

Submerging markets?

Emerging markets have thrived in the years of easy money and economic boom. But as interest rates rise, they are increasingly vulnerable to a downturn in global growth.



BARRY EICHENGREEN is

George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley. He is also a Research Associate of the National Bureau of Economic Research and a Research Fellow of the Centre for Economic Policy Research. In 1997-98 he was Senior Policy Adviser at the International Monetary Fund. He has published widely on the history and current operation of the international monetary and financial system, most recently *Global Imbalances and the Lessons of Bretton Woods* (MIT Press, 2006).

Emerging markets have been awash with liquidity for several years. In 2005, net capital inflows to developing countries hit a record-high, of nearly \$500bn, for the second year running. These funds came from private investors – net official financing was negative, that is, developing countries repaid more than they borrowed from rich-country governments and the international financial institutions last year – and were spread broadly across different forms of debt and equity in a large number of recipient countries. Not since the first decade of the 20th century has so much foreign capital flowed to so many emerging markets. Unfortunately, though, the favourable financial conditions and robust global growth that have given rise to this happy era appear to be turning sour.

Until recently, global – and in particular, US – interest rates have been exceptionally low. Portfolio managers expected to match historical returns have, in effect, been forced to invest in emerging markets – the only markets still offering sufficiently high yields – and have funded their positions by borrowing at low interest rates in the advanced markets. Meanwhile, the world economy is set to grow faster this year

than at any time since the breakdown of the Bretton Woods System some 35 years ago, according to the IMF's spring forecast. As a result, corporate profits are overflowing – and with emerging economies notching up growth of over 5% for the fourth year running, they are an obvious place to reinvest these funds. High oil and commodity prices have also heightened the allure of countries that export energy and raw materials.

But this happy era is now coming to a close. Already, the US Federal Reserve has sharply raised interest rates, while the European Central Bank (ECB) and Bank of Japan have also started to tighten, albeit more slowly. Suddenly, global liquidity is no longer so abundant. As a result, investors' appetite for risk has declined since the spring meetings of the IMF and World Bank in April. What's more, monetary tightening, high energy prices and capacity constraints are casting a shadow over prospects for US growth. And while China may be maintaining its extraordinary double-digit growth rates for now, the faster its economy grows the more investors fret about the possibility of a hard landing. Emerging markets could thus soon face a



lethal combination of higher interest rates and slower global growth. Worse, the collapse of the WTO's Doha Round makes it unlikely that world trade will continue to grow faster than incomes. The pattern of global imbalances – a disturbingly large US current-account deficit matched by large Asian surpluses – creates further uncertainty, not to mention the volatile geopolitical situation.

Blessed are the prudent

Although the future is, of course, unpredictable, the risks to emerging markets are certainly different than in previous periods of volatility. For one thing, the financial effects will be more selective. Prudent emerging economies, such as Mexico and Venezuela, that have already funded their borrowing requirements for 2006 and beyond are in a much stronger position than profligate ones, such as Hungary, Turkey and South Africa, which have big current-account deficits and correspondingly large financing needs.

Prudent governments have taken advantage of cheap and plentiful external finance to strengthen their financial positions. They have stockpiled reserves and pre-funded their borrowing needs; some have even capitalised on investors' appetite for their domestic debt securities to eliminate their foreign-currency debts. Since these prudent economies do not have to borrow to roll over maturing debts or finance current-account deficits, they are less susceptible to a shortfall of foreign funds. Having stockpiled reserves, they have more scope to prevent their currency collapsing if foreign investors draw in their horns. And even if their exchange rates do weaken, their banking systems will not collapse because their currency mismatches are better managed.



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But if international investors' tolerance for risk continues to fall, profligate economies could find that the inflows financing their current-account deficits – which are now approaching 7-8% of GDP in some cases – dry up abruptly. Although they may buy some time by spending their currency reserves, they will eventually have to dramatically improve their trade balance. In the short term, that requires an import squeeze, through a rise in interest rates that curbs consumption and investment ➤



If Asian central banks grow reluctant to accumulate more US bonds, the dollar could fall sharply, pushing up import prices and forcing the Fed to raise interest rates further.

- – resulting, more likely than not, in a recession. In turn, this implies a rise in nonperforming loans and problems for banking systems. Eventually, the currency depreciation that occurs as foreign investors reduce their purchases of domestic securities will boost exports, but that takes time – and the interim could be painful.

The past few months suggest that investors can distinguish between countries' differing circumstances. As investors' appetite for risk has declined, countries with large current-account deficits have suffered most. Surplus countries such as Mexico and Brazil, which were susceptible to such changes in sentiment in previous periods, have remained largely immune. The risk of financial instability is by no means gone, but it appears to be much greater for profligate emerging economies than for prudent ones.

Diversify your borrowing

That the risks have changed heightens the danger of fighting the last war. Countries such as Brazil have traditionally experienced instability when the demand for their foreign debt has declined. When their currency has weakened, they have been smashed by the increased cost of servicing their dollar-denominated debt. To avoid this, they have taken advantage of the good times to exchange virtually all of their dollar debt for securities denominated in local currency, floating these on domestic markets and selling them to both local and foreign investors.

But much of this debt is short-term or at floating rates. Although long-term issuance is growing, investors remain wary of tying up their funds at fixed rates for long periods. So, if global interest rates spike up – which ➤

➤ could happen if foreigners grow more reluctant to finance the US current-account deficit – so too will the cost of servicing this debt. Dollar-denominated debt may be out of fashion, but prudent governments unable to borrow long-term at fixed rates should not rely exclusively on domestic-currency debt. Rather governments with big debts should spread their risks by issuing a diversified portfolio of securities denominated in both foreign and domestic currency.

Does this mean that countries in external surplus with light debt loads can relax? Hardly. For them, the main risk is that a global slowdown will depress export growth. By some measures, the US and China have together accounted for some two-thirds of global growth in recent years. But if growth in the US and China slows, so will developing-country exports of goods and primary commodities to their respective markets.

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However admirable some developing countries' budget and current-account surpluses may be, their restrictive policies make them dependent on exports as a source of demand. If the US slows, Mexico and East Asia, in particular, will suffer. Nearly 80% of Mexico's exports go to the US, while Asian countries – especially small, highly open economies such as Singapore and Taiwan – also rely heavily on the US market. Asian countries that specialise in producing consumption goods – consumer electronics, for example – will be hit hard by softening US demand. If China slows, exporters of raw materials and energy, such as Indonesia



and Peru, and exporters of capital goods, such as South Korea, will be hit hardest.

A happy ending?

The happy scenario is one in which slowing growth in the US and China is offset by accelerating growth in Europe and Japan. Global imbalances decline gradually towards more sustainable levels, with the US consuming less while Europe and Japan consume more. The world economy keeps motoring along, and emerging markets escape collateral damage.

Unfortunately, there are several less rosy alternative scenarios. First, there could be a hard landing in the US. US growth is



Consumer spending has increased dramatically in China, but efforts to prevent the economy overheating could depress its growth too much.

heavily dependent on consumer spending – and if the housing market softens further, consumer confidence will suffer. It also depends on foreign investors, notably Asian central banks – and if they grow reluctant to accumulate more US bonds, the dollar could fall sharply, pushing up import prices and forcing the Fed to raise interest rates further. Rather than a gradual deceleration, the US could experience an abrupt slump.

Second, efforts to prevent the Chinese economy overheating could depress its growth too much. Whereas in advanced financial systems, the central bank can fine-tune credit conditions and demand growth by tweaking lending rates, China's financial

markets are not sophisticated enough to permit this. Also, China's reluctance to see its currency fluctuate more freely against the dollar heavily constrains its ability to alter its interest rates independently. So the Chinese authorities must rely on blunt instruments, such as raising reserve requirements and instructing the banks to lend less, to slow the breakneck speed of investment. Since their efforts have been ineffective so far, they may be tempted to resort to more extreme measures – but if they overdo it, investment could collapse, and with it Chinese growth.

Third, Europe and Japan could fail to pick up the slack. The prospect of structural reforms inevitably increases the uncertainty ➤

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➤ faced by European consumers, while the size of government debts and deficits limits the scope for fiscal stimulus. And with euro-zone inflation above its target range, the ECB is reluctant to apply monetary stimulus. Germany has been able to grow by exporting, but if the world economy slows this last source of demand will disappear too. Japan, for its part, will be battling the headwinds of rising interest rates, as its central bank seeks to move from a zero-interest-rate policy to levels comparable to those of the Fed and the ECB. What's more, both economies have ageing populations,

which limits potential growth. At best, Europe and Japan will be lucky to grow by 2% a year.

If one of these three events occurs – a hard landing in the US or China, or continued slow growth in Europe and Japan – the result will be a global slowdown. If two or more happen, this would almost guarantee a global recession, with export-dependent emerging markets suffering disproportionately.

If the problem originates in the advanced economies and China, the solution must be found there too. The US could address the roots of its twin deficits by letting President Bush's tax cuts expire. With less fiscal stimulus, there would be less need for monetary tightening to counter inflation, and less downward pressure on the housing market. If the dollar falls sharply before these adjustments are undertaken, the Fed could avoid overreacting. Weaker domestic demand would at least partially offset the inflationary effects of higher import prices. The Fed should avoid battering the economy with higher interest rates when activity is already on the way down.

Europe and Japan should also avoid excessive monetary tightening. With luck, the Bank of Japan understands that it will take some years to raise interest rates to world levels. If Europe finally begins to make progress on fiscal consolidation, there would be more scope for the ECB to relax. And if the dollar does fall sharply, European exporters would face stiffer competition, and therefore need a more accommodating monetary policy that prevents the euro from rising excessively.

China, for its part, would be able to manage its economy more effectively if could adjust ➤



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➤ interest rates more freely – which, in turn, requires a more flexible exchange rate. As its exposure to international capital markets increases, China cannot enjoy monetary autonomy if it insists on keeping its exchange rate against the dollar stable. It also needs to develop its financial system to make it easier to fund the higher consumer spending and increased public expenditure on healthcare, education and rural infrastructure that would reduce the economy's excessive dependence on export demand.

But what about emerging markets other than China? For the most part, they must just sit tight and hope that they are lucky. Asian countries could reduce their dependence on uncertain world markets

by letting their currencies rise, while supporting domestic demand by raising public spending, but they are unlikely to do either unless China does so first. Latin America has little scope for using fiscal policy, given its high public debts and chequered fiscal history.

Since the turn of the century, most emerging markets have embraced the conventional wisdom that says: avoid budget deficits, run current-account surpluses and keep your currency competitively valued in order to promote export growth. This strategy of tying their fortunes to world markets has served them well in the years of easy money and global boom. But if the world economy now turns sour, the future could be much less rosy. ■