How Vulnerable are Emerging Economies?

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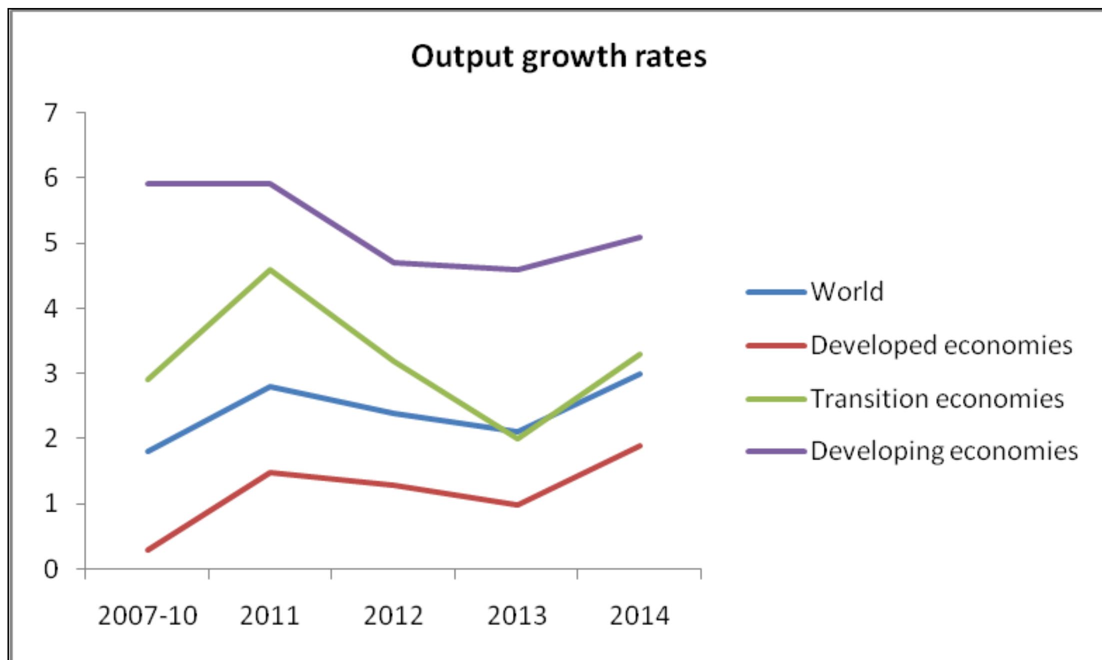
The general consensus seems to be that most emerging markets are in for a bit of a rough ride in the coming year. The economic recovery in the North is still weak and quite fragile, subject to all sorts of risks that may not be so easy to deal with. And, as Chart 1 shows, despite all talk of decoupling, global output is still highly synchronised. So changes in GDP across developed and developing countries are still broadly in the same direction over the different years.

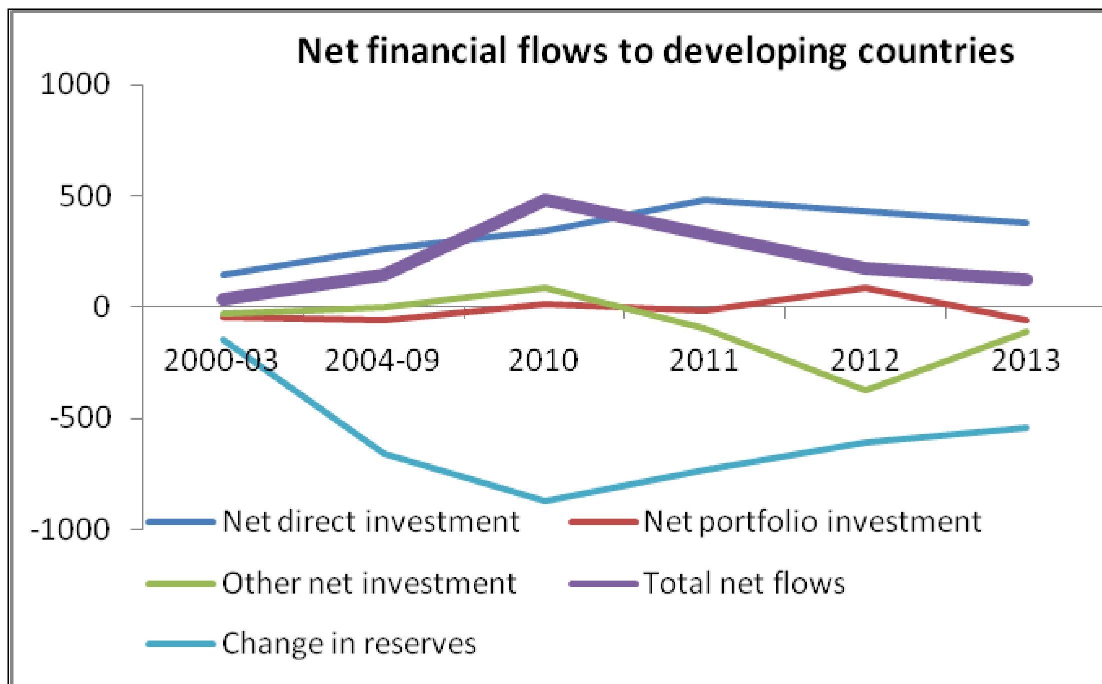
Chart 1: Global output is still synchronized



Partly this is due to the effect of trade, which has become the major driver of economic expansion across the developing world. While South-South trade is increasing, North-South trade still occupies a significant role in total world trade, at around 40 per cent. And since much South-South trade is in intermediate goods with final demand in the North, there is an important indirect effect as well.

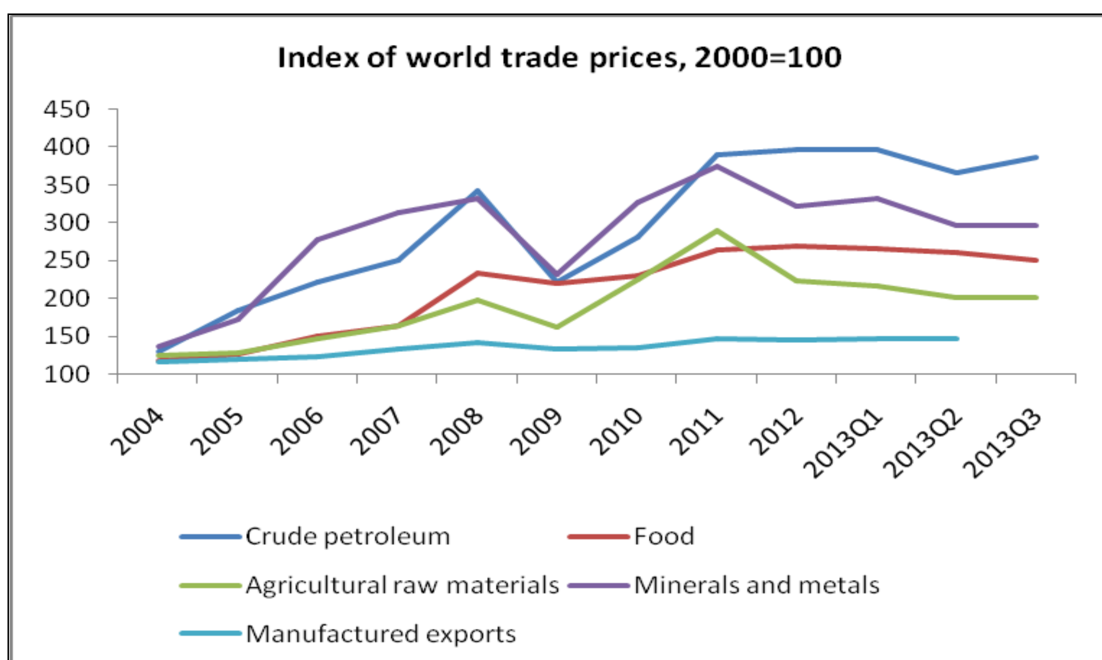
The other important reason is capital flows, which have become drivers of volatility in the emerging countries, even if they are not always responsible for more investment or output growth. Chart 2 shows that net financial flows to developing countries have been falling since 2010. Both portfolio capital flows and other net investment (such a commercial lending) were negative in 2013, while in any case net inflows were dwarfed by the continued build-up of external reserves by developing countries as a group. While such reserve accumulation has come down a bit since its peak in 2010, it was still very large at about $550 billion in 2013. But capital flows may reverse even more once developed countries start to tighten their monetary policies.

Chart 2: Capital flows to developing countries are much more volatile



The other impact comes from primary commodity prices, which affect developing countries as both exporters and importers. Chart 3 shows that other than for crude petroleum prices, most primary commodity prices have been coming down from the most recent peak of 2011. However, while the commodity super-cycle may now be on the downtrend, such prices remain volatile because of the continued involvement of financial players in such markets. Meanwhile, exporters of raw materials and minerals face lower prices than earlier. However, manufactured export prices have been flat for some years now, reflecting some overcapacity among manufactured goods exporters of developing countries in the context of the global slowdown.

Chart 3: Primary commodity movements can work both ways



So what are the short-term risks for developing countries in the volatile global economy? Four risks need to be highlighted because they are common to several of the major emerging economies, including India.

First is the possibility of "disorderly adjustment" (which could even lead in some cases to exchange rate or balance of payments crises) to the tightening of monetary policy in the US and Europe. The "extraordinary measures" that were put in place by the US Federal Reserve in terms of huge expansion of liquidity and near-zero interest rates have already begun to be reversed, or "tapered". This has already created two episodes of capital flight from emerging markets, an unpleasant foretaste of what may be in store when the tightening begins in earnest.

Second is the fact that most of the major emerging market economies are themselves in some danger of financial crisis because of internal concerns, such as currency and maturity mismatches in external borrowing and domestic financial bubbles. Some asset bubbles (in stock markets and real estate) have already started to subside in some countries, while others may burst more roughly. Both have adverse implications for financial stability, especially since the financial interconnectedness has grown greatly because of shadow banking and other tendencies.

Third is the continued prospect of volatility in global markets for food, fuel and currencies because of the unpredictable role of financial investors who continue to have significant involvement. Even very short-term movements that are later reversed in direction can have significant and unpleasant effects within developing countries, adding to both financial and real economic fragility.

Fourth is the fact that export markets of most developing countries are likely to be increasingly constrained. Manufactured exporters are already facing stagnant prices (falling in real terms) and shrinking markets, with heightened competitive pressures. Primary commodity exporters are also facing falling and volatile prices. The rebalancing of the global economy is very much under way, with the US trade deficit falling rapidly and the Chinese trade surplus also coming down. The consequences for other countries are not easy, because this means net declines in export markets at a time when many countries face balance of payments and currency pressures.

In particular, the impact of Chinese rebalancing is likely to be very significant for other developing countries because China has become the most significant trade partner for most developing nations. There are already signs of the start of a shift at the margin in China, away from investment and net exports towards household consumption. This will affect China's imports, with a possible reduction in the share of iron ore, copper and machinery and electrical goods and parts. However, given the continued pace of urbanisation and infrastructure development in China, this change will be relatively slow and may not be so acute for particular products. But China's trading partners will need to consider how to alter their own export composition to cater to the new patterns of demand emanating from within the country.

So there is a formidable set of economic challenges for developing countries in the near future. The surprise is that so far at least, this does not seem to be factored into economic policies in most countries.

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