

# Intermediation, Growth and Emerging Markets After the Crisis.

Suman Bery, Director-General

Member, Economic Advisory Council  
to Prime Minister

OECD NERO Meeting

Paris, 21 September 2009

- Macro diagnosis of crisis has largely focused on net imbalances between “core” and “periphery”, exchange rate system, “exorbitant privilege” (Eichengreen 2007).
- Pre-crisis era period of buoyant growth in emerging market economies (EMEs).
- Apart from demand channel, this “excess growth” in EMEs has been linked to enhanced financial integration, abundant liquidity, financial innovation.

- If correct, latter channel implies focus on gross cross-border flows, role of advanced financial markets in providing risk management, term transformation services.
- Future market, regulatory environment uncertain.
- Raises following questions:



- What are prospects for future gross flows to EMEs? How are these linked to reduction in U.S. deficit, reduced global imbalances?
- Might reduced cross-border gross flows harm growth prospects in the EMEs?
- How can domestic financial intermediation and/or regional arrangements provide a substitute?
- What are/should be EME interests in the G-20 financial regulation agenda?



- Will look at these issues from the perspective of India, as a part of “emerging Asia”.
  - Asia both a major supplier and potential user of global savings.
  - Can it do more of its own intermediation in future? What will drive this? Will anything change? Why?



- Eichengreen examines sustainability of “Bretton Woods II” (Dooley et. al. 2009) by contrasting (East) Asia today, Europe in the 1960s as “periphery” to U.S. “core”.
- Similarities: willingness by “core” to trade off current consumption for growth, through undervalued exchange rate, accumulation of reserves.
- Concern about U.S. policy, potential capital losses on reserve holdings (Triffin dilemma).





- Differences: Availability today of euro as alternative to dollar.
- Less experience, fewer institutions in Asia to solve “collective action” problem of central bank co-ordination in supporting dollar.
- Till late 1960s U.S. ran current account surpluses, capital account deficit.
- Interpreted as offering “term transformation” services to a less sophisticated European financial system.





- Observations:
- International need for dollar liquidity not necessarily linked with U.S. current account position (cf. Victorian Britain).
- “Term transformation” about gross flows, perceptions of relative real returns.
- Arguably driven more by development strategy concerns than straight portfolio management.





- Issues: how important have gross inflows been to EMEs?
- What drives these flows?
- How linked are gross and net flows?
- What might happen in the future? Might “Asian” finance replace “Atlantic” finance? How quickly?





- These issues addressed by Lane-Milesi-Ferreti (2006, 2008).
- While emerging markets have accounted for a growing fraction of world GDP, trade, reserves, this is not in general true for cross-border trade in other financial assets.
- The recent explosive growth was mainly among advanced countries.



- Between 1996 and 2006 Advanced Country share of portfolio equity assets only declined from 92.6% to 90.8%; of FDI assets from 90.2% to 89.1% of global totals.
- Share of reserves however declined from 48.3% to 28.3%.
- But these are shares of a rapidly expanding total.

- We should be more interested in the growth of cross-border assets and liabilities of emerging markets as a share of their economies; and the public/private mix on both sides of the balance sheet.
- “Term transformation” story would be long-term private inflows (mainly equity, FDI) partially or wholly offsetting short-term, largely official outflows (reserves).



IMF WEO (2009) data appendix allows one to construct a simple “sources and uses” framework for all “emerging and developing economies” as follows:

**Current Account Surplus + Gross Private Inflow + Net Official Capital  $\equiv$  Private Capital Outflow + Change in Reserves.**

Net Official Capital is balancing item.





# BIS data (2008)



For 2007, numbers are as follows (USD bn):

## Sources

– Current Account	741
– Gross Private Inflow	2130
– Net Official	- 79
Total	2792

## Uses

– Gross Private Outflow	1513
– Change in Reserves	1279



- Strong correlation between growth of gross private inflows, outflows in this period:
  - Gross private inflows:
    - 2003 \$418 bn.
    - 2007 \$2130 bn.
  - Gross private outflows
    - 2003 \$268 bn.
    - 2007 \$1512 bn.

- Suggests considerable interdependence between inflows and outflows.
- Some possibilities:
  - Classification issues (e.g. state-led actors such as sovereign-wealth funds classified as private).
  - Rapid liberalisation of outflows to manage exchange rate in light of strong inflows.



- IMF also provides decomposition by region, type of private flow, but in net, not gross terms. (Same data also used by BIS.)
- Confirms that largest net category has remained FDI, even in latest surge (over 50% of total); within this Asia and Western Hemisphere are dominant regions.
- Private net portfolio flows smaller, more volatile; unspecified “other net private” large and volatile.





- Provisional conclusions:
  - At aggregate level EMEs can indeed be seen to be using advanced markets for “term transformation”, “exchanging” (official-to-official) reserves for (private-to-private) net FDI, expatriating term and credit risk .
  - However, net private capital includes significant gross private outflows, through outbound FDI, sovereign wealth funds etc. Official aid also becoming important in Middle East, Asia.





- Even assuming gross private inflows are autonomous, reflection in the current account (i.e. absorption) depends on stance of macro policy, nature of exchange rate regime, desire for self-insurance against “sudden stops”.
- Economies with already high saving, investment rates (e.g. Asia, Middle East) may prefer to enjoy allocative benefits of gross private flows without increasing current account deficit.





- Turn finally to “likely pattern of global financial intermediation” following the crisis, and the role of domestic, global policies.
- IMF (April WEO, more recent updates), takes a view both on financial flows, current account deficits.
- On former (p.147), its judgment is that (gross) “capital flows to emerging economies will suffer large declines and recover slowly, especially banking-related flows”



- If true, will impact more on regions with relatively low domestic saving rates, particularly Central and Eastern Europe.
- Asian, Indian perspective somewhat different.
- Low dependence on banking flows (carry trade once again attractive); FDI and equity flows driven by perceived high relative returns. Intermediaries less affected.

## Global gross saving and investment

As a percentage of GDP

	Saving				Investment			
	1995	2001	2007	2008	1995	2001	2007	2008
Advanced economies	21.4	20.0	19.9	18.8	21.6	20.6	21.0	20.4
United States	16.0	16.4	14.2	11.9	18.6	19.1	18.8	17.5
Japan	30.5	26.9	28.9	26.7	28.4	24.8	24.1	23.5
Germany	21.1	19.5	25.8	25.7	22.2	19.5	18.3	19.3
United Kingdom	15.9	15.4	15.3	15.1	17.2	17.4	18.2	16.8
Other <sup>1</sup>	21.4	22.5	22.5	21.9	20.1	21.2	23.5	23.2
Emerging economies	26.8	26.6	35.4	36.6	27.6	25.1	30.2	31.8
China	42.1	37.6	57.6	59.0	41.9	36.3	46.6	49.0
Other emerging Asia <sup>2</sup>	31.7	27.6	32.8	32.1	32.5	24.2	28.9	30.1
Latin America <sup>3</sup>	17.0	18.0	22.8	22.3	19.2	20.6	22.2	22.8
Middle East <sup>4</sup>	24.0	33.3	49.6	50.8	20.9	24.8	26.5	26.7
Other <sup>5</sup>	22.7	23.0	23.1	24.3	23.1	20.2	23.5	24.3
Total	22.5	21.4	24.3	24.2	22.8	21.5	23.6	23.9

Country groups and total are calculated as the sum of saving or investment in the component countries, divided by the sum of GDP in those countries, all expressed in US dollars.

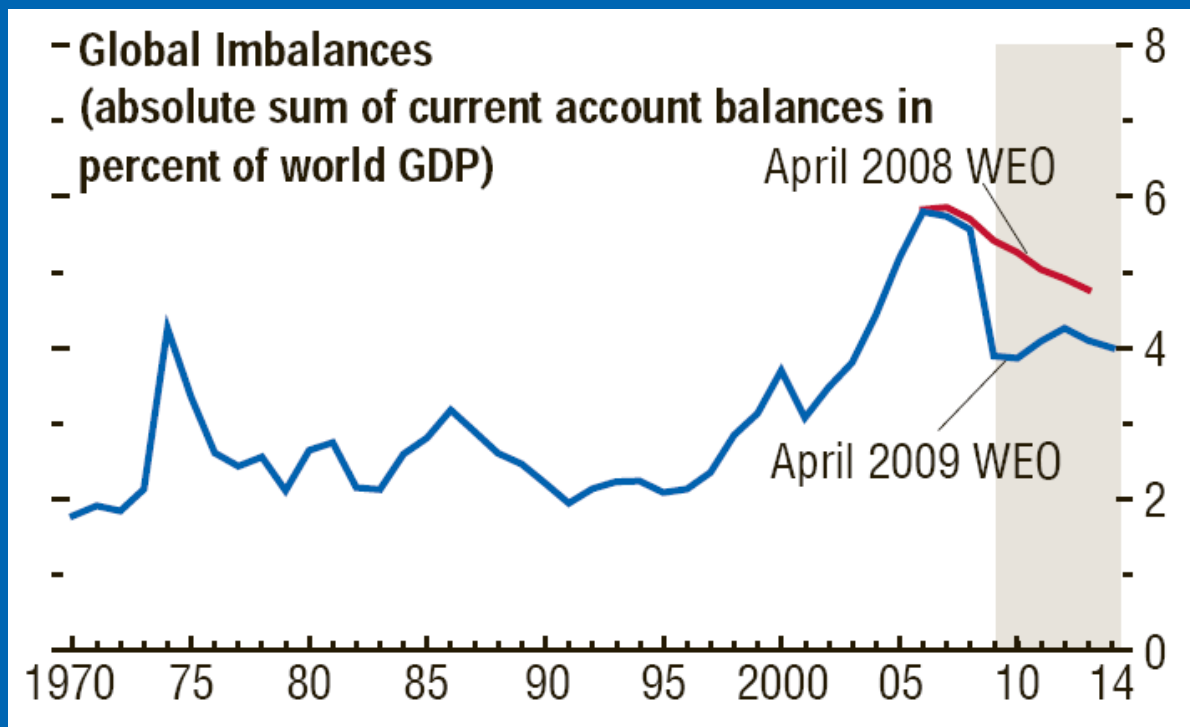
<sup>1</sup> Australia, Canada, Denmark, New Zealand, Norway, Sweden, Switzerland and euro area economies excluding Germany.

<sup>2</sup> Chinese Taipei, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. <sup>3</sup> Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. <sup>4</sup> Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia and Yemen. <sup>5</sup> The

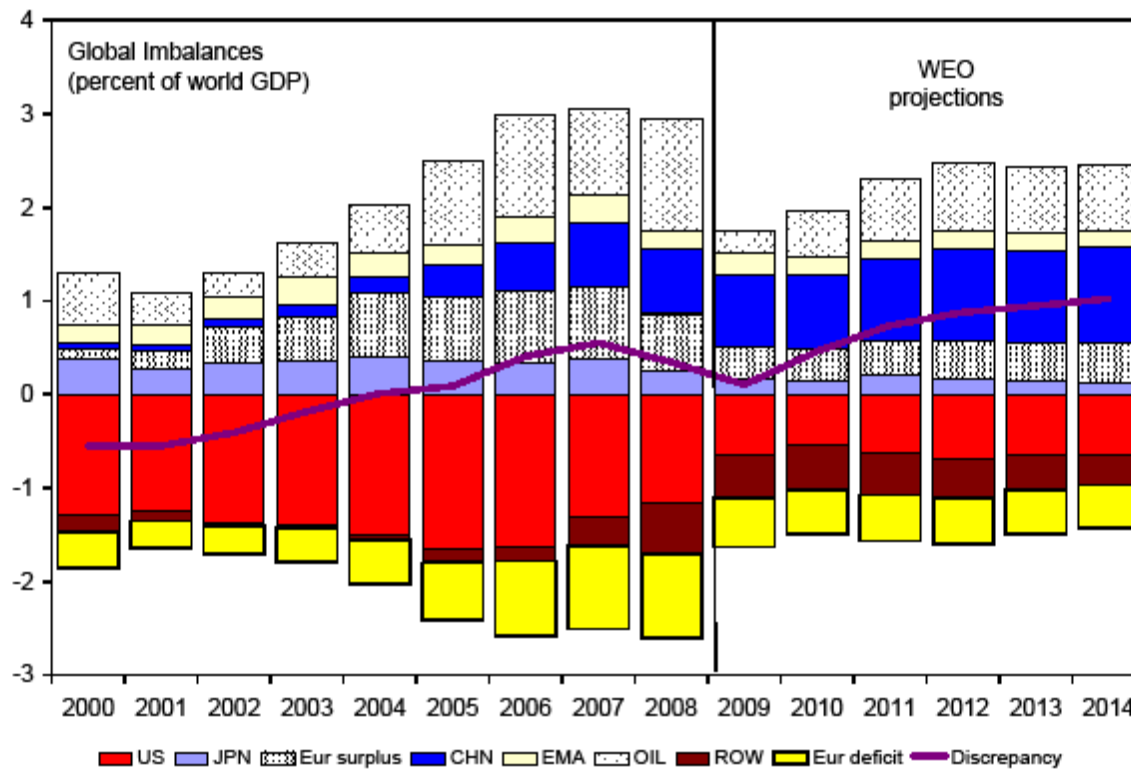
Czech Republic, Hungary, Poland, Russia, South Africa and Turkey.

Source: IMF, *World Economic Outlook*.

Table IV.1



# Global current account projections





- Prospects for Asia are for buoyant gross inflows, reduced current account surpluses, provided global regulatory regime remains supportive.
- Implies shift in resources/output toward non-tradables while maintaining fast growth in productivity (canonical case: Indian rural mobile telephony)
- Tricky to prevent this from creating domestic asset bubbles (e.g. real estate).



- Improved resource allocation likely to be facilitated by more, not less, domestic financial liberalisation, greater nominal exchange rate flexibility.
- Not widely accepted in India, China-exporters' lobby; legitimate fear of “sudden stops”.



- “There is evidence that domestic financial development spurs growth under the right conditions, and these conditions—plus domestic financial development itself—are likely to make capital inflows from abroad more productive” (Obstfeld 2009).





- Challenge is to direct into productive uses without excessive appreciation of the real exchange rate. Requires greater flexibility in non-tradables supply.
- Broad conclusion similar to Obstfeld. Main challenge is to ensure productive resource allocation through micro, fiscal reform.
- Domestic finance can help; foreign finance is at best an additional discipline.



**Thank You**

