Emerging market finance in good times and bad: are EME financial crises a thing of the past?

Speech by Mr William R White, Economic Adviser and Head of Monetary and Economic Department of the BIS, at the IIF 25th Anniversary Membership Meeting "Financing conditions for EMEs", Washington, 20 October 2007.

Abstract:

Are crises in emerging market economies a thing of the past? Recent high rates of return on financial assets, resilience to the recent financial turmoil in industrial countries and better "fundamentals" all suggest a positive response to this question. Yet, on closer examination, a number of important sources of concern can still be identified. In particular, efforts to resist upward pressure on exchange rates could set the scene for forthcoming problems in some emerging markets, while at the same time aggravating the dangers associated with global trade imbalances.

Full speech:

1 Introduction

Are emerging market crises a thing of the past? Answering this question requires not only data and judgment but also the capacity to overcome what seems to be a “natural” weakness in our human capacity to make forecasts. The inability to reassess “all the data all the time” naturally leads us to use simple heuristic devices. These might normally be efficient but can sporadically be dangerous. A few years ago, Larry Summers highlighted these dangers with an equally simple question: 1, 2, 3... what comes next? He then brilliantly showed, using extrapolation, mean regression and other common assumptions, that 4, 3, 2 and 1 were each possible right answers. The fundamental problem is that market observers commonly rely on 4 to be next, only to find in retrospect that it was a big mistake.

It is a fact that we have had repeated and serious economic and financial crises in both advanced and emerging market economies (EMEs) from time immemorial. Over the last two centuries, one could note major depressions starting in 1825 and 1873 in the United Kingdom and the United States. The Great Depression of the 1930s was truly global but affected the United States in a particularly damaging way. Recall the problems of Japan in the 1990s, the Southeast Asian crisis which unfolded in the second half of the 1990s, and many other serious difficulties as well. The point deserving emphasis is that most of these crises began suddenly and essentially without warning. Rather, most of the prior talk in each case was of increased productivity and growth rates, justifiably higher asset prices, and the arrival of a “New Era”. Sir Josiah Stamp gave something of the flavour when he remarked, after the onslaught of a massive downturn in the United Kingdom in late 1920, that it was the refusal to mature of an anticipated inflation…. It is just the feeling you have when you go upstairs in the dark and tread on a top step that isn't there.
And let me note, as an important aside, that none of these major crises was preceded by any significant degree of CPI inflation. Price stability clearly helps support longer-term sustainable growth, but historically it has not been sufficient to avoid serious macroeconomic problems.

Closely related to these reflections is another one. It seems that another natural human failing is that we constantly expect to fight the last war. We see this in so many areas of life that one must doubt that economists alone have been spared this tendency. Emerging market economies have been subject to many crises in the past, and particularly over the last decade or so, when the interaction of trade deficits and low international reserves made them especially susceptible to capital outflows. Today, however, there is a tendency to say that those particular problems are no longer a source of concern and therefore future prospects must look good. Yet a simple counterargument can be made. The absence of old risks need not imply the absence of new ones. Indeed, to go further, steps taken to avoid old dangers might themselves be instrumental in generating new vulnerabilities. I will return to this in a moment.

But enough of the generalities. Let me now turn to more concrete facts and judgments to respond to the question of whether crises in emerging market economies are a thing of the past. There are two sets of “facts” to which commentators frequently allude, but each is subject to alternative interpretations.

2 Now for the good news!

Returns and resilience?

Returns on EME investments have recently been unusually high. Sovereign and corporate bonds have both been favoured, with spreads falling to near record lows. Returns from investment in equities in many countries have been even higher, little short of spectacular, while investments in property have also seen unusually high rates of return. Moreover, the resilience of EME financial markets to the recent turmoil in the financial markets of the industrial countries has also been far greater than earlier anticipated. Indeed, already robust capital inflows to EMEs actually accelerated as the turmoil worsened, and particularly after the Federal Reserve cut its policy rate in response. The fact that corporate borrowers were particularly favoured, in an environment marked by record issues of IPOs, was also notable and welcome.

Better fundamentals?

One can also point to a long list of “fundamentals” where many EMEs are alleged to have improved their economic performance. Domestically, growth has remained strong while inflation has to date stayed relatively subdued in spite of sharp increases in commodity prices. Government deficits and debt levels have also been brought under control, in part due to more restrained fiscal policies, but also reflecting in many cases the beneficial fiscal effects of higher commodity prices. Further, in a number of countries, improvements in banking supervision and more disciplined lending policies have reduced the proportion of non-performing loans while reducing the threat of financial instability more generally. In addition, the development of local currency bond markets has both improved the efficiency of
domestic capital allocation and reduced the threat of financial instability arising from currency mismatch problems.

Similarly, a number of improvements can be noted on the external side. In many, perhaps even most, EMEs, the current account position has improved dramatically, while external debt burdens have been commensurately reduced. Further, most countries have substantially increased the level of their external reserves as governments have generally used sterilised intervention to respond to various combinations of current account surpluses, workers’ remittances and capital inflows. Taken all together, these developments have even led some commentators to describe the recent increase in capital inflows into EMEs as a “flight to quality”, against the backdrop of considerable financial turmoil elsewhere. If so, this would constitute a truly remarkable turnaround from earlier days.

3 But now for the bad news?

Returns and resilience?

While recognising the recent high rates of return on EME assets, it is a simple truth that the future need not be like the past. Indeed, sovereign spreads now seem unusually low and price/earnings ratios rather high, dramatically so in the case of China and India. Mean reversion would have a big impact, though the likelihood of this is clearly dependent on an assessment of the “fundamentals” as well.

As to the resilience of EMEs to recent financial turmoil, and the associated capital inflows, here too causes for concern can be identified. To a very large degree, these inflows seem to have been motivated by short-term portfolio incentives which could easily be reversed. In particular, the search for high return along with low correlations has been a dominant influence, as indicated by the increase in flows after the recent cut in the fed funds rate. Unfortunately, we know from history that these correlations can turn on a dime, sometimes to devastating effect. Think, for example, of the recent carnage which affected many “quant funds” for exactly this reason. Perhaps most ominous, from an investor’s perspective, is that the authorities in many EMEs are themselves deeply concerned about a sharp reversal of recent capital inflows. Indeed, in many countries, most recently India, policy measures have been put in place to try and reduce such exposures.

In passing, it should also be noted that the much lower prevalence of securitised debt in EMEs has indeed helped insulate them from the recent financial turmoil. Nevertheless, it must be assumed that, in the fullness of time, these markets will also grow in EMEs because of the many benefits they can provide. This accepted, EMEs could then eventually be exposed to their costs as well.

Better fundamentals?

Many of the improvements noted above seem likely to be sustainable. In particular, the authorities in most countries now seem well aware of the costs of currency mismatches. Yet, this said, it is also worth noting that much of the better performance in the EMEs also reflects a highly supportive global economic environment that might or might not be sustainable. Evidently, I do not have time to comment on all of these alleged improvements, so let me
focus on just one of them. In doing so, I hope to provide some evidence that it is often worth digging below the surface of appearances.

Foreign exchange reserves are often said to provide insulation against future EME crises. Indeed, some say the principal lesson of the Asian crisis was that all EMEs needed more reserves as cushions. I disagree with this assertion. I thought the principal lesson was the need for more exchange rate flexibility. Indeed, I would go even further in asserting that the reliance on reserve accumulation and relatively easy monetary policies to hold down exchange rates could have set the stage for future crises in many EMEs. In effect, holding more reserves means a country can cope better with a crisis, but it may make a crisis more likely. Let me expand on such undesirable effects, at both the domestic and the international level.

**a) Undesirable domestic effects**

In their attempt to resist currency appreciation, through intervention and easier monetary policies, many countries have created truly “exuberant” domestic monetary conditions. Moreover, as in the industrial countries, financial deregulation and innovation have considerably amplified these procyclical tendencies.

To support this assertion, it can be noted that credit and monetary growth have in recent years been remarkably high in every major region in the emerging markets. Moreover, real interest rates virtually everywhere have been commensurately low, particularly relative to higher “natural” rates of interest generated by relatively higher potential growth rates. These developments clearly have the potential to generate overt inflation, even if it has not yet emerged in full force. In many EMEs, wages of skilled labour are rising fast and near-term capacity limits are being approached. Further, high food prices at the global level constitute a serious shock to both inflation and potentially inflationary expectations. This is particularly so given the relative importance of food in the typical EME consumer basket. At the least, it is clear that, over the next few years, the EMEs, and particularly China and India, will no longer be an important source of disinflationary pressure for the rest of the world.

But rising CPI inflation is not the only possible outcome arising from a long period of easy credit conditions. Another is the generation of various imbalances in the economy, both real and financial. Indeed, asset prices have been rising strongly in many EMEs, as noted above. Perhaps most important has been the increase in house prices in a wide range of countries. Finally, in a number of countries production and spending patterns look “abnormal”, though in often divergent ways. China particularly stands out, with an investment ratio of close to 50% of GDP and a personal consumption ratio that has been falling sharply. To me, this combination of easy credit conditions, rising asset prices and unusual spending patterns seems to be the classic set of preconditions for a possible “boom-bust” cycle. Moreover, the likelihood of this would be reinforced should the credit-induced expansion flatter assessment of the fundamentals and falsely inflate confidence. Such patterns have been seen in many countries over the years.

As for the argument that high foreign exchange reserves and trade surpluses offer protection against the emergence of such domestic problems, historically it has not been true. Japan was blessed with similar circumstances in the 1980s, yet subsequently experienced over a
decade of stagnation. While it is popular in China today to say that Japan’s problems began with letting the yen rise in 1985, this is a misreading of history. The fundamental Japanese mistake was trying to keep the yen down through massive credit expansion. And, as a further historical reference, look at the domestic credit card booms and busts that we have recently seen in Korea and a number of other countries in Southeast Asia. All had high reserves and current account surpluses.

It must of course be admitted, and welcomed, that trade surpluses and ample reserves provide a cushion against external shocks. But even here there can be dangers. In particular, they can incite a degree of optimism about the exchange rate that can lead to imprudent behaviour. Consider, for example, the extent to which banks in Russia and Kazakhstan have recently been willing to borrow abroad in foreign currency to finance domestic consumers. And, closely related, consider how optimism related to future entry into the EMU zone has also led to large-scale consumer borrowing in foreign currencies in a number of countries in central and eastern Europe. This phenomenon of good news leading to bad outcomes has been referred to by some of my colleagues as “the paradox of credibility”, and again is well documented historically.

b) Undesirable international effects

The efforts made by many EMEs to keep down the value of their currencies have impeded in various ways the adjustments required to deal with global current account imbalances, in particular the massive external deficit of the United States. First, keeping up the effective value of the US dollar undermines the “elasticity” channel of adjustment which works through relative price effects favouring US exports and discouraging US imports. Second, by reinvesting accumulated reserves in US dollars, EMEs put downward pressure on US long rates. This encourages spending and thus undermines the “absorption” channel of adjustment. Absent adequate, visible signs of external adjustment, the danger arises that markets might lose patience and that the recent orderly decline in the value of the dollar might turn disorderly. Perhaps worse than a loss of patience by markets, the US Congress might be tempted to revert to protectionism. This, in turn, would probably spark retaliation, which might take various dangerous forms.

It is also worth noting that, over the last five years or so, the EMEs have been responsible for over half of the growth in global monetary and credit aggregates. The liquidity they have created has thus materially augmented the credit excesses already of concern to many in the industrial countries themselves. In effect, EMEs’ exchange rate policies have increased the likelihood of sudden “boom-bust” adjustments elsewhere in the global economy. Should, in such a context, all asset prices be repriced, then the real-side fallout could be greater than many today expect. In particular, household saving rates that have fallen to levels without precedent in many countries, most of them English-speaking, might well rebound with substantial effects on growth and employment.

If the EMEs have contributed to this set of global circumstances, it would be only fair that they would also be affected in the event of a downturn in the industrial countries. But, apart from fairness, there are many reasons to believe that a full disconnect is not likely. First, slower growth in industrial countries will hurt the exports of EMEs directly. References to enhanced intraregional trade, especially in Asia, seem less soothing once it is recognised
that much of that trade involves importing parts for assembly in China and subsequent export to the industrial countries. Second, commodity prices are more likely to weaken. Third, general confidence effects could hit investment everywhere, particularly investments destined to produce goods for export markets. Fourth, a downturn in what has been a global housing boom of unprecedented scope and magnitude cannot be ruled out. Fifth, higher risk premia in the financial markets of industrial countries would probably be reflected in the markets of EMEs, particularly in countries already suspect for various reasons. And finally, should the US dollar fall more sharply in such an environment, by definition this implies a still stronger tendency to appreciation elsewhere. This would not only reduce exports from affected countries, but would also imply substantial valuation effects (losses) on creditors elsewhere. This reflects the size of US gross external liabilities, virtually all of which are denominated in US dollars. While many of these losses will be borne by official foreign exchange reserves, and thus “socialised”, negative wealth effects on both spending and financial stability could not be ruled out. In sum, in an increasingly “globalised” world, we are all in this together.

4 Will the good news or the bad news prevail?

The short answer is “who knows?”. There seems to be a growing inflation risk in both the industrial countries and the EMEs, but in recent decades inflation has surprised us repeatedly on the downside. As well, there do seem to be many credit-driven imbalances also affecting a wide range of countries. In this regard, Herb Stein once famously said, “If something is unsustainable, it will stop”, but Rudi Dornbusch then added, “Yes, but it will go on far longer than you expect”.

I think virtually everyone has been amazed over the last decade or so at the strength and resilience of the global economy. It could well carry on for an extended period, even if what we are now seeing in EMEs does eventually prove to be unsustainable. Nevertheless, the investors in this room should be aware that there are exposures out there, both in industrial countries and EMEs, that deserve serious attention. The recent turmoil in financial markets reminds us that the conclusion that 4 comes next is not always self-evident.