CHAPTER 2

THE GROWING IMPORTANCE OF FINANCIAL SPILLOVERS FROM EMERGING MARKET ECONOMIES

Summary

Trade and financial integration of emerging market economies into the global economy and financial system has increased significantly over the past two decades. As a result, spillovers of emerging market shocks to equity prices and exchange rates in advanced and emerging market economies have risen substantially and now explain over a third of the variation in asset returns in these countries. Bond market spillovers, however, do not display a corresponding trend, since they continue to be driven largely by global factors.

In recent years, the importance of financial factors in explaining spillovers has grown relative to that of trade linkages. The rise in financial market integration has strengthened spillovers across countries. More than its economic size, the degree of financial integration matters for a country's importance as a receiver and transmitter of spillovers.

Spillovers tend to occur more between countries with similar macro-financial fundamentals. Cross-country spillovers are strongest within sectors. Sectors that are more dependent on external finance are more subject to spillovers, as are firms with lower liquidity and higher borrowing. Purely financial contagion effects remain less significant in the case of China. However, the impact of shocks to economic fundamentals, such as news about China's growth, on equity returns in both emerging market and advanced economies has been rising. China's spillovers to global financial markets will likely increase considerably in the next few years.

Finally, structural changes in financial markets, notably the growth in mutual fund intermediation of capital flows, appear to have increased the importance of the portfolio channel of contagion from emerging markets.

These findings suggest that when assessing macro-financial conditions, policymakers may increasingly need to take into account economic and policy developments in emerging market economies. In particular, as China's role in the global financial system continues to grow, clear and timely communication of its policy decisions, transparency about its policy goals, and strategies consistent with their achievement will be ever more crucial. Finally, given the evident importance of corporate borrowing and mutual fund flows in amplifying spillover of shocks, it will be essential to shape macroprudential surveillance and policies to contain systemic risks arising from these channels.

CHAPTER 3

THE INSURANCE SECTOR—TRENDS AND SYSTEMIC RISK IMPLICATIONS

SUMMARY

This chapter describes major insurance sector developments over the past decade and assesses changes in the systemic importance of insurers. Insurance firms play an important role as providers of protection against financial and economic risks and as financial intermediaries.

The chapter shows that across advanced economies the contribution of life insurers to systemic risk has increased in recent years, although it clearly remains below that of banks. This increase is largely due to growing common exposures to aggregate risk, caused partly by a rise in insurers' interest rate sensitivity. Thus, in the event of an adverse shock, insurers are unlikely to fulfill their role as financial intermediaries precisely when other parts of the financial system are failing to do so as well. The higher common exposures do not seem to be driven by marked changes in insurers' investment portfolios, although smaller and weaker insurers in some countries have taken on more risk.

The findings suggest that supervisors and regulators should take a more macroprudential approach to the sector. Doing so is necessary if supervision is to go beyond guarding against the solvency and contagion risks of individual firms and take on the systemic risk arising from common exposures. Steps that would complement a push for stronger macroprudential policies include the international adoption of capital and transparency standards for the sector. In addition, the different behavior of smaller and weaker insurers warrants attention by supervisors.