Global Macro Views – EM Contagion Risk

May 22, 2018

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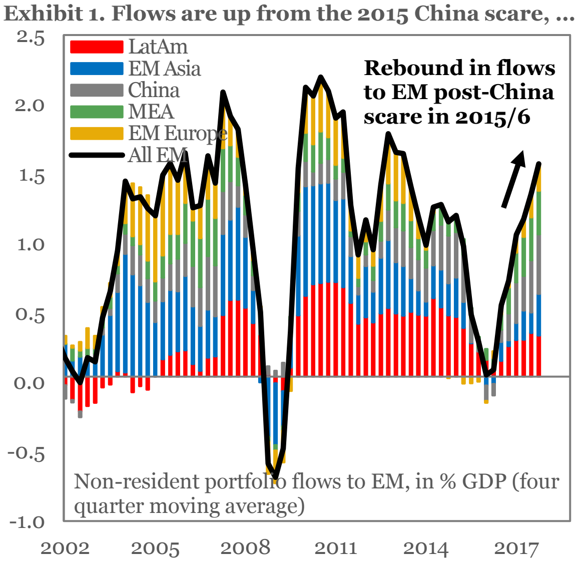
- The Argentinian Peso and Turkish Lira have fallen sharply this year, …
- but spillovers to the broader emerging markets complex have been limited.
- We examine contagion risk through the lens of non-resident portfolio flows.
- The pace of these flows rose sharply in the wake of the China scare in 2015/6, …
- even as those flows became more concentrated in a few emerging markets, …
- including Argentina, South Africa, Colombia, Egypt, Mexico and Indonesia.

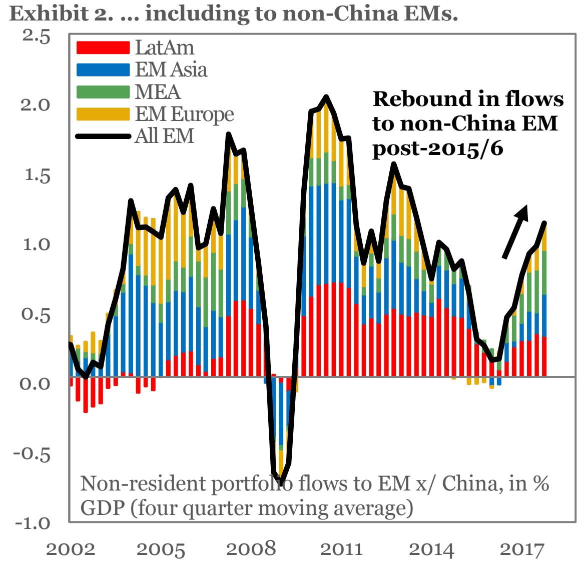
We turned more cautious on emerging markets in February and signaled substantial overvaluation for the Argentinian Peso and Turkish Lira. Both currencies have fallen sharply since then, but spillovers to the rest of the EM complex have been limited so far. We build on the Capital Flows Report to examine contagion risk through the lens of non-resident portfolio flows to emerging markets. Those flows have seen a sharp rise since the China devaluation scare in 2015/6 and by the end of last year had returned to a pace last seen in the run-up to the 2013 taper tantrum. That said, these flows were skewed towards a few emerging markets, including Argentina, South Africa, Colombia, Egypt, Mexico and Indonesia. Though the higher degree of concentration may dampen broader contagion risk, we remain worried for the following reason. The underlying driver of the sell-off is this year's rise in the 10-year Treasury yield from 2.4 to 3.0 percent, which is half the size of the move (from 1.6 to 3.0 percent) that started the taper tantrum. If emerging markets are this vulnerable to what can only be described as a moderate rise in global funding costs, we worry about the underlying resilience of EM.

Exhibit 1. Flows are up from the 2015 China scare, …



Source: Haver, IIF

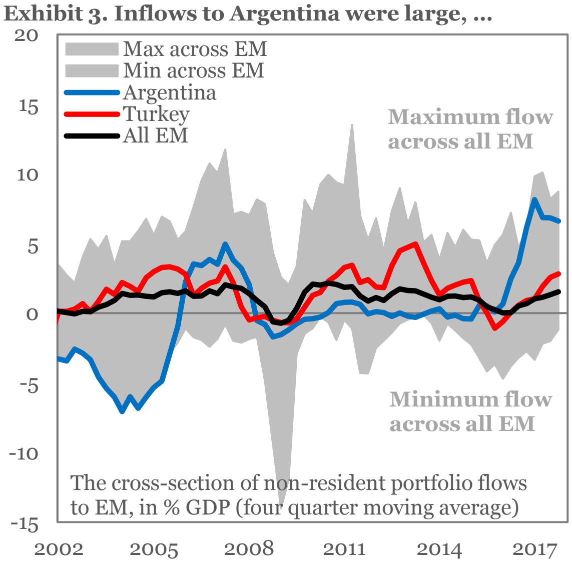
Exhibit 2. … including to non-China EMs.



Source: Haver, IIF

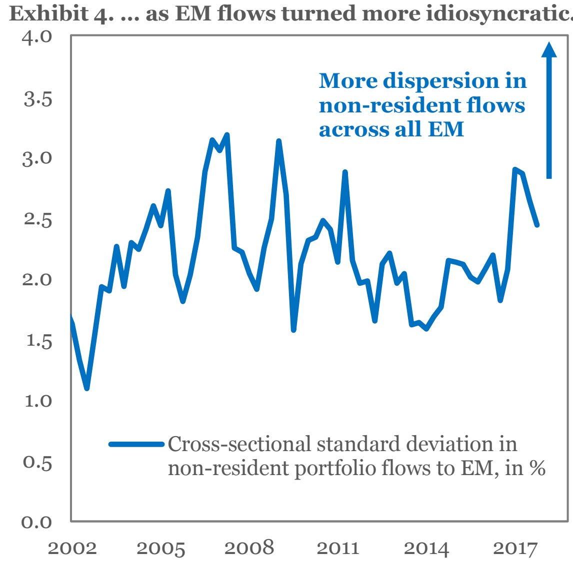
Non-resident portfolio flows to EM fell sharply around the China devaluation scare in 2015/6 (Exhibit 1), but have rebounded sharply since then and are almost back to levels last seen ahead of the 2013 taper tantrum. The rebound is not just a China story, given that flows to the rest of EM have also risen (Exhibit 2). We examine where non-resident portfolio inflows have been large in relation to the local economy by scaling inflows by GDP. The grey shaded area in Exhibit 3 shows the cross section of EM in this perspective, highlighting Argentina (blue) and Turkey (red) in particular. It is clear that Argentina emerged in recent years from quasi-autarky, with sovereign bond issuance and associated inflows putting it near the top of EM in terms of inflows. Meanwhile, non-resident portfolio inflows to Turkey have been more modest, i.e. close to the average across all EM (black line). We examine the dispersion in non-resident portfolio flows, calculating the cross-sectional standard deviation of our GDP ratios at every point. Exhibit 4 shows that this dispersion rose last year, to levels last seen at times of peak inflows to EM, as for example ahead of the global financial crisis. Our interpretation is that it becomes harder to identify profitable opportunities as the global *"flow"* cycle matures, so that non-resident portfolio flows shift to increasingly idiosyncratic places. This can cause flows to become concentrated in a few places, i.e. for positioning to build up.

Exhibit 3. Inflows to Argentina were large, ...



Source: Haver, IIF

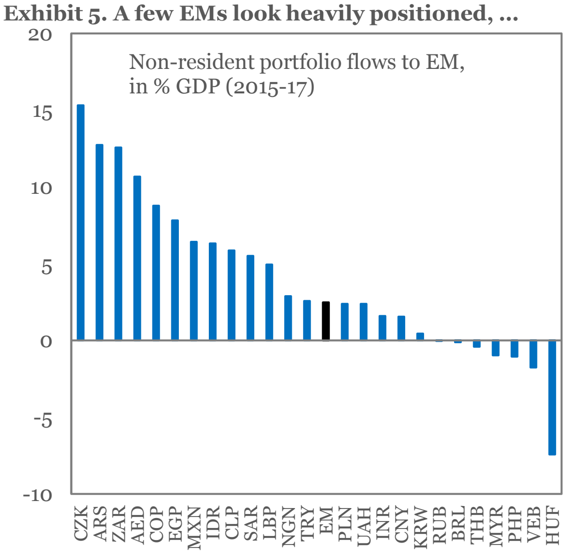
Exhibit 4. ... as EM flows turned more idiosyncratic.



Source: Haver, IIF

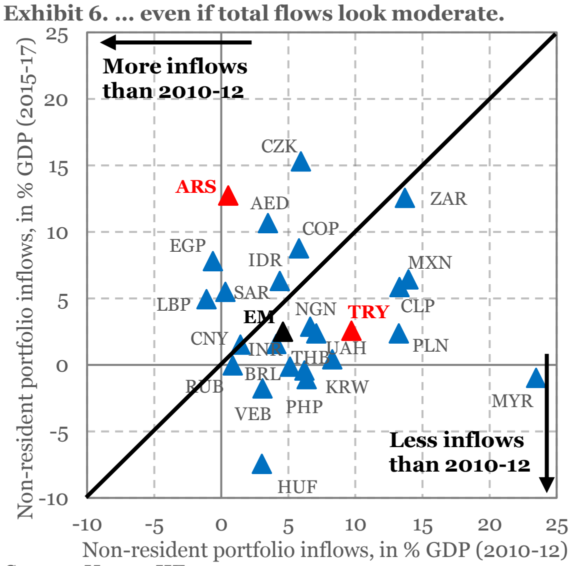
Exhibit 5 provides a ranking (in descending order) of non-resident portfolio flows in the three year window from 2015 to 2017. The EM aggregate is highlighted in black. A few emerging markets, including Argentina (ARS), South Africa (ZAR), Colombia (COP), Egypt (EGP), Mexico (MXN) and Indonesia (IDR), have received especially large inflows in relation to GDP. At the same time, it is true that comparing 2015-17 to the three years leading up to the 2013 taper tantrum shows that portfolio inflows in aggregate have been somewhat more modest recently. Exhibit 6 shows inflows during the recent window on the vertical axis and the 2010-2012 period on the horizontal axis. Most EMs are below the diagonal, but a few idiosyncratic places stand out for positioning that could make them vulnerable. Overall, we remain cautious on EM, given that the underlying driver of this sell-off – a moderate rise in core G-3 rates – is modest. This leaves us worried how well the EM complex will digest a continued move higher in global funding costs.

Exhibit 5. A few EMs look heavily positioned, ...



Source: Haver, IIF

Exhibit 6. ... even if total flows look moderate.



Source: Haver, IIF

