Emerging countries
One risk can hide another

- Economic growth in emerging countries has moderated during the summer following a strong Q2.
- Financing conditions remain favourable both in terms of capital inflows, market access and cost of financing.
- We have slightly revised our growth forecasts for 2014 and 2015 owing to stagnation in Brazil this year and a recession in Russia next. Political risk is more and more acute.
- A recent IMF study confirms that China has all the warning signs of a “insidious” credit crisis.

After accelerating rapidly last spring, growth in the emerging countries eased over the first two months of summer. Economic growth shows good resilience. However risks are on the rise.

A vigorous spring rebound …

Aggregate real GDP for our sample of 23 countries rose at an annualised seasonally adjusted quarterly rate (q/q saar) 5% in Q2 (4.7% y/y) after slowing to 3.1% q/q saar in Q1 (chart 1). The emerging countries benefited notably from the rebound in foreign trade (+17% y/y in volume in Q2 according to the Centraal Planning Bureau of Netherlands statistics). By region, the upturn in growth was mainly due to the emerging Asian countries, where aggregate GDP rose nearly 7% q/q saar (vs. 5% in Q1). The two heavyweights, China and India, made large contributions, with growth of 7.6% q/q saar and 8%, respectively. Inversely, growth was mild in the central European countries, Russia, and most probably Turkey (but after a very strong Q1 performance). In Latin America, growth trends vary widely: Mexico is in a recovery phase (+4.2% q/q saar in Q2 vs. 0.7% in Q4 2013), Brazil has entered recession (chart 2), crushing hopes that hosting the World Cup Games would create a positive boost. Argentina is mired in stagflation, the consequence of January’s devaluation (inflation is now officially above 40%) and the country was forced to default on its restructured debt as sovereign bondholders became the collateral victims of the government’s doomed legal battle against activist American funds Elliot and Aurelius. As to Venezuela, it stopped reporting statistics in late 2013, which says a lot about the deterioration of the country’s economic situation.

…followed by mild summer gains

In July-August, manufacturing PMI surveys pointed to a slowdown in Asia while confirming the one in the central European countries. Surprisingly, Russia’s PMI held above 50, the level normally compatible with expansion. Yet with US and EU economic sanctions, and with Russia’s trade embargo imposed in retaliation, foreign trade contracted abruptly and the automobile market collapsed. Given the very poor correlation between PMI and the economic indexes (GDP, industrial output), however, it is highly probable that the Russian economy has already swung into recession.

Growth resilience

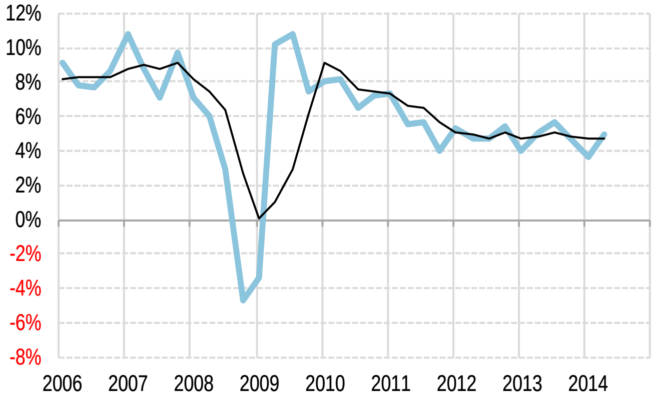

Chart 1

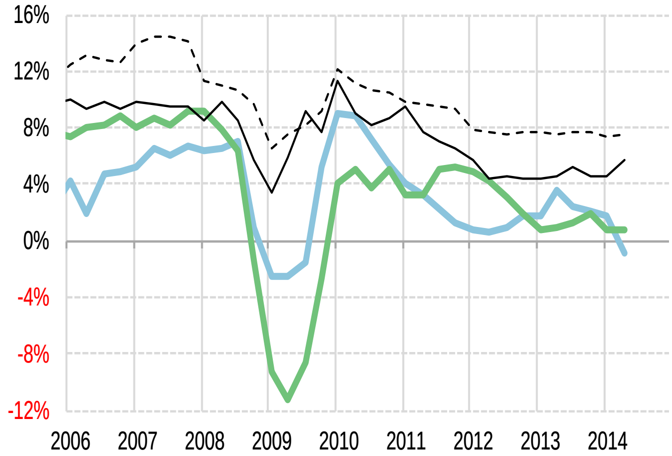

Chart 2 Sources : Datainsight - BNP Paribas

Easier financing conditions

On average, financing conditions have eased in the emerging countries in recent months. Retail funds' investment inflows picked up again (about USD40bn between June and August after USD130bn outflows between June 2013 and May 2014 – chart 3). The cost of debt in dollars, measured by the yield on 10-year US government bonds + the EMBIG spread, has also declined by a little more than 200bp (from 7.5% at the beginning of the year to 5.4% in early September). The cost of borrowing in local currencies, measured in real terms (yield on the GBI-EM index – the average core inflation rate of countries included in the index) has stabilised after rising sharply during the summer 2013, mainly in the Asian countries (chart 4). The average real interest rate thus stands between 4% and 5%, which is more in line with the real GDP growth trend.

Since the beginning of the year, the output gap has become slightly negative, which should help ease core inflation (chart 5). At the same time, food and energy prices (which can account for nearly 50% of the household consumer basket in some countries) should have a very negative contribution to headline inflation in the months ahead, given the sharp drop in agricultural commodities and oil prices since last spring (chart 6). As a consequence, monetary policies in the emerging countries could stay or become more accommodating given the stability of exchange rates (compared with 2013) since the beginning of the year.

Political risk: a permanent danger

Political and security risks remain acute in traditionally vulnerable countries and regions: in Ukraine and Russia obviously, but also in Afghanistan, Irak and Syria with the rise of radical Islamism; in Libya with the "Dawn of Libya' Islamist-leaning tribal militia; in Nigeria with the expansion of the Boko Haram sect; in Israel with renewed tensions in the Palestinian territories, and in Pakistan with the anti-government rebellion.

Besides, the spread of the Ebola outbreak led the police forces to crack down the desperate protest movement of people being quarantined. On a much more peaceful note, there is also Hong Kong and the protest movement against Beijing and its attempts to reform the procedure for selecting candidates to the post of Chief Executive of the former British colony.

For the moment, with the exception of the Russian-Ukrainian conflict, these risks are unlikely to have a significant impact on growth prospects and/or financing conditions in neighbouring countries, whether through the foreign trade or financial channels. So far, the Russian-Ukrainian conflict and tensions in the Middle East have not had an impact on oil prices.

And yet as the numerous hotbeds of radical Islamism show, this trend is spreading and gaining strength, making it an ongoing factor aggravating country risk in the neighbouring regions and countries of these sources of instability.

Portfolio investissements' comeback

Bond funds Equity funds

(Net flows – USD bn)

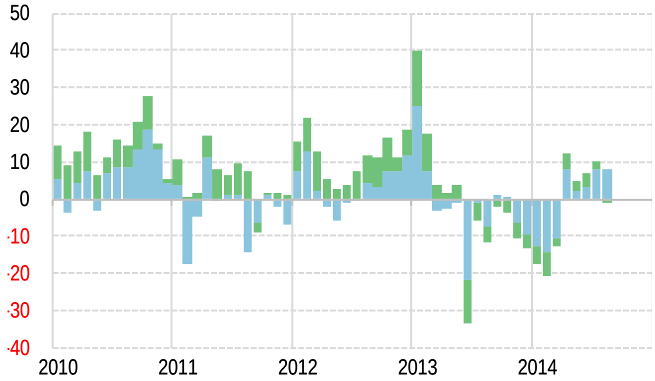

Chart 3 Source : IIF

The rise in the cost of financing has come to an halt

— real domestic interest rate - Interest rate on the USD-denominated external debt

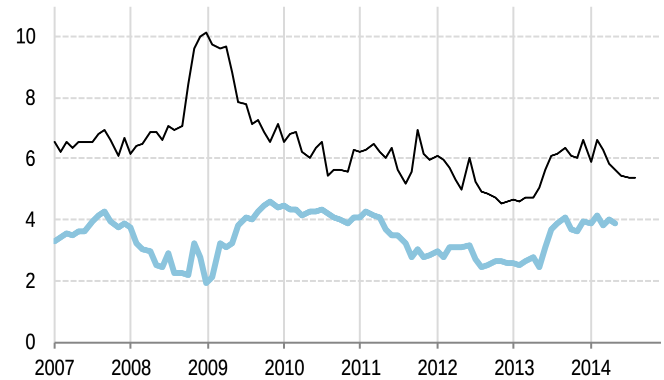

Chart 4 Source : Datainsight – Calculations: BNP Paribas

We have slightly revised our growth forecasts for 2014 and 2015 owing to stagnation in Brazil this year and a recession in Russia next. Political risk is more and more acute.

Risk of an "insidious" crisis: China, the next textbook case?

The resilience of economic growth in the emerging countries does not rule out the risk of a crisis, notably an "insidious" crisis, to use the term coined by two IMF economists[1]. Unlike conventional crises, which arise from excessive domestic demand that is characterised by current account deficits, strong price and wage inflation, an appreciation of real exchange rates and swelling external debt, insidious crises are generated by excessive domestic demand fuelled not by external borrowing but by a boom in domestic credit and asset price bubbles, notably real estate bubbles. Unlike conventional crises, "insidious" crises may occur without external account imbalances or high inflationary pressures on goods and services.

The two authors insist on the fact that although the early warning indicators of traditional crises have been clearly identified, the same cannot be said for those of the second type of crisis. Above all, we would add, these signals tend to be minimised.

As illustrations of conventional crises, the two authors point to Thailand in 1997-98 and Estonia in 2009, while insidious crises include Japan's decade-long slump following the bursting of an asset price bubble in the 1980s, and the more recent, more abrupt and apparently shorter-lived crisis of Ireland in 2009-10. Most importantly, the two authors conclude their article by examining the current situation in China, which presents all the characteristics of an "insidious" crisis.

Core inflation easing …

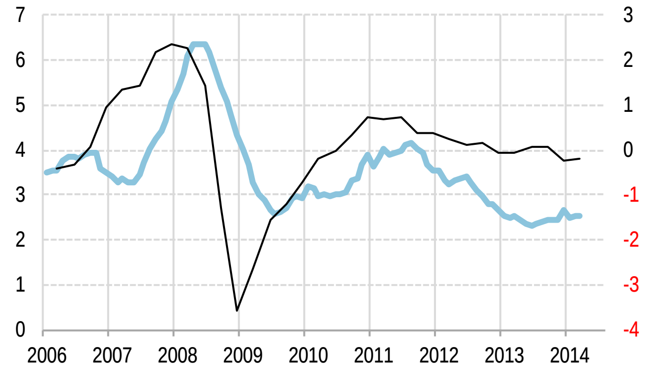

Chart 5 Source : Datainsight – Calculations : BNP Paribas

… and commodity prices deflation

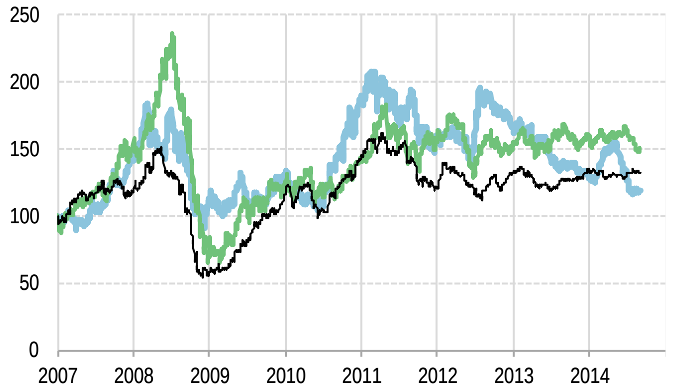

Chart 6 Source : Datastream

[1] *Bas B. Bakker and Leslie Lipschitz « Conventional and Insidious Macroeconomic Balance-sheet Crises » IMF WP/14/160 – August 2014*