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Strategy outlook Q2 2018

Faced with mounting trade tensions, countries will not respond in unison

Published quarterly by Symbiotics

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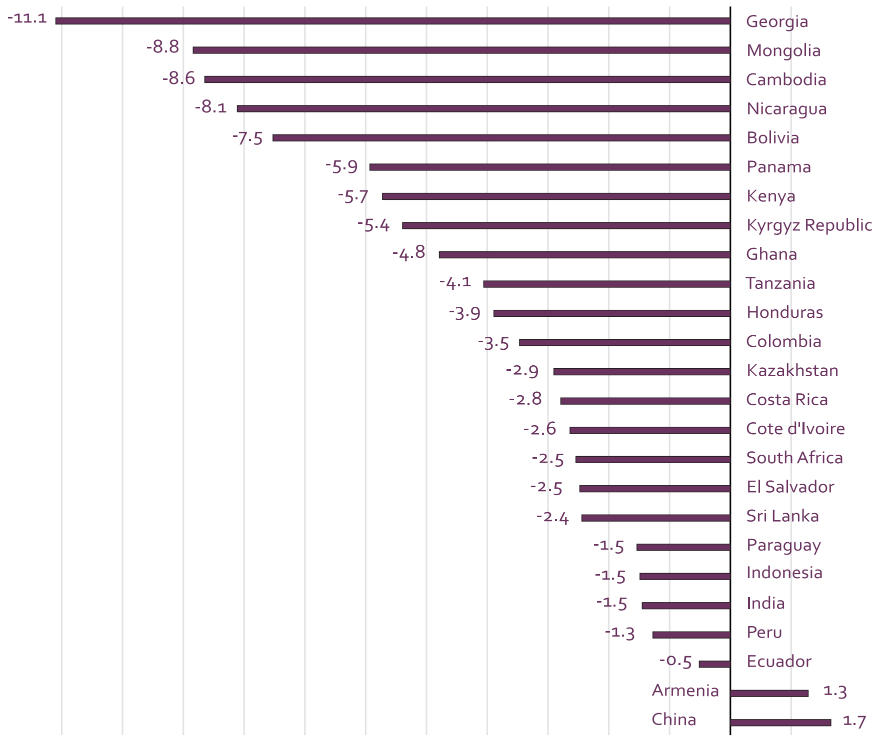
Demands by the United States to redefine trade relations with China have cast a threatening shadow of returning protectionism over the global economy in recent months. While it is generally accepted that impact investments, and more specifically microfinance, promote the development of real economies locally, the credit risk on such investments is nonetheless sensitive to the macroeconomic context and fluctuations in exchange and debt markets. It is therefore necessary to question the capacity for resilience of the main investment destinations in the face of a possible contraction in trade.

It is possible to obtain some answers by using the economic statistics of emerging and frontier markets to analyze the balance of payments and levels of exposure to foreign trade. The trade balance is a good starting point given the sensitivity of these countries to their external environment. However, the positioning of the trade balance must be qualified by the country's ability to borrow on the debt market, open its domestic market to foreign investments, and draw on its foreign exchange reserves to support its currency or offset any deficits.

Figure 1: Trade balance (% GDP)



Source: 2017, IHS, IMF

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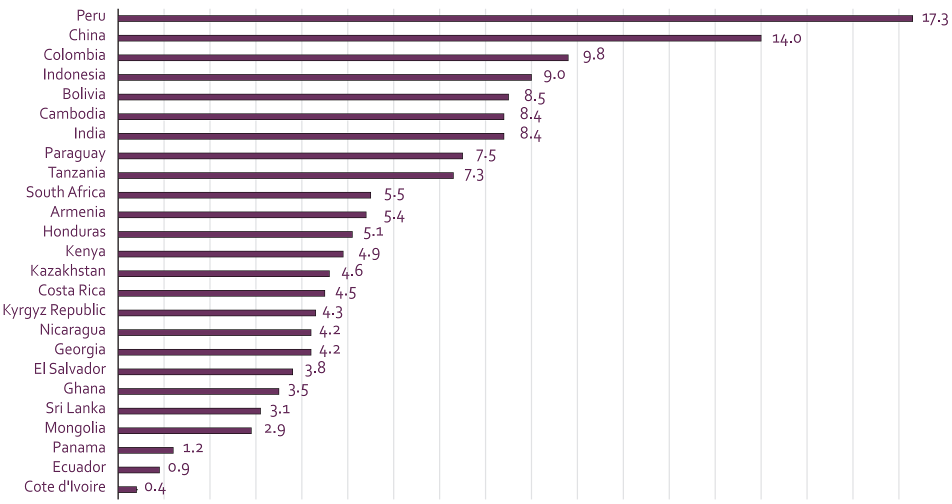
Figure 2: Import coverage based on foreign exchange reserves (months)



Source: IHS, IMF

China, with foreign exchange reserves amounting to 2.6 trillion dollars and a trade surplus of 1.7% of its GDP, has the means to fiercely defend its interests against the American position. Its total foreign exchange reserve levels compared import coverage is about 14 months and its low external debt at about 13% of GDP mean the country has several strategies in the event of a threat to its balance of payments. In the current context of tensions with the United States, the possibility that China, in retaliation, will offload some of its US Treasury bond holdings cannot be completely ignored. Given the volumes involved, this would severely destabilize markets through higher US debt rates and an increase in the dollar's volatility; it would also have consequences for emerging market bonds. At this stage, this scenario has little chance of being realized because it requires a significant escalation of tensions. The current climate is rather leaning towards conciliation, with China implementing reforms to further open up its economy, and in particular the financial sector, to foreign investment.

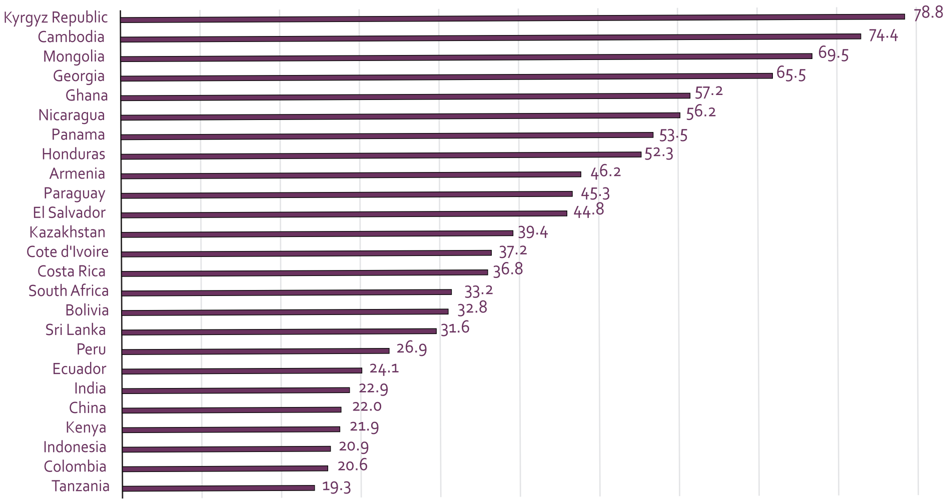
Among China's neighbors, Mongolia is receiving significant impact investment inflows. The country has a trade deficit of -8.8% of GDP and its external debt of 208% of GDP is very high. Foreign exchange reserves, meanwhile, barely cover three months of imports, which leaves little means for Mongolia to finance a possible widening of the deficit, especially if a new copper crisis, whose extraction constitutes the country's primary source of income, should crop up. The economy is highly dependent on foreign trade, with a trade-to-GDP ratio – the sum of the volumes of imports and exports compared to GDP – of 69.5%. It is also highly dependent on its commercial relationship with China, which captures 85% of exports. In addition, China does not hesitate to use taxes and trade barriers to pressure its neighbors, making the external trade environment less predictable in the long run.

Further south, but still within China's influence, Cambodia also has a high trade deficit. The country benefits, however, from economic growth based on foreign direct investments, notably in the textile industry, that partly compensate for this deficit. Although its external debt is also significant (59% of GDP), Cambodia has foreign exchange reserves that would provide some resilience in the event of a deterioration of the terms of trade.

Elsewhere in Asia, a trade deficit does not necessarily lead to a difficult economic situation. India and Indonesia illustrate this well. Import coverage based on reserves of between 8 and 9 months and trade-to-GDP ratios below 25% offer these countries the means to resist in the event of widening trade deficits by financing trade using foreign exchange reserves or by borrowing.

India, Indonesia and Cambodia, like many countries in South and Southeast Asia, have a multitude of trading partners, which provides excellent diversification in terms of bilateral relations and favorable positioning in the absence of foreign trade restrictions among their trading partners.

Figure 3: Trade-to-GDP ratio (as %)



Source: 2017, IHS, IMF

Economies in the Caucasus and Central Asia are strongly dependent on foreign trade and foreign capital flows. Armenia's reserves cover only five months of imports and its external debt is high (81.4% of GDP). Its trade surplus of 1.3% of GDP thus does not guarantee immunity in the event of a contraction in trade flows. Nevertheless, its strong commercial relationship with Russia, which buys 24% of Armenian exports, and its multitude of European partners (Switzerland, Bulgaria, Germany) allow it to better resist any eventual shocks that would provoke greater tensions between the United States and China.

At 11.1% of GDP, Georgia's trade deficit weakens its economy, which is highly dependent on foreign trade. This position of weakness is confirmed by import coverage of only four months and external debt of 115% of GDP. Given the economy's dollarization level, increased borrowing is the main viable medium-term solution to equal out its balance of payments. Like Georgia, Kyrgyzstan is also highly dependent on foreign trade and has a low stock of reserves. Nevertheless, both countries have a diverse group of export partners, including Switzerland, Russia, Kazakhstan and Turkey, which they can rely on to foster long-term direct investments in the local economy.

It is interesting to note that no country in Latin America is at the top of the list of countries most exposed to foreign trade. In a context where export relations with the United States are tense, this ability to rely on internal trade allows for some resilience.

With trade deficits below 2%, Peru and Paraguay have a good capacity for resilience. Peru has significant foreign exchange reserves – more than 17 months of import coverage – and controlled external debt (34.5% of GDP). Paraguay is relatively less well positioned due to lower import coverage, higher external debt at 55.7% and, above all, greater exposure to international trade, with a trade-to-GDP ratio of 45.3% compared to 26.9% for Peru. Nicaragua, Bolivia and Panama have the highest trade deficits. Panama also has high external debt (166% of GDP), leaving little room for deficit financing other than the negotiation of bilateral agreements with the United States, its main trading partner.

Ecuador presents a unique situation. A low trade deficit is explained by the economy's peg to the dollar to avoid cascading devaluations and an inflation explosion. Its very low level of reserves, with less than a month of import cover due to the drop in oil prices between 2014 and 2016, however, leaves the country little room for action in the event of an increase in its trade deficit.

In Africa, Kenya has a trade deficit of 5.7% of GDP, with reserves covering around five months of imports. Yet the country does not hesitate to use its reserves to keep the price of the shilling at a level that contains imported inflation. In order to maintain this policy, the country regularly borrows from external sources. Neither Kenya nor Tanzania has strong extractive industry exports, such as oil or industrial minerals – a rarity in Africa. This explains their low trade-to-GDP ratio, 19.3% for Tanzania and 21.9% for Kenya, and therefore their reduced dependence on foreign trade.

As can be seen, the countries most vulnerable to a contraction in international trade have common characteristics: limited trading partner diversity, trade deficits and high external debt, and in some cases weak exchange reserves or a strong dependence on foreign trade compared to the size of their GDP.

A lack of foreign direct investment means these countries have to resort to debt to offset their balance of payments; this usually results in an increase in risk premiums, which translates into upward pressure on debt yields and more expensive currency hedging.

They must therefore put in place reforms and frameworks that allow them to diversify their economies – measures that would offer them the dual benefit of multiplying the number of business opportunities, and therefore trading partners, and of attracting the long-term investments needed to develop an internal economy that generates jobs and more stable and sustainable economic growth.