The financial crisis and its international transmission: selected lessons

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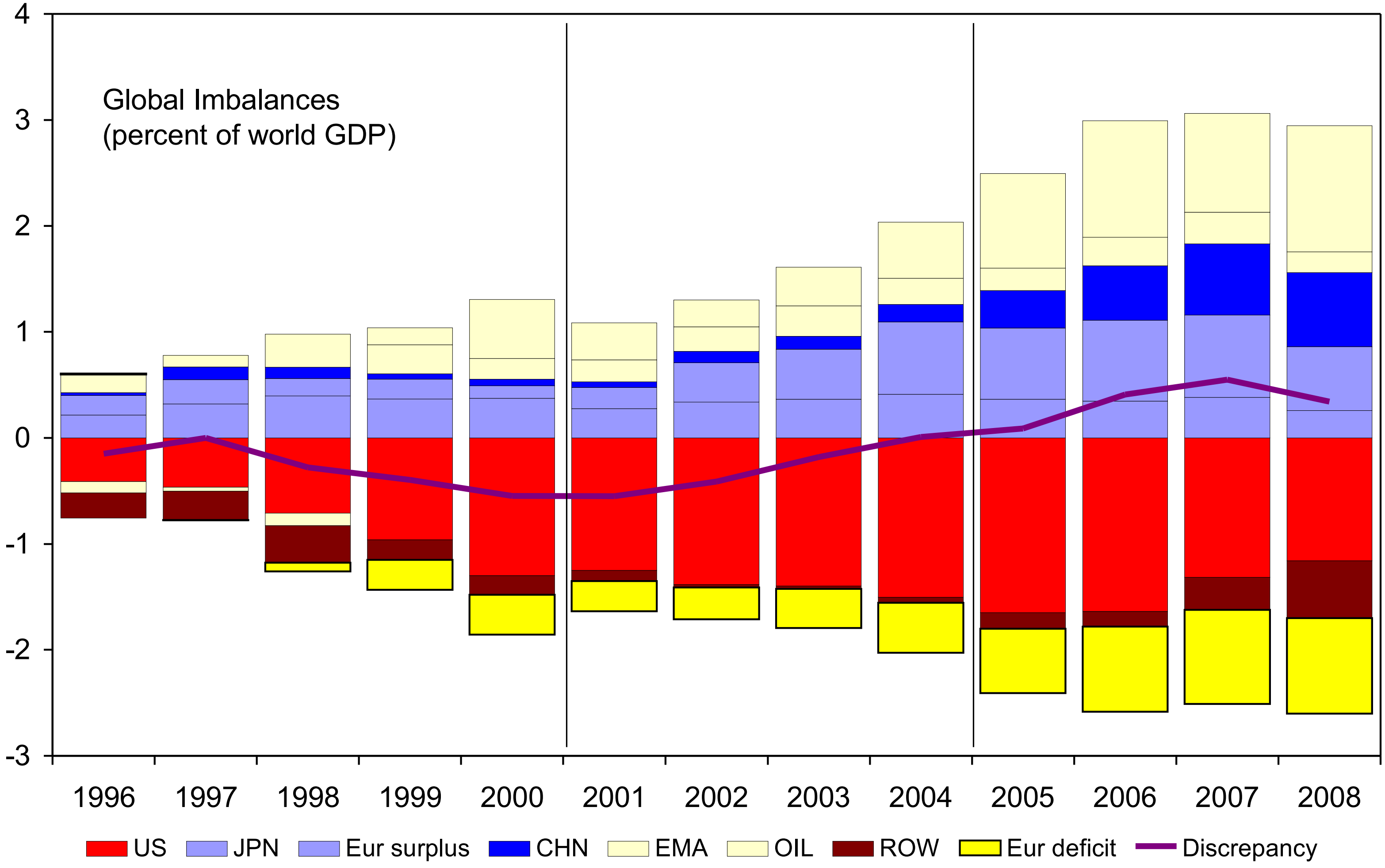
Structure of presentation

- Overview of cross-border financial flows
  - Global imbalances
  - Gross flows
- Cross-border holdings and transmission of the crisis
- Some tentative lessons

Global imbalances

- Different players and drivers at different stages
  - US investment boom, Asian investment bust (1996-2000)
    - US financing through FDI, equity flows
    - Surpluses in Japan, emerging Asia
  - Recession-recovery and US fiscal deficits (2001-2004)
    - Financing through US bonds (including foreign CB)
    - Surpluses in Central-Northern Europe, oil exporters, plus Asia
  - Global boom and bust (2005-2008)
    - Stable/declining deficits in US, large deficits in peripheral Europe
    - Boom in surplus in China, oil exporters, Central-Northern Europe

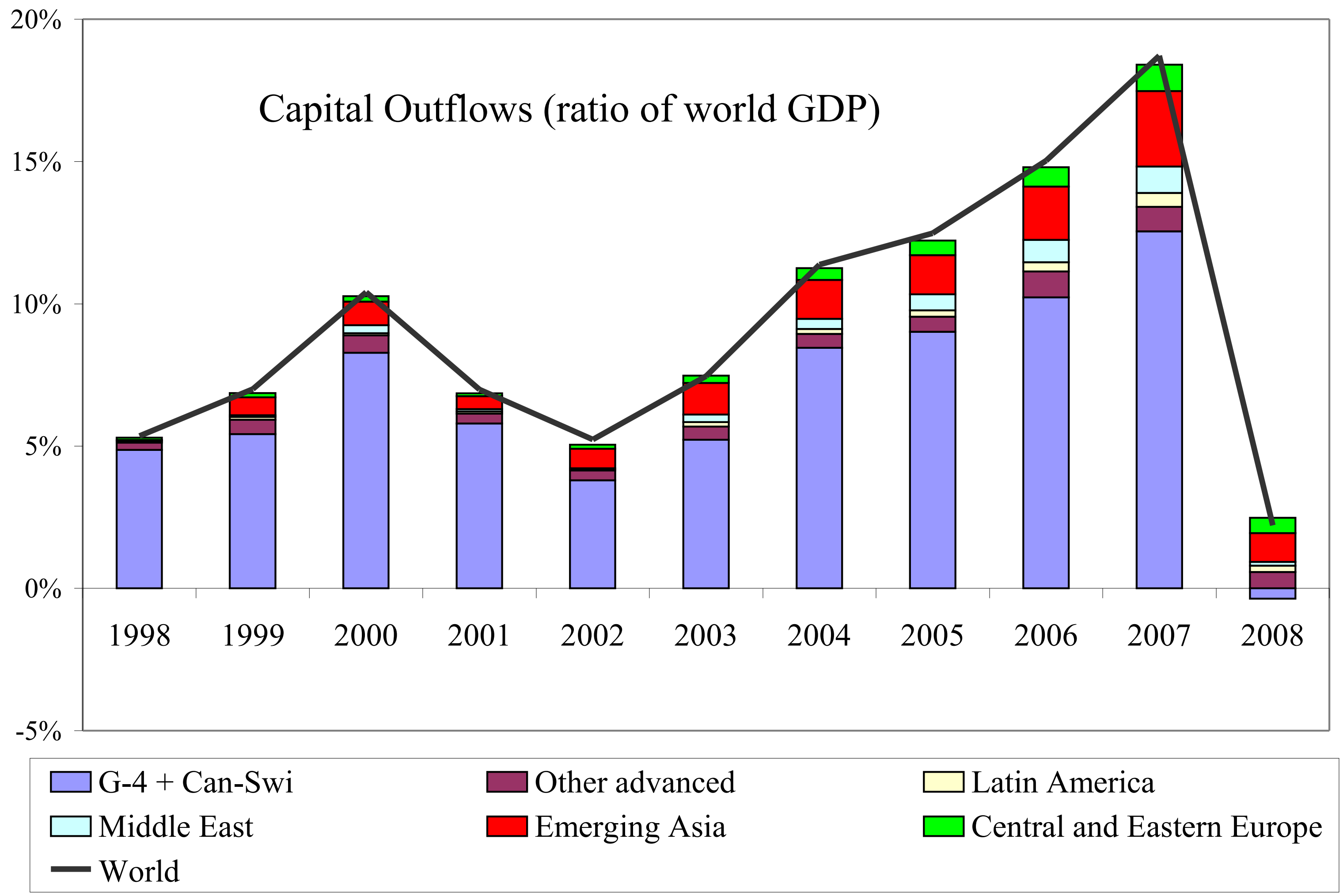
Global imbalances 1996-2008
An evolving story



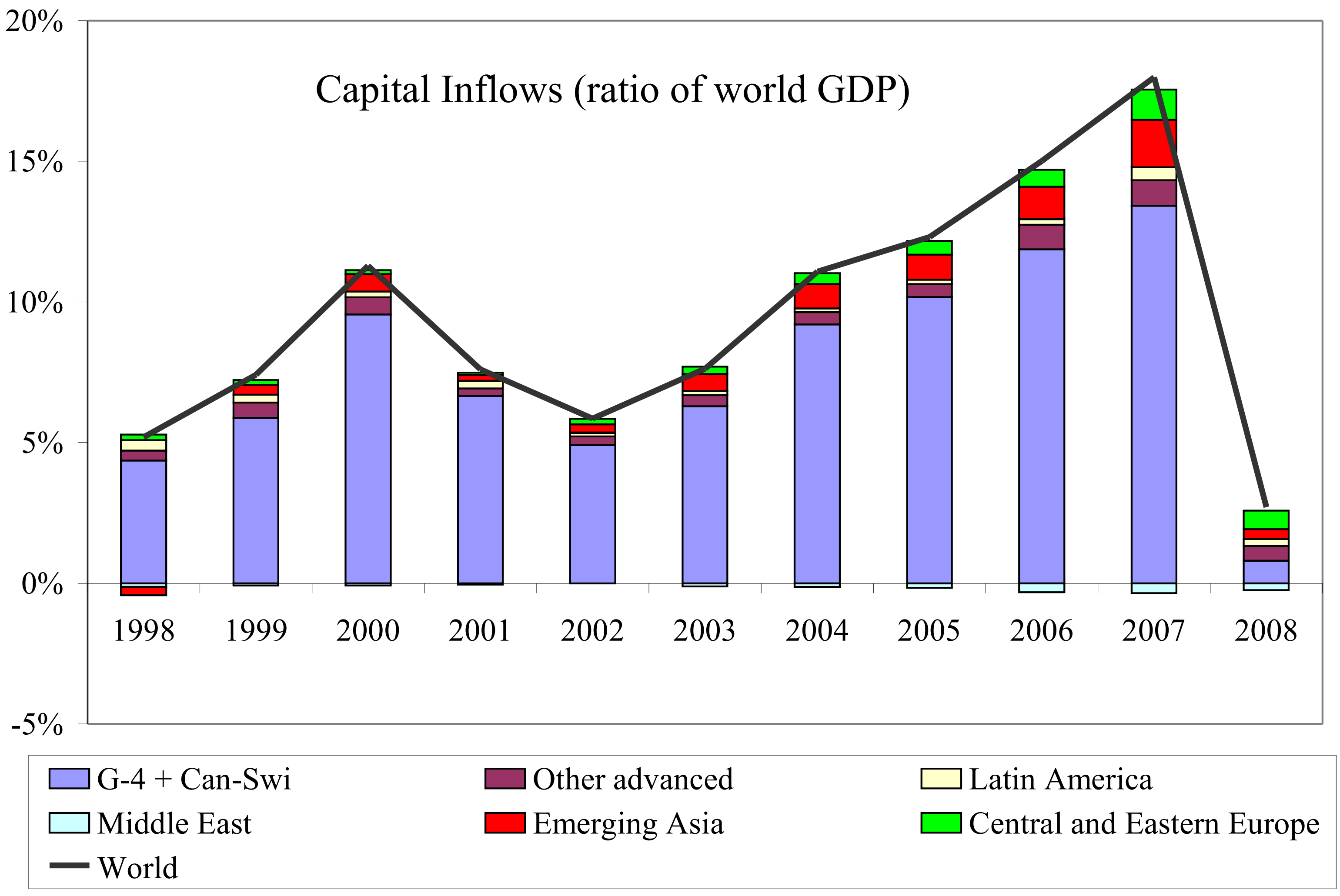
International financial integration

- Boom in cross-border holdings amongst advanced economies
  - Increase in cross-border banking activity
- Change in balance sheet structure for emerging markets
  - Reduced external debt
  - Higher FDI and portfolio equity liabilities
  - Higher reserves
  - Improved net external position

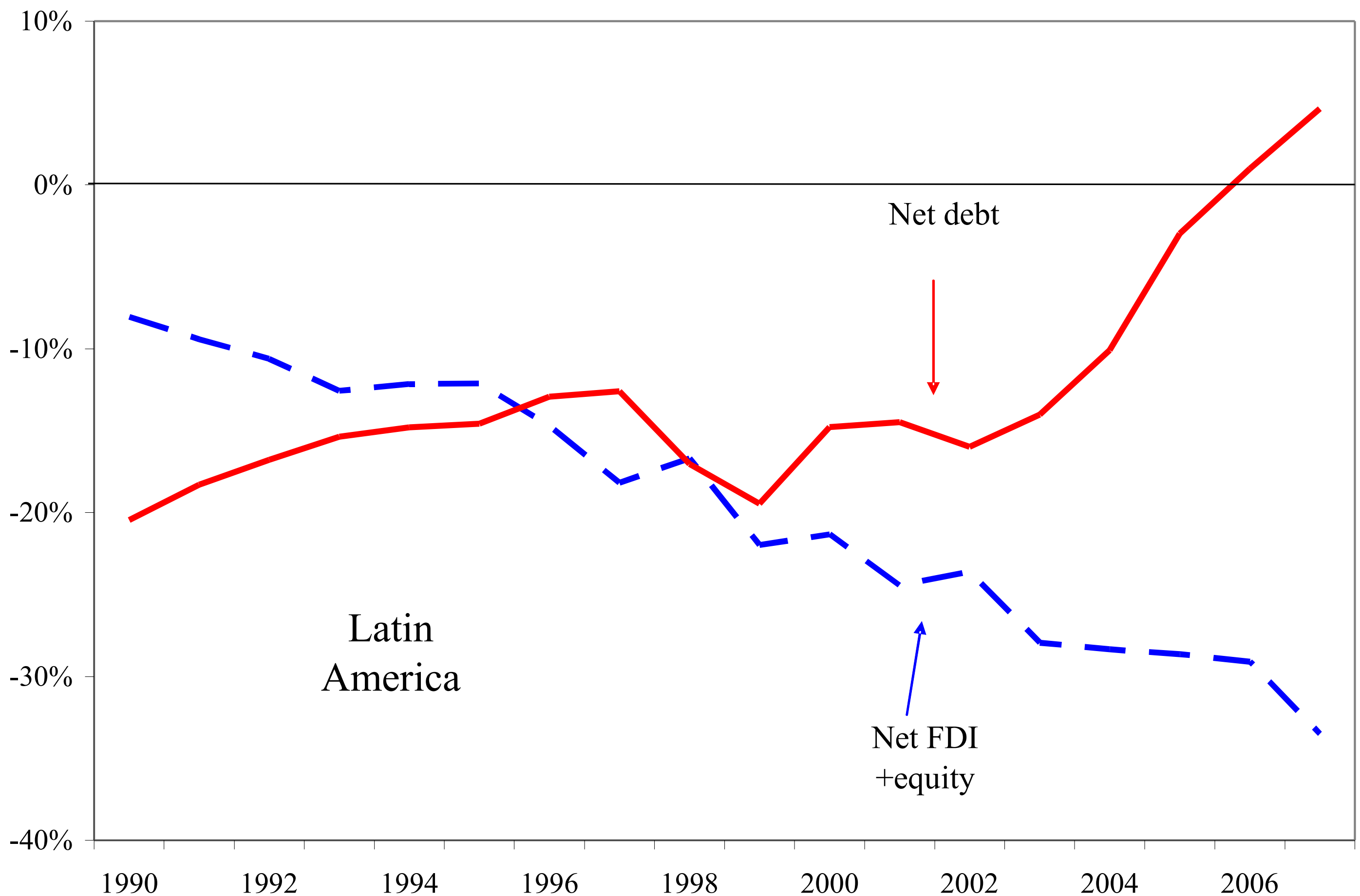
Global capital outflows



Global capital inflows



Change in structure of portfolio in EM: Latin America



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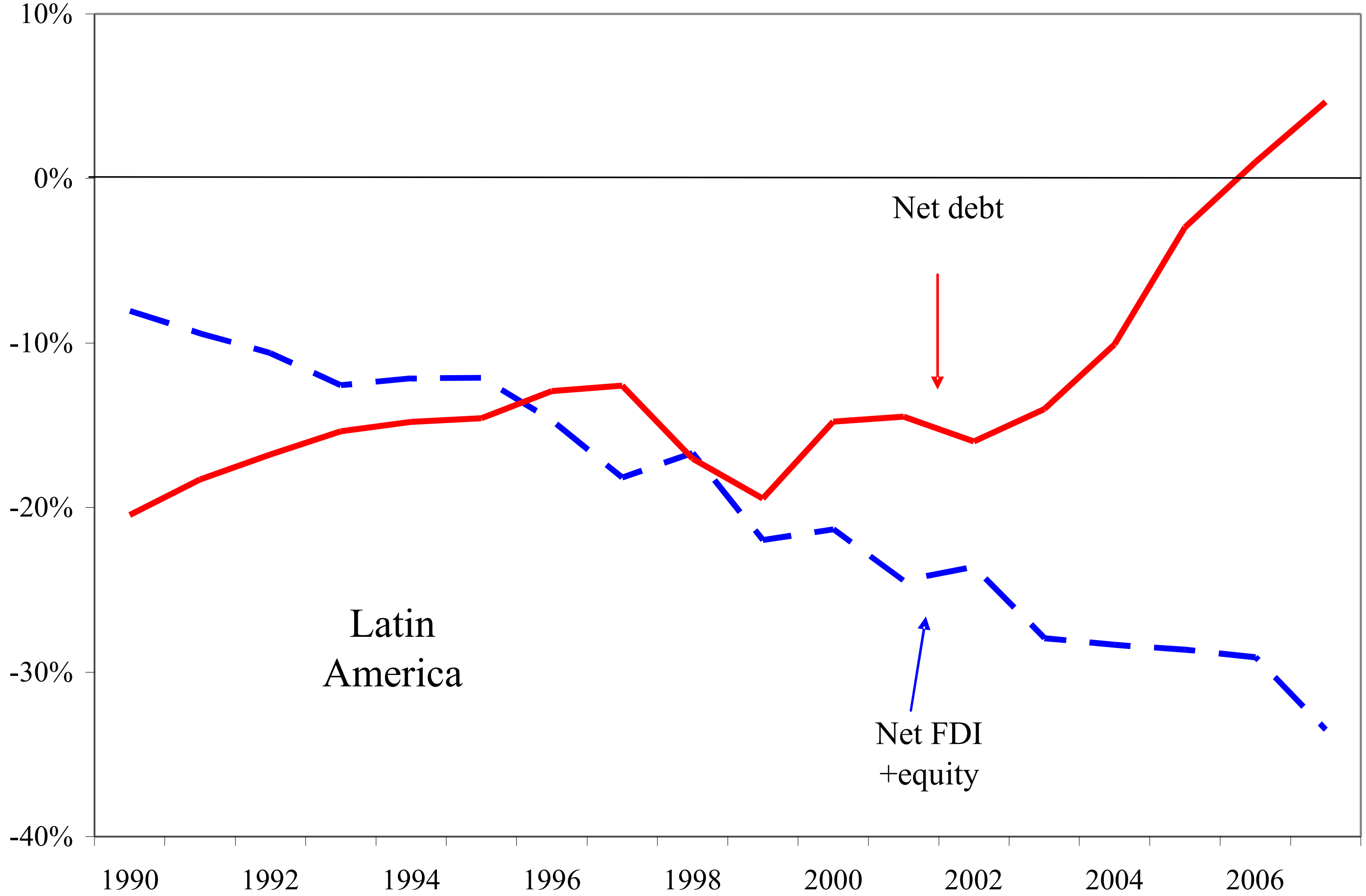
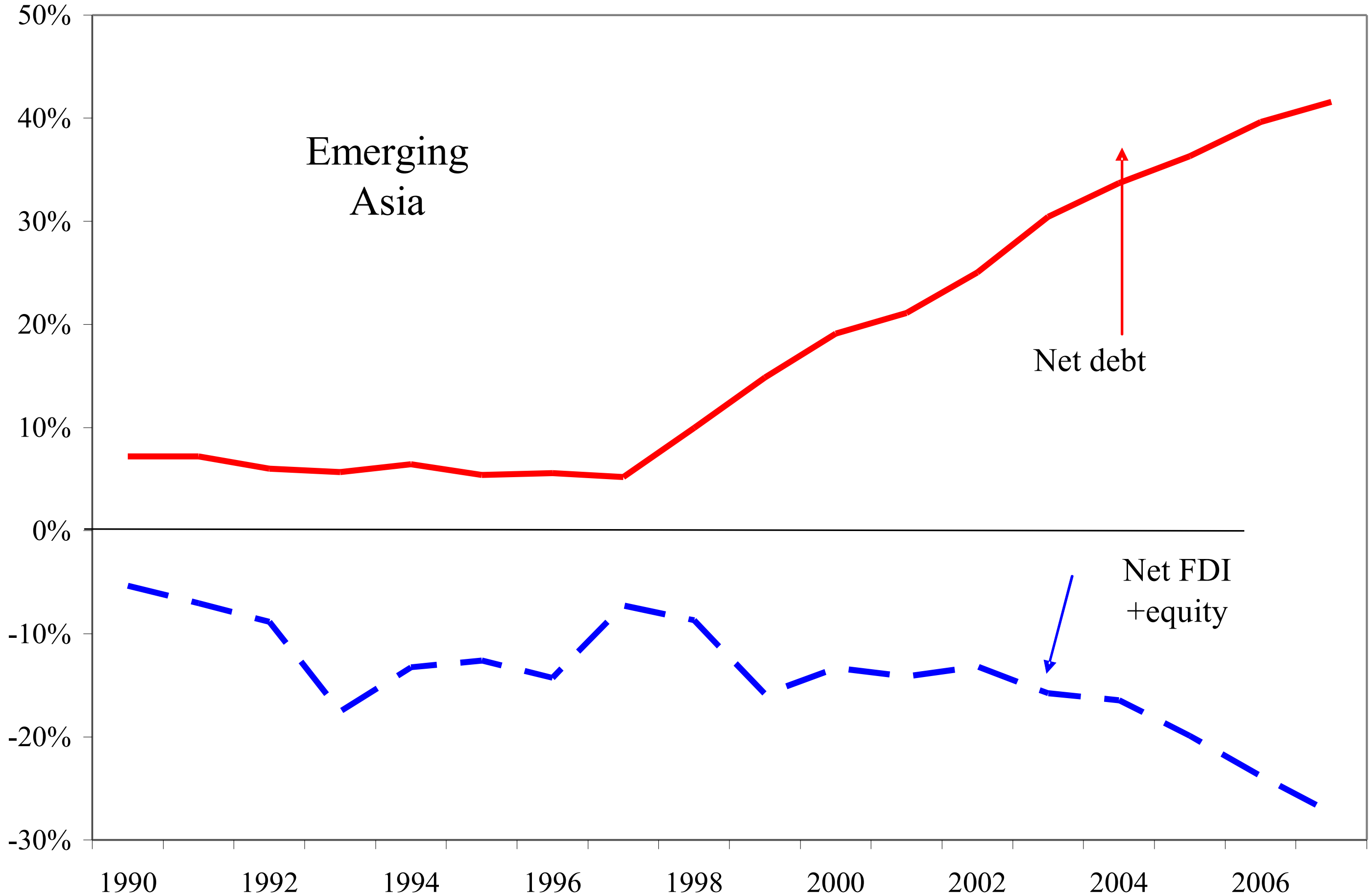
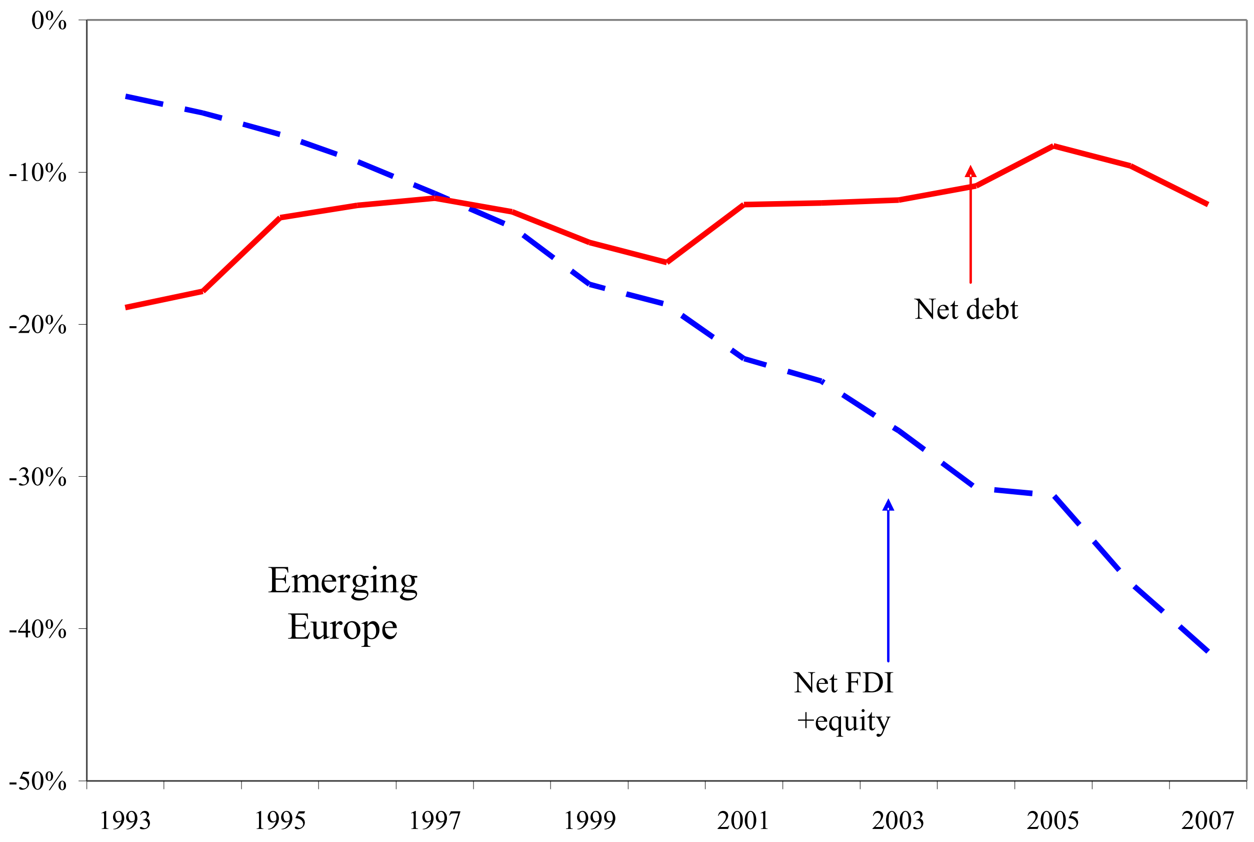


Change in structure of portfolio in EM: emerging Asia



Change in structure of portfolio in EM: emerging Europe

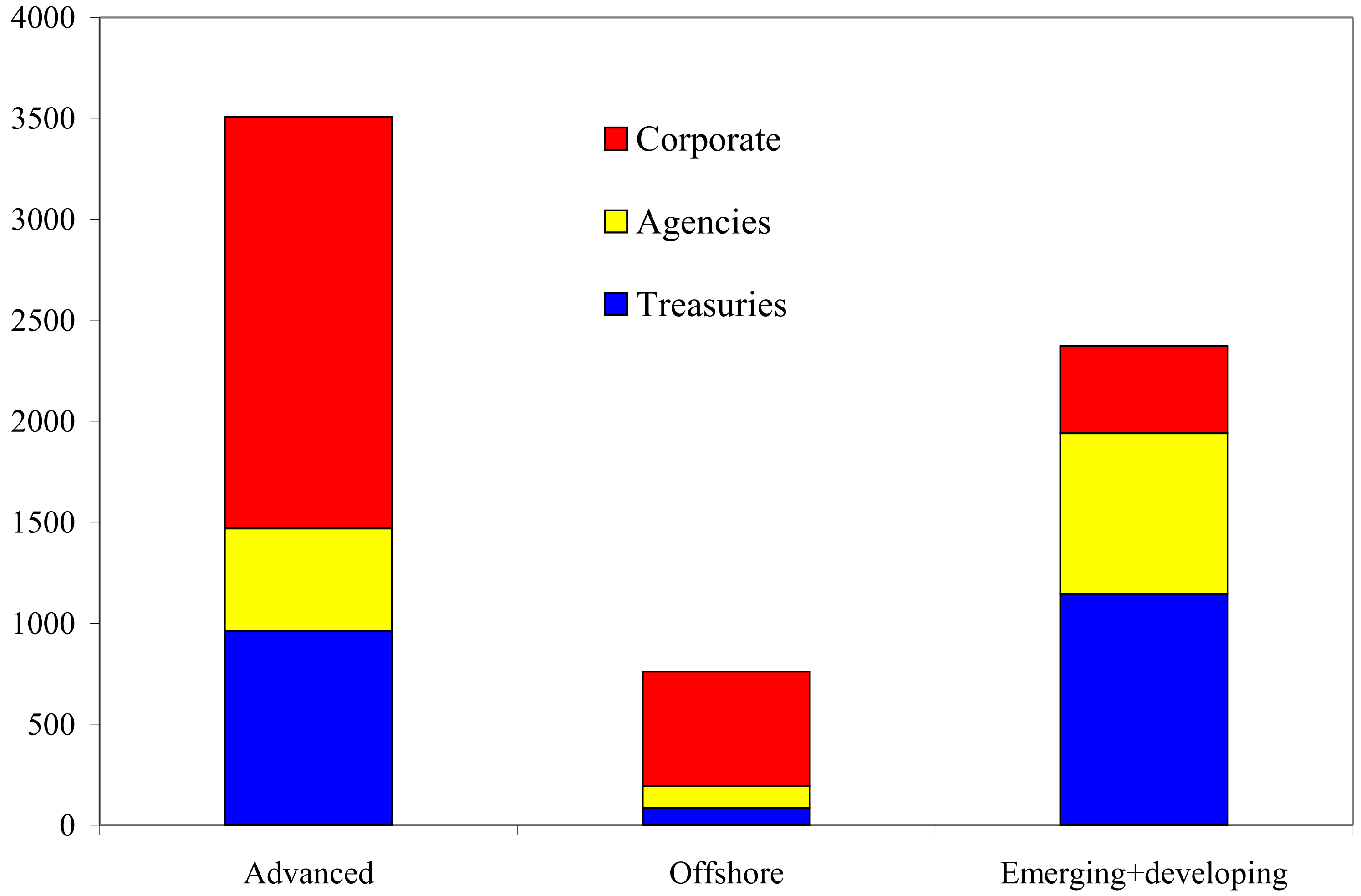


Pre-crisis exposure to US bonds

- Net terms: high holdings of US securities by China, Japan, SWF in oil exporters (mostly Treasury and agency bonds)

- Gross terms: large cross-border positions of European countries vis-à-vis the US (large holdings of corporate bonds, including ABS). Also, exposure to US through
  - US subsidiaries
  - Offshore centers

Foreign holdings of US bonds prior to the crisis (June 2007)



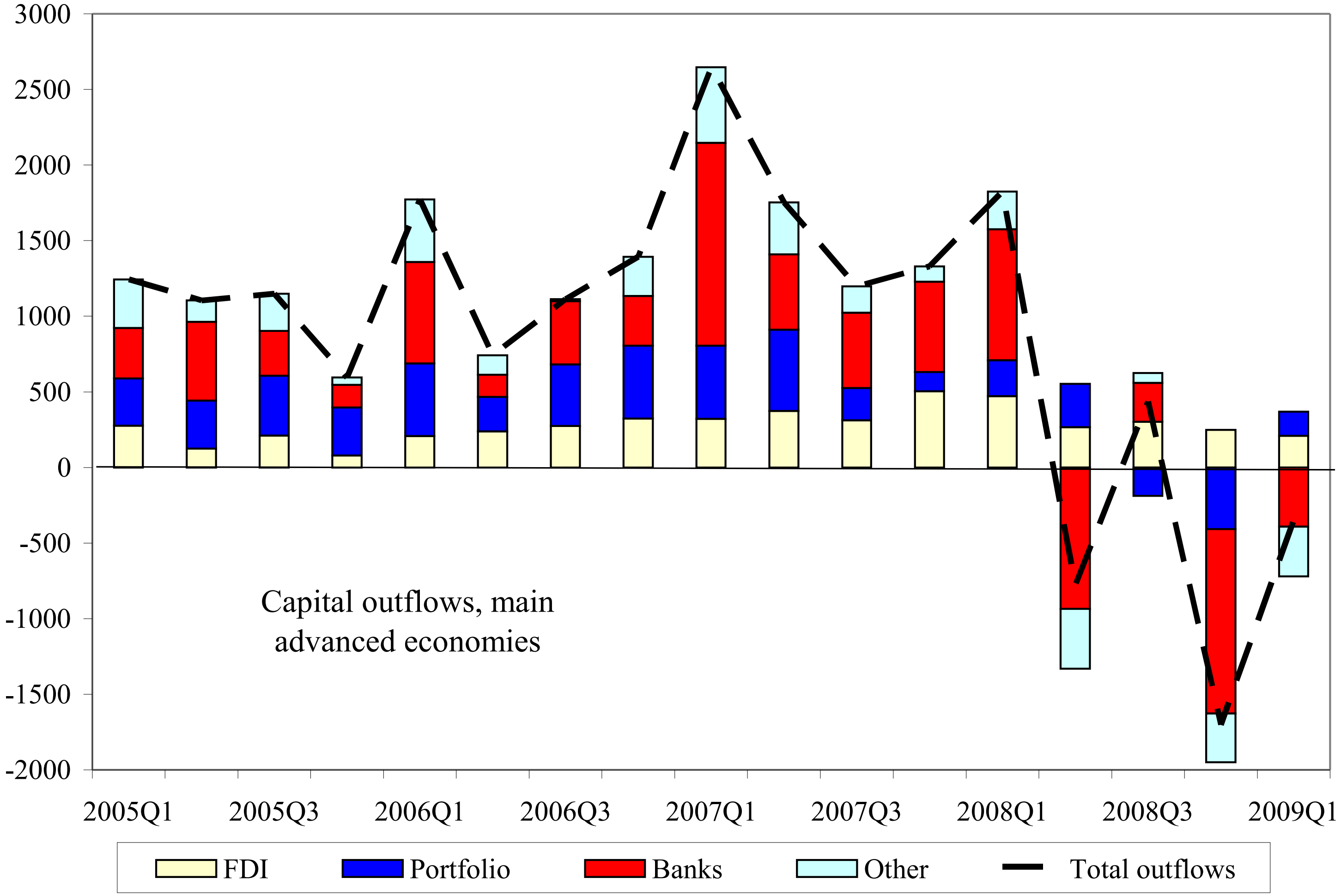
Cross-border crisis implications

- Direct “hit” on banks (mostly in Europe)
- Problem enhanced by
  - Leverage
  - Maturity mismatch (financing of ABS holdings through short-term borrowing in conduits/SIV)
- Direct effect of risk reappraisal for countries running large CA deficits
- “Tsunami” effect on other EM through liquidation of portfolio instruments/bank capital repatriation

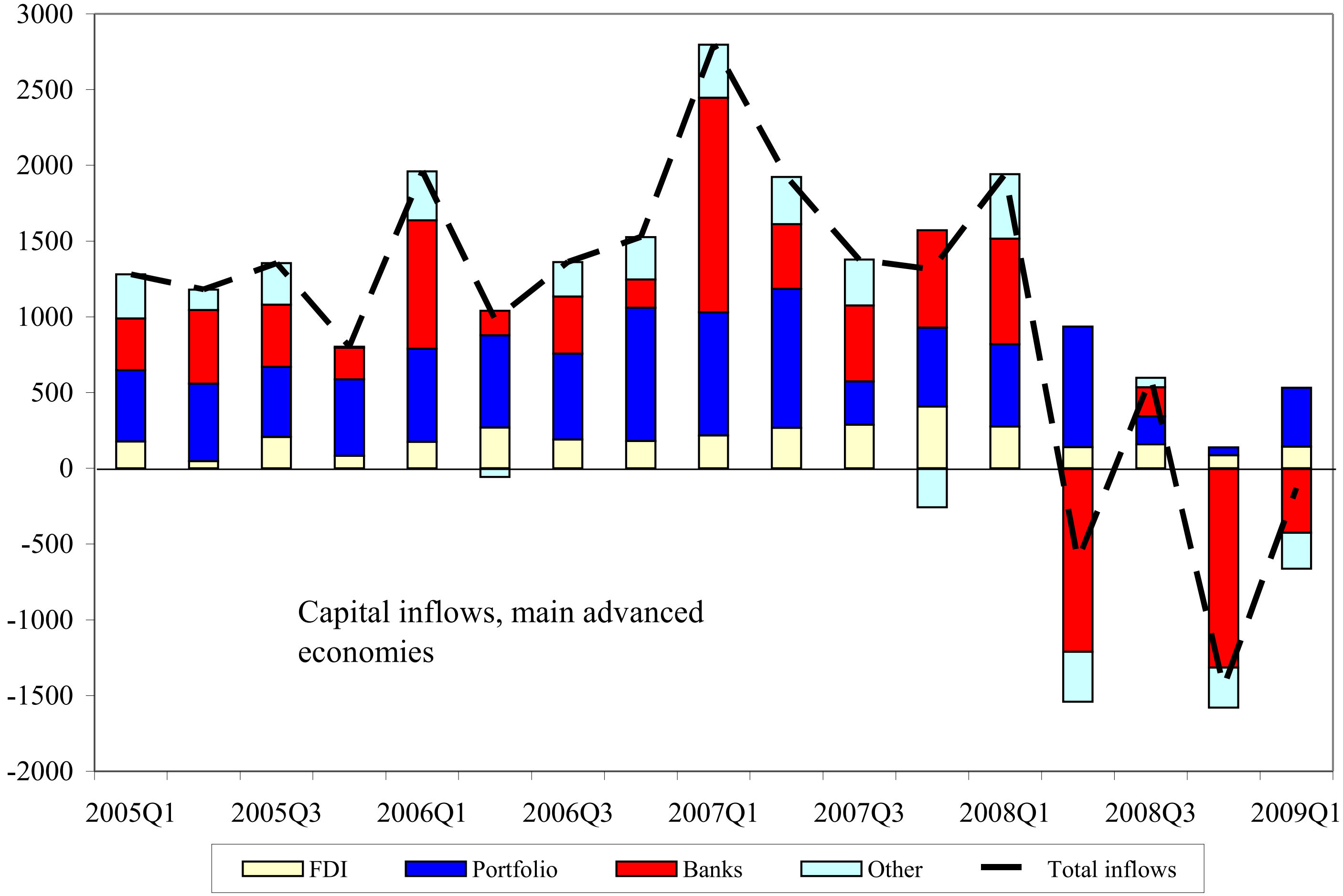
How to understand financial developments in Q4 2008?

- Deleveraging process
- Flight from risk
- “Dollar shortage”
- Increase in home bias (likely influenced as well by measures implemented nationally to deal with banking sector problems)

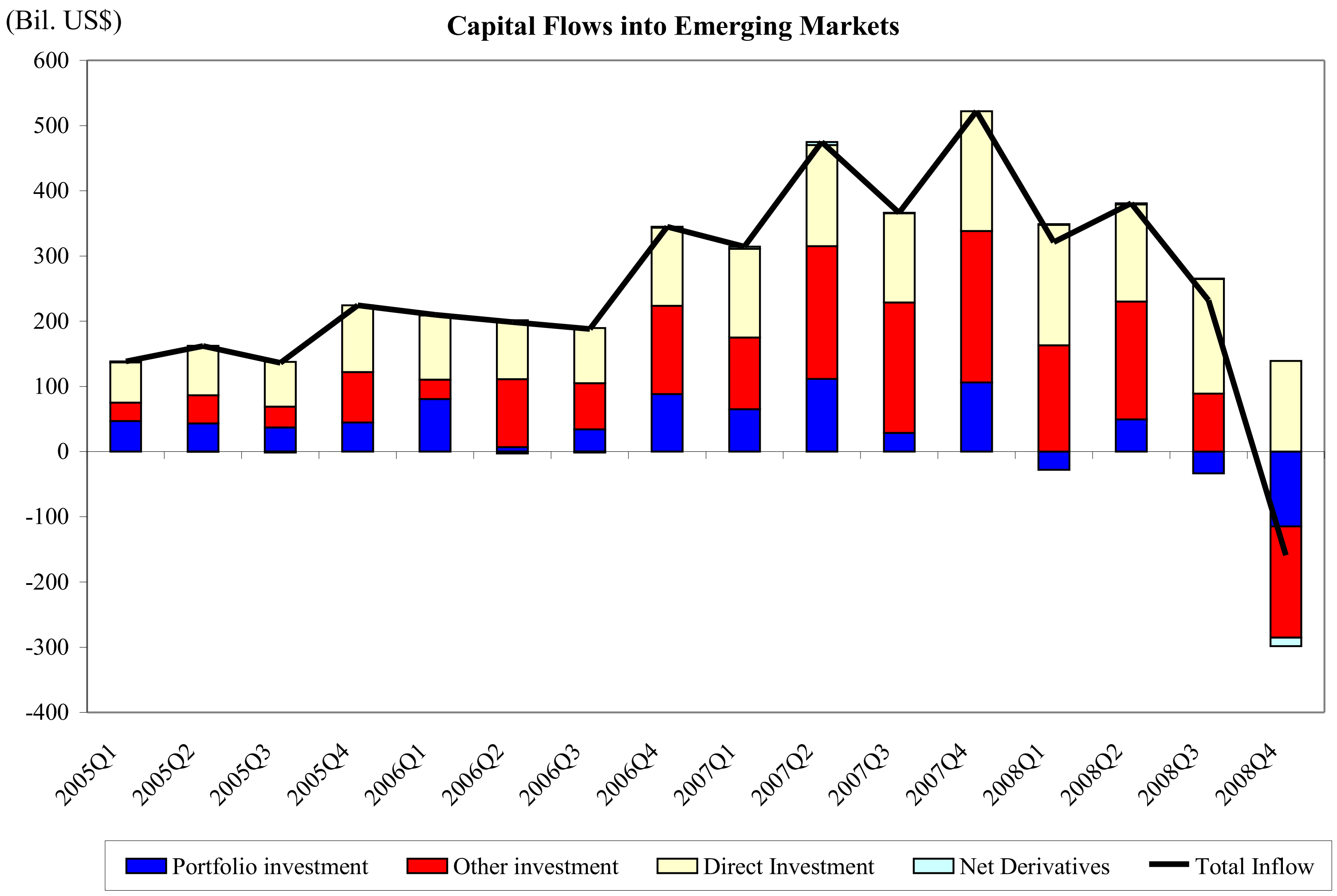
The sudden stop (advanced economies)



The sudden stop (advanced economies)



The sudden stop: emerging markets



Lessons from crisis

- Selected list of topics with cross-border emphasis. Important omitted topics:
  - Financial regulation (domestic and cross-border aspects), including scope for “macro-prudential” regulation
  - Monetary policy

Lessons for crisis (I)

- Dangers of large current account deficits
  - Global imbalances (systemic countries)
    - Not direct trigger of crisis…
    - …rather symptom of underlying excesses (esp 2005-08)
    - Policy advice mostly right
    - Costly adjustment
    - Need for demand rebalancing to sustain recovery
    - Smaller exchange rate adjustment than previously thought?
  - Large deficits in smaller countries

Selected lessons from crisis (I)

- **Large CA deficits in smaller economies**

	Current account balance, 2008	Net foreign asset position, 2008
Belarus	-8.4%	-23.0%
Hungary	-7.8%	-105.0%
Iceland	-34.7%	-302.7%
Latvia	-13.2%	-81.7%
Pakistan	-8.4%	-43.9%
Romania	-12.6%	-57.4%
Serbia	-17.3%	-68.4%
Ukraine	-7.2%	-37.6%

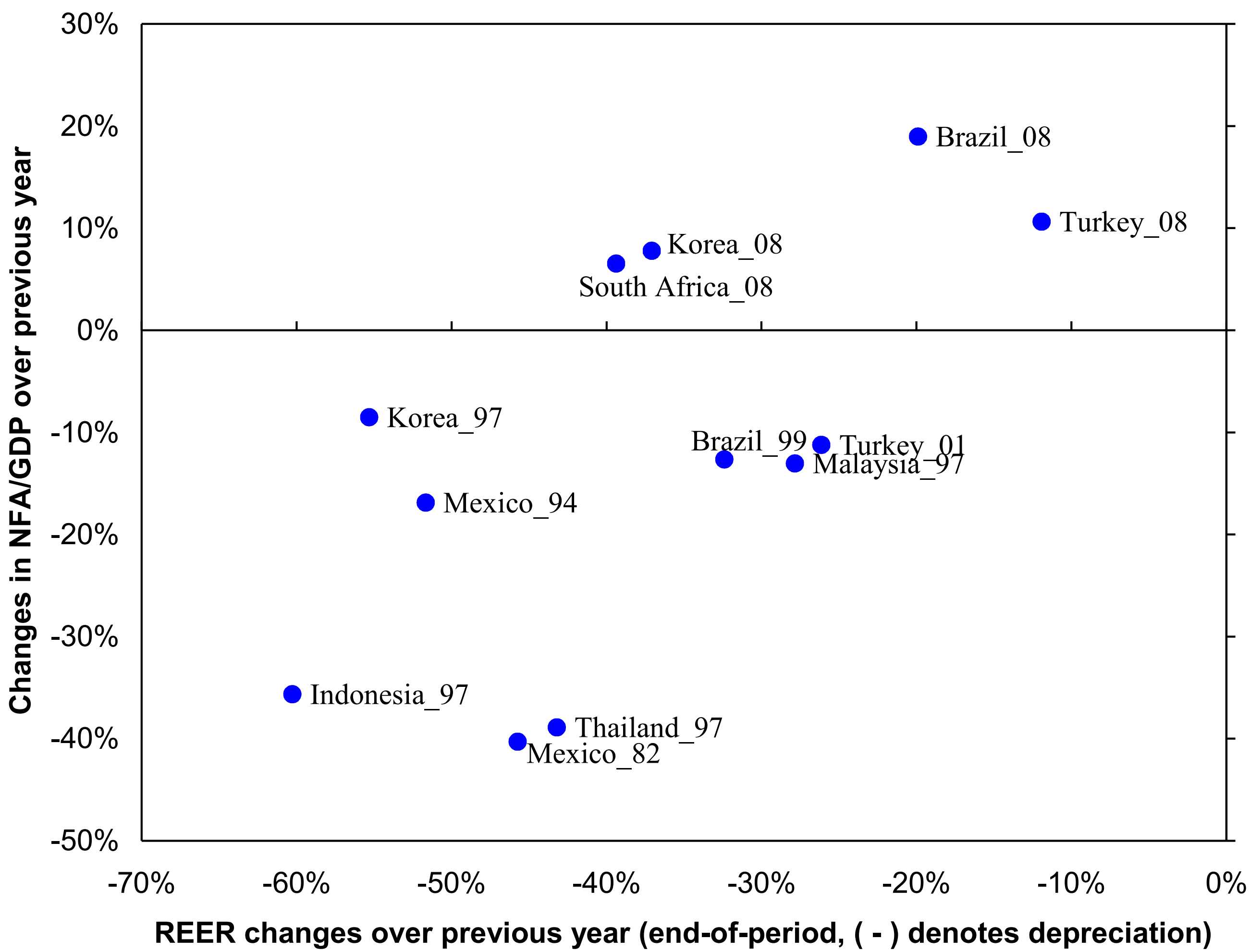
Selected lessons from crisis (II)

- **Importance of sectoral exposures**
  - Impact of crisis magnified manifold by the fact that initial losses were concentrated in highly-leveraged financial institutions
  - Emerging Europe – exposure of unhedged sectors (households, some corporates) to exchange rate depreciation

Selected lessons from crisis (III)

- **Exchange rate flexibility and portfolio structure**
  - In many EMs, exchange rate flexibility becomes a shock absorber
  - Key factors
    - change in FX exposure (many liabilities denominated in domestic currency)
    - Relatively modest CA deficits
    - Ample reserves

Impact of depreciation on NFA: a big change relative to the past



Selected lessons from crisis (IV)

- **Danger of credit booms under fixed exchange rates**
  - Difficulty in handling unsustainable credit booms and their REER and CA implications
  - What policy response?
    - Fiscal policy (but booms improve fiscal accounts, large surpluses politically difficult)
    - More pro-active prudential regulation/supervision
    - Capital controls?

Selected lessons from crisis (V)

- **Credit booms flatter fiscal accounts**
  - Dramatic underlying deterioration in fiscal accounts with the financial crisis in countries such as Ireland, United Kingdom, the Baltics
  - Output above potential
  - High revenues from taxes related to the credit boom (over and above the ‘automatic stabilizer” effects
  - Ex post, past “structural” fiscal policy much looser than previously thought

Selected lessons from crisis (VI)

- **International Financial Architecture**
  - Crisis clearly shows the need for mechanisms that ensure the rapid availability of resources for countries facing sudden stops in capital flows through no fault of their own.
  - Many outstanding questions….

Selected lessons from crisis (VI): Questions

- **International Financial Architecture**
  - Is there a risk of “global imbalances mark II” with emerging markets stepping up again purchases of U.S. Treasury securities—which will be in plentiful supply?
  - Or will the crisis have a lasting negative effect on the role of the dollar as reserve currency, as “flight-to-safety” wanes?
  - To what extent can the increase in IMF resources and the FCL help provide an alternative to reserve accumulation as an insurance mechanism?
  - What role can the SDR play?
  - What role can other cross-border insurance mechanisms, such as reserve swaps and other reserve-pooling agreements?

- Thank you.