

Discussion Paper

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Will the US Rebound Cause Another Emerging Markets Crisis?

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The financial crisis of 2008-2009 began in the US. Compared to past crises, emerging markets were in a much better condition to weather the storm. While the global economy did suffer, emerging markets generally outperformed their counterparts in the developed world and the decoupling thesis reached its height of popularity.

With the worst of the crisis now over and more positive economic signals coming from the US economy, what can we expect next for the emerging markets? What will a rebound in the US mean for emerging markets?

Emerging market leaders have complained loudly about the US Federal Reserve's Quantitative Easing program. These countries already were suffering from high levels of inflation and massive inflows of foreign capital. Cheap money and limited opportunities in the US market have only made matters worse for them. As the US economy rebounds and capital is redeployed to chase related opportunities, emerging markets can expect to suffer as a result. While most of these markets are much more stable and prepared than they were in the 1990s, recent events in the Middle East show just how skittish international investors are and how little they distinguish among emerging markets.

This Discussion Paper reviews past financial crises in emerging markets with particular focus on the origins of these crises in the developed world. The conclusion is that most if not all of these crises did originate in the developed markets of the world. It seems that booms and busts in the US both have negative consequences for emerging markets. As we move forward into a US recovery, investors,

businesses, policymakers and others should be wary of its potential effects on emerging markets. This article goes further to analyze how the impacts of market shifts in developed markets might be softened or controlled. Individual bank policies, financial sector conditions and macroeconomic and monetary policies all contribute to the reaction of any one emerging market to changes in developed markets. Changing these conditions or at least being aware of them in a given market can make a huge difference in the effects of market disturbances on individual businesses and countries.

Going back to the 1920s we find evidence of emerging market financial crises caused by events in the US. Sovereign borrowers in Latin America found it difficult to refinance their debts for lack of liquidity. The money was chasing the booming stock market and other rewarding investments in the roaring US market. The situation was similar during the Volker era of rapidly rising interest rates in the US led to an appreciation of the US dollar and set the stage for the early 1980s Latin American debt crisis.

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The origin of the Mexican Crisis of 1994-1995 showed how sensitive international investors can be and how that sensitivity can quickly translate into a crisis. Investors were worried about the Mexican presidential election of 1994. Those election year jitters led to reduced capital inflows. The central bank used its reserves to maintain the fixed exchange rate. As the central bank's reserves depleted, creditors began to worry about repayment of their loans. The currency was devalued then eventually allowed to float. The ensuing panic left the government without any creditors. This was an example of a government that was illiquid but not insolvent. The US and others stepped in with an emergency loan package that

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stabilized government finances and restored confidence. The loan was repaid earlier than scheduled in 1996¹.

The shock of the Mexican crisis was felt in Argentina which had its own election in 1995. In that case, investors questioned the new government's commitment to the currency board arrangement and the fixed exchange rate it featured. Panic ensued and affected the crisis. High reserves did lessen the impact of the crisis, however. Bank reserves were held in US T-bills and other low-risk assets that were able to provide 70 percent of the required liquidity during the bank runs and capital flight during the crisis. An international rescue package set Argentina back on track, at least until its next crisis in 2001-2002².

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Many factors contributed to the East Asia Financial Crisis of 1997. In terms of developed market factors, the US rebounded from its recession in the early 1990s, attracting capital to its shores and appreciating its currency. At the time, the region was characterized by fixed exchange rates. The pegged currencies became more expensive causing exports to decrease. At the same time, Japanese banks faced falling prices in real estate and equities at home so pulled their capital from the emerging markets of East Asia. These two trends were exacerbated by the growth in Mexico and China and their strategic currency devaluations. Both were major export competitors to the countries of the region. The collapse of the Thai baht in July 1997 sparked fear and launched the East Asian Financial Crisis³.

Beyond a lack of reserves, analysts highlighted a variety of issues in the financial sectors of the East Asian economies that made the crisis worse once it set into motion. In general, there was a lack of risk management in the financial sector. These countries had embarked on aggressive financial sector deregulation without appropriate regulation. Financial liberalization in Indonesia fueled a tripling of private

banks from 74 in 1988 to 206 in 1994. Thailand sought to compete with Singapore and Hong Kong as a financial center through its Bangkok International Banking Facility. Korea also opened the door to short-term international borrowing for its banks⁴.

These measures led to a rapid and unchecked expansion of credit. By the mid-1990s, banks featured a high percentage of non-performing loans. The region suffered from "crony capitalism" or politically connected and directed lending and other financial services. New technologies and foreign investment had begun to unveil some of the features of this environment. Given the fixed exchange rates, there was no active currency hedging. When the crisis, these vulnerabilities were exposed.

East Asian economies reacted differently to the crisis, with some suffering much more than others. The Philippines, Malaysia and Taiwan had large reserves relative to their short-term borrowing which helped soften the impacts of the crisis. Korea, Indonesia and Thailand meanwhile all had relatively low reserves. They were all severely affected by the crisis. Indeed, in Indonesia, the crisis led to the end of the 31-year Suharto regime. As financial centers, Singapore and Hong Kong had a different experience through the crisis. Much of their financial data is not indicative since it reflects their status as financial centers more than their local economies.

The financial crisis of 2008-2009 was different for emerging markets than previous crises. Current accounts were generally in surplus or balanced. The crisis originated in the US, not in the emerging markets, and featured troubled international banks deleveraging and reducing the supply of financing available to emerging markets⁵. Demand for exports from emerging markets declined sharply, devastating export-oriented economies but damaging larger markets with significant domestic demand as well. As indicated by the International Monetary Fund's (IMF) data presented in the graph below, emerging markets generally fared better than developed economies. In the worst quarter of the crisis, developing economies suffered a four percent decrease in GDP while the figure was eight percent for the advanced economies and more prolonged than for emerging markets.

¹ Radelet & Sachs 1998.

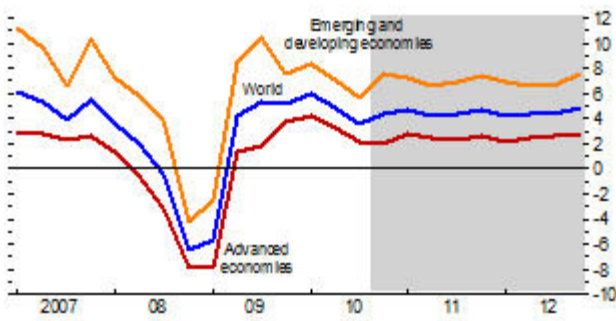
² Radelet & Sachs 1998.

³ Radelet & Sachs 1998.

⁴ Radelet & Sachs 1998.

⁵ Radelet & Sachs 1998.

Figure 1. Global GDP Growth
(Percent, quarter over quarter, annualized)



Source: IMF staff estimates.

As with past crises, the effects on emerging markets were different in both type and severity. Most developing countries feature low penetration by the banking sector as reflected in low ratios of loans/GDP and deposits/GDP. The limited deposits that banks do have are typically used to hold short-term government paper, central bank securities and some short-term loans to the private sector. Any significant banking activity may be done off-shore or in another currency. Prior to the most recent crisis, lending was growing faster than deposits among emerging markets. Foreign sources of capital fueled rapid expansion of credit. Foreign currency lending was still a major issue in Eastern Europe, for example, where it was favored since 2000-2001 because of the declining dollar⁶.

Some effects of the crisis were not under the control of the emerging markets themselves. The behavior of international banks in emerging markets depended on their internal structures in terms of liquidity management, capital structure and lending decisions. Centralized banks such as Deutsche Bank and UBS were more likely to withdraw their capital or re-deploy it and decentralized banks such as BBVA and HSBC were more likely to maintain positions within their markets. In some emerging markets, subsidiaries were raided for capital by their parent bank, thereby reducing liquidity in markets with solid fundamentals. In other markets, subsidiaries from one emerging market helped fund those in other emerging markets where liquidity was strained⁷.

⁶ Radelet & Sachs 1998.

⁷ BIS 2010.

The regulatory framework in Malaysia proved quite resilient during the crisis and serves as a model for other emerging markets. Malaysia features a developed capital markets with total outstanding bonds amounting to 86 percent of GDP. Since 1998, just after the East Asian Financial Crisis, regulators have required Malaysian banks to maintain surplus liquidity of three percent for assets with one-week maturities and five percent for assets with one month maturities, after adjusting for historical risk factors. As a result, bank risk-weighted capital ratios were above 12.5 percent and core capital ratios were above 9.9 percent throughout the entire crisis. These were historic highs. Average return on assets (ROA) was 1.6 percent and average return on equity was 20.8 percent during the crisis, cooling to 1.2 and 13 percent respectively in 2009. Malaysia demonstrated that requiring foreign banks to incorporate and commit capital locally does provide insulation to global crises⁸.

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Business funding sources in Malaysia are balanced among equity, bonds and bank loans. Banks have adopted the “originate and hold” business model which maintains risk on bank balance sheets and encourages bank vigilance over borrowers. Bank vigilance is further encouraged by the March 2005 decision to increase the risk weight of non-performing housing loans to 100 percent. Deposits account for 70 percent of bank funding and these are mostly in domestic currency. The loan/deposit ratio was moderate, averaging 77.3 percent during the crisis.

In the face of the financial crisis and a prevailing trend toward protectionism, Malaysia unveiled a new package of liberalization in April 2009. This included new banking and insurance licenses for international financial institutions, higher foreign equity limits to allow greater international participation in domestic institutions and more flexibility in operations.

⁸ BIS 2010.

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In conclusion, past experience with emerging market financial crises shows that many crises originate in developed markets. Others result from international investor reactions to events in emerging markets. Most emerging markets are much better prepared for financial crises now than they were in the 1990s. Improvements include floating exchange rates and improved macroeconomic and monetary policies. However, many still rely on foreign financing for most banking activities and the domestic deposit base generally remains weak. Foreign currency lending is still high and while this has been welcome during the past decade of general dollar decline, a reverse to dollar appreciation would present challenges in these markets.

One might foresee another emerging market crisis unfolding as a result of the US economic recovery. Many emerging market leaders have already complained about the Federal Reserve's Quantitative Easing program, believing that loose monetary policy in the US is fueling bubbles not only in global commodities but in emerging market equities and real estate. As the US continues its recovery and interest rates in the US begin to rise, it is reasonable to expect a certain level of reversal in the flow of funds. Such a choke might cut off the rally in emerging market equities and real estate and begin a downward spiral in prices. If this were combined with additional political crises beyond the current unrest in the Middle East, it could be disastrous for many emerging markets. Declines in those markets could depress global

commodity prices, creating trouble for commodity-based exporters. Basically, the stage could be set for a repeat of the late 1990s when the rebounding US economy helped precipitate the East Asian Financial Crisis which in turn depressed commodity prices and led directly to the Russian crisis of the following year.

What can be done to prevent such financial crises from occurring? The best solution is to further develop local financial sectors. One major lesson from the US experience during the crisis was that over-reliance on short-term borrowing can bring down major financial institutions in well developed markets very quickly as financial conditions deteriorate. Emerging market banks would be wise to learn from this episode as well as their own past experiences and focus, as they have done, on increasing deposits in the same markets where they make their loans. Likewise, emerging market governments can learn from their peers how best to regulate their markets to protect themselves from adverse trends in developed markets and prevent those trends from ballooning into crises.

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