Will Fed tightening choke emerging markets?

By Jeffrey Frankel

March 23, 2015 – *Project Syndicate*

As the Federal Reserve moves closer to initiating one of the most long-awaited and widely predicted periods of rising short-term interest rates in the United States, many are asking how emerging markets will be affected. Indeed, the question has been asked at least since May 2013, when then-Fed Chairman Ben Bernanke famously announced that quantitative easing would be "tapered" later that year, causing long-term US interest rates to rise and prompting a reversal of capital flows to emerging markets.

The fear, as IMF Managing Director Christine Lagarde has reminded us, is of a repeat of previous episodes, notably in 1982 and 1994, when the Fed's policy tightening helped precipitate financial crises in developing countries. If the Fed decides to raise interest rates this year, which emerging markets are most vulnerable to a capital-flow reversal?

There is no question that emerging markets are highly sensitive to global market conditions, including not only changes in short-term US interest rates, but also other financial risks, as measured, for example, by the volatility index VIX. Capital-flow bonanzas, often spurred by low US interest rates and calm global financial markets, end abruptly when these conditions reverse.

By the end of the currency crises in East Asia and elsewhere in the late 1990s, emerging-market governments had learned some important lessons. Five reforms were particularly effective: more flexible exchange rates, larger foreign-currency holdings, less pro-cyclical fiscal policy, stronger current accounts, and less debt denominated in dollars or other foreign currencies.

Many, but not all, developing and emerging-market countries took steps to implement these desirable policies. Their choice was put to the test during the 2008-2009 global financial crisis. Countries that had adopted such reforms were, on average, less adversely affected. Those that had not, particularly middle-income countries in Central Europe and the continent's periphery, tended to be hit the hardest.

In particular, after 2001, many developing countries overcame their historic pattern of using periods of capital inflows to finance large fiscal and current-account deficits. As a result of reduced debt and enhanced reserves, their creditworthiness improved during the 2003-2007 boom. By 2008, they were in a strong enough position to respond to the financial crisis by allowing larger budget deficits and thus mitigating the downturn in 2009. Chile was the star reformer, but other countries – including Botswana, China, Costa Rica, Malaysia, the Philippines, and South Korea – also avoided pro-cyclical fiscal policies.

Unfortunately, policy backsliding is jeopardizing this historic "graduation" from pro-cyclicality. Countries like Brazil did not take advantage of the recovery from 2010 to 2014 to strengthen their budgets, and are now in a difficult position. Some of these countries used the renewed capital inflows to run large current-account deficits after 2010 as well. Such deficits, together with high inflation rates, earned Brazil, Turkey, and South Africa their membership on the Fragile Five list of countries that were hit particularly hard by Bernanke's announcement in 2013. India and Indonesia were on this list as well, though they

have begun to move in the right direction since then (thanks in part to new governments).

Then there are the countries – including Venezuela, Argentina, and Russia – that never moved in the reform direction in the first place. They were temporarily bailed out by strong world prices for their export commodities, but that ended last year.

A less visible threat is the denomination of debt in dollars and other foreign currencies. The currency crises of the 1980s and 1990s were particularly devastating because devaluations so often hit countries that had borrowed in dollars. This resulted in a "currency mismatch" between dollar liabilities and revenues that were often denominated in local currencies. When the cost of dollars doubled in terms of pesos or rupiah, otherwise-solvent local banks and manufacturers could no longer service their dollar debts. Owing to this adverse balance-sheet effect, devaluation turned out to be contractionary, leading to severe recessions.

Most emerging-market borrowers had learned their lesson by the turn of the century, as exchange-rate volatility had made the risks of currency mismatch more tangible. When international investors came knocking again in 2003, many emerging markets declined to borrow in dollars or other foreign currencies. Instead, they took the inflows in the form of direct investment, equity, or debt denominated in local currency.

The relative absence of mismatch was one of the reasons why emerging markets did much better when their currencies depreciated in 2008-2009 than in past crises. Exceptions like Hungary, where homeowners had foolishly borrowed in seemingly cheap euros and Swiss francs, proved the rule.

Unfortunately, in the last five years, many emerging markets have reverted to borrowing in foreign currency. Though, for the most part, governments have continued the shift away from dollar debt, the corporate sector, as the Bank for International Settlements has warned, has been tempted by ultra-low interest rates.

The Chinese private sector may have the biggest problem. Much of its recent borrowing violates key tenets of hard-earned wisdom gained in past crises: it is foreign exchange-denominated, short-term, shadow-bank-intermediated, and housing-backed.

Even though the Fed has not yet started raising interest rates, the well-established US economic recovery and the prospect of monetary tightening have, over the last year, caused the dollar to appreciate sharply against most currencies, those of emerging markets and advanced countries alike. If the Fed tightens as early as the middle of this year, further dollar appreciation is likely. Those who have been playing with mismatches may be about to get burned.

Jeffrey Frankel, a professor at Harvard University's Kennedy School of Government, previously served as a member of President Bill Clinton's Council of Economic Advisers.