

EMERGING MARKETS MONITOR | January 2022

Which emerging markets are most at risk from US rate hikes?

Our model shows which emerging nations are most vulnerable to a tightening of US monetary policy.

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Our capabilities

Emerging Markets

When America sneezes, the world catches a cold. And when the world's biggest economy raises interest rates to combat surging inflation, households, businesses and governments around the world feel the repercussions on their own borrowing costs. That is particularly true in emerging markets, where a significant proportion of borrowing tends to be in US dollars.

With the US Federal Reserve expected to deliver three interest rate hikes this year and more in 2023, investors in emerging markets might be forgiven for feeling a little nervous. But our analysis shows that it would be wrong to tarnish all developing economies with the same brush; their vulnerability to Fed tightening varies widely.

To zoom in on the differences, our model analyses 13 risk factors, including measures of public and private debt, current account balances, the strength of foreign exchange reserves and interest rate differentials versus the US (see Fig. 1). The 25 EM economies in our model are then ranked from best (1) to worst (25) for each indicator.

Fig. 1 - Vulnerability scorecard
Emerging market countries' vulnerability to Fed interest rate hikes

	TAIWAN	RUSSIA	INDIA	CHINA	KOREA	ISRAEL	POLAND	THAILAND	ARGENTINA	INDONESIA	S. AFRICA	CZECH REP.	PAKISTAN	TURKEY	BRAZIL	UKRAINE	PERU	MEXICO	PHILIPPINES	EGYPT	MALAYSIA	ROMANIA	CHILE	HUNGARY	COLOMBIA
Vulnerability score	6.2	6.9	9.1	10.0	10.4	11.6	11.7	11.8	11.8	11.9	12.2	13.1	13.2	13.4	13.4	13.5	14.3	14.3	14.6	14.7	14.9	14.9	16.7	17.3	17.3
1. Current Account	1	3	11	7	2	4	16	22	9	12	5	10	21	14	19	15	18	8	13	24	6	17	23	20	25
2. Net foreign assets	1	5	12	8	6	4	20	2	7	13	18	10	25	21	14	15	17	16	9	19	3	24	11	22	23
3. External debt	5	6	3	1	8	7	19	11	20	13	15	23	12	18	2	24	14	10	4	9	21	17	22	25	16
4. Public debt	3	1	23	19	7	21	6	12	11	8	20	9	10	5	24	18	4	14	15	25	16	13	2	22	17
5 Fiscal balance	11	2	9	17	3	25	1	10	8	12	16	19	14	5	13	6	4	7	22	23	15	20	18	24	21
6. Excess private debt	10	9	4	16	18	6	2	20	7	11	3	8	-	5	15	-	14	12	17	-	19	-	21	1	13
7. Excess bank loans	14	9	6	23	25	11	3	24	10	17	2	15	13	5	7	1	19	16	21	20	22	4	12	8	18
8. Govt debt hard currency	-	8	-	2	3	15	13	1	23	11	9	6	4	16	7	10	22	12	17	20	5	21	14	19	18
9. NFC debt - hard currency	7	16	8	10	12	23	4	11	9	13	20	18	2	5	21	14	17	24	15	1	22	3	25	6	19
10. FI debt - hard currency	9	11	7	6	24	8	13	15	3	16	10	21	4	23	12	5	22	18	17	1	25	2	20	14	19
11. FX reserves	5	3	8	6	12	1	19	10	14	13	16	11	23	25	2	20	4	22	9	17	18	21	15	24	7
12. CPI	5	20	13	1	7	4	18	2	25	3	10	11	21	24	22	23	12	17	8	15	6	19	14	16	9
13. Real rate differential	2	10	9	1	5	14	24	3	21	4	11	8	17	19	25	20	16	13	15	6	7	23	18	22	12

Notes: (1) to (5) %GDP, 12-month moving average; (6) & (7) %GDP, deviation from long-term trend; (8) to (10) %GDP, 4-quarter moving average; (11) %Imports; (12) %Y/Y, last quarter (13) average of 3 interest rates spreads with US. Source: Pictet Asset Management, BIS, CIS, Refinitiv, Bloomberg.

Aggregating the scores shows that Colombia, Hungary, Chile and Romania are likely to be the most vulnerable to US rate hikes. All four have high external financing needs, often in hard currency.

At the other end of the scale, Taiwan, Russia, India, China and Korea are likely to prove the most resilient. They generally have healthy foreign exchange reserves – meaning they can intervene to support their currencies against the dollar, if needed – and low levels of external debt.

So, for example, Taiwan has the best current account score on our grid, with a surplus of 14.4 per cent of GDP, while Colombia ranks the worst with a 5.1 per cent deficit, leaving it reliant on foreign capital in order to close the gap between domestic spending and domestic investment. Combine that with high levels of net foreign assets and external debt, and a fragile fiscal balance, and the risks mount up.

History suggests that the negative impact of US rate hikes on EM is exacerbated during times of slower economic growth, which we believe is the most likely scenario for this year. In 2022, we expect growth to recover from a trough reached in the third quarter of last year, which then may offer some buffer against rising US rates. In the longer term, the imbalances should correct themselves, as we saw in 2013, during the QE taper. The currencies of the worst affected EM countries will weaken, making their exports more competitive and, in time, stimulating growth.

Overall, our analysis highlights that emerging markets are not a homogenous universe. Within that group of countries, in-depth analysis and active allocation is crucial in unearthing investment opportunities and avoiding the biggest risks. Including ones linked to Fed tightening.

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