

Comments

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Financial crisis and its impact on developing countries
Kennedy School, April 2009

Global imbalances

- A big ingredient in the crisis. But are they the *key cause* of the crisis?

Blaming the bartender for the patrons' heavy drinking?

Story: big massive capital inflows to finance U.S. current account deficits put heavy stress on financial intermediation.

CA deficits are matched by *net* flows – demands on intermediation more closely related to *gross* flows.

Big stresses / bubbles can arise with zero net flows too. And gross and net flows need not move together.

Feedback effects: financial innovation itself helped reduce U.S. saving (and encourage residential investment!) and widen the U.S. CA deficit

Household Saving Rates for Selected Countries



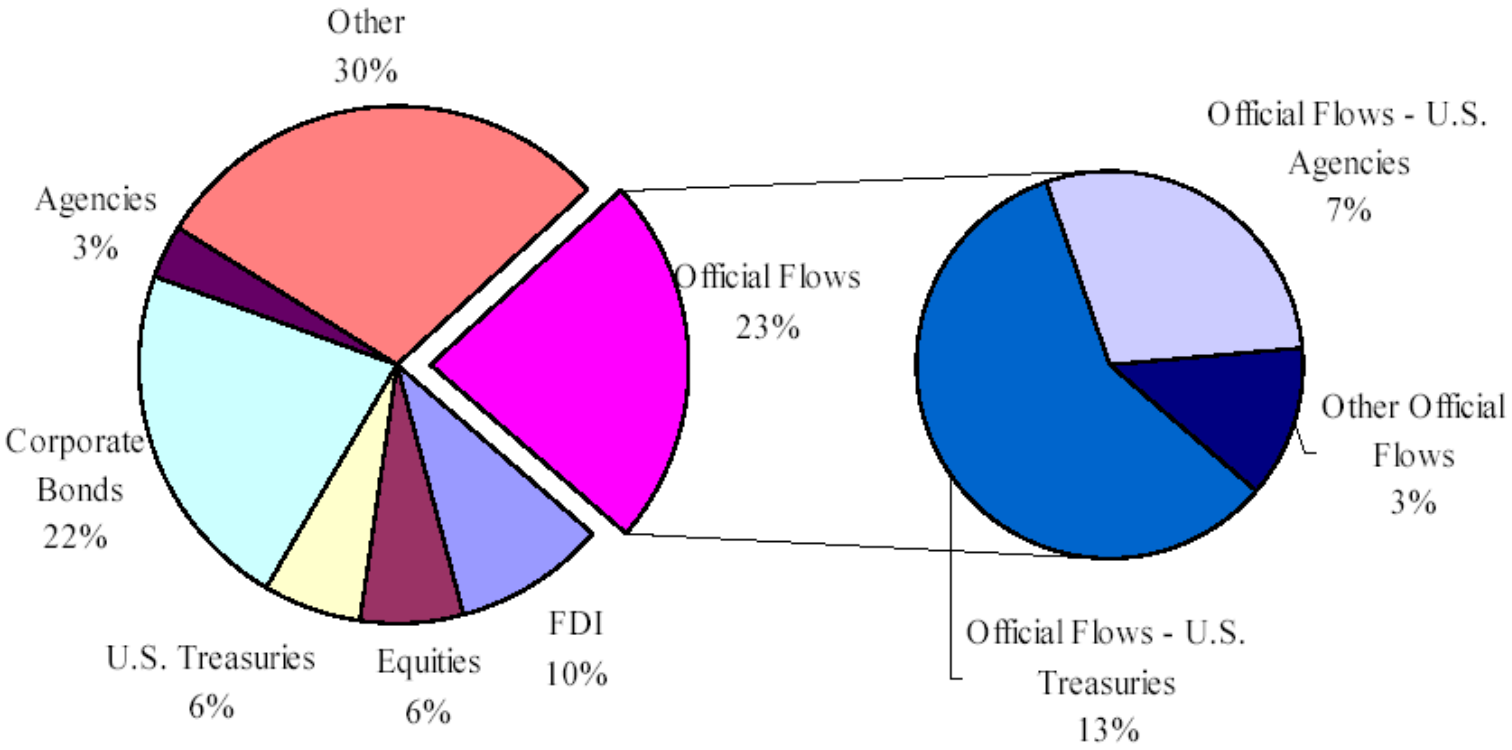
Global imbalances

Where did they come from?

1. Global excess demand for sound financial assets (Caballero et al 2008)

- Soundness of U.S. financial assets clearly questionable now – and this is reflected in recent inflow patterns
- Not the right explanation for the big *official* inflows into the U.S. (e.g., China)
- But a testable hypothesis: do *private* investors from countries with less-developed financial markets invest more in the U.S. ? Forbes (2008): yes

Figure 2a
Composition of Gross Foreign Capital Inflows - 2002-06



Based on data from Bureau of Economic Analysis, *Survey of Current Business* (July 2007), U.S. International Transactions table.

From Forbes (2008)

Global imbalances

2. Deliberate buildup of foreign asset stocks in emerging markets

2a: 'Bretton Woods II': new mercantilism of export-oriented growth

2b: Self-insurance against external (financial) disturbances

Insurance mechanisms not available in world markets, so self-insurance is next best.

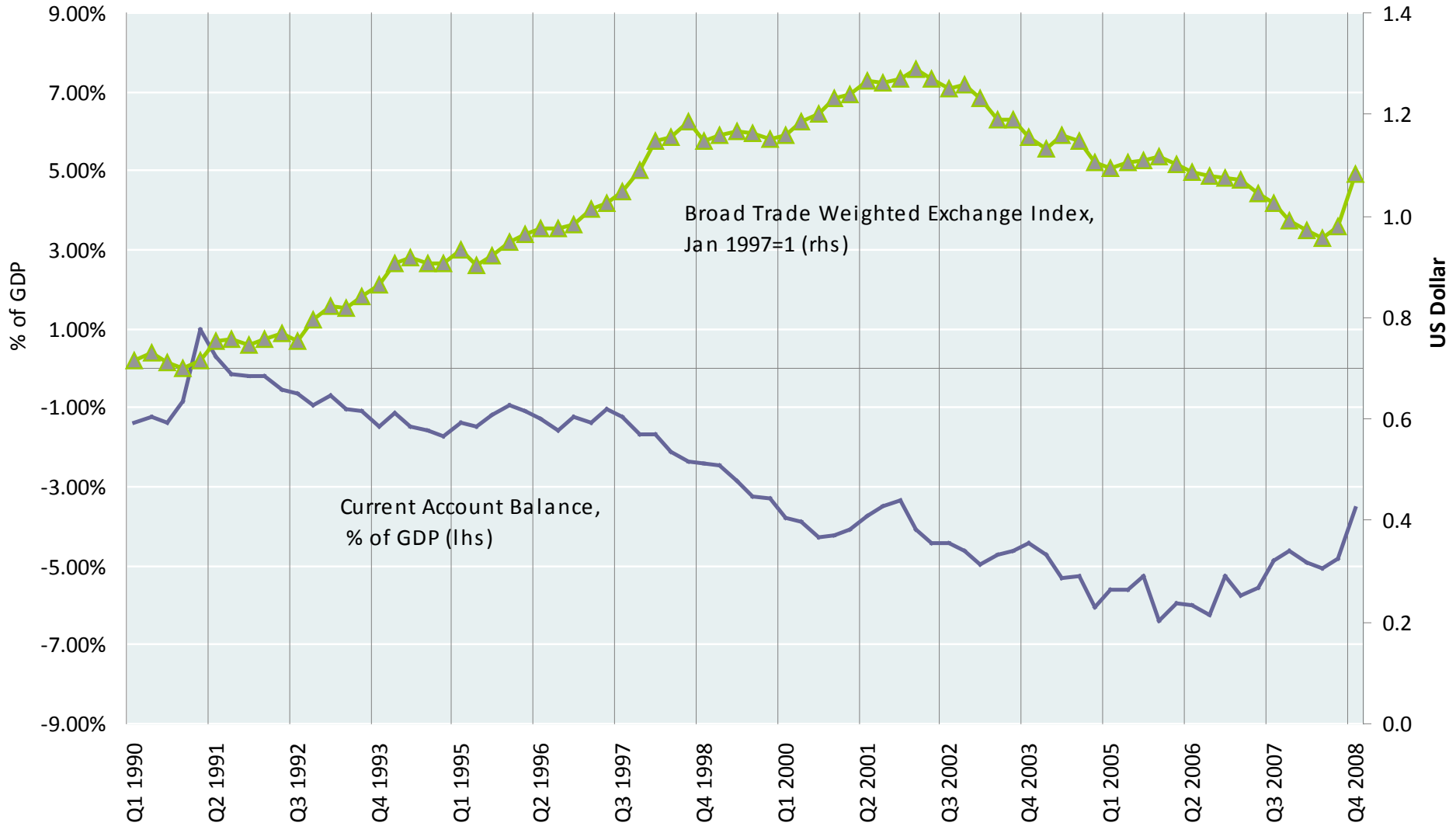
But this is more a rationale for holding liquid gross assets than for large *net* assets.

Empirically, some evidence for both 2a and 2b (Aizenman and Lee 2007)

The end of global imbalances?

- The U.S. current account gap has declined – but not through the dollar collapse that many had been predicting
- ‘Flight to safety’ into U.S. assets, and real appreciation.
- But a change in gross capital flows: foreign inflows are coming to a halt. They have been replaced by negative outflows (= repatriation by U.S. investors)

U.S. current account and exchange rate

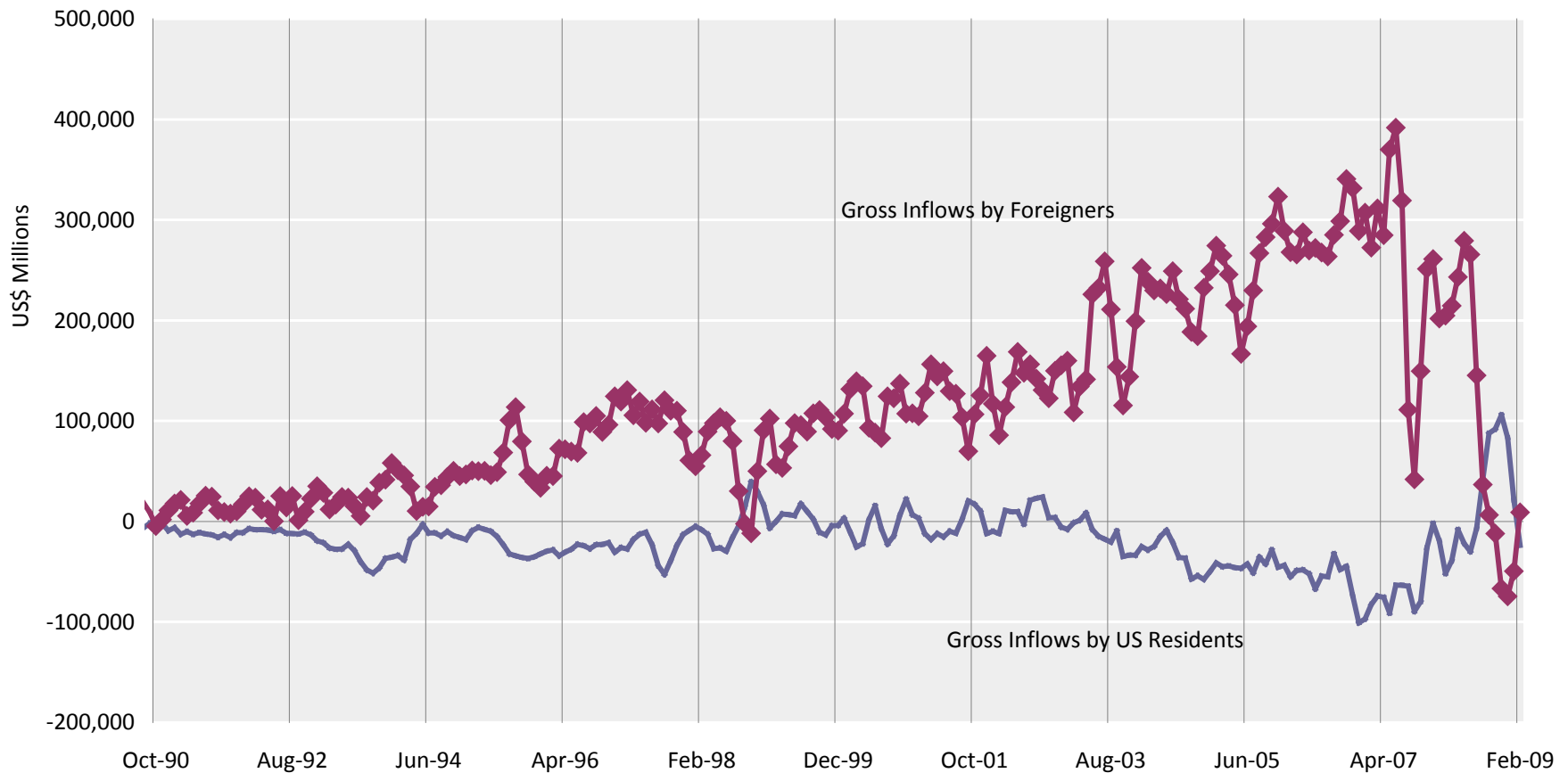


The end of global imbalances?

Figure 2

US Gross Capital (Long-Term Security) Flows

This figure presents gross inflows to the US by foreigners and by US residents, considering only long-term securities (excluding bank flows). Gross inflows by US residents are calculated as the negative of gross outflows, which are gross purchases of foreign stocks and long-term bonds by foreigners from US residents minus gross sales. Gross inflows to the US by foreigners are calculated as gross purchases of long-term US Treasury and Federal Financing Bank bonds and notes, bonds of US government and federally sponsored agencies, and US corporate bonds and stocks minus gross sales. Data are presented in millions of US dollars for the period 1990 to 2009 on a monthly frequency and come from the US Treasury Department.



The end of global imbalances?

Perhaps. But:

- The limited availability of safe stores of value in emerging markets remains unchanged (Caballero et al 2009)
- The incentives for self-insurance have increased
 - Countries that amassed big war chests are doing better (so far) in the crisis – more room for maneuver.
 - This may encourage further future asset buildups
- Massive U.S. fiscal deficit from stimulus package likely to overwhelm the rise in private saving

But adjustment through dollar depreciation and rising U.S. rates looks likely in the medium term.

The end of global imbalances?

Policies to finish them off:

- Enhanced availability of insurance schemes to discourage self-insurance via reserve hoarding
- Impulse to EM financial market development to discourage investor flight to rich-country markets

Challenging objectives !

Rethinking prudential regulation

Deep shortcomings exposed by the crisis:

- excessive *micro* focus on risk management of the *individual* financial institution, with too little attention to *system-wide* risk
 - Spillovers imply that what's good for stability of the individual institution may be bad for system stability
- incentives to pro-cyclical risk-taking
- inadequate regulation of large, complex institutions

Focus has shifted to macro-prudential regulation

Rethinking prudential regulation

- Basel II does not offer much help
 - Not a ‘systemic’ perspective
 - Does not deter procyclicality (e.g., Repullo 2008)
 - Asset valuation issues: ratings agencies; internal models...
- Patch up Basel II, or skip to a ‘Basel III’?
 - various proposals to fix prudential regulation (Geneva report, Group of 30, Stern/NYU...)
- common focus on rules rather than discretion, addressing externalities / spillovers...

Rethinking prudential regulation

Many basic questions in need of solution

- How to measure institutions' 'systemic' risk
 - CoVaR = systemic analogous to VaR
 - 'Systemic capital requirement' (NYU/Stern)
- How to design cyclical adjustments to prudential requirements
 - Macro multiplier for Basel II requirements? (Group of 30)
 - Procyclical capital requirements (Spain); anti-cyclical LTVs, leverage limits...
 - How should the cycle be measured?
- How should assets be valued ?
- How to identify (and unwind!) large, complex institutions...

Rethinking prudential regulation

Can monetary policy do more for financial stability ?

- IT (and most other monetary regimes) focus only on goods price inflation
- Should they look at *asset* price inflation too – to ‘prick bubbles’ (or at least not fuel them)?

Cecchetti et al: Yes. ‘Flexible IT’ can do no worse than standard IT.

Bernanke, Gertler, Mishkin: No, react only to bubble consequences

- Timely identification of bubbles is hard
- Mis-timed response can be destabilizing
- Monetary transmission to asset prices -- e.g., real estate -- may be weak, or impact too many assets – bubbly and bubbleless

Bigger problem: political economy of discretionary tightening in the boom (also for macro-prudential!)

Additional credibility / transparency problem for EM ITs

Risk and regulation

Three “mistaken beliefs” about risk

1. The end of aggregate volatility
2. Markets can self-regulate
3. Large established firms can self-monitor

Danger that crisis (anti-market?) responses may go against fundamentals of long-term growth

Hard to disagree with this.

Risk and regulation

Changing nature of volatility

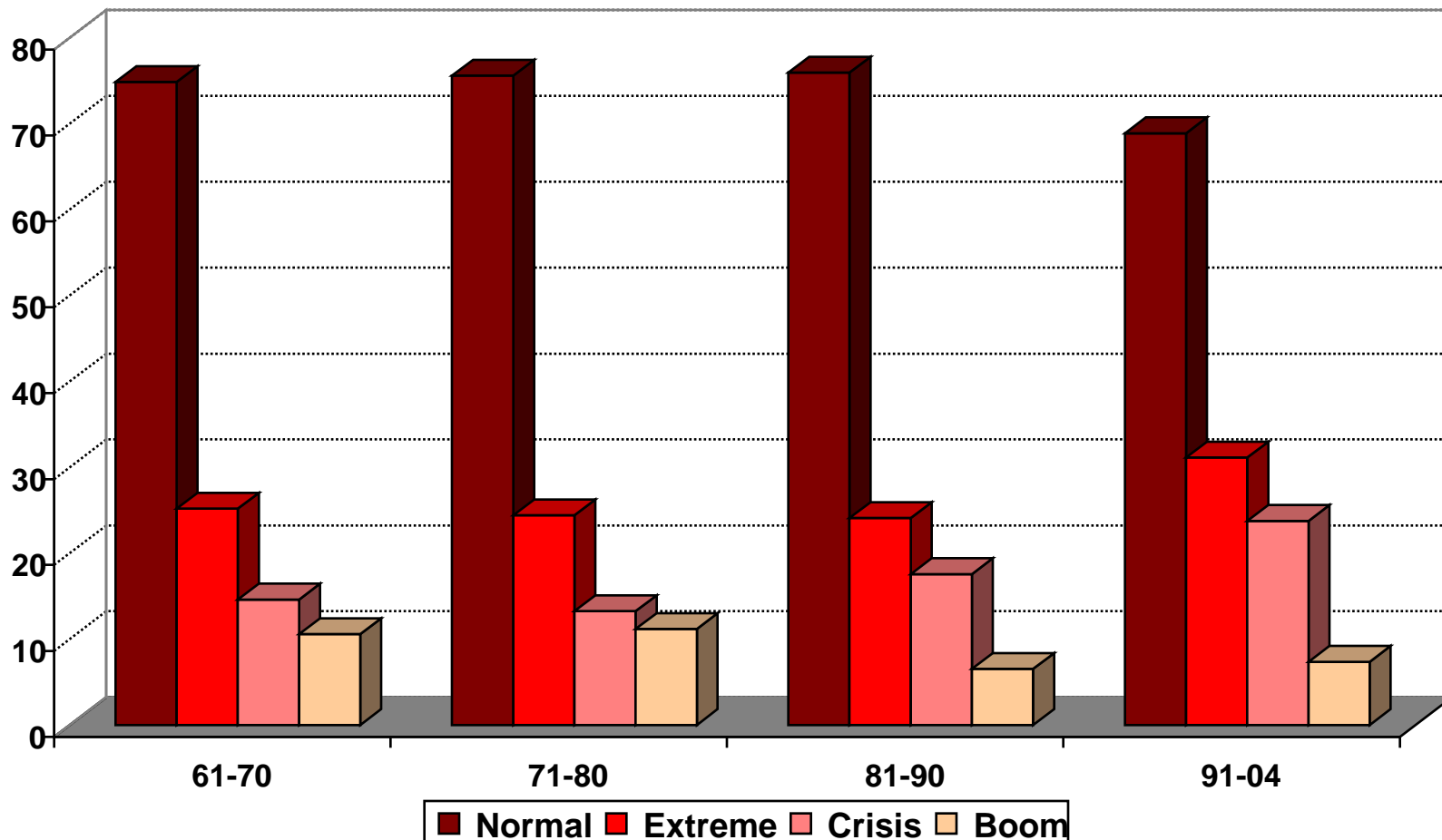
More integration / interconnection (across firms and countries) facilitates propagation of shocks.

Empirically, across countries common factors play an increasing role in real fluctuations, financial flows...

Aggregate volatility has declined in most countries, but extreme adverse events account for an increasing share of the total

“Normal” volatility is down, “extreme” volatility is not.

Figure II.2. Structure of GDP Growth Volatility
(percent, mean of 77 developing countries)



Sources: Hnatkovska and Loayza (2004); authors' calculations.

Notes: Total volatility = Normal + Extreme; Extreme = Crisis + Boom. Extreme shocks are defined as those exceeding two standard deviations of output growth over the respective decade.

Risk and regulation

Dual role of volatility

Some volatility can be good – ‘creative destruction’, reallocation, innovation...the Schumpeterian engine of growth.

Across countries, high volatility is negatively related to growth – but low volatility is not. If anything, it is *positively* related to growth.

Risk and regulation

Risk that crisis-containment measures may sacrifice long-term growth

Captured by statu-quo interest groups (financial, industrial...)

- Example: support to declining industries (GM?) deters reallocation and innovation.

Empirically, long-run productivity growth is higher in countries with more active firm dynamics (entry, reallocation, exit)

But doing nothing may be even worse – may lead to liquidation rather than reallocation, an “expectational trap” and anti-market backlash.

- The challenge is to design the crisis response with attention to long-run growth fundamentals.

Yes, but how exactly?

Risk and regulation

Similar dilemmas for developing countries

'Innocent bystanders' hit by collapsing world demand, remittances, and capital inflows

Cannot 'export their way out of the crisis' like in past EM crash episodes.

Risk of backlash against trade openness, financial integration, market economy, pro-growth reforms...

And less room for maneuver through stimulus packages (with exceptions; e.g., China)

Risk and regulation

One potential growth-friendly crisis measure for developing countries is raising infrastructure investment

Likely to have high medium-term growth payoff because of low infrastructure endowments in LDCs.

More future output also means more government revenues – so might be fiscally sound too.

But there are caveats too...

Fiscal stimulus with high debt and large risk premia can be counterproductive.

Lots of waste in the past, in the name of public investment

Why were those good infrastructure projects not taken up before?
Fiscal institutions? Political economy? Technical capacity?

Perhaps an opportunity for reform – ‘never let a good crisis go to waste’

End