Have EM lost their shine?

Overview

- A look at EM financial markets
- Economic activity
- Inflation and monetary policy
- What's next for EM?

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Financial markets

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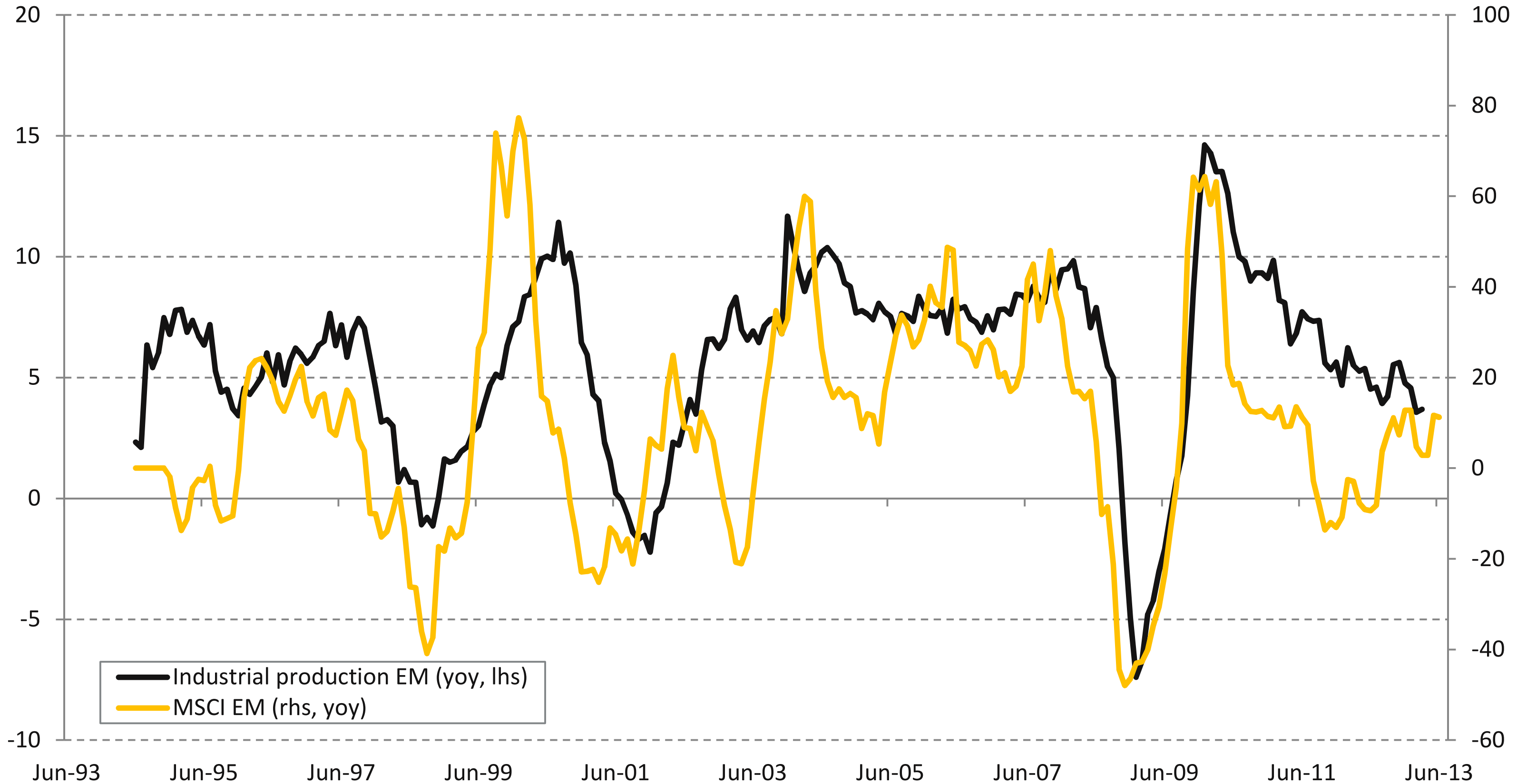
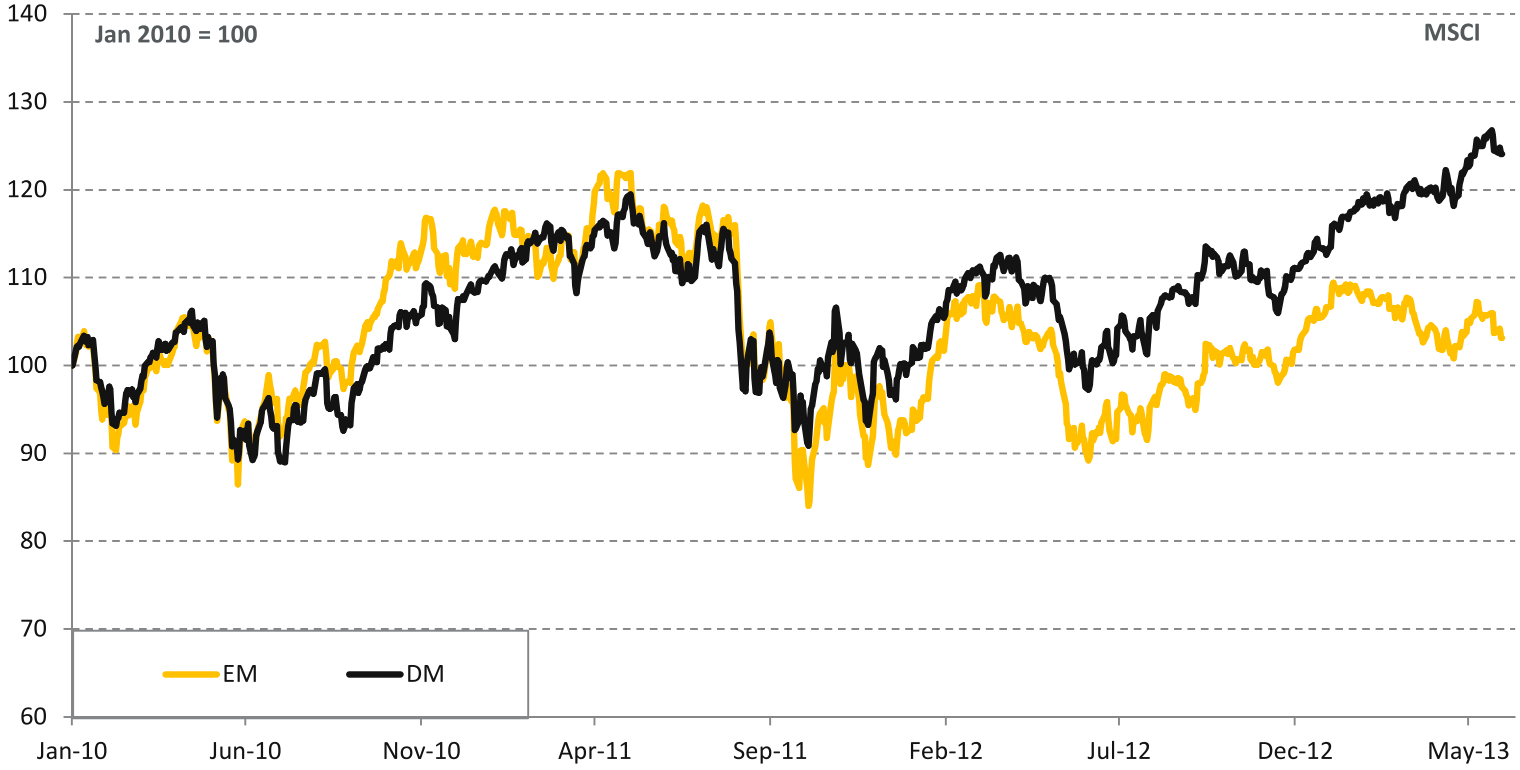
EM equities pre-crisis run has been spectacular…

…and in line with economic activity

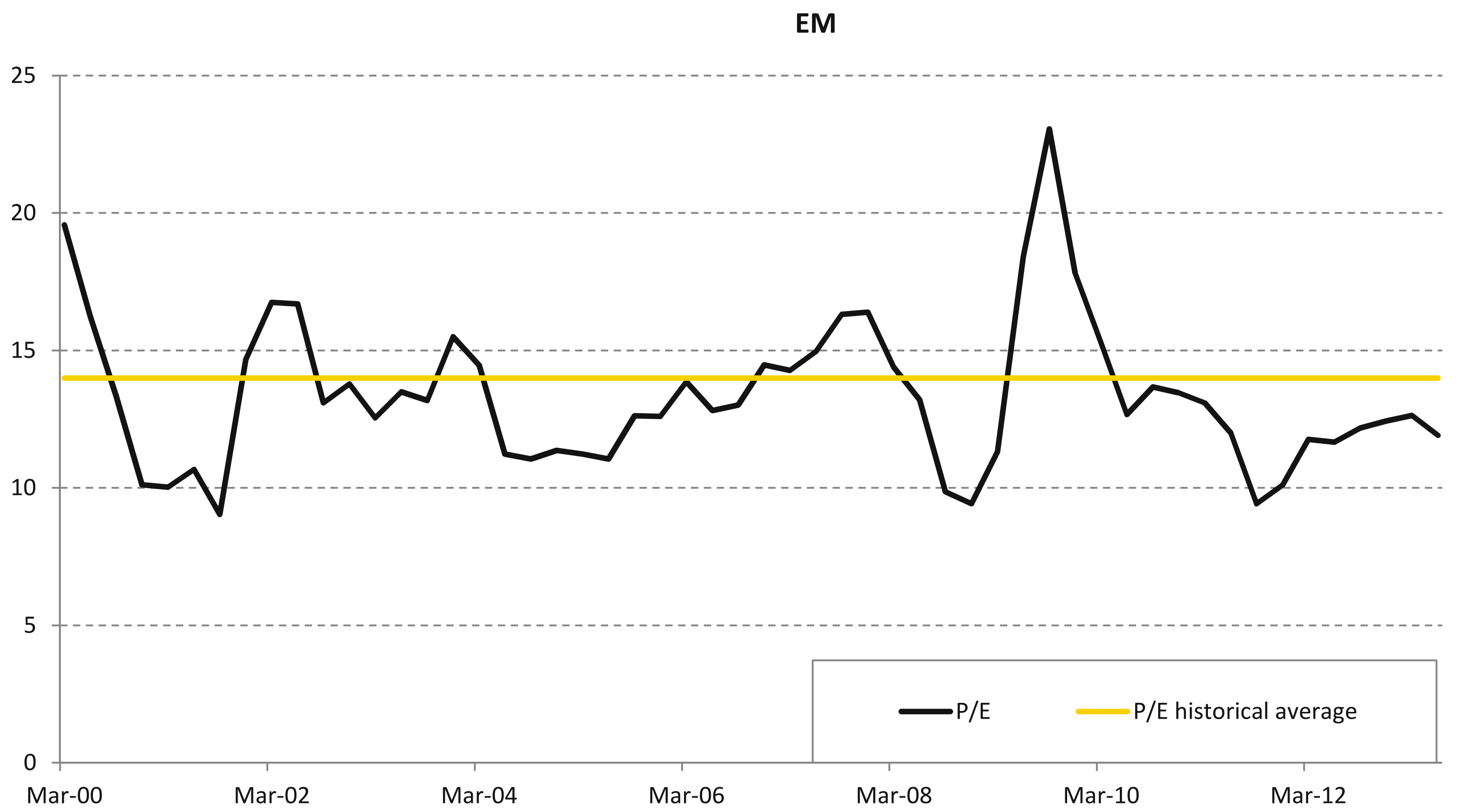


EM equities have lagged behind recently…



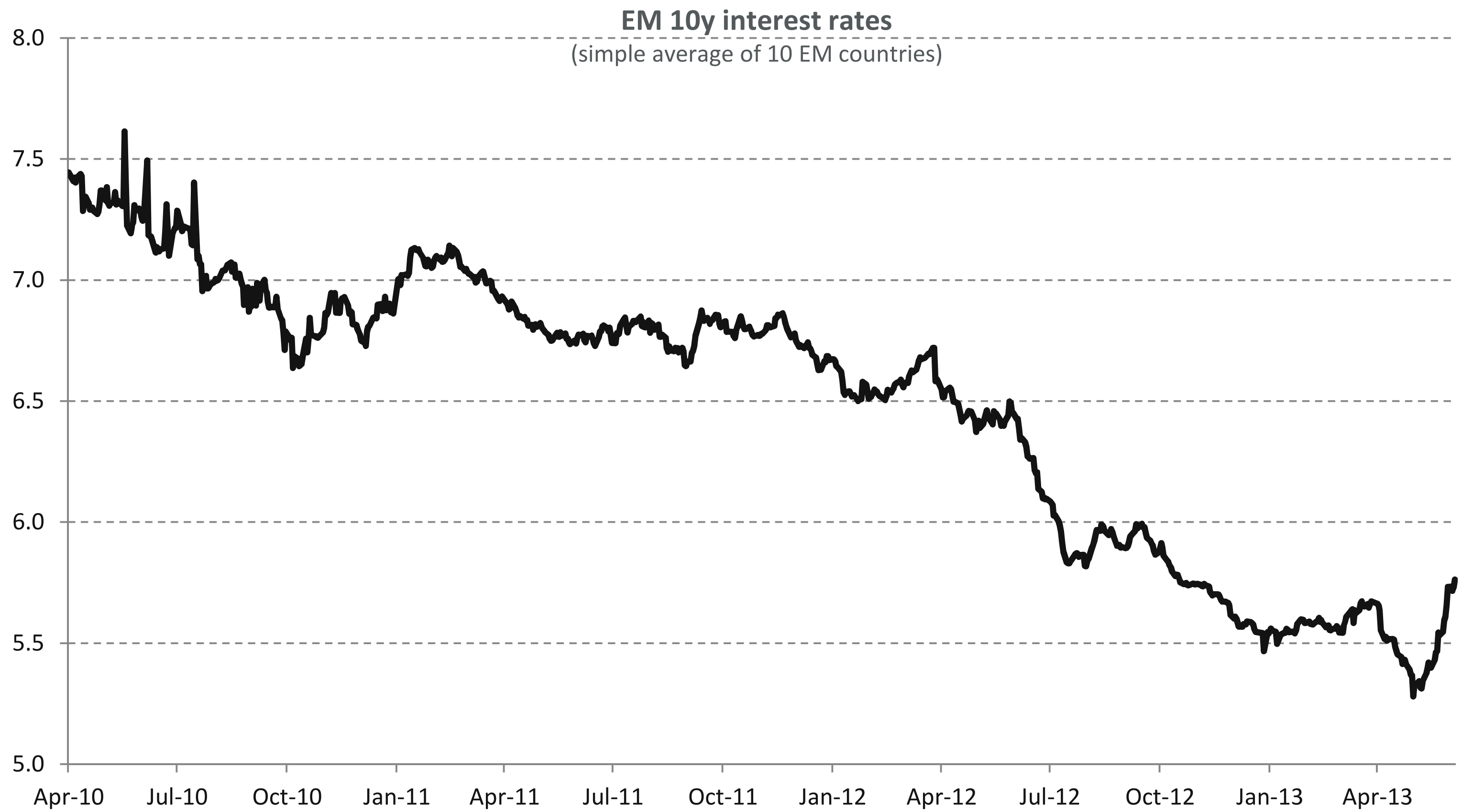
…mostly the BRIC’s

EM equities rather cheaply priced

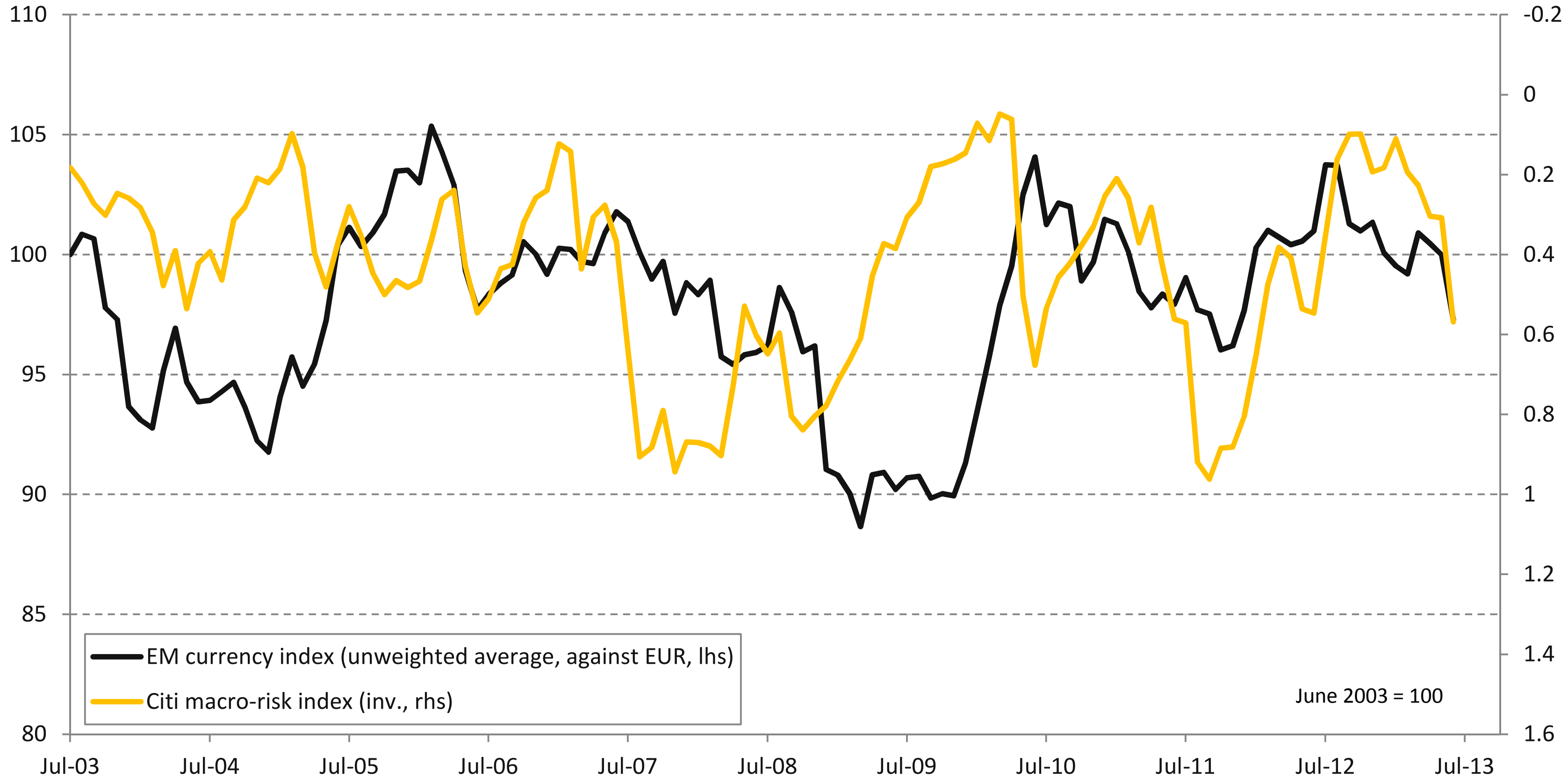


EM interest rates have risen sharply in recent weeks…

Though still close to historical lows

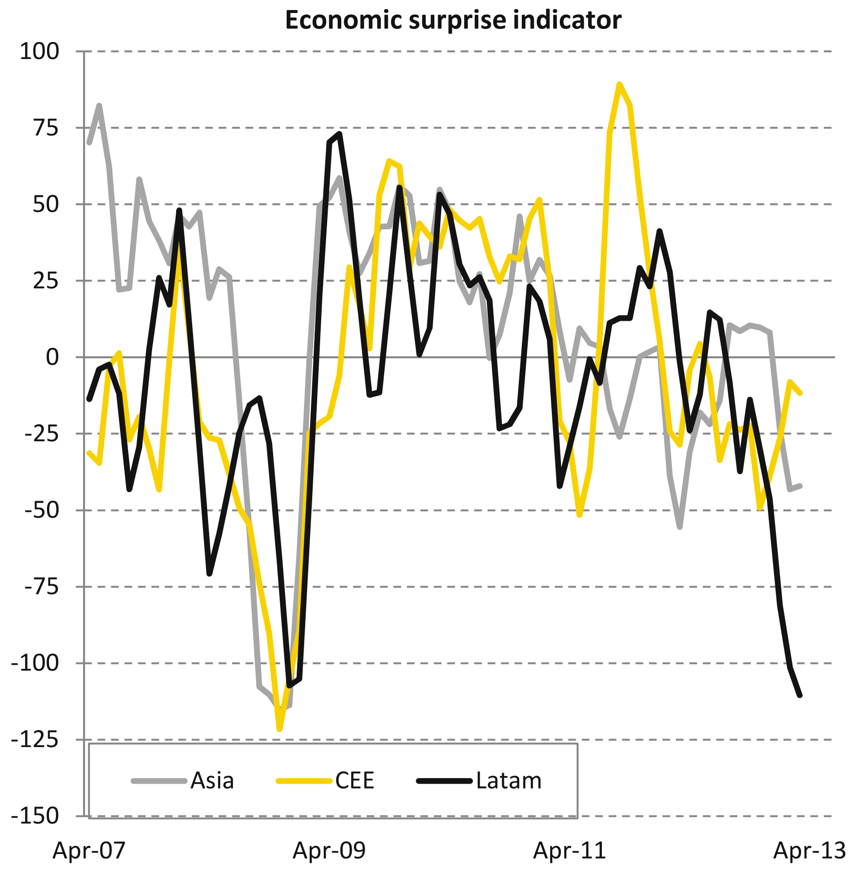


EM currency sell-off on the back of rising market uncertainty

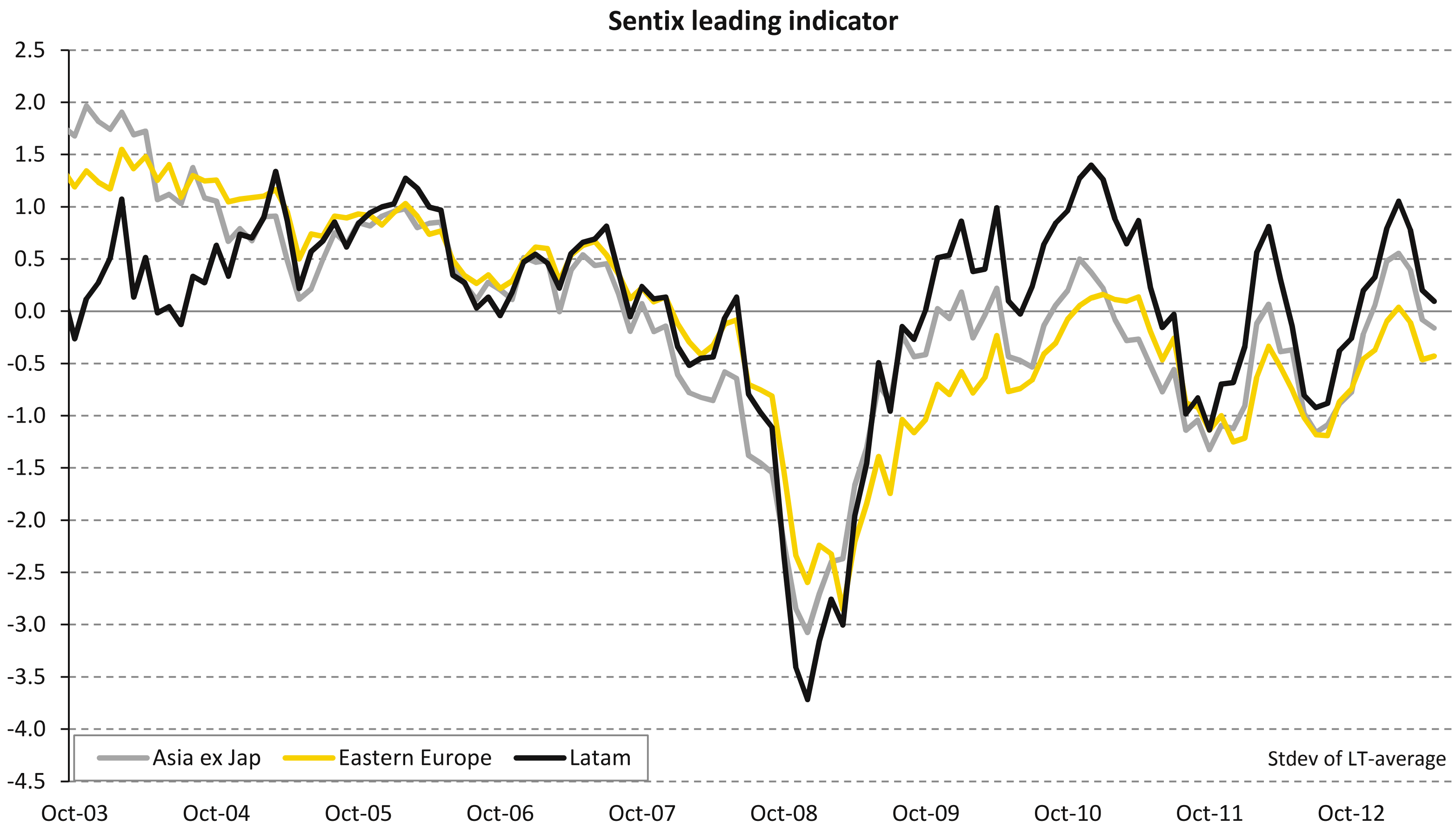


Economic activity

EM growth disappoints

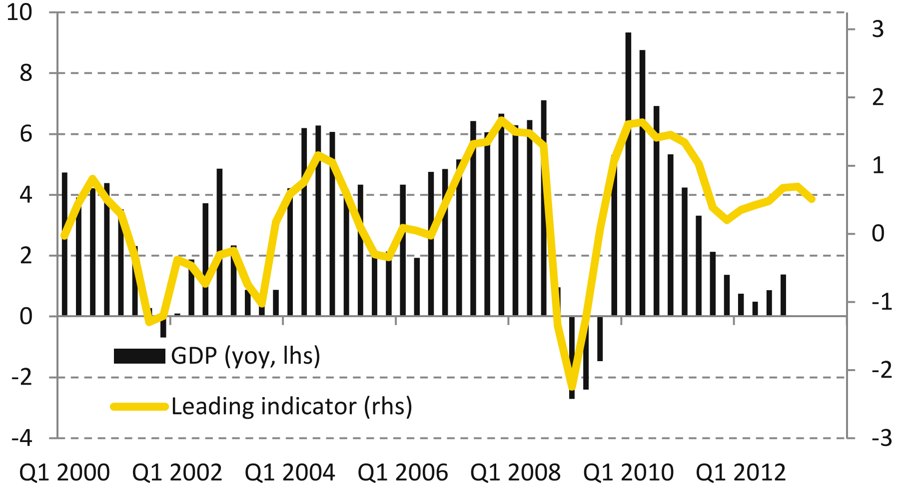


Economic activity slows

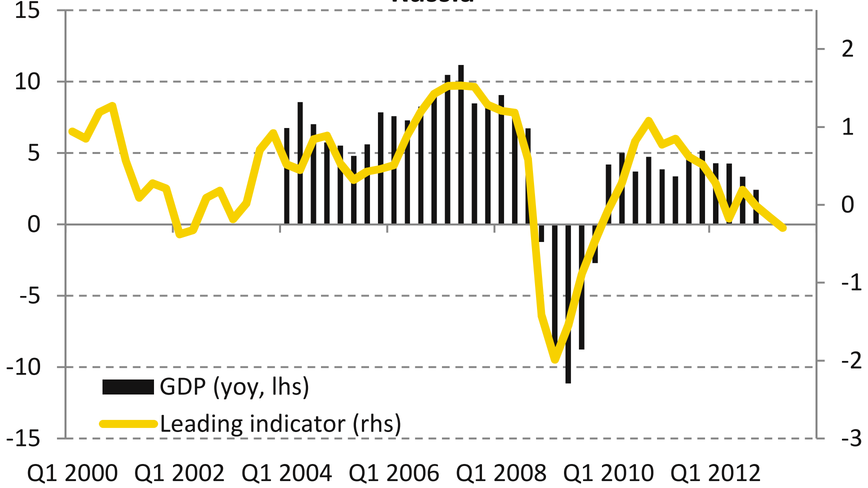


Cheerless BRIC outlook

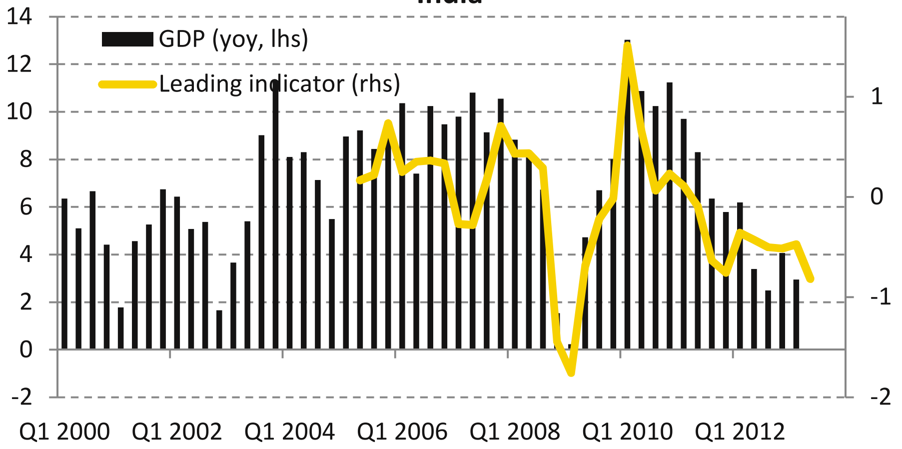
Brazil



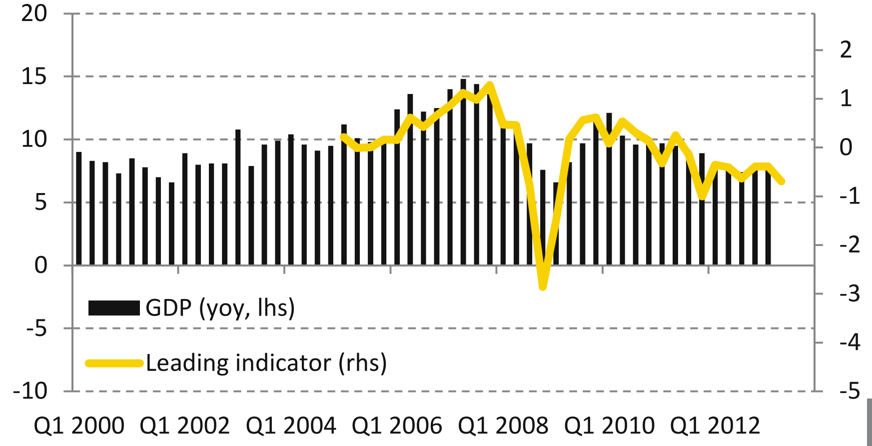
Russia



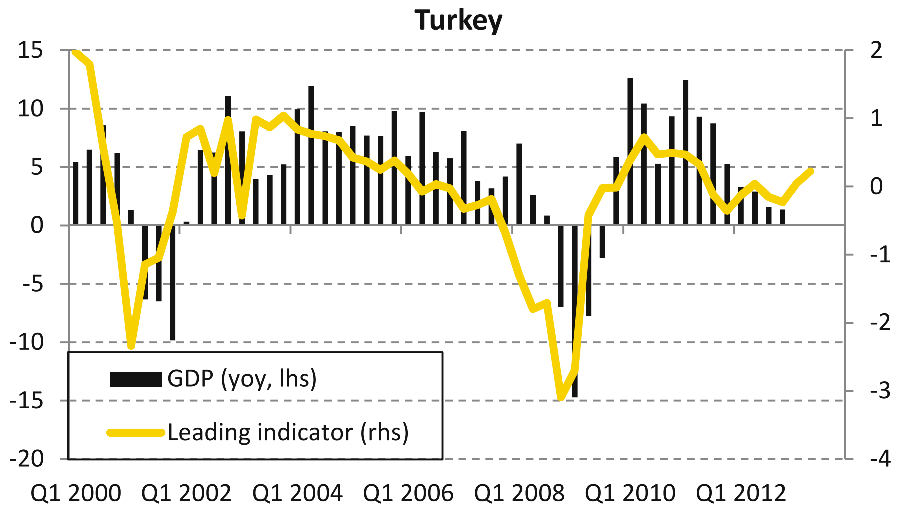
India

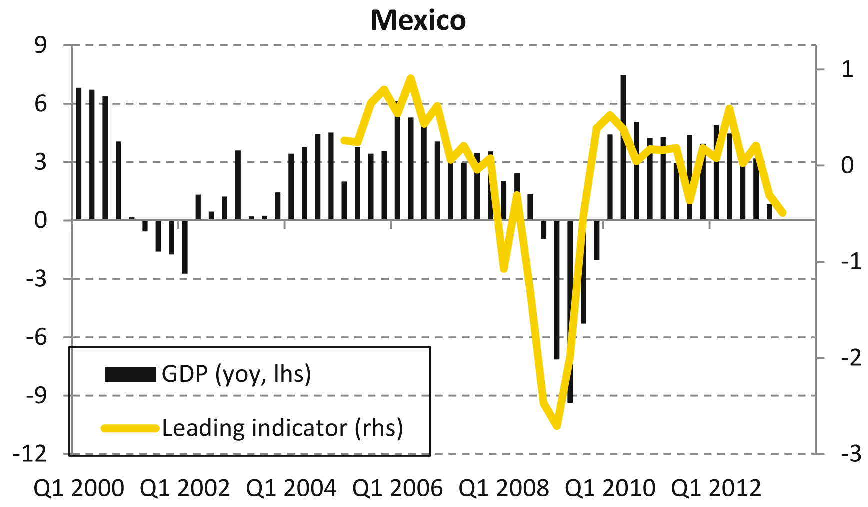


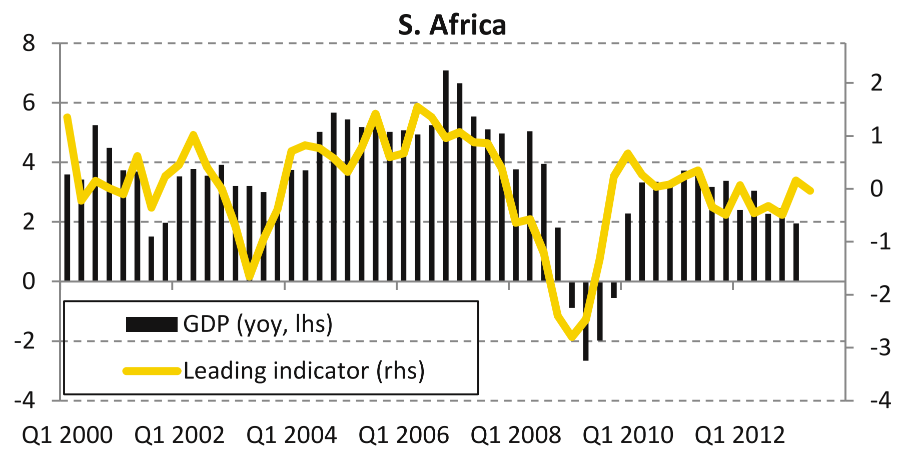
China

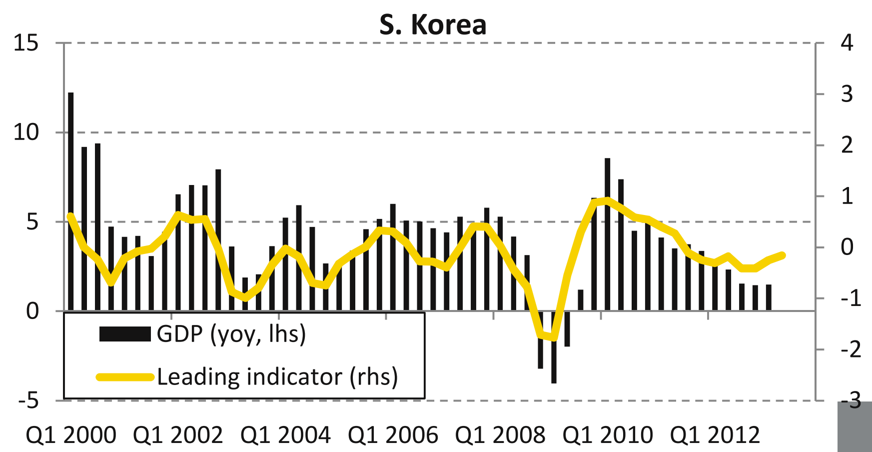


Mixed growth outlook in non-BRIC's

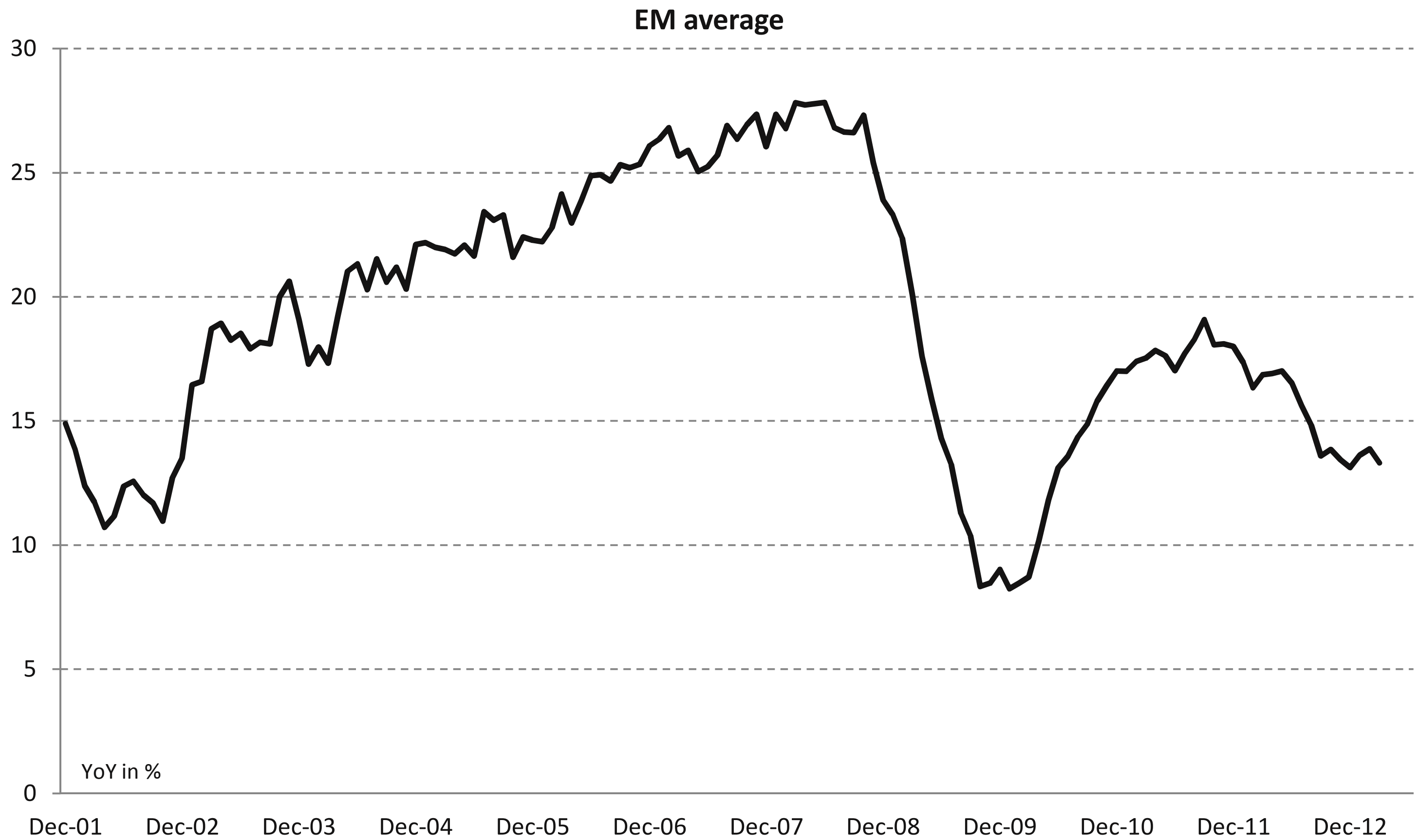








Credit growth decreases



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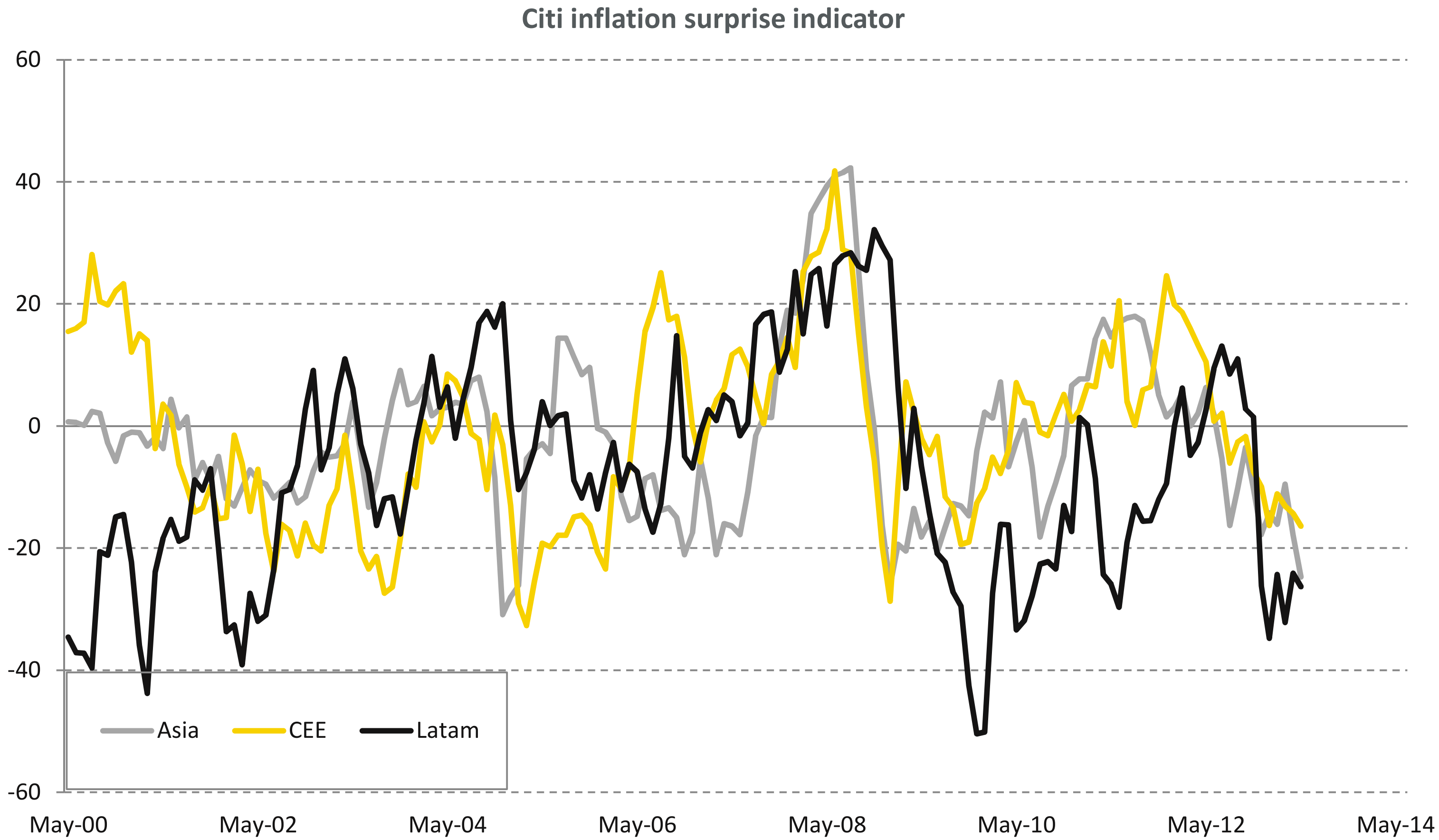
Monetary policy and inflation

EM inflation remains below expectations



Easing core inflation

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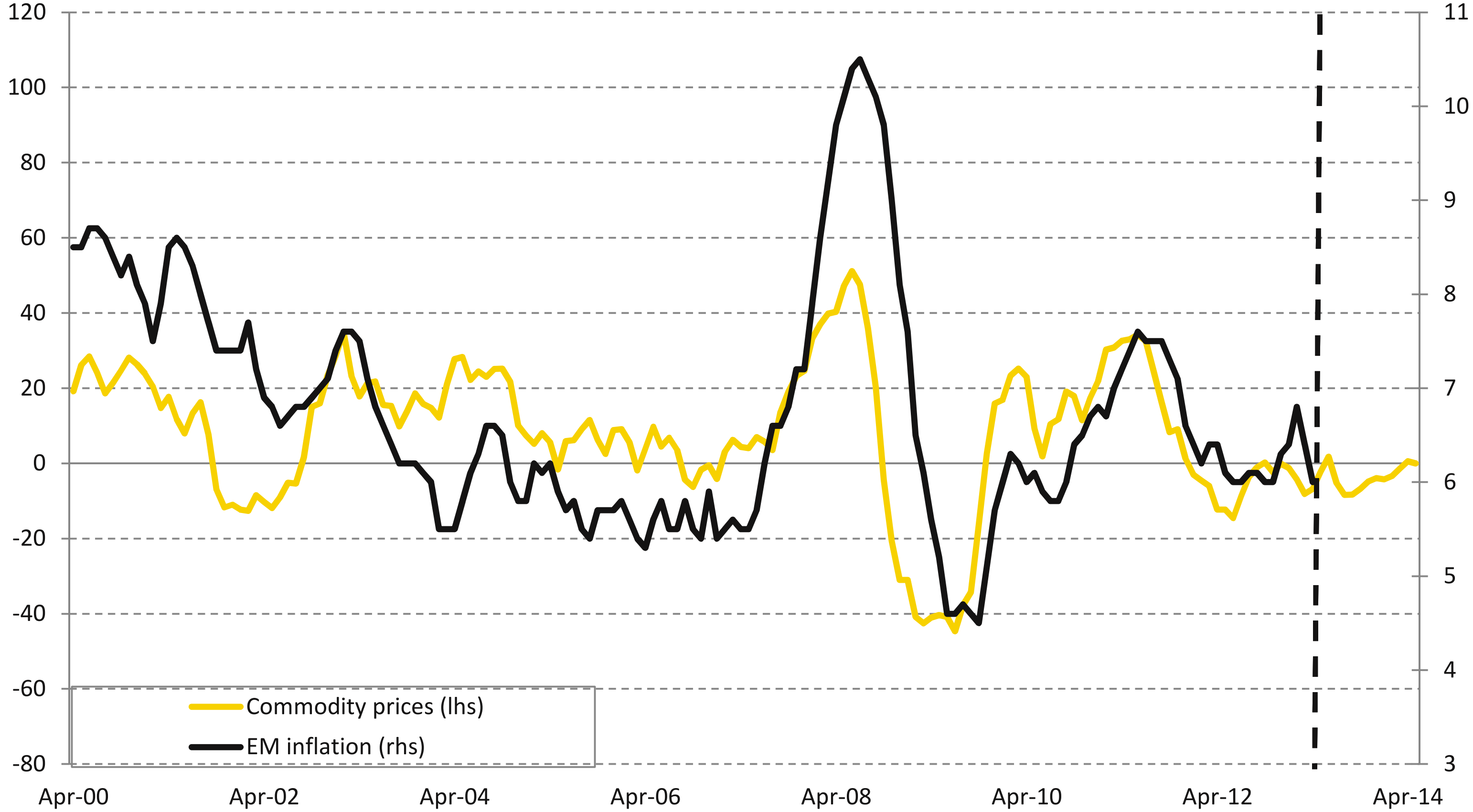
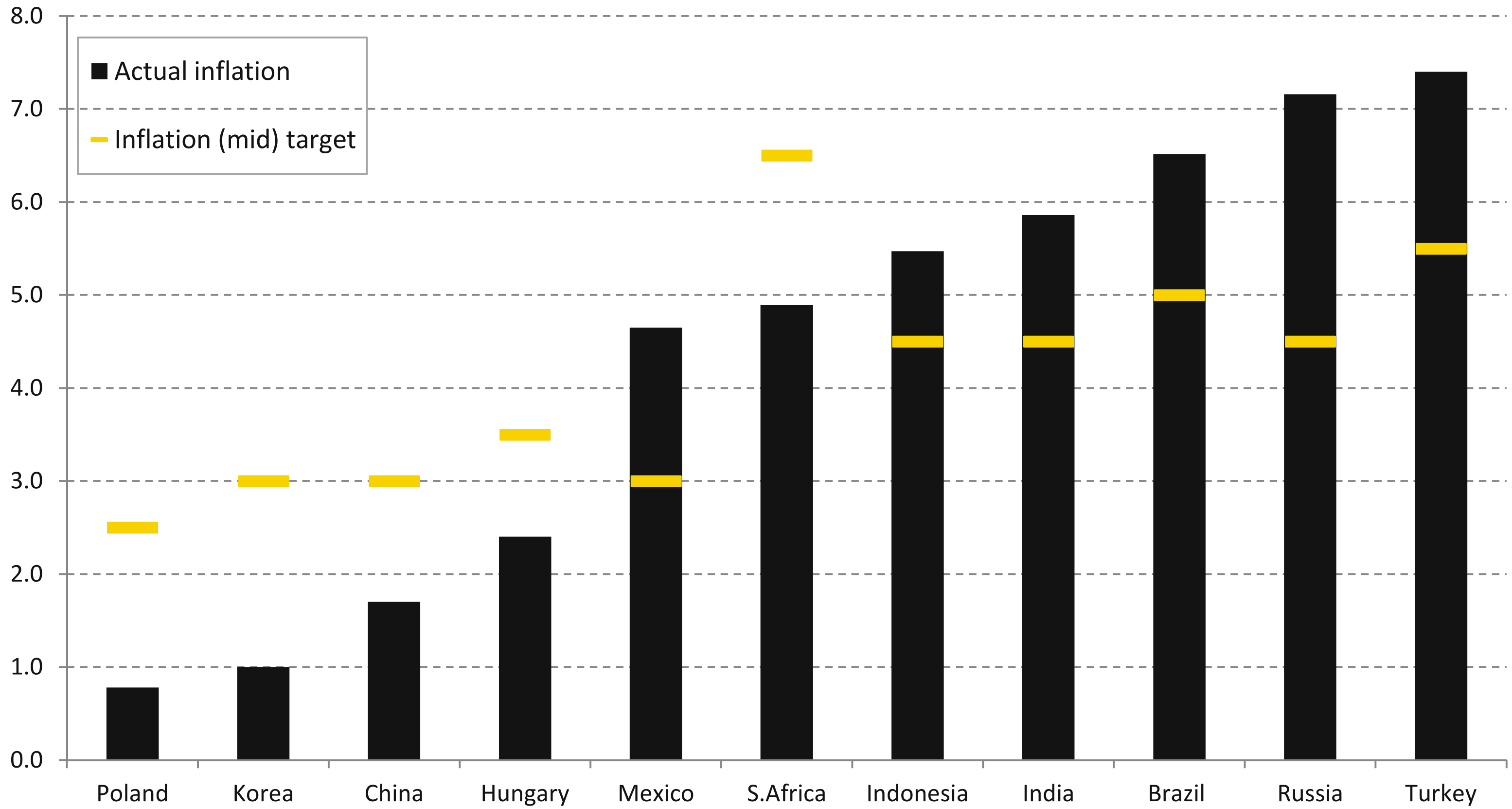
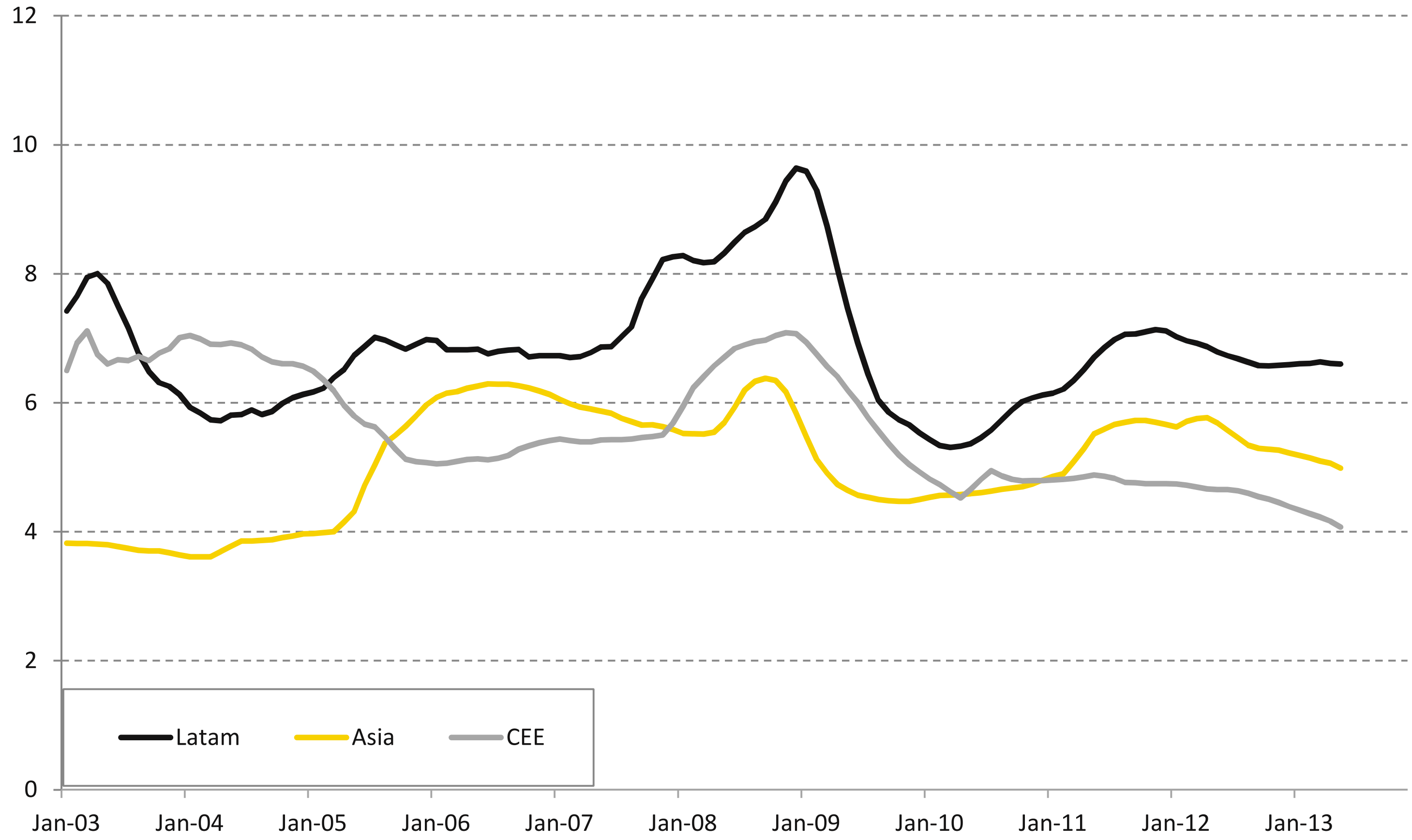
EM inflation to remain broadly in check...



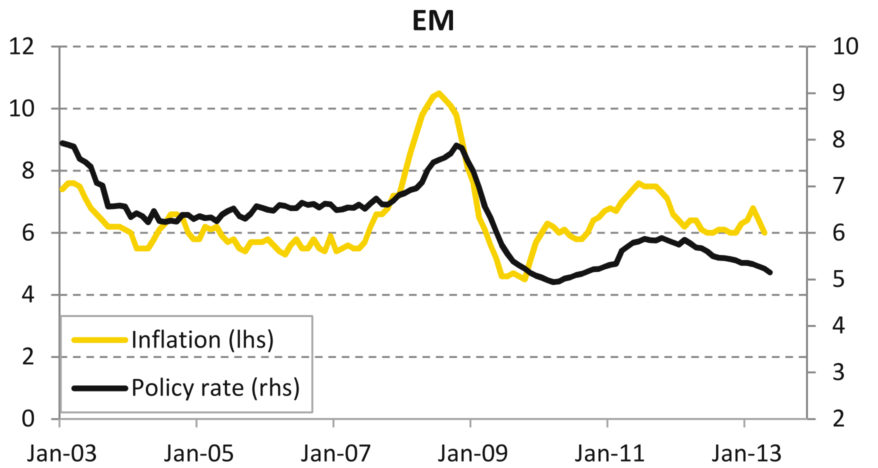
....though a strong focus is still required

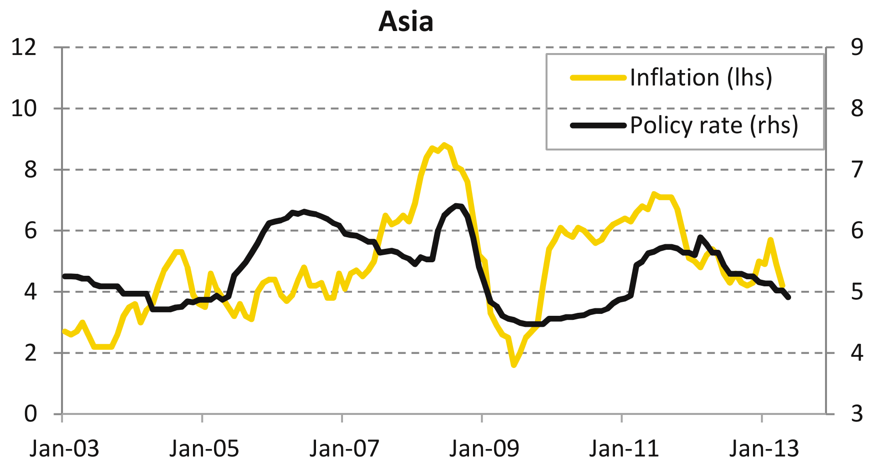


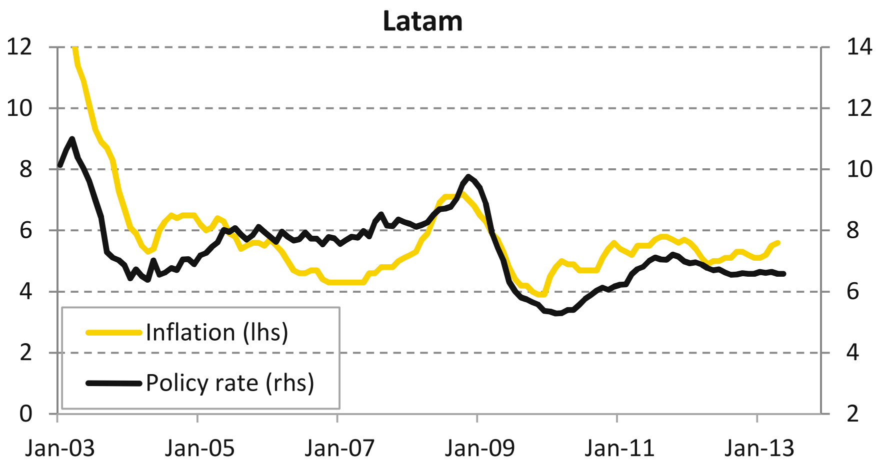
EM Monetary policy in easing mode

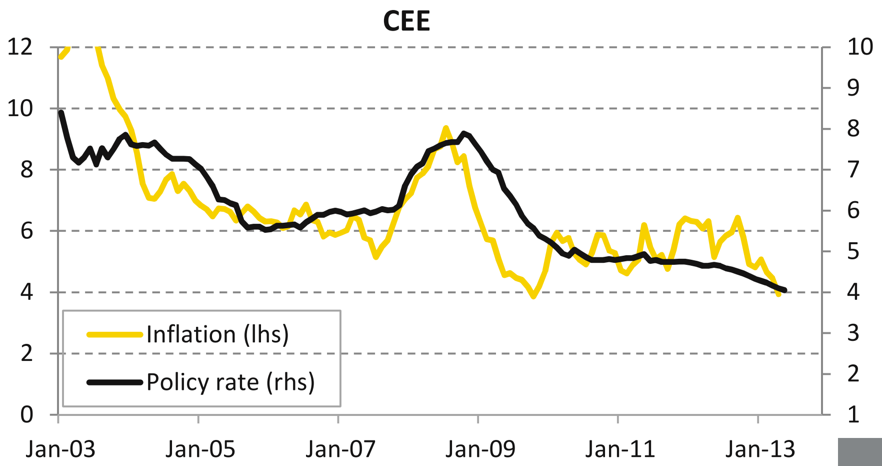


Monetary policy and inflation by region





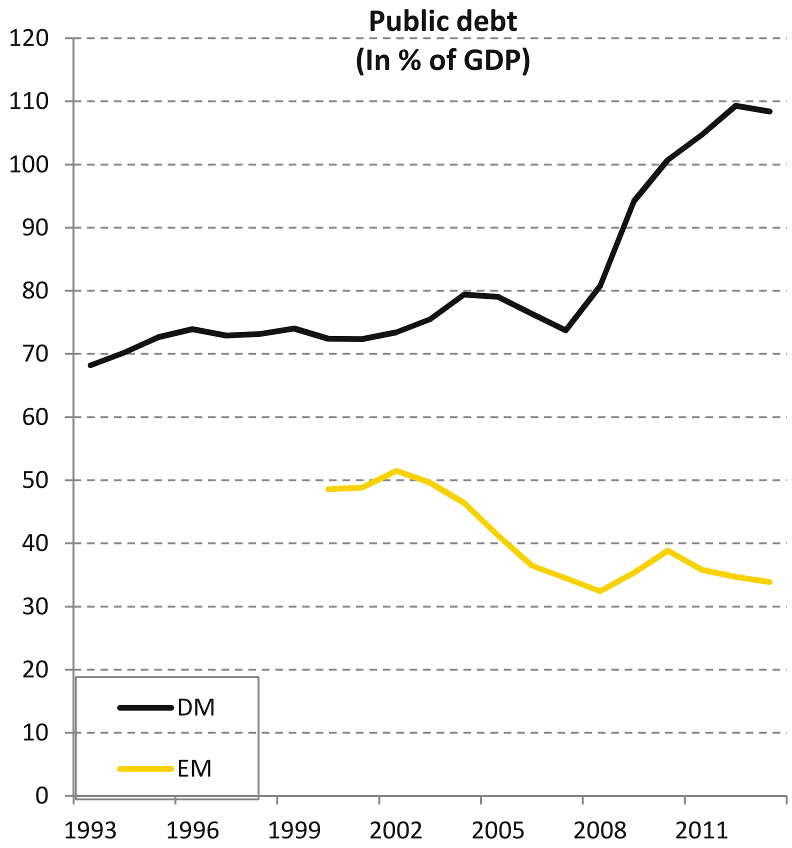


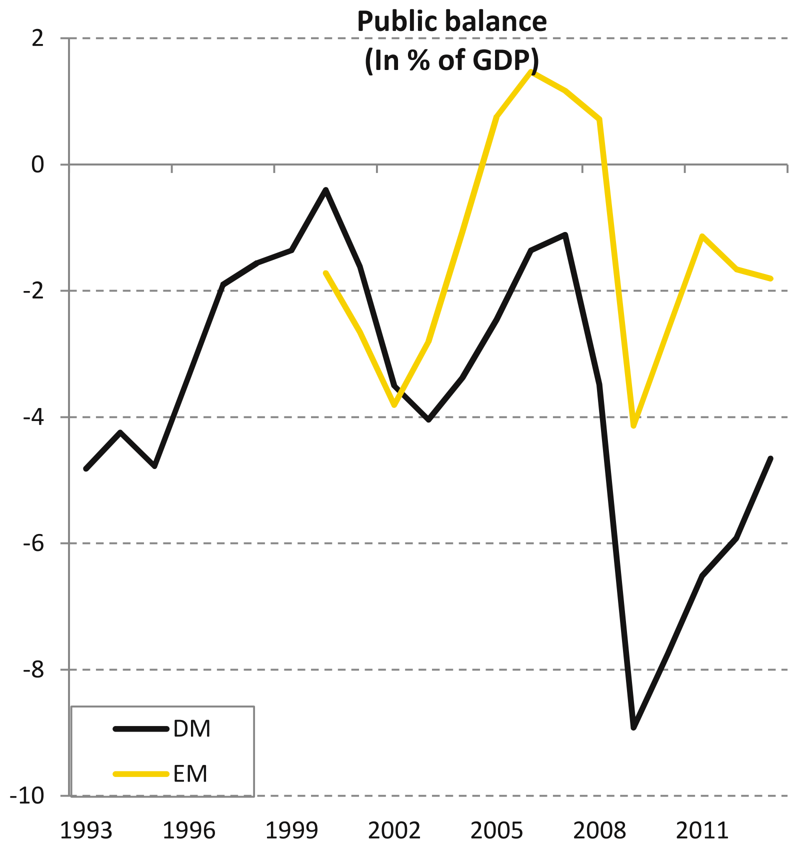


Emerging markets

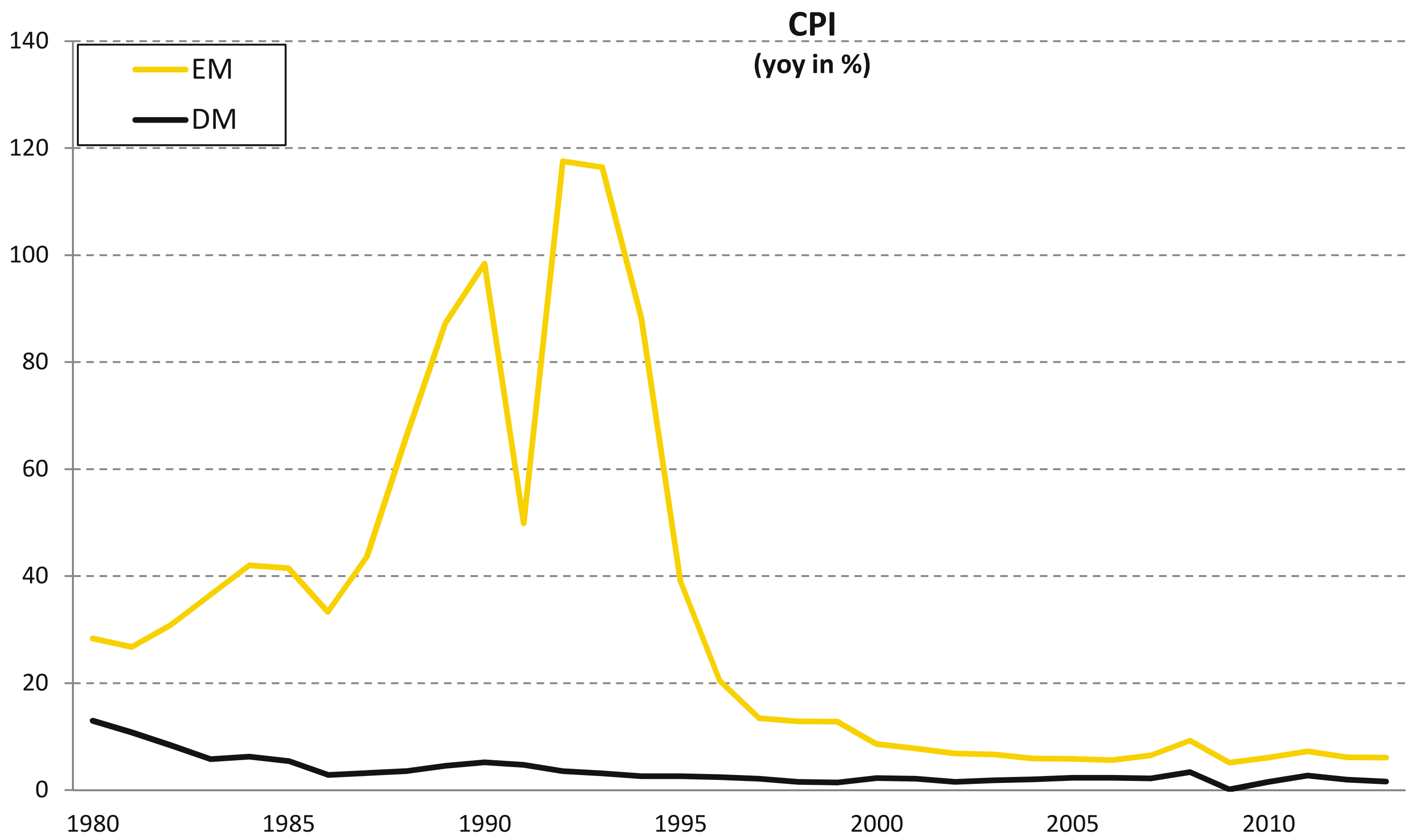
Underlying fundamentals remain healthy

Public finances in healthy shape



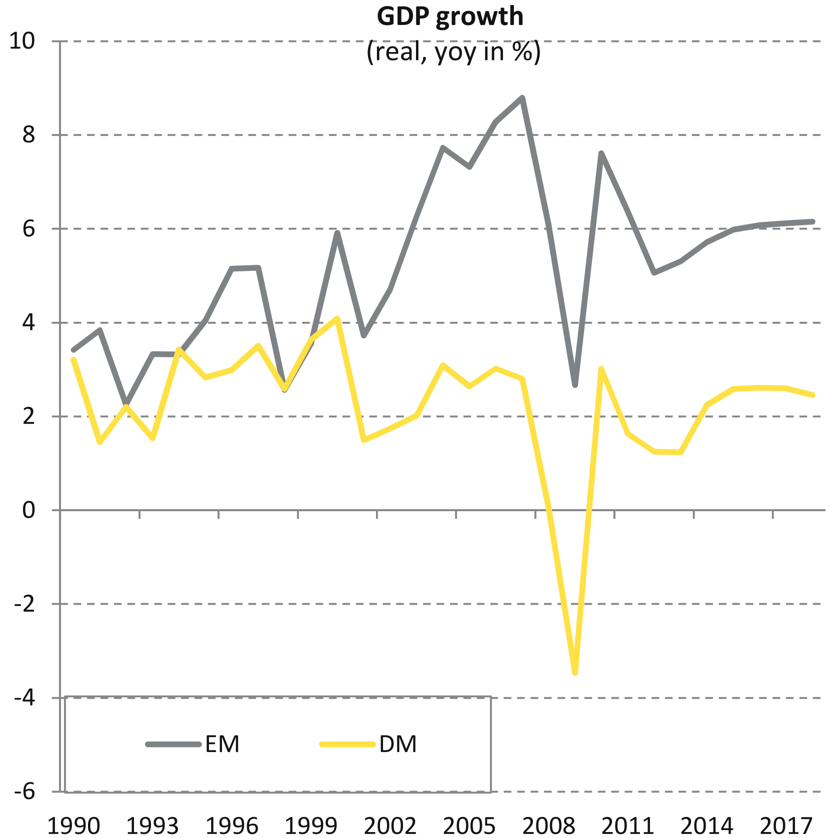


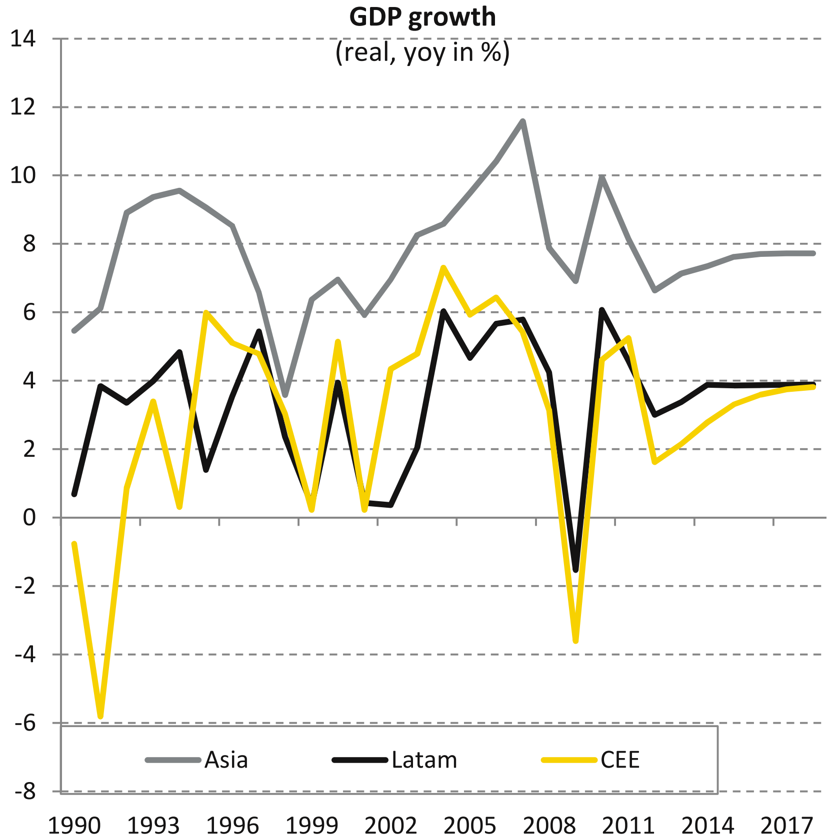
Inflation broadly under control



Relative fast growth set to remain in place…

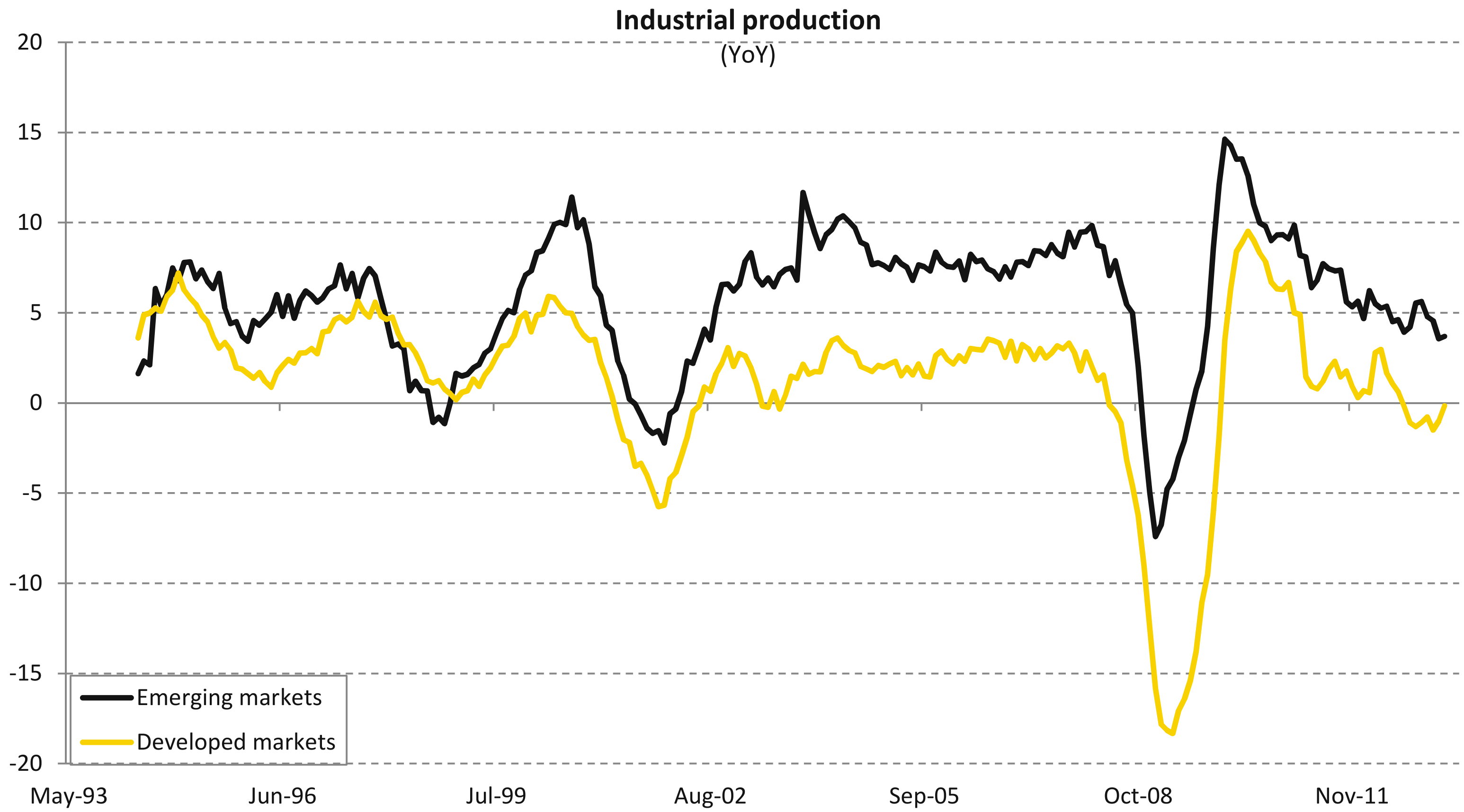
No return to pre-crisis stellar growth rates





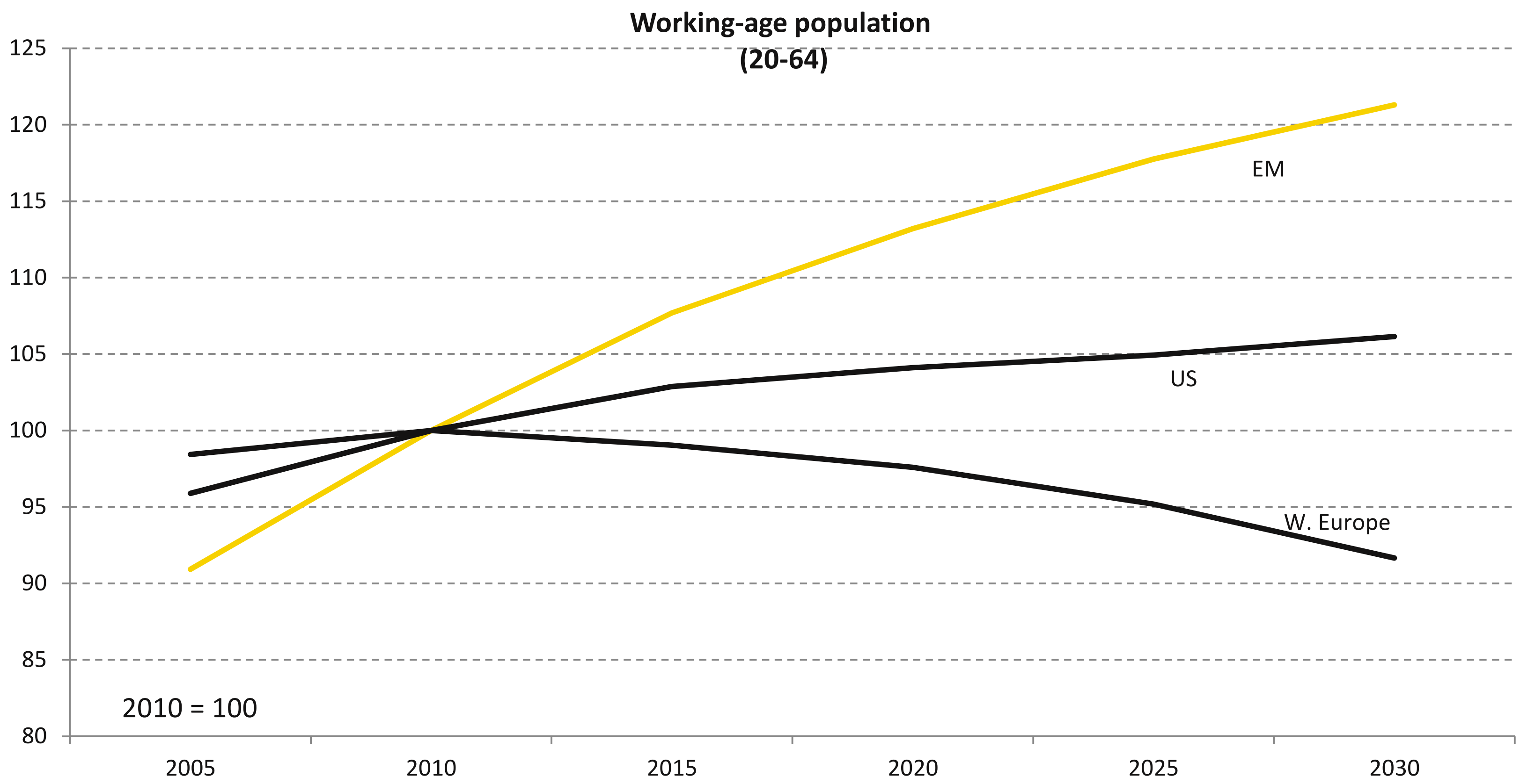
…though EM and DM will continue to move in tandem

Near-term decoupling looks unlikely



Favourable demographics

China and Russia are notable exceptions



BRIC's not up for a decent recovery

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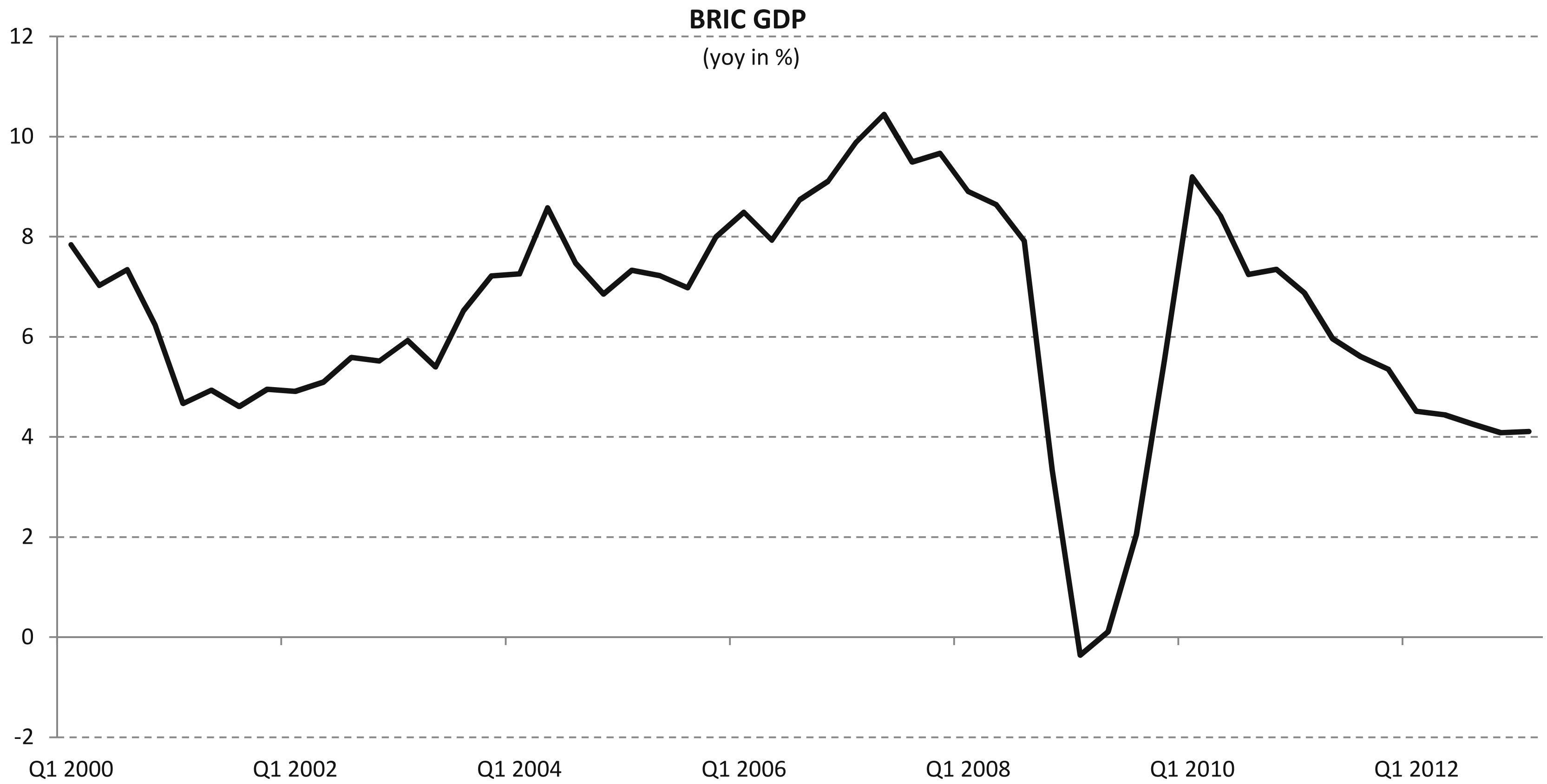
Struggling BRIC's



Structural impediments hold back BRIC's

BRIC's recovery likely to disappoint

- **Brazil**
  - Pre-crisis growth based on debt-fueled consumer spending and rapidly rising commodity prices
  - Challenge? Economic rebalancing away from consumption and towards investment
  - How? Rise in domestic savings
  - Difficulties? Political ly impopular decisions + 2014 upcoming elections

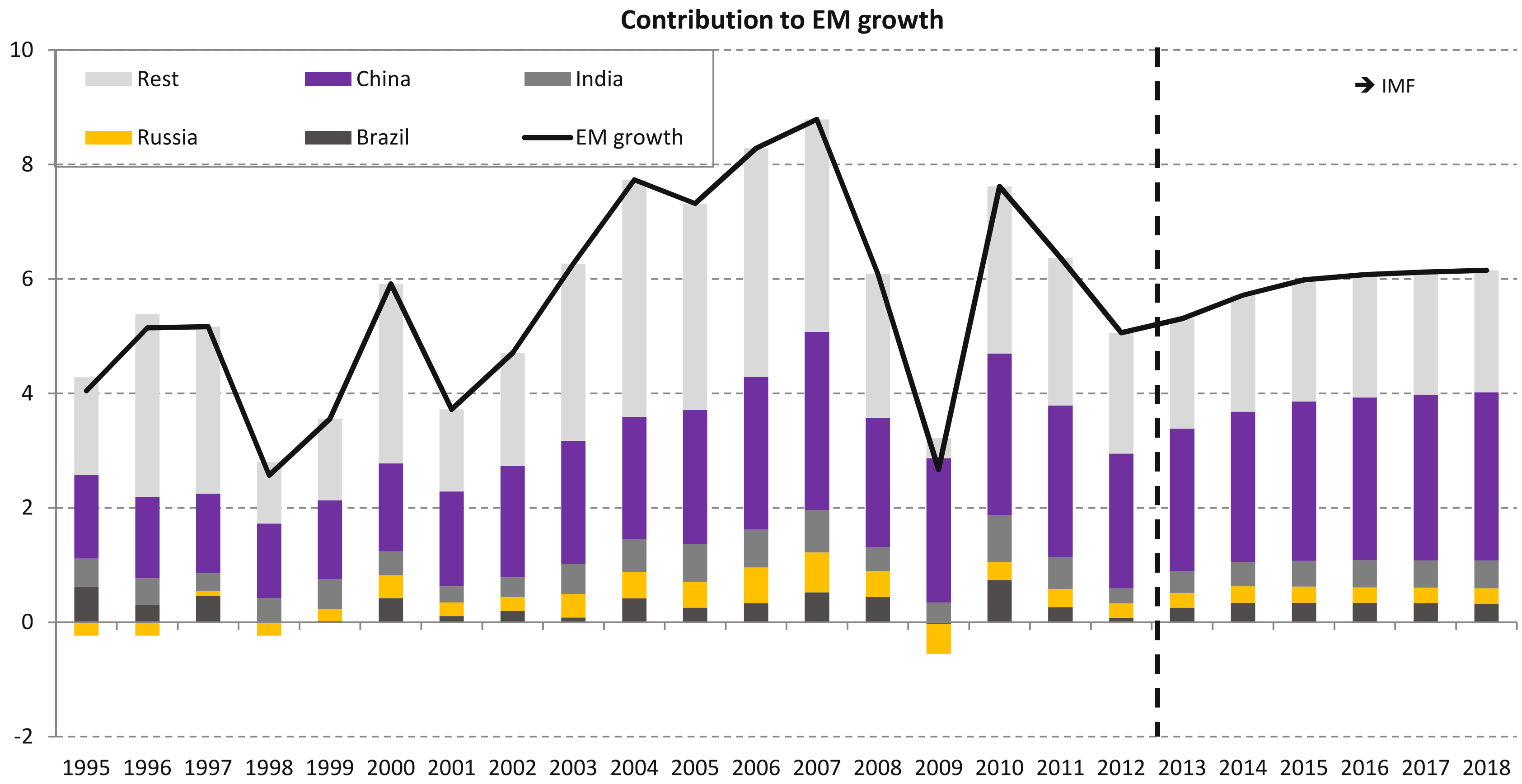
- **Russia**
  - Pre-crisis growth based on high oil prices and subsequent consumption boom
  - Challenge? Economic rebalancing away from consumption and towards investment
  - How? Drastic improvement in (foreign) investor climate
  - Difficulties? Vested interests + corruption + lack of democracy + weak institutions

- **India**
  - Pre-crisis growth based on policy liberalisation reforms between 2000 and 2004 (which increased productivity)
  - Challenge? Proceed with further reforms
  - How? Liberalisation of labour market, increase of competition, reduction of bureaucratic inefficiency
  - Difficulties? Vested interests + corruption + 2014 upcoming elections

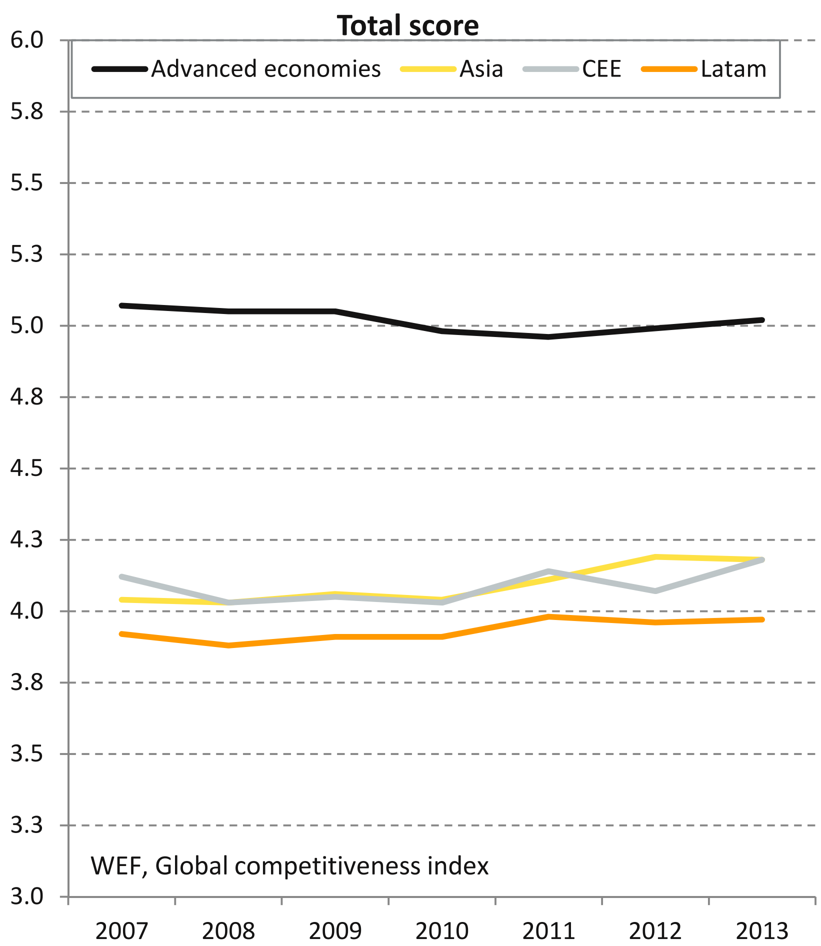
- **China**
  - Pre-crisis growth based on over-investment
  - Challenge? Economic rebalancing away from investment and towards consumption (slower growth inevitable)
  - How? Stronger safety nets (social security), interest rate liberalisation
  - Difficulties? Vested interests (SOE's), democratic deficit

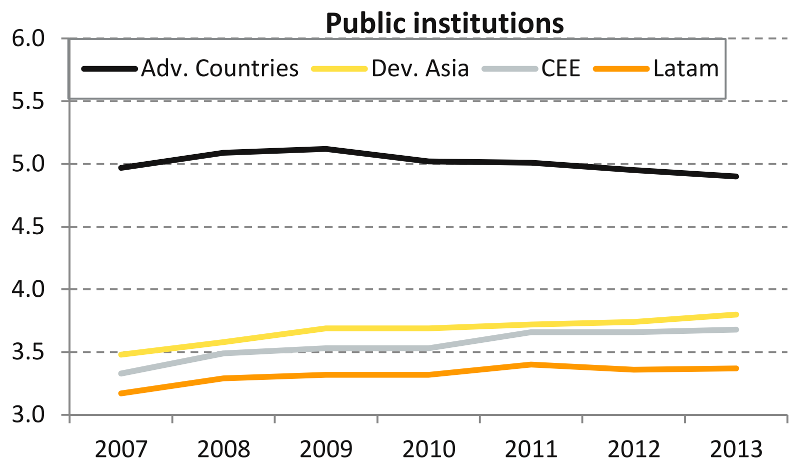
BRIC's dominate EM growth

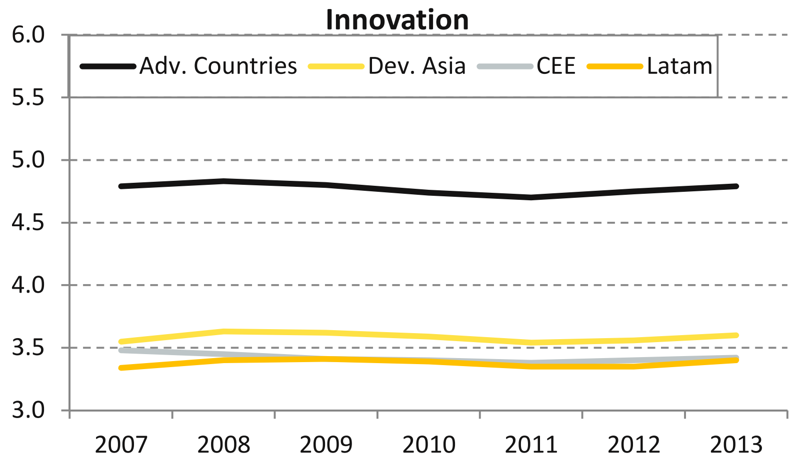
Which implies EM growth is set to remain modest at best



Structural progress does not come overnight







Main risk

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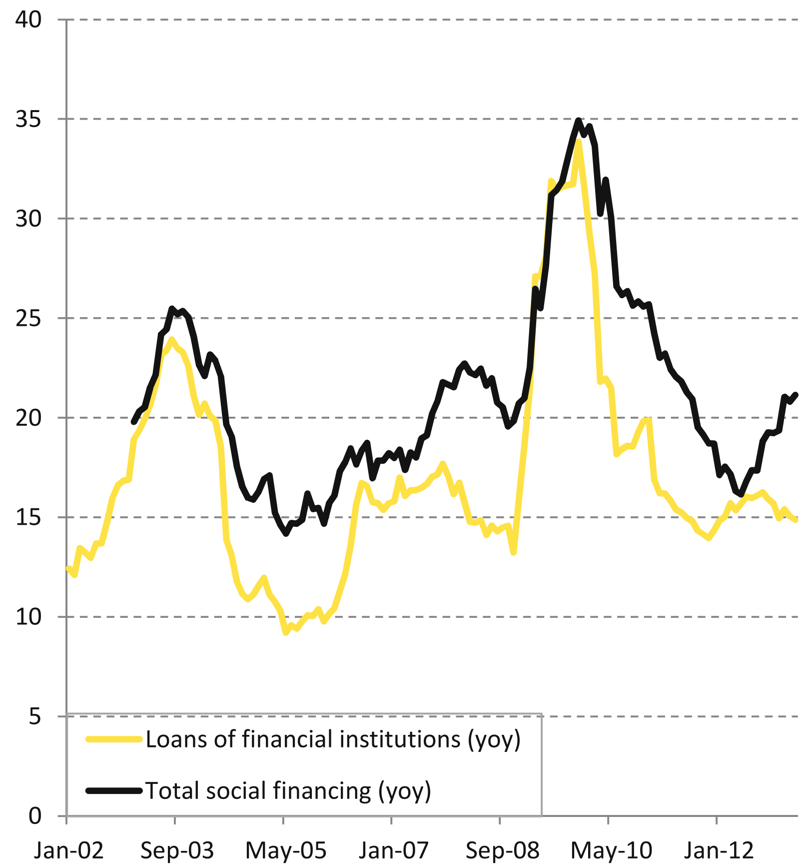
China

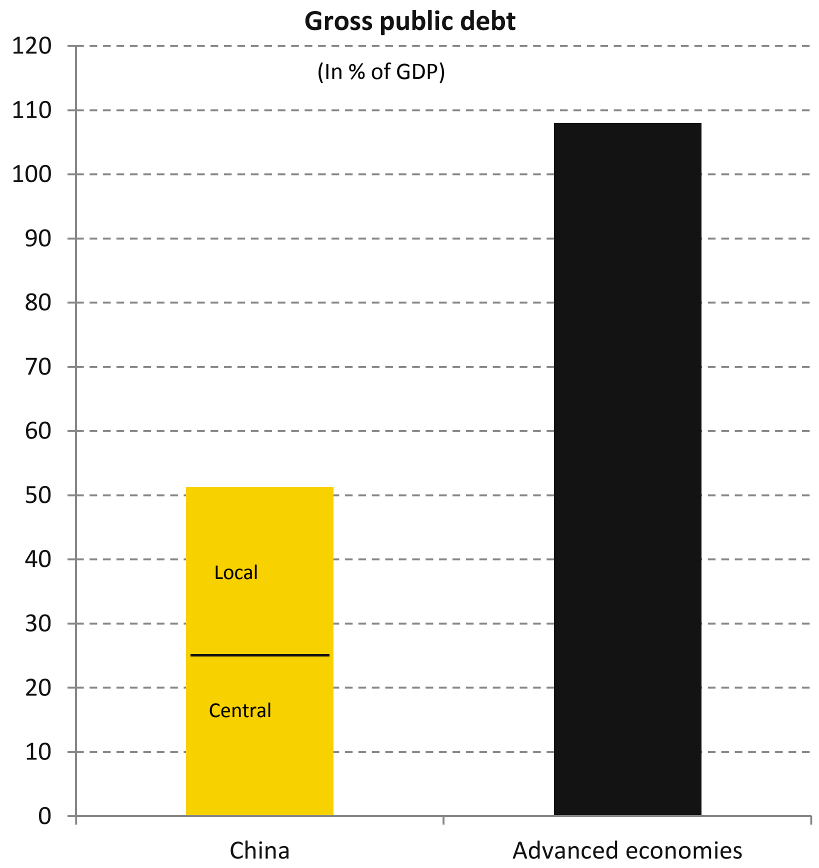
Off-balance debt has risen quickly in recent years



- Total social financing (TSF) is the best measure of credit growth
- TSF encompasses official bank loans and off-balance financing
- Off-balance debt has risen quickly in recent months…
- …spurring more fears of unsustainable credit growth and local government default

China

Local debt, how big of an issue?



- Local government debt is reasonably estimated at 30% of GDP, in general backed by local infrastructure projects which generate revenue

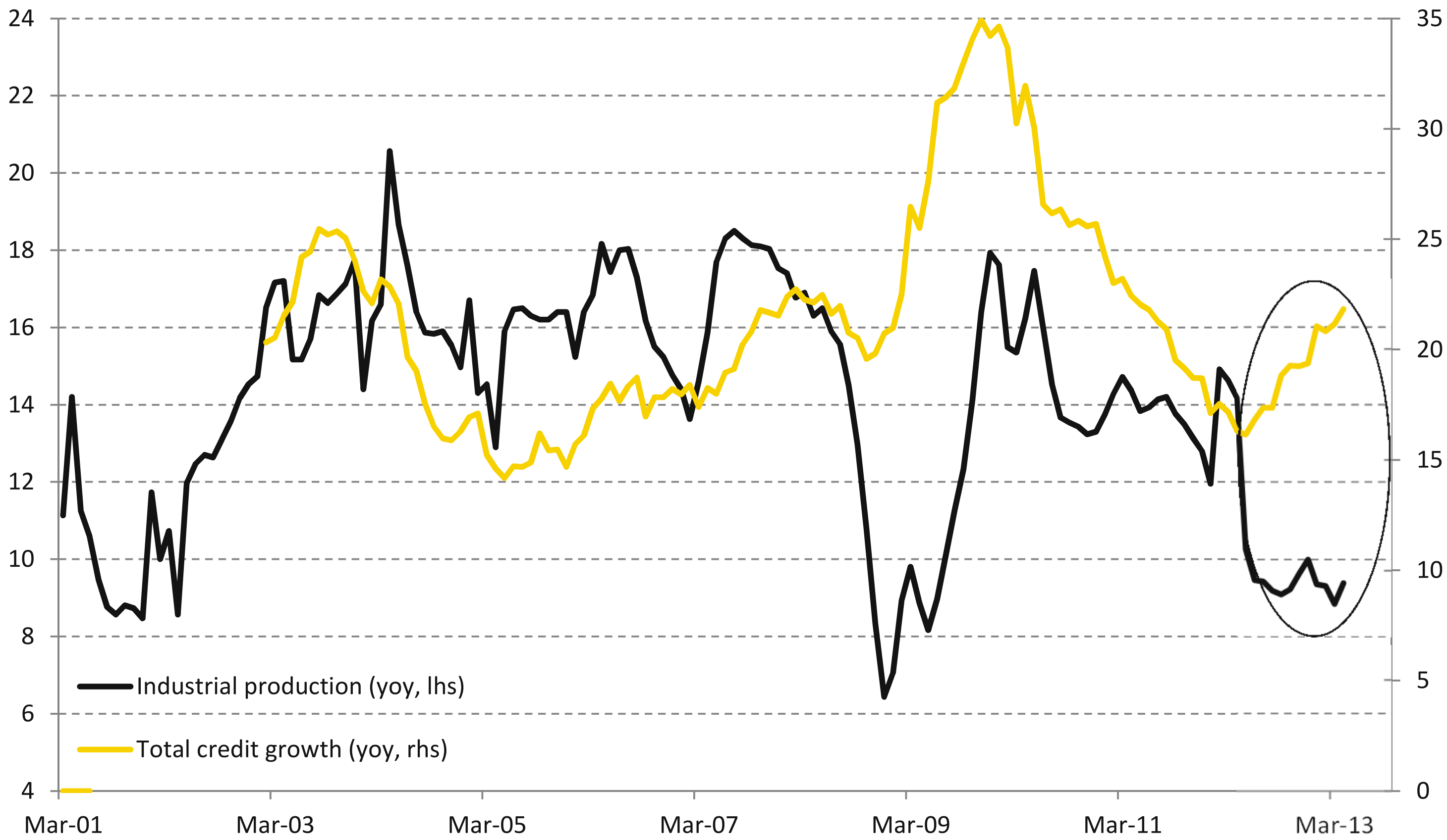
- It is more than likely that a (substantial) part of these projects don't generate enough cash to pay back debt (misallocation of capital)

- It is impossible to roll over local debt indefinitely. In the end someone has to pay. Most likely, this comes down to burden sharing between central authority, local authorities and state-owned banks

- Combined local and central government debt is about 50% of GDP, still largely manageable

Divergence between credit growth and economic activity

Key question: why isn't growth picking up?



What explains this divergence?

No clear-cut single explanation

<u>Several possible explanations have been cited:</u>

- **Central governments and companies don't have enough cash**
  - Consequently, they take on new debt to roll over maturing obligations
- **Deteriorating credit growth efficiency**
  - Falling returns on investment on the back of overcapacity
- **New cash sitting in bank deposits**
  - Waiting for new local leaders to launch new projects
  - Local governments and companies adopt a wait-and-see approach until the political outlook is more clear
- **Double counting in credit numbers**
  - Multiple layers of intermediate lenders before a loan reaches its destination
- **Our view**
  - See next slide

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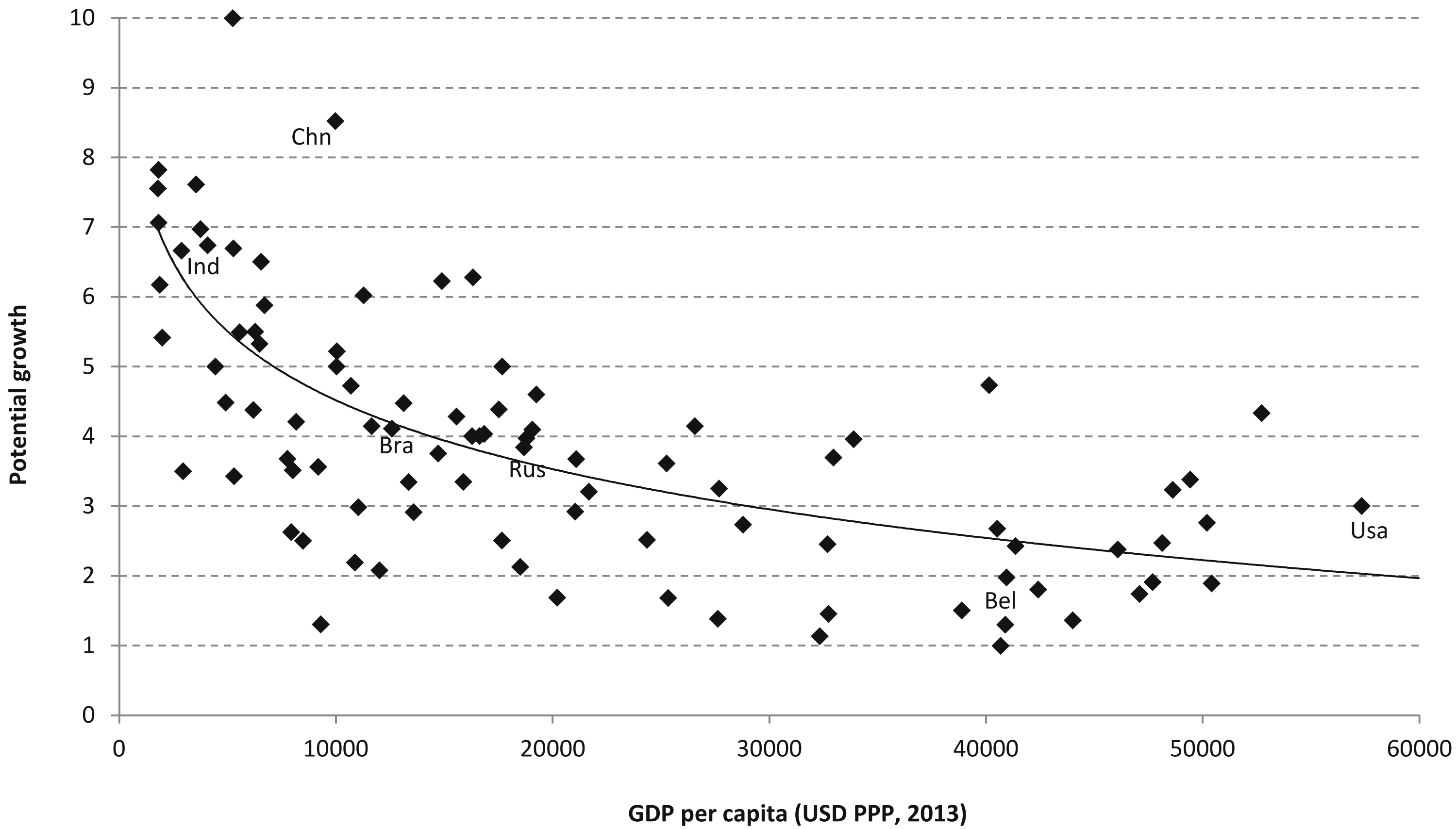
A Chinese financial crisis/Minsky moment looming?

Fears of a full-blown financial crisis seem exaggerated

- **Current credit growth is unsustainable and requires strong focus in near-term future**
  - The increase in credit growth is probably somewhat overstated (see previous slide)
  - It is difficult to see rolling over maturing debt obligations (Ponzi Scheme) as convincing explanation since that would not lead to a surge in credit growth in the first place (net balance = 0)
  - A phase of (corporate) deleveraging cannot be ruled out in the near-future, putting extra pressure on economic activity
- **However, fears of a full-blown financial crisis in the next few years seem exaggerated:**
  - China has very limited external debt, a current account surplus and a closed capital account (so that the classical trigger of foreign investors fleeing the country is not present)
  - Loan to deposit ratios have remained healthy, implying that banks continue to fund themselves from a broad deposit base

Chinese GDP growth set to slow inevitably



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Conclusion

- **EM financial markets under pressure on the back of rising uncertainty surrounding US monetary policy**
  - However, FED still adding monetary stimulus; an actual exit strategy is probably not on the cards before 2015
  - BoE, ECB and BoJ set to announce more stimulus measures
  - EM equities rather cheaply priced

- **Economic activity disappoints**
  - On the back of lacklustre growth in advanced economies and structural problems in BRIC's

- **Inflation remains broadly under control for now**
  - Easing core inflation
  - Credit growth slows
  - Monetary policy remains in easing mode

- **Main risk: China hard landing**
  - Chinese growth is poised to come down inevitably
  - Credit growth is somewhat worrying , definitely unsustainable and a key thing to watch
  - A major financial crisis in the next few years does not look the most realistic scenario

- **Have EM lost their shine?**
  - Underlying fundamentals remain healthy
  - BRIC's unlikely to make sufficient steps in the right direction (structural reforms)
  - As the BRIC's make up roughly half of EM economic activity, a rapid EM recovery should not be expected
  - The US recovery in H2 should provide some support for economic activity in EM