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Financial Turmoil & Emerging Market Resilience: A Macroeconomic Perspective

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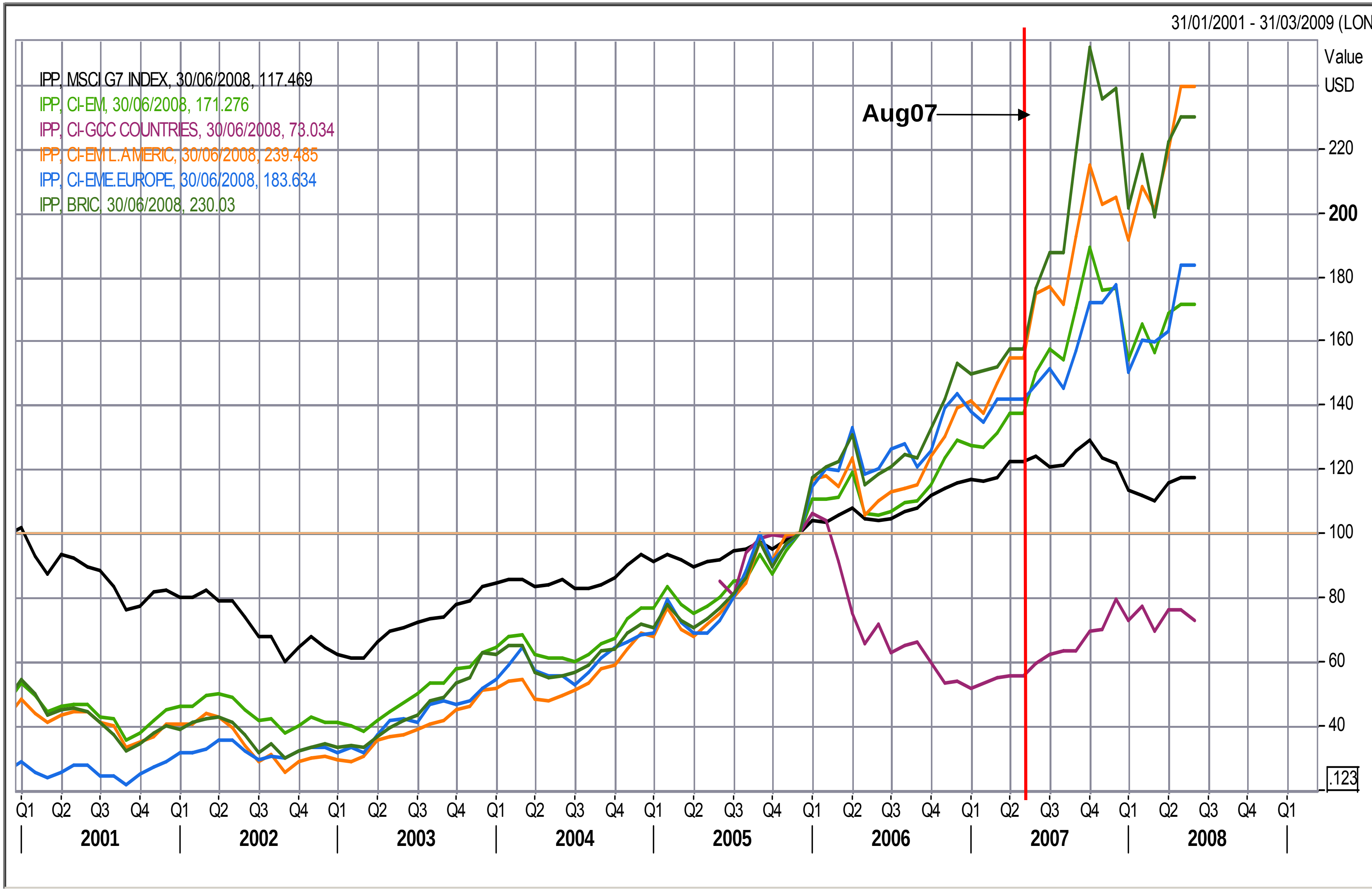
Agenda

- Global financial markets & fallout from the sub-prime crisis
- Impact of the financial crisis on EMEs and GCC/MENA region
- Opportunities for institutional investors
- Growing concerns: inflation, growth and oil prices, regulatory reforms
- Concluding remarks

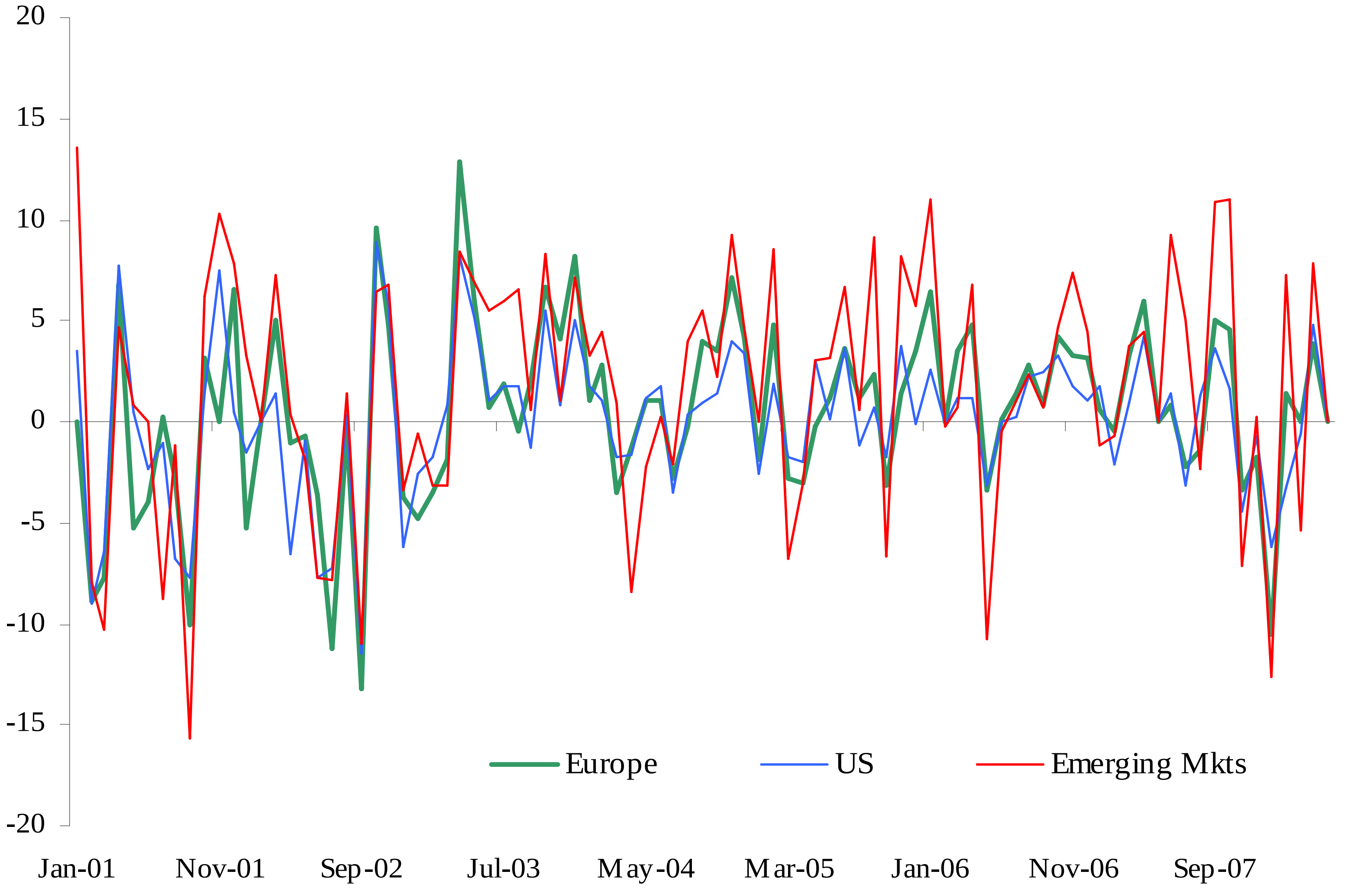
Emerging Markets remain resilient

- Emerging market economies (EMEs) have shown remarkable resilience in the face of financial turmoil
- Strong macroeconomic fundamentals and external positions lend credibility & financial buffer
- De-coupling is more visible – no longer the case that when the US catches a cold, the rest of the world sneezes!
- Shock to equity markets was accompanied by a rise in bond yields, especially in EMEs
- Bond prices have been less volatile in EMEs compared to the mature markets. However, there has been a substantial decline/postponement in bond issuance
- Debt spreads in the emerging corporate markets have widened; EME corporations are facing greater difficulty in getting external financing as a result of contagion from mature markets.
- Evidence of re-pricing of absolute risk in global capital markets, as well as a huge shift in relative risk - in favor of emerging market assets
- Increased risk aversion has resulted in a flight to quality and highly liquid instruments thereby adding to the attractiveness of EMEs

Emerging Equity Markets outperform G7



EME equity returns remain more volatile



MSCI Indices - Returns and Volatility

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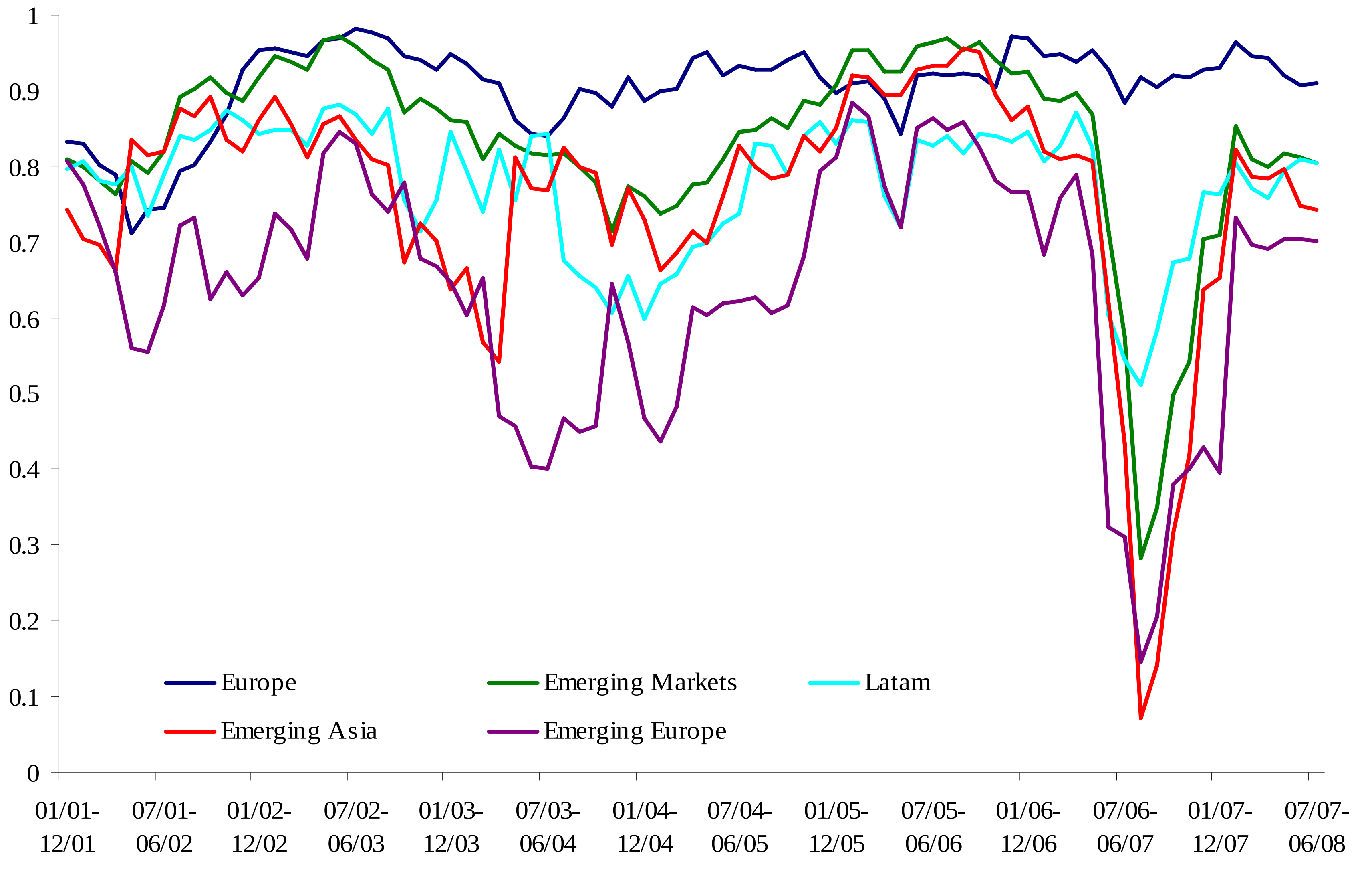
Returns on MSCI Indices

	2006	2007	2008 (June)
MSCI US	1244.14	1393.76	1300.65
MSCI Emerging Markets	800.18	1079.63	1162.09
MSCI Emerging Asia	322.27	445.81	455.48
MSCI Emerging Europe	270.97	326.68	359.36

Volatility of MSCI Indices

	2006	2007	2008 (June)
MSCI US	6.28	6.83	11.25
MSCI Emerging Markets	19.02	13.57	26.50
MSCI Emerging Asia	17.10	14.98	30.47
MSCI Emerging Europe	23.96	15.87	24.90

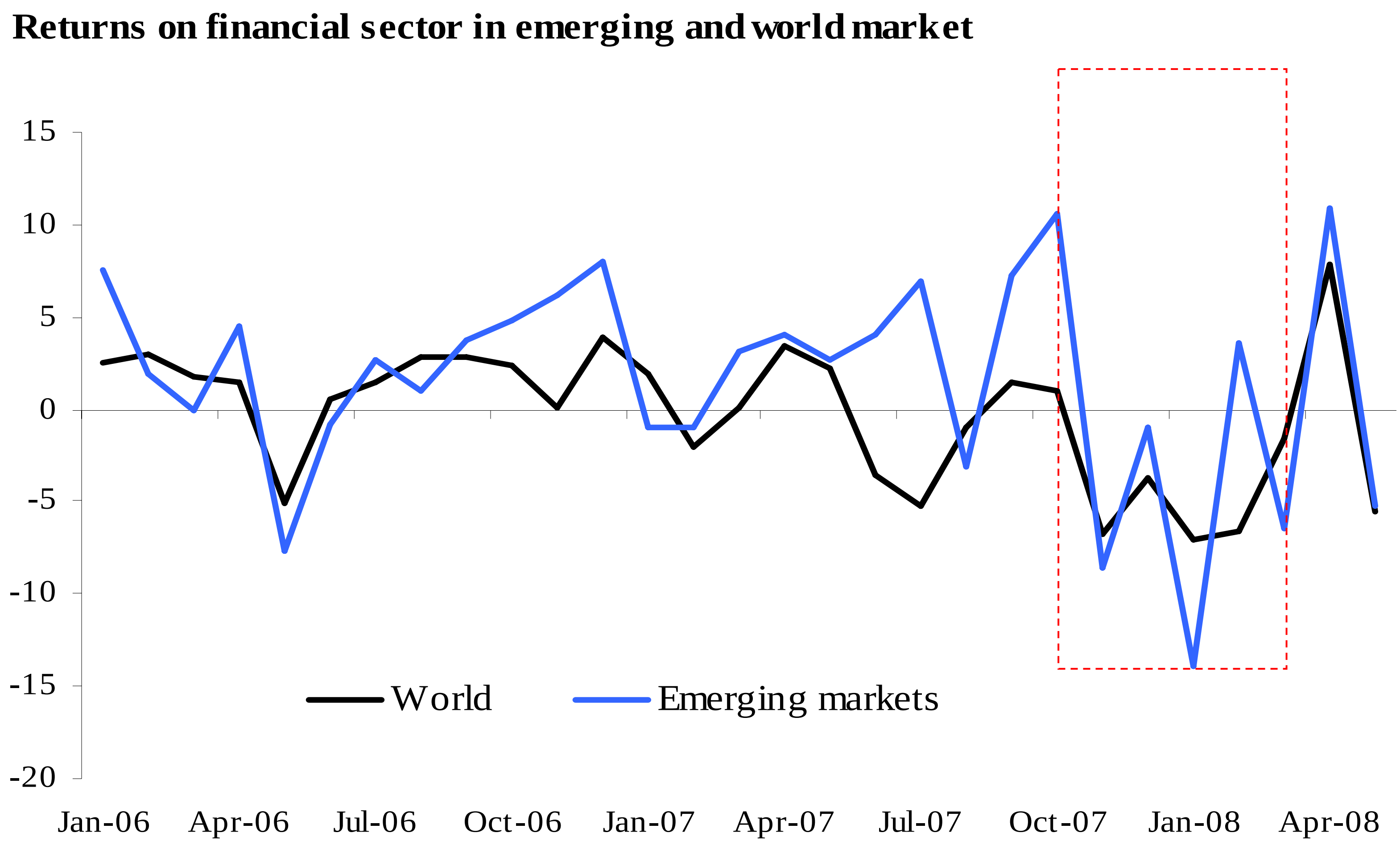
Selected Equity Indices 12m rolling cross correlations of returns with MSCI G7



Equity returns in the financial sector

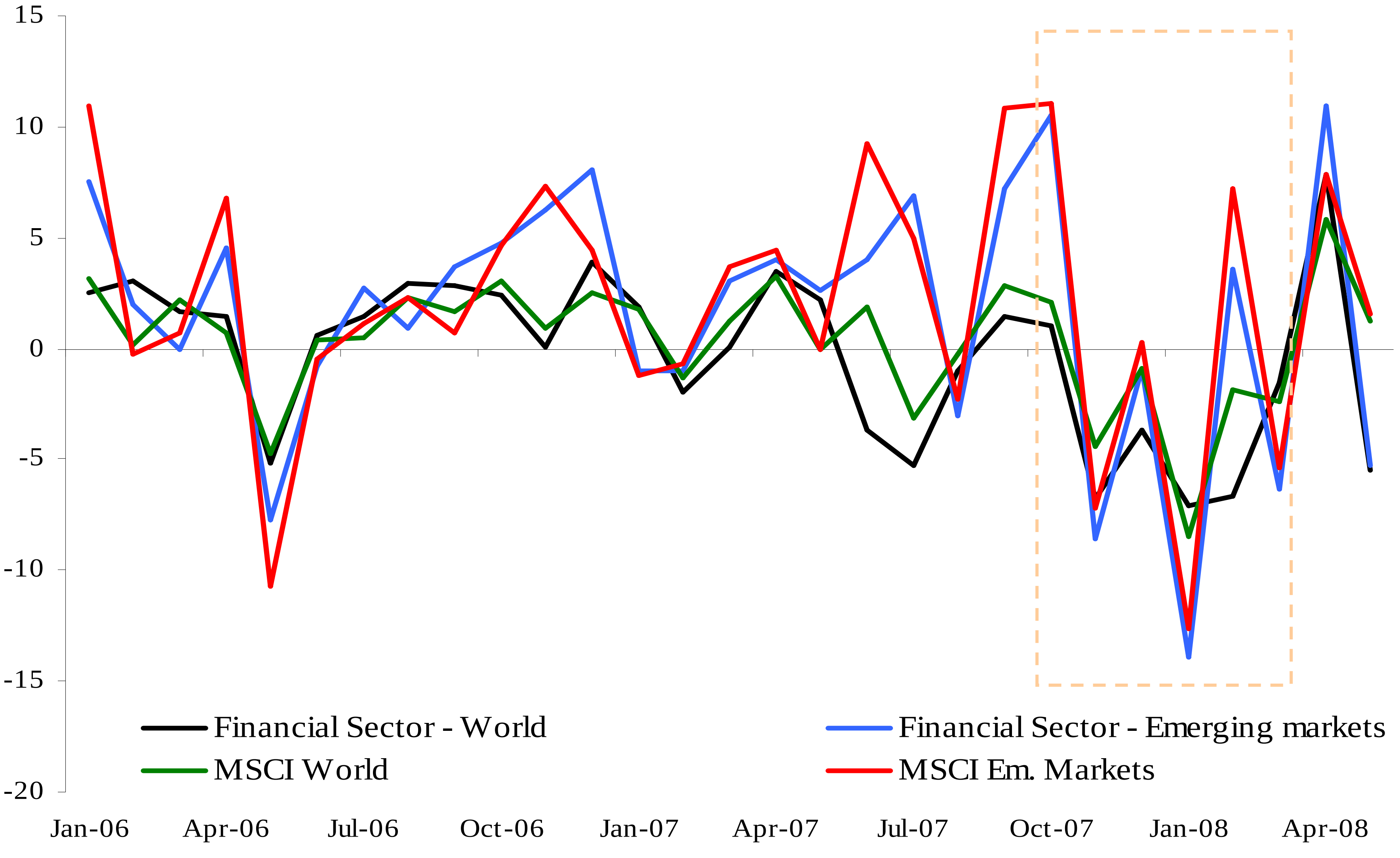
(Source: Reuters, MSCI)

- Since the tipping point was the sub prime crisis in the US, it is little wonder that within the equity market banks and financials bore the brunt

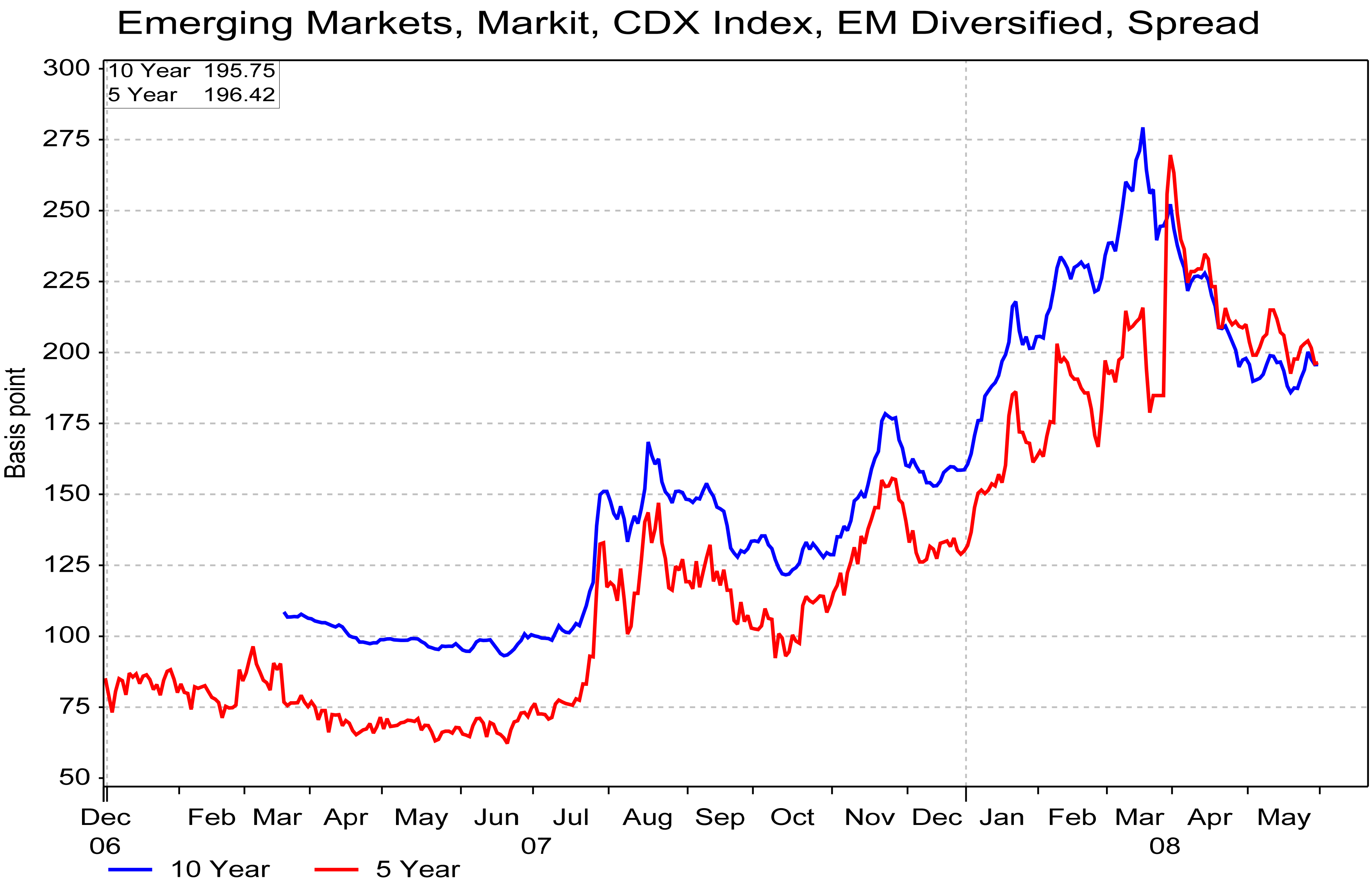


Equity returns – total market vs. financial sector

(Source: Reuters, MSCI)

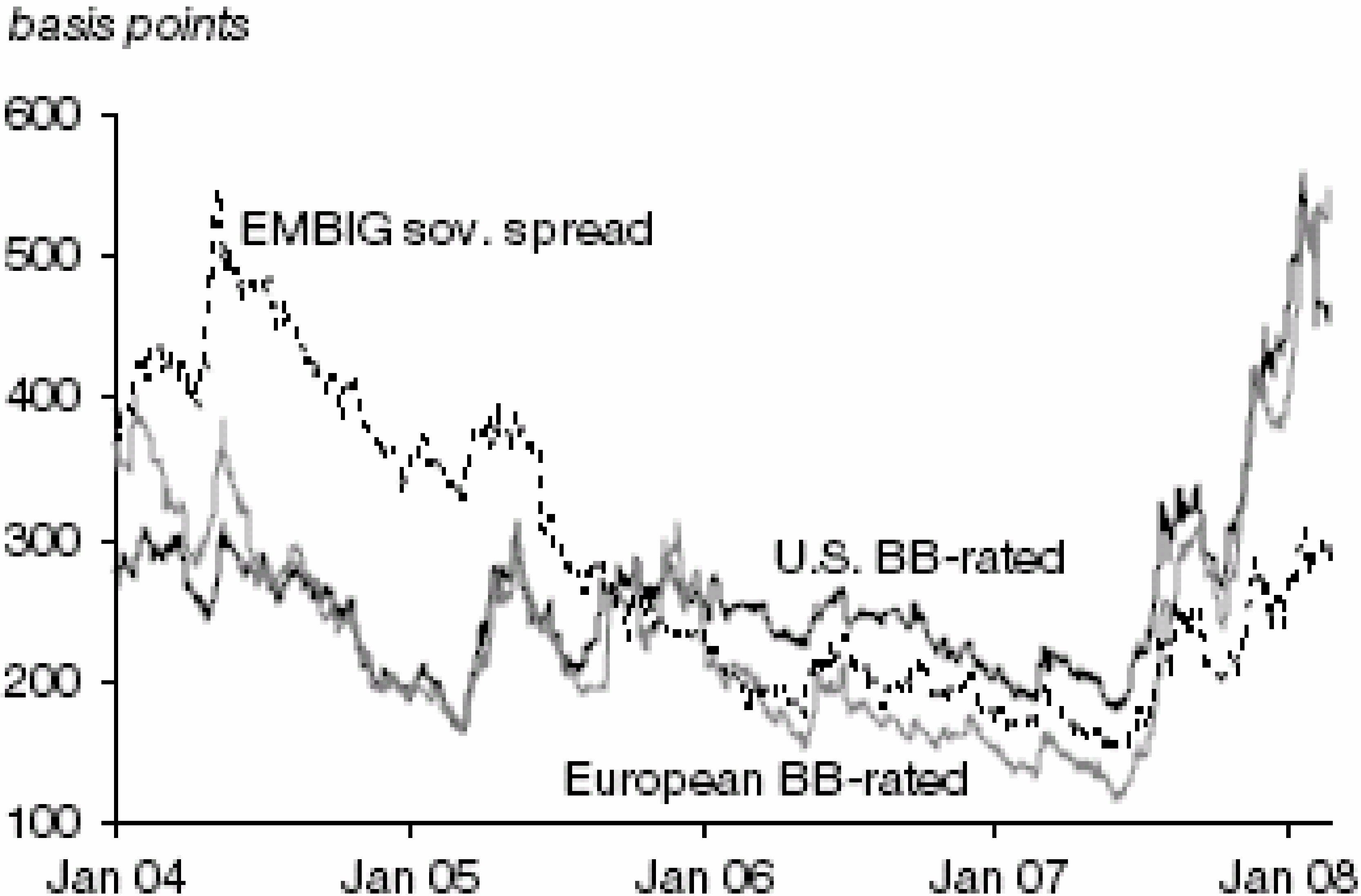


Emerging market bond yields have risen during the crisis period



Source: Reuters EcoWin

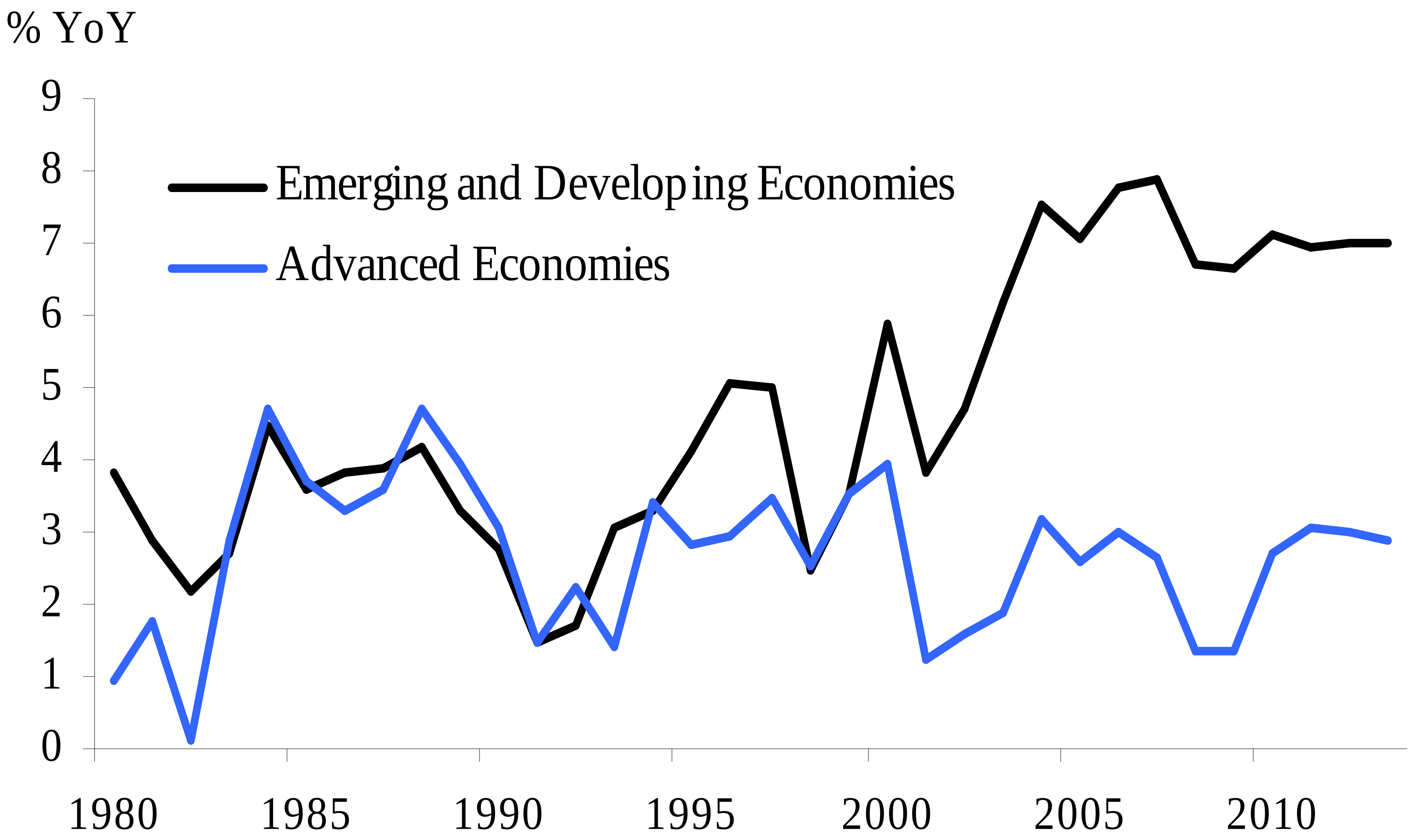
Corporate and Sovereign Bond spreads: shift in relative risk, in favor of the emerging market assets (Source: IIF)



EMEs out-performance: structural rather than cyclical

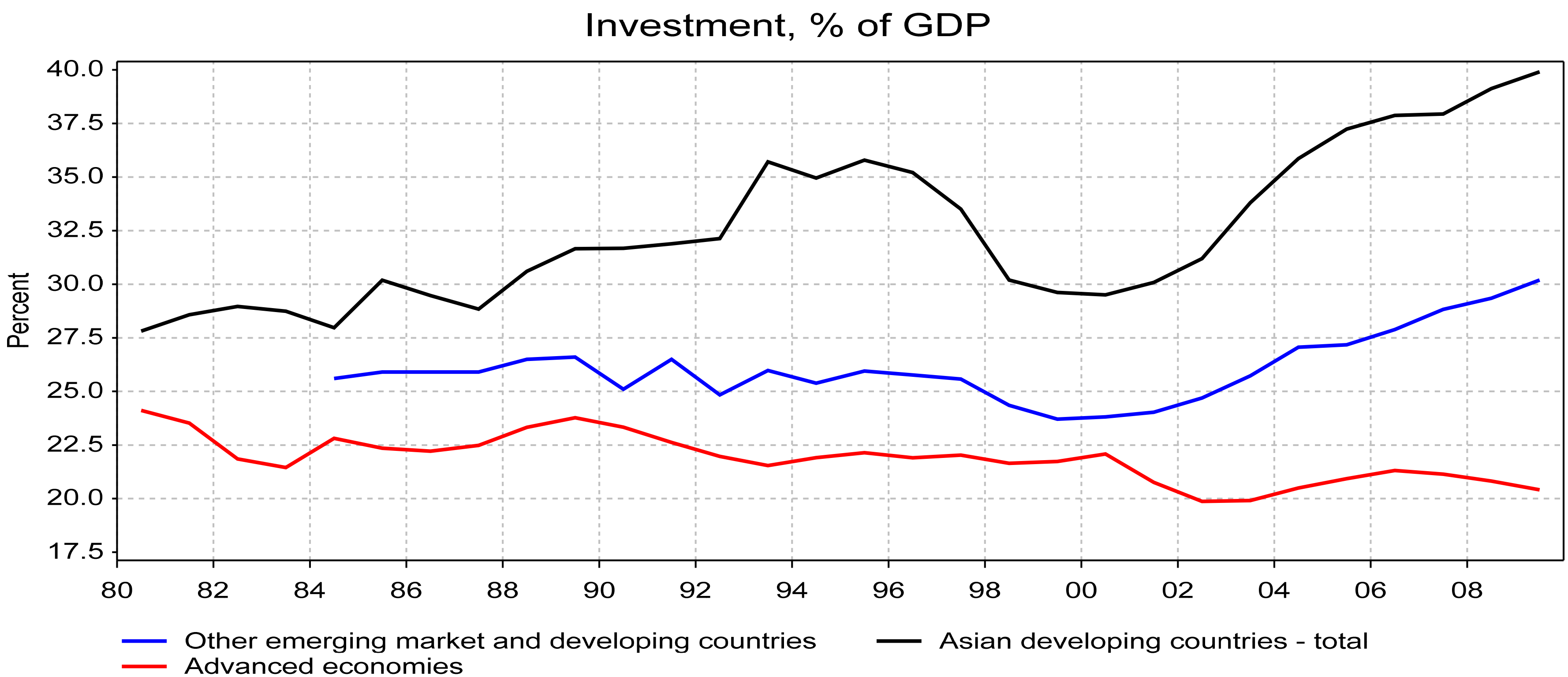
(Source: WEO)

GDP growth shows evidence of decoupling



Infrastructure investment & demographics: main drivers of growth

- Growth in the EMEs has a close correlation with investment. Investment as a % of GDP has grown at a faster pace in the EMEs. Infrastructure investment leading to ↑ productivity growth & economic diversification.
- International investment portfolios can hence benefit from the important role of infrastructure investment in the emerging markets.

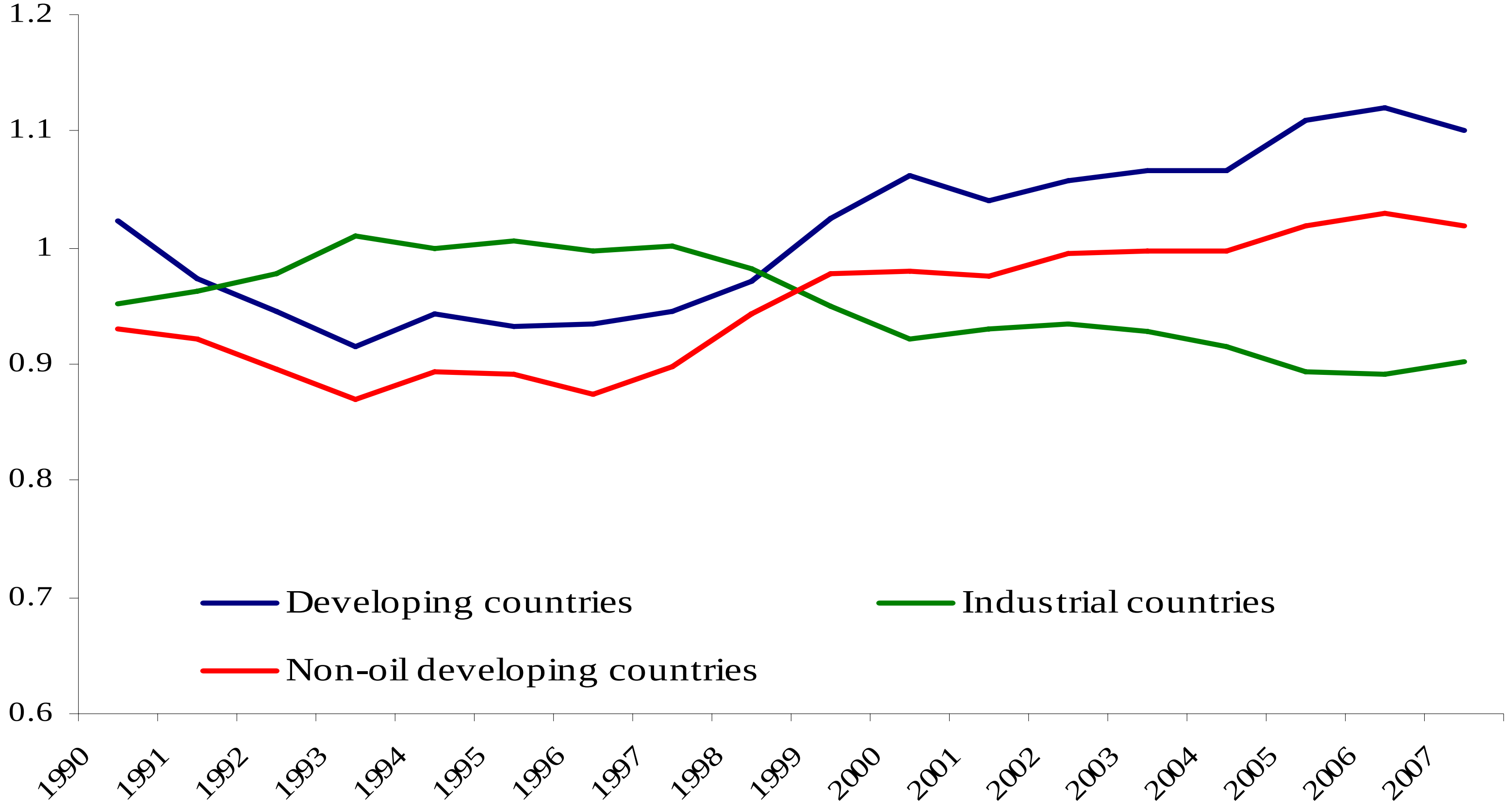


Source: Reuters EcoWin

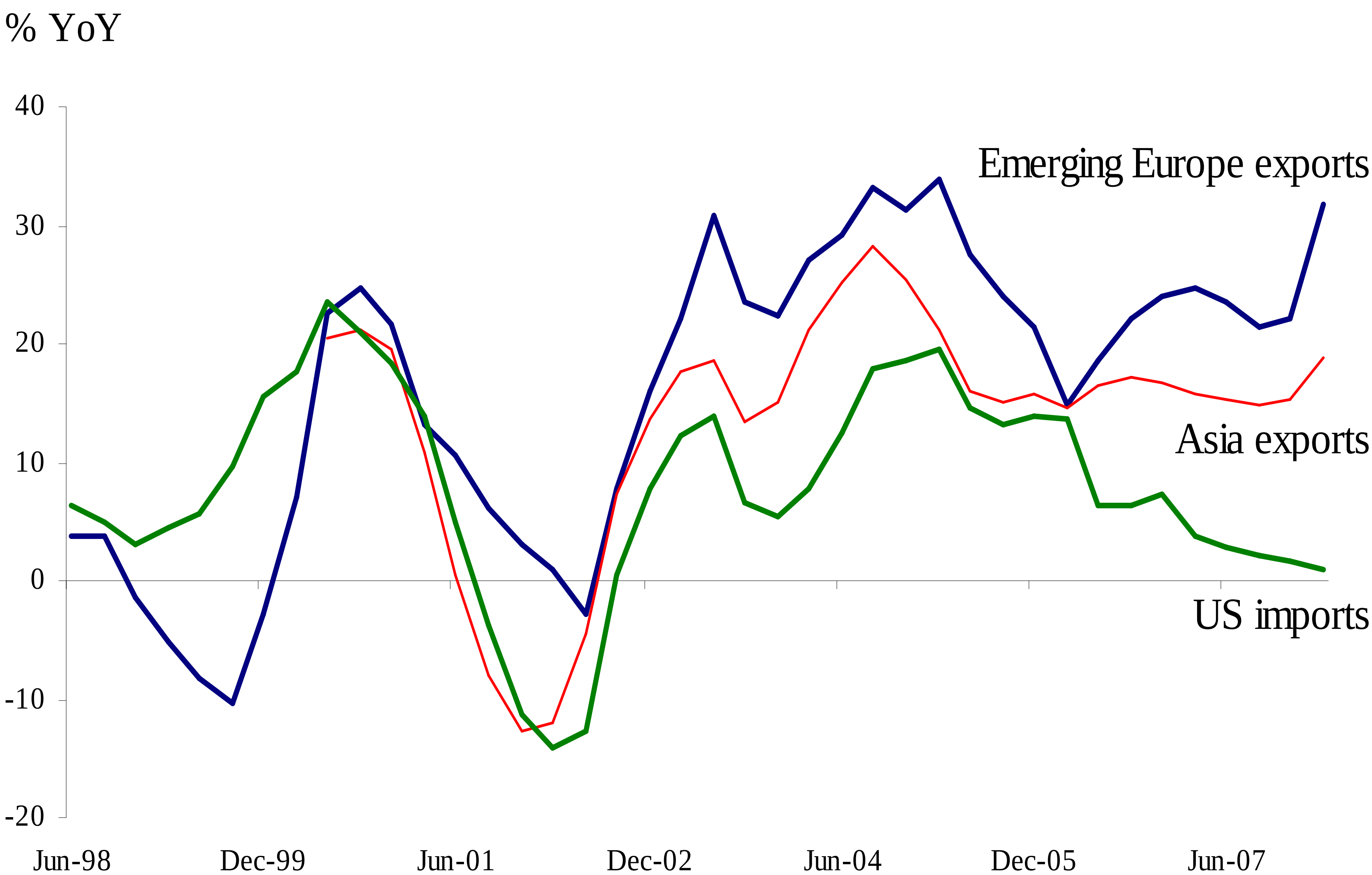
Terms of trade favour EMEs

(Source: IFS)

- Shift in income towards the largely commodity-exporting developing nations.
- This will mitigate the risks from the slow growth of the US economy post-financial crisis.



EME exports no longer dependent solely on US consumers



Macro and Financial Indicators in select EMEs

(Source: GFSR Apr 2008): Concern for emerging Europe

	Current Account (percent of GDP)	Growth in Private Credit (percent year-on-year)	Change in Private Credit as Share of GDP (percentage points)	External Position vis-à-vis BIS Reporting Banks (percent of GDP)
Europe, the Middle East, and Africa				
Bulgaria	–21.4	62.5	19.7	–11.9
Croatia	–8.8	17.8	3.4	–50.8
Estonia	–16.0	41.8	15.1	–68.7
Hungary	–5.6	16.8	1.6	–42.5
Kazakhstan	–6.7	55.2	12.5	–9.5
Latvia	–22.9	45.0	10.7	–53.9
Lithuania	–13.3	45.3	10.9	–34.7
Poland	–3.7	39.6	8.0	–12.7
Romania	–14.5	60.4	10.7	–25.7
Russia	5.9	51.0	7.1	8.3
Serbia	–16.5	40.1	6.0	–7.6
South Africa	–7.4	22.0	5.4	9.6
Turkey	–7.6	26.5	4.1	–13.9
Asia				
China	11.1	19.5	2.1	0.8
India	–1.4	21.7	2.6	–3.0
Indonesia	2.3	22.4	2.0	–7.9
Korea	0.6	13.5	8.7	–13.9
Malaysia	13.7	11.8	3.4	0.5
Philippines	4.4	3.3	–1.5	–0.4
Thailand	5.6	3.9	–1.4	5.1
Latin America				
Argentina	0.7	37.0	1.4	–7.1
Brazil	0.3	28.5	5.1	–7.8
Chile	4.7	20.8	5.9	–8.0
Colombia	–3.8	23.5	4.7	–7.3
Mexico	–0.8	19.0	2.2	–5.8
Peru	1.6	22.3	6.2	–0.5
Venezuela	9.2	72.5	4.9	2.9

Sources: Bank for International Settlements (BIS); European Central Bank; IMF, *International Financial Statistics* and *World Economic Outlook*; and IMF staff estimates (preliminary data as of March 3, 2008).

Note: The gray boxes of the table point to areas of potential concern. Cutoff values are as follows: current account balance below –5 percent of GDP; private sector credit growth greater than 20 percent year-on-year; growth in the ratio of private sector credit to GDP of more than 10 percent year-on-year; and net external position to BIS banks less than –10 percent of GDP.

MENA - Limited Repercussions

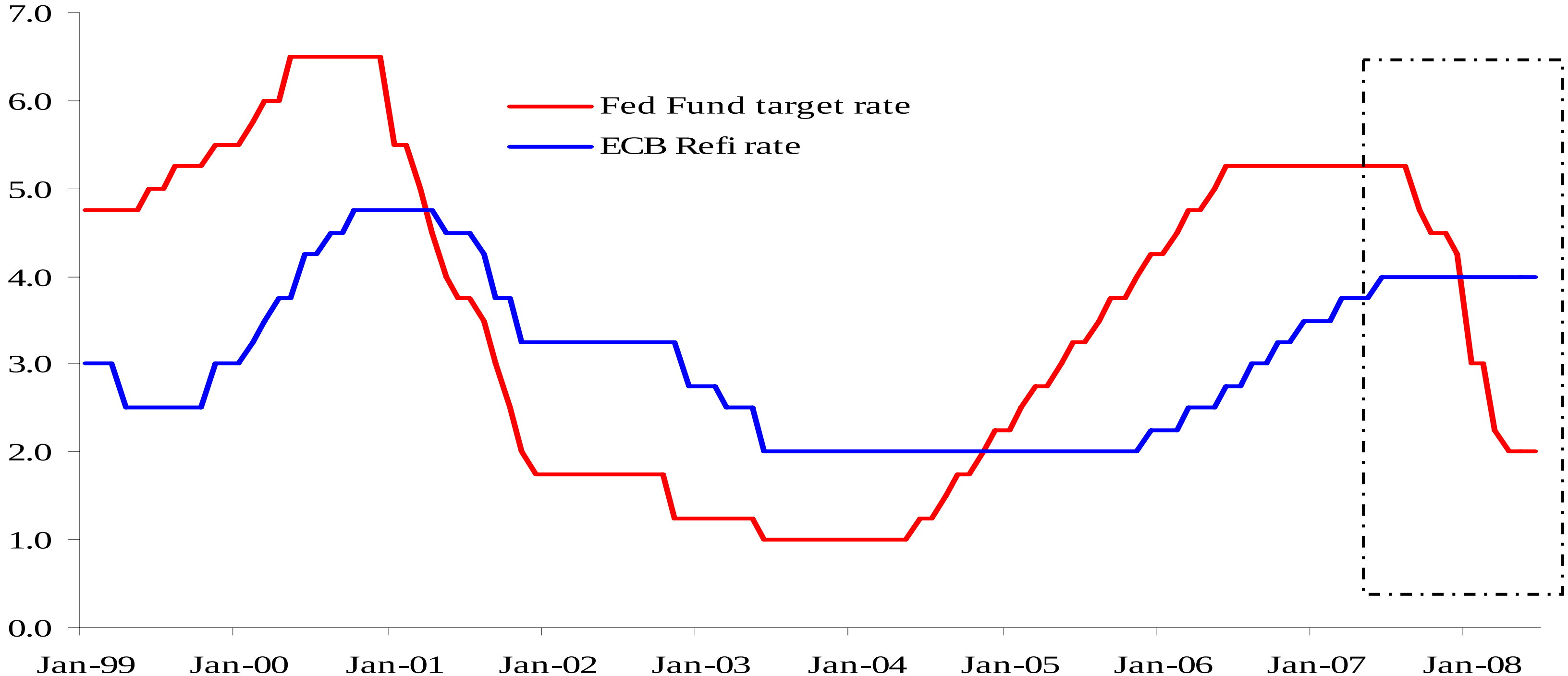
- MENA, especially the Middle East region, has been minimally affected by the recent crisis due to:
  - Strong macroeconomic fundamentals
  - Ample liquidity in the region & profitable domestic markets
  - Small stock of outstanding securitised/structured products
  - Limited exposure & expertise in managing structured investment products
  - Regulatory/prudential requirements limited exposure to sub-investment grade investments & instruments
  - Growing importance of Shari'a compliant banking & finance
- Risk factors:
  - Gulf banks' increasing number of "young loans", including fast-growing exposures to the real estate sector
  - Active FDI, M & A activity outside the region
  - Given strong capital inflows and the 'safe haven' features of EMEs, the volatility of such flows can be a source of risk
  - Pegged rates have resulted in negative real interest rates and below 'natural real rates' which is exacerbating the 'exuberant' monetary & financial conditions pressures

Opportunities for institutional investors

- Financial turmoil revealed the resilience of emerging markets
- Focus of the long-term institutional investor will shift to EMEs given strong fundamentals => less vulnerability to external shocks
- Equity markets volatility due to increasing risk aversion rather than correction => current crisis is likely to have driven away short-term speculative investors
- Bond yields started to rise after the sub-prime crisis hit the financial market; it might hence be a wise to invest in a diversified portfolio – with defensive assets (cash, FI) and inflation hedges
- Inflationary fears cast doubts about economic growth. So, until markets have a clearer view of economic developments, it is unlikely that a meaningful equity rally will occur.

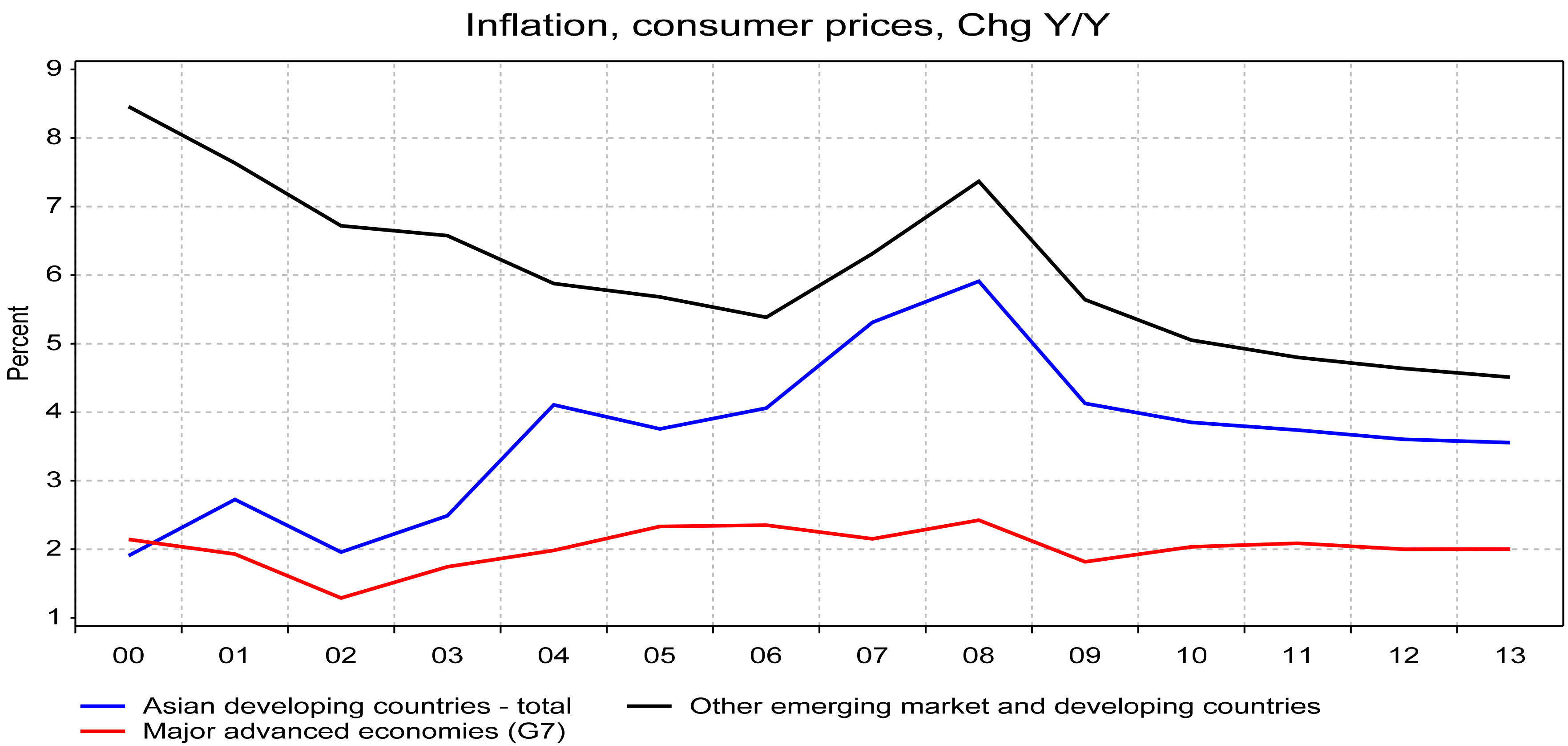
Central Banks' dilemma: Aid growth or contain inflation?

- **Monetary policy decisions have been poles apart in the US and the Eurozone**
- **The Fed followed an aggressive easing of rates (from 5.25% in 1Q07 to 2% in 2Q08) in an attempt to boost spending to aid growth**
- **Concurrently, its counterpart, the ECB, has kept the rate at 4% - its bigger concern and focus being on inflation than growth**
- **Across most developing nations, central banks have been maintaining a hawkish stance in an attempt to contain inflation.**



Inflation: Growing Concern

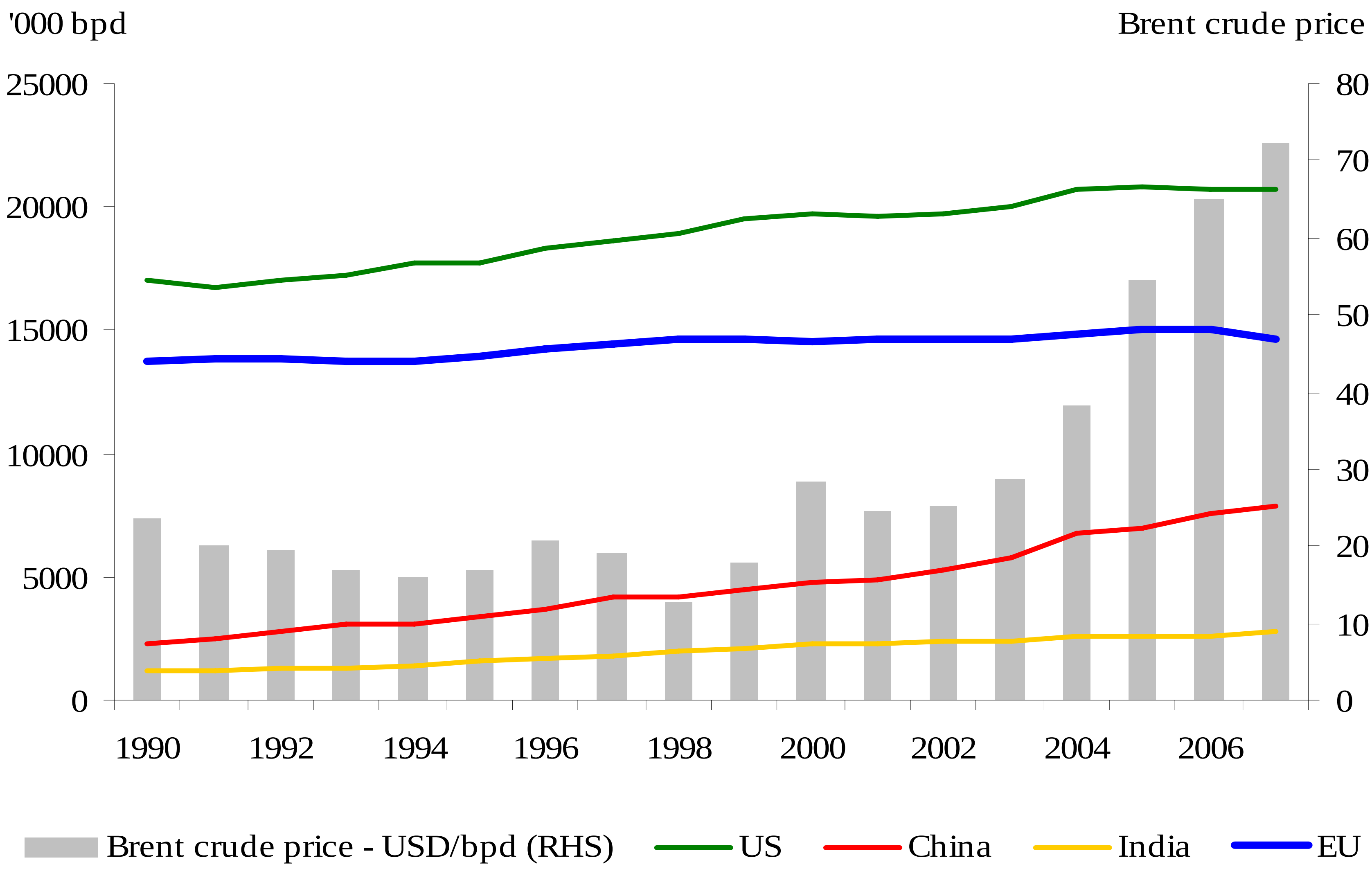
- Inflation has been a growing concern for central banks and investors across the world
- Inflation rate has grown at a faster pace and at higher levels in the developing countries, mainly because of the larger share of essential commodities like food and fuel in their CPI baskets.



Source: Reuters EcoWin

Higher oil prices: no substantial drop in demand

(Source: BP Statistical Review 2008)



Oil revenues and Sovereign Wealth Funds

- Revenue from oil has been rising rapidly, given the spike in oil prices
- Energy revenues over 2001-2007 in the GCC (net of fiscal expenditures) was in the order of 500 billion US dollars.
- Total value of SWFs estimated by IMF at between $1.9 trillion and $2.9 trillion, growing to about $12 trillion by 2012
- A recent McKinsey report estimates the volume of NFA created from oil revenue in the GCC states to surpass $10.5 trillion by 2020 (oil at $100 a barrel).
- To diversify against commodity price volatility and revenue risks, the GCC countries invest profusely through SWFs
- SWFs allow countries to separate the management of their revenues from natural resources from their fiscal and monetary policies: act as “automatic sterilization mechanisms”
- SWFs have exerted a stabilizing influence on markets
- SWFs face investment & financial protectionism: guidelines in Oct ‘08

Bottomline

- The credit crisis, has had limited consequences for EMEs
- EME resilience, based on strong economic fundamentals and external positions, should give sufficient incentive to big institutional investors to increase their exposure
- Regulatory failure will result in reforms encompassing: transparency & disclosure, accounting rules, role of rating agencies, ‘extension of regulatory frontier’, Basel II, single/independent regulator model, CG
- Growing concerns stem from inflation, oil and commodity prices and their impact on growth
- Exchange Rate flexibility is necessary to deal with real shocks and external volatility
- SWFs have been crucial in containing the contagion risks, supporting equity valuations worldwide and recapitalizing distressed banks.
- Change in global economic geography will be supported by new financial market geography: EME capital market development is an imperative