

April 9, 2014

## Risk of financial crisis in emerging countries Despite the recent lull, concerns persist

Serious concerns about emerging countries have persisted for about a year now. The tapering of the U.S. Federal Reserve's (Fed's) securities purchases has been fuelling fears of a possible global monetary tightening and a drop in capital flows to these countries. In addition, structural weaknesses in several emerging countries recall some of the symptoms that were seen before the 1997–1998 Asian financial crisis. Even if China appears more immune to a reversal in global capital flows, the slowdown in economic growth and the challenges facing China are also raising concerns.

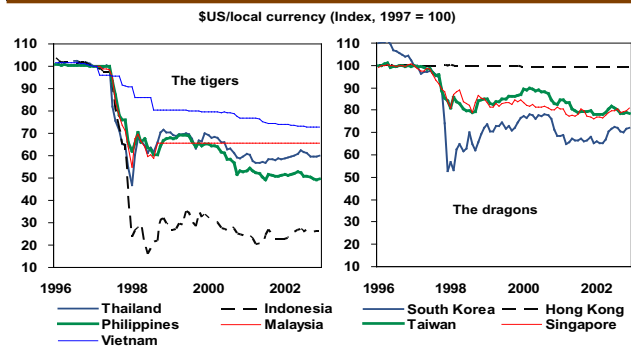
This *Economic Viewpoint* takes a look back at the financial crisis of 1997–1998 and draws comparisons with the current situation. While several elements have been noted that reduce the odds of a similar crisis, other aspects, such as chronic overinvestment in China, represent serious risks to the global economy and the stability of financial markets.

### THE 1997–1998 CRISIS

After several years of strong growth buoyed by investment, the economic miracle of several Asian countries—referred to as tigers and dragons<sup>1</sup>—came to a brutal halt in 1997. Foreign debt and signs of overinvestment, especially in real estate, raised eyebrows and a massive outflow of capital followed. The crisis began in Thailand. Faced with these capital outflows, the monetary authorities proved unable to defend the baht's fixed exchange rate, which in the end was dropped in July 1997 in favour of a free floating currency. Thailand's currency depreciated sharply as a result, pulling down in its vortex other currencies in the region (graph 1). Most tigers and dragons operated with fixed or administered exchange rate regimes, and speculators doubted their sustainability. This sentiment was reinforced by the perception that the structural weaknesses threatening Thailand had spread to other countries in the region.

<sup>1</sup> The dragons, or the first tigers, are represented by South Korea, Hong Kong, Singapore and Taiwan; they constitute the first wave of Asian countries that experienced rapid growth after Japan. The tigers, or new tigers, are represented by Indonesia, Malaysia, the Philippines, Thailand and Vietnam. Development in these countries began after the four dragons, and they are still considered as emerging countries today.

Graph 1 – Asian currencies suffered sharp declines in 1997



Sources: Datastream and Desjardins, Economic Studies

A sharp decline in the exchange rate can be beneficial to stimulate exports, but when a country is grappling with high foreign currency debt, the situation becomes much less favourable. Once a national currency suffers a sharp drop, the foreign currency debt burden increases, along with the risk of bankruptcy for governments and businesses. Most tigers and dragons were accumulating current account deficits before the crisis in 1997; this speaks volumes about the great need for foreign capital (graph 2 on page 2). Banking on the sustainability of fixed exchange rate regimes, financial institutions in Thailand and in surrounding countries also

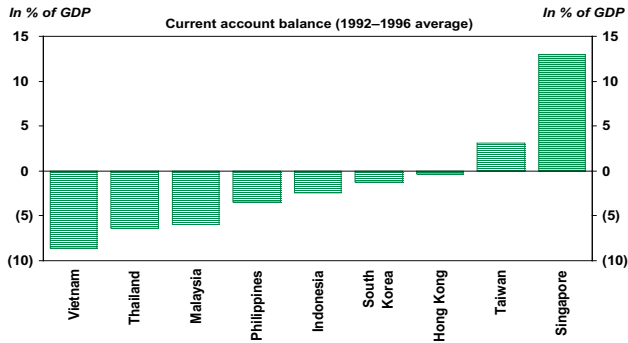
**François Dupuis**  
Vice-President and Chief Economist

**Yves St-Maurice**  
Senior Director and Deputy Chief Economist

514-281-2336 or 1 866 866-7000, ext. 2336  
E-mail: [desjardins.economics@desjardins.com](mailto:desjardins.economics@desjardins.com)

**Hendrix Vachon**  
Senior Economist

**Graph 2 – Great need for foreign capital in several Asian countries**



Sources: International Monetary Fund and Desjardins, Economic Studies

miscalculated the risks they were taking by borrowing massive amounts in foreign currencies. In so doing, several banks became insolvent in 1997, dragging the economy into a severe recession.

Most countries tried to limit the sharp drop in their currency, but when foreign exchange reserves dry up, significant hikes to interest rates is the only way to turn things around. And yet, high interest rates also increase the cost of carrying debt. Consumption and investment become stifled. Hong Kong managed to defend its fixed exchange rate, but the rise in interest rates still damaged its economy.

**THE IMPACT ON THE REST OF THE GLOBAL ECONOMY**

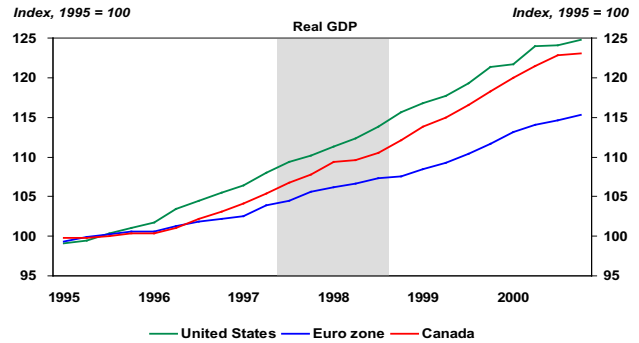
Despite sustaining considerable financial losses, the crisis in Asian countries did not affect the overall global economy too badly. International trade in particular did not decline as severely as it did during the recession of 2001 or the Great Recession of 2008–2009 (graph 3). The fact that the economy in the U.S. and in other advanced nations was relatively unscathed is likely the reason why the momentum across the globe continued to hum (graph 4).

**Graph 3 – International trade did not decline during the 1997–1998 crisis**



Sources: Datastream, CPB Netherlands Bureau for Economic Analysis and Desjardins, Economic Studies

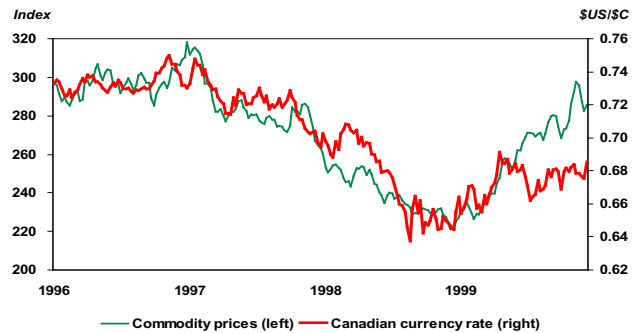
**Graph 4 – Advanced economies kept growing despite the crisis**



Sources: Datastream and Desjardins, Economic Studies

Still, Canada’s economy lagged somewhat in 1998. The steep drop in investments in Asia fuelled speculation about a significant decline in demand for commodities. Resource prices corrected, dealing a blow to several economies that had to grapple with diminishing revenues, and the commodity currencies, like the Canadian dollar, also depreciated sharply (graph 5).

**Graph 5 – The Canadian dollar dipped in step with commodity prices**



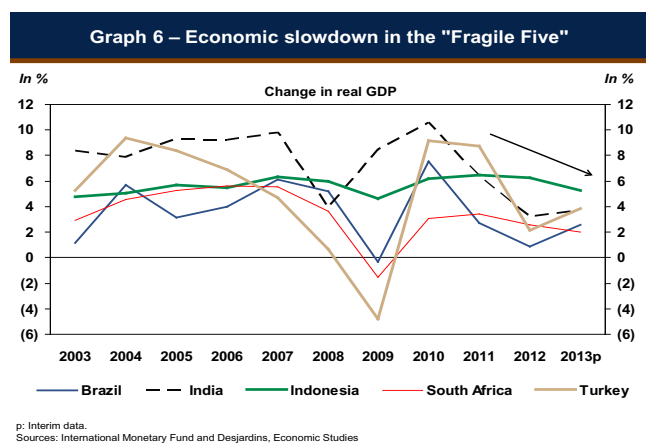
Sources: Datastream, Bank of Canada and Desjardins, Economic Studies

Other economies that depend on global demand for commodities were more heavily affected than Canada. This was the case in Russia and Brazil whose difficulties were a second chapter to the Asian crisis. Both countries were already weakened by the state of their public finances, and the drop in commodity prices made the situation worse. Both countries also had fixed exchange rates, and again speculators doubted their sustainability. Russia yielded in August 1998, announcing the devaluation of the ruble and a default on its sovereign debt payment. The shockwave sent the Long-Term Capital Management (LTCM) hedge fund into bankruptcy in September 1998 and greatly increased volatility on financial markets around the world.

Brazil gave up in January 1999, despite the support it received from the International Monetary Fund to replenish its foreign exchange reserves. Concerns about other countries in Latin America also rattled the markets for some time. Argentina had reinforced its financial system a few years earlier, thus limiting the damage. The flexibility of exchange rates in Mexico and Chili also helped, as did the decision by the Federal Reserve in fall 1998 to cut its key interest rate.

### WHAT COUNTRIES ARE CAUSING CONCERNS TODAY?

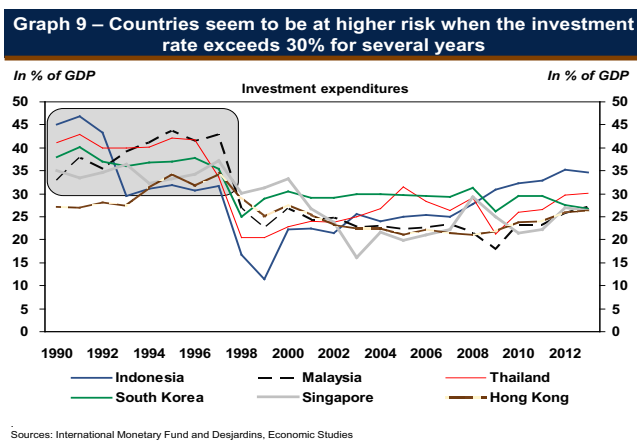
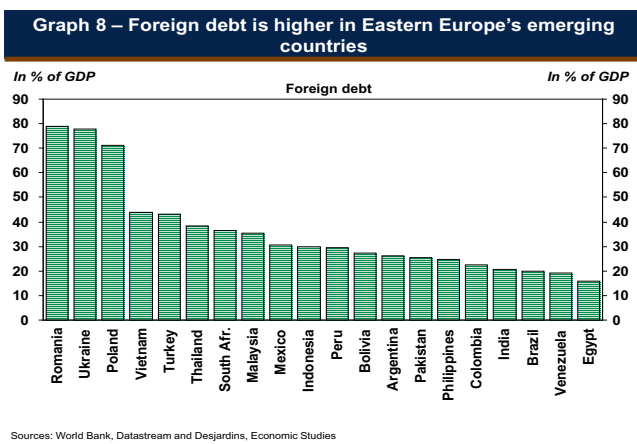
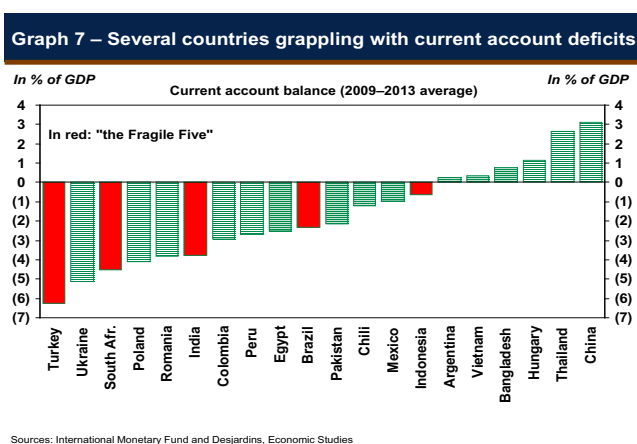
For the past year, five emerging countries have been the subject of new-found focus: Brazil, India, Indonesia, Turkey and South Africa. A new acronym, BIITS, has even been coined, as has the expression, the “Fragile Five.” Several elements pushed these countries into the harsh spotlight, particularly the slowdown in economic growth (graph 6) and the deterioration of their current account balance.



Much like the tigers and dragons in the 90s, the Fragile Five depend heavily on foreign capital to finance their growth. A flight of capital would be very damaging to these countries—with no financing, they would have to revise their consumption, investment and public spending downwards. That other emerging countries are also dealing with major current account deficits is worth noting, especially countries in Eastern Europe (graph 7). These countries also bear the burden of the highest foreign debt (graph 8).

### OVERINVESTMENT IN CHINA

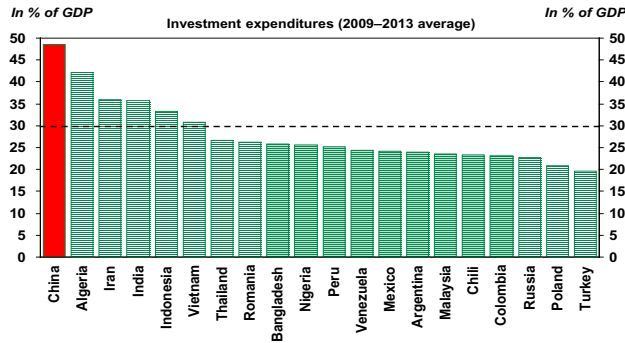
The countries that experienced difficulties in the 90s had also maintained an investment rate of more than 30% of GDP for several years (graph 9). Overinvestment can lead to several problems, such as the formation of speculative bubbles, or a drop in corporate profitability due to an overabundance of production capacity. Recent data show that China has



largely exceeded the 30% threshold, with an average rate of investment of almost 50% of GDP (graph 10 on page 4).

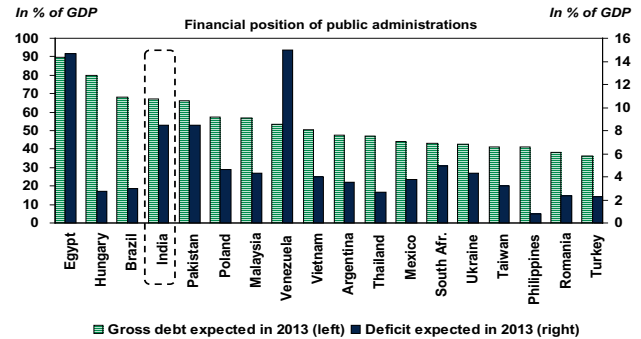
The problem of overinvestment in China is exacerbated by the growth of credit outside the regulated banking sector (graph 11 on page 4). If the number of underperforming loans were to rise, China’s financial markets and economy would be further destabilized. China still has a trump card, however; it does not depend on foreign capital inflows to

**Graph 10 – China significantly above the critical 30% threshold for investment expenditures**



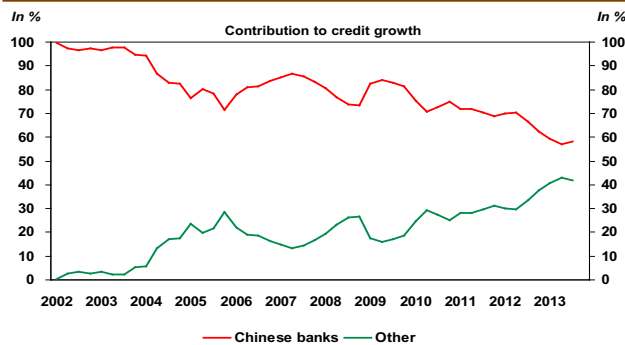
Sources: International Monetary Fund and Desjardins, Economic Studies

**Graph 12 – The state of India's public finances is another source of concern for this country**



Sources: International Monetary Fund and Desjardins, Economic Studies

**Graph 11 – Banks losing ground in granting credit to China**



Sources: Bank for International Settlements and Desjardins, Economic Studies

finance its investments. Increased concerns among foreign investors would not be enough to trigger a shock, as was the case with Asia's tigers and dragons in 1997.

Algeria is in second place—at more than 40% of GDP—in terms of its investment rate, followed by Iran, India, Indonesia and Vietnam with rates varying between 30% and 35%. The importance of the oil and gas industry in Algeria and Iran can justify the high investment rates. The situation appears more problematic for the other three countries, and especially India, given its stronger reliance on foreign capital.

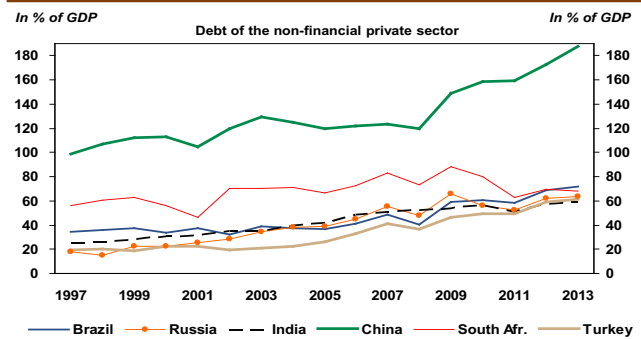
**THE STATE OF PUBLIC FINANCES IS FUELLING RISK IN SOME COUNTRIES**

The difficulties in Brazil and Russia in 1998 stemmed from the poor state of public finances. These days, India represents one of the most worrisome situations given the burden of its debt and public deficit (graph 12). Brazil is also heavily indebted, but its deficit is under better control. Egypt, Venezuela and Pakistan are other countries to be monitored, as are some Eastern European countries. Russia is no longer a frontrunner, but recent tensions with the West

on Ukraine have triggered new risks for its economy and, by extension, its State revenues.

But public debt is only one side of the coin. Debt in the private sector can also increase the risk of financial difficulties. Yet, China is way ahead on this front, with public sector debt (excluding the financial sector) in excess of 180% of GDP (graph 13). The private debt of the other main emerging countries is only somewhere between 60% and 80% of GDP. The gap between China and other countries is indeed wide, even if we add the weight of public debt to the private debt. Doing so in India, for example, would result in 126% of GDP.

**Graph 13 – The non-financial private sector's debt is especially high in China**



p: Interim data.  
Sources: Bank for International Settlements, International Monetary Fund and Desjardins, Economic Studies

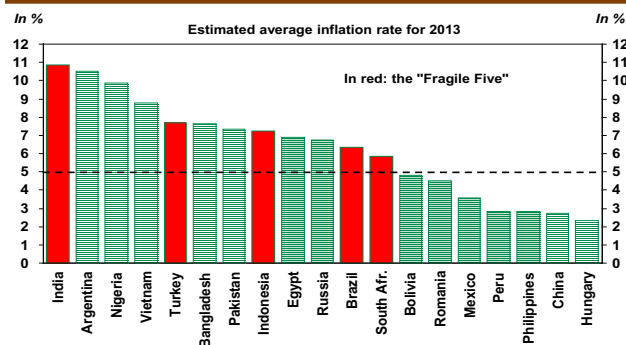
**INFLATION: A HEADACHE FOR CENTRAL BANKS**

Monetary policy is usually relaxed when economic growth slows. Yet several countries, including the Fragile Five, are also struggling with high inflation, or in excess of 5% (graph 14 on page 5). This greatly limits the ability of central banks to intervene to kick-start the economy. Most central banks in fact raised their interest rates this past year.

Making growth or inflation a top priority represents a very big dilemma. If a central bank cuts its interest rates and



Graph 14 – Inflation is high in several emerging countries



Sources: International Monetary Fund and Desjardins, Economic Studies

inflation rises as a result, this will harm exchange rates. Yet, a currency's depreciation increases the weight of foreign currency debt, which pushes foreign investors further away. The risk of a financial crisis is therefore higher if inflation is not kept under control. In contrast, weaker economic growth will also see foreign investors flee. The central banks in emerging countries have to strike an acceptable balance between economic growth and inflation.

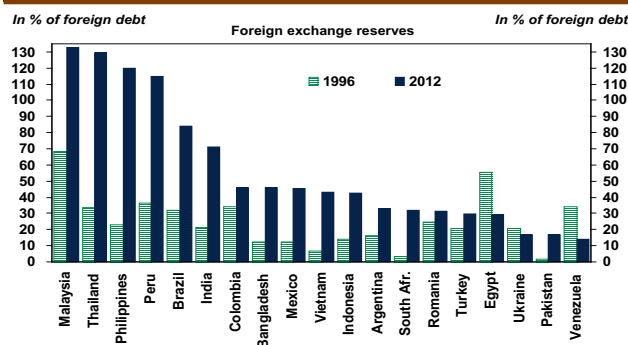
### A LOOK ON THE BRIGHT SIDE

If several red flags are being spotted in emerging countries right now, many factors argue against the risk of a crisis, starting with the low prevalence of fixed exchange rate regimes that were clearly an aggravating factor in the 1997–1998 crisis. Defending exchange rates causes serious economic harm. What's more, when exchange rate targets are dropped, the ensuing depreciation is often very fast and violent, intensifying panic on financial markets. The exchange rate depreciation in several emerging countries this past year was spread out over a longer period of time, and it never reached the range of fluctuations experienced by the tigers and dragons in 1997.

Even in a flexible exchange rate regime, situations can arise when a country has to vigorously defend its currency. The size of a country's foreign exchange reserves becomes hugely important, since it lends credibility to a country's capacity to support its currency. Foreign exchange reserves also help offset capital outflows and limit the introduction of interest rate hikes. By comparing the data on foreign exchange reserves held today vs. that held 16 years ago, a considerable increase in several countries was observed (graph 15). This is especially the case in Asian countries that were impacted by the 1997–1998 crisis, but in India and Brazil as well.

The news in terms of economic growth is not all gloom and doom either. The recovery is firming up in advanced nations, and this will have positive repercussions on

Graph 15 – Foreign exchange reserves have been increased



Sources: World Bank and Desjardins, Economic Studies

emerging economies seeking a surge in global demand. An uptrend in growth will help reduce the level of uncertainty looming over emerging economies, and the risk of foreign capital flight.

However, rising interest rates in the advanced nations is a major issue that affects capital flows. On this front, long-term bonds have already risen significantly in 2013 and future increases will be very slow to materialize. Despite the tapering of the Fed's securities purchases, U.S. bond yields have advanced very little since the beginning of the year. Interest rate increases on a global scale will also be limited due by divergences in monetary tightening at main central banks. The European Central Bank and the Bank of Japan, among others, should prove to be more patient than the Fed or the Bank of England.

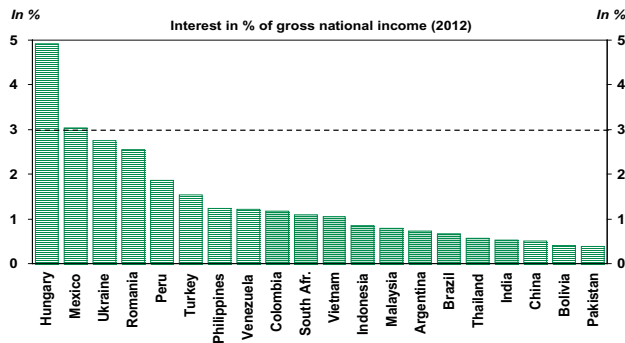
Interest rate increases also influence foreign debt payments and the risk of payment defaults. At the moment, total interest charges are very weak in most emerging countries, suggesting that these countries have significant leeway (graph 16 on page 6). Several countries that had experienced difficulties in the 1990s had a bill of interest corresponding to about 3% of gross national income. The countries in Eastern Europe are slightly more at risk on this front.

### CONCERNS POISED TO PERSIST FOR SOME TIME

The risk of a financial crisis appears higher in Turkey, South Africa and India, as well as in certain Eastern European countries due to the steeper deficits in their current accounts. India is of particular concern, due to several other weak points, including the precarious state of its public finances, signs of overinvestment and high inflation, which prevent the country from easing its monetary policy.

Even if worries persist for some time, several favourable elements reduce the risk of a widespread financial crisis caused by capital flight. Expectations for ramped up growth in the advanced countries should go far in settling the

**Graph 16 – Interest paid on foreign debt**



Sources: World Bank and Desjardins, Economic Studies

situation in the emerging nations given the widespread rise in investor confidence. That said, emerging nations must still address their structural problems.

China constitutes a particular case. This country depends very little on foreign capital and enjoys extensive foreign exchange reserves. However, the problem of overinvestment and increased risk credit are clouding China’s economic outlook. Yet, due to its massive economic weight, a slowdown or a recession in China would likely affect the rest of the global economy, and perhaps even wipe out the positive impact expected from improvements in advanced economies. As a result, if China’s economy were to skid, the risk of a financial crisis in the other emerging countries would increase. Special attention must also be paid to countries with more exposure to commodities. China’s leaders are aware of the weaknesses in their economy and hope to reform their growth model. Whether they will rise to this challenge in time remains to be seen.

Finally, the recent tensions between Russia and the West on the situation in Ukraine are simply added to these risks, but any apprehended outcome would be far less harmful than a slowdown or a recession in China. Ukraine remains a small country that represents about 0.4% of the global economy, while Russia represents about 3%. Other Western Europe countries that might suffer from the effects of a spillover also have relatively little weight compared with China, which accounts for about 15% of the global economy, while the Fragile Five account for about 12%—combined. Therefore it doesn’t take much to spot the elephant in the room.

**Hendrix Vachon**  
Senior Economist