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Reverse currency war puts emerging markets at risk

Financial tightening, slowing growth and rising uncertainty are creating challenges for the most vulnerable countries

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EXECUTIVE SUMMARY

- The increasingly hawkish US Fed has triggered a "reverse currency war" as central banks tighten their stance more than would otherwise be necessary if inflationary pressures were less universal. The combination of tighter global financial conditions and persistently weak risk sentiment favors a substantially stronger US dollar and thus puts increasing pressure on many emerging market (EM) countries with unsustainable external imbalances.
- Eleven larger EMs are at risk of a balance-of-payments (BoP) crisis: Argentina, Chile, Colombia, Egypt, Ghana, Kenya, Tunisia, Pakistan, Hungary, Romania and Turkey. Assuming a global EM BoP crisis would result in strong recessions in these 11 markets, the direct impact on global GDP growth could be up to -0.3pp, while we would expect on balance limited contagion to other EMs.
- Seven of these eleven EMs – Argentina, Egypt, Ghana, Kenya, Tunisia, Pakistan and Turkey – also have an elevated sovereign default risk. In contrast, Chile, Colombia, Hungary and Romania face milder problems, for different reasons, and/or they have extra backstops, e.g. the EU and ECB for Eastern Europe. As a result, we do not expect these countries to default.
- However, significant downside risks could trigger a wider EM crisis: a deeper-than-forecasted global slowdown, China failing to contain its ongoing debt crisis and the consequences spilling over to other EMs or an entrenched energy crisis that keeps financial conditions tighter for longer. According to our initial estimations, if the Fed funds rate remains above 3.5% (or equivalent to 2.5% for the ECB) for longer than a year, we expect a second set of countries to be at risk (including Mexico, South Africa and Poland).
- Even without any increase in the outstanding debt, large EM countries have more than USD75bn in maturing hard currency bonds until end-2023 that they will need to refinance. We project a contained increase for our benchmark for EM USD spreads, with risks tilted to the downside. A the shock from tighter financial conditions (excluding a financial crisis), would increase EM sovereign spreads and BBB corporate spreads by between 0.65 and 1.25 for our set of countries.

Emerging markets stuck in a "reverse currency war"

The increasingly restrictive US monetary policy stance has had an outsized tightening effect on the rest of the world, with emerging markets (EM) being most affected. Central banks in most EMs started raising rates to counter the effects of rising commodity prices long before the US Fed pivoted to a more restrictive monetary stance. However, the Fed's more aggressive rate hikes over the last three months to combat more persistent and broadening inflation have amplified pre-existing EM challenges. This month, the Fed proceeded with its third consecutive 75bps hike (to 3.25%) and raised its expectations for the coming year.

The rapid rise of US rates has also led to a considerable appreciation of the US dollar, which has not only squeezed FX-denominated borrowing in EMs but also exacerbated inflation by raising further the cost of commodities, most of which tend to be priced in US dollars. High inflation makes it virtually impossible for EM central banks to let exchange rates rebalance their external imbalances due to higher net capital outflows. Instead, they also need to raise rates to limit imported inflation at the risk of excessively tightening financing conditions. In this situation of a "reverse currency war", the combination of monetary policy divergence and persistently weak risk sentiment favors a substantially stronger US dollar and puts increasing pressure on EMs, which are left with more serious policy measures, such as intervening in FX markets (or even imposing capital controls).[1]

Limited space for supportive fiscal and monetary policy in EMDEs as global growth decelerates

Most EMs are leaning on monetary policy to tackle inflationary pressures, which are now expected to peak in early 2023, as the global energy shock has intensified over the summer. Furthermore, the trajectory after the peak will adjust more gradually than previously expected. Fiscal policy space remains limited as public finances are still stretched due to measures implemented during the Covid-19 crisis. So central banks will mostly have to do the trick. However, in some countries, a certain hiking fatigue has appeared since the direct effect of additional rate hikes on inflation appears limited in the context of the global energy shock. If the risk of social discontent is high, authorities may refrain from aggressive hiking.

There are also regional differences. The largest interest-rate increases are expected in Emerging Europe, where the most negative real policy rates prevail as inflation has surged to double digits. Latin America (where central banks have been more aggressive to date) and Africa (where interest rates were generally higher prior to the energy crisis) follow. Emerging Asia will continue to have less pressure to hike rates as inflation has mostly remained in the single digits. Monetary policy in the Middle East mostly follows the Fed, owing to prevailing currency pegs. Starting in mid-2023, EMs are expected to begin with gradual monetary easing. Countries in the Middle East and Asia will be the first in line, followed by Latin American ones. Central banks in Emerging Europe and Africa, where inflation is forecast to be more persistent than elsewhere, will lag behind.

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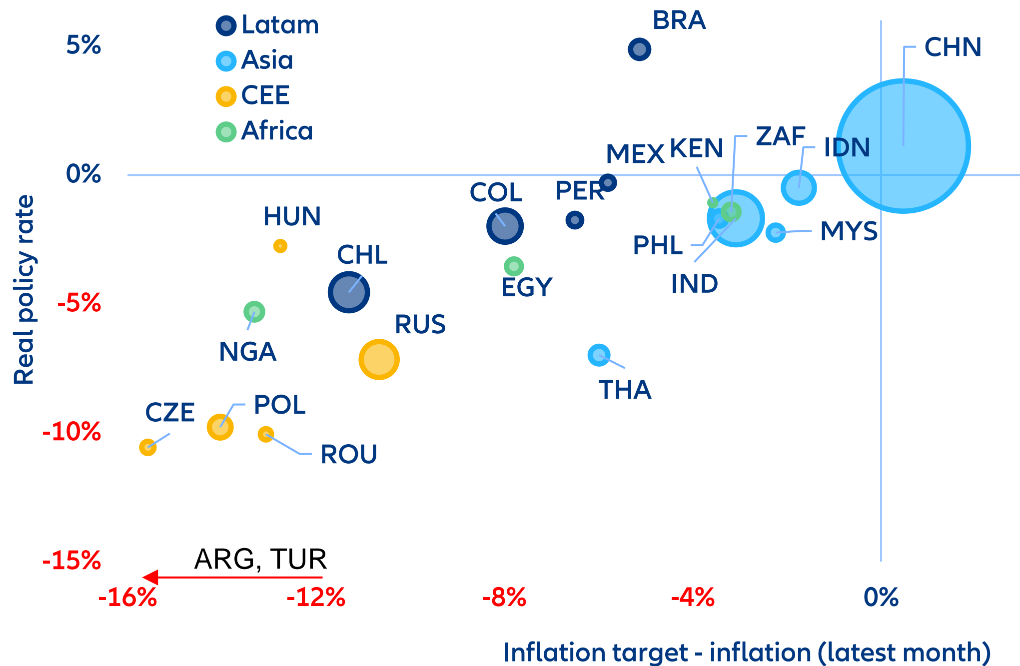
[1] However, FX interventions through selling liquid US-dollar-denominated assets (such as Treasuries) will contribute to even higher US rates and ultimately further amplify depreciation pressures.

Figure 1. Negative real interest rates across emerging markets



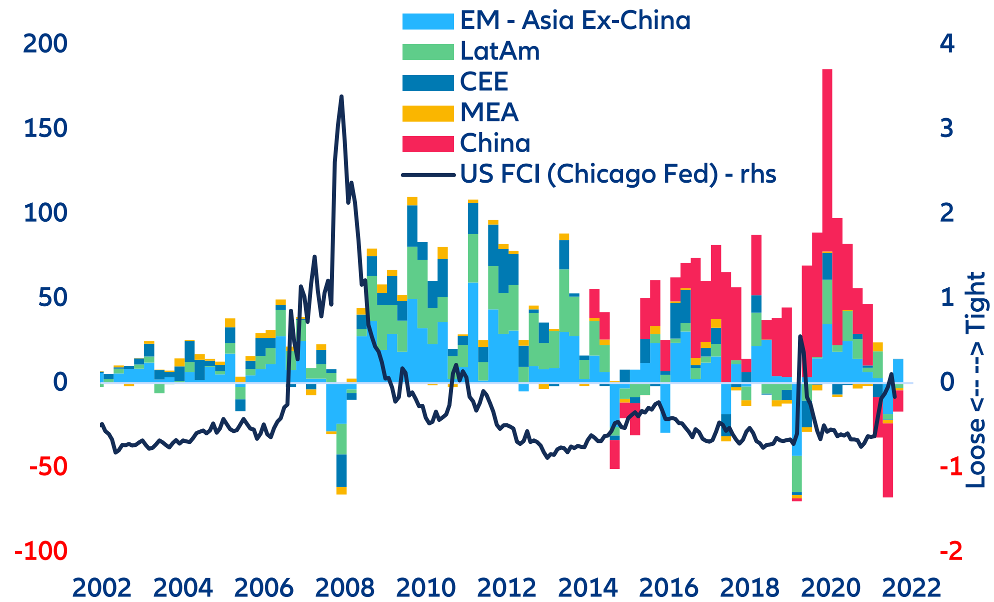
Sources: Refinitiv, Allianz Research. Many developing economies do not have an inflation target, including those with a US dollar-pegged exchange rate, such as the Gulf countries. Bubbles indicated the relative size in terms of GDP.

However, not all EMs are tightening financing conditions. There are three large countries where the effective policy rate is now lower than it was at the beginning of the year: (i) China, which has more space because of lower inflation, has eased monetary policy to diminish the effects of the debt crisis. (ii) Turkey, which since President Erdogan increased his influence on the central bank, has extended its unorthodox monetary policy despite rampant inflation and the depreciation of the Lira. Finally, (iii) Russia, where the central bank, after rapid intervention to avoid bank runs and the RUB depreciation, has shifted to an easing of the monetary policy that can support the economy once the initial goals were secured.

The war in Ukraine further prompted the flows to the USD. Especially since the start of the war in Ukraine, the turmoil in the commodities market (priced in USD), geopolitical concerns and the subsequent impact on global inflation have pushed the USD to historical highs. At the same time, this has increased the pressure on the Fed, a doubly challenging problem for EMDEs. For the time being, commodity exporters have avoided the correction, while Asian and Eastern European currencies have suffered more due to the widening interest rate differential (these countries did not have the same inflationary pressures and therefore have opted for a less aggressive interest rate policy). Eastern European currencies are also suffering because of the structural problems that the war has created in Europe (the EUR itself has lost almost 15% against the USD and remains below parity).[2]

[2] In fact, at the last UN General Assembly, several EM country representatives emphasized that the impact of US monetary policy is constraining their ability to support Western sanctions against Russia (e.g. the recent swing to net negative capital outflows).

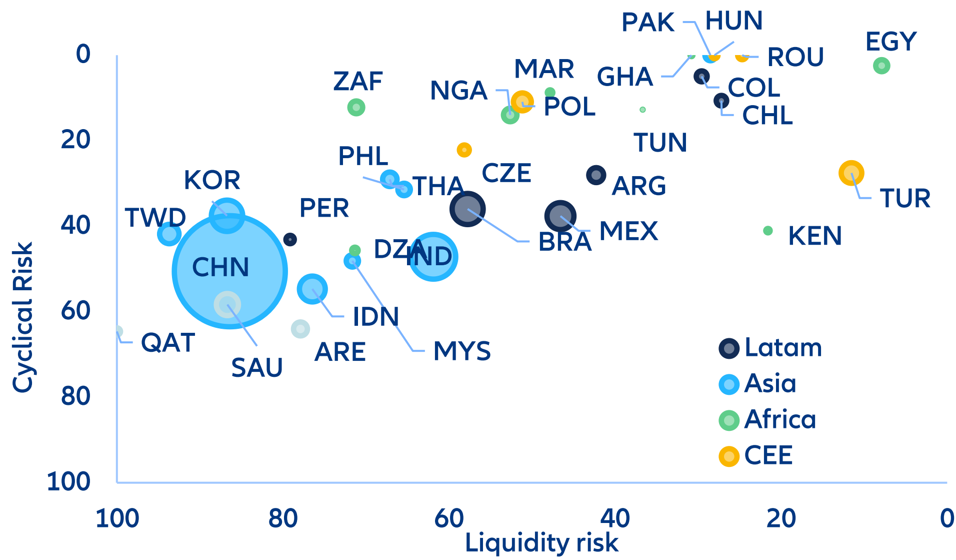
Figure 2. Portfolio flows from/into EMs (USD bn).



Sources: IIF, Refinitiv, Allianz Research. Notes: i) The subsample includes all the countries for which the IIF reports this data. ii) Monthly data aggregated by quarters. iii) Different countries report with different lags, which means that the latest regional aggregates will change.

While countries had gradually improved their external positions and built policy buffers over time, there are several (large) EMs that have become highly vulnerable to tighter financing conditions. By assessing liquidity and cyclical risks, we identify some countries in Emerging Europe (Hungary, Romania and Turkey), Africa (Egypt, Ghana, Kenya and Tunisia), Pakistan in Asia and, to a lesser extent, in Latin America (Argentina, Colombia and Chile). In these countries, the global tightening cycle could cause periods of stress in terms of severe capital outflows and potential BoP crisis, especially if the right counterbalancing measures are not taken (Figure 3). While these metrics refer to the economy of the country and not to the public sector in particular, the tensions will be transmitted to public finances, and disproportionally more in those with a higher sovereign risk. On the other side of the spectrum, we find the Asian countries – although deteriorating from three months ago. Gulf countries – which have benefited from the events (high prices, volatility, sanctions on Russia) in the energy commodities markets – are also in a better situation. Should global financial conditions remain tight(er) for longer, the risks in these countries would become acute, and they could spread to a second set of countries (including Mexico, South Africa and Poland). Our analysis shows that one year of interest rates above 3.5% in the US and 2.5% in the Eurozone would be enough to trigger such a situation.

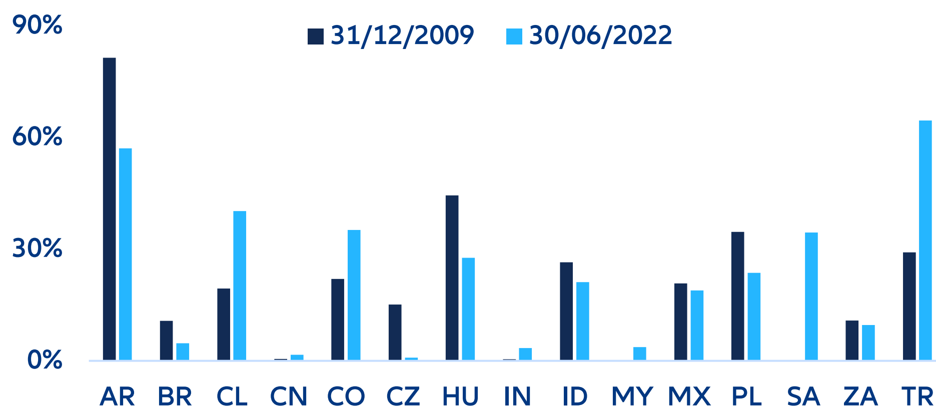
Figure 3. EM country vulnerabilities to global financial tightening



Sources: Refinitiv, Allianz Research. Bubbles indicated the relative size in terms of GDP. Larger risks correspond to values closer to 0.

However, there are some signs that EMs are more resilient today than they were during previous debt crises in the 1980s and 1990s due to floating exchange rates, a larger role (and development) of the local (currency) debt market and their early tightening of monetary policy. The strong pegs existing in the 1980s were one of the reasons that delayed gradual external rebalancing through the FX rate. During past BoP crises in EMs, central banks drained their FX reserves to defend unsustainable FX rates, widening the differential between nominal and real effective exchange rates. This eventually led to an abrupt and extreme drop in the countries' currencies, which in turn led to even higher inflation and defaults. Nowadays, even as countries intervene in FX markets, their currencies remain floating, allowing a gradual adjustment of the relative cost of imports/exports and reducing the pressures on central banks. On the other hand, the more crucial the imports are for the countries' functioning (e.g. food and oil), the more painful the adjustment is, and the more pressure it adds to policy makers to try to intervene the FX fall.

Figure 4. Share of hard currency as % of total sovereign debt, vs. the 2009s.

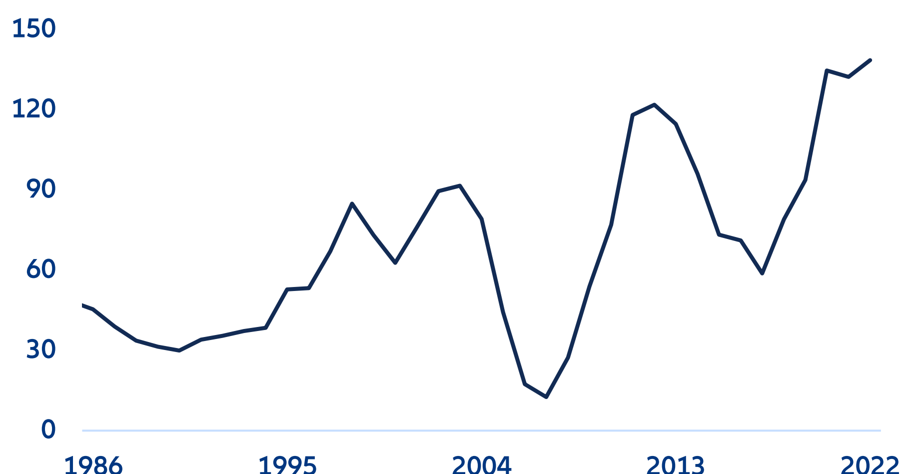


Sources: IIF, Allianz Research.

As much as the risks of BoP crises have increased, so have the risks of sovereign defaults

International financial institutions have scaled up their support to EMs. While some EM countries have sought help from China as a large external creditor, the IMF remains the preeminent crisis lender. This year, IMF lending to vulnerable countries has reached a new record of more than USD130bn worth of loans disbursed so far.

Figure 5. IMF lending in the last 40 years. Loans disbursed in USD bn.



Sources: IMF, Allianz Research. Value for 2022 only takes into account the first eight months of the year.

Short term liquidity vs. medium term solvency. Shortly after the onset of the war, the combination of soaring commodity prices and rising capital outflows claimed its first default – Sri Lanka. Though Sri Lanka's relevance in the global debt market is small, it served as the bellwether of widening EM default risk. What then was the peak of a liquidity problem for commodity importers[3] could turn into a debt sustainability problem should the situation not improve. With the exception of Argentina, Pakistan, Egypt and Turkey, which have significant default risk, we do not expect a default wave among large EMs over the next year. However, a wave of defaults among developing economies cannot be ruled out, with El Salvador, Ethiopia, Ghana, Kenya, Malawi, Mozambique and Tunisia being most at risk. Moreover, given the fragile environment that EMs will continue facing in 2023, a deterioration from our baseline expectations increases the default risk of the four large EMs mentioned above and may increase defaults of smaller EM countries, notably in Africa. Such a deterioration could be sparked by different triggers, for example by the global recession turning out worse than expected, by China failing to contain the debt crisis or by central banks in advanced economies having to maintain high rates for longer.

The fact that a 2-year US Treasuries trade at a 4%-yield has enormous repercussions for EMDEs' debt financing. For the time being, yields and spreads of existing bonds have surged in the larger EMs and skyrocketed in DEs (Figure 6 shows how the number of countries with sovereign spreads above 1,000bps is the largest in the time series). Nonetheless, given that DEs' debt is more illiquid and is only marginal in global benchmark indexes, our analysis hereinafter focuses on a subset made of the largest EMs.

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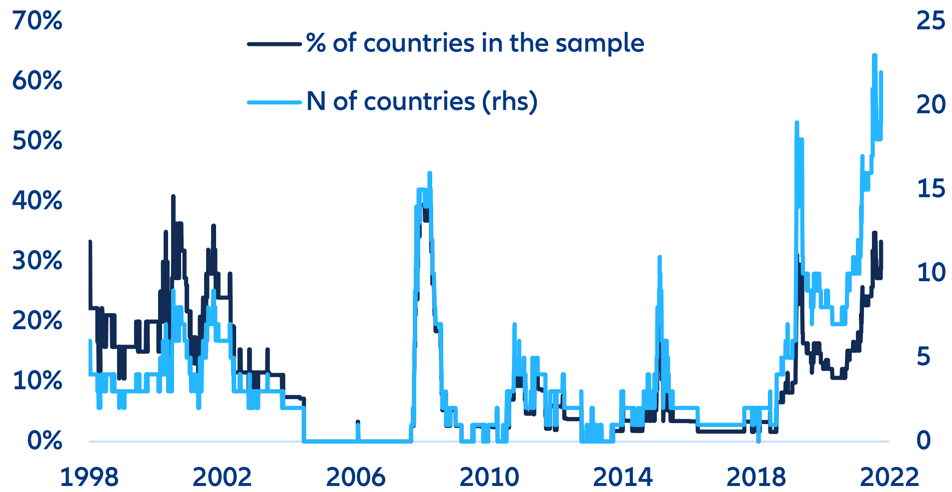
[3] Larger countries also had to ask for extra support, for example Egypt devalued the EGP and has been renegotiating financial help with the IMF.

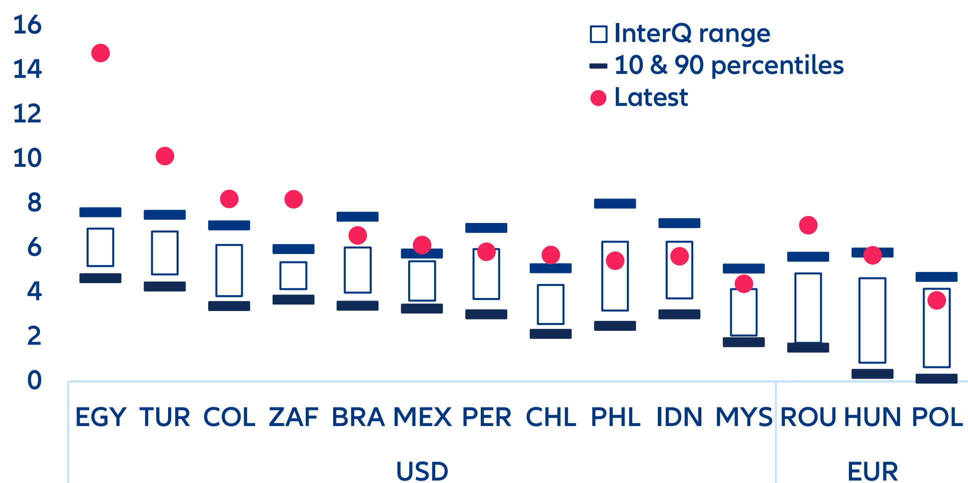
Figure 6. EMDEs USD sovereign spreads trading above 1000bps, as per JPM indexes.



Sources: Bloomberg, Allianz Research. A detailed view of sovereign spreads can be found at Annex I; important to remark that besides Argentina and Egypt no other large EM country has passed this threshold.

Although the stress may not seem as high if we focus only at index levels, the reality beneath is far from calm. The predominance of oil exporters slightly distorts hard currency indices given the developments in the energy markets, and the increasing weight of Asia – still more robust, especially the largest economies – complicates comparisons between different points in time. Nonetheless, the steep increase in yields has brought them to the highest levels since 2009, reflecting the greater risks. Leaving aside the GCC countries, where fossil fuel revenues (and the partial bans on Russian commodities) have improved the outlook, the situation has worsened significantly. The yields of hard currency bonds are already at the upper tranche of the distribution of the last 20 years (Figure 7), except for some countries in Asia.

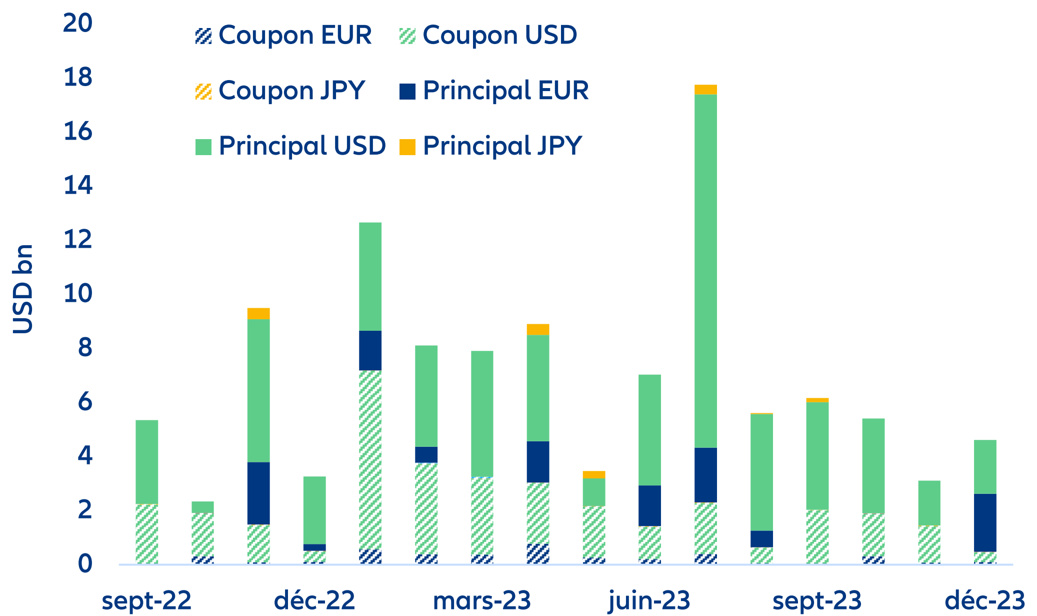
Figure 7. Current yields (%) of key EMs' sovereign bonds vs. daily distribution since 2003. Ex Middle East.



Sources: Refinitiv, Allianz Research.

Many EMs have postponed debt issuance as cost of issuing new debt is becoming prohibitive. Tapping the local market (where there is still some appetite), shortening the maturity profile or testing new markets (EUR issuances, or to a lesser extent JPY, GBP or CNY) could be solutions that would allow countries to cope with the current cycle. Countries where the yields have not increased to unsustainable levels also have larger margin of maneuver. However, the larger EMs face more than USD75bn worth of hard currency bonds maturing by end-2023 (Figure 8). Of those, an analysis of amounts maturing, payment capacity and recent stress suggests that Argentina, Turkey and Pakistan would be the weak spots in 2023, in terms of how the debt schedule fits the global financial cycle.

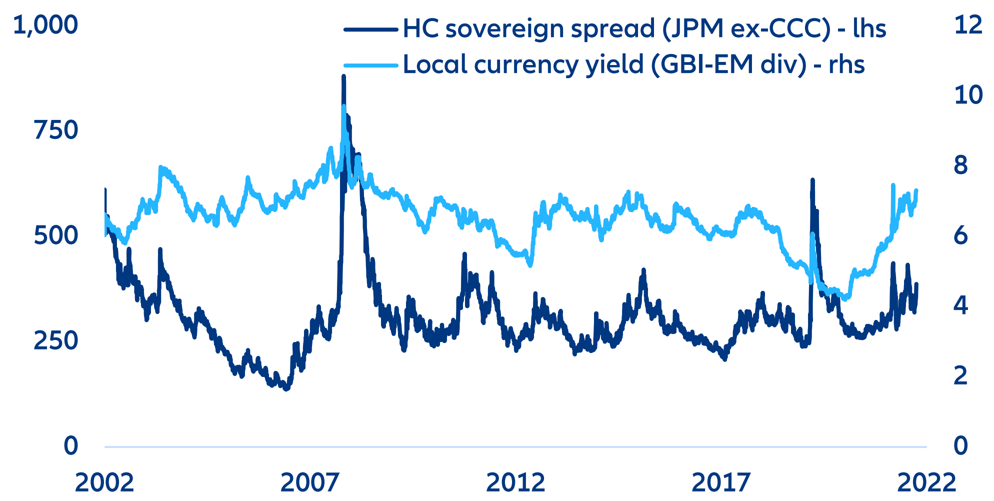
Figure 8. Redemption schedule (coupon and maturity) of foreign-currency-denominated debt for larger EMs.



Sources: Refinitiv, Allianz Research. The schedule comprises the debt of six countries in Latin America, six in Asia, five in Emerging Europe and five in Africa. It doesn't include any country with official peg to the USD/EUR.

We project a contained increase for our benchmark for EM USD spreads, although we acknowledge that the downside risks are significant. Should the shock come uniquely from tighter financial conditions (excluding extreme events such as another GFC), we find a sensitivity of changes in EM spreads and BBB corporates spreads between 0.65 and 1.25 for our set of countries. Other important shocks could come from a reduction in the oil price, as the pass-through to sovereign spreads in commodity exporters is also quite significant – a sensitivity of around -0.8 between the barrel-price (USD/bbl) increase and the widening of sovereign spreads (bps). In a downside scenario, EM spreads could temporarily reach levels above 600bps, as they did in the past.

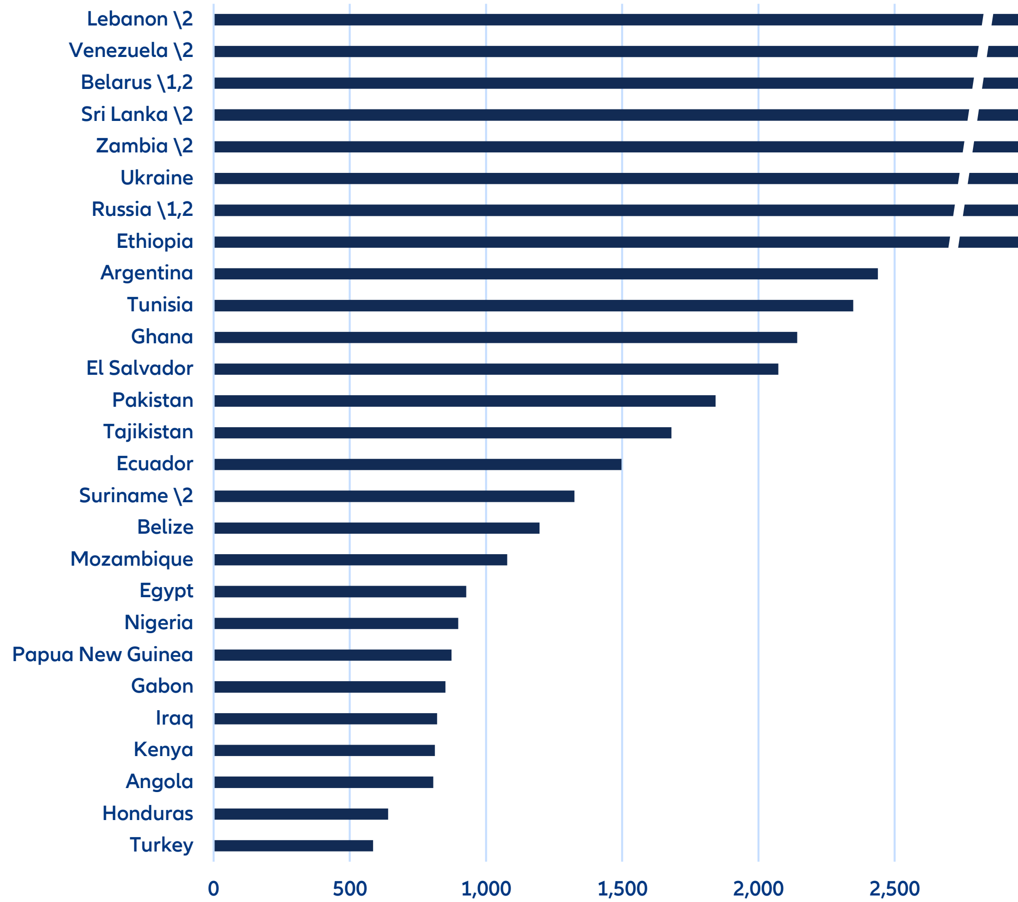
Figure 9. Evolution of key EM sovereign indexes since the 2000s



Sources: Refinitiv, Allianz Research.

Annex I. Selection of countries with largest sovereign spreads

Figure AI.1. Sub-selection of countries with the largest spreads.



Sources: Refinitiv, JPM, Allianz Research. Notes: \1 Russia and Belarus were excluded from JPM indexes, values showed are the latest reported; in any case both are already in default. \2 Countries currently in default. Ukraine was downgraded to selective default, but was then upgraded after the country reached agreement with creditors to delay debt payments.

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