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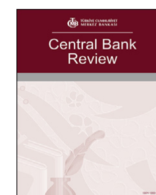

Resilience of emerging market economies to global financial conditions

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ABSTRACT

With lessons learned from previous episodes as well as substantial improvements in economic policies and fundamentals over the years emerging market economies (EMEs) on average are better positioned to withstand financial turbulences, both now and in the near future, than in the past. Since their respective last financial crises most EMEs have been implementing more prudent policies, made stronger their governance frameworks and created financial safety nets as a buffer against adverse shocks. As a result, they were able to strengthen their stock and flow balances and policy frameworks, deepen local capital markets, and diversify their production and exports together with stronger global trade and financial linkages.

1. Introduction

In recent years, the importance of emerging market economies (EMEs) has further increased as they account for not only a much increased share of world population but also a rising share of global economic output and exports, and a substantial fraction of world growth.[1] Emerging market (EM) countries have also become increasingly more connected to the global financial system as, on the one hand, with their strong growth prospects and higher interest rates they have attracted foreign investors and, on the other hand, they have accumulated large foreign assets as foreign exchange reserves. On the back of these developments the question whether these economies with still emerging financial markets have sufficiently advanced their resiliency to external shocks has a greater importance than in the past.

Indeed, the history shows that numerous financial crises and subsequent economic recessions took place in the EM world. With the help of strong pull such as the catch-up effect and push factors such as external shocks, on average, EMEs tend to grow at faster rates than advance economies (AE) and are hence likely to incur external imbalances in the form of trade and/or capital account deficits. Foreign investors finance these external imbalances to the extent that the resulting higher rates of return in EMEs are greater than those in AEs in risk adjusted terms. The imbalances often accumulated fast and worsened stock balances (such as government debt to GDP and external debt to GDP ratios) too. Furthermore, strong capital inflows to EMEs mostly led to a strong real appreciation of their currencies which, in turn, worsened their current account balances further as they suffered from the loss of competitiveness.

In the 1980s and 1990s EMEs experienced financial crises following a sudden reversal of capital flows. In fact, during this period there were two waves of financial crisis in the EM world. The first wave was associated with currency crises as significantly strengthened US dollar led to massive adjustments in the fixed EM exchange rates. This followed sovereign debt crises in many emerging markets, i.e., Mexico, Brazil and Argentina. The second wave was triggered by sudden stop of capital inflows. The EM banks having intermediated these flows, as a result, caused these severe financial crises in several EMEs such as Mexico and Turkey in 1994, East Asian countries after mid-1997 and Russia in 1998. The insufficient volume of external safety nets as well as the underdeveloped nature of financial markets in EMEs made financial crises unavoidable. In addition, having not able to implement countercyclical policies EMEs suffered from larger damaging effects of financial crises on their real economies otherwise.

It is noteworthy that despite the lack of capacities in avoiding financial crises EMEs mostly managed to recover swiftly from their acute past financial crises succeeding severe economic recessions.

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[1] Numerous books and reports underscore rising interests in EMEs. They include King (2010), Magnus (2012), Sharma (2012), Abiad et al. (2012), Karolyi (2015).

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They include countries of the 1997 Asian financial crisis, Mexico, Turkey and others. Likewise, most EMEs survived once in a century event – global financial crisis of 2008 (GFC) in spite of its profound impacts on the financial systems of AEs. The GFC exposed excessive levels in private debts including households, nonfinancial companies and financial firms. The need for deleveraging of these debts led to balance sheet recessions in AEs, also deemed as the great recession. The unprecedented stimulus and bailout policies undertaken in the aftermath of the GFC probably had some mitigating effect on the great recession but could not prevented it. EMEs again escaped the great recession though some of them had brief economic recessions.

With lessons learned from previous episodes and improvements over the years EMEs are, on average, better positioned to withstand financial turbulences, both now and in the future, than in the past. They embarked on extensive structural reforms aimed at overhauling financial regulatory and supervisory systems, strengthening public finances and fiscal discipline, granting central banks independence, and adopting flexible exchange rate systems. These reforms enabled them to implement more prudent and countercyclical policies. EMEs supported their post crisis reforms by accumulating adequate foreign exchange reserves so as to avoiding the strict conditionality features of the International Monetary Fund (IMF) provided global financial safety nets as well as their insufficiency and by further deepening and broadening their domestic financial markets. As a result, stock and flow balances, policy frameworks, and levels of economic confidence and market development in EMEs have strengthened critically and radically. It is fair to say that they now look strong enough to render the adverse effects of external financial shocks manageable.

However, the current unconventional monetary policies of AEs in the form of low or even negative nominal policy rates as well as quantitative easing together with unintended consequences of the financial sector reforms across the world pose new challenges to EMEs. Until recently because of better growth prospects and lower levels of leveraging, EMEs attracted capital inflows with their non-financial corporates having lion shares. The normalization of global monetary policies has reversed the course of capital flows and led to the sizable depreciation of EM currencies against the dollar. This creates inflationary pressures due to the pass-through impact and impairs balance sheets due to tightening global financial conditions and worsening growth prospects. Furthermore, the sharp fall in oil prices exacerbates the deterioration in economic outlook for commodity importing countries. Going forward, the normalization of the US monetary policy, diverging monetary policies of AEs, uncertainty in commodity prices and the risk of Chinas economic hard-landing all will likely to contribute to volatile global financial markets and widening spreads for EMEs.

This paper evaluates the developments, trends and frameworks characterizing the EM world. Section 2 describes stock and flow balances in EMEs. External shocks to EMEs are explained in Section 3. The final section provides a brief conclusion.

2. Strong stock and flow balances in EMEs

The great financial crises of 1980s and 1990s such as the Asian, Latin American and Turkish financial crises decisively altered the economic policy paradigm of the EM world. Almost in all cases the two factors—a rapid increase in leverage and a sharp appreciation of the currency[2]—caused these financial crises. Consequent IMF stand-by programmes played the major role in this paradigm shift. The stand-by programmes painfully required them to embark on the so-called first generation of structural reforms involving the overhaul of financial regulatory and supervisory system, strong public finances and fiscal discipline, and central bank independence. In the wake of these crises EMEs have been methodically implementing prudent and countercyclical policies to prevent macroeconomic and external imbalances building. Having the institutional structures and policy frameworks in place the EMEs have not only prevented deteriorations in stock and flow balances but also recorded strong improvements.

2.1. Stock balances

2.1.1. Public and private debt

Since EMEs mostly suffered from sovereign debt crises, fiscal discipline has been the cornerstone of the first generation of structural reforms. Prudent fiscal policies have played a key role in maintaining low budget deficits and hence lowered debt levels to the extent that budgets delivered primary surpluses (Fig. 1). Lower interest rates implied by improved financial needs of the government sector then further reinforced fiscal positions. As a consequence, the share of government bonds in emerging debt markets has declined and created room for the private sector debt market to grow (Fig. 2). Private debt levels in EMEs have also stayed at moderate levels on average (Fig. 3). This feature basically creates two advantages. The first is related to the fact that lower indebtedness levels are associated with lower degrees of debt overhang problem and hence makes adverse effects of negative shocks more manageable than otherwise. Second, low levels of debt indicate that there is room for creation of healthy loans that will support growth and economic development.

2.1.2. External debt

Declined public debt also implied lower bases for external debt. In additions to this development, EM governments have consciously borrowed less in foreign currencies in the wake of their earlier financial crises. Combined effects have, on average, reduced government owned external debt to GDP ratio from 35 percent at the beginning of the 2000s to 25 percent in 2013 (Fig. 4). This decline in eurodollar loans manifests deepened domestic debt markets and hence have reduced the so called “original sin” problem of EMEs to the extent that foreign investors willing to lend in domestic currency as opposed to hard currencies. Hausmann and Panizza (2003, 2011) argue that one of the factors that created economic instability in EMEs is the original sin problem. According to this hypothesis emerging and developing countries are unable to

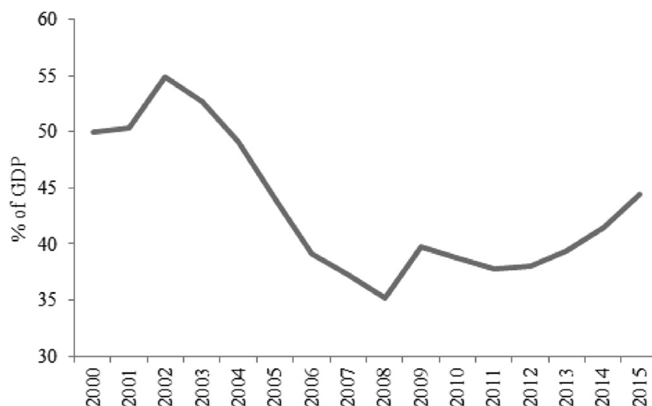

Fig. 1. EM gross government debt.

[2] See Gourinchas and Obstfeld (2012).

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