

The Global Financial Crisis and Development Strategy for Emerging Market Economies

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The global financial crisis of 2008–09 is a watershed event that cries out for a reexamination not only of industrial countries' financial systems but also of growth strategies in developing countries. I will argue that the worst of the crisis is over, and that the developing countries are emerging with less damage than in the debt crisis of the 1980s, for Latin America, and the financial crisis of the late 1990s, for East Asia. Nonetheless, serious fiscal challenges will confront the industrial countries in the coming years, as a consequence of bailout costs and recessionary fiscal losses. Moreover, several key emerging market economies will need to reorient their growth strategies away from mercantilist trade surpluses toward production for domestic demand and greater expansion of balanced trade among themselves.

Why should one think that the worst of the crisis is behind us? This crisis was the first of the postwar period to be caused by a near-collapse of the banking system in the advanced economies. The aggressive measures taken by the Federal Reserve, Treasury, and FDIC have stabilized the US banking system. The great anxiety that the main banks would have to be nationalized has now passed. Confidence has been revived by the stress test exercise that greatly increased transparency and demonstrated that it would require even worse loss rates than in the great depression to cause severe jeopardy to the banks' capital position. Several major banks have now repaid the Troubled Asset Relief Program (TARP) money, and if the other key banks need more capital, they will simply become somewhat more nationalized as they sell more shares to the government, rather than collapsing.

Some worry that European banks are in severe danger, and cite the International Monetary Fund (IMF) estimates of larger credit losses ahead (\$750 billion) than for the US banks (\$550 billion). But those losses would be against a much larger asset base in the eurozone (\$34 trillion in bank assets) than in the United States (\$11 trillion). So it is unlikely that European banks in general are in worse shape, although those that are disproportionately exposed to Central Europe may be. If the heart of the crisis was the shock to the banking system, then overcoming that shock should mean that the worst part of the crisis has been overcome.

The forecasts do indeed show moderate recovery next year from this worst recession since the Great Depression. Based on IMF and private sector forecasts, industrial countries' output will fall nearly 4 percent this year, but be back to positive growth of 1 percent next year (figure 1). Emerging Asia will do the best, returning to 6 percent growth next year after keeping positive growth of nearly 4 percent this year. Latin America, Eastern Europe, the Middle East, and South Africa should return to about 2 percent growth next year after sharp declines this year (especially in Europe). The overall pattern is that this global recession is

worse than the one in 1982 for industrial countries (especially Japan, where output will fall 7 percent this year), but not as severe for Latin America, nor as severe as the late 1990s crisis for East Asia.

The forecasts are counting on a sharp reversal of severe setbacks in late 2008 and early 2009. In the main industrial countries, industrial production in the first quarter was about 20 percent below a year earlier (figure 2). Given the tight interconnection in international production chains, there was a corresponding collapse in exports of both industrial and emerging market economies. The plunge in exports for countries such as China and Singapore is evidence that the main problem has been foreign demand, not lack of export finance (given their massive reserves).

Nonetheless, markets are signaling that the worst is over for emerging markets. Risk spreads on the JP Morgan EMBI+ index surged from 200 basis points at the end of 2007 to 750 basis points at the height of the crisis, but are now back to 450 basis points (figure 3). This level is moderate compared to the far higher ranges in the crises of the late 1990s and the Argentina-Brazil crises of 2001–02. Moreover, because US long-term Treasury base rates are far lower than in the earlier periods, the actual level of the emerging market sovereign interest rates are lower than might be inferred from the spreads. Indeed, this time the crisis has mainly been for corporates rather than sovereigns.

Stock markets are also showing a bounce-back from the depths of the crisis for emerging markets, except in Eastern Europe (figure 4). Similarly, emerging economies that allow flexibility in their currencies experienced a sharp decline at the acute phase of the crisis in October through March, but have now seen substantial rebounds. Most of these currencies are back to within about 10 to 15 percent of where they stood at mid-2007 (figure 5).

There is great concern about the severe downswing in private capital flows to emerging market economies. Total private flows amounted to \$890 billion in 2007, fell to \$390 billion in 2008, and will fall further to \$140 billion this year, but will rebound to \$375 billion next year, according to the Institute for International Finance (IIF) (figure 6). As happened in the East Asian crisis, foreign direct investment has held up remarkably well. The greatest collapse was in net flows from banks, from \$400 billion in 2007 to -\$90 billion in 2009. Portfolio equity also swung to outflows but will rebound to positive flows already this year.

What is seldom recognized, however, is that, at least in the aggregate, these capital flows were not really crucial for growth, because the emerging market economies have been running large surpluses in their current accounts, at about \$400 billion annually in 2007–08 (and even more if the Gulf States are included) and still about \$300 billion annually in 2009–2010 (figure 6). So the huge inflows of capital, plus the earnings from current account surpluses, were going to finance massive buildups in reserves and private capital outflows from emerging market economies. The corollary is that the sharp drop-off in capital flows in 2008–09 is likely mainly to curb further reserves increases rather than choke off imports needed for development. In that light, the promises of several hundred billion dollars for the IMF serve mainly as a confidence booster rather than a true source of extra capital likely to be needed. Indeed, the IIF projections show a still puny \$50 billion in official capital flows to emerging market economies in 2009 and again in 2010, most of which will go to Eastern Europe.

The buildup in reserves was of course the most dramatic in China, where they have risen from \$300 billion in 2003 to \$2 trillion now (figure 7). But the buildup of reserves has been a much more widespread pattern in the main emerging market economies (figure 8). India, Brazil, Korea, and Russia all now hold more than \$200 billion in reserves. For 12 major emerging market economies, the holdings of reserves rose more than three-fold over the past six years on average. The popular lore has it that this was a reaction to the dangers revealed by the East Asian financial crisis. But that explanation is dubious. If it were accurate, the

acute phase of reserve buildup would have been from 1999 to 2003. In that period, reserves of the same countries rose less than 10 percent per year.¹ A simpler explanation for the explosion of reserves in 2003–07 is on the supply side rather than the demand side. The Federal Reserve’s low interest rate policy and the reduction of risk spreads brought a wall of money into emerging market economies, and they sensibly set most of it aside in reserves rather than spending it on an import binge.

Indeed, the stylized fact is that this became the period of a new mercantilist growth model that emphasized increasing exports rather than importing capital equipment. China has been the prototype, but the pervasive buildup in reserves has given the impression that the mercantilist model is pervasive. In fact it is only a handful of mainly Asian economies that have pursued the model (figure 9). If we set as the criteria for mercantilist growth an end-period current account surplus of 2 percent of GDP or more, and a rising surplus trend, and exclude oil exporters, then from 1999 to 2007 only eight large emerging market economies are in this group: Singapore, Malaysia, Hong Kong, China, Taiwan, and the Philippines, in Asia, and only Chile and Israel elsewhere. In contrast, 13 other major emerging market economies did not meet these criteria of mercantilist growth. India, for example, was far from qualifying (it kept a steady 1 percent of GDP current account deficit), despite its massive buildup in reserves. So rising reserves have probably contributed to an optical illusion that most emerging market economies are pursuing mercantilist growth.

It would be the wrong lesson for emerging market economies to draw from the financial crisis that they should join the mercantilist growth bandwagon in order to build up enough reserves to be safe. First of all, most of these economies had such large reserves already that they were able to weather the 2008– early 2009 crisis with only a modest loss of reserves. The largest loss was by Russia, yet its reserves remain massive. More fundamentally, for the next decade it will be increasingly problematical for emerging market economies to count on ever-widening surpluses and resultingly larger international imbalances. The United States will need to hold its current account deficits to the range of 3 to 4 percent of GDP, despite rebounding oil prices, instead of the much higher 6 percent reached in 2006. Even China and the rest of the East Asian mercantilist group will need to curb their surpluses. The mercantilist model will not support a piling on by a long list of additional emerging market economies without putting renewed pressure on external imbalances with the United States and some other (mainly Anglo-Saxon) developed economies that have had large deficits but now need to adjust.

What about fiscal policy in the aftermath of the global financial crisis? Debt held by the public is set to rise from under 40 percent of GDP to about 70 percent in the United States by 2011. The specter of much higher public debt even before the entry of baby-boomer social payments will limit the scope for policymakers to return for more fiscal pump priming if the recovery proves anemic. As for emerging market economies, those such as Chile that built up macro countercyclical funds when commodity prices were high should indeed carry out infrastructure spending as part of the global fiscal response to crisis. Similarly, China’s forceful fiscal-stimulus investment program is contributing importantly to its recovery and therefore that of global commodity prices and activity. For most developing countries, however, the sobering lesson of decades of development is that it is better to err on the side of fiscal caution.

Finally, I do not think it is likely that the main emerging market economies will reject fundamental market principles on grounds that the global crisis has shown capitalism does not work. Nor should they close off capital markets, especially for direct foreign investment, which has proven more stable. In any event, doing so would be fighting the last war. Enhanced regulation and risk supervision in industrial countries, and at best stabilization rather than a return to bubble conditions in the housing and stock markets, make it unlikely that

¹ Excluding Russia, where the 1999 level was abnormally low.

there will be a repetition of the capital flows bonanza of 2003–07 any time soon. Instead, the early signs are that the main lesson of this crisis will be that the system has withstood the most severe shock in nearly three-quarters of a century. The main pendular swing will be back toward greater prudential regulation and less exposure of the system to risk from financial firms too big to be allowed to fail. Emerging market authorities will want to carry out their own due diligence to ensure that such risks are monitored within their countries, but the main task in this regard will be at the center of the system in the United States and Europe.

Figure 1

Growth Outlook (%)

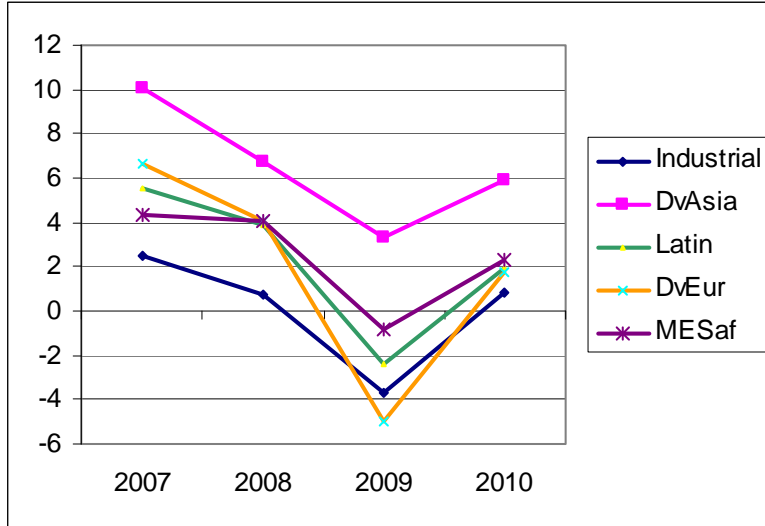


Figure 2

Change in Industrial Production and Exports (%, Q1 from year earlier)

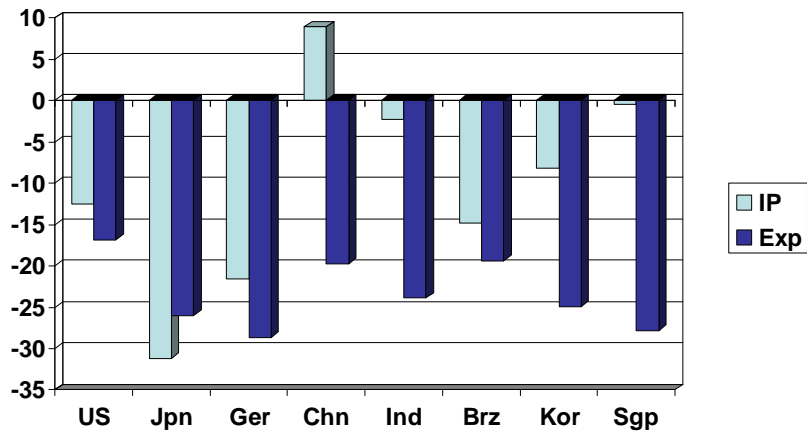


Figure 3

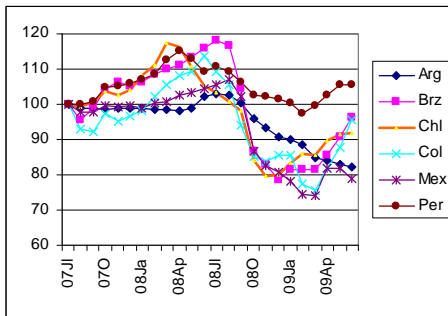
EMBI+ Spreads, 97-09 (bp)



Figure 4

Exchange Rates vs Dollar

Latin



Asian

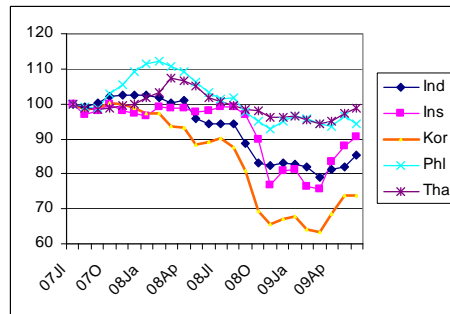


Figure 5

Net Private Capital Flows to Emerging Market Economies (\$ bn)

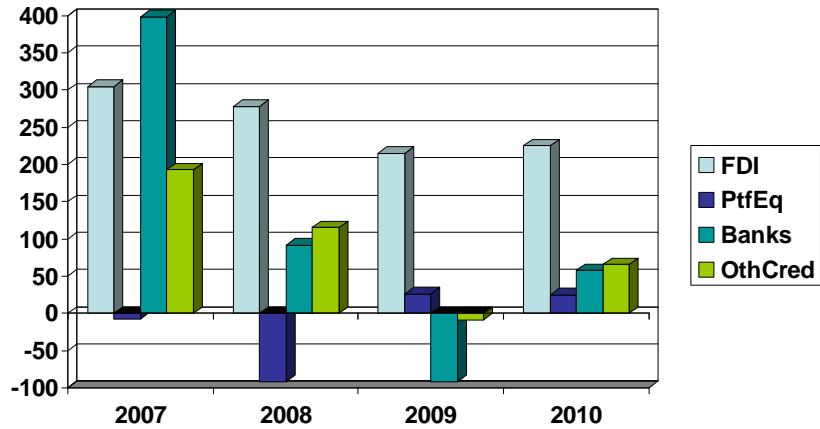


Figure 6

Financing Use of EME Capital Flows (\$bn)

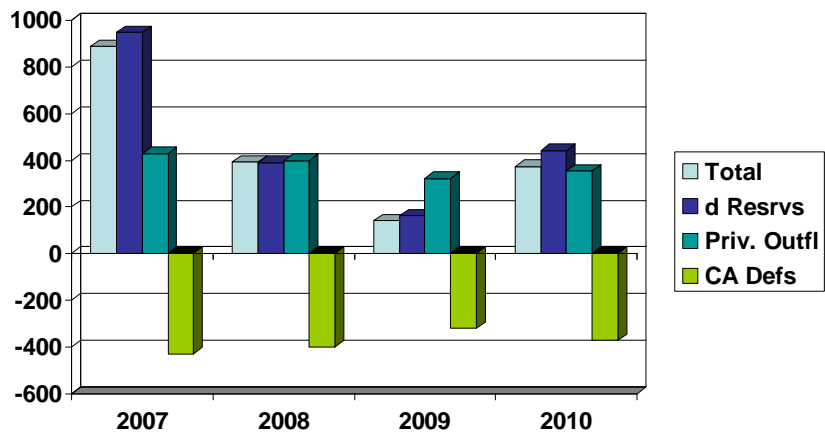


Figure 7

China, External Reserves (\$ bn)

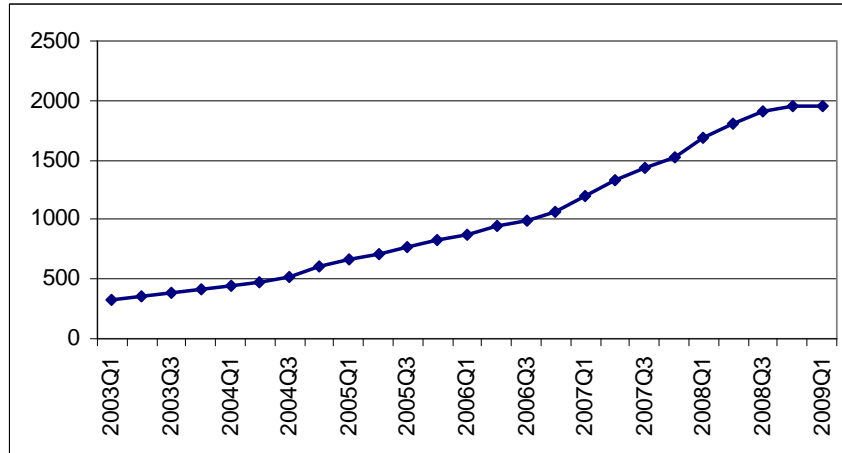


Figure 8

Reserves (\$bn)

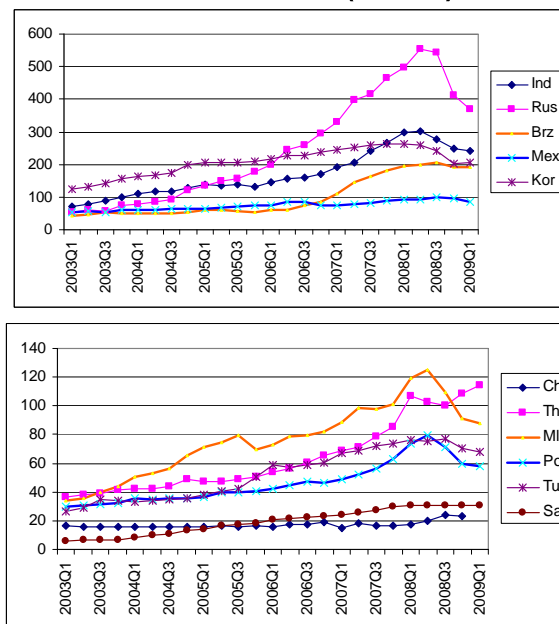


Figure 9

Mercantilist Growth (top) or Not (bottom):
Current Acct % GDP, 99-00 to 06-07

