Financial situation in developing countries, an overview

Seppo Honkapohja
Aalto University School of Business, Finland
Introduction

- Currently, the economic and financial situation in the world is significantly worsening.
- This has happened at the same time as the Covid pandemic was getting better under control.
- The negative trends stem from supply-side concerns in the aftermath of the pandemic and commodity price increases.
  - The war in Ukraine delivered further negative shocks to the European economy this year.
- In terms of economic variables, two main concerns are the considerable rise of inflation and consequent tightening of monetary policy.
- Risks to financial stability have increased. The outlook is increasingly negative.
  - Increased volatility in both equity and bond markets in advanced economies.
  - Risks to near-term economic growth forecasts have increased.
  - Policy interest rates are increasing and are expected to increase through year 2023.
  - Southern European bond yields are now at or above the pre-pandemic level.
  - Overall EM stock markets have developed negatively.
- Figure 1 illustrates these developments in terms of financial conditions and by showing volatility of interest rates and decreasing liquidity.
Figures 1

**Financial conditions index**

1. Advanced economies
2. China
3. Other emerging market economies

**Volatility and liquidity (20-day moving average, index)**

1. Volatility
2. Liquidity (right scale)

Source: IMF Global Financial Stability Review, October 2022, Key Highlights.
Situation in EM and developing economies

• The problems just outlined are apparent also in emerging and developing countries.
• There are negative developments in EMEs.
  • Commodity prices increased in early 2022 and they been volatile (oil, wheat and natural gas).
  • Prices of metals show similar developments, increases in early 2022 and then volatility.
• EMEs have recently faced an increasingly tight macro-financial environment.
  • Central banks in both advanced economies and EMES are in the process of tightening their interest rates.
  • Stock and bond prices have fallen in US, European and emerging markets, except for commodity exporters.
  • US dollar has appreciated against currencies of other advanced economies as well as EMEs.
  • Borrowing costs in low-rated emerging markets (high-yield sovereign spreads) have increased a lot and in relation to investment-grade sovereign spreads.
  • Portfolio flows have been under pressure, with increased currency outflows that stabilized for some but not all EMEs.
• Figure 2 illustrates some tendencies the EME financial systems.
Figures 2

Financial Condition: Emerging Markets
(Standard deviations from the mean)

1. China
2. Asia excluding China
3. Europe, Middle East and Africa
4. Latin America

Source: IMF GFSR, Oct. 2022, Chapter 1.

Percent of bank assets below the 4.5% common equity Tier 1 ratio

- Advanced economies
- Emerging market economies

Source: IMF GFSR, Oct. 2022, Key Highlights.
• These developments are also reflected in fluctuations in financial conditions indexes around the world, as was seen in earlier Figure 1.

• The developments do not seem to stem from a global systemic event.
  • The Ukraine war is not a global event though it has had international repercussions that are well beyond Europe.
  • Supply bottlenecks, e.g. China lockdowns are also significant shocks, but is it global systemic event?

• It should be noted that the year 2022 is still ongoing and there are time lags in much of the data, which makes it difficult to form a systematic picture.
  • Only data on prices and nominal values is available for good part of 2022.
The covid pandemic has tightened sovereign-bank nexus in EMEs.
- Sovereign debt holdings in EMEs in 2021 was about 17% of total assets.
- In advanced economies they were around 7-8 percent.
- At the same time public debt are at high levels and sovereign credit outlooks are deteriorating.
- The nexus could create a feedback loop threatening macro-financial stability.
  - This can adversely constrain the funding of non-financial firms.
- The process is going on and the situation is becoming challenging for policy makers in EMEs.
- See figures 3.
Figures 3

Banks’ Domestic Sovereign Debt Exposure, 2005-21
(Percent)

1. AEs
2. EMs

Percent of banking sector assets


Change in Local Currency Sovereign Bond Holdings
(Billions of US dollars, cumulative change since end-2019)

1. Banks
2. Foreign
3. Other domestic
4. Central Banks

Source: IMF Global Financial Stability Review, April 2022, Chapter 2.