Chapter 4

Ensuring Global Financial Stability

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Chapter 4
Ensuring Global Financial Stability

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1. Introduction

The current financial stability issues facing the global economy are not only the result of the legacies of the coronavirus disease (COVID-19) crisis, but also of peculiar features of the recovery process under way and the economic effects of the geopolitical risks generated by the Russian invasion of Ukraine. The legacies include the high debt levels facing essentially all economies, and changes in labour markets in some of them (a reduction in labour market participation, in particular). The peculiarities are associated with global inflationary trends – the worst in several decades – which originate not so much in high aggregate demand but in a mix of supply problems that became evident in the last months of 2021 but have worsened with the invasion of Ukraine.

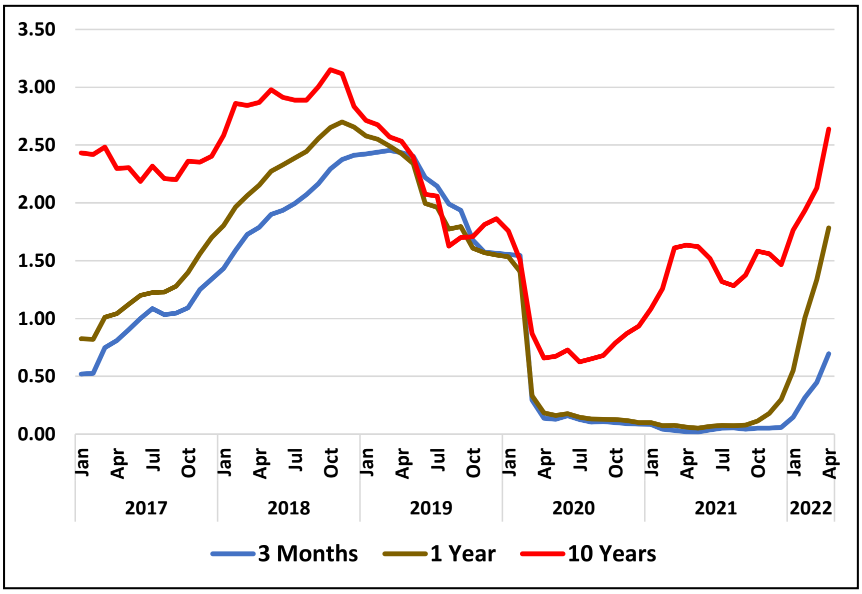
The response of the United States (US) Federal Reserve has been to start to increase interest rates and dismantle quantitative easing. The European Central Bank is also reducing quantitative easing, and long-term euro rates have also started to increase although it has not announced changes in interest rates. The mix of rising interest rates and high debt ratios will not have strong effects in developed countries but is affecting stock markets, which experienced a boom during the crisis thanks to the expansionary monetary policies adopted to manage it. In emerging and developing countries, the problem is more complex since several monetary authorities have increased interest rates on a broader scale, and the mix of high debt ratios and rising international interest rates generates additional risks – particularly of a reduction in private external financing and open debt crises in some countries. This limits their capacity to adopt expansionary macroeconomic policies – a policy space that, in any case, was weaker for most of these countries during the COVID-19 crisis.

This paper examines these issues. The first section covers global conditions. It analyses the trends in interest rates and stock markets, and briefly discusses the challenges associated with the insolvency of some private firms – though with no sign of possible banking crises – as well as the risks generated by crypto assets and the financial effects of climate change. The second section concentrates on the issues affecting emerging and developing countries in relation to debt ratios, and the possible effects of changing global financial conditions on capital flows, both in terms of availability and cost. The last section presents brief conclusions.

2. Global Financial Conditions

Global financial conditions changed dramatically during the COVID-19 crisis and the dramatic worldwide recession it generated. To respond to the crisis, all major central banks sharply cut interest rates and adopted aggressive quantitative easing programmes. The expansionary monetary policies were maintained for longer than during the 2007–2009 North Atlantic financial crisis.[1] Figure 4.1 shows that US interest rates were already declining in 2019 due to the economic slowdown but fell sharply in March 2020 – reflecting the strong cut in interest rates by the Federal Reserve. The fall included the 10-year US Treasury bond, which is the reference rate for emerging market bonds. Euro interest rates were already negative in 2019, and thus had less margin to fall in 2020.

Figure 4.1: US Interest Rates (%)

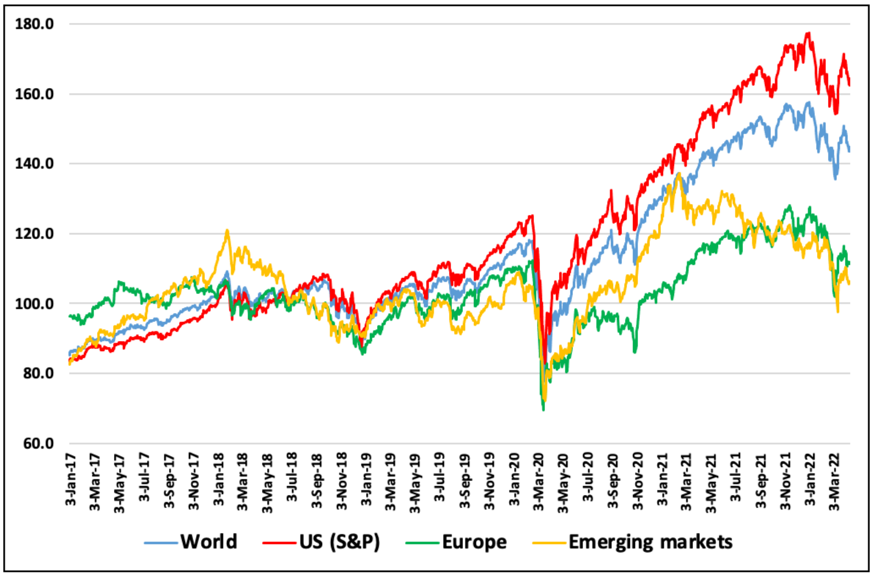


US = United States.
Source: US Treasury Department.

One of the effects of the aggressive monetary policy was to induce a global stock market recovery from mid-March 2020, followed by a veritable boom throughout that year, particularly in the US (Figure 4.2). Emerging market stock markets also saw a recovery and boom, whereas the recovery in Europe was weaker and only experienced a significant increase in 2021. As we will see in the next section, the expansionary policies also induced a strong recovery in bond financing to emerging economies at low costs. This early stock market recovery, which was also partly associated with quantitative easing, was a very peculiar effect of monetary policies because it took off in the second quarter of 2020 as the world economy was entering a very strong and widespread recession – the most synchronised one in world history (China had been hit earlier, during the first quarter).

[1] 'North Atlantic financial crisis' is used rather than 'global financial crisis' because the crisis was concentrated in the US and Western Europe despite its global effects.

Figure 4.2: Stock Market Prices (average of 2017–2019 = 100)



S&P = Standard & Poor's, US = United States.
Source: Bloomberg.

US dollar interest rates started to increase in early 2021 as a response to the recovery of the world economy, but the trend was soon partially reversed, and rates remained significantly below pre-crisis levels. The 10-year euro interest rates also increased, but more moderately. The US and European stock markets continued to boom in 2021. Emerging markets experienced a correction, although equity prices remained significantly above pre-crisis levels – particularly in Asia, but not in Latin America (the regional details are not shown in Figure 4.2).

Uncertainties associated with world economic growth, and more so with an increase in interest rates as a response of central banks to rising inflation – a phenomenon that was already taking place in emerging and developing countries – generated the end of the stock market boom in late 2021 and an adverse trend in the first months of 2022. This was compounded by slower growth in earnings as well as the risk of repricing due to over-stretched asset valuations, as the October 2021 *Global Financial Stability Report* of the International Monetary Fund (IMF) had warned (IMF, 2021). The IMF's January *World Economic Outlook Update* projected slower economic growth in 2022 – 4.2% – down from the October 2021 projection of 4.7% at market exchange rates (IMF, 2022a). In turn, world inflation increased to levels not seen during the past four decades, particularly due to rising oil and food prices and global transportation constraints. Rising food prices have severely affected low-income households worldwide, but particularly in developing countries. They have been associated, amongst other phenomena, with climate shocks in several parts of the world, and with rising fertiliser prices and the incentive to produce biofuels generated by high oil and gas prices.

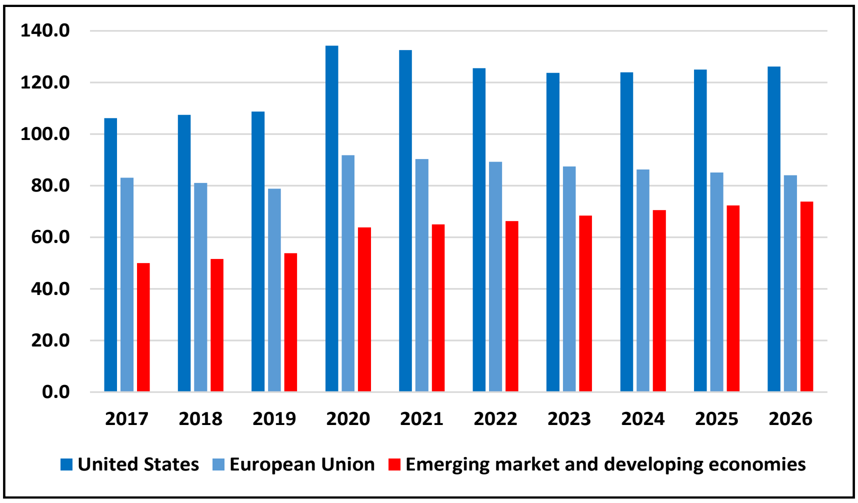
The geopolitical crisis generated by the invasion of Ukraine has also affected global economic trends. It has increased oil, gas, fertiliser, and some food prices (wheat, barley, corn, and sunflower oil, in particular). It has also generated an additional downward hit on global economic growth – to 3.5% according to the April 2022 issue of the IMF's *World Economic Outlook* – due to its strong effects on Western Europe and the collapse of the Russian economy (IMF, 2022b). Lockdowns in China may also affect world economic growth and will particularly hit sectors in which it plays an essential role in global value chains.

The sanctions against Russia have been severe – including the immobilisation of Russian central bank reserves held in Western countries, strict controls on Russian commercial banks' access to the Western financial system, limitations on imports of energy products from Russia, expropriation of assets of the Russian elite, and controls on Western exports of technology products to Russia.

Western firms with investments in or trade with Russia have been affected, but the global financial effects of sanctions have been limited. The initial effect on world stock markets was adverse but short-lived, and even the initial depreciation of the rouble was reversed due to a sharp increase in Russian interest rates, capital controls, and high oil and gas prices that have generated a strong trade surplus in that country. It remains to be seen whether a Russian default will have stronger effects. Standard & Poor's declared Russia in 'selective default' on 4 April 2022 because of the announcement that it would pay its foreign debt in roubles. However, even a final default may have limited effects on global financial markets according to certain analysts (Economic Intelligence Unit, 2022).

Another legacy of COVID-19 is high public sector debt ratios (Figure 4.3). These increased worldwide – particularly strongly in the US and less strongly in the European Union and emerging and developing countries, where they were on an upward trend before the crisis (regional trends amongst these countries will be analysed in the next section). The expectation of the IMF (Figure 4.3) is that public sector debt ratios will fall moderately in advanced countries but will continue to increase in emerging and developing countries. Rising interest rates will have a stronger effect on debt ratios in the last group of nations, but they have continued to be negative in real terms in developed countries.

Figure 4.3: Central Government Gross Debt (% of GDP)



GDP = gross domestic product.
Source: IMF (2022), World Economic Outlook database, April 2022 edition. https://www.imf.org/en/Publications/WEO/weo-database/2022/April (accessed 18 April 2022).

The private banking sector is not facing particularly adverse conditions. A remarkable feature of the COVID-19 crisis and current analyses of the world financial situation is that there is no risk of significant banking crises. COVID-19 has had adverse effects on some sectors, and the recovery has been uneven, so some firms may face solvency risks as the World Bank and the IMF Strategy, Policy and Review Department have pointed out (World Bank, 2022; Pazarbasioglu and Weeks-Brown, 2022, based on Araujo et al., 2022). Non-financial firms entered the crisis with elevated debt levels, which had been increasing in emerging market economies, and they rose even further in 2020. One of the most critical cases is that of the Evergrande Group in China, perhaps extensive to housing construction and financing in that country. However, insolvencies declined in 2020 due to significant policy and regulatory support from several governments and central banks, but such support is more limited now. As both Bretton Woods institutions have pointed out in the references, there is therefore a need to improve the insolvency systems of countries where they may not be sufficiently robust. At the same time, commercial banks' defences need to be shored up to absorb the associated losses.

As IMF (2021: 41–57) and many other analysts have pointed out, risks are already significant in the world of crypto assets. These assets sharply increased in value and diversified in 2021. However, the risks are not systemic because of the size of the market.[2] The problems are multiple and include (i) lack of protection for depositors; (ii) very high price volatility; (iii) evidence that some crypto exchanges involve illegal transactions; (iv) weakening of controls over foreign exchange and capital account regulations that many emerging and developing countries continue to experience; and (v) in the case of those countries, the risk of digital dollarisation. There is, therefore, a need to develop global regulatory standards for crypto assets and the agents issuing them, as was the case in the past in other areas of financial regulation that generated major crises. Forthcoming regulations have been announced but have not yet come to fruition. Digital moneys issued by central banks should also assume part of the role those crypto assets play today.

Another essential issue is the financial demands generated by the climate change agenda approved in Paris in 2015 and enhanced at the United Nations Climate Change Conference in Glasgow in 2021 (COP26). This involves increasing financing for climate change mitigation and adaptation, which includes developing new financial institutions and instruments. In terms of risks, the topic of this paper, they involve several issues: (i) the recognition that climate change generates widely known physical risks, particularly disasters associated with hydro-meteorological events that have regional as well as macroeconomic effects, which can severely affect firms and households located in the affected regions; (ii) the adoption of rules for both the financial and non-financial sectors that standardise and make climate-related risk disclosures mandatory, which will also improve the pricing and transparency of these risks; (iii) the adoption of prudential regulation aimed at redressing possible under-pricing of climate risks in financial markets; and (iv) defining an adequate taxonomy of 'green' and sustainable assets that are important for the development of green bonds and markets, and for carbon pricing. These rules will not only help manage climate-related risks at a broad level, but also embed them in firms' risk management and investment decisions. Some advances in this area have been made by the

[2] At its peak in April 2021, the crypto market reached US$2.5 trillion – equivalent to about 12% of US M1.

Network of Central Banks and Supervisors for Greening the Financial System, created in 2017 under the leadership of the Banque de France, as well as the Task Force on Climate-related Financial Disclosures created by the Financial Stability Board.[3]

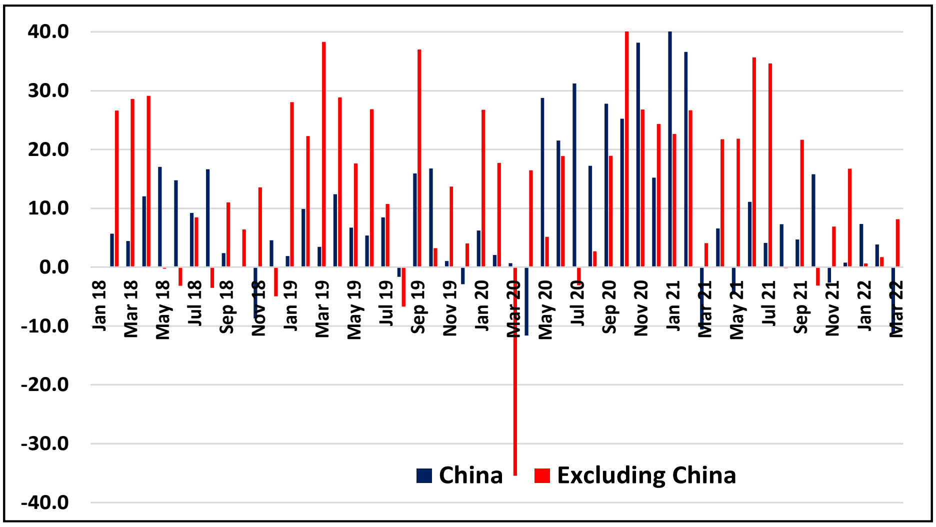
3. Financial Conditions in Emerging and Developing Countries

The previous section pointed out certain macroeconomic and financial stability issues that affect emerging and developing countries. To complement this discussion, it is important to underscore the risks associated with a possible tightening of external financing conditions that may generate low capital flows or even reversals, as well as rising costs of private financing in these countries. These risks may generate severe problems in some of these countries due to the high public sector and external debt ratios, as well as the inadequate institutions and mechanisms developed to manage debt renegotiations and eventual defaults.

As in previous crises – the crisis that started in East Asia in 1997 and deepened with the Russian default in 1998, and the North Atlantic financial crisis of 2007–2009 – capital flows to emerging economies collapsed at the start of the COVID-19 crisis. This was a 'sudden stop' in external financing, as it has been called in the literature, and risk spreads for emerging banking bonds increased the cost of financing. However, the crisis in financing was much shorter and less intense than previous ones.

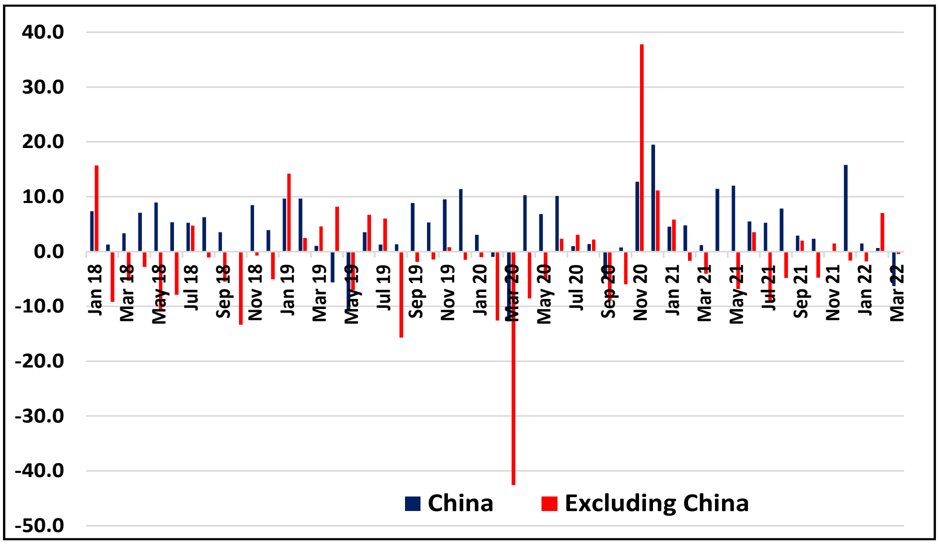
Figure 4.4: Capital Flows Towards Emerging Economies, 2018–2022 (US$ billion)

A. Debt Flows



[3] See a broader analysis of these issues in Bernal and Ocampo (2020).

B. Equity Flows

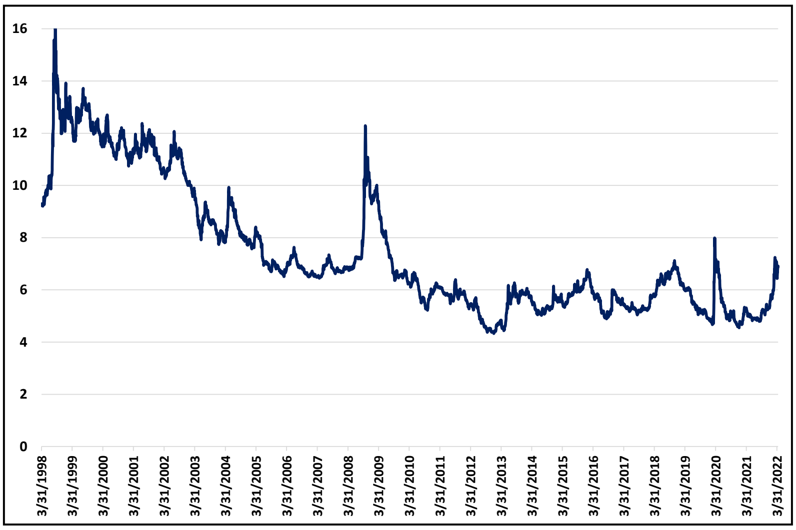


Source: Institute of International Finance.

According to estimates by the Institute of International Finance, as well as other sources,[4] there was a significant outflow of capital from these countries in March 2020, which was characterised at the time as the worst in history. However, thanks to the very expansionary monetary policies of advanced countries, access to hard-currency bond markets returned in mid-April – again, during the global recession – generating a positive net flow in bond financing that month, although it continued to be negative for China (Figure 4.4.A). Therefore, the net interruption of debt financing in this segment of the market only lasted a couple of months, compared with slightly more than a year during the North Atlantic crisis. Equity flows were also strongly negative in March 2020, but also recovered in April, although in this case largely to China – where those flows have largely concentrated since 2018 (Figure 4.4.B).

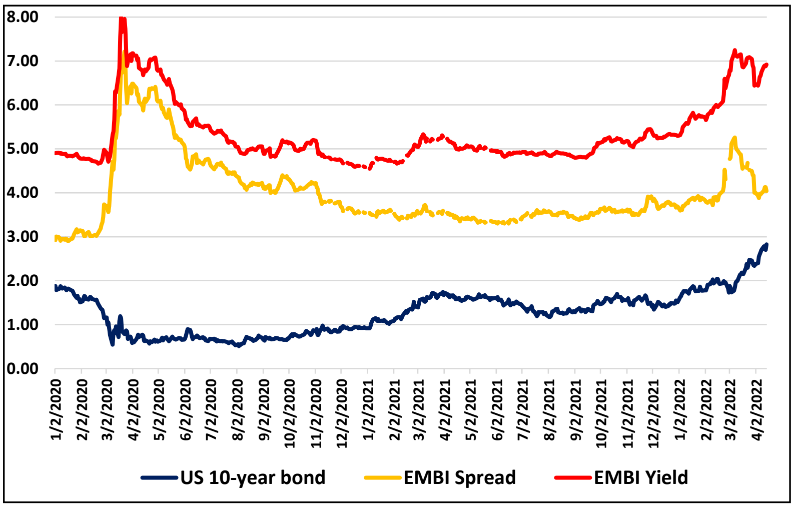
Figure 4.5: Yields of Emerging Banking Bonds (JPMorgan EMBI)

A. Historical Trend, 1998–2021



[4] See the regular issues of JPMorgan's *EM Flows Weekly*.

B. Determinants of Yields, 2020–2022



EMBI = Emerging Market Bond Index.
Source: JPMorgan.

In turn, the costs of financing, as reflected in the Emerging Market Bond Index (EMBI) yields for emerging market bonds estimated by JPMorgan, also increased in March 2020. This was despite a reduction in the interest rate of 10-year US Treasury bonds that serves as a reference and was thus determined by a large increase in risk spreads. However, following the historical series since these data have been available, the increase in yields for emerging market bonds was shorter and less intense than during the previous two crises. It returned to pre-crisis levels 5 months after the initial shock, compared with more than a year during the North Atlantic crisis and 5 years after the 1998 Russian default (Figure 4.5.A). The increased risk spreads were not fully reversed, but the mix of their fall since May, together with a reduction in the basic US interest rate, generated a return to pre-crisis yield levels (Figure 4.5.B).

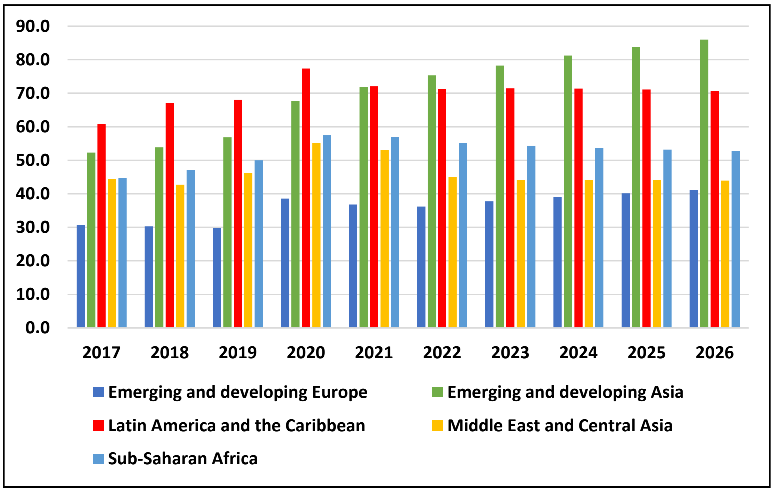
The performance of private bond markets was no doubt a reason for the limited demand for IMF financing in 2020. IMF financing was made available during the peak of the crisis to many countries through emergency facilities, but the amounts were modest. Financial conditions deteriorated moderately in early 2021, pushed by the increase in US interest rates, and in a stronger way since late 2021, pushed by both rising US rates and risk spreads. The upward trend speeded up in March 2022 and was associated with a strong increase in risk spreads, which started before but was enhanced by the invasion of Ukraine. However, risk spreads moderated in April, and although yield levels are now higher than pre-crisis levels (Figure 4.5.B), they continue to be moderate or even low by historical standards (Figure 4.5.A).

In a modest way, the evolution of both capital flows to emerging and developing countries and the cost of private financing for them may be starting to reflect the attraction of issuing bonds in developed country markets as interest rates increase. This 'flight to quality', as this trend is sometimes called, may become stronger as interest rates continue to rise. Except for a few months, debt flows towards emerging markets have been smaller since August 2021 (Figure 4.4.A). The invasion of Ukraine has also negatively affected flows to China, both of bond and equity financing (Figures 4.4.A and 4.4.B).

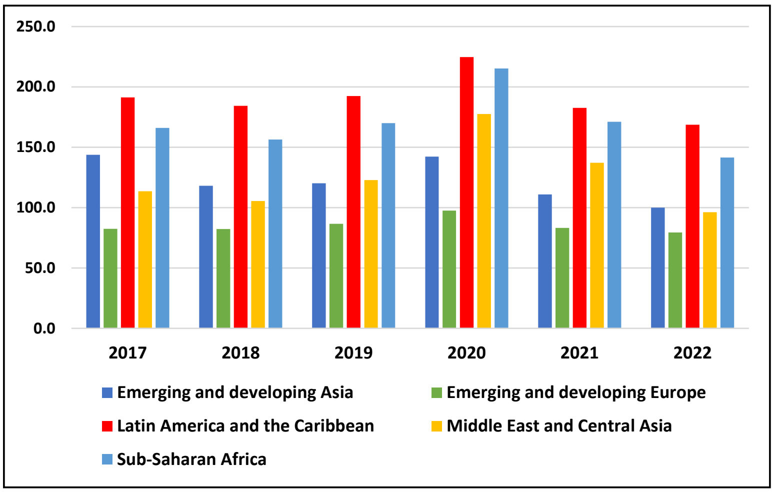
Furthermore, the direct effect of rising US interest rates worsens the conditions faced by countries that have high debt ratios, both because of pre-crisis trends and the effects of COVID-19. Figure 4.6.A illustrates the average public sector debt–gross domestic product (GDP) ratios of different regions in the emerging and developing world, while Figure 4.6.B shows the external debt as a proportion of exports of goods and services.

Figure 4.6: Debt Ratios of Emerging and Developing Countries

A. General Government Debt (% of GDP)



B. External Debt (% of exports of goods and services)



Source: IMF, *World Economic Outlook* database, April 2022 edition. https://www.imf.org/en/Pub//lications/WEO/weo-database/2022/April (accessed 18 April 2022).

As these figures show, the problems surrounding debt vary significantly by region – and obviously, by country within regions, a topic that is not addressed in this paper. Regionally, the most significant problems are those faced by Latin American and Caribbean countries for both indicators and by Sub-Saharan Africa for external debt. The price boom that has taken place since 2020 for non-oil commodities and since 2021 for oil will tend to alleviate the conditions of commodity exporters in both regions but can have negative effects in the case of countries that are food and/or oil importers. Developing Asia has the highest public sector debt ratios, which the

IMF expects will increase even further in the next 5 years, but this is not a major risk, since this region has the lowest external debt ratios.

The possible restriction of private external financing calls for stronger efforts to use multilateral development banks (MDBs) as an instrument of financing for emerging and developing countries. The countercyclical response of these institutions to the COVID-19 shock was much weaker than during the North Atlantic crisis – credit commitments from MDBs were 36% higher in 2020 relative to 2017–2019 levels, but they nearly doubled between 2007 and 2010. During both crises, the World Bank was very active, but there were remarkable differences amongst regional MDBs during the COVID-19 crisis – the Asian Development Bank grew faster in 2020 than other regional banks, and the two new institutions headquartered in China (the New Development Bank and the Asian Infrastructure Investment Bank) aggressively expanded their financing; in contrast, regional MDBs serving Africa, Europe, and Latin America and the Caribbean increased their financing very moderately (Ocampo and Ortega, 2022).

In addition, while the Global Plan for Recovery and Reform (adopted by the G20 Leaders in London on 2 April 2009) called for the capitalisation of MDBs, there was no such call during the COVID-19 crisis. This must be, therefore, one of the crucial actions in international cooperation if private external financing to emerging and developing countries is significantly affected. In the case of low-income countries, increased concessional financing through MDBs is also crucial, as well as official development assistance, which has grown very moderately in recent years and remains slightly above 0.3% of GDP in the case of members of the Organisation for Economic Co-operation (OECD) Development Assistance Committee – well below the 0.7% UN target (OECD Development Assistance Committee, 2022).

Another issue is the need for debt relief and better debt workout mechanisms. Actions during the COVID-19 crisis were moderate and limited to low-income countries. The major decision was the launch of the Debt Service Suspension Initiative (DSSI) by the G20 at the onset of the pandemic, which was extended and complemented in November 2020 with a mechanism that allows these countries to renegotiate their debts on a case-by-case basis, which came to be called the 'Common Framework'. But the use of these initiatives – particularly the Common Framework – has been limited, as well as private sector participation in both. Nothing similar has been offered to middle-income countries, though some (notably Argentina and Ecuador) were able to renegotiate their debts in 2020 based on existing frameworks. The issue of the debt overhangs of a growing group of emerging and developing countries has been high on the agenda of the IMF,[5] the World Bank (World Bank, 2022), and the UN. The UN is particularly concerned and has stated that the world is 'on the brink of a global debt crisis' (UN, 2022: 10), but this is not necessarily such a broad-based phenomenon. Solutions for highly indebted countries could include debt-for-nature swaps, large-scale debt relief linked to climate adaptation and mitigation, and more ambitious reforms efforts in sovereign debt relief and management. In this area, several independent proposals are on the table.[6] Therefore, debt relief efforts – including the renewal of initiatives for low-income countries but also programmes for middle-income countries – should be

[5] See, amongst others, Georgieva, Pazarbasioglu, and Weeks-Brown (2020).
[6] See, for example, Friedrich-Ebert-Stiftung and Consensus Building Institute (2021).

a central issue in the management of global finance in 2022. Unfortunately, however, decisions in this area have always come with a lag and have been partial in their scope.

It is also useful to think of using a new issue of the IMF's special drawing rights (SDRs), following the successful allocation of US$650 billion of these reserve assets in August 2021. This would be particularly important for emerging and developing countries facing international liquidity problems – as a group, they would receive close to 40% of these assets. There is also the possibility of the 'recycling' of unused SDRs to low-income countries through the Poverty Reduction and Growth Trust and the recently created Resilience and Sustainability Trust, which would also benefit middle-income countries and the climate change agenda. A structural reform of SDRs would also be an excellent initiative, as this is one of the most underused instruments of international cooperation.[7] One of the recurrent proposals is to increase the share of emerging and developing countries in those allocations, but this would require a change in the IMF Articles of Agreement, which would be a long-term process.

4. Conclusions

The major challenges to global financial stability are associated with the expected increase in interest rates in the face of global inflation and the slowdown in the global economy. Both phenomena started in late 2021 but have been speeded up by the economic effects of the Russian invasion of Ukraine. Rising interest rates are particularly important due to the high public sector debt ratios inherited from the COVID-19 crisis. There are also major risks that emerging and developing countries will have to confront a reduction in international private capital flows and a rise in financing costs. Capitalising and increasing financing from MDBs and official development assistance, as well as a new allocation of SDRs, could mitigate these problems. Debt relief and better debt workout mechanisms would also play a role for emerging and developing countries facing high debt ratios. Stock market corrections in developed countries, associated with rising interest rates and the overvaluation of some assets, may also generate financial stability issues, but are less important than those faced by emerging and developing countries. Action is also needed to manage the risks associated with the growth and high volatility of crypto assets, and the financial risk that climate change is generating. Private creditors face risks in loans to sectors and firms that were strongly affected by the COVID-19 crisis, but there is no evidence of risks of banking crises.

[7] See a summary of the reform proposals in Ocampo (2021).

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