QNB Economics
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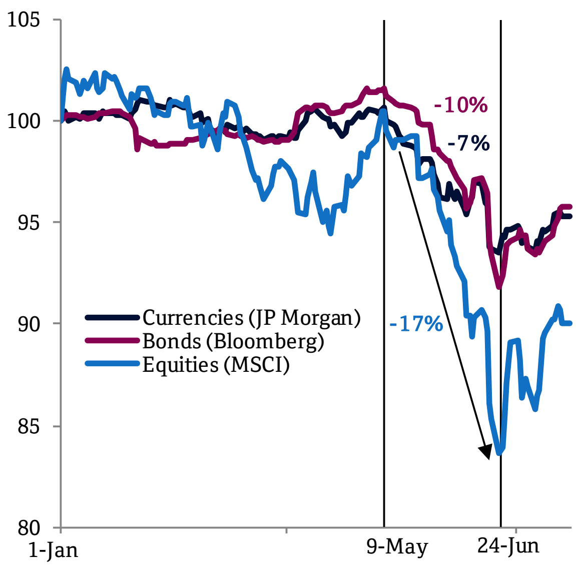
Emerging Markets Enter a Difficult Period of Weaker Growth, Capital Flight, and Tighter Monetary Policy, According to QNB Group

Many emerging markets (EMs) are entering a difficult period of weaker economic growth, capital flight and tighter monetary policy, according to QNB Group. This new period has been marked by the sharp downturns seen in most emerging market asset classes—currencies, equities and bonds—since May 2013. QNB Group expects this trend to continue in the coming months until EM economies improve in early 2014.

In the years following the global financial crisis of 2008, emerging markets performed relatively well in comparison to advanced economies. During the period 2009-11, their economies maintained relatively high growth rates and their currencies appreciated in real terms. EM stock market indexes outperformed other indexes around the world and their bond prices rose considerably since the returns they offered were attractive to investors "hunting for yield," and they represented a way to diversify global portfolios. This hunt was a response to the very low yields available from advanced economies, where loose monetary policy and Quantitative Easing (QE) drove interest rates to historic lows. Funds investing in EM bonds and equities, a key indicator of portfolio flows, saw some US$90bn in net inflows in 2012 and a further US$46bn in the first four months of 2013.

Things began to shift in early May 2013. Indices tracking baskets of EM equities, bonds and currencies (compiled by MSCI, Bloomberg and JP Morgan, respectively) all declined sharply starting on May 9 (see chart). By June 24, equities were down 17%, bonds 10% and currencies 7%. There has been a small bounce back in the last month, but all three indexes remain well below their recent peaks. These sharp declines have been driven by the withdrawal of funds by foreign investors. US$7bn was withdrawn from EM bond funds in June alone (around 3% of the total value) and equity funds saw even larger withdrawals (US$5bn in the first week of June, the largest withdrawal in nearly two years).

Emerging Market Indices
(rebased to Jan 2013=100)



Source: MSCI, JP Morgan, Bloomberg

The immediate catalyst for this shift from emerging markets is the expectation that the US Federal Reserve will soon begin to taper its QE purchases, ending them sometime in 2014 and raising interest rates starting in 2015. One strong indicator of these expectations is the yield on 10 year Treasuries, which rose from a low of 1.62% at the start of May to a peak of 2.74% in early July. With higher yields on offer in the US, EM bonds look less appealing, partly explaining the capital outflows and their fall in value. In July, EM indices have partly recovered, and US yields have fallen slightly, as Fed officials have backtracked on talks of QE tapering, emphasizing that it will be dependent on the health of the US economy as well as domestic factors and opportunities for global risk diversification.

Expectations about the precise timing of QE tapering and monetary tightening will continue to add to market volatility. However, the broad policy direction is clear and emerging markets are now being forced to respond to capital flight by tightening monetary policy, thus reducing their growth prospects.

Three major emerging markets have raised interest rates recently. The Brazilian central bank began tightening last April and has increased policy rates by 100 bps in the last few months. Bank Indonesia raised its rates by 75bps during the same period. India has been the most aggressive, raising its lending rate (though not yet its benchmark repo rate) by 200bps on July 15 in an attempt to stem the sharp decline of the rupee, which recently hit an all time low against the US dollar. Turkey was the most recent country forced to act, raising its base rates by 75bps on July 23.

The problem emerging markets are facing is that monetary tightening will suppress economic growth by making it more expensive for companies and individuals to borrow for investment and consumption. This is coming at a particularly bad time, as many of them are already facing growth rates well below trend, although still ahead of most advanced economies. Brazil, in particular, is struggling and had its IMF growth forecast revised down recently by 50bps for 2013 to 2.5% and 80bps for 2014 to 3.2%. Indeed, India, which is growing at the slowest rate in a decade, was in a cycle of easing monetary policy in the first half of 2013 (cutting rates by 75bp in stages) precisely to support growth.

Aside from monetary policy, some emerging markets have recently made tax and legal changes to encourage capital inflows. Brazil eliminated a 6% tax on foreign bond investment and a 1% tax on currency derivatives (which were introduced a few years ago when the Brazilian Real was appreciating too quickly). Meanwhile India sought to catalyze investment by removing a cap on foreign equity ownership in the telecoms sector, while introducing restrictions on gold imports to reduce its large current account deficit.

Some concerns have been raised about a potential repeat of the Mexico crisis of 1994, when emerging markets suffered substantial capital flight after the Fed tightened policies in 1994. According to QNB Group, this is unlikely because most emerging markets have stronger balance sheets—lower levels of foreign debt and higher foreign currency reserves—than they did in mid-1990s. Although a broad-based emerging market crisis is unlikely, the end of an era of ultra cheap money will still put pressure on the most vulnerable countries. According to QNB Group, further tightening of monetary policies will therefore be inevitable, resulting in lower economic growth in emerging markets during the coming months, until a recovery takes hold in 2014.