December 2022

The Return of Orthodoxy

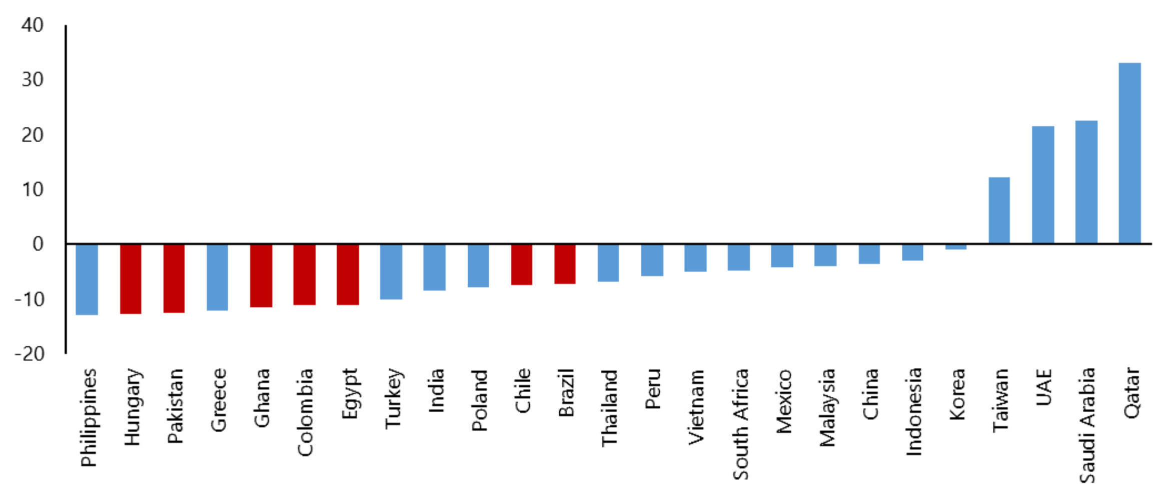
In October, the incoming Brazilian president was asked about a sell-off in his domestic markets, which was widely connected to his generous spending plans. Lula attributed the sell-off, instead, to stock market "speculators," who he called "not serious people." So which attribution is more accurate?

The pattern now seems clear to us. Back in the 2010s, when interest rates hit historic lows, the markets punished a handful of free spenders for extreme fiscal or monetary irresponsibility. The list of targets was short: most notably Turkey, Argentina, and Greece. Now inflation is back, rates are rising, and with debt levels elevated worldwide, investors are targeting an expanding list of countries, using a stricter standard of responsibility.

The Emerging Market Targets

It would be hard to dismiss the choice of targets as frivolous. So far this year investors have forced a change in policy or tone, not only on Brazil—where Lula's finance minister had to dial back his remarks—but also in Chile, Colombia, Ghana, Egypt, Pakistan, and even defiantly populist Hungary. Not coincidentally, these seven countries all have among the worst twin deficits—government and current account—in emerging markets (see chart below).

Chart 1. Emerging Markets, ranked on a metric to measure the twin deficit pressures
(Percent of GDP)



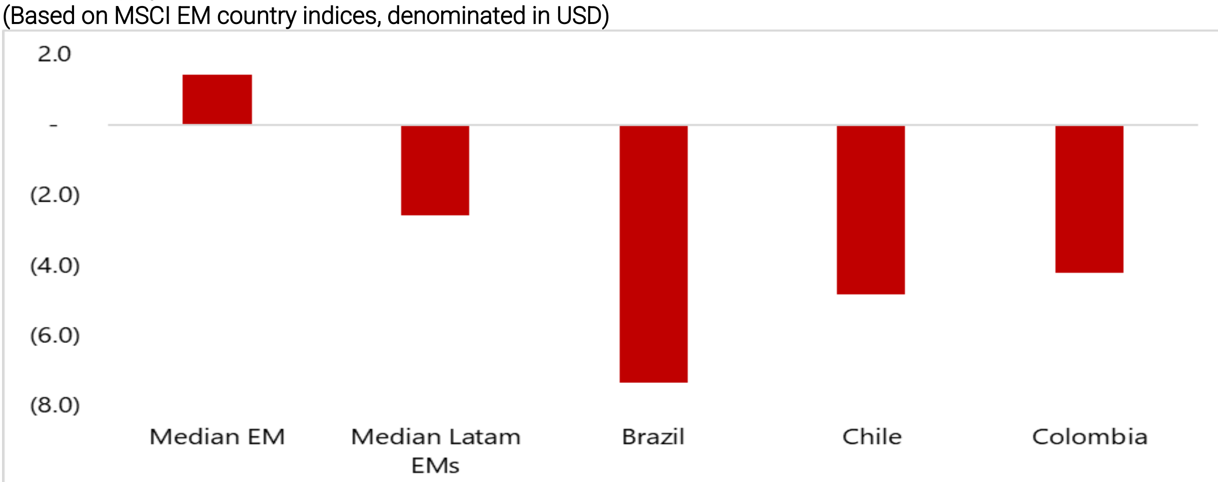
Source: Bloomberg Forecasts, Breakout Calculations.
Note: Calculated as the sum of current account balance and fiscal balance for 2022

These seven countries also had leaders whose spending promises or policies threaten to make these imbalances worse. In some countries, the return to orthodoxy came in the form of leaders or their aides dialing back on grand plans—Colombia's finance minister felt compelled to promise markets that he "will not do crazy things." In others, it came also from central banks, which reversed a premature shift to easing and resumed raising rates to fight inflation.

The Latin Left Has Been Warned

Interestingly, the EM targets are from the right and the left, run by populists, an ex-general, and socialist firebrands. Again, the market is showing seriousness, not irrational ideological bias. If there is a pattern, it is in Latin America, where all three countries targeted this year are led by newly elected populists of the left—Lula of Brazil, Gabriel Boric of Chile and Gustavo Petro of Colombia. Brazil has stabilized a bit since Lula's ministers walked back his dismissive attack on speculators, but the country is still one of the worst performing EMs (see chart below).

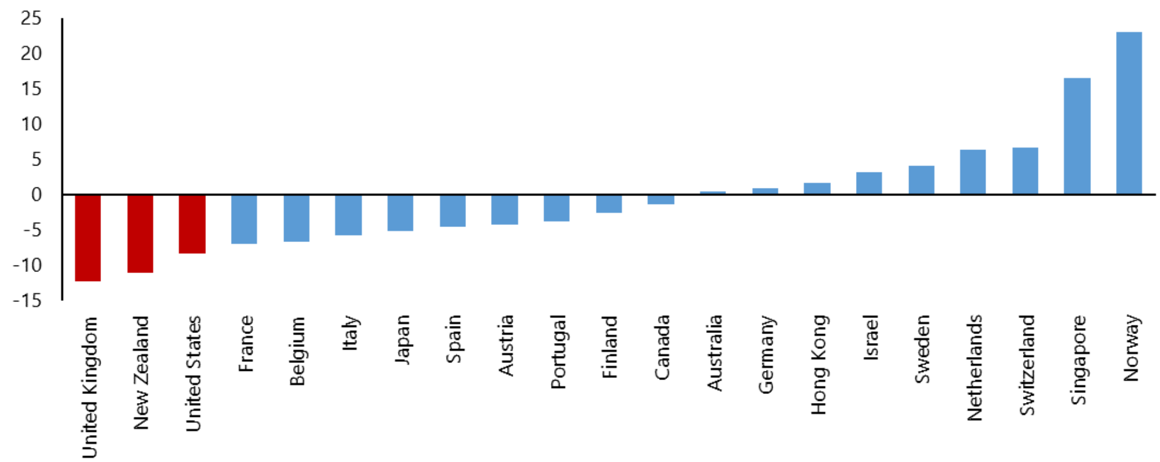
Chart 2. Equity and FX Performance in the last 3 months
(Based on MSCI EM country indices, denominated in USD)



Developed Markets

The big surprise this year was that investors first began turning on unorthodox leaders, not in emerging markets—where they have a long history—but in the oldest developed market of all, the United Kingdom. The UK problem was, in part, unorthodox leadership under prime minister Liz Truss, but the fundamentals raised the same red flags that were rising in emerging markets: the UK had the worst twin deficit among developed markets. The chart below sends a cautionary message to countries like New Zealand and the United States, which are running very high deficits, and leaders dabble in unorthodoxy at their own risk.

Chart 3. Developed Markets, ranked on a metric to measure the twin deficit pressures (Percent of GDP)

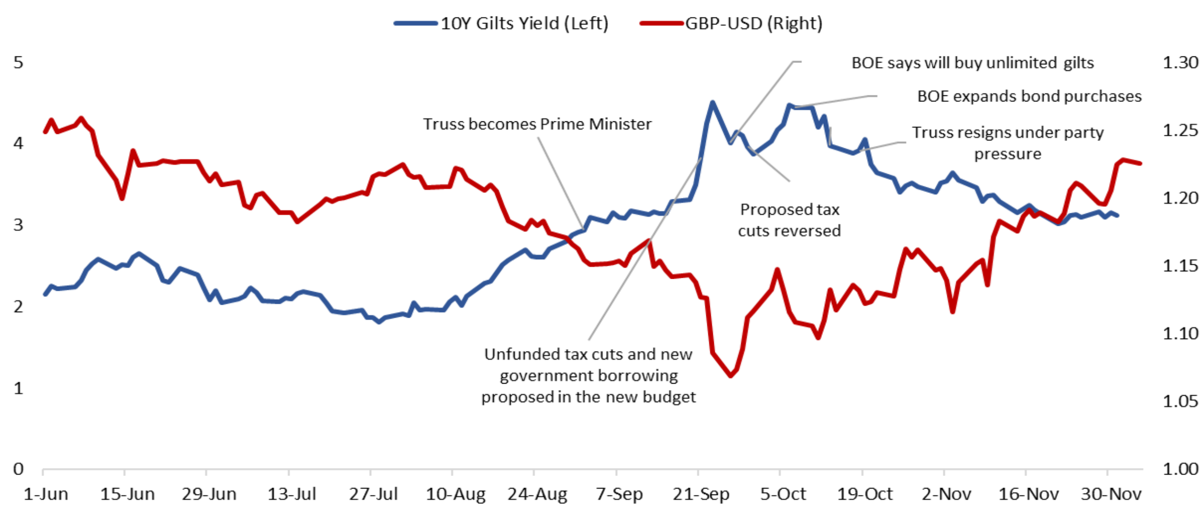


Source: Bloomberg Forecasts, Breakout Calculations.
Note: Calculated as the sum of current account balance and fiscal balance for 2022

The Unusual Case of the UK

Truss came to office in September signaling plans to cut taxes and raise spending, despite rising inflation. The market immediately began selling off the pound and 10 year UK government bonds (gilts), slowly at first, then in a rush as it became clear Truss was serious. The selling slowed when Truss backed off the tax cuts, and when the Bank of England vowed to buy gilts in bulk but calmed only when Truss was forced out in October—the shortest serving prime minister in UK history. Orthodoxy was restored.

Chart 4. Volatility in the UK Financial Assets



Source: Bloomberg

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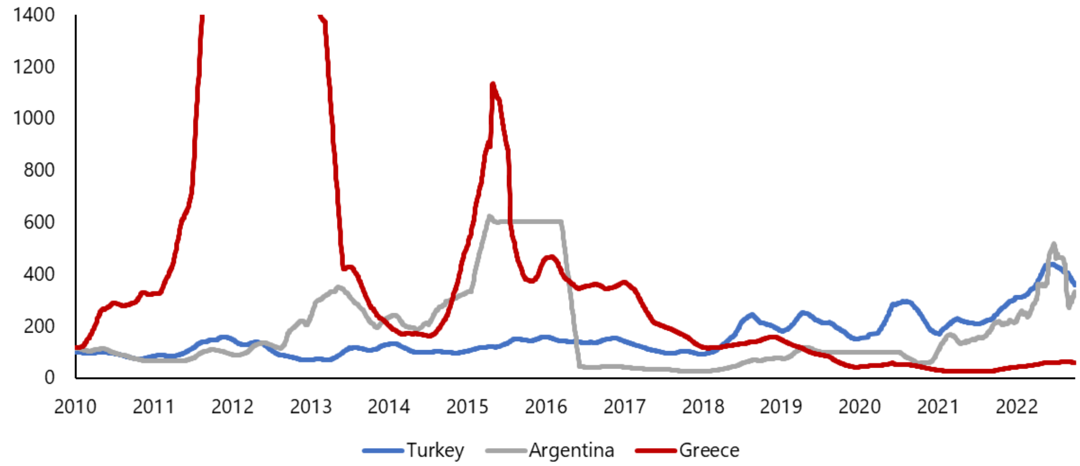
The Return to Orthodoxy

The return to orthodoxy can work. Look at what happened to the countries punished by markets in the 2010s: Greece returned to orthodoxy, and the punishment—delivered in the form of exorbitant international borrowing costs—was lifted. Argentina and Turkey continued to follow their irresponsible political muses, and still face punishingly high interest rates.

Chart 5. Credit Default Swap Spreads (normailized to 100 at the beginning)



Source: Bloomberg, Breakout Calculations

These market pressures are rational, predictable, and will continue to raise the likelihood of a worldwide return to financial orthodoxy.

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