Allianz Research

Centrifugal emerging markets

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EXECUTIVE SUMMARY

- **Crisis after crisis, emerging market economies (EMs) have questioned a global financial system dominated by advanced economies and anchored to the US financial cycle.** From pandemic-strained supply chains, over exposed flaws in energy markets and sanctions coordination, to the most recent tremors in the banking sector—fragmentation seems to become inevitable. In the meantime, China and several larger EMs have become more deliberate and strategic in promoting initiatives to achieve greater monetary sovereignty and reducing their dependence on cross-border capital flows from advanced economies.

- **A multipolar financial system could be more resilient and welfare-enhancing, especially for smaller economies dependent on foreign capital—but it also raises the stakes for greater policy coordination.** Deeper local capital markets in EMs could help cushion the impact of external shocks, and more so when cycles are not completely synchronized. However, decoupling also means matching the policy framework and governance in EMs to the standards underpinning the current global financial system, which will take time. Geopolitical tensions require more (rather than less) interaction and coordination to help shape a global financial system that acknowledges the greater economic role of EMs.

The consensus on the post-Bretton Woods framework of global finance seems to be fraying

Growing fragmentation and geopolitical tensions are challenging globalization just when international coordination is needed the most. The recent crises have strained global supply chains, tested the willingness of countries to coordinate their containment of a deadly virus and exposed critical flaws in energy markets in many parts of the world. At the same time, policy choices adopted to address these economic shocks have had unintended consequences and, if used deliberately for economic gains at the expense of others, could also slow or even reverse decades of global integration. In many countries, public support for economic openness has declined and cross-border flows of goods and capital have levelled off for more than a decade (in relation to GDP), even as data flows have increased massively. In addition, current tremors in the banking sector further the raise the stakes for greater policy coordination to mitigate the risk of adverse spillover effects from financial shocks.

Added to this are geopolitical tensions, which have made it even more difficult to achieve international agreement on critical challenges and raised the specter of international finance and trade fragmenting into rival economic blocs. More recently, the three prominent bank failures in the US and the recent shotgun wedding of UBS and Credit Suisse have inflicted financial-sector trauma again in advanced economies, hinting at further dislocations, which are likely to have outsized economic implications for many emerging market (EM) economies. According to a recent IMF study (2023), the longer-term cost of trade fragmentation alone could range from 0.2% of global output in a limited fragmentation scenario to almost 7% in a severe scenario. If technological decoupling is added to the mix, some countries could see losses of up to 12% of GDP.[1]

The energy crisis (and related Western sanctions[2]) triggered by the war in Ukraine has also catalyzed efforts to dismantle the current global financial system. The freeze on Russia's foreign exchange reserves held by other central banks raised concerns in several large EM countries about the dominance of the US financial system and the extent to which the global monetary regime is entangled with US foreign policy (and that of mostly Western allies). But even before the war in Ukraine, BRICS countries had already become more deliberate and strategic about gradually weaning themselves off the US-dominated financial-market infrastructure and intermediation of global capital flows.

Many EMs want to achieve greater monetary sovereignty and less reliance on foreign capital through greater regional integration of trade and finance

Given their limited local capital market development and high reliance on external borrowing, EM countries tend to be highly vulnerable to financing conditions in advanced economies. For instance, during tightening cycles, central banks in EMs have little room to maneuver lest they put exchange rate stability at risk (since a high share of USD-denominated trade invoicing limits the benefit from cheaper exports). One of the preconditions for monetary sovereignty in an open economy is sufficient size. While China has made some efforts[3] in opening its capital account to internationalize its currency, the share of the Chinese Yuan in central bank reserves is still small (Box 1, Figure 1.1). Smaller EM countries have proposed common currency areas to achieve greater size by aggregation. However, insufficient economic and financial integration limits their potential for creating effective and sustainable currency unions (Figure 1). Alternatively, monetary sovereignty can be achieved via reserve accumulation, and we find a clear trend in many EMs towards greater reserve accumulation in non-USD assets, such as gold (Box 1, Figure 1.2). The temporary one-sided gold-fixing of the Russian ruble in combination with ruble-invoicing of energy exports reintroduced a de facto gold standard, which could provide the blueprint for commodity-exporting countries to depart from the post-Bretton Woods system of fiat currencies and achieve greater monetary sovereignty.

Seeking greater monetary sovereignty also means greater mutual crisis support without the involvement of advanced economies. Intra-EM monetary support has increased over the last 30 years in the wake of painful crises in the 1980s and 1990s. In the wake of the Asian crisis, the Chiang Mai Initiative (CMI)[4] of major Asian economies introduced a regional multicurrency swap arrangement, which has fostered greater coordination of monetary policy in the Asia-Pacific region. The bilaterally-agreed currency swaps among EM countries are another more

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[1] The full impact would likely be even larger, depending on how many channels of fragmentation are factored in. In addition to trade restrictions and barriers to the spread of technology, it could be felt through restrictions on cross-border migration, reduced capital flows and a sharp decline in international cooperation that would leave us unable to address the challenges of a more shock-prone world.

[2] Read our full report on the topic at Rallying Ruble and the weaponization of finance.

[3] Read our full report on CNY rise at : Financial globalization: moving towards a polarized system?

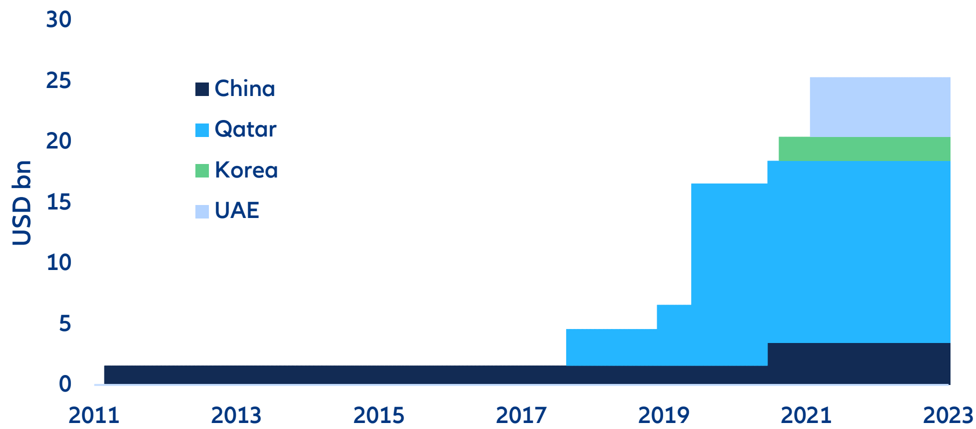
[4] The CMI is the first regional currency swap arrangement launched by the ASEAN+3 countries in May 2000 at an annual meeting of the Asian Development Bank to address short-term liquidity difficulties in the region and supplement existing international financial arrangements. Although it cannot be considered an EM-only initiative since it includes Japan and South Korea as member countries, it is a regional initiative that promotes financial assistance independent of institutions and arrangements that involve the US.

recent example, including the Central Bank of Turkey's "lira-ization" experiment (Figure 2), which has arguably kept it going.

Figure 1: Common currency proposals in emerging market (EM) countries

Source: Allianz Research. Note: Brazil has been part of Gaucho, Sur and R5 initiatives. 1/ R5 current proposal is an SDR-type reserve currency rather than common currency area.

Figure 2: Bilateral FX swap agreements with the Central Bank of Turkey



Sources: Central Bank of Turkey, Allianz Research. Note: The chart does not include other type of support that has de facto helped the country in the same way (e.g. Saudi USD deposits at the Central Bank of Turkey).

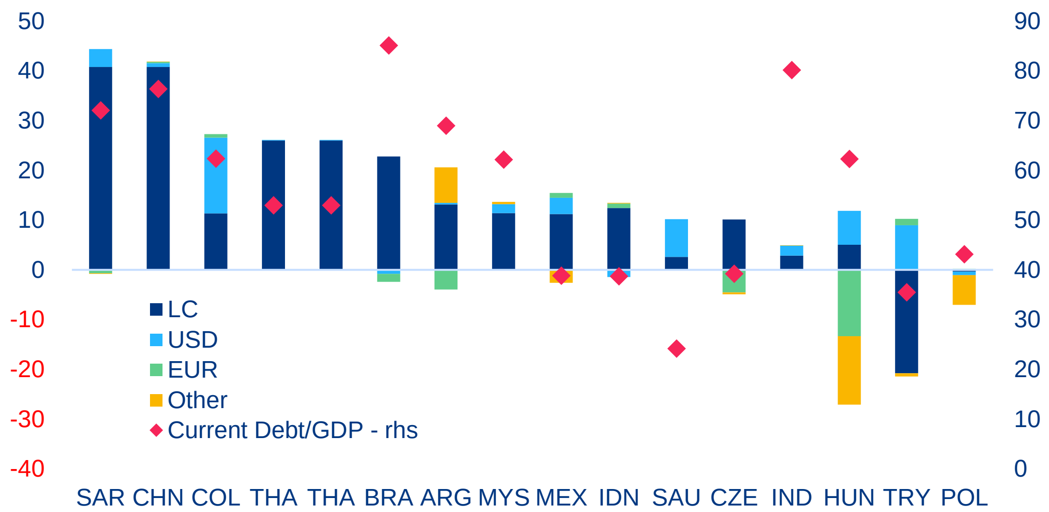
Some EMs are also trying to reduce their dependence on the US-dominated monetary system and financial-market infrastructure. Since many US banks pared back their correspondent networks and services[5], many EMs were left without sufficient or affordable access to the global

[5] *Although de-risking has been a general trend, it has disproportionally affected those countries with weaker institutional frameworks, of which many are EM countries.*

financial system. As a result, China set up its own wholesale[6] payment system (CIPS) to facilitate cross-border settlement without access to the global financial system. BRICS member countries plan to explore the creation of their own reserve currency, as well as interoperable central bank digital currencies. These would directly connect digital currencies within a common technical infrastructure (e.g. "Project mBridge" by the Hong Kong Monetary Authority, the Bank of Thailand, the People's Bank of China and the Central Bank of the United Arab Emirates).

In addition, many EMs are trying to diversify their cross-border capital flows. Traditionally, advanced economies were the main source of external finance for EMs, largely via financial hubs that would recycle EM savings. As a result, a large proportion of the external debt issued by EMs is still denominated in USD, and to a lesser extent in EUR, because of the resulting cheaper cost of funds. However, several EMs are moving away from this "original sin" to diversify funding and mitigate their dependence on US monetary policy (Figure 3). As much as borrowers benefit from a larger pool of lenders, countries such as China and Gulf Cooperation Council members have also increased their bilateral lending to vulnerable EM countries or expanded their foreign direct investment activities. The Belt and Road Initiative is a case in point, with the surge in lending by China to African countries and rising geo-economic influence in many countries in Central and South-East Asia.

Figure 3: Change in currency composition of government debt (% of GDP) in selected emerging market countries

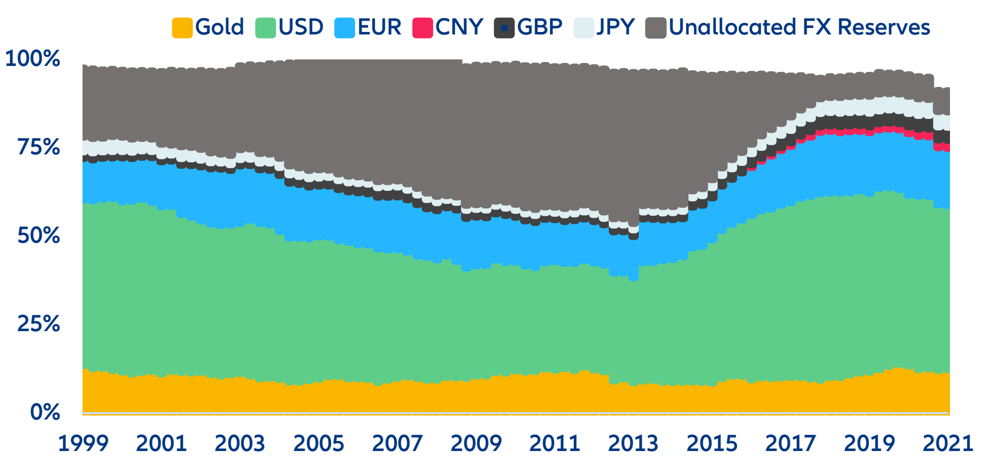


Sources: Institute for International Finance (IIF), Allianz Research

[6] *A wholesale payment system is a contractual and operational arrangement that banks and other financial institutions use to transfer large-value, time-critical funds to each other. It is operated either by a central bank or by a coalition of banks and financial institutions.*

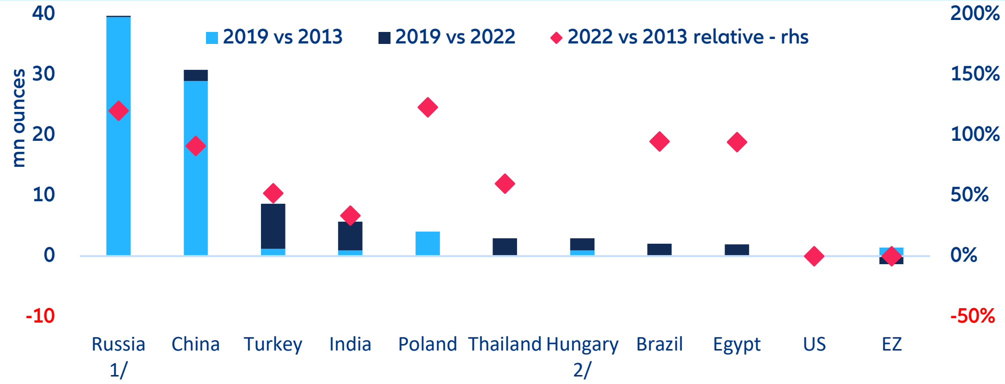
Box 1: Composition of central bank FX reserves in emerging market (EM) countries.

Figure 1.1: Composition of official CB reserves



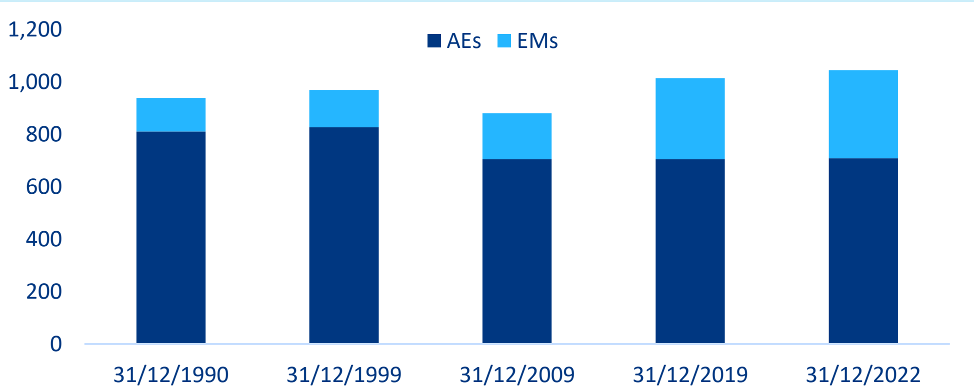
Sources: IMF, Refinitiv, Allianz Research

Figure 1.2: Increase in gold holdings in selected advanced and emerging market economies



Sources: IMF, Refinitiv, Allianz Research. Note: 1/ official gold reserves in the CBR were last reported in January 2022; 2/ Hungary gold holdings in 2013 were close to zero.

Figure 1.3: Gold holdings convergence between advanced and emerging market economies (mn ounces)



Sources: IMF, Refinitiv, Allianz Research

The establishment of international financial institutions – especially led by China – is another sign of increasing influence via investment. As a result of its dissatisfaction with its limited influence within international financial institutions such as the World Bank, China created the Asian Infrastructure Investment Bank (AIIB), which unlike the Asian Development Bank (ADB) excludes the US and Japan[7]. While its investment activities remain small compared to those of the ADB, it is a clear political statement looking to reshape regional influence. The BRICS group also created its own international financial institution, the New Development Bank, to create a financing arm for the group's ambitious plans. The bank even includes smaller EM countries that are not members of the BRICS group (for a summary of potential joiners to the group, see Figure 4).[8] In particular, China has scaled up its FDI in EMs, a strategy conceived at the People´s Congress Meeting in 2000, which eventually became part of 10th Five Year Plan. The country has become the second-largest foreign investor since 2015 and has expanded its sphere of influence ever since (Figure 5). In this context, private capital has become the major driver of FDI over time.

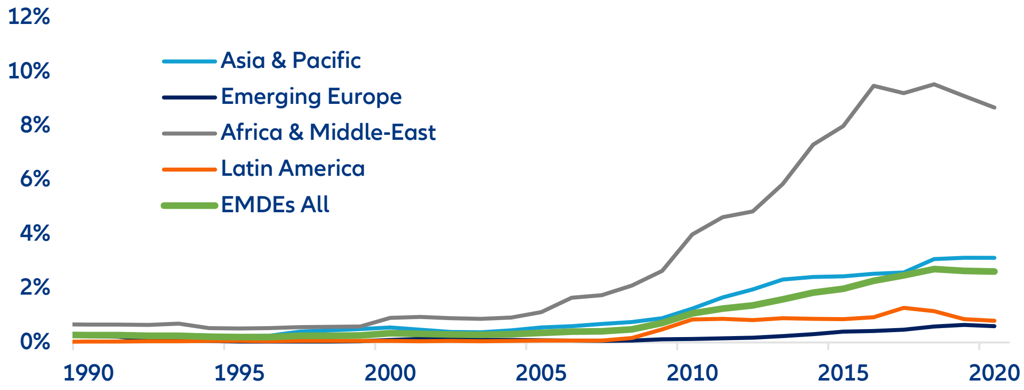
Figure 4: Overview of BRICS membership (current and proposed member countries)

Source: Allianz Research. Note: the extended membership (BRICS+) would comprise 50% of the global population and its GDP would be 30% higher than that of the US, with an important control over energy commodities (particularly natural gas).

Alongside the start of financial decoupling, global trade and political relationships are also fragmenting. New institutions have emerged, such as the Shanghai Cooperation Organization (SCO),[9] while the established fora for trade negotiations, such as the WTO, have fallen out of favor relative to regional trade agreements (also partly due to the protectionist shift from the US).

[7] However, other Western economies are part of the non-regional members and in fact contribute with important amounts: Australia, Canada, several Eurozone countries and the UK.
[8] Argentina is allegedly poised to join, with other countries such as Iran, Saudi Arabia, Egypt and Turkey showing increasing interest. Unanimous acceptance is needed.
[9] Initially a Sino-Russo initiative to solve border disputes, it has gone from dealing with security to boosting members' economic cooperation. Its Asian membership covers 40% of the global population and 30% of GDP. Among its members are China, India, Russia, Pakistan and Iran, and there are plans to attract, Egypt, Saudi Arabia, and Turkey as new members.

Figure 5: Share of emerging market external debt owed to China (%)



Sources: World Bank, Allianz Research

A multipolar financial world could be more resilient and welfare-enhancing if it helps deepen local capital markets and cushion the impact of external shocks on EMs. However, decoupling also means matching the policy framework and governance in EMs to the standards underpinning the current global financial system, which will take time.

These assessments are, as always, subject to the disclaimer provided below.

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