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Preparing for the Next Emerging Market Crisis

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OVERVIEW

Bottom Line: Emerging markets face the greatest risk of contagion from a hard landing in China. The threat seems modest compared to the Asian financial crisis or Great Recession, but, in the event of a crisis, policymakers may not be up to the task of an aggressive and coordinated response.

At the recent International Monetary Fund (IMF) and World Bank annual meetings in Peru, the central debate was over whether China's economic crisis represents a systemic threat to the global economy. August's sharp drop in financial markets—now partly reversed—was to some an overreaction to China's economic problems and to others a harbinger of worse to come. Trade flows have dropped, with the commodity-exporting countries hit particularly hard, but it was the emerging markets' financial linkages to China that drew the most discussion. The IMF's *Global Financial Stability Report* made the controversial argument that high levels of debt and leverage in major emerging markets create a systemic risk that could endanger the global recovery. That was the story from Lima.

> *The China-driven concerns are modest compared to the 1997 Asian financial crisis or the Great Recession.*

The consensus of mainstream economists is that these China-driven concerns, although mounting and worrisome, do not match the threat posed by the 1997 Asian financial crisis or the Great Recession. In the years since the Asian financial crisis, many emerging-market governments have built large levels of international reserves to provide a buffer against such shocks. China illustrates the trend: despite massive losses over the past three months, its international reserves are more than $3 trillion, well in excess of obligations coming due (even acknowledging that not all of the government's reserves are liquid and useable). In addition, structural reforms have opened economies and made them more flexible, and financial regulation is more focused on limiting risk from large exchange-rate movements. Lessons have been learned.

Perhaps most importantly, there is a far greater degree of exchange-rate flexibility in the major emerging markets now than there was in the 1990s, which has prevented substantial currency misalignments of the magnitude that triggered exchange-rate crises in the past. Goldman Sachs, for example, argues that emerging markets are far more competitive now than at the start of earlier crises (see figure 1, where low values reflect greater undervaluation).

REASONS FOR CONCERN

Still, if there is a hard landing in China and a resulting reemergence of the kind of financial stress witnessed in August, policymakers must be prepared to respond. On this count, there are four reasons for concern.

FIGURE 1. EMERGING MARKET CURRENCY VALUATION

Source: Goldman Sachs, Investment Strategy Group, Investment Management Division © 2015

First, the scale of the financial imbalances is large. The massive growth in emerging markets, and their greater integration in global financial markets, has been reflected, in particular, by a rapid rise in corporate and household indebtedness and far more complex financial linkages than in the past. Corporate emerging-market debt now stands at $18 trillion, or close to 75 percent of gross domestic product (GDP), and leverage has soared. The Great Recession reminded us that interconnectedness—even more than the size of financial institutions—can be a recipe for crisis. The lack of transparency regarding China's economic policies and relationships matters as well. China's importance for financial markets and supply chains is not well understood, and a hard landing in China, renewed crisis in Europe, or even the anticipated normalization of U.S. monetary policy could cause real distress in countries as diverse as Brazil, Turkey, and Korea.

But there are reasons for concern: large financial imbalances, weak global growth, inadequate official resources, and political pressures.

Second, the currently weak global growth environment limits the scope for policymakers to respond, should demand fall sharply. A few years ago, the judgment that emerging markets had come out of the Great Recession with strong fiscal and monetary positions—"policy space"—provided optimism that these markets could outgrow the industrial world and would be able to adopt expansionary cyclical policies in the face of a global shock. That optimism is now dashed, in part reflecting that many countries' strong fiscal positions have been wasted and market reforms rejected.

Nowhere is that sense of lost opportunity more acute than in Brazil. Since taking office in 2011, the Dilma Rousseff administration has pursued an expansionary fiscal policy that appears not to have contributed much support to economic growth. Meanwhile, inflation is rising, and failure to address structural problems in the economy has lowered productivity and crippled private sector confidence. Unsuccessful efforts to restore fiscal balance this year have further undermined confidence in the government. As a result, Brazilian markets have come under increased market pressure.

Third, the global fire station is poorly equipped to deal with future blazes. Over the past two decades, the policymaking community's official resources to address crises have not kept pace with the rapid growth of financial markets. The IMF has seen its resources bolstered, but a recent reform package that would have strengthened its governance and ensured broad support for its crisis resolution efforts remains stuck in the U.S. Congress. At the same time, growing fiscal constraints in the major creditor countries limits the capacity of governments, most significantly in the United States and Europe, to contribute bilateral funds to rescue efforts. Coming up with the necessary official sector finance will pose an increasing challenge for dealing with protracted, large-scale financial crises. In Greece in 2012 and Ukraine this year, it was the inadequacy of official funding and the resultant financing gaps, as much as anything else, that dictated the timing and extent of private debt restructurings.

While a severe global financial crisis remains a tail risk, policymakers need to be prepared to respond.

Fourth, political pressures on governments are also limiting their ability to respond actively with financing and the other tools at their disposal—including regulatory measures and through the bully pulpit—to address market crises. In Europe, rising populism on both the left and the right, and bailout fatigue after years of crisis in the periphery, has weakened governments and reduced support for bailouts. In the United States, the Dodd-Frank Act and other postcrisis legislation and regulation limit the capacity of the Federal Reserve and Treasury to provide emergency support. In contrast, during the 1994 Mexican bailout and the 1997 Asian financial crisis, the creative use of U.S. economic power—including moral suasion on banks to participate in restructurings—played a central role in stabilizing markets. In recent years, the Group of Twenty (G20) has been the focus of policy coordination, but whether that group could find common cause as it did in 2008 remains a question.

CRISIS PREPAREDNESS

Chinese policymakers have the tools and the resources to stabilize their economy in coming months, though the multiyear challenge of rebalancing and reforming their economy and dealing with the legacy of past overlending is still to be firmly addressed. Although a severe global financial crisis remains a tail risk and not the base case, governments should be prepared to respond. A strengthened and reenergized G20, an IMF with adequate resources and improved governance, and governments willing to act aggressively to deal with potential contagion are all needed to ensure that the downside scenario, if it occurs, does not become a major crisis.

Looking Ahead: Kahn's take on the news on the horizon

United States
While keeping the current interest rate unchanged, the Federal Reserve also signaled a possible rate increase in December and downplayed previously highlighted concerns over China.

Europe
The European Central Bank (ECB) is likely to expand quantitative easing by December, though some ECB officials do not see a convincing reason for rush action.

China
The Chinese Communist Party, at its Fifth Plenum, has laid out the next Five Year Plan (2016–2020). Although its details are not yet public, the plan targets an annual growth of no less than 6.5 percent for the next five years.