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Emerging countries' role in rebuilding international finance

- Interview with Bulent Gultekin by Tetsuya Inoue -

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Executive Summary

Emerging economies recovered from the global financial crisis relatively early to spearhead global economic growth. Over the past few years, however, their fortunes have changed in the wake of China's economic slowdown and declining commodity prices. NRI's Tetsuya Inoue spoke to Wharton Professor Bulent Gultekin about the structural economic challenges facing emerging economies and how they can play a bigger role in long-term rebuilding of the international financial architecture.

Bulent Gultekin

*Associate Professor, Wharton School,
University of Pennsylvania*

Wharton, 1981-present; Governor, Central Bank of the Republic of Turkey, 1993; Chief Adviser, to the Ministry of Privatization, Poland, 1990-91, to the Prime Minister of Turkey, 1987-89, 1991; President, Housing Development and Public Participation Administration, Turkey, 1987-89; Director General for Research, Central Bank of the Republic of Turkey, 1986-87

Tetsuya Inoue

*General Manager,
Financial Technology and Market Research Department,
Nomura Research Institute*

Master of Arts, Yale University, 1992; Bank of Japan, 1985-2008 (1994-96 Secretary to Deputy Governor Fukui, 1996-2000 Manager at IMES, 2000-2003 Staff to Policy Member Ueda, 2004-2006 Head of Forex Operations Div., 2006-2008 Associate Director-General, Financial Markets Dept.); NRI, 2008-present (2009- Organizer of Financial Markets Panel)

Structural challenges facing emerging market economies

Tetsuya Inoue: After the global financial crisis, emerging economies were first to recover and collectively assume the role of global economic growth driver, but they have been losing momentum in recent years. Market views on emerging economies also has taken a turn for the worse.

Bulent Gultekin: Yes, concerns about emerging economies have escalated in response to slower growth in China and commodity price declines. Emerging economies have been heavily affected by European and especially US monetary policy in my opinion. They were hurt by the US subprime crisis but, because they were not at the epicenter, to a lesser extent than the US and Europe were. While the US was not doing well and the euro zone was in a deep trouble, India, China et al. were enjoying relative stability.

Meanwhile, US and European quantitative easing (QE) dramatically increased liquidity, much of which flowed into emerging markets for lack of a better destination. Local currencies consequently appreciated in countries like Turkey and Brazil. Their central banks wanted to do something in response, but they couldn't do much. If you sterilize capital inflows, interest rates tend to go up and you end up attracting even more capital inflows. Of course, such capital flows helped emerging economies drive global economic growth, but if they continue for too long, they'll cause distortions somewhere.

Inoue: Such distortions in emerging economies were unwound by the 2013 taper tantrum (market volatility driven by fears that the Fed was about to scale down QE).

Gultekin: That's right. People started thinking, "Hey, wait a sec. It's about time to shift into reverse." Actually, capital inflows to emerging markets were already slowing but the taper tantrum triggered a drastic change in sentiment. We're now in uncharted waters in terms of how developed countries' central banks will exit from their accommodative monetary policies and what will happen to emerging economies when they do.

Inoue: What about the impacts of geopolitical issues?

Gultekin: They were probably an even more important factor behind the change in sentiment toward emerging economies. Russia's annexation of Crimea had an especially big impact. Europe suddenly faced a new storm. After the Berlin Wall collapsed, many economists thought politics would decrease in importance and economics alone would rule the world, but such thinking proved illusory.

With the Cold War now over, we're back to 19th Century as issues like micronationalism in Europe have cropped up. And Russia’s transformation from a communist economy to a market economy turned out to be more of a plunder than a methodical, orderly transition. It essentially created what I call Mafiosi capitalism, where a few people ended up owning most of the nation's assets and wealth.

Inoue: At the time, you were involved in economic reforms and privatization in Russia and Eastern Europe.

Gultekin: Indeed I was, but I don't know what could have been done to avert such an outcome in Russia. We managed to achieve a better transition to a market economy in Poland. Putin has since changed the whole structure in Eastern Europe. Today there is almost a Cold War-like structure between Russia and Eastern Europe. And the US invasion of Iraq has severely destabilized the Middle East. It basically completely destroyed the knife-edge equilibrium between Shiites and Sunnis in the Muslim world.

Now Syria also is in crisis, I think mostly because Qatar and the Saudis just did not like Assad. Syria is a totally failed state. Of its former population of about 20 million, 10 million have fled to Turkey, Lebanon, Jordan and elsewhere.

The Arab Spring inspired hopes of democracy among Middle Easterners but ended up as another tremendous disappointment. Another example is Libya, where French military intervention sparked a civil war and caused major turmoil. Toppling an undesirable government just leads to a different sort of authoritarian regime and breeds chaos.

How much more capable have emerging countries become in terms of institutional design and policymaking?

Inoue: I think emerging countries' institutional design and policymaking capabilities have improved dramatically since the 1997 Asian currency crisis. For example, many emerging countries have adopted inflation targets and flexible exchange rate regimes in addition to carrying out various structural reforms. Emerging economies have been amassing foreign reserves also. Their capacity to withstand exogenous shocks seems to have improved greatly.

Gultekin: I agree. First, Asians learned a lot from the currency crisis. Southeast and East Asian central bankers in particular are very competent, both academically and policy-wise. Meanwhile, the public has learned that central banks and other such institutions need to be protected and that the cost of failing to do so could be very high.

Second, substantial growth in the middle class has contributed greatly to improving emerging countries' policymaking capabilities. With hundreds of millions of people in China alone above the poverty line if not in the middle class, policymakers can't be as irresponsible as in the past. If you are living below the poverty line, you're unaffected by economic volatility. If you're in the middle class, however, you have a mortgage, your children are going to school, so you're much more exposed to economic shocks. Policymakers in countries with a large middle class have to be much more diligent and careful.

Inoue: Emerging economies' exchange-rate regimes also are more flexible than in the past. Is there scope for further improvement? Has greater exchange rate flexibility enabled emerging economies to, for example, insulate themselves against the impacts of US QE that you mentioned earlier?

Gultekin: A flexible exchange rate theoretically should absorb such impacts to some extent but, by itself, is not going to solve the problem. Emerging economies by definition don't have all the resources of developed economies. They don't have the human capital and all that. Policymakers may not be well versed in exchange-rate regimes. Additionally, the political process is usually a much more rough-and-tumble affair than in developed countries. Emerging economies' central banks are exposed to various external influences. I personally know a Turkish central banker. His interactions with politicians are not like they would be in the US or Germany.

In Germany, the central bank is sacred. No German politician would dare meddle in the Bundesbank's affairs. In emerging markets, central banks do not enjoy such deference. It's sometimes hard for them to be independent in practice.

It takes time to develop institutions and even longer for the public to respect them and understand their importance. Yes, policymaking is better than it used to be but the nature of emerging markets is that you should still always be prepared for surprises.

Inoue: You mentioned that emerging countries learned from the Asian currency crisis. Conversely, did their success in surmounting such a crisis give rise to complacency? This may apply more to developed countries, but I feel that successfully dealing with an initial small crisis often leads to complacency that causes a bigger financial crisis later.

Gultekin: Good point. The global financial crisis was preceded by the so-called Great Moderation, a period from the mid-1980s until the financial crisis when cyclical variability in GDP growth and inflation rates diminished relative to historical norms. I think we became overconfident in economic policy's capabilities as a result.

In the US, the Greenspan Fed successfully navigated the S&L crisis and 1987 stock market crash by stimulating the markets. Continuation of such accommodative monetary policy gave rise to bubbles. The argument was, "We may not be able to foresee bubbles but we can mop up afterwards with monetary policy." Regulatory complacency also came in to play. Since the Clinton Administration in particular, there has been a misplaced belief that financial markets can police themselves. They usually do not, because things move too fast in financial markets. Regulators consequently often fall behind the curve. Second, people are greedy by nature and find ways to circumvent regulations.

So while the financial crisis was partly caused by monetary laxity, it was also largely attributable to global complacency unnoticed by most observers.

How should emerging economies contribute to rebuilding international financial architecture?

Inoue: Developed countries have been at the forefront of international finance until now, but with emerging countries also gaining competence, I think developed and emerging countries should engage more actively in dialogue with each other about the future of international financial architecture.

Gultekin: I agree. International institutions such as the IMF and World Bank are trying to empower emerging economies internationally. On the actual front lines, however, such institutions are still largely controlled by four or five developed countries. Emerging countries need to be allowed to play bigger role in these institutions.

Inoue: From a competence standpoint, emerging countries deserve to hold more key positions in international institutions.

Gultekin: Yes, the US and Europe don't have a monopoly in terms of competence. When developed countries alone run the show, they tend to dictate draconian, one-sided policy prescriptions like we saw during the 1997 East Asian currency crisis. It’s high time to democratize and reform these organizations so that developed and emerging countries can develop policies jointly.

Inoue: I agree. In addition to the need for stronger cooperation between developed and emerging countries on a global level, I feel it's becoming more important for emerging countries to play a major role in the economic integration underway in numerous regions of the world.

Gultekin: I think some such integration is happening naturally. For example, China and the rest of East Asia plus Indonesia, Thailand and even Australia and New Zealand are sort of a natural bloc.

Inoue: They form a geographic value chain, including Japan also of course.

Gultekin: A number of regional economic blocs are forming globally, but economic integration seems stronger in East Asia than anywhere else. One area where you have to be careful is that countries within such economic blocs constantly influence each other positively or negatively, particularly on the financial side, such as through capital flows. In such tightly integrated regional economies, building stable, integrated systems is more important than merely achieving economic integration, lest small problems develop into larger, global problems. Building such systems requires better mechanisms for funneling trade and capital flows. Liquidity requirements for financial institutions also should be revised. I think that most previous emerging market crises could have been largely avoided if banks had sufficient liquidity at the time.

Emerging economies also need to diversify their forex reserves away from the US dollar so they are not as much at the mercy of US monetary and economic policies. When in need of foreign currency liquidity during financial crises or other stress events, having options other than the US dollar would make a lot of sense in terms of flexibility. The US's QE policy launched in response to the global financial crisis worked because the US dollar is an international reserve currency. In this sense, the US solved its own economic problems by virtue of US dollar seigniorage. Emerging economies don't have that privilege.

Inoue: Emerging countries shouldn't set their forex reserve allocations mechanically. Any country that holds another country's currency as reserves will be affected for better or worse by the other country's policies. Asian countries cannot depend on the US dollar forever. Whether Asian countries can realize some form of regional common currency is a long-term story, one that I personally will be watching closely.

Gultekin: A regional common currency would facilitate problem-solving on a regional basis if a country in the region gets into trouble. From a long-term perspective, even Asia could end up having a regional currency. We're still living in the Bretton Woods world, same as it's been for the past 70 years. The world has to evolve, little by little.

Inoue: I hope that whichever country issues the new international reserve currency conducts its economic policy from an international, not solely domestic, perspective and exercises some sort of discipline, because it has some sort of externality.

Gultekin: I absolutely agree but doubt it will ever happen. I feel the US acts selfishly, like a small country, in international organizations.

Inoue: For the sake of international reserve currency diversification, I hope leaders with a sense of responsibility emerge throughout the world.

Thank you very much for sharing your valuable insights today.

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Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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