RBC Global Asset Management

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Emerging Markets - This Time It's Different

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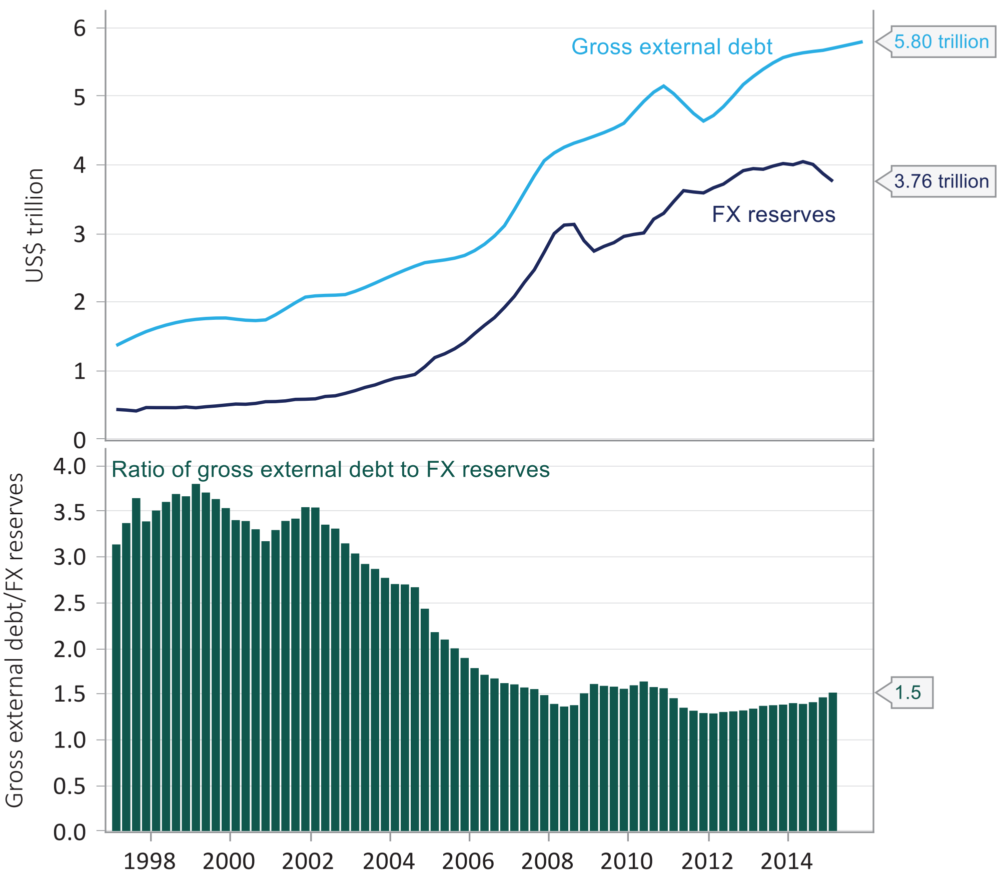
A better fundamental picture within emerging market economies today means a return to a 1997-style crisis seems unlikely.

Emerging market (EM) economies and financial assets are currently being buffeted by a perfect storm of fears of a China-led downturn in global growth, falling commodity prices and the prospect of higher U.S. interest rates and dollar. Some commentators have suggested that EM face a crisis similar to 1997-98 when currency crises that began in Asia culminated with the Russian rouble default in August 1998. Comparisons with 1997-98 distort rather than illuminate the current challenges facing emerging economies and investors. In our opinion, EM fundamentals are very different now to then and the likelihood of a systemic liquidity and solvency crisis is low.

We believe the rise in emerging economies' external indebtedness has been matched by the rise in EM foreign exchange reserves. Gross external debt has risen more than four-fold to US$5.8 trillion according to Fitch Ratings, though crucially much of the increase has been driven by foreign investment in local currency denominated government bonds and has been more than matched by the increase in export earnings. Moreover, EM (ex-China) total foreign exchange (FX) reserves currently stand at almost US$3.8 trillion compared to less than US$0.5 trillion in 1998. As shown in the lower panel in the chart below, the ratio of gross external debt to FX reserves has fallen from around 3.5 times to 1.5. Many EMs are well-placed to absorb 'sudden stops' in capital flows and if necessary fund the re-financing of foreign borrowing by domestic corporations that are generally less leveraged than their developed market peers.

Emerging Markets (ex-China) External Debt & International Reserves

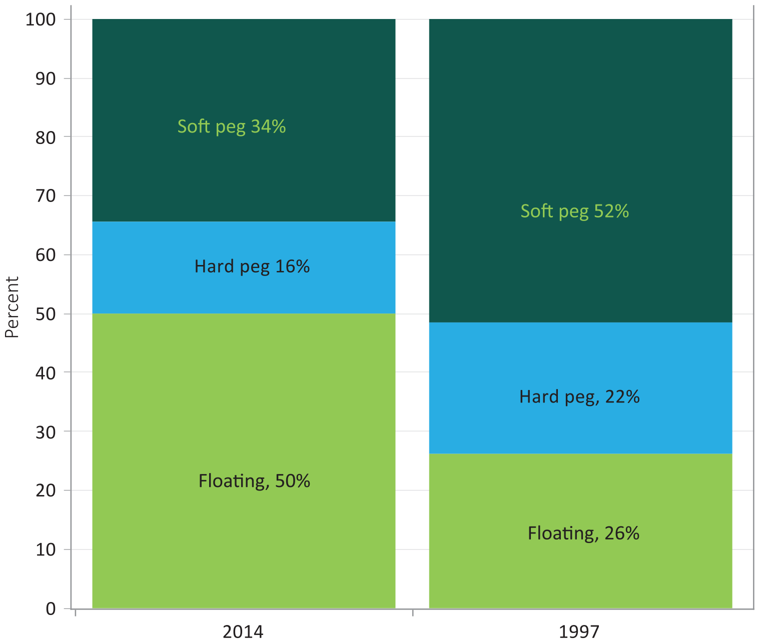


Note: Gross external debt includes local currency denominated debt held by non-residents as well as foreign-currency denominated debt. EM constitutes emerging and developing countries excluding China.

Source: Macrobond; IMF; Fitch Ratings; BlueBay calculations; latest data at 2015 Q1

Today half of EM economies operate under free or managed floating exchange rate regimes, while in 1997 three quarters had 'hard' or 'soft' exchange rate pegs (see the chart below). The apparent stability of these exchange rate pegs proved illusory as they encouraged a build-up of foreign currency denominated debt, often short-term and unhedged. Moreover, necessary exchange rate adjustment in response to economic 'shocks' were delayed, exacerbating macroeconomic imbalances. Unsustainable fixed exchange rate regimes that were prevalent across major EMs during the 1990s ended in currency crises that quickly became sovereign and corporate financial crises.

Emerging Markets: Exchange Rate Regimes



Note: Note: 32 countries covered by analysis: Argentina, Brazil, Bulgaria, Czech Rep., China, Colombia, Egypt, Ecuador, HK, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Panama, Peru, Phillipines, Poland, Russia, Singapore, South Africa, Sri Lanka, Thailand, Turkey and Venezuela.

Hard peg includes currency unions, currency boards and "dollarization"; soft peg includes fixed and cralwing pegs; floating covers free floating and managed floats with no pre-determined path

Source: IMF; Fitch; data at August 2015

More flexible exchange rate regimes and the development of local debt markets have transferred much more of the currency risk from the domestic economy to investors (painful though that is). Combined with ample foreign exchange liquidity, economies are much better placed to absorb as well as ultimately benefit from weaker currencies. Gains in international competitiveness have in aggregate totalled some 15% since mid-2011, partially offsetting the impact of weak external demand on export performance.

More resilient corporate and sovereign balance sheets and flexible exchange rate regimes act as shock-absorbers, providing economies and policy makers time to adjust to a less favourable global economic environment. A key challenge for investors is to correctly identify those economies with the political will and capacity to effectively manage the macroeconomic adjustment and implement 'second generation' structural reforms necessary to boost long-term growth potential.

The extraordinary easy monetary policies of the U.S. and other major central banks and the global hunt for yield fuelled macro-financial imbalances in several emerging economies. Less commodity and trade-intensive global growth has rendered the adjustment more difficult for many EMs. Emerging economies face a period of sub-par growth and heightened policy and political risk as they adjust to the changing global economic and financial environment, prompting a re-rating of EM assets. The sovereign credit profiles of some countries will likely deteriorate until the adjustment is complete. But a 1997-98 style EM crisis remains a tail risk that value-driven investors are right to largely discount.

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