As the year 2012 unfolds, its main legacy will be its game changing impact on global financial markets. Waning global growth along with central banks’ bold monetary easing policies in advanced economies (AEs) to try to reverse it are changing market dynamics in unexpected ways, across both AEs and emerging market economies (EMEs). The combination of monetary stimulus, fiscal austerity and hesitant structural economic policy reforms in AEs, particularly in Europe, is taking the global financial system into increasingly uncharted territory. How the European Union will address the future of the eurozone, including uncertainties over its banking sector, as well as how the United States handles its Fiscal Cliff, will weigh heavily on economic balances across all economies worldwide. This seems to be a significant point of inflection on the speed of the rebalancing of economic relevance of AEs in favor of EMEs taking place over the last 12 years. Under this scenario, the ability of EMEs to handle their own fiscal, financial, and real economy weaknesses is critically tied to their ability to weather external shocks and take advantage of growing global savings while searching for yield and growth opportunities.

A New Financial Landscape

Policies to manage global macrofinancial instabilities are leading to, at best, challenging existing assumptions of risk valuation and capital allocation. The new global scenario entails a persistent, stronger presence of governments and/or central banks in asset pricing. This trend is reflected through several channels, among which the most important are: (i) monetary easing programs of various sorts in AEs are flattening yield curves and bringing long-term yields to historic low levels; (ii) liquidity regulations are creating a sizeable captive demand for government bonds, implying further drops in yields; (iii) public sector interventions to support banks either through bailouts and generous liquidity facilities are creating distortions in their cost of funding compared to other issuers; (iv) currency manipulation has become a widespread behavior across AEs and EMEs, generally to mitigate currency appreciation (Gagnon 2012), but also to reduce volatility; and (v) central banks’ balance sheets have expanded to unseen levels in both AEs and EMEs, for different reasons, but with consequences on the economy and the financial sector still to be assessed.

While the new scenario is still being defined, market allocation strategies are guided by bursts of alternate risk-on and risk-off capital flows. The underlying trend is a “flight-to-safety” mainly targeting G-4 economies, which is creating unprecedented low yields in government debt despite low growth prospects and high fiscal imbalances (figure 1).
Where Do EMEs Stand?

This does not mean that the structural shift rebalancing EMEs weight in relation to AEs that seemed to be consolidating after the 2008 crisis is in doubt. On the contrary, the trend is still there, but its pace has slowed down temporarily, and it is still an open question whether the structural rebalancing favoring EMEs will resume the faster track observed in recent years.

There are differences between regions depending on where each country stands and its exposure to AE’s retrenching banking sector, direct trade dependency on AEs, or commodity exports. However, some common patterns may be drawn.

On the negative side, expected gross domestic product (GDP) growth in EMEs and developing economies for 2012 and 2013 has been downgraded several times in a row, and is now expected to be 5.6 and 5.9 percent respectively (IMF 2012b), well off its postcrisis peak of 7.5 percent in 2010 (figure 2). China’s GDP growth has also been hit, as shown by the 7.6 percent figure released for the second quarter of 2012, down from 8.1 percent in the first quarter. This will drag down most Asian economies and commodity exporters in other regions such as Brazil, the Russian Federation, and South Africa.

Vulnerabilities in EMEs cannot be overlooked because they combine external factors and home-grown imbalances. The former include volatile capital flows amid depreciating currencies, dependency on single exporting products and commodities, as well as the potential fatal impact of prices increases for soy, corn, and wheat after the drought in the United States, putting pressure on inflation through food prices, together with weaker prices for metals affecting growth (figure 3).

Domestic weaknesses include the fact that large EMEs are at the end of the credit cycle (IMF 2012a), and that physical infrastructure is still deficient across all EMEs. Both factors are constraining EMEs’ growth potential, even in a scenario of fiscal and monetary stimulus.

On the positive side, EMEs have fiscal and monetary space to take counterbalancing measures, given their lower fiscal debt and relative high interest rates when compared to AEs (IMF 2012a). Central banks have already been conducting monetary easing by lowering policy rates and reserve requirements in all regions. The most conspicuous example is Brazil, which has lowered its policy rate by 450 basis points in less than a year. Other large EMEs, such as China, India, Indonesia, Turkey, and South Africa have also eased monetary conditions with the consequence of depreciating currencies. The big question is whether these measures will be as effective as during the 2008 crisis given EMEs’ mentioned structural constraints and stronger economic imbalances in AEs.

Credit ratings are still holding for all EMEs, but India’s risk of being the first of the BRIC members (Brazil, Russia, India, and China) to lose investment grade status after S&P’s negative outlook in April is a warning for other EMEs. As global economic conditions get
tougher, there will be a clearer differentiation favoring EMEs that are able to continue with structural reforms.

**An Uncertain Scenario for Investment Allocations and Capital Flows to EMEs**

The changing financial landscape, the enduring crisis in developed economies, and the downward revisions in global growth are setting the tone for investment allocations and capital flows to EMEs. The prevailing uncertainty of outcomes and duration of these key drivers are having at least three major consequences on flows and preferences across assets classes:

i. A great share of global liquidity is piling up and sitting on the fence: flight-to-safety, especially to G-4 sovereign debt, is undermining potential investments and slowing the pace of portfolio allocations to emerging market assets.

ii. Volatility of capital flows to EMEs has increased: equity markets are being more severely impacted, influenced by risk-on and risk-off behavior, and mirroring the uncertainty of growth outlooks. Already in the first half of 2012, for example, equity markets in EMEs have experienced large swings in capital flows, starting with a buoyant period in the first two months, a sharp reversal up to May, and a recovery by the end of June (figure 4).

iii. Flows to EMEs’ (sovereign and corporate) bonds have been comparatively more stable and concentrated on hard currency: volatility of bond flows has so far been just a fraction of that observed in equity markets, with 80 percent of EME fixed-income flows in the first half of 2012 directed toward hard currency instruments (JP Morgan 2012).

Against this backdrop, sovereign and corporate emerging market bonds in hard currency—represented by the EMBIG and CEMBI indices, respectively—have performed consistently well both over a period of one year and year to date (figure 5). Commodities and EME equity returns have been disappointing and volatile in line with the global downturn.

Looking forward, volatility in capital flows seems unlikely to dissipate while global uncertainties remain, but whether hard currency EME assets will continue to deliver strong performance is less predictable. Compressed EMBIG and CEMBI spreads, the renewed cycle of easing monetary policies in EMEs, and adjusted levels of exchange rates in several of these economies may make the selection between hard and local currency assets less straightforward.
Adding to the uncertainty of capital flows to EMEs is a whole suite of regulations to bring under control some of the triggers of the 2008 financial crisis, such as liquidity requirements on banks and insurance companies through higher government bond holdings and the Volcker rule banning U.S. banks from proprietary trading.

**Selecting Policies to Weather the Crisis and Resume Sustainable Growth**

Gloom for AEs is gloom for EMEs as well. However, there will be a great difference between countries when global growth resumes on a more stable basis. The challenge is to work on a mix of policies that can mitigate the impact of the global crisis while better preparing these economies to tap savings from AEs when the crisis is over. Prudent macroeconomic policy is a prerequisite for EMEs’ continuous good performance, but it does not guarantee success under the current scenario, where countries are exposed to external shocks beyond their control. How each country is able to manage the following three risks will determine its position to take advantage of external savings:

i. Excessive exposure to the global economy and little room to maneuver in the persistent downturn (for example, high dependency on trade and commodity exports). The challenge is to implement structural reforms leading to fiscal sustainability, broader economic diversification, and increased weight of domestic demand in GDP growth.

ii. The risk of asset misallocation caused by two factors—current distortions leading to too low yields (for example, asset bubbles and misallocated capital), and the excessive role of the state in capital allocation to counterbalance the downturn.

iii. The persistence of the downturn in AEs impacting EMEs’ growth through the channels of trade, banks, and capital flows.

**Acknowledgment**

The authors would like to thank Olga Akcadag and Ying Ling for their excellent research support. This note is based upon the forthcoming “Foreword” in the 2013 Euromoney Emerging Markets Handbook. The content and design has been adapted for the Economic Premise series.

**About the Authors**

Otaviano Canuto is Vice President and Head of the Poverty Reduction and Economic Management (PREM) Network of the World Bank. Catiana Garcia-Kilroy is a Senior Securities Markets Specialist and Anderson Caputo Silva a Lead Securities Market Specialist, both in the Securities Markets Group of the Financial and Private Sector Development (FPD) Network of the World Bank.

**Notes**

1. The U.S. Fiscal Cliff refers to the convergence of the expiration of tax cuts and automatic spending cuts agreed upon in the U.S. Congress, which will be triggered at the end of 2012. The U.S. Congressional Budget Office estimates that they will cut GDP by 4 percentage points in 2013.

2. In the case of AEs, the origin of expanded balance sheets was the purchase of domestic assets to ease monetary conditions, while in the case of EMEs it was related to funding the accumulation of foreign reserves either for precautionary reasons or to manage the exchange rate. See an interesting analysis of Asia and further references in Filardo and Yetman (2012).

3. G-4 countries are Germany, Japan, the United Kingdom, and the United States. Other countries perceived as low risk but with lower capital absorption capacity because of their smaller size, such as Switzerland, Denmark and Sweden, are also being used as safe havens.


**References**

The Economic Premise note series is intended to summarize good practices and key policy findings on topics related to economic policy. They are produced by the Poverty Reduction and Economic Management (PREM) Network Vice-Presidency of the World Bank. The views expressed here are those of the authors and do not necessarily reflect those of the World Bank. The notes are available at: www.worldbank.org/economicpremise.