



Bank of Thailand Symposium 2007

Challenges to Managing Risk and Volatility in the Emerging Market Context

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1. Introduction: Key Questions

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- i. Why would society be concerned with managing risk and volatility?
- ii. What makes managing risk and volatility so challenging in emerging market economies?
- iii. What are some of the key policy issues in this respect?



What Makes Risk a Concern?

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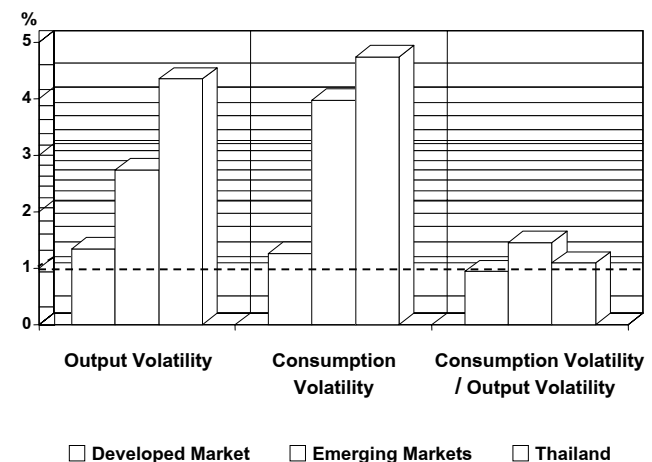
At the fundamental level, what matters is consumption

- Consumption risk related to level and volatility of consumption
- Evaluation of policy must be conscious of this
- Volatility matters only insofar as it affects consumption



2. Stylized Facts: Consumption and Output Volatility

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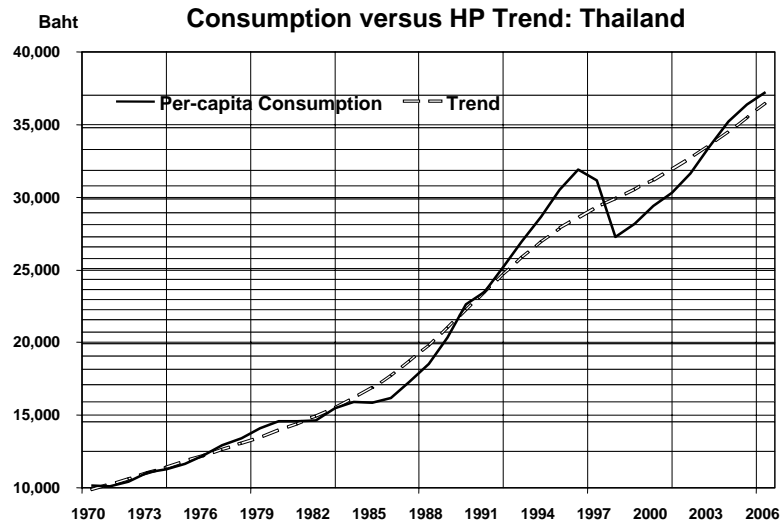
Source: Aguiar and Gopinath (2007)

Note: Reported figures are average values of cyclical fluctuations for the group of 13 emerging and 13 small-open developed economies.



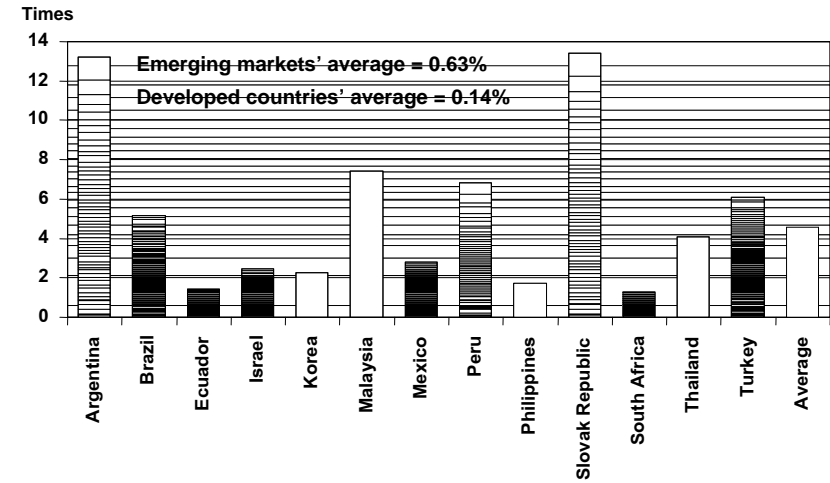
3. Welfare Cost of Consumption Volatility

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Relative Cost of Consumption Volatility

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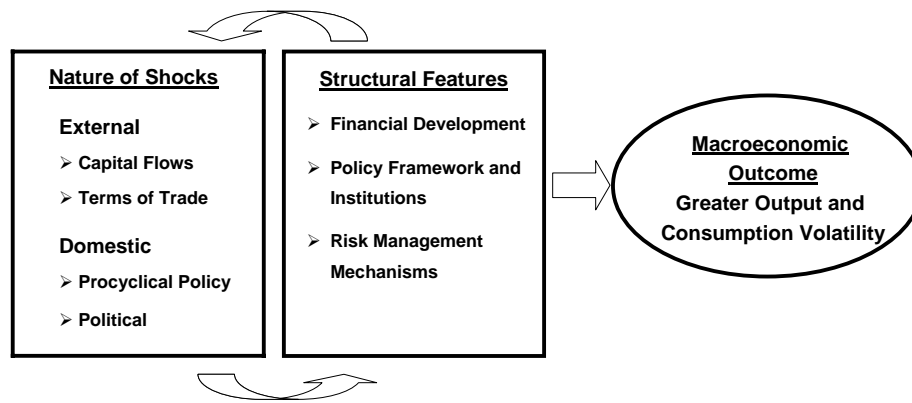


Note: Figures shown are the cost in each emerging market relative to the group average of developed countries.



4. What is Different About Emerging Markets?

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4.1 Nature of Shocks

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External

- Capital Flows: Procyclical access to international capital markets
- Terms of Trade Fluctuations

Domestic

- Procyclical Policy
- Political Instability: Abrupt regime switch

These shocks may interact when it rains...it pours

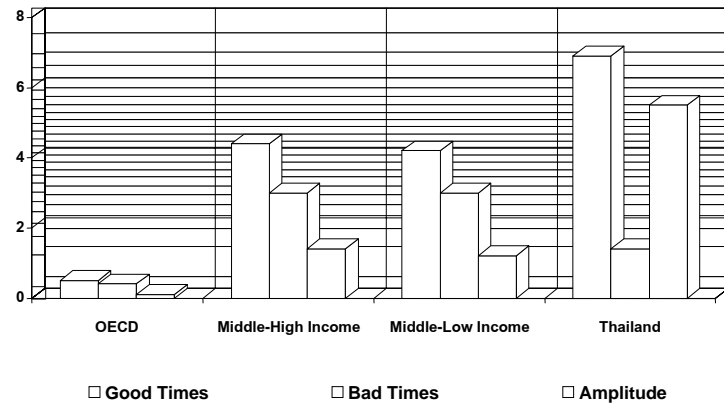




Nature of Shocks: Capital Flow Procyclicality

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Net Capital Flow
as % of GDP



Source: Kaminsky et al. (2004) and IFS data for Thailand

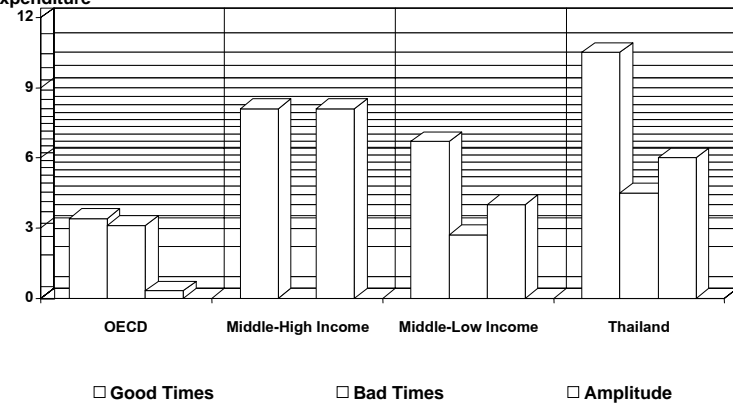
Note: Data starts from 1975 to 2006 for Thailand. Others are from 1960 to 2003.



Nature of Shocks: Fiscal Procyclicality

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% Increase in real
expenditure



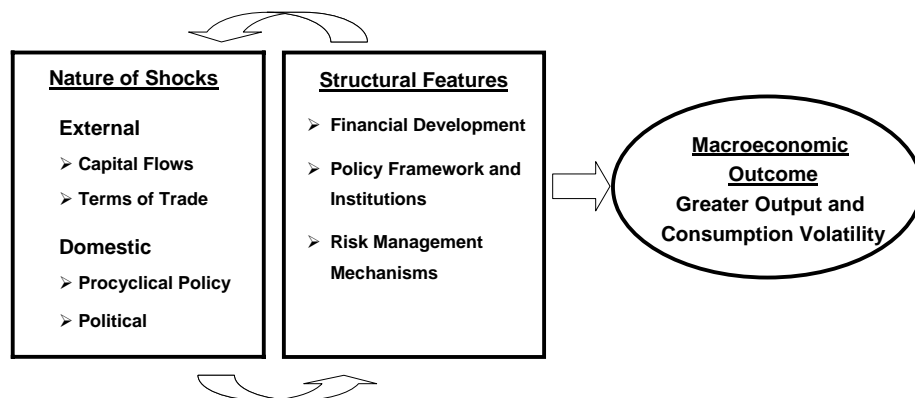
Source: Kaminsky et al. (2004) and NESDB data for Thailand

Note: Data starts from 1960 to 2003.



4. What is Different About Emerging Markets?

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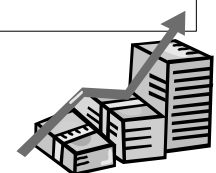


4.2 Structural Characteristics

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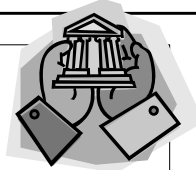
Financial Development

- Lack of well-balanced financial sector (no spare wheel)
 - Capital markets lack liquidity and depth
- Inadequate access for large segments of the population





Policy Framework and Institutions



- Lack of political independence and credibility
- Lack of institutional constraints to prevent policy volatility
- Rigid policy regimes in response to shocks
- Weak financial sector supervision



Risk Management Mechanisms



- Life is risky, especially in rural areas
- Are these risks insurable?
 - Idiosyncratic risk
 - Aggregate risk
- What mechanisms are available to manage risk?



Risk Management Mechanisms (cont.)



- Income VS Consumption Smoothing
- Limitations to smooth income and consumption
 - Lack of access to formal financial sector
 - Entry constraints to profitable activities
- Greater reliance on informal risk sharing mechanisms

Risk-sharing takes place but far from complete



Risk Management Mechanisms (cont.)

- Shallow financial integration inhibits international risk-sharing
 - International capital markets enables diversification of country-specific shocks
 - Evidence of weaker international risk-sharing in emerging markets





5. Policy Implication

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Short-Run: Stabilization Policy

Objective

- Better utilization of macro policies to offset aggregate shocks (reduce procyclicality)

Limits to Stabilization Policy

- Long and variable lags
- Uncertain policy multipliers
- Public expectations of future policy
- Effectiveness depends on nature of shocks

Policy volatility detrimental to growth



5. Policy Implication

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Long-Run: Structural Reforms

Objective

- Embedding macroeconomic stability in the underlying economic structure
- Improve ability of households to shield consumption from shocks

Priorities

- Financial Development
- Policy Framework and Institutions
- Risk Sharing Mechanisms

Short-Term Smoothing VS Long-Term Stability