Financial (in)stability swinging to central banks’ tunes

Emerging Markets Mid-Year 2023 Outlook

Triodos Investment Management

Although the global consequences of sharp interest rate hikes fall outside the mandate of major central banks, it is becoming urgent to expand their existing toolkit and that of multilateral institutions to safeguard financial stability in other countries.

As shown time and again, the global impact of rate hikes is high, including a delay in financial development. The bill is usually paid by the low-income countries with limited fiscal and monetary buffers.

Financial (in)stability swinging to central banks' tunes

The unexpected sharp rise in interest rates in advanced economies has exposed fragilities in the financial system that had been building up slowly over the long period of low interest rates, adding to the impact caused by the pandemic and Russia's war against Ukraine. Early this year the costs of this fragility in regulation and banking were exposed by the steep rise in interest rates in the US, leading to the failure of Silicon Valley Bank (SVB) and Signature Bank (SBNY). In Europe, Credit Suisse faced other woes and was taken over by UBS.

And now a discussion has opened questioning whether monetary policy considerations can be separated from financial stability concerns. However, this discussion is still segmented, focusing mainly on advanced economies and the available tools that major central banks have to mitigate financial stability risks. But there is still the 'impact elsewhere' consideration. Monetary tightening in advanced economies is contributing to weakening macroeconomic conditions in emerging economies **through volatile currencies, widening sovereign spreads and in some cases capital outflows**.

Indeed, with increasing global financial integration, most of the world cannot help but swing to the tunes of major central banks, because their policies have proven important in driving global risk appetites and financial flows. For instance, banks in the US play a critical role in global financial intermediation and foreign banks hold US treasury bonds as safe haven assets. So, what happens in the US matters in terms of global spill-over effects.

And although we do not expect a new episode of global financial stress in the near-term, it is becoming more urgent to expand the existing toolkit from multilateral institutions and central banks to safeguard financial stability of emerging economies affected by monetary policy decisions in advanced economies.

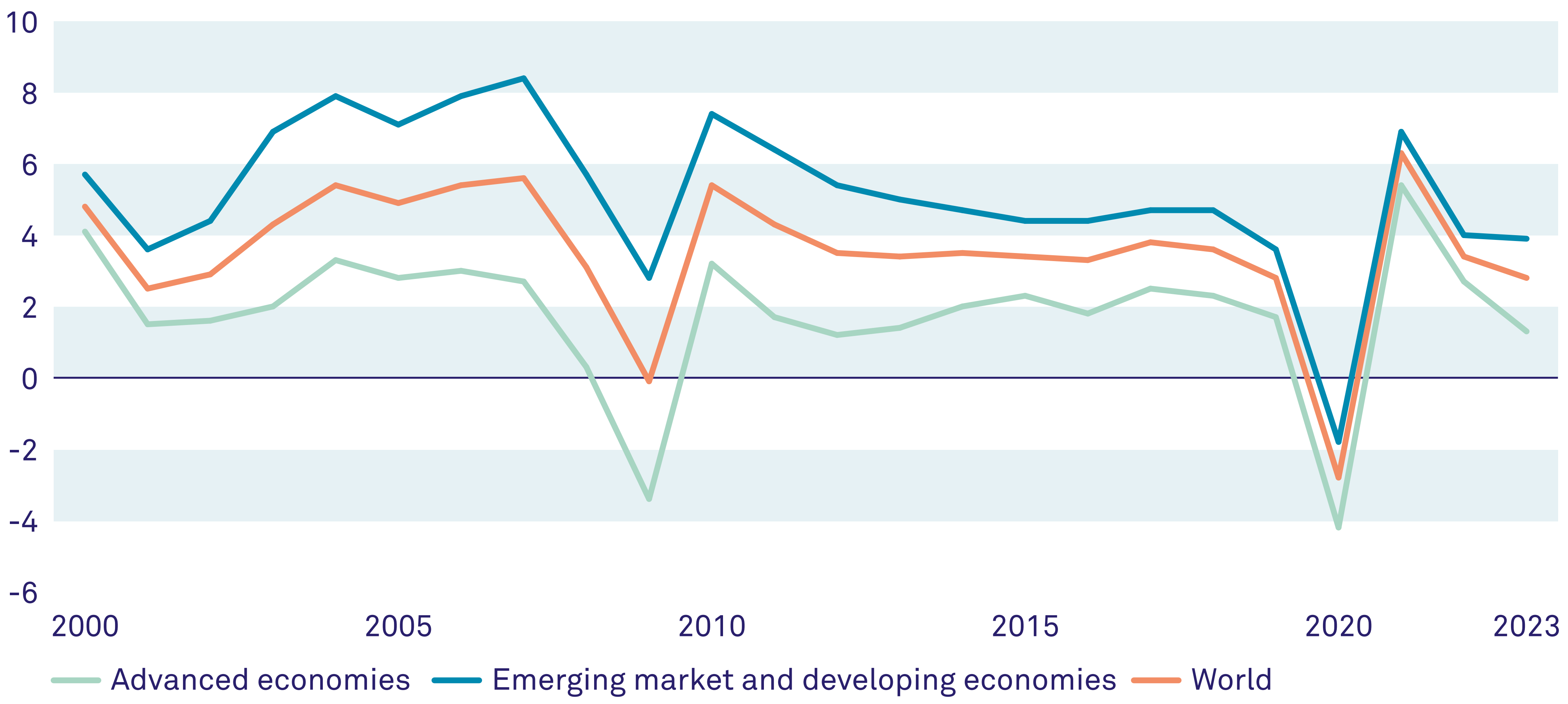
Emerging market developments

The slowdown in global GDP growth that started in 2022 slightly reversed in the first half of 2023 (figure 1). The feared recession in advanced economies, which was expected to be the price of the aggressive pace of rate hikes delivered by major central banks over the past two years, did not materialise, as labour markets and consumer spending held up well in both the US and the eurozone.

In the first half of 2023, emerging markets continued to show growth momentum and generally a remarkable economic resilience, especially in Asia, supported by the uplift from China's reopening after COVID. More recently, however, China has disappointed somewhat on the strength of its comeback. Surprisingly, emerging Europe managed to maintain moderate growth and elude the spill-over effects from the war in Ukraine. Latin America has displayed impressive resilience as well, despite political instability in several countries, including Bolivia and Ecuador.

Figure 1 GDP growth

% yoy



Note: 2023 includes the most recent available data. Source: IHS

Developments in African countries, on the other hand, have been more concerning. Countries that rely heavily on imports of food, energy, and fertilizer, are still suffering from the impact of a severe rise in the cost of living, while a general external funding squeeze has also been affecting the region. The latter was driven by the rising costs of foreign financing, amidst large fiscal deficits and a long-term decline in aid budgets.

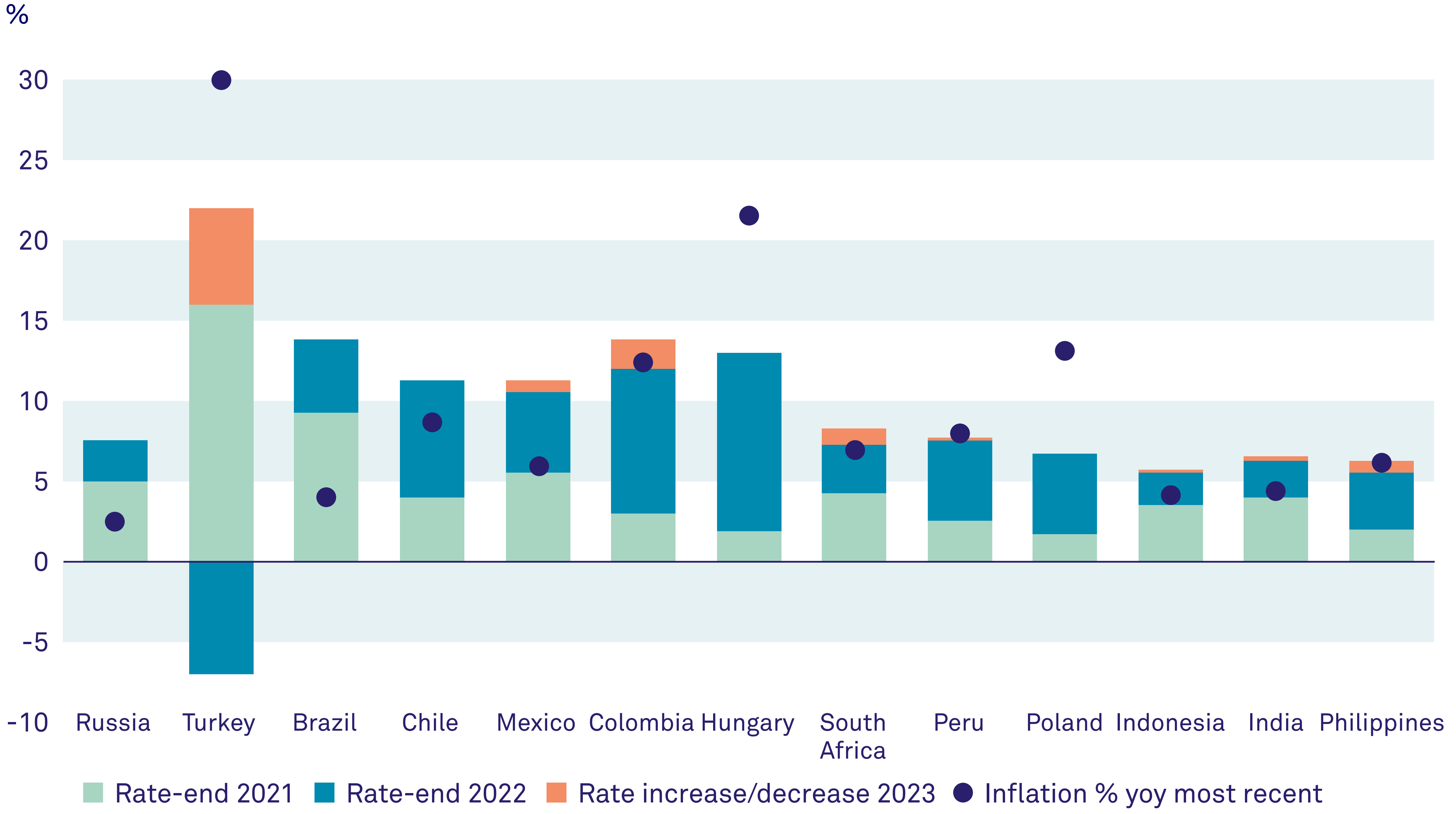
Despite all this, some business sectors in the region are doing well thanks to a young population and strong potential demand, including in Nigeria and Kenya. These countries have managed to create the right entrepreneurial environment for fintech start-ups in renewable energy and commodities and these companies are rapidly expanding to other countries in the region.

While the recent financial stress did not expand to emerging market banks, efforts to fight inflation in advanced economies have resulted in a slowdown of capital inflows to some emerging economies. Fortunately, global headline inflation has taken a step back and the pace of rate hikes is slowing. Many emerging markets have already paused their rate hikes following a substantial drop in headline inflation and a visible slowdown in core inflation - excluding energy and food (figure 2).

Yet, the timing for a pause of interest rates in advanced economies is still in discussion because of the stickier core inflation. And there are other downside risks to consider, including the magnitude of credit tightening due to the more expensive cost of capital and strict lending standards.

In a negative scenario, if investors' mood turns and financing for banks in emerging markets becomes

Figure 2 Emerging markets' central bank policy rate and inflation



Source: National Central Banks updated 20 June 2023

harder to obtain, investment and consumption will fall, and companies are likely to feel the pinch. Studies show that usually this negative feedback loop caused by higher interest rates has a larger negative effect on emerging economies than on advanced economies.

Fortunately, communication from major central banks has become more cautious and most investors are expecting monetary authorities to move slowly and even cut interest rates in 2024. We expect emerging markets growth to be less strong in the second half of 2023 compared to the first half, on the back of a gradual slowdown in advanced economies, China's reopening maturing, while the effects of domestic rate hikes will likely impact demand in most emerging markets. The second half should also bring about a more visible decline in core inflation in most countries.

Emerging markets' financial sector eludes recent stress

Emerging markets are familiar with financial sector stress. Historically, contagion in the banking system has been more virulent in countries where governance structures were weak. And more recently, the tumultuous years of COVID and the war in Ukraine have been a test for financial stability. In many cases financial stability was supported by better governance and risk management than in the past and by the temporary policies put in place, including credit moratoria, to weather the impact of COVID.

And even earlier this year, the direct spill-over effects from financial stress in the US and Europe were limited. In part aided by the better-than-expected performance of the major economies. Additionally, in contrast to the US, most emerging markets apply the Basel III regulatory standards to *all* banks, not just the largest banks. The state of implementation of these rules varies significantly between countries, however.

It also helps that banks' funding structures in emerging markets appear less reliant on wholesale funding and more sensitive to changes in the cost of deposits. In many low-income countries, remittances are a relatively stable source of capital flows, and these are increasingly channelled to bank deposits. Studies show that generally a steady flow of remittances is positively and significantly correlated with credit and deposits in emerging economies.

But when economies are vulnerable, with large fiscal and current account deficits, stress episodes can trigger vicious circles. For instance, in Bolivia capital flow reversals were almost unavoidable after the interest rate hikes. International reserves rapidly depleted, which made demand for US dollars surge, putting significant pressure on local banks because of the scarcity of US dollars and eventually leading to a loss of confidence in local banks.

Additionally, as foreign investors become increasingly cautious, in a context of high interest rates and weaker capital flows, debt restructurings in the more vulnerable economies cannot be ruled out. This often has implications for the banking sector, as has been the case in for example Ghana and Sri Lanka, because local banks often have large exposures to sovereign debt in their own country. In some economies, government debt amounts to a quarter of bank assets. These are clearly circumstances where swift IMF support is required to prevent a sovereign crisis transforming into a financial crisis – which would have a much longer lasting impact on the economic development of a country.

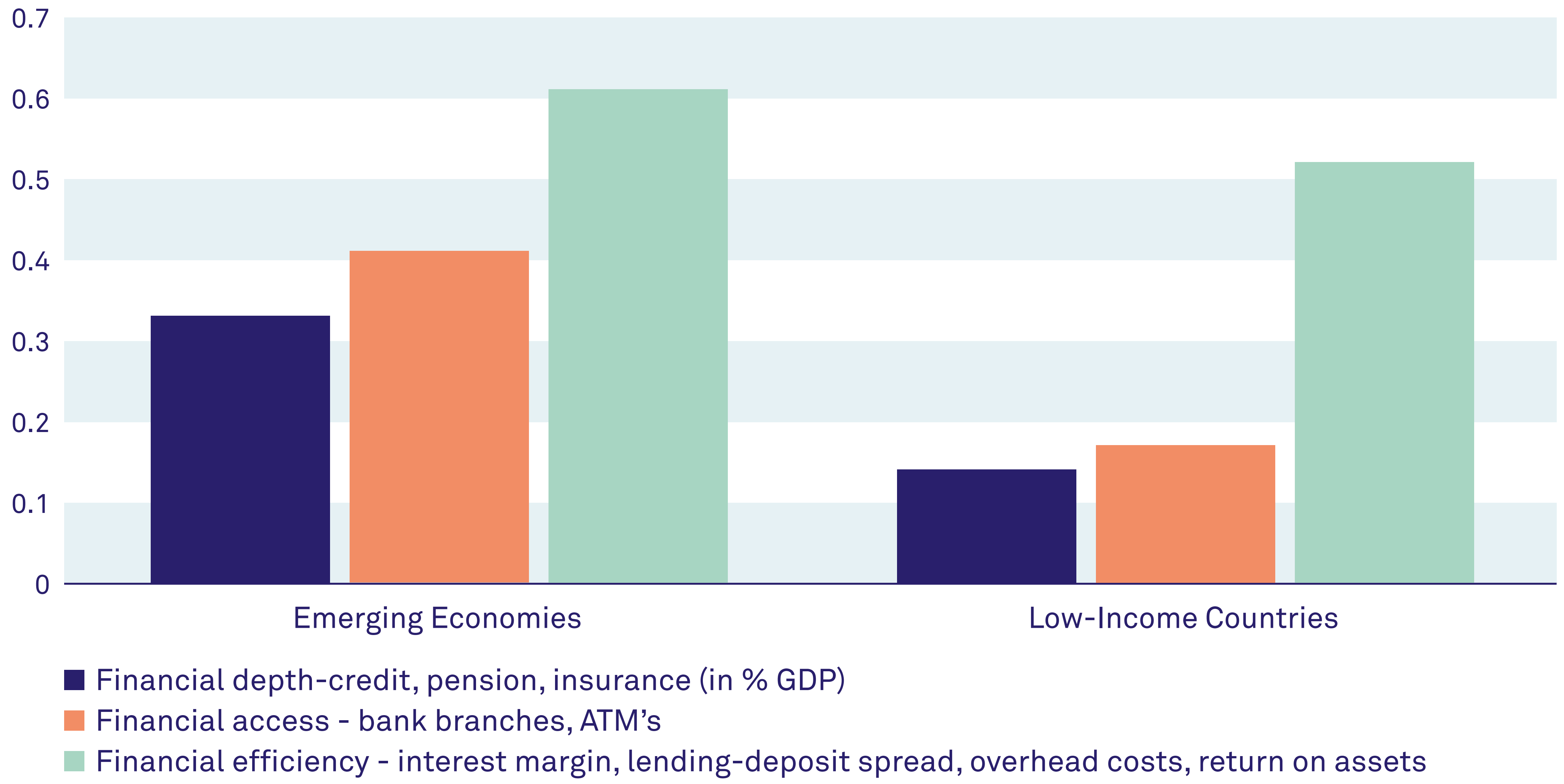
Future-proof financial system

In most emerging markets, domestic private banks are the most important source of financing the economy. Local banks are important parties in supporting the real economy and propelling sustainable transitions. Access to financial services opens doors for families, allowing them to smooth out consumption and invest in their futures through education and health. Access to credit enables businesses to expand, while creating jobs and reducing inequality.

Within emerging markets, differences in financial development are large and generally a combination of: i) cyclical factors, such as the gap between demand and supply of financing, the size of the local investor base and the costs of funding (risk premium), ii) structural economic factors, including the stage of economic development and demographics, as well as iii) technological innovations and regulatory insights, which together also determine the depth and soundness of a financial system. A snapshot comparison shows that low-income countries have room for improvement compared to other emerging economies (figure 3).

Nonetheless, many emerging markets are currently seeing rapid growth of their banking sector. The world's biggest banks are now in China and Brazil, both countries with a growing middle class and a huge demand for financial services. Here, too, the poorer countries are lagging, with a large segment of the population still having no or limited access to financial services. As impact investors, through our financial inclusion funds, we have a specific focus on reaching out to those traditionally excluded from

Figure 3 Financial Development Index
Latest 2020



Score 0 lowest 1 highest. Source: IMF

access to affordable, effective and transparent financial products and services. Especially people living in rural areas and women are in disadvantaged positions in many developing countries and emerging economies.

For positive impact, it is the knowledge of and care for the clients that is important. Because this is often the first contact that smaller businesses and households have with the financial system. Additionally, some of the world's most advanced digital platforms and fintech firms are in emerging markets. India, through its digital public infrastructure has become a template for other emerging economies to facilitate payments through mobiles and accept remittances in real time at a low cost.

This raises the question how financial systems can develop soundly, when external monetary cycles, particularly decisions made by the Fed, **influence global credit growth and the prices of financial investments around the world**, while risk management still needs to catch up. There is no silver bullet, but financial systems must put clients first, with the help of strong supervision and regulation. And for the poorer countries' small financial institutions, the synergy of financial inclusion and fintech can contribute to better access and affordability.

Linking fintech with financial development and inclusion

Fintech companies have a positive impact on financial development and inclusion. The elevated fees and transaction costs in serving the poorer segments of the population provides little incentive for the traditional banking sector. This is exactly where the growth of fintech has been the greatest.

For instance, **Neogrowth**, a company in India financed by Triodos Investment Management lends to small businesses using digital technology using unbiased lending criteria and focusing more on small regular payments as opposed to large payments in the case of traditional banks. This lowers the threshold of clients' access to lending and improves financial inclusion.

Africa is also showing increasing potential, receiving **40% of start-up capital** for payment-focused fintechs in the past year. Apollo Agriculture, a Kenyan company financed by Triodos Investment Management, is a good example. It leverages mobile technology, satellite data and machine learning to support subsistence farmers in becoming more profitable and scalable.

As for global coordination, although the consequences of high interest rates may fall outside the mandate of major central banks, it is becoming more urgent to expand the existing toolkit to safeguard global financial stability. This requires better cross-border risk management arrangements and international safety nets, particularly for low-income countries. Financial crises in many emerging economies may not have systemic impact, they do have significant distributional effects, exacerbating inequality. In an integrated global economy this problem is eventually for us all.

Forecast table- emerging markets selected countries

	GDP growth (% yoy)				**Inflation** (CPI, % yoy avg)				**Government debt/GDP** (%)				**Government balance/GDP** (%)				**Current account** (% GDP)			
	2020	2021	Prelimi-nary 2022	Forecast 2023	2020	2021	Prelimi-nary 2022	Forecast 2023	2020	2021	Prelimi-nary 2022	Forecast 2023	2020	2021	Prelimi-nary 2022	Forecast 2023	2020	2021	Prelimi-nary 2022	Forecast 2023
Belarus	-0.7	2.3	-4.5	-2.4	5.5	9.5	15.2	4.6	33.7	45.6	56.6	59.1	-1.7	0.2	0.4	0.5	-0.3	3.2	4.5	-4.2
Bolivia	-8.7	6.1	3.5	2.8	0.9	0.7	1.7	3.4	63.8	68.3	74.9	78.8	-12.7	-9.3	-7.9	-7.7	0.0	2.2	3.8	-2.0
Brazil	-3.6	5.3	3.0	2.1	3.2	8.3	9.3	4.6	78.8	73.3	65.1	63.6	-13.3	-4.3	-4.6	-7.9	-1.9	-2.8	-3.0	-2.4
Chile	-6.3	11.9	2.5	0.4	3.0	4.5	11.6	7.7	36.3	38.0	33.7	30.6	-7.3	-7.7	1.3	3.2	-1.9	-7.3	-9.0	-2.4
China (mainland)	2.2	8.4	3.0	5.5	2.5	0.9	2.0	1.2	101.0	110.0	122.0	129.0	-6.2	-3.8	-4.7	-4.4	1.5	1.8	2.1	1.4
Colombia	-7.3	11.0	7.3	0.9	2.5	3.5	10.2	11.4	48.4	38.7	35.0	31.6	-8.0	-5.2	-4.1	-4.8	-3.5	-5.6	-6.2	-5.3
Ecuador	-7.8	4.2	2.9	2.3	-0.3	0.1	3.5	1.8	57.2	54.4	45.5	43.4	-5.5	-1.6	-0.9	-2.2	0.8	-1.5	-1.9	-2.1
India	-5.9	9.1	7.2	5.8	6.6	5.1	6.7	4.9	50.3	49.4	54.2	54.2	-6.0	-6.2	-6.7	-6.4	1.2	-1.1	-2.3	-1.4
Indonesia	-2.1	3.7	5.3	4.7	2.0	1.6	4.2	3.8	41.1	40.1	37.2	37.6	-6.2	-4.1	-0.8	-2.7	-0.4	0.3	1.0	0.2
Kazakhstan	-2.5	4.3	3.3	3.7	6.8	8.0	15.0	14.8	22.3	21.4	25.8	30.5	-3.9	-1.2	-2.9	-3.7	-6.4	-1.3	4.2	1.2
Kenya	-0.3	7.6	4.8	4.5	5.4	6.1	7.7	7.0	63.6	69.6	70.0	68.9	-8.1	-8.2	-6.2	-5.6	-4.8	-5.2	-5.4	-5.1
Mexico	-8.2	4.9	3.0	2.4	3.4	5.7	7.9	5.8	41.0	38.8	37.3	36.9	-2.8	-3.0	-3.3	-3.8	2.1	-0.6	-0.9	-1.2
Pakistan	-1.3	6.5	4.5	-0.4	9.7	9.5	19.9	28.9	87.1	89.7	92.2	93.8	-7.2	-6.1	-7.9	-6.5	-0.2	-3.6	-4.0	-3.5
Peru	-11.1	13.5	2.7	1.8	1.8	4.0	7.9	6.9	34.8	33.0	35.8	35.6	-8.3	-2.5	-1.4	-2.5	1.1	-2.2	-4.0	-2.6
Philippines	-9.3	5.6	7.6	5.9	2.4	4.0	5.8	5.7	60.4	60.9	64.0	61.2	-7.6	-8.6	-7.3	-6.3	3.2	-1.5	-4.4	-3.6
Poland	-2.0	6.8	5.5	0.8	3.7	5.2	13.2	12.2	54.2	49.7	53.4	52.9	-6.9	-2.0	-1.0	-4.9	2.5	-1.4	-3.0	-1.6
Russia	-2.7	5.6	-2.1	0.1	3.4	6.7	13.7	3.9	17.2	21.0	27.6	35.4	-4.0	0.8	-1.6	-3.6	2.4	6.7	10.4	2.6
South Africa	-6.0	4.7	1.9	0.4	3.3	4.6	6.9	5.9	67.8	70.1	74.2	75.7	-7.9	-4.7	-1.9	-4.0	2.0	3.7	-0.4	-2.2
South Korea	-0.7	4.1	2.6	1.4	0.5	2.5	5.1	3.4	53.6	55.1	57.7	58.1	-3.7	-1.5	-3.0	-2.9	4.6	4.7	1.8	0.6
Thailand	-6.1	1.5	2.6	3.5	-0.8	1.2	6.1	1.9	52.8	53.6	51.6	50.8	-5.6	-4.9	-2.4	-2.7	4.2	-2.1	-3.5	0.0
Turkey	1.7	11.6	5.4	1.6	12.3	19.6	72.3	42.2	37.9	26.9	49.5	46.1	-3.5	-2.7	-0.9	-5.2	-4.4	-0.9	-5.3	-5.3
Uganda	-1.4	6.7	4.7	5.5	2.8	2.2	7.2	7.2	55.0	58.1	58.9	59.0	-7.4	-9.4	-11.3	-12.0	-9.3	-8.3	-8.6	-8.3
Uzbekistan	1.9	7.4	5.7	4.7	12.9	10.8	11.4	10.4	36.6	35.8	35.2	34.7	-4.2	-6.2	-3.8	-2.8	-5.0	-7.0	-0.8	-6.8

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Investing in positive change

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