KFW-DEVELOPMENT RESEARCH

# Views on Development

No 3, 9 July 2013

# Effects of the euro crisis on developing countries: Risks and future challenges

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Four years have passed since Lehman Brothers went bankrupt, and the world economy still has not fully recovered. Many parts of the Eurozone are still stuck in recession and, even in the US, the economy is only recovering slowly. By contrast, contrary to initial fears, most developing and emerging countries had until recently come through the global financial crisis relatively unscathed.

The turbulences in the Eurozone, which are at least in part related to the distortions in global financial markets in the wake of the US subprime crisis, had thus far had only limited effects on developing and emerging economies. Although their real growth has also recently collapsed, this has not diminished their lead in terms of growth compared to industrialized countries; the convergence process is unabated. Thus, as a result of the crisis, the world economic power structure has further shifted in favour of developing and emerging nations, which are rightly demanding greater influence in international financial institutions like the International Monetary Fund (IMF) and the World Bank. But, even though the emerging nations' assertiveness has greatly increased and their growth trends are clearly outstripping those of the industrialized countries: the continuing cyclical weaknesses in the world economy and the enduring crisis in the Eurozone imply a whole range of risks for developing and emerging countries owing to the strong mutual inter-relations that exist.

### The new role of stabiliser for the emerging markets

In the wake of the global financial crisis, developing and emerging countries have taken on an important role as stabilizing factors. Most developing and emerging nations recovered quickly from the global financial crisis and, already by 2010, had recouped and even exceeded their pre-crisis growth rates, generating a large part of global growth. In particular, emerging markets in Asia and Latin America increased imports from industrialized countries in line with their high growth rates and thus supported their growth. Imports by developing countries formed a large part of export driven GDP in industrialized countries. Around 63 per cent of German and French export growth to countries outside Europe in 2012 was attributable to exports to developing and emerging markets and not to other industrialized countries. The high domestic demand in developing and emerging markets has therefore constituted a significant growth driver for the world economy in the past few years. The disconnection between growth rates of industrialized and developing countries has led to an ever-increasing role for developing countries in global trade in both absolute and relative terms. According to World Bank estimates, the share of developing countries in global trade will be around 35 per cent in 2015.

### Real risks for developing and emerging nations

The ever-increasing integration of developing and emerging nations into global trade does nonetheless also mean that they are not entirely able to dissociate themselves from what is happening in the industrialized countries. Although the significance of south-south trade integration has greatly increased in recent years (the share of south-south trade now constitutes more then 50 per cent of exports from the south), the economic situation of many developing and emerging countries are still influenced by cyclical developments in the major industrialized countries. For instance, to date, about two-thirds of exports from Asian emerging economies have been linked to demand from Europe and the US.

As a result, the euro crisis holds serious risks for developing and emerging countries because the enduring problems in the Eurozone are not only having the effect of significantly slowing down the global economy but are also affecting growth in developing and emerging countries. In the Eurozone, growth rates are, and will continue to be, low. In its latest prognoses for 2013, the IMF anticipates a drop in growth in the Eurozone by 0.3 per cent and a 1.1 per cent growth recovery in 2014. In a scenario such as this, the effects on developing and emerging nations should be limited, even if the recession in Europe and weak growth in the US have already led to a weaker economy in developing and emerging countries, with growth rates estimated at 5.1 per cent in 2012 and forecast at 5.3 per cent in 2013. However, an unforeseen worsening of the crisis (a scenario that unfortunately cannot be ruled out) would again plunge the global economy into a precarious position. A drastic fall in demand in the Eurozone would hit emerging nations hard. Even now, global trade is struggling due to the growth problems in industrialized countries, especially the Eurozone, which is after all the largest trade block in the world: whereas global trade growth in 2011 still stood at 6.0 per cent, in 2012 it slumped to 2.5 per cent. That was the lowest growth since 2009.

### Unabated protectionism is slowing down global trade

The growth problems and the attendant high levels of unemployment in many industrialized countries are leading to more vociferous calls to protect production at home from foreign competition and are thus posing the risk of new protectionist measures. The new protectionist measures introduced between October 2011 and May 2012 are affecting 0.9 per cent of total global imports, according to information from the World Trade Organization.

### Monetary and financial risks for developing and emerging countries

Particular risks exist due to the extremely expansive monetary policies of most industrialized nations. Considerable advances were made in integrating developing (and especially emerging) economies into the international financial markets over the past decade. The large increase in liquidity on the global financial markets stemming from the low-interest policies and unconventional measures adopted by the world's major central banks is now having direct and indirect effects in developing and emerging economies.

Low interest rates in industrialized countries are whetting the appetite for capital flows towards developing and emerging countries, where both interest rates and economic growth are at much higher levels. At first sight, this is no bad thing, though these capital flows also pose a number of potential risks. Firstly, large capital inflows can contribute to sharp rises in the money supply and credit and can overheat the economy, raise inflationary pressure on consumer prices and asset values or even provoke the creation of a bubble in the capital markets. Secondly, large capital inflows also hold dangers for the stability of the financial system if they lead to the formation of currency and maturity mismatches in borrowing and investments. For example, the emergence of short-term borrowing abroad and long-term investment in domestic real estate was a major cause of the Asian financial crisis at the end of the 90s. A rapid withdrawal of portfolio investments can trigger considerable drops in exchange rates and lead to a collapse of financial markets. Whereas the foreign indebtedness of emerging economies at "investment grade" is increasingly incurred in their own currencies because international investors want to profit from the structural increments in the values of these countries' currencies, low-income countries and poorer medium-income countries continue to be exposed to the danger of currency risks and maturity incongruences between borrowing and investment.

The US Federal Reserve's announcement in June 2013 that it is likely to begin tapering its quantitative easing program and moderate the pace of bond purchases later this year demonstrates a further danger for emerging nations, to which billions of dollars of portfolio investments previously flowed. In the middle of June 2013, equity and bond funds under the "emerging markets" label saw the biggest outflows since the start of 2008, to the tune of US$ 10 billion.

In addition, many European banks are being forced to reduce their balance sheets in the wake of the financial crisis, which has led to lower growth and higher equity requirements. This "deleveraging" by the European banks has contributed to intensifying volatility on the markets and poses serious risks to the financial stability of emerging economies, for which European banks are a significant source of credit. A renewed deepening of the European banking crisis could thus lead to contagion effects in emerging countries, whose banking systems are intertwined with the European banks, and could cause liquidity shortages there. The solvency ratio of large, systemically relevant banks in emerging countries could worsen considerably in the event they are unable to replace the capital from foreign banks.

Deleveraging could also further restrict the trade finance of European banks and thus weaken trade. Restrictions in the commitment of European banks further to dollar shortages already led to significant falls in trade finance in the period 2009-2012 by around a third compared to the period 2005-2008. Furthermore, it is difficult to replace the financial resources of European banks in certain specific areas, such as for project finance. The deleveraging of European banks could, for instance, affect wholesale financing on the local Asian banking system and its derivative markets.

### Currency war

Not without cause, heated discussion has broken out about a so-called "currency war", in which the emerging economies are accusing the central banks in the US, the Eurozone and now also Japan of trying to apply lax monetary policy in order to keep the exchange value of their currencies down and so promote domestic exports. The upward pressure on the value of emerging nations' own currencies is also affecting their foreign assets, e.g. foreign currency reserves for which investments were made in dollars and euros. If it actually should end up in a currency war with a battle for reciprocal devaluation of currencies and trade-protectionist measures, the entire global economy would feel the effects, with unforeseeable consequences, not least for developing and emerging nations.

### "Financialization" of the commodities markets

A further consequence of the rise in global liquidity as a result of the extremely loose monetary policy practised by most industrialized countries due to the sub-prime and euro crisis is its effects on prices on the international commodities markets. In past years, there has been a "financialization" of the commodities markets, including the foodstuffs markets. This has led to prices developing in a manner that is unrelated to fundamental data and is clearly more volatile. The great mass of liquidity on the international financial markets has further aggravated this process, which was triggered by deregulation of the commodities markets. Although high commodities prices can have a positive effect for export countries through rising export revenues, the effects among commodities importers are negative. They are particularly negative in terms of price volatility, which has very much intensified over the past five years. Especially on the foodstuffs markets, large price fluctuations can have grave consequences for developing and emerging nations, especially for the poorest levels of society.

### Future challenges

There are therefore numerous risks posed by the way in which the problems of industrialized countries, and especially the Eurozone, can affect developing and emerging economies. In order to further settle and stabilize the growth rates in developing and emerging countries, what is needed is durable high productivity created by structural reforms, investments in human capital and improved governance and investment conditions. Further bolstering domestic demand by means of a shift to consumption by the rapidly expanding middle classes in emerging economies will contribute to reducing dependence on exports and thus the vulnerability for external demand shocks. Strengthening social security systems is also a means to help emerging markets reinforce domestic consumption, which in turn reduces export-dependence and augments the resistance capabilities of those economies.

To be able to absorb new, exogenous shocks stemming from enduring crisis problems in the industrialized countries and especially the Eurozone, it is necessary for developing and emerging nations to have room for economic manoeuvre, particularly in the area of fiscal policy. Before the outbreak of the global financial crisis, many developing and emerging nations had built up enough of a fiscal buffer but, in the wake of the crisis, the budget situation in many countries has worsened significantly. According to IMF data, the budget balance in low-income nations in 2007 still stood at -0.4 per cent measured against GDP; by 2012, the budget deficit among this group of nations was at -3.3 per cent of GDP. The budget situations of emerging markets also deteriorated, from 0.0 per cent to -2.1 per cent, over the same period. For this reason, these countries in particular should be reinforcing their revenue sources. This includes developing their tax systems and their domestic bond markets.

In order to even up European banks' financial resources in emerging countries, local banks should be trying to attract as much local deposits as possible. Likewise, subsidiaries and branches of international banks in developing and emerging nations should rely on local deposits rather than wholesale funding. A further buffer against the credit crunch caused by European banks lies in the regional banks. In Asia, for instance, Japanese and Australian banks have extended their loan facilities, thus partly offsetting the utilization of financial resources from European banks.

The further development of domestic bond markets in local currencies will also reduce dependence on international banks and raise the financial markets' resistance capabilities. Support in developing robust banking systems and bond markets is an area in which development cooperation should also lend a hand. This would also foster the financing of infrastructure projects and a green transformation in the respective economies, since it would improve and lend constancy to the generation of domestic resources.

Lasting growth, industrialization and urbanization need investment in energy, water and waste-water disposal and transportation routes, as well as information and communications technology. The annual financial requirement to cover the lack of infrastructure in developing and emerging nations is put at US$ 2,000 billion. Of that, only two to three per cent is currently covered by multilateral development banks and development aid. A new BRICS development bank could bring lasting change to the architecture and dynamics of international development finance. The combination of BRICS finance from various BRICS sources (alongside the new BRICS bank, their national development banks, sovereign wealth funds and state pension funds) would help to leverage the new BRICS development credits, alleviate project risks through collective action and thereby break down the current risk aversion that besets major infrastructure projects.

To stimulate trade, the international financial institutions should continue to support trade finance. In this context, the Global Trade Finance Program of the International Finance Corporation and programs set up by other multilateral, regional development banks such as the Asian Development Bank are playing a significant role. These programs offer guarantees against banks' risks in financing trade.

To increase the stability of the international financial system, it is necessary to construct a "global financial safety net" for countries susceptible to crisis, in the structuring of which the emerging nations have to assume a major role. To achieve this, a comprehensive governance reform of the international financial institutions is essential so that emerging countries not only rise to the global economic governance obligations commensurate with their growing economic importance but also have an appropriate voice in these matters. The lack of readiness on the part of the EU member states, often also including the smaller EU countries, to relinquish their World Bank and IMF mandates constitutes the greatest barrier to a shift of voting rights from the industrialized to developing and emerging nations. Because of the complex structure of interests within the Eurozone, a rapid resolution of the crisis is not within sight, and this is having negative effects on developing and emerging nations that are alluded to above. It is hence all the more important that Europeans wake up to their responsibility and clear the way for a long-overdue reform of the international financial institutions. ■

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