Box A

Emerging Market Vulnerabilities and Financial Conditions in Advanced Economies

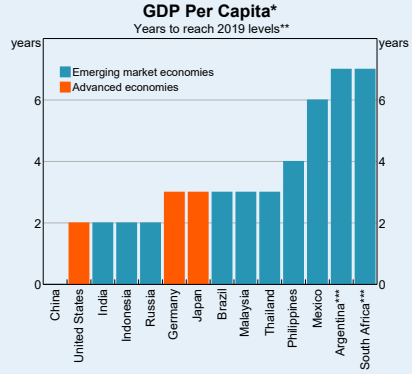
The rise in bond yields in advanced economies since earlier this year has been underpinned by better prospects for the global economic recovery. Stronger global growth will support output in emerging market economies (EMEs) through stronger demand for exports. However, there is a risk that higher yields in advanced economies will lead to tighter financial conditions in EMEs than is justified by their economic fundamentals, which are likely to warrant substantial monetary and fiscal support for some time. In particular, compared with advanced economies many EMEs face protracted recoveries, which will be further delayed because of high and rising rates of COVID-19 cases and relatively slow vaccine rollouts. For example, GDP per capita is not expected to return to its pre-pandemic level for several years in many EMEs, well behind the United States and China (Graph A.1).

Financial conditions in advanced economies transmit to EMEs through a number of different channels. Many EMEs have current account deficits, which necessarily involve net capital inflows from foreign investors. These net capital inflows are often in the form of lending (through loans and bonds) to corporations and governments. There is a risk that net capital inflows decline if the risk-adjusted return on lending to EMEs becomes less attractive once yields rise in advanced economies. Moreover, net capital inflows could become net capital outflows if foreign investors become concerned about whether they are likely to be repaid.

The risk of a decline in net capital inflows is likely to be particularly problematic in situations where governments have high levels of debt, following years of large fiscal deficits (Graph A.2). EME governments in this situation already have limited fiscal space to respond to weak growth, and further poor outcomes are likely to heighten concerns among foreign investors of losses on the EME debt they hold.

A decline in capital inflows will lead to depreciation pressures on exchange rates. While an exchange rate depreciation typically supports economic growth (at least for a time) by boosting net exports, it can also lead to large and persistent increases in inflation in EMEs where inflation and inflation expectations are less well-anchored.[1] A depreciation also increases the cost for local borrowers to service and repay their debts

Graph A.1



* National currencies, constant prices
** Based on WEO April 2021 forecasts
*** GDP per capita has not reached 2019 levels by 2026; forecast periods ends at 2026
Source: IMF

that are denominated in foreign currencies if these are unhedged. Many EMEs have historically borrowed abroad in foreign currency, particularly in US dollars, in part because markets to borrow in local currency were under-developed. Moreover, there can be limited opportunities to hedge these foreign currency debts in EMEs where financial markets are less developed or there is less incentive to do so because the exchange rate is managed in a way that reduces exchange rate risk. The value of unhedged domestic assets held by foreign investors also falls when the exchange rate depreciates, possibly prompting further capital outflows. These dynamics can put pressure on EME central banks to raise policy rates to try to stem capital outflows and avoid rising inflationary pressures, even if domestic economic conditions would not warrant a tightening in domestic financial conditions.

In recent decades, many EMEs have taken steps to improve the resilience of their domestic financial systems and institutions to swings in capital flows and exchange rates. Many EMEs have enhanced the independence of their central banks and adopted inflation targets, which has helped to anchor inflation and inflation expectations more effectively. Some EMEs have developed deeper and more liquid local currency bond markets and financial products that enable foreign exchange risks to be hedged. Many economies in Asia have also increased their foreign exchange reserves, which has given them more capacity to intervene to smooth volatility in foreign exchange markets related to rapid changes in capital flows.

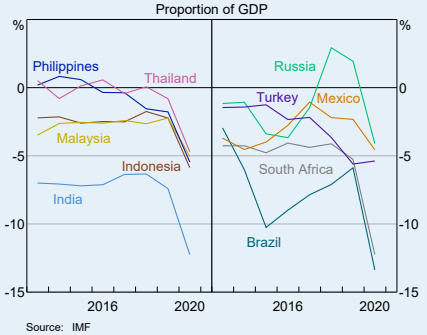
As a result, many EMEs in Asia have experienced a more modest tightening of financial conditions, with bond yields rising and exchange rates depreciating by less than for EMEs in other regions. Compared with EMEs in other regions, most Asian EMEs have lower foreign currency debt obligations, foreign ownership of debt and government debt; they are also running current account surpluses (Graph A.3). These factors, in addition to improved institutional frameworks, reflect efforts by policymakers to build more resilient institutions, economies and financial systems in the two decades since the Asian financial crisis.[2]

Financial conditions in EMEs stabilised over March and April, but remain tighter than at the start of the year. If strains in individual EMEs become acute they could spill over to

Graph A.2

Fiscal Balances

Proportion of GDP

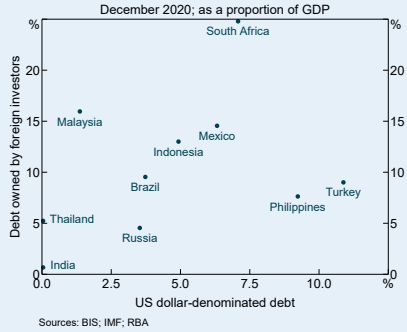


Source: IMF

Graph A.3

Emerging Market Government Debt

December 2020; as a proportion of GDP



Sources: BIS; IMF; RBA

other economies. From a trade perspective, EMEs such as Brazil and Mexico are relatively large and have deep trade ties with other economies, including major advanced economies. Disruptions to their economic activity would be felt by their trading partners and affect cross-border investment flows and global supply chains. From a financial perspective, banks and investors in both advanced and emerging economies could be directly exposed to losses on loans to EMEs. If international investors sought to reduce their exposures to EMEs generally, this could result in contagion whereby financial conditions tighten significantly even in EMEs with reasonable fundamentals.

Access to emergency multilateral financial assistance can prevent temporary external funding pressures from spilling over to other economies. Financing from the International Monetary Fund (IMF) is already providing support to low-income countries and some EMEs. There is also broad support for the IMF to proceed with a US$650 billion allocation of Special Drawing Rights later this year, which, if approved, will boost countries' reserves of foreign currency. Around US$200 billion is expected to be allocated to EMEs and developing countries, which would increase their total reserves by around 5 per cent.

Endnotes

[1] Pass-through from the exchange rate to inflation expectations is often higher in EMEs; see Borio (2019), 'Monetary policy frameworks in EMEs: practice ahead of theory', Speech on the occasion of the Bank for International Settlement's Annual General Meeting, Basel, 30 June. Available at <bis.org/speeches/sp190630a.pdf>.

[2] See RBA (2018), 'Box A: Financial Market Resilience of Emerging Asia', *Statement on Monetary Policy*, August, pp 22–24. Available at <https://www.rba.gov.au/publications/smp/2018/aug/box-a-financial-market-resilience-of-emerging-asia.html>