MARKETS

# As Pakistan Starts Talks, Emerging Markets Look to Contain Damage

Many have taken steps to limit fallout from U.S. dollar strength

A new road building project in Multan, Pakistan. The country, which has spent heavily on infrastructure, is the latest emerging market to come under scrutiny. PHOTO: AHMAD KAMAL/ZUMA PRESS

*By Josh Zumbrun in Washington, Paul Hannon in London and Saumya Vaishampayan in Hong Kong*

Updated Oct. 8, 2018 11:01 p.m. ET

Pakistan's decision to start bailout talks with the International Monetary Fund is the latest in a series of threats to hit emerging markets that have been challenged by weakening currencies and rising U.S. interest rates.

While Pakistan has unique issues, including a ballooning trade deficit and ambitious infrastructure program, the stronger dollar and higher U.S. rates more broadly are leading capital to flow out of emerging markets. That has caused financial strain, including challenges paying off U.S. dollar debt and pressure on developing-economy stock markets.

Fears of a broad emerging-market crisis emerged in May, when Argentina's peso fell so sharply that the nation sought a bailout from the IMF. The Turkish lira, falling throughout the year, tumbled in early August.

Pakistan's Finance Minister Asad Umar will begin negotiations at the annual meeting of the IMF in Bali, Indonesia, this week, Pakistan's finance ministry said Monday.

Many emerging markets—including Mexico, Indonesia, India and the Philippines—have responded with higher interest rates of their own to insulate their economies, limiting the scope of emerging-market stress, but Pakistan's announcement shows the risk of escalating problems in emerging markets hasn't gone away.

"The major enemy most of the central banks are forced to address is time," said Roland Mieth, an emerging-markets portfolio manager at Pacific Investment Management Co. in Singapore. "The longer the pressures continue, the more gradually difficult it will be."

Several factors so far have helped to prevent problems in individual emerging markets like Pakistan and Turkey from turning into a global contagion.

Clear communication from the Federal Reserve that it would raise rates gradually has given emerging economies time to adjust. A powerful display of IMF firepower, which came to Argentina's rescue with a $50 billion bailout package that was later expanded to $57 billion, RELATED

- Pakistan Requests IMF Bailout Talks
- IMF Lowers Global Growth Forecasts

reassured investors that other countries wouldn't be allowed to spiral out of control, economists say.

Officials in many emerging markets also have made some difficult adjustments of their own. Indonesia's central bank, for example, has raised short-term interest rates five times since May and intervened in the currency market to stabilize the rupiah.

The government also delayed construction of power plants that would have required imported goods and raised a tax on some foreign products. The Reserve Bank of India lifted borrowing costs twice this year. Mexico raised its target interest rate to 7.75% from 5.75% last year. Negotiators from rival political parties worked together to hash out a rewrite of the North American Free Trade Agreement, resolving a key source of uncertainty.

The Institute of International Finance, a banking group in Washington that tracks emerging markets, was among the first to sound the alarms about vulnerabilities in emerging markets, arguing that a number of markets—most acutely Argentina and Turkey—had dramatically overvalued currencies.

Now that so many emerging market currencies have fallen, they no longer appear so out of whack.

"The most egregious FX overvaluations have been eliminated," Robin Brooks, the chief economist of the IIF, said in an email. That means there is less country-specific risk and more broad-based risk, such as a sudden devaluation of the Chinese yuan or rising U.S. inflation, he added.

In its global economic forecasts released last week, the IIF said the biggest risk to emerging markets is no longer the currency turmoil from earlier this year, but rather the risks of a slowdown in China, perhaps exacerbated by escalating tariffs between Beijing in Washington.

The IIF's forecasts project that Argentina's and Turkey's economies will contract in 2019, but nearly all other major emerging markets will continue to expand.

Newsletter Sign-up

What has so far been a mostly orderly adjustment in emerging markets could worsen if U.S. interest rates rise more than expected. Yields on 10-year U.S. Treasury bonds have climbed to their highest level since 2011. That draws capital out of emerging markets and into the U.S.

"Emerging and developing economies are already feeling the pinch," said IMF managing director Christine Lagarde in a speech previewing themes for discussion at the IMF's annual meetings. "That process could become even more challenging if it were to accelerate suddenly."

**Write to** Josh Zumbrun at Josh.Zumbrun@wsj.com, Paul Hannon at paul.hannon@wsj.com and Saumya Vaishampayan at saumya.vaishampayan@wsj.com