

FINANCIAL CRISIS AND EMERGING MARKETS: IMPACT AND PROSPECTS

Forum Istanbul 2009, 28-29 May

YILMAZ AKYUZ

UNCTAD and South Centre, Geneva

Issues

1. How we got here
2. Vulnerabilities in EMs and impact
3. The day after: Medium-term prospects

How we got here?

- Crisis came after exceptional global economic performance during 2002-07:
 - Rapid growth in DEEs (7%, double the rate in 90s); broad-based: Asia/CEE/SSA/LA
 - Trade expansion, commodity boom (first time since the 1970s)
 - Record capital flows; from \$100 billion to some \$900 billion
 - BOP and currency stability in EMs (no crisis!) even in externally fragile economies
- Boom driven primarily by easy money: US (response to dot-com bust), Japan (deflation, almost zero interest rates) and even ECB joining in.
- Search-for-yield: deregulation and speculative lending and investment in US and capital flows to EMs looking for windfall gains and arbitrage profits.
- Crisis and imbalances: Exchange rate and reserve policy in China (FEs) prolonging the bubble: yield curve flattening – Greenspan's conundrum.
- Once again IMF failed to see the crisis coming despite greater emphasis on early warning after the Asian crisis (ROSC, FSAP)

EMs: Victors or victims?

- EMs are not just victims but also beneficiaries of the bubble driving the preceding expansion. In many EMs growth acceleration was due mainly to global boom rather than policy; they are now rapidly shrinking
- But while benefiting from the boom, many EMs saw build-up of fragilities:
 - Credit, asset and investment bubbles (China, India, Korea..) resulting from surge in capital flows, increased foreign presence in equity and property markets, and failure to fully sterilize currency interventions
 - Some (China; SEA) came to depend heavily on foreign markets; weak currency, CA surpluses; vulnerability to dollar collapse (China: \$2.2 tr. reserves \$1.5 tr. in dollars)
 - Others (CEE, TR, SA) addicted to foreign capital to fill CA gaps, widened by inflows and currency appreciations; rapidly worsened net foreign asset positions; build-up of external private debt.

Transmission and Impact

1. *Exposure to toxic assets:* Chinese reserves in US agency debt (Fannie and Freddie); private exposure looks small, but information limited
2. *Reversal of capital flows:* Asset bubbles bursting, cutting growth by at least 2 points; currencies under pressure; large reserve losses (Korea, India).
3. *Trade:* Markets shrinking, trade finance drying up; exports to US/EU collapsing (by 20-40 % in Asia). Intra-Asian trade linked to production networks falling; declines in export-oriented investment. Industrial output falling by 15-25 % in Asia, faster than in 97 crisis
4. *Remittances:* gained growing importance for DEEs (some \$170 billion). Declines in remittances from US/UK hitting India; from Gulf hitting Pakistan; intra-SEA remittances also declining, hitting Indonesia and Philippines.

Short-term projections (table)

- Green shoots or yellow weeds? Positive signs in US, China, commodity pick-up, but contraction is still at full steam; easing of pace of decline rather than beginning of recovery.
- Considerable uncertainty: projections are held with no more confidence now than a year ago; lack of clear understanding of nature and extent of financial difficulties, links with real economy and impact of policy interventions.
- IMF: Only Asia and Africa to register positive growth. Asia: strong fundamentals, Africa: weak links to global finance. CEE loses more growth than US; TR even worse.
- Projections maybe optimistic, but the ordering is probably right.

Recent Growth and Projected Swings (per cent per annum)

| | 2002-2007 | 2009 Proj. | SWING |
|--------|-----------|------------|--------|
| AFRICA | 6.1 | 2.0 | - 4.1 |
| ASIA | 8.9 | 4.8 | - 4.1 |
| China | 10.7 | 6.5 | - 4.2 |
| India | 8.0 | 4.5 | - 3.5 |
| CEE | 5.8 | - 3.7 | - 9.5 |
| Turkey | 6.8 | - 5.1 | - 11.9 |
| LA | 4.2 | - 1.5 | - 5.7 |
| | | | |
| US | 2.5 | - 3.8 | - 6.3 |
| EU | 2.4 | - 4.0 | - 6.4 |

Medium-Term Prospects

- Return to 2002-07? Many governments (and markets) would love to: Fed to sustain rates near zero and China/FEs to keep down long-term rates by continuing to peg to the dollar and providing financing to US consumers (BW2) so that EMs can “carry” on?
- But a repeat is unlikely; could be disaster for international monetary stability
- More likely scenario:
 - Consumer retrenchment and external adjustment in US.
 - Exit from fiscal stimuli and bailouts; focus on inflation control (tight money) and fiscal consolidation.
- EMs need to address weaknesses: some (China) to create domestic markets, some (CEE, TR) domestic resources; some (India, SEA) solid industrial base.
- If not, growth in EMs can be sluggish even if US/EU recover strongly.

India

- Remarkable acceleration from Hindu growth of 3%, exceeding 9% in 2005-07. Projected to be halved in 2009. Can it be restored with return to normalcy of global conditions? Now political stability and optimism, but serious weaknesses:
- Twin deficits during expansion, now getting worse with budget deficits close to 10% of GDP; risk of sovereign debt rating to be downgraded to junk (non-investment) status.
- IT exports slowing sharply; more than 60% of outsourcing linked to US financial firms (some bankrupt); may not pick up with US recovery. Buy American can also reduce outsourcing
- Remittances remain sluggish – US/UK recovery likely to be jobless
- Still sizeable reserves (despite loss of \$58 billion); but they are “borrowed” (mainly portfolio inflows, now exiting), not earned from CA surpluses as in China and SEA.
- High corporate leverage in forex to acquire assets abroad (Tata)
- Little investment in industry despite an investment boom (from 23% to 39% of GDP between 2003-08); 30% was from FDI. Poor infrastructure.
- Can it skip industrialization and develop on services exports?

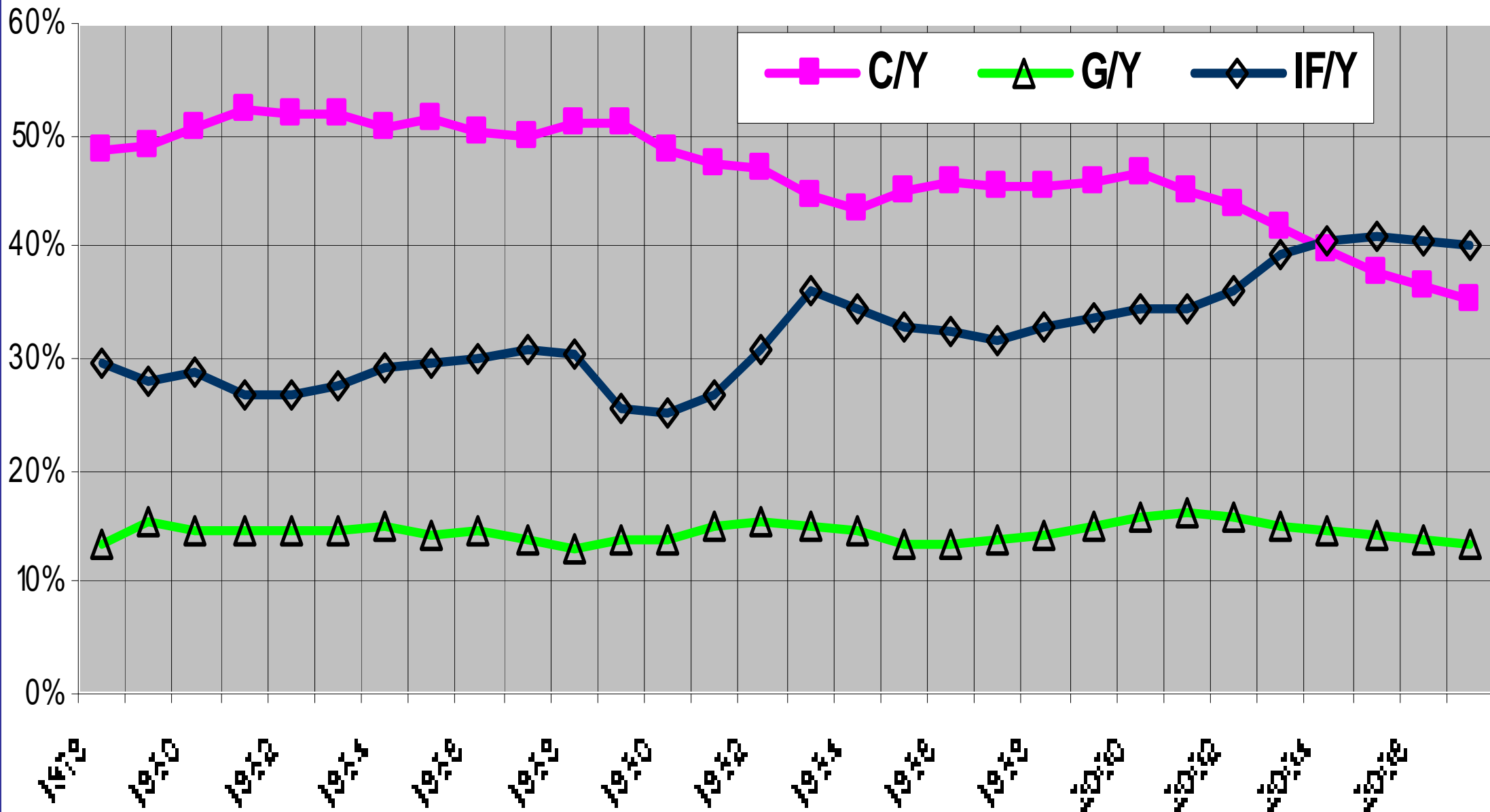
China: Policy Challenges

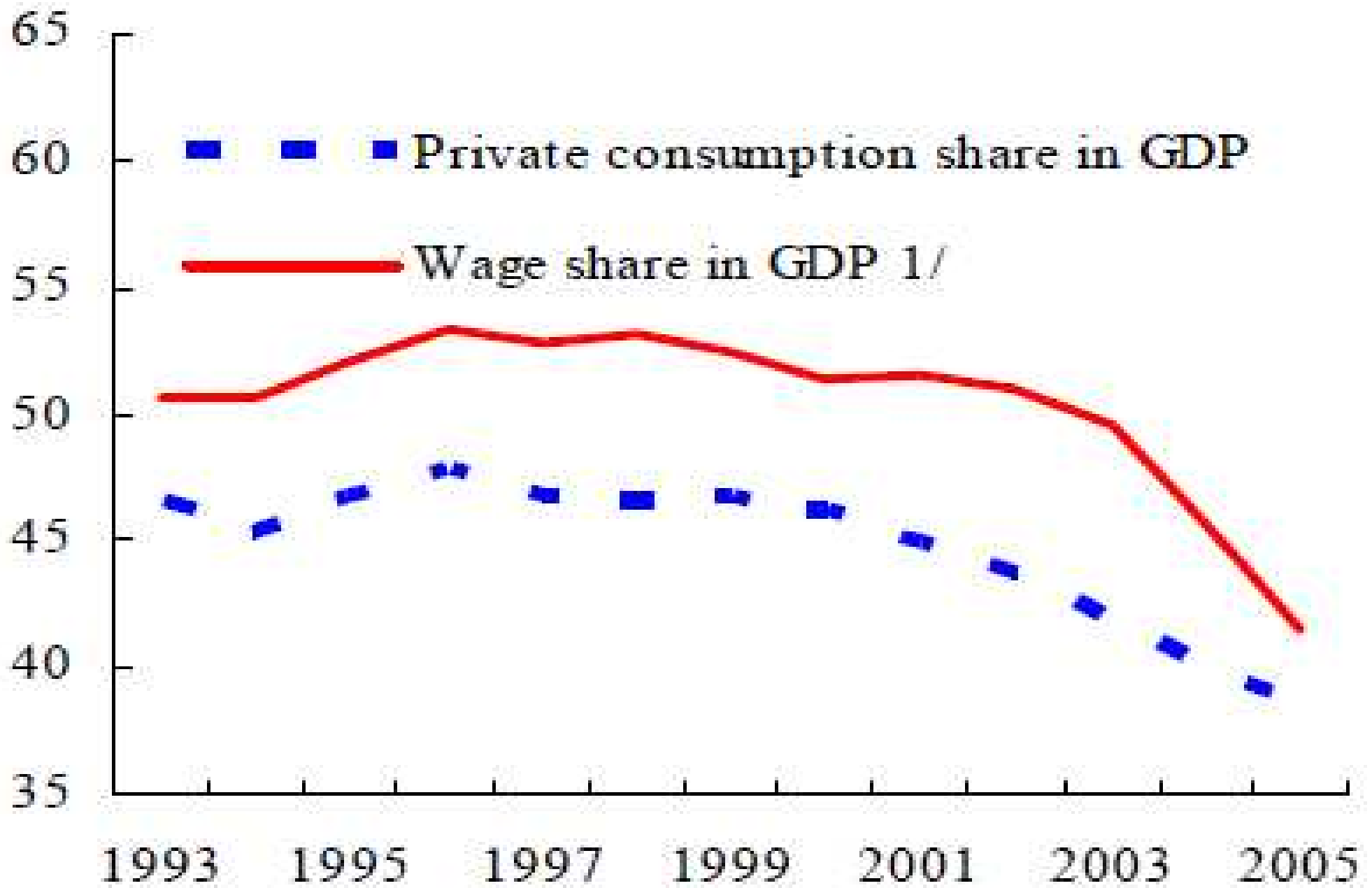
- *Immediate:* Need to avoid destabilizing feedbacks between financial and real sectors. Banks are keeping many firms afloat. Danger of sharp slowdown causing financial instability by leading to widespread defaults and NPL (not the other way round, as in US/EU). This feeding into lower growth and social instability.
- *Medium term:* Consumer retrenchment and external adjustment in the US will require structural adjustment in China so as to reduce its dependence on foreign markets
- Policy response now should address the immediate problem while facilitating medium-term adjustment; that is, China needs more than counter-cyclical macroeconomic policy.

China's dependence on foreign markets

- Root cause: under-consumption, excessive profits, over-investment.
- C/GDP falling since 2000 with I/GDP rising; recently C/GDP=39%, I/GDP= 43% (Chart)
- When investment grows faster than consumption, net exports need to keep on rising.
- Under-consumption linked to income distribution: Real wages rising but wage share falling because wages lag productivity growth; W/GDP declined by 10 percentage points since mid-1990s. C/GDP mirrors W/GDP (Chart)
- Corporate retentions exceed 20% of GDP; fully re-invested, notably in SOEs which do not pay out dividends. Considerable excess capacity and white elephants; 40% reported running losses/declining returns (BIS). Could be exposed without subsidized finance
- Savings (precautionary) from wages also high, compared to DEEs at similar per capita incomes, because of lack of adequate social safety nets.

Components of Domestic Expenditure as Shares of GDP





• Source: WB Beijing

Policy response: Structural problems addressed?

- Need higher wages and consumption-linked spending – direct income transfers to poor; subsidies for education, health, housing, higher pensions and unemployment benefits; can be financed with dividends from SOEs.
- Aggressive monetary easing not seen since Asian crisis and a large fiscal package
- But only a small portion of fiscal package (10%) is allocated to social welfare. Emphasis on infrastructure investment (up by 40%) with weak impact on consumption. Consumption growth sluggish, based on pent-up demand and special (one-off) incentives rather than income (wage) growth
- Now exports falling, investment rising; solving or aggravating structural problems?
- Risk of fiscal pump not priming as in Japan in 1990s, with economy going flat after the withdrawal of fiscal stimulus

The day after?

- Talk of end of export-led growth in China. But more likely a shift towards that practiced by Korea and Japan – no cheap currency/cheap labour, exports for dynamic benefits not jobs. Need is recognized, but can it make the transition orderly and successfully?
- Can China unload massive dollar reserves without causing havoc and suffering losses? Onto IMF (subs. acc., Zhou)? Or keep on buying US paper?
- Is RMB likely to become a reserve currency soon? First regionally, then globally? (recent swaps, use of RMB in trade settlement). Or a regional (EA) reserve currency (like euro)?
- US to come out stronger, given its flexibility and reserve currency status?
- Or end of US hegemony and demise of the dollar following massive bailouts and build-up of public liabilities? Unthinkable: US having to borrow in other currencies– RMB?
- What is the next crisis going to be like? Commodities, bonds (US treasuries), the dollar?
- Jury is still out; but unlikely that business is going to be as usual. EMs such as TR should better prepare for that.