Summarizing the Vulnerability Rankings

Table 11 brings together the vulnerability rankings presented previously under the five transmission channels. Five (most vulnerable) economies are listed under each channel. For exchange rates, only the overvaluation cases are presented (under the assumption that overvaluation problems are more pressing than undervaluation ones).[1] *In terms of frequency of appearance in table 11, Venezuela heads the hit parade, appearing in four of the five vulnerability channels; next in line are Turkey and Hungary, which each appear in three of the five channels. The next tier of vulnerability is represented by Argentina, Brazil, Mexico, and Russia, which each appear in two of the five transmission channels. If the criterion were instead the number of appearances in the top-three vulnerability positions, then Turkey tops the list (appearing in that spot under three channels), followed by Argentina and Brazil (each with top-three vulnerability rankings under two channels).*[2] Given the focus of this paper on cross-country differences in vulnerability across various transmission channels, I don't think it's useful to push the average vulnerability conclusions beyond that.

IV. CONCLUDING REMARKS

In this paper I have outlined a story in which an overlapping growth slowdown in China and the United States, along with deterioration in global financial conditions linked to a disorderly correction of global payments imbalances, could put emerging markets on the threshold of a new financial crisis. I have emphasized that it makes a great deal of difference to emerging-market prospects if the US/China slowdown is or is not accompanied both by a large increase in emerging-market interest rate spreads and by a large decline in private capital flows to them. Interestingly enough, the latest issue (April 2005) of the World Bank's *Global Development Finance* (World Bank 2005b) seems to come to a similar qualitative conclusion: It finds that a rise by 200 basis points in US short- and long-term interest rates (relative to the baseline scenario) slows developing-country growth (again relative to the baseline) by 1 percentage point each in 2005 and 2006. But if that same rise in US interest rates is accompanied by a return of emerging-market interest rate spreads to "normal" levels, then the decline in developing-country growth is much larger—by over 2 percentage points in 2005 and by roughly 4½ percentage points in 2006 (relative to baseline).

I have also tried to highlight the point that the identification of those emerging economies that would be most vulnerable to a crisis is not invariant either to the way in which the crisis unfolds or to the different characteristics of individual emerging economies themselves. Some emerging economies have strong bilateral export links with China and/or the United States, while others do not. Some have a relatively high concentration of exports in those primary commodities where China and/or the United States could affect the world price, and others do not. Some have financing requirements and debt positions that make them quite sensitive to large increases in global interest rates and to large declines in private capital flows, while others are much less sensitive. Some have net foreign asset positions in foreign exchange, while others have net liability positions. Some have significant foreign-currency debt in nondollar currencies; others do not. Some still have relatively serious currency mismatches and/or large real exchange rate misalignments to contend with, while others do not. Some have good monetary policy frameworks in place, have turned in very good inflation performance of late, and might well be able to take some countercyclical policy action if hit with a serious external shock; others do not, have not, and could not. Some have to carry the baggage of fragile banking systems, while others are much farther along on banking reform. The various indicator tables included in the paper represent a first-pass to deal with some of those cross-country differences.

But if the threat of a new emerging-market crisis is not something to be dismissed lightly, it is natural to ask what might be done to reduce the risk and to strengthen the forces of crisis prevention going forward ?

Since my crisis story is linked to a disorderly correction of global payments imbalances, a good place to start on crisis prevention would be to make the payments-adjustment process more orderly and more effective. That entails at least three complementary sets of policy actions. In the United States, there needs to be a

[1] To determine the ordinal ranking for overvaluations, I averaged the three overvaluation measures listed in table 9.
[2] If the cutoff were instead the top seven economies under each transmission channel, then Venezuela and the Philippines lead the pack, appearing in four of the five channels.

credible plan to reduce the structural budget deficit to less than 1 percent of GDP by 2010; there is no such plan on the table right now. Also, the US Federal Reserve needs to continue with its ongoing tightening of monetary conditions so that US domestic demand growth is brought beneath the growth of output and stays there until the US current account deficit is roughly half its present size. In Europe, the ECB should be cautious in raising interest rates so that domestic demand growth in the European Union can grow faster than output growth. In Asia, the imperative is to get more appreciation of key Asian currencies—especially the Chinese renminbi—so that the needed second wave of dollar depreciation can be both broadly distributed among nondollar currencies and large enough to perform its expenditure-switching function.

The emerging markets too still have plenty to do, so that they are both better equipped to withstand a shift toward less benign global financing conditions and less likely to throw fat on the fire with their own country-specific difficulties. This means continuing to work toward reducing high public debt ratios and currency mismatches, taking action to remove large over and undervaluations of their real exchange rates (before the markets force such a change on them), persuading more emerging economies to adopt transparent frameworks for the conduct and evaluation of monetary. policy, building deeper local bond markets, and increasing efforts to reduce the fragility of domestic banking systems. The fact that (almost) everybody has heard this diagnosis and prescription before doesn’t make it any less relevant.