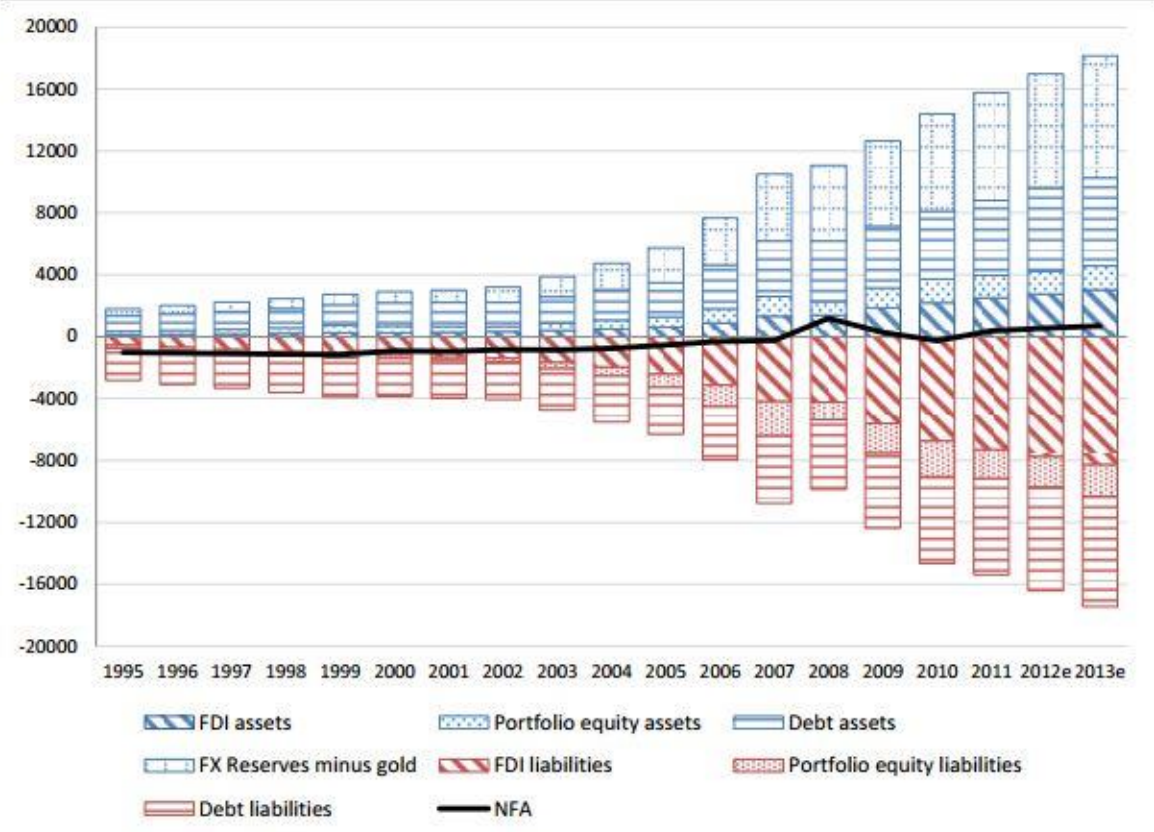
“Almost all” developing countries now vulnerable to financial crisis: sobering new report

There are now two types of developing countries, and both have become increasingly vulnerable to financial crises in recent years. This is the main message of an [impressive and sobering new report from inter-governmental think tank, the South Centre]().

The first type looks familiar to students of previous financial crises. They have “bubbles in domestic credit and asset markets” and are heavily dependent on external financing – so changes in exchange rates, or in the opinion of international investors, can spell disaster. The chart below shows that developing economies’ financial assets (that they own overseas) and liabilities (that foreigners own in their countries) have grown rapidly in the past decade. This means, or course, that they are now “closely integrated” into “an inherently unstable international financial system”.

Chart 2: External Assets and Liabilities in EDEs

(Billions of U.S. dollars)



Source: South Centre calculations and estimates based on Lane and Milesi-Ferretti (2007), IIF (2014) and IMF *WEO* (April 2014).

e: estimates.

The second type is new, and mostly affects East Asian countries that look – from the outside – as if they are safe. They have “strong external positions” – meaning that they are not so vulnerable to the “typical external financial crisis [where] an emerging economy finds its access to international financial markets interrupted and faces a sudden stop in capital inflows.” Instead, their own domestic financial markets have been the scene of increasing activity by foreign investors, meaning the crisis could arise from within – but be triggered by the actions of those foreign investors.

Here are the some of the key findings (but it's worth reading the report itself, or at least looking at the graphs if the language veers too much to economics wonkery for your taste):

- "In many [developing countries] foreign presence in equity markets is greater than the US and Japan."
- "A very large proportion of private external debt is in foreign currency."
- "International banks…. Market share in [developing countries] has reached 50 per cent compared to 20 percent in OECD countries."
- "As a result of a shift of governments from international to domestic bond markets and opening them to foreigners, the participation of non-residents in these markets has been growing."
- "The sovereign debt of [developing countries] is held by fickle investors abroad rather than by foreign central banks as international reserves."

Sobering stuff, particularly when we remember that this "increased presence of foreign investors and financial institutions in domestic asset and credit markets of [developing countries], together with dismantling of controls over international capital flows have made them highly vulnerable to global financial boom-bust cycles generated by policy shifts in major financial centres." The main worry here, of course, is that the inevitable wind-down of the massive quantitative easing programmes and future raising of interest rates in developed countries could cause foreign capital to desert developing countries and return home, triggering crises.

As the report points out, this means the absence of any effective mechanism for dealing with crises shows the need for major reforms to the international economic architecture, including, for example, a sovereign debt workout procedure. This is on the table, with the UN set to agree a new framework for resolving debt crises this year.

However, it also supports Eurodad's call for a fundamental shift in the way we discuss international private financial flows at the upcoming Financing for Development conference – highlighting the risks, not just the rewards. This means emphasising that simply encouraging more capital flows – as donors including the European Commission frequently do – is a mistaken agenda: without ensuring that developing countries have the tools to manage those flows, this could spell disaster.