Monthly Comments – Emerging Markets

MacroFinance Research – April 2021

Key Messages

Country Focus – Egypt: enduring resilience amidst structural bottlenecks

Egypt has displayed a surprising economic resilience, at a time of extraordinary economic challenges caused by Covid-19. It is one of the few EMs that have recorded a positive GDP growth thanks to a partial lockdown, adequate domestic policy measures, and international financial support. Meanwhile Egypt has persistently faced elevated political risk, high dependence on commodities, and repeated debt restructuring. However, these risks are unlikely to manifest in the short-term given the strong economic resilience. Going forward, Egypt's favorable Overall Index of Sensitivity to Post-Covid Transition, with low Credit Sensitivity (high forex reserves, contained corporate indebtedness, and manageable sovereign risk), contained Covid-19 situation, favorable global oil prices, and expected rebound in international trade and tourism will aid the cyclical recovery to pre-Covid levels in 2021-22.

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RiskWatch – Capital flows in EMs: riding the roller coaster

Overall US financial conditions have become less accommodative with the rapid increase in US long-term interest rates and the stop in USD depreciation. However, the current context is quite different from the *taper tantrum* observed in 2013-2014: (1) Fed Funds rates will remain unchanged at zero-level for long (at least until mid-2022), and (2) acceleration in activity in the US is expected to be much stronger in the next quarters than it was during the taper tantrum. The impact on Emerging Markets should also be very different from the 2014-2015 period of sudden dry-up of capital inflows. Indeed, our quantitative models using our macro-scenario as key assumptions show that overall capital inflows should remain substantial in 2021 at USD 900bn for the year. However, the relative attractiveness of EM compared to the US will progressively decline, resulting in a gradual reduction in capital inflows during the second part of 2021 and a relative stabilization at lower levels in 2022.

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As always, readers are most welcome to come back to us for further details or clarifications.

Completed on April 14, 2021.

Country Focus – Egypt: enduring resilience amidst structural bottlenecks

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Economic resilience during the pandemic…

Egypt is one of the few emerging economies to display extraordinary resilience in the event of unprecedented challenges due to Covid-19. Given the scale of the pandemic, there was slowdown in economic growth in 2019-20, but it remained positive (at +3.6% y/y).

Indeed, our Index of Sensitivity to Post Covid Transition for Egypt is favorable, indicating a faster transition to pre-covid levels as early as 2021-22. The country displays a very strong *Resilience* component (among the 10 top performers in our 100 countries) and a relatively low *Credit Sensitivity*, thanks to limited corporate indebtedness.

Index of Sensitivity to Post-Covid Transition – Credit, Growth & Resilience

from 0 (best) to100 (worst)

	Egypt	Rank from worst out of 100 countries
Liquidity Index	41	51
Shock to corporates	38	54
Shock to Sovereign	53	53
Gross Credit Risk	46	64
Credit Sensitivity	**37**	**66**
Covid-19 Situation	55	52
Lockdown Stringency	57	24
Monetary support	60	12
Fiscal support	70	30
International transmission	53	50
Growth Sensitivity	**55**	**28**
Resilience Growth 2020	33	91
Timeline to recovery	40	81
FX rate and volatility	12	67
Resilience	**29**	**93**
Overall Index	**42**	**61**

Source: TAC ECONOMICS

a) …due to contained health situation and adequate policy support

Economy was supported by the country not going into full lockdown, non-essential businesses remained open with reduced hours. In addition, the government announced significant fiscal measures (1.8% of GDP) to support households and corporates, through an extension of cash transfer programs (Takaful and Katama) among other programs on deferrals on debt payments; tax relief for key industries and lowering energy costs for industrial sector. Meanwhile, the Central Bank of Egypt reduced the policy rate by 400bps in 2020 (to 8.25%) and announced waivers and support to the tourism industry (12% of GDP).

b) …and steady support from international community

Egypt historical privileged access to international funding came to rescue even during the pandemic - funding from IMF (USD 8bn) and an UAE-led consortium (USD 2bn). In addition, the Egyptian Treasury's international bonds were oversubscribed (USD 5bn in May 2020 and USD 3.75bn in Feb. 2021).

Strong cyclical recovery despite inherent fault lines

Egypt faces few persistent risks: a precarious political climate (frequent regime changes in past decade); the high dependence of commodities and its history of repeated debt restructuring. Moreover, structurally, Egypt's persistent poor business environment and low investment levels have impinged on growth potential. However, since currently there are very few triggers to destabilize the political climate, these risks can be considered 'strongly-present with low materialization'.

Hence, going forward, aiding Egyptian transition post Covid-19 are its large foreign currency reserves (USD 40bn at end-2020) reducing the volatility of the Egyptian Pound (although it is currently overvalued against main competitors), low corporate indebtedness and contained sovereign debt. Moreover, the health conditions are improving (daily infections below 800 as of April 13, 2021 and roll-out of the government's vaccination program). Thus, the consequent ease in movement restrictions will increase domestic consumption (as indicated by the positive dynamic of our leading indicator for domestic demand).

Meanwhile, there is a positive outlook for global trade (after the new wave of infections subsides), along with favorable Brent prices (65$/bl in 2021) and expectations of rebound in tourism. In addition to these factors, new agreements to explore oil and natural gas will boost the cyclical recovery: pick-up to pre-Covid-19 growth in 2021/22 (+5.5% y/y) from a weaker 2020/21 (+2.5% y/y).

RiskWatch – Capital flows in EMs: riding the roller coaster

Overall US financial conditions have become less accommodative with the rapid increase in US long-term interest rates and the stop in USD depreciation. However, the current context is quite different from the taper tantrum *observed in 2013-2014: (1) Fed Funds rates will remain unchanged at zero-level for long (at least until mid-2022), and (2) acceleration in activity in the US is expected to be much stronger in the next quarters than it was during the taper tantrum. The impact on Emerging Markets should also be very different from the 2014-2015 period of sudden dry-up of capital inflows. Indeed, our quantitative models using our macro-scenario as key assumptions show that overall capital inflows should remain substantial in 2021 at USD 900bn for the year. However, the relative attractiveness of EM compared to the US will progressively decline, resulting in a gradual reduction in capital inflows during the second part of 2021 and a relative stabilization at lower levels in 2022.*

About to experience taper tantrum 2.0?

The taper tantrum episode in 2013-2014 resulted in a drastic dry up of capital inflows to Emerging Markets. Indeed, US monetary tightening along with increasing risk aversion weighed on EM attractiveness for international investors.

The current international financial environment is characterized by a rapid steepening of the US yield curve (increase in US 10-year Treasury rate and still accommodative US monetary policy). However, the current context is quite different from the taper tantrum observed in 2013-2014 in at least three main ways:

(1) Fed Funds rate will remain unchanged at low levels for long (at least until mid-2022), whereas the taper tantrum was characterized by the expectations of increasing short-term interest rates in the US;

(2) Acceleration in activity in the US is expected to be much stronger in the next quarters than it was during the taper tantrum, at least partly pulling the rest of the world;

(3) Commodity prices were clearly on the decline at the time. Our scenario for the next quarters is that prices stabilize at comfortable levels during most of 2021 and early 2022.

Key drivers of capital inflows

We use three separate econometric models, on four major components of private capital flows: FDI, debt, equity and other inflows[1] to the 10 key EM[2]. The models are calibrated on quarterly data from 2005Q1 to 2020Q4. Overall, the statistical quality is very strong.

Theoretical, academic and applied research into capital flows into EM broadly converges in grouping the key explanatory factors in four broad categories:

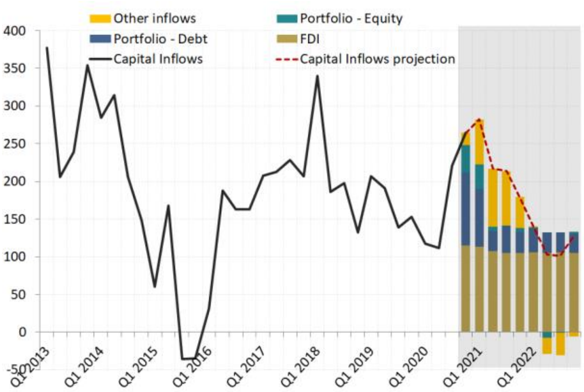
- Factors related to economic growth and activity (including the differential with mature economies), with the simple assumption that fast / faster growth attract both physical and financial capital.
- Factors related to financial conditions and returns (interest rate differentials, asset markets' valuations differentials and dynamics, exchange rate), here again reflecting the simple logic behind capital allocation.
- Factors related to commodity prices (oil, other commodities), as a large share of FDI is concentrated in the mining and energy sectors, and as swings in prices affect both the expected return of such mining investments, but also the domestic economic and financial performances of commodity exporters, hence impacting also portfolio investors.
- Factors related to global risk aversion or appetite, which we try to capture by using indicators like the VIX index or EMBI+ spreads over US Treasury rates.

Capital flows supportive in 2021

Overall capital flows into the 10 Key EM averaged about USD 200bn per quarter between 2017 and 2018; they declined afterwards to USD 150bn in 2019Q4 on the back of the US-China trade war.

Capital inflows projection

10 Key EM (bn USD)



Sources: Datastream, TAC ECONOMICS

When the Covid-19 pandemic emerged early 2020, another USD 50bn decline was registered (USD 100bn in 2020Q2), largely related to a massive pause in FDI (divided by two during 2020H1). Despite all the worries about a stampede exit of capital from Emerging Markets at the time, we note that the aggregate decline in capital

[1] Such *other inflows* are mostly international banks' loans to EM borrowers

[2] China, India, Indonesia, South Korea, South Africa, Turkey, Poland, Russia, Mexico, Brazil

flows was actually much milder than during 2015-2016, and far away from the massive outflows observed in the wake of the global financial crisis in 2008-09.

With the materialization of V-shaped economic profile related to the pandemic, 2020H2 was the scene of a spectacular surge in capital inflows to the 10 Key EM, more than compensating 2020H1 collapse: FDI inflows were rapidly back to "normal" (above USD 100bn in 2020Q3 and Q4), and portfolio inflows increased massively, notably for bonds (from zero in 2020Q2 to USD 100bn in 2020Q3), in relation with the ultra-low yields seen then in mature markets.

Looking forward, our tools suggest that the combination of better cyclical performances in EMs associated with a declining relative attractiveness compared to mature markets (US turbo-charged acceleration and rising government bond yields) would lead to a progressive decline in total capital flows into EMs over 2021-2022.

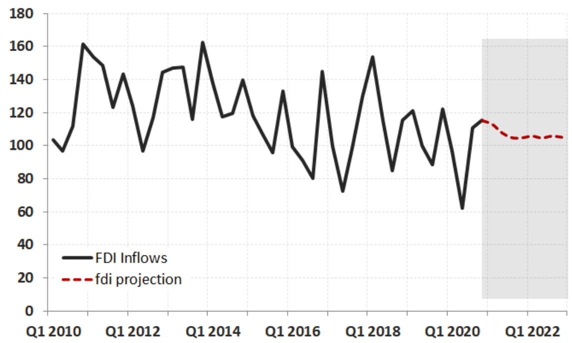
FDI inflows should stabilize close to their historical level (above USD 100bn per quarter on average) due to substantial growth expected in EM in 2021 associated with comfortable commodity prices.

After a spectacular surge since a trough in 2020Q2, flows into fixed-income instruments should revert as the long-term interest rate differential between EM and US will progressively lose attractiveness. Portfolio equity inflows and other capital inflows would rapidly exhaust in 2021 and remain very low in 2022 (near zero or even negative figures) on the back of increasing risk aversion on financial markets and arbitrage in favor of the US.

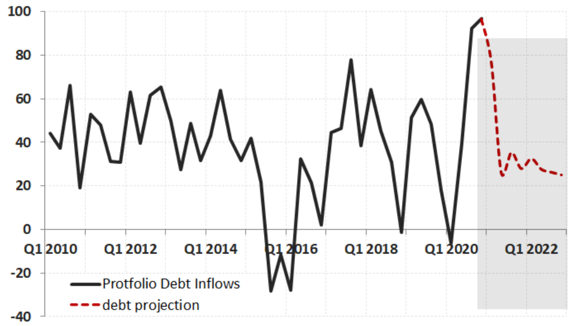
The expected reversal in financial inflows is fully consistent with our call for a change in US monetary policy guidance towards normalization at the end of 2021.

Overall, capital inflows would reach almost USD 900bn in the 10 Key EM for the whole year 2021 (i.e. close to levels observed in 2013 and 2014), before rapidly decreasing below USD 500bn in 2022, even though capital flows will remain substantially above the historical lows (global financial crisis, taper tantrum).

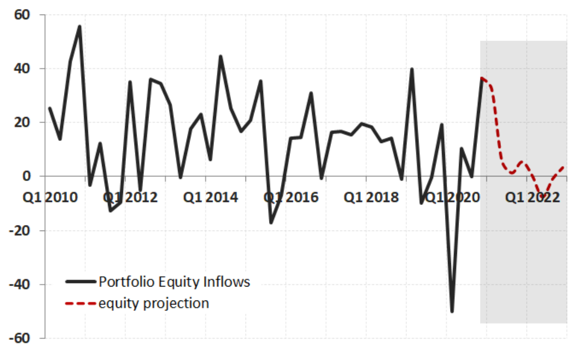
FDI inflows projection
10 Key EM (bn USD)



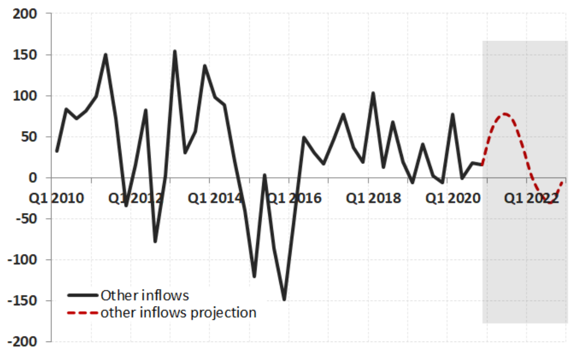
Portfolio Debt inflows projection
10 Key EM (bn USD)



Portfolio Equity inflows projection
10 Key EM (bn USD)



Other inflows projection
10 Key EM (bn USD)



Sources: Datastream, TAC ECONOMICS

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