

## **Eighth KfW International Financial Sector Symposium**

Co- sponsored by the German Federal Ministry of Economic Cooperation and Development and FMO of the Netherlands

### **Session 1: Crisis Vulnerability and Access to Finance - The Macro-Perspective<sup>1</sup>**

Summary prepared by Michael Klein and Rainer Hartel

Session 1 was composed of the following experts:

#### Keynote Speaker:

**Michael Klein** Consultant, Former Chief Economist IFC

#### Panellists:

**Adalbert Winkler** Professor, Frankfurt School of Finance and Management

**Radovan Jelasic** Governor, National Bank of Serbia

**Shamshad Akthar** World Bank, Vice President, Middle East and North Africa, former Governor, State Bank of Pakistan

**Louis Kasekende** Chief Economist AfDB, Former Deputy Governor, State Bank of Uganda

**Jacob Dahl** McKinsey & Company

#### Moderation:

**Jürgen Zattler,** Division Chief, Federal Ministry for Economic Cooperation and Development

### **How are emerging market and low income countries affected by the crisis?**

**Take away 1 – Most developing countries have escaped the immediate impact of the global financial crisis while the drop in global demand adversely impacted on their real economies.**

With the exception of Eastern Europe, for example, Ukraine, Hungary, Latvia and a few other countries such as Kazakhstan and Nigeria, ***most of the developing world has so far not suffered from a financial crisis proper with a breakdown of markets and significant bank failures.*** Countries in Asia, the Middle East, and Africa fared relatively well.

***But neither have poorer countries escaped the fall-out from the crisis.*** Most importantly the crisis has pushed about 100 million more people into extreme poverty below the US\$ 1.25 per capita per day threshold and thus added a massive 10 percent to the ultra-poor. ***The main transmission mechanism worked through a drop in global demand and a consequent fall in exports from emerging market and low income countries.*** Demand for commodities and food are critical factors transmitting the crisis to poorer countries, for example, in the Middle East and Africa.<sup>2</sup> ***As banks in rich countries de-leverage, they may complicate access to finance for poorer countries as well. Yet, the effect of reduced demand appears vastly more important than the credit***

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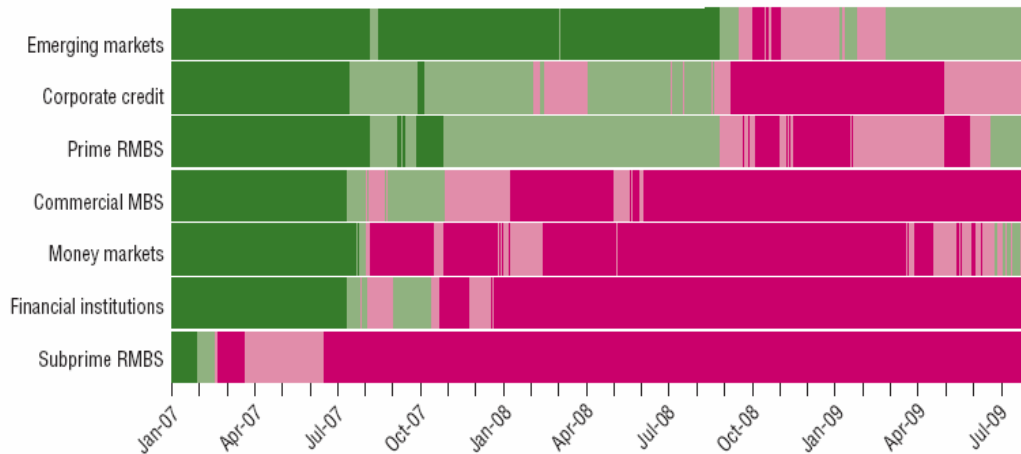
<sup>1</sup> For details see also keynote presentation of M.Klein and listen to his keynote speech.

<sup>2</sup> For further details on the Middle East and Africa see S. Akthar's and L. Kasekende's presentations. For details on India see R. Mallah's presentation (Session 4)

*crunch*. For example, the observed reduction in trade finance may well be 90 per cent due to demand reduction.

The IMF “Heat Map” illustrates that assets invested in emerging markets have been the most resilient over the past three years compared with other asset classes mostly originated in advanced countries except high quality government paper.

**Chart 1: Heat Map, Development in Systemic Asset Classes**



Source: IMF staff estimates.

Note: The heat map measures both the level and one-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2003–06 (i.e., wider spreads, lower prices and total returns, and higher volatility). That deviation is expressed in terms of standard deviations. Dark green signifies a standard deviation under 1, light green signifies 1 to 4 standard deviations, light magenta signifies 4 to 7 standard deviations, and dark magenta signifies greater than 7 standard deviations. MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

### What makes for resilience in developing countries and their ability to recover?

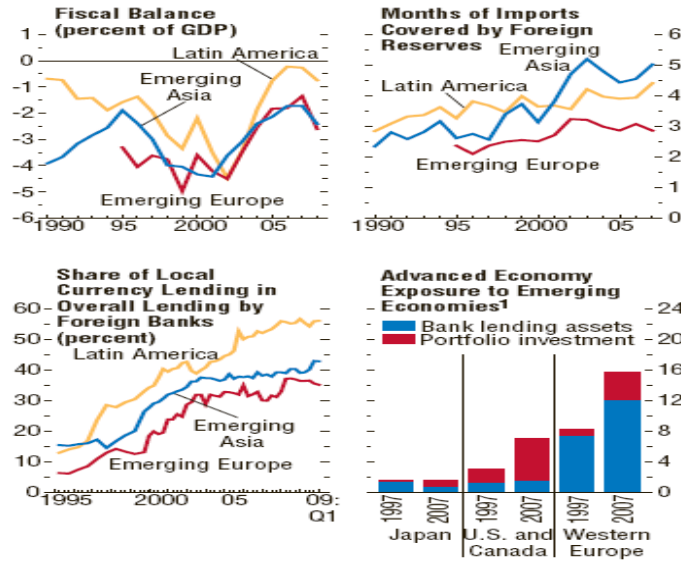
**Take Away 2: The crisis has reaffirmed the value of macro-economic prudence. The relative initial strength of developing countries going into the crisis enabled them to respond without excessive hardships, for example through fiscal stimulus and liquidity provision.**

During the last decade, poorer countries had improved fiscal and foreign reserve positions, increased the share of local currency-denominated credit and the share of foreign bank assets in local financial systems, not least in Eastern Europe and Africa. In particular China and India (India see Mr. Mallah’s presentation) fared relatively well.

Contrary to initial fears **foreign banks in Eastern Europe have turned out to be a source of strength**, helped along, for example, by the Vienna Initiative that is supported by a number of DFIs. The following Chart illustrates that BIS reporting international banks have increased their net claims both in foreign and domestic currencies through the crisis and thus contributed to market stability, whereas BIS reporting banks reduced their net positions in Latin America and Emerging Asia during the same period. During the crisis syndicated loans to emerging markets dropped massively on a global scale. However this negative impact was partly offset through the issuance of new bonds.

Chart 2:

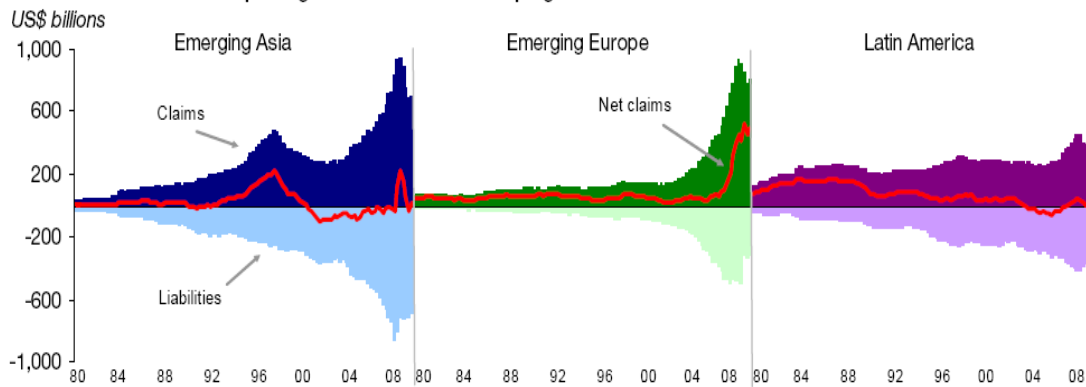
**Emerging Economies: Factors Affecting Resilience**



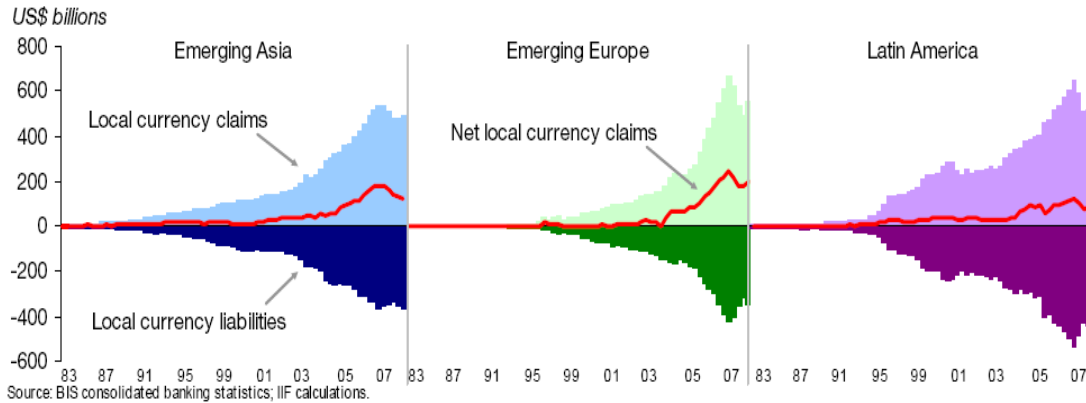
Sources: Bank for International Settlements; IMF, Coordinated Portfolio Investment Survey; and IMF staff calculations.  
<sup>1</sup>Assets in percent of advanced economies' GDP.

Chart 3 +4

**External Position of BIS-reporting Banks vis-à-vis Developing Countries\***



**Local Currency Position of BIS-reporting Banks' Foreign Offices vis-à-vis Local Residents**

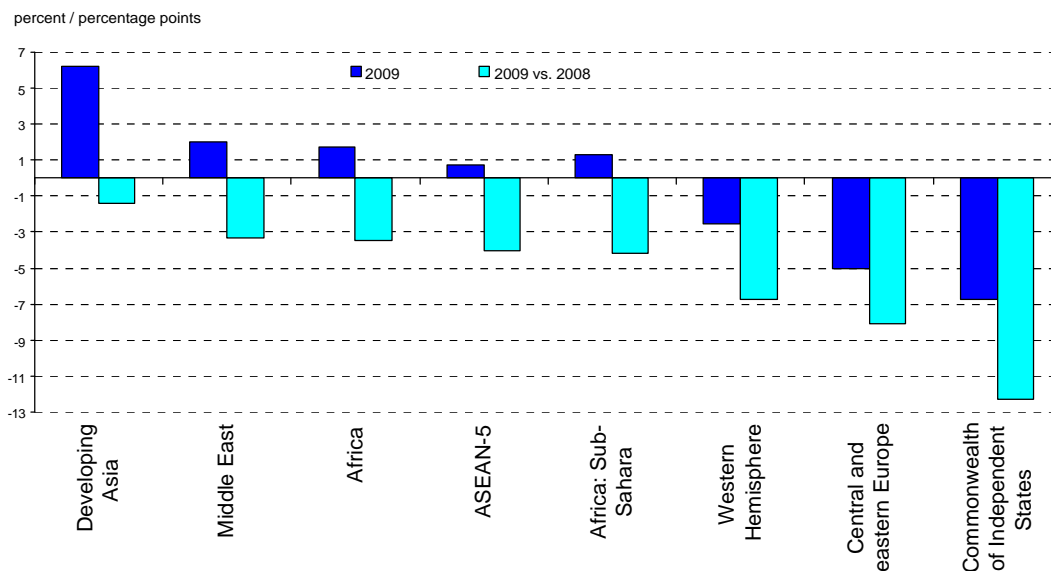


**Emerging markets also provide some of the best examples of prudent monetary and regulatory policy leaning against excessive credit growth and thereby reducing the built-up of unsustainable bubbles.** Central banks in countries as diverse as Colombia, Croatia, India and Serbia<sup>3</sup> resisted intense political pressures for politically popular credit growth. In retrospect they became national heroes. However being perceived as a hero may require that other countries get into trouble to visualize the alternative outcome under different policies.

**The relative initial strength of developing countries going into the crisis enabled them to respond without excessive hardships, for example through fiscal stimulus and liquidity provision.** Few developing countries experienced hardships of past emerging market crises where a combination of fiscal and balance of payments problems posed severe dilemmas. Such tough choices are currently limited to relatively few countries, notably the Baltic economies.

Chart 5:

2009 GDP growth and change in GDP growth compared to 2008



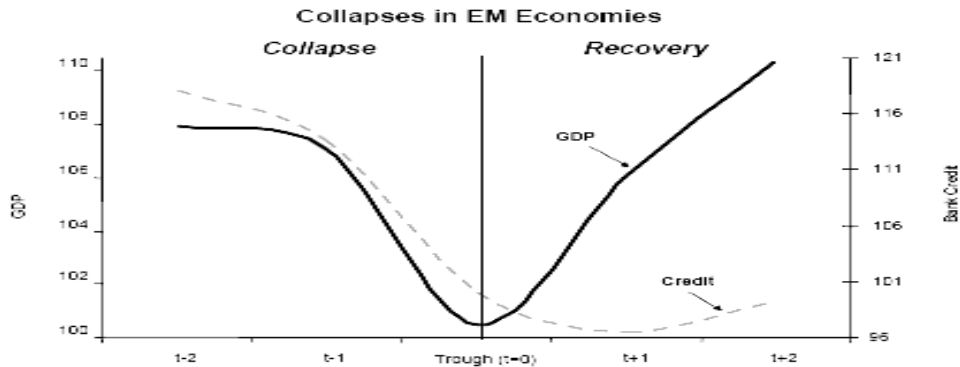
**Take Away 3: Recovery of demand leads economic recovery and domestic demand appears to be the key driver.**

**Recovery prospects of all countries depend heavily on recovery of demand and, initially, less on credit growth.** Experience from past large crises suggests that during the crisis output and credit collapse together. Then output recovers first, while credit languishes until emergence of new investment opportunities stimulates new credit growth. **Domestic demand played a bigger role in the recovery from the Asian crisis than foreign demand.** If this pattern prevails in this crisis, emerging markets are unlikely to be held back substantially by credit restrictions and slow recovery of demand in advanced countries.

<sup>3</sup> For details on Serbia see R. Jelasic's presentation on session 1 and his paper

Chart 6:

### Bank Credit Dynamics (deflated by CPI, average 3S episode)



Source: G. Calvo, 2006

#### Should attitudes to financial sector reform and liberalization change?

**Available evidence suggests that finance supports growth by enhancing productivity and not by raising saving.** Also finance tends to be pro-poor as greater access to finance gives talented poorer people a chance to succeed even when they are not well connected. However these basic insights about the potential contribution of financial development to poverty reduction require us to establish whether indeed financial institutions help improve the allocation and management of resources and whether indeed financial access reaches more people that are currently underserved.

**Take Away 4: As a source of growth and instability integration into global financial markets is a double-edged sword.** <sup>4</sup>

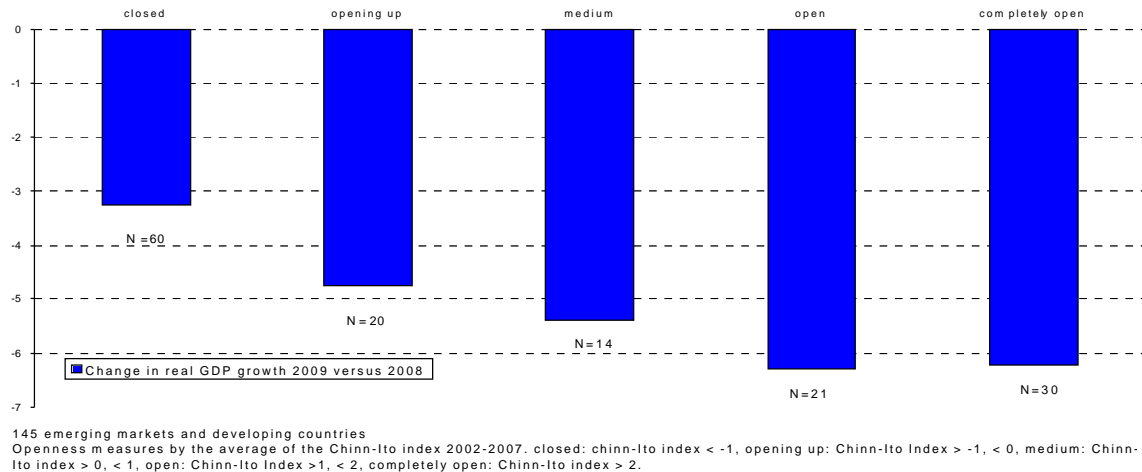
Integration into the global economy allows countries to adopt and adapt new technology and better ways of conducting the business of firms and governments. The result is faster growth and poverty reduction. Yet, the crisis demonstrates that integration into global financial markets also exposes countries to pressures that are sometimes hard to manage and periodically to severe shocks. The basic lesson – sometimes forgotten – remains that financial deregulation and liberalization needs to be complemented by appropriate monetary policy and regulation. Expect also more liberal use of capital controls trying to stem excessive flows.

Essential for attention of policy-makers and financiers is due regard for the quality of decisions and skepticism against pure volume of funding as a measure of success.

<sup>4</sup> See presentation of A. Winkler for this session.

Chart 7:

Financial openness leading to bust?



### What type of global structural shifts may result from the crisis?

**Take away 5: The global recovery is likely to be slow since the US will not be able to absorb the current account deficits as in the past. Fast growing emerging markets and classical high saving countries may only gradually take over the role played by the US in the past.<sup>5</sup>**

The current crisis that originated in the United States has raised the fundamental question as to whether the export-led growth model will resume and which regions will account for the consumption. Over the last 10 years US household liabilities have risen by a massive 24% above the 30 year historical trend to nearly 130% of their disposable income in 2008. This is clearly not sustainable since US households need to reduce their accumulated debt and thus reduce consumption. Global demand has been supported in the short term by fiscal stimulus, but basic fiscal prudence may limit reliance on this mechanism. Ideally, consumption growth should originate from classical high savings countries as China, Germany and Japan. Also the rising number of people with significant per capita income - McKinsey currently estimates 1.5 billion people earning more than USD 5000 per year – will provide opportunities to other countries including the emerging markets. Whether and when such shifts can be achieved remains unclear. For example, the need for old age provision is may continue to drive more conservative savings patterns at least in China and uncertainties associated with the crisis are unlikely to boost consumption. Production patterns also need to adjust to the needs of consumers located in poorer countries which differ from those in today's rich countries.

**Take away 6: Despite the current G20 coordination success, global harmonization of policies appears a very challenging process and national governments and regulators are expected to explore individual approaches.**

Financial markets will be heavily affected by regulation. Yet, the advocated strengthening of macro prudential surveillance appears hard to manage on a global scale in a fully co-ordinated manner. Revamping the Basel Capital adequacy regime for

<sup>5</sup> See presentation of J.Dahl (Mc Kinsey & Company) for this session.

banks to deal with incentives for pro-cyclicality and the previous low cost of capital for large sophisticated banks remains a challenge. The current crisis has highlighted that financial institutions may not only be too big to fail but also too big to be saved. In their response to the crisis national governments' plan are subject to vested interests that may undermine a cost-effective management of the crisis. The political economy thus further limits the available policy options. As there is no simple regulatory blueprint there may well be national experimentation and somewhat different development patterns across countries.

**Take away 7: Countries based on domestic capital formation grow faster.**

As first described by Nobel Laureate Lucas increasing volumes of finance are flowing from poor to rich countries. Yet, major investment opportunities exist in poorer countries. It turns out that the fast growing high-investment countries also have increased saving rates and thus do not need to rely on foreign capital. In recent decades, countries with high investment levels and low current account deficits grew faster than those who rely on foreign borrowings to fund their growth. However foreign direct investment supported the fast growing countries. This suggests that cross-border money transfers as such are not the issue. What matters appears to be the channels by which best practice (technology, management practice) is transmitted to poor countries enabling them to grow faster.

**Take away 8: Emerging market economies will continue to outpace advanced countries, who's fiscal and monetary positions have been weakened by the crisis.**

The fiscal and monetary stimulus and banking sector rescue packages in advanced countries have severely affected fiscal sustainability. As a result the advanced countries may languish while emerging markets may further increase their weight in the global economy. Liquidity provision by big central banks has led to a new "carry-trade" where, for example, cheap dollars are invested in high interest rate currencies as in Brazil. This may well complicate global co-ordination of exchange rate policies and lead to further capital controls on inflows.

**What are the implications for Development Finance Institutions?**

**Take away 9: The expansion of DFI commitments is putting a price on the quality.**

To mitigate the shock of the collapse in market funding to developing countries DFIs' financial commitments have exploded. Since some funding is politically motivated sound underwriting practices need to be preserved and the quality of funding requires greater scrutiny.<sup>6</sup>

Demand reduction should not be interpreted as reflecting a lack of credit supply. As economies recover opportunities for restructuring and reshaping growth patterns are likely to emerge. The crisis accentuates the relative plight of market segments that are hard to serve, like SMEs.

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<sup>6</sup> Session 5 discussed DFI response on the crisis and qualitative aspects in detail.