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Quantitative easing: End of the line

By Robin Wigglesworth and Stefan Wagstyl

With the Fed eyeing an exit from loose monetary policy, emerging markets are coming under pressure

International investors have long shunned Honduras, an impoverished Central American country plagued by violence and coups. That changed this year.

Although Honduras struggles to pay its bills and suffers one of the world's highest murder rates, it made a bond market debut in March, with investors happy to lend $500m for the next decade. Without the bond, the country could well have defaulted on domestic debts. In large part, Honduras can thank the US Federal Reserve for its unlikely salvation.

The Fed has been at the forefront of central banks seeking to stimulate economic recoveries through creating trillions of dollars to buy bonds and wrestle down global interest rates. Much of the new money has spilled into the developing world as investors have desperately sought better returns in

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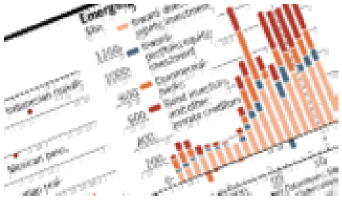

Equity sell-offs, currencies and net private flows

new markets. This helped countries from Honduras to Rwanda gain access to international capital for the first time, and buoyed the bigger developing markets.

But Ben Bernanke, the Fed chairman, has reminded investors and borrowers of an inconvenient truth: the party cannot last forever. On May 22 Mr Bernanke told the US Congress that the Fed's $85bn-a-month bond purchases could soon be reduced – a message he reiterated last week. His words have echoed across global financial markets but nowhere as loudly as in emerging economies.

The subsequent sell-off in currencies, stocks and bonds has been sharp, deep and indiscriminate. Investor favourites such as Mexico have suffered almost as much as less favoured countries. "We've been absolutely spanked," says one hedge fund manager. Central banks have been forced to intervene to stem currency declines and officials have scrambled to reassure investors but to little avail. The currencies of Turkey and India slid to record lows last week, and emerging stock markets have fallen almost 15 per cent in a month.

Investors have overreacted, argues John Beck of Franklin Templeton, a big US investment group. "The idea that this is a death knell for emerging markets is wrong," he says.

If not a death knell, it is a warning bell. The era of cheap and abundant central bank money will have to end eventually. When this happens, it will raise many difficult questions for emerging markets, which have been among the main beneficiaries of the Fed's policy of quantitative easing.

Some investors are concerned that the recent bout of turbulence could be a harbinger of deeper turmoil when QE ends. "Markets will shiver," says David Jacob, vice-chairman of Henderson Global Investors. "We've become addicted to easy money. I don't see how we can avoid a violent reaction."

If so, will it prove a temporary spell of turmoil – painful but fleeting – as investors and countries adjust to a new monetary era? Or will it herald a more testing period for emerging markets, with echoes of the crisis-riddled 1980s and 1990s?

A final reckoning is probably not imminent. Even if the Fed cuts the QE programme, it is still not raising interest rates. The Bank of Japan is also aggressively buying bonds. Overall, the central bank -financed party could keep rolling for some time.

In many respects, the developing world is also strong enough to deal with any fallout from a change in the US monetary regime. During previous crises, many countries had pegged exchange rates, low reserves, rigid economies and big US dollar-denominated debt burdens. These vulnerabilities have mostly been addressed.

The latter factor – what economists call the “original sin” of emerging markets – has in the past proved particularly toxic. Historically a strengthening US dollar has spelt trouble for emerging markets due to currency pegs and foreign liabilities. But classic original sin has now been much reduced.

In other words, emerging market balance sheets have been transformed, argues Ramin Toloui, a senior fund manager at Pimco. “Markets can go down and economies may slow but they won’t fall into the death spirals of the 1990s,” he says.

Emerging markets are also far less indebted than developed countries. The overall credit-to-gross domestic product ratio is about 70 per cent against the 145 per cent average for advanced economies, according to the International Monetary Fund.

And although economic growth has disappointed recently, the IMF still estimates that output in developing countries will expand an average of 6 per cent annually between 2013 and 2018. Ample foreign currency reserves will act as insulation against any market chills.

Michael Collins of Prudential Fixed Income argues emerging markets are merely experiencing a “mini-bust” triggered by a reappraisal of Fed policy. He points out that many pension funds and insurers are still keen to diversify away from traditional markets and into emerging ones. “Their horizons are longer and some volatility won’t deter them,” he says.

Norway’s $700bn sovereign wealth fund last year changed its bond index to give emerging markets a bigger weighting. Other big SWFs have followed suit. But many investors have been slower. US pension funds and insurers have an average of 4 per cent of assets allocated to emerging markets but many aim to double that over time.

Each additional percentage point increase in portfolio exposure would funnel $485bn into emerging market bonds alone, according to estimates by BlackRock.

Emerging markets for the most part bounced back quickly and strongly from the global financial crisis, demonstrating their newfound resilience. Optimists say that if they could survive this, the end of QE will prove eminently manageable. Some veterans of past emerging market crises scoff at talk of a rerun.

Hung Tran of the Institute of International Finance argues the longer-term outlook remains positive. “The story remains a compelling story because growth in developed markets will be depressed for some time to come,” he says.

Nonetheless, the withdrawal of central bank money is likely to uncover – and exacerbate – several emerging market vulnerabilities.

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Growth is already slowing, and could slow further if local central banks are forced to raise interest rates to defend their wilting currencies. BNP Paribas recently slashed its emerging market growth forecast to 4.8 per cent this year, down half a percentage point from March.

Slower growth is already having an impact on emerging equity markets, which have recently markedly underperformed bourses in supposedly sickly developed markets. Martial Godet of BNP Paribas highlights a “fast and large” deterioration in earnings growth, profitability and margins since 2012.

The most exposed are countries with current account deficits: those that buy more from foreigners than they sell, and need international capital to bridge the difference. That list is now a long one. The overall current account surplus of emerging markets has shrunk from a peak of almost 5 per cent in 2006 to just 1 per cent this year, according to the IMF. Even that is flattered by the huge trade surpluses enjoyed by the oil-rich Middle East states and China.

Morgan Stanley estimates that the developing world has $1.5tn in external funding requirements to roll over every 12 months. While the bank’s analysts do not foresee this being a problem for the vast majority, some countries are “vulnerable” in a new, less forgiving environment.

Michael Riddell, a fund manager at M&G Investments, says that the recent sell-off was merely a “tremor” and remains convinced that “the big one” is still coming. “Things could get messy,” he warns.

Concerns over some specific countries are already apparent. India, Turkey, South Africa and Brazil all have big current account deficits, and their currencies and markets have been among this year’s worst performers. The dangers are magnified for countries where international investment fuelled domestic credit booms, such as Indonesia. Countries dependent on resource exports are also a source of unease, given the slump in commodity prices.

Many countries also rely on foreign investors to finance budget deficits. Hungary stands out as one country with sizeable foreign liabilities. Even those that rely on local bond markets – avoiding the classic original sin of foreign currency debt – face climbing borrowing costs if international investors pull out.

Deutsche Bank highlights countries including Malaysia, Indonesia, Mexico, Poland, Turkey and South Africa, where foreigners make up a large part of the local investor base.

Any erosion of this would “not only create potential balance-of-payments vulnerability but also pose a risk of disruptive rises in bond yields if foreign investors sell”, Deutsche analysts argue. For the moment the pain is being felt by investors. In the longer run, countries themselves "could also experience macro and funding challenges".

In some countries political turmoil is exacerbating investor concerns: Recep Tayyip Erdogan, Turkey's prime minister, has faced public protests; labour unrest has spooked investors in South Africa; and in Brazil, President Dilma Rousseff is facing public anger against corruption, poor services and weak infrastructure.

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So is this time truly different? There will inevitably be casualties in a world of less abundant capital. The tide that previously lifted all ships – including those with leaky hulls, such as Honduras – will be less supportive now that the Fed has shifted its position. Some smaller, poorer countries are particularly vulnerable and officials at the IMF and World Bank are worried about possible developmental consequences. Some projects – such as a convention centre in Kigali, Rwanda, which investors financed this year – may prove to be white elephants.

Nevertheless, the developing world has without question seen immense improvements since past crises. Investors will become more careful and discriminating, although they have recently dumped the good along with the bad. Well-run economies such as the Philippines and Mexico are unlikely to suffer too much damage.

Mr Toloui of Pimco concedes that the "golden era of emerging markets growth has definitely passed". That will necessarily lead to more differentiation by investors. But he argues that the risk of systemic emerging market crises is also greatly reduced.

Others are less optimistic. Stephen Jen of SLJ Macro Partners, a hedge fund, believes investors have piled into emerging markets too uncritically and indiscriminately for the long boom not to end badly. Although he does not foresee a reprise of the crises of the 1990s, he predicts that an inevitable "quake will be a bigger, more intensive version of the tremors we've seen so far".

Additional reporting by Vivianne Rodrigues and Alice Ross

India: Little room to move as economy slows

Jitters about the US Federal Reserve's quantitative easing could scarcely have come at a worse time for India, **writes James Crabtree**.

Even before Ben Bernanke, the Fed chairman, kicked off a volatile month in the markets with his speech in May, Indian growth had sunk to its lowest level in a decade. The current account deficit has climbed to a record 6.7 per cent, an alarmingly high level even for an economy that has long been dependent on foreign capital inflows.

But just as it appeared a return to growth was possible – in part because moderating inflation and fiscal pressures were expected to allow fresh cuts in interest rates – international turbulence sent the rupee to record lows. This forced the Reserve Bank of India to forgo a rate cut last week. The rupee is likely to translate into more costly oil and raw material imports, fuelling inflation and raising the government's subsidy bill.

"Of the larger developing economies, India really does stand out as vulnerable," says Eswar Prasad, an economist at Cornell University, noting flagging growth, weak government and worrying external imbalances.

Raghuram Rajan, the government's chief economic adviser, argued on a cable television news show that India's position was weak but other developing nations were doing just as badly.

"The fact is, across the emerging world growth has tanked," he said.

Yet other experts say a pullback in foreign investment could be especially problematic for an Indian economy where policy makers have little room for remedial measures.

India has been one of the biggest recipients of equity investment in emerging markets, attracting $67bn of inflows since January 2010, more than in the previous decade, according to UBS. That is now under pressure.

Arvind Subramanian of the Peterson Institute says: "India is endangered because its current account is high but there is a deeper concern about its growth story, too.

"Investment is weak, a number of corporates are overextended and the banking system is vulnerable because of that. So where is investment going to come from?"