# THIS MONTH'S TOPIC

## Emerging markets: navigating uncharted territories

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### The essential

- A more challenging global financial environment is putting pressure on EM risky assets with particular impact in some segments (Local Currency)
- EM Markets are still very dependent not only on global financial conditions but even on global demand.
- EM Monetary Policy is shifting towards a tighter stance further penalising domestic economic cycles
- External vulnerability has reduced in the years but the conditions are very heterogeneous among different countries
- Three cases of vulnerability: Brazil, Turkey and Argentina

Since the beginning of the year, emerging market risky assets have become more volatile. Segments like local currencies have performed poorly (YtD -6.8% as of the 21st of June), due to a strong USD that has finally emerged, along with the Federal Reserve's pursuing its monetary policy normalization process. Flexible exchange rates are acting as a shock absorber, and they should allow economies to adjust, provided that sufficient buffers are there to prevent disorderly developments. However, the level of stress expressed in the financial markets is not comparable to that of past crisis events (based on the portfolio outflows and CDS widening) and there is still some appetite for EM assets. This reflects a combination of still appealing relative returns, together with the view of improved fundamentals within the asset class, barring any further disruptive scenario in terms of trade war and unexpected/uncontrolled monetary policy actions by the main central banks. This has been partially visible as far as Asian markets are concerned.

**Indeed, current positive fundamentals and constructive macroeconomic conditions should not conceal the fact that emerging market countries are still very dependent on external demand. EM aggregate profits growth is very closely correlated with EM exports performance. Different dynamics in terms of commodity prices or the manufacturing cycle can shift the growth premium in favour of commodity or manufacturing producers, simply making a growth re-distribution.**

**However, that doesn't change the relevance that external demand overall holds for EMs. Very few countries have been able in recent years to re-engineer their economic model from an economy mainly externally driven to one driven by domestic demand with proper governance shared between monetary and fiscal authorities and a virtuous and sustainable allocation between labour income and profits. China may be the only country slowly planning and succeeding in such a transition.**

Together with external demand being threatened by the current developments in world trade, there is another potentially negative aspect to impact the domestic economic cycle: EM monetary policy stance is turning more hawkish than expected at the beginning of the year. Global financial conditions are still accommodative but are tightening marginally and some EM central banks have started to react, increasing policy rates. Monetary policy stimulus reduction will occur alongside EM economic cycle stabilization and cooling down.

## External vulnerability

Since April, USD has been appreciating versus EUR on the back of different factors:

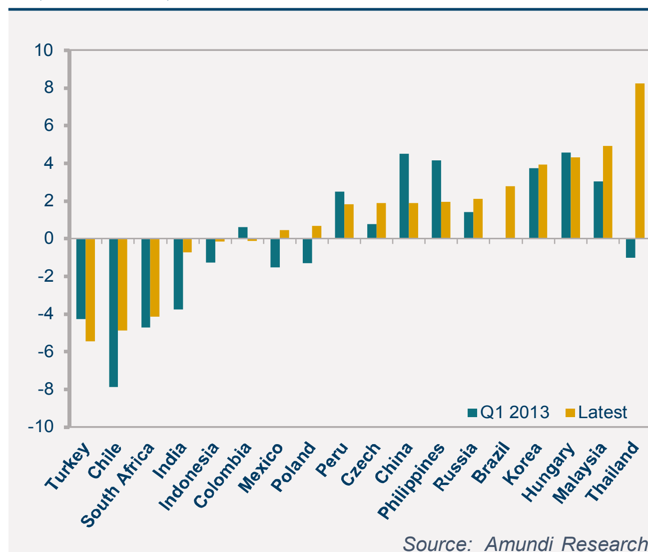
1. stronger macroeconomic momentum in the US in comparison with the euro area;
2. a divergent inflation path, with US inflation rising to the target, while euro inflation is struggling to pick up (core CPI mainly);
3. a less synchronized monetary policy, with the Federal Reserve more hawkish than ECB;
4. a greater awareness of political/geopolitical risks around the world.

Since 2013 (and the taper tantrum episode), external vulnerability has declined in emerging market countries. Basic balances have generally narrowed, with very few exceptions. The countries then called the "fragile five" (Brazil, India, Indonesia, Turkey and South Africa) have mostly adjusted their external unbalances. In that respect, only Turkey and partially South Africa are as vulnerable as they were in 2013. The current account deficits of commodity importers like Turkey and India have recently widened further on the back of higher oil prices.

The huge increase in capital inflows in recent years has helped build reserve buffers to be used during periods of strong volatility. Different measures of reserves adequacy ratios (such as import cover and reserves on short-term external debt) have been improving, with some exceptions.

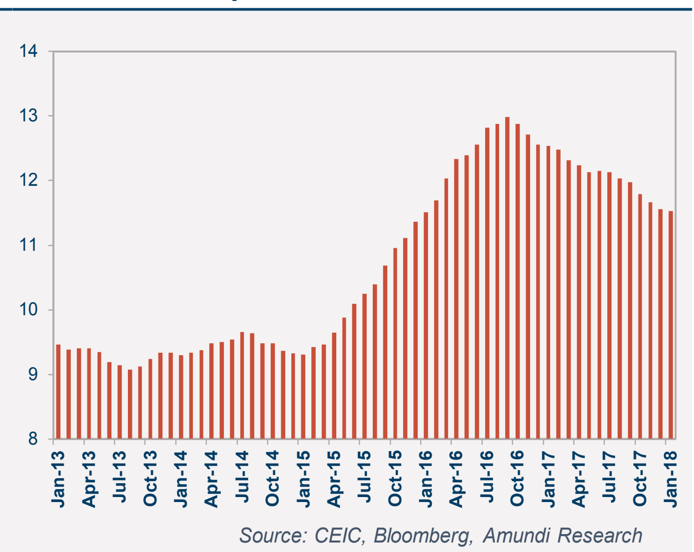
In the most recent financial turmoil, the markets at first went after the most vulnerable countries on the external side: Argentina and Turkey (see Boxes). Since Q2 2013, Turkey's current account deficit has risen from 5.8% of GDP to 6.3% in Q1 2018, with FDI stable at 0.8% of GDP, not enough to adequately fund the deficit; reserves adequacy ratios are very poor with 4M of Import Cover and a 0.7% ratio of reserves on short-term external debt. Argentina has a strong dependency on foreign flows: PTF investments came to 8% of GDP in 2017 and are now down to 6.4% (Q4 2017) while the current account deficit went from 0.9% of GDP in Q2 2013 to 4.9% in Q4 2017. Then the pressure increased in other countries exposing very great fragility, like the fiscal position in Brazil (see Box).

1/ **EM Basic Balance (CA + FDI)**




Source: Amundi Research

2/ **EM (ex-China) FX reserves: Months of Import Cover**




Source: CEIC, Bloomberg, Amundi Research

## Banks & financial vulnerability

Since the global financial crisis, banking regulation has increased worldwide, balance sheet leverage has been reduced, capital requirements have increased, and liquidity is more strictly regulated. Unlike past crisis episodes, the EM banking sector is less dependent on a common global/foreign lender and local banks are more domestically/ regionally oriented, which could lower the risk of a local event degenerating in a global crisis. On the other hand, EM banks have been increasing their relevance globally.

Dollarization risk (FX risk) has fallen somehow since the global financial crisis and even more so since the 2015 CNY depreciation but is still substantial. Good practices since then have significantly reduced lending to households and increased hedging on the corporate side, thanks to macro prudential policies dictated by central banks in some EM countries. On top of that, FX corporate lending has been targeting more and more companies with USD revenues. However, keep in mind that the actual size of FX risk is uncertain. Our perception of a reduction in risk comes from a bottom-up analysis at the level of companies and banks.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## Brazil: old habits prevailing on fiscal responsibility

**Ratings**

| Moody's | Standard & Poor's | Fitch |
|---|---|---|
| Ba2 / Stable | BB- / Stable | BB- / Stable |

First, we need to clarify that **Brazil is not at all vulnerable on the external side**, according to the various measures that we monitor. The current account deficit is quite small in comparison to the taper tantrum episode, at 0.4% out of GDP from 3.2%; external debt is still relatively very low at around 15% out of GDP and the reserves adequacy ratios are definitely sound, with import cover a little less than 30M.

Following the recent turmoil generated by a stronger USD, we do believe that **a combination of domestic factors has put Brazil on the spot among other (more externally) vulnerable emerging market economies.**

1. **Deteriorating economic conditions.** Following the economic figures released so far, covering the first part of the year, buoyant expectations in terms of GDP growth over 2018 have been significantly knocked down. Some weakness in the households sector is showing up as a consequence of decelerating real wages growth. On top of that the recent trucks strike hit economic activity further in May. Inflation is at historically low levels; the oil price spike has not been passed on to consumers, thanks to Petrobras' price freeze policy. The risk for economic conditions is on the downside.
2. Lack of progress on social security and the Eletrobras privatization bills, together with the resurgence of old habits in fixing oil prices (ending up with Petrobras CEO's resignation) are all weighing on fiscal accounts heavily, constraining any effort to put the country on a path of fiscal sustainability. The **fiscal gap is between 5%-10% and government debt is heading up towards 90% of GDP.** Talks between Petrobras and the government have been stepped up to see the expected oil auction under the transfer-of-rights contracts by 2018 in order to lift the fiscal toll in the current year.
3. After a long and significant easing cycle, BCB was expected to stay on hold for a while, thanks to a very benign inflation environment. However, the USD's recent strengthening and the perceived capitulation on the fiscal side, together with a very uncertain political environment ahead, have been hitting the BRL hard, forcing the BCB to intervene. The **latest Copom meeting showed a very pragmatic and flexible approach by BCB: neutral stance on the inflation target with an eye on the BRL depreciation's impact on inflation.**

| Economic | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (YoY %) | 4.0 | 1.9 | 3.0 | 0.5 | -3.6 | -3.5 | 1.0 | 1.7 |
| Inflation (YoY %) | 6.5 | 5.8 | 5.9 | 6.4 | 10.7 | 6.3 | 3.5 | 3.2 |
| Unemployment Rate (%) | 8.0 | 7.4 | 7.1 | 6.8 | 8.5 | 11.5 | 12.7 | 12.6 |
| Public Debt (% GDP) | 61.2 | 62.2 | 60.2 | 62.3 | 72.6 | 77.6 | 83.1 | 87.3 |
| Fiscal Balance (% GDP) | -2.5 | -2.5 | -3.0 | -5.4 | -10.3 | -9.0 | -7.8 | -8.3 |
| Private Debt (% GDP) | 65.0 | 68.1 | 72.3 | 71.5 | 76.8 | 71.5 | 68.6 | na |
| Current Account (% GDP) | -2.9 | -3.0 | -3.0 | -4.2 | -3.3 | -1.3 | -0.5 | na |
| Gross Ext. Debt (% GDP) | 11.8 | 13.3 | 12.7 | 14.4 | 18.6 | 18.2 | 15.4 | na |
| External Reserves (months of imports) | 17.8 | 19.8 | 18.2 | 19.1 | 25.2 | 31.2 | 29.3 | na |
| Central Bank Policy Rates (%) | 11.0 | 7.3 | 10.0 | 11.8 | 14.3 | 13.8 | 7.0 | 6.5 |
| BRL per USD | 1.65 | 1.87 | 2.05 | 2.36 | 2.66 | 3.96 | 3.25 | na |
| Real Effective Exchange Rate (YoY%) | -4.8 | -9.2 | -5.7 | -0.4 | -20.2 | 24.6 | -4.3 | |

*Sources: Datastream, Amundi Research updated 20/06/2018*

## Argentina: still tough times ahead

**Ratings**

| Moody's | Standard & Poor's | Fitch |
|---|---|---|
| B2 / Stable | B+ / Stable | B / Stable |

### Background

Since election of the Mauricio Macri government in 2015 and the settlement of external debt with the 'holdouts', markets were for a while positive on Argentina. However, the adjustment has been 'too gradual', resulting in large twin deficits and loss of credibility of the policies.

As a result of large fiscal deficits, inflation has been overshooting the target and begun to accelerate in the second half of 2017. With larger current account deficits, external financing needs have become larger. With both local and foreign investors getting jittery and with capital flight, the exchange rate and reserves have taken a hit. In May, the central bank had to hike to policy rate to 40% .

As a result of this difficult situation, Argentina had to ask the IMF for help and signed a letter of intent for a US$50 billion 3-year Stand-by Package, the terms of which are still unfolding. In addition, multilaterals are expected to contribute an additional US$5,7bn.

Despite the IMF package, we believe that there are serious macro, social and political challenges ahead. The economic turmoil has already had a political toll with the resignation of the Central Bank governor Federico Sturzenegger and his team, and his replacement by Luis Caputo, who headed the Ministry of Finance. There is likely to be social and political pressures against the austerity measures required to meet the various IMF criteria. The population has some bitter memories of past IMF programmes. We also expect a rough ride on the way, especially in the current global macro context.

### Macro outlook

The macro outlook is far from bright. With high policy rates, fiscal consolidation efforts and a poor agricultural output due to the drought, GDP growth is expected to fall below 1% in 2018. The currency continues to depreciate. The ARS has lost over 30% of its value against the US$ year to date. With the continued exchange rate depreciation, inflation is expected to accelerate further. Inflation is currently at 27% (versus the target of 15%). The IMF target for inflation for end 2019 is 17%.

### External accounts

As a result of growing interest payments on external debt, an increasingly negative services balance, and a trade balance now in deficit, the current account deficit has been widening. The current account deficit could reach $28bn in 2018 or 5% of GDP. With financial account capital outflows and local buying dollars, international reserves have declined to $49bn or below 8% of GDP. We estimate gross external financing needs over the next 12 months at above US$100bn, including external debt repayments, well in excess of the IMF package of US$50bn which is over 3 years.

| Economic | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (YoY %) | 6.0 | -1.0 | 2.4 | -2.5 | 2.7 | -1.8 | 2.9 | 0.8 |
| Inflation (YoY %) | 9.5 | 10.8 | 10.9 | 23.9 | na | na | 24.8 | 28.0 |
| Unemployment Rate (%) | 7.2 | 7.2 | 7.1 | 7.3 | 6.7 | 8.4 | 8.4 | 8.0 |
| Public Debt (% GDP) | 37.5 | 38.9 | 41.7 | 43.6 | 55.1 | 53.3 | 52.6 | 65.0 |
| Fiscal Balance (% GDP) | -2.7 | -3.0 | -3.3 | -4.3 | -5.8 | -6.4 | -6.5 | -5.5 |
| Private Debt (% GDP) | 18.4 | 19.2 | 19.8 | 17.2 | 18.7 | 18.2 | 19.8 | |
| Current Account (% GDP) | -1.0 | -0.4 | -2.1 | -1.6 | -2.7 | -2.7 | -4.8 | -5.0 |
| Gross Ext. Debt (% GDP) | 26.4 | 23.6 | 24.0 | 25.8 | 27.0 | 34.4 | 36.0 | 45.0 |
| External Reserves (months of imports) | 8.5 | 8.4 | 6.1 | 5.6 | 6.5 | 7.3 | 7.0 | 6.0 |
| Central Bank Policy Rate (%) | - | - | - | - | 33.0 | 24.7 | 28.7 | 40.0 |
| ARS per USD | 3.9 | 4.3 | 4.9 | 6.5 | 8.4 | 12.9 | 15.8 | 33.0 |
| Real Effective Exchange rate (YoY %) | -4.8 | 6.4 | -4.9 | -12.6 | 18.8 | -28.4 | -6.1 | |

*Sources: Datastream, Amundi Research updated 20/06/2018*

## Turkey: the authorities have no other choice but to restore credibility to their economic policies!

**Ratings**

| Moody's | Standard & Poor's | Fitch |
|---|---|---|
| Ba2 / Watch Neg | BB- / Stable | BB+ / Stable |

**Turkey** may look like an Eldorado, with almost 7.5% growth in real GDP in 2017 and in the first quarter of this year, let's not overlook the fact that it i**s walking a tightrope. The current pace of growth is unsustainable**, and we continue to forecast a considerable slowdown this year, with growth averaging 4.3%. Base effects are likely to become less meaningful, and household consumption and private investment are likely to slow. **Credit**, source of financing private demand, has risen by more than 40% since 2013. It **now accounts for almost 85% of GDP** and cannot continue to rise at such a pace. Meanwhile, to cope with a depreciating currency, the Turkish central bank has had to raise its key rate by 800bp to 17.75%, within less than two months. **This massive tightening in monetary conditions is likely to weigh on domestic demand,** especially since **it is not certain that the rate hikes will suffice to stabilise inflation in the coming months** and, hence, prevent a decline in household purchasing power. Lastly, although exports are expected to expand, imports remain high, and external trade is projected to make a negative contribution to growth.

**Officials have limited leeway to support growth.** Pressures on inflation and the lira are unlikely to vanish any time soon, which augurs in favour of keeping a tight monetary policy. Public debt is relatively low (at about 30% of GDP) but the public deficit now stands at 3% of GDP. **Further easing in fiscal policy would be ill perceived by the markets**, and therefore seems unlikely. Recent public statements by President Erdogan have made international investors even more wary as they were already concerned about the widening current account deficit (6% of GDP), declining international reserves – only enough to cover five months of imports – and foreign currency debt equivalent of 65% of GDP. Clearly, **unless the Turkish authorities manage to make their economic policies more credible, capital flight**, already at high levels, **is likely to accelerate further**.

| Economic | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (YoY %) | 11.1 | 4.8 | 8.5 | 5.2 | 6.1 | 3.2 | 7.0 | 4.4 |
| Inflation (YoY %) | 10.4 | 6.2 | 7.4 | 8.2 | 8.8 | 8.5 | 11.9 | 10.9 |
| Unemployment Rate (%) | 9.1 | 8.5 | 9.1 | 10.0 | 10.3 | 10.9 | 10.9 | 10.5 |
| Public Debt (% GDP) | 36.5 | 32.7 | 31.4 | 28.8 | 27.6 | 28.3 | 28.5 | 27.8 |
| Fiscal Balance (% GDP) | -0.7 | -1.8 | -1.5 | -1.4 | -1.3 | -2.3 | -2.3 | -2.9 |
| Private Debt (% GDP) | 61.5 | 63.0 | 72.0 | 75.0 | 80.0 | 85.0 | 85.0 | na |
| Current Account (% GDP) | -8.9 | -5.5 | -6.7 | -4.7 | -3.7 | -3.8 | -5.5 | -5.4 |
| Gross Ext. Debt (% GDP) | 36.7 | 38.8 | 41.1 | 43.1 | 46.2 | 47.0 | na | na |
| External Reserves (months of imports) | 4.4 | 4.6 | 5.3 | 5.5 | 5.9 | 6.0 | 4.7 | 4.0 |
| Central Bank Policy Rate (%) | 5.8 | 5.5 | 4.5 | 8.3 | 7.5 | 7.5 | 8.0 | 8.0 |
| TRY per USD | 1.56 | 1.90 | 1.78 | 2.15 | 2.33 | 2.91 | 3.54 | 4.24 |
| Real Effective Exchange Rate (YoY %) | -9.90 | 2.80 | -2.80 | -6.10 | 0.40 | -1.90 | -14.40 | na |

*Sources: Datastream, Amundi Research updated 20/06/2018*

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