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Charting a different course

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Will emerging economies change the shape of global finance?

Illustration by Belle Mellor

"THE United States has been a model for China," says Yu Yongding, a prominent economist in Beijing. "Now that it has created such a big mess, of course we have to think twice."

The future of global finance depends on what kind of rethinking takes place in Beijing and the rest of the emerging world. So far the signals have been mixed, even within the same country. In India, for instance, the central bank—long a reluctant liberaliser—recently changed its mind about allowing credit-default swaps, arguing that the subprime crisis showed the time was not "opportune" for such innovations. But at the end of August India launched exchange-traded currency derivatives, giving people a means to hedge against fluctuations in the rupee.

Chinese officials have been unusually outspoken about Wall Street's failures. But just as several rich countries, from Britain to Australia, have banned or reined in short-selling (selling borrowed shares) in a misguided effort to stop share prices falling, China's cabinet agreed to allow investors to buy shares on credit and sell shares short.

By and large, emerging economies' attitude to Anglo-Saxon finance is deeply pragmatic, defined more by the lessons of their own financial crises in the 1990s than by today's calamities on Wall Street. Those crises inflicted far greater economic pain than anything the rich world has seen so far. Mexico's GDP, for instance, fell by 6% in

1995 and Indonesia's by 13% in 1998.

Those collapses held powerful lessons: foreign-currency debt was dangerous, the IMF was to be avoided at all costs and prudence demanded the build-up of vast war chests of foreign-exchange reserves. Rich countries typically have foreign-currency reserves worth about 4% of their GDP. The level in emerging economies used to be much the same, but over the past decade that ratio has risen to an average of over 20% of GDP. China has a whopping $1.8 trillion, and eight other emerging economies have more than $100 billion apiece.

At first sight, fat cushions of reserves have stood emerging economies in good stead. They are one reason why these countries have proved so resilient in today's global turmoil. But, as this special report has argued, these war chests introduced many distortions and rigidities that helped to inflate the global financial bubble and stoke domestic inflation. The challenge for emerging economies is to create a system of global finance that is more flexible yet still safe.

The academic evidence is not reassuring. After the 1990s crisis economists began to look closely at what poor countries gained from integration with global capital markets. The answer appeared to be not much. An influential study for the Brookings Institution in 2007 by Eswar Prasad of Cornell University, Raghu Rajan of the University of Chicago and Arvind Subramanian of the Peterson Institute showed that poor countries that relied on domestic savings to finance their investment grew faster than those that relied more on foreign money.

Nor did foreign capital seem to help emerging economies to cope better with sudden income shocks. In another paper Mr Prasad, together with Ayhan Kose and Marco Terrones of the IMF, showed that the volatility of consumption in emerging economies has increased in recent years. Poor countries with weak financial systems, it appears, cannot cope with floods of foreign capital. The money is often channelled to unproductive areas such as property. Such inflows seem to make boom-bust cycles worse.

The news was not all bad. Studies also showed that foreign direct investment and equity flows brought in know-how and improved corporate governance. And the evidence also suggests that competition from foreign banks and foreigners' money in stockmarkets can improve emerging economies' own financial systems. But long before Mr Volcker questioned the wisdom of globalised finance in America, academics were having second thoughts about the wisdom of financial globalisation for the emerging world.

Ignore the ivory tower

Ironically, this intellectual backlash was taking place even as emerging economies were becoming financially ever more integrated with the rest of the world. All in all, the citizens of emerging countries now have some $1 trillion deposited in foreign banks, a threefold increase since 2002. By every measure, the gross flows of capital involving emerging economies have grown since the mid-1990s and accelerated in the past few years. The composition of those flows has changed: foreign direct investment and equity flows have risen much faster than debt. But the overall level of financial integration is up significantly.

Financial globalisation sped up partly because governments did not listen to the academic sceptics. Most continued to open up, particularly to equity and foreign direct investment. According to the IMF's index of capital controls, only two emerging economies closed their capital accounts between 1995 and 2005, whereas 14 countries opened up fully. The rest came somewhere in-between but were mostly moving towards greater openness.

At the same time foreign banks were playing an ever bigger role. By 2007 almost 900 foreign banks had a presence in developing countries. On average they accounted for some 40% of bank lending, up from 20% a decade earlier. In some places, particularly in eastern Europe and Latin America, foreign banks dominate the domestic financial system. Even China and India, which have been slow to allow in foreign banks, have opened up more in the past decade.

More important, financial integration was accelerating regardless of any deliberate policy choices. In a fast-globalising world even countries with strict capital controls saw an increase in actual capital flows. One explanation is that more trade inevitably produces more capital integration. A financial infrastructure grows up to support global supply chains. Larger trade flows make it easier for firms to evade capital controls, by over- or under-invoicing their transactions. And fast growth has made emerging economies an attractive target for foreign investors and their own citizens living abroad, who can find ways to get around capital controls.

The distortions and costs associated with capital controls are rising as emerging economies become more globalised. Temporary taxes to discourage sudden surges of capital may still have a role to play, even though they can sometimes prove counterproductive. Thailand, for example, imposed a tax on foreign capital inflows into its stockmarket in 2006 but saw the market plunge and quickly reversed the decision. In the longer term the distortions caused by such measures become more burdensome. China, for instance, has some of the strictest controls among large emerging economies, partly insulating itself from global capital markets, but the controls needed to deter speculative capital are becoming ever more intrusive. Since July the State Administration of Foreign Exchange (SAFE) has demanded more information on export earnings. For many small-scale exporters that is a big burden. Globalised finance, it turns out, is an inextricable part of global integration.

That means the right question for emerging economies to ask is not whether global finance is a good thing but how to maximise the gains and minimise the costs. The answer is to rely more on markets, not less, but try to avoid the mistakes that the rich world made.

At home that means adopting more of the new finance. Emerging economies vary enormously in their domestic financial development, but some of the biggest are still surprisingly primitive. India, for instance, has highly sophisticated equity markets but its banking system is underdeveloped and distorted by government edicts. Some 40% of India's bank loans are directed to "priority sectors" such as agriculture, and the main source of credit for the typical citizen is the informal moneylender.

The harder question is how to deal with foreign capital. Top of the list should be greater currency flexibility. The risk for emerging economies that open themselves up to global capital flows is destabilisation. Money will slosh in and out, driving underdeveloped local asset markets up and down and affecting the level of demand in the real economy. Countries that allow foreign banks to enter their markets will be affected by these banks' fortunes elsewhere in the world. Losses that European banks make on American mortgage products, for instance, may cause tighter credit in Hungary.

To deal with such volatility, emerging markets need to manage demand in the way that rich nations do: through more flexible interest rates and exchange rates. By allowing their exchange rates to rise and fall as capital flows wax and wane, emerging economies should be able to keep a measure of control over their domestic monetary conditions. Firms and investors in developing countries also need the risk-sharing derivatives developed by Anglo-Saxon finance. Some already have them. Brazil's market for foreign-exchange derivatives, for instance, is one of the most sophisticated and transparent in the world. Others, particularly in Asia, have much further to go, though India's recent innovations are encouraging.

By removing the need to accumulate vast foreign-exchange reserves, greater currency flexibility would also create a more stable global monetary system. The war chests of reserves could be used to boost domestic financial development. In the summer 2008 issue of the *Journal of Economic Perspectives*, Messrs Prasad and Rajan offer an intriguing proposal. Countries with plenty of reserves, such as China or India, could allow mutual funds (domestic or foreign) to issue shares in domestic currency with which they could buy foreign exchange from the central bank. These mutual funds would then invest abroad on behalf of domestic residents. The result would be a controlled liberalisation of capital outflows, along with the creation of new financial institutions and instruments at home. Oil-exporting countries could achieve much the same effect by issuing their citizens with an oil dividend that could be invested abroad through similar mutual funds. Under both models the management of emerging economies' foreign assets would be shifted increasingly to the private sector. That would allow private investors from China or Saudi Arabia to pick over the carcass of Wall Street.

The heavy hand of the state

At present, though, the trend is still in the opposite direction. Governments in Asia and emerging oil exporters already control some $7 trillion of financial assets, most of it in currency reserves, the rest in sovereign-wealth funds. Analysts at the McKinsey Global Institute reckon that the total could reach $15 trillion by 2013. That would make government-controlled funds a large force in global capital markets, with the equivalent of 41% of the assets of global insurance companies, 25% of global mutual funds and a third of the size of global pension funds (see chart 11).

There is an irony here. By and large, emerging economies shut their ears to the anti-market sceptics who argued that global capital flows were dangerous. But in resisting one statist temptation they have succumbed to another: they have accumulated vast sums of capital in government hands, transforming the nature of global finance long before Wall Street's implosion. However professionally these funds are managed, such huge government-controlled assets will change the balance between state and market. They will also add to the biggest risk for global integration: rising protectionism.