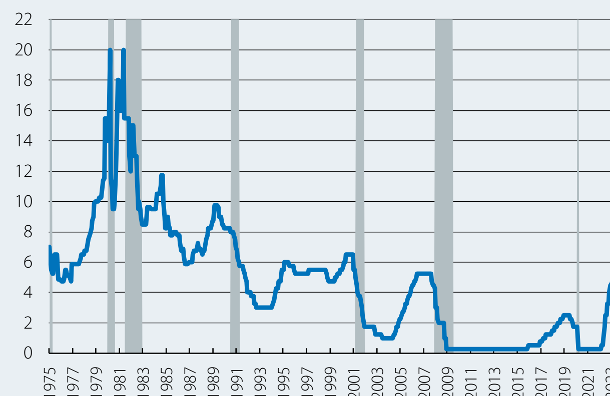
Emerging markets amid US rate hikes and the recent financial turbulence

US: monetary policy interest rates

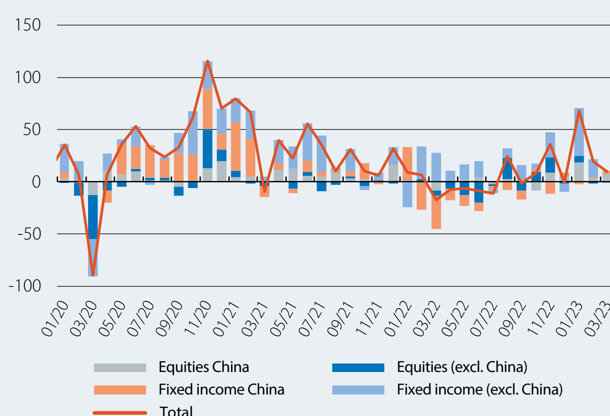
(%)



Note: *The grey shading marks periods of economic recession in the US according to the National Bureau of Economic Research.*
Source: *CaixaBank Research, based on data from the Federal Reserve and the National Bureau of Economic Research.*

Emerging markets: net inflows of foreign capital

(USD billions)



Note: *Net foreign investor portfolio flows to emerging economies.*
Source: *CaixaBank Research, based on data from the IIF.*

The Fed has been forced to provide a decisive response to contain the inflation rally and keep expectations in check: in no other previous cycle of rate hikes had the benchmark rate been risen so much (500 bps) in such a short period of time (just over a year), and this has caused a significant tightening of financial conditions around the world. What are the repercussions of this episode for emerging economies?

Over the past four decades, emerging countries have experienced a number of crises throughout the various cycles of monetary tightening in the US, enduring a very high economic and financial cost. Although the causes of each episode are different (the Fed's rate hikes are more directly linked to the debt crises in Latin America in the early 1980s and that of the Mexican peso in 1994), what is clear is that the Fed's monetary policy decisions affect global financial conditions, and this has a potentially negative impact on the most vulnerable emerging economies.

Moreover, the impact that a rate hike has on global financial markets is not always equal, as it depends on the reason for the hike, as the World Bank has recently analysed.[1] According to its report, the triggers to monitor are (i) an inflation shock, (ii) the markets' anticipation of further monetary policy tightening, or (iii) a positive growth shock. Historical experience shows us that if rate hikes are related to the first two aspects, they are more likely to have adverse indirect effects on emerging markets, as both of these situations entail economic slowdown in the US at the same time as a deterioration in investor confidence. The opposite is true when rate hikes are implemented in response to a positive growth shock. The bad news is that the Fed's rate hike cycle initiated in 2022 is primarily driven by the first two groups of factors.

In addition, under these circumstances, emerging economies that are under pressure often experience a loss of value of their currencies. In this regard, during 2022 a number of emerging currencies suffered significant depreciation against the dollar, amounting to more than 15% in the case of the Turkish lira, the Colombian peso, the Argentine peso and the Egyptian pound, as well as other emerging-market and low-income currencies.

First consequences for emerging markets

The impact of the tightening of monetary conditions in the US had not been as intense as in previous cycles until the instability in the US banking sector in early March triggered a shock in the global financial markets. Up until then, the early steps taken to normalise monetary policy in many emerging economies (in some cases, such as in Latin America, this process was begun in late 2021) favoured a widening of the spread in real rates relative to advanced economies, and this helped bolster emerging markets' resilience during much of 2022. However, the recent episodes of financial instability have intensified the narrowing of this spread, to the detriment of emerging markets. This correction is especially pronounced in Latin America, where, moreover (and beyond extreme cases such as those

1. See World Bank Group. December 2022. «How Do Rising U.S. Interest Rates Affect Emerging and Developing Economies? It Depends».

endured in Venezuela and Argentina), inflation persists at higher levels than desired despite the central banks' rate hikes.

Another important aspect is the impact that the Fed's decisions would have had on foreign investment flows to emerging economies. Since the beginning of this year, a reduced risk appetite driven by fears of a slowdown in the global economy, combined with the narrowing of emerging-economy sovereign spreads relative to US Treasuries, makes investments in these countries' financial assets less attractive, especially those denominated in local currency. On the other hand, the financial turbulence experienced in the US and Europe in March following the collapse of Silicon Valley Bank significantly increased instability in the financial markets. However, while the impact was clearly more pronounced in developed economies than in emerging markets, the latter have by no means emerged unscathed.[2]

In fact, according to data from the International Institute of Finance (IIF), as a result of this sharp increase in risk aversion, net investment flows to emerging markets fell by 52% in March alone, with the biggest reductions occurring in fixed-income securities (public and private). Thus, the future evolution of foreign investment in these countries faces significant risks, in what is already a demanding environment. On the one hand, their debt levels are at an all-time high,[3] after several years of accommodative financing conditions. On the other hand, following the pandemic, investors discriminate more rigorously in their investment choices according to the credit rating of the issuing countries. This explains why new debt issues from countries with larger foreign deficits are almost non-existent.

China, a special case

Unlike many emerging economies, China has not been forced to tighten its monetary conditions in order to contain inflation, as the implementation of its zero-COVID policy caused a significant cooling of its economy, with the consequent disinflationary impact: average inflation in 2022 was 2.0% and in the year to date it has fallen to 0.7%. Indeed, its central bank has been pursuing a clearly expansionary policy in order to sustain economic growth in this context dominated by the country's health policy, the effects of which were intensified by the slowdown in demand from its main trading partners. Moreover, China does not have a problem with access to credit in the financial markets, given that its foreign debt represents just 15% of its GDP, and its reserves also exceed its total stock of foreign debt by more than 15%. Thus, China is less vulnerable to episodes of global financial instability or a tightening of global financial conditions. However, one of the main problems of the Chinese financial system is its high exposure to corporate debt: in Q3 2022 it stood at almost 160% of GDP. Most of this debt is issued by public companies (which are highly leveraged) and it is also largely concentrated in short-term maturities. This problem is especially relevant in the country's regional banks and China's central bank itself acknowledged that there were some 300 entities considered high-risk.

Emerging markets: financial conditions index
Standard deviation (points)

Note: *Calculated using financial indicators for 13 emerging economies.*
Source: *CaixaBank Research, based on data from Capital Economics and Refinitiv.*

In conclusion, it seems that the increase in financial instability mainly affects those emerging economies that are more dependent on foreign savings for their financing. Aspects such as high current account deficits or high percentages of short-term foreign debt are a source of fragility for their currencies, with their depreciation serving as one of the key indicators of their risk. In this regard, and as we will expand on in a later Focus, we can anticipate that the economies most exposed to a change in investor sentiment in 2023 include Turkey, Argentina, Malaysia, Chile, Peru, Colombia, South Africa and Egypt.

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2. In part, this is because of the differing composition of banking sector balance sheets in emerging markets, where retail deposits and medium-term debt are predominant, with a smaller role of mark to market assets, contrary to the sector's balance sheets in advanced economies.
3. According to the IIF, in 2022 the debt of emerging countries reached a record 98 trillion dollars, 30% higher than in 2019; and the debt-to-GDP ratio stood at 250%.