››› Are developing countries becoming more susceptible to global financial crises?

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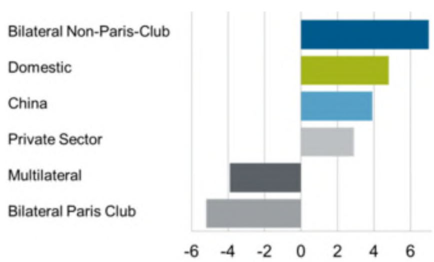
Developing countries made it through the 2008 financial crisis relatively unscathed. In the years after the crisis, they saw relatively stable economic growth with an average of 6.5%. However, a new impending financial crisis may affect developing countries much more as their interdependence within the global financial market has increased. Because economic growth went hand in hand with increasing debt and a change in debt structure.

Considerable changes in the debt landscape

According to the World Bank, the foreign debt of low- and middle-income countries (LICs/MICs) has doubled to USD 7.1 trillion since the financial crisis. The changes in debt structure associated with this are:

- **An increasing share of foreign currency:** by now, the share is around 80% for public and public guaranteed debt in LICs.
- **Changing donor composition:** traditionally multilateral and bilateral creditors (Paris Club members) are becoming less important for LICs.

Graph 1: LIC debt according to type of creditor
(Change in percentage points, 2007–2016)



Source: IMF, based on 37 LICs

The majority of bilateral loans now comes from China. Private investors are also playing an increasingly important role.

- **An increased share of bonds**: bonds issued by governments and corporations reached a record high of USD 355 billion in 2017 in LICs and MICs. Although China is the main issuer, USD 261 billion of the total volume is attributed to the other developing countries.
- **Growing private sector debt:** corporate debt has doubled in the last ten years. Two thirds of this growth alone is attributable to private companies from MICs and LICs.

Reasons for this development also lie in the last financial crisis

The key driver is industrial countries' expansive monetary policies as a result of the financial crisis. Investors channelled their capital into developing countries that promised higher returns during a period of zero interest policies. BRICS countries such as China in particular were looking for lucrative investment opportunities. Declining grant funding from traditional donor countries and the associated increasing demand for loan financing throughout the global financial markets contributed to increasing bond issues.

The result is increasing interdependencies in the financial markets

According to the IMF, increasing exchange rate risks and rising interest charges result from this debt situation because of (i) the increased share of bond financing, (ii) more variable interest agreements and (iii) shorter financing terms with higher follow-up financing and interest rate risks. Moreover, the lack of transparency and heterogeneity of debt is increasing, which makes coordination between the individual creditors more difficult. In addition, interdependencies of many developing countries with the international financial market are growing. The net flow of capital to LICs and MICs rose in the past ten years from USD 633 billion to USD 1.1 trillion.

Although positive effects are attributed to financial globalisation, it also increases susceptibility of developing countries to financial crises, including so-called spill-over effects. If there is a new financial crisis, developing countries will be threatened by significant capital outflow if private investors act procyclically and take their capital out of developing countries. Due to increasing interdependence, developing countries are more strongly affected by financial market regulation and interest policies. If these change, for example, because of increasing capital requirements due to expectations or in response to a new financial crisis, this will increase financing costs in developing countries much more than it would have in the past.

At the same time, the risk factors for a new financial crisis are intensifying. So as the interest rates turn in the US, this increases pressure to refinance – especially in emerging economies that suffer high budget deficits and have large debts in USD. Furthermore, it is difficult to tell what the effects of Brexit and new foreign trade policies of the US will be.

Conclusion

Increasing interdependency of developing countries in the international financial market and rising involvement of private capital in development financing are objectives that were defined for international development policy, however, they can also have unintended negative consequences for developing countries. To minimise the impacts of future global financial crises, development finance providers are called upon to support moderate debt policies that focus on the long term and minimise currency and interest risks. Furthermore, borrowing must be connected to efficient and productivity-enhancing investment projects.■

Note: This paper reflects the opinion of the authors and does not necessarily represent the position of KfW.