



## The Fallout from the Financial Crisis (1): Emerging Markets under Stress

by Helmut Reisen

- ◆ The global credit crisis constitutes a key test regarding the resilience and sustainability of emerging-market policy performance.
- ◆ Even strong performers are not shielded against “pure” financial contagion, but once confidence is restored, they may well recover quickly.
- ◆ In the future, development finance is likely to rely less on private debt.

The contagion of the global credit crisis from the industrialised countries to the emerging markets has taken some time to develop. Then, in October 2008, it spread rapidly, afflicting all emerging markets, without any distinction or regard to their so-called “fundamentals”. For believers in “decoupling”, the high growth rates, massive foreign exchange (FX) reserves, balanced budgets and rising consumerism in the emerging markets at first reassured investors. It is now clear that the diagnosis of emerging-market policy performance suffered from hyperbole. In the end, all emerging market asset classes were hit: stocks, bonds and currencies.

The current financial crisis has lessons for

- ◆ the diagnosis of emerging-market policy performance,
- ◆ the channels of crisis contagion, and
- ◆ the future of private and official development finance.

Optimists about decoupling underplayed the cyclical and endogeneity of important policy performance indicators:

- ◆ *Emerging-market growth rates:* Much of the recent growth has been driven by an extraordinary bonanza in raw-materials prices and low financing costs. Many analysts forgot the basic principle that growth rates can only be sustained over the long run when underpinned by productivity growth. Arguably, from this perspective, many Asian countries have more sustainable growth rates than emerging markets in other regions.

- ◆ *FX reserve levels:* Their durability depends very much on the exchange rate regime. Authorities may wish to avoid a currency slump, and may need to recapitalise their banking systems; but if both foreign and domestic investors lose confidence, even very impressive levels of FX reserves can melt quickly away (as witnessed in Russia recently). As long as reserves are below the liabilities of the banking system (M2), individuals may rush to convert their domestic currency deposits into foreign currency and put pressure on the currency as reserves dwindle...
- ◆ *Public budgets:* A mistake which is often made by rating agencies<sup>1</sup> is to focus excessively on debt-GDP ratios and public deficits. Typically, both debt and deficits decrease during the boom, but can shoot up quickly during the crisis. Tax collection flourishes with high exports and raw material prices but tumbles during the bust. Similarly, currency appreciation during the boom gives way to an endogenous rise in debt ratios as currencies and GDP growth weaken.

Not everything is negative, however. To the extent that fuel and food prices fall due to the crisis, government budgets in low-income countries which subsidise fuel and food prices may benefit as costly price subsidies can be reduced (though this positive effect may be mitigated by currency depreciation). In addition, public debt management has improved in many countries: Brazil, for example now has a net long position in dollars, such that currency depreciation actually improves its net worth.

1. Reisen, H. and J. von Maltzan Pacheco (1999), “Boom and Bust and Sovereign Ratings”, *International Finance*, 2(2), 273-93.

What about the future? It is possible to distil important policy lessons about preventing, managing and resolving financial crises from recent emerging-market crises. One thing in common with these crises is that they were less caused by domestic factors and more related to crisis contagion from elsewhere. Furthermore, such policy lessons need to inform debates regarding the construction of a new international (or regional) financial architecture<sup>2</sup>. Crisis contagion in principle occurs through three channels:

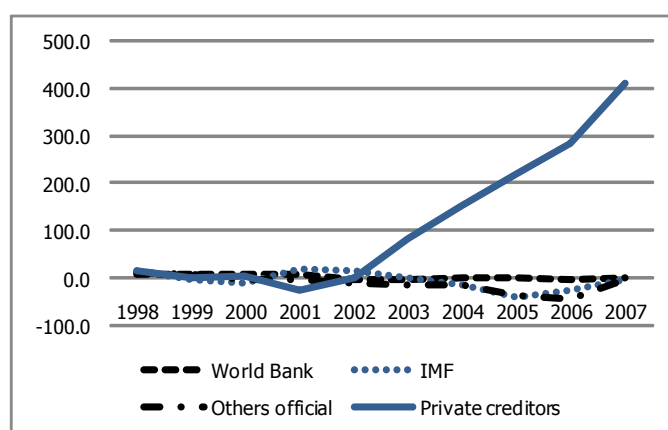
- ◆ Through foreign trade (sometimes known as the “monsoon effect”): the monsoon effects hit small open economies easily through merchandise trade precisely because they are both small and open to trade. Low-income countries will be mostly hit through the monsoon channel as recession in OECD countries deepens.
- ◆ Through financial contagion, when money invested is repatriated. Currency mismatches in corporate and bank balance sheets can cause widespread company and bank failures.
- ◆ Through “pure” contagion, as happened in October 2008, when a systemic and simultaneous breakdown of money and banking markets leads to generalised risk aversion and the shedding of all assets without public guarantees.

Financial crises that are caused by the monsoon effect or by financial contagion can in principle be predicted through the monitoring of macroeconomic variables. Pure contagion, by contrast, hits countries regardless of their level of economic integration and is hard to predict or to quantify. A wave of pure contagion, however, can be stopped more easily by reversing expectations through implementing decisive reflationary policies.

2. Reisen, H. (1999), “After the Great Asian Slump: Towards a Coherent Approach to Global Capital Flows”, *Policy Brief* No. 16, OECD Development Centre, Paris, January.

As a mid-term consequence of the global credit crisis, private debt will be financed only reluctantly, and capital costs are bound to rise in the face of higher risk. Solvent governments and public institutions will be forced to become the lenders of last resort. The consequences for development finance and the global financial architecture will be important. Figure 1 shows clearly how development loans by the World Bank, the IMF, and the regional development banks had been crowded out by private-sector lending throughout the boom decade. The supply of public development finance will rise and regain some of the attractiveness to poor countries that it lost during the boom period.

Figure 1. **Net Lending to Developing Countries**  
(USD billion)



Source: World Bank (2008), *Global Development Finance*.

Using a small part of emerging countries’ high FX reserves to leverage them through multilateral development banks is a feasible way to restore development finance. Likewise, the role of public guarantees, in particular by AAA-rated governments, will have to be enhanced.