Commentary: Role Reversal in Global Finance

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It is a pleasure to discuss Eswar Prasad's very interesting and broad-reaching paper. One of its strengths is that it weaves together a large amount of material. In particular, it does an excellent job of highlighting some important and dramatic changes in emerging versus advanced economy linkages with the global financial market. While I agree with many of its conclusions, my role as discussant is to emphasize some of the areas where we have a different take or perhaps disagree.

Let me start with the paper's title—role reversal—which frames much of the approach taken in the first half of the paper, and thus many of the conclusions. As Eswar convincingly demonstrates, this characterization of what has happened in global financial markets is true in some very striking ways. However, there are also some ways in which I find it misleading, as discussed below.

In the 1980s and 1990s, as a group the emerging markets—or the developing countries as they were then called—were struggling to grow, there was considerable truth in the saying that when the advanced countries caught a cold, many developing economies caught pneumonia. They were mired in external debt, often related to large, unsustainable fiscal deficits. They were extremely vulnerable to balance of payments driven financial crises. In contrast, advanced countries increasingly thought those types of vulnerabilities were behind them. They no longer expected to have any need for balance of payments support from the IMF, and instead to be a resource for less-developed economies that got into trouble.

A large literature related developing countries' vulnerability to balance of payments crises to a variety of structural issues. As the paper effectively highlights, these included weak governance institutions, underdeveloped domestic financial market, dollarization and "original sin." Their vulnerability also related to mismatch in the currencies of assets and liabilities, sudden stops of cross-border credit flows, limited availability of domestically controlled external resources and insufficient financial market regulation.

Fast forward to the more recent period—say 2000-08. As the paper documents very nicely, this characterization no longer fits the emerging markets group. There have been tremendous changes, in particular, in terms of the composition of balance sheets of emerging markets, with liabilities shifting away from debt and assets shifting toward foreign exchange reserves.

Another striking difference is that emerging markets—not the advanced economies—have become the drivers of global growth. Again, this is well documented in the paper. (While metrics based on purchasing power parity (PPP) instead of market exchange rates would be preferred, this would not alter these basic points.) The emerging markets are trade powerhouses. There have also been striking shifts in their net foreign asset position and composition, as already discussed. Not only have they proved themselves much less vulnerable to financial crises, they are now financing significant portions of the debts of the advanced countries.

Clearly, all of this constitutes strong evidence of role reversal. Overwhelmingly, these changes should be seen as indicative of ***huge*** policy successes among emerging economics, associated with dramatic improvements in current living standards and prospects from a significant share of the world's population.

In contrast, advanced countries are struggling to grow. Many confront major fiscal challenges. Unfortunately, they have learned the hard way that they are, indeed, vulnerable to financial crises. In part, their vulnerability is related to instability in their own banking systems—not because of underdevelopment, but because of the extremely rapid growth in the size and complexity of financial markets. This growth would have created challenges for prudential regulation, even if oversight had not been lax.

Extensive and growing cross-border linkages have created problems of currency mismatch for advanced countries that have been difficult to unwind. And post-Lehman, they have also learned they are (still? again?) subject to sudden stops in cross-border capital flows. Again, I fully agree that these changes reflect important dimensions in which the role of advanced versus developing countries has "reversed." In this sense, the term "role reversal" provides a valuable frame for understanding developments in global financial markets.

However, in other ways, the role reversal terminology may be misleading. In particular, it could be taken to suggest that emerging markets are increasingly taking over from advanced economies to drive global financial market integration, as they are increasingly driving cross-border trade in goods and services. I do not see emerging markets assuming this role in financial markets to date. Further, I see little indication that "role reversal" in this sense is on the horizon.

Beginning in the 1960s, advanced economies markets have liberalized their financial borders. They have embraced—indeed becoming stewards of—relatively unfettered cross-border capital flows, albeit subject to prudential regulations. The emerging markets—and I would argue for good reason—have a much more varied and ambivalent attitude. I do not think, and the paper does not explicitly argue, that these countries are moving to take over this historically important dimension of the advanced countries' financial market role.

The paper documents that global financial market integration has resumed post-crisis and that flows are again on the rise for major economies. However it does not point out that this process has gone much more slowly in the emerging markets than it has for the industrial countries. While emerging economies account for half of global gross domestic product (GDP), (using PPP measures), their share of the global financial market remains substantially smaller in terms of growth as well as level. These countries are increasingly attractive sites for global capital, so this is, at least in part by design, reflecting slower and more nuanced financial liberalization policy. This suggests we are shifting toward a global economy in which one set of (emerging) countries dominates growth in real transactions while financial transactions are dominated by actors from a different set of (advanced) countries. Certainly a new and interesting international environment—but not one accurately described as role reversal.

The paper also provides an extensive and valuable discussion of the many challenges and risks of grappling with global integration. However, it concludes that capital controls are a poor way to address those challenges. I take a much more nuanced view. In particular, it is important to separate controls on inflows from controls on outflows, recognizing that these can have very different implications. In particular, Magud, Reinhart, and Rogoff (2011) provide a comprehensive assessment, highlighting that inflows have been helpful in retaining monetary authority as well as in changing the composition (not the volume) of inflows. In some circumstances, the net benefits may be positive. I agree with those who argue that some types of capital controls are a useful part of the policymakers' toolkit.

Also relevant in the context of this conference on growth is work by Aizenman, Pinto, and Radziwill (2007), which examines the extent to which fixed capital formation has been financed by foreign versus domestic saving. Based on analysis of a large sample of countries throughout the 1990s, it concludes that domestic sources accounted for some 90 percent of investment. The domestic share did not decline in the periods of increasing financial integration, and countries with higher self-financing ratios exhibited faster economic growth. In the context of the growth theme of this conference, this perspective raises questions about the costs and benefits from external capital. As Ross Levine argues persuasively in his paper for this volume, more need not be better—warranting a much stronger emphasis on type of capital and its allocation, than on the volume of capital.

Eswar argues the recent crisis was just a brief pause in financial integration. I would cast this a little differently. It seems to me the recent crisis exacerbated some of the differences in perspective on the extent to which global integration is important for growth. I don't want to be misinterpreted. I certainly believe that financial systems can play an extremely positive role in supporting growth. But, as noted above, allocation is at least as, if not more, important than the total amount. We also have to be broad-minded about appropriate timing for liberalizing capital markets in the context of a broader portfolio of associated policies, especially given all the uncertainty surrounding us.

I would like to suggest a different "frame" for thinking about the issues addressed in the second half of the paper than the "role reversal" frame emphasized here. The frame that kept occurring to me as I read the paper relates to a 1985 movie, "Back to the Future." I hope those of you who remember the movie will forgive my simplified and selective summary of the main theme. In "Back to the Future," the main character is accidentally transported back in time a quarter of a century and confronted by a world of the past featuring many things he thought had been left behind, including a bully, which I will come back to later. His main task is to figure out how to get back to the future, which of course is the "real" world he has just come from. In doing so, he figures out how to tame the bully, so the future he actually returns to is, in fact, a much rosier one.

Here's the analogy. Think of us as having been accidentally transported back to a world of about 25 years ago, in which advanced as well as emerging market economies were extremely vulnerable to financial crises. The bully in this story, of course, is that part of the financial system associated with very large and predatory cross-border capital flows. Our challenge is how to get back to the future we thought we were living in—one in which we could harness those financial flows in order to support growth, and knew how to remove or reduce the vulnerability to financial crisis. From the vantage point of this frame, the "simple insurance mechanism" outlined in the second half of the paper is really a proposal to try to help us tame that bully.

The paper motivates its insurance mechanism proposal with a brief discussion of foreign exchange reserve accumulation as a means of self-insurance against financial crises. As it notes, reserve holdings have exploded since 2000—with many emerging economies accumulating both before and after the crisis—and some (including China) even continuing to accumulate during the crisis. This puzzling behavior has generated a growing literature, to which the paper provides a helpful overview. It emphasizes the costs of this self-insurance to individual countries. However, especially for small economies, in the absence of a reliable external alternative, the discussion may understate the benefits since large reserve stocks do seem to have helped insulate many emerging economies against an output collapse. The paper also mentions that this reserve accumulation behavior creates a collective action problem by encouraging fiscal profligacy and by increasing the instability of global financial markets. However, these are only a subset of the systemic issues involved. For instance, the paper gives short shrift to the important challenge of China's massive reserve accumulation, and the associated currency misalignment that imposes significant costs on the global economy. As the countries accumulating reserves have grown, global assessments of the costs and benefits of this behavior have become more important relative to assessments from each individual country's perspective. These complex issues warrant considerably more research as well as more attention than they are given here.

The paper develops a very interesting proposal to tame the financial bully through an ex ante global insurance mechanism. The features of this proposal are clearly described in the paper, and I will not repeat them here. To put my punch line up front, while I see some real strength in the proposal, I was not ultimately convinced of its feasibility.

In terms of strength, the paper does a good job of spelling out some of the key features such a mechanism ought to have. Specifically, the proposal is intended to help depoliticize access to liquidity in times of need, and reduce the stigma associated with some of the IMF facilities. Importantly, it stresses the value of shifting from a purely individual calculation by countries to a much more systemic understanding of the costs and benefits of individual country behavior on the global economy.

In terms of feasibility, I would highlight the following three challenges. First, how would the insurance premiums be determined and by whom? It is not at all clear how to set nonlinear weights to relate a country's annual premium to its debt level, or how to set that weight relative to the weight on, say, "excess" foreign exchange reserves, in such as way that participating countries would agree. Without a "benevolent dictator" or a well-functioning global governance institution, determining important "details" as these seem likely to be stymied by politics. The proposal really doesn't address the issue of how all of that would get worked out. Second, who would bear the risk? The mechanism is intended for liquidity, not solvency challenges. As stated, participating countries would be allowed to borrow for a year (or specified period). Those that do not pay back on time would get kicked out to the IMF. But that does not pin down who would be left holding the bag. And finally, although addressed briefly, more attention needs to be paid to moral hazard. The idea of access to unconditional finance raises additional questions about implications for runs on countries that participate.

In sum, this is a very interesting paper that is already quite widely cited. After documenting some of the dramatic changes in key financial market metrics, it convincingly forecasts that, in the coming decade, advanced economies will remain vulnerable to external crises while emerging economies will be more exposed to domestic fragility. This is indeed a striking reversal, and the author offers a valuable discussion of possible implications—some of which reflect ways in which the roles are only partially reversed. While his creative global liquidity proposal seems unlikely to tame the bully of the financial markets and help us to get "back to the future," putting proposals like this on the table do provide a valuable step in that direction.

References

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