Economic Vulnerability Varies by Country

By Francisco Torralba

If inflows of capital suddenly tighten, certain emerging markets are more at risk than others.

Investments in emerging-markets economies have outperformed those in developed countries over the global business cycle that began in 2009. Loose monetary conditions set by the central banks of Japan, the United Kingdom, eurozone, and, most importantly, the United States, depressed yields and prompted developed-market investors to seek higher yields overseas, often in emerging markets. A consensus is forming, however, that tighter monetary conditions are on the horizon. Moreover, cyclical and structural factors are beginning to slow down the economies of some emerging markets. It is only a matter of time before the most skittish of those investors return home.

Most emerging-markets countries are particularly exposed to the risk of an abrupt end to capital inflows, which we have learned from the past 40 years of markets history. As such, analysts tend to lump developing countries together in a way they never would with advanced economies. Headlines this past summer about sinking currencies and money gushing out of emerging-markets funds led one to believe that all emerging-markets economies would wreck in the event of a "sudden stop" of capital. My analysis suggests that that is not the case.

I focused on gauging the vulnerability of 16 emerging-markets economies to a freeze in capital inflows. My scorecard consists of 18 metrics that have been linked to such risk, grouped into four sets. For each set, I generate a score, which I derive from the relative position of each country in the cross sectional distribution. I then average the four scores to produce an overall index of vulnerability. The index can take a maximum value of five, for the highest degree of vulnerability, and a minimum of one, the lowest.

Current Account

The first set of characteristics relates to the external balance.

A large current-account deficit implies lots of borrowing from abroad, which might precipitate a crunch if funding dries up. In addition, I check the basic balance, which adds net foreign direct investment (FDI) to the current account balance. FDI is the stickiest and most reliable form of foreign financing. A country with a negative basic balance cannot cover its financing needs with FDI, depends on flightier forms of foreign inflows, and is more vulnerable to sudden stops. For both the current account and the basic balance, I consider as metrics the average balance over the past three years (through the second quarter of 2013), as percent of GDP, and the change from the average balance in the previous three-year period, for a total of four metrics.

On these measures, Turkey fares worst, with a score of five, due mostly to an eye-popping current account deficit of 7.9% of GDP. Note also the big decline in the current account surplus of Malaysia from three years ago. Hungary can brag about a sterling score, although this metric fails to capture why and how the country has achieved that score (hint: plummeting imports and deleveraging pressure).

Financial Inflows

The second set of metrics looks directly at financial inflows.

Portfolio inflows, aka "hot money," tend to go directly into stocks, bonds and bills, bank deposits, and loans. Getting out of a portfolio investment tends to be faster and cheaper than unwinding an FDI investment. Therefore, reversals of hot money flows tend to be more sudden and more disruptive than those of FDI. As a metric, I consider portfolio gross inflows as percent of GDP over the past three years, and their change from the previous three years. A second metric is gross FDI inflows as a percent of gross portfolio and FDI inflows, as well as its change. (In the case of the second metric, a *higher* number implies a *lower* degree of vulnerability.)

Here, Mexico and Turkey share the dubious honor of being the most exposed. For both,

portfolio inflows are more than three times larger than FDI. South Africa and Malaysia are not far behind. Also, Malaysia takes in gross portfolio inflows worth a whopping 7% of GDP. China, on the other hand, draws in very little hot money, thanks to capital controls.

External Debt and Liquidity
The third area of vulnerability, and perhaps the most important, is external debt and liquidity.

The "original sin" of emerging markets was that they issued debt under another country's jurisdiction, typically denominated in a foreign currency and held mostly by foreign creditors. When foreign investors rush to pull their money out, local currencies depreciate, and emerging markets with external debt are hit by a double whammy: They have trouble rolling over their debt, and their indebtedness rises in terms of the local currency.

To try to capture this vulnerability, I consider six metrics. First and second are total external debt as a percent of GDP and the change of this ratio from its value three years before. Next are short-term external debt as a percent of international reserves, and its three-year change. A high level of short-term debt relative to the stock of reserves means that the economy does not have a large buffer to tide the country through a storm in global financial markets. The final two metrics are short-term external debt as a percent of *total* external debt, and its three-year change. The more a country relies on short-term financing, the more disruptive a sudden stop will be.

Turkey once again leads the bunch, along with Argentina. Both stand out for their daring levels of short-term debt relative to reserves. Hungary has more total external debt than anybody else, relative to its GDP, but most of it is long term.

Domestic Credit and Money Growth
The fourth group of vulnerability metrics regards domestic credit.

Vulnerability to a Sudden Stop of Capital Inflows

Scores Range From 1 to 5, With 5 Being the Most Vulnerable

	Current Account	Financial Inflows	External Debt	Domestic Credit	Vulnerability Score
Turkey	5.0	4.7	4.3	2.7	4.1
Thailand	2.3	2.7	3.3	4.0	3.1
Mexico	2.2	5.0	3.3	1.7	3.0
Malaysia	2.3	4.3	2.9	2.5	3.0
Argentina	2.5	1.5	3.6	4.3	3.0
Colombia	2.3	2.5	2.6	4.3	2.9
South Africa	3.8	3.3	3.0	1.5	2.9
Chile	2.8	3.5	2.5	2.8	2.9
Philippines	1.7	4.3	1.9	3.2	2.8
Poland	3.3	2.5	3.0	1.7	2.6
India	4.3	1.7	2.6	1.7	2.6
Indonesia	2.5	1.3	2.1	4.0	2.5
Brazil	1.8	1.3	1.5	3.7	2.1
China	2.3	1.0	1.9	2.7	2.0
Hungary	1.0	3.0	2.6	1.0	1.9
Russia	2.0	1.3	2.0	1.7	1.7

Sources: Morningstar, with data from central banks, national statistics offices, IMF, and FactSet.

Rapid credit growth often is linked to overstretched firms and households, overvalued asset prices, and capital misallocation. Excessive growth of domestic credit, which could be fuelled by the foreign inflows, increases the reliance of local banks on external capital. A measure of excess credit is the difference between the growth rate of domestic credit and nominal GDP. Although it is normal in emerging markets for domestic lending to grow a bit faster than GDP, a yawning gap between the two growth rates is cause for concern.

Because measuring domestic credit is difficult, I take two approximations (as well as their three-year changes). The first one uses credit to private non-financial sectors, as estimated and reported by the Bank for International Settlements. The second one is M2, a money aggregate that is easier for central banks to measure than credit. (The intuition here is that the growth rates of credit and money are highly correlated.)

Excess credit growth appears to be worst in Thailand, Indonesia, Brazil, Argentina, and Colombia. In Hungary, on the other hand, credit is growing less than nominal GDP, a reflection of the deleveraging I mentioned above.

Tallying the Scores
When all the scores are combined, Turkey appears at the top of the mast of vulnerability. Three of its four sets of indicators of vulnerability are flashing bright red. Thailand, Mexico, Malaysia, and Argentina complete the quintet of most vulnerable emerging markets. Colombia, South Africa, and Chile are not far behind.

Russia, on the other end, looks like the strongest of the pack, thanks to a current-account surplus, a small influx of hot money, a mighty stash of foreign exchange reserves, and a mild excess of credit growth. China, often the focus of concern of many global macro commentators, is well down the ranking of vulnerability. (That, I would argue, is not because China is a safe haven, but because its macroeconomic Achilles' heel are *domestic*, not external, imbalances.)

Any assessment of vulnerability to a capital freeze is bound to suffer from omissions, mismeasurement, and arbitrariness. I might not have included all the indicators that matter, and not all the ones I use might make a difference. It is also difficult to draw the line that separates the critically vulnerable from the merely fragile. Moreover, my metrics partially overlap, leading to exaggerating the degree of vulnerability for high-risk countries and underestimating it for the low-risk ones.

I believe, however, that my compass is adept at assessing the *relative* degree of vulnerability within the group. This exercise may also inform more systematic analyses of country risk for investment decisions, and provide a reference point to country rankings produced by more sophisticated methodologies. Countries with extreme scores, especially those with high vulnerability scores across several factors, should be approached with caution.

Navigators of the financial seas, ye have been warned. M

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Shifting Sands in Foreign Equity Markets

By Kevin McDevitt

Five years from the nadir of the global financial crisis, U.S. commentators have focused their postmortems mostly on what has happened in the United States. While the shifts here have been tectonic, everything from a rethink of housing to unprecedented Federal Reserve intervention, the upheaval in financial markets has been just as significant overseas. In some ways, the remodeling outside of the United States has been even more fundamental.

Emerging Markets: Beyond Oil and Ore

What these changes mean for investors is that they may need to redraw their mental maps of overseas markets. Nowhere is this more true than in emerging markets. Many long-held assumptions about emerging markets no longer apply. For years, many thought of emerging markets as fairly homogenous economies dominated by commodity-oriented sectors. But overall, emerging markets are now less driven by those sectors. In October 2008, energy and materials stocks consumed nearly a quarter of the MSCI Emerging Markets Index. Today, that combined weighting is below 20%. Instead, less commodity-focused firms have become much more prominent in emerging markets. Technology firms have made some of the biggest strides, with Samsung, Taiwan Semiconductor TSM, and Tencent now qualifying as three of the five largest companies in the MSCI Emerging Markets Index.

Branded Companies Thrive

One common theme across markets has been the increasing prominence of consumer-goods companies. Even as growth has slowed in emerging markets, many consumers there now have the disposable income to spend on branded products. The shares of European upscale spirits companies Pernod Ricard RI and Diageo DEO have doubled during the past five years, thanks largely to their growth in emerging markets. Such stocks now count for a larger share of the major indexes, both developed and emerging. Consumer discretionary and consumer staples stocks combined now account for 17% of the MSCI EM Index up from 11.5% in 2008.

Financials Share of Emerging World

Sure, the share prices of U.S. and European financials have begun to recover after being decimated by the crisis. Bank stocks such as Wells Fargo WFC and JPMorgan Chase JPM in the U.S. and Lloyds Group LYG and Credit Suisse CS in Europe have all rebounded since 2008.

But, at least in the developed world, financials still claim a far smaller share of their respective indexes. Whereas financials accounted for 30% of the MSCI EAFE Index in early 2007, today they're less than 26%. The decline has been even more pronounced in the United States: Financials account for just 16% of the S&P 500 after claiming more than 22% of the index in early 2007. It's a different story, though, in emerging markets. With economic growth there creating greater demand for financial services, that sector has increased its share of the MSCI EM Index to more than 26% from 21%.

Price Multiples No Longer Depressed

After the crisis, the U.S. rebounded more quickly than other developed markets. The road out of purgatory was slowed significantly in Japan and Europe because of the Fukushima disaster and Greece's debt crisis in 2011.

With foreign stocks on a slower trajectory, their shares looked comparatively cheap heading into 2012, especially those in Europe. At the Morningstar Investment Conference that June, Leuthold's Doug Ramsey said that European stocks were the cheapest they had been in decades. Indeed, the average stock in the MSCI Europe Index was trading at just 10 times earnings. Those who acted on Ramsey's advice have plenty to smile about, with the MSCI Europe Index up 42.7% since then versus the S&P 500's 37.4% gain. Not surprisingly, European stocks are no longer the bargain they once were. The average P/E for the MSCI Europe Index is now above 15, its highest level since year-end 2006.

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