




Opinions

1%-Point Interest Rate Differential: A Tipping Point for Massive Capital Outflows?



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On June 13, the U.S. Federal Reserve raised its benchmark rate by 25 basis points. Now the federal funds rate stands at 2.0%. Central banks in emerging markets responded swiftly prior to the June FOMC (Federal Open Market Committee) meeting to heed the pressure of capital outflows. In May, Bank Indonesia lifted its policy rate by 0.5% points up to 4.75%. The Reserve Bank of India adjusted its policy rate up by 0.25% points to 6.25%. The Central Bank of Argentina raised its rate by 12.5% points to a whopping 40%. Despite these earnest measures by emerging central banks to curb the speed of outflows, the outcome looks beyond the capacity of these central banks to control. About 8 billion dollars flowed out of Asian emerging countries in May alone, a record-high figure for monthly outflows since November 2016.

The Bank of Korea (BoK) has reacted in a somewhat different manner from other emerging central banks. The BoK's policy rate has frozen in the range of 1.50 percent during the past seven months since November 2017. The rate gap between the Fed and the BoK expanded to 0.50 percent points after the June FOMC meeting. The global financial markets expect two more rate hikes by the Fed this year. There has been a

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strong argument that capital outflows are unavoidable in situations where the interest rate gap between the Fed and BoK widens to over 1%-points. What poses a threat to financial market participants and policy makers is a massive "sudden stop" of capital movements.

Interest rate differential apparently plays a vital role in bringing about capital outflows from the emerging economies. The U.S. benchmark rate is now higher than the BoK rate by 0.50%-points. It seems quite natural that a portion of foreign capital would leave the Korean market back to its origin. However, such interest rate gaps are only a part of the various elements triggering capital outflows. A Sino-American trade conflict and political turmoil in Middle-Eastern countries may have an even bigger impact in terms of capital movement. The recent pressure generated by outflows of equity funds from the Seoul market reflects foreigners' combined response to the expanded rate gap plus these geo-political events. Foreign equity funds have seen a net outflow of 2.8 billion dollars from January to May. Nobody, however, is pronouncing that Korea is now exposed to the risk of a so-called "sudden stop" in capital flows. With the huge current account surplus, capital outflows seem to be acceptable if the speed of outflow is manageable. Making a fuss over everyday events can lead to a self-fulfilling crisis.

The bond market story looks dissimilar to that in the stock market. Foreign investment in Korean bonds has consistently expanded. Seven billion dollars of bond funds have flowed into Korea between January to May. Most of these inflows (6.3 billion dollars) are from foreign central banks and sovereign funds. As of May, the total amount of foreign bond investment stands at 100.3 billion dollars. Bond fund investments by central banks and sovereign funds total 73.3 billion dollars. Profitability does not seem to be the priority principle for these central banks and sovereign funds. Their strategy rests on securing low risk even at smaller profit margins. They are less sensitive to interest rate differential and exchange rate fluctuations. The Korean market has traditionally served as a destination for "flight-to-quality" at times of rising uncertainty in the global financial markets. The European fiscal crisis (August through December 2011), the Taper Tantrum speech by then-Fed Chairman Ben Bernanke (May 2013) and the Argentine crisis (June 2015 through February 2016) are all good cases in point. According to market specialists, central banks in the Middle-Eastern countries have recently boosted their portion of Korean bond portfolios on the strength of rising oil prices.

For overseas investors, the external robustness of the Korean economy is its main attraction. The economy has maintained a current account surplus position for 74 months. The Bank of Korea's foreign reserves exceed 400 billion dollars, a record high. The ratio of short-term for-

foreign debt has remained below 30 percent since the year of 2011. The global rating agency Moody's has declared it will sustain the sovereign credit rating for Korea at its current level. Overall, overseas investors appreciate the resilience of the Korean economy against any external shock.

The recent negative swap spread (-1.70% points) at the FX funding market gives an arbitrage opportunity to foreign investors. This swap spread represents the revenue/loss from exchange rate gap. Foreigners bring dollars into Korea and exchange them into Korean won to purchase Korean bonds and stocks. When the Korean government bond has a yield of 3%, domestic investors' return at the maturity date will be 3%, but foreigners' gain will be 4.7%. The negative swap spread of 1.7% will serve as additional exchange rate revenue for foreigners. The interest rate gap between the U.S. and Korea (0.5% points) is still smaller than the magnitude of the swap spread (1.70%).

This strongly indicates that foreigners' investments in Korean bonds look profitable as ever. That a 1%-point rate interval would provoke huge capital outflows out of Korea seems too blunt and unilateral a claim. **KIEP**