



**Discurso do Diretor de Assuntos Internacionais e Gestão de Riscos Corporativos do Banco Central do Brasil, Tony Volpon, no XXXV *Central Bank Seminar*, organizado pelo *Nomura Securities*, na cidade de Quioto, Japão.**

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# Looking back, looking forward: The emerging market “crisis”

**Tony Volpon<sup>1</sup>**

Let me begin by thanking Nomura for the invitation to talk to you today at its Central Bankers Seminar. As most of you know, I worked at Nomura for around five years as an investment strategist. This covered the periods of euphoria with Emerging Markets (EM) after the Global Financial Crisis (GFC) followed by the increasingly darkening prospects that started to manifest themselves around 2011 and 2012. Being here today, I thought it would be interesting to look back at some of what I wrote during this period as a way to look forward to where we are potentially going in EM.

Looking back at what one has written is a humbling experience, – to say the least. But let me, in what is admittedly a biased look-back exercise, pick out a few things that I said about EM right after the “taper tantrum” and some specific comments about Brazil.

In June of 2013<sup>2</sup>, thinking about the possible consequences of the then recent “taper tantrum”, I wrote the following:

*Are [the current] positive factors [in emerging markets] sufficient to break the historical cycle of inflow “bonanzas” followed by “sudden stops”? We believe the answer is no.*

*The reasons for this are manifold... While we agree with the view that the pace of (U.S.) policy normalization will be slow, cumulative levels of inflows into emerging markets have been unprecedented. Second, while economic policy improvements have been widespread - with some notable exceptions - we believe much of the recent growth in EM has had strong capital inflows as a necessary condition, and much of what passes as improvements, especially on the fiscal front, could see deterioration if capital inflows are significantly reduced.*

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<sup>1</sup> Deputy Governor for International Affairs and Corporate Risk Management at the Central Bank of Brazil (BCB). These remarks are those of the author and do not necessarily reflect those of the BCB, or its Board Members.

<sup>2</sup> See “Back to the future: 1994”, Nomura Emerging Markets Research, June 3, 2013.

I believe what we have seen up to today has vindicated this view, which is now part of the conventional wisdom. I also made an explicit comparison with the then still on-going European crisis:

*As seen in the case of the Europe periphery... once sustainable balance sheet structures and fiscal positions can rapidly become unsustainable if there is not a rapid return in growth. Restoring growth quickly then becomes the key challenge to mitigate the initial negative impact of a change in capital inflows and so not allowing second-order effects to arise.*

In short, in 2013 I saw the “taper tantrum” as the start of a capital flows “sudden stop”<sup>3</sup> that would have dire consequences for EM growth rates, with specific challenges to fiscal positions overly dependent on continuous robust revenue growth. The challenge, as I saw it, was to differentiate between EM economies that would suffer larger current account adjustments due to lower capital inflows and those who had greater “policy space” to implement pro-growth policies in a sustainable manner to “bridge over”, on a cyclical basis, the impact of lower inflows until other fundamental drivers of growth could be established.

In the specific case of Brazil, my pessimism began even before the “taper tantrum”. In April of 2012, I wrote about the end of what I called the “Lula growth model” of high consumption and credit growth<sup>4</sup>. Blaming the industrial malaise already evident at that time on an overvalued exchange rate was only “one half of the story”, with the other half being the continuous rise in local labor costs due, in part, to the demand-boosting, “countercyclical” policy response that became so popular following the GFC. I wrote about this again in May of 2013<sup>5</sup>:

*We believe that Brazil's low growth conundrum is driven by a noxious mix of supply-side constraints that have been accumulating for many years but became manifest since 2011, due to a rapid increase in labor costs as the country reached full-employment. This led to a rapid loss of competitiveness that affected the more open manufacturing sector.*

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<sup>3</sup> Reminding that a “sudden stop” does not literally mean a total cessation of inflows, but a large and more importantly unexpected decrease.

<sup>4</sup> See “The end of the ‘Lula model’?”, Nomura Emerging Market Research, April 24, 2012.

<sup>5</sup> See “The BCB delivered”, Nomura Emerging Market Research, May 30, 2013.

So even before the “taper tantrum” and its systemic effects on inflows to emerging markets, Brazil was already facing domestic structural growth headwinds and what proved to be a not very helpful policy response.

Obviously, much has happened since then which, in retrospect, has had an equally important impact on EM growth, particularly the lower-than-expected and changing composition of growth in China and the effects of overinvestment in many commodity sectors that has led to a large increase in supply just as demand growth has fallen.

Despite this, I will argue that the basic insight I defended in 2013 is still largely valid. Growth, even in the absence of capital inflow “bonanzas” and ever-higher commodity prices, is still the name of the game. From the perspective of 2013, when the global EM correction was in its early stages, what seemed then most relevant was to measure the “policy space” to maintain growth in the face of external headwinds. Now, three years into the EM correction, or crisis, depending on your perspective, what is most relevant is to measure how far EM economies have gone in their unfortunately painful economic adjustments as a necessary prior condition for a return to sustainable growth, and what, if any, are the newly emerging drivers of that growth.

Given the external nature of the shocks faced by EM economies, i.e. capital flows determined by “push” factors and international commodity prices, a full adjustment in external accounts is a necessary, if not sufficient, condition for a return to sustainable growth. This is because the adjustment of the balance of payments will imply a period of domestic demand contraction that has a negative impact on growth. Once the adjustment approaches completion, downward factors forcing the adjustment to aggregate demand will ease, allowing growth to return to its potential. Then, of course, the problem shifts to the supply-side: what, if any, will be the new sources of growth in the post-boom and post-adjustment period?

In what follows, I will look at some data for a group of EM economies to gain some cross-sectional perspective. I will also make more detailed comments about how I see the situation evolving in Brazil.

So where are we in the adjustment process? We can look at this from two perspectives: one is directly, by looking at adjustments to the current account, remembering that the current account is both an index of the demand for foreign savings, and also a measure of domestic absorption versus potential. We should also look at the capital account to see how

deficits are being and have been financed – that is, from both a flow and stock perspective, and whether the adjustment to lower inflows is generating financial vulnerabilities. Second, we can look at how key “macro prices” have adjusted, since only the adjustment in these prices – which is what causes most of the negative economic effects during the adjustment phase – will make it likely that the positive results “stick” even as the growth recovers back to potential.

As an aside, I have been speaking of adjustments to lower capital inflows and terms of trade because I am thinking mainly about Brazil, but of course, while most emerging economies have been facing a more hostile financial environment, changes in terms of trade have been very different across countries, depending on the pattern of trade.

Let’s begin by looking at the current account (**Table 1**). If we look at current accounts for 2015, we notice that for Brazil, Russia, Turkey and India there has been improvement both in comparison to 2014 and in comparison to the five- and ten-year averages. In Mexico and Indonesia, we notice a small deterioration from their historical averages, but from generally low levels of around 2.0% of GDP. Only South Africa has shown a more persistent deterioration of its current account position over time.

Looking at the consensus forecast for 2016 and 2017, we see further improvement expected in the case of Brazil and South Africa and stability in the case of the other countries.

Another metric in judging the adjustment of the current account is by looking at how far, according to IMF estimates, each country is from a level that stabilizes its net financial asset position, the sum of assets and liabilities the country has against the rest of the world. We can see, if we look at forecasts for 2017, that some countries are either closer to – in the case of Brazil and Mexico – or above, in the case of Russia, Indonesia and India, to their equilibrium levels. Only South Africa and Turkey are seen as being more than 2.0% of GDP away from equilibrium.

Thus, the data shows that many emerging economies have made good progress in their current account adjustment. Nonetheless, as I argued above, we need to see changes in key relative prices for these changes to last even after the demand contraction ends. The two key “macro” prices are the real exchange rate and unit labor costs in foreign currency.

Looking at real effective exchange rates (REER), we see that all countries, with the exception of India and Indonesia, have already witnessed very significant devaluations. In terms of unit labor costs, a key component of competitiveness that may also imply possible inflationary pressures, we have also seen a large adjustment in most countries, with the exception of Russia and Indonesia.

Now let's take a closer look at the adjustment process so far in Brazil.

It's clear that the performance of the Brazilian economy since the beginning of 2015 has been disappointing – many have used terms like “depression” to describe what is going on in Brazil. In fact, a Google search of the question: “Is Brazil facing an economic depression?” that I made last week yielded a staggering 112 million hits!

While I do not want to, in any way, diminish the many difficulties Brazil is facing, I think the view that no progress was made in 2015 is wrong. From the perspective of the needed adjustment process, much did happen which can serve as the basis of economic recovery if the right policy choices are made.

First of all, as we already have seen above, there has already been a very large adjustment in unit labor costs and the real exchange rate (**Figure 1**), of 42.6% and 68.7% respectively, from their peak levels in mid-2011. These are some of the factors leading to an expected USD80 billion improvement in the current account from its peak level in 2014, compared to its expected level at the end of this year (**Figure 2**). Much of this improvement has been achieved by compression of import consumption. As you can see (**Figure 3**), import quantum (the volume of imported goods) is very variable and has already fallen 20.3% from its peak value, while export quantum is much less elastic but is actually now at its highest value since 2003.

I believe these improvements in the external balances is one of the reasons that, despite the recession, as well as fiscal and political difficulties, we have not seen in Brazil what usually accompanies adjustment processes in many emerging markets: some sort of financial crisis.

The reason for this financial stability has to do, I believe, with both stocks and flow conditions which are dampening, and not propagating, the adjustment shocks. In terms of stock positions, an issue I dealt with in some

detail in a speech in New York last year<sup>6</sup>, we have a net financial assets position whose liability is over 50.0 % denominated in BRL (**Figure 4**). This means, unlike what used to happen in the past, that a weaker BRL improves the country's balance sheet. Therefore, the exchange rate adjustment has led to an improvement of both the flow position through the current account and the stock position through changes in the net foreign liabilities. This powerful combination greatly diminishes any risk of Brazil not honoring what it owes to foreign investors, which in turn, is serving as a counterpoint to the current fiscal uncertainties.

The positive impact of the external adjustment on how investors see the fiscal position do not, in any way, decrease the need for fiscal consolidation in face of what looks like a structural break lower in fiscal revenues. Having more time to do what is needed cannot be confused with not having to do what is needed.

What about the future sources of growth in Brazil? There is also now, not surprisingly, a lot of pessimism about how much the economy can grow even after needed external, monetary and fiscal adjustments. I think here investors need to be careful not to make the same type of mistake, just in the opposite direction, of the exaggerated optimism felt after the most acute phase of the GFC, when Brazilian growth reached over 7% a year.

I believe the root cause of the current recession is the impact of uncertainty on aggregate demand. Uncertainty about the future inhibits investments and consumption of durables, important and volatile components of aggregate demand that largely determine the economy's cyclical position. Needed adjustments often have recessionary consequences, as I argued earlier, but as we've seen, many of the adjustments that Brazil needs have already taken place. The one adjustment that has lagged, fiscal consolidation, may well have positive, not negative, impact on growth through the confidence channel. Therefore, a reduction in uncertainty – which in the case of Brazil is essentially non-economic in nature – could have a surprisingly rapid, positive impact on economic growth.

Let me end by making some last comments on the global picture. I have tried to show that the needed adjustments in emerging economies have already gone a long way. With the right policies, the post-adjustment

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<sup>6</sup> See [“The Emerging Market Crisis of 2015 or the Third Stage of the Global Financial Crisis”](#), BCB Speeches, November 6, 2015.

scenario could see a return of sustainable growth, but at likely lower levels than before the adjustment process began.

Thus, while these adjustments may be necessary for the countries involved, I believe there is a fallacy of composition going on at a global level. If many emerging markets are decreasing their current account position, this is also decreasing their contribution to global aggregate demand. These “spillbacks” have become more important and have gained more attention lately, but so far we have not seen a coordinated effort to find new sources of demand from other economies such as, for example, the many countries that today are financing their sovereign debts at negative nominal rates. This is the most important debate that we should be having at a global level.

Thank you for your time.

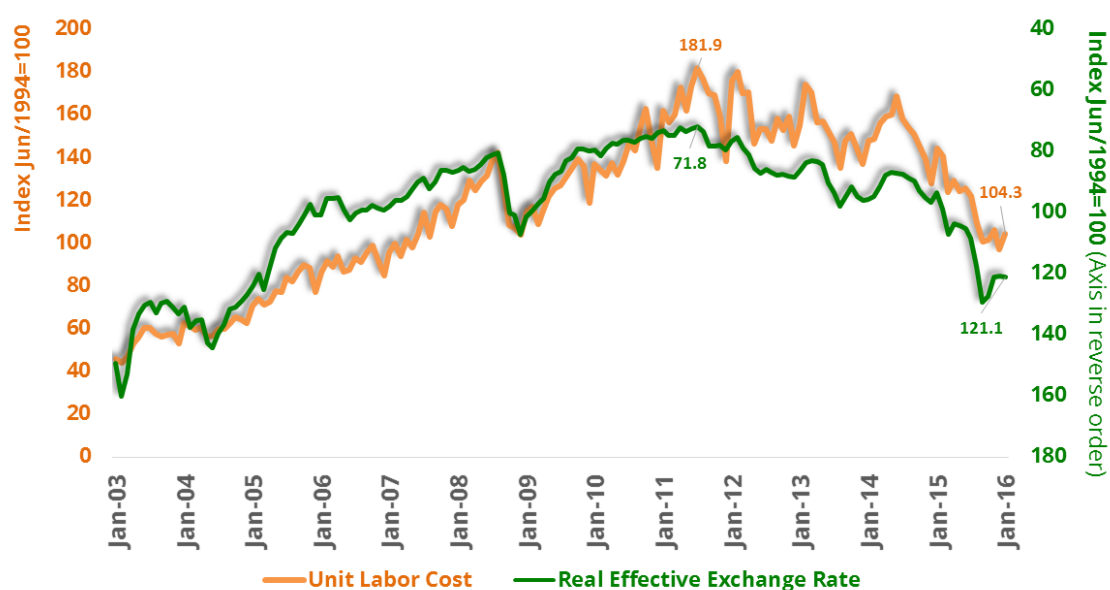


**Table 1 – EME: Current Account, Real Effective Exchange Rate and Unit Labor Cost**

Countries	Value	%GDP						Value	Change (p.p.)		Source
CA/GDP (%)	2015	2014	AV10Y (2005-14)	AV5Y (2010-14)	2016*	2017*	Average Forecast (2016-17)	CA/GDP Stabilizing NFA	2015 - Stabilizing	2017* - Stabilizing	
Brazil	-3.3	-4.3	-1.7	-3.3	-2.3	-2.0	-2.2	-1.2	-2.1	-0.8	Bloomberg / IMF
Mexico	-2.0	-1.9	-1.3	-1.4	-2.7	-2.5	-2.6	-1.9	-0.1	-0.6	
Russian Federation	5.3	3.4	5.4	3.6	4.0	4.2	4.1	2.8	2.5	1.4	
India	-1.1	-1.4	-2.3	-3.2	-1.0	-1.3	-1.2	-2.1	1.0	0.8	
Turkey	-5.2	-5.9	-5.9	-7.2	-4.8	-5.2	-5.0	-2.9	-2.3	-2.3	
Indonesia	-2.1	-3.1	-0.1	-1.6	-2.3	-2.4	-2.4	-3.5	1.4	1.1	
South Africa	-5.1	-4.8	-4.1	-3.8	-4.3	-4.5	-4.4	-1.8	-3.3	-2.7	
REER (CPI, Index)	Value	Index				Percent Change in the Index (2015)		Percent Change in the Index (2016)			
	2015	2014	AV10Y (2005-14)	AV5Y (2010-14)	2016 (Jan)	AV10Y (2005-14)	AV5Y (2010-14)	AV10Y (2005-14)	AV5Y (2010-14)		
Brazil	67.6	84.2	87.0	92.2	67.7	-22.4	-26.7	-22.2	-26.6	BIS	
Mexico	87.0	97.1	101.8	98.5	83.7	-14.5	-11.7	-17.8	-15.1		
Russian Federation	71.6	73.2	94.5	96.8	66.0	-24.2	-26.0	-30.2	-31.9		
India	104.0	99.0	95.2	96.5	104.3	9.2	7.7	9.6	8.1		
Turkey	82.6	88.9	92.0	90.0	83.3	-10.2	-8.3	-9.4	-7.5		
Indonesia	89.8	91.2	91.4	93.4	91.2	-1.8	-3.9	-0.2	-2.3		
South Africa	66.3	77.1	89.5	87.5	61.8	-25.9	-24.2	-30.9	-29.3		
ULC (Index)	Value	Index				Percent Change in the Index (2015)		Percent Change in the Index (2016)			
	2015*	2014	AV10Y (2005-14)	AV5Y (2010-14)	2016*	AV10Y (2005-14)	AV5Y (2010-14)	AV10Y (2005-14)	AV5Y (2010-14)		
Brazil	86.2	104.5	101.4	110.5	73.8	-14.9	-21.9	-27.2	-33.2	Oxford	
Mexico	72.1	86.5	96.0	91.1	56.5	-24.9	-20.9	-41.1	-37.9		
Russian Federation	118.3	113.1	87.7	104.8	106.2	34.9	12.9	21.1	1.4		
India	97.4	101.8	102.5	101.7	94.5	-4.9	-4.2	-7.8	-7.0		
Turkey	85.5	94.8	97.2	96.9	91.1	-12.0	-11.7	-6.2	-5.9		
Indonesia	106.0	94.1	99.6	105.1	105.2	6.5	0.9	5.7	0.1		
South Africa	108.0	100.0	109.8	115.7	127.7	-1.6	-6.6	16.3	10.4		

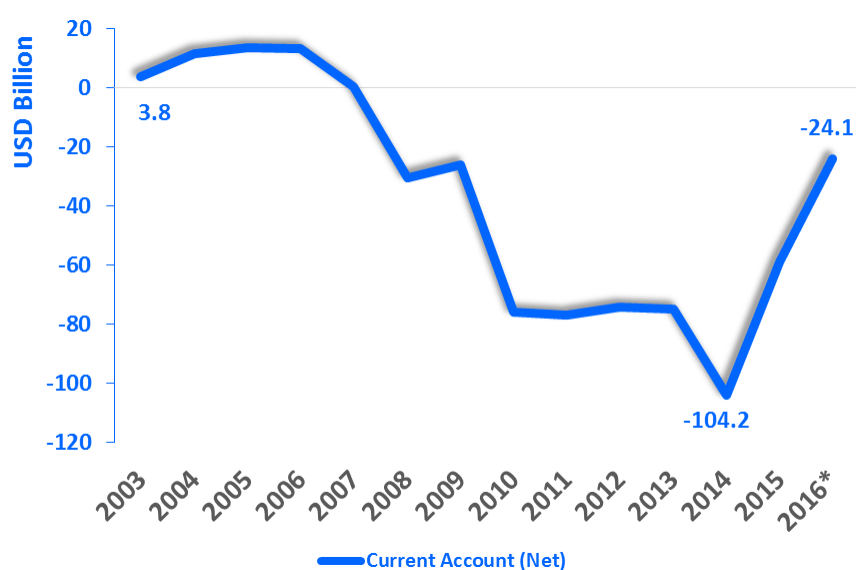
Sources: IMF; Bloomberg; BIS; Oxford Economics. Note: \*Forecast.

**Figure 1 – Brazil: REER and ULC Adjustments**



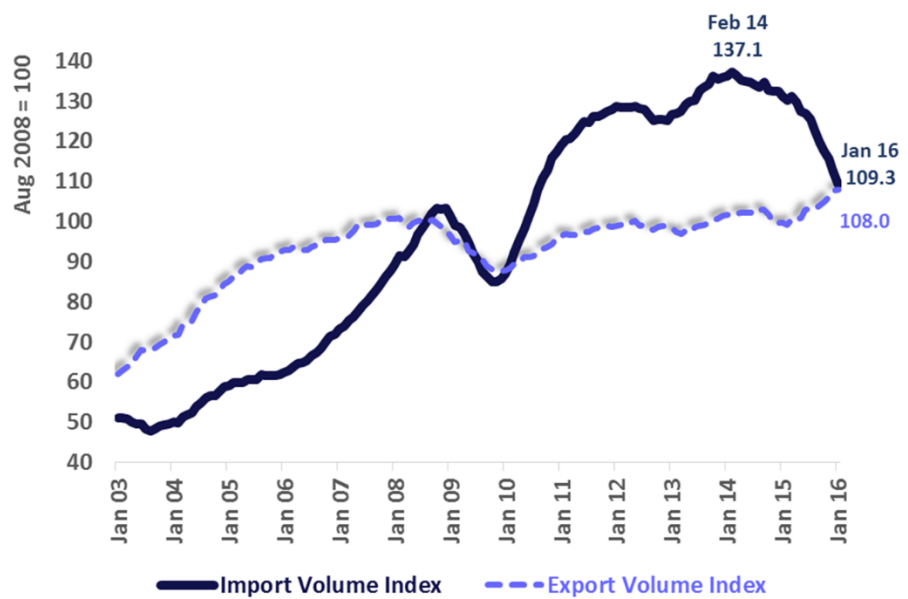
Source: BCB. Notes: REER through Jan 2016; \*Median of expectations on Mar 11<sup>th</sup>, end of period (Focus Report).

**Figure 2 – Brazil's External Sector Adjustment**



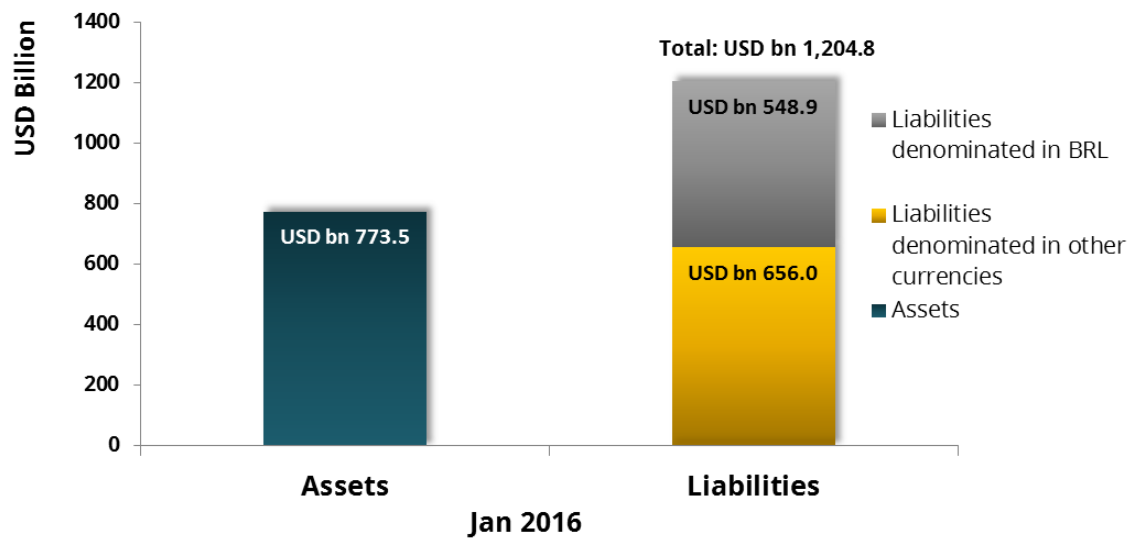
Source: BCB. Note: \*Median of expectations on Mar 11<sup>th</sup> (Focus Report).

**Figure 3 – Brazil: Import and Export Volume Indices**



Source: Funcex.

**Figure 4 – Brazil's International Investment Position**



Source: BCB.