Issued: 20 April 2020

Ashmore

The case for a *global* macro-prudential policy

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Summary and conclusion

The tendency for global capital to flee 'risky' Emerging Markets (EM) countries indiscriminately in favour of 'risk free' developed markets during outbreaks of global risk aversion is one of the great international market failures of our time. This behaviour has been ubiquitous in past crises and the 2020 Coronavirus Crisis is no exception. EM countries have experienced indiscriminate outflows, regardless of their policies or fundamentals. Fortunately, today most established EM countries have local markets, so their vulnerability to outflows is significantly reduced.

However, the least developed EM countries remain completely exposed. In addition to not having sufficiently developed domestic markets to meet their financing needs they are completely cut off from international capital in crises. Unable to undertake any counter-cyclical policies, they are not only at risk of major economic crises, but the crises could potentially migrate to other countries with similar characteristics in a classic contagion dynamic.

Until now, there has been little interest in addressing the global market failures that precipitate such tragedies. However, given the general weakness of the global economy due to coronavirus, the world can now ill afford to turn a blind eye on completely preventable crises.

We believe that it is within the capabilities of International Financial Institutions (IFIs) to design new programmes – call them global macro-prudential polices – to address global market failures. These programmes could involve credit lines to enable EM countries to buy back their own debt during periods of extreme market stress, or bond purchases undertaken by the IFIs themselves.

The 2020 coronavirus crisis

The 2020 Coronavirus Crisis is the most extraordinary exogenous shock to hit the world in modern times.[1] It profoundly affects every economy in the world. The International Monetary Fund (IMF) estimates that global real Gross Domestic Product (GDP) growth will contract by 3% in 2020, making it the deepest and sharpest recession outside of war time. Asset prices have fallen sharply. The crisis has imparted a heavy economic blow to countries that depend on selling oil and other goods in international markets, but the damage is greatest of all for those countries that have few or no means of implementing countercyclical policies to offset the loss of external demand. The ability to implement counter-cyclical policy hinges critically on access to finance.

IFIs have the capabilities to design global macroprudential polices to address global market failures. This could involve credit lines to enable EM countries to buy back their own debt during periods of extreme market stress

Global market failures

Investors find it challenging to determine the fair value of assets during major crises. The depth and duration of the shock can be difficult to gauge. The economic fallout is also unknown and there may be powerful feedback loops between markets and economies, which further complicate matters. When hard data is difficult to come by, investors often extrapolate into the future from the conditions prevailing during the shock, which leads to exaggerated estimates of the impact and duration of such shocks.

While these market inefficiencies are well-known and present in most markets, major risk aversion events tend to give rise to dynamics which differ dramatically across countries. In particular, investors tend to default to oddly binary distinctions between 'risky' and 'risk free' countries and

[1] Exogenous shocks are unexpected or unpredictable events that affect an economy, either positively or negatively, independently of endogenous or domestic factors.

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then proceed to make very large portfolio shifts along these lines. Typically, they withdraw large sums of capital from countries regarded as 'risky' and ply the capital into so-called 'risk free' markets. The result is so-called 'flight to safety' in developed countries and capital flight from EM.

It is hard to overstate how ubiquitous this type of investor behaviour is. There has never been a bout of global risk aversion, where investors have not pulled capital out of EM. Withdrawals cut across all EM countries, often quite indiscriminately with little attention paid to differences in fundamentals or the quality of policy. Since the price action is often very violent, bank analysts and members of the media find it irresistible to whip up the sentiment, which contributes further to the price action as weaker hands are sucked in.

This tendency towards 'dumbing down' to a simple binary world of 'safe' and 'risky' remains one of the great, pervasive and longest ignored market failures in global finance. This simplistic behaviour deprives large segments of the world economy of access to finance at critical times, with pernicious long-term economic consequences for some of the poorest countries in the world. The distinction between 'safe' and 'risky' countries has long since been sown into the very fabric of global finance. This is why there is chronic under-investment in EM in institutional investors' portfolios. The blatant discrimination against EM in financial regulations and biases in EM sovereign credit ratings exacerbate the issue.

EM financial markets are significantly smaller than EM GDP for this reason. In the poorest and least developed parts of EM, such as Sub-Saharan Africa, financial markets market share are a shocking 30% of their GDP share in the world (Figure 1). By contrast, in developed economies financial markets are 3.6x larger than their GDP share in the world.

Fig 1: **EM sovereign Dollar debt credit ratings (% share of EMBI GD)**

Region	Market share		GDP share (PPP-adjusted)	Ratio: Financial markets share to GDP share
	Stock	Bonds		
Africa	**1%**	**1%**	**5%**	**0.3**
Emerging Markets	*31%*	*23%*	*60%*	*0.9*
Developed Markets	*69%*	*77%*	*40%*	*3.6*

Source: Bloomberg, IMF, Ashmore, MSCI, BIS, JP Morgan, Ashmore. Data as at end-2018.

Learning to cope

The Dollar-denominated EM sovereign debt universe now only account for USD 1.3trn of the USD 26.5trn EM debt universe, or 5%

Fortunately, not all EM countries are equally vulnerable to investor's tendency to dump EM assets at the first sight of global risk aversion. Most established EM countries have reduced their dependence on global capital markets by developing their own sources of finance, thereby enabling them to escape the large 'contagion' episodes, which once caused such enormous economic damage in EM. Indeed, the average EM sovereign today obtains nine times more financing in local markets than in external debt markets. They also have increasingly sophisticated policy tools to cope with shocks, including liquidity injections, credit lines, repo facilities, and debt buybacks. With low inflation, EM central banks have room to cut rates as larger debt burdens in local currency lead to deflationary drags. They can even do quantitative easing if liquidity in their bond markets is impaired. This makes many EM local bond markets look very similar to bond markets in developed countries.

The corollary of greater dependence on local markets is less dependence on external capital. The Dollar-denominated EM sovereign debt universe now only account for USD 1.3trn of the USD 26.5trn EM debt universe, or 5%. The bonds have been issued by 74 individual sovereigns and a large number of affiliated quasi-sovereign corporations. Hence, many individual EM countries have very little external debt, and some, like Thailand, have none at all. Much of the debt is very long-dated and the quality is generally quite high. For example, as of the end of March 2020 just shy of 58% of EM external debt was rated investment grade. In short, there is no systemic problem as far as EM debt is concerned.

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What is different about this crisis?

In 2008, the direct impact of the mortgage crisis on banks and insurance companies led to an acute systemic risk. Auto companies were considered 'too big to fail'. The coronavirus crisis has created a different kind of systemic risk by collapsing liquidity in the service sector. Many sub-sectors, such as restaurants, bars, retail shops, gyms and live entertainment have hundreds of thousands of small companies that together add up to some of the large employers in today's societies. They are 'too many to fail'.

In developed countries and in the more advanced EM countries with domestic bond markets, governments have responded as quickly and comprehensively as possible to these problems by making direct cash transfers to small businesses and individuals, a temporary moratorium on loans and rents, tax breaks and employee subsidy schemes as well as short term loans on subsidised rates.

The vulnerable fringe

However, one group of EM countries remains completely at the mercy of global capital market failures, namely the least financially developed and economically diversified economies in the world. Unlike rich countries and those EM countries that already finance in local markets, this group faces major problems when risk aversion spikes. Not only are they immediately cut off from financing in international markets, but they also do not have sufficiently well-developed domestic financial markets to enable them to obtain the financing they need at home.

This gives rise to a dangerous and potentially systemic problem. Shocks not only have the potential not just to push individual countries into outright economic, financial and humanitarian free fall, but since there are many countries with similar characteristics in EM there is risk that this type of crisis creates a classic contagion.

What to do?

Market failures should either be fixed or measures put in place to ameliorate their deleterious effects. Either way, this will inevitably have to involve IFIs.

The IMF in particular must do more. While the IMF generally does an excellent job in advising governments on how to overcome economic shocks (using the conventional remedies of fiscal, monetary and exchange rate policies), the IMF has been unimpressive when it comes to fulfilling its mandate of ensuring stability in the international financial system, particularly as far as the least developed EM economies are concerned.

A new set of instruments – call them global macro prudential instruments – should be designed to provide a backstop against the damaging effects of market failures

The IMF's Rapid Financing Instrument (RFI) and Rapid Credit Facility (RCF) are important steps forward, but there are two short-comings with these programmes.

First, they are not big enough. The combined amount of capital behind RFI and RCF is USD 36bn. This represents approximately 1% of the GDP of Frontier Markets. For comparison, the average rich country and EM countries with local markets have so far committed about 8% of GDP, including temporary cash transfers, loans and guarantees. While the IMF has committed an additional USD 100bn in RFI and RCF, this is still insufficient.

Second, they do not address the fundamental problem of dependence on external finance. Most IMF programmes do not help countries to develop their own capital markets without which EM countries are likely to remain dependent on foreign capital. They also do nothing to address the major market failures in global finance that cut off EM countries from capital during shocks.

A new set of instruments – call them global macro prudential instruments – are therefore needed. They should be designed to prevent bond prices from spiralling into a vicious cycle, providing a backstop against the damaging effects of market failures.

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There are two ways of doing this:

1| The IMF can offer funding for countries to buy back their own debt in the secondary market. If Ecuador were to have access to such a facility, for example, the country would have been able to wipe out USD 3bn of principal (c. 10% of total Eurobonds issued) and save approximately USD 300m of coupon payments annually for every USD 1bn of lending with less than USD 30m of interest. The bang for the buck of what is, in effect, a market-friendly debt re-profiling exercise would be enormous. To be exact, in Ecuador's example, the direct savings could be more than 2% of GDP. The subsequent credibility boost would deliver further indirect savings due to a reduction of the country's cost of debt.

2| The IMF could itself buy the bonds on the primary and secondary market, thus providing a similar role as the ECB with respect to peripheral European economies, when they lost access to private capital in the 2012 Eurozone debt crisis. We believe this approach is inferior to the previous proposal in that it does not allow the country to cancel its own Eurobond and thus reduce interest payments. However, it may be simpler to implement from a legal and moral hazard point of view.

In both circumstances, the IMF could automatically embed buyback facilities within programmes with countries that comply with advice and meet pre-established quantitative targets, be it within a formal funded programme or purely within the context of a policy support mechanism. The provisions would, in themselves, have a powerful preventative effect by reducing the likelihood that countries lose market access in the first place.

However, these programmes should not be open to all countries. The loss of access to finance should be attributable to market failures, not bad or unsustainable policies. Countries must ensure that their finances are in order. For countries with bad policies, the loss of market access is justified and existing IMF programmes and tools are appropriate, as any funding would have to come with strong conditionality attached. Of course, the emergency tools such as RFIs and RFCs should be expanded and still be readily available to deal specifically with the coronavirus crisis.

What not to do:

It is as important to be clear about what to do as what not to do. As a matter of principle, everything should be done to protect the toeholds that the least developed EM countries have attained in global financial markets. Access to global capital is a key milestone in the development of any country. Finance provides an important 'hand maiden' service to development and growth. Government yield curves are key pieces of financial infrastructure that are essential to pricing corporate bonds and therefore stimulate the private sector development without which poverty can never be eliminated. Policy makers and academics should therefore stop their incessant calls for debt moratoria at the first sign of market volatility. Maintaining access to global markets is not the problem, rather it is part of the solution.

The sustainable way to help low income countries extricate themselves from vulnerability to global capital market failures is help them build local markets

Hence, the encouragement for private sector participation in the recently agreed proposal for a broad moratorium on debt for IDA countries is misguided, even if well meaning. Of course, others have gone to even further extremes. For example, Harvard economist Carmen Reinhart and Kenneth Rogoff recently called on all EM countries to default.[2] In our view this would be a major mistake. Defaults make financing even more difficult to access as the perceived riskiness of the country increases, driving the cost of funding up permanently. Perversely, defaults impede or even reverse the important task of developing domestic bond markets, because subsidiaries of international banks and local banks reduce operations in countries that default and long-term saving rates decline.

The only truly sustainable way to help low income countries extricate themselves from vulnerability to global capital market failures is help them build local markets, not to put them into a state of permanent dependence on multilateral and bilateral lenders, which is exactly what the Reinhart/Rogoff proposal would do. It is the opposite of development; instead it could be considered slavery.

[1] See: *'Rebuttal to Carmen Reinhart and Kenneth Rogoff's proposal that Emerging Markets suspend debt payments'*, The Emeging View, 15 April 2020.

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Conclusion

Gross market failures have characterised global markets since long before the dawn of modern Emerging Markets in the late 1980s. The British economist John Maynard Keynes was one of the first to note that Adam Smith's 'invisible hand' does not always allocate resources efficiently. He was particularly adamant that self-adjusting market mechanisms are prone to failure during major economic dislocations. When entire markets become mispriced then asset allocation often becomes perverse, exacerbating rather than solving problem.

Given the failure of IFIs to address the failures in global markets, the more advanced EM countries have over time found ways to insure against shocks by developing their own financing sources at home. Their dependence on unpredictable cross-border flows is now very low. However, the least developed countries in the world still lose access to external sources of finance every time major shocks occur. Since they do not have the ability to finance at home, loss of external funding can push them into spirals of self-perpetuating downturns during global upheavals. The downturns become longer lasting and costlier than warranted by circumstances and the risk of contagion to other countries with similar vulnerabilities goes up.

Due to the severity of the coronavirus crises, the world can ill afford to continue to ignore global market failures. As institutions with global governance responsibilities, IFIs have special responsibilities to address failures in operation of global capital markets. In addition to the strong economic reasons for resolving these problems, there is now also a very powerful moral imperative to do so, because the world poorest and least diversified countries are at risk.

It is therefore the right time to develop a new set of international policy instruments that are designed specifically to address global market failures. These could revolve around credit lines to enable EM countries to buy back their own debt during periods of extreme market mispricing or bond purchases could be undertaken by the IFIs themselves.

The big question is whether IFIs will get the green light to go ahead with such decisive proposals. In the past, IFIs have completely ignored global market failures. The reason is political. The main shareholders of the IFIs are rich countries, which benefit greatly from 'flight to safety' flows in crises. They have no incentive to dismantle what effectively amounts to a financial insurance policy that pays out precisely when needed, even if this is at the expense of the most vulnerable people in the world.

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