A gap to fill
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Two years ago, nearly a trillion dollars flowed into emerging markets as investors in rich countries toured the globe in the hunt for yield. Now there is a melancholy, long, withdrawing roar as private capital flees to safer havens.

In the past, when the money stopped flowing in, it precipitated financial meltdowns - across Asia and in Russia in the 1990s and in Latin America a decade earlier. This time, it is increasingly clear, the official institutions set up to cushion the impact are too small for the task.

Net capital flows to emerging markets will drop to just $165bn (£115bn, €130bn) this year, down from $929bn as recently as 2007, according to estimates by the Institute of International Finance, which represents the world's leading financial companies. Net lending from commercial banks, the IIF says, is likely to go into reverse.

The reasons for this are not altogether straightforward. Some accuse rich governments, particularly the US, of "crowding out" emerging markets, sucking up all the available capital to finance their stimulus packages. But Brad Setser, a former International Monetary Fund and US Treasury official, notes that as the private sector retrenches, the US current account deficit - and hence its need for outside financing - has actually been declining.

More likely, he says, is that emerging markets are being hit by a general decline in demand for riskier assets, as banks and investors haul money back home to shore up balance sheets and reduce borrowings. Similarly, the global shortage of the trade credit that finances cross-border commerce reflects a general desire of banks to reduce leverage, not the rich countries hogging all the available loans.

Enter, in theory, the official sector. In the same way that the rich world's governments are proving to be the consumers and lenders of last resort, movements in international private capital flows can be offset by the IMF and its sister, the World Bank - along with smaller cousins including the regional development banks for Asia, Africa and Latin America. "At a time when the other financial institutions in the world are in turmoil, we can lean forward to help," says Robert Zoellick, World Bank president.

But they cannot lean forward very far without overbalancing. "There was a very large run-up in the private sector's exposure to the emerging world during the boom years, and no equivalent increase in the official sector's lending potential," Mr Setser says. "It is just not big enough to fill the gap."

For example, Mr Zoellick says the International Bank for Reconstruction and Development, the arm of the World Bank that lends to middle-income countries, can increase its lending to about $35bn a year. That is two or three times its level in recent years, but it is not enough to fill a hole that could total hundreds of billions of dollars. Its limited capital constrains it from going too much further.

Last Friday the World Bank, along with the European Investment Bank and the European Bank for Reconstruction and Development, announced a €24.5bn ($31bn, £21.7bn) plan to shore up banking systems in central and eastern Europe. But markets were unimpressed, judging it too small.

Similarly the World Bank, together with national export credit agencies and other institutions, is trying to put together a package of $25bn to ease trade finance. But as Mr Zoellick admits:

"Frankly, given the need out there, I'm not sure it's going to be enough." Private sector participants at a World Trade Organisation trade credit conference last year said there was a $25bn shortage that needed to be filled right now.

Even more pressing, given its role as a short-term lender to countries in crisis, is the size of the IMF. The fund in effect cycles money among its member governments like a credit union. The "quotas" that each government contributes determine how many votes it has on the executive board. The IMF currently has $142bn in easily available resources, plus another $50bn or so it can borrow from its richer governments if necessary. On top of that, Japan recently finalised an ad hoc loan of $100bn outside the quota system.

But a flurry of lending to small and medium-sized countries in trouble - Iceland, Ukraine, Hungary - has already started to deplete its resources. Crises involving a string of bigger countries such as Turkey - already in talks with the fund - could threaten to exhaust its supply.

Dominique Strauss-Kahn, IMF head, wants to double its lending capacity to $500bn: last month he won European Union leaders' backing for the boost. But Simon Johnson, a former IMF chief economist, reckons the fund might need $2,000bn to be a serious global player. As in Hungary and Iceland, the IMF can encourage institutions such as the European Commission or individual governments to supplement its rescue programmes with bilateral money. But private investors are more likely to be reassured by a multilateral lender arriving on the scene with a big war chest than one passing round the hat each time. Other options include borrowing direct from the markets, or issuing special drawing rights - the IMF's own "currency" - to members, but officials say these are complex and time-consuming. So it is hard to imagine the fund raising that kind of money without tapping countries with huge reserves, such as China, Korea and Saudi Arabia.

But unlike Japan, emerging markets such as China seem reluctant to recycle more of their surpluses to deficit countries through the IMF without a bigger say over how the fund is run. Asked about increasing IMF contributions in a recent interview with the FT, Wen Jiabao, the Chinese premier, said that first "we should increase the voting share, the representation, and the say of developing countries".

European and some IMF officials say the longer-term question of voting power is separate from the campaign to raise ad hoc contributions. But emerging market governments have been pushing the issue ahead of the Group of 20 summit of industrialised and developing nations in London in April.

After its latest bruising review of quotas, the IMF last year reached a fragile compromise that gave a little more power to those emerging markets, particularly in Asia, currently under-represented relative to their weight in the global economy and trade. But the deal still overweights the smaller European countries.

In the past, voluntary increases in contributions have proved an effective way for countries including Saudi Arabia to lay the groundwork for an increase in official quotas later. But Europeans may have to make prior commitments to a shift in voting power - at the very least accelerating the next discussion of IMF quotas from its planned date of 2013 to 2010 or 2011 - if they want to attract contributions.

Some question the whole obsession with recycling the official reserves of the surplus emerging markets to deficit countries' governments. Jerome Booth, head of research at Ashmore Investment Management, notes that emerging markets requiring traditional balance of payments support are mainly confined to eastern Europe. Other emerging markets have used inflows to build up their reserves rather than running current account deficits. Some, such as

Mexico, have been able to keep borrowing in the capital markets. East Asian governments recently upgraded the so-called Chiang Mai currency swap arrangements to create a common pool of foreign exchange reserves.

"Much of Asia and Latin America haven't got the same credit crunch and deleveraging issues because they didn't leverage up in the first place," Mr Booth says. Fixing trade finance, he adds, should be tackled not by recycling money from government to government but by encouraging private lending, perhaps by relaxing regulatory constraints on banks lending to emerging market governments.

But with eastern Europe in particular being swept by confused alarms of struggle and flight, there seems little doubt that official institutions will have a big part to play in preventing capital market dramas turning into economic crises. And the gradual shrinking of those institutions over the years relative to the global markets is now becoming all too obvious.

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