

Emerging markets have become more resilient,

But not all of them have the same room for manoeuvre

Freedom from financial fear

The Economist, October 5, 2017

IN WALKING A middle path, between self-indulgence and self-mortification, Buddhists face great temptations. This struggle for self-control animates many of their paintings, including “Star’s Seed” by the Thai artist Thawan Duchanee. The painting depicts a muscular man with the mandibles of a rhinoceros beetle—bestly appendages that symbolise man’s base cravings. Only by shedding these cravings, Buddhists believe, can man be free from fear.

The painting hangs on a wall in the Bank of Thailand, which faces its own temptations and fears. Like any central bank, it must resist the lure of inflation. And like many of its peers in emerging markets, it lives with a fear of global financial forces beyond its control. When America’s Federal Reserve raises interest rates, when global investors lose their appetite for risk, or when multinational banks shrink their lending, emerging markets worry about the impact on their own currencies, balance-sheets and economies.

The temptations and the fears are connected. Emerging markets have traditionally struggled to keep inflation under control. For that reason, they have often tethered their exchange rates to the dollar and borrowed in hard currencies at the insistence of foreign creditors. This institutional anchoring helped them attract inflows of foreign capital, which often financed large current-account deficits. But their anchors also acted as shackles. They forced the central banks slavishly to follow the Fed’s monetary policy so as to preserve their currency’s standing against the dollar. And they left their economies vulnerable to any interruption in foreign lending and investment.

Whenever foreign capital inflows dried up, emerging markets wrestled with a painful dilemma. To appease foreign investors and defend their currencies, they could raise interest rates to punishingly high levels; but that would bankrupt many domestic companies. Or they could ease monetary policy and let their currencies drop; but that would also bankrupt any companies with dollar debts. Either way promised ruin.

Ruin duly arrived in a succession of financial crises. When the Fed raised interest rates to 20% to fight inflation in 1979-81, Latin American governments could no longer afford to service the vast dollar loans extended to them by American banks. The debt crisis that followed condemned the region to a “lost decade” which may have helped inspire the notion of a middle-income trap.

Something similar happened in Mexico in 1994, when the Fed again raised rates faster than expected. And a broader wave of crises struck emerging markets from July 1997, when the Thai baht broke its peg to the dollar, to January 2002, when Argentina formally abandoned the peso's parity with the greenback. These blows rid them of both their shackles and their anchor. Without the external discipline provided by the dollar, they had to build their own institutional defences against inflation.

Control yourself

Happily, in the subsequent struggle for macroeconomic self-control, emerging markets have proved themselves more man than beetle. Inflation, averaged across the world's emerging and developing countries, fell from 13% in 1999 to less than 4.4% last year, according to the IMF. In the members of the MSCI emerging-markets index it is even lower. The latest average, weighted by each country's size in the index, is only 2.6%, says Bhanu Baweja of UBS, a bank (see chart).

This self-control has brought a number of benefits. First, it has allowed emerging-market governments to sell bonds denominated in their own currencies, which has given them more fiscal room for manoeuvre. For most of the past half-century, their tax and spending policies have been stuck in a "procyclicality trap", according to Carlos Végh, Daniel Lederman and Federico Bennett of the World Bank. Governments have raised discretionary spending during booms, to placate clamorous constituents, then cut it during busts, to appease jittery creditors.

But in more recent years the pattern has shifted. Of the big emerging economies, Chile, South Korea, Turkey, India, China, Mexico, South Africa and Malaysia have all been able to pursue countercyclical policies, on average, since the turn of the century; and since the global financial crisis that began in 2007, Peru and Colombia have joined their ranks. "The region appears to have begun to finally break the shackles of the procyclicality trap," note Mr Végh and his team.

In addition to this fiscal flexibility, the increased macroeconomic credibility of emerging markets has won them an unaccustomed degree of monetary freedom. When the Fed tightens monetary policy, they no longer have to follow in lockstep. They can keep interest rates steady, letting their currency fall against the dollar, without worrying as much about the increased threat of inflation or the heavier weight of dollar debt. Indeed, since the Fed began to raise interest rates in December 2015, many emerging-market central banks have shifted their own rates down, not up. In 17 out of the 24 members of the MSCI emerging-markets index, the central bank's policy rate is now the same or lower than it was before the Fed's first hike.

Mostly moderating

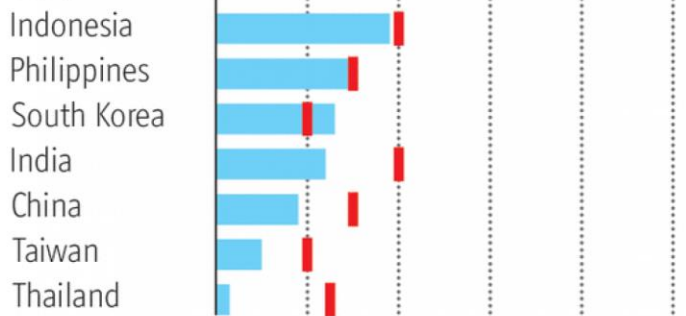
■ Consumer prices, August 2017 or latest
% increase on a year earlier

■ Central-bank inflation target, %

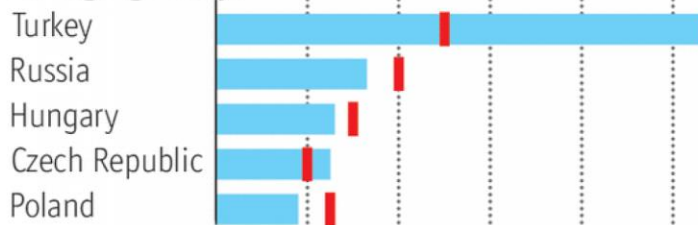
Middle East and Africa



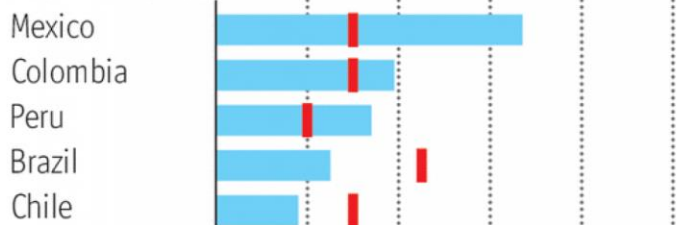
Asia



Emerging Europe



Latin America



Sources: Haver Analytics; central banks

But some sources of vulnerability remain. The central bank's policy rate is not the only determinant of a country's financial conditions. Some economists, such as H el ene Rey of the London Business School, have argued that broader financial conditions, including longer-term interest rates, credit growth and capital flows, are driven by a forceful and synchronised global financial cycle that is beyond the control of local central banks. Even when they are not constrained by a peg to the dollar, emerging markets cannot free themselves from these global forces, Ms Rey argues. Policymakers must either submit to them or repel them by erecting capital controls.

The "taper tantrum" of 2013 lent support to this fear. Governments and especially companies in emerging markets had taken advantage of worldwide monetary easing to issue large amounts of cheap debt. These lax financial conditions were, however, rudely interrupted in May 2013, when Ben Bernanke, then the Fed's chairman, mused on an eventual slowdown in the bank's asset purchases. That was enough to unsettle big emerging markets like Brazil, India, Indonesia, South Africa and Turkey, despite their flexible currencies. They became known as the "fragile five".

The tantrum demonstrated that floating currencies could not insulate emerging economies entirely from global financial forces, as Ms Rey has argued. But recent research by Maurice Obstfeld, Jonathan Ostry and Mahvash Qureshi of the IMF confirms that flexible exchange rates still offer more autonomy than dollar pegs. And that autonomy is greater still in countries with narrower trade deficits, lower inflation and lower levels of debt.

The fragile five seem less delicate today than they did in 2013. In the intervening years, all of them have narrowed or eliminated their current-account deficits; all except India have benefited from an improvement in the competitiveness of their currencies; and all except Turkey have reduced inflation and credit growth. In both India and Brazil, the combined debt of households and non-financial corporations has declined as a proportion of GDP since the taper tantrum. In South Africa it began falling in 2016, and in Indonesia it has increased only slowly.

The credit growth causing most concern among emerging economies is not in the formerly fragile five but in China. Its stock of outstanding credit as a proportion of its GDP is a massive 213%. This figure, known as "total social financing" (TSF), is supposed to capture all sources of finance for households and enterprises. Economists often subtract some items from this total (such as equity financing) and add others (such as the local-government bonds that have replaced

some bank loans to infrastructure ventures). But these adjustments do not greatly change the underlying story.

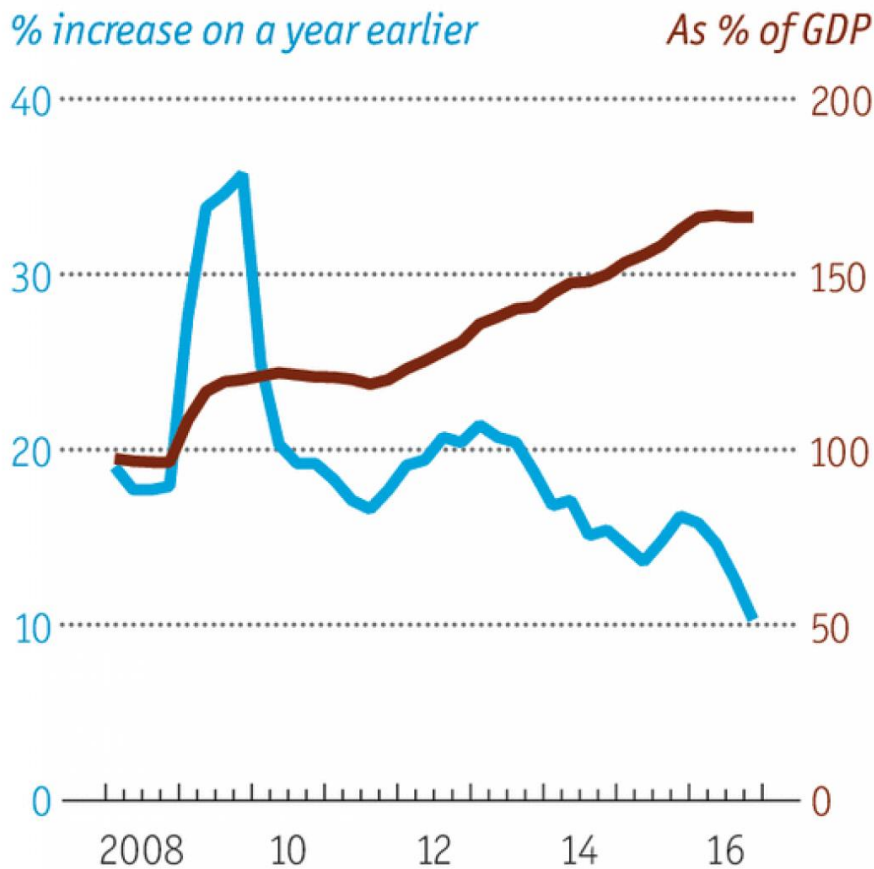
What is scary about the number is how quickly it has risen. Five years ago it was below 169%. The IMF has identified 43 previous cases in which a country's ratio of credit to GDP has risen by more than 30 percentage points in five years. In 38 of them the boom ended in a financial crisis or "major" slowdown. And in two of the remaining five the crisis arrived a few years later.

Many economists worry that a similar fate awaits China. Some bearish investors are counting on it. They have bet heavily against the yuan in the belief that a financial bust in China will oblige its authorities to ease monetary policy and cheapen its currency. Such exchange-rate fluctuations are now commonplace in other emerging economies. But China is still an outlier. It allows the yuan to move each day by just 2% either side of a benchmark dollar rate it sets each morning. In August 2015 it tried both to devalue the currency modestly and to introduce more two-way flexibility in its movements, but succeeded only in creating self-fulfilling expectations of further depreciation.

For a few months China seemed caught in the same trap that ensnared other Asian emerging markets in the late 1990s. It appeared to face an invidious choice between vigorously tightening monetary policy to defend the yuan, or letting the currency fall. But China had four defences that other economies lacked. Its dollar debts were modest relative to the size of its economy; it still had a large current-account surplus, which brought in a steady stream of dollar earnings; it was sitting on a bigger stockpile of foreign-exchange reserves; and it had retained closer controls on capital outflows.

Too intense

China, corporate credit



Source: Bank for International Settlements

Economist.com

Between August 2015 and January of this year it lost over \$500bn of reserves as it tried to cushion the yuan's decline. It cracked down on what it deemed to be wasteful overseas acquisitions by Chinese firms. And it subjected requests for dollars by companies and individuals to heightened regulatory scrutiny, including a daunting increase in paperwork. Eventually it was able to quash the downward pressure on the currency. Over the first eight months of this year the yuan strengthened by over 5% against a dollar that had lost much of its upward momentum. In August, the dollar value of China's foreign-exchange reserves increased for the seventh month in a row.

Whatever its impact on the yuan, will China's credit boom nonetheless result in a sharp slowdown in growth? To answer this question, it helps to scrutinise why its credit-to-GDP ratio rose so quickly in the first place. During the crisis year of 2009, the ratio jumped because credit grew dramatically, thanks to China's stimulus efforts; but since then credit growth has been slowing steadily (see chart). The ratio has nonetheless continued to rise because nominal GDP has expanded unusually slowly.

Many economists point out that the credit-intensity of China's economy deteriorated between 2011 and 2016. It took more credit to generate a yuan of growth. The reason may be that much of this credit was spent not on newly produced assets such as buildings or machinery, but on existing assets such as land and previously constructed buildings. This kind of spending adds nothing to GDP, which measures only new production, not transfers of ownership of existing wealth.

If that credit mix could be reversed, it would help China to reduce leverage without reducing growth. The relationship between new credit and new production would improve. Fortunately, that improvement has already got under way: credit growth has slowed in recent quarters even as nominal GDP growth has picked up. In response, China's credit-to-GDP ratio in the second quarter fell by a fraction of a percentage point. If it continues to stabilise, it will lift a big macroeconomic cloud still hanging over emerging markets—especially those that provide the raw materials for China's growth.

This article appeared in the Special report section of the print edition under the headline "Freedom from financial fear"