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Easy monetary policy in the form of low real interest rates, especially in the United States, helped fuel the flow of capital into emerging markets during 2002-04, as it did also in the late 1970s and the early 1990s. It is also clear that tightening of monetary policy during 1980-82 helped precipitate the international debt crisis, and the same in 1994 for the Mexican peso crisis. The question is, with US interest rates now again on the rise in 2005, will international investors this year pull out of emerging markets and precipitate a new round of crises? Other markets now look vulnerable to a reversal of the 2001-04 “dollar carry trade” – U.S. bonds, real estate, commodities... Why not emerging markets too?

Interest rates are of course not the only determinant of the demand for emerging market securities. Prospects for growth are as relevant as the discount rate. Such prospects look good for many developing countries.

Equally as important as actual growth fundamentals is investor sentiment. The waves of sentiment for emerging markets seem to follow the biblical pattern: 7 fat years followed by 7 lean years. Consider the last three decades:

- Strong capital inflows during the seven years, 1975-1982,
- net outflows during the “lost decade” that followed the 1982 international debt crisis, 1983-1989.
- Strong inflows again: 1990-96.
- And outflows during the East Asian and subsequent crises, 1997-2002.

If this pattern holds true, we are still at a relatively early stage of the latest boom phase of the cycle, and not particularly vulnerable to interest rates or other shocks. Is the biblical cycle to be taken seriously? What is the mechanism? 7 years may be how long it takes for a given class of investors to forget about the risk of a crash, to decide exuberantly that they are living in a new world, and to overextend themselves. Perhaps the mechanism is job turnover in banks and other institutional investors. In any case, 2005 seems too soon to worry. Memories are still fresh. Today’s investors are aware of the risks, and not overextended.