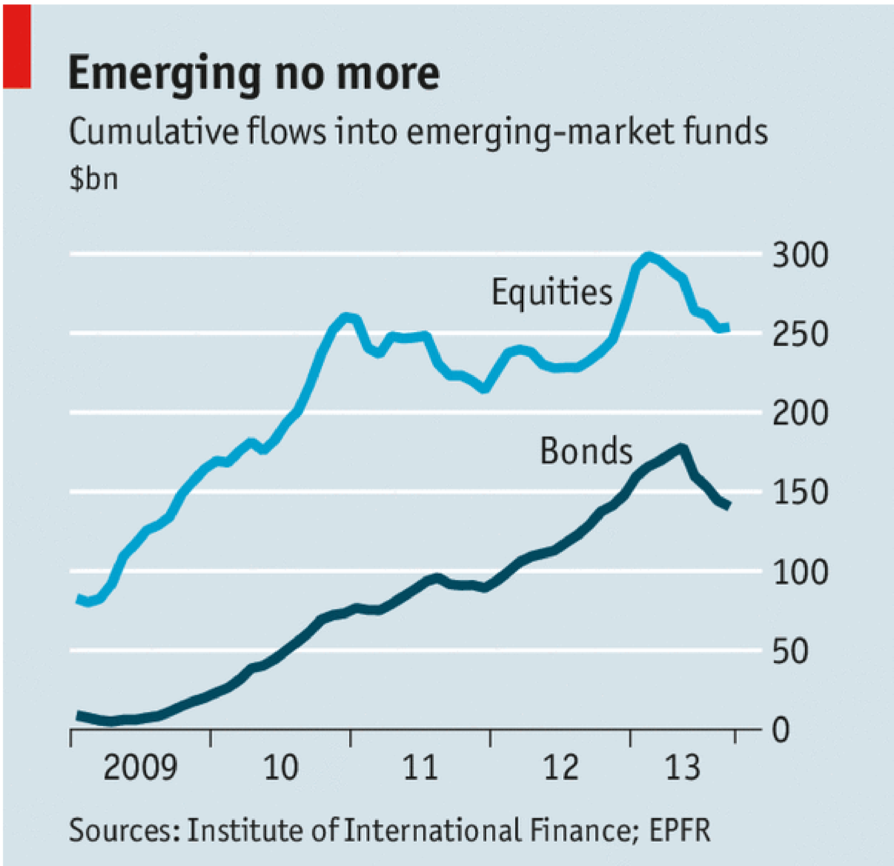
Emerging markets

Sleepless nights

After a decade-long boom, emerging markets have flopped and then bounced in the past six months. The gyrations are not over yet

Nov 9th 2013 | MUMBAI |From the print edition

THE head of an emerging-market central bank recently asked a counterpart in another country how he got to sleep at night. The real problem, came the reply, was not nodding off, but jolting awake in terror later. This summer officials in many emerging markets must have had trouble sleeping. Having spent years as favoured spots for investment for asset-managers, industrialists, cab drivers and monkeys throwing darts, their economies suddenly fell from grace. The plunge proved short-lived, but local policymakers are still not sleeping soundly.



Emerging economies have been slowing for several years—in mid-2013 GDP growth hit 4.5%, the lowest level for a decade, excluding the nadir of the global financial crisis. In May the Federal Reserve compounded this by signalling it would “taper” its purchases of American bonds. These purchases, known as quantitative easing (QE), had been intended to suppress American interest rates; a side-effect of five years of QE-squelched yields in America had been a great sloshing of money into emerging markets in search of higher returns. Funds doing “carry trades”, borrowing cheaply in dollars and buying riskier assets abroad, had thrived.

But the Fed’s comments sparked a rout. From peak to trough emerging-market shares fell by 17% in dollar terms; currencies dropped by up to a fifth; bond yields shot up by 2-4 percentage points and the price of credit-default swaps (CDSs), a hedge against missed payments on bonds, suggested that risk had soared. Foreigners dumped emerging-market assets and locals shipped cash abroad, particularly in the “fragile five” (Brazil, India, Indonesia, South Africa and Turkey), big emerging markets with worrying current-account deficits. There was talk of intervention by the International Monetary Fund.

Then, just as suddenly, everything went into reverse in early September. The Fed delayed tapering (it is now expected to begin early next year). Markets leapt. Shares have recovered most of their lost ground. About a third of the sell-off in bonds, CDSs and currencies has been reversed. Foreign investors are buying again. Governments and firms are issuing bonds.

An alarmist view is that emerging markets are still on the edge of a cliff. In the Fed’s nine tightening cycles since 1958, its base rate has risen by a median of roughly four percentage points over about two years. Today markets expect a rise of just one percentage point over three years. Emerging economies’ bonds have merely tracked the modest shift in American treasuries. Eventually a huge adjustment will still be required to get back to normal.

Assume, however, that America’s bond market is right and that this process will be gradual. The rout was a reminder that in some respects emerging markets are more resilient than they were in the 1990s. They have floating currencies, big foreign-exchange reserves and less government debt denominated in foreign currencies. But in other ways they look fragile. Even a tiny move in interest-rate expectations led to a mini-crash. Perhaps unorthodox monetary policy has encouraged unstable speculative positions. “QE is leading to a massive carry trade that creates distortion,” says Christopher Wood of CLSA, a broker. “A bit of this unwound during July and August but who knows how much is left?”

Local bond- and money-markets were meant to have become deeper and more sophisticated, but in India and Indonesia they froze, and fears grew about bad debts hobbling local banks. Trading dried up in supposedly liquid currencies. Ramin Toloui of PIMCO, an asset manager, says emerging markets are not yet a mainstream part of all portfolios, so not enough folk buy on the dips. “When you have moments of volatility, emerging markets don’t have the same installed base of buyers.”

All this means even a slow normalisation of the Fed’s policy could yet cause more disruption. Short-term interest rates in several emerging markets are below consumer-price inflation, notes Chetan Ahya of Morgan Stanley. Easy money leaves them vulnerable to renewed selling by investors looking for high returns.

How to fix the fragile five

In an ideal world policymakers would try to control inflation and also address the slow down in growth. With the exception of Turkey, the “fragile five” need to adjust fiscal policy—tax receipts may not grow as fast as they used to. On November 5th and 6th Brazil’s currency gyrated as investors fretted about its budget deficit. To tackle their economic problems and boost their potential most emerging markets need a “second generation” of reforms to improve infrastructure, liberalise labour markets and make doing business easier.

The best-run economies, notably South Korea and Mexico, have been safe havens throughout 2013. Following their example is easier said than done, though. Officials have certainly been adept at passing administrative measures. For example, Indonesia has renewed a $12 billion currency swap arrangement with Japan and also sought to repeal red tape on certain kinds of foreign direct investment. But deep reforms require political impetus. All of the fragile five face elections in 2014, making populism a risk. South Africa has faced a wave of debilitating strikes.

Emerging economies have a right to feel aggrieved. Their finances are in less of a mess than those of rich countries and their politics do not seem so dysfunctional alongside those of Washington, DC. The Fed may take ages to normalise interest rates. Yet a big change has taken place—after a decade-long boom their growth rates have slumped. That will take more than a few weeks to get used to.