Caught the second time around

Developing nations that escaped the initial sub-prime crisis are now in its grip

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When the subprime financial crisis broke out a year ago, it did not affect developing countries directly on account of their limited exposure to derivatives. The expectation was that robust growth in emerging economies would rescue the global economy as they had 'decoupled' from OECD countries. However, it now appears that the second round effects of the sub-prime financial crisis, particularly through the associated spike in oil prices, is devastating for Asian countries at several levels since they are mostly commodity importers. Indeed, but for the cushion created by the reserves built up assiduously over the last few years, several Asian economies have the ingredients of a classic currency crisis: simultaneous sharp reversals in capital flows, current account balances and fiscal deficits.

By dramatically lowering interest rates in response to the credit freeze, the US Fed set the stage for a sharp depreciation of the dollar — the currency in which oil is internationally traded. Plummeting real estate, stock and financial asset prices also redirected liquidity, earlier distributed amongst other asset classes, towards commodities, particularly oil, further intensifying the price rise even as growth prospects moved in the reverse direction. Thus, while oil and commodity prices had been rising steadily for a few years consequent on sustained high rates of global growth, especially in BRIC countries, they went ballistic, quite out of proportion to the underlying demand-supply imbalance, following the onset of the sub prime financial crisis in August 2007. The six monthly moving average price of Brent crude which fluctuated within the range of \$60-70/barrel between end 2005 and mid 2007, rose steeply to cross \$80/barrel by December 2007, \$90/barrel by March 2008, breached the \$100/barrel barrier by May and threatened to top \$150/barrel in July 2008, before falling back recently.

One year on, the second round effects of the subprime financial crisis on emerging economies are apparent at several levels. Firstly, the spike in oil prices has sharply worsened the current account of several Asian countries, which are major oil importers, while strengthening the current account of commodity exporting emerging economies. This has split the BRIC economies down the middle, with the economic prospects of Brazil and Russia brightening and those of China and India dimming. In the aggregate, the global imbalances that inflated the sub-prime bubble are still intact.

While commodity prices, including oil, metals and food, appear to have peaked in mid-July 2008 and are now falling, they are still 20 per cent higher than what they were a year ago. It is therefore too early to call whether this is simply a 'correction' or whether a 'commodity bubble' has been 'pricked'. The long-term upward pressure on oil prices, consequent on sustained high rates of global growth, especially in emerging markets, needs to be separated from short-term liquidity-induced volatility. Oil prices are widely expected to remain firm for some time on account of the anaemic supply response and IMF's current (July 2008) forecast of continuing robust demand expansion in emerging economies.

Secondly, the belief that oil prices are likely to stay firm means that it is no longer possible for governments to insulate retail consumers in an open-ended manner. The consequential increase in retail oil prices, although modest in relation to international prices, combined with the spike in food prices that have become increasingly linked to oil prices through the biofuels link, has meant that inflation rates have increased much more sharply than in the advanced countries, since both oil and food have a greater weightage in the general price index in emerging economies.

Thirdly, the increase in retail prices notwithstanding, there is a sharp increase in fiscal deficits in emerging economies as governments try to absorb and stagger the commodity price shock. This has not only contributed to worsening the inflation outlook over the medium term, but has also led international credit agencies to consider downgrading credit ratings of some of the worst affected emerging economies, including India's. Should this occur, the rupee could come under greater pressure through rebalancing of currency portfolios.

Fourthly, the continuing credit freeze in western capital markets evident in wide TED (difference between 3-month Treasury bills and 3-month Libor) and financial CDS spreads notwithstanding, the deteriorating macro-economic environment in emerging economies and the diminishing influence of the 'decoupling' hypothesis has sharply reduced capital flows, worsened the balance of payments outlook and sharply lowered stock market valuations in commodity-importing countries. The reduction in capital flows may have made monetary management easier, but has put several Asian currencies, including the Korean Won, Thai Baht, Vietnamese Dong, Indonesian Rupiah and Indian Rupee, under pressure against the US dollar, even as the latter has been depreciating against major international currencies. The reduction is so sharp that the rupee in particular has come under heavy pressure. While the current account deficit is eminently manageable in view of large foreign currency reserves, rupee depreciation at this point will only feed inflationary pressures.

Fifthly, it is now clear that the asset wealth loss, including housing equity that was a major source of household demand in the US, and prolonged financial squeeze and deleveraging in international markets, is depressing global demand and growth. While the decline in US growth to date not been as sharp as forecast on account of fiscal stimulus, easing of monetary policy and a surge in exports consequent on the depreciation of the dollar, the diminishing US trade deficit is weakening the US role as global consumer of the last resort, recessionary clouds are growing darker in the Euro area and Japan. While India is not as dependent on external markets as several other economies, notably China, this cannot but have a dampening effect on growth in the emerging world, since the US accounts for about a quarter of global demand. According to the IMF this decline would be differential, with OECD countries showing a sharper and more protracted decline, followed by Asian countries like China and India that are commodity importers, while commodity exporters like Russia and Brazil would be the least affected. Growth in oil exporting Middle-eastern countries is expected to accelerate slightly in 2008.

The writer is a civil servant. The views are personal