3 Donald Trump: a new factor of uncertainty for emerging market economies

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The essential

After a number of tough years for many emerging countries, things began to take a turn for the better. But by electing Donald Trump to the White House, American voters may have altered things.

In fact, the new President of the United States, who will be sworn in on 20 January, holds views on several issues that do not augur well for the emerging countries. The countries that rely most heavily on trade with the United States, capital inflows and dollar-denominated debt are the most at risk.

After a number of tough years for many emerging countries, things have begun to take a turn for the better. But by electing Donald Trump to the White House, American voters may have altered things. In fact, the **new President of the United States**, who will be sworn in on 20 January, **holds views on several issues that do not augur well for the emerging countries**.

First, the protectionist rhetoric from Donald Trump and the measures he has announced (the repeal of a number of trade agreements, raising import duties, etc.) may in actuality hinder world trade and global growth, both of which have been less vibrant over the past few years. Although exports as a percentage of GDP are on a downward trend in the emerging countries, in many of them exports still remain relatively high, especially in those economies that are net exporters of commodities and/or small economies that are very open to the outside world. **Among the leading countries likely to suffer from the introduction of protectionist measures by the United States** is **Mexico**, where 9% of net exports are with the United States, followed by **China and Thailand** with 2.5%, **Korea** (2%) and **Malaysia** (1.5%).

Second, markets seem to have bought the idea that Donald Trump's economic policy could support at least one or two more years of US growth. An economic environment in which the US labour market is approaching full employment has resulted in rising inflation expectations, higher bond yields, greater inflows of capital and an appreciating dollar. The Fed's decision to raise its policy rate in December has only galvanised this process. This **portfolio reallocation** has been mainly **unfavourable to the emerging markets.** Although equities have been impacted to some extent, it is **primarily portfolio bond flows that have been the most affected**. According to data from a sample based on EPFR data on 14 December 2016, **Turkey, Chile, South Africa, Korea, Mexico and Russia** have suffered the most pronounced slowdowns (greater than 3% in a single month).

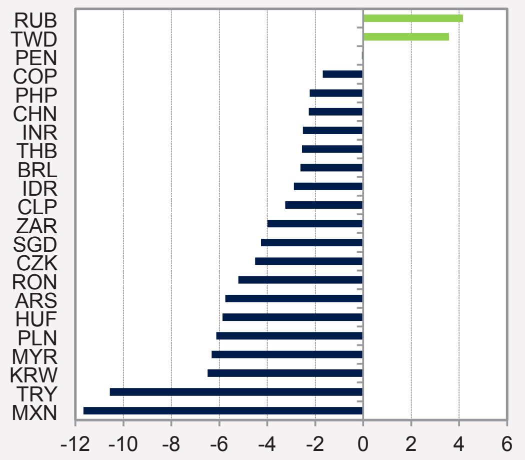
In light of **Donald Trump's rhetoric** during the campaign about **Mexico, this comes as no surprise.** In fact, if the incoming US Administration were to impose every measure mentioned (expulsion of Mexican nationals, extending the wall along the border, raising import duties, etc.), the Mexican economy would certainly be one of the most affected due to its commercial and financial integration with the United States. For **Turkey**, it is obvious that not only **(geo) political risks** but the **surprise drop in GDP of 1.8% over 12 months in Q3 – well below the consensus view (+0.3%) and significantly lower than Q2 (+3.1%) – played a determining role in these portfolio shifts. Likewise, the domestic political crisis and weak economic performance of South Africa is increasing the perception of risk by investors, who, should a new uncertainty arise, will shy away a further more from this country. In Korea, the extent of commercial ties with the United States and political procrastination are the cause of the slowdown in capital inflows. The high exposure of Chilean debt to the US dollar may be the explanation for the decrease in capital inflows (see below).**

On the other hand, the decline in bond inflows is, on the face of it, more surprising with respect to Russia. In fact, in light of Donald Trump's praise of Vladimir Putin, **Russia would appear to be other winner of the US elections.** However, because the Russian economy is expected to climb out of recession and inflation has fallen dramatically, **the markets are pricing in a sharp drop in key Russian interest rates** in the near future, giving Russian securities less appeal. Meanwhile, **note that equity-related capital inflows have increased.**

As the same time as these portfolio shifts, **emerging currencies, with the exception of the rouble and the Taiwan dollar, fell relative to the US dollar**: the Mexican peso (-12%), the Turkish lira (-11%), etc. (See Chart 1). In an

“The election of Donald Trump does not augur well for the emerging countries”

1 **FX changes vis-à-vis USD (Nov 8-Jan 2nd)**



Sources: Datastream, Amundi Research

“The US Administration's embrace of protectionism will affect global growth” environment where **USD-denominated debt as a percentage of GDP has been rising in nearly every emerging country since 2013** (See Chart 2), a sustained appreciation of the greenback is **increasing the dollar-denominated debt burden**. In the second quarter of 2016, **foreign-currency-denominated debt as a percentage of GDP was greater than 100% of GDP** in Croatia, Hungary, and **Chile** and greater than **60%** in Bulgaria, **Malaysia, Turkey, Colombia and Peru**. For the countries in Emerging Europe, the euro remains the most heavily used foreign currency in debt issues, which limits their exposure to any further appreciation of the dollar. By contrast, the Latin American countries mentioned above are indeed fully concerned as are Turkey and Malaysia.

Furthermore, note that certain countries with **foreign exchange reserves less than or equal to 1/3 of foreign-currency-denominated debt (Argentina, Mexico, Colombia, Chile, Turkey, South Africa and Indonesia) are extremely vulnerable** to further strengthening of the US dollar (See Graph 3). **Peru, the Philippines, Malaysia and Korea** are also vulnerable, but to **a lesser extent**. Foreign exchange reserves cover nearly half of foreign-currency-denominated debt.

Lastly, **Donald Trump's harsh language** directed at some emerging countries – particularly China – **is in no way reassuring. Neither is Trump's choice to head the White House National Trade Council: Peter Navarro**, the author of "Death by China: How America Lost Its Manufacturing Base" and a vigorous opponent of China and R. Lighthizer[1] as US Trade representative. Either this is **a "bluff" on the part of Donald Trump**, or a **"declaration of a trade war"**.

If the latter is the **option being considered** by Donald Trump, then it is certain that the **Chinese authorities will fight back**. By once again modifying the reference basket of currencies used to set the yuan's exchange rate in late December 2016, **the PBoC appears to be keeping abreast of the latest developments**. In fact, by reducing the weight of the US dollar and currencies pegged to the US dollar to 2.4%, China is disconnecting a bit more from its peg to the dollar and has **opened the door to further depreciations**. **In addition to its currency, which it can depreciate considerably**, China has several more "deterrent weapons". It could, for instance, **opt to massively sell its US debt holdings**.

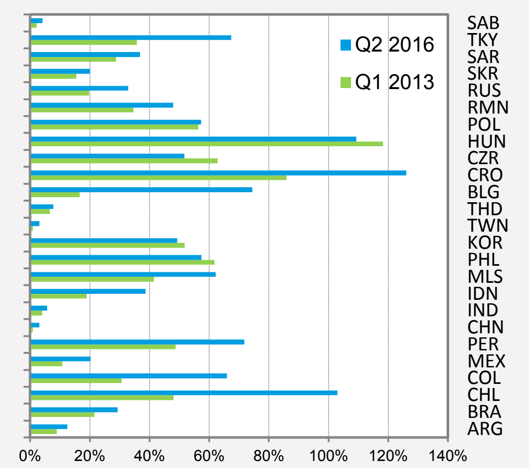
Naturally such measures are not in China's interests in an environment where fundamental changes are being made to its business model. A sweeping devaluation of its currency could sharply reduce capital inflows and would slow the yuan's process of internationalisation so hoped for by the Chinese authorities. Likewise, a liquidation sale of US debt issues could cause bond prices to plunge. **However, in the event of force majeure, the Chinese authorities will not hesitate to bring their full weight to bear.**

Under this scenario, China would not be the only loser. The global financial markets would be the first to be affected by these reprisals. In particular, **as far as the emerging countries are concerned, it is primarily the foreign exchange markets that could suddenly come unglued. Furthermore, as China represents the largest economy in the world** (in terms of real GDP) **and the No. 1 importer of commodities, most of emerging countries** which are highly integrated into the Chinese value-added chain (Asian countries), net exporters of commodities, or whose performance is tied to the yuan **will also be weakened**.

In conclusion, the arrival of Donald Trump to the highest office of the US government is not, at this stage, the best one can hope for emerging market economies, particularly those countries who were just beginning to see their prospects improve after several fairly tough years. **If Donald Trump and his administration start implementing all the protectionist and isolationist measures they have announced, then the most vulnerable countries will not get away unscathed. A trade war with China would be a worst-case scenario. The emerging markets may be the most vulnerable but the world's financial markets will not be spared.**

> "If portfolio reallocations favouring the United States and the appreciation of the US dollar intensify, they could further weaken the most vulnerable emerging market economies"

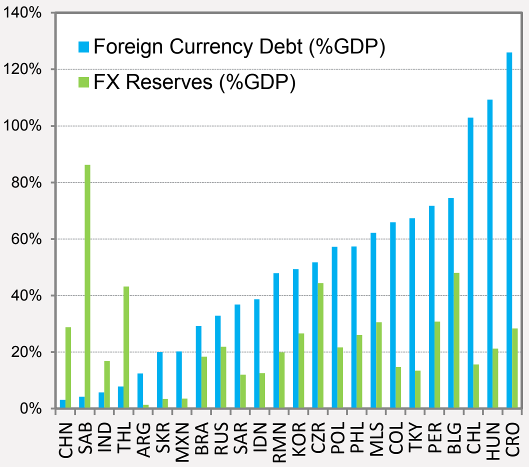
2 **Share in % GDP of FX denominated Debt Outstanding**



Sources: BIS, Amundi Research

> "For emerging market economies, the worst-case scenario would be a trade war between the United States and China"

3 **Vulnerability to USD appreciation**



Sources: BIS, Amundi Research

[1] *R. Lighthizer has already occupied this position during D. Reagan and is known to be the one who was leading of the trade war with Japan.*

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