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WEEKLY INVESTOR RESEARCH

Ashmore

China's FX reserves reach new high as Indian inflation declines

By Jan Dehn

The World Bank paints a more positive picture for the global economy in 2014, including Emerging Markets (EM), but parts of the media appear spellbound by the risk scenarios. Meanwhile, in EM China's reserves set a new record, Indian inflation headed lower, Russia took another step towards a fully flexible currency, Turkey's public finances remained solid, Brazil hiked 50 basis points again, and JP Morgan added South Korea to its ELMI+ index.

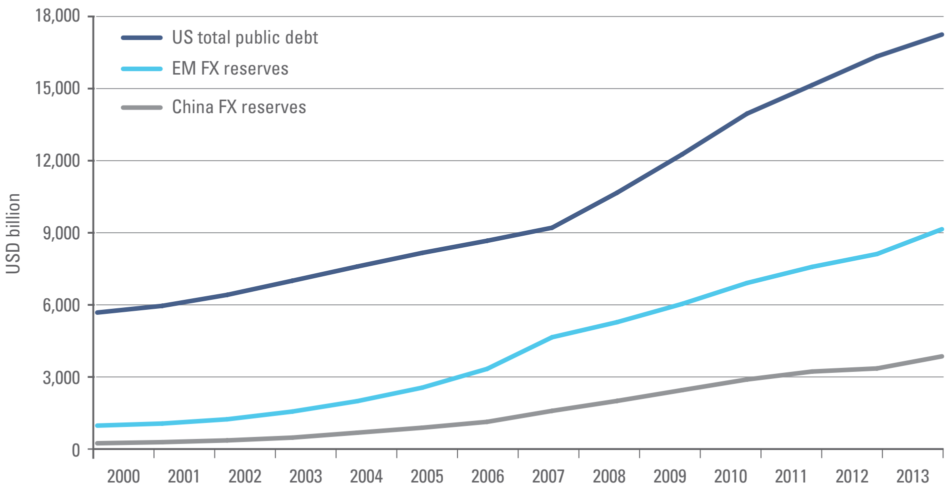
Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	971		-0.63%
MSCI FM	611		1.32%
GBI-GD	6.82%		-0.91%
ELMI+	4.41%		-0.68%
EMBI GD	5.81%	317 bps	0.37%
EMBI GD IG	4.92%	212 bps	0.42%
EMBI GD HY	7.86%	552 bps	0.28%
CEMBI BD	5.59%	319 bps	0.30%
CEMBI BD HG	4.74%	234 bps	0.19%
CEMBI BD HY	7.34%	498 bps	0.42%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,839	1.08%
VIX Index	12.44	-6.33%
5 year UST	1.63%	4 bps
10 year UST	2.82%	-1 bps
10 year Bund	1.75%	-7 bps
EURUSD	1.3559	-0.70%
USDJPY	104.22	1.03%
Brent	$107	1.31%
Copper	$342	0.99%
Gold	$1256	0.32%

Emerging Markets

- **China:** China is continuing to gradually tighten monetary policy. Fresh data on monetary aggregates shows that base money increased marginally slower than real GDP, while broader money aggregates grew marginally faster than nominal GDP. The narrow money aggregate M0 was up 7.1% yoy versus 8.0% yoy expected, while M1 was up 9.3% yoy versus 9.0% yoy expected. The broader M2 aggregate rose 13.6% yoy versus 13.9% expected. Consistent herewith total social financing in China in December rose to RMB 1.23trn versus RMB 1.14trn expected and RMB 1.23trn in November. The other notable observation was the Chinese foreign exchange reserves continued to rise in December. Total FX reserves now stand at USD 3.82trn, a new high. This means that China accumulated USD 508bn in FX reserves during 2013. Over the same period, total EM FX reserves rose by USD 1.05trn and now stand at USD 9.12trn. Over the same period, US total public debt rose marginally faster (to USD 14.9trn). Like Russia, we believe China is also pursuing a strategy to allow for more flexible exchange rates, more open markets, and domestic bond market developments in the future. The rationale for China's reforms is to ensure that the country can rebalance its economy away from overinvestment and exports to consumption in order to continue to grow in the face of future substantial RMB appreciation against the US dollar as the US begins to deflate away its debt.

Fig 1: **EM and Chinese FX reserves vs. US public debt**



Source: Bloomberg.

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Emerging Markets

- **India:** Indian inflation is now heading decisively lower. In the past week, Wholesale Price Inflation declined from 7.52% yoy in November to 6.16% in December. December's CPI inflation rate also dropped sharply from 11.2% in November to 9.9% yoy in December (the difference between the two indices largely reflects different weights of food prices). The decline in inflation strongly vindicates the decision of Reserve Bank of India (RBI) Governor Raghuram Rajan not to raise rates in December (See Weekly Investor Research, 23 December 2013). Rajan's decision not to hike was criticised at the time as reckless, but he knew what he was doing and the decline in inflation shows that he was right. Rajan's strong leadership at the RBI is helping to re-establish the credibility of the Indian central bank, which was damaged somewhat under its previous management. RBI credibility is an absolutely necessary requirement for restoring business confidence in India, at home as well as abroad. In addition to restored confidence in macroeconomic management, India is in the enviable position that it can harvest a great many low-hanging fruits. The banking system is being modernised and a Goods & Services Tax is likely to be introduced. These reforms will materially improve the outlook for the economy and fiscal balances. India could also massively improve the efficiency of its monetary transmission mechanism and boost its currency by opening its local bond markets to foreign investors. On that note, the RBI last week gave permission for free cancellation and rebooking of all FX forward contracts out to 1 year maturity for both capital and current account transactions.

- **Russia:** Russia took another step towards a fully flexible Ruble, when it announced last week that it will no longer undertake targeted currency interventions. The measure follows a number of other important steps in what can only be described as an amazing change in Russian macroeconomic policy since the 2008/2009 crisis. Why has Russia gone away from a peg towards a flexible Ruble, and why does it matter? The backdrop is that the Ruble lost all credibility in 2008/2009, when the central bank was forced to abandon the peg under heavy selling pressure amidst falling oil prices. Up to that point, the government had insisted that a stable currency was a sign of strength. After abandoning the peg, the central bank needed to find a new way to anchor inflation and so it did by implementing an inflation target regime using interest rates and macro-prudential policies to achieve its goal. However, in the dirty peg regime, in the case of a new external shock the central bank would still be forced either to raise interest rates or to sell US dollars aggressively in the market in order to counterbalance outflows of capital. By contrast, in a fully floating FX regime any external shock (say a large decline in the price of oil) would initially be absorbed by the currency, allowing the central bank to cut rates to support a weakening economy. Similarly, in case of a positive supply shock (oil prices rising), the Ruble would appreciate, naturally stabilising the country's external accounts. Net net, the credit is stronger and Russia's decision to move to Euroclearable bonds increases liquidity by broadening the number of participants in its market. This means that the monetary transmission mechanism from interest rate changes is much more effective.

- **Turkey:** Despite the political noise, Turkey's public finances remain sound. The government ran a primary surplus in 2013 of 1.9% of GDP, in line with its medium term expenditure programme target. Revenues were up 17% yoy due to strong tax receipts, dividend income, privatisation revenues, and other one-off intakes. Primary spending increased at a slower 15% yoy pace with a big chunk due to capital spending. We expect a weaker fiscal out turn in 2014 on account of slower domestic demand growth, but Turkey's public finances are strong and the country's public debt dynamics should continue to improve. Total government debt is roughly 35% of GDP compared to an average of about 46% of GDP across EM and more than twice that amount in the US and Europe.

- **Brazil:** Brazil's central bank defied market expectations by raising the SELIC policy rate by 50bps (instead of 25bps as expected) in last week's monetary policy meeting. Rates have now been raised from 7.25% in April 2013 to 10.50% following last week's decision. The Central Bank signalled that its decisions will now be more data dependent. Brazil's macroeconomic challenges are relatively modest thanks to the low levels of debt and its large stock of foreign exchange reserves. Moreover, there is a broad commitment to keeping inflation under control by the Central Bank. But the main challenge facing the government is how to restore business confidence. Heavily interventionist policies have destroyed business confidence and hence the desire to invest.

A modest, but credible fiscal adjustment together with the relaxation of the intervention in State owned companies would allow for a big bounce in confidence and sentiment. Brazilian retail sales rose at a stronger than expected 1.3% mom sa rate in November following a strong print in October (2.0% mom sa), indicating that the underlying economy remains resilient in spite of the government's fiscal slippage.

Lastly, JP Morgan has announced changes to the composition of its Emerging Markets FX forwards index (ELMI+). As of 31 March 2014, South Korea will be included in the index, where its weight will gradually be increased from 2.5% in March to 10% by the end of June 2014. The Argentinean peso (ARS) will be excluded from the index on account of liquidity concerns, while Hong Kong's currency (HKD) will also be excluded because it has a hard peg against the US Dollar. Both HKD (9.69%) and ARS (1.47%) will be phased out of the index by June 2014.

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Global backdrop

The World Bank issued its Global Economic Prospects for 2014. Though not as keenly followed as the IMF's World Economic Outlook we think both publications will convey roughly the same messages.

Specifically, the World Bank believes that:

- Emerging Markets growth will increase from 4.8% in 2013 to 5.3% in 2014
- All regions of Emerging Markets will either grow at the same speed as 2013 or faster
- High income countries will grow 2.2% compared to 1.3% in 2013
- Global growth will increase from 2.4% in 2013 to 3.2% in 2014

Fig 2: **World Bank: Global economic prospects 2014**

Region/country	2014 % real GDP growth	2013 % real GDP growth
Emerging Markets	5.3	4.8
Sub-Saharan Africa	5.3	4.7
South Asia	5.7	4.6
Middle East and North Africa	2.8	-0.1
Latin America	2.9	2.5
Europe and central Asia	3.5	2.4
East Asia and Pacific	7.2	7.2
China	7.7	7.7
India	4.8	6.2
Brazil	2.2	2.4
Mexico	1.4	3.4

Source: World Bank.

The World Bank's positive sentiment about 2014 is sharply at odds with sections of the media's coverage of its report. For example, the *Financial Times* last week chose to highlight the report's alternative risky scenarios rather than its base case (*"World Bank warns of Emerging Markets risk," Financial Times*, 15 January 2014).

Our view is that stronger global growth benefits Emerging Markets. Stronger global growth increases exports, stimulates growth, improves fiscal balances, and reduces debt to GDP ratios.

As for the risks of tapering associated with stronger growth, we think market sentiment and the media are both over-reacting. We believe developed markets are fundamentally more at risk from tapering than Emerging Markets. They have more debt and they received disproportionately many of the QE flows. EM receives the vast bulk of their financing from local sources. Also, despite volatile asset prices, EM began to grow roughly around the time the Fed first announced QE in May 2013. EM growth looks set to continue to increase this year. Finally, EM local borrowing costs have already re-priced to levels that were last seen when 10 year US treasuries traded at 4.5%. At the time of writing, the US treasury market is pricing the 10 year yield to 3.31% twelve months forward.

US data over the past week has been consistently stronger than what was implied by last week's very soft non-farm payroll print. Retail sales, Empire Manufacturing, inflation, the Beige book, Philadelphia Fed Manufacturing, and initial claims were in line or stronger than expected. This keeps the Fed on it pre-announced tapering track, in our view.

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