Argentina, Turkey, Indonesia - why it's too early to speak of contagion in emerging markets

By Alain Naef

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Turkey, Indonesia and Argentina have all seen their currencies experience huge drops in recent months. Similarly, stocks in India, South Africa, Mexico and others have taken a hit.

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Emerging markets across the board have been under pressure since the US Federal Reserve raised interest rates in June. Governments and companies had borrowed in dollars when interest rates were low and the dollar was weak. Now the dollar is strong and interest rates are rising. And research by economists Michael Bordo, Chris Meissner and David Stuckler has shown that countries with higher foreign currency debt are more likely to experience currency and debt crises, especially in countries with lower policy credibility.

Some fear a repeat of the 1997 Asian financial crisis when contagion spread from the Thai baht to other South-East Asian currencies, resulting in a large regional economic crisis. But contagion this time round is unlikely.

The 1997 Asian financial crisis has changed the way economists approach currency crises. Before, they mainly believed that a run on a currency would occur only when a country was running a balance of payment deficit and the central bank did not have sufficient reserves to defend the currency. Following the Asian crisis, current IMF chief economist Maurice Obstfeld was among the first economists to show that currency crises can be a self-fulfilling prophecy, as happened in 1997. If investors start to have a pessimistic outlook on emerging markets currencies, it can lead to runs on currencies with no unhealthy economic fundamental or no misguided government policies.

This is not what is happening now. Argentina shows weak fundamentals and the government is struggling to finance its budget for the upcoming years. Turkey’s central bank is under attack from its president, Recep Tayyip Erdoğan, and needs to prove its independence to investors. But these are isolated situations and it is unlikely we will see global contagion.

The Fed recently issued a note explaining that the global crisis risk associated with emerging market currencies. According to the note, the risk of contagion among emerging currencies is low as only a limited number of countries present a risk, and their importance relative to the global economy is small. They based their reasoning on a study by Harvard economist Laura Alfaro and colleagues that demonstrated that emerging markets after the global financial crisis are less at risk than the five Asian crisis countries before 1997.

Different approaches

The Argentinian case is interesting, however, because the current government has been the poster child of orthodox economic policies. If the economy were to fall further, it would show that even by following most IMF recommendations, growth is not achievable. This would open the door to a more populist backlash or the return of Peronist opposition in the upcoming 2019 general election.

But all is not lost. The US$50 billion that the IMF offered Argentina is a significant amount compared to the size of the currency market in Argentina, which the Bank for International Settlements estimates to be roughly US$1 billion a day. This means that the central bank will have room for manoeuvre as long as Argentina's president, Mauricio Macri, refrains from any missteps, such as when he announced his desire for help from the IMF via YouTube. The move reflected the president's willingness to get his country on board to talk again to the IMF, an institution that is closely linked to the bankruptcy of the country in the early 2000s. But markets felt less reassured by his comments.

Turkey, meanwhile, has implemented measures to try to stop the fall in the lira and to make it more difficult for speculators to bet against or "short" the lira. This has had some effect without solving the crisis. The real issue remains whether the central bank will be able to remain independent of Erdoğan, as economist Barry Eichengreen recently argued. The Turkish president's disdain for central bank independence shows how different Turkey's situation is from Argentina's.

It is too easy to lump together all emerging markets. But, although contagion is not yet on the agenda, this does not mean that all is fine. A recession in the US is overdue after over nine years since the last official recession, and this would have a more serious effect on the global economy by putting pressure on exports from emerging markets. This would be likely to lead to more currency crisis. But until then, contagion should be limited.

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