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ANALYTICAL COMMENTARY

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MACROECONOMICS | WORLD

NEW (IN)STABILITY?

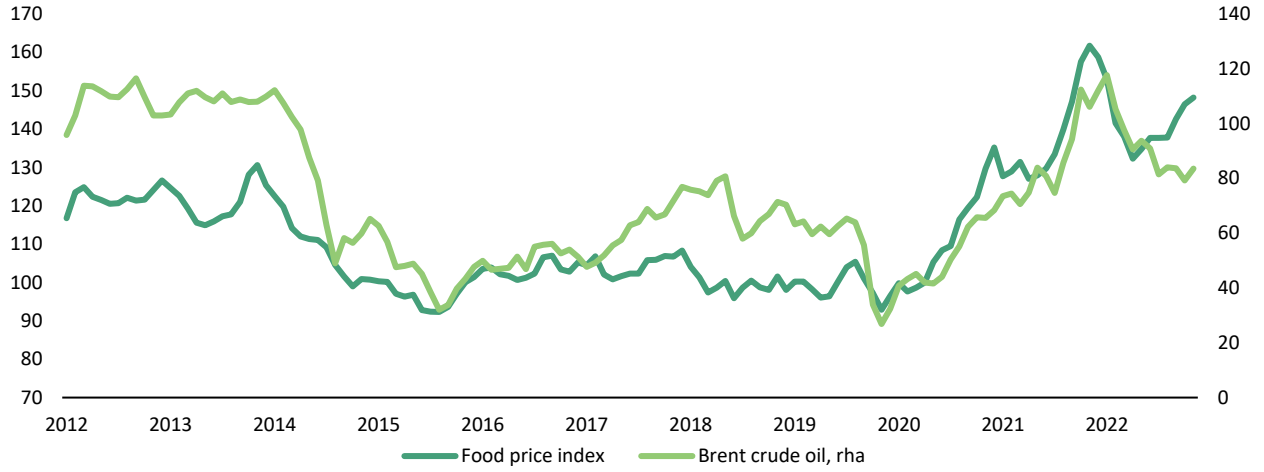
Increased external risks along with the end of a 15-year period of low global rates have so far had a limited negative impact on emerging markets

- Developing countries have again experienced external shock in the form of growth of food and energy prices. Policy rates in developing countries returning to their levels before the financial crisis of 2008–09 has significantly complicated or closed access to foreign markets for individual countries. An additional factor that spurred inflation was the depreciation of the currencies of a number of developing countries.
- Accumulated experience of overcoming crises and a more balanced external position have generally helped soften the negative impact of shocks.
- International institutions — the G20 and the International Monetary Fund (IMF) — have played an active role in maintaining the debt sustainability of emerging markets. A number of tools have been provided to both suspend external debt payments and introduce new mechanisms for its restructuring.
- Growing coordination of creditors (IMF, Paris Club, China, India, private creditors) and the involvement of borrowers in the process of restructuring public debt act as additional stabilizing factors.
- Besides the IMF and the abovementioned countries, a number of other countries are starting to play an active role in providing emergency financing to developing markets. China, which has traditionally financed infrastructure development as part of its Belt and Road Initiative, has begun providing emergency funding to support economies. India and Persian Gulf countries are also becoming more important in terms of supporting developing countries, and therefore, the latter have additional sources of financing to reduce macroeconomic risks.
- Budget consolidation, savings from increased budget revenues received against the backdrop of high inflation, further development of capital markets in national currencies, and also actions to increase government revenues may contribute to the further strengthening developing economies' resilience against shocks.

Developing countries have faced new challenges

A range of negative external macroeconomic factors have impacted emerging markets over the past few years. In 2020, developing countries substantially increased public expenditures to overcome the COVID-19 pandemic. At the same time, revenues declined, and so public debt served as the main source for covering financing needs. The imposition of pandemic restrictions disrupted supply chains around the world. Together with the investment cycle in raw materials, these factors led to a significant increase in prices. Growth of world prices, primarily for food and energy (*Fig. 1*), has accelerated against the backdrop of the current geopolitical situation.

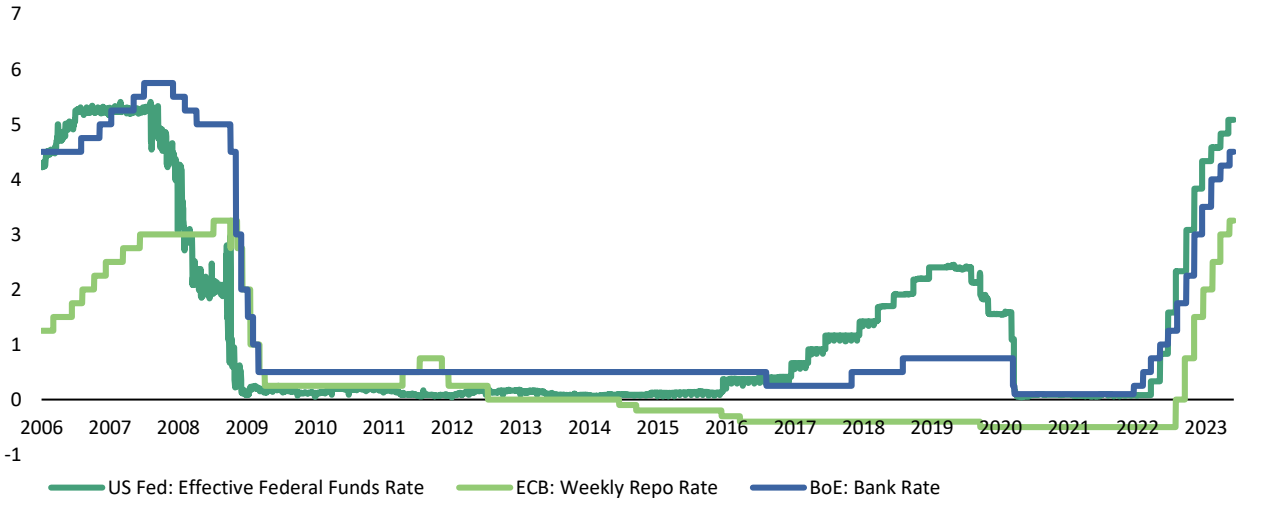
Figure 1. Food and energy prices



Sources: IMF, ACRA

In order to stabilize prices, the central banks of developed countries started actively hiking interest rates, which reached or approaches levels prior to the crisis of 2008–09 (*Fig. 2*). A 15-year period ended, which at one time was called the "new normal", that is, the expectation that low interest rates would persist for a long time.

Figure 2. Policy rates of central banks of selected developed countries



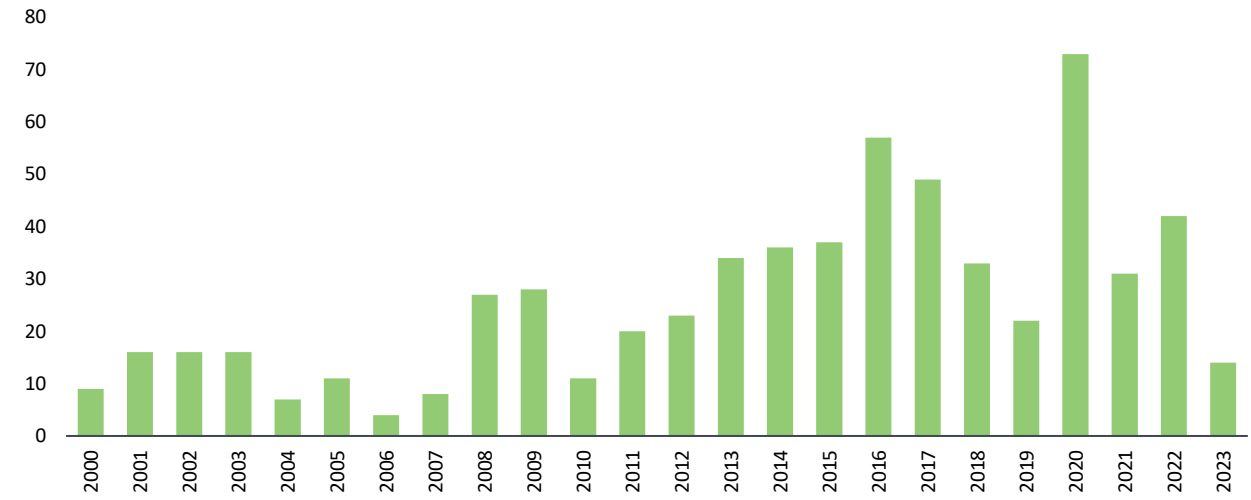
Sources: US Federal Reserve System, European Central Bank, Bank of England, ACRA

The central banks of emerging countries also entered a cycle of hiking interest rates. As a result, the cost of borrowing grew in both foreign and national currencies. In addition, the exchange rate of national currencies declined in a number of emerging countries (*Fig. 7*), which put additional pressure on prices. Unorthodox economic policy pursued by some countries further aggravated their economic situation. Hungary, for example, froze prices for basic necessities, fuel, housing and utilities, and mortgage rates. This, in turn, led to a deficit of various products and the country was forced to withdraw or weaken control over prices for certain products, including fuel, which provoked additional growth of prices in these product categories. Consequently, inflation in Hungary hit the highest level in the European Union (around 25%), while in most other European countries it had already fallen below 10%. Another example is Sri Lanka, whose government heavily cut taxes prior to the pandemic and also prohibited the use of chemical fertilizers, which ramped up the country's dependence on food imports. Against the backdrop of anti-pandemic measures, foreign exchange earnings from tourism, one of the main sectors of the economy, significantly decreased. As a result, reserves were depleted and the country was unable to service its debt.

See ACRA's analytical commentary Sri Lanka in Default: Causes and Consequences from July 19, 2022 for further information.

The credit quality of many developing countries deteriorated. In 2020, the number of countries whose credit ratings were downgraded by global rating agencies[1] reached its highest point since 2000 (*Fig. 3*). Ratings continued to be downgraded in the following years.

Figure 3. Number of downgraded countries

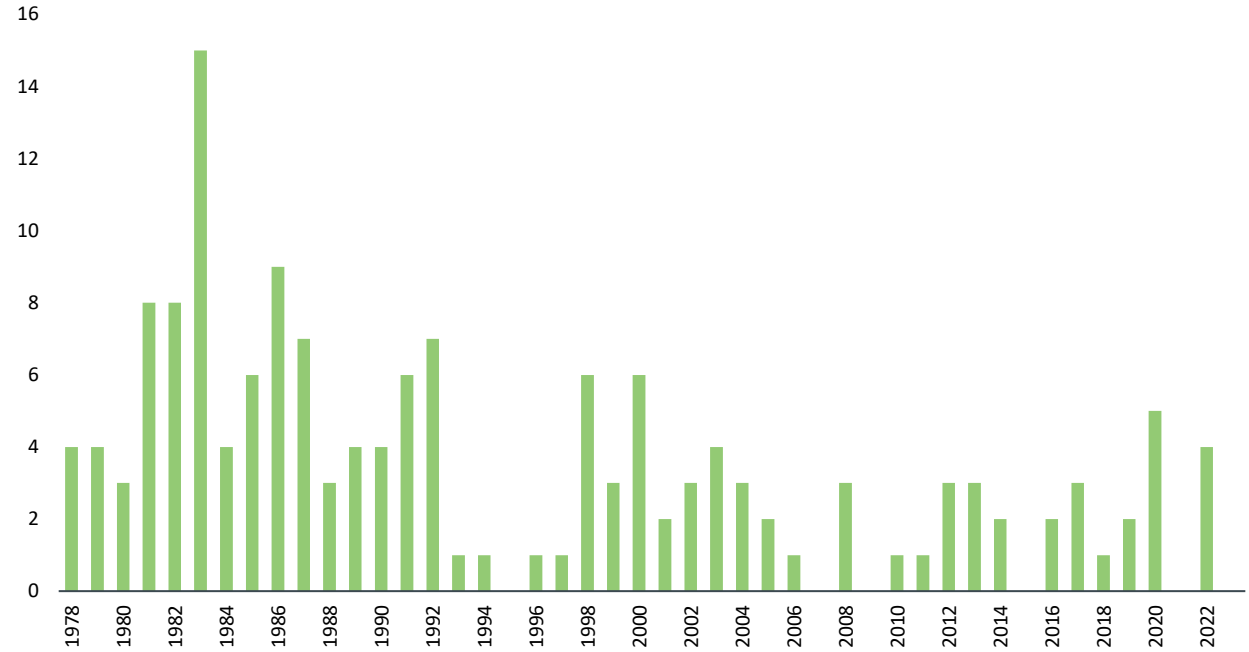


Sources: Moody's, S&P, Fitch, ACRA

The number of defaults increased (*Fig. 4*) alongside the decline in credit quality. As part of this analytical commentary, ACRA has reviewed the defaults recorded by the three international rating agencies (Moody's, S&P and Fitch), which note defaults predominantly in regard to private creditors. However, sovereign governments also borrow from official creditors — international financial organizations. Defaults on such debt — so-called hidden defaults — have not been considered in this commentary due to the limited availability of information about them. The restructuring or write-off of debt owed to China by a number of countries is a clear example of hidden defaults.

[1] Moody's, S&P, Fitch

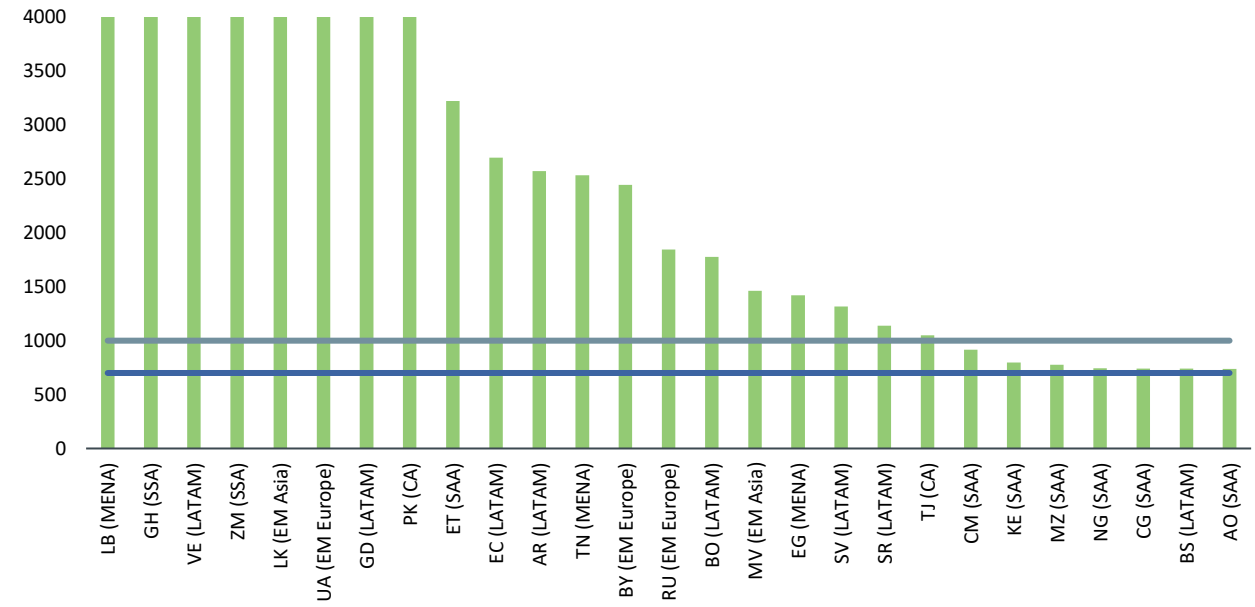
Figure 4. The number of defaults has grown



Sources: Moody's, S&P, Fitch, ACRA

Of the developing countries that have access to the international market on market terms (countries that previously issued Eurobonds), 27 are in a state of financial stress (spread exceeds 700 bps). At the same time, the Eurobonds of 20 countries out of 27 are traded at actual pre-default levels (spread exceeds 1,000 bps) (*Fig. 5*), and eight countries out of 20, according to the IMF, have defaulted. The total Eurobond debt of these 27 countries amounts to USD 407.6 bln (out of the total USD 1.4 tln worth of Eurobonds of emerging markets). ACRA notes that out of these 27, a third (11) are Sub-Saharan African countries, six are Latin American countries, and one is from the CIS (Tajikistan). All of these countries are rather small — the nominal GDP of 21 out of 27 does not exceed USD 100 bln. The large countries analyzed are Ukraine, Argentina, Pakistan, Egypt, and Nigeria. Thus, currently the negative impact of the shock is mainly limited to two regions and relatively small economies.

Figure 5. Eurobond spreads[2] of selected developing countries[3]



Sources: Cbonds, ACRA

Accumulated experience and international support help soften external shocks

Emerging markets are currently demonstrating that they can more successfully adapt to external shocks compared to their reactions to the shocks of previous years. This is due to a number of qualitative changes and thanks to international support.

Qualitative factors include the fact that countries have taken into account experience of previous crises — amid growing inflation, some countries started increasing interest rates before developed countries. For example, Brazil and Russia began hiking their policy rates as early as Q1 2021. Currencies have become more flexible — in 2007, 40 countries had floating currency regimes, while in 2021, this number had increased to 62. The external position of developing countries prior to the COVID-19 pandemic was more balanced — their current account deficits were around 0.4% of GDP (average for five years prior to the pandemic), compared to a deficit of around 1.5% of GDP as of the end of the 1990s and a surplus of around 3–4% prior to the crisis of 2008–09. Developing countries actively carried out stress testing, including as part of the IMF's Debt Sustainability Analysis (DSA), and also began to rely more on public debt in national currencies by developing domestic capital markets. A clear example is Russia, a country that has significantly reformed its domestic capital market, which has become its main source of borrowing. External borrowings were carried out with the main goal of forming benchmarks for companies.

The **Heavily Indebted Poor Countries Initiative (HIPCI)**, launched in 1996 by decision of the IMF and the World Bank, is an important international support tool. It has helped provide support totaling USD 76 bln (in 2017 dollars) to the world's least developed countries. In addition to the HIPC, in 2005 the **Multilateral Debt Relief Initiative (MDRI)** was launched to reduce the debt of the poorest countries owed to international development institutions. The debt burden of developing countries was thereby reduced by USD 3.4 bln. It should be noted that Russia participated directly in these initiatives after it recovered its debt stability following the 1998 crisis. After the COVID-19 pandemic, international institutions launched a number of new programs. At the start of 2020, the G20 introduced the **Debt Service Suspension**

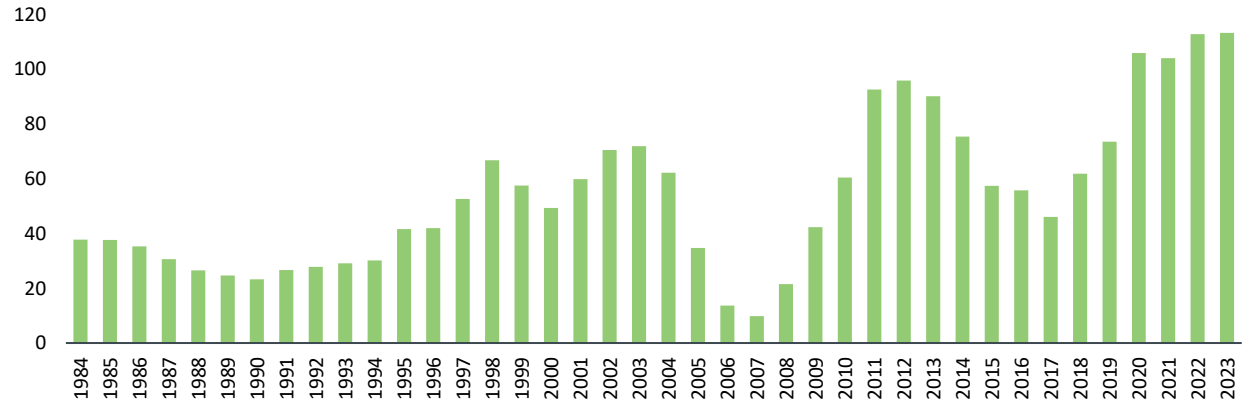
[2] Difference between the Eurobond yield and the risk-free rate in the borrowing currency.

[3] The list of countries and regions is provided in Appendix 1.

Initiative (DSSI) for the least developed countries. The purpose of this initiative was to mitigate the one-time shock that could destabilize the economies of developing countries, and therefore its duration was limited to the end of 2020. As a result, out of the 77 countries targeted by this initiative, 43 took advantage of it and freed up around USD 13 bln. The Kyrgyz Republic was one of the CIS countries that took advantage of this relief. After this initiative finished, the G20 proposed a new tool, the **Common Framework for Debt Treatments beyond the DSSI**. This mechanism brought together creditors from the G20 and the Paris Club with the intention to engage other creditors, including China, India, Saudi Arabia, and Kuwait, to regulate the post-pandemic debt problems of developing countries. The Republic of Chad, Zambia, and Ethiopia joined the mechanism to restructure their debts, which shows the necessity of this format. In February 2023, the meeting of ministers of finance and heads of central banks of the G20 countries announced the creation of the **Global Sovereign Debt Round Table (GSDR)**. A key aspect of the GSDR is that besides official creditors (the G20 and the Paris Club), private creditors and borrower nations are involved in regulating debts. One of the key advantages of this mechanism is the participation of China. According to the IMF, the debt of the poorest countries to China exceeds their debt to other states, so China's participation should increase the effectiveness of the new mechanism. India is also among the creditors. As of present, four countries — the Republic of Chad, Ethiopia, Zambia, and Ghana — have requested for their public debt to be restructured as part of the GSDR. However, the Republic of Chad and Ethiopia were not in default — their appeals were preemptive. It is worth noting that the Republic of Chad has already reached an agreement with creditors.

Having created debt settlement mechanisms, the IMF also distributed special drawing rights (SDR) equivalent to USD 650 bln among IMF member countries. This amount was used to increase the reserves of these countries, allowing them to strengthen their resilience to external shocks. As part of regular support through standard mechanisms, including urgent support, the IMF provided about US 24 bln to emerging economies since the beginning of the COVID-19 pandemic. The total amount of outstanding debt to the IMF reached a record SDR 113.3 bln (*Fig. 6*).

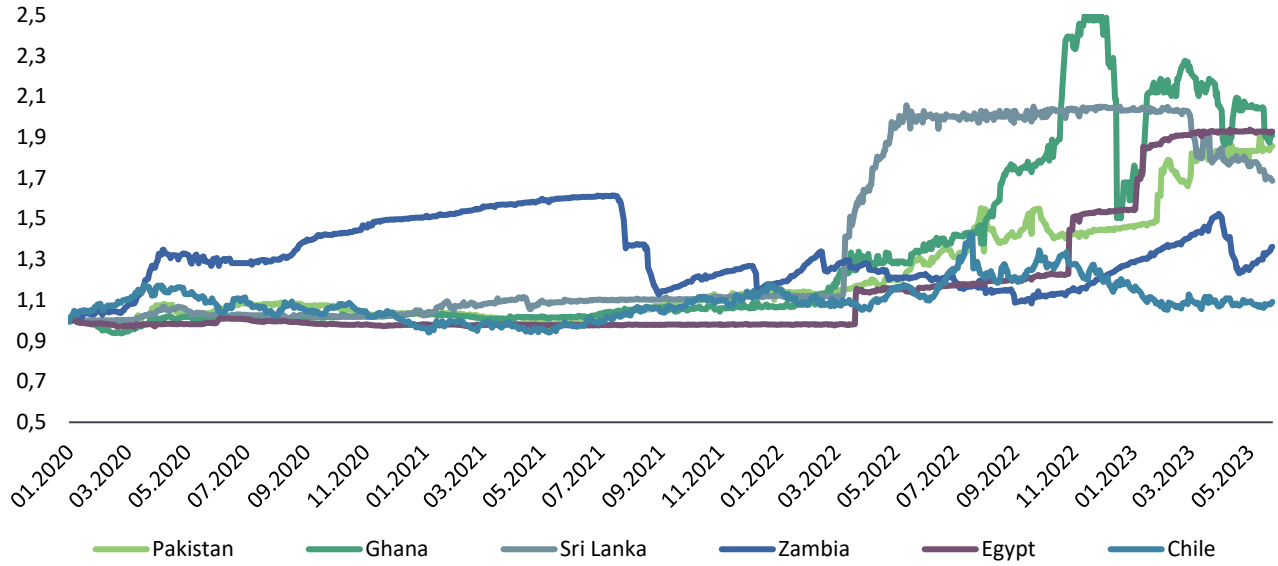
Figure 6. Total debt to the IMF has reached maximum, SDR bln



Sources: IMF, ACRA

The currencies of some emerging economies have stabilized since the IMF's decisions to provide support or the start of negotiations on restructuring risk premiums, (*Fig. 7*).

Figure 7. Currencies of emerging economies to the US dollar, normalized



Sources: Yahoo, ACRA

Another tool aimed at reducing the debt of emerging economies is the **Capital Adequacy Framework (CAF)**[4], which is being discussed by G20. For example, 23% of Zambia's external debt is due to international financial organizations.

Other official creditors

In the current economic situation, countries that are on the verge of macroeconomic instability have alternative sources of emergency funds besides the IMF. China has traditionally been a major lender for developing countries. Its financing was either of an investment nature (investments in infrastructure to expand trade corridors), or was used to spread the yuan across the globe (bilateral currency swap agreements). However, over the past few years, the following trend has been observed: China, along with the IMF, is beginning to play the role of lender of last resort. China has started to provide emergency funding both from its budget and state-owned banks. The instruments of this financing are quite diverse, including emergency loans, currency swap agreements, import prefunding, debt waivers (in 2022, China waived the debt on 23 loans provided to 17 countries), and reallocation of funds received from the IMF (SDR 10 bln). China's financial support differs from that of the IMF — on the one hand, China sets no requirements of any economic reforms in the borrower country, and, on the other hand, there is lower transparency and higher borrowing costs[5]. In addition to China, other sources of emergency funding for developing countries include funds from Persian Gulf countries and support mechanisms established by the South Asian Association for Regional Cooperation (SAARC)[6]. Support is provided through various instruments such as currency swaps, deferred payments, deposits, and import financing.

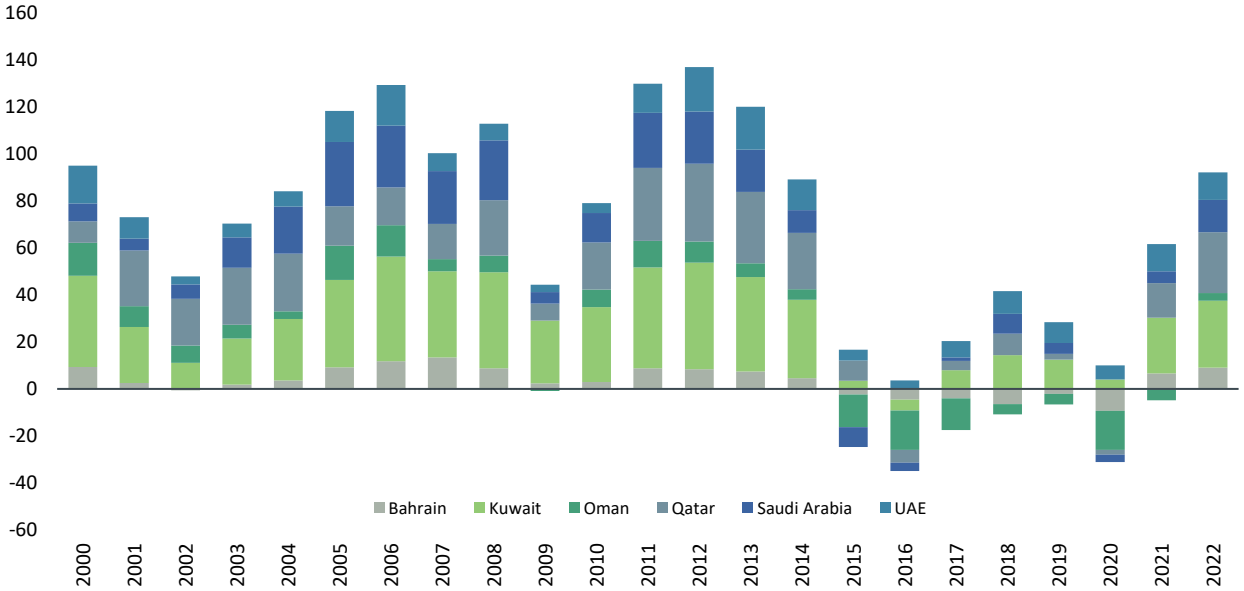
Against the backdrop of rising energy prices last year, Persian Gulf countries received significant additional revenues (*Fig. 8*). Having replenished their own reserves and sovereign wealth funds, these countries use such revenues to support other countries.

[4] https://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/news/news/CAF-Review-Report.pdf

[5] https://www.aiddata.org/publications/china-as-an-international-lender-of-last-resort

[6] Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka.

Figure 8. Current account balance of Persian Gulf countries, % of GDP



Source: IMF, ACRA

Egypt received USD 13 bln in deposits from the UAE, Saudi Arabia, and Qatar. Saudi Arabia agreed to postpone Pakistan's payment for its oil and provided (through the Saudi Export-Import Bank) USD 200 mln to Tunisia to finance oil purchases.

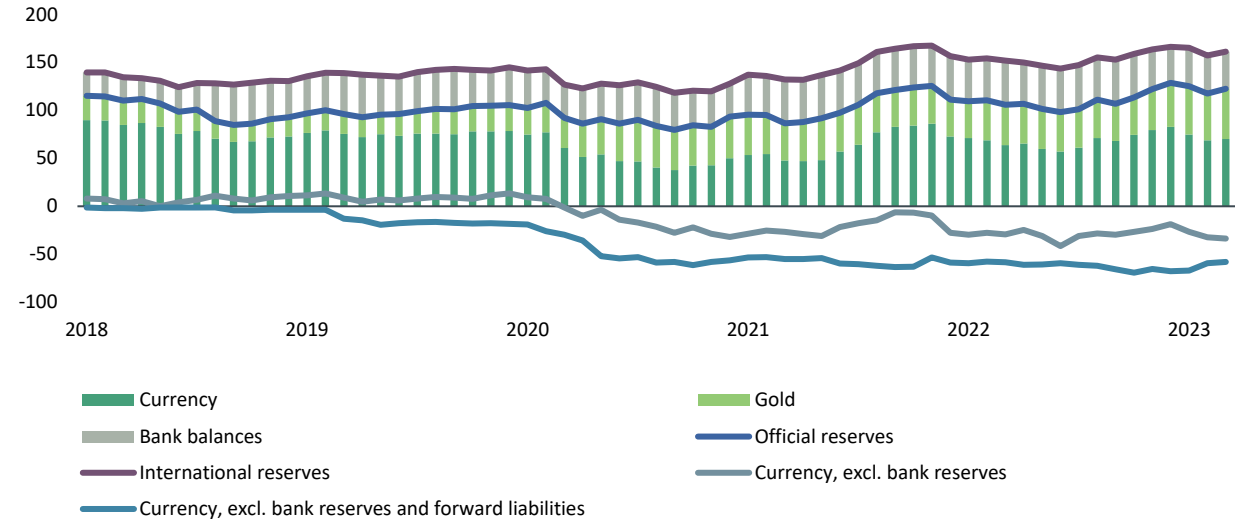
In addition to Persian Gulf countries, India also provides economic assistance to other countries. To smooth out the volatility of its currency, the country is interested in providing currency swaps to SAARC member countries. In November 2012, the members of the association entered into an SAARC currency swap facility, under which India, for example, in order to reduce external shocks, can provide funds in the equivalent of up to USD 2 bln in US dollars, euros or Indian rupees. In April 2022, India extended its USD 400 mln currency swap with defaulted Sri Lanka. In addition, Sri Lanka received about USD 1 bln in loans from India. In December 2022, India signed a USD 200 mln swap agreement with the Maldives to provide emergency financing.

In order to restore Sri Lanka's depleted reserves, Bangladesh, regardless of its own difficult debt situation, provided it with a USD 200 mln swap.

As for Russia, its importance in financing the Republic of Belarus has increased. Historically, Russia has been its main lender; Belarus also borrowed in foreign markets and loans from international financial agencies. After the closure of access to international financial institutions, the reliance of the Republic of Belarus on Russian financing has increased.

The most notable example of a country that looks for additional financial opportunities without turning to the IMF is Turkey, where an uncommon monetary policy (reducing the key rate against the background of rising inflation) has almost exhausted its reserves. For several months now, its net foreign exchange reserves have been negative (*Fig. 9*). To support the lira, the Central Bank of Turkey uses the foreign exchange balances of commercial banks and borrows currency from them, as a result of which its foreign currency liabilities are higher than foreign currency assets.

Figure 9. Reserves of the Central Bank of the Republic of Turkey



Sources: Central Bank of the Republic of Turkey, ACRA

As a result of its monetary policy, Turkey was forced to look for additional sources to replenish its reserves. The country has restored relations with Saudi Arabia, which placed a USD 5 bln deposit in the Central Bank of Turkey. Before that, Turkey also signed currency swap agreements with Qatar (for USD 15 bln) and the UAE (for USD 5 bln). The currency swaps with China is totaled USD 6 bln. Turkey has already received USD 1 bln from South Korea as part of a USD 2 bln agreement. A EUR 1 bln swap agreement with Azerbaijan is about to be concluded. Thus, Turkey managed to attract additional sources of external support without resorting to IMF funds. The key question is whether they will be enough in the event of a further decline in its reserves.

Ways to strengthen macroeconomic stability

Following the results of the regular semi-annual sessions held by the IMF this spring, the fund's experts made a number of recommendations for emerging economies in order to increase their fiscal sustainability. Among other things, we can highlight:

- Budget consolidation through the end of COVID-19 pandemic support measures (for example, more targeted subsidies to the energy sector);
- Saving increased budget revenues caused by high inflation.

The above recommendations may be expanded by the following:

- Stronger collectability of budget revenues (30% of emerging economies have budget revenues of less than 20% of GDP, and in seven countries, including Bangladesh and Sri Lanka, they are less than 10% of GDP);
- Further development of public debt markets in national currencies (following the example of the Asian Bond Markets Initiative described above).

Summing up, we note that a large-scale crisis in emerging markets has been avoided so far. Problems are mainly experienced by small economies concentrated in certain regions of the world. Relative stability was achieved, among other things, thanks to reforms of the regulatory and institutional environment, the emergence of new funding sources, and coordinated actions of players in the global capital market. Current stability will depend both on the success of contractual relations between lenders and borrowers, and on further movement towards increased transparency, the development of national markets and multilateral support mechanisms.

See ACRA's analytical commentary Asia's Experience for the Russian Market from November 29, 2022 for further information.

APPENDIX 1

List of country abbreviations	
LB	Lebanon
GH	Ghana
VE	Venezuela
ZM	Zambia
LK	Sri Lanka
UA	Ukraine
GD	Grenada
PK	Pakistan
ET	Ethiopia
EC	Ecuador
AR	Argentina
TN	Tunisia
BY	Belarus
RU	Russia
BO	Bolivia
MV	The Maldives
EG	Egypt
SV	El Salvador
SR	Suriname
TJ	Tajikistan
CM	Cameroon
KE	Kenya
MZ	Mozambique
NG	Nigeria
CG	The Congo
BS	The Bahamas
AO	Angola

List of region abbreviations	
LATAM	Latin America
MENA	Middle East and Northern Africa
SSA	Sub-Saharan Africa
EM Europe	Emerging Europe
EM Asia	Emerging Asia
CA	Central Asia

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