Monthly Comments – Emerging Markets

MacroFinance Research - April 2018

Key Messages

Country Focus – Mexico: likely monetary easing to support economic growth in a context of US tightening, political and trade uncertainty

The latest Mexican inflation data at 5.0% in March 2018 confirms disinflation pressures resulting from weak demand, the appreciation of the Peso (MXN) against the dollar since early-2017 and declines in fuel and food prices. This is consistent with recent movements in our Cyclical Balance and suggests that the Central Bank of Mexico (Banxico) will cut interest rates during the year, though not at the April 12 Monetary Meeting (Banxico held yesterday its key rate steady at 7.5%). In a context of high uncertainties related to the Presidential election in Mexico next summer and the outcome of current trade tensions worldwide, this expected monetary (and modest fiscal) easing should support the economic outlook notwithstanding the US monetary tightening, implying a modest MXN depreciation against the USD early 2019.

Read more on page 2…

RiskWatch - One Hundred!

With five countries newly added in our RiskMonitor set of tools, our world coverage reaches 100 countries among emerging markets and developing economies. Three of these five countries are from Sub-Saharan Africa (Guinea, Cabo Verde and Rwanda), one from the Caribbean (Dominica) and one in Southern Europe (Macedonia). All are either landlocked or small islands, hence facing specific developmental challenges. Their economic performances and risk metrics are highly heterogenous, from favorable global country risk premia around 200 basis points for Cabo Verde and Dominica to a very high 690 bp for Guinea, affected by a WatchList Indication of potential shock on economic activity over the medium-term.

Read more on page 3…

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

Completed on April 13, 2018.

Country Focus – Mexico: likely monetary easing to support economic growth in a context of US tightening, political and trade uncertainty

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Unimpressive economic performances despite strong risk fundamentals

Mexico has registered disappointing growth since 2013 (2.2% per year on average), partly related to structural / institutional factors, partly to Chinese competition combined with lower oil prices and fiscal constraints.

However, our favorable Economic & Financial Risk rating (33-B) reflects strong fundamentals from a risk perspective, with the (foreign) Debt and Banking System Balances providing most of the favorable inputs. Associated with sound macroeconomic policies, a flexible exchange rate regime, this allowed the country withstanding successive external shocks (2008/09 global crises, 2013 US *taper tantrum*).

After the 2017 economic slowdown (+2.0% for GDP growth), activity should trend modestly upwards as a result of (paradoxically) faster US / worldwide demand and external trade in 2017, of pre-elections spending and of increases in real wages. This would offset the impact of electoral, policy and trade uncertainties over the very short-term.

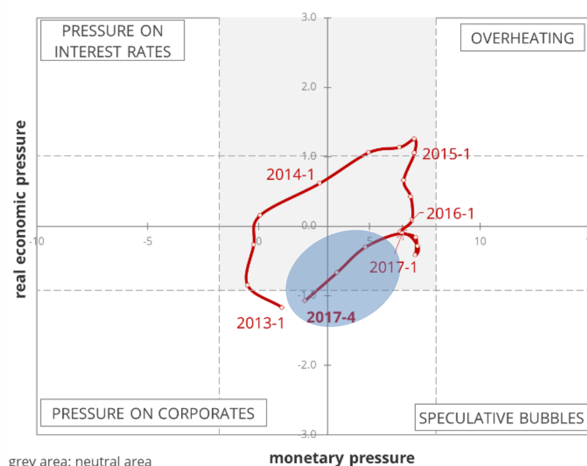
However, the update of the Mexican Cyclical Balance has shown a rather rapid move characterized by a simultaneous decline in *real economic pressure* and *monetary pressure* indexes, suggesting both a persistent disinflationary bias and a rapidly weakening domestic momentum in 2019.

Annual inflation declined to 5.0% in March 2018 (after 5.3% in Feb.) and is indeed expected to slow further towards 4% by the end of 2018, within the range of the Central Bank target (3% +/- 1 point).

Achieved partly through, the monetary tightening engineered since the first increase in Fed Fund rate in Dec.2015 (+450pbs since then to 7.5% on April 2018), this positive price performance should invite the Central Bank to ease somewhat its policy in the quarters ahead, especially if the USD remains broadly weaker.

Mexico – Cyclical Balance

The Cyclical Balance gives a view of the cyclical position and allows a measure of the quality of the economic policies, looking at the stance of monetary policy *(monetary pressure - horizontal)* and the domestic demand momentum *(real economic pressure – vertical)*



Source: TAC ECONOMICS

Domestic political uncertainty more likely than trade to weigh on financial and currency risks

The likely exclusion of Mexico from US taxes on steel and aluminum argues for relative optimism for a positive NAFTA deal. In parallel, the move of bilateral trade tensions towards Asia / China might bring benefits to Mexico in the context of growing regional trade, especially when taking into account the MXN competitiveness (a 30% competitive advantage, according to our Foreign Exchange Balance). In parallel, the traditional sensitivity to US monetary cycles is likely to be mitigated by the dollar weakness, expected to last until 2018 year-end.

Conversely, higher political uncertainties with the Presidential election (July 1st 2018) is likely to induce sharper capital movements and financial volatility. In parallel, monetary divergence would lead to a modest weakening of the exchange rate towards MXN 19.5 against the USD early-2019, compared to a current value of MXN 18.3, possibly after a last short-term appreciation move in the short-run.

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The table and chart below provide summarized characteristics of each country from a structural and overall risk perspective.

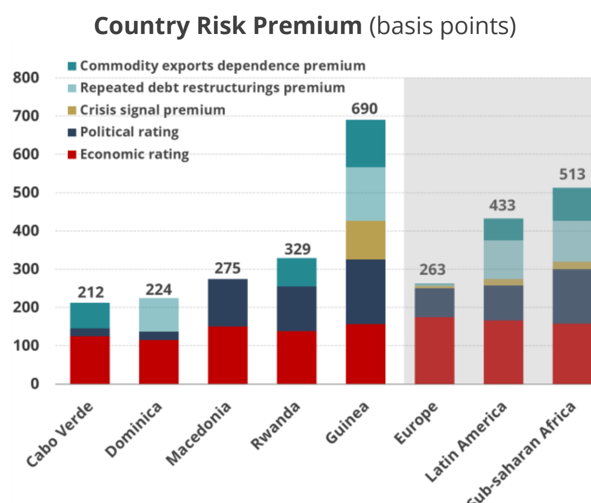
Structural features are highly heterogeneous, as probably best highlighted by the presence of two least-developed countries (Guinea Conakry and Rwanda, both with GDP per capita below 1,000$, associated with very rapid population growth, low degree of urbanization and lower life expectancy). Among the five, Macedonia shows a clearly insufficient investment effort despite an attractive ranking in the Ease of Doing Business. Finally, we note the high credit leverage and poor business environment in Cabo Verde.

For more details, the set of charts next page provide our synthetic polygons of performances for our six Fundamental Balances underpinning our Economic & Financial Risk ratings, with a comparison with their respective regional average. Key take-aways are highlighted and a short comment on development issues and recent performance is added.

Structural Data

	Cabo Verde	Dominica	Guinea	Macedonia	Rwanda
Population (mn)	0.5	0.1	13.0	2.1	11.8
Population growth (%)	+1.3	0.0	+2.5	+0.1	+2.6
Population 15-64 (% total)	65	67	54	70	57
Urban Population (% total)	66	70	38	57	30
Literacy Rate	87	92	32	98	71
Life Expectancy at birth (years)	72	77	59	75	67
GDP current (bn $)	1.7	0.6	9.2	11.4	8.9
GDP per capita ($)	3 213	8 592	708	5 500	754
Investment (%GDP)	40	23	23	14	25
Domestic Credit (%GDP)	86	34	23	55	19
Ease of Doing Business (rank / 190 countries)	127	98	153	11	41

Country Risk Premium (basis points)



Source: TAC ECONOMICS

Dominica at a glance:

Dominica with its tropical island climate and national parks has tourism as its highest source of revenue followed by exports of bananas. The country has insufficient infrastructure to support its tourism industry and is constantly hit by natural disasters. The country has 23% investment to GDP, which is directed towards infrastructure needs following the devastation after the hurricanes.

Dominica witnessed GDP growth at +3.1% y/y in 2017 (from +1% y/y in 2016). This favorable growth comes after the country has been hit by natural calamities two years in a row. Tropical Storm Erika disrupted 96% of the GDP and in 2017 hurricanes Irma and Maria caused damages about 225% of GDP. As a counter the government has been encouraging large scale projects (close to 40% of GDP in 2016) focusing on infrastructure.

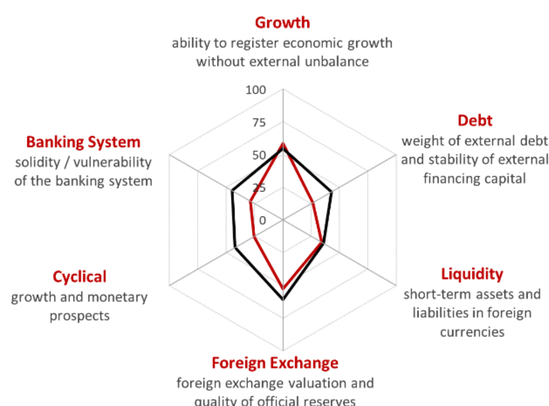
Owing to low growth, the inflation has remained low (at 0.6% in 2017) and the Central Bank, the Eastern Caribbean Central Bank (ECCB) retained the interest rates low (at 1.96% in 2016) to kick start the economy.

The external account deficit has widened (11.8% of GDP in 2016) since there is an increase in imports of goods and services with increase in investment. The country however continues to have sufficient reserves (USD 229mn in 2016) covering almost 8 months of imports. The currency, East Caribbean dollar is pegged to U.S dollar at USD/XCD 2.70 (since July 1976) as Dominica is a member of Eastern Caribbean Currency Union.

The biggest issue for Dominica is the disruption caused by frequent natural disasters that affects the main source of income from tourism industry and export of bananas. The banking sector although has excess liquidity (due to The ECCB's policy of Minimum Savings Rate), private sector lending is predominantly through Credit Unions since there is lack of information on quality of borrower's and high collateral. Such systemic vulnerabilities in this sector has led to high Non-Performing Loans (NPLs) which accounted for 17% of total loans in 2017. Additionally, large construction projects need timely completion to remove capacity constraints and improve business conditions.

Dominica - Risk Scores on Fundamental Balances

from 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

- Performances are much better than LatAm for three out of six balances, notably Banking System, Cyclical and Debt, and similar for the other three balances.
- Most worrying elements are Growth (mediocre growth with deteriorating external accounts) and Liquidity (stabilization in fx reserves).

Macedonia at a glance:

Macedonia has carried various reforms in the last decade and is an upper-middle income country. It depends largely on Europe as its key trading partner. The main sector in the economy is textiles, acting as primary source of export revenues. Investment constitutes only 14% of GDP given the precarious political situation since 2014 that normalized only in 2017.

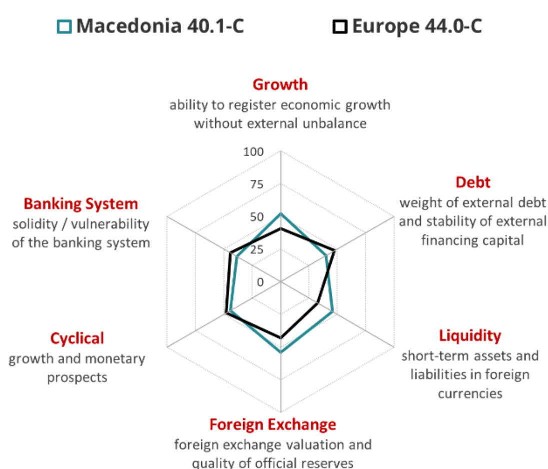
Coming out of political instability from 2014- mid 2017, growth moderated in 2017 (+1.2% Q4), meanwhile the trade balance increased (-2,048mn) reflecting the increase in economic activity as imports (USD 7,719mn) grew at faster rate than exports (USD 5,671mn) in 2017. However, the current account deficit narrowed (USD -128mn) with supportive energy prices. Inflation, although slightly rising, continues to be low (at +2.4% in 2017Q4). To propel economic growth, the Central Bank (NBRM) furthered the accommodative monetary policy in March 2018 by reducing its policy rate to 3.0% from 3.25%.

The banking sector in Macedonia with capital adequacy ratio at +8.0% (2016) has sufficient liquidity with low Non-Performing Loans (NPL) at +6.5%. The Macedonian Denar follows pegged exchange rate to Euro at around EUR/MKD 61.0.

The recent political coalition is fragile and the upcoming elections might trigger fresh political uncertainty, which would diminish the chances for attracting FDI. Although NPL is low in the banking sector, the non-financial sector lending constitutes 12% of GDP, that poses credit risk.

Macedonia -Risk Scores on Fundamental Balances

from 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

- Overall performances are quite similar to Eastern and Central Europe's average, though Growth, Liquidity and Foreign Exchange Balances are poorer.
- A much lower credit leverage (Banking System) and increasing / large FDI are sufficient enough to compensate the previous weaknesses.

Cabo Verde at a glance:

Cabo Verde's economy is heavily driven by flourishing tourism industry (47% of exports of goods and services), while efforts to diversify the economic activity (agriculture) is underway. The economy currently has a very high investment-GDP ratio of 40% due to strong foreign direct investment and will further expand in the coming years with diversification in manufacturing, catering and promoting private sector.

Owing to strong recovery in services sectors which accounts for 70% of GDP (of which, tourism accounts for 20% of GDP), given trend, the growth is estimated at 4% in 2017. As the economy is very services driven, it is expected to have a positive impact on consumer and business confidence in the economy providing a favorable economic growth in the short and medium term. From a deflationary situation (-1.4% y/y) due to low energy and food prices in 2016, inflation is estimated to improve to 1.1% in 2017. While the budget deficit eased (from 4.1% y/y in 2015 to 3.3% in 2016), the country is still saddled with high public debt (130% in 2016).

In the long-term, the policy priorities need to be focused on structural changes focusing more on economic diversification (moving from the dependency on tourism) and building strong capital buffers to absorb shocks in the economy. The challenges in rising cost of external borrowing due to appreciating dollar.

Rwanda at a glance:

Rwanda has carried out significant structural reforms in the past decade in controlling corruption and increasing access to public goods. Under the guidance of IMF's policy support Instrument Program, Rwanda has shown strong economic performance. Its growth story as always been aimed around three core areas - accelerating economic growth, productivity & incomes of the poor, and strong public policy. The country has a high investment-GDP ratio of 25% and is heavily relied on foreign aid. In the future, the focus would be to reduce the dependency on foreign aid by shifting the attention to developing the economy from agri-centric to a more service-oriented economy.

The robust GDP in 2017 (+6.1% y/y) was propelled due to positive trade balance owing to the impact to robust policy changes (exchange rate adjustments and structural policies) in the economy. The inflation remains low at (0.9% y/y in March 2018) with low food prices. The monetary and fiscal policies also support the development with the monetary policy being more accommodative (rates adjusted downwards by 100 bps since November 2016) and the fiscal policy for FY 2018/19 is more relaxed.

While the country has positive fundamentals, the medium and long-term risks surrounding the growth is still persistent particularly in improving the structural changes such as improving fiscal transparency and shifting to an interest rate-based policy framework. However, in the short term, the priority remains in improving the domestic economy by reviving industrial activity supported by fiscal and monetary policies.

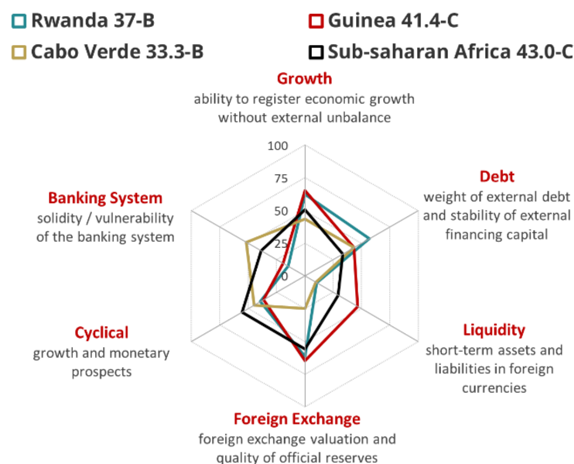
Guinea (Conakry) at a glance:
Guinea is a minerally rich country with gold and bauxite (7% of world bauxite production in 2014) as the main source of export revenue (88% of the export revenue in 2014) for the country. Since 2013 the country has been severely affected by Ebola virus before it was certified free of the virus in 2015. Guinea is currently negotiating Extended Credit Facility (ECF) with IMF to support its National Social and Economic Development Plan (2016-20).

Following the aftermath of Ebola outrage and adverse low commodity price shocks, the economic activity in the country is improving (driven by production of bauxite and gold) while services sector (tourism) is yet to revive. GDP is estimated to grow at 6.4% in 2017 (after +6.6% y/y in 2016). Despite enjoying positive commodity exports (bauxite and gold driven), the economy's import is relatively higher due to infrastructure related imports (mining & energy and transportation) which further deepens the Current Account Deficit (from 34.2% in 2016 to an average of 43% in 2017-19). Inflation is strongly influenced by rising import oil prices keeping it elevated but contained at 8.4% in 2017 owing to cautious monetary policy stance.

Guinea is severely exposed to commodity price shocks, especially due to limited diversification and there has been an increase in NPLs (11.4% in June 2017) which has further reduced bank lending to private sector.

Rwanda, Cabo Verde and Guinea

Risk Scores on Fundamental Balances
from 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

- The three Sub-Saharan countries have highly different performances, with Cabo Verde being penalized only by a weak Banking System Balance (reflecting a high credit leverage) while all other Balances are much stronger, resulting in a favorable risk rating below 35.
- Rwanda also shows a favorable average risk rating (37-B), supported by very low leverage (Banking System), strong Liquidity and positive Cyclical Balances, but Growth and Debt are more worrying.
- Conversely, Guinea has very negative performances on the Liquidity, Foreign Exchange and Growth Balances, resulting in a higher risk rating, and a WatchList Indication on economic activity suggesting a very high vulnerability to potentially acute reversal in economic growth in-between 2019 and 2021.

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