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Emerging Markets Crisis: Composure and Realism

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In the midst of the emerging market turbulence, several European ministers have tried to provide reassurance: fear not, they insist, the recovery in the euro area and in individual countries (including Italy) is not at risk, our forecasts still hold, economic growth will return in 2014. But, one wonders, how can such a fragile recovery remain unaffected by difficulties in as wide a swathe of export markets? Concerns arise spontaneously and official assurances tend, perversely, to reinforce them.

As often happens in such cases, the truth straddles the two views. The official view is unrealistically rosy, and politically motivated. It is clearly naïve to believe that the euro zone can remain immune to the difficulties of the one country group that has driven world economic growth in recent years. The top 15 countries for Italian exports include the likes of China, Turkey, Poland, Russia, Romania and Brazil. Not all are experiencing the same difficulties, but the slowdown in China is among the major risk factors for the world economy, and Turkey and Brazil are among those on the frontline of pressures. Their currencies have dropped by 20-25% against the euro since May 2013, providing valued support to their exports and braking imports. This is a called-for correction, especially for Turkey (whose current account deficit exceeds 7% of GDP), but with negative spillovers for Italy and other partners (with neighbouring Greece suffering the most direct contagion). To counter their currency's free-fall and its inflationary impact, many emerging countries have raised interest rates, at times aggressively so, thereby braking domestic demand. This process is set to continue. To state, as some European officials have indeed done, that all of this "has nothing to do with us" is clearly ingenuous. Exports, the only engine of European growth so far, will inevitably be whacked.

At the same time however it is also right not to overstate the likely impact. The IMF, in last week's update of the World Economic Outlook, did indeed cut its projection for emerging market growth, but upped that for the world economy as a whole, thanks to the increasing strength of advanced economies, particularly of the U.S. (Italy being a sad exception, with its growth forecast for 2014 revised downward, albeit by only one-tenth of a percentage point, to 0.6 %). Above all, one has to agree with those who maintain that this emerging market crisis differs from those of the past. Certainly, saying "this time is different" is rather boldfaced, given the phrase's unfortunate use in the recent past. But there are good reasons to believe that many emerging countries – though admittedly not all (Argentina) – are now better equipped to withstand market pressures, with more flexible exchange rates, higher reserves, and lower debt levels.

There is finally a more general lesson from current emerging market developments. The Fed's accommodative monetary policy stance has flooded the world with liquidity, raising risk appetite and giving rope to emerging economies. Some have employed it wisely (e.g., Chile, Poland and Mexico), others have stretched it too far or even ultimately used it to hang themselves. With the gradual withdrawal of liquidity, the latter countries' problems have come home to roost. As will happen for all sectors sustained in this manner, including in part stock valuations. We will know today (Wednesday 29) whether the Fed will alter the pace of tapering in light of recent developments; it seems unlikely, and the trend to withdraw stimulus is in any event firmly en route.

A similar situation prevails within the euro zone, where ECB policy has served to ease sovereign debt pressures, while helping banks with portfolios stuffed with government bonds. Here too, however, if the resulting virtuous situation is not used to address the ingrained structural problems, both of the economy and of banks, the underlying difficulties will re-emerge at the first sign of reversal of the easing cycle. Or perhaps even earlier than that, with the return of greater investor risk appetite – possibly already under way. Again, this would be a suicidal use of the rope provided by central banks. Dealing with the present emerging market crisis thus requires both composure and realism. The composure prescribed by an awareness that this is not a repeat of the past deep crises, but also the realism to recognize that, in a more interconnected world, whoever stops on the road to reform will fall by the wayside.

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