Seven Questions about Emerging Markets and the Financial Crisis

M. Ayhan Kose

Emerging market economies (EMEs) have become a dominant presence in the world economy over the past two decades. The global financial crisis, however, cast a pall over the notion that EMEs had become self-reliant and had insulated themselves from advanced country developments. Still, the EMEs as a group have weathered the crisis better than the advanced economies. This article provides brief answers to seven commonly asked questions about the EMEs' experience during the crisis.[1]

Question 1: What was the major debate about the EMEs before the global financial crisis?

The spectacular growth performance of EMEs in recent decades has attracted a lot of attention. The emerging markets' shares of world GDP, private consumption, investment, and trade nearly doubled in the space of less than two decades. Before the crisis, these changes prompted questions about the relevance of the conventional wisdom that these countries' fortunes were heavily dependent on the developments in advanced countries. The conventional wisdom came into question because emerging market growth continued to be strong despite relatively tepid growth in the advanced economies over 2003–07. A fierce debate began in 2006–07 over whether global business cycles were converging, or cycles in emerging markets had started to diverge from fluctuations in advanced-country business cycles. The divergence argument is of course directly linked to the issue of the resilience of EMEs, as it implies that those economies have become less vulnerable to external shocks emanating from the advanced economies.

Question 2: How did the financial crisis change the debate?

The global financial crisis changed the direction of this debate and cast a shadow over the ability of the EMEs to insulate themselves from shocks in advanced countries. In particular, the problems in the financial systems of advanced countries rapidly spread to a number of EMEs during the last quarter of 2008 and the first half of 2009, disrupted their asset markets and stunted their short-term growth prospects. This was not altogether a surprising outcome, as past episodes of business cycles suggest that deep and highly synchronized recessions in advanced countries tend to have large spillovers to EMEs. Remarkably, however, most EMEs have bounced back briskly from the global recession since mid-2009, and as a group have weathered the crisis much better than the advanced economies. There is of course significant variation in the degree of resilience displayed by different groups of emerging markets. Nevertheless, the core fundamentals of the EMEs suggest that most of these countries have the potential to generate sustained high growth over the long term, so the shift in the locus of global growth from the advanced economies to the EMEs is likely to persist. These developments call for a deeper analysis of the implications of shifts in the global economic structure.

Question 3: How did the EMEs perform during the global financial crisis?

Although EMEs, as a group, performed well during the global recession, there were sharp differences across emerging economies in different regions. The economies of emerging Asia had the most favorable outcome, with relatively modest declines in growth rates. China and India, which are the two largest economies in emerging Asia and which maintained strong growth during the crisis, obviously played an important role in this result. Excluding these two countries and Hong Kong SAR from the emerging Asia group leaves that group with a less impressive performance overall. Emerging Europe had the sharpest fall in total output during 2009, followed by Latin America.

By contrast, and somewhat surprisingly, the economies of the Middle East and North Africa, as well as those of sub-Saharan Africa, weathered the crisis better, with only small declines in output. The relatively modest exposure of these two groups to trade and financial flows from advanced economies may have limited the extent of spillovers from the global shock. Latin America, by contrast, is more closely integrated with advanced economies, especially the United States. Although Latin American EMEs suffered growth contractions during the crisis, they bounced back relatively strongly. This is in contrast to previous episodes of global financial

[1]Based on Emerging Markets: Resilience and Growth Amid Global Turmoil, by M. Ayhan Kose and Eswar S. Prasad, published by Brookings Institution Press in November 2010.

turbulence, when Latin American economies proved to be vulnerable to currency and debt crises.

Question 4: What are the major factors explaining the resilience of the EMEs?

Many factors account for the relative resilience of emerging markets, as a group, during the global financial crisis. Some relate to policy choices made by these countries, while others are associated with underlying structural changes in their economies. These factors also help explain differences in degrees of resilience across different groups of EMEs.

First, the EMEs have become less dependent on foreign finance and have been able to reduce the share of external debt denominated in foreign currency. This has reduced their vulnerability to swings in capital flows. As a group, emerging economies have been net exporters of capital during the past decade. Asian emerging markets, especially China, have run significant current account surpluses in recent years. There are of course other emerging economies, especially those in Europe, which were running large current account deficits before the crisis.

Second, the EMEs came to the crisis with large buffers of foreign exchange reserves, which provided insurance against sudden reversals in investor sentiment. Of course, the benefits of large reserve stocks have to be considered relative to the costs of accumulating them, both in terms of the quasi-fiscal costs and the more subtle costs of constraints on domestic policies.

Third, greater trade linkages among EMEs have increased their resilience as a group. In particular, commodity-exporting countries have been shielded to some extent from slowdowns in advanced economies by strong growth in the EMEs.

Fourth, emerging markets have become more diversified in their production and export patterns, although this has, to a significant extent, been offset by vertical specialization, particularly in Asia, through regional supply chains. Even though diversification offers limited protection against large global shocks, as long as the effects of shocks are not perfectly correlated across countries (export markets), diversification can promote resilience in response to normal shocks.

Fifth, there has been a divergence of EMEs' business cycles from those of advanced economies. This divergence has happened because of the factors noted above, in addition to greater intragroup trade and financial linkages.

Sixth, during the era of Great Moderation (1985–2007), most EMEs succeeded in bringing inflation under control through a combination of more disciplined fiscal policies and more credible monetary policies. Indeed, a large number of EMEs have now adopted some form of inflation targeting—either explicit or implicit, soft or hard—along with flexible exchange rates, which act as shock absorbers for external shocks. This has led to moderate and less volatile inflation. In turn, stable macroeconomic policies have facilitated a shift toward more stable forms of financial inflows and also made international investors less concerned about the safety of their investments in emerging markets.

Finally, rising per capita income and a burgeoning middle class have increased the size and absorptive capacity of domestic markets, making EMEs potentially less reliant on foreign trade to benefit from scale economies in their production structures and also less susceptible to export collapses.

Question 5: Why did some EMEs do reasonably well while others suffered during the crisis?

The factors discussed above are brought into sharper relief when one examines more closely the experiences of two sets of EMEs between which there is a clear contrast in terms of resilience to the global financial crisis. Before the crisis, average per capita GDP growth was highest in emerging markets in Asia and Europe. But since then these two groups' fortunes have diverged. While Asian emerging markets, particularly China and India, have been among the most resilient during the crisis, some economies of emerging Europe were the hardest hit.

Emerging Asia was relatively insulated from the effects of the financial crisis for three possible reasons. First, its financial markets are relatively insulated, especially in their limited dependence on foreign bank financing, which narrowed the channels for financial contagion and also kept trade finance from collapsing. Second, the region's high and rising saving rates have more than kept pace with rising investment rates, leading to current account surpluses and growing stocks of foreign exchange reserves, thereby insulating the region as a whole from the effects of a sudden stop in capital flows from advanced economies. Third, prudent macroeconomic policies practiced by a number of these countries allowed the fiscal flexibility to respond aggressively to the spillover effects of the crisis.

By contrast, emerging Europe was particularly vulnerable to the aftershocks of the crisis. It had a high level of dependence on external finance, as reflected in large current account deficits; significant exposure to foreign banks, which had many benefits but also served as a transmission channel for the crisis; and rapid credit expansion in the years before the crisis, which was difficult to sustain after foreign bank financing dried up.

Question 6: What policy lessons should the EMEs take from their experience during the crisis?

The experience from the crisis brings lessons for three interconnected categories of policy—macroeconomic, structural,

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and financial policies. First, during good times, policymakers should work to create more room for macroeconomic policy responses to adverse shocks. EMEs that had lower levels of public debt (as ratios to GDP) had more room for aggressive countercyclical fiscal policy responses to the global financial crisis and less concern about worsening their debt service obligations. As this crisis has shown, coordinated and preemptive domestic macroeconomic policies can substantially dampen the effects of major shocks. A well-functioning financial system can enhance the transmission of monetary policy and add to its potency as a countercyclical tool, so financial market development and reforms are an important priority in most EMEs. Although some EMEs seem to have benefited—in terms of not being hit hard by the crisis—from having underdeveloped financial markets, this has potentially adverse long-term implications for growth as well as distribution.

Second, it is tempting for EMEs to increase self-insurance through reserve accumulation. This strategy certainly seems to have helped stave off the worst of the crisis for many EMEs, but it comes at a significant cost in terms of the policy distortions needed to accumulate reserves.

Third, a growth strategy that is well balanced in terms of domestic and external demand can lead to more stable outcomes. Reliance on external demand creates vulnerability to demand shocks originating in trade partners.

Fourth, EMEs can derive significant benefits from openness to foreign capital, but should be cautious about dependence on certain forms of capital, particularly short-term external debt. Dependence on foreign finance exposes a country to sudden stops or reversals of capital inflows. There is evidence that short-term external debt is a particularly risky form of inflow, but the experiences of some economies in emerging Europe indicate that even relatively stable forms of inflow such as foreign direct investment can turn volatile at a time of global financial turmoil. Robust public sector and corporate governance as well as deep and well-regulated financial markets seem to tilt capital inflows toward more stable forms and also help countries cope better with the volatility of capital flows.

As a more general point, EMEs should maintain effective financial market regulation and rapidly counteract credit booms that can turn into busts, especially if these booms are fueled by foreign capital inflows and if the associated busts can be compounded by spillover effects of external shocks. As financial markets in EMEs become increasingly sophisticated and complex, it is important to have in place the regulatory capacity and nimble regulatory frameworks to keep up.

Question 7: What are the implications of the changes in EMEs for advanced countries?

Advanced economies should adapt to the rising prominence of emerging markets. There are a number of implications of the changes in EMEs for advanced countries, but it is useful to focus on the three most relevant ones here. First, although some EMEs have per capita incomes well below those of the advanced countries, the growing size of EMEs and their rapidly rising per capita incomes are expanding the size of their domestic markets, making them less reliant on demand in advanced economies. Since the EMEs have high saving rates, they are also becoming less dependent on foreign finance, especially from advanced economies. This gradual process of structural divergence of EME business cycles from advanced economy business cycles, along with the strong growth potential of the former group, suggests that advanced economies should be looking to expand trade relationships with the EMEs in order to diversify their export base and benefit from the growth potential of EMEs.

Second, advanced economies should consider ways to promote greater financial integration with EMEs, particularly by creating more channels for two-way private capital flows that could be mutually beneficial. Given that EMEs have strong growth potential and can provide good opportunities for investors from advanced economies to diversify risks, there are good reasons to create stronger financial links with these economies, especially those with deep and stable financial markets. However, this does create some potential risks that will need to be managed, as discussed below.

Cross-border bank exposure needs to be monitored carefully so regulators and central banks can take action to counter the spread of financial shocks through this channel. This proved to be a channel through which financial systems in some advanced European Union economies were vulnerable to growth collapses in emerging Europe. Better coordination across national regulators in the supervision and regulation of large multinational banks has also become a priority.

Third, there is a strong need among advanced economies for more disciplined macroeconomic policies—especially sustainable and prudent fiscal policy, but also structural policies, including labor market flexibility and sound financial markets—so they can work as shock absorbers in response to both domestic and external shocks, including those originating in EMEs. Rising global integration will increase vulnerability to external shocks, including those emanating from EMEs, making this an important priority. In addition, given the degree of openness to trade among advanced economies, it is in their best interest to promote a more stable and transparent global trade regime.