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EXTERNAL SHOCKS AND FINANCIAL STRESS POST THE GLOBAL FINANCIAL CRISIS

UNCTAD financial conditions indicators and financial vulnerabilities in emerging markets

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Introduction

Ten years after the global crisis, the financial system remains a Damocles sword hanging over the world economy. The introduction of new national and international supervisory bodies, as well as the implementation of financial reforms, has undoubtedly increased banks' minimum capital requirements and reduced their exposure to specific risky assets. However, many financial risks remain unaddressed, and channels of transmission to the real economy, unattended. The largest banks have paradoxically grown even bigger (Standard and Poor's Global, 2017), especially in developed countries, on the back of public money intended for bailouts of the financial sectors. The new regulatory measures have not prevented the spread of toxic financial assets. In the meantime, shadow banking has continued to expand, representing a $160 trillion business (Financial Stability Board, 2018), twice the size of the global economy.

Emerging markets and developing economies are particularly exposed to the hazards of the unfettered and unstable growth of the financial sector. The explosion of private debt in these countries, feeding off a lingering belief in decoupling, combined with the relentless quest for high yields by investors, is becoming a major source of concern. These economies' share in global debt stocks increased from 7 per cent in 2007 to 26 per cent in 2017, while their ratio of credit to non-financial corporations to gross domestic product (GDP) increased from 56 per cent in 2008 to 105 per cent in 2017 (United Nations, 2018). Cheap liquidity made available in developed country markets prompted overheating in asset markets resulting in a fundamental disconnect between the financial system and the real economy. Moreover, the increase of private debt of non-financial corporations did not revive productive investment that has stalled almost everywhere (UNCTAD, 2018). While asset prices have exploded to unsustainable levels, nominal wages increased by much less, and stagnated in many countries. The ongoing emancipation of finance from the real economy fuels a spiral of debt, with economic growth mostly driven by sluggish household demand that has been sustained only by renewed debt bubbles.

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Given these idiosyncratic financial risks and weaknesses of the post-2008 era, the question arises as to what extent developing countries are equipped to deal with the many hazards in their paths. In this context, six emerging countries have recently come under the spotlight, including Argentina, which has recently suffered the deepest financial crisis. The others, often referred to as the "fragile five", are Brazil, India, Indonesia, South Africa and Turkey. Over the last decade, their domestic economies have been critically affected by imbalances and instabilities in the international financial realm that became particularly problematic as soon as monetary conditions in the United States of America were expected to tighten, sparking several episodes of drastic capital outflows alongside severe currency depreciations. The latter, in turn, often translate into runaway inflation but also increased pressures on the sustainability of foreign currency debt, whose share in emerging countries' total debt keeps ramping up.

The fate of these economies is of key interest, since together they accounted for approximately 9.3 per cent of world GDP[1]– and 15.6 per cent of GDP based on purchasing power parity (International Monetary Fund, 2018) – in 2017. This makes fears of contagion and concerns of whether any one of these economies could turn out to be "patient zero" of a new global economic crisis all the more pertinent. While the rapid expansion of capital account liberalizations has undoubtedly exacerbated the exposure of developed and developing economies

1. UNCTADstat, available at http://unctadstat.unctad.org/EN/ (accessed 25 January 2019).

The anxiety over these emerging economies is further heightened by the fact that they were thought to be adequately shielded against exogenous financial shocks.

alike to financial twists and turns, anxiety over these emerging economies is further heightened by the fact that they were thought to be adequately shielded against exogenous financial shocks. Since the end of the 1990s, and following almost 20 years of intermittent financial crises, these economies have been urged to embrace floating exchange rates and improve their balance sheets, mostly accompanied by strenuous efforts to continuously build up foreign exchange reserves. While these measures have strengthened their resilience to external shocks, they obviously fail to deliver on the promise of financial stability, especially in the current era of hyperglobalization.

Against this background, the six emerging economies considered here would seem to have little room for manoeuvre to defend their currencies and curtail capital outflows. Substantial increases in domestic interest rates in many of these economies have mostly failed to stem capital flows, while at the same time slowing down the domestic economy, thus reinforcing downward trends arising from secular stagnation tendencies and the prospect of protracted global trade wars. In this wider context, the growing difficulties faced by this group of upper-middle-income developing countries may also turn out to be a case study for lower-income countries, which does not bode well for the continuation of their financial integration.

The objective of this paper is to measure and track financial stress in these six fragile emerging economies in the aftermath of the global financial crisis of 2008, using UNCTAD financial conditions indicators. The next section argues that there is a need for better tools to measure financial stress in the context of growing instabilities and complexities in international and domestic financial markets. The third section briefly presents the indicators and compares these with relevant existing indices of financial instability. This is followed by an overview of the occurrence of financial stress episodes in the six selected economies since the onset of the global financial crisis. The paper further discusses the likelihood of a synchronization of such stress episodes across countries, the role played by external drivers of financial instability and countries' capacity for resilience to exogenous shocks.

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