



Rewind or Fast Forward?

On 15 December, 2008, Ecuador defaulted on its external government debt.¹ While an important development for emerging markets (EM) investors, it was barely noticed by global investors who have understandably become desensitised to extreme or unusual financial developments over the past year. But we think that a critical question for all investors is, *What are the implications of Ecuador's default?* Does it mark the end of several years of stability and a return to the EM sovereign debt problems of the past, or is it simply a one-off event?

First, it is important to understand the nature of the default. Ecuador's decision not to make a US\$30 million coupon payment while maintaining over US\$5 billion of foreign currency reserves is a clear example of a lack of *willingness* to repay as opposed to a lack of *ability*.²

The default also highlights a new reality of the current global financial crisis, namely that the global deleveraging and credit contraction means that less capital will be available for marginal or highly risky investments. For some borrowers, potential access to future financing has diminished significantly, and thus the "cost" of a

default is perceived as less. Under this framework, concerns about repayment by countries with unorthodox economic regimes (such as Argentina and Venezuela) increase significantly. Indeed, the cost to hedge against a default in Argentina has increased from 900 basis points (bps) in early September 2008 to 4500 bps at year-end and in Venezuela from 700 bps to 3250 bps.

Should investors be concerned that the global credit crises will set off a domino effect across emerging economies, resulting in serial defaults like in the 1980s or the 1930s? After witnessing events over the past year that would have been unthinkable only 18 months ago, it would be foolish not to acknowledge the possibility of a wide range of different outcomes. But within that range, we think that most likely there will be key distinctions across credits, with countries and companies of systemic importance and who have access to external or internal support significantly outperforming credits without such access.

One clear example of external policy support was the announcement by the US

Federal Reserve that it would make available US\$30 billion of reciprocal currency arrangements³ to the central banks of Brazil, Korea, Mexico and Singapore. If needed, these central banks could exchange the equivalent of US\$30 billion of their own currencies for \$30 billion in US dollars from the Federal Reserve, thereby increasing their ability to repay US dollar-denominated debt. As a policy response, this is an effective way of limiting the possibility that a financial crisis and ensuing capital outflows will create a vicious cycle of lower foreign exchange reserves, increased risk and more outflows.

The current crisis has exposed many of the vulnerabilities of our global financial system, including the asymmetric nature of credit creation. That is, it is much easier to create credit via leverage, fractional reserve banking and other similar mechanisms than it is to allow credit to be withdrawn. One of the elegant aspects of the reciprocal currency arrangement is that it adds a lender of last resort of US dollars for some foreign central banks up to a certain limit. One inherent instability of foreign central banks is that when dollars⁴ are flowing into their countries, they can print their own currencies almost without limit⁵ to purchase the dollars and increase foreign reserves. However, when dollars are flowing out of the country they can only

sell the limited amount of dollars they have. In previous periods such as the Asian crises of 1997, this characteristic created “bank runs” on reserves, with foreign investors rushing to not be the last out. Effectively, these arrangements create additional scope for dealing with currency outflows, thereby reducing the likelihood that the outflows occur.

In addition to external support, countries that entered this crisis in relatively strong financial condition also have the scope for generating their own internal policy responses. These responses can come in many forms, most notably fiscal stimulus programs where governments borrow money to invest in public works and boost economic activity. For example, we have seen a range of responses from the BRIC countries (Brazil, Russia, India and China). Notably, China announced a series of measures totalling some 4 trillion CNY⁶ designed to increase domestic consumption, including public spending on housing, infrastructure, agriculture, healthcare and social programs. Russia has announced a US\$186 billion stimulus program and India and Brazil have announced similar though smaller programs as well.

Will It Be Back to the Past or Ahead to the Future?

Regular readers of Emerging Markets Watch will be familiar with our view that

many emerging economies are undergoing a secular journey toward a destination characterised by higher standards of living and greater reliance on domestic sources of demand. As the dynamics of the globalisation of labour and goods markets continue to play out, we expect the wide gap in wages between, say, auto workers in China, India, Germany and the US to converge, with auto workers in China and India seeing a noticeable increase in their standards of living relative to those in Germany and the US.

Interestingly, the current global financial crisis could in fact accelerate this journey, thanks to the policy responses being embraced by many emerging economies. China is perhaps the best example, where the massive domestic infrastructure program is designed to maintain strong economic growth. Given the high domestic savings rate, there is scope for increased domestic consumption. Contrast this with the US, which will also likely announce a massive domestic fiscal stimulus program, but where the consumer enters the crisis with a low or negative savings rate. Success for the US consumer will mean avoiding losing his or her home or recently purchased flat-screen TV and starting to save more, while success for the Chinese consumer will mean a new home and a flat-screen on top of some savings.

For those emerging market countries that entered this financial crisis in strong enough shape to support themselves internally – or that have access to external support – the crisis may serve to fast forward the transformation.

What Are the Investment Implications?

First, in emerging market external debt there will be a significant differentiation between the countries and companies that have access to insurance, either via self-insurance or external support, and those that do not. We would argue that default probabilities for countries like Brazil, Korea, Mexico and Singapore remain very low, and that current spreads for their sovereign debt represent a compelling risk/return opportunity. At the other extreme, we would argue that access to finance will be significantly reduced for countries with unorthodox economic strategies, and therefore the possibility of defaults will likely increase markedly for these types of credits.

Second, extremely low policy rates in the US, Japan and Europe and the sharp slowdown in global economic activities will create the scope for lower policy rates across many emerging economies. Further, because the current global crisis started in the developed economies, the many emerging economies that entered this

crisis with improved balance sheets⁷ have an opportunity to break from past crises, when the typical EM policy response was to increase interest rates and tighten the fiscal belt. So far in this cycle, EM countries have been reducing policy rates⁸ in response to the global crisis and the drop in domestic economic activity, a response previously reserved for the developed world. We see this as evidence of a “fast forward” rather than a “rewind” and looking forward we see the scope for even lower policy rates.

Finally, lower domestic interest rates, credit contraction from global deleveraging and reduced export demand will put downward pressure on emerging currencies. With the J.P. Morgan Emerging Local Markets Index Plus down 3.8% for the year and off 13% from mid-year highs, markets have recognised and priced in a fair amount of these headwinds. Going forward, we expect many central banks will continue to be judicious in using foreign exchange reserves to smooth capital outflows, looking to reduce exchange rate volatility rather

than maintain specific exchange rates. Unlike in prior dislocations such as the Asian crises, when fixed currencies were a vulnerability, floating exchange rates should be able to play more of a role as a shock absorber this time, minimising the pass-through impacts of global deleveraging to the domestic economies. Thus we have tempered our secular enthusiasm for a generalised strengthening of emerging currencies versus the US dollar, given the cyclical headwinds.

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¹ This was Ecuador's second default in a decade; the country previously defaulted in October 1999.

² For more on Ecuador's wiliness versus ability and PIMCO's investment decision to avoid Ecuador, see *Emerging Markets – A Look Back, A Look Ahead*.

³ Also called “swap lines” and described in Federal Reserve press release dated October 29, 2008.

⁴ US dollars are just an example; it could be any foreign currency: euros, pounds, yen etc.

⁵ Not without consequence, however; the increase in money supply can be inflationary, hence the practice of “sterilisation.”

⁶ Roughly US\$586 billion at the time of the announcement. The stimulus package did include some previously announced programs.

⁷ Better balance sheets defined broadly would include smaller debt stocks, longer debt maturity profiles, reduced sensitivity to exchange rate movements and lower interest servicing costs relative to GDP.

⁸ China, India, Korea, the Philippines, Thailand, the Czech Republic, Hungary, Poland, Slovakia, Colombia, South Africa and Turkey have all cut rates recently.

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JPMorgan Emerging Local Markets Index Plus tracks total returns for local currency-denominated money market instruments in 22 emerging markets countries with at least US \$10 billion of external trade. It is not possible to invest in an unmanaged index.

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