Deutsche Bank

Emerging markets and the fear of the Fed

Joint Vienna Institute
March 27, 2015

Passion to Perform

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Contents

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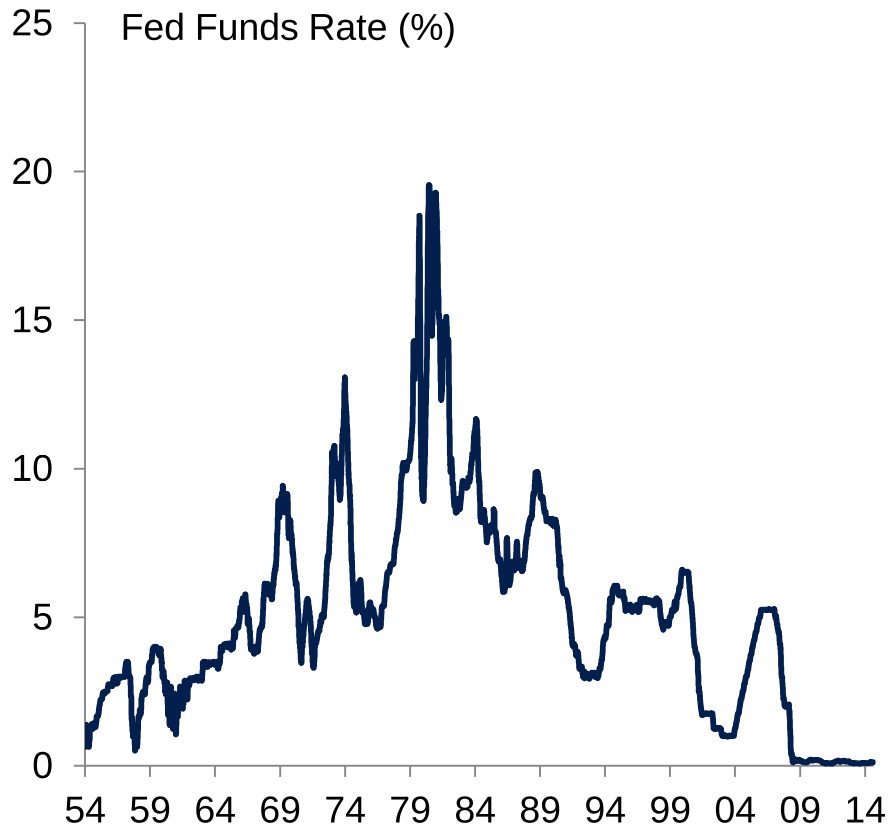
The Fed is in unprecedented territory

Interest rates are at historically low levels...



Source: Haver Analytics, Deutsche Bank Research

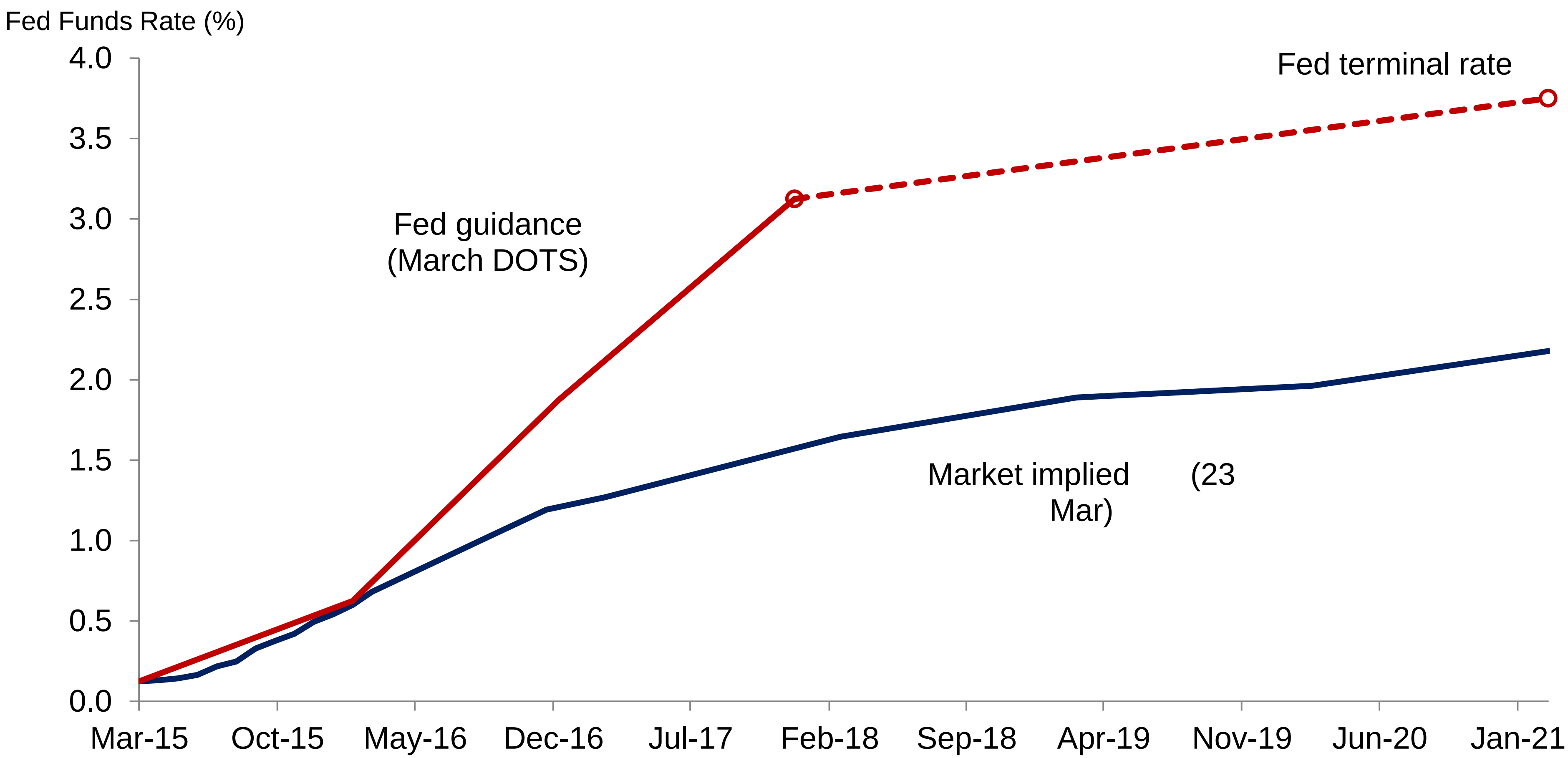
...and have been so for an extraordinarily long time

Start hiking cycle	Days since last hike
March 84	• 231 days
January 85	• 168 days
July 85	• 119 days
April 86	• 208 days
May 86	• 50 days
January 87	• 214 days
August 87	• 97 days
March 88	• 188 days
February 94	• 1724 days
March 97	• 783 days
June 99	• 827 days
June 04	• 1506 days
Today	• 3193 days
September FOMC	• 3367 days

Source: Haver Analytics, Deutsche Bank Research

The Fed and markets view the world differently

...market pricing is not consistent with Fed guidance



Source: Bloomberg Finance LLP, US Federal Reserve, Deutsche Bank Research

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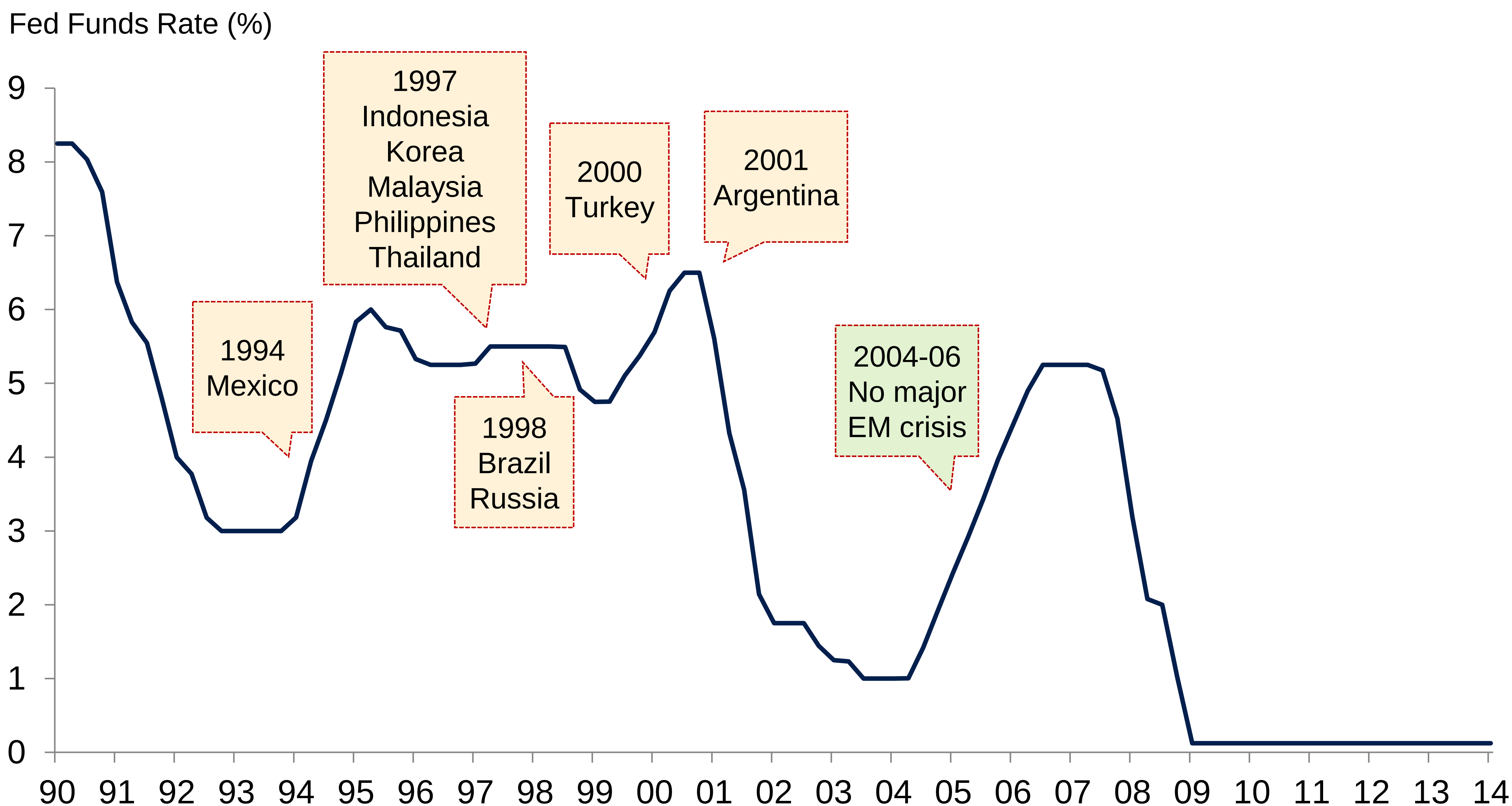
Why we worry: the fear that Fed hikes trigger new EM crises



Source: Haver Analytics, Deutsche Bank Research

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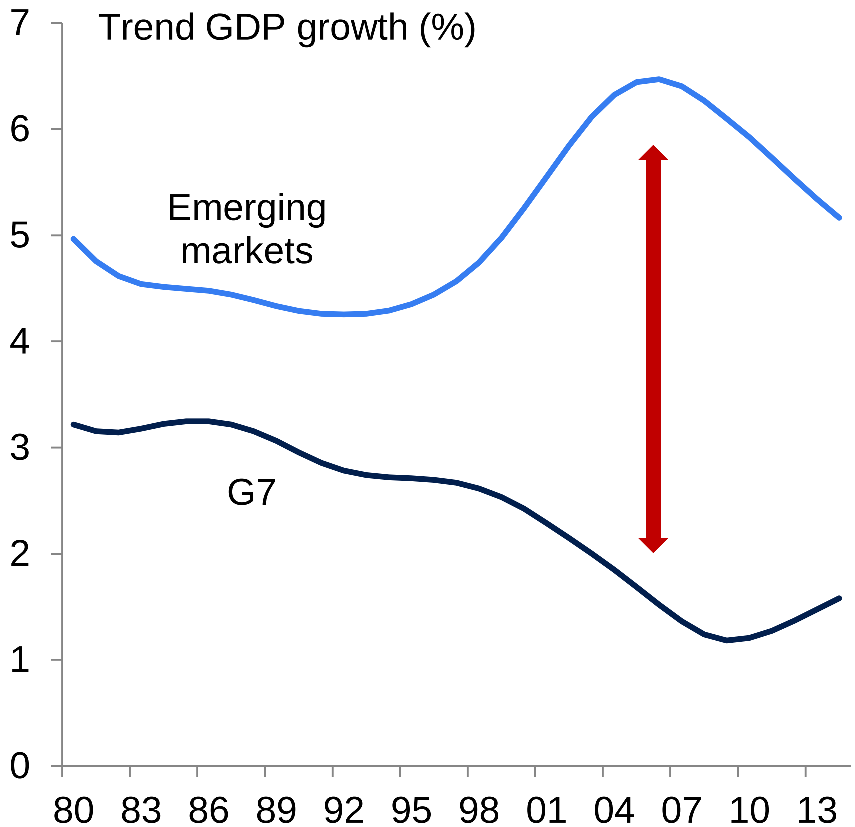
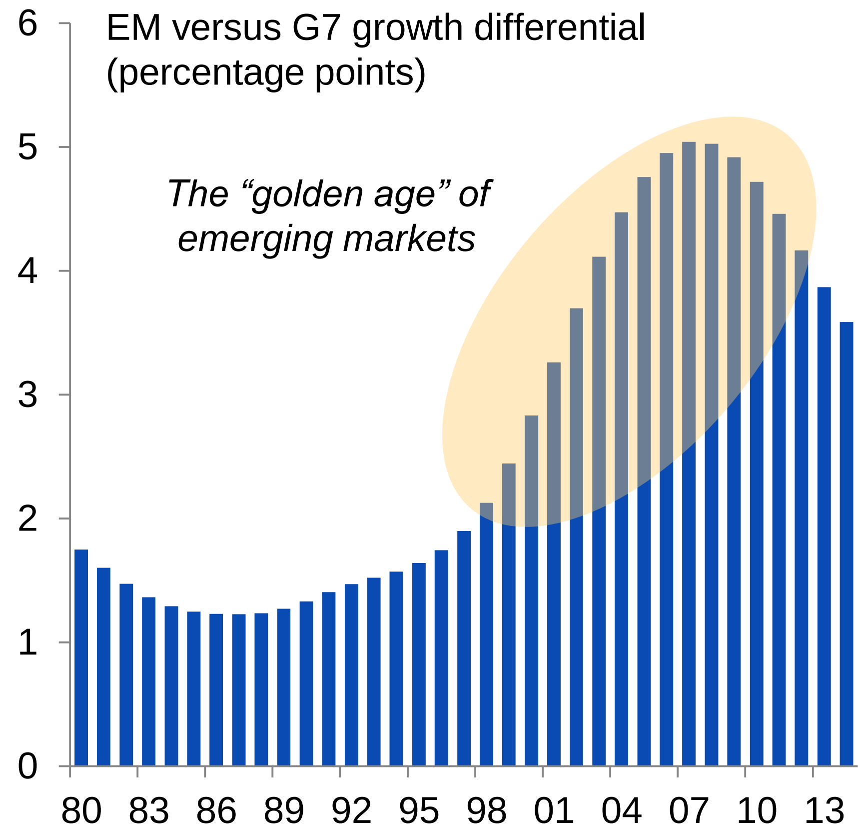
We have been through a golden age for emerging markets during which the last Fed hiking cycle barely registered

Emerging markets offered an unprecedented growth premium over advanced economies in the last decade



Source: Haver Analytics, IMF *World Economic Outlook,* Deutsche Bank Research

This premium reached 5 percentage points prior to the global financial crisis



Source: Haver Analytics, IMF *World Economic Outlook,* Deutsche Bank Research

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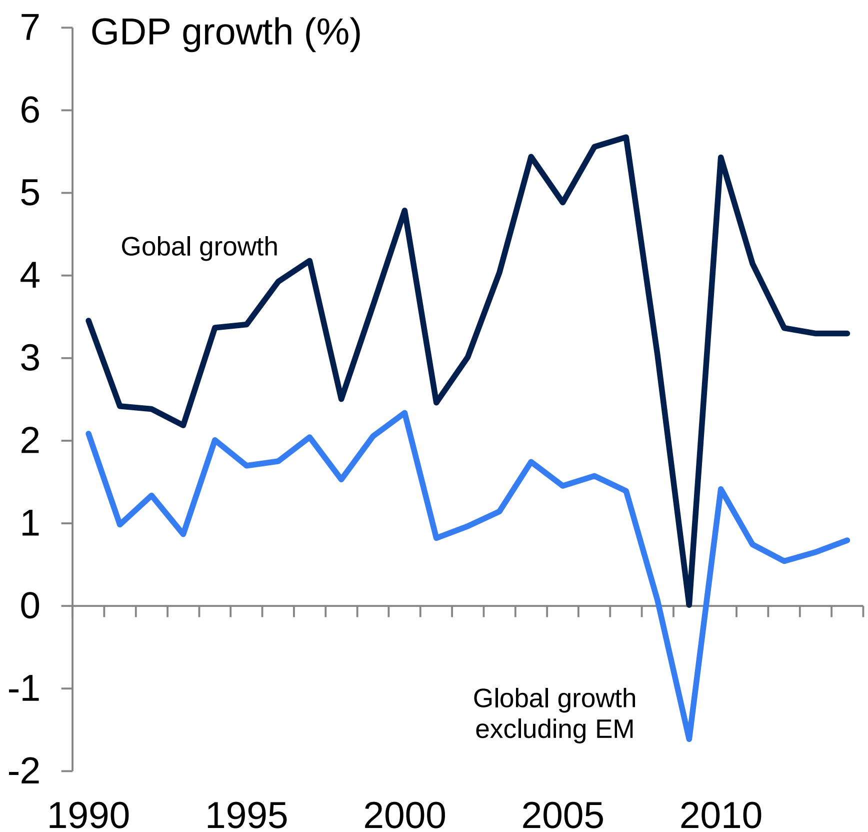
Why did it happen?

Emerging markets have accounted for over three-quarters of total global growth over the last 10 years



All the stars were aligned for emerging markets from the early part of the last decade onwards

1. The 'great moderation' which saw strong growth and low inflation in the US and elsewhere
2. The establishment of the single market in Europe
3. The widespread adoption of reforms following the emerging markets crises of the late-1990s
4. The emergence of China and its integration with the world economy
5. The super-cycle in global commodity prices
6. Favourable demographics
7. Monetary expansion by major central banks

Source: Haver Analytics, IMF *World Economic Outlook,* Deutsche Bank Research

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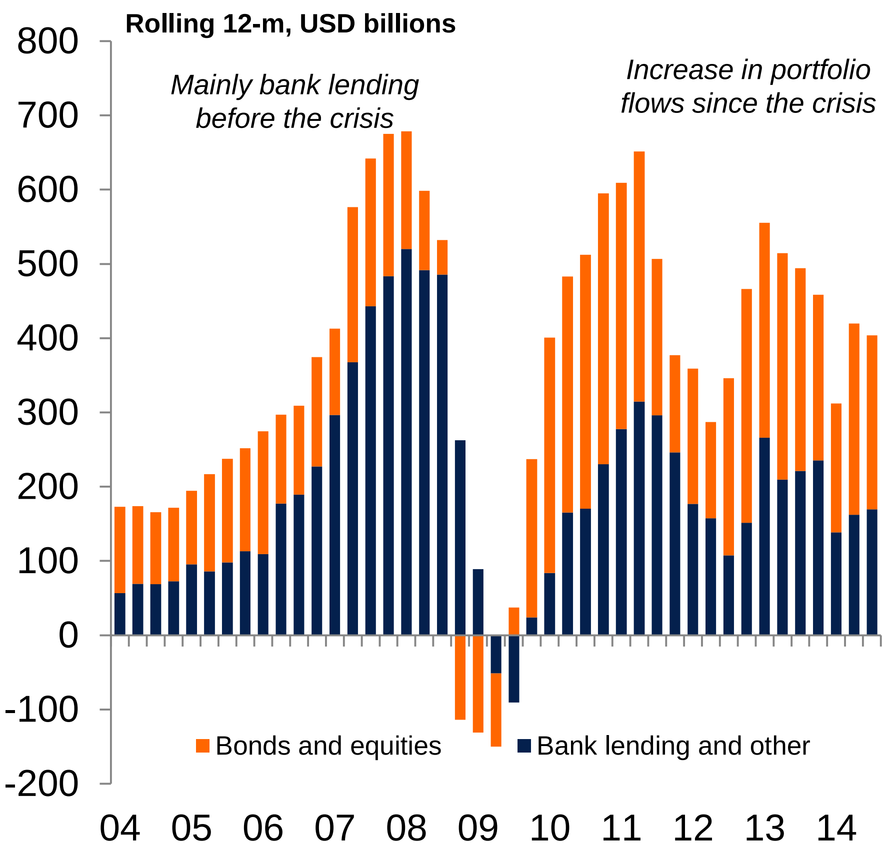
It resulted in an unprecedented increase in investment flows into emerging asset markets

Capital flows to EM expanded dramatically though their composition changed after the crisis



Source: Haver Analytics, Deutsche Bank Research

Emerging markets have increasingly been able to finance themselves in their own currencies

Source: Haver Analytics, Deutsche Bank Research

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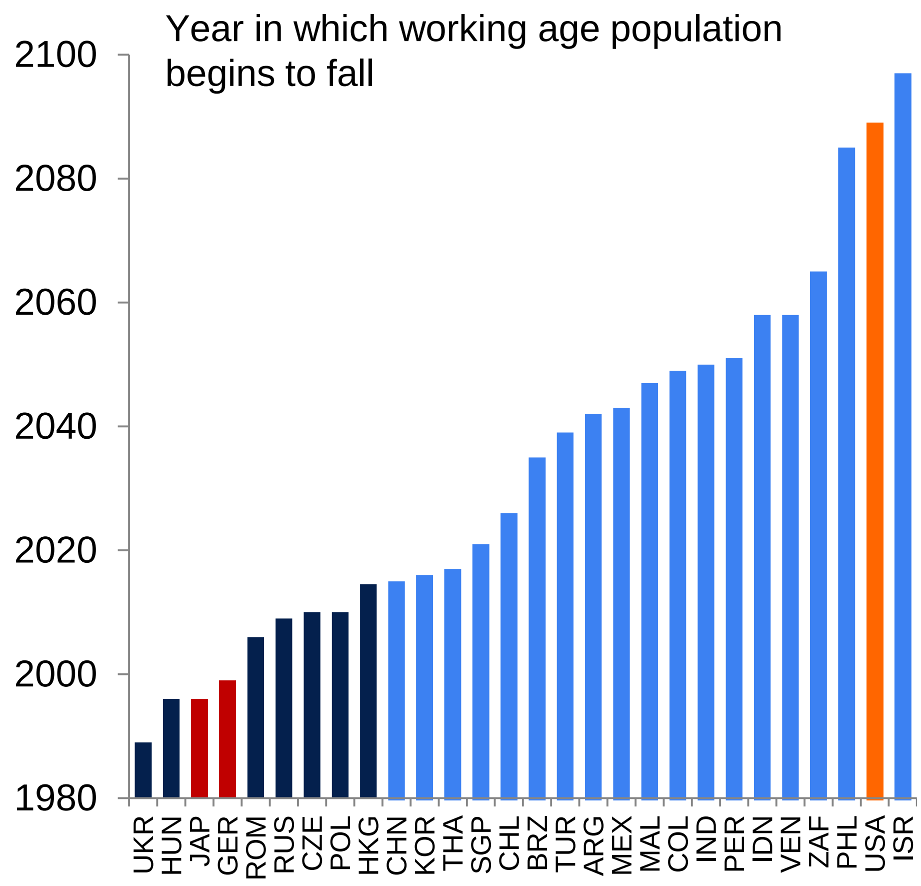
The future for emerging markets will be more challenging

Many of the tailwinds that propelled emerging markets in the last decade have turned into headwinds

1. Growth in major markets may accelerate but is unlikely to return to pre-crisis levels
2. Demographics will turn less favourable, imminently for some countries like Russia
3. Commodity prices past their peak, partly due to China rebalancing
4. The cost of external financing will rise as the Fed and others eventually withdraw monetary stimulus
5. Growth models in many emerging market countries are past their 'sell-by' date
6. A multi-year dollar upswing will present challenges for some EMs

Demographics is one example of this



Source: Haver Analytics, United Nations, Deutsche Bank Research

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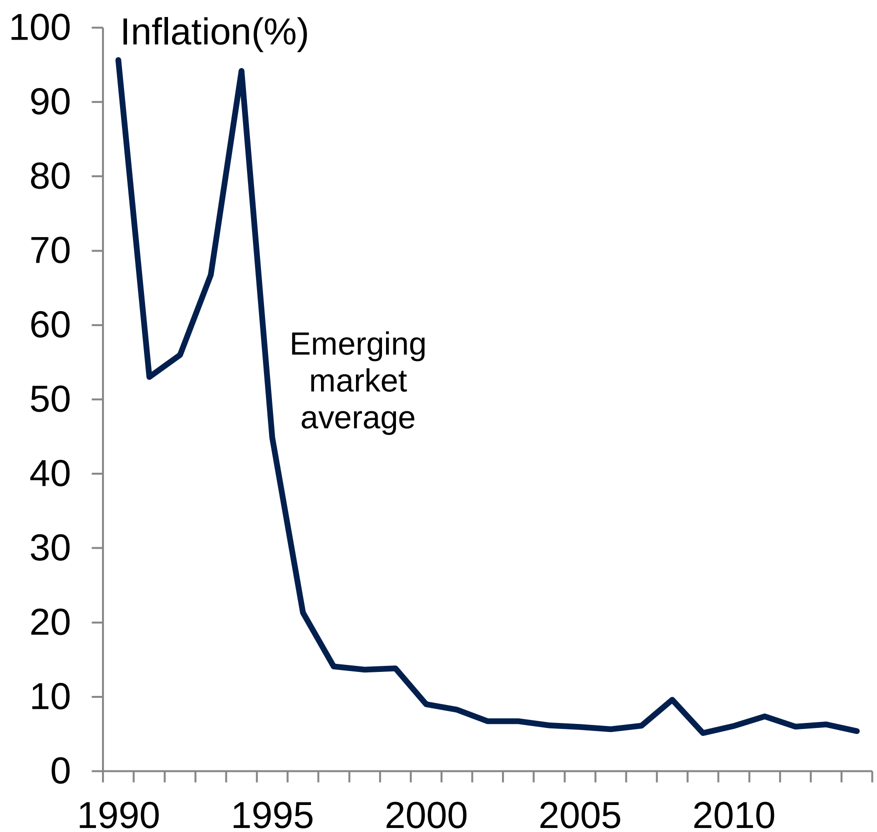
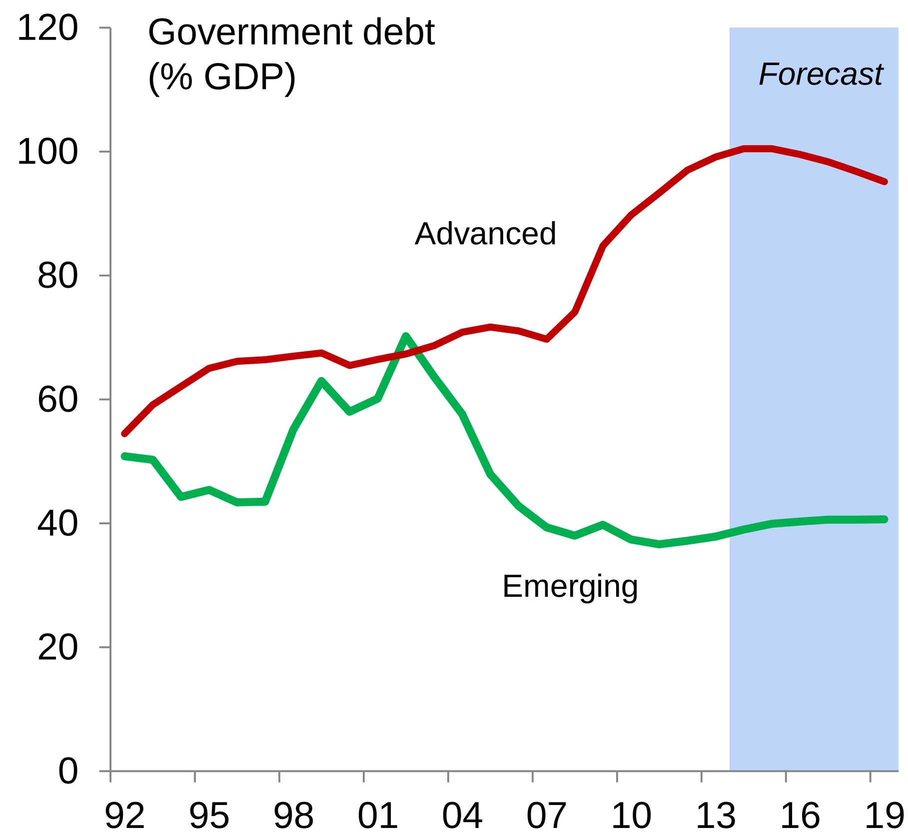
While EM faces a period of difficult adjustment, we think this will not translate into systemic crises of the kind we saw in previous decades

Better macroeconomic management has brought inflation more firmly under control



Source: Haver Analytics, Deutsche Bank Research

Government debt levels are significantly lower than in advanced economies



Source: Haver Analytics, Deutsche Bank Research

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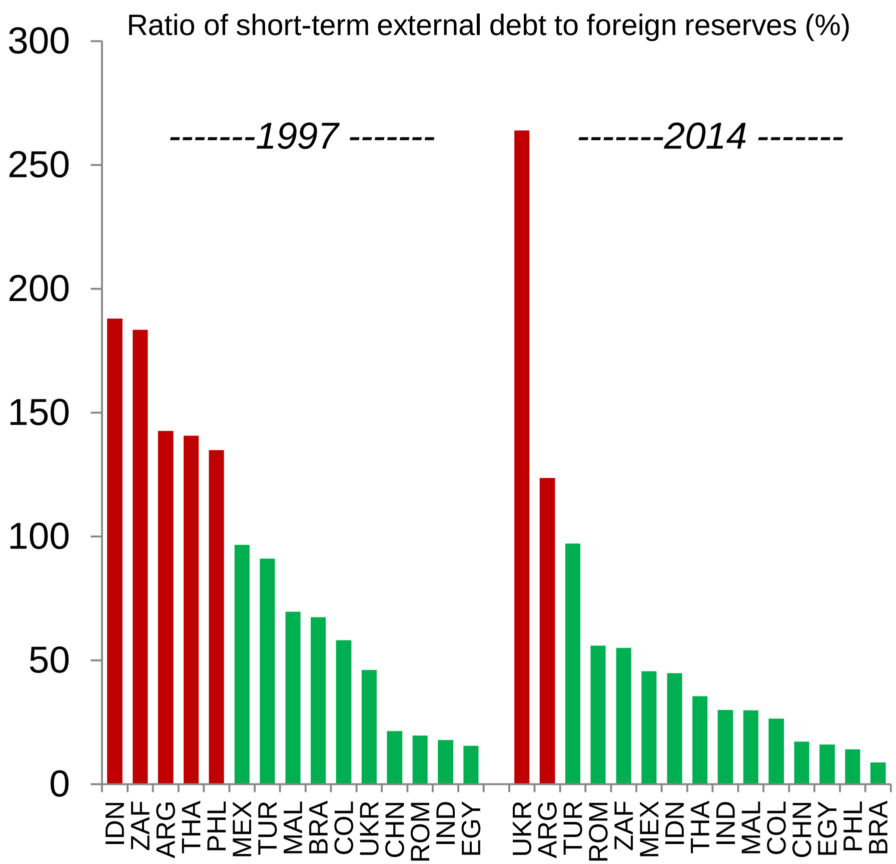
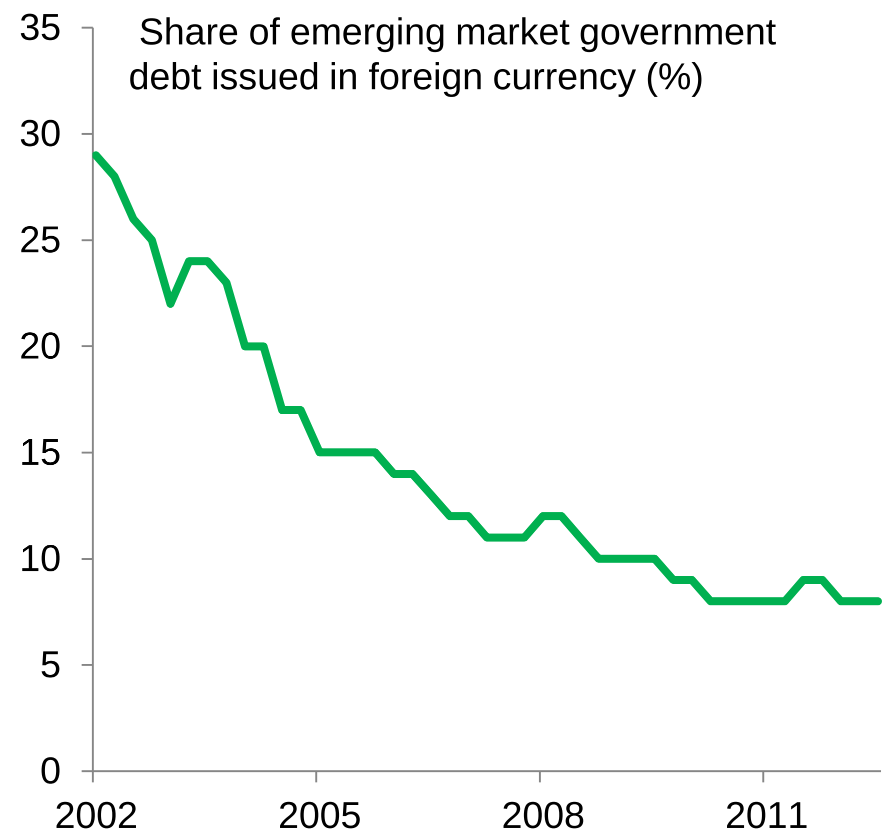
Currency pressure is much less of a threat to emerging markets than in the past...probably

Foreign reserves levels are significantly higher as countries have sought to self insure against crisis risks



Source: Haver Analytics, Deutsche Bank Research

The currency mismatches that once characterized emerging market balance sheets are now less prevalent



Source: IMF, Deutsche Bank Research

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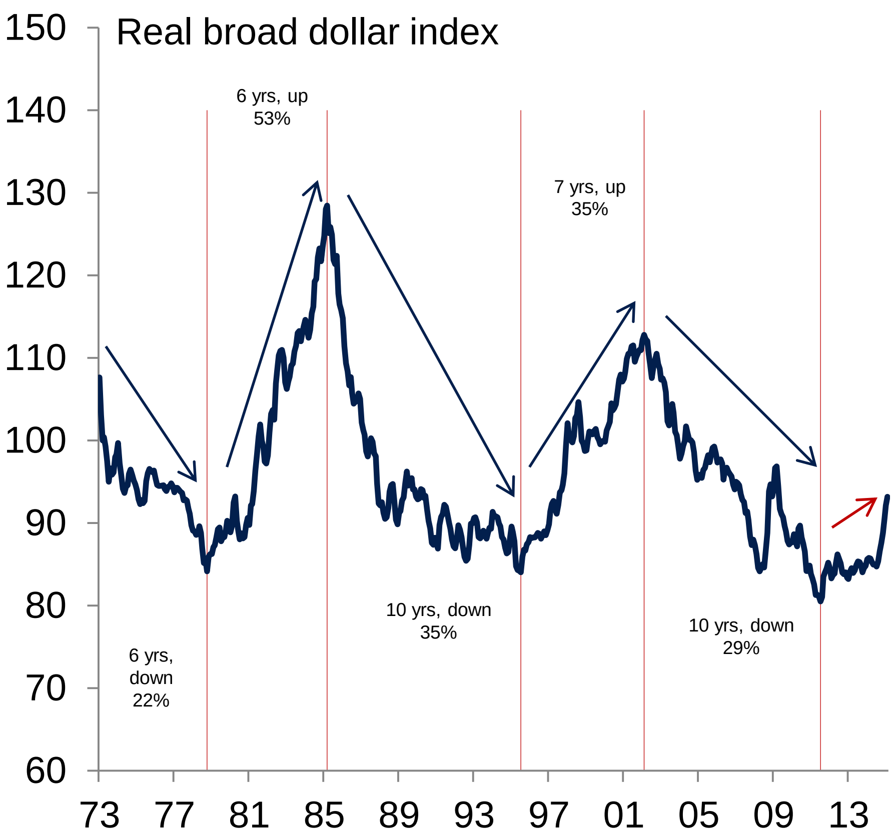
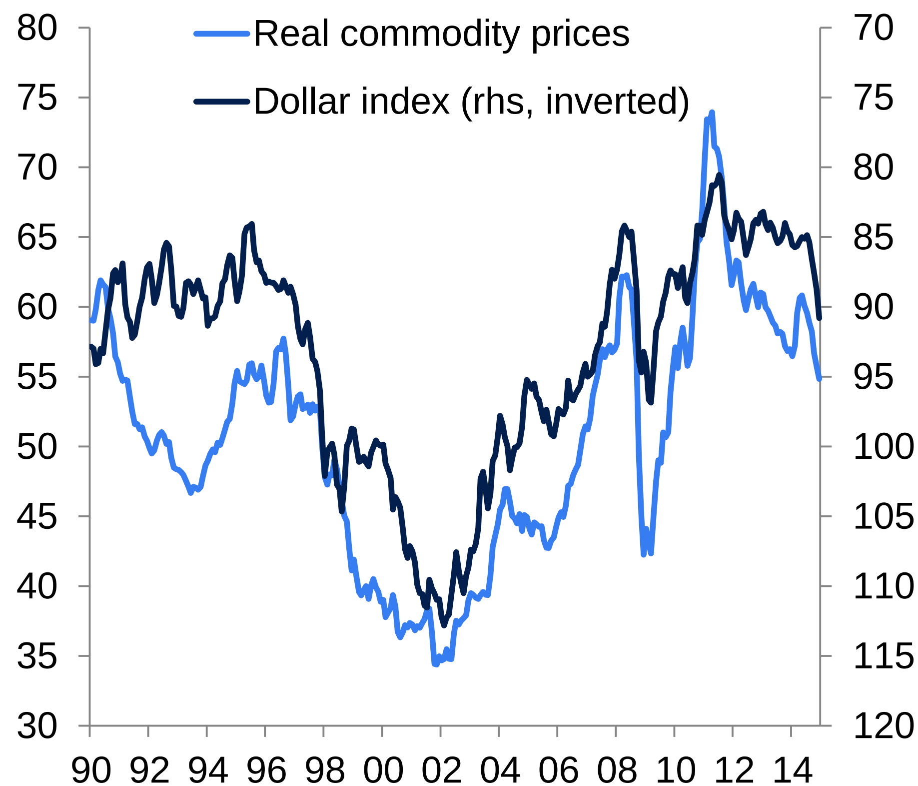
Divergences in growth and monetary policy point towards a stronger dollar, which could in turn weigh on commodity prices

Rising differences in growth and nominal yields between the US and Europe point to dollar strength



Source: Haver Analytics, Deutsche Bank Research

Commodity prices have tended to underperform in strong dollar environments



Source: Haver Analytics, Deutsche Bank Research

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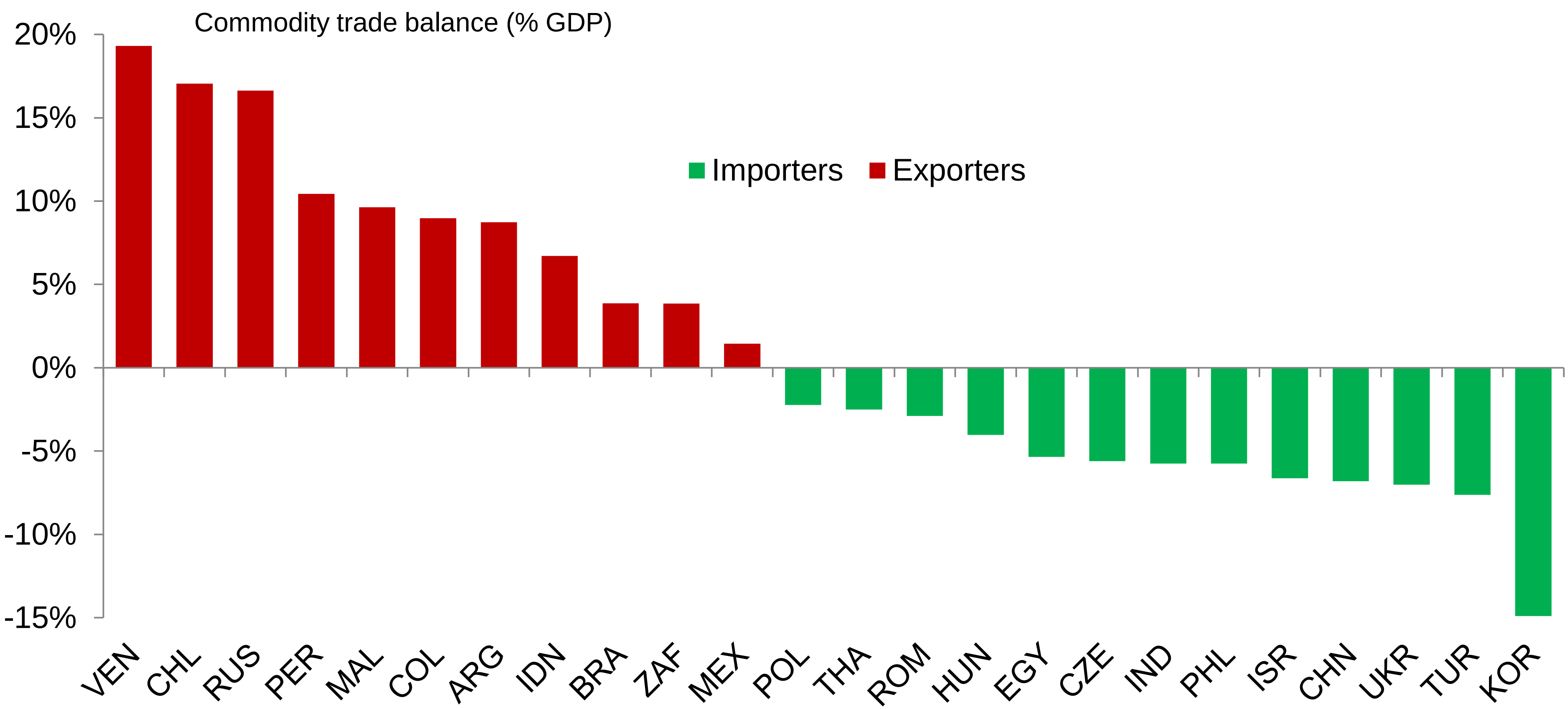
Weaker commodity prices create some (mostly obvious) leaders and laggards among emerging markets

Weaker commodities would tend to favour much of Asia and EMEA over Latin America, where every country is to varying degrees a net commodity exporter



Source: UN Comtrade, Haver Analytics, Deutsche Bank Research

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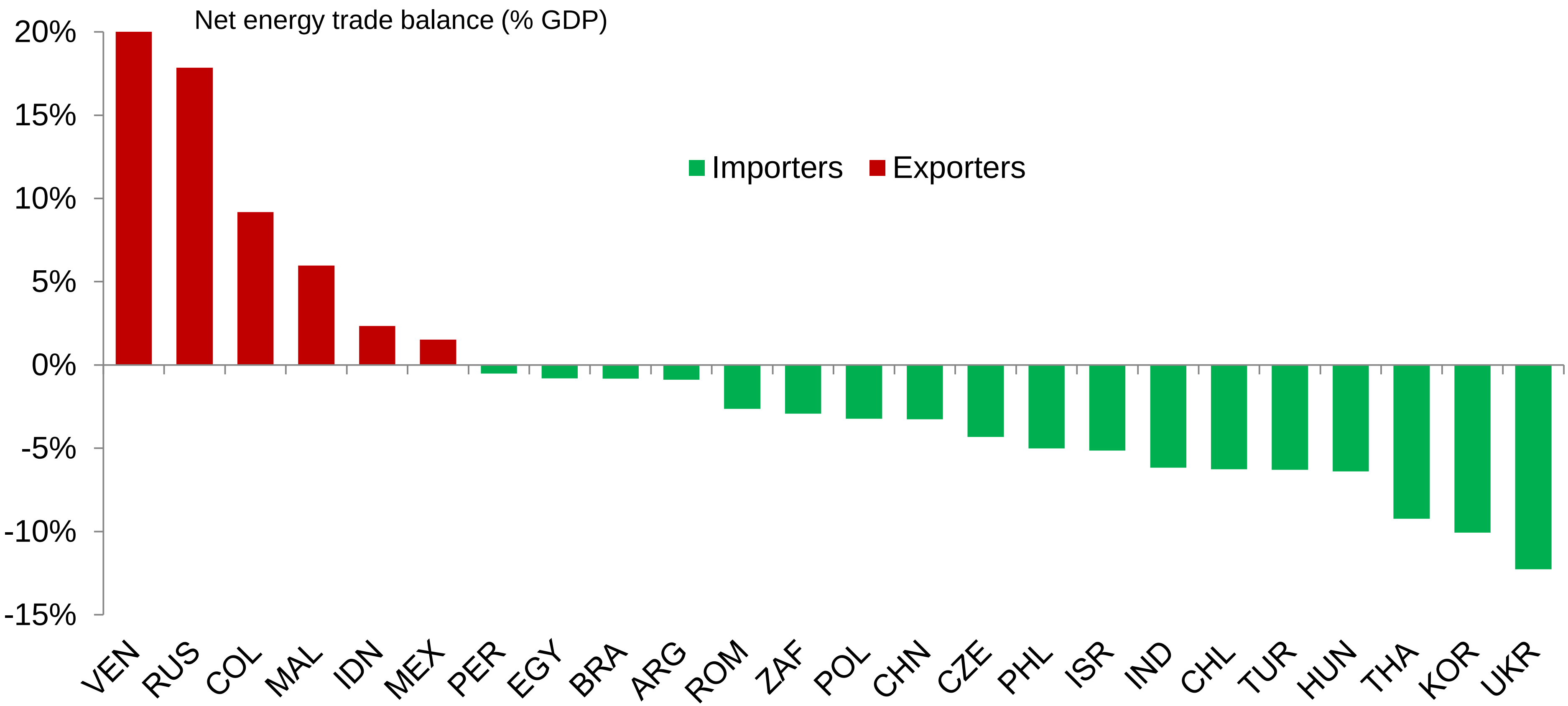
Energy exporters face the most acute challenges: oil prices have weakened by much more than food and metal prices

Among the major EMs, Venezuela and Russia are the most exposed. India, Turkey, Hungary, Thailand, and Korea are the major beneficiaries



Source: UN Comtrade, Haver Analytics, Deutsche Bank Research

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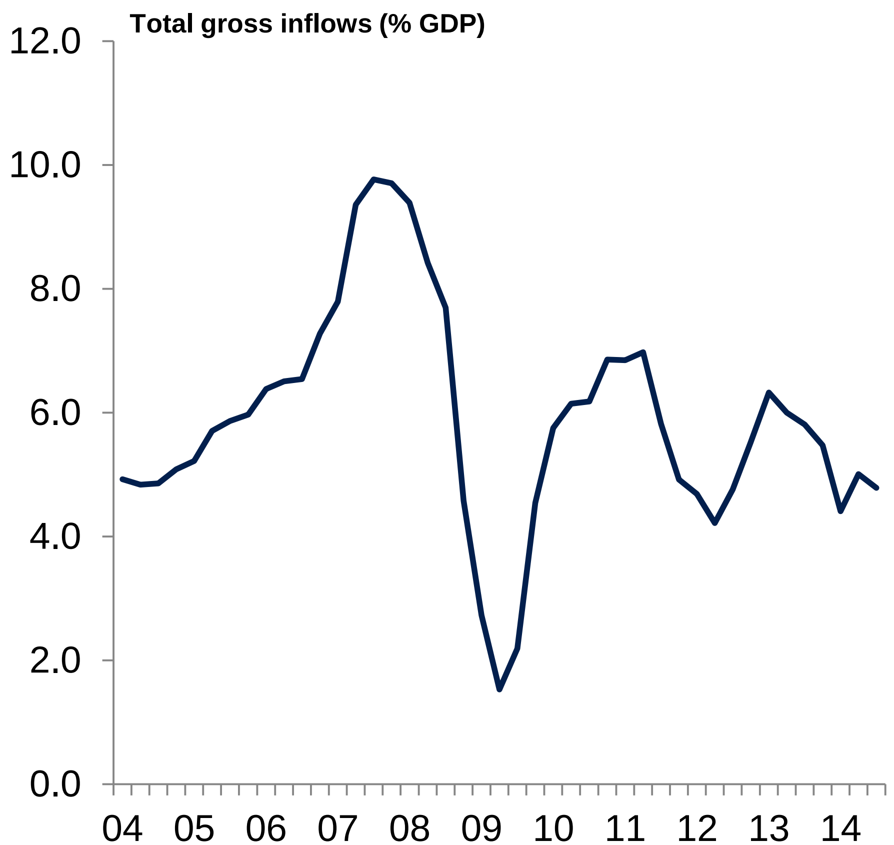
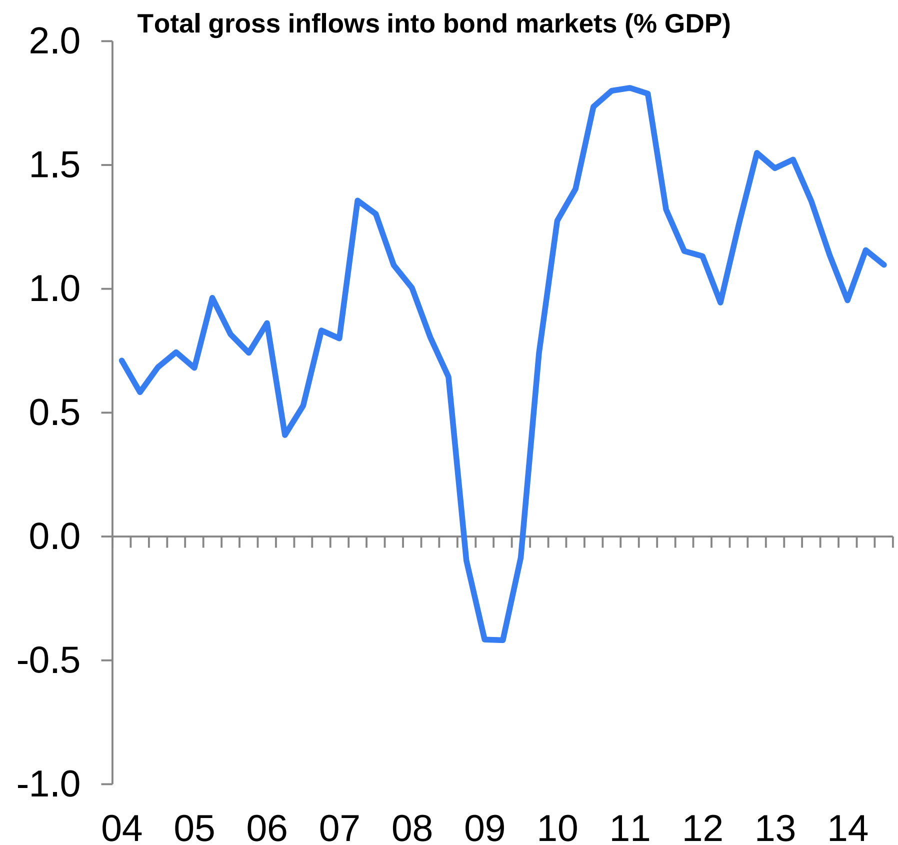
Have capital flows to emerging markets surged to such an extent that a sudden stop is now inevitable?

The current rate of capital flows to EM is not especially strong by recent standards...



Source: Haver Analytics, Deutsche Bank Research

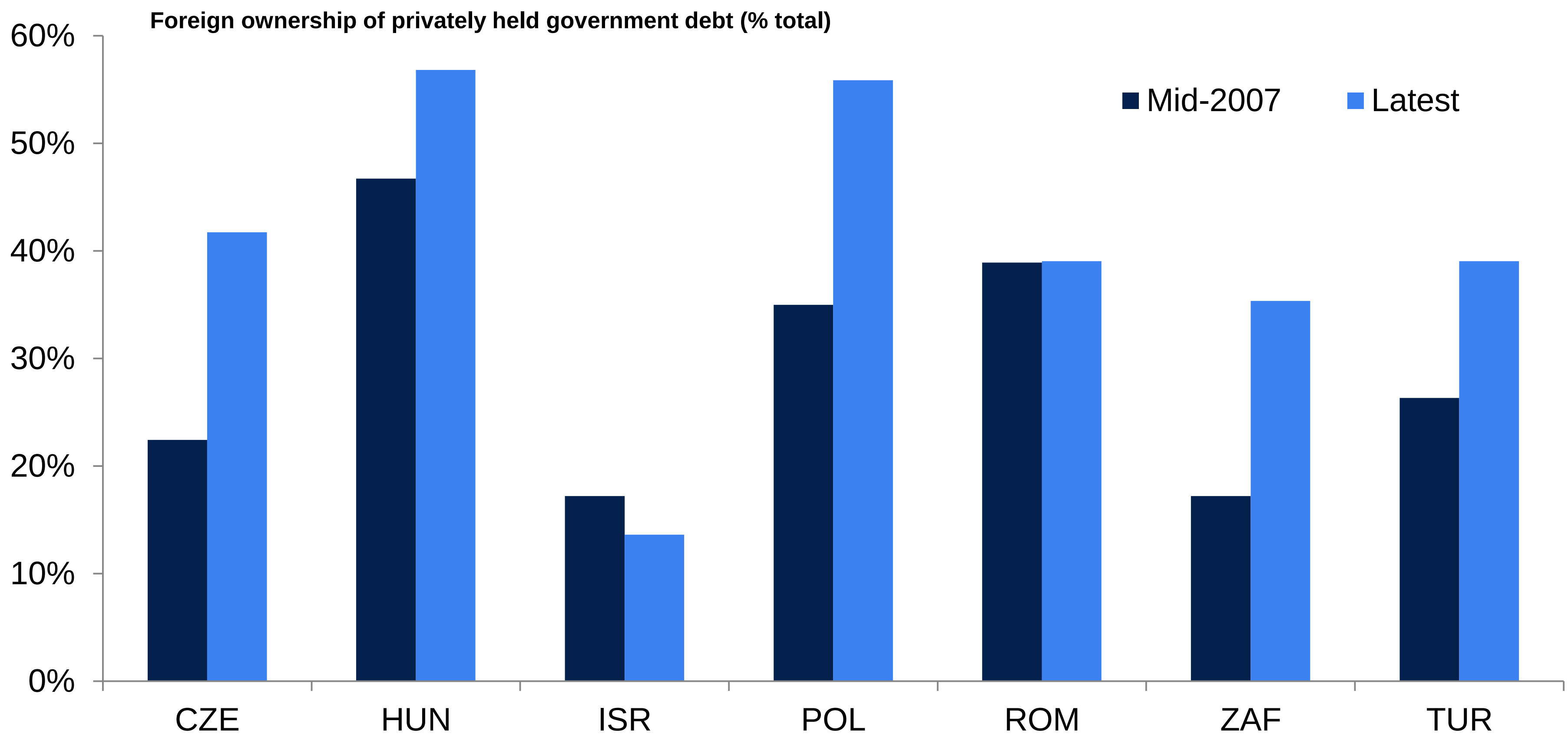
...this is true even in bond markets



Source: Haver Analytics, Deutsche Bank Research

Stocks and flows: following years of inflows, however, foreigners now own a lot more EM debt than they did before the global financial crisis

Foreign ownership of privately held government debt has gone up by over 10 percent of recipient GDP on average



Source: Haver Analytics, Deutsche Bank Research

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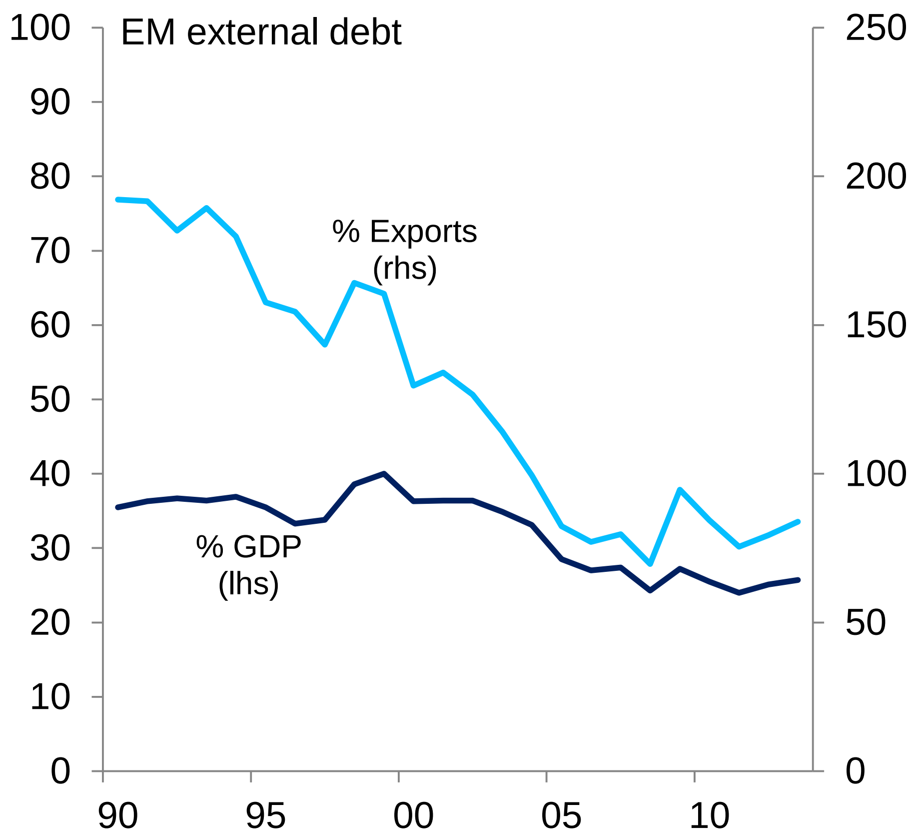
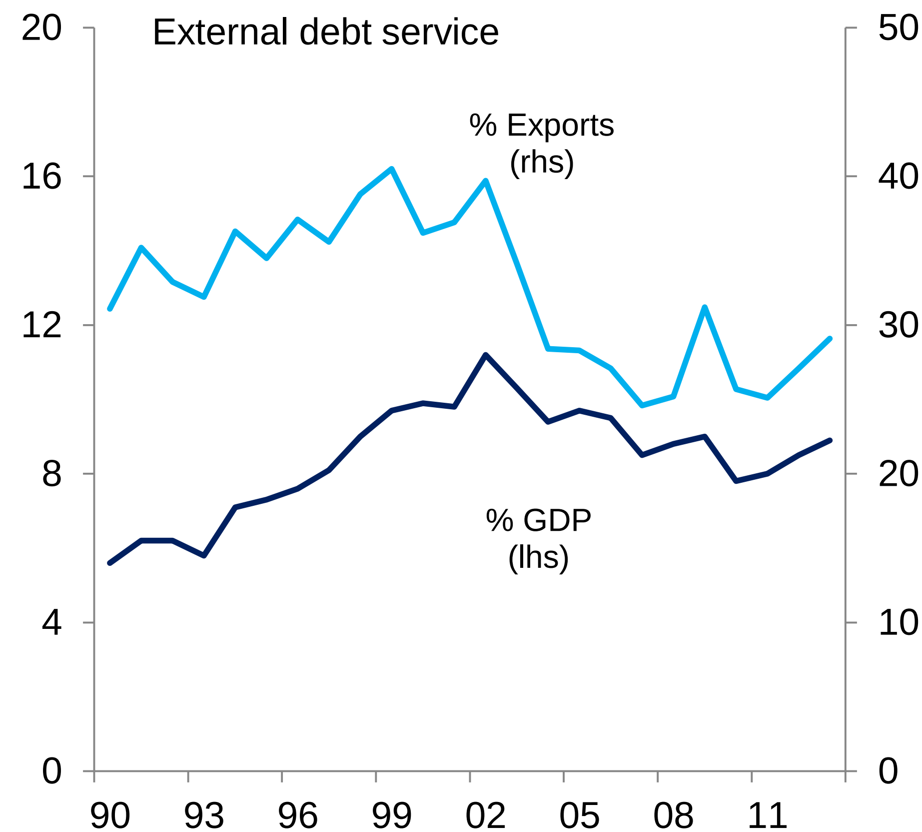
Another EM debt crisis?

External debt levels are still quite moderate...



Source: Haver Analytics, IMF *World Economic Outlook,* Deutsche Bank Research

...though debt service indicators are a bit more mixed



Source: Haver Analytics, IMF *World Economic Outlook,* Deutsche Bank Research

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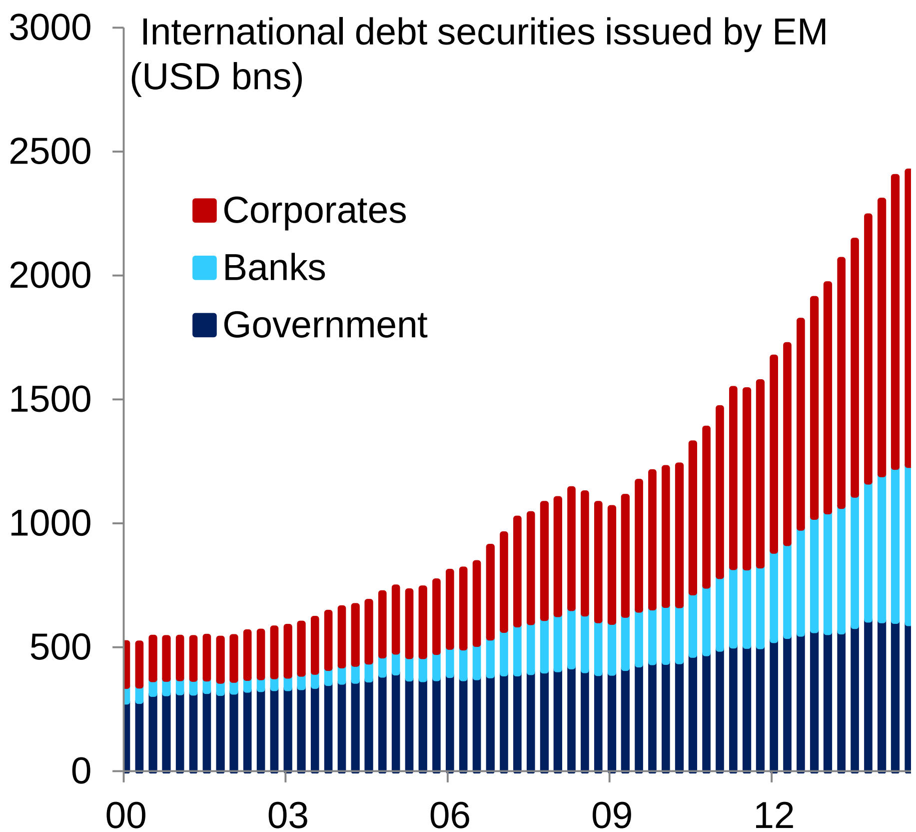
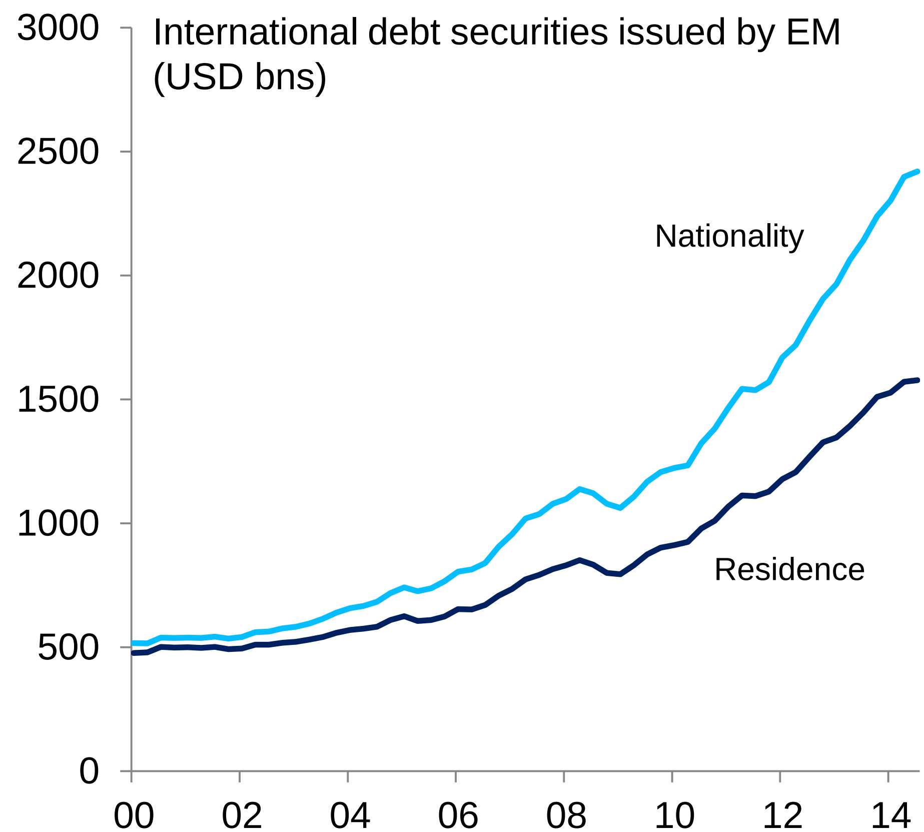
But there has been an increase in dollar debt issuance by the private sector in EM

The increase has been concentrated in companies and banks rather than government...



Source: Haver Analytics, BIS, Deutsche Bank Research

...some of the increase in issuance has been through offshore affiliates of EM companies and banks.



Source: Haver Analytics, BIS, Deutsche Bank Research

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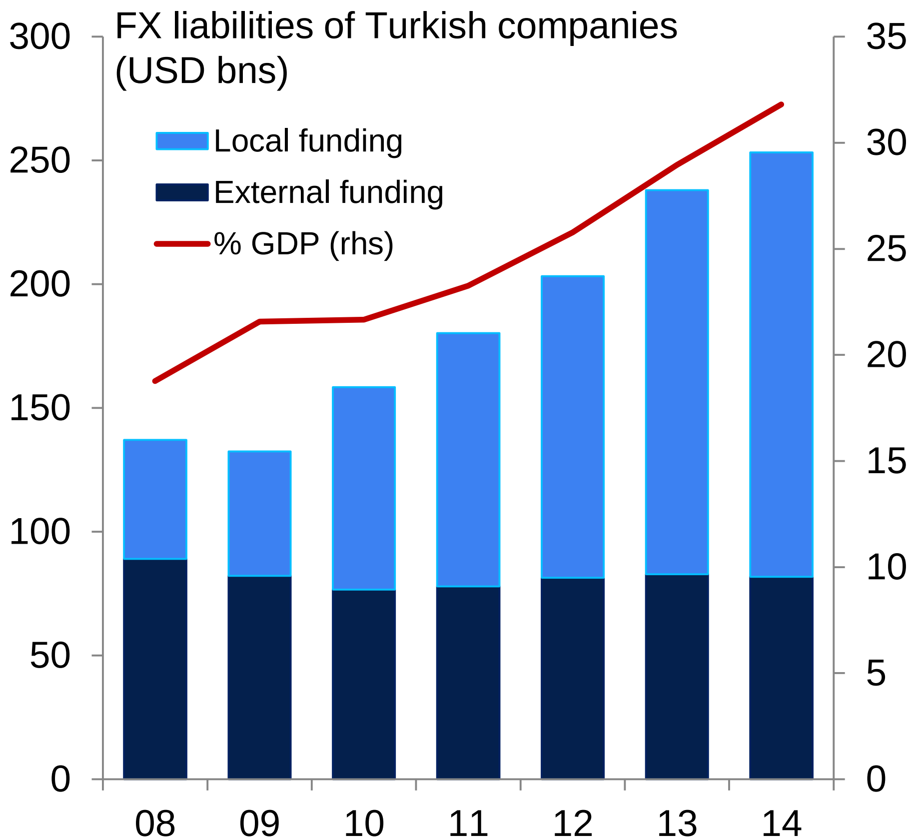
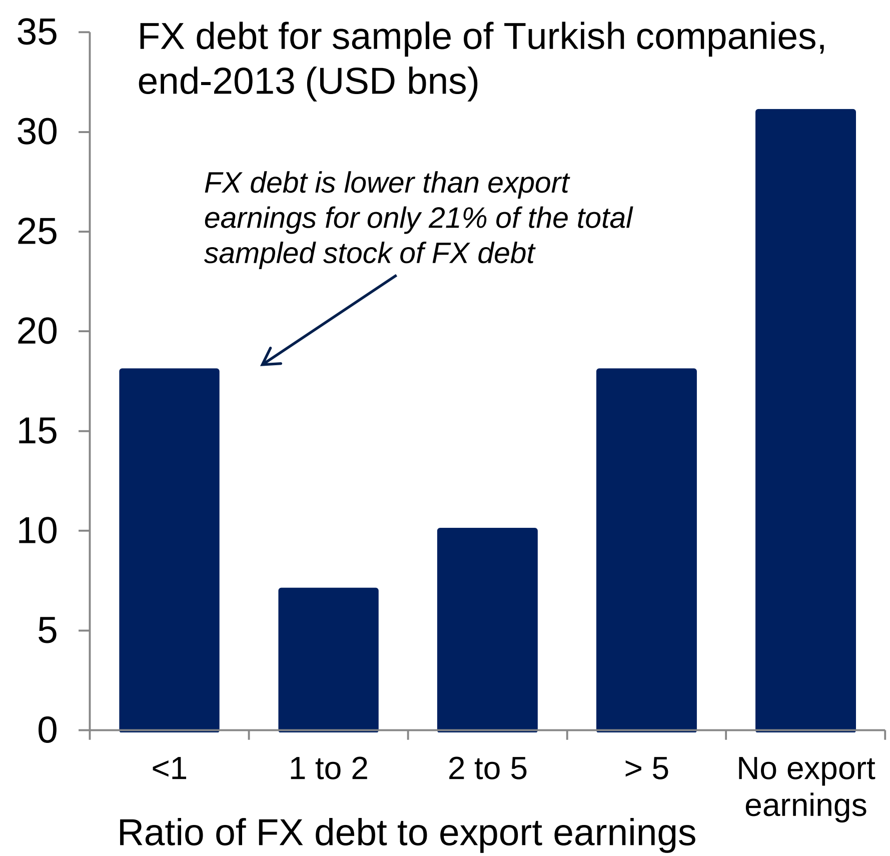
In Turkey, the increase in corporate dollar funding has been intermediated through local banks

Turkish companies have substantial FX liabilities...



Source: Central Bank of Turkey, Deutsche Bank Research

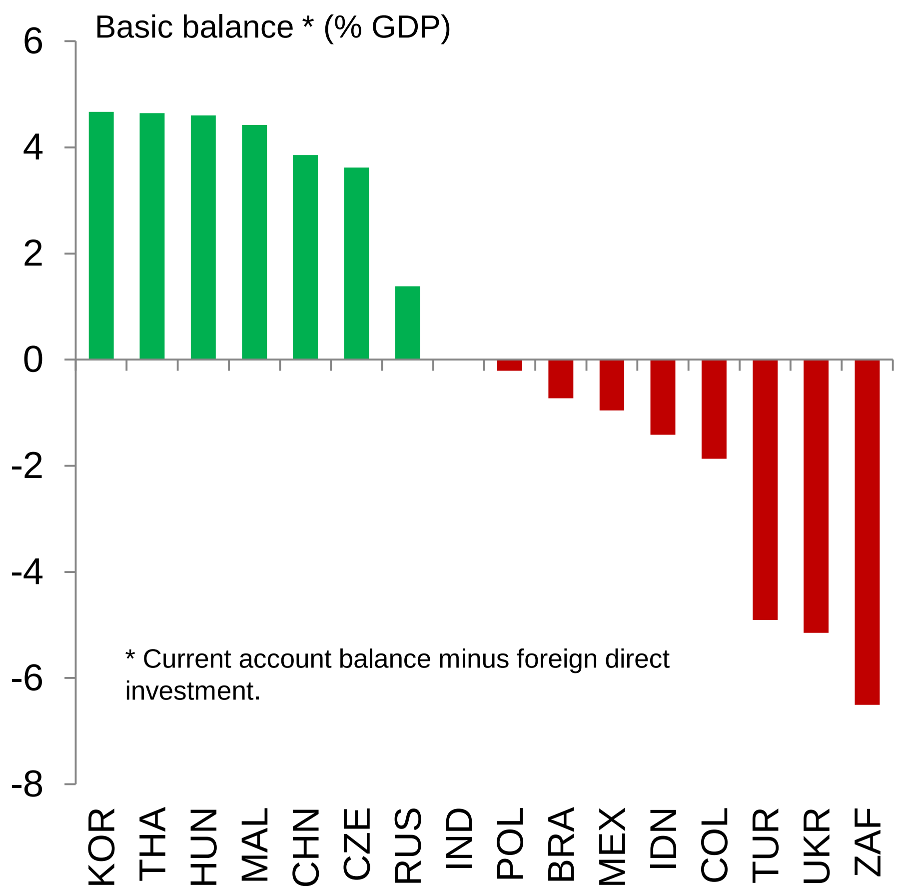
...and relatively little is naturally hedged



Source: Central Bank of Turkey, Deutsche Bank Research

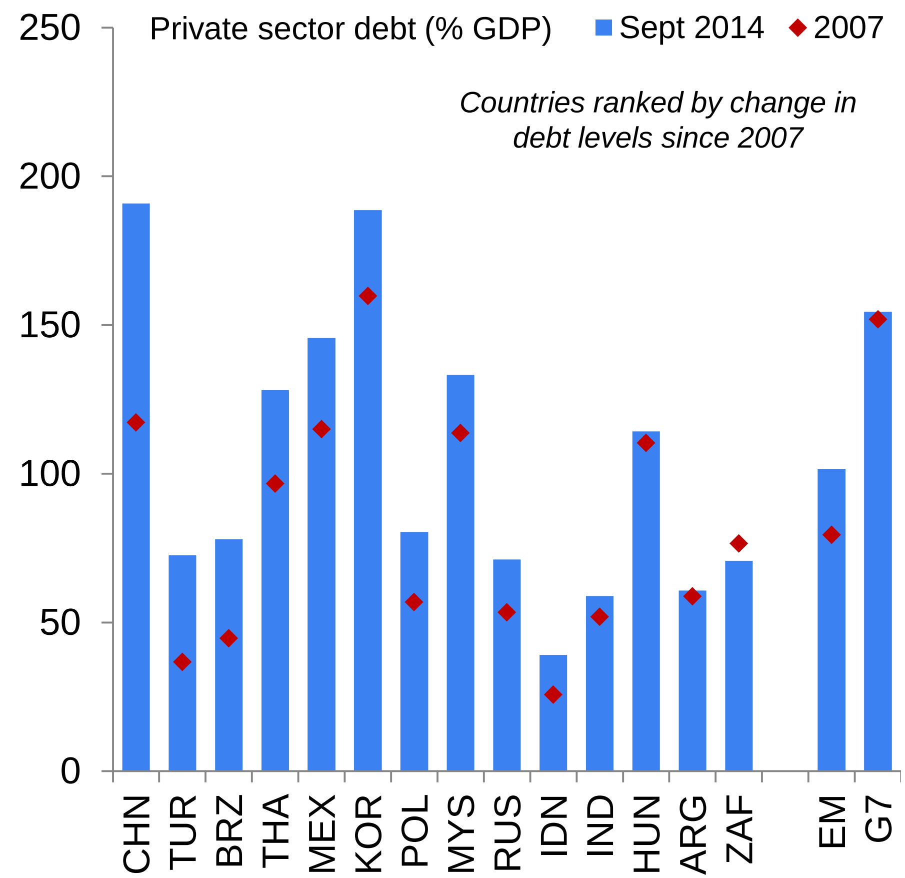
Emerging markets that are either highly reliant on external funding or heavily levered are potentially vulnerable to higher US rates

During “Taper Tantrum 1.0”, markets focused on a handful of EMs with large external deficits...



Source: Haver Analytics, Deutsche Bank Research

...though not so much on countries with large and/or rapidly growing private debt levels



Source: Haver Analytics, BIS, Deutsche Bank Research

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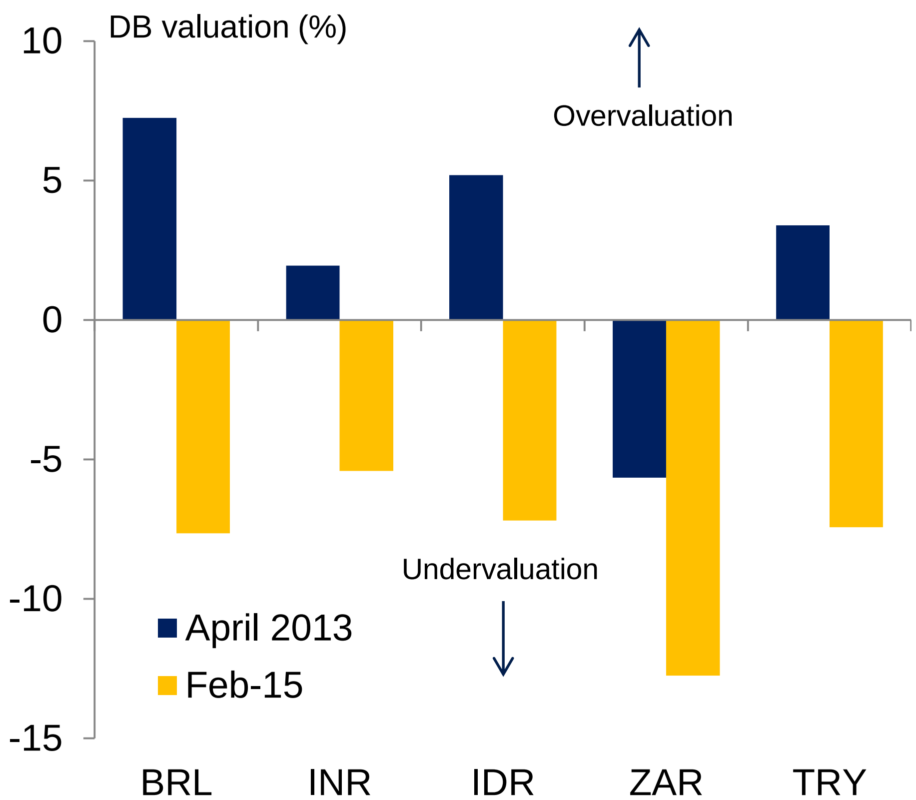
Some of the more fragile EMs have made progress in adjusting over. But this process is incomplete.

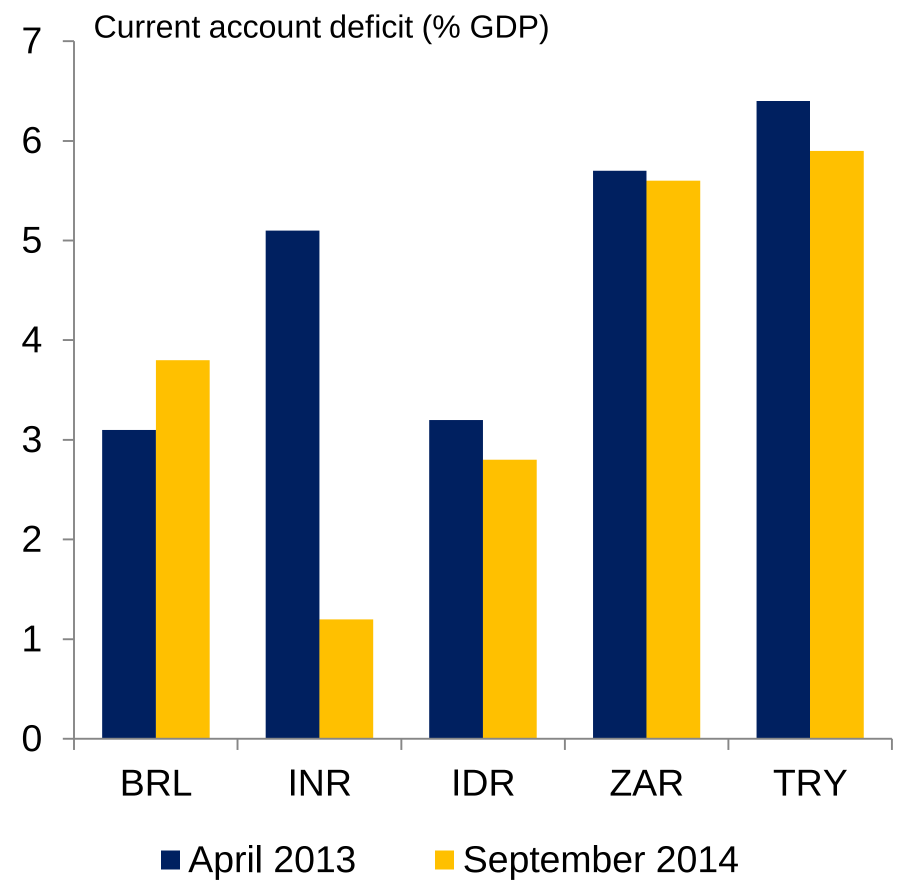
FX valuation in the so-called fragile five emerging markets has improved since the taper tantrum



* Average of behavioural equilibrium exchange rate and productivity adjusted PPP exchange rate

Source: Haver Analytics, Deutsche Bank Research

Current account adjustment on the other hand has lagged, with the notable exception of India



Source: Haver Analytics, Deutsche Bank Research

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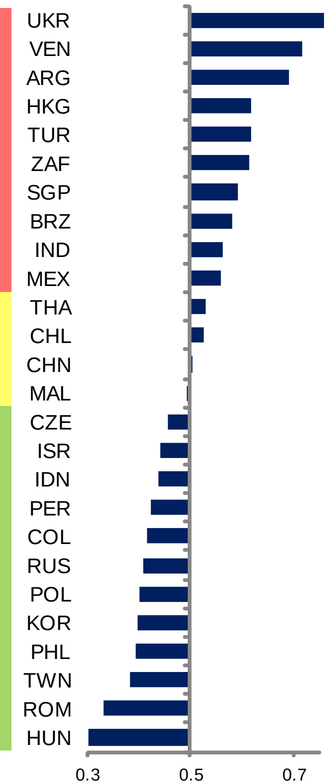
EM Vulnerability Assessment confirms high risks in Ukraine, Venezuela and Argentina

	Growth	Inflation	Credit growth	Private debt	Real rates	Current account	Reserve cover	FX valuation	Public debt	Fiscal balance	Overall
	Z-score	YoY%	Excess %	% GDP	%	% GDP	% GEFR	%	% GDP	% GDP	Percentile
UKR	-1.18	22.2	12.0	69.2	-14.0	-4.7	26.7	-32.3	67.6	-5.8	0.80
VEN	-0.11	63.8	28.5	36.3	-29.9	1.2	110.2	103.0	35.6	-14.2	0.72
ARG	-0.36	42.6	0.3	14.5	-15.6	-0.9	97.5	30.1	48.9	-4.5	0.69
HKG	-0.05	5.2	11.0	330.8	-4.5	2.7	35.0	11.3	6.5	2.6	0.62
TUR	-0.57	8.8	11.4	58.6	1.1	-5.8	73.6	-3.6	33.6	-2.0	0.62
ZAF	-0.18	5.8	0.7	74.8	0.2	-5.6	95.9	-13.0	47.9	-4.9	0.61
SGP	-0.93	-0.2	6.9	135.0	0.6	19.4	24.3	7.0	103.1	4.3	0.59
BRZ	-1.03	6.5	4.3	74.3	4.4	-4.0	259.6	-5.4	65.8	-3.9	0.58
IND	-0.93	4.8	0.9	56.6	3.8	-1.3	291.3	0.8	60.5	-7.2	0.56
MEX	0.33	4.2	7.9	45.2	-0.9	-2.0	151.2	-3.2	48.0	-4.2	0.56
THA	-0.69	1.1	3.7	134.8	1.1	3.6	264.2	6.6	47.9	-2.5	0.53
CHL	-0.85	5.3	2.7	79.0	-2.1	-1.9	171.6	-12.5	13.9	-1.8	0.53
CHN	-1.82	1.6	5.4	139.4	2.8	2.0	548.4	9.8	40.7	-1.0	0.50
MAL	-0.07	2.9	1.7	124.9	0.8	5.5	104.3	-6.0	56.6	-3.6	0.49
CZE	-0.13	0.5	0.6	54.8	-0.1	0.2	109.0	-2.3	44.4	-1.2	0.46
ISR	-0.42	-0.2	0.0	115.5	0.4	3.7	241.7	-4.9	67.4	-2.9	0.44
IDN	-0.05	6.5	3.9	34.3	0.9	-2.9	153.5	-4.5	26.2	-2.5	0.44
PER	-0.63	3.0	8.5	33.3	1.4	-4.6	376.0	-1.1	19.3	-0.1	0.42
COL	-0.02	3.3	5.0	43.1	0.9	-4.2	165.9	-17.2	34.0	-1.5	0.42
RUS	-0.95	9.6	9.8	55.4	3.1	2.6	527.1	-30.2	15.7	-0.9	0.41
POL	-0.26	-0.4	1.8	51.9	2.4	-1.3	202.4	-6.7	49.4	-3.2	0.40
KOR	-0.34	1.0	0.4	160.7	1.1	6.2	293.7	4.5	35.4	0.3	0.40
PHL	0.49	3.6	7.2	46.4	-1.9	3.6	838.9	2.3	36.3	-0.3	0.39
TWN	0.14	0.8	1.2	142.3	0.0	12.3	237.3	-2.8	39.9	-2.3	0.38
ROM	-0.25	1.3	-8.6	32.6	0.5	-0.5	176.5	-12.3	39.9	-2.2	0.33
HUN	0.05	-0.7	-8.8	42.7	2.8	4.1	198.5	-4.6	79.1	-2.9	0.30



Source: Haver Analytics, Deutsche Bank Research

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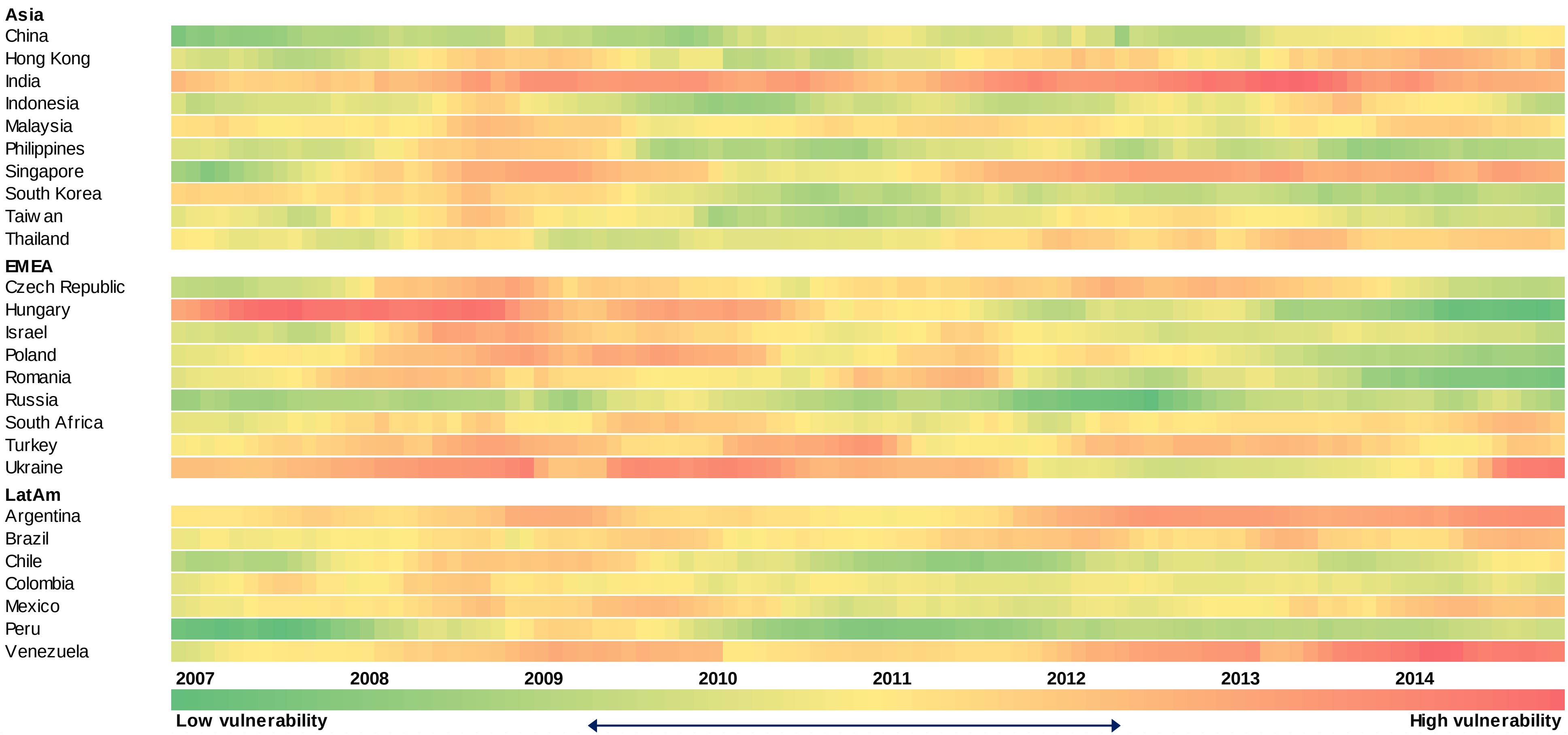
Our vulnerability heat map points to a reduction in risks in Central Europe, India, and Indonesia; but rising risks in Latin America



Source: Deutsche Bank Research

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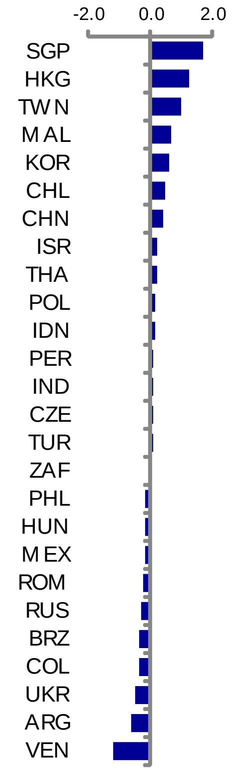
Good macro management has never been enough: structural policies also matter and this will become increasingly apparent.

	Institutional quality	Infrastructure	Education	Financial market	Economic openness	Goods market	State intervention	Labour market	Overall
SGP	1.69	2.58	2.76	1.58	1.81	1.69	0.91	0.54	1.70
HKG	1.55	2.92	1.28	1.84	-0.24	1.30	0.91	0.67	1.28
TWN	1.03	1.92	2.27	0.47	-0.17	1.09	0.84	0.50	0.99
MAL	0.28	1.31	0.91	1.11	-0.19	1.29	0.20	0.46	0.67
KOR	0.76	1.99	1.83	-0.89	-0.30	0.23	0.58	0.59	0.60
CHL	1.29	0.65	0.33	0.32	0.04	0.49	0.34	0.04	0.44
CHN	-0.92	0.62	0.48		0.63	-0.23	0.15	2.66	0.38
ISR	0.60	1.04	0.92	0.29	-0.33	-0.20	-0.67	-0.12	0.19
THA	-0.56	0.64	-0.26	0.04	0.06	-0.03	0.70	0.85	0.18
POL	0.87	0.05	0.90	-0.05	0.75	-0.06	-1.25	-0.17	0.13
IDN	-0.61	0.27	0.33	-0.52	0.19	0.07	0.72	0.44	0.11
PER	-0.48	-0.42	-0.76	-0.11	1.29	-0.05	0.90	0.38	0.09
IND	-0.58	-0.27	-0.44	0.32	0.38	-0.21	0.47	0.73	0.05
CZE	0.90	0.82	0.53	-0.49	0.54	-0.29	-2.05	0.06	0.00
TUR	-0.29	0.56	0.20	-0.23	0.20	0.37	-0.88	0.10	0.00
ZAF	0.12	0.22	-1.35	1.56	0.30	0.72	-0.09	-2.05	-0.07
PHL	-0.56	-0.53	-0.29	-0.22	-0.27	-0.72	1.14	0.26	-0.15
HUN	0.64	0.47	0.56	-0.84	0.34	-0.35	-1.93	-0.50	-0.20
MEX	-0.36	0.24	-0.37	-0.50	-0.25	-0.52	0.15	-0.06	-0.21
ROM	0.00	-0.60	-0.27	-0.80	0.60	-0.62	-0.62	0.31	-0.25
RUS	-1.09	0.72	0.48	-1.53	0.18	-0.90	-1.11	0.56	-0.33
BRZ	-0.20	0.11	-0.49	-0.23	-0.02	-1.10	-0.82	-0.03	-0.35
COL	-0.56	-0.42	-0.52	-0.64	0.20	-0.85	-0.02	-0.26	-0.38
UKR	-1.07	0.16	0.69	-1.44	0.51	-1.19	-1.90	0.22	-0.50
ARG	-0.60	-0.41	0.44	-1.96	-0.36	-2.25	-0.26	0.19	-0.65
VEN	-1.81	-1.34	-0.43	-2.05	-0.41	-2.61	-1.00	-0.09	-1.22
Asia average	0.21	1.14	0.89	0.34	0.19	0.45	0.66	0.77	0.58
EMEA average	0.08	0.38	0.30	-0.39	0.34	-0.28	-1.17	-0.18	-0.11
LatAm average	-0.39	-0.23	-0.26	-0.74	0.07	-0.98	-0.10	0.03	-0.33
EM average	0.00	0.51	0.37	-0.20	0.21	-0.19	-0.18	0.24	0.10



Source: Deutsche Bank Research

value >= 0.15
value >-0.15 and <0.15
value <=-0.15

Values are normalized such that zero represents that average for EM in 2007

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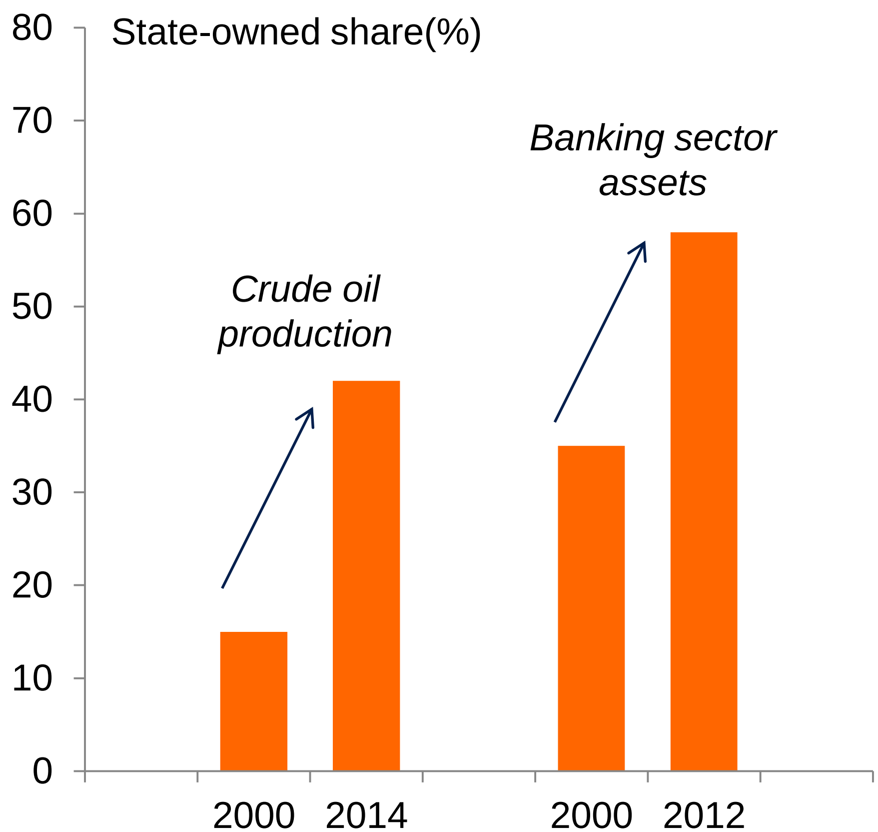
The structural reform process in Russia has stalled and may swing into reverse if the government pursues a more inward-looking strategy

Russia has made little progress reducing the role of the state in the economy....



Source: Haver Analytics, Deutsche Bank Research

...and little progress in diversifying economic activity away from the oil and gas sector

Source: Haver Analytics, Deutsche Bank Research

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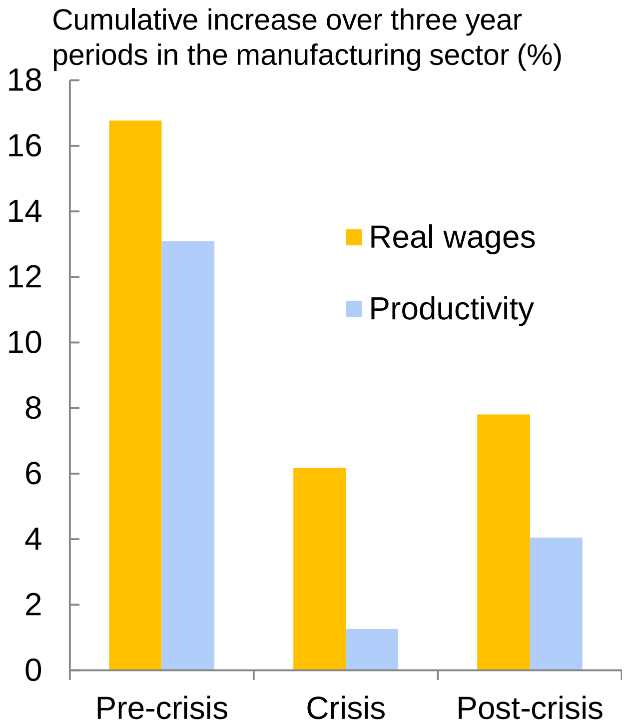
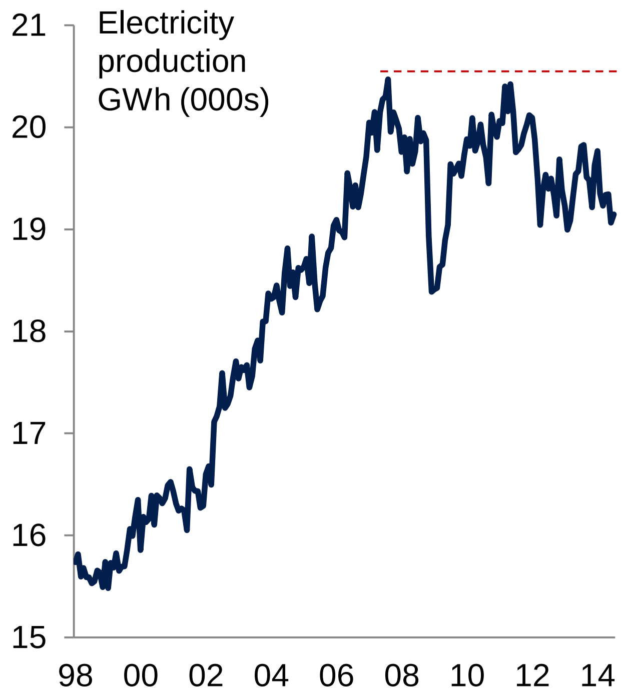
The failure to address long-standing structural weaknesses has undermined South African economic performance

A toxic combination of poor labour relations and a weak education...



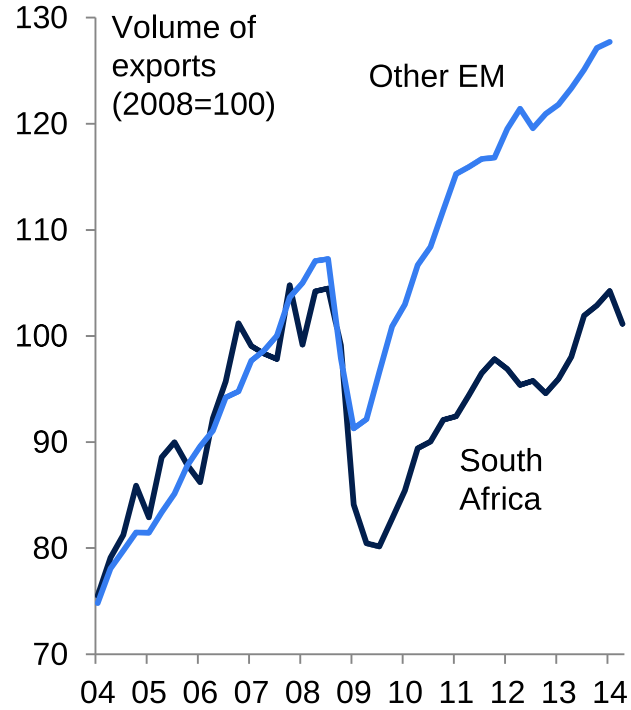
Source: Haver Analytics. Deutsche Bank Research

...and a failure to invest in critical infrastructure at an early stage



Source: Statssa, Deutsche Bank Research

...has hit exports despite a much weaker rand



Source: Haver Analytics, Deutsche Bank Research

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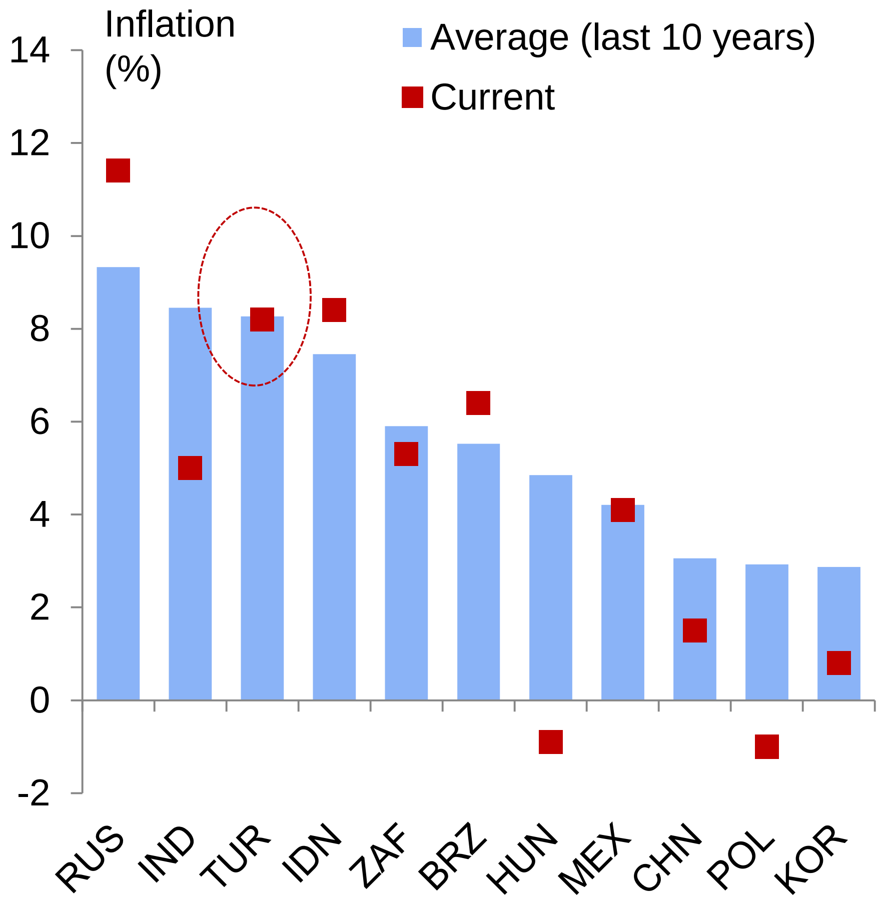
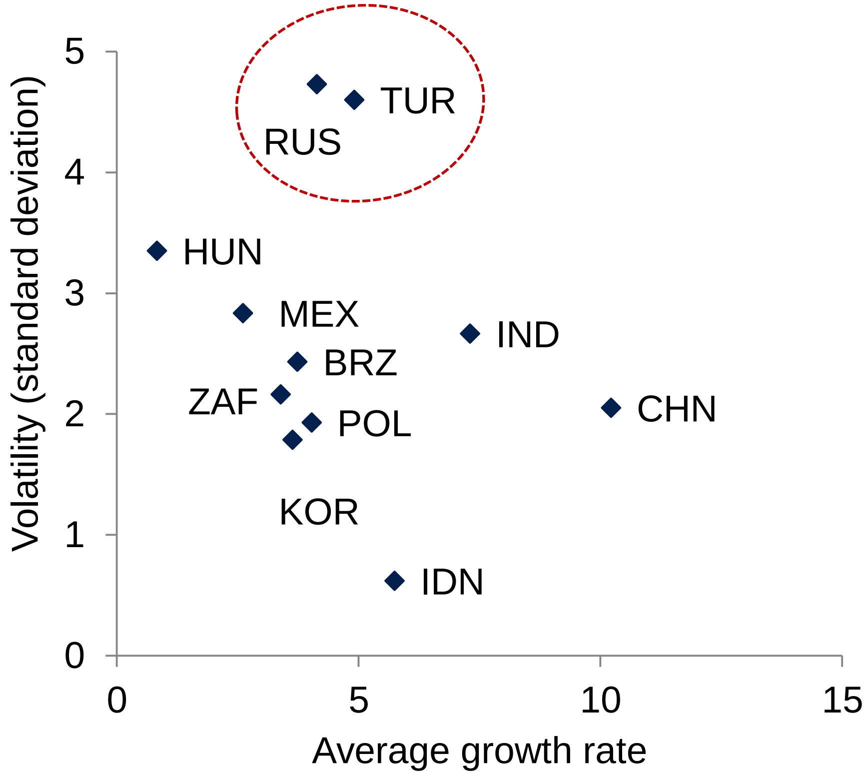
Turkey is a little unusual insofar as its problems are as much macroeconomic as structural in nature

Turkey has yet to bring inflation firmly under control...



Source: Haver Analytics, Deutsche Bank Research

...contributing to low private saving, chronic reliance on foreign saving, and a tendency to boom-bust cycles



Source: Haver Analytics, Deutsche Bank

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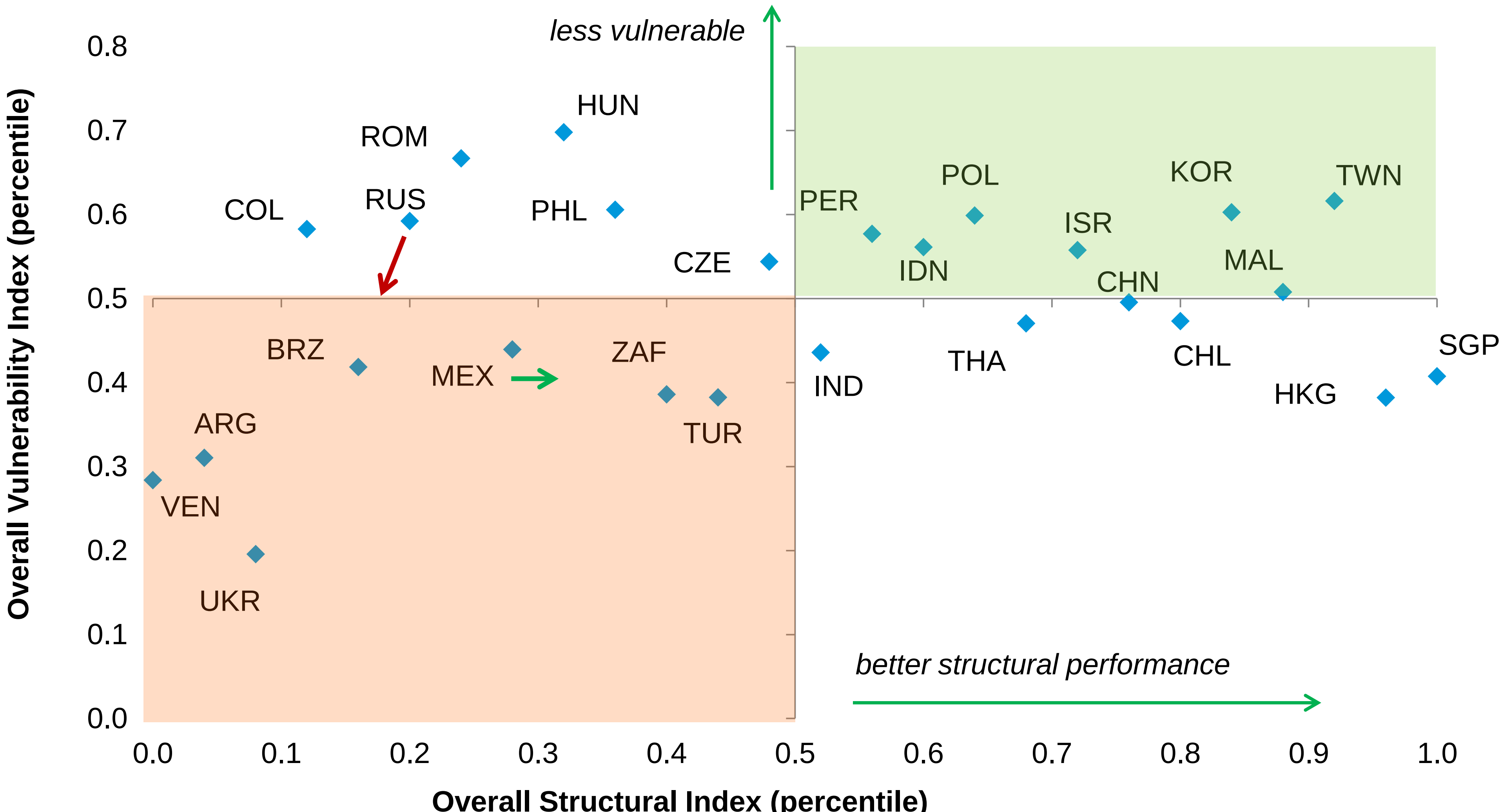
Combining our macroeconomic and structural assessments helps to identify countries that could struggle in a rising rate environment



Source: Deutsche Bank Research

Conclusions

- The normalization of US monetary policy will represent a key stress test for emerging markets
- Market pricing suggests the process could be a benign one, characterized by very gradual increases, a low terminal rate, and offsetting flows from the ECB
- This could provide policymakers within EM additional time to adjust
- We continue to think a systemic EM crisis remains unlikely, reflecting the buffers put in place over the past 10-15 years
- But even a benign US hiking cycle could present challenges where there have been rapid increases in leverage, especially if funded in dollars
- The days in which emerging markets collectively under- or over-performed are likely behind us: we expect greater divergence in performance
- It will ultimately be the quality of economic policymaking within EM – structural as much as macroeconomic – that will drive this performance

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End

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