Monthly Comments – Emerging Markets

MacroFinance Research – May 2021

Key Messages

Country Focus – Brazil: enduring pandemic slows economic recovery

The economic growth prospects for Brazil narrowed in 2021 as the Covid-19 cases remain unabated, well into 2021Q2, and the policy space is reducing due to exhaustion of massive fiscal spending in 2020 and significant monetary tightening by the Central Bank (to bring down heightened inflation levels). However, the economic growth would still be supported by the competitive currency, expanding exports, favorable global oil prices along likely reduction in Covid-19 infections (in 2021H2). Going forward, the pandemic will heighten Brazil's risks in the upcoming years by deepening its structural weaknesses (low investment and poor business environment), increase its political fragility while the public debt is already much heightened. These factors will stymie any robust economic growth prospects for the next few years.

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RiskWatch – Banking sector in EMs: absorber or amplifier of the pandemic shock?

In times of economic crisis, the banking sector can either act as a shock absorber thanks to its structural strengths or it can amplify the economic shock if its pre-existing fundamentals are weak (high domestic leverage and poor quality of loans). Since the domestic leverage in the EMs was stabilized (in relation to economic growth) for around four years before the pandemic, there has not been any broad or significant accumulation of banking sector risks in most regions. At regional level, MENA and Asia display higher banking vulnerabilities, hence facing heighted vulnerabilities to global uncertainties (speed and breadth of global recovery, tightening in financial conditions). When combining several identifiers (rapidly deteriorating credit leverage, insufficient capital adequacy, and massive recession), 11 EMs are at risks of serious of upcoming banking difficulties: Algeria, Bahrein, Bolivia, Brazil, Chile, Morocco, Mauritius, Malaysia, Sri Lanka, and Venezuela (with at least 2 of the 3 unfavorable markers), along with Angola, because of specific combination of large currency depreciation and excessive external funding for banks' refinancing.

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

Completed on May 19, 2021.

Country Focus – Brazil: enduring pandemic slows economic recovery

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Yet to be controlled Covid-19 situation

The unfolding of Covid-19 continues to impact the economic growth dynamics in Brazil, where a previously estimated stronger recovery in 2021 is currently diminished. The level of new infections since early 2021 remains unabated (around 65k daily cases, 7-day average, as on May 18), with the country recording second highest number deaths globally (439k). The inoculation program is mired in obstacles and only 8% of the population is fully vaccinated as of May 18 (17% of total population received at least one dose).

However, unlike last year, aiding the cyclical revival is the partial and localized mobility restrictions that ensured functioning of non-essential businesses. Indeed, even while the business conditions have softened, it has remained above average (Manufacturing PMI above 50 since Jun. 2020). Thereby, while a slowdown is inevitable in 2021H2, the pace of recovery is likely to pick up later in the year (provided the pandemic comes under control).

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

from 0 (best) to100 (worst)

	Brazil	Rank from worst out of 100 countries
Liquidity Index	28	70
Shock to corporates	87	10
Shock to Sovereign	45	75
Gross Credit Risk	51	48
Credit Sensitivity	**40**	**56**
Covid-19 Situation	88	11
Lockdown Stringency	32	62
Monetary support	41	50
Fiscal support	93	5
International transmission	25	95
Growth Sensitivity	**53**	**31**
Resilience Growth 2020	47	64
Timeline to recovery	29	96
FX rate and volatility	72	5
Resilience	**49**	**29**
Overall Index	**47**	**34**

Source: TAC ECONOMICS

Limited policy space dimming growth outlook

After a massive fiscal spending in 2020 (14% of GDP to be spent in 2020–2021), there are no new announcement matching the scale (even though the level of infections is significantly higher). Only a marginal portion from last year's fiscal stimulus will be available in 2021, hence negating fiscal spending as a catalyst for economic growth this year.

Moreover, the Central Bank has begun significant monetary tightening (Selic rate at 3.50% witnessed consecutive increases by a total hike of 150 bps in March and May). Further rate hikes are expected to rein in the elevated inflation (+6% y/y in March) caused by currency pass-through and higher producer prices (increasing global oil prices). Hence the tighter monetary space does not bode well for the already modest domestic demand and for the heavily indebted corporates.

2021 - Weak but not out

GDP growth would reach +3.8% y/y in 2021 and the Brazilian Real (BRL) is expected to experience successive episodes of appreciation and depreciation during 2021 and 2022 in an average range of USD/BRL 5.2-5.6, associated with still high volatility (sensitivity to rise in US bond yield, risk aversion). Irrespective of the challenges and reduced economic growth prospects (from previous estimates) for 2021 will still be a decent year for Brazil due to:

- technical rebound in activity accounted for base effect from 2020;
- improvement in the pandemic situation supported by unfolding of vaccination program;
- a global exit from Covid-19 is spurring international trade (Brazilian trade balance is at record highest in April at USD 10bn);
- improving global oil prices (Brent estimated at about 65$/bl for 2021);
- BRL is competitive despite its recent appreciation (-8% against the USD since mid-April) and sufficient forex reserves (almost USD 350bn in April) to buffer any excessive currency volatility.

With the raging pandemic and a narrow economic growth, the main risks for 2021 are for the highly indebted corporates facing heightened chances of default in the current tight monetary conditions. In addition, the dissatisfaction with the political handing of the Covid-19 situation is likely to witness social unrest in coming years, if not in the present year.

2022 – Risks will persist

After a year of modest growth in 2021, the impact from the pandemic in the medium-term would exacerbate Brazil's risks: enduring structural weaknesses (low investment, poor business environment), heavy public debt burden (100% of GDP even in 2020-end), growing social and political unrest (general election in Oct. 2022). That might well result in higher risks materialization for corporates and lower economic growth (GDP growth at +2.3% y/y in 2022, and long-run potential estimated at a mediocre 2.5%).

RiskWatch – Banking sector in EMs: *absorber* or *amplifier* of the pandemic shock?

In times of economic crisis, the banking sector can either act as a shock absorber thanks to its structural strengths or it can amplify the economic shock if its pre-existing fundamentals are weak (high domestic leverage and poor quality of loans). Since the domestic leverage in the EMs was stabilized (in relation to economic growth) for around four years before the pandemic, there has not been any broad or significant accumulation of banking sector risks in most regions. At regional level, MENA and Asia display higher banking vulnerabilities, hence facing heighted vulnerabilities to global uncertainties (speed and breadth of global recovery, tightening in financial conditions). When combining several identifiers (rapidly deteriorating credit leverage, insufficient capital adequacy, and massive recession), 11 EMs are at risks of serious of upcoming banking difficulties: ***Algeria****,* ***Bahrein****,* ***Bolivia****,* ***Brazil****,* ***Chile****,* ***Morocco****,* ***Mauritius****,* ***Malaysia****,* ***Sri Lanka****, and* ***Venezuela*** *(with at least 2 of the 3 unfavorable markers), along with* ***Angola****, because of specific combination of large currency depreciation and excessive external funding for banks' refinancing.*

Banking System in EM: a potential key risk factor

The Banking System Balance is a measure of the risks associated with imbalance in the overall banking situation of the country. In a period of crisis, the banking sector can either act as an absorber of shock or an amplifier of the crisis, fundamentally depending on its inherent capital strength, funding structure, and overall credit leverage.

In our Banking System Balance, we use these three main determinants, and combine them with a measure of *domestic leverage*, which incorporates both total credits distributed by banks and their capital strength (horizontal axis on the charts), and a measure of *foreign financing* that captures the degree of banks' refinancing through international borrowings in foreign currency.

While a low *domestic leverage* means that the transmission of cyclical shocks to the banking system is limited and real economic activity is somewhat protected from financial crises, it also constrains countries' growth during periods of global economic expansion and hinders recoveries in case of crises. In parallel, a depreciating currency coupled with high *foreign financing* portends high risk of losses in the financial sector related to potential currency mismatch in banks' balance sheets.

Banking System Balance: clear divergence across regions

Regional trajectories on the Banking System Balance since 2016 highlight five relevant features:

(1) Overall, no major change in *domestic leverage* was observed between 2016 and end-2020, as credit distribution matched the overall dynamic of nominal GDP growth and / or was associated with stronger capital buffers in banks. This is a major indication that the so-called "credit splurge" that was associated with policy response to the pandemic has not translated into broad deteriorations is risks supported by banking systems so far. The only exception is for MENA, mostly because the whole period 2016-2020 was associated with lower oil revenues partly compensated by faster domestic credit distribution.

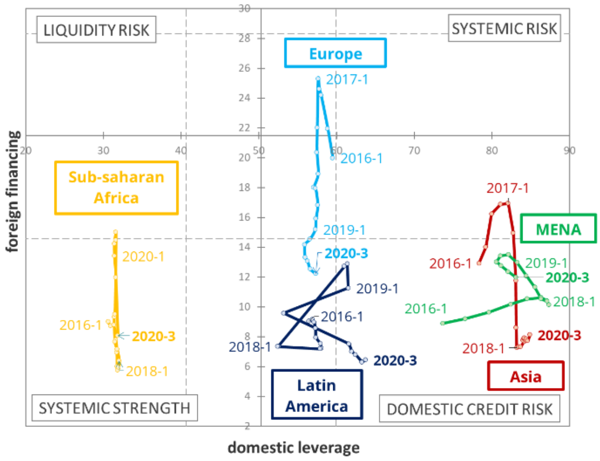
(2) Medium-term reductions in *foreign financing* are visible for all regions though with different magnitude and time-profiles; this clearly suggests lower sensitivity of banking systems to potential turbulences in currency markets.

(3) MENA and Asia are the two regions that exhibit *domestic leverages* much higher than our risk thresholds, thus pointing to higher vulnerability to an unavoidable increase in non-performing loans as a result of the pandemic-related economic shock.

(4) Conversely, Sub-Saharan Africa (SSA) is better positioned in a so-called *systemic strength* area, here implying that the relatively underdeveloped banking intermediation and significant improvement in domestic funding mobilization create a substantial shock absorber.

Banking System Balance

By Region



Source: TAC ECONOMICS

In Asia, while **China**, **South Korea**, **Taiwan**, and **Vietnam** have the highest *domestic leverage* (and mediocre equity-to-assets ratio), the overall banking risk is moderated by the low share of foreign funding, the fast post-pandemic economic recovery, and the appreciation of their currencies against USD. However, banking sectors in the **Philippines**, **Thailand**, and **India** are more likely to face difficulties because of the large economic recession, lingering uncertainties (massive pandemic resurgence in India, delayed pick up in tourism in South-East Asia) and already high *domestic leverages*.

The MENA region displays an ambiguous combination with high *domestic leverage* and *foreign financing* that remains close to the risk threshold. However, our metrics overstate the risks for most GCC countries (notably **Qatar**, **UAE**, and **Bahrain**, located in the highest risk area of the Banking System Balance) by not incorporating the foreign currency assets of the local banking systems and because of the role and size of offshore banking operations.

Latin American and European countries show on average an intermediate *domestic leverage* and receding *foreign financing*, thus well contained within the *domestic credit risk* area. Only **Brazil** and **Venezuela**, and to a lower extent **Turkey**, **Chile**, and **Bolivia**, have much higher credit leverage in the economy, thus vulnerabilities in their banking system has increased with the Covid-19 crisis in 2020.

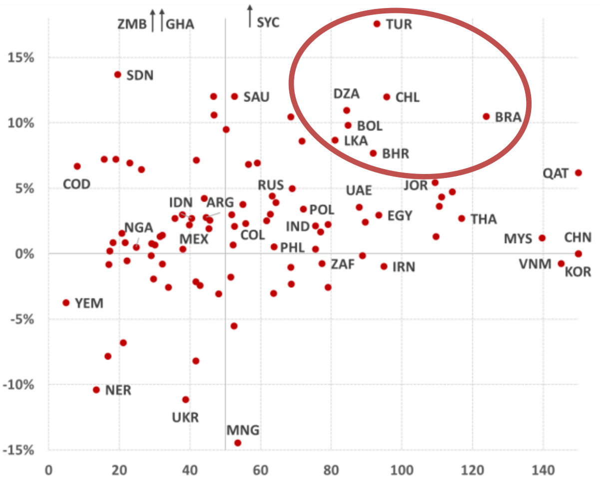
While the SSA region displays very low potential for banking risk materialization, its largest economy **South Africa**, as well as smaller ones like **Mauritius** and **Cape Verde** face relatively higher risks due to massive economic recessions in 2020.

Red flags in and for the banking industry

Substantial debt buildup in EMs during crisis due to large budgetary and monetary support leading to a large build up in credit supply, hence the total debt in EMs increased +16% y/y in 2021Q1 (up to around 245% of GDP[1]), mostly on account of sovereign and non-financial corporate sectors. After incorporating latest data for our synthetic index of relative credit supply in the economy, we clearly observe noticeable hikes in few largely indebted countries (upper right area of the below graph): **Brazil**, **Turkey**, **Chile**, **Algeria**, **Bolivia**, **Bahrain**, and **Sri Lanka**.

Domestic leverage

level and change from 2019Q4

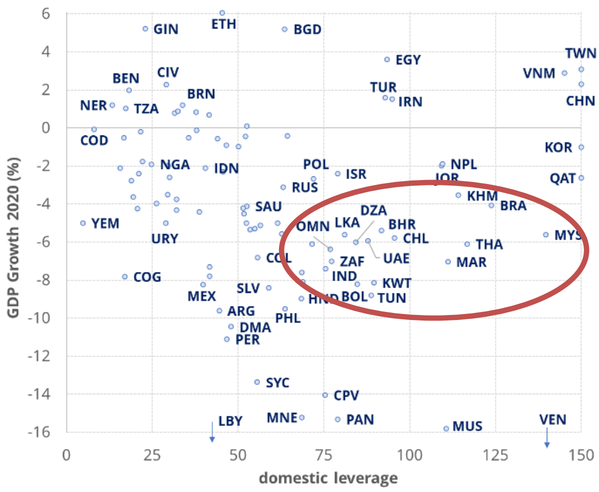


Source: TAC ECONOMICS

Significant currency depreciations can have a large impact on countries displaying excessive reliance on foreign currency refinancing in local banks' total liabilities. To illustrate this vulnerability, crossing the past movement of EM currencies (from beginning of 2020 till date) against the index of *foreign financing* allows to evidence **Angola** as the only country that registered a large depreciation of its currency (Kwanza up by 35% against USD since Jan. 2020), hence worsening external credits of domestic banks, while their asset quality has been severely impacted by the Covid-19 pandemic.

Severe activity shock and dependence on credit for domestic development greatly diminishes the ability of banking system as a shock absorber. This implies that banks' asset quality will also severely deteriorate, even more so when authorities will start tightening monetary stance and banking regulations. The next graph combines both *domestic leverage* and 2020 GDP Growth, with most vulnerable EM in the bottom-right with notably **South Africa**, **India**, **Argentina**, **Tunisia**, **Brazil**, **Malaysia**, etc.

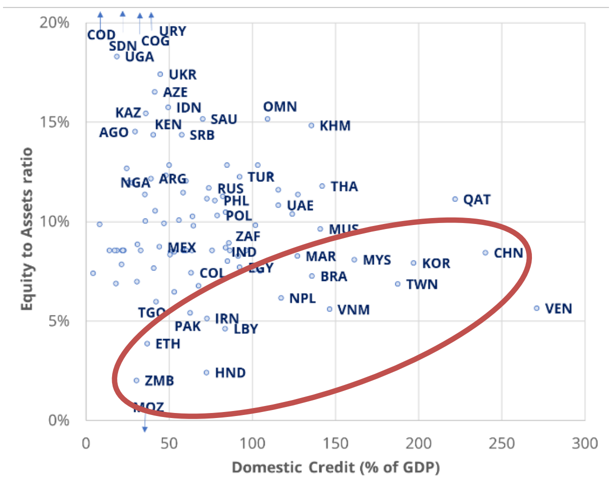
Domestic leverage and 2020 GDP Growth



Source: TAC ECONOMICS

Sufficient capital adequacy improves resilience capabilities of banks. Since our *domestic leverage* incorporates both the dynamics of credit-to-GDP ratio and the capital to asset ratio. This latter resilience component indicates that more heavily capitalized banking systems can better absorb shock for a certain level of credit leverage. in **Honduras**, **Pakistan**, **Nepal**, **Vietnam**, **Brazil**, **Morocco**, **Malaysia**, **Taiwan**, **South Korea**, and **China**, overall banking system resilience will be severely affected in case of mediocre capital buffers.

Domestic Credit and Equity to Assets Ratio



Source: TAC ECONOMICS

[1] Source: Institute for International Finance

Appendix 1: List of 100 countries monitored by alphabetical order of ISO3 Code

ISO 3 Code	Country Name
AGO	Angola
ALB	Albania
ARG	Argentina
ARM	Armenia
AZE	Azerbaijan
BEN	Benin
BFA	Burkina Faso
BGD	Bangladesh
BGR	Bulgaria
BHR	Bahrein
BIH	Bosnia
BLR	Belarus
BOL	Bolivia
BRA	Brazil
BRN	Brunei
CHL	Chile
CHN	China
CIV	Cote d'Ivoire
CMR	Cameroon
COD	DR Congo
COG	Rep. of Congo
COL	Colombia
COM	Comoros
CPV	Cape Verde
CRI	Costa Rica
CZE	Czech Rep.
DMA	Dominica
DOM	Dominican Rep
DZA	Algeria
ECU	Ecuador
EGY	Egypt
ETH	Ethiopia
GAB	Gabon
GEO	Georgia
GHA	Ghana
GIN	Guinea
GNB	Guinea Bissau
GTM	Guatemala
HND	Honduras
HRV	Croatia
HUN	Hungary
IDN	Indonesia
IND	India
IRN	Iran
ISR	Israel
JOR	Jordan
KAZ	Kazakhstan
KEN	Kenya
KHM	Cambodia
KOR	Korea

ISO 3 Code	Country Name
KWT	Kuwait
LAO	Laos
LBY	Libya
LKA	Sri Lanka
MAR	Morocco
MDG	Madagascar
MEX	Mexico
MKD	N. Macedonia
MLI	Mali
MMR	Myanmar
MNE	Montenegro
MNG	Mongolia
MOZ	Mozambique
MUS	Mauritius
MYS	Malaysia
NER	Niger
NGA	Nigeria
NPL	Nepal
OMN	Oman
PAK	Pakistan
PAN	Panama
PER	Peru
PHL	Philippines
POL	Poland
PRY	Paraguay
QAT	Qatar
ROU	Romania
RUS	Russia
RWA	Rwanda
SAU	Saudi Arabia
SDN	Sudan
SEN	Senegal
SLV	El Salvador
SRB	Serbia
SYC	Seychelles
TGO	Togo
THA	Thailand
TUN	Tunisia
TUR	Turkey
TWN	Taiwan
TZA	Tanzania
UAE	UAE
UGA	Uganda
UKR	Ukraine
URY	Uruguay
VEN	Venezuela
VNM	Vietnam
YEM	Yemen
ZAF	South Africa
ZMB	Zambia

Appendix 2: List of 100 countries monitored by region

Eastern & Central Europe, CIS (19)			
ALB	Albania	KAZ	Kazakhstan
ARM	Armenia	MNE	Montenegro
AZE	Azerbaijan	MKD	N. Macedonia
BLR	Belarus	POL	Poland
BIH	Bosnia	ROU	Romania
BGR	Bulgaria	RUS	Russia
HRV	Croatia	SRB	Serbia
CZE	Czech Rep.	TUR	Turkey
GEO	Georgia	UKR	Ukraine
HUN	Hungary		

Latin America (18)			
ARG	Argentina	SLV	El Salvador
BOL	Bolivia	GTM	Guatemala
BRA	Brazil	HND	Honduras
CHL	Chile	MEX	Mexico
COL	Colombia	PAN	Panama
CRI	Costa Rica	PRY	Paraguay
DMA	Dominica	PER	Peru
DOM	Dominican Rep	URY	Uruguay
ECU	Ecuador	VEN	Venezuela

Asia (18)			
BGD	Bangladesh	MNG	Mongolia
BRN	Brunei	MMR	Myanmar
KHM	Cambodia	NPL	Nepal
CHN	China	PAK	Pakistan
IND	India	PHL	Philippines
IDN	Indonesia	LKA	Sri Lanka
KOR	Korea	TWN	Taiwan
LAO	Laos	THA	Thailand
MYS	Malaysia	VNM	Vietnam

Middle East & North Africa (15)			
DZA	Algeria	MAR	Morocco
BHR	Bahrein	OMN	Oman
EGY	Egypt	QAT	Qatar
IRN	Iran	SAU	Saudi Arabia
ISR	Israel	TUN	Tunisia
JOR	Jordan	UAE	UAE
KWT	Kuwait	YEM	Yemen
LBY	Libya		

Sub-Saharan Africa (30)			
AGO	Angola	MDG	Madagascar
BEN	Benin	MLI	Mali
BFA	Burkina Faso	MUS	Mauritius
CMR	Cameroon	MOZ	Mozambique
CPV	Cape Verde	NER	Niger
COM	Comoros	NGA	Nigeria
COG	Rep. of Congo	RWA	Rwanda
COD	DR Congo	SEN	Senegal
CIV	Cote d'Ivoire	SYC	Seychelles
ETH	Ethiopia	ZAF	South Africa
GAB	Gabon	SDN	Sudan
GHA	Ghana	TZA	Tanzania
GIN	Guinea	TGO	Togo
GNB	Guinea Bissau	UGA	Uganda
KEN	Kenya	ZMB	Zambia

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