Emerging markets may feel financial pain next

By David J. Lynch, USA TODAY

The flow of capital into emerging markets is slowing, raising fears that another phase of the global financial crisis may be brewing.

Most at risk: economies that operated during the recent global boom like miniature versions of the United States, consuming more than they produced and running up large deficits in their trade accounts. From the tiny Baltic nations to nuclear-armed Pakistan, they now face a crunch.

But even investor darlings with strong economic managers, such as Brazil and India, are being hammered. The Brazilian currency, the real, fell more than 4.5% Wednesday and has lost 28% of its value since the beginning of August.

"What is the next shoe to drop? I say look at emerging markets," says Stephen Jen, Morgan Stanley currency strategist in London.

The Baltics are tiny. Latvia's $27 billion gross domestic product is about equal to one hour's worth of U.S. production. But a panic or widespread defaults now could shake an already unstable global financial system.

The Baltics' rapid growth came with heavy borrowing by banks, non-financial businesses and individuals.

Under pressure to shed risk, banks are cutting back on loans to the developing world. Next year, banks are expected to provide just $135 billion, down two-thirds from the 2007 level, according to the Institute of International Finance, a global association of financial institutions.

The Baltics already are slowing. From average growth of about 9% in 2007, Baltic economies are expected to shrink marginally next year, the International Monetary Fund says.

Some analysts still expect the larger developing countries, which are the most important U.S. export markets, to ride out the financial storm. Following the 1997 Asian financial crisis, countries such as China, South Korea and Russia built up enormous foreign exchange reserves as protection against a run on their currencies.

With almost $1.9 trillion in reserves, China is especially well positioned.

"I'm relatively optimistic that most emerging market economies are going to dodge the bullet. … I don't see any economy really facing a meltdown," says Cornell economist Eswar Prasad, a former IMF official.

But slowing global growth, tightening credit and sagging commodity prices have inflicted serious damage elsewhere. Ukraine on Wednesday said it might seek aid from the IMF as its currency came under pressure. Earlier this week, the IMF said it could provide "technical and financial support" to Hungary.

Pakistan isn't waiting for the IMF. Its president has gone for help where the real money is these days: Beijing.

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