Emerging countries

Is the restart of portfolio investments justified?

■ According to the Institute for International Finance (IIF), foreign portfolio investment flows have more than doubled between the periods March-May and June-August 2016. Asia still accounts for the lion's share of these investments, while South America continues to lag behind.

■ The inflow of portfolio investments is a double-edged sword. On the one hand, by improving financing conditions, it helps ease the external debt service. On the other hand, their extreme volatility increases the country's external vulnerability. This is true not only for the emerging countries, but also for the "frontier" markets.

■ On the whole, the geographic breakdown of portfolio investment flows in recent months is in keeping with their relative performances in terms of growth.

■ For Africa and the Middle East, persistently low commodity prices, despite their recent consolidation, increase pressures on external accounts and public finances, which in turn fuels social unrest and political risks during elections.

Despite the aggravation of domestic political and social risks (failed coup attempt in Turkey, growing nationalist tendencies in central Europe) as well as geopolitical risks (further tensions between Russia and Ukraine, and the intensification of combat in Syria against a backdrop of persistent disagreements between the Americans and the Russians), the emerging financial markets have benefited from renewed confidence from foreign investors.

Portfolio investment makes a comeback

According to estimates by the Institute for International Finance (IIF), non-resident portfolio investment flows amounted to a cumulative total of about USD77bn in the period June-August. This is more than double the figure for March-May, when investment flows became positive again but had remained highly volatile. In June-August, Asia continued to account for the lion's share, with 62% of net investment flows in June-August, followed by Europe at 22%. In contrast, Latin America attracted only 10% of portfolio investments.

The intensification of portfolio investment flows resulted in the consolidation of the currency appreciation movement that began in early February (notably for the Brazilian real). Although investment flows were concentrated in the equity markets (70% of portfolio investment flows in June-August), the risk premium on external borrowing has fallen sharply (by about 50 basis points on average since April for sovereign and quasi-sovereign issuers, and by 100 basis points for corporate issuers, which followed on a 100 bp decline for both type of issuers between February and March). Are investors overreacting given the still fragile external economic environment - even if it has improved somewhat - or are they correctly anticipating the long-awaited recovery of growth in the emerging countries (or the end of recession in certain countries) after a 5-year slowdown?

■ Rebound in foreign portfolio investments to emerging markets ...

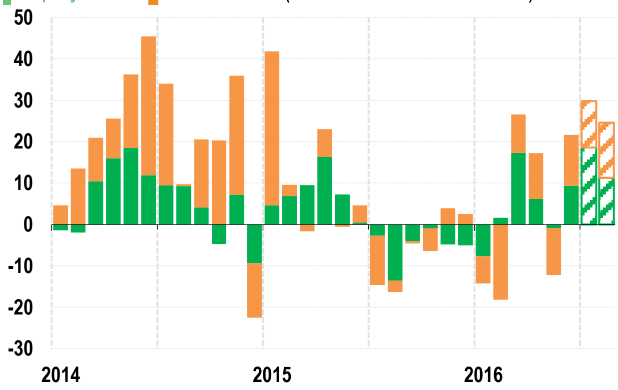

Chart 1 Source: IIF

■ ... especially in Asia

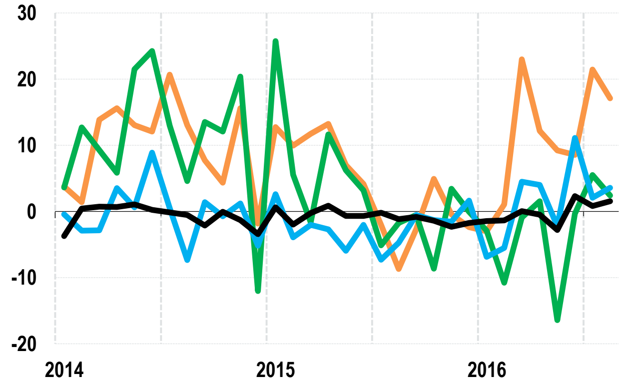

Chart 2 Source: IIF

In its analysis of portfolio investment flows and the key factors behind them, the IIF underscores both the appetite for risk and the improvement in domestic growth factors. In contrast, it points out the fact that changes in US monetary policy expectations have only played a secondary role. Apparently, the economic consequences of *Brexit* imply that monetary policy will remain very accommodating over the long term (*interest rates lower for longer*). This means that for a given risk premium, hard currency financing rates will remain sustainably low, a factor that eases the external debt service and facilitates refinancing. Another consequence, which may conversely be negative, is that the protracted attraction to speculative strategies (carry trades) could increase a country's external vulnerability. On this subject, a recent IMF study[1] shows that since the financial crisis, portfolio investment flows to the so-called "frontier" countries (those with a much lower level of development and less liquid financial markets than the emerging countries, but whose growth potential is probably just as high) increased much more rapidly than inflows to the emerging countries (a normal catching-up effect). Above all, the report shows that the sensitivity of these investments to market trends (measured by beta) has become significantly positive. Consequently, the combination of these two factors implies that in recent years the frontier countries have become just as vulnerable as the emerging countries to a drying up of portfolio investment.

Looking beyond the trade-off caused by foreign portfolio investments inflows between easing financing conditions and external vulnerability of the country, do changes in economic trends in the emerging countries justify larger inflows?

A certain consistency between regions

Based on our sample of 27 emerging countries, real GDP growth levelled off at 4.1% year-on-year in H1 (for the vast majority of these countries, statistics are available through Q2 2016). For BRIC countries as a whole, growth accelerated to 5%, after bottoming out at 4.5% in Q4 2015, but this rebound was driven solely by the easing of the recession in Brazil and Russia, and not by stronger growth in China or India. In China, economic growth continued to slow gradually (6.7% in H1 2016). Manufacturing output and exports kept on weakening while private consumption and services both stalled. Even so, the most recent economic indicators seem to point to a slight improvement in domestic demand. The authorities' stimulus efforts have bolstered public investment and the real estate sector, but it is becoming increasingly difficult to maintain this expansionist policy. In India, private investment seems to be in no hurry to recover, but disinflation and the accompanying decline in money market and long-term rates should eventually provide a stimulus. This summer, the Senate also approved the government's proposal to standardise the tax on goods and services. Yet the positive effects – in the form of lower interest rates and a broader indirect tax base – are likely to be very gradual since 1/ the market interest rates pass-through to lending rates takes a long time and 2/ the change in tax risks being hindered at the regional level.

For the remaining 23 countries in our selection, growth seems to have levelled off at 2.5% since Q1 2016 (vs. 3% in H2 2015). In Asia (excluding China and India), growth accelerated to 3.8% in Q2 2016, from 3.4% in Q4 2015. The dynamic momentum of domestic demand, and consumption in particular, has so far offset sluggish exports. For Indonesia and the more industrialised countries (South Korea, Taiwan and Singapore), purchasing manufacturing indexes (PMIs) remained just above 50.

In South America, the situation is radically different. Argentina will very probably enter recession in Q2 2016, the situation in Venezuela's is worsening desperately, and in all the other countries, the slowdown continues. In Brazil, despite the severe recession, the still very high inflation has delayed the easing of monetary policy so far. Between Asia and Latin America, there is thus a certain

[1] « Changing times for frontier markets : a perspective from portfolio investment flows and financial integration » - Working Paper 16/117 August 2016

Firmer exchange rates …

Exchange rate index against the USD of the main emerging currencies with a floating-rate regime and receiving portfolio investments

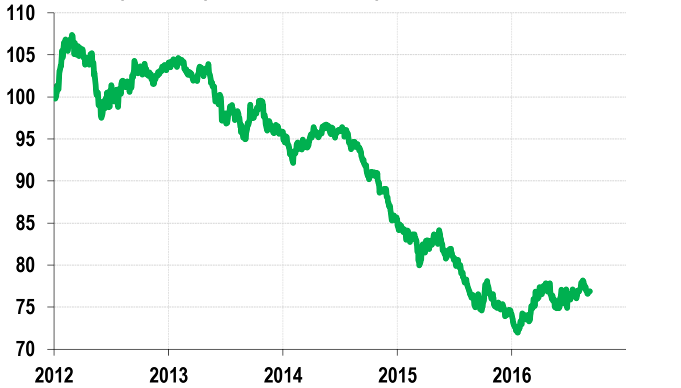

Chart 3 Sources: Datastream, BNP Paribas

... and risk premium easing

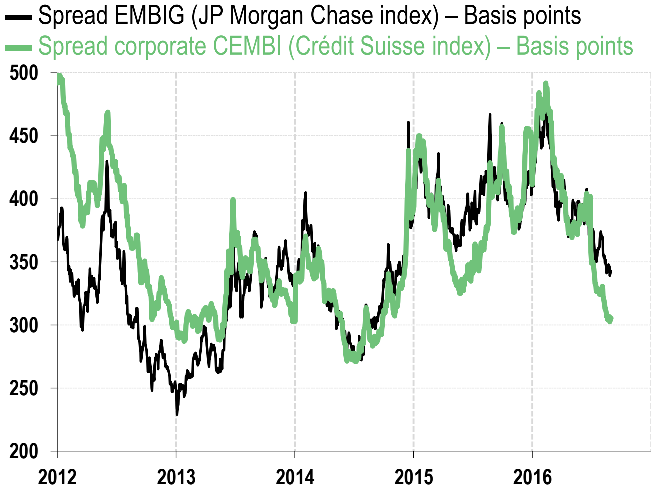

Chart 4 Source: Bloomberg

consistency between portfolio investment and relative growth performance and outlook.

Central Europe is in an intermediary situation. Growth slowed to 3.1% in H1 2016, but from a very high level (3.7% in H2 2015) due to the accelerated "consumption" of structural funds. The region's PMIs continued to decline through the summer, raising expectations of an ongoing slowdown, especially since this is the only emerging region that is potentially vulnerable to a direct contagion effect from Brexit via the external trade channel. In Turkey, the slowdown has been milder so far than in the central European countries. Growth was still sustained through Q2 2016 (averaging 4.3% in the four quarters for which real GDP is available). But the drop in tourism activity and a tougher business environment following the failed coup attempt on July 15 should lead to a sharp slowdown or stagnation in the second half of the year. Yet the pressures on foreign exchange rates and domestic interest rates as well as risk premiums have eased again after the failed coup attempt. In the end, portfolio investment outflows and the decline in USD deposits held by residents have been relatively mild since mid-July. The Turkish economy did not suffer a financial shock but business confidence has eroded (PMI dropped to 47), which will strain investment spending by both residents and non-residents (via direct investment). All in all, the persistently weak rebound in portfolio investment flows to Europe is in keeping with 1) specific country risks in Russia and Turkey, and 2) the easing of growth in central Europe.

Africa and the Middle East: a region in trouble

Regarding Africa and the Middle East (MEA), the remaining region, South Africa is the only country for which data are available for both capital flows and economic indicators. Portfolio investment in the country declined between March-May and June-August, but the bond component was still very upbeat. Real GDP picked up in Q2, but investment remains depressed, reflecting domestic political risks (confrontation between the president and the minister of finance) and the country's structural shortcomings (power rationing) in the midst of a very deteriorated labour market situation and potential social unrest.

Looking beyond South Africa, economic and political risks are rising in MEA, even though oil and metal prices have consolidated after rebounding strongly earlier this year. Nigeria has slipped into recession and Angola will probably follow suit. Nigeria's foreign reserves continue to decline despite tighter currency controls. Saudi Arabia is also expected to enter recession, which has led the authorities to inject liquidity into the banking system. If Egypt manages to avoid a balance of payments crisis, it will be thanks solely to the IMF's conditioned support. Parliament must still approve the plan, which must also win commitments from the other lending countries, notably the GCC.

As a general rule, for a number of MEA countries, low commodity prices increase pressures on the external accounts and public finances, which in turn fuel social unrest and political risks during election periods (Gabon).

Business confidence has remained resilient …

Composite PMI indexes in the manufacturing sector

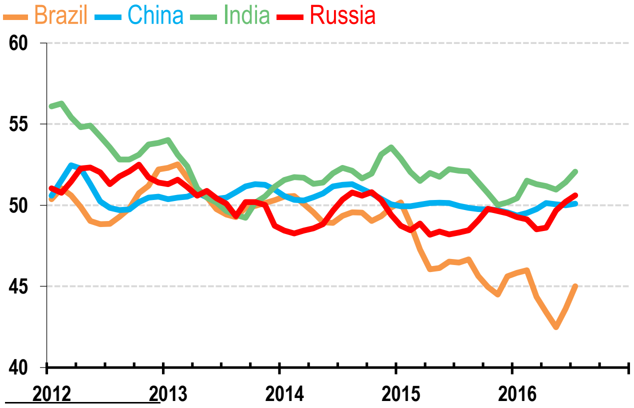

Chart 5 Source: Markit

… except in Brazil and Turkey

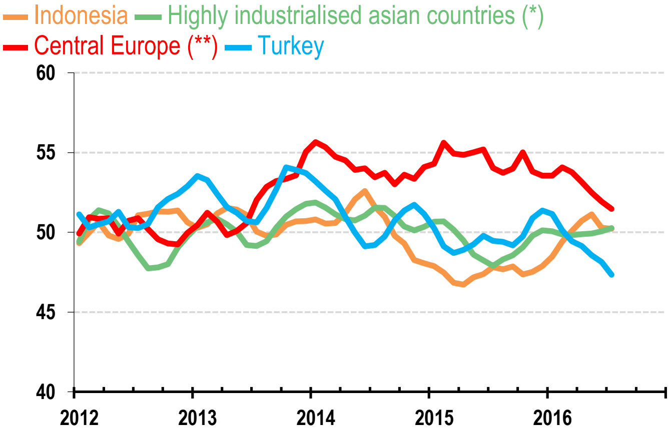

Chart 6 Source: Markit

(*) South Korea, Singapore, Taiwan (**) Hungary, Poland, Czech Rep