Emerging Markets: Challenges and Rewards

*By Marek Belka**

Emerging Europe has stepped back from the abyss. For a region relying heavily on capital inflows made scarce by the global financial crisis the worst could be expected. And indeed, several economies have suffered a great deal and had to rely on help from their friends. But global risk appetite has returned and the global recession seems to be bottoming out. Does this mean that strong growth and renewed convergence will return naturally to emerging Europe?

Not necessarily. Just as hopes of decoupling from the epicenter of the crisis were dashed, so will the notion that all emerging economies will automatically recover alongside the advanced economies. Surely, some bounceback will occur, as trade has started to resume. But it is already noticeable that the downturn is lingering longer in a number of emerging market economies. Why? Many of these countries were severely impacted by the slowdown in portfolio inflows and the reduction in credit by troubled cross-border banks deleveraging their balance sheets. As capital flows have started to resume, much more differentiation is taking place as investors are more keen to scrutinize external and internal vulnerabilities.

This change in investor attitude has caused a dramatic shift in market risks. As the global factors that drove both risks and attitudes to unprecedented levels recede, domestic factors and policies surface as reasons for investors to differentiate among countries. On the top of their list of worries seem to be the state of private balance sheets and the financial system, as well as the closely related issue of fiscal sustainability. The result is that investors demand higher risk premiums, slowing down the recovery in the region.

But investors' newfound scrutiny is also a chance to get rewarded for sound policies. In fact, countries with better policies fared much better already during the crisis. What should be the priority now? Immediate action to plug holes in the banking system is likely to pay off handsomely. In many cases these holes stem from the combination of the economic slowdown and vulnerabilities associated with foreign currency–denominated debt overhangs by corporations (as in the Baltics, Hungary, Bulgaria, and Romania) and by households (as in the Baltics, Hungary, Romania, and Poland).

Another priority should be to put in place policy frameworks to ensure long-term fiscal sustainability and predictability. Countries such as Hungary, Poland, and Romania have already begun the process of setting credible medium-term targets. The benefits are fewer surprises in fiscal policy and less volatile business cycles. Such frameworks should therefore reduce sovereign risk premiums and speed up the recovery.

However, even if the damage caused by the crisis was quickly repaired, the overall level of risk premiums will probably remain higher than before. This will drag down potential growth, posing a major challenge for the emerging economies. Policies to foster structural change would therefore be required to develop services and industries less dependent on foreign capital, to improve export performance, and reassure more fickle international

investors. In many emerging countries, just as much as elsewhere in continental Europe, adjusting to the post-crisis world will necessitate increased labor market flexibility and further liberalization of service and product markets throughout the EU.

Shoring up a recovery in emerging markets will therefore depend on government action. It requires the combination of a resolute and proactive approach to reduce uncertainly lingering in the financial system, efforts to ensure a business-friendly environment and improved policy frameworks to reduce uncertainty, and enhanced structural flexibility to ensure higher potential growth. In the end, the market's view of such reforms will determine the speed at which Europe's emerging economies will return to a healthy level of capital inflows commensurate with the much-needed continuation of convergence and economic integration processes. So while the challenges for the emerging market economies have increased, so have the rewards for sound policies.

** Marek Belka is Director of the European Department of the International Monetary Fund (IMF)*