Emerging markets: caught in a taper tantrum?

At a glance…

Emerging markets have been having a rough ride recently. While advanced economies have picked up speed, emerging markets have been slowing down, posing challenges for international investors and businesses.

Tapering is the catalyst…

Since May last year, when the Federal Reserve first raised the prospect of tapering its monthly asset purchases, currencies in the “Fragile 5” vulnerable economies (Brazil, India, Indonesia, Turkey and South Africa) have depreciated by around 20%. Brazil and Turkey have had to intervene to stabilise their currencies.

…but it’s not the cause

However, we think tapering has been the catalyst for, rather than the cause of, these developments as it has exposed some underlying vulnerabilities:

- Economic growth in some emerging markets has become unbalanced. Since 2009, the current account deficits of the 5 most vulnerable emerging markets have grown by up to 6% of GDP.
- Failures to reform markets and build stronger institutions are contributing to volatility and uncertainty, damaging investment and future productive capacity.

Not all emerging markets are made equally

Following a strong performance in our recent ESCAPE index (see Figure 1), we interview Patrick Tay from PwC Malaysia to understand why his country, with economic growth of around 5% and unemployment of just 3.4% at the end of 2013, is one of the emerging markets that is bucking the recent trend.

The economic recovery in the Eurozone is proceeding

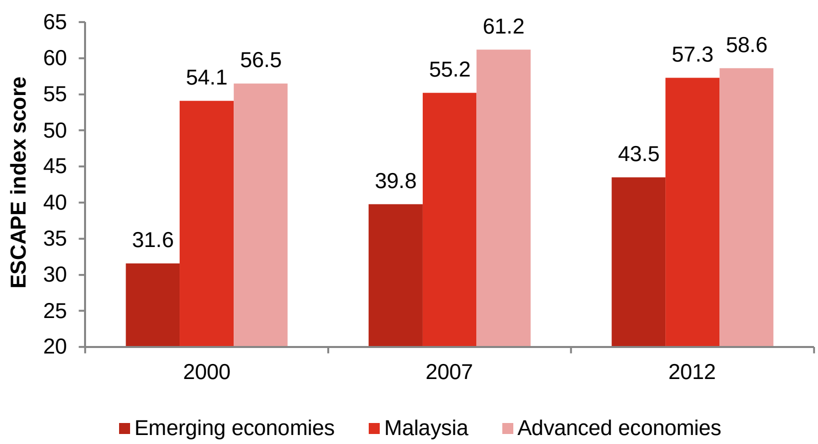
We think the situation in the Eurozone is looking increasingly positive: the latest set of GDP growth figures suggest that the recovery is bedding down across the region.

At the heart of the bloc, Germany grew by 0.4% in the 4^{th} quarter and France by 0.3%, while Italy recorded positive growth (albeit only 0.1%) for the first time in over two years.

Although activity is picking up, economic performance is still quite different between the North (e.g. Germany) and the South (e.g. Spain, Italy).

High unemployment rates continue to restrain domestic demand in the southern economies as they seek to regain competitiveness. Businesses are also being hampered by higher interest rates than those enjoyed by similar companies elsewhere in the region.

Fig 1: An example of a successful emerging market, Malaysia scores highly on our ESCAPE index



Source: PwC ESCAPE index

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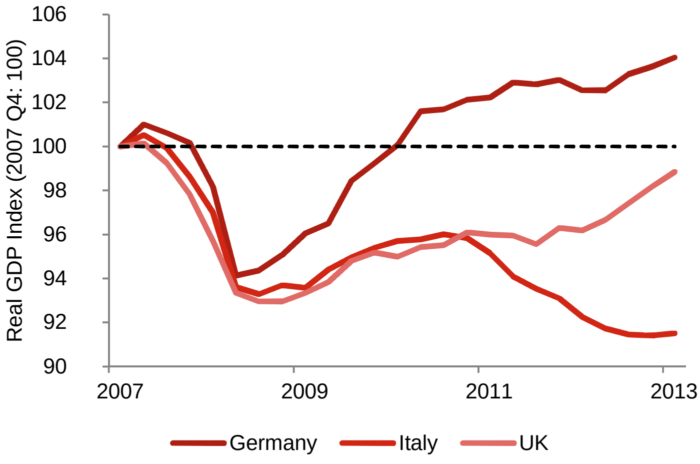
Economic update: Recovery in the Eurozone is proceeding

Recent GDP figures paint an increasingly positive picture for the Eurozone with solid growth recorded across most economies in the fourth quarter of 2013. Northern European economies picked up pace, with Germany expanding by 0.4% in Q4, whilst Southern European economies also grew. Italian output, for example, expanded for the first time after nine consecutive quarters of negative or no growth.

Despite the recent broad based pick-up, the Eurozone recovery remains a tale of two halves. Northern European economies like Germany (4%) are clearly bigger than their pre-crisis peak at the end of 2007, but Southern European economies like Italy (-8%) are still significantly smaller (figure 2). Southern economies are also facing weak levels of domestic demand as they continue to struggle with high unemployment. Businesses are also struggling with higher funding costs than in the "core" economies, which put them at a competitive disadvantage.

Overall, the Eurozone economy remains around 1% smaller than its pre-crisis peak at the end of 2007, which is similar to the UK. By comparison, the US economy, is now around 6.5% bigger than at the end of 2007.

Fig 2: The recovery in the Eurozone has reached most economies, but stark differences in performance remain



Source: Eurostat, PwC analysis

Focus on...Malaysia

In our recent ESCAPE index* report Malaysia performed well, ranking 14th out of our sample of 42 countries. We caught up with **Patrick Tay, Economics Advisory, PwC Malaysia**

1. *What have been the drivers of Malaysia's success and how will they develop?*

I think the situation in Malaysia right now shows that growth is solid and momentum in the economy is picking up. For example, overall growth for 2013 was 4.7%, but in the fourth quarter the economy expanded by 5.1% year on year. One of the key reasons for this pickup has been high levels of investment into infrastructure to remove some supply side bottlenecks. Additionally, this has been supported by household spending: Malaysia has very stable employment conditions so this is helping to sustain real growth in the economy.

The Malaysian government has also been enacting a number of reform measures that reach across the whole economy. The effects of these reforms are beginning to kick in now and will continue to do so. In addition to measures to restrain spending growth so as to manage the budget deficit, the government is also progressively liberalising certain sectors and installing a competition commission to oversee these new markets.

2. *Where do you see the sectors in Malaysia's economy that will prosper in the future?*

The government has identified 12 key economic areas, which it has identified as sectors with significant growth opportunities where Malaysia can compete globally. There are several that are particularly important to the economy, including "soft" commodities related to food and sectors where Malaysia can leverage its skilled workforce and good labour market conditions.

Malaysia exports a significant amount of palm oil, which is used in a variety of food and consumer products like shampoo and cosmetics. Demand for these products (and the demand for palm oil) is expected to rise as incomes increase across the South East Asian region.

Healthcare services (particularly for overseas visitors) is another area that Malaysia can exploit. It has a good supply of highly skilled medical labour and good infrastructure. This means that Malaysia can deliver comparably quality healthcare to that in Singapore but 30-40% cheaper

Conventional tourism is also a growth sector for Malaysia - it currently attracts around 26m visitors per year. In 2014 the government is targeting a "Visit Malaysia" year and is hoping to increase tourist numbers by 10%.

Another key growth sector is services outsourcing, particularly MRO (maintenance and repairs), where airlines in particular are outsourcing skilled maintenance work to Malaysia due to our competitive labour rates and infrastructure capacity.

3. *How are local and international businesses positioning to take advantage of Malaysia's growth and position in the Asian economy?*

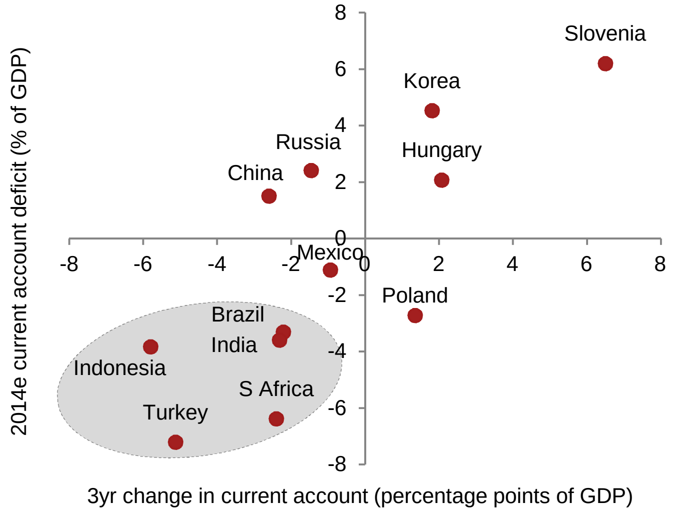
Malaysia's position in a fast growing economic region means that it has a strong external focus. What is more interesting is that Malaysian businesses are looking further afield for growth. From 2000-2011, exports to non TPPA members (Trans Pacific Partnership Area, 12 predominantly advanced economies across the Asia-Pacific rim) have grown 5 times faster than exports to TPPA members (160% to 30%), driven by strong growth in China, Indonesia and Thailand.

Malaysia's businesses, particularly its property developers, are also looking even further afield for growth. A very interesting current example is the Battersea regeneration in London, where businesses from Malaysia and other Asian economies are key investors. It's a really interesting signal of how dynamic and interlinked the global economy has become.

Available here: http://www.pwc.co.uk/economic-services/issues/escape-index-mapping-how-markets-emerge.jhtml

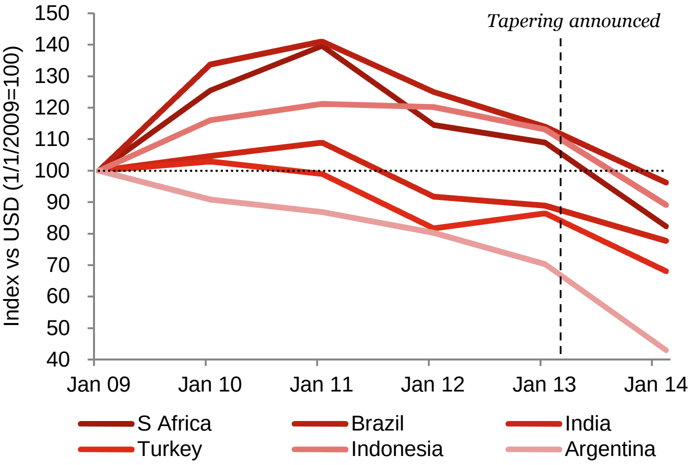
Emerging markets: will they be stranded at low tide?

Fig 5: Not all emerging markets are in the danger zone



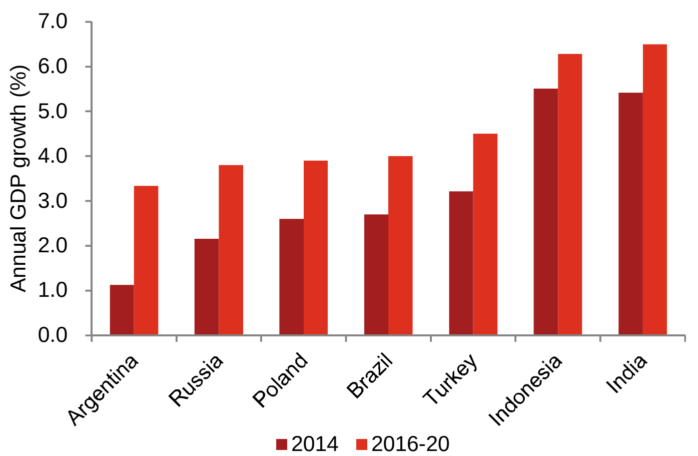
Source: OECD, PwC analysis

Fig 6: Falling to BIITS? Some emerging market currencies have had a painful run



Source: Datastream, PwC analysis

Fig 7: But poorer growth in 2013/14 should be seen in the medium term growth context



Source: PwC analysis

While advanced economies were struggling with the consequences of the financial crisis, emerging markets remained resilient as economic growth held broadly steady.

Now, as economic conditions are improving across advanced economies, the opposite seems to be the case in emerging markets. Sharp falls in exchange rates (Figure 6), coupled with slowing growth and some domestic political troubles, may give the impression that the wheels are coming off the emerging market growth story, but what is behind the headlines?

The truth is that some emerging markets are suffering more than others – with the so called "Fragile 5" (highlighted in figure 5) capturing the most attention. A key vulnerability has been the deterioration of their external positions over the last few years – in simple terms, exports have struggled while foreign liabilities have piled up.

Strong domestic currencies (driven by "cheap money" from the Federal Reserve and other central banks), coupled with slow growth in advanced economies, damaged their ability to export (Figure 5). At the same time, foreign liabilities have mounted as international investors searched for yield. For example, since 2008, net foreign liabilities owed by Turkey's corporate sector have almost tripled to approximately $170bn.

The announcement and start of tapering by the Federal Reserve has been a catalyst for a reversal in investor sentiment in emerging markets, especially the conviction that higher risks were justified by higher expected returns.

Emerging markets were lifted by a tide of liquidity provided by the Fed but, as this is wound down, the fear is that some of these economies will become "beached" as currencies fall, interest rates rise and growth slows.

To an extent, the data supports this concern as rises and falls in exchange rates have been broadly aligned to the actions of the Fed since the financial crisis, but there are other factors at play.

Economic "governance issues" across emerging markets are becoming harder to ignore. One notable example is the high level of political engagement in central banks in some emerging markets. A prime example is Turkey, where recent interest rate hikes have met with stiff political opposition. In the "Fragile 5", as well as other emerging markets facing election cycles in 2014, it could be that "easy options" will be chosen over reforms that carry benefits over the longer term.

We still believe that most emerging markets have the economic fundamentals (in terms of labour force growth and potential for capital investment and productivity improvement) for solid economic growth in the longer term. But risks undoubtedly exist and it will be a bumpy ride for some emerging markets.

In the short term, despite substantial falls, it's by no means certain that some currencies have bottomed out. Meanwhile, continued shortfalls in economic governance suggest that volatility and policy uncertainty are likely to be the dominant themes of the day. This is clearly reflected in our expectation of relative growth underperformance in 2014 in many emerging markets compared to the stronger potential that we think these economies possess in the medium term (see Figure 7).

Projections: March 2014

	Share of 2012 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2013e	2014p	2015p	2016-2020p	2013e	2014p	2015p	2016-2020p
Global (market exchange rates)		100%	2.5	3.1	3.2	3.2	4.7	5.0	5.6	4.7
Global (PPP rates)	100%		3.0	3.5	3.7	3.7				
United States	19.5%	22.5%	1.9	3.0	3.0	2.4	1.5	1.8	1.9	1.9
China	14.7%	11.4%	7.7	7.5	7.2	7.0	2.7	2.5	2.7	3.4
Japan	5.5%	8.3%	1.6	1.5	1.1	1.2	0.4	2.1	1.8	1.5
United Kingdom	2.8%	3.4%	1.8	2.6	2.4	2.4	2.6	1.8	1.9	2.0
Eurozone	13.5%	16.9%	-0.4	1.0	1.3	1.5	1.4	1.3	1.5	1.9
France	2.7%	3.6%	0.1	0.9	1.2	1.6	1.0	1.2	1.6	2.0
Germany	3.8%	4.7%	0.5	1.7	1.9	1.5	1.6	1.7	1.8	2.0
Greece	0.3%	0.3%	-3.8	0.2	1.8	2.5	-0.9	-0.3	0.1	1.0
Ireland	0.2%	0.3%	0.1	2.1	1.8	2.5	0.5	1.4	1.2	1.7
Italy	2.2%	2.8%	-1.8	0.4	1.0	0.8	1.3	1.1	1.3	1.7
Netherlands	0.8%	1.1%	-0.9	0.8	0.9	2.0	2.6	1.4	1.7	2.1
Portugal	0.3%	0.3%	-1.2	1.3	1.6	1.8	0.4	0.5	1.2	1.5
Spain	1.7%	1.8%	-1.2	0.7	0.9	1.7	1.5	0.9	1.2	1.7
Poland	1.0%	0.7%	1.3	2.6	3.4	3.9	1.2	2.0	2.5	2.5
Russia	3.0%	2.8%	1.6	2.2	2.9	3.8	6.8	5.8	5.5	5.6
Turkey	1.3%	1.1%	3.7	3.2	4.4	4.5	7.5	7.3	6.1	4.8
Australia	1.2%	2.1%	2.4	2.7	3.0	3.1	2.4	2.8	2.6	2.7
India	5.7%	2.6%	4.7	5.4	6.4	6.5	6.3	5.2	6.0	6.0
Indonesia	1.4%	1.2%	5.8	5.5	5.8	6.3	7.0	6.2	5.2	5.1
South Korea	1.9%	1.6%	2.8	2.8	4.0	3.8	1.2	1.8	2.9	2.9
Argentina	0.9%	0.7%	5.0	1.1	1.8	3.3	10.5	11.2	13.3	9.7
Brazil	2.8%	3.1%	2.2	2.0	2.5	4.0	6.2	5.8	5.6	4.8
Canada	1.8%	2.5%	1.7	2.3	2.5	2.2	0.9	1.7	1.9	2.1
Mexico	2.2%	1.6%	1.6	3.2	3.7	3.6	3.8	3.8	3.9	3.6
South Africa	0.7%	0.5%	1.9	2.8	3.2	3.8	5.8	5.4	5.0	4.8
Saudi Arabia	1.1%	1.0%	3.8	4.4	4.2	4.3	3.5	3.1	3.5	4.0

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the CPI, with the exception of the Indian indicator which refers to the WPI. Note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

**PPP refers to Purchasing Power Parity and MER refers to market exchange rates.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	QE tapering to continue during 2014	18/19 March
European Central Bank	0.25% (November 2013)	On hold	6th March
Bank of England	0.5% (March 2009)	On hold	6th March

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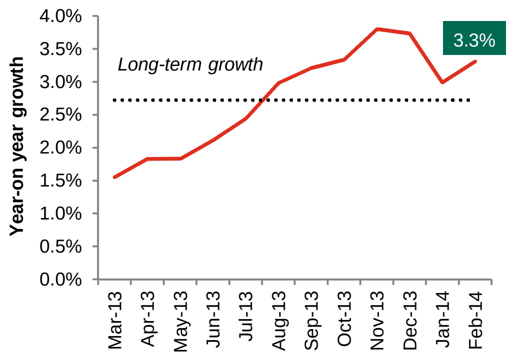
PwC's Global Consumer Index – February 2014

Global consumer spending growth picked up from last month and we estimate it grew by 3.3% year-on-year which is above long-term trends.

The latest data shows that industrial production in China, the US, South Korea and Russia continues to increase. This underscores rising confidence in businesses who expect consumer spending to hold up their domestic and international markets.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit ***www.pwc.co.uk/globalconsumerindex***

We help you understand how big economic, demographic, social, and environmental changes affect your organisation by setting out scenarios that identify growth opportunities and risks on a global, regional, national and local level. We help make strategic and tactical operational, pricing and investment decisions to support business value creation. We work together with you to achieve sustainable growth.

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