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Ties to old world hit emerging markets

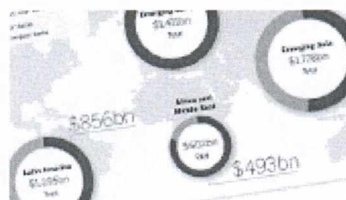
By Stefan Wagstyl in London

Continuing Europe tumult affects economies of developing world

As the eurozone crisis spreads from Greece to Italy, countries far afield are being sucked into the maelstorm.

The world's emerging markets, which led the way out of global recession in 2009, are now suffering because of their ties to the Old Continent. And they may not be as well placed as three years ago to again help pull the world back from the brink.

On Thursday, Asia bore the brunt, with equities falling 3.8 per cent in US dollar terms, the biggest drop for nearly two months, and Asian currencies generally sliding against the dollar, led by a 1.2 per cent drop in South Korea's won.



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In Latin America, markets were steady, having fallen heavily on Wednesday. But in the emerging markets of eastern Europe, which are more closely tied to the eurozone than the rest of the developing world, currencies saw another sell-off, headed by Hungary's fragile forint, which lost nearly 1 per cent against the euro to trade at its lowest since March 2009, the nadir of the post-Lehman Brothers crisis.

While there are local difficulties, from inflation in Africa to controversial bank laws in Hungary, all eyes are on Rome. "If Italy explodes then the whole world is toast," says Arnout van Rijin, an Asia-Pacific fund manager at Robeco, the Dutch financial group.

The decline in emerging markets since the eurozone crisis intensified in the summer is striking. The MSCI emerging markets equities index is down 17 per cent since July1, compared with a 13.5 per cent drop in leading European stocks and 7.5 per cent in the US S&P 500.

In the flight to safety, emerging market currencies have plunged. Brazil's real 12.2 per cent, the forint by 14.4 per cent and South Africa's rand 15.5 per cent.

Central banks have tried to control the shock by buying their own currencies, with growth in emerging market foreign reserves falling to zero. But emerging market policymakers are content to see some decline, as this should make exports more competitive.

So, some banks have also been cutting interest rates, led by Brazil and Indonesia, which on Thursday cut interest rates for a second time since the summer with a 50 basis-point drop to 6 per cent, twice as much as investors had expected.

beyondbrics

Opinion: How the IMF can bring in the Brics to fix the eurozone

Emerging market political leaders are becoming more outspoken in criticising eurozone governments. Following exhortations voiced at the Cannes summit of the Group of 20, China and India this week issued a rare joint statement which talked pointedly about "uncertainty over the sustainability of sovereign debts in some advanced economies".

On Thursday, Lee Hsien Loong, Singapore's prime minister, said the clock was ticking on European policymakers. "This European problem is not one that's susceptible to a single, big solution. It's very deep," said Mr Lee in a television interview.

The financial impact is clear around the emerging market world. Portofolio capital flows into emerging markets, which have totalled over $500bn since early 2009, went into sharp reverse in August and have stayed negative. Nick Chamie, of RBC, the Canadian bank, says "the risks [of big outflows] have risen dramatically in recent months."

Meanwhile, eurozone banks' efforts to boost capital will hit emerging markets hard, given that eurozone banks account for around two-thirds of all cross-border loans. Eastern Europe, where eurozone bank credits are around 35 per cent of GDP, will suffer more than Latin America (18 per cent) or Asia (10 per cent). But as Stuart Gulliver, the chief executive of HSBC, warned this week, Asia too will feel the chill.

As China's latest trade numbers showed on Thursday, the eurozone crisis is already hurting the real economy. Exports rose 15.9 per cent year-on-year in October, down from 17.1 per cent a month earlier. Last week's Korean data was worse, with and increase of 9.3 per cent in October down from 18.8 per cent in September. Monthly figures are volatile – and October trade data from Taiwan, the third big exporter in emerging north Asia, was strong – but the cause of the trade slow down is unmistakeable – falling demand in the European Union.

There's still plenty of life left in emerging economies. Indonesia this week reported a 6.5 per cent year-on-year GDP jump for the third quarter of 2011; China grew 9 per cent. Some countries, notably Italy, still see fear inflation as much as they do Italy.

However, the signal from the emerging world's financial markets is clear: watch out for the eurozone.