Prospects for Emerging Markets/Trillion Dollar Club

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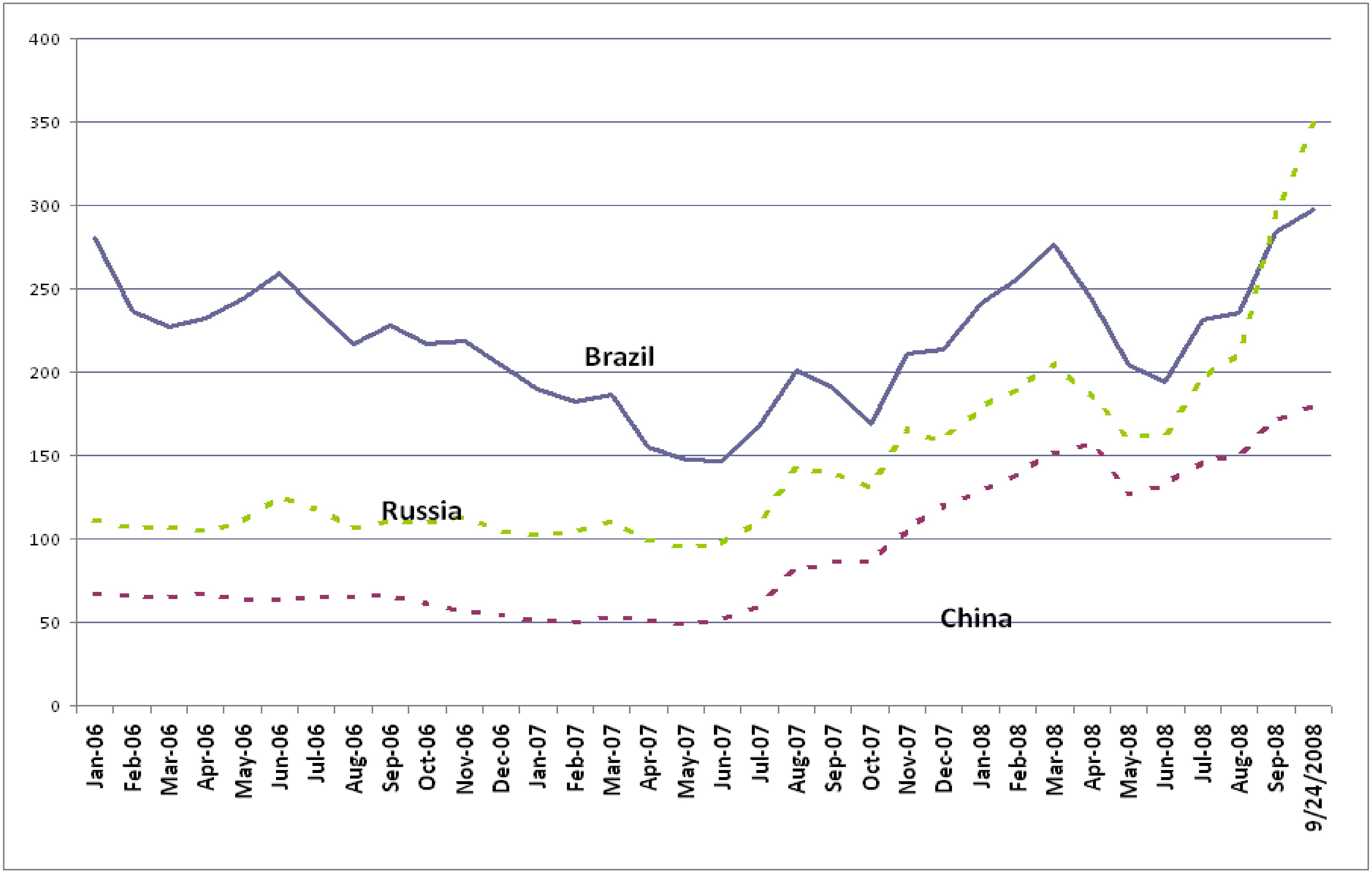
Central Scenario: Limited Impact

Country/Region	Weight	2007	2008	2009
Emerging Markets	47.5	7.4	6.4	5.7
Asia	25.0	9.0	7.8	7.1
China	10.5	11.9	10.0	9.0
India	4.5	8.7	7.7	7.0
Other	10.0	6.7	5.5	5.2
Latin America	7.8	5.7	4.4	3.8
Argentina	0.8	8.7	6.0	4.2
Brazil	2.9	5.4	4.8	4.3
Mexico	2.1	3.2	2.4	2.6
Other	2.0	6.5	4.8	4.4
Central and Eastern Europe	3.9	5.5	4.2	3.8
Commonwealth of Independent States	4.4	8.5	7.5	6.2
Russia	3.2	7.5	7.2	6.0
Middle East	2.9	6.0	6.5	6.0
Africa	3.4	6.0	5.5	5.0

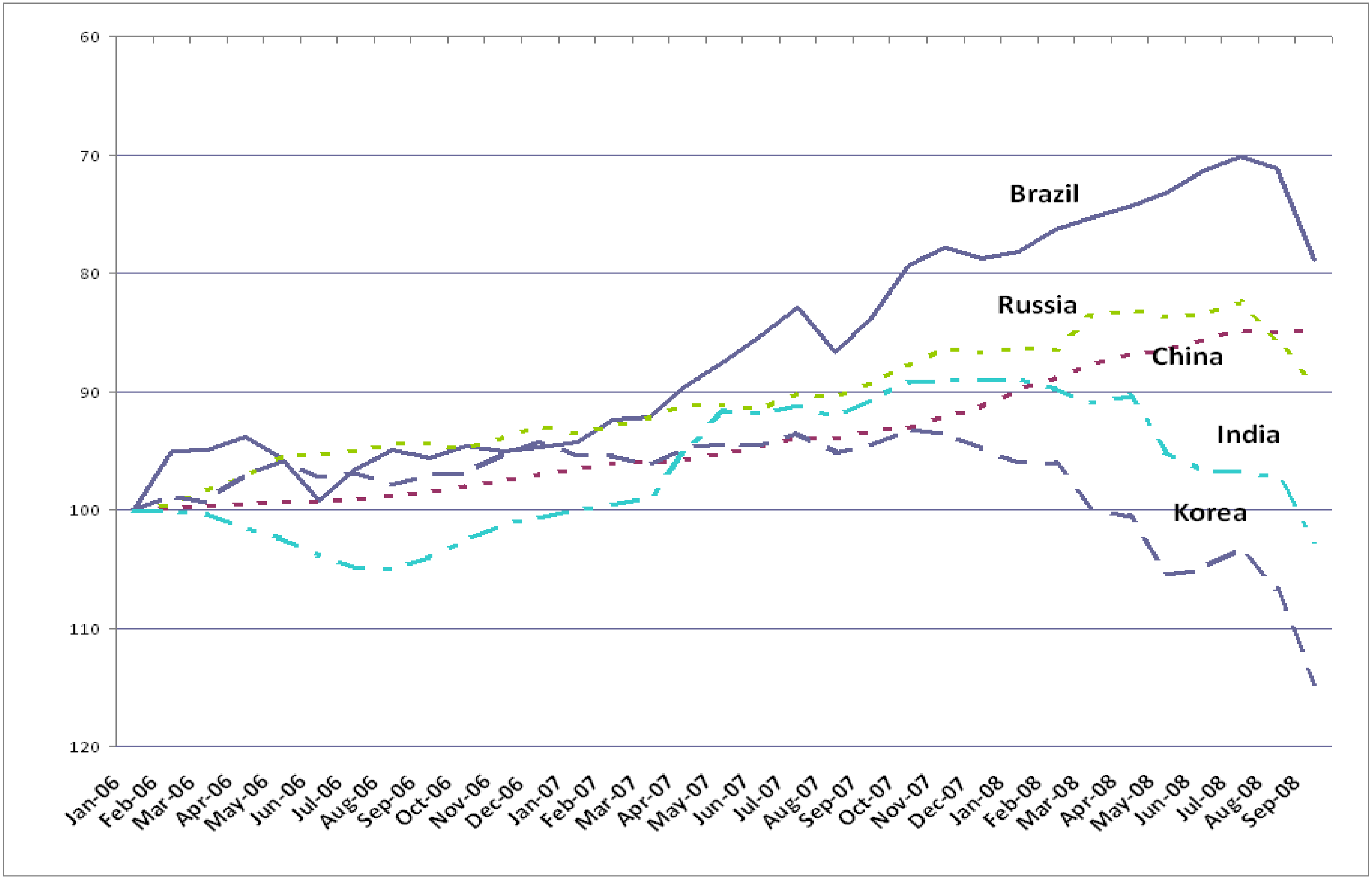
- Thus far, impact on major emerging markets relatively modest
- Financial contagion limited and greater ability to contain financial contagion (high reserves, moderate external debt): China seems least vulnerable
- Trade contagion limited because industrial country slow-down not yet serious

Risk Perception

(JP Morgan EMBI stripped spreads)



Exchange Rate



Risks (1)

- But risks are (all?) on the downside.

- Some countries vulnerable to financial contagion:
  - Large current account deficit countries (Bulgaria, Romania, South Africa);
  - Commodity exporters (Russia);

- Another vulnerability: Healthy <u>net</u> positions and sound <u>sovereign</u> balance sheets do not necessarily provide insulation
  - Countries with foreign borrowing by corporates (Asia) and vulnerable banking systems (Russia) vulnerable
  - <u>Gross</u> flows important because of rollover risk
  - Private investment could be adversely affected

Risks (2)

- Impact of “BenHanke” plan uncertain: Financial crisis deepens→recession in US/EU→trade contagion (China)
- Moreover, external shock could interact with other vulnerabilities: e.g., real estate sector softness in China; oil price decline in Russia
- Monetary policy space to re-balance growth toward domestic demand limited because inflation remains high (Brazil, Russia, India, and Korea)
- Some fiscal space especially in China: feasibility and timing
- Bottom line:
  - Not inconsiderable risks of significant slowdown in emerging markets.
  - Confidence bands around predictions much wider

Concluding Observations

- Two related processes under way: re-balancing of global demand and re-pricing of risk: minimally disorderly or maximally so?

- Finance is global and regulation largely national: need for greater multilateral cooperation?
  - Causes: savings glut and undervalued exchange rates
  - Solutions: burden sharing on the down-side