

Contemporary Issues in Finance - Lecture 7

Lesson Title: Emerging
Market Finance

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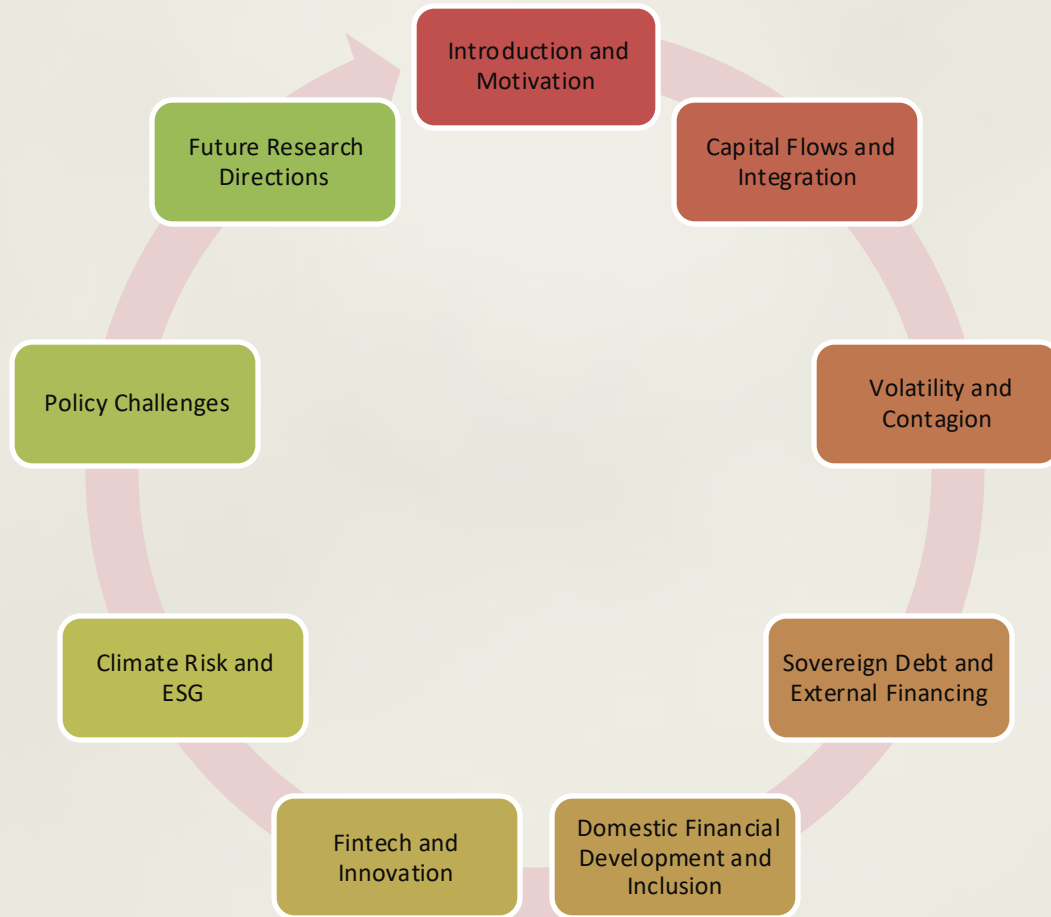


Course Overview

Emerging markets play a vital role in global finance, combining high growth potential with significant risks. This lecture reviews recent research on key issues including market liberalization, capital flow volatility, sovereign debt, financial inclusion, domestic market development, climate and digital finance, and regulation. It emphasizes current challenges and policy implications for emerging economies facing interconnected shocks such as pandemics, geopolitical tensions, and climate risks. This lecture explores the evolution, challenges, and innovations in emerging market finance, focusing on policy, risk, and institutional dimensions.



Outline



Introduction and Motivation

Emerging markets (EMEs) play an increasingly vital role in global finance. They face unique challenges related to volatility, governance, and integration into global financial systems.



Capital Flows, Liberalization & Financial Integration

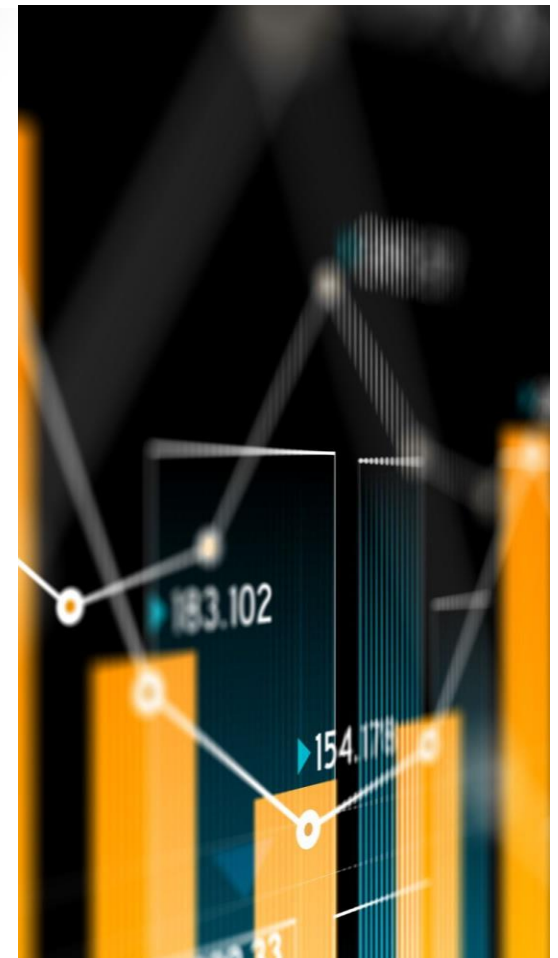
Segmentation
vs Integration

Empirical
patterns in
capital flows

Volatility,
sudden stops,
and reversals

Theoretical foundations: segmentation vs integration

- In segmented markets, assets reflect local risk premia; in integrated markets, pricing aligns with global factors.
- Integration raises asset prices via diversification benefits (Bekaert & Harvey, 2003).



Empirical patterns in capital flows



- EMEs experience surges in FDI, portfolio flows, and hot money.



- Stable FDI and equity flows are less disruptive than debt.



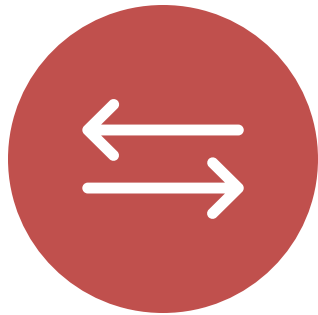
- Post-2020, EMEs' debt levels rose, raising vulnerability.

Capital flow volatility, sudden stops, and reversals

- Managing volatility and contagion is critical.

- Past crises (Asian 1997, taper tantrum 2013, Covid shock) show the role of weak buffers and currency mismatches.

Volatility, Contagion, and Early Warning



- RETURN DYNAMICS AND HIGHER MOMENTS



- CONTAGION AND SPILLOVERS



- EARLY WARNING SYSTEMS (EWS) AND CRISIS PREDICTION

Return dynamics and higher moments

- In EMEs, returns often exhibit high volatility
- As markets integrate, correlations with global factors
- Investigate how volatility of capital flows itself is procyclical and feedbacks into macro outcomes.





Contagion and spillovers

- Cross-market contagion in emerging markets
 - Distinguishing genuine (fundamental) contagion from mere market noise .
 - Analyze transmission mechanisms to trace and understand contagion pathways.
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Early Warning Systems and Crisis Prediction



Indicators: current account, reserves, credit growth.

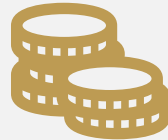


Machine learning models improve predictions but face interpretability and data challenges.

Sovereign Debt, Debt Sustainability, and External Financing



- Debt trends and vulnerabilities



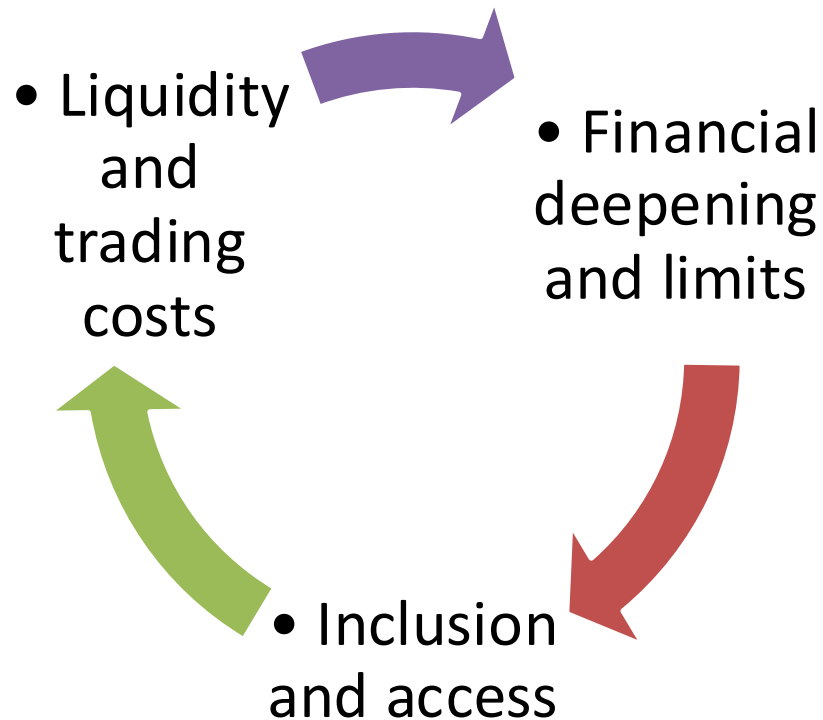
- Debt sustainability and external constraints



- Sovereign credit spreads and exit strategies

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- **Debt trends and vulnerabilities:** Pandemic-era borrowing increased EMDE debt. Rising global rates elevate servicing costs and refinancing risks (IMF).
 - **Debt sustainability and external constraints:** Traditional debt sustainability frameworks must now include climate shocks, commodity volatility, and geopolitical risk.
 - **Sovereign credit spreads, default risk, and exit strategies:** Default risk models integrate political and reputational factors. De-dollarization and local currency issuance are growing trends.
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Domestic Financial Development, Inclusion, and Market Microstructure



Domestic Financial Development, Inclusion, and Market Microstructure

Financial deepening and its limits :Deeper markets enhance stability but excessive financialization may harm growth (the 'Too Much Finance' hypothesis).

Financial inclusion and access: Fintech, mobile money, and agent banking drive inclusion in Africa and Asia, but require consumer protection.

Market microstructure, liquidity, and trading costs: Illiquidity and information asymmetry raise costs; reforms in infrastructure can attract long-term investors.

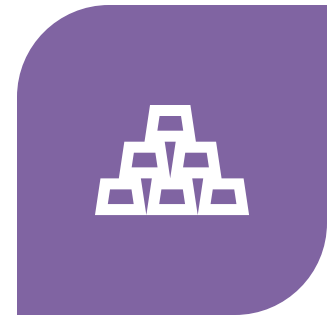
Fintech, Digital Finance, and Innovation



- ADOPTION IN EMES



- RISKS: CYBERSECURITY,
REGULATION



- CRYPTO, TOKENIZATION,
AND CBDCS



Fintech adoption in EMEs

EMEs leapfrog traditional systems, using mobile payments and microfintech innovations to reach unbanked populations.



Risks:
cybersecurity,
regulation,
consumer
protection

Balancing innovation and stability requires interoperable systems, supervision, and consumer trust.



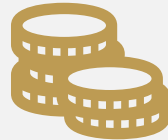
Crypto, tokenization, and CBDCs

CBDCs and tokenized assets offer promise but raise design and regulatory tradeoffs.

Climate Risk, ESG, and “Green” Finance in EMEs



- Exposures and imperatives

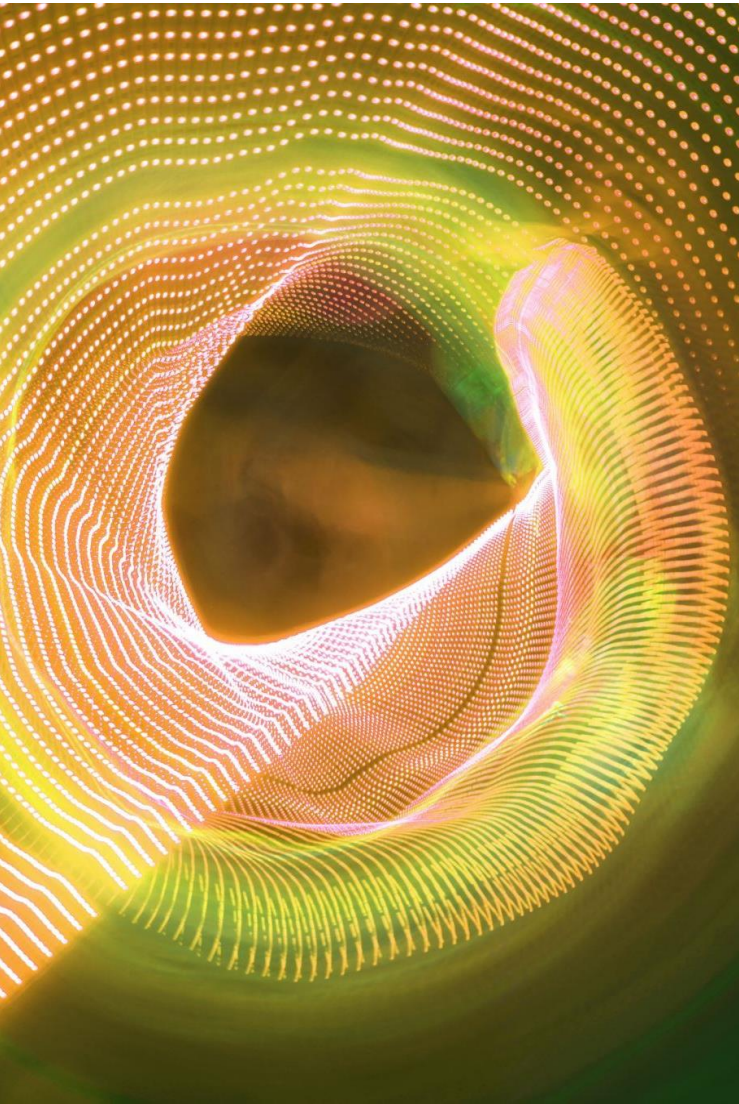


- Green bonds and sustainable finance



- Climate stress testing and disclosure

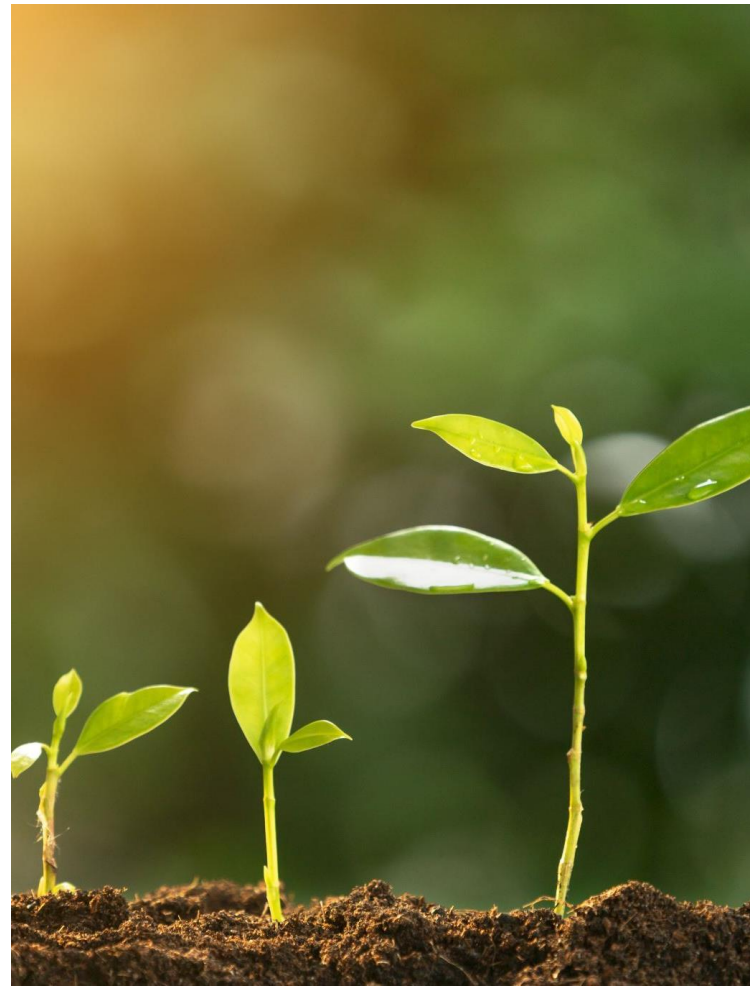
The imperatives and exposures



EMEs face severe climate risks but limited fiscal space for adaptation and mitigation.

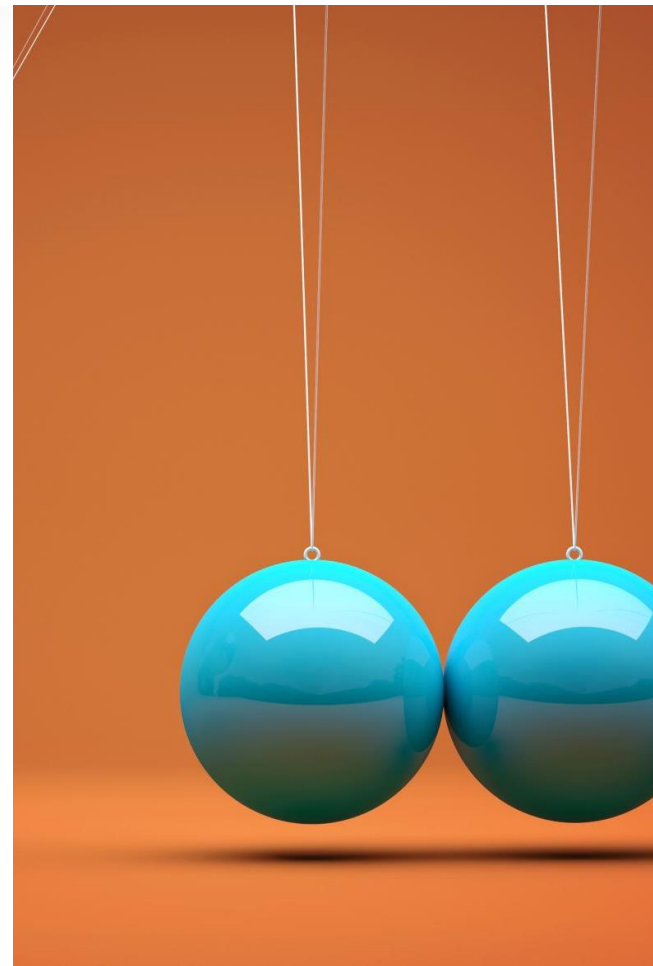
Green bonds, sustainable finance, and transition investments

Green bond growth is constrained by credibility and verification issues; blended finance helps attract capital.



Stress tests, physical vs transition risk, and disclosure

Central banks are integrating climate risk into stress tests, but data and capacity gaps persist.




Policy Challenges and Institutional Constraints

- Policy coordination

- Governance and institutional capacity


- International coordination

- Data and comparability



Monetary, fiscal, and macroprudential coordination

- Small open economies face limited monetary independence; macroprudential tools act as first defenses.



Institutional capacity, governance, and political economy

- Corruption, instability, and weak institutions hinder implementation and investor confidence.

International architecture and coordination

- Global shocks, IMF/World Bank support, and calls for better restructuring and global liquidity mechanisms.

Data, measurement, and cross-country comparability

- Data gaps, lack of standardization, and weak transparency limit policy analysis.

Concluding Remarks and Future Research Agenda

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- HYBRID EARLY WARNING SYSTEMS



- CLIMATE RISK INTEGRATION IN CREDIT MODELS



- FINTECH REGULATION



- INSTITUTIONAL REFORMS AND INVESTOR CONFIDENCE



- CAPITAL FLOW MANAGEMENT EVALUATION

References

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(PowerPoint presentation created using Microsoft 365)

Thank You

