Eurozone Crisis Threatens Emerging Market Economies

Posted on

As the eurozone's three-year-old debt worries continue to punish the global economy, there are new warnings that reduced lending by European banks mean the effects of the crisis could be most deeply felt in the developing world.

Stephen Lowman / dpa / The Interview People

In what it called a "bombshell" for developing nations, a June analysis by the Overseas Development Institute, a London-based think tank, estimated that the effects of the eurozone crisis would cost the developing world 238 billion dollars in 2012 and 2013.

The report singled out Mozambique, Kenya, Niger, Cameroon, Cape Verde and Paraguay among the countries most at risk."The ability of developing countries to respond to the shock waves emanating from the euro area crisis is likely to be constrained if international finance dries up and global conditions deteriorate sharply," wrote Isabella Massa, the report's author. Indeed, European banks began closing their credit spigots to emerging economies as their attention shifted to the financial turmoil at home.

Between 2000 and 2008, investors and lenders in eurozone countries were the world's chief source of private capital, and a particularly important lender to emerging markets.

However, the International Finance Corporation (IFC), an arm of the World Bank that promotes the private sector in developing countries, reported in June that capital outflows in the form of foreign direct investment (FDI), portfolio equity investments and commercial bank lending had seen significant declines.

In 2011, outflows from the eurozone to the rest of world totaled 248 billion dollars, an amount that was about half that of the previous year. Capital inflows to emerging economies declined over the same period, according to the IFC.

This decrease in lending threatens developing economies that depend on financial backing from developed economies such as the 17-nation eurozone. The International Monetary Fund has forecast a 5.4-per-cent growth rate for emerging markets in 2012, a decrease from the 6.2 per cent experienced in 2011. The fund blamed this slowdown, in part, on weaker capital flows from Europe.

“When investors panic they get risk averse from emerging markets,” said Franto Ricka, a principal economist with the European Bank for Reconstruction and Development (EBRD).

He said this has led European banks to cut financial ties with emerging markets, especially as financial regulators demand that they deleverage and strengthen their balance sheets. Private capital flows into the transition economies monitored by the EBRD – Central and Eastern Europe, as well as four countries in Middle East and North Africa – were negative in the third and fourth quarters of 2011 and most recent data suggest they remained negative in the first quarter of 2012 as well. Economists said that declining private financing can lead to reduced economic growth, income and access to liquidity in developing countries. Unemployment is almost certain to rise in such conditions.

Perhaps most significantly, the shrinking supply of credit has the potential to cause disruptions in the energy and agriculture sectors of the most vulnerable countries, an outcome the IFC warned “would produce very negative consequences.” To combat this, the EBRD and IFC have programmes that aim to mitigate the risk to banks undertaking trade-related financing to emerging markets.

For instance, in March the IFC launched the Critical Commodities Finance Program, which shares the investment risk with banks that have become hesitant to provide credit to agriculture-related businesses in developing countries. The programme is crucial, according to the IFC, because 38 of the world’s poorest countries rely on their agriculture sectors to provide more than half their nation’s jobs.

Africa, which exports mainly commodities to Europe, is particularly vulnerable to spillover effects from the eurozone crisis. Europe remains Africa’s largest trading partner as a region and moreover, stalling European economies are also contributing to cooler growth in China, an increasingly important player in African economies.“A sustained debt crisis translates to decreased demand for Africa’s exports,” said Memory Dube, senior economics researcher at the South African Institute of International Affairs.

A May report by Ernst & Young held good news: FDI projects on the continent, many from Europe and China, jumped 27 per cent in 2011 from the previous year. But Dube, who characterized the impact the eurozone has had to date on Africa as “fairly limited,” said that deteriorating economic growth in Europe “threatens” FDI investment in Africa. “We cannot afford to have the crisis drag on because then we will start feeling the impacts in the same way as the global economic crisis of 2008,” she said.