Euler Hermes Economic Research

Economic Insight

Fed quake: Who will bear the BRuNTS?

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Ludovic Subran, Chief Economist
✉ ludovic.subran@eulerhermes.com

Frédéric Andrès, Economist for France
✉ frederic.andres@eulerhermes.com

Mahamoud Islam, Economist for Asia
✉ mahamoud.islam@eulerhermes.com

Daniela Ordóñez, Economist for LatAm
✉ daniela.ordonez@eulerhermes.com

Executive summary

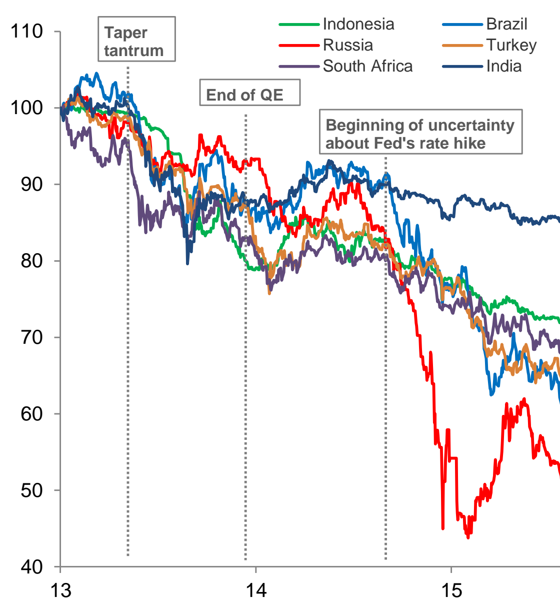
- The Federal Reserve (Fed) will raise interest rates and tighten its monetary policy by the end of 2015. Compared to previous tightening cycles, communication has been more transparent for anticipations to be better managed. This telegraphed tightening cycle will be gradual.
- Financial instability in Emerging Markets running large current account deficits will increase as a consequence of capital outflows and higher cost of financing in USD. However, Collective Crashes à la 1990s should be avoided as abundant global liquidity and foreign exchange reserves make them more resilient to external shocks.
- Selective shocks are still likely, shaving off between 0.2 and 0.5pps of GDP growth in some countries. The **BRuNTS** (Brazil, Russia, Nigeria, Turkey and South Africa) are the most vulnerable with weak underlying growth drivers and constrained policy-making. The **MIMiCC** (Mexico, Indonesia, Malaysia, Colombia and Chile) should experience a rough 6 months due to lower revenues from commodities and strong reliance on short-term capital inflows. Last, the **CIPPeT** (China, India, Poland, Philippines and Thailand) should be relatively spared.

Fed monetary policy to tighten (softly) by the end of the year, unlike 1994

It is happening. The Fed could eventually start increasing interest rates later this year. This rate hike cycle will be very gradual (25bps every quarter at most) for at least two domestic reasons. First, at +4%, nominal GDP growth remains markedly below pre-crisis levels of about +5%. Further, the core PCE (Personal Consumption Expenditures) price index is only rising at 1.3% a year. Second, at 2.1%, wage growth is still far from the 3-4% range consistent with Janet Yellen's implicit target. This range is unlikely to be achieved until 2016, despite a falling unemployment rate. One explanation is that the raw unemployment figure misrepresents the degree of slack in the labor market. For instance, under-employment, which includes marginally-attached workers, stands at 10.5%, the highest level since 1994 excluding the current cycle.

The parallel with the 1994 "Bond Massacre" is important for the US and for the rest of the world. The poster child for concerns over interest rates, 1994 will be remembered for the massive credit crunch in the US, and the many aftershocks in emerging countries - such as the deep recession

Figure 1: Selected Emerging Markets currencies (100 = Jan 2013)



Sources: IHS, Euler Hermes

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which followed in Mexico: the Tequila crisis. The sell-off was the result of large, surprising and preventive rate hikes from the Fed. From February 1994 to February 1995, the US interest rate was raised by 300bps in seven large hikes. The willingness to surprise markets was also a way to be perceived as a forceful inflation fighter. Two decades later, things are different. The Fed is more transparent and will telegraph the hike. However, beyond the US borders, the impact could still be noticeable: the "Taper Tantrum" of mid-2013 was a kind reminder of what the Fed decision can mean for countries with large current account deficits around the world. The mere announcement of the end of Quantitative Easing (QE) did cause currency depreciations by 20% in some countries (see Fig 1). The question is: are Emerging Markets ready for the Fed quake?

Will the Eurozone be left unscathed?

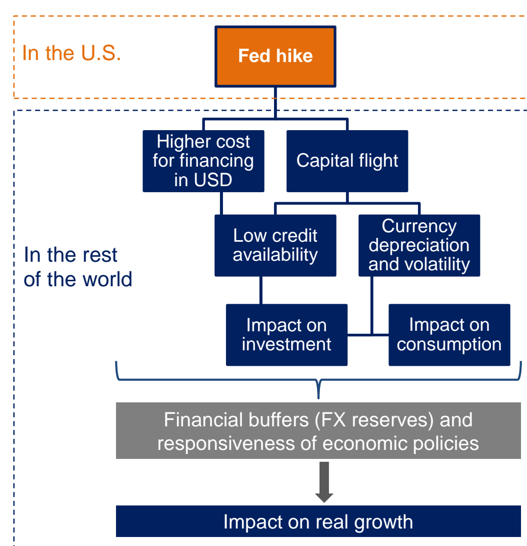
After falling markedly in 1993, bond yields in the European Union soared by 267bps in 1994, on average, following the Fed's hike. Country by country, vulnerabilities were more visible: German and French 10-year bond yields only rose by 213bps and 264bps respectively, while in Italy and Spain, they rose by 350bps and 367bps. The Italian Lira even depreciated 20% against the Deutsche Mark. Nowadays, the spillovers will be very limited. The single currency is acting as a strong shield and the European Central Bank's (ECB) own QE (until end of 2016) will help. However, the reversibility of the euro and further political brinkmanship, as epitomized in Greece, could exacerbate the impact of a Fed hike on bond yields in Europe, drain USD liquidity and reignite tensions in the countries with most fragile banking systems.

Financial instability to increase for emerging markets but no collective crash à la 1990s is expected

A rate hike by the Fed usually leads to an increase in global risk aversion and makes USD-denominated investments (above all debt instruments) relatively more attractive. Investors usually respond by reallocating their portfolios away from emerging market assets. Financing dries up or becomes too expensive, and capital flight causes currency depreciations and falling asset prices. For companies, tangible assets often act as both factors of production and collateral for a loan; the fall in value reduces borrowing power and leads to an investment crunch. A fast-depreciating currency is also conducive to balance-sheet mismatches for firms as assets are denominated in local currencies and liabilities in USD. To curb capital outflows, monetary policies respond with increased interest rates, which in turn exert downward pressures on investment, and economic growth. For a rapid analytical framework of the causal chain, see Fig 2.

In the 1990s, collective crashes were common as country weaknesses such as twin deficits and financial fault lines, were exacerbated by strong capital outflows following tightening by the Fed. Lack of economic and financial buffers and wrong policy-making caused major recessions. Fragile domestic demand, low foreign exchange reserves, high short-term external debt, the absence of fiscal space for stimulus and erratic monetary policies

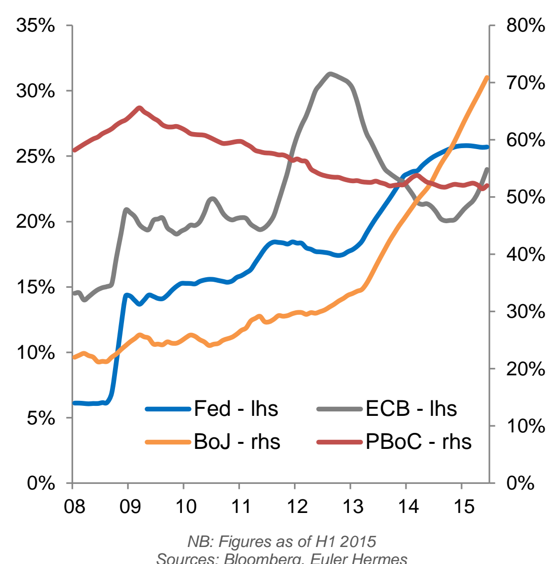
Figure 2: Fed quake channels



Source: Euler Hermes

were common. Argentina, Mexico and Thailand, and their neighbors still bear scars to this day. This time will be different: No crash but still a few bumps (recessionary episodes). Global liquidity is indeed set to remain abundant: apart from the U.S., Central Banks will remain accommodative (see Fig 3), especially the ECB, the Bank of Japan (BoJ), and the People's Bank of China (PBoC). The latter even emerged as a lender of last resort for financially-isolated countries (Ecuador, Venezuela, Argentina, Iran).

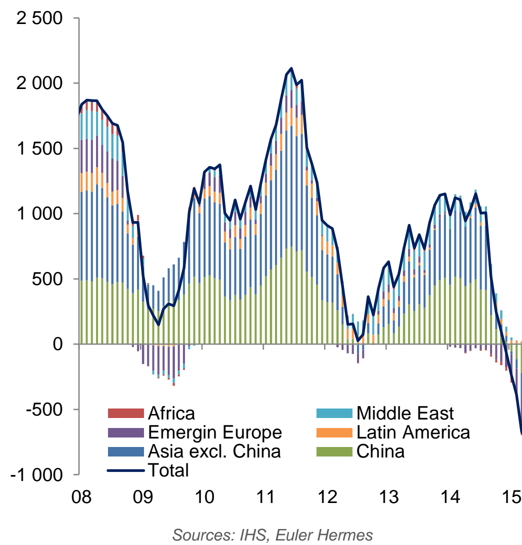
Figure 3: Central Banks' Balance sheet (% GDP)



NB: Figures as of H1 2015
Sources: Bloomberg, Euler Hermes

A further reason for avoiding a "Fed-mageddon" is the improved resilience of Emerging Markets. Financial buffers have been strengthened for most: higher import cover, better managed public finances and lower external debt. Further, policymakers, especially Central Bankers, have gained credibility moving to clearer targets. Last, the slow onset of the Fed rate hike has enabled investors to begin to move capital away from emerging markets. As a result, authorities already had to dig into their reserves to offset strong market pressures on their currencies (see Fig 4).

Figure 4: Emerging markets: annual change in FX reserves (USD bn)



Sources: IHS, Euler Hermes

Selective shocks are likely: Who will bear the brunt?

Even though collective crashes will be avoided, some countries may feel the heat: lower growth and tightening financing conditions. Total impact on GDP growth should be limited to -0.2 pps on average on our panel of 15 Emerging Markets (see Fig 5.). We identified three clusters of impacted countries, from least to most: the **CIPPeT**, the **MIMiCC** and the **BRuNTS**. Note that we excluded Argentina, Ukraine and Venezuela from the analysis since they are in significant recession, with limited buffers (especially import covers), and have already been deserted by international investors.

The CIPPeT: China, India, Poland, Philippines and Thailand. Broadly diversified, growth drivers are strong including a large consumer base (China, India, and Poland) and a solid export performance (China and Thailand). Moreover, the public sector can and will support the economy if needed. These economies have sound current and fiscal accounts. China, the Philippines and Thailand have large current account surpluses and their public finances are solid; India and Poland have stabilized their twin deficits. Inflation is below Central Bank targets and currencies have been broadly stable during recent months. In these countries, policymakers can support growth through interest rate cuts, fiscal stimulus and adopt tailored measures to ensure financial stability. GDP growth is set to remain solid with small deviation (-0.2pps over two years, at worst). As for Thailand, another period of political instability would inevitably damage investor sentiment and limit the scope for responsive policymaking.

Figure 5: Impact of Fed tightening in 2015-2016

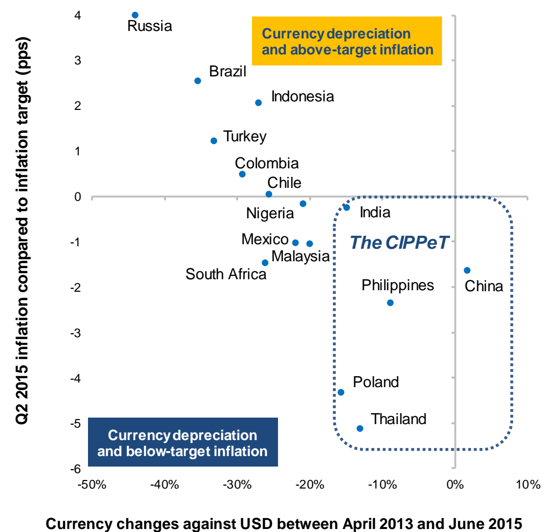
	GDP growth forecasts (2015-2016 average, %)	o.w FED cumulated impact (pps)	Financing conditions*
China	6.9	0.0	● (green)
India	7.7	-0.1	● (yellow)
Poland	3.4	0.0	● (green)
Philippines	6.0	-0.2	● (yellow)
Thailand	3.0	-0.2	● (yellow)
Malaysia	5.1	-0.4	● (orange)
Mexico	3.2	-0.4	● (orange)
Indonesia	5.0	-0.4	● (orange)
Chile	2.9	-0.3	● (orange)
Colombia	3.4	-0.4	● (orange)
Brazil	0.0	-0.3	● (red)
Russia	-3.0	-0.3	● (red)
Nigeria	5.0	-0.5	● (red)
South Africa	2.5	-0.5	● (red)
Turkey	3.5	-0.5	● (red)
Total	4.4	-0.2	● (yellow)

** Stable financing conditions*

Worsening financing conditions

Source: Euler Hermes

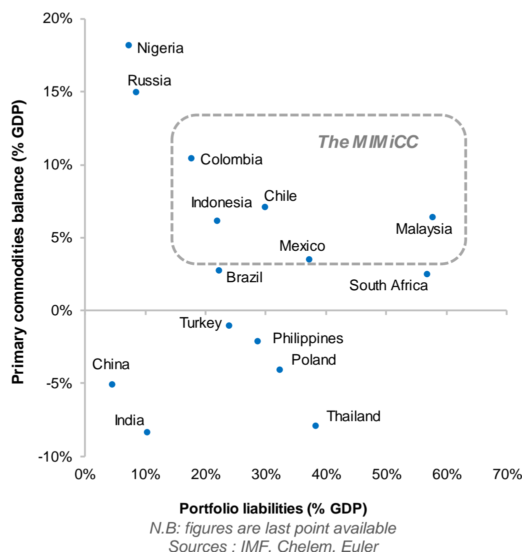
Figure 6: Monetary constraints are less significant for the CIPPeT countries



Source: IHS, Euler Hermes

The MIMiCC: Mexico, Indonesia, Malaysia, Colombia and Chile. These countries have strong domestic demand and a manufacturing base. External balances and public finances are not of significant concerns. Twin deficits are limited in Chile, Colombia and Indonesia (below 4% GDP) and fiscal deficits under control in Mexico and Malaysia. However, these countries face cyclical vulnerabilities. First, commodities represent a significant part of their economy and weak prices weigh on growth prospects. Second, short-term financing represents a significant part of capital inflows. These countries are prone to panic effects. Short-term turbulence over a period of six months following the rate hike is expected. Capital outflows and currency depreciation could be sizeable. Policymakers will have to focus on financial stability by increasing interest rates and using foreign exchange reserves (with limited efficacy and the risk of being too late). Credit availability and costs could prove challenging. However, strong domestic demand is likely to keep economic growth in check and the impact would be at worst 0.4pps over two years in countries like Malaysia and Mexico.

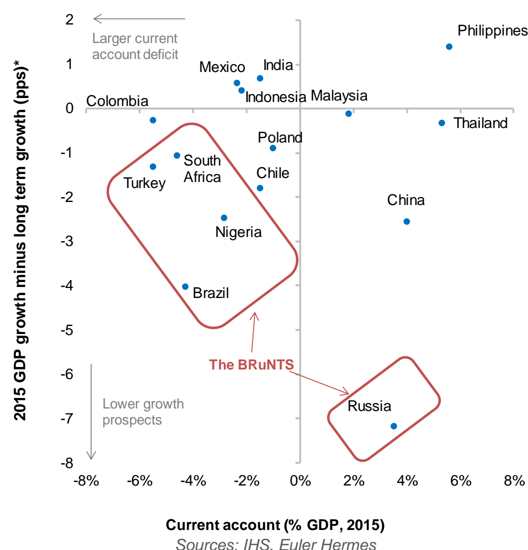
Figure 7: MIMiCC cyclical vulnerabilities - reliance on commodities & short-term capital flows



N.B: figures are last point available
Sources : IMF, Chelem, Euler

The BRuNTS: Brazil, Russia, Nigeria, Turkey and South Africa. These large economies are already facing serious difficulties in 2015. First, economic growth is disappointing. Russia and Brazil are in recession, Nigeria is experiencing a sharp slowdown and recoveries are mild in Turkey and South Africa. Fundamentals are weak, including high unemployment and low business confidence, and credit conditions are broadly tight. Policymakers' room to maneuver is limited. Relatively isolated and prone to financial shocks (currency pressures and capital outflows), Russia will probably focus on ensuring currency stability. Elsewhere, the BRuNTS run twin deficits and public stimulus is not on the table. Monetary policy is constrained by significant inflationary pressures and large past depreciations. A Fed hike would thus lead to strong capital outflows and further currency depreciations. Central Banks will probably be reacting strongly and tighten further. The impact is estimated at -0.5pps over 2015-16 in South Africa for instance.

Figure 8: BRuNTS to face serious threats



Sources: IHS, Euler Hermes

The Fed quake risk heat map

		General gov. Balance (% GDP, 2015)	Current account (% GDP, 2015)	2015 GDP growth minus long term growth*	Portfolio liabilities (% GDP)**	Primary commodities balance (% GDP)**	Currency change vs USD (June2015/ April2013)	Q2 2015 inflation compared to inflation target (pps)	External Debt (% of GDP)	Import cover (months)
The CIPPeT	China	-2.6%	4%	-2.6	4%	-5%	2%	-1.6	9%	19.5
	India	-7.0%	-1%	0.7	10%	-8%	-15%	-0.2	23%	7.1
	Poland	-2.9%	-1%	-0.9	32%	-4%	-16%	-4.3	71%	5.1
	Philippines	-0.9%	6%	1.1	29%	-2%	-9%	-2.3	27%	10.7
	Thailand	-1.9%	5%	-0.8	38%	-8%	-13%	-5.1	38%	8.4
The MIMiCC	Malaysia	-3.5%	2%	-0.1	58%	6%	-20%	-1.0	68%	6.3
	Mexico	-4.1%	-2%	0.4	37%	3%	-22%	-1.0	35%	4.9
	Indonesia	-2.3%	-2%	0.3	22%	6%	-27%	2.1	33%	7.2
	Chile	-2.3%	-2%	-1.8	30%	7%	-26%	0.1	38%	5.8
	Colombia	-3.0%	-6%	-0.3	18%	10%	-29%	0.5	24%	6.8
The BRuNTS	Brazil	-5.0%	-4%	-4.0	22%	3%	-35%	2.6	21%	14.5
	Russia	-3.0%	4%	-7.2	8%	15%	-44%	4.0	43%	9.8
	Nigeria	-2.8%	-3%	-2.5	7%	18%	-21%	-0.2	3%	10.3
	South Africa	-3.3%	-5%	-1.1	57%	2%	-26%	-1.5	38%	4.6
	Turkey	-2.0%	-6%	-1.3	24%	-1%	-33%	1.2	59%	4.7

**Long term growth refers to 20-year average*
*** last point available in IFS-IMF database*
Sources: IHS, Euler Hermes

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Contact Euler Hermes Economic Research Team
✉ research@eulerhermes.com

Publication Director
Ludovic Subran, Chief Economist
✉ ludovic.subran@eulerhermes.com