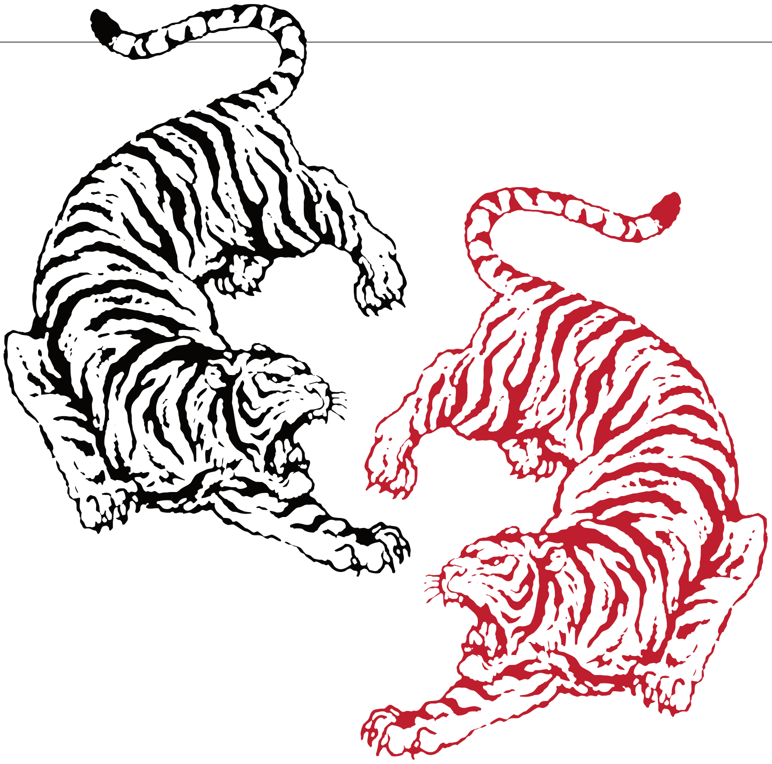
{ EMERGING MARKETS }

JEREMY WARNER

The jitters in Asia are a reminder that we are all part of a large, global economy



First things first. We are not about to experience another emerging markets crisis of the sort seen in the late 1990s, or in India's case, the trauma of 1991. Today's jitters are neither on the same scale, nor do these economies have anywhere near the same sort of external vulnerabilities.

Back then it was fixed exchange rates, crony capitalism and high levels of dollar-denominated debt that did it for the Asian tigers. These foreign currency debts are not nearly as high today, while floating exchange rates provide a natural, market-driven mechanism for economic adjustment.

What is more, most emerging markets have substantial FX reserves, enabling their central banks to smooth the process of currency depreciation. Admittedly, these reserves are being burnt through at quite a rate, and some countries don't have as big a buffer as others. Turkey and India look particularly vulnerable on this count. All the same, most developing economies are better prepared to deal with the turmoil than they were then.

That said, withdrawal by the US Federal Reserve from "unconventional monetary policy", or quantitative easing (QE), was always going to cause problems, and, perhaps oddly, these have not been properly anticipated. Just to get this in perspective, no one is yet talking about reversing the asset purchase programmes that major central banks around the world have been engaged in. In the Fed's case, all that's being proposed is to slow the pace of purchases, with the programme due to cease altogether some time next year.

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Yet markets will always front-run any shift in policy, and it is not entirely clear the Fed chairman, Ben Bernanke, took this into account when he first started to talk about 'tapering'.

Market interest rates, not just in the US, but in the UK, Europe and the developing world, have been rising more sharply than central bankers would like, threatening a renewed credit shock just as major advanced economies seemed to be achieving 'escape velocity'.

Be that as it may, emerging markets should have been better prepared for the cessation of QE, and the reversal in capital flows this was likely to cause. It was always only a question of when, not if. Countries that stalled on reform during the years of plentiful money, and allowed deficits to grow – Brazil, India, Indonesia, Turkey and so on – are now suffering the consequences. Capital controls and higher interest rates, further crimping growth at a time when the Chinese juggernaut is in any case slowing, are the inevitable result.

QE was a justified strategy when the financial crisis began. Indeed, there would arguably have been a depression without it. But the risks associated with demand stimulus of this kind were bound to grow the longer it went on. The newly printed money had to go somewhere, and this has led to a renewed failure to adequately price risk. This was particularly in evidence in emerging markets, which with Western economies out of favour, were targeted as the next big thing. As we discovered during the banking crisis, chasing yield always spells trouble.

Both in pursuing QE in the first place, and now in withdrawing from it, the Fed has not adequately factored in the international impact. For Bernanke, this was entirely a home game.

If the US is growing again, this should obviously be good for emerging markets, too. Even so, too little regard is paid in setting domestic monetary policy to its wider international impact, and the negative feedback loops this can set in train. Central banks need to move much earlier to prevent the development of asset bubbles. They must also recognise that they are not just setting policy for themselves. All economies are now part of a bigger, global economy.

Jeremy Warner is assistant editor of *The Daily Telegraph* and one of Britain's leading business and economics commentators