Hello 2015: divergence in developed markets will set the stage

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By Mohamed El-Erian

One of the main challenges facing emerging countries in 2015 will be dealing with increased economic and policy "divergence" within the advanced world. It is a challenge that will widen the gap between well- and poorly-managed economies. It is also one that will tax even the best-run economies. In turn, their response will influence the prospects for the advanced world.

Divergence among advanced countries takes two major forms: bigger differences in growth and other major aspects of economic performance; and, related to this, opposite paths for central bank policies.

At one end, the US will continue its steady recovery in 2015, increasing the probability of an economic liftoff down the road that would help overcome remaining pockets of excess indebtedness. The Federal Reserve will feel both able and willing to continue the gradual orderly normalisation of its unconventional monetary policy, supplementing its recent exit from QE with less aggressive forward policy guidance and interest rate hikes starting in the middle of the year.

Not so for Europe and Japan. Their economic baseline will be challenged by stagnant growth and recurrent concerns about some countries' longer-term debt dynamics. Central banks there will be pushed deeper into experimental monetary policies, particularly as the balance of risks for their economies is tilted to the downside on account of economics, geo-politics, and domestic and regional political issues.

For emerging economies, this advanced world configuration translates into (i) G-3 currency volatility, including further pressures for broad-based dollar appreciation; (ii) growing risks of global policy tensions and, with that, growing political pressure for trade protectionism; and (iii) periodic bouts of financial market instability.

It is an environment that offers risks, as well as opportunities for the emerging world. Where they end up in 2015 will be materially influenced by countries' initial conditions and policy responsiveness.

Oil importers with the trifecta of flexible exchange rate regimes, robust international reserve cushions and larger trade links to the US – such as Indonesia and Korea – start the year in the best position. It is also the case for China, where more aggressive management of the currency is only being held back by the desire to impose discipline on companies that need to gradually re-orient as part of the general evolution in the country's growth model.

If these economies are able to progress on their own structural reforms, they will enhance both their relative and absolute standing in the global economy. By benefiting economically from lower commodity prices and using their considerable self-insurance as a buffer against inevitable global financial and currency volatility, they will reinforce their prospects for faster growth and continued developmental maturation.

At the other extreme, countries like Russia and Venezuela, will struggle mightily, facing the triple threat of recession, inflation and financial instability. Delays in putting in place comprehensive policy responses will aggravate the risks of further currency implosions, disruptive capital flight, and spreading import shortages.

Debt characteristics will also be a differentiating feature, though not as significant as in the past.

Countries with large currency mismatches in their debt denominations – or what is known as the problem of "original sin" whereby the dollar debt servicing requirements far exceed borrowers' direct ability to generate dollar revenues – will face a tougher time. The greenback's broad-based appreciation will accentuate the problem, particularly for those with unfavourable maturity structures that involve considerable debt service payments in the next 18 months.

Fortunately, this is unlikely to become a repeat of the crises of 1994-95, 1997-98 and 2001-02. Distorted debt characteristics are a lot less common today than they were in that emerging world of old. Moreover, where they still prevail, they tend to be concentrated more in the corporate sector than in sovereigns. As such, timely policy responses stand a greater chance of stopping the disruptions from spreading to the wider economy and then to the world at large. (This is not to under-estimate, however, the challenge facing countries such as Russia where the debt imbalance is heavily concentrated in financial and energy companies.)

In aggregate, this emerging country differentiation adds up to a whole that is a lot less threatening to the global economy than in earlier periods of sustained dollar strength. Moreover, if large emerging economies (such as China, India, Indonesia and Poland) succeed in translating lower commodity input prices into high-quality growth, and if Brazil resists the temptation of slipping back into inefficient statism, it is one that could eventually serve to underpin a global economic rebalancing.

For such a comforting outcome to go from hope and reality, well-managed emerging economies will need to avoid policy mistakes; advanced countries will need to reconcile their divergence without resorting to "beggar-thy-neighbour" policies; global policy coordination will need to substantially improved; and the recent phases of excessive financial risk taking will need to hold together long enough for gradually-improving fundamentals to have time to validate the artificially-high asset prices.

This is far from a done deal unfortunately. But it is a better place to be than during past periods of divergence in the advanced world.

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This is the first in a series of guest posts on the outlook for emerging markets in 2015.

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