Recent changes in the global financial system vis-à-vis developing countries.[1]

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At the beginning of the current decade, let us say in 2002, the insertion of the emergent market economies into the global financial system that evolved from the mid-seventies seemed to have turned into a burden for growth and a source of instability. There wasn't much room for optimism with respect to the prospects of those countries. Let us mention the main stylized facts giving support to that view.

Firstly, financial and currency crises in emergent market economies were increasingly frequent and intense. Taking into account only the main episodes from the early nineties on, the sequence was composed by the cases of Mexico and Argentina in 1995, the five East-Asian economies in 1997-98, Russia and Brazil in 1998-99, and Argentina and Turkey in 2001. Even the most favourable observers of the financial globalization process, like the Manager Director of the IMF, predicted the continuity of that trend and the emergence of new crises in emergent market economies, as an intrinsic characteristic of the global financial system.

Secondly, there was the striking evidence about the volatility of capital flows and the propensity to international contagion. These characteristics had become illustrated by the Mexican and Argentine crises in 1995 and by the strong global financial impacts of the Asian and Russian crises.

Thirdly, there were the extreme cases of highly indebted countries, like Argentina and Brazil, which at the end of the nineties were locked in financial trap situations, with high country risk premiums, slow growth or recession and great external financial fragility. The Argentine crisis erupted in 2001 and was followed by the default of the external debt. Brazil had experienced the currency crisis in 1998-99 without defaulting on its external debt; however, even though its exchange rate policy had become more flexible after the episode, the economic policy and the economic performance continued to be locked in a financial trap at the beginning of the present decade.

Fourthly, although other emerging market countries had managed their policies in order to avoid highly indebted positions and financial traps, they were integrated to

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the global system in a segmented mode. After participating in the financial globalization process for a long time (almost three decades in the case of the Latin American economies), their financial assets constituted a “class” of assets whose yields incorporated a considerable country risk premium. The country risk premiums had reached a minimum level in 1997, just before the devaluation in Thailand occurred. But since then the country risk premiums increased and remained high at the beginning of the current decade. Hence, given that the sum of the free-risk international rate plus the country risk premium set the floor for domestic interest rates, the financial integration seemed to condemn the emerging market economies to systematically higher interest rates than those of the developed countries, with negative consequences on growth and income distribution.

Lastly, there is another negative feature of the situation at the beginning of the current decade that it is worth mentioning. It is the reversal of the initiatives for international coordination that had followed the crises of the late nineties. At that time, some initiatives were taken in order to improve the so-called “international financial architecture”, to reduce volatility and contagion, to prevent crises and to improve the international management of the crises that would take place in the future. However, since 2001, the new US administration and the novel authorities in the IMF held the perspective that the very existence of multilateral support mechanisms set incentives for overindebtness and increased the probability of crises. On the other hand, the IMF began to work on the Sovereign Debt Restructuring Mechanism, but this initiative, originally suggested by the new US administration, was abandoned some time after. In parallel, also the interest in the “international financial architecture” fainted. Consequently, at the beginning of the present decade the stability of the financial links of emerging market countries became more dependants on the spontaneous behaviour of the markets than ever before.

In synthesis, far from achieving the promise of greater stability and growth formulated by the promoters of financial liberalization and opening, the process seemed to have resulted in a source of volatility and a burden for growth for many emergent market economies. In order to face the external financial context that resulted from financial globalization, prevention and defensive measures had to be implemented by those countries, without the support and in many cases against the orientation of the multilateral financial institutions. As we already mentioned, these circumstances did not leave much room for optimism.

In the introductory remarks to the IPD Capital Market Liberalization Task Force meeting that took place in September 2002 I attempted a synthesis of the difficulties then confronted by the emergent market economies:

"A country that intends to implement capital market and capital account regulations to avoid an unsustainable financial integration path has to confront with the IMF and the pressure of the financial markets. It is a difficult task, but some countries have managed to do it. With regard this issue, the target is well defined. We should put our efforts in promoting the appropriate changes in the IMF and other multilateral institutions rules and conditionality.

In contrast, it seems difficult to find ways out of the situation of highly indebted emerging market countries, and more generally, to establish an institutional context able to neutralize segmented integration, without an important effort of international cooperation. The essence of the problem lies on the inconsistency that exists between nations's States and an international financial system that lacks most of the institutions that have been developed over time in national systems to improve their stability and the way they work".

The diagnosis was not wrong, given the evidence we had in 2002 and the experience of thirty years of financial globalization, but the pessimism was a posteriori not justified. Actually, in the following years the countries found unforeseen ways to avoid unsustainable paths and high debt financial traps without confronting with the IMF. On the other hand, the segmentation of emerging markets assets almost vanished in the following years without any improvement in the international institutional setting. Those unforeseen novel trends are associated with a remarkable change in the financial insertion of the emergent markets economies and in the global system. The change was starting to take place precisely in 2002 and became more evident from 2003 on.

The changes with respect to the previous trends of the global financial system are well represented by two facts. Firstly, there were no new crises in emergent market economies, in spite of the emergence in the recent period of various episodes of financial turmoil with contagion effects. Remarkably, the USA subprime crisis did not trigger a financial crisis in any emergent market country. Secondly, country risk premiums have followed a declining trend from early 2003 and from mid-2005 they fell below the minimum attained in the pre-Asian crises period. In early 2007 country risk premiums reached their historical minimum, significantly lower than the minimum level of the pre-Asian crisis period and also significantly lower than the spread of US high yield bonds.

The mentioned facts are associated with the main change in the process of financial globalisation since it started to develop over thirty years ago. Net flows of capital now move from developing to developed countries, reversing the former situation[2]. Many of the emerging market countries, which had inserted into the system as recipients of capital inflows financing current account deficits, started to generate current account surpluses –or to reduce significantly the previous deficits – and to persistently accumulate international reserves. There was a turnaround in the international financial insertion of these countries: by shifting from being external-savings users to performing as savings exporters and intermediaries of international capital flows, these emerging market countries changed their position in the financial system.

Let me exemplify with some Latin American cases how the changes in the balance of payments helped the countries to find ways to overcome the hard constraints confronted at the beginning of the present decade. In the case of Brazil, for example, the strong improvement in the external accounts was the key factor that allowed the country to leave behind the financial trap in which it was locked in. In the case of Argentina, after the default of the external debt and its successful restructuring –also indirectly facilitated by the novel international financial conditions – the new context contributed to the rapid economic recovery. For the LA region as a whole, including both Argentina and Brazil, the change in the international financial situation led generally to the drastic reduction in the country risk premiums, which reached their minimum historical level in early 2007, together with the rest of emergent markets[3].

The current account surplus and the availability of large international reserves are indicators of external robustness as so are assessed by the international investors. A surplus in the current account points to a low probability that the country will confront difficulties in accomplishing its external commitments. So, it seems clear why the

[2] In the eighties, in the period between the Latin American debt crisis and the nineties, capital moved from low income to high income countries. This was a transitory consequence of the external sector adjustment of the Latin American economies after the crisis.
[3] The Argentine country risk premium followed a rising trend from March 2007 and reached high levels in 2008. The Argentine anomaly is not explained by the weakening of the fundamentals but by a lost of government credibility mainly associated with the manipulation of official statistical data.

perceived risk and the risk premium followed downward trends in the cases where the current account result turned to surplus.

But the emergence of a number of surplus countries has also beneficial effects on the cases where current account deficits persisted and on the working of the whole system. The lesser number of deficit countries, in a context where many emergent market countries show surplus, diminishes the risk of herd behaviour and contagion and thus reduces the perceived risk of the deficit countries. The emerging market asset class is more heterogeneous and many of these assets correspond to robust economies. This configuration benefits the perception of risk of the deficit countries and the perception of risk of the whole asset class.

A number of comparative international studies have been produced recently analyzing the relations between the current account results, the real exchange rates and the rates of growth in the period of financial globalization, before the beginning of the recent phase. The empirical results show a positive correlation between the current account result and the rate of growth. The countries that grew more were those who less relied on external savings. One of the reasons is that countries with higher current account surplus (or lower current account deficit) have not suffered from external crises. But the association between growth and the current account result does not follow exclusively from avoiding crises because the correlation also holds in periods in which no crises were observed.

Under the light of the mentioned studies, the recent phase, with numerous developing countries exhibiting current account surplus, financial robustness and accelerating rates of growth can be seen as an amplification of a historical pattern. In the recent phase more developing countries have followed paths showing both current account surpluses and higher rates of growth. In some cases those outcomes resulted from policies explicitly oriented to foster growth throughout the management of competitive exchange rates that simultaneously generate higher rates of growth, current account surpluses and accumulation of reserves. In other cases those outcomes resulted mainly from international factors that were exogenous to the countries' economic policies (i.e. low international interest rates, high expansion of the USA economy, rising commodity prices). But even in the cases in which the outcomes could not be attributed to domestic policies, many countries also implemented policies intended to generate additional external robustness throughout the accumulation of reserves. So, the recent pattern followed by numerous developing countries seems to have been an a posteriori confirmation of the policy lessons implicit in the above mentioned studies.

Beyond the effects of the new pattern at the individual countries level, an important feature of the recent phase has been the beneficial effect of the new configuration on the working of the global financial system vis-à-vis the whole set of emergent market countries. As was already mentioned, the new configuration has at least significantly alleviated the most negative aspects of financial globalization.

The advantages obtained by the developing countries from the new configuration of the global financial system have not been recognized by the multilateral financial institutions. The official doctrine of the IMF does not seem to recognise the virtues of this new context in terms of financial solidity and growth. For instance, the institution continues officially recommending macroeconomic policies based on pure floating and inflation targeting. In the present context pure floating means appreciating exchange rates and ceasing to accumulate reserves, consequently reducing the current account surplus and the rate of growth.

This suggests that the pending agenda of institutional reforms of the global financial system should be broadened. The pending agenda claimed for institutions capable of preventing, managing and compensating the instability of the global financial system, because instability was perceived as its most important negative characteristic. This agenda is still valid; particularly because the system should be better prepared to digest abrupt changes in the present configuration (for instance, an important fall of commodity prices). But presently instability is not the most threatening feature of the system vis-à-vis the developing countries.

One important lesson of the recent developments of the system underlines the crucial role of markets for developing countries exports. The experience of financial globalization tells us that capital inflows and external savings are by no means substitute for growth-cum-exports. So, together with institutional reforms intended to stabilize the working of the global financial system vis-à-vis the developing countries, these countries should presently claim for a deeper reform, intended to consolidate the positive features of the new configuration of the system. For instance, they should pursue an international agreement on exchange rates that could allow developing countries to follow high rates of growth-cum-exports paths.