CEPS COMMENTARY
Thinking ahead for Europe

Emerging Markets' Euro Nemesis

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BRUSSELS – The currencies of many emerging markets are crashing, and their central banks are busy tightening policy, trying to stabilize their countries' financial markets. Who is to blame for this state of affairs?

A few years ago, when the US Federal Reserve embarked on yet another round of "quantitative easing," some emerging-market leaders complained loudly. They saw the Fed's open-ended purchases of long-term securities as an attempt to engineer a competitive devaluation of the dollar and feared that ultra-easy monetary conditions in the United States would unleash a flood of "hot money" inflows into their markets, driving up their exchange rates. This, they worried, would not only diminish their export competitiveness and push their external accounts into deficit; it would also expose them to the harsh consequences of a sudden stop in capital inflows when US policymakers reversed course.

At first sight, these fears appear to have been well founded. As the title of a recent paper published by the International Monetary Fund succinctly puts it, "Capital Flows are Fickle: Anytime, Anywhere." The mere announcement that the Fed might scale down its unconventional monetary-policy operations has led to today's capital flight from emerging markets.

But this view misses the real reason why capital flowed into emerging markets over the last few years, and why the external accounts of so many of them have swung into deficit. The real culprit is the euro.

Quantitative easing in the US cannot have been behind these large swings in global current-account balances, because America's external deficit has not changed significantly in recent years. This is also what one would expect from economic theory: in conditions approaching a liquidity trap, the impact of unconventional monetary policies on financial conditions and demand is likely to be modest.

Indeed, the available models tell us that, to the extent that an expansionary monetary policy actually does have an impact on the economy, its effect on the current account

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should not be large, because any positive effect on exports from a weaker exchange rate should be offset by larger imports due to the increase in domestic demand.

This is what has happened in the US, and its recent economic revival has been accompanied by an expansion of both exports and imports. The impact of the various rounds of quantitative easing on emerging markets (and on the rest of the world) has thus been approximately neutral.

But austerity in Europe has had a profound impact on the eurozone's current account, which has swung from a deficit of almost $100 billion in 2008 to a surplus of almost $300 billion this year. This was a consequence of the sudden stop of capital flows to the eurozone's southern members, which forced these countries to turn their current accounts from a combined deficit of $300 billion five years ago to a small surplus today. Because the external-surplus countries of the eurozone's north, Germany and Netherlands, did not expand their demand, the eurozone overall is now running the world's largest current-account surplus – exceeding even that of China, which has long been accused of engaging in competitive currency manipulation.

This extraordinary swing of almost $400 billion in the eurozone's current-account balance did not result from a "competitive devaluation"; the euro has remained strong. So the real reason for the eurozone's large external surplus today is that internal demand has been so weak that imports have been practically stagnant over the last five years (the average annual growth rate was a paltry 0.25 %).

The cause of this state of affairs, in one word, is austerity. Weak demand in Europe is the real reason why emerging markets' current accounts deteriorated (and, with the exception of China, swung into deficit).

Thus, if anything, emerging-market leaders should have complained about European austerity, not about US quantitative easing. Fed Chairman Ben Bernanke's talk of "tapering" quantitative easing might have triggered the current bout of instability; but emerging markets' underlying vulnerability was made in Europe.

The fickleness of capital markets poses once again the paradox of thrift. As capital withdraws from emerging markets, these countries soon will be forced to adopt their own austerity measures and run current-account surpluses, much like the eurozone periphery today. But who will then be able – and willing – to run deficits?

Two of the world's three largest economies come to mind: China, given the strength of its balance sheet, and the eurozone, given the euro's status as a reserve currency. But both appear committed to running large surpluses (indeed, the two largest in the world). This implies that, unless the US resumes its role as consumer of last resort, the latest bout of financial-market jitters will weaken the global economy again. And any global recovery promises to be unbalanced – that is, if it materializes at all.