GFSR – APRIL 2014

TITLE: Moving From Liquidity- to Growth-Driven Markets

CHAPTER 2: HOW DO CHANGES IN THE INVESTOR BASE AND FINANCIAL DEEPENING AFFECT EMERGING MARKETS?

Summary

The landscape of portfolio investment in emerging markets has evolved considerably over the past 15 years. Their financial markets have deepened and have become more globalized. New asset class segments have developed, including local-currency sovereign debt, with increased direct participation of global investors. The mix of global investors has also changed. The role of bond funds—especially local-currency bond funds, open-end funds with easy redemption options, and funds investing only opportunistically in emerging markets—has risen.

This chapter aims to identify the effects of these changes on the stability of portfolio flows and asset prices in emerging markets with a range of methods using relatively unexploited data. We examine the sensitivity of flows from various types of global investors to assess whether the new mix of investors has made portfolio flows more or less sensitive to global financial shocks. We also investigate the role of investor herding and domestic macro fundamentals. Moreover, we analyze how the strength of local financial systems affects the sensitivity of local asset prices to global financial shocks.

We find that both the structures of the investor base and local financial systems matter. The new mix of global portfolio investors is likely to make overall portfolio flows more sensitive to global financial conditions. The share of more volatile bond flows has risen, and larger foreign participation in local markets can transmit new instability. Growing investment from institutional investors that are generally more stable during normal times is welcome, but these investors can pull back more strongly and persistently facing an extreme shock. While domestic macroeconomic conditions matter, investor herding among global funds continues, and there are few signs of increasing differentiation along macroeconomic fundamentals during crises over the past 15 years. Nonetheless, the progress made by emerging markets toward strengthening their financial systems reduces their financial asset prices' sensitivity to global financial shocks.

Our results suggest options to enable emerging markets to reap the benefits of financial globalization while minimizing its potential costs. Governments can promote larger local investor bases, deeper banking sectors and capital markets, and better institutions. Initiatives to support local currency bond market development are beneficial, but the size of direct participation of foreign investors in local markets needs to be monitored and be balanced

with broad financial system development policies. Knowing the investor base and its characteristics is critical for assessing the risks of capital flow reversals and designing macroprudential policies.

CHAPTER 3: HOW BIG IS THE IMPLICIT SUBSIDY FOR BANKS CONSIDERED TOO IMPORTANT TO FAIL?

Summary
Government protection for too-important-to-fail (TITF) banks creates a variety of problems: an uneven playing field, excessive risk-taking, and large costs for the public sector. Because creditors of systemically important banks (SIBs) do not bear the full cost of failure, they are willing to provide funding without paying sufficient attention to the banks' risk profile, thereby encouraging leverage and risk-taking. SIBs thus enjoy a competitive advantage over banks of lesser systemic importance and may engage in riskier activities, increasing systemic risk. Required fiscal outlays to bail out SIBs in the event of distress are often substantial.

The TITF problem has likely intensified in the wake of the financial crisis. When the crisis started in 2007, and especially in the wake of the financial turmoil that followed the collapse of Lehman Brothers in September 2008, governments intervened with large amounts of funds to support distressed banks and safeguard financial stability, leaving little uncertainty about their willingness to bail out failing SIBs. This reinforced incentives for banks to grow larger, and together with occasional government support for bank mergers, the banking sector in many countries has, indeed, become more concentrated.

In response, policymakers have launched ambitious financial reforms. They imposed higher capital buffers and strengthened the supervision of global systemically important banks (G-SIBs) to reduce the probability and cost of failure and contagion. They are working on improving domestic and cross-border resolution frameworks for large and complex financial institutions. In some countries, policymakers decided on structural measures to limit certain bank activities.

This chapter assesses how likely these policy efforts are to alleviate the TITF issue by investigating the evolution of funding cost advantages enjoyed by SIBs. The expectation of government support in case of distress represents an implicit public subsidy to those banks. Estimated subsidies for systemic banks have sharply declined from their 2008–09 peak in the United States, but they remain high in the euro area. Subsidies rose across the board during the crisis but have since declined in most countries, as banks repair their balance sheets and financial reforms are put forward. Yet, subsidies remain more elevated in the euro area than in the United States, likely reflecting the different speed of balance sheet repair as well as perceived differences in policy frameworks for dealing with the TITF issue. All in all, however, the expected probability that SIBs will be bailed out remains high in all regions.

Not all policy measures have been completed nor implemented yet, and there is still scope for further strengthening of reforms. This includes enhancing capital requirements for SIBs or imposing a financial stability contribution based on the size of a bank's liabilities. Progress is also needed in facilitating the supervision and resolution of cross-border financial

institutions. In these areas, international coordination is critical to avoid new distortions and negative cross-country spillovers, which may have increased due to country-specific policy reforms.