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# TalkingEconomics: Global liquidity and emerging markets

Emerging markets have benefited from an extremely accommodative environment but global liquidity conditions are becoming less easy than they used to be. We look at where the vulnerabilities may lie.

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## Global liquidity and emerging markets: where are the danger points?

Today we find ourselves in a world where central banks are reviewing their unconventional stimulus measures. The European Central Bank (ECB) is discussing tapering quantitative easing (QE) while the Federal Reserve (Fed) is looking at reducing its balance sheet and policy is turning tighter in China.

That said, though the Fed balance sheet is set to shrink, we still expect central bank balance sheets to expand in aggregate. This suggests the potential for asset markets to remain supported, but the withdrawal of dollar liquidity specifically could cause stress for certain emerging economies with high levels of dollar dependence.

Today, most of the emerging market (EM) economies that suffered due to their high dollar dependence in the 2013 “taper tantrum” have markedly improved their external positions, suggesting a degree of market calm regarding the prospect of liquidity withdrawal is warranted. However, levels remain elevated, and for a small group of economies have actually risen. We would still regard South Africa, Turkey, Peru, Chile, Colombia and Malaysia as at risk, based on this metric.

However, while reliance on foreign finance is important, strong domestic credit growth can also be a risk if global liquidity tightens. Central banks in EM economies could be forced to tighten policy to defend against the inflationary impacts of exchange rate moves, and to prevent large capital outflows. Since the crisis, Latin America and EM Asia (even excluding China) have seen relatively rapid re-leveraging by the private sector, with EMEA (Europe, Middle East and Africa) far more restrained, although even within regions there are considerable differences.

## Global liquidity unlikely to threaten EM this year

On balance, given that we expect central bank balance sheet expansion to continue in aggregate this year, and that even Fed balance sheet reduction is not expected until September or later, global liquidity conditions seem unlikely to threaten EM as a whole this year.

However, given also that we expect the Fed to surprise the market with a more aggressive hiking profile, we do see risks on the horizon in 2018, particularly for the more exposed EMs. South Africa, Turkey, and certain Latin American economies seem vulnerable. By contrast, EM Europe and much of EM Asia look insulated by their lower levels of debt and inflation, and higher real interest rates.