



Economics

Free exchange

Return of the glut

Jul 26th 2010, 21:11 by R.A. | WASHINGTON

WITH a return to global growth, we have observed a resumption of many of the patterns that prevailed before the recession trade crash. Trade surpluses and deficits have been widening out once more, and that has meant a corresponding increase in the foreign exchange reserves accumulated by many emerging markets. In a common telling of the pre-crisis world, emerging markets sought large surpluses in part because they were the flip-side of export-oriented growth (a proven path to development) and in part to insure against the financial crises that battered industrialising countries in the late 1990s. Never again would emerging economies be held prisoner by panicky lenders in developed nations. But those surpluses gave way to a "global savings glut"—a giant pool of credit that was recycled to developed nations to preserve consumption there, and which ultimately fueled dangerous, leveraged financial activity.

Today, reserve growth is therefore considered by many (though not necessarily by the surplus economies that weathered the downturn well) to be problematic. They represent barriers to global rebalancing and the potential for new financial misadventures. But emerging markets will surely argue that they remain unable to trust the developed world to provide liquidity in a crisis.

So this week we have also asked our guest network of economists the following question: [what will it take to convince emerging markets to halt reserve growth?](#)

Ricardo Caballero (http://www.economist.com/economics/by-invitation/guest-contributions/developed_world_must_shape) says the problem lies with the developed world:

[I]t is not a matter of "convincing" emerging markets. I can see why Asian economies could do a little more in letting their currencies appreciate, but it may well be that as they do this they experience even larger capital flows and end up accumulating even more reserves. I think it is more a matter of the developed world getting its act together.

Harold James (http://www.economist.com/economics/by-invitation/guest-contributions/emerging_markets_must_mature_further) argues that the maturation of emerging markets will solve the problem, while Eswar Prasad (http://www.economist.com/economics/by-invitation/guest-contributions/emerging_markets_need_credible_global_crisis_insurance_s) and Guillermo Calvo (http://www.economist.com/economics/by-invitation/guest-contributions/emerging_markets_require_effective_protection_against_su) both make the point that a credible international insurer is required. Michael Pettis (http://www.economist.com/economics/by-invitation/guest-contributions/american_anger_may_give_way_protectionist_response) suggests that the situation may ultimately, and unfortunately, be resolved by protectionism, while Ajay Shah (http://www.economist.com/economics/by-invitation/guest-contributions/problem_going_away_over_time) provides historical perspective. It's interesting to note that international negotiations in the wake of the crisis have focused narrowly on China's currency and on financial regulation (which can only be so effective against tides of recycled foreign capital), while largely neglecting the issue of emerging economy capital market vulnerability that helped

trigger reserve growth in the first place.

Anyway, do click through. The discussion will continue through the week.

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A response to:

What will it take to convince emerging markets to halt reserve growth?

Jul 23rd 2010



Emerging markets need a credible global crisis insurance system

Eswar Prasad our guest wrote on Jul 25th 2010, 12:42 GMT

WITH their strong growth prospects, emerging markets are once again becoming the darlings of international investors in search of decent yields. This will lead to even more capital flowing towards these economies, exposing them to the fickleness of these flows. Capital accounts of emerging markets, even those that ostensibly have capital controls, are becoming increasingly open in de facto terms, making it difficult to stanch these inflows.

Naturally, emerging markets want to protect themselves against volatile capital flows and reduce their vulnerability to balance of payments crises resulting from sudden stops or reversals of capital inflows, which have burnt many of them in the past. Building up reserves is one solution.

Do emerging markets need such large and expanding hoards of reserves? The crisis has in fact accentuated the incentives for reserve accumulation. First, during the crisis, reserve levels that were regarded as very high relative to traditional benchmarks such as imports and external debt didn't seem to make economies bullet-proof. Countries like India and Russia lost about a fifth of their reserves in just a few months. Second, the resources of international financial institutions like the IMF were clearly not sufficient to support the major emerging markets if they all came under pressure at once. Even with the increase in the IMF's financial resources sanctioned by the G-20, self-insurance still seems like a reasonable approach as the IMF may run out of money if another global crisis were to come along. Third, the leveraging effect of IMF loans disappeared during the crisis. In the past, accepting policy conditions attached to IMF

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loans would bring in private capital. That did not happen during the crisis, when there was a worldwide credit crunch.

Of course, it is inefficient and costly for emerging markets to self-insure by accumulating reserves. But they do not see any good alternatives. Regional insurance mechanisms are unlikely to be of much use as many shocks tend to be regional in nature, affecting many countries in the region at the same time. An international insurance mechanism through an institution like the IMF would be the obvious answer. However, any association with the IMF remains toxic for political leaders in emerging markets, especially those in Asia. The IMF also lacks legitimacy in the eyes of emerging markets as voting shares at the institution are heavily tilted towards advanced economies and reforms to give emerging markets more representation have been moving at a glacial pace.

What's the solution? I have proposed a global insurance scheme that would allow countries to directly purchase insurance against crises, removing the stigma of depending on an institution like the IMF to save them from crises [see [this \(http://www.brookings.edu/opinions/2009/0310_insurance_prasad.aspx\)](http://www.brookings.edu/opinions/2009/0310_insurance_prasad.aspx)]. Such a scheme would allow countries to buy as much insurance as they wanted (with the premiums determined by the quality of their macroeconomic policies and the desired quantum of insurance), with no ex-post conditionality attached to the payouts.

The IMF can still play a useful role through other lending mechanisms; reforming the institution's governance structure would certainly make a difference in the level of trust that emerging markets have in the institution.

These steps would make a good start at reducing the need for self-insurance through reserve accumulation, which is costly for individual emerging markets and could perpetuate global imbalances—one factor that got us into this mess in the first place.