Have Emerging Markets Become Obsolete Markets?

Until as recent as a year ago, emerging markets were the apple in the eye of global investors. With the collapse of western financial institutions and the impending threat of world recession, emerging markets are now being relegated to oblivion. This survey of the impact of the global financial crisis on emerging markets raises a number of fundamental questions, not all of which have clear or easy answers. One of the key issues raised is whether the global financial crisis is having a direct or indirect impact on all emerging markets, and if so, whether the affect is uniform? The issue is not whether there are winners or losers. It would be folly and blindly optimistic to suggest that some countries are spared the wrath of the fallout, or could actually benefit from the crisis. Some emerging economies are definitely worse off than others. The negative impact in the less fortunate emerging markets is manifested in further deterioration of domestic financial institutions, slowdown in growth and changes in international relative prices. Which countries are the hardest hit by the crisis? Broadly speaking, it is those countries with large balance of payments and fiscal deficits. Why are different markets affected differently? Differences in impact are mainly due to varying affects of the decrease in oil prices on oil and other commodity exporting countries on global markets, differences in the capacity of countries to offer fiscal stimulus packages and to the extent to which exports are represented as a significant portion of GDP. Other more specific factors which contribute to deteriorating conditions linked to the financial crisis include, the depreciating value of currency, the threat of inflation, poor credibility of banks, the limited amount of room for policy maneuver and a notable decline in remittances for those countries that are heavily reliant on remittances as a major source of revenue. The impact of the crisis is further exacerbated in some emerging market regions by financial contagion and the massive outflow of capital in fear of currency devaluation, decline in external demand and changes in prices.

The BRICs’

Whilst several Chinese sovereign wealth funds have lost US$ billions by investing in US banks such as Morgan Stanley and Lehman Brothers, the sub-prime crisis and toxic assets in the US and in Europe crisis have not directly affected the Chinese economy on the whole. The speculative bubble in the luxury housing market in major urban areas of China has also burst, but given that over 12 million migrants gravitate annually to different Chinese cities, the demand for a different type of housing will at least partially absorb decline in demand in the high end housing market. On the other hand, the sharp drop in demand from the US, China’s key export market, is clearly having a detrimental indirect impact on employment. China is fortunate to have a number of internal solutions to combat the crisis including, domestic demand and fiscal balance. Private consumption is still less than 50% of GDP. Hence the government is taking measures to increase consumption. The government’s fiscal package increases spending on education, health and pensions amounts to 5% of GDP. A US$ 586bn central government initiative in new infrastructure projects will also ensure that economic growth is not derailed. China is a net oil importer and benefits from the drop in oil prices. Lower inflation permitting the central bank to lower interest rates and the reserve requirement ratio may also contribute to growth. The decrease in exports presents a risk to China, but possibly not a very high
one given that the nature of production involves majority of inputs being imported from neighboring Asian countries. Therefore, the fallout of the crisis will greatly harm China’s suppliers of inputs (The Economy in 2009: out of the Twilight zone. The BRICs are also suffering, some more than others. La Caixa, Monthly Report, num 320 - January 2009).

While the major Indian IT companies such as Infosys, Wipro and Tata Consulting Services have been hit hard by the financial crisis, given that many of the loss making US financial institutions were their key clients, at a national level, India is also protected from the decrease in global trade, as exports form a relatively smaller part of GDP. The drop in oil prices will also benefit the country and reduction of subsidies on fuel contributes to the government’s ability for maneuver. Nevertheless, the country can be expected to receive less investment flows, resulting in less liquidity in the financial system. As in China, the drop in inflation has led to government ability to reduce the interest rate and reserve requirement ratio. The government has released a stimulus package amounting to more than 1% of GDP.

Brazil and Russia on the other hand, the two countries that depend heavily on commodity exports will suffer most from decreased demand and falling prices for the commodities goods which they export. Falling oil prices will have a marked effect on Russia, as falling revenues will reduce its capacity to carry out expansionary fiscal policies. Depreciation of local currency has lead to increased inflation, which limits monetary policies. Russia was forced to increase interest rates in December in order to stop capital flight from the country, which represents a loss of international reserves, loss of liquidity in the system and reduces access to credit. Brazil maintains a slightly stronger position due to its comparatively more solid fiscal situation and credibility of its central bank, but exports of commodities such as iron ore to China, which represent approximately 40% of its market, will clearly be harmed as result of a decline in global demand. In sum, China’s economic growth is expected to continue to be around 7 – 8%, while the Indian economy is forecasted to grow at 5%, Brazilian growth to drop to 2% and Russia is expected to have negative growth (ibid; 2009). While current trends may suggest that BRICs’ may not become as influential on a global scale by 2050 as suggested by the Goldman’s Sachs report, the reality is that they may become more influential in a shorter period of time, given the expected higher contribution of China and India to Global GDP growth over the next two decades.

Eastern Europe and Central Asia

Eastern Europe and Central Asia regions are deeply affected by the crisis as they are directly linked to Western Europe for exports, remittances and banking systems. Declining remittances will most strongly affect Bosnia and Herzegovina, the Kyrgyz Republic, Moldova and Tajikistan, while more developed countries such as Bulgaria, Hungary, Romania, Serbia, Ukraine and the Baltic States are facing debt rollovers. Finally, commodity exporters will be affected by declining prices of oil and gas, effecting especially Russia, where GDP growth is expected to be less than 3%. Most of the region has been directly hit by the crisis because their main trading partners and key source of credit flows are other Western European countries. Slovakia and the Czech Republic, for
example, have become major suppliers of auto components over the past decade. The global car manufacturing industry is at an all-time historical low, and hence the residuals will be harshly felt in East European countries that specialize in this sector. At least six countries from the region have succumbed to IMF and World Bank bailouts (The Impact of the Financial Crisis on the Developing world, World Bank Research Digest, winter, 2009).

Latin America
The crisis is arriving in Latin America due to financial contagion, drop in external demand, and changes in prices. That the crisis has led to changes in Latin American financial markets is indicated by slower portfolio flows, decreases in stock price indexes and currency adjustments. As external borrowing costs continue to increase, Latin American firms may have to rely on domestic funding. In general less access to credit can be expected. Mexico and Central American countries, with more connection to the US economy through trade links and remittances, will be affected first, while Argentina, Peru, Brazil, and other countries with stronger links to other regions will be affected more slowly. Commodity prices will also cause the crisis to affect different parts of Latin America differently. Half of the countries in the region, generally in Central America and the Caribbean, are net commodity importers, but the relief provided by decreased commodity prices will be offset by decreased remittances and decreased economic growth. Latin America in general is in a good position to confront the crisis than in the past due to improvements in macroeconomic and financial policies and decreased dependency on external capital inflows (Latin America and the Global Crisis, World Bank, Oct 8, 2008).

Sub-Saharan Africa
African banks were insulated from the crisis, but Africa is vulnerable to decreased commodity prices, private capital flows, remittances, tourism and aid. Angola, Chad, Mozambique and Nigeria are expected to be especially affected by the price decline as well as tourism dependent economies such as Kenya, Mauritius and the Seychelles. 77% of remittances to Africa come from the USA and Europe so they are also likely to decrease. The majority of FDI is received by Nigeria and South Africa, but they are also likely to experience greater risk aversion. South Africa meanwhile is vulnerable to global economic slowdown, decreased commodity prices and decreased external capital flows, but the financial sector is less exposed to spillover effects of the financial crisis. The same cannot be said for other commodity exporters such Nigeria (Emerging Market Economies and the Global Financial Crisis: Resilient or Vulnerable in Turbulent Times, Emerging Markets Forum, Jack Boorman, Anupam Basu, Manu Bhaskaran and Claudio Loser, 2008).

Middle East and North Africa
These regions will suffer from commodity price declines despite being well-prepared for the crisis than emerging markets on average due to the strength of the banking system and accumulated foreign reserves in oil-rich countries. However, oil countries will be affected by decreases in oil-prices. Countries with more diversified economies such as
Jordon, Morocco and Tunisia stand to benefit from these decreased prices, but links with European economies also increase their level of risk (ibid; 2008).

South Asia
Governments in South Asia are restricted in their ability to respond to decreased demand due to the previously implemented terms of trade shocks, which have led to a decrease in current account and fiscal balances. The commodity price decline may help the region if changes in terms of trade lead to greater room for policy maneuvers. While the regions banks were relatively insulated, there was significant correction in equity markets as well as decreased bank borrowing and issuance of equity and bonds. GDP growth in the region is expected to be around 4% (The Impact of the Financial Crisis on the Developing world, World Bank Research Digest, winter, 200). IMF World Economic Outlook Update, Global Economic Slump Challenges Policies, January 28, 2009).

The new World Bank Chief Economist, Justin Lin, maintains that investment led growth in the developing world set the stage for deeper effects from the current crisis by increasing export growth, increasing commodity prices, increased foreign direct investment, and remittances. Increase in funding from FDI’s, remittances and exports led to an investment boom. From 2003-2007, the developing world grew more than 5% per year – the highest growth rate in decades. However, this growth also led to the development of similar weaknesses to those found in developed countries such as inflated real estate prices and surges in equity markets. Effects of the crisis on developing countries will include decreases in exports, decreases in investment in emerging markets (and higher interest rates when capital is attainable), and decreased remittances. Currently uncompleted investment projects may either be left uncompleted or, once completed, increase excess production capacity possibly leading to deflation. As the current crisis originates in the developed world, the effects of the crisis will be felt in all of the regions of the developing world, unlike previous crisis, which were regional. (The Impact of the Financial Crisis on Developing Countries, Justin Yifu Lin, World Bank Paper, Oct 31, 2008).

Concluding Remarks
This short survey of emerging market trends illustrates that the detrimental fallout from the financial crisis is inescapable. It also reveals that the impact is felt more sharply by some countries than by others. What policy responses are available to emerging markets to withstand the current crisis? Are stimulus packages and adjustment measures in monetary and fiscal policies available in equal portions to all emerging economies? The short and straight answer is an outright “no”. Investment in infrastructure and social programs are options that are available to large emerging markets from Asia, such as China, that have large foreign currency reserves, but they are clearly not there for most sub-Saharan African countries. What are the ramifications of adhering to the policy recommendations global financial institutions? Capital market liberalization, greater openness to trade, promotion of outward and export led growth, removal of tariffs and non-tariff barriers, and import substitution industrialization strategies were imposed upon emerging economies, as conditions for being eligible for structural adjustment loans from the IMF and the World Bank. Developing countries were encouraged to exploit their
comparative advantage, whether in commodity goods or in manufacturing. Those countries that diligently followed such advice are now waiting for answers from the same institutions. A comprehensive response from the international community will be required to offset current global imbalances. While attention to inward looking policies will once again be reviewed, a return to protectionism of national economies and strong import substitution measures are clearly not viable solutions. Such policy measures would only contribute to further delaying the recovery period from the current global financial crisis.

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