

WILL EMERGING MARKETS ESCAPE THE NEXT BIG SYSTEMIC FINANCIAL CRISIS?

Kenneth Rogoff

For the past four centuries, emerging market debt crises have broken out like clockwork. In the early period, it was the European countries—the emerging markets of that era—that did the defaulting, with France renegeing on its external debt eight times and Spain, the all-time record holder, 13 times (see Reinhart, Rogoff, and Savastano 2003). Over the last two centuries, it is today’s emerging markets, with countries like Brazil and Mexico having defaulted eight times, and Turkey six times. Venezuela leads them all with nine defaults. Defaults were relatively unknown in Asia until the 1990s, though in large part because most of these countries had been too poor until recently to become major borrowers on the world scene. Another factor, of course, is that they have achieved independence only this century.

Today, the world seems very different, with credit risk premia on emerging market debt near record lows, and most countries in a position to borrow liberally on international capital markets. Indeed, the idea that emerging market countries cannot borrow in their own currency, which Eichenbaum and Hausman (2002) term “original sin,” seems like a distant memory, with many governments having issued large pools of internal market-based debt, with foreigners freely entering these markets. Even countries like Brazil, which has experienced two hyperinflations in the past 20 years, have succeeded in issuing domestic currency bonds sold directly to international investors. Now some people are even asking if European countries like Italy may soon face higher spreads than today’s emerging markets. Has the world been turned upside down?

In this article, I will consider some rather sharply opposing perspectives on the admittedly complex current situation.

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The Optimists

One perspective, advanced by Cooper (2005), among others, is that we are living in a second golden era of globalization, not unlike the halcyon days of the pre-World War I gold standard, where the world enjoyed a long and relatively stable period of growth. According to this perspective, by 2020, Asia will be populated by numerous Korean-success story look-alikes, and the 1990s debt crisis will be seen as a normal growing pain. Latin America, too, will have emerged, with these markets offering real economic growth and financial returns far in excess of anything in the advanced countries. Thus, there is no need for another deep financial crisis, the past is behind us.

A different but also optimistic perspective is that we are in the midst of a global savings glut, potentially implying low real interest rates for a long period to come (Bernanke 2005, Dooley et al. 2004). Low real interest rates bid up the value of income streams from emerging markets, raising their value in much the same way low interest rates bid up global housing prices. Indeed, one could further argue that the effect in emerging markets is even larger because they are plagued by financial market weakness and liquidity constraints, so that easier finance has a disproportionate effect on growth. If low interest rates are really driven by savings trends, and given that savings trends tend to be very long-lived, the benign environment might last for some time to come.

Less Optimistic Perspectives

But there are also less optimistic, and arguably more mainstream, perspectives on the current situation. Even recognizing the favorable overlay of globalization trends and long-term productivity gains, one can still assess the world as in *cyclic* upswing. The International Monetary Fund projects that global growth (in purchasing power parity terms) will be 4.9 percent in 2006, roughly the same as in 2005. Although this growth performance is not as strong as in 2004, when global growth achieved a remarkable 5.3 percent, it is still somewhat above trend growth of the previous two decades. The fact that the world is in the middle stage of an expansion crisis hardly precludes having emerging market crises: one only has to remember the many crises during the middle of the 1990s, but it does make countries have to work harder and go farther astray to have problems.

Relatedly, Bulow and Rogoff (1990) and Bulow, Rogoff, and Bevilacqua (1992) show that commodity price cycles and global real interest rates cycles are the two strongest predictors of emerging

market debt problems. Even if the current low level of global real interest rates were to prevail (not necessarily a central scenario), commodity prices are notoriously cyclical. The world may have changed so that the cycles depend as much on Chinese growth as on U.S. growth, but China too will have cycles, whether the data show it or not. And these will be reflected in commodity price cycles.

Does this mean any particular emerging market will necessarily have to suffer another crisis? Absolutely not. Though few country leaders will admit it, most now follow reasonably conservative macroeconomic policies that basically are in complete compliance with the most essential elements of the much reviled “Washington consensus.” Governments that have seldom or never run budget surpluses are doing so, and thanks to the incredible tide of the U.S. current account deficit, most countries are either in current account surplus, or near it. Collectively, emerging markets and oil-producing economies are running current account surpluses of more than 1.5 percent of world GDP, thereby financing much of the U.S. current account deficit (International Monetary Fund 2005).

Implications of the U.S. Current Account Deficit

The massive U.S. current account deficit—which in 2004 accounted for roughly 75 percent of all current account deficits in the world—is another factor that is taking the pressure off emerging markets. As I have argued in a series of papers with Maurice Obstfeld (2001, 2005, 2006), it is not easy to paint a scenario where this imbalance unwinds or even divides in half—from over 6 percent of U.S. GDP to 3 percent—without a large depreciation of the dollar, especially against Asian currencies and emerging market currencies. If the real price of oil remains high, then the dollar must also depreciate against oil exporters as well.

Obstfeld and Rogoff (2005) show that if the process is driven by a rebalancing of global demand, then even for the U.S. current account deficit to be cut in half, the dollar must depreciate by almost 20 percent on a trade-weighted basis. Only if the unwinding of global current account imbalances takes place extremely slowly—say over 15 years—will it be possible to escape this large depreciation. Over a long transition, shifts in capital and labor across industries and around the globe can obviate the need for major exchange rate shifts. But such a smooth transition hardly seems like the central scenario. Roubini and Setser (2004), for example, illustrate a number of darker outcomes, as does Cline (2005).

What does long-term dollar weakness mean for the vulnerability of

emerging markets? It is critical because downward pressure on the dollar generally means upward pressure on emerging market currencies, raising the value of emerging market output in world markets. Crises tend to happen under precisely the opposite circumstances, when a country's currency unexpectedly depreciates, so that the dollar burden of its debt suddenly becomes more onerous, and typically its banking system falls under pressure. The overlay of dollar weakness is thus very positive for emerging market countries, particularly to the extent that so many continue to quietly follow "Washington consensus" budget policies.

Persistence of Difficulties in Emerging Markets

Does the foregoing mean that even the more pessimistic views really imply that emerging markets will be relatively immune to the next round of crises, where the dollar will be at the epicenter? Unfortunately, a close look at the history of emerging market debt crises suggests that some countries will have problems, almost invariably politically induced. Almost surely, if global growth suddenly slows, or interest rates spike, and commodity prices drop, at least a couple countries will be caught on their back foot. Particularly vulnerable are those countries such as Brazil and Turkey with still very high public debts, more than 50 percent of GDP, far above the levels found relatively safe by Reinhardt, Rogoff, and Savastano (2003) or the subsequent research in the IMF *World Economic Outlook* (2003). For a country such as Brazil, especially, one has to be concerned that growth remains tepid (under 4 percent) even under extraordinarily favorable external circumstances.

Also of concern is the fact that many major emerging markets are facing highly unpredictable elections in the near future, particularly in Mexico where an extreme populist candidate leads the polls, and in South Africa where the 2007 round of succession can lead in any number of divergent directions. Major defaults often happen at precisely the confluence of electoral shifts and uncertainty together with a sharp shift in global markets. One must also look to Central Europe, where many countries (most notably Hungary) are running massive fiscal and current account deficits, while suffering perhaps more than any other region from high energy prices.

Conclusion

The world is no doubt a better place, and the ongoing process of globalization has helped yield a deeper and more sustained expansion

than we might otherwise be enjoying. But the view that we are going to perpetually live in a “goldilocks” economy is just a bit too sanguine. Emerging market debt crises are likely to recur during the next decade and when they do, let’s hope that the world will not be asking, once again, why the powers that be failed to plan adequately for them.

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