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Emerging Crisis in Demerging Markets

"The Raft of the Medusa", Théodore Géricault- 1818

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The raft of the Medusa

In July, 1816, the French frigate "Medusa", ineptly navigated by the Viscount Hugues Duroy de Chaumereys, who had spent 20 years away from sea, was shipwrecked near the coast of Mauritania. As the lifeboats could only hold 250 people, from total of 397 onboard, the crew improvised a barge, which carried the remaining 147 passengers and lower ranked crew, with water and food for only one day. 13 days later there were only 15 survivors to tell of the horrible takes of mutiny, the drownings of the weakest members, and cannibalism. The "Medusa" shipwreck episode was an embarrassment for the recently-restored Bourbon monarchy.

During the summer of 2015, China announced a surprising devaluation of its currency, the yuan. Soon this devaluation resulted in a series of complex factors associated to the "black Monday" downturn in the Chinese stock market, which dropped 7.4%, the largest fall in 20 years. These events hadn't taken place in isolation, as throughout the year many emerging countries had observed a worsening acceleration of their fundamental problems. In a crazy race, many emerging currencies had been depreciated and devalued, reaching historic lows, in a context of extremely weak commodity prices, which gradually resulted in recessions, downturns and the genesis of a financial and fiscal crisis. Such phenomena are generally paired to a lack of leadership, possibly explained by the apparent bonanza.

The "emerging storm" would be more intense and lasting than what the market predicts. A series of factors have aligned to form an extremely negative situation for many countries. There will be those that will be more and less affected, but there will be some difficult years that lie ahead, which could leave more than just sovereign bankruptcy in their path.

Emerging markets, a history of success?

The first reflection is just like that of the years from 2007-2015, when the West lived through one of the greatest crisis in its recent history, while at the same time, emerging countries have been experiencing extraordinary boom years since the beginning of the decade. The reason for this has been due to the positive alignment of the stars.

- An improved competitive position, thanks to the very low labor costs and increasing productivity, which made it possible to generate a growth model via external demand, what fueled a strong growth in investment (domestic and foreign) that has led to high job creation.
- As this model of growth creates employment, it has created an extraordinary phenomenon in which approximately 80 million people a year have left poverty and moved into the middle class (possible the largest reduction of poverty in the history of mankind), resulting in a growing middle class that has helped encourage consumption.
- The demand of commodities, coupled with some years of underinvestment, caused a boom in prices of almost all commodities, processes which helped many emerging economies benefit from the greater price of exports, allowing them to accumulate enormous reserve levels which are essential to achieving a certain macroeconomic stability.

In this context, and helped by low interest rates in the West, capital was attracted quickly into emerging countries, causing a rise in stock market prices, bonds and a relaxation in financing on the part of banking sector and banking related areas… As this increased the prices of homes, it similarly accentuated the credit cycle and consumer confidence, further accelerating GDP.

This confluence explains the spectacular growth of many emerging countries in this period. However, as Paul Krugman signaled more than 20 years ago in his excellent article "The Myths of Asia's Miracle", economic growth is relatively easy if it comes from a low base. Just like the growth of the Soviet Union in the 50's, Japan in the 60's or the Asian tigers of the

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80's… it was simply enough increase their active population, train it and add capital stock. The problem however is focused in growth once an economy has matured. The growth mentioned above depends on the entire productivity of factories, and there is a danger of falling into "middle income trap", consisting of taking the easy route and not the difficult one.

Many emerging countries have enjoyed these great boom years; the question is whether they were preparing themselves for the hard years ahead. This preparation would have been based on structural reforms, promoting productivity in order to prevent a loss of competitiveness through wages, not feeding asset bubbles, nor neglecting the current account deficit, and above all, to diversify the economy, reducing its dependency on commodities. As we will see below, very few countries have made these reforms, and when they do, they will already be too late.

In many of these countries, a positive and financial cycle has come together; the enormous danger faced is thee generation of bubbles of asset prices which can later cause a confluence of an economic and financial crisis, as predicted by Hyman Minsky; crises which have confronted many Western countries. Minsky said that the few "good" years that come with the economic boom, causes a relaxation of credit conditions, generating "bad" years by giving credit to unworthy projects as a consequence of the economic euphoria. An event with greater media resonance may cause a turning point, called "Minsky moment", and whether they cut their credit flow to learn from the past excesses of the banks, the economy becomes infected, which in turn exacerbates the credit shortage credit. A vicious cycle is produced. In this sense, while the subprime crisis began in 2006, it was the closing of investment funds in the summer of 2007, and especially the fall of Lehman which detonated the great recession. While alarm signals were already in place for many emerging nations from 2014, the storm in China this summer will probably accelerate the weakness for many emerging economies. Let's look at the transmission mechanisms.

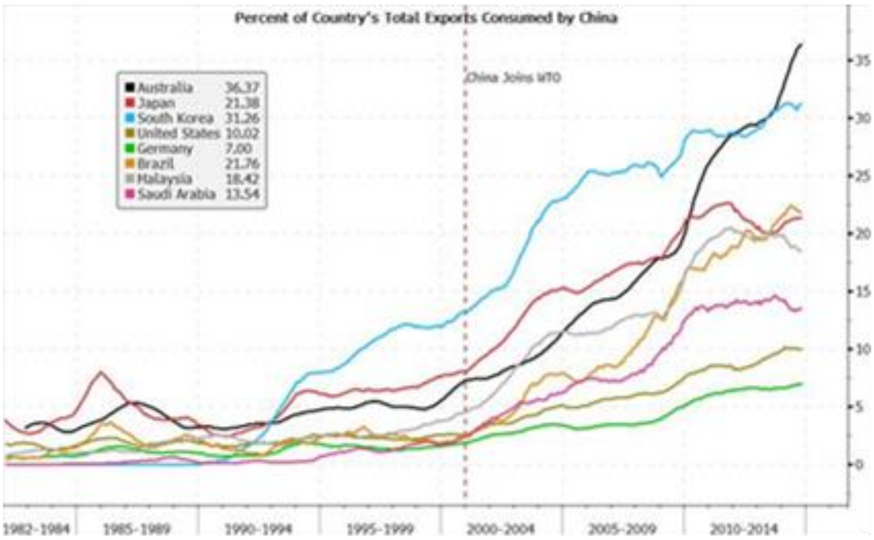
How China infects other countries

During the last twenty years, China has been a major consumer of commodities, of which it is dependent on. Furthermore, China has consumed more cement in a year than the U.S has in decades, China for example represents half of the global demand for nickel, aluminum and copper, and 30% of the global demand for gold and silver. China is the consumer that marks the marginal price of many commodities; therefore a greater or less appetite for commodities will have a severe impact on their prices.

The economic crisis that has led to a lower demand for commodities, in a backdrop of rising production has provoked steep falls in commodity prices, as we shall see in the next section. For many countries to be dependent on the exports of commodities, a fall in their prices opens up a large weakness in their economies. As well, because commodities are subjected to a strong taxation on the part of Governments, the fall in prices reduces the fiscal income (Mexico is a good example), forcing them to react by raising taxes or cutting expenditure accentuating the economic contraction. Therefore the extreme weaknesses of many commodities is contagious for many nations, including Russia's oil, gas and coal, mining materials in South Africa, Argentina, Venezuela, Peru, Colombia, Brazil, Chile (copper), Sub-Saharan Africa (all kinds of general materials related to the mining and agricultural commodities, and oil in the case of Nigeria and Ghana), Asian countries (such as Thai rubber, coal or gas from Kazakhstan), the Persian Gulf (oil, gas), and including developed such as Canada and Australia.

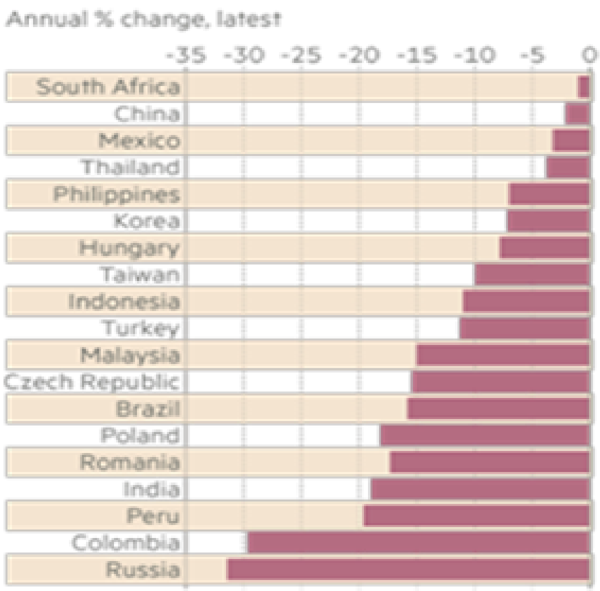
As Chinese imports continue to fall, (Table 1) the countries that they sell to also suffer. We have already seen the impact from commodities, but the volume of goods and services consumed by China is much greater. The most affected nations that are geographically closest are the most affected, above all, the countries that make up the ASEAN, as well as Japan, and especially if the countries have lost competitiveness during the "good" years. Altogether this situation is fed back, causing a widespread decline of exports (Table 2).

Table 1. Chinese contagion



Source: Bloomberg

Table 2. Exports slump across emerging markets



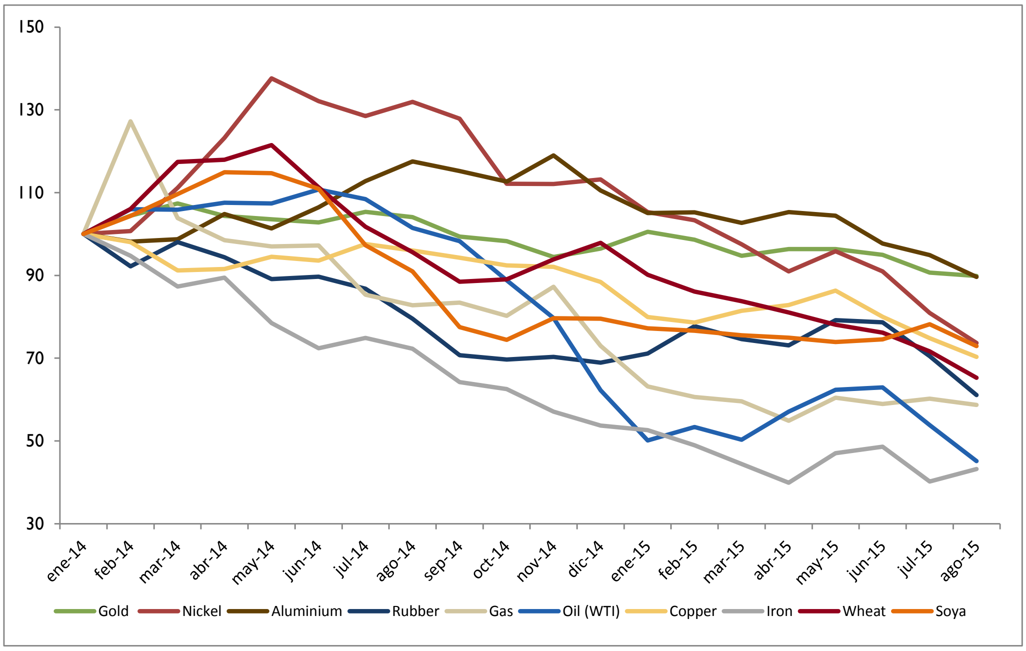
Source: Capital Economics, FT

The other fundamental factor is the impact on confidence which the crisis generates, bridging the differences, just as Lehman Brothers assumed at the time. The risk aversion is reflected in capital flows departing emerging economies. If these are current account deficits (they invest above gross savings) they will experience a strong liquidity crisis, and will require them to raise interest rates in order to attract capital (Brazil), or a necessary adjustment to the fall of internal demand (just like the painful adjustment that Spain led following the crisis, which saw a 19% reduction in its domestic demand to close a current account deficit 10% of GDP). In general these adjusted changes provoke a severe recession, as we shall see in the following paragraphs.

The relevance of commodities

The bullish commodities super-cycle has been caused by an unusual and intense demand, not only from China but from many emerging nations, in a period when production was scarce. The reason is that the production curve of certain commodities (especially those which are mined) is inelastic, taking a long time for the investment to produce more until the new production reaches the market. A bullish super-cycle generates many investments…the danger is if the product of such an investment reaches the market at a time of lower demand for commodities. In this way, the investment of mining companies, which stood at approximately USD 35 bn. by 2000 increased to USD 200 bn. by 2012 and it still stands at USD 135 bn. All this investment leads to greater production in times of lower demand. The tragedy of prices is served (Table 3).

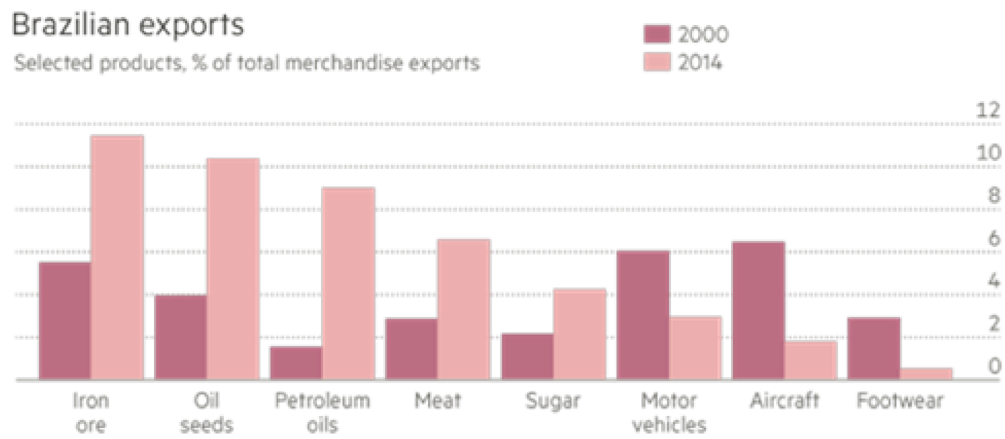
Table 3. Evolution of commodity prices during 2015 (base 100, January 2014)



Source: Bloomberg

This is just what happened with iron, the fundamental element for the production of steel. Australia, one of the leading producers of iron, recently increased their investments and at the start of 2015 the Australian production of iron reached all-time highs, but by then the Chinese slowdown was evident, amongst other things, because many of the steel factories installed were not selling their production. The result of this cocktail of increased supply and reduced demand was a calamitous fall for the price of iron by almost 75%, its lowest in years, which is bad news for their exporters such as Australia or Brazil, which have not reduced their exposure to commodities, but have increased it instead (Table 4).

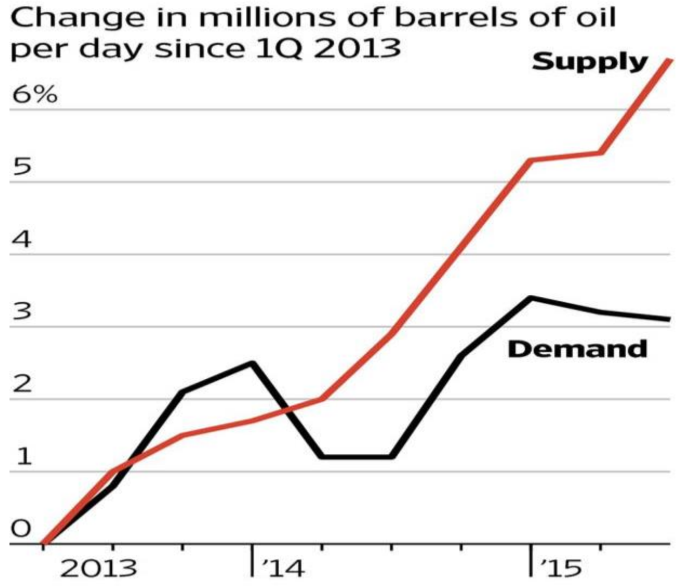
Table 4. Brazilian Exports



Source: Unctad and FT

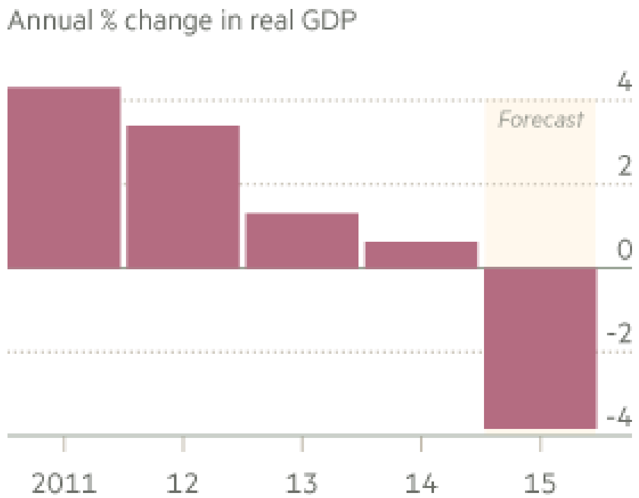
The fall in oil prices since the autumn of 2014 have been of particular significance, caused by many factors, including increased Saudi production (at its highest level on record of 10.6 million barrels per day, to try to reduce the production competition which are experiencing greater extraction costs) small Chinese demand, U.S production and recently the return of the Iranian production to the market (0.8 million barrels a day), all together offering greater supply (Table 5). The collapse of the oil prices has led to a very severe crisis in countries which are excessively dependent on this raw material, both for exports and for fiscal income that it represents. The reason is that the taxes on oil represent around 80% of its selling price. This explains why many countries balance their accounts with oil prices between USD 90 and USD 110 (Saudi Arabia, Russia, Venezuela, Iran…). A continued drop in oil prices results in a reduction of reserves (as governments tap into their reserves to maintain public spending), but this situation cannot continue in such a time, or they produce enormous fiscal cuts (which can cause serious discontent and social unrest), or alternatively the reserves run out and the country goes bankrupt. Russia has been one of the biggest hit, and its economic recession is experiencing a formidable year-on-year contraction of 4.6% (Table 6). Venezuela is by far the most vulnerable nation, and while Saudi Arabia can endure more years than most due to its reserve levels, the situation is not sustainable (its fiscal deficit could already be at 15% of GDP).

Table 5. Outstripping demand



Source: International Energy Agency and WSJ

Table 6. Russian GDP growth



Fuente: IMF and FT

The weakness is generic. Copper, in a minimum of six years fell 35%, has hurt Chile which is very dependent on these exports, and in consequence observe its growth deteriorate (from 3.6% to 2.5% and falling). Gold has fallen by 30%, coal 30% (12 year low); silver 50% in three years and aluminum is at a six year low. South Africa for example, with a large mining output, is already experiencing a recession, with annualized falls at 1.3%. The agricultural commodities are not spared, with corn and wheat dropping by 40%.

Collapse of currencies

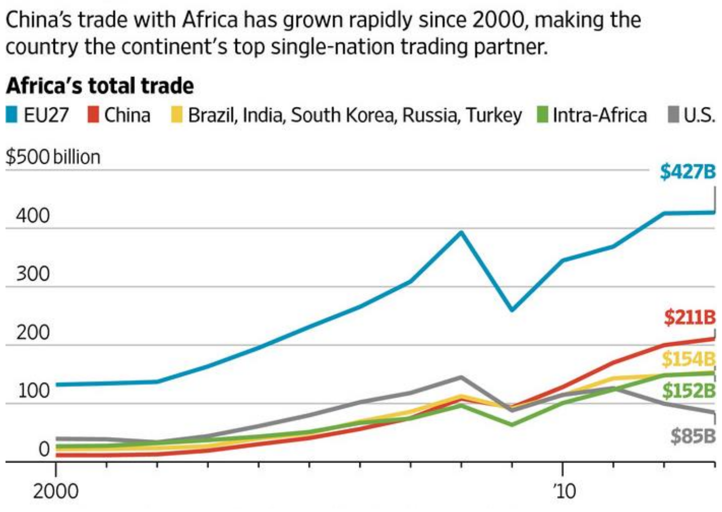
With the scenario described above, it is not surprising how the great crisis of falling commodity prices soon cause a collapse of the currencies in those countries dependent on such income (Table 7).

Table 7. Weak FX (JP Morgan Index)

Source: Bloomberg

The Russian ruble has dropped to historic lows, falling by 44% in one year reaching historic lows, the Indonesian rupiah is at a 17 year low (its exports have already dropped by 19%), the Taiwan dollar, the Korean won and the Malaysian ringgit are also experiencing a large weakening, while the Mexican Peso already fell by 23% up to USD 16 as its economy continues to contract (already growing below 1.7%), the Chilean Peso has accumulated a fall of 60%, the Brazilian Real 36%... In Africa the South African Rand (mining) is listed at a 14 year low, as well as the Angolan Kwanza (oil), the Zambian Kwacha, dependent on oil and copper, too, generally caused by Africa's dependence on Chinese trade (Table 8). Weakness also affects the developed currencies with relevant exports of commodities, such as the Canadian dollar, and the New Zealand Dollar (which has forced the central banks to lower rates for the first time in four years) or the Australian dollar.

Table 8. Looking East



Source: African Development Bank calculation bases on U.N Comtrade data, WSJ

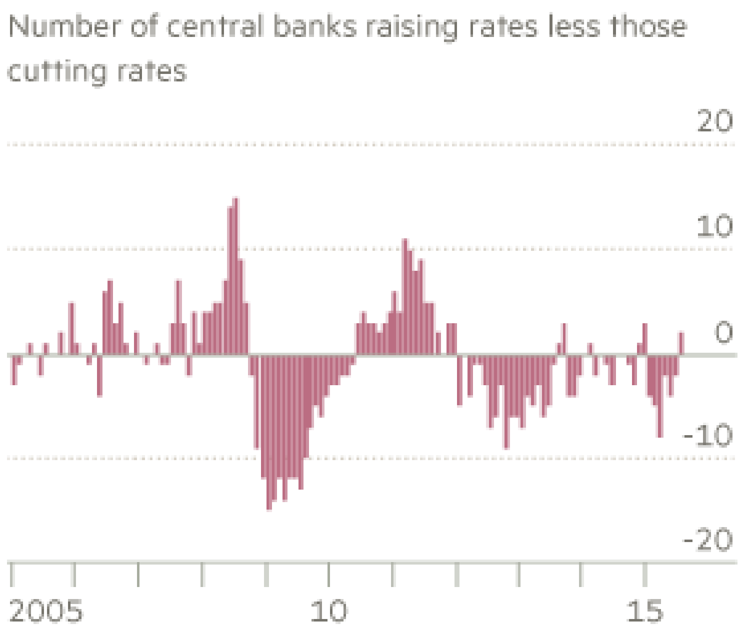
The collapse of currencies forces other neighboring countries to also undertake a process of devaluation, to prevent a loss of competitiveness that could erode their export base, or to replace domestic production for foreign produce. It is the phenomenon of the currency war. Kazakhstan announced a devaluation of 25% (to confront the devaluation of the ruble), Vietnam also devalued its currency…in theory devaluations make exports of a country more expensive, but a synchronized devaluation does not continue this effect…for the simple reason that the Earth does not export to Mars.

Emerging economies which are not raw material producers, but which are dependent on foreign capital for their production (current account deficit) observed an outflow of capital due to their enormous vulnerability, which also brings down their currencies. What better example than the Turkish lira, at 2.85 to the USD, the all-time low.

Some countries have opted to use their reserves in order to defend its currency. Both Russia and China were unsuccessful in defending their currencies, Russia spent close to USD 80 bn. to protect the ruble, while China employed nearly USD 200 bn. to protect the yuan. In the long-term the market can be larger than the central bank reserves as we have seen in the case of Thatcher. The result has been an accelerated fall in reserves, and thus increased vulnerability.

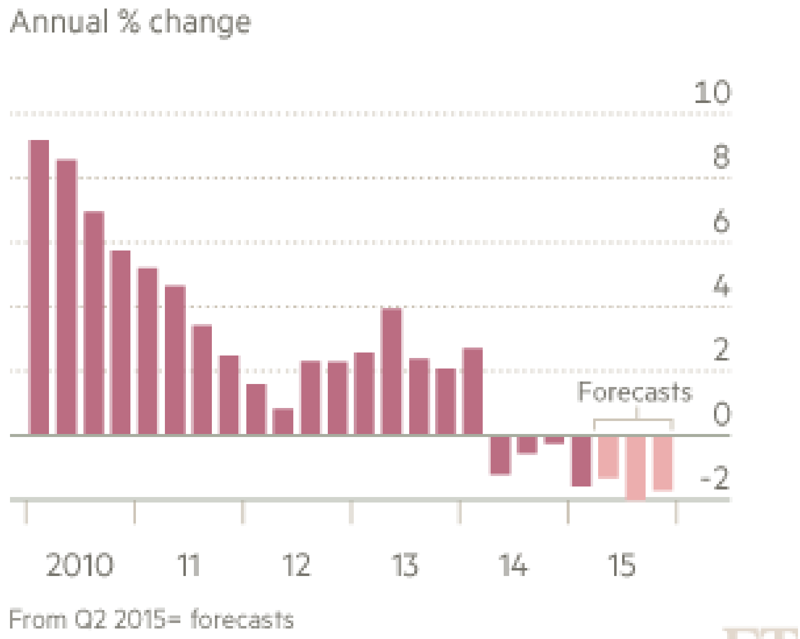
In addition, as the pace of capital flows reduces liquidity, interest rates rise (Table 9) and the economy cools down even more. Some central banks, such as that of Brazil have tried to raise rates (up to 14.25%) to attract capital and fight against inflation (10%, a 10 year high), but with the country entering a recession (Table 10), the rate hike, although necessary, will reduce activity even more.

Table 9. Emerging market monetary policy



Source: Capital Economics and FT

Table 10. Brazilian economy



Source: Thomson Reuters Datastream, Bloomberg, FT

Even countries that have long advocated for a pegged system against the dollar, like the Hong Kong Dollar (32 years) or the Saudi Riyal (29 years) are experiencing strong convulsions in their capital balances, which raise the sustainability of the fixed system.

As a whole, it is calculated that emerging countries have seen falling reserves by USD 1 trillion in the last 13 months, explaining the currency collapse.

The terrifying current account deficit

A country can maintain a level of savings similar to the sum of what it invests, in which case it does not require foreign capital. If it saves more, it will then present a current account surplus and export foreign capital to the rest of the world. Ideally the domestic investments will produce cash flows that should reduce the country's external dependency in the medium term. However, if the capital inflow is short term driven (movements in the portfolio, such as the purchase of bonds and stock) then a country is extremely vulnerable. If the country continues attracting cash flow, once it is out of fashion cash flow will suddenly be cut short, the currency will sink, and the country will have to live through a painful adjustment of lower domestic demand, often causing a recession. Usually this process tends to lead to a banking crisis.

Countries that in previous years were very competitive and exporting capital to the rest of the world (such as Brazil until the arrival of Lula) have gradually become dependent on foreign capital (Brazil is already experiencing a deficit of 4.5% of GDP vs. surpluses in 2004), and losing competitiveness. The current emerging crisis casts doubt over the sustainability to attract these flows, indicating the painful adjustment of the effects referred to in Brazil (GDP falling by 2%). Other very vulnerable countries are Turkey (a deficit of 6%), Mexico (2%), Indonesia (3%), Colombia (5%), South Africa (5%), or Peru (4%). In a context of rising rates in the U.S, capital will be attracted there, especially in a context of risk aversion, while countries with a current account deficit will greatly suffer as a consequence.

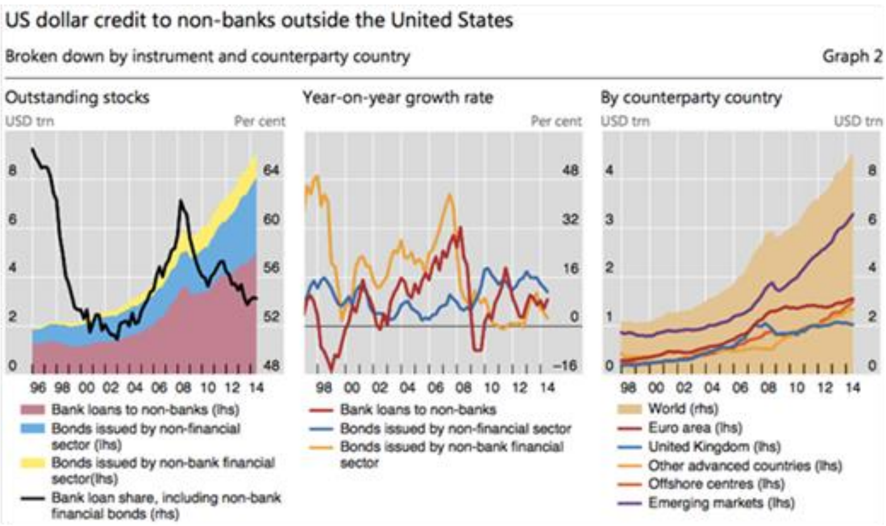
Falling asset prices and financial crisis

If the excessive confidence of the "good" years resulted in an acceleration of credit, this phenomenon provoked the appearance of bubbles in asset prices, especially in real estate. When the capital flows reverse, asset prices fall. As many banks loans have real estate as collateral, and at the same time the banks are heavily indebted, minimum falls in house prices can cause a banking crisis. In general this context causes a progressive drowning of the interbank markets, which in turn leads to lower lending to businesses and citizens, who respond by cutting investment and consumption.

The most disturbing risk factor lies in the huge levels of debt in dollars and other strong currencies by many companies from the "good" years. Overconfidence leads to the hypothesis that exchange rates will not change much, and as funding is cheaper in dollars that in the local currency, many companies incur this currency risk (Table 11). With the huge fall of currencies during 2015, many companies that generate their incomes in local currency will be unable to repay their debt in dollars. It is the genesis of a banking crisis.

We know how in China the corporate debt in dollars has increased, from USD 100 bn. to USD 700 bn. in a few years, in Turkey from USD 6.5 bn. in 2002 to USD 178 bn. an outrageous amount taking into the consideration the relatively small size of its GDP (it total external debt has already increased to a whopping USD 400 bn.). At the same time, many Eastern European countries have incurred the same problem, with enormous emissions in euros and dollars. The same phenomenon occurred in many Latin American countries. When the corporate debt emitted in dollars reaches they will produce defaults (due to exchange rate, the economic slowdown and the difficulty or refinancing position), which would explain a banking crisis, states will have to react before or after cleaning up the banks, therefore the debt will fall into sovereign hands…and an intervention by the IMF. What better notice for navigators that the public debt of Brazil has just been degraded to "junk" bond status…an event which could inflict disastrous consequences (many investors are not authorized to hold this type of investment in their portfolio).

Table 11. Dangerous levels of corporate debt



Source: WSJ

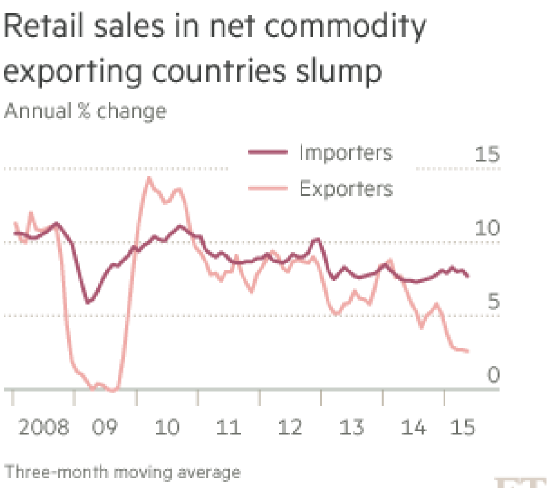
The current context of falling asset prices, sinking currencies and recessions will no doubt cause banking crises. And banking crises coupled with an economic one can be devastating, we are well aware of in the West.

Contagion of consumption, investments, public spending…GDP

The collapse of currencies presents very perverse conditions for the rest of the economy. In this sense, imports become more expensive which triggers inflation (very harmful for the poorer classes, and can increase social discontent), which reduces consumption (for example Russian inflation has already reached 15%), which further reduces invest and increases unemployment, very harmful for the GDP.

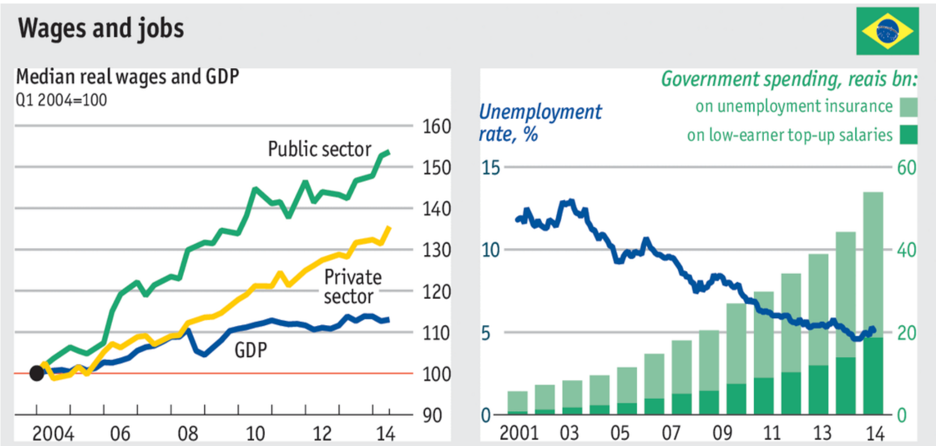
In this context, emerging retail sales are growing at their lowest level for six years (Table 12). Even less effected countries like that of India experiencing falling car sales and including falling demand for electricity. It is not surprising that the latest data of Indian growth, at 7%, will remain below expectations (7.5%), the contagion effect may cause even add to the slowdown. In Brazil, the loss of competition (Table 12), the collapse of consumer confidence (as unemployment continues to rise) and employers (Table 13) has represented as it could not be otherwise, falls in consumption, industrial production (down 9%), if the collection and the investment, which has led to a recession in the country (Table 14). South Korean growth is at its lowest level of growth in two years (2.2%), as many Asian nations reduce investments which in turn damage Korean exports. As we have seen above, Russia is in a recession, the Andean basin (Colombia, Peru, Chile) are in full deceleration, just as Mexico is.

Table 12. Emerging minority sales



Source: Capital Economics and FT

Table 13. Brazil loses competitiveness



Source: National Accounts, IBGE, Central Bank of Brasil and The Economist

Table 14. Brazil heading into a recession

Source: Trading Economics

Geopolitical tension

The Europe before World War One was a rich Europe, and immensely interconnected across commerce. In spite of many free market capitalists that argue trade prevents the devastating conflicts that come with war, it demonstrated the opposite. The principle reason was founded on nationalism.

Today, Asia presents a disturbing scenario, with nationalist leaders in China (Xi Jinping), India (Modi), Russia (Putin), and Japan (Abe). A more aggressive Russian foreign policy has had knock on effects in Georgia and Ukraine (a country which had to restructure its debt, recognizing a loss of 20%). China in turn has taken a more aggressive stance than it did under Deng Xiaoping, resulting in conflicts with Japan (Senkaku Islands), and different Asian countries (South China Sea). In turn, Turkey is located in a practice of guerrilla warfare against the Kurdish Worker's Party. In the Gulf, Sunni and Shia tensions remain at their all-time high. All of these conflicts can be watered down when the economy is doing well, but when things go badly there is a greater risk that they become more serious. Admittedly a fall in GDP…but a recession causes discontent, and especially in countries under a dictatorship it is an easy means to divert a population's attention and precisely place it in a military conflict (Las Malvinas is a sad example).

It's not all bad news

The situation in the emerging nations presents differences to the crisis of 1997-1998. Many countries are enjoying enormous reserve levels. The current account deficits are much less bulky than then, it also follows the interest rate hikes that must be applied, which will be less damaging, there are even countries that can afford the luxury of lower levels (China, India, Korea, Thailand). The weakness of the commodities is good for some countries (China, India, Turkey), and the falling currencies is always good for the exports. In addition, it should be remembered that emerging countries continue to show higher growth potential in the medium term, since they are based on much lower productivity.

However, we live in a more interconnected, as it has been evident in this report and the interconnection, joined with the asset bubble, makes the confluence of a financial and economic crisis particularly dangerous.

It will take time to see the light at the end of the tunnel.

Conclusions

In a famous speech before the United Nations Assembly Ninita Jruschev lashed out at the West saying "we will bury you". He was referring to an economical burial, since the USSR was growing at almost three times the rate of the West, and many Western "intellectuals" defended the model as "superior" to the market economy.

The world of Bretton Woods II, inspired by capitalist principles has resulted in what we have experienced to be the greatest reduction of poverty in history, most of it concentrated in emerging economies. We should all be proud of our achievements. However, many emerging countries have also copied the stupidities of the Western nations, lacking reforms, accumulating asset bubbles, expansion of absurd credit….

As with the barge of "Medusa" today it appears late to react. Severe casualties and defaults will follow in the coming years.

APENDIX

Acronyms / Definitions

ASEAN	Association of Southeast Asian Nations
BIS	Banks for International Settlements
FT	Financial Times
IMF	International Monetary Fund
WSJ	Wall Street Journal

About Arcano: The reference firm to invest in Spain

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Ignacio de la Torre is partner in Arcano since 2008, and is the author of the series of reports "The Case for Spain". He has 16 years of working experience in investment banking and capital markets, having worked before Arcano, in the equity research and equity sales teams of Deutsche Bank and UBS Investment Bank.

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