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Vulnerable Emerging Markets

Atradius Economic Research - October 2014

Many emerging markets were adversely affected by a change in international investor sentiment in 2013, as a result of the announced change in US monetary policy conditions. Some emerging markets are today still vulnerable to further shifts in sentiment.

Tapering: introduction

The United States Federal Reserve (the Fed) started to reduce its monthly purchase of financial assets – the so-called 'tapering' - in January this year and is expected to reduce its purchasing to zero this month. This will, however, be just the start of the reduction of the US's expansionary monetary policy, designed to return it to more normal levels. If the US economy continues to perform well, an interest hike is to be expected next year.

We have already seen a rise in the long-term yield curve on US government bonds. This implies that the US has is already becoming a more attractive destination for foreign financial investors and, in contrast, that other markets will continue to become relatively less attractive for investors.

In the summer of 2013 there was some significant 'taper turbulence' in several emerging markets. Brazil, India, Indonesia, South Africa and Turkey were coined the 'fragile five' countries and their currencies suffered significant depreciations.

Taper turbulence: the mechanism

The 'taper turbulence' is associated with an outflow of capital and drop in investor confidence, with the following consequences:

(1) Depreciating exchange rates of Emerging Market (EM) currencies;

(2) Rising yields of sovereign and private debt in EMs;

(3) Decreasing stock indices of EMs;

(4) Deterioration in the balance of payments due to capital outflows from EMs.

The payment capacity of emerging markets is, in principle, negatively affected by all of these, in the following ways:

(1) Financing costs of existing foreign currency debt will increase. Companies, households and governments with high (unhedged) foreign currency obligations will find themselves in dire straits.

(2) Companies and governments are confronted with higher interest costs on new to be issued bonds.

(3) The required return on EM equity will rise and this increases financing costs for private enterprises in EMs.

(4) The conversion and transfer of capital (due to the sell-off of financial assets by foreign investors) results in a deficit on the capital account and possibly a reduction of foreign exchange reserves: ultimately leading to a balance of payments crisis.

It is worth considering whether the currency depreciations are the cause or the result of the turbulence on financial markets that we saw in 2013. Although the trigger for the changing behaviour of international financial markets was obviously the US tapering policy, this does not explain why some emerging markets were hit badly and others proved to be resilient. Moreover, it seems unlikely that global risk appetite has decreased to an extent that investors would immediately be prepared to swap high yield EM bonds for a still low yielding US government bond.

It seems more plausible that the tapering policy has opened investors' eyes to structural weaknesses in emerging market economies and made them re-assess their asset allocation. If this is true, a solid political and macro-economic risk analysis of individual emerging markets could point to those countries that are most vulnerable to further actions by the Fed.

What countries are vulnerable for capital flight?

A first step in this analysis is to list the countries with a large quantity of foreign capital within its borders. This is, after all, the amount of capital that could potentially be withdrawn from the country in times of financial panic.

The IMF provides data on the International Investment Position (IIP) of many countries. If we take the liabilities side of the portfolio investment IIP and divide this by the foreign exchange reserves, we have a good indicator of the potential vulnerability to capital flight.

Examples of emerging markets with a high IIP/reserves ratio are: Brazil, South Africa, Mexico, Poland and Turkey.

What countries are vulnerable for a change in investor's sentiment?

As already said, the tapering policy could be the trigger for a renewed assessment of financial investment. It will then be very apparent which countries have inherent macro-economic weaknesses. We have selected two macro-economic indicators that may worry international financial investors: the external financing requirement (EFR) and the economic policy effectiveness indicator.

The external financing requirement is the sum of the current account balance, the short-term debt and the obligations on long-term debt (interest and repayments). This is the total amount denominated in foreign currency denominated that a country needs to pay within 12 months. If we divide this, again, by the foreign exchange reserves we have an indicator of the short-term vulnerability for a balance of payment crisis.

Examples of emerging markets with a ratio of >100% are Chile, Indonesia, South Africa and Turkey.

A proxy for economic policy effectiveness can be obtained by taking the five years cumulative real economic growth minus the five years cumulative inflation: in particular, when this indicator turns out to be significantly lower than earlier expected. From a financial investor's view this makes sense. Real economic growth is an important determinant of demand for almost all goods and services, while high inflation increases the chance of currency depreciations and also results in the erosion of consumer purchasing power.

Examples of emerging economies with a strongly negative economic policy effectiveness indicator are: Brazil, Hungary, India, Romania, Russia, South Africa and Turkey.

The following table shows emerging markets that are particularly vulnerable according to the three criteria mentioned above.

Vulnerable Emerging Markets			
Country	Capital flight	EFR	Policy effectiveness
Brazil	●		●
Chile	●	●	
Hong Kong	●		
Hungary	●		●
India			●
Indonesia	●		
Israel	●	n.a.	
Malaysia	●		
Mexico	●		●
Poland	●	●	
Romania			●
Russia			●
South Africa	●	●	●
South Korea	●		
Turkey	●	●	●

Source: Atradius Economic Research

Other factors that may affect financial unrest

While this may suggest that financial markets react perfectly rationally, that is not the case. Negative sentiment, for whatever reason, towards a certain country may trigger financial asset sell-offs which become self-fulfilling. In this context, political uncertainty may weigh against a country and micro-economic factors, such as a high average price/earnings ratio of the shares in the stock index, may act as catalysts for capital flight and currency depreciation.

Conclusions

The change in US monetary policy has resulted in many financial investors re-assessing their asset allocations. This also means that political and financial risks in emerging markets will be analysed more closely. If any shortcomings are revealed (not necessarily new, but previously neglected) this may result in financial assets being sold and a depreciation of the currency, which also comes with associated risks. However we should emphasize that the macro-economic fundamentals in many emerging markets are much stronger than they were in the past, significantly reducing the risk of balance of payment or financial crises.

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