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Abstract

This article focuses on the financial globalization of the emerging market economies (EMEs) and the important differences across countries and country groups in this regard, particularly in the relative importance of different types of capital inflows and the pace of financial globalization. That the extent of financial globalization in the EMEs is both qualitatively and quantitatively different from the other country groups can be established with the help of the *de jure* and *de facto* measures. The author provides details of global private capital flows to the EMEs since the early 1970s. The following time period has been divided into various sub-periods. The characteristic features and trends for each period have been identified and analyzed.

Keywords: financial globalization, emerging market economies, financial crisis, capitol flows, global private capital flows

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I. Financial Integration of the Emerging Market Economies

> The emerging-market asset class has moved into the main stream in the wake of deepening financial integration across high-income and developing countries and much improved macroeconomic management in many developing countries.
>
> —Justin Yifu Lin (2008, p. xi)

The integration of emerging market economies (EMEs) into the global financial markets has been progressively growing. Although they are not an integral part of the financially globalized economy, since the early 1970s several of them certainly have been increasingly active participants in it. In the process, they have been persistently contributing to financial globalization of the world economy. It is evident from the sustained rise in gross capital inflows into EMEs and outflows from them that they now have an exclusive niche in the global financial landscape.

This subgroup of developing economies accounts for the bulk of global financial integration among the developing economies *per se*. After the advanced industrial economies, this group of economies adopted financial globalization most successfully and benefited from it. Proponents of globalization see the EMEs as a conclusive evidence of the validity of their assertion. China's vertiginous economic growth, its vaulting over other economies to become the third largest in the world and its economic and financial integration with the global economy in an astonishingly short time span exemplify this fact (Das 2008a).

EMEs lack any semblance of uniformity. They are far from a monolithic group of economies. Scrutinizing financial globalization in the EMEs is worthwhile and rewarding because there are important differences across country groups in the pace of financial globalization. A comparison of financial integration of Mexico with the global financial system with that of China and India is a case in point. In addition, relative importance of different types of capital inflows is different for different groups of EMEs.

Over the last two decades, financial globalization in the EME picked up momentum and non-resident purchase of EMEs' domestic assets as well as EME residents' purchase of foreign assets grew appreciably, albeit not monotonically. Of late, the role of EMEs in the global banking and capital markets has expanded at a remarkable pace. One convincing indicator of deeper integration of EMEs with the global financial markets is the financial account of the balance of payments of EMEs.

In the 1990s, gross private capital flows averaged US$170 billion a year, of which US$100 billion was foreign direct investment (FDI). By 2007, gross private capital flows exceeded US$1,400 billion. Gross capital flows are the sum of total inflows and total outflows. It is a better indicator of financial integration than the net inflows. The reason is that it provides a less volatile and more reliable indicator of financial integration. This indicator has the advantage of capturing two-way flows. Net private capital flows are inflows minus outflows. Net flows into the EMEs have also steadily risen. They exceeded US$400 billion in 2007, more that four times the amount in the 1990s (Turner 2008). Concurrently, the aggregate current account position of EMEs has shifted from deficits over the 1980s and the 1990s to wholesome surpluses during the present period (Section II).

This article presents the contour of deepening financial globalization of the EMEs *en masse*. Financial deepening implies rapid growth of financial assets. This development is viewed with optimism because it makes financial intermediation more efficient, enables investors to diversify risk and entrepreneurs' need for expensive bank capital is reduced. Evidence is available to demonstrate that financial deepening is associated with higher economic growth (King and Levine 1993, Levine 2005).

This article begins by providing an explanation regarding what the EMEs are and the challenges of preparing a universally agreed upon country classification (Section II). In a comprehensive section (Section III), the qualitative and quantitative evolution of global private capital flows to EMEs has been analyzed. To render precision to the analysis, this section has been divided into cohesive chronological sub-periods. Temporal evolution of financial flows from the global private capital markets has been profiled in this section. It exemplifies that global integration of EMEs took place in the manner of a crescendo, reaching its qualitative climax in the post-2002 period. Quantitatively, 2007 was the high noon of financial globalization in the EMEs (Section IV). The sub-prime mortgage crisis erupted in the autumn of 2007, mutated into a global financial crisis, spilled into the real economy and put paid to financial globalization of EMEs. The ongoing financial globalization reversed abruptly. Section V focuses on the transmission mechanism of the financial stress from the advanced industrial economies into the EMEs. Section VI sums up the article.

II. What Are EMEs?

The term "emerging market economies" was coined in 1981 by Antoine W. van Agtmael of the International Finance Corporation. This concept has the inherent shortcoming of being somewhat loosely defined and has several definitions, each slightly at variance from the other. There is neither a universally accepted list of countries called EMEs nor a definition on which there is wide agreement. The developing countries that are placed in this category vary from small to large. They share neither history nor similarities in income or resource endowment.

A Plausible Definition

A functional definition of an EME could be a developing economy that has undertaken sustained macroeconomic reform measures, which in turn have resulted in sustained rapid gross domestic product (GDP) growth for a decade or so. Typically, an EME is a market economy and has a reasonably successful external sector.[1] The other necessary idiosyncratic feature is a fairly reliable financial infrastructure, albeit the level of market efficiency and standards in accounting and securities regulations are not on par with advanced industrial economies. Superior growth performance and prospects of sustainable growth are widely accepted attributes of the EMEs.

An EME deliberately builds a transparent and efficient domestic capital market. In developing its external sector, it pays specific attention to its exchange rate regime and ensures a stable currency. The basic objective of doing so is to encourage confidence in the economy, so that investors in the global private capital markets regard it as suitable for investment. When the global investing community discerns these tell-tale traits in an economy, they react in an appropriate manner. Global retail and institutional investors as well as the transnational corporations (TNCs) have fittingly increased their exposure to this group of economies. Also, their domestic financial markets have succeeded in integrating with the global financial system.

Country Classification Conundrum

The concept and definition of EMEs vary according to the institution using them. Even the Bretton Woods institutions have not put forward and agreed upon standardized classification in this regard. At times, one organization uses two country classifications. Esteemed supranational institutions like the International Monetary Fund (IMF) were found to use inconsistent definitions. Although the IMF classifies the newly industrialized economies (NIEs) as a distinct group,[2] in presenting statistical tables it includes them with the EMEs, rendering confusion and presenting inflated and misleading statistical data. It classifies 23 countries, including the four NIEs, as the EMEs.[3] There is a small hint of commonality in the total number of EMEs in various classifications. It hovers around 30 countries. *The Economist* and the Institute of International Finance (IIF) include 34 countries in their classifications, many of them common to the two classifications.

Morgan Stanley Capital International, a leading provider of investment data to principal financial institutions, computes indices of portfolio risk for the EMEs. Their list of EMEs includes the following 25 economies: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Kuwait, Malaysia, Mexico, Morocco, Pakistan, Peru, the Philippines, Poland, Qatar, the Russian Federation, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates. This classification was revised in 2008.

The Financial Times and London Stock Exchange jointly publish the FTSE indices for the EMEs. The FTSE indices are extensively used by a range of investors, asset owners, investment banks and fund managers. They classify EMEs into two subgroups. Advance EMEs includes six countries, namely, Brazil, Hungary, Mexico, Poland, South Africa and Taiwan. There are 16 secondary EMEs: Argentina, Chile, China, Colombia, the Czech Republic, Egypt, India, Indonesia, Malaysia, Morocco, Pakistan, Peru, the Philippines, the Russian Federation, Thailand and Turkey.

Complete Lack of Homogeneity

While they share several traits, it has been noted in Section II that there are important differences across country groups in terms of the size of the GDP, per capita income, the pace of financial globalization as well as the relative importance of different types of capital inflows. They also differ structurally. Notwithstanding the fact that the market economy has been taking hold in China and Vietnam, they regard themselves as socialist market economies. However, as a group, EMEs account for the bulk of global financial integration among the developing economies *per se*. After the advanced industrial economies, this group of economies adopted financial globalization most successfully and benefited from it. Proponents of globalization see the EMEs as a conclusive evidence of the validity of their assertion.

Prominent EMEs

China, a manufacturing powerhouse, is the largest and the most important EME. China and India, the two populous giants, and Brazil are the three largest EMEs. Together they account for almost 10 percent of the world's GDP at current market exchange rates. If they continue to invest in and welcome technology inflows, their large labor forces and expanding skill bases would certainly succeed in creating high productive potential for these EMEs. They could grow and be among the world's largest economies. As alluded to in the preceding section, in 2009 China has already acquired that sought-after position. The growth of these economies will affect not only goods and services markets but also global flows of savings and investment (Das 2006).

If the four NIEs are excluded as a distinct category, the six largest EMEs are Brazil, China, India, Indonesia, Mexico, and the Russian Federation. Some of the other large EMEs include Argentina, Chile, Colombia, the Czech Republic, Kenya, Malaysia, Poland, South Africa, Turkey, and the United Arab Emirates. These economies are regarded as being a transitional group placed between the developing countries on one side and matured industrial economies on the other. They assumed the emerging status essentially by implementing macroeconomic policy reforms, liberalizing their economies and adopting market-friendly economic and financial policies, which resulted in a sounder economic policy structure compared to the other developing economies. The result was more rapid growth rates.

Many of the EMEs have succeeded in alleviating poverty and improving the standards of living of their populations. The size of their middle class has been steadily growing (Das 2009a). In addition, the EMEs are growing into an important phenomenon for the business corporations of the advanced industrial economies. Prahalad (2004) pointed to the EMEs as a source of not only a large number of value-conscious customers but also creative entrepreneurs. Several of the EMEs are individually regarded as an important economy and market in its own right. EMEs, like China, have been playing an important global role individually (Das 2008b). Their combined impact on the global economy has progressively increased and has become discernible. Together they are an economic entity to reckon with and are changing the contours of the global economy.

III. Differentiating Financial Globalization in the EMEs

That the extent of financial globalization in the EMEs is both qualitatively and quantitatively different from the other country groups can be established with the help of the *de jure* and *de facto* measures as well as the temporal evolution of capital flows to the EMEs (Section IV). *De jure* measures are based on the traditional measures of legal restrictions. They calibrate the degree of financial globalization with the help of the degree of controls on cross-border capital movements and those on foreign exchange transactions. These measures have several limitations and are therefore not regarded as accurate. Conversely, *de facto* measures of global integration are quantity based and are calibrated from the actual capital flows. Quantity-based measures of financial integration can also be price-based measures and those based on saving–investment correlations. This genre of measures is regarded as relatively superior measures of a country's *de facto* integration with global financial markets.

Using both *de facto* and *de jure* indicators, Kose et al. (2009) inferred that the level of global financial integration has indubitably been the highest in the advanced industrial economies. This was an inescapable conclusion. Among the developing economies, the EMEs were found to have made the maximum progress in financial globalization. Since 1990, the gross stock of assets and liabilities of the EMEs rose by more than fivefold. Their magnitude has been much larger than the average for the other developing countries.

Both *de jure* integration measure, which was computed from the IMF's binary capital account restrictiveness measures, and *de facto* measures of financial openness, computed from the stock of financial assets and liabilities expressed as a proportion of GDP, were compared for different country groups. Both these indicators established it beyond doubt that the advanced industrial economies have become significantly integrated into the global financial markets. For the EMEs, the *de jure* integration measure did not show a large change over the period under consideration. However, the *de facto* measures of financial openness showed dramatic increase. As opposed to this, for the other developing economies *de jure* openness rose sharply during the period under consideration, but the *de facto* measures did not change at all.[4]

IV. Capital Flows to the EMEs: Qualitative and Quantitative Dimensions

This section succinctly provides details of global private capital flows to the EMEs since the early 1970s, when the so-called oil-shock struck the global economy. It had enormous significance for the global financial markets. The following time period has been divided into various sub-periods, which have been analyzed independently below. Temporal evolution of capital flows to the EMEs has been portrayed in this section. Both qualitative and quantitative details of the financial flows and the emerging trends during each sub-period have been analyzed. The Latin American and Asian financial crisis have not been analyzed in depth but have been alluded to in the discussion of the relevant periods.

Post-oil Shock Era and the Latin American Debt Crisis

Following the quadrupling of oil prices in 1973, many large commercial banks in the large industrial economies, called the money center banks, found themselves holding large petrodollar deposits. During this period, it was essentially the US banks that were most active in international banking, followed by the European banks and those from Japan. The money center banks recycled liquid resources to some of the better-performing, creditworthy countries. It was a productive and prudent investment strategy. This liquidity was turned into sovereign loans to EMEs. These were syndicated loan arrangements on floating interest rates. Due to an ambiance of rising commodity prices and improving terms-of-trade, borrowing economies did not face problems in servicing their debts. Global financial flows to the EMEs were low, a paltry US$28 billion, during the mid-1970s. Global private capital flows steadily increased reaching US$49.8 billion in 1981 and peaking at US$57.0 billion in mid-1982. Growth of the Eurodollar markets facilitated the bank lending of the late 1970s and early 1980s. A large proportion of sovereign loans had gone to the EMEs of Latin America, with capital flows to the region peaking at US$44 billion in 1981. As a proportion of GDP, it was 6 percent of the GDP of this region.

During the early 1980s, global economic environment changed radically from that in the 1970s. In that, commodity prices softened and there was a spike in the interest rates to levels not seen since 1930s. The London Interbank Offer Rate reached an unprecedented level. In addition, the advanced industrial economies suffered a recession. The three factors coalesced to create serious debt-servicing problems for the Latin American EMEs, the largest borrowing EMEs. They found themselves in dire financial straits. Beginning with Mexico in August 1982, several of them declared moratoriums on their sovereign obligations. This developed into a major financial crisis of global proportion, the first in the post-World War-II era. For the global financial markets, the EMEs suddenly became the pariahs. The Latin American debt crisis of 1982–83 caused serious deterioration in the macroeconomic performance of the EMEs, particularly those in Latin America. It also made the capital markets more cautious in making syndicated sovereign loans. Capital flows from the other channels also suffered a decline. Net private capital flows to the EMEs declined to a trickle. The annual average net capital flows for the 1983–89 period plummeted to US$11.6 billion. Compared to this, the average net capital flows for the 1971–79 period were US$17.8 billion.[5]

The EMEs, particularly those in the Western Hemisphere, experienced severe debt-servicing difficulties and their rate of inflation had accelerated menacingly. They found themselves laboring under inordinately heavy debt servicing burdens. The most heavily indebted EMEs had the ratio of external debt to exports in the neighborhood of 370 percent in the latter half of the 1980s. This group of EMEs were not only excluded from the capital market flows but also forced to run current account surpluses to enable them to repay their external debts (Kaminsky 2005). Global private capital market observers, therefore, argued that it could take several years before market access for the EMEs from Latin America could be fully restored. It was reasonably expected that these economies needed several years of macroeconomic and financial restructuring and adjustments. Declining global private capital flows to the EMEs during the 1980s led some observers to qualify this period as the “lost decade”. The International Financial Institutions, particularly the IMF, took up the slack. Throughout the 1980s, the IMF introduced a number of new lending facilities aimed at assisting the highly indebted economies of the Western Hemisphere. The US Treasury took initiative to launch the Brady Plan in 1989 to facilitate the debt-ridden economies to restructure their debt.

Towards the end of the 1980s, the gloomy relationship between the EMEs and the global capital markets began to transform. The EMEs again became a favorite investment destination. However, the come back made by the EMEs was under strikingly different set of circumstances. As elaborated below (Section IV), this time capital flows to the Asian EMEs surged at a rapid clip. Global private capital flows to this group of EMEs were 10 times large in the late 1980s compared to their average in the early part of the decade. Also, the composition of capital flows changed. The relative significance of FDI was on the rise since the latter half of the 1980s. Bank lending was no longer the principal channel of capital transfer; it was supplanted by portfolio investment, which comprised FDI, equity, and bond investment.

Transforming Scenario of the 1990s

Not only the relationship of the EMEs with the global capital market transformed during the 1980s but they were also being widely extolled for their sound macroeconomic policies, superior institutional base, market-friendly and pragmatic governments, and high quality of their human resources. The EMEs from Asia became the largest recipients after 1993. Cumulative private capital flows to the EMEs for the 1990–96 period added up to US$1,055 billion. This was sevenfold the amount this group of economies received during 1973–83. This was also ninefold the amount borrowed from the official creditors—both bilateral and multilateral—by the EMEs during the same period. By the mid-1990s, a veritable explosion in capital flows to the EMEs occurred (Table 1).

Table 1: Net Private Capital Flows to Emerging Markets (1990–2002) (in billions of US$)

Year	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Total Net Flows	45.7	118.1	120.6	176.3	151.5	208.3	228.3	75.5	53.4	96.0	51.1	38.8	85.9
Net FDI	18.8	31.5	35.3	57.9	80.6	95.0	109.5	136.0	148.8	156.8	149.0	170.5	139.2
Net Equity Investment	17.0	24.7	55.6	98.7	113.0	48.0	94.6	48.5	1.7	41.4	12.1	–38.5	–36.6
Other Net Flows	9.9	62.0	29.7	19.6	–41.9	64.6	24.2	–108.8	–97.1	–102.2	–110.1	–93.2	–16.7
Total Net Flows to:													
Asia	21.4	24.8	29.0	31.8	70.3	98.4	132.2	12.0	–44.9	6.3	–18.3	–15.5	69.5
Middle East and Europe	7.0	65.7	38.8	29.1	15.7	8.2	9.5	16.9	10.2	–3.9	–18.8	–38.3	–25.3
Western Hemisphere	10.3	24.1	55.7	61.4	47.1	39.1	65.3	58.7	63.3	50.0	50.5	34.7	2.1
Economies in Transition	4.2	–9.9	3.1	19.7	4.3	51.4	20.2	–20.9	14.5	29.8	32.9	20.9	34.1

Sources: IMF 1999, IMF 2002, IMF 2003.

Note: Net capital flows comprise net FDI, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowings from the global capital markets.

FDI became an important and dependable source of finance not only for the EMEs but also for several other middle-income developing countries during the 1990s. Its growth was particularly strong during this period. A good part of FDI to EMEs was in the form of mergers and acquisitions (M&As). This was a period when many EMEs and large developing economies were privatizing their public sector enterprises. The EMEs and other large developing economies that were rated as creditworthy by the global capital markets succeeded in drawing FDI. In accordance with the above-mentioned transformation in the composition of capital flows to the EMEs in the later part of 1980s, proportion of bank lending to EMEs of both Asia and Latin American began plummeting. It was 70 percent of the net private capital flows during the decade of the 1970s, but declined to mere 20 percent for the mid-1990s. The proportion of FDI and bond and equity investment in total private capital flows to EMEs soared. It accounted for 40 percent of the total in the mid-1990s (Kaminsky 2005).

There was a sanguine mainstream view of FDI. Its growth during the 1990s was regarded as a wholesome development for the EMEs and the global economy. This mode of global capital transfer set itself apart from the other channels of private capital flows. It not only overcame the pervasive investment–saving gap but also ushered modern management techniques and advanced technologies into the recipient EMEs. This provided a tangible impetus to economic growth rate, without sacrificing current consumption. Stability was another one of its favorable attributes. FDI was usually viewed as a long-term commitment by the investing TNCs. Its growth impact on the recipient EME was significant and it reduced external vulnerability. Large current account deficits in the EMEs were considered sustainable if they were largely financed through FDI, instead of bank lending or equity investment, both of which are characterized by a high degree of volatility.

Bank lending to EMEs after 1990 also underwent qualitative transformations. First, as expected it was most pronounced in Asia, followed by Europe and Latin America. Conversely, it stagnated in Africa and the Middle East. Second, a large part of the increase in bank lending to Asia was in short-term claims. This trend has been attributed to several factors. These included rapid growth in trade financing, the establishment of offshore financial centers, and the so-called "arbitrage" opportunities offered by a combination of high local nominal interest rates on the one hand and fixed or nearly fixed exchange rates on the other. Exposure to short-term bank credits was considered as easy to monitor and manage by the borrowing firms in Asia, giving it an impetus. In addition, during this period, the financial sector was being liberalized briskly in many EMEs. The prevailing regulatory framework also encouraged short-term capital flows from the global capital markets.

Two characteristic features of the global financial markets during the decade of the 1990s were a remarkable growth in international bank lending and investments from the non-bank financial institutions going to the EMEs. This set of institutions included mutual funds, insurance companies, pension funds, and hedge funds, which were liquidity rich. Presence of these institutions broadened the investor base of the global capital market. They found equity investment as their favorite instrument. Table 1 shows that total net capital inflows soared from US$45.7 billion in 1990 to US$228.3 billion in 1996. Bank lending and equity investments in the EMEs are known to be highly volatile. Net FDI flows soared from US$18.8 billion to US$109.5 billion over the same period. These are more than fivefold increases in net terms. Net global capital flows to the EMEs peaked in 1996. However, net FDI flow resisted this trend and continued to increase, peaking in 2001 at US$170.5 billion.

The trend in portfolio investment, particularly in capital flows through international bonds, was not so smooth. They rose from US$17 billion to US$113 billion between 1990 and 1994, but declined sharply to US$48.8 billion in 1995. This was less than half the level a year earlier. The currency crisis in Mexico had begun in the last quarter of 1994 and the international bond market was adversely affected by it. After dampening down, the net capital flows through portfolio investment again picked up in 1996 reaching US$94.6 billion, which was again much less than the peak reached in 1994. Likewise, the category of other net flows, which includes mostly bank lending, after rising sharply during the early 1990s, became negative in 1994. This implies that withdrawals or repayments were larger than fresh lending. However, 1995 again saw steep increases in net flows in this category. They reached US$46.6 billion in 1996. The Mexican currency crisis had failed to affect the global capital flows to the EMEs of Asia. It is worth pointing out that official capital flows—both bilateral and multilateral—during this period remained flat (Table 1).[6]

Two other notable financial market trends of the 1990s helped stimulate the private capital flows to the EMEs. The first one was globalization of markets for securities of EMEs. The second one was the broadening of investor base due to the activities of liquidity-rich non-bank institutions. Latin American securities were being sold in the stock markets of Europe and Asia. Similarly, as the range of mainstream institutional investors grew, the investing institutions in the EMEs grew more diverse. The pricing process of the securities of EMEs was working reasonably well; consequently, new investors from the global private capital markets were attracted towards them. The decade of the 1990s is also known for a string of financial crises (Section V). They caused reversal of capital flows, which naturally reignited the debate on the costs and benefits of financial globalization in the economic profession and the policy-making community.

On the Eve of the Asian Crisis

After peaking in nominal terms in 1996, net capital flows to EMEs did not recover for a while. As seen in Table 1, considerable tightening in emerging market financial conditions took place after this juncture. The principal reason obviously was recurring crises in individual EMEs and groups thereof during 1997–98 (Section V), which led to an increased perception of risk in them in the global private capital markets. The Asian crisis (1997–98) and the Russian default (1998) in particular had a pronounced effect over the global financial markets. Asian EMEs had accumulated large short-term liabilities (Section III). In the latter half of 2007, large international banks rapidly moved to reduce their claims on Asian borrowers through non-renewal of short-term loans.

The combined influence of the Asian crisis and the Russian debt moratorium was far from localized. They impeded cross-border capital flows in a definite and lasting manner. To be sure, Asian EMEs suffered most. The crisis did not cause a sudden stop of global private capital flows but a reversal. Total capital flows declined from a large inflow of US$132.2 billion in 1996 to an outflow of US$44.9 billion in 1998 (Table 1). Beginning in the second half of 1998, all EMEs, except those in Africa and the Middle East, were affected by the retrenchment in international bank lending following the Russian debt moratorium. The decline in lending activity reflected both reduced willingness to lend by banks and a weak demand from borrowers, particularly from the Asian firms. Asian EMEs sharply reduced their bank borrowings because: first, in the aftermath of the crisis Asian corporations were rapidly deleveraging and second, their economies shifted to current account surpluses. In addition, increasing inflows of equity capital made external bank borrowings redundant for them.

Portfolio investment in the EMEs through stock markets peaked in real terms at US$103 billion in 1996 (Das 2004). Global non-bank or institutional investors were the principal users of this channel of investment. They found it functional and profitable. Mutual funds, insurance companies, and pension funds routed significant amounts of capital through this channel into the EMEs. To match this proclivity, the EMEs had implemented wide-ranging financial restructuring and reforms to facilitate portfolio investment from the liquidity-rich financial institutions. This process suffered during the Asian crisis, and private capital flows through this channel sharply declined.

As the mutual funds, pension funds, hedge funds, insurance funds, and others began to play a greater role, the structure of the global financial markets began to transform. The large commercial banks continued to provide loans in the 1990s, albeit their volumes were limited. They were still active in originating, distributing, trading, and investing emerging market assets. Hedge funds have emerged as increasingly active traders of emerging market assets. In addition, large mutual and other funds became much more significant investors in the EMEs. The large commercial banks were relegated into a secondary position by the activity of mutual and other funds (Leijonhufvud 2007).

On the eve of the Asian financial crisis in July 1997, net flows reached their peak in real terms.[7] This was the highest level they reached in two decades. It is well known that the Asian and other crises had a serious deleterious impact and the financial flows to the EMEs suffered a sharp decline. The composition of external capital flows also underwent a dramatic transformation after this juncture. The official development assistance (ODA) either stagnated or declined. Consequently, their relative significance in cross-country capital flows declined. In place of ODA, private capital flows from the global financial markets became the major source of external finance for a good number of EMEs.

That in the matter of financial globalization, EMEs were distinct from the other developing countries had become obvious in the decade of 1990s. The middle-income developing countries were able to attract much smaller amounts of net global capital than the EMEs. In accordance with the perception of creditworthiness, the lion's share of global capital flows was attracted by top 12 recipient countries during the 1990s.[8] All of them fell in the category of EMEs, which were relatively more financially globalized than the others. Although the EMEs were the more attractive destination for the global private capital flows, an interesting feature of the 1990s was that these capital flows were far from uniform across the EMEs. Five major EMEs, namely Brazil, China, Korea, Mexico, and Thailand, accounted for over half of the total inflows. If this tally is extended to a dozen of EMEs, they account for almost 80 percent of the total global private capital flows.

As the global capital flows began accelerating towards these EMEs, the composition of the total global financial resources going to the developing economies *en masse* was affected. The proportion of financial flows dedicated to the low- and middle-income developing economies declined significantly towards the end of the 1990s. For all appearances, many individual economies in the EME group of rapidly financially globalizing economies were diverging from the rest of the developing economies in terms of economic performance (Das 2003).

Dawn of the Twenty-first Century

Global equity markets remained volatile in 2000. Noteworthy was sovereign default by Argentina and deep recession in the EMEs of the Western Hemisphere during 2001–02. The FDI flows to EMEs did not strengthen but were not particularly badly affected. The Asian crisis and the individual country crises failed to dampen the FDI flows significantly down. In absolute terms, they declined from US$170.5 billion in 2001 to US$139.2 billion in 2002. This decline was part of the general decline in the FDI flows. The essential causes were unsettled investor sentiment until 2003 and fall-off in the privatization activity in the EMEs and transactions involving acquisitions and mergers (A&Ms). As in the past, FDI continued to be heavily concentrated in a small number of host countries.

Weakness in the equity markets continued and equity investment in the EMEs turned negative in 2001. Due to high-risk perception, institutional investors in the advanced industrial economies were not eager to invest in the EMEs. Stock markets in the EMEs continued to lose ground until 2003. Return on equity in the EMEs by and large followed the trend set by the matured industrial economies. The EMEs of Asia were supported by improvements in macroeconomic fundamentals. Asian business corporations had healthier balance sheets as a result of continued deleveraging since the Asian crisis. Yet Asian equity markets performed poorly in 2002, although dollar returns were slightly inflated due to regional currency movements. Only the EMEs in Europe generated positive returns in dollar terms. The worst performance in dollar terms was that of the stock markets in the Western Hemisphere. Sizable depreciation in the regional currencies is partly to be blamed for this. It reflected dollar's decline vis-à-vis the euro.

The syndicated bank lending that had slipped into the negative quadrant during the Asian crisis had not become positive. Despite marginal improvement in 2002, syndicated loan volumes remained weak. Due to several high profile bankruptcies in the corporate world in the European Union (EU) and the US and sovereign default in Argentina, banks continued to tighten their lending standards. However, lending activities remained buoyant in the high-grade sectors and problem-free economies.

Due to the recession, there was a sharp decline in the global capital flows to the EMEs of the Western Hemisphere during 2001–02. Risk perception in the global financial markets for the EMEs in the Western Hemisphere and the Middle East had increased during this period. However, by the end of 2002, the EMEs of the Western Hemisphere had regained market access to the global capital markets. The saving grace was that, with some exceptions, flexible exchange rate regime facilitated a relatively smooth adjustment to the movement of funds in major currencies. As the net cross-border capital flows had maintained a low level since 2000, prospects of a contagion spreading in the EMEs had markedly declined.

Net private capital flows to EMEs in 2002 were US$85.9 billion (Table 1), close to the 1997 Asian crisis year level. There was an improvement in 2003. In terms of the proportion of the net private capital flows from the global capital markets, Asian EMEs overwhelmingly dominated the early 2000s. They became so much more important for the global investing community that in 2002 they accounted for 80.9 percent of the total net flows to the EMEs. Real GDP growth rate in this group of EMEs, in particular China, exceeded expectations, increasing their appeal as destinations for the global investors. However, there was a downside. After the burst of the so-called dot-com bubble in 2001, the information and communication technology (ICT) sector had slowed down in the ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand) economies.

During the 2000–02 period, there was a strong trend of reversal of capital flows in the EMEs of Europe and the Middle East. The EMEs of the Western Hemisphere were grappling with their problems and were not able to attract much capital from the global private capital markets. They received merely 2.4 percent of the total net capital flows in 2002. Although GDP growth rate turned up in 2003, serious vulnerabilities remained in Argentina, Brazil, and Uruguay. Political crisis in Venezuela continued to have its economic fallout. Net capital flows to Africa were weak and grew weaker after 2000.[9]

V. An Extraordinary Phase of Financial Globalization in the EMEs

During the 1990s and the early 2000s, several financial crises struck the global economy, in particular the EMEs, both individually and in a group. The Western European exchange rate mechanism crisis of 1992 was the first, followed by the Mexican peso crisis (1994–95), the Asian crisis (1997–98), the Russian ruble crisis and debt moratorium (1998), and the Brazilian crisis (1998–99). Turkey (early 2001) and Argentina (late 2001) were the last to suffer financial crises during this period. This litany could be regarded as an *aide-memoire* of the plausibility that a financially globalized economy could be an unstable economy and that rises can also reverse financial globalization. These financial crises demonstrated that small errors in macroeconomic policy could draw swift punishment from the global financial markets. They also showed that severe crises could occur even without any visible signs of weakness in the macroeconomic policy. Despite some similarities, these crises featured substantial differences among them.

Once this crisis-filled period was over, the EMEs again began turning in a stellar economic performance in 2002. A period of crisis-free uninterrupted growth followed. Global private market capital flows to the EMEs through FDI, portfolio, and international bonds were strong. The net financial flows soared at a rapid rate reaching a peak of US$617.5 billion in 2007. When they peaked, they were 5 percent of the GDP of the EMEs. Judged by historical standards, sovereign spreads were also low for several years. For majority of EMEs, external accounts swung sharply towards surpluses and their foreign exchange reserves accumulation further enlarged. The EMEs learned precious lessons from the crises and addressed their financial vulnerabilities by correcting the currency and maturity mismatches in their national balance sheets. Some EMEs abandoned their firm exchange rate pegs, which had proved to be problematic in the past and moved towards flexible inflation targeting. All these policy moves coalesced to create a superior fiscal and financial policy domain.

Not one single rationalization is enough to vindicate this qualitative improvement in economic policy and performance in the EMEs. Low real interest rates in the global economy due to high savings during this period reduced the potential for a crisis. Besides, strong net external positions, along with large foreign exchange reserves, were helpful. Together they spawned greater confidence among the global investing community, both retail and institutional, in the potential of returns in the EMEs. There were two additional factors rationalizing the improvements in economic performance in the EMEs. First, their real economic performance was *inter alia* driven to a higher level by a strong export demand from the advanced industrial economies, in particular the US. Second, extraordinary firmness in the commodity prices had created boom conditions in many EMEs during this period (Devereux and Sutherland 2009).

One attribute that stood out for this period from any previous episodes of high capital inflows into the EMEs and rapid growth was their extraordinary level of participation in the financial globalization. During this phase, their participation in the global financial markets had attained unforeseen heights. Their role was no longer confined to being large recipients of global capital or originator of outflows. Many EMEs recorded immense growth in gross external financial assets and liabilities. It was much larger than their net positions. This trend was identical to the past experiences of many advanced industrial economies documented in the influential publications by Lane and Milesi-Ferretti (2005, 2007).

As set out earlier (Section II), the contemporary period is known for significant net external surplus of the EMEs as well as perverse flows of global capital from the EMEs to the high-income industrial economies. However, this capital flow was not unilateral. While the EMEs were investing in the US Treasury bills, they were concurrently recipients of large portfolio investments in the form of FDI and equity investment as well as international bond market investment. Majority of the EMEs were substantial net debtors in the mid-1990s. Their borrowing from the banks and US dollar bonds was sizable (Table 1). They turned into net creditors in fixed income assets, as well as net debtors in portfolio equity investments. This is an efficient form of financial globalization in terms of sharing international risk (Devereux and Sutherland 2009). Based on an analysis built around a dynamic stochastic general equilibrium model of the interaction between an EME and the rest of the world economy, Devereux and Sutherland (2009, p. 182) concluded that an EME may build up "positive gross positions in non-contingent international bond assets, and negative positions in FDI and portfolio equity, and may offer a considerable enhancement of international risk-sharing".

The turning point was 2003. In this juncture, private capital flows had recovered and capital flows to EMEs resumed following the decline in interest rates in the advanced industrial economies in 2003. The Fed reduced its interest rates down to 1 percent. Low interest rates logically attract investors to high yields offered by EMEs, particularly those in Asia and Latin America. Private capital flows from the global financial markets increased almost steadily (Table 2). As stated above, 2007 was the peak performance year for the capital flows to the EMEs. This was the fifth year of strong gains. Financial integration between the EMEs and the advanced industrial economies has deepened over this period and the emerging market asset class has moved into the mainstream. Macroeconomic and financial management in the EMEs and large developing economies have considerably improved. The standing of EMEs in the global economic and financial order has changed.

Banking systems in the EMEs were increasingly perceived as healthy and well capitalized. They had diverse earning sources and sound asset quality. Improved economic fundamentals, abundant reserves and strong GDP growth all helped catalyze global private capital glows to the EMEs. The EMEs of Asia continued to be the largest attraction even in 2007 (Table 2). The sub-prime mortgage crisis erupted in the UK and US in autumn. The financial markets in the EMEs were initially expected to remain immune to the financial

Table 2: Net Private Capital Flows to EMEs (2003–08) (in Billions of US$)

	2003	*2004*	*2005*	*2006*	*2007*	*2008*
Total Net Capital Flows	154.21	222.0	226.8	202.8	617.5	109.3
Net FDI	161.3	183.9	243.7	241.4	359.0	459.3
Net Equity Investment	–3.8	10.0	–5.6	–100.7	39.5	–155.2
Other Net Private Capital Flows	–3.3	28.0	–11.3	62.2	219.2	–194.6
Total Net Capital Flows to:						
Africa	4.9	13.0	26.0	35.2	33.4	24.2
Asia	66.9	145.6	85.3	31.8	164.8	127.9
Commonwealth of Independent States	19.0	2.6	30.4	55.1	127.2	–127.4
Middle East	1.4	–17.7	–53.7	–50.0	11.0	–120.9
Western Hemisphere	19.7	17.1	39.0	10.8	107.4	58.5

Source: Statistics gleaned from *World Economic Outlook 2009*. April 2009b, IMF, Washington, DC, Table A13, p. 212.

shocks from the matured financial markets. However, as analyzed below, these hopes for decoupling of the EMEs did not last for long.

Private capital flows to the EMEs slumped precipitously in 2008 to US$109.3 billion (Table 2). Deleveraging by global financial institutions raised the cost and reduced the availability of finance from the global capital markets. In addition, investor risk appetite had declined, sharply reducing the demand for EME assets. Bank assets fell at the most rapid rate in 2008 (Table 2). The two factors driving cross-border deleveraging were: first, credit risk concerns by banks induced them to withdraw funds because they perceived themselves as less able to manage credit risk from a distance. Second, cross-border exposures typically involved a higher regulatory capital charge due to currency or country risk. Therefore, shedding these assets was a quick route to improving capital ratios. These factors and risks were particularly strong in case of lending to EMEs. In addition, EMEs experienced large outflows of portfolio capital in 2008. They accelerated in the last quarter. Given continued pressure on leveraged investors to shed assets, there was a risk of further redemption from the EMEs. Similarly, the FDI flows slowed. Due to the lack of credit available to finance acquisitions, FDI flows were set to slow further. According to the projections of the latest *Global Financial Stability Report*, on balance, EMEs should see net private capital outflows in 2009 and a lackadaisical recovery in 2010 (IMF 2009c).

VI. Current Crisis and the EMEs: Transmission of Financial Stress

As the financial markets in the EMEs were not directly exposed to the sub-prime mortgage crisis that originated in the UK and the US and did not have toxic assets on their books, initial expectation in the EMEs was that the impact of the financial crisis would be confined to the advanced industrial economies. In the early phase of the crisis, the EMEs did remain resilient and continued on their normal growth trajectory. This line of thinking squared up with the decoupling theory that was gaining ground for the last few years. In the last quarter of 2008, following the bankruptcy of Lehman Brother, the crisis was mutated into a full-blown global financial crisis. The credit crunch proliferated instantaneously in a financially globalized economy. The specter of Great Depression seemed to rise from the bygone era of history.

These tremors reached EMEs as well. Their early self-assurance evaporated and many of them came under financial stress in their foreign exchange, stock and sovereign debt markets during the last quarter of 2008. Market sentiments turned fragile and financial strains from the global credit crisis continued to weigh on the EMEs' economic prospects. These circumstances exerted pressure on exchange rates in the EMEs. They caused currency depreciation and depletion of foreign exchange reserves. Many EMEs had succeeded in engendering a comfortable situation in the area of reserves over the preceding 10 years. Some were definitely in more than a comfortable situation.

As the global banks lending capacity shrank and global investors reduced leverage, capital inflows to the EMEs dwindled (Dattels and Miyajima 2009). Equity investment from the global investing community, particularly large institutional investors began to be swiftly withdrawn from the EMEs in the third quarter of 2008. Institutions like the IMF and the IIF reported sharply falling capital inflows into the EMEs in 2008 and forecasted further sharp declines in 2009 (IIF 2009). Concerns regarding external sustainability drove sovereign spreads up. The EMEs in Europe and Latin America were most adversely affected by rising spreads. However, the stock markets in the EMEs that had performed steadily and well over the last few years were the hardest hit. Stock indices in many of them went into an abrupt decline, some even went into a nosedive.

A high-frequency measure of global private capital flows to the EMEs is the issuance data on bonds, equity, and bank loans. These statistics substantiate the same trend as indicated in the preceding paragraph. That is, global capital flows to the EMEs from these financial channels decelerated in the third quarter of 2008. Capital flows through bonds and equity channels affected the EMEs in Asia and Europe to the maximum degree. Similarly, bank lending was sharply scaled back. For many EMEs, bank liabilities shrank as much as 20 percent of the receiving EME's GDP by September. Currencies in the EMEs appreciated vis-à-vis the dollar during the first half of 2008, which was partly responsible for the declining capital inflows.[10]

Abrupt and unexpected slowdown in capital inflows during a crisis period is termed "sudden stop" in the crisis literature. It is known to have dire economic consequences in the EMEs. Towards the end of 2008, in many EMEs industrial production either dramatically declined or came to a virtual standstill. The European EMEs recorded a contraction in their industrial output in the early months of 2009. The credit crunch set off by the global financial crisis weakened import demand in the advanced industrial economies. This is a common after effect of a financial crisis and was observed during the earlier crises as well. In the past crises, global private capital inflows to the EMEs dried up for a substantial length of time and industrial output took a fairly long time to recover and reach the level prevailing before the crisis. The Asian crisis (1997–98) testifies to this trend. Thus, a financial crisis has a large effect on the real economy.

To analyze the level of financial stress in the EMEs as well as to study transmission of stress from advanced industrial economies to them, a stress index was devised by the IMF for 18 EMEs (IMF 2008, 2009b). The findings of this index were revealing. Its first deduction was that the present crisis is more severe than any in the last three decades. In that, it has had a negative economic impact over all segments of the global financial system and all the regions of the global economy. For the EMEs, the financial stress of the current crisis reached the level reached during the peak of the Asian crisis. Second, a strong link was observed between the financial stress in the advanced industrial economies and EMEs. Due to the progress made in financial globalization, the crisis transmitted swiftly and directly from the former economies to the latter. Crisis transmitted instantly and strongly to the EMEs that had closer financial associations with the financial markets in the advanced industrial economies.

The financial stress index revealed that the present level of financial stress is rooted in the banking system of the advanced industrial economies. It can therefore be projected that the capital flows to the EMEs will suffer a large decline. The recovery to normalcy will be slow. Capital flows through the banking sector will be the slowest to recover. One favorable characteristic that saved the EMEs from more financial stress and dire consequences was that their current account and fiscal deficit were low, reflecting their superior macroeconomic management over the past decades. The EMEs had also succeeded in accumulating a sizable level of foreign exchange reserves. The large reserves can help the EMEs during their sudden stop periods.

As for the appropriate response to cope with the financial crisis, the EMEs need to focus macroeconomic and financial policies

> … on averting further escalation of stress in emerging economies. This would not only limit the impact on the real economy in these countries, but also would thwart a second round of global deleveraging in the wake of damage to lenders' balance sheets in mature markets. (IMF 2009c, p. 141)

In a financially integrated global economy, cross-country spillover tends to occur promptly. This is a strong reason supporting the need for a coordinated strategy between the EMEs and the advanced industrial economies. The systemic stabilization endeavors in the latter should be aimed not only at their own financial systems but also to foster a reduction of stress in the EMEs.

Continuance of progress in global financial integration is an essential element of a prospering global economy. The current financial crisis and recession provides a meaningful perspective for the policy mandarins. As strengthening financial linkages also increase transmission of financial stress from the crisis economies to others, there is a collective need to multilaterally indemnify against the external financial shocks. The objective is to shield and support the economies that have creatively and ingeniously followed sound macroeconomic and financial sector policies, governed their economies well and promoted global integration.

VII. Composition of Recovery from the Crisis

In the mid-2009 review of the global recession, the World Bank (WB) admonished that global growth in 2009 will be more negative than computed earlier. The new projection for contraction in the global GDP was 2.9 percent (WB 2009). The global economy was showing symptoms of entering a period of slow growth, which called for tighter and more effective oversight of the global financial system. In the revised projections, the global contraction has been forecast to turn into a mild recovery. The global economy will grow at the rate of 2 percent in 2010.

Although there are normal caveats about these projections, there are signs that the bottom may have been reached in several large economies. According to the projections made by the WB (2009), the EMEs are projected to perform better than the global economy in 2010. Their growth was projected at 3.2 percent. The performance of the advanced industrial economies is forecast to be markedly different (1.3 percent) from that in the EMEs. Also, growth rates with regions will vary substantially. The EMEs of Asia and South Asia are expected to lead with 5.0 and 5.3 percent growth rates, respectively. Once again, China and India will turn in stellar performances, with 7.5 and 5.6 percent growth, respectively.

Challenges Pushed to the Fore by the Crisis

The positive aspect of a crisis is the lessons that public policy professionals can learn which have utility for the future. It also brings to light the causal factors behind the crisis. Once revealed, these systemic limitations can be addressed. The EMEs can individually and collectively learn lessons from the current crisis and benefit. They can find pragmatic ways to resolve the problematic issues. The first and imperative lesson is regarding regulatory and supervisory bodies. A great deal of culpability for the current crisis is put at their doors. In view of the transforming global financial scenario, these systems need updating and redesigning. It needs to reflect the changing structure, practices and procedures in the global capital markets. They should be more meticulously redesigned than in the past. These regulatory and supervisory institutions need to remain ever more vigilant.

The large foreign reserves accumulated by several EMEs, particularly those from Asia, is another germane issue. They went a long way in cushioning many EMEs from the current global financial crisis. The question that needs to be deliberated upon is whether the cost involved in maintaining such large reserves is worth it. If this cushion could be provided by a lower level of Forex reserves, then it needs to be determined what an appropriate lower level is. This would enable the EMEs to avoid the high costs of maintaining excessive reserves. A related issue is the role of the dollars as the first priority reserve assets in the world. Calls for a new reserve currency that is not the currency of a country have recently been made by large EMEs. According to some EMEs, Special Drawing Rights (SDR), managed by the IMF, fit the bill and should be made the *de jure* reserve currency for the global economy. In the Group-of-Twenty (G-20) summit in London in April 2009, China was the first to broach this issue and subsequently the Russian Federation joined in. Before the G-8 summit in the Italian city of L'Aquila began on July 8, 2009, China, India, and the Russian Federation called for an end of dollar's dominance in the global monetary system again. According to the Chinese proposal, the dollar should no longer be an international reserve currency. It should be replaced with a global reserve currency, the SDR, created by the IMF in 1969.[11] China also sees the SDR basket to be expanded to include the renminbi yuan. An interesting point is that nothing needs to be done *de jure* in this regard. If China and other EMEs stop accumulating their Forex reserves in the dollar, its significance will decline, which in turn is not in the interest of EMEs like China, which have large investments in the US Treasury securities.

The EMEs of Europe opened their capital account a bit too rapidly. These countries allowed a lot of capital to gush in from the global capital markets. They ran current account deficit of the order of 10 percent, even more. Their economies suffered serious damage when capital flows reversed and capital fled to safety in 2008.

When the recession started, these economies suffered huge disruptions to their exchange rates, asset prices, and financial systems. To an extent, policies pursued in opening their capital account were to be blamed. The IMF needs to provide policy advice to this group of EMEs regarding adoption of the most pragmatic ways of capital account liberalization.

Asian EMEs and the Green Shoots of Recovery

Although the performance of EMEs in general, in the second quarter of 2009, was far superior, this applied *a fortiori* to the EMEs of Asia. During the second quarter, the Asian EMEs grew at an average annualized rate of 10 percent. According to the recent forecasts, this subgroup of EMEs may well record a GDP growth rate of 5 percent for the 2009 year (*The Economist* 2009). As the Group-of-Seven (G-7) economies are projected to contract by 3.5 percent in 2009, the growth gap between the two groups would be at its widest. Interestingly, this testifies to the fact that a small group of EMEs did manage to decouple from the advanced industrial economies in a period of dire global recession (Pula and Pultonen 2009).

During the third quarter of 2009, the term "green shoots" began to be used for indications of a recovery. Some glimmers of green shoots were visible in the EU and the US economies, but recovery first took hold in China. Japan and the EMEs of Asia followed. Asia had a lush jungle of the so-called green shoots. The emergence and growth of the middle class in China, India, and other Asian EMEs will continue to drive domestic consumption of the region (Das 2009b). China in particular was singled out by Robert Zoellick, the president of the WB, for helping in preventing the global financial crisis from getting worse (AFP 2009). It played a more consequential role in leading the region out of the doldrums.

Growth forecasts for the regional economy were revised upward in mid-September 2009 by the Asian Development Bank (ADB). Several EMEs began their recovery sooner than anticipated earlier. This validates the fact that they have come to acquire a certain degree of macroeconomic and financial maturity in their right. According to the ADB update, the region was projected to grow by 3.9 percent in 2009 and 6.4 percent in 2010, up from 3.4 and 6.0 percent, respectively (ADB 2009). Performance of some sub-regions—East Asian and South Asian—recorded remarkable recent gains, improving prospects for the region as a whole.

Average statistics conceal a great deal of diversity in growth performance in Asia. As noted, three large Asian EMEs—China, India, and Indonesia—had managed to continue to grow despite the global economic downturn. To be sure, some of the relatively smaller Asian EMEs, Hong Kong SAR, Korea, Malaysia, Singapore, Taiwan, and Thailand were in recession and were adversely hit by the downturn. Of these, Korea and Singapore rebounded vigorously in the second quarter of 2009. Part of the reason behind the rebounding Asian EMEs was an impressive upturn in their industrial production during the second quarter of 2009. This upturn was assisted by 11 percent growth in imports in China.[12] Thus viewed, China helped in stabilizing Asian economy and Asia's EMEs in turn were playing a meaningful role in the global recovery. They evidently were leading it. The other factors that underpinned the rebound of the Asian EMEs were aggressive monetary and fiscal easing by them as well as the ripple effects of large stimulus programs in many other economies around the globe.

There is an element of surprise in Asia's export-dependent EMEs resuming growth before the global economy, particularly the G-7 economies. The factors behind this surprise are: first, aggressive domestic fiscal and monetary stimulus packages were launched throughout the region, which helped strengthen domestic demand. If a regional comparison is made, no other region launched large stimulus packages as did the Asian economies. In several Asian EMEs, it was as large as 4 percent of the GDP. China's massive 4 trillion renminbi yuan (US$585 billion) stimulus package was 15 percent of Chinese GDP (US$3.9 trillion), the largest of any economy. It was accompanied by a huge surge in government-mandated bank lending. It is justly credited with offsetting the export downturn, rescuing the domestic economy, and propping up the regional economy. Second, when the global recession began, budget deficit in most Asian EMEs was low, or none at all. India was the only errant Asian economy and a notable exception in this regard. Consequently, the public debt in the region will rise to a meager 45 percent of the GDP at the end of 2009. This is an indication of unassailable budgetary health. To put this in perspective, the estimates of public debt of the Organization for Economic Cooperation and Development (OECD) countries at the end of 2009 are double the Asian level. Third, in comparison to the advanced industrial economies, financial sector in the Asian EMEs was robust. It provided a buffer against the global financial turmoil. Fourth, Asian economies have traditionally been high savers. As Asian households were not debt ridden, fiscal and monetary stimulus was more likely to be spent by them than saved, rendering it more effective than that in the G-7 economies. That being said, as demand from the advanced industrial economies is weak and likely to continue to be so, it will be difficult for Asian economies to resume their pre-crisis GDP growth.

VIII. Summary and Conclusions

The concept of EMEs is somewhat loosely defined, rendering it to multiple definitions. Therefore, there are many country classifications of EMEs. Although they tend to be highly diverse, it is possible to assign certain common characteristics to the EMEs. Integration of the EMEs into the global financial markets has been growing, albeit not steadily. Although these groups of economies have not become an integral part of the financially globalized economy, they have become active participants. It is logical to focus on the financial globalization of this group because there are important differences across country groups in this regard, particularly in the relative importance of different types of capital inflows and the pace of financial globalization. That the extent of financial globalization in the EMEs is both qualitatively and quantitatively different from the other country groups can be established with the help of the *de jure* and *de facto* measures.

This article provides details of global private capital flows to the EMEs since the early 1970s, when the so-called oil-shock struck the global economy. It had enormous significance for the global financial markets. The following time period has been divided into various sub-periods, which have been analyzed independently. The characteristic features and trends for each period have been identified and analyzed. Also, temporal evolution of capital flows to the EMEs has been portrayed for each sub-period. Both qualitative and quantitative details of the financial flows and the emerging trends during each sub-period have been analyzed. The Latin American and Asian financial crisis have not been analyzed in depth but have been alluded to in the discussion of the relevant sub-periods.

The 1973 oil-price hike left many large money center banks in the US, Europe, and Japan holding large sums in petrodollar deposits. They began investing them in the EMEs, particularly those of Latin America. In the early 1980s, the global economic climate changed and several factors coalesced to create serious debt-servicing problems for the Latin American EMEs. They found themselves in dire financial straits. Beginning with Mexico in August 1982, several of them declared moratoriums on their sovereign obligations. This developed into a major financial crisis of global proportion, the first in the post-World War-II era. For the global financial markets, the EMEs suddenly became the pariahs and capital flows to them dwindled.

Towards the end of the 1980s, the gloomy relationship between the EMEs and the global capital markets began to transform. They again became a favorite investment destination. This time capital flows to the Asian EMEs surged at a rapid clip. Global private capital flows to this group of EMEs were 10 times large in the late 1980s compared to their average in the early part of the decade. The 1990s were the period of acceleration in the financial integration of the EMEs. After peaking in nominal terms in 1996, net capital flows to EMEs did not recover for a while. The Asian financial crisis precipitated in 1997. Considerable tightening in emerging market financial conditions took place after this juncture. The principal reason obviously was recurring crises in individual EMEs and groups thereof during 1997–98 (Section V), which led to an increased perception of risk in them in the global private capital markets. The Asian crisis (1997–98) and the Russian default (1998) in particular had a pronounced effect over the global financial markets and the psychology of investors. At the turn of the twenty-first century, global equity markets were volatile. Noteworthy was sovereign default by Argentina and deep recession in the EMEs of the Western Hemisphere during 2001–02.

The financial crises of the 1990s and early 2000s are a reminder of the plausibility that a financially globalized economy could be an unstable economy and that crises can also reverse financial globalization. Once these crises were behind, a period of crisis-free uninterrupted growth followed. Global private market capital flows to the EMEs through FDI, portfolio, and international bonds were strong. The net financial flows soared at a rapid rate reaching a peak of US$617.5 billion in 2007. When they peaked, they were 5 percent of the GDP of the EMEs. Judged by historical standards, sovereign spreads were also low for several years. For majority of EMEs, external accounts swung sharply towards surpluses and their foreign exchange reserves accumulation further enlarged. The EMEs learned precious lessons from the crises and addressed their financial vulnerabilities by correcting the currency and maturity mismatches in their national balance sheets. Some EMEs abandoned their firm exchange rate pegs, which had proved to be problematic in the past and moved towards flexible inflation targeting. All these policy moves coalesced to create a superior fiscal and financial policy domain.

This period is known for a significant net external surplus of the EMEs as well as perverse flows of global capital from the EMEs to the high-income industrial economies. However, this capital flow was not unilateral. While the EMEs were investing in the US Treasury bills, they were concurrently recipients of large portfolio investments in the form of FDI and equity investment as well as international bond market investment. Majority of the EMEs were substantial net debtors in the mid-1990s. Their borrowing from the banks and US dollar bonds was sizable. They turned into net creditors in fixed income assets, while net debtors in portfolio equity investments. This is an efficient form of financial globalization in terms of sharing international risk.

Two large EMEs, China and India, have been slowly but surely expanding their activities and prominence in the global financial markets. Both the EMEs have been making their presence felt in the international capital markets. The exchange rate and capital account liberalization policies of both the economies are in their evolutionary phase. Both of them are sure to undergo further financial development and liberalization. They are well on their way to have an increasing role in the global financial system as well as private capital markets.

Initial expectation in the EMEs was that the impact of the ongoing financial crisis would be confined to the advanced industrial economies. In the early phase of the crisis, the EMEs did remain resilient and continued on their normal growth trajectory. However, in the last quarter of 2008, following the bankruptcy of Lehman Brothers, the crisis was mutated into a full-blown global financial crisis. The credit crunch proliferated instantaneously in a financially globalized economy. The specter of Great Depression seemed to rise from the bygone era of history. The EMEs were badly affected by it. Capital flows precipitously declined in 2008. It was projected to decline in 2009, setting off financial deglobalization. Concerns regarding external sustainability drove sovereign spreads for the EMEs up.

Notes

1. Although China has an active state-owned enterprizes sector, with vestiges of central planning, it can be regarded as a near-market economy.
2. The four NIEs are the Republic of Korea, Hong Kong SAR, Singapore, and Taiwan.
3. The 23 countries on the IMF list classified as the EMEs are: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Hungary, Hong Kong SAR, India, Indonesia, the Republic of Korea, Malaysia, Mexico, Peru, the Philippines, Poland, the Russian Federation, Singapore, South Africa, Taiwan, Thailand, Turkey, and Venezuela.
4. See also Kose et al. (2006).
5. Das (2004) compiled and reported these statistical data from the *World Economic Outlook* for various years.
6. Ibid.
7. The Asian crisis started in Thailand, but the contagion effect soon gripped other Asian economies and subsequently the region. The Thai baht collapsed due to the decision of the Thai Government to float it, cutting its peg to the dollar.
8. This group comprised Argentina, Brazil, Chile, China, India, Indonesia, Korea (Republic of), Malaysia, Mexico, the Russian Federation, Thailand, and Turkey.
9. Das (2004) compiled and reported these statistical data from the *World Economic Outlook* for various years.
10. The source of statistics in this section is IMF (2009a), Chapter 9.
11. The SDR is based on the weighted average of the dollar, euro, yen, and pound. The SDR was designed as a reserve currency, but it never took off. In 2009, SDR added up to less than 1 percent of total global reserves.
12. This increase took place during 1 year between July 2008 and July 2009.

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