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Emerging markets need bigger war chest

By John Plender

Every now and then, markets are overtaken by an urge to rethink risk. Since early January they have done so in a big way, in relation to equities generally and emerging market economies in particular. One part of the story is about politics. Events in Thailand, Ukraine, Turkey and South Africa, to name a few obvious suspects, suggest that political risk has been underpriced for some time. It seems the elites of the developing world, who have been pouring capital into property in London and other cities in the US and Europe, have shown a more acute sense of the fragility of their countries' governance than western investors have done.

The more important reason for market turmoil is that the growth prospects of emerging economies are being reassessed in light of tightening global financial conditions as the US Federal Reserve continues to reduce its bond purchases. Here there is a risk that pessimism becomes self-fulfilling. The negative market reaction to recent rises in interest rates in Turkey, India and South Africa implies that investors will not be reassured without bigger rate hikes. So growth prospects look worse and more capital flows out of countries with big external financing requirements.

The chief destination is the US Treasury market. An old-fashioned flight to quality has caused yields to fall as capital has been repatriated. And as emerging market economies struggle to cope with the backwash from this portfolio exodus there is bound to be renewed debate about what level of foreign exchange reserves they need to insulate themselves from volatile outflows. How big a war chest is optimal?

Since the global financial crisis managers of official reserves have tended to feel that you could never have enough protection. The difficulty with maximising protection was that the world's stock of safe assets was shrinking as the demand for them increased. The crisis exposed the credit rating agencies' alchemy, whereby risky asset-backed securities could be turned into triple A paper through securitisation. Then the eurozone sovereign-debt crisis showed that much sovereign debt was anything but safe. Now the fiscal situation of the US, predominant provider of safe assets to the world, is sufficiently parlous to raise questions about whether even US Treasuries can be considered safe.

In effect, the risk in emerging central-bank balance sheets has shifted from the liability side to the asset side. Since the 1990s, capital inflows have increasingly taken the form of foreign direct investment, which is more stable than short-term bank finance.

On the other hand, emerging market official reserve assets, which topped $7tn in 2012, are increasingly hostage to fiscal pressures in the advanced countries arising from demography, expensive welfare systems and, in the case of the US, reckless politicians who risk the country's credit rating in the interests of parochial infighting.

In his authoritative new book on the dollar, Eswar Prasad, professor of trade policy at Cornell University and senior fellow at the Brookings Institution, argues that China and other foreign countries that own around half the outstanding US federal government debt are trapped in a risky game where the US may be tempted to renege on its debt obligations by printing more dollars.* But he reckons that domestic holders of US debt constitute a powerful political constituency that would inflict a huge political cost on an incumbent government if inflation were to rocket.

The game is nonetheless morally hazardous, in that foreigners are making it easy for the US to indulge in fiscal profligacy. The opportunity cost is high, since Treasuries yield less than investments in the developing world. And developing countries are bound to lose eventually because their higher productivity relative to developed countries means that their currencies will appreciate over the long run and leave them with big currency losses. Yet countries prefer to incur these costs as protection against outflows and as part of a mercantilist strategy to enhance competitiveness.

Overall, this amounts to a very fragile balance. For reserve managers there is no realistic alternative store of value to the dollar for the foreseeable future, even if other currencies increasingly serve as a means of exchange. The euro is beset by obvious problems, while the renminbi lacks the backing of developed markets.

Paradoxically, says Mr Prasad, the equilibrium in which the dollar remains the dominant global reserve currency is suboptimal, but stable and self-reinforcing. His conclusion is that, in a troubled world, we could do much worse than put our money and trust in the US.

**The Dollar Trap: How The US Dollar Tightened Its Grip On Global Finance*, Eswar Prasad

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