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GLOBAL ECONOMIC &
MARKET OUTLOOK

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Eurobank EFG

FOCUS NOTES

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Emerging Markets Outlook: Growth to remain robust, despite the ongoing slowdown

- 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 previous year.
- Recent data on economic sentiment indicators across all EM regions point to some improvement in economic activity, after several months of deterioration.
- Export growth in EMs has dampened significantly due to the stagnation in world trade, though we expect the slowdown to be contained.
- Capital flows to emerging markets have fallen sharply since the third quarter of 2011, mainly because of intensifying financial stresses in the euro area. Concerning portfolio inflows, the prospects are more positive in 2012, compared to the previous year.
- Headline inflation in most EMs has stabilised, as food prices have started to recede from their 2011 peaks. Nevertheless, some upward price pressures still remain.
- Monetary policy is expected to be supportive for growth this year. However, credit conditions are still tight.
- 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.
- Higher oil prices and a deeper recession in the euro area constitute the main risks to our emerging markets outlook.

Leading indicators point to some improvement in emerging market economic activity

The significant deceleration of economic growth in most parts of the developed world along with monetary tightening has taken its toll on emerging market (EM) economies over the past year. Emerging economies' real GDP growth slowed to 6.2% (in ppp terms) in 2011 from 7.3% in 2010. However, this growth rate is considered still robust as it hovers well above the thirty year average of 4.5%. Moreover, it is substantially faster than that of advanced economies which expanded by 3.8% in 2011, down from 5.2% in 2010. Industrial production data across emerging market regions suggest a slight improvement in industrial activity over the last quarter of 2011 compared with a year earlier (Figure 1). The only exception is Central and Eastern Europe, as it is the region that affected the most by the recession in the euro area. In line with the pick up of industrial production, recent data on economic sentiment indicators across all EM regions point to some improvement in their economic activity, after several months of deterioration (Figure 2).

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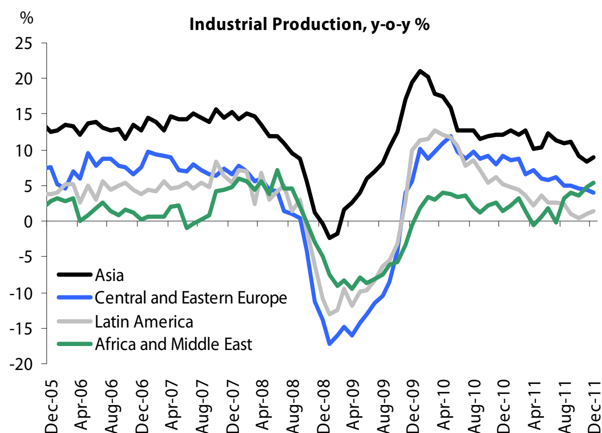
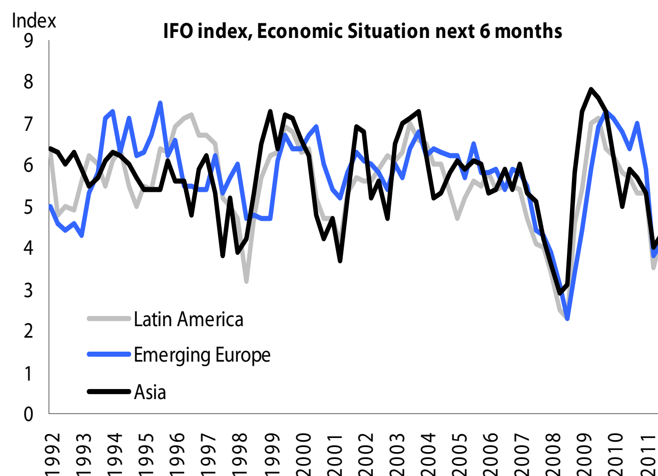
Figure 1



Source: CPB Netherlands Bureau for Economic Policy Analysis

Figure 2

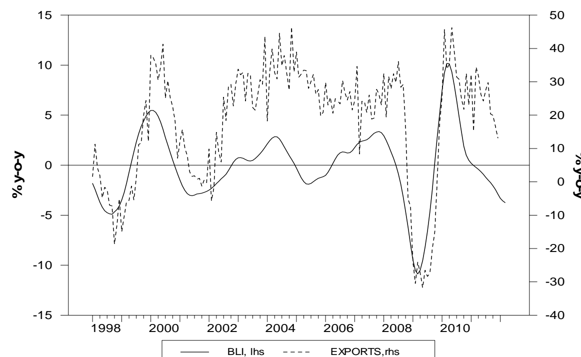


Source: Ecowin

Export growth in EM has dampened significantly due to the stagnation in world trade, though we expect the slowdown to be contained

In line with the deterioration in global economic environment, emerging markets' export demand declined significantly in 2011, with momentum stalling particularly in the second half of the year. Emerging Asian exports suffered the most due to the region's close trade links with developed economies. We believe that downside risks to external demand, particularly from the euro area, will persist at least for the first quarter of the year. This is also confirmed by our BRIC's leading indicator[1] (Figure 3).

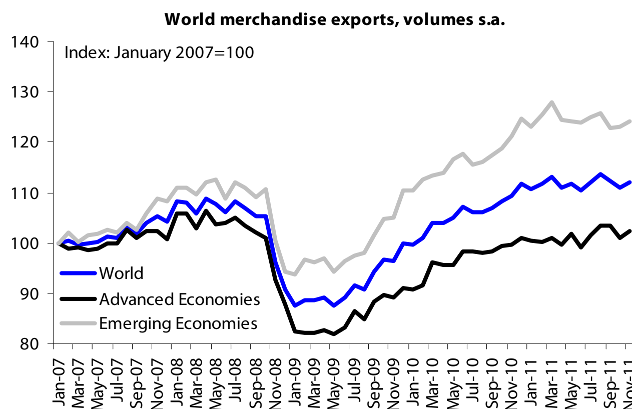
Figure 3
BRICs Leading Indicator* & Exports



** 3 month forward*
Source: Eurobank EFG

However, we expect the slowdown to be contained, due to several reasons. In particular, commodity prices are expected to remain elevated compared to historical levels over the course of the year. Furthermore downside risks to global growth have receded substantially, suggesting that external demand in EM would likely improve in the coming months. Better demand prospects are stemming particularly from the US, where leading indicators point to accelerating economic activity. Indeed, according to the latest data from the CPB Netherlands Bureau for Economic Policy Analysis, the level of merchandise export volumes for emerging economies has already recovered fully from the 2008-2009 global recession and it is hovering about 10.2% above its pre-crisis peak. In contrast, the corresponding level for advanced economies is 4.0% below its pre-recession peak (Figure 4).

Figure 4



Source: CPB

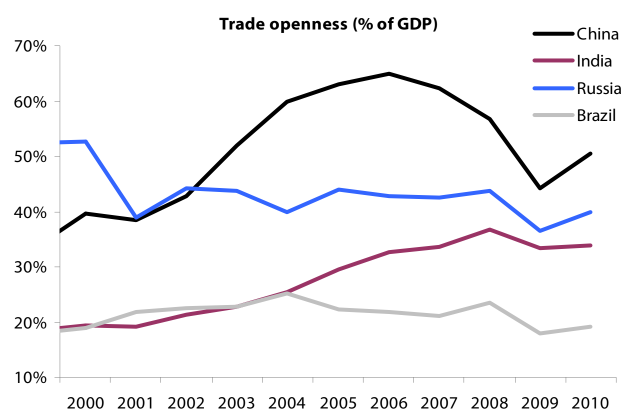
Among emerging economies, those having a larger degree of openness to international trade are more vulnerable to a sudden global shock. Figure 5 illustrates that China and India are likely to

[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.*

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.

It is worth noting that EMs importance in world trade has increased considerably over the past two decades. Between 1990 and 2011, their share of merchandise exports in world merchandise exports has increased gradually from about 20% to more than 40%, while that of advanced economies has decreased from 80% to 60% over the same period. Thus, EMs are playing a significant role in determining the prospects of world trade. Their robust growth and, particularly, their strong domestic demand is expected to be supportive for world trade in the years ahead.

Figure 5

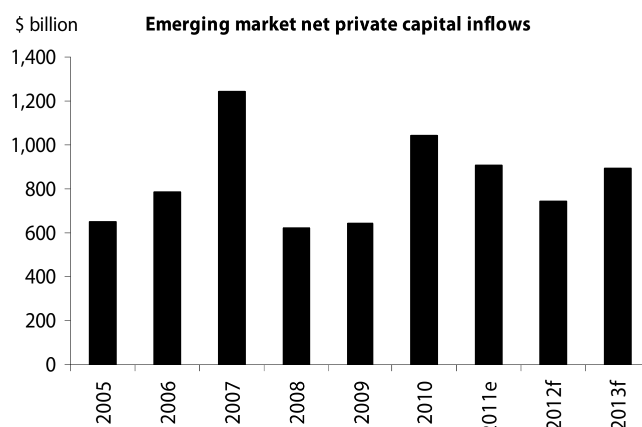


Source: IMF, Directional of Trade Statistics & World Economic Outlook Database September 2011

Capital flows to EMs weakened sharply in 2011

Capital flows to emerging markets have fallen sharply since the third quarter of 2011, mainly because of intensifying financial stresses in Europe that reduced the willingness of lenders to fund emerging economies and reduced investors' appetite for EM assets. According to the Institute of International Finance (IIF), net private inflows are estimated to have been $910 bn in 2011, down from $1,040 bn in 2010 and projected to decline further to $746 billion in 2012 (18% below those recorded in 2011) (Figure 6). Euro area's external deleveraging has weighed the most on EM capital flows. In particular, claims of European banks on EMs, which account for about 20% of their GDP, appear to have been particularly affected by the ongoing debt crisis. Bank of International Settlement (BIS) data on cross-border bank claims indicate that European banks reduced their claims on EM economies by a total of about $233 billion in Q3 2011 compared with the previous quarter. This was the first quarter-on-quarter decline in European banks claims on EMs since Q2 2010.

Figure 6

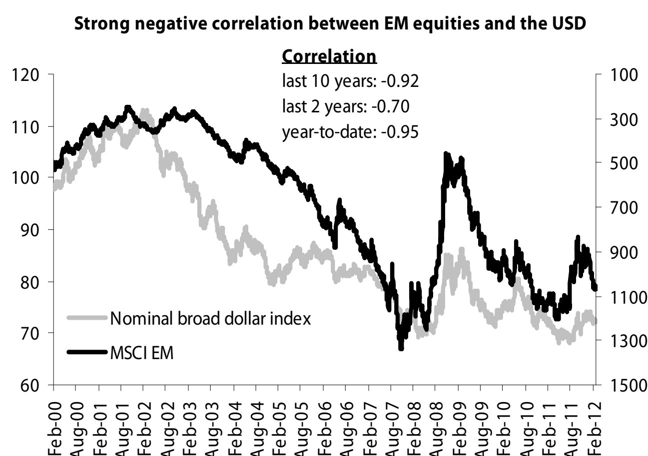


Source: IIF

More positive prospects for portfolio inflows in 2012 compared to the previous year

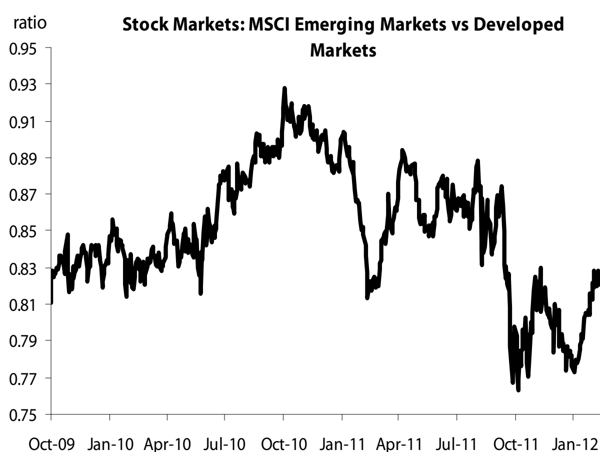
Regarding portfolio investment, concerns about the risk to growth from the deteriorating global economic environment weighed on investors' sentiment over the previous year, leading to a flight to safe heaven assets like the US dollar (Figure 7). Indeed, historically, it has been witnessed a strong negative correlation between EM equities and the US dollar. Emerging market equities underperformed developed market (DM) equities by almost 15% in 2011. In tandem with other risky asset markets, since the beginning of 2012, portfolio equity flows in emerging markets have revived, on the back of expectations of an improvement in the global economic environment. This is confirmed by the overperformance of emerging market equities versus developed market equities (Figure 8). In fact, EM has almost doubled the return of DM for the year-to date. We believe that the recent rally in EM equities is vulnerable to setbacks, particularly if the effectiveness of policy efforts to stabilize the euro area prove insufficient and risk aversion returns to investors. However, given that the decline in portfolio inflows was attributed mainly to external factors and that economic fundamentals in EMs continue to be robust, we believe that portfolio inflows are likely to increase in 2012 compared to the previous year. Furthermore, in 2011, EM equities suffered mainly due to rising inflation, decelerating growth, monetary tightening and elevated fears about contagion from European crisis. Now, inflation pressures have eased significantly and developments in advanced economies have become supportive for risky assets. In the US, leading indicators point to accelerating economic activity and the euro area is expected to avoid a deep recession. In addition, in most advanced economies monetary policy continues to be extremely loose and the tightening cycle in emerging economies has already come to an end.

Figure 7



Source: Bloomberg

Figure 8

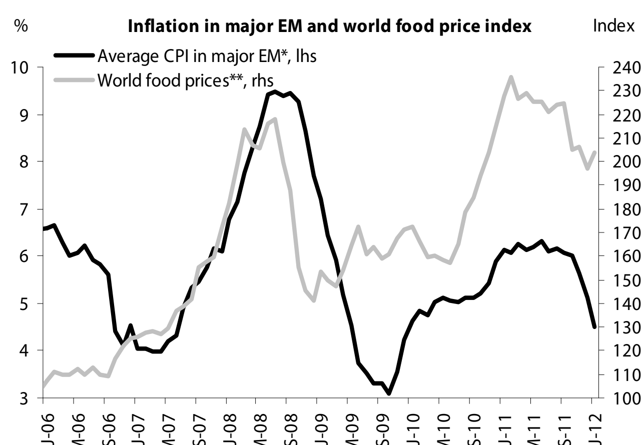


Source: Bloomberg

Inflation has receded significantly, though upside risks persist

Average headline inflation across major EM economies had been on the rise since 2009, on the back of rising food and commodity prices. In fact, it increased from 4.5% in 2009 to 5.1% in 2010, while over the first half of 2011 it rose further to an average of 6.2% y-o-y (Figure 9). However, since mid-2011, headline inflation in most EM has started to lose momentum, as food prices, which have a large weight in the consumer price baskets across the emergers, have started to recede from their 2011 peaks. Nevertheless, as Figure 9 depicts, world food prices remain elevated compared to historical levels, with the 2011 average food price index being 24% above its average in 2010. Besides this, in January, food prices posted a significant increase. Generally, some upward price pressures still remain. 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 that keep food prices relatively elevated and volatile. Moreover, high oil prices push up input costs which in turn is translated into higher producer prices and, consequently, into higher non-food inflation. In addition, there are also others sources of upside risks for inflation. Super expansionary monetary policy in the major developed economies creates a glut of money which pumped into economies and magnify upside risks to inflation. Moreover, prices in most commodity prices remain elevated, creating significant price pressures in emerging economies.

Figure 9

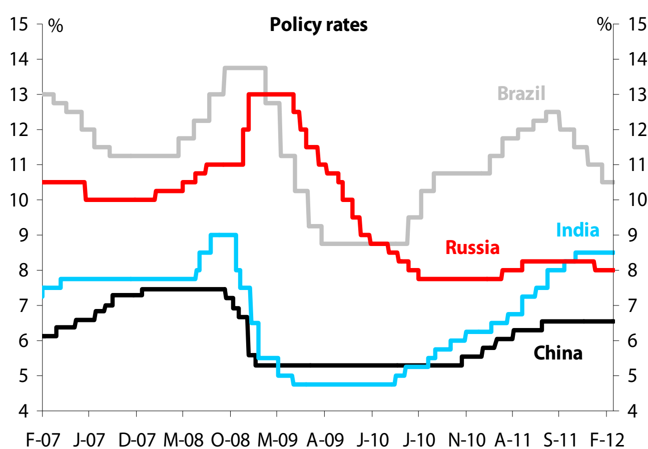


** Brazil, Chile, China, India, Indonesia, Philippines, Russia, Singapore*
*** The Economist Food Price Index*
Source: Ecowin

Monetary policy supportive for growth, while credit conditions are still tight

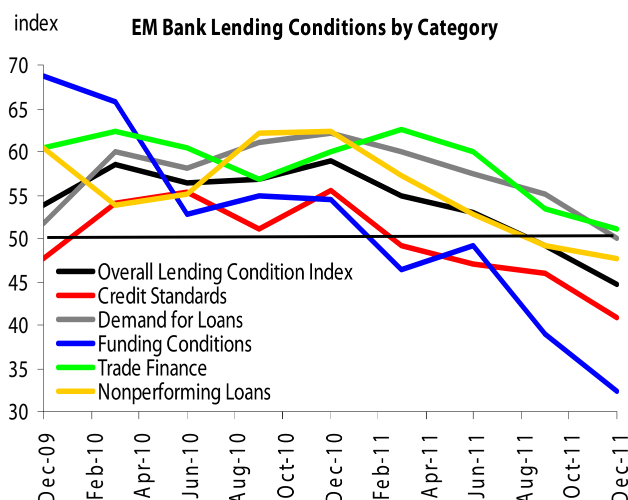
In 2011, easing inflationary pressures and a broad-based slowdown in global growth, led the EMs policy tightening cycle to an end, causing a number of countries to either hold interest rates or ease (most notably in Latin America) (Figure 10). However, central banks in most EMs, and especially in emerging Asia, are now expected to cut rates less than before in tandem with stabilization in global growth and the persistence of upside risks to prices. Monetary policy easing should be beneficiary for EMs growth in 2012. Nevertheless, despite the positive impact from monetary support, EMs continue to face the challenge of tight credit conditions, mainly from international tight funding conditions. According to the Institute of International Finance (IIF) EM Bank Lending Conditions Survey, over the past three months funding conditions worsened and credit standards became stricter, resulting in a significant tightening in bank lending standards. The most significant deterioration has occurred in emerging Europe, reflecting spillover from the euro area crisis (Figures 12, 13).

Figure 10



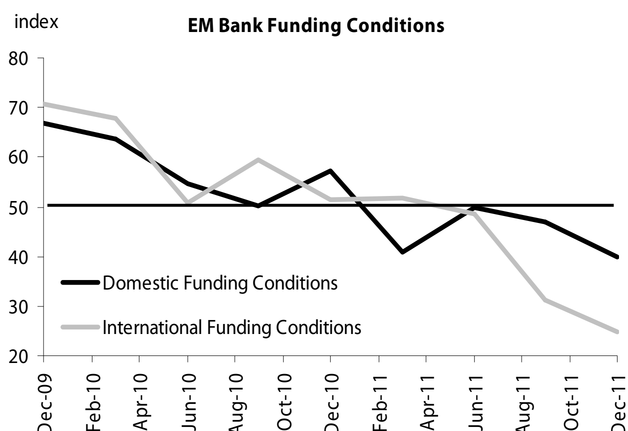
Source: Bloomberg

Figure 11



Source: IIF

Figure 12



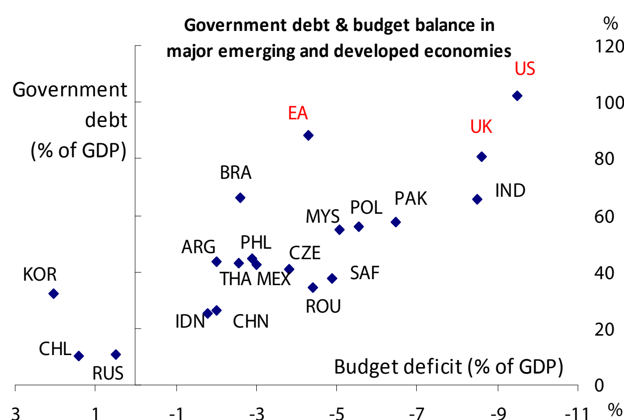
Note: Values above 50 indicate improving conditions. Values below 50 indicate deteriorating conditions

Source: IIF

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, if the global economic backdrop worsens further, given that EMs' fiscal situation is relatively healthy compared to advanced economies. General government gross debt in emerging and developing economies was 37.8% of GDP in 2011, well below that of advanced economies (103.5% of GDP in 2011) (Figure 13). Second, part of the slowing of EM growth in 2011 was due to the withdrawal of policy accommodation. However, in 2012, monetary policy easing in EMs is expected to provide a cushion for growth. Third, domestic demand in EMs is particularly strong. On top of this, a number of EMs, 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 13



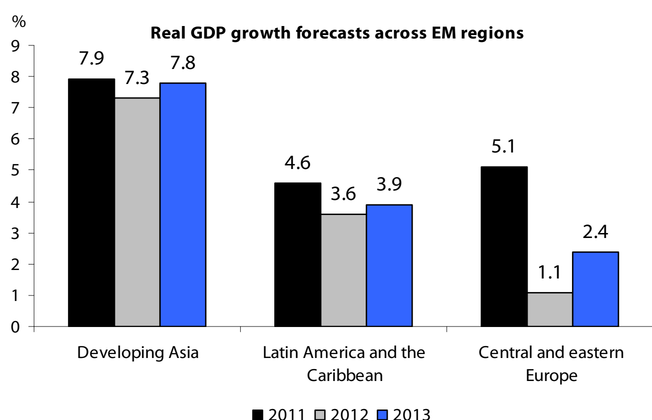
Source: IMF

All in all, we expect better growth in most of the EM world in the second half of the year, thanks in part to the lagged effects of monetary policy easing. Although EM economies are slowing down, they 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 2012 and 2013, growth in emerging and developing economies is expected to moderate to still buoyant growth rates of 5.4% and 5.9%, respectively. Over the past decade, EM economies have increased significantly their share in global GDP (from 37% in 2000 to 49% in 2010) and from 2013 onward are expected to surpass advanced economies, becoming gradually the world's largest economies. The significant momentum in Emerging Asia's economic activity implies that the region will continue to outperform its peers, with growth of 7.3% this year versus 7.9% in 2011 (Figure 14). China

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

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, weaker commodity imports from China played a significant role in the deterioration of the region's export growth. As major commodity exporters, most countries in the region are expected to benefit from elevated commodity prices and relatively strong performance of Asian economies, particularly China, a key destination of the region's exports. Emerging Europe is the region most exposed to the troubles in the euro area, so its economic performance in 2012 will rely mainly on the depth of the euro area's recession, which we expect to be mild.

Figure 14



Source: IMF

We anticipate two major risks to our emerging market outlook

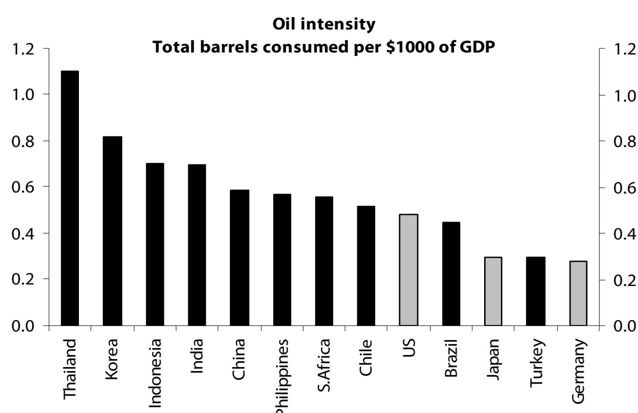
Higher oil prices

The first risk is associated with higher oil prices and sanctions on Iranian crude oil imports. Oil prices have increased about 17% year-to-date, and are already 13% above the 2011 average. Geopolitical tensions along with easy money globally and tight fundamentals, in our view, will maintain oil prices at current elevated levels across 2012, with upside risks to oil prices rising markedly on the back of recent developments in Syria and Iran. Should oil prices remain at current levels, this would mean that 2012 average oil prices would be at record highs. Indeed, Brent averaged $110/barrel in 2011, setting an all-time high and surpassing the previous annual record of $98.3/barrel in 2008. What's more, sanctions on Iranian crude imports, including a US and EU embargo, may introduce another headwind to emerging economies that rely heavily on Iran for their oil import needs. Crude oil imported from Iran accounts for 11% of China's and India's total crude oil imports, and 10% of South Korea's imports. As a result, a cut of supplies from Iran that will drive oil prices even higher would hurt growth in these countries and translate into higher consumer prices. The vulnerability of each individual country to higher oil prices depends mainly on whether the country is net oil importer, its oil intensity and its flexibility to substitute less expensive sources of energy for oil. As Figure 15 shows, energy intensity in emerging Asian countries, which are net oil importers, is higher compared to other EMs and major advanced economies. Consequently, these countries are expected to be most negatively affected. Indeed, according to IMF (2000)[3], a permanent $5/barrel increase in the price of oil will cut approximately 0.4% and 0.1% off emerging Asia's and Latin America's GDP growth, respectively, after one year. The corresponding effect for emerging Europe and Africa is +0.1%, due to the larger positive influence of net oil exporters in aggregate activity (Table1). Apart from economic growth, higher oil prices have also a key impact on inflation. Again, emerging Asia is expected to experience the largest increase in inflation. The impact on inflation can be shielded, by existing fuel subsidies in countries, such as India, Indonesia, Malaysia and Thailand. However, in some of these cases, government finances will suffer instead, as large fiscal deficits may not allow governments to bear the escalating costs of higher fuel subsidies for longer. Incomes of major commodity exporters would be hard hit and their fiscal conditions would deteriorate rapidly.

A deeper recession in the euro area

The situation in Europe also presents a significant source of risk going forward. Should conditions in the euro area deteriorate sharply, GDP growth in emerging economies would be much weaker than expected, reflecting mainly a drying up of international capital flows, trade effects and a significant degree of deleveraging of European banks. In particular, risk aversion could escalate further and international capital flows could decline even more. EM countries with close trade linkages with the euro area would experience a sharper deceleration in export growth. Other economies particularly reliant on European banks (mainly in emerging Europe) would be affected by a sharp reduction in wholesale funding and domestic bank activity. Slower commodity demand growth due to a deeper recession in the euro area could result in a major decline in commodity prices.

Figure 15



Source: EIA

[3] *IMF, 2000, "The impact of higher oil prices on the global economy".*

Table 1

Emerging Markets
Estimated effects after 1 year of a $5 oil price hike

	Real GDP	Inflation
Latin America	**-0.1**	**0.6**
Argentina	-0.2	0.1
Brazil	-0.2	1.0
Chile	-0.2	1.0
Mexico	0.0	0.1
Asia	**-0.4**	**0.7**
China	-0.4	0.4
India	-0.5	1.3
Indonesia	0.1	1.0
Korea	-0.9	0.8
Malaysia	-0.2	1.0
Philippines	-0.8	0.8
Thailand	-0.9	0.4
Emerging Europe & Africa	**0.1**	**0.3**
Pakistan	-0.5	0.4
Poland	-0.3	0.0
Russia	0.7	0.0
South Africa	-0.4	1.2

Source: IMF

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