2018 – a pivotal year for financial inclusion in emerging markets
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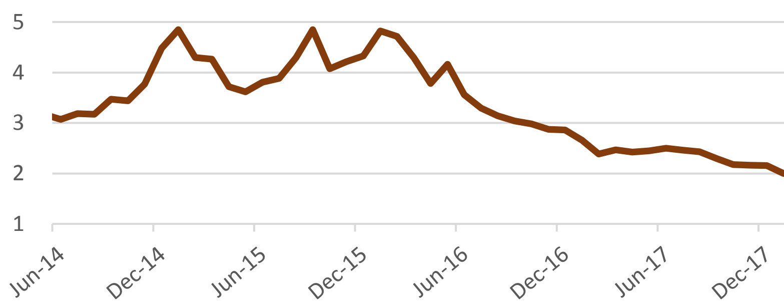
In emerging countries, 2018 should be marked by wide monetary policy disparity but a common desire to accelerate economic reforms, especially those aimed at accelerating financial inclusion.

2017 will have been a year of recovery in emerging markets during which US rates will nevertheless have been enhanced by 75 basis points throughout 2017; the emerging market three-year risk premium as represented by interest rate spreads between emerging market bonds and US bonds is now at its lowest since the subprime mortgage crisis. Emerging countries are hence facing a possible constraint of being obliged to raise, in turn, their key rates, but they don't have the same levers to maintain their attractiveness vis-à-vis US rates, which should continue to increase.

Figure 1: 3-year interest rate differentials between issuers from emerging countries and US bond issuances since the commodities crisis (%)



Source: Bloomberg

Accelerating regulatory and governance reforms – a necessity

The most diversified emerging economies have taken advantage of falling commodity prices to consolidate or strengthen their fiscal and trade balances, increase foreign exchange reserves or adopt policies to support growth. This is the case of countries like Bangladesh, China, India, the Philippines and Tanzania. These countries are less directly threatened by the rise in US rates because their fundamentals are attractive and the continuation of economic reforms should allow them to improve investment risk perceptions.

A second group of countries, one that is more dependent on commodity exports, also attracted the attention of investors. These countries include Albania, Botswana, Cambodia, Colombia, Costa Rica, Indonesia and Vietnam. As with the first group, they have relatively strong political and economic governance institutions and they initiated pro-private sector development reforms at a time when commodity prices were still in the upward phase of the cycle.

These two groups of countries – with relatively diversified economies and strong financial fundamentals – will be the most resilient in the face of rising US rates. It will potentially also be the least inclined to engage in more restrictive policies, unless inflationary risks threaten the stability of the currencies and the purchasing power of consumers.

Then comes a group of economies whose level of diversification ensures that commodity price fluctuation dependencies are contained despite tenuous financial situations. For these countries, including Argentina, Brazil, Kenya, Morocco and Sri Lanka, the retention of foreign investment flows and

the renewal of external debt are essential to maintaining business and stabilizing growth. The rise in US rates is creating an urgent need for these countries to carry out fundamental reforms that will enable them to improve their competitiveness.

The last group, which closes this breakdown is characterized by strong economic dependencies on commodity fluctuations and precarious financial situations. This is the case for example in Angola, Azerbaijan, Ecuador, Mongolia, Nigeria and South Africa. Low foreign exchange reserves, debt ratios that are above norms in these markets, and large fiscal or trade deficits lead these countries to resort most often to the International Monetary Fund's (IMF) bailout programs.

Going all out to promote financial inclusion

Whatever the economic situation, however, there is a desire in all emerging countries to promote financial inclusion through conventional measures to increase the supply of funds or by promoting access to innovative financing solutions.

In Argentina and Costa Rica, regulators foster the collection of deposits by increasing the amounts guaranteed. Argentina is supporting these reforms with the establishment of an inter-ministerial committee on financial inclusion. India, in order to boost bank growth, has embarked on a campaign to clear bad debts held by state-owned and provincial banks, including an associated capital injection plan of about USD 30 billion and governance practice reforms. Morocco has granted a dozen licenses to Islamic banks in 2017, while Kenya has established a regulatory framework for Islamic finance. Tanzania is considering putting limiting the interest rates that banks can charge. This measure already used to accelerate financial inclusion by countries such as Kenya, Cambodia and Colombia, has, however, shown its limits. In Colombia, the financial regulator is thinking of reversing course and removing the ceiling on rates to boost credit activity through offerings.

Globally, there is balanced distribution between reforms aimed at reducing bank risk and those aimed at expanding the credit market. Faced with the normalization of US monetary policy, they offer an alternative to a rise in domestic key rates that would penalize recovery policies when local economic actors are only just recovering from the previous crisis.

However, despite the undertaken reforms, the most dependent emerging economies on foreign capital and commodity prices will be forced to raise policy rates to finance fiscal and trade imbalances in the short and medium term.