Global Liquidity and Financial Contagion

Transcript of the comments by Amar Bhattacharya, Director of the Secretariat, Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development

I will bring a comparative perspective to the discussion, and I will do it in three parts based on the questions that had been posed: I will talk first about the latest wave of capital flows and its characteristics; I will then tie some of the threads that we have heard on policy responses and challenges for emerging markets; and finally, I want to talk about one last aspect that has not been highlighted, which is the importance of global financial safety nets for emerging markets.

Global Liquidity and Capital Flows

As we have heard that there has been a sharp increase in official liquidity due to the unprecedented expansion in the balance sheets of major central banks. What is striking is not just the increase, but also the flip side, which is a huge contraction in private liquidity. Private liquidity expanded very sharply in the period before the Lehman crisis, with banks and wholesale banking across borders playing a major role focused primarily on the advanced markets. After the Lehman crisis there was a sharp contraction, and global private liquidity remains well below pre-crisis levels. The contrast between emerging markets and advanced countries is very striking, in that capital flows to emerging markets have recovered, although they have been volatile (and I will come to that in a second), but capital flows amongst advanced countries have sharply declined. This is really a story about banks (which I will also come back to shortly).

Among flows to emerging markets, you see a great deal of variation across regions. I don't have the time today, but one can talk about individual regions and why this is taking place. There is also a clear story about the composition of capital flows. Essentially, FDI has remained relatively robust, though not throughout the period. What is noteworthy is that non-FDI flows– and in particular debt financing – have been sharply negative primarily due to a sharp contraction in cross-border bank lending. In the case of advanced countries, it was wholesale banking flows, particularly intermediated through European banks that provided for the huge cross-border boom that took place prior to the crisis. While the decline in bank lending has primarily affected advanced economies, emerging markets have also been affected by the de-leveraging of the banks. Some of this has now been replaced, as Manuel said, by issuance of market-based finance, a lot of which is done by asset managers, which is something new and, importantly not without risk. The second issue, which is equally important, is the internationalization of corporates in emerging markets and the taking on of large amount of unhedged debt. I will discuss the incentives for that shortly.

Overall, these two very important changes in the structure of capital flows are occurring at this very moment. The fundamental driver for this has been the sustained interest differential between AEs and EMDCs, but also the very low interest rates in the advanced countries, as Manuel pointed out. This has created two major incentives: one is the search for yield, and the other is the incentive for un-hedged borrowing on the part of emerging markets, especially emerging market corporates. At the same time, we have to remember that we have lived through a period of huge changes in risk appetite. This has been primarily due to developments in the advanced economies; the Euro crisis has been the most significant but the stalemate with regards to the US debt ceiling also introduced a large measure of volatility during this period of continued capital flows. One result of this has been very significant exchange rate volatility. In the case of Brazil, for example, there was a huge appreciation of the Real and very large capital inflows, which was followed in the subsequent period by very significant depreciation. An important factor in this is the double bet that Manuel talked about, whereby private investors bring in money because yields are relatively high but they also anticipate that the exchange rate will appreciate with additional benefit. Of course, somebody has to pay the price of this, including the central banks. Thus increased exchange rate volatility in emerging markets has been an important characteristic of this most recent period and has been a source of vulnerability.

There is another important and not widely recognized shift that has taken place since the crisis.. A massive rebalancing has taken place in global trade balances driven by the emerging markets. Emerging markets other than China and Japan have swung from a surplus before the crisis to an aggregate trade deficit in the post-crisis period that is now greater in absolute magnitude than the US. This extraordinary shift has been facilitated by abundant capital flows but it also reflects the fact that emerging markets and developing countries have been the principal drivers of global growth and demand during this period. What is equally striking, and I think this is something Andrew had pointed out, is the flip side, which is that Europe went from a modest surplus to an extraordinary surplus. This is an important aspect of the rotation of the demand that needs to be addressed going forward.

This rebalancing and the contribution of emerging markets to global demand has led to increased macro-vulnerability, particularly in terms of increased current account and fiscal deficits. If you look at the graph in the presentation, you see that the five countries that came under most pressure – India, South Africa, Turkey, Brazil, and Indonesia - indeed have larger current account deficits and larger fiscal deficits than other emerging markets and developing countries. This fact is used to suggest that the markets are differentiating between “better performing” countries and “worse performing” countries. But let me reject that proposition quite unequivocally. The same fundamentals were evident for these countries one year ago, so why did the money come in? If these countries were so vulnerable, why were they the beneficiaries of all this money, and if the money is going out, is it really correct that these countries represent a significant solvency risk on the basis of which you would withdraw the money? Yes, there was some link between capital flows and credit risk, but it has not been of the order of magnitude that represents more than a cyclical risk. If you look at the impact of tapering, you see huge impact on emerging markets and developing countries. Again, is this really warranted given the fundamentals? To the contrary, fundamentals in emerging markets are substantially stronger than they are in advanced economies. When you look at debt levels adjusted for growth, even India looks pretty good compared to the United States or Europe. And the same is true in terms of the health of the financial sectors and the track record on policy adjustments. So this issue of fundamentals can be overdone in terms of emerging markets, and, as I had pointed out, emerging markets have been the drivers of the global economy. So one of the risks is that if we allow this beauty contest to simultaneously constrain emerging markets to lower levels of debt and current account deficits, it won't be just bad for the emerging markets, it will be bad for the global economy.

Policy Challenges for Emerging Markets

Let me then come to the policy challenges facing emerging markets in a world capital flow volatility. Looking at the recent ebb and flows, you find that all emerging markets used a degree of exchange rate flexibility to cushion themselves. On the other side, everybody has used a certain degree of foreign exchange intervention. Emerging markets have also deployed a wide range of macro-prudential measures, and in this sample, Brazil, Indonesia and to some extent South Africa, used direct and targeted capital account measures as well.

I want to spend some time on macro-prudential measures. Emerging markets have deployed macro-prudential measures with a far greater degree of frequency and a far greater degree of diversity than advanced economies, and a lot of these macro-prudential measures have been targeted at un-hedged forex exposures, as should have appropriately been the case. You also find, for example, that they have used reserve requirements, counter-cyclical capital requirements, and ceilings on credit growth with greater frequency. So a lot of action now is not in what we used to consider capital account management measures in a narrow sense, but rather on macro-prudential measures. Some of these are steady state, and appropriately so, because it is important to focus on the balance sheet and not just on the flows. Overall, this has been an area where emerging markets have deployed a wide array of measures, and the micro data shows that this has had a very positive impact on financial institutions, with financial institution risks in emerging markets having been contained as a result. So what accounts, then, for this greater volatility of emerging markets, despite their fundamentals - both their macro-fundamentals and financial sector fundamentals - being better than those of advanced economies? I argue that a major contributing factor is the lack of deep, liquid resources which they can tap.

The Importance of the Global Financial Safety Net for Emerging Markets

We learnt from the crisis that, in a world of uncertainty and multiple equilibria, you need strong firewalls, in order to persuade the markets that we are not going to allow short-term borrowing to take us towards an abyss. We also realized, unfortunately, that early action on this is critical. The drawn out discussions on the firewall was certainly one of the reasons why this crisis lasted long as it did.

We are now moving towards a multi-layered global financial safety net, with central banks swap arrangements, regional financing arrangements, build-up of international reserves, and augmentation of IMF instruments and resources. As far as central banks swaps are concerned, amongst major advanced economies, we have moved from relatively modest sums before the Lehman crisis to an unprecedented expansion and now to virtually unlimited swaps amongst major central banks. Some emerging markets and some smaller advanced economies were included in these swap arrangements originally, but are no longer part of it. So there is now a system where the advanced economies have unlimited swaps in order to deal with potential instability, but there is no equivalent cover for emerging markets. What emerging markets have done is of course build up reserves, but there is a big problem with this approach, in that while reserves can be useful in dealing with tides, but they are not very helpful in dealing with Tsunamis. This is because the use of reserves is seen as a signal of vulnerability. Thus, while it is good to have a cushion of reserves, they are not costless as Louis mentioned. The ability to use them in times of crisis is actually limited. Moreover, the amount of reserves compared to the gross liabilities is very small and it will always be very small when you compare it to the external liabilities. As such, it is not possible to achieve adequate cover, except perhaps for China.

I don't want to spend time on the regional financing arrangements (RFAs). There are initiatives underway to buttress RFAs but these are subject to some inherent limitations and exclude many emerging markets. There are discussions under way as you know on the contingency reserve arrangements amongst the BRICS. But these arrangements are still relatively modest in magnitude and subject to covariant risk, and in some sense they are unable to really deploy when you have huge, systemic risk. So while they are important and will play a role, they again are not enough to deal with Tsunamis.

That takes me to the IMF. The IMF's resources have been significantly augmented since 2009. The Fund's resources have been increased in two ways. . First, through something called New Arrangements to Borrow, which is a structured arrangement but a time-bound one. When the European crisis deepened, there was also a supplementary bilateral program, to which emerging markets contributed quite significantly. But both of these, the New Arrangements to Borrow and the 2012 bilateral borrowings, are temporary arrangements. Once the 2010 quota is increased and the board amendment comes into place, we will get an increase in quotas of about $250bn, which would double the existing level of quotas, but, when compared to the central bank swaps arrangement, it is relatively modest. So the Fund needs a permanent resource base that is suitable for a world of volatile capital and contagion, and nothing short of a trillion dollar fund would be credible for the kinds of volatility that we are thinking about. The whole purpose of an adequate arsenal is not to deploy it but for markets to know that emerging markets and others have access to this in addition to the reserves that they have. It is also important to make clear that the conditions under which it is given do not arise because of problems with fundamentals, but rather because markets now are much more volatile and liquidity mechanisms are necessary to deal with this. At this moment, therefore, getting a permanent increase in IMF resources and getting the governance changes to go with it must be something which we put full force behind. So while we are talking about the domestic measures, we must also be mindful of the international measures that need to be taken.