Financial Crises and Emerging Market Economies – Challenges and medium term persepctives

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Outline

1. **Recent developments**

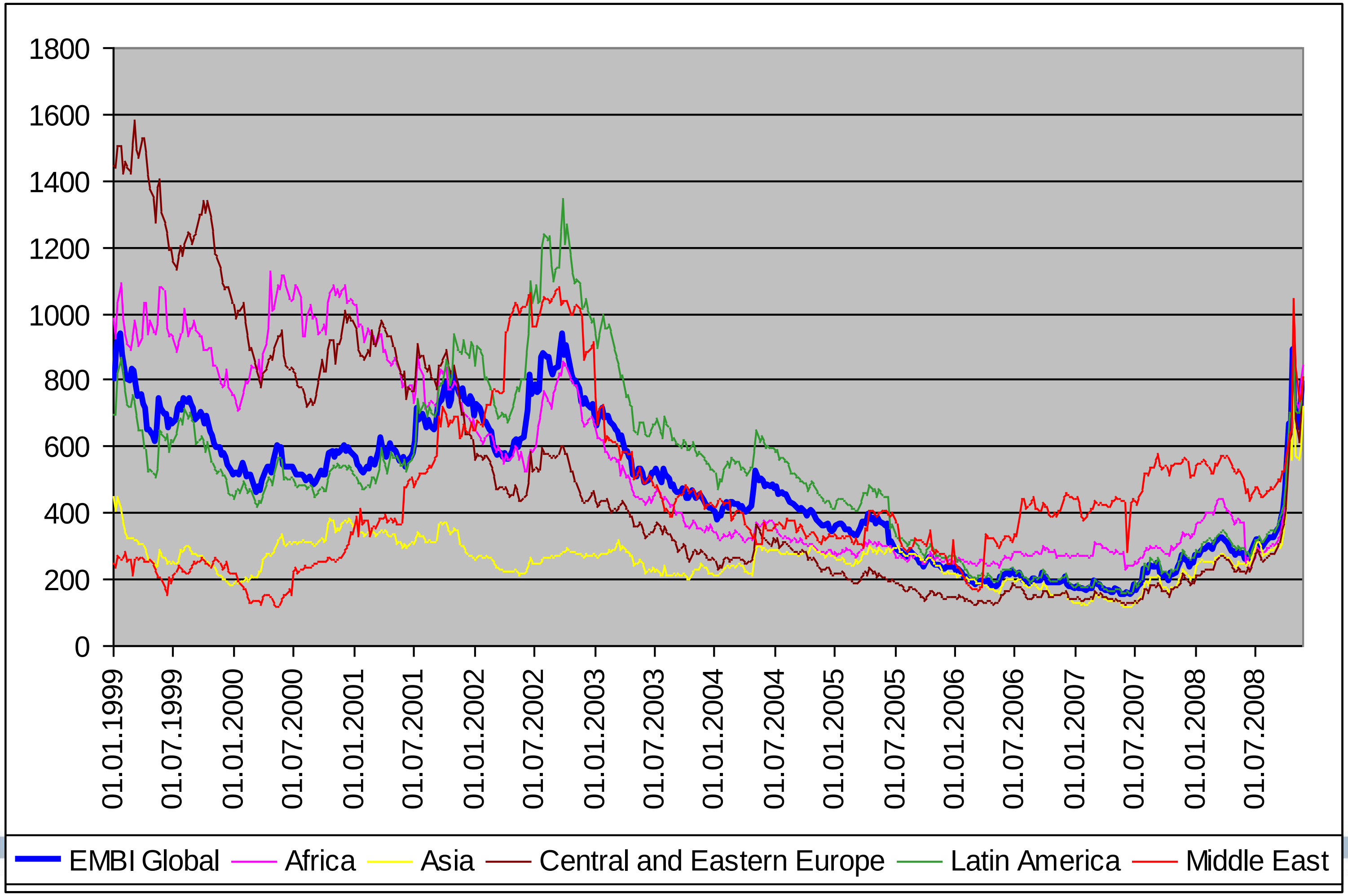
2. **Medium-term perspectives**

3. **Challenges ahead**

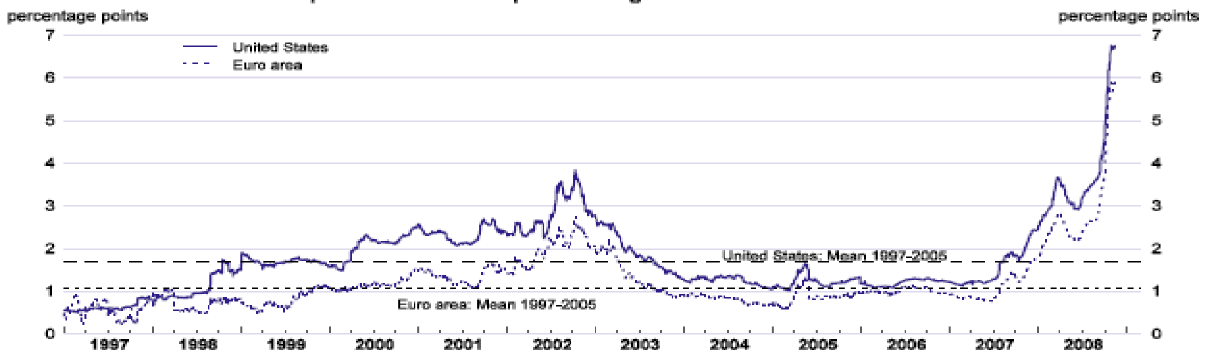
I. Recent developments - EMBI Global

- EMBI Global around 300 bp since September, in October increase to levels around 900 bp
- Increase across all EM regions
- Even more pronounced widening of EME corporate spreads
- … reflecting difficulties for refinancing of corporates in EMEs

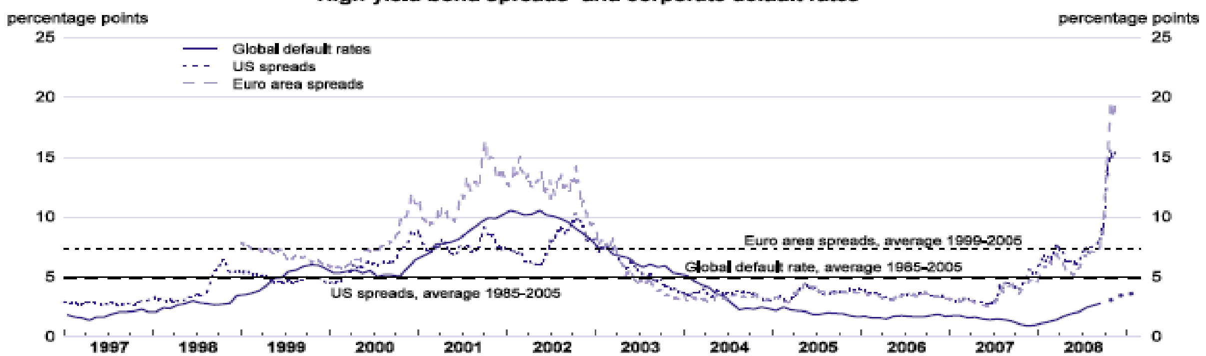
Risk premium in Emerging Market Economies – Sovereign Debt Instruments



Credit spreads between corporate and government benchmark bonds[1]



High-yield bond spreads[2] and corporate default rates[3]



Global capital flows

Global capital flows reflect increasing importance of financial market channel: Quantum leap in quantity and quality

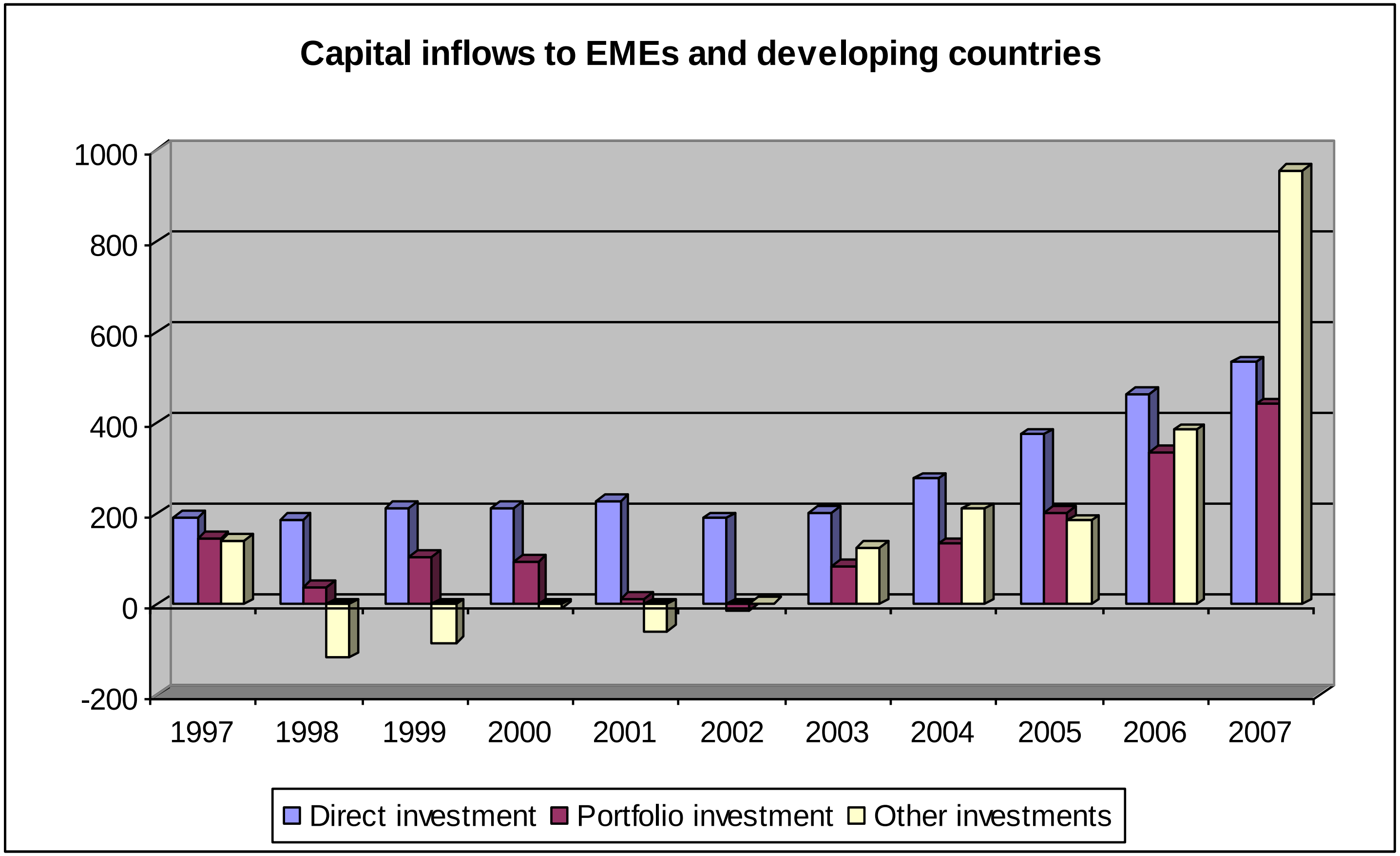
(i) Increasing global capital flows: 2007 around 2 billions US $

(ii) Importance of portfolio investments – short term; arbitrage oriented;

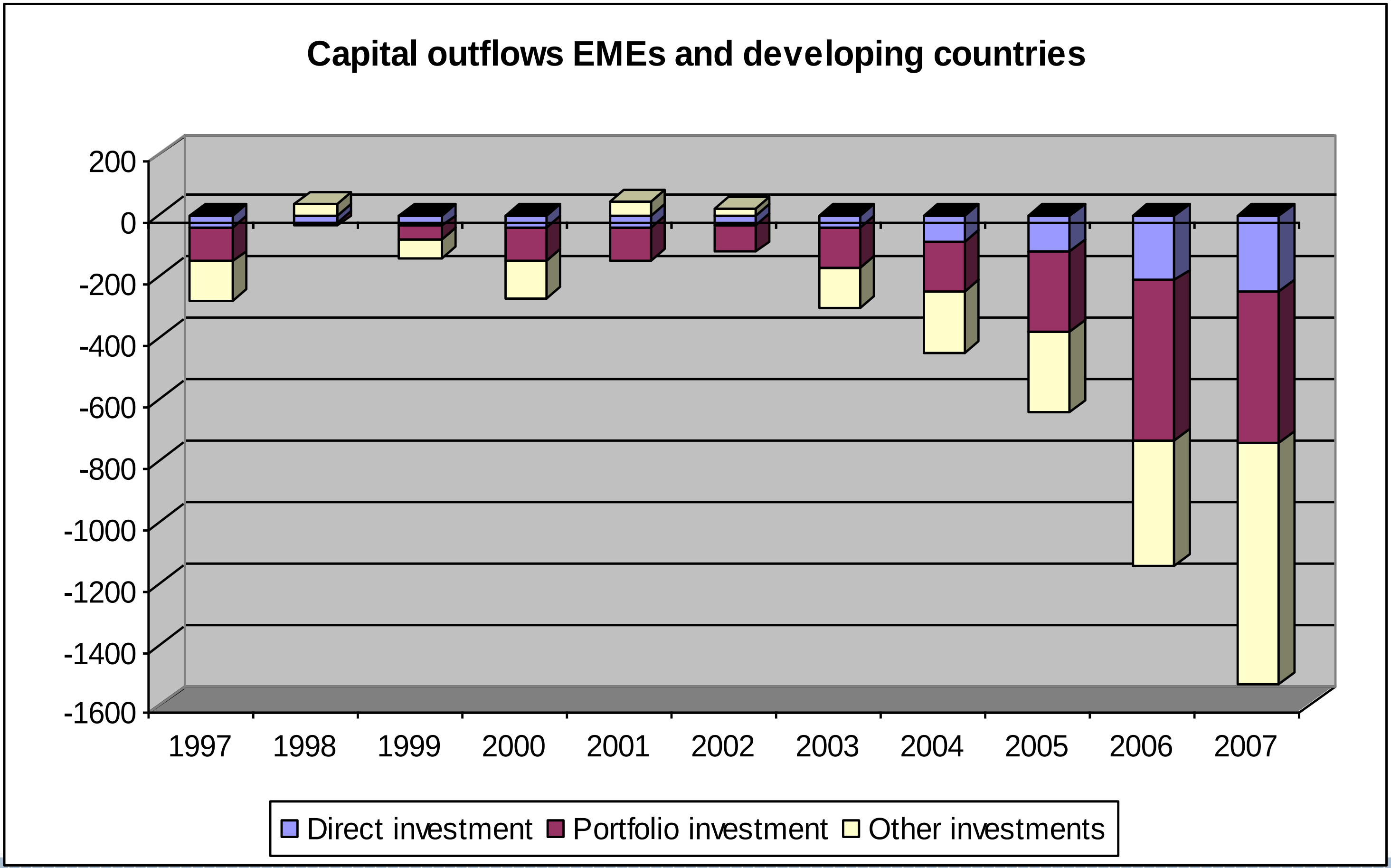
(ii) Significant increase of „other investments“ – as high as foreign direct investments and portfolio flows together

- This position mainly reflects international credit channel
- Increase of around 420 % compared with 2005
- and the potential of further de-leveraging and „imported credit crunch“ in some EMEs

Changing structure of global capital flows



Also capital outflows dominated by other investments



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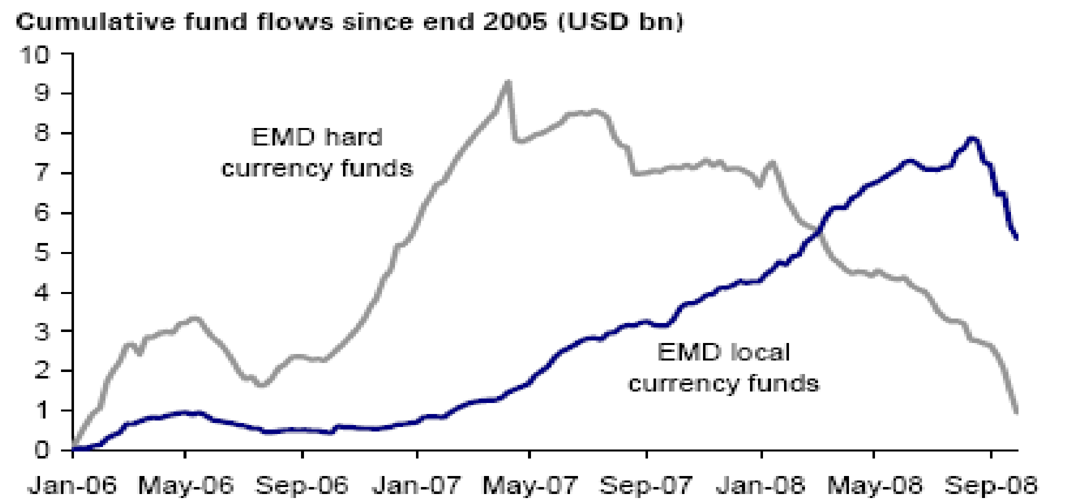
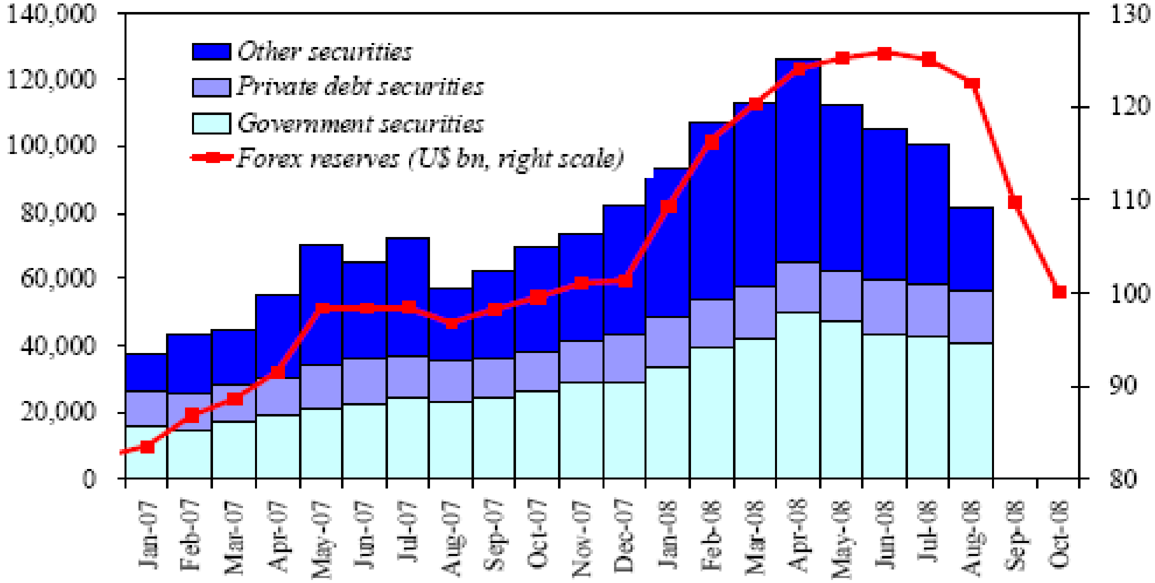
Moving out of external into local debt



Source: Deutsche Bank
EMLIN: Korea, Malaysia, Indonesia, Hong Kong, Poland, Hungary, Czech Republic, Russia, Slovakia, Brazil, Mexico, Peru, Turkey, South Africa, Israel, Egypt

Malaysia: Foreign Holding of Local Debt
(In millions of Malaysian ringgits)



Note: Bank Negara bills and notes represents a large share of other securities.

EME – heterogenous asset class?

- **To what extent have international institutional investors evaluted EMEs as a heterogenous or homogenous asset class?**
- **Highly relevant for intensity of contagion effects**
- **No significant differentiation across *stock markets*; all relevant EMEs are affected despite different current account positions, macroeconomic framework etc.**
- **MSCI Emerging Market Index in local currencies (MSCI EM local): decrease of around 54,1 % between 19.05. 08 (51.475,7 points, high in 2008) and 23.642,5 (24.11.08) points**
- **Exhange rates: depreciation more pronounced in countries with high current account deficits**
- **CDS differentiation before crises,**

II. First lessons and medium-term perspectives

1. **Outlook for Emerging Market Economies**

2. **No decoupling**

3. **Even Emerging Market Economies with a stable macroeconomic framework have been heavily affected**

4. **Local currency bond markets have stabilised financial system during last months**

Outlook for EMEs – Economic weight of EMEs have increased significantly

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Relative Weight of EME Capital Markets
billions of $

	GDP	Stock Markets	Debt Securities	Bank Assets	Capital Markets
World	54545,1	65105,6	79821,9	84784,5	229712
Euro Area	12202,06	10040,1	23023,8	30137,1	63461,4
United States	13807,6	19922,3	29879,3	11194,1	60995,7
Japan	4381,6	4663,8	9217,5	7839,4	21720,6
Emerging Markets	17281,7	20950,2	7820,1	15003,8	43774,1
% of world					
Euro Area	22,4%	15,4%	28,8%	35,5%	27,6%
United States	25,3%	30,6%	37,4%	13,2%	26,6%
Japan	8,0%	7,2%	11,5%	9,2%	9,5%
Emerging Markets	**31,7%**	**32,2%**	**9,8%**	**17,7%**	**19,1%**

Outlook – dampening but recovery during 2009

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World Economic Outlook Projections

	Year over Year				Q4 over Q4		
	2006	2007	2008	2009	2007	2008	2009
World Output	**5,1**	**5**	**3,7**	**2,2**	**4,8**	**2,5**	**2,4**
Advanced Economies	3	2,6	1,4	-0,3	2,6	0,3	0,3
United States	2,8	2	1,4	-0,7	2,3	0,4	-0,5
Euro Area	2,8	2,6	1,2	-0,5	2,1	0,1	
Japan	2,4	2,1	0,5	-0,2	1,4	-0,3	0,4
Newl ind. Asian Economies	5,6	5,6	3,9	2,1	6,1	2,2	4,4
EME and Developing Ec.	7,9	8	6,6	5,1	8,5	5,9	5,7
World trade (volume)	**9,4**	**7,2**	**4,6**	**2,1**			
Consumer Prices							
Advanced Ec.	2,4	2,2	3,6	1,4	3	2,9	1,4
EME and developing ec.	5,4	6,4	9,2	7,1	6,7	7,2	5,9

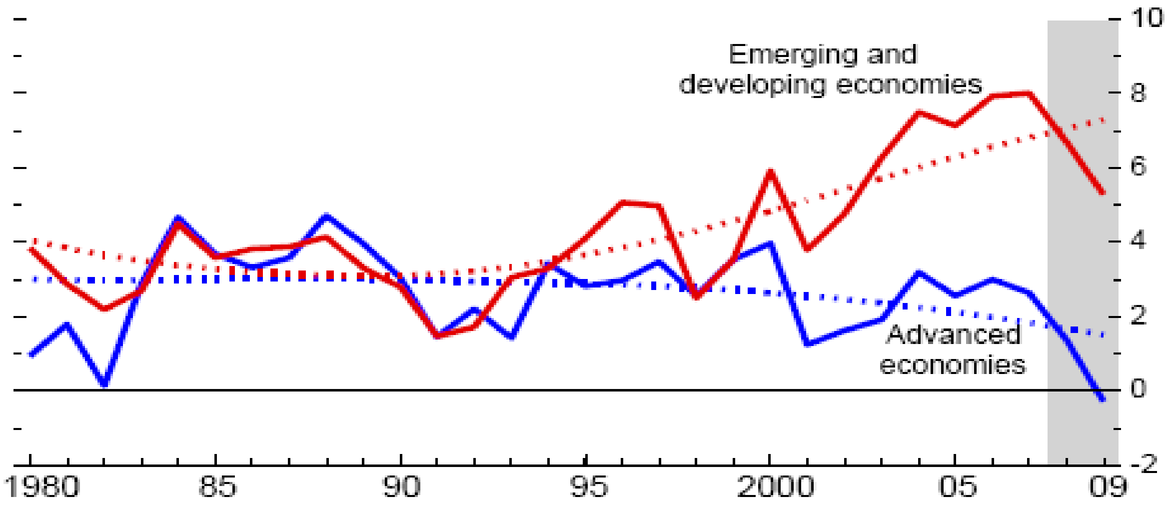
IMF Nov. 2008

IMF-OECD Projections

	2009		2009	
	Year	over Year	Q4	over Q4
	IMF	OECD	IMF	OECD
GDP				
USA	-0,7	-0,9	-0,5	-0,9
Euro Area	-0,5	→ -0,6	….	→ -0,1
Japan	-0,2	-0,1	0,4	0,3
Inflation				
USA		1,6		1,3
Euro Area		1,4		1,3
Japan		0,3		-0,1

World Economic Outlook

Figure 1. Real GDP Growth and Trend
(Percent change)



Source: IMF staff estimates.

Inflation

- **Bursting bubbles, de-leveraging, decreasing oil prices and recessionary tendencies; main reasons, why market participants have significantly reduced inflation expectations in particular in advanced economies**

- **To what extent, lessons can be drawn from the boom-bust cycle in Japan for evaluating further challenges in some advanced economies?**

- **Despite some moderating due to decreasing commodity prices, inflation rates remain high in EMEs, depreciation**

- **High volatility of inflation rates; due to high weight of commodities in the basket of goods in EMEs**

Inflation rates 1997/98 (1,2) and 2006-08 (3-5) in 23 selected EMEs and developing countries

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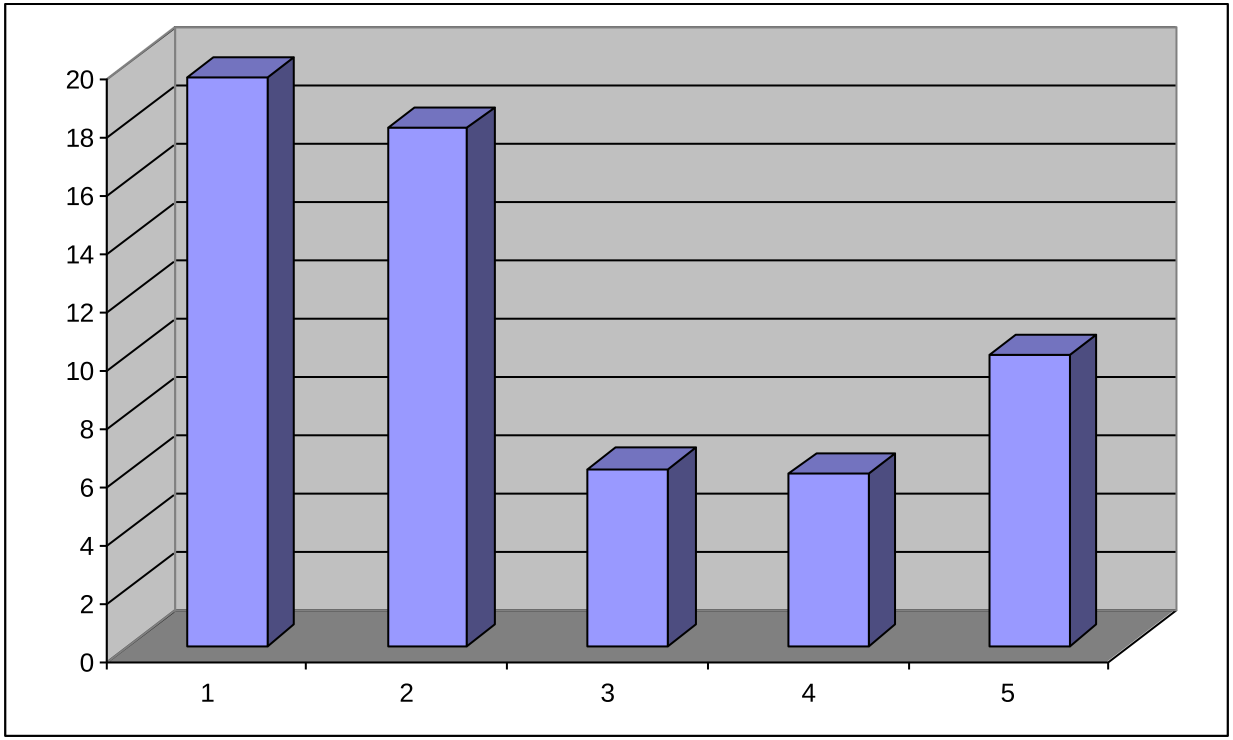


No-decoupling - re-synchronisation of business cycles

- **Globalisation and de-coupling: no need for further discussion**
- **EME: Dampening but slight recovery during 2009**
- **Stronger growth than in advanced economies**
- **No significant recovery in advanced economies**

No room for further de-coupling

Traditional de-coupling pro-arguments

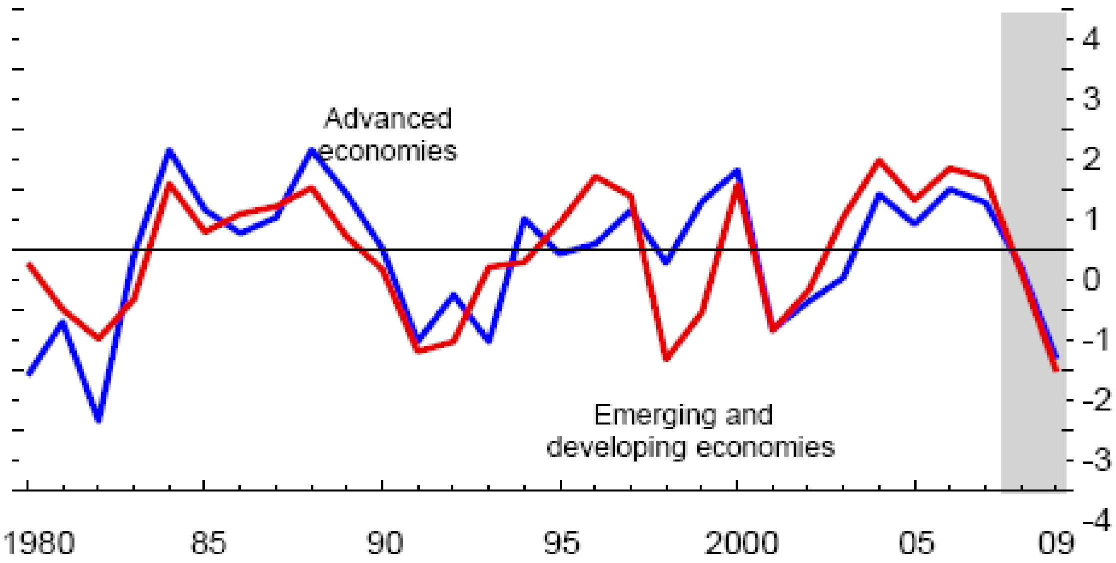
- **Increasing importance of intraregional growth**
- **Domestic demand led growth**
- **Empirical studies**
- **Significant progress in stabilising macroeconomic framework**

Reasons for stonger synchronisation of business cycles

Contra arguments

i. **Variance of domestic demand highly driven by exports**
ii. **Financial globalisation and financial market channel**
iii. **Changing structures of financial markets and transmission channels of disturbances to the real economy not sufficiently covered by macroeconomic models – one of the main priorities for future research**
iv. **Trade channel: variance of domestic demand to a high degree driven by external factors**
v. **Expectations – these are increasingly important determinants for a stronger international synchronisation of business cycles; orientation at few leading indicators**

Figure 2. Real GDP Growth—Deviation from Trend



Source: IMF staff estimates.

Increasing importance of financial market channels

Key question:

- **What do increasingly globalised financial market cycles mean for national real economic cycles, in particular for Emerging Market Economies?**

  - Financial market prices and spreads of increasing importance for national real economic development …

  - … but asset prices and spreads more and more influenced by global factors

    - 50 % of spread variance in EMEs determined by global factors
    - …. with significant repercussions to WORLD economic growth
    - 80 to 90 % of all rating changes in EMEs are determined by global factors, what does it mean for countries with very different economic structures?

  - Changing financial conditions in EMEs with significant repercussions to world economic growth, 200 bp increase in spread levels in EMEs dampens world economic growth by around 0,9 % compared with baseline scenario in the following year

Financial market channel

Lessons to be learned; future research

- **Even domestic demand led EMEs can be heavily affected by international financial market disturbances!**
- **Even EMEs with stable macroeconomic framework**
- **Implications of financial globalisation: international financial sphere of increasing importance for national business cycles**
- **Dynamically changing financial market channels – international and national - not sufficiently covered by macroeconomic models**

Financial market channel

- Increasing importance of internationally operating institutional investors; better knowledge of their strategies are key for a better understanding of disturbances and contagions
- 30 % to 40 % of the variance of investments in the real economy of EMEs are influenced by credit growth
- Increasing importance of cross border loans of internationally operating banks: in some regions 70 % of all assets hold by foreign banks,
- … better knowledge of these internal capital markets and implications of a centralised liquidity and credit portfolio management of global banks are of key importance
- Significant spreading of risks and distortions with complex financial innovations

Crises compared with 1997

Vulnerabilities in EMEA* 1997 and 2007	June 1997	2007
Macro Indicators		
Current Account (% GDP)	-5,0	-9,3
External Debt (% GDP)	43,4	67,5
Fiscal Balance (% GDP)	1,1	-0,2
Public Debt (% GDP)	23,5	27,0
Real GDP Growth	7,0	6,7
Inflation (yoy)	5,9	9,9
Banking Indicators		
Loan to deposit ratio	110,4	139,0
FX Loans (% total)	12,1	47,7
Foreign Ownership (%)	11,0	71,0
Real credit growth (yoy)	19,5	28,8
Private credit (% GDP)	71,4	57,0
Liquidity Indicators		
Reserves to short-term debt	74,7	129,9
Avg Net Private Capital Flows**	5,3	8,0
Short-term debt (% GDP)	14,2	17,1

** Baltics, Hungary, Romania, Poland, Bulgaria, Turkey, Ukraine, Russia, Czech Republik, Croatia*

* *(3 preceding years)

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III. Further challenges

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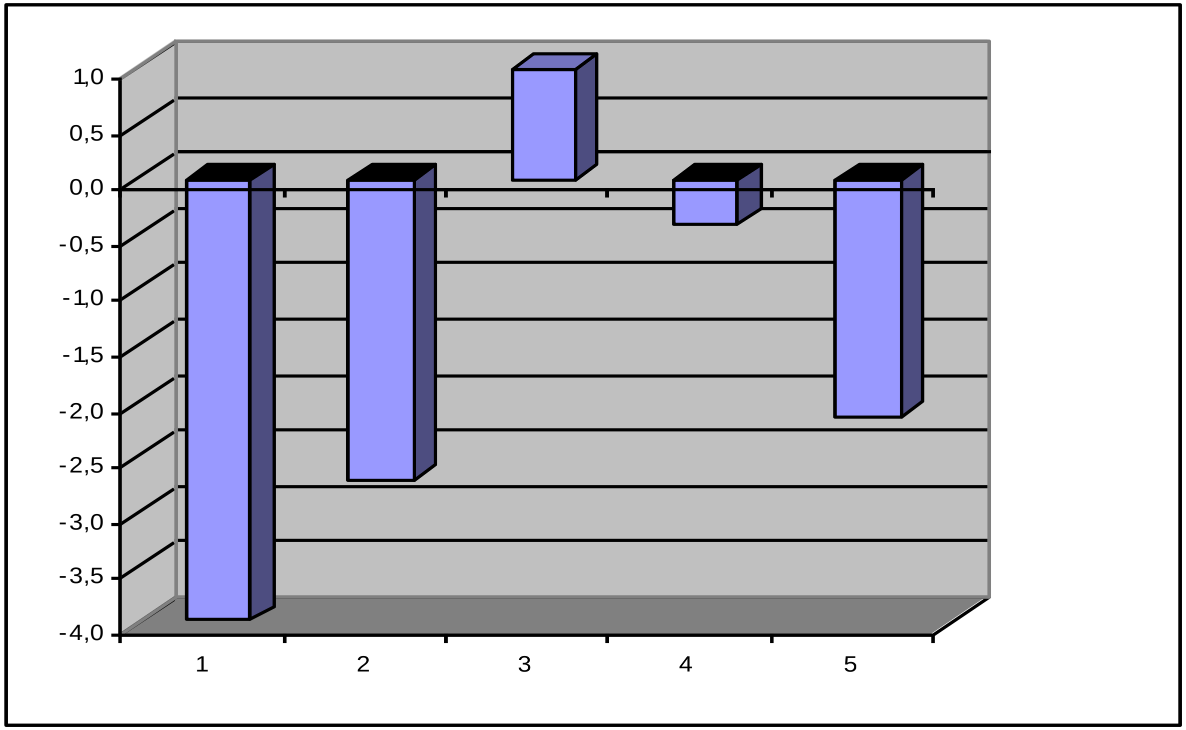
Challenges

- Stable macroeconomic framework …
- … in times of financial market crises, credit crises, fluctuating commodity prices
- More exchange rate flexibility, in particular against the backdrop of financial globalisation
- Implications of changing financial transmission mechanisms for financial stability and growth
- Further reduction of currency and maturity mismatches
- Absorption of increasing financial volatility
- Still different financial landscapes in industrial and emerging market economies in structure and size

- **Macroeconomic conditions are better today compared with 1997**
- **On average of 23 selected EMEs and Delevoping Countries**
- **Inflation rates are significantly lower**
- **Same is true for current account deficits, but here reverse into deficits is also significant, reflecting a high sensitivity of EMEs to commodity price development and high dependency on trade with some advanced economies**

Current accounts 1997/98 (1,2) and 2006-08 (3-5) in % of GDP of 23 selected EMEs and Developing Countries



Challenges ahead - better monitoring of the build-up of financial distortions

- **How to avoid that financial distortions will have sustained and long lasting dampening effects in the real economy?**
  - Reduce currency and maturity mismatches
  - Avoid the build up of financial distortions in times with no financial or real tensions
  - Avoid that bank balance sheets are significantly driven by distorted asset price movements
  - Enhance disincentives of excessive risk taking
  - Risk management is no substitute for an effective incentive systems

Challenges ahead - anchoring inflation expectations under volatile market conditions

- **Of key importance for developing and deepening financial markets**
- **Consumer prices in some/most EMEs are still above inflation targets**
- **Foreign institutional investors avoid volatile financial markets – new empirical studies – significantly below benchmark**
- **Re-stabilising inflation expectations needs more time in Emerging market economies than in industrial countries – history matters**
- **Emerging market economies with an inflation target have been more successful in constraining inflation and in anchoring inflation expectations**