# EMERGING COUNTRIES: FINANCIAL VULNERABILITY IS LOWER THAN IT ONCE WAS.

**The two most recent shocks to emerging countries (the 2022-2023 tightening of US monetary policy, and the election of Donald Trump at the end of 2024) have not affected their financing conditions[1]. However, supporting factors have weakened since the second half of last year. In the coming months, financing conditions could tighten as a result of rising geopolitical risk in particular. However, the adverse impact on emerging economies should be viewed in perspective, given the low transmission of the two recent external shocks to interest rates. Although exchange rates have continued to depreciate against the dollar, the vulnerability of debt to foreign exchange risk is moderate or low for households and non-financial companies. And, contrary to a popular belief, the vulnerability of companies has not increased over the past decade, and has actually decreased slightly.**

**Since 4 November, emerging countries' financial conditions have eased overall, despite fears of a negative Trump effect.**

• The currencies of the 30 main emerging countries have depreciated against the US dollar by 1% on simple average (-1.8% for the median). However, the depreciation rate has not worsened (-0.3% as a monthly equivalent, compared to -0.5% between the end of 2023 and 4 November 2024 as a simple average as well as a median).

• CDS premiums on dollar sovereign bonds have remained generally stable (-8 basis points on simple average, -6 bps for the median), with the Romanian premium as the sole exception, with a modest increase of 27 bps. The total cost of borrowing in dollars for sovereign borrowers from emerging countries has fallen accordingly, with the yield on US government bonds remaining stable at 4.3% for a 10-year security (after temporary spike at 4.8% in mid-December).

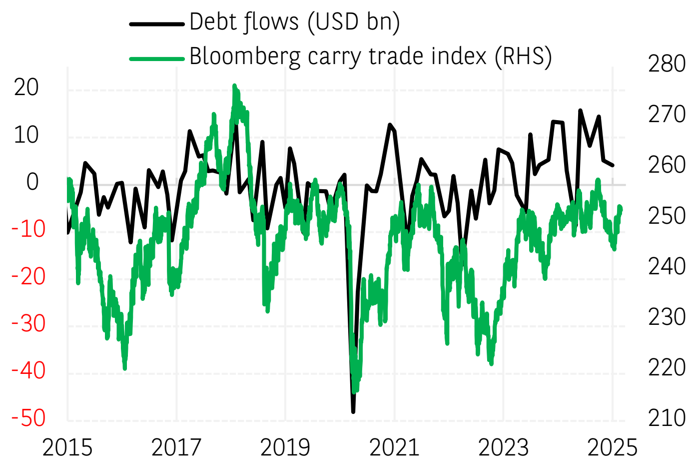
• Government borrowing costs in local currency have also decreased for 70% of the main emerging countries, albeit with some notable exceptions, in descending order: Brazil, Chile, South Africa, Romania and Vietnam. Most importantly of all, the currency depreciation has not deterred half of the central banks from cutting their key interest rates.

• Since the start of the year, EM international bond issues have reached EUR bn 81 in just 2 months, compared with EUR 181 bn for the entire year 2024, which was already a very good vintage.

**The main reason for the lack of pressure on financing conditions in emerging countries is that investment flows in bond markets remained strong until January**, according to the Institute for International Finance's (IIF) monthly trackers for non-resident portfolio investment inflows (bonds and equities) for the 25 main emerging countries. Bond inflows remained at USD 31 billion per month on average between July and January (USD 36.1 billion excluding China). They largely offset the withdrawals on the equity markets recorded since October (USD -4 billion on average, including USD -2.5 billion excluding China).

Given that geopolitical uncertainties have intensified in recent months, bond investments remaining high is even more noteworthy.

NON-RESIDENT PORTFOLIO DEBT FLOWS TO EM* AND BOND YIELDS DIFFERENTIAL




*BRAZIL, MEXICO, INDIA, INDONESIA, HUNGARY, POLAND, TÜRKIYE AND SOUTH AFRICA

SOURCE: BLOOMBERG, IIF, BNP PARIBAS

CHART 1

**An explanation often given for this is the continuation of carry trade transactions.** In a sample of 8 main financial markets in emerging countries (Brazil, Mexico, India, Indonesia, Hungary, Poland, Türkiye and South Africa), there is indeed a fairly close correlation between non-resident bond investments for these 8 countries and the Bloomberg carry trade index (i.e. the bond yield spread between the investment currency and the reference financing currency, divided by the volatility of the investment currency).[2] However, there was a joint downturn in the two sets of figures during the second half of 2024.

**Sustained bond investment activity has been supported through other channels than the traditional determinants (US monetary policy, yield spreads and growth performance).** The other most likely sources are international bond issues (which were steady throughout 2024) and institutional investors which are not just looking to make carry trade transactions when investing (sovereign funds).

1 This is only the case, with very few exceptions, for emerging countries. This is not the case for developing countries, many of which have seen their risk premiums on dollar-denominated financing rise. As a result, their vulnerability has increased all the more, as they will be hit with the cuts to development aid announced by the US administration.

2 The sensitivity of bond investment flows (in % of GDP) to the carry trade index is 0.4 according to our estimates on a panel of 15 main emerging countries (excluding China), which means that a permanent 100 basis increase in bond yield spread (scaled by volatility) generates USD 25 bn in bond inflows over a year.

In 2025, developments in the traditional determinants will have a neutral impact (with the increasingly likely prospect of monetary *status quo* in the United States), or will adversely affect (downgraded growth forecasts) bond investments. In addition, the geopolitical risk is rising due to the Trump administration's trade and foreign policy. . This could lead to higher currency volatility, which would then reduce the appeal of carry trade transactions. In addition, geopolitical uncertainty could prompt institutional investors with a long-term investment strategy to shift their diversification policy more towards dollar-based support. The uncertainty could even lead central banks in emerging countries that have initiated monetary easing to be more cautious.

**As a result, financing conditions for emerging countries could tighten this year.** However, the adverse impact on emerging economies should be viewed in perspective, given the low transmission of the two recent external shocks (the tightening of US monetary policy in 2022 and the election of Donald Trump at the end of 2024) to interest rates. The main source of risk comes from the depreciation of exchange rates. However, once again, the impact should not be overestimated at least for non-financial private borrowers.[3] Contrary to common belief, companies and households do not have a great deal of foreign currency debt, and they no longer have as much debt as they did at the end of 2019 or even at the end of 2015.

Households generally have a minimal amount of foreign currency debt (1% of GDP on average, 0.2% for the median and a maximum of 2.9% on a sample of about forty countries), as regulations in many countries prohibit it. For companies, a distinction must be made between external debt and domestic debt in foreign currencies, as the latter is the main source exposure to fx risk in particular. This is because the external debt of non-financial companies, which are often very large companies (or multinationals, is frequently covered by income in foreign currencies from exports of goods and services. Therefore, at an aggregate level, external debt is a source of foreign exchange exposure if the ratio is high and if it drifts upwards. However, when using both the data from the IIF and the Bank of International Settlements, this ratio of external debt-to-G&S exports was 13.1% on average in September 2024, and 11% for the median (with very high variability, however, the maximum ratio is 85%). The average and median for this ratio are currently lower than they were at the end of 2019 and at the end of 2015. Finally, non-financial companies' domestic debt in foreign currencies is moderate (5.9% of GDP on average, 10.6% on the median) and the ratio has also fallen over the past decade.

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**Data visualisation and cartography: Tarik Rharrab**

3 For sovereign borrowers, the assessment is more mixed. Foreign currency indebtedness has increased over the last decade and is high for a number of Latin American countries. It is also high for Egypt and Türkiye (but for Türkiye, domestic financing can easily replace external financing). On the contrary, foreign currency indebtedness is low for Asian countries and Central European countries. See Emerging markets: which sovereign debts are most vulnerable to rising global financial volatility? by Lucas Plé.

The GCC States, which are all oil- and gas-producing countries, also have dollar debt but their income provides a natural hedge against the risk of dollar appreciation. Besides, Bahrain would not theoretically be supported by Saudi Arabia.