

EM five years after the start of the Great Recession



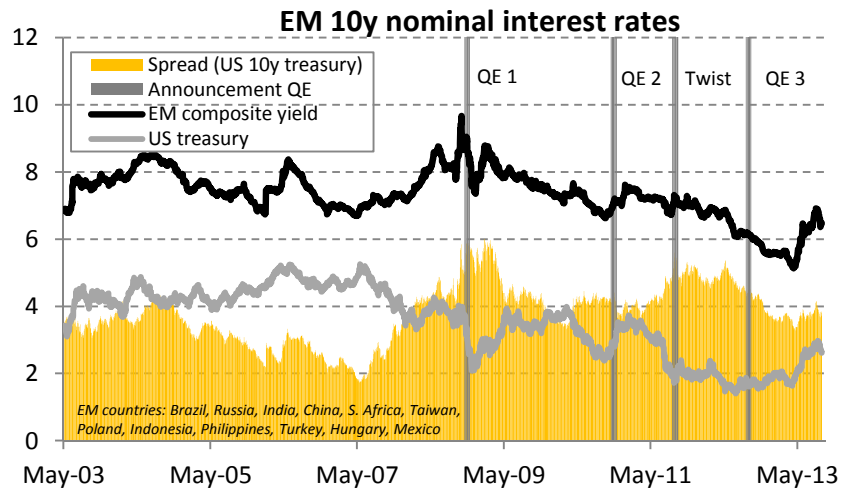
What kind of EM recovery?

No return to pre-crisis stellar growth rates

➔ **The recovery in EM is likely to remain modest at best**

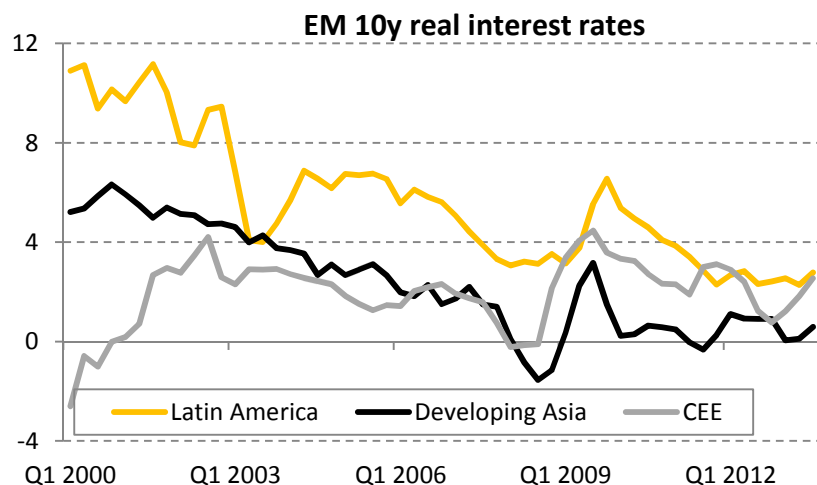
- ▶ Chinese growth likely to decrease further in coming years despite current improvement in momentum
- ▶ A number of EM can no longer count on the pre-crisis commodity boom
- ▶ Structural problems in BRIC's remain
- ▶ Upcoming 2014 elections in S. Africa, Indonesia, Brazil, Indonesia risk holding up structural reforms
- ▶ Credit growth is probably still too high in a number of countries

EM (real) interest rates



→ Spreads throughout EM tightened significantly until mid-2007. They then began to widen drastically until begin 2009.

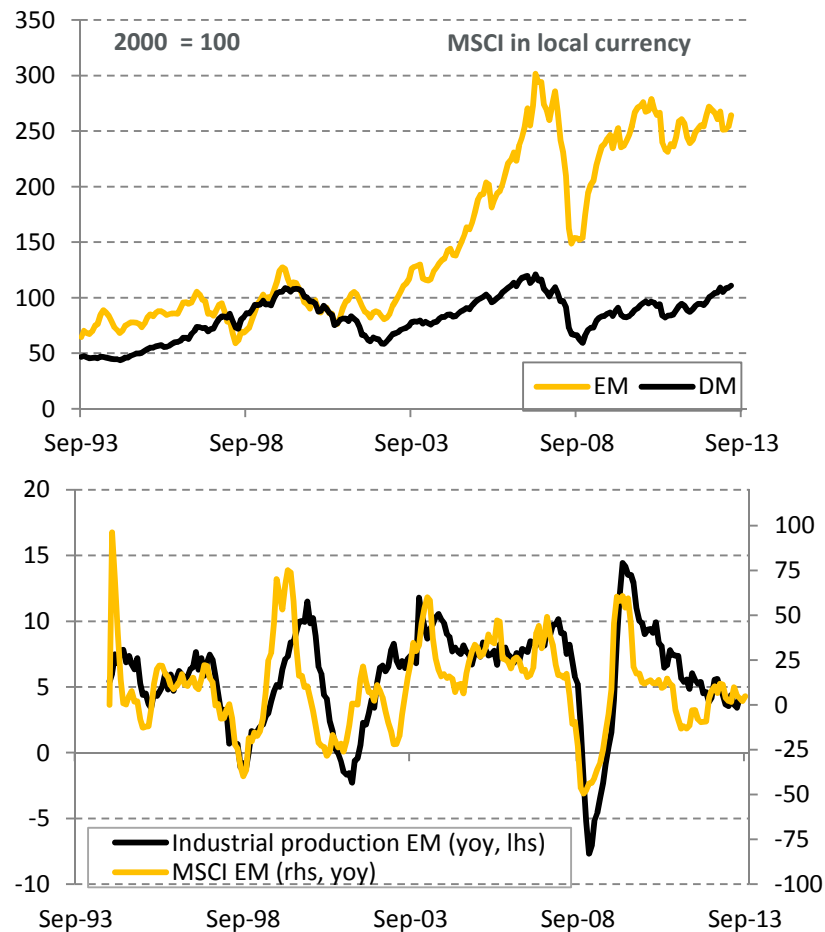
→ After 2009 interest rates in EM declined gradually and moved more or less in line with US interest rates. Average EM spreads have been hovering around 4% for a couple of years now, above the 2004-2007 levels



→ Real interest rates have come down gradually in the run-up to the 'Great Recession'. This has contributed to (very) high credit growth

→ Real interest rates in Latin America and Emerging Asia have been at historically low levels in the wake of the 2008-2009 crisis and private sector credit growth in a number of EM is probably still not sustainable (see previous slide)

EM equities have moved in line with economic activity

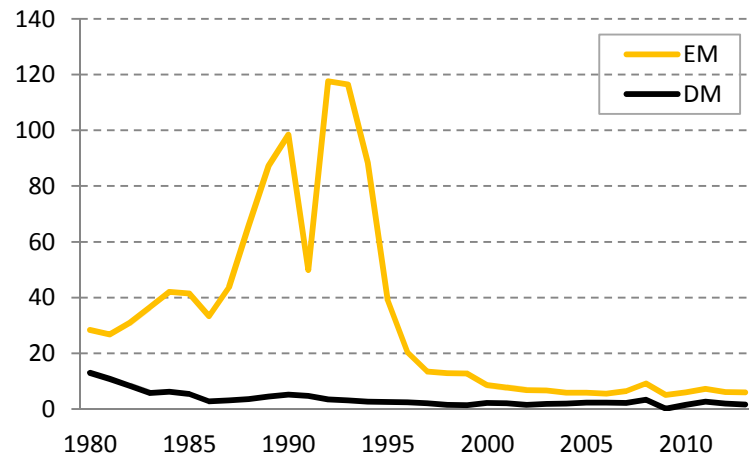


→ Some observers have described the pre-crisis equity run in EM equities as a bubble

→ But in fact EM equities have moved broadly in line with EM economic activity

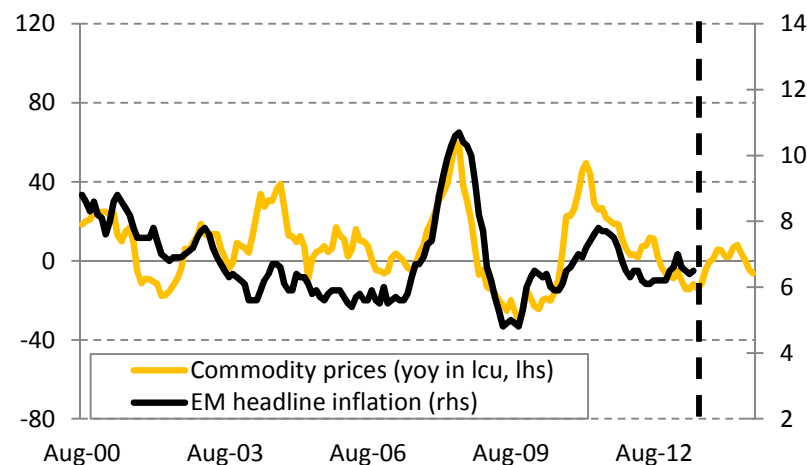
→ EM equities are not expensive by historical P/E ratios

Inflation largely under control



→ **EM have come a long way in getting inflation (expectations) better under control**

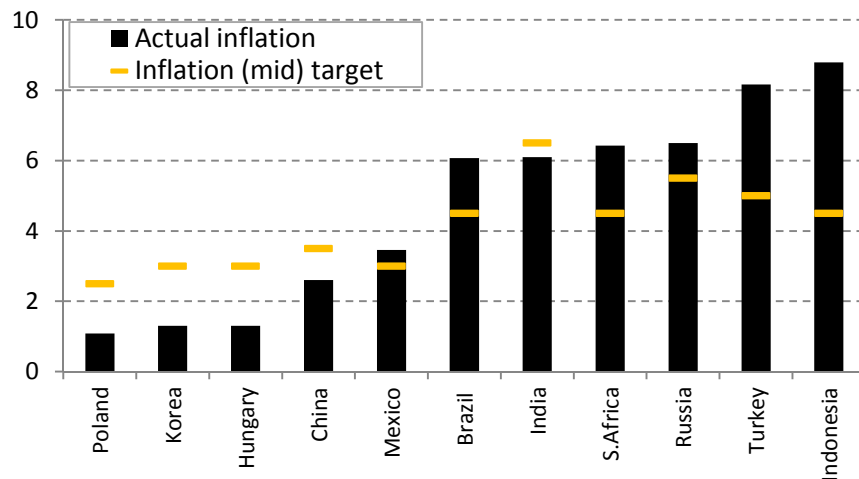
- ▶ Largely thanks to the implementation of inflation targets but also increased discipline with regards to public finances



→ **Despite significant EM currency depreciation in recent months, EM wide inflation will stay broadly in check**

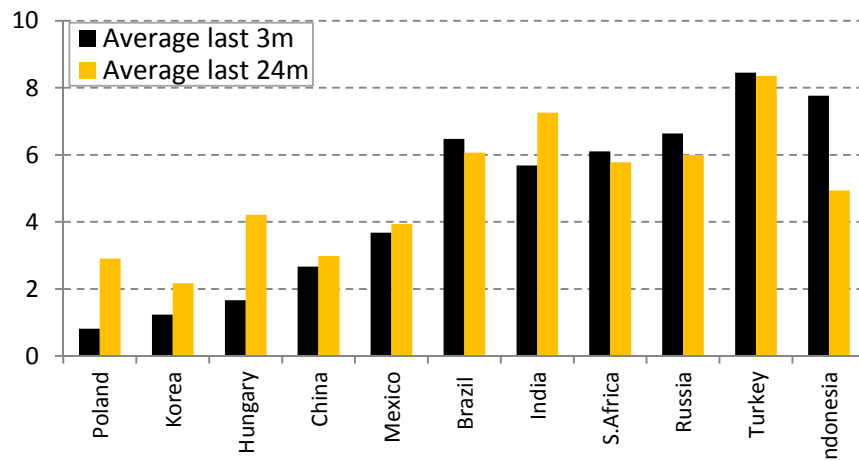
- ▶ As a result monetary policy in EM is set to stay relatively loose in the near future
- ▶ This does not exclude the fact that inflation is too high in a number of countries (see next slide)

But some countries already facing above target inflation



→ A strong focus is still required for a number of countries

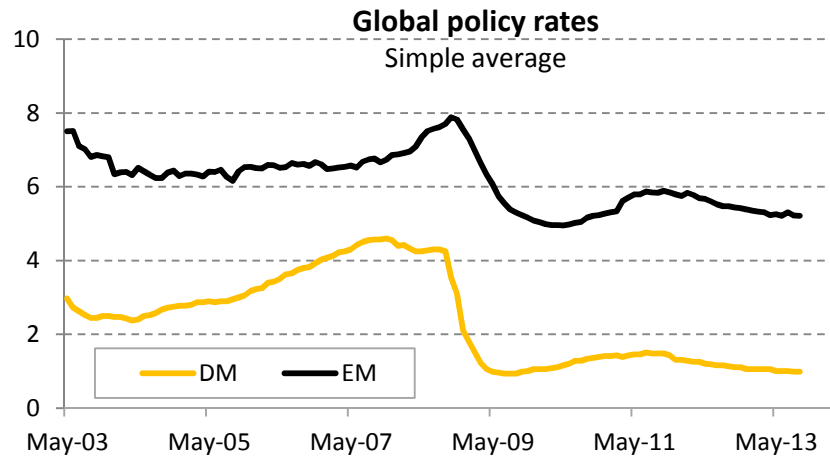
- ▶ Indonesia (upper target is 5.5%)
- ▶ Turkey (target is 5%)
- ▶ S. Africa (upper target is 6%)
- ▶ Brazil (upper target is 6.5%)
- ▶ India: wholesale price inflation (WPI, focus of Indian central bank policy) is displayed on the graph, but consumer price inflation (CPI) actually hovers around 10%



→ Other EM report below target inflation

- ▶ Poland
- ▶ Korea
- ▶ Hungary
- ▶ China

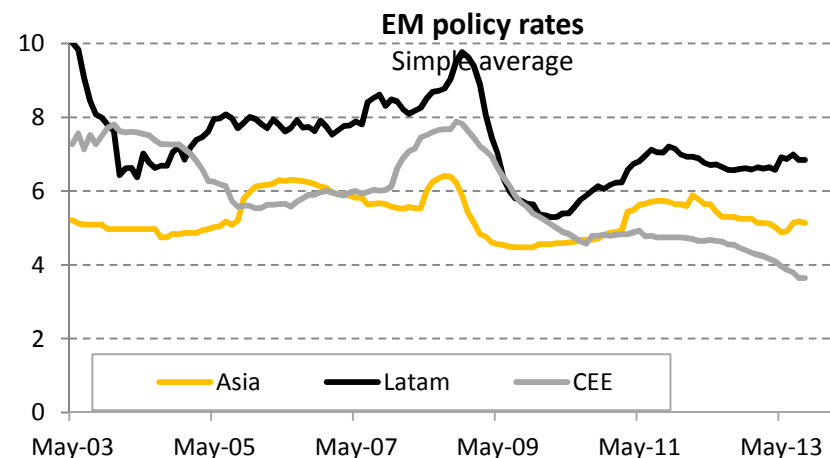
Monetary policy in EM stays loose



→ Global monetary policy stays very loose for the time being. Monetary policy throughout EM remains very accommodative despite the fact that EM currency depreciation has sparked (largely unjustified) fears of inflation

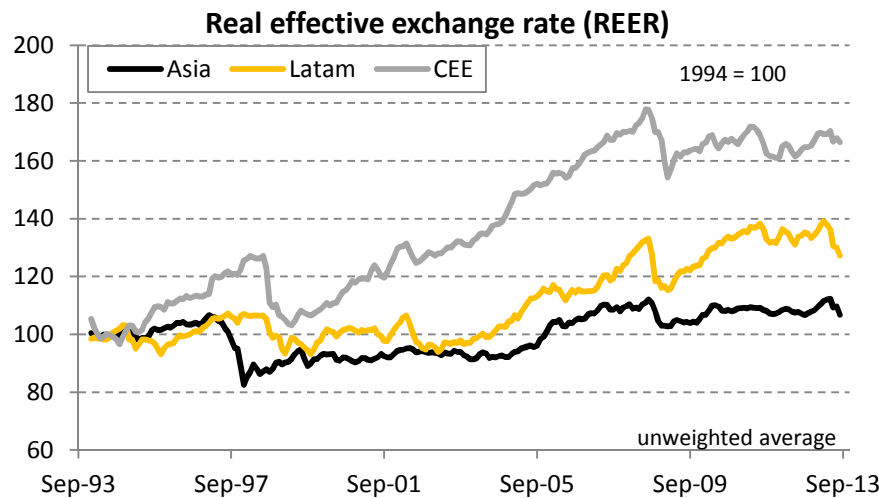
→ This does not ignore the fact that some countries have tightened monetary policy (although very modestly) to stem currency depreciation

- ▶ Indonesia
- ▶ India
- ▶ Turkey



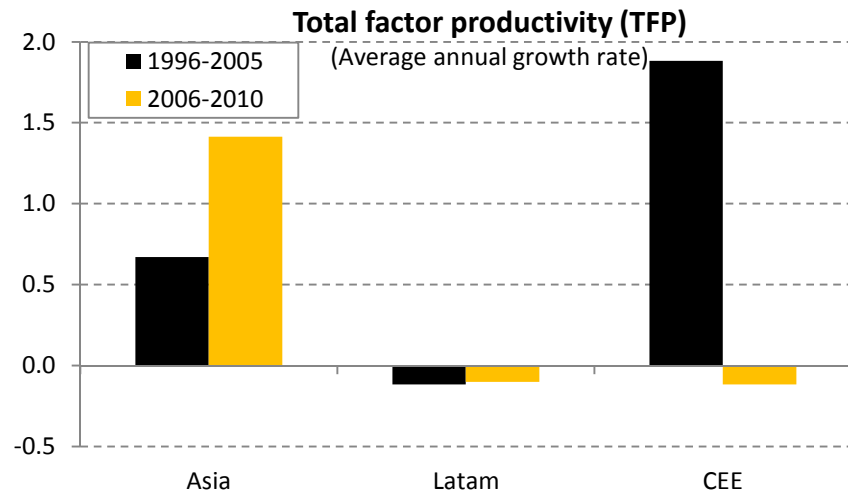
→ Tighter monetary policy in Brazil in recent months was mainly a reaction to years of above target inflation rather than an outright concern about the fall of the (probably still overvalued) BRL

EM currencies before the Great Recession



➔ **Over the last two decades:**

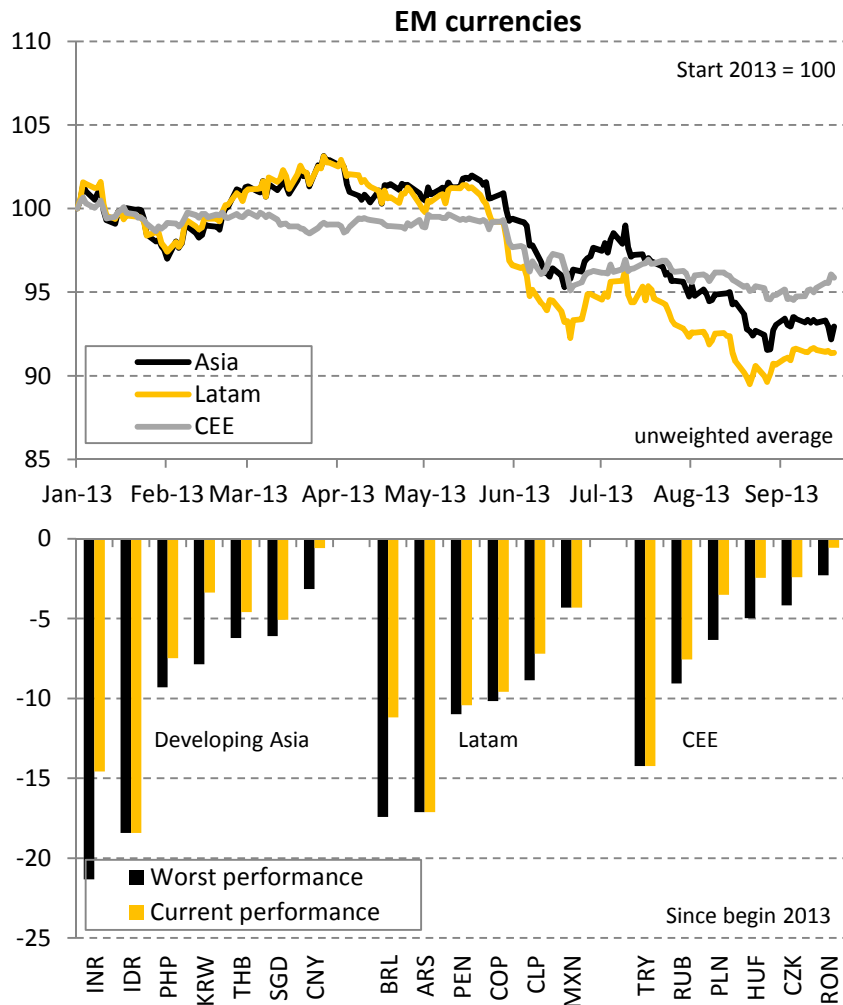
- ▶ REER in CEE have appreciated sharply since the late nineties. This evolution was accompanied by a deterioration of CA balances (see below and slide 16).
- ▶ On aggregate, REER in Emerging Asia and Latin America started to appreciate since 2003. The appreciation was more outspoken in latin America (with Brazil in particular; China is an exception in Emerging Asia).
- ▶ In the case of Latin America, however, the appreciation was not accompanied by an equal rise in productivity growth (see graph below). Most probably this can be explained by the commodity boom in the mid-2000's (~Dutch Disease).



➔ **What to make of the rapid rise of the REER in CEE prior to 2008-2009?**

- ▶ To an important extent, this can be attributed to the productivity gains that followed the transition from communism. Because the rise in the REER was underpinned by rising productivity, this didn't make CEE currencies very uncompetitive.
- ▶ Some of the rise in the REER (2006-2008) can be attributed to overheating, which led to wider current account deficits (see slide 24).
- ▶ In Russia, the REER continued appreciating rapidly after 2006 while TFP slowed significantly. This is probably due to the boom in oil exports.

EM currencies in calmer water after the recent sell-off



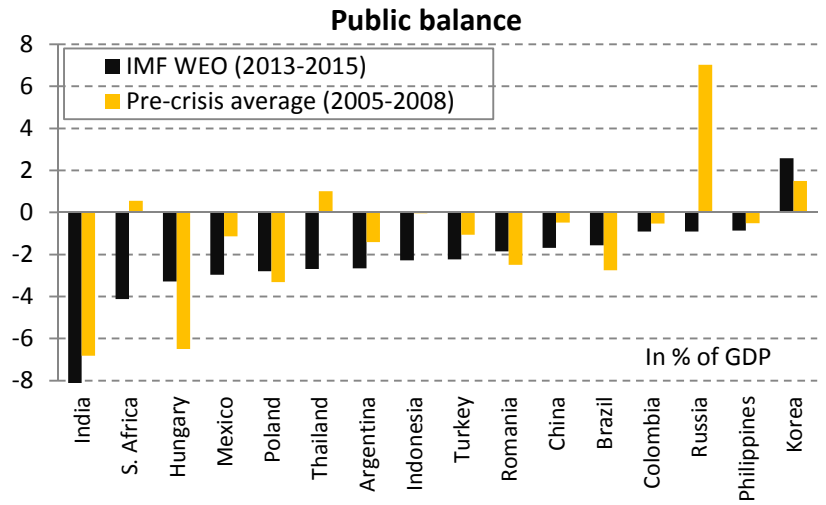
➔ **Following the EM currency sell-off since May, EM currencies have stabilized**

- ▶ Fears of a repeat of the late nineties are exaggerated
- ▶ External debt levels are relatively low
- ▶ Most currencies are no longer pegged to the USD
- ▶ Presence of a large pool of international reserves
- ▶ Monetary policy is likely to stay loose for the foreseeable future

➔ **EM currencies are likely to remain vulnerable in the face of the (very) gradual unwinding of extremely loose US monetary policy**

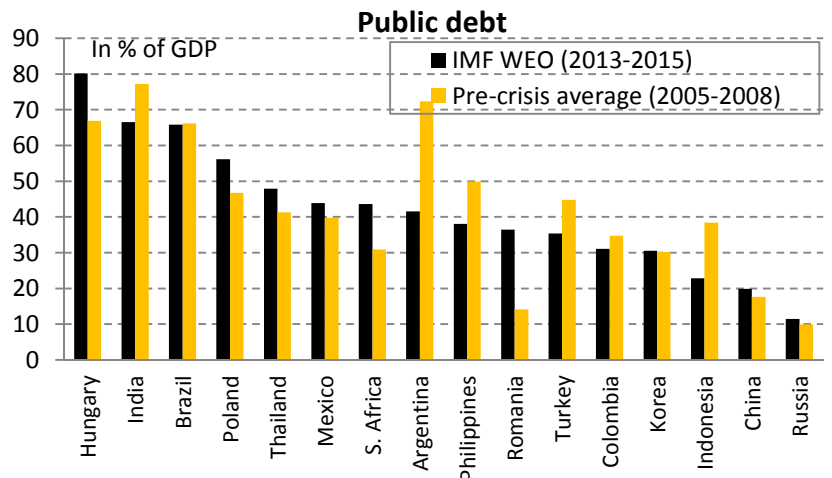
- ▶ External imbalances likely to remain important explaining factor of currency vulnerability.

EM public finances largely under control



→ All in all, public finances in EM are in pretty healthy shape with the notable exception of India where the situation was already worrying before the crisis

→ S. Africa is struggling to get its public finances back on track but public debt levels remain under control for now



→ In most EM public finances are still recovering from the 'Great Recession'

→ In Russia, although public debt levels are extremely low, public surpluses have decreased sharply after the 2008-2009 crisis

Measuring external imbalances in EM

Methodology

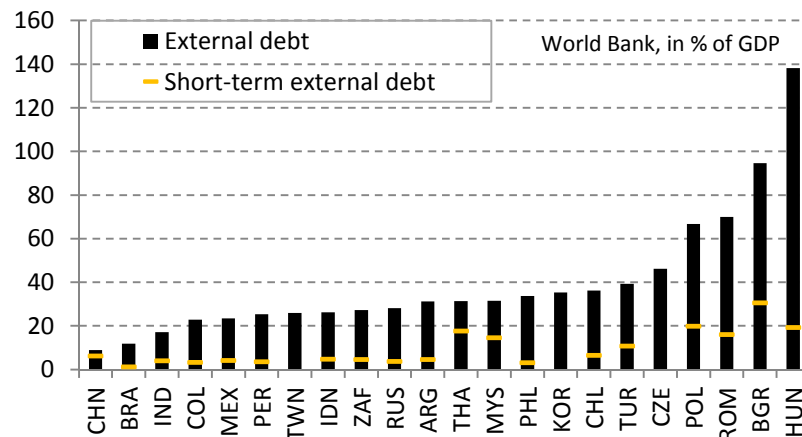
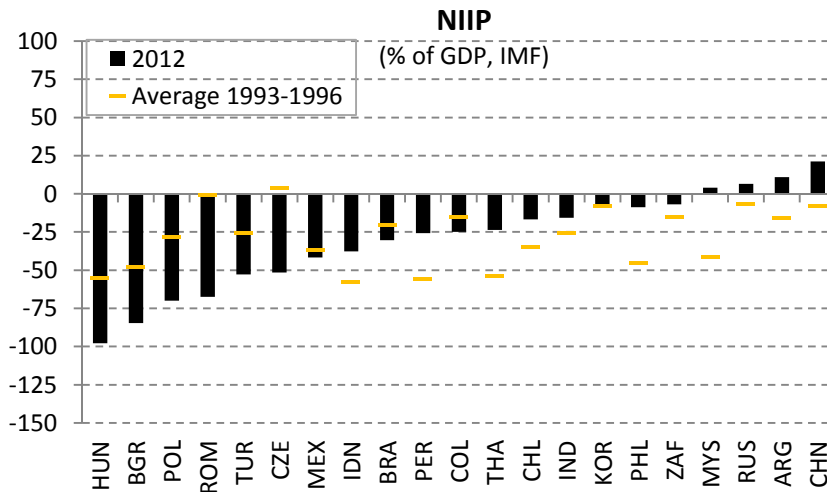
- **Probably the most comprehensive way to measure a country's external vulnerability is to do so via a combination of a stock and flow approach**

- **Stock approach → Net International Investment Position (NIIP)**
 - ▶ This indicator measures the value and composition of an economy's external financial assets (FDI, portfolio equity, portfolio debt, FX reserves) and external financial liabilities (FDI, portfolio equity, portfolio debt) at a specified date
 - ▶ The difference between these two sides of the balance sheet provides the net position (NIIP)
 - ▶ If the value is positive (negative) , the country is an international creditor (debtor)

- **Flow approach → Balance of Payments (BoP)**
 - ▶ This indicator summarizes the transactions of an economy with the rest of the world (for a specific time period)
 - ▶ Transactions between residents and non-residents can include goods, services and income (current account) or include financial claims/liabilities vis-à-vis the rest of the world (financial account).
 - ▶ When a country runs a current account deficit, this must be financed by inward financial flows
 - ▶ With regards to financial flows, liabilities in the form of FDI are more stable and therefore less risky. Portfolio flows and other private financial flows (bank lending) are often referred to as 'hot money'
 - ▶ This indicator includes all sectors (government, financial and non-financial corporations and households)

Stock approach

Net international investment position



- The following CEE countries stand out in a negative way:
 - ▶ Hungary
 - ▶ Bulgaria
 - ▶ Poland
 - ▶ Romania
 - ▶ Czech R.
 - ▶ Turkey
 - ▶ Croatia (see appendix 2)

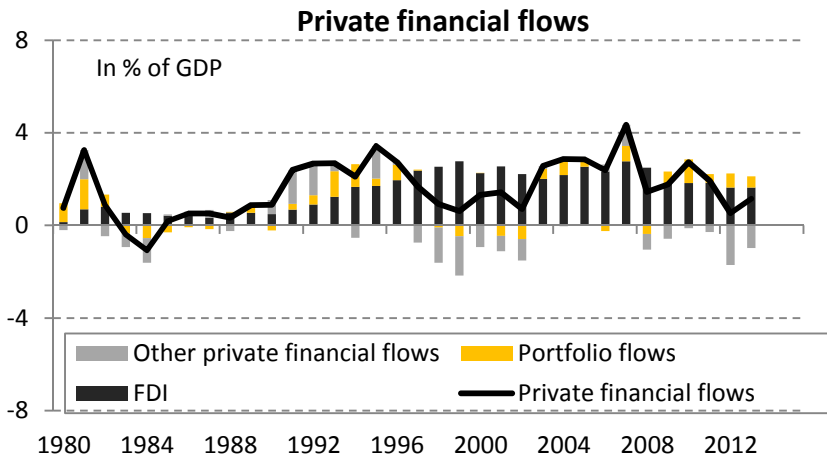
- A substantial part of external debt liabilities consists of short-term debt obligations. This increases the external vulnerability

- In S. Africa, Turkey and Poland FX reserves are not sufficient to cover the short-term external financing needs (ST-external debt + CA deficit, see appendix 2)

- In the rest of EM, NIIP's are not only (considerably) higher compared to the levels in CEE but also healthier than in the mid-nineties. Within this group, short-term debt ratios are highest in Malaysia and Thailand (but comfortably covered by FX reserves, see appendix 2)

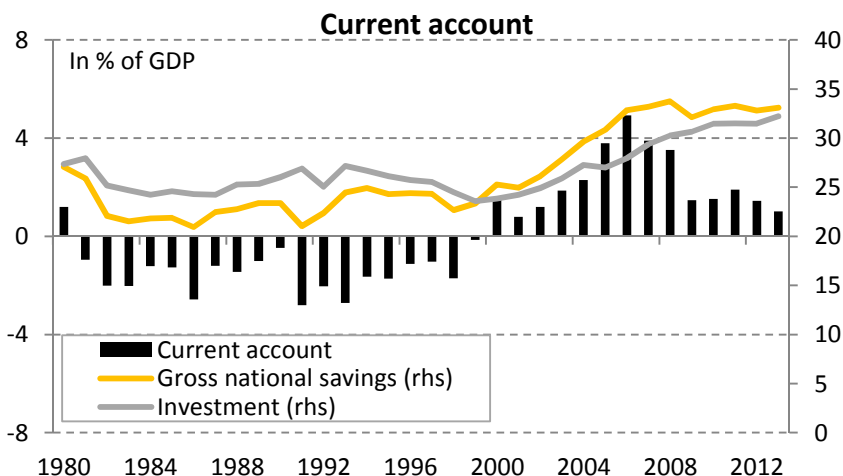
Flow approach

Financial and current account



→ Prior to the 2008-2009 crisis, EM received sizeable amounts of 'hot money' (though not as large as in the years before the EM crises in the late nineties). These inflows turned negative at the onset of the 'Great Recession'

→ Net inflows came back in positive territory in the second half of 2009 and 2010 on the back of strong economic recoveries in EM. Net inflows dried up in the second half of 2011 with the intensification of the eurocrisis, before picking up again as financial stress eased mid-2012



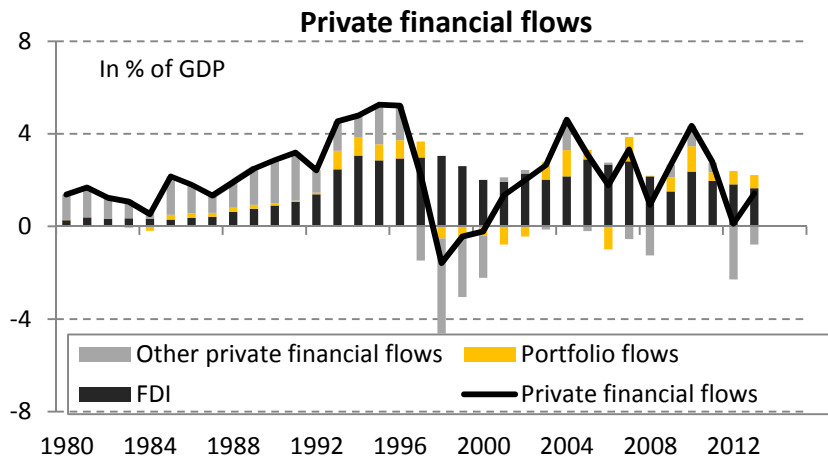
→ Following the FED's communication (on thinking about tapering QE) late May this year, net inflows decreased again (not on the graph)

→ The external surplus in EM has narrowed significantly in recent years

- ▶ Most of this adjustment is due to Developing Asia Latin America's surplus before 2008 turned negative
- ▶ CEE's current account deficit decreased
- ▶ Russia's CA surplus has come down significantly

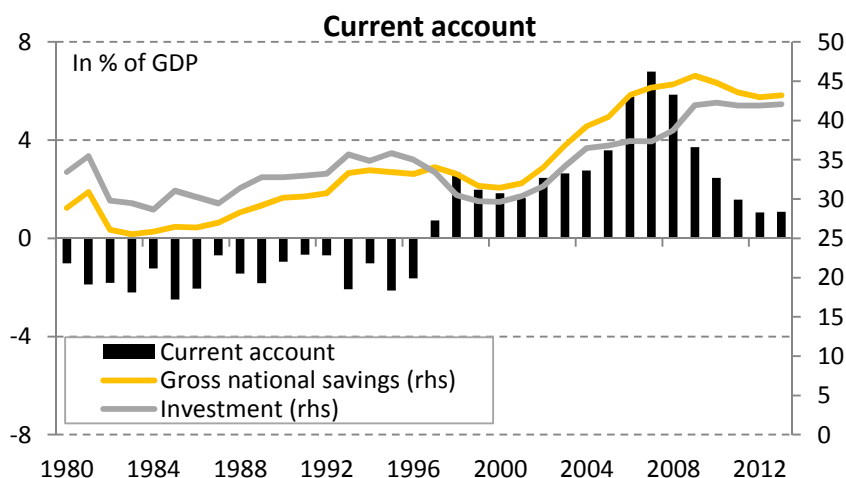
Emerging Asia

Financial and current account



→ The capital outflows following the Asian crisis in the late nineties reversed in 2003 and 2004 but there were no massive 'hot money' inflows prior to the 2008-2009 crisis.

→ In 2009 and 2010 Emerging Asia received sizeable 'hot money' inflows as growth rebounded sharply and monetary policy throughout the Western world was extremely loose.

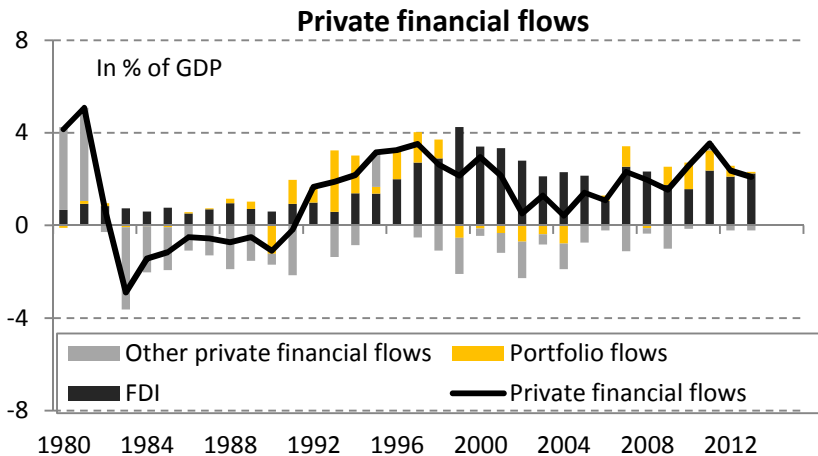


→ Investment in Emerging Asia (and China in particular) increased sharply from the beginning of the new millenium but this was more than underpinned by a surge in savings. As a result the region recorded big current account surpluses and a huge increase in international reserves.

→ Following the 2008-2009 crisis, Emerging Asia's CA surplus narrowed substantially. China is an important explaining factor here though not the only one. In India and Indonesia the CA surpluses prior to 2008 turned into (sizeable) CA deficits (see slide 24).

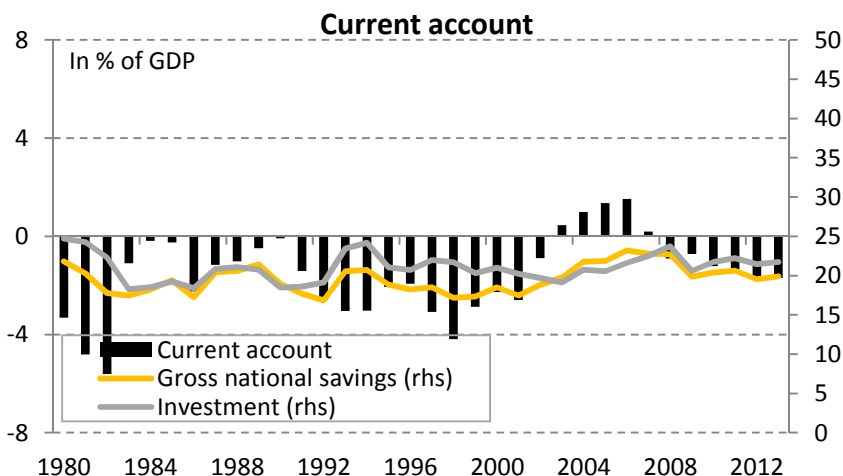
Latin America

Financial and current account



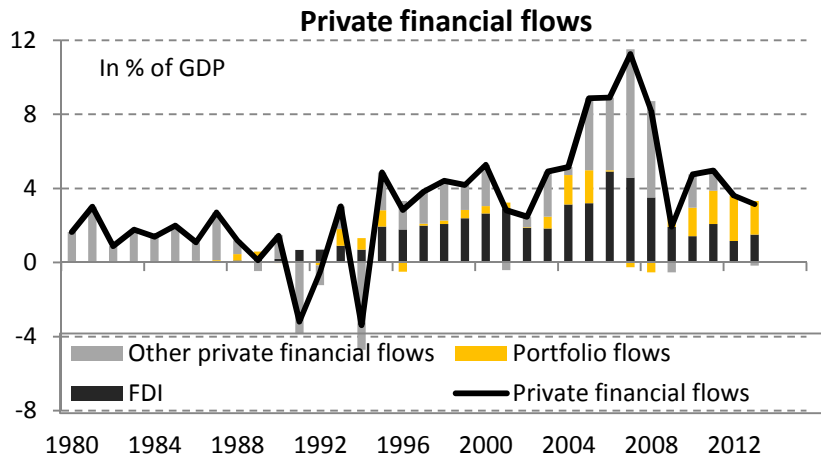
→ Financial flows to Latin America in the run-up to the 2008 crisis were positive but only due to net FDI. Net Portfolio flows (equities and bonds) and other private financial flows (mostly bank lending) were largely negative.

→ In 2010 and 2011 Latin America received sizeable portfolio inflows as growth rebounded sharply and monetary policy throughout the Western world was extremely loose.



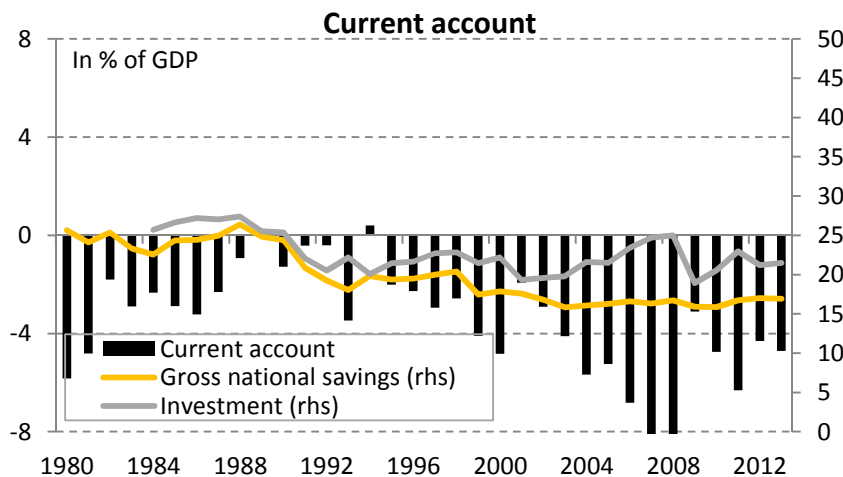
→ Investment levels in Latin America are generally low but (except for the commodity boom years 2003-2007) not underpinned by national savings. As a result the region now records a (small) current account deficit.

Financial and current account



→ Financial flows to CEE increased massively since 2002 and overwhelmingly in the form of intra-bank lending. This evolution stopped at the onset of the crisis.

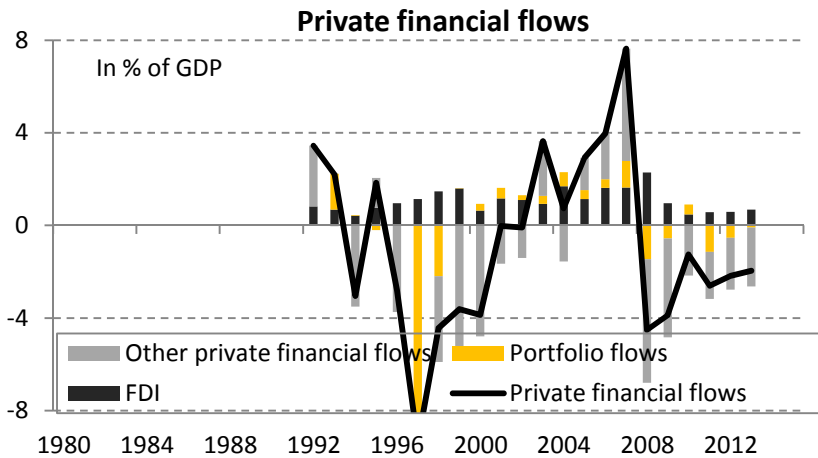
→ In 2010 and 2011 net inflows to CEE picked up again but particularly in the form of portfolio flows. Net FDI are now historically low.



→ The mirror image of the evolution in massive financial inflows (prior to 2008) has been an increase in investment and consumption leading to a big current account deficit for the region (which does not include Russia).

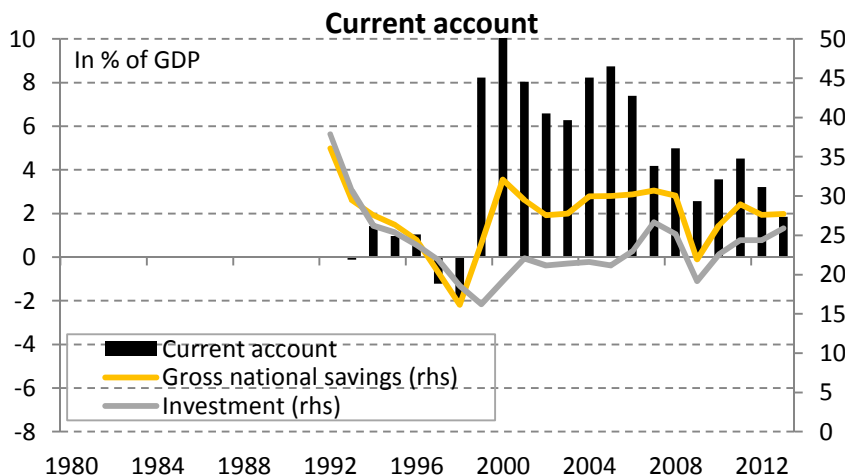
→ Following the 2008-2009 crisis CA deficits throughout CEE (except Turkey) narrowed significantly (see slide 24).

Financial and current account



➔ Negative financial inflows throughout most of the nineties reversed in the beginning of the millenium, followed by a huge increase in bank lending prior to 2008 and a sharp decrease at the onset of the crisis. Up to now financial flows to CIS are still negative.

➔ The sharp depreciation of the RUB following the Russian crisis (1998) and the commodity boom since 2003 resulted in very large CA surpluses before 2007

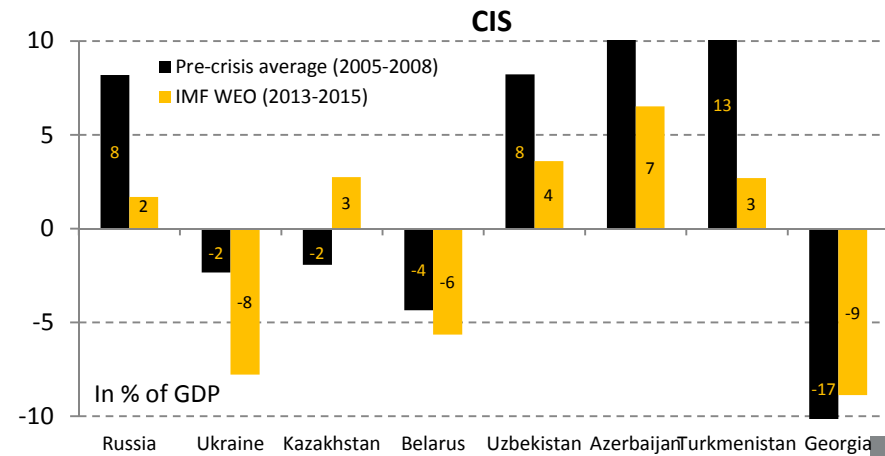
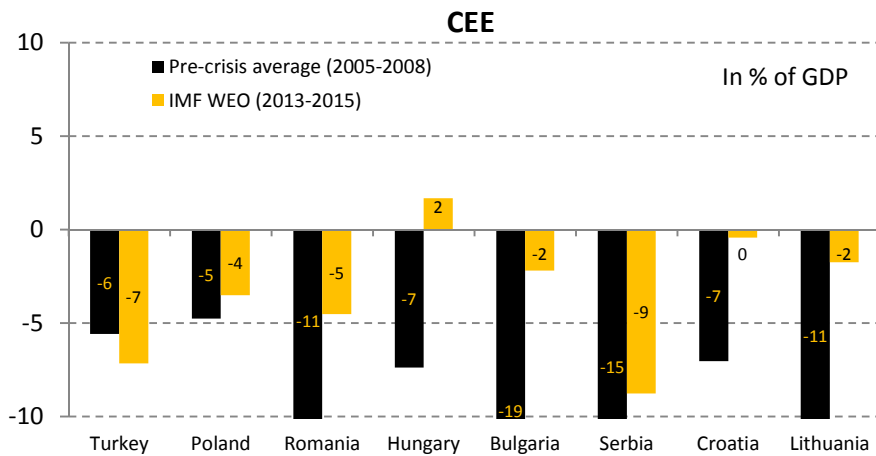
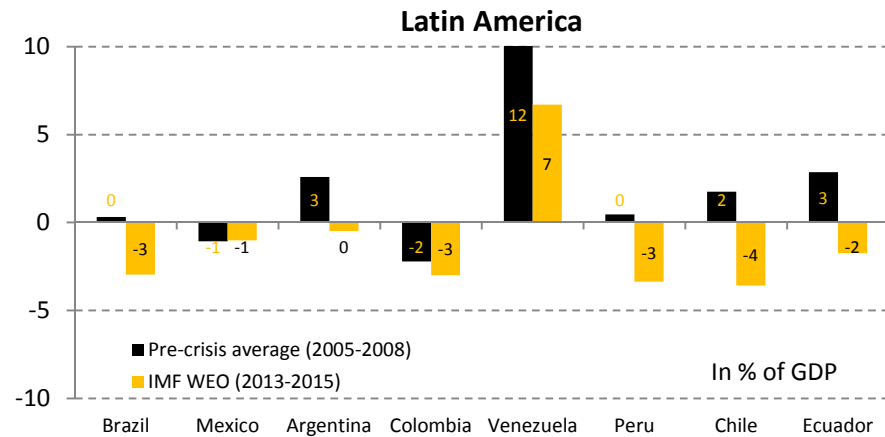
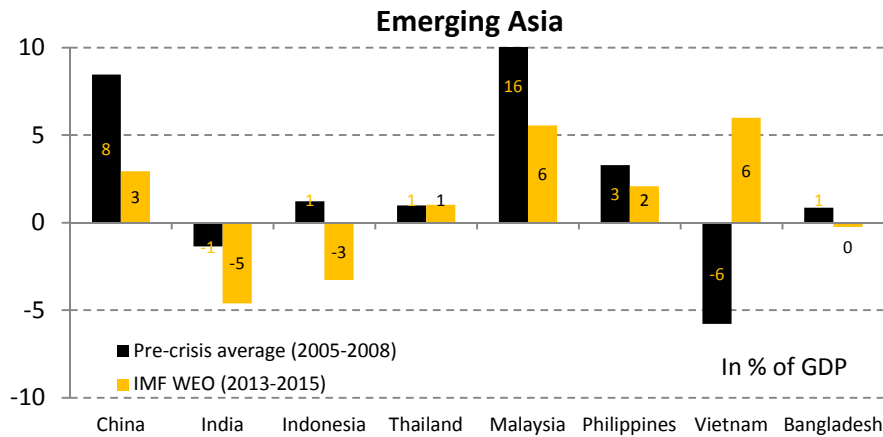


➔ The (private) spending boom (particularly in Russia) already led to a narrowing of the CA surplus in the 2 years prior to the 'Great Recession'.

➔ The region now records a small current account surplus largely due to the sharp decrease in Russian public savings (see slide 13) and the sharp deterioration of the CA balance of Ukrain (see slide 24).

Current account balance

By country



EM five years after the start of the Great Recession

Conclusion

- **The recovery in DM should support EM exports and economic activity. Nevertheless economic activity in EM is likely to remain relatively (compared to previous decade) modest:**
 - ▶ Chinese growth likely to decrease further in coming years despite current improvement in momentum
 - ▶ A number of EM can no longer count on the pre-crisis commodity boom
 - ▶ Structural problems in BRIC's remain
 - ▶ Upcoming 2014 elections in S. Africa, Indonesia, Brazil, Indonesia risk holding up structural reforms
 - ▶ Credit growth is probably still too high in a number of countries

- **Inflation remains broadly under control but some countries cope with above target inflation. Monetary policy throughout EM will remain relatively loose for the time being**

- **A return of the EM crises in the late nineties is very unlikely but EM currencies are likely to stay vulnerable against the back of (very gradual) unwinding of US monetary policy**

- **External imbalances in EM (aggregate level) have narrowed in recent years. In general, CA (im)balances have narrowed in big surplus countries and the same has happened in big deficit countries. A number of countries, however, have seen a (substantial) deterioration of the CA balance, making them more vulnerable to a sudden reversal of capital flows.**

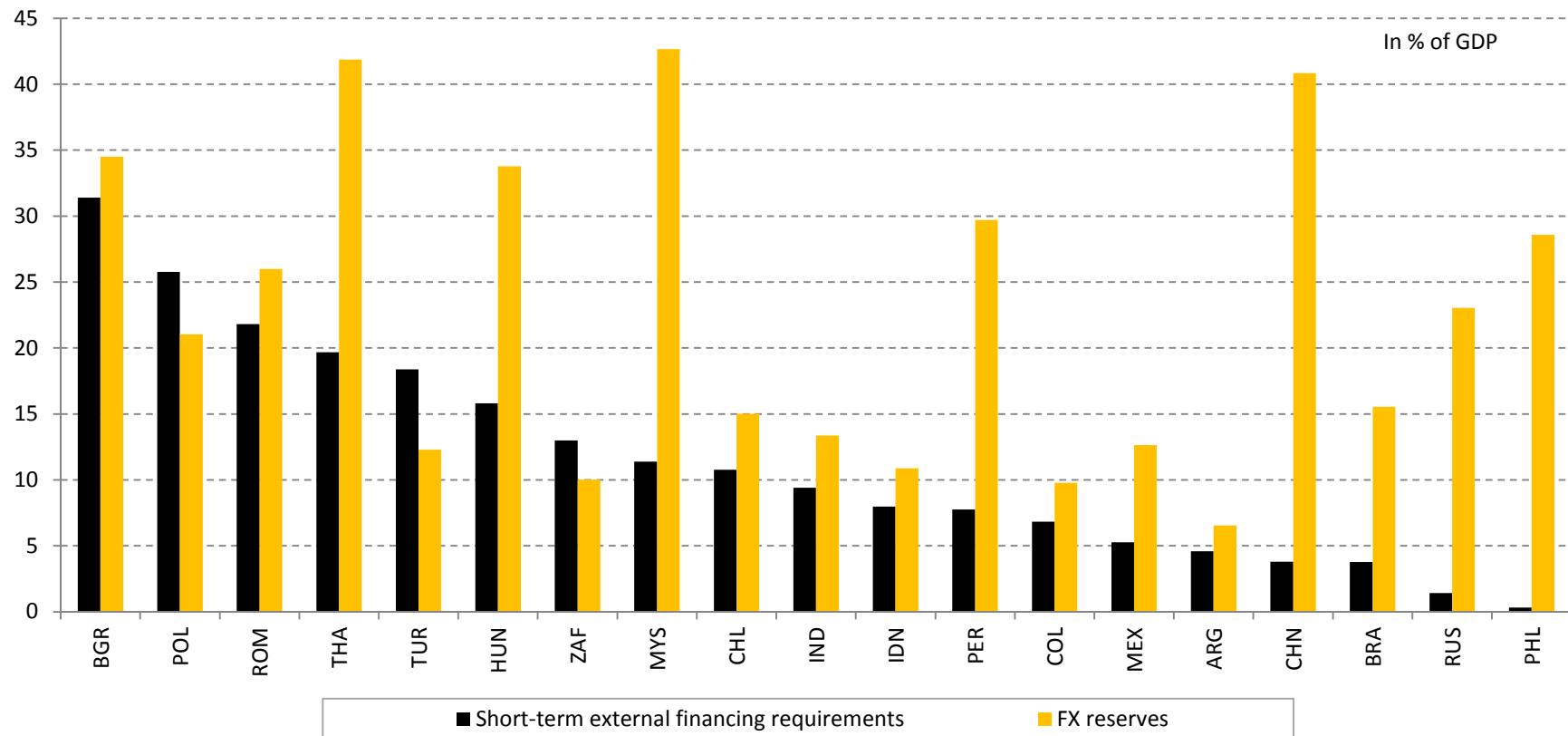
- **EM countries that look most vulnerable are:**
 - ▶ CEE: (Hungary, Poland, Bulgaria, Croatia, Romania, Turkey). CA deficits in CEE have narrowed significantly (although still negative) but external liabilities remain (very) high
 - ▶ India: CA deficit deteriorated significantly in recent years
 - ▶ Indonesia: CA deficit deteriorated significantly in recent years
 - ▶ S. Africa: CA deficit is high (around 6% of GDP)

➔ **Sources:**

- ▶ IMF World Economic Outlook
- ▶ Oxford Economics
- ▶ Bank of International Settlements (BIS)
- ▶ Dutch Bureau for Economic Policy Analysis (CPB)

Appendix (2)

Short-term external funding needs



$$\text{Short-term external funding needs} = \text{CA deficit} + \text{Short-term external debt}$$

