



EM anti-crisis measures

Separating the wheat from the chaff

June 16, 2009

Emerging markets have put together sizeable stabilisation and support programmes and other measures to combat the effects of the financial crisis. Looking at the headline figures as announced by the respective governments, the largest packages are in UAE, China, Russia, Kuwait, Hong Kong and Kazakhstan, each amounting to at least 10% of GDP.

There are two main differences between anti-crisis measures in EMs and in developed markets. First, the majority of EM programmes do not contain significant recapitalisation schemes for banks, which to a large extent is due to the relatively good shape of many EM banking sectors. We built a composite index of financial soundness according to which Asian and Latin American banking sectors are faring quite well.

Second, emerging markets have had to fight the EM-specific problem of FX liquidity shortages. When a crisis erupts, typically EM currencies depreciate sharply, creating problems in the balance sheets of governments (less so in recent years) and the private sector. EM governments have reacted by injecting FX liquidity and intervening in the market to contain currency depreciation. This has shown that the amount of FX reserves in relation to external financing requirements is still crucial to the assessment of countries' resilience to external shocks. From a policy perspective, accumulating FX reserves still seems to be pretty good insurance.

As in the case of developed markets, there is a trade-off between fiscal stimulus and the sustainability of fiscal policy. Given emerging markets' history of macroeconomic instability, the issue of credibility of policies is especially important for EMs. In terms of their fiscal health at the onset of the crisis, the Gulf countries, Russia, Chile and Hong Kong possessed outstandingly high capacity to implement countercyclical measures.

In recent weeks there have been some signs of stabilisation in financial markets and selected economic data. It is difficult to assess to what extent stimulus packages have played a role (there are indications that this is the case with China). To be sure, the much-enhanced IMF role in providing assistance as well as massive support measures in developed markets have been critical, but the reaction of emerging market governments has been constructive overall, which bodes well for the post-crisis recovery period.

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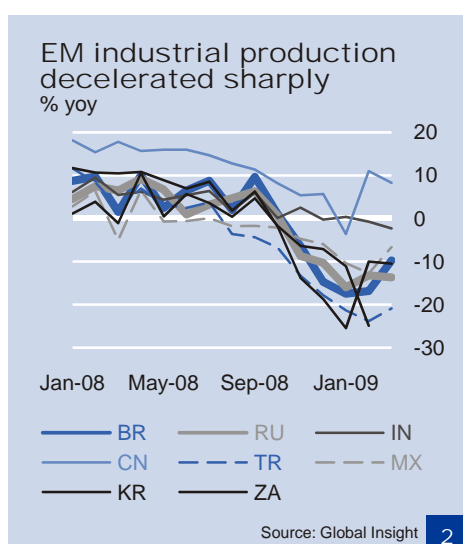
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Asian and LatAm banks are in a better shape than CEE banks

EM anti-crisis measures – separating the wheat from the chaff

Emerging markets have been hard hit by the global financial crisis, particularly in the post-Lehman phase starting in September 2008. Following a sudden and dramatic increase in investors' risk aversion, capital flows to EM came to a "sudden stop", leading to a sharp and indiscriminate sell-off in emerging market assets. Currencies and stock markets plunged and risk premia soared. The plunge in commodity prices compounded the gloom. Soon after, the effects of the crisis on the real economy became evident: exports, industrial production, retail sales, confidence indicators, etc. slowed significantly or declined (see charts).

Against this background, many emerging market governments put together "anti-crisis" programmes. To a large extent, these programmes are similar in nature to those announced by developed countries. An important difference, however, is that emerging market packages usually contain foreign-exchange support measures, be it in the form of FX swaps, outright FX intervention or government support for external debt service by companies.

In the following we present a brief overview of EM measures. A comparison of the stimulus and support packages is very difficult, and we do not attempt to present a comprehensive description of each country's measures or to measure their fiscal impact in 2009-10¹. Instead, we look at headline announcements and "tick boxes" with respect to the type of measures included in each package. We also discuss briefly monetary policy measures and the health of EM banking sectors, and we place the stimulus measures in the context of macroeconomic stability. Finally, we present some concluding remarks.

EM stimulus packages: A bird's eye view

Stimulus packages in emerging economies are largely aimed at easing liquidity restrictions and boosting domestic demand. Most packages include infrastructure spending and support to SMEs and strategic industries, as well as liquidity and funding support to banking systems. Notably, and in contrast to developed markets' packages, only a few of the EM packages contain bank recapitalisation funds. This can be taken as an indicator of the relatively good health of EM banks, although it may still be early days considering that asset quality deterioration typically lags the economic slowdown and therefore a substantial rise in NPLs and accompanying strains on EM banks' capital may still lie ahead.

Asian and Latin American banks seem to have learnt from their past crisis episodes. In general, they have restricted foreign-currency exposures and funded credit expansion with domestic deposits. Thus, most banking systems have suffered from tighter liquidity conditions but only a few have needed recapitalisation (Korea, India and Hong Kong). On the fiscal side, government packages seek to neutralise the effect of shrinking domestic demand as well as supporting local companies unable to roll over their foreign debt obligations.

China's stimulus package is one of the most ambitious in the EM world, and it has been argued that the package has played a key

¹ Calculations of fiscal stimulus from the packages for 2009-10 can be found at the IMF (2009), Companion Paper—The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis, March 6 and OECD (2009), Fiscal Packages across OECD countries: Overview and Country Details, March 31.

Sizeable external assets allowed Middle East countries to help their banks

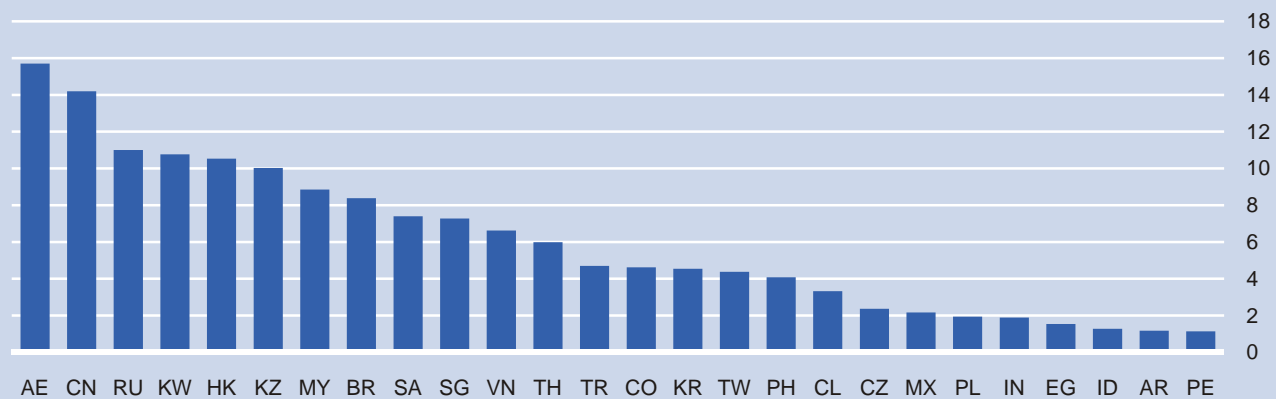
role in the pick-up in economic activity seen in Q1. Russia's and Kazakhstan's programmes are quite substantial, too. In these countries, support for the banking sector constitutes an important part of the packages, although tax cuts (Russia) and aid for the real estate sector (Kazakhstan) are also significant.

Oil-rich countries in the Middle East have used some of their sizeable (external) assets to inject liquidity into their banking sectors. For example, UAE's central bank recently launched a large liquidity facility aiming to help Dubai's financial sector to cushion the slowdown and regain investors' confidence. Overall, the UAE anti-crisis package is the largest among EMs.

In Latin America, the example of Chile has been (justifiably) commended. The country has a countercyclical fiscal rule that mandates the saving of copper price windfalls. These accumulated savings now allow the country to provide fiscal stimulus without jeopardising macroeconomic stability.

Central and Eastern European (CEE) countries have experienced severe liquidity stress owing to banks' reliance on external funding. Most of the CEE countries are in recession. But restricted fiscal capacity (except in Russia and Kazakhstan) has only allowed them to provide modest stimulus. Some countries, like Hungary, have even had to resort to tightening measures in order to correct macroeconomic imbalances.

Unveiled stimulus packages
% of GDP, 2008

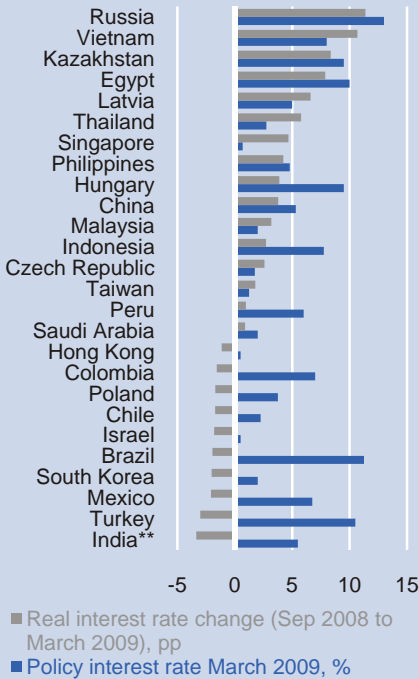


Source: DB Research **3**

Measures included in unveiled stimulus packages												
Country	Fiscal stimulus					FX support ^(a)	Bank support					
	Infrastructure/ construction	Tax cuts businesses	Tax cuts individuals	SME/strategic support	Social services/ safety net		Other	Capitalisation	Liquidity & funding support	Increased deposit protection		
UAE							X					
China	X		X	X					X			X
Russia	X	X	X	X					X			
Kuwait					X				X			X
Kazakhstan	X	X	X	X					X			X
Hong Kong	X		X		X				X			X
Malaysia	X	X	X	X								X
Brazil		X	X	X					X			
Saudi Arabia						X						X
Singapore	X	X	X	X					X			X
Vietnam	X	X	X	X					X			
Thailand	X	X	X						X			X
Colombia	X								X			
Korea	X	X	X	X					X			
Turkey		X	X	X					X			
Taiwan	X	X	X	X						X		X
Philippines	X	X	X					X**				X
Chile	X			X				X*				X
Czech Republic	X	X	X	X								X
Mexico		X		X					X			
Poland												X
India	X	X	X	X								
Israel	X	X	X	X					X			
Egypt	X			X								
Indonesia	X	X	X									X
Argentina				X								
Peru	X	X	X	X								X
Countries that implemented the measure, %	65	62	65	65	46	8	12	27	73	50		

Source: DB Research

Real interest rates have only declined in a few EMs*



*Real interest rate calculated as the difference between the policy interest rate and the actual inflation rate.
 **Real interest rate from Sep to Feb 2009, policy interest rate Feb 2009.

Sources: Global Insight, DB Research **4**

Monetary policy response: Some room left

Synchronized monetary easing has been taking place in developed and emerging economies. Contrary to most developed markets, interest rates in EMs are still well above zero. EM central banks have hiked interest rates several times over the last few years, due to significant inflation pressures (most recently in H1 2008, due to the sharp hike in food and commodity prices).

As concerns about weakening domestic demand mounted, the second half of 2008 saw EM central banks start to cut rates to support the economy (as well as adopt other monetary measures such as reducing reserve requirements). But, since inflation declined as well, real interest rates did not actually fall in most of the countries, and even increased in many cases (see chart). Only one third of the countries in our sample have seen a decline in real rates recently. These are countries which had high nominal interest rates at the beginning of the easing cycle (such as Brazil, Turkey and Colombia) and those who have cut more aggressively (Chile).

EM central banks thus have scope to continue easing. Some restrictions on the scale of the easing may arise from current- and capital-account pressures on the exchange rate. These will be higher for countries with pegged exchange-rate regimes or larger foreign currency-denominated balance sheets. Put simply, if exports continue to fall and capital inflows do not recover, currency weakness will act as a brake on monetary stimulus.

External financing remains Achilles' heel

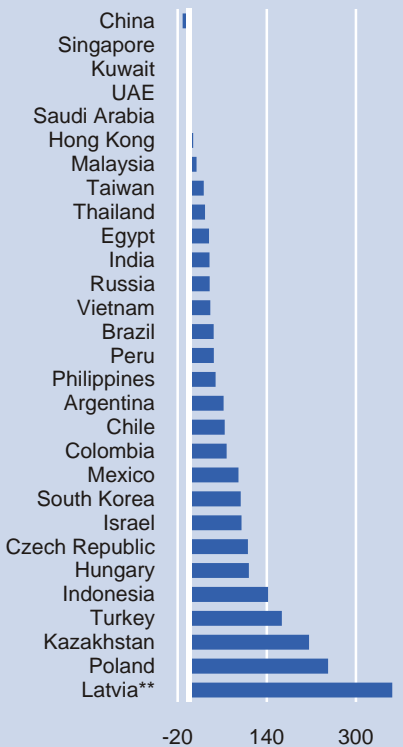
Many emerging markets have improved their external liquidity position substantially over the past few years, accumulating FX reserves, paying down external debt, reducing the FX links in the economy ("de-dollarisation"), etc. However, sudden and pronounced currency depreciation – as seen in recent months – still causes significant problems, especially for the private sector.

Some EMs' packages included specific measures to prop up currencies (such as swap contracts and repo operations). But most countries over the last few months resorted to traditional FX intervention via FX reserves to control the pace of depreciation. Countries that saw their FX reserves decline by 15% or more in the process include Russia, Malaysia, Kuwait, Poland and Saudi Arabia.

Other countries have had to resort to multilateral financial support in order to obtain FX liquidity and avoid a currency crisis. The IMF currently has 19 arrangements in place (stand-by loans or flexible credit lines), of which all but two were granted since November 2008². The EU and other institutions such as the EBRD, as well as bilateral donors, have also contributed to financial support packages, especially in Central and Eastern Europe. Another "line of defence" has been the granting of currency swap arrangements, such as those provided by the US Fed, the ECB, as well as those in Asia in the context of the Chiangmai Initiative.

As long as capital inflows to emerging markets remain subdued (which is likely this year and next), countries' external financial requirements and their coverage will continue to be key indicators for assessing emerging markets' economic health. Furthermore, in light of the relative resilience of Asia and Latin America in comparison to Eastern Europe, it may well be the case that one of the lessons learned from the current crisis is that accumulating

A strong external position gives room for manoeuvre
 EFR* in 2009 / FX reserves+ counter-cyclical & SWF funds at end-2008, %

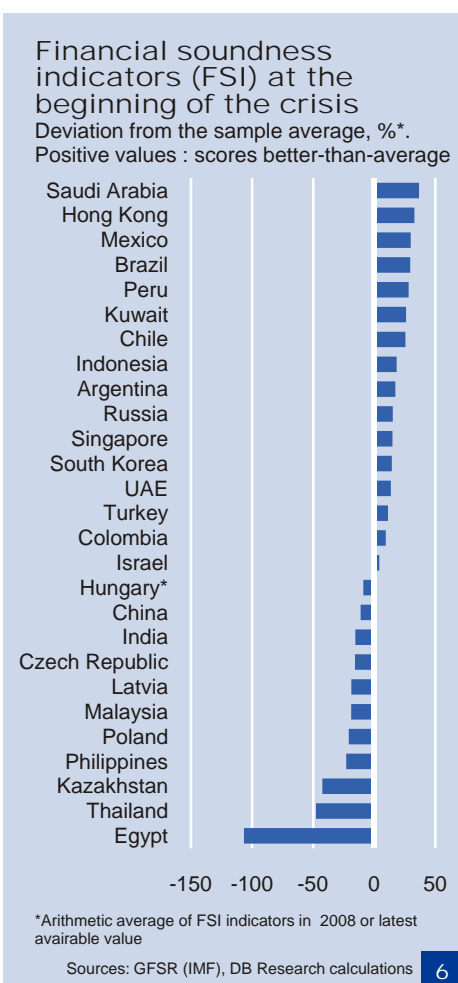


*External financing requirements: Current account deficit +short-term debt +debt amortisation.
 ** FX reserves+ IMF loan payments until Dec 2008.

Source: IFS, DB Research **5**

² As of May 21, 2009, see www.imf.org.

Higher dependency on external funding is problematic



abundant FX reserves is the best anti-crisis insurance. Needless to say, this would not be conducive to a correction of the “global imbalances”.

How well can EM banking sectors cope with financial stress?

It is now well known that banking sectors which are more dependent on external funding – such as those in Eastern Europe – have suffered the most severe direct impact from the crisis, as lending from developed market banks has dried out. Latest BIS data for Q4 2008 show that total foreign claims of BIS reporting banks in developing regions³, which had already been slowing since the beginning of 2008, contracted 3.6% yoy in Q4 2008. This downward trend is likely to continue or even intensify in 2009 owing to pressure on the capital position of international banks.

In order to assess banking systems’ resilience to the current external shock and the need for government intervention, both the size of the banking sector in relation to GDP as well as its financial soundness are important.

Other things being equal, large banking systems pose a higher risk to the economy as a whole and may demand a higher amount of fiscal resources to deal with stress. This is mostly the case in Asian countries, as measured by the size of credit to the private sector as a percentage of GDP (Hong Kong, Taiwan and Singapore have ratios exceeding 100%). Two important mitigating factors are the high level of deposits to assets in Asian banking sectors and relatively well developed capital markets in some of these economies, therefore providing more readily available domestic funding. Moreover, these countries enjoy a fairly healthy fiscal position (more on this in the next section). At the other end of the spectrum, the small size of some countries’ banking sectors (like Argentina and Mexico at 13% and Peru at 15%) will possibly limit the need for government intervention.

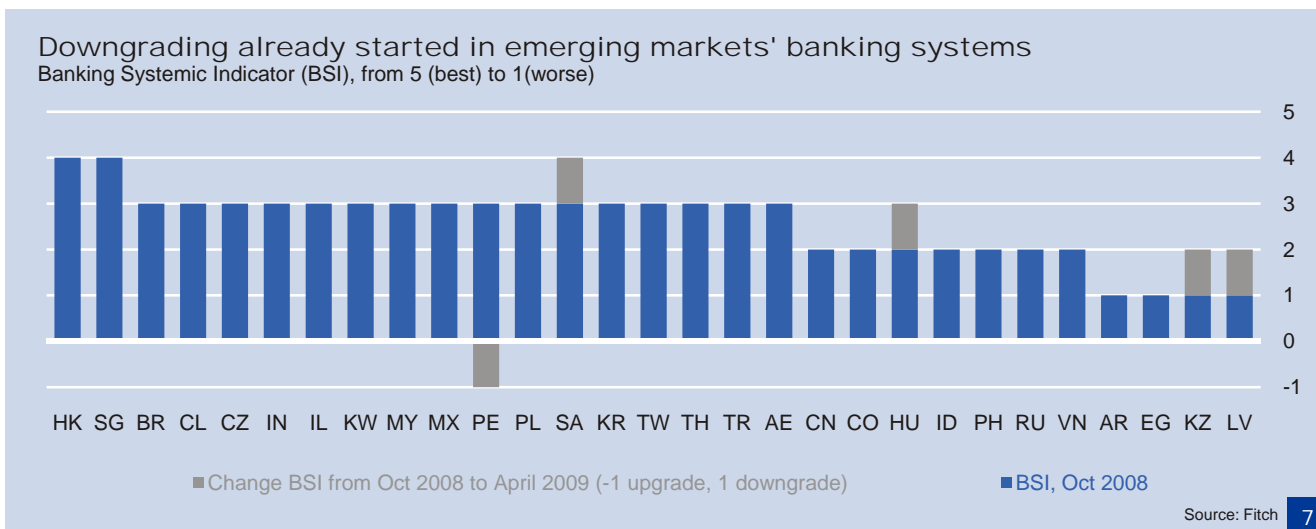
With respect to financial soundness, banks in emerging economies are in the best shape in years, having profited from a favourable macroeconomic environment up until recently. Aggregate non-performing loans and returns have improved significantly across regions. Banking systems have strengthened their provisions and capital ratios, prudential supervision and the regulatory framework have become more efficient. We have ranked emerging banking systems according to a composite index of financial soundness indicators. The index shows that Asian and Latin American banking systems are better prepared to face the global crisis (see chart).⁴

An alternative index is Fitch’s Banking Systemic Indicator (BSI). This is based on variables that measure systemic risk and on the weighted average of banks’ ratings in a particular country. The BSI shows a roughly similar ranking to ours. Since October 2008 Fitch has downgraded the BSI for Hungary, Kazakhstan, Latvia and Saudi Arabia, and upgraded Peru. We would not be surprised to see more downgrades, given that financial soundness will likely deteriorate further on the back of rising asset quality pressures following the economic slowdown. In the final analysis, the shape of a banking

³ Cross-border claims + local claims of banks foreign affiliates in all currencies.

⁴ For a more detailed analysis of Latin America’s banking sectors see DB Research’s Talking Point “Latin American banks: Profiting from a better macroeconomic environment” in www.dbresearch.com.

sector at the start of the crisis will to a large extent determine their resilience to the crisis' stress.



7

Can (EM) fiscal expansion put hard-won macroeconomic stability at risk?

A medium-term fiscal plan is also necessary

A recent study published by the IADB⁵ that examined 18 external financial crises in Latin America concluded that expansionary fiscal policies that do not affect credibility or solvency can reduce the slump in output after a “systemic sudden stop” (sharp deterioration in the capital account). Thus, initial fiscal conditions are crucial to the success of the fiscal policy. Countries that have accumulated fiscal savings during favourable times will be more prepared to self-finance stimulus packages. Put differently, sound inter-temporal fiscal behaviour and a low debt burden are prerequisites for the affordability of expansionary policies. Moreover, it is important to anchor these measures in the context of a sustainable medium-term fiscal plan. Of course, these challenges are not restricted to Latin America or emerging markets but resonate in the US and Europe as well, for example in the context of recent sovereign rating action for developed markets.

The importance of fiscal solvency was emphasised at the G20 meeting

Following the G20 meeting in March, the IMF recommended a four-pillar strategy to preserve fiscal solvency: 1) temporary stimulus measures; 2) clear government commitment to fiscal correction once the conditions improve; 3) structural reforms to improve growth and medium-term revenues and 4) commitment to health and pension reforms in countries facing demographic pressures.⁶

An empirical study published by the IMF on developed economies in the latest World Economic Outlook⁷ shows that expansionary fiscal policies are particularly effective in shortening the duration of financial crises and helping countries to grow faster in the recovery phase. The study, however, also showed that the effectiveness of fiscal stimulus decreases for countries with higher debt burdens.

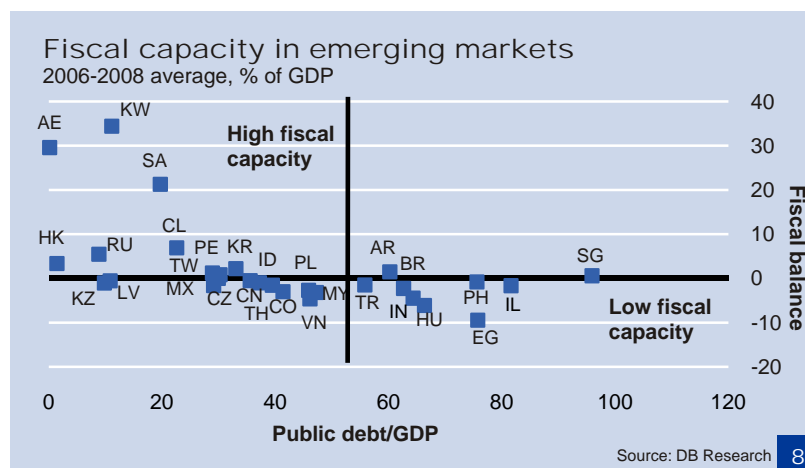
⁵ Cavallo, E. & Izquierdo, A. (2009), Dealing with an international credit crunch: policy responses to sudden stops in Latin America, Inter-American Development Bank.

⁶ IMF (2009), G-20 Meeting of the Ministers and Central Bank Governors, Global Economic Policies and Prospects, London, March 13-14.

⁷ IMF (2009), World Economic Outlook: Crisis and Recovery, April.

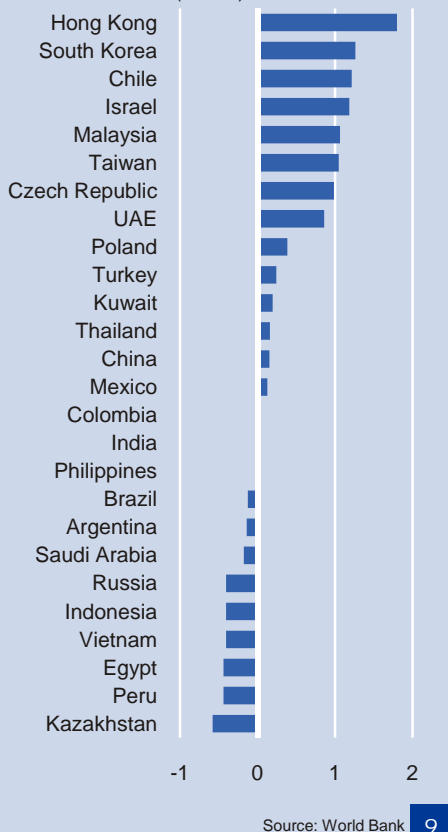
Fiscal capacity differs among emerging markets

In the EM context, Middle Eastern countries (UAE, Kuwait and Saudi Arabia) have significant fiscal leeway to support their economies as they accumulated fiscal savings in the last few years and public sector indebtedness is low. Russia, Chile, Hong Kong, South Korea and Peru are other examples of countries that can rely on their fiscal resources to offset the effects of the global slowdown with a relatively low risk of losing fiscal credibility (see chart).



Successful stimulus requires efficient implementation

2007 government effectiveness index, from 2.5 to -2.5 (worse)



Unveiling is not the same as implementing

As shown above, EM governments have unveiled fairly substantial stimulus packages in the last few months. However, the success of these plans will depend on governments' capacity to rapidly inject these resources into productive use. One way to assess the likelihood of package implementation is to look at an index of "government effectiveness" such as that compiled by the World Bank. Advanced Asian economies feature prominently at the top, together with Chile and the Czech Republic. Comparing this table with some of the larger packages shown on page 4 yields a relatively optimistic outlook for stimulus measures in Hong Kong and Malaysia and less so for Russia and Kazakhstan.

Concluding remarks

In contrast to previous episodes of stress in emerging economies, this time governments have reacted fast and decisively and, most importantly, have in general been able to provide fiscal and monetary stimulus without running into a confidence crisis.

It is difficult to assess causality and evaluate the impact of government announcements (the actual implementation of the programmes will only take place gradually), but some recent signs of economic stabilisation are already bringing calm to emerging financial markets. The much-enhanced IMF role in the crisis as well as massive support measures in developed markets have undoubtedly played a crucial role, but we believe emerging market governments' reaction has been constructive.

The crisis is not over yet and we do not rule out additional bumps in the road. However, it is fair to state that in a more globalised world characterised by stronger linkages among economies, emerging markets are proving to be better prepared to face external shocks than in the past. In this report we have highlighted the relevance of effective implementation as well as the need to preserve fiscal prudence. We believe these principles will determine the ultimate

success of stimulus packages, not only in emerging markets but also in developed economies. Countries which have strong institutions and which do not lose sight of medium-term fiscal discipline will be the winners.

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