Myths and Dangers for Emerging Markets

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THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

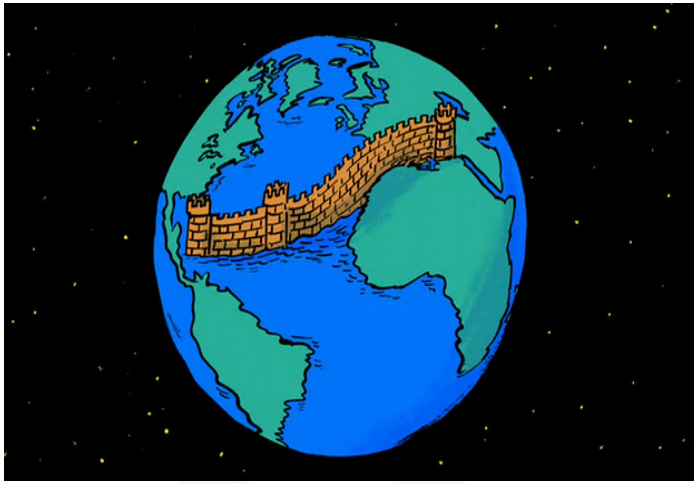
I will talk about …

1. Clear and present dangers
2. Risks overstated
3. Risks deliberately ignored
4. Risks not fully recognised
5. … and democracies' real big problem

So let's see how many imagined and real elephants in the room are around…

1. Clear and present danger: prospects of a global trade war

- Large welfare losses on all sides on the longer term. No real winners
- But: easy short-term wins for populists, particularly in the US (by virtue of size) - elsewhere too. In this sense Pdt Trump is sadly right



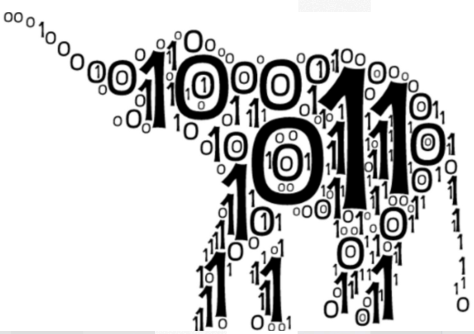
Resist!

2. Risks overstated: fears about QE unwinding

- Lessons have been learnt from 2013 " taper tantrum" by central banks and markets
- No central bank is rushing – first (real) mover's disadvantage
  - US – likes weak $
  - BoE – Brexit
  - BoJ - slow
  - ECB – biggest risk as most independent (no fiscal authority) but has large current account surplus
  - AD central banks are stiff scared - EMs just need to play it safe
- Pas de panic!

Risks overstated: cryptocurrency

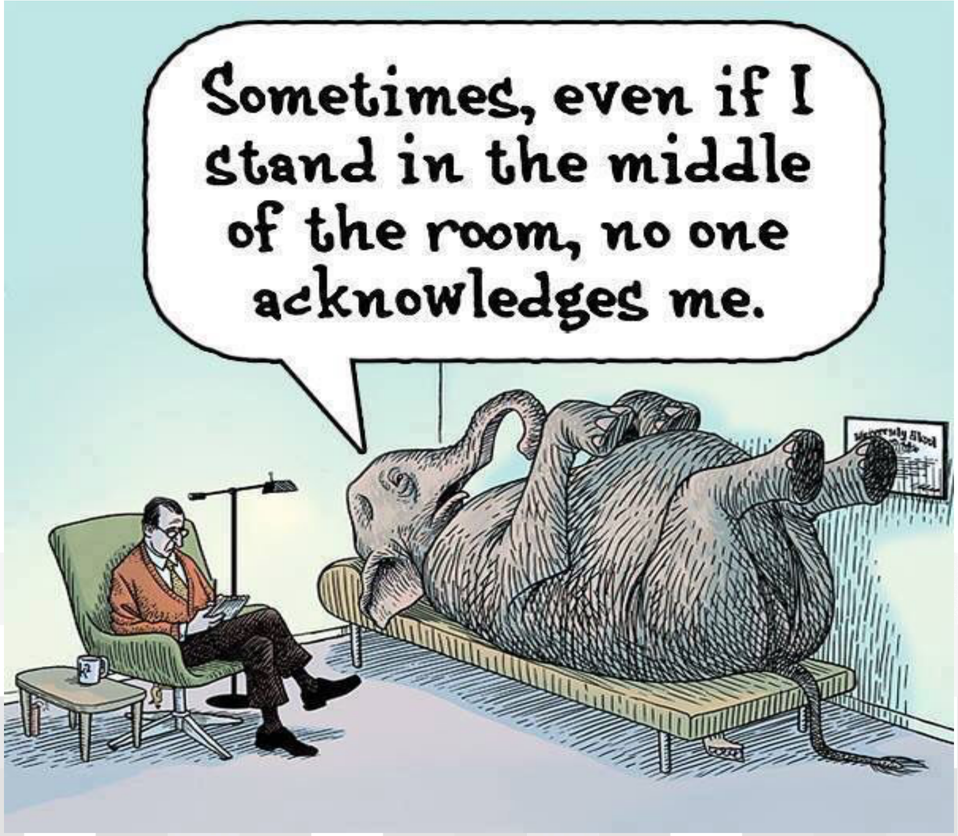
- CCs are a form of private money that have long history
- But also qualitatively different: lack of dominant central authority - itself weak with long history of inflation – maybe be not an issue thanks to solid technological benefits & assurances
- CCs challenge status quo of both commercial banks and the central bank – why is competition and disruptive innovation a bad thing when we like it elsewhere?
- Do not over-regulate – not a real elephant!



3. Risks deliberately ignored

- Post crisis financial regulation has <u>not</u> reduced big systemic risks:
  - Capital and liquidity improvements at bank level will not help at the system level if crisis hits
  - Too-big-to-fail problem is NOT resolved; bank concentration risk has increased
  - No real approach to network/connectivity risk

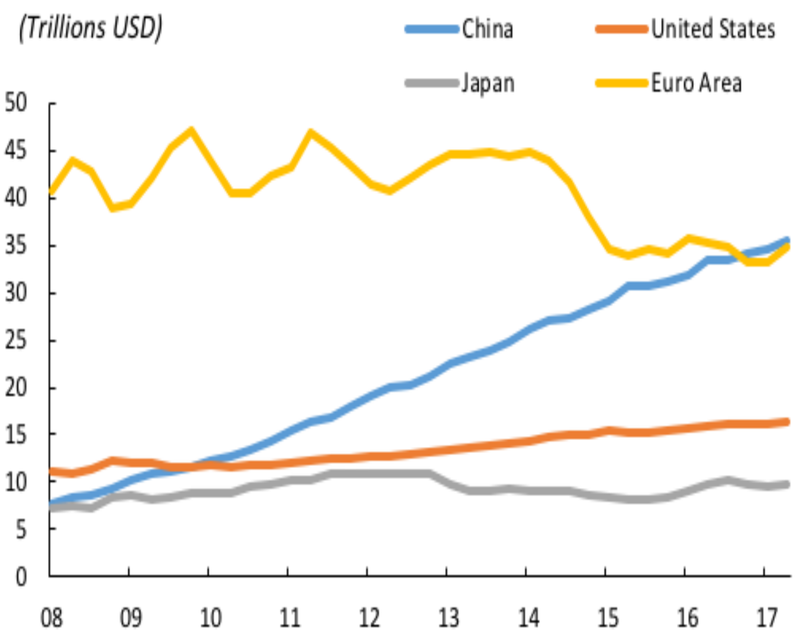
Elephant #1 in the room: bank size



4. Risks not fully recognised: China's bloated financial sector

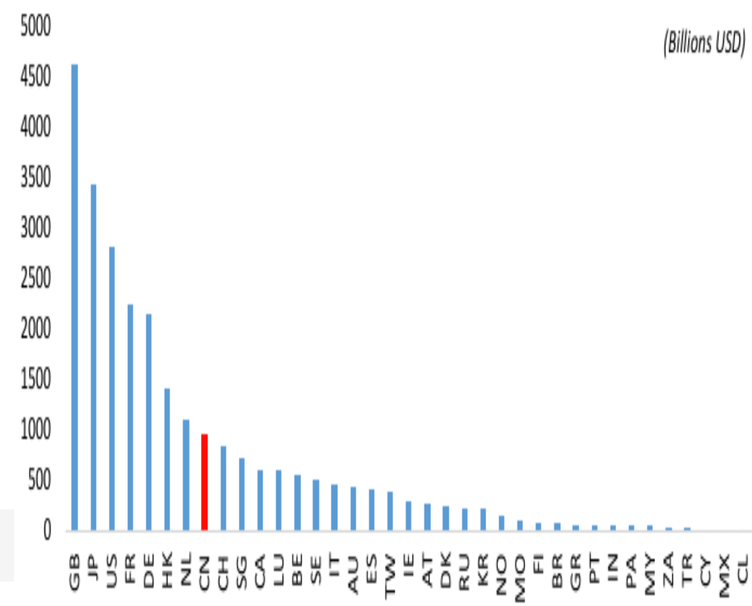
New research by Cerutti & Zhou, IMF

China has by far the biggest banking sector



Sources: Cerutti & Zhou: The Chinese banking system, VoxEU, February 2018; BIS, ECB, IMF

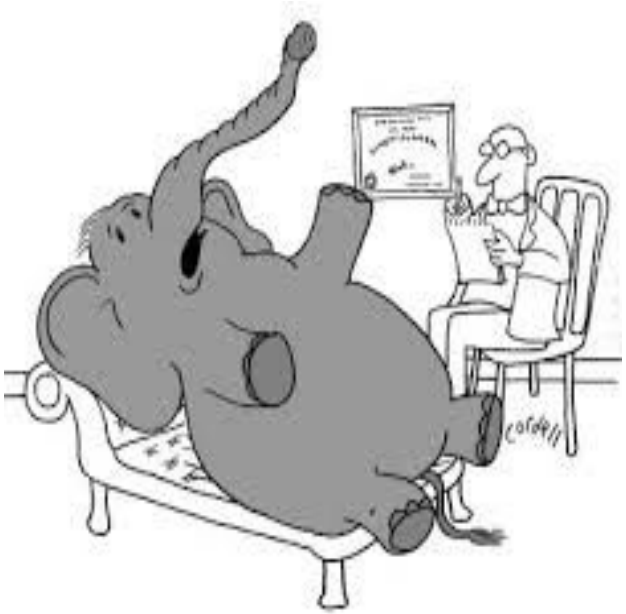
Though most is domestic, external claims are rapidly rising



Source: BIS, External claims, 2017 Q2

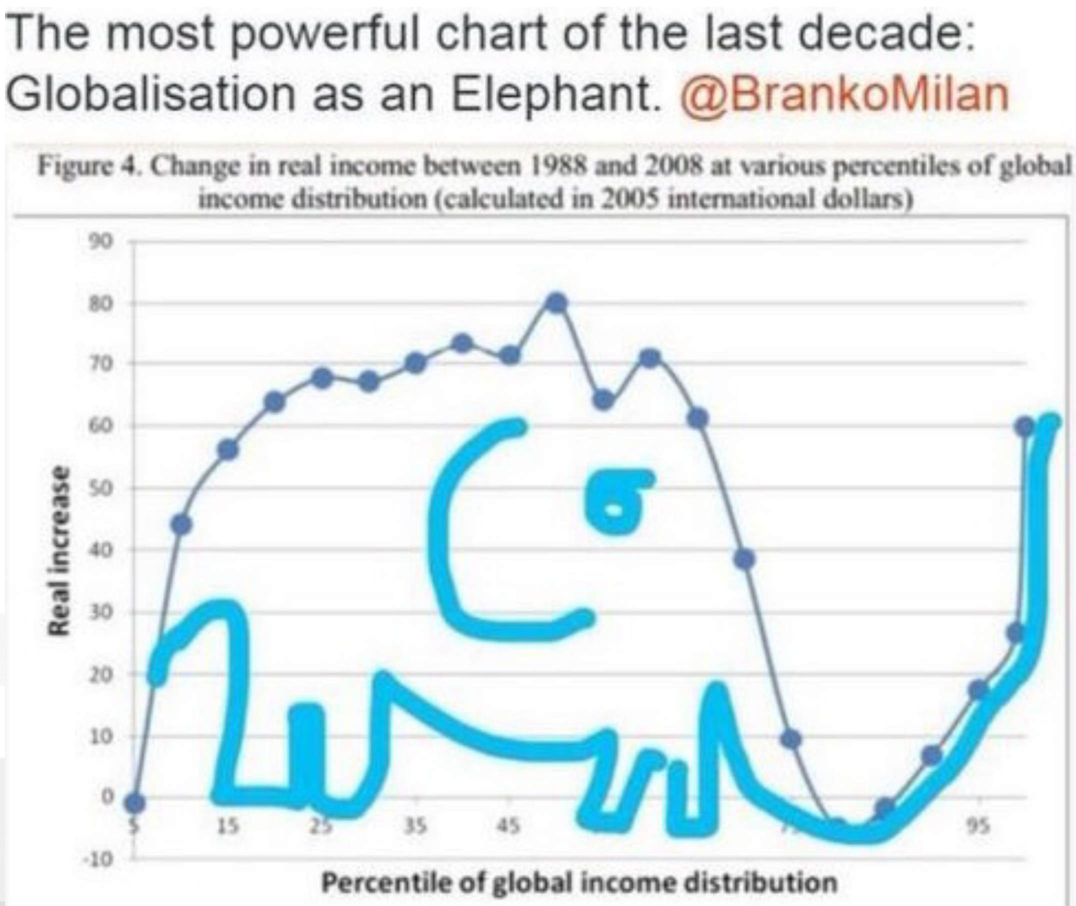
Elephant #2 in the room: China risk

- While external financial linkages are most systemic in EMs and DEs, some of it is quasi-aid
- The real issue is the financial contagion of any major shock in the domestic system to *advanced economies:* see the Shanghai stock exchange "shock" in early 2016
- No reserves is enough to mitigate fallout
- Cleaning up and transforming China's giant banking sector is a global concern - and interest



"Whenever I walk in a room, everyone ignores me."

5. Democracies “real elephant”: inequality



THANK YOU!

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