

# **The Financial Crisis in Emerging Markets: Lessons for Global and Not-So-Global Financial Architecture**

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Remarks are in personal capacity and need not reflect the views of the EBRD



## The crisis is now global

- Recession in all major industrial regions
- World trade and global capital flows falling
- Emerging markets facing "sudden stop"
- Emerging Europe is particularly threatened
- But even China severely affected
- "Global Financial Architecture" discussion is (once again) in full swing



# How much “global financial architecture” reform do we need?

**Objective of this talk: to convince you of three points.**

1. The real news not the lack of decoupling of emerging markets but rather their extraordinary resilience
2. The cause of this crisis not found in the “international financial architecture” but in *national* (and *regional*) architectures in the face of excess global savings
3. But deficiencies in the international financial architecture an important impediment in containing the crisis. *This is where progress is urgently needed.*





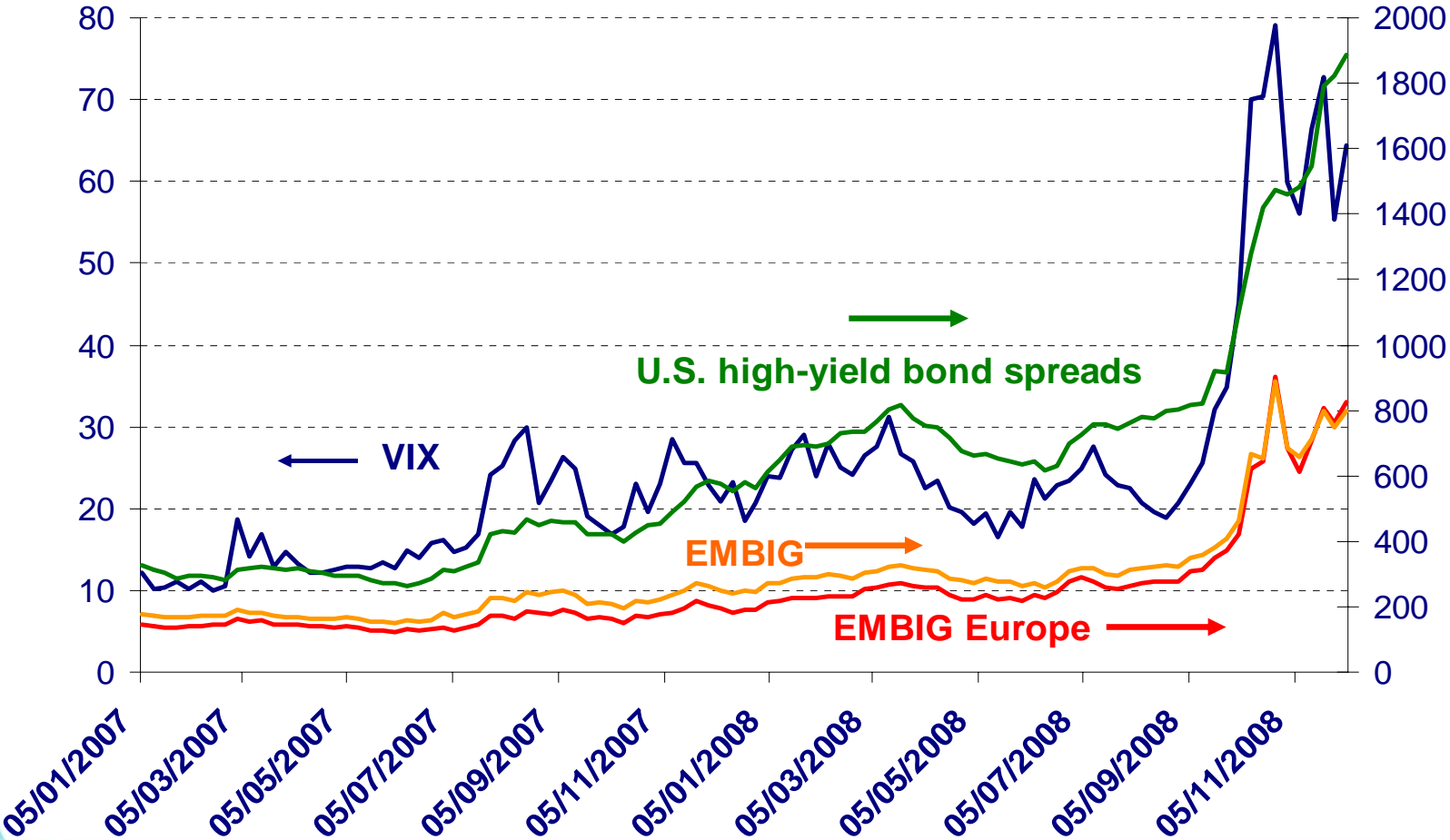
## Claim 1

With respect to emerging markets, the real news in this crisis is *extraordinary resilience*

*(yes, so emerging markets have finally been hit. But it took a nuclear explosion in the centre of the system to get to this point—not, as in the past, “the drop of a pin”)*

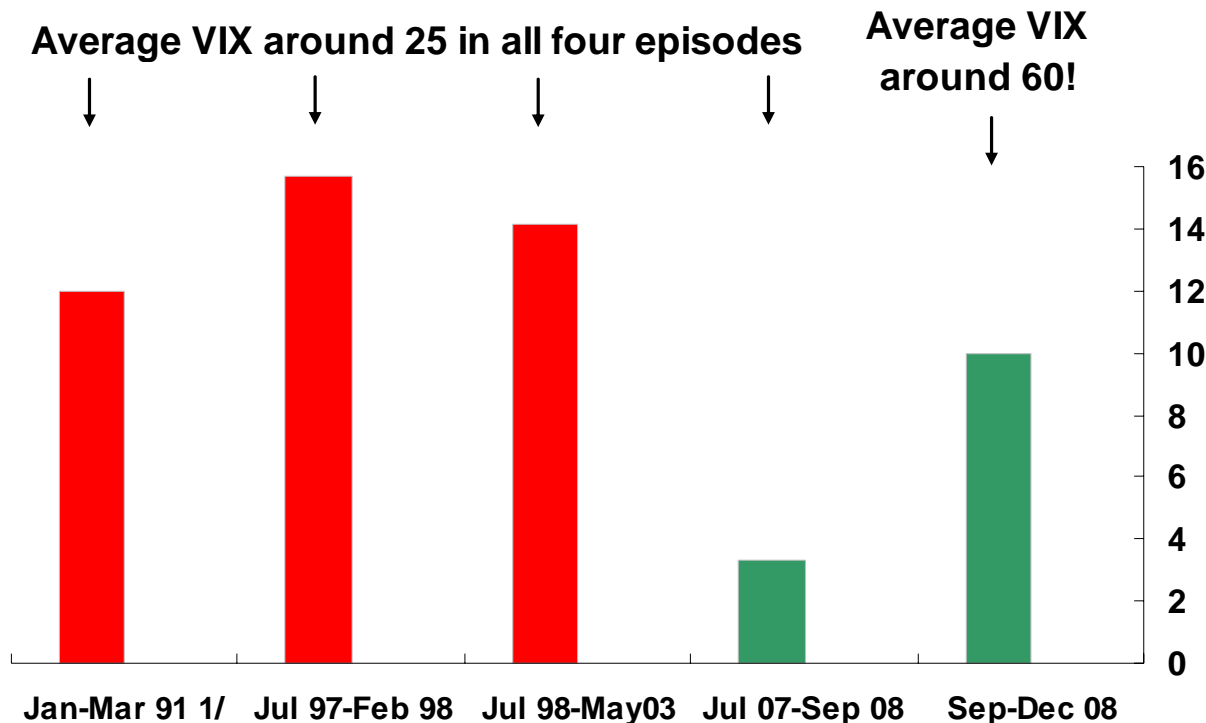


# Until September 2008, emerging markets had largely “decoupled”



# Emerging markets much more resilient than in earlier crises

Average response of EMBI to daily changes in the VIX during periods of financial volatility in the United States



Note: Based on regression of daily changes in EMBI spreads on changes in the VIX in periods during which the VIX consistently exceeded 20 points.

1/ Constrained by data availability. Turbulence period started in July 1990.



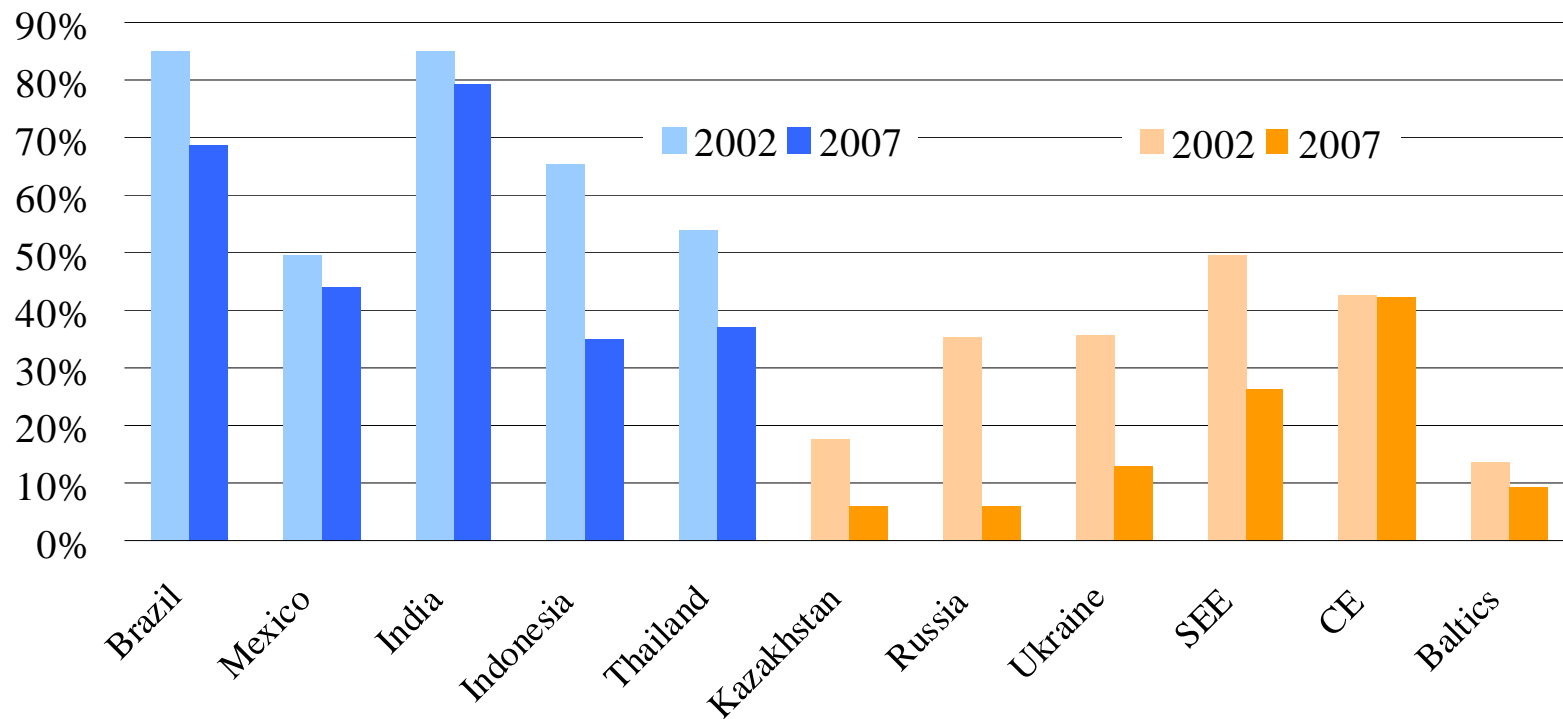
# What explains the resilience of emerging markets—until now?

- **Not:** Better “international financial architecture”. Since 1998 much talk, no action.
- **Rather:** improvements in emerging market fundamentals: policies and institutions.
  - In most countries: lower public debt, better fiscal policies; better monetary frameworks; more stable external capital structures
  - In some countries (but not in transition economies): lower foreign currency external debt



# Public debt ratios have declined – and are especially low in Eastern Europe

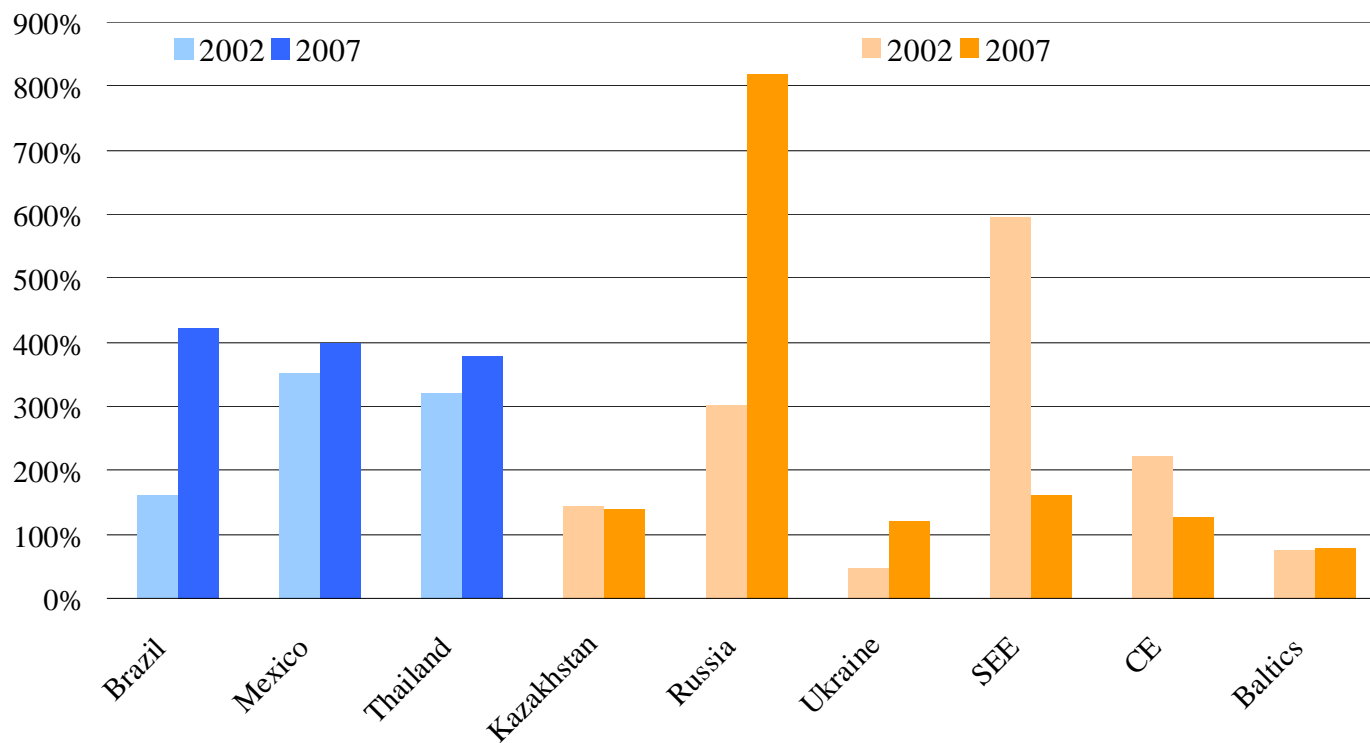
Public debt over GDP



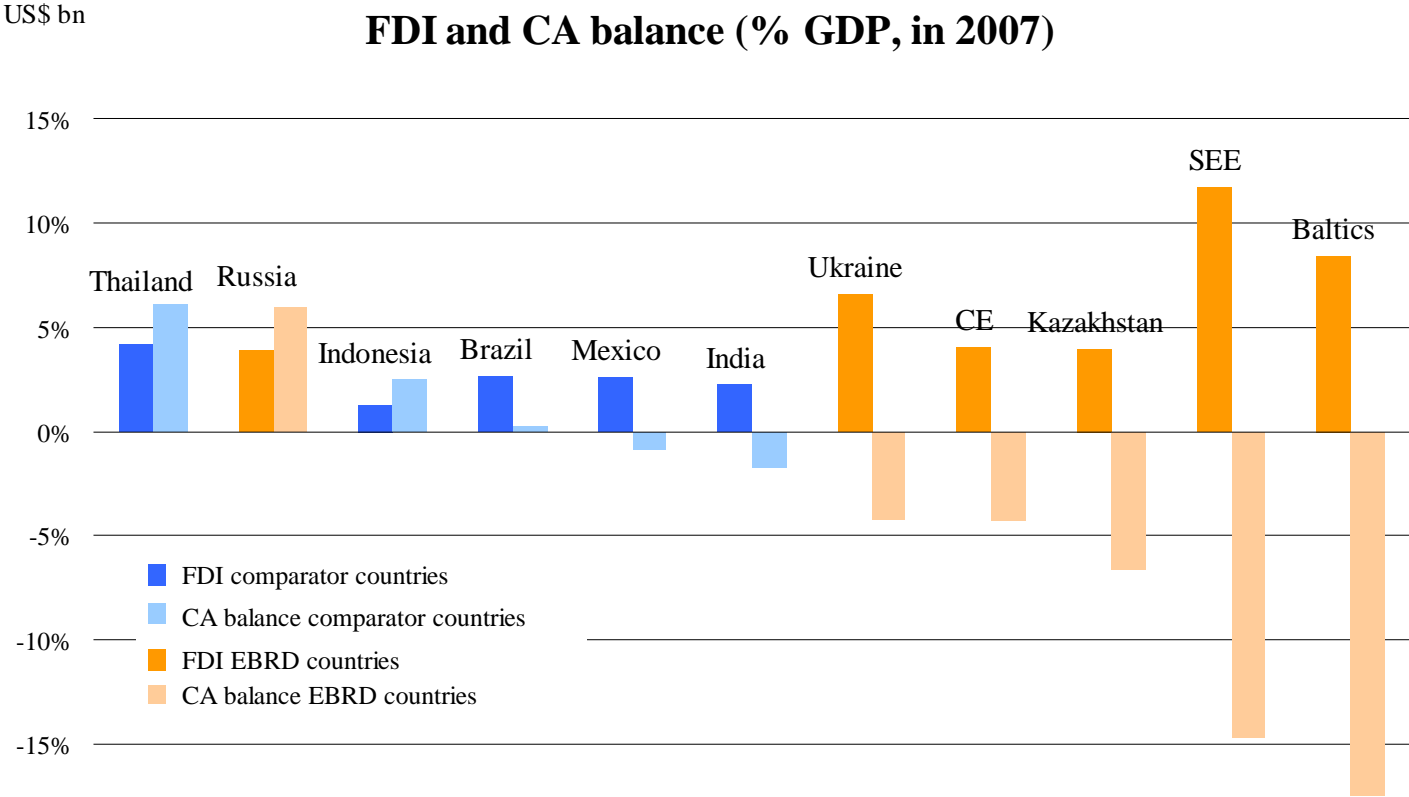


# Liquidity ratios improved in many emerging markets, not in Eastern Europe

## Reserves over short-term debt



# Unlike other emerging markets, current account deficits large in Eastern Europe

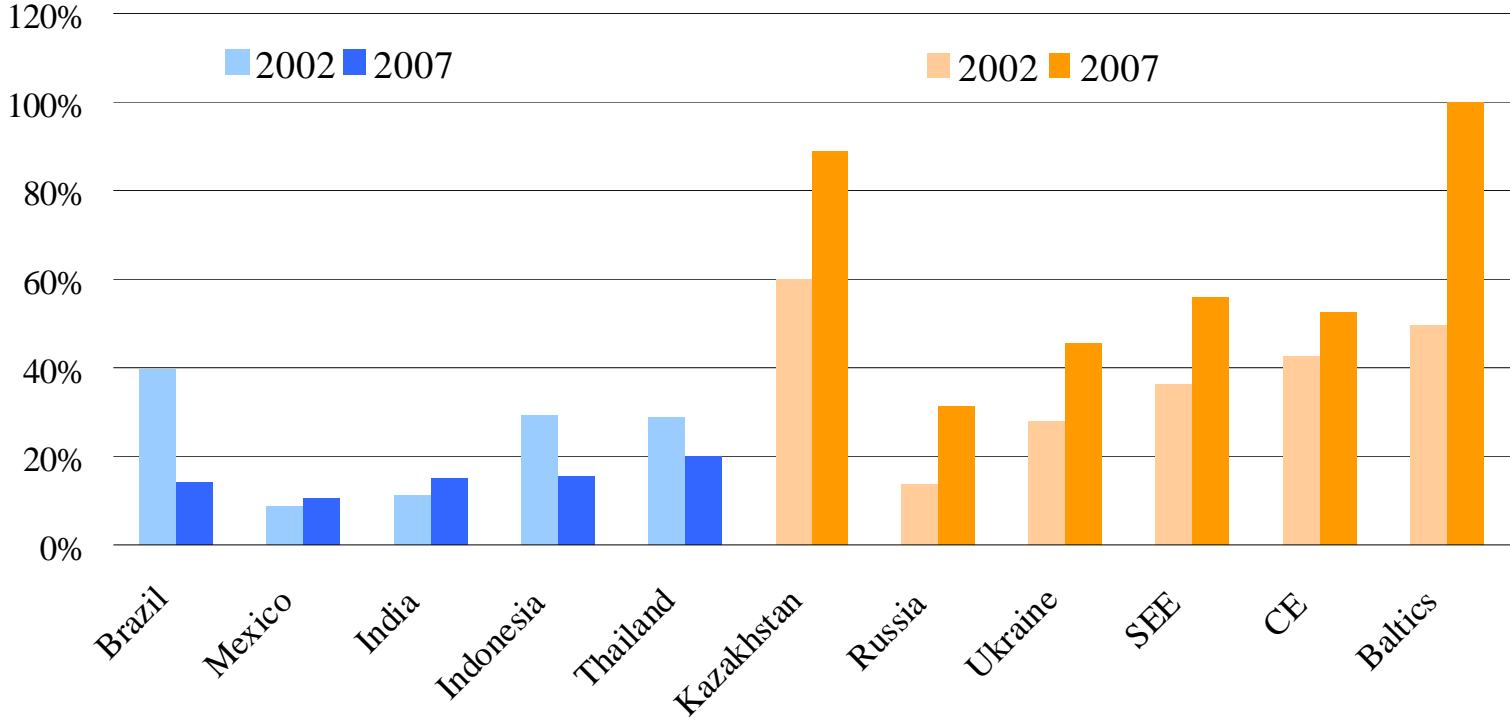


...though they have largely been financed by FDI



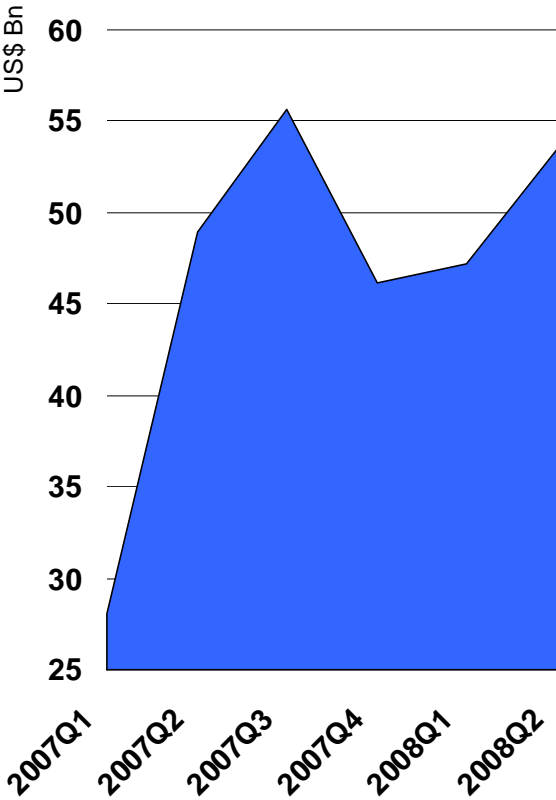
# What sets aside Eastern Europe is the huge increase in private external debt ...

### Private debt over GDP

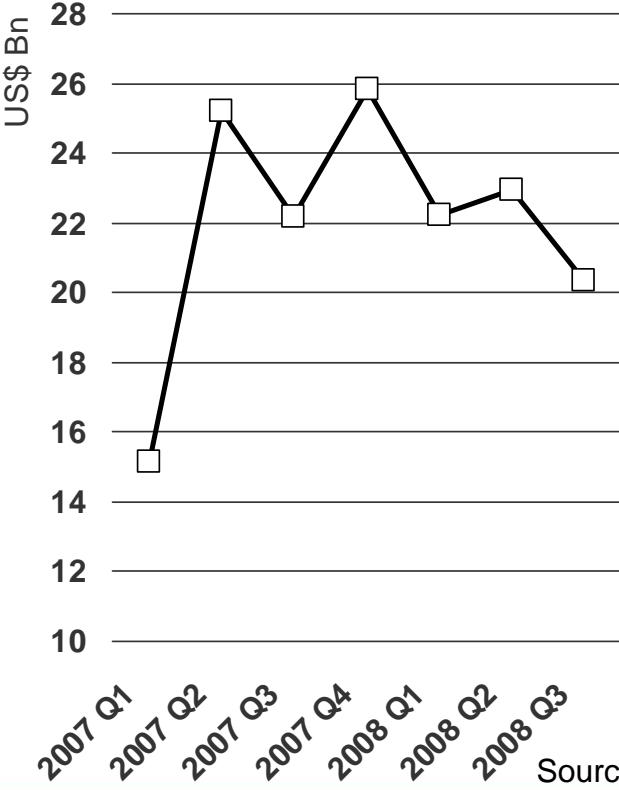


# Syndicated lending is sharply down, but parent bank financing has held up so far

**Total** net bank lending: still high ... in spite of declining wholesale lending



Source: BIS



Source: Dealogic





## Claim 2

Deficiencies in the “international financial architecture” cannot be blamed for the current crisis (and more generally, so far do not matter a whole lot in crisis prevention)

*(omnipotent, perfect international institutions could prevent crises – but so could omnipotent, perfect **national** institutions)*



## The list of potential crisis culprits is long ...

- Too high global savings chasing too few assets
- Liquidity fueled by lax monetary policy
- Distortions caused by the GSE model in the U.S.
- Failures to regulate subprime lending in the U.S.
- Failure to regulate exposures to structured products across the globe
- Failures of financial institutions and rating agencies to recognize dangers associated with structured products
- Allowing Lehmann to collapse...



## ... but global financial architecture is not on the list

- Problem was not collective action at the international level, or lack of global institutions
- Global institutions would only have helped if they had been *both* more powerful *and* wiser than national institutions – a tall order



## **More generally, lack of global coordination is rarely the bottleneck in crisis prevention**

- Domestic policy failures and spillovers across countries together produce international crises
- But lack of cross-country coordination rarely explain why policymakers fail to prevent crises
- So far, if policymakers had always taken the right crisis prevention steps from a purely national perspective, they would also have gotten it right from an international perspective





## **...but failure of EU architecture made Eastern Europe highly vulnerable**

- Eastern European banking system controlled (80 per cent) by international banking groups
- EU members (and candidates) deregulated their capital accounts
- Regulation and supervision through home-host country coordination failed
- Lack of centralized financial regulation and supervision at the EU level





## **Claim 3**

In contrast to crisis prevention, the international dimension is hugely important in crisis *resolution*

*(and this is where the beef is right now)*



# Two international dimensions to crisis resolution

- Once a crisis hits, emerging markets are (almost by definition) in need of external funding
- In a crisis, countries often tempted to take actions that are individually rational (in the national interest) but make everyone worse off collectively. True in the Great Depression - and in the current crisis.

The current crisis response fails along both dimensions



## Problem 1: Underfunded international crisis lending

- IMF quotas have not been revised since 1998. The IMF is ill-equipped to deal with the current crisis
- European Commission funds are even smaller
- If rescues with high private rollover rates a gamble during the Asian crisis – with ample international liquidity – they are an even bigger gamble today
- In the short run, the IMF should use ad-hoc liquidity promises (Japan) to scale up its financial support. In the longer run, significant quota increase needed



## Problem 2: Adverse spillovers from national rescue packages

In a financially integrated system, national rescues can have adverse external effects

- *Passively*: by drawing deposits and capital flows away from countries with weaker government support and distorting competition
- *Actively*: by limiting international banking groups' ability to support subsidiaries across borders

Reinforced the crisis in Eastern Europe, and worsen as the capitalization of banking groups deteriorates



## Needed: a coordinated resolution of financial sector problems in East and West

- Government banking support should focus on the *group*, not just the parent or just the subsidiary
- Requires close home-host country coordination
- Governments should not get in the way of parent bank support for subsidiaries
- International institutions can help, either at parent bank level (EIB) or at subsidiary level (EBRD, IFC)



# Conclusion

- The international financial architecture a non-issue both with respect to the causes of the crisis, and in explaining the resilience of emerging markets (weak EU architecture made Eastern Europe vulnerable)
- **But a huge issue in the crisis going forward.**
- Eastern Europe immediately needs a plan involving both home and host countries, and international banking groups and international lenders
- In the longer run, the global architecture needs a not-so-global (regional) intervention mechanism that mirrors the integration at the bank group level

