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A new financial crisis in emerging markets

Ahead of next week's prominent meetings between IMF & World Bank policy-steering bodies, it seems important to stress that global markets once again appear to be hurtling towards a new financial crisis. Fueled by loose domestic monetary policies and unimpressed by low yields at home, massive flows of hot money are increasingly leaving advanced economies towards rapidly-growing, capital-hungry emerging markets - and gradually shifting towards higher and higher levels of risk as they do so. In light of these trends, we must draw lessons from the similar experiences of past financial crises. We cannot afford to blindly trust markets. We cannot ignore the great risks that large and volatile capital flows can create for financial and economic stability, especially in developing countries. In the wise words of economists Carmen Reinhart and Kenneth Rogoff, we cannot be so foolish as to simply hope that *this time it's different*.

Following the devastating impacts of the global financial crisis in 2008-2009 (already the result of massive global imbalances in capital markets), developing countries rapidly returned to robust growth rates while developed economies have struggled to recover. Still in 2013, the International Monetary Fund (IMF) expects advanced economies will grow by only 1.4% - compared to projected 5.5% growth in emerging and developing economies, led by 7.1% growth in developing Asia.

Throughout this slow recovery, governments in advanced economies (particularly the United States, the Euro area, Britain, Japan) with limited room for fiscal policy have relied heavily on expansionary monetary policies to stimulate their domestic economies. In addition to near-zero interest rates, central banks have also undertaken successive rounds of *quantitative easing* - the introduction of new liquidity into markets in order to further boost the money supply, despite already low nominal interest rates.

However, despite record performances in equities and improving real estate markets, stimulative monetary policies have mostly failed to generate enough domestic investment in production. The hoped-for growth in the real economy has largely not materialized. Instead, as authorities keep injecting cheap money into domestic markets, corporations and private investment vehicles are increasingly turning abroad in their search for profits, largely towards high-growth emerging economies. This pattern was evident just this month in Japan, when a new round of domestic quantitative easing was immediately followed by an outflow of money and a spike in demand emerging markets assets. After gradually rising in recent years, the flow of funds into emerging markets has accelerated through the second half of 2012 and is reaching record levels in early 2013.

One main risk is for a vicious cycle to set in via self-reinforcing feed-back mechanisms. As demand remains high for bonds, it will continue to push down borrowing costs, which risks causing asset mispricing in recipient countries. The opportunity to borrow for cheap in turn creates an incentive for further debt issuance, and therefore may induce excessive leveraging or facilitate the financing of poor investments. Moreover, as rising demand continues to drive down yields on more secure emerging market bonds, investors are increasingly channeling money into junk bonds or into weaker emerging economies, as their desire for more attractive returns pushes them to accept higher and higher levels of risk.

As witnessed countless times in the past, emerging country financial markets and regulatory systems may not be ready to cope with these massive hot flows of capital, which come with inflationary pressures and high risks of asset bubbles. A change in policies or market sentiments (loss of confidence) could cause an abrupt reversal of these capital flows, which has a proven capacity to cause dramatic economic and financial losses in both emerging and developed countries.

In order to avoid a new crisis, there must be a concerted international effort to address the many underlying factors driving current trends:

- Developing country governments must resist the temptation of rapid short-term growth and instead build up their resistance to the pressures of liberalized global financial markets. As such local authorities must adopt the necessary macroprudential policies and reinforce their internal regulatory frameworks – this should include temporary capital controls to stem the influx of foreign funds, conducting stress tests, and closer oversight and controls over domestic capital reserves and debt markets.
- Leading international finance institutions (IFIs) cannot wait passively to step in as lenders of last resort once a crisis has already hit. Globalized financial markets absolutely require pro-active international policy coordination, and IFIs must lead this coordination. While recent increases in the IMF's lending capacity may be a positive step, it cannot replace working closely

with governments to implement preventative measures - and it also risks creating moral hazard by increasing countries' expectations of emergency funds.

- Finally, the governments of major economies must recognize the spillover effects of their domestic policies. At present, a change to tighter domestic monetary policies could spell disaster for markets and smaller countries by causing a reversal in the direction international financial flows. These governments must take responsibility and be committed to better international policy coordination.