Mojmír Hampl: Examining the resilience of emerging markets

Speaking points by Mr Mojmír Hampl, Vice Governor of the Czech National Bank, at the third Annual SSGA-OMFIF Roundtable, London, 10 April 2018.

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Let me start with a discussion of what it means for an economy to be classified as "emerging". First of all, it is important to realise that our current taxonomy is to a large extent based on the Marxist tradition of classifying economies according to "stages of development". Prior to Marx, there was no such taxonomy and really no need for it. Instead, we used to group countries according to different criteria, such as religion, race, or territory.

But any discrete classification is arbitrary and artificial, and can sometimes even be confusing. For example, the post-communist countries of Central Europe are typically classified as "developed" by most governmental or international institutions (the IMF, World Bank and EBRD), but as "emerging" by most market institutions (FTSE, MSCI, S&P and J.P. Morgan, among others). What makes the entire issue even more complicated is that having an emerging financial market does not immediately imply being an emerging country, and theoretically vice versa.

To put these thoughts into perspective, let me use the classification put forward by J.P. Morgan, according to which both Bangladesh and the Czech Republic rank as emerging economies: in this taxonomy, they are at the same stage of development. But the Czech Republic has a higher GDP per capita than Portugal (or Greece, for that matter, and many other countries in the euro area) and is getting closer and closer to Spain, a solidly developed country according to all measures.

The Czech Republic also has a human development index comparable to that of Austria and Italy. In fact, living standards in the Czech Republic have been higher than those in Portugal for at least a quarter of a millennium, since the start of the industrial revolution (with the possible exception of a couple of decades centred on 1990). But once a country enters the euro area, it is almost automatically treated as a developed country, even in the eyes of the markets. Personally, I find that rather confusing.

In practice, therefore, we observe that some nominally "emerging" countries (such as Poland, Israel and Singapore) have been dealing with exactly the same issues as the nominally developed ones. At the same time, some nominally developed countries (such as Greece) are dealing with problems typical of developing countries, issues including incomplete land registries and an insufficient basic ability to collect taxes.

This confusion in taxonomy complicates our discussion a great deal, especially in the years of the crisis and its aftermath. The question at the beginning of the crisis was: who in Europe will prove to be most vulnerable to shocks? Many believed it would be Central and Eastern European countries. But, in contrast to that prophecy, at the end of the day the countries that did not have to bail out any of their financial institutions were, with one exception (Malta), located typically in the CEE region.

So it seems to me that GDP per capita, human development and industrial tradition are not the criteria driving the market's classification of "emerging" economies. Should euro membership automatically make a country "developed"? In other words, does giving up independent monetary policy make a country more "stable"? But why, then, isn't Bulgaria considered a developed country, when it holds a fixed exchange rate against the euro? Why not Kosovo and Montenegro, which have adopted the euro unilaterally?

Much space has been devoted to the so-called decoupling debate, in which many experts

claimed that emerging countries were less affected by the global financial crisis. But with the benefit of hindsight, we now know that the GDP declines in emerging countries were, on average, just as steep as those experienced by developed countries.

A part of the explanation, once again, lies in the confusing taxonomy: we see huge differences among individual emerging countries as well, even within BRICS. I suggest an analogy to the decoupling debate: we are now observing a "BRICS decoupling" to the power of two: only China and India have shown robust growth since the Great Recession. Russia, Brazil and South Africa have been stagnating, each for its own specific reasons.

But despite these differences, a common theme arises: emerging markets dependent on the production and export of raw materials (Russia, Brazil and South Africa serve as good examples) are less resilient than countries dependent on vigorous labour force and innovations (exemplified, within BRICS, by China and India).

There are also differences in resilience among the "emerging" countries of Central Europe. During the Great Recession, Poland – a big country (by Central European standards), less open and with greater potential for catch-up growth – proved to be the most resilient. The Czech Republic was also quite resilient (it experienced its own banking crisis in the late 1990s, with banks becoming more conservative and risk-averse in consequence). Hungary and Slovenia proved less resilient, and in these countries the government had to intervene in the financial market. In the case of the Czech Republic, the fact that our host financial sector was more resilient to shocks than its home countries was the reason why we never joined the Vienna Initiative.

The resilience of emerging economies is now under the spotlight also because we remember the effects of the 2013 taper tantrum. That year, many emerging countries experienced a huge outflow of capital, while at the same time some other countries like the Czech Republic and Poland were effectively trying to discourage foreign short-term capital from coming in. This discouragement was accompanied by interest rate cuts and other forms of monetary easing in general. And we are observing no taper tantrum in response to the current plans aimed at unwinding the ECB's QE: so far, emerging countries appear to be surprisingly resilient. The likely reason is a different backdrop, with rising commodity prices and synchronised global growth as the leading factors.

I will close with a short observation on the so-called China effect in relation to emerging markets' resilience. For decades, China has pumped savings into the global economy. Among other effects important for advanced and emerging economies alike, this inflow of savings has depressed the global equilibrium interest rate. The decrease in the equilibrium rate has, in turn, restricted the options of central banks around the world and nudged them to rely more on unconventional policies, with important effects on the stability of flows to and from emerging economies. But the China effect will soon start to ebb as the country's dependence ratio spikes, pushing global interest rates higher.