



## THE FINANCIAL TURMOIL AND THE LESSONS FROM THE EMERGING WORLD *by: José María Fanelli (CEDES)*

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### The International Crisis and the Gloomy Expectations about Future Growth

The world is undergoing the worst financial turmoil in decades. Many observers argue that the size and severity of the disequilibria are comparable to those that followed the 1929 stock market crash. It is no wonder, then, that expectations about the evolution of the global economy are gloomy. Indeed, pessimistic expectations have become a problem per se. Bad expectations about the evolution of the real economy are feeding into the current value of assets, impeding the stabilization of stock prices and the restoration of credit.

What can be done to combat gloomy expectations? Two steps are both urgent and important; first, restore liquidity and overcome the credit crunch in advanced economies so as to dampen the effects on the global economy; and second, to implement counter-cyclical policy packages to reduce the risks of a painful global recession.

The authorities in developed countries will surely act aggressively on the fiscal, monetary, and financial fronts. However, since the crisis is global, national efforts must be coordinated if they are to be effective. Looking at the way in which the global economy overcame the recessionary forces at work in earlier crises, it is clear that developing countries were key. This suggests that preserving growth in emerging economies is decisive to avoiding the risk of a global economic collapse.

### Financial Crisis, Volatility and Institutions: the Experience of Emerging Countries

In the last two decades, financial shocks – either external or domestic – have had a strong deleterious effect on growth in emerging countries. The following set of features has been typically present in financially troubled emerging countries.

- Misguided macroeconomic policies and/or weak financial regulations and supervision, which resulted in excessive external exposure, have traditionally played a central role in nurturing financial disequilibria.
- Emerging countries have a limited institution-building capacity and it is very difficult to preserve good policies and rules under volatile conditions and political turmoil. One particularly negative effect of crises is the destruction of institutions, making it very difficult to re-build the regulatory infrastructure under volatile conditions.
- Financial disarrays have been extremely costly from the fiscal and political points of view. The fiscal imbalances provoked by the bailout of the banking system eroded public debt sustainability. Furthermore, crisis-related fiscal expenditures crowded out social and public investment expenditures, affecting development and political legitimacy.

- Via credit crunch, financial stress has always caused strong output losses and reduced investment. Key in this regard has been the inability to conduct appropriate fiscal and monetary policies in a context in which capital flows behaved counter-cyclically, driven by sudden changes in risk aversion and domestic de-leveraging. In addition, the resources that international financial institutions (IFIs) provided to counterbalance capital outflows and ease the credit crunch did not suffice to significantly smooth aggregate fluctuations. More often than not, the conditionality attached to the funds did not help, either.

- The simultaneous occurrence of financial and real shocks (for example, interest rate and terms of trade shocks) compounded the size of growth collapses.

- The overall stability of world capital markets was never seriously jeopardized by emerging countries' instability. Consequently, troubled economies perceived the global economy as an opportunity to overcome the downturns that accompanied national/regional crises. In particular, a number of countries adopted a "mercantilist" stance aimed at recovering growth by boosting exports and increasing central bank reserves.

### global growth will depend on the ability to coordinate counter-cyclical policies with the reform of the international financial architecture

In light of these stylized facts, the spread of the current financial turbulence to emerging and less developed countries is raising serious concerns. One additional source of uncertainty is that the crisis has novel characteristics. In contrast earlier analysis considered that financial instability was primarily a national problem, rooted in policy and institutional flaws and, consequently, that problem should be addressed domestically.

A good number of emerging countries gave serious consideration to this diagnostic and acted accordingly. First, they made substantial efforts to strengthen financial regulations and supervision. Second, macroeconomic policies were considerably streamlined. Steps were taken to increase the independence of the central bank and to implement fiscal responsibility laws aimed at containing public debt. Third, to face sudden capital stops and create room for anti-cyclical responses, emerging countries have been accumulating reserves and creating sovereign funds. These efforts were rewarded. In the years that preceded the sub-prime crisis, risk premia fell and some bonds were re-classified as investment grade.

The strategy based on sounder macro fundamentals and domestic institutions plus self-insurance seemed to work well and, in such a context, efforts to improve the international financial architecture faded. Then the current crisis hit the coasts of emerging economies, revealing that international coordination and cooperation were necessary after all. It is no wonder, then, that there are strong demands to restructure the international financial architecture institutions in order to address the global imbalances and regulatory problems in a coordinated way.

## Coordination Failures and the Policy Challenges Ahead

These stylized facts suggest that future global growth will depend on the ability to coordinate counter-cyclical policies with the reform of the international financial architecture and pro-growth policies. Among the most relevant international coordination failures that could jeopardize financial stability and growth in developing countries the following deserve consideration.

First, self-insurance can be self-defeating. The current crisis is associated with global imbalances which are probably not independent of self-insurance strategies. That is, the fear of sudden stops may have helped create a savings “glut” in some key emerging economies and induce excessive consumption and bubbles in certain developed countries. In addition, an excessive supply of loanable funds may have endogenously induced a relaxation of monetary policy and of the supervision of credit markets. In the 1990s, a distressed country could rely on the world economy to foster its post-crisis economic recovery via exports. If emerging countries hit by the financial turmoil followed this strategy all together in the near future, it would worsen international trade conditions. The disincentive to mercantilist, beggar-thy-neighbour policies calls for international coordination.

Second, fast growth in emerging economies in recent years has been greatly favoured by exports of manufactures in the case of Asia and of natural resources in the case of Africa and South America. The sustained growth in exports, in turn, has been facilitated by the evolution of aggregate demand and imports in the US economy. The current crisis strongly indicates that the post-2001 global growth dynamics had been unsustainable. The emphasis on exports as the engine of growth in emerging countries will have to be complemented with stimuli for domestic absorption. But more domestic absorption means lower current account surpluses and, *ceteris paribus*, lower reserve accumulation and less reliance on self-insurance against external shocks. The reforms in the international financial architecture will have to allow developing countries to achieve the same level of hedging against global risks with lower reserves. It is necessary, then, to organize an efficient network of arrangements to supply short-term facilities for emerging countries facing liquidity constraints. This should embrace not only an appropriate reform of the IMF but also the mobilization of the funds of surplus countries and the organization of regional pool arrangements.

Third, it should be noted that the current global imbalances are associated not only with pitfalls in financial regulations and monetary policies, but also with pronounced and long-lasting changes on the real side of the global economy. The most salient are the sharp changes in productivity and international competitiveness (China, India), in relative prices (oil and natural resources), and the world’s sources of savings and effective demand (USA).

Monetary policies and the adjustments in exchange rates in the developed world were not efficient enough to facilitate the correction of global imbalances, if we are to judge by the results. Policy and regulatory decisions were mainly made at the center of the global economy but they also affected the periphery. It seems only natural that emerging countries demand a greater involvement in the decision-making process. This, of course, calls for voice and representation in the institutions of the international financial architecture.

## Conclusions

The protection of world growth is vital to avoid a painful global depression. Just-in-time facilities should be made available to prevent credit crunch and facilitate counter-cyclical fiscal and monetary actions aimed at sidestepping serial downturns in the developing world. Since the problem is global, these facilities should not be circumscribed to “strategic” emerging economies and the conditionality should both provide incentives to adopt sound policies and protect economic activity. In this sense, the recent steps taken by the IMF and the Fed to preserve the liquidity of financial markets in key emerging economies are only first steps in the right direction. The extended facilities should not be circumscribed to short-run liquidity problems and should not overlook non-strategic countries. To this purpose, institutional mechanisms should be designed to mobilize the resources of countries that are generating a structural surplus.

Policy decisions oriented to correcting the existing global imbalances must consider the effects on the developing world. This is particularly relevant with respect to exchange rates and initiatives to restore liquidity conditions in the global markets. Developing countries must be able to participate in the groups and institutions that seek to coordinate international decisions in accordance with their significance among the global sources of growth.

It is time to tackle the issues of international reserves creation and of designing efficient multilateral arrangements for the provision of international liquidity. Lack of success in providing this global public good will result in suboptimal, probably unstable, unilateral/regional solutions. In particular, this is central for emerging countries to avoid inefficient strategies of self-insurance. A dysfunctional IFA creates incentives for the authorities to follow “mercantilist” strategies and manipulate exchange rates.

Feedback effects between volatility and institutions will continue to haunt developing countries. This is why policy actions should seek to minimize the negative effects of the global turbulence on the institutional infrastructure that supports financial intermediation in developing countries. The reforms of the international financial architecture must be coordinated with the reforms of the domestic financial architecture.

Institutional reconstruction is far more difficult in emerging economies and recommendations about standards and codes will not be enough; developing countries need a blueprint and appropriate strategies for institution building and enforcement. It is central to take into account the idiosyncratic features of emerging economies: the types of shocks that normally hit the economy, the degree of volatility, the quality of the overall institutional framework, and political constraints.

Finally, it must be kept in mind that political legitimacy matters for institution building. Macro volatility in developing countries will probably increase as a consequence of the international crisis. Volatility will reflect on domestic absorption and consumption, as a result, poor people will get poorer. Stabilization policies must be accompanied with more efficient and well-founded safety net mechanisms, and mobilizing resources for development must be part and parcel of the strategies to strengthen the banking sector and capital markets.

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