Emerging markets are again being whipsawed by the two largest economies in the world.

The surging Chinese economy, a large contributor to world growth in recent years, shows signs of cooling. And with the US economy firming up, the Federal Reserve has started cutting back on its bond-buying programs.

The change in the global economic and financial climate is prompting international investors to take a critical look at their investments in emerging markets, and don’t like what they’re seeing. For one thing, economic growth is slowing in many of these countries, due to economic mismanagement and political uncertainty.

This is a problem, especially for countries such as Argentina and Turkey, which need investor money to finance sizable current account deficits. The fact that they’re facing internal political turmoil doesn’t exactly make them a magnet for global capital at the moment, either.

Despite all this turmoil, it is unlikely that more than a couple of emerging markets are exposed to the sorts of destructive currency crises that many faced in the 1980s and 1990s. Most emerging market countries now have much less foreign debt than in those earlier decades (relative to their economic size). Also, a significant portion of this debt is denominated in local currencies.

Moreover, most emerging markets now have floating exchange rates—their currency values are volatile but at least their central banks are not trying to target specific currency values, which could make them subject to speculative attacks. And finally, many emerging markets have enough foreign exchange reserves to cover their debt obligations, although not enough to protect their currencies from sharp volatility.
Indeed, emerging market economies with relatively large stockpiles of foreign exchange reserve and trade surpluses seem to be weathering this episode fairly well—at least so far.

In fact, if there’s one lesson that emerging market policymakers might take from the recent history of volatility it’s this: They can never have a cushion of foreign currency reserves that is thick enough. In other words, emerging market countries now have even stronger incentives put in place policies—such as holding down their exchange rate and boosting exports—that help them sock away more reserves. Those buffers serve as a kind of insurance policy and help reduce dependence on foreign finance.

But that’s not the end of the story. These countries will have to park their pile of foreign exchange reserves somewhere. And that place will likely be US Treasury securities, in other words, the US dollar.

Hence, as I argue in my new book, *The Dollar Trap*, we will once again behold a paradox that has played out repeatedly during and after the financial crisis. The world will come to US financial markets to protect itself from turmoil created in small or large part by US policies themselves.

*Eswar Prasad’s new book, The Dollar Trap: How the US Dollar Tightened Its Grip on Global Finance, will be published next week.*