Financial situation in developing countries, an overview

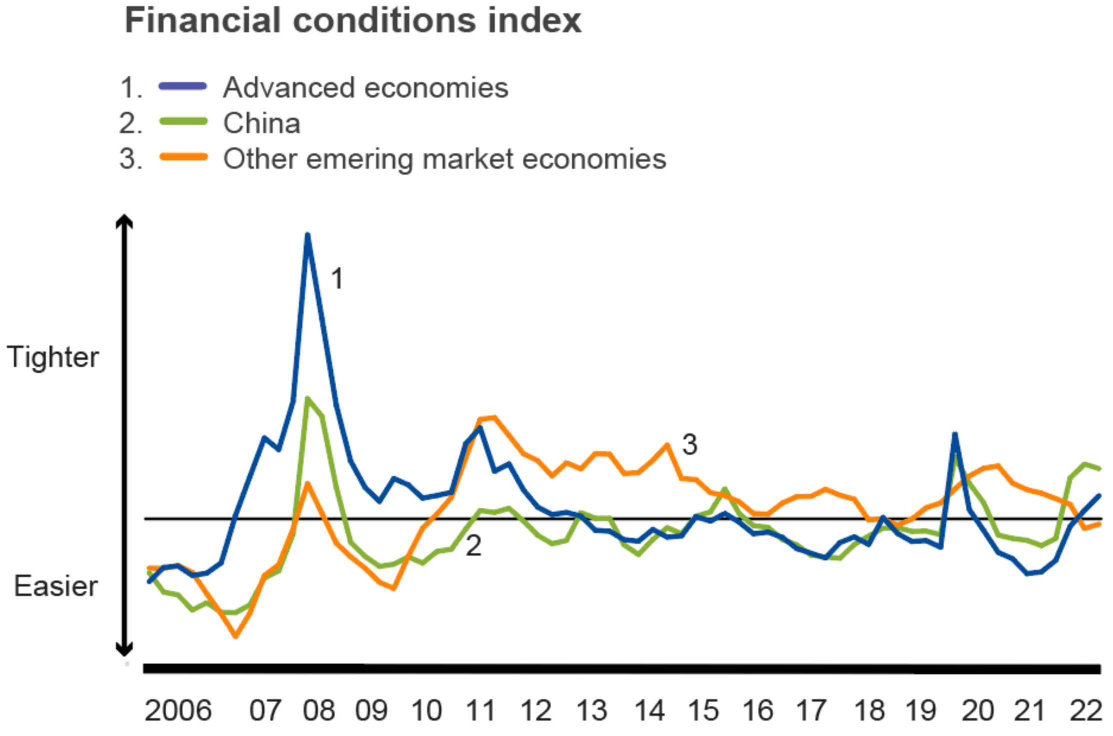
Seppo Honkapohja

Aalto University School of Business, Finland

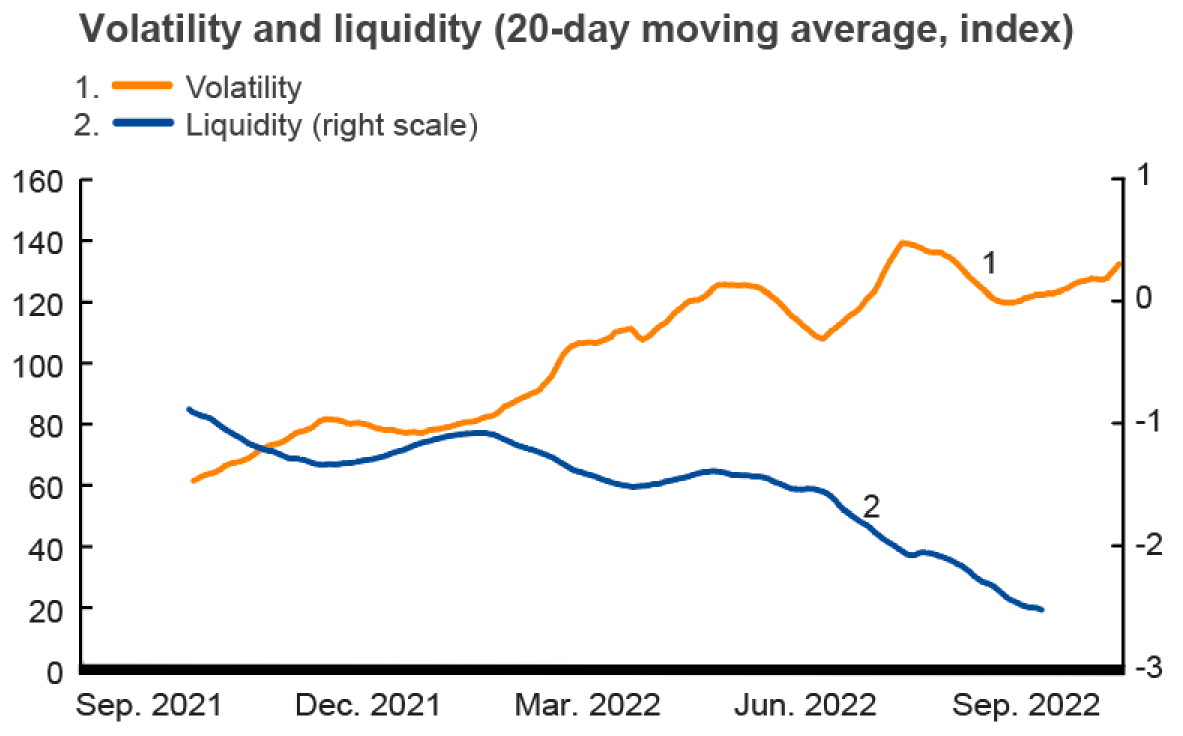
Introduction

- 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



Source: IMF Global Financial Stability Review, October 2022, Key Highlights.

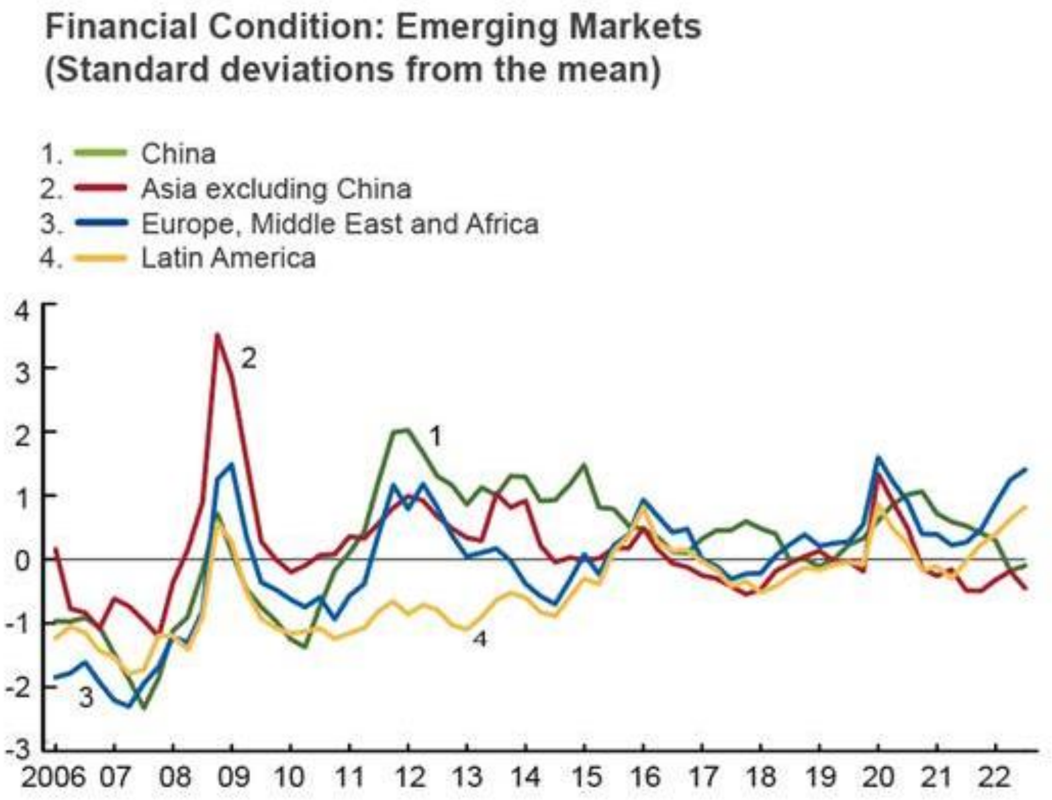


Source: IMF Global Financial Stability Review, October 2022, Key Highlights.

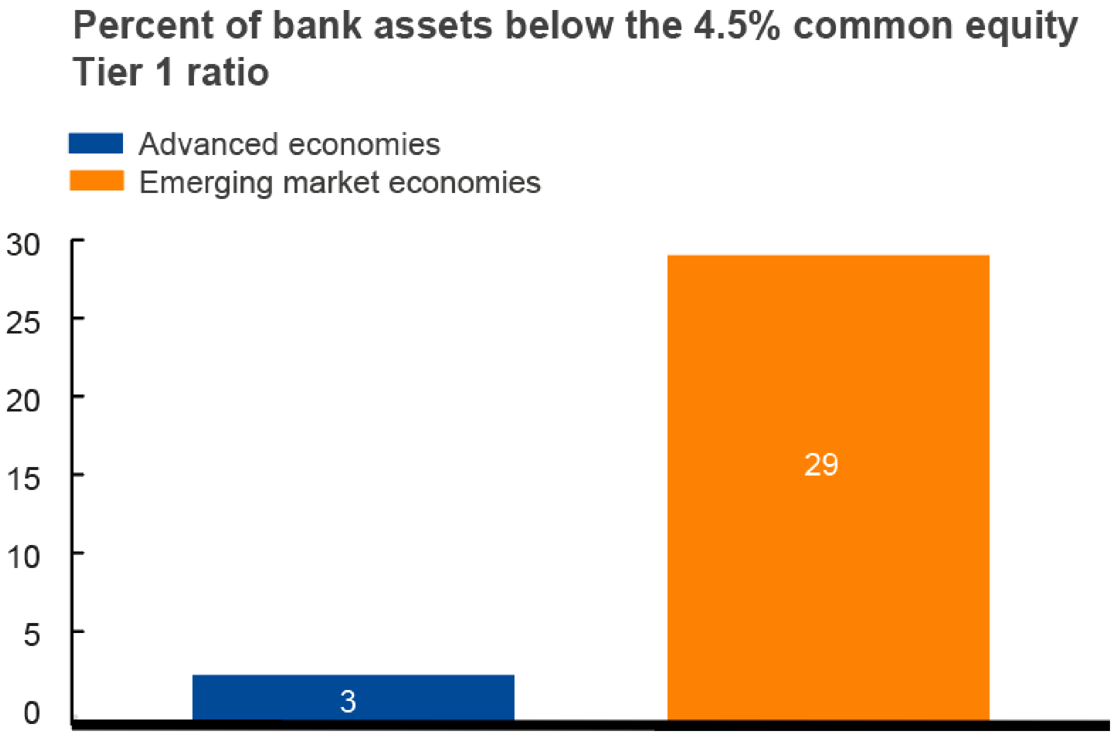
Situation in EM and developing economies

- 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



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



Source: IMF GFSR, Oct. 2022, Key Highlights.

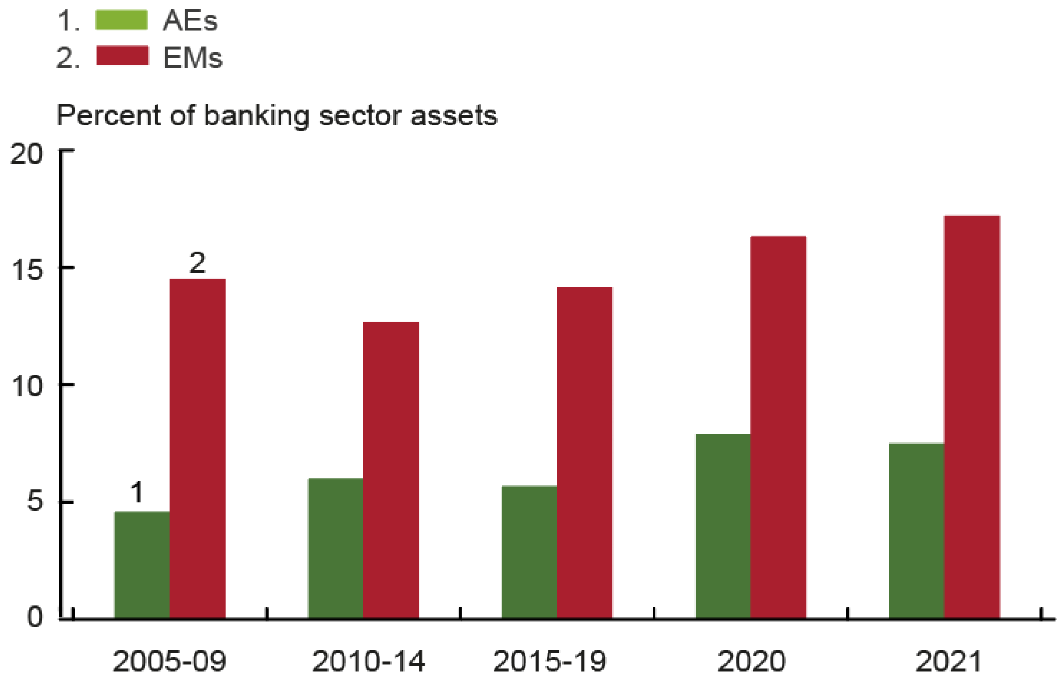
- These developments are also reflected in fluctuations in financial conditions indexes around the world, as was seen in earlier Figure 1.
- The developments do not seem to stem from a global systemic event.
  - The Ukraine war is not a global event though it has had international repercussions that 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.

Risks in sovereign-bank nexus in EMEs

- 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.

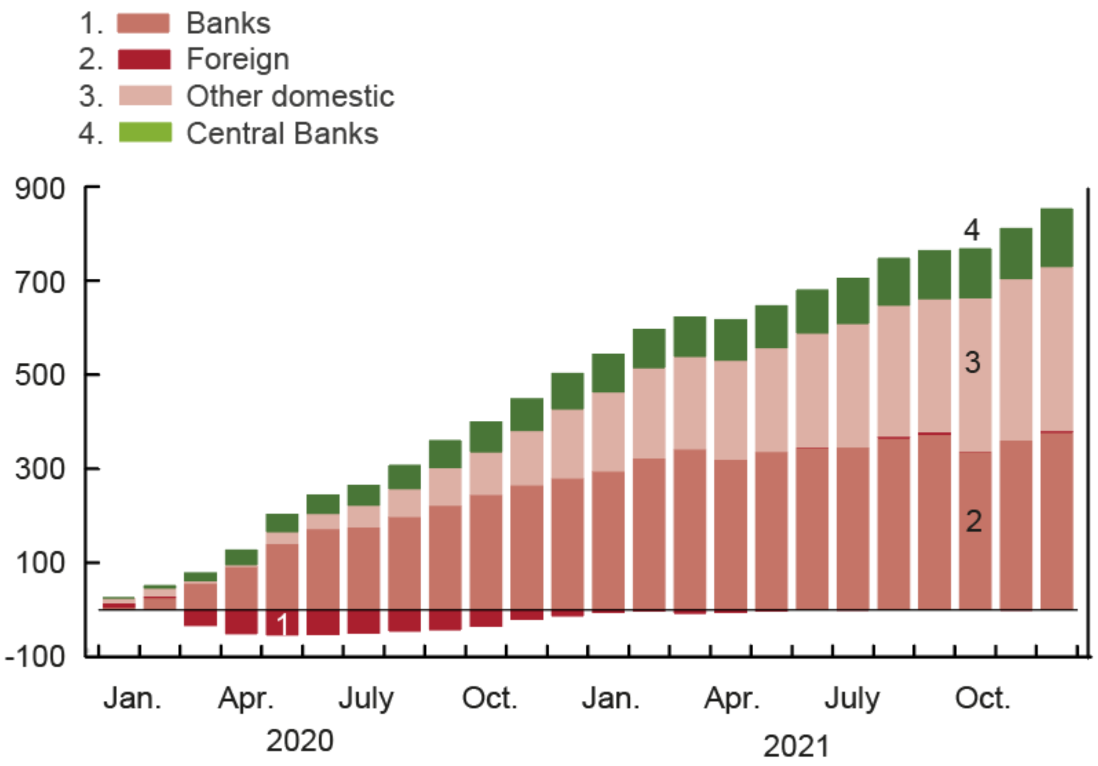
Figures 3

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



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

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



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