'Submerging markets' pose global threat

Currency weakness and poor political stewardship are weakening major emerging economies

by Desmond Lachman in Washington

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Renewed currency weakness in Argentina and Turkey underlines the risks that emerging markets, or rather 'submerging markets', could pose to the global economic recovery in the year ahead. Equally alarming is how highly indebted, particularly in dollar-denominated terms, the emerging market corporate sector has become.

The largest International Monetary Fund financial programme on record and the Federal Reserve's pivot to an easier monetary policy stance have not spared Argentina's currency from renewed downward pressure. Since the start of the year, the peso has lost another 16% in value, taking its total loss over the past year to around 50%.

The plunging currency has contributed to an increase in Argentine inflation to around 50% and to a sharp decline in output and employment. With presidential elections scheduled for October and the global economy weakening, it is difficult to see how Argentina could devise a near-term turnaround.

Turkey has fallen into recession as the lira has lost 30% of its value over the last year. All indications are that the country's credit bubble has burst and that President Recep Tayyip Erdogan's political position has weakened substantially following defeats in local elections in Ankara and Istanbul. Analysts doubt Turkey's corporate sector will be able to service the $275bn it has borrowed in dollar-denominated terms.

Given their relatively small size, the Argentine and Turkish economies, however troubled they might be, cannot by themselves constitute a significant threat to the global economic recovery. The same might not be said of Brazil and Mexico, which after China are the world's two largest emerging economies. Both these countries appear vulnerable to crisis in the light of the seemingly shaky economic stewardship of their respective new presidents.

Jair Bolsonaro's ascendancy to the Brazilian presidency at the beginning of this year, coupled with his appointment of a market-friendly finance minister, held out the hope that Brazil would finally address its chronic pension system deficit problem. That would have enabled Brazil to reduce its bloated budget deficit (around 7.5% of GDP) and to put its high public debt level on a sustainable path.

Bolsonaro's initial months in office suggest he lacks the temperament to build the necessary coalition in Brazil's highly fractured Congress to secure passage of much-needed economic reform. This makes Brazil especially vulnerable to a further slowing in the global economy, as well as to any deepening of Argentina's economic troubles.

While the Mexican economy starts with much sounder economic fundamentals than does Brazil's, its long-term trajectory has been clouded by the election of Andrés Manuel López Obrador to the presidency.

In his first 100 days in office, López Obrador's market-unfriendly and populist approach to economic policy has undermined foreign investor confidence in the country. Recent ill-advised Mexican policy decisions include the controversial cancelation of an international airport project, the postponement of oil and gas auctions, which has raised questions about the maintenance of an open energy market, and the reduction of public salaries that threatens to incite a flight of talent from the public sector.

Until recently, emerging markets were a principal source of the world's economic growth. If these countries continue to slow and their currencies to depreciate, it will become increasingly difficult for their corporations to service their debt mountains. According to estimates from the Bank for International Settlements, emerging market corporates hold dollar-denominated debt greater than $3tn.

Policy-makers have correctly identified Britain's exit from the European Union, China's troubles and the European economic slowdown as possible risks to the global economy. They would be well advised to add the emerging markets to their list of worries and keep a close eye on their economic policy direction.

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