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# US recession would give emerging economies a boost

David Lubin

Markets Insight

US recession now! It doesn't really seem like the most obvious rallying cry for emerging economies. Yet the fact is that a US recession may well be what's needed to make room for a reliable decline in real US interest rates, and a reliable weakening of the dollar.

And that loosening of US monetary conditions would certainly do some good for emerging economies now. The recent tightening of those conditions has had some pretty awful consequences for them.

It has eroded their access to international capital markets; increased the risk of debt default, especially for low-income countries; and destabilised their currencies, pushing price stability further from the grasp of even the most adept central bank.

The idea that capital flows will return to emerging markets in the wake of a US recession has some history to back it up. Two episodes are especially worth considering: the early 1990s, and the aftermath of the global financial crisis in 2008.

The US experienced recessions from 1990 and from 2007 that lasted eight months and 18 months respectively. Both these episodes allowed a meaningful loosening of US monetary conditions, which helped trigger capital inflows to emerging economies after a period of risk aversion that was not unlike what we have been through recently.

By 1992, for example, international capital markets supplied net lending to emerging economies to the tune of about 1 per cent of gross domestic product after nearly 10 years of taking money away from them. By 2010, that flow had risen to 2 per cent of GDP, after two barren years when the Lehman crisis and its aftermath unfolded.

It has to be said that both these episodes ended badly: the rise in capital flows in the early 1990s came to an abrupt halt with Mexico's "Tequila Crisis" in late 1994. And the post-financial crisis boom in capital inflows ended in a series of bumps: a hefty sell-off in asset prices towards the end of 2011, and the "taper tantrum" starting in spring 2013 when the Federal Reserve triggered market turmoil by tightening monetary policy.

It is also true that these two "boom episodes" in capital flows to developing countries were not entirely the result of a loosening in US financial conditions, since there were other factors at play.

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Such a loosening is best understood as a "push" factor for capital flows: investors want to seek higher yields from developing countries when US rates are low and when the dollar's value is declining.

But "pull" factors are also relevant. You can think of these as the growth potential of emerging economies, the effort that their policymakers put into encouraging inflows of long-term investment capital and the overall confidence that market participants have that "things are looking OK" for the developing world.

Looking back at those two historical episodes mentioned above, it is worth pointing out that on both occasions the "pull" factors were pretty strong.

In the early 1990s, EMs benefited from investors' excitement about the proposed benefits of globalisation and the effort that countries — Mexico, Turkey, Thailand and the like — were making to reduce trade barriers, integrate themselves in the global economy, cut budget deficits and reduce inflation.

In addition, since the early 1990s, several countries had benefited from debt reduction under the Brady initiative. So EMs' balance sheets were perceived to be cleaner than they had been in the crisis period of the 1980s.

Equally, the post-financial crisis environment also saw a substantial EM "pull" factor. Emerging economies were relatively unscathed by the crisis, while growth expectations were supported by the late-2008 decision by China to launch a huge programme of stimulus, which reinjected life into global commodity prices and global trade growth.

Strong EM "pull" factors are difficult to point to these days. Global trade growth is weak, which harms developing countries disproportionately. Protectionism is rising while geopolitical tensions threaten globalisation. And there is little evidence of growth-enhancing domestic economic reforms — with exceptions such as Indonesia or Vietnam.

So it likely that "push" factors will be important in determining capital flows to EMs. The trick will be to make sure that any post-US recession boom in such flows doesn't, as in the past, turn to bust.

*David Lubin is head of emerging markets economics at Citi*