Financial Market Turbulence and Policy Responses
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Financial Market Turbulence and Policy Responses: Whither the Emerging Markets?

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Agenda

- Some stylized facts from Emerging Market Economies: Subprime blues, decoupling or lags?
- An overview on the repercussions of the subprime crisis in the Emerging Market Economies
- Some Policy Lessons for Central Banks and regulators

Subprime crisis and EME Exposure: stronger macro ‘fundamentals’

EMEs have been characterised by:

1. **Strong macroeconomic fundamentals:** fiscal improvement with lower deficits or surpluses, decline in government debt/GDP levels
2. **Major beneficiaries of the ‘Great Moderation’**
3. **Evidence of ‘real’ de-coupling increasingly visible**
4. **Strong external positions:** running current account surpluses, declining/low levels of foreign debt/GDP, maintaining large foreign reserves, and diversifying exports
5. **Improvements in banking regulation & supervision** with higher bank capitalisation (Basel I, Asian crisis lessons effects), reduction in NPLs, improved soundness and lower vulnerability indicators
6. **Limited exposure of EME banks to: (a) structured products**, CDOs, ABS, credit derivatives; (b) **international credit & bank market; (c) OBS items**
7. **High rate of return on EME local market assets**:
    1. High returns (though with associated volatility) of equity markets, with diversification benefits for international investors
    2. Sovereign and corporate credit spreads that fell to near record lows
    3. High returns on real estate & property, but driven by fundamentals and relatively modest compared to US, UK, Ireland, Spain
8. **Development of local currency debt and bond markets; these have become ‘safe havens’**

Macro and Financial Indicators in select EMEs
(Source: GFSR Apr 2008)

	Current Account (percent of GDP)	Growth in Private Credit (percent year-on-year)	Change in Private Credit as Share of GDP (percentage points)	External Position vis-à-vis BIS Reporting Banks (percent of GDP)
Europe, the Middle East, and Africa				
Bulgaria	–21.4	62.5	19.7	–11.9
Croatia	–8.8	17.8	3.4	–50.8
Estonia	–16.0	41.8	15.1	–68.7
Hungary	–5.6	16.8	1.6	–42.5
Kazakhstan	–6.7	55.2	12.5	–9.5
Latvia	–22.9	45.0	10.7	–53.9
Lithuania	–13.3	45.3	10.9	–34.7
Poland	–3.7	39.6	8.0	–12.7
Romania	–14.5	60.4	10.7	–25.7
Russia	5.9	51.0	7.1	8.3
Serbia	–16.5	40.1	6.0	–7.6
South Africa	–7.4	22.0	5.4	9.6
Turkey	–7.6	26.5	4.1	–13.9
Asia				
China	11.1	19.5	2.1	0.8
India	–1.4	21.7	2.6	–3.0
Indonesia	2.3	22.4	2.0	–7.9
Korea	0.6	13.5	8.7	–13.9
Malaysia	13.7	11.8	3.4	0.5
Philippines	4.4	3.3	–1.5	–0.4
Thailand	5.6	3.9	–1.4	5.1
Latin America				
Argentina	0.7	37.0	1.4	–7.1
Brazil	0.3	28.5	5.1	–7.8
Chile	4.7	20.8	5.9	–8.0
Colombia	–3.8	23.5	4.7	–7.3
Mexico	–0.8	19.0	2.2	–5.8
Peru	1.6	22.3	6.2	–0.5
Venezuela	9.2	72.5	4.9	2.9

Sources: Bank for International Settlements (BIS); European Central Bank; IMF, *International Financial Statistics* and *World Economic Outlook*; and IMF staff estimates (preliminary data as of March 3, 2008).

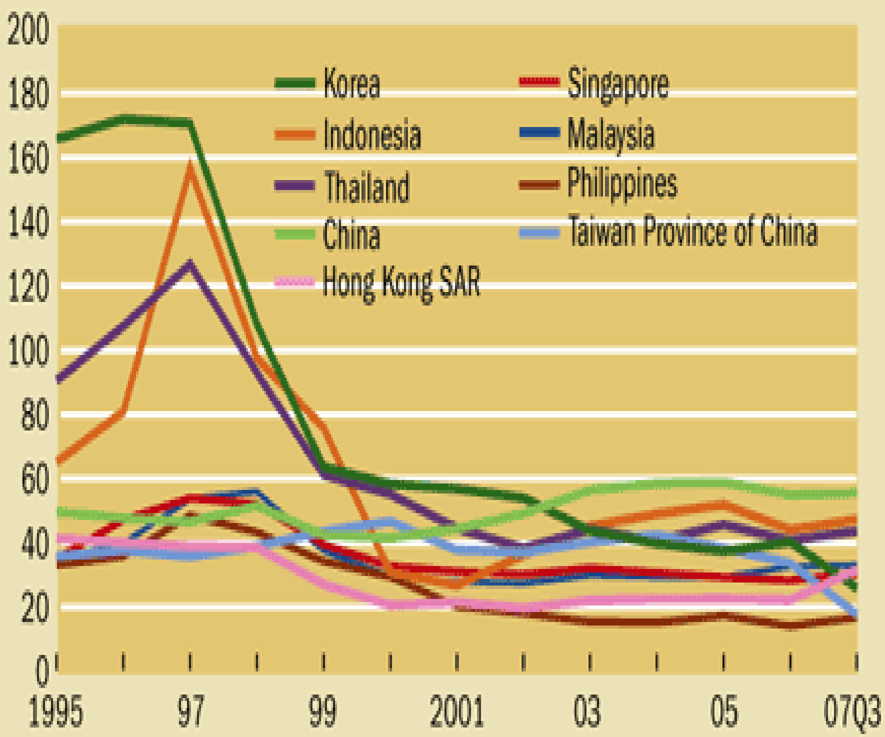
Note: The gray boxes of the table point to areas of potential concern. Cutoff values are as follows: current account balance below –5 percent of GDP; private sector credit growth greater than 20 percent year-on-year; growth in the ratio of private sector credit to GDP of more than 10 percent year-on-year; and net external position to BIS banks less than –10 percent of GDP.

Emerging markets' resilience: stronger corporate & bank balance sheets & performance

Improving balance sheets

Corporate debt-to-equity ratios have improved dramatically in many Asian countries since the 1997 financial crisis.

(debt to equity, percent)

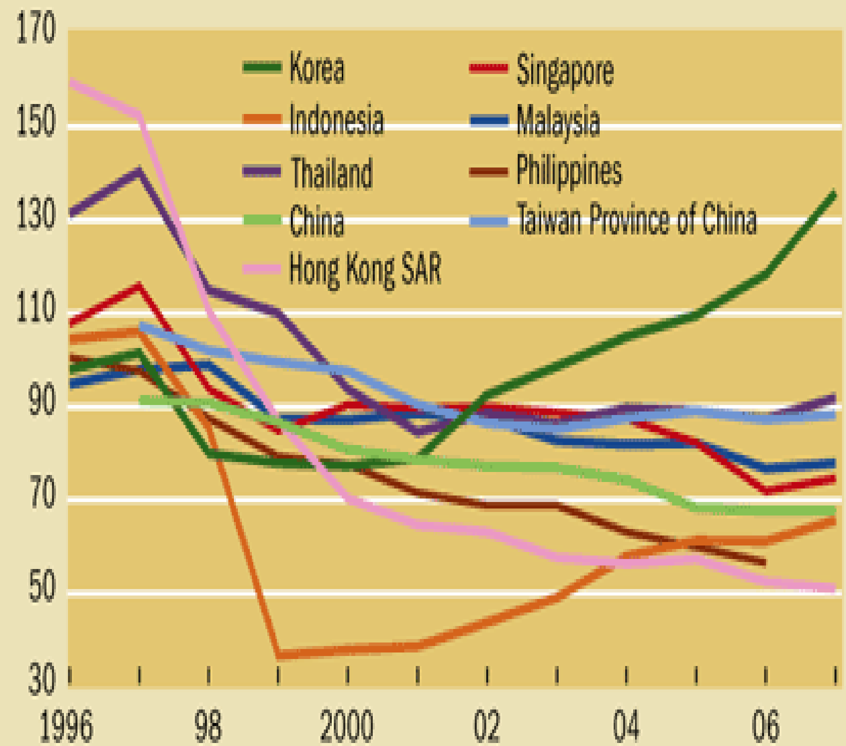


Source: Thomson International.

Banks are stronger

Generally, low loan-to-deposit ratios have helped Asian banks avoid liquidity and funding stress in the current turmoil.

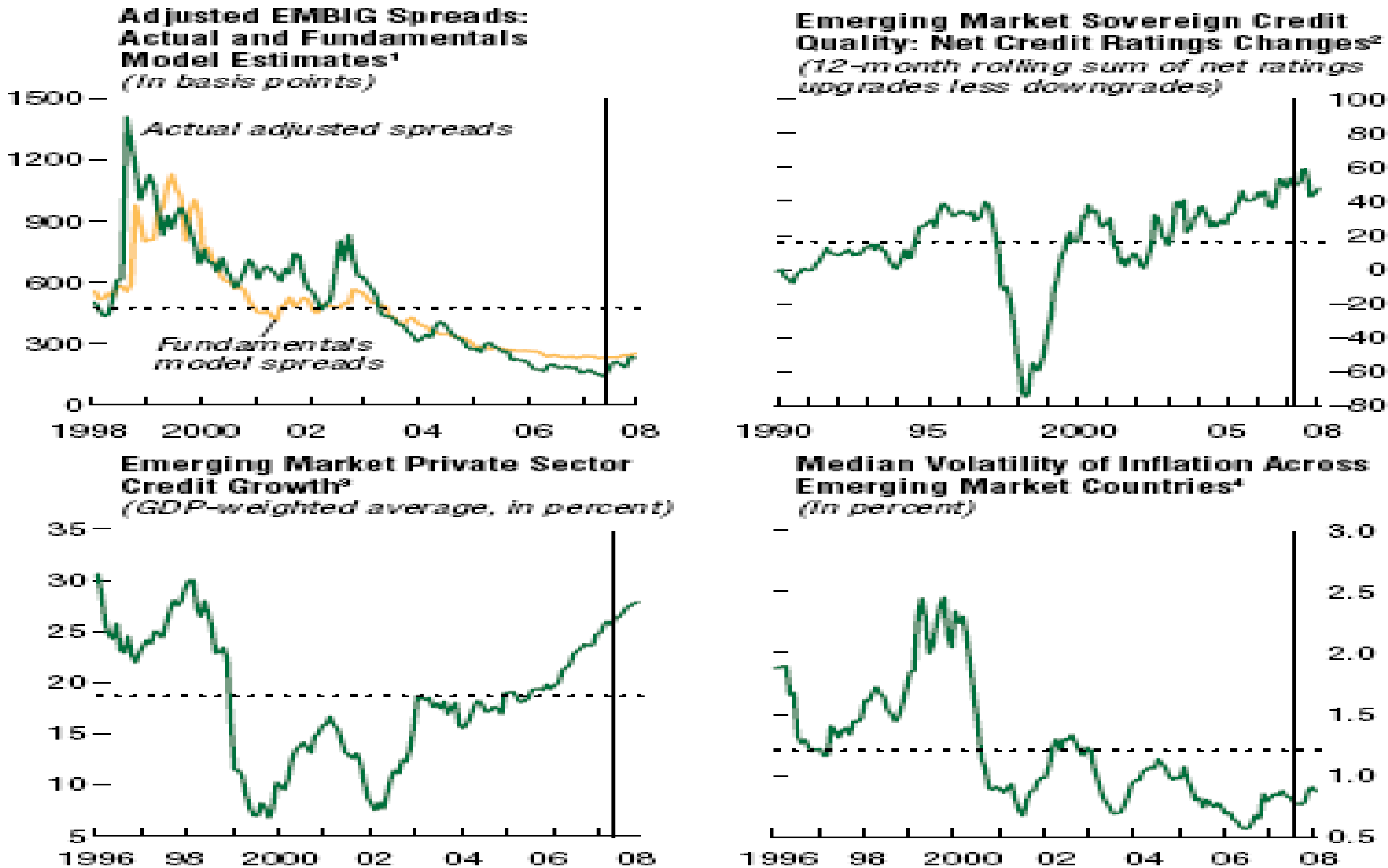
(loans to deposits, percent)



Source: CEIC.

EMEs: major beneficiaries of the 'Great Moderation'

DIFC



[1]EMBIG = Emerging Market Bond Index Global. The model excludes Argentina because of breaks in the data series related to debt restructuring. Owing to the short data series, the model also excludes Indonesia and several smaller countries. The analysis thus includes 32 countries.
[2]Net actions of upgrades (+1 for each notch), downgrades (–1 for each notch), changes in outlooks (+/– 0.25), reviews and creditwatches (+/–0.5).
[3]44 countries.
[4]Average of 12-month rolling standard deviations of consumer price changes in 25 emerging markets.

EME/ MENA limited subprime exposure

- Profitable domestic markets
- Low prevalence of securitised/structured products
- Limited expertise in managing structured investment products
- Regulatory/prudential requirements limited exposure to sub-investment grade investments & instruments
- Growing importance of and compliance with Shari’a.
- Standard & Poor’s survey of 20 rated Gulf banks (Aug 2007):
  - Aggregate exposure to subprime mortgage-backed securities of stood at less than 1% of their total assets.
  - Two-thirds of the aggregate exposure were in high-investment grade (‘AAA’ and ‘AA’ categories).
- Risk factors:
  - Pegged rates have resulted in negative real interest rates and below ‘natural real rates’ which is exacerbating the ‘exuberant’ monetary & financial conditions
  - Gulf banks’ increasing number of “young loans”, including fast-growing exposures to the real estate sector
  - Active M & A activity outside the region.

Risks & Potential Contagion effects

Transmission and Contagion can occur through different channels

- Financial channel

  - Increased financial markets volatility

  - Increased global risk aversion and shift in preferences induced by new information arising from US experience on sources of potential risk become available investors

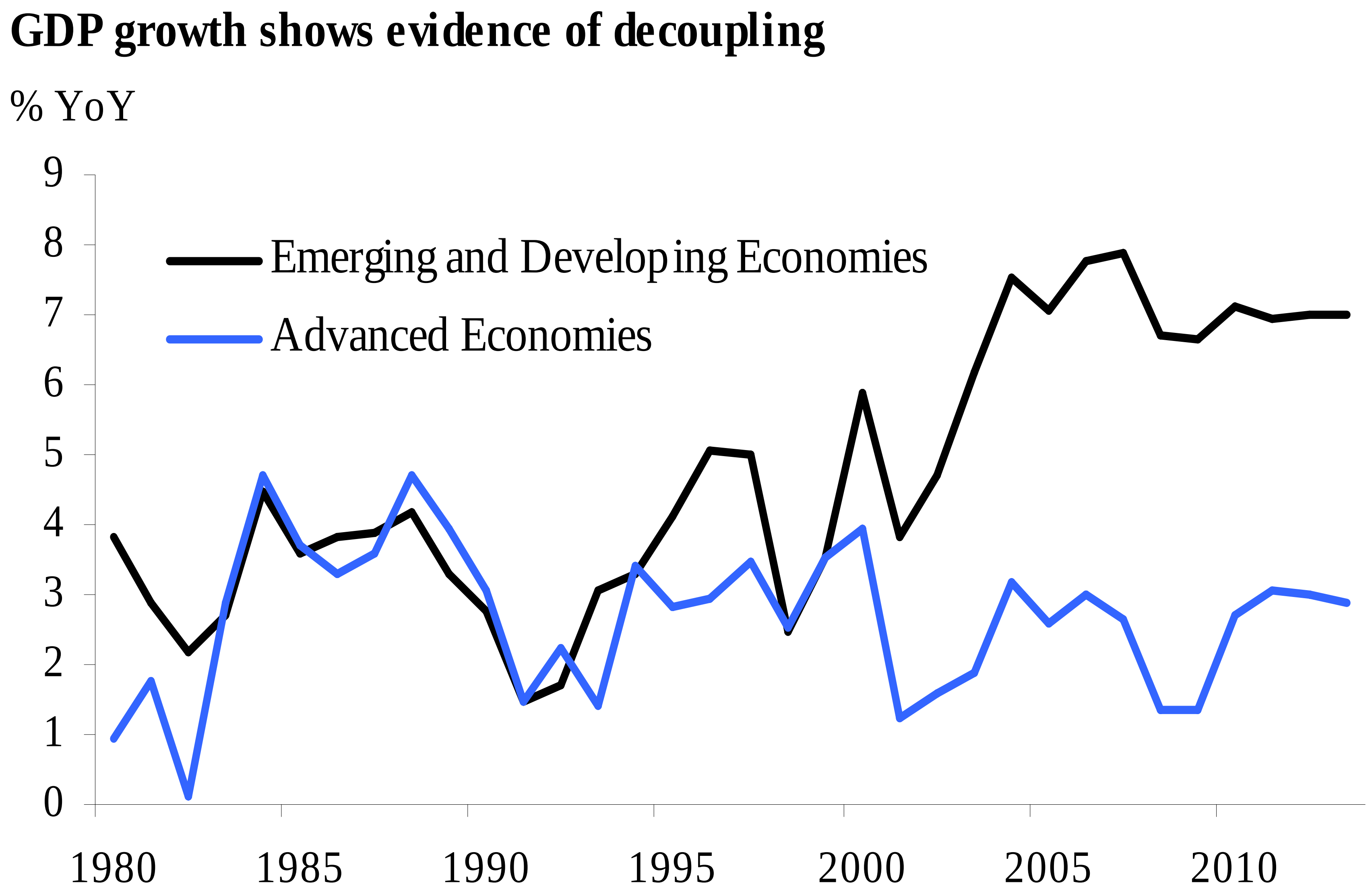
- Economic activity channel

  - Credit contraction → US recession leads to lower imports/FDI → lower exports/investment by the EMEs →lower EME growth

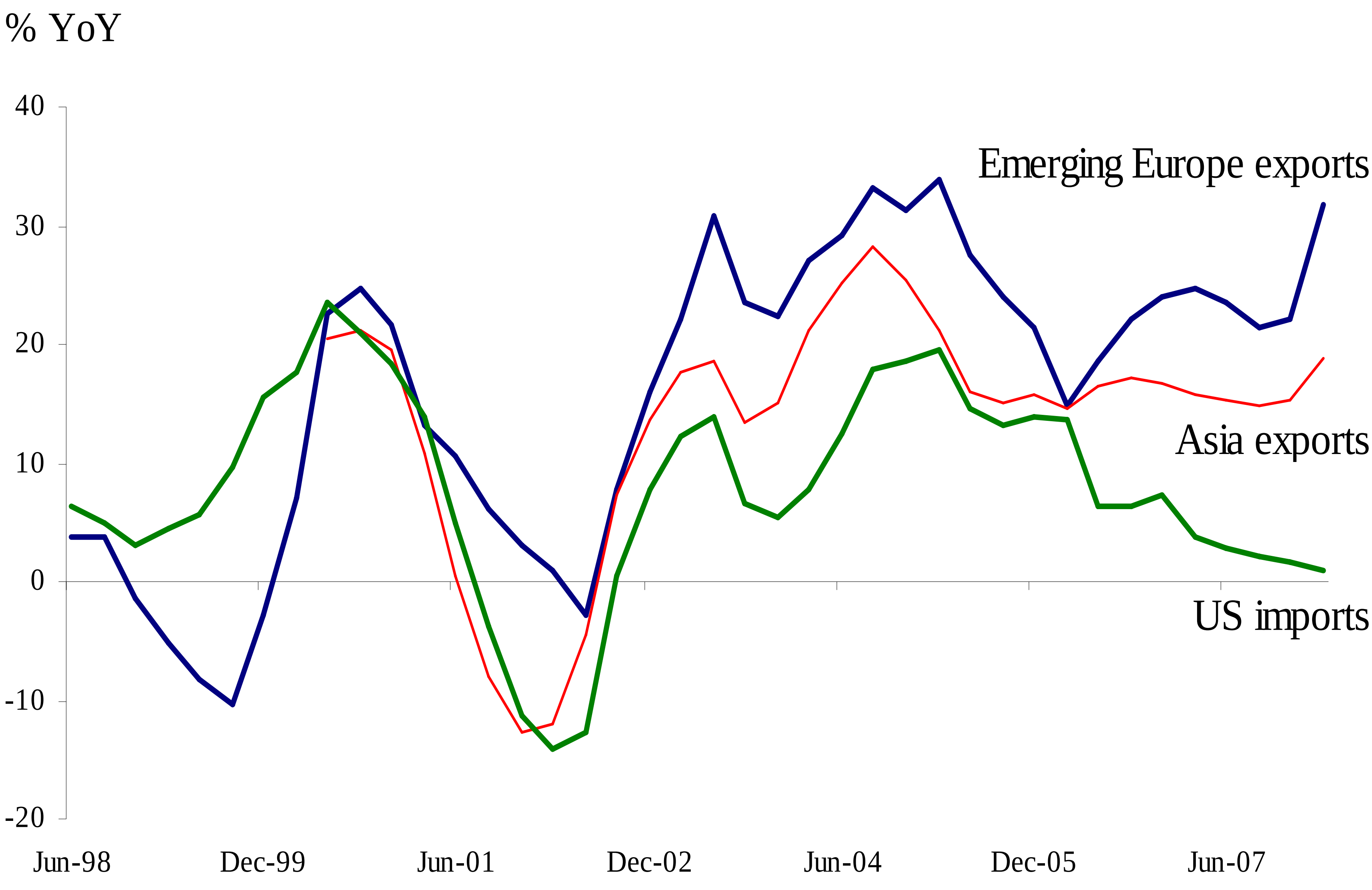
- Important caveat - not all correlations point toward contagion. Increased correlation between two countries during a period of crisis could simply be the consequence of their exposure to a common factor.
- Limited impact on capital flows into EMEs: steady, no "sudden stop"
- EME Equity markets have proved resilient and continue to out-perform developed markets, though they are more volatile
- Bond prices have been less volatile in EMEs when compared to the mature markets.
- However, there has been a substantial fall/postponement in bond issuances in the recent past

EMEs continue to out-perform: structural effects dominant

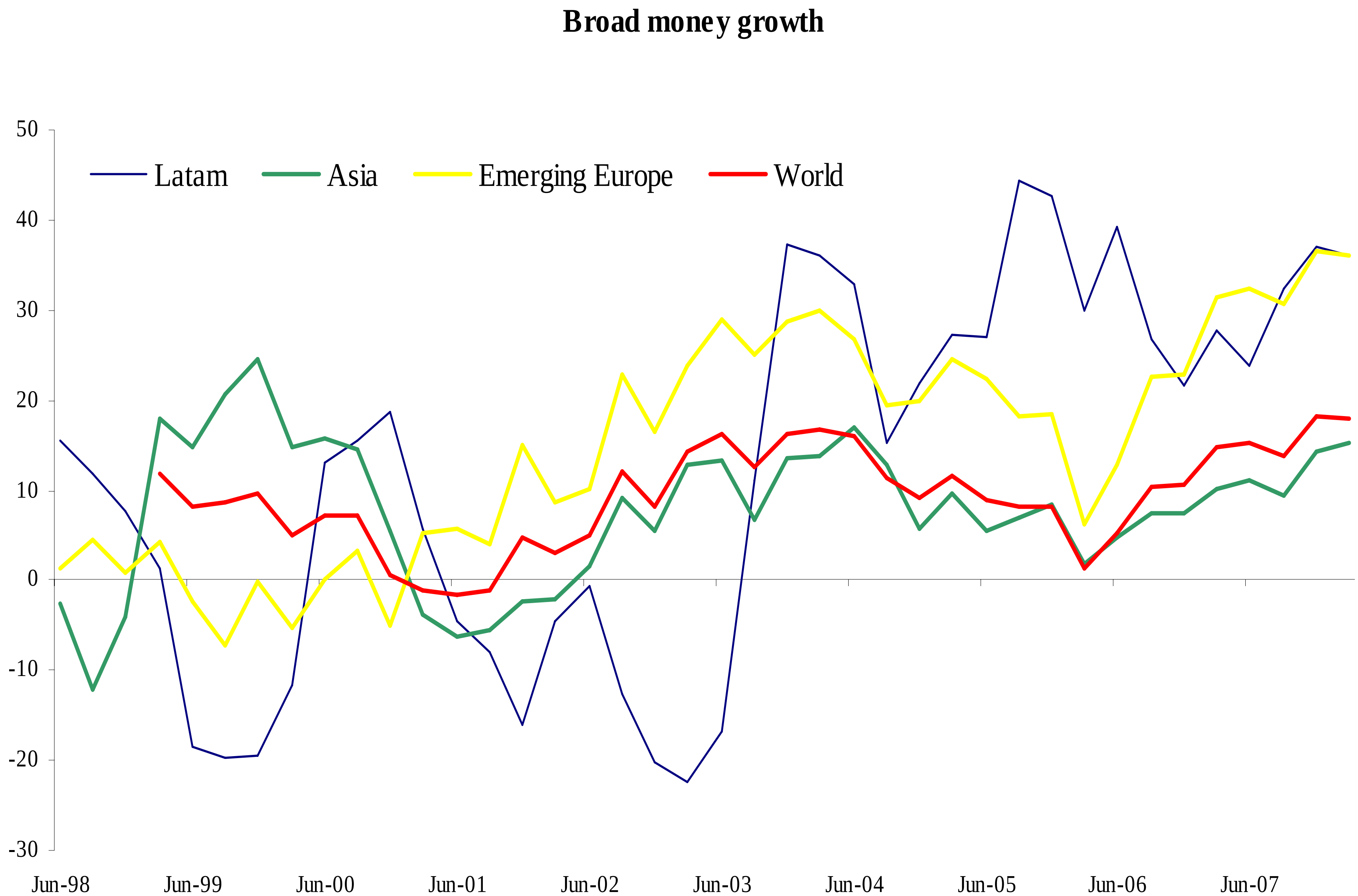
(Source: WEO)



EME exports no longer dependent solely on US consumers

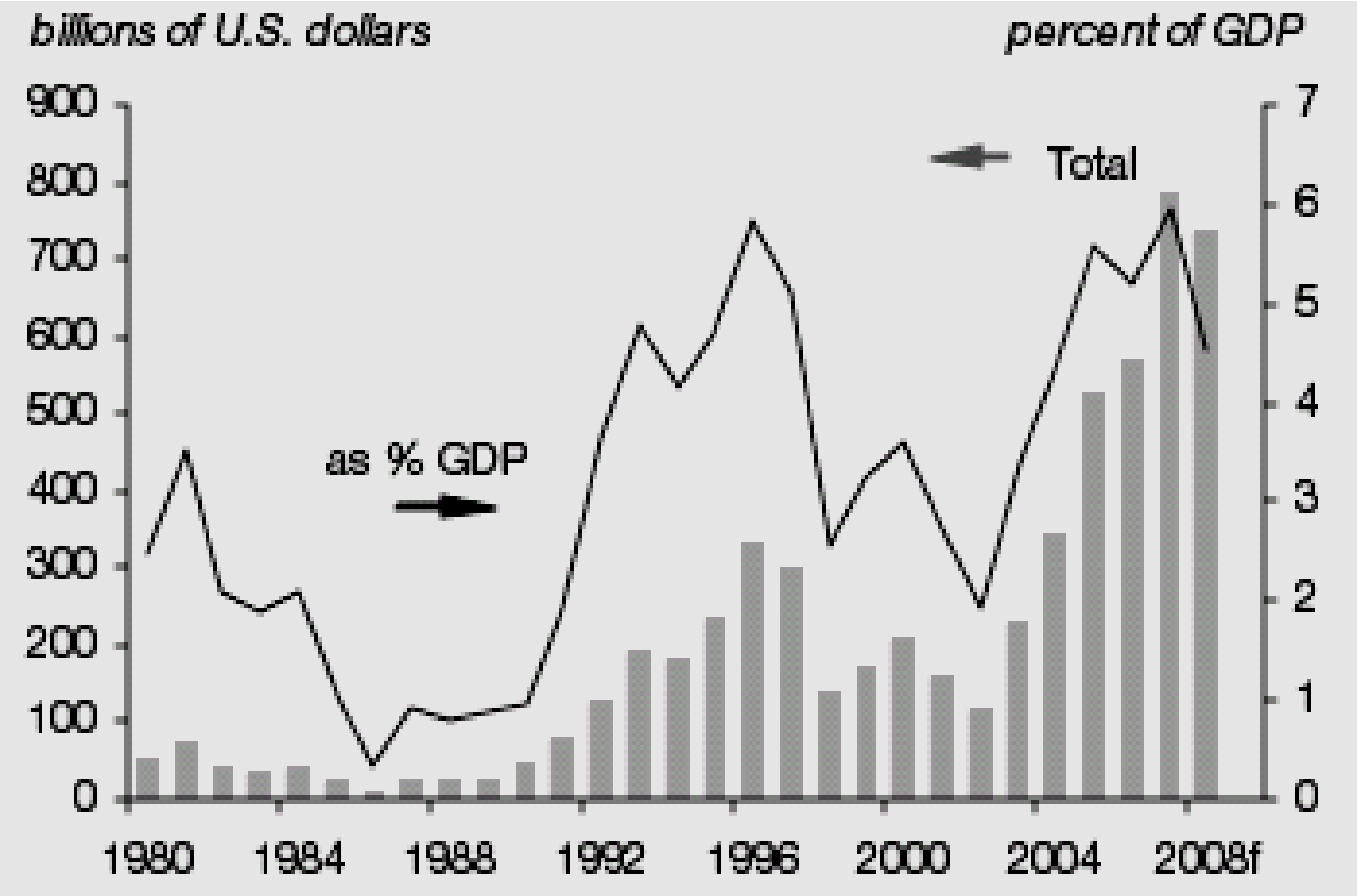


Increased liquidity: EMEs have been responsible for over half of the growth in global monetary and credit aggregates



Net Private Capital Flows into Emerging Markets

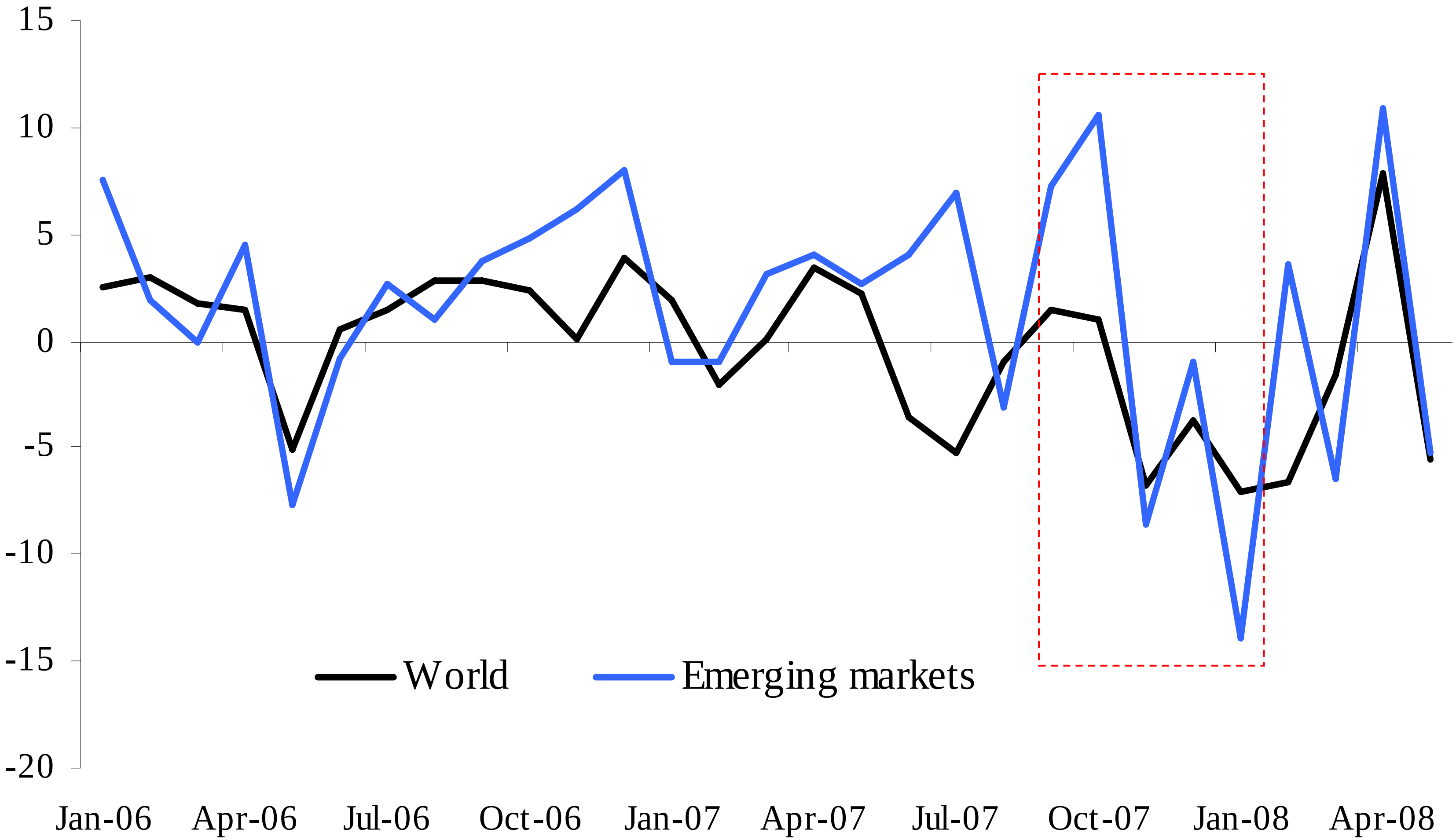
(source: IIF report)



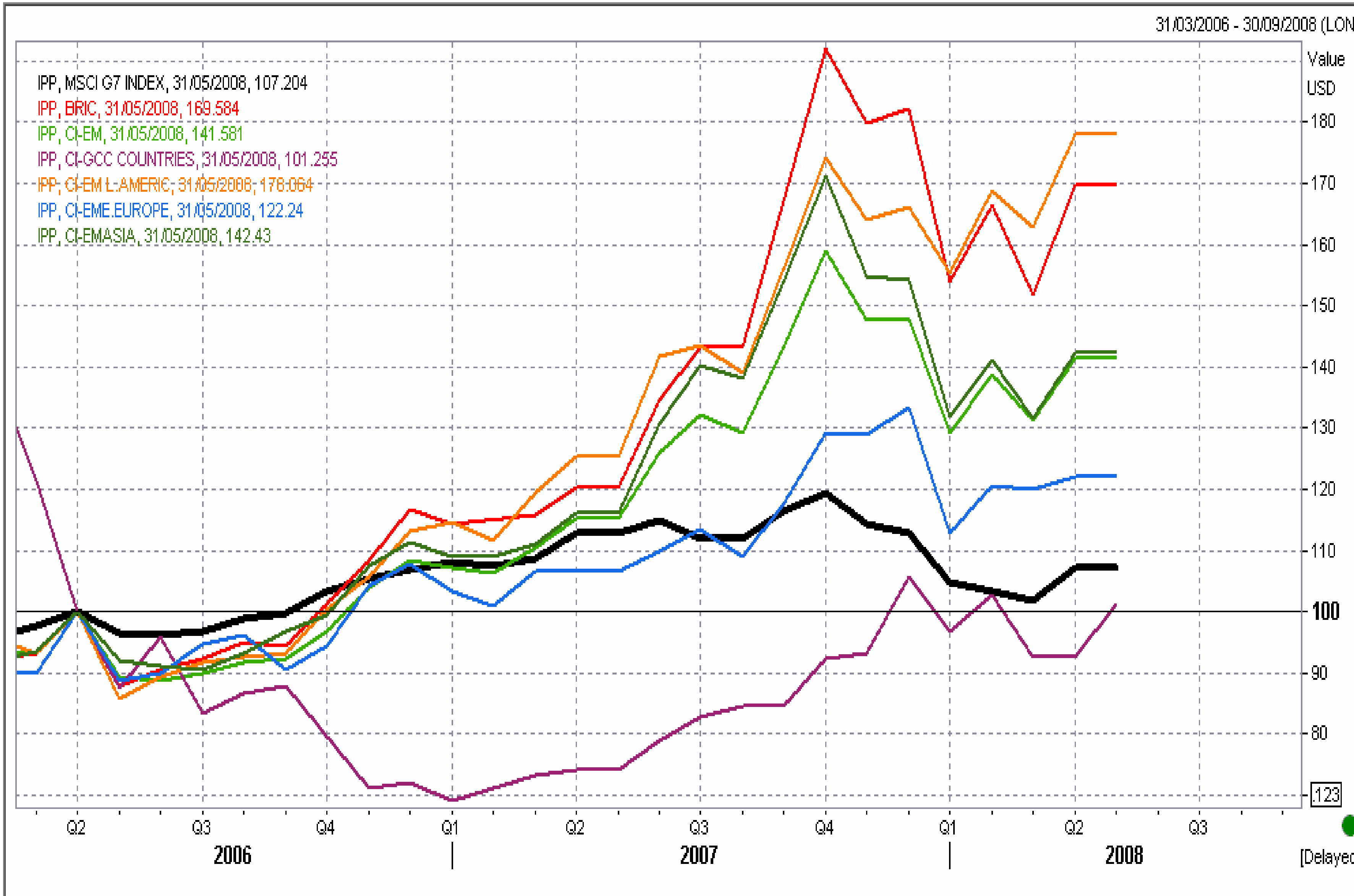
Equity returns in the financial sector

(Source: Reuters, MSCI)

Returns on financial sector in emerging and world market

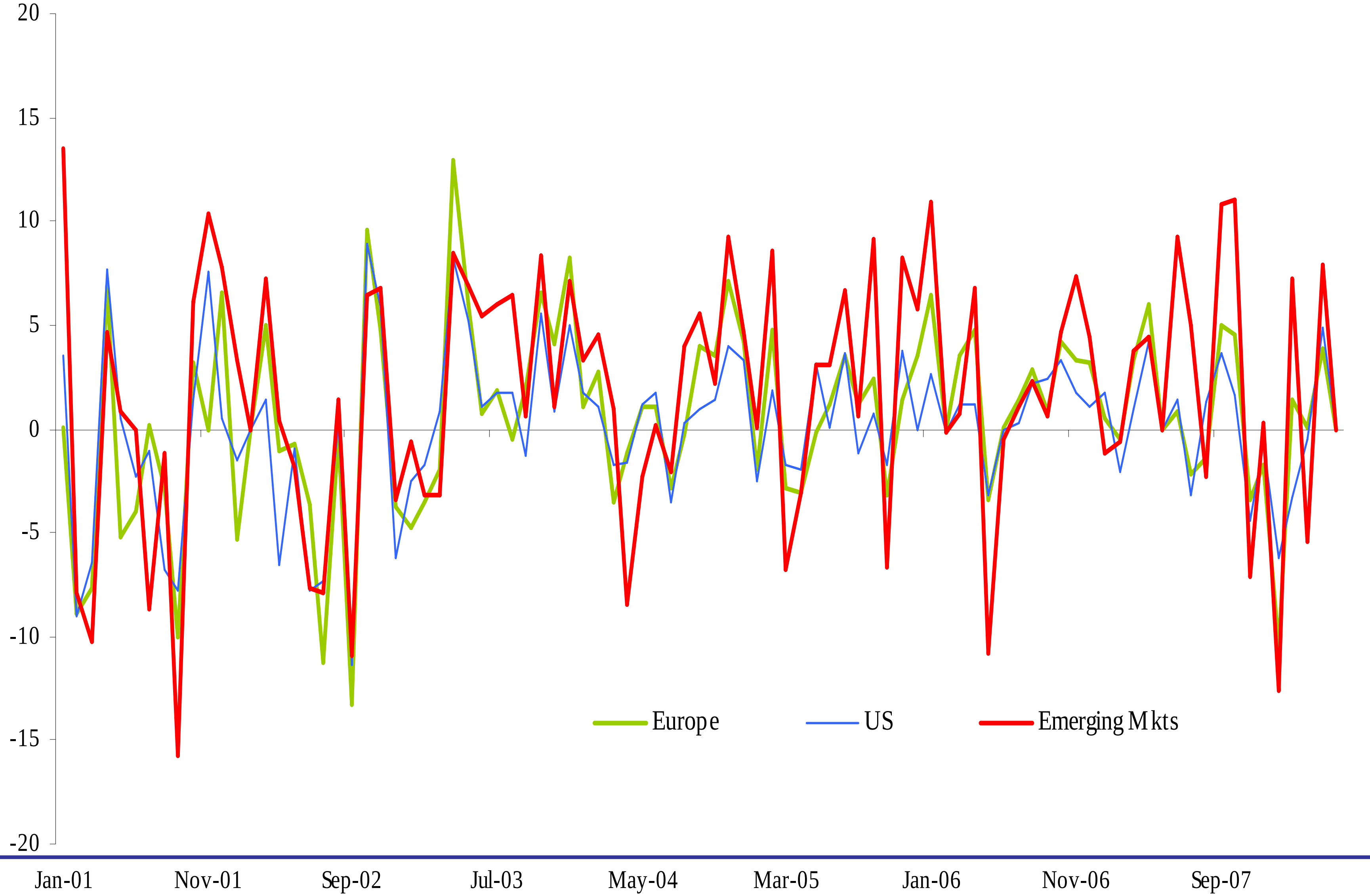


Emerging equity markets outperform G7 ….



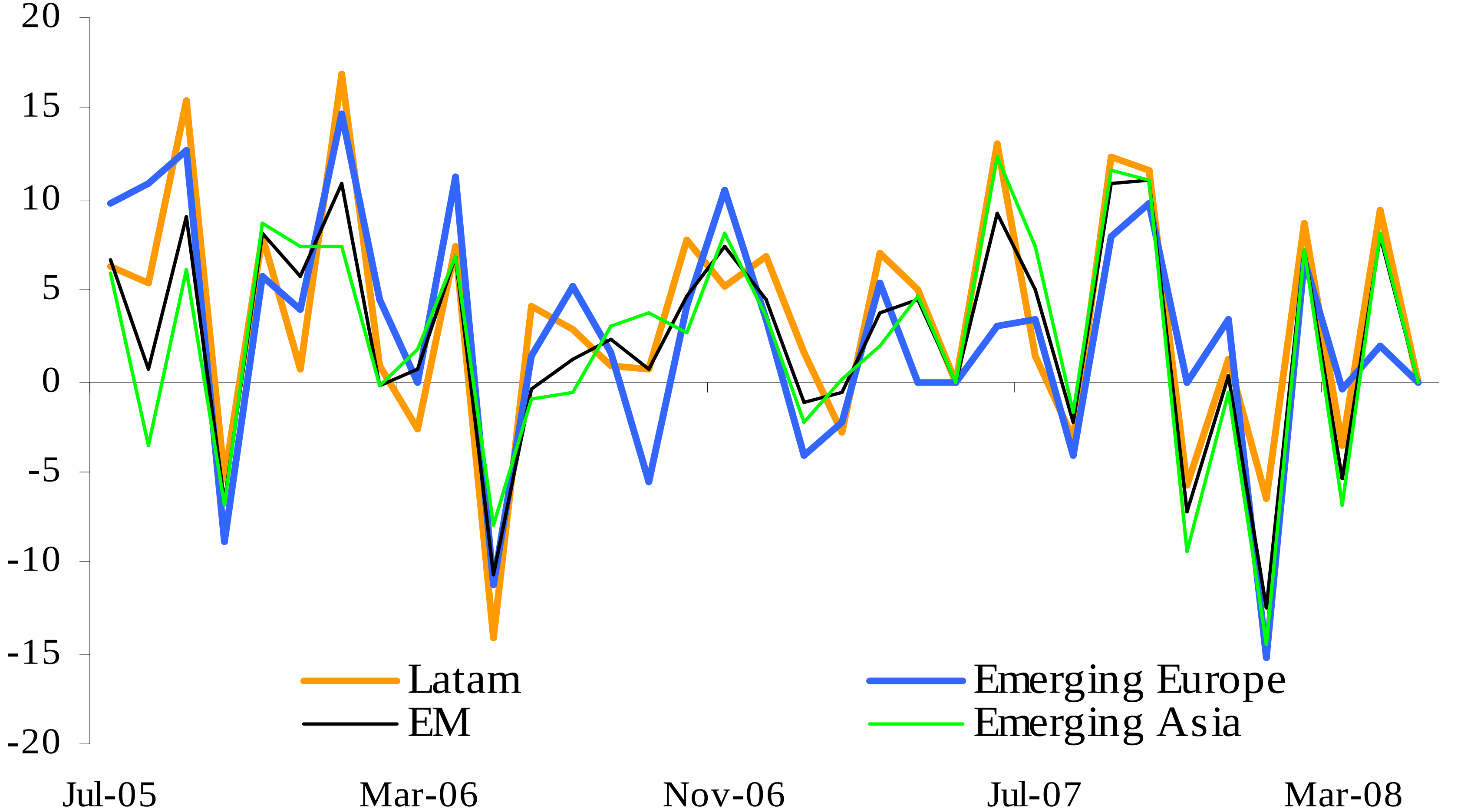
…however EM equity returns are more volatile

Comparing equity returns in developed and emerging markets

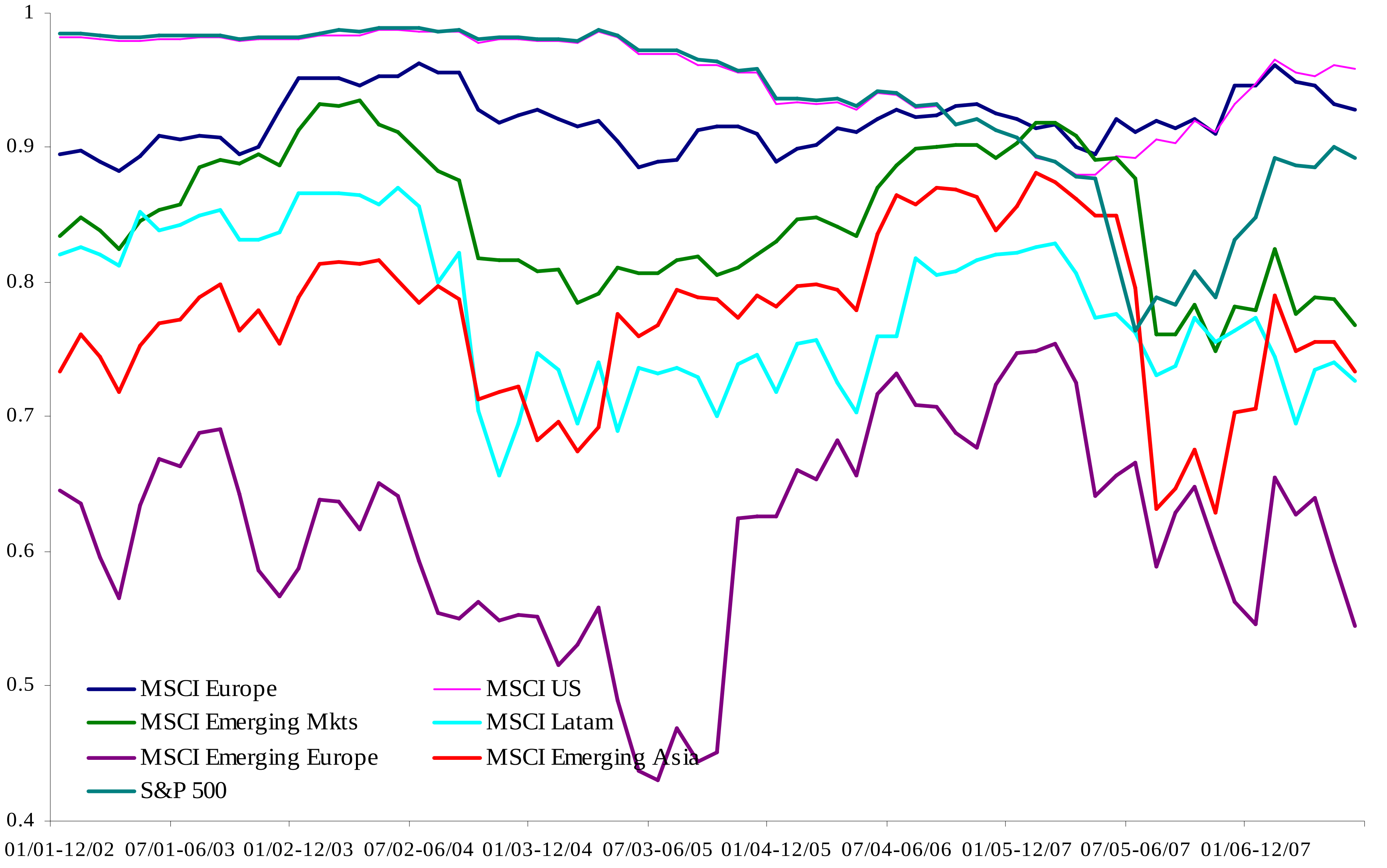


Comparing EM equity returns

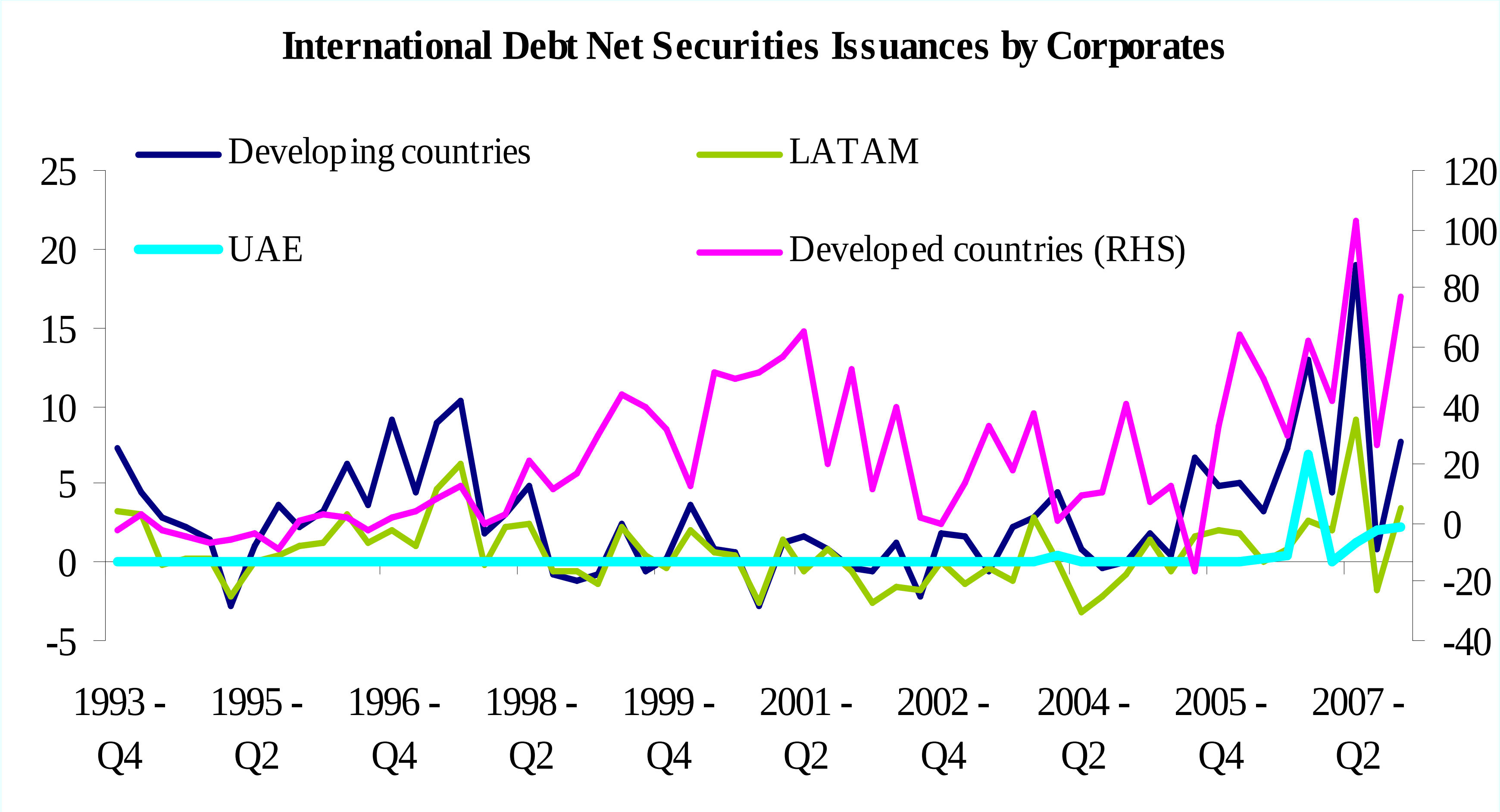
Returns on MSCI indices in emerging markets



Selected Equity Indices 24m rolling cross correlations of returns with MSCI G7



Net issues of international debt securities by corporations



- Net issues of international debt securities by corporations seem almost unaffected by the subprime crisis
- However, amongst developed countries, net issues from Europe was the most adversely affected
- Issuances from UAE form the bulk in the MENA region

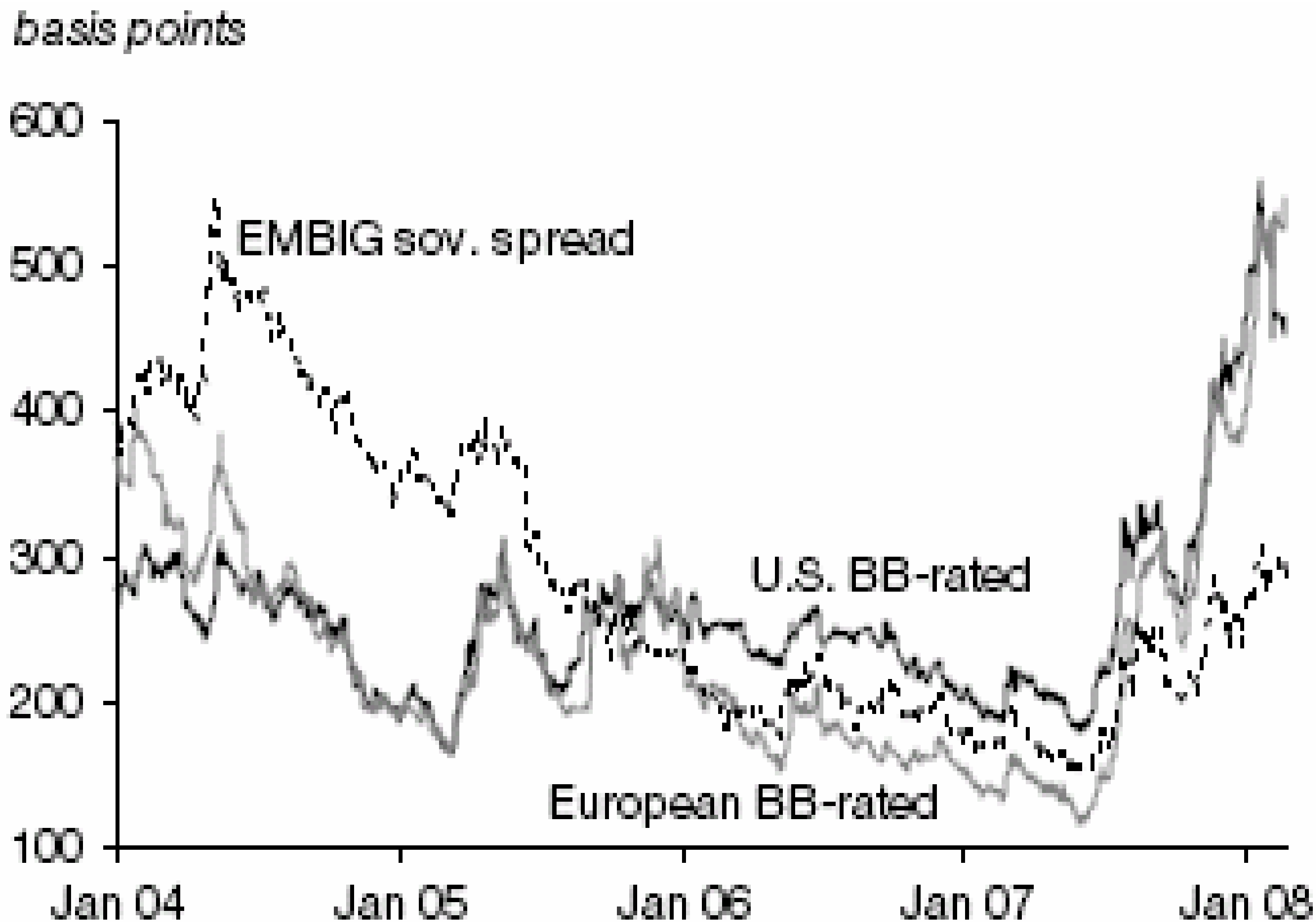
Decline in bond issuance

(Source: IIF Report)

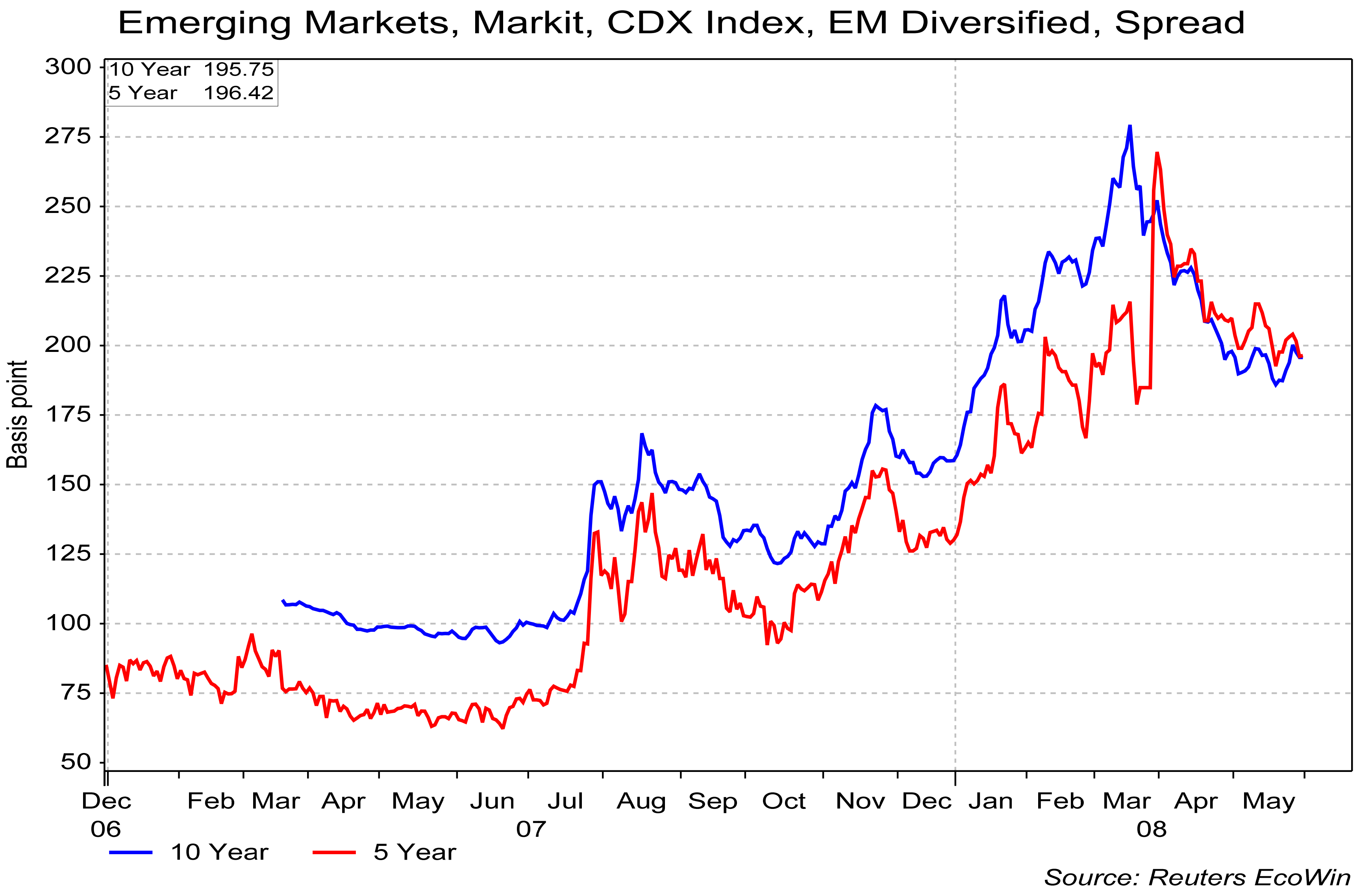
Bond Issuance
billions of U.S. dollars

	2006	2007	Sep-Feb 06-07	07-08	% Δ
Emerging Europe	46.3	50.1	36.7	11.5	-69
Russia	20.4	26.9	14.8	5.0	-66
Turkey	8.0	6.9	7.3	2.4	-67
Emerging Asia	43.4	49.1	28.7	19.9	-31
India	6.7	12.9	5.9	3.3	-44
South Korea	20.8	22.5	12.5	10.0	-20
Latin America	29.0	40.3	18.2	9.6	-47
Argentina	1.7	5.6	1.8	0.4	-75
Brazil	11.6	9.8	8.9	0.0	N/A
Mexico	7.8	11.2	3.8	6.6	76
Africa/Middle East	5.6	14.0	5.2	0.5	-91
South Africa	3.4	9.3	1.5	0.5	-69
Total	124.3	153.5	88.7	41.4	-53
Other EM Countries	49.9	40.1	38.8	12.6	-67
Kazakhstan	10.1	8.3	8.0	0.8	-91
Utd Arab Em	14.8	19.6	13.2	7.2	-46

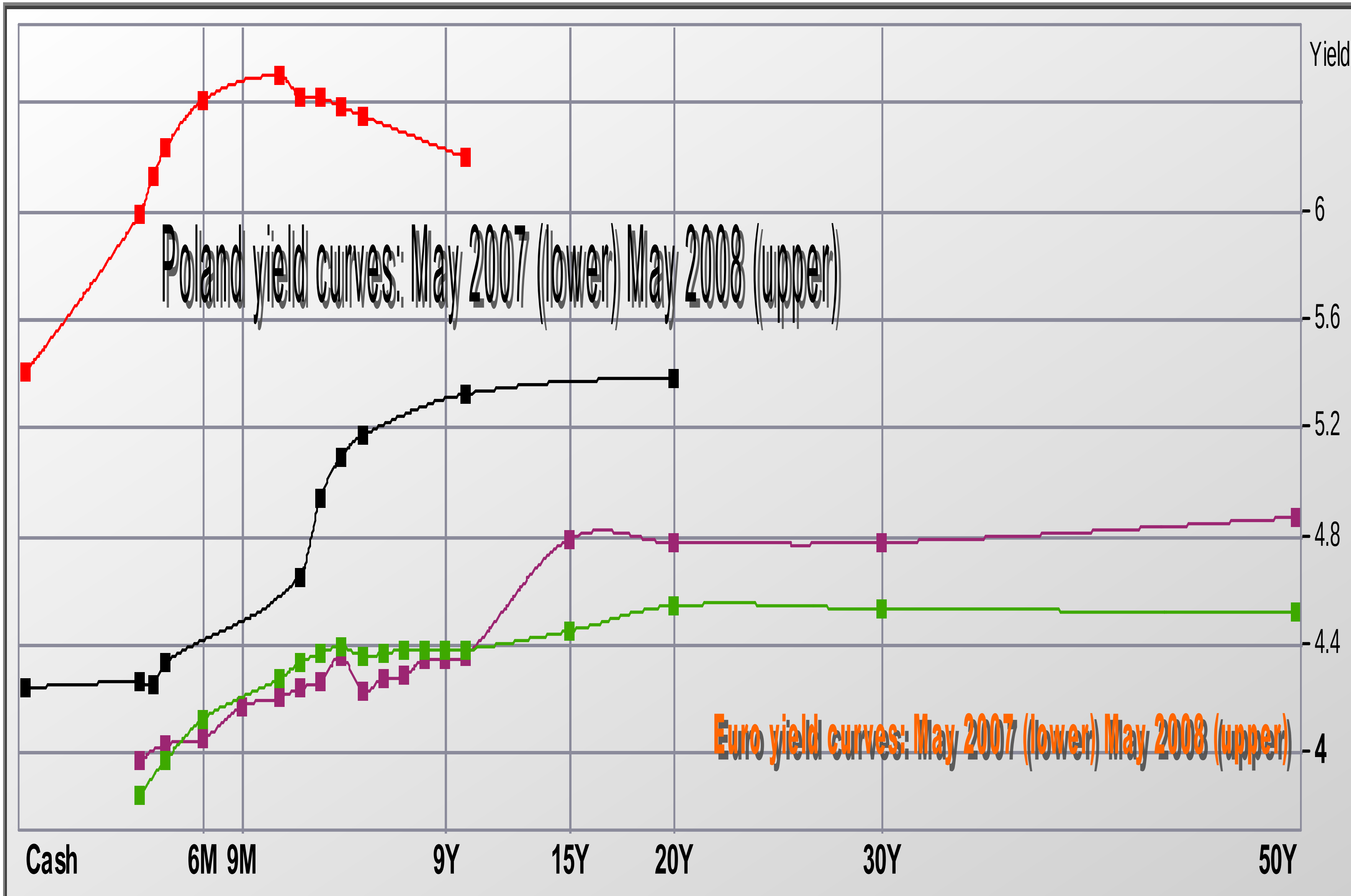
Corporate and Sovereign Bond spreads: shift in relative risk, in favor of the emerging market assets (Source: IIF report)



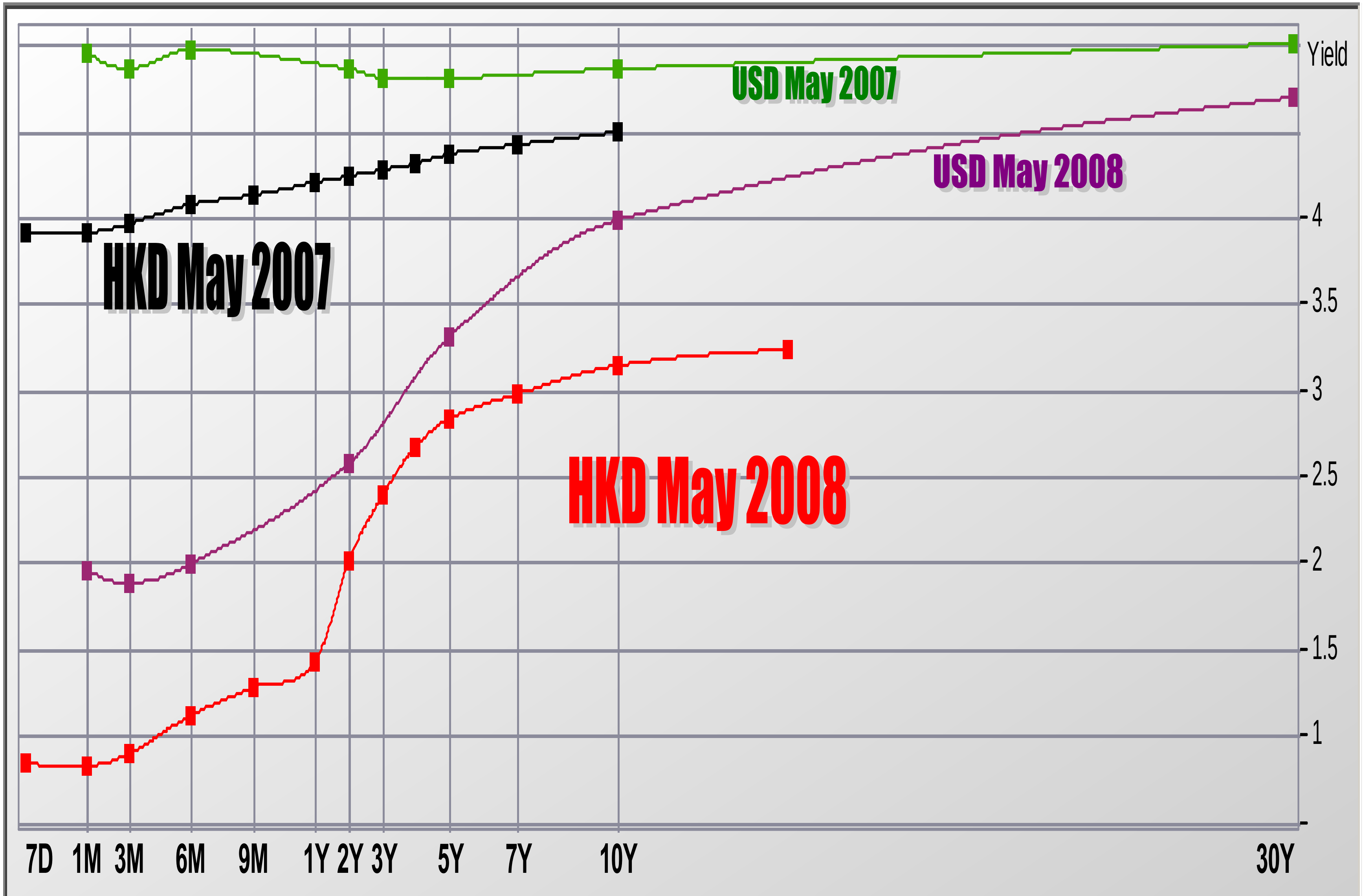
EM Bond Index spread



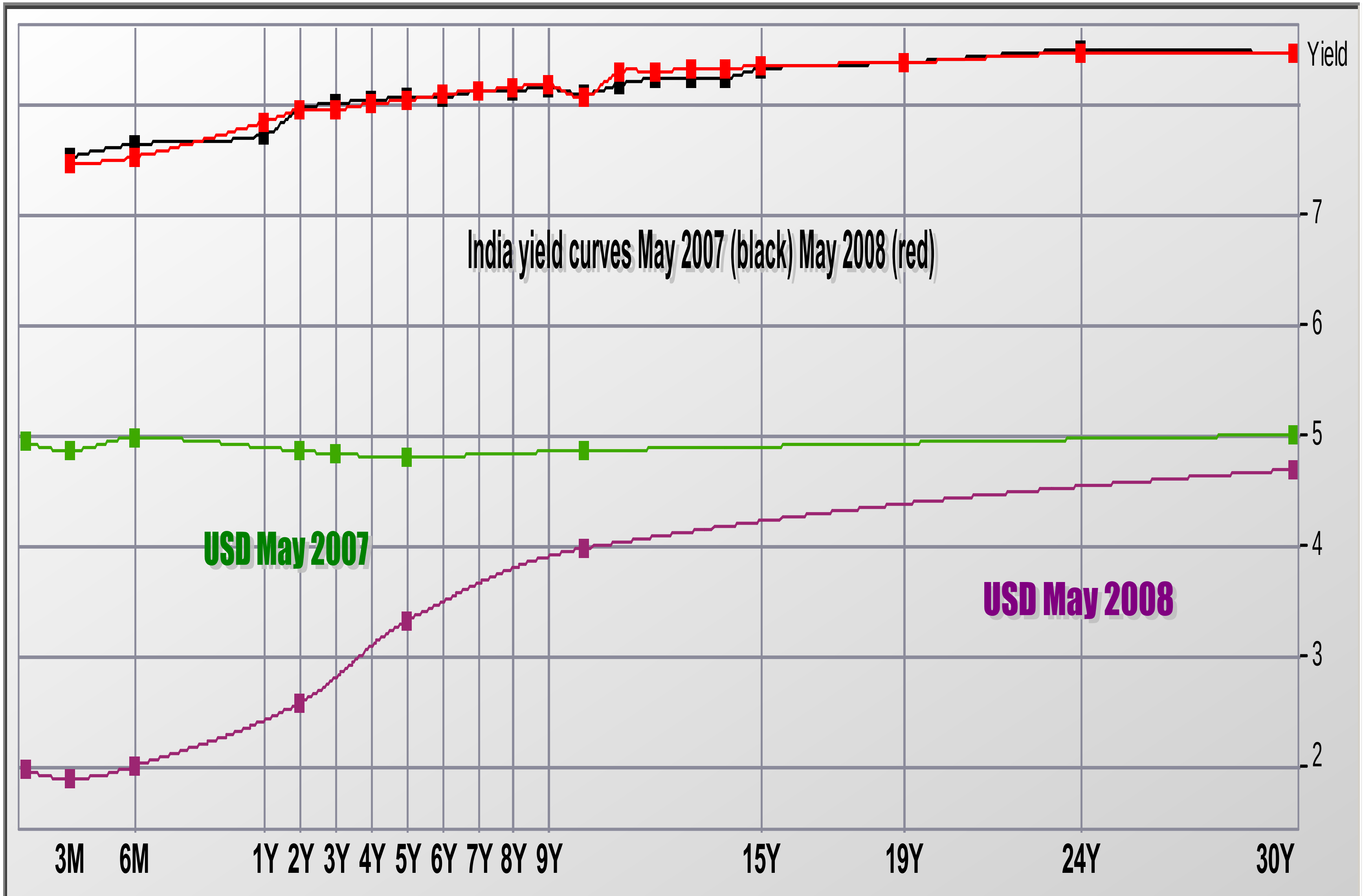
Historical and Real time Yield curves – PLN&EUR



Historical and Real time Yield curves – HKD&USD



Historical and Real time Yield curves – INR&USD



Lessons for central banks in EMEs

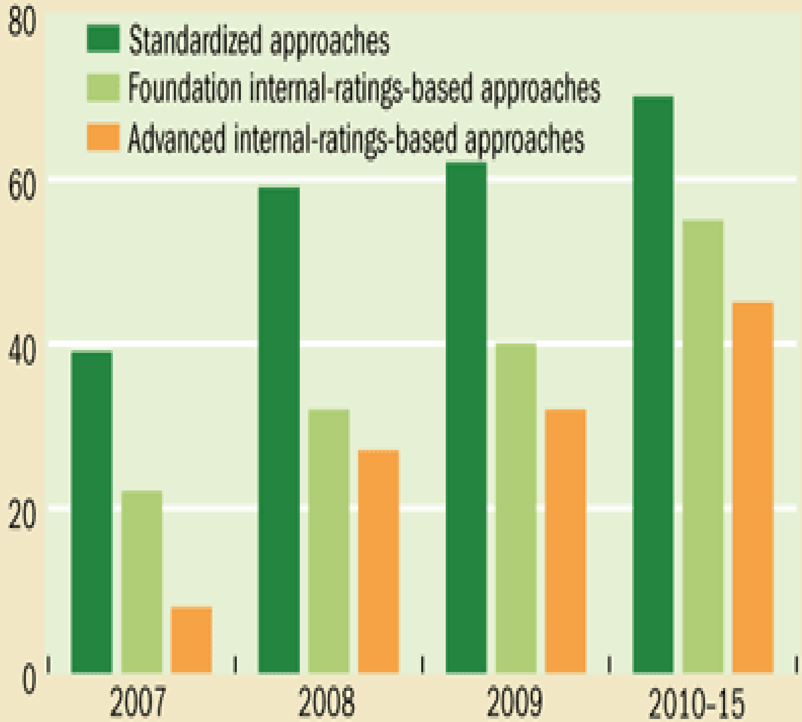
- Though minimally affected by the recent crisis, identifying and recommending solutions to the weaknesses seen in the developed economies would help the EMEs in the event of repeat occurrence
- Hyman Minsky, Financial Instability hypothesis (1992): a period of strong growth encourages increased leveraging.
- Private agents expected to enforce transparency & governance standards, disclosure and accuracy in information have misled investors to pursue immediate benefits
- Poor risk management practices by firms, weaknesses in disclosure, weaknesses in the originate to distribute model, regulatory frameworks, poor performance by the credit rating agencies in rating models (esp. in the case of structured credit products) are some of the pressing problems that need to be addressed
- Basel II implementation has become pressing but we need to incorporate lessons from current crises

More countries to implement Basel II… eventually

Popular option

In the coming years, more countries are likely to follow Basel II's standardized approaches to determining risk parameters.

(cumulative Basel II implementation plans, number of countries)



Source: Financial Stability Institute, 2006.

Still in transition

Most countries had not fully put in place the Basel II framework when the financial turmoil started unfolding in August 2007.

(Basel II implementation schedules)

	Credit risk (standardized)	Credit risk (advanced)
Australia	January 2008	January 2008
Canada	November 2007	November 2007
European Union	January 2007	January 2008
Hong Kong SAR	January 2007	January 2007
Japan	March 2007	March 2008
Korea	January 2008	January 2008
Singapore	January 2008	January 2008
South Africa	January 2008	January 2008
United States	NA	mid-2009

Sources: Supervisory agency websites and announcements.

Note: NA = not announced.

Lessons for the future (and Basel III)

- Private entities have too strong incentives to abuse their positions as referees or de facto regulators.
- These functions should be re-assigned to public entities or independent authorities
- Damages to investors' trust from these fiascos cannot be remedied by injection of cash or loose monetary policy: improve regulation, oversight and governance

Some Lessons for EMEs

1. Imperative to build resilient, sound Capital Markets and Bond Markets (GEMLOC)
2. Exchange Rate flexibility is necessary to deal with real shocks and external volatility;
3. Invest in good Corporate Governance frameworks and compliance to address issues of transparency, disclosure, risk management and executive compensation
4. CBs and regulators must build capacity and expertise to deal with new financial products and innovations; macro-prudential indicators & analysis
5. Establish Early Warning Systems
6. CBs should focus on sources of transmission & contagion risk; need new regional fora and instruments for cooperation & information exchange
7. Implementation of Basel II should remain on track: important for discipline and credibility of policy makers
8. Basel II should be augmented by a Liquidity Management Framework: LOLR & eligible collateral
9. Need to develop risk management and LOLR function for Islamic finance

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