Emerging Markets: Deja vu all over again

Jayati Ghosh

So now we have witnessed yet another sell-off of emerging market assets in global financial markets in the last week of January, which has caused currencies to depreciate from Argentina to Indonesia and many countries in between. For those who had seen it coming, it was one more reminder of the extreme fragility generated by global financial integration, and the problems that such exposure can create for developing countries whether or not they also have specifically domestic economic concerns. Essentially, these markets are now so peculiarly integrated into the global financial system that they are part of the collateral damage whenever U.S. monetary or fiscal policy changes.

Indeed, the first round of such capital flight in the middle of 2013 did not even require any actual policy change in the United States. Rather it was generated simply by talk, when U.S. Federal Reserve Chairman Ben Bernanke announced the likely possibility of tapering down the massive monetary stimulus that had been feeding capital markets with huge amounts of liquidity since 2009. Suddenly, “taper” entered the financial lexicon of developing countries with an extremely adverse connotation, as the fear of capital inflows to emerging markets reducing or even reversing in the wake of such a move caused anticipatory movements, often by residents of the countries themselves rather than only external investors.

The irony is that both strategies of the U.S. Fed—first the “extraordinary measures” that unleashed massive liquidity in global markets and then the recent attempts to reduce these somewhat—have created problems for emerging markets. Several of the countries who were particularly badly hit and suffered relatively sharp currency depreciations in 2013—such as Brazil and India, for example—were also the ones that had complained the loudest just the previous year about the adverse effects of the massive quantitative easing indulged in by the U.S. (and the EU) and the policy of very low, near-zero interest rates. In Brazil, the carry trade that was sparked by the interest rate differentials was so large that it caused the Brazilian real to appreciate rapidly, affecting the competitiveness of domestic economic activity and forcing the government to institute some controls on capital inflows in an effort to stem the rush. In India as well, there was significant increase in short-term capital inflows, which became a dubious and ultimately problematic way of financing the burgeoning current account deficit.

While the inflows did pose a problem, the disorderly nature of the outflows has been even worse for these and other economies. And clearly, this is just the beginning. For if the first round of turmoil was created only by a verbal threat of future tapering, the second most recent round has been driven by the gentlest of declines in the U.S. Fed’s extraordinary measures: a reduction of only $10 billion (from $75 billion to $65 billion) in the asset purchases of the U.S. central bank. This can barely be called a tightening of monetary policy yet, as the monetary injection remains huge and interest rates remain low. If and when the U.S. economic recovery advances, this process is likely to strengthen and make matters that much worse for emerging markets in terms of probable capital outflow.

This is the context for the recent outburst by India’s central bank chief, Raghuram Rajan, who lashed out at the U.S. for not thinking of the impact of its monetary policies on the rest of the world. He was quoted as saying that “emerging markets helped pull the global economy out of crisis starting in late 2008. Industrial countries have to play a part in restoring that, and they can’t at this point wash their hands off and say we’ll do what we need to and you do the adjustment. … We would like to live in a world where countries take into account the effect of their policies on other countries and do what is right, broadly, rather than what is just right given the circumstances of that country."

It is hard to believe that a person of Rajan's experience and exposure could be so naive about the drivers of macroeconomic policy in any country and particularly the United State. But this wounded cry highlights the particular vulnerabilities for developing countries that are created by financial integration and capital account liberalisation.

So it is surprising that Rajan's own solutions to India's balance of payments woes have thus far been in the direction of further financial liberalisation and further measures designed to attract hot money flows. It should be obvious that such flows are not stable, and can reverse with any supposed "bad news" about the Indian economy or even "good news" for investors somewhere else. Yet the government of India and the central bank persist in dealing with the problem of the current account deficit by doing whatever they can to somehow finance it for the moment, without addressing the fundamental fragilities created by financial liberalisation in the first place.

In this situation, obviously India and other emerging economies will continue to be buffeted by external winds in damaging ways. As the poet T.S. Eliot wrote, "Think / Neither fear nor courage saves us." What is more likely to save us is something that is apparently still not being considered: a re-regulation of cross-border finance that would reduce or prevent such destabilising flows.

* This article was originally published in the Triple Crisis blog on February 3, 2014.