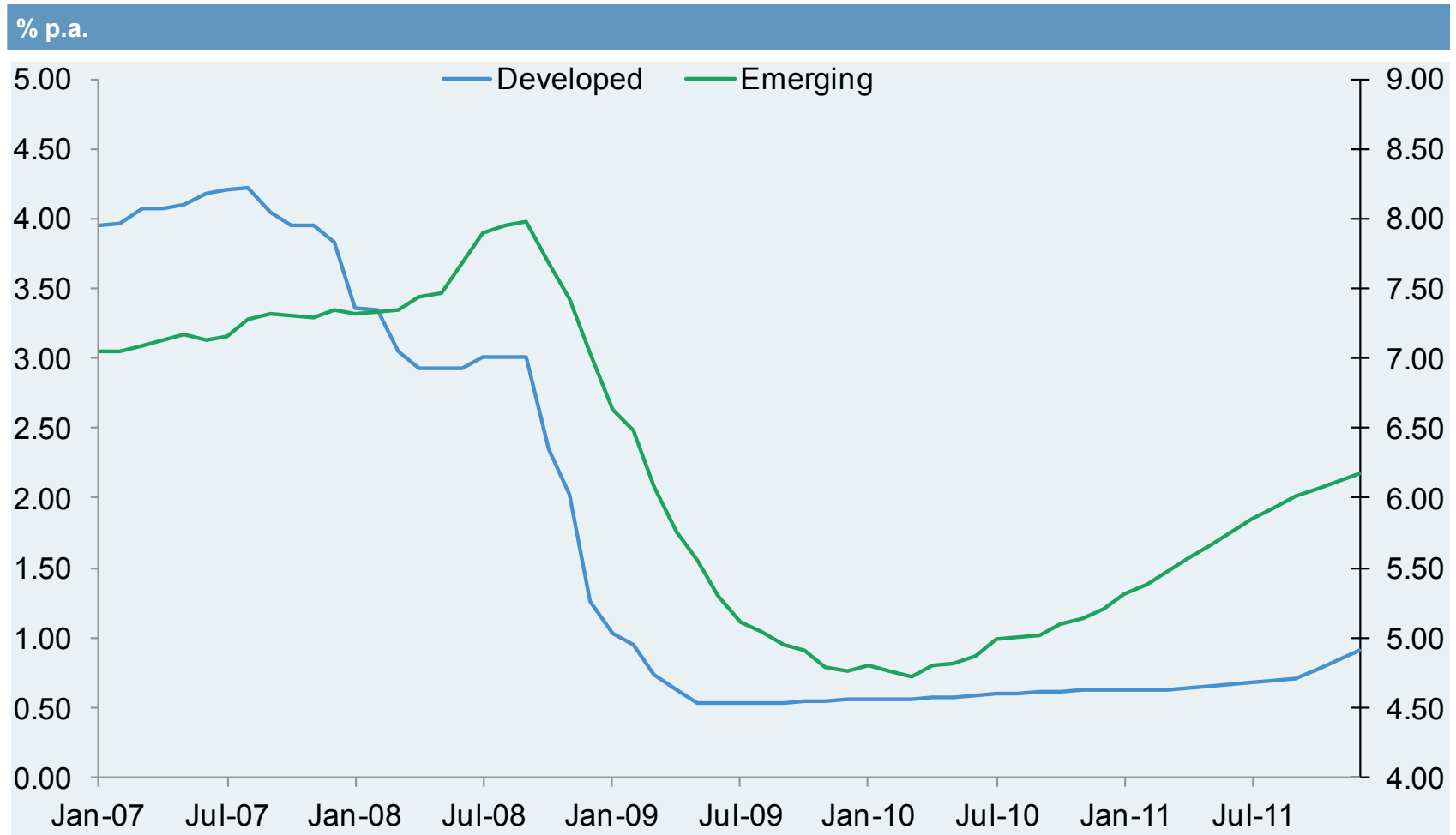
### Local bond yields\* (%)



\* For 10-year government bonds or latest tenor available.

Source: Bloomberg

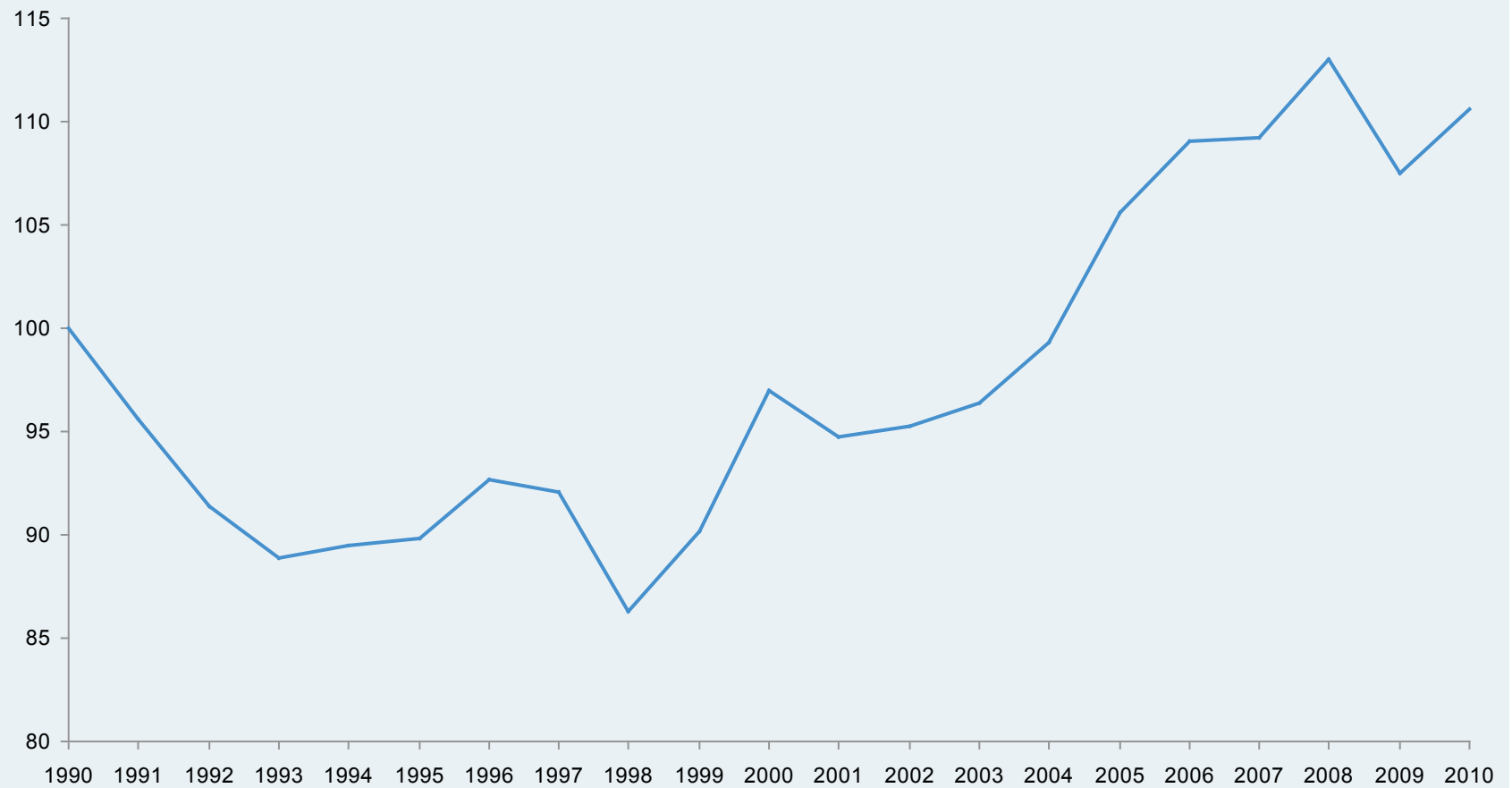
# EM policy rate differential has widened to DM policy rates since mid-2010



Source: J.P. Morgan

## EM terms of trade at 20-year highs

Terms of trade (Index level, 1990 = 100)



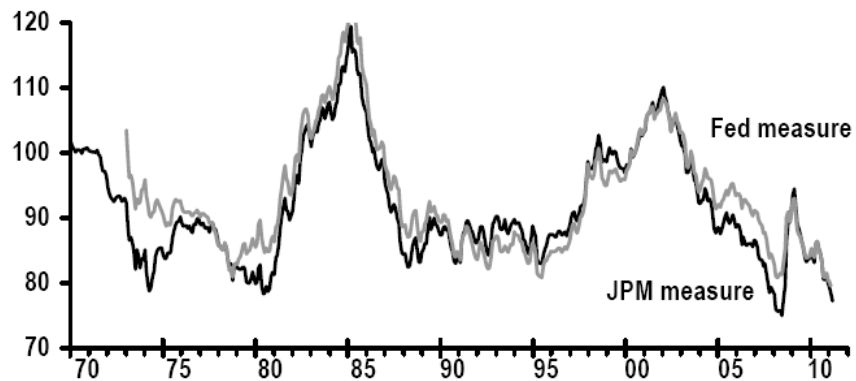
Source: IMF

# Dollar flagging against board range of currencies

## USD real effective exchange rate

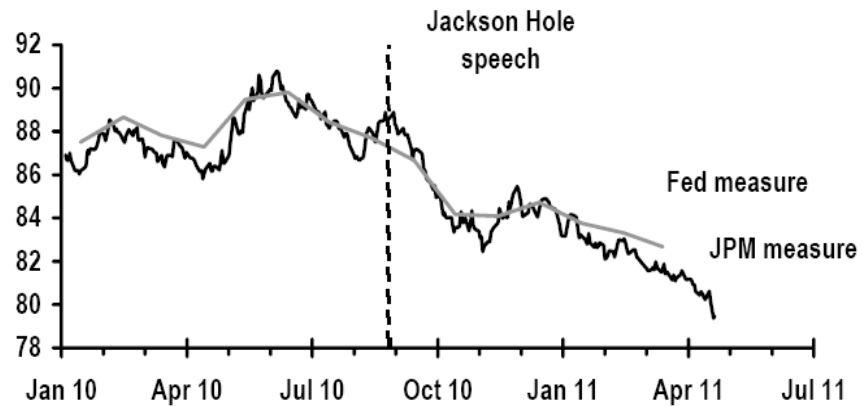
### USD real effective exchange rate

Indexes, 2000 = 100



### US real effective exchange rate

Indexes



Source: J.P. Morgan

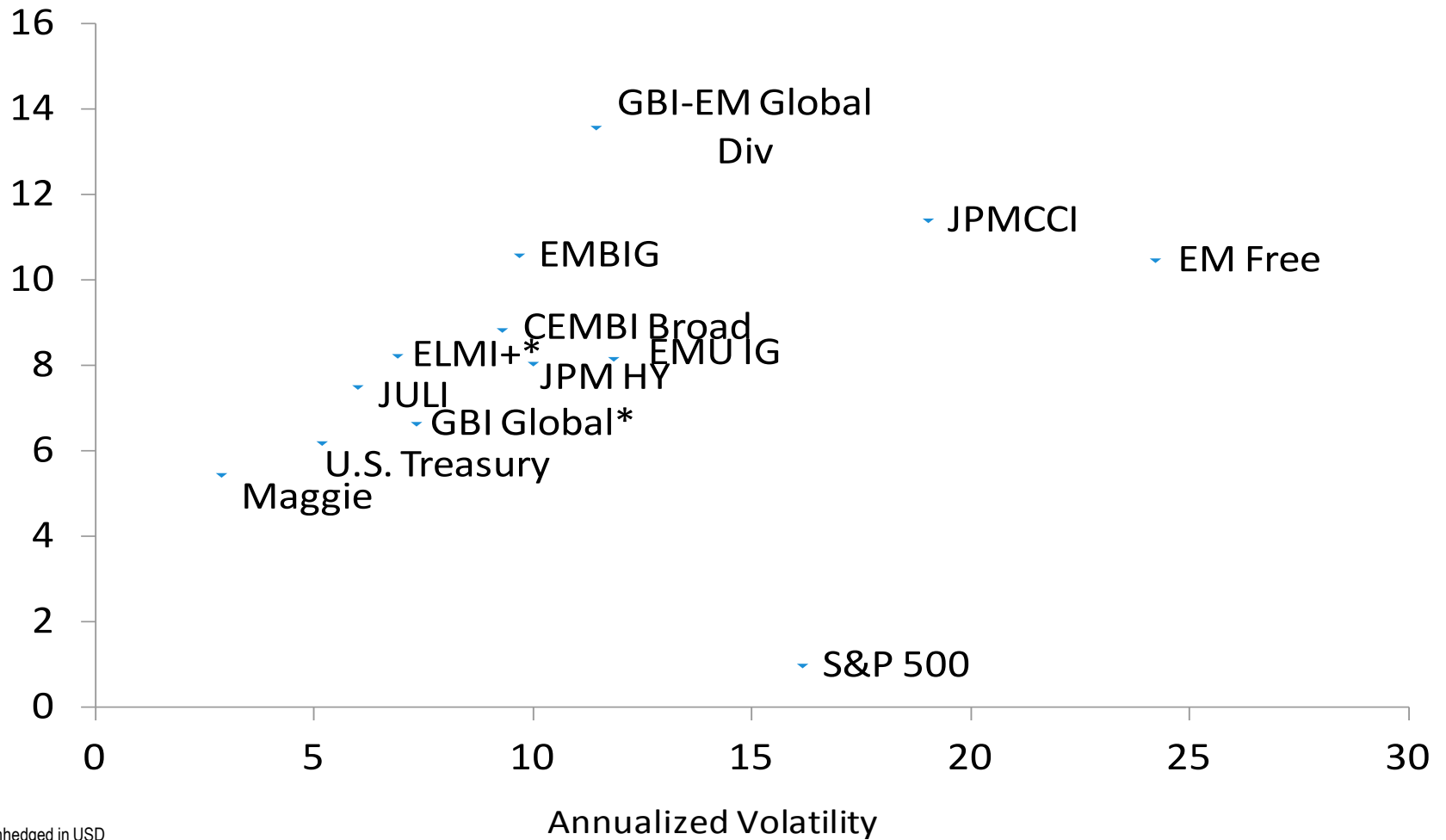
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## GBI-EM still offers the highest risk-adjusted return

### Returns

Annualized Return



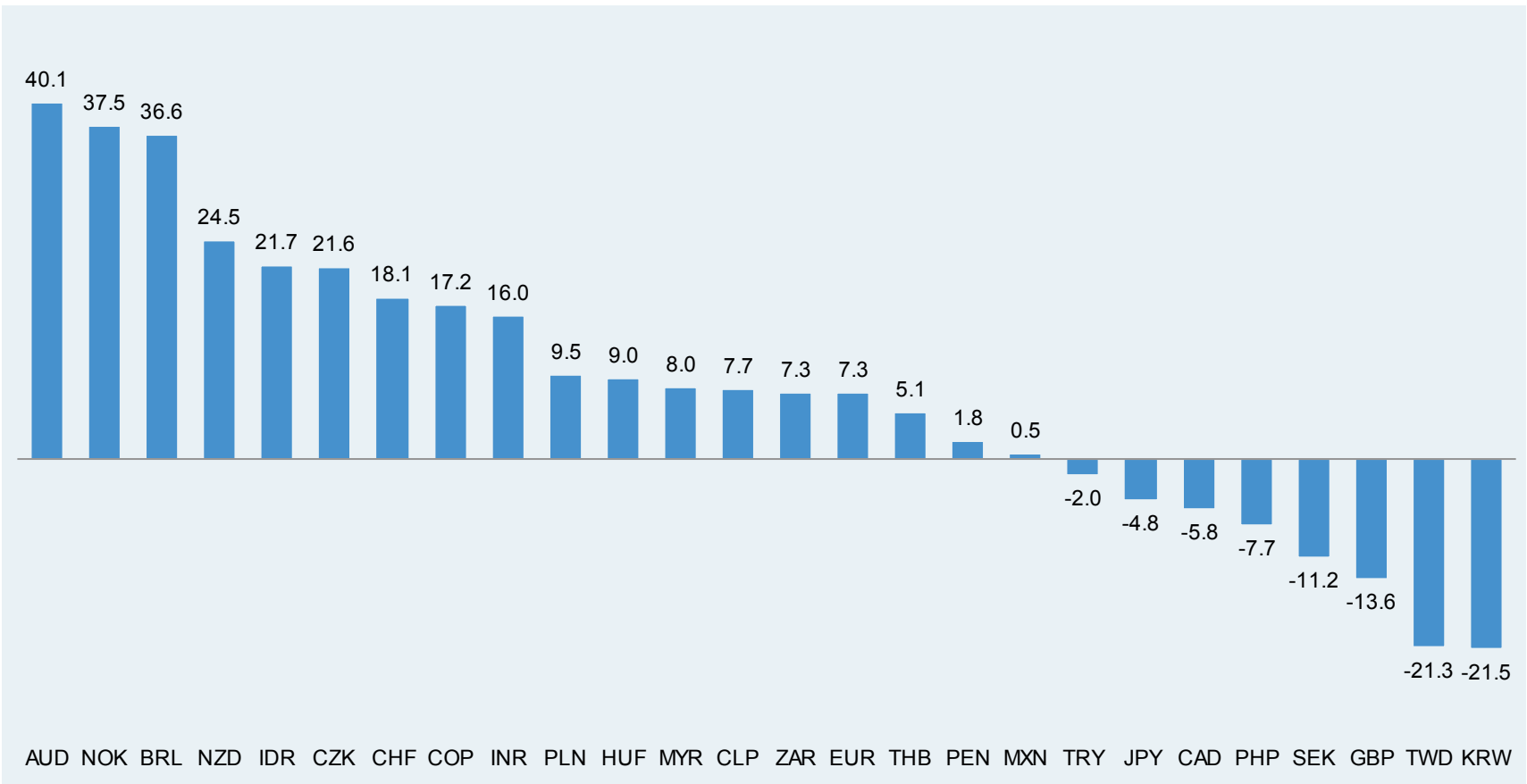
\* Unhedged in USD  
 Note: For period December 2000 to May 18, 2011  
 Source: J.P. Morgan



# Growth, commodity prices and rate differentials have put pressure on EM policymakers to contain FX appreciation

GLOBAL DIVERSIFICATION STILL AT A NASCENT STARTING POINT: INFLOWS UNLIKELY TO ABATE

REER: Current versus 30-year average (except CEE3 12-year average and Peru since Jan 91)



Source: Bloomberg, J.P. Morgan

## Global FX reserves on pace to top \$11 trillion in 2011

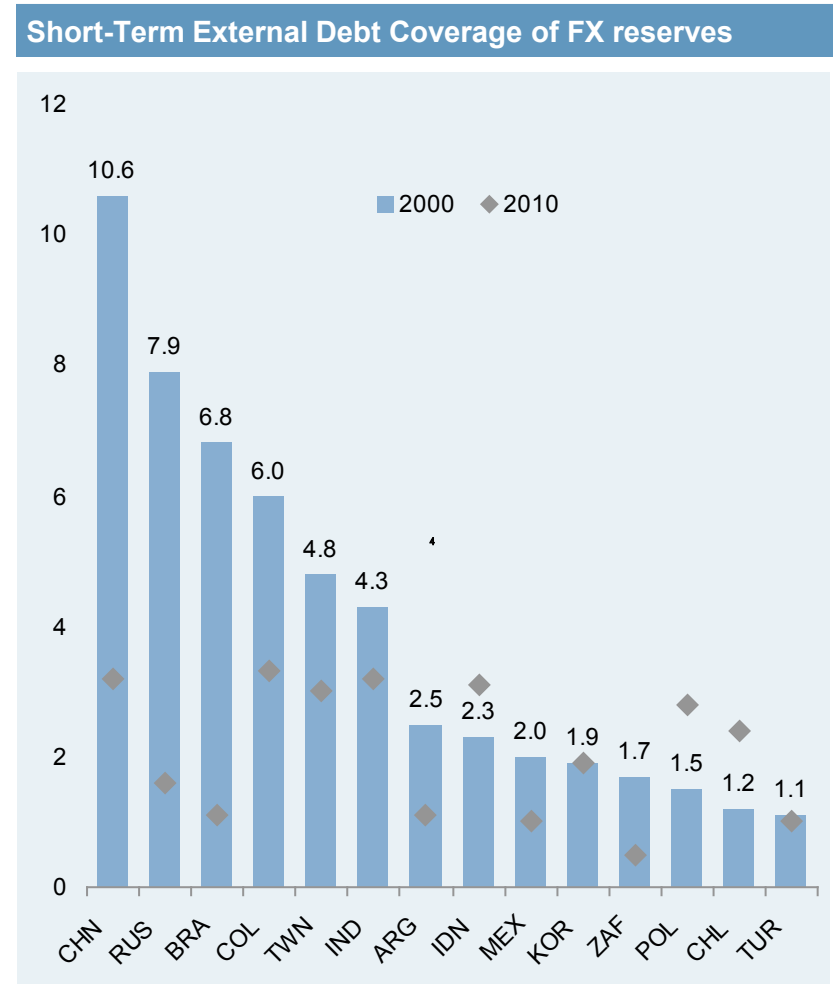
## FX reserve

	Change, US\$ bn					US\$ bn
	Jun07 to Sep08	Sep08 to Jan09	Jan09 to Dec09	Dec09 to Dec10	Dec10 to Feb11	Feb 11
Global	1,531	-419	1,075	1,094	262	9,611
Developed	69	-31	131	209	14	1,986
Emerging	1,462	-388	944	885	248	7,624
EM Asia	760	-59	773	660	172	4,942
China	573	8	486	448	132	2,979
Middle East	219	-7	4	70	15	701
EM Europe	219	-243	94	61	33	896
Latin America	133	-45	53	84	25	632
	Percent change, % (annual rate)					Share, %
Global	19.7	-15.7	16.4	13.3	18.0	100
Developed	3.4	-5.5	8.8	11.9	4.4	21
Emerging	25.4	-18.3	18.7	13.6	21.9	79
EM Asia	22.5	-5.1	25.5	16.1	23.7	51
China	33.1	1.2	28.0	18.7	31.1	31
Middle East	41.8	-3.3	0.8	11.3	13.7	7
EM Europe	23.3	-58.8	14.6	7.7	25.2	9
Latin America	27.0	-23.8	12.4	16.1	27.7	7

Source: J.P. Morgan

# Reserve accumulation well beyond precautionary measures - Points to FX manipulation

GLOBAL DIVERSIFICATION STILL AT A NASCENT STARTING POINT: INFLOWS UNLIKELY TO ABATE



..but EM FX still undervalued despite real appreciation according to IMF estimates

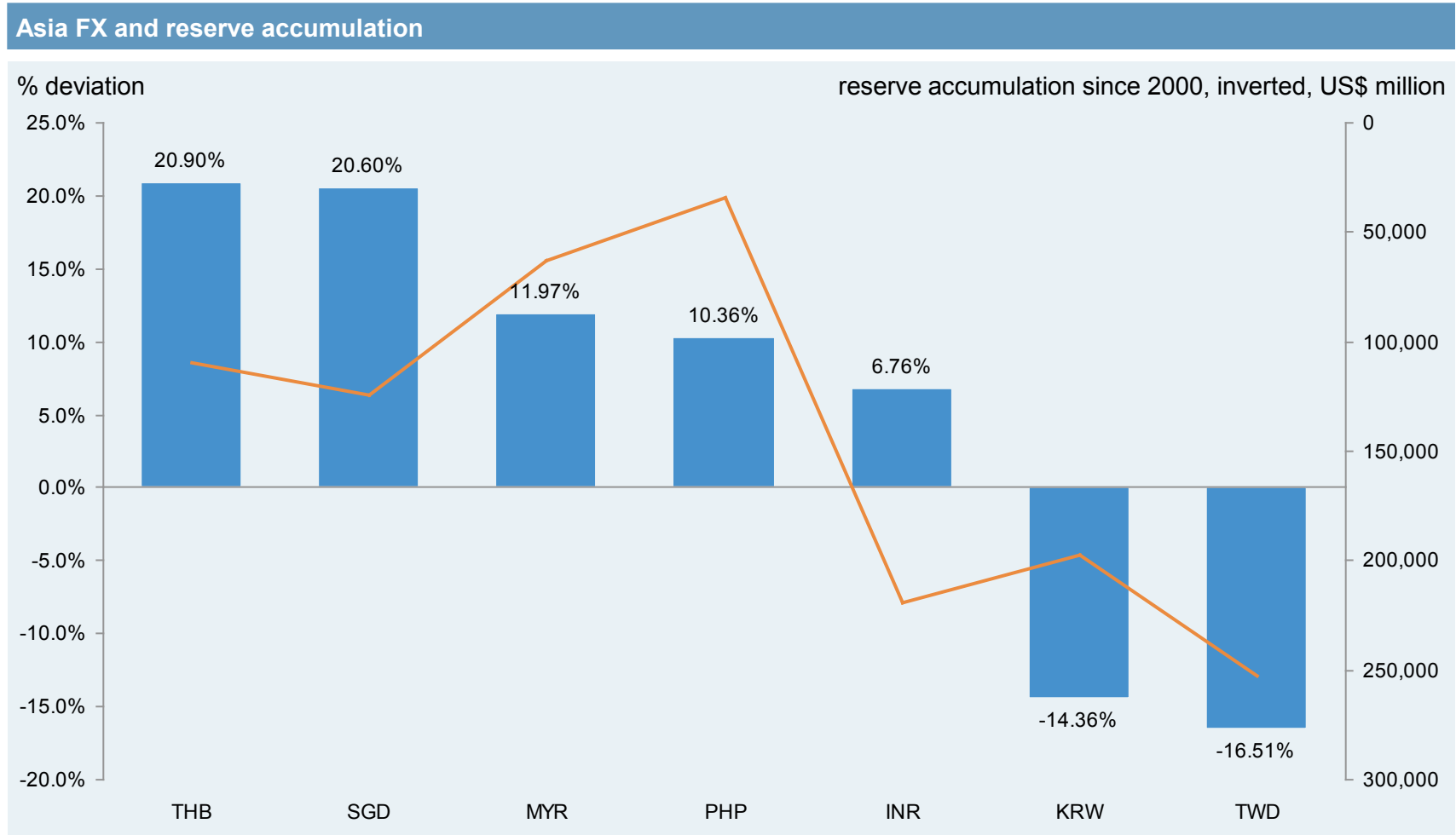
### IMF Purchasing Power Parity Estimates

	IMF PPP	Market	Valuation to IMF PPP	Relative to EM Avg
Argentina	2.35	3.96	-40.6%	-9.0%
Brazil	1.65	1.70	-1.5%	30.0%
Chile	408.75	489.00	-14.8%	16.7%
Colombia	1227	1840	-32.5%	-1.0%
Mexico	8.31	12.34	-33.6%	-2.0%
Peru	1.57	2.79	-43.8%	-12.2%
Uruguay	17.14	19.95	-15.4%	16.2%
Czech	14.49	17.61	-18.6%	13.0%
Egypt	2.41	5.78	-58.1%	-26.5%
Hungary	143	195	-28.9%	2.7%
Israel	3.78	3.65	4.9%	36.5%
Poland	1.95	2.85	-32.1%	-0.5%
Romania	2.03	3.08	-34.8%	-3.2%
Russia	20.29	30.80	-33.7%	-2.1%
South Africa	5.10	6.98	-26.8%	4.8%
Turkey	1.160	1.426	-18.9%	12.7%
China	3.86	6.69	-41.9%	-10.3%
India	18	44.48	-60.1%	-28.5%
Indonesia	6143	8928	-31.2%	0.4%
Korea	792	1116	-29.9%	1.7%
Malaysia	1.81	3.10	-41.9%	-10.4%
Philippines	24.48	42.92	-45.7%	-14.1%
Singapore	1.03	1.29	-21.6%	10.0%
Taiwan	16.83	30.48	-45.4%	-13.8%
Thailand	17.16	29.88	-42.7%	-11.1%

Source: IMF

# Central bank intervention has depressed valuations in EM Asia FX

GLOBAL DIVERSIFICATION STILL AT A NASCENT STARTING POINT: INFLOWS UNLIKELY TO ABATE

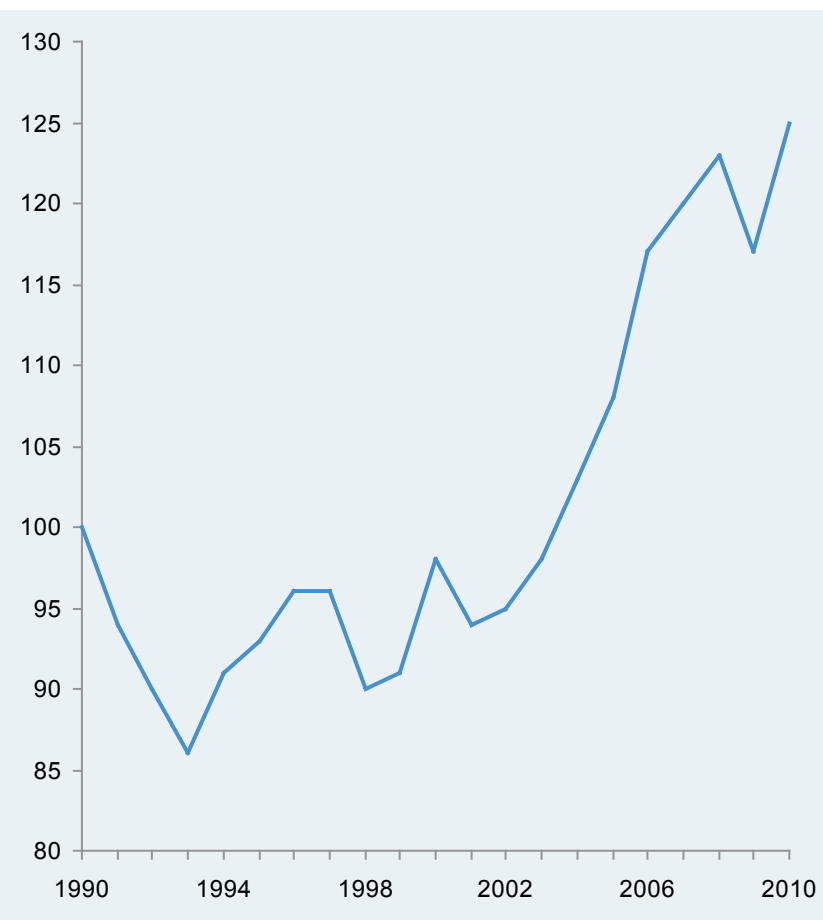


Source: J.P. Morgan

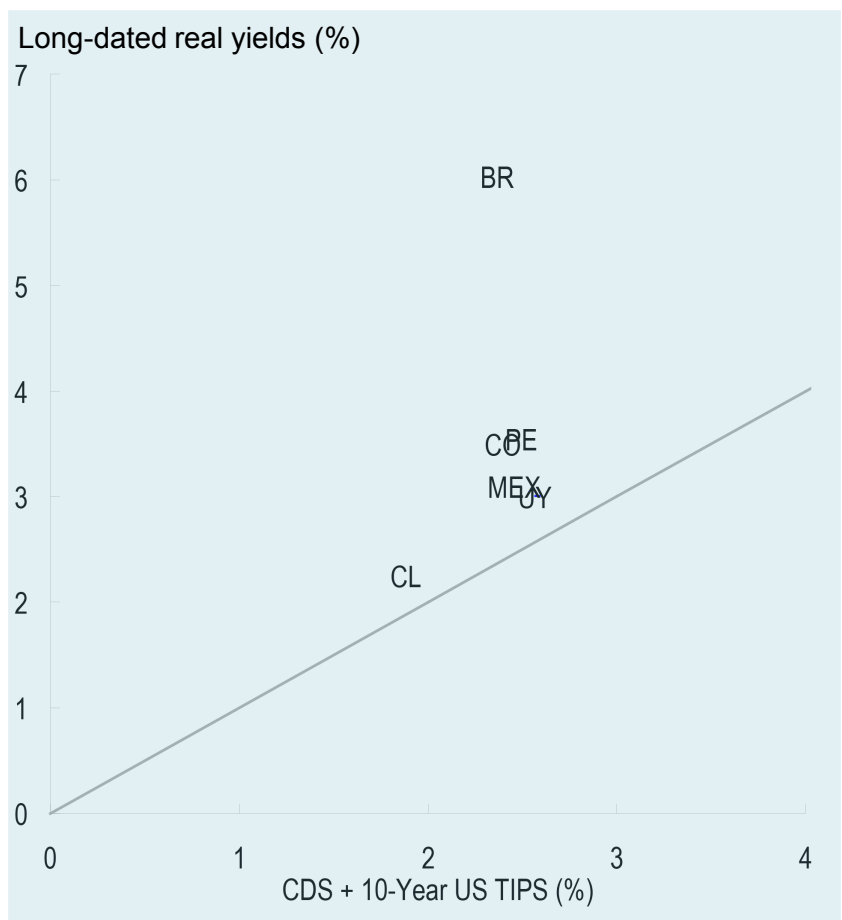
# Wide real interest rate differentials and tight output gaps may keep REERs in Latin America overvalued over the next few years

GLOBAL DIVERSIFICATION STILL AT A NASCENT STARTING POINT: INFLOWS UNLIKELY TO ABATE

Latin America terms of trade at 20-year highs



Latin America versus US real interest rate differentials



## Macroprudential Controls have become a Consensus Part of the Policy Tool Box

State of Play					
	FX Regime	Recent Measures	Possible Future Measures	Reserve Accumulation 2010 (US\$ Bn)	2010 % Change in Reserves
China	Closed Capital Account. Bond Investment only possible through QFI, but discouraged by authorities	None	None	448	19%
India	Strict Limits on size of foreign bond investment. Limit of \$5bn on government bonds and \$15 bn on corporates	In September, SEBI accounted the increases in the FII Limits to \$10bn for government bonds and \$20 bn for corporates	Potential for currency intervention, but we expect no action against bonds.	9	4%
Indonesia	Interest and income tax at 20%, but majority of investors use tax treaties to reduce these taxes between 0-10%	1-month minimum holding period for foreigners investing in SBIs. SBI auctions now scrapped up to 6M tenor	Further restrictions on SBIs; Tax increases are unlikely as it needs parliamentary approval	30	46%
Korea	Withholding tax was made exempt on MSB and KTB since May 2009	In October, caps on banks' FX forward positions. In January, re-imposed WHT on MSBs and KTBs.	Potential tightening of banks' fx forward position limit, but unlikely in the near-term.	22	8%
Malaysia	No taxes	None	None	10	10%
Philippines	Income tax of 20% on interest income and capital gains.	In November, administrative measures to facilitate FX buying was introduced	Potential measures to cap bank NOP and NDF positions	18	41%
Singapore	Open capital account. No taxes.	None	None	37	20%
Sri Lanka	Strict Limits on size of foreign investment in T-bonds and T-bills at 10% of total outstanding. Investment in corporate bonds is not permitted.	None	Easing of capital controls.	34	16%
Taiwan	Time deposits are not allowed for foreigners. FINI account required for foreign investment, frequent inspections of custodian banks	Verbally discourage fixed income investment by FINI accounts, propose mandatory use of USD for foreigners equity margin accounts.	None	34	10%
Thailand	Foreigners exempt from WH tax for government bonds	15% WHT was reintroduced two weeks ago to equalize with current tax regime for domestic holders.	Potential introduction of across the board tax on all fixed income inflows with potential restrictions on minimum holding period.	32	24%
Argentina	Non Convertible and capital outflow controls remain in place with a minimum holding period of 1year and US\$2mm outflow per month	None	None	3.2	7%
Brazil	Non Convertible. Tax of 6% on foreign fixed-income investment and 2% on equity investment. Increase margin for derivative transactions	Increase IOF Tax on fixed income investment to 4% on Oct 4th, to 6% on Oct 18 and recent increase in reserve requirements to 60% on bank short USD position on Jan 6	Risks remain high for further interventions and possible new tax measures	50	21%
Chile	Non Convertible. No capital controls	US\$12 billion reserve accumulation program for 2011 announced Jan 3, US\$50 million per day intervention.	None	2.5	10%

# Macroprudential Controls have become a Consensus Part of the Policy Tool Box (continued)

GLOBAL DIVERSIFICATION STILL AT A NASCENT STARTING POINT: INFLOWS UNLIKELY TO ABATE

State of Play					
	FX Regime	Recent Measures	Possible Future Measures	Reserve Accumulation 2010 (US\$ Bn)	2010 % Change in Reserves
Colombia	Non Convertible. 34% tax on income and capital gains and 6% WHT on coupon payments for bonds with maturities up to 5 years and 4% for longer bonds.	USD purchases of \$20mm day and complementary actions (such as postponing the USD inflows from the official sector)	Risks remain high for further interventions both in spot fx and potentially increases in Reserve Requirements for foreign investors.	3	12%
Mexico	Free floating and deliverable. No FX controls. Banxico sells \$600mm of USDMXN puts per month.	None	Increase in the size of USD/MXN put option auctions per month or outright spot USD purchases possible if MXN rallies below 11.5	22.8	25%
Peru	Non Convertible. Reserve Requirements on foreign deposits (120%), 30% tax on interest paid to non-residents. Limits on pension fund short USD positions	USD purchases in the spot market and increase in reserve requirements on inflows from abroad	FX intervention should remain high. Although tax measures are unlikely, this possibility is still in the cards	11	33%
Czech	Free floating and convertible.	None	None	1.1	3%
Hungary	Free floating and convertible. Note the heavy indebtedness of the private sector in foreign currency debt.	None	None	1.1	2%
Israel	Managed float and convertible. Heavy ad-hoc interventions.	Imposed 10% reserve requirement (RR) on Israeli banks on transactions in fx swaps and forwards with non-residents. And imposed disclosure requirement on transactions of both residents and non-residents in fx derivatives and Makams (BoI T-bills) of more than USD 10mn in one day.	The Ministry of Finance plans to abolish tax break (15%) for non-residents holding of Makams (BoI T-bills).	10.3	17%
Poland	Free floating and convertible.	None	None	12.9	7%
Russia	Managed float vs a basket of EUR and USD (45%/55%). Current band of the basket is between 32.45 and 37.45	Recently widened the band	Moving towards more currency flexibility	36.8	8.4%
South Africa	Freely convertible. SARB does intervene on occasion. No capital controls	Increased FX purchases by SARB and national treasury Increased offshore allowance for local institutional investors to help counter portfolio inflows	None	6.4	18%
Turkey	free float and convertible. CBRT engages in daily fx auctions of \$50mm USD to increase its FX reserves	Increased in RRR rates on TRY deposits instead of rate hikes.	Risk of aggressive and unorthodox intervention is low, but policy of building reserves remains in place.	10	14%



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