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Emerging Economies' Misinsurance Problem

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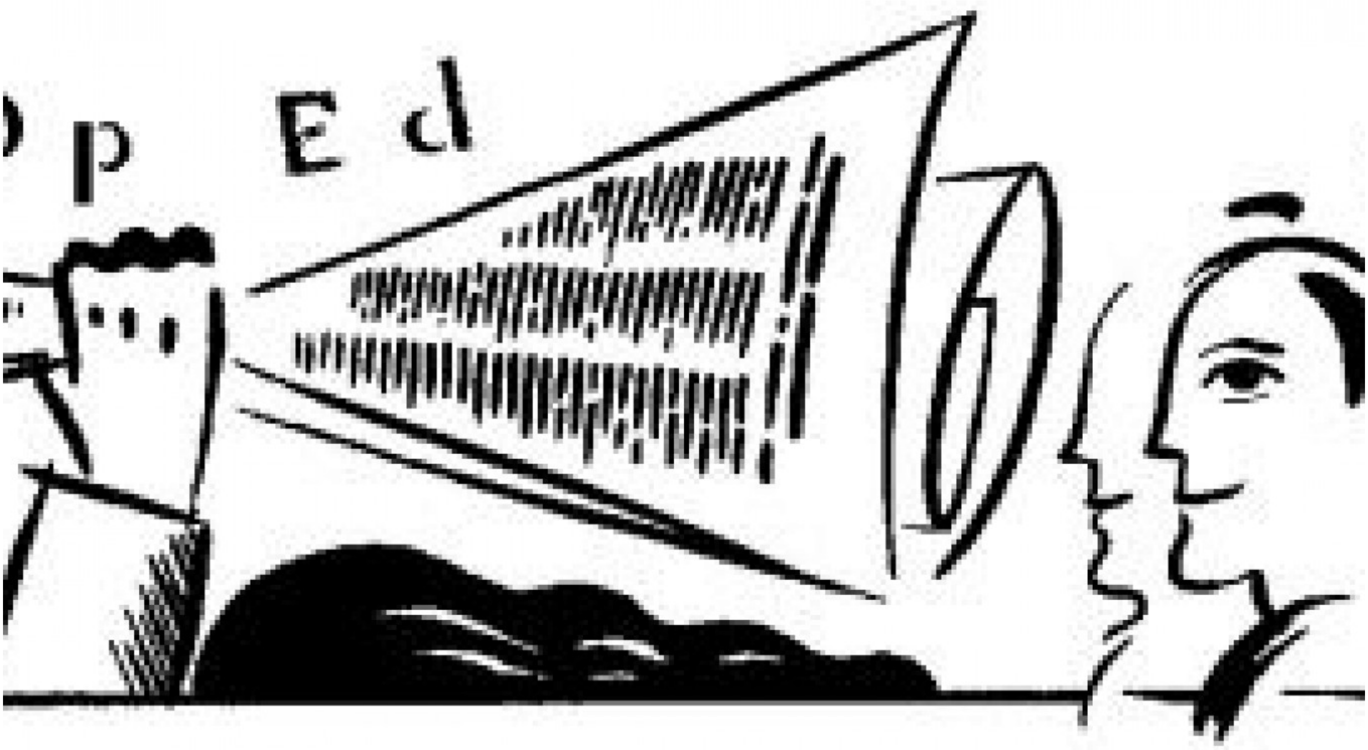

Over the past decade, U.S. expansionary monetary policy and China's rapid growth have been the two key drivers of global financial flows. Now both dynamics are being reversed, generating new risks for the global economy — particularly for emerging countries. Whether they can cope with these changes will depend on whether they have taken out enough insurance against the right risks.

Following the Asian financial crisis of the late 1990s, emerging economies began to accumulate massive foreign exchange reserves to protect themselves against the risks of external over-indebtedness. In fact, they amassed far more than they needed — $6.5 trillion at last count. This means they are effectively over-insuring against external balance-of-payments shocks.

But they remained underinsured against domestic credit risks, the leading threat to emerging economies today. After the global financial crisis erupted in 2008, interest rates plummeted, fueling private-sector credit booms in many of the largest emerging markets, including

Brazil, India, Indonesia and Turkey.

Although these booms were initially financed by domestic capital, they soon became dependent on foreign capital, which flowed into their economies as advanced-country central banks pumped huge amounts of liquidity into financial markets. Now just as the U.S. Federal Reserve contemplates an exit from its unconventional monetary policies, emerging economies' current-account positions are weakening, making their reliance on capital inflows increasingly apparent — and increasingly dangerous.

Ironically, today's pain stems from one of the great successes that emerging economies have achieved: the reduction of foreign-currency funding in favor of local-currency debt. As emerging-market central banks leaned against heavy capital inflows to mitigate exchange-rate appreciation, their currencies became less volatile. The resulting perception that currency risk was declining bolstered capital inflows further.

This virtuous feedback loop has now turned vicious, with capital inflows amounting to only a fraction of outflows. Given this, the likely upshot of monetary tightening in the advanced economies will be a long depreciation of emerging-market currencies and, in turn, a significant interest-rate hike — a trend that puts emerging economies at risk for the kinds of credit crises that have bedeviled developed economies over the past six years.

The higher interest rates rise to stabilize emerging markets' currencies, the more severe their crises will be. Ultimately, even if emerging economies manage to diversify their funding away from foreign currencies, they will remain hostages to U.S. monetary-policy cycles.

Had emerging economies resisted the temptation of excessive private-sector credit growth, raising interest rates to stabilize currencies would not pose a severe threat to economic performance. But unsurprisingly, they did not. Rather, they succumbed to the notion that unprecedentedly high rates of growth in gross domestic product were the new normal.

Nowhere was this more apparent than in China, where double-digit annual output gains long obscured the flaws in a state-led, credit-fueled growth model that favors state-owned enterprises and selected industries, like the real estate sector, to the detriment of private savers.

Since 2008, banking-sector credit growth in China has been among the fastest in the world, far outpacing GDP growth, and China's total debt has risen from 130 percent of GDP to 220 percent of GDP. As of this year, 1 yuan of GDP growth is consistent with more than 3.5 yuan of credit growth. China's financial sector is now increasingly feeling the strain of this rapid credit growth, which has led to overcapacity in favored sectors and mounting debt problems for local governments, state-owned enterprises and banks.

Meanwhile, China's shadow-banking system has expanded at an unprecedented rate. But here, too, mounting risks have been largely ignored, owing partly to the collateralization of real property, which is believed to retain its value permanently, and partly to the system of implicit government guarantees that backs loans to local governments and state-owned enterprises.

At the very least, the combination of higher interest rates in the shadow-banking sector and weaker nominal GDP growth undermines borrowers' debt-repayment capacity. In a worst-case scenario, falling property prices or diminishing faith in implicit government guarantees would compound the risks generated by the shadow-banking system, severely undermining China's financial stability.

In that sense, although China, with its $3.5 trillion stock of foreign-exchange reserves, may seem to exemplify emerging economies' tendency to be over-insured against external risks, it actually faces the same credit risks as its counterparts. The difference is that China has implemented structural — and thus longer-lasting — credit-based policies, while other emerging economies have been drawn into a cyclical lending binge.

Indeed, China's slowness to implement an alternative to the investment-led, debt-financed growth model that has prevailed for the last two decades means that its domestic credit risks are the most significant threat to the global economy today. While China may have the financial resources to cover its debt overhang, it risks being left with a low-to-middle-income economy, high debt levels and nominal growth rates roughly two-thirds lower than the 17 percent average annual rate achieved from 2004 to 2011. This is bad news for other emerging economies, which have depended heavily on China's growth for their own.

Unless emerging-market governments take advantage of the limited space provided by their foreign-exchange reserves and floating currencies to enact vital structural reforms, the onus of adjustment will fall on interest rates, compounding the effects of slowing growth and the risks associated with bad debt. Whether this becomes a systemic issue affecting the entire global economy will hinge on China.

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