Center for Social and Economic Research

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The Impact of Financial Crisis on Emerging Markets: Transmission Channels, Vulnerabilities and Expected Challenges

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Plan of presentation

- Sources and nature of the crisis
- Channels of contagion (to emerging markets)
- Vulnerabilities of CEE/CIS region
- Policy responses
- Expected policy challenges in a post-crisis period

Basic characteristic of the crisis

- Truly global financial crisis caused by bursting several bubbles
- Started at core and is moving towards periphery (opposite to 1997-1998 emerging market crisis and similarly to the Great Depression and 1972 US dollar crisis)
- Preceded by overheating of the world economy

Transmission channels to emerging markets

- Emerging-market economies have been hit relatively late (end of 2008)
- Weaker global demand (trade channel)
- Fall of commodity prices (balance-of-payments, fiscal and second-round domestic demand consequences)
- Global liquidity squeeze (credit channel)
- Troubles of “mother” financial institutions (not so much)
- Increasing risk aversion
- Increased exchange rate volatility
- Crowding out financial resources by fiscal stimulus
- Decreasing demand for labor migrants

Real GDP annual changes in %

Country	2007	2008	2009
Albania	6.3	6.8	0.7
Bosnia & Herzegovina	6.8	5.5	-3.0
Bulgaria	6.2	6.0	-6.5
Croatia	5.5	2.4	-5.2
Estonia	7.2	-3.6	-14.0
Hungary	1.2	0.6	-6.7
Latvia	10.0	-4.6	-18.0
Lithuania	8.9	3.0	-18.5
Macedonia	5.9	4.9	-2.5
Montenegro	10.7	7.5	-4.0
Poland	6.8	4.9	1.0
Romania	6.2	7.1	-8.5
Serbia	6.9	5.4	-4.0
Turkey	4.7	0.9	-6.5
CEE	**5.5**	**3.0**	**-5.0**
Armenia	13.7	6.8	-15.6
Azerbaijan	23.4	11.6	7.5
Belarus	8.6	10.0	-1.2
Georgia	12.3	2.1	-4.0
Kazakhstan	8.9	3.2	-2.0
Kyrgyzstan	8.5	7.6	1.5
Moldova	3.0	7.2	-9.0
Mongolia	10.2	8.9	0.5
Russia	8.1	5.6	-7.5
Tajikistan	7.8	7.9	2.0
Turkmenistan	11.6	10.5	4.0
Ukraine	7.9	2.1	-14.0
Uzbekistan	9.5	9.0	7.0
CIS	**8.6**	**5.5**	**-6.7**
World	**5.2**	**3.0**	**-1.1**
Euro area	**2.7**	**0.7**	**-4.2**
Middle East	**6.2**	**5.4**	**2.0**
Brazil	**5.7**	**5.1**	**-0.7**
China	**13.0**	**9.0**	**8.5**
India	**9.4**	**7.3**	**5.4**
Japan	**2.3**	**-0.7**	**-5.4**
United States	**2.1**	**0.4**	**-2.7**

Countries most affected by the financial crisis through financial channels

Rank**	Country	Currency Depreciation (%)	Bond Spreads(Bps)	Equity Market (%)
1	Ukraine	-59.9	733	-66
2	Argentina	-21.4	735	-58
3	Hungary	-18.9	283	-58
3	Poland	-35.2	127	-53
5	Jamaica	-20.4	439	-51
6	Ghana	-28.0	448	-35
7	Russia	-22.0	144	-44
8	Kazakhstan	-22.0	167	-34
9	Bulgaria	-1.5	175	-51
10	Mexico	-22.6	73	-35
11	Turkey	-21.7	44	-40
12	Greece	-1.2	95	-47
13	Sri Lanka	-6.6	464	-27
14	Indonesia	-8.8	85	-29
15	Austria	-1.2	39	-49
15	Pakistan	-6.3	132	-26
17	El Salvador	-0.3	176	-35
18	Vietnam	-7.1	53	-33
19	Italy	-1.2	13	-50
20	Lebanon	-0.3	57	-45
21	Netherlands	-1.2	17	-42
22	Brazil	-8.4	36	-28
23	Belgium	-1.2	14	-36
23	Chile	-5.5	80	-14
23	Tunisia	-7.7	62	-14
26	Ecuador	0.0	2528	-13
26	Egypt	-3.4	-137	-39
28	Spain	-1.2	20	-31
29	France	-1.2	11	-34
30	Colombia	-3.4	63	-10
30	Germany	-1.2	0	-34
32	Malaysia	-0.9	81	-12
33	Philippines	-0.1	53	-21
34	Peru	-0.4	42	-15
35	South Africa	1.5	39	-20
36	US	0.0	0	-24
37	Japan	9.2	-5	-17
38	China	0.3	-31	-11

CASE

Note: **Rank from most to least affected. The country with the greatest currency depreciation was given a 1 (data from Wall Street Journal). Local currencies were compared to U.S. dollar, U.S. given 0 percent in currency depreciation. The country with the largest percentage drop in equity markets was given a 1 (data from World Bank GEM, Japan data from MSCI Barra). The country with the largest growth in bond spreads was given a 1 (data for EU countries from The Economist; data for remaining countries from World Bank GEM). EU bond spreads were compared to the German bund, while other bond spreads were compared to U.S. Treasuries (U.S. and German were given 0).

Vulnerabilities of CEE/CIS countries

- High level of trade and financial openness
- Export monoculture (mostly basic commodities)
- Deep recession in major destination markets (EU and Russia)
- Poor business climate in many countries
- Immature and fragile financial sector
- Currency and time mismatches in corporate and household sector
- Limited credibility of domestic currencies (high level of actual dollarization/ euroization)
- Lax fiscal policy in good times/ no fiscal reserves apart from Russia and Kazakhstan

Policy responses – general recommendations

- Avoid protectionism and beggar-thy-neighbor policies (including competitive devaluation and labor migration restrictions)
- Nationalization limited to banks only (when other sources of bank recapitalization are not available), on temporary basis, without nationalist bias and with clear exit strategy
- Return to structural reforms (e.g. labor market flexibility, limiting unfunded public liabilities, etc.)
- Overhaul of financial supervision on national level and creating supra-national financial supervision (especially within the EU)
- More global macropolicy coordination (G20, IMF)

Policy responses in emerging markets

- Monetary policy: depends on monetary regime and individual country conditions but generally no room for aggressive easing and sterilization of capital outflow (danger of speculative attack)
- Market-friendly rehabilitation of financial sector (where necessary)
- Very limited room for anti-cyclical fiscal policy (borrowing constraints) – apart from countries which have accumulated sovereign funds/ other forms of fiscal reserves
- Credibility challenge (broadly defined)

Challenges ahead

- Unknown crisis length, its impact on financial sector and post-crisis economic perspective
- Risk of overcoming crisis too quickly (lesson of 2001 dotcom recession)
- Risk of deflation spiral vs. risk of stagflation and building the new bubbles (e.g. in commodity market); asymmetric risks for developed and developing countries
- Fiscal challenges requiring adjustment in expenditure policy (mostly social)
- After-crisis growth slow or moderate (2003-2007 growth rates over the potential) $\Rightarrow$ necessity to increase growth potential
- Risk of further turbulences (banking crisis, sovereign default)
- Reassessment of monetary regimes in emerging markets