IB 460 Course Pack

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What Explains the Resilience of Emerging Markets?

Based on the comparative stylized analysis of the experiences of emerging Asian and European economies, as well as the analyses in the previous chapters, we now provide a catalogue of seven factors that appear to have underpinned the relative resilience of emerging market economies (EMEs) as a group during the global financial crisis. These factors could also help explain differences in resilience across different groups of EMEs. Our list includes a few factors that have not been covered in depth in our own extensive analysis but have come to be accepted in the existing literature (see the literature survey in earlier chapters). We do not cover the role of macroeconomic policy responses in this list; these we leave for the concluding chapter.'

Factor 1. Less Dependence on Foreign Finance and a Shift away from External Debt Denominated in Foreign Currencies

As a group, emerging markets were net exporters of capital during the last decade. Asian emerging markets, especially Chinaand also others, such as Russia and some of the Latin American economies-have been running significant current account surpluses in recent years. Of course certain groups of EMEs, especially those in emerging Europe, have been running large current account deficits and financing their domestic investment using foreign savings. This group indeed proved most vulnerable to the crisis. Eichengreen (2010) documents that countries with large current account deficits and corresponding large financing requirements were hit harder by the crisis. But the majority of emerging markets have become a lot less reliant on foreign finance, particularly external debt. Indeed, there has been a significant shift in gross capital flows to emerging markets away from debt and toward foreign direct investment (FDI) and portfolio equity flows, with FDI becoming the dominant form of inflows (Kose and others 2009a; chapter 6 figures).2

Factor 2. Large Buffers of Foreign Exchange Reserves

Following the Asian financial crisis of 1997-98, emerging markets around the world built up large buffers of foreign exchange reserves, partly as a result of export-oriented growth strategies and partly as a form of selfinsurance against crises associated with sudden stops or reversals of capital inflows. Frankel and Saravelos (2010) present evidence that foreign exchange reserve levels had a major impact on countries' vulnerability to the global financial crisis.' The total stock of international reserves held by emerging markets rose from about $0.5 trillion in 1990 to roughly $5 trillion in September 2009. Foreign exchange reserves account for the bulk of gross reserve holdings. China accounts for nearly $2.3 trillion of these foreign exchange reserve holdings, but even excluding China, foreign exchange reserves held by emerging markets amount to about $2.5 trillion, a historically unprecedented level in either absolute terms or relative to such economic indicators for these economies as GDP, external debt, and foreign liabilities.

Although reserve levels for emerging Europe also increased in recent years, they were apparently not large enough to protect these economies from sudden stops of capital inflows, particularly as these economies had become quite dependent on external finance. Of course, the benefits of large reserves stocks have to be considered relative to the costs of accumulating them, both in terms of the quasi-fiscal costs and in terms of the more subtle costs of constraints on domestic policies.4

Factor 3. Greater Trade Linkages among EMEs

Greater trade linkages have increased the resilience of EMEs as a group. In particular, commodity-exporting countries have been shielded to some extent from slowdowns in advanced economies by strong growth among EMEs. For instance, China's continued rapid growth during the crisis, fueled by a surge in investment, boosted the demand for commodities from emerging markets such as Brazil and Chile and also increased the demand for other raw materials and intermediate inputs from other Asian emerging markets.

Factor 4. More Diversification in EME Production and Exports

Emerging markets have become more diversified in their production and export patterns, although this has, to a significant extent, been offset by vertical specialization, which has led to integration of some emerging markets, particularly in Asia, through regional supply chains.5 Even though diversification offers limited protection against large global shocks, as long as the effects of shocks are not perfectly correlated across countries (export markets), diversification can promote resilience in response to more normal shocks. Diversification of production, especially to reduce dependence on exports of commodities and raw materials that have long and volatile price cycles, can also increase resilience.

Factor S. Separation of EMEs' Business Cycles from Advanced Economies' Business Cycles

Divergence between the business cycles of emerging economies and those of the advanced economies has happened on account of the factors noted above, in addition to greater intragroup trade and financial linkages (chapter 9). As we document in chapters 5 and 6, trade and financial flows among EMEs have proliferated, both at the regional and at the interregional levels. This phenomenon is partly the natural result of geographical proximity boosting trade flows and also the result of financial flows following trade flows.

There have also been specific policy initiatives in certain regions to promote regional financial integration. Examples of this are the Chiang Mai and Asian Bond Fund initiatives set up as ways to encourage regional financial integration and financial market development among the participating Asian countries. However, the scope and scale of these initiatives have remained limited and, even for the Asian region as a whole, financial flows with the rest of the world still dwarf intra-Asian flows. Over the long run, initiatives to develop regional insurance mechanisms by pooling reserves and attempts to increase the use of major currencies such as the Chinese renminbi could serve to insulate the region better from global shocks.

Factor 6. Better Macroeconomic Policies, Including Flexible Exchange Rates, in Emerging Markets

During the Great Moderation most emerging markets succeeded in bringing inflation under control through a combination of more disciplined fiscal policies and more credible monetary policies. Indeed, a large number of emerging markets have now adopted some form of inflation targetingeither explicit or implicit, soft or hard-along with flexible exchange rates, which act as shock absorbers for external shocks (Rose 2007). This has led to moderate and less volatile inflation.6

In turn, stable macroeconomic policies have facilitated a shift toward more stable forms of financial inflows and also made international investors less concerned about the safety of their investment in emerging markets. Prudent fiscal policies that have resulted in low levels of fiscal deficits and public debt seem to have created room for EMEs to respond aggressively with countercyclical fiscal policies to offset the contractionary effects of the crisis (Ghosh and others 2009). Economies with high credit growth rates seem to have fared worse, but only if credit expansion was largely financed through foreign capital (as in the case of many countries in emerging Europe) rather than domestic savings (China and India).

Factor 7. Rising per Capita Incomes and a Burgeoning Middle Class

These two factors have increased the size and absorptive capacity of domestic markets, making emerging markets potentially less reliant on foreign trade to benefit from scale economies in their production structures and also less susceptible to export collapses (Kharas 2010). In emerging Asia, for instance, the share of private consumption in GDP rose by nearly 4 percentage points between 2008 and 2009, partially staving off the effects of a fall in export growth. Nevertheless, the high level of trade openness of emerging markets suggests that private consumption may not always be able to take up the slack in the face of adverse shocks to export growth. Furthermore, China is a special case in that the ratio of private consumption to GDP is very low by international standards and a rebalancing of growth toward private consumption-led growth is needed.