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Brazil, India and South Africa: Low Spill-over, High Resilience of Financial Sector

by Martina Metzger

The course of the global financial crisis displayed widespread flaws in regulation and supervisory failure. The financial sectors of advanced countries piled up systemic risk comprising almost all financial institutions. In addition, high cross-border exposure between the financial institutions resulted in a core meltdown when the bubble burst in 2008. The financial sectors of many advanced countries risked collapse, meaning unprecedented monetary and fiscal intervention by policy authorities was necessary to stabilise the situation.

In contrast, many emerging market economies weathered the financial tsunami not only better than expected in terms of financial and macroeconomic stability given their previous performances during crises, but also better than G7 countries. Against this backdrop, we begin to question which factors account for the low impact of the global financial crisis and which features might explain the strong resilience of emerging markets' financial sectors. The countries under consideration here are Brazil, India and South Africa. Apart from being heavy weights in their respective regions and continents, the financial sectors of these three countries showed a remarkable resilience to the global financial turmoil.

Low spill-over to Brazil, India and South Africa

With the default of Lehman Brothers, the US subprime crisis transformed into a global financial crisis, also affecting the financial markets of emerging market economies. Apart from a short period of stress in the second half of 2008 resulting in steep stock market corrections and a strong volatility of prices, in particular exchange rates, financial sectors in Brazil, India and South Africa proved to be robust.

First round effects or direct impacts of the global financial crisis on emerging market economies in general and on Brazil, India and South Africa in particular were low, as exposure of their domestic financial institutions to toxic assets had been small. There was only minimal investment in complex instruments and marginal exposure to risky financial products – marginal to such an extent that it was not necessary for regulatory authorities to fall back on counter-actions.

In addition, the share of foreign banks with majority ownership in the domestic financial system is negligible in India and South Africa, while in Brazil it is still low compared with more affected emerging market economies or transition countries; hence direct spill-over from banking headquarters in advanced countries to host countries was limited.

However, there had been considerable second-round effects with the financial sector and more importantly the trade sector as main transmission channels. The real economy had to bear the major burden: in the wake of declining exports, industrial production, investment and employment fell and real growth was depressed. All three countries slipped into a recession with a sharp slump of real growth in 2009.

Policy responses

Despite some differences in the magnitude of the spill-over and severity of the transmission channels, policy responses by fiscal and monetary authorities of the three countries under consideration were quite similar. First, central banks increased liquidity by cutting policy rates; in a second step central banks reduced reserve requirements and compulsory deposits to provide additional liquidity to credit institutions; a third measure covered companies and banks which were affected by the restricted access to international and domestic finance, in particular trade finance. All in all, there was a sizeable monetary accommodation to cushion liquidity shortages and credit crunches in order to stabilise the domestic financial sector. Additional to the monetary policy measures fiscal policy initiated a package of measures with discretionary counter-cyclical instruments to dampen negative impacts of the global financial crisis on domestic growth and employment.

The fiscal stimulus packages focused on stabilising the level of domestic demand. Governments provided finance to mitigate the most severe impacts on vulnerable groups, in particular poor and low-income households as well as small-and-medium-sized enterprises. On the other hand, the governments of India and South Africa extended pre-crisis infrastructure programmes and initiated new ones in order to strengthen their economies' potential to grow and at best to increase the economic inclusiveness.

In contrast to previous times of crisis in the 1980s and 1990s, this time central banks and governments of the three countries disposed over adequate policy space to use multiple instruments, including non-conventional monetary measures and counter-cyclical fiscal measures.

Features of Financial Sector Resilience

Conventional wisdom suggests that the capacity to manage a crisis mainly depends on what policy has realised during good times, e.g. the creation of sound financial institutions, the improvement of regulatory and institutional capacities, the deepening and broadening of domestic financial markets and the design of an adequate monetary and fiscal framework which allows the involved institutions to work out a consistent response to a crisis in a coordinated way. Even so, the low impact that the financial meltdown in advanced countries had on the financial sectors of Brazil, India and South Africa raises the question of whether and to what extent specific characteristics and features of their financial market architecture and regulatory approaches can explain such high resilience.

There are four outstanding factors which might claim to have insulated the financial sector of these three countries from the worst woes of the global financial crisis. First, one key problem of past crises has been high foreign debt and associated currency and maturity mismatches; balance sheet effects were a major factor which exposed developing countries and emerging market economies most to hazard with regards to macroeconomic stability and development. Accordingly, Brazil, India and South Africa reduced their outstanding foreign debt exposure over time and from the turn of the millennium also succeeded in increasing their foreign exchange reserves.

Second, the macro-prudential approach which is applied by the central banks of Brazil, India and South Africa is another distinguishing mark of their financial architecture. As experience has shown that financial sector-related crises are an important feature of market economies, their central bank policy takes into account financial stability considerations – a task which many central banks in advanced countries rejected due to a perceived conflict of interest with the objective of price stability.

Third, another aspect in the financial market regulation shared by the three countries is the rule-based rather than principle-based approach. A rule-based approach with universal standards entails less forbearance and enables less regulatory arbitrage; supervisors' decisions are based on transparent and reliable indicators, e.g. equity capital, non-performing loans or credit ratios. Hence, regulation based on a rule-based approach is easier to impose and decisions can be taken quicker which is backing pre-emptive surveillance.

Fourth, Brazil, India and South Africa exhibit country-specific features in a narrow sense, which contributed to the resilience of their financial systems. With regard to Brazil, for instance, it is worth mentioning that the supervision covers all financial institutions, including hedge funds and OTC derivative markets; another particularity is the so-called Public Hearing Process for regulatory proposals concerning securities. India, on the other hand, developed a special framework for non-banking financial companies (NBFCs) with an explicit treatment and deliberate prudential norms of those entities. Furthermore, banks have to make provisions for a counter-cyclical Investment Fluctuation Reserve, which bears some resemblance to the currently debated liquidity buffers by the Financial Stability Board. In South Africa the regulation on collective investment schemes, including hedge funds, comprises a ban on leverage and short selling strategies. With the National Credit Act, South Africa also developed a broad spectrum of instruments to protect consumer rights. In case of complaints by consumers and disputes with credit providers, including banks, the National Consumer Tribunal enforces a hearing process at which end it can completely suspend the credit agreement to the disadvantage of the credit provider when proved reckless.

Taking these features into account it comes as no surprise that banks in the three countries are on average sound, and banking behaviour has adapted to legal restrictions and norms; they even hold reserves and liquidity in excess of regulatory requirements, something considered inefficient and non-innovative before the crisis. More importantly, at the time of writing, banks in Brazil, India and South Africa had not been infected by the notorious originate-and-distribute virus of granting loans, which was a major driver of the credit and securitisation bubble which finally resulted in the global financial crisis; instead, they still execute the original banking model with a buy-and-hold strategy based on thorough credit assessment and borrower supervision.

In sum, the combination of a reduction of foreign debt exposure, a macro-prudential approach in supervision and a rule-based approach in regulation, complemented by a variety of country-specific rules applied by these countries even before the crisis, together with non-orthodox monetary and fiscal policies during the crisis can be identified as the main features of economic success.

The high resilience of the financial sectors of Brazil, India and South Africa is a result of continuously strengthening financial sector institutions and adjusting the regulatory framework to the respective country's needs and vulnerabilities. This is an ongoing process which started two decades ago. Crisis heritage has proven a major motivation for macroeconomic and financial sector improvements while at the same time Brazil, India and South Africa constructively turned the drastic experience into a cautious and thorough handling of financial sector-related issues. In the hostile environment of a global financial crisis, the specific art of supervision performed by Brazil, India and South Africa was put to test – and impressively passed it.

Martina Metzger is the executive director of the Berlin Institute of Financial Market Research (BIF). Before joining BIF, she taught macroeconomics at several universities and worked with UNCTAD. Her areas of interest include financial market development in emerging market economies, macroeconomic stabilization and sustainable development.

FURTHER READING:

Martina Metzger and Günther Taube (2010), 'The Rise of Emerging Markets' Financial Market Architecture: Constituting New Roles in the Global Financial Governance', BIF Working Papers on Financial Markets, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1844444