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Assessing EM vulnerability in the run-up to Fed tightening

Financial crises in EM in the early eighties and late nineties were preceded by monetary tightening cycles in the US. With the 2013 taper tantrum fresh in the memory and the Fed moving closer to its first rate hike, it's important to assess the potential negative impact on EM. Although none of the EM analyzed in this short research note seem to be on the brink of collapse, we continue to see risks for several EM.

- Tighter monetary policy in the US has played a catalyst role in the Latin American sovereign debt crisis in the early eighties and the Asian financial crisis in the late nineties. More recently in 2013, EM came under severe pressure when the Fed signaled it was considering the tapering of its third QE program. So the obvious but challenging question is what to expect when the Fed effectively start to hike interest rates.

- It's fairly safe to argue that a crisis similar to those witnessed in the final two decades of the previous century is not on the cards. The most important reason is that by the turn of the century most EM had learned important lessons. The test came in the form of the 2008-2009 Great Recession and was passed with flying colors. Not only did EM show remarkable resilience they also recovered more quickly than DM in general.

- These important lessons include more flexible exchange rates (overcoming the "fear of floating"), less pro-cyclical fiscal policies allowing larger budget deficits in times of crisis, less debt in foreign currency (the original sin) avoiding a currency and maturity mismatch between domestic revenues and foreign liabilities, and significantly more international reserves that can be run down to mitigate currency depreciation. The latter is important because for heavily indebted countries with liabilities in foreign currency, FX depreciation can be contractionary instead of expansionary.

- Renewed capital inflows driven by ultra-low interest rates in DM in the wake of the Great Recession (the search for yield) and policy backsliding in EM running larger current account deficits exposed their fragility in 2013 when the Fed signaled it would not continue its third QE program forever. Few EM were able to escape the turmoil but members of the "Fragile 5" club (India, Indonesia, Turkey, Brazil and S. Africa) proved particularly vulnerable.

- Whether the first rate hike of the Fed will cause more EM turbulence is uncertain. After all, since May 2013, most EM currencies except the CNY, KRW and TWD have already depreciated a lot. The INR (-12%), IDR (-25%), TRY (-30%), BRL (-37%) and ZAR (-22%) have all lost heavily against the USD. Moreover, tightening measures following the first rate hike are also likely to take place much more gradually than was the case in the late seventies and early eighties when Volcker aggressively fought inflation (hiking the policy rate from 10% to almost 18% in two years time) and in the mid-nineties when the Fed took markets by surprise.

- However, all this does not mean that EM are now completely out of the woods and tighter US monetary policy will not pose further problems for EM. Given the current low growth environment, the recent fall in commodity prices and China looking increasingly vulnerable, higher US interest rate could very well expose more EM weakness.

- No single framework will be able to adequately and consistently determine both the exact timing of a crisis event and the selection of countries most exposed to it. Over the last two years, the size and previous deterioration of the current account deficit did a pretty good job to detect the most vulnerable EM. Even

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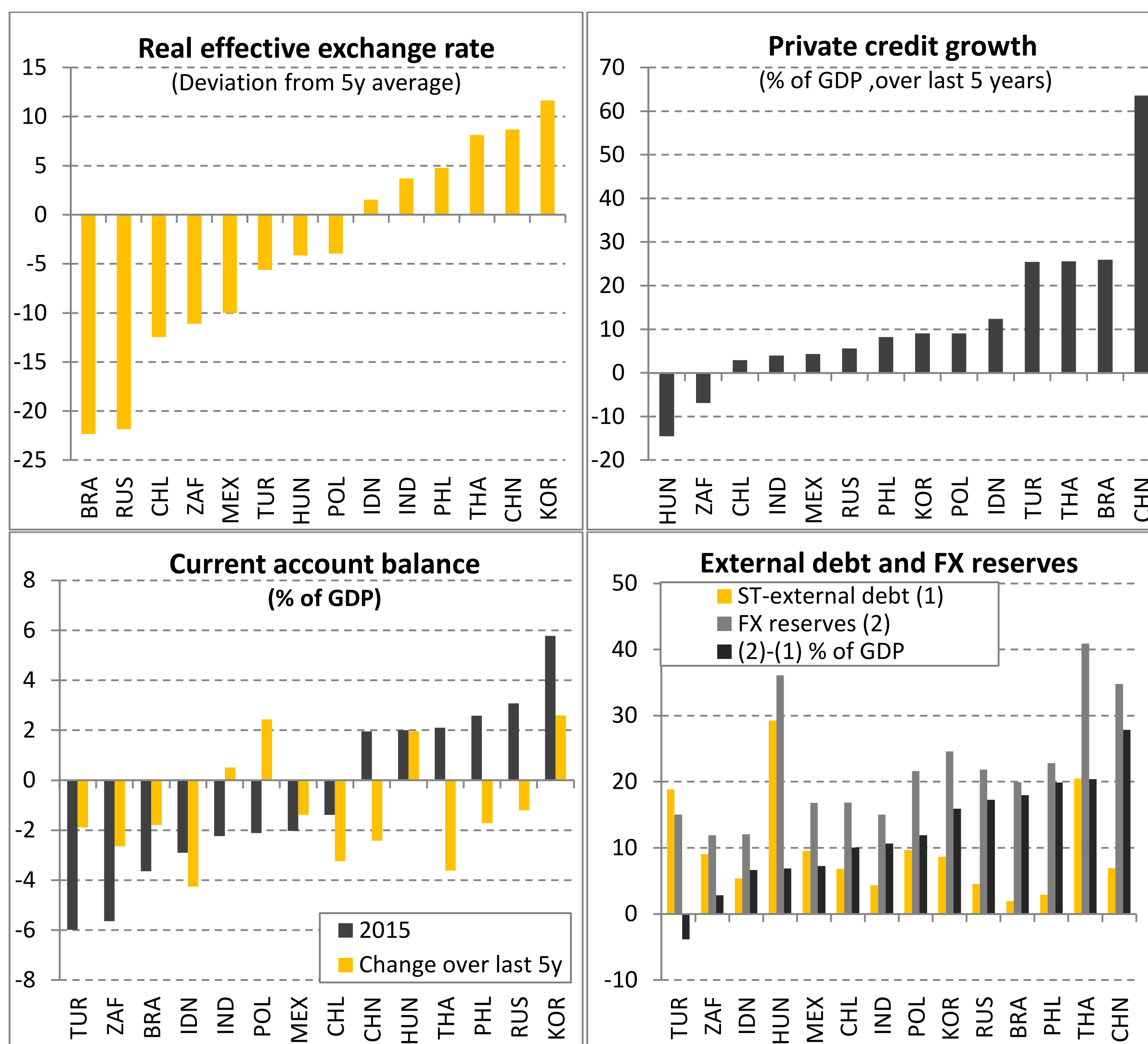
with the currency depreciations witnessed in these EM over the last two years, we see little reason to argue that this will no longer play a role this time around. In addition, economic literature finds that the two most robust predictors of crises in general are real currency appreciation and credit growth with the latter potentially more damaging if more short-term foreign debt is involved. More foreign exchange reserves, on the other hand, reduce the probability of a crisis. Although we find no waterproof arguments to argue that a financial crisis is just around the corner in one or several of the EM analyzed in the exercise below, several interesting (though not necessarily new) conclusions can be drawn.



- China and Thailand have seen fast credit growth, significant real exchange rate appreciation and also deterioration of their current account position in recent years. These are all clear warning signals that deserve close monitoring even though the presence of a large amount of international reserves reduces the likelihood of an imminent crisis in these countries.

- The KRW has appreciated significantly in real trade weighted terms in recent years. Against the backdrop of the depreciation seen in Japan, one of Korea's main competitors, it's difficult to imagine that the Korean economy will stay immune for this.

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- Although over the last five years no EM has experienced a credit boom like the one witnessed in China, credit growth in Brazil, Thailand and Turkey has been clearly unsustainable. The latter country is even more vulnerable when its external position is taken into account.

- External vulnerability remains highest in Turkey and S. Africa. Brazil still copes with a sizeable current account deficit but several factors including the depreciation seen over the last five years, the proportion of FDI inflows (more stable), and large pool of FX reserves mitigate the external risk.

- Finally, with regard to India and Indonesia, the other two members of the "Fragile 5" club, their position now appears stronger. Last year's elections in both countries have produced a change in leadership and the implementation of a new set of reforms in order to increase domestic savings. These countries, and India in particular, are likely to prove much more resilient in case a new wave of panic hits EM.

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