Can emerging markets be a source of global troubles again?

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Abstract

After two turbulent decades (1980s and 1990s) when emerging-market economies were frequent victims of financial crises, in the first two decades of the 21st century their macroeconomic performance improved. Nevertheless, there were three crisis episodes that hit some of these countries: (i) the spill-over effects of the global financial crisis in 2008–2009; (ii) the consequences of the decline in commodity prices in 2014–2016 for their exporters; (iii) the turbulence in Argentina and Turkey in 2018. Currency crises in Argentina and Turkey in 2018 underlined again the key role of prudent domestic policies. Early policy correction can help to prevent a crisis and avoid its economic, social and political costs. If crisis cannot be avoided, the comprehensive anti-crisis package, including up-front monetary and fiscal adjustment, should be adopted as quickly as possible to arrest market panic and reverse negative expectations.

Keywords: emerging markets, financial crisis, currency crisis, crisis prevention, spill-over, contagion.
JEL classification: E63, E65.

1. Introduction

According to popular perception, emerging-market economies have not experienced serious macroeconomic and financial turbulence since the beginning of this century. This perception was not entirely correct because it disregarded spill-over effects of the global financial crises of 2008–2009, the consequences of the decline of oil and other commodity prices in 2014–2016, economic and financial troubles caused by violent conflicts and regional political instability (for example, Ukraine and several Arab countries) or individual cases caused by domestic macroeconomic mismanagement (Venezuela, Zimbabwe and Belarus).

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Finally, two large emerging-market economies and members of G20 — Argentina and Turkey — were affected by currency crises in 2018. In the case of Argentina, where the scale of experienced turbulence and underlying macroeconomic instability was much larger than in Turkey, authorities had to ask the International Monetary Fund (IMF) to provide a rescue program.

Nevertheless, there were no serial emerging-market crises involving cross-country or even cross-regional contagion, as had occurred in the 1980s or 1990s, except for the former Soviet Union (FSU) where such an intra-regional contagion could be observed, both in 2008–2009 and 2014–2016. Besides, victims of the 1990s crises in Latin America and Asia were only partly affected by the global financial crisis of 2008–2009. Macroeconomic and financial instability did not originate from emerging markets, but from the US and Europe.

Against the above background, this paper has three major purposes. First, it analyzes factors, which decreased frequency and magnitude of emerging-market crises in the first two decades of the 21st century. Second, it looks at risk factors faced by emerging-market economies at the end of 2010s. Third, it comes back to the debate on the most effective anti-crisis policies.

The paper's structure reflects the above purposes. Section 2 presents basic definitions and the brief historical background of emerging-market crises since 1980s. Section 3 discusses changes in macroeconomic performance of emerging markets since 2000. They resulted in reduced frequency, and magnitude, of financial crises, which, however, did not disappear completely. Section 4 analyzes three recent emerging-market crisis episodes: (i) the spill-over effects of the global financial crisis in 2008–2009; (ii) the consequences of decline in commodity prices in 2014–2016 for their exporters; (iii) turbulence in Argentina and Turkey in 2018. Section 5 comments on risk factors faced by emerging-market economies at the end of the 2010s. Section 6 deals with crisis prevention and anti-crisis policies. Section 7 contains conclusions and general policy recommendations.

The paper has both diagnostic and normative character and is partly based on earlier publications (see Dabrowski, 2010, 2015, 2016, 2018).

2. Emerging-market crises: definitions and historic overview

2.1. Definition of financial, debt and currency crises

For the purposes of this paper, we define financial crisis as a sudden decline in confidence in the ability of a country's government/central bank and banking sector to pay back their liabilities (on committed terms). Such a broad definition includes all types of instability related to monetary and financial systems (see WEO, 1998, pp. 74–76).

There are three specific forms of financial crisis: (i) banking crisis; (ii) public debt crisis; (iii) balance-of-payments crisis. Banking crisis refers to actual or potential bank runs or failures that induce commercial banks to suspend the internal convertibility of their liabilities. A public debt crisis occurs when a government cannot service its foreign and/or domestic debt. A balance of payments crisis involves a structural imbalance between a deficit in the current account (absorption) and capital and financial accounts (sources of financing) that leads to a cur-

rency crisis after international reserves are exhausted. Finally, a currency crisis is defined as a sudden decline in confidence in a given currency, usually leading to a speculative attack against it. Analytically, a currency crisis can be detected by either substantial depreciation of a given currency, a decline in a country's international reserves, or both (Dabrowski, 2003, p. 5).

2.2. Theoretical models of currency crises

Historically, three major generations of theoretical models followed the respective rounds of currency crises. The first-generation models were developed by Krugman (1979), and Flood and Garber (1984), among others, in response to a series of currency crises in Latin America in the 1970s and early 1980s and focused on the inconsistency between the exchange-rate peg and expansionary macroeconomic policies. In these models, the central bank accommodates changes in domestic money demand through purchases or sales of international reserves. Therefore, if domestic credit expansion (typically caused by monetization of a fiscal deficit) exceeds the money demand, international reserves will decline at the rate of credit expansion, ultimately leading to their depletion. Furthermore, once they understand that the collapse of an exchange-rate peg is unavoidable, economic agents will trigger speculative attacks to avoid losses or to earn speculative gains. Thus, the moment of a currency crash can be hastened relative to the pace of reserves depletion under "normal" circumstances (mechanism of multiple equilibria).

In the second-generation models (see, among others, Obstfeld, 1994, 1997; Drazen, 1999) developed after speculative attacks against the Exchange Rate Mechanism in Europe (ERM1) in 1992 and the Mexican peso in 1994, the government can choose between defending an exchange-rate peg and abandoning it. The latter choice could be justified, for example, by the expected output/employment losses caused by the high interest rates required to stop speculative attacks on the currency. Economic agents are not certain as to which option will be chosen, which creates uncertainty and various market-game strategies. Therefore, the behavior of economic agents is determined not only by their perception of macroeconomic fundamentals (as in the first-generation models) but also by the expected reaction of the government.

The experience of the Asian crises in 1997–1998 led to a third-generation of models that focus on the moral hazard driven over-borrowing by large but poorly regulated banks, other financial institutions and non-financial corporations (McKinnon and Phil, 1996; Krugman, 1998, 1999; Corsetti et al., 1998a, 1998b, 1998c). According to these models, an economic agent may expect a government rescue operation for a large bank or corporation with good political connections in the event that it faces solvency problems. Therefore, part of private sector "over-borrowing" can be understood as implicit government debt (a contingent fiscal liability), which may eventually have to be monetized.

2.3. Definition of emerging markets

In 1981, Antoine van Agtmael from the International Finance Corporation first used the term emerging market (Economist, 2017). One can find various defini-

tions of emerging markets or emerging-market economies in economic literature. For the purpose of our analysis, we understand emerging-market economy as a middle-income economy integrated into the world economy in terms of trade, investment and financial flows but with immature/imperfect market mechanisms and institutions. That is, in practical terms, this group neither includes those economies that already graduated to the group of high-income countries (for, example, South Korea, Taiwan, Singapore, Hong Kong, the Baltic countries, Czech Republic and Slovakia) nor low-income countries with underdeveloped financial sectors (most of the African countries).

2.4. Emerging-market crises in 1980s, 1990s and early 2000s

Although financial crises of various kinds have a long history (see Reinhart and Rogoff, 2009), in this paper we are interested in a more recent period when serious turbulences in emerging markets started to have a "serial" character, including cross-border spill-over and contagion effects and had repercussions for the entire global economy or at least individual regions. Thus, we are less interested in crises limited to individual countries and caused by their domestic economic and political problems even if they represent prominent cases of economic mismanagement (think about the situation in Venezuela or Zimbabwe).

Given the above limitations, our overview starts with the series of currency and public debt crises in the early 1980s, mainly in Latin America. The crisis started in Mexico in 1982 (Brinke, 2013) and then spread to other countries of this region (Chile, Argentina, Uruguay and Brazil) and outside (Philippines) (Barkbu et al, 2012).[1] Most of these crises were caused by imprudent fiscal and monetary policies and by currency pegs incompatible with those policies (first-generation crises). The sharp tightening of US monetary policies at the end of 1970s and early 1980s (to fight two-digit inflation) played a role of external trigger —interest rates in the US and internationally increased to a record-high level and the US$ strengthened against other major currencies.

The Mexican crisis of 1994–1995 with negative spill-over effect to other Latin American countries, mainly Argentina (the so-called Tequila crisis) was the next major crisis episode, this time reflecting the second-generation model of currency crisis.

Finally, the years 1997–2002 brought the largest wave of emerging-market crises, which affected more than one region. It started in Thailand in June 1997 and then spread to the Philippines, Malaysia, Indonesia and South Korea in the same year and in early 1998. As mentioned in Section 2.2, Asian financial turbulences represented the third-generation model of currency crisis (see Moreno, 1998; Krugman, 1998).

In August 1998, the triple crisis, involving large-scale domestic currency depreciation, default on public debt and insolvency of several banks, hit Russia. In the following six months, other FSU countries were also affected. Large fiscal imbalances were the primary cause of these crises; that is, these were classic cases of the first-generation model (Dabrowski, 2016).

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[1]   Earlier, in March 1981, the Government of Poland declared default on its debt to foreign banks. However, due to the autarkic economic model based on central planning this default did not lead to external spillovers.

Then crisis spread to Brazil which had to abandon the peg of the real to US$ in January 1999. Similarly to Russia and other FSU countries, fiscal imbalance was the main reason. In turn, devaluation of the real affected terms of trade of Brazil's direct neighbors—Argentina and Uruguay. Together with their domestic fiscal imbalances, it led to triple financial crises in both countries in 2001–2002 (see Spiegel, 2002 for Argentina and Taylor, 2007 for Uruguay). They had to devalue their currencies in 2002 and defaulted on their sovereign debt.

The Argentinian crisis was particularly messy and involved abandoning the currency board, a deep devaluation of peso, the default of banks on their liabilities to depositors and a default on public debt. The long conflict with foreign holders of government bonds was resolved only in 2016 (Mander and Moore, 2016; Reinhart, 2016).

The large-scale banking and currency crisis in Turkey (2000–2001) was a culmination of at least two decades of lax monetary and fiscal policies, high inflation, and volatile growth in that country (Sasin, 2001). That is, it had mainly domestic roots but international contagion (and resulting capital outflow) also played an important role.

3. The period of relative calm and prosperity

Financial crises in Turkey, Argentina and Uruguay in 2000–2002 were the last episodes in the large wave of emerging-market turbulences analyzed in Section 2.4. Overall, the first two decades of the 21st century brought significant changes in the macroeconomic performance of emerging-market economies.

First, this was the period of rapid growth of this group of countries (Fig. 1). Its pace was systematically higher than that of AEs.[2] However, growth was uneven
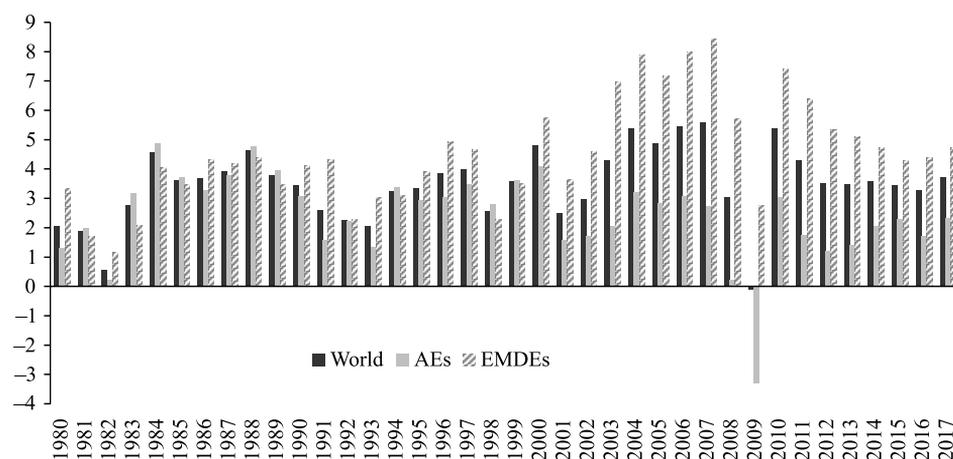

Fig. 1. World economy, annual changes in real GDP, 1980–2017 (%).
Source: IMF World Economic Outlook database, October 2018.

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[2] Following the IMF World Economic outlook database (October 2018 edition), we disaggregate the global economy into two subgroups: (1) advanced economies (AEs); and (2) emerging market and developing economies (EMDEs). The latter is a broader category than the emerging-market economies analyzed in this paper because it also covers low-income countries weakly integrated into a global economy (see Section 2.3).
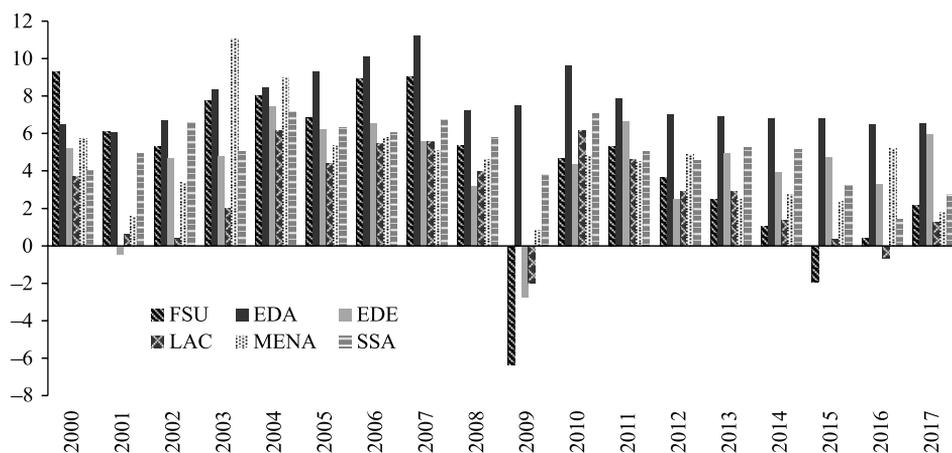
Fig. 2. EMDE regions, annual change in real GDP, 2000–2017 (%).

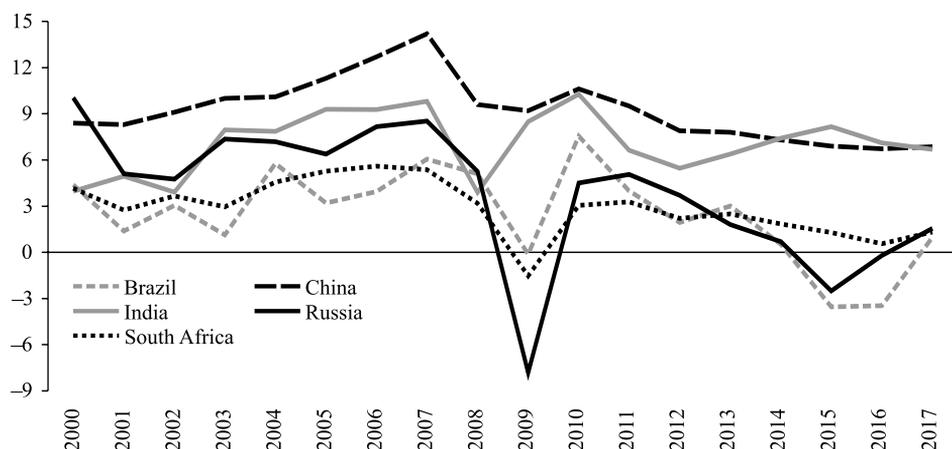*Source:* IMF World Economic Outlook database, October 2018.

Fig. 3. BRICS countries, annual change in real GDP, 2000–2017 (%).

Source: IMF World Economic Outlook database, October 2018.

across regions (Fig. 2) — the highest one in Emerging and Developing Asia (EDA) and the lowest — in Latin America and Caribbean (LAC) and FSU (in the latter — since 2008). Given its predominantly low-income status and rapid population growth, Sub-Saharan Africa (SSA) also underperformed. When we look at BRICS countries[3] (Fig. 3), we also see differentiation of growth rates, especially in 2010s: China and India grew much faster than Brazil, Russia and South Africa.

Second, inflation in EMDEs has declined to one-digit level (Fig. 4) converging towards the level observed in AEs. This has been a tremendous achievement, in particular for LAC (that suffered from numerous high-inflation and hyper-inflation episodes in 1970s and 1980s — see Dornbusch and Edwards, 1991), FSU, Emerging and Developing Europe (EDE) and SSA. Nevertheless, there is

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[3] The BRICS acronym stands for Brazil, Russia, India, China and South Africa and was originally introduced by O'Neill (2001) as BRIC for Brazil. Russia, India and China (South Africa was added later).
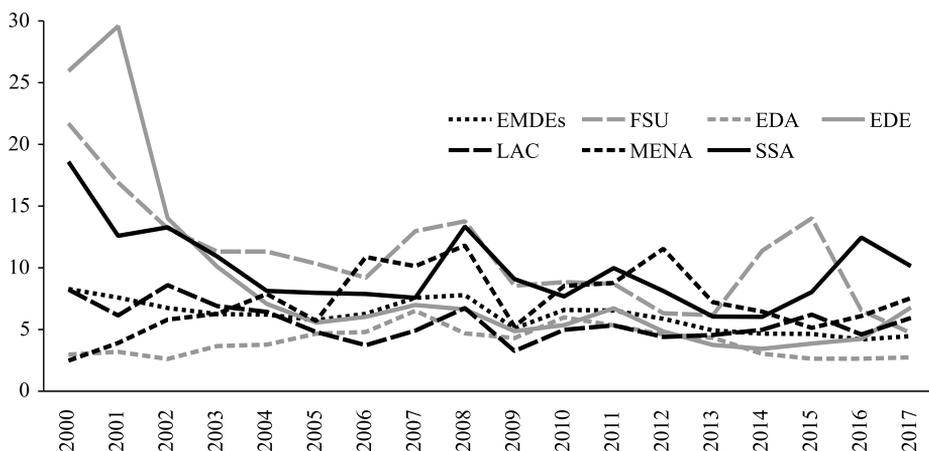
Fig. 4. End-of-year inflation in EMDEs, in percent, 2000–2017 (%).

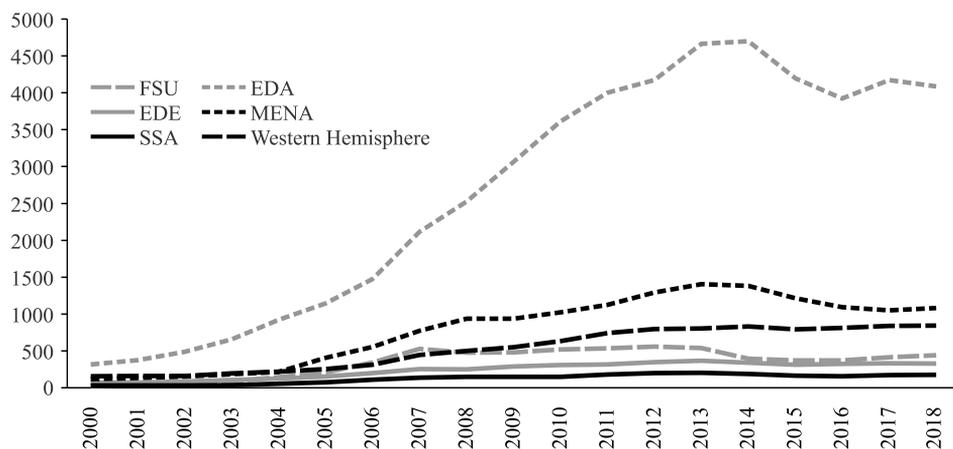*Source:* IMF World Economic Outlook database, October 2018.

Fig. 5. Total reserves of central banks in EMDEs minus gold, 2000–2018 (US$ billion).

Source: IMF International Financial Statistics.

differentiation of inflation performance between regions, with EDA, EDE and LAC doing better and FSU, Middle East and North Africa (MENA) and SSA lagging behind.

Third, most emerging-market central banks accumulated substantial international reserves (Fig. 5) following recommendation of the IMF. This increased their resilience to external shocks, for example, during the global financial crisis of 2008–2009 and in the period of commodity price decline in 2014–2016.

Fourth, fiscal performance also improved, especially in the early and mid-2000s (Table 1). In particular, oil and other commodity exporters built up sovereign wealth funds (SWFs), sometimes quite substantial ones that helped many of them to cushion the negative effects of both the 2007–2009 financial shock and commodity price decline in 2014–2016. Nevertheless, fiscal improvement did not happen everywhere and was not consequent enough to eliminate the macroeconomic vulnerability of emerging markets (see Sections 4 and 5).

Table 1
General government gross debt in selected EMDEs, 2000–2017 (% of GDP).

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Argentina	42.1	49.4	152.2	128.7	117.3	79.2	69.8	61.0	52.6	53.8	42.0	37.5	38.9	41.7	43.6	55.1	55.0	57.6
Belarus	n/a	n/a	n/a	n/a	9.5	8.4	12.7	16.4	21.0	32.5	36.8	58.2	36.9	36.9	38.8	53.0	53.5	53.4
Brazil	65.6	70.1	78.9	73.9	70.2	68.7	65.9	63.8	61.9	65.0	63.1	61.2	62.2	60.2	62.3	72.6	78.4	84.0
Chile	13.2	14.5	15.2	12.7	10.3	7.0	5.0	3.9	4.9	5.8	8.6	11.1	11.9	12.7	15.0	17.3	21.0	23.6
China	22.8	24.4	25.7	26.6	26.2	26.1	25.4	29.0	27.0	34.3	33.7	33.6	34.3	37.0	39.9	41.1	44.2	47.0
Colombia	38.1	41.2	47.7	45.2	41.6	38.6	36.1	32.7	32.4	35.4	36.6	35.8	34.0	37.6	43.3	50.4	49.8	49.4
Croatia	33.2	34.6	36.6	38.1	40.4	41.3	38.9	37.7	39.6	48.9	58.1	65.0	70.6	81.6	85.7	85.3	82.3	77.8
Egypt	71.7	79.1	85.8	97.1	96.5	98.3	85.9	76.3	66.8	69.5	69.6	72.8	73.8	84.0	85.1	88.5	96.8	103.0
Ethiopia	93.6	97.3	107.4	103.7	103.1	78.2	70.0	46.8	41.7	37.8	40.5	45.3	37.7	42.9	46.8	54.0	53.2	54.2 [a]
Hungary	55.0	51.6	54.8	57.4	58.3	60.2	64.4	65.3	71.2	77.5	80.2	80.5	78.4	77.1	76.6	76.7	76.0	73.6
India	73.6	78.7	82.9	84.2	83.3	80.9	77.1	74.0	74.5	72.5	67.5	69.6	69.1	68.5	67.8	70.0	69.5	71.2
Indonesia	87.4	73.7	62.3	55.6	51.3	42.6	35.8	32.3	30.3	26.5	24.5	23.1	23.0	24.8	24.7	27.5	28.3	28.8
Iran	11.9	11.7	21.6	19.5	16.2	13.0	11.9	11.4	9.1	10.1	11.7	8.9	12.1	10.7	11.8	38.4	47.5	39.5
Jordan	100.5	96.5	99.7	99.6	91.8	84.3	76.3	73.8	60.2	64.8	67.1	70.7	80.7	86.7	89.0	93.4	95.1	95.9
Kazakhstan	n/a	n/a	17.6	15.0	11.4	8.1	6.7	5.9	6.8	10.2	10.7	10.2	12.1	12.6	14.5	21.9	19.7	20.8
Lebanon	148.2	163.2	163.2	171.4	169.7	179.0	183.1	169.0	160.9	144.2	136.9	133.9	131.0	136.6	137.2	140.9	145.5	146.8 [a]
Malaysia	32.9	38.5	40.1	42.0	42.6	41.4	40.2	39.9	39.9	51.1	51.9	52.6	54.6	56.4	56.2	57.9	56.2	54.1 [a]
Mexico	40.3	39.3	41.9	44.2	40.8	38.5	37.4	37.2	42.5	43.7	42.0	42.9	42.7	45.9	48.9	52.8	56.8	54.3
Morocco	70.2	65.4	64.3	61.6	58.9	59.3	54.8	50.9	45.4	46.1	49.0	52.5	56.5	61.7	63.3	63.7	64.9	65.1
Nigeria	57.6	53.1	43.3	42.1	35.5	18.9	9.4	8.1	7.3	8.6	9.6	12.1	12.7	12.9	13.1	16.0	19.6	21.8
Pakistan	76.8	81.2	76.1	70.5	63.2	58.9	53.7	52.4	57.2	58.5	60.6	58.9	63.2	63.9	63.5	63.3	67.6	67.0
Philippines	61.1	61.5	67.5	74.1	73.9	67.4	59.7	52.4	52.1	52.1	49.7	47.5	47.9	45.7	42.1	41.5	39.0	39.9
Poland	36.4	37.1	41.5	46.3	45.1	46.4	46.9	44.2	46.3	49.4	53.1	54.1	53.7	55.7	50.3	51.1	54.2	50.6 [a]
Romania	29.4	27.2	27.3	24.0	21.0	17.5	12.5	12.3	13.0	22.6	30.8	34.1	37.7	39.0	40.5	39.4	38.8	36.8
Russia	55.7	44.3	37.5	28.3	20.8	14.8	9.8	8.0	7.4	9.9	10.9	11.2	11.9	13.1	16.0	16.3	16.1	15.5
South Africa	42.2	42.4	35.5	35.4	34.4	33.2	31.4	27.1	26.5	30.1	34.7	38.2	41.0	44.1	47.0	49.3	51.6	53.0
Tunisia	65.9	54.7	54.2	55.1	54.1	52.4	48.0	44.8	42.0	40.7	39.2	43.1	47.7	46.8	51.5	55.4	62.3	70.3 [a]
Turkey	51.6	76.1	72.1	65.7	57.7	50.8	44.7	38.2	38.2	43.9	40.1	36.5	32.7	31.4	28.8	27.6	28.3	28.3
Ukraine	43.8	35.3	32.3	28.3	23.9	17.1	14.3	11.8	19.7	34.1	40.6	36.9	37.5	40.5	70.3	79.3	81.2	71.0 [a]
Uruguay	n/a	54.9	109.6	111.5	93.5	83.9	75.7	68.0	59.8	63.1	59.4	58.1	58.0	60.2	61.4	64.6	61.6	65.7
Vietnam	31.4	32.3	35.2	37.9	37.4	36.5	38.4	40.9	39.4	45.2	48.1	44.7	48.4	52.0	55.0	57.4	59.9 [a]	58.5 [a]

[a] The IMF staff estimate.
Source: IMF World Economic Outlook database, October 2018.

Several factors facilitated the improvement in macroeconomic performance of emerging markets in the early and mid-2000s. First, this was the period of global economic boom, which increased demand for commodities produced predominantly by EMDEs, and their prices (Fig. 6). Part of this boom was fuelled by lax monetary policy in the US and other AEs, which led to building up bubbles on credit, stock, housing and commodity markets (Dabrowski, 2010). Busting those bubbles in 2007–2008 was a major cause of the global financial crisis. Second, emerging markets, particularly in EDA, EDE and LAC, benefited from global and regional trade liberalization in 1990s and early 2000s, which boosted their manufacturing exports and allowed for the inclusion of their producers into global value chains (GVCs). In many instances, this also helped in their structural diversification. Third, they also benefited from financial globalization, which allowed for large-scale inflow of foreign investment (Fig. 7) and improvement in resource allocation. Last but not least, most emerging markets benefited from far-reaching economic and institutional reforms in 1990s and 2000s, partly in response to the painful lessons of the previous crises. The transition from a centrally planned to a market economy in EDE, FSU, China and Vietnam is the most
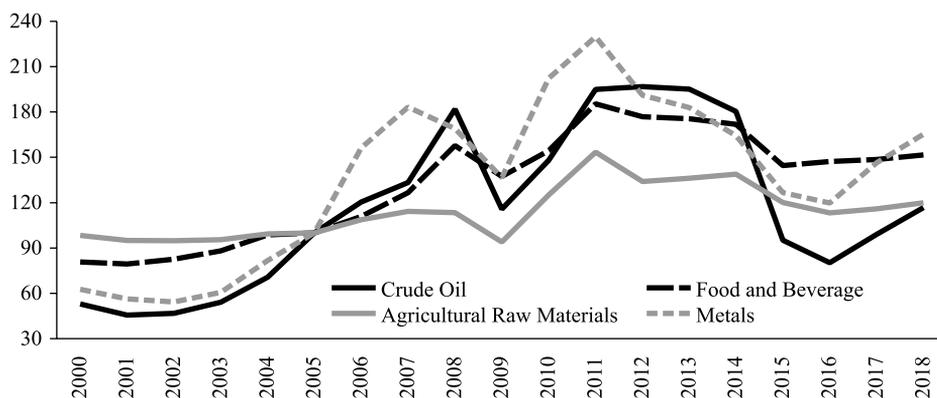

Fig. 6. Commodity price indexes, 2000–2018 (2005 = 100).
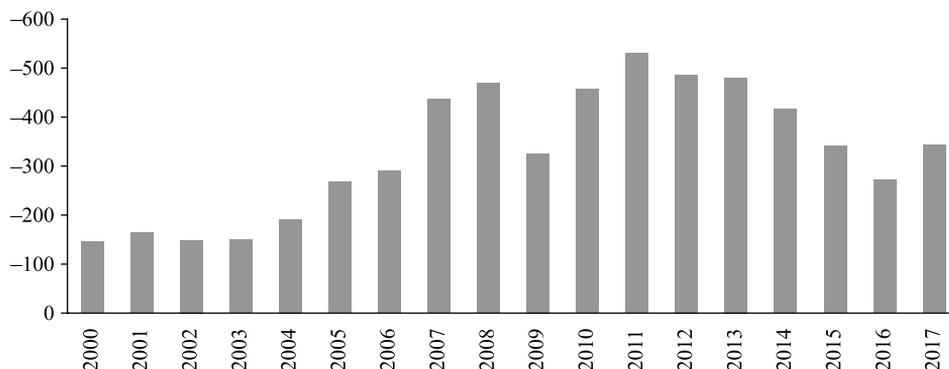Source: IMF World Economic Outlook database, April 2018.

Fig. 7. Net direct investment flows to EMDEs, 2000–2017 (US$ billion).
Note: Sign (–) means positive net inflow to EMDEs.
Source: IMF World Economic Outlook database, October 2018.

prominent case of such reforms. However, market-oriented reforms were also conducted in India, LAC, SSA, and, to a lesser degree, in MENA.

4. New crisis episodes

In spite of policy improvement discussed in Section 3, emerging-market crises have not disappeared completely. At least three episodes deserve a closer attention: (i) the spill-over effects of the global financial crisis in 2008–2009; (ii) the consequences of decline in oil and commodity prices in 2014–2016 for their exporters; (iii) the turbulence in Argentina and Turkey in 2018.

4.1. Global financial crisis (2008–2009)

While the global financial crisis of 2008–2009 originated in the US financial sector and hit predominantly AEs, EMDEs did not remain unaffected. After the bankruptcy of the Lehman Brothers on 15 September 2008, international liquidity and credit dried up, and capital started to fly back to the main financial centers, mostly the US. Stock markets and commodity prices declined (see Fig. 6), risk premiums for both sovereign and private borrowing grew dramatically, and many emerging-market currencies depreciated (especially in countries which run floating exchange rate regimes), threatening the massive insolvency of economic agents who borrowed in foreign currencies. Those emerging-market banks, non-banking financial institutions and non-financial corporation, which relied on financing on international financial markets, faced liquidity problems, and some of them became insolvent. In the real sphere, external demand for exported goods and labor declined (Dabrowski, 2010).

The culmination of the shock was observed in the nine-month period between September 2008 and May 2009. As Table 2 shows, all emerging-market regions were affected but with dominance at FSU, EDE and LAC. The same conclusion can be drawn if one looks at GDP (see Fig. 2) and capital flow (see Fig. 7) data. In 2009, three regions — FSU, EDE and LAC — recorded output decline while others (EDA, SSA, MENA) continued growing albeit at a lower pace. In 2010, all emerging-market regions returned to growth.

The case of EDE and FSU is perhaps the most interesting. In mid-2000s, these two regions were seen by financial markets as a success story of post-communist transition, which resulted in the acceleration of capital inflows in 2005–2007. In particular, due to its EU membership/ candidacy status and expected fast-track accession to the Eurozone, EDE was seen by financial markets as a relatively "safe haven", resulting in exceptionally low risk premiums (Luengnaruemitchai and Schadler, 2007). On the other hand, the global commodity boom, especially of oil, natural gas, metals and food products, boosted growth in the FSU and improved its investment rating.

However, financial markets overlooked numerous vulnerabilities in both regions. For example, rapid credit growth and excessive borrowing in foreign currencies led, in many instances, to deterioration of credit portfolios. Unfortunately, it became fully visible only when the crisis hit the region and previously optimistic growth prospects had to be revised. In some countries (Russia, the Baltic countries, Bulgaria and, to a lesser extent, Poland) it also

Table 2
Countries most affected by the global financial crisis through financial channels
(between September 2008 and May 2009).

Country	Currency depreciation (%) against US$	Bond spreads (bps) against US Treasuries or German bunds (EU)	Equity market (%)
Ukraine	−59.9	733	−66
Argentina	−21.4	735	−58
Hungary	−18.9	283	−58
Poland	−35.2	127	−53
Jamaica	−20.4	439	−51
Ghana	−28.0	448	−35
Russia	−22.0	144	−44
Kazakhstan	−22.0	167	−34
Bulgaria	−1.5	175	−51
Mexico	−22.6	73	−35
Turkey	−21.7	44	−40
Sri Lanka	−6.6	464	−27
Indonesia	−8.8	85	−29
Pakistan	−6.3	132	−26
El Salvador	-0.3	176	−35
Vietnam	−7.1	53	−33
Lebanon	-0.3	57	−45
Brazil	−8.4	36	−28
Chile	−5.5	80	−14
Tunisia	−7.7	62	−14
Ecuador	0	2528	−13
Egypt	−3.4	−137	−39
Colombia	−3.4	63	−10
Malaysia	-0.9	81	−12
Philippines	-0.1	53	−21
Peru	-0.4	42	−15
South Africa	1.5	39	−20
China	0.3	−31	−11

Source: Ali et al. (2009).

led to a substantial growth of real estate prices before the crisis (Bakker and
Klingen, 2012, p. 7, fig. 1.4).

After 2008, over-optimistic assessments and expectations had to be correct-
ed which led to the reduction (EDE) or even reversion (FSU) of capital flows.
Several countries in both regions—Armenia, Belarus, Bosnia and Herzegovina,
Georgia, Hungary, Kosovo, Kyrgyzstan, Latvia, Moldova, Romania, Serbia,
Tajikistan, and Ukraine—had to ask for the IMF rescue programs to deal with
the consequences resulting from a sudden cessation of capital flows.

4.2. Decline in commodity prices (2014–2016)

The decline in commodity prices in 2014–2016 (see Fig. 6) generated a heavy
macroeconomic shock on commodity producers and exporters. In particular, those
countries whose GDP and exports were dominated by oil (the source of highest re-
source rents) became seriously affected. However, the negative effects were smaller
as compared to the similar price decline in the mid-1980s. Better macroeconomic
fundamentals (see Section 3) and accumulation of substantial monetary and fiscal
buffers (large international reserves of central banks and SWFs) in the boom period

made oil and other commodity producers more resilient to negative price shock. Furthermore, in many countries these buffers were large enough to launch aggressive countercyclical fiscal and monetary policies that mitigated the negative impact on the real sector. Fig. 8 shows that in most oil-producing countries growth in real GDP continued in the crisis period, albeit at slower pace.

Nevertheless, there was a group of oil exporters such as Algeria, Azerbaijan, Belarus[4], Kazakhstan, Malaysia, Nigeria, Russia and Venezuela, which suffered from substantial depreciation of their currencies (Fig. 9), surge in inflation and
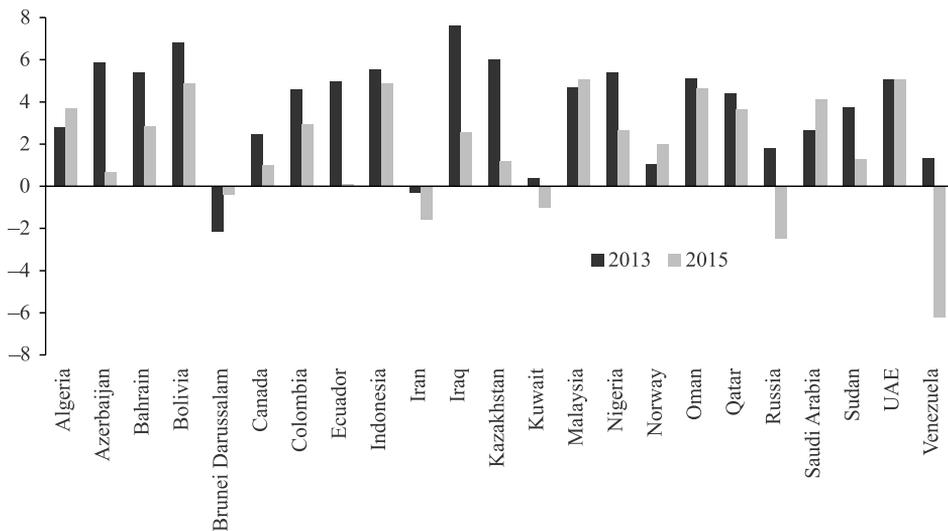
Fig. 8. Oil producers: annual real GDP growth, 2013 and 2015 (%).

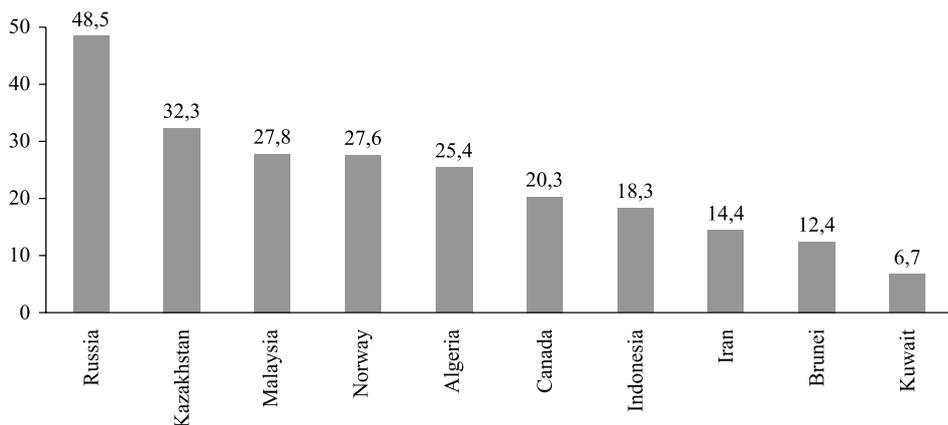Source: IMF World Economic Outlook database, October 2018.

Fig. 9. Depreciation of oil exporters' currencies between 30.06.2014 and 30.09.2015 (US$ per local currency unit, percentage change).

Source: IMF International Financial Statistics.

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[4] Belarus is not a producer of crude oil but it imports Russian crude oil at Russian domestic prices (lower than international ones) and then re-exports oil products at international prices.

banking sector problems. In the case of Venezuela and Nigeria, these were consequences of overspending in the boom period and populist economic policies, in FSU countries — effect of macroeconomic and financial fragility caused by past crises and poor business climate (Dabrowski, 2016). The US and EU economic sanctions against Russia launched in 2014 in response to its annexation of Crimea and intervention in Donbas magnified the negative effect of oil price decline on this country (Dabrowski, 2015).

4.3. Troubles of Argentina and Turkey (2018)

In 2018, the currencies of two large emerging-market economies and members of the G20 — Argentina and Turkey — suffered from substantial depreciation. The culmination of the speculative attack came in August and September 2018. Other currencies, including the Indian rupee, Indonesian rupiah, Brazilian real, Pakistani rupee, Russian rouble and South African rand also recorded losses, but smaller ones compared to Argentina and Turkey (Fig. 10).

The spreads on credit default swaps (CDS) for Argentinian and Turkish government bonds denominated in US dollars (Fig. 11) started to increase from the beginning of 2018, but picked up dramatically in August and September 2018 — by some 400 basis points for Argentina and 300 basis points for Turkey. Even though they decreased at the end of September and early October 2018, they continued to stay far above the pre-crisis level.

Both countries have been characterized by numerous macro- and microeconomic vulnerabilities, which made them potential victims of market pressure.

Argentina recorded high and increasing inflation and fiscal deficit, and several episodes of recession since the period of global financial crisis of 2008–2009 (Table 3). This resulted from the populist policies of President Cristina Fernandez de Kirchner, who ruled the country between 2007 and 2015. These policies included excessive public spending in the years of the commodity boom; price, foreign exchange and export controls; energy subsidies; a complex and non-transparent tax system; trade protectionism; manipulation of price and GDP statistics; the undermining of central bank and judicial independence (OECD, 2017).
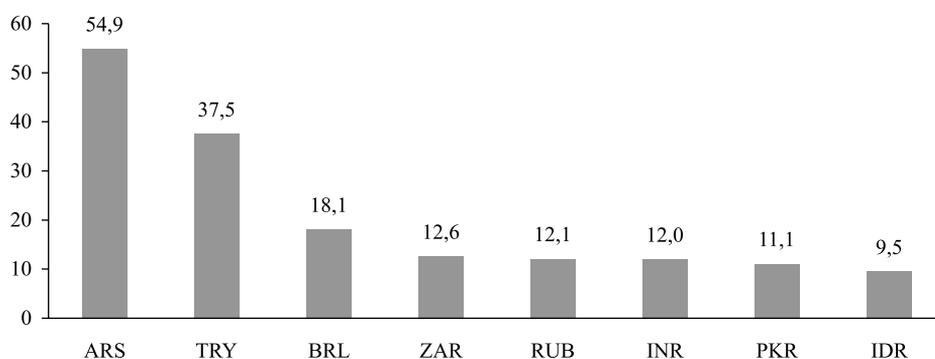
Fig. 10. Depreciation of emerging-market currencies between 31.12.2017 and 30.09.2018 (US$ per local currency unit, percentage change).
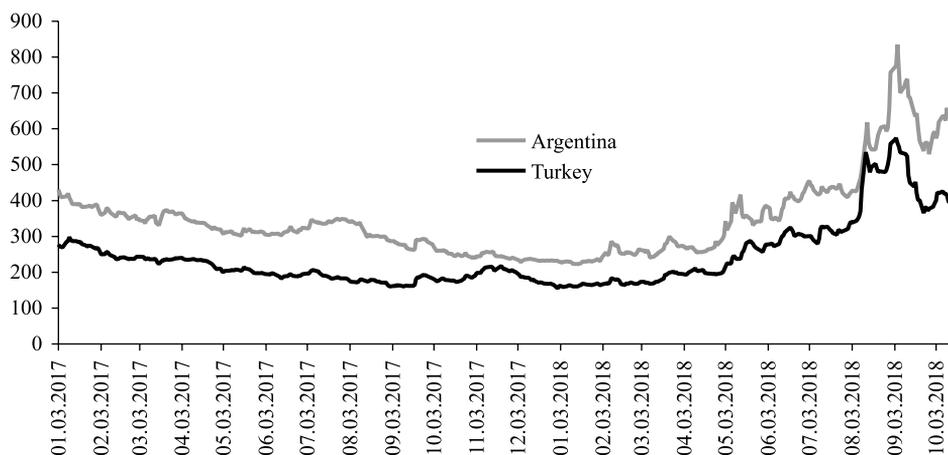
Source: https://www.x-rates.com/historical/?from=USD&amount=1&date=2018-09-30

Fig. 11. CDS of Argentina and Turkey, 5-year US dollar denominated government bonds,
2017–2018 (basis points).

Source: Bloomberg database.

Table 3

Argentina and Turkey: basic macroeconomic indicators, 2007–2017.

Subject descriptor	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Argentina											
Real GDP growth, %	9.0	4.1	−5.9	10.1	6.0	−1.0	2.4	−2.5	2.7	−1.8	2.9
Inflation, e-o-p, %	8.5	7.2	7.7	10.9	9.5	10.8	10.9	23.9	n/a	n/a	24.8
GG net lending/ borrowing, % of GDP	−0.1	0.2	−2.6	−1.4	−2.7	−3.0	−3.3	−4.3	−6.0	−6.6	−6.7
GG gross debt, % of GDP	61.0	52.6	53.8	42.0	37.5	38.9	41.7	43.6	55.1	55.0	57.6
Current account balance, % of GDP	2.1	1.5	2.2	−0.4	−1.0	-0.4	−2.1	−1.6	−2.7	−2.7	−4.9
Turkey											
Real GDP growth, %	5.0	0.8	−4.7	8.5	11.1	4.8	8.5	5.2	6.1	3.2	7.4
Inflation, e-o-p, %	8.4	10.1	6.5	6.4	10.4	6.2	7.4	8.2	8.8	8.5	11.9
GG net lending/ borrowing, % of GDP	−1.9	−2.7	−5.9	−3.4	-0.7	−1.8	−1.5	−1.4	−1.3	−2.3	−2.3
GG gross debt, % of GDP	38.2	38.2	43.9	40.1	36.5	32.7	31.4	28.8	27.6	28.3	28.3
Current account balance, % of GDP	−5.5	−5.2	−1.8	−5.8	−8.9	−5.5	−6.7	−4.7	−3.7	−3.8	−5.6

Source: IMF World Economic Outlook database, April 2018.

The case of Turkey was slightly different. The country recorded high growth and ran a moderately prudent fiscal policy. However, its monetary policy was too lax — as demonstrated by increasing inflation (much higher than the levels of its main trading partners) and low interest rates (negative in real terms). Furthermore, an authoritarian trend in domestic politics led to a deterioration in economic institutions and the reversal of many reforms of the early 2000s (Acemoglu and Ucer, 2015). For example, the Central Bank of the Republic of Turkey (CBRT) was under pressure to avoid an increase in interest rates

backed by an "unorthodox" president's opinion that higher interest rates lead to higher inflation.

The failed military coup d'état in 2016 led to massive personal purges in the judiciary and public administration, which also meant deterioration in economic governance. The new round of ethnic conflict with the Kurdish minority, engagement in the conflict in Syria, tensions with traditional allies (the US and Europe) and practical freezing of the EU accession process forced many investors to reassess geopolitical risks and prospects of deeper integration with the EU economy.

In 2017–2018, both countries recorded increasing current account deficits. In Argentina, this has been the effect of fiscal imbalance and a low rate of private saving; in Turkey, it has been born of private sector over-borrowing and an investment boom. In principle, such deficits can be seen as a normal phenomenon in the world of unrestricted capital movement, in which investors seek the highest rate of return (Dabrowski, 2013). However, if a country has limited access to the world capital market (Argentina), if its domestic investment climate is not rated favorably and if macroeconomic policies are too expansionary (both cases), then the increasing current account deficit should serve as a warning signal and strong argument in favor of policy correction.

Both Turkey and Argentina have also had reputation problems due to several macroeconomic and financial crises in their history (Reinhart and Rogoff, 2009). The most recent episodes happened in both countries not so long ago, in 2000–2002 (see Section 2.4). Widespread spontaneous dollarization reflected their continuous macroeconomic fragility even in good times.

5. Potential risk factors

While the aim of this paper is not to speculate whether, in the coming months and years, we will see more crisis episodes and which countries could be affected, the risk of such developments remains relatively high. This has been caused, in the first instance, by tightening of US monetary policy in 2016–2018. Although the Federal Open Market Committee of the US Federal Reserve Board suspended its tightening cycle on 20 March 2019,[5] it is very likely that it will be resumed when inflation pressure intensifies.

Historical experience tells us that increasing interest rates in the US have usually led to the US dollar strengthening, capital outflow from emerging markets, and pressure on their currencies. To resist these pressures, domestic interest rates must also be taken up, thus increasing the cost of credit to economy and the cost of servicing public debt.

The increasing global economic uncertainty associated with protectionist policies, such as the Trump administration is implementing in the US, is another factor which can hit many emerging-market economies, in particular those that developed export-oriented manufacturing capacity and participate in GVCs. If the pessimistic scenario of gradual decomposition of the existing global trading system materializes (see Dadush and Wolff, 2019) it will destroy many GVCs and create heavy adverse shock to those emerging markets, which have become

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[5] See https://www.federalreserve.gov/newsevents/pressreleases/monetary20190320a.htm

deeply involved in the international division of labor. This may lead to the partial undoing of the positive effects of globalization, including income-per-capita convergence in several emerging-market economies.

It is also worth reflecting that most of the factors that contributed to emerging-market boom in the first two decades of the 21st century (see Section 3) do not work any longer. This concerns, for example, positive effects of post-communist transition and economic reforms in other emerging-market regions. In most countries, the reform process stopped around mid-2000s and, in some cases, earlier reforms were even partly reversed. Two decades of good economic performance weakened pressure for further reforms and, in many instances, increased the temptation to return to imprudent policies (see Section 6).

The positive effects of trade liberalization under the Uruguay Round (completed in 1994) were largely consumed by mid-2000s while new trade negotiation under the Doha Round failed. Similarly, productivity gains of the information and communication revolution that gave a strong boost to global growth between mid-1990s and mid-2000s have been much weaker thereafter (Gordon, 2016, pp. 601–602).

The same concerns the peace dividend after the end of Cold War in 1990s, which many countries benefited from. These gains started to disappear in the early 2000s as a result of the "war on terror". Further deterioration has been noticed in the decade of the 2010s, especially in the MENA, SSA and FSU regions. Violent conflicts and increasing geopolitical rivalry of global and regional powers negatively influence the business and investment climate, leading to higher military and security spending at the cost of other public goods such as education, health or infrastructure, and damaging trade in goods and services (especially in such security-sensitive sectors as tourism or transportation).

All these risks create challenge not only for emerging-market economies. The global impact of any large-scale emerging-market crisis can be much stronger now than it was in 1980s and 1990s for the simple reason that the share of emerging markets in global GDP and global trade has increased since then.

6. Crisis prevention and crisis management

Given a risk of new emerging-market turmoil (see Section 5) and its potentially devastating impact on the world economy, policies aimed at crisis prevention are extremely important. If a crisis happens anyway, equally important is to ensure competent management, so as to minimize its costs and the risk of cross-border spill-over or contagion. In our discussion of crisis prevention policies and crisis management, we will concentrate on the recent cases of Argentina and Turkey.

6.1. The role of early warning signals

As in many similar cases in the past, Argentina and Turkey could have avoided their 2018 crises if their policies had been corrected in time. Both were warned well in advance by international organizations such as the IMF (2014; 2016) and OECD (2016; 2017). Each country was advised to tighten monetary and fiscal policies in order to curb inflation, and to conduct a series of structural and regu-

latory reforms to improve the business climate. In addition, Argentina was advised to remove distortions of Kirchner's era and Turkey was warned of the risk of overheating.[6] However, either they did not follow these recommendations (Turkey) or they followed them too slowly (Argentina).

There are many reasons why politicians are reluctant to correct unsustainable policies.

First, they are afraid that corrections mean admitting the shortcomings of previous policies — especially if they have been engaged in defending them by use of various "non-orthodox" doctrines.

Second, the required policy tightening often remains in conflict with the political timetable; for example, forthcoming elections. In Turkey, this was the constitutional referendum on 16 April 2017 and presidential and parliamentary elections on 24 June 2018.

Third, financial markets rarely react immediately to imprudent policies, especially in tranquil times. Rather, their reaction has a non-linear character, a typical case of multiple equilibria. Politicians often misinterpret such delayed reaction as the tacit approval of their policies. It creates a feeling of impunity and a temptation to continue testing market tolerance.

When the market wake-up call finally comes — in the form of higher yields for government bonds, greater spreads on CDS, inflationary pressure, capital outflow, banking panic, or all these phenomena together — it is usually too late for minor adjustment steps. More bold and comprehensive actions are required to stop market panic and reverse negative expectations. They are costlier, economically and politically, than earlier corrective measures.

6.2. Fighting crisis: gradual stabilization is not a remedy

However, even when crisis is already at the door, governments and central banks often are not ready to act quickly and decisively, choosing instead a strategy of gradual adjustment. This is caused either by an underestimation of the real threat, or a belief that gradual changes will be politically more acceptable and involve smaller output and employment losses, or both. However, a strategy of gradual adjustment works best when policy corrections are done in advance — that is, when the macroeconomic situation is still relatively good and under control. This is also an acceptable approach in the case of more complex structural and institutional changes, under condition that the entire reform plan remains credible and will not be abandoned when the economic situation starts to improve. However, gradual adjustment does not work in an environment of speculative pressure and financial-market panic, because it lacks credibility and is unable to change market expectations. Furthermore, it extends the period of pain and delays the perception of improvement.

Unfortunately, authorities of both analyzed countries were not ready to act quickly and decisively enough when the first signs of the forthcoming crisis were tangible. The CBRT took its first decision to increase the one-week repo auction rate from 8.00% to 16.50% on 1 June 2018, followed by another hike to 17.75%

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[6] The first signs of market vulnerability of the Turkish lira were already observed at the end of 2013 (O'Neill, 2018).

one week later.[7] These higher interest rates were not able to stop capital outflow and abrupt depreciation of Turkish lira in August and September, especially because they were not supported by other policy measures — in particular, in the fiscal sphere.

This led to one more hike to 24% on 14 September 2018. In October 2018, yields on five-year government bonds denominated in US dollars amounted to more than 7%, and on 10-year bonds stayed around 8% (Pan and Samson, 2018). The anti-crisis actions and policy statements remained contradictory (Smith, 2018).

Argentina's story is even more illustrative of the ineffectiveness of gradual stabilization. President Mauricio Macri won the 2015 election on the promise to depart from the populist policies of his predecessor and restore macroeconomic stability. However, reforms that were implemented were slow and not always consistent enough, and the macroeconomic policy stance remained loose — as illustrated by Table 3.

After the first signs of market pressures at the end of 2017, macroeconomic policy was tightened but not enough to change expectations. Episodes of market panics were repeated several times, especially in August and September 2018. The Central Bank of the Republic of Argentina increased its key interest rate in several steps — from 27.25% in April to 72.83% on October 4th 2018[8] — but the situation remained very fragile.

Politically, the new administration wasted the window of opportunity to stabilize and reform the economy in the first two years of its term, when the blame could be put on the previous government. As result, it had to fight a crisis that was largely attributed to its own indecisive actions, and tighten policy a year before the next election and during the country's presidency of G20.

7. Summary: lessons to be learnt

The 2018 turmoil in Argentina and Turkey, still limited by historical standards, should serve as both the warning signal and source of policy lessons for both countries in trouble and others, including advanced economies, many of which walk on the edge of fiscal sustainability (examples include Japan or Italy).

First, the era of extremely low interest rates in AEs is coming to an end. This will have a strong impact on both them and emerging markets, in terms of direction of capital flows, public and private debt sustainability, financial sector stability, growth dynamics, and many others.

Second, the growth recovery, which started in AEs in 2017, could be short-lived, due to tensions in the global trade system, other geopolitical and security risks, supply-side constraints such as shrinking and ageing population and necessary tightening of monetary and fiscal policies. If growth in AEs weakens, this will have an additional negative impact on emerging-market economies.

Third, populist policies that ignore fiscal and monetary arithmetic are always of a limited lifespan. The question is only when the country will have to pay for such policies and how much.

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[7] http://www.tcmb.gov.tr/wps/wcm/connect/EN/TCMB+EN/Main+Menu/Core+Functions/Monetary+Policy/
   Central+Bank+Interest+Rates/1+Week+Repo
[8] https://countryeconomy.com/key-rates/argentina

Fourth, if economic policy requires corrections, it is always better and less expensive — in economic and political terms — to introduce them sooner rather than later. If the country faces the risk of becoming a victim of market turmoil, the policy adjustment should be fast and strong enough to arrest negative trends immediately and create positive expectations.

Although the above policy lessons are not new, they have to be repeated again and again. The memory of politicians is usually short as they tend to concentrate on current developments and concerns. Thus, if there have not been recently major crisis episodes, politicians tend to ignore risks and believe that "this time is different", referring to the title of Reinhart and Rogoff's (2009) historical analysis of financial crises.

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