

A perfect storm?

A number of events on the horizon could combine to form the “perfect storm” for emerging markets, says **Kristin Forbes**, unless governments and the international financial institutions act now

In October 1991 a “perfect storm” swept across the Atlantic, wreaking havoc and killing several Massachusetts fishermen (in a story later popularized by Hollywood). A perfect storm occurs when several specific events – each manageable in itself – build on and magnify each other. Emerging markets have been sailing in unusually-calm waters over the past few years, but this will not last. Interest rates are rising in the world’s leading economies and risk premiums will increase from their recent record lows. The world’s two growth engines, the US and China, are expected to slow. Commodity prices have already fallen from recent record highs. Could this confluence of events generate a perfect storm for emerging markets – causing a series of financial crises and even contagion around the globe?

Calm waters

The global environment has been supportive for emerging markets over the past few years. In 2004, global growth reached its highest rate in 30 years, driven largely by demand in America and China. This has pushed many commodity prices to record highs, favouring emerging markets and generally stimulating trade. Low interest rates in America, the eurozone and Japan have reduced borrowing costs around the world. Moreover, emerging-market borrowers have had to pay less of a risk premium over the “risk-free” rate that the American government borrows at, thanks to strong global growth, low levels of volatility in that growth and an absence of financial crises since 2001.

With nominal interest rates at or close to a post-war low, investors have looked for higher yields in non-traditional asset classes, such as emerging markets. The Institute of International Finance projects that total net private capital flows to emerging markets will reach a record \$345 billion in 2005 – up \$130 billion from 2003. Inauspiciously, the previous record was \$323 billion in 1996 – the year before the Asian financial crisis. Emerging markets have also been borrowing heavily through the bond markets and are expected to have set a record in bond issuance in 2005.

Low reward for risk

As capital has flowed to emerging markets, returns have fallen to levels that are hard to justify. “Spreads” on emerging market debt (or the risk premium) have declined fairly steadily



over the past three years, reaching a record low of 231 basis points (hundredths of a percentage point) in October 2005. As of early November 2005, the sovereign debt of Bulgaria, Egypt, Malaysia and Tunisia paid holders less than one percentage point more than America’s. Even a rise in inflationary concerns has had no noticeable impact on the cost of borrowing for emerging markets. Investors are requiring less compensation to invest in emerging markets – assets that are becoming riskier and riskier.

To be fair, this interest in emerging markets reflects a substantial improvement in their economic policies as much as the global backdrop. Real national income growth topped 7% in emerging markets in 2004 – the fastest rate in more than 20 years.

Many emerging markets have adopted more responsible fiscal and monetary policies and accumulated large reserves. Many now run current account surpluses rather than deficits (in layman’s terms, they are exporting more than

they are importing), making them net international lenders. Emerging markets have even been repaying the international financial institutions such as the International Monetary Fund (IMF) and the World Bank since 2003, with net repayments from emerging markets to official creditors expected to reach a record of \$50 billion in 2005.

Not only are emerging markets borrowing less, but many have also improved the structure of their borrowing. For example, Brazil and Colombia recently issued local-currency (instead of dollar-denominated) debt – thereby reducing their exposure to exchange-rate movements. Other countries have attempted to borrow for longer or to borrow money that they don't need yet to take advantage of today's low rates.

While these policy improvements undoubtedly make emerging markets less vulnerable, the global economic outlook is worsening. America's core interest rate increased by more than three points between June 2004 and December 2005, and is expected to rise to 4.5% by the end of January. Moreover, as rates increase, risk aversion is also likely to increase – a trend that could be accelerated by growing concern over large global imbalances.

At the same time, American and Chinese economic growth is expected to slow. This would not only reduce export growth in emerging markets, but would also lower demand for commodities, so many emerging markets would face lower export volumes as well as lower prices.

Worrisome trends

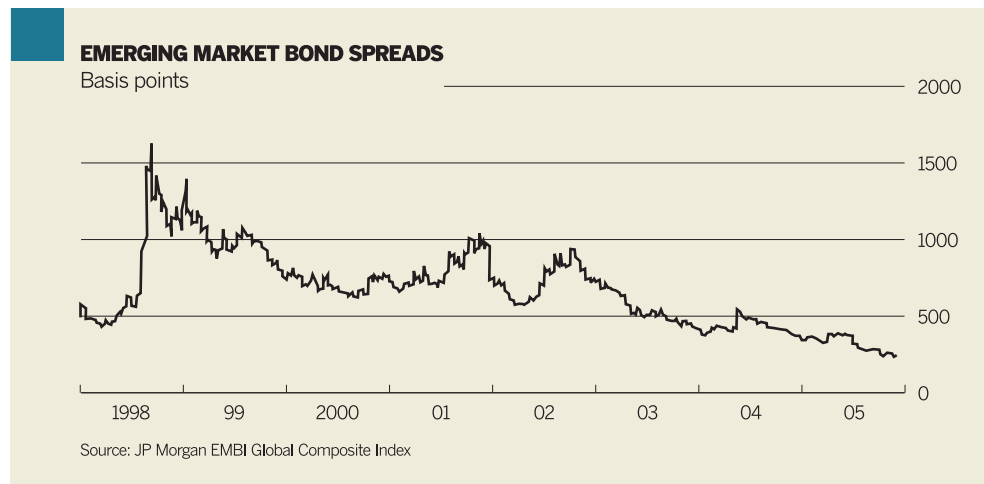
These changes could occur gradually, but several recent trends pose risks to a benign adjustment. One is the increased use of leverage in financial markets. Many investors have been borrowing today at low interest rates to invest large sums in riskier assets and increase their returns. Greater leverage increases the risk that one bad bet could force a big investor to unwind positions in other assets, magnifying the impact of the initial loss and raising the spectre of "contagion" from one market to another.

Another disconcerting trend is that – despite their policy improvements and more responsible fiscal policies – several major emerging markets still have high debt levels and vulnerable debt structures. The IMF expects that public debt in emerging markets will average 60% of national income by the end of 2005 – well above the 25% to 50% band generally considered safe for these countries.

While many have sensibly switched, at least in part, to local-currency denominated debt, this has often come at the cost of increased exposure to floating interest rates and short-term debt. So countries have often swapped exchange-rate risk for interest-rate risk.

A final, worrisome trend is the imbalances accumulating around the world. The IMF predicts that America's current-account deficit will reach about \$750 billion in 2005, while the Middle East will have a current account surplus of more than \$200 billion, Japan of \$150 billion, Germany of \$120 billion and China of \$100 billion.

Several analysts also worry that there are bubbles in the two engines of growth: a fixed investment bubble in China and a house-price bubble



in America. Soon these imbalances will begin to adjust, possibly causing sudden currency movements, sharply-higher interest rates and increased risk aversion, which would disproportionately raise the cost of borrowing for riskier emerging markets.

The changes that are likely to occur over the coming few years are far graver than the events that sparked previous financial crises. It is impossible to predict exactly what will trigger a crisis: an election upset, a terrorist attack on a financial centre or the rapid spread of bird 'flu. It could be a sharp fall in American housing prices, an increase in political unrest in China or riots in Paris, sparking violence in poor suburbs elsewhere. It could even be a breakdown of the global trade talks, combined with an outbreak of protectionist sentiment in major economies.

Thankfully, there is plenty that policymakers and investors can do to reduce the risk of a severe financial crisis. The greatest responsibility lies with governments in emerging markets. Not only is it their citizens who suffer most from financial crises, but sound economic policies and good governance are the best way to build investor confidence.

Weathering the storm

Emerging-market governments should continue their sound monetary and fiscal policies, and accelerate structural reforms to raise productivity growth. Vulnerable countries should consider establishing programmes with the IMF providing automatic credit lines if a crisis strikes – thereby strengthening investor confidence in their ability to finance their debts. Emerging markets should also consider introducing new financial instruments – such as bonds with payments linked to their own growth rates or to growth in their export markets – to help provide a natural hedge against future slowdowns.

Investors should also carefully assess their portfolios and should avoid making investments to match a benchmark if they do not believe that the expected return adequately compensates them for the risk. They should also limit their leverage and ensure that they have policies for prudent risk management.

Although risk assessment models (such as the popular value-at-risk models) should be part of this, these models are imperfect and often fail

to capture the risk of severe illiquidity during the extreme market movements that tend to occur during a perfect storm.

The IMF and World Bank also have a role to play. Most important, they must not be complacent. Instead, they should provide regular warnings of the potential vulnerabilities in emerging markets. This includes forthright and timely reporting based on their monitoring of financial markets. The IMF and World Bank should also support new financial instruments that would help emerging markets better hedge against future risks from the deterioration in the global economy. The IMF should consider developing a "shocks" facility to provide financial assistance to countries that follow sound policies but are affected by events outside of their control.

If government officials, investors and the international financial institutions fail to take these steps, the risk of a perfect storm will increase substantially as the global environment deteriorates. The risks in early 2006 are fairly modest, especially if growth slows gradually in America and China, and interest rate increases are moderate. But, over the next few years, the risks will escalate – especially if combined with other unforeseen events. Several large emerging markets remain highly vulnerable and may not be able to withstand this combination of powerful forces.

As the Massachusetts sailors learned in 1991, once the perfect storm forms, it can be hard to avoid and impossible to stop. **GA**



CV KRISTIN FORBES

Kristin Forbes is associate professor of economics at the Sloan School of Management at the Massachusetts Institute of Technology and a Young Global Leader (WEF). She served on the White House Council of Economic Advisers from 2003 to 2005.