

Next Emerging-Market Crisis Is Five Years Away

Commentary by Andy Mukherjee 2007-05-08 12:10 (New York)

May 9 (Bloomberg) -- Harvard University economist Jeffrey Frankel has an interesting theory about the timing of the next emerging-market meltdown.

Capital flows into developing economies, he says, follow a 15-year pattern: "seven fat years followed by seven lean years." The year between the two phases is when the flow of money suddenly stops.

Why 15 years?

"After 15 years have gone by, there is somebody new on the trading desk who did not personally live through the last crash," Frankel said at an April 27 globalization forum, organized by the International Monetary Fund in Washington. "They sort of know about it, but it is easier for them to say the world has changed than if they lost money in it."

There have been two such cycles in the recent past, according to Frankel. The first wave began around 1975, following a sharp increase in oil prices in 1973-74.

After seven years of frenzied recycling of petrodollars into emerging-market securities, Mexico blew up in 1982.

Then there were seven slow years, before investors came back to these markets with renewed vigor in the early 1990s.

That boom, which again went on for seven years, ended with the Asian crisis in 1997.

By this logic, the next blow to emerging-market economies will come in 2011 or 2012. So all those who envision that the current subprime mortgage crisis in the U.S. will lead to investors bailing out of risky, emerging-market securities may be disappointed.

Another Asian Crisis?

The time isn't ripe, yet, for a disaster.

"It is too soon, memories are still fresh," Frankel said. "Argentina and Turkey, they were not that long ago, so I think it is too soon."

Could the next meltdown start in Asia?

The region has a seemingly inexhaustible war chest of \$2.5 trillion in foreign-exchange reserves.

Besides, most Asian current accounts are now in surplus. East Asia is no longer financing its economic expansion with capital borrowed from overseas. Now it is exporting capital -- the region's cumulative current-account surplus was 7 percent of gross domestic product last year -- to the rest of the world.

All of this makes a currency crisis highly unlikely.

However, other risks remain.

Nouriel Roubini, chairman of Roubini Global Economics LLC in New York, is predicting "a new and different type of financial crisis in Asia," one that's triggered by excessive liquidity and asset bubbles.

Misaligned Currencies

The risks stem from Asia's currency policies.

China remains reluctant to allow the yuan to trade more freely. That means other Asian nations won't be able to tolerate significant currency appreciation without their exports losing market share to cheap Chinese-made goods in Western markets.

One country that did try to live with faster currency gains -- Thailand -- had to resort to capital controls to prevent its exports from sinking under the weight of a stronger baht.

Cheap Asian currencies aren't a free lunch.

The bloated and growing Asian foreign-exchange reserves are being increasingly financed by an expansion in the monetary base. Base-money growth in China was 21 percent in 2006, double the annual average of 2004 and 2005. It was about 20 percent in Korea in 2006, six times the average in the preceding two years, according to a World Bank report last month.

Unmistakably, Asia is contributing -- along with petrodollars and Japanese carry trades -- to a surfeit of global liquidity and a mispricing of risk.

Trouble Ahead

For now, excesses may continue to build up.

The spread, or the extra yield demanded by investors to hold dollar-denominated emerging-market bonds instead of risk-free U.S. securities, has shrunk to about a 10th of its post-Asian crisis level, according to a JPMorgan Chase & Co. index.

Those who want to sell you developing-country debt will tell you what a fine job these nations have done in containing public debt and inflation. Besides, countries such as Brazil are buying back dollar bonds, reducing supply; so the high valuations are warranted, they will say.

Standard & Poor's, which raised the credit rating on eight out of 34 emerging-market sovereigns and lowered its assessment on just one in the 12 months through August 2006, is talking about the need to redefine the "emerging market" label, and in certain cases, even eliminate it.

This excessive show of optimism has "bubble" written on it in bright neon. Yet, investors will wait to see emerging-market risk turn to zero before being stung by losses.

The same is true for equity.

Morgan Stanley Capital International's MSCI index of emerging-market shares reached 1000 this week. It has doubled in 2 1/2 years. Don't be surprised if it doubles again.

The bubble is alive and well. It just might keep growing for the next five years, if Frankel's prophecy is right.

(Andy Mukherjee is a Bloomberg News columnist. The opinions expressed are his own.)