III. Issues in emerging market economies

Highlights

Over the last year, growth in all the major emerging market regions was surprisingly strong (Table III.1). The already healthy rates observed in 2003 were exceeded, and growth reflected a better balance between external and domestic demand. Indeed, global conditions remained unusually favourable for exports from emerging economies and for capital inflows. Consumer and investor confidence rebounded in all regions. This rapid growth put pressure on many critical resources, such as oil. In sharp contrast to the past, however, higher oil prices did not lead to a marked resurgence of inflation. Interest rates in Asia and elsewhere remained low – in part because currency appreciation pressures may have encouraged monetary policy to be easier than it would otherwise have been.

Output growth and inflation[1]

	Real GDP				Consumer prices[2, 3]			
	Average 1995–2003	2004	2005		Average 1995–2003	2004	2005	
			First quarter	Fore-cast			First quarter	Fore-cast
Asia[4]	6.6	7.8	7.3	7.2	4.2	4.4	3.7	3.9
China	8.5	9.5	9.5	8.9	3.0	3.9	2.8	3.2
India	5.9	7.1	6.7	7.1[5]	5.2	6.7	5.1	5.6[5]
Korea	5.1	4.6	2.7	4.0	3.9	3.6	3.2	3.2
Other Asia[4, 6]	3.6	6.0	4.7	4.8	5.8	3.4	4.3	4.2
Latin America[4, 7]	2.0	5.9	4.3	4.3	11.2	6.6	6.6	6.3
Argentina	0.4	9.1	8.3	6.8	4.8	6.1	9.1	10.0
Brazil	2.1	5.2	3.8	3.6	9.3	7.5	7.5	6.5
Mexico	2.5	4.4	2.4	3.9	16.6	5.2	4.4	4.0
Central Europe[4, 8]	3.7	4.8	3.3	4.0	10.2	3.9	3.1	2.4
Russia	2.4	7.1	6.0	5.8	49.5	10.2	12.9	11.6
Turkey	3.7	8.9	0.1	5.7	64.9	10.6	8.6	8.0
Africa	3.7	5.1	…	5.0	15.6	7.7	…	7.7
Middle East	4.1	5.5	…	5.0	9.2	8.3	…	8.6
Total[4, 9]	5.2	7.2	6.2	6.3	9.4	5.4	5.0	5.0
Memo: G7 countries	*2.4*	*3.2*	*2.5*	*2.3*	*1.9*	*2.0*	*2.2*	*2.0*

Note: Forecasts and most first quarter 2005 GDP data are based on May consensus forecasts, JPMorgan Chase and IMF, *World Economic Outlook*.

[1] Average annual changes, in per cent. [2] For Latin America, end of period. [3] For India, wholesale prices. [4] Weighted average of the economies listed, based on 2000 GDP and PPP exchange rates. [5] Fiscal year beginning in April. [6] Hong Kong SAR, Indonesia, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [7] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [8] The Czech Republic, Hungary and Poland. [9] Economies above excluding Africa and the Middle East.

Sources: IMF; © Consensus Economics; JPMorgan Chase; national data; BIS estimates. Table III.1

In this setting, an ongoing issue is whether emerging market economies have become more resilient to shocks. A number of considerations indicate that the answer is yes. First, the increasing importance of domestic demand suggests that growth could continue even if external demand were to weaken. Second, there have been noticeable improvements in fiscal positions, in some cases supported by legislative reforms and the development of local bond markets. Third, inflation appears to have become more stable, in some instances reflecting improved monetary policy credibility. And, to the extent that countries have become less committed to an explicit exchange rate target, this too reduces their vulnerability to shocks. Fourth, the current accounts of most emerging market economies have strengthened. Fifth, there have been improvements in banking performance.

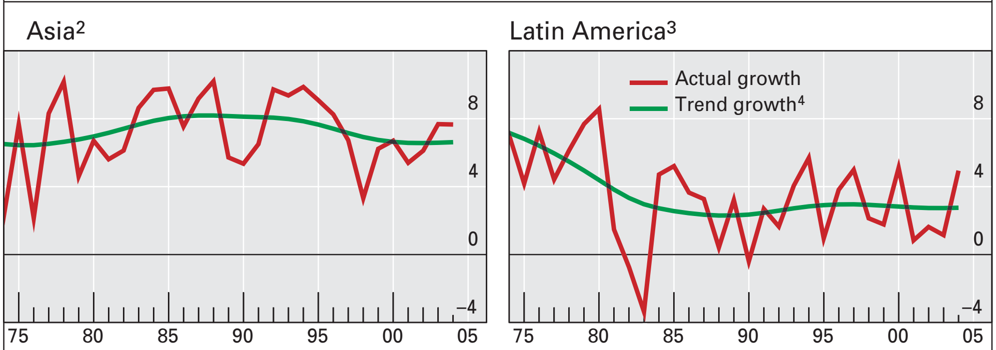
However, these observed gains may themselves be the result of favourable cyclical factors. A global slowdown could undo some recent improvements, just as a monetary tightening in industrial countries could slow the pace of capital inflows, reverse recent currency appreciation and pose fiscal challenges. In contrast, should growth be maintained, inflation expectations in some countries might rise. Ratios of short-term to total external debt also remain high in some countries, although risks have been considerably attenuated by high levels of official foreign reserves. Finally, banking sectors are still exposed to various risks, and improvements in the regulatory environment need to go further in some cases.

Recent developments

Exceptional growth in 2004

Virtually all emerging market economies have shared in the current expansion, which started in late 2001 (Table III.1). Last year, output growth was strong in most countries and appears to have exceeded trend growth during the past two years (Graph III.1). Despite some recent adverse shocks, such as higher oil prices, average growth in emerging economies is forecast to remain

Actual and trend growth[1]



[1] Real GDP; annual changes, in per cent. Weighted average of the economies listed, based on 2000 GDP and PPP exchange rates. [2] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [3] Brazil, Chile, Mexico and Peru. [4] Estimated using a Hodrick-Prescott filter.

Sources: IMF; national data. Graph III.1

Balance of payments developments

In billions of US dollars

	Current account balance			Net private capital flows[1]			Change in reserves[2]		
	Average 1990–96	Average 2000–03	2004	Average 1990–96	Average 2000–03	2004	Average 1990–96	Average 2000–03	2004
Asia	–10.3	120.7	184.9	47.1	2.9	148.4	43.8	141.6	363.4
China	5.1	29.8	68.7	20.8	30.5	110.7	12.6	62.1	206.7
India	–4.4	1.9	–3.9	5.6	14.7	24.7	2.4	16.4	27.5
Korea	–7.1	9.4	27.6	11.4	10.2	13.8	2.6	20.2	43.7
Other Asia[3]	–3.9	79.6	92.5	12.8	–52.5	–0.8	26.2	42.8	85.5
Latin America[4]	–28.6	–21.5	20.8	50.2	24.9	–5.1	16.3	9.2	21.1
Brazil	–6.0	–12.7	11.7	18.2	15.0	–3.6	7.3	3.6	3.6
Mexico	–14.8	–14.9	–8.6	20.3	21.5	12.9	1.9	6.7	5.0
Central Europe[5]	–6.1	–15.0	–18.0	3.2	18.0	18.4	7.8	5.1	7.7
Russia	8.6	36.3	60.1	8.8	–9.8	–3.4	5.2	16.2	47.6
Turkey	–1.7	–4.1	–15.5	3.5	1.1	18.0	1.7	2.7	1.7
South Africa	0.5	–0.5	–7.0	1.1	2.0	9.9	–0.0	0.0	6.6
Total[6]	–72.7	130.8	277.3	116.1	24.8	155.3	89.3	176.1	454.6
Memo:									
Oil-exporting countries[7]	*–8.9*[8]	*53.2*	*120.4*	*37.3*	*–16.2*	*–18.9*	*9.5*[9]	*26.5*	*60.6*

[1] Direct investment, portfolio investment, financial derivatives and other investment excluding investment by monetary authorities and government. Partly estimated. [2] A positive value indicates an increase. [3] Hong Kong SAR, Indonesia, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [4] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [5] The Czech Republic, Hungary and Poland. [6] Economies above plus Israel and Saudi Arabia. [7] Indonesia, Mexico, Russia, Saudi Arabia and Venezuela. [8] 1994–96. [9] 1996.

Sources: IMF; national data. Table III.2

steady at over 6% this year. In Asia, the expansion has been led by China and India, but other economies are not far behind. In Latin America, Argentina, Brazil and Mexico have all witnessed a strong revival; growth in a number of economies in the region has been above trend. In central and eastern Europe, despite a recent slowdown, all major economies are expected to grow strongly in 2005. Moreover, over the last year growth has rebounded in Turkey and remains robust in Russia. Economic activity has also accelerated in most of Africa.

Growth boosted by strong global demand ...

Several factors played a role in supporting growth in emerging market economies. First, global demand conditions were highly favourable to these economies, mainly reflecting buoyant growth in the United States and China. Many countries witnessed export growth of 20–40% last year. In Asia, despite some weakening of the IT cycle in the second half of 2004, export growth remained strong as US and Chinese demand for non-electronic exports rose. Demand for commodity exports from Latin America, Russia and South Africa was also brisk. The strength of exports led to improved current account balances. Indeed, the aggregate surplus of emerging economies reached a record high of $277 billion in 2004 (Table III.2). While Asia accounted for much of this surplus, several Latin American countries also enjoyed significant current account surpluses, which helped them to reduce external debt exposures and rebuild reserves. In central Europe, however, current account deficits remained large.

Second, stronger domestic macroeconomic fundamentals improved the credit standing of many countries. Combined with ample global liquidity, this led to an increase in private capital inflows to emerging market economies. Last year flows to China picked up significantly as buoyant inward direct investment coincided with a marked expansion in portfolio inflows and private commercial borrowing; expectations of a renminbi revaluation probably contributed to this. Foreign direct investment to India and Korea rose sharply, with India also witnessing strong portfolio inflows. Capital flows to Southeast Asia also revived in 2004, although they remained depressed compared to the levels seen prior to the 1997–98 financial crises. In Latin America, some countries repaid external debts and refinanced part of their high-cost debt by borrowing at lower interest rates. Net flows to the major countries in the region nevertheless fell slightly. Capital inflows to central Europe remained strong, and those to South Africa increased.

... large capital inflows ...

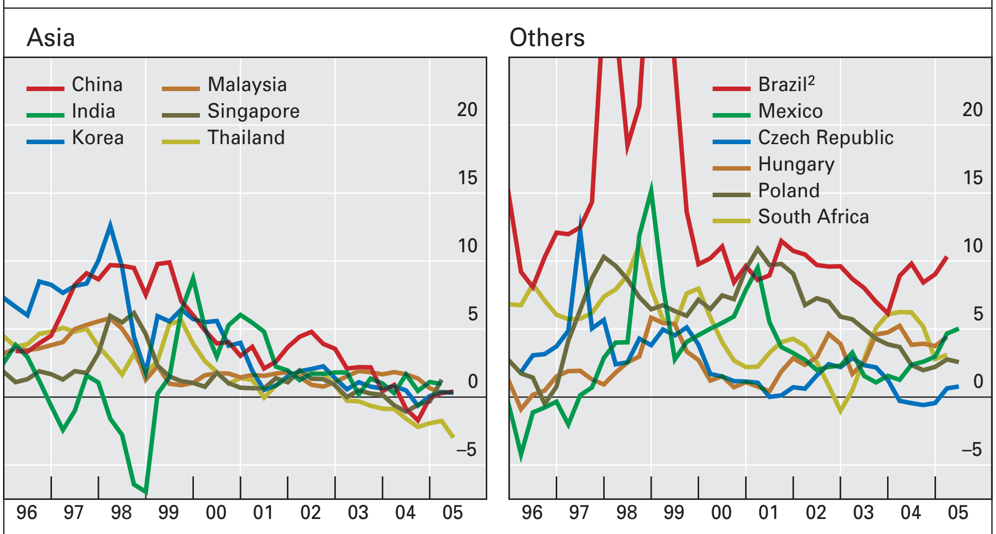
Third, domestic demand rebounded in all regions. Notwithstanding the recent increase in policy rates by several central banks, monetary policy remained supportive of demand in all regions in spite of signs that in some cases capacity utilisation had risen significantly. Real short-term interest rates have been near zero or negative in most of Asia over the past three years (Graph III.2, left-hand panel). By past standards, real short-term rates also remain low in much of Latin America and in central Europe. In many countries – and especially Asia – currency appreciation pressures may have led policy rates to be lower than otherwise, perhaps reflected in further declines in real long-term bond rates and higher equity prices (Graph III.3).

... and buoyant domestic demand

In Asia, easier financing conditions and stronger investor confidence translated into higher capital spending. Although still below the levels seen prior to the 1997–98 crises, investment ratios recovered in a number of

Higher investment in Asia ...

Real short-term interest rates[1]

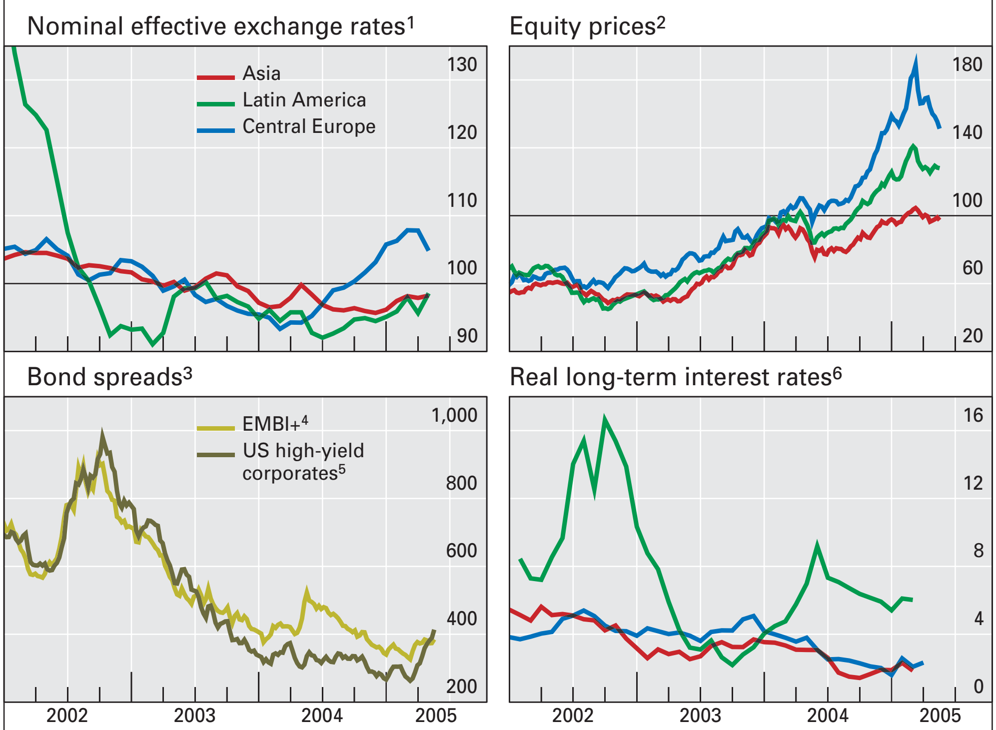


[1] Three-month annual interest rates deflated by annual consumer price inflation. Definitions may differ across countries. [2] Peak values close to 35% in 1998 Q4 and 1999 Q1.

Sources: Bloomberg; Datastream; national data.

Graph III.2

Financial market conditions



Note: The country composition for Asia and Latin America differs between panels. Regional averages using 2000 GDP and PPP exchange rates.

[1] 2002–04 = 100; an increase indicates an appreciation. [2] In US dollar terms; US S&P 500 peak (24 March 2000) = 100. [3] In basis points. [4] Over US Treasuries, as calculated by JPMorgan Chase. [5] Index yield for a basket of non-investment grade corporate bonds denominated in US dollars over 10-year swap rates. [6] Domestic currency, deflated by annual consumer price inflation; in per cent.

Sources: Bloomberg; Datastream; JPMorgan Chase; national data; BIS. Graph III.3

Southeast Asian economies last year. Following monetary and administrative tightening measures, nominal fixed investment growth in China slowed substantially during 2004. Even so, the ratio of nominal fixed asset investment to GDP increased further from 47% in 2003 to 51% in 2004, and investment in some overheated sectors such as real estate continued apace. Moreover, capital spending in projects outside the already overheated sectors is reported to have grown strongly last year, in part due to demand diverted by the administrative measures. Several calculations based on macroeconomic data suggest that the rates of return on some investments have been unusually low. At the same time, private consumption has recovered in China and exports have remained strong.

... and a recovery of demand in Latin America

In Latin America, the rebound in domestic demand during 2004 was striking. Private consumption recovered in Argentina, Brazil and Venezuela from the collapse suffered during recent crises, and strengthened further in Chile and Mexico. Several countries recorded real growth rates of investment between 10 and 40% last year. A similar picture was seen in major central and eastern European economies, with investment growth of between 5 and 10% in the Czech Republic, Hungary and Poland. In Russia, while consumption has been the major driver of domestic demand, investment has slowed over the past year. In Turkey the return of confidence after the recent financial crisis has been associated with a sharp acceleration of domestic demand.

Inflation poses challenges ...

Nevertheless, the current expansion has also posed challenges for authorities on several fronts. For instance, strong demand and higher commodity prices last year raised inflation rates in some emerging market economies. In Asia, for example, although average inflation in 2004 was only slightly higher than in 1995–2003, several countries saw a general increase in inflation rates (Table III.1). In China, consumer price inflation rose to over 5% in the third quarter of 2004 before falling in subsequent months. In contrast, producer prices continued to grow strongly. Similarly, in India inflation rose to 8% during 2004 before declining in early 2005. In Latin America and central and eastern Europe, inflation remained low by past standards in 2004. During the first quarter of 2005, however, Argentina saw increased inflationary pressures, and inflation also rose in Brazil in April.

... leading to some tightening of monetary policy

As a result, some countries have had to tighten monetary policy. China and India have tightened both through direct measures, such as raising reserve requirements on banks, and indirectly by increasing interest rates. Thailand has raised interest rates substantially since August 2004 to reduce the risk of future inflation. The Philippines and Indonesia raised policy rates by 25 basis points in April 2005. Interest rates have also gone up in several countries in Latin America, including Brazil and Mexico.

Currency appreciation ...

In addition, sizeable balance of payments surpluses have put upward pressure on currencies in countries with flexible exchange rates. In all regions, this was reflected in greater currency appreciation against the dollar (euro for central Europe) in 2004 than in previous years. Nevertheless, as discussed in Chapter V, the authorities in most Asian economies continued to intervene in the foreign exchange market to limit the appreciation of their currencies or to maintain a fixed exchange rate. Consequently, aggregate foreign exchange reserves in emerging Asia rose at an unprecedented rate last year (Table III.2). In nominal effective terms, therefore, most Asian exchange rates continued to depreciate through much of last year before reversing the trend in early 2005 (Graph III.3, top left-hand panel). As noted above, the accumulation of reserves appears to have been complemented by monetary policy that tightened less than might otherwise have been the case.

... with constraints on intervention

As inflationary pressures rise, this accommodative stance of monetary policy may have to be reversed. In addition, the rapid household credit growth seen in many countries last year, accompanied by an increase in property prices (see below), could also lead central banks to quicken the pace of monetary tightening. Moreover, intervention policies might also have to be revisited. The growing carrying costs of reserves entail fiscal costs – and perhaps balance sheet losses should currencies be forced to appreciate. The market perception that such heavy exchange market intervention might not be sustainable could in itself lead to sizeable short-term speculative inflows. In India, inflows into the stock market are reported to have risen sharply towards the end of last year. In Korea, expectations of currency appreciation during that same period reportedly prompted residents to repatriate capital invested abroad.

High commodity prices: causes and effects

Commodity price developments have exerted an important influence on the emerging economies. Since the beginning of 2002, oil prices in US dollars have risen by 150%. The increase has been particularly pronounced over the past year, with oil prices reaching successive new peaks before falling back in mid-March 2005 (Graph III.4). Nevertheless, oil prices in real terms remain below the levels seen during the second oil crisis in 1979. Real metal prices have also recovered strongly from their late 1990s trough, although at their current level they are no higher than at the beginning of 1990 (Graph III.5, left-hand panel). The prices of key industrial inputs such as copper, lead and coal, which grew modestly during 2003, have risen sharply since early 2004.

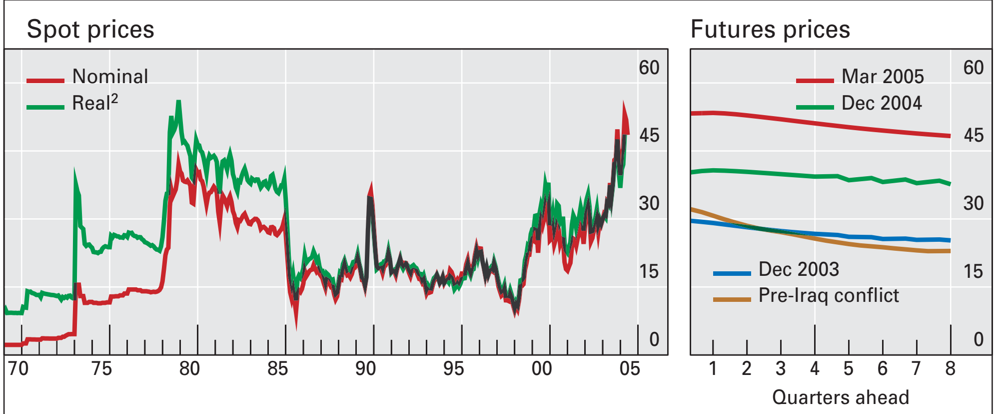
Booming oil demand ...

Commodity prices have been driven by a number of common factors. The strong global expansion of manufacturing has raised the demand for primary inputs and, given low short-run supply elasticities, lifted prices. A key factor for oil prices has been the increasing concentration of global growth on a number of oil-intensive economies in Asia. As a result, the growth of global oil demand accelerated from less than 1% in 2002 to 3½% in 2004. China alone accounted for about one third of incremental oil demand last year, and other Asian economies an additional 17%.

... and tight supply constraints ...

At the same time, despite increased production by non-OPEC countries, global oil supply has become progressively tighter, reflecting a long period of low investment in the oil sector. The spare capacity of OPEC (excluding Iraq) has fallen to very low levels in recent months – between 1 and 2 million barrels a day or about 2% of global oil supply. Such tight market conditions have accentuated the oil price reaction to recent adverse factors such as growing uncertainty about supply from the Middle East and recurrent production disturbances in non-OPEC countries. Temporary refinery constraints in converting heavier crude into transportation fuel have also contributed to a widening price differential between lighter and heavier crude. The difference between the lighter Brent and heavier Dubai benchmark crude widened from

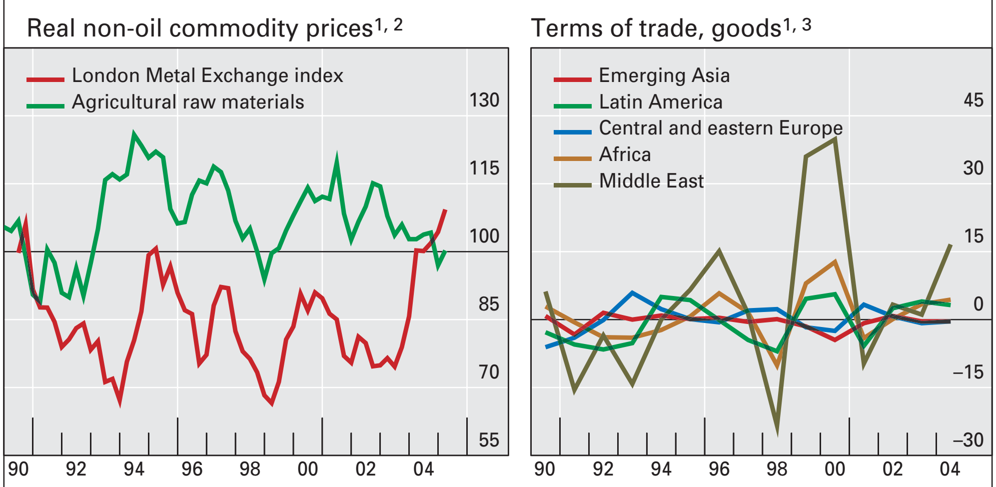
Brent oil prices[1]



[1] Monthly averages, in US dollars per barrel. [2] Deflated by world export prices; base year 1990.

Sources: IMF; Bloomberg. Graph III.4

Non-oil commodity prices and terms of trade



[1] Average of period. [2] 1990 = 100; deflated by world export prices. [3] Annual changes, in per cent. Country coverage according to the IMF.

Sources: IMF, *World Economic Outlook*; Datastream; national data. Graph III.5

less than \$3 a barrel in 2003 to about \$14 a barrel in mid-October 2004 before falling back considerably in the past few months.

... may imply a fundamental change in the oil price outlook

Expectations that the medium-term level of oil prices will remain high have also had a major impact. In the early part of the cycle, for example, when spot prices were pushed up to high levels, oil futures prices rose less rapidly or even declined on the expectation that the shock would be temporary. In February 2003, for instance, the spot price of Brent stood 27% above the one-year futures price. In contrast, in more recent months, both spot and futures prices have tended to move together. The upward shift of oil futures curves across the entire maturity range since the beginning of 2003 (Graph III.4, right-hand panel) suggests a change in the fundamental outlook for the level of oil prices.

Yet another factor has been the role of current low real interest rates. With yields from financial assets remaining low or falling and the scarcity value of oil rising, some non-commercial investors have been increasingly attracted to the commodity market. The greater use of commodities as a hedge against future dollar depreciation may also have added to this trend. One indicator of the growing role of non-commercial traders is the recent sharp rise in their positions on oil futures. At the same time as long positions in the New York Mercantile Exchange – the largest segment of the oil futures market – more than tripled between January 2002 and March 2005, the share of non-commercial traders rose from about one quarter to two fifths (see Chapter VI).

Terms-of-trade gains for exporters ...

The boom in commodity prices has boosted the terms of trade of most commodity-exporting countries (Graph III.5, right-hand panel). Last year, export windfalls from higher oil prices are estimated to have exceeded 8% of GDP in oil-exporting countries. Gains were also substantial for major non-oil commodity exporters such as Brazil and Chile. In Chile, for instance, revenue from copper increased by over 80% in 2004. A number of African countries have also experienced significant gains from commodity exports.

For oil-exporting countries, dealing with oil windfalls has not proved easy in the past, particularly during the second oil shock in 1979. In many countries, the revenue gains were assumed to be permanent, and led to structural increases in government spending programmes. When the gains proved only temporary, underlying fiscal imbalances became apparent. Such policy challenges were often compounded by currency appreciation and a loss of competitiveness. When oil prices subsequently collapsed in the 1980s, many oil-exporting countries experienced difficulties.

… but better managed than in the past

In the current cycle, however, responses to windfall gains appear to have improved in a number of commodity exporters. One reason is that many countries now have established procedures (eg commodity stabilisation funds) and specific fiscal rules to deal with revenue volatility. Last year, for example, Mexico transferred excess oil revenues amounting to $1 billion to an oil stabilisation fund established in 2000. Moreover, a large part of such revenues was earmarked for infrastructure investment, including in the oil sector. In Algeria, the outstanding balance in the oil stabilisation fund, which was established in early 2000, had risen sharply in relation to GDP by December 2004. Russia also set up such a fund last year. A second welcome response is that many oil-exporting countries have used a large part of their oil revenues to repay outstanding debt. In Saudi Arabia, the government has reduced the public debt to GDP ratio by 32 percentage points since 2002. Payments to cut outstanding debts have also been significant in Algeria and Russia. To the extent that exceptional revenues in oil stabilisation funds were invested abroad or were used to repay debts, they might also have helped to contain short-term pressures for currency appreciation.

One possible risk for commodity exporters is that a combination of strong global demand and sharp increases in commodity prices across the board might lead to expansions in production capacity that could later prove to be unprofitable. If supply came on line after demand had begun to subside, experience would suggest that price reversals could be both sudden and

Importance of oil

	Net oil imports[1]			Oil consumption[2]		
	1995	2000	2003	1995	2000	2003
Asia	1.1	2.2	2.2	0.15	0.15	0.14[3]
China	0.2	1.3	1.5	0.18	0.17	0.15
India	1.9	3.1	2.8	0.16	0.16	0.15[3]
Korea	2.4	4.2	3.8	0.14	0.12	0.11
Other Asia[4]	0.6	1.5	1.9	0.14	0.15	0.15[3]
Latin America[5]	–1.2	–2.1	–2.4	0.12	0.12	0.12[3]
Central Europe[6]	1.5	2.0	1.4	0.10	0.09	0.08[3]
Memo: G7 countries	*0.5*	*0.9*	*0.9*	*0.06*	*0.05*	*0.05*

[1] Petroleum, petroleum products and related materials (SITC Rev. 3), as a percentage of nominal GDP. Negative values indicate that exports exceed imports. [2] Barrels per unit of GDP at 1995 prices and US dollar exchange rates. [3] 2002. [4] Hong Kong SAR, Indonesia, Malaysia, the Philippines, Singapore and Thailand. [5] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [6] The Czech Republic, Hungary and Poland.

Sources: United Nations, *Commodity Trade Statistics*; WTO; US Energy Information Administration; national data. Table III.3

large. The growing links between financial and commodity markets could accentuate volatility in commodity prices even further. Such considerations may partly explain why investment in commodity-producing sectors has remained moderate to date, in spite of higher profits.

The effects of oil price increases ...

For oil-importing countries, higher oil prices raise inflation and reduce aggregate demand. Asia tends to be particularly hard hit because of its marked dependence on imported oil and higher oil intensity of output (Table III.3). Estimates by the International Energy Agency suggest that a sustained $10 per barrel increase in oil prices would cut GDP growth by close to 1 percentage point in Asia, a year after the shock, while inflation might rise by 1½ percentage points.

... have been muted

The output effects of higher oil prices in most oil-importing emerging markets appear to have remained muted so far. Part of the reason is that strong global demand and a general upturn in the prices of Asian exports have contained the adverse terms-of-trade implications. For example, in contrast to a decline of about 1% during 2000–02, export prices in developing Asia increased by over 7% in the past two years.

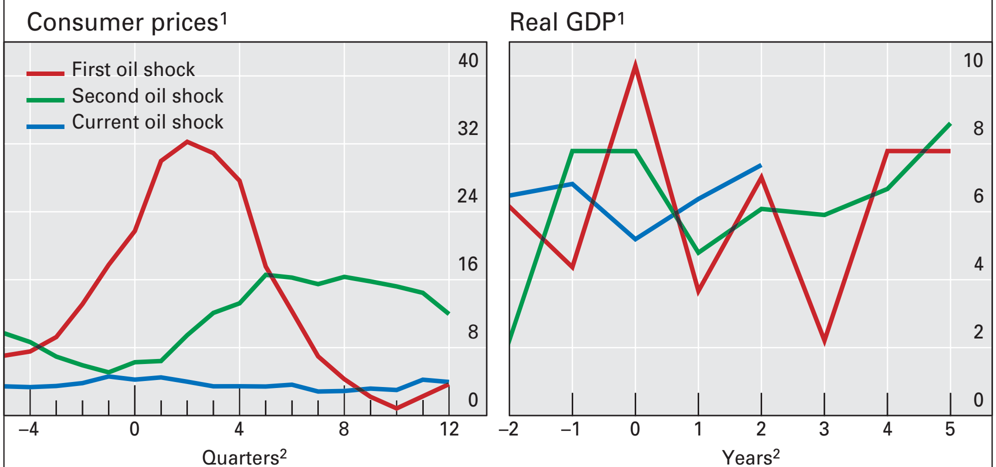
Inflation is comparatively low ...

Such developments could well have raised domestic inflation even more. As noted earlier, headline inflation rates in a number of countries have indeed risen – most notably in India and the Philippines. Nevertheless, the impact has remained muted, particularly when compared with the experience during the first and second oil crises in 1973 and 1979, which were associated with inflationary pressures throughout Asia (Graph III.6).

... owing to the different cycle ...

There are a number of reasons for this muted behaviour. First, the underlying cycle has been different. In earlier episodes, inflation was already accelerating before oil prices rose markedly: the negative supply shock was thus associated with much higher inflation. In contrast, in the current episode,

Inflation and growth in Asia following oil shocks



[1] Annual changes, in per cent. Weighted average of China (except for inflation), Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand, based on 2000 GDP and PPP exchange rates. [2] Zero quarters/years correspond to 1973 Q4/1973 (first oil shock), 1978 Q4/1978 (second oil shock) and 2001 Q4/2001 (current oil shock).

Sources: IMF; national data. Graph III.6

the increase in oil prices has followed upon several years of low inflation. To the extent that inflation expectations are better anchored, this may have contributed to reducing second-round effects (see below).

… and large oil subsidies in Asia

Second, several Asian economies have administered prices for oil. Increases in domestic oil prices were then postponed, which in effect provided direct fiscal subsidies. Some countries have also reduced taxes on imports and sales of oil to partly offset higher international prices. Oil subsidies remained particularly high in India, Indonesia, Malaysia and Thailand last year. Such policies inevitably weaken fiscal positions, blunt incentives to limit oil use and thus exacerbate oil dependency. Many Asian economies have therefore more recently begun to pass on higher oil prices to consumers. Third, in some countries with flexible exchange rates, currency appreciation against the dollar may have helped contain the direct impact of higher oil prices.

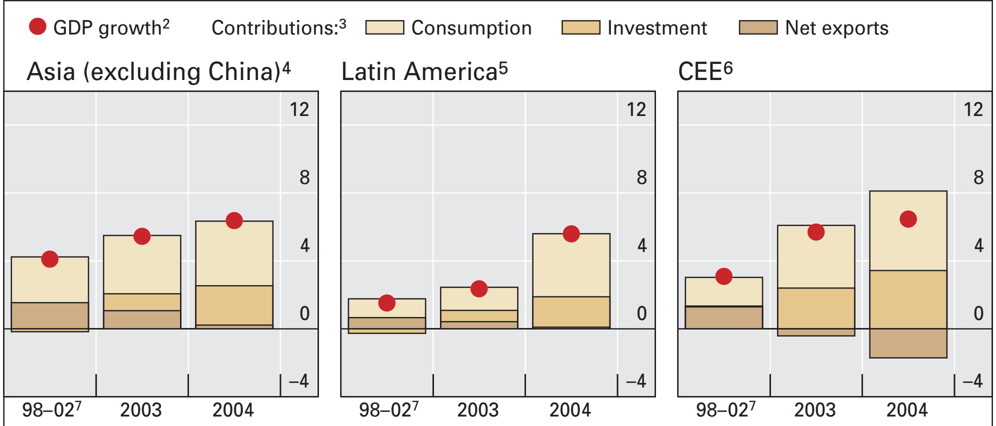
Factors influencing resilience to external shocks

The authorities in many emerging market economies are faced with a still relatively weak fiscal structure, a more formal framework for monetary policy that is of only recent vintage, and a marked degree of exposure to external financial shocks. Yet several developments over the past two years could help enhance emerging market economies' resilience to external shocks.

The influence of stronger corporate balance sheets …

First, domestic demand has played a much greater role in the past two years than previously (Graph III.7). Such a development might better cushion growth should global demand slow sharply. Moreover, the sustainability of domestic demand might be helped by the fact that it has been accompanied by structural reforms to boost private sector investment. In Asia, the expansion has followed a period of corporate restructuring, as firms have reduced debt levels and improved their profitability. In Korea, for instance, the debt/equity

Contributions to GDP growth[1]



[1] Weighted average of the economies listed, based on 2000 GDP and PPP exchange rates. [2] In per cent. [3] In percentage points. [4] Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [5] Argentina, Brazil, Chile and Mexico. [6] Central and eastern Europe: the Czech Republic, Hungary, Poland, Russia and Turkey. [7] Annual average for the period.

Sources: United Nations; CEIC; JPMorgan Chase, *World Financial Markets*; national data. Graph III.7

ratio in the manufacturing sector fell from close to 400% at the end of 1997 to about 100% at the end of March 2004. In India, business spending has been underpinned by strong corporate earnings. In Latin America, investor confidence has improved substantially following important structural reforms. In Chile and Mexico, for example, capital spending has been supported by a significant increase in productivity growth. In central and eastern Europe, a special factor in recent years has been convergence towards the European Union, which has strengthened capital inflows and promoted foreign investment in the region.

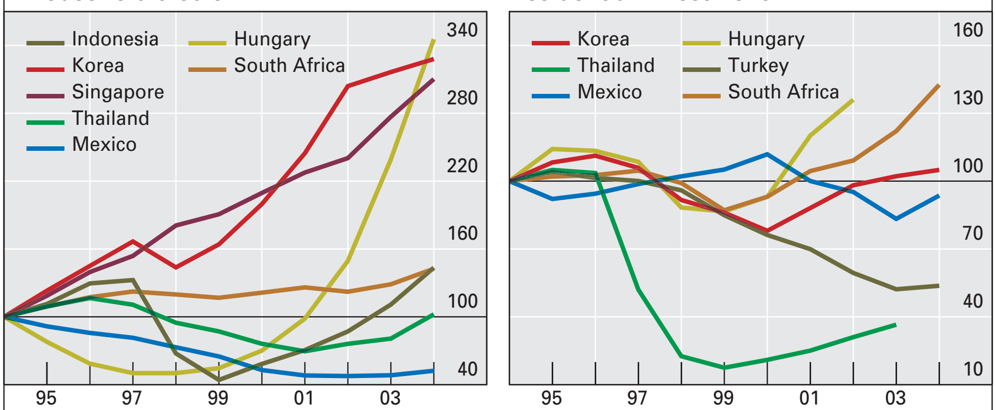
... and household spending

Second, households have played a more important role in domestic demand developments than in previous cycles. In particular, many countries with an inadequate housing stock have seen a sharp rise in residential investment over the past few years (Graph III.8), and in spending on household durables. While low mortgage and consumer financing rates have encouraged households to borrow, banks became more willing to lend to households in the wake of corporate losses during and after the Asian crises. Other factors such as credit market liberalisation and increased competition in retail banking, often led by foreign banks, have also played a major role.

Strong household demand partly structural ...

In countries where household debt/income ratios remain low, and the banking system is well equipped to manage new types of risks arising from exposure to the credit card and property sectors, lending to households could well rise further without difficulties emerging. In many countries, the demand for housing and consumer durables appears to be driven by such secular factors as rising household income and urbanisation, as well as the growing realisation that home ownership is a realistic option. In India, for instance, such a trend has been supported by the growing size of the middle income segment of the population. Some credit allocated to households is actually credit to small businesses, and may reflect the growing importance of the services sector. In Latin America, the recent reduction in interest rate volatility – which

Household credit and residential investment[1]



[1] In real terms; 1994 = 100. [2] For 2004, partly estimated. [3] For Korea, Mexico and Turkey, private residential investment only.

Sources: OECD; United Nations; CEIC; national data. Graph III.8

in the past inhibited the development of the mortgage finance market – has been another particularly important factor.

... but with a risk of overborrowing

Nevertheless, there are also potential risks. Households might borrow too much. As Korea's experience suggests, a sharp rise in the household debt/income ratio could curtail future household spending. In Korea, the adjustment involved a contraction in outstanding household debt, from about 64% of income at the height of the credit card bubble in 2002 to 60% of income at the end of 2004. Following several quarters of decline, private consumption picked up only towards the end of 2004. Another risk is that the rapid growth in household credit might lead to excessive increases in property prices. For instance, in Thailand, residential and commercial property prices have been rising strongly since 2003. In Shanghai, real estate prices were, by the first quarter of 2005, rising at about 20% a year, and the nationwide index by about 10%. Finally, the financial sector could also be hurt by a decline in property prices (see below).

Greater exposure to China

A third development has been the greater exposure to China. The combined trade surplus of major emerging economies vis-à-vis China increased from about $7 billion in 2000 to $30 billion last year. Because of their proximity and trade complementarities, the impact has been strongest on Asian economies, but the effect on Latin America has also been important. In addition, China has contributed to improving the terms of trade of most commodity exporters.

The growing Chinese penetration of specific export markets could, however, also create some challenges for other emerging markets. Since the abolition of export quotas in textiles at the beginning of 2005, there has been a sharp increase in China's textile exports. Moreover, given their cost and productivity advantages, both China's and India's share of textile exports is expected to rise, putting pressure on other textile-exporting countries to adjust.

Reduced fiscal vulnerability?

The ratio of the fiscal deficit to GDP declined in several emerging market countries last year (Table III.4). In Asia, for instance, average fiscal deficits have fallen from the high levels reached in 2001 and 2002, when many countries provided fiscal stimulus to boost domestic demand. Nevertheless, fiscal deficits remain large in India and the Philippines, and debt-to-GDP ratios have in some cases risen. In China, although conventional fiscal ratios improved, they do not reflect the large contingent liabilities arising from the actual and potential cost of bank restructuring (see below).

Low fiscal deficits in Latin America

Significant improvements in fiscal positions have recently been recorded in Latin America, particularly in countries exposed to international capital markets. In Argentina, the federal government primary surplus rose from a little over 2% of GDP in 2003 to 4% in 2004, exceeding the target of 2½% agreed with the IMF. In January 2005, the government relaunched the debt restructuring programme it announced last year. If successful, this would have a substantial impact on the country's medium- to long-run fiscal position. Similarly, with its primary surplus rising to over 4½%, Brazil recorded a reduction in the net public debt ratio in 2004, the first time in the past decade.

Fiscal balances and public and external debt[1]

As a percentage of GDP

	Fiscal balance			Government debt			Total external debt	
	2002	2003	2004	1997	2000	2004	2000	2004
Asia[2]	–4.4	–4.1	–3.5	26	41	43	27	21
China	–3.0	–2.5	–1.5	11	22	25	14	14
India[3]	–9.5	–9.4	–9.1	59	66	78	25	19
Other Asia[2, 4]	–1.8	–2.0	–1.8	25	55	45	58	41
Latin America[2, 5]	–2.8	–2.5	–0.9	37	45	59	37	43
Argentina	–1.5	0.5	2.7	35	46	121	55	111
Brazil	–4.6	–5.1	–2.7	34	49	52	36	34
Mexico	–1.2	–0.6	–0.4	47	42	44	26	21
Central Europe[2, 6]	–5.2	–6.5	–4.3	40	36	45	45	42
Russia	1.3	1.5	3.0	54	56	20	67	36
Turkey	–12.6	–8.8	–3.9	53	57	81	60	53
South Africa	–0.7	–2.5	–2.1	49	44	38	28	19

[1] Definitions differ across countries. Some 2004 data are estimates and projections. [2] Weighted average of the economies listed, based on 2000 GDP and PPP exchange rates. [3] For government debt, fiscal years beginning in April, of central and state governments. [4] Indonesia, Korea, Malaysia, the Philippines and Thailand. [5] Argentina, Brazil, Chile, Mexico and Peru. [6] The Czech Republic (except for external debt), Hungary and Poland.

Sources: Asian Development Bank; Economic Commission for Latin America and the Caribbean; IMF; European Commission, *Economic Forecasts*; Institute of International Finance (IIF); JPMorgan Chase, *Emerging Markets Debt and Fiscal Indicators*; Moody's; national data.

Table III.4

Public debt ratios also fell in Chile, Mexico and Peru last year. These countries either increased their primary surpluses or used part of the revenue from higher commodity prices to retire outstanding debts.

Better debt composition

In several cases, the composition of debt has also improved. One indicator of this has been a greater reliance on domestic rather than foreign borrowing in fiscally vulnerable countries. In Brazil and Mexico, for instance, the share of domestic public debt in total outstanding debt increased by about 5 percentage points last year. Another indicator is the declining share of short-term liabilities in total domestic debt in certain countries, which has lowered the refinancing risk. Moreover, the fiscal authorities in some countries have been able to cut their exposure to currency risks by reducing the share of debt that is linked to the exchange rate. For example, in Brazil the share of dollar-indexed bonds in total domestic debt fell from 37% at end-2002 to 10% by end-2004.

Similarly, the fiscal situation has improved markedly in Turkey since the crisis in 2001. The consolidated public sector primary surplus increased to 6½% of GDP last year. The authorities also reduced the share of foreign currency-linked securities in total domestic debt to 18% at the end of 2004, down from 36% at the end of 2001. Turkey's improved fiscal position enabled it to enter a new standby agreement with the IMF in May 2005.

In contrast, in central Europe fiscal imbalances remain large. Hungary last year lowered its budget deficit to 4½% of GDP from over 7% in 2002–03. The 2004 deficit in Poland was lower than originally projected because of strong economic growth in 2004; yet the fiscal imbalance remained high.

Fiscal balances in Africa generally improved last year, reflecting higher growth and commodity prices as well as efforts to strengthen fiscal management in several cases. In South Africa, with the government stepping up infrastructure and social sector spending, fiscal policy at the national level has been expansionary.

Sustainability of fiscal improvements?

One reason for optimism that recent improvements will endure is that several countries have introduced fiscal responsibility legislation that aims explicitly to discipline fiscal policy. A notable example is Chile, which introduced a structural budget surplus rule of 1% of GDP in 2000: it has adhered to this rule in both the downward and upward part of the cycle. With rising copper revenues, the overall budget surplus increased to over 2% of GDP last year. In Brazil, the 2000 fiscal responsibility law has had a similar impact by setting a primary surplus target for each level of government and prohibiting unfunded permanent spending programmes. This has had the effect of insulating fiscal programmes from electoral cycles. The law has probably enhanced investor confidence, contributing to the reduction in the large risk premium that the country previously had to pay on its foreign currency debts. Fiscal responsibility laws have recently been introduced in other countries as well, including Colombia, India and Peru.

Nevertheless, optimism about permanent fiscal improvements must be tempered. Economic conditions during the past two years have been very favourable for fiscal authorities. As strong growth has boosted tax revenues, low domestic and external interest rates accompanied by appreciating exchange rates have sharply reduced debt servicing costs. Moreover, debt levels are still too high in a number of countries. In some cases, a high share of floating rate and short-term debt in total domestic debt will constitute a significant exposure once the current phase of easy global monetary conditions comes to an end. In Brazil and Turkey, for instance, floating rate debt represented about 50% and 40%, respectively, of total debt at the end of 2004. In Asia, given the large financing cost of oil subsidies, budget balances remain especially vulnerable to higher oil prices.

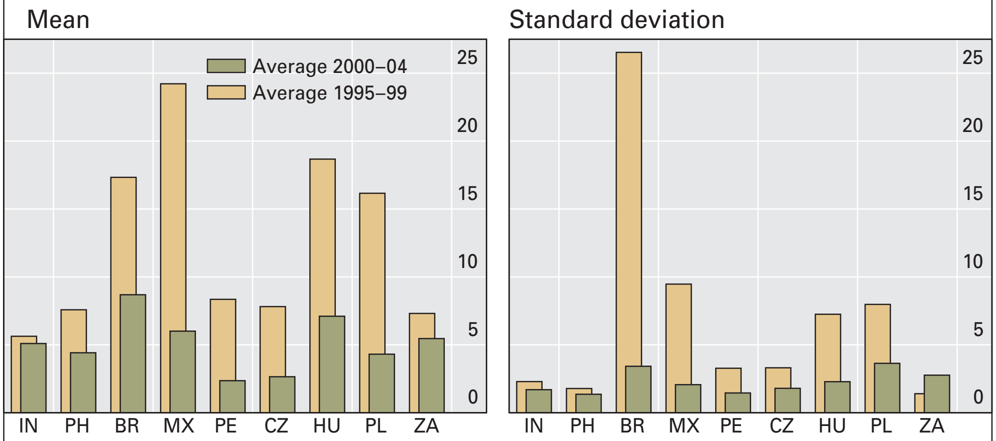
More stable inflation?

The average inflation rate in emerging economies as a whole fell from 13% in the second half of the 1990s to 5½% in 2000–04. The most notable reductions have taken place in countries with historically medium to high inflation rates (Graph III.9). At the same time, inflation volatility has fallen sharply in most cases. To the extent that inflation is seen to be under control, it could enhance investor confidence and reduce risk premia on the debts of emerging economies. In addition, low inflation should give central banks more flexibility in responding to real shocks, including relative price shocks.

Monetary regime changes foster low inflation

As discussed in Chapter II, a number of global forces have driven inflation to low levels: the greater contestability of markets; reduced pass-through of exchange rate and commodity price changes into final consumer prices; and, in some cases, significant productivity improvements. Consistent with this, core inflation has remained low in many emerging economies in recent years (see Graph II.4 in Chapter II). However, lower inflation also reflects the

Inflation[1]



BR = Brazil; CZ = Czech Republic; HU = Hungary; IN = India; MX = Mexico; PE = Peru; PH = Philippines; PL = Poland; ZA = South Africa.

[1] Annual change in consumer prices (for India, wholesale prices), in per cent.

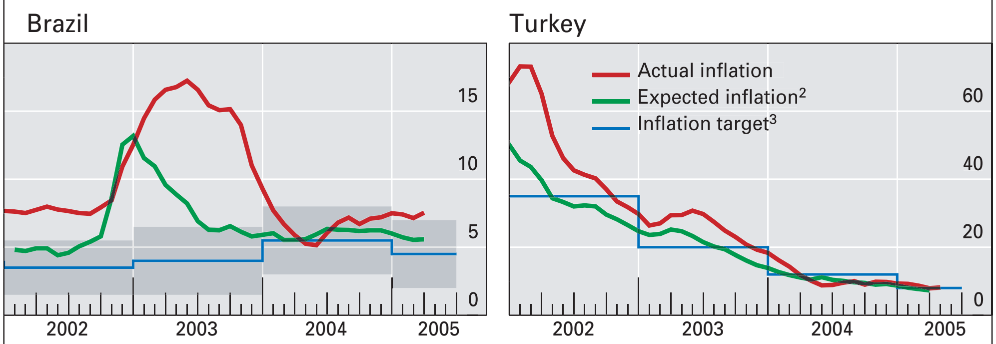
Sources: IMF; national data; BIS calculations. Graph III.9

maturing of new monetary policy frameworks in emerging economies, where the authorities have either introduced explicit inflation targeting or otherwise sharpened their focus on inflation control. The average inflation rate of the 12 major emerging market economies that have adopted formal inflation targeting regimes has fallen from 11% during the three years preceding the introduction of the regime to 5% thereafter.

Greater central bank credibility

In several cases, sounder monetary and fiscal policies seem to have been reflected in the growing credibility of the authorities and lower inflation expectations. In recent years, for instance, long-term bond rates in many countries – especially in Latin America – have become more stable. In addition, inflation expectations appear to have fallen particularly sharply in countries where they had been high and volatile. In Brazil, for example, a combination of

Inflation expectations and outcome[1]



[1] Annual changes in headline consumer prices, in per cent. [2] Twelve months ahead. [3] For Turkey, implicit end-year target; official target not yet introduced.

Source: National data. Graph III.10

tight fiscal and monetary policy has brought inflation down again, following the overshooting of the target in 2002. Moreover, the private sector responded with a very short lag by sharply reducing its inflation forecasts (Graph III.10). Similarly, Turkey has successfully stabilised both actual and expected inflation below double digits in recent months. In both cases, however, real interest rates remain high. This suggests that the inflation risk is still present in the minds of financial sector participants, even if average inflation expectations are much lower.

Reduced external vulnerability?

Current account surpluses and foreign exchange reserves in emerging market economies have increased, partly in response to more responsible and stable macroeconomic policies. External debt-to-GDP ratios have also fallen (Table III.4) along with debt service ratios. In Chile, for example, the central bank used foreign reserves to repay its foreign currency denominated domestic debt coming due within a year. Russia has also used part of its foreign reserves to pay back its debts to the IMF. Improvements such as these were reflected in a string of sovereign rating upgrades in the second half of 2004.

A possible turn in the credit cycle

The main vulnerability may lie in a possible turn in the international credit cycle, which could provoke a simultaneous worsening of the terms of trade and widening of credit spreads. A second concern is that short-term external debt as a proportion of the total has remained relatively high in a number of emerging markets. Short-term external debt averaged 11% of the total in Asia and 13% in Latin America in 2004 (3% and 6% of GDP respectively). A number of explanations can be offered: private sector issuers may not have easy access to external long-term credit, and short-term debt can appear cheaper. Moreover, some governments seem to have relied more heavily on the accumulation of foreign exchange reserves than on lengthening maturities on debt to reduce external debt vulnerability.

Reserves have risks

Foreign reserve accumulation was particularly strong in Asia in 2004, but has also been significant in other emerging market regions. The financing costs of this have been reduced by relatively low domestic interest rates. In Brazil, the central bank stepped up its efforts to acquire foreign reserves in advance of the government's decision to discontinue its IMF programme in March 2005. In many cases, however, accumulated foreign reserves now exceed common measures of reserve adequacy in emerging economies. For example, at the end of 2004, the ratio of gross reserves to short-term external debt was well above the conventional threshold of 1 in almost all countries. In response to such reflections, and recognising the carrying costs of reserves, Mexico has sought to limit reserve accumulation: a portion of the increase in foreign reserves is automatically sold if it exceeds a certain threshold.

Are banking systems stronger?

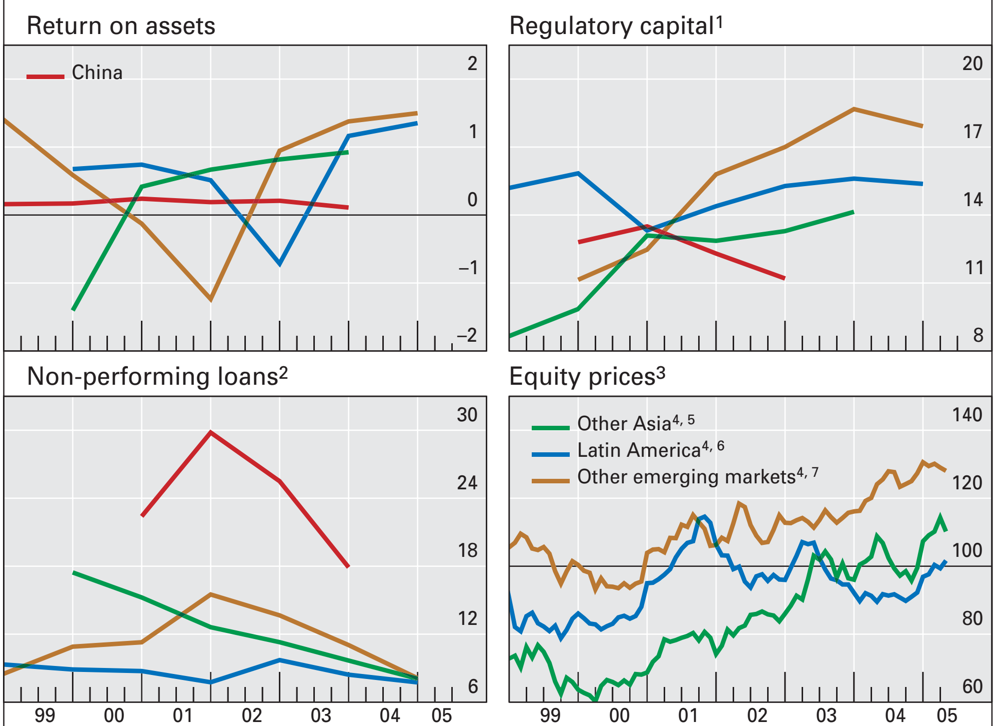
Improved bank performance ...

The medium-term outlook for emerging market economies has been helped by a significant and broad-based improvement in bank performance. First, profitability as measured by the return on assets (Graph III.11, top left-hand panel) has tended to rise. This was particularly the case in 2004, when banks in a number of emerging market economies recorded high profits. Cyclical factors, such as strong growth and low global interest rates, have doubtless played a role in boosting profitability. In India, for instance, strong demand and the revival in industrial activity have increased lending and associated interest revenues, while declining long-term interest rates from 2001 to 2004 allowed Indian banks to book profits from sales of government securities. Moreover, in several countries earlier financial sector difficulties are being overcome. For example, in Korea, bank earnings increased fivefold in 2004 as problems with household credit eased.

… stronger balance sheets …

Second, the quality of banks' balance sheets has improved. Regulatory capital ratios have risen in some regions (Graph III.11, top right-hand panel). In Brazil, for instance, capital ratios have risen in recent years to average 18.3% in 2004, well above the 11% minimum requirement. Capital ratios averaged around 12% in Korea and Thailand in 2004, and over 20% in Turkey. In some cases, higher capital ratios reflect the recapitalisation of banking systems, either by governments in the aftermath of crises in the late 1990s, or by foreign investment in the banking sector. However, increases in profitability, at times associated with significant reductions in non-performing loans (NPLs), have also played an important role. The decline in NPLs has been particularly sharp

Banking indicators



[1] As a percentage of risk-weighted assets. [2] As a percentage of total loans. [3] Relative to overall equity price indices; 1995–2004 = 100. [4] Weighted average of the economies listed, based on 2000 GDP and PPP exchange rates. [5] Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. [6] Argentina, Brazil, Chile, Colombia, Mexico and Peru. [7] The Czech Republic, Poland, South Africa and Turkey.

Sources: IMF, *Global Financial Stability Report*; Datastream; Fitch Ratings. Graph III.11

in Asia (Graph III.11, bottom left-hand panel), although high NPLs remain an issue in the Philippines, Thailand and China (see below). While these data clearly point to improvements, they must also be interpreted with caution. For example, the rise in capital ratios in some cases could reflect just a temporary reduction in risk-weighted assets. This would be the case if a fall in the price volatility of banks' assets, in the current relatively benign financial environment, lowered estimates of market risk. Capital ratios could then decline again should volatility increase. Other issues regarding the measurement of capital adequacy in emerging market economies are discussed below.

… better market sentiment …

Improvements in bank performance have been mirrored by better market sentiment. As illustrated in Graph III.11 (bottom right-hand panel), the ratio of bank stock price indices to overall stock indices has in recent years tended to rise or has remained flat in most major emerging market regions, even as stock prices have broadly risen. In emerging Asia, excluding China, relative prices of bank stocks have done particularly well on average, although there have been marked differences across countries. In India, the relative index has more than doubled since 2000, but it only remained flat in Indonesia. In further contrast, the relative index has broadly declined in Korea and Singapore, and fallen even more steeply in the Philippines and Thailand. In Latin America, relative bank stock prices in Mexico have performed better than the (flat) regional average. Finally, relative bank stock prices have tended to rise in recent years in central Europe and Turkey, and also South Africa, but have declined sharply in Russia since its crisis in 1998.

… but limited increase in financial strength?

Another measure of the underlying resilience of banking systems provides fewer grounds for optimism. One widely used indicator of the likelihood of a financial institution requiring outside financial support has generally remained flat or improved only modestly in recent years. This suggests that a significant part of the improvement in bank performance indicated by financial statements largely reflects cyclical factors. In particular, recent credit rating upgrades of external bank debt in emerging markets reflect not just the improvement in banking sector fundamentals, but also the greater ability of governments to support the financial sector. This capacity has also been reflected in recent sovereign upgrades.

China's banks: hard to gauge

The situation of banks in China is particularly difficult to gauge. On the one hand, available data suggest declining returns on assets and lower bank regulatory capital in recent years. On the other hand, there have also been marked reductions in NPLs. China has invested massive resources to recapitalise banks and deal with their NPL problems. The government issued 270 billion yuan, or about $32.5 billion, in special treasury bonds to recapitalise banks in 1998, and established asset management companies to assume 1,000 billion yuan in NPLs in 1999. Since 2003 the government has allocated $60 billion in foreign exchange reserves to recapitalise major banks. This has also been associated with NPL write-offs.

It may also partly be the case that NPL ratios have fallen in recent years due to rapid credit growth. If the credit quality of new loans is low, however, this could reverse. Much will depend on the extent to which credit allocation is now based on likely economic returns rather than government guidelines.

According to a survey by the People's Bank of China, government-directed lending, defaults by state enterprises on directed loans and local government involvement in credit decisions were important contributors to earlier NPLs. Sentiment towards the corporate sector, including banks, has been hurt by widely publicised corporate governance problems. However, the government is taking steps to address these problems in the banking sector through changes in management and diversification of ownership.

Factors influencing risks in the banking sector

Four sources of risk

The resilience of the banking sector will depend on the types of risks to which it is exposed. Four aspects deserve attention: first, exposures arising from the rapid growth in credit to households; second, the risks from exposure to currency mismatches; third, the significant banking sector exposure to long-term government debt; and finally, exposures arising from changes in banking structure and an increasingly competitive environment.

Increased lending to households

As noted earlier, the pickup in economic activity in emerging economies during recent years has been associated with much higher lending to households. This reflects greater demand for credit, due to the factors cited earlier, as well as increased supply due to the perception that credit to households offers banks a profitable and comparatively safe opportunity to diversify away from lending to corporations. This shift to household credit could lead to banking problems. Credit card debt has expanded rapidly and the sharp rise in delinquencies on credit card debt has already created significant problems in Korea in recent years. Mortgage debt is safer for banks than other types of consumer credit because of the collateral provided by the house, but the rapid price increases highlighted earlier underline the need for caution. A reversal in house prices would expose banks directly to default risks on property-related loans. Moreover, it could have indirect effects as well if reductions in household wealth and consumption (see Chapter VII for a fuller discussion of these effects in the context of developed markets) were to have macroeconomic consequences and further increase loan losses.

Policy responses

Policy responses in a number of emerging markets also indicate concerns that existing prudential arrangements and market mechanisms might not be able to contain the risks to banks associated with sharp increases in property prices. For example, although the rise in property prices has moderated in Korea, the government has maintained measures to penalise speculation in property markets, and in some instances has prohibited real estate transactions until perceived speculative pressures ease. In early 2005, the Chinese authorities sought to dampen property price increases in some cities, especially Shanghai, by various administrative means. They raised down payment requirements to 30% from 20%, while eliminating the favourable interest rate previously applied to mortgage financing. In addition, they imposed a 5.5% tax on price gains on property sold within 12 months of purchase. In Thailand, the down payment has also been increased.

Financial innovations mitigate risks

Recent financial innovations can reduce the risks arising from lending to households, or can allow these risks to be distributed more widely. With respect to risk reduction, the spread of credit bureaus is improving the ability to

Private sector currency mismatches are a concern ...

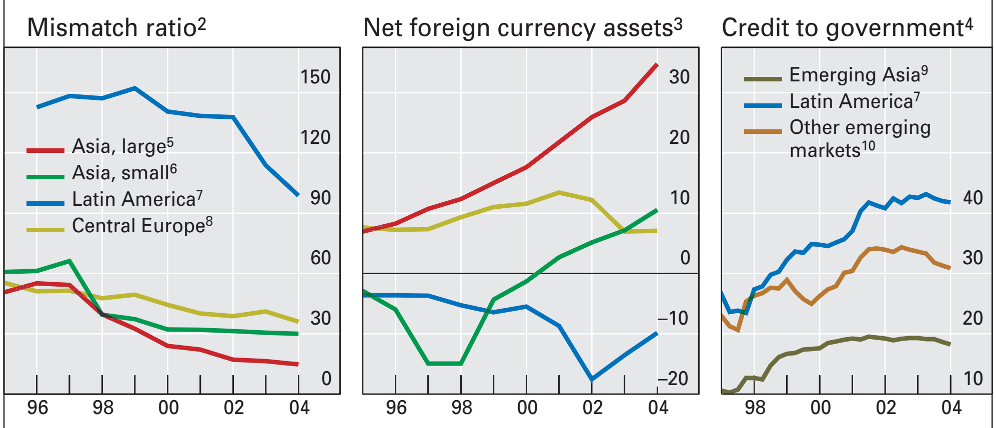
... as is exposure to government bonds

assess borrowers' debt servicing capacity. As for risk distribution, debt is increasingly being securitised or repackaged in other ways that limit the exposure of creditors. For example, Korea's mortgage-backed securities market grew significantly in 2004, and a number of cross-border securitisation transactions have already been completed. Moreover, various countries, including China and Thailand, have also taken steps that could lead to the securitisation of mortgages in the near future. Many of these innovations, however, could themselves pose risks that are imperfectly understood.

A second risk to which banking systems might be exposed is currency mismatches in the economy as a whole. During the past decade, the degree of currency mismatch in the main regions has fallen sharply, as indicated by a measure of the size of foreign currency debt relative to exports. Net foreign currency balances have also improved (Graph III.12, left-hand and centre panels). However, in some countries (particularly in Asia), this reflects large central bank foreign reserves; indeed, private sector foreign currency mismatches remain significant in a number of countries. This points to the need to ensure that the financial sector is taking adequate care to manage the risks associated with these mismatches.

A third cause for concern is the banking sector's exposure to government, which has tended to rise in all emerging market regions (Graph III.12, right-hand panel). In some cases, increases in bank holdings of public debt reflect the recapitalisation of banks in the aftermath of crises. In other cases (eg India), banks have traditionally been major holders of government bonds. This raises the possibility that banks might face associated market risk: higher long-term interest rates could create capital losses, and such risks are not always hedged in emerging market economies.

Indicators of currency mismatch and credit to government[1]



[1] Weighted average of the economies listed. [2] Foreign currency share of total debt divided by the ratio of exports to GDP. [3] Estimate for banks and non-banks including foreign currency securities outstanding, as a percentage of GDP. [4] Banks' claims on central government as a percentage of total claims on central government and the private sector. [5] China, India, Korea and Taiwan (China). [6] Indonesia, Malaysia, the Philippines and Thailand. [7] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [8] The Czech Republic, Hungary and Poland. [9] Large and small Asia excluding Taiwan (China) and including Hong Kong SAR. [10] Central Europe, South Africa and Turkey.

Sources: IMF; national data; BIS. Graph III.12

Finally, the resilience of the banking sector also depends on competitive pressures and structural characteristics. Such pressures have intensified in many countries, which can encourage increased bank efficiency. At the same time, pressures on profitability, brought about by stronger competition, in effect reduce the franchise value of the banking sector and encourage a switch into potentially riskier non-traditional business lines (see Chapter VII for further discussion of issues of bank profitability in the context of developed markets). Competitive pressures have not been consistently reflected in falling net interest margins, which are also influenced by a number of other factors (Graph III.13). For example, net interest margins have declined over time in Mexico, but risen recently in Brazil. However, non-interest expenses have fallen in some emerging markets, indicating higher efficiency, and the share of other operating (non-interest) income in total revenues in some emerging markets has risen, as banks have begun to move beyond traditional commercial bank lending activity. These welcome trends are all already well established in the industrial world, as a result of competitive pressures (see Chapter VII).

Competitive pressures have risen

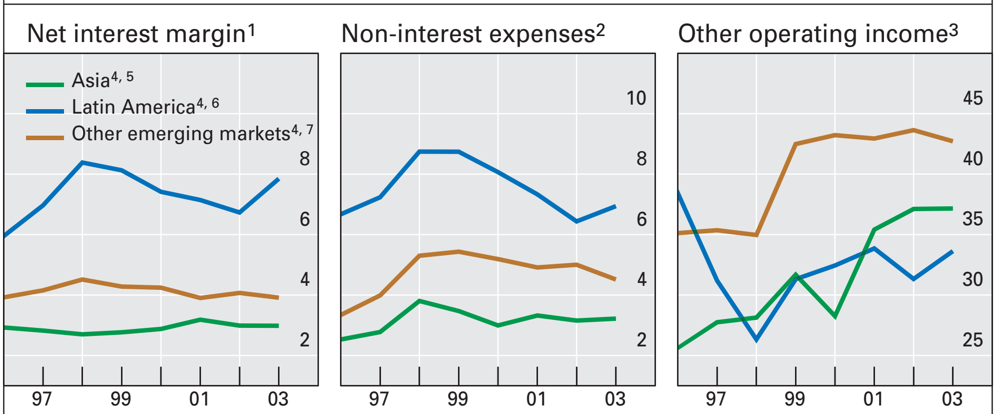
At the same time, three particular trends in market structure might contribute to a greater resilience of the banking sector. First, an extended decline in bank concentration up to the mid-1990s has since shown signs of stabilising or reversing in a number of economies. Research indicates that increases in bank concentration reduce the probability of banking crises. The reason is that larger banks can diversify risk more readily, are able to earn higher profits, and are more easily monitored by depositors.

Concentration …

A second trend has been to a lower, albeit in some countries still large, share of assets held by public banks. A large public bank presence tends to inhibit financial market development. Moreover, public banks in emerging markets have not performed as well as private banks, according to conventional financial performance criteria, because they are usually expected to achieve

… a reduced public sector role …

Indicators of performance



[1] Net interest income as a percentage of earning assets. [2] As a percentage of total assets. [3] As a percentage of the sum of net interest revenue and other operating income. [4] Weighted average of the economies listed, based on 2000 GDP and PPP exchange rates. [5] Hong Kong SAR, India, Korea, Malaysia, Singapore, Taiwan (China) and Thailand. [6] Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [7] The Czech Republic, Hungary, Poland and South Africa.

Source: Fitch Ratings. Graph III.13

certain public policy goals regardless of the impact on profitability. According to estimates by the Inter-American Development Bank, publicly owned banks in Latin America charge lower loan rates than private banks, and have higher NPL rates and lower returns on assets. Public banks also pay lower deposit rates than private banks, further suggesting that they are being used to subsidise borrowers.

... and more foreign bank entry

Finally, a growing role has been played by foreign banks, notably in Latin America and central and eastern Europe. In addition to stimulating competition more generally, foreign banks also play an active role in introducing innovations into emerging markets, many of which help improve risk management procedures. They can also be a source of financial support to the banking system since they are less vulnerable to country-specific (systemic) risk, less sensitive to host country cycles, and can also obtain foreign currency liquidity during episodes of financial stress. These issues have recently been explored in reports by the Committee on the Global Financial System.

Some concerns

While these three trends are, on balance, expected to strengthen banking sectors in emerging market economies, some concerns remain. In certain situations, higher concentration could weaken the banking system, for example if it leads to more opaque banks, if authorities find it difficult to withhold support or if it is the result of the merger of poorly performing banks. Foreign bank entry also raises some issues, including possible exposure to shocks affecting the parent company; loss of information that can arise when domestic banks are acquired and delisted from local stock markets; lack of access to decision-makers in the parent bank whose actions may have a large impact on the foreign bank subsidiary and the host country; and challenges in achieving the required level of communication between home and host country supervisors.

The regulatory environment

Regulation and supervision have improved ...

A number of emerging market economies have taken steps to enhance bank regulation and supervision, and some have already developed quite sophisticated approaches to monitoring their banking systems. Nevertheless, improvements in the regulatory environment in recent years have in some cases been limited. Recent financial stability assessments conducted by the IMF and World Bank, focusing in part on progress in implementing the Basel Core Principles for Effective Banking Supervision, suggest that certain weaknesses in banking supervision remain.

... but some issues remain

Four issues are of particular concern. The first is the absence of consolidated supervision in some countries. This increases the risk that subsidiaries of banking institutions could experience financial difficulties which are not readily detectable, adversely affecting the financial sector and the economy. A second concern has to do with deficiencies in risk management. Many countries have not succeeded in instilling a culture of risk management in banking institutions, and thus compliance with banking regulations tends to be largely mechanical. By the same token, regulations on credit exposures and on connected lending are seen as not strict enough. In addition, in some countries there are insufficient regulations for managing market risk. A third issue is the problem of measuring bank performance. Some crucial measures of bank performance can give a misleading picture of risks to the financial system. For example, capital adequacy ratios are sometimes not calculated on a consolidated basis, risk weightings are inadequate because of a lack of appropriate measures, or inappropriate capital components are included. Lastly, remedial measures are commonly deficient, reducing the incentives for diligent risk management. Such deficiencies include undue forbearance (ie the willingness of regulators to postpone action when certain thresholds are breached), the lack of supervisory capacity or authority for timely intervention, and the lack of immunity for supervisors. While there have been improvements in bankruptcy legislation in some countries, problems in enforcing creditor rights remain formidable.