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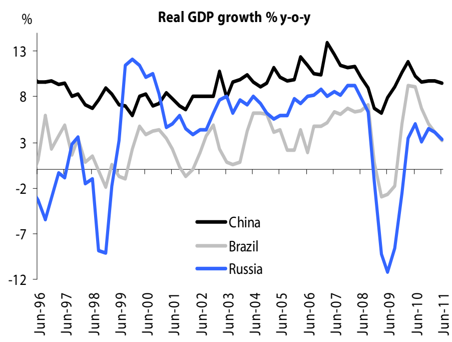
Emerging Markets: Growth expected to remain robust, though moderate to more sustainable rates

- The significant deceleration of economic growth in advanced economies along with monetary tightening has resulted in the moderation in emerging markets' economic expansion over the past year.
- Economic sentiment indicators across all emerging market regions point to further weakness in the remainder of 2011.
- Inflation in most emerging markets is expected to come down only gradually, given that there are still risks of second-round effects from past food and energy hikes and spill over of still high producer prices into core inflation.
- The emerging market policy tightening cycle has likely reached its peak, easing some of the headwinds that interest rate hikes brought to real incomes and private consumption.
- We believe that most emerging economies are well-positioned to withstand deepening turbulence in the global economy and growth is expected to remain robust, despite the ongoing slowdown.

Slowdown in emerging markets is underway

The significant deceleration of economic growth in most parts of the developed world along with monetary tightening has taken its toll on emerging markets (EM) economies over the past year. Recent data on real GDP growth confirm the moderation in the pace of expansion (Figure 1).

Figure 1



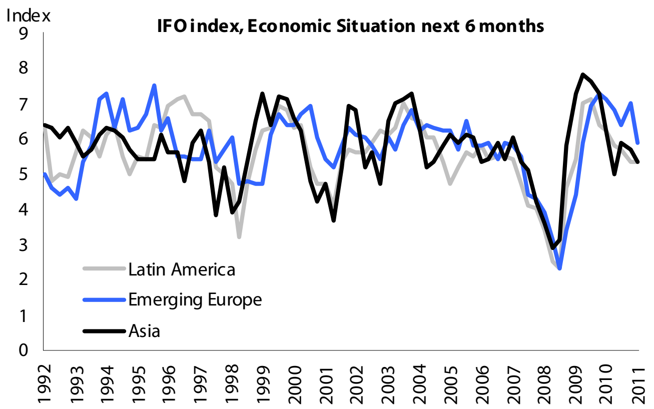
Source: Bloomberg

In line with real GDP data, economic sentiment indicators across all EM regions have been trending down since 2010 and point to further weakness in the remainder of 2011. However, they remain above the 5-point-level that indicates expansion (Figure 2). As Figure 3 depicts, until recently, the slowdown of global growth has not hurt EMs' nominal exports that much, partly because of elevated commodity prices. The latter have receded recently and downside risks to global growth have grown substantially, suggesting that external demand in EM would likely deteriorate in the coming months, which is strongly confirmed by our BRICs leading indicator[1] (Figure 3). Among emerging economies, those having a larger degree of openness to international trade are

[1] We compute the BRICS leading indicator as the weighted sum of each country's monthly OECD composite leading indicator. The weights are the corresponding gross domestic product based on purchasing-power-parity (PPP) share of world total. BRIC's leading indicator identifies the signals of changes in the economy almost three months before the actual turning points are found in the economic activity.

more vulnerable to a sudden global shock. Figure 4 illustrates that China and India are likely to see a quicker transmission of slowing external demand into domestic activity than Russia and Brazil. However, it is worth noting that trade openness has been shrinking in recent years, particularly in China where a rebalancing of the economy towards consumption is underway, a fact that helps in cushioning spillovers from weakening advanced economies.

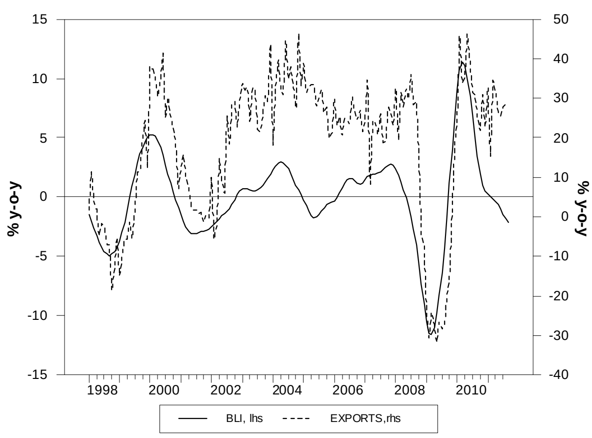
Figure 2



Source: Ecowin

Figure 3

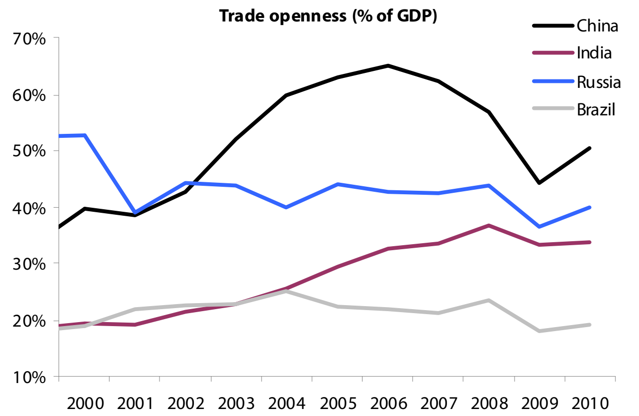
BRICs Leading Indicator*



** 3 month forward*

Source: Eurobank EFG

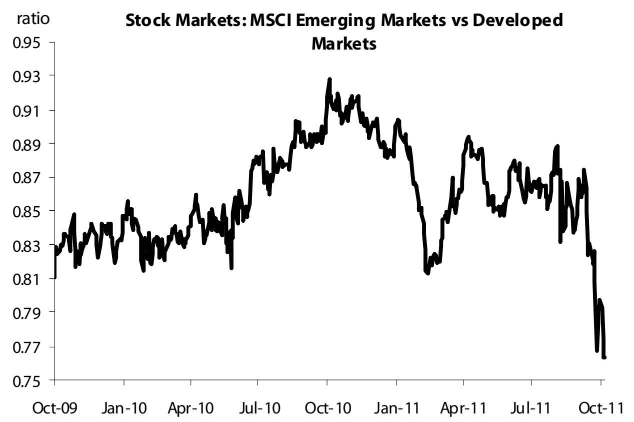
Figure 4



Source: IMF, Directional of Trade Statistics & World Economic Outlook Database September 2011

The adverse impact of the global turmoil is also evident in emerging economies' financial markets. Concerns about the ongoing risk to growth from tighter monetary policy in EM and slowing external demand weighted on investors' sentiment, leading to the underperformance of emerging market equities versus developed market (DM) equities. Since the beginning of the year, EM equities underperformed DM equities by 16% (Figure 5).

Figure 5

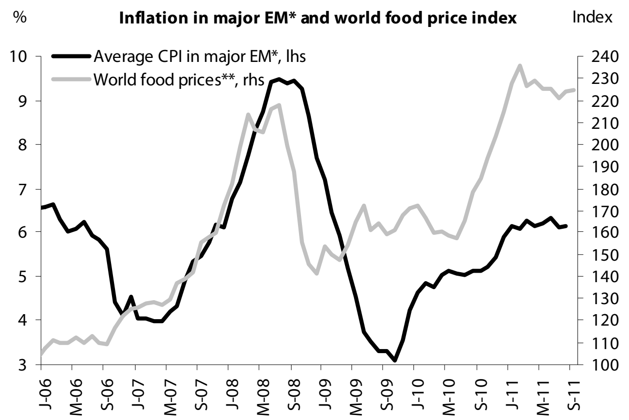


Source: Bloomberg

Inflation has receded recently, though is expected to remain relatively elevated

Average headline inflation across major EM economies has been on the rise since 2009, on the back of rising food and commodity prices. In fact, it has increased from 4.5% in 2009 to 5.1% in 2010, while over the first half of 2011 it has risen further to an average of 6.2% y-o-y (Figure 6). Since mid-summer, headline inflation in most EM appears to be losing some momentum but only to a small extent. Food prices, which have a large weight in the consumer price baskets across the emergers, have receded only modestly from their 2011 peaks and are likely to stabilize at present elevated levels. Low inventories, climate change, expanding income and population growth and structural changes in consumption patterns in developing countries are just some of the leading causes expected to keep food prices relatively elevated and volatile. Notwithstanding the recent drop in food prices, and even if food prices not reaccelerate in the coming months, we expect inflation in EMs to come down only gradually, given that there are still risks of second-round effects from past food and energy hikes and spillover of still high producer prices into core inflation.

Figure 6



** Brazil, Chile, China, India, Indonesia, Philippines, Russia, Singapore*
*** The Economist Food Price Index*

Source: Ecowin

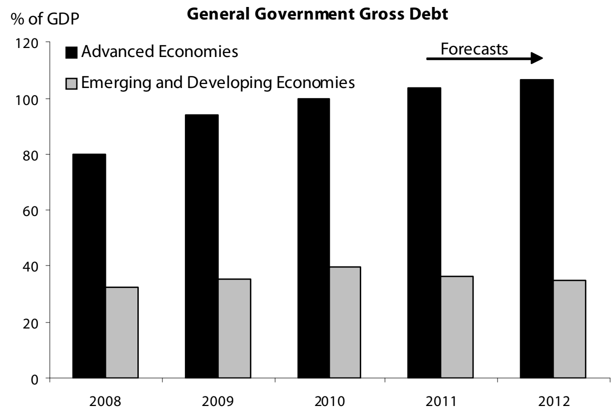
Monetary tightening has likely peaked, supporting growth

As a result of easing inflationary pressures and a broad-based slowdown in global growth, the EMs policy tightening cycle has likely reached its peak, causing a number of countries to either hold interest rates or ease. In particular, Brazil's central bank cut its key policy rate 50bp to 12% in an unexpected move on August 31, after a tightening cycle that began in April 2010 and resulted in policy rates higher by 375 basis points. This surprising interest rate cut came at a time when inflation is running at a six-year high of 7.2% y-o-y in August 2011. In fact, Brazil's monetary authorities believe that in order to promptly mitigate the effects of a more restrictive global environment, a moderate adjustment in the level of the policy rate is consistent with inflation converging to the target in 2012. Indeed, it seems that policymakers in EMs are showing growing tolerance for higher inflation, turning their attention from fighting inflation to supporting growth.

Despite the ongoing slowdown, growth in most EM economies is expected to remain robust

Looking forward, we believe that most emerging economies are well-positioned to withstand deepening turbulence in the global economy and sustain moderate growth in 2012. First, there is still room for fiscal easing to support growth, given that EMs' fiscal situation is relatively healthy compared to advanced economies. General government gross debt in emerging and developing economies was 39.3% of GDP in 2010, well below that of advanced economies (100% of GDP in 2010) (Figure 7). Second, the end of the monetary tightening cycle is expected to ease some of the headwinds that interest rate hikes brought to real incomes and private consumption since the tightening cycle in EM has started, approximately a year ago. Third, domestic demand in EM is particularly strong and a number of EM, in particular China, have already indicate policy reforms aiming at rebalancing their economies from foreign to domestic demand and, thus, supporting steady improvement in private consumption.

Figure 7



Source: IMF

All in all, growth in EM remains fairly robust, although it is moderating and EM economies are expected to remain the leaders of global growth, growing substantially faster than advanced economies over the next few years. According to the latest IMF forecasts[2], in 2011 and 2012, growth in emerging and developing economies is expected to moderate to still buoyant growth rates of 6.4% and 6.1%, respectively, well above the thirty year average of 4.5%. In addition, these rates are significantly higher than the expected growth rates of 1.6% and 1.9% in

[2] *IMF, World Economic Outlook Update, September 2011*

advanced economies. Over the past decade, EM economies have increased significantly their share in global GDP (from 37% in 2000 to 48% in 2010) and are expected to surpass advanced economies over the next two years, becoming gradually the world's largest economies. It is worth noting that advanced economies' share in global GDP has declined through time (52% in 2010 versus 63% in 2000).

As far as particular EM regions are concerned, in Emerging Asia the significant momentum in economic activity implies that the region will continue to outperform its peers. China and India will continue to play the most important role in the region and robust domestic demand will spread from these countries to their Asian peers. In Latin America, the possibility of further correction in commodity prices would play a significant role in determining the slowdown in the region. Emerging Europe's main challenge is the impact that the deterioration in the economic and financial situation in the Euro area will have on the region's activity.

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