

SPEECH

Reflections on Progress and Prospects in the Emerging Markets

May 31, 2007

Posted June 4, 2007

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Remarks at the Institute of International Finance's 2007 Spring Membership Meeting, Athens

Good afternoon, and thank you, Yusuke, for your very kind introduction. It is a pleasure to be here among so many friends, and to have this opportunity to share with you some thoughts on the progress that has been made in the emerging markets, and the potential issues that may lie ahead.

As Yusuke noted, much of my professional career has been devoted to dealing with financial vulnerability and volatility in the emerging world.

And certainly, over the years, and into the start of this decade, there has been no shortage of excitement. Crises such as 1980s debt crisis, the 1994 tequila crisis, the Asia crisis and the Russian default each had important global implications, and demanded the attention of policymakers worldwide.

But when we speak of the emerging markets today, it seems, in a sense, that the world has been turned on its head. The emerging market economies—which for so long were seen as a seemingly endless source of instability, fragility and chronic shortages of capital—are now an important part of global resilience.

The emerging world has become an important source for the global supply of goods and services, and of savings, and, at the margins, an important influence on the price of both.

Through a combination of better policies, better economic performance, and in some cases, just better luck, the emerging world appears considerably less likely to be an independent source of volatility for the global financial system during the years immediately ahead, and perhaps for considerably longer.

How that happened is familiar, but it is no less remarkable for that reason.

- External balances have improved, with current accounts in most of the emerging world now in surplus, or modest deficit, and more than covered by equity inflows.
- Countries have substantially reduced their foreign debt burdens and built reserves, providing a much larger cushion against adversity. Almost every major borrowing country now holds official reserves sufficient to cover one year's worth of maturing debt. In fact, in some countries reserves now exceed gross external debt.
- Fiscal performance has improved substantially, and countries have placed much greater emphasis on structuring their debt to contain currency and rollover risks.
- Across the emerging world, monetary and exchange rate regimes are more resilient and flexible, as countries have moved away from the fixed-but-adjustable pegs that proved so dangerous in the past. Important progress has been made in building credibility for new, independent monetary policy regimes, and inflation is generally well under control.
- Governments have made major investments in recapitalizing and restructuring their financial systems, and credit growth has resumed.
- Finally, GDP growth rates have improved across the board, with EM growth in 2006 capping the strongest four year run in decades; borrowing costs have fallen dramatically; and capital market access has been more than amply restored.

To be sure, the progress I've just described has occurred in the midst of an extraordinarily supportive global environment, on both the real and the financial sides. And the outlook, it seems, is for more of the same. According to the IMF, global GDP growth should continue to be strong in both 2007 and 2008. If that's right, the strongest four-year run in decades will soon enough become the strongest six-year run since they began keeping the books.

Volatility has been remarkably low across a broad range of markets—debt, equities, currencies—and, across the board, ample flows are continuing, if not accelerating. True, we saw a brief flurry of excitement in EM financial markets earlier in the year. But you

would need a magnifying glass to see it against the broader pattern of historical volatility. And since then, EM equity markets have reached news highs, while EM debt spreads have breached already historic lows. In the process, the markets seem to have been hearing every potentially discordant note as sweetly harmonious.

So, in a world in which almost every risk looks worth taking, almost every investment appears worthy, almost every country worth betting on, what should we be looking at for clues as to the shape of things to come?

Let me offer a few thoughts, in no particular order, on developments that might be worth thinking about.

The first has to do with local political and policy risks. Yes, it is remarkable how much has been accomplished with regard to macro policy in recent years, and how relatively disciplined countries have been in the absence of strong market constraints. And yes, vulnerability has been reduced. But that does not automatically translate into the underpinnings for growth.

Progress on the micro side has been far more modest. In many countries, complex, politically contentious structural reforms are needed to consolidate progress and improve prospects for sustained growth. Unmet structural challenges are holding potential growth in check, limiting job growth and real incomes, leaving countries vulnerable to the global commodity cycle—and to erosion of domestic political support. Without a broader distribution of the benefits of reform—and by that I mean better growth in employment prospects and real incomes, less inequality, better institutions, better public services—stability in a number of countries is by no means assured. We have already seen the specter of populism emerge in one region and, while that threat appears to have diminished at the margin, it would be foolish to assume it's been banished forever.

The second goes to the broader context. It hardly seems to do justice to current market conditions to describe them as "benign". Years of strong global growth, low and stable inflation, and low and stable long-term interest rates have combined to create an environment in which almost every risk *does* look worth taking. All credit spreads are narrow, fueling everything from private equity to the housing market to emerging market funds to EM and global economic activity.

And in this environment of generalized enthusiasm, emerging market spreads have emerged as the narrowest of the narrow, with prices on most EM assets trading through comparably rated corporates.

Now, a case can be made that global credit spreads *should* be low. As we all know, financial innovation has allowed risk to be sliced, diced and traded as never before, both spreading risk and, at least theoretically, shifting it to those better positioned to bear it. But we also know that low interest rates, low volatility, and the seeming ability to trade out of any risk create obvious incentives to build up leverage, often in ways that are not readily transparent. Leverage contributes to very tight pricing in good times. But it also introduces the scope for large and sudden reversals when the cycle turns. And unfortunately, leverage is something that we often measure least well where it counts the most.

Not many of the intermediaries I talk with believe risk is fairly priced today. In the tradeoff between business risk and financial risk, the balance remains tilted in the direction of financial risk, as firms find it hard to sacrifice predictable benefits in the face of unpredictable risks.

To state the matter more generally, the recent long period of stability may contain the seeds of its own undoing. To quote an old friend: "Long trends are inherently dangerous. They make people forget what different environments look like, and encourage people to incorporate into their thinking only data from recent history". This makes reversals all the more sudden, surprising and powerful. And in this connection, we haven't lived through a full credit cycle with the complex structured credit products that currently dominate the landscape.

Third, there does seem to be a bit of a disconnect, at present, between global economic and financial performance on the one hand, and the geopolitical context on the other. The relative calm that has characterized the global economy is all the more remarkable when you think about some of the things that have occurred or are currently unfolding, including—the unsettled security situation across the Middle East, heightened tensions over nuclear proliferation, the re-emergence of political risk in some countries in Latin America, the coup in Thailand, violent protests in Hungary, unrest in the CE-3, the assassination of a reformer in Russia, disputes between Russia and its neighbors over energy, the failure to make progress on the trade front, the visible rise of protectionist sentiment and so on.

Fourth. While use of derivative structures has massively lowered the barriers to entry and helped to make massive amounts of capital available to countries that might not otherwise have had access, it is worth noting that this is also likely to be the case about barriers to exit.

Fifth. Linkages. The financial markets are much more tied together today than in the past by webs of debt, derivatives and structured products. These relationships are fantastically complicated, and as yet untested in any meaningful way.

And it is worth noting that the incentive structures today are quite different than those that once motivated collective action in times of stress. Said another way, it is not at all clear today, in the event of distress, who will “own the problem”. It is now easier to price and insure against risk, although it is only in retrospect that investors will know whether they have purchased as much insurance as they thought.

A related point: If there has been one theme that has dominated in recent years, it has been liquidity. Markets today are awash with liquidity, and the emerging world is enjoying record gross inflows. Abundant global liquidity has been a powerful wind at the back of economic and policy progress and has brought substantial benefits. But it is also bringing with it new pressures—on exchange regimes, on institutional frameworks, on asset prices and on policy makers. And it is introducing the potential for distortions. Witness what occurred early this year in one country in the Far East. In addition, as we all know, liquidity is ephemeral—it disappears at the most inconvenient times.

Sixth, there have been a number of changes in the pattern of capital flows to and from the emerging world that are potentially altering the landscape in important ways and thus worth thinking about.

One is the predominance of private-to-private flows, from private investors and lenders to private sector targets, involving a myriad of instruments—FDI, equities, bonds, loans and local securities, and increasingly, derivatives. This pattern contrasts with the former world of private-to-public flows, where claims on EM public sector borrowers accounted for the bulk of the capital inflows, and problems dealing with those debts were the key source of stress.

As I mentioned earlier, these days, in most countries, public external debt is declining or being held level in nominal terms, and shrinking quickly as a share of GDP. On the other hand, private sector indebtedness is on the rise, and will likely account for the bulk of future increases in international debt issuance. Indeed, corporate bond issuance has risen more than four-fold since 2001, and growth in syndicated loans to EM corporates has been even stronger.

In an environment of largely private-to-private linkages, the macro and fiscal backdrop remain essential—this was certainly a lesson of the Asia crisis. However, the connections between that backdrop and credit performance on individual loans become less direct. And with potential weaknesses in private sector balance sheets a source of risk, the strength of the local legal and institutional structure becomes more central to how effectively and efficiently distress can be managed.

And as I mentioned earlier, much remains to be done to strengthen local financial institutions, credit cultures, the legal framework for enforcing contracts and corporate governance.

In addition, in an environment of private-to-private linkages, getting a big-picture view of how balance sheets in the private sector are evolving, and of the sources and uses of funds, is often easier said than done. There is room for bodies such as the IIF to work with emerging market authorities to identify ways to strengthen the information architecture, thereby promoting better credit decisions by investors and creditors, foreign and domestic alike.

Another trend with potentially important implications is the growing internationalization of local debt markets. Foreign interest in the EM domestic debt markets has been spurred by low interest rates in the advanced world and perceptions of improved risk profiles in many potential recipient countries. To date, these flows have gone mostly to public debt securities. Growth of derivative exposures has also been significant and, in some cases, exceed outright holdings. Let me simply say this could be a source of unusual price action in future stress. People who are relying on conformance of credit derivatives and the underlying credit are likely to be surprised and disappointed.

Increased local market investing has brought with it important benefits for EM economies, often enabling borrowers to reduce FX exposures, and to issue at more attractive yields and longer maturities. But experience with foreign investment in local debt securities have not always been happy—think Mexico 1994, or Russia 1998. Large inflows into local securities markets can sustain or even fuel large current account deficits, even when net public borrowing is modest. And since local debt markets in many countries are still quite small, foreign investors can be “big fish in a small pond,” swelling liquidity when they swim in, and draining it when they swim away.

Finally, the traditional framework for thinking about potential stress needs to be broadened, away from its current focus on difficulties in countries making payments to advanced economy creditors. The emerging world is becoming an important exporter of capital. To date, the bulk of these outflows have gone to foreign exchange reserves and been managed by official sectors, largely in a cautious fashion.

But the growing interest in earning better returns on reserve assets may signal reduced caution going forward. Moreover, the private sector is increasingly playing a larger role in the recycling of external surpluses in the emerging world. As a result, capital flows *from* the emerging world could play an important new role in how future episodes of stress in the global financial system originate and are transmitted. Indeed, the ongoing debate as to whether the eventual unwinding of global imbalances will proceed in orderly or disruptive manner centers on precisely the stability of those flows. And for all the fuss about hedge funds, let me just observe that assets under management by sovereign wealth funds are about twice those in hedge funds—and growing—and less transparent.

In this connection, I mentioned stronger external liquidity positions as among the fundamental improvements that have left EM countries less crisis prone. However, reserve stockpiles in a number of countries now have moved well beyond plausible self-insurance needs, and reserves continue to be purchased to resist local currency appreciation. For these countries, further reserve purchases may be less a sign of strength than of the need for more progress in building domestic demand as a source of growth and in completing the transition to a modern monetary regime. Such progress, in turn, would help ensure that global current account adjustment takes place in gradual and orderly manner.

All of the developments that I have discussed—the broad environment, the rise of private to private flows, the growth of local currency investment, and the evolving role of the emerging economies as a source of capital—have many positive aspects to them. And many of the structural changes that I have referred to will take years to fully present themselves.

As these changes take place, they will also introduce new complexities and new linkages, and thus new potential pathways for risk. And they will introduce new challenges for monitoring and assessment that go well beyond the traditional architecture of country risk assessment. The challenge for risk managers, which in a broad sense includes all of us, is to try to anticipate what the future may bring, not just to avoid the mistakes of the past.

Let me close by sharing with you a saying that I am particularly fond of and that I think is worth keeping in mind: “When what is important changes, and the way you look at it doesn’t, you are going to be surprised...and the likelihood is that it won’t be a happy surprise.”

Thank you.
