CAN EMERGING MARKETS WITHSTAND GLOBAL MONETARY TIGHTENING?

Global central banks—the U.S. Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ)—have stopped easing. There is little doubt that monetary policy tightening will follow. Only the pace is uncertain. The question now is, can emerging markets (EM) thrive when global monetary conditions tighten? We believe the answer is yes.

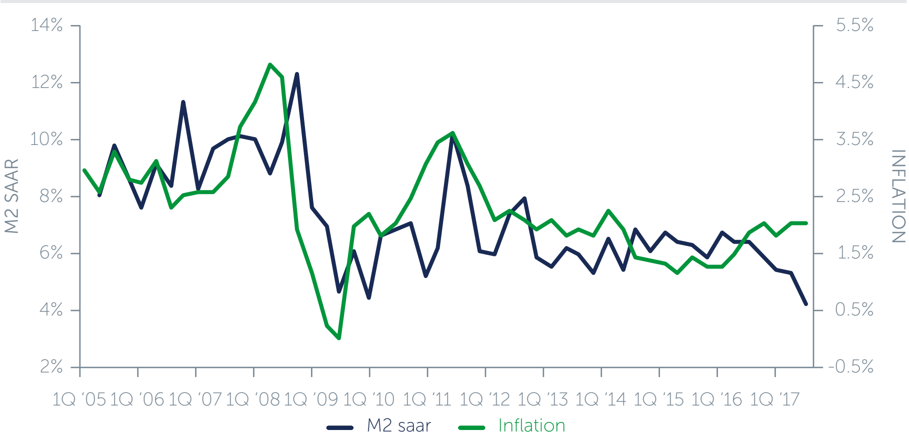
Have global monetary conditions really been that easy?

Since the Great Financial Crisis (GFC), a large number of economic commentators have confused central bank action with global monetary conditions. While there is no doubt that central banks have eased money aggressively post 2008, it is less clear that global monetary conditions have actually been easy. In fact, if one judged global monetary conditions by the global supply of money aggregate (M2), one could argue that global monetary conditions have been tighter following the GFC than they were before. Global M2 growth has fallen from 9.5% per annum from 2005–2008 to 6.3% from 2009–2018. Using this method, it is not surprising that global inflation has been so well behaved (FIGURE 1).

Taken at face value, figure 1 also suggests that global central banks should be in no rush to tighten—something that cannot be denied given the lengthy time that both the Fed and the ECB have underachieved their inflation targets.

But even if global monetary conditions have not been as easy as commonly believed, and assuming that central banks will tighten monetary conditions at a somewhat faster pace, does that mean now is not a good time to invest in EM—especially considering that EM currencies are the most sensitive asset class to global monetary conditions? On the contrary, we believe EM remain quite attractive.

FIGURE 1: GLOBAL M2 GROWTH AND GLOBAL INFLATION (ANNUAL PERCENTAGE CHANGE)



SOURCE: *BLOOMBERG PROFESSIONAL, HAVER AND BARINGS LLC. AS OF FEBRUARY 2018. GLOBAL M2 IS THE GLOBAL SUPPLY OF MONEY AGGREGATE.*

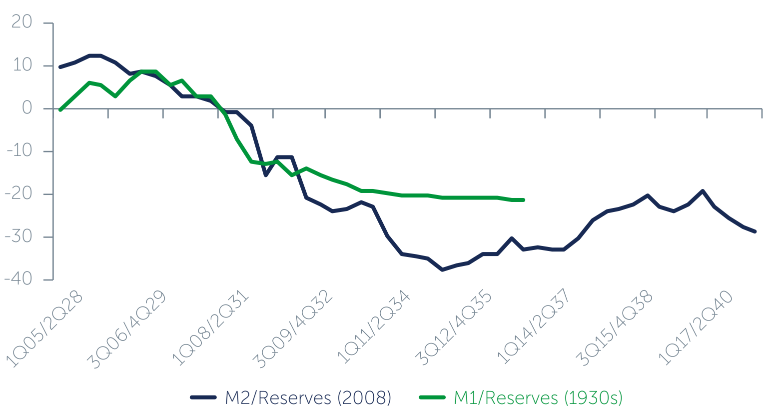
Highlights

- In assessing the investment case for EM assets, focusing only on central banks' expected actions could be very misleading.
- It is unclear how much EM assets benefited from quantitative easing, making it difficult to argue that they will suffer without it.
- A global environment where central banks tighten but commercial banks regain strength could be very supportive of EM assets.

FIGURE 2: EMERGING MARKETS NON-FDI FINANCIAL FLOWS (CUMULATIVE SINCE 2008)

SOURCE: *HAVER ANALYTICS AND BARINGS LLC. AS OF FEBRUARY 2018.*

FIGURE 3: GLOBAL BANKS MONEY MULTIPLIER (CUMULATIVE, IN LOGARITHMIC POINTS)



SOURCE: *BIS, FED, ECB, AND IMF WEO. AS OF FEBRUARY 2018.*

FIGURE 4: GLOBAL BANKING LEVERAGE (NET OF FED AND ECB)

SOURCE: *BIS, FED, ECB, AND IMF WEO. AS OF SEPTEMBER 2017*

Upending conventional wisdom about EMs

It was in anticipation of ECB easing and in its early stages (post 2013) when EM currencies fell the most. It is therefore difficult to argue that in the absence of quantitative easing, EM currencies and other EM assets will suffer, given that it is unclear how much they actually benefited from it.

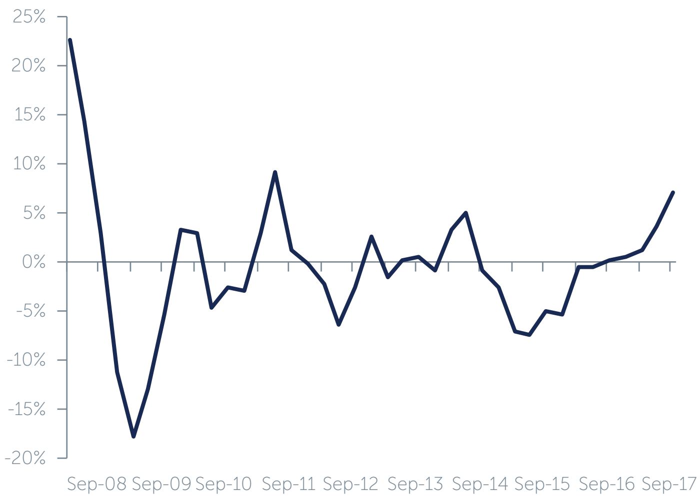
This observation is confirmed by looking at EM financial inflows net of foreign direct investment (FDI). Quantitative easing did not result in an acceleration of flows into EM. The big jump in financing inflows into EM occurred in the first two years following the GFC, when EM received $750 billion in financial inflows net of foreign direct investments. During the most aggressive Fed, ECB and BoJ balance sheet expansions, EM inflows slowed down to slightly over $100 billion a year (FIGURE 2).

Where has all the money created by global central banks been going? As important as central banks are in determining global monetary conditions, they only control reserve money, with commercial banks completing their work through the money multiplier. Following the GFC, global banks contracted M2 twice as much as during the Great Depression (FIGURE 3). Had it not been for central banks' aggressive monetary action, the world would likely have experienced another great depression.

Bank of International Settlements data make the same point. The ratio of global banks' foreign claims (ultimate counterparty) to global GDP (IMF/WEO data), net of ECB and Fed assets (our measure of global bank leverage), shows how much less levered the global banking system is than before the GFC (FIGURE 4).

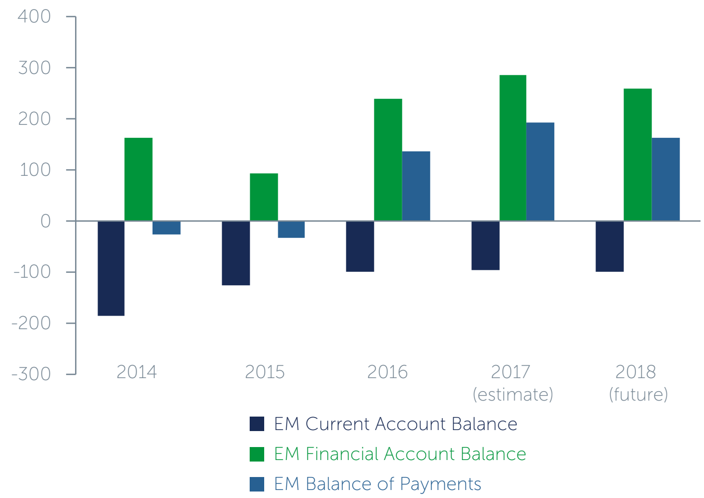
Focusing only on central banks' expected actions in deciding whether or not to invest in EM assets could be very misleading. Since the GFC, commercial banks have been undoing what central banks have been creating; alternatively, central banks have been filling the gap created by commercial banks. At present, there are tentative signs of global bank re-leveraging (FIGURE 5). Should our assessment be correct about global monetary conditions not having been particularly easy, future central bank tightening will only need to be fast enough to partially compensate for commercial bank re-leveraging, while keeping the pace of global M2 growth on an even keel.

FIGURE 5: GLOBAL BANKS FOREIGN CLAIMS (ANNUAL CHANGE IN US$)



SOURCE: *BANK OF INTERNATIONAL SETTLEMENTS. AS OF SEPTEMBER 2017.*

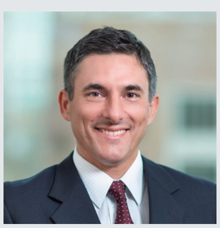
FIGURE 6: EMERGING MARKETS ACCOUNT BALANCES



SOURCE: *HAVER AND BARINGS PROPRIETARY FORECASTS.*

An ideal environment for EMs?

A global environment where central banks tighten but commercial banks regain strength will be close to an ideal environment for EM assets, in our view. As shown in figure 6, we forecast EM net financing needs to be $100 billion in 2018 (current account balance). We anticipate foreign direct investment inflows (FDI) into EM of around $200 billion; FDI flows have historically been stable and unaffected by global monetary policy conditions. We expect global financing flows net of FDI to slow down from $80 billion in 2017 to about $60 billion in 2018. As a result, even in a world where global central banks tighten, EM should receive $160 billion in excess of their 2018 financing needs. EM asset prices could be very well supported in such a global environment.



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