Deutsche Bank
Research

The next EM crisis is here

#PositiveImpact

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Emerging economies face an extremely challenging environment. Rising USD and EUR yields as the Fed and ECB raise policy rates quickly to try to stabilize prices; depreciating currencies, especially against the dollar, as a consequence; slowing growth; extreme climate events and the economic consequences of the war in Ukraine in the form of a further boost to food and fuel prices.

The outlook for the Fed – the fastest and most extensive rate hikes in the post-Volcker era – raises immediate concerns about the potential for financial crises in emerging markets. Rate hikes either triggered or were a catalyst for economic crises in the 80s, 90s and early 2000s. Even if the US doesn't itself experience a crisis, it looks increasingly likely that the US and EU economies will fall into recession, imparting a significant negative drag on emerging markets growth.

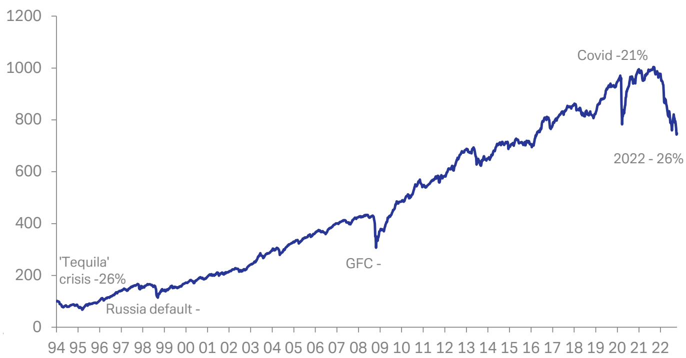
So is a crisis inevitable?

It helps to define what we mean by a crisis. A sudden decline in an asset price can be a crisis for certain investors – and important asset price corrections are often described in those terms by market commentators. But a genuine crisis in our view involves a breakdown in the availability of finance – at almost any price – to a broad swathe of economic agents. A sovereign default or a banking crisis have such potential. A sudden exchange rate devaluation – a balance of payments 'crisis' – wouldn't, in our view, constitute a genuine crisis unless it led to a withdrawal of financing to an economy out of concern for heightened sovereign credit risk or a halt to bank financing because of banks' or corporates' losses on FX liabilities. Not all large depreciations cause crises. The economic collapse in Sri Lanka surely constitutes a crisis.

But from an external creditor perspective, another 14 countries have seen access to international credit virtually shut off. Debt relief by public sector creditors, including China, has reached record numbers of countries over the past two years and IMF credit in SDR terms reached record levels with 35 new programs. While the unprecedented scale of fiscal stimulus in the major advanced economies helped avert an economic catastrophe in 2020-21, official sector support to developing countries largely insulated private creditors from the consequences of what was still the worst year on record for developing economies in 2020 with a 2% GDP decline.

But that fiscal stimulus is, in most countries, being withdrawn while central banks are tightening monetary policy. Recession looms for the global economy again over the next year while pandemic emergency financing is no longer available. Private creditors have already suffered a crisis-like decline in the value of their claims on emerging market sovereigns and worse is likely yet to come.

Already a crisis? EMBI Global diversified 1994-2022



Source: Bloomberg Finance LP and Deutsche Bank Research, Total returns index.

Deutsche Bank Research clients can access the full report here.