

Advanced Economies Pose Three Financial Risks to Developing Countries in 2011

By Liliana Rojas-Suarez

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ABSTRACT

As in recent years, the major risks for emerging market economies in 2011 will come not from the policies and actions of the countries themselves, but from developments in advanced economies. There are three major risks: the debt crisis in Europe and the ramifications of potential sovereign defaults, continued sluggish growth in the United States, and China's role in the so-called "currency wars" that are adversely affecting many developing countries. Many developing countries have recently become notably resilient to adverse external shocks; with good macroeconomic policies and some good luck, they may be able to weather the storm, but the United States, Europe, and China have large roles to play in their success or failure to do so.

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Except for some Eastern European countries, developing countries have performed extremely well over the last two years. Not only have most developing regions effectively managed the adverse effects of the international financial crisis, but by 2010 they were back on a path of rapid economic growth. For example, after contracting 1.7 percent during 2009, economic activity in Latin America and the Caribbean grew by 5.7 percent in 2010, surpassing the region's average annual pre-crisis rate of growth. Likewise, sub-Saharan Africa rebounded from a 2.5 percent rate of growth in 2009 to 4.9 percent in 2010, quickly moving back toward its pre-crisis growth path. East Asia grew by 9.3 percent in 2010, and South Asia by 8.7 percent.

As in recent years, the major risks for emerging market economies in 2011 will come not from the policies and actions of the countries themselves, but from developments in advanced economies. In my view there are three major risks:

1. The debt crisis in Europe and the ramifications of potential sovereign defaults
2. Continued sluggish growth in the United States
3. China's role in the so-called "currency wars" that are adversely affecting many developing countries

The debt crisis in Europe

This year will determine prospects for the euro and the euro-zone, where governments and banks need to roll over a lot of maturing debt in the international capital markets. Indeed, according to some market calculations, Greece, Italy, and Spain alone will need to refinance over €65 billion of maturing government bonds in the first quarter of 2011. The estimated governmental refinancing needs of Greece, Ireland, Italy, Portugal, and Spain combined reach more than €270 billion for the year. Investors, uncertain about whether or not these countries can make the fiscal and structural reforms needed to bring their debt-to-GDP ratios back to sustainable levels, are charging higher and higher yields on every new bond issuance. (Or, equivalently, the spreads between government bond yields of these countries and those of Germany are widening.) The recent sharp increase in Portugal's bond yields ahead of important debt auctions is a case in point.¹

¹ On Monday, January 10, 2011, the European Central Bank purchased Portugal's government bonds to control the increase in the yield of 10-year debt, which had reached 7.18 percent. This number is significant because Portugal's officials had previously argued that yields above 7 percent were unsustainable.

If this trend continues—and I see no strong indications of change—sovereign-debt defaults in Europe will become more likely in the coming months. Indeed, I would not be at all surprised if countries begin restructuring their debt in 2011, perhaps starting with Greece and Ireland. The central reason for restructuring would be the same as in most crises: increased borrowing costs for the government bring about a vicious cycle of contracting growth, larger financing needs, and, therefore, further increases in borrowing costs. Countries default when the large fiscal adjustments needed to restore creditworthiness become unpalatable to large segments of society, who through their politicians then demand an abandonment of fiscal austerity.

I would not be too concerned if European defaults could be contained to a couple of countries. The problem is that default in a euro-zone country would be a clear signal that the European Monetary Union cannot continue in its current form, since the default would signify a decision by the European Central Bank to cease financial support to that country. The political implications of such a development are hard to predict, but one thing is certain: under that scenario, unless the European Union and the European Central Bank come up with a *credible* plan to convince the markets and European citizens that selective default in *some* countries is the best alternative to restore long-term credibility in the European Monetary Union, uncertainties will wreak economic havoc and sovereign yields in most other euro-zone countries (excluding Germany and, most likely, France) would jump to unsustainable levels, forcing serial sovereign defaults.

What happens in Europe does not stay in Europe. Defaults would have grave effects on growth and stability in developing. The damage could come through four transmission channels:

1. interconnected financial markets
2. disruptions in global bond markets
3. European bank activity in developing countries
4. the trade channel

Financial markets are highly interconnected, as we learned well during the U.S financial crisis. A sharp decline in European sovereign bonds would affect the balance sheets of many private and public financial institutions around the world, including those developing countries. Central banks in developing countries, which now hold more euro-denominated assets after having diversified the foreign assets they hold as international reserves, would not be spared.

Disruptions in global bond markets would likely follow serial European defaults. These disruptions would cause sharp increases in borrowing costs, which would adversely affect corporations and governments that meet their financing needs on global markets. It is important to note that this transmission channel would affect a number of low-income and lower-middle-income countries that have issued bonds (or are planning to) in international capital markets. For

example, Ghana, The Gambia, and Senegal have recently raised funds by issuing Eurobonds. Last week, Mr. Aganga, Nigeria's finance minister, announced the government's intention to issue its first Eurobond soon.

The activities of major European banks in developing countries make up the third channel of transmission. As UK Chancellor of the Exchequer George Osborne stated in a [recent *Financial Times* article](#), many European banks are not in a strong position.² European defaults would weaken banks' balance sheets even further by reducing the value of European treasury bonds they hold and by increasing the interest rates on loans. Eastern Europe and Latin America would be the hardest hit because European banks are more prominent in their financial systems.

The fourth channel of transmission, trade, would directly and indirectly spread the effects of European defaults to all developing regions. This channel is very well-known and does not require further explanation.

Continued sluggish growth in the United States

The current risk from sluggish growth in the United States, in contrast to those from previous downturns, is related not only to the effects of low growth on trade and financial activity, but—more significantly—to unprecedented U.S. economic policies intended to restore growth.

Let me provide an example. Until the beginning of December 2010, the full burden of achieving faster growth was on the shoulders of the Federal Reserve, which had announced a second round of quantitative easing, dubbed QE2. Its intention was to purchase long-term Treasury bonds to reduce long-term interest rates, increase stock-market prices, and create incentives for Americans to increase consumption. Increasing consumption, the lion's share (albeit decreasing) of U.S. GDP, is essential for economic growth, but this policy decision misses an important point: *as long as the problem of excessive bad debt in the mortgage markets is unresolved* (the so-called debt-overhang), consumers will not borrow and credit will not expand. The main reason is that the value of many existing mortgages is higher than the value of the properties themselves. Many people are therefore disqualified from refinancing their mortgages or taking on new loans. Under these conditions, more liquidity cannot generate more credit; QE2 will do little to stimulate growth in the United States.

At this point a clarification is needed. Observing the recent behavior of 10-year U.S. Treasury yields, some analysts argue that QE2 has not effectively reduced long-term rates. This conclusion is misleading. Long-term interest rates declined from August to November 2010

² George Osborne, "Europe Must Start Putting Its House in Order," *Financial Times* January 5, 2011, <http://www.ft.com/cms/s/0/6055d566-1904-11e0-9c12-00144feab49a.html> [gated].

because of expectations that the Fed would expand liquidity. For example, the 10-year Treasury yield declined by 11 basis points while the 10-year TIPS (Treasury Inflation-Protected Securities) yield declined by 47 basis points. The expansionary fiscal package announced in early December, however, led to a jump in rates that partially offset the initial effect of monetary policy. Thus, the net effect of QE2 has been to maintain interest rates *below what they otherwise would have been in the absence of the policy*. Notwithstanding this clarification, my argument about the limited effect of QE2 in promoting credit and employment remains.

Expansionary monetary policy in the United States is having important effects on developing countries. How, exactly? By increasing capital flows to these economies. Facing low interest rates in the United States, investors are flooding many developing countries with funds directed toward purchasing local assets, including government bonds and equities in local stock exchanges. This raises two important risks for developing countries. The first is the potential of creating asset price bubbles. The second is the risk of a rapid and excessive appreciation of their currencies and the consequent decline in international competitiveness, especially in countries with deep financial markets such as Brazil and South Africa. The Brazilian real has appreciated over 35 percent over the past year. Other countries that experienced significant appreciation of their currencies include Indonesia, Thailand, and Taiwan.

Significantly, the currency appreciations already taking place are complicating the conduct of monetary policy in many developing countries. Ideally, central bankers would like to increase interest rates back to “normal levels” to prevent their economies from overheating. Now, however, doing so is very difficult because higher interest rates would attract more capital inflows, exacerbating the problem. I will further expand on this issue below.

What, then, is the adequate solution to the lack of growth in the United States that can also mitigate risks for emerging markets? The solution for the United States is complex, but a major component lies in the fiscal and regulatory camps. I identify three crucial steps:

1. Resolve the mortgage crisis
2. Implement countercyclical fiscal policies
3. Implement norms and regulations related to the 2010 Financial Reform Bill

The United States needs to resolve the crisis in the mortgage market, perhaps along the lines of a [proposal advanced by Martin Feldstein](#) as early as 2008.³ In addition, a comprehensive restructuring program of the government-sponsored enterprises Fannie Mae and Freddie Mac is a necessary precondition to the full resolution of problems in the mortgage markets. However, it needs to be acknowledged that the solution to the problem will involve recognizing previously

³ Martin Feldstein, “How to Stop the Mortgage Crisis,” *The Wall Street Journal*, March 7, 2008, A15. Available at www.nber.org/feldstein/wsj03072008.html

unrecognized bad loans and that this will possibly lead to further losses in the financial system and, quite likely, larger fiscal costs.

Implementing countercyclical fiscal policies will help. In this regard, the recent Obama package (extending the Bush-era tax cuts, along with unemployment insurance, the payroll tax deductions, and other measures) is good news. However, as the economy recovers, this policy needs to be complemented with a plan to reverse the recent fiscal expansion because, in the medium term, the high level of sovereign debt poses significant threats to U.S. financial stability and to the credibility of the U.S. dollar as the major reserve currency. While there is no consensus among economists about the best way to achieve long-term fiscal sustainability, I share the view of those, such as [Simon Johnson](#) of the Peterson Institute, who argue that cutting taxes for the very rich is not an effective way to stimulate the economy.⁴ Granting that such a policy was implemented to achieve political agreement on a fiscal package, I find that there is no excuse not to reverse it as soon as concrete signs emerge that the United States has begun to recover.

Prompt implementation of norms and regulations related to the Financial Reform Bill approved by Congress in the summer of 2010 is crucial for reviving growth. Without clear rules, the current credit crunch will continue.

For all of us concerned with developing countries' prospects, it is essential to carefully watch whether necessary policy choices are made in the United States. If they are, the observed rapid rates of growth in a number of developing countries will be sustainable; otherwise, the risk of a downturn is quite large.

China's role in the "currency wars"

The third risk I would like to mention involves China, but not its rate of growth (which will continue to be high in 2011) or its problems of inflation and overheating (which I believe are medium- rather than short-term problems). Instead, I wish to focus on its role in the so-called "currency wars" that are adversely affecting many developing countries.

While very low interest rates in the United States—but also in other advanced economies—are at the root of the excessive capital inflows to developing countries, the reluctance of China to appreciate the yuan faster exacerbates pressures for exchange-rate appreciation in many developing countries. This is because appreciation pressures are being absorbed by those capital-recipient countries with more flexible exchange rates.

⁴ Simon Johnson, "What Goldman Sachs Failed to Acknowledge," *Economix* (*New York Times*) blog entry posted January 13, 2011, <http://economix.blogs.nytimes.com/tag/simon-johnson/>

The defensive actions developing countries have taken in response have varied. For example, some countries, especially in Asia and Latin America, are intervening in the foreign exchange market and accumulating international reserves. In a very telling move in early January 2011, Chile, a defender of market-determined exchange rates, announced a policy of intervention in the foreign exchange market. Others such as Brazil, Thailand, and Colombia are imposing capital controls. However, given that capital controls have been relatively mild and that the current external environment strongly attracts investors to developing countries, I do not think that controls can be very effective this time around.

Most importantly, it is scary to think that the use of capital controls might expand more and more around the world. Brazil's recent increase in the number of controls in place is the latest example of this trend. The widespread use of this type of policy can result in what we economists call "the fallacy of composition"—what might be good for each individual country is bad for the system as a whole. In the end, if carried out, such a policy would come back to haunt all countries because the benefits already achieved through globalization could be reduced dramatically.

Aware of these problems, the IMF has just released a [document](#) proposing an increased role for the institution in developing *rules of the game* for global capital flows.⁵ At this time, however, no specific recommendations have been put forward. While I believe that the IMF is the right place to develop rules for global coordination regarding the international movement of capital flows, I doubt that it will get a clear mandate from its membership anytime soon. The vague text in the G-20's recent [communiqué](#) issued in Seoul on this question supports my point.⁶

The obvious solution to the currency wars remains in bilateral coordination between the United States and China. But, unfortunately, that does not seem likely in the foreseeable future.

Having expressed these concerns, I want to end with a positive note. While the risks discussed are indeed large, I am optimistic about the newfound resilience of many developing countries to withstand adverse external shocks. Adequate macroeconomic policies and some good luck (for the commodity exporting countries) will keep these economies growing and in good financial health during 2011. Weighing the risks, I find the potential for sovereign defaults in Europe to be the most frightening since they might trigger substantial turmoil in global financial markets. If, instead, Europe is able to avoid serial defaults, the growth prospects for developing countries, albeit with sharp differences among them, look bright in 2011.

⁵ International Monetary Fund, "The Fund's Role Regarding Cross-Border Capital Flows," approved by Reza Moghadam and Sean Hagan (November 15, 2010), www.imf.org/external/np/pp/eng/2010/111510.pdf.

⁶ "The G-20 Seoul Summit Leaders' Declaration, November 11–12, 2010." Available at www.g20.org/Documents2010/11/seoulsummit_declaration.pdf.