Domino theory
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Where could emerging-market contagion spread next?

THE drought of foreign capital is beginning to wreck many economies in central and eastern Europe. Currencies, shares and bonds are tumbling, and some economists fear that one or more of these countries could default on its foreign debts. Emerging-market crises have a nasty habit of spreading as investors flee one country after another. Some Middle Eastern markets, notably Dubai, are already in trouble. But which of the larger emerging economies are most vulnerable?

To answer that question in the past, economists used to pay most attention to the solvency of governments, and hence their debt-to-GDP ratios. But today, the biggest risk in the emerging world comes not from sovereign borrowing, but from the debts of firms and banks. As foreign capital dries up, they will find it harder to refinance maturing debts or to raise new loans.

If one green bottle should accidentally fall...

Country	Current-account as % of GDP*	Short-term debt as % of reserves*	Banks' loan/ deposit ratio	Overall risk ranking†
South Africa	-10.4	81	1.09	17
Hungary	-4.3	79	1.30	16
Poland	-8.0	38	1.03	14=
South Korea	1.3	102	1.30	14=
Mexico	-2.5	39	0.93	12=
Pakistan	-7.8	27	0.99	12=
Brazil	-1.5	22	1.36	10=
Turkey	-2.3	70	0.83	10=
Russia	1.5	28	1.51	9
Argentina	0.2	63	0.74	8
Venezuela	0.8	58	0.75	7
Indonesia	1.2	88	0.62	6
Thailand	0.3	17	0.88	5
India	-2.4	9	0.74	4
Taiwan	7.9	26	0.87	3
Malaysia	11.3	15	0.72	2
China	5.2	7	0.68	1

Sources: HSBC; Economist Intelligence Unit *2009 forecast †Higher score implies higher risk

Our table (based largely on figures provided by HSBC) uses three indicators to judge how vulnerable economies are to the global credit crunch. The first is the expected current-account balance for this year. Large deficits need to be financed, but banking and portfolio inflows are now scarce, and even foreign direct investment, which used to be seen as less volatile, has fallen sharply this year. Many of the smaller east European economies had double-digit deficits as a share of GDP in 2008, although deep recessions will reduce them this year. Among the countries in the table, Pakistan, South Africa and Poland are tipped to run current-account deficits of 8% or more of GDP this year—the size of Thailand's deficit before its crisis in 1997.

As well as financing a current-account shortfall, a country has to repay or roll over existing debts. If external finance is not available, it must run down its reserves. Thus a useful measure of financing risk is short-term debt (due within 12 months) as a percentage of foreign-exchange reserves. Anything above 100%, implying that debts exceed foreign exchange, should ring alarm bells. (At the start of 1997 Thailand's short-term debt was 130% of its reserves.) The ratio is estimated at over 250% in both Latvia and Estonia, but in all the larger emerging economies it is below 100%. However, HSBC forecasts that South Korea's short-term debt will exceed its shrinking reserves before the year is out. The reserve cover in Indonesia, South Africa and Hungary is also looking thin. Russia's reserves have plunged by more than one-third as the central bank has tried to prop up the rouble, but it still has a comfortable cushion.

The third indicator, the ratio of banks' loans to their deposits, is one measure of the vulnerability of banking systems. When the ratio is over 1.0 (as in, say, Russia, Brazil, South Korea and Hungary), it means that the banks depend on borrowing, often from abroad, to finance domestic lending and so will be squeezed by the global credit crunch.

To get an overall sense of financial vulnerability we have ranked all the countries on each of the three measures and then taken their average score. If all emerging economies were included, the smaller east Europeans, such as Latvia, Ukraine and Romania, would dominate the top of the risk league. Among the 17 larger economies shown in the table, South Africa and Hungary look the most risky; China the least. Hungary has already had to go cap in hand to the IMF for a loan. South Africa may yet have to. Despite higher gold prices, weaker mineral exports are causing its current-account deficit to swell, possibly to more than 10% of GDP this year, at the same time as net foreign direct investment is expected to slump, so the country needs to borrow even more. The rand, which has already fallen sharply, remains one of the most vulnerable emerging-market currencies.

Not again

In contrast, the Asian emerging markets generally look the safest, taking all six slots at the bottom of the table. The main exception is South Korea, which, thanks to its large short-term foreign debts and highly leveraged banks, is deemed to be as risky as Poland. (Vietnam, though not included in the table, also scores high on the risk rating). South Korea is in much healthier shape than during the 1997-98 crisis. For example, it is expected to move back to a small current-account surplus this year and its reserves are much larger. But its banks and its currency still look vulnerable. The won has already fallen by almost 40% against the dollar over the past year, swelling the local-currency value of its foreign debts. Increased financial jitters in east Europe could make it harder for South Korea to roll over the $194 billion debt which falls due this year. But currency-swap agreements with America, Japan and China will give it plenty of firepower to draw on.

The overall score in the table only ranks countries' relative risks. To assess the absolute risk of a crisis you need to estimate external-financing needs (defined as the sum of the current-account balance and the stock of short-term debt) over the next 12 months. Jonathan Anderson, at UBS, has calculated the gap between this and the stock of foreign-exchange reserves for 45 countries. The good news is that only 16 of them have a financing "gap"; in all the others, reserves are more than sufficient to cover a year's worth of payments, even if there were no new capital inflows. Virtually all of those 16 countries are in central and eastern Europe. They include only two large emerging economies from outside the region: Pakistan, which already has an IMF programme, and South Africa. By contrast, South Korea should not have a financing gap, thanks to its expected move back into current-account surplus. Most emerging economies' large reserves will help to keep them out of danger. Unfortunately, the longer that the credit crunch continues, the more those reserves will start to dwindle.

Money's muddled message
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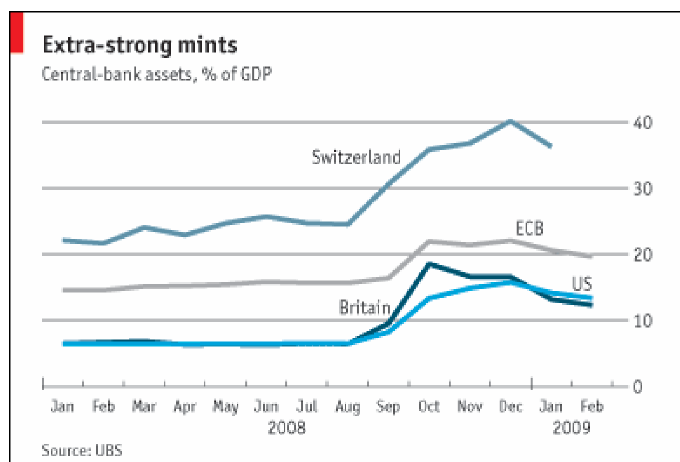
Today's fattened central-bank balance-sheets evoke fears of inflation. Deflation is the bigger worry

BACK in 2002 Ben Bernanke, then still a Federal Reserve governor, declared that "under a paper-money system, a determined government can always generate higher spending and hence positive inflation." That does not mean it is easy.

On March 18th America's inflation rate was reported at 0.2%, year on year, in February. The same day the Fed said "inflation could persist for a time" at uncomfortably low levels. Yet some

economists and investors insist high inflation, even hyperinflation, is lurking in the wings. They have two sources of concern. The first is motive: the world is deleveraging, ie, trying to reduce the ratio of its debts to income. Policymakers might secretly prefer to do that through higher inflation, which lifts nominal incomes, than through the painful processes of cutting spending and retiring debt, or default. The second is captured by the Fed's announcement that it plans to purchase $300 billion in Treasury bonds and an additional $850 billion of mortgage-related debt, bringing such purchases to $1.75 trillion in total, all paid for by printing money. It is not alone: around the world, central-bank balance-sheets have ballooned (see chart).



This is scary stuff to those who swear by Milton Friedman's dictum that "inflation is always and everywhere a monetary phenomenon." But the role of the money supply in creating inflation is less obvious than monetarism suggests.

The quantity theory of money holds that the money supply, multiplied by the rate at which it circulates (called velocity), equals nominal income. Nominal income in turn is the product of real output and prices. But does money supply directly boost nominal income, or does nominal income affect velocity and the demand for money? The mechanism is murky.

Central banks control the narrowest measure of the money supply, called the monetary base—typically, currency plus the reserves that commercial banks hold with the central bank. But the relationships between the monetary base, broader monetary aggregates and nominal income is highly unstable.

Central banks have mostly given up trying to target inflation via the money supply. Instead, they study the "output gap" between total demand and the economy's potential to supply goods and services, determined by such things as the labour force and capital stock, as well as inflation expectations. When demand exceeds supply, inflation rises. When it falls short, inflation falls, and in the extreme becomes deflation. To influence demand, the central banks move a short-term interest rate up or down by adjusting the supply of bank reserves. Changes in the policy rate ripple out to all interest rates paid by borrowers.

The financial crisis has bunged up that transmission mechanism. Risk aversion, fear of default and depleted bank capital have caused private borrowing rates to deviate sharply from policy rates. Central banks have responded by expanding loans to financial institutions, purchasing private securities and buying government debt. They have financed this growth in their assets through increased liabilities such as commercial-bank reserves, swaps with central banks and other ways of printing money.

Is this monetarism? It depends on whom you ask. The Fed calls its policy "credit easing" to emphasise that, though its policy rate is almost zero, it is using different channels to ease credit and boost spending. Even its Treasury purchases are to "improve conditions in private credit markets". That these actions expand the money supply is secondary. Similarly, the Bank of Japan is buying stocks and may make subordinated loans to banks to boost their capital and lending capacity; the money supply is not a consideration. The Bank of England, on the other hand, calls its purchases of government and private debt "quantitative easing" and explains it in monetarist terms. It expands investors' holdings of money, encouraging them to shift to other assets, boosting wealth and investment. It acknowledges this may not work. Indeed, merely the news that it would purchase government debt drove down long-term interest rates, just as the Fed's announcement did, an entirely conventional stimulus to demand. The rhetoric may be different but the policies are largely the same.

If the unprecedented monetary and fiscal stimulus works, output gaps will eventually close. Then central banks will have to reverse their unconventional policies and raise interest rates. They may hesitate in the face of political pressure or an explicit decision to err on the side of inflation rather than deflation. In that case, inflation will rise.

Go forth and multiply

But for the moment deflation is a bigger threat. If the Fed's current policies fail, fiscal policy can be employed to boost demand. There, too, the Fed has a role: it could buy the bonds needed to finance tax cuts or government spending, thereby limiting the impact on long-term rates. Such debt monetisation evokes fears of hyperinflation. But inflation would result only if monetisation boosted aggregate demand enough to exceed aggregate supply. Laurence Meyer of Macroeconomic Advisers, a consultancy, reckons America's output gap will reach 9% of GDP by next year. To eliminate that he says the Fed would have to monetise more than $1 trillion of additional stimulus over two years, assuming standard multiplier effects.

The obstacles are primarily political, not economic. Finance ministers are averse to debt and central banks even more so to monetising it for fear of becoming a tool of the government. That aversion is usually healthy but not when deflation looms. The option should be on the table, as long as there are safeguards for the Fed's independence. Frederic Mishkin, a former Fed governor now at Columbia University, says the important thing is that the Fed, not the Treasury, be the initiator of such purchases, and only after stating that it is consistent with price stability.

On March 15th Mr Bernanke said that the biggest risk facing the economy now is that "we don't have the political will, we don't have the commitment to solve this problem." At least for the moment, it is not the Fed chief's gumption that is lacking.

http://www.economist.com/finance/economicsfocus/PrinterFriendly.cfm?story_id=13326779

Revenge of the Glut

By Paul Krugman | Published: March 1, 2009 | nytimes.com

Remember the good old days, when we used to talk about the "subprime crisis" — and some even thought that this crisis could be "contained"? Oh, the nostalgia!

Fred R. Conrad/The New York Times
Paul Krugman

Today we know that subprime lending was only a small fraction of the problem. Even bad home loans in general were only part of what went wrong. We're living in a world of troubled borrowers, ranging from shopping mall developers

to European "miracle" economies. And new kinds of debt trouble just keep emerging.

How did this global debt crisis happen? Why is it so widespread? The answer, I'd suggest, can be found in a speech Ben Bernanke, the Federal Reserve chairman, gave four years ago. At the time, Mr. Bernanke was trying to be reassuring. But what he said then nonetheless foreshadowed the bust to come.

The speech, titled "The Global Saving Glut and the U.S. Current Account Deficit," offered a novel explanation for the rapid rise of the U.S. trade deficit in the early 21st century. The causes, argued Mr. Bernanke, lay not in America but in Asia.
In the mid-1990s, he pointed out, the emerging economies of Asia had been major importers of capital, borrowing abroad to finance their development. But after the Asian financial crisis of 1997-98 (which seemed like a big deal at the time but looks trivial compared with what's happening now), these countries began protecting themselves by amassing huge war chests of foreign assets, in effect exporting capital to the rest of the world. The result was a world awash in cheap money, looking for somewhere to go.

Most of that money went to the United States — hence our giant trade deficit, because a trade deficit is the flip side of capital inflows. But as Mr. Bernanke correctly pointed out, money surged into other nations as well. In particular, a number of smaller European economies experienced capital inflows that, while much smaller in dollar terms than the flows into the United States, were much larger compared with the size of their economies. Still, much of the global saving glut did end up in America. Why?

Mr. Bernanke cited "the depth and sophistication of the country's financial markets (which, among other things, have allowed households easy access to housing wealth)." Depth, yes. But sophistication? Well, you could say that American bankers, empowered by a quarter-century of deregulatory zeal, led the world in finding sophisticated ways to enrich themselves by hiding risk and fooling investors.

And wide-open, loosely regulated financial systems characterized many of the other recipients of large capital inflows. This may explain the almost eerie correlation between conservative praise two or three years ago and economic disaster today. "Reforms have made Iceland a Nordic tiger," declared a paper from the Cato Institute. "How Ireland Became the Celtic Tiger" was the title of one Heritage Foundation article; "The Estonian Economic Miracle" was the title of another. All three nations are in deep crisis now.

For a while, the inrush of capital created the illusion of wealth in these countries, just as it did for American homeowners: asset prices were rising, currencies were strong, and everything looked fine. But bubbles always burst sooner or later, and yesterday's miracle economies have become today's basket cases, nations whose assets have evaporated but whose debts remain all too real. And these debts are an especially heavy burden because most of the loans were denominated in other countries' currencies.

Nor is the damage confined to the original borrowers. In America, the housing bubble mainly took place along the coasts, but when the bubble burst, demand for manufactured goods, especially cars, collapsed — and that has taken a terrible toll on the industrial heartland. Similarly, Europe's bubbles were mainly around the continent's periphery, yet industrial production in Germany — which never had a financial bubble but is Europe's manufacturing core — is falling rapidly, thanks to a plunge in exports.

If you want to know where the global crisis came from, then, think of it this way: we're looking at the revenge of the glut. And the saving glut is still out there. In fact, it's bigger than ever, now that suddenly impoverished consumers have rediscovered the virtues of thrift and the worldwide property boom, which provided an outlet for all those excess savings, has turned into a worldwide bust.

One way to look at the international situation right now is that we're suffering from a global paradox of thrift: around the world, desired saving exceeds the amount businesses are willing to invest. And the result is a global slump that leaves everyone worse off. So that's how we got into this mess. And we're still looking for the way out.

http://www.nytimes.com/2009/03/02/opinion/02krugman.html?_r=4&em=&adxnnl=1&adxnnlx=1236067413-7csSE7Sv1XgzL4D6VafoNQ

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