

FOCUS ON

How deep is the rabbit hole?

Produced by the
Economic Analysis
and Research

China and emerging markets amid leaps and bubbles,
panic and opportunity

EXECUTIVE SUMMARY

- *The thesis of perennial stagnation or speculative bubbles as the only instruments for fueling economic growth has resurfaced in recent weeks. China is experiencing its third bubble in six years, this time of a financial nature. Apart from the current financial hysteria, we must not forget the structural change the Asian giant is undergoing. Beijing is guiding its economy toward a medium/long-term development model, more focused on consumer spending.*
- *The Chinese bubble is lifting the veil on stability in the real economies of the emerging markets and their demand for goods and services. SACE has analyzed the top 20 emerging markets for Italian exports to determine which areas will actually be vulnerable to exogenous shocks.*
- *China, Saudi Arabia, the Emirates and Poland, which represent 28% of Italian exports to emerging markets, are important customers for the Italian goods that will remain the focus, net of current fluctuations. The potential for additional Italian exports to these four countries might exceed a total of € 11 billion in the next three years, equivalent to 30% of current exports.*
- *Conversely, Argentina, South Africa, Brazil, Russia and Turkey (but also Chile, Egypt and Malaysia to a lesser extent) are more exposed to turbulence. The greater vulnerability of the emerging world can still be managed through adequate risk management solutions.*

CHINA: KEEP CALM, NO CATASTROPHE ON THE HORIZON

"This latest financial turmoil raises a broader question: why have we been having so many bubbles? For it's now clear that the flood of money into emerging markets, was yet another in the long list of financial bubbles over the past generation" (Paul Krugman, 2013).

The specter of market saturation has re-emerged in recent weeks, supporting the thesis of perennial stagnation or speculative bubbles as the only instruments for fueling economic growth. China, which has registered double-digit growth in recent decades, is witnessing its third bubble in six years, financial this time, after the real estate bubble and private and local government debt bubble.

The repeated tumbles of the Shanghai stock exchange reverberated throughout the principal financial markets. On closer examination, however, the Shanghai index had more than doubled in the previous 12 months, many listed companies were capitalizing 100 times their revenues (with a P/E⁰¹ tending toward infinity, in a few cases), and USD 6 trillion (three-and-a-half the Italian GDP) was invested in hedge funds and speculative ETFs⁰². The shock of recent weeks does not seem to reflect the fundamentals of Chinese real economy, however, and an "adjustment" of market prices was predictable.

In an overvalued context, financial capital had begun to emigrate months ago (USD 400 billion exited from China in the first half of the year), and today attention seems to have shifted to greater mobility of the currency. After a 24% appreciation in the past ten days, in fact, the Chinese government devalued the yuan by 3%. The moderate action adopted by the Central Bank of China is a signal more indicative of greater liberalization of the exchange rate regime and less support to exports short term, but in our opinion the devaluation will remain limited. Excessive devaluation of the yuan would, in fact, go against the interests of Beijing, if the medium-term objective is to bring it closer to the principal international currencies, bringing it into the FMI currency basket for computing the special drawing rights⁰³.

Apart from the recent financial hysteria, we must not forget the structural change the country is experiencing: Beijing must guide its economy toward substantial change in the medium-long term, even at the cost of negative short-term repercussions, and the transition toward a development model based on consumer spending, rather than exports and investments, may slow GDP growth. This adjustment may require years as well as political determination and economic resources, which China possesses but is utilizing cautiously, especially if compared to the enormous stimuli proffered since 2009. It is precisely this attitude of less intervention on the part of the Chinese authorities and greater openness to the market that has caused some panic in the financial markets.

⁰¹ Price/earnings, ratio of share price to expected earnings per share

⁰² Source Muzinich.com

⁰³ SDRs are units of account used by the FMI, their value being derived from a basket of currencies (for now USD, EUR, JPY and GBP)

THE QUEST FOR CERTAINTIES, AMID PHANTOMS AND FEARS

The propagation of the effects of the Chinese bubble to other emerging markets lifts the veil on the solidity of the real economy in those countries—rather than the Asian giant—and thus on their demand for goods and services, perhaps even more important for Italian companies than demand from the Far East (China alone represents “only” 2.6% of our exports). That the turmoil is general in scope seems evident observing the trends in the MSCI indices of emerging and advanced countries⁰⁴ (Figure 1). Unlike 2009, this turmoil has a much greater effect on the emerging countries, but in the past five years the cycles of capital inflow and outflow from those areas, especially equity, have been much shorter, confirming the speculative-financial nature of these movements.

FIGURE 1. Performance of the equity markets (August 2008 = 100)



Source: Thomson Reuters

⁰⁴ The MSCI World index considers 23 advanced markets

The other phantom haunting the world is the decline in commodity prices: first coal and steel, then natural gas and petroleum. It is the exports of commodities, in fact, that has driven the demand of the emerging countries and global growth post-2008. But here again our memory is short: in 2008 it was the decline in crude oil prices (from 146 dollars/barrel in July to 34 in November) that gave a strong boost to recovery of the global economy and the financial markets.

Today, the pressure on prices is the result of excess supply rather than weak demand: the producing countries may suffer a bit—but most of them are well equipped to sustain the effort—and will devalue their currencies to cope; the others will derive benefit from energy efficiency and abundant, cheap energy.

The reduced revenues of the commodity exporting countries, and the consequent reduction in public spending and higher debt levels, along with the currency turbulence triggered by the expected moves by the U.S. Federal Reserve, are current phenomena that have a stronger impact of the emerging economies in their catch-up phase, weakening the economic fundamentals and prospects for growth.

THE SEASONS OF THE OTHERS: AT WHICH DOORS WILL GENERAL WINTER BE KNOCKING?

Which emerging countries are at greatest risk, in terms of prospects for exports and Italian companies? To understand which of them are more or less vulnerable to external shocks at the moment, we have analyzed the 20 top emerging markets for Italian exports (they accounted for 20% of Italian exports in 2014), which together represent 46% of world GDP and import 35% of goods traded.

In considering the exposure of these countries to the current turbulence in the international markets, we have assessed their positions on a series of sensitive variables to measure their ability to absorb external shocks (Table 1), classifying them into three categories: markets with low, medium and high vulnerability (for the original data, see Annex 1 at the end of this document).

	SACE Credit Risk Index	GDP growth (outlook '15)	Foreign debt	Foreign currency reserves	Exchange rate vs USD 2015 (Jan vs Aug)	Exchange rate vs EUR 2015 (Jan vs Aug)	Change in equity market (since 01/09/2014)	Change in equity market (since 01/06/2015)
Algeria	!	→	●	●	↓	↓	*	*
Saudi Arabia	✓	→	▲	●	**	↑	↓	↓
Argentina	✗	↓	●	◆	→	→	→	↓
Brazil	!	↓	▲	●	↓	↓	↓	↓
Chile	✓	→	◆	▲	↓	→	→	↓
China	!	↑	●	●	→	↑	↑	↓
Colombia	!	↑	▲	▲	↓	↓	↓	↓
UAE	✓	↑	◆	***	**	↑	↓	→
Egypt	✗	↑	●	◆	→	→	↓	↓
India	!	↑	●	▲	→	↑	→	↓
Indonesia	!	↑	▲	▲	→	→	↓	↓
Malaysia	✓	↑	◆	◆	↓	→	↓	↓
Mexico	!	→	▲	▲	↓	→	→	↓
Nigeria	✗	↑	●	◆	→	→	↓	↓
Poland	!	↑	◆	▲	↑	↑	→	↓
Russia	✗	↓	▲	●	→	↑	↑	↑
South Africa	!	→	▲	▲	↓	→	→	↓
South Korea	✓	↑	▲	▲	→	→	↓	↓
Thailand	!	↑	▲	▲	→	→	↓	↓
Turkey	!	↑	◆	▲	↓	↓	→	↓

* The Algerian stock exchange was not considered because of its small size compared to the other markets and its extremely limited impact on the real economy.

** Countries whose currency is pegged to the U.S. dollar.

*** The official reserves do not include the funds available in the sovereign fund, more than USD 700 billion, equivalent to 50 months of import cover.



LOW VULNERABILITY

China: limited external debt and abundant current reserves provide a sufficient buffer to absorb short-term fluctuations. The performance of the stock exchange, though decidedly negative in the recent past, is still higher today than the levels of a year ago.

Saudi Arabia and the UAE: despite the collapse of petroleum prices, foreign reserves are abundant, sufficient to absorb a relative long period of moderation in the commodities market without concerns about the ability defend their currencies.

Algeria, India, and Poland: Italian exports to these countries currently total € 18 billion. Despite the currency turbulence, the currencies of these countries (except for Algeria) have appreciated against the euro since the start of the year⁰⁵, preserving the competitiveness of European (and thus Italian) exports, SACE estimates the potential increase in sales of Italian goods to these areas at around € 6 billion in the next three years.



MEDIUM VULNERABILITY

Egypt: foreign reserves are low but are gradually being reconstituted thanks to the support of the Gulf countries. Despite the repercussions of the international turmoil on stock prices, the prospects for growth are positive and the outlook on credit risk is improving.

Indonesia: the stock market has been impacted by the decline in the Shanghai exchange. The exchange rate is still relatively stable, however, and growth prospects are positive (+5.2%).

Mexico: a third of state revenues derive from the oil industry, so the drop in crude prices and the liberalization of the energy market are critical factors, at least short term. The Mexican economy is strongly linked to that of the United States, so the depreciation of the peso against the dollar, though it represents a factor of currency vulnerability, makes Mexican goods more competitive.

Chile, Colombia, Malaysia, Nigeria, South Korea, and Thailand: the euro has appreciate somewhat against the currencies of this group, except for the Colombian peso, against which it has lost much competitiveness. In this context, Italian exports might be negatively influenced (but only slightly) in the short-term. The current major infrastructural and investment programs in some of these areas, however, have kept the business opportunities for Italian companies on course.

⁰⁵ Much of the fluctuation in bilateral exchange rates with the euro derives from variations in the USD/EUR exchange rate, which has declined 5% since January



HIGH VULNERABILITY

Argentina: the level of foreign debt is low because the country is unable to access the international markets because of last year's default. Reserves are low, exposed to the policy of controlled exchange rates, and growth prospects are negative (-0.3%).

Brazil: negative prospects because of the weak commodities market and exchange rate volatility. GDP is expected to decline by 1% in 2015.

Russia: although a few indicators have improved in the period considered (particularly exchange rate and stock prices), the country is still feeling the effects of the sharp devaluation of the ruble in late 2014-early 2015. Therefore, the trend in the exchange rate in the first half of the year must not be interpreted as greater competitiveness of the euro.

The growth prospects are also negative, influenced by the negative context in the commodities markets and political-commercial tensions with the U.S. and Europe.

South Africa: The decline of commodity prices has negatively influenced one key sector of the country already affected by frequent strikes: the mining industry. The public accounts are vulnerable to external shocks, since they depend on the flow of portfolio investments from abroad; this, along with further devaluation of the rand, is overclouding growth prospects.

Turkey: although growth prospects are positive, this country is extremely vulnerable to short-term exogenous shocks because of its dependence on short-term foreign capital flows.

The euro has strongly appreciated against the currencies of these four countries so, apart from the problems cited above, exporters will have to deal with competition from lower-cost goods coming from outside the euro-zone and leverage more on the quality of their products and services, including financial packages in favor of the counterparties.

CONCLUSIONS

The emerging countries still offer good prospects for export and investment activity, despite the short-term fluctuations in the financial markets. The markets may still cause difficulties for the less-equipped economies (medium- and high-vulnerability countries), so they must be closely monitored in coming months.

In particular: China, Saudi Arabia, the UAE and Poland, which represent 28% of Italian exports to the emerging markets (equal to 7.8% of total exports) are important markets for Italian goods, requiring attention apart from the current context. The potential increase in Italian exports to these four countries might exceed a total of 11 billion in the next three years, a figure equal to 30% of current exports.

In the medium-and high-vulnerability countries, company business can be further protected through instruments that will provide adequate risk coverage and permit greater financial competitiveness, thus offsetting the disadvantage of currency fluctuations. The current turbulence might lead countries suffering from structural weaknesses to take measures to restrict the convertibility and transfer of their currencies abroad. Nonetheless, in certain contexts, we should not rule out possible political developments that would undermine business transactions and the countries' openness to trade. Here again it is possible to continue investing in these markets by adopting appropriate instruments of protection.

CONTACTS

Customer service: +39 06 6736000 - info@sace.it

Press Office: +39 06 6736888 - mediarelations@sace.it

	SACE Credit Risk Index (0-100)	GDP growth (outlook '15)	Foreign debt	Foreign currency reserves	Exchange rate vs USD 2015 (Jan vs Aug)	Exchange rate vs EUR 2015 (Jan vs Aug)	Change in equity market (since 01/09/2014)	Change in equity market (since 01/06/2015)
Algeria	47	2.6%	2	26.8	15.3%	10.0%	*	*
Saudi Arabia	25	3.0%	25.2	32.1	**	-4.7%	-32.1%	-22.2%
Argentina	96	-0.3%	21.8	4.3	7.4%	2.3%	-1.7%	-9.1%
Brazil	43	-1.0%	30	14.5	32.5%	26.2%	-27.1%	-16.0%
Chile	23	2.7%	60.2	5.8	10.4%	5.2%	-7.7%	-7.8%
China	35	6.8%	9.1	21.7	1.6%	-3.1%	32.7%	-38.6%
Colombia	42	3.4%	33.9	7.6	24.4%	18.5%	-39.7%	-12.6%
UAE	29	3.2%	58.7	***	**	-4.7%	-15.5%	-5.0%
Egypt	80	4.0%	15.8	3.5	7.6%	2.6%	-27.7%	-21.8%
India	48	7.5%	19.5	7.1	4.1%	-0.8%	-3.1%	-6.5%
Indonesia	58	5.2%	31.8	7.2	9.0%	3.9%	-18.3%	-18.9%
Malaysia	31	4.8%	64.5	4.4	12.2%	7.0%	-16.2%	-10.3%
Mexico	34	3.0%	41.9	5.2	11.8%	6.6%	-7.5%	-6.1%
Nigeria	67	4.8%	5	3.8	6.9%	1.9%	-30.4%	-15.4%
Poland	39	3.5%	73.2	5.2	-2.3%	-6.9%	-5.8%	11.2%
Russia	71	-3.8%	36.5	11.6	1.4%	-3.3%	19.1%	2.5%
South Africa	40	2.0%	40.8	5.1	11.0%	5.7%	-4.2%	-5.9%
South Korea	24	3.3%	30.1	7.7	8.2%	3.1%	-10.7%	-12.2%
Thailand	47	3.7%	34.8	6.9	7.8%	2.7%	-15.4%	-11.5%
Turkey	53	3.1%	53.4	5.6	21.4%	15.7%	-9.1%	-8.6%

Source: SACE, FMI, EIU, Thomson Reuters

* The Algerian stock exchange was not considered because of its small size compared to the other markets and its extremely limited impact on the real economy.

** Countries whose currency is pegged to the U.S. dollar.

*** The official reserves do not include the funds available in the sovereign fund, more than USD 700 billion, equivalent to 50 months of import cover.