Strategy outlook Q1 2018

2018 – a pivotal year for financial inclusion in emerging markets

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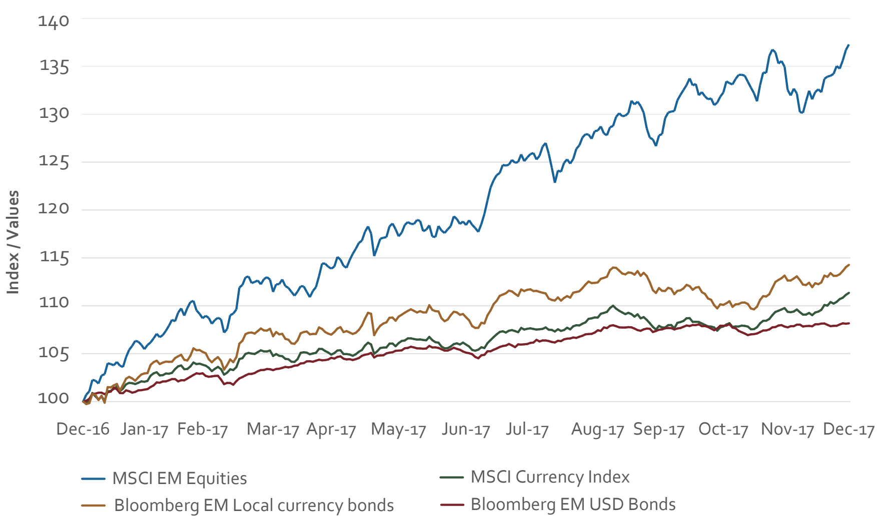
2017 saw the revival of emerging assets against a backdrop of slower raise in US rates than what was expected following the announced end of monetary easing and the arrival of Donald Trump in the White House. In emerging and frontier countries, 2018 should be marked by wide monetary policy disparity but a common desire to accelerate economic reforms, especially those aimed at accelerating financial inclusion.

*Figure 1: Evolution of equities, bonds and emerging currencies in 2017**



**Base 100 as at 29.12.2016. Source: Bloomberg*

Past performance is not indicative of future returns.

2017 – a good year for emerging economies

Emerging markets achieved a Grand Slam in 2017, with positive performances in all organized financial markets. Equities yielded a total return of 37% according to the MSCI Emerging Markets Index, bonds denominated in foreign currency delivered an average performance of 14%, while bonds denominated in dollars delivered a performance of 8.7%. As for currencies, they appreciated by 11% on average.

As a reminder, these markets were heavily discounted and suffered from the fall in commodity prices, especially oil, between early 2014 and late 2016. For example, over this period the annualized total return on emerging market equities was -0.46 %; it is currently 10.66%. The gap is equally significant in emerging market bonds. A year ago, the same calculation of the annualized yield on emerging market sovereign bonds in local currencies equated to a result of -3.40%; today it stands at +3.69%.

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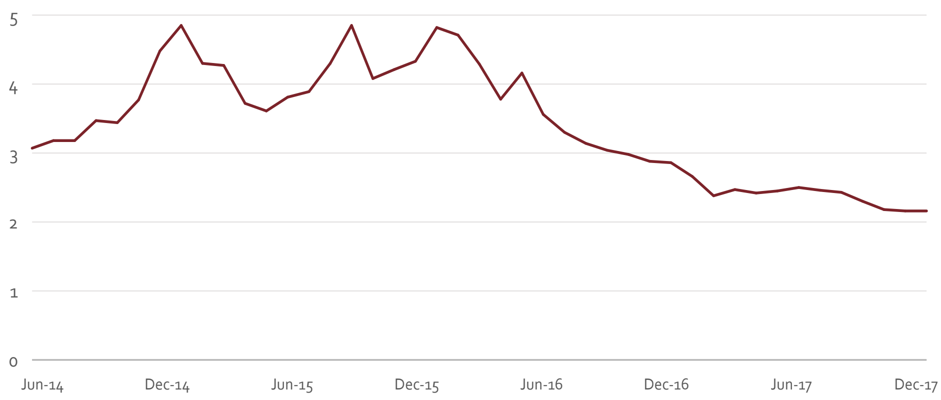
Figure 2 : 3-year interest rate differentials between issuers from emerging countries and US bond issuances since the commodities crisis (%)



Source: Bloomberg

The rise in US rates – a differentiating factor

2017 will have been a year of recovery in emerging markets with, in addition, a significant return of investors as illustrated by the net investment flow that in 2017 exceeded USD 70 billion according to Bloomberg. Investors who had massively turned their portfolios towards US assets in 2015 and 2016 in anticipation of an acceleration in the pace of US key rate hikes rebalanced their allocations following the Federal Reserve's more accommodating stance. The Fed's governors nonetheless raised US rates by 75 basis points throughout 2017; the three-year interest rate spreads between emerging market bonds and US bonds are now at their lowest since the subprime mortgage crisis. In the debt markets, emerging countries are thus finding themselves under pressure, with the possible constraint of being obliged to raise, in turn, their key rates in order to maintain their attractiveness vis-à-vis US rates, which should continue to increase in 2018 and 2019.

Yet they are not all in the same boat. The drop in commodity prices in 2014-2015 exposed the economic and structural disparities between countries. Thus, emerging countries today form a more heterogeneous group than ever before. Depending on whether they are more or less diversified or vulnerable to external shocks, these economies do not have the same room for maneuver in trying to retain foreign capital in the face of economic improvements announced by advanced countries, particularly the United States.

Accelerating regulatory and governance reforms – a necessity

The most diversified emerging economies in terms of public revenue sources have used falling commodity prices to consolidate or strengthen their fiscal and trade balances, increase foreign exchange reserves or adopt monetary and fiscal policies to support domestic growth. This is the case of countries like Bangladesh, China, India, the Philippines and Tanzania. These countries are less directly threatened by the rise in US rates because their fundamentals are attractive and the continuation of reforms, primarily to boost domestic growth, should allow them to improve investment risk perceptions with foreign investors.

A second group of countries, one that is more dependent on commodity exports, also attracted the attention of investors. These countries include Albania, Botswana, Cambodia, Colombia, Costa Rica, Indonesia and Vietnam. As with the first group, they have relatively strong political and economic governance institutions and they initiated pro-private sector development reforms at a time when commodity prices were still in the upward phase of the cycle.

Together, these two groups of emerging countries – with relatively diversified economies and strong financial fundamentals – will be the most resilient in the face of rising US rates. It will potentially also be the least inclined to engage in more restrictive monetary and fiscal policies, unless an inflationary risk threatens the stability of the currencies and the purchasing power of local populations.

Then comes a group of countries whose level of income source diversification ensures that commodity price fluctuation dependencies are contained despite tenuous financial situations. For these countries, including Argentina, Brazil, Kenya, Morocco, Romania and Sri Lanka, the retention of foreign investment flows and the renewal of external debt are essential to maintaining business and stabilizing growth. The rise in US rates is creating an urgent need for these countries to carry out fundamental reforms that will enable them not only to increase and retain foreign direct investment but, more generally, to improve their competitiveness compared to the countries of the first two groups. Thus, Brazil has embarked on a reform of its pension system to reduce public spending. In Argentina, President Macri's pro-liberal vision should favor the development of economic activity. Romania is pursuing a policy of fiscal expansion that, coupled with rising household incomes, has boosted its economic growth; yet the country will need to launch reforms that are more sustainable to see foreign capital return. Morocco has a policy of active openness to foreign investment based on tax benefits and monetary measures to increase its competitiveness. Kenya and Sri Lanka could do better because the measures taken to strengthen control and transparency standards in their banking sectors in order to accelerate private sector financing are insufficient.

The last group, which closes this breakdown, is not least. It is characterized by strong economic dependencies on commodity fluctuations and precarious financial situations inherited from governance practices that have deteriorated with the fall in commodity prices in 2014-2015. This is the case for example in Angola, Azerbaijan, Ecuador, Mongolia, Nigeria and South Africa. Low foreign exchange reserves, debt ratios that are above norms in these markets, and large fiscal or trade deficits lead these countries to resort most often to the International Monetary Fund's (IMF) life-saving assistance.

When political institutions guarantee voting freedom, unexpected political dissension situations can erupt within the ruling political movement, as is the case in South Africa with the victory of Cyril Ramaphosa as President of the African National Congress (ANC), which led to the resignation of Jacob Zuma two months later, before the end of his presidential term; or in Ecuador with tensions within the Alianza País (AP) between supporters of former president Rafael Correa and those of current president Lenin Moreno that were created by charges of corruption and the reforms needed to redress public accounts.

Going all out to promote financial inclusion

Whatever the economic situation, however, there is currently a desire in all emerging countries to promote financial inclusion, meaning improving bank penetration either through conventional measures to increase the supply of funds – for instance the granting of new banking licenses – or by promoting access to innovative financing solutions dedicated to unbanked or under-banked populations, such as rural populations or households whose income comes from the informal sector.

In Argentina and Costa Rica, regulators are working on measures to increase the deposit amounts guaranteed in cases of bankruptcy. These measures should improve confidence in banking institutions and lead to better deposit mobilization. Argentina is supporting these reforms with the establishment of an inter-ministerial committee on financial inclusion. In Azerbaijan, following a series of bankruptcies in 2016, including that of Bank Standard, the sixth largest bank in the country by assets, the regulator has defined a regulatory framework to strengthen the control of banks having solvency issues. India, in order to boost bank growth, has embarked on a campaign to clear bad debts held by state-owned and provincial banks, including an associated injection plan of about USD 30 billion and governance practice reforms. Morocco has granted a dozen licenses to Islamic banks in 2017, while Kenya has established a regulatory framework for Islamic finance. Nigeria, which wants to increase its financial inclusion rate from 60% to 80%, has increased bank fee transparency in order to create competition in pricing, triggering an influx of new customers. In Uganda, banks are now allowed to market their offers via third-party distribution networks (agency banking) and Tanzania is considering putting a limit on the interest rates that banks can charge. This rate cap, used to accelerate financial inclusion in countries such as Kenya, Cambodia and Colombia, has, however, shown its limits. It should be noted that in Colombia, the financial regulator is thinking of reversing course and removing the ceiling on bank interest rates to boost credit activity through offerings.

Emerging countries rather welcoming of fintechs

However, the measures put in place to promote access to innovative solutions, particularly through fintechs, constitute the most significant progress. Peru, Argentina, Mexico and Brazil are putting in place legislation regulating fintechs. Colombia is also working on how to best bring these new players together with traditional banks, while local subsidiaries of the BBVA and Scotiabank groups have announced investment plans of USD 150 million and USD 40 million respectively to develop their digital strategies. The People's Bank of China, the central regulatory body, has set up a supervisory committee for fintechs as they have a similar concern to better regulate their commercial activities. In India, the consequences of the demonetization reform conducted in November 2016 are still difficult to quantify. Nevertheless, even if it fails to achieve its initial goal of reducing the grip of the informal sector, it has led to excess liquidity in the banking sector, lower borrowing rates and a sharp increase in the number of fintechs and new digital solutions.

South Africa has recently granted two banking licenses to two new fintech players, with the aim of better covering financing needs in areas far from urban centers. Kenya retains its lead in the fintech field and several players in the banking sector are setting up strategic partnerships with telecoms to take market share from leader Safaricom and its M-Pesa offer. After several months of debate and rumors about a possible abuse of Safaricom's dominant position, the Communications Authority (CA), the country's communications regulator, issued a verdict in 2017. It will not order the splitting of Safaricom's mobile phone division and its mobile banking division M-Pesa because it would amount, in its words, to "punishing the success" of the telecom company. At the same time, M-Pesa and its competitors are now required to be more transparent about their fees.

Reforms as alternatives to rising rates

Globally, there is balanced distribution between reforms aimed at reducing bank risk and those aimed at expanding the credit market. Although the political leaders in place retain the credit for these reforms, this wisdom is often the result of the IMF's watchdog role over the most crisis-ridden countries or even the consequence of the major rating agencies threatening to lower credit ratings, which would cause major capital flight.

All of these measures aim to structurally, and thus sustainably, improve emerging economies' growth prospects and their ability to attract foreign investment. They are even more relevant today because, faced with the normalization of US monetary policy, they offer an alternative to a rise in domestic key rates that would penalize recovery policies when local economic actors are only just recovering from the previous crisis.

As shown here, those emerging economies most dependent on both foreign capital and commodity prices still face many challenges. Despite the reforms undertaken to diversify the economy, improve tax administration efficiency and promote private sector development, these countries will have no other choice than to raise domestic key rates to retain foreign capital and finance fiscal and trade imbalances in the short and medium term.