# EMERGING MARKETS QUARTERLY

# Growing Pains

By the RGE Economic Research and Market Strategy Teams

## October 24, 2011

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# Executive Summary: Tug of War



By Arnab Das

- ***The Here and Now*—Catching Up Is Hard to Do:** The abundance of riches due to excessive current and/or capital account inflows and a fear of overheating stalking emerging markets (EMs) was overtaken by a sudden reversal of fortune: Capital fled EMs due mainly to global/eurozone (EZ) event risks, even as global deceleration due to balance-sheet challenges and the premature withdrawal of stimulus restricts external demand; and as tightening restrains domestic demand. These cyclical challenges, combined with structural challenges, including governance and policy errors they encourage (such as excessive reliance on export demand or capital imports), stand against the secular catch-up story that comprises the central EM investment thesis. For as long as the systematic global risks remain in the ascendant, the governance and cyclical challenges will also stay front and center, outweighing the secular story and exposing EMs' weak underbelly. We therefore remain underweight the riskiest parts of EM—asset classes and regions.

- ***EM Equity*—Good for a Mild Recession but Still Risky:** **We underweight EM equity with the following regional ranking, given high EZ cyclical and event risks:** EM Asia equity is most insulated by high savings/strong current accounts and reserves; LatAm next, given high direct trade and indirect commodity and capital-flow links to the EZ and EM Asia; followed by MENA and Russia/CIS; emerging Europe is most directly exposed, clearly. EM equity funds flows and return beta now display an asymmetric response to EZ-driven risk-on/-off global market behavior—lagging risk-on, but responding rapidly to rising event risk/risk-off—confirming our bias that EM as a whole, including EM equity is highly exposed to, rather than being a safe haven from, any major deterioration in global macro or financial conditions.

- ***EM Credit*—Delayed Reaction:** **Nonsensical EM decoupling and much-ballyhooed EM safe-haven claims were roundly debunked** in the recent sell-off. EMs and developed markets (DMs) are in the throes of globalization, implying synchronized trade and capital flows—the opposite of decoupling. EM credit—sovereign and corporate—remains a high-beta bet. So we're in sight of taking profits on our key, globally driven EM credit view—the long EM sovereign/short EM corporate credit—pending greater visibility on U.S. recession/EZ event risk.

- ***EM Rates/Currencies*—In Defense of the Defensive:** **So we stay underweight EM local currency debt and, for now, currencies.** We expect the current risk-on episode to give way to risk-off once the EZ-Summitry short-covering/relief rally fades, giving way to weakening global growth and still-sky-high EZ event risks. With EM growth and inflation momentum both rapidly rolling over in most key EMs, we expect front-loaded EM monetary easing to take away policy-rate differential-based EM FX support for a time. But with EM growth prospects still relatively strong in a secular sense, weaker currencies and lower rates should help drive growth and inflation back up, steepening local currency curves in due course.

- ***EM Commodities*—Russia, China and the Ties That Bind:** **Greater fragmentation due to regional supply/demand and energy politics points to higher European gas prices; LNG will absorb excess global supply, making it a good long-term play.** EMs are on different sides of the ages-old "resource curse" amid an ever-evolving "Great Game" of energy security—either they are major exporters (Russia, Brazil), or importers ("Chindia"). Weakening U.S., EZ/EU and indeed global growth will reduce energy demand growth. Meanwhile, Russia, still searching for "security of energy demand," will continue to diversify its gas exports to the east, even as it seeks to secure greater control of the supply side of the regional energy market by extending and entrenching influence in its "near-abroad," via its Eurasian union with Belarus, Kazakhstan and perhaps eventually Ukraine and even more of Central Asia.

# The Here and Now: Catching Up Is Hard to Do



By Arnab Das, Rachel Ziemba, Christian Menegatti

- The impending recession in developed markets (DMs) and rising risk of a financing shock from the eurozone (EZ) will exacerbate the slowdown that is already on course in emerging markets (EMs).
- We expect more pro-active monetary easing and some fiscal stimulus to cushion domestic economies, but most countries will see below-potential growth as trade falls and financing costs rise. EMs (like DMs) have less space for stimulus than in 2008, having already used some of their capacity.
- Asia remains most resilient, emerging Europe is most exposed through direct trade and financial links, while Latin America and the Middle East and Africa (MENA) are vulnerable to the indirect effect on commodity prices and demand and the decline in capital flows, especially FDI.
- In this context, we expect a continued decline in the unfounded view of EMs as somehow de-coupled from risks of U.S./EZ slowdown or full-blown EZ financial crisis, or as "safe havens" of any kind. Rather, we expect a continued rise in home bias as/when risk aversion rises, and advise shifting global EM exposure away from equities to bonds, and away from the most exposed to the least exposed countries and regions, particularly from net-debtor/deficit to net-creditor/surplus economies.

The here-and-now global macro themes for EMs are the same as dominate other global markets: The confluence of high and occasionally rising EZ fiscal/financial crisis/event risk; global economic deceleration, despite the recent improvement in U.S. macro data; EM-wide challenges stemming from episodic risk aversion even as DM fiscal and past EM monetary tightening slow external and domestic demand at once; and resulting pressures on country-specific weaknesses in the growth model, including imbalances such as excessive current-account/trade surpluses, which restrict the depth, maturity and credibility of governance/institutions and capital markets.

Against these four cons are still ranged a few major pros. Namely: Stronger national balance sheets in many key EMs, far less encumbered by expensive welfare states or rigid labor markets (albeit that there has been a rapid leveraging up in some EMs of household, financial or corporate sectors in the past couple of years); and therefore greater secular growth prospects, with the benefit of being able to catch up by adopting technologies and ideally avoiding the mistakes of the past.

Which of these will win out in the tug of war as EMs continue to struggle to grow and catch up with high-income countries? Though these are broad brush questions, they have immediate here-and-now implications since the pressures in the global economy and financial markets can at any time force capital to return home, precipitating a sharp downward shift in global growth or even the level of activity.

Furthermore, the big-picture thematic risk as the crisis continues to roll from victim to victim is of de-globalization, in which case EMs and the asset class would be a key loser, just as they have been among the main beneficiaries. So far, explicit protectionism has been restrained throughout the crisis, with little beyond token gestures to vested interest groups. However, the crisis is far from over, and during crisis, people take care of themselves first, their countries next and the problems of other countries or the world as a whole last. Already in the EU, the Schengen Treaty, which provides for visa- and other restriction-free travel within a large part of the continental customs/currency union, is being rolled back. Asset protectionism has long been underway, at least as long as reserve accumulation and the desire of sovereign wealth funds and creditor countries in general to diversify their risk away from currencies and bonds of reserve-currency countries to equity and real, directly productive assets.


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Now, liability protectionism is in full swing, as EMs seek to protect their high-yield/high-return local markets, complete with currency kickers, from attracting excessive inflows, even as DMs arguably engage in financial repression via low or negative real interest rates to ease the burden of excessive debt.

In our Age of Crisis with the increasingly fragile upside hopes, we expect the EM growth differential relative to high-income countries to prove less than hoped in the immediate aftermath of the 2008-09 Global Crash, even though catch-up prospects will ensure that EMs continue to grow far faster than DMs if globalization is not rolled back. EMs, like DMs, have less policy space. China's growth model, in particular, a fount for supporting non-inflationary, leveraged growth models across rich countries as well as rapid, high/rising-commodity price-led growth in much of EM, is running out of steam. And, with it, the terms-of-trade gains that fuelled consumption in resource-rich EMs will be less dramatic than before. And even before the China investment bubble bursts or even if the EZ fiscal/financial crisis does not get out of hand, the internal inconsistencies in key EMs' growth processes and models—excessively easy monetary policy and China/USD-shadowing or pegging—will face headwinds of their own as global growth slows.

**Risks Rising From DMs**

With the risks of recession elevated in DMs, particularly the EZ, we examine the resilience of EMs to recession and major financing shocks. A severe recession and systemic Lehman-like event emanating from the EZ is not our base case—nevertheless, it is a major fat tail-risk scenario given the fluidity of continued struggles with the EZ political economy. A coercive recapitalization of EZ banks, a meaningful net present value reduction of Greek debt and a big boost to the lending power of the European Financial Stability Facility (EFSF) are all necessary, albeit far from sufficient, to prevent a disorderly Greece default/exit and cascading contagion. Putting in place all three conditions is proving quite challenging; moreover, doing so might only end up borrowing time (say 12 months) by temporarily alleviating pressure on Italy and Spain. The failure to provide a credible plan would not only pose further downside risks to economic and trade growth globally, but could prompt additional capital outflows.

For now, our baseline expectation is a relatively mild recession in the U.S. and a more pronounced one in Western Europe. The risks to this scenario are, however, heavily tilted to the downside given the forthcoming EZ bank deleveraging (which provides about 80% of EZ credit intermediation) and the high risk of a credit crunch. In fact, many of the downside growth risks highlighted in our recent Outlook Update have already come to pass, including a deterioration of EZ growth prospects, significant capital outflows from EMs, which have tested central banks, and weaker trade and industrial production growth. All this will adversely affect EM growth, weighing on goods and services exports and raising financing costs—with no country immune. We anticipate a growth slowdown across EM, and a switch from the at- or above-potential growth of the past two years to mostly modestly below potential readings. While EMs have stronger balance sheets than DMs and intra-EM trade is increasing, we hold to our view that EM final demand is insufficient to fully decouple from the ongoing painful DM deleveraging.

**Some EMs Are Much More Favorably Positioned**

Although key regional trends emerge, the ability of policy makers to respond varies greatly across the emerging world, as shown in our accompanying chartbook. Within each region, there are a number of countries that are particularly vulnerable, including Vietnam in Asia, Argentina and Venezuela in Latin America, Egypt in MENA and Romania in emerging Europe.

**Emerging Asia** continues to outperform, with robust national balance sheets keeping an isolated financial crisis from spilling across borders. The trade channel will be the primary link to the global economy, with the more open economies set to suffer the most extensive stall, even as more closed China, India and Indonesia step up stimulus.

Stimulus by China will dampen the impact on emerging Asia, but there will be less than in 2008. Vietnam stands out as most vulnerable to trade/financing shocks; a banking/FX crisis is a meaningful risk.

Weaker growth in Asia and increased risk aversion in global markets will hit **Latin America** whose growth is highly reliant on resource exports, terms of trade, as well as FDI; and whose asset markets are substantially driven by DM-EM flows of funds. Its external deficits are better financed than those of emerging EMEA (Europe, the Middle East and Africa), but a pullback in FDI and domestic investment would undermine the growth trajectory.

**Emerging Europe** is much more vulnerable across a range of indicators, given it has more extensive external debt (especially Hungary), greater short-term external financing needs, more trade and financial linkages to DMs (especially to the EZ), persistent current account deficits and lower-quality financing. Less extensive reserve stockpiles limit the scope of emerging European countries to intervene in the face of persistent currency pressure.

Weaker commodity demand will dampen growth in **MENA**, meaning exports will not offset domestic stress in economies affected by the Arab Spring. Weaker demand and financing from Europe will reinforce domestic weakness and add to economic and political strains in North Africa, raising financing costs, particularly for Egypt.

**Policy: Readying the Ammunition**

EM policy makers, especially central bankers, have already started to position for more supportive policy. Although nominal rates are much lower than they were before the financial crisis, real policy rates are generally higher and inflation expectations are trending down. However, fiscal positions have weakened, and credit-to-GDP ratios have expanded, which will limit but not eliminate the ability of policy makers to respond to a recession in DMs.

We expect most EM central banks to ease monetary conditions in the event of a financing shock from the EZ: Brazil, Turkey, Indonesia and Israel having already acted, and we expect others to follow. Persistently high inflation across much of Asia, and FX pressures in emerging EMEA, will limit the easing. The most vulnerable countries, like Hungary and the frontier Africa economies, may even have to hike rates further to prevent capital outflows.

Although all countries now have either wider fiscal deficits or smaller surpluses than in 2008, there is still space for fiscal stimulus (particularly in Asia and Latin America) to offset weaker FDI flows and private demand. Emerging European countries will need to push on with fiscal consolidation, with the exception of Russia, which will draw on its resource wealth. Similarly, despite financial repression, the banks will not be as supportive as in 2008, particularly in China, which does not have the space for a 30%-of-GDP credit stimulus.

Central banks will likewise continue to intervene in FX markets, but those in EMEA, especially non-oil exporters, could quickly run out of ammunition if current portfolio capital outflows persist. Turkey, Poland, Egypt and South Africa stand out as having limited reserve cushions. In aggregate, corporations and banks have a lower reliance on short-term foreign financing than in 2008, but nations are more reliant on shorter-term fickle capital. Existing credit lines provide a cushion for countries like Mexico, Colombia and Poland, while countries with weaker balance sheets could rely again on standby agreements. Key global central banks could re-establish credit lines if core EMs face major dollar funding strains. Doing so could have geopolitical as well as economic implications—as the recent Bank of Japan-Bank of Korea line suggests.


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# Equity: Beware of Momentum



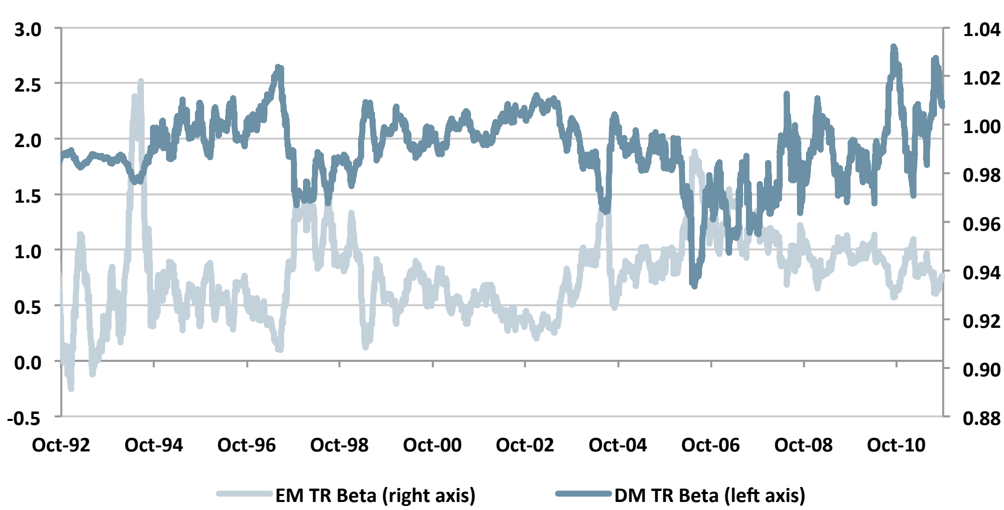
By Gina Sanchez

- We continue to remain **overweight developed market (DM) equity relative to emerging market (EM) equity;** we expect that risk aversion will likely overtake reasonably strong fundamentals.
- Regionally, we are **underweight emerging Europe and Latin America** relative to EMs as a whole. Emerging Europe will be hampered by both financial and trade links to Western Europe, while Latin America will suffer commodity volatility.
- On a sector basis, we are **reducing our energy overweight back to neutral,** as fundamentals may not be able to overcome valuations.

**Overview**

Emerging markets have not decoupled, though many still have enough room for policy responses such to give the appearance of decoupling under a mild recession scenario. That said, in a deeper recession, most countries are constrained either on the monetary side, with very low real rates, or on the fiscal side, where budgets are overextended. With the exception of emerging Europe, most countries are not directly linked to the eurozone (EZ), but many are indirectly linked through trade channels (Mexico, Chile and Peru), claims on FX reserves (Asia) or commodity channels (South Africa). In the case of emerging Europe, EMs are tied through trade and financial channels, as well as direct exposure. Moreover, these channels not only extend to the EZ, but to the entire developed world, which has become the epicenter for continual crisis. Generally, when crisis erupts in DMs, EMs suffer because they are perceived to be more risky. We have seen this in both money flows and sentiment over the past few months as EZ tensions have flared up, yet again. Interestingly, betas for EMs as a whole have been falling over time and are currently below DM beta, as compared to the total global equity markets. When markets did poorly, risk aversion drove EMs to a higher beta response, but when risk re-asserted itself into market behavior, EMs lagged. However, this relationship is far from stable and we prefer to look to the fundamentals to guide longer-term investment strategy. For those concerned about surviving to the long term, though, we highlight momentum as your biggest challenge.

**Figure 1: EM Equity Beta to Global Equities Trending Down**




*Source: Factset*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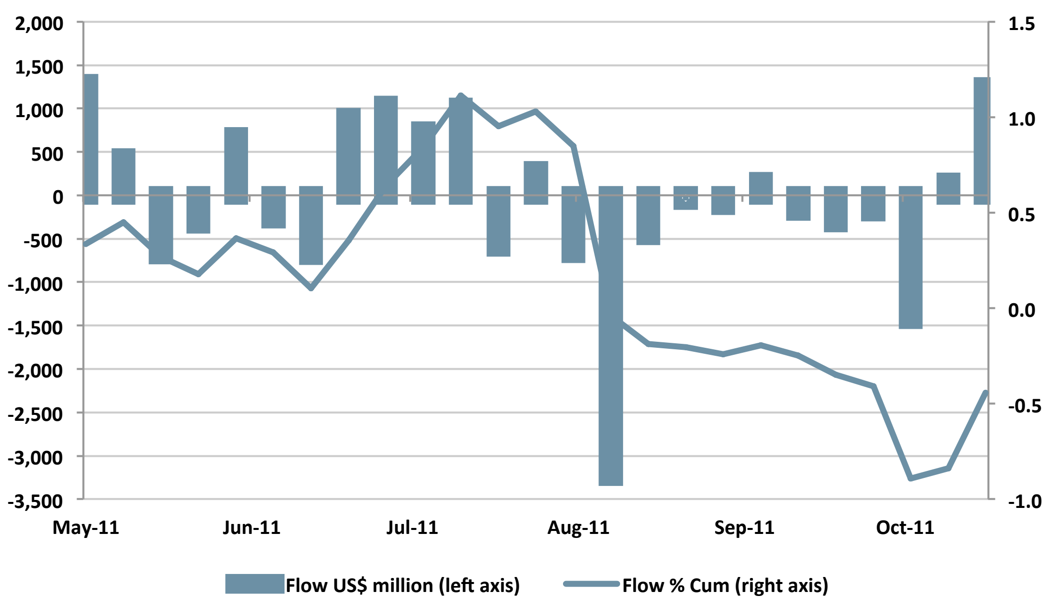
**Fund Flows Are Turning**

In attempting to understand what has been driving equity market performance, we looked at several relationships that might give us a clue as to investors' behavior. As this is a macro world, we expected the countries with highest macroeconomic vulnerabilities to have the worst performance, but that didn't line up. We looked at individual macro indicators and found no relationship as well. We looked at fundamentals and there was very little correlation between the most improved fundamental stories and the best performers. Interestingly, EMs seems to be very momentum driven and two factors had the most explanatory significance in this exercise. First, net portfolio flows as a percentage of GDP seemed to give us the best insights into performance. And, not surprisingly, fund flows seem to beget performance, as happens when momentum matters. It is worth noting that fund flows had been very negative for many weeks as we headed into the downturn for equities. However, recently, fund flows have started to turn around markedly. This is clearly a reaction to slightly improved sentiment in Europe, but we would warn that underlying fundamentals are not improving, but deteriorating, with revisions sentiment negative and expectations for EPS, sales and ROE all being revised downward. Until the outlook for the fundamentals is revised, we don't buy into this recent turnaround in sentiment.

**Figure 2: Is Risk-On Finding Its Way into EMs? (fund flows)**




*Source: EPFR*

**Risk-On and Risk-Off EM Sentiment**

EMs have continued to lag DMs as strong risk aversion took hold during the last three months. However, it is worth noting that this trend corrected in the past month when risk reasserted itself in the U.S., parts of Europe and in developed Asia. In EMs, Chile, Czech Republic, China, India, Indonesia, Philippines and South Africa have crossed into risk-seeking territory. The lag in EMs during the DM risk-on bounce suggests that even in risk-seeking periods, there is some concern by market participants that even if the EZ can create a plan, the weak outlook for DMs will have some kind of an impact on EMs.


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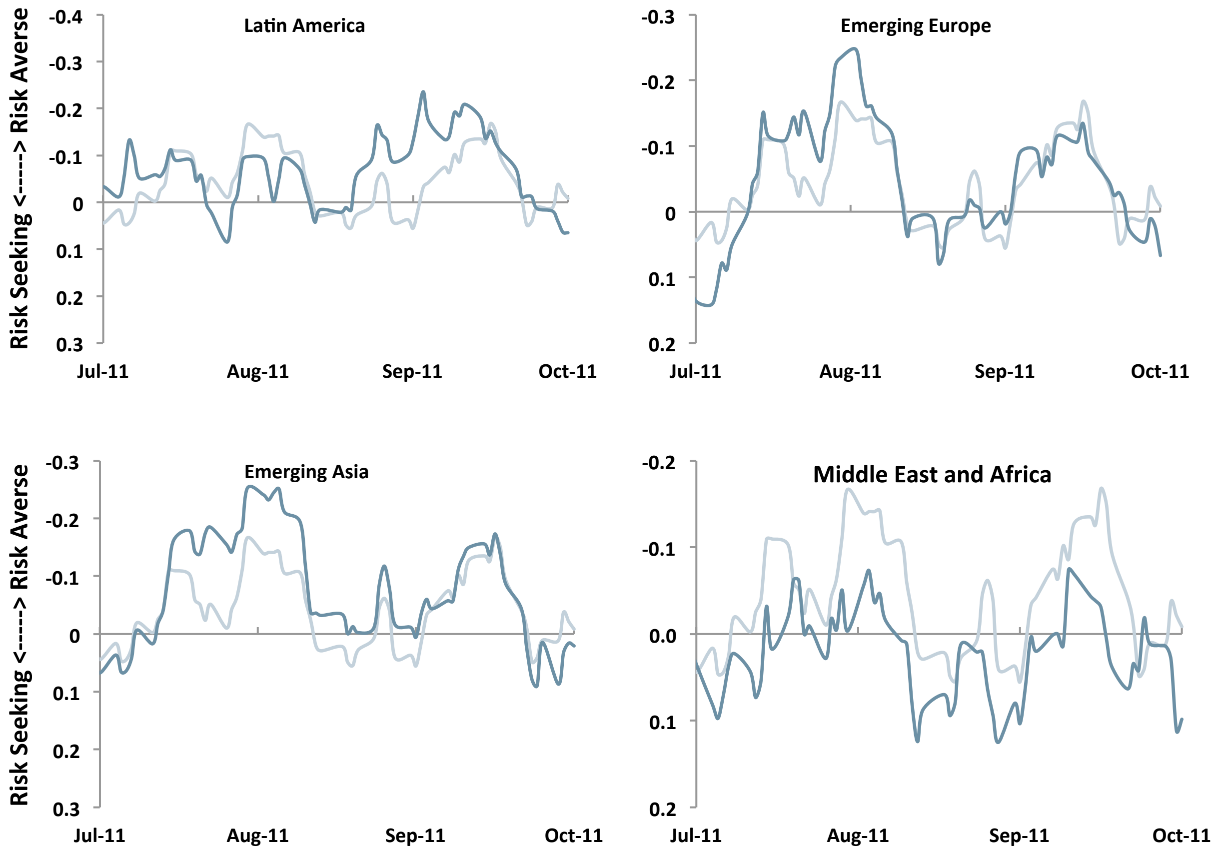
**Figure 3: Risk Seeking Behavior Across EMs (sentiment, global EMs average in light blue)**




*Source: Factset*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# Credit: Delayed Reaction



By David Nowakowski and Tsolmon Enkhbayar

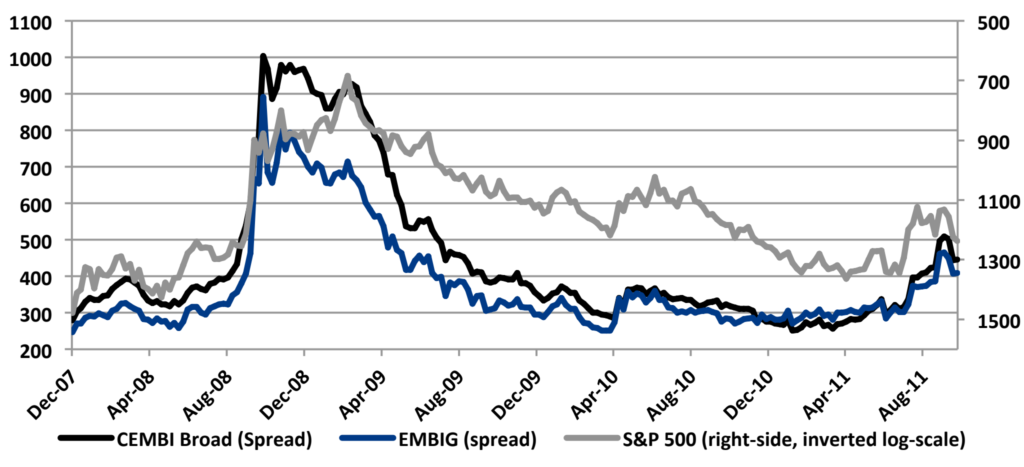
- The eurozone crisis took two years to force a major repricing in emerging market (EM) credit and FX. The CEMBI Broad widened 256 bps to a high of 555 bps in Q3, before tightening along with other asset classes.
- Decoupling? Not that story again…The thesis that EMs can sail through a developed market (DM) slowdown—let alone crisis—has once more been torpedoed. Yet if fundamentals remain intact—and we think they largely have—the sell-off is mainly a buying opportunity, though investors must recognize both market risks and economic spillovers. In this context, the Middle East and North Africa (MENA) and Central and Eastern Europe (CEE) are more vulnerable than LatAm or Asia.
- Banking links matter. The history of EMs gives hints as to where fault lines lie: e.g., French banks have strong links to Indochina, including Vietnam; Dutch banks have a presence in Indonesia; Spanish and Portuguese banks are big in South America. Even without a "Lehman" event in Europe, asset sales and credit crunches emanating from Europe will have effects, both economic and financial. RGE expects CEE banks will be more affected, as local branches in Asia and Latin America have, in general, stronger domestic funding and deposit franchises. Longer term, we do expect more bank bailouts, but the wealth of many EM governments does not make it clear how much equity or bondholders will need to suffer, as discussed in RGE's Critical Issue on China's secondary market intervention in its Big Four banks.

**The Myths of Decoupling and Safe Havens De-bunked (Again!)**

In mid-2008, amid much talk of EMs representing the calm in the storm, many EM currencies hit record levels, and EM spreads were at just 260 bps for the EMBIG and 316 bps for the CEMBI Broad. The nonlinear nature of the spillover in contagion and liquidity relationships was clear by October: EM currencies fell an average 21% based on the ELMI+ (versus USD), while EM sovereign and corporate spreads widened to 890 bps and 1044 bps, respectively.

The same this-time-really-is-different attitude was again clear in mid-2011 when, despite increasing strains in the eurozone and U.S. equity and debt markets, EM fixed income remained relatively solid, though again EM equities were shaky. But once more, the high-beta Mister Hyde came out of hiding, sending EM assets tumbling (Figure 1).

**Figure 1: EM Assets Were Not Bullet-Proof, After All**




*Source: JP Morgan, Bloomberg, RGE*

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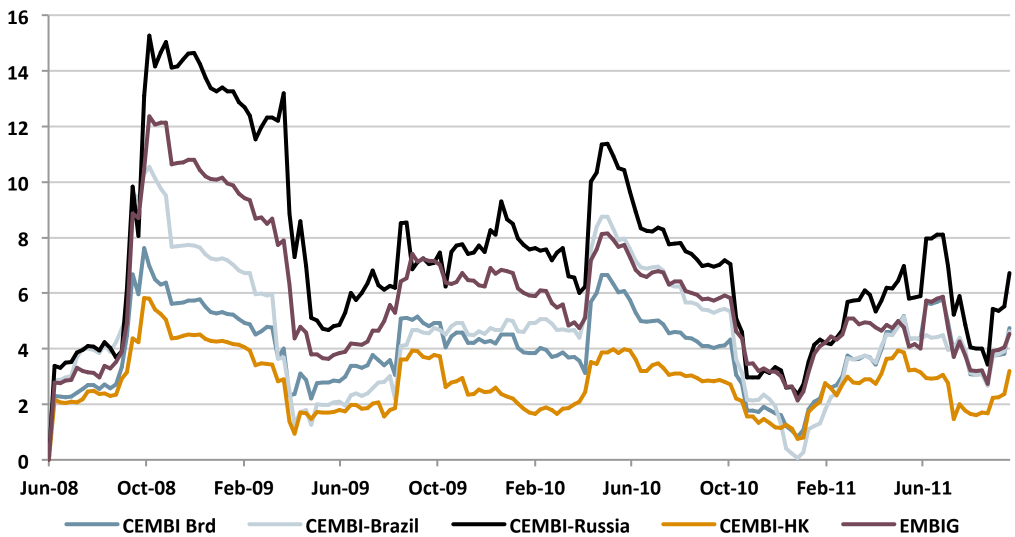
**EM Corporate Credit Will Be a Late Bloomer**

We're close to taking profits on our relative value trade (short CEMBI, long EMBIG), but hold it for now. This was initiated six months ago when CEMBI traded 35 bps through EMBIG, but the relationship has flipped and corporates are now 37 bps wide to the sovereign index. While EM corporates have just about doubled in spread, we see no hurry to rush into longs, as investor inflows will not return in force until after global risk aversion ebbs and global HY markets look healthier, and the economic effects of DM slowdowns and recessions is clearer. We expect to miss the peak, but still catch most of the rally. As with HY overall, we keep our powder dry until asset classes are not just cheap, but fully priced for the downturn.

**Figure 2: EMBIG, CEMBI and Selected Country Corporate Spreads' Trailing Beta to S&P 500 (bps per 1% move in the S&P 500)**




*Source: JP Morgan, Bloomberg, RGE*

The beta for the CEMBI Broad index climbed to 4.7 as of October 14, recovering from earlier drop to 2.7 in mid-September. It had been climbing steadily after its low of just 0.8 in January, when it seemed to have decoupled from DMs. The increase in volatility since July caused investors to reduce their exposure to this less liquid asset class and spreads widened significantly. The correlation to the S&P 500 reached a high of 0.78 in the third week of July and has since decreased to 0.66. EM corporate beta has converged with that of EMBIG since July, amid the volatility that saw wild fluctuations in both the S&P 500 and EM bond spreads, but betas could rise further if the crisis worsens again and the eurozone's problems spill over further into EMs.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# Commodities: Russia, China and the Ties That Bind



By Shelley Goldberg

- China's growing demand for energy will weaken as its economy slows, yet its reliance on Russian gas is intensifying relative to other energies, leaving Russia less dependent on Europe as a trade partner.
- U.S. natural gas supplies should continue to grow as new production comes online, capping any sustainable Henry Hub price appreciation, even at current repressed prices.
- In light of these global supply and demand dynamics, we favor European and UK gas over U.S., and believe liquefied natural gas (LNG) will absorb excess global supply, making it a timely and positive long-term play.

**Russia and Energy: Tied at the Hip**

Energy runs Russia, Russia's government runs energy and China is in bed with both. Given Russia's political and energy dominance historically, it is no surprise that Dmitri Medvedev, Russia's previous chairman of the gas monopoly Gazprom, is the nation's president, that Vladimir Putin, the ex-president and current prime minister, took control of the nation's largest oil company, Yukos, or that Viktor Zubkov, the former prime mister, became Gazprom's chairman. Since Putin's ascendency in 1999, Russian oil production has swelled from six to 10 million barrels per day, eclipsing Saudi Arabia to become the world's largest producer. Energy is set to provide 65% of Russia's 2011 export revenues, and an even greater share of government revenue. Of the total, crude accounts for about 12% of Russia's GDP, while natural gas is set to account for more. Russia owns the largest proven gas reserves (1,700 trillion cubic feet (Tcf)) not counting the Arctic Circle, followed by Iran and Qatar. Today, it produces 19.5 Tcf annually, second only to the U.S. at 21.0 Tcf, but exports the most in the world (7.3 Tcf), almost all of it to Europe, with the balance going to Turkey, Japan and other Asian nations (Figure 1). Now, with the eurozone (EZ) debt crisis and slowing EZ economies, Russia needs more trading partners. Europe's gas consumption fell in the last economic crisis and will likely do the same now (Figure 2).

**Figure 1: Russia's Largest Natural Gas Export Regions by Volume (of a total 6.5+ Tcf)**

| Destination | 2009 Export Volumes (Bcf) |
|---|---|
| FSU Countries | 2,239 |
| Western Europe | 3,297 |
| Eastern Europe | 1,275 |

*Source: Eastern Block Research*

**Figure 2: Change in Total Gas Demand During Winter Times in OECD Europe (2008-10)**

| Time Period | Observed | Temperature-Corrected |
|---|---|---|
| Winter 2008/09 compared to winter 2007/08 | -16.2% | -26.8 |
| Winter 2009/10 compared to winter 2008/09 | +22.25 | +14.0 |

*Source: Oxford Institute for Energy Studies*

**Enter China: A Marriage of Convenience**

China became a net natural gas importer in 2007 for the first time in two decades. Natural gas is a core element of China's newly adopted Five-Year Plan and, as a result, China more than doubled its imports of natural gas from 2009 to 2010. Today, China uses about 4.1 Tcf annually, 4% of its energy consumption, of which over 86% is domestically produced and 14% is imported. While gas represents only 4% of Chinese energy consumption, the government estimates it will grow to 10% by 2020, partly for environmental reasons. The shift to natural gas in

China is even more likely, given its slowing GDP growth (9.1% y/y) and strong crude oil prices (its September crude imports eased 12.2% y/y to 20.45 million metric tons) amid tight coal markets. Recent consumption growth has shifted from industrial users to power, utilities and residential sectors. Chinese demand leaves Russia less reliant on Europe for its energy exports, while Europe will need to seek out other energy sources. Political and economic disputes between Ukraine and Belarus in 2006-07, and more recently its immediate neighbors, has resulted in Russia's opportunistically cutting gas flows to Europe, such that Europe's search for alternative sources, via the spot market or LNG, is not a new phenomenon. In fact, Russia promoted the controversial and soon to open Nord Stream Project, an offshore natural gas pipeline from Russia to Germany, which maintains European energy dependence on Russia. Thus, because of China's vast energy needs, it cooperates with Russia out of sheer necessity, while Russia views East Asia, particularly China, as an outlet for its oil exports. Neighbors of Russia now find themselves in a more vulnerable position to negotiate gas contracts with Russia, as they realize Russia's market has expanded into Asia. For example, Ukraine, faced with slowing industrial production, is currently at the drawing table with Gazprom.

**The History: Nations Trading Places and the Sino-Soviet Race Toward Growth**

The China-Russia relationship has oscillated between China looking to the Soviets for guidance, to decades of mutual mistrust, while both economies were reeling from traumatic changes. In the 1980s, Russia suffered a humiliating economic failure after the collapse of oil prices, while China was attempting to recover from Cultural Revolution after-effects. Russian Communist ideology backfired and a few years after the 1991 dissolution of the Soviet Union, the Russian Federation suffered a 50% decline in GDP and industrial output. Meanwhile, from 1989-1992, Chinese society, politics and the economy were essentially frozen. In 1992, Deng Xiaoping launched his Southern Tour, jump-starting the economy. Reforms coupled with cheap labor and strong demand for Chinese manufactured goods led to double-digit growth.

Meanwhile, Boris Yeltsin carried out the privatization of resources at fire-sale prices, spawning a corruption engrained oligarchy that continues to dominate Russian society. Putin brought along a coterie of security agency apparatchiks who today account for well over 50% of key governmental figureheads. By 2004, Putin embraced energy imperialism by taking over industrials. Today, almost 50% of Russia's GDP depends on the upstream oil and gas sectors, and dictates the nation's economic health; in essence, Dutch disease. Today, Russia's terms of trade, the increase in related investments and high state rents and royalties from the energy sector support consumption and domestic growth. Russia has experienced a renationalization, whereby now most the resources are managed by state-owned enterprises that are only partly privatized. With such a divergence in the growth paths of the world's two former communist pillars, China is now the second-largest economy, whereas Russia ranks seventh. In 1991, Russia's GDP was over US$500 billion, larger than China's. China's economy has since become nearly 15 times bigger, and almost three times the size of Russia's.

**The LNG Outlet: Natural Gas Turns Global**

The global availability of natural gas, combined with restrictive logistics, make gas a regional commodity, unlike crude oil or aluminum; therefore, price variability of contracts is common (Figure 3), due to regional fundamentals. Natural gas is an abundant resource and is becoming increasingly easier to obtain, as a result of hydrofracking and other technologies. And drillers keep on drilling, as gas has lower emissions than other fossil fuels, making it a more attractive energy source. Meanwhile, many sources are still untapped, unlike other depleting fossil fuels such as crude oil. The market for LNG serves as an outlet for excess gas supplies, even more so in times of slowing global growth, helping to transform gas into a global commodity. LNG global infrastructure is still in its early stages, particularly in China, where about half of the imported gas is delivered by pipeline from central Asia and the other


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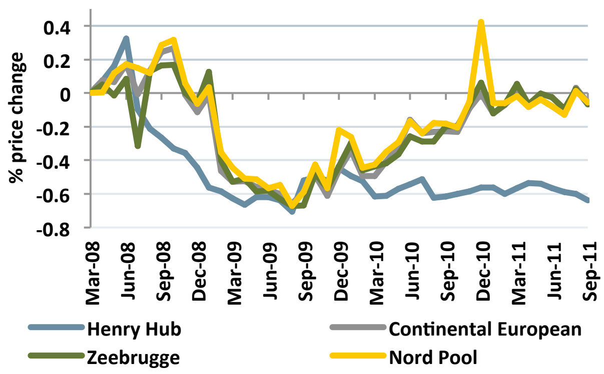
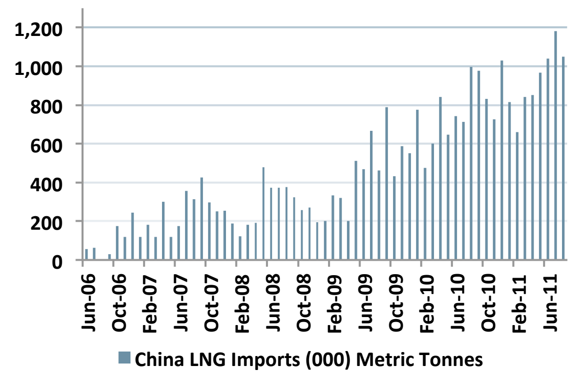
half in the form of LNG (Figure 4). China and other emerging market countries are expected to become buyers of cheaper LNG from Canada when its new LNG export terminal is completed in British Columbia in 2015. Further, the U.S. will gradually look to the LNG export market to alleviate its growing domestic natural gas supply.

**Figure 3: Natural Gas Price Moves U.S. vs. European Grades**




*Source: Bloomberg, RGE*

**Figure 4: China's LNG Demand**




*Source: Bloomberg, RGE*

**Playing Nice in the Sandbox**

In mid-June, Chinese President Hu Jintao made his annual pilgrimage to Russia and energy deals, as always, were on the agenda. This time, China drew out the negotiations, hoping it could hold out longer than Russia and get a better deal. Hu highlighted that trade between two nations grew from US$55 billion in 2011. He expects trade to grow to US$100 billion by 2015 and US$200 billion by 2020—and that "it was all going to be energy." Both Russia and China need to play fair, as they share the same sand box. China's own natural gas will take significant time to come online in a meaningful way, and can no longer rely on tax reductions, rebates, fiscal subsidies and government expenditures to the extent it has in recent history. And Russia needs China as a trade partner, particularly in light of the EZ debt crisis, and the formation of new international pipelines and transit channels that reduce Russia's pricing power. Additionally, Russia's competitor, Qatar, is successfully filling some of the supply gaps in Asia. China provided extensive capital to Russian oil companies to fund their investment plans (US$20 billion in 2009) as well as natural gas and coal projects, yet Gazprom firmly stated it will not subsidize China on gas prices, particularly in light of China's massive foreign currency reserves.

**Next Step: Diversification**

The Russians have been pushing to diversify their relationship with China beyond energy. China's sovereign wealth fund agreed on October 19 to invest US$1 billion in a Kremlin-backed investment vehicle in areas outside of the energy sector. The deal marks the first commitment by an investor to the Russian Direct Investment Fund set up in June as a way to diversify the country away from its unhealthy oil dependency. This is only the first step in Russia's long overdue effort to wean itself from energy dependency. Should the EU/EZ integration continue to remain under pressure, Ukraine will fall further back into the Russian sphere of influence, particularly after the jailing of Yulia Tymoshenko. Thus it is not unreasonable, given Russia's history of geopolitical dominance, to envision a more formal economic union of Russia, Belarus and Kazakhstan eventually giving Russia more pricing power. Such a scenario makes natural gas a bullish play—albeit in the long run.

# Rates/Currencies: In Defense of the Defensive



By Natalia Gurushina

- We see potential for a short-term relief rally on the back of reasonably positive news from the eurozone, but believe that it will provide a good opportunity to short many emerging market (EM) assets, as the upcoming EU summits are unlikely to deliver a sustainable solution for the periphery debt problem.
- We maintain small strategic "underweight" in EM local currency and external debt, albeit a potential relief rally provides an opportunity for tactical bottom-fishing in long-dated sovereign external debt with near-zero incremental default risk in high-beta countries (Russia's 2030 bond or Argentina's Boden 2015 bond). We are evaluating a possibility of re-entering inflation-linked debt longs in Turkey (short end) and Brazil (middle of the curve).
- We maintain interest rate swap steepeners in Poland, the Czech Republic, Brazil, Mexico, India, Malaysia and Thailand, but believe that the short end of the cross-currency swap curve in Turkey can climb further.
- Our EM FX outlook for the next few months remains defensive—even though we acknowledge a possibility of short-term relief rallies. Asia ex-Japan (AXJ) FX would be a clear outperformer during the periods of risk-aversion and we recommend re-entering AXJ FX longs against EMEA FX during risk-on rallies.
- We recommend using dips in volatility to buy VIX contracts (at 25 and below) as "insurance policy."

**EM Rates: Sell Into Relief Rallies**

The forthcoming rounds of eurozone debt talks have the potential to reduce near-term tails risks associated with disorderly defaults and bank failures, in which case it would be reasonable to expect a relief rally in most risky assets. Still, we remain skeptical about EU officials' ability to deliver a sustainable long-term solution to the periphery debt problem and believe that selling into relief rallies makes sense—especially when there is uncertainty about the extent of longer-term fundamental support for EM fixed income and EM local currency debt in particular. On the one hand, we expect growth to moderate across EMs in 2012, moving below potential in some countries in Europe, the Middle East and Africa (EMEA), and LatAm. Further, inflation pressures are currently easing across the board, with the largest drop in inflation momentum expected between November 2011 and March 2012. We believe that several central banks are likely to use this opportunity to frontload monetary easing. At the same time, the impact on inflation of weaker currencies, robust commodity prices and a lack of fiscal adjustment in many EMs should not be ignored, and shows in our calculations as a potential reversal in inflation momentum as we near Q2 2012. This can limit the extent of local yields compression. Another potentially aggravating circumstance is that EM local currency debt out- or underperformance in USD terms in the past few weeks (especially in the case of aggregate indexes, such as GBI-EM) was largely due to the currency component of total return. Our EM FX outlook for the next few months remains defensive, even though we acknowledge a possibility of short-term relief rallies. As such, we believe that from the strategic point of view, a small underweight position in EM local currency debt (unhedged) is justified at this stage.

Given that our official policy rate forecasts point toward frontloaded easing (for those central banks that will be cutting rates), we believe that this should lead to steeper curves in EMs. We think that the cleanest way to express this view is via 2y-5y interest rate swap steepeners in Poland, the Czech Republic, Mexico, India, Thailand and Malaysia. We also maintain a January 2012/January 2017 Pre-DI steepener in Brazil. At the same time, persistent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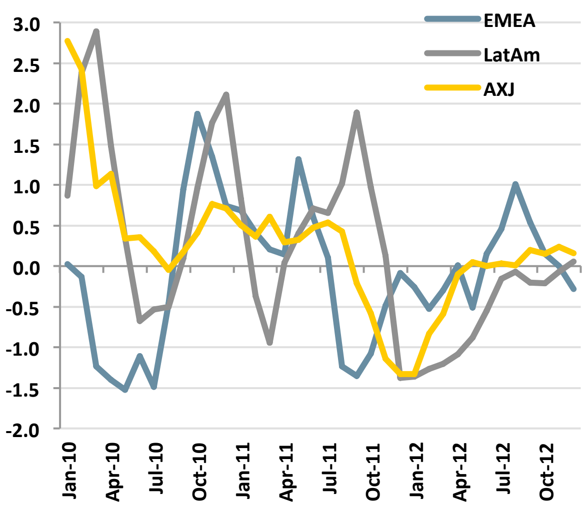
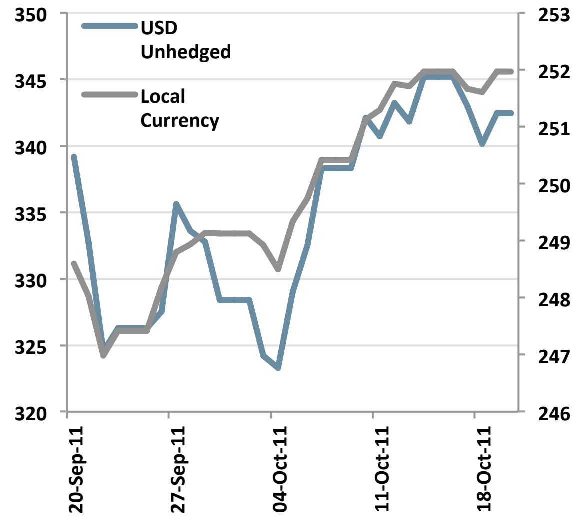
inflation pressures in Turkey, exacerbated by lira weakness and the apparent change in the Central Bank of Turkey's previously dovish stance, suggest that the short end of the local cross-currency swap curve is likely to go further up.

**Figure 1: Inflation Momentum in EMs**




*Source: RGE, Bloomberg*

**Figure 2: GBI-EM Performance**




*Source: RGE, Bloomberg*

As regards EM external debt, a relief rally can provide an opportunity for tactical bottom-fishing in long-dated sovereign external debt with near-zero incremental default risk in high-beta countries (Russia's 2030 bond or Argentina's Boden 2015 bond). However, these should be highly tactical trades with very tight stop-losses. In our portfolio allocation—which is more strategic and has a longer-term horizon of around six months—we prefer to keep a small underweight in EM external debt for now.

Finally, we've been largely absent from the EM inflation-linked debt for the past few months, as inflation pressures across most EMs were heading south. However, we have started to evaluate opportunities for re-entering selective longs in this asset class—more specifically, the shorter end of the curve in Turkey and the medium part of the curve in Brazil, where inflation pressures appear to be more persistent than elsewhere in EMs.

**EM FX: And the Winner Is…**

Our stance in the EM FX space is fairly similar to that in EM rates. We see a possibility of a relief rally on the back of even slightly reassuring news from the eurozone, however, we would not expect such a rally to be long-lasting. In EMEA, such rally would provide an opportunity to open CZK longs against regional peers with weaker fundamental support, such as PLN and HUF (all tactical PLN longs opened after the parliamentary elections should now be closed). A risk here is stronger-than-expected growth moderation in the Czech Republic that might force the CNB to be more pro-active in preventing additional CZK strength. Shorting RUB—against fundamentally stronger MYR—is another regional trade that we believe has good potential (with entry points below 9.6). We also believe that commodity-based ZAR is likely to underperform TRY in a weaker global growth environment, especially if the CBT's less dovish stance becomes more pronounced (albeit it might take time for this to actually kick in). Key risks here are Turkey's financing needs and the fact they are running low on reserves relative to short-term debt.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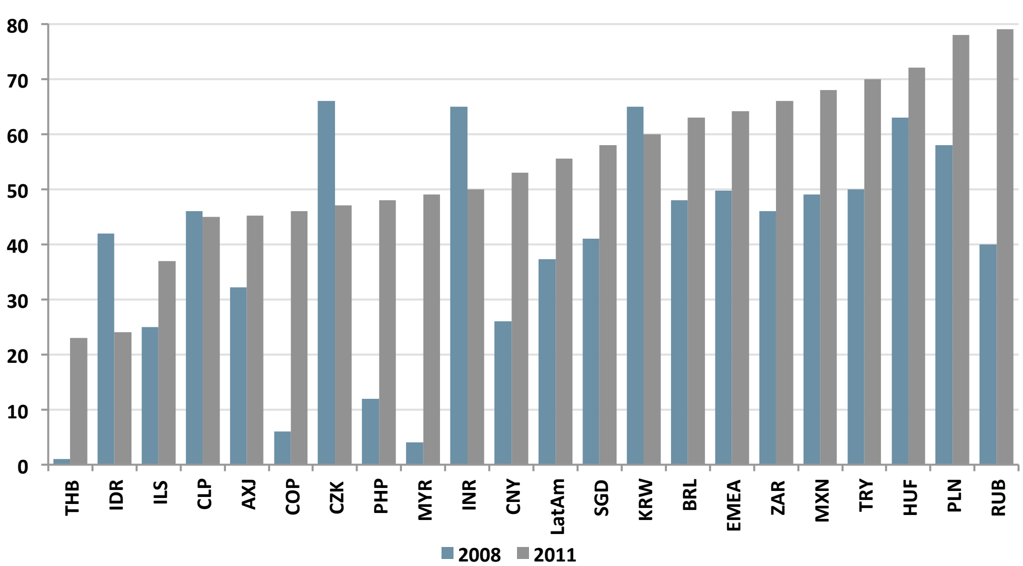
In AXJ, a long SGD/INR recommendation makes a lot of sense to us, as both currencies have similar sensitivity to global risk factors but SGD will be supported by superior fundamentals. Our only concern at this stage is that the cross moved nearly two standard deviations in October, so we will wait for better entry points (around 38.0). We also recommend adding to long THB/TWD positions because, within Asia, Taiwan looks particularly exposed to a drop in global trade. In LatAm, we think that CLP is the weakest link in the region as it has the highest beta to commodity prices (copper) and we would short it against COP or USD on dips.

Looking at more global themes in the EM FX field, a lot of factors continue to point to AXJ FX's likely outperformance during periods of risk aversion and weaker global growth. First, Asian economies are the main beneficiaries from lower commodity prices, especially oil. Second, most Asian economies are net creditors with large current account surpluses and sizeable international reserves. Our most recent estimates show that the appreciation pressures in that part of the world are still the highest among EMs. Finally, AXJ is the only region within EMs where currency risk premium still appears to be driven in larger part by local/intra-EM factors (55% of the variance in 2011, according to our recent study). By contrast, in EMEA the regional currency risk premium now appears to be driven predominantly by global factors (64% of the variance in 2011). The difference between the two regions is significant—in EMEA, global factors account for an additional 20% of the FX risk premium variance, compared to AXJ FX. There are several reasons behind such divergence, including Asian central banks' more aggressive (on average) intervention in FX markets than their peers in other regions, a greater role of the current account inflows in the appreciation pressures and a smaller size of carry (one can argue that higher-carry EM FX/assets attract more foreign investment during risk-on periods, but then suffer disproportionately when carry trades are reversed). An additional consideration here is that EMEA might have the additional conceptual exposure to a thesis that the EZ/EU integration is going into reverse, affecting capital and trade flows (albeit this particular argument is highly contingent on how the EZ plays out). We believe that these factors support our view that AXJ FX is likely to outperform its EMEA peers during the periods of risk aversion and we therefore recommend entering long Asia FX/short EMEA FX trade on dips and corrections.

**Figure 3: Share of Global Factors in EM FX Risk Premia (%)**




*Source: RGE, Bloomberg*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# Asia: Hot Shots! Part Deux



By Adam Wolfe and Michael Manetta

- Emerging Asia's direct financial exposure to a eurozone (EZ) crisis is limited and should be contained, with the likely exception of Vietnam.
- The impact from trade, however, will be severe. Most of the region—particularly small, open economies—would fall into a technical recession following a Lehman-like external shock.
- The policy space available to offset such a shock is smaller than it was in 2008, but most countries would be able to ease monetary policy and offer a modest fiscal stimulus. China's stimulus necessarily would be much smaller than 2008, which would likely result in a longer recovery for the rest of Asia.

**Braced for Financial Impact**

Emerging Asia is most exposed to a EZ debt debacle through the trade channel, with small, open economies expected to take the brunt of the impact. The region's direct financial exposure is relatively low, with European banking sector claims only a small fraction of most countries' FX reserves. Emerging Asia's major financial centers do have relatively high exposures to European banks, but 78% of the claims on Hong Kong and 46% of those on Singapore come from the UK, which should mitigate the contagion. Even if we assume global contagion from a Lehman-like event in the EZ, Asian financial sectors appear rather well inoculated as, with the exception of South Korea, they rely on local deposits for funding. Still, emerging Asia remains vulnerable to a global flight to safety, as we saw in late September when emerging market (EM) Asian currencies sold off sharply, despite the best efforts of central bankers to stem the outflow. If global investors liquidate their EM positions to cover losses elsewhere in their portfolio, EM Asian currencies and markets would swoon, which would have knock on effects for domestic consumption, still a bright spot in the region. The share of foreign holdings in local currency government bonds has increased since 2008, with Indonesia and Malaysia seeing a sharp increase, which would exacerbate the problem and require additional central bank intervention, though both have ample reserves.

Of the major EMs in Asia, South Korea and Vietnam remain the most exposed to a financing shock out of the eurozone, though in Korea's case we expect the impact to be more contained than in 2008. In September, Korea's Financial Supervisory Service said that all South Korean banks' foreign currency liquidity positions would be able to withstand a shock on the scale of the 2008 hit, as banks have reduced their short-term external financing. Regulators also have also guided banks' loan-to-deposit ratios down to an aggregate 113% as of August 2011 from 142% three years prior. Additionally, Korea has FX swap lines with China and Japan, and would likely be able to restore its expired swap line with the U.S. should liquidity become problematic.

Our bigger concern is Vietnam. The risk of a currency crisis remains, a situation that would only worsen if EZ financial conditions deteriorate further. Roughly 50% of the Vietnamese banking system's outstanding cross-border liabilities are owed to European banks (of which half are to French banks), and the inability to roll these over would add to the system's problem of undercapitalization, particularly if banks' dodgy real estate loans begin underperforming. Of course, Vietnam remains an outlier in the region, and the robust national balance sheets across the rest of EM Asia should keep an isolated financial crisis from spilling across borders.

**Less Spring in the Shock Absorbers**

As we noted in our most recent Asia Outlook Update, many EM Asian economies still depend on final demand from the U.S. and EU, either directly or indirectly, and another crisis-induced drop in global trade would likely tip


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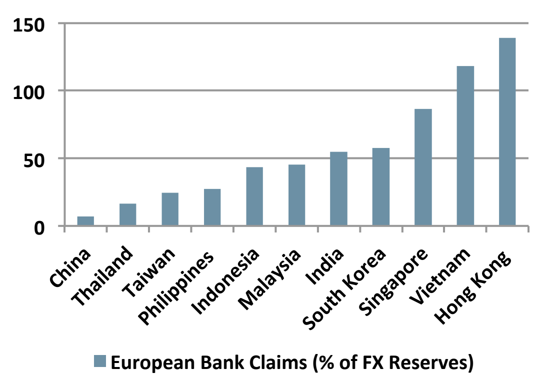
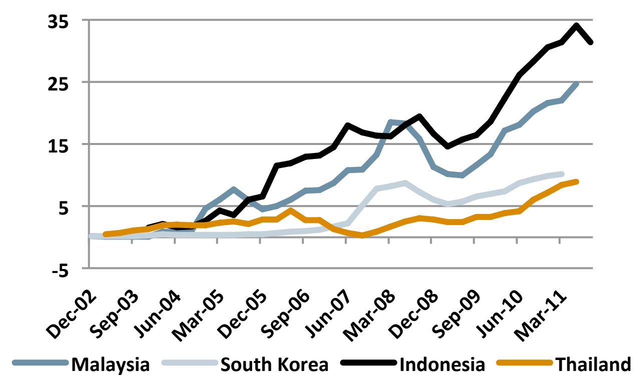
several of the small, open economies into a technical recession. Moreover, the policy space to mitigate such a shock is smaller than it was in 2008. Real policy rates in emerging Asian countries are generally lower than they were in August 2008, but most central banks have room for some easing. China, South Korea, Taiwan and Malaysia could all cut rates as early as December following an external shock. As we expected, Indonesia didn't even wait for a shock to fully materialize, and will cut rates once more in Q4. Likewise, from a flow perspective, the fiscal balance of every country in Asia is weaker than it was in 2007. However, on a stock basis, strong nominal GDP growth in the interim kept debt-to-GDP ratios in check, and nearly every country in the region would be able to offer a modest fiscal stimulus if need be, though India's fiscal position is more constrained.

The big problem for the region, and the global economy, is that China will not be able to offer another 13%-of-GDP stimulus like it did in 2008. The hangover from that outlay is still setting in, and, instead, policy makers are likely to only offer a modest 4%-of-GDP stimulus, assuming a two-year horizon, with the central government picking up the bulk of the bill, as local governments cannot cover their existing debt obligations. The rest of Asia bounced back sharply in H2 2009 after China's stimulus kicked in. This time, the region's recovery would likely be less V-shaped, but still better than that in the rest of the world.

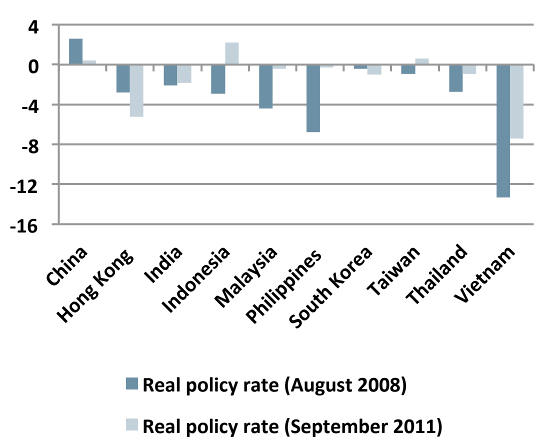
**Figures 1 and 2: EZ Financing Shock Should Be Contained, But Exposure to Global Markets Is Higher (European bank claims as % of FX reserves; foreign holdings in LCY government bonds, % of total)**

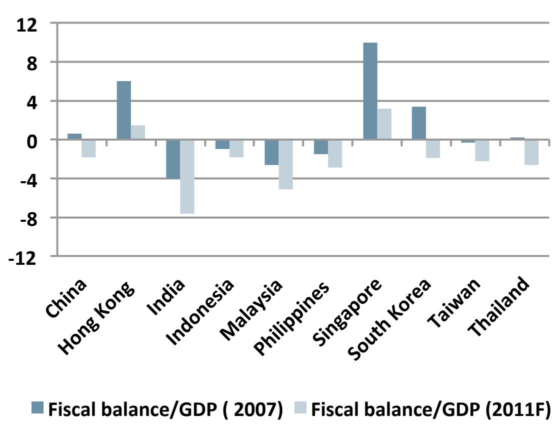



*Source: BIS, Bloomberg, Asian Development Bank, RGE*

**Figures 3 and 4: Less Room to Maneuver (real policy rates; fiscal balance)**




*Source: Haver Analytics, EMED, national sources, RGE*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# Emerging Europe and CIS: Greater Exposure, Less Policy Space

By Jelena Vukotic and Rachel Ziemba

- Emerging Europe has not only the most direct exposure to the eurozone (EZ) of any emerging market (EM) region through trade and financial channels, but also the weakest domestic balance sheets—meaning external stresses will reinforce domestic vulnerabilities.
- Having expended policy bullets to recover from the global financial crisis, EM Europe economies in aggregate have less policy space than in 2008.
- The central banks' wait-and-see monetary policy mode largely reflects uneasiness about sharp exchange rate movements that could swell debt levels and boost FX pass-through to inflation. Compared to other EMs, central banks have limited reserves to intervene.

**Managing the Exposure**

EM Europe's exposure to the EZ turmoil is amplified by the vulnerabilities left by the previous economic crisis. The region's economies face worsened public finance profiles, weaker banking sectors and limited space for monetary loosening. Fiscal consolidation efforts in the region (with the exception of Russia) will weigh on growth, especially as exports to key trading partners in the EZ suffer. Local banks, handicapped by rising shares of bad loans and, in some cases, hefty sectorial taxes, could see reduced parent support in the face of EZ financial strain. The recent Swiss franc surge has put further pressure on banks' balance sheets in countries with large currency mismatches (Poland, Hungary, Romania). The lack of policy space, along with a potential negative feedback loop between the real and the financial sector, will weaken the recovery and prevent growth from broadening to domestic demand.

Financial links will intensify the stress. With the exception of Turkey, the region's current account deficits have rapidly narrowed since 2008, but the deteriorating quality of external financing is a source of concern. FDI flows remain below precrisis levels, while a recent pick-up in more volatile portfolio inflows (especially in Romania, Hungary and Turkey) leaves the region's economies more vulnerable to a reversal in capital flows. A drop in growth expectations, along with a rise in risk aversion, would likely spur portfolio outflows, as seen at the height of the previous crisis and in the late September selloff. A more challenging funding environment for the Western European banks, which play a key role in EM Europe's financial sectors, is stoking fears that these banks could reduce financial support to their subsidiaries. The announced recapitalization of the Hungarian units of Erste and Raiffeisen, which took a hit on foreign-currency-denominated loans, confirms the parent banks' continued commitment to the region. Nonetheless, limited external financing will continue to tighten the already strained credit supply and weigh further on the region's growth prospects.

**Tight Policy Space**

Financial stability concerns and/or below-neutral rates will limit the central banks' policy space. While easing inflation and bleaker growth prospects call for more accommodative monetary policy, central banks will remain on hold in the near term, reflecting concerns about sharp exchange rate movements that could swell debt levels and boost FX pass-through to inflation. Wary of policy rate cuts in an environment of heightened risk aversion, a number of central banks in the region (Romania, Hungary, Turkey, Poland) decided to tap FX reserves to prop up


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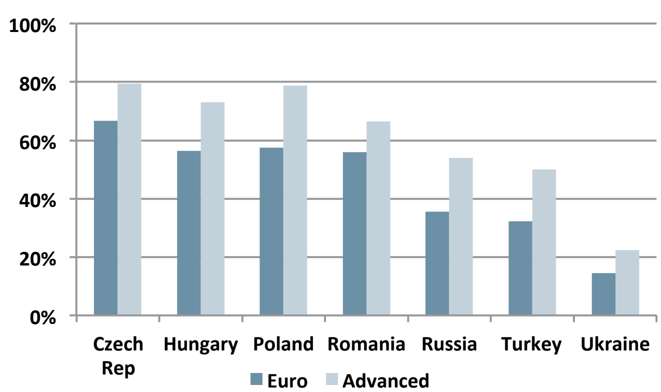
sliding currencies through spot market interventions, changes in required reserves and other measures. The expected reversal of the ECB's monetary policy tightening will open up space for the Czech Republic, Poland and Russia to cut rates in 2012. Meanwhile, Turkey's unorthodox policy of relying on macroprudential measures to support GDP growth has fueled inflation, credit growth and the current account deficit, and has recently edged towards a tightening stance. Policy makers will be reluctant to hike interest rates as growth slows sharply, but could be faced with little choice, if efforts to stabilize the lira fail.

Fiscal consolidation across the region and investors' increased focus on public finance precludes the possibility of using fiscal stimulus to cushion the impact of deteriorating growth this time around. Countries like Poland, Hungary, Romania and Ukraine should maintain prudent fiscal policies due to market pressure, legislative requirements and/or IMF-mandated reforms. Turkey and the Czech Republic are among the few economies in the region that could delay fiscal consolidation and afford stimulus to support growth. Russia, too, will draw on oil revenue savings to step up spending ahead of parliamentary and presidential elections late in 2011 and in 2012.

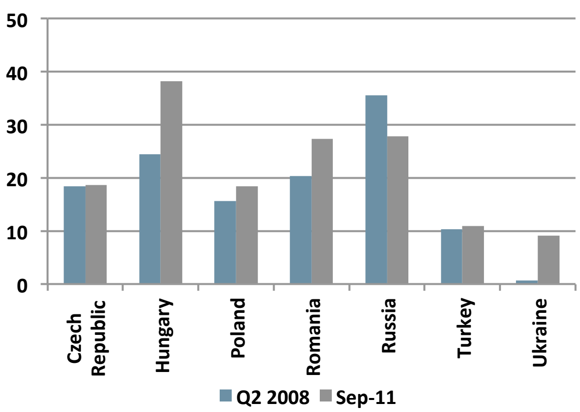
Countries with IMF support programs, such as stand-by arrangements (Romania, Ukraine) or flexible credit lines (Poland), are better placed to cope with external financing pressures and severe growth slowdowns. Should a Lehman-like event take place in the EZ, we expect the IMF and other multilaterals to step up their involvement in the region once again. Hungary, which broke ties with the IMF in 2010, is likely to return to the lender and strike another stand-by agreement to fend off negative spillover effects.

**Figure 1: Eastern Europe's Exports Go Mostly to the Eurozone (share of total exports)**




*Source: IMF, Haver*

**Figure 2: Except in Russia, Reserves Are Higher Than 2008, But Are Being Depleted (US$, billions)**




*Source: IMF, RGE*


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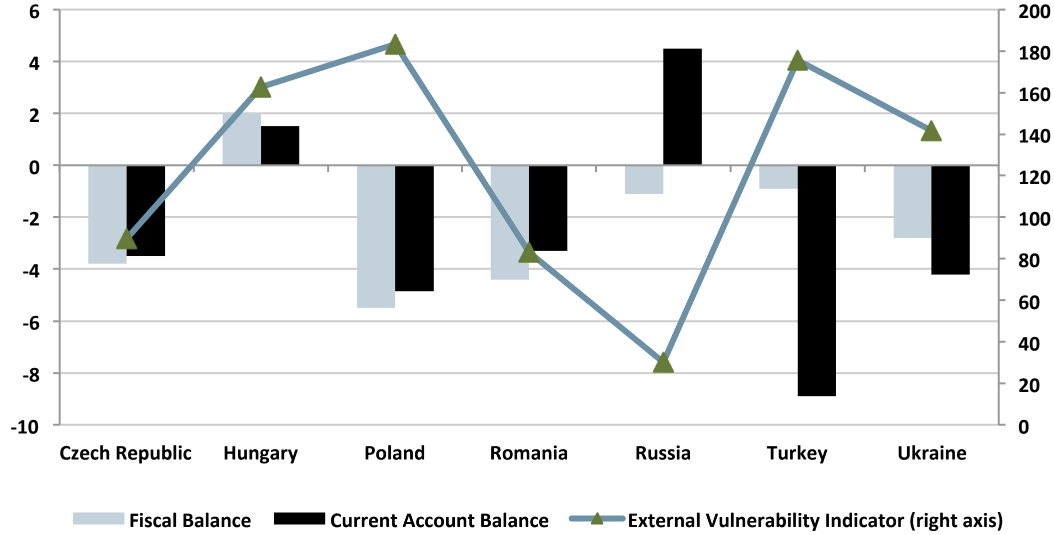
**Figure 3: External Financing Needs Are High, Especially in Poland, Turkey and Ukraine (2011f)**






*Source: Moody's, IMF, RGE*

*Note: The External Vulnerability Indicator measures* (short-term external debt + currently maturing long-term external debt + total nonresident deposits over one year)/official FX reserves.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# Latin America: Bring It On



By Juan Lorenzo Maldonado and Bianca Taylor

- Strong balance sheets and counter cyclical policies should allow the region to counteract a mild recession in the global economy.
- Banking sector risks should not be ignored, but effects will be more muted than in other regions.
- Counter-cyclical fiscal policy will be a function of the political dynamics of each country, and high variance in outcomes cannot be ruled out.

**LatAm in Strong Position to Weather Mild Recession, but Still Vulnerable**

Latin America enjoys a solid position from which to weather a new recession in the advanced world, although the resilience of the region will depend on the length and depth of such recession. Throughout LatAm, government debt levels are low, as is external debt, and international reserves are strong thanks to an improved management of boom-period excess revenues from commodity exports (in most countries). Improved macroeconomic management has also fostered important FDI flows. With the exception of Argentina, most countries should have access to financing due to strong fundamentals or abundant cash flows.

However, the region faces vulnerabilities that need to be addressed with policy action. Varying exposure to the U.S. and eurozone (EZ) through the trade channel will affect countries differently. Furthermore, there are spillover effects related to the risk of contagion to the domestic economy through a contraction in investment spending due to uncertainty and sentiment shifts. In terms of exposure, Mexico presents the higher vulnerability, with exports to the U.S. reaching 24% of GDP, crippling the effectiveness of a policy response. Venezuelan, Peruvian and Chilean exports to U.S. and the EZ reach 12%, 11% and 10% of GDP, respectively, while Colombia, Argentina and Brazil show less exposure at 6%, 4% and 3% of GDP, respectively. However, sentiment shifts related to risk aversion episodes may also have an impact on regional growth. Vicious cycles derived from shocks to equity prices and business confidence translate into lower materialized investment. During 2009, fixed capital formation led the downturn in the economies of the region (except in Mexico, where consumption led the decline).

Although the foreign banks in the region operate through local subsidiaries, which mainly fund their operations with domestic deposits, Latin America will also be susceptible to a credit crunch derived from distress in sovereign debt markets of the eurozone periphery, although its effect will likely be more muted than in other emerging markets. According to the IMF, a shock in the peripheral countries of the eurozone that induces a sharp deleveraging of European banks could cause a contraction of up to 2.5% of GDP in Chile, 1.5% in Brazil and 1.25% in Mexico, while the rest of the continent will experience a contraction of less than 0.5% of GDP.

**Policy to the Rescue: Fiscal Policy Has More Fire Power**

In the event that advanced economies enter a new recession, policy makers have an ample toolkit and enough space to act. In our baseline scenario of a mild recession, the first line of action will be monetary policy: central banks in the region (Brazil, Peru, Mexico and Chile) have already made explicit their intent to shift the path of monetary policy if conditions deteriorate in the global economy, as we have expected since early August.

However, when facing a more prolonged shock, monetary policy may fall short, as real rates are already at low levels (around 1%, with the exception of Brazil), and lower rates are unlikely to drive credit once appetite for investment dries up. Hence, fiscal policy will become the most important tool for the region. Despite fiscal

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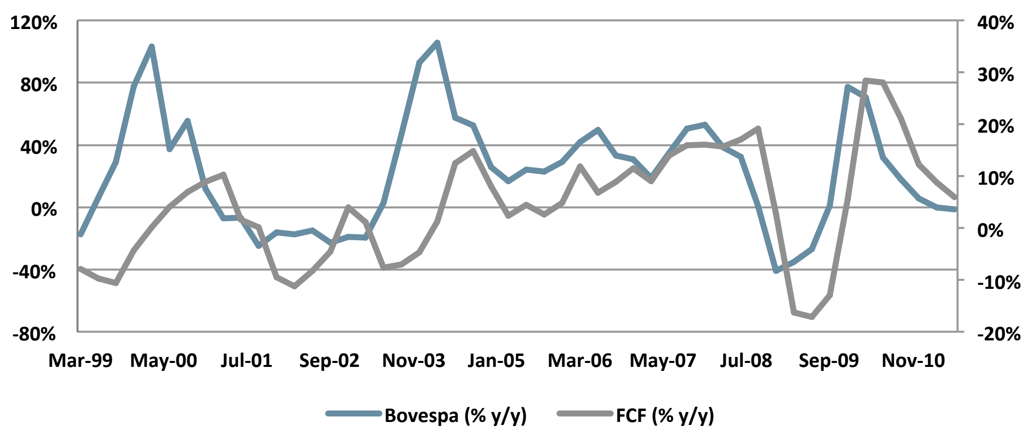
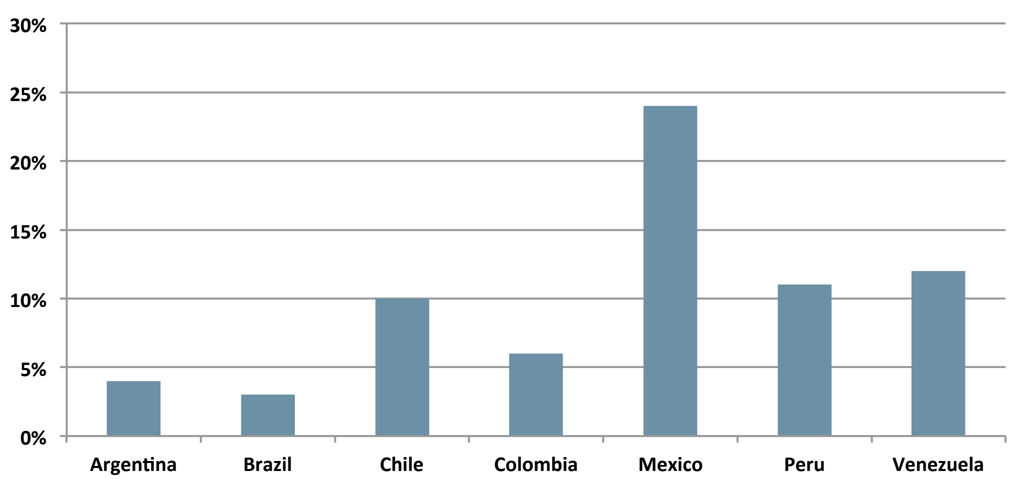
balances being in a weaker position than in 2007, when all countries enjoyed primary surpluses, LatAm governments will be able to provide economic stimulus. Low levels of government debt and investment grade ratings will guarantee funding for governments and enable them to access international capital markets in search for liquidity or capital. Furthermore, fiscal savings in Chile and Peru, and Colombia and Mexico's flexible credit lines with the IMF provide an additional layer of solvency, should liquidity be needed. These actions will be a function of the internal political processes of each country, thus we cannot rule out high variance in efficacy and economic outcomes. In Argentina and Venezuela, however, prior unrestricted use of boom-time revenues has prevented fiscal accounts from improving and fiscal savings from growing, and has deteriorated macroeconomic fundamentals. A lack of structural reforms, independent institutions and fiscal discipline, compounded with political instability, will weigh in economic performance if a downturn comes to pass. Both economic models are reliant on fiscal spending, which is sustained by elevated commodity prices, particularly in Venezuela, where private-sector activity has been vanquished. This in turn will restrict the extent and price at which these countries can finance fiscal expansion.

**Figure 1: Sentiment Shocks Affect Real Growth**




*Source: Haver*

**Figure 2: Share of Exports to U.S. and Europe (% GDP) Is Not Negligible**




*Source: Central banks, statistics institutes and RGE*

# MENA: Arab Spring Amplifies Vulnerabilities

By Ayah El Said and Rachel Ziemba

- Weaker oil demand and prices will expose MENA countries' fiscal fragility and reduce liquidity and trade volumes.
- Egypt, with high deficit and short-term (local currency) debt burdens, will need foreign assistance, as trade and revenues continue to disappoint.
- Within the GCC, any global financing shocks will have a particularly severe impact on the UAE, given its openness and financing links with Europe. Government support will provide an offset.

A combination of regional and global factors will slow MENA growth in 2012, with the growth rates of the GCC and North Africa starting to converge as the former slows due to lower oil output. While Maghreb countries like Morocco and Tunisia trade heavily with Europe and rely on tourism flows, on the whole, it is the indirect effects of a DM recession to which MENA is most exposed. These indirect effects include lower demand for oil, further weakening of capital inflows and higher financing costs for sovereigns and state-linked companies as they seek to rollover their debt. Compared with 2009, the space for local governments to respond is more constrained, particularly in oil importing countries that have suffered from political uprisings.

**Narrowing Fiscal Space**

Fiscal policy will remain supportive but its effect will wane over the course of 2012. The global recession and Arab Spring have exacerbated ongoing increases in the public payroll and subsidy bills, leaving less space for more stimulus. GCC government spending will remain expansionary, but the recent spending trajectory is not sustainable. Political pressures prompted spending in 2011, supporting consumption, but increasing the oil price needed to balance budgets. The GCC thus will be quicker to cut oil production if demand falters or Libyan production rises, seeking to maintain revenues. Although some of the 2012 budget drafts are conservative, we expect governments will need to boost social spending further, implying that spending will continue to outstrip plans. This may imply tapping into past savings, including reserves replenished in 2010-11. The richer GCC countries like Saudi Arabia and Qatar will extend financial support not only to Bahrain, which has the sub-region's weakest fiscal position, but also Jordan and North Africa.

Following social spending increases in 2011, the region's oil importers, with their large fiscal deficits, have even less space for more stimulus and instead will be reliant on external official financing to defer politically unpopular fiscal consolidation. Weaker external and domestic demand and lower capital inflows will tighten financing conditions. Egypt, which has a double-digit fiscal deficit and high public debt (80% of GDP)—including US$65 billion in debt to roll over before the end of 2012 (35% of GDP)—is particularly vulnerable. Given its stagnant growth, capital outflows and extensive obligations (US$53 billion) in T-bills to roll over in the next year, we continue to believe Egypt will need finance both from multilateral institutions and the GCC (which would be politically more palatable).

**Monetary Policy: Still Easy**

Easing global commodity prices and weakening economic growth have helped dampen inflationary pressures, particularly in Egypt, which has the region's highest inflation. Israel has already started reversing its early tightening, and deterioration in external demand will prompt another cut before the end of the year. The Bank of Israel is also likely to use other easing measures and to intervene in the face of any appreciation pressures. Should

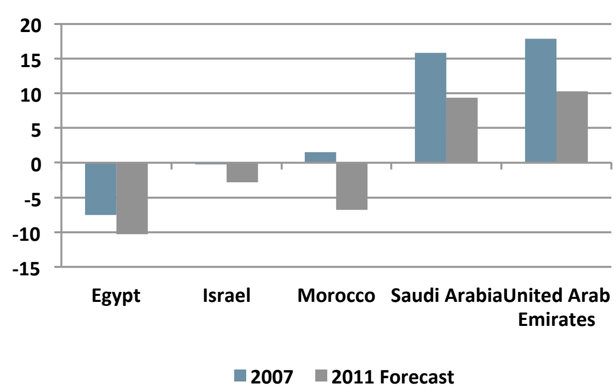
Egypt's inflationary pressures continue to ease, the central bank will consider cutting interest rates, but we fear doing so would add to depreciation pressures on the Egyptian pound, which could weaken sentiment ahead of elections. Despite cuts in neighboring Tunisia, Morocco's central bank will remain on hold, particularly since the country has already been suffering outflows. Dollar-peggers will keep rates on hold, with even Qatar likely to hold off from further cuts given the easing of capital flows. Depegging remains off the GCC policy agenda, though nonpeggers such as Kuwait will support FX depreciation.

**Financial Sector Support May Be Needed**

Government stimulus has added to liquidity and bolstered deposits, but credit growth has remained subdued as banks, particularly in the UAE and Kuwait, continue to rebuild balance sheets, and those in Egypt absorb hefty government bill issuance, which is crowding out private sector lending. The macroprudential measures taken by GCC central banks in the global financial crisis are still in place and, having received few inflows in 2010-11, there is no new bubble to burst. In oil importers, government borrowing needs and weaker growth will impair credit supply due to increased non-performing loans and the confidence shock will dampen demand.

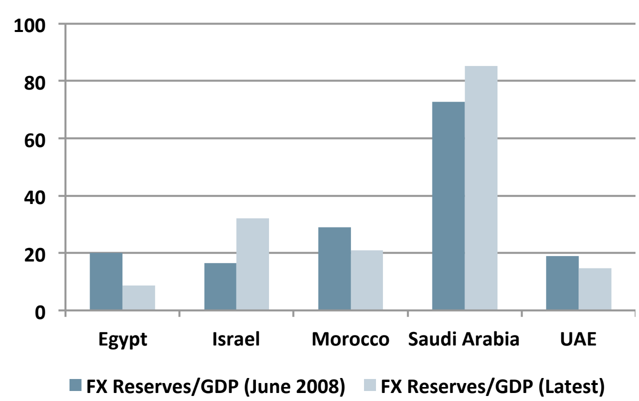
Government support allowed UAE banks to partly rebuild their balance sheets but financing strains could tighten local liquidity, particularly if regional safe-haven flows slow. The UAE has the greatest exposure to European (albeit mostly UK) banks and some global investment banks are now closing operations due to low domestic activity and global cost-cutting efforts, a risk we noted in our last outlook. Regional players will continue to build market share but the growth of the financial and property sector will be constrained. We expect the governments of Dubai and Abu Dhabi will have the resources to roll over much of the quasi-sovereign debt coming due, lest restructuring further undermine the local property and sukuk markets. The local interbank rates have remained moderate, unlike in 2008 and 2009, and we believe that, if needed, central banks could boost liquidity to offset strains.

**Figure 1: Less Fiscal Space Available Across MENA Than in 2007 (fiscal deficit/GDP)**




*Source: Moody's and RGE estimates*

**Figure 2: Pressure on Reserves in Egypt and Morocco**




*Source: RGE, IMF, national central banks*

# Sub-Saharan Africa: Sheltering From the Storm



By Maya Senussi and Rachel Ziemba

- Risks to commodity prices and demand threaten Africa's outlook, reinforcing domestic vulnerabilities in South Africa.
- Exchange rate and inflationary pressures will keep central banks from easing monetary policy; in fact, hefty rate hikes in frontier markets will cool domestic demand.
- Governments have less fiscal space than in 2008 and some could turn again to the IMF.

Despite relatively limited integration with global markets and few financial linkages with the eurozone, Sub-Saharan Africa (SSA) is vulnerable to weaker demand for commodities. With key emerging markets (EM) also slowing down, demand for and pricing of key commodities, especially metals, will weaken and related capital flows might remain scarce, starving infrastructure projects of needed capital. While SSA proved more resilient than many other regions in the global recession, expanding government spending to support consumption, it has fewer policy bullets at its disposal this time around. Most countries have stretched their finances and few can afford to provide the same level of stimulus as they did in 2008/09. Those with some policy space left, however, will aim at easing their fiscal policies, to provide a buffer against the impact of financial volatility and weaker demand.

**South Africa: Policy to Remain Accommodative**

Market volatility has weighed on already weak domestic sentiment in South Africa, which faces stagnant employment, high household leverage and supply-side constraints. The rand slid by about 15% in September—and over 20% year to date—as investors fled to safety. Exports, particularly of metals, will come under pressure, as EMs like China, South Africa's main customer, also slow. South Africa has maintained a modestly expansionary fiscal policy since the recession, though the over-5%-of-GDP fiscal deficit will be a restraint. South Africa has very low levels of public debt and should have little trouble financing its deficit.

Still, in comparison to 2008, South Africa's fiscal position has become less favorable and its primary balance has widened, in part due to public-sector wage hikes in excess of inflation. The government's need to provide extensive support to the labor market not only adds to competitiveness issues, but leaves the country with less space to spend its way to recovery. The same is true of monetary policy. Despite weak domestic demand, rising wages and the pass-through from a weak rand will limit the central bank's (SARB) room for cutting rates from the current 5.5%, as inflation remains near the upper end of the target. With a lower reserve stockpile, we expect the SARB will remain much less likely than other EMs to intervene in FX markets, doing so only to reduce volatility.

**SSA: Holding the FX Line**

Despite having more closed economies, the policy space is even more constrained in SSA's frontier markets, particularly in drought-stricken East Africa. Expansionary fiscal policy supported growth through the recession and recovery, but the deterioration of fiscal and external balances has contributed to outflows and persistent inflation as government spending fueled imports and capital flight persisted. Nigeria, Kenya and Uganda have experienced persistent capital outflows and pressure on their exchange rates, prompting central banks first to act to quash rising inflation and subsequently to hike interest rates sharply to deter outflows. These contractionary policies will undermine economic growth, even if they succeed in luring sufficient capital, as local banks will more than pass on policy rate hikes.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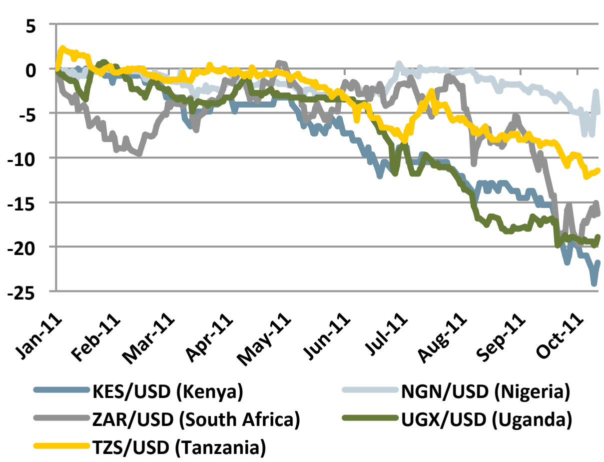
In Q3, Nigerian monetary policy shifted from inflation-fighting, aimed at offsetting fiscal expansion, to avoiding a currency crisis. Dollar demand far outstripped supply at the central bank's regular FX auctions, offsetting trade-related (oil) inflows, and the naira recently sank through its 3% band to a record low. Nigeria's 275-bps hike to 12% on October 10 (for a total 550 bps of hikes in 2011) was designed to shock markets and end the slow stream of capital flight. Despite supportive base effects, inflation accelerated back above 10% y/y in September as the naira weakened and fiscal expansion supported imports. While the hike may reduce the short-term heat on the naira, the country's imbalances persist and, in the face of weaker oil prices, the government may wish to boost revenues in local currency terms. We expect that the central bank will eventually allow more FX depreciation, given its limited resources.

Moreover, further hikes could add pressure to the domestic economy, including the still-fragile banking system. Higher interest rates and the doubling of the required reserve requirements (to 8%) will further reduce liquidity, ultimately hurting the growth of the real economy—especially the manufacturing sector and raising government financing costs. On a positive note, the now-positive real interest rates could deter capital and depositor flight. A more effective tool might be using the nascent sovereign fund to anchor fiscal policy—a politically difficult task.

Kenya and Uganda likewise hiked their key rates by 400 bps to 11% and 20%, respectively, in early October to prop up currencies abandoned by risk-averse investors in the face of spiraling inflation. Chronic food shortages saw inflation leap to 17.3% y/y in Kenya and 28.3% in Uganda. In fact, in mid-October, all five East African central banks pledged to coordinate monetary tightening, though implementation may be difficult given inflation differentials. In West Africa, a weak cedi (Ghana) and rising inflation might prompt further rate hikes to offset fiscal expansionism.

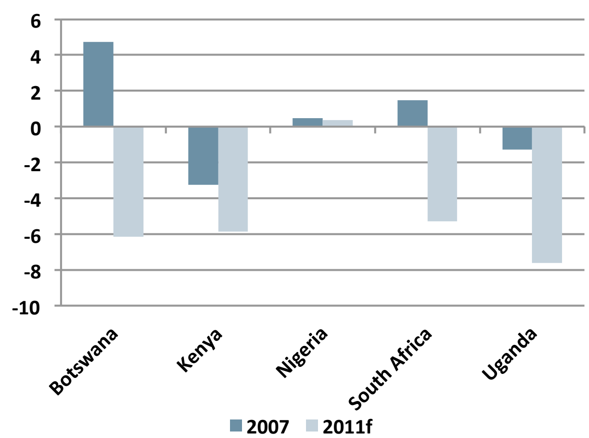
In the face of severe global financial stress, countries could turn to the IMF, whose support avoided pro-cyclical fiscal cuts in 2008, when African nations were hit first by high food prices and then a fall in global demand. The IMF's credit facility for low-income countries can benefit 32 countries; others could turn to some of the IMF's special financing frameworks. Others still, particularly Ghana, will be supported by a pipeline of resource and infrastructure-related investment from China and other EMs.

**Figure 1: Sharp Currency Depreciation**




*Source: Bloomberg*

**Figure 2: Government Finances in Worse Shape Than Precrisis (% of GDP)**




*Source: IMF, RGE estimates*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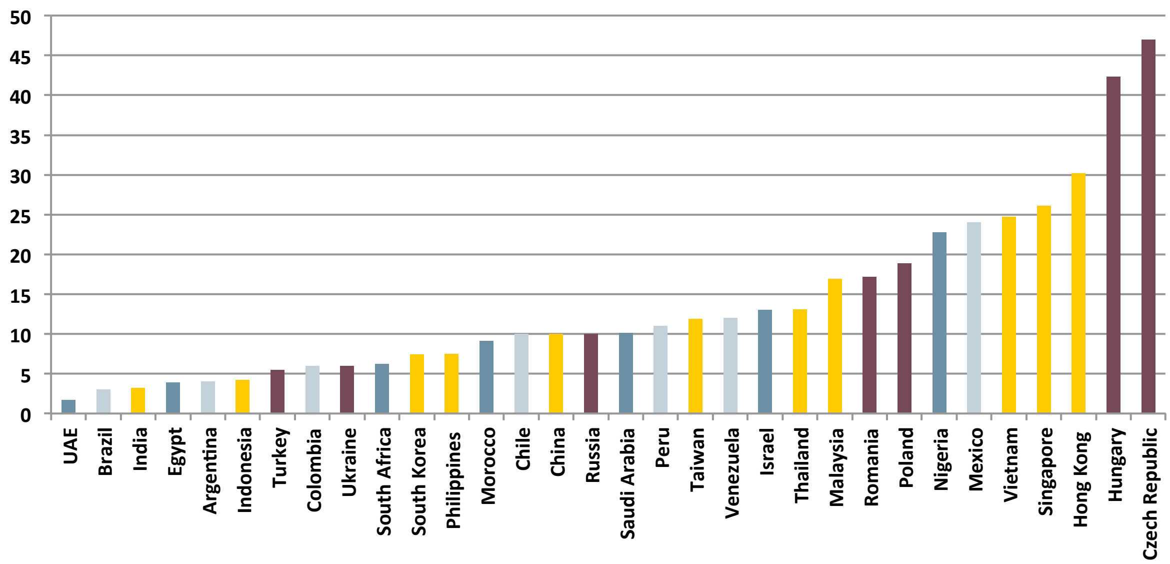
# Emerging Markets Chartbook

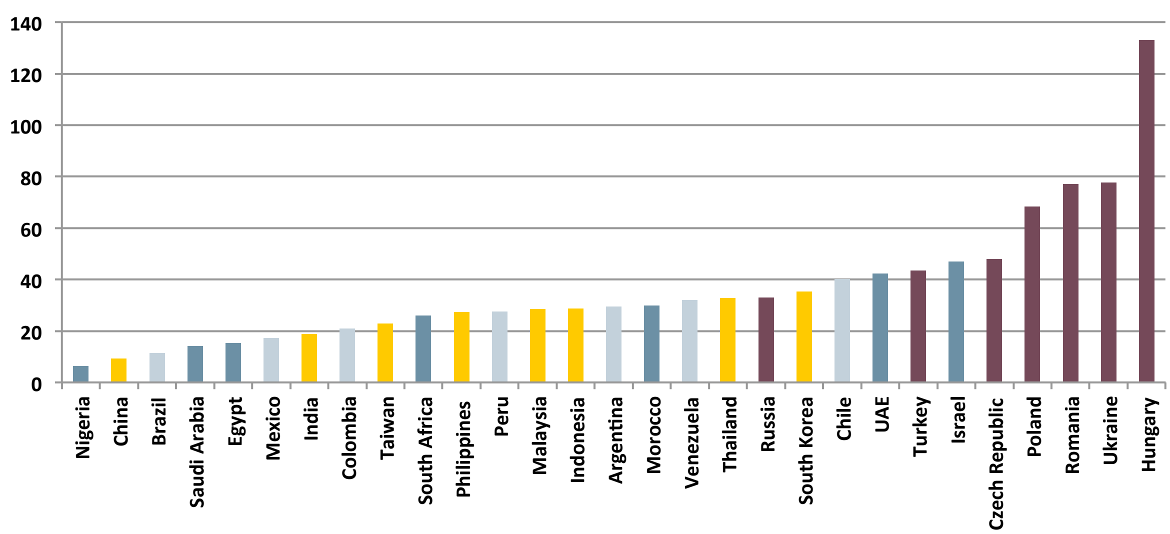
**Figure 1: Exports to U.S. and EZ (% of GDP, 2010)**




*Source: UN, national statistics, Haver, RGE*

Emerging Asia and Eastern Europe are the most exposed to a recession in the eurozone (EZ) and/or U.S.

**Figure 2: External Debt (% of GDP)**




*Source: National statistics, Haver, RGE*

The external debt of Eastern Europe economies far outweighs that of other EMs, leaving them more exposed to a financial shock and currency depreciation.


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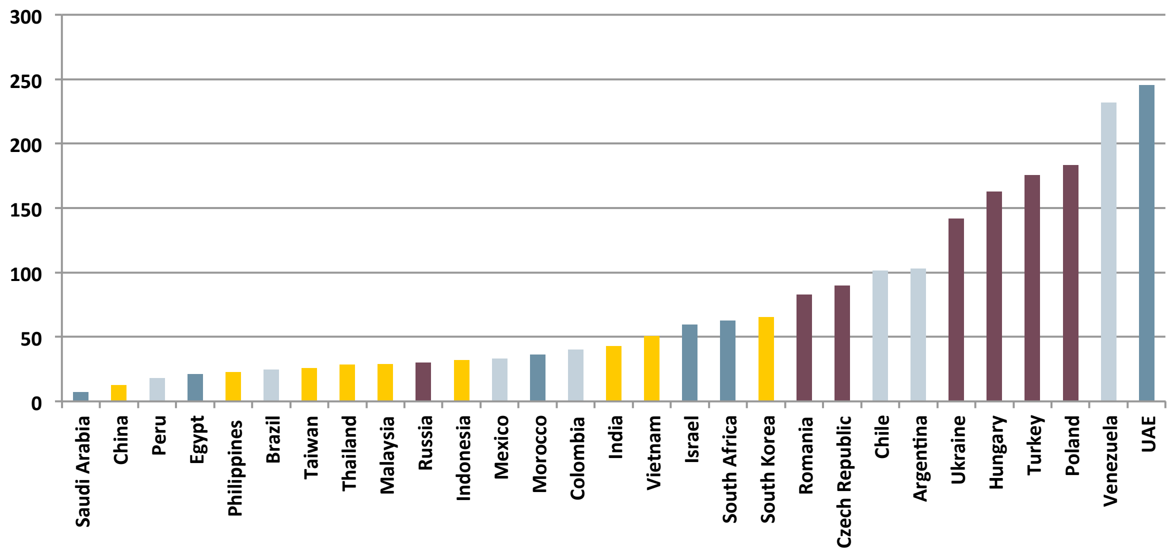
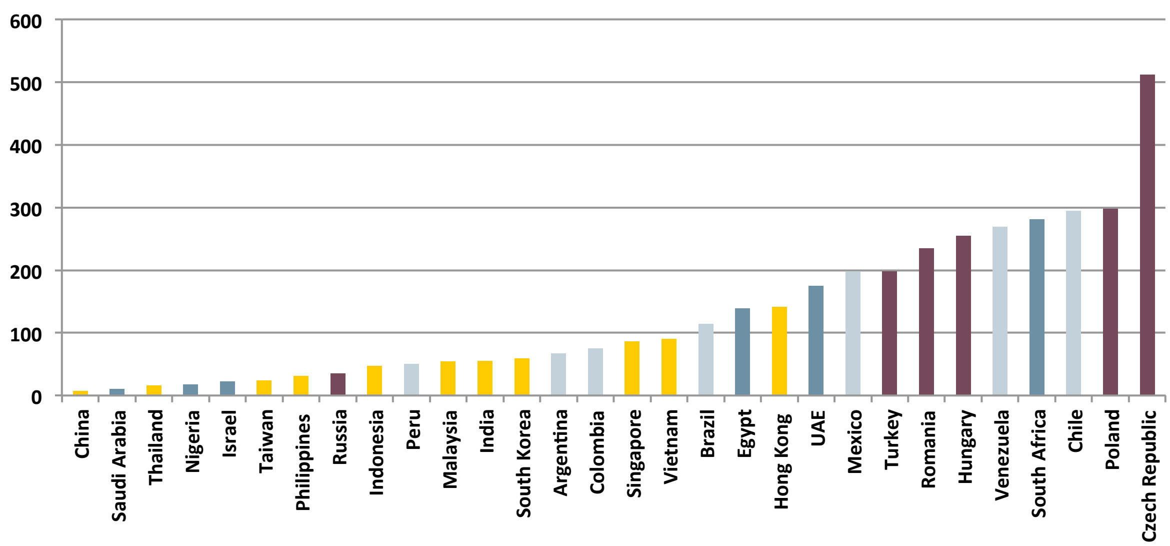
**Figure 3: External Vulnerability Indicator (2011 forecast)**




*Source: Moody's*

External vulnerability indicator = (short-term external debt + currently maturing long-term external debt + total nonresident deposits over one year)/official foreign reserves.

**Figure 4: European Bank Claims as a Share of FX Reserves**

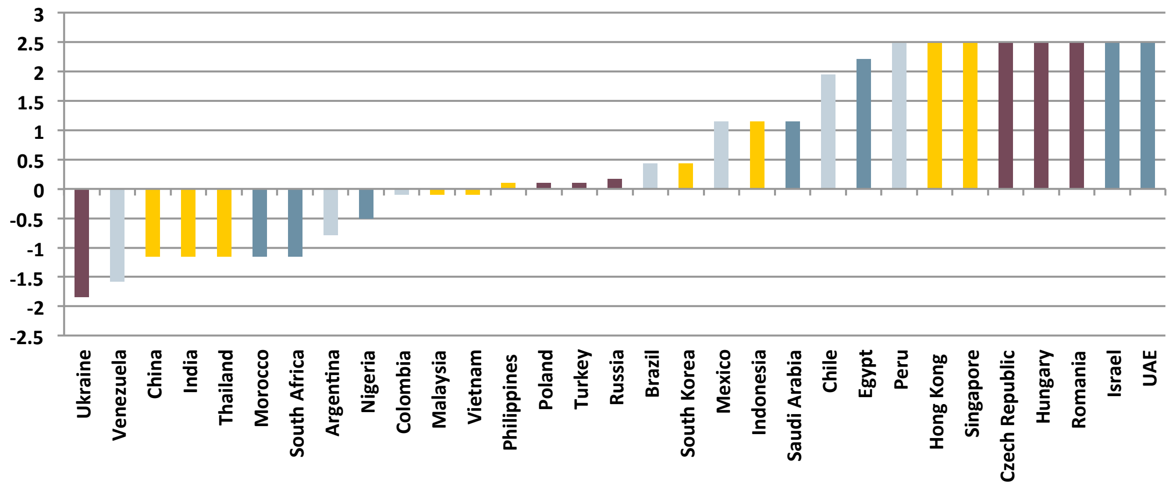



*Source: BIS, IMF, RGE*

Not surprisingly, Eastern Europe's exposure to European banks is the highest.

**Figure 5: Financial Openness (Chinn-Ito, 2009)**

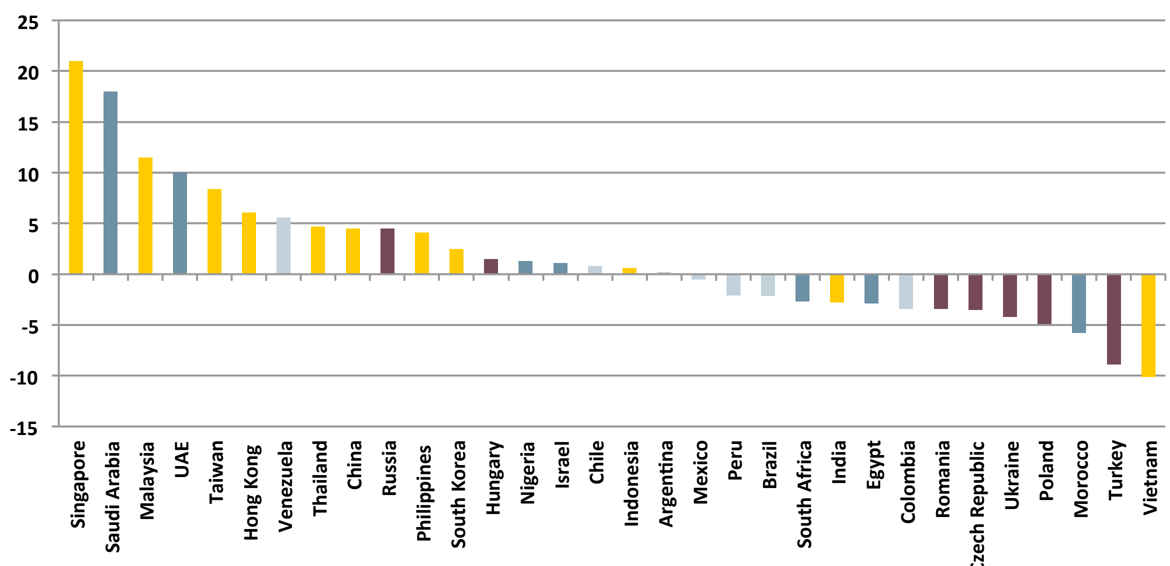





*Source: Menzie D. Chinn and Hiro Ito*

In this index, closed capital accounts have negative values. The index is derived from the restrictions on cross-border financial transactions data reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions.

**Figure 6: Current Account (% of GDP, trailing 12 months ending in June 2011)**

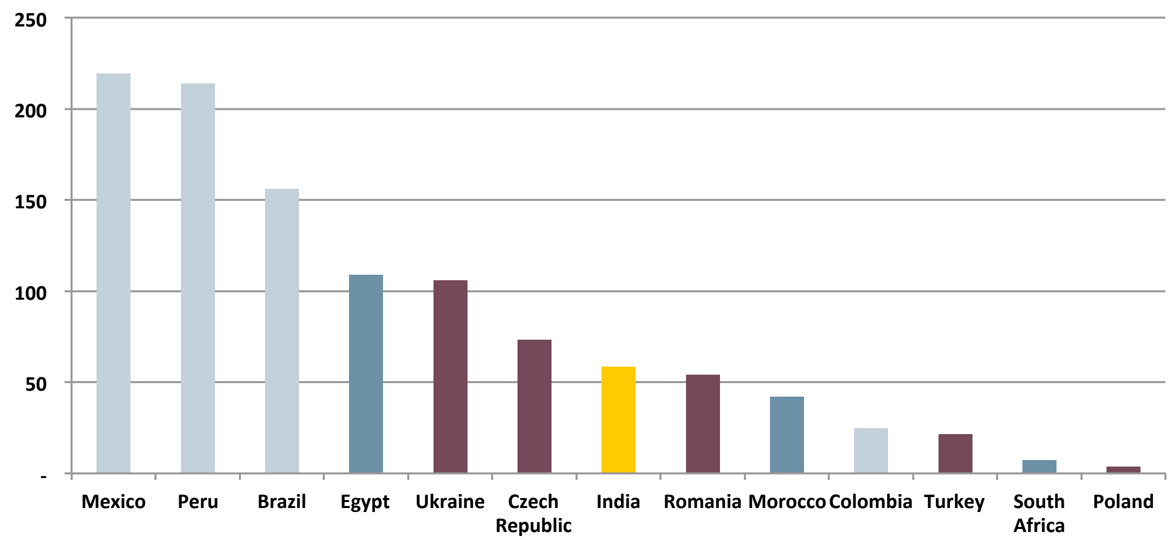



*Source: National statistics, Haver, RGE*

Asia's large surpluses should shield it from any external financing shocks, while once again Eastern Europe looks vulnerable, even though deficits have narrowed since 2007.

**Figure 7: FDI Coverage of Current Account Deficit (12 months to June 2011)**

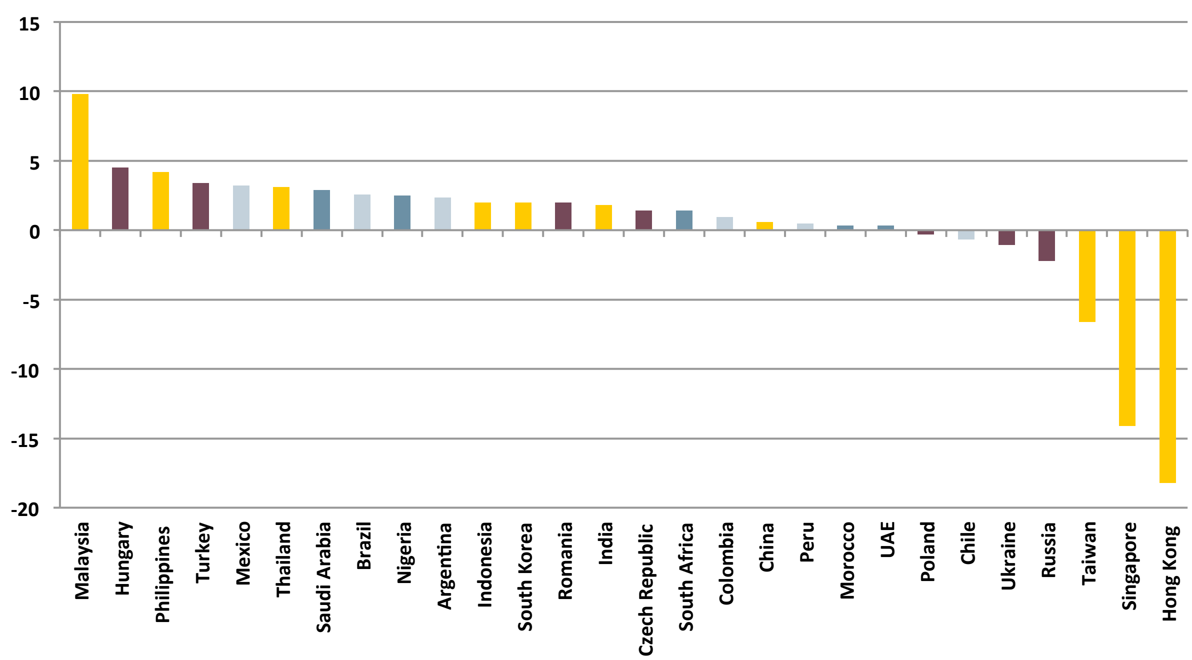





*Source: National statistics, Haver, RGE*

The financing of Latin American current account deficits is generally better than those in emerging Europe or Africa.

**Figure 8: Net Portfolio Flows (% of GDP, most recent 12 months)**




*Source: Haver, national statistics, RGE*

Countries like Turkey who have run large current account deficits on the back of portfolio inflows may be vulnerable to an external financing shock from the EZ.


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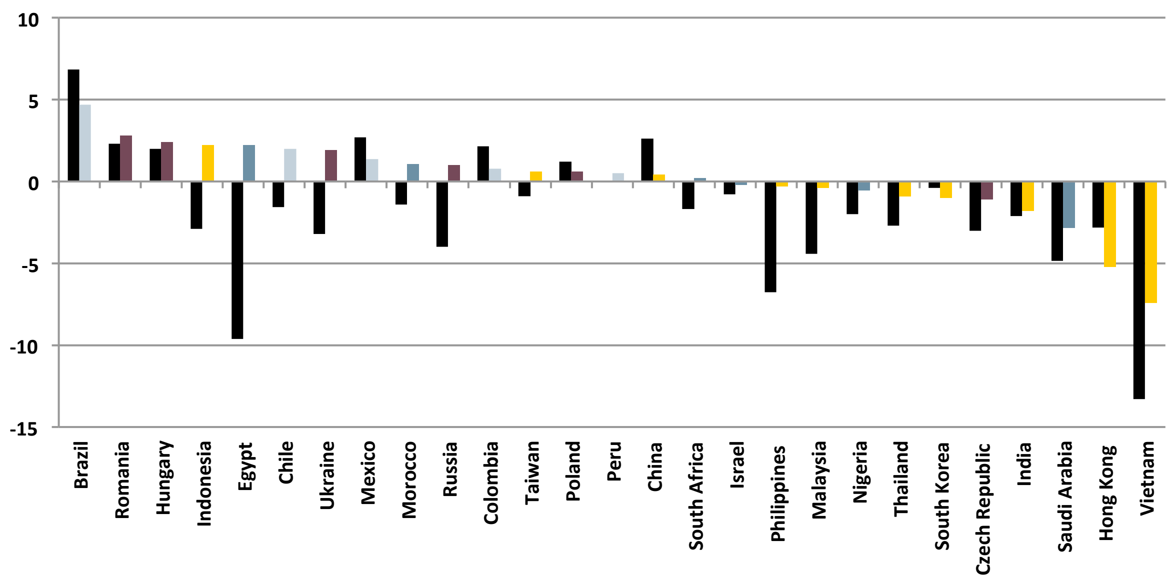
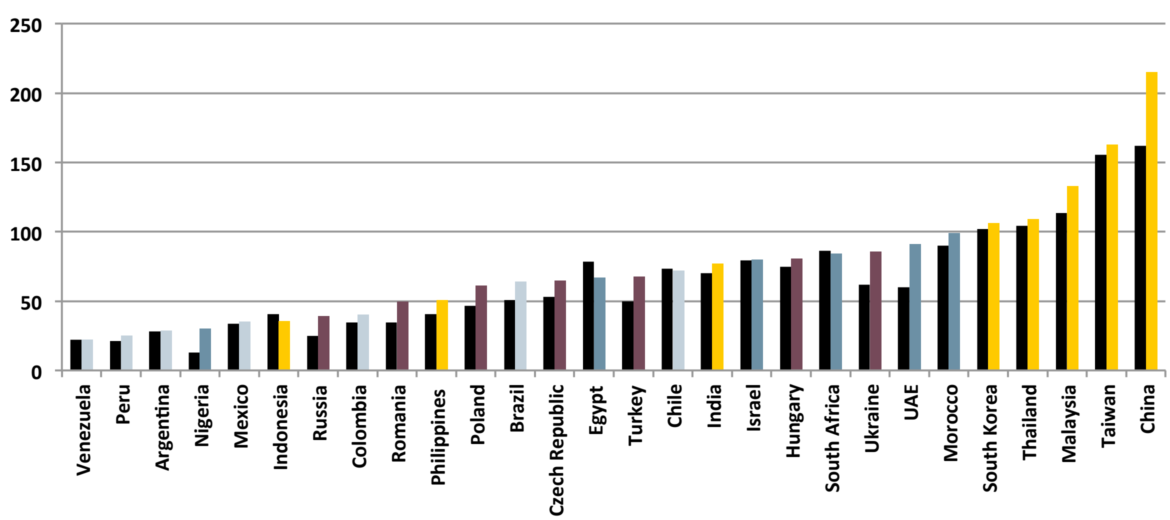
**Figure 9: Real Policy Rate (%; August 2008, September 2011)**




*Source: National statistics, Haver, Bloomberg, EMED, RGE*

Most countries have room to ease monetary policy, given that real interest rates are higher than their precrisis levels.

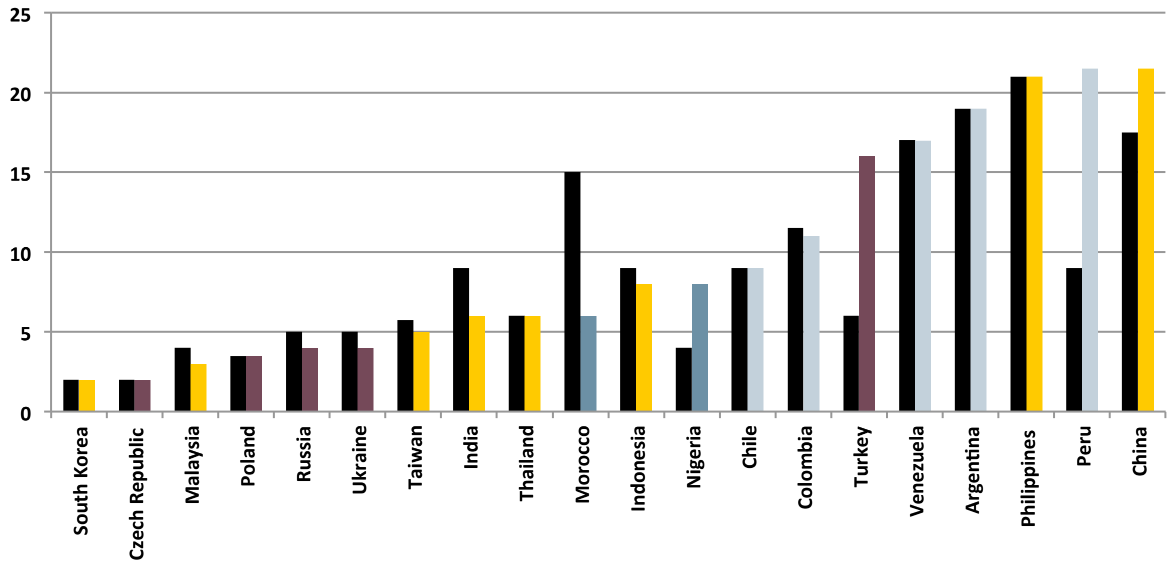
**Figure 10: Domestic Credit (% of GDP; 2007, 2011 forecast)**




*Source: Moody's, RGE*

Most EMs levered up after the financial crisis; none more so than China. This will limit the impact of looser monetary conditions.

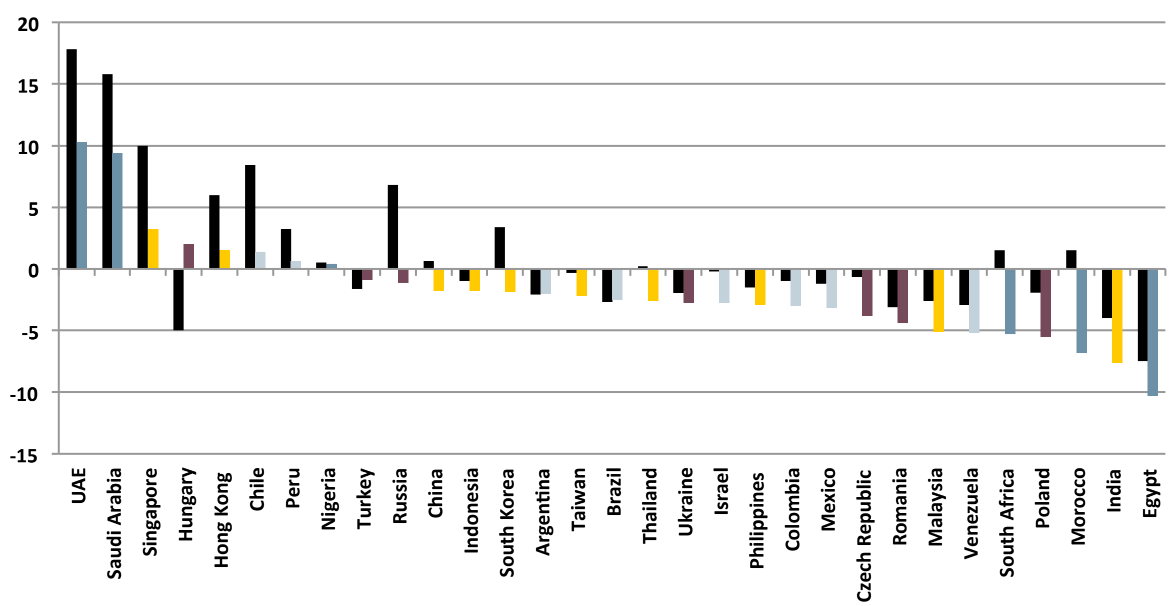
**Figure 11: Required Reserve Ratio (August 2008, current)**




*Source: National statistics, Haver*

Several EMs have followed China's lead in using required reserve ratios to absorb capital inflows since the crisis. This should provide a liquidity cushion for the domestic banking sector.

**Figure 12: Fiscal Balance (% of GDP; 2007, 2011 forecast)**




*Source: National statistics, Haver, Bloomberg, RGE*

Every country's fiscal position is weaker than it was in 2007, narrowing the room for counter-cyclical spending.


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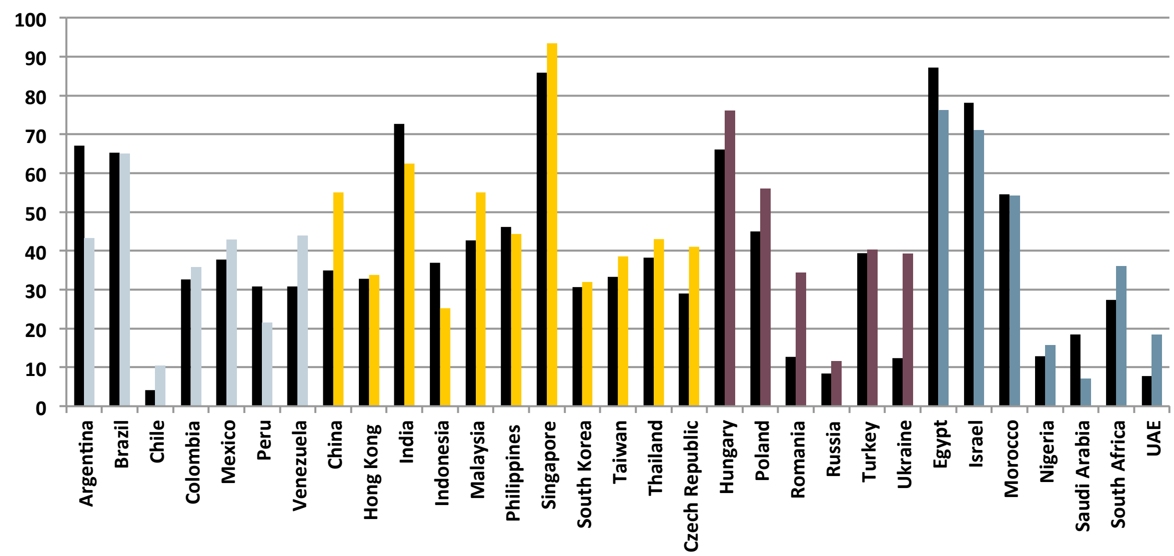
**Figure 13: Government Debt (% of GDP; 2007, 2011 forecast)**

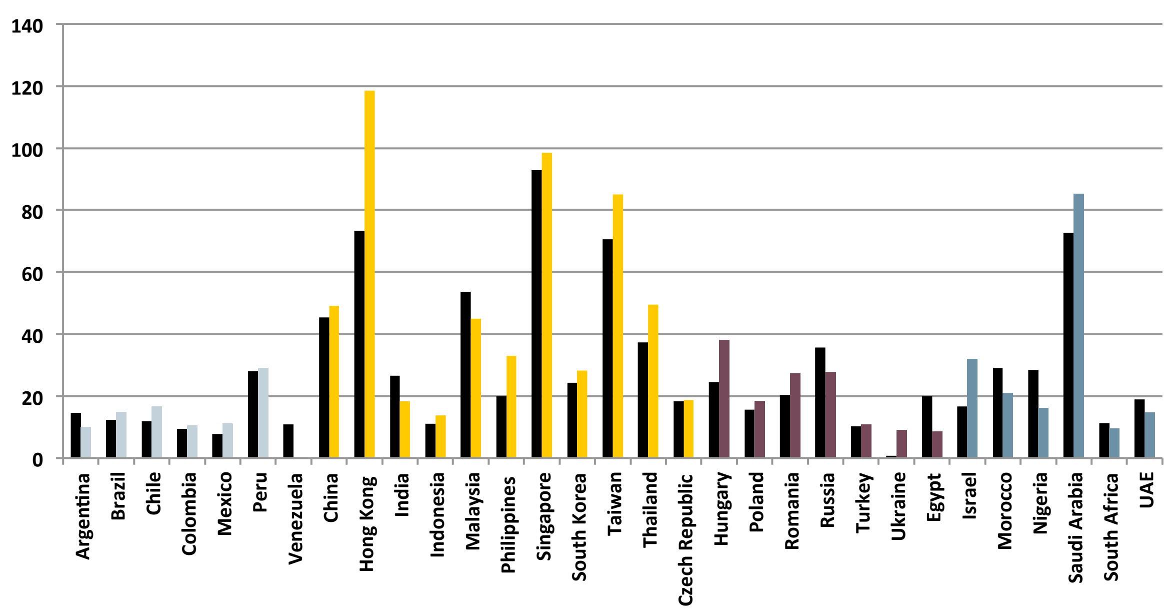





*Source: IMF, RGE*

However, most government balance sheets could withstand additional stimulus if need be.

**Figure 14: FX Reserves (% of GDP; June 2008, most recent available)**




*Source: IMF, national statistics, Haver, RGE*

Asia's FX reserves will prove useful in fending off financial contagion, while Latin America and Eastern Europe are more exposed.


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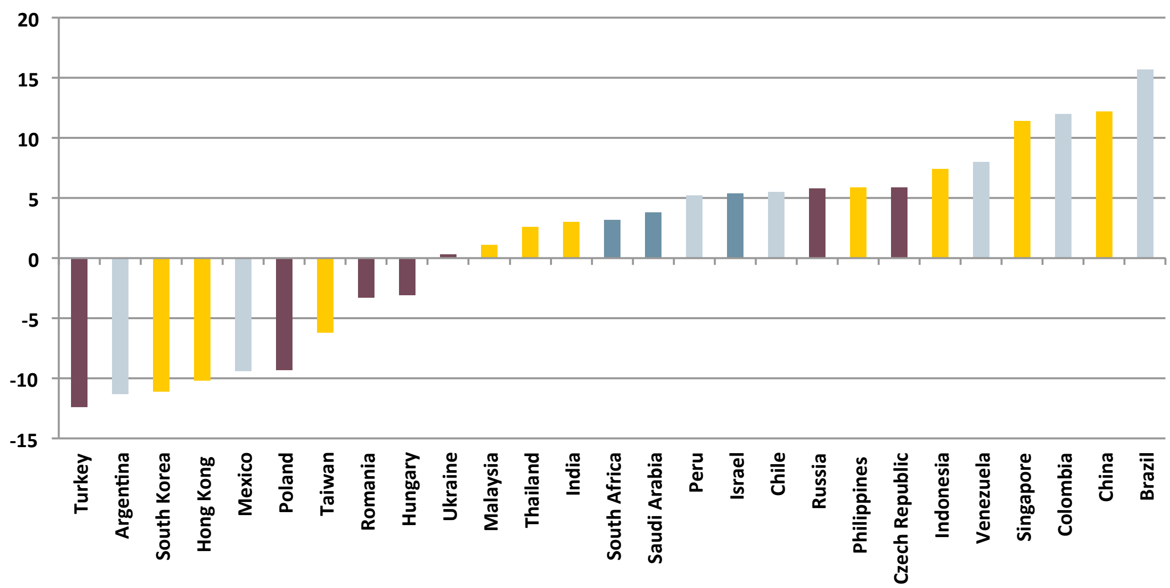
**Figure 15: Real Effective Exchange Rate (%, September 2011/five-year average to December 2010)**

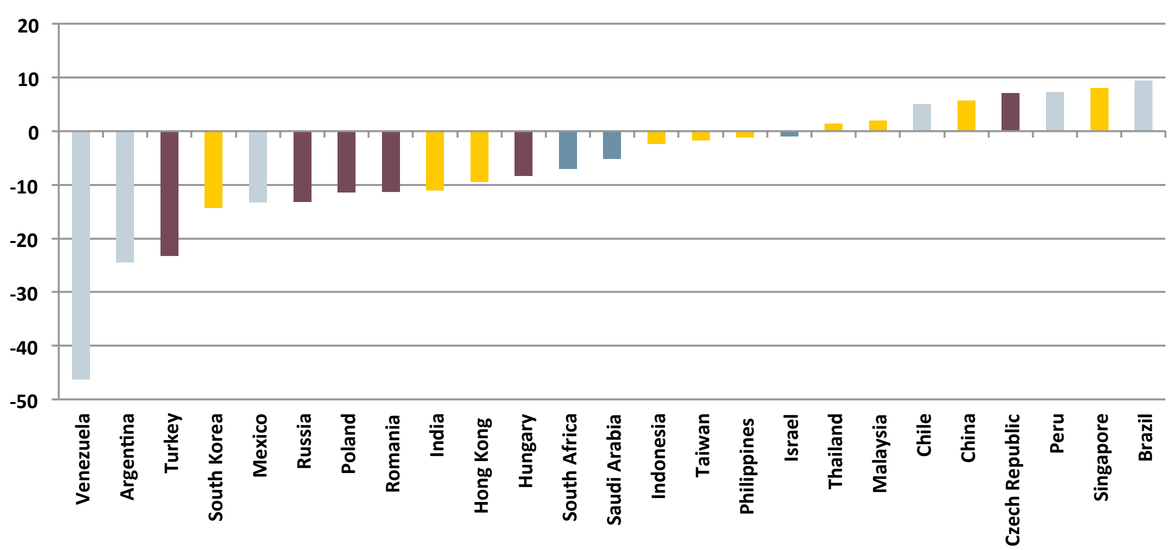





*Source: BIS, RGE*

Most EM currencies have appreciated in real terms since the financial crisis.

**Figure 16: Nominal Effective Exchange Rate (%, September 2011/five-year average to December 2010)**




*Source: BIS, RGE*

Most EMs have limited nominal FX appreciation through central bank intervention, getting higher domestic inflation instead.