Crisis Transmission to Emerging Markets: The Financial Challenge

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EM: Three Stages of the Crisis

- Resilience and “Decoupling”

- Full Contagion

- Recovery and “Re-decoupling” (?)

- Until the collapse of Lehman Bros. Emerging Markets seemed to have “graduated” into a new successful asset class.

- Strong fundamentals, macro stability, and strong terms of trade seem to have eliminated ***contagion*** with EMs decoupling from the world crisis.

- Substantial development of financial markets supported by rapidly increasing volume of Capital Inflows

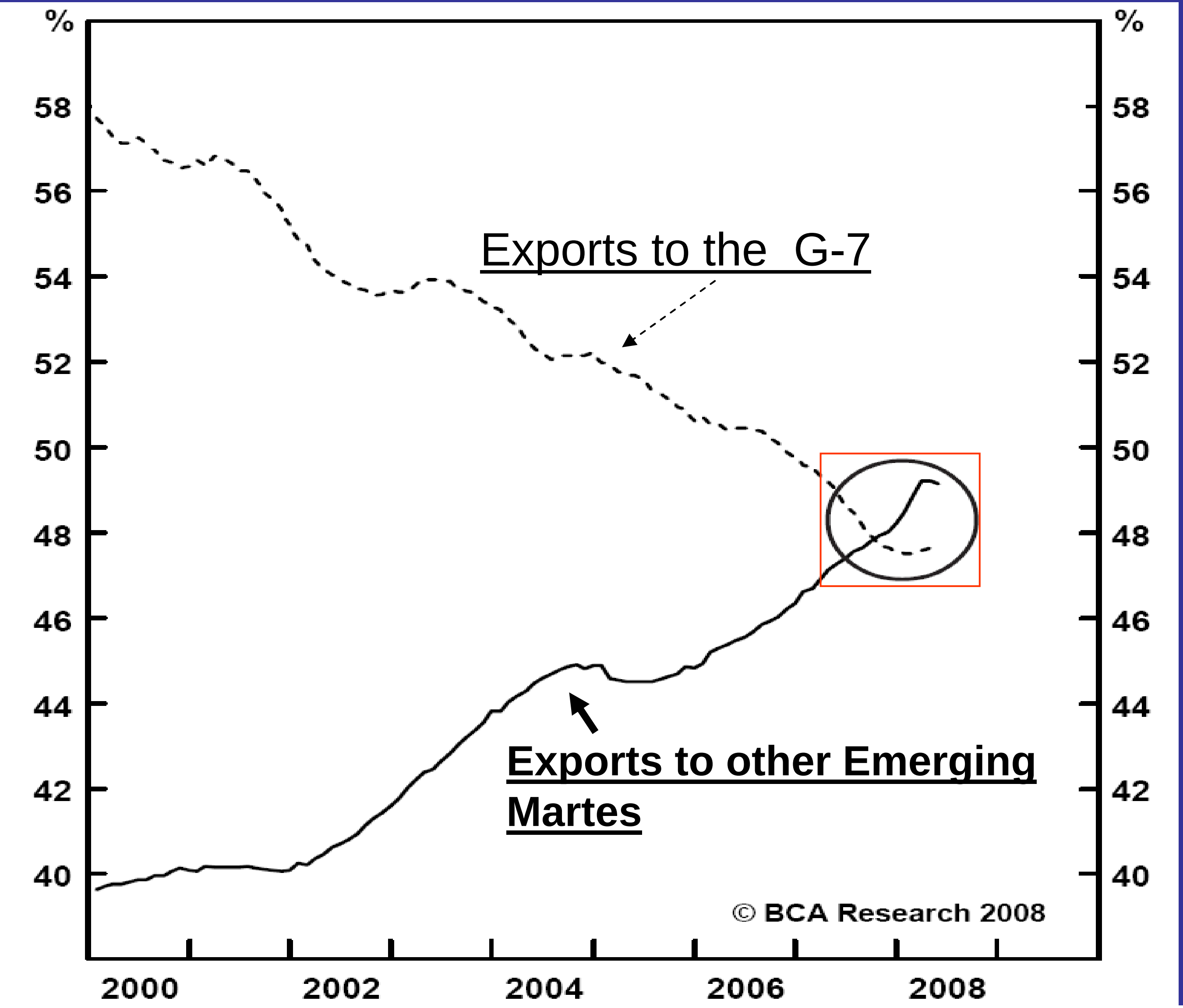
- Growing local currency markets seem to have eliminated the “original sin” problem.

- However, following the Lehman Bros. debacle, EM were strongly affected by the crisis in mature markets, demolishing the “decoupling” hypothesis.

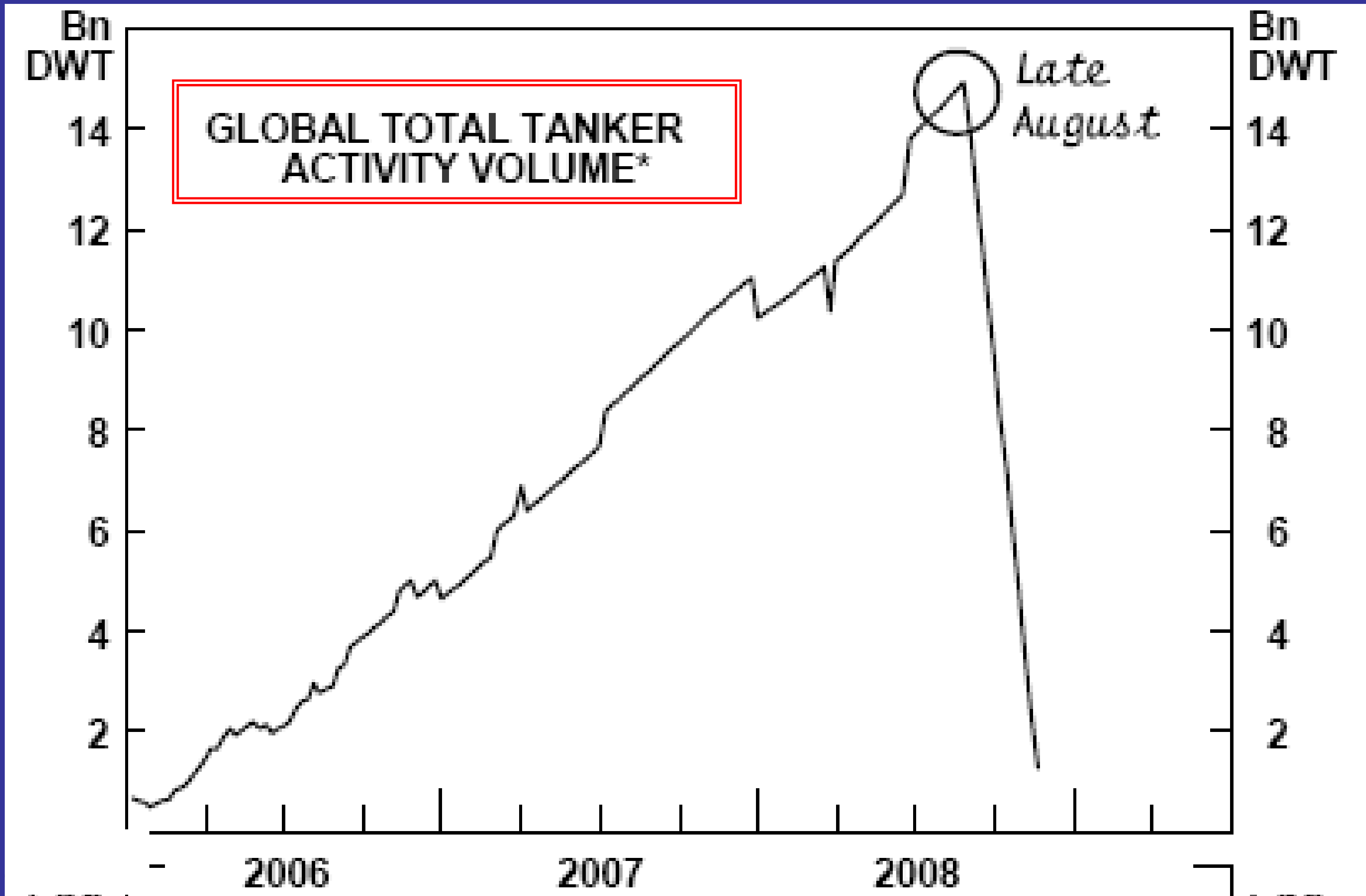
- Contagion worked trough three channels:
  - -- Commodity Prices
  - -- The Collapse of International Trade
  - -- Capital Market Reversals

EMs: Exports to the G-7

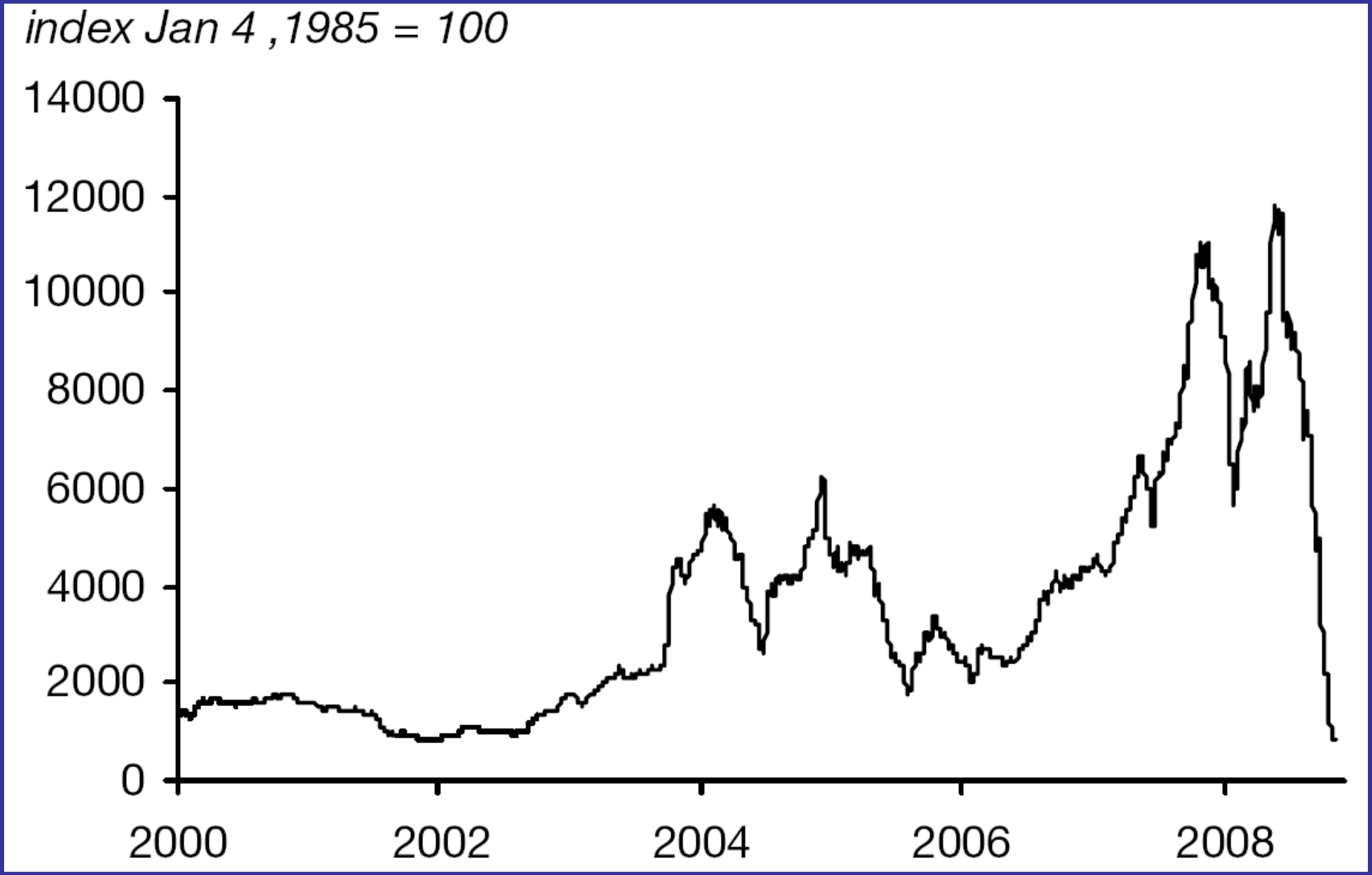
(as % of total exports)



The Collapse of International Trade



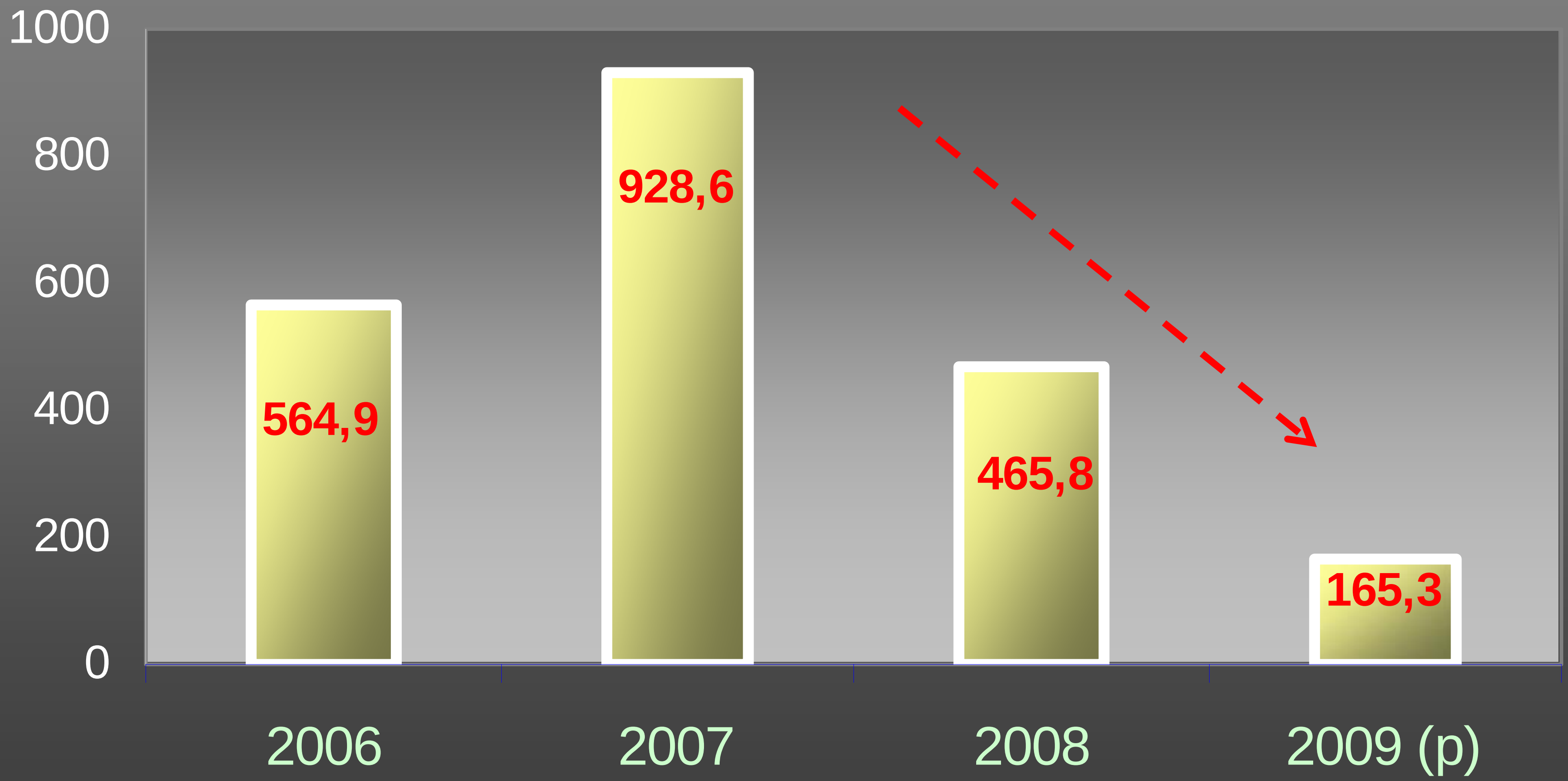
Baltic Dry Freight Index



Very rapid decline in Trade Financing leading to a Real Collapse in Trade Volumes

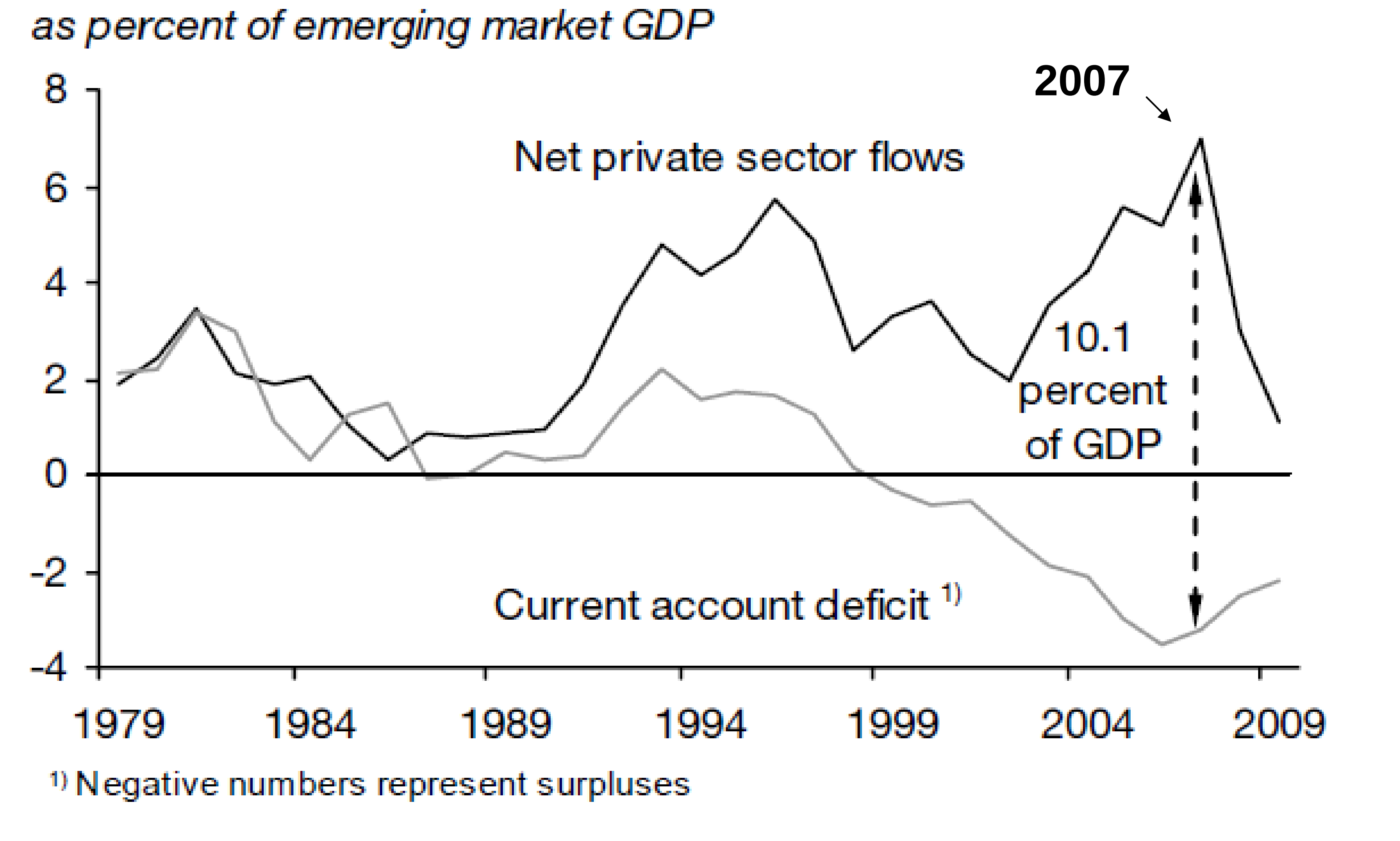
The Capital Flows Reversal and the Financing Problem

Private Capital Flows to Emerging Markets (in U$S bn)



Source: IIF

Net External Financing of Emerging Economies



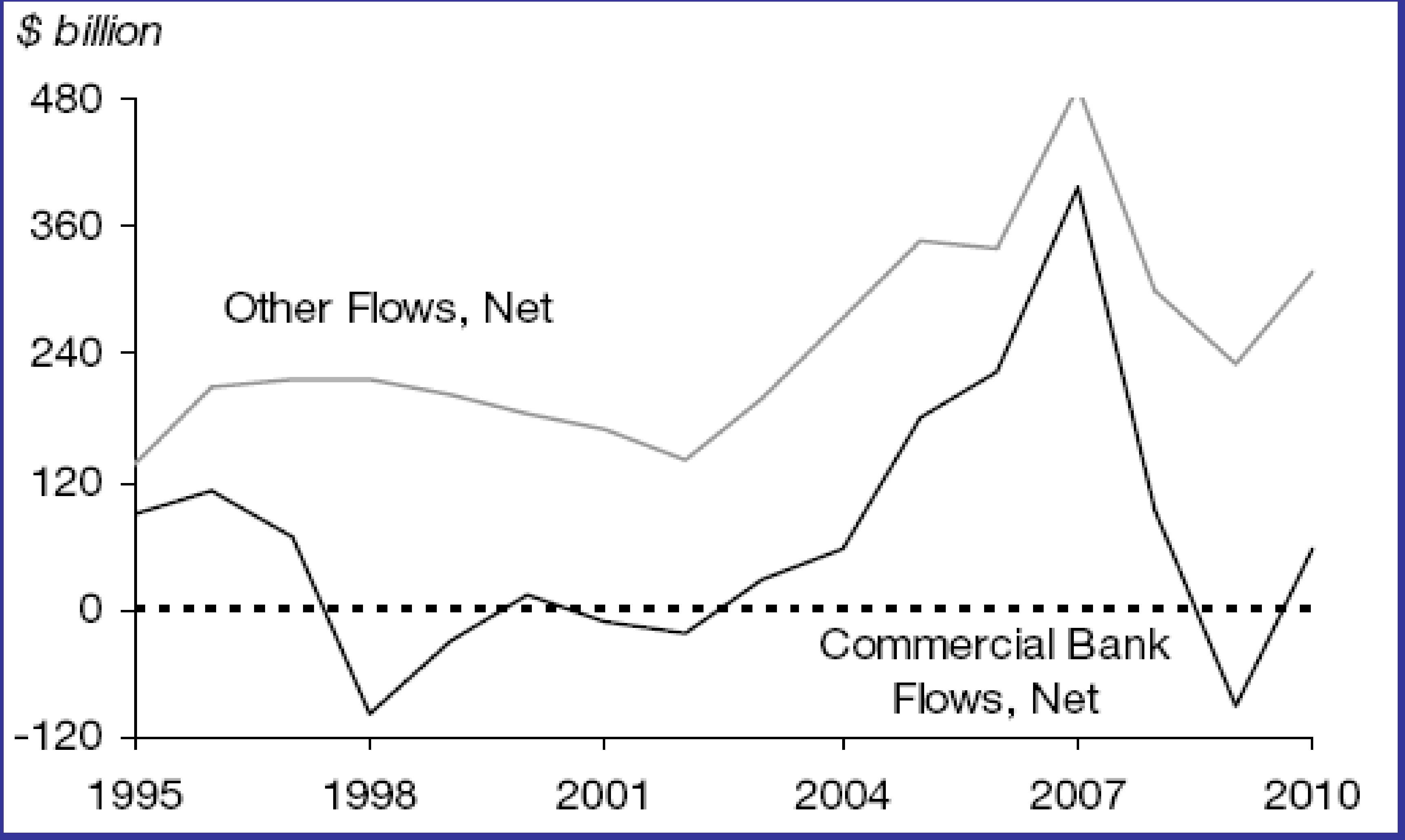
Source: IIF

Two Distinctive Characteristics

I. **Bank lending** ties, directly or trough home-host relationships, have emerged as one of the main channels of contagion. Banking flows to EM have taken a severe hit.

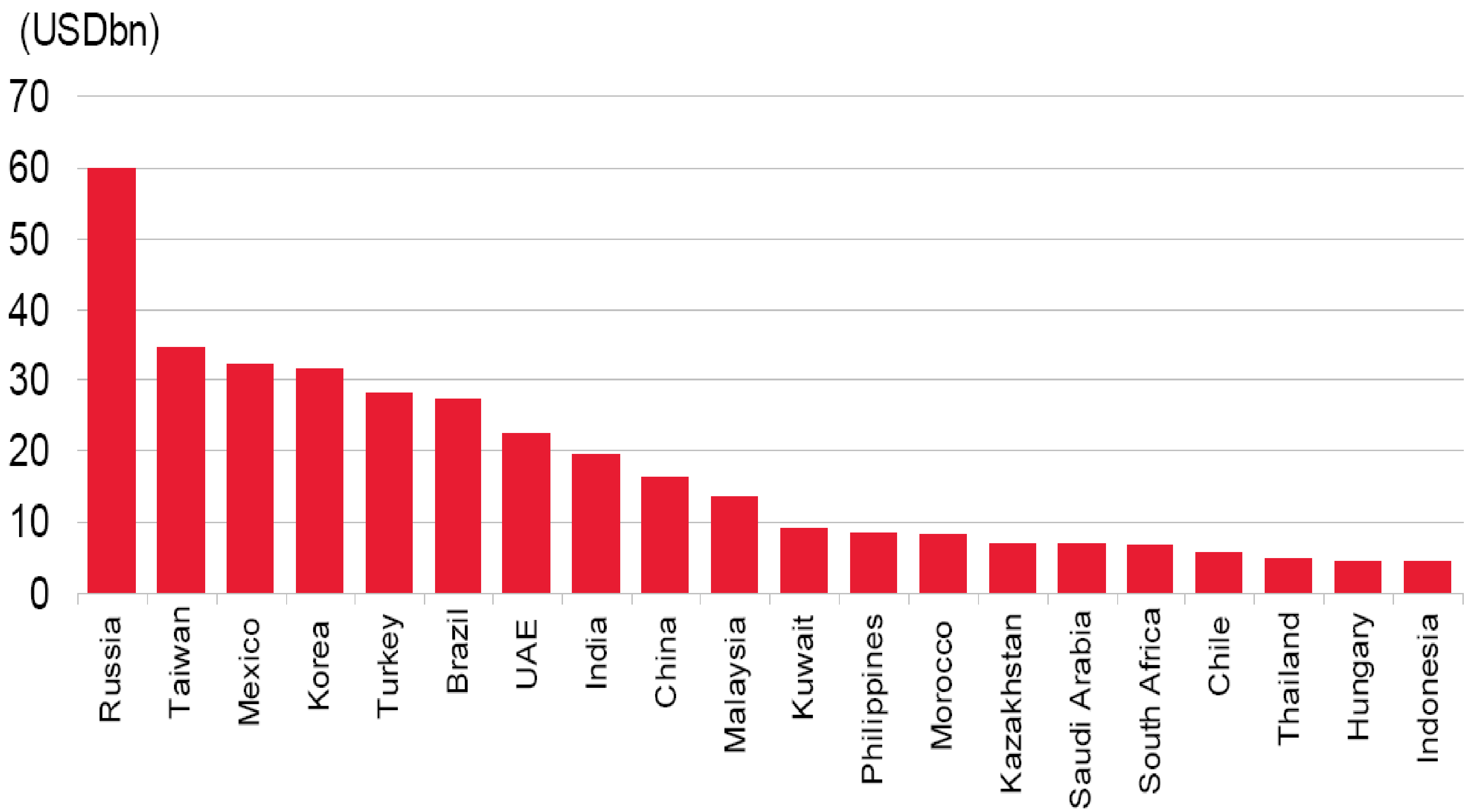
II. The drying up of capital flows is becoming a **private sector, corporate problem**, rather than the more traditional sovereign problem

Changes in the Composition of Net Capital Flows to Emerging Markets

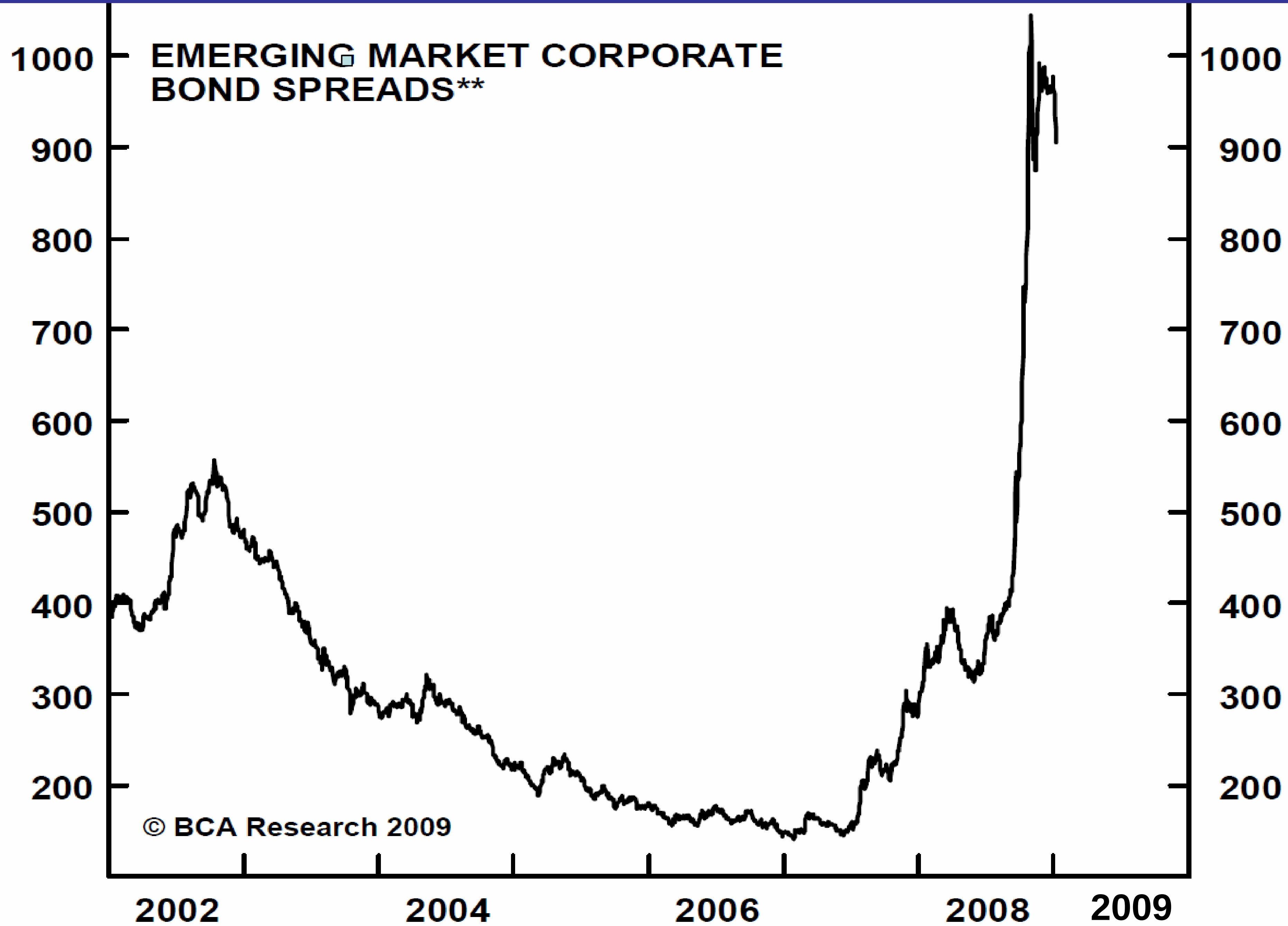


The Corporate Rollover Problem

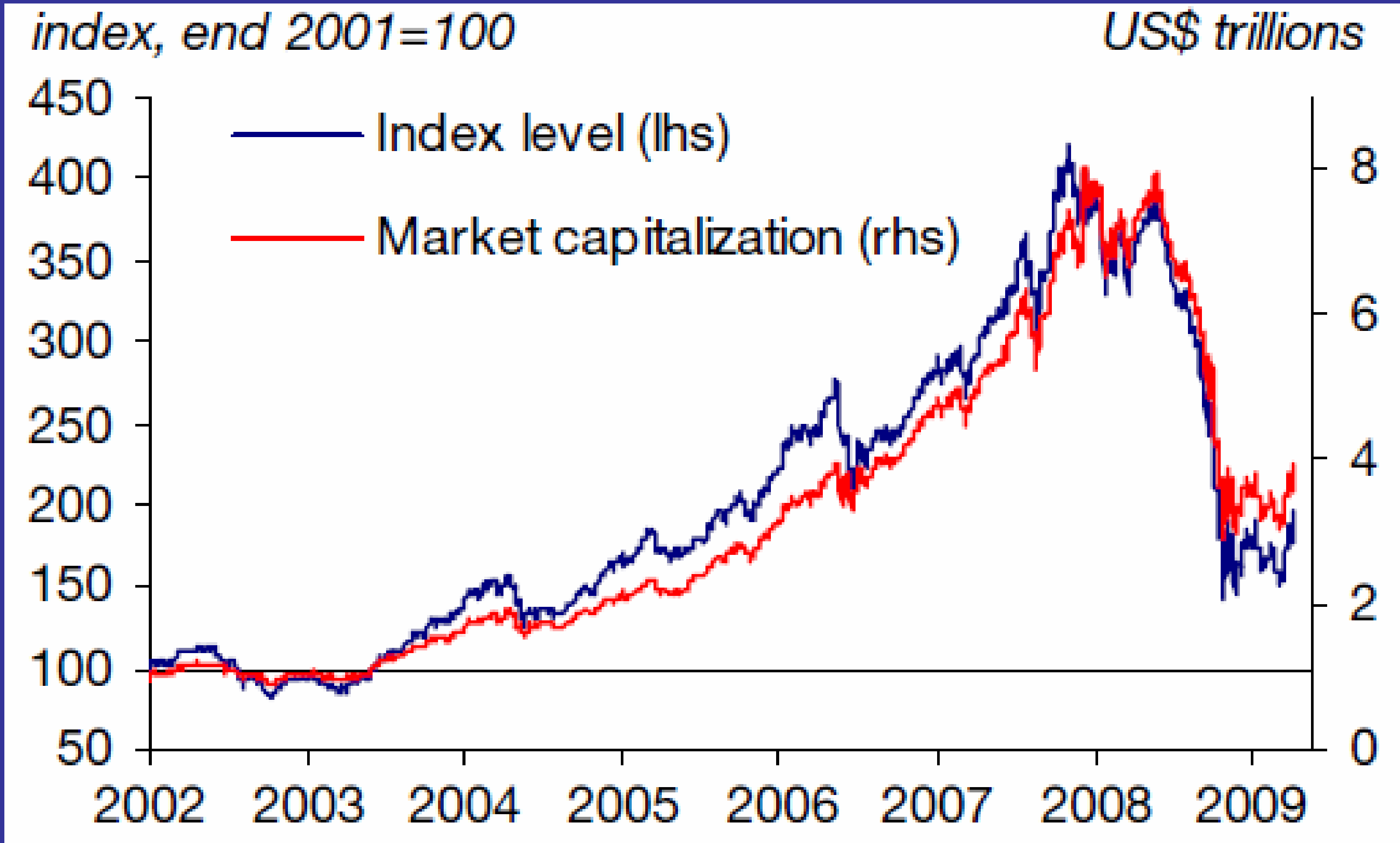
Corporate and Bank External Debt Maturing in 2009



Source: Dealogic, Bloomberg, Fitch Ratings


EMERGING MARKET CORPORATE
BOND SPREADS**
1000
900
800
700
600
500
400
300
200
© BCA Research 2009
2002
2004
2006
2008
2009

Performance of Emerging Equity Markets

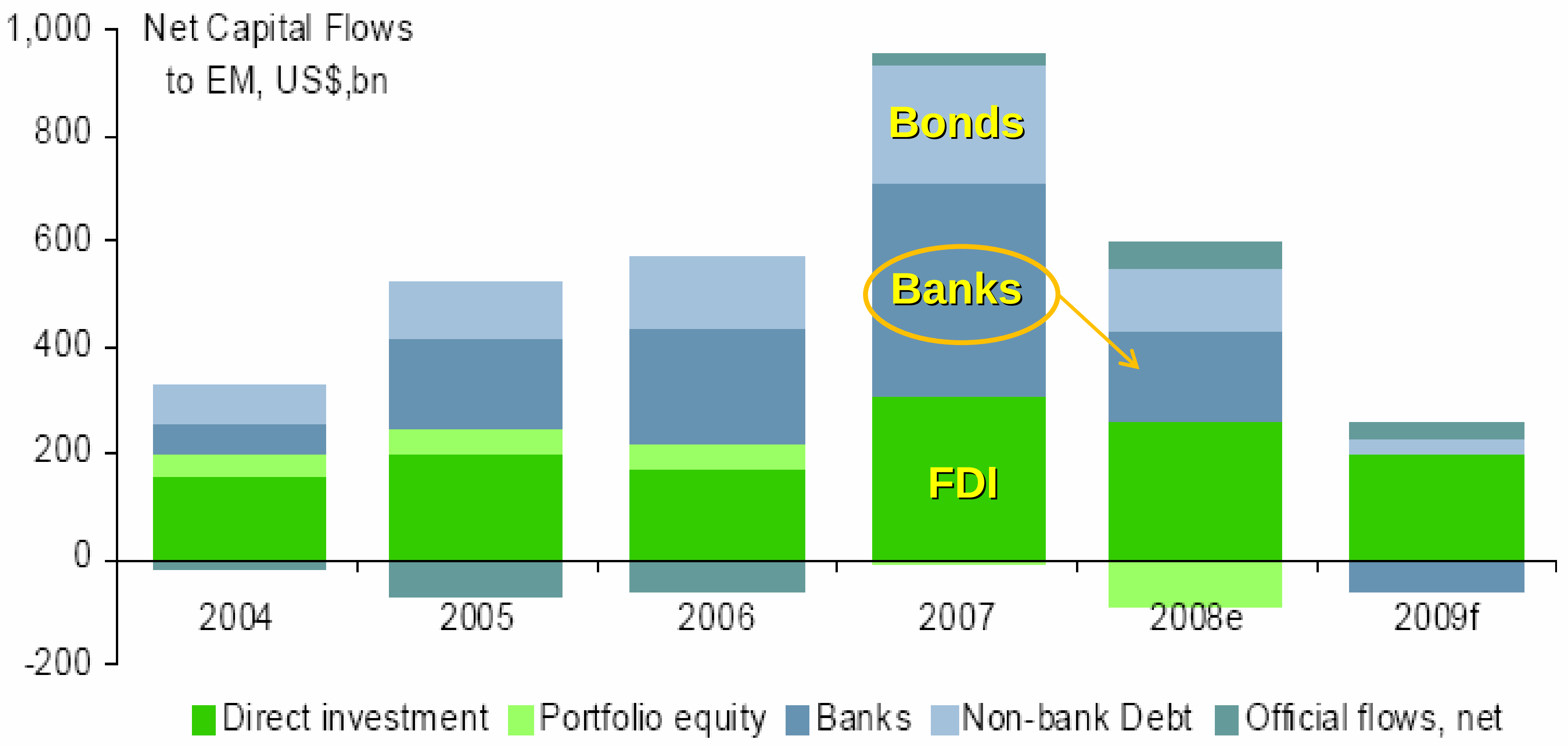


Source: IIF Capital Market Monitor

What are the main reasons for the credit contraction?

- Banking claims on emerging market economies initially held up quite well.

Emerging Markets: Capital Flows



Source: IIF

What are the main reasons for the credit contraction?

- Banking claims on emerging market economies initially held up quite well.

- The initial contraction in credit followed the shrinkage in the balance sheets of major international banks who are seeking to liquidate assets, in order to improve liquidity and reduce leverage ratios. It was caused by home country stress

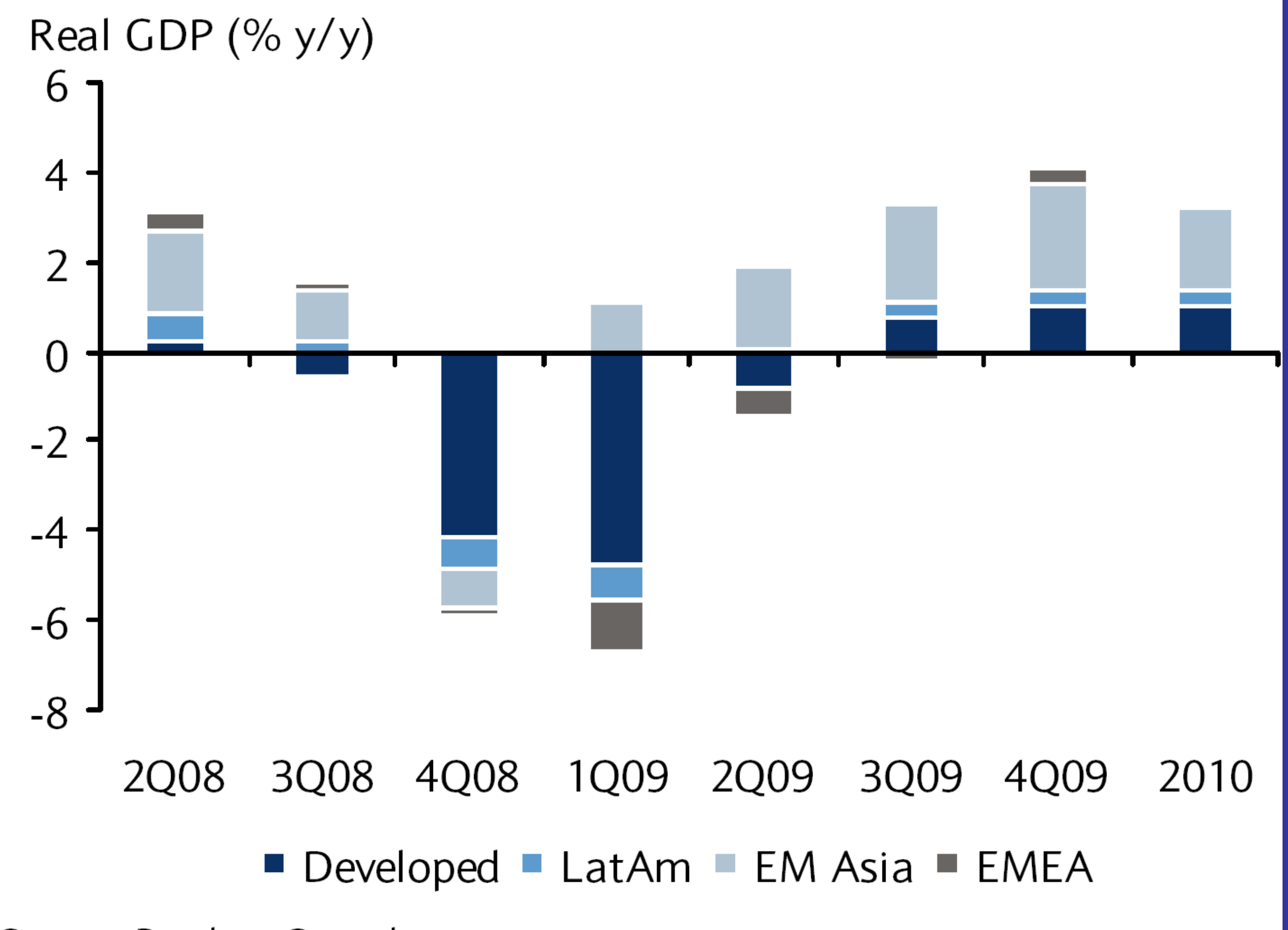
But a major reason is the increase in global risk aversion and the perception that Emerging Markets continue to be a higher risk class in the midst of the global crisis

Why this perception of higher risk returned regarding emerging market assets?

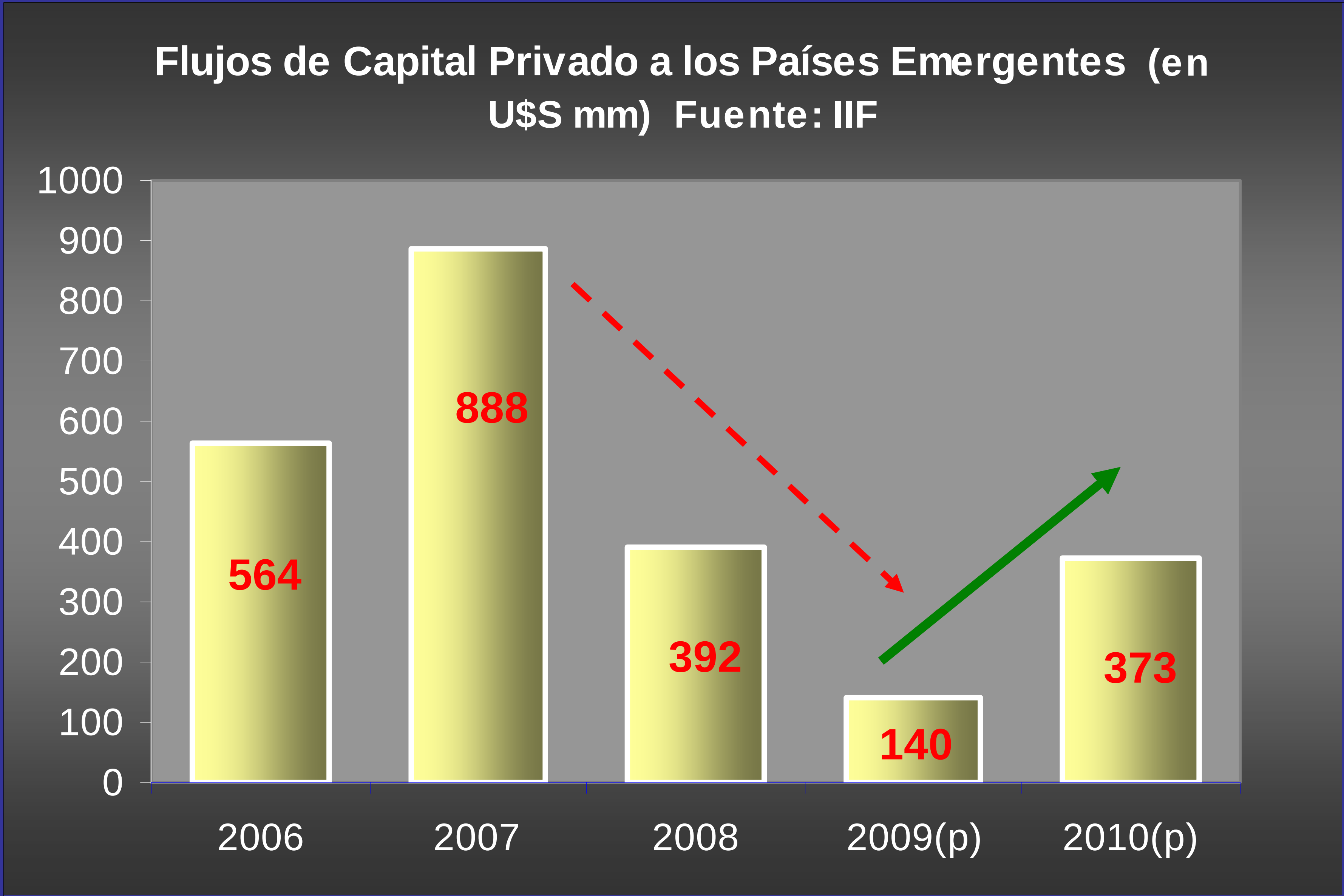
- Traditional Macro and Structural Factors
- Perception of inability of emerging countries to implement strong countercyclical policies (lack of fiscal space)
- Lack of financial resources for credible fiscal stimulus

Need to Reduce Risk and Risk Perception about Emerging Markets

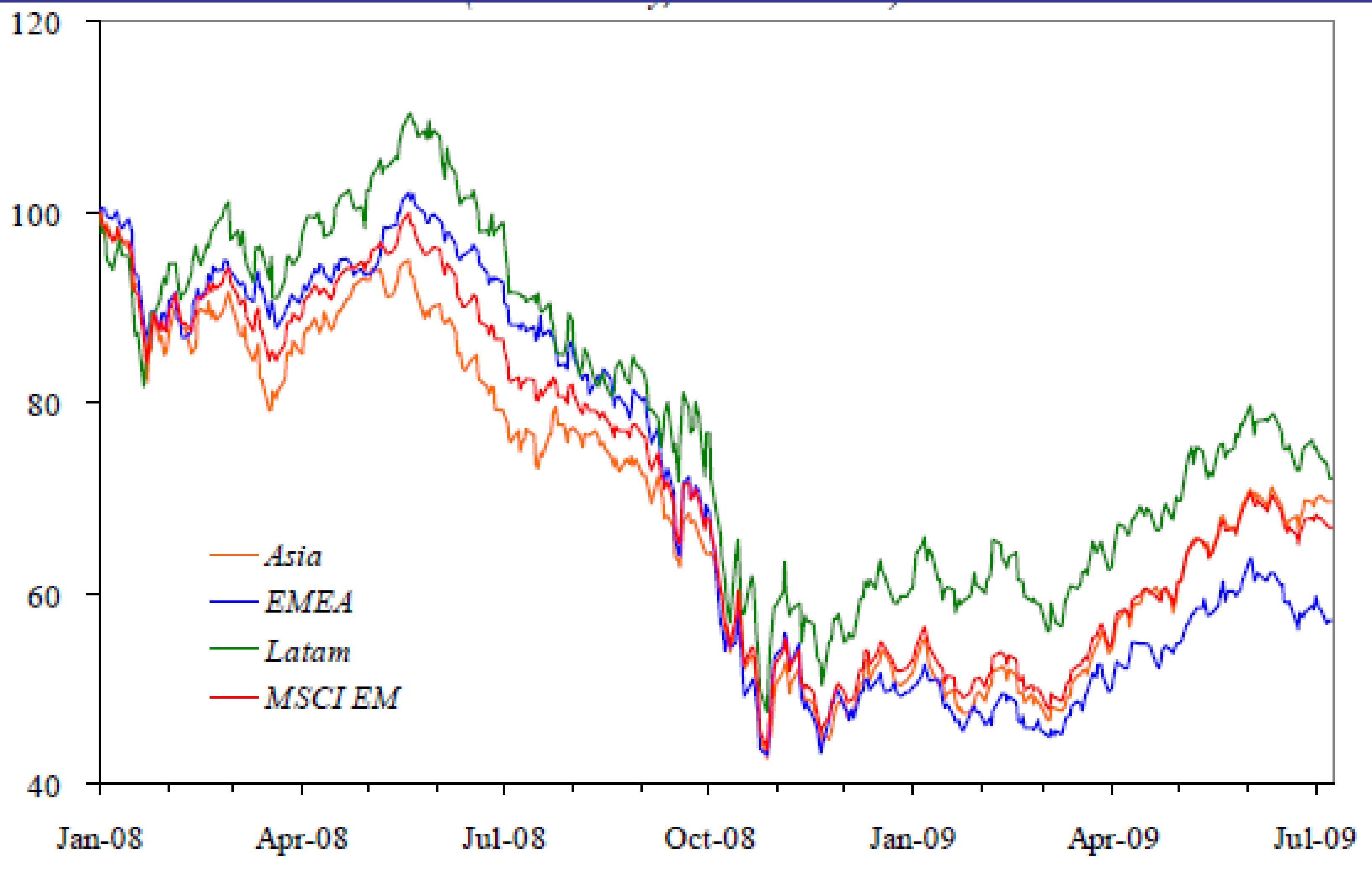
Contribuciones Relativas al Crecimiento del PBI Mundial



Source: Barclays Capital


Flujos de Capital Privado a los Países Emergentes (en U$S mm) Fuente: IIF
1000
900
800
700
600
500
400
300
200
100
0
564
888
392
140
373
2006
2007
2008
2009(p)
2010(p)

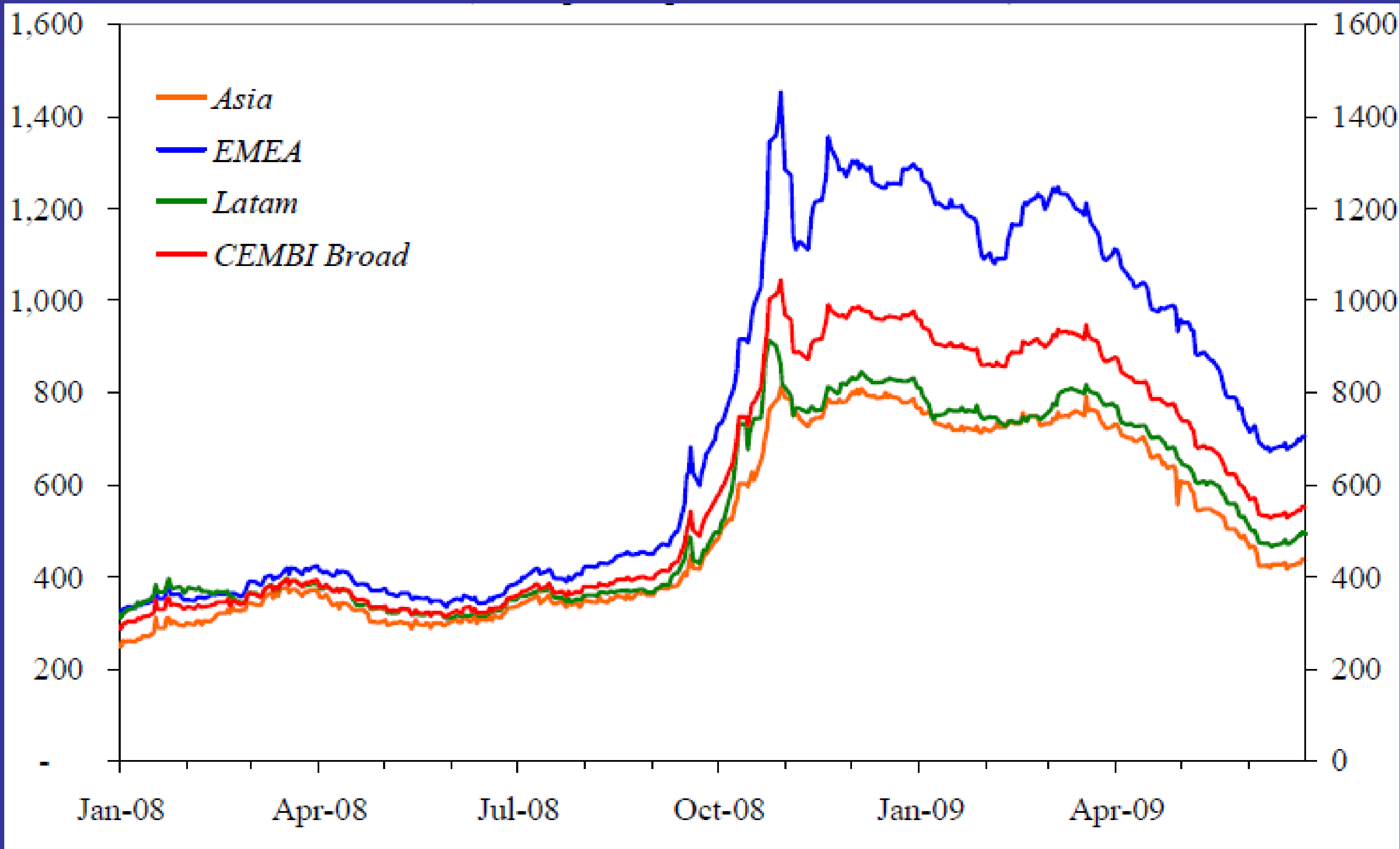
EM: Equity Markets
(in local currency)



Source: IMF

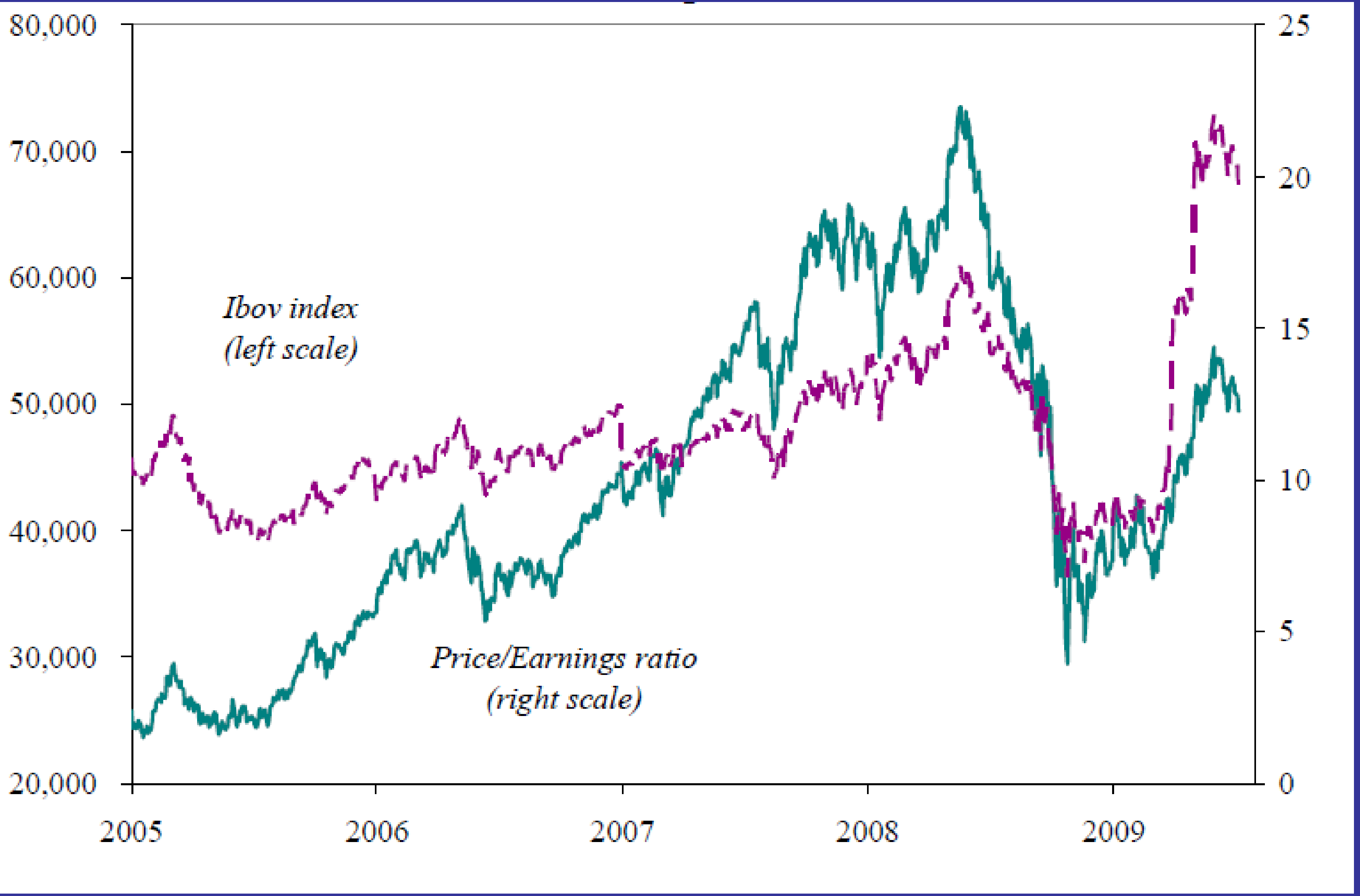
EM: Corporate Debt Spreads

(bps over Treasuries)



Source: IMF

Brazilian Equities

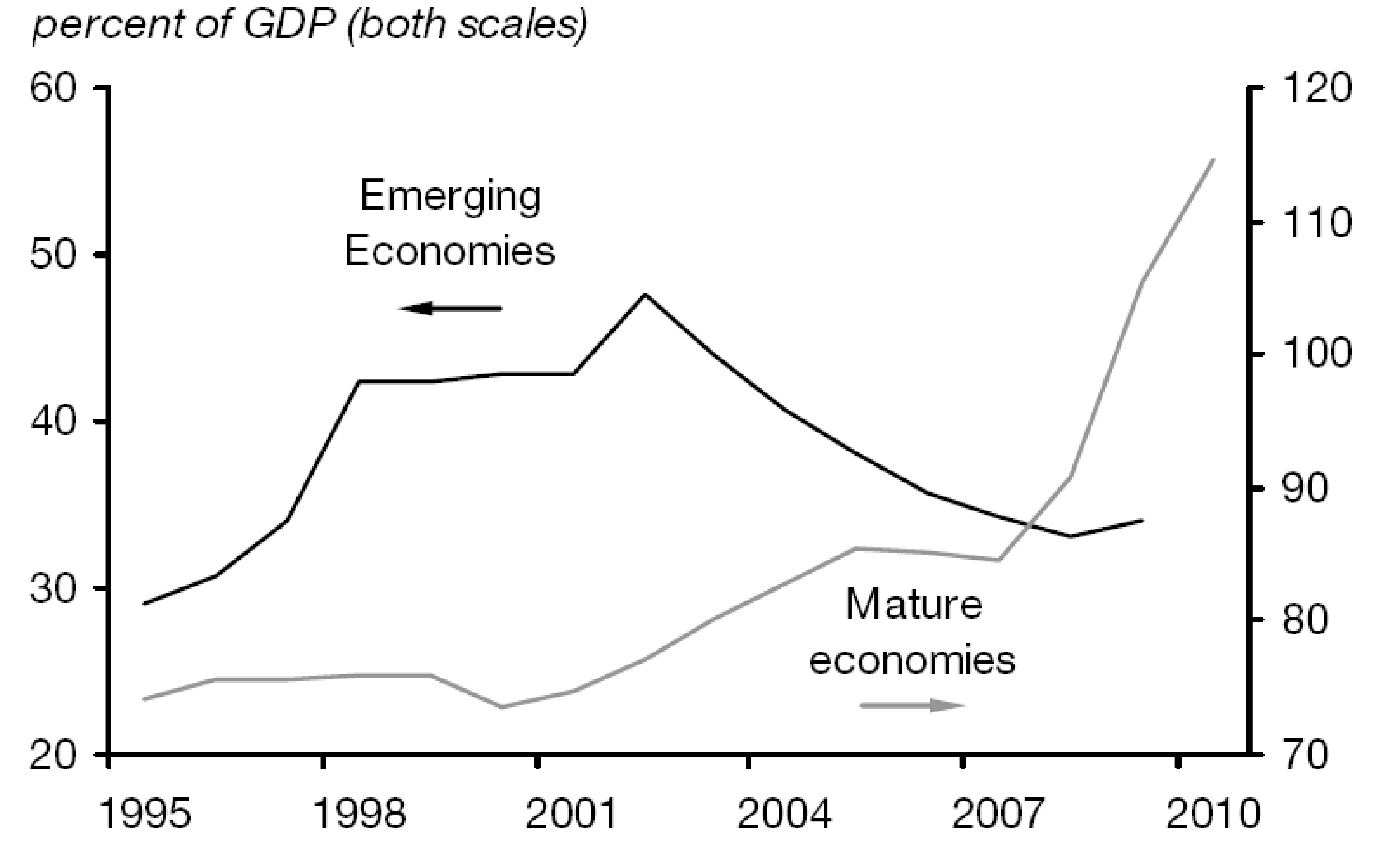


“Decoupling” after all?

Relative volatility: Between 1990-2006 EM average GDP growth volatility was almost twice that of mature economies. Over the past year, volatility in mature economies has reached the level of emerging markets.

Debt Burden: a much higher stock of public debt left to be serviced in advanced economies, compared with EMs.

GROSS PUBLIC DEBT



Source: IIF

Need to Reduce Risk and Risk Perception about Emerging Markets

- Need for Standing FX Liquidity Facilities. Require mechanisms to provide broad FX liquidity insurance

- Could be done domestically if there are sufficient accumulated international reserves

But Arrangements should be mostly international or regional

- Support Internationally Active Banks but Avoid Financial Protectionism in Bank’s Home Countries.

- Currency Swap Arrangements
  Currency swaps with Ems have been mainly with countries that have already high levels of reserves. The main function of the swap is to reduce the foreign-currency liquidity risk.

Role of the IFIs

- Enhanced IFIs resources and the new lending facilities (IMF's FCL) are very important risk mitigation instruments.

- IFIs (and particularly the Fund) should leverage their resources to reduce the private sector risk in maintaining their exposure to EMs trough the provision of Guaranties and facilitation of swaps.

THANK YOU