THE FINANCING OF EMERGING ECONOMIES IN 2022 – 2023

Policy Brief n°1 – April 2022

Emerging economies will be confronted in 2022 to a very demanding global environment and numerous policy challenges. For them, like for advanced Economies, the COVID-19 crisis has left a legacy of increased public debt and reduced fiscal space. Just like advanced economies, they will face inflation pressures coming from supply bottlenecks, as well as rising commodity, energy, and food prices. All these factors will be amplified by the consequences of the Ukraine invasion and subsequent sanctions imposed by western powers on Russia. In addition, they may face specific headwinds and constraints on capital flows, debt, and exchange rate management.

This Policy Brief presents some perspectives and thoughts. It is by no means a comprehensive analysis. Rather, it discusses possible challenges and trends in the current financial and geopolitical environment as well as possible policy responses. It is primarily, but not exclusively focused on low-income countries and emerging economies.

TENSIONS AND CHALLENGES FROM 2020 TO 2022

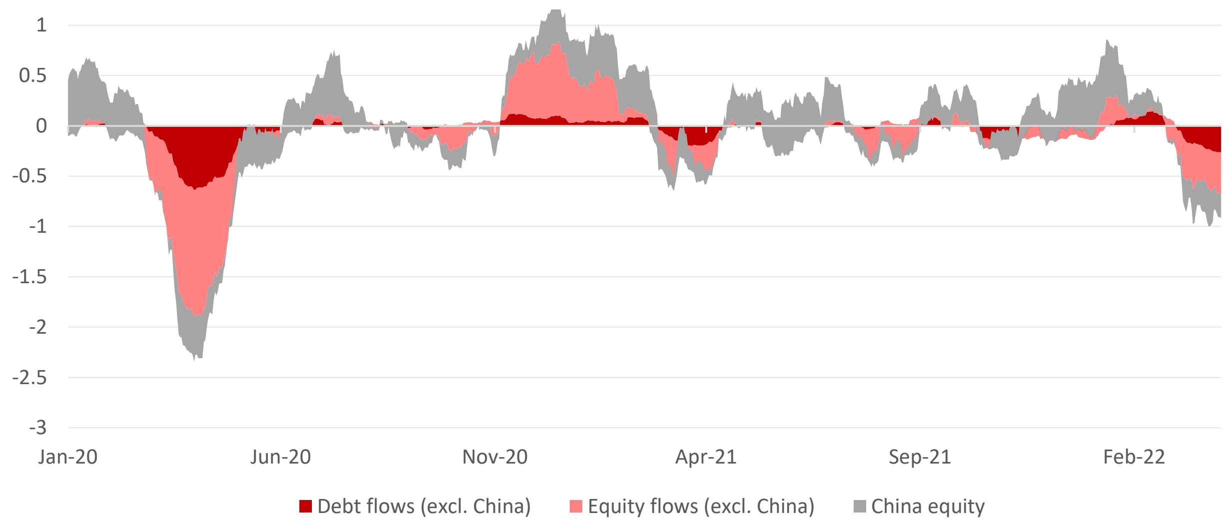
A defining and common characteristic of emerging market economies (EMEs) is their exposure to external financial shocks. These shocks are transmitted by cross-border capital flows. Through their influence on interest rates and exchange rates, changes in US monetary policy spill over to EMEs. Global monetary conditions, largely influenced by advanced economies, also drive risk appetite and aversion in global capital markets. The alternance of "risk on" and "risk off" regimes is a major source of volatility for capital recipient countries.

One earlier example is the "taper tantrum" that occurred in May-June 2013 when the Federal Reserve hinted at a reduction and phase-out of its asset purchase program. The sole perspective of future changes in US monetary policy was sufficient to trigger a significant increase in long term rates, as well as strong and sudden capital outflows from emerging economies – even though the policy shift did not finally materialize.

A more recent – and different – episode occurred with the US Treasury bonds market turmoil in March 2020. In reaction to the COVID-19 shock, investors sought to increase the liquidity of their portfolios by selling US Treasuries in ample amounts, creating imbalances and significant disruptions. In March, this flight to liquidity turned into an extreme 'dash for cash', with even the market for very safe assets becoming thin. The situation was only resolved after a massive intervention by the Federal Reserve, whose balance sheet expanded by USD 3.1 trillion from March to November 2020.

This episode of extreme risk aversion triggered a “sudden stop” in capital flows to emerging and poor economies. Outflows were brutal, large, and synchronized across EMES (with Brazil, South Africa, Turkey, Poland and Thailand particularly affected). Outflows appeared to be uncorrelated with the severity of the pandemic's spread locally, or the stringency of lockdown measures implemented (Bank of England). Just like in advanced economies, conditions were reversed after the Fed’s intervention and inflows resumed at their previous levels.

Figure 1 – Capital flows to emerging markets (billion USD, six-week moving average)



Source: Institute of International Finance

In response, emerging countries deployed an extensive and atypical range of policies. In past episodes of sudden stops, the standard response was to tighten monetary policy to stem capital outflows and limit exchange rate depreciation. On the contrary, in March 2020, monetary policy was aggressively loosened in many emerging economies and exchange rates were allowed to depreciate to absorb the shock of capital outflows.

Figure 2 – Evolution of the MSCI International Emerging Market Currency Index in 2020

Source: Bloomberg

Monetary interventions included the use of asset purchases for the first time by some countries. Some EMEs' Central Banks, in particular, purchased local-currency bonds to offset foreign investors' sales.

That policy response may not be available to the same extent going forward. In March 2020, EMEs appropriately exploited the policy space offered by the low inflation environment and the low and decreasing inflation expectations at the time. Circumstances have dramatically changed. High inflation pressures impose, contrary to 2020, a tightening of monetary policies. They make nominal exchange rate depreciation a less effective tool for insulating the economies from the effects of capital outflows. The policy space has narrowed, and external financial shocks may have more negative effects on growth and macro-economic performance.

RISKS AND EVOLUTIONS IN DEBT MARKETS

Ample liquidity helps to absorb shocks. Reduced liquidity amplifies them. In 2022-23 high uncertainty and elevated perceptions of risk will lead to tightening financial conditions and higher volatility for emerging economies.

Potential shocks may be coming from many sources:

- The **withdrawal of monetary accommodation** in advanced economies, now clearly announced both by the Federal Reserve and the ECB – which, contrary to 2013, did not, at this stage, trigger massive outflows.

- The **general uncertainty** created by the COVID-19 pandemic, the invasion of Ukraine and subsequent sanctions imposed on Russia.

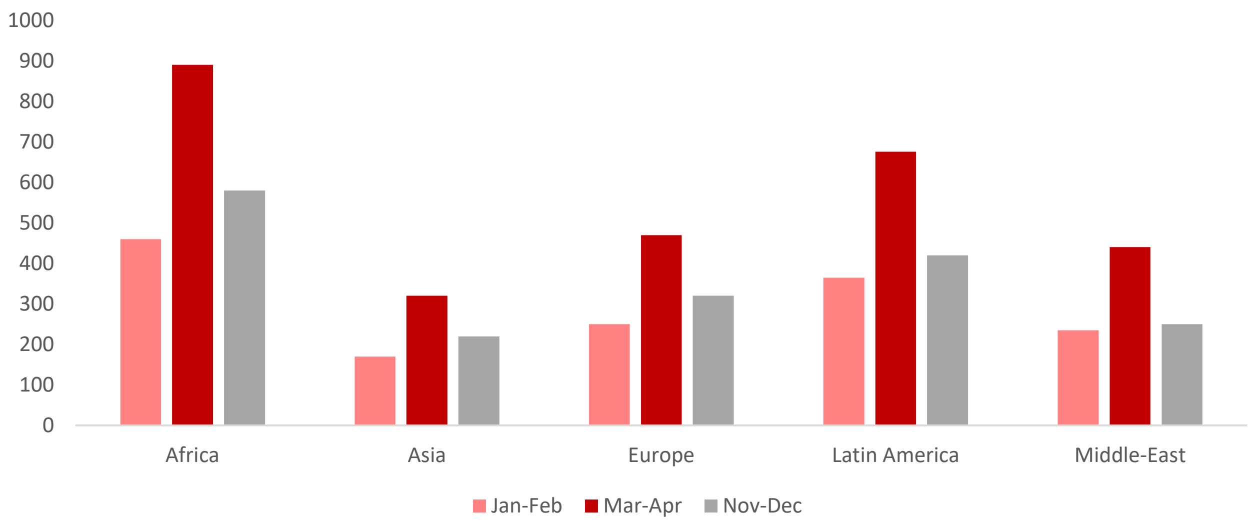
- Possible "**flight to quality**" episodes which generally result in increases in sovereign spreads cross EMEs, an appreciation of the dollar, all factors that penalize the most fragile economies.

In that environment, adverse market dynamics may develop with:

- A **greater sensitivity and volatility** of capital flows and exchange rates in reaction to news (related to COVID-19, Ukraine).

- A **greater differentiation of risks** between EMEs and a widening of spreads. With slower growth, more debt, and debt denominated in foreign currencies, countries in Latin America and Sub-Saharan Africa may be especially exposed, as they were in the March 2020 market turmoil (G30).

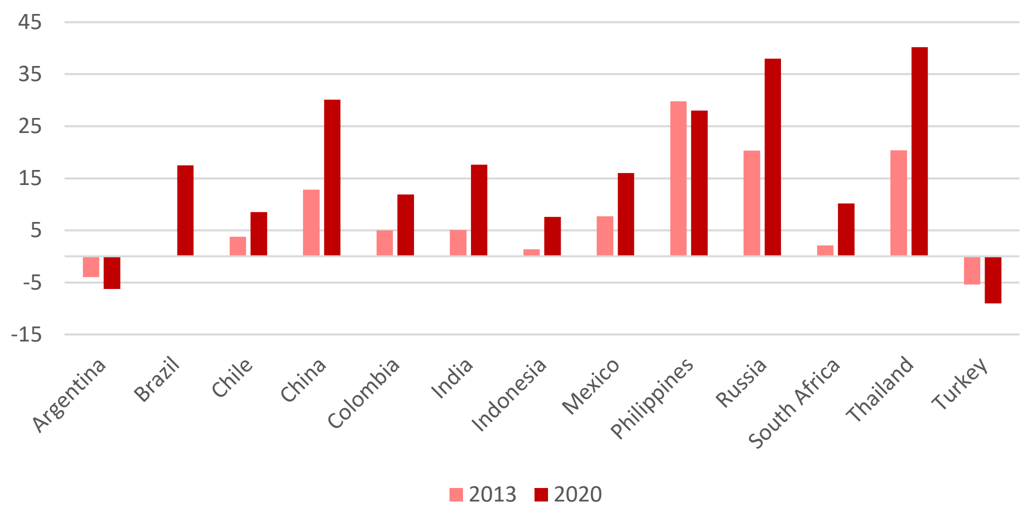
Figure 3 – JP Morgan EMBI bond spreads by EMDE region in 2020



Source: Bloomberg, French Treasury calculations

- Localized episodes of **liquidity stress**. EMEs and low-income economies have very different levels or foreign exchange reserves – and therefore are unequally equipped to absorb sudden stops in capital flows. The chart below provides a comparative assessment on the basis of adequacy ratios as defined by the IMF.

Figure 4 – Reserve adequacy in 2013 and 2020, percent of GDP



Source: IMF

- A significant risk of **interruption of market access** for lowest income and most indebted countries. In the last two years, the three largest credit rating agencies issued more than 50 sovereign downgrades and hardly any upgrades for low- and middle-income countries. This trend could further amplify. (G30)

Should a wave of default or restructurings start and expand amongst low-income countries, it could have systemic consequences, including for advanced economies. For emerging (and low-income) countries, a significant share of the foreign debt is held by investment funds. Conversely, exposure to emerging countries amounts to around one third of the assets of those funds. Most invest into illiquid assets and issue instantly redeemable liabilities. Those financing structures, with high liquidity and maturity mismatches, are especially vulnerable. Funds are prone to large outflows when global financial conditions tighten, or the perceived riskiness of their assets increase. They could face massive redemptions and runs - leading to a general loss of confidence.

PERSPECTIVES ON PUBLIC POLICY

Over the last two decades, sovereign debt has changed in many ways. The creditor landscape has been transformed as China and investment funds have become major lenders to EMEs. Any future restructuring will therefore involve a more diverse and dispersed set of creditors. Debt is also more diverse, more opaque, often collateralized by real assets of future income flows.

Together, these evolutions make it more difficult to align lenders and coordinate them into consistent and fair debt restructurings. Numerous and diverse private creditors have reduced incentives to participate. Comparability of treatment will become more difficult to define and implement. In turn, with no guarantee of comparability, the temptation to free ride will be larger for a number of lenders. Breaking that spiral may prove extremely difficult. Those elements of fragility have been present for some time, but their effect will be magnified in a post COVID-19 / post Ukraine invasion environment, with elevated levels of debt and geopolitical tensions between the major lenders.

During the pandemic, significant initiatives have been taken by the G20 and multilateral institutions. They include:

- **Temporary increases in access limits to many of the IMF facilities**, together with the introduction of a new lending tool; the Short-Term Liquidity Line (SLL) with revolving access and cheaper conditions than previous similar facilities.

- **The biggest allocation of Special Drawing Rights (SDRs) in history** (equivalent to USD 650bn) whose conditions of redistribution and usage still remain to be fully developed.

- **The Debt Service Suspension Initiative (DSSI)** allowed for a temporary suspension of official bilateral debt service payments. It was approved initially in April 2020 until December 2020, with an extension to at least 2021. The DSSI has provided some relief but has shown limits. Some countries that had kept market access refrained from using it in fear of stigma. The real threat of immediate downgrades and the absence of private creditors participation made it much less attractive than expected.

- **In November 2020, the G20 unveiled its "Common Framework for Debt Treatments beyond the DSSI"** with the participation of both Paris Club members and non-Paris Club G20 members, including China. It provides a forum for DSSI-eligible countries to seek debt relief, primarily in the form of maturity extensions and interest rate reductions. Nominal reduction of face value remains an option for the "most difficult cases". Contrary to the Paris Club, the Common Framework currently lacks a mechanism to incentivize private sector participation even though it requires comparability of treatment.

Overall, it is not certain that current public policies are robust enough to absorb the upcoming shocks. Should policymakers look for different approaches? Should they try and fill gaps in the existing architecture by seeking new international “umbrella “agreements? There is traditionally much reluctance to do so, for fear of triggering a loss of confidence in existing debt and reduce the attractiveness (and liquidity) of future debt. However, if the problem was seen as systemic, some avenues might be considered:

- **Some form of Sovereign Debt Restructuring Mechanism** (SDRM) giving the IMF strong coordination powers.
- **Some changes in domestic legislations** redacting the power of holdout creditors to block restructuring agreements.
- **New – and less conditional – IMF facilities**.

Upcoming Policy Briefs will have a deeper look at some of these issues.

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