THE GLOBAL FINANCIAL CRISIS – LESSONS FOR FINANCIAL SECTOR REFORM

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New Delhi, 20 March 2009
Overview

• Recap: the story so far
• Outlook: how bad will it get?
• Causes of the crisis
• Lessons for financial sector reform
Recap: the story so far
Recap: the story so far

- Unlike previous developing and emerging markets crises, the ongoing financial crisis originated in mature economies.

- When the sub-prime crisis erupted in the US in 2007, not only Europe but also developing and emerging countries were thought to be immune (decoupling hypothesis) on account of:
  - limited exposure to sub-prime market/impaired assets
  - improved fundamentals and policy framework
Recap: the story so far

• Decoupling hypothesis proved to be a myth
• Even countries whose financial sector was not or hardly exposed to “toxic assets” are hit
• Dependencies on developed markets exist, both in trade and finance, and they are felt now
• Countries with large current account deficits and financing needs, exposure to foreign exchange risk, and high leverage were hit the hardest
Recap: the story so far

Contagion has been making its way through:

• **Financial market links**
  Deleveraging and heightened risk aversion on the back of existing vulnerabilities → financing in int’l capital markets more difficult and costly

• **Real economy links**
  Global slowdown/contraction → lower trade, falling commodity prices, decline in remittances
  - Indirect impact on bank credit risk/quality of loan portfolio
  - Indirect impact on government revenue and fiscal balance
Recap: the story so far

Heightened risk aversion

EMBI + spread
Recap: the story so far

Plunging stock markets

- Merval Argentina
- RTSI Russia
- BOVESPA Brazil
- BSE SENSEX India
- IPC Mexico
- IHSG Indonesia

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Recap: the story so far

Depreciating currencies

Source: IMF/IFS
Recap: the story so far

Tumbling commodity prices

Source: Bloomberg and Global Insight
Recap: the story so far

Other effects

• Decline in foreign direct investment (FDI) by an estimated 10% in 2008 (UN Jan 2009)
• Sharp decline in remittances, which in 2007 amounted to $282 billion worldwide (about 3 times as much as ODA, and about 6% of GDP of LIC; according to the World Bank)
• Global shortfall in trade finance has soared to about $100bn (WTO March 2009)
Global financial crisis & dev. countries

Outlook: how bad will it get?
How bad will it get?

GDP growth (% change)

Source: IMF World Economic Outlook Update, January 2009
### How bad will it get?

**Growth estimates for developing countries for 2009**

<table>
<thead>
<tr>
<th>Region</th>
<th>2007</th>
<th>2008</th>
<th>Pessimistic scenario</th>
<th>Middle scenario</th>
<th>Optimistic scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transition economies</td>
<td>8.3</td>
<td>6.9</td>
<td>2.7</td>
<td>4.8</td>
<td>6.1</td>
</tr>
<tr>
<td>Developing countries</td>
<td>7.2</td>
<td>5.9</td>
<td>2.7</td>
<td>4.6</td>
<td>5.1</td>
</tr>
<tr>
<td>Africa</td>
<td>6.0</td>
<td>5.1</td>
<td>0.1</td>
<td>4.1</td>
<td>4.7</td>
</tr>
<tr>
<td>East Asia</td>
<td>9.0</td>
<td>6.9</td>
<td>4.6</td>
<td>5.9</td>
<td>6.4</td>
</tr>
<tr>
<td>South Asia</td>
<td>7.4</td>
<td>7.0</td>
<td>4.0</td>
<td>6.4</td>
<td>6.6</td>
</tr>
<tr>
<td>West Asia</td>
<td>4.7</td>
<td>4.9</td>
<td>1.6</td>
<td>2.7</td>
<td>3.3</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>5.5</td>
<td>4.3</td>
<td>-0.2</td>
<td>2.3</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Source: UN World Economic Situation and Prospects 2009
How bad will it get?

Growth in global industrial production and merchandise trade (annualised 3-months %change)

Source: IMF World Economic Outlook Update, January 2009
### How bad will it get?

**External financing flows to emerging market economies (millions of dollars)**

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008e</th>
<th>2009f</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Private flows, net</strong></td>
<td>236,746</td>
<td>333,311</td>
<td>523,486</td>
<td>564,909</td>
<td>928,553</td>
<td>465,792</td>
<td>165,328</td>
</tr>
<tr>
<td><strong>Equity investment, net</strong></td>
<td>138,539</td>
<td>195,006</td>
<td>250,082</td>
<td>222,309</td>
<td>296,131</td>
<td>174,065</td>
<td>194,823</td>
</tr>
<tr>
<td><strong>Direct equity investment, net</strong></td>
<td>103,168</td>
<td>154,659</td>
<td>197,322</td>
<td>170,911</td>
<td>304,146</td>
<td>263,358</td>
<td>197,476</td>
</tr>
<tr>
<td><strong>Portfolio equity investment, net</strong></td>
<td>35,371</td>
<td>40,347</td>
<td>52,760</td>
<td>51,478</td>
<td>-8,015</td>
<td>-89,293</td>
<td>-2,653</td>
</tr>
<tr>
<td><strong>Commercial banks, net</strong></td>
<td>34,994</td>
<td>62,215</td>
<td>163,946</td>
<td>211,915</td>
<td>410,259</td>
<td>166,643</td>
<td>-60,642</td>
</tr>
<tr>
<td><strong>Credit flows, net</strong></td>
<td>37,650</td>
<td>64,403</td>
<td>164,223</td>
<td>210,915</td>
<td>408,353</td>
<td>167,620</td>
<td>-60,604</td>
</tr>
<tr>
<td><strong>Interest receivables</strong></td>
<td>678</td>
<td>53</td>
<td>-20</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>410</td>
</tr>
<tr>
<td><strong>Discounted debt transactions</strong></td>
<td>-1,350</td>
<td>122</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Other private creditors, net</strong></td>
<td>63,214</td>
<td>76,091</td>
<td>109,459</td>
<td>130,684</td>
<td>222,163</td>
<td>125,083</td>
<td>31,147</td>
</tr>
<tr>
<td><strong>Official flows, net</strong></td>
<td>-19,942</td>
<td>-15,397</td>
<td>-65,460</td>
<td>-57,499</td>
<td>11,374</td>
<td>40,971</td>
<td>29,374</td>
</tr>
<tr>
<td><strong>International financial institutions, net</strong></td>
<td>-6,133</td>
<td>-14,336</td>
<td>-40,305</td>
<td>-30,436</td>
<td>2,651</td>
<td>16,642</td>
<td>31,013</td>
</tr>
<tr>
<td><strong>Official bilateral creditors, net</strong></td>
<td>-13,809</td>
<td>-1,061</td>
<td>-25,155</td>
<td>-27,063</td>
<td>8,723</td>
<td>24,329</td>
<td>-1,639</td>
</tr>
<tr>
<td><strong>Errors and omissions, net</strong></td>
<td>-23,769</td>
<td>27,959</td>
<td>-59,796</td>
<td>-21,222</td>
<td>-41,157</td>
<td>-28,013</td>
<td>0</td>
</tr>
<tr>
<td><strong>Monetary gold (= increase)</strong></td>
<td>709</td>
<td>646</td>
<td>1,069</td>
<td>-81</td>
<td>283</td>
<td>129</td>
<td>139</td>
</tr>
<tr>
<td><strong>Reserves excluding gold (= increase)</strong></td>
<td>-272,503</td>
<td>-400,113</td>
<td>-429,204</td>
<td>-554,838</td>
<td>-948,656</td>
<td>-444,289</td>
<td>-245,860</td>
</tr>
</tbody>
</table>

*f = IIF forecast, e = estimate*

## Current account balance of emerging market economies
(millions of dollars / % of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008e</th>
<th>2009f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance</td>
<td>204,022</td>
<td>244,287.0836</td>
<td>347,916.1497</td>
<td>463,576.97</td>
<td>491,524.4471</td>
<td>510,731.3498</td>
<td>477,593.8613</td>
</tr>
<tr>
<td>Merchandise exports</td>
<td>1,791,942</td>
<td>232,768.5424</td>
<td>28,225,178.32</td>
<td>341,896.1577</td>
<td>407,699.3526</td>
<td>485,725.8109</td>
<td>448,875.3436</td>
</tr>
<tr>
<td>Private transfers, net</td>
<td>65,838</td>
<td>72,701.73124</td>
<td>934,35.44981</td>
<td>1,084,86.407</td>
<td>1,294,75.3112</td>
<td>1,567,71.1259</td>
<td>1,431,82.7733</td>
</tr>
<tr>
<td>Official transfers, net</td>
<td>6,546</td>
<td>631,15.6126</td>
<td>672,649.104</td>
<td>8,809,42.383</td>
<td>1,140,4.53565</td>
<td>8,175.5</td>
<td>10,356.73013</td>
</tr>
<tr>
<td>Current account balance</td>
<td>128,547</td>
<td>164,894.1804</td>
<td>276,918.4209</td>
<td>383,948.6431</td>
<td>434,008.7433</td>
<td>387,377.5837</td>
<td>322,777.0609</td>
</tr>
<tr>
<td>(% GDP)</td>
<td>1.9</td>
<td>2.079248562</td>
<td>2.949246221</td>
<td>3.493216037</td>
<td>3.248071436</td>
<td>2.473000826</td>
<td>2.17308282</td>
</tr>
</tbody>
</table>

f = IIF forecast, e = estimate

How bad will it get?

• The World Bank estimates that the slowdown in economic growth will push 53 million people into poverty, in addition to the 155 million already suffering the effects of the food and energy crisis.
How bad will it get for India?

- “India is safe from the global turmoil. [...] The only fear is fear itself.” (Palaniappan Chidambaram, Finance Minister, 6 October 2008)
- “The Indian financial sector has shown resilience and there are no signs of a currency crisis or a banking crisis.” (Usha Thorat, Deputy Governor, Reserve Bank of India, 6 March 2009)
# How bad will it get?

## Real GDP growth forecasts for India 2009-10

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF</td>
<td>9.3</td>
<td>7.3</td>
<td>5.1</td>
<td>6.5</td>
</tr>
<tr>
<td>World Bank</td>
<td>9.0</td>
<td>6.3</td>
<td>5.8</td>
<td>7.7</td>
</tr>
</tbody>
</table>

Sources: IMF (WEO Update January 2009) and World Bank (Global Economic Prospects 2009, December 2009)
Causes of the crisis
Causes of the crisis

Regulation failure!

DOGBERT THE FINANCIAL ADVISOR

YOU SHOULD INVEST ALL OF YOUR MONEY IN DISEASED LIVESTOCK.

IT WOULD BE UNWISE TO INVEST IN JUST ONE SICK COW, BUT IF YOU AGGREGATE A BUNCH OF THEM TOGETHER, THE RISK GOES AWAY.

IT'S CALLED MATH.

SUDDENLY I FEEL ALL SAVVY.
Causes of the crisis

Excessive liquidity as a result of

- Lax monetary policy in the US and elsewhere
- Global imbalances & “global savings glut”
Causes of the crisis

Current account balance (in billion USD)

Source: IMF/IFS
Causes of the crisis

Accumulation of foreign exchange reserves (in billion USD)

Source: IMF/IFS
Causes of the crisis

Trade balance (in billion USD)


Brazil  India  China  Hong Kong  Russia

Source: IMF/IFS
Lessons relearned that should guide policy responses aiming at a reform of the int’l financial system:

• Financial stability is a public good on the national, regional, and global level

• International co-operation is needed to ensure financial stability
Two sides of financial co-operation:

• Crisis prevention
  - Surveillance
  - Exchange of information
  - Cross-border arrangements between financial entities

• Crisis management
Lessons for financial sector reform

- Better financial regulation and supervision of national AND international financial markets
- WB & IMF FSAPs should be made mandatory for all (systemically) important countries and published
- No tolerance of shadow financial sectors and tax havens
- BUT: desirable forms of financial regulation will inevitably differ across countries, depending on their preferences and level of development
Lessons for financial sector reform

• Strengthened role of IMF and other IFIs, which requires a more equitable governance structure of these institutions
• Regional financial cooperation and reserve pooling arrangements could complement IFIs
Lessons for financial sector reform

• Further development of financial markets in developing countries and emerging economies is key
  → More banking and securities markets needed – not less!!!

• Strong rationale for strengthening of national and regional financial markets to better channel developing countries’ savings to investments