WILL EMERGING MARKETS FALL IN 2012

By Jeffrey Frankel

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Emerging markets have performed amazingly well over the last seven years. In many cases, they have far outperformed the advanced industrialized countries in terms of economic growth, debt-to-GDP ratios, countercyclical fiscal policy, and assessments by ratings agencies and financial markets.

As 2012 begins, however, investors are wondering if emerging markets may be due for a correction, triggered by a new wave of "risk off" behavior. Will China experience a hard landing? Will a decline in commodity prices hit Latin America? Will the European Union's sovereign-debt woes spread to neighbors such as Turkey?

Indeed, few believe that the rapid economic growth and high trade deficits that Turkey has experienced in recent years can be sustained. Likewise, high GDP growth rates in Brazil and Argentina over the same period could soon reverse, particularly if global commodity prices fall – not a remote prospect if the Chinese economy begins to falter or global real interest rates rise this year. China, in turn, could land hard as its real-estate bubble deflates and the country's banks are forced to work off the bad loans.

This is not wild doom-and-gloom speculation. The World Bank has just downgraded economic forecasts for developing countries in its 2012 Global Economic Prospects, released

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this month. For example, Brazil's annual GDP growth, which came to a halt in the third quarter of 2011, is forecast to reach 3.4% in 2012, less than half the 7.5% rate recorded in 2010. Reflecting a sharp slowdown in the second half of the year in India, South Asia is slowing from a torrid six years, which included 9.1% growth in 2010. Regional growth is projected to decelerate further, to 5.8%, in 2012.

Three possible lines of argument – empirical, literary, and causal, each admittedly tentative and tenuous – support the worry that emerging markets' economic performance could suffer dramatically in 2012.

The empirical argument is simply historically based numerology: emerging-market crises seem to come in a 15-year cycle. The international debt crisis that erupted in mid-1982 began in Mexico, and then spread to the rest of Latin America and beyond. The East Asian crisis came 15 years later, hitting Thailand in mid-1997, and spreading from there to the rest of the region and beyond. We are now another 15 years down the road. So is 2012 the year for another emerging-markets crisis?

The hypothesis of regular boom-bust cycles is supported by a long-standing scholarly literature, such as the writings of the American economist Carmen Reinhart. But I would appeal to an even older source: the Old Testament – in particular, the story of Joseph, who was called upon by the Pharaoh to interpret a dream about seven fat cows followed by seven skinny cows.

Joseph prophesied that there would come seven years of plenty, with abundant harvests from an overflowing Nile, followed by seven lean years, with famine resulting from drought. His forecast turned out to be accurate. Fortunately, the Pharaoh had empowered his technocratic official (Joseph) to save grain in the seven years of plenty, building up sufficient stockpiles to save the Egyptian people from starvation during the bad years. That is a valuable lesson for today's government officials in industrialized and developing countries alike.

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For emerging markets, the first seven-year phase of plentiful capital flows occurred in 1975-1981, with the recycling of petrodollars in the form of loans to developing countries. The international debt crisis that began in Mexico in 1982 catalyzed the seven lean years, known in Latin America as the "lost decade." The turnaround year, 1989, was marked by the first issue of Brady bonds (dollar-denominated bonds issued by Latin American countries), which helped the region to get past the crisis.

The second cycle of seven fat years was the period of record capital flows to emerging markets in 1990-1996. Following the East Asia crisis of 1997 came seven years of capital drought. The third cycle of inflows occurred in 2004-2011, persisting even through the global financial crisis. If history repeats itself, it is now time for a third "sudden stop" of capital flows to emerging markets.

Are a couple of data points and a biblical parable enough to take the hypothesis of a 15-year cycle seriously? Perhaps, if we have some sort of causal theory that could explain such periodicity to international capital flows.

Here is a possibility: 15 years is how long it takes for individual loan officers and hedge-fund traders to be promoted out of their jobs. Today's young crop of asset pickers knows that there was a crisis in Turkey in 2001, but they did not experience it first hand. They think that perhaps this time is different.

If emerging markets crash in 2012, remember where you heard it first – in ancient Egypt.

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