Ewald Nowotny: Emerging markets – boom and bust

Speech by Prof Dr Ewald Nowotny, Governor of the Central Bank of the Republic of Austria, before the United Nations Economic and Social Council, New York, 14 April 2014.

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Recent economic developments in emerging markets and outlook

The global economy has gone through turbulent times since the outbreak of the financial and economic crisis in 2008. Following the "great recession" in 2009, the global economy gained momentum in 2010 and 2011, mostly on the back of the strong economic performance of emerging market economies. After another slump in economic activity in 2012 and 2013, mostly due to the sovereign debt crisis in Europe, advanced economies are now back on the recovery track while emerging markets have come under pressure.

A decisive factor in this context seems to be the future conduct of monetary policy in advanced economies. The increase in government bond yields in the U.S.A. since early 2013 and the Fed's indication of May 2013 that it may taper its unconventional monetary policy have correlated with sizable capital outflows and currency depreciation in emerging markets; this points to pronounced global macro-financial interdependencies. However, as I will discuss in more detail later on, it should be noted that domestic macroeconomic fundamentals play an equally decisive role in emerging markets. Apparently, emerging market economies with larger external and internal imbalances have been faced with stronger currency depreciations (as shown in the IMF's GFSR, October 2013).

Most of the countries under pressure tightened their monetary policies to dampen capital outflows. Although these actions have so far helped to lift some pressure on financial market indicators, the cost of capital has increased, which is expected to dampen investment and weigh on growth. Accordingly, in its recent World Economic Outlook the IMF revised downward the 2014 and 2015 GDP growth forecasts for several emerging market economies (among others, Argentina, Russia and Turkey).

Let me briefly stress the related impact on countries in Central, Eastern and Southeastern Europe (CESEE, "emerging Europe"). Most of these countries have so far weathered the pullback of capital rather well. Since 2008, current account and fiscal imbalances have decreased and most CESEE countries have become less reliant on foreign capital. As a result, these CESEE countries will most likely not be forced to abruptly raise interest rates to fight currency depreciation. For those CESEE countries with well-capitalized banking sectors that do not rely on capital imports, some weakening of their currencies could even give some momentum to economic recovery.

On the other hand, we have seen that the Fed's announcement of tapering has had a substantial impact on Russia, Ukraine and Turkey, which have been experiencing considerable capital outflows and currency depreciation since mid-2013. These developments in Russia and Ukraine were exacerbated by rising political uncertainty, which reached its climax in the context of the geopolitical tensions caused by the crisis over Crimea in March 2014. A further escalation of the conflict, including EU sanctions vis-à-vis Russia, could severely affect the economic situation of the whole region. So far, however, the impact of the political crisis on other CESEE countries has been contained. The countries have relatively limited direct export linkages with Ukraine. Also, Russian gas exports seem to continue to run smoothly. Similarly, the crisis has so far had only limited impact on financial markets in the region. The Russian economy, by contrast, already seems to be substantially affected (rising capital outflows, rating downgrades, slowdown of economic activity).

From boom to bust or back to balance? The nature of current emerging market problems

In order to better understand the general picture behind the shift in capital flows and the depreciation pressure in several emerging markets, let me briefly reflect on the build-up of these problems. Apparently, they are rooted in the period of easy finance after 2008. Global liquidity and access to foreign capital at relatively low cost were ample during this period. While advanced economies contracted, many emerging market countries launched domestic stimulus measures and eased the monetary policy stance to compensate for the decline in exports. In many emerging markets, moderate credit growth before 2008 turned into credit booms and rapid asset price increases, as these countries strengthened domestic demand and took advantage of capital flowing out of advanced economies.

At the same time, the drive for reform diminished, resulting in a loss in external competitiveness. Altogether, these developments led to considerable exchange rate appreciation and a significant increase in current account deficits in most emerging market economies (also Russia has experienced a shrinking current account surplus). Several emerging markets eased monetary conditions further to limit exchange rate pressures. As a consequence, a number of emerging market economies were challenged by a combination of exceedingly large current account deficits, too strong exchange rates and overly low interest rates when entering the recent period of economic recovery and pending exit from expansionary monetary policy in the U.S.A.

The question arises whether what we see now is just a reversal of imbalances that will be accompanied by a soft landing or whether we have to worry about a severe economic bust. In general, there is ample empirical evidence that compared to advanced economies, emerging economies experience larger output volatility and a more frequent sequence of boom-bust cycles. However, although each crisis has its own particularities, and “sudden stop” events are nearly impossible to predict, I do not believe that at the current stage we are facing an emerging market crisis of a dimension similar to the one of the 1990s.

What are the key differences to the emerging market crises in the 1990s?

Let me first point out the positive developments we have seen over the past decade: Macroeconomic policy frameworks and structural fundamentals have improved in many emerging market economies. Most notably, emerging markets should now be less prone to exchange rate mismatches. Most of them have shifted toward exchange rate flexibility; in many instances, exchange rates are no longer the nominal anchor, as emerging market central banks are now largely pursuing inflation targeting. Moreover, foreign currency debt has been settled to a large extent, while sizable foreign currency reserves have been piled up during the boom years. At the same time, domestic-currency bond markets have been established. Equally noteworthy are substantial reforms in financial regulation and supervision as well as more fiscal vigilance and lower public debt ratios.

Nevertheless, as I have mentioned before, some new risks have emerged and they must be taken seriously.

- First, the current combination of interest rate hikes and slowing GDP growth in several emerging markets may put stress on domestic borrowers and the banking sector. If this pressure is significant enough, additional capital exit and currency depreciation could be the consequence.
- Second, emerging markets and advanced economies are now much more integrated than they used to be in the 1990s. The share of emerging markets in global trade and GDP has increased strongly. In addition, despite the build-up of domestic-currency bond markets, there is still considerable dependence on foreign funding as a large share of local currency bonds is held by foreign investors.

Altogether, these observations point to an easier transmission of shocks from advanced to emerging economies and vice versa.

- Third, tighter monetary policy conditions in advanced economies could also result in lower global commodity prices, which would have a negative impact on emerging markets as many of them are the main exporters of commodities.
- Fourth and probably most worrisome, in several emerging market countries considerable political tensions have emerged recently, which may have been masked by the economic boom of previous years. We must not forget that the people's trust in their governments is a key prerequisite for a soft landing and maintaining financial sector stability.

What policy challenges lie ahead?

Let me conclude with some policy considerations. At the current stage it is of utmost importance that a further escalation of geopolitical tensions in Ukraine can be avoided. A spiral of economic sanctions of increasing severity cannot be in the interest of either Russia or the EU or the U.S.A. Moreover, it is important to contain political risks in other emerging markets.

The delay in the Fed's tapering should be used to address external and internal macroeconomic imbalances in the emerging market economies as soon as possible in order to be better prepared for the eventual monetary tightening in the U.S.A. Prudent macrofinancial measures are necessary to address potential negative balance sheet effects on domestic borrowers or a stagnation in lending, which could arise in the medium run from the combination of increasing interest rates and relenting GDP growth.

Finally, it should be noted that global financial stability is a shared responsibility. The Fed should therefore clearly communicate the path of its intended policy actions to minimize negative spillovers which could undermine the policy adjustment efforts of emerging markets.

Altogether I believe that emerging market economies will be able to address these challenges appropriately and that they will emerge from this crisis situation stronger and more resilient!