Into the storm

FOR much of the past year the fast-growing economies of the emerging world watched the Western financial hurricane from afar. Their own banks held few of the mortgage-based assets that undid the rich world's financial firms. Commodity exporters were thriving, thanks to high prices for raw materials. China's economic juggernaut powered on. And, from Budapest to Brasília, an abundance of credit fuelled domestic demand. Even as talk mounted of the rich world suffering its worst financial collapse since the Depression, emerging economies seemed a long way from the centre of the storm.

No longer. As foreign capital has fled and confidence evaporated, the emerging world's stockmarkets have plunged (in some cases losing half their value) and currencies tumbled. The seizure in the credit market caused havoc, as foreign banks abruptly stopped lending and stepped back from even the most basic banking services, including trade credits.

Like their rich-world counterparts, governments are battling to limit the damage. That is easiest for those with large foreign-exchange reserves. Russia is spending $220 billion to shore up its financial services industry. South Korea has guaranteed $100 billion of its banks' debt. Less well-endowed countries are asking for help. Hungary has secured a €5 billion ($6.6 billion) lifeline from the European Central Bank and is negotiating a loan from the IMF, as is Ukraine. Close to a dozen countries are talking to the fund about financial help.

Those with long-standing problems are being driven to desperate measures. Argentina is nationalising its private pension funds, seemingly to stave off default .But even stalwarts are looking weaker. Figures released this week showed that China's growth slowed to 9% in the year to the third quarter—still a rapid pace but a lot slower than the double-digit rates of recent years.

Blowing cold on credit

The various emerging economies are in different states of readiness, but the cumulative impact of all this will be enormous. Most obviously, how these countries fare will determine whether the world economy faces a mild recession or something nastier. Emerging economies accounted for around three-quarters of global growth over the past 18 months. But their economic fate will also have political consequences.

In many places—eastern Europe is one example - financial turmoil is hitting weak governments. But even strong regimes could suffer. Some experts think that China needs growth of 7% a year to contain social unrest. More generally, the coming strife will shape the debate about the integration of the world economy. Unlike many previous emerging-market crises, today's mess spread from the rich world, largely thanks to increasingly integrated capital markets. If emerging economies collapse—either into a currency crisis or a sharp recession—there will be yet more questioning of the wisdom of globalised finance.

Fortunately, the picture is not universally dire. All emerging economies will slow. Some will surely face deep recessions. But many are facing the present danger in stronger shape than ever before, armed with large reserves, flexible currencies and strong budgets. Good policy—both at home and in the rich world—can yet avoid a catastrophe.

One reason for hope is that the direct economic fallout from the rich world's disaster is manageable. Falling demand in America and Europe hurts exports, particularly in Asia and Mexico. Commodity prices have fallen: oil is down nearly 60% from its peak and many crops and metals have done worse. That has a mixed effect. Although it hurts commodity-exporters from Russia to South America, it helps commodity importers in Asia and reduces inflation fears everywhere. Countries like Venezuela that have been run badly are vulnerable , but given the scale of the past boom, the commodity bust so far seems unlikely to cause widespread crises.

The more dangerous shock is financial. Wealth is being squeezed as asset prices decline. China's house prices, for instance, have started falling . This will dampen domestic confidence, even though consumers are much less indebted than they are in the rich world. Elsewhere, the sudden dearth of foreign-bank lending and the flight of hedge funds and other investors from bond markets has slammed the brakes on credit growth. And just as booming credit once underpinned strong domestic spending, so tighter credit will mean slower growth.

Again, the impact will differ by country. Thanks to huge current-account surpluses in China and the oil-exporters in the Gulf, emerging economies as a group still send capital to the rich world. But over 80 have deficits of more than 5% of GDP. Most of these are poor countries that live off foreign aid; but some larger ones rely on private capital. For the likes of Turkey and South Africa a sudden slowing in foreign financing would force a dramatic adjustment. A particular worry is eastern Europe, where many countries have double-digit deficits. In addition, even some countries with surpluses, such as Russia, have banks that have grown accustomed to easy foreign lending because of the integration of global finance. The rich world's bank bail-outs may limit the squeeze, but the flow of capital to the emerging world will slow. The Institute of International Finance, a bankers' group, expects a 30% decline in net flows of private capital from last year.

A wing and a prayer

This credit crunch will be grim, but most emerging markets can avoid catastrophe. The biggest ones are in relatively good shape. The more vulnerable ones can (and should) be helped.

Among the giants, China is in a league of its own, with a $2 trillion arsenal of reserves, a current-account surplus, little connection to foreign banks and a budget surplus that offers lots of room to boost spending. Since the country's leaders have made clear that they will do whatever it takes to cushion growth, China's economy is likely to slow—perhaps to 8%—but not collapse. Although that is not enough to save the world economy, such growth in China would put a floor under commodity prices and help other countries in the emerging world.

The other large economies will be harder hit, but should be able to weather the storm. India has a big budget deficit and many Brazilian firms have a large foreign-currency exposure. But Brazil's economy is diversified and both countries have plenty of reserves to smooth the shift to slower growth. With $550 billion of reserves, Russia ought to be able to stop a run on the rouble. In the short-term at least, the most vulnerable countries are all smaller ones.

There will be pain as tighter credit forces adjustments. But sensible, speedy international assistance would make a big difference. Several emerging countries have asked America's Federal Reserve for liquidity support; some hope that China will bail them out. A better route is surely the IMF, which has huge expertise and some $250 billion to lend. Sadly, borrowing from the fund carries a stigma. That needs to change. The IMF should develop quicker, more flexible financial instruments and minimise the conditions it attaches to loans. Over the past month deft policymaking saw off calamity in the rich world. Now it is time for something similar in the emerging world.

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