

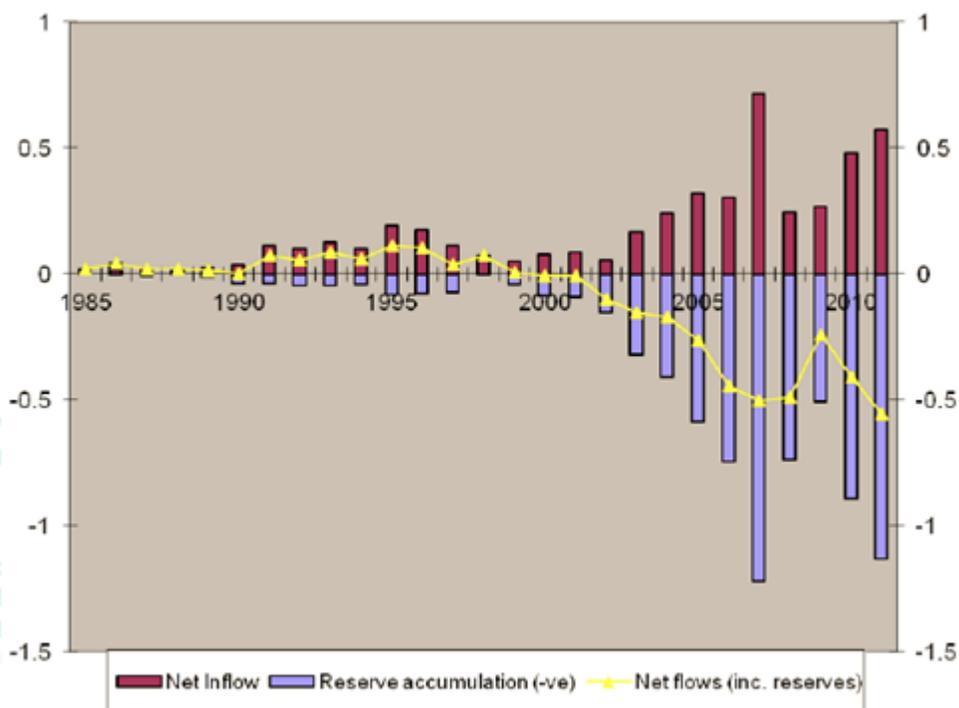
Emerging Markets Self-Insurance: The Gains and Pains

Generally speaking, although there are still some significant shocks, the emerging markets nowadays have much stronger immunity from spillovers from major economies.

1. EMERGING MARKETS HAVE MANAGED TO INSURE THEMSELVES THROUGH THE ACCUMULATION OF FOREIGN EXCHANGE RESERVES.

Before the new century, capital flew to emerging markets from other economies. However, there is a turning point around 2000. After that point, international capital continuously flew out of emerging markets in the form of increasing reserve holdings.

Figure 1 EMERGING COUNTRY NET FLOWS AS % GDP



Source: Stephen Grenville (2012), Rethinking Capital Flows for Emerging East Asia, Asia Development Bank Institute, Working paper Series No. 362, June.

According to Pradhan and Taylor (2011)¹, in 2000 the reserves held by emerging markets as a group totaled around 700 billion USD. By 2010, this figure was approaching 6 trillion USD!

It is easy to understand that some of the economies, such as the ASEAN countries and China, have drawn lessons from the 1998 financial crisis and improved their immunity to the spillovers through the accumulation of reserves.

2. THE NEGATIVE EFFECTS OF THE SELF-INSURANCE SOLUTION

Firstly, not all emerging markets hold large reserves. For India, Indonesia, Brazil, South Africa and Turkey, which are called the “fragile five”, their reserves are embarrassingly low.

Secondly, there are some negative externalities. When emerging markets successfully

¹ Pradhan, Manoj, and Alan M. Taylor. “The Great Rebalancing” Emerging Issues, Morgan Stanley, 2011.

accumulated a large amount of reserves, they also contributed to the serious problem of global imbalances.

Moreover, economic growth rates are generally higher in emerging markets. This means the return on investment tends to be higher as well. But emerging economies are sending their capital to the US and other advanced economies. It is typically a kind of mismatch of the resources. Some the observers or officials think this cost is to some extent an insurance premium.

3. ALTERNATIVES TO THE SELF-INSURANCE SOLUTION

The creation of a supranational reserve currency could be one of the options. Yet there is a long way to go if this is to be realized. More practically, there could be some progress in the level of regional cooperation. For example, within the framework of ASEAN+3 (China, Korea and Japan), The Chiang Mai Initiative multilateralization and Asia Bonds Market are the backbones for strong regional cooperation. At the same time, the internationalization of China's yuan also provides a potential choice for a new reserve currency.

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