DEEPENED FINANCIAL INTEGRATION AND CHANGING VULNERABILITIES OF THE GLOBAL SOUTH

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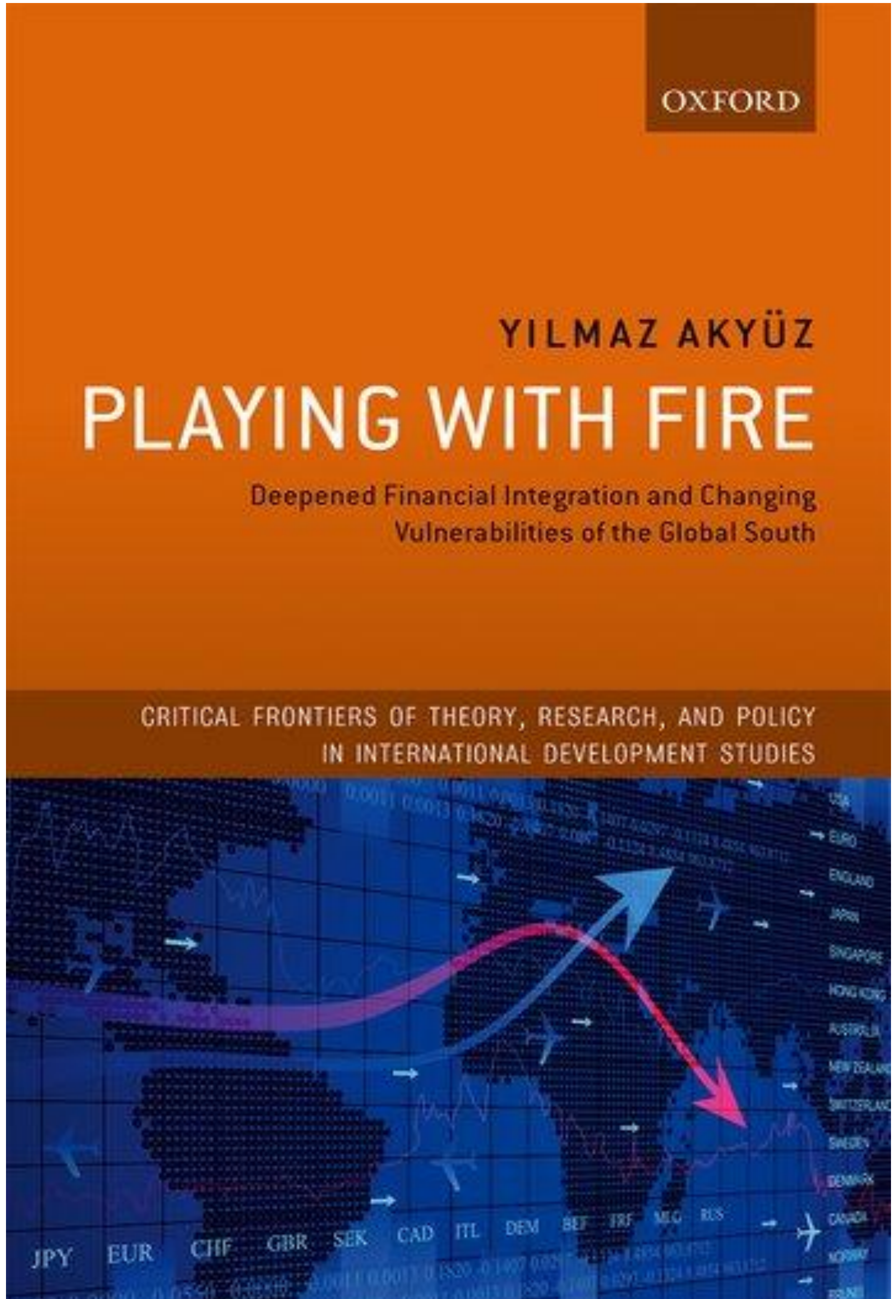
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YILMAZ AKYÜZ
PLAYING WITH FIRE
Deepened Financial Integration and Changing
Vulnerabilities of the Global South
CRITICAL FRONTIERS OF THEORY, RESEARCH, AND POLICY
IN INTERNATIONAL DEVELOPMENT STUDIES

Key messages

- Rapid integration of EMEs into the global financial system after a series of crises in 1990s and early 2000s.
- Integration has not only deepened but its pattern changed significantly.
- While old vulnerabilities to financial shocks remain largely unabated, new channels have emerged in the transmission of shocks.
- All EMEs are susceptible in one way or another, including those with strong IIP and external balances.
- Exceptional global financial conditions that have prevailed since 2008 due to ultra-easy monetary policies in AEs should not lead to complacency. EMEs should be prepared for financial shocks in the period ahead.

Financial integration and external balance sheets

- Integration is about cross-border debt and ownership; growth of external balance sheets through non-resident capital inflows and resident capital outflows and greater market access and commercial presence.

- External financial fragility to be assessed on the basis of **gross assets and liabilities** rather than **net** balances: even countries with current account (CA) surpluses and positive IIP can become illiquid.

- Attention to leverage and structure of external balance sheets: External assets and liabilities do not belong to the same people or have the same instrument, currency, maturity and liquidity profiles.

Deepening financial integration of EMEs

- Third post-war boom in capital inflows, stronger than previous ones. Non-resident inflows to EMEs taken together never negative since 1980s, implying constant increase in gross external liabilities.

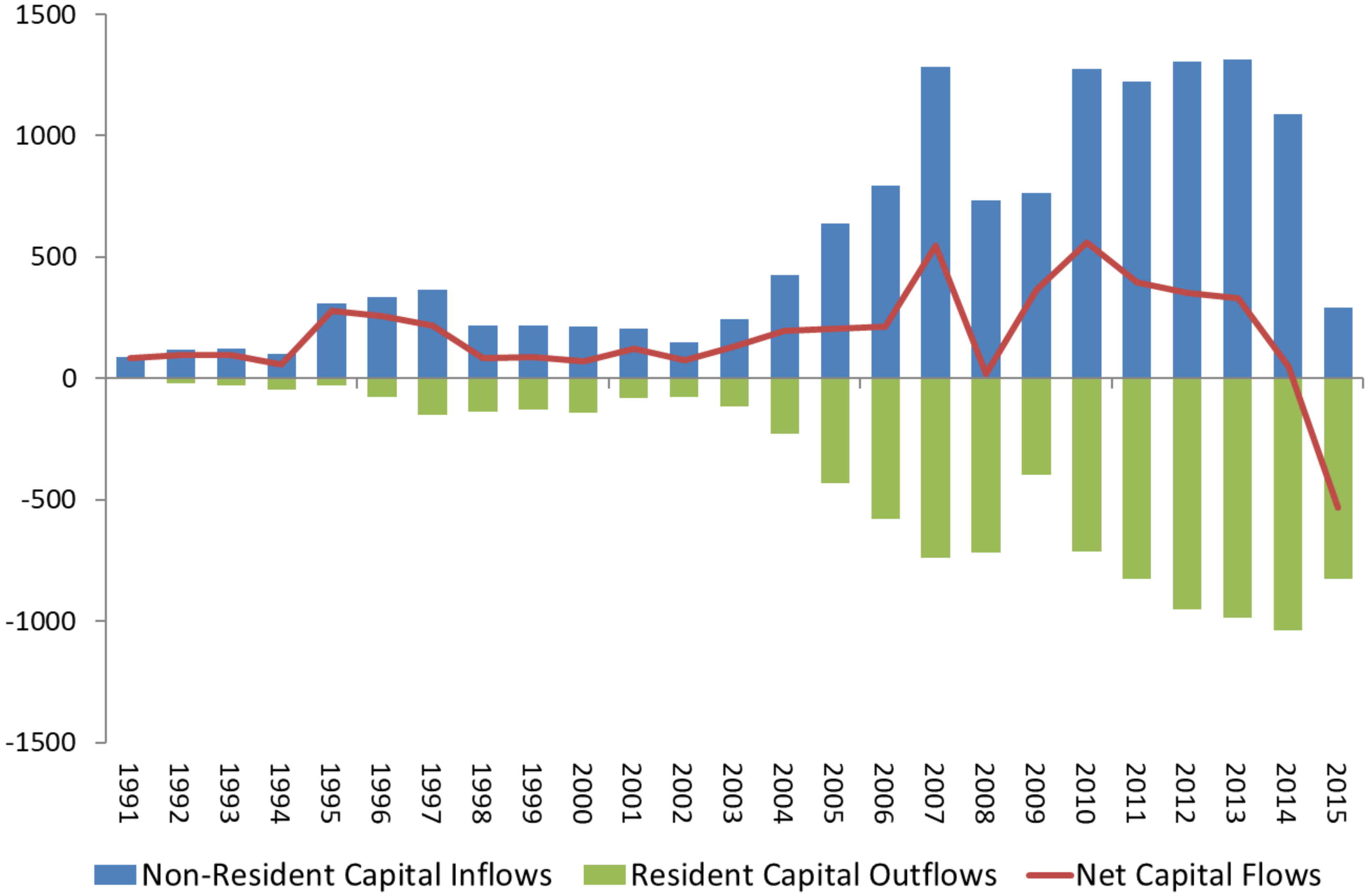
- Rapid rise in gross external assets and liabilities as % of GDP; almost 90 per cent of outstanding assets and liabilities accumulated after 2000.

- Gross foreign assets rose faster than liabilities because of CA surpluses.

- But surpluses concentrated in a few major EMEs (China, Russia). Most others had cumulative deficits. They accumulated assets from inflows, not from CA surpluses. Balance sheets highly leveraged.

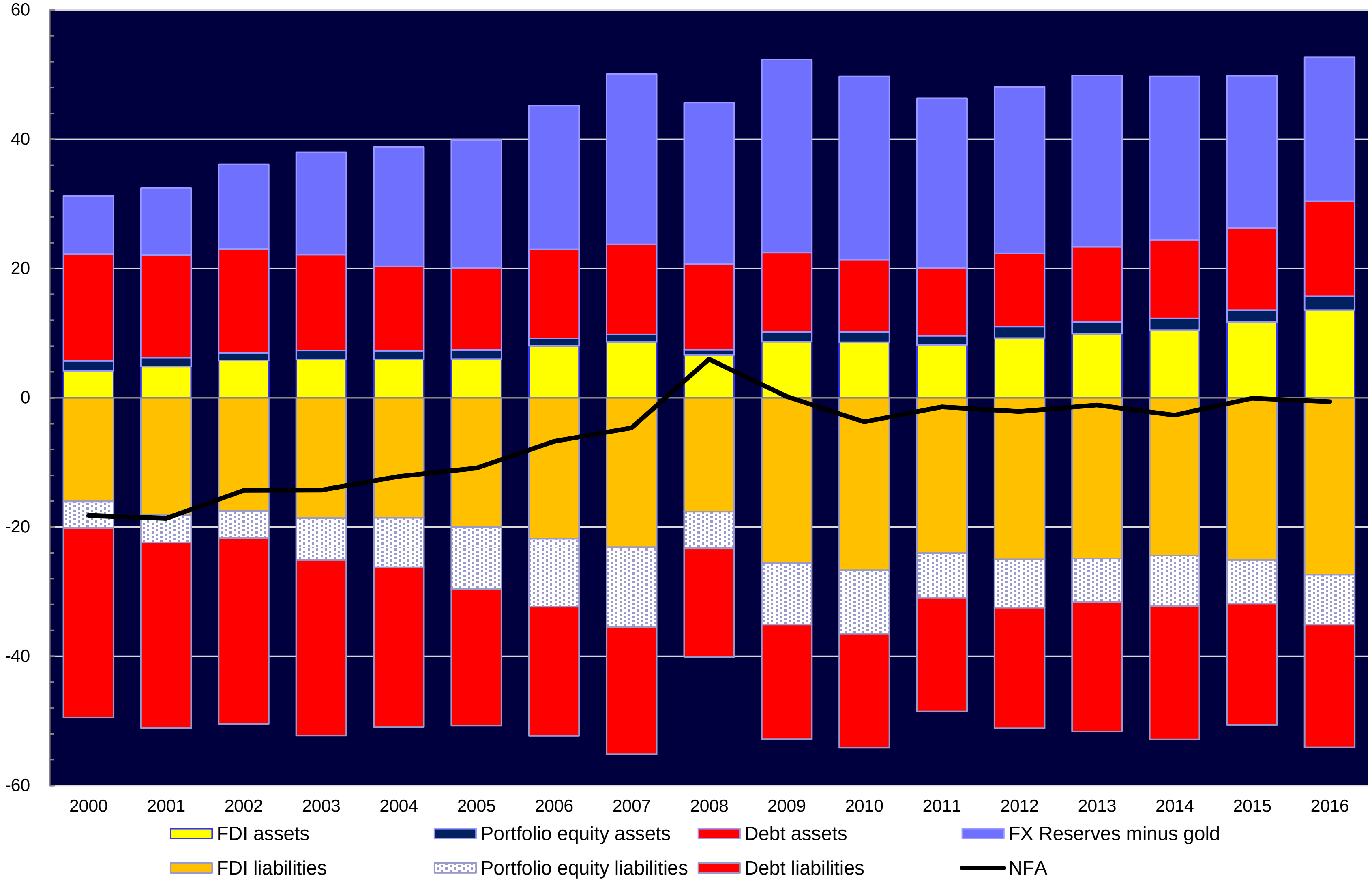
- Significant changes in the composition of external balance sheets, notably liabilities.

Aggregate inflows never negative since 1980s



Growth of external balance sheets of EMEs: 2000-2016

(Per cent of GDP)



IMF IIP

Factors deepening Integration – Monetary policy in AEs

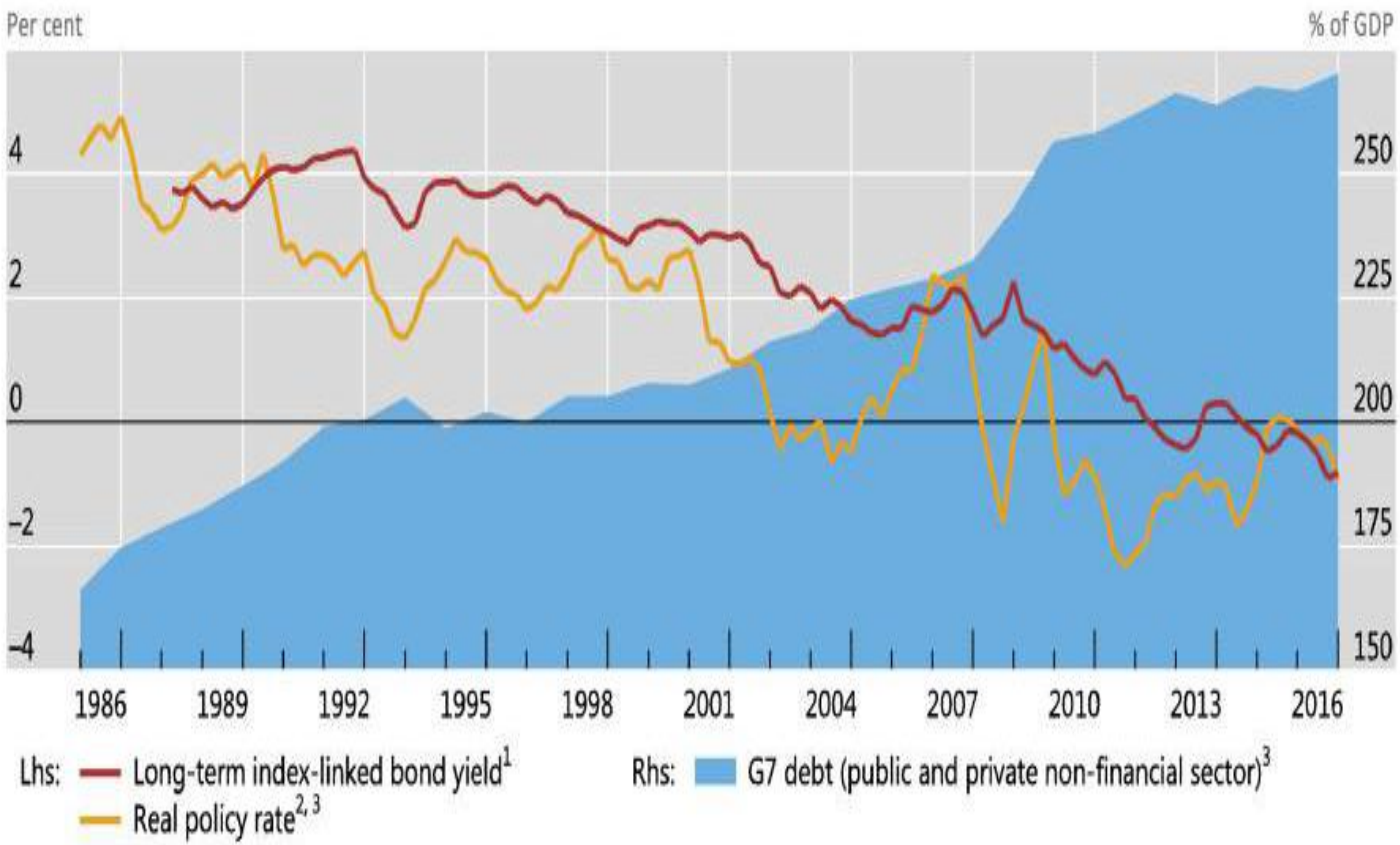
- Progressively looser monetary policy in US since 1980s; Fed cutting interest rates more and more during downturns and raising them less and less during upturns; creating a downward bias in nominal and real interest rates.

- Japan has done the same since early 1990s. Other AEs joined in the 2000s, more so after the sub-prime crisis.

- Falling rates have been accompanied by rising debt relative to GDP, making it difficult for CBs to raise policy rates for fear of bursting assets and credit bubbles.

- Monetary policy in AEs led to a search for yield in high-return, riskier assets, including in EMEs, creating surges in capital inflows.

Downward bias in interest rates, upward bias in debt in G7



Source: Hannoun and Dittus

Factors Deepening Integration – Liberalization in EMEs

- Policies often designed to address the last crisis; but inadequate to prevent the next one; can even cause it.

1. Shift from debt to equity by liberalizing FDI regimes and opening stock markets on grounds that equity is more stable and less risky than debt.
2. Shift exchange rate risk to international lenders and investors by opening up bond and deposits markets and borrowing in local currency.
3. Open capital account for resident outflows rather than restrict inflows in order to avoid cost of currency interventions and appreciations.
4. Encourage corporations to become global players, allow them freedom to operate in international markets as investors and borrowers.
5. Open to international banks to increase competition, improve efficiency in intermediation and enhance resilience to external financial shocks.

Changing composition of external balance sheets

- **Assets**:
  - FDI up relative to debt assets (bonds, deposits, reserves)
  - Reserves up relative to other debt assets (bonds, deposits)

- **Liabilities**:
  - Share of debt down, equity up; most EMEs long in debt and short in equity.
  - Sharp increase in portfolio equity; a large part of FDI are from local profits.
  - Shift from bank loans to bonds; debt now more susceptible to conditions in international bond markets than in international banking
  - Private share in external debt up, public down; over 75% on average. Non-financial corporate external debt exceeds sovereign debt.
  - Share of local currency in external liabilities up (equity and local bonds).

External vulnerability

- Foreign presence in equity markets; 40% vs 15% in US; shallow local investor base; susceptible to entry/exit of foreigners; correlation with global markets.
- Sovereign debt internationalized even more than US; 40% of local bonds held by non-residents against 1/3 in US; held by fickle investors not by CBs.
- Integration of bond markets; long-term rates now highly susceptible to US bond markets; local bond markets can no longer act as spare tyre.
- Resident outflows one way traffic; will not return in rainy days.
- Corporate debt in dollars; exchange rate risk remains where it matters most.
- Foreign bank share 50% against 20% in AEs; local rather than cross-border lending. Regulatory arbitrage; transmitting instability from home countries (EZ)
- Shocks through these channels seen on many occasions since 2007: Lehman, taper tantrum, US rate increases. But these shocks were temporary

Measures to increase resilience

- Shift to more flexible currency regimes
- More effective banking regulations and supervision
- Better fiscal discipline
- Large stock of reserves as self insurance

Currency regimes and vulnerability to shocks

- Fixed pegs problematic, shift to more flexible regimes commendable.
- But under free capital mobility no regime can guarantee stable rates. Currency crises can occur under flexible rates as under fixed rates. All depends on how surges in capital inflows are managed.
- Unlike fixed pegs, floating during strong inflows can cause nominal appreciations and encourage even more short-term inflows.
- If surges are allowed to create large imbalances and fragility, when inflows are reversed it would not matter whether currency is fixed or floating – in both cases it can end up in free fall – Indonesia in 1997.
- Mismatches in private balance sheets accelerate currency falls as debtors try to close short positions; more destabilizing than mismatches in public balance sheets

Banking regulations and supervision

- Banking regulations and supervision improved, restricting currency and maturity mismatches in bank balance sheets.

- However, banks now less prominent in intermediation of international capital flows than in the 1990s. International bond issues have grown much faster than cross-border bank lending. A large part of capital flows now goes directly into securities markets rather than through banking.

- Lending in dollars by domestic banks and migration of exchange rate risk to borrowers, turning it into credit risk. Lack of effective mechanisms restricting such lending to sectors without forex earning capacity (property).

- Such risks are not addressed by Basle requirements.

Fiscal discipline and sustainability

- Public debt now more manageable because of better fiscal discipline; but also thanks to favourable global financial conditions.

- Sovereign international borrowing rarely cause of crises in EMEs; only one in last 8 major crises (Argentina). Others were due to private external borrowing (Asia); domestic sovereign debt (Mexico and Russia) or a combination of the two (Brazil and Turkey).

- In all EMEs crises caused by excessive private indebtedness, sovereign debt sustainability was undermined; public debt rose sharply due to bailouts and contraction; in EMEs on average by 36% of GDP; also seen in EZ crisis.

- Sovereign currency risk now lower but interest rate risk higher. Tightening of global bond markets can create domestic debt difficulties.

Reserve Accumulation: How much self-insurance?

- EMEs are commended for building self-insurance by accumulating large reserves.

- However, in most EMEs these came from capital inflows rather than CA surpluses; they are borrowed not earned; corresponding increases in external liabilities. They may not be adequate against massive and sustained exit of capital.

- Changing concept of reserve adequacy (IMF). Short-term debt in dollars is no longer only or most important drain on reserves.

- Foreign holdings in stock, bond and deposit markets and capital flight by residents pose much greater threat. Recently seen in some countries with strong reserve and BOP positions (Malaysia, China).

Potential shocks

- World is addicted to cheap money and has accumulated massive debt for a decade. Cannot say when and how this will end, but hard-landing possible.

1. Inflation and faster monetary tightening in US.

2. Arrival of Minsky moment- bearish markets (not correction or profit taking) reassessment of risks, capital reversal, hikes in risk premia and borrowing costs even without Fed tightening.

3. Recession in US spreading globally; debt can become unpayable even without hikes in interest rates. US policy options to respond limited.

4. Financial turmoil in China; could be contained thanks to state control over debtors and creditors. Not much direct exposure of EMEs and global banks to China; but strong negative impact on global risk appetite; contagion.

Policy response to shocks

- EMEs policy space to response to shocks more limited now than 2008.

- Business as usual? Maintain open capital account, stay current on debt, use reserves, then go to IMF, bail out private debtors and foreign creditors, austerity.

- Few other options where fragility severe and shocks strong; not much appetite or scope for temporary standstills, exchange controls and selective trade measures.

- A global strategy lacking:

  - Problems in liquidity provision: Scale now much bigger. IMF resources limited; S-S mechanisms inadequate; SDR? AEs to come to rescue? Not likely – their banks are not so exposed to EMEs as in previous crises.

  - How to involve creditors and investors in crisis resolution? Perennial question

  - International mechanisms for effective and equitable resolution of liquidity and debt crises in EMEs (proposed by UNCTAD in 1986).

Conclusions

- Main issue is not whether or not we'll have yet another bout of liquidity and debt crises in EMEs, but development prospects.
- Can EMEs achieve rapid industrialization and development if their key determinants are left to the whims of inherently unstable international financial markets, and policies in major AEs continue to neglect their impact on EMEs?
- In late-industrialization successful policies are associated not with autarky or full integration, but strategic and selective integration suitable to stage of development reached, seeking to use opportunities that a broader economic space may offer while minimizing the potential risks it may entail.
- In finance the pendulum has swung too far and that is a bigger concern than the likelihood of an imminent crisis in EMEs.