CAPITAL MARKETS ECONOMICS

Derek Holt (416) 863-7707
derek.holt@scotiabank.com

Dov Zigler (416) 862-3080
dov.zigler@scotiabank.com

Special Report: Should The Fed Pay Heed To Emerging Market Concerns?

- **Delaying tapering because of foreign concerns would only delay the inevitable required adjustments still needed across some but not all emerging markets.**

Blaming the Fed. It's often an emerging market (EM) pastime, but the sharp EM currency and asset market realignment since May reflects a far more fundamental and arguably inevitable force than to simply pin EM challenges upon US monetary policy. As we explain our case, the key market implication is that — within reason — we do not think the Fed will — or should — let EM complaints get in the way of eventually tapering asset purchases. It may be too soon to taper for domestic reasons in our opinion (December is our call), but when the time does come, EM complaints should not stand in the way of the Federal Reserve's ability to tailor monetary policy to the needs of the US economy and markets. To allow this to happen would only delay the inevitable by way of necessary further realignments to global imbalances that require reforms and greater discipline across some (but not all) emerging markets. Indeed, one of our core assertions at Scotiabank remains that not all EM countries are alike and that the broad space must be segmented according to differential risks and opportunities. A knock-on argument is therefore that the impact of the Fed differs based upon the fundamentals of the particular country as opposed to sweeping blanket observations that may not apply to all.

Before delving into our arguments, our thesis is not to deny the role of Federal Reserve policy in influencing emerging markets, but we continue to stress the importance of getting the chicken and egg arguments right. We think that relative GDP growth remains the dominant driver of relative capital flows over time. Monetary policy adjusts to and can amplify changes in relative growth. It is well understood that currencies bear the brunt of these adjustments and often overshoot during the earlier phases of this process. As the Federal Reserve eventually shifts toward reducing the amount of policy accommodation, the carry trade into EMs has become less attractive and thus shifted the capital flows that once represented an embarrassment of riches to many EMs.

EM Complaints Didn't Stop The Fed Over The Entry Phase

That said, our first argument is that the Fed did not pay heed to EM complaints during the phase in which it was cutting its policy rate to the lower zero bound and then rolling out QE1-3 policies and operation twist. It is likely to retain a domestic policy bias on the exit phase that will be drawn out over the years ahead. The economic case for doing so relates to the sheer size of the domestic US economy and its relatively lower degree of reliance upon international trade. The US is an open economy, but it is much less of a passive price-taker in global markets than many other countries. A limit to this argument, however, is that the US would not be well served by a serious crisis in EM countries that rocks global market confidence. This clearly makes the EM space worth monitoring, but it would take greater evidence of a full-blown EM crisis that is not our base case to risk stopping the Fed in its tracks as opposed to treading carefully.

EM Countries Have Had Ample Opportunity To Adjust

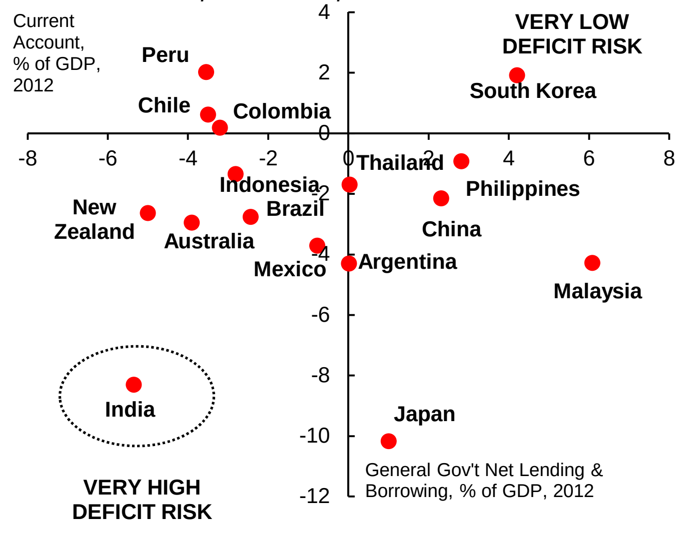
Second, it is not clear that giving emerging markets more time to adjust their own policies by delaying tapering for an extended period will be met by an adequate response given the slow pace of progress toward reforms to date. Indeed, EMs as a group should thank their lucky stars that Fed policy was so stimulative over past years because it gave them a chance to realign domestic policies in the global rebalancing wave after the boom years in their key export markets. A sharp inflow of capital into EM markets may have been wanted less by some than others, but it delayed the process of global rebalancing in investment flows, trade balances, broader current account balances, stockpiled savings, and a panoply of other real and financial market variables. The policy case for delaying these

Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia.economics@scotiabank.com

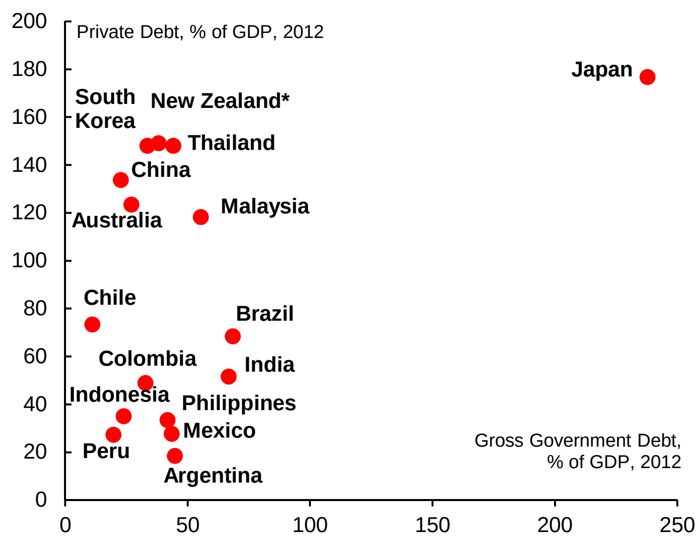
adjustments is that they would have been too abrupt with severe dislocation effects on economies had the Federal Reserve not embraced unconventional policy measures, and that carried benefits to emerging markets themselves in comparison to watching their export markets truly implode and perhaps never recover within a reasonable time frame. This period granted EM countries enormous flexibility during which to realign their policies with less emphasis upon the past growth model that was so heavily skewed toward saving export receipts generated from selling into once rapidly growing and relatively more mature economies. Reforms would have required greater discipline over leverage within EM countries, and policies to unshackle domestic growth drivers and thus lift the allure of their own markets to companies and investors across the deep capital markets of the mature economies. Several EM countries are now challenged because they pursued inadequate reforms. If they did not do so to date, what confidence are we to have that they will truly do so if the Fed provides an extra one, two, three, six or twelve months to adapt before shifting course on monetary policy? True, many emerging markets are more open and less opaque capital markets with floating or dirty-floating currencies (except China) compared to the fixed pegs that existed into the 1997-98 Asian crisis, and often have more foreign reserves and less external debt than at that time. More recent reforms, however, have been inadequate and have arguably stalled out perhaps due to the lack of discipline owing to the world's love affair with EM investments and due to inadequate domestic policy foresight.

Chart 1 **Current Account & Government Net Lending**
No Surprise that Rupee Has Been Nailed



Source: IMF, Bloomberg, Scotiabank Economics.

Chart 2 **What Qualifies as 'Lots of Debt'?**



* 2010 Private Debt. Source: IMF, Bloomberg, Scotiabank Economics.

But The Adjustment Evidence Is Weak

What is the evidence of inadequate adjustment on this count? By multiple measures, several nations across the EM space are paying a price for a sustained focus upon leveraged growth and structural rigidities that have not adapted to the post-boom years in the developed economies. Underlying challenges were papered over by debt and lax regulation. Consider charts 1-4 that we will now assess and that focus upon data from the IMF and World Bank. Recent higher frequency data is deteriorating at a quicker pace in many instances but is not always available for all countries in a commonly defined set.

First is that twin deficits — trade and fiscal — are often large and rising in several countries (chart 1). India is the stand-out in this regard as it is in the worst shape on both fiscal and current account balances. South Korea is in the relatively best shape on these measures with surpluses on both counts. Note that almost all countries in our mixed Asia-Latam EM sample (with some developed markets tossed in because they too are under pressure) are running government deficits with exceptions including Peru, Chile, and Colombia. For many, this is not a new development, including China, India, Indonesia, and Malaysia among others.

Second, evaluating country risk must also consider leverage in both the private and public sectors (chart 2). Shadow banking leverage is more difficult to measure consistently across countries and has a heavy distorting influence in some economies such as China. With that caveat that would only add to leverage concerns, we flag that several of the countries in our sample have hardly been lightweights in terms of drawing heavily upon debt markets to feed domestic excesses over a very extended period of time. While Japan is a mature economy stand-out that distorts the scales, and Australia and New Zealand are not without their challenges, the EM space is replete with examples of countries that have very high private debt burdens including South Korea, Thailand, China and Malaysia. Lax domestic regulatory policies that fostered excessive domestic credit growth have been a contributor to the challenges in several EM nations as their private sectors get maxed out on debt and the currencies adjust to reflect this. As an aside, their own high and rising debt burdens make it passé to blame the world's troubles upon the years of excess leverage in the US economy. Several EM countries that enjoyed a massive terms of trade lift over a prolonged period could have invested the proceeds toward becoming more competitive economies, but instead spent the gains on current consumption and leveraged them. Even among developed nations, Australia's lightweight status on government debt after having nonetheless recently lost its prior net financial asset position has to be weighed against a high private debt burden.

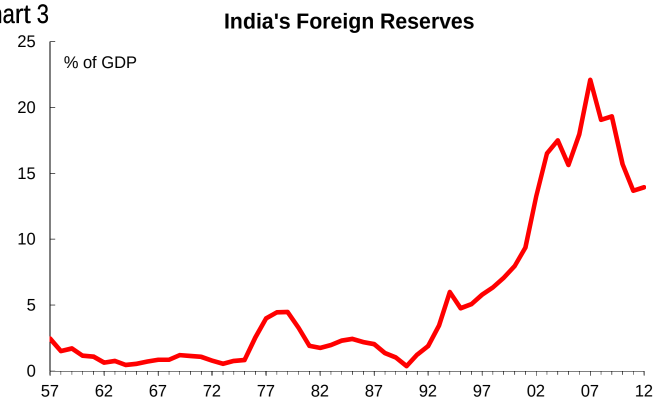
How rapid depreciation in a nation's currency impacts the current account balance by stimulating exports while raising import costs is uncertain, and so is the impact of currency depreciation upon foreign debt payments. To grapple with this uncertainty, we therefore need to assess an additional consideration.

Many nations retain large stockpiled reserves accumulated during the boom years for exports into the mature economies when they were growing more rapidly. Witness India for example (chart 3). These reserves are now under pressure, but this is a natural force across many EM countries as the sources and dispersion of global growth become redistributed and repriced.

Whether those reserves are adequate to defend against speculative attacks depends upon the individual country. Charts 4 and 5 show two ways of considering how a country's reserve buffers stack up by way of their adequacy against further balance of payments risks. One is that countries running large current account deficits and that have modest reserves (in the lower bottom left of chart 4) face the risk of depleting their reserves at a relatively rapid pace and thus potentially making their currencies a sitting duck against predatory trades. Two is that countries that have large external debt obligations owing to reliance upon foreign creditors to fund their leveraged ways alongside small reserves face a potential mismatch on their international balance sheets by way of net currency exposures that is skewed in the direction of sizeable net foreign obligations (chart 5).

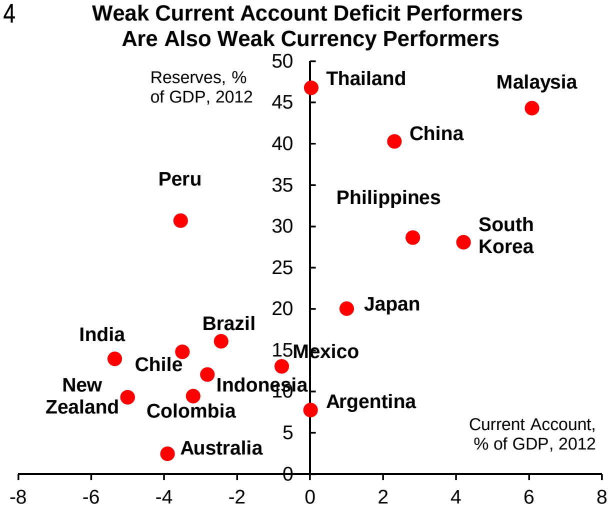
A caveat to assessing the adequacy of an individual country's reserve position shines through in Bank Indonesia's recent swap agreement with the Bank of Japan equal to $12 billion that is designed to share the two countries' FX reserves. This follows on the heels of swap lines between central bank counterparties around the world over recent years as evaluating country risk can no longer be done in the context of just that nation's finances if it can tap another stronger one. In that sense, Japan is very much acting in its own interests since it hardly needs an EM crisis on its doorstep. That doesn't paper over Indonesia's challenges, however, as the country still has to grapple with a sharply weakening position reflected in a high and rising current account

Chart 3



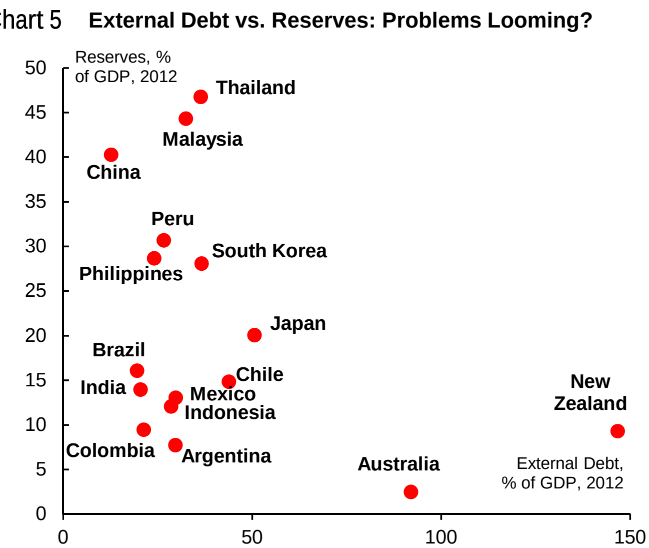
Source: IMF, Scotiabank Economics.

Chart 4



Source: IMF, Bloomberg, Scotiabank Economics.

Chart 5



Source: IMF, World Bank, Scotiabank Economics.

deficit that poses the risk of rapidly eroding the country's own FX reserves that are more modest than several of its Asian peers when scaled relative to the respective sizes of their economies. Having access to Japan's reserves won't be costless and has its limits, but offers insurance against balance of payments difficulties — for a price.

It's Up to Bodies Other Than The Federal Reserve

The Federal Reserve is an important institution with global reach, but it does not have all-encompassing responsibility for solving all of the world's troubles. It is too often blamed for developments in emerging markets in such fashion as to absolve local policymakers from responsibility over their own countries' conditions. It also must be noted that we are cautiously optimistic toward the longer run outlook for the US economy and this may well assist the outlook for many emerging market economies. Apart from the responsibility of individual governments, however, regional and world bodies such as the International Monetary Fund (IMF), Asian Development Bank (ADB), the Association of Southeast Asian Nations (ASEAN) and the Organization For Economic Cooperation And Development (OECD) are also important agencies that need to step up to the plate when actions in one major country or region potentially have an impact upon others. The delicate balance that must be struck here lies between such organizations using a carrot and a stick approach to avoid rewarding poor policy making and irresponsible behavior while simultaneously containing risks facing more prudent countries that themselves may face trouble. The challenge for such world bodies will be to either support of isolate weak links.

Caveats To Our Thesis

In conclusion, the whole global rebalancing argument always had a lot to do with hoarded savings and large current account surpluses in the EM space becoming rebalanced to new conditions in the advanced economies that point to a reduction in longer-run growth potential compared to the boom years. In that sense, what is welcome about currency realignment is that currencies are doing exactly what they should be doing in this context. As export prospects wane relative to imports and current account deficits bloom, currencies need to reprice in the context of the broader leverage, twin deficit, and reserve pictures. If governments and businesses won't take steps to become more competitive, eventually the bottom will fall out of the currency and spark instability in financial markets with disciplining effects on the economy.

Of course, there are three important caveats to our core assertion that the forces affecting emerging markets cannot hold back Federal Reserve plans. One is that strengths in some EMs can succumb to a crisis affecting another via contagion effects and the most recent lesson in this sense was the small country challenge in Europe as relatively modest zones of economic activity tripped up and caused enormous upheaval across the whole block. Even a minority of countries suffering a full-blown balance of payments crisis could therefore alter plans for the Fed and this point makes it important to continue monitoring circumstances.

Second is that the off-balance sheet exposures of many of these countries are not well understood. Recall that Thailand had pledged its reserves into the forward market going into the 1990s crisis.

Third is that we do not know if abrupt relative price swings in capital markets have sparked systemic risk by sharply impairing the viability of some investors to the detriment of global systemic risk. Some global accounts that can make large leveraged bets may have watched markets swing about in unanticipated fashion and this could pose the risk of financial instability. Examples like LTCM are fresh enough in recent memory to merit caution on what may lie beneath the surface. The massive relative price swings across many markets may well have been so rapid and unexpected as to catch large leveraged investors off guard.

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A slide deck is available upon request that provides a fuller history of trends across each of the measures considered within this report and across each of the countries that we have examined.