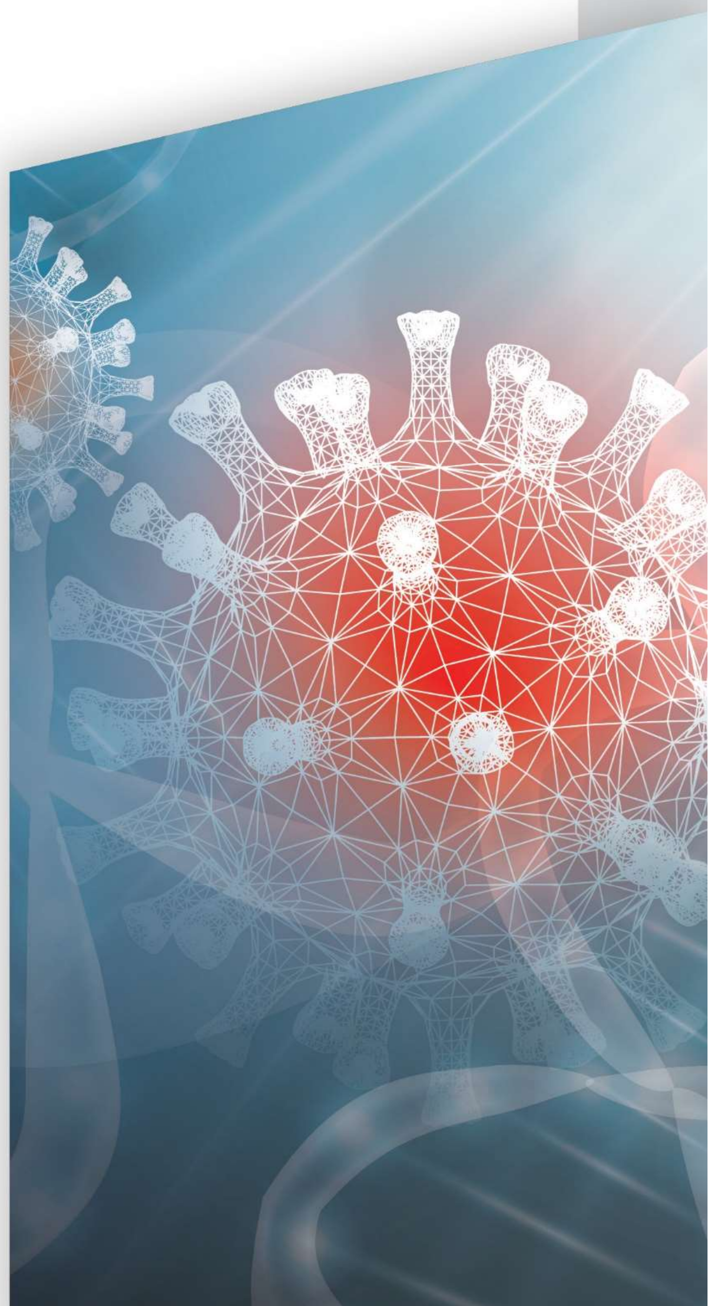
UNITED NATIONS DEVELOPMENT ACCOUNT PROJECT

COVID-19 RESPONSE

JUNE 2022

COVID-19
Response and Recovery
Mobilizing financial resources for development

DA-COVID-19 project led by Debt and Development Finance Branch, Division on Globalization and Development Strategies (DDFB/DGDS)



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Buckle up, it’s a bumpy ride: financial instability and volatility in developing and emerging economies

Short Policy Paper

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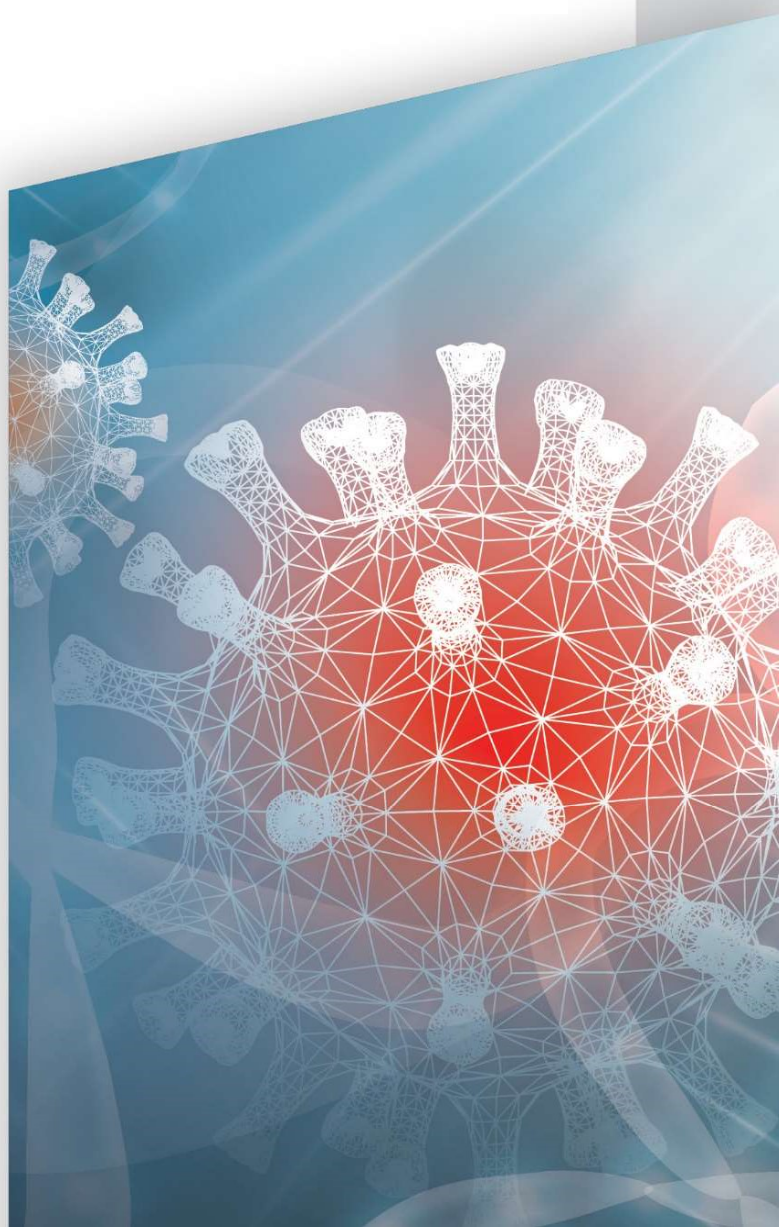


About the COVID-19 Response and Recovery project

This paper is an output from the project "Response and Recovery: Mobilising financial resources for development in the time of COVID-19", which is co-ordinated by the Debt and Development Finance Branch of UNCTAD and jointly implemented with ECA, ECLAC and ESCAP. This project is one of the five UN Development Account short-term projects launched in May 2020 in response to the COVID-19 crisis.

In this work, a framework to assess external debt and financial sustainability and public sector sustainability through the lens of the achievement of the Sustainable Development Goals (SDGs) is presented. The approach differs in some key areas from the International Monetary Fund's (IMF) Debt Sustainability Analysis (DSA), placing the external constraints and the resulting possible growth rate at centre stage. This in turn provides information on the fiscal space available to policy makers with which to achieve the SDGs through public investment.

The COVID-19 crisis has exacerbated the many challenges that developing and emerging economies are confronted with. With the background of the War in Ukraine, and in the face of the unwinding of emergency policy measures, such as the G20 debt service suspension initiative, and the tightening of monetary conditions to curb inflation in the North, the global South is bracing itself for new turbulences in international capital markets. Ever since the liberalisation of global finance, financial conditions in developing regions have been vulnerable to shocks and changes in market sentiments. The new generation of UNCTAD financial condition indicators (FCIs) reveals the extent to which hyperglobalised finance has turned capital markets in developing and emerging economies into a seemingly endless ride on a roller coaster: over the past 15 years, financial market conditions in most countries were subject to large up and downturns, which constitutes a major roadblock to long-term and sustainable development. The analysis in this Policy Brief calls for a renewed endeavour to reform the global monetary system and employ targeted policy measures to strengthen resilience and financial stability in developing and emerging economies.

Common vulnerabilities, common fate

The new generation of UNCTAD FCIs presents an innovative approach to analysis and policymaking: instead of analysing FCIs for individual economies, the indicators present the values for country-clusters that reveal similar patterns of financial vulnerabilities, as defined by the data. Bouhia et al. (2022)[1] presents and discusses the methodology, the data and the analysis of the new generation of the FCIs in greater detail. This approach entails several advantages. First, the findings are more robust than previous FCIs, given that data gaps and low data quality have a lower distortive impact. Secondly, especially for the most vulnerable and poorest economies in the world, which suffer from significant data gaps, the aggregated FCI allows to derive targeted policy conclusions to stabilise capital markets. The analysis of 76 developing and emerging countries in total revealed the emergence of five different clusters[2] with shared financial characteristics and vulnerabilities (cf. Figure 1)[3].

[1] Bouhia R., Blanc G., Falciola J., Kaczmarczyk P., and J. Bodelet (2022): "Between stress and strain: understanding, measuring, and analysing financial conditions in developing countries in times of Covid-19 and beyond". UNCTAD Research Paper. To be published.

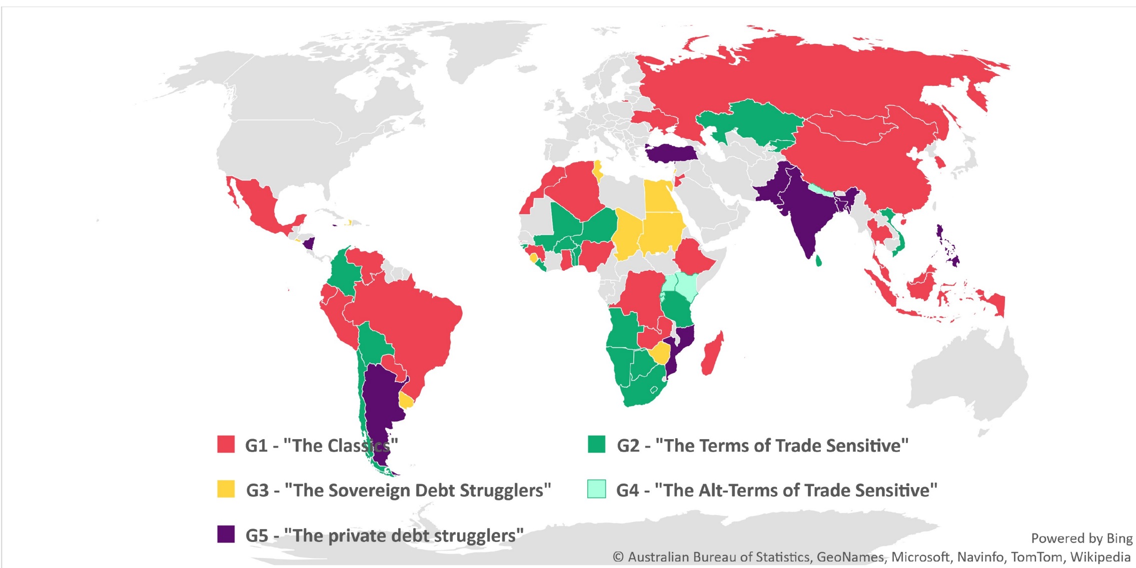
[2] The five clusters result from an ex-post classification that is without any preconceived assumption on how to group countries together. The analysis of the loadings from the factor analysis, which measure how well-fitted countries are in their clusters, shows that this ex-post classification performs far better than any ex-ante classification, based on geographical or income groups, for instance.

[3] The FCIs quantitatively summarize common patterns within clusters, their interplay with global drivers – such as global monetary conditions and commodity prices – and pave the way for better evidence-based global governance. To this extent, they do not reflect the full complexity of and nuances across national situations.

Same story, different impacts

At the heart of the boom-and-bust patterns, across all developing and emerging market economies, lies a dysfunctional and casino-like global financial system. As speculators place their bets, self-reinforcing sentiments and herd behaviour repeatedly lead to false pricing across financial asset classes. Once the music stops and speculators turn their back, these economies are left in peril. Yet, although the large swings in financial conditions were common across all groups, there are also distinct features as to how each cluster reacts to different financial shocks (cf. Figure 2). Group 1 and 2 are the main groups, since they contain about 70 per cent of the developing and emerging economies in the sample. Groups 3-5 are variants of those main clusters.

Figure 1: Overview of the five FCIs' clusters



Group 1 – "the classics" – constitutes the largest group of developing and emerging economies. Close to 40 percent of countries fall into this category, mostly high- and middle-income economies from Latin America and East Asia. The key characteristics of this group are their dependence on commodity prices and global monetary conditions, and therefore their susceptibility to the vagaries of speculative capital flows, especially in form of carry trades[4] that dampen their competitiveness. Financial shocks, such as the 2008 global financial crisis (GFC), the commodity slump of 2014, the US-Dollar appreciation of 2018, or

[4] Carry trade generally consists in borrowing in a low-interest rate currency, such as the US dollar, and lending in a high-interest rate currency, such as the Brazilian real, in an attempt to make profits.

the Covid-19 market turmoil in 2020 have significant adverse effects on financial conditions in this group.

Group 2 – “the terms of trade sensitive” – comprises the majority of low-income countries and the greater number of African countries. In this group, the effects of global monetary conditions and commodity prices are the opposite of those in group 1. In moments of financial shocks, financial conditions of this group are eased via improving terms of trade because the fall in commodity prices which outweigh the effects of capital flight to safety. This group overall benefits from a stronger dollar and lower oil through imports. Therefore, contrary to “the classics”, the commodity slump of 2014 improved financial conditions.

Group 3 – “the sovereign debt strugglers” – mostly includes countries in Middle East and North Africa and Sub-Saharan Africa with very high shares of public debt in GDP and in which political uncertainty, social unrest or even wars over the last decades have compounded risk premia. These economies are engulfed in a spiral of public debt: the high debt stocks accumulated over the years have not spurred investment, nor have improved the ability to raise domestic financial resources or diversify the sources of financing that would ensure long-term debt sustainability. In a context of stalled structural transformation, currency depreciation has failed to rebalance current account deficits, which remain wide and persistent, but instead, have induced high inflation and exacerbated foreign-currency denominated debt burden. Given underdeveloped capital markets, jitters in global monetary conditions directly translate into fiscal crises and looming sovereign risks. Already prior to the Covid-19 pandemic, most of the “sovereign debt strugglers” were already in great difficulty and started to default or to restructure their debt.

Table 1 List of countries by cluster and associated loadings

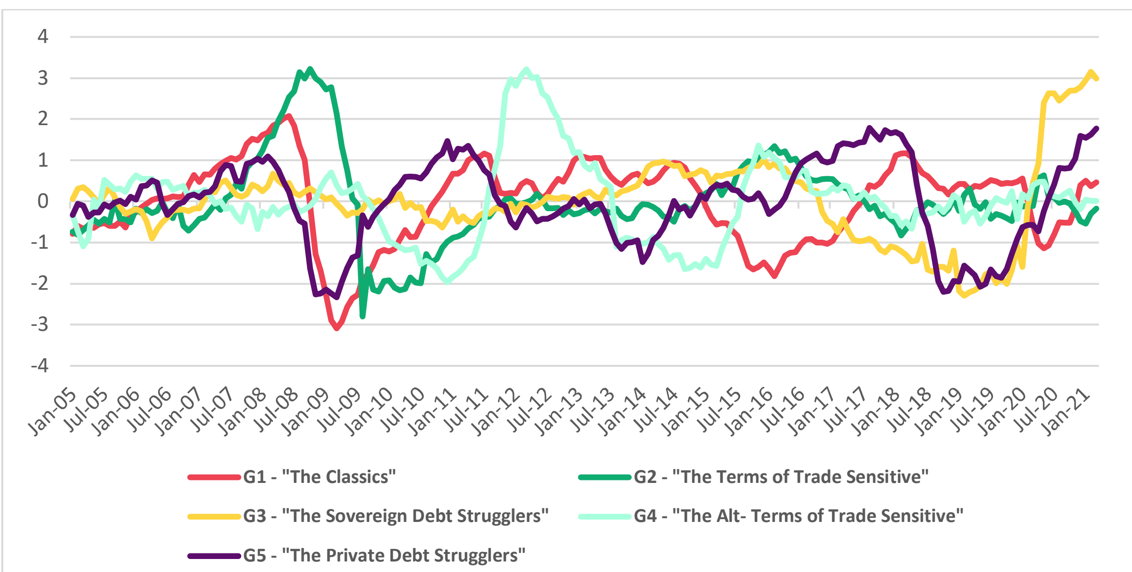
G1 - "The Classics"		G2 - "The Terms of Trade Sensitive"		G3 - "The Sovereign Debt Strugglers"		G4 - "The Alt-Terms of Trade Sensitive"		G5 - "The private debt strugglers"	
Member	*Loading*	*Member*	*Loading*	*Member*	*Loading*	*Member*	*Loading*	*Member*	*Loading*
Singapore	96.2%	Mali	88.5%	Lebanon	91.9%	Kenya	88.3%	Pakistan	86.1%
Malaysia	91.6%	Niger	83.6%	Zimbabwe	83.4%	Uganda	82.4%	Argentina	85.1%
Hong Kong SAR China	88.4%	Lesotho	81.1%	Haiti	78.0%	Nepal	78.8%	Nicaragua	82.3%
China	83.2%	South Africa	79.8%	Tunisia	69.8%	Rwanda	68.6%	Turkey	70.5%
Thailand	81.7%	Burkina Faso	79.1%	Sudan	66.6%	Burundi	33.6%	Philippines	59.3%
Korea	81.4%	Guinea-Bissau	78.4%	Chad	66.4%			Mozambique	57.7%
Russia	81.4%	Colombia	75.8%	Sierra Leone	59.6%			Bangladesh	53.9%
Ghana	78.9%	Togo	71.4%	Egypt	56.3%			India	52.0%
Mexico	78.7%	Botswana	69.2%	El Salvador	54.7%			Jamaica	49.0%
Peru	78.5%	Chile	63.7%	Uruguay	47.4%				
Brazil	78.2%	Benin	63.4%						
Mongolia	76.5%	Namibia	63.4%						
Ecuador	76.3%	Bolivia	63.3%						
Zambia	75.9%	Tanzania	56.0%						
Ukraine	72.4%	Kyrgyz Republic	53.8%						
Algeria	65.2%	Sri Lanka	51.8%						
Paraguay	64.8%	St. Vincent and the Grenadines	45.0%						
Mauritius	63.9%	Kazakhstan	42.7%						
Ethiopia	63.8%	Angola	42.3%						
Indonesia	63.6%	Vietnam	36.2%						
Democratic Republic of the Congo	60.8%	Liberia	29.9%						
Nigeria	59.4%								
Jordan	59.0%								
Cabo Verde	51.5%								
Guinea	51.3%								
The Gambia	48.3%								
Morocco	44.9%								
Venezuela	37.1%								
Madagascar	28.6%								

Note: **The closer to 100% the loading, the better represented the country is in its cluster**

Group 4 – “the alt-terms of trade sensitive” – is the smallest group and emerges as a variant of Group 2, with which it shares the same overall patterns. It mostly comprises countries from the Eastern African Community which exhibit remarkably synchronized financial conditions. This group differs from group 2 essentially before 2013, with a delayed impact of the GFC and, more importantly, a higher sensitivity to precious metal prices, in particular gold, which partly explains the sharp rise of the FCI at the end of 2010 while gold prices were breaking records high. All these countries are indeed located in gold trade routes connecting gold producing areas to gold trading hubs. However, this gold-price sensitivity tends to wane over time so that this group's FCI slowly converges into group 2 's FCI.

Group 5 – "the private debt strugglers" – are an extreme version of "the classics" with similar trends but much higher volatility. This group contains economies from across the globe, including Argentina, Turkey, India, and the Philippines. As "the classics", capital markets in "the private debt strugglers" group are subject to carry trades and huge reversals of capital flows. Yet, their very high share of private foreign-currency denominated debt, excessive leverage in the private sector, and low stocks of reserves leaves them much more vulnerable to changes in market sentiments. As speculative investors start to flee their capital markets, national currencies start to dive. High inflation, sharp depreciations, waves of non-performing loans, bankruptcies and, ultimately, sovereign defaults are a recurring outcome. The recurrence of financial crises emanating from the private sector progressively dents the long-term resilience of the government against debt distress.

Figure 2: Financial Conditions Indicators between January 2005 and March 2021



Global policy recommendations

The prospects for sustainable development are greatly impeded if financial conditions in developing and emerging economies continue to resemble a ride on a roller coaster. Due to the chaos on foreign exchange markets, meant to be transitory after the collapse of Bretton

Woods, the global economy remains in desperate need of a reform of the international monetary and financial system that restores stability. Such reforms ought to address at least three policy domains. First, the goal must be to curb speculative capital flows. This can be achieved either via (1) outright capital controls, (2) financial transaction taxes that render short-term currency speculation unprofitable, and (3) restrictions to derivatives trading to those actors that possess the underlying assets. Secondly, to ensure smooth functioning of international trade and development, mechanisms must be put in place that stabilise real exchange rates. To that end, central banks must commit to foreign exchange market interventions to offset inflation rate differentials between different currency areas, which would take away the incentives for carry trades. Third, developing and emerging economies must be granted better, stable, and cheap access to reserve currencies, which would require a reform of multilateral lending practices. This wider access to foreign reserves should go hand in hand with a coordinated increase in global demand to clamp down persistent global imbalances and restore inclusive and sustainable growth paths for all. Last, as debt distress is bound to persist, it is urgent to adopt a new international framework for debt resolution which extends the scope of not only beneficiaries but also creditors. In this regard, UNCTAD proposed an "International Developing Country Debt Authority" established to oversee the implementation of comprehensive temporary standstills as well as case-by-case longer-term debt sustainability assessments and consequent sovereign debt relief and restructuring agreements.

Targeted policy recommendations per cluster

As desirable and necessary as such global institutional adjustments are, the international community has not made significant steps into the right direction over the past 50 years. It had to take tragedies, such as the GFC and the pandemic, with huge socioeconomic toll to see encouraging, yet insufficient, progress. The disappointing experiences do not make it likely that such bold institutional engineering will take place in the near-term future. However, since the new generation of UNCTAD FCIs highlights group-specific financial vulnerabilities, it is possible to derive policy recommendations for each individual cluster whose implementation is more realistic.

For "the classics", which are vulnerable to global monetary conditions and commodity price shocks, we recommend the implementation of capital controls to insulate the economy from the vagaries of international finance. If capital controls were not a feasible option, for example due to conditionality of external creditors, central banks in emerging and developing economies ought to intervene in foreign exchange markets by offsetting currency appreciations through purchases of foreign exchange reserves. Additionally, ideally, if the Global Financial Safety Net[5] could be extended to provide swap lines and credit facilities with the main currency areas' central banks, this would ease liquidity pressures. In case of high demand for foreign reserves, this would constitute an additional safety buffer to stabilise exchange rates that developing countries could draw on. To address the dependence on and volatility of commodity prices, we propose to set up an international buffer stocks for all main commodities. Financing of these stocks should be linked ideally to SDRs. This would prevent sharp appreciations of the US-Dollar and/or a depletion of foreign reserves in times of higher demand for drawing on that stock. Yet, it is likely that the very existence of such reserve stocks – in combination with curbs on speculative finance – would suffice to provide commodity price stability and enhance development prospects.

The benefits of more stable commodity prices would also play out in favour of both the "terms of trade sensitive" and "the alt-terms of trade sensitive". Yet, in contrast to "the classics", much more policy emphasis must be put on diversifying the economy. Their productive capacities lie, on average, below those of group 1 and the dependence on individual commodities, predominantly base and precious metals, tends to be higher. To obtain more stability in capital markets, both groups must therefore be granted the policy space to improve regional integration and pursue industrial policy to diversify the economy. In addition to fairer trade and investment agreements, access to cheap and stable funding is required. In this regard, it is crucial that developed economies meet their commitments in terms of Official Development Assistance and expand availability for concessional finance flows, especially in the constrained context of climate challenge and "just transitions".

The third cluster, the "sovereign debt strugglers" have had the most stable financial conditions over time due to higher shares of public as opposed to private debt. Policy priorities for this group include the expansion of debt relief and debt restructuring programmes to ease the public debt burden, not only in scale but also in scope, i.e., via including developing countries in need, regardless of their GDP per capita. A sufficiently large "breathing space" is required to clamp down recurring sovereign defaults and social unrest. Moreover, to tackle the high and persistent current account deficits, policymakers must stabilise the external sector. The main objective thereby must be boosting exports and speeding-up structural transformation. As in the case of the "terms of trade sensitive",

[5] See www.mobilizingdevfin.org

industrial policy, regional integration and increased access to concessional finance are *sine qua non* to this end.

For the fifth cluster, the “the private debt strugglers”, similar measures as for the “classics” must be put in place. Notably, these economies should adopt capital controls to mitigate the fallout from the boom-and-bust cycles that speculative capital engenders, implement measures to limit excessive leverage in the corporate sector and revive the “profit-investment” nexus to shift private resources towards productive investment rather than speculation. Given their low stocks of foreign reserves, credit facilities and swap lines, in particular with the Fed, would be a meaningful and effective tool to counter the sharp depreciations these economies recurringly face. In the long run, a de-dollarisation of the economy must become a top priority.