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Econ 4905

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Brief Overview of the Emerging Markets in 2018

Introduction

Emerging markets refer to a group of countries that are in the phase of a transition from developing to developed. The most commonly cited 10 big emerging markets economies are Argentina, Brazil, China, India, Indonesia, Mexico, Poland, South Africa, South Korea and Turkey. Over the past few years, the inflation rate in most emerging markets have been quite stable.[①] Economic disturbances appeared multiple times but did not have much effect to the macroeconomic in the long run. This year, the emerging markets have been challenged by a continuum of increases in the interest rate in the US, and some other idiosyncratic shocks, to see whether improvements should be made in the policies made by their governments.

① Chart of the inflation rate measured by CPI for emerging markets can be found at https://data.oecd.org/price/inflation-cpi.htm

What happened this year

- *The Strong Dollar Effect*

Due to the Recession in 2002, Fed lowered the interest rate to below 2%, incentivizing the public to take higher risks to compensate for the loss. Then, from Jun 2004 to Aug 2006, Fed has raised the effective federal funds rate from 1% to a little bit over 5%. Then, when the crisis came in 2008, the fed funds rate dropped drastically from 5% to around zero. Quantitative easing was also applied in order to increase the domestic money supply. At that time, due to high returns from the emerging markets, this stimulates investment into those emerging markets. The emerging markets GDP has grown rapidly due to these investments, but as the dollar-denominated debts are piling up, the marginal returns of these investments are decreasing, and the risks are increasing. The fed funds rate was kept at almost the same level until late 2016.

As a result, after the US economy recovered, the Fed gradually raised interest rate. This would make the dollar-denominated assets more attractive, bring investments back to the domestic market, and allow the US to be prepared for the next economic crisis and possibly for the trade war.

When the Fed first started raising interest rates this year in March, the central banks of Turkey, Argentine, and that of many other emerging markets are faced with a major problem where these countries national currency depreciated strongly against the US dollar, consequently causing their real GDP to fall due to the expenditure-shifting effect with a large magnitude.

Though some might argue that the Fed should consider more about its monetary policy affecting the global economy, it is difficult for the Fed to do better about the interest rate. The Fed had to raise the interest rate in 2004, because they need to control the increasing inflation rate, and since the interest rate had been low for a relatively long time, they had to be prepared for the possible asset price bubbles. The action couldn't have been taken earlier than 2004, due to increasing unemployment rate and a decrease in real GDP growth. But the Fed could have tightened the lending standards which would help deleverage, and reduce carry-trade.

- *The Trade War*

The trade war between China and the US might negatively affect the emerging markets, and that the crisis in Argentina and Turkey could be contagious and expand globally. Though the trade war is suspended for now, the US has introduced several rounds of new tariffs, and China announced plans for retaliation, which added uncertainties to economies of countries that involve trading with these two countries. Central banks of emerging markets, such as Turkey, Argentine, India, and Indonesia, have raise interest many times this year. Argentina has asked IMF to boost the $50bn bail-out money. Other emerging markets such as South Africa and Brazil and many more have seen capital outflows.

The US-China trade war is indeed hurting the emerging markets in the short run. However, it is still possible that in the long run, there will be positive impact of the trade war on the emerging markets. For foreign investors, the valuation of emerging markets in portfolios has become more reasonable compared with that of a few years ago. Also, as a result of the trade war, some developing countries could possibly replace China in exporting to the US in the future.

- *Their Effect*

Take Turkey as an example of an emerging market struck by the strong US dollar. A panic took place in Turkey in August, where its currency depreciated around 80% against the US dollar. The central bank could raise interest rate to lower the depreciation rate, a policy that President Recep Tayyip Erdogan of Turkey is not in favor of. On Sept.13, two hours after the President publicly announced his disapproval over raising interest rate, the central bank of Turkey raised the rate from 17.75% to 24%.

Table.1

Time	Previous	Actual
06/07/2018	16.5%	17.75%
09/13/2018	17.75%	24%

Source: *tradingeconomics.com*

This reveals a small portion of turbulence among the policy makers in Turkey, potentially causing a loss in confidence of the investors, and pushing investors further away from these developing countries. Such domestic turbulence took place in other countries as well, such as Argentine, to be mentioned later. Apart from the strong dollar effect, President Trump’s announcement on increasing tariff on steel and aluminum from Turkey accounts for another reason why Turkish Lira depreciates. Turkey now still has problems of high inflation (caused by external price pressures and changes in longer-term inflation expectations.), huge part of GDP being contributed by piles of dollar denominated debts, and high deficit.

Similarly, Argentine Peso has fallen over 50% against USD, Indonesian Rupiah hit the lowest point over the past 20 years, and currencies in other emerging markets all encountered some level of depreciation.

As for Argentina, On Sept. 26th, the IMF agreed to speed up the bail-out loan for Argentina, and additionally, increased the bailout size to $57.1 billion. However, even with such help from IMF, Argentina should still be in turbulence for relatively long time, since President Macri’s term ends in 2019. Political uncertainty about the election adds to its economy’s vulnerability.

Figure.1

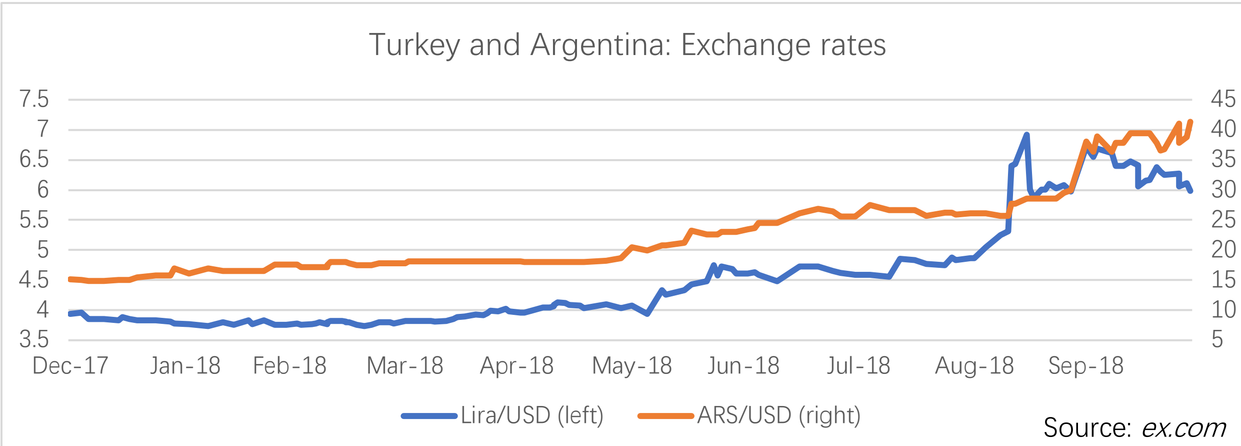

Table.2

12/1/2018	US-China tariff truce
9/26/2018	Fed funds rate reaches 2.25%
9/17-18/2018	China finalizes tariffs on $60 bn of imports from United States
8/23/2018	US and China each impose second phase of $50 bn tariffs
7/6/2018	Tariffs on $34 billion in imports begin.
6/13/2018	Fed funds rate reaches 2.0%
5/29/2018	U.S. announces that it's moving ahead with tariffs on $50 billion of imports and a plan to curb investment in sensitive technology.
3/21/2018	Fed funds rate reaches 1.75%

Source: PIIE

However, comparison of the dates where Lira and Peso sharply depreciated with important dates regarding progress of trade war and the Fed raising interest rate, there seems to be no instant or direct impact of trade war on Lira and Peso. Instead, a sharp depreciation of Lira happened after Erdogan's comment on no raise in interest rate, and Peso depreciated smoother – Only recently has peso paused the signal of continuum of depreciation, which could be accounted for by help from the IMF. As the Fed has not yet raised the interest rate a fourth time, and the trade war held paused, it remained unclear how the emerging markets will go.

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