Macro Research

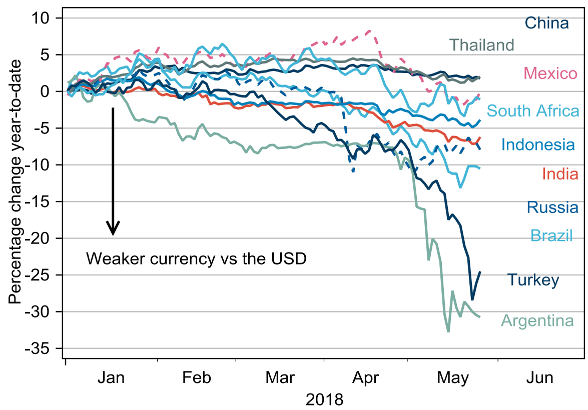
Emerging Markets Comment

EM turmoil not the overture for a full-blown crisis

Some emerging markets (EM) have experienced very severe stock market losses and currency weakening this year, particularly since mid-April, and hardly any EMs have avoided the fallout from a stronger USD and tighter global liquidity. On various vulnerability indicators, several EMs (including Argentina and Turkey) indeed look fragile, and we have most likely not seen the worst yet. On the other hand, the current turmoil should not be the beginning of a widespread EM crisis, in our view, as EMs on aggregate are not much worse off now than before the two most recent EM asset sell-offs.

Many emerging markets (EM) have experienced financial turmoil this year, particularly since mid-April, with stock market declines and markedly weaker currencies. The currency weakness has been led by Argentina and Turkey, who have seen their currencies loosing 30 and 25 percent respectively versus the USD, year to date. However, most other EM currencies have weakened as well (see chart 1).

1. EM FX sell-off in recent months



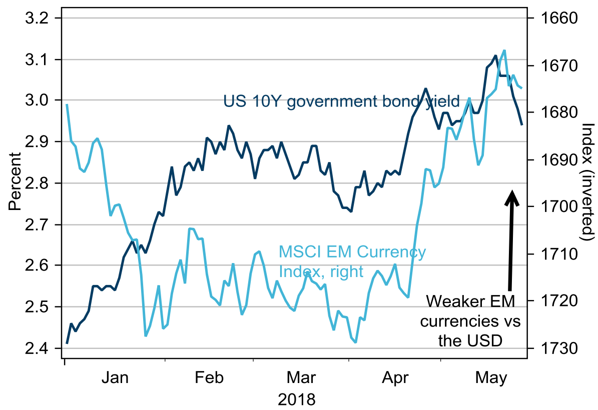
Source: Macrobond

Blame it on the Fed

The main explanation for the overall EM FX weakness is the tighter monetary policy globally and especially in the US, where the central bank (Fed) has hiked its policy rate six times and signalled more to come. The tighter liquidity globally pushes up interest rates, for instance, the yield on the 10-year US government bond in late April increased above 3 percent for the first time since 2011 (see chart 2).

The higher interest rates in the developed economies dampen investors' 'search for yield' and thus their appetite for relatively more risky EM assets. The same pattern of capital flowing out of EM assets happened during the 'taper tantrum' in 2013 when the Fed started to talk about scaling back the quantitative easing. Higher interest rates and a stronger USD also make it more difficult for debt-loaded EMs to service their USD-denominated debt.

2. Tighter global liquidity hurts EM



Source: Macrobond

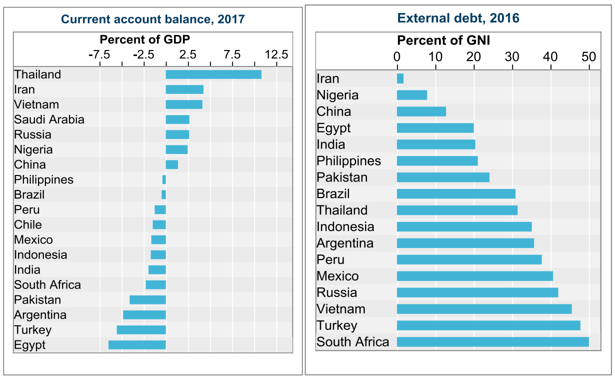
There are also country-specific factors at play. Argentina's relatively new government was expected to finally lift Argentina's economy out of the doldrums following its many crises and debt defaults. However, the situation once again seems to be running out of control, with the most recent turmoil triggered by a badly communicated rise of the inflation target. Argentina has reportedly already taken up discussion with the International Monetary Fund (IMF) for a precautionary loan agreement. In Turkey, high inflation is one source of worry, which is coupled with the messy political situation, as the government opposes any attempt from the central bank to combat inflation. Obviously, problems in one EM threaten to spread to other EMs via investors' reduced appetite for EM assets generally, despite the problem initially being specific to only one country.

Indicators of vulnerable EMs

A good starting point when assessing which EMs are most vulnerable is current account balances. A deficit here means the country has to attract capital to finance the deficit. If the situation worsens and it could become more difficult, or even impossible, to attract capital because global investors lose appetite and repatriate their EM investments, the country basically cannot pay for its imports and/or service its debt.

It is also relevant to look at the level of external debt, which in essence is the accumulated current account surpluses over time. Higher debt makes the country more vulnerable to higher interest rates and a weaker currency. The latter is particularly true if a huge chunk of the external debt is denominated in foreign currency, as is often the case in EMs. Measured on both current account deficit and external debt, Argentina and Turkey score low, as do other fragile economies such as South Africa, Pakistan and Egypt (see chart 3).

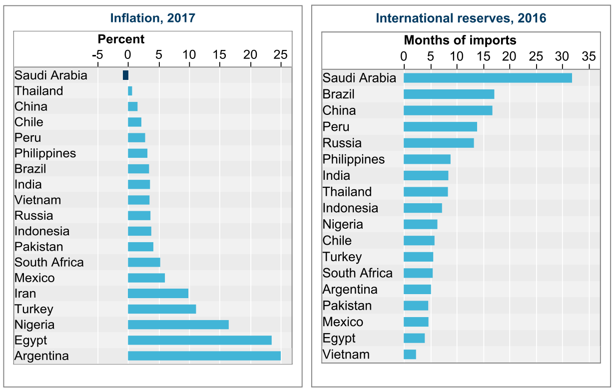
3. External financing needs make EM exposed



Source: Macrobond

The most straightforward way of measuring overheating is via inflation. A country might experience high inflation even without an overheated economy if a negative price-wage spiral has started, but that is just as bad and definitely also a warning sign. Again, Argentina and Turkey stand out, together with Nigeria and Egypt (see chart 4, left).

4. Overheating and depleted reserves is bad



Source: Macrobond

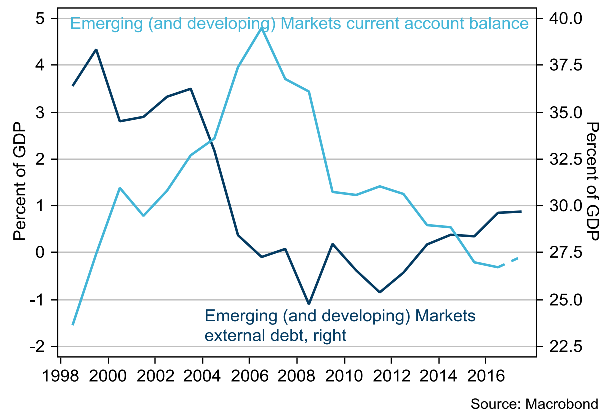
Once a crisis hits an economy and the country becomes unable to borrow from abroad, the country ultimately has to rely on its reserves to service its debt and pay for necessary imports. Thus, a relevant indicator is international reserves, measured as months of imports (see chart 4, right). Holding adequate reserves of foreign exchange becomes even more important if the country pursues a fixed or quasi-fixed exchange rate regime, as many EMs have flirted with from time to time. On this measure, Argentina, Pakistan and Egypt score low, as do Vietnam and Mexico, but their current account deficits are less worrying.

Full-blown EM crisis is not on the cards

We have probably not seen the worst for Argentina and Turkey yet, and other vulnerable EMs are likely to follow, we believe. However, in our view, the current turmoil is not the overture for a full-blown EM crisis, where contagion from one troubled country hits neighbouring countries, spreading regionally or even globally. The main reason is that EMs, taken together, seem almost in as good shape as during the 'taper tantrum' in 2013 or before the global financial crisis in 2008.

The aggregate current account balance for EMs as a whole has deteriorated since the global financial crisis (we use IMF's country group definition 'emerging and developing countries' which also includes poorer countries than those we consider as EMs, but due to the small size of their economies, the error is negligible). An aggregate surplus of almost 5 percent of GDP, before the global financial crisis, has dwindled to a slight deficit and is a reason for worry (see chart 5). On the other hand, a big part of this reduction is due to the biggest EM, China, having reduced its huge current account surplus from close to 10 percent of GDP to a still healthy 1-2 percent of GDP.

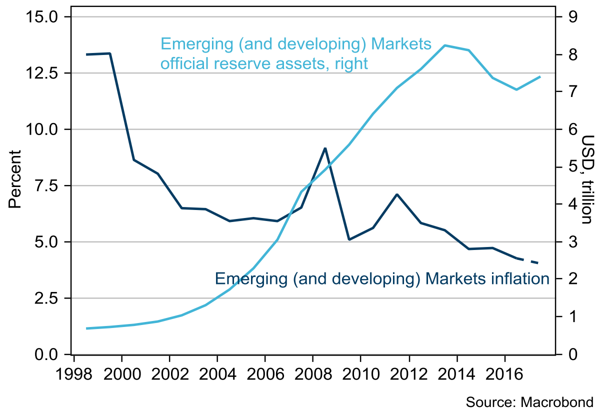
5. EMs on aggregate are somewhat worse off



Source: Macrobond

The dwindling current account surplus implies that external debt stopped falling (see chart 5 again). Still, aggregate external debt is not much higher today than in 2013 or 2008.

6. Inflation on aggregate not a problem



Source: Macrobond

The same story holds for FX reserves. Most EMs built-up reserves in the years before the global financial crisis. Aggregate reserves peaked in 2013 (see chart 6). They have since come down somewhat, as some countries spend their reserves defending currency pegs amid capital outflows, following the 'taper tantrum' and again recently. Again, a large chunk of the aggregate EM-reserve decline is explained by China drawing heavily on its reserves in 2015 and 2016. Despite this, China's reserves are still swelling.

Our last EM risk indicator, inflation, shows lower EM inflation than ever (see chart 6 again) as the global low inflation environment also affects (most) EMs. If aggregate EM inflation takes off again and becomes double-digit as it was before the start of the century, that would indeed be worrying. For now, cases of out-of-control inflation, as for instance in Argentina, seem to be isolated and should not spread, in our view.

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