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Emerging markets more vulnerable than ever to Fed tightening, warns BIS

Bank for International Settlements says there had been a “massive expansion” in borrowing on global bond markets by banks and companies in developing countries

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Brazil is facing pressure on every front. Its budget deficit surged to $65bn in 2013. The current account deficit widened to 3.7pc of GDP Photo: Rex Features

Emerging markets may be even more vulnerable to an interest rate shock today than they were during the East Asia crisis in 1998, the Bank for International Settlements (BIS) has warned.

The Swiss-based watchdog said there had been a “massive expansion” in borrowing on global bond markets by banks and companies in developing countries, leaving them exposed to “powerful feedback” risks as borrowing costs rise in the West.

“The deeper integration of emerging market economies into global debt markets has made emerging market bond markets much more sensitive to bond market developments in the advanced economies,” the BIS said in a working paper.

“The global long-term interest rate now matters much more for the monetary policy choice facing emerging market economies than a decade ago,” it said.

The findings are at odds with widespread claims that these states are mostly insulated from monetary tightening by the US Federal Reserve, purportedly because they have borrowed in their own currencies over recent years and have huge foreign reserves.

The warning came as bourses in Asia and Latin America fell to a seven-month low, testing levels seen in last June's "taper tantrum". Chinese computer giant Lenovo fell 16pc on rating downgrades.

The moves followed a 326-point fall on the Dow on Monday. Markets have been unsettled by a sharp slide in US factory orders and further signs that China's boom is deflating, with knock-on effects for commodity exporters.

Brazil's industrial output slumped 3.5pc in December as the delayed effects of monetary tightening bite deeper, a foretaste of what lies in store for a string of countries that have raised rates to defend their currencies. "This was the biggest monthly contraction since December 2008," said George Lei, from Nomura.

Brazil is facing pressure on every front. Its budget deficit surged to $65bn in 2013. The current account deficit widened to 3.7pc of GDP, hit by sliding iron ore prices.

Edmar Bacha, from the Casa das Garças Institute, said Brazil is living beyond its means and will have to accept a "contraction of internal demand" to right the ship.

Marcelo Ribeiro from the hedge fund Pentagono said Brazil needs a 60pc to 70pc devaluation to restore industrial competitiveness. "This will end badly," he said.

Brazil is a textbook case of the "Dutch Disease". Neil Shearing, from Capital Economics, said the country became over-reliant on raw material exports during the boom, allowing the real to rise too far and hollow out manufacturing industry. Brazil is now stuck in 1970s-style stagflation.

"They need deep structural reform. Their trend growth has fallen to just 2pc to 2.5pc, but we could see some real problems if China slows sharply," said.

The BIS report said debt issuance in emerging markets has been so great that a "sudden stop" could overwhelm central banks and pose a risk to financial stability. The twin effects of falling currencies and rising bond yields may feed on each other in a vicious circle.

Unprecedented access to global capital markets has allowed emergin market companies to borrow vast sums at real interests rates near 1pc, almost doubling their local currency debts to $9.1 trillion since 2008. This is a Faustian Pact, leaving them more leveraged than ever before to the global cost of money.

The BIS said quantitative easing by the US, UK and Japan - combined with surging foreign reserve accumulation by China and other emerging powers - held borrowing costs by around 250 basis points below historic levels, until the Fed lost control last year and long-term rates began to spike.

This so-called "term premium compression" led to a surge in offshore dollar lending through the bond markets. Companies and banks raised almost $2 trillion from 2010 to mid-2013, creating a liability mismatch that could go badly awry if the dollar surges - as it already has against the real, the Turkish lira, the Indian rupee and South Africa's rand.

The BIS hinted at a nasty possibility in which emerging market companies rush to pay off foreign debts and try to raise debt in their own currencies instead from local banks.

This would cause a "sharp drop" in the exchange rate even for states with an ostensibly healthy current account surplus, an effect seen in Russia in 2008-2009. The BIS said extremely complex forces are at work and nobody really knows how this will end.