Special Report 2008/02

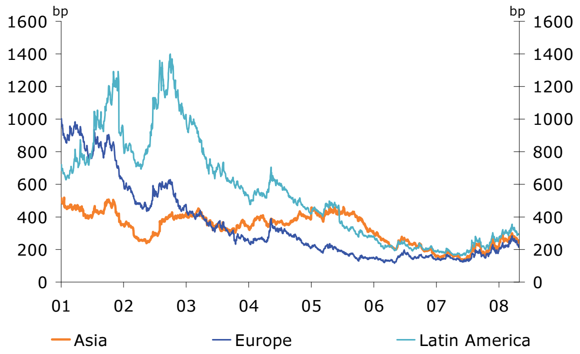
Emerging markets emerged?

Since the Tango crisis of 2001-2, the emerging markets have been on a path of continuous growth. Spurred by the development of China as one of the main world economies, emerging markets have benefited from higher commodity prices and greater export demand. Some analysts have stated that the evolution in the emerging markets have rendered the countries immune to a slowdown in the US. We do not share that analysis. Although the emerging markets have reduced their economic vulnerability, there is still a huge reliance on US demand in order to continue developing the economies. Even though the first round effects will be limited, reduced growth may lead to social upheaval and a reversal of the prudent economic policies of the past years. Emerging markets are not as vulnerable as before, but thinking emerging markets are immune would be a mistake.

Contagion: How does it work?

There are two channels for a western economy's sneeze to turn into an emerging markets pneumonia. First, capital becomes more expensive for and less available to emerging markets. "The market is always right" is a very familiar saying. However, rather than looking at the fundamentals of an issuer of bond or stock, traders tend to look at market behaviour itself.
A riskier economic situation in the west provides the perception that risk in emerging markets will increase likewise. This behaviour is reflected in the EMBI spreads, the difference between emerging market bonds and US Treasury bills with a similar tenor. Until April 2007, herd behaviour had led to unprecedented low spreads on emerging market bonds (graph 1).
From April 2007 onwards, and especially since October 2007 as the real trouble in the banking sector started, have the spreads increased. The spreads are currently probably a better reflection of the actual risk, as ratings and spreads are closer to its historic average. Nevertheless, the slightly higher spread is a sign that capital is available to emerging markets, but only under a higher price.
The second channel is via trade. This road usually takes a little while to manifest itself, as trade contracts are already signed and will be honoured. However, a US crisis would lead to reduced demand for imports from emerging markets. Also, a domestic crisis in the US will lead to a change in the exchange rate. As the dollar drops versus the emerging market's currency, the emerging markets lose a competitive advantage, further reducing its exports.

Graph 1: EMBI spreads, regional since 2001

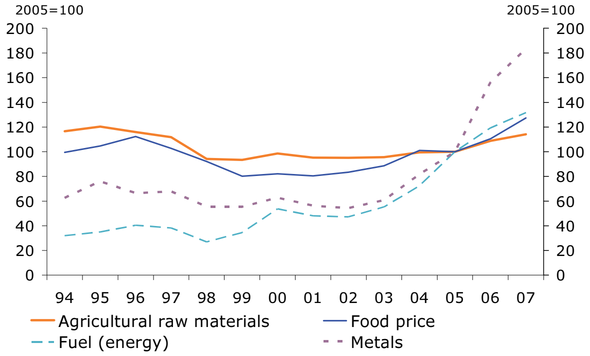


Source: JP Morgan

Are emerging markets less vulnerable?

There has not been a deep emerging market crisis since the Tango crisis in 2001 and 2002 affected the economies of Argentina and Uruguay. Furthermore, only in the 1990s did we encounter crises with severe cross-border effects such as the Tequila crisis in 1994 affecting entire Latin America, the Asian crisis hurting its region in 1997 and the Russian crisis in 1998 strangely affecting Brazil.
Since the Tango crisis, emerging markets have benefited from a benign international economic climate, with the G7 growing at an average pace of 2.2%.

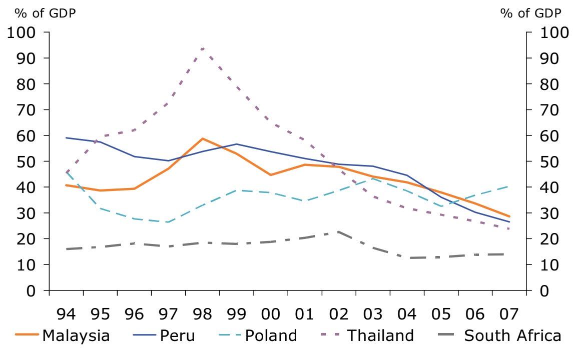
Graph 3: Commodity prices index



Source: Ecowin

Furthermore, China has become an engine of global economic growth and to a lesser extent, so has India. Their demand for commodities and energy have led to higher prices for those basic goods, abundant in emerging markets such as in the Middle East (oil & gas), Africa (cotton, cacao, gold), Latin America (sugar, beef, copper) and Russia (almost all). Also, the rest of southeast Asia could increasingly complement China's role as factory of the world. It has led to high and stable growth percentages in all the emerging regions save eastern Europe.
Meanwhile, the governments of most emerging markets have been using the economic wealth to build up the economic structure by reducing vulnerabilities. The main issue that has been tackled is the indebtedness. Using the windfall gains from high commodity prices and higher exports, countries have repaid and prepaid creating the opportunity for these countries to change the make-up of the debt.

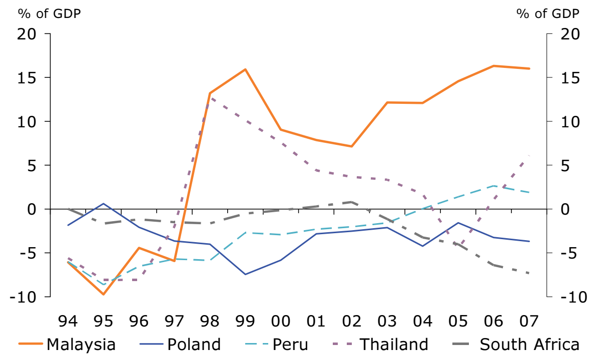
Graph 4: Foreign debt-to-GDP



Source: Ecowin

In the past few years, the average debt maturity was extended while more and more debt was denominated in local currency. This reduced the risk of countries defaulting on their debt due to sudden changes in the international capital market. Rising interest rates and currency depreciation will have a smaller effect on the liquidity position of any given country.
Furthermore, the central banks in many countries have been given more leeway to tackle inflation. Their increased independence has led to an improved weighing of the consequences of interest rate hikes to both inflation and economic growth. The central banks have indeed raised rates to counter inflationary pressures.

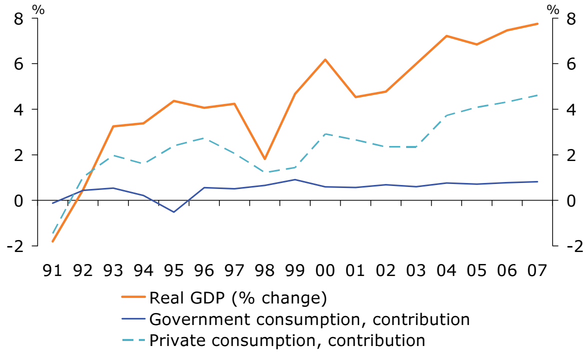
Graph 5: Current account balance



Source: Ecowin

Lastly, economic policy as a whole has been more prudent in the last couple of years. Even leftist politicians looked at the long-term future of the economy and decided on restraint on expenditure. Economic growth was already aiding the poor in these countries, creating the political opportunity to show that restraint.
All these factors mentioned have contributed to the most important factor in the 'decoupling-theory': the creation of a stable domestic market. As the economies grew, so did the disposable income of its inhabitants. These were more and more willing to spend that money on consumer goods. The domestic market has increasingly become an important driver of domestic growth, partly replacing the role of the external sector. Graph 6 shows the

Graph 6: BRIC & South Africa unweighted average



Source: Ecowin

average contribution of private consumption to the overall growth level in the BRIC-countries (Brazil, Russia, India and China) and South Africa has risen strongly over the years. In the risk analysis of emerging markets, a lot of emphasis is put on the local market reducing country risk.

The risk of a US slowdown spreading through the two main channels of contagion is limited to a certain extent. The capital flows are protected by an improved external balance. The effects of reduced trade are countered by increased domestic demand. There will still be a reduction of foreign trade, but its effects on GDP growth will prove limited.

So, where is the risk of contagion?

Although the growth levels will not be affected by much – on a macroeconomic level – by the trade effect, it will still have its effects on the external sector of an emerging market. As we have stated above, governments have been able to pursue prudent economic policies on the back of high economic growth. As these levels of growth decline, so will the natural ability of the economy to reduce social problems such as poverty and unemployment. Governments will be looked upon to actively start improving the lives of the social less-fortunates.

The effects of governments' pursuing expansionary policies will have detrimental effects. On a domestic level, the fiscal balances will deteriorate, and the debt-to-GDP ratios will rise. This is no cause for immediate concern, as these debt ratios have been moving in the right direction for some years. However, expansionary policies will put pressure on the central banks' monetary policy. To counter the effects of government spending on inflation, the central banks will be forced to take action for instance by raising the interest rate. As this will affect investment and thereby growth, it will not only counter the effects on inflation, but also the injection the government would want to give domestic demand. In a worst case scenario, the independent positions of many of the central banks may come under scrutiny.

In that case, the international standing of the country will come under pressure. The track record that many countries have built over the past years will be destroyed. Investor's confidence may be suffer, which will bring us back to the capital channel of contagion.

The second round effects of the US reduction of growth may have deeper effects than would appear at first sight. This is the time for *emerging* markets to show how far they have actually emerged.

Conclusion

To state that emerging markets are immune to the effects of a western slowdown is rather unrealistic. Rather, to state that emerging markets have been successful in recent years to reduce their vulnerability would be more accurate. In their current state, the effects of a western crisis will affect these countries later and less deep than they would ten years ago. Nevertheless, a prolonged period of dampened growth in the US is likely to affect the economic policies and thereby the long-term growth prospects of the emerging markets. It is important to keep a close eye on continued progress on a structural level to see which countries will really be more or less immune to western world economic slowdown.

May 2008

Jeroen van IJzerloo (030 - 2162406)
J.IJzerloo@rn.rabobank.nl