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Impact of global financial crisis on emerging markets

This article is focused on the implications of the financial crisis for emerging markets. The author analyses the impact of financial turmoil on the economic growth in emerging economies and gives possible recommendations to mitigate this impact.

Global financial crisis, emerging markets, economic growth, investments, currency risks, reserve funds.

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In contrast to previous financial crises, the current crisis originated in the United States in the summer of 2007, and from there its waves began to spread around the world. And although the causes of the crisis were, first, in the weak regulation and bias promotion in the USA financial markets, it embraced the whole world within a few months. Thus, the current crisis has important implications for countries with high, middle and low income.

This article examines the impact of financial crisis on emerging economies, which are also classified as middle-income countries. Taking into account the origin of the crisis, great attention in the scientific literature is paid to the development of recommendations for developed countries. The impact of the crisis on the plight of the poor countries was investigated by such organizations as the International Monetary Fund, the United Nations and the Institute of International Development. Consequences of the crisis for middle-income countries received less attention. For a while there was a belief that developing economies are separated from the advanced countries and, consequently, the crisis has no significant impact on them. However, in practice the situation appeared to be opposite: in this case the example of the People's Republic of China is the most notable, where there was a decrease in exports and slowdown in economic growth for the first time.

Recommendations for the USA and other developed countries are defined by the international community: it is necessary to strengthen the supervision and regulation in financial markets, to solve the problem of budget deficits and growing debt. Low-income countries, in turn, must continue to invest in education, health care, infrastructure development essential to penetrate to foreign markets. In addition, they must be prepared to rely only on their own forces, as slower economic growth in the donor countries does not allow them to provide large financial aid.

The influence and impact of financial crisis on emerging markets are more ambiguous. In this connection it is necessary to make recommendations on the interaction of this group of countries with the world economic community, to identify methods of control and regulation the financial systems of developing economies, given the inadequacy of the measures that are used in developed countries, traditionally regarded as "role models".

The global financial crisis showed that the strategy of export-oriented growth entails a

greater risk than previously estimated, because international trade is more elastic with respect to the cycle and more vulnerable to economic downturns. Thus, the decrease in exports in developing countries in Asia in late 2008 and early 2009 was about 40% [2], economic growth rates also fell sharply, and in some countries, growth even changed into fall. Taiwan's GDP fell by 8%, Thailand – by 4.3%, Singapore, South Korea, Hong Kong – on 3.7; 3.4 and 2.5% respectively [6]. Thus, we can conclude that the negative impact on the economy of this group of countries have not only problems with external financing, but the decline in international trade.

Destabilizing effect of macroeconomic factors in developing countries where the attraction of investment is directly dependent on exports is more significant. For example, in China gross fixed investment in export-oriented sector has increased from 28% of the total investment in the first half of 1990-es to 36% in 2003 – 2007, while in Brazil – from 19 to 56% [1]. Above all the fall in export demand leads to a reduction in domestic demand, which also has a negative impact on economic growth.

The risks associated with excessive dependence on foreign financing should also be noted for emerging markets. Countries with large current account deficit and external financing needs have disproportionately suffered from the crisis, as foreign investors reduced their funding, and capital flows "dried up". Developing economies in Asia and Latin America managed to balance the current accounts and external financing needs, while countries in Central and Eastern Europe have experienced a significant balance payments deficit (in Latvia it was about 25% of GDP).

However, countries of Eastern Asia and Latin America could not avoid the negative effects of currency risks and risks of maturity mismatches in their assets and the maturity of the principal obligation. Thus, the problem of the Republic of Korea was, basically, in terms of contractual mismatch on the inflow and outflow of funds: banks that provided long-term lending to shipbuilding companies which received payments by debit debt in USA dollars closed their foreign exchange accounts at the expense of short-term offshore borrowing in USA dollars. When the crisis began, their short-term dollar financing collapsed, causing anxiety in the markets. In Mexico and Brazil, by contrast, the threat was represented by currency risks: while on the balance sheet accounts the foreign currency mismatch has been reduced, corporations, playing on the devaluation of local currency in both countries have significantly increased the amount of off-balance currency position through derivatives, which depreciated by over 30% after the bankruptcy of Lehman Brothers. Thus, the need for more stringent regulatory controls not only in the banking sector, but also forward and options markets as a whole becomes evident.

The role played by foreign banks in developing countries is worth noting. Other things being equal the volume of cross-border lending fell less than in the countries with a significant presence of foreign banks than in emerging markets, where foreign banks had not taken a dominant position. Foreign banks have provided substantial support to their subsidiaries in emerging markets.

It is interesting to consider the impact of foreign currency reserves on strengthening of the economic situation. For example, China's reserves of more than 1,500 US dollars per capita make up 25% of per capita income. If one directs those resources to real investment, they would provide a yield of 8%, while for China it will be equivalent to another two percentage points to economic growth. Or, if you send these resources for consumption, the standard of living will be two percentage points higher. The same situation is in Korea and in other countries with high reserves [3].

In addition to the high cost of foreign currency reserves there is a risk of being unable to use them. The fall of foreign exchange reserves of Korea below 200 billion US dollars led to panic in the market, making it difficult to use them. In order to maintain foreign currency liquidity in the private sector, the Bank of Korea

had to sign a swap agreement to the sum of up to 30 billion US dollars with the USA Federal reserve system.

One possibility for reducing the negative impact of the crisis is the creation and development of regional reserve associations. Thus, the "ASEAN plus 3" continues to work on the "Chiang Mai Initiative", involving the creation of regional mechanisms that complement the emergency loans in the IMF and World Bank in order to prevent financial crises. In the spring of 2009 another step in the development of multilateralism and creation of a regional monitoring group was made. However, there also observed the reluctance of some participants to intensify the agreements reached. Principal problematic moments were the requirements for obtaining and repayment of loans: the countries are reluctant to credit if there is no guarantee of loan repayment, and foreign policy is still plays a more important role in this matter than economic calculation.

In Latin America, where the reserve associations are at an even at an earlier stage of development, Colombia and Mexico signed a contract of insurance with the IMF. However, when Mexico, as well as Korea, required additional financial resources, it signed a swap agreement on 30 billion US dollars with the Federal reserve system. Obviously, the FRS is the reinsurer of last resort, like the European Central Bank in Europe.

Another means of effective sharing of reserves is the IMF. As the imbalance of payments balances is more manifest at the regional level, international reserve funds have a definite advantage in comparison with the regional ones. Moreover sharing of reserves was one of the main justifications for the creation of the IMF. However, the question of how they accounted the past experience, which was not always positive, to make the IMF programs more attractive for emerging markets remains actual. One of the solutions could be the reform of quotas in the IMF. In addition to the IMF reform one should pay special attention to promoting the wider use of national currencies in cross-border operations.

Thus, it is impossible to deny the impact of the crisis on emerging economies. Particular attention is paid to the analysis of several reasons for negative effects of the current financial crisis on emerging economies, and the possible recommendations to mitigate this impact.

The current global financial and economic crisis showed the danger of using policies of export-oriented growth and reliance on external financial resources for emerging economies and the need for tighter financial regulation, not only in banking but also in the derivative markets.

On the other hand, in times of crisis the presence of foreign banks in emerging markets had a positive impact on macroeconomic stability. The problems of effective creating and using of foreign exchange reserves of developing economies also became obvious. The attempts to organize financial assistance funds at the regional level by some countries, and their not so optimistic results demonstrate the relevance of interaction with the International Monetary Fund and the Federal reserve system.

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