POINT OF VIEW

Where Are Emerging Markets Headed?

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LITTLE more than a year ago, emerging markets were in turmoil. Investors, still reeling from the Asian and Russian crises, were watching a disorderly devaluation of Brazil's currency, the real, threaten financial stability throughout Latin America. The index of emerging market bond returns had declined by more than 17 percent in a 12-month period. Emerging economies were facing more difficult credit conditions: not only was the average spread standing at about 1,300 basis points (implying an average cost of 18 percent, before adjustment for the Russian restructuring), but the market for new issues was basically closed.

The emerging markets look very different in early 2000. Growth is picking up in most economies, with countries like Brazil also making remarkable financial recoveries and Mexico just being upgraded by Moody's to the much-coveted investment rating. The index of emerging market bonds is up 28 percent on a 12-month basis, surpassing all other pure fixed-income indices. Average spreads have narrowed to around 800 basis points. Thus, notwithstanding both higher interest rates in the industrial countries and the issuance by major emerging economies of more than $5 billion in new 10–30-year bonds in January alone, the average interest rate has declined to less than 15 percent.

This turnaround is particularly impressive given what else has been happening in international financial markets. For example, the U.S. treasury market has been volatile as it tries to adapt to new realities concerning treasury buybacks, as well as to the U.S. Federal Reserve System's tightening of monetary policy. Swap spreads are unusually wide, while the corporate market (high grade and high yield) is having to deal with its own dislocations as reflected in high and volatile credit spreads. And U.S. equities have exhibited their own type of volatility and dispersion. Meanwhile, on the emerging market front, four countries—Côte d'Ivoire, Ecuador, Pakistan, and Ukraine—have joined Russia in either defaulting outright on external debt obligations or implementing exchanges that, de jure, reduce the contractual value of creditors' claims.

Has the world changed so much that emerging markets can now be seen as an island of stability in a more turbulent international financial environment? Or are we watching a cyclical process unfold that promises another round of disruptions and crises for emerging markets in the months ahead?

Recent developments

After all is said and done, this asset class benefited in 1999 from a rare alignment of three stars: better country fundamentals, a supportive external environment, and promising "market technicals" (that is, favorable initial valuations and investor positioning).

Specifically, several countries, aided by programs supported by IMF financing and advice, strengthened their domestic policy stances. Stronger policies contributed to a recovery in economic activity, the containment of inflationary pressures, and an improvement in the balance of payments. External conditions also supported emerging countries' economic recovery and improved their balance of payments outlook: growth remained extremely buoyant in the United States while picking up in Europe. The income boost that resulted from export growth in emerging economies was supplemented by higher world prices for hard commodities, led by oil.

Finally, the emerging markets asset class was starting from valuations that had been overly depressed by what had seemed like an endless procession of crises circling the globe. But like the debt crisis of the 1980s, the crisis of the 1990s was also shaking out much of the overindebtedness that was associated with the excessive borrowing and leveraging of previous years. Moreover, compared with the debt crisis of the 1980s,

the crisis of the 1990s was taking place in "fast forward."

Outlook

So much for the past; where do we go from here? Three hypotheses emerge from an assessment of domestic, external, and technical factors:

• First, emerging markets face a choppy outlook, as generally supportive internal factors compete with significantly more difficult external ones. Also relevant here is the fact that a few countries with potential systemic influences are being strongly challenged on the policy front.

• Second, and in the midst of greater volatility, the generally narrower spreads could persist for the immediate future, although further significant tightening would need to overcome a large pipeline of new issues as well as the uncertain external environment.

• Third, individual emerging economies that are already at opposite ends of the spectrum—at one end, countries with strong economic fundamentals; at the other, countries whose economic and sociopolitical outlook is particularly challenging—could become increasingly disconnected from each other. The good news here is that turmoil in countries like Côte d'Ivoire and Ecuador will not have an adverse impact on the asset class as a whole. The bad news is that the asset class cannot rely just on favorable developments in countries like Korea and Mexico to create a rising tide that lifts all boats.

Rationale

These hypotheses reflect certain expectations about domestic policy, market technicals, and the external environment.

Domestic policy fundamentals will continue to improve, especially given that a significant and growing portion of the recent policy strengthening is rooted in structural improvements and institutional gains. Indeed, the key question is no longer the damage that disruptions in emerging economies can inflict on the economies of the industrial countries. Rather, the question today is the extent to which the stronger fundamentals in emerging economies can help them withstand pressures from dislocations in industrial country financial markets.

Within this baseline, three issues should be kept on the radar screen: the risk of policy complacency, the difficulties that emerging economies typically face in "managing success," and the fact that the jury is still out as to whether some countries of systemic importance (such as Argentina, Russia, and Turkey) will be able to sustain sound policies in the context of domestic and external challenges, as well as large external funding needs.

Turning to market technicals, the key question relates to the extent to which crossover funds return. Such funds, many of which still view emerging market exposure as part of their tactical (rather than structural) investment strategies, exited the asset class en masse in 1998 because of the various crises. Having generally remained on the sidelines in 1999, a growing number of them are now looking to reenter emerging markets, albeit gradually, cautiously, and selectively.

But the external environment remains a cause for concern, for two reasons. First, the downside risks to the baseline scenario of a faster and more balanced growth for the world economy might be increasing. Second, the current dislocations in industrial country financial markets (government debt, swap spreads, and corporate bonds, for example—and all in the context of worries about the valuation of certain equity markets) could well result in a de facto increase in average investor risk aversion. This would reduce both the absolute and the relative attractiveness of investing in emerging market assets.

Implications

This outlook accentuates the importance not only of sound economic policies in emerging economies but also of appropriate contingency plans. Indeed, while emerging economies may benefit from a quick resolution of the technical dislocations in the external financial markets, they are best advised to plan for the possibility of negative contagion through both financial-sector and real-economy channels.

It also implies that liability-management opportunities may once more become available to emerging countries. Such opportunities allow them to retire expensive debt through exchanges and buybacks—thereby improving creditworthiness, capturing net-present-value gains, establishing a better benchmark for both foreign direct investment evaluations and private sector access to international capital markets, and, in some cases, releasing collateral. Recall that in 1999, some countries—Brazil, Mexico, and the Philippines, for example—were quick to seize "win-win" opportunities. Brazil and Mexico have done so again this year. But other countries—such as Bulgaria, Jordan, and Poland—missed out on such opportunities last year. They could well get another chance at them this year.

Finally, the mixed outlook reinforces the importance of countries providing markets with timely and comprehensive information. Indeed, experience suggests that well-informed investors are less likely to react prematurely, or to overreact, to external volatility because of their more thorough understanding of emerging market conditions. F&D

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