Emerging Economies: Managing the Permanence of Spillovers

Center for Global Development

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September 2019

Sources of Spillovers

- When assessing spillovers, a central issue for EMs' policymakers is the extent and speed to which their countries' assets lose liquidity in international capital markets
  – Especially since the resolution of the GFC and consequent long period of low interest rates created **temporary** liquidity for EM assets

- Two features of sources of spillovers in the post GFC period:
  - **Have taken the form of "Waves"**
  - **Have displayed "Persistence"**

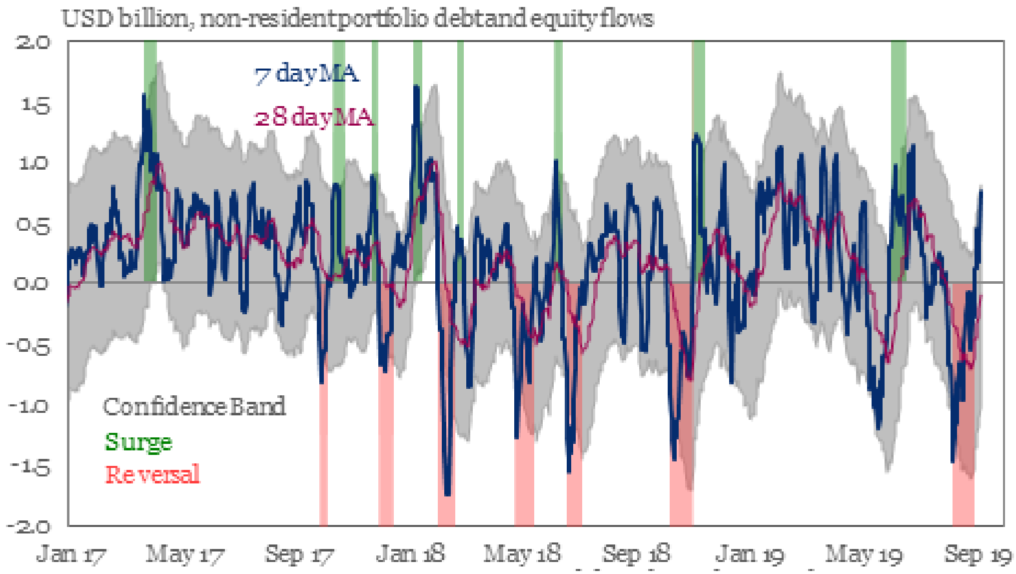
Sources of Spillovers

- For the Emerging Markets asset class, spillovers from the US seem to dominate:
  - o Fed rates
  - o Dollar appreciation (through trade and financial channels)
  - o US-led trade war
- Although indicators of China’s persistent slowdown also play a key role
- And are resulting in increased volatility in investors’ sentiments toward the asset class, albeit with significant country differentiation

Sources of Spillovers

Events in 2018-19: Global stock market correction, concerns about the pace of adjustment of US interest rates, spillovers from Turkey and **trade fears** (ongoing) are reminders of the vulnerability of Emerging Markets to investors' reactions to policy changes in advanced economies and turbulence in key emerging markets (contagion)

Daily non-resident portfolio flows to EMs



Source: IIF

- Capital flow reversals to Emerging Markets have been more frequent and with increasing duration

How Vulnerable are EM to most recent sources of Spillovers?

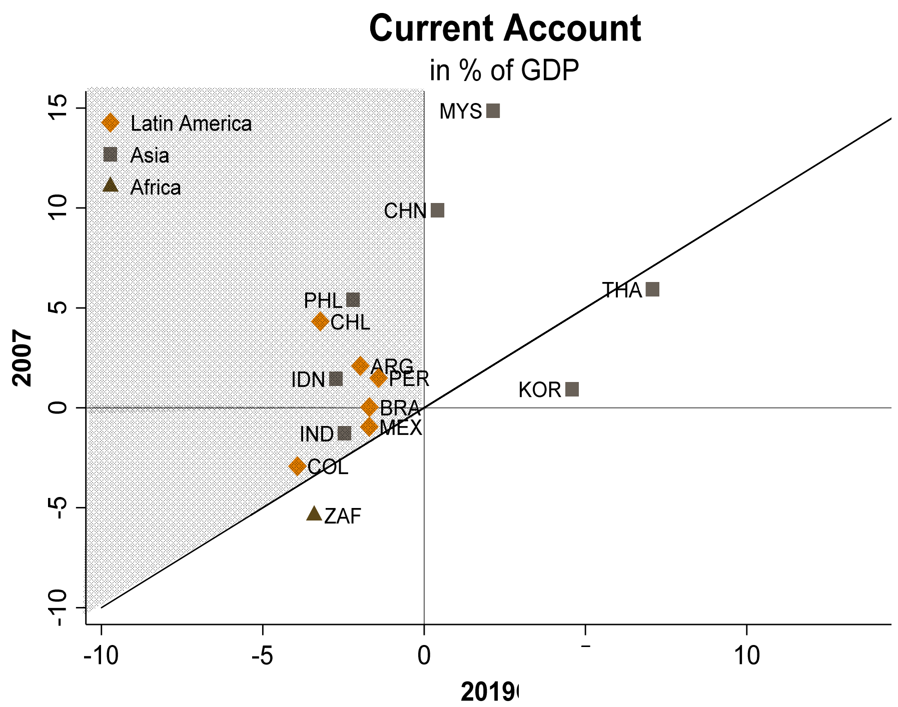
In the foreseeable future, countries probably most affected will be those with:

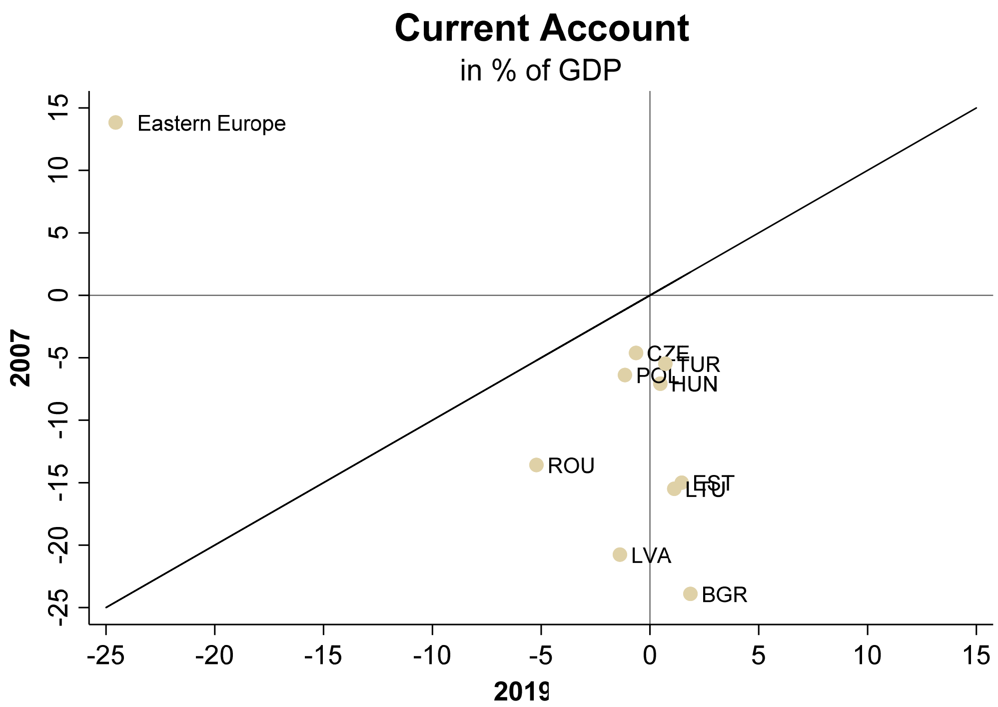
1. Largest external financing needs
2. Largest share of debt denominated in US dollars (unhedged)
3. Weak domestic growth dynamics, making it harder to face global slowdown

Although one cannot rule out a "contagion effect" affecting the Emerging Markets asset class (especially for *technical reasons*: a large proportion of investors in EM are cross-over funds rather than dedicated

How Vulnerable Are Emerging Markets?

1. Countries that exhibit large and persistent borrowing requirements are particularly exposed to capital market disruptions



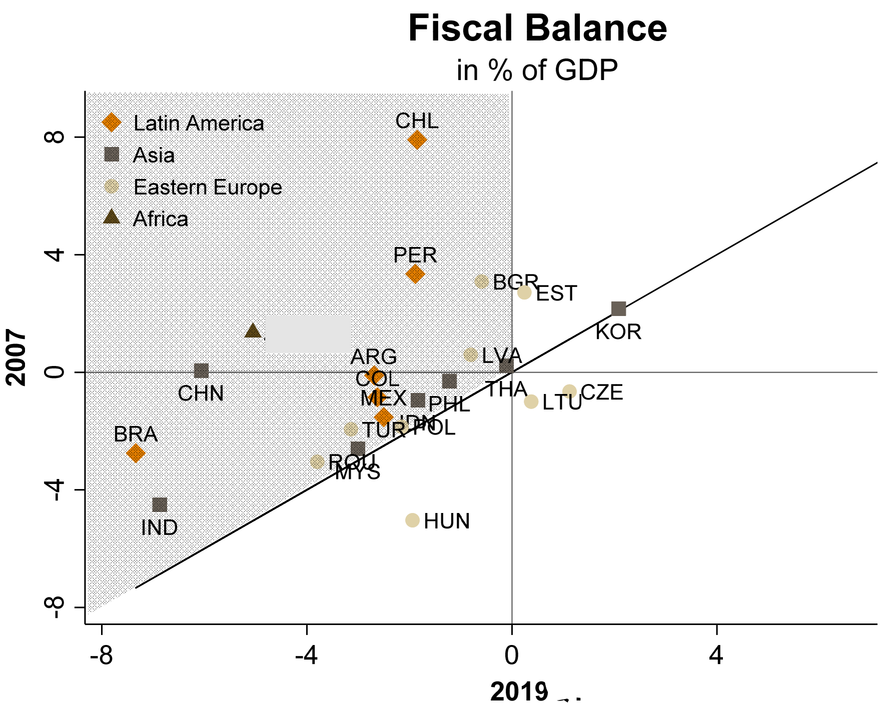


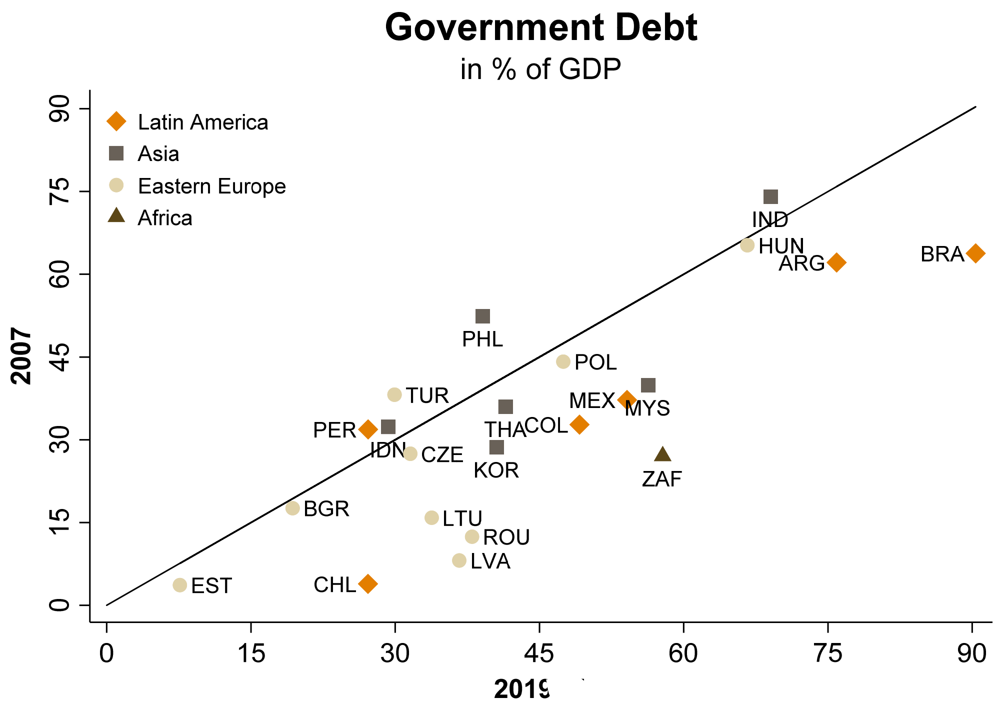
Source: IMF-WEO

While in the pre-global crisis period, large external borrowing needs was largely an Eastern Europen story, in early 2019, the current account of many countries was in a significantly worse position than a decade ago (although improving in some)

How Vulnerable are Emerging Markets?

1. Deteriorating fiscal positions have been the mirror image of the story in a number of countries, as they have been a major source of external financing needs. Argentina is a case in point.
   Some countries exhibit large fiscal deficits and display a large public debt to GDP ratio.



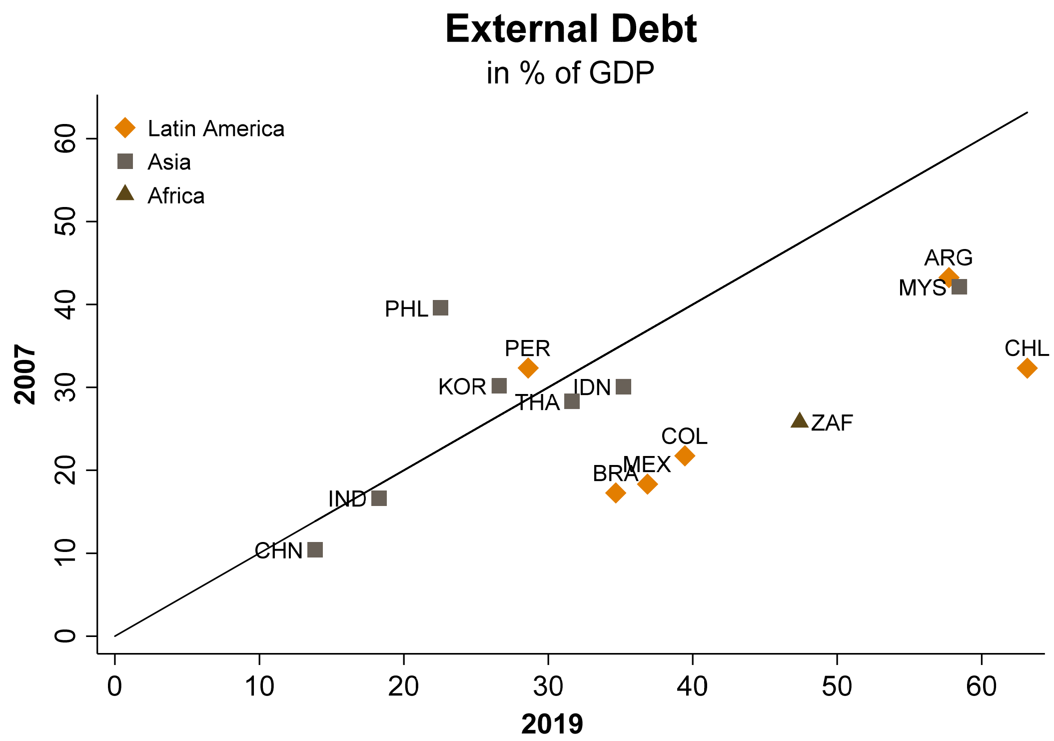


Source: IMF-WEO

Fiscal space for counter-cyclical policies has deteriorated in many countries over the last decade. Absence of corrective action in EM "good times" is now hindering an effective response to adverse external shocks.

How Vulnerable are Emerging Markets?

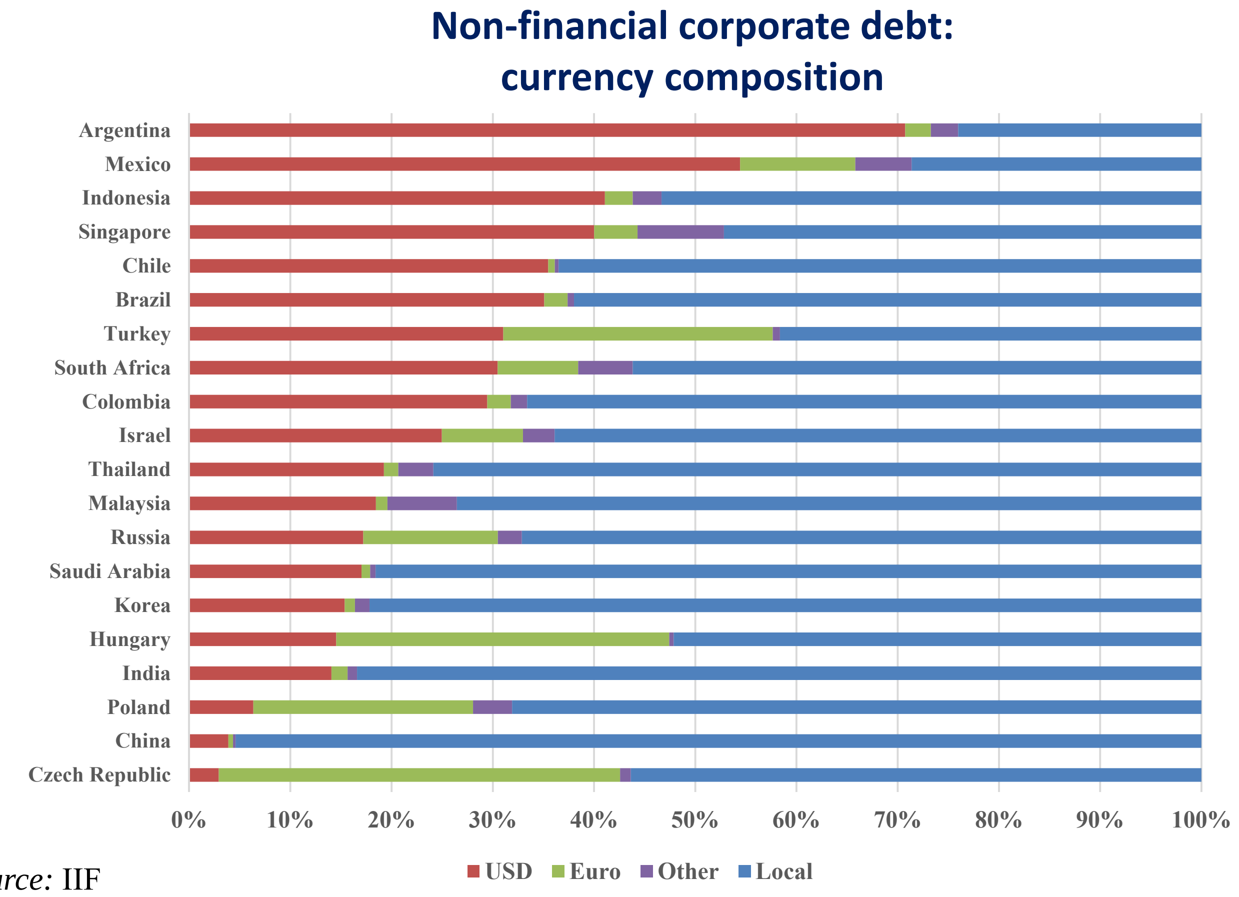
Increased external corporate debt has added to external government debt over the last decade. Thus, the ratios of *total* external debt to GDP have increased significantly in a number of countries



Source: World Bank-IMF, Quarterly External Debt Statistics

How Vulnerable are Emerging Markets?

2. Available data show that Latin American corporations, in general, are more vulnerable to dollar appreciation than other corporations in Emerging Market regions

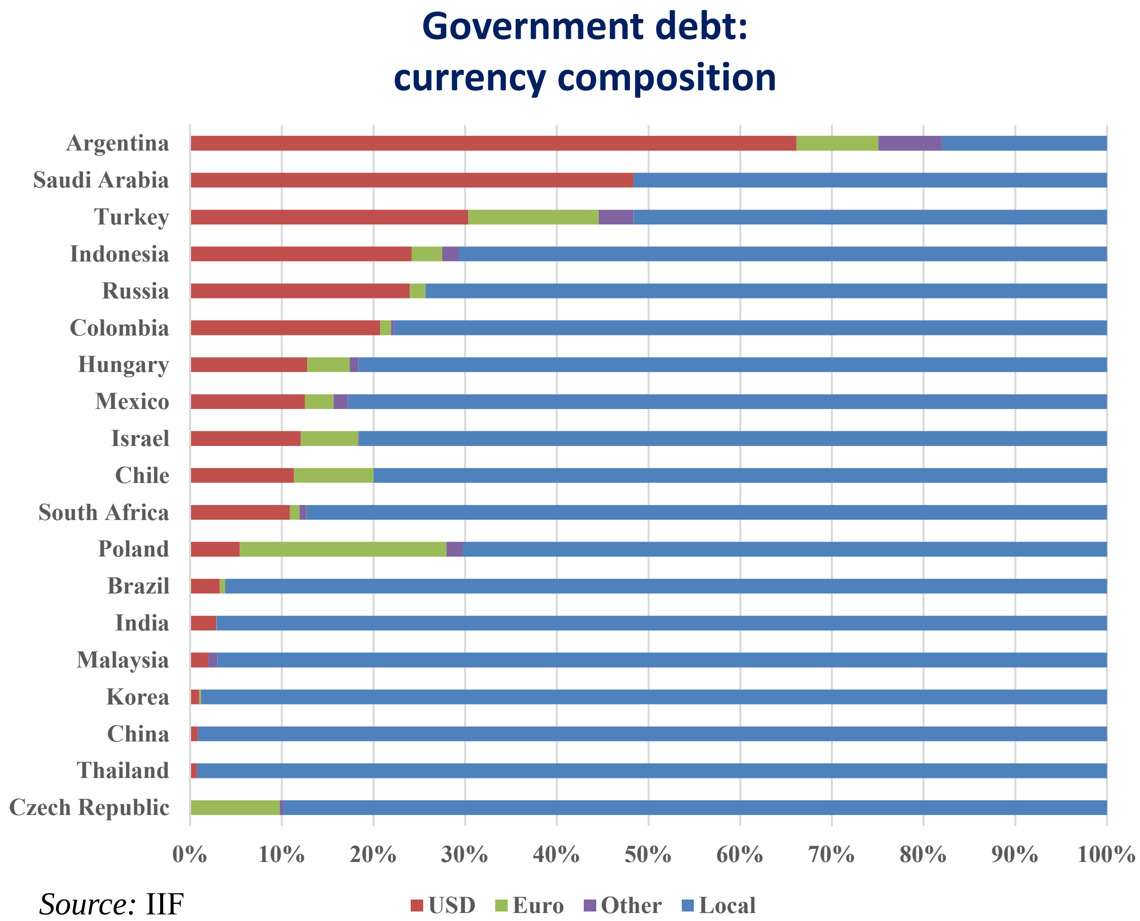


Source: IIF

The degree of vulnerability, however, depends on the extent of unhedged exposure by corporations, for which data are not fully available. Hard to assess currency mismatches

How Vulnerable are Emerging Markets?

2. The picture is somehow more mixed for government debt, although Argentina stands out



Source: IIF

Properly Assessing and Dealing with Currency Mismatches is Imperative Now

What about Policy Strengths?

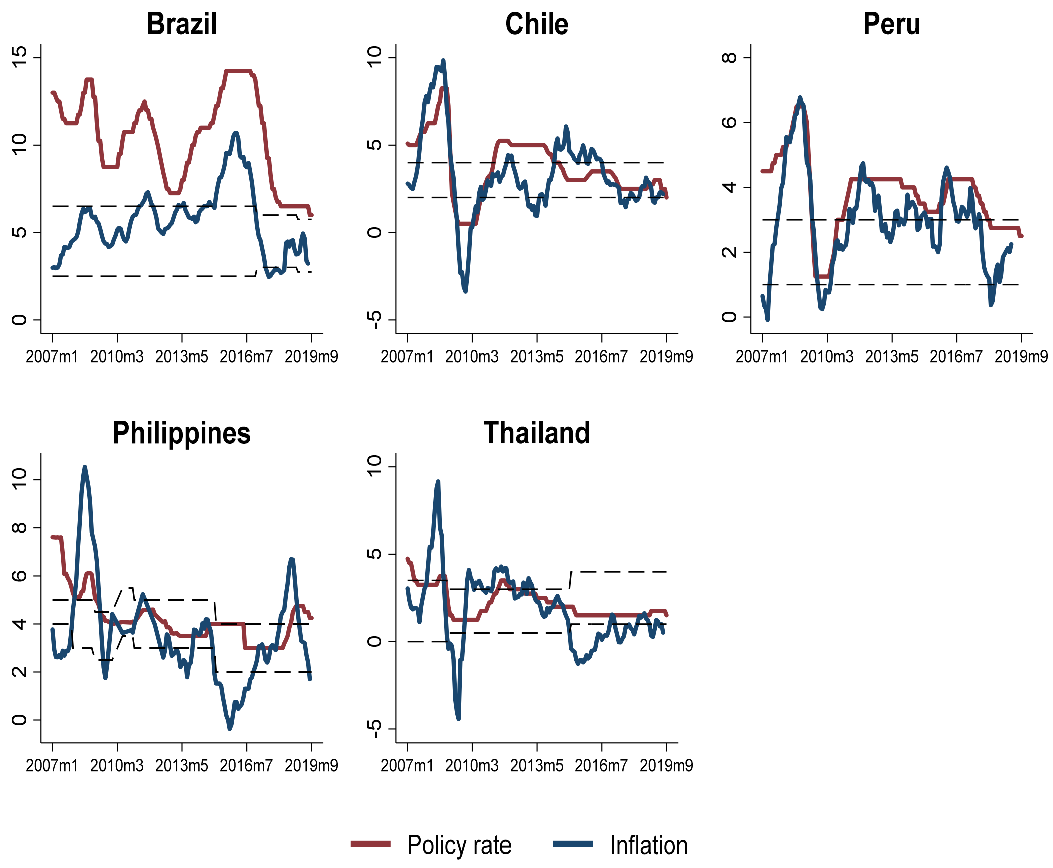
- While debt and external financing positions show fragility in a number of countries …
- …Assessing overall strength or weakness requires exploring the authorities’ ability to quickly implement adequate policies to face a less favorable external environment

What about Policy Strengths?

- Although fiscal space is quite limited in many countries, central bank policies have been largely adequate

- With some obvious exceptions, most countries have kept inflation within target and there is sufficient space for counter-cyclical monetary policies

Inflation and Policy Rates in Selected Emerging Markets (in percent)



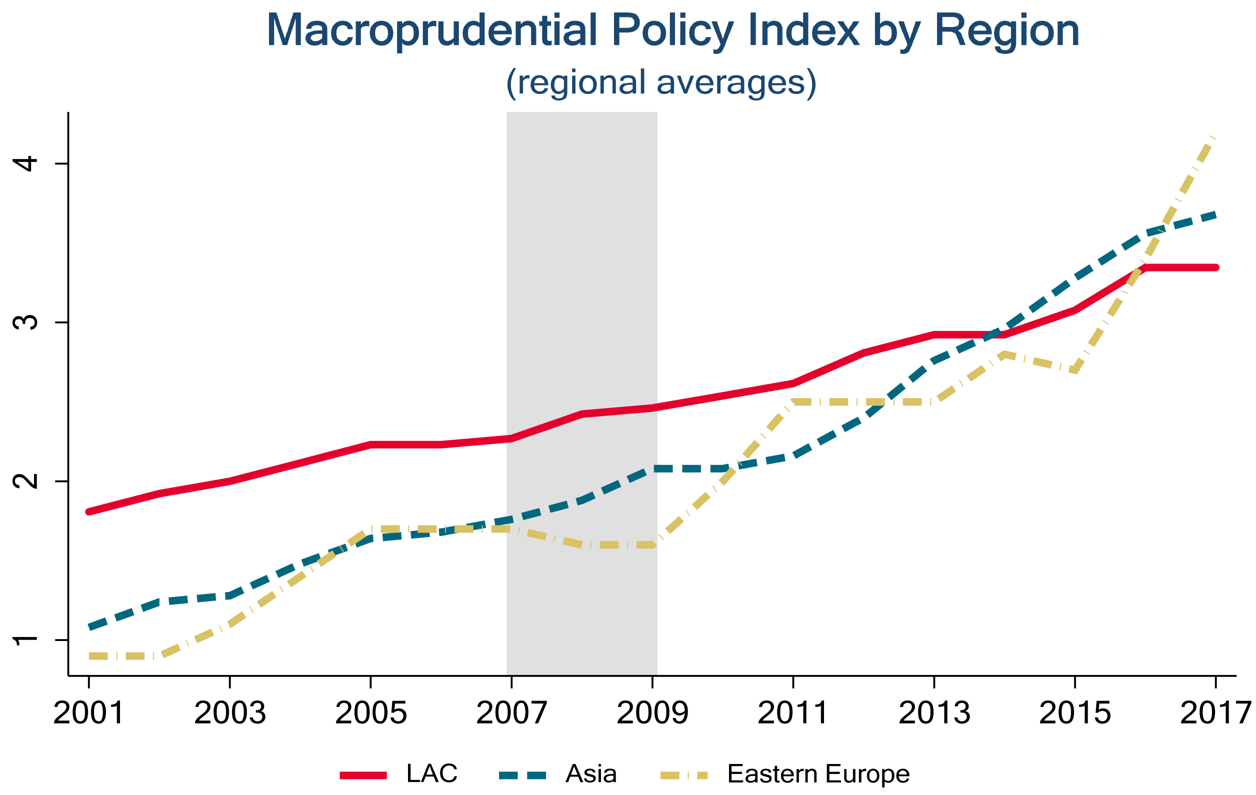
Source: IMF and central banks

What about Policy Strengths?

- However, high expected volatility in international capital markets, in the context of existing vulnerabilities in some EMs, weaken the effect of monetary policy, with more unpredictable results (e.g. an increase in local liquidity might fuel capital outflows rather than stimulate economic activity)

- This calls for increased usage of complementary macroprudential policies

What about Policy Strengths?

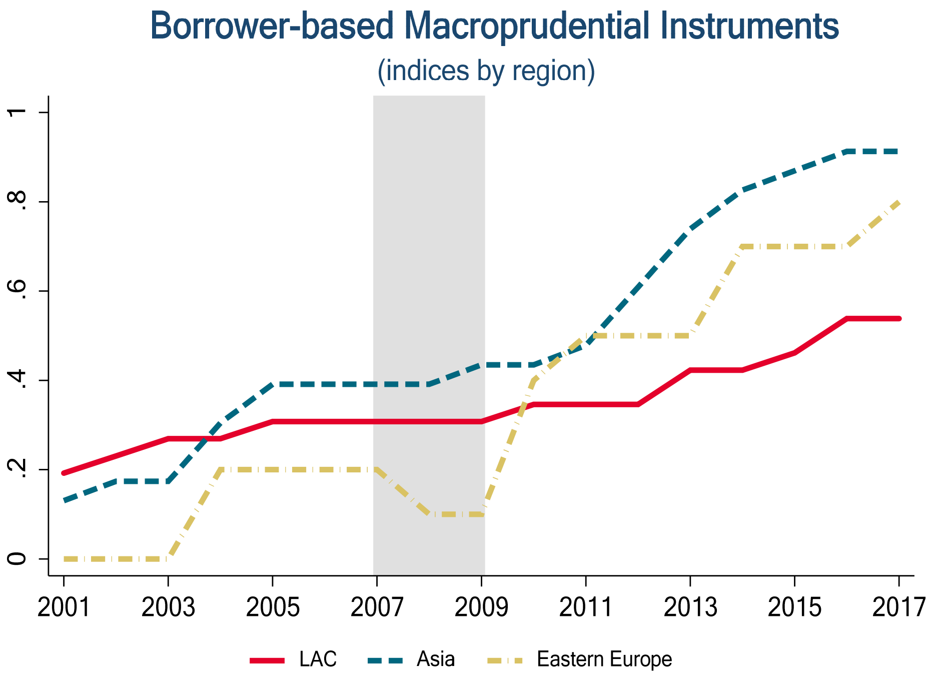


Source: based on Cerutti et al (2015)

See http://www.eugeniocerutti.com/Datasets for latest data

- Which have indeed significantly increased since the GFC
- While Latin America used to lead the EM world in terms of usage of macroprudential tools, since the global financial crisis Asia and Eastern Europe have increased their usage; and differences between regions have become small

What about Policy Strengths?



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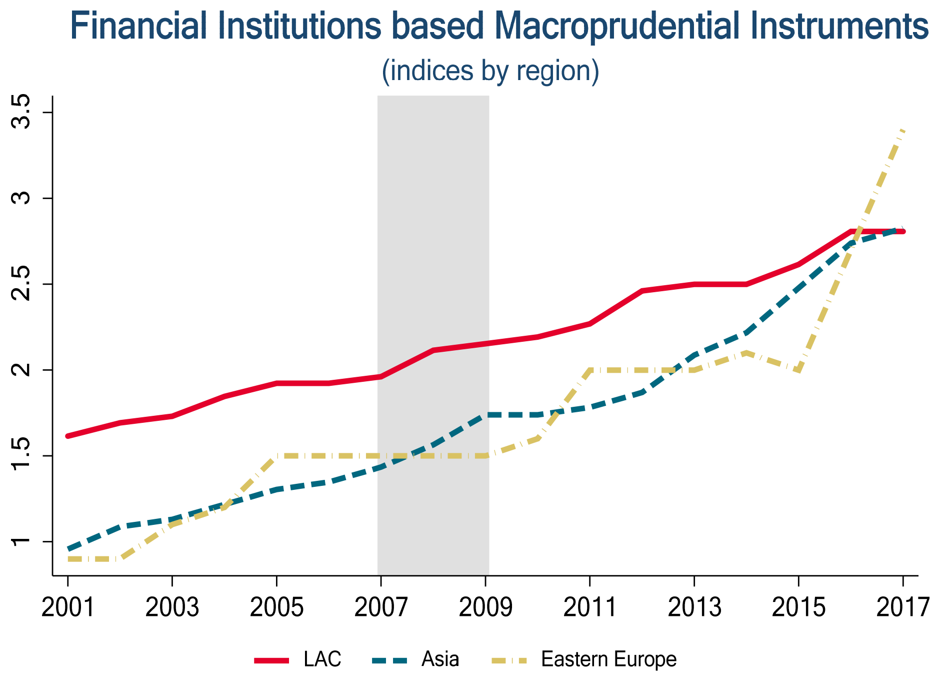

Source: based on Cerutti et al (2015)

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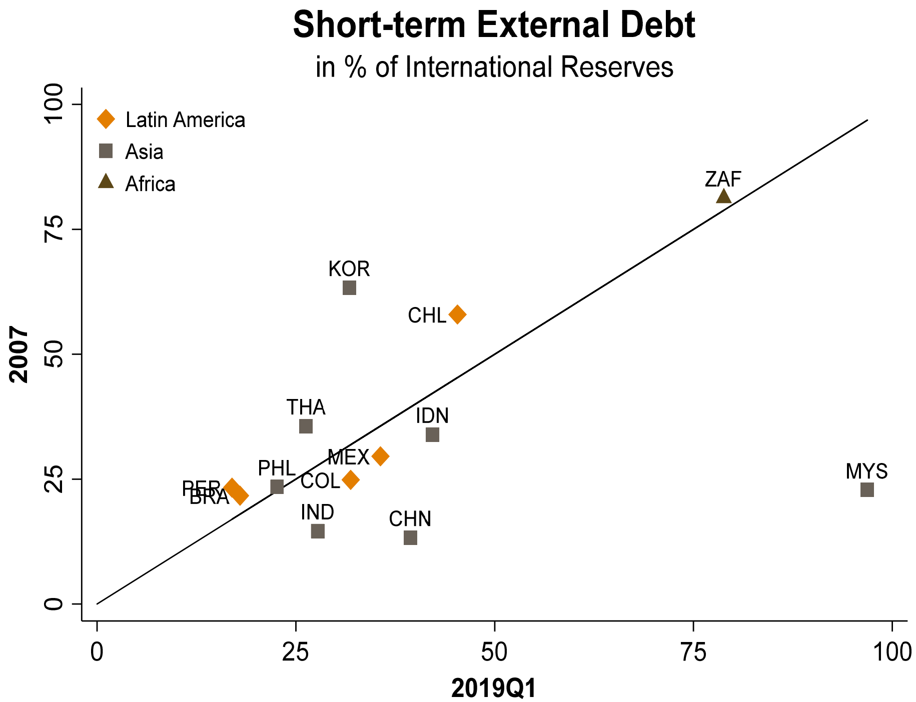
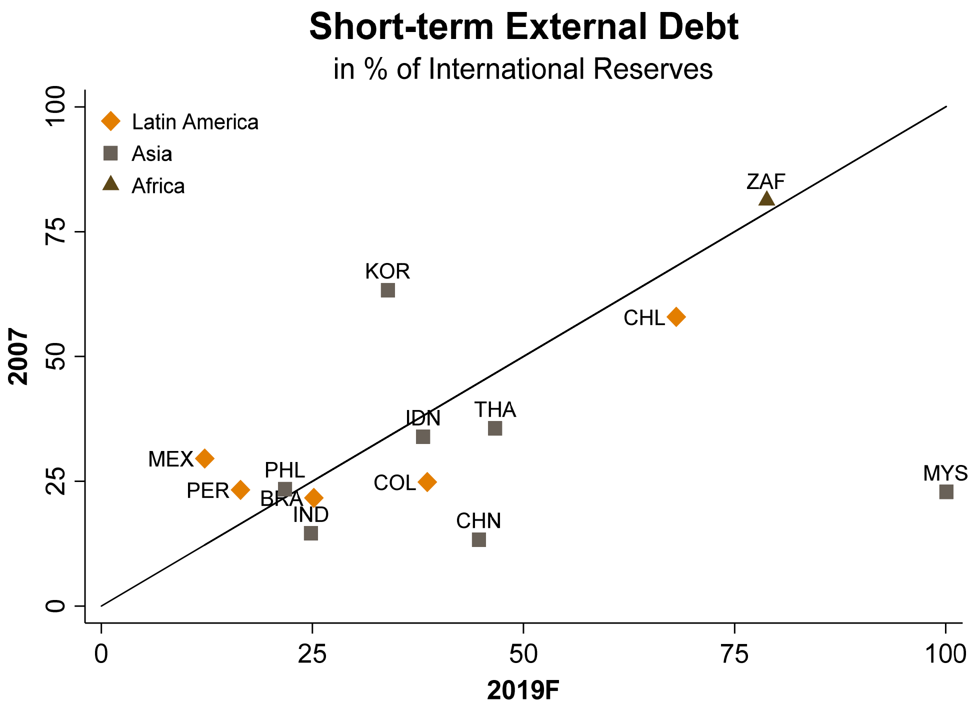
- Asia distinguishes itself in its usage of borrower-based tools (such as caps on loan-to-value and on debt-to-income), especially relative to Latin America
- Regarding the usage of financial institutions-based instruments (such as dynamic provisioning, leverage ratios, concentration limits, reserve requirements, limits on foreign currency loans and taxes on financial institutions), Asia and Latin America have converged and Eastern Europe has taken the lead.

What about Policy Strengths?

- Moreover, an indicator of strength is the ratio of short-term external debt to international reserves, which for a number of countries had declined by 2019 Q1, even in some countries with high ratios of external debt to GDP.
- But forecast for end-2019 show an increase in the ratio





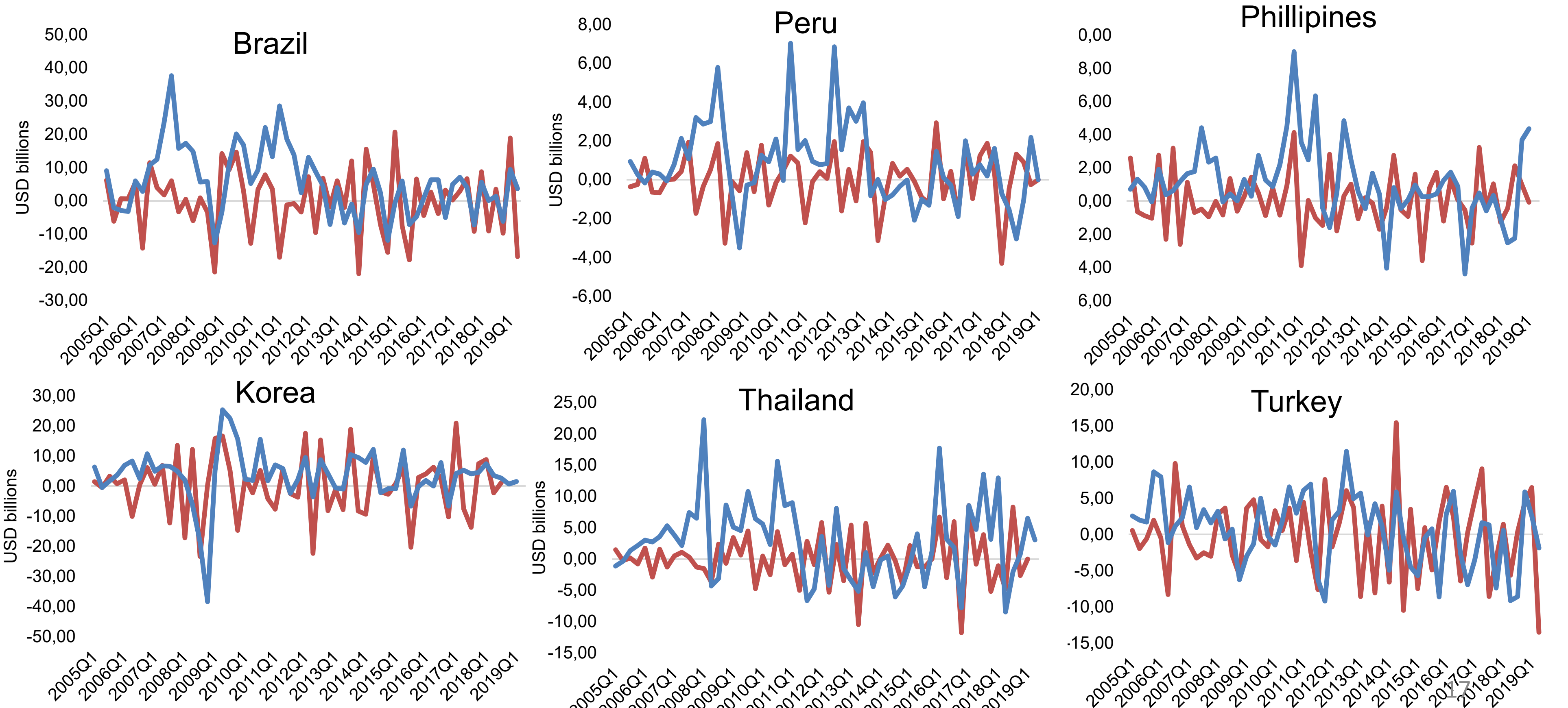
Source: Own elaboration based The World Bank-IMG Quarterly External Statistics

Self-insurance through accumulation of international reserves may, once again, play a major role in containing exposure to vulnerabilities

What about Policy Strengths?

- As stated by Jeanne (2015) and de Gregorio (2010) central banks from most EMs have relied more on international reserve management to deal with capital flow volatility than on any form of CFM: accumulate reserves in good times to use them in bad times.

Change in International Reserves and Portfolio Inflows



Source: IFS

What about Policy Strengths?

A recommendation from CLAAF:

- In the face of significant reduction of international liquidity, reserves should be used to facilitate foreign currency funding in critical sectors. A successful case of this unorthodox policy is Brazil in 2002, when towards the end of the Cardoso Administration, the Central Bank facilitated export sector access to credit lines in dollars.

What about Policy Strengths?

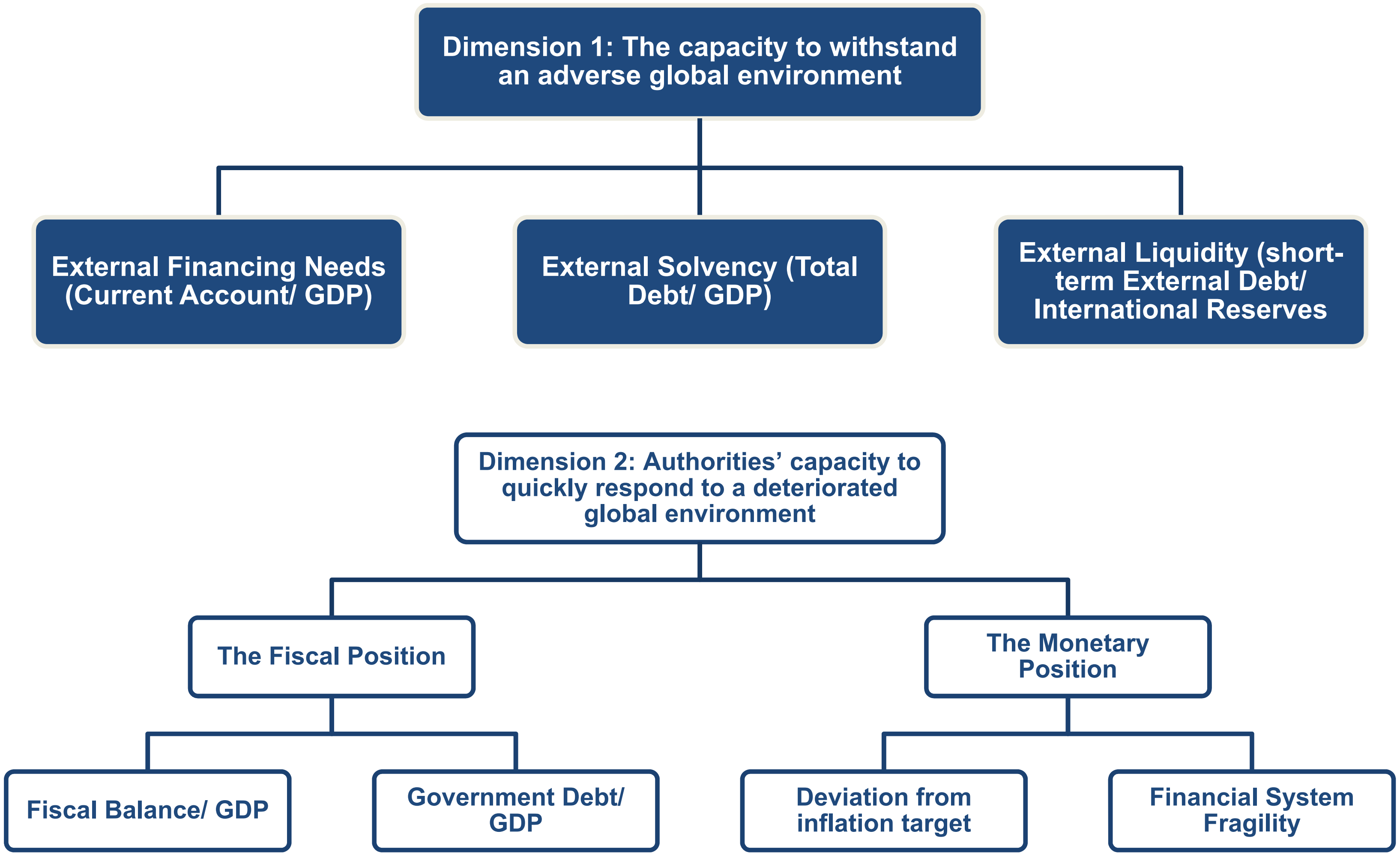
And what about the role of flexible exchange rates?

- A common argument since the GFC: Most EMs, especially in Latin America, have not experienced financial crises in spite of sharp depreciation of their currencies
  - o This shows the advantages of flexible exchange rates as shock absorbers
- While the benefits of flexible exchange rates in Latin America are unquestionable, especially since they allow for the pursuit of countercyclical monetary policy …
- … A note of caution, is due: Most of these exchange rate movements took place in the context of abundant global liquidity:
  - o Investors' large appetite for risk → insufficient discrimination between countries → no refinancing problems

- *For governments and corporations with (a) high refinancing needs and (b) important currency mismatches, a sharp deprecation of the currency in the context of decreased global liquidity (increased risk aversion) might prove severely hazardous*
- *The message is not to question the importance of flexible exchange rates, but to avoid the imbalances that constrain their usefulness*

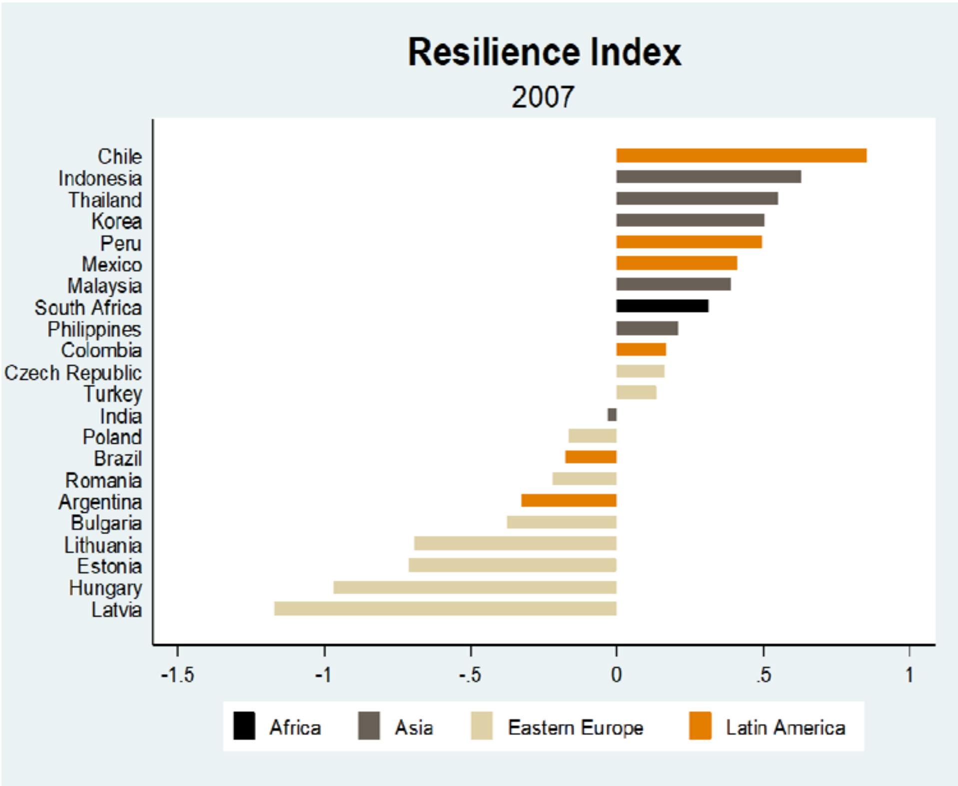
Combining Strengths and Vulnerabilities

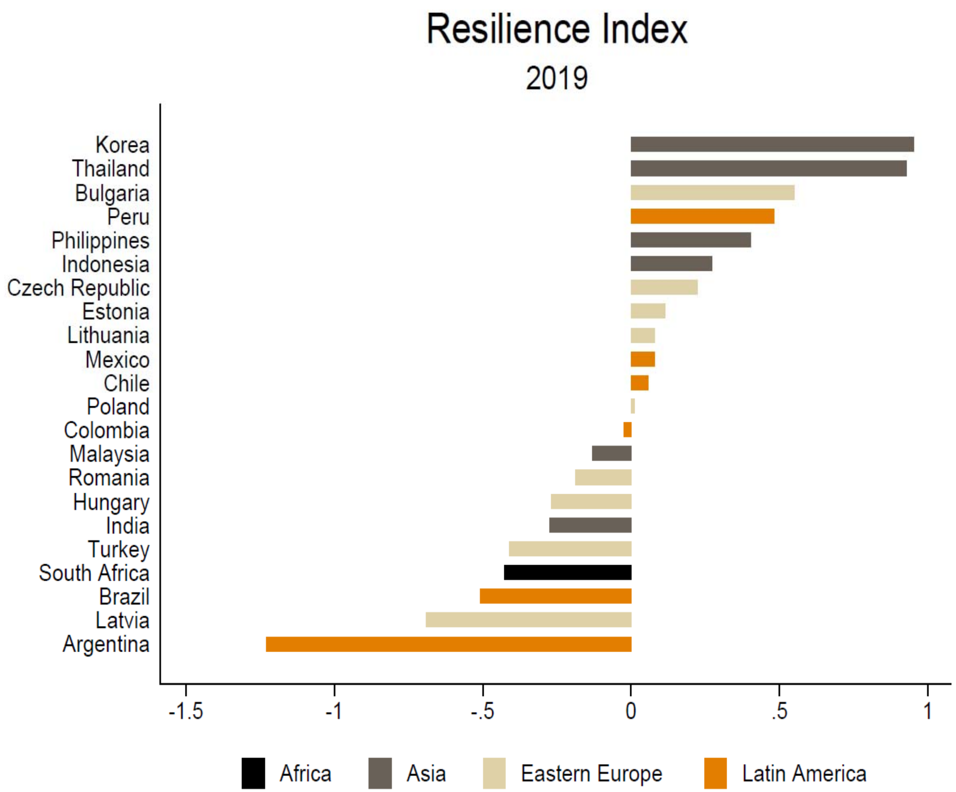
Through the construction of a **resilience** indicator that categorizes the analysis so far into two dimensions:



Large Diversity in Resilience

When classifying countries by their **resilience**, in contrast to the GFC, there is not a "regional story" today. Vulnerabilities are, for now, idiosyncratic.





Beyond countercyclical policies

3. Growth Dynamics

- Beyond short-term resilience to ongoing global developments, a worrisome red flag in a number of EMs is that experts' analyses indicate weak long-term growth
    - There is consensus on deficiencies in productivity and the lack of necessary reforms to boost potential growth
- Lacking sufficient local drivers for high and sustained growth, a number of countries might face further challenges in the context of sustained tightening in international markets conditions

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