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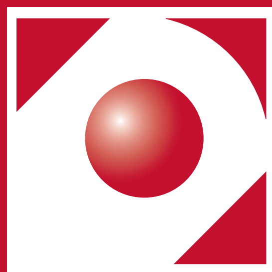

Emerging Markets Forum

A nonprofit initiative of the Centennial Group

The Impact of the Financial Crisis on Emerging Market Economies:

The Transmission Mechanism, Policy Response and Lessons

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Discussion Draft

Global Meeting of the Emerging Markets Forum 2009

Emerging Markets Forum[1]

The Impact of the Financial Crisis on Emerging Market Economies:

The Transmission Mechanism, Policy Response and Lessons

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[1] The Emerging Markets Forum is a not-for-profit venture of the Centennial Group, a Washington based strategic advisory firm specializing in emerging market economies. The Forum was created to allow senior political and corporate leaders and public servants to reach actionable conclusions on economic, political and social issues facing emerging market economies. The agenda for the Forum is driven by the priorities of the emerging market countries

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The Impact of the Crisis

The financial crisis that began in the United States in the sub-prime mortgage market in 2007 and that spread quickly to Europe has become a global crisis, affecting both financial systems across the globe and economic activity in virtually all countries. Emerging market countries have been hit hard. Even those countries that had strengthened their policies and built defenses to withstand a less benign global environment than that which existed for much of the previous decade have not been spared.

The serious nature of this still-unfolding crisis is evident in the increasingly pessimistic picture painted by forecasts for economic growth. Since the beginning of the crisis in 2007, forecasts for growth rates in 2008 and beyond have been repeatedly revised downward. As of this writing, this monotonic pattern of downward revisions has yet to be reversed. The latest projections from the IMF World Economic Outlook are shown in Table 1.

Table 1: GDP Growth Projections
(in percent)

	2008	2009	2010	2011
World	3.2	-1.3	1.9	4.3
Advanced Economies	0.8	-3.8	0.01	2.6
US	1.1	-2.8	-0.05	3.5
EU	1.1	-4.0	-0.3	1.7
Japan	-0.6	-6.2	0.5	2.2
Emerging Market Economies	5.2	0.01	3.2	5.7
Emerging Asia	6.3	2.5	5.0	7.6
Emerging South Asia	7.0	4.3	5.3	6.6
Emerging Europe	4.0	-4.8	0.7	3.6
Emerging Americas	4.0	-1.7	1.6	3.5
Emerging Middle East	5.3	0.5	2.4	3.9
Emerging Africa	4.8	1.5	3.7	5.2
Newly Industrialized Asia	1.6	-5.6	0.8	4.4
Developing Asia	7.7	4.8	6.1	8.3
China	9.0	6.5	7.5	10.2
India	7.3	4.5	5.6	6.9

Source: IMF, World Economic Outlook, April, 2009

The global economy is now expected to contract this year by 1.3 percent – the first such contraction since the Second World War. However, this figure hides significant differences among countries and regions. The worst affected regions include emerging Europe, the CIS countries and the newly industrialized Asian economies, each of which is expected to see contractions in GDP in 2009 near or even above five percent. Some other regions are expected to do much better, including the emerging market countries of South Asia, Africa and the Middle East, most of which are expected to avoid recession. But there is a wide range of projections even within regions. Most notably, while emerging Asia as a whole is projected to grow by 2.5 percent this year, the developing countries within the region are set to grow at near five percent, while the newly industrialized countries are projected to contract by 5.6 percent. The worst hit counties are expected to include Singapore (-10 percent), Taiwan-China (-7.5 percent), Hong Kong-China (-4.5 percent) and Korea (-4 percent). China and India, the largest emerging economies in the region and in the world, are projected to grow by 6.5 percent and 4.5 percent, respectively. While surprisingly good in the current environment, these growth rates are, of course, below those registered by these countries in recent years. Some of the reasons for this diverse performance will be touched upon in subsequent sections of this paper.

The global contraction is forecast to give way to renewed growth next year, with world GDP increasing by almost two percent. Again, however, the performance in the advanced economies is expected to be

markedly different from that in the emerging market economies; and growth rates within regions are also expected to vary substantially. The major industrial economies are expected to see little or no growth year-on-year in 2010, and, at best, to return to potential only at the end of the year. The emerging economies, however, are projected to grow by over three percent, with Asia leading the way at about five percent. Once again, the developing countries in Asia are expected to register the best performance. As always, there are significant caveats about these projections. However, there are recent signs that the bottom may have been reached in a number of countries, including in Asia, so that the next revision of these projections may see at least a halt to the repeated worsening of the picture seen over the last two years. For example, the most recent data from China indicate that investment spending, bolstered by the stimulus package introduced late last year, has risen to record highs, bank lending is already ahead of the government's target for all of 2009, industrial production is expanding significantly, and retail sales have recovered.

That said, there are well known lags in the recovery process – including in the recovery of employment. This is particularly the case in the advanced economies where employers commit to new hiring only after clear signs of a rebound in activity. Thus, in most of the industrial world, unemployment is expected to continue to increase throughout most of 2010, causing continued pain. Moreover, there will be a critical question about the sustainability of any recovery. A return to the global imbalances of the past decade will threaten that sustainability.. Renewed global growth will be secure only if the macroeconomic structures of a number of economies – especially the savings balances in the United States and China – emerge as significantly different from what they were in the lead up to the current crisis.

The Transmission Mechanism

The transmission of the crisis from the U.S. and Europe to the rest of the world came through a number of channels. The financial institutions in most emerging market economies had not engaged in the kind of practices seen in the institutions that populate the financial centers in the major industrial countries. Balance sheets were typically not exposed to the toxic assets that increasingly dominated positions in the major institutions. Derivatives were employed much less frequently and were generally limited to the more traditional instruments employed to hedge against currency and other risks associated with trade. Financial institutions in the emerging economies either shied away from the more exotic instruments, including such things as credit default swaps and collateralized debt obligations, or were prevented by regulation from holding or trading such instruments. Banking was generally of the more "boring", old fashioned kind!

But, in the end, this did not protect these countries. Five major channels brought the crisis home to these economies:

- First was the withdrawal of funds by some of the major financial institutions from their subsidiaries located in the emerging economies. The general contraction of the balance sheets of the major institutions and the need to rebuild their capital base has constrained the funding available to other institutions in both the industrial countries (e.g., hedge funds) and in the emerging world that rely on dollar (or even Euro) funding. This has been the case notwithstanding the massive support injected into banking systems in the financial centers that are home to most of the major international banks.

- Second was the seizing-up of the international credit markets. Credit flows through the international banks and global bond markets to emerging market countries all but dried up. This has created significant financial stress in some of those countries – especially those in central and Eastern Europe – that ran up dangerously large current account deficits and took on substantial international debt. For example, BIS data show that consolidated claims of BIS-reporting banks on all emerging market economies decreased from a peak of $5.4 trillion in June, 2008 to $4.6 trillion by December – a decline of over 14 percent. No emerging

market regions were spared, and all of them saw similar declines. Recent anecdotal evidence suggests that this withdrawal has continued in most regions. Data on capital flows show an even more dramatic picture. Net private flows to emerging market countries peaked at about 5 percent of GDP in 2007. However, all categories of inward flows to emerging market countries have registered significant declines from 2007 to 2008 and are projected to decline further in 2009. The cumulative decline in the major categories of flows to emerging market countries between 2007 and 2009 are currently expected to be very large: 62 percent for international bond issues; 61 percent for commercial bank loans; and 54 percent for inward direct investment. (Table 2) The flow of export credits to the emerging market countries as well as inward portfolio investment all but collapsed in 2008. The withdrawal of portfolio investment was a key factor behind a decline in emerging stock markets that exceeded the sharp declines in advanced economy markets.[3]

Table 2: Capital Flows, Export Financing and International Reserves

(US$ billions)

	2006	2007	2008	2009	2010
Emerging Market Countries:					
Export Credits	37.4	48.7	62.6	-100.8	13.5
International Bond Issues	133.8	189.0	142.4	71.4	100.6
Commercial Bank Loans	403.9	505.1	453.0	195.6	254.7
Inward Portfolio Investment	156.0	231.4	-214.3	-55.2	76.9
Inward FDI	487.6	656.8	674.0	299.1	399.6
Change in International Reserves	724.2	1,248.5	458.5	-393.3	135.4
Emerging Asia:					
Export Credits	13.1	16.5	28.0	-42.0	7.5
International Bond Issues	46.1	46.5	39.4	23.5	30.4
Commercial Bank Loans	100.8	102.3	81.5	37.3	52.0
Inward Portfolio Investment	106.9	184.0	-159.8	-68.1	29.3
Inward FDI	215.6	303.1	317.2	127.2	165.1
Change in International Reserves	416.6	711.3	423.1	-37.7	110.8
Emerging South Asia:					
Export Credits	3.6	3.2	6.8	-6.1	2.1
International Bond Issues	5.9	6.2	5.8	4.7	5.2
Commercial Bank Loans	10.2	9.8	9.2	7.0	8.2
Inward Portfolio Investment	6.9	36.5	-15.6	5.5	16.1
Inward FDI	25.1	31.2	47.7	32.6	38.3
Change in International Reserves	43.2	102.7	-25.1	-37.6	-15.0

Source: The Economist Intelligence Unit

In total, emerging market economies – especially those that are heavily indebted and face large financing requirements both from current deficits as well as from the need to refinance maturing debt - have seen a substantial decline in all major categories of capital inflows. Some of the worst affected countries have also recorded significant capital flight and sharp depreciations of their currencies. All of this has been reflected in a substantial fall in international reserves, with emerging market countries in all regions of the world other than East Asia recording significant declines; emerging countries in Europe were the most seriously affected.

- Third, was the impact of the crisis on economic activity - in the first instance, in the United States and Europe, and subsequently in Japan. Initially, this manifested itself in a sharp

[3] That pattern has now been reversed with emerging stock markets significantly outperforming advanced county markets since the beginning of this year.

contraction in exports from those emerging market countries that had become the largest exporters to the industrial world. Quite rapidly, however, exports declined from the other emerging economies, i.e., those whose exports consisted of raw and intermediate goods shipped to those larger emerging market countries, particularly China, that had become key providers of final manufactured goods in the increasingly complex supply chains that came to populate world trade.

This fall in exports – at a virtually unprecedented rate of collapse - created an internal feedback loop wherein the initial reduction in trade weakened the domestic economies of the emerging market countries, with further negative feedback on the financial sectors in those countries as the quality of domestic credit deteriorated.

- Fourth, are the still uncertain prospects for remittances – an important source of income and foreign exchange in many emerging market economies. Total remittances to emerging market countries were over US$ 206 billion in 2007 and are estimated to have reached more than $230 billion in 2008 (Table 3). Like unemployment figures, remittances tend to lag the decline in economic activity – and will likely lag in the recovery. While recent data are sketchy, remittances to emerging market countries appear to be falling significantly and are estimated to total only about $170 billion this year before recovering somewhat to about $195 billion in 2010.[4] Such projections are subject to a wide margin of error and are dependent on an assumed recovery in the global economy. Interestingly, the transfer of domestic remittances, i.e., those remittances that go from individuals who have moved to urban areas in search of employment and higher income to those left behind in the rural or less developed regions of a country, have also declined. This is helping to transfer the weakness in the export and service sectors in emerging economies to parts of those countries that otherwise would have been less affected. The return of workers from abroad could put additional pressure on these regions as those workers seek employment in already depressed economies.

Table 3: Workers Remittances

(US$ billions)

	2006	2007	2008	2009	2010
Remittance inflows to: Emerging Market Countries	172.3	206.2	231.7	170	195
Emerging Asia	86.3	111.8	132.9	95	115
Emerging South Asia	38.7	50.4	63.3	46	57
India	25.7	35.0	45.0	30	40
China	22.5	32.0	37.0	26	34
Philippines	14.9	15.6	16.8	12	11
Vietnam	4.8	7.6	9.3	7.8	7.9
Bangladesh	5.5	6.9	8.5	6.7	7.8
Pakistan	5.4	6,0	7.1	6.8	6.9

Emerging Markets Countries are classified as Algeria, Angola, Argentina, Bahrain, Bangladesh, Bolivia, Botswana, Brazil, Bulgaria, Cameroon, Chile, China, Colombia, Costa Rica, Cote d'Ivoire, Croatia, Czech Republic, Czechoslovakia, Ecuador, Egypt, Estonia, Ethiopia, Ghana, Hong Kong (China), Hungary, India, Indonesia, Iran, Israel, Jordan, Kazakhstan, Kenya, Korea, Kuwait, Latvia, Lithuania, Madagascar, Malaysia, Mauritania, Mauritius, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Poland, Romania, Russia, Saudi Arabia, Senegal, Serbia, Serbia and Montenegro, Sierra Leone, Singapore, Slovak Republic, South Africa, Sri Lanka, Taiwan (China), Tanzania, Thailand, Togo, Trinidad and Tobago, Tunisia, Turkey, Uganda, Ukraine, United Arab Emirates, Uruguay, Venezuela, Vietnam

Source: The Economist Intelligence Unit

4 In Asia, remittances are expected to fall by almost 30 percent this year to $95 billion from the peak of over $130 billion reached in 2008, but to rebound to about $115 billion in 2010. The countries in the region that are the largest recipients of remittances (India, China, the Philippines, Vietnam, Bangladesh and Pakistan) will see flows decline from over $123 billion in 2008 to less than $90 billion in 2009. A recovery to about $107 billion is forecast for 2010.

- Fifth, and finally, is the psychological factor. The world has become all too familiar with financial cries. But a financial crisis originating in the United States and spreading quickly to other industrial countries took most of the world by surprise. So did the severe worsening of the crisis in September and October, 2008 which saw the collapse of some of the world's most prized private financial institutions and extraordinary – and untested – policy actions by industrial country governments. This was quickly followed by a seizing-up of financial markets around the world, a massive loss in asset values, and a virtually unprecedented collapse of exports. It is fair to say that no one was prepared for this, and that it undermined the business plans and expectations of almost everyone. The decline in asset values, especially of equities and houses, and the rapid rise in unemployment brought that insecurity and its accompanying fear to consumers. Financial systems and economies are driven by confidence. These events thoroughly shook consumers' confidence, causing a self-aggravating feedback to the rest of the economy. This experience may well affect the nature of any recovery in ways as yet not fully understood.

The Policy Response

Reserve- Enhancing Measures

Virtually all emerging market countries have been affected by these developments. However, the policy responses have been very different and go some way to explain the diversity of growth prospects pointed to above.In light of the impact of the crisis on the availability of capital through the international financial markets, a number of countries have entered into swap arrangements so as to strengthen their reserve positions. The largest such operations have involved the U.S. Federal Reserve Bank entering into temporary reciprocal currency arrangements for the provision of dollar liquidity with Brazil, Mexico, Singapore and South Korea. Other bilateral swap arrangements have been agreed or increased, and a number of multilateral arrangements have been discussed, e.g., through the G7 and through the Chiang Mai Initiative. A significant number of emerging market countries have turned to the International Monetary Fund (IMF) for support. Since mid-2008 – after a steady decline in both the number of countries borrowing from the IMF and in the outstanding claims of the institution on member countries – fourteen emerging market countries have secured IMF financial support totaling more than US$53 billion. The largest financing arrangements have been with Hungary, Pakistan, Ukraine, Belarus and Iceland. Most recently, Mexico has availed itself of the IMF's new Flexible Credit Line (FCL) in an amount of about $47 billion. This arrangement, the first under the IMF's new crisis prevention facility, is intended to be precautionary and the Mexican authorities have indicated that they do not intend to draw on those resources. With the absence of a quick recovery in international credit markets, the IMF is likely to see increasing demand from emerging market countries facing declining exports and the need to roll-over substantial amounts of international debt.

Measures to Strengthen Financial Sectors

Measures taken by some countries have attempted to address the impact on the banking sector and the financial sector more generally of both the direct effects of the financial crisis and the emerging effect of weakening domestic economies. In at least twenty emerging market countries, existing deposit insurance schemes have been modified to broaden the kinds of deposits covered or to increase the maximum amount covered. A number of countries in Asia that had not previously had deposit insurance schemes have introduced them as a means of bolstering public confidence in their banking systems.

Other measures directed at the banking and financial systems have included capital injections and other support mechanisms for domestic banks, both to assist banks in meeting minimum capital adequacy standards and to support bank lending operations, especially in the critical area of trade credit. Many of the measures taken have been ad hoc and have confronted the same problem that surfaced in the more advanced economies, i.e., the consistency and coordination across borders of measures to support domestic banking systems. (See the section below on lessons from the crisis for more on this issue.)

Fiscal Stimulus Packages

Along with most of the world's more advanced economies, a large number of emerging market countries have also introduced ambitious fiscal stimulus packages. For example, the emerging market countries that are members of the G20 have taken significant measures to bolster domestic activity. Of those 11 countries, only Turkey has chosen not to introduce a special stimulus package. The largest such initiative by far has been undertaken by China. A package comprised solely of expenditure measures is estimated by the staff of the IMF to amount to US$93.3 billion in 2009 and an additional US$102 billion in 2010 - over two percent of China's GDP in each of those years. The packages announced by the other countries in the group total over US$80 billion, with India accounting for US$6.8 billion. On average these stimulus packages are estimated to add almost 1.5 percent to the GDP of most of these economies. In a number of countries, automatic stabilizers that lower the tax burden or increase public spending will add to the impact of these discretionary measures. However, the impact of those stabilizers is generally minor and varies significantly across the emerging market countries.

There is considerable variation across these countries in the composition of these stimulus packages. On average, about one-third of the measures comprise direct government tax cuts and other revenue measures to spur private spending and about two-thirds comprise expenditure measures. In virtually all countries the expenditure measures are heavily weighted towards infrastructure spending. In China, for example, the stimulus package is comprised solely of expenditure measures. In India, on the other hand, about one-third of the measures are temporary indirect tax reductions. Some of these emerging market countries that are taking these measures are those that have built up sizeable international reserves and have run significant fiscal surpluses in recent years. These policies have created both fiscal space and the reserves needed to manage large stimulus packages. Other countries, India included, have been more constrained in their capacity to employ fiscal stimulus to help counter the impact of the crisis. Still other countries, especially in Eastern Europe, have had no scope to take such actions and, indeed, have had to take measures to tighten expenditures.[5]

For some other countries, stimulus packages – along with the impact of declining levels of activity in their economies – will worsen both fiscal positions and debt profiles in the short run. These realities have led a number of countries to hesitate in announcing further stimulus measures for 2010. This caution is warranted, not least as the global conditions for securing new financing that confront these countries – and the private sectors in these countries – may deteriorate further. That will depend on the extent to which the contraction of international capital flows to these countries since early 2008 will be reversed. That, in turn, will depend on how the unprecedented levels of borrowing by many of the major industrial countries affect conditions in the global markets, including interest rates.[6]

Protectionist Measures

Unfortunately, and in contrast to the generally constructive measures described above, protectionist trade measures have also been part of the response to the crisis. Recalling the experience of the 1930's, the leaders of the G20 signed a pledge at their November 15, 2008 summit to avoid protectionist measures. That pledge notwithstanding, by February 2009, 17 members of the G20 had implemented 47 restrictive trade measures. According to the World Bank's monitoring list of trade and trade related measures, 66

[5] The recent actions taken by Latvia to reduce its budget deficit, in large part through sharp cuts in spending, constitute one of the most dramatic examples of such policies.

[6] The OECD estimates that its member governments will issue almost $12 trillion in debt (gross) in 2009, about one-third more than the $9 trillion issued two years ago. The U.S. alone is expected to sell almost $8 trillion in government securities. There have already been some troubling signs in government debt markets in the industrial countries: a failed issue by Germany earlier in the year; a recent sharp uptick in the 10 year bond rate in the United States and a generally poor reception to the government's 10-year bond auction which saw an unusual yield markup on issue.. In the market for U.S. debt in particular, there is an additional threat of "roll-over risk" as the average maturity of government debt is only about 4.7 years – unusually short by industrial country standards. In the emerging market countries, there are troubling signs as well. There was a failed auction by Latvia of $100 million in short term treasury bills in early June; and warnings have been issued by some of the rating agencies over the creditworthiness of some Asian countries, including the lowering of outlooks for India and Taiwan from stable to negative by Standard and Poor's and a cut in Malaysia's long term local currency rating from A-plus to A by Fitch.

trade-restrictive measures have taken effect since the beginning of the crisis.[7] Developed countries have relied solely on subsidies and other support packages. Developing countries have employed a variety of measures, including subsidies, import duties, import bans and non-tariff measures. In the developed countries, and particularly in the high income countries, subsidies to the auto industry have proliferated and are estimated to total $48 billion worldwide. But the emerging market countries have also been active in the automotive sector, especially in protecting their component suppliers. Protectionist tendencies have also been evident in the financial sector: virtually all nations have focused their financial sector subsidies on domestically owned banks rather than subsidiaries of foreign banks.

While many of these protectionist measures, thus far, are relatively minor, they are of significant importance for particular exporters. They also reflect a trend that contradicts the pledges made by the countries in the G20, both developed and emerging economies. This is a matter of concern and warrants close monitoring and publicity to help stem this tide. There is no need to learn again the lessons of the 1930's!

Decoupling

The impact of the crisis in the US and Europe on the emerging market economies has surprised some analysts. A proposition had been put forward that the emerging economies had "decoupled" from the industrial world to a degree that would permit them to more easily absorb the impact of a slowdown in economic activity in those countries. The serious global impact of this crisis would seem to put the lie to that proposition. The evidence is growing that decoupling has not occurred to anything like the extent that would be needed to isolate the emerging economies from a weakening of activity in the industrial world.[8] Indeed, it could be argued that the explosion of global trade – the major force in the rapid growth of many of the emerging economies over the last few decades, together with the design of the world's supply chains, as well as the ever-increasing integration of financial markets has, in fact, increased the coupling of the emerging market economies – and many of the poorer developing countries - with the industrial world.

Perhaps even more important, beyond trade, other inter-linkages have developed that increase the dependency among various groups of countries and, in some ways, reverse the direction of influence. For example, for years it was the developing world and the emerging market countries, in particular, that were dependent for their financing on the global financial markets centered in the industrial countries. Large current account deficits in the emerging market countries were financed through capital flows from the industrial world. Much of that financing took the form of bank loans until the mid 1980's; and then increasingly took the form of flows through the bond markets. That story ended in the financial crises in Latin America in the 1980's and in Asia and elsewhere in the 1990's and the first few years of this millennium. Important lessons were learned in those crises and many of the emerging market countries fundamentally changed the management of their economies. Macroeconomic policies became more orthodox; policy-making institutions were strengthened; and the flow of capital shifted dramatically. Together with the rise in crude oil and other commodity prices, the rapid growth of emerging market countries with high savings rates, and the shift in the United States to negative savings by both the government and consumers, fundamentally changed the nature and the flow of capital – and dependency – among the world's economies.

[7] These measures do not include "automatic" increases in agricultural protection, contingent protection (e.g., anti-dumping), WTO-sanctioned measures to retaliate against trading partners that have not complied with findings of a WTO dispute settlement panel, or financial sector subsidies. Antidumping cases surged in 2008, with initiations rising by 15 percent and findings with imposition duties growing by 22 percent. India is the most active, accounting for 29 percent of total initiations. See Trade Protection: Incipient but Worrisome Trends, Elisa Gamberoni and Richard Newfarmer, in Trade Notes, Number 37, The World Bank, March, 2009.

[8] Some of the original arguments about decoupling rested on the ever-increasing trade among the emerging market economies themselves. But much of this trade reflected the fundamental shift that was occurring in the locus of manufacturing – the supply chain – in the global economy. Much of that trade between the emerging market economies – and, indeed, even between the industrial and emerging market economies – reflected the specialization of manufacturing in different countries on inputs and components that were then shipped elsewhere for further processing and assembly before shipment to the final user. In many ways, this led to an increase in the inter-linkages between economies rather than a reduction. Interestingly, this increased interdependence through supply chains may have helped limit the protectionist response of some countries to the downturn in the global economy as export interests are relatively much more powerful than before in many countries.

The increase in commodity prices was further evidence of the shift in influence that was taking place. It was the rapid growth of many of the emerging market countries themselves that led to the sharp rise in commodity and raw material prices. That development, in turn, became the dominant influence on inflationary pressures in the industrial world, limiting the power of traditional central bank policy instruments to control domestic inflation. Thus, the interlinkages between the industrial and emerging world have become far more complex and multi-dimensional – and the very concept of decoupling seems almost quaint! The framework of analysis can no longer be limited to the impact of the level of activity in the industrial world – or the impact of a single market, such as that for equities - on the emerging market economies. As important are the influence of high savings rates and capital flows from the emerging economies to the industrial world – and especially to the United States.

Thus, rather than a decoupling, an increased inter-dependence has emerged. Policy in the industrial countries needs to anticipate the impact of growth in the emerging world (through the effects on commodity prices, for example), and the impact of changing savings rates and portfolio investment preferences on interest rates and exchange rates. In turn, policy in the emerging market countries needs to anticipate the impact of changing levels of activity in the industrial world on exports and on foreign direct investment, and changing savings rates, especially in the U.S.

Notwithstanding the apparent power of these arguments, the proposition that emerging market countries have de-coupled from the industrial world still finds some favor. In a recent issue of the Economist (May 22-29, 2009) it is argued that (1) "…the biggest emerging economies are less dependent on American spending than commonly believed;" and (2) "…they have proven more able and willing to respond to economic weaknesses than many feared.". The first of these propositions may turn out to be correct. That will be tested if the recent increase in savings by the American consumer persists and the spending rate does not recover to earlier levels.[9]

Perhaps more important, it is not clear that the second point made above has much to do with the basic concept of decoupling. Decoupling is a proposition about the impact of a slowdown in activity in the industrial or developed world on the level of activity and growth in the emerging, and developing world. If the emerging economies have shown that they have the capacity to offset that impact to some degree through their own countercyclical policies, that is to be welcomed. But one should not confuse that with decoupling. That is, instead, a matter of the extent to which emerging economies can offset the impact of changing levels of activity in the countries to which they are coupled. So long as they remain coupled, the important questions will be to what extent they have the capacity to take such offsetting action. It is not a matter of taking solace in the possibility that there will be no impact.

This interpretation of what may now be happening is important. It leads to questions about what emerging market countries need to do to keep themselves ready to respond to a slowdown in the industrial world. It does not suggest that they need not be so prepared because they have decoupled! The reason that many emerging market economies were prepared to design and implement policies to help counter the impact of the current recession in most of the industrial world was the result of the fundamental shift in the practice of economic management that took place in those countries in the wake of the financial market crisis that hit so many of them from the mid 1990's until the early 2000's. Far more responsible fiscal policies were introduced in many countries; inflationary risks were taken more seriously and monetary policy was more singularly focused on that objective; better regulation – and greater transparency – was introduced into banking systems; many governments got out of businesses that are better left in the hands of the private sector; international reserves were increased by substantial amounts – in some cases excessively; and so on. These were hard won achievements, but they have paid off in faster growth and in a capacity to counter contractionary forces

[9] That outcome would appear quite likely – at least for a number of years, as a structural shift appears to be taking place in the saving habits of individuals in response to the significant decline in asset values that has occurred. The assumption that saving out of current income was unnecessary as wealth could more painlessly be accumulated through ownership of houses and other real assets has been severely tested and found wanting. It is no coincidence that the highest net debt to GDP ratios in the U.S. were registered just before the depression of the 1930's and just before the current crisis. In the earlier episode, the saving rate increased, and debt levels fell, for a long period after the depression.

originating elsewhere. If some of the emerging market countries succeed in their efforts to stabilize their economies and to maintain or restore growth, they should ask which policies allowed them to do that and how they can maintain that readiness in the future. Other emerging economies that skated closer to the edge with weak fiscal positions, over-borrowing, lax regulations, unsustainable borrowing, weak debt management policies, and mistaken capital market liberalization polices should learn from the success of the others.

Lessons from the Crisis

Against this background, a number of critical policy questions now confront the emerging market countries. Mmuch work will be needed to sort through the lessons of this crisis. This paper will raise only four of the questions that need to be addressed – both individually by these countries, and collectively by both the emerging and the more developed countries. These include:

1. What has been learned about financial sector regulation and supervision in the current crisis? More generally, what is the appropriate model for emerging market countries to look to in designing their financial regulatory systems?

2. Did the accumulation of large stocks of international reserves by many of the emerging market countries put them in a better position to confront the current crisis? Was it beneficial from a longer term cost/benefit perspective, or was it overdone? Related to the question of the appropriate level of reserves, are there lessons to be learned about the dominant role of the U.S. dollar as the primary reserve asset in the global system?

3. What preliminary lessons have been learned about the capacity of the emerging market economies to engage in stimulative domestic monetary and fiscal policies in the face of a softening or a contraction of global demand? What conditions are necessary for such measures to be both feasible and effective and how powerful can the impact of such measures be on the global economy? And

4. A number of countries, in Eastern Europe and elsewhere, have been severely damaged by the reversal of capital flows in the past year. In many cases, the fault has been seen to lie, at least in part, in the policies pursued in opening their capital markets. What are the lessons that have been learned? What should be done to avoid a repeat of this experience in these and, as importantly, in frontier emerging economies? Is there a greater role for the IMF here?

These are all difficult questions. In the remainder of this paper, the first three questions will be elaborated upon to begin a discussion of the issues they raise. The last question is addressed in separate papers and may be an element in the discussions to take place in subsequent days regarding the reform of the IMF and of the global economic and financial architecture.

Financial Sector Regulation

One of the major factors leading to the current crisis was what many consider to have been inadequate regulation and supervision both within and across those countries that host the global financial centers and the major international financial institutions. It was facilitated by the extraordinarily weak performance of many of the credit rating agencies – which failed in their most fundamental fiduciary responsibilities. Much of this stemmed from the persistent trend towards deregulation in the U.S. – driven more by ideology than by evidence; from an almost blind faith in the efficient markets hypotheses; from the competitive pressures that undermined prudent financial risk management in some of the major global financial centers; from the possibilities that existed to arbitrage regulations across jurisdictions; and from the complexity of some of the financial innovations of this period.

Notwithstanding the increased complexity of the global financial markets, much of the regulatory failure

resulted from ignoring the basics. It was a failure to demand basic transparency in the financial system - from the special investment vehicles (SIVs) that have come to plague the banking system in the U.S., and in the trading of credit default swaps and other exotic – and, it might noted, formerly illegal – instruments. It was reflected in inadequate capital and liquidity requirements that failed to keep up with the innovations that were taking place in the banks and in the financial system more generally. But perhaps most importantly – and most inexcusably – many of the problems that developed stem from a simple lack of attention to the incentives that were permitted to build in the system. The result was that the system went from "exotic" to "toxic" in short order!

Take just the example of the sub-prime mortgage market in the United States.

- Mortgage originators held virtually none on the debt they created; they sold it off as fast as possible after the mortgage was signed and got their fees. As a result, they had little interest in the quality of the credit; they had, as is said, "no skin in the game"!

- The mortgages were then quickly sold to Wall Street to bundle with other mortgages into securitized instruments to be sold to investors. Those doing the bundling received their fees and, like the originators, had little interest in the quality of the credit. Wall Street profited enormously from this business and quickly developed a voracious appetite for mortgages to slice and dice into more and more exotic instruments, putting further pressure on the originators to deliver more and more mortgages.

- The compensation structure in the banks and other institutions was based on the short term payoff to activities such as this. It was divorced from the longer term risks that the institutions were taking on – especially as they began to hold these instruments themselves on their own balance sheets or off-balance sheet in the SIVs.

- The rating agencies – which should have cared about the quality of the credit, and had a fundamental responsibility to have such concerns – received their fees from those who had bundled the mortgages and were trying to market them. If a particular rating agency did not provide the rating wanted by the issuers, it would lose the business to a more willing agency. This represented a clear conflict of interest; but nothing was done to halt the process.

- The target investors, who were searching for yield in a low interest rate environment that was allowed to persist for far too long, failed in their own due diligence. If those investors saw some risk in the instruments they were purchasing, there were other institutions that happily sold the credit default swaps to insure against default. But those latter institutions saw virtually no risk of default and failed to provision anywhere near sufficiently against those losses. They even sold insurance to investors who did not own the underlying instrument they were betting against. This is a big part of the AIG story!

Where were the regulators and supervisors while all this was going on? They were apparently blinded by the deregulation mantra that had developed, by the priority to home-ownership that became policy in the United States and in some other countries, and by the view that central banks could not, in any case, do anything to prevent bubbles.[10] And so they let the party continue! Unfortunately, regulators in some other

[10] There is an interesting contrast between the U.S. and Canada as regards the regulation of the mortgage market. In the U.S., interest payments (within generous limits) are deductable from federal income taxes; minimum required down payments all but disappeared during the housing boom that began in the mid 1980's; mortgage originators were not required to hold on their own books any part of the mortgages they created. The vast majority of mortgages ended up being bundled into securitized instruments, further distancing the debtor from the ultimate creditor; and most mortgages were written with variable interest rates, many with "teaser" initial rates. Many of these policies and practices were introduced or endorsed as a means of encouraging home ownership in the United States. By contrast, in Canada, none of these policies or practices was permitted. But the results in the two countries are remarkable. In recent years, the home ownership rate in the U.S. reached a peak of 68.4 percent of the population. In Canada, the rate has been around 68 percent! Canadian banks, now amongst the largest in the world, have suffered virtually no mortgage related losses in the current crisis. There is surely a lesson here!

jurisdictions were also paying too little attention. In the end, the crisis spread to other countries and to other markets from mid 2007 to mid 2008 – mostly through banks and other financial institutions that had taken on risks similar to those taken on by the large banks in the U.S.

Fortunately, there is now significant public pressure in both the United States and Europe for a reform of the financial regulatory framework. Fortunately, as well, most regulatory regimes in emerging market countries never adopted the de-regulation fervor that affected the United States. But still there are lessons to be learned from the experience in the United States and Europe. There is a very large agenda to be covered in considering the reforms needed to better regulate and monitor financial systems. A paper prepared in the IMF earlier this year set out that agenda rather clearly.[11] The main elements were listed as follows:

- Instituting a macro-prudential approach to supervision and assigning a clear mandate to a systemic stability regulator.
- Expanding the perimeter of financial sector surveillance to ensure that the systemic risks posed by unregulated or less regulated financial sector segments are addressed.
- Ensuring that prudential regimes encourage incentives that support systemic stability and discourage regulatory arbitrage, and assure effective enforcement of regulation.
- Addressing the procyclicality of existing capital requirements and other prudential norms, preferably in a manner that is rules based and counters the cycle.
- Filling the information gaps, especially with regard to lightly regulated financial institutions, and ensuring that both supervisors and investors are provided more disclosure and a higher level of granularity in information provided.
- Resolving the political and legal impediments to the effective regulation of cross-border institutions; developing special insolvency regimes to be used for large cross-border financial firms; and harmonizing remedial action frameworks.
- Strengthening the capacity of central banks to provide liquidity and respond to systemic shocks.
- Improving the capacity of national authorities to respond to systemic crises, including by establishing mechanisms for coordination both within and across borders.
- Establishing the basis for fiscal support during the crisis containment and restructuring phase, and an exit strategy for withdrawing public support and for a transition to a new and more stable financial market structure.

An additional item could be added to this list that should be on the agenda of every financial sector regulator in the world. Should financial institutions be prevented through regulation and supervision from ever becoming too large to fail?

This is an ambitious agenda and will require the active engagement not only of national regulators and supervisors but also of the relevant regional and international bodies such as the Basel Committees, the international standard setting agencies, the Financial Stability Board, and others. It will also require a broadened surveillance mandate for the IMF, especially to widen the focus of its Financial Sector Assessments (FSAPs) and to make them mandatory.

[11] "Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management", International Monetary Fund, February 4, 2009.

Considerations on the Accumulation of Reserves

When considering the policies of emerging market countries that warrant re-thinking, the reserve accumulation policies of some of those countries over the last decade must be near the top of the list. This is, of course, related to the undue reliance on exports as a source of growth for many emerging market countries and the associated trade and current account surpluses that resulted. The global imbalances of the past decade are an integral element of the tapestry that led to the explosion of credit that took place across many corners of the global economy and, ultimately, to the financial crisis in the United States. In turn, those imbalances were made possible by the decline in savings in the United States – both by consumers and by the federal government. At least for American consumers, this is changing and it will force a rethinking of the policies of the last decade – in both the United States and in many of the largest emerging market countries. At the federal government level, both in the U.S. and elsewhere, the current deficits resulting from the stimulus packages, the support measures for the financial sector, and other policies are, in general, the appropriate response to the current crisis. However, those deficits cannot be sustained without threatening the credit worthiness of the country or forcing tax and spending adjustments that will be politically unacceptable. So change will come. It will either be forced in a disorderly manner, or it can be managed through policy adjustment. The latter would obviously be a better process!

But there are other reasons for change. Some emerging market countries, China in particular, have persisted with polices that one can argue may not have been in their own best interest. They have accumulated far larger reserves than can be justified by almost any logic and done so at the cost of more rapid improvement in the living standards of their people.[12] Also, they have accumulated assets – dollar denominated, and sometimes yielding negative returns – that suggest that this has been a very costly trade off for these countries.[13] In the case of China, there are different views regarding what can be done to increase spending by Chinese consumers – a sine qua non for an orderly correction of the imbalances. Some argue that the creation of social safety nets – already underway by the Chinese authorities, will decrease the felt need to save. Others argue that the high savings rates are, at least in part, the result of (relatively) declining rural incomes in the country and that greater infrastructure and other investments and an expansion of banking in those areas will help bring about the needed change. Whatever the remedy, most observers believe that it is possible through changed policies to generate much larger internal demand in China. The outcome of China's current stimulus package may hold important lessons in regard to the capacity to spur domestic demand through public policy.

Such a fundamental restructuring of the Chinese economy and some other large emerging market economies will cause these countries to become somewhat less coupled to the industrial world, and to the U.S., in particular. This is probably to the good for the performance of the global economy. However, this will occur in an orderly manner only if this systemic issue is addressed through internationally coordinated policies. The IMF has a role to play here both in the conduct of its surveillance responsibilities and in its role as a forum for the engagement of senior policy makers on the economic and financial issues that confront individual countries and the global economy. However, it will have the authority and capacity to play that role only if fundamental changes are made to the governance structure and some of the operations of the institution.[14]

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[12] An important question regarding the IMF needs to be addressed in this connection: was one of the motivations for the large reserve accumulation that took place in so many emerging market countries motivated, at least in part, by a lack of trust in the institution? The IMF is, among its other functions, intended to be the global reserve-pooling organization. Why have the emerging market countries felt the need to insure themselves through the accumulation of their own excessively large holdings of reserves? Some of this has to do with the experiences of those countries that fell into crises over the past two decades in dealing with the IMF; some of it had to do with the increasing stigma that became attached to borrowing from the institution; some of it may have come from the perception – and reality! – that the resources available to the IMF were not nearly sufficient to the needs of 21st century global financial markets; and some of it may have been the result of a growing disparity in the IMF between the economic and financial place of these countries in the global system and their place in the governance structure of the IMF. Hopefully, the reforms recently made in the IMF and those that are now under discussion will fundamentally change the institution in a way that will permit all countries to see it as a trusted partner in the event of a need for financial support.

[13] It is also likely that the existence of these claims – in the form of obligations to foreign holders of US treasury bills and agency securities – led to second best policy choices by the U.S. government in deciding on actions to deal with certain aspects of the recent financial crisis.

[14] See Jack Boorman, "Global Governance and Reform of the International Monetary Fund: An Update", Emerging Markets Forum, Mumbai, India, June 24, 2009.

Stimulus Packages

The third question raised above can be answered only as more experience is gained with the policies that emerging market countries have designed and implemented to help counter the current recession. While the initial impressions are generally positive, it will take more time to see their results and judge their effectiveness. There has been debate on the potential costs and benefits of such measures since the crisis turned for the worse in the fall of 2008 and countries began to introduce stimulative packages. At the meeting of The Group of Twenty in Washington, D.C. in November, 2008 a Declaration was issued by the Leaders pledging to "Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability".[15] Commitments were also made, with fiscal implications, to "Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system".

Even as the measures were being prepared and announced, many of the familiar critiques of fiscal policy were voiced:

- Fiscal policy – especially spending measures - inevitably acts with sometimes long and unpredictable lags. This runs the risk that the impact on the economy may well be felt only after the economy has already begun to recover.

- The effectiveness of spending measures is likely to be adversely affected if those measures are rushed and not subjected to the scrutiny possible in calmer times.

- The possibility of withdrawal of the stimulus is limited when large projects are involved and which must be brought to completion to produce intended results.

- Such spending can be counterproductive in terms of its impact on the economy if it is not accompanied by a credible plan to restore fiscal rectitude so as to avoid adverse or negative effects in the financial markets.

These and other arguments must be taken seriously if fiscal stimulus measures are to have their intended effects. Needless to say, it is not possible to generalize across the many countries that have adopted such policies, nor has there been sufficient time to assess the impact of most of the packages that have been announced and are being implemented. But there are some negative signs already emerging that must be taken seriously and, to the extent possible, used to adapt policies already announced or even in place to counter the potential negative effects. Many of the stimulus packages have focused on infrastructure. There can be no doubt that almost all countries are in need of sometimes substantial investment in infrastructure to improve the growth prospects of their economies. However, those projects with long planning horizons and long gestation periods must be kept under review to avoid a situation in which such projects inappropriately crowd out private spending as a recovery begins to take hold. To the extent such projects are judged to be worth pursuing, consideration should be given to raising taxes to pay for them.

Even more important, plans must be elaborated for the withdrawal of stimulus: tentative plans to cancel or phase out projects, plans to increase taxes to better marry the size of the stimulus to the needs of the economy as recovery takes hold. Credible plans to wind down and reverse the stimulus and to restore long term, sustainable fiscal positions should be elaborated. This last point is worth emphasizing in light of the enormous financing demands that are going to emerge from the measures already announced by so many countries. The financial tensions emerging in the debt markets cannot be permitted to intensify to the point where they begin to crowd out emerging private activity that will be needed to sustain any recovery. As noted earlier in the paper, this is already becoming an issue. In the recent downgrades and lowered outlooks

[15] Declaration: Summit on Financial Markets and the World Economy, November 15, 2008.

announced by the credit rating agencies, the "…fiscal deterioration associated with providing support for their respective economies …" has been highlighted. The impact on interest rates and on the receptivity of markets to debt auctions is already becoming evident.

None of this argues for premature withdrawal of the stimulus that is needed to help foster a sustainable recovery in many countries and in the global system. The lessons from the reversal of policies in the United States in 1937 and in the similar experience of other countries need to be remembered. However, the markets will need to be continuously reassured that these policies are temporary and that they will be adjusted to the needs of the economy as their impact begins to be felt. This is also an argument for better global coordination of these policies. The markets that fund sovereign debt are global and the policies that affect the behavior of participants in those markets must be globally coordinated and consistent.

Conclusion

Some of the causes of the current crisis are clear. These include the failure to correct the global imbalances that ballooned in the years leading up to the crisis; the absence of the needed degree of transparency in financial markets; the failures of national regulatory and supervisory systems and the absence of sufficient mechanisms for international regulatory coordination; the failures to prevent the emergence of perverse incentives in the financial system, especially in mortgage markets in the United States; the willingness of senior people in the banks and other financial institutions to accept financial innovations and instruments that even they now admit they did not understand. And there are many others.

In general terms, the lessons to be learned are implicit in the causes. But there is a great deal more that needs to be done to translate the lessons into specific measures that will have the power to correct the practices that got the world into this mess – and that has been so costly both to societies and to so many individuals. The measures needed will affect both domestic agencies and international organizations.

Discussion in this Forum can make an important contribution to the ongoing debate about preventing another crisis of the nature and magnitude now confronting the entire world. In addition to the three questions elaborated above, other questions that would be worth discussing include the following:

1. Have the emerging market countries decoupled from the industrial world to any significant degree or have the two groups, on the contrary, become even more mutually dependent on each other? Is "decoupling" - framed as a proposition about the linkages between the major industrial countries and the emerging market countries - even a useful concept any longer? Are not the inter-linkages between the larger emerging market countries – China, Brazil, India and others – becoming analytically and empirically just as relevant?

2. What are the prospects that the macroeconomic structures in key countries that led to the global imbalances of the last decade – and helped bring about the current crisis, will change with a recovery in those countries, avoiding a return to another unsustainable pattern of growth?

3. Related to this, can the emerging market countries succeed in stimulating their domestic economies, i.e., by structurally increasing domestic demand, if growth in the industrial countries remain as weak, or even weaker, than projected?

4. What are the prospects for access by the emerging market countries to global credit and capital markets given the continued deleveraging that is likely to occur in major financial institutions and the possibility that they will be crowded out of the debt markets by sovereign borrowers facing the need to finance unprecedented fiscal deficits and to roll over existing debt?

5. Is protectionism a serious threat? Is it possible that the authorities in countries adopting such measures are carefully responding to the inevitable political demands for protection in a recessionary environment while not doing much that could threaten a recovery of trade?

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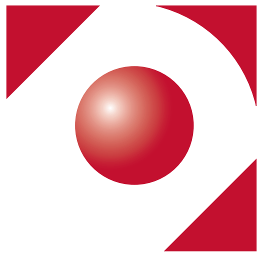

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