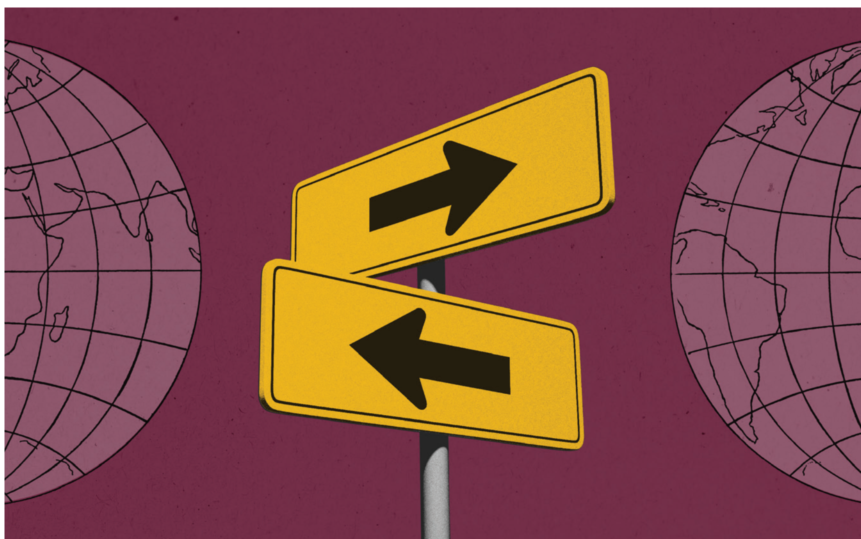

# Emerging Markets' Two-Way Traffic

David Lubin

*Financially fragile economies are pursuing market-friendly reforms, while some stronger emerging market economies are doing the opposite*

It is always the case that some countries embrace market-friendly reforms, while others do the opposite. And most of the time, there seem to be few distinct patterns in the choices different countries make.

But these days there is a more visible trend in policymaking across emerging market and developing economies: the most financially fragile countries are pursuing disciplined market-friendly reforms, while some of the more historically stable developing economies seem to be moving in the opposite direction. Call it "two-way traffic" in emerging markets.

This year has been remarkable for the sheer number of financially fragile emerging market economies adopting economic reforms aimed at eliminating vulnerabilities. Argentina, Ecuador, Egypt, Ethiopia, Kenya, Nigeria, Pakistan, Sri Lanka, Türkiye, and others are making efforts to end distortions in their foreign exchange markets, rein in the growth of public debt, accumulate foreign exchange reserves, and set the stage for sustainable growth.

At the same time, several middle-income emerging market economies with healthier macroeconomic fundamentals and more stable relationships with international capital markets are adopting, or soon seem likely to adopt, looser policies that threaten to erode public sector balance sheets and push up country risk premiums. Examples include Brazil, Hungary, Indonesia, Mexico, Poland, and Thailand.

Bond prices in emerging markets have responded in a predictable way to these trends: credit spreads of countries that are fragile but improving have narrowed disproportionately. In the first nine months of 2024, sub-investment-grade dollar-denominated sovereign debt in emerging markets returned more than 15 percent. By contrast, investment in more creditworthy countries returned less than 5 percent during the same period.

High-yield bonds can outperform investment-grade assets by more than 10 percentage points in the first nine months of a calendar year, but it is unusual. Over the past three decades, it's happened only three times, in 1999, 2003, and 2009.

## Aftermath of a crisis

What those historical episodes have in common is that each was in the aftermath of a crisis of some sort. That makes intuitive sense: when risk appetite returns to a market after a crisis, investors tend to bias their portfolios toward riskier countries that will benefit disproportionately from a rise in confidence.

But this time is a little different, in that there hasn't been a major financial crisis, either for emerging markets or the world in general. Indeed, the stock of sovereign debt in default was a mere half percent of global GDP last year, according to a database on sovereign default maintained by the Bank of Canada and the Bank of England. Although that's higher than a few years ago, the prevalence of default is nevertheless way lower than in the late 1980s, when the stock of defaulted debt was more than 2 percent of global GDP.

One explanation is that the dangers posed by vast yet volatile capital flows are much better managed today than in the 1970s and 1980s. That's because many developing economies have learned two important lessons: keep current account deficits within limits and accumulate foreign exchange reserves.

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Illustration by Chantal Jahchan

The former insulates countries from the "flow vulnerability" of too much dependence on external financing. The latter insulates against the "stock vulnerability" of having too few dollars when financing sources dry up.

And this may help explain why so many financially fragile countries have embraced reform. The benefits of self-insurance—and the need to limit both flow and stock vulnerability—are so well known now that fragile countries may be getting the message that living permanently beyond their means is not a viable policy choice, particularly when the US is tightening monetary policy.

## More spending

Some of the fiscal adjustments being undertaken by historically fragile countries are highly ambitious. In Argentina, for example, the authorities are aiming to turn a primary budget deficit of 3 percent of GDP in 2023 into a 1 percent surplus next year. Egypt's government is targeting a primary surplus of 5 percent in the fiscal year ending June 2027. Türkiye plans to turn a primary deficit of 2.6 percent of GDP in 2023 into a surplus of 0.5 percent of GDP next year.

By contrast, countries with stronger national balance sheets and fewer recent memories of financial instability seem determined to spend more. Mexico's President Claudia Sheinbaum has inherited a 2024 budget deficit of some 6 percent of GDP, the largest since 1989. Market participants have valid concerns that a sustained period of fiscal loosening may be starting.

Brazil's government is struggling to persuade investors that President Luiz Inácio Lula da Silva's tilt toward fiscal loosening is compatible with financial stability. Notwithstanding a sovereign upgrade by Moody's, a rating agency, market participants worry that a recent surge in GDP growth is keeping the economy growing faster than potential, and that weaknesses in the government's financial position will quickly come to light when growth slows.

Indonesia's President Prabowo Subianto has raised the prospect of a big hike in government debt to complete the construction of a new capital city, raise defense spending, and provide free school meals. He says he has "no problem" letting the debt-to-GDP ratio rise to 50 percent, up from 39 percent at present.

One way of explaining this two-way traffic in emerging markets is to keep in mind the distinction between financial globalization, which in recent decades created space for a surge in volatile capital flows, and real globalization, which during the same period made room for a surge in trade.

Looking back to the 1980s and 1990s, two decades marked by intermittent financial crises in emerging markets, it's easy to suggest now that developing economies faced the negative consequences of financial globalization even while enjoying the positive consequences of real globalization. Global trade growth was predictably robust back then, except in a small number of years when the world economy fell into recession. Global capital flows, by contrast, were unpredictably volatile.

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## World trade hostility

The opposite may now be true. Global capital flows are still volatile, for sure, but emerging market economies have learned ways of managing the risks, or at least responding sooner than they used to.

The bigger problem today seems to be with real globalization: global trade growth has been markedly weak compared with GDP growth in the past two years, as it has for much of the past decade. And global trade hostility seems more likely than not to bite harder in the future. That leaves exports less reliable as a path toward growth for emerging market economies—and it may be this weakening external trade environment that is encouraging countries with healthy balance sheets to consider spending some of their accumulated reputational capital to support domestic demand. The demands of the climate transition and national defense will amplify this trend.

If fiscal easing is moderate, boosts productivity, and adds to potential growth, these cases of looser policy may not cause market participants particular concern, and the two-way traffic now visible in emerging markets will not be a bad thing. But if the problems associated with real globalization get worse—if, in other words, global trade suffers a steeper or more protracted collapse—public sector balance sheets will deteriorate further. Market participants are then likely to charge higher rates to supply credit.

The future of global trade could, therefore, play an important part in deciding the kind of traffic patterns we end up with in emerging markets and whether they embrace market-friendly reform—or the opposite. F&D

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