COMMENTARY

# BRICs are dead, long live Emerging Markets!

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**By Thierry Apoteker**

INVESTORS may be forgiven for feeling cheated about the promises of Emerging Markets (EMs) as the 21st-century economic powerhouses. When Goldman Sachs famously heralded a new period of "Building the World with BRICs" back in 2003, Brazil, Russia, India and China (to whom South Africa later adhered for the capital "S" of BRICS) were supposed to be the engines of growth up to 2050, with the expected consequences on financial and industrial investment opportunities.

Candid observers pointed out then that such different nations could not possibly form a homogeneous group over the long run, but the appeal of the acronym and the exceptional China-driven and commodity-fuelled growth in most developing countries invited massive capital inflows in these countries. Alas! Today, worries abound about a Chinese economic hard landing, Brazil is getting further into recession, and sanction and oil-hit Russia struggles with massive economic contraction. The Brazilian real, the Russian rouble and the South African rand have taken a beating, and even the mighty Chinese yuan reversed its long-term appreciation trend. For all practical and analytical purposes, BRICS are dead as a concept.

### PERFECT STORM FOR EMERGING MARKETS LEADS TO OVERSHOOTING ON FINANCIAL AND CURRENCY MARKETS

These five large developing countries account for a substantial share of the world gross domestic product (GDP) and therefore their difficulties are weighing down on the world economic outlook. As a consequence, EMs as a whole have suffered from large capital outflows, massive currency depreciation and collapsing asset values.

So, is it the end of the story about a long-term trend of faster growth and structural rise in living standards in EMs?

The idea of a Perfect Storm about to derail the overall EM situation is fed by an unfavourable combination of three major headwinds: China's slowdown; forthcoming US monetary tightening; and renewed decline in oil and commodity prices. Among EMs, countries most sensitive to this harmful combination are Brazil, Russia and South Africa, and – to a lesser extent – Turkey, Indonesia and Malaysia.

### MOST OF THE NEGATIVE FORCES SHOULD SUBSIDE NEXT YEAR

This idea of a Perfect Storm always carries risks of being a self-fulfilling bet, as the more widespread it gets, the larger the capital outflows from EMs and the more difficult becomes each country's situation. A full-blown market panic over EMs cannot be ruled out. Is it however a "fundamentals-driven" adjustment related to medium-term/deep-seated problems with EMs and therefore a long or structural change that we have yet to "price" correctly in both asset and currency markets? I believe it is a too-negative market perception and therefore a too-violent self-reinforcing financial process that will end over the next few quarters.

Regarding China, quantitative tools developed by Tac Economics have correctly announced both the cyclical softness and the currency risks; the same tools however are not pointing to a faster economic deceleration. Despite the limited depreciation so far, Chinese exports' high sensitivity to relative prices added to positive news on real-estate sales and further policy easing indicates that activity is unlikely to collapse further. What about Federal Reserve chair Janet Yellen's pushing the "nuclear button"? First and foremost, remember that a move from 0 per cent fed funds to 0.25 per cent and a plausible 150 basis-point increase over the next 12 months cannot be characterised as a move towards a global crunch on available liquidity.

Such increases in fed fund rates would reflect the acceleration in nominal GDP and probably credit distribution, hence creating initially larger liquidity requirements and supply through banks and markets, despite a higher price for such liquidity. Moreover, both the Bank of Japan and the European Central Bank are actively expanding their balance sheets, and the People's Bank of China has eased substantially its monetary policy and started to directly inject liquidity in the markets. Last but not least, past episodes of US monetary tightening have not been systematically associated with large capital movements, which usually take place before the actual policy implementation.

The outlook for oil prices remains highly uncertain, but the argument for higher prices over the near term is still very present, with visible signs now of supply and demand, even though the extraordinarily large level of inventories precludes a large upward reversal over the next few quarters, and can even create temporary conditions of further price declines. We also know that many EMs are large beneficiaries of lower oil prices, while some large producers have substantial financial resilience limiting the negative impact over the short term.

### FAVOURABLE STRUCTURAL TRENDS AND ADJUSTMENT POLICIES

During moments of heightened uncertainties and acute market volatility, it is worth looking back at the structural factors at work: Have they changed radically over the past year? No, unless you forgot to see that China was mechanically getting to a slower gear . . . but don't forget that the structural transformation of the country will create higher-quality growth, whether from an economic efficiency perspective or from an environmental angle.

Elsewhere in most EMs, the demographic transition towards a larger working-age group in total population, higher investment spending, improving business frameworks and better education are continuing to feed the long-term growth trend. Over the shorter term, adjustment policies, either forced by capital outflows or engineered with fiscal or monetary rooms-to-manoeuvre, are likely to provide modest but critical support to economic activity as well as currency rates during 2016.

By the way, we use a two-year forward-looking Economic & Financial Risk Rating to assess the cyclical, exchange rate and payment risks in more than 80 EMs and developing countries. The overall average across all countries deteriorated substantially from 2011 to the end of 2013: The usual time lead suggests therefore we are currently exactly in the eye of the storm. The same risk rating started to improve from Q4 2013 up to Q4 2014 and stabilised thereafter: If the tool keeps the promises of its track record, overall risk materialisation in EMs should decline in 2016.

Neither China, nor the Fed nor the oil prices are the most likely to derail this scenario; the one thing that can trigger a much more negative outcome would be large and widespread social tensions – progressively better economic conditions will take time to translate into social improvements – as the poorer segments of the population and a disappointed middle class may feel even more cheated than international investors about the promises of a golden dawn.

The writer is chairman of Tac Economics

**If the Germans disregard their own rules in environmental technology, other people are not likely to heed Germanic strictures in economics.** PHOTO: REUTERS

# The retreat of German rigour

**By David Marsh**

CHARLES Goodhart, the distinguished British economist and former member of the Bank of England's monetary policy committee, and Volkswagen, the German car giant, were both born within a few months of each other, in October 1936 and May 1937 respectively. There, you might think, the similarities end. But there is more to it than that.

Our good and now not-so-distinguished friends at VW have just demonstrated – in a striking way that is reverberating around Europe and the world – the fundamental truth of a "law" that Prof Goodhart formulated, with regard to monetary targets, about 40 years ago: "Any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes."

In other words, when the authorities start to measure some kind of variable and use it as a barometer of policy and performance, the parameter ceases to hold meaning. Once a measure becomes a target, it loses its validity, as VW – in literally breath-taking manner – has shown with its clinical use of engineering and software to sidestep controls on harmful emissions.

The VW affair is likely to have repercussions for monetary union because, in this matter of truth, trust and statistics, we have been here before. With some strong-arming from its friends like then French President François Mitterrand, Germany agreed to give up its currency after unification in 1990 on condition that its European partners would show the same steadfastness and discipline that Germany had appeared to show in its post-war stewardship of the Deutsche mark.

Whether in diesel cars or the money supply, trust is a valuable commodity. If a nation such as Germany is held in high esteem in a certain field, and that trust is eroded for any reason, then the effects can be far more harmful than slippages in countries not normally thought to adhere to high standards.

Just before monetary union started in 1999, Theo Waigel, the then German finance minister, stood accused of failing to adhere to the Maastricht convergence target that he himself had helped to formulate, of a budget deficit of 3 per cent of gross domestic product. This gave extra leeway to counties such as Italy that were themselves struggling, with all kinds of somewhat unorthodox measures, to meet the criteria for joining the euro.

A few years later Hans Eichel, finance minister under Chancellor Gerhard Schroder, exceeded the 3 per cent deficit target in the "stability and growth pact" to give the German economy extra slack during the sluggishness of the early 2000s. The decision, gleefully backed by the European Commission and followed, too, by France, resulted in only a small overshooting – but the symbolic damage was great. Jean-Claude Trichet, the then European Central Bank president, still blames the Germans for fatally undermining budgetary discipline throughout the euro area – a somewhat overdone charge, but one that has stuck.

The implications this time are still more serious. German-style rigour is on the retreat everywhere in the euro area. Wolfgang Schauble, the finance minister, cuts a lonely figure in European councils. If the Germans disregard their own rules in environmental technology, other people are not likely to heed Germanic strictures in economics.

Prof Goodhart's law says that any rule propounded as a target will cease to have meaning. Germany seems to have taken this one step further by saying that these rules are anyway solely for other people. I predict that, in forthcoming discussions about austerity throughout Europe, heads of government and finance ministers will find themselves talking, however improbably, about diesel emissions. OMFIF

The writer is managing director of the Official Monetary and Financial Institutions Forum

# China's 'One Belt, One Road' holds economic promise

Projects in China and major Asian countries could potentially benefit from the much-talked-about Chinese initiative. BY SHU-CHING JEAN CHEN

CHINA has couched its "One Belt, One Road" initiative in grand and cryptic terms, in its typical way. Still, it is possible to qualify what it means in economic terms.

The belt that China has in mind refers to the extensive land routes along the ancient Silk Road corridor passing through Central Asia. The road it envisions, on the other hand, is not of a physical construction: it is the maritime Silk Road route beginning in the southern Chinese coastal province of Fujian all the way to Venice.

In short, the initiative amounts to an infrastructure and strategic roadmap for the global trading community to be connected by a seamless network of transportation links over land, on the sea and in the air.

Analysts at CLSA, a regional brokerage now owned by Beijing-based Citic Securities, have identified projects in major Asian countries that could potentially benefit from the Chinese initiative, with interesting figures to match.

In India, CLSA's local analysts have found US$505 billion worth of projects suitable for OBOR, the acronym for the Chinese initiative, top among them being renewable energy in solar and wind power generation, as well as in the construction of railways.

In Indonesia, China's initiative could help finance the private-sector funding in the country's infrastructure spending, equivalent to at least 26 per cent of the total official estimate of US$86 billion required each year for its proposed infrastructure reform.

Elsewhere, CLSA analysts identify US$57.5 billion worth of projects in Malaysia with potential Chinese involvement, including the planned mass rail transit line 2, Penang transportation master plan and light rail transit line 3.

But the most progress is found in Pakistan where the China-Pakistan Economic Corridor is seen as the signature OBOR project and where CLSA says ongoing infrastructure projects already total US$28 billion.

China itself also has a domestic OBOR initiative to begin with, listing a batch of infrastructure projects at home to link with neighbouring countries, the costs of which CLSA says could reach 2 per cent of its GDP.

And the scope could be expanded indefinitely. In the action plan for the initiative published in March, the Chinese government stated that any country outside the Belt and Road area – which already covers 60 per cent of the world's population in 60-plus countries – is eligible to participate.

With sufficient funding and enough goodwill, China does have the wherewithal to bankroll such an infrastructure spree in roads and railways that it pinpoints as the key strength of the initiative. Chinese companies have been developing infrastructure projects in the developing parts of Africa and the Latin America.

By coining the phrase "One Belt, One Road" in late 2013, Chinese President Xi Jinping has prioritised what previously had been loosely under a resources-led, going-out policy whose results were not all that well-received.

This time, Mr Xi appeals specifically, and wisely, to the spirits of free trade, market forces, mutual respect, market disciplines and international norms, all indispensable elements for the continued prosperity of global trade, even though the official plan remains light on details.

Of course China is not all that altruistic. It also hopes to cultivate new markets outside of Europe and the US as future destinations for its excess domestic industrial capacities, while promoting trade payments using its currency, the yuan.

"It is a golden opportunity for China and for countries in Central Asia, and for multinational financial banks," says Yuejiao Zhang, member of the appellate body at the World Trade Organisation (WTO).

She says China's OBOR initiative would be complementary to the more costly, bureaucracy-laden infrastructure projects undertaken by the Asian Development Bank. And the demand is far from being met. About 70 per cent of roads in Central Asia are in poor condition, for instance, she adds.

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Officials in Hong Kong are quick to see the brighter side of the economic implications. Financial Secretary John C Tsang described it as "a once-in-a-lifetime opportunity that brings to us and to the world in an unprecedented way immense business opportunities", when addressing an audience of the city's first international forum on the topic in late July.

He went on to say: "To put things in context, the Belt-Road initiative could likely be the guiding path for us, for our economic development for the next 30, or even 50 years."

His colleague, Secretary for Financial Services and the Treasury, KC Chan, made added comments in a blog published at about the same time. Mr Chan said China's Silk Road initiative would unleash the persistently low inter-regional trade, hovering at the 50 per cent level since 2002 and most of which is part of a global supply chain tied to the Western market, through the promotion of regional cross-border infrastructure building and by serving as an action agenda for China-led multinational development agency, the Asian Infrastructure Investment Bank.

Infrastructure integration like this could lead to other forms of integration in Asia such as stockmarket connection or mutual recognition of investment funds, Mr Chan noted. He said a host of new financial services business introduced by Hong Kong in recent years, such as Islamic bonds and measures to lure companies into setting up corporate treasury management and establishing corporate self-insurance known as captive insurance, were being taken with an eye for regional integration.

Competition for funding will be acute. A similar initiative was simultaneously launched in October 2013, in South Korea, by President Park Geun-hye, called "Eurasia initiative", which also envisions a regional integration of energy and logistics infrastructure including rail, oil and gas pipelines and electricity for the continent.

Asif H Quershi, professor at the Korea University, says: "It seems to require a large amount of funding either from China or member countries. Investment agreements for infrastructure projects as we all know are a hot item in investment disputes. Because this is a new attempt, a new initiative, there are many new issues that we'd have to tackle."

China's version seeks to build key transportation infrastructure in roads, railways, ports, aviation and cross-border fibre optic telecom backbone, to protect the safety of gas and oil pipelines and underwrite the construction of cross-border power lines and grids.

Trade and investment are another two key areas highlighted in the Chinese action plan. It calls for the establishment of free trade zones, WTO-sanctioned one-stop customs clearance procedures (such as mutual recognition of safety certificates for so-called authorised economic operator), cross-border e-commerce, as well as the elimination of trade barriers and double taxation. In addition, it highlights a whole range of industries for joint investment including forestry, agriculture, mining, clean energies, to information technology and biotech.

For all this, China's Asian Infrastructure Investment Bank will work with a very modest capital base, totalling US$100 billion from 57 countries, of which China's share is set to rise to about one-third. Separately, Chinese policy banks have committed US$40 billion to launch a Silk Road Fund. By comparison, the Asian Development Bank has US$165 billion in capital from 67 shareholders.

The scale of the task will be unprecedented; it will amount to the export of the massive infrastructure foundation that China has built up over the decades in its export-competitive regions. So will be the commitment, time and financial resources required of China and its partners to make the new initiative happen.