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The role of domestic fundamentals on the economic vulnerability of emerging markets

Katia Rocha [a,b,*], Ajax Moreira [a]

[a] Institute for Applied Economic Research of Brazilian Government–IPEA, Av. Presidente Antônio Carlos 51, 17th floor, 20020-010, Rio de Janeiro, Brazil
[b] Industrial Engineering Department, Pontifical Catholic University of Rio de Janeiro–PUC-Rio, Brazil

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ABSTRACT

This paper empirically evaluates policies that can potentially reduce the economic vulnerability of emerging market economies. Through panel data estimation on a group of 23 countries, we relate sovereign spreads to global risk shocks, and explore the argument suggested by Calvo (2003) which focuses on macroeconomic fundamentals as multipliers of external shocks. The results support policies towards financial liberalization, public debt management, consistent economic growth, development of the domestic financial market and improvements in governance indicators. We argue that those policies were crucial for the projected rapid economic rebound of the emerging market economies facing the global crisis of 2007–2009.

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1. Introduction

Since 2003, emerging markets have been enjoying an extremely favorable economic climate, generated by high global liquidity. In the beginning of 2007 the excess of liquidity and the overall positive economic performance of these countries led to the lowest sovereign spreads in history, measured by the JPMorgan Emerging Markets Bond Index Global–EMBIG[1], falling below 200 basis points, as shown in Fig. 1.

After 2007 and especially in the last quarter of 2008, the US sub-prime mortgage crisis changed this positive scenario and led to a generalized increase in the global market risk perception with the VIX index

* Corresponding author. Institute for Applied Economic Research of Brazilian Government–IPEA, Av. Presidente Antônio Carlos 51, 17th floor, 20020-010, Rio de Janeiro, Brazil. Tel.: +55 21 35158658; fax: +55 21 35158615.
E-mail address: katia.rocha@ipea.gov.br (K. Rocha).

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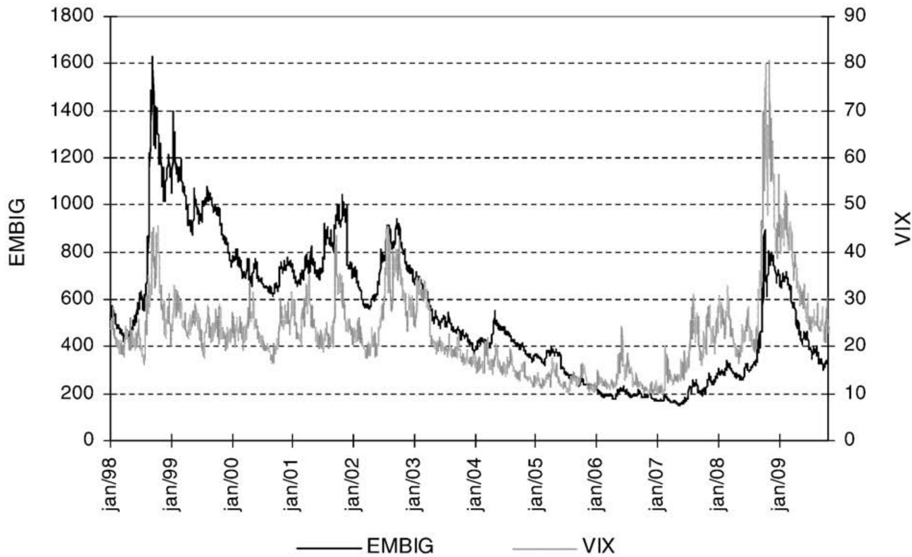

Fig. 1. EMBIG × VIX.

increasing by four times[2]. Nevertheless, it has been noteworthy that emerging countries have been reported higher resilience to the current global crisis of 2007–2009, with the EMBIG spreads roughly double in the same period, and returning to its 300 basis point level in November 2009. During the crisis, the highest level of EMBIG spreads was 800 basis point, a significant smaller figure than the previous levels achieved at the Russian (1998), the Brazilian real devaluation/depreciation (1999/2002) and the Argentinean default (2001/2002) crises.

Such resilience can also be noted by comparing the evolution of sovereign spreads in basis point with those on high yield US corporate bonds (JPMorgan Domestic High Yield) as shown in Fig. 2. Both were grouped according to the rating classifications B and BB[3], and one can see that during the global crisis of 2007–2009, sovereign spreads were lower than US corporate bonds spreads of same rating.

The economic resilience facing the global crisis is also emphasized by the Global Financial Stability Report (2009) and World Economic Outlook (2009), where emerging economies are expected to rebound faster than most developed markets. The rebound is driven by China, India, and a number of other emerging Asian economies. Other emerging economies are benefiting from commodity price increases, as well as from stronger policy frameworks implemented during previous years. Eyzaguirre (2009) especially mentions the Latin American and Caribbean (LAC) region which faced the crisis better equipped with sound economic policies, relying on smaller financial, external, and fiscal vulnerabilities, which allowed a number of countries of the region to implement countercyclical monetary and fiscal policies.

According to the Global Financial Stability Report (2007), the improvement in sovereigns' economic vulnerability was achieved through policies implemented after 2003, during the favorable global economic climate. Among those domestic policy efforts it is worthy to mention: i) the improvement in public debt management, by increasing the average debt maturity, decreasing the stock of FX-currency debt and placing external debt denominated in domestic currency; ii) the development of domestic financial

[2] The VIX Index, sometimes called the “investor fear gauge”, was first introduced in 1993 by the Chicago Board Options Exchange to reflect the 30-day expected volatility of eight S&P100 at-the-money call and put options. It was expanded in 2003 to include a broader range of options based on the S&P500, considering various weights on options prices with diverse strike prices. This index is widely used as a global risk aversion proxy.

[3] Rating criteria consist of an appraisal of each country's overall creditworthiness, both from a quantitative and qualitative standpoint. The rating agencies analyze both economic and political risk as the key determinants of credit risk. The ratings are usually classified from the highest to the lowest as: AAA–AA–A–BBB–BB–B–CCC–CC–C–D, with a subdivision of +, − or neutral. Ratings above BBB (inclusive) are considered as “investment grade”.

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