

The International Financial Crisis

What Next For Emerging Markets?

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By now we are in the middle of an unusual financial crisis with global proportions. Already many articles are being written about the causes of the crisis, its patterns and developments, and lessons to be drawn. More will be written over many years and views about causes and lessons will remain somewhat unsettled for a while. But as the Danish philosopher Kierkegaard said, “Life can only be understood backward, but it has to be lived forward.” And so, in the middle of the crisis, here are some perspectives on four broad themes:

- the dimensions of the crisis;
- the phase we may be in right now;
- the broad impact on emerging markets;
- the debates on the future of policy advice; and the international financial architecture.

Dimensions of the crisis in financial markets

Freeze in interbank markets

In September 2008 interbank markets in the United States and European economies were disrupted in unusual, if not unprecedented, ways. Financial institutions and even corporations came to rely mainly on central bank funding. In an attempt to shore up cash positions financial institutions placed a lot of liquidity right back with the central bank. The resulting excess liquidity held by the Federal Reserve, for example, rose

to levels not seen since the Great Depression—sort of once-in-a-century event. All this despite a number of actions by central banks to provide ample liquidity to markets. From this perspective the extraordinary level of uncertainty and fear, including worries about an actual return of that Great Depression, is understandable.

The dramatic developments in financial markets gave rise to unprecedented activism by central banks and governments, particularly in the United States and Europe. We are benefiting from the fact that people like Federal Reserve Chairman Ben Bernanke, who wrote “the book” on the Great Depression, did not mistake excess liquidity at the central bank as a sign of excessive liquidity, in markets. Beyond provision of extraordinary liquidity, the authorities tried to tackle the ever more apparent root causes of the problem, notably insolvency in important parts of the financial system. Not everything went smoothly, whether in the genesis of the U.S. TARP program or the European response starting with the Irish decision to guarantee deposits of Irish banks. Yet, all in all, the response by governments has been impressive and so far shows signs of dealing with the breakdown of trust in financial markets.

The cost of the rescue so far

However, “rescues” come at a cost. TARP, for example, amounts to about 5 percent of the U.S. GDP. As it tends to happen in financial crises, ultimate costs

end up higher than estimated. Let us assume, for argument's sake, that gross costs go to 10 percent of GDP. It currently seems likely that the United States will be able to fund this cost at moderate interest rates, say 4 percent, quite possibly less. Funding debt equivalent to 10 percent of GDP at 4 percent would impose an extra fiscal charge of 0.4 percent of GDP. If the government succeeds in recovering value for taxpayers, and if interest rates remain lower, the cost would shrink further. Compare this to the 17 episodes of financial distress studied in the IMF's October 2008 World Economic Outlook. The average cost of rescues was 16 percent of GDP and real interest rates were, if anything, higher. From this perspective, the current troubles may turn out to be quite manageable.

The difference with past episodes is, of course, that this time the world's largest economy, and many other very large ones are involved. So the sums are unprecedented. Also the United States has now reached gross debt levels, if one consolidates Fannie Mae and Freddie Mac, of over 110 percent of GDP. Net debt levels are surely significantly lower, but we may recall that 10 years ago, Japan was downgraded from AAA to AA when its debt reached levels of about 110 percent and 40+ percent of GDP, respectively.

Of course the size of rescue packages will vary among countries, as will the cost of financing. The key point is that what we see so far are packages that are not unusually large compared to past ones. In emerging markets, that is also the case. For example, the Hungarian rescue is currently equivalent to about 18 percent of GDP, very similar to the Mexico package in 1995 and Indonesia during the East Asian crisis. However, more countries are affected and the share of global GDP dedicated to rescue operations has increased.

Global economic growth

Finally, consider global economic activity. In mid-October 2008 the IMF came out with a forecast of some 3 percent of global growth for 2009. That would be a significant slowdown from over 5 percent

growth in recent years but still about half a percentage point higher than during the Asian crisis. In recent days the IMF downgraded its forecast to a little over 2 percent—based on recessions in many developed countries and a slowdown of emerging markets from roughly 8 to roughly 4 percent. Two percent is still higher than the worst economic slowdown since World War II, that of 1981/82, when global growth reached about 1 percent. If the crisis response works it might still be possible that the world will test the lows of 1982. However, it remains very unlikely that we will see a repeat of the Great Depression—barring major policy mistakes, including protectionism. Whatever happens, it is likely that 2009 will be the first year when 100 percent of any global growth comes from emerging markets.

The current phase of the crisis

One might distinguish two major forces playing out at the moment and their effect on emerging markets—the problems of financial institutions and the recessionary forces that have now spread across the world.

Effects of the financial crisis

In recent months stock markets in emerging markets have fallen as drastically as in the Asian crisis countries 10 years ago. Currencies have depreciated significantly, although less so far than in the Asian crisis countries 10 years ago. Countries that looked relatively strong on typical indicators of vulnerability, such as current account deficits and rapid credit growth, have been hit in this way such as Brazil and Mexico. At the same time countries that showed less favorable macroeconomic vulnerability indicators, such as some smaller economies with less developed financial markets hardly saw their exchange rates budge.

A possible explanation for this *prima facie* surprising picture is the search for cash of financial institutions in developed countries. As the current quip has it, “their balance sheets have nothing right on the left hand side and nothing left on the right hand side.” As financial institutions search for cash in this process, they take

it where they can. Hence stronger players with liquid markets are vulnerable because of that strength, whereas smaller illiquid markets are of lesser interest.

Now, as interbank and commercial paper markets appear to be improving, the pressure to withdraw cash from wherever one can find it may subside again.

Forces of Recession

For some time now, a slowdown in some markets has been underway. U.S. consumption has slowed down since 2006 as the large current account deficit of the United States finally started to unwind. Asset bubbles are bursting—most notably housing bubbles. Consumers are less wealthy. They consume less. Even in China the rapid slowdown of growth to about 6 percent in Q3 of 2008 (down from 12 percent a year earlier) may in part be due to the bursting of the domestic real estate bubble.

Financial institutions rode the bubbles, creating ever more debt secured by assets that now implode. To restore the health of their balance sheets they need to find either equity or shed debt. Finding equity has become harder. So shedding debt (deleveraging) is the order of the day. Deleveraging may take a substantial amount of time, possibly even a few years, until it is truly over everywhere.

A background study by the IMF for the October 2008 World Economic Outlook shows recessions tend to be more severe when preceded by a financial crisis and a housing bubble. So the ingredients are in place for a significant slowdown globally and recessions in many countries, mostly in the United States and in Europe.

As the global slowdown unfolds, underlying “typical” vulnerabilities of countries may well become more prominent again such as high current account deficits and rapid credit growth. More countries will be affected through channels such as lower exports, lower tourism receipts, lower remittances and the like. In the first round several countries in Eastern Europe appear most vulnerable, less so countries

in Asia, Latin America, the Middle East, and even Africa.

As the global slowdown spreads, poorer countries will be hit more, for example, through reduced exports, falling remittances, and lower tourism receipts. The poorest of the world were recently hit by a food and fuels shock, which may have pushed as many as 100 million people into extreme poverty. They now face a financial and fiscal shock with additional and severe consequences. For the first time in decades the source of the trouble is in rich countries—all the more reason to hold those countries to their aid commitments despite fiscal challenges.

As mentioned earlier the world may well test the depths of the 1981 slowdown. Trade may fall in absolute terms for the first time since then. Currently the IMF forecasts a 2.5 percent drop in trade. A dramatic signal is provided by the Baltic Dry Index, which captures shipping conditions. It has collapsed from 15,000 to 892 over the last year and a half. The fall is presumably due to the switch from very tight capacity constraint that drove the index up extremely high to a situation of excess capacity. We also see some trade credit disruptions due to the financial crisis. The stresses on trade are among the most worrying features of the current situation. It will be good to remember that the Great Depression arose from the interaction of inappropriate monetary policies and rising protectionism. Today’s monetary policy response appears very sensible. Hopefully, protectionism can be prevented.

Among the practical steps to revive growth and job creation are practical reforms of the business environment. For example, the Scandinavian countries reformed their business environments substantially following the dramatic financial crises of the early 1990s. Precisely because the immediate crisis response tends to raise fiscal costs, and because the forces of recession raise unemployment, it is critical to do what can be done to generate new jobs and sources of tax revenue. Creating more dynamic business environments that make it easier to set up domestic small and medium enterprises, that make it easier for firms to grow, and

that create competitive conditions to encourage innovation and upgrading is critical. Access to finance for small businesses is best supported by improving credit bureaus and collateral systems so that trust in new debtors can be built more easily.

Perspectives on financial vulnerability of emerging markets

The “fundamentals”

In recent years many emerging markets have strengthened their economic fundamentals, built up foreign exchange reserves, reduced debt and improved fiscal positions. Nevertheless, sovereign bond spreads for emerging markets rose from about 450 bp in September 2008 to 891 on October 24. Emerging markets seemed quite vulnerable after all. And yet, bond spreads rose no more than traditional models expected given the increase in market uncertainty as the IMF’s forecasting models suggest. In fact, emerging markets with strong fundamentals saw their bond spreads rise less than forecast by the models. In the last week or two spreads have come down by about half the rise and have narrowed over developed country spreads.

This is encouraging as many have feared that the many blanket guarantees in rich countries would make financing costs for poor countries even worse. It is also intriguing to see that we have so far not seen significant real interest spikes in emerging markets hit by currency weakness and essentially no resort to capital controls. If truly short term liquidity issues (the search for cash by rich country banks) caused much of the stress on emerging markets currencies and stock markets then this would make sense. The extension of swap lines by the U.S. Fed to Brazil, Korea and Mexico would equally make sense from this vantage point. But matters look more worrying for Eastern Europe for the reasons mentioned above.

Commodity prices and deleveraging

Both the fall in commodity prices and the global deleveraging tend to reduce fears of inflation and have indeed given rise to fears of deflation in some countries.

While some emerging markets still experience inflationary pressures, the trade-off between inflation fighting and coping with a slowdown would broadly diminish and facilitate macro-economic policy-making.

Of course, a fall in commodity price would in many countries help to cushion the slowdown as it increases incomes. Even countries that export commodities might not be too badly hit as the commodity bubble was fairly recent and many oil exporters, for example, still budgeted with oil prices in the order of \$70 per barrel.

Long-term growth prospects

Notwithstanding the impending global slowdown, long-term growth prospects for emerging markets remain strong. For several decades now trend growth rates in emerging markets have risen steadily. Underlying this are the very “advantages of backwardness” (in the words of Gerschenkron). Emerging markets can catch up relatively fast with rich countries as they can adopt and adapt technologies, business practices and government organizations that have already been invented elsewhere. Unless the global knowledge and trading system breaks down this should continue.

In 2008 emerging markets accounted for about 45 percent of global GDP (evaluated at purchasing power parity exchange rates). On recent trends, this share will rise above 50 percent by 2013, and by 2050, emerging markets may well account for around 80 percent of global economic activity.

Policy responses

The unprecedented strong policy response by developed countries and the mostly prudent policies in emerging markets augur well for a solution to the crisis. By happenstance, the IMF is also relatively well positioned to respond as it had few clients recently and can now deploy some \$250 billion. The Fed and ECB have been flexibly supporting some emerging markets—Brazil, Hungary, Korea and Mexico.

The World Bank is also making its contribution. IBRD stands ready to ramp up lending to some \$100

billion over the next three years and its private sector arm, IFC, is planning to direct up to \$30 billion of operations towards crisis resolution over the same period. The World Bank advises governments on crisis preparedness in the financial sector—a topic of great interest currently for many emerging markets not yet hit by the crisis. The Bank currently also provides advice on distressed bank resolution and work-outs in three countries—together with the IMF in two and one other as free-standing advice to the government. IFC’s operations will emphasize help with short-term liquidity issues, especially trade finance, with Bank recapitalization through a special fund and commercial approaches to improve the work-out of non-performing assets.

The impact on financial flows to emerging markets

What we may then see is the following scenario. Foreign direct investment in emerging markets may not slow too much given long-term growth prospects. Portfolio equity flows may be especially hard hit right now by the search for cash, but may well resume in the near future. Non-bank debt investors are also again eyeing emerging markets as deeper local currency-denominated financial markets are likely further to rise in importance—not least as a protection against dependence on international markets. Bank debt on the other hand may continue to be hard to come by as banks continue the deleveraging process for quite some time.

The future of international financial sector policy

There is much talk these days of the need for fundamental reform, of “Bretton Woods II,” of summits. Consider just a few perspectives on what may emerge.

Global sources of liquidity for emerging markets

Up to now the concert of rich country central banks has provided liquidity to markets mostly within their own countries, but also beyond in some cases (Brazil, Korea, Mexico, Singapore). New providers of liquid-

ity are being courted and are emerging. Saudi Arabia just held out an offer of \$4 billion to Pakistan. China, Japan, and Korea are setting up an \$80 billion facility for Asian nations. A new consortia may form among central banks, governments with strong foreign exchange reserves, and international financial institutions.

Yet there remain lingering doubts whether the current system can provide enough liquidity if things get really worse in emerging markets. The resources of the IMF alone may not suffice as various analysts have argued. New players and the consortia may help but may still not be enough or in time.

There is one more radical approach that is conceptually “simple”: expand the IMF’s ability to create SDRs from a few hundred billions of dollar equivalent to a few trillion. That would be a feasible solution without dreaming up new institutions.

Regulatory co-ordination

Financial markets have become more global and contagion spreads from country to country. Clearly it makes sense to find ways for regulators to exchange more relevant information across borders on a timely basis through mechanisms such as regulatory “colleges.” It might even be possible to agree on more basic principles that govern the conduct of cross-border regulation. It gets more difficult when determining who should pay for rescue operations. It may also be hard to get agreement on practical ways to intervene with banks and seize their operations across borders. Conceptually solutions may be found, but politically this will be hard even within common areas like the EU and even more so between countries like the United States and China.

Substantive rules

Some areas for reform are relatively clear and “easy.” These cover agreement on greater transparency in markets (regarding, for example, rating agencies), greater standardization and a better settlement system for derivatives and some other areas in the field of financial market infrastructure.

Then there will be calls for greater state involvement in ownership of financial institutions. Here there will be greater reliance on various forms of (partial) state ownership, particularly as part of rescue operations. However, in the longer run there is no reason to believe that state ownership makes financial institutions more prudent. In several rich countries state-owned banks have had as much or more trouble than private ones. In many emerging markets there is a legacy of governance problems associated with state banks. More likely a variety of pragmatic responses will prevail and many financial institutions will be returned to the private sector as in the past.

The core issues revolve around better prudential regimes. The scope of regulation will be much debated. Unregulated institutions will be brought under oversight. Off-balance-sheet vehicles will be scrutinized more assiduously and more consolidation enforced—under the “duck-spotting” principle: “if it talks like a duck, walks like a duck and looks like a duck—it is a duck.” Some regulators have already practiced this to some degree, as in Spain. Hence progress is clearly possible.

Then there is the issue of systemic risk that each financial institution by itself neglects. Each institution may feel it is right to continue taking risks as long as all others do and the aggregate amount of risks and system-wide feedbacks may not be taken into account by its risk models. This calls for stronger assessment of systemic risks by regulators. It also calls for powers for regulators to say “the party is over” before everybody is “too drunk.” This will be hard. Conceptually it is not straightforward to assess systemic risks. Politically it may be even harder. When a regulator makes the right call a crisis is avoided, but the party

is stopped. There will be strong resistance by those who party because it will be hard to demonstrate that a crisis is indeed around a corner but it will be easy to show how unpleasant the end of the party is.

Finally, there is a renewed debate about how to find ways to avoid pro-cyclical regulation and other related policies. This would end up requiring regulators to “see through the cycle.” A similar challenge arises for monetary policy and its ability to avoid accommodating bubbles. Conceptually this is hard. Again it would require giving the relevant authorities greater powers. Greater powers can be abused and politics may not allow them to be used well.

It is clear that action is required to help prevent the recurrence of the type of crisis we just saw. Some talk of the need for a “Bretton Woods II.” It might be useful to remember that it took the Great Depression, World War II and the existence of a dominant global power to get to Bretton Woods. None of these factors are in place today—thankfully. In the world today new powers are rising. Any solution that is to endure for decades will take them into account in new ways. But by the same token there is no easy way to build global consensus when a major transition in global power is underway. Hence the search should be on for practical steps that can help, not for grandiose solutions.

The efforts of central banks and other authorities in this crisis have shown that even without a truly global financial regime much can be done. Of course, one needs to be careful with reforming too much in the midst of a crisis. But if practical steps can be taken and as long as the global knowledge and trading system are preserved, the world is set to come out of the crisis intact and with continued prosperity for all. ■