The trouble with emerging markets

Nouriel Roubini | Roubini Global Economics | 06 February 2014

The financial turmoil that hit emerging-market economies last spring, following the US Federal Reserve's "taper tantrum" over its quantitative-easing (QE) policy, has returned with a vengeance. This time, the trigger was a confluence of several events: a currency crisis in Argentina, where the authorities stopped intervening in the forex markets to prevent the loss of foreign reserves; weaker economic data from China; and persistent political uncertainty and unrest in Turkey, Ukraine, and Thailand.

This mini perfect storm in emerging markets was soon transmitted, via international investors' risk aversion, to advanced economies' stock markets. But the immediate trigger for these pressures should not be confused with their deeper causes - many emerging markets are in real trouble.

The list includes India, Indonesia, Brazil, Turkey, and South Africa - dubbed the Fragile Five because all have twin fiscal and current-account deficits, falling growth rates, above-target inflation, and political uncertainty from upcoming legislative and/or presidential elections this year. But five other significant countries - Argentina, Venezuela, Ukraine, Hungary, and Thailand - are also vulnerable. Political and/or electoral risk can be found in all of them, loose fiscal policy in many of them, and rising external imbalances and sovereign risk in some of them.

Then, there are the over-hyped BRICS countries, now falling back to reality. Three of them - Brazil, Russia, and South Africa - will grow more slowly than the United States this year, with real (inflation-adjusted) GDP rising at less than 2.5%, while the economies of the other two - China and India - are slowing sharply. Indeed, Brazil, India, and South Africa are members of the Fragile Five, and demographic decline in China and Russia will undermine both countries' potential growth.

The largest of the BRICS, China, faces additional risk stemming from a credit-fueled investment boom, with excessive borrowing by local governments, state-owned enterprises, and real-estate firms severely weakening the asset portfolios of banks and shadow banks. Most credit bubbles this large have ended up causing a hard economic landing and China's economy is unlikely to escape unscathed, particularly as reforms to rebalance growth from high savings and fixed investment to private consumption are likely to be implemented too slowly, given the powerful interests aligned against them.

Moreover, the deep causes of last year's turmoil in emerging markets have not disappeared. For starters, the risk of a hard landing in China poses a serious threat to emerging Asia, commodity exporters around the world, and even advanced economies.

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At the same time, the Fed's tapering of its long-term asset purchases has begun in earnest, with interest rates set to rise. As a result, the capital that flowed to emerging markets in the years of high liquidity and low yields in advanced economies is now fleeing many countries where easy money caused fiscal, monetary, and credit policies to become too lax.

Another deep cause of current volatility is that the commodity super-cycle is over. This is not just because China is slowing; years of high prices have led to investment in new capacity and an increase in the supply of many commodities. Meanwhile, emerging-market commodity exporters failed to take advantage of the windfall and implement market-oriented structural reforms in the last decade; on the contrary, many of them embraced state capitalism, giving too large a role to state-owned enterprises and banks.

These risks will not wane anytime soon. Chinese growth is unlikely to accelerate and lift commodity prices; the Fed has increased the pace of its QE tapering; structural reforms are not likely until after elections; and incumbent governments have been similarly wary of the growth-depressing effects of tightening fiscal, monetary, and credit policies. Indeed, the failure of many emerging-market governments to tighten macroeconomic policy sufficiently has led to another round of currency depreciation, which risks feeding into higher inflation and jeopardizing these countries ability to finance twin fiscal and external deficits.

Nonetheless, the threat of a full-fledged currency, sovereign-debt, and banking crisis remains low, even in the Fragile Five, for several reasons. All have flexible exchange rates, a large war chest of reserves to shield against a run on their currencies and banks, and fewer currency mismatches (for example, heavy foreign-currency borrowing to finance investment in local-currency assets). Many also have sounder banking systems, while their public and private debt ratios, though rising, are still low, with little risk of insolvency.

Over time, optimism about emerging markets is probably correct. Many have sound macroeconomic, financial, and policy fundamentals. Moreover, some of the medium-term fundamentals for most emerging markets, including the fragile ones, remain strong: urbanisation, industrialisation, catch-up growth from low per capita income, a demographic dividend, the emergence of a more stable middle class, the rise of a consumer society, and the opportunities for faster output gains once structural reforms are implemented. So it is not fair to lump all emerging markets into one basket; differentiation is needed.

But, the short-run policy tradeoffs that many of these countries face - damned if they tighten monetary and fiscal policy fast enough, and damned if they do not - remain ugly. The external risks and internal macroeconomic and structural vulnerabilities that they face will continue to cloud their immediate outlook. The next year or two will be a bumpy ride for many emerging markets, before more stable and market-oriented governments implement sounder policies.

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