Emerging Markets

Navigating a minefield

Emerging markets (EM) growth will improve slightly in 2016 due to a slowing pace of contraction in Russia and Brazil. However, on average, EM will continue to face a challenging environment. **The issues that came to fore in 2015 will continue to be the main causes of underwhelming growth in 2016 – namely, low commodity prices, lacklustre external demand, and high debt levels – but next year EM will also have to contend with rising US interest rates.** A stabilisation in commodity prices will allow for some relief for commodity exporters such as Russia, where a reduction in inflation and policy rates should support an economic recovery over 2016. Emerging markets as a whole are set to become increasingly heterogeneous, as regional and sectoral performance continues to diverge. China's slowdown, Brazil's political and economic meltdown, and Middle East geopolitical risks will continue to affect global sentiment and regional performance.

Further dampening growth is the fact that the scope for policy easing is limited in most countries. Fiscal policy is relatively tight across EM, as few countries have room to raise public debt levels and monetary policy is constrained by a combination of elevated private debt levels (see Chart 10) and risks surrounding Fed normalisation. Additionally, in many instances structural reforms are necessary to boost growth, but with a few exceptions, namely India, Mexico, and China, results have been disappointing. This has left currency weakness as the primary adjustment mechanism in many cases. Although external imbalances are adjusting in countries that have experienced currency depreciation, the pass-through to inflation is further restricting monetary policy. Countries with a strong reform agenda and flexibility to implement fiscal and monetary easing are positioned to outperform relative to their EM peers. Indonesia is a good example; it has begun to loosen public spending on infrastructure projects and, due to its relatively low debt-to-GDP ratio, it is also positioned to cut policy rates and increase credit growth. Externally, Indonesia is still running a current account deficit but currency weakness has begun to close the gap.

Although the outlook remains subdued, there are some signs that EM economies are bottoming out. Manufacturing PMIs have improved since September (although not yet expansionary) and EM industrial production began to accelerate from its trough in the first half of the year (see Chart 11). The largest cause of the trade and IP contraction experienced this year was the slowdown in China, which we believe was worse than official data reflected. As such, we see some room for cyclical upside. It's important to clarify we do not see any scope for improvement in the official data. But as we believe the slowdown in industrial activity was not fully captured in official data, we think there is some upside for economic activity to improve on a cyclical basis as true industrial activity moves back towards trend. In China, we expect policymakers to continue walking the tightrope of balancing enough fiscal and monetary stimuli to prevent a sharper growth collapse, while slowly proceeding with supply-side reforms. Nonetheless, significant risks remain as debt levels continue to grow and weak demand could begin to cause strains in the financial sector. China will remain one of the biggest threats to EM growth as Chinese leaders struggle to balance a complicated policy agenda.

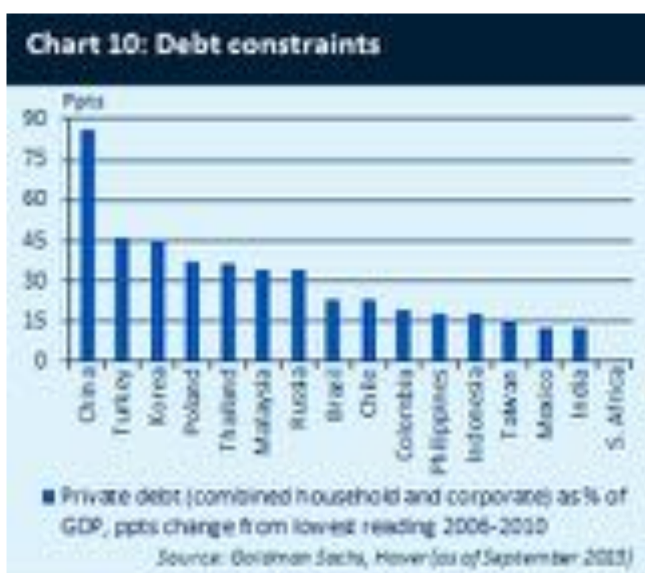

Chart 10: Debt constraints

Chart 11: Troughed?

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