The crisis of emerging countries and its impact upon the global economy

Paolo Guerrieri

University of Rome, Sapienza

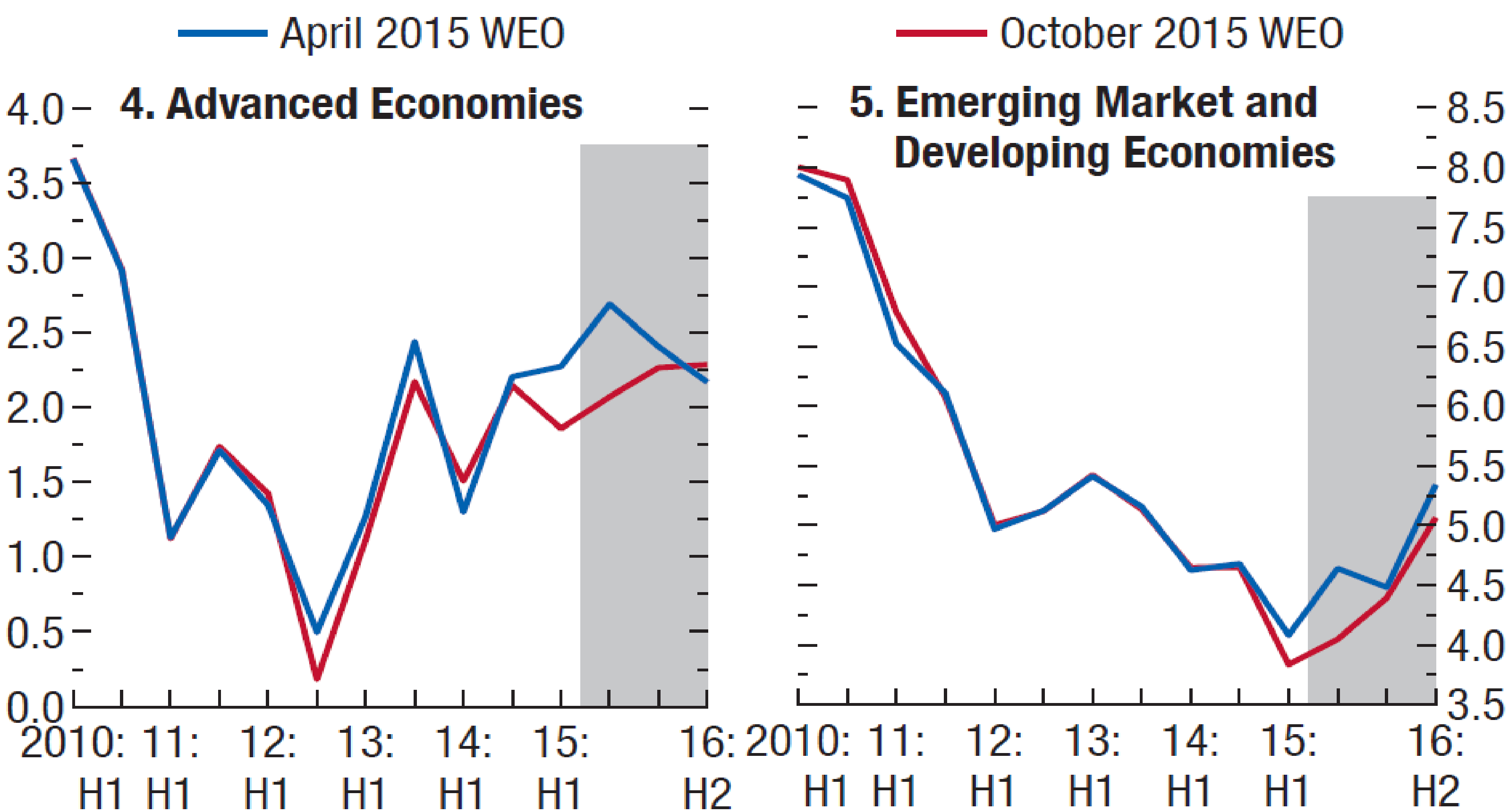
College of Europe, Bruges

Torino – 27-28 November 2015

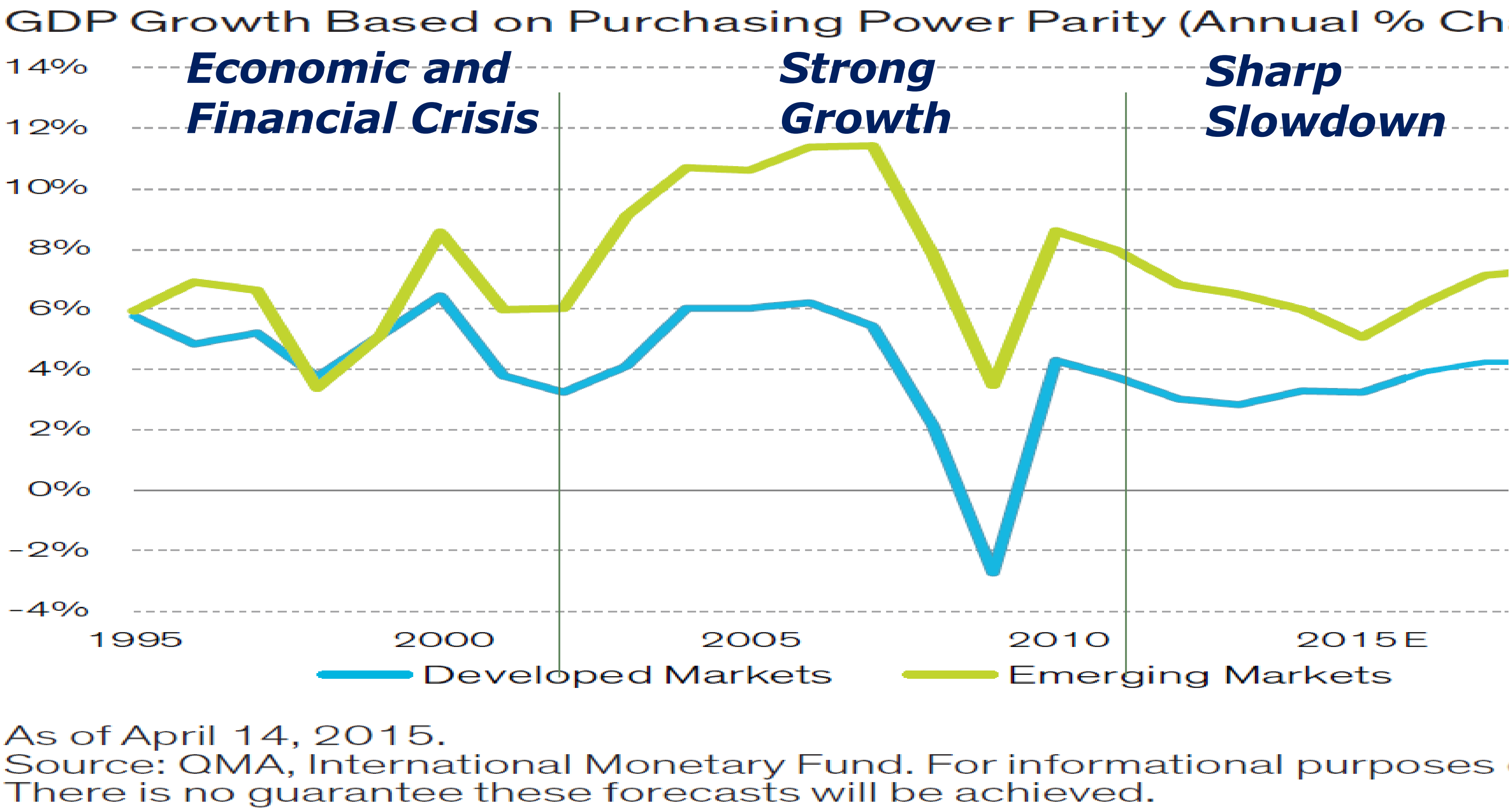
CONTENT

- ✓ *Sharp slowdown of growth in EM and financial pressures on EM markets,*
- ✓ *Reversals of DM vs EM Growth Fortunes*
- ✓ *The recent slowdown of EM: cyclical and structural factors*
- ✓ *Will financial pressures intensify to the point of a crisis in some EM or will they diminish?*
- ✓ *It is very clear that the risks in the global economy are rising*
- ✓ *Medium term optimism for EM in spite of short run pressures*

GDP Growth
(Annualized semiannual percent change)



In 2012-15: Sharp slowdown of growth in EM and financial pressures on EM markets, signs of stronger growth in DM (US, UK, less so in EZ and Japan)



- ✓***Emerging market (EM) economies experienced many economic and financial crises in the 1994-2002 period***
- ✓***Strong growth in EM in the last decade (2003-2012) due to structural factors and cyclical ones***

Reversal of DM vs EM Growth Fortunes

- Emerging market financial crises 1994-2002:
  - Mexico (1994), East Asia (1997-98), Russia (1998), Brazil (1999), Turkey and Argentina (2001), Uruguay and Brazil (2002)
- Strong growth in EM in the last decade (2003-2012)
- Domestic factors:
- - Sounder monetary and fiscal policy and stronger balance sheets after the EM crises of the 1990s
  - Macro structural reforms (trade liberalization, openness to FDI, privatizations)
- External factors:
  - **China strong lasting growth (10% growth)**
  - Commodity price rise (partly because of China)
  - Easy monetary policies in DM. Zero rates and liquidity searching for yield after 2009

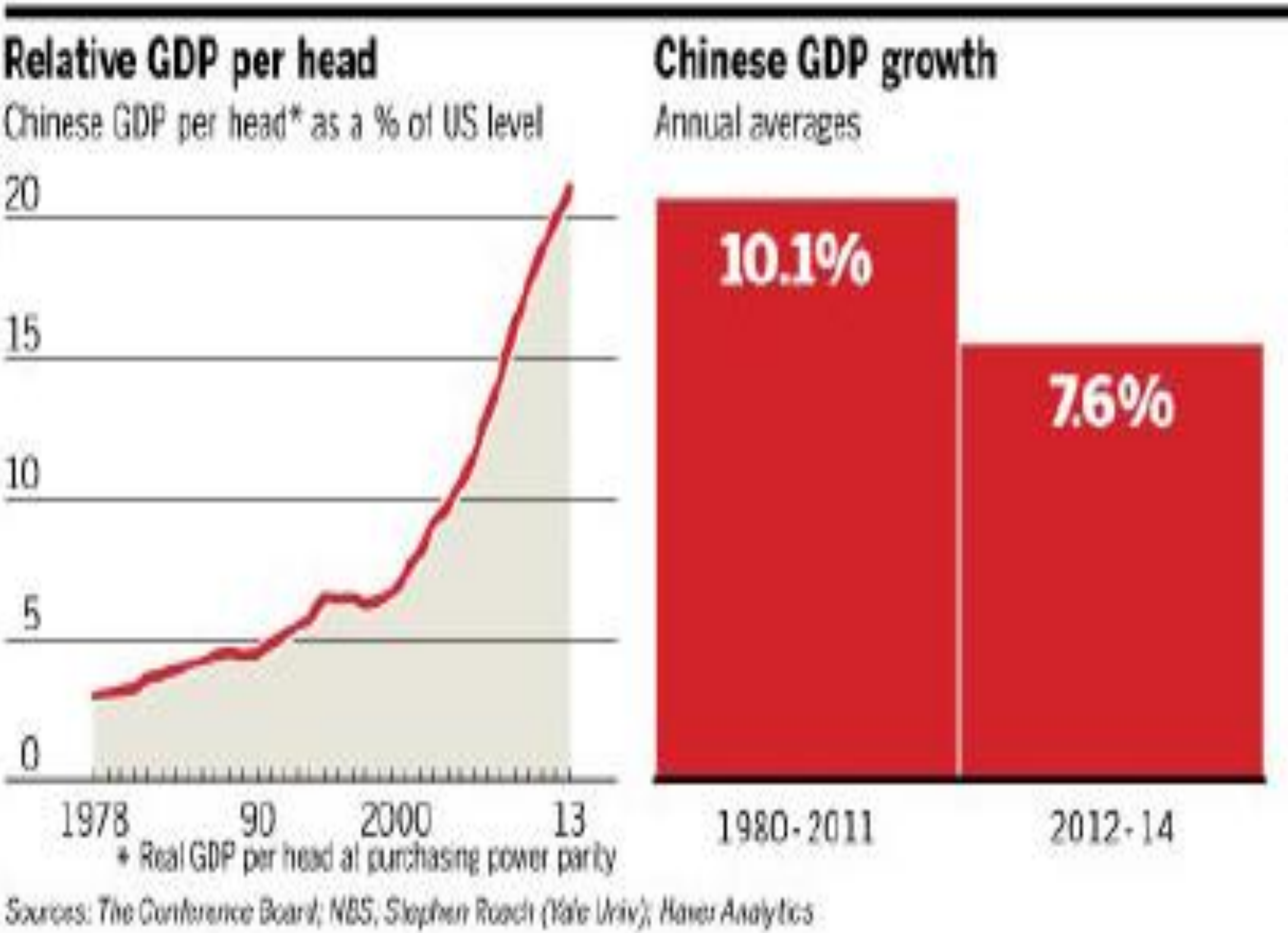
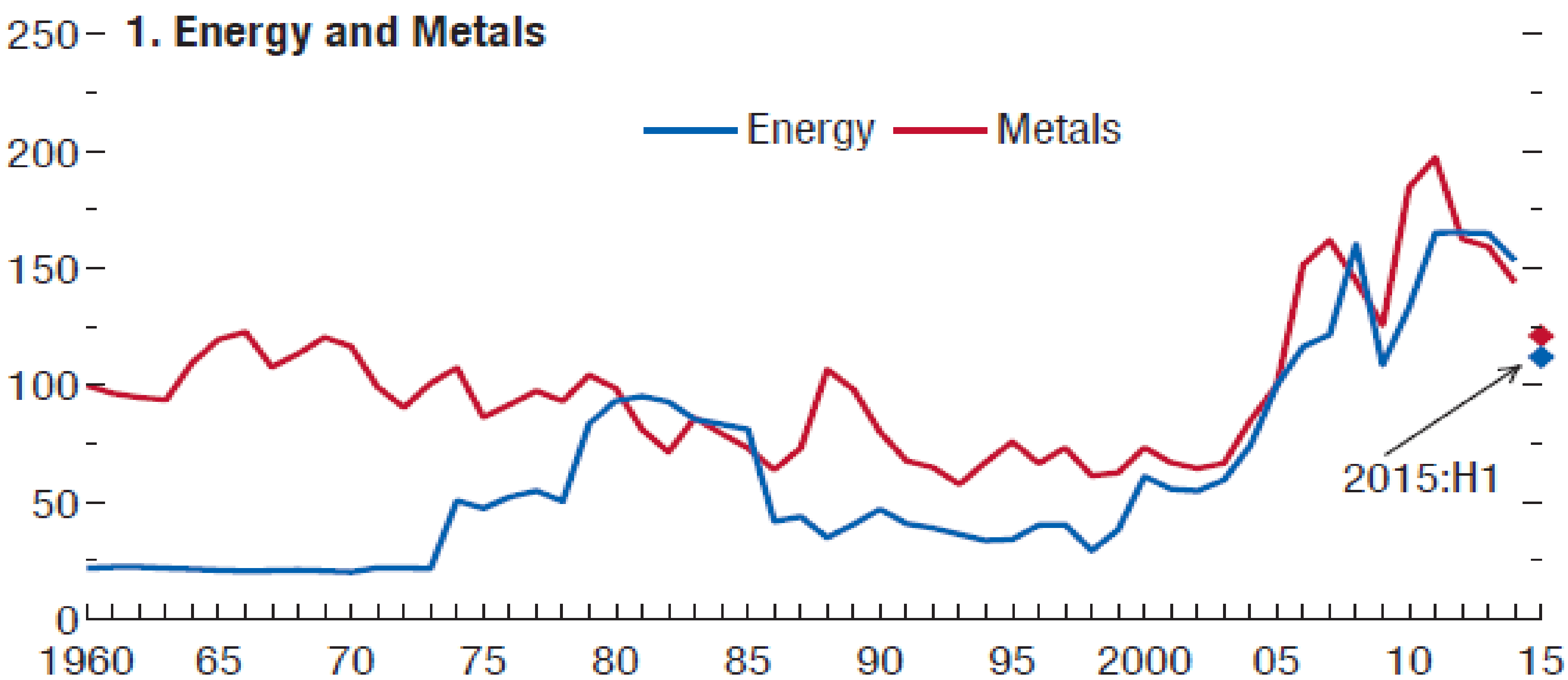

Relative GDP per head
Chinese GDP per head* as a % of US level
20
15
10
5
0
1978
90
2000
13
* Real GDP per head at purchasing power parity
Chinese GDP growth
Annual averages
10.1%
7.6%
1980-2011
2012-14
Sources: The Conference Board; NBS, Stephen Roach (Yale Univ); Haver Analytics

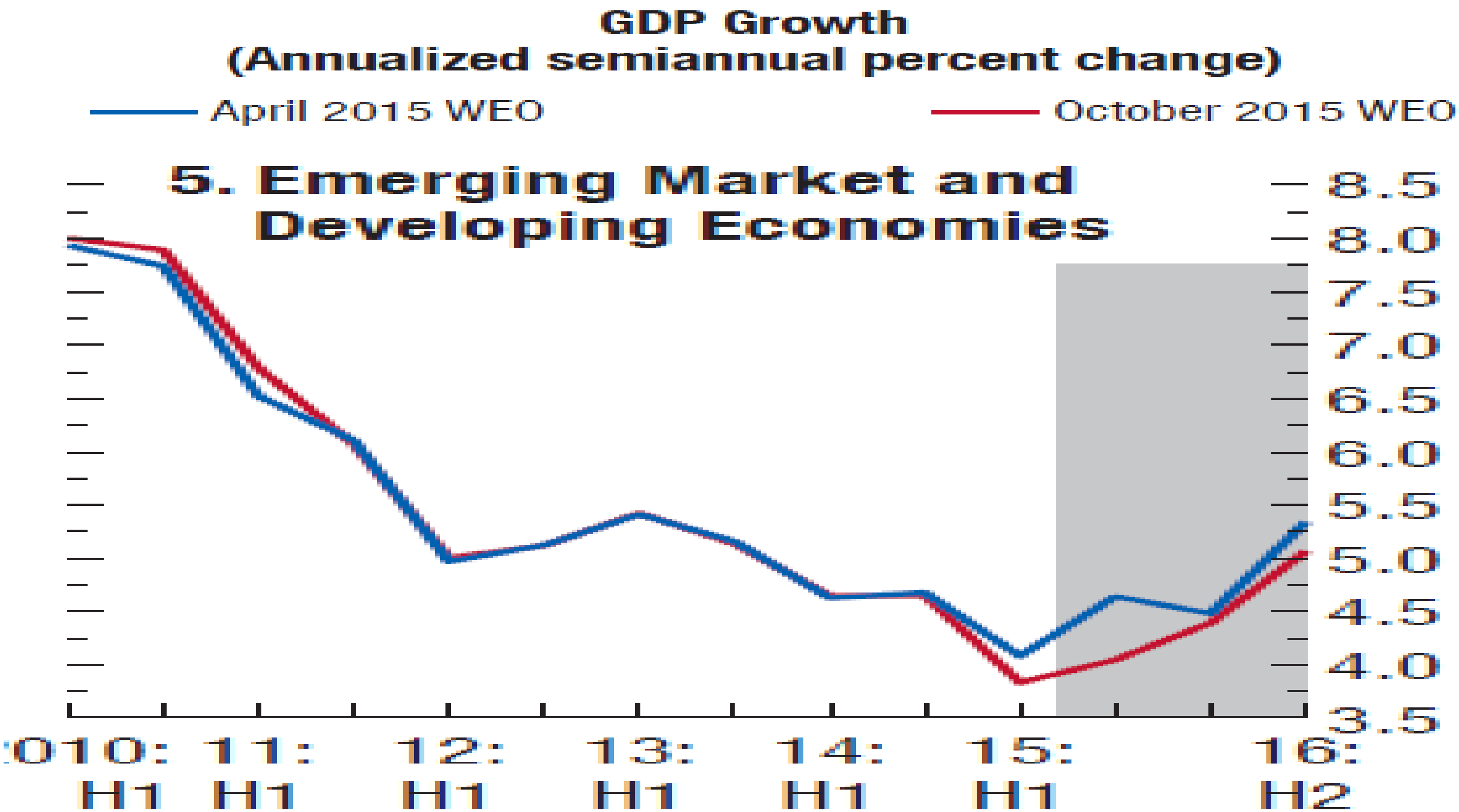
Figure 2.1. World Commodity Prices, 1960–2015

(In real terms; index, 2005 = 100)

After a dramatic rise in the 2000–10 period, the prices of many commodities have been dropping sharply. The cycle has been especially pronounced for energy and metals.



Sources: Gruss 2014; IMF, Primary Commodity Price System; U.S. Energy Information Administration; World Bank, Global Economic Monitor database; and IMF staff calculations.



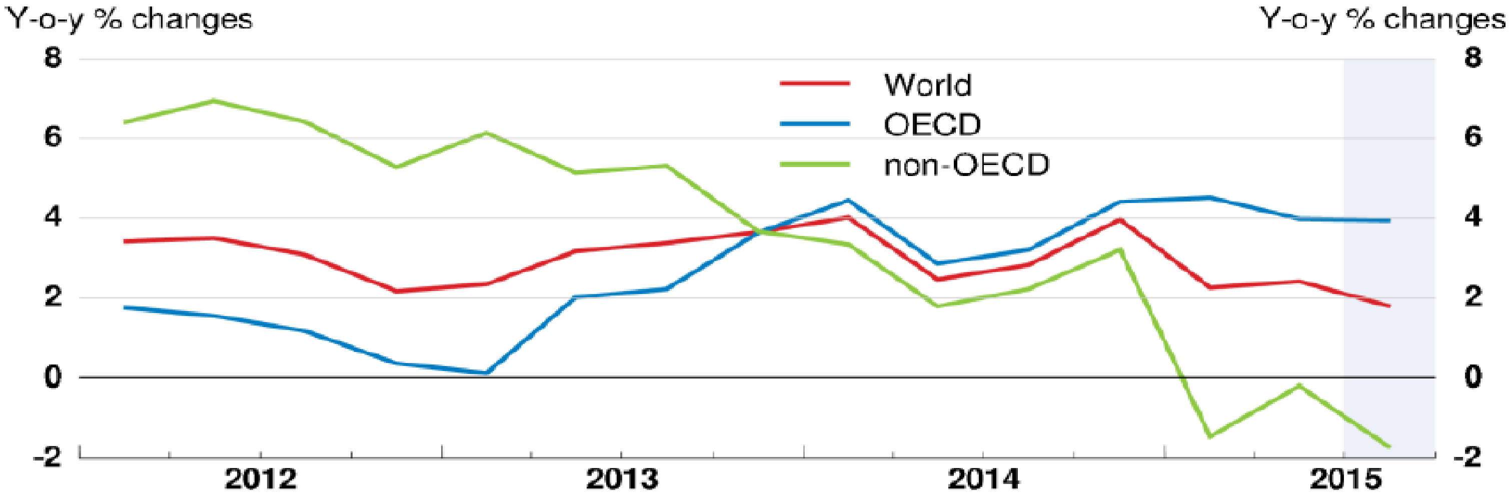
Sources: CPB Netherlands Bureau for Economic Policy Analysis; Haver Analytics; Markit Economics; and IMF staff estimates.

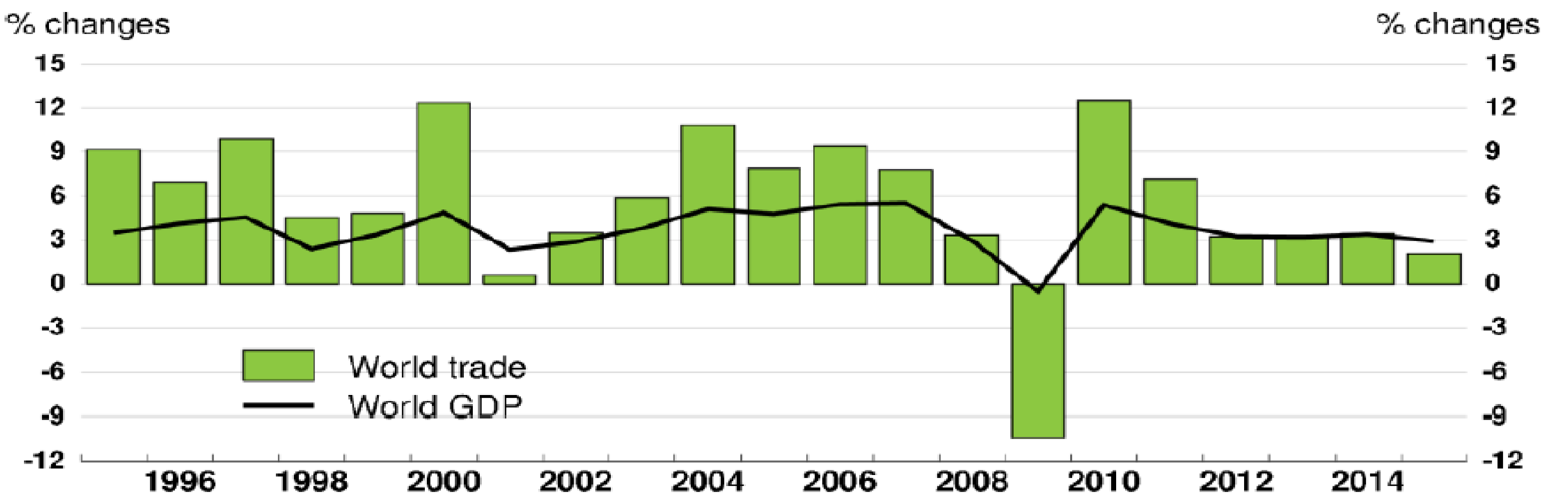
In 2012-15: Sharp slowdown of growth in EM and financial pressures on EM markets, signs of stronger growth in DM (US, UK, less so in EZ and Japan)

Dramatic slowdown in global trade growth

Such slow rates historically occur with recessions

Import Volumes





: OECD November 2015 Economic Outlook database.

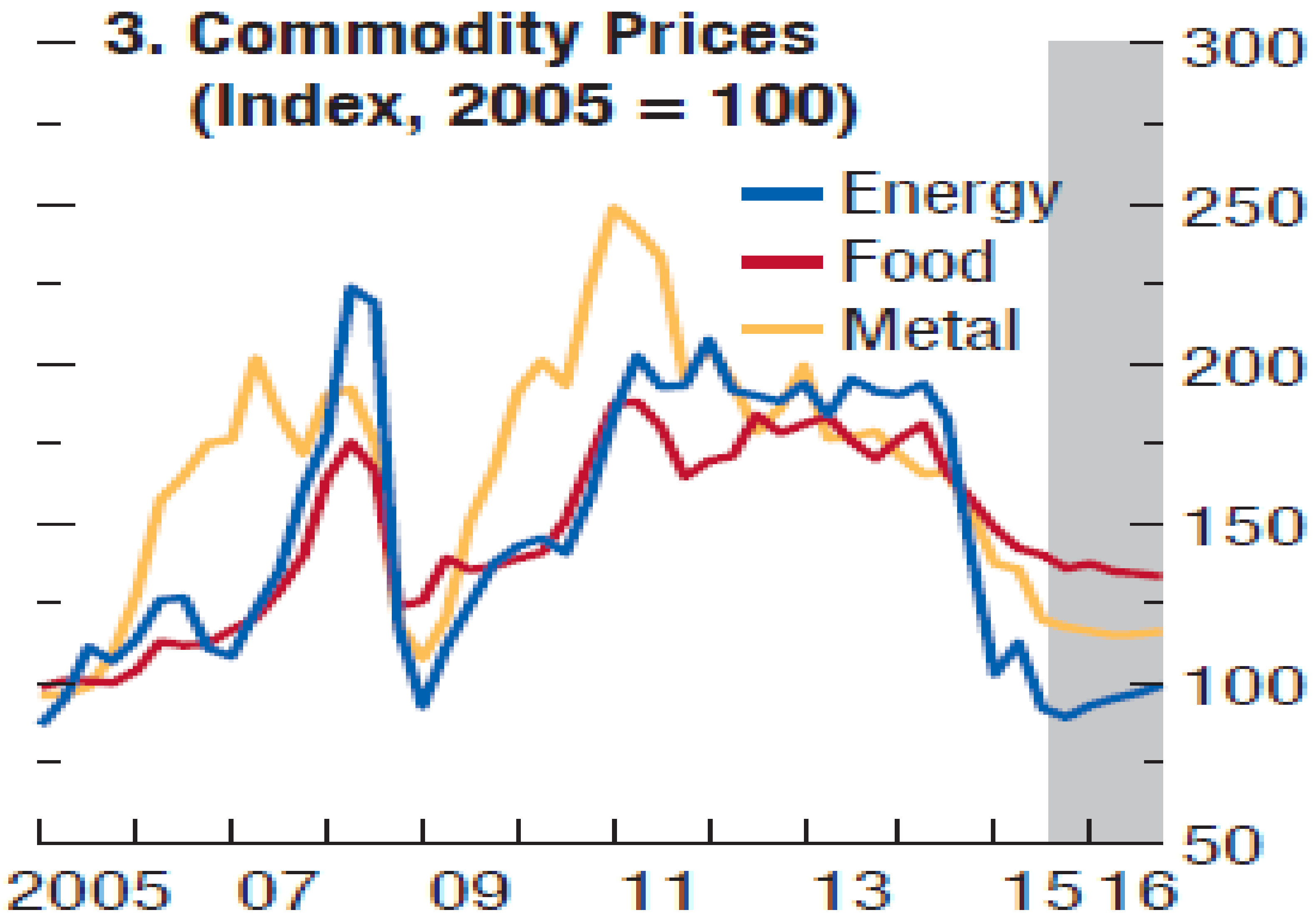
Why slowdown of growth in the EMs?

EXTERNAL FACTORS

- ✓ *China is slowing and shifting to a more domestic demand-led model*
- ✓ *The commodity super-cycle is over. Lower commodity prices are driving changes in the winners and losers among Ems*
- ✓ ***The Fed will exit 0% rates even though gradually and US bond yields are going to increase***

DOMESTIC FACTORS

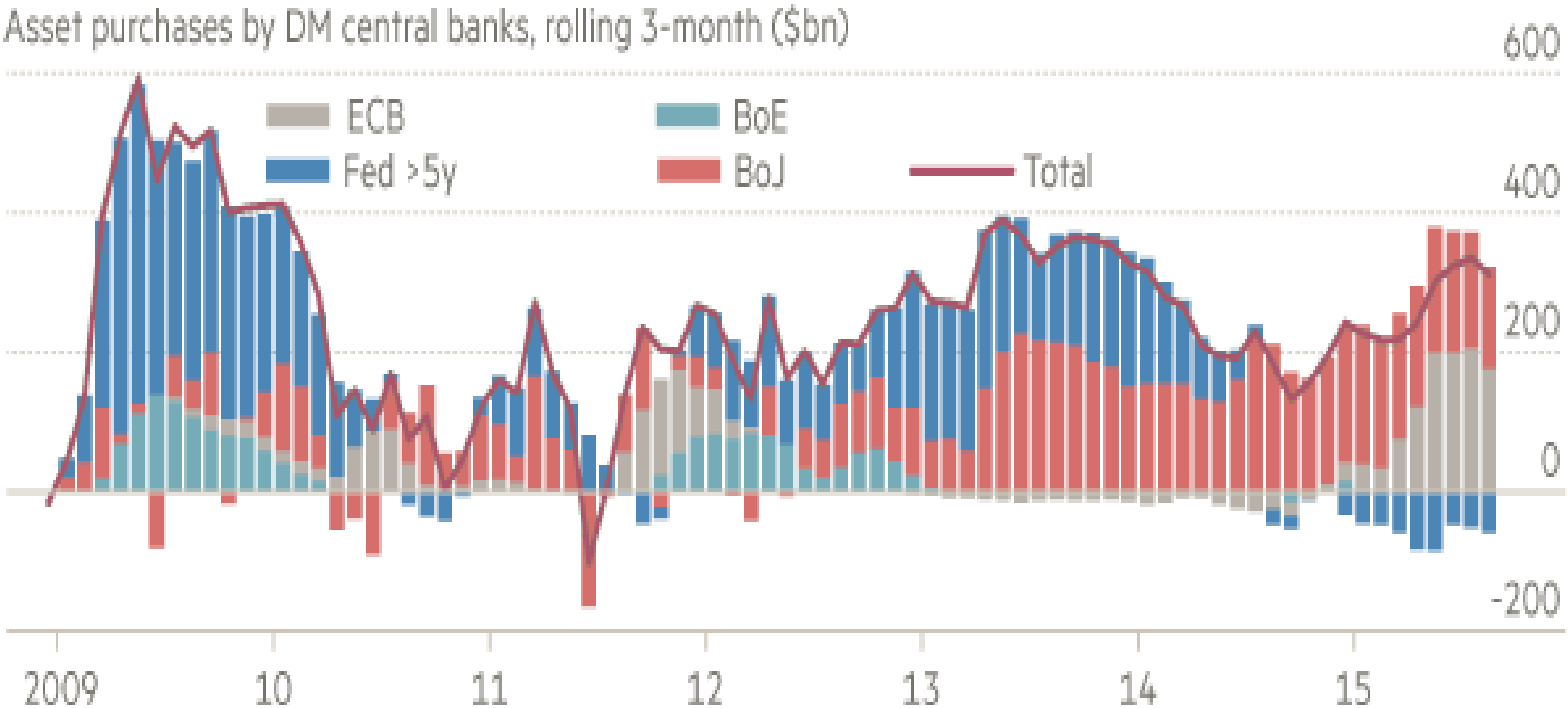
- ❑ *Some excess in monetary and fiscal policy as liquidity was abundant, interest rates too low and credit excesses*
- ❑ *Micro reforms that increase competition and productivity did not occur*



Sources: Consensus Economics; IMF, Primary Commodity Price System; and IMF staff estimates.

QE delivered a wave of money after the crisis...

The US Federal Reserve led QE from 2008. Other central banks joined in, hoping to stimulate growth. The Fed stopped last year; the BoJ and ECB continue, although a printed dollar has more impact globally than a printed yen or euro

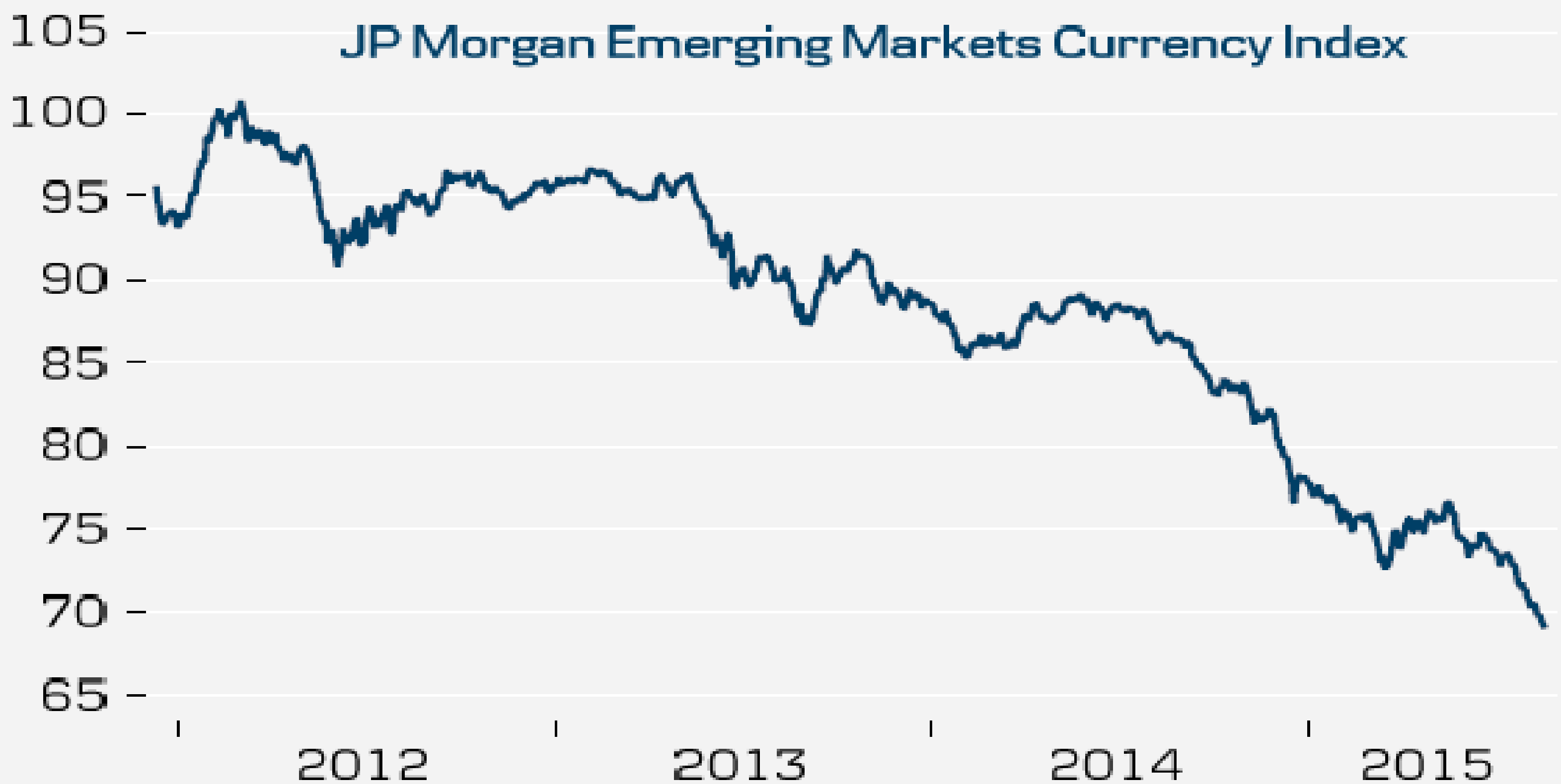


Sources: Citi Research; Haver Analytics

QE DELIVERED A FLOW OF MONEY AFTER THE CRISIS

- ✓ Western central banks have created QE money since 2008.
- ✓ By some estimates, $7tn of QE dollars have flowed into emerging markets since the Fed began buying bonds
- ✓ “Carry trade”: borrowing in currencies where interest rates are low and investing the proceeds where they are high.
- ✓ This works while exchange rates are favourable — but can go wrong when they change.
- ✓ Capital outflows weaken the local currency, pushing up foreign borrowing costs and tightening local lending conditions.
- ✓ But the problem now is much deeper and much more general than a currency mismatch.

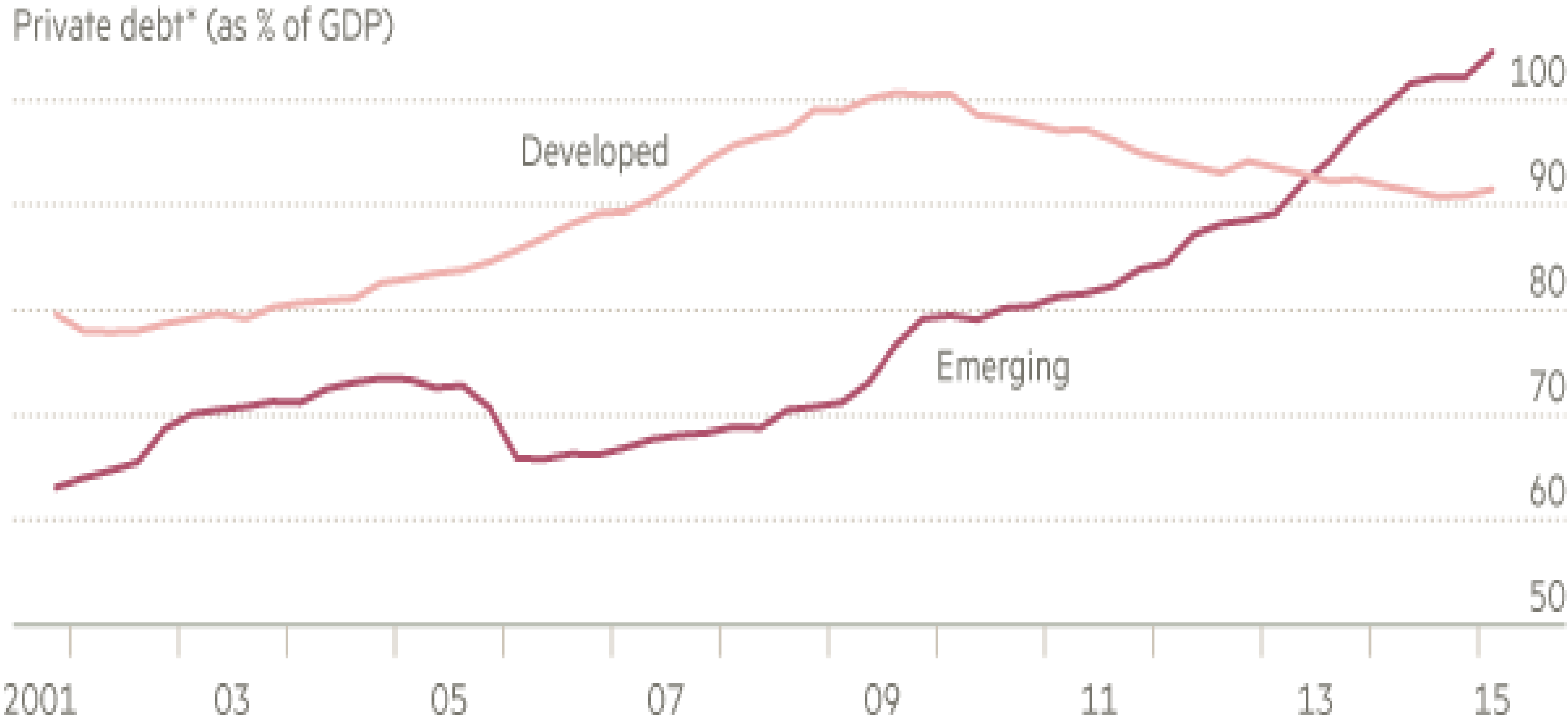
EM currencies in freefall



Source: Macrobond Financial, Danske Bank

... and putting the private sector in trouble...

Private-sector debt in emerging markets is now greater as a percentage of gross domestic product than it was in developed markets on the eve of the global financial crisis. But a lot of debt does not show up in published data

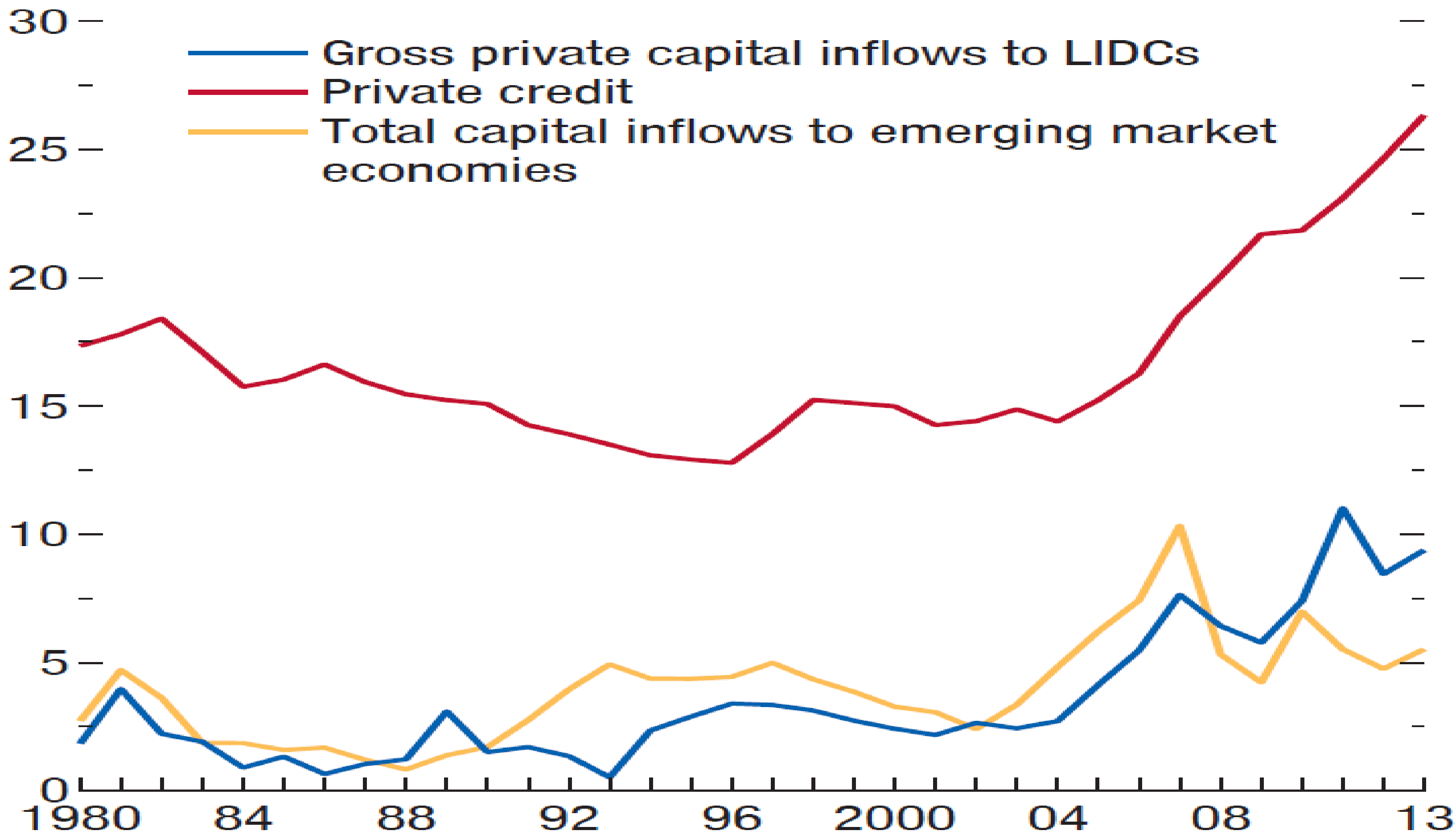


* Households and non-financial corporates

Sources: IMF; Andrew Hunt Economics

FT

Figure 1.3.1. Gross Capital Inflows and Private Credit in Selected Low-Income Developing Countries
(Percent of GDP)



Source: IMF staff calculations.

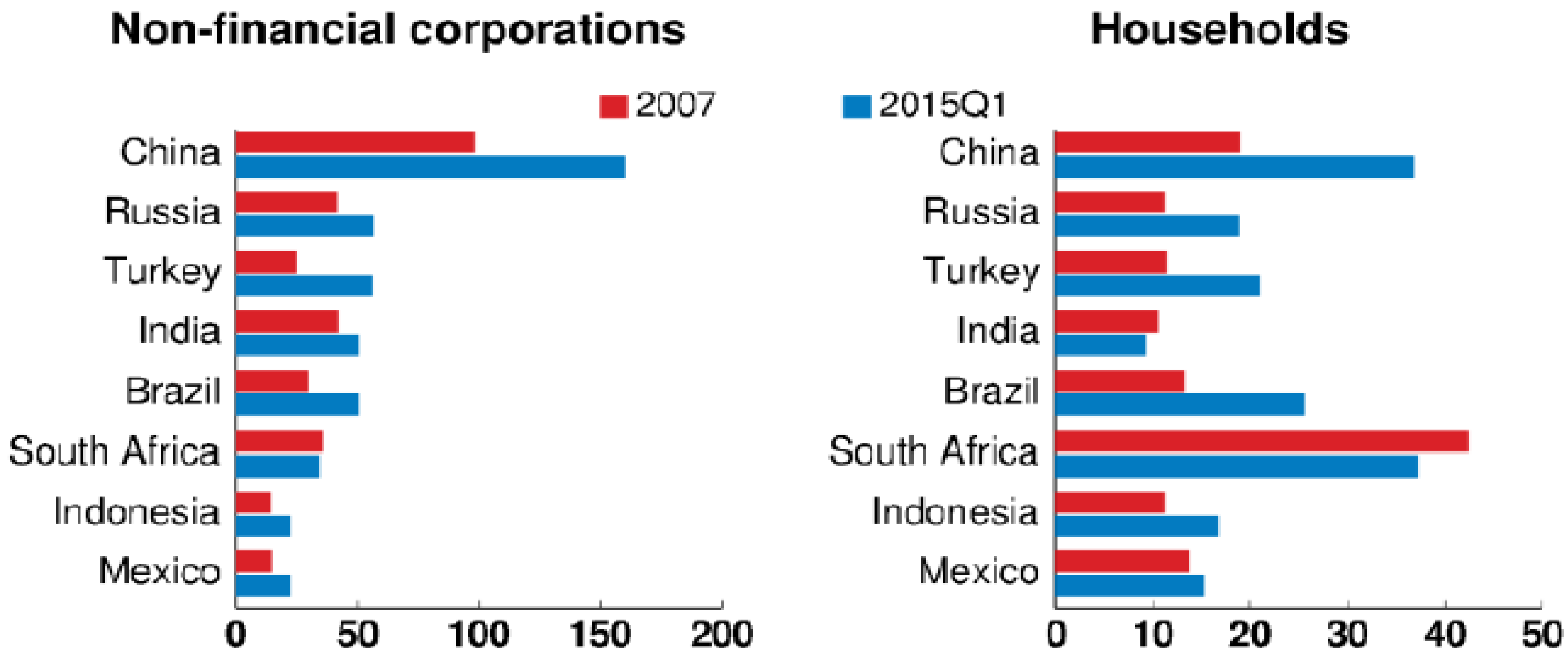
OVERALL FINANCIAL EXPOSURE HAS GREATLY INCREASED

- ✓ The leveraging of QE money has resulted in piles of debt around the emerging world that are very hard to measure or even to detect
- ✓ What is clear is that debt has risen to alarming levels
- ✓ Major concern is the heavily indebted companies and the banks exposed to them, as they fall into a vicious circle of low profitability, higher non-performing loans and tighter credit conditions.
- ✓ "It is often only after things go wrong that the size and destructive power of hidden debts become apparent" (Carmen Reinhart)
- ✓ The process is not over yet: as the Fed pulls back, the ECB and BoJ are still in QE mode.

Financial exposures have increased

Increase in debt levels in EMEs **E**

end-period, per cent of GDP

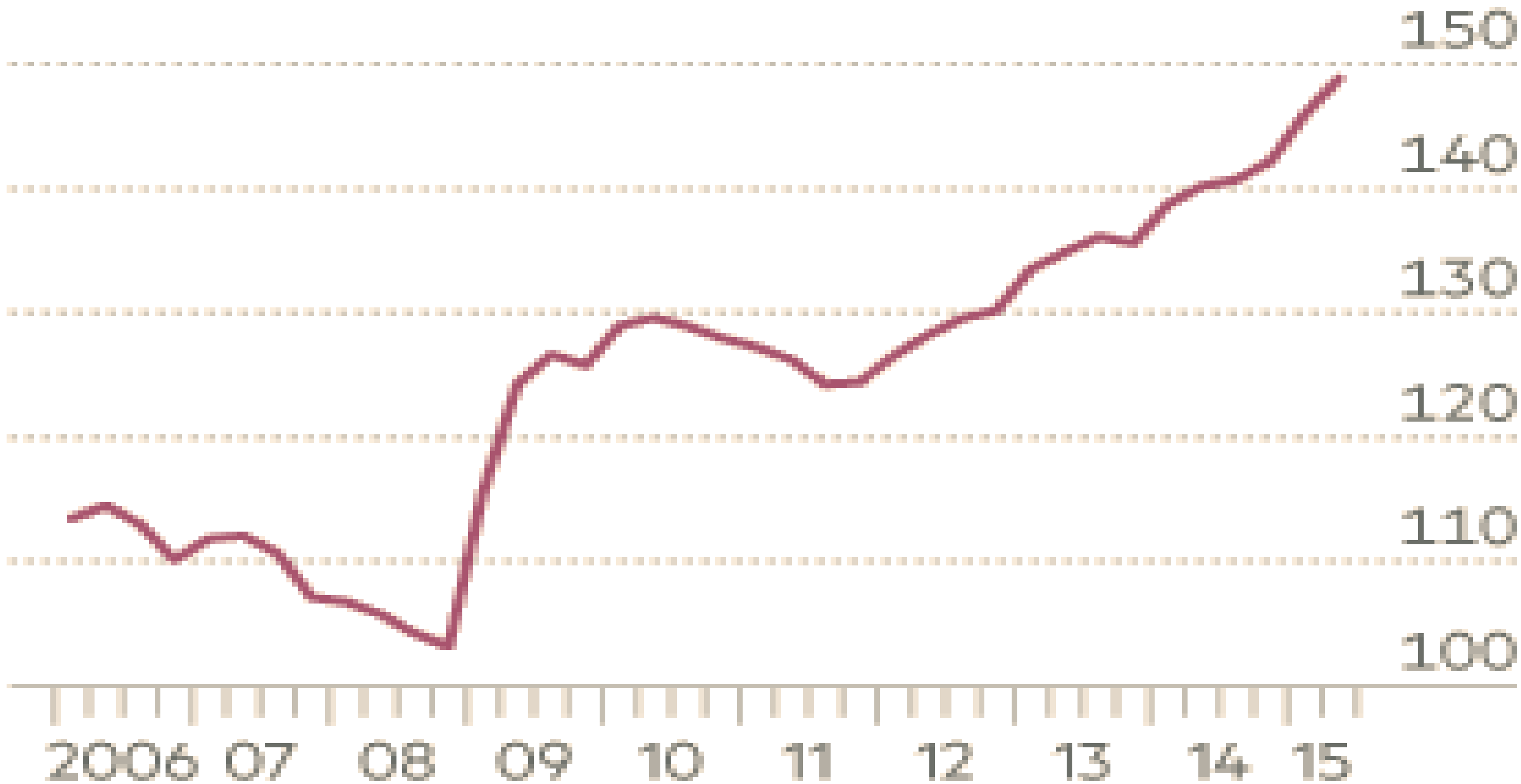


***Note:** Credit from banks and non-banks adjusted for breaks. For South Africa 2008 instead of 2007.*

***Source:** BIS.*

China credit

% of GDP



Source: IMF

Will EM experience a severe crisis?

- Will financial pressures intensify to the point of a crisis in some EM?
- Which EM are most at risk?
- What policy options are available for these EM at risk?
- What impact on DM?

Compared to the past EM have some positive factors:

- Flexible exchange rates rather than fixed ones that could collapse
- More forex reserves to avoid liquidity runs on banks, currencies and governments
- Lower private/public/external deficits and debts: less solvency risk
- Better regulated banks and financial systems

But some EM have weaker fundamentals

- Some EM have weaker macro, financial and policy fundamentals
- Weaker ones include countries with large current account deficits, large fiscal deficits, falling growth, commodity exporters, rising inflation, socio-political protest
- Weaker group includes the Fragile Five: India, Indonesia, Brazil, Turkey, South Africa
- Other fragile EM include Russia, Argentina, Venezuela, Malaysia, Ukraine

Medium term optimism for EM in spite of short run pressures

- Medium term positive trends (per capita income growth) in EM
- A larger share of global GDP and growth in EM

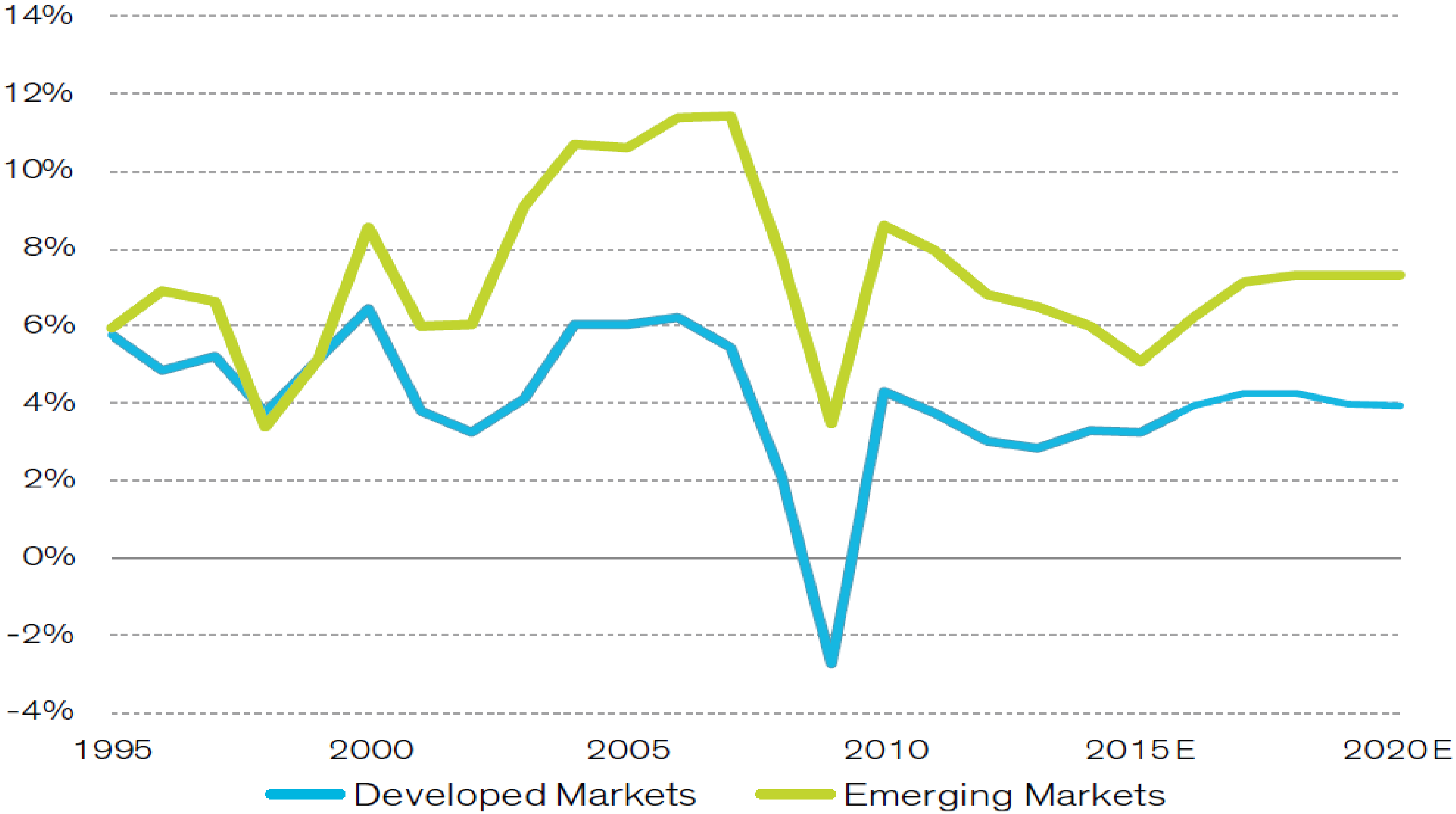
given by:

- Demographic dividend (high population growth)
- Micro generation reforms to boost competition and productivity
- Ability to absorb existing and new technologies developed in DM
- Technological innovation in some EM (China, India, etc)
- Urbanization and Industrialization
- Rise of middle classes and consumer society

Figure 3.

EMERGING GROWTH CONTINUES TO OUTPACE DEVELOPED

GDP Growth Based on Purchasing Power Parity (Annual % Change)



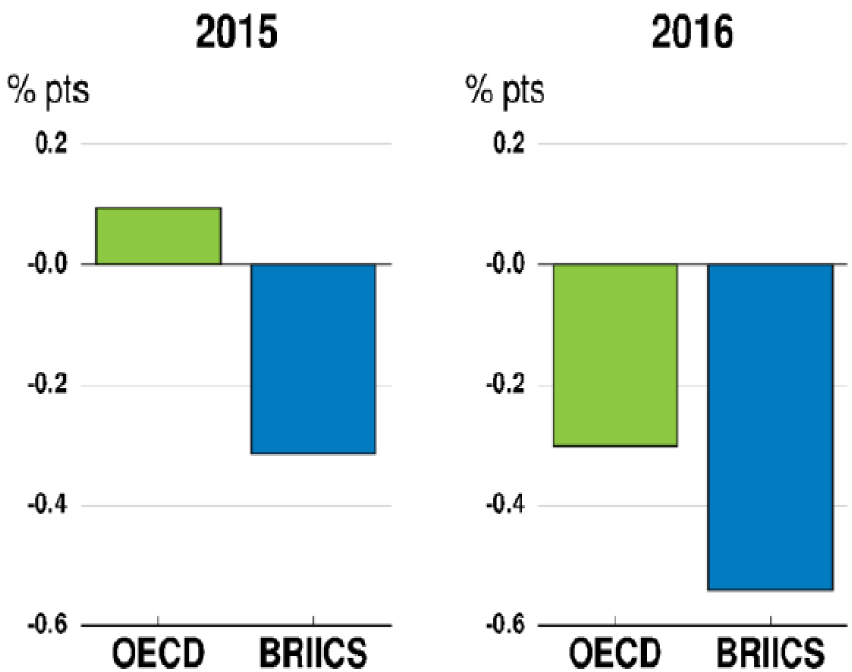
As of April 14, 2015.
Source: QMA, International Monetary Fund. For informational purposes only.
There is no guarantee these forecasts will be achieved.

Is the developed world heading for a recession similar to the one that followed the Asian financial crisis of the late 1990s?

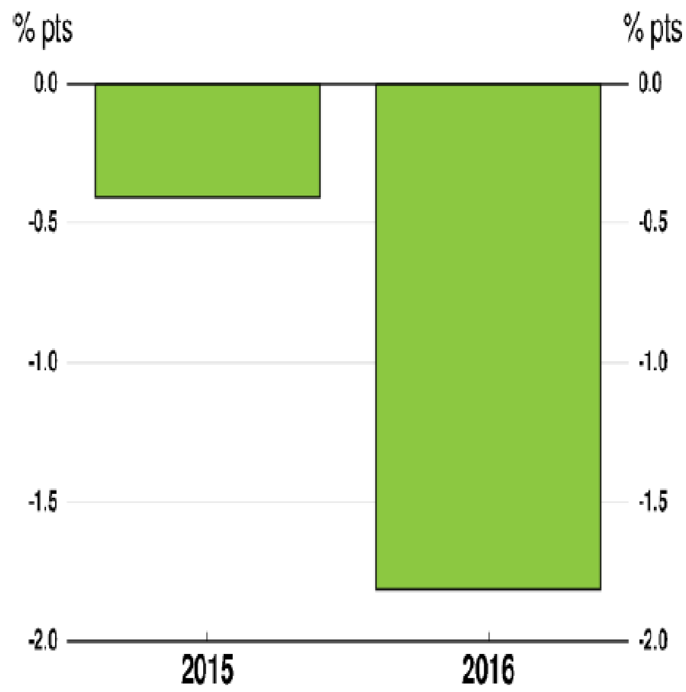
As a group, advanced economies have so far been resilient to EME weakness

Revisions to the OECD Economic Outlook projections between June and November 2015

GDP Projections

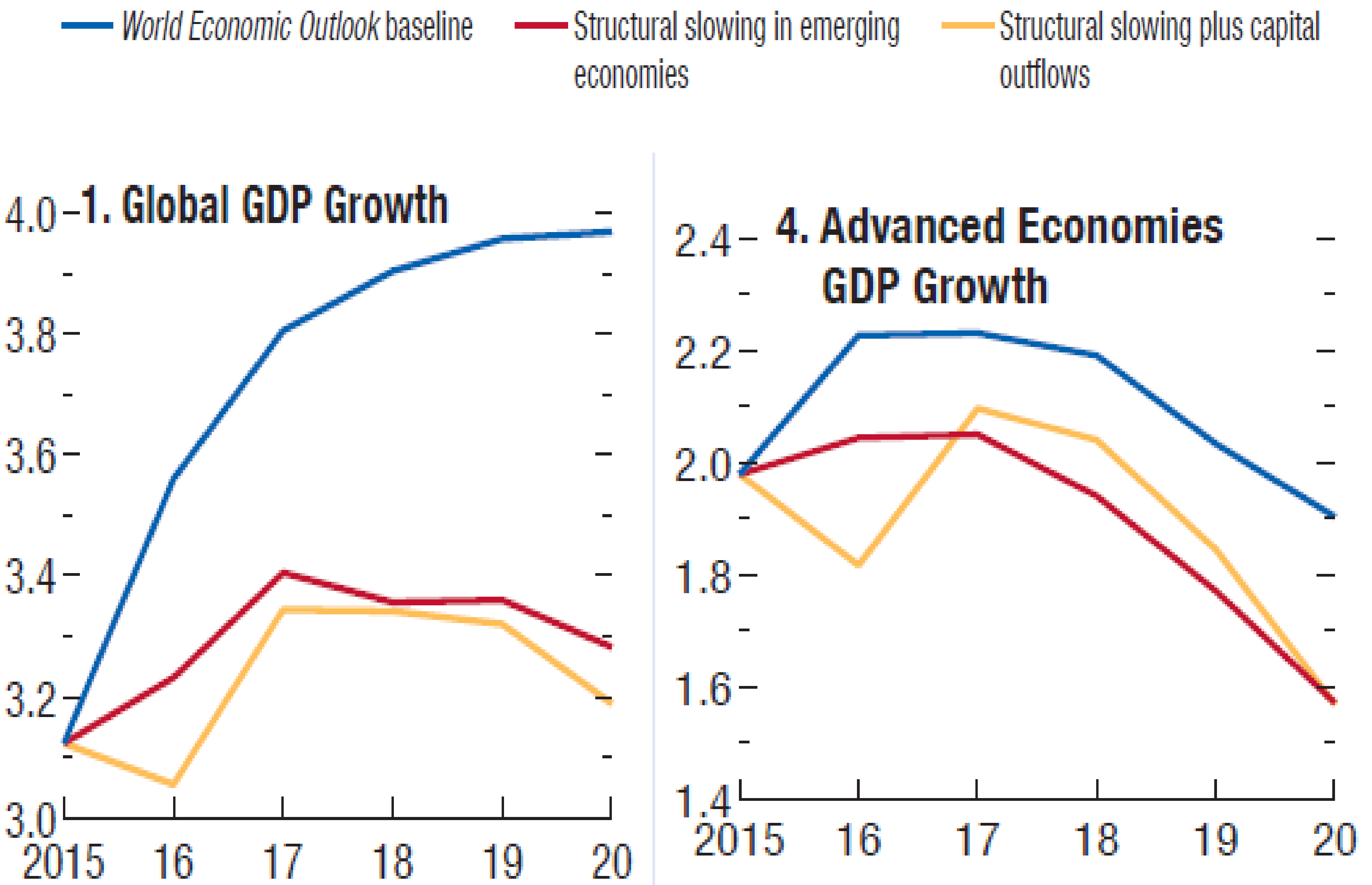


EXPORT Projections



Sources: OECD June and November 2015 Economic Outlook databases.

Scenario Figure 1. *World Economic Outlook* Stagnation Scenario
(Percent, unless noted otherwise)



Sources: IMF, G20MOD simulations; and IMF staff estimates.

Concluding remarks

- Growth in emerging markets have been unsustainably high in last decade, and will come down by a couple of points
- Financial pressures intensify in the short run to the point of a crisis in some EM
- EM have some fundamental macro and structural problems that will take time to resolve. So DM and EM may decouple
- Convergence will continue in medium term, but not as rapidly, and in large part because of low growth in advanced economies
- As domestic rather than global trends drive growth, significant heterogeneity in long-term performance across developing countries is likely

The End

Thanks for your attention!