The Weak Link

The world ignores emerging markets at its peril.

BY DESMOND LACHMAN

It is said that those who cannot remember the past are condemned to repeat it. If ever that statement had applicability, it has to be in relation to current U.S. economic policymaking in seeming total disregard of the fallout of those policies for the emerging market economies.

By not remembering the recurring emerging market boom-bust cycles, U.S. policymakers seem to be setting us up for the next major emerging market bust. If that were to occur, it could very well derail the U.S. economic recovery. This would seem to be particularly the case considering how important the emerging market economies have become and how very heavily indebted they are to the global financial system.

One instance of U.S. policymakers' seeming indifference to the emerging market economies is a recent statement by Federal Reserve Chairman Jerome Powell that the emerging market economies should have little difficulty in handling the Fed's normalization of interest rate policy. Never mind that all too many past episodes of Federal Reserve tightening—such as those in the early 1980s, the late 1990s, and in the mid-2000s—have been singularly unhappy ones for those economies as capital flows reversed.

A more serious indication of indifference to the emerging markets are President Trump's undisciplined budget policy and his America First trade policy. By engaging in a large tax cut and public spending increases

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at this late stage in the U.S. economic cycle, the Trump Administration seems to be disregarding how seriously the emerging market economies might be affected by higher U.S. interest rates and a stronger dollar that are all too likely to flow from those policies.

By engaging in a trade war with China, imposing steel tariffs on Brazil, and taking a tough line on NAFTA, the Trump Administration seems to be unconcerned about the economic fallout from those policies for systemically important emerging market economies such as Brazil, China, and Mexico.

Judging by U.S. policymakers' seeming indifference to the emerging markets, one might be forgiven for thinking that those economies constituted a small part of the global economy. Yet, according to the International Monetary Fund, the emerging market economies now account for well over half of the world economy. At the same time, their governments and their corporations are hugely indebted to the global financial system as they have never been before. This is underlined by overall debt-to-GDP ratios for those economies that are now well above their 2008 pre-crisis peak levels.

This has to make one think that the U.S. policymakers are ignoring at their peril the adverse impact of U.S. monetary, fiscal, and trade policies on the emerging market economies. This is particularly the case at a time when all too many of these larger economies such as Argentina, Brazil, China, Mexico, South Africa, and Turkey all face daunting economic challenges and considerable political uncertainty.

According to a Wall Street adage, when the winds are strong even turkeys fly. By this is meant that when money is easily available in the global financial market, even borrowers with the weakest of economic fundamentals can borrow and thrive. However, once that liquidity dries up, the weakest borrowers come crashing down to earth as they face difficulty in financing their deficits and in rolling over their debt.

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This adage has particular relevance for today's emerging market economic outlook. This would seem to be particularly the case at a time when many years of ultra-easy global liquidity conditions are coming to an end and when those easy money conditions lulled emerging market policymakers to be very much less disciplined in their economic policies at home.

During the years when the world's major central banks maintained extraordinarily low interest rates and expanded

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the combined size of their balance sheets by some US$10 trillion, the emerging market economies had little difficulty in tapping the international capital market.

Indeed, between 2008 and 2017, emerging market companies managed to increase their borrowing by some US$15 trillion. In the process, they more than doubled their overall indebtedness to a staggering US$25 trillion, with more than US$3 trillion of that debt in dollar-denominated terms. And they did so at very low interest rates that did not nearly compensate investors for the default risk associated with that borrowing.

Equally striking is the fact that last year, when global liquidity was still unusually ample, a country with as checkered a default record as Argentina could issue a 100-year bond on relatively favorable terms. Seemingly, investors were undaunted by the fact that over the last one hundred years Argentina had defaulted no less than five times on its debt.

Similarly, eyebrows might be raised by the fact that global investors eagerly snapped up sovereign bonds issued at relatively low yields by countries with as dubious economic and political fundamentals as Iraq, Kenya, Mongolia, and Tajikistan. Or by the fact that the International Monetary Fund is now warning that all too many African countries are drowning in debt.

Sadly, for the emerging market economies the strong winds of very easy global liquidity conditions are now rapidly dying down. The Federal Reserve is now well on its way to normalizing interest rates and to reducing the size of its bloated balance sheet. At the same time, the

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European Central Bank has announced that it will stop its quantitative easing program by the end of the year.

The shift in the Fed's policy stance, which has been occasioned in part by an expansive U.S. budget policy, has already resulted in ten-year U.S. Treasury yields approaching 3 percent. It has also resulted in a marked strengthening in the U.S. dollar. With more attractive U.S. yields now on offer and with the dollar appreciating, it should be little wonder that the capital repatriation phase of the credit cycle has begun in earnest and that emerging market currencies are under severe pressure.

The last thing that the emerging market economies now need is a slowing in the Chinese economy and a depreciation of its currency. Not only would that crimp demand for international commodities, which is the lifeblood of many emerging market economies. It would also heighten the risk that China and the United States, the world's first- and second-largest economies, would drift further towards a full-scale trade and currency war that might derail the global economic recovery.

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Yet it is difficult to see how China can succeed in avoiding a slowing in its economy and a weakening in its currency as it tries to address its own domestic credit and housing bubbles of epic proportions. This would seem to be especially the case at a time when its economy is also being adversely impacted by a restrictive U.S. trade policy.

Hopefully, the recent large movements in the currencies of Argentina, Brazil, China, South Africa, and Turkey will alert U.S. policymakers to the fragility of the emerging market economies and to their importance for the U.S. economic outlook. However, in light of the latest U.S. America First trade measures and of Chairman Jerome Powell's recent pronouncements downplaying the impact of Fed interest rate hikes on the emerging markets, I am not holding my breath for those economies to get any relief anytime soon from U.S. economic policy decisions. ◆