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Economic Research:

Following The Fed: ECB Tightening Could Further Stifle Capital Flows To Emerging Markets

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Key Takeaways

- We believe foreign capital flows to emerging markets are likely to remain under pressure over the next couple of years as monetary policy tightens in major advanced economies.
- "Fed risk" stems from a likely repricing of market expectations regarding the path of interest rate increases by the U.S. central bank.
- Compared with emerging-market economies in other regions, European emerging economies are more exposed to the risk of tightening by the European Central Bank, which will start normalizing monetary policy in 2019.
- Turkey remains highly vulnerable to further deterioration in external credit conditions, because the country's external financing needs remain significant, given the high level of external indebtedness among its banks and corporates.

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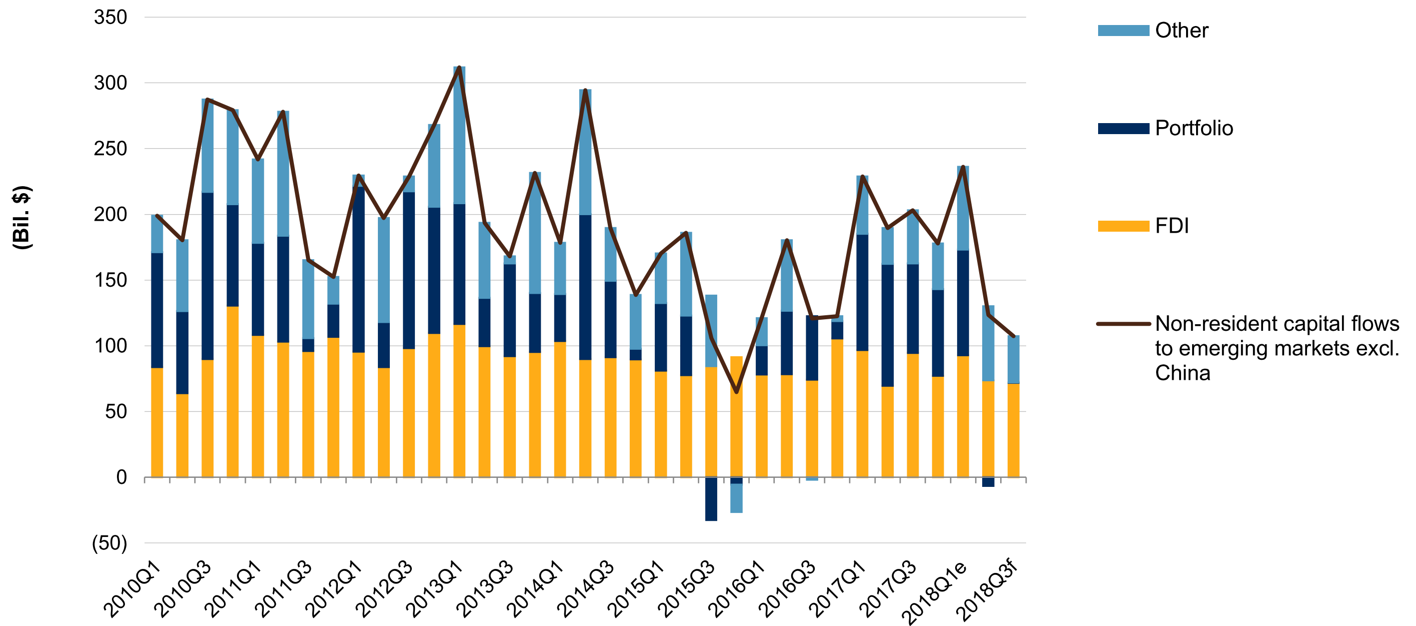
The global environment for emerging-market economies has become more challenging in recent months, with rising U.S. interest rates, a strong U.S. dollar, and global trade tensions weighing on investor sentiment. As a result, foreign capital flows to emerging markets (excluding China) slowed markedly over the second and third quarters of 2018, according to estimates by the Institute of International Finance (see chart 1). Notably, nonresident portfolio investors pulled US$25 billion out of emerging market equities (excluding China) over the period, while average quarterly debt flows dropped to below $10 billion from $65 billion in the five previous quarters. Foreign direct investment and other inflows (mostly banking) also declined from the first quarter of 2018.

Chart 1

Foreign Capital Flows To Emerging Markets Have Slowed Down Markedly This Year



Source: IIF; S&P Global Ratings. FDI--Foreign direct inflows.

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In our view, capital flows to emerging markets are likely to remain under pressure over the next couple of years as monetary policies in advanced economies tighten. Importantly, starting next year, the European Central Bank (ECB) will join the U.S. Federal Reserve on the tightening path. Other central banks in advanced European economies outside of the eurozone are also set to tighten over the next 12 months, partly following the ECB, but also responding to domestic economic conditions.

"Fed Risk" Is Still At Play

"Fed risk" to capital flows to emerging markets, stemming from the U.S. Federal Reserve's tightening of monetary policy, has long been on our radar and the radar of investors. As the U.S. central bank continues normalizing monetary policy, we believe the Fed factor will remain a driver of capital flows to emerging markets. Fed risk in coming months is likely to arise from the difference between market expectations about the pace of Fed rate hikes, and the path suggested by the rate-setting Federal Open Market Committee (FOMC) for instance in its "dot plots." If the economy evolves as the Fed anticipates, an upward market repricing of interest rates is likely, which would weigh on capital flows to emerging markets. For our part, we expect the Fed to hike one more time this year and three times in 2019, in line with the most recent FOMC's median dot plot projection.

Another development to watch is recent rise in the term premium, which is still in negative

territory, according to estimates by New York Fed economists. Solely because of the rise in term premium, 10-year bond yields rose by 19 basis points (bps) to 3.23% over the first week of October, before easing to 3.16% by mid-October. Market participants have so far expected the term premium to remain low, in part because of strong demand for long-maturity safe assets. Should these expectations change, an upward repricing of the longer end of the curve would reduce the attractiveness of emerging-market assets, resulting in a slowdown (or outright reversal) in foreign capital flows to emerging economies. Indeed, preliminary estimates by the Institute of International Finance signal net outflows out of emerging markets in the first week of October.

Monetary Normalization In Europe Is Likely To Add Pressure On Capital Flows To Emerging Economies

Highly accommodative monetary policies in other major advanced economies, led by the ECB and the Bank of Japan, have so far supported investors' appetite for higher-yielding emerging-market assets and partially offset the pressures on capital flows into these countries coming from the Fed hikes. However, the ECB will start normalizing monetary policy from next year. We expect the ECB to end additional asset purchases in December 2018, and to begin a cycle of rate hikes in third-quarter 2019. We see the ECB raising rates twice a year in 2020 and in 2021. This would increase returns on euro assets and make riskier emerging-market assets relatively less attractive.

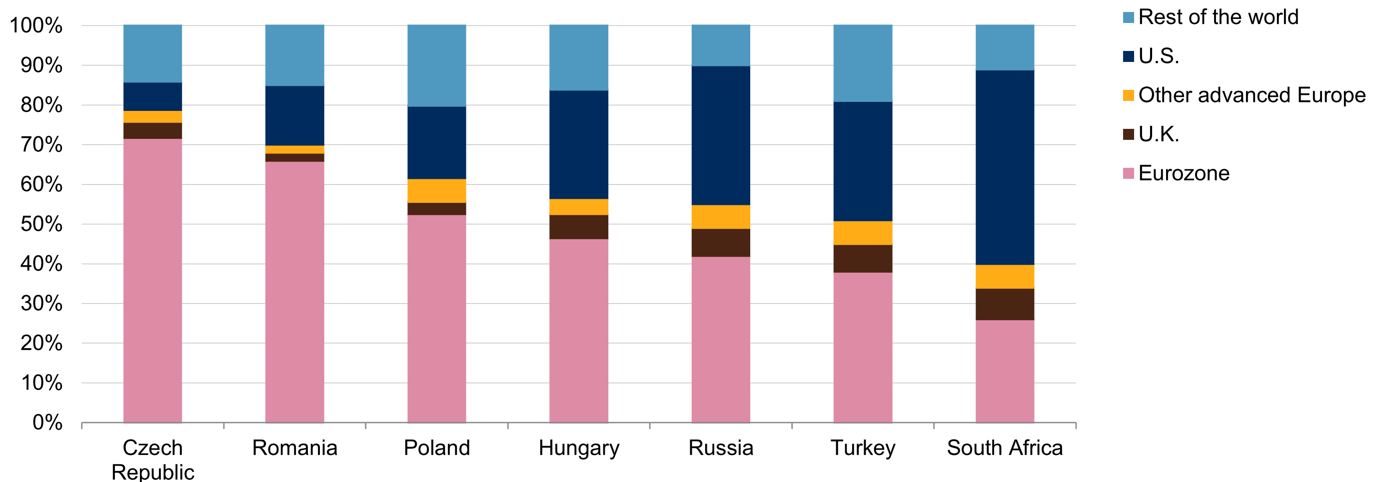
ECB rate rises would increase returns on euro assets and make riskier emerging-market assets less attractive.

Monetary policy in advanced European economies outside of the eurozone is also set to tighten over the next 12 months, in part following the ECB, but also in response to domestic economic conditions. The Norwegian central bank raised its key policy rate by 0.25 bps to 0.75% in September. In Sweden, we expect the central bank to raise rates this quarter. We believe the Swiss central bank will deliver its first rate increase at the same time as the ECB in third-quarter 2019.

Emerging European economies are more exposed to the risk of the ECB tightening, in our view, as they are more dependent on European funding than emerging-market economies in other regions. We note that eurozone investors own a significant share of outstanding portfolio investment in European emerging economies, ranging from about 40% in Turkey and Russia to more than 70% in Czech Republic (see chart 2). By contrast, only a quarter of total portfolio investment to South Africa originates in the eurozone, with half of funds coming from the U.S. Investors from advanced economies outside of the eurozone (Denmark, Norway, Sweden, and Switzerland) hold about 6% of outstanding portfolio investment in Poland, Russia, South Africa, and Turkey.

Chart 2

European Investors Hold A Significant Share Of Outstanding Portfolio Investment In EMEA Emerging Economies



Source: IMF CPIS; S&P Global Ratings. Note: Data is as of December 2017.

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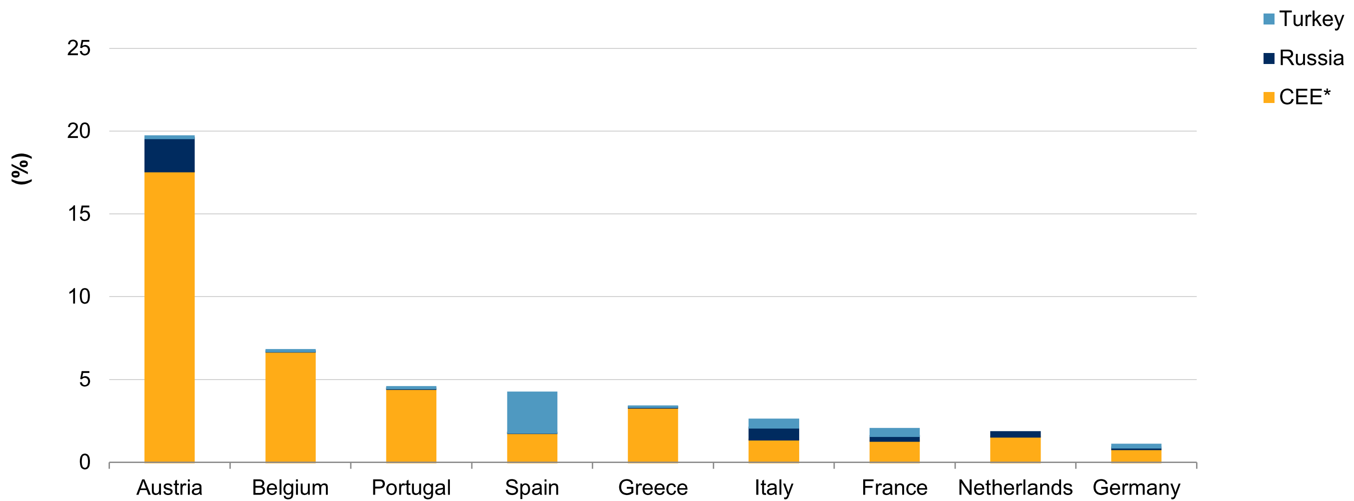
What's more, eurozone banks account for a significant share of total foreign banks' exposure to emerging Europe, at more than two-thirds in Turkey and Russia, above 80% in Poland, Hungary, and Romania, and over 90% in Czech Republic (see table 1). At the same time, eurozone banks account for only one-fifth of total foreign bank claims on South Africa. Measured as a share of GDP, foreign banks' claims on EMEA economies are much more significant in Central and Eastern Europe (CEE), varying from more than 30% of GDP in Romania and close to 100% of GDP in the Czech Republic (which saw material speculative capital inflows ahead of the removal of the exchange rate floor in April 2017). It remains to be seen to what extent rising interest rates in the eurozone, by improving banks' profitability at home, will affect their investments in emerging economies.

We note that exposure to the CEE, Russia, and Turkey accounts for a relatively small share of total eurozone bank assets, apart from Austria where it is close to 20% (see chart 3). We believe that European banks will remain active in the region to maintain business and geographic diversity, with the parent's commitment to their subsidiaries likely to remain strong.

Chart 3



Source: BIS; S&P Global Ratings. Note: Data is as of end-March 2018. *CEE--Czech Republic, Poland, Hungary, Romania.

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Zooming In On EMEA

Turkey

In our view, Turkey remains highly vulnerable to the risks of further deterioration in external financing conditions. While the forced external adjustment has pushed the current account in surplus in August, Turkey's external financing needs remain significant, given the high level of external indebtedness among its banks and corporates.

We reviewed our macroeconomic forecast for Turkey in August and now expect a "hard landing" for its economy after a prolonged period of overheating and widening macroeconomic imbalances, with output falling by 0.5% in 2019 (See: "Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable," published on Aug. 17, 2018.

Our baseline forecast of a mild recession assumes that Turkey's indebted banks and corporates will be able to roll over their existing stock of foreign debt. Should rollover rates drop below 100%, this would almost certainly result in a much more pronounced economic adjustment and output volatility than we currently project.

Russia

Russia is not particularly vulnerable to the tightening of global liquidity, due to its continuous--and widening--current account surpluses and strong external balance sheets. The unusual combination of higher oil prices and a weaker ruble has led to a strengthening of Russia's fiscal and external accounts, and a return to "twin surpluses." Consequently, Russia's economic

growth should be relatively resilient to the deterioration in external conditions, but its pace will remain modest, reflecting numerous structural constraints and restrictive macroeconomic policies. We expect GDP growth to average 1.8% this year and to slow to 1.6% next year on the back of tighter credit conditions, the VAT hike, and softer oil prices. The risk of significant tightening of international sanctions has risen, following new proposals by the U.S. Congress over the summer.

Central and Eastern Europe

CEE is likely to be well shielded from a generalized emerging market capital flight from emerging markets, especially if compared to the region's position prior to the past global financial crisis. Most CEE economies now operate current account surpluses, their net external private and public debt has been declining, with banking systems in most of CEE maintaining net external creditor positions (see "Central And Eastern Europe And CIS Sovereign Rating Trends Midyear 2018," published on July 16, 2018 on RatingsDirect). That said, the region's exposure to European funding, in light of the start of normalization of monetary policy in Europe, suggests that monetary conditions will tighten gradually.

We expect the CEE to see the peak of its strong cyclical recovery in 2018

In 2018, we expect the region to see the peak of its strong cyclical recovery, with real GDP growth rate averaging some 4% in 2018. In the future, we believe growth is likely to decelerate, albeit to still-firm levels. We see three risks to our current projection of what amounts to a comfortable landing scenario:

- First, evidence of overheating is ample in national housing and labor markets, as well as tightening capacity constraints, not least in the construction sectors. Should wage growth consistently exceed productivity gains, the consequence would be deteriorating external deficits, and a potential for balance-of-payment shocks, particularly if regional central banks are slow to respond.
- Second, implications of global trade tensions for small and very open CEE economies could be sizable, particularly via second-round effects of the slowdown in Germany.
- Third, under the current proposal for EU funding post-2020, many CEE sovereigns could face sizable cuts in cohesion funds (not least due to an open standoff with the EU authorities) eliminating programs that have generally been very supportive of their investment and economic growth.

South Africa

South Africa remains vulnerable to changes in investor sentiment due to its current account deficit financed by volatile portfolio and other investment flows. The external gap has narrowed, however, and we expect the current account deficit to average 3% of GDP in 2018-2021, from over 5% in 2012-2014. Moreover, in stark contrast to Turkey, South Africa is a net external creditor. The country's key vulnerability is related to its poor growth track record, which weighs on its fiscal position.

We have lowered our GDP growth forecast for South Africa to 0.8 % this year, reflecting the impact of a second-quarter contraction in output that threw the economy into a technical recession and weaker sentiment amid external headwinds. Key domestic risks are the potential fallout from the land reform debate, and a possible waning reform momentum in the run up to next year's elections. This could weaken foreign investor sentiment and result in the decline in capital inflows. This, in turn, may influence the country's short-term growth prospects via their impact on

currency, inflation, and bond yields. Conversely, faster implementation of key reform initiatives, including the recently announced fiscally neutral growth package would boost confidence, investment, job creation and growth.

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