Developing Nations Anxiously Watch Fed at Jackson Hole

Central bankers fueled an emerging-market credit boom that could deflate when they change course.

BY JAMILA TRINDLE

Emerging markets used to be for the few brave investors willing to trade high risk for high rewards. Countries even riskier, like Zambia and Pakistan, were for the real cowboys. No longer. Since the financial crisis spurred central bankers to hold down interest rates, investors have poured billions of dollars into emerging and frontier markets.

Now, all eyes are on the U.S. Federal Reserve and its annual conference in Jackson Hole, Wyoming, which begins Friday and will feature speeches by Federal Reserve Chairwoman Janet Yellen and European Central Bank President Mario Draghi. The Fed is expected to end its stimulus program this fall and start raising interest rates next year; any sign that Yellen is changing course and raising rates sooner could rattle investors, not only in emerging markets, but across all assets.

As developed economies stagnated after the financial crisis, the Fed pushed more money into the system to try to spur growth. Interest rates on safer assets in the United States and Europe fell and investors started looking for higher returns from riskier assets. That's how they ended up buying bonds from Ivory Coast, Cyprus, Ecuador, and similar nations.

The IMF estimates that investments in bonds from emerging-market countries like Brazil, China, and South Africa have more than doubled over the past few years. Since 2010, foreign holdings of emerging-market debt have expanded from $400 billion to $1 trillion. Frontier markets, a rough set of countries even newer to the international
market than "emerging" countries, are also expanding like never before. That group, which includes Kenya and Ecuador, sold $20 billion worth of bonds last year, according to the Financial Times -- twice what was issued in 2012. Fourteen countries issued their first bonds in 2010 or later, for a total of $8.5 billion worth of debt, according to a recent IMF paper.

That dynamic has economists worried that when the Fed raises rates, investors could pull their money out of emerging-market countries and put it back in the United States, where they would be getting solid returns for far safer assets. That kind of move could wreak havoc on the economies of developing countries because a drop in the value of their currencies would mean they would have a harder time paying back their bonds, which are usually denominated in dollars or euros.

Nicholas Spiro, a sovereign-debt analyst in London, said investors have plowed money into far-flung markets because of the Fed's easy-money policies. When the investment tide flowing into emerging markets recedes, it will reveal who took on bets that were too risky or who is "swimming naked," he said, paraphrasing Warren Buffett's famous line.

"It's already clear which of the swimmers have skimp?y bathing suits," said Spiro, the managing director of his own Spiro Sovereign Strategy. "None of these swimmers want to put on full-fledged diving suits."

Beyond overexposed investors, experts worry about what will happen to the countries that are borrowing money by issuing bonds. Charles Blitzer, a private consultant who previously worked on sovereign-bond defaults at the IMF, said he's particularly concerned about small African countries that have less experience selling bonds.

"There's a lot of dumb borrowing going on and, of course, dumb lending," Blitzer said. "Some of that is going to end up in trouble."
Blitzer said leaders who make mistakes setting up their bond offerings in the beginning make it harder for their governments to pay the money back over time. Sometimes, for instance, officials structure the debt to come due all at the same time, which makes it more likely that one bad economic event will force a country into default.

"None of the finance ministers want to admit that they don't have the experience," he said.

Blitzer points to Angola, which has chosen in the past to issue debt through expensive private placements with investors, rather than selling bonds on the open market. Private placements make it harder to track the debt, Blitzer said, because the details of the sales aren't public. Angola borrowed $1 billion this way in 2012, but the government has long discussed issuing publicly-traded bonds.

"Angola would be well advised to take whatever rating they can get from the rating agencies and proceed into public markets," said Blitzer.

Despite being the third-largest economy in Africa, Angola has dismal ratings on corruption. Transparency International ranked Angola 153rd out of 177 countries in its corruption perceptions index. The Angolan government recently put off opening a stock market until 2017, according to Bloomberg, so that its companies can clean up their finances.

Though corruption threatens to get in the way in some places, each country's situation is different. The flood of cheap debt also gives governments the chance to invest in boosting economic growth. Senegal, which has a higher credit rating than many other frontier markets, including Angola, sold $500 million worth of bonds this year. Senegalese officials told Bloomberg the money will go to building roads and improving access to electricity in order to better attract foreign investment in the country's mining sector.
Gabriel Sterne, head of global macro investor services at Oxford Economics Ltd. and a former IMF and Bank of England economist, warned in a recent paper that investors have been so eager to buy emerging-market debt that it has made it cheaper for those countries to borrow. Lenders usually demand higher interest rates from borrowers -- countries, companies, or individuals -- that are considered more likely to default on their loans. But when there are lots of lenders in the market, or lots of bond buyers, interest rates drop. Stern warns that, historically, 24 percent of countries that are rated as riskier investments by credit ratings firms end up defaulting.

"Eventually, when the Fed and the ECB start raising rates, they're not going to be able pay it back," said Diego Ferro, co-chief investment officer at Greylock Capital Management, based in New York.

Ferro has reason to be more sanguine about the risk, however. His firm makes money when a country can no longer pay its bills. He buys up bonds on the cheap when other investors flee and then negotiates with governments to get the best deal possible. His firm negotiated with Greece, Ivory Coast, and Belize when those countries defaulted on their debt.

"We should think about the positive side: In the past they weren't able to get money; now they can get it," said Ferro. "Is it bad? No one's forcing them to get the money."

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