Macro Focus

The top 6 emerging markets at risk

Group Economics
Emerging Markets & Commodities

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- **A tough year for emerging markets.** The slowdown in emerging markets (EMs) is accelerating this year, driven down by weak domestic demand, subdued external demand and falling commodity prices. Moreover, the recent market turmoil surrounding China and other EMs and the looming Fed lift-off has triggered capital outflows and a tightening of financial conditions. We have recently cut our growth forecasts for several EMs in Asia (South Korea, Taiwan, Singapore, Thailand) and Latin America (Brazil, Colombia, Chile) and expect overall EM growth to fall to around 3.5% this year (2014: 4.4%), picking up to around 4.5% in 2016.

- **Risks tilted to the downside.** However, uncertainties about the EM outlook have clearly risen, with risks tilted to the downside. Assuming a scenario in which risk sentiment versus EMs remain negative until the start of 2016, annual growth in EMs could fall by roughly 0.5 – 1 %-point in 2015 compared to our base scenario. As a result, 2016 will start on a weaker footing. In an even more adverse scenario – assuming risk sentiment versus EMs to remain similar to the situation seen in late August - we may see annual EM growth falling by more than 1%, with even larger spill-over effects into 2016.

- **EM vulnerabilities stem from China and the Fed.** We investigate which EMs are most vulnerable to two dominant risk factors: China's slowdown and the related drop in commodity prices as well as the anticipated Fed lift-off. We have distinguished three vulnerable groups (although with some overlap): 1) commodity exporters, 2) EM Asian countries with strong "China-linkages" and 3) countries with fragile external finances.

- **Commodity exporters feeling the heat.** Countries we deem most vulnerable to the fall in commodity prices are the 'usual suspects': Russia and Ukraine in emerging Europe, Brazil, Chile, Colombia, Peru, Ecuador and Venezuela in Latin America and Malaysia and Indonesia in Asia. In addition, the Gulf region and most parts of the CIS and Africa are also impacted strongly. However, for many EMs (including China, India, South Korea and CEE countries) the drop in commodity prices is a net positive.

- **Emerging Asia: Which countries are most exposed to China risks?** In emerging Asia, Hong Kong and South Korea have the strongest export linkages to China, followed by Philippines, Singapore, Malaysia and Thailand. In addition, currency depreciation versus the US dollar adds risks as repaying FX-denominated obligations will become more expensive. We believe those risks are rising, but are still contained for most of Asia except for Indonesia.

- **Which countries are most vulnerable to a Fed lift-off?** Looking at emerging markets' external vulnerability, countries such as Turkey, Brazil, Colombia, South Africa, Malaysia, and Indonesia stand out. Typically, these countries have a combination of large current account deficits, high short-term debt service burdens, significant amounts of portfolio investment liabilities and/ or external debt and only limited buffers in terms of FX reserves.

- **So, which countries are most at risk?** Taking all risk factors into consideration, we have selected six countries which we deem the most vulnerable and classify as ABN AMRO's fragile six. Countries in Latin America seem to be hard hit, according to our analysis. We are particularly worried about Brazil and Colombia. Both countries are commodity exporters, have weak external fundamentals, while Brazil is also facing political turmoil. In Asia, Indonesia and Malaysia stand out due to their dependency on commodities, trade links with China and external fragilities. Finally, we conclude our list with Turkey and South Africa. Both countries face political challenges, while having to cope with poor external fundamentals.

- **Downward rating pressures to intensify.** There is an increased likelihood that some of these countries will face rating downgrades. Moody's recently downgraded Brazil to the lowest investment grade (Baa3), while S&P (BBB-) and Fitch (BBB) have a negative outlook. S&P is also worried about Turkey, as is Moody's, while Fitch's outlook of South Africa is negative. If sentiment does not improve, these countries are likely to face outgoing capital outflows, which will put negative pressures on their currencies. In turn, this will drive up inflation and force their central banks to take action, denting their economic outlook even more, and risking that these countries fall into a vicious downward spiral.

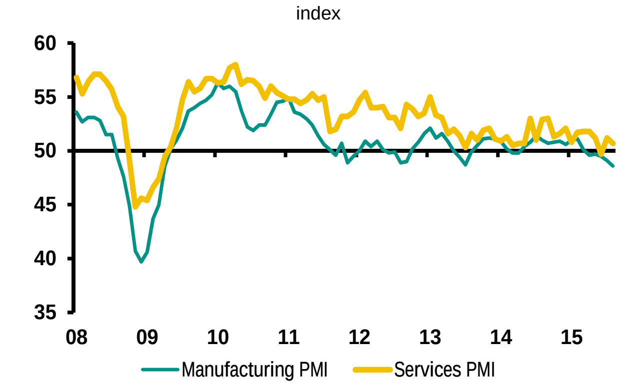
INTRODUCTION

The slowdown in emerging markets (EMs) is accelerating this year, driven down by weak domestic demand, subdued external demand and falling commodity prices. Moreover, the recent market turmoil surrounding China and other EMs and the looming Fed lift-off has triggered capital outflows and a tightening of financial conditions. In this report, we will look at which EMs are the most vulnerable to these forces.

1. A TOUGH YEAR FOR EMERGING MARKETS

Growth slowdown EMs accelerates this year
Emerging economies are still growing faster than advanced economies, but the relative momentum has turned. While the advanced economies have slowly accelerated in recent years, EM growth has continued to edge down since the post-financial crisis revival in 2010. What is more, this slowdown is worsening significantly this year. This reflects both a weakening of domestic demand as well as subdued external demand from key trade partners, including from the advanced economies and from China. EM's weighted manufacturing PMI reached a post-financial crisis low of 48.6 in August, remaining in contraction mode for the fifth consecutive month. The services PMI for EMs shows a somewhat better picture, but remains clearly below the historical average.

EM manufacturing PMI reaches post-crisis low

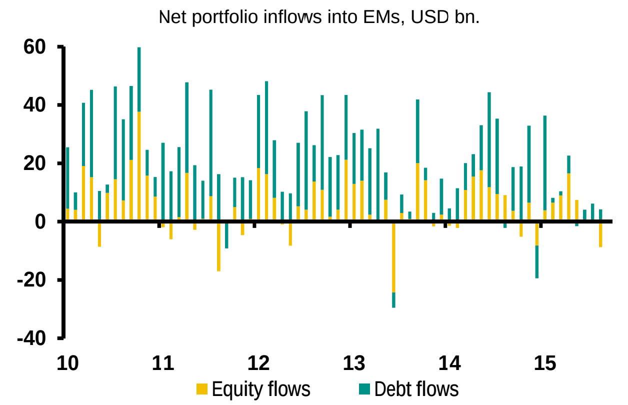


Source: Thomson Reuters Datastream

Drop in commodity prices reveals structural issues
Meanwhile, commodity exporters have been hit by the sharp drop in commodity prices, which is partly related to the drop in China's commodity imports as well as by the increased in production capacity in recent years. Brazil and Russia, for instance, are undergoing a sharp contraction this year. These two countries are illustrative for a broader EM problem, as structural weaknesses, a disappointing pace of reforms, a poor policy mix and (geo)political risks leave many EMs vulnerable in the current tide of weak global growth, low commodity prices and tighter financial conditions.

Turn in risk sentiment triggers net capital outflows …
Meanwhile, risk sentiment versus EMs has deteriorated. This reflects China-related concerns, triggered by the stock market correction and the unexpected adjustment in the CNY regime, falling commodity prices and a looming Fed rate hike. IIF data show that this caused a drop in portfolio capital inflows into EMs, turning into net capital outflows in August (driven by equity outflows, with bond flows more resilient). The total outflows measured in August so far are still below the levels seen during the "taper tantrum" in 2013 (and below the net outflows registered in late 2014). Still, on 'Black Monday' (24 August), there was a sudden jump in outflows, similar to the levels seen at the time of the 2008 Lehman default.

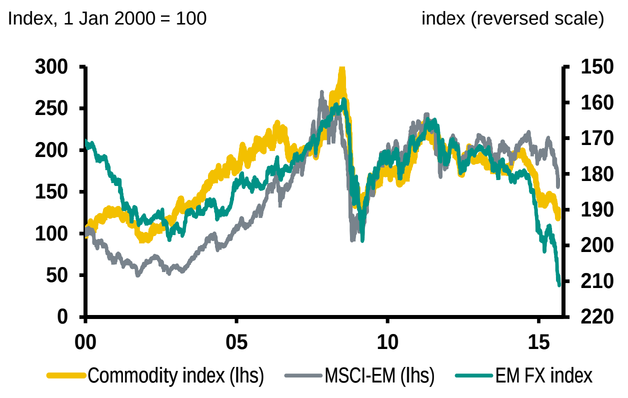
Net capital inflows EMs down, net outflows in August



Source: IIF

… putting pressure on EM currencies and stocks
The reversal in capital flows has triggered EM currency weakness and sent EM stock markets lower. The EM currency index versus the US dollar has fallen to below the previous dip reached during the global financial crisis (this also reflects USD strength). Meanwhile, the underperformance of EM stocks versus DM stocks has widened further.

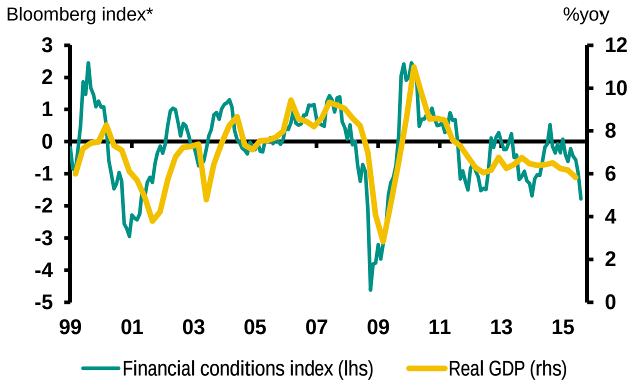
Sharp correction commodities and EM FX / stocks



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

… with tighter financial conditions another risk to growth
All this has contributed to a deterioration in financial conditions, which puts another brake on growth. We have recently cut our growth forecasts for several EMs in Asia (South Korea, Taiwan, Singapore, Thailand) and Latin America (Brazil, Colombia, Chile). In our base scenario, we now expect overall EM growth to fall from 4.4% in 2014 to around 3.5% in 2015 (whereas we still expected 4.5% back in December 2014). We expect EM growth to accelerate to around 4.5% in 2016. This scenario assumes that the deterioration in risk sentiment versus EMs and further contagion from the Fed lift-off remains manageable, while EMs will gradually profit from the growth pick-up in advanced economies.

Emerging Asia: financial conditions and real GDP

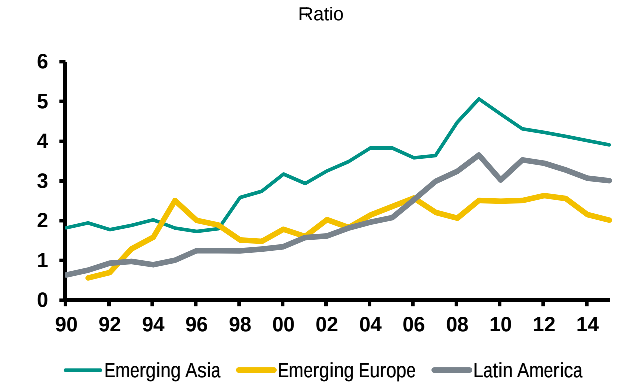


Source: Bloomberg
*negative values point to a tightening of financial conditions.

However, uncertainties about the EM outlook have clearly risen, with risks tilted to the downside. Assuming a scenario in which risk sentiment versus EMs remains negative for the remainder of this year and the start of next year, annual growth in EMs could fall by roughly 0.5 - 1 %-point this year compared to our base scenario, implying that 2016 will start on a weaker footing. In an even more adverse scenario, in which risk sentiment versus EMs would remain similar to the situation seen in late August, we may see annual EM growth falling by more than 1% compared to our base scenario in 2015, with even larger spill-over effects into 2016.

Sovereign fundamentals weaker than during taper tantrum
Weak export volume growth and lower export prices have not helped EM external fundamentals, which look weaker compared to the taper tantrum in 2013. The current account surplus for all EMs combined has fallen in recent years, mainly driven by rising current account deficits in Latin America. By contrast, emerging Asia and emerging Europe have a combined current account surplus, which has risen over the past few years. External debt ratios have risen in Latin America and emerging Europe, both in GDP and export terms, while external indebtedness in emerging Asia has been more stable. Thanks to the build-up in the aftermath of the Asia crisis in the 1990s, FX reserves' coverage of short-term external debt is still above 1 in all regions (with the highest coverage in emerging Asia), although the coverage ratios have fallen in recent years.

FX reserves / short-term external debt



Source: EIU

Meanwhile, public finances have also weakened compared to the taper tantrum, particularly in Latin America. Average budget deficits are expected to rise this year, with public debt ratios averaging over 50% of GDP in Latin America and around 30% of GDP in emerging Asia and emerging Europe.

… but better than during the Asia crisis in the late 1990s
Compared to the Asia crisis in the late 1990s, EM fundamentals still look better. This is particularly true for emerging Asia itself and to a lesser extent for emerging Europe and Latin America. Emerging Asia has a combined external surplus of around 2.5% of GDP now (1997: +1%). No Asian country has a current account deficit similar to the size Thailand had back in 1998 (-7.5% of GDP), as the majority of countries has adopted a more flexible exchange rate regime. EM Asia's external debt levels have fallen compared to 1997/98 (both in GDP and export terms), while the ratio between FX reserves and short-term external debt is now more than double the level of 1997. However, the combined budget deficit for emerging Asia is larger now (-3% of GDP) than back in 1997 (-0.3%), while the public debt ratio is at similar levels.

However, private debt build-up adds to risks
There has been a rapid accumulation of private debt in EMs since the global financial crisis, although the pace of credit growth has fallen sharply since mid-2013. This debt load is concentrated in emerging Asia and mainly driven by developments in China, although other Asian countries (South Korea, Hong Kong, Singapore, Thailand, Malaysia) have high private debt ratios too. These high debt levels will continue to be a drag on growth. The latter is also true for countries in other regions that have relatively high private debt burdens, including Brazil, Chile and Turkey.

We would like to add that overall EM and regional averages mask vulnerabilities at individual countries. We will zoom in more on the country level in the next chapters. We have distinguished three vulnerable groups (although with some overlap):

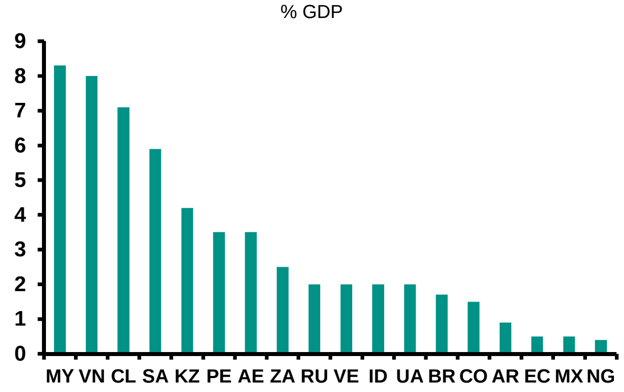
1) Commodity exporters
2) EM Asian countries with strong "China-linkages"
3) Countries with fragile external finances (deemed most vulnerable to a Fed lift-off).

2. COMMODITY EXPORTERS: FEELING THE HEAT

Sharp drop in commodity prices leaves its toll

As China plays a dominant role in the global commodity markets, we have looked at commodity exporters' export dependence on China in relation to GDP. In terms of GDP, exports to China are relatively high (6-8%) in Malaysia, Vietnam, Chile and Saudi Arabia, followed by Kazakhstan, Peru, UAE and South Africa (2-4%). For Argentina, Ecuador, Mexico and Nigeria exports to China are less than 1% of GDP.

Commodity producers' exports to China



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Still, commodity exporters are not only linked to China through direct export ties, but also by the impact of (perceived) developments in China on global commodity prices levels. All in all, the countries we deem most vulnerable to the fall in commodity prices are Russia and Ukraine in emerging Europe, Brazil, Chile, Colombia, Peru, Ecuador and Venezuela in Latin America and Malaysia and Indonesia in Asia. In addition, the Gulf region and most parts of the CIS and Africa are also impacted relatively strongly. The negative impact of lower commodity prices will be felt in public and external finances and GDP growth.

However, we would like to add that the drop in commodity prices does not only have negative effects for EMs. For example, being net oil importers, most Asian (including China, India and South Korea) and eastern European EMs (including Turkey, Poland, Czech Republic, Hungary and Romania) will profit from the drop in oil prices. The same applies for China, India and parts of Central Europe in the case of metals and for China, Mexico and parts of Africa in the case of agri-food.

3. EM ASIA: WHO IS MOST EXPOSED TO CHINA RISKS?

Lower Chinese imports affect Asian EM exports

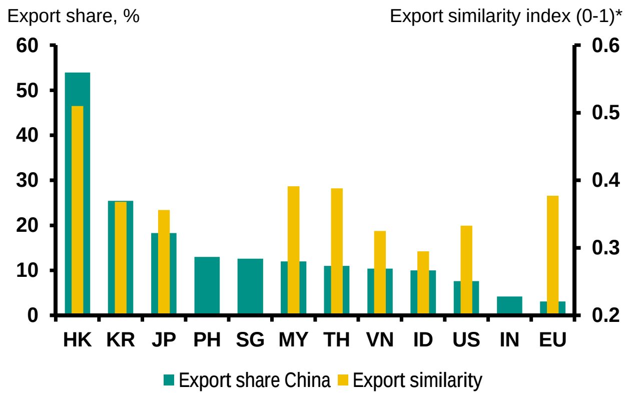
In the previous chapter, we focussed on the effect of China's slowdown on commodity exporters, but the effects go beyond commodities. Countries with a more diversified export base that export to China or that compete with China on third markets are affected as well. We have chosen to focus on emerging Asia in that regard, as these countries seem to be particularly relevant here.

China's overall imports (commodities and non-commodities) have been in contraction territory for a while now (down by 8.1% yoy in July 2015). This reflects not only lower import prices, but also weak domestic demand, in particular subdued investment. Measured in GDP terms, Hong Kong and Singapore are most exposed to a China slowdown, followed by South Korea, Malaysia, Vietnam and Thailand.

Will CNY depreciation affect third market competition?

Some fears have risen that the adjustment of China's exchange rate on August 11 would affect countries that compete with China on third markets. Most vulnerable to this effect could be countries that have a similar export structure as to that of China. Within EM Asia, the export similarity index with China is relatively high for Hong Kong. Malaysia, Thailand and South Korea follow at a certain distance (though the export composition of the latter three countries will be quite different).

Exporting to China or competing on third markets?



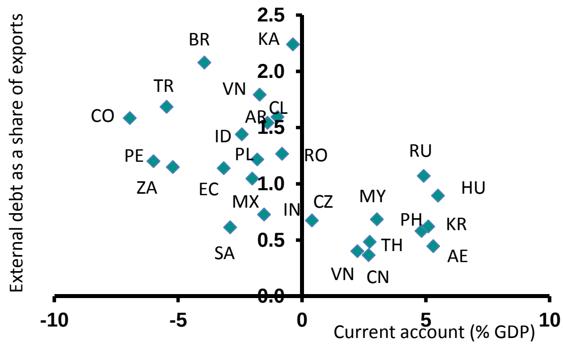
Sources: IMF, UN Comtrade, ABN AMRO Group Economics
*An ESI value of 1 corresponds to identical export structures. No ESI values available for India, Philippines and Singapore.

Still, we think this type of contagion should not be overestimated, as we do not expect a sharp CNY depreciation. In fact, the CNY has rebounded recently on PBoC interventions and has only depreciated by 2.5% versus the USD since the regime change. Moreover, most other Asian currencies have come under pressure after the regime change and have even depreciated versus the CNY since 11 August.

4. WHO IS MOST VULNERABLE TO A FED LIFT-OFF?

Another factor that could rock emerging markets in the coming months is the Fed starting its interest rate hike cycle. Granted, recent market volatility means the first rate will likely be in December rather than September, but more rate hikes will likely follow next year. This suggests that emerging markets with weak external fundamentals which have seen large capital inflows during times of very accommodative US monetary policy may soon show up as increasingly large blips on investors' radar screens. The graph below shows that countries such as Turkey, Brazil, Colombia, Peru, South Africa, Indonesia have large current account deficits and huge piles of accompanying external debt. India's current account deficit has fallen sharply since the taper tantrum, while external debt levels are quite low.

CA deficits and Ext. debt sources of vulnerability

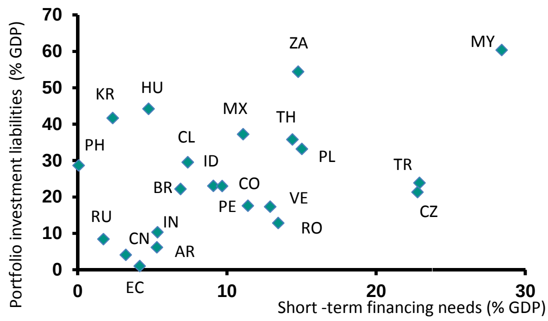


Source: EIU

The picture changes somewhat when we focus on two other key metrics. We take into consideration that countries are extra vulnerable when they have to service large amounts of short-term debt. Together with the current account balance, this gives an estimate of a country's short-term financing needs. Secondly, we look at the stock of portfolio investment liabilities. In contrast to foreign direct investment, these investments can be easily withdrawn and are thus more susceptible to sharp changes in market sentiment.

Malaysia's short-term debt exceeds 30% of GDP, as the country has large short-term financing needs, despite its modest current account surplus. In addition, it has high portfolio investment liabilities. The Czech Republic also faces significant financing needs, although the healthy growth outlook for this country will probably prevent it from ending up in the eye of the storm were investor sentiment to deteriorate sharply. On these two metrics, Brazil and Indonesia seem a bit less fragile, though Turkey and South Africa still continue to stand out as being vulnerable.

Financing needs and portfolio liabilities

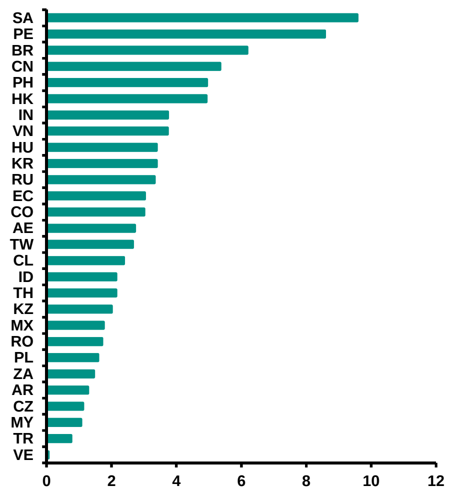


Source: EIU, IMF, ABN AMRO

Finally, we take a look to which extent countries' FX reserves will be a buffer during times of market unrest. Venezuela and Turkey both have levels of reserves that are not able to cover short-term debt. Meanwhile, Malaysia, the Czech Republic, Argentina and South Africa also score poorly, with levels of reserves being less or equal than one-and-a-halve times short-term debt. Indonesia does better with reserves covering short-term debt twice, while Chile's reserves enable it to cover its short-term debt almost two-and-a-halve times. On the upper end of the spectrum are India (almost four times short-term debt), China's (more than five times) and Brazil's (more than six times short-term debt). Finally, Saudi Arabia tops our list, with reserves that are almost ten times as large as short-term debt.

FX reserves providing some shelter?

FX reserves/ short-term debt



Source: EIU

Taking everything together, countries such as Brazil, Colombia, Turkey, Malaysia, Indonesia and South Africa stand out as having the largest external vulnerabilities. Typically, these countries have current account deficits, need to service a lot of short-term debt, have large amounts of portfolio investment liabilities and/or external debt and only limited buffers in terms of FX reserves.

5. So, which countries are the most at risk?

ABN AMRO's fragile six,…
Taking all risk factors into consideration, we have selected six countries which we deem to be the most vulnerable and classify as ABN AMRO's fragile six. Countries in Latin America are hard hit, according to our analysis. We are particularly worried about Brazil. The country will shrink by around 2% this year on the back of lower commodity prices, and a central bank that has been forced to tighten monetary policy. The country also has weak external fundamentals, while scandals related to Petrobas imply that there is a lot of political unrest which will weigh further on investment sentiment. Colombia is also at risk in our view. Its current account deficit is expected to surge to almost 7% of GDP this year, suggesting that the country is poorly positioned to deal with any market unrest if the Fed starts to tighten monetary policy. Meanwhile, lower commodity prices have left their mark on its growth outlook too.

In Asia, we are the mostly concerned about Indonesia and Malaysia. Both countries are commodity exporters that have strong trade ties with China, suggesting they are susceptible to lower commodity prices and/or the risk of a slowdown in China. Both countries also have weak external fundamentals, with Indonesia having a current account deficit and relatively high external debt, while Malaysia's short-term financing needs are high.

The final two countries in our vulnerability list are Turkey and South Africa. Turkey has a large current account deficit, political challenges with President Erdogan being forced to call snap elections in November, and geopolitical problems related to the Kurds and IS on the south of its border. Finally, South Africa has got external fragilities on top of political risk issues.

…likely to face downward rating pressure
There is an increased likelihood that some of these countries will face rating downgrades. Indeed, Moody's recently downgraded Brazil to the lowest investment grade (Baa3), while S&P (BBB-) and Fitch (BBB) have put Brazil on negative outlook. S&P is also worried about Turkey, as is Moody's, while Fitch's outlook of South Africa is negative. If sentiment does not improve, these countries are likely to face outgoing capital outflows, which will put negative pressures on their currencies. In turn, this will drive up inflation and force their central banks to take action, denting their economic outlook even more, and risking that these countries fall into a vicious downward spiral.

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