Emerging markets and the fear of the Fed

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Robert Burgess,
Chief Economist, Emerging Markets (Europe, Middle East, and Africa)

Robert Burgess | (+44) 20 7547-1930 | robert.burgess@db.com
Contents

1. Fed rate hikes – remember them?
2. Why did emerging markets sail through the last Fed hiking cycle?
3. The dollar and commodity prices: new (old) kids on the block
4. Capital flows and dollar debt – triggers for a new crisis?
5. Which EMs look vulnerable?
6. Don’t forget structural factors
7. Conclusions
The Fed is in unprecedented territory

Interest rates are at historically low levels...

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

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<th>Start hiking cycle</th>
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<td>Today</td>
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<td>September FOMC</td>
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The Fed and markets view the world differently

...market pricing is not consistent with Fed guidance

Fed Funds Rate (%)


Fed terminal rate

Fed guidance (March DOTS)

Market implied (23 Mar)

Source: Bloomberg Finance LLP, US Federal Reserve, Deutsche Bank Research
Why we worry: the fear that Fed hikes trigger new EM crises

Fed Funds Rate (%)

Source: Haver Analytics, Deutsche Bank Research

1994 Mexico
1997 Indonesia
Korea
Malaysia
Philippines
Thailand
1998 Brazil
Russia
2000 Turkey
2001 Argentina
2004-06 No major EM crisis
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. This premium reached 5 percentage points prior to the global financial crisis.

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

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

Source: Haver Analytics, Deutsche Bank Research

Rolling 12-m, USD billions

Foreign holdings of Mexican government debt

Source: Haver Analytics, Deutsche Bank Research
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
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
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

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

Source: Haver Analytics, Deutsche Bank Research

Source: IMF, Deutsche Bank Research
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

Commodity prices have tended to underperform in strong dollar environments

Source: Haver Analytics, Deutsche Bank Research
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
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.
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...

...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.
Another EM debt crisis?

External debt levels are still quite moderate...

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

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

...some of the increase in issuance has been through offshore affiliates of EM companies and banks.
In Turkey, the increase in corporate dollar funding has been intermediated through local banks.

Turkish companies have substantial FX liabilities...

![FX liabilities of Turkish companies (USD bns)](chart1)

- Local funding
- External funding
- % GDP (rhs)

...and relatively little is naturally hedged

![FX debt for sample of Turkish companies, end-2013 (USD bns)](chart2)

- FX debt is lower than export earnings for only 21% of the total sampled stock of FX debt

Source: Central Bank of Turkey, Deutsche Bank Research

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...

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

Basic balance * (% GDP)

Private sector debt (% GDP)

* Current account balance minus foreign direct investment.

Source: Haver Analytics, Deutsche Bank Research

Source: Haver Analytics, BIS, Deutsche Bank Research
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.

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

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

Source: Haver Analytics, Deutsche Bank Research
EM Vulnerability Assessment confirms high risks in Ukraine, Venezuela and Argentina

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Source: Haver Analytics, Deutsche Bank Research
Our vulnerability heat map points to a reduction in risks in Central Europe, India, and Indonesia; but rising risks in Latin America.
Good macro management has never been enough: structural policies also matter and this will become increasingly apparent.

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Asia average

| EM EA average       | 0.21           | 1.14      | 0.89             | 0.34             | 0.19         | 0.45              | 0.66        | 0.77    | 0.58    |
| Lat Am 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    |

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

Source: Deutsche Bank Research

Value >= 0.15
Value >-0.15 and <0.15
Value <=-0.15

Robert Burgess | (+44) 20 7547-1930 | robert.burgess@db.com
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....

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

Source: Haver Analytics, Deutsche Bank Research

State-owned share(%)
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...

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

...has hit exports despite a much weaker rand

Source: Haver Analytics. Deutsche Bank Research

Source: Statssa, Deutsche Bank Research

Source: Haver Analytics, Deutsche Bank Research
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...

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

Source: Haver Analytics, Deutsche Bank Research

Source: Haver Analytics, Deutsche Bank
Combining our macroeconomic and structural assessments helps to identify countries that could struggle in a rising rate environment.

Overall Vulnerability Index (percentile) vs. Overall Structural Index (percentile)

- **Less vulnerable** countries are located in the upper right quadrant.
- **Better structural performance** countries are located in the lower left quadrant.

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
End
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