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Financial divergence: How ready are Emerging Markets for global financial tightening?

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Introduction

Contrary to popular perceptions, Emerging Markets (EM) countries have been deprived of their fair share of global finance. A disproportionate amount of global capital has gone to developed markets, especially since the onset of QE. EM financial market 'divergence' from developed financial markets has taken place in spite of evidence of EM's strong and continuing economic convergence with developed markets.

This is the conclusion we draw from our work of combining the largest available databases on EM economic and financial market variables.

The fact that EM countries have not gorged themselves on cheap money may ultimately prove quite beneficial to EM. After all, past deprivation means that EM will not face as great fundamental challenges in adjusting to a smaller global financial pie as developed economies.

Have EM countries gorged themselves on cheap credit?

The global economy is in a state of extreme disequilibrium. It is not possible to continue to print money without creating inflation, to issue debt without pushing up rates or build external surpluses with ever weaker currencies. These financial disequilibria are merely symptoms of temporary deleveraging and we think will inevitably end. Regardless of its form, financial tightening will shrink the global financial pie.

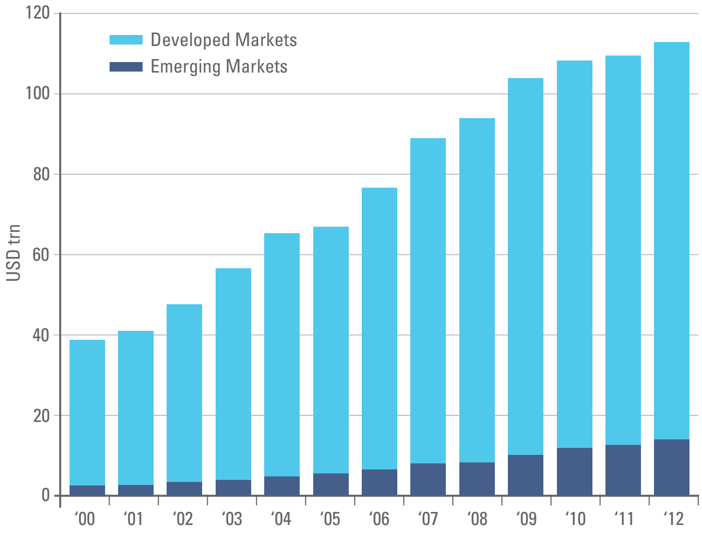
How will this shrinking impact EM? How EM financial markets cope depends on how extended – or addicted – they have become over the last few years of extremely easy global monetary conditions.

To highlight this issue we have combined the IMF's latest WEO numbers with a large and comprehensive database on the size of the EM fixed income markets.[2] Here are our most important conclusions:

- **Developed economies are vastly more 'addicted' to fixed income than Emerging Markets.** Ahead of the start of global financial tightening, it is clear that developed countries are far more exposed to headwinds in fixed income markets than Emerging Markets. Just two dozen developed economies account for 88% of global fixed income (USD 100trn), while EM countries have issued a relatively puny USD 14trn. Bear in mind that EM countries now account for more than 50% of global GDP, so it is clear that the level of 'addiction' to fixed income in EM is far lower. Indeed, total fixed income markets average just 52% of GDP across our 54 country sample of EM countries compared to 222% of GDP in developed countries.

The level of 'addiction' to fixed income is far lower for EM countries – less than a quarter than for developed countries.

Fig 1: **Global fixed income markets (USD trn)**



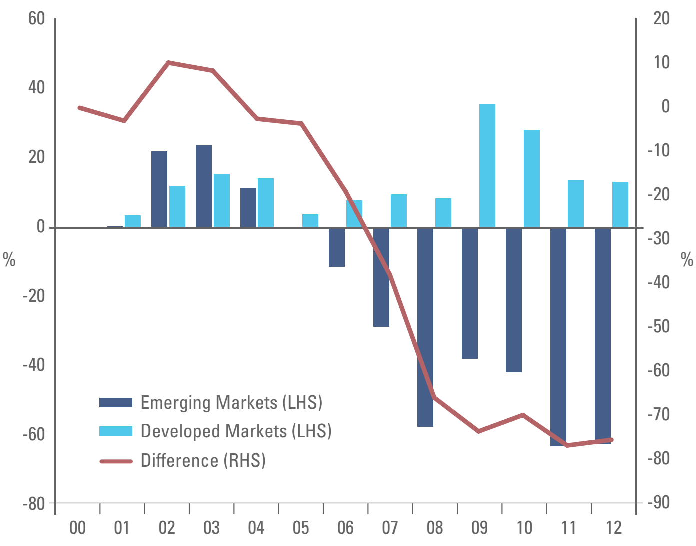
Source: BAML, Ashmore, April 2014.

[1] *A Pleasant Fiction*, The Emerging View, September 2013.

[2] *Size and structure of Global Emerging Markets debt, GEMs FI Strategy Viewpoint*, Bank of America Merrill Lynch, 31 July 2013.

- **The global crisis has accelerated the divergence between EM and developed economies in terms of their dependence on fixed income.** Since 2000, EM fixed income markets grew (as a share of GDP) at exactly the same percentage rate as developed markets (4.4% per year). But because per capita incomes expanded much faster in EM economies than in developed countries, and because developed fixed income markets are so much larger, EM per capita financial deepening has slowed dramatically compared to developed economies. This can be seen from the chart below, which shows the cumulative percentage change in fixed income market depth in EM and developed economies between 2000 and 2012. EM financial markets 'shallowed' by 63% in GDP per capita terms, while developed markets 'deepened' by a cumulative 13% for a cumulative difference in favour of developed markets of 76% by end-2012. This divergence is likely to have increased further in 2013.[3]

Fig 2: **Percentage cumulative per capita financial deepening – EM versus DM**

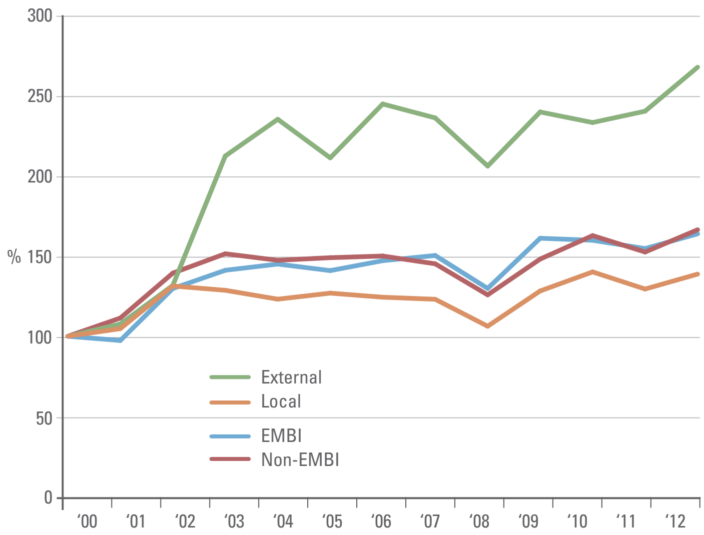


Source: BAML, IMF WEO April 2014, Ashmore.

- **Financial 'shallowing' in EM has increased, especially since QE began.** Financial deepening in developed economies and 'shallowing' in EM have become particularly pronounced since the onset of QE in November 2008. This supports a hypothesis that EM countries have not secured the bulk of QE money – an observation that is also supported by the fact that EM spreads are far wider today than before QE while EM debt levels have continued to fall over the period. This indicates that EM countries are fundamentally less vulnerable to tapering than developed economies. We note in passing that we also found no evidence that EM countries in the main EM fixed income indices had seen faster growth in their fixed income markets than non-index EM countries, but we did find a large increase in the pace of Dollar issuance relative to local bond issuance. This is probably due to the rise in corporate lending across EM. We do not think this is a problem. Corporate bond markets in EM are young. Borrowing has started from a low base in the early 2000s and many corporate borrowers have dollar earnings and/or hedge their FX exposure.

EM markets did not receive the bulk of QE money – leaving EM countries fundamentally better prepared to cope with a smaller global financial pie.

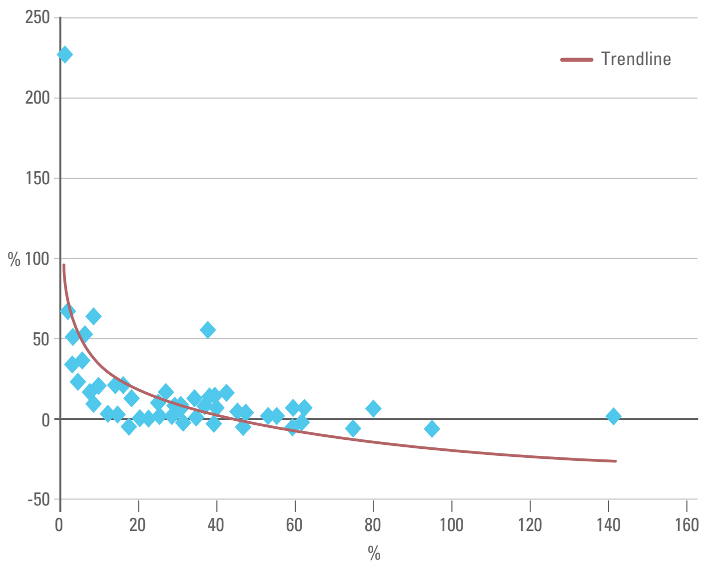
Fig 3: **Pace of fixed income growth as % of GDP – by type of market (index 2000=100)**



Source: IMF WEO April 2014, Ashmore.

- **EM financial deepening has been strongest in the shallowest markets.** We believe this shows that EM fixed income markets are growing in a healthy way, because it points to structural rather than cyclical drivers of markets.

Fig 4: **Growth in fixed income 2000-2012 (vertical axis) versus market size in 2000 for the 54 countries sampled (fixed income per GDP, horizontal axis)**



Source: BAML, IMF WEO April 2014 Ashmore.

3 We calculate the changes in per capita financial deepening as the difference between the growth of financial markets as a percentage of GDP and growth in per capita. If this ratio rises the country's financial markets are growing relative to the per capita economic strength of the country. Per capita is the relevant metric, because debt ultimately has to be repaid by people.

Conclusion

The world is about to change significantly. There will be less money around. EM will be affected. The good news is that we see no evidence that EM countries have gorged themselves on cheap credit. Instead, EM fixed income markets appear to have grown mainly for structural reasons, which is strongly related to starting out with shallow financial markets.

By contrast, developed economies' fixed income markets have expanded significantly faster **relative to their per capita income.** In other words, developed markets have absorbed more than their fair share of global finance rendering them fundamentally more vulnerable to global financial tightening than EM countries, in our view. This divergence between developed and Emerging Markets in financial terms has occurred even as EM countries have expanded faster in economic terms.

Today EM countries obtain 80% of their funding from local sources. They already fund at yields close to 7%. Global financial tightening may scare some investors and cause the usual knee-jerk selling of EM, but as 2013 shows it does not, in our view, pose a huge fundamental challenge to EM.[4] Investors are right to discount the volatility caused by the herd mentality of others and the shrill media headlines from EM doom merchants. We believe the right approach is to maintain a firm focus on the positive fundamentals and technicals.

[4] See our discussion of four major misconceptions about Emerging Markets and tapering in "*Emerging Markets and tapering*", The Emerging View, July 2013.

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