



*Emerging market risks in
face of global imbalances*

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Motivation

- ✧ Transpacific imbalance and unsustainability of US CA deficit trajectory
- ✧ Expected rise in US interest rates
- ✓ Already addressed what are possible causes (Jan23rd) and what is happening (Jan30)
- ◇ But what will be the impact on Emerging Market (EM) economies?

Why in face of global imbalances?

- ✧ EMs have historically been the most exposed countries to destabilizing forces
- ✧ Many of those forces are present today
 - ✧ Rising oil prices ⇒ Potential negative supply effects for the whole world
 - ✧ High commodity prices ⇒ Burst of commodities bubble are likely to have serious impacts on developing economies (primary product exporters)
 - ✧ Developed countries growth slowdown
 - ✧ And...

Why in face of global imbalances?

- ✧ ...the resolution of global imbalances
- ✧ Current juncture is unsustainable in the medium term
- ✧ Imminent adjustment with significant probability makes this likely to be the next source of strain for EMS.
- ✧ Therefore we will be addressing how global imbalance resolution may affect EMS.

Roadmap

- I.** Past conditions - EM crises of the 90s
- II.** Current conditions - EM present vulnerabilities
- III.** Different perspectives on the adjustment path
- IV.** Analyses and conclusions

What is the link between past and present EMs' conditions and Global Imbalances?

- ✧ Global imbalances are a source of disruption for EMs
- ✧ The way those disruptions affect the economies will depend on their situation, their present conditions
- ✧ And we use past conditions as comparison of how those interactions can impact developing countries.
- ✧ In one sentence...

Speculative attacks in the 90s

✧ What caused them

✧ Why they were clustered in time

✧ Why they were associated with rising US interest rates

Treasury Bills



Source: Federal Reserve – 6-Month Treasury Bills

Potential causes of the attacks

- ✧ Frankel & Rose (1995) showed the following variables were significant to currency crises:
 - ✧ High domestic credit growth
 - ✧ Increases in foreign interest rates
 - ✧ Low real GDP growth rates
 - ✧ Low foreign exchange reserves
 - ✧ Small FDI/debt ratio
- ✧ Sachs (1996) argues the following precipitate crises:
 - ✧ Over-valued real exchange rate
 - ✧ Low amounts of international reserves
 - ✧ High levels of accumulated debt

Frankel and Rose (1995)

- ✧ "Currency crashes in emerging markets"
- ✧ Empirical study analyzing the magnitude of certain variables on countries vulnerability to currency crises
- ✧ They define a currency crash as an sharp and accelerating currency depreciation

Table 1
Probit estimates

	Default		Predictive	
	GF(x)/Sx	Z	SF(x)/Gx	Z
Commercial Bank/Debt	-0.07	0.57	0.03	0.21
Concessional	-0.10	1.74	-0.14	2.10
Variable Rate	0.03	0.21	-0.03	0.22
Short Term	0.04	0.34	0.23	1.97
FDI/Debt	-0.33	2.88	-0.31	2.47
Public Sector/Debt	0.11	1.32	0.19	2.18
Multilateral/Debt	-0.03	0.46	-0.06	0.81
Debt/GNP	0.03	1.33	-0.04	1.71
Reserves/Imports	-0.01	1.99	-0.01	3.39
Current Account	0.10	1.03	0.02	0.22
Over-Valuation	0.05	1.51	0.08	2.53
Government Budget	0.27	1.90	0.16	1.06
Domestic Credit	0.13	4.78	0.10	3.24
Growth Rate	-0.38	3.13	-0.16	1.29
Northern Growth	0.55	0.98	-0.85	1.50
Foreign Interest	1.27	4.50	0.80	2.60
Sample Size	803		780	
Pseudo-R ²	0.20	P-Val	0.17	P-Val
Ho: Slopes = 0; x2(16)	93.6	0.00	81.2	0.00
Ho: Debt Effects = 0; x2(7)	14.2	0.05	25.5	0.00
Ho: External Effects = 0; x2(4)	8.8	0.07	16.5	0.00
Ho: Macro Effects = 0; x2(3)	32.9	0.00	12.3	0.01
Ho: Foreign Effects-O; x2(2)	21.5	0.00	15.4	0.00
Default model: Goodness of fit				
	Tranquility	Crash	Total	
Predicted tranquility	727	65	792	
Predicted crash	6	5	11	
Total	733	70	803	
Predictive model: Goodness of fit				
	Tranquility	Crash	Total	
Predicted tranquility	707	64	771	
Predicted crash	4	5	9	
Total	711	69	780	

Probit slope derivatives (X 100, to convert into percentages) and associated z-statistics (for hypothesis of no effect). Slopes significantly different from zero at the 0.05 value in bold. Model estimated with a constant, by maximum likelihood. Predictive model lags regressors 1 year.

Have EM reforms occurred?

Things look very different...

- ✧ CA balances ⇒ East Asia and other developing countries have shown consistent CA surpluses
- ✧ External debt
 - ✧ Falling as share of GDP
 - ✧ Change in composition ⇒ longer maturities; denominated in home currency; fixed rather than floating interest rates
- ✧ Reserves ⇒ Sharp accumulation, maybe even excessive
- ✧ Macroeconomic policies
 - ✧ Primary surpluses enough to stabilize or even reduce share of debt to GDP
 - ✧ Flexible exchange rate regimes
 - ✧ Responsible monetary policies

Questions we will try to answer

- ✧ Were the past crises the result of fundamental economic and financial weakness at the national level?
- ✧ How likely are CBs to cut financing to US? (Central fallacy)
- ✧ Are EM today still vulnerable to sudden stops?
- ✧ What level of insurance is adequate to protect against crises?

Scenarios of rebalancing

1. Hard landing
2. Soft landing for US; Sudden Stop in EMS
3. Currency adjustments and policy coordination

1. Disorderly correction of global imbalances

- ✧ CBS stop accumulating US assets
- ✧ Dollar $\downarrow \Rightarrow$ Price of US assets $\downarrow \Rightarrow$ Yields on US assets \uparrow (Eliminating the Greenspan Conundrum)
- ✧ Falling dollar also implies imported inflation $\Rightarrow i \uparrow$ further $\Rightarrow Y \downarrow$
- ✧ Central fallacy (Calvo) \neq Possible but unlikely (Eichengreen)

2. Soft landing in the US Sudden Stop in EMs

- ✧ Calvo and Talvi believe the impact would be felt by EM and unaffected the US economy
 - ✧ If Asian central banks reversed their policy, private investors would finance US debt directly rather than indirectly
 - ✧ Flight to quality
- ✧ “The US is likely to make a smooth transition at the expense of other more financially vulnerable economies.”

3. Eichengreen's view

- ✧ If countries take appropriate measures, it is likely that:
 - ✧ There is no sudden stop
 - ✧ Exchange rates adjust, reducing EMS surpluses and US deficit
 - ✧ Impact of adjustment and how much of a dollar depreciation is needed depends on how quickly it begins

Would US financing be cut off abruptly?

- ✧ For Calvo and Talvi, no: if CBs were to stop buying US assets, private investors would virtually take over such role. There would be flight to quality and money flowing out of EMS.
- ✧ For Eichengreen and Park it is possible but unlikely. Central Banks have a vested interest in continuing the external finance to avoid a possible recession. If they do, however, better fundamentals in EMS will prevent a sudden stop.

Higher US Interest Rates Perspectives (1/3)

- ✧ Calvo and Talvi:
- ✧ Higher US interest rates, however this happens, will cause “flight to quality” .
- ✧ These effects will force private investors to pull out of EM and flock towards higher quality assets

Higher US Interest Rates Perspectives (2/3)

- ✧ Goldstein
 - ✧ Longtime IMF staffer who went to a think tank (The Institute for International Economics).
 - ✧ Focus of the paper: possibility of another EM crisis and its format
 - ✧ Argument: Higher US interest rates will trigger inflows into the US and a higher risk premium for EM

Higher US Interest Rates

Perspectives (3/3)

- ✧ Eichengreen and Park
 - ✧ Effects of higher US interest rates depend on the *reason* for the rise.
 - ✧ If Fed is tightening monetary policy, the increase will be gradual and more easily absorbed by EMs.
 - ✧ If the rise is caused by foreigners unwillingness to finance the US deficit, then according to interest parity condition, higher interest rates in US will cause lower interest rates in for example, the Euro area, so effects may not be so obvious.
 - ✧ Can higher US interest rates help imbalances?
- ✧ The effects of higher US interest rates this time around may not be as damaging for EM.

Another perspective

- ✧ Charles Wyplosz: "Is East Asia safe from Financial Crises?"
- ✧ Many vulnerabilities in EMs have been removed, but some still exist
- ✧ EMs are never safe from speculative attacks no matter how many reserves they accumulate; their current stock should not be a deterrent from removing other vulnerabilities

Financial Vulnerability of EM

- ✧ Calvo and Talvi: EMs are still vulnerable to fluctuations in foreign interest rates and have weak financial institutions.
- ✧ Wyplosz: International reserves can never fully protect a country from speculative attacks; EMs still vulnerable to certain extent
- ✧ Eichengreen and Park: financial system is strong. EM are running CA surpluses, minimizing borrowing; large amounts of reserves will prevent the “flight to quality”
 - ✧ What channel do they believe EMs are most vulnerable to?

Where is the main risk then from global imbalances?

- ✧ Main fear is a slowdown in US growth and import demand and dollar depreciation
 - ✧ EM dependence on exports to United States
 - ✧ Possible dollar depreciation could be damaging
 - ✧ Effects of exchange rate fluctuations?
- ✧ Magnitude of the dollar depreciation on EM depends on level of EM currency appreciation and their share of exports to the US
- ✧ Eichengreen and Park believes EMs will be affected through trade channels.

Our analysis

- ✧ Higher foreign reserves do provide a cushion against crises
- ✧ The fact that they are not perfect insurance is mitigated by additional reforms implemented by EMS
- ✧ Given the past and present conditions, it is our conclusion that EMS are indeed better protected against speculative attacks.
- ✧ BUT: far from an impossibility, this is a probabilistic analysis.

Our analysis

- ✧ Additionally, CBs have an interest in protecting the value of their reserves, so it is unlikely that they will cut off financing
- ✧ They also want to keep an undervalued currency as means of increasing their goods competitiveness internationally
- ✧ THUS: We conclude that EM are not prone to experiencing a financial crisis.

Additional points

- ✧ EMS reliance on export led growth could be damaging if their currencies begin appreciating or if the US experiences a decline in growth.
- ✧ Will EMS, with or without US cooperation, be able to make the necessary reforms to move away from export demand?
 - ✧ Demand rotation from exports to domestic markets (Eichengreen & Park)?
- ✧ Is there potential for policy cooperation?