

OPINION: Emerging markets, risks and objective forecasts

by Iwan J. Azis

JAKARTA (The Jakarta Post/ANN) - Entering 2016, the prospects for the world economy are more uncertain than ever. Although forecasts made by international financial institutions (IFIs) show a growth recovery for this year, what has happened in the last few months has put their numbers in doubt.

Entering 2016, the prospects for the world economy are more uncertain than ever. Although forecasts made by international financial institutions (IFIs) show a growth recovery for this year, what has happened in the last few months has put their numbers in doubt.

Even in the recovering US economy some analysts have started using the “R” (recession) word. Markets now bet confidently that there will be no more federal fund rate increases this year.

The story of Europe is not encouraging either. Even without considering the geopolitical challenges, Brexit (British exit) and thorny migration issues, the European economy remains lethargic.

It is the new story of emerging markets that many people are still not aware of.

A “double track” growth scenario displaying emerging markets’ strength to pull global growth when advanced economies slowed was made possible by a favorable external environment. That is no longer the case, and the track divergence is now narrowing.

Actual growth is lower than secular (trend) growth in emerging markets due to mounting spare capacity. Even more worrying, the secular growth itself has been falling consistent with the productivity slowdown.

As commodity prices show no sign of recovering and liquidity begins to tighten, risks and uncertainty are heightened.

All eyes are on China’s slowdown. But other countries also play a big role in elevating the risks.

Companies throughout emerging markets have dramatically increased their dollar debts, reaching US\$4 trillion, four times higher than in 2008.

A stronger dollar puts them under severe stress. The lesson of the 1997 double-mismatch is forgotten, that a financial crisis is likely to be triggered by an over-leveraged private sector rather than government sector.

Predicting what will happen to emerging markets’ financial situations is nerve-racking. Last year alone, capital outflows reached a whopping net \$735 billion.

This is huge and the first time since 1988 that emerging markets faced net negative flows.

Of course China’s slowdown matters, but it should have been expected. After years of rapid, unbalanced and unsustainable growth, reforms began in China. However, it takes time to get the outcome. In the interim, growth is likely to slow. Expecting structural reform and accelerated growth at the same time is self-delusion.

Given the sheer size of China’s economy, it is not surprising that growth slowdown feeds back negatively to other countries and hence to global growth. What is surprising is that cross-border repercussions appear larger than previously envisaged.

Even countries having limited direct links with China are also feeling the pinch. No one knows exactly why and how, but transmissions through market confidence channels are surely at work as the episode following a sharp fall in China’s equity market last summer has shown.

But other countries should have also realised that relying too much on external demand from one source (China), let alone focusing on primary commodities, makes their economies vulnerable. Yet, some did precisely that.

With the above trend and elevated risks, what prognosis can one make for this year?

Making prognoses and forecasts is always difficult but necessary. In the midst of current elevated risks and uncertainty, however, it should not be business as usual. Nothing is more important than incorporating the behavior of agents who actually move markets based on their insights and perceptions.

Market anomalies are in the making: volatile at the beginning of this year and (probably) settling down later. This is unusual and worrisome. Yet, when financial markets had the worst start on record this year, the International Monetary Fund (IMF) believed markets were “overreacting”. This is similar to their reaction prior to the 1997 Asian crisis.

Despite the elevated risks and market turmoil, the IMF’s latest World Economic Outlook (WEO) continues to predict higher growth for this year compared with last year: 3.6 per cent for the world and 4.5 per cent for emerging markets and developing countries.

But during the last four years the WEO has consistently made over predictions: Global growth was always slower than forecast.

A study commissioned by the IMF itself also concludes that the IMF’s forecasts “display a tendency for systematic over prediction” (“An Evaluation of the World Economic Outlook Forecasts”, IMF Working Paper No. 06/59, 2006). One then wonders whether their current forecast and analysis can be taken seriously.

Multilateral development banks also made over predictions, but for a different reason. They rely on member countries’ expectations (especially those of officials) rather than on an objective analysis or market perceptions. It is difficult to distinguish the resulting forecasts from wishful thinking.

IFIs also like to use inconsequential words to describe their forecasts: “uneven”, “moderating”, “poised to meet growth”, “gradually improving”, “challenging”, etc. Words like these are opaque and not too meaningful. Worse, they can be harmful by causing complacency.

Back in 2008, the failure of major rating agencies to downgrade financials and the real estate sector contributed to financial meltdown. The newly released movie The Big Short captures the episode well. The raison d’être (most important) was a conflict of interest, and the outcome was clear: tarnished credibility. IFIs could be in the same predicament if they fail to provide objective analysis free from optimistic bias.

To manage elevated risks, emerging markets need more accurate and objective descriptions than ever about the global and regional economy, and how uncertainty and market turmoil will play out.

IFIs could and should provide such descriptions without adopting an optimistic bias.

(The writer is a professor of Cornell University and the University of Indonesia.)