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Emerging Markets: Prospects and Challenges

Tryggvi Gudmundsson, Vladimir Klyuev, Leandro Medina, Boaz Nandwa, Dmitry Plotnikov, Francisco Schiffrer, and Di Yang

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Emerging Markets: Prospects and Challenges

Tryggvi Gudmundsson, Vladimir Klyuev, Leandro Medina, Boaz Nandwa, Dmitry Plotnikov, Francisco Schiffrer, and Di Yang*

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ABSTRACT: This article documents recent developments in emerging markets in the context of the COVID-19 pandemic, assesses their prospects and challenges, and discusses appropriate policy settings for the medium term. It argues that EM policymakers' ability to grapple with an incomplete and uneven recovery will be constrained by high public debt and uncertain inflation prospects as well as external risks surrounding capital flows and exchange rate developments. The paper also discusses potential impact of a tightening in global financial conditions and appreciation of the US dollar that could be triggered by a general increase in risk aversion or a reassessment of the likely path of US monetary policy.

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WORKING PAPERS

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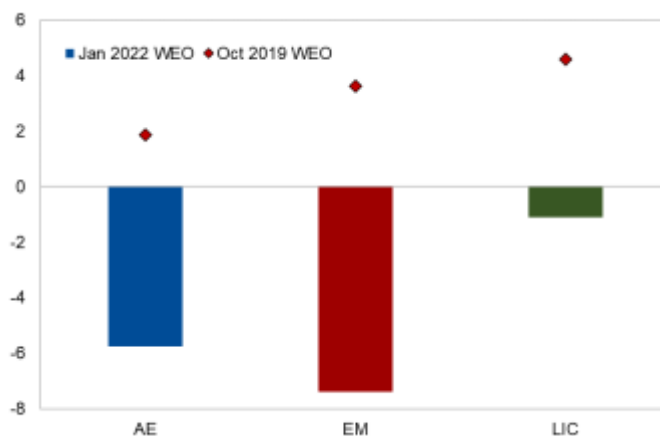
1. Introduction

COVID-19 dealt a huge blow to the world economy, resulting in an unprecedented 3-percent contraction in global output. The emerging markets (EMs) were affected particularly strongly. The impact would have been even larger had it not been for decisive and unprecedented policy actions. These actions came with a price, though – their virtually unavoidable side effect was accumulation of vulnerabilities in many countries and sectors. This article documents recent developments in EMs, assesses their prospects and challenges, and discusses appropriate policy settings for the period ahead. Toward the end, it zeros in on one particular challenge – the risk of a tightening in global financial conditions and appreciation of the US dollar that could be triggered by a general increase in risk aversion or sudden reassessment of the likely path of the US monetary policy.

2. Rearview

COVID-19 delivered a major shock to the global economy. It led to massive underperformance relative to projections, and in most countries (including 90 percent of EMs), outright declines in output (Figure 1).

Figure 1. 2020 GDP Growth Outcome vs Projections
In Percent



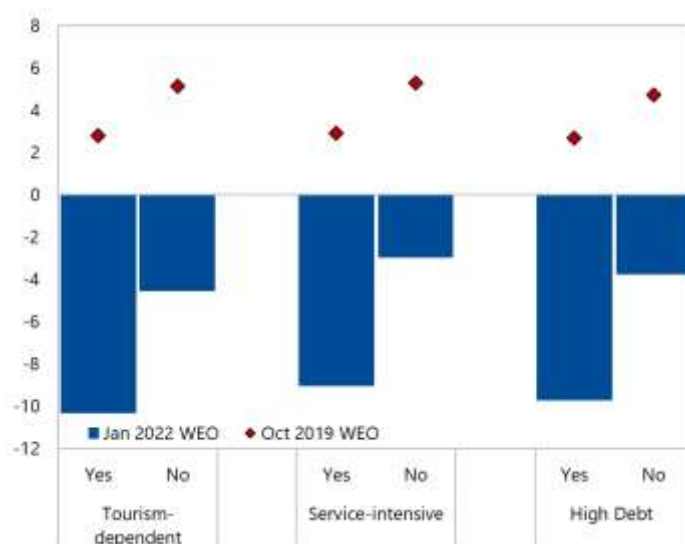
Sources: WEO January 2022 and October 2019.

Real GDP in EMs dropped 7.4 percent on average in 2020, 10 percentage points below pre-pandemic expectations.¹ The downturn was particularly deep in countries relying on tourism and those with large service sectors – reflecting the nature of the crisis and ensuing lockdowns and border closures – and in countries with high public debt (Figure 2).

¹ Unless otherwise noted, numbers in the text and in the figures are simple averages.

The impact in the first year of the crisis was higher in EMs than in advanced economies (AEs) and in low-income countries (LICs). This outsized decline in EMs relative to AEs was partly due to lower-capacity health systems, which forced reliance on stricter mobility restrictions, and smaller proportion of “teleworkable” jobs ([IMF \(2021a\)](#)). While some LICs avoided output decline, partly due to their younger populations and initially slower virus spread, their 2020 growth as a group was significantly slower than expected prior to the crisis.

Figure 2. EM: 2020 GDP Growth Outcome vs Projections
In Percent



Sources: WEO January 2022 and October 2019.

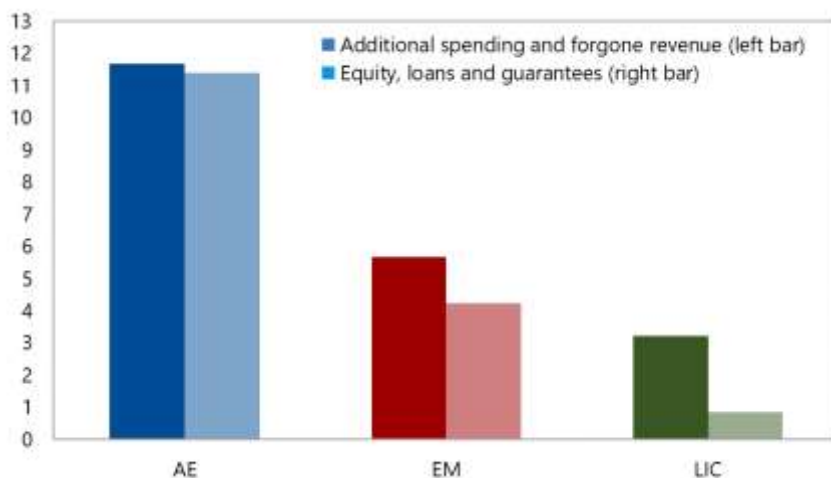
Widespread and unprecedented policy support prevented an even worse outcome. Fiscal, monetary and macroprudential policies were relaxed dramatically around the globe.

The fiscal policy reaction following the initial outbreak of COVID-19 in EMs was decisive. This is in sharp contrast to many previous episodes where fiscal policy support came too late and tended to be procyclical (see e.g., [Cuadra et al \(2010\)](#)). In addition to directly addressing the health crisis, the fiscal policy response in EMs put a floor under output and managed to mitigate the worst effects of the pandemic. The policy easing came through a variety of channels, including both above-the-line (such as additional health, social and public works spending, subsidies, tax breaks and deferrals, employment and unemployment support) and below-the-line measures (such as equity injections, asset purchases, and debt assumptions) as well as guarantees and quasi-fiscal operations. The ability to provide a countercyclical response was in part due to the forceful action of AE central banks, which helped ease global financial conditions and indirectly facilitated continued market access for EMs.

While the average size of fiscal response to the COVID-19 shock in the EMs was substantial, it was still noticeably smaller than in AEs ([IMF \(2021d\)](#), [Alberola et al \(2020\)](#)), which – in addition to the factors mentioned above – explains why EMs experienced a larger growth decline than AEs.

Fiscal responses varied by country depending on their borrowing access and their pre-crisis debt levels ([Gaspar et al \(2020\)](#)). Specifically, in many highly indebted EMs and LICs, governments had limited space to increase borrowing, which restricted their ability to scale up fiscal support (Figure 3).

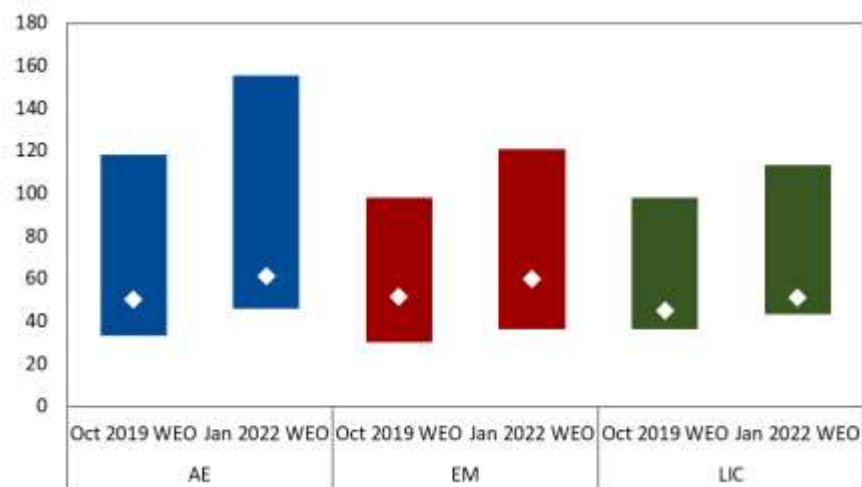
**Figure 3. Discretionary Fiscal Response to the COVID-19 Crisis
In Percent of GDP; Weighted Average**



Source: Database of Fiscal Policy Responses to COVID-19 - October 2021.

Because of this still unprecedented fiscal support, public debt increased significantly. The median public-debt-to-GDP ratio in EMs at the end-2021 stood at 60 percent – 8 percentage points higher than the IMF had expected before the pandemic (Figure 4). The change in the debt ratios reflects not only net new borrowing but also other factors affecting the stock of debt, including currency depreciations, as well as the decline in real GDP.

Figure 4. Public Debt-to-GDP Ratio in 2021
In Percent



Sources: WEO January 2022 and October 2019.

Note: The top and bottom edges of the box represent the 75th and 25th percentile, respectively. The horizontal line in the middle represents the median.

Monetary policy also played a key role in the countercyclical response of EM policymakers to the economic effects of the pandemic. Over 90 percent of EM central banks undertook conventional easing by reducing their policy interest rates ([IMF \(2020a\)](#)), but perhaps more striking was the widespread and unprecedented usage of asset purchase programs among EMs to help ease financial conditions and maintain credit in their domestic economies ([Muhleisen et al \(2020b\)](#)). Early evidence suggests that these programs were by and large successful in stabilizing financial markets and reducing bond yields ([Fratto et al \(2021\)](#), [World Bank \(2021\)](#)).

Prudential policies were also loosened to maintain the flow of credit to the economy and to prevent a wave of bankruptcies triggering a downward spiral. Such actions included, for example, relaxation of loan classification and provisioning rules and lowering countercyclical capital buffers. In some countries, insolvency frameworks for corporates and individuals were suspended or temporarily modified.

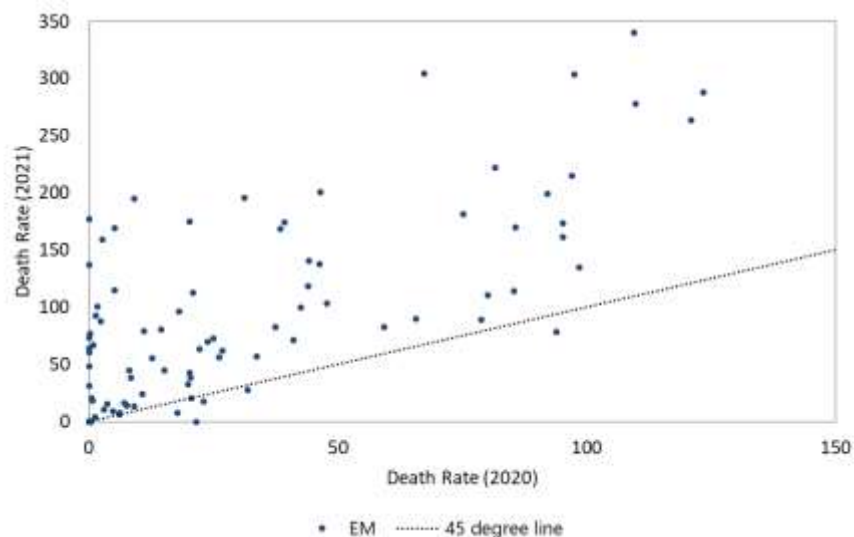
3. Where are we now?

The current conjuncture presents multiple challenges for EM policymakers.

For one, COVID continues to affect lives and livelihoods. Since the first quarter of 2020, global outbreaks of COVID-19 have come in several waves, with each reaching higher daily infection rate than the one before. COVID-19 remains widespread in many EMs, and in most of them, the number of COVID-related deaths in 2021 surpassed that in the first year of the crisis, 2020 (Figure 5). Vaccination rates, although rising, remain lower than targeted by health officials (Figure 6).² Thus, the pandemic continues depressing economic activity.

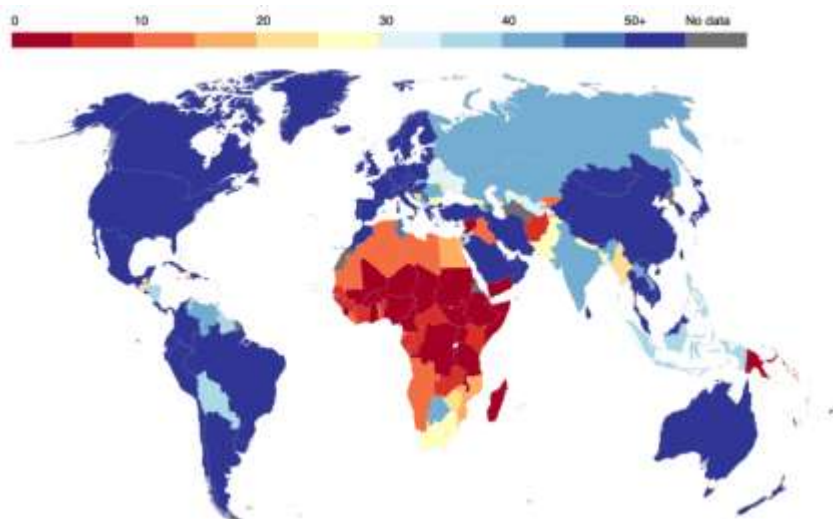
²About 63 percent of EM population had received at least one vaccine dose by end-2021, Institute for Health Metrics and Evaluation at <https://www.healthdata.org/>.

Figure 5. COVID Death Rates
Per 100,000; 2020 vs 2021



Source: Our World in Data, WHO.

Figure 6. Vaccination Rates
Fully Vaccinated; In Percent of Population



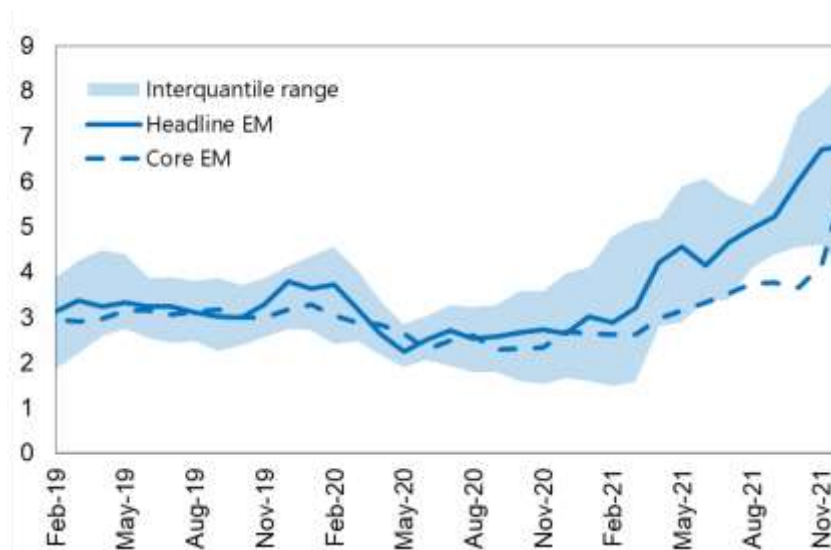
Note: Country borders do not necessarily reflect the IMF's official position.

Source: Our World in Data, WHO. Last update: Dec 23, 2021

Inflation declined early in the pandemic as demand contraction outweighed supply constraints and as commodity prices dropped markedly. The pendulum has swung back in a dramatic fashion, however, with resurgent commodity prices, supply-chain disruptions, labor shortages, and recovery in domestic demand spurring inflation to levels not seen in years ([IMF \(2021f\)](#), [Adrian and Gopinath \(2021\)](#) and [Danninger et al.\(2022\)](#)). The median year-on-year inflation among EMs rose to 6.7 percent in November 2021, compared to

about 3 percent before the pandemic (Figure 7). In countries like Argentina, Brazil, Turkey, and Ukraine inflation has exceeded 10 percent. Many EMs are experiencing a sharp rise in food prices, which account for a sizable share in their consumption basket ([Caselli and Mishra \(2021\)](#) and [IMF \(2021f\)](#)). Core inflation has also risen in many EMs, albeit at a more modest pace, with currency depreciation affecting the price of imported goods. Medium-term inflation expectations appear reasonably well-anchored in most EMs for the moment, but there is a concern that persistently high inflation may affect expectations, making the job of bringing inflation down considerably harder.

Figure 7. EM Inflation
Medians and Headline interquartile range, Percent

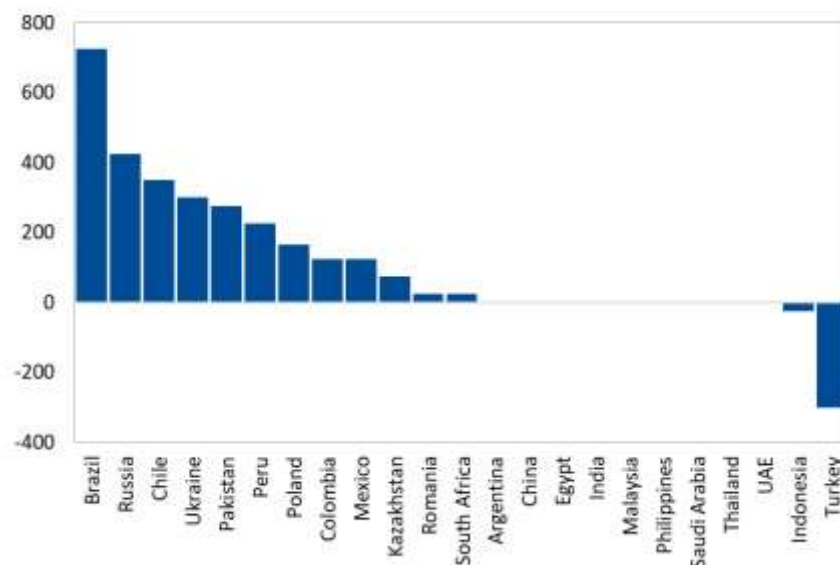


Sources: IMF CPI, GDS databases.

[Note: Only showing 80 percent of the sample in December 2021 due to data availability.]

Concerns over rising inflationary pressures and currency depreciation have compelled an increasing number of EM central banks to begin tightening monetary policy (Figure 8).

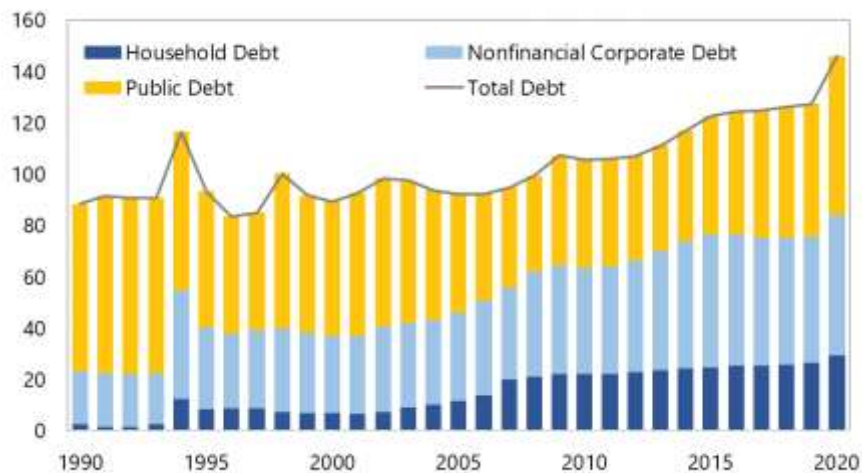
Figure 8. EM Central Bank Moves in 2021
Policy rate, basis points



Source: Haver Analytics.

Troubling levels of public debt have been mentioned above. It is worth noting that private non-financial debt also attained record levels in EMs during the pandemic (Figure 9).

Figure 9. Debt to GDP Ratios Among Ems
Percent of GDP; Excl. China

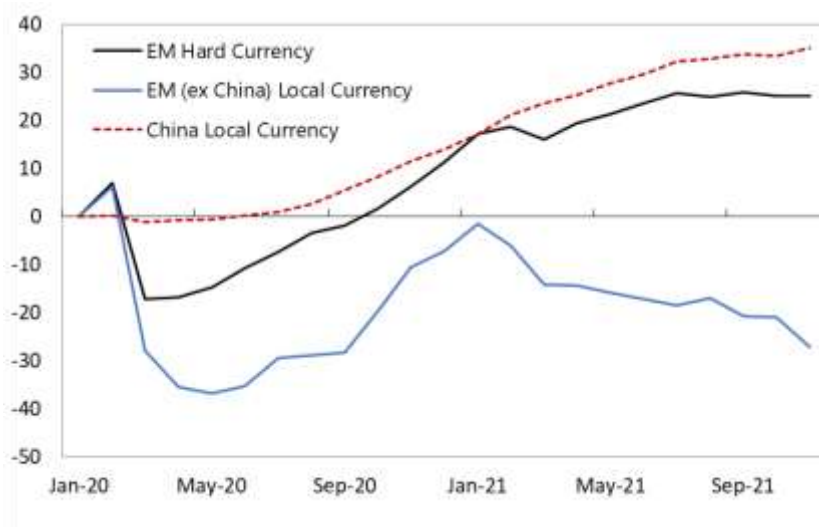


Note: The estimated ratios of global (94 EM countries) debt to GDP are weighted by each country's GDP in USD.

Source: IMF Global Debt Database

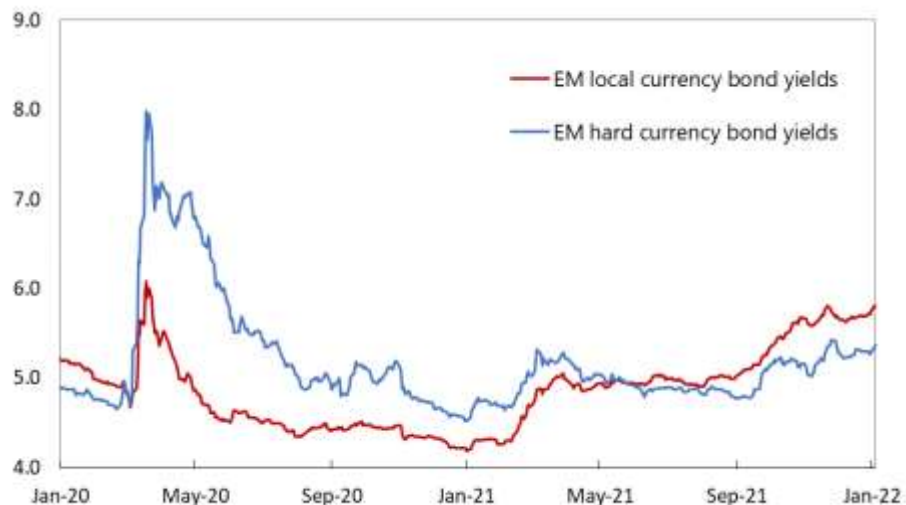
On the positive side, most EMs have substantial FX reserves, partly due to a historic SDR allocation implemented in 2021. While the capital outflows from EMs at the start of the pandemic were large and abrupt (about US\$65 billion between February and May), they were short-lived. Capital inflows began to recover as soon as June 2020, although during 2021 outflows resumed from EM ex. China local currency debt (Figure 10) and yields on that instrument have risen (Figure 11). EM current account positions were stronger in 2019 than before the Global Financial Crisis, and in 2020 current accounts improved in more than half of them, reflecting import compression in those countries and demand for imports in AEs (where production was affected by lockdowns while demand was supported by monetary and fiscal stimulus). Reserves were further boosted by an August 2021 SDR allocation equivalent to US\$650 billion, of which US\$224 billion went to emerging markets ([IMF \(2021b\)](#)). As a result, at the end of 2021, 58 percent of EMs were estimated to have international reserves exceeding 100 percent of the IMF's adequacy metric (Figure 12). Some EMs also benefit from precautionary arrangements with the IMF, swap lines with AE central banks, and other elements of the global financial safety net. Consequently, in aggregate EMs are facing the current uncertain environment with relatively strong external buffers.

Figure 10. Cumulative Emerging Market Bond Fund Flows
In USD billion, since January 2020



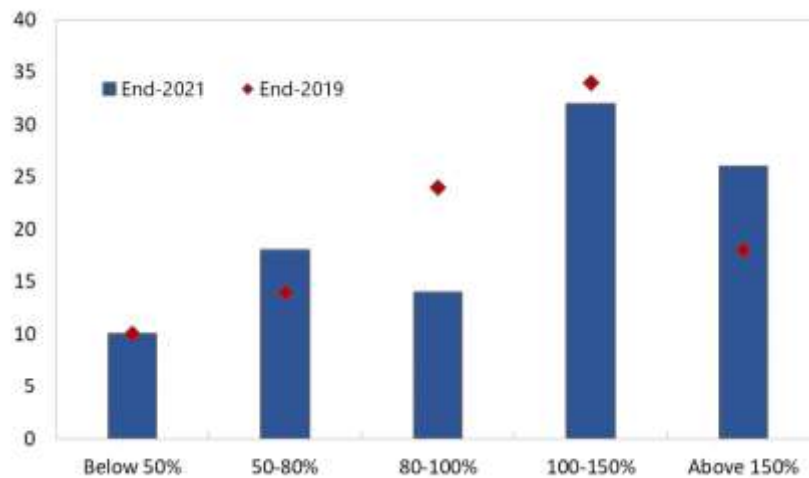
Source: EPFR Database.

Figure 11. Emerging Market Bond Yields
In Percent



Source: Bloomberg.

Figure 12. Reserves Adequacy
In Percent of EMs



Sources: Assessing Reserves Adequacy Database; WEO January 2022; and staff calculations.

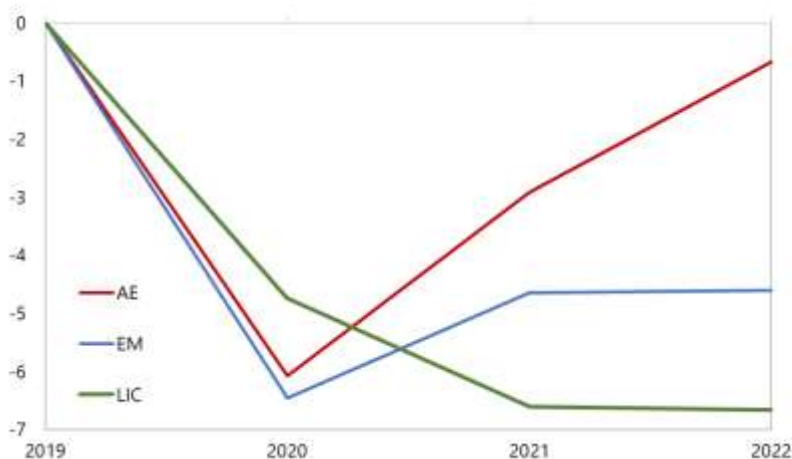
Note: Reserves in percent of the weighted sum of four potential BOP drains, specifically short-term debt, broad money, net-exports, and other external liabilities.

4. Prospects and Policy Challenges

Most EMs have entered 2022 against the background of tightening global financial conditions, with the pandemic still depressing activity but inflation significantly exceeding desirable levels and with elevated public and private debt – vulnerabilities somewhat mitigated by considerable international reserves. What are their near-term prospects and what are the optimal economic policy settings in these challenging circumstances?

The economic recovery is expected to continue but to remain incomplete, uneven, and subject to downside risks. The IMF is projecting a significantly slower return to pre-pandemic output for EMs than AEs, in part due to a slower rollout and administration of vaccines ([IMF \(2022\)](#)); it does not expect EMs as a group to catch up to their pre-pandemic trajectory (Figure 13). Rising energy and food prices coupled with persistent supply chain disruptions amid high uncertainty regarding the evolution and consequences of the pandemic continue to exert inflationary pressures in EMs that is envisaged to remain elevated through 2022, albeit with significant variation across the EM countries ([Adrian and Gopinath \(2021\)](#) and [Danninger et al \(2022\)](#)). Core inflation is also expected to remain elevated in 2022, buoyed by a rebound in domestic demand, wage pressures in some labor market sectors, lingering supply disruptions, and an increase in shipping costs. These inflationary pressures are, however, expected to subside in 2023 reflecting softening of commodity prices, ebbing of supply-demand imbalances, and anchoring of inflation expectations due to tightening of monetary policy, alongside further scaling back of fiscal support, contributing to more subdued aggregating demand.

Figure 13. Activity Shortfall
Percent Deviation from OCT 2019 WEO Projection



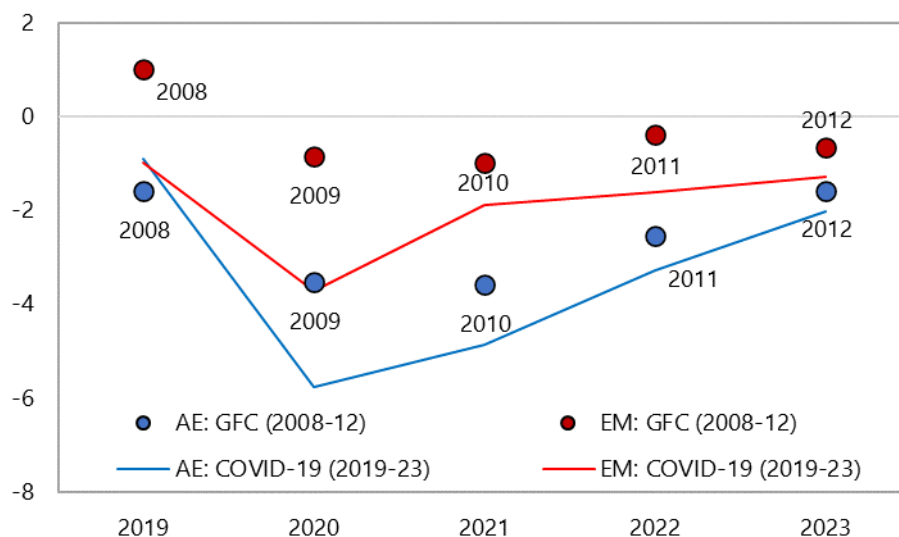
Sources: October 2019 and January 2022 WEO

4.1 Policy responses

For EMs as a group, the strength of the recovery is constrained by the limited ability of policymakers to support growth, compared to their AE counterparts ([Muhleisen et al \(2020a\)](#)). This is the case both for fiscal policy, where debt levels are elevated (Figure 14), and for monetary policy, where interest rates are increasing from historically low levels, inflation is in many cases above target, and the ability to ease is restricted by external considerations such as capital flows and exchange rate moves. However, there is great heterogeneity within

EMs in terms of the availability of policy space, both on fiscal and on monetary front. Furthermore, structural challenges to growth and the extent to which the sectoral composition constitutes a headwind or tailwind to the post-pandemic world are highly country-specific. The rest of this section discusses these factors, how policymakers can boost the recovery prospects, and a number of constraints that are particularly acute for emerging markets.

**Figure 14. Fiscal Support: G-20 General Government cyclically adjusted primary balance
Percent of potential in fiscal year GDP**



Notes: Data not available for SAU. Aggregates are simple averages across G-20 economies.

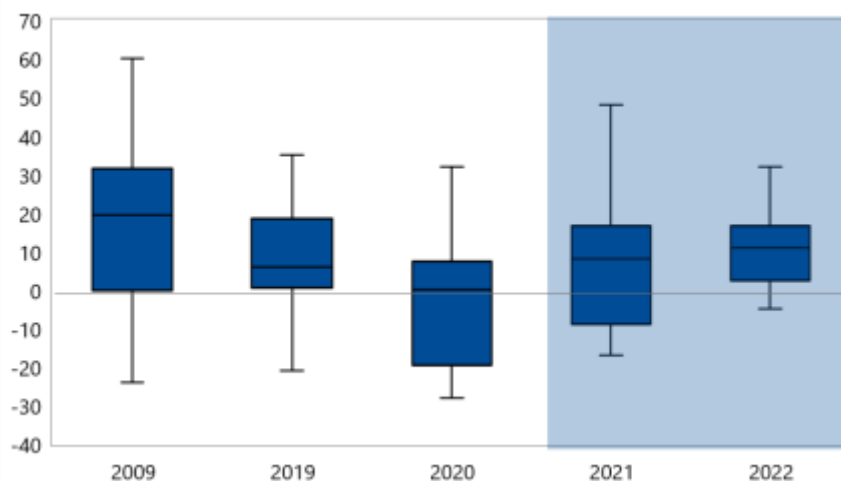
Sources: January 2022 WEO; and IMF staff calculations. See IMF (2022 forthcoming).

4.2. Debt issues

The debt levels represent a key risk to emerging markets as a group, even as the recovery continues, as a rise in growth may not fully compensate for the adverse effect that higher interest rates will have on debt dynamics. Countries are therefore expected to face a tradeoff between supporting the recovery and addressing debt sustainability concerns, which will constrain EMs more than AEs during the tightening cycle, just as it did in the expansionary period of 2020 (Blanchard et al (2021)). This will in turn complicate the outlook in coming years for EM policymakers and potentially affect their development agendas (Gaspar et al (2021)). This is particularly the case for countries with especially elevated debt levels, large exposures to foreign currency debt, and short maturities with large repricing and rollover risks.

As noted above, not only public but also private debt has risen to concerning levels. High corporate and household debt makes the financial system vulnerable to an increase in interest rates. While the multi-faceted supportive policies and relaxation of prudential rules have kept many stressed corporates afloat, such that the initially expected wave of bankruptcies did not materialize, eventual withdrawal of extraordinary support and forbearance along with tightening of financial conditions will likely lead to a spike in insolvencies (Figure 15).

Figure 15. Corporate Insolvencies: Distribution across EMs
Annual change in percent



Sources: Euler Hermes, and IMF staff calculation

A surge in defaults could affect the banking system and restrict the flow of credit. The negative impact on the economy would affect tax collection, potentially exacerbating concerns about public debt sustainability. Corporate and sovereign spreads tend to move in tandem ([Augustin, et al., \(2018\)](#)). During the onset of the pandemic, both corporate and sovereign spreads spiked due to heightened uncertainty and shocks but later narrowed as conditions improved and as governments infused significant support into the corporate sector. Looking ahead, EM policymakers should rebuild buffers as market conditions allow, including by reducing public debt and increasing foreign exchange reserves as needed. In addition to these required efforts, the IMF's recent Special Drawing Rights (SDR) allocation helped increase policy space for several countries and improved liquidity conditions ([IMF \(2021c\)](#)). To deal with lingering effects from the pandemic, tailored support measures to viable firms is important while macroprudential policies should be mobilized to address building financial vulnerabilities such as rising house prices in some EMs (see [IMF \(2021e\)](#)).

4.3. Monetary policy tightening

As has been mentioned, many EMs moved ahead of AEs in unwinding emergency measures and tightening monetary policy. This response has helped sustain policy credibility and likely contributed to long-term inflation expectations remaining broadly anchored, apart from a handful of idiosyncratic cases, during the initial stages of the recovery. Nevertheless, the challenge of tightening policy to secure price stability will be sizeable going forward in light of the significant output and employment shortfalls that still remain in most EMs and the need to recoup these to the extent possible ([Adrian and Gopinath \(2021\)](#)).

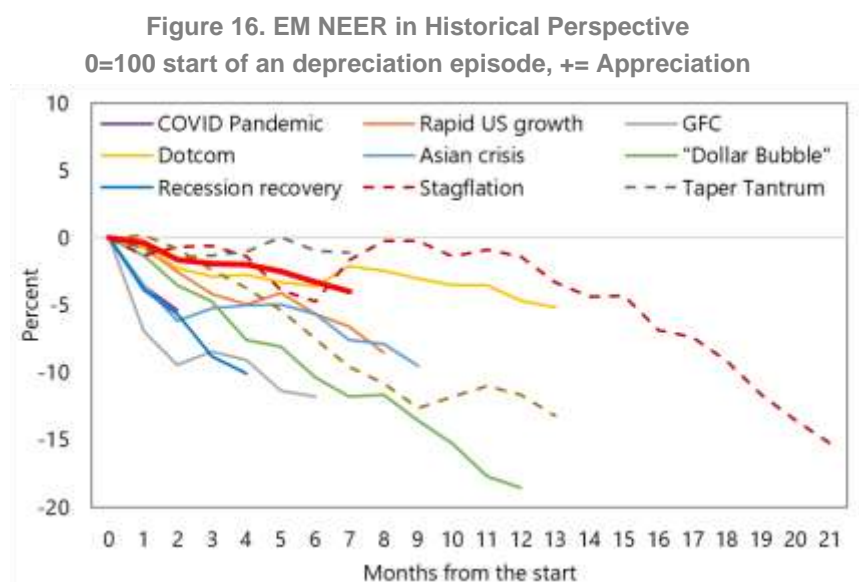
The challenges to calibrating monetary policy stem from the heightened uncertainty caused by the pandemic, the tradeoff between supporting the economy and fighting inflation, and the exposure to external conditions. External risks stem primarily from EMs' reliance on global financial markets and their consequent sensitivity to global financial conditions ([Mimir and Sunel \(2019\)](#), [Tobal and Menna \(2020\)](#)).

In particular, tightening of monetary policy in the US could involve significant spillovers in terms of capital flows and exchange rate movements of emerging markets. These spillovers would subsequently affect domestic financial conditions and inflation. Countries with strong fiscal positions, robust institutions, and smaller exposure to both currency volatility and interest rate shocks will be better able to respond to adverse shocks.

On the other hand, vulnerable countries with elevated debt levels and weaker institutions may struggle to mitigate any spillovers from global conditions on the domestic economy ([Harjes et al \(2020\)](#)). The next section considers this challenge in some detail.

5. Potential tightening in global financial conditions and US dollar appreciation

Concerns are growing about the impact on emerging markets of a significant rise in US interest rates, which could lead to a tightening of global financial conditions and US dollar appreciation (see, e.g., [Mishra \(2021\)](#)). While the recent EM currency depreciation – and its flip side, US dollar appreciation – appears moderate by historical standards, dollar appreciation episodes are often prolonged, and the current trend may continue, putting more pressure on the EMs (Figure 16).

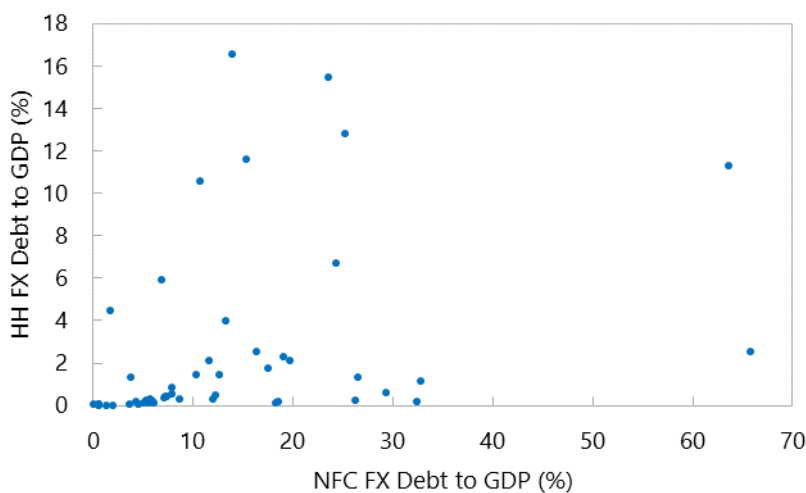


As noted in [IMF \(2021a\)](#) and in [Hoek et al \(2021\)](#), when an increase in the expected US policy rate is driven by positive news about economic activity in the US, on balance this combination tends to be beneficial for EMs, supporting them through the trade channel and through a reduction in risk premiums and often stimulating capital inflows. The situation may be quite a bit more challenging when the tightening of global financial conditions is driven by concerns about inflation or changes in risk sentiment ([IMF \(2022\)](#)).

Recent analysis under the umbrella of the Integrated Policy Framework ([IMF \(2020b\)](#)) makes a strong case that countries with large unhedged foreign exchange liabilities or high inflation passthrough may be particularly vulnerable to a tightening of global financial conditions and US dollar appreciation ([Adrian et al, \(2020\)](#) and [Basu et al \(2020\)](#)).

Data shows that private non-financial debt in foreign currency relative to the size of the economy varies considerably across countries, and some have significant exposures, particularly on the corporate side (Figure 17). Some sovereigns are also exposed to exchange rate fluctuations, although much less than in the past thanks to the greater prevalence of borrowing in domestic currency.

Figure 17. Foreign Exchange Debt of households and Non-Financial Corporations percent of GDP



Notes: HH= Households, NFC= non-financial corporate sector, FX – foreign exchange.
Sources: Bank for International Settlements and International Financial Statistics.

As a caveat, some of these liabilities may be offset by foreign exchange assets or by natural or financial hedges, but comparable data on such offsets across countries is unavailable.

Meanwhile, Uncovered Interest Parity (UIP) premiums – a measure of frictions in shallow foreign exchange markets – spiked for many countries during the COVID shock, showing their continued vulnerability to swings in investor sentiment ([Das et al \(2022\)](#)).

Regarding the passthrough from local currency depreciation into inflation, recent research has documented a noticeable decline in passthrough in emerging markets after the Global Financial Crisis as well as the fact that passthrough remains higher in EMs than in advanced economies ([Jasova et al \(2019\)](#)).

How should countries react to the tightening in financial conditions? This depends on country characteristics, and also on the nature of tightening – whether it is orderly or accompanied by market turbulence, including episodic tantrums in US dollar funding markets.

Drawing on the above-mentioned Integrated Policy Framework analysis, we note that countries without meaningful currency mismatches and with deep foreign exchange markets and well-established monetary frameworks should allow exchange rate flexibility to absorb the shocks while using the policy rate to control domestic financial conditions.

On the other hand, if inflation expectations are not well anchored or if investor sentiment shocks destabilize UIP premiums in shallow currency markets, foreign exchange intervention may help contain the premiums and limit depreciation – provided the country’s international reserves are adequate. Of course, the benefits of intervention need to be considered against potential impact on market development and other long-term effects. High public debt may create additional challenges in countries with less credible central banks. Communicating clearly plans for medium-term fiscal consolidation and reasserting the independence of monetary policy is essential to allay fears of debt monetization. In the event of a sudden stop, interest rate defense of the exchange rate alongside outflow capital flow management measures may be necessary.

As usual, being proactive is better than being reactive. Countries with excessive foreign currency debt should encourage private sector deleveraging. Macroprudential policy could play an important role in addressing nonfinancial sector vulnerabilities, mitigating future financial stability risks, and strengthening resilience. Countries where inflation expectations are not well anchored should bolster the credibility of their monetary policy frameworks. Of course, this takes time. Meanwhile, some countries could benefit from various precautionary arrangements available through the global financial safety net to install additional buffers.

6. Conclusion

Emerging markets have withstood the shock of COVID-19. The blow was heavy, but widespread economic collapse has been avoided thanks to credible institutions in many EMs, decisive policies and, in some cases, emergency financial support. A recovery is under way, but it is incomplete, uneven, and subject to downside risks.

A challenging period lies ahead for emerging markets. Both the shock and the extraordinary policies to soften its impact have led to accumulation of public and private debt and other vulnerabilities. These vulnerabilities have reduced policy space and sharpened the tradeoffs between supporting growth and maintaining stability.

Appropriate calibration of the pace at which policy support is withdrawn is a key challenge for emerging market policy makers.

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