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Policy makers have been remarkably proactive ...

The U.S. Federal Reserve's decision to extend swap line to Brazil, Mexico, Singapore and South Korea represents a bell-wether decision for emerging markets. While not entirely new, Mexico had access to the Fed in 1995 and Japan has established swap lines with other Asian central banks since 2001, it should be interpreted as recognition by the G7 that emerging markets matter deeply to overall economic conditions. The critical mass of policy measures including earlier bank guarantees, large IMF packages for Hungary and Ukraine and the IMF's new facility are expected to provide support for a turn in sentiment. Policy makers have demonstrated that they are willing to act, throwing a lot of public money at the problem, to avert a further deterioration of the international economy.

The Fed measure affirms that emerging markets form part of the core of the international economy. Explicit acceptance of emerging markets currencies by a key central bank is also expected to give rise to a more general diversification of central bank currency portfolios. The Fed has effectively accepted that holding emerging markets currencies is endogenous to relative emerging markets currency stability.

... putting a floor under economic performance.

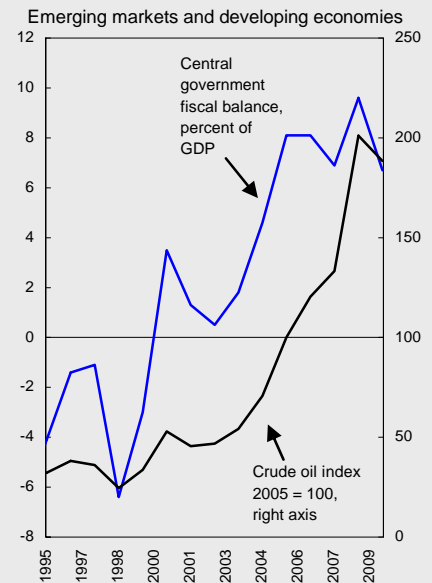
The spectre of a sudden stop of capital flows to emerging markets remains amid the risk of persistent contraction of bank credit and other capital flows to emerging markets. Market analysts have been busy adjusting their macro views about the resilience of emerging markets referring to oil prices for balanced budgets and reserves levels to meet external liabilities among others. We think those views are deeply flawed in both methodology and concept and within customary bounds provide little if any indication as to the ability of a given country to withstand current shocks. Resilience to crisis rests in large part on policy makers' ability to implement sensible policies. While sudden stops pose substantial challenges for any economy, their actual effect on output and stability will differ greatly as a function of the policy response. The bean-counting approach to measure fiscal and quasi-fiscal safeguards is misleading at best.

Fiscal budgets are subject to many assumptions including economic growth, the exchange rate and for commodity exporters the price of the main commodity. Any variable can cause excesses or shortfalls of fiscal revenues. Oil-price dependent fiscal budgets will naturally be subject to swings in oil prices. In principle, there is no reason to assume that a budget should be balanced in any particular fiscal year.

Possible policy reactions to shortfalls in revenues are many. In the short-term, governments can reduce expenditure by executing less of their budgets; they can raise duties and excises that in many instances do not require legislation, they can reduce subsidies, run arrears to domestic entities including general government entities and cut other transfers and they can incur a larger/lower than-programmed deficit/surplus. The deeper the revenue short-fall the more governments will probably rely on a mix of possible measures. Deficits need to be financed, not unduly crowd-out financing for the private sector and/or not provide unwarranted stimulus to the economy. Depending on where a country is cyclically, any of those may indeed pose a problem.

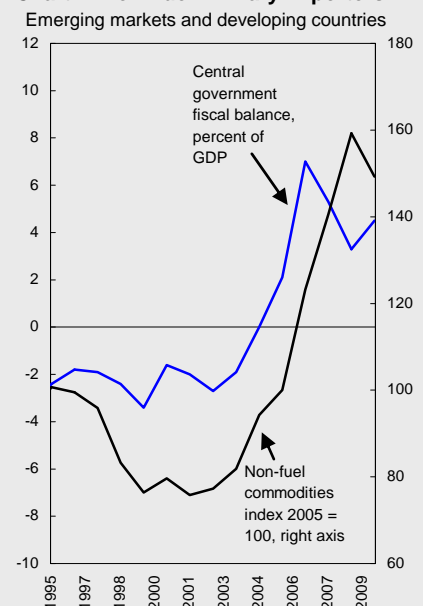
The impact of oil and non-fuel commodity prices on budgets is an empirical one. Countries have reacted to low and rising commodity prices differently. The fact is that emerging markets have managed prolonged periods of relatively low commodity prices causing varying degrees of fiscal performance. Lower commodity prices in general may cause hardship but need not lead to default and any other drastic credit event (Chart 1 and 2).

Chart 1. Fuel Exporters



Source: IMF. Ashmore calculation. 2008 and 2009 projections.

Chart 2. Non-Fuel Primary Exporters



Source: IMF. Ashmore calculation. 2008 and 2009 projections.

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It is the speed of the policy reaction ...

The level of international reserves is another comfort indicator for foreign investors. The current environment has undoubtedly tested central bankers' willingness to use these reserves. Market analysts have provided numerous studies to show how many months reserves would last for a given pattern, mostly linear, of intervention. However, unless under a pegged exchange rate regime, central bank intervention remains discretionary. We find central bank intervention on a massive scale extremely unlikely. Central banks normally intervene to mitigate undue foreign exchange market volatility and not to reverse a fundamental trend. Reserves are therefore in general expected to be used sparingly.

Emerging markets currency pressures are estimated to have emanated largely from local bank and corporate demands for foreign exchange amid reduction of credit lines by external banks. While central bank reserves can be used to accommodate part of the foreign currency demand, it is assumed to be limited to large systemic institutions. Corporates will have to rely on their local banks and there may be selected bank and corporate failures where foreign loan calls cannot be met.

Loan and debt securities data through the last emerging markets crises have shown some volatility. External loans, syndicated facilities and debt securities have seen a decline by 11 percent between 1995 and 2002 and have taken 7 quarters to rebound to previous highs. The share of emerging markets in total external claims has declined significantly from a peak in 1997 and rebounded only slightly highlighting the fact that strong leverage expansion has been above all an industrialised country phenomenon (Chart 3).

International reserves on average have fluctuated in part due to past fixed exchange rate policy frameworks. Following the 1995 and 1998 emerging markets crises, reserves dipped, excluding extension of IMF resources. As policy makers had made adjustments on several fronts to mitigate the effect of sudden stops, reserve movements have remained relatively benign (Chart 4).

... that kills a sudden stop.

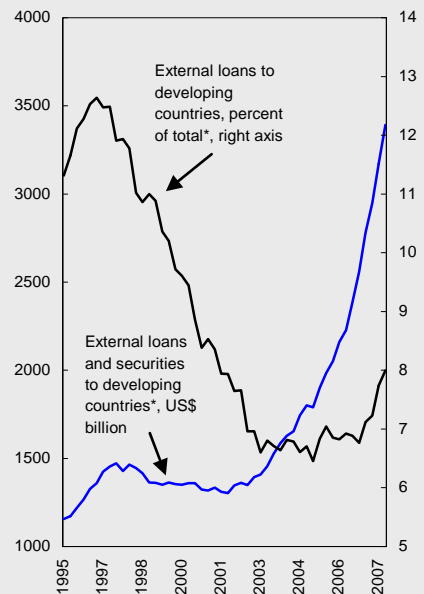
Empirical observations suggest that fluctuations in budget deficits and reserves bear little resemblance to static bean counting measures. Policy makers are very unlikely to take a myopic view that would guide short-term accommodations without considering broader policy options and leave them empty handed at the end of the spending/intervention cycle. They have done so in the past and are expected to do so again.

Emerging markets policy makers will be tested and performance differences will show. However, the basic assertion remains that it would take enormous policy errors to reverse the new-found economic performance. Emerging markets are set to continue to outperform and recent measures indicate that policy makers, in particular in the G7, are willing to provide sufficient resources to make it happen. While additional support mechanisms may be needed, conditions for a benign outlook have already been met.

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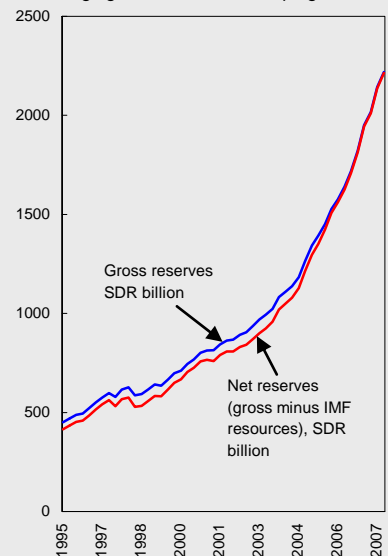
Chart 3. Sudden Stop



Source: BIS. Ashmore calculation. *Emerging markets and developing countries. Loans by BIS reporting banks excluding to off-shore centres.

Chart 4. International Reserves

Emerging markets and developing countries*



Source: IMF. Ashmore calculation. *Excluding China.

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