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Endemic uncertainties in developing countries: Issues arising from an increased interdependence between banks and the state

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MacroDev - Semestrial Panorama

Semestrial Panoramas are special issues of the **MacroDev** series written by analysts from the Agence Française de Développement (AFD) (French Development Agency). They present a synthesis of macroeconomic and socioeconomic analyses of emerging and developing countries (EDCs). One feature of these short, country-focused articles is a thematic section that sheds light on the short-term and structural issues and major challenges affecting these countries.

List of authors

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Editorial:

Endemic uncertainties in emerging and developing countries

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After a chaotic year of recovery primarily led by the advanced economies, as we begin 2022 it is clear that the anticipated normalization of the economic situation in emerging and developing countries (EDCs), and their return to pre-COVID-19 trajectories, face numerous obstacles. First, the rapid spread of the Omicron variant threatens to prolong the impact of the pandemic on the global economy. In the medium term, the slow progress of COVID-19 vaccination programs in many EDCs (notably in Africa) increases the likelihood of new viral mutations emerging, although this is offset by a lower mortality rate than in the rest of the world. Further slowdowns in activity, additional supply chain disruption, and international travel restrictions therefore need to be incorporated into the main economic scenario for 2022, if not beyond. Uncertain economic prospects, combined with slowdown in China, are also likely to curb the commodity price increases seen last year. The rise in inflation, even when energy and food prices are excluded, has also been more significant and sustained than expected. Continued high inflation levels for at least the first part of the year will negatively affect growth through their impact on consumption—a recessive effect likely to be exacerbated by the tightening of monetary policy in several emerging countries, notably in Latin America. In order to maintain their credibility, several central banks have been forced to react rapidly to inflation that is higher than target figures by raising their base rates, in countries that experienced major recessions in 2020 and where employment has not returned to pre-pandemic levels. Low-income countries are also particularly affected by rising food prices.

Finally, the accelerated normalization of monetary policy in advanced economies, particularly in the United States, is likely to have an impact on EDCs by creating tougher international financial conditions. While acute financing problems remain highly localized at this stage, some countries which had benefited from a relatively high appetite for global risk are now seeing their spreads rise again, and for the vast majority of EDCs these are still higher than they were in December 2019. Concomitant appreciation of the US dollar presents a further risk for EDCs with high levels of debt held in this currency. Against the backdrop of a general rise in debt levels, the fiscal policy of EDCs is also likely to remain constrained this year, between the pressure to reduce budget deficits and the persistent impact of the pandemic on employment and purchasing power among vulnerable populations. In several countries, upcoming elections could further complicate the fiscal equation by exacerbating social and political tensions. Increased use of financing from the domestic banking sector in order to cover the additional spending arising from the COVID-19 pandemic has provided a major source of resilience for many EDCs. When the withdrawal of capital flows and the rise of spreads on international financial obligations resulted in external financing largely drying up at the height of the pandemic, mobilization of the local financial sector enabled numerous states to cover their public financing needs at a relatively low cost due to accommodative monetary policies. This second issue of *MacroDev: Semestrial Panorama* offers a cross-country analysis of the medium-term consequences of a rise in sovereign debt held by the local financial sector, and the risks associated with the increased interconnectedness of the state, central banks, and commercial banks. Ten country focus articles also illustrate the wide variety of issues arising from the financing of the economy and government by the local banking sector, and summarize the key economic and financial developments in the countries concerned: Cameroon, Ethiopia, Ghana, Kenya, Togo, Indonesia, Lebanon, Brazil, Costa Rica, and the Dominican Republic.

Thematic section

Issues raised by the banking sector financing the government in developing countries

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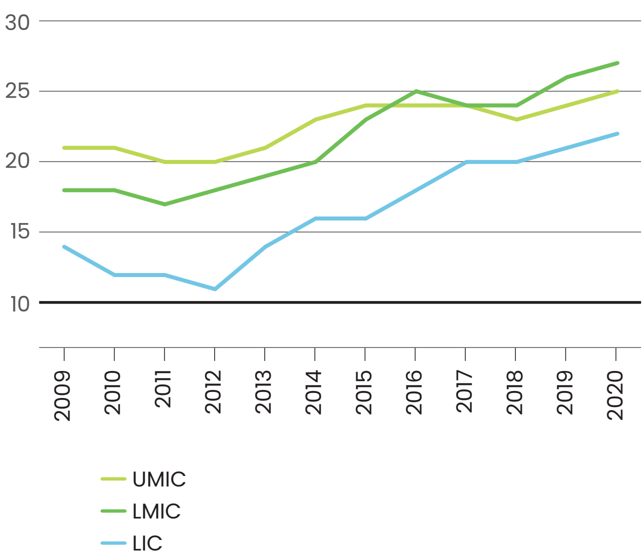
In the April 2021 Global Financial Stability Report, the International Monetary Fund (IMF) noted the increased interconnectedness of sovereign risk and banking risk in major emerging countries due to the economic and financial impact of the COVID-19 crisis (IMF, 2021a). The pandemic has generated large public financing needs in these countries, and over 60% of the additional public debt has reportedly been absorbed by the domestic banking sector. The same is true for the vast majority of emerging and developing countries (EDCs) more broadly, where the exceptional external financing provided by the international community has not always been sufficient to cover public financing needs.

The developments seen in 2020 and 2021 have, however, merely accentuated an already existing trend toward an increased role for domestic financing of governments in EDCs, i.e., by actors such as banks, central banks, and public and private nonbank financial institutions. On average, domestic public debt has thus seen a regular increase since 2010 (Figure 1), particularly in low income countries (LICs) and lower middle-income countries (LMICs).

Figure 1 – Change in domestic public debt (% of GDP)



Sources: IMF (IFS, WEO; IMF 2021c), calculations by the author.

Sample of 101 countries including 21 LICs, 43 LMICs, and 37 UMICs.

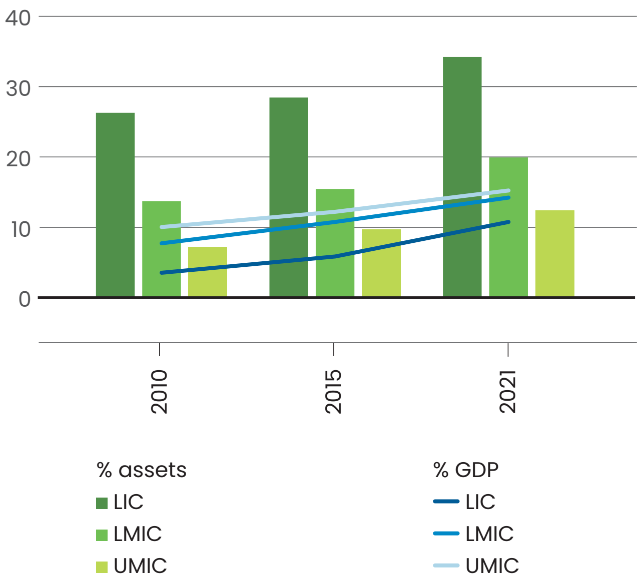
Domestic public debt in EDCs requires specific analysis. On the one hand, it can be seen as an instrument for reducing risk by lessening the impact of exogenous shocks, by strengthening public liquidity management, and by reducing dependence on external financing, which can be volatile. This is particularly the case in countries where the local markets on which government debt securities are issued and traded are well developed, and which have relatively deep financial sectors, in particular the banking sector (IMF, 2021b). On the other hand, defaults on domestic debt have been relatively common in modern financial history, as shown by Reinhart and Rogoff (2011). The impact of a default on, or restructuring of, domestic debt may also result in serious macroeconomic imbalances (IMF, 2021c), in particular due to the fact that the main domestic creditors play a crucial role in financing the economy as a whole. These interrelated risks are analyzed through the concept of interconnectedness or the "sovereign-bank nexus."

1. An upward trend in banks' exposures to sovereign counterparties in EDCs since 2010

The profile of domestic creditors in EDCs depends on a series of factors, beginning with the respective depth of the banking and financial sectors, and the role assigned to the central bank by local legislation. In LICs, domestic public debt is thus primarily held by central banks and the banking sector while in LMICs and upper middle-income countries (UMICs), the nonbank financial institution sector (including insurance companies, investment funds and pension funds) is deeper and more developed, and thus plays a bigger role. In all cases, however, commercial banks require particular attention due to their role in the allocation of domestic saving, collecting deposits, financing the economy, and money creation.

Commercial banks may contribute to financing the government by providing loans or buying bonds (medium to long-term maturities) and Treasury bills (short-term maturities). In EDCs, the share of sovereign debt held by commercial banks has markedly increased since 2010, both in proportion to GDP and in proportion to their total assets. In LICs, where the banking sector is often shallow, the gross sovereign exposure of banks represented on average a third of total assets in 2021 (equivalent to 11% of GDP), compared to a quarter in 2010 (3% of GDP). In UMICs, where the banking market is deeper, in 2021 it accounted for 12% of total assets on average (15% of GDP), compared to 7% (10% of GDP) in 2010 (Figure 2).

Figure 2 – Change in banks' exposures to sovereign risk between 2010 and 2021



Sources: IMF (IFS, WEO), local sources, calculations by the author.

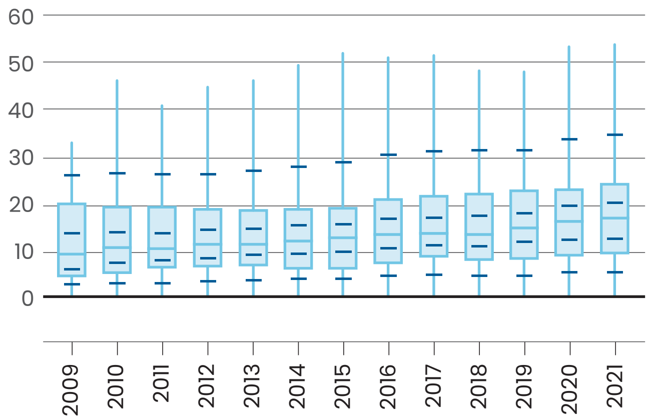
Sample of 101 countries including 21 LICs, 43 LMICs, and 37 UMICs.

This increase in sovereign debt holdings has paralleled the rise in the financing needs and public debt of EDCs over the past decade. In a number of countries, it has been facilitated by the gradual development of domestic and local currency bond markets (IMF, 2021c). Some EDCs have also opted to prioritize domestic debt, or have done so due to a lack of external financing opportunities. Banks may also prioritize holding public bonds and bills over providing credit to the private sector, where financing is often riskier due to the business climate and asymmetric information, as well as being less profitable and sometimes presenting insufficient aggregate demand. The data therefore reflect different realities on the ground, with explanatory factors specific to each country.

The Egyptian banking sector, for example, is highly exposed to the State (over half of bank assets), notably due to a preference for financing the deficit by domestic banks, which in turn favor holding public bonds over financing a sluggish private sector, often riskier and less profitable. In Burundi, banks also show a high level of sovereign exposure (over 40% of assets), but this is due to a marked slowdown in financing from international donors since 2015 as a result of the social and political context. The share of public debt held by banks and the central bank thus grew from 40% in 2014 to over 65% in 2020. Finally, Brazilian banks hold over 60% of the country's total public debt, amounting to a third of their assets, but the public bond market in Brazil is well developed, liquid, and deep, and the country's robust financial sector represents over 200% of GDP.

This heterogeneity of idiosyncratic factors specific to each country explains the differences in levels of exposure across EDCs, irrespective of their income. In around a quarter of the 101 EDCs for which data are available, bank exposure to sovereign risk is lower than 10% of their assets, and this share has not grown significantly on average since 2010. This is the case in Cambodia, for example, where domestic debt instruments are almost never used, in the Comoros where the banking sector is underdeveloped, but also in Ecuador, where actors in the banking sector are averse to sovereign risk. At the other end of the spectrum, in 25 EDCs bank exposure to public debt exceeds 25% of their assets (and in ten of these countries exceeds a third of their assets), and the average exposure in this quartile has grown from 26% to 34% over the last ten years (Figure 3). These countries include some with a small banking sector in comparison to their very large public financing needs (Pakistan, Angola, and Ghana), some with limited access to external financing and an underdeveloped banking sector (Gambia, Burundi, and South Sudan), and some that make structural use of domestic debt as a source of financing (Brazil and Mexico).

Figure 3 – Distribution of banks' exposures to sovereign risk in EDCs



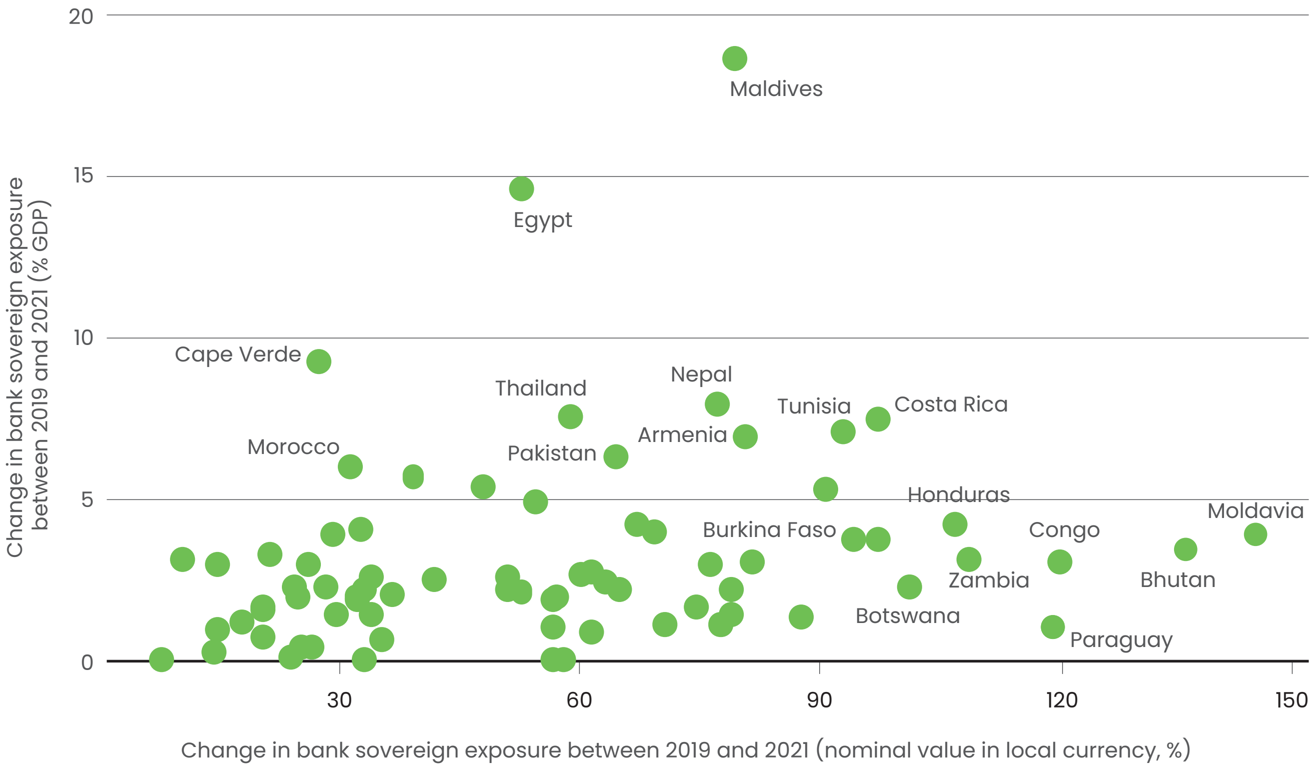
Sources: IMF (IFS, WEO), local sources, calculations by the author.

Sample of 101 countries including 21 LICs, 43 LMICs, and 37 UMICs.

2. Marked intensification of the sovereign-bank nexus in 2020–2021

In EDCs, the increase in bank exposure to sovereign risk was particularly marked in 2020 and 2021, with the economic and financial impact of the COVID-19 crisis leading to increased government financing needs due to widening fiscal deficits. In addition, tougher financial conditions on the international markets made external debt refinancing uncertain despite EDCs receiving exceptional financing from the international community. As a result, domestic actors played a major role in covering the public financing needs of EDCs in 2020 and 2021. The monetary easing implemented by a number of central banks in response to the crisis (both through rates cuts and through additional liquidity provision) further favored this increase in domestic debt, including via commercial banks.

Figure 4 – Increase in banks' sovereign exposures between 2019 and 2021



Source: IMF (IFS, WEO), local sources, calculations by the author. Sample of 101 countries including 21 LICs, 43 LMICs, and 37 UMICs.

Thus, in over fifty EDCs (Figure 4), the total sovereign debt held by the banking sector grew by over 50% in nominal value between end-2019 and the first few months of 2021, even doubling in ten countries. The increase is also highly significant for some countries when compared to GDP: the additional exposure thus corresponds to over 15 percentage points (pp) of GDP for Egypt, 8 pp of GDP for Thailand and Costa Rica, 7 pp of GDP for Tunisia and Armenia, and 6 pp of GDP for Pakistan, Morocco, and the Philippines.

3. The ambivalent role of central banks in financing the government

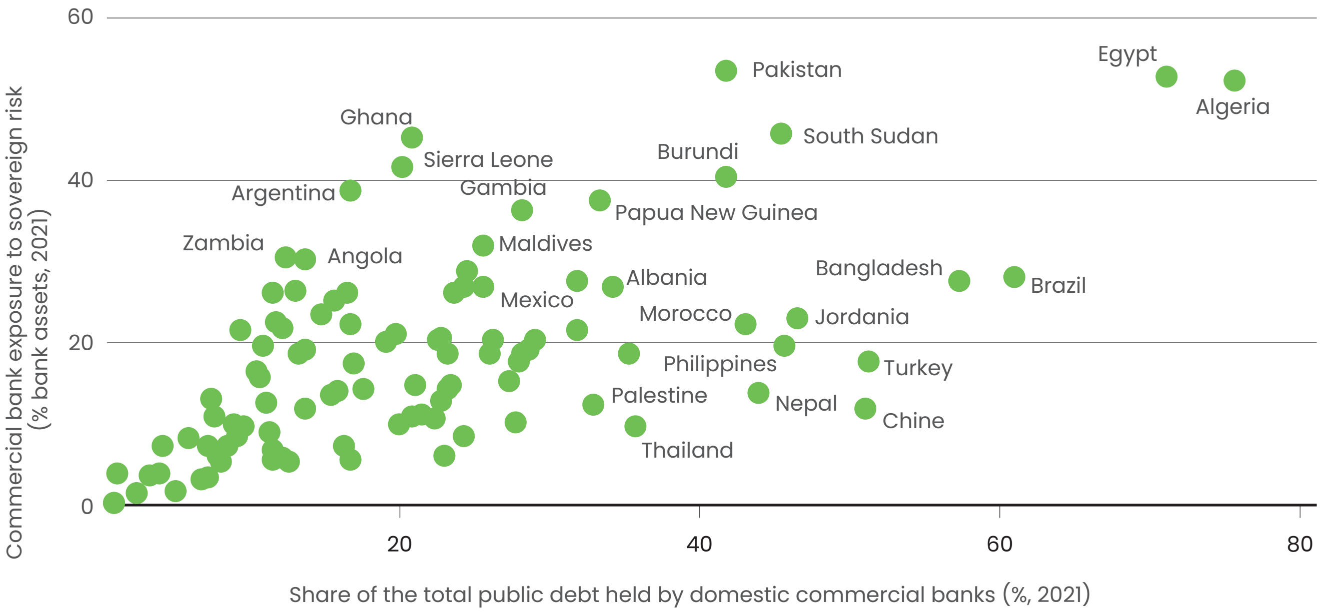
One key factor to consider in the context of the 2020 crisis is the role of central banks in financing public deficits in EDCs. As in advanced economies, the balance sheet of the central banks in some EDCs grew substantially between 2019 and 2020, among other reasons due to buying government debt securities and granting loans or advances to the government. In a dozen EDCs, central banks played an important role by dedicating over 10% more of their assets to financing the government. These included, among others, Sri Lanka (where over 60% of the central bank balance sheet was exposed to sovereign risk in mid-2021, compared to 17% in 2019), Ghana (35%), Indonesia (35%), Bolivia (33%), Tanzania (30%), Tunisia (30%), and the Philippines (27%). In certain cases, this was an exceptional operation contrary to domestic legislation (in cases where this proscribed monetary financing) or against IMF recommendations, particularly in countries under an IMF program.

Such increases raise three key points of interest. The first is the potential impact on the structure of the central bank balance sheet (particularly in terms of foreign reserves where these are used to finance deficits), but also on prices and the credibility of the local currency. The second concerns measures for reducing central bank balance sheets where these mechanisms to support liquidity and governments are temporary. It can add refinancing uncertainties when governments have to reimburse loans and advances and when the central banks will have to sell bonds on the secondary market. The third point of interest is the interconnectedness of risk between banks, central banks, and states, the most striking example of which is provided by Lebanon. In 2019, on the eve of the country’s economic and financial crisis, the high level of banks’ direct exposure to the State (44% of GDP) was compounded by the fact that they had placed nearly half of their assets with the central bank, which itself held the equivalent of 65% of GDP in Lebanese public debt (43% of the total public debt). The risks were thus intensified, and following the country’s sovereign default and financial, monetary, and economic crisis, the most recent estimates calculate the losses in the banking sector and central bank as totaling over 130% of 2021 GDP. Less extreme examples of such interrelated exposure also include the Dominican Republic (where the exposure of banks to the central bank, excluding reserve requirements, exceeds 25% of their total assets, and where the central bank holds 20% of the total public debt), Mozambique (23% and 13% respectively), Belize (17% and 13%), and Bolivia (16% and 23%).

4. The limitations of financing of the government by the banking sector

The high level of bank exposure to sovereign risk, and the growing share of the public debt held by the banking sector (Figure 5), may act as a further constraint on governments’ financing strategies in EDCs, and exposes them to refinancing risks due to the often shorter maturities of domestic government bonds.

Figure 5 – The sovereign-bank nexus in EDCs in 2021



Source: IMF (IFS, WEO), local sources, calculations by the author.Sample of 101 countries including 21 LICs, 43 LMICs, and 37 UMICs.

The level of bank exposure to sovereign risk, when already very high, limits the State's capacity for domestic financing. In twenty EDCs, sovereign debt now represents over a third of bank assets (Figure 4), and it could prove difficult to go beyond certain thresholds, both in terms of risk management by banks (which now find themselves excessively exposed to risk from a single counterparty) and a crowding-out effect on financing of the real economy. There is also a refinancing risk, although this is in theory lower than for external debt or foreign currency debt. It is accentuated by fiscal deterioration, which has the effect of increasing public financing needs and reducing bank confidence in, and appetite for, government bonds at the same time. The refinancing risk is also higher in EDCs where the banking sector is weak (whether in terms of solvency, asset quality, or liquidity), and thus more subject to volatility in financing capacity.

In Ghana, for example, the withdrawal of domestic investors from the local currency (cedi) debt market, reduced deficit financing by the central bank, and tougher conditions on international markets could result in the banks playing an increasing role in deficit financing and refinancing of the domestic debt from 2022 onward. Yet government bonds already absorb 40% of bank assets, and the banks will not have the financial depth to cover all public financing needs. Deepening and improving the operations of domestic government bond markets may help minimize these risks (IMF, 2021b), but EDCs have not yet all reached this stage of capital market development. The World Bank estimates that just 41% of LICs use market-based issuance mechanisms for local currency government securities, and only half of them communicate with their investors in an adequate manner (Rivetti, 2021).

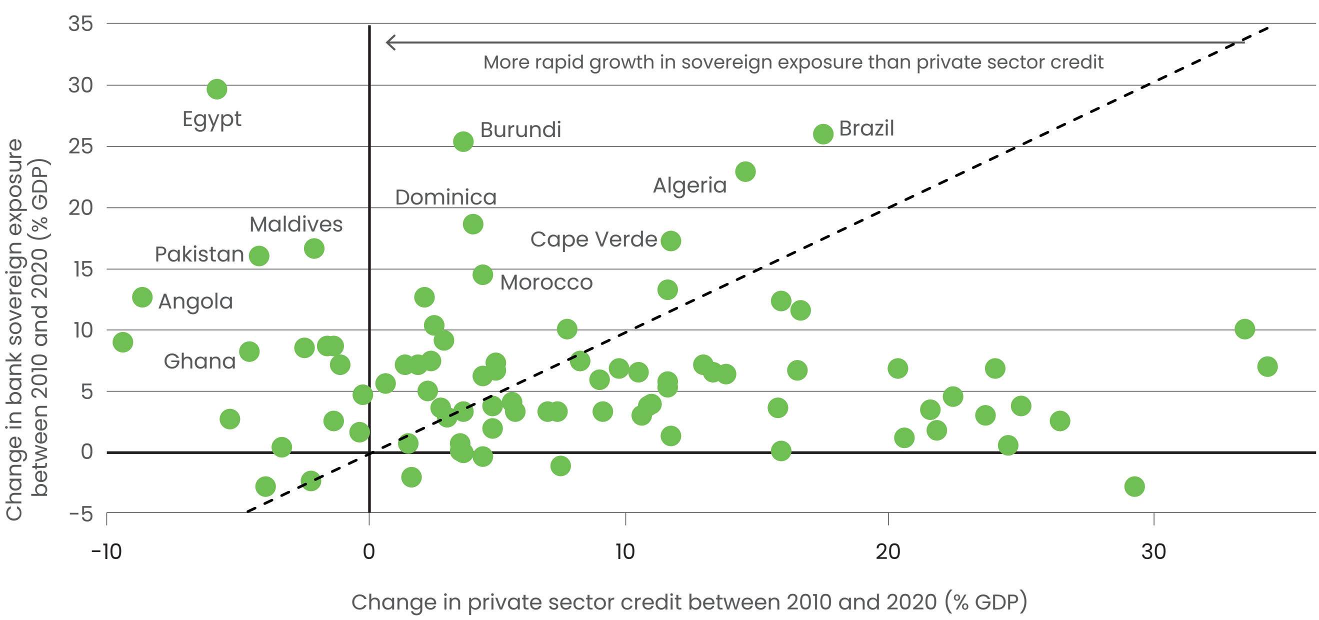
Domestic financing can also sometimes be more costly than external financing, adding to budget constraints. The importance of this factor depends on domestic financial conditions, and the conditions of the external financing available to the country (access to concessional loans from international backers, and conditions and risk premiums on the international capital markets). Interest rates on domestic sovereign debt (both nominal and real) remain high, however, particularly in LICs and LMICs. In a number of EDCs the burden of interest has substantially increased. In Egypt, for example, interest on the domestic public debt absorbed half of budget revenues in 2020, compared to less than a third in 2010, while in Pakistan it absorbed 37% of revenues in 2020 compared to 22% in 2010.

5. An additional constraint on private sector financing in EDCs

The crowding-out effect on financing of the real economy is a potential risk, particularly as the banking sector is still underdeveloped in many EDCs: in 2020, it represented just 42% of GDP in LICs, 84% in LMICs, and 110% in UMICs, with a positive correlation to per capita income that can be explained by the level of domestic savings. In this regard, the growing share of public debt held by the banking sector may represent an obstacle to credit to the private sector. In over thirty-five EDCs, financing of the government grew more rapidly than credit to the private sector between 2010 and 2020, and in fifteen countries credit to the private sector (as a % of GDP) even decreased in parallel with an increase in bank sovereign exposure (Figure 6). As a result, in 2020 the total public debt held by banks was greater than the outstanding credit to the private sector in at least ten EDCs (Algeria, Angola, Argentina, Burundi, Egypt, Ghana, Pakistan, Papua New Guinea, Sierra Leone, and Zambia). Similarly, in over thirty EDCs, financing of the private sector represented less than 20% of GDP.

The growing weight of financing of the government is not of course the only obstacle to the development of credit to the private sector in EDCs. Other factors hinder both the supply and demand for credit, particularly in LICs: a high level of informality in the economy, limited access to banking by SMEs, a high level of risk reflecting financial conditions, and limited diversification of financial instruments and securities. Holding public debt is sometimes still preferred over financing of the private sector, which is judged to be riskier and less profitable. This crowding-out effect is particularly problematic in EDCs where a dynamic private sector would represent an important source of growth for economic and social development.

Figure 6 – Change in sovereign exposure and credit to the private sector



Source: IMF (IFS, WEO), WB (WDI), local sources, calculations by the author. Sample of 101 countries including 21 LICs, 43 LMICs, and 37 UMICs.

The growing exposure of the banking sector to sovereign debt also places a further constraint on the policy mix of EDCs. Depending on its level of independence, central bank monetary policy may, for example, be influenced by the government's desire to lower the cost of its financing. This adds to monetary and financial market distortion, and limits the effectiveness of the transmission channels of monetary policy to the real economy.

The impact on financing of the real economy is particularly marked in cases where increased public financing needs generate macroeconomic imbalances. These may be external in nature, such as an effect on exchange rate volatility with a potential impact on both the economy and banks due to imbalances with banks' and businesses' foreign currency balance sheets. Domestic government financing may also have an impact on prices if the central bank intervenes in direct—monetary—or indirect government financing (see above).

6. The risk of sovereign default and domestic debt restructuring: A major problem for the banking sector

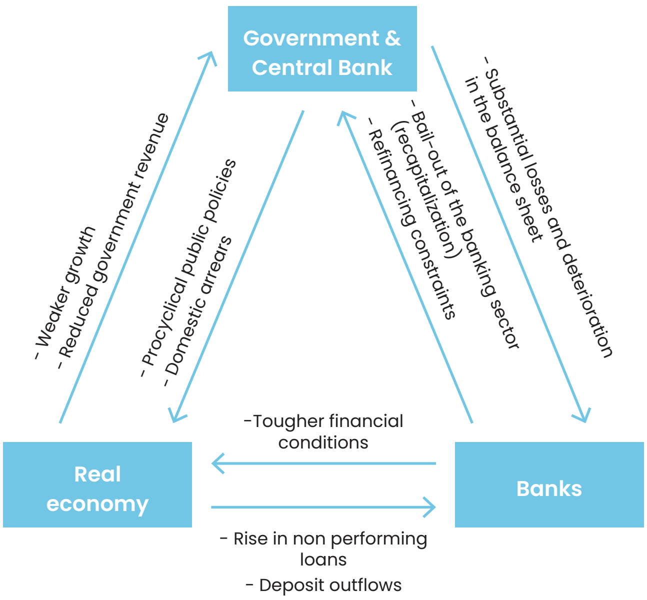
Since the global financial crisis and eurozone crisis, economists have revisited their analysis of the sovereign-bank nexus. The analytic framework ought to be updated for EDCs in light of the growing exposure of the banking sector to sovereign debt, with a marked increase in counterparty risk. Materialization of this risk cannot be ruled out, particularly in EDCs where public debt sustainability has been shaken by the 2020 crisis.

Historically, domestic debt restructuring in EDCs has occurred relatively often (Reinhart and Rogoff, 2011) and may happen at the same time as external debt restructuring. While episodes of unsustainable domestic debt have been managed in the past through money creation, inflation, or financial repression[1], the IMF (2021c) judges, on the basis of experience, that this is less and less the case due to the growing global financial integration of EDCs, which should favor restructuring. Failure to bring about orderly resolution of a sovereign default can have a devastating impact on a domestic economy and creditors: this is the case in Lebanon, where the lack of a decision on the issue since spring 2020 has resulted in an unprecedented economic and financial crisis. The Lebanese crisis also shows that in the absence of orderly restructuring, it is ultimately the depositors (and thus the population) that bear the cost of default.

The consequences of domestic debt restructuring can also, however, be significant, and include an impact on domestic creditors (banks, the central bank, and financial sector) that play a role in financing the economy and financial stability (Figure 7). In EDCs, banking crises are more often caused by sovereign debt crises than vice versa (Panizza and Borzensztein, 2008). Furthermore, the direct consequences of a sovereign default are compounded by secondary effects with feedback loops (including on the public finances if the banking sector is to be recapitalized, for example) that may result in costs that exceed the anticipated benefits of restructuring. This is all the more true given the fact that the deteriorating economic situation or exogenous shock that led to the sovereign default may also affect the banking sector at the same time (including, for example, through an increase in nonperforming loans, lower solvency ratios, lower profitability, and liquidity problems). All of these elements were accentuated during the 2020 crisis, and an analysis of the effects of public debt restructuring (domestic, external—for example under the Common Framework for Debt Treatments—or combined) on the banking sector is therefore required. Defaults on domestic debt also occur more frequently when the share of total debt held domestically is increasing and when the banking sector has little depth and provides little financing to the real economy (IMF, 2021c). This is currently the situation in a growing number of EDCs.

1 A term used for unilateral measures taken by authorities with a legislative or executive advantage. They may include a legal requirement for banks to hold public bonds, interest-free arrears, or capping interest rates on government securities

Figure 7 – The sovereign-bank nexus in a sovereign debt crisis



Source: World Bank (2019).

The main channel via which restructuring of the domestic public debt is transmitted to banks essentially consists of their balance sheet exposure to the State, which as we have seen has risen significantly over the last decade, and in particular since 2020. The higher a bank's level of exposure, the greater the share of their assets likely to be depreciated—whether this is through a substantial loss of market or net present value, a "haircut," or securitization of their Treasury bills holdings. This first weakens the banking sector, whose profitability and liquidity are automatically reduced. Second, it may result in a significant reduction in solvency ratios (particularly as in a period of stability, government bonds benefit from a favorable risk weighting in prudential ratios) and a major need for recapitalization, and in the most extreme cases a haircut on deposits. Finally, the risks of credit contraction and deposit flight are also high. A sovereign default on debt held by the banking sector may therefore involve action by the fiscal and monetary authorities to limit the contagion on the economy as a whole: recapitalization (accentuated in the presence of systemically important public banks or problems at the central bank, whose essential functions must be preserved), activation of contingent liabilities, and injection of public liquidity. This is why the fiscal cost of banking problems or a banking crisis is higher on average in EDCs than in advanced economies (IMF, 2018; Balteanu and Erce, 2017).

In EDCs, the political economy of the sovereign-bank nexus also requires specific analysis. The interrelated interests of bank shareholders or major depositors on the one hand, and the political authorities on the other, may hamper the rapid resolution of a sovereign default or banking crisis. This factor may play a major role in countries with a weak legal and institutional framework, as is more often the case in some EDCs (IMF, 2021c). This was again the case in Lebanon, where the interrelated interests of the various stakeholders and disagreement over the distribution of losses explain the failure to agree on a general restructuring plan for nearly two years.

7. Financing the government via banks: A source of systemic risk or a way to reduce vulnerabilities?

The sovereign-bank nexus is thus a source of growing concern in relation to the stability of EDCs. It has intensified since 2020, with a deterioration in the sustainability of public debts in conjunction with the increased exposure of the domestic banking sector to sovereign risk. The history of some countries shows however that under certain conditions, domestic debt restructuring can be absorbed by the banks without any great difficulty—particularly when the sector is well regulated and well capitalized (World Bank, 2019; IMF, 2021c). Most importantly, domestic financing of the public debt should not be seen as an intrinsic vulnerability factor, since it remains a tool for macroeconomic stabilization by reducing exposure to exogenous shocks and deepening domestic capital markets. The intensification of the sovereign-bank nexus thus primarily requires attention from political decision-makers, who must decide between the inherent risks of each public financing option and preserve the sustainability of the domestic public debt.

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Country focuses

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Cameroon: Increasing government dependence on banking and external financing

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Since 2014, the fall in oil prices, combined with a deteriorating security situation and the impact of the COVID-19 pandemic, has led to a slowdown in economic growth and an increase in Cameroon's public debt. To finance its deficit, the government has had to make substantial use of bank and external financing. While this strategy is weakening the banking sector, constraining development of the private sector, and driving up the cost of debt service, the country's medium-term economic prospects are relatively good.

While the oil industry remains one of the main drivers of growth in Cameroon, the country has the most diversified economy in central Africa. It includes dynamic agriculture (cocoa, cotton, coffee, fruit, rubber, and palm), forestry, and mining sectors and, more recently, the rapid development of its gas sector. The economy has slowed down since the fall in raw material prices in mid-2014, but has shown a certain level of resilience. It has also been impacted by the deteriorating security situation—particularly in its western English-speaking regions and due to incursions by Islamist groups —with an average annual growth rate of 4.0% between 2015 and 2019 (compared to 5.0% in 2010–2014).

An economic recovery supported by a rebound in raw material prices and investment

In 2020, the economy was hit by the effects of the pandemic, particularly the fall in oil prices, along with major flooding and tensions in the country's English-speaking regions. Despite this, it managed to maintain a positive growth rate of 0.5%. According to the IMF, growth bounced back to 3.5% in 2021, benefiting in particular from the increase in raw material prices and the growth in agricultural production, despite the slow progress of the COVID-19 vaccination program.

In the medium term, economic growth is expected to accelerate and exceed 5% from 2024. It is likely to be driven by the development of new infrastructure (such as roads, dams, ports, and gas terminals), in line with the government's "SND30" strategy, which is set to invest a total of USD 65 billion by 2030. The government thus projects an increase in capital expenditure alongside increased foreign investment and multilateral support over the next few years.

Growing exposure of the Cameroonian banking sector to the CEMAC sovereigns

The Cameroonian financial sector has limited depth. Bank assets represented just 30% of GDP in 2020, while only 35% of Cameroonians had access to financial services in 2017, and 10% had a bank account.

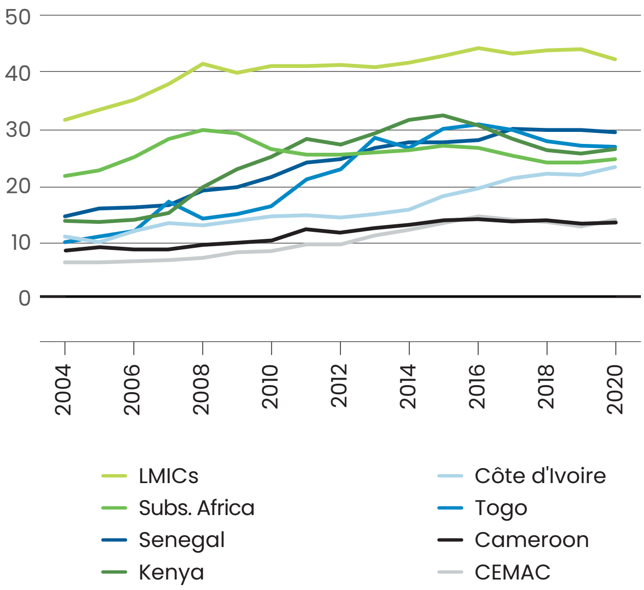
The banking sector has a high level of exposure to the sovereigns of the subregion (which consists of Cameroon, Gabon, Equatorial Guinea, Chad, the Republic of the Congo, and the Central African Republic), with more than a quarter of Cameroonian bank assets consisting of government loans and bonds (excluding state-owned companies).[2] This exposure increased nearly fivefold between 2014 and 2020, with the banks largely steering their financing toward the public sector against a backdrop of widening fiscal deficits. With the Cameroonian banking sector appearing to be relatively fragile (with a nonperforming loan rate of 14% in August 2021), this shift has significantly

2 The debt of CEMAC states held by Cameroonian banks represents 26% of assets (IMF data).

strengthened the interdependence of the two sectors, and thus the systemic risk. Similarly, the total government financing provided by the central bank increased by a factor of 14 over the same period, a trend also seen at the regional level.[3]

Conversely, the Cameroonian private sector (particularly SMEs) appears to be underfinanced, as shown by the low level of private sector credit: 13% of Cameroon's GDP (stable since 2014), compared to 24% of GDP on average in Sub-Saharan Africa. While there is a crowding-out effect—with the public sector, seen as more profitable, "hoovering up" a large share of bank financing—the underfinancing of the private sector can also be attributed to various structural rigidities related to the business climate.

Figure 8 - Credit to the private sector, % of GDP



Sources: IMF, WB.

In parallel, increased use of external financing to fully cover public financing needs

Despite the fiscal consolidation efforts seen since 2017, the public deficit was 4.1% of GDP on average between 2015 and 2020. The public account imbalance is structural, and related to weak revenue levels (linked to the widespread informal economy and declining oil reserves), which are insufficient to cover spending. In the shorter term, this imbalance has been exacerbated by the low raw material prices seen since 2014, security tensions, and the COVID-19 pandemic.

Cameroon's resulting surplus debt—with the public debt-to-GDP ratio doubling between 2014 and 2020 (from 22% to 46% of GDP)—could only be partly financed by domestic resources (primarily banks). The debt held by residents thus increased by 9 pp of GDP over the period, compared to 16 pp of GDP for nonresidents. The conditions associated with this external debt are however less favorable (with debt owed to China and private creditors in particular), and have contributed to driving up the cost of debt service. This led the IMF to successively reclassify Cameroon's risk of external debt distress from "low" to "moderate" (2014), then "high" (2015).

Issuance of a new Eurobond and agreement on an IMF program to support public finances

In June 2021, the government announced it had successfully issued a EUR 685 million Eurobond (3.2 times oversubscribed), which will in particular refinance, under more favorable conditions, a previous Eurobond issued in 2015 (6% coupon with a twelve-year maturity, compared to 9.0% in 2015). In parallel, in July 2021 it reached an agreement with the IMF over a new three-year arrangement that will give it access to a disbursement of USD 690 million, helping to support the government's SND30 investment plan. In September, the World Bank also announced financing for new projects in Cameroon, with a total of USD 735 million in the form of concessional loans.

The Cameroonian public accounts therefore appear to be on a positive track. Despite an anticipated rise in capital expenditure, the public deficit should move closer to zero, while the level of public debt is expected to begin falling in 2022 (projected at 35% of GDP in 2026).

3 The Cameroonian state debt held by the Bank of Central African States (BEAC) grew from XAF 81 billion in 2014 to XAF 1,123 billion in 2020 (BEAC data).

Ethiopia: A Horn of Africa champion in trouble

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Implementation of an industrialization policy, supported by public investment, has enabled a rapid economic catch-up in Ethiopia over the last decade. It has not, however, been enough to raise Ethiopia out of the LIC category, despite its ambition to become a LMIC by 2025, and has accentuated the vulnerability of its economic fundamentals. The marked deterioration in the security situation since summer 2021 threatens to have a negative impact on an economy already weakened by the pandemic, droughts, and locust swarms. Ethiopia is, along with Chad and Zambia, one of the main beneficiaries of the introduction of the Common Framework for Debt Treatments.

While Ethiopia's economic dynamism, structural transformation policy, and progress in human development terms have long won admiration from the international community, eyes are now turning toward it with concern. Beyond its impact on economic prospects, the deteriorating security situation raises fears of a serious humanitarian crisis and destabilization of the wider subregion.

A decade of lightning-speed socioeconomic progress

Between 2010 and 2018, Ethiopia's real GDP grew by an exceptional average annual rate of 9.7%. This strong growth was driven by an agricultural modernization and industrialization program introduced by the Ethiopian People's Revolutionary Democratic Front (EPRDF), a coalition dominated by the Tigray People's Liberation Front (TPLF) that remained in power for nearly three decades from 1991. This strategy was supported by major public investments (including in transport and electricity), reflecting a state that has continued to play a significant role even after the toppling of the Marxist Derg regime (1975–1991). The country's economic growth was accompanied by social progress, most notably a doubling of the adult literacy rate (52%) and an increase in life expectancy of nearly 20 years (to 67 years) since 1994.

This impressive economic growth has not however been enough to significantly improve the population's standard of living, and Ethiopia lags behind in terms of human capital. As Africa's second most populous country (115 million inhabitants), its demographic growth puts a strain on nominal income per capita, which at less than USD 900 keeps Ethiopia in the LIC category. In addition, the country's low starting point means that it is still only ranked as 173rd out of the 189 countries on the Human Development Index (HDI). Finally, the economy continues to be negatively impacted by several structural weaknesses partly resulting from the Marxist ideology that has influenced the country's economic policy since 1975.

Still-weak economic fundamentals

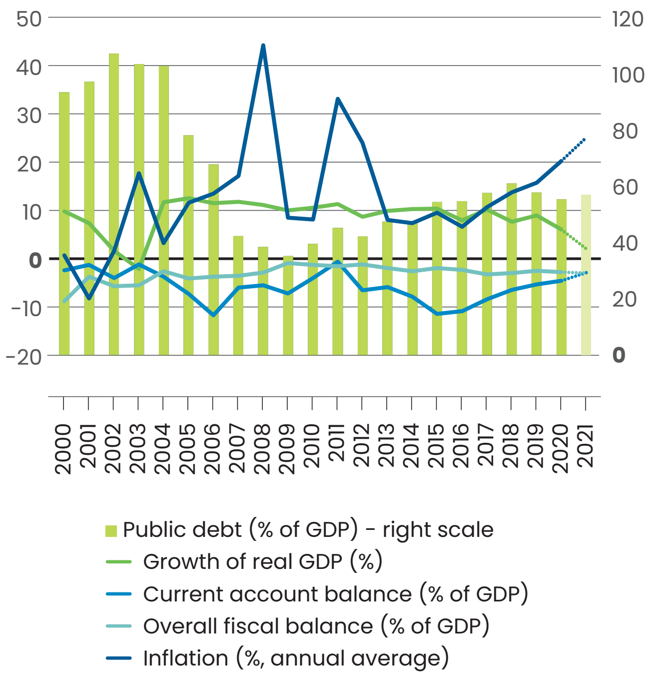
As Ethiopia's tax revenue is limited (11.7% of GDP in 2020[4]), the large-scale public investment policy led by the EPRDF was financed primarily by loans from external creditors, notably based in China. This resulted in a major increase in the public debt, which reached nearly 110% of GDP in 2004. After falling back below 40% due to support from the Heavily Indebted Poor Countries (HIPC) Initiative, continued investment led to the debt increasing again to 55.4% of GDP in 2020. The structure of the debt is also a source of concern: with over 50% of it held in foreign currency, its sustainability is compromised by the structural weakness of Ethiopia's foreign exchange reserves. The country's trade deficit is caused by its substantial capital goods requirements, primarily met by imports, combined with limited exports due to an overvalued exchange rate. This situation has a negative impact on the accumulation of foreign exchange reserves, which rarely cover more than two months

4 The macroeconomic statistics provided by the IMF and local authorities are reported by fiscal year: the year 2020 corresponds to the fiscal year 2019–2020, which ran from the start of July 2019 to the end of June 2020.

of imports, encouraging downward pressure on the birr (-20% in 2021) and contributing to rising domestic prices. The country has had two-digit inflation since 2017, with an upward trend in late 2021 fueled by the effects of the conflict and drought.

With a view to favoring a transition from the public sector to the private one, and thus facilitate a rebalancing of the public finances, moderate reforms have been introduced by Abiy Ahmed, Ethiopia's prime minister since 2018. Early signs of state disengagement from the economic sphere have been observed, notably in the telecommunications sector. The planned reforms were supported by an IMF program agreed in December 2019, whose concessional component has since expired.

Figure 9 – Key macroeconomic aggregates



Source: IMF (WEO, 2021).

The harmful impact of the conflict on the real economy, in particular the banking sector

The concentration of central power—which has retained a major role despite the proclamation of a federal system built on ethnolinguistic lines in 1994—in the hands of the Tigrayans for thirty years, combined with poor redistribution of the benefits of growth, stoked discontent in the rest of the population, and resulted in the resignation of Hailemariam Desalegn as prime minister, followed by the appointment of Abiy (who is from the Oromo ethnic group) in 2018. After sidelining several Tigray leaders from power, Abiy merged the parties of the EPRDF into the new PB (*Paartii Badhaadhiinaa*, Prosperity Party). The current conflict has been sparked by the TPLF's refusal to join the PB, and to agree to the central government's demand to postpone the legislative elections.

The country's dynamic growth has been stalled by the COVID-19 pandemic, poor yields in the agricultural sector, and the initial clashes between the central government and TPLF since November 2020. According to the IMF, growth slowed to 6.1% in 2020, and to around 2% in 2021 (WEO, October 2021). The IMF's projections do not go beyond 2021—reflecting the uncertainty related to the deteriorating security environment—but the escalating conflict risks could impact the real economy via: i) agricultural production, which comes primarily from the conflict areas; ii) potential disruption of the Addis Ababa-Djibouti route for exported and imported goods; iii) suspension of the African Growth and Opportunity Act, which enables certain Ethiopian products to enter the United States market duty-free; iv) disengagement of foreign backers and investors; and v) additional fiscal tensions related to the conflict.

The banking sector could also be significantly affected by the conflict. It is underdeveloped (bank assets represent just 60% of GDP) and dominated by two public banks. While it has been open to Ethiopian-born foreign nationals since 2019, other foreign investors are still not permitted to invest in it. Furthermore, while the requirement for private banks to invest 27% of their loan portfolio in bonds issued by the central bank has been lifted, the banking sector continues to essentially finance the public sector, strongly exposing it to the risk of default by the state and state-owned companies. This puts the private sector—which already faces a foreign exchange shortage, institutional obstacles, a lack of infrastructures, and power cuts—at a disadvantage.

Ghana: From fiscal to macroeconomic and financial imbalances

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The Ghanaian economy benefits from structural economic advantages, and a more favorable social and political stability and business climate than other countries in the region. This accounts for the high levels of economic growth observed since 2010 (6.6% on average), with the country expected to return to this trajectory in 2022. Its macroeconomic stability is however exposed to significant risk due to successive fiscal slippages that have resulted in a significant rise in the public debt (from 29% of GDP in 2010 to about 80% at the end of 2021) and public financing needs. It may prove difficult to cover these in 2022 due to the rise in sovereign spreads observed in the final quarter of 2021, and the relative withdrawal of foreign investors from the local bond market. This is also expected to significantly increase the country's vulnerabilities in terms of external balances and monetary, financial, and banking stability.

Deterioration in the sustainability of the Ghanaian public finances over several years

Fiscal deterioration is the country's main economic weakness. Despite Ghana's high level of growth, the public deficit has represented an average of 6.8% of GDP over the past decade, and has never dropped below 4% of GDP. It reached a record level in 2020 (15.7% of GDP) on the background of the economic and public health crisis, and the IMF does not expect it to fall below 10% before 2025, unlike the government, which has just adopted a 2022 budget that sets a target public deficit of 7.4% of GDP. These high deficits in recent years have resulted from both low budget revenues (notably from tax revenues, which equated to just 12% of GDP in 2020 while they amounted to 15% of GDP in 2012), and structural obstacles to reduce spending, notably the wage bill (45% of public revenue) and debt interest (50% of revenue, compared to 17% in 2012).

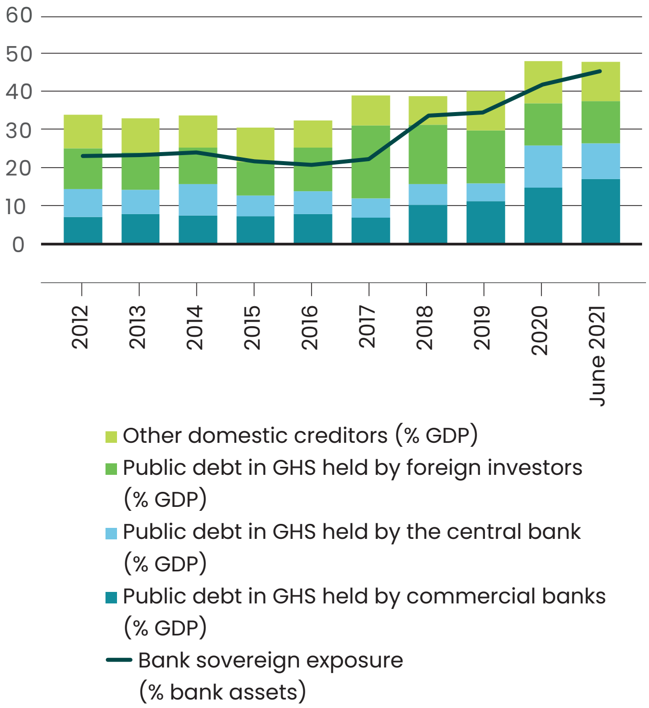
Due to the accumulation of these deficits, the public debt has grown significantly. It increased from 29% of GDP in 2010 to 79% in 2020, and could go over 80% at the end of 2021. The profile and structure of the public debt have also deteriorated, with increased dependence on non-concessional external financing and the domestic banking market (with shorter maturities and higher financing costs), which represent a growing risk to its medium- and even short-term sustainability. The country's public financing needs continue to be significant (over 20% of GDP on average over the next five years), with the potential for macroeconomic imbalances.

Potential challenges for the government's capacity to secure external financing in 2022

Since the early 2010s, the role of private foreign investors in government financing has grown significantly: first due to use of international capital markets (Eurobonds), with the country issuing Eurobonds almost every year since 2013 with a cumulative total of nearly USD 18 billion; and second, due to the growing appetite of foreign investors for the local currency public debt market seen until 2017.

These financing sources are accompanied by significant potential risks that ultimately materialized in 2020–2021. Ghana did succeed in placing over USD 3 billion in Eurobonds in spring 2021, but with high coupon rates (8.625% on the 12-year tranche, for example). Most importantly, market sentiment has deteriorated since September due to concern about continued high public deficits, and the anticipated normalization of monetary policy in the United States. Sovereign spreads in foreign currency thus rose to over 1,000 basis points in December 2021, resulting in the de facto withdrawal of access to international markets. The government thus decided not to issue bonds on international markets for a second time in 2021, contrary to its plans at the start of the year. Similarly, for the first time in over five years the 2022 budget approved in late November does not include plans for a Eurobond issue. The dynamism of foreign investors on the domestic debt market has also slowed over several years, with their share dropping from 40% of the debt in cedi in 2017 to just under 20% in mid-2021.

Figure 10 – Change in the public debt in local currency



Sources : IMF (IFS), Bank of Ghana

Fiscal imbalances risk spreading to the economy as a whole

The first impact of this squeeze on external financing of the state would be on the country's external balances. The country's external financing needs are expected to remain high over the next few years due to the widening of the current account deficit, and the rise in the level and cost of the external debt. Since 2013, Eurobonds have constituted the country's main source for both external financing and accumulation of foreign exchange reserves. Its disposable and liquid reserves did not however exceed three and a half months of imports in mid-2021, and the country may struggle to cover its external financing needs in 2022, with a resulting impact on the value of the cedi.

The second impact is on Ghana's banking and financial stability. The stop in Eurobond issuances, the withdrawal of foreign investors from the domestic debt market, and the end of financing of the public debt by the central bank (which has seen exceptional growth in its sovereign exposure, to 17% of its balance sheet in 2019 and 34% in 2020, after years of decreasing) are likely to result in increased use of the domestic banking sector to finance the public debt and refinance the public debt held in cedi. The Ghanaian banking sector is however underdeveloped (consolidated total assets in the sector represented 40% of GDP in 2020) and already highly exposed to sovereign risk, with government securities absorbing over 45% of bank assets in June 2021 (compared to 20% in 2017). The capacity of the State to secure financing from local banks is therefore limited, and threatens the stability of the sector, which is just seeing the results of a major consolidation and restructuring work that began in 2016. The crowding-out effect on credit to the private sector will also be significant, while Ghana already has one of the lowest levels of private sector credit in the region, at just 11.5% of GDP at the end of 2020. This will also have an impact on the monetary policy decisions made by the central bank, whose policy mix will be constrained by the need to contribute to economic recovery, control inflation (which since September 2021 has exceeded its upper target), curb the costs of public financing, and attract foreign investors. Ghana's government thus faces numerous complex challenges in 2022.

Kenya: Growing vulnerabilities

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Despite the dynamism of the Kenyan economy and its relative diversification, the country's economic growth remains volatile and vulnerable to climate change and political turbulence. While public investment has supported growth since 2010, the slowdown in growth over the last three years reveals the vulnerabilities of the Kenyan model and the private sector's struggle to take up the baton. Public investment in infrastructure and the public health crisis are reflected in high twin deficits and an upward trend in the public debt. The country faces strong external pressures, and a continued need for fiscal adjustment.

Following two decades of sluggish growth that resulted in a stagnation of real income per capita between 1977 and 2000, Kenya's economy has accelerated significantly. The political violence of 2008 and the global financial crisis had only a temporary effect on growth, and economic activity bounced back rapidly in 2010 (6% average annual growth over the course of the decade). Private consumption is by far the main driver of growth, supported by a rising standard of living and transfers from the diaspora.

Multiple obstacles to growth

In 2020, the country's growth was stopped in its tracks (-0.3%) by the global crisis resulting from the COVID-19 pandemic, which caused supply chain disruption and a reduction in exports and income from tourism. In 2021, growth could bounce back to +5.6%, primarily due to a base effect and to a lesser extent recovery in domestic demand and the service sector. With the next presidential and legislative elections set to take place in August 2022, the campaign is already underway, with ensuing political agitation that could lead to social unrest as in previous elections. The regional environment is still unstable, notably due to attacks by Al-Shabab, and relations with neighboring countries sometimes fraught.

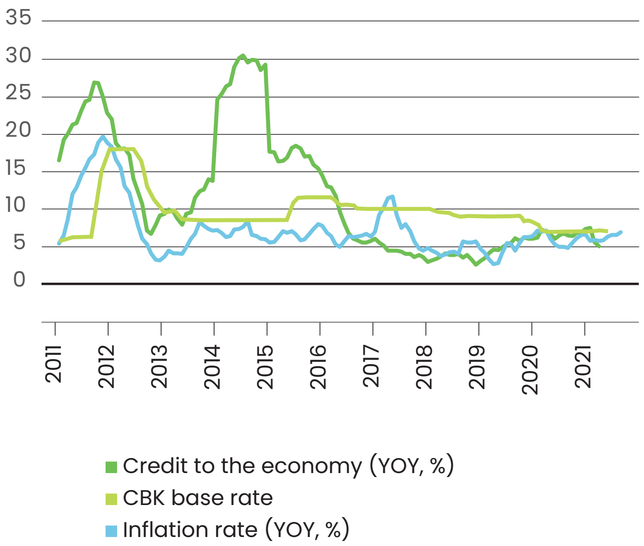
Finally, Kenya is particularly exposed to climate risk due to the dominance of its agricultural sector (26% of value added), with agricultural production representing the main source of income for over half of the population. Kenya is 34th of the 182 countries listed by the Notre Dame Global Adaptation Index (ND-GAIN)—which measures the exposure of countries and their capacity to adapt—and thus one of the countries with the least resilience to the effects of climate change.

Financing the deficit via the domestic market at the expense of private sector financing

Since mid-2015, the growth of private sector credit has slowed down in nominal terms, and decreased in real terms, on a background of reluctance among economic operators due to election-related unrest, the reduced dynamism of the private sector linked to the contraction of public investment over recent years, and the impact of the interest rate cap between 2016 and 2019. In line with the government's expansionary fiscal policy, the National Treasury has made extensive use of bond issuances on the domestic capital market, capturing a growing share of bank liquidity (35% of loans in 2021, compared to 20% in 2016). The introduction of the interest rate cap exacerbated this trend and severely restricted the growth of private sector credit, thus reinforcing the crowding-out effect on the private sector in favor of financing the public sector.

While a weak recovery in the growth of private sector credit was seen following the removal of the rate cap (+6% on a year-on-year basis at the start of 2020), the pandemic stopped this in its tracks. The doubling of the nonperforming loans ratio, including as a consequence of payment arrears from the public sector to its suppliers, also illustrates the difficulties faced by the private sector. Private sector credit penetration remained low in 2020 (26% of GDP compared to 32% in 2015, according to data from the IMF's Africa Regional Economic Outlook database). The financial sector is innovative and highly profitable, with strong financial inclusion (one of the highest levels in East Africa).

Figure 11 – Credit growth,
inflation rate and policy rate (%)



Sources: IMF (IFS), CBK, author calculations.

Increased dependence on external financing

The Kenyan economy is characterized by major twin deficits that make it dependent on external financing. Following the violence of 2008 and the global financial crisis, the government loosened fiscal constraints in order to ease social tensions and revive activity via an ambitious investment program. With the decrease in budgetary revenue and high spending levels, the budget deficit has remained high over the last five years (8% of GDP on average). The lack of fiscal discipline is encouraged by the relative ease—but at a cost—of access to international and national financial markets (facilitated by the interest rate cap) to finance the budget deficit. Despite the country's dynamic GDP growth, its public debt has thus continued to grow: +15 pp over the past five years, to 70% of GDP at the end of June 2021.

The public debt held in foreign currency (36.5% of GDP at the end of June 2021) has significantly increased in recent years, with a greater share of loans with commercial conditions driving up the cost of the public debt. Shorter maturities on the public debt held in local currency further increase financing needs. Over half of government bonds in local currency are held by commercial banks, and to a lesser extent, by pension funds.

Since May 2020, the IMF's Debt Sustainability Analysis has put Kenya at a high risk of debt distress on the basis of it exceeding the thresholds for two ratios, one for solvency and the other for liquidity, until at least 2025. As the country emerges from the crisis, the recovery of exports and economic growth should help improve its debt sustainability indicators. In structural terms, however, the sustainability of the debt is reliant on consolidation of the public finances. In April 2021, the IMF Executive Board approved a new program for Kenya (USD 2.4 billion), the aims of which include encouraging fiscal consolidation through increasing tax receipts, and controlling spending while protecting the most vulnerable.

The current account deficit, structurally high since 2010, stabilized in 2019 at the high level of 5.8% of GDP. Although Kenya's trade deficit rose to 11.2% of GDP in 2019, the dynamism of the tourism sector and transfers from the diaspora (2.9% of GDP in 2019) have helped curb the current account deficit. Transfers from migrants have become the main source of foreign exchange, ahead of tourism and exports of tea, coffee, and horticultural produce. In 2020, the current account deficit narrowed to 4.6% of GDP, with an improvement in the trade balance (to -8.5% of GDP) and growth in transfers from migrants (+10% in 2020 according to the Central Bank of Kenya [CBK]). The current account deficit is primarily financed by public sector debt-generating flows (4.5% of GDP in 2020), while foreign direct investment is declining (to 0.4% of GDP in 2020). Kenya's external financing needs (EFN) were estimated at around 6.7% of GDP in 2021, primarily covered by borrowing from the public sector (World Bank, African Development Bank, IMF [Extended Credit Facility/Extended Fund Facility], Debt Service Suspension Initiative [DSSI] moratorium). In 2021, its foreign exchange reserves increased by USD 1.8 billion (to nearly six months of imported goods and services). The further allocation of SDR 520 in late August 2021, equating to USD 730 million, contributed to shoring up the reserves.

Togo: Reviving the macroeconomic consolidation interrupted by the pandemic

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The COVID-19 crisis brought to an abrupt end the macroeconomic consolidation that began in 2017; however, the Togolese economy has still shown signs of resilience. Growth slowed in 2020 (+1.8%), and IMF projections for October 2021 called for a 4.8% recovery over the previous year, supported by an increase in phosphate prices and a pick-up in public and private investment. Discussions are expected to continue over finalizing a new extended credit facility agreement with the IMF designed to support economic growth and the public finances of the low income country in the grip of social and political upheaval.

Togo is a small open and undiversified economy, that has positioned itself as a transport hub for West Africa, particularly following the Ivory Coast crisis in the 2000s. The country's standard of living per capita dropped significantly during those years, damped by demographic growth outstripping erratic economic progress that was undermined by social and political tensions. The country has however embarked on a path of catch-up since the return of international backers and more sustained, less volatile economic growth, with an average annual growth rate of 5.7% between 2010 and 2019. Major investment in transport and energy infrastructure, and an improved business climate, have supported growth in the agricultural sector (primarily cotton, coffee, and cocoa), as well as the mining (clinker and phosphate) and service and transport sectors (Lomé port and airport). The 2018–2022 National Development Plan is designed to support Togo's strategy of becoming a regional transport hub, developing agricultural centers and supporting human development.

Recession avoided in 2020, substantial revision of GDP, and favorable growth prospects despite social and political risks

Togo's economic growth in 2020 has been revised upward by the IMF to 1.8% (compared to 0.7% in IMF's April 2021 World Economic Outlook) and may have bounced back to 5% in 2021 prior to accelerating by 6% in 2022, supported by rising phosphate prices and a pick-up in public and private investment. The IMF estimates the country's growth potential in the medium term at 6.5%. Gross national income per capita increased to USD 920 in 2020, keeping Togo in the LIC category (the 22nd lowest in the world).

President Faure Gnassingbé, who took office in 2005 and succeeded his father who had led the country for thirty-eight years, was finally re-elected in February 2020 in a more peaceful environment, after the social turmoil of 2017–2019. Extension of the sanitary state of emergency until September 2022 is however fueling tensions and presenting a risk of sporadic problems that could affect investor confidence. The social and health programs rolled out in response to the pandemic, such as transfers via cellphones to support workers in the informal economy, may have helped ease social tensions, in a country ranked 167th of 189 countries on the 2019 HDI.

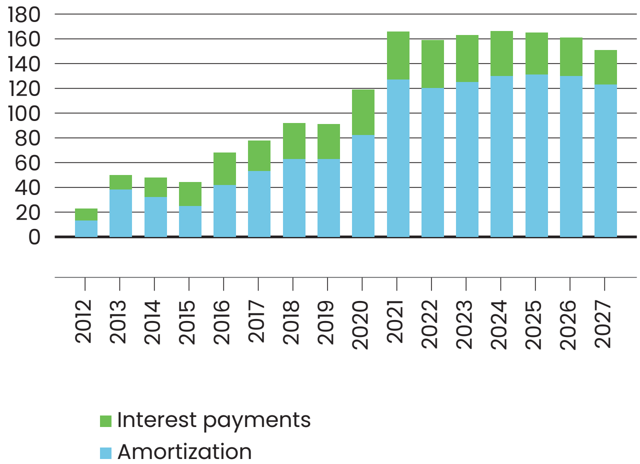
Further fiscal deterioration after consolidation work prior to the COVID-19 crisis

Budget consolidation efforts that were undertaken under the aegis of the EFC program, which ended in April 2020 and whose renewal is currently being negotiated with the IMF, allowed for a reduction of the pre-crisis budget deficit (+1,6% in 2019). However,the economic and social recovery plans, inevitably increased the ratio of government spending-to-GDP by around 7 pp in 2020. The budget deficit is expected to reduce to -6% of GDP in 2021 (compared to -7% of GDP in 2020), reflecting increased revenue and stable spending (WEO, 2021).

The public debt grew by 8pp to 60% of GDP in 2020, affected by issuances of treasury bonds and COVID-19 treasury bonds, and is expected to reach 63% in 2021. In order to reduce the cost of its domestic debt (60% of the public debt in 2020–2021), Togo began reprofiling its debt at the end of 2019 through more favorable external financing conditions with longer maturities and a lower interest rate.

The burden of public debt service is however expected to increase significantly over the coming years (Figure 12), and the average maturity of the debt portfolio remains fairly short (three years for the domestic debt). Yet all of the outstanding debt is at a fixed rate. The risks on the external debt result from a peak in repayments from 2026 to 2029. The external public debt is estimated at 25% of GDP in 2021, although it remains broadly concessional.

Figure 12 – Public debt service profile (in USD millions)



Sources: World Bank, author calculations.

Additional funding needs covered by the regional market, the BCEAO, and international backers

Following substantial growth in the government bonds held by Togolese commercial banks between 2016 and 2019, bank exposure to sovereign risk decreased in 2020–2021, from 17% to 14% of consolidated assets, and from 23% to 18% of the outstanding public debt. Public debt reprofiling has replaced domestic debt with external debt (in foreign exchange). The loan of EUR 103.6 million from an international commercial bank in 2019, and a further loan of EUR 150 million in May 2020 (equating to 3% of GDP in total) were used for early repayment of a loan taken out with the Togolese bank Ecobank, equivalent to 3% of the total public debt. Between 2019 and 2021, the exposure of the Central Bank of West African States (BCEAO) to the Togolese government grew from 3% to 4% of GDP, equivalent to 6% to 7% of the country's public debt (peaking at 8% in 2020). However, the regional bond market of the West African Economic and Monetary Union (UEMOA) absorbed twice as many Togolese government bonds in 2020–2021 as in 2018.

International backers have also helped the country cover its public and external financing needs through new financing, donations, and debt service suspension. In particular, Togo received USD 350 million in loans from the World Bank in 2020–2021, a disbursement from the IMF as part of its sixth review under the ECF in 2020, and dual relief of its debt service under the IMF's Catastrophe Containment and Relief Trust and the and the Debt Service Suspension Initiative (DSSI) of the G20/Paris Club (0.4% of GDP in 2020, followed by 0.3% of GDP in 2021).

The reduction of the current account deficit since 2017 has also helped reduce Togo's EFN. The structurally high current account deficit has benefited from a major drop in imports, notably in intermediate and capital goods following completion of the extension and modernization work at the Lomé airport and port. As a result of the impact of the COVID-19 crisis, the current account deficit widened slightly to 1.4% of GDP in 2020 (partly offset by lower imports and the fall in oil prices), and this trend is expected to continue into 2021. Finally, in relation to external liquidity, Togo's foreign exchange reserves, pooled within the UEMOA zone, were estimated at 6.2 months of imports in mid-2021, above the level of 5 months of imports recommended by the IMF.

Indonesia: from stability to development

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The archipelago of Indonesia has passed the latest test of the COVID-19 crisis thanks to its relatively solid macroeconomic fundamentals and contracyclical room for maneuver. Questions remain over its move away from expansionary and non-standard economic policies, but these do not currently challenge the credibility of the country's policy mix or its macroeconomic stability. The end of the COVID-19 crisis presents an opportunity for accelerating the transformation of the economy. Indonesia still faces huge challenges in terms of socioeconomic development and adaptation to climate change risks and energy transition.

The principle of *Pancasila* ("five principles"), proclaimed at the time of independence in 1945 by President Sukarno and enshrined in the Indonesian constitution, requires the country's democracy to seek consensus, which is not always conducive to effective public policy and the adoption of reforms, whether these are unpopular or clash with established economic interests. The end of the COVID-19 crisis should however provide an opportunity to accelerate the reforms[5] introduced by the Jokowi administration[6] since 2014 in order to modernize the economy, avoid the middle-income trap, and address social and environmental challenges, during the year of Indonesia's G20 presidency.

The rocky road to the club of high-income countries

The 2.1% contraction in Indonesia's GDP in 2020 was relatively mild in comparison to that of some of its neighbors (India, Thailand, Philippines, and Malaysia). But economic activity only bounced back to around 3% in 2021, due to the continued pandemic, a sluggish vaccination campaign weakening the confidence of economic agents, despite dynamic exports, and extended budgetary support (4.2% of GDP in 2021, following 3.8% of GDP in 2020).

One of the major challenges faced by the country is to avoid K-shaped post-pandemic economic growth, synonymous with growing multidimensional inequalities (in income, education, health, and digital technology), which the country's vulnerability to climate change (110/182 in the ND-GAIN index) could exacerbate. While the World Bank estimates that 4.3 million people have escaped poverty through the country's COVID-19 response plan, in 2020 Indonesia's nominal income per capita fell below the threshold for the UMIC category (USD 4,096), after exceeding it in 2019. The government's ambition for Indonesia to become a high-income country (for which the current threshold is USD 12,696) by 2045 would require GDP growth of 6–7% per annum.

The IMF, however, estimates its medium-term GDP growth potential to be 5–5.5%, in line with the growth trend (5.4% on average, per year, for the last two decades). While levels of investment are structurally high (32% of GDP), the demographic dividend of the world's fourth most populous country is expected to decline, and its total factor productivity is weak or even negative.

Normalization of the policy mix set for 2023, and moderate risks related to the sovereign-bank nexus

The return to fiscal orthodoxy (deficit capped at -3% of GDP) and monetary orthodoxy (end of monetary deficit financing) will be scrutinized by the markets in 2022–2023 against the backdrop of a squeeze on global liquidity.

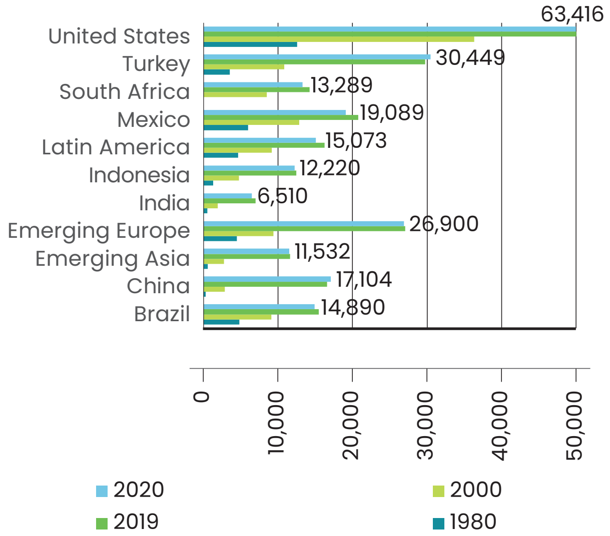
Low tax revenue (9% of GDP, equivalent to the average of LICs) is the Achilles' heel of Indonesia's public finances, constraining the government's capacity to meet its social spending and public investment needs (just 3.6% of GDP on average since

5 These consist of improved operation of the market economy (distortions of competition), competitiveness (business climate, corruption, human capital, infrastructure, labor rights, and digitization), industrial diversification, attractiveness for investors, participation in regional and global value chains, shrinking the informal economy, fiscal reform, and reform of state-owned companies.

6 Jokowi is the nickname of President Joko Widodo.

2000). After a budget deficit of around 6% in 2020–2021, the 2022 budget targets a deficit of 4.8% of GDP. The burden of debt interest will absorb nearly 17% of public revenue in 2022, but the public financing needs are expected to be contained to around 5% of GDP by 2025.

Figure 13 – A standard of living that remains relatively low



Source: IMF (WEO).

The IMF expects the public debt—which grew by 9pp in 2020–2021 to 41% of GDP—to remain moderate and sustainable in the medium term (Art. IV March 2021), at 48% of GDP in 2025 in an adverse scenario. The share of public debt held in foreign currency declined from 38% in 2019 to 32% in 2021, while the share held by nonresidents (including Indonesian investors based in Singapore) declined from 58% to 45%. One aspect to keep an eye on is the materialization of contingent liabilities associated with the country's many state-owned companies, recently reflected in recapitalizations borne by the Treasury.

In a context of coordination of the policy mix and sharing the cost of the COVID-19 recovery plan, Bank Indonesia (BI) has conducted standard monetary easing (reducing the policy rate to 3.5% since February 2020) and non-standard monetary easing (with a government bond purchasing program on the primary and secondary markets), with no short-term inflationary risk given inflation below BI's target of 3% (+/- 1pp) in 2020–2021 and anchored expectations. BI's exposure to the government grew from 18% to 35% of its assets between 2019 and 2021, equivalent to 17% of the outstanding public debt.

Commercial banks have also played their part in absorbing the state's additional financing needs. Four of the five biggest local banks are state-owned banks, without any major interference from the state shareholder. Commercial banks' holdings of government bonds increased from 8% to 14% of consolidated assets in the sector between 2019 and 2021 (21% of the public debt), pointing to a risk of a crowding-out effect on private sector credit rather than overexposure of the banks to the sovereign, whose credit rating remains good. The high level of capitalization (CAR of 25.2% in 2021) in the banking sector allows it to absorb shocks. Private sector credit penetration is moderate (39% of GDP), and credit growth, which was negative in 2020, saw weak recovery in the second half of 2021. The quality of bank assets remains good, with a level of nonperforming loans (NPL) of 3.2% in 2021, with the easing of bad debt classification and loan restructuring procedures maintained until the first quarter of 2022.

Still exposed to the global liquidity squeeze, but less vulnerable than in the past

Indonesia's credible monetary policy and managed floating exchange rate system give it a certain degree of flexibility in response to exogenous shocks and financial turbulence. Dubbed one of the "Fragile Five" during the Fed's previous tapering in 2013–2014, Indonesia has since seen an improvement in its net external liability position, from -43% of GDP to -26% of GDP (greater growth in foreign assets than in liabilities). The country appears to be less exposed than its neighbors to shocks on external demand, with a low openness to trade (14% of GDP) and less integration in Chinese value chains. The effect of economic conditions in China is indirectly felt through terms of trade, with commodities (raw or processed) representing over 50% of Indonesian exports (hydrocarbons, coal, and palm oil), further exposing the country to a risk from the energy transition in the medium and long term.

In the short term, the current account balance is close to balance (compared to -3.2% of GDP in 2013), limiting the country's dependence on volatile, debt-generating capital flows to make up for weak FDI. Its EFN (around 7% of GDP in 2021) should remain manageable in the medium term, with the external debt service moderate, and foreign exchange reserves hitting a record level of USD 145 billion at the end of 2021 (nine months of imports).

Lebanon: A tale of banks and state bankruptcy

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Lebanon is in the grip of a major political, economic, and financial crisis—one of such scale that the World Bank estimates it to be the sixth or even third worst crisis in modern times, and predicts that it will take twelve to nineteen years for the country to recover, depending on scenarios projected for 2022 after two years of recession (-25% in 2020, followed by -10% in 2021). Lebanon's bankruptcy was caused by the collapse of a system, nourished by the diaspora, that for three decades had provided financing for an indebted state via the local banking sector.

The very high level of interdependence between the state and the banking sector: A Gordian knot that has not yet been cut

Lebanon has one of the world's highest public debt ratios, at nearly 180% of GDP at the end of 2020. Until the default on payments in spring 2020, this debt was financed through a very high level of interdependence between the state, the central bank (Banque du Liban, BdL), and the banking sector. As over three-quarters of the debt was held by residents, all the actors involved were incentivized to support the other parties in order to avoid a full-blown crisis.

In order to finance its deficit (-9% of GDP on average between 2005 and 2019) and service its debt, the state issued treasury bonds that were primarily bought by Lebanese commercial banks and the central bank. The commercial banks attracted capital, notably in foreign currency, through attractive returns, uncoupled from USD deposits in the United States since the global financial crisis of 2008. These flows financed government bond purchases and supplied the BdL with bank deposits, enabling it to post high foreign exchange reserve figures that reassured investors about the credibility of the fixed exchange rate between the Lebanese pound (LBP) and the USD. The BdL offered attractive rates of return on its deposit certificates, and in particular on deposits in dollars, which in turn enabled it to purchase treasury bonds.

The persistence of this system, highly dependent on deposits from nonresidents, is partly explained by the central role of the less risk-averse diaspora, and partly by the limited number of actors involved (1% of accounts held 50% of deposits). These savers, highly exposed to the Lebanese banking sector, were encouraged to pursue their investments in order to maintain the stability of the financial system.

The system was not, however, without its vulnerabilities. The banking sector, oversized in relation to the real economy (~300% of GDP between 2003 and 2010, 405% of GDP at the end of 2016), presented a systemic risk. Similarly, the scale of the BdL's assets (220% of GDP) was unparalleled anywhere else in the world.

The headlong rush into financial engineering

This system of financing the public deficit was sustainable as long as capital inflows remained dynamic. But in early 2016, against a backdrop of low confidence among external investors after two years of political paralysis and lower dynamism in the Gulf states, Lebanon saw a decline in inflowing deposits from nonresidents. In order to reverse this trend, the BdL introduced financial engineering mechanisms. First, it swapped its LBP treasury bonds for a Eurobond of USD 2 billion newly issued by the treasury, and second, it offered to buy back from the commercial banks, above market price, their holdings of government bonds and deposit certificates, on the condition that they buy them back for an equivalent amount in USD (equating to USD 14 billion).

This operation had two results: first, it enabled the banks to offer very attractive returns on deposits in USD and to strengthen their balance sheet; and second, it led to a recovery in foreign exchange reserves (+12% between June and August

2016) through the net recovery in deposits. The high cost of keeping the system balanced was however borne by the BdL's balance sheet. The respite was short-lived, and loss of confidence in the system resulted in net outflows of deposits from May 2019 onwards (-24% in August 2021 compared to the end of 2018). In order to prevent this, the banks introduced capital controls in November 2019.

In parallel, sovereign default became almost inevitable. Interest payments (10% of GDP) on the Lebanese debt, contracted at relatively high borrowing rates accounted for nearly half of public revenue alone. Public income was also constrained by low tax receipts (16% of GDP) compared to other countries with a similar level of development. Unable to refinance itself, and required to pay back USD 4.6 billion including interest, Lebanon was unable to honor the USD 2.5 billion in Eurobonds that came to maturity in 2020.

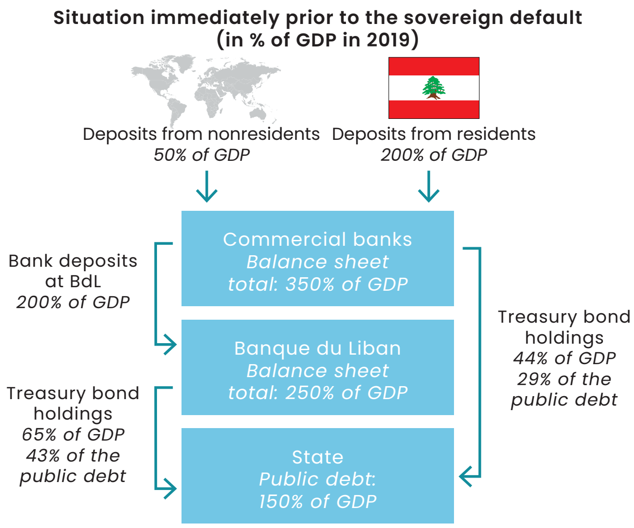
Fallout from the sovereign default

The sovereign default precipitated the collapse of the banking system. Colossal restructuring is required to restore it to health, but the official quantification of its scale is invalid and incomplete. In May 2021, the credit rating agency Standard & Poor's estimated that it could generate losses of up to 134% of GDP projected for 2021, even without considering any impact on devaluation of the LBP, which has lost over 90% of its value on the black market. The lack of convincing progress with restructuring the debt, getting the banking system back on its feet, and implementing the structural reforms expected by the international community has left Lebanon with no financial support from donors, other than humanitarian aid.

This intentional wait-and-see attitude reflects the interrelated interests of a political class that is highly exposed to the banking sector. While a plan to restructure the domestic public debt and banking sector would likely mostly hit those with large savings, the entire population is effectively seeing a haircut on its deposits, materialized in drastic limits on withdrawals and their forced conversion into LBP.

Lebanon is now in the grip of a humanitarian crisis that is having a disastrous impact on its people. Its multidimensional poverty index has nearly doubled, from 42% of the population in 2019 to 82% in 2021. Hyperinflation (+460% over two years in September 2021) and shortages in energy, food, and medicine are being exacerbated by the halting of subsidies on raw material imports that was forced by the country using up its foreign exchange reserves in late summer 2021. The country has almost no social infrastructure, leaving the population with no safety net. Health and education services are unable to operate due to electricity shortages, and the supply of drinking water is a source of increasing concern. The crisis could get worse yet.

Figure 14 – Interdependence of actors



Sources: Banque du Liban, IMF.

Brazil: A short-lived lull

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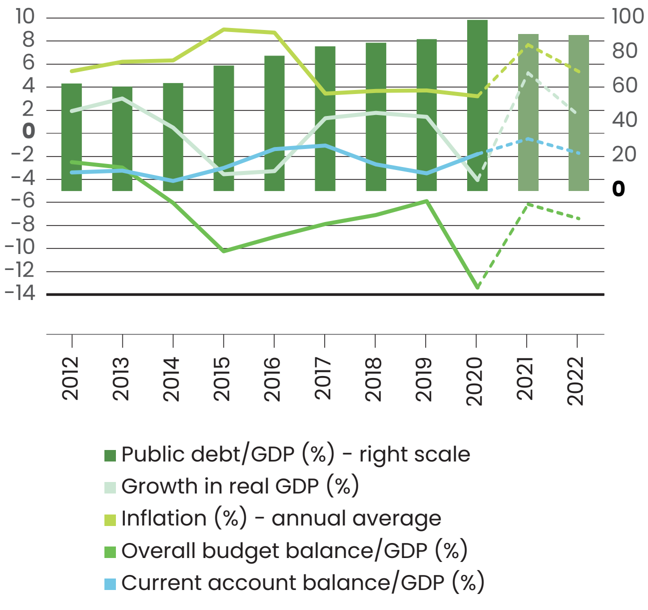
The COVID-19 pandemic and ensuing public health toll (the second highest a historic worldwide, with over 600,000 deaths) hit Brazil just as its economy was slowly recovering from an historic recession (-3.5% per annum in 2015 and 2016) that had shone a light on the country's economic weaknesses. The fiscal and monetary response has been massive, mitigating the scale of the shock. But in an election year which promises to be tense, the economy is facing two major challenges: keeping public finances under control, and reforming its growth model.

"The fiscal framework has not changed. We will help Brazilians by slowing the pace of the fiscal adjustment," announced Brazil's finance minister Paulo Guedes in late October 2021. But by proposing changes that threaten the fiscal rule introduced in 2016, Brazilian president Jair Bolsonaro and his government have put the focus back on the main area of concern of the Brazilian economy: its public finances.

Figure 15 – Key macroeconomic aggregates



Source : IMF (WEO, oct. 2021)

A very short-lived recovery

In mid-2021, the Brazilian economy had a boost of optimism. After the recession was limited to -4.1% in 2020, its projected growth for 2021 was revised upwards: primarily driven by consumption, it was forecast in July as 5.3%, compared to 3.6% in April (WEO), while the country's GDP had returned to its pre-pandemic level by the first quarter of 2021. Over the course of the year, economic growth and the phase-out of the fiscal stimulus are expected to bring the primary fiscal balance back to its pre-pandemic levels (-1.6% of GDP). As such, and due in particular to a favorable growth-interest rate differential, public debt, which had been rising since 2015, is expected to fall to 90.5% of GDP in late 2021 after peaking at 99% in 2020. In terms of external balances, sustained demand from trade partners and rising commodities prices should allow the current account balance to reach equilibrium in 2021. Brazil's structurally high foreign exchange reserves (covering over 16 months of imports) constitute a major factor in attenuating external liquidity risk. Finally, the unemployment rate began to fall to 12.6% in the third quarter of 2021, after a historic high of 14.9% in the first quarter of 2021. President Bolsonaro's efforts to revise the constitutional public spending cap have however cast a gloom over this picture (see below).

Few risks associated with the sovereign-bank nexus, but public finances remain a major cause of concern

The public debt profile is favorable, with both low foreign exchange risk (only 5% of the debt is denominated in foreign currency) and low refinancing risk (only 15% of the debt is held by nonresidents). Public financing needs are amply covered by a deep (200% of GDP) and highly liquid financial sector. Banks are structurally well capitalized, profitable, and resilient to the crisis (RoE of 15% and low NPL rate of 2.4% as of mid-2021), and only 30% of their assets are exposed to sovereign debt. The potential risks from the sovereign-bank nexus are thus low. However, the levels of debt (over 90% of GDP) and of public financing needs (~25% of GDP) call for increased vigilance. Keeping the budget under control, which remains a major challenge, is required to reduce such level.

The Brazilian economy has not generated a primary surplus since 2013 and the reversal of the commodities supercycle, and thus has a structurally high fiscal deficit: -7.7% of GDP on average over 2014–2019. To reduce the deficit, fiscal consolidation was underway before the pandemic. It was materialized in particular by the constitutional public spending cap introduced in 2016, and the launch of a large pension reform at the end of 2019. Consolidation was suspended in 2020 to allow for the budget stimulus, and resumed in 2021. Although welfare aid was extended between April and July, in March Congress voted through a law strengthening compliance with fiscal rules, including a freeze on public sector pay in times of crisis. These measures should bring the budget deficit down to -5% of GDP by 2025, while it should already be cut down to -6.2% of GDP in 2021 (-13.4% in 2020).

In early December, however, the approval of a constitutional amendment, pushed by Bolsonaro to increase social spending, threatens to permanently breach the spending cap. Presented as necessary in order to finance the new *Auxílio Brasil* program, an ambitious successor to the famous *Bolsa Família*, the amendment is suspected of primarily serving electoral purposes by shoring up Bolsonaro's waning popularity. Above all, it undermines the credibility of the government, raising fears of fiscal slippages from 2022. As a direct consequence, risk premiums on Brazilian sovereign debt have increased (+100bp for the EMBIG spread in the second half of 2021) and could remain high for the foreseeable future. This, combined with the current hikes in policy rates to combat inflation, will substantially drive up the cost of public debt (with interest on public debt already accounting for 18% of public revenues on average since 2016), and is likely to put the level of public debt back on an upward trajectory in 2022.

Escaping the middle income trap

Other clouds have also built up on the horizon in recent months. The economy is in technical recession, with GDP declining over two consecutive quarters (-0.4% in the second quarter, -0.1% in the third quarter), indicating that the recovery is running out of steam despite acceleration of the vaccination campaign (80% of the population had received their first dose by the end of 2021). Inflation, initially deemed temporary, has persisted and is now over 10% (yoy), forcing the central bank (Banco Central do Brasil, BCB) to impose aggressive monetary tightening (+725 bp in 2021) which will curb growth in 2022 to just +0.5%, according to a BCB survey of economists. The tense political climate is also likely to weigh on confidence and the recovery, and to increase volatility: the Brazilian electorate still has no "third way" candidate, but appears to be highly polarized between the return of former president Lula and the repeated excesses of President Bolsonaro.

In more structural terms, in the medium term, the Brazilian model is itself in doubt. Its primarized economy (dependent on agriculture commodities) has been unable to capitalize on the strong growth of the 2000s (CAGR of 3.4%) in order to move upmarket. On the contrary, Brazil is in fact engaged in a process of "impoverishing specialization," producing more basic goods with low added value. Weak investment (15.1% of GDP on average since 2016), productivity, competitiveness, and integration into global trade, now limit potential growth to less than 2%. Despite the reforms introduced since 2018—and pursued, even during the pandemic—to improve the business climate, growth drivers are hard to identify. As such, Brazil could remain stuck in the middle income trap, with levels of poverty (30% of the population below the national poverty line) and inequality (Gini index at 0.53) remaining high.

Costa Rica: A weakened model of stability

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Since 2016, economic slowdown combined with fiscal deterioration, has led to an increase in Costa Rica's public debt and public gross financing needs. This trend has been exacerbated by the COVID-19 crisis. The government's fiscal space has further reduced, while the use of domestic banking market faces a number of limitations. In March 2021, in order to restore the public finances' sustainability, the country requested an IMF program, which should enable it to partly cover its public gross financing needs and help catalyze financing from international investors. However, the program's implementation faces challenges, especially as legislative and presidential elections are fast approaching.

Costa Rica is seen as an atypical model of democratic stability and economic development within an unstable Latin American region — as demonstrated by its recent accession to the OECD in May 2021 — but has faced rising popular discontent in recent years in face of rising inequality and gradual fiscal deterioration, which is weighing on economic activity. The COVID-19 crisis has exacerbated these trends. The government faces growing hostility from local actors, which came to a head during the negotiations over an IMF program in late 2020–early 2021.

A model of political stability and gradual economic transformation. . .

Costa Rica has a long history of democratic stability. The country's elections have been free and transparent since 1949, without any contested results, while the multiparty system is firmly anchored in Costa Rica's political system. Costa Rica has also posted solid economic performance figures since the early 1980s (average annual growth of 3.8%), enabling it to double its GDP per capita over the same period. Primarily agricultural in the early 1950s, the country introduced liberal and market-friendly policies from 1980 onward, that enabled it to attract foreign investors. Since 1990, the service sector has grown rapidly (70% of GDP in 2019), led in particular by the country's dynamic telecommunications and tourism sectors.

. . . undermined by a slowdown caused by fiscal deterioration. . .

The central government's public deficit has risen significantly since the 2008 global financial crisis, with the temporary budget stimulus implemented to support the economy becoming more permanent than initially intended. Moreover, economic growth has slowed down since 2016, primarily due to the unrest in Nicaragua, which has negatively affected exports. In order to restore public finances, the government adopted a long-awaited fiscal reform in end-2018, introducing a VAT and a new fiscal rule. The public sector's liquidity issues and uncertainties regarding the fiscal reform, negatively impacted growth in 2018 and 2019 (2.7% and 2.1%).

The growth of the public deficit led to a rapid increase in public debt. In 2020, the COVID-19 crisis plunged the country into recession (-4.8%) and further weakened its fiscal position, which stood at 82.6% of GDP at the end of 2020. At first glance, the debt structure appears relatively favorable: the share held by nonresidents is 24% of outstanding debt, and 35.5% is held in foreign currency. However, the government's increased use of domestic bond market to cover its financing needs, with shorter maturities and higher costs, has generated liquidity tensions (higher interest rates, temporary use of monetary financing of the deficit in 2018).

. . . having a negative impact on the banking sector

The Costa Rican financial sector remains highly concentrated,[7] in a country of just 5,1 million people. At the end of 2020, total assets of the financial sector amounted to over 110% of the GDP. With the banking sector accounting for 80%, and the three public banks accounting for 60%.

The country experiences a significant level of financial dollarization, with around 38% of deposits and 35% of credit held in USD. This is a source of systemic fragility, should the colón depreciate, as around two-thirds of borrowers in foreign currency are not covered against foreign exchange risk. This is mainly an issue for private banks, which struggle to capture deposits in local currency in the absence of a deposit guarantee framework, , whereas public banks benefit from an explicit guarantee from the government in case of default. Howver, the most recent stress-tests conducted by the IMF indicate that the banking sector as a whole remains sufficiently capitalized, even in the event of an extreme shock.[8]

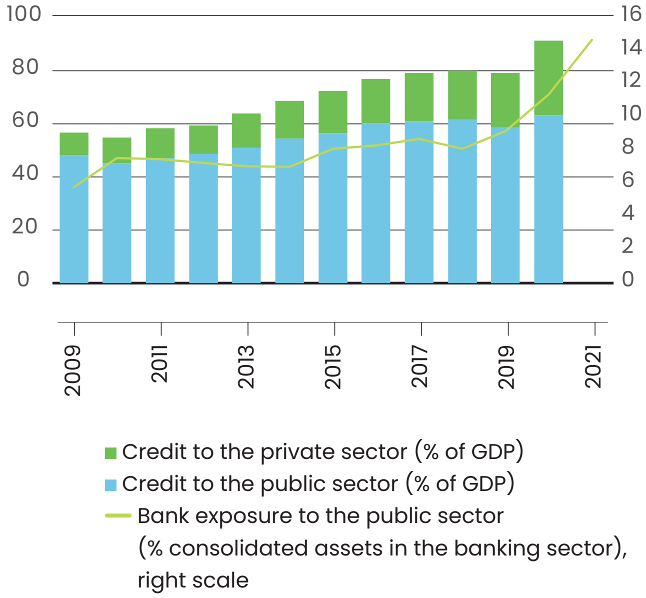
The banking sector is also increasingly exposed to the public sector, due to the widening fiscal deficit and increased gross public financing needs. At the end of 2020, claims on the public sector represented 13.5% of total banking assets, an increase of over three pp since 2018, but still a modest share. Increased growth of local bank exposure to the sovereign could however lead to a crowding-out effect on private sector credit, and be a source of systemic fragility on the back of fiscal deterioration.

Private sector credit grew from 26% of GDP in 2000 to 62% in 2018. However, credit growth has slowed down significantly since mid-2017 and even contracted in early 2020, in light of the tightening of monetary policy between 2018 and 2010, the slowdown in growth, and the gradual decline in private actors' confidence since 2018.

7 At the end of 2020, it consisted of 16 banks (3 public banks, 2 banks created by special law, and 11 private banks), 23 credit unions, and 9 financial institutions.

8 Stress-tests conducted in 2020, combining a rise in interest rates, nonperforming loans, and depreciation of the colón.

Figure 16 – Evolution in credit and public sector exposure



Sources: IMF (IFS), BCCR, World Bank.

Restoring public finances: A lifeline for recovery and economic stability

In 2021, in order to restore the sustainability of public finances, Costa Rica requested an IMF program designed to bring down the fiscal deficit to around 3.5% of GDP by 2024. The success of this program is crucial in order to improve public finances, to partly cover public gross financing needs (which peaked at 14% of GDP in 2021), to reduce the public debt, and to help catalyze financing from international investors in order to limit the saturation of the domestic market. The country could also issue new Eurobonds in 2022.

However, the upcoming legislative and presidential elections in February 2022 pose a risk to the program's sustainability. Costa Rica's potential growth also remains modest, at an estimated 3.5% of GDP. Improving the quality of education, developing infrastructure, promoting formalization of the labor market, and reducing red tape could all help to improve the business climate, increase Costa Rica's potential growth, and make it more inclusive.

Dominican Republic: Greater shock resistance since the 2003 financial crisis

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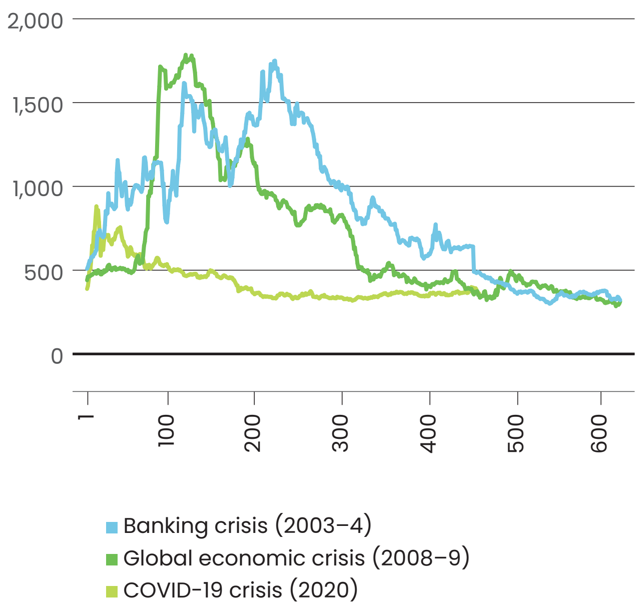
The Dominican Republic is expected to have one of the quickest recoveries from the crisis in the Latin America and Caribbean region, with economic activity returning to pre-pandemic levels from 2021. Thanks to its robust macroeconomic fundamentals and the responsiveness of the public authorities in terms of support measures, a dynamic recovery began in under a year. But while the traditional drivers of growth and the economic dynamism of the last two decades have enabled the country to increase its resilience to shocks, vulnerabilities stemming from the 2003 financial crisis are still having a negative impact on the balance sheet of the central bank and public finances.

Over the past two decades, the Dominican Republic has faced three major crises: the 2003 banking crisis, the 2008 global financial crisis, and the crisis associated with the COVID-19 pandemic. Despite the scale of these problems, the recessive impact of each crisis has been short-lived. The economic dynamism and experience acquired by the authorities have enabled the country to increase its resilience to shocks while increasing market confidence, as illustrated by the time taken for spreads to normalize, which has markedly improved with each crisis (fifteen months, thirteen months, and six months respectively). In early December 2021, Standard & Poor's and Fitch lifted their negative outlooks for the country.

Figure 17 – EMBI Global Index, from the first day of the crisis



Source: JP Morgan.

A model of outward-looking growth, creating both opportunities and vulnerabilities

In the 1980s, the Dominican economy underwent a profound transformation, moving from the sugar industry and import substitution to the development of tourism and free zones. This increasingly outward-looking approach is reflected in a high level of dependence on the outside, in particular on the United States, which supplies the biggest contingent of tourists, and where the majority of the diaspora sending transfers is based.

After a period of high growth in the 1990s (annual average of around 6%), the economy was hit by a banking crisis in 2003 following the collapse of Baninter, one of the biggest local banks. The ensuing shockwaves across the whole of the banking system had major monetary and financial consequences. The exchange rate dropped to 60% against the dollar in 2003, inflation skyrocketed (from 10% in 2002 to 53% in 2003), and the public debt doubled (from 21% of GDP in 2002 to 41% of

GDP in 2003). However, transfers from migrants continued to flow in during the crisis, and free zone exports and tourism were stimulated by depreciation of the peso. The external drivers of growth thus significantly cushioned the shock. Compared to recessions in the Asian countries that experienced a financial crisis, the crisis in the Dominican Republic was notably limited and short-lived (with one year of recession of -1.3% in 2003, while Thailand had two years of recession of -2.7% in 1997 and -7.6% in 1998).

The pandemic has however had a severe impact on the economy, notably due to its high dependence on tourism, and, compounded by the effects of national public health restrictions and pandemic-related uncertainty, domestic demand contracted sharply in 2020. The recessive impact was however again short-lived, with a dynamic recovery established from the second half of 2020. The Dominican economy has taken advantage of its diversification and leveraged the opportunities created by the crisis. Export companies adapted rapidly, in particular by increasing exports related to the medical sector, and free zone activity was sustained through diversification toward activities with high added value (pharmaceutical and electrical products). The pandemic has also confirmed the enduring support of the diaspora, whose transfers rose strongly in 2020 (9.9% of GDP, equating to +2.5 pp on 2019). After experiencing its sharpest recession in 2020 (-6.7%) since 1990, growth in real GDP is thus expected to rebound to +9.5% in 2021.

A resilient financial system in considerably better health since the 2003 banking crisis

The institutional fragilities of the financial system were a major factor in triggering and escalating the banking crisis. Aware of the potential for social, political, and financial destabilization, the authorities thus set about introducing the reforms necessary to restoring the health of banking activity and improving oversight. Banking regulation has since considerably improved, and balance sheet ratios have consistently demonstrated the sector's financial strength. Private sector credit has grown strongly since 2013 (+12% average annual growth in nominal terms) although it still only represented 29.2% of GDP in 2020, 10 pp below its pre-banking crisis level. Regulatory flexibility has enabled the financial sector to maintain a sufficient level of profitability, solvency, and liquidity to react promptly to changes in market conditions and the economic situation.

In addition, drawing on its experience of previous crises, the Central Bank of the Dominican Republic (BCRD) has put in place a coordinated, rapid, and appropriate response package (gradual monetary easing via reducing the base rate, and strengthening the bank liquidity available to businesses and households). It has also intervened in the foreign exchange market in order to limit the volatility of the peso, mitigating the impact of the crisis.

A central bank that is effective, but with a permanently weakened balance sheet since 2003

The 2003 banking crisis was handled in two stages. First, the BCRD injected massive amounts of liquidity into the banking system in order to guarantee the deposits of struggling or failing banks. The increase in the money supply, generated against a backdrop of loss of depositor confidence, was reflected in arbitrations to the detriment of the peso, leading to an increase in the dollarization of monetary assets. This resulted in the depreciation of the national currency, and accelerated inflation. Second, in order to counter these imbalances, the BRCD implemented a "sterilization" strategy designed to reduce the monetary assets circulating in the economy by increasing its issues of deposit certificates. This tandem movement of injection followed by sterilization had a sustained, significant weakening effect on its balance sheet, with the losses stemming from the costs incurred totally absorbing its capital. The BRCD Recapitalization Act, which transferred the cost of this recapitalization to the government in 2008, continues to have a negative impact on the consolidated public sector deficit. The central bank holds 20% of the total public debt. Its recapitalization thus appears crucial in order to strengthen its financial and institutional independence, and also enable it to reduce risk premiums on bond issues.

Acronyms and abbreviations

AAGR Average annual growth rate

BCB Banco Central do Brasil (Central Bank of Brazil)

BCEAO Banque Centrale des États de l'Afrique de l'Ouest (Central Bank of West African States)

BCRD Banco Central de la República Dominicana (Central Bank of the Dominican Republic)

BDL Banque du Liban (Central Bank of Lebanon)

CAR capital adequacy ratio

CBK Central Bank of Kenya

CEMAC Central African Economic and Monetary Community

DSSI G20/Paris Club Debt Service Suspension Initiative

ECO Economic Diagnoses and Public Policy department of the Agence française de développement (AFD) (French Development Agency)

EDC Emerging and developing country

EFN External financing needs

EMBIG JP Morgan's Emerging Markets Bond Index Global

EPRDF Ethiopian People's Revolutionary Democratic Front

EUR Euro

FDI Foreign direct investment

GDP Gross domestic product

HDI: Human Development Index

HIPC Heavily Indebted Poor Countries

IFS IMF International Financial Statistics

IMF International Monetary Fund

LBP Lebanese pound

LIC Low income country

LMIC Lower middle-income country

NPL Nonperforming loans

PB Paartii Badhaadhiinaa (Prosperity Party)

PP percentage points

ROE Return on equity

SDR Special Drawing Right

SMES Small and medium-sized enterprises

TPLF Tigray's People Liberation Front

UEMOA West African Economic and Monetary Union

UMIC Upper middle-income country

USD US dollar

WB World Bank

WEO IMF World Economic Outlook

YOY Year on year

XAF Central African CFA franc

Table of figures

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