OUTCOMES BEYOND PERFORMANCE

AHEAD OF THE CURVE

Emerging-market economies: a brighter outlook for 2019?

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KEY POINTS

- A number of headwinds – tighter financial conditions, a China slowdown and trade tensions – created a challenging backdrop for emerging markets in 2018.
- However, emerging-market stress has been confined to countries with weak fundamentals or political instability, such as Turkey and Argentina.
- Emerging-market sovereigns should therefore no longer be considered a single asset class. Instead, they should be grouped together based on different credit qualities and their ability to pay their external debt obligations.
- Today, emerging-market economies are better placed to weather negative shocks than in the past: financial systems are more resilient; better policies have been implemented; there are fewer currency pegs; and the majority of central banks are independent.
- In addition, recent cross-border lending data (levels and growth rates) from the Bank of International Settlements (BIS) suggests that financial stability risks have receded compared to 2007.
- The reliance on US dollar-denominated credit in emerging markets is still pronounced. But there are mitigating factors: emerging markets hold substantial foreign exchange reserve.
- However, bouts of financial disruption may look different in the future. For example, the shift in financial intermediation from banks to capital markets means that the corporate sector is more vulnerable to a snapback of long-term interest rates and increased volatility than before the global financial crisis.
- We maintain a cautiously constructive outlook for emerging markets. We believe that some emerging market economies may be well placed to benefit from a small number of tailwinds in 2019.

Emerging-market economies experienced a year of tumult in 2018 amid less accommodative global financial conditions, slowing economic growth in China and fraught US-China trade relations.

However, economic stress has largely been localised: developing countries with weak economic fundamentals or considerable political instability, such as Turkey or Argentina, have come under pressure. But they have left few scars on other emerging-market economies. This is unlikely to change in the near future.

CONFRONTING CHALLENGES IN THE GLOBAL ECONOMY

Growth engine splutters

Global economic growth lost momentum and became less synchronised in 2018, with a marked divergence between the US and the rest of the world. In the past, periods of growth divergence have not been sustainable, lasting between one and two years. It is therefore conceivable that a more homogenous growth picture will reassert itself in 2019.

Trade tensions escalate

Meanwhile, **trade tensions – notably, between the US and China – have been brewing and an escalation of these tensions is the biggest risk for the world economy**. In the final days of 2018, markets were encouraged by US President Donald Trump's latest claims of "big progress" in Sino-US trade relations. In a tweet on 29 December, Trump said that a negotiations between the two sides were "moving along very well". And at the time of writing, US-China trade talks were still ongoing (they are expected to come to a head by early March). Indeed, the evolution of trade tensions between both countries could be key to determining the direction of convergence. In particular, an escalation of trade tensions could trigger convergence through a US slowdown. What's more, additional US-driven trade measures have the potential to backfire, thereby offsetting the residual positive impact from fiscal stimulus in 2019.

So far, **China has suffered the most from rising protectionist tensions**. Trade tensions with the US – and its accompanying uncertainties – have put additional external strains on an already slowing economy, which has been hurt by deleveraging efforts that were implemented in late 2016 and 2017.

With trade tensions likely to persist, China's economic growth will probably continue to slow in a controlled fashion, from about 7% in recent years to about 6% in 2019. Indeed, a 25% tariff on all Chinese imports to the US (amounting to about $500bn of Chinese goods) would reduce Chinese growth by about one percentage point. And should the trade spat continue, Beijing would need to walk a fine line between providing short-term support to the economy and enabling structural adjustment (de-risking and correction of overcapacity) in a medium- to long-term perspective.

In such a scenario, our base case is that authorities would deploy fiscal and monetary measures to only partially offset the negative impact from higher US tariffs. That means our underlying assumption is that Chinese authorities will remain in control, and they will manage to strike the right policy mix, thereby allowing for a soft landing and a smooth adjustment to a more balanced growth regime. However, trade-offs may become more pronounced and **the risk of policy errors may increase**.

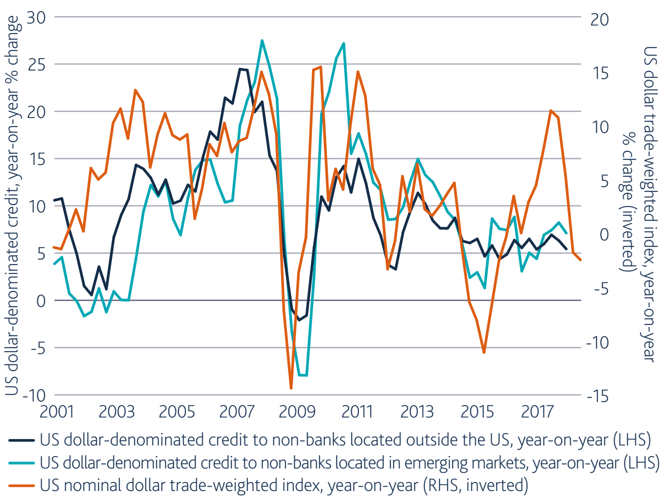
Financial conditions tighten

At the same time, **global financial conditions have become less accommodative**, reflecting a number of connected developments:

- Rates and yields have increased somewhat over the last year, as major central banks began to gradually withdraw the extraordinary monetary stimulus that was injected into the global economy in the wake of the financial crisis. This has been achieved by hiking policy rates and normalising their balance sheets. The US Federal Reserve (Fed) has led the way: it has raised its policy rates nine times since December 2015, and in October 2017, it began a gradual and passive reduction of its bloated balance sheet.
- The Fed's hiking cycle and the outperformance of the US economy have strengthened the US dollar: in 2018, the US dollar trade-weighted index gained almost 8%. That's also a source of tighter financial conditions, given the role of the US dollar as a global funding currency (see chart 1).
- In recent months, there has been a correction in global equity markets. For example, the MSCI global equity index fell by almost 8% in December, leaving the index down by about 7.5% compared to the start of 2018.
- Oil prices (Brent) have lost about 30% from their October peak – a boon for countries that import the commodity. But the average price in 2018 was still about 30% above its 2017 average.

It is therefore no surprise that 2018 was a challenging year for emerging-market economies.

Chart 1. There is a strong correlation between the US dollar and credit growth across the world



Source: Bank for International Settlements as at December 2018.

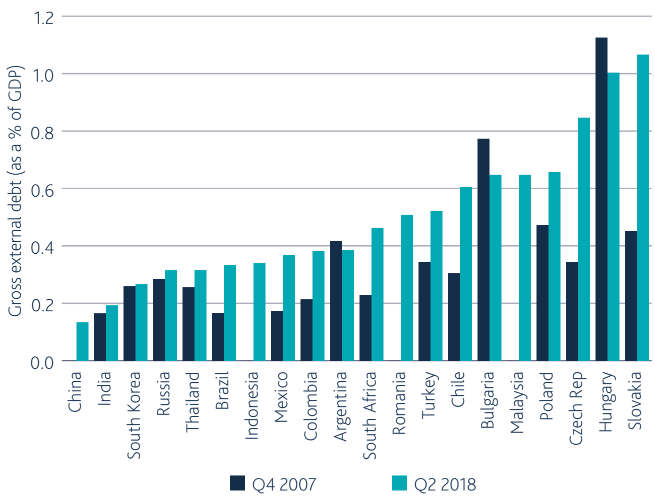
EMERGING MARKETS: DEMONSTRATING GREATER RESILIENCE

Emerging markets are generally open economies that rely heavily on external trade and financing. In addition, Asian economies usually have close ties with China.

However, as mentioned above, recent emerging-market stress has been confined to countries that have weak fundamentals as well as political instability, such as Turkey, Argentina and South Africa. This suggests that emerging-market sovereigns should no longer be considered a single asset class, instead they should be grouped together based on different credit qualities and their ability to pay based on their external debt obligations.

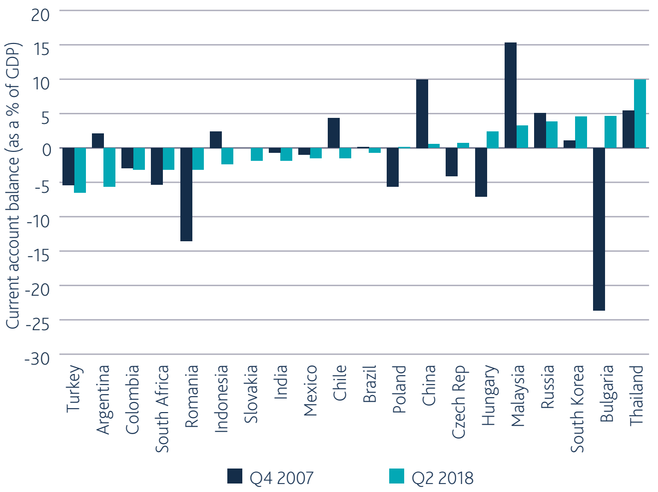
Today, emerging-market economies seem better placed to weather negative shocks than they were in the past. Indeed, they have learned lessons from previous crises: financial systems are more resilient and better policies have been implemented. For the most part, external debt ratios in emerging-market economies have stabilised since the onset of the global financial crisis (see chart 2), while current account deficits are less pronounced (see chart 3). What's more, there are fewer currency pegs, the majority of central banks are independent, and for the most part, they have already tightened their monetary policies in an orthodox fashion to shore up local currencies and curb inflationary pressures.

Chart 2. External debt ratios in emerging markets have stabilised since the onset of the global financial crisis



Source: The World Bank's Quarterly External Debt Statistics database as at December 2018.

Chart 3. Emerging-market economies' current account deficits are less pronounced today



Source: Reuters Datastream as at December 2018.

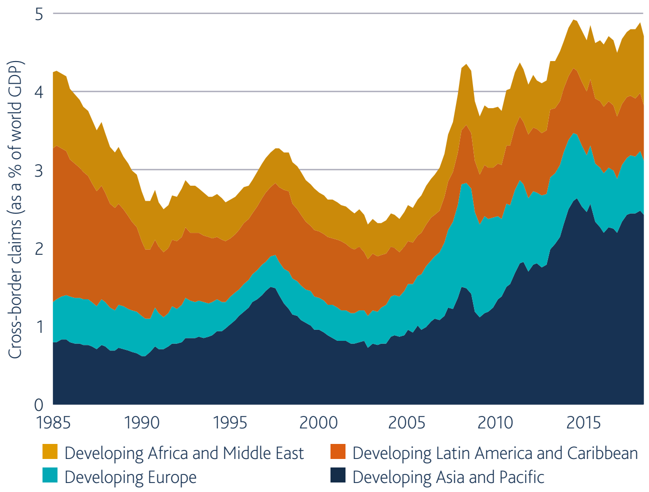
For this reason, contagion risk should remain limited going forward. But that's not to say that in a world characterised by slower growth and increased protectionist threats, weak links do not exist, they do. For example, non-commodity-exporting sovereigns that have a high exposure to short-term US dollar-denominated debt and foreign saving needs will remain vulnerable.

CROSS-BORDER BANK LENDING TO EMERGING MARKETS

The cross-border lending data[1] from the BIS provides an in-depth insight into the evolution of financial imbalances in emerging markets. As highlighted by the 2018 working paper *Gauging procyclicality and financial vulnerability in Asia through the BIS banking and financial statistics*, the build-up of financial vulnerabilities is reflected in the procyclicality and slow-moving nature of balance sheet aggregates, especially for the banking sector[2]. Indeed, it is easier to capture lending trends by focusing on the cross-border component of a bank's balance sheet. Indeed, there is typically a close link between cross-border credit and domestic credit, with the former tending to amplify moves in the latter.

The BIS cross-border bank lending data shows that lending to emerging-market economies has changed in the last four decades (see chart 4). The market has grown from less than $350bn at the end of 1980 to almost $4tn by end of 2017 (lending to advanced economies grew from $800bn to $20tn over the same time period)[3]. At the same time, there have been shifts among regions too. In the 1980s, the biggest emerging-market economy borrowers could be found in Latin America. Today, lending to emerging Asia accounts for roughly half of all bank lending to emerging-market economies[4].

Chart 4. Lending to emerging-market economies has changed markedly in the last 40 years



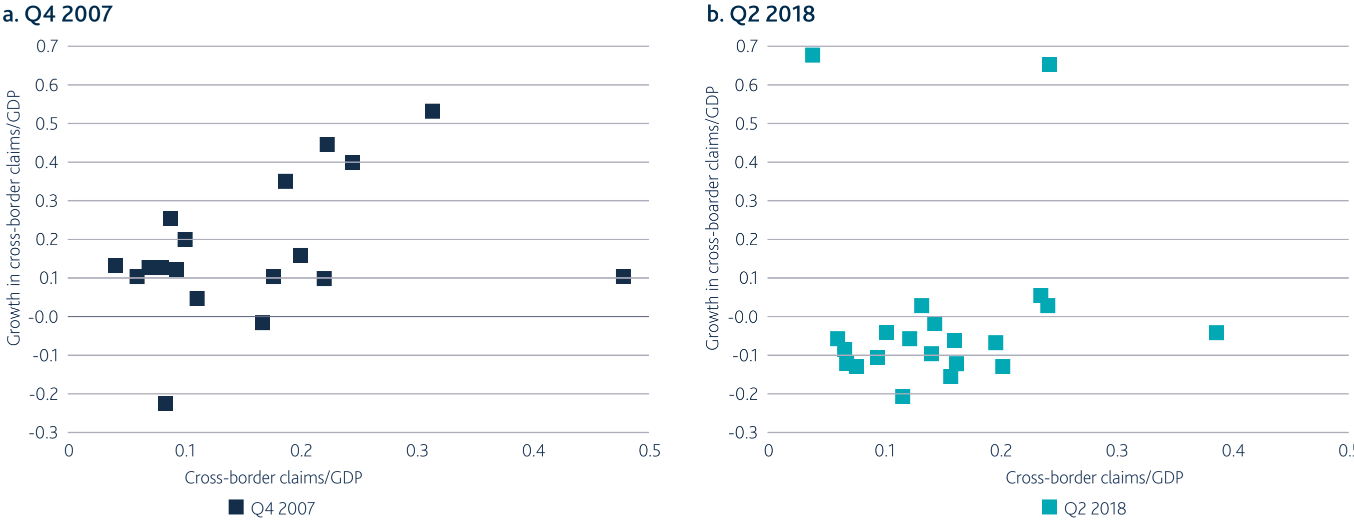
Source: Bank for International Settlements and International Monetary Fund as at December 2018.

In addition, the 12-quarter growth rate of the ratio of cross-border claims on a given country to its GDP is a useful early indicator of systemic banking crises. This information on growth rates, coupled with information on levels (cross-border claims/GDP), provides a reliable indication of whether – and where – vulnerabilities are building up in the system. **The lending picture (in terms of levels and growth rates), as depicted below in Chart 5a and 5b, shows that financial-stability risks are lower in Q2 2018 than they were in Q4 2007**.

[1] According to the Bank for International Settlements, cross-border claims are claims between residents and non-residents in the sense of the balance of payment accounts. For example, a claim booked by a bank in Japan on a counterparty residing outside Japan would be classified as a cross-border claim.

[2,3,4] "Gauging procyclicality and financial vulnerability in Asia through the BIS banking and financial statistics," published by the Bank for International Settlements in July 2018.

Chart 5. Financial stability risks have receded since the global financial crisis



Source: The Bank for International Statistics and Reuters Datastream as at December 2018.

THE ROLE OF THE US DOLLAR

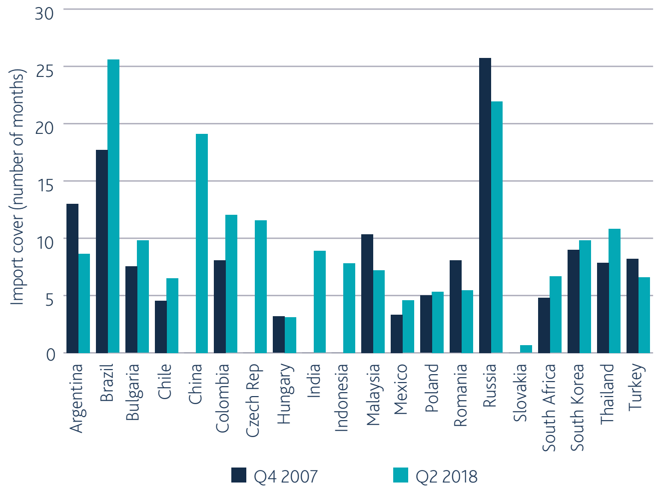
The reliance on US dollar-denominated credit is another element of vulnerability for emerging-market economies. The US dollar played a prominent role in the Asian financial crisis, as it was the main currency in which most cross-border claims of Asian countries were denominated. In the early 2000s, US dollar-denominated borrowings to emerging markets began to accelerate again, touching new highs just before the onset of the global financial crisis.

According to global liquidity data from BIS, the trend has continued in the last decade. Indeed, outstanding stock of US dollar-denominated credit to non-bank emerging-market borrowers has roughly doubled since 2008 to $3.7tn in mid-2018.

However, in the current cycle, there are **a number of factors mitigating financial stability risks from large stocks of US dollar-denominated debt**. First, US dollar-denominated debt securities, which are issued by emerging-market borrowers, have longer maturities than in the previous cycle. That means they are less vulnerable to run and rollover risks. However, they are exposed to market risk: bond prices are more sensitive to yield changes, reflecting longer durations.

Second, and more importantly, emerging markets hold substantial foreign exchange reserve. Today, the import cover of emerging market sovereigns – that is, how many months of current imports are covered by a country's foreign exchange reserves – has improved compared to the run-up to the global financial crisis (see Chart 6). In general, an import cover rate of three months or less is considered dangerous, particularly if an emerging-market economy is oil dependent. In addition, many emerging-market issuers are global firms, with revenues in foreign currency.

Chart 6. The import cover of emerging-market sovereigns has improved in the last decade



Source: Reuters Datastream as at December 2018.

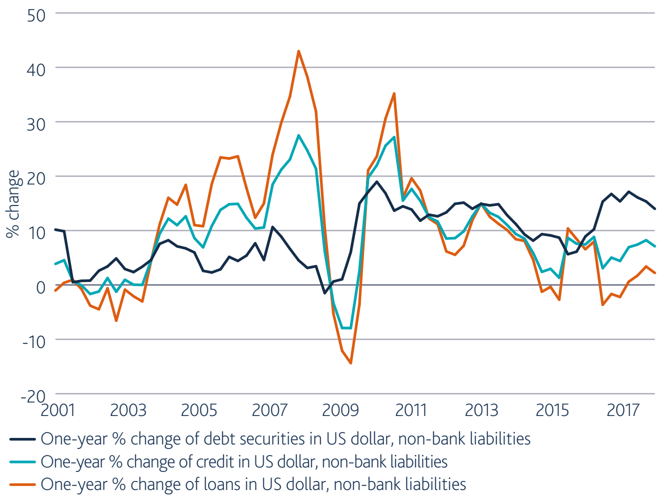
While these mitigating factors are encouraging, it is possible that future bouts of financial disruption may look different.

Credit conditions may be more vulnerable to a snapback of long-term interest rates and increased volatility than before the global financial crisis, which could spur a reversal of cross-border portfolio flows. That's because in recent years, there has been a **shift in financial intermediation from banks to capital markets** – most notably, to fixed income instruments (see chart 7). Since the global financial crisis, there has been a retrenchment in cross-border bank flows, while US dollar-denominated debt securities issued by emerging-market borrowers has expanded. In China and Brazil, a large portion of this growth can be attributed to offshore issuance – that is, outstanding US dollar-denominated bonds issued offshore (i.e. outside the country) by non-banks.

Indeed, the ramifications of such a development include:

- The corporate sector, which has done much of the borrowing, may be more vulnerable to market risk. As emerging-market borrowers have issued US dollar-denominated debt securities with longer maturities, they are more sensitive to yield changes.
- Central banks' intervention could be more challenging in a bond-dominated setting, compared to traditional bank-dominated setting. They can use foreign-exchange reserves to support commercial banks or intervene in swap or forward markets, but it would be harder to provide direct support to the corporate sector.
- Financial activity by corporates borrowing in foreign currency could spill over to the rest of the economy. In fact, a quarter of foreign currency borrowing raised by emerging-market companies through bond issuance ends up as cash on their balance sheets[5] – that is, a domestic currency bank deposit, a claim on the shadow banking system or a financial instrument issued by another firm. A reversal of US dollar-denominated borrowing would result in restrictive financial conditions across the economy.

Chart 7. Fixed income instruments have grown faster than bank loans in recent years (compared to the early-2000s)



Source: The Bank for International Statistics as at December 2018.

Is 2019 a turning point for emerging markets?

With the New Year upon us, we maintain a cautiously constructive outlook for emerging markets. We think that economic stress will probably remain contained to emerging-market countries with weak fundamentals or political instability.

On a relative basis, we believe that some emerging-market economies may be well-placed to benefit from a small number tailwinds, including:

- A dovish turn in the narrative from the Fed in 2019: the Fed's recent communications have already had a more dovish construct, which has resulted in the stabilisation of the US dollar.
- Lower oil prices: Brent crude has fallen by about 30% in US dollar terms from its October highs, providing relief for oil-importing countries.

In addition, central bank-policy response is likely to remain more proactive than in the past. And although vulnerabilities exist, emerging-market economies appear more resilient than they were in the past.

[5] "Global dollar credit and carry trade: a firm-level analysis," by V Bruno and H S Shin (BIS paper No 510) in August 2015.

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