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# POLICY BRIEF

## Key points

- A prominent feature in the current cycle of capital flows is the rising share of external debt held by the non-government sector, creating new vulnerabilities for developing countries.
- Rapid expansion of domestic credit to the private sector is another worrying trend, which creates further vulnerabilities.
- Multilateral action is needed to reduce global financial volatility; there is also an urgent need for policymakers to explore stronger, wider and more permanent controls on capital flows.

## THE RECENT TURMOIL IN EMERGING ECONOMIES

Since early 2014, heightened volatility in international financial markets has hit emerging economies hard. In the year leading up to 5 March 2014, emerging economies saw about US\$30 billion in equity outflows, which was twice as much as the total outflows for the whole of 2013 (Reuters, 2014a and 2014b).<sup>1</sup> This latest turmoil occurred only a few months after emerging economies were battered by sudden capital reversals, caused by the Chair of the United States Federal Reserve hinting (in May 2013) that the Federal Reserve would begin reducing quantitative easing. This has come as a surprise to many observers and analysts who had, since the financial crisis of 2008, suggested that emerging economies had “decoupled” from trends and policies in advanced economies. The worry now is that having missed the warning signs, emerging economies will be on the receiving end of the wrong diagnosis if there is a more dramatic turn for the worse, with inappropriate remedies likely to follow.

### Old wine, new bottles?

The reaction of financial analysts and pundits to recent events is somewhat perplexing given that the underlying story is a familiar one. Since the end of the Bretton Woods system, developing countries have been subject to a series of financial shocks and crises associated with boom-and-bust cycles in private capital flows. Booms are generally driven by an increased global appetite for risk and low interest rates in source countries. Thus asset bubbles and interest-rate differentials attract liquid and short-term capital flows which initially reinforce confidence in the stability of the exchange rate. The newly deregulated banking sector expands into new areas of domestic business, and domestic firms borrow abroad to take advantage of lower interest rates, thereby exposing themselves to exchange-rate risks. With growing economic imbalances come heightened financial fragility and uncertain expectations. In the bust phase triggers tend to be varied, but a change in the policy stance in source countries has often been involved. This leads to a rapid outflow of capital and increases the probability of a severe crisis as a result of a falling exchange rate and rising interest rate which threatens corporate bankruptcies and the solvency of domestic banks.

A prominent feature in the current cycle is the rising share of external debt denominated in foreign currency held by the non-government sector. This shift creates new vulnerabilities for emerging economies. On the one hand, it can limit the ability of the Governments of emerging economies to provide effective responses when financial crises arise, but on the other hand, it does not preclude Governments from having to absorb the losses of systemically important institutions. A second feature is the willingness of foreign investors to hold emerging economy government and corporate bonds denominated in the local currency, with non-residents holding on average 27 per cent of such emerging economy bonds, but reaching as high as 60 per cent (Peru) and above 30 per cent even in some of the larger economies (Indonesia, Turkey and South Africa) (World Bank, 2013). While this helps reduce the exposure of emerging economies to foreign exchange risk, it makes international investors more sensitive to expectations about currency devaluation. A third feature is the increased frequency of shocks and the narrowing amplitude of the current cycle, taking away from emerging economies the necessary time to fully recover and rebuild buffers.

<sup>1</sup> These data reflect only fund flows provided by the fund-tracking firm EPFR Global. They therefore represent a subset of capital flows.

## Fragility: Local or systemic

In the 2000s, emerging economies made considerable efforts to build resilience to future shocks: a number were able to accumulate large international reserves (some from export earnings, others through borrowing abroad), thereby covering a high proportion of their annual external financing requirements. Their government external debt as a proportion of gross domestic product declined, maturities lengthened and a larger portion was denominated in local currencies. In addition, some emerging economies introduced more stringent macroprudential regulation to reduce vulnerabilities, for instance by imposing upper limits on foreign exchange exposure by their financial institutions. Furthermore, since the global crisis of 2008, others adopted capital account management measures to stem or reduce capital inflows and outflows, albeit with varying degrees of efficacy (see UNCTAD Policy Brief No. 28). Despite such precautionary measures, the reduced exposure of the government sector and the shift in the composition of external debt mentioned above, most emerging economies are being affected in one way or another by the current turmoil.

Thus far, some economies have witnessed sharp currency devaluation, prompting higher domestic interest rates. Between the beginning of tapering of bond purchasing announced on 18 December 2013 and 10 March 2014, the Argentine peso lost 20 per cent of its value against the United States dollar, the Turkish lira lost 8 per cent and the South African rand, 6 per cent.<sup>2</sup> Furthermore, there is considerable risk that policy responses may bring countries closer to the full-blown economic crisis they are meant to avert. Argentina's short-term interest rates shot up by more than 10 percentage points and Turkey's, by more than 4 percentage points. Interest rate rises may only temporarily contain the outflows, but they tend to weaken domestic demand and the appetite of long-term investors. Likewise, to the extent that Governments end up rescuing sectors of systemic importance, they will eventually be under pressure to sacrifice their long-term policy goals, including the need to support infrastructure investments which, again, will alienate long-term foreign investors.

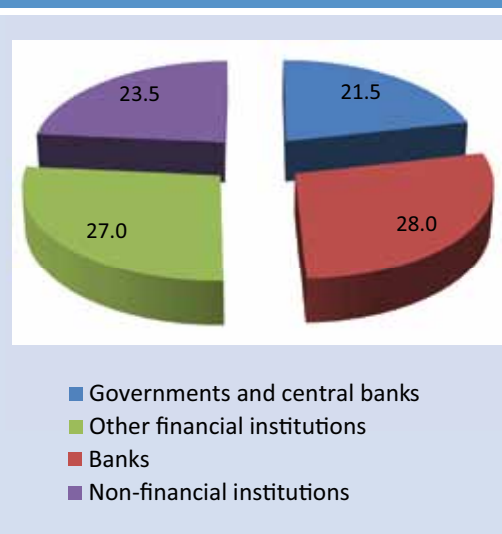
More worryingly still is that the crisis may also affect some of the poorest countries in sub-Saharan Africa, which have only recently gained access to international capital markets. Recently, Ghana has imposed foreign exchange controls to contain currency depreciation.

Although analysts point to home-grown factors to explain the problems facing Ghana, the economy is among those few in sub-Saharan Africa becoming increasingly integrated into global capital markets. It is thus also vulnerable to the ongoing turmoil. However, the capacity of Ghana – and more broadly of sub-Saharan Africa – to mitigate the impact of crisis, particularly on the poorest communities, is far lower compared to richer emerging economies. Where next?

Having listened to the siren calls of financial markets, international analysts and policymakers have since begun scrambling to get things back on track. In doing so, there has been a rush to put the blame on the government sector for problems arising from the private sector. As a result, some important trends in the recent profile of emerging economies are in danger of being missed.

In the current cycle of capital flows, international bonds issued by emerging economies have been greater in value than bank borrowing: in the period from 2010 to the first half of 2013, the former reached an accumulated value of US\$991 billion and the latter, US\$862 billion. As regards international bonds, from 2010 to 2013 it was the non-government sector which issued 79 per cent of that total accumulated value; and of this total in turn, financial corporate firms were responsible for 70 per cent, and non-financial corporate firms, for the remaining 28 per cent (see figure).

Figure  
**International bond issuance by emerging economies, by category of issuers, 2010–2013**  
(Share of the total accumulated value, as a percentage)



Source: Based on Turner (2014), table 2 and table A1.

<sup>2</sup> See <http://www.bloomberg.com/markets/currencies/> (accessed 11 March 2014).

These figures indicate that, at least in some countries, the corporate sector is very vulnerable to foreign exchange risks. In Turkey, for example, the country's rated corporate firms have 90 per cent of their debt denominated in foreign currency (Phillips, 2014). In relation to external debt by financial institutions, macroprudential regulation may have helped in reducing exposure to some currency risks. However, the reality is that risks associated with inflows of foreign capital have been transferred rather than eliminated. Domestic banks, for example, may reduce currency mismatches in their balance sheets by providing loans denominated in foreign currency, but this only transfers the risk to the borrower, while increasing the bank's credit risk. In the case of non-financial corporate firms, it may well be that they are hedged against currency risk, for instance if their main revenues are generated in foreign currency. The evidence however is that, taking emerging economies as a whole, recent increases in issuing of international bonds have not been related to increases in exports, suggesting that exposure in foreign currency has grown (Turner, 2014). Thus, despite the rise in external debt denominated in local currency, emerging economies still find themselves very vulnerable to significant currency devaluation.

Moreover, in recent years a few economies have witnessed rapid expansion of domestic credit to the private sector as a proportion of gross domestic product. This is particularly true in parts of South-East Asia but also in Brazil, India and South Africa where external capital inflows have contributed to credit expansion to support debt-based consumption (Zalk, 2014). Although the mix of funding on which banks draw to lend varies, the figures above suggest that, in some cases at least, banks have drawn significantly on funding from abroad or from wholesale deposits by corporate firms which have borrowed from abroad and deposited their cash in domestic banks (Turner, 2014). This type of funding again heightens vulnerability, since in times of crisis both banks and non-bank corporate firms have difficulty refinancing their debts.

A combination of unstable funding sources and high-level of corporate external (and in some cases household) indebtedness can be explosive: at the moment when banks are under pressure to recall loans due their own funding problems, a strong devaluation and an interest rate rise would hit borrowers hard and, worryingly, push many of them over the edge, with far-reaching consequences for the whole economy.

## **The socialization of losses**

Inasmuch as the private sector has large exposures to exchange and interest rate risks, the fallout may be great and Government has to step in, bailing out the sector and absorbing most of the losses to avoid a generalized economic meltdown, as the recent eurozone crisis so starkly demonstrates.

By way of illustration, large exposures may initially be concentrated in the non-financial corporate sector and households. A combination of exchange and interest rates shocks may initiate a series of credit defaults, hitting the balance sheets of the banking sector and causing a situation of extreme distress. Alternatively (or in combination), the banking sector may be directly exposed to foreign exchange risks. To avoid a generalized collapse of the private sector, Governments have to intervene to rescue the banking system of countries, as has happened in the past.

This was the situation, for example, during the external debt crises of the early 1980s in Latin America. While the exact form of rescue varied from case to case (through recapitalization schemes, creation of "good" and "bad" banks, etc.), the common element was that, in the end, losses were taken on by Governments, with far-reaching implications regarding the latter's ability to use conventional policy instruments, such as fiscal policy, to support recovery. The end result was years of protracted slow growth and/or unacceptably high levels of unemployment and social costs.

## **Action on all fronts**

None of the emerging economies appear to be close to the tipping point. However, the lesson from recent crises is that international financial flows move quickly and unexpectedly, and the warning signs are there. Moreover, the crisis of 2008 has largely failed to bring about the reforms to the financial system that many had hoped would follow. Arguably the current turmoil is a reflection of that failure. What is needed now is concerted action on several fronts – multilateral, regional and national.

Multilateral action is needed to reduce global financial volatility and its impacts on developing countries. A concerted approach is in the interest of both advanced economies and emerging economies, since a generalized crisis would have significant feedback effects on advanced economies. As far back as 1998, the Interim Committee of the Board of Governors on the International Monetary System (today's International Monetary and Financial Committee

of the Board of Governors) of the International Monetary Fund (IMF) agreed that the IMF “should intensify its surveillance of financial sector issues and capital flows, giving particular attention to policy interdependence and risks of contagion, and ensure that it [was] fully aware of market views and perspectives” (IMF, 1998).

## Policy recommendations

- At the international level, effective surveillance of the policies of the major industrial countries, especially with respect to their effects on capital flows and exchange rates of developing countries, needs to be undertaken more systematically.
- There is an urgent need to have in place a framework on sovereign debt workouts to support orderly debt resolution and rapid recovery in countries facing a debt crisis – the eurozone crisis is a further reminder of this need.
- At the regional level, new initiatives should be undertaken to expand existing regional reserve funds, such as the Chiang Mai Initiative of the Association of Southeast Asian Nations Plus Three and the Latin American Reserve Fund, and create new ones, for example for Africa, in addition to cross-regional funds such as the one proposed by the Governments of the

BRICS – Brazil, the Russian Federation, India, China and South Africa. These funds have the potential to play an important role in the future in protecting and supporting countries facing shocks.

- At the national level, Governments must take steps to reduce their vulnerability to external financial shocks meaningfully and durably and, to this end, draw on a number of tools such as capital account management and adopt stronger macroprudential financial regulation.
- There is an urgent need for policymakers to explore stronger, wider and more permanent controls on unruly capital flows both for entry and exit, despite the adoption of precautionary measures in some developing countries referred to above.
- As in previous crises, Governments of developing countries have to play a central role in mitigating the economic and social damage caused by financial crises in ways that do not generate excessive costs for the State. This requires a crisis resolution approach that focuses on systemically important institutions and that ensures that, among those institutions that are rescued, new management practices are adopted to avoid a repetition of past mistakes.

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## Contact

Richard Kozul-Wright,  
Director,

Division on Globalization and  
Development Strategies  
Tel. +41 22 917 5615  
[richard.kozul-wright@unctad.org](mailto:richard.kozul-wright@unctad.org)

Press Office  
+41 22 917 58 28  
[unctadpress@unctad.org](mailto:unctadpress@unctad.org)  
[www.unctad.org](http://www.unctad.org)



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