Emerging Market Turmoil and the U.S. Taper

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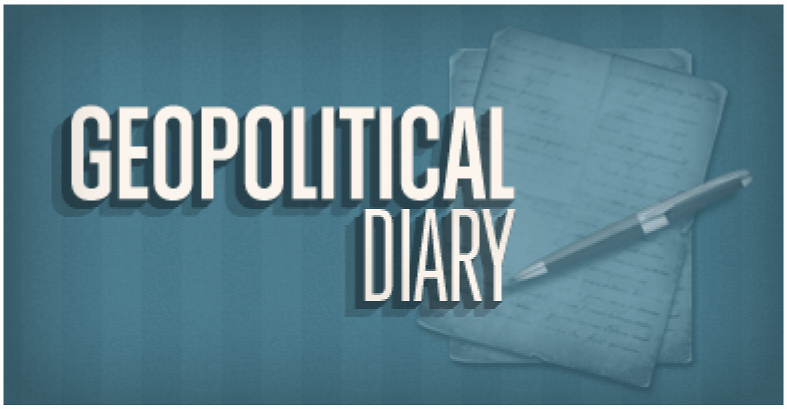

The U.S. Federal Reserve's decision to taper monetary expansion by another $10 billion Wednesday has major ramifications for world markets. In comparison to the total amount being spent on a monthly basis, the taper may seem gradual, but it has created an enormous hole in market demand. To put it in context, $10 billion of debt purchases is more than the average monthly portfolio investments into Turkey, India, Brazil, Indonesia, Thailand, Chile and Ukraine combined. The $20 billion that has already been removed from the market is roughly equivalent to the monthly flows of all those countries plus Mexico and Canada.

The decision brings total U.S. monetary expansion down to $65 billion per month going forward until the next decision to scale down asset purchases in long-term treasuries and mortgage-backed securities. Ongoing purchases will add to an unprecedented $3 trillion growth in the balance sheet of the Federal

Reserve since 2008. In the process, the Federal Reserve has played a key role in buoying global capital markets by sending investors who might otherwise have invested in U.S. assets searching elsewhere for a return.

The countries best able to take advantage of this have been the so-called emerging markets that are large and liquid enough to support the flow of speculative capital aiming to benefit from strong growth prospects. These inflows went into portfolio investment -- liquid investments like private and public debt and equities -- as opposed to direct investment into companies and productive assets, which is less mobile and less likely to be withdrawn quickly. The profiles of these countries varied widely, from commodity producers like Chile, Colombia and Peru to more complex and industrialized markets like Mexico, China and Poland. The defining characteristic tying them together is their connection to global capital markets combined with a favorable political environment in the eyes of global investors. In dark economic times, these markets took on renewed importance by offering returns that the stagnating developed markets could not.

For a handful of countries with fragile manufacturing export industries, like Colombia and Brazil, these inflows were not all good news. As external demand drove up currency values, their exports became less competitive. The changing currency values also increased costs for companies earning dollars but paying in local currencies. For these countries, recent declines in the value of the local currency will be a boon -- facilitating exports and reducing costs for dollar-earning exporters. On the other hand, many countries that saw significant financial inflows turned them into consumption and investment booms that fueled domestic growth but also spurred increasingly large import bills. India, Turkey and Indonesia have all seen trade-fueled current account deficits worsen sharply in recent years as imports outpaced exports and earnings on foreign investments. Brazil and Thailand have also seen their current accounts turn negative, though Brazil's situation has been driven primarily by non-trade factors and Thailand's took a downturn only recently.

All of these factors are manageable from a governmental perspective, absent a true political crisis. However, a change shift is taking place. The United States is recovering from the financial crisis at a pace that has at the very least satisfied the leaders of the Federal Reserve. But the United States has also been steadily eating away at its trade deficit, which has reduced by 38 percent since 2007, meaning that a U.S. recovery may not be the panacea for exporters that it once was. For its part, Europe continues to stagnate while Germany has emerged as the most competitive exporter in the world. Opportunities for export-led growth are understandably slim, and even with China moving slowly out of the low-end manufacturing market, there are comparatively few opportunities ahead for emerging markets to secure a competitive advantage.

Ultimately, U.S. monetary decisions are being made on the basis of U.S. domestic economic conditions. The impact on foreign countries has in part been to buoy local markets, but recent growth was not necessarily being driven by improvements in core economic functions, and many weaknesses will be exposed as the Federal Reserve continues to withdraw stimulus.