

Emerging Focus: Risks Of Overheating Rise In Emerging Market Economies

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Emerging market economies led the global economy out of global economic crisis in 2008-2009 and continue to fuel the recovery owing to strong domestic demand and rising disposable incomes.

However, since early 2011, risks of overheating have increased as inflationary pressures are rising in many of these economies and domestic credit is expanding. In addition, widening interest rate differentials compared to advanced economies are leading to large capital inflows, stronger currencies, and impacting the export competitiveness in many of these economies.

Key points

- In its September 2011 World Economic Outlook update, the IMF listed risks related to rapid credit expansion and buoyant domestic demand as a key concern facing emerging market economies (EMEs). There is, however, significant diversity amongst these economies where signs of overheating are emerging in Asia and Latin America. These signs include rising inflationary pressures fuelled by high food and energy prices, a credit boom, rising asset prices like equities and real estate, deteriorating current account balances and consistently appreciating currencies;

- In 2011, annual inflation on a monthly basis in many EMEs in Asia and Latin America has been above their central bank's inflation target for 2011. For example, in China, annual inflation stood at 6.2% in August 2011, surpassing the central bank's target of 4.0% set for 2011;

- High interest rate differentials compared to advanced economies have led to strong capital inflows in EMEs. For example, by the end of September 2011, the USA's federal funds rate and the European Central Bank's key interest rate stood at 0.08% and 1.5% respectively compared to Brazil's Selic rate of 12.0%. However, this "hot money" has caused excess liquidity in recipient economies leading to higher inflationary pressures and a steady appreciation of their currencies;

- Many EMEs are taking mitigating policy actions like monetary tightening measures to cool down domestic economies. Some EMEs like Brazil, Indonesia and South Africa are also implementing protectionist measures like capital controls and increased taxes on foreign investors in order to slow down the flow of investments and curb inflationary pressures;

- High credit and asset price growth can undermine stability in global financial markets. According to the IMF, credit growth in many EMEs has almost doubled between 2005 and 2010 in per capita terms. Excessive lending stimulates demand and increases the risks of overheating. It can also affect exchange rate stability that can cause current account imbalances.

Domestic imbalances are growing

Several EMEs are seeing buoyant growth with many rebounding strongly from the global economic crisis of 2008-2009 and reaching pre-crisis output levels by the end of H1 2011 according to the IMF. In addition, these economies are characterised by low unemployment levels and high inflation despite the uncertainties surrounding the global economy suggesting that domestic imbalances are growing.

- Rising inflation is a key issue central banks of many EMEs are grappling with owing to the unprecedented rise in food and energy prices since the beginning of 2011 as well as buoyant domestic demand. Annual inflation in 25 key EMEs is expected to average 6.2% in 2011 compared to 5.3% achieved in 2010. Within EMEs, Vietnam, Argentina, Egypt and India are expected to witness an annual inflation rate of over 10.0% in 2011;

- According to the IMF, overheating risks are more imminent in Argentina on the domestic front. Argentina's annual inflation rate is expected to rise to 11.5% in 2011 from 10.4% in 2010. However, analysts estimate that consumer price inflation in the country has been much higher than official estimates since 2007;

- In many EMEs, annual inflation on a monthly basis is exceeding the inflation targets for 2011 set by their respective central banks. For example, in China, annual inflation stood at 6.2% in August 2011, surpassing the central bank's target of 4.0% set for 2011. Brazil, India, and Turkey are also amongst those where monthly annual inflation has been well above the inflation target set for 2011. According to the IMF, Chile, Indonesia, South Africa, Peru and Mexico are amongst those within the 2011 inflation target range.

Financial and external sector vulnerabilities

- The current account balances in many EMEs are deteriorating increasing external vulnerabilities. In 2010, the current account balance for EMEs stood at 1.6% of GDP compared to 3.7% of GDP in 2005 and a peak of 4.3% of GDP in 2006. During the same year, Turkey had the highest current account deficit within EMEs at 6.5% of GDP followed by Morocco, Poland, Vietnam and Colombia. However, current-account surplus economies like China also need to implement structural reforms to divert the dependence from foreign demand to domestic demand;

- In addition, capital inflows have risen significantly as a result of high interest rate differentials compared to advanced economies leading to excess liquidity and appreciating currencies. Foreign direct investment (FDI) inflows in EMEs totalled US\$395 billion in 2010 compared to only US\$262 billion in 2005. Within EMEs, Brazil, Colombia and China were amongst those that saw the largest appreciation against the US dollar between 2005 and 2010. During this period, the Brazilian real rose by 27.7% to reach R\$1.8 per US\$ in 2010;

- According to the IMF, Brazil's economy is at risk of overheating on the external front owing to large capital inflows. In 2010, Brazil was the fifth largest recipient of FDI inflows in the world and the second largest recipient within EMEs after China. Between 2005 and 2010, FDI inflows increased by 84.8% in real terms and reached US\$48.4 billion by the end of the period;

- Inflationary pressures have also been stoked by strong credit growth within EMEs. According to the IMF, indicators of financial developments such as credit growth are a concern particularly in Argentina, Brazil and Turkey. By June 2011, annual credit growth in these countries expanded by 32.1%, 18.2% and 32.2% respectively, compared to a year-on-year increase of 5.6%, 9.6% and 20.9% respectively in the same month of 2010. Credit expansion in China, India, Indonesia and Peru has also been buoyant and could prove to be a concern if excess liquidity is not reined.

Mitigating policy action and impact on domestic and global economy

High credit and asset price growth can undermine stability in global financial markets. In addition, rising inflation can raise cost pressures for business and limit domestic consumer spending. As a result, central banks of many EMEs have been taking mitigating actions to prevent the risk of overheating and avoid "hard landing" a rapid shift from solid to sluggish growth:

- Since early 2011, central banks of many EMEs like China, India, Indonesia and others are raising interest rates and taking other monetary tightening measures to reduce credit growth and curb inflationary pressures. For example, China's central bank has made price stability its top priority through prudent monetary policy measures. Since October 2010, the central bank has raised its benchmark interest rate five times to 3.5% and also raised reserve requirement ratios several times to curb food and property prices;

- In the case EMEs like Argentina, Brazil, Chile, Thailand, Turkey and South Africa central banks aim to regulate capital inflows into their economy that have led to stronger domestic currencies against the US dollar and are impacting export competitiveness. For example, in October 2010, the Brazilian government increased taxes on foreign investment inflows. On the other hand, Argentina and Chile have actively intervened in foreign exchange markets in 2011 to slow down the appreciation of their currencies to protect domestic industries and exports.

Rising interest rates and increased intervention in foreign exchange markets impact the domestic and global economy:

- As interest rates rise, the cost of borrowing increases for both, businesses and consumers, and can result in a fall in consumption and investment. For consumers, interest payments on credit cards, loans, mortgages become more expensive and as a result, they will have less disposable income. In addition, the high interest rates make it more attractive to save rather than spend;

- While protectionist measures like intervention in foreign exchange markets can help protect the domestic economy, it can also lead to "currency wars" which have key implications for world trade, commodity prices, consumer and business behaviour, as well as political relations between countries.

Prospects

- Despite growing uncertainties in the global economy and the measured slowdown in EMEs, these 25 key EMEs are forecast to post solid growth in 2011 and 2012 with an annual real GDP growth of 6.5% and 6.2%, respectively, from 7.7% recorded in 2010. However, challenges like correcting capacity constraints, building social safety nets and rebalancing from external to internal demand will remain in order to sustain their growth momentum;

- Of the key 25 EMEs, economies in Asia and Latin America are particularly at risk of overheating. For many of these economies where credit growth and asset prices are still very buoyant, tighter monetary policy may be warranted in the coming months to curb inflationary pressures and related financial stability risks.

- However, monetary tightening measures in EMEs should be handled delicately without damaging the global economy and the IMF suggests that more fiscal consolidation could help reduce the burden on monetary policy. Many EMEs have sought to reduce overheating risks and avoid “hard landing”™. However, if the latter occurs, it could harm the global economy amid the uncertainties generated by the US and eurozone debt crisis.

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