A SYMPOSIUM OF VIEWS

Are the Emerging Markets Finally Decoupling from the United States?

For the past few decades, every cycle of rising interest rates in the United States has brought economic contraction and widening interest rate spreads among emerging market borrowers—particularly in Latin America. We now approach a period where U.S. interest rates are again expected to rise further, perhaps significantly. Have the increasing depth of global financial markets and the improved efficiency and credibility of emerging market economic policies made international borrowers less vulnerable to the effects of a rise in U.S. interest rates than in the past?

PEDRO-PABLO KUCZYNSKI
Minister of Economy and Finance, Peru

The omens are good.

It is too early to tell although the omens are good. The international setting is at present very favorable to commodity and semi-industrial exporters like most Latin American economies. Exports are rising fast, so are reserves, and all this makes following good policies easier. It will take a tougher international setting before one can tell if Latin American countries have really decoupled from the United States. Decoupling is not an attainable goal, but gaining a degree of financial independence is.

Domestic fiscal policies, always the Achilles heel of Latin economies (including the Latins of Europe), have greatly strength-

ened, well before the international improvement picked up speed. This is why Chile and Mexico are rated "investment grade" and others, such as Brazil and my own country of Peru, are rapidly gaining ground. In Peru, for example, the consolidated public sector deficit is down to about 1 percent of GDP (with a central government surplus), domestic interest rates have plummeted, and exports are up 70 percent in three years (up 50 percent by volume), while domestic inflation is comparable to that of the United States.

A key element in decoupling is building up domestic capital markets. Chile has been the pioneer: as private pension funds have grown, the financial effects have spread to insurance companies and mutual funds, giving local capital markets much greater depth, especially in the bond market with greater liquidity and longer maturities. In Peru, private prime corporate borrowers regularly tap the soles market, at fixed rates to seven years and variable rates up to twenty-five years, as does the government. We are studying prepaying a part of our Paris Club debt through a local issue, thereby reducing the foreign exchange exposure of our debt.

Finally, another key element is to reduce the burden of public debt as a percentage of GDP, a natural outcome of pursuing prudent fiscal policies, especially during times of bonanza. Some Latin American countries still have debt ratios that are too high. In order to begin to gain a reasonable degree of financial independence, these debt ratios must come down sharply, especially at a times such as now.

2005 seems too soon to worry.

JEFFREY FRANKEL
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Easy monetary policy in the form of low real interest rates, especially in the United States, helped fuel the flow of capital into emerging markets during 2002–04, as it did in the late 1970s and the early 1990s. It is also clear that tightening of monetary policy during 1980–82 helped precipitate the international debt crisis, and the same in 1994 for the Mexican peso crisis. The question is, with U.S. interest rates now again on the rise in 2005, will international investors this year pull out of emerging markets and precipitate a new round of crises? Other markets now look vulnerable to a reversal of the 2001–04 "dollar carry trade"—U.S. bonds, real estate, commodities—so why not also emerging markets?

Interest rates are of course not the only determinant of the demand for emerging market securities. Prospects for growth are as relevant as the discount rate. Such prospects look good for many developing countries.

Equally as important as actual growth fundamentals is investor sentiment. The waves of sentiment for emerging markets seem to follow the biblical pattern: seven fat years followed by seven lean years. Consider the last three decades:

- Strong capital inflows during the seven years from 1975 to 1982;
- Net outflows during the "lost decade" that followed the 1982 international debt crisis from 1983 to 1989;
- Strong inflows again from 1990 to 1996; and
- Outflows during the East Asian and subsequent crises, 1997–2002.

If this pattern holds true, we are still at a relatively early stage of the latest boom phase of the cycle, and not particularly vulnerable to interest rates or other shocks. Is the biblical cycle to be taken seriously? What is the mechanism?

Seven years may be how long it takes for a given class of investors to forget about the risk of a crash, to decide exuberantly that they are living in a new world, and to overextend themselves. Perhaps the mechanism is job turnover in banks and other institutional investors. In any case, 2005 seems too soon to worry. Memories are still fresh. Today's investors are aware of the risks, and not overextended.

There is a possible "sea change" underway, but it depends on how the Fed goes.

JIM O'NEILL
Head, Global Economic Research, Goldman Sachs International

The apparent resilience from major emerging markets to the Fed tightening cycle so far raises the possibility that we have entered a "sea change" in terms of historical comparisons. What is not clear is whether this will persist if the Fed continues to tighten. The answer will depend on exactly how and why the Fed will need to tighten further, and also whether there are true fundamental changes to major emerging markets.

We have showed that by 2050, there is a possibility that the combined GDP of the so-called BRICs (Brazil, Russia, China, and India) economies could exceed the combined GDP of the current G6 (G7 minus Canada). This prospect has been influential in driving financial markets in the past couple of years in addition to the cyclical strength of their economies and overall balance of payments situation. Normally, most emerging market nations will run balance of payments deficits to varying degrees. Currently, the BRICs economies appear to be posting strong basic surpluses. Linked to this economic health, the appearance of the BRICs nations at the February G7 meeting was *de facto* recognition of their growing importance to the world, thus warranting perhaps some permanent reduction in the associated risk premia.

Despite these optimistic factors, the improved performance of emerging markets is taking place at the same time as strong belief that the Federal Reserve will only need to raise interest rates modestly in the coming year or so. At the moment, futures markets expect a Fed funds rate close to 3.5 percent by the end of 2005, and more generally markets seem to be debating whether the Fed will need to raise rates beyond 4 percent or not. If there was an inflation surprise in coming months, and markets were forced to reconsider Fed policy and anticipate, for example, the risk of short rates rising to 6 percent or higher, then this might be a more challenging environment for emerging markets. Indeed, it would probably require such a challenge before one could conclude that emerging market borrowers are less vulnerable than in the past. To help provide a positive answer, it remains important that key emerging market nations continue with their generally impressive policies including adopting the best macro policy practices from the major economies. On balance, circumstances warrant a continued optimistic stance toward emerging market debt.

The Asian economies will definitely be affected.

WILLIAM H. OVERHOLT
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U.S. interest rates still drive Asian interest rates and economic performance.

First, over a period of time economies whose currencies are tied to the U.S. dollar come under pressure for interest rate parity with the United States. The economic consequences are strongest in Hong Kong with its small economy and sensitive property sector. But other forces also affect rates.

Second, if U.S. interest rates tighten sufficiently to mop up loose money, the rising tide of U.S. imports necessarily decelerates. The trade adjustment will be very difficult for Asia and Latin America. In Asia, that is unlikely to cause economic contraction, but it is very consequential. It will decrease U.S. demand from China and therefore decrease Chinese demand for imports from the smaller Asian economies and Japan. The primary effect in China is not to raise interest rates, but rather to reduce loan volume, worsen overcapacity, and increase non-performing loans; the impact is deferred but it is hard to overemphasize the scale of overcapacity and the potential consequences of rapid consolidation. In the rest of Asia, it will reduce capacity utilization and widen credit spreads.

Third, loose money in the United States has created U.S. dollar weakness and triggered vast speculation on Asian currency revaluations—some $75 billion to China last year. Those speculative inflows have been increasing Asian loan volumes and reducing interest rates. If U.S. interest rates were to rise to the point where they began to stabilize the U.S. dollar, the (potentially spectacular) reduction of speculative flows would sharply tighten the volume of lending in China and raise interest rates in other dollar-related economies.

In the meantime, when we don't know where the tipping point on the dollar is, foreign exchange risk rises and should increase risk premiums for numerous Asian businesses.

The issue for the markets is not whether substantial increases in U.S. interest rates would affect emerging markets, but rather how substantial the U.S. increases will actually be.

Most are less vulnerable to swings.

JOHN WILLIAMSON
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So far in this upswing, emerging markets have been able to borrow more, but they have not used the proceeds to run current account deficits. Rather, they have built up their reserves and allowed their citizens to build up their holdings of foreign assets. This makes most emerging markets (doubtless there are exceptions) much less vulnerable to swings in financial conditions in the United States than they traditionally have been. It is this, rather than a greater depth of global financial markets, that is the basis of the hope that this time the emerging markets will be able to decouple themselves from the prospective tightening of U.S. monetary policy.

One may doubt whether most emerging markets will be able to continue running current account surpluses once the adjustment in the U.S. balance of payments starts in earnest, as it will have to do one of these days. But this does not condemn emerging markets to a return to the days of crisis. The level of debt could decline even as countries return to current account deficit provided that the deficit is smaller than the inflow of foreign direct investment minus the outflow of residents' capital. Even if the level of debt rises, vulnerability can still decline over time provided that the growth rate of debt is less than that of GDP and exports. And debt does not need to be the threat that it was in the past if reserves are maintained high, short-term borrowing is discouraged, and most borrowing is in domestic currency rather than dollars. Many countries appear to have learned these lessons, and provided they maintain their prudent stance as the cycle progresses there is every reason to hope that decoupling will remain a reality.

They're less vulnerable than a decade ago, but external events still could produce a serious setback.

DANIEL TARULLO
Professor of Law at Georgetown University and former Assistant to the President for International Economic Policy

It seems a bit churlish to sound a note of caution on emerging market investments, since lately there has been so much to applaud in the policies and performance of those markets. Fiscal and external accounts have been generally well managed. Borrowing has become more diversified, with increasing numbers of issues denominated in euros. Several global issues have even been offered in local currencies, a promising sign that the "original sin" of developing country finances can indeed be expunged. Foreign direct investment, less volatile by nature, is now the most important source of foreign capital in all regions except emerging Europe.

Yet some nagging facts remain. The substantial increases in bank and bonded lending to emerging markets that has compressed spreads below 400 basis points over U.S. Treasuries have been significantly driven by a search for yield. The allocation of investment capital to emerging markets, as well as other high-yield destinations, is dependent on expectations that the Federal Reserve will make good on its promise of measured increases in interest rates. Any more abrupt change could produce some disruption in emerging market capital flows. Needless to say, a less-than-orderly decline in the dollar would be similarly disruptive. Perhaps more importantly, emerging markets—like the rest of the world—are still dependent on continued demand by U.S. consumers for foreign goods and services. Any setbacks in the real economy will quickly be felt abroad, particularly in emerging markets.

In short, in the near term problems in emerging markets are unlikely to begin at home. They are surely less vulnerable to full-fledged crisis than a decade ago. But external events could still produce a serious setback. Policymakers in emerging markets can only hope that the current confidence of U.S. policymakers does not, in retrospect, look more like complaisance. ◆