

# Press Article

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Economic Analysis

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## Emerging Markets' Complacency in a New Era of Monetary Policy

A small sneeze from the Federal Reserve was enough for the whole emerging world to catch a strong cold, even pneumonia in the case of India and Brazil. In fact, both the rupiah and the real have lost over 15% of their value and their country risk has increased considerably (over 140 basis points in the case of India) since the Federal Reserve started giving signs of a possible exit from its ultra-expansive policy back in May. Interestingly, the market crash in emerging markets is hardly affecting other risky countries elsewhere, such as Southern European ones. Such asymmetric impact seems hard to explain by fundamentals such as external or fiscal indebtedness (half the size for emerging countries) or growth differential (at least double as much growth in the emerging world). In the same vein, any portfolio theory would caution against a reversion of capital flows into emerging markets due to their still very limited weight in investment portfolios compared to their economic weight in the world.

The question, thus, is why these markets have been hit so hard at the first hint of a change in direction in the Fed's monetary policy. My one word answer is complacency. Although the 2008 crisis hit the emerging world abruptly and violently, it happened at the best possible time. Many of these countries had never had such sound fiscal and external positions, not only compared with the developed world but also with their own historical record. Furthermore, there was no hint of a bubble in asset prices in emerging countries in the run-up to the crisis as the euphoria had focused on the developed world. In fact, global savings already had enough on its plate to finance the huge current account deficits of the U.S., United Kingdom, Spain and even Australia. Starting from the soundest situation ever, emerging markets had the room to use aggressive expansionary monetary and fiscal policies to mitigate the impact of a shock that a priori looked huge. The clearest case is China, which was hardly affected by the crisis thanks to an overreaction which has ended up causing an even more unbalanced growth model. Brazil and India also pushed through quite expansionary monetary policies with the caveat that their starting positions were much worse than that of China, both in terms of inflation and public debt. In the case of India, the additional weakness of a very large current account deficit further complicated its situation. Finally, a large group of emerging economies hugely benefited from a prolonged surge in commodity prices, allowing them to maintain a very favorable external position compared with their past experience.

The logical consequence of a shock of the 2008's size not having a major negative impact should have been easy to foresee: Complacency began to take hold of the economic authorities in emerging markets. For the first time they felt they were part of the solution to the crisis rather than the origin of it. In an uncontrolled race to unsustainable growth rates, emerging markets generally maintained excessively lax monetary and fiscal policies. Combined with the hugely unconventional monetary policies conducted by major central banks in the developed world and the resulting volatility in capital flows, bouts of overheating and bubbles in various asset prices could not but appear in several emerging countries. Five years after the 2008 episode, some of the emerging economies have lost much of their strength. At an imminent crossroads in the stance of monetary policy in major central banks (specially the FED), they will have to tackle their vulnerabilities as quickly as possible. Investors are starting to use a magnifying glass to differentiate among emerging countries. Investors' herd behavior should not be expected this time as opposed to 2008.