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How do macroeconomic indicators influence stock market returns in emerging economies?

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ABSTRACT
This paper analyzes the impact of the most significant macroeconomic variables on stock returns in emerging nations, such as inflation, interest rates, gross domestic product (GDP) growth, exchange rate, unemployment, money supply, and trade balance. Emerging nations, characterized by rapid economic transformation, growing integration with the global market, and structural vulnerabilities, have unique dynamics in the macroeconomic performance-stock performance relationship. The paper outlines how the shifts in these variables influence investor sentiment, market volatility, and long-term investment trends.
On the basis of both theoretical evidence and empirical evidence from countries like India, Brazil, South Africa, Indonesia, and Turkey, the paper establishes trends in economic performance and its correlation with stock returns over the past six years. The evidence suggests that growth in GDP and growth in the money supply have the potential to support market appreciation, but high inflation levels, currency fluctuations, and unemployment have the potential to erode investor confidence. The evidence also suggests the effect of cautious monetary and fiscal policies in mitigating risks and increasing capital market stability.
This research contributes to the existing body of knowledge on the financial behavior of emerging markets and offers insights to policymakers, investors, and analysts seeking to comprehend the intricacies of economic systems and make informed stock market investment policy choices.

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I. LITERATURE REVIEW

There has been a wide literature investigating relationships between macroeconomic variables and stock market performance, particularly for developing economies. This has examined the impact of macroeconomic variables such as inflation, interest rates, exchange rates, GDP growth, unemployment, money supply, and trade balance on investor sentiment, volatility, and aggregate returns.

Fama (1981) was the first economist to suggest that stock returns can be predicted based on macroeconomic fundamentals. He found real economic activity, and in particular real GDP and industrial production, to be highly positively related to stock returns for U.S. markets. They have since been used for emerging markets but with increased volatility due to structural variations between financial systems and regulatory regimes.

Chen, Roll, and Ross (1986) pushed the Arbitrage Pricing Theory further by discovering macroeconomic factors—such as inflation, interest rates, and industrial production—having a significant effect on asset prices. These initial results have shaped the majority of the empirical research in emerging market regimes.

Fisher (1930) developed the Fisher Effect, which states that nominal interest rates contain expected inflation. As far as it is possible to go, stock markets respond negatively to inflation surprises because it reduces real returns. These are more suscepti ble to inflation shocks in emerging markets, where inflation is less regulated and more volatile. Such a study by Mukherjee and Naka (1995) confirms that inflation negatively impacts the performance of the stock market, especially in countries with poor monetary systems.

Interest rates have two functions. According to Maysami et al. (2004), increased interest rates increase the price of borrowing, which decreases corporate earnings and decreases equity prices. Conversely, low interest rates increase consumption and investment, which leads to bullish behavior in the market.

There is two-way causality between growth in GDP and the development of the stock market, and this was observed by Levine and Zervos (1998). Increased GDP growth reflects better earnings of firms, which encourages investment. High returns on the stock market in emerging economies are due to high GDP growth, but the transmission is hindered by structural deficiencies. Empirical observations by Bekaert and Harvey (2003) show that economic growth increases stock returns but country-specific risk factors like governance and inflation decrease the impact.

Exchange rate volatility is a major issue for emerging market investors. Aggarwal (1981) showed that currency appreciation is positively related to stock returns. Literature on emerging markets, nonetheless, like Phylaktis and Ravazzolo (2005), presents mixed findings. Currency depreciation, for example, can be detrimental to import-based firms but beneficial to export-based firms.

Even though unemployment is a lagging indicator, it plays a psychological role in affecting investor assumptions. High unemployment implies reduced consumer demand and reduced estimates of earnings. Underground labor markets in developing countries make it difficult to determine the accuracy of the unemployment rate, but rising unemployment is typically associated with bearish market sentiment (Barro, 1997).

The money theory of share prices would suggest that money supply increases with higher liquidity, reduces the interest rate, and induces investment. It goes on to say that, according to the Quantity Theory of Money, suggested by Friedman (1968), an excess supply of money would lead to inflation unless and until it is curbed by economic output. The Indian and Brazilian experience validates the case of liquidity—money supply increases tend to drive stock market indices (Dhakal, Kandil, and Sharma, 1993).

Trade balance affects investor trust in economic stability. Countries with recurring trade deficits may be affected by falling currencies and capital flight. Dornbusch and Fischer (1980) believed that recurring current account disequilibria, without balanced capital inflows, undermine the confidence in the equity markets. But in some emerging market economies, a trade deficit in the short term would be tolerable if it is on account of import growth (e.g., capital goods), as suggested by Sachs (1985).

II. INTRODUCTION

An emanate market economy is the economy of an emerging country that is increasingly engaging with world markets while developing. Emerging economies are nations that have some of the characteristics of a developed market. Characteristics of developed markets may include strong economic growth, high per capita income, liquid debt and equity markets, access by foreign investors, and a stable regulatory system.

It tends to grow more integrated in the world economy as an emerging market economy evolves. It can have greater liquidity in local equity and debt markets, greater trade volume, and foreign direct investment. It can establish sophisticated financial and regulatory institutions. Emerging market economies are India, Mexico, Russia, Iran, Saudi Arabia, China, and Brazil. An emerging market economy is transitioning from a less developed, low-income, usually agrarian economy to a developed industrial economy with improved standards of living.

Investors look for emerging markets for the potential for a high return because the markets are likely to grow at a higher rate as reflected by their gross domestic product (GDP). Higher returns, however, are typically accompanied by very much higher risk, though.

Political instability, domestic infrastructure issues, currency fluctuation, and illiquid equities are all risks that may be present because a lot of large firms can still be state-owned or privately held. Local stock exchanges may not have liquid markets to be tapped by foreign investors. The markets and the overseeing organizations are typically not well developed in emerging markets as they are in established countries. Efficiency of markets and strict standards on accounting and securities regulation are typically not as strong as they are in established economies like those of the United States, Europe, and Japan.

There is an infrastructure that is physical and financial in nature in the emerging markets, such as banks, a stock exchange, and one uniform currency. One of the features of emerging economies is that they embrace improvements and establishments such as those in advanced developed nations in the long term. This encourages economic growth. Emerging economies also shift away from primary production or extractive industries activity towards fabrication and productivity activities instead. Their governments generally have explicit industrial and trade policies that promote economic development and industrialization.

Export-led growth and import-substituting industrialization are some of these policies.

Export-led growth is more typical of emerging economies as it promotes more interaction and trade with the global economy. Emerging market countries also have domestic efforts such as the establishment of education systems, building infrastructure, and the establishment of legal reforms to ensure the property rights of investors.

The stock market is a shorthand for the network of exchanges, brokerages, and over-the-counter markets through which investors purchase and sell shares of publicly traded companies. Although individuals often refer to the New York Stock Exchange (NYSE) or the Nasdaq as a synonym for "the stock market," these exchanges represent a subset of a broader global marketplace. When individuals refer to the stock market, they generally refer to a particular exchange, such as the New York Stock Exchange. But the stock market is a larger system of exchanges, brokerages, and over-the-counter markets: Wherever you can purchase a piece of a company is part of the stock market.

In this vast, complex net of trading activity, company shares are bought and sold, protected by anti-fraud and other anti-fair-trading legislation. The stock market is a critical component of contemporary economies by facilitating the transfer of money between companies and investors. People invest in stocks for a variety of motives. Some hold shares in expectation of dividend returns. Others look for bargains in stocks that are likely to rise in value so that they can sell for a profit. Others might desire to have a say in the way particular companies are run. That's because you get to vote at shareholders' meetings based on the number of shares you own. Share ownership gives you a stake in the company's profits, typically in the form of dividends, and sometimes the right to vote on company matters.

An economic indicator is an item of economic data, typically of macroeconomic size, which specialists utilize to interpret existing or prospective investment prospects. Economic indicators also assist in determining the general well-being of an economy. Although there exist numerous distinct economic indicators, some items of information published by the public sector and voluntary organizations have become commonly monitored. These indicators, among others, are the Consumer Price Index (CPI), gross domestic product (GDP), or unemployment levels.

An economic indicator is only as useful as it is correctly interpreted. History has provided good correlations between profit expansion by corporations and economic expansion as measured by GDP. However, deciding if a specific company will be able to grow earnings based on a sole measurement of GDP is almost unfeasible. There is no escaping the factual meaning of interest rates, gross domestic product, secondhand home sales, and other indicators. The indicators indicate the price movement of money, consumption, investment, and the level of activity of most of the entire economy.

As with most other types of financial or economic measures, economic indicators are of vast value when compared over a period of time. Governments, for instance, might see how unemployment rates have moved in the last five years. An unemployment rate at a snapshot in time is of no value; however, the comparison to previous periods enables analysts to view the problem in its context. More significantly, most economic indicators have a baseline established, either by a government department or other organizat ion. Take the example of the Federal Reserve target rate of inflation normally being 2%. The Federal Reserve then makes policy based on readings of CPI in an attempt to meet this target. In the absence of such a baseline, analysts and policymakers would have no notion of what is good or bad value for an indicator.

Macroeconomic Indicators

1) Inflation Rate

Inflation is a slow monetary erosion expressed in a widespread rise in the prices of commodities over time. The inflation rate is the average increase in prices of a consumer basket over a twelve-month period. High inflation shows that prices are increasing quickly, while low inflation shows that prices are increasing slowly. Inflation is similar to deflation, in which prices decrease and purchasing power increases. When inflation occurs, money loses its purchasing power. This can occur within any industry or in an entire economy. The fear of inflation itself can further increase the depreciation. Workers might demand more wages and businesses might charge more prices, anticipating ongoing inflation. This again supports the conditions that lead to increasing prices.

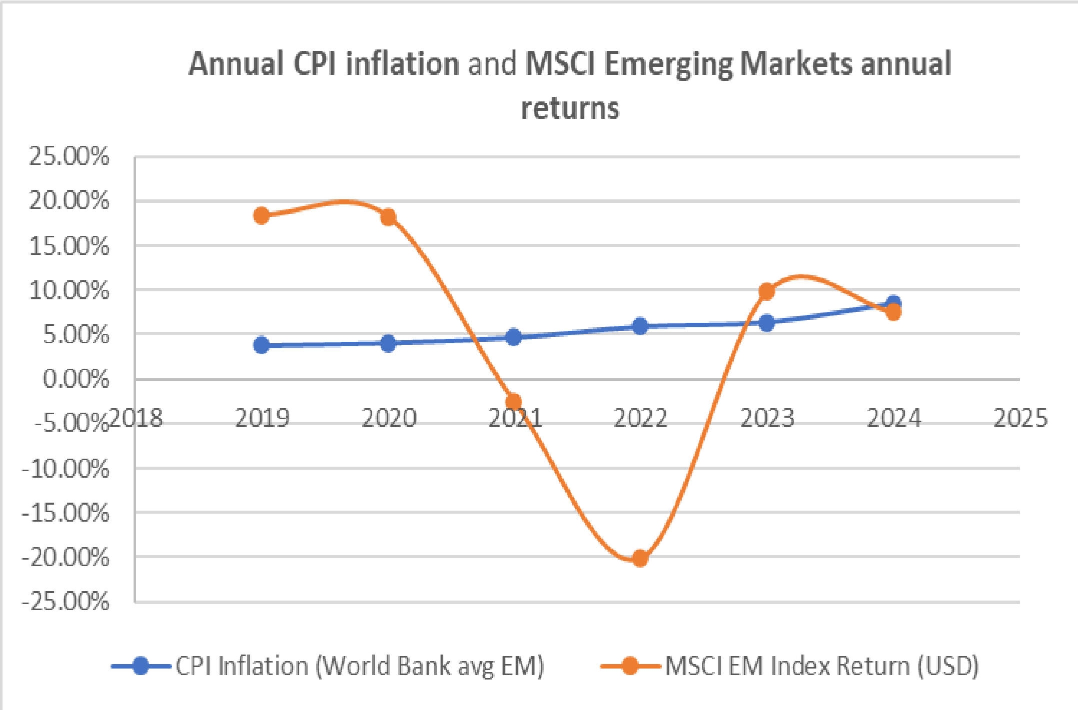
While it is simple to quantify the change in the price of a product over a period of time, human requirements go beyond one or two products. People require a vast and diversified group of products and a group of services to live comfortably. They encompass commodities such as food grains, metal, fuel, services such as electricity and transport, and services such as health, entertainment, and labor. Inflation tries to quantify the aggregate effect of price change for a diversified group of products and services. It provides a one figure representation of the sustained increase in the general price of commodities in an economy over a given time.

Increase in prices means that one unit of money will buy fewer commodities. The monetary erosion impacts the cost of living for the general populace which ultimately leads to a deceleration in economic growth. The consensus among economists is that only when the expansion of a country's money supply is greater than the expansion of the economy will inflation perpetuate itself. To offset this, the monetary authority (in most cases, the central bank) does what is necessary to manage the supply of money and credit so that inflation is contained within tolerable limits and the economy continues to run smoothly.

Theoretically, monetarism is a firmly developed theory describing the relationship between inflation and money supply of an economy. For instance, after the Spanish conquest of the Aztec and Inca empires, huge amounts of gold and silver poured into Spanish and other European economies. When money supply increased very fast, money decreased in value, causing prices to increase at a rapid rate. Inflation is quantified differently based on the nature of goods and services. It is a counterpart of deflation, a general reduction in prices when the inflation rate is below 0%.

Annual CPI inflation and MSCI Emerging Markets annual returns

2024	8.5%	7.5%
Year	CPI Inflation (World Bank avg EM)	MSCI EM Index Return (USD)
2023	6.4%	9.8%
2022	5.9%	-20.1%
2021	4.7%	-2.5%
2020	4.1%	18.3%
2019	3.8%	18.4%



2) Interest Rates

The rate of interest as a proportion of the principal is the interest rate. It could be that charged by a lender to a borrower or that earned on a deposit account. The rate of interest on a loan is most often expressed on an annual basis and in the form of an annual percentage rate (APR). An interest rate can also be applied to assets or a certificate of deposit (CD). In these cases, a credit union pays a percentage of the money deposited to the holder of the account. Annual percentage yield (APY) is the interest on these deposit accounts that is earned.

Interest is levied on most lending or borrowing transactions. Individuals borrow money to buy homes, fund projects, pay for education, commence businesses, or fund university. Businesses take loans to finance capital projects and grow their operations by purchasing fixed and long-term assets such as land, buildings, and machinery. The borrowed amount is repaid either in a single amount by a due date or in periodic installments. In loans, the interest rate is levied on the principal, which is the borrowed amount.

The interest rate is the return to the lender and the cost of debt to the borrower. The repayment amount is usually greater than the amount borrowed since the lenders have to be compensated for not using the money for the loan period. The money could have been invested by the lender for the period instead of offering a loan, and this would have brought the lender returns on the asset. The repayment sum minus the borrowed amount is the interest paid.

The interest rate of a bank is determined by a number of factors, including the health of the economy. The interest rate is determined by a country's central bank (in the case of the United States, for instance, the Federal Reserve). Every bank uses this rate as a reference to determine the APR range it offers. If the central bank fixes high interest rates, the cost of debt goes up. If the cost of debt is high, it discourages people from borrowing and reduces consumer spending. Interest rates rise with inflation too. In an economy with high interest rates, businesses have very little capital finance with debt, and this could lead to economic contraction.

Economies are boosted when there are low interest rates since borrowers obtain loans at low costs. Since there are low interest rates on savings, business companies and individuals will invest and purchase riskier investment options like stocks. Consumption drives the economy and brings money to capital markets resulting in economic growth.

There is data that indicates white people are more likely to be approved for mortgages. Data gathered under the Home Mortgage Disclosure Act, the biggest publicly available data on mortgage market activity, revealed Black, Hispanic, and Asian conventional mortgage loan applicants were denied in 2023 17.1%, 12.1%, and 9.7% respectively. White applicants had a lower denial rate of 6.8%.

This interest rate discrimination on home mortgages has also been validated by other organizations, such as Harvard University and the Urban Institute, who, in 2022, determined that the typical Black homeowner pays an additional 33 basis points of interest compared to the typical white homeowner and pays approximately $250 a year in interest.

Not everyone shares these findings. Economists at the Federal Reserve Board found in a study that no racial group is privileged, and its authors speculated that variations elsewhere are occurring because a high percentage of Black and Hispanic borrowers pay a little extra in interest to pay less in fees upfront. The Federal Reserve Board believes discrimination is improving and attributes this, at least in part, to an increase in automated underwriting and increased enforcement of the Fair Housing Act and the Equal Credit Opportunity Act.

3) GDP Growth

Gross Domestic Product, or GDP, encompasses consumer expenditures, government expenditures, net exports, and total investments. It is an overall scorecard of a country's economic health. GDP can be adjusted for inflation, as well as population. Real GDP is adjusted for inflation, while Nominal GDP is not adjusted for inflation. A country's GDP is the final market value of all the goods and services that a country produces during one year. Another method of measuring GDP is adding up four components: consumer expenditure, government expenditure, net exports, and total investment.

In the U.S., the GDP is quarterly estimated by the Bureau of Economic Analysis, or BEA. The BEA estimates are based on price estimates, surveys, and other information gathered by other agencies like the Census Bureau, Federal Reserve, Department of the Treasury, and Bureau of Labor Statistics. The GDP growth rate is a ratio of a nation's year-to-year (or quarterly) economic output change to determine the rate at which an economy is expanding. Typically an economic rate in percentage form, the measure is especially prevalent for the application of economic policymakers due to the fact that GDP growth is believed to be heavily linked with policy issues such as inflation and unemployment rates.

When GDP growth rates are rising, it is a sign of an overheating economy, and the central bank will have to increase interest rates. On the other hand, central banks take decreasing (negative) GDP growth rate (i.e., recession) as a sign that rates have to be decreased and that stimulus has to be provided. The expenditure method, or spending approach, estimates spending by various groups involved in the economy. The American GDP is estimated mostly through the expenditure approach. The expenditure method can be computed by the formula:

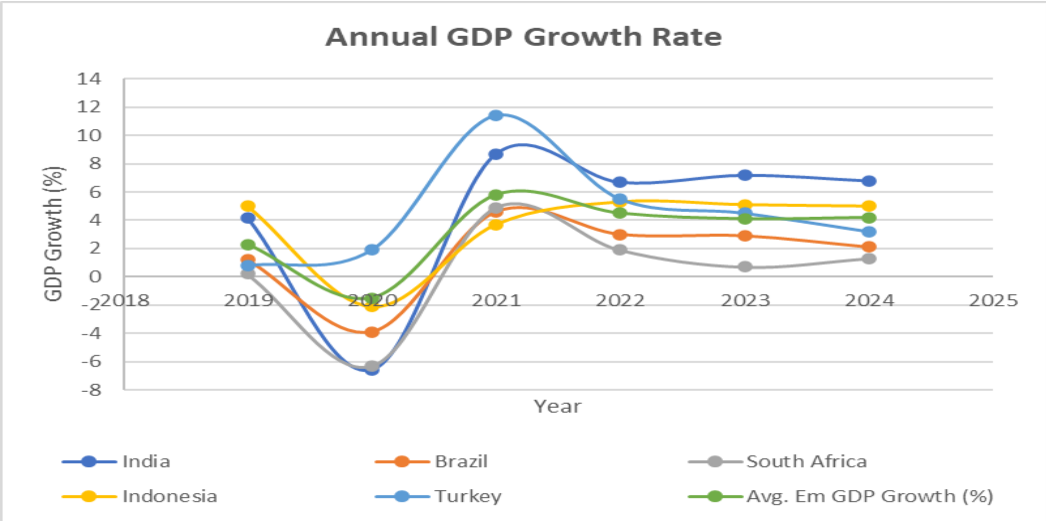
$$GDP=C+G+I+NX$$

where:
C=Consumption G=Government spending I=Investment
NX=Net exports

Investors follow GDP because it is a backdrop for making decisions. The corporate profits and inventories parts of the GDP report are an excellent source of information for equity investors as well, as both series reflect aggregate growth over the period; corporate profits data also reflect pretax profits, operating cash flows, and detail for the economy's major sectors. Comparing the growth rates in GDP across countries can be used in asset allocation to decide whether to invest in rapidly growing economies overseas and, if so, where. One of the more intriguing measures investors can turn to in an effort to gain an idea of an equity market's valuation is the ratio of total market cap to GDP. The best available proxy for this for the purpose of stock valuation is a firm's market cap to total sales (or revenues), which on a per-share basis is the famous price-to-sales ratio.

Year	India	Brazil	South Africa	Indonesia	Turkey	Avg. Em GDP Growth (%)
2024	6.8	2.1	1.3	5.0	3.2	4.2

2023	7.2	2.9	0.7	5.1	4.5	4.1
2022	6.7	3.0	1.9	5.3	5.5	4.5
2021	8.7	4.6	4.9	3.7	11.4	5.8
2020	-6.6	-3.9	-6.3	-2.1	1.9	-1.5
2019	4.2	1.2	0.2	5.0	0.8	2.3



4) Exchange Rates

An exchange rate is the worth of a country's currency when it is exchanged for another currency. The relative strength or weakness of a country's currency has a significant impact on its trade with other countries, its tourism sector, and the prices its customers pay for their imports. An exchange rate is the worth of a country's currency when it is exchanged for another currency. The relative strength or weakness of a country's currency has a significant impact on its trade with other countries, its tourism sector, and the prices its customers pay for their imports.

Exchange rates may be fixed or free-floating. A free-floating exchange rate varies and depreciates as a consequence of the foreign exchange market movement. A fixed exchange rate is pegged to the value of a different currency. The Hong Kong dollar is pegged to the
U.S. dollar at 7.75 and 7.85, so the exchange rate of the Hong Kong dollar to the U.S. dollar will be between these figures.

Exchange rates have both a spot value or cash value that's the market value at present. Forward rates can also have a forward value that is dependent on expectations of appreciation or depreciation of the currency relative to its spot price. Forward rate values change as a result of changes in expectations of future interest rates in one nation relative to another.
Traders would seek to buy the dollar against the euro if they expect the eurozone easing monetary policy relative to the U.S., leading to a declining value of the euro.

Exchange rate changes impact firms by raising or lowering the price of foreign inputs and finished goods imported from another nation. It alters, for better or for worse, foreign demand for their exports as well as domestic demand for imports. Large changes in a currency price can stimulate or discourage foreign travel and investment in a nation.

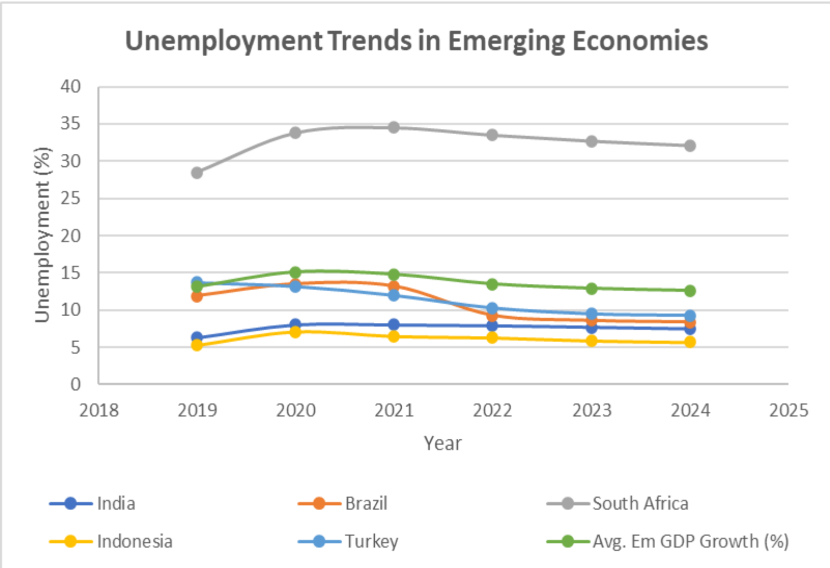
5) Unemployment

Unemployment is when an individual actively searches for work but fails to find work. Unemployment is believed to be the most accurate measure of the condition of an economy. The most common measure used to assess unemployment is the unemployment rate. It is computed by the number of unemployed divided by the number of members of the labor force.

Unemployment is a significant economic indicator since it reveals labor's ability (or inability) to obtain remunerative employment and be productive to the economic output of the economy. The more unemployed labor, the less the overall economic output. The unemployment definition omits individuals leaving the labor force due to retirement, higher education, and disability. Unemployed individuals are supposed to have at least subsistence consumption when they are unemployed. It implies that an economy with unemployment produces less output without a corresponding decrease in the demand for basic consumption.

Modern economists identify three primary forms of unemployment: frictional, structural, and cyclical. Frictional unemployment is caused by voluntary changes in jobs within an economy. Frictional unemployment cannot be helped, even in a healthy, expanding economy as workers switch occupations. Structural unemployment can lead to persistent disruptions because of permanent and fundamental changes which take place in the economy's structure. Such changes have the potential of marginalizing a section of workers.

Year	India	Brazil	South Africa	Indonesia	Turkey	Avg. Em Unemployment (%)
2024	7.5	8.4	32.1	5.7	9.3	12.6
2023	7.7	8.6	32.7	5.9	9.5	12.9
2022	7.9	9.3	33.5	6.3	10.3	13.5
2021	8.0	13.2	34.5	6.5	12.0	14.8
2020	8.0	13.5	33.8	7.1	13.2	15.1
2019	6.3	11.9	28.5	5.3	13.7	13.1



6) Money Supply

The supply of money is the total amount of all of the country's money and other liquid funds on the date it is measured. Money supply consists of all cash in circulation and all deposits in banks that the owner can readily sell for cash. To stabilize the economy, bank regulators add to or subtract from the supply of money available by policy moves and regulatory actions.

In the US, the Federal Reserve or the Fed is the policy-making institution that manages the supply of money. Its economists monitor the supply of money over time to see if excess money is flowing, which will result in inflation, or too little money is flowing, which will result in deflation.

The Fed does have some levers that it can employ in order to maintain the economy expanding at a decent pace. It regulates interest rates by determining the key rates that it lends to the country's banks overnight for cash from the government. All other loan rates are based on those federal lending rates. It increases or decreases cash in the system by adjusting the volume of money that goes to banks to be used in business and consumer loans.

A rise in money supply will decrease interest rates, encouraging investment and placing more money in people's pockets, which, in turn, leads to increased spending.
Companies react by purchasing more raw materials and producing more. The growth in business activity increases the demand for labor. The reverse can occur with a contraction in money supply or a deceleration in its growth. Banks lend less money, companies delay new projects, and consumer demand for home mortgages and cars decreases.

The nation's money supply plays a significant role in shaping its macroeconomic environment, more so on the interest rate, inflation, and business cycle. When the Fed constricts the money supply through contractionary or "hawkish" monetary policy, interest rates increase and the borrowing cost increases. There is a fine line to walk when such decisions are made. Reducing the money supply can slow inflation, as the Fed would recommend, but threatens to reduce economic growth as well and thus lead to more unemployment.

A central bank controls the volume of money within a nation. A central bank, by monetary policy, is able to implement an expansionary or contractionary policy. An expansionary policy would seek to expand the supply of money. For instance, the central bank may conduct open market operations. It means that it will buy short-term U.S. Treasury bills with freshly printed money. That money thereby flows into circulation. A contractionary policy would involve selling Treasuries. That drains some of the money in circulation.

7) Balance of Trade

Balance of trade (BOT) refers to the difference between the value of a country's exports and its imports for a given period of time. Balance of trade is the largest and a significant component of a country's balance of payments (BOP) as it records all the economic transactions. At times, the balance of trade between a country's goods and the balance of trade between its services are distinguished as two separate figures.

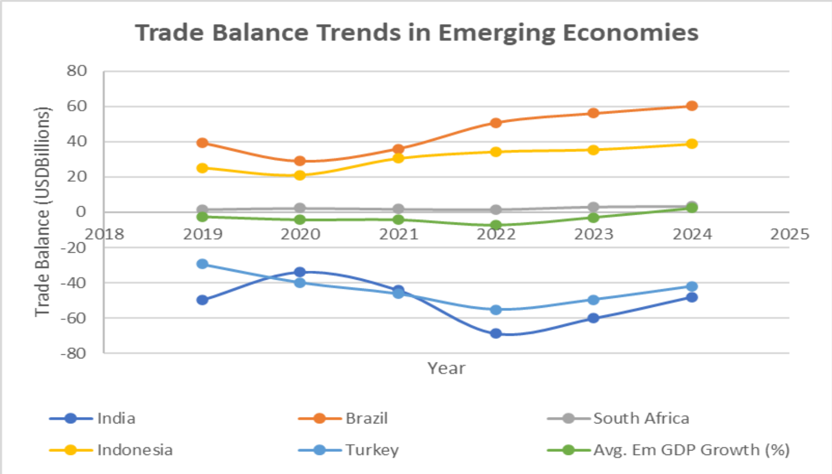
A country that imports more commodities than it exports in terms of value has a negative trade balance. On the other hand, a country that exports more goods and services than it imports has a trade surplus or a positive trade balance.

A trade surplus indicates that a country's producers have an active international market. After producing sufficient goods to satisfy domestic demand, there is enough demand from consumers abroad to keep domestic producers busy. A trade deficit means that currency flows outwards to pay for exports, indicating that the country may be heavily reliant on international goods. However, that distinction is not always maintained. It could also indicate that the country is wealthy and has a high level of domestic demand that needs to be satisfied.

A country with a significant trade deficit borrows an amount to pay for its commodities, while a country with a large trade surplus lends money to deficit countries. However, a country may only be able to borrow a lot to run that deficit if it is deemed dependable and creditworthy. The United States would be a great example of such a country. In contrast, a country with lower credits has higher borrowing costs, and therefore its deficit will be more damaging.

A trade surplus is not always an accurate indicator of an economy's health, and it must be analyzed in the context of the business cycle and other economic indicators. For instance, during a recession, countries aim to export more to generate employment and in turn more demand in the economy from those benefiting from the new jobs. In times of economic expansion, countries have a great appetite for imports and may use them to increase price competition, which limits inflation.

Year	India	Brazil	South Africa	Indonesia	Turkey	Avg. Trade Balance (USD Bn)
2024	-48.0	60.2	3.5	38.7	-41.8	2.5
2023	-60	56.1	3.2	35.5	-49.4	-2.9
2022	-68.5	50.8	1.7	34.3	-55.1	-7.4
2021	-44.0	36.0	1.9	30.5	-46.1	-4.3
2020	-34	29.0	2.4	21.0	-39.7	-4.3
2019	-49.7	39.4	1.7	25.2	-29.3	-2.5



Emerging Economies: Features and Challenges

The world of emerging markets is diverse and resists a unifying narrative. Although there is no formal definition, emerging markets are generally defined based on such factors as regular access to markets, progress toward becoming middle-income economies, and rising global economic prominence. However, these economies are not uniform, and the demarcation between emerging markets and other developing economies is also blurred.

Emerging markets have made strides in unifying their macroeconomic policies since the start of the twenty-first century, and this assisted in more than doubling average per capita incomes. Monetary policy in 65 percent of emerging markets we have recognized is under forward-looking inflation-targeting regimes, and inflation has decreased and stabilized in the majority. Fiscal policy in the majority is anchored by fiscal rules. The majority of them instituted fundamental banking sector reforms following the banking crises of the 1990s. The progress was moderated by the 2008–09 global financial crisis, but not diverted.

This economic performance assisted policymakers in the emerging markets to adopt strong measures in the pandemic without reversing market confidence. Relief measures in the economy comprised increases in government expenditures, injections of liquidity into firms and banks, release of bank capital buffers with the aim to finance lending, and central bank asset purchase programs in order to stabilize domestic markets. Low domestic inflation and monetary easing in the advanced economies also provided room to the central banks in the emerging markets to slash domestic policy rates aggressively. Household savings rose in most of the emerging markets subsequent to the outbreak of the pandemic. Most of the domestic savings were employed in financing the government, decreasing the requirement for foreign borrowing, which, along with lower private investment, kept current account deficits in check.

But some of these steps—like direct financing of budget deficits or short-run moratoriums on repayment of loans introduce new risks. Policymakers justified them as short-run measures to ease massive economy-wide pressures. Larger fiscal deficits have also contributed to already high levels of sovereign debt in some nations. In others, high corporate sector debt, including state-owned enterprise debt, and unhedged foreign exchange exposures in corporate debt have contingent fiscal risks in the case of corporate stress. Higher government debt held by domestic banks also makes the link between the government's and the banking system's health tighter.

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