



EMERGING MARKETS ECONOMICS UPDATE

The SVB collapse & contagion risks in EMs

- **At the time of writing, financial markets appear to be stabilising after the turmoil caused by the collapse of SVB. And it doesn't look like EMs have suffered large capital outflows or strains in their banking sectors. If this relatively benign scenario persists, EM central banks might begin to ease monetary policy sooner than we currently have in our profile. But otherwise the macro implications will be limited. In a more malign scenario, however, the growth outlook for EMs would be altogether much worse. While most central banks would cut interest rates aggressively, those of countries with large current account deficits (e.g. Colombia, Romania, Hungary) could be forced to hike interest rates to shore up their currencies.**
- Our coverage of the collapse of SVB and its implications for the US economy, global economy and financial markets can be found on our dedicated [webpage](#). You can also watch an on-demand recording of our Drop-in webinar [here](#). The situation may develop in unpredictable ways (see our latest [Global Update](#) for scenarios). From an EM perspective, there are five key channels through which there could be contagion.
- **The first is via direct exposure to SVB.** Fortunately, these links appear to be small. SVB has provided financing to relatively few companies in EMs. That said, one country where policymakers appear to be concerned is Israel, the so-called “start-up nation” whose tech sector plays a large role in the economy.
- **Second, to the extent that financial conditions in the US tighten and import demand weakens, that will weigh on EM exports.** Those EMs that are particularly dependent on trade with the US – notably Mexico – would be most affected. Weaker US import demand could weigh on oil prices and the revenues of major EM producers in the Gulf and elsewhere (Russia, Colombia, Nigeria, etc.). The fortunes of producers of many metals are likely to be far more closely tied to developments in China though.
- **Third, higher risk aversion could weaken capital flows to EMs.** So far, there isn't much evidence of this happening, at least based on developments in FX markets. The moves in EM currencies since problems at SVB flared up last week have been pretty small. And many are actually up against the dollar over the past few days, perhaps helped by expectations for a lower path for US rates (more below). (See Chart 1.) We'll take a closer look at what's happened to capital flows later this week in our *EM Capital Flows Monitor*.
- But were problems in the US banking system to become more acute and risk aversion to spike, we'd be most worried about those EMs with large current account deficits, which indicates that they're particularly dependent on foreign capital flows. As we noted in our recent [Financial Risk Monitor](#), current account deficits are generally narrowing in EMs, but they remain wide in a handful of countries, including Colombia, Chile, Hungary, Romania, Turkey and Philippines. (See Chart 2.)
- Vulnerabilities would be particularly severe in those countries whose banking sectors rely on foreign wholesale financing markets. This was, after all, the Achille's heel of Eastern European banks during the Global Financial Crisis, which resulted in a sharp credit crunch and a very slow recovery after the crisis. While Eastern European economies have much lower external vulnerabilities than in 2008/09, capital inflows from foreign banks remain largest there. (See Chart 3.) If capital flows were to weaken, currencies will depreciate and monetary and fiscal policy will need to tighten to restore external stability.
- **The fourth channel is domestic monetary policy.** EM central banks have taken their cue to a much greater extent from domestic inflation developments than the Fed during this hiking cycle. But with the path for [interest rates in the US](#) now looking like it may be lower than before, policymakers in the handful of EMs that have yet to finish their tightening cycles (Mexico, Colombia, and the Philippines) are likely to tread more cautiously and may bring their cycles to an end sooner. And the odds are also shifting to an earlier start to the EM interest rate *cutting* cycle than we currently have in our profile.
- Were strains in the US financial sector to get worse, a few EM central banks could be forced to hike interest rates to shore up their currencies. But this is primarily a risk for those EMs that are heavily dependent on



foreign capital flows mentioned above. Most other central banks would probably start to cut interest rates aggressively (and would probably counter currency weakness through FX intervention).

- **And, finally, domestic credit conditions are likely to tighten.** Our measure of EM financial conditions has tightened a little since late last week (see Chart 4), although conditions remain looser than they were in the middle of last year. But lower confidence and a greater risk aversion by domestic banks could result in weaker lending growth.
- **The big wild card in all this is, of course, whether similar problems to those that caused SVB’s collapse (unrealised losses on a bond portfolio) emerge in EM banking sectors too.** In general, EM banks look well capitalised. And central banks have tools to counter contagion risks (via liquidity provision, or broadening deposit insurance). Indeed, policymakers deployed such tools during the pandemic which was notable for being the only period of global market stress in recent history that wasn’t marked by EM banking crises. Nonetheless, developments of the past few days underscore the point that it may only take problems at one bank to cause strains across the sector.
- **And, more broadly, the current period of high interest rates in EMs is likely to have spill-overs to domestic banks. Non-performing loans are likely to rise,** particularly in those countries where the increase in interest rates – and the associated rise in private sector debt servicing costs – has been particularly sharp. From our modelling, this group of countries includes Brazil, Chile, Hungary and Korea among others. And while banks are well capitalised in aggregate, that may not hold for all institutions. From our recent analysis, tail risks exist in banking sectors in India, Poland, Colombia and Israel.

Chart 1: Exchange Rates vs. US\$ (% Change Since 9th March)

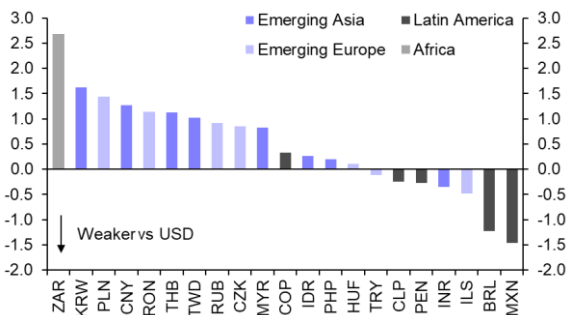


Chart 2: Current Account Balances (% of GDP, SA)

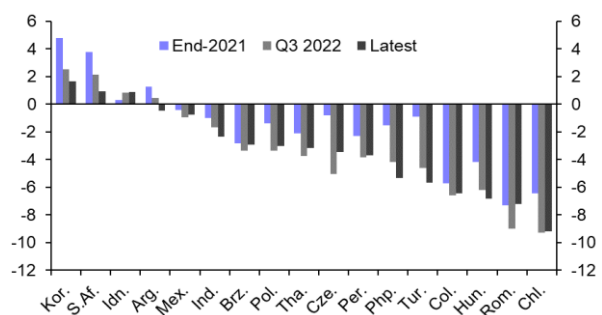


Chart 3: Banking Sector (“Other”) Capital Inflows (% of GDP, 4Q Sum, Latest)

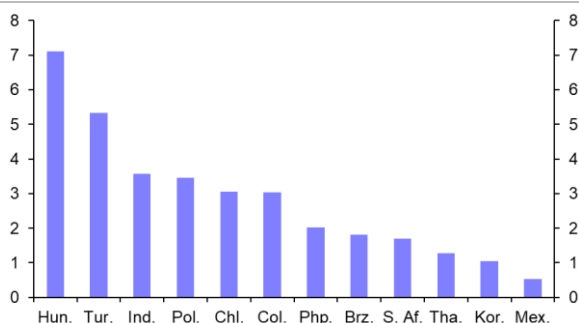
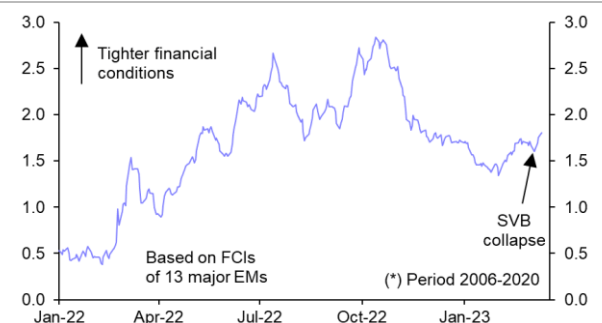


Chart 4: CE EM Financial Conditions Indicator* (Standard Deviations)



Sources: Refinitiv, IMF, Capital Economics



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