Eyes of IIMA Institute for International Monetary Affairs

2016.2.9

Commodity Price Shocks and Financial Instability
~IMF concerns transmission channels to financial sector~

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South American nation of Suriname asked for help from IMF and delegations are visiting the country very soon. Seemingly this is not a big news for most of the people. The country had tumbled from “natural resource-dependent, bubble-like high economic growth (e.g. income had grown 5 times during the past 10 years)” to a “serious recession caused by export slump given the plunge of international commodity prices”. Then “the fiscal balance and current account balance have been largely deteriorated” and “the foreign currency reserves dried up”. As a result, the country, facing the risk of default, is asking for support from the international institutions.

Most commodity prices have declined by about 50% since mid-2014, and the possibility is getting high that low-income commodity producing counties are in the midst of hardship and likely to “Surinamize” in not very distant future. The above-mentioned news, a crisis of the smallest nation in South America, looks negligible but could be a tip of iceberg.

Asked recently what kept her up at night, Christine Lagarde, Management Director of the IMF, said she worries about the fate of oil producing countries with low-income. In the interview, she named Nigeria in which 90% of export and 60% of revenues are oil-dependent. It is said that Nigeria is considering the support from IMF, World Bank, African Development Bank and other international organizations for about USD 9 billion loan, and she just made an official visit to Nigeria early this year. To cite the other country on the list, Azerbaijan is now under negotiation with IMF for support of about USD 4 billion. Venezuela said to be looking for other sources for help (it struck a deal with China to provide oil in exchange for aid), and according to the Financial Times, Ecuador, Angola and Gabon are the possibly follow suit. Due to the plunge of commodity prices, many low-income and natural resource-dependent countries are facing crisis-level difficulties which require international support.

What truly kept Mrs. Lagarde up at night is, however, not the conventional phenomena of fiscal deficit or balance of payment induced crisis. According to latest IMF working paper “Commodity Price Shocks and Financial Sector Fragility”, the concern varies to more vulnerable financial sector and its spill-over effect to global financial market.

The working paper, which was based on the analysis of 71 emerging and/or developing countries, the commodity price shocks will increase the fragility of financial system through 3 channels: 1) banks‘ balance sheets will be weakened by recession, 2)it will lead deposit withdrawals and liquidity shortage, while the foreign currency denominated debt will be swollen given the currency depreciation. 3) fiscal balance will deteriorate due to the revenue fall and fiscal stimulus to support the economic downturn.

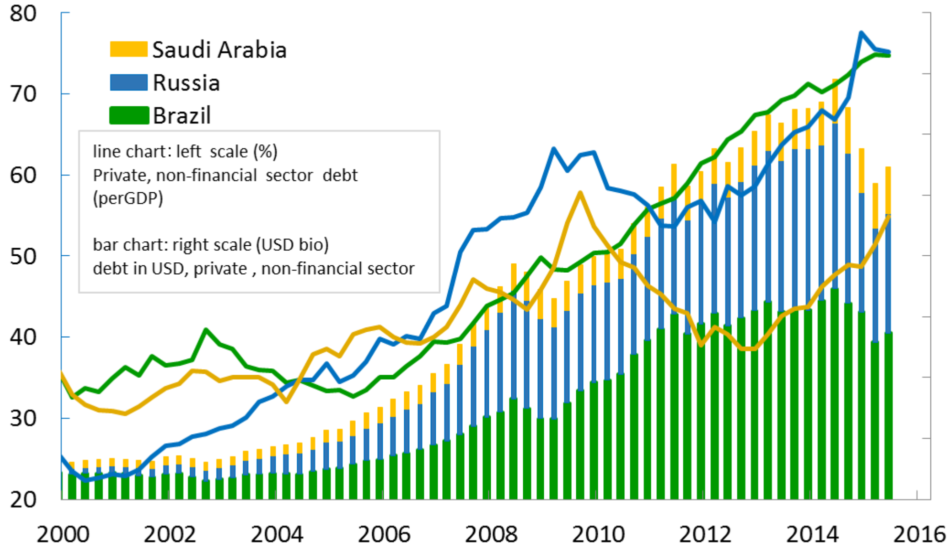
The paper also indicates about the channels that the adverse commodity price shocks influence financial system: a) the recession will generate non-performing loans weakening banking sector profitability, b) the typical aspects of lower-income nations such as poor governance, high debt and low financial development will coincide detrimental effects. According to the author, the macro-economic variables such as GDP growth, governmental revenues and expenditure and savings ratio are the key indicator as well as the amount of foreign currency denominated debt.

On the other hand, the characteristic of a country whose financial systems are relatively stable are the better governance, lower fiscal debt, pile of national wealth such as SWF, and diversified economic growth model. The reason why Russia and Brazil (one of the largest resource-dependent emerging countries) are holding out against the financial crisis is that both countries have an advantage of safety net such as huge accumulation of foreign reserves and SWF. However, they also lack the diversity in their economic growth model which heavily relies on natural resources. And moreover, as they possess huge amount of USD-denominated foreign debt (see Chart 1), it is very uncertain whether if they are remote from the financial fragilities which IMF concerns.

Last month, World Bank revised down the oil price outlook from USD 51 to USD 37 per barrel. As the decline of oil-led commodity price is likely to continue, the hardship of resource dependent low-income countries will be no longer momentarily experiencing matter. In other words, countries which rely too much to the natural resources are facing structural requirement to shift their economic growth model to be premised on “decades of low commodity prices”. This may be the essence of the adverse commodity price shock since mid- 2014.

Also, as to see the nature of recent financial crisis, it is not just about fiscal deficit or current account balance of specific country but also the global spill-over effect through malfunction of the financial system that should be carefully watched. As the globalization goes on, the transmission channels of adverse commodity price shock likewise will transform.

Chart 1: Debt in Private, Non-Financial Sector



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