Emerging
Markets
Forum

A Market Player's View of the Implications of Current Global Financial Turmoil

Caio Koch-Weser, Gustavo Canonero,
Arend Kapteyn and Michael Spencer

Discussion Draft

Deutsche Bank Securities Inc.

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Authors :

Caio Koch-Weser
Vice Chairman
Deutsche Bank

Gustavo Canonero
Chief Economist, Latin America
( ) 212 250-7530
gustavo.canonero@db.com

Arend Kapteyn
Chief Economist, EMEA
(+44) 20 754-71930
arend.kapteyn@db.com

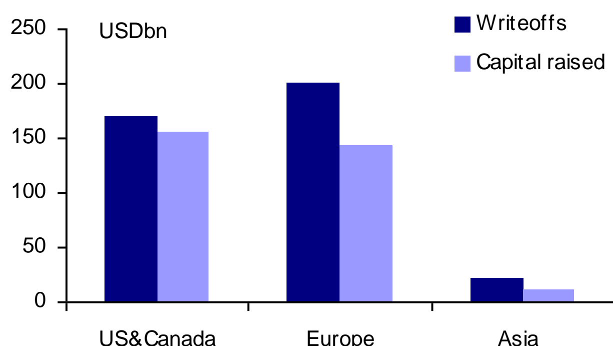
Michael Spencer, Ph.D
Chief Economist, Asia
(++852) 22038303
michael.spencer@db.com

Economics

Subprime is a G3 crisis, not an EM crisis

The "sub-prime crisis" is, in its immediate balance sheet impact, essentially irrelevant to emerging market economies. Of the USD391bn of writeoffs and credit losses reported by banks around the world over the past year, none has been reported by banks in emerging European or Latin American economies and only USD3.1bn has been attributed to banks in emerging Asia.

Fig 1: Bank write-offs and capital raised since 2007Q1



Sources: Bloomberg and Deutsche Bank
Note: "Asia" includes Japan, Australia and emerging Asia

The "sub-prime crisis" has long since moved beyond sub-prime mortgages, of course. Contagion rapidly spread to other credit products. This was in part because of the opacity of asset-backed securities holdings – the losses on mortgages were unknown both in size and incidence across the investment community. Structured credit products themselves, regardless of the quality of the underlying credit, became less desirable precisely because of their complexity.

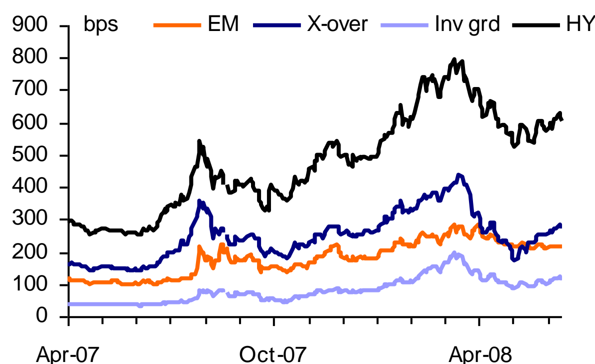
And astonishingly, to most observers, it quickly emerged that supposedly low-risk money market funds had invested to a much greater extent than was previously believed in sub-prime mortgages and other asset-backed securities. So the loss of confidence in securitized credit resulted in losses on supposedly "safe" investments – transmitting the "sub-prime" crisis throughout the industrialized economies.

Securitization was still an infant industry in emerging market economies in 2007, though, and so even as prices for structured credit products declined, losses among emerging market investors were limited simply because comparatively little of these products was owned outside the G3 economies.

Moreover, the liquidity crisis that struck US and European banking systems last summer has also largely escaped emerging market banking systems. While uncertainty surrounded the capital positions of some money center banks in the US and Europe, this has rarely been a problem in emerging market banking systems. And with most major emerging market economies continuing to enjoy external surpluses, for most central banks the management of surplus liquidity has remained a more common concern.

However, as investors took losses on structured credit and credit derivatives, their appetite to take on new credit exposures declined. Moreover, as banks' ability to distribute credit risk suffered, their willingness to originate new loans or underwrite bonds declined. Unlike the immediate balance sheet impact of the crisis, this deterioration in market conditions has impacted emerging markets issues significantly.

Fig 2: CDX spreads



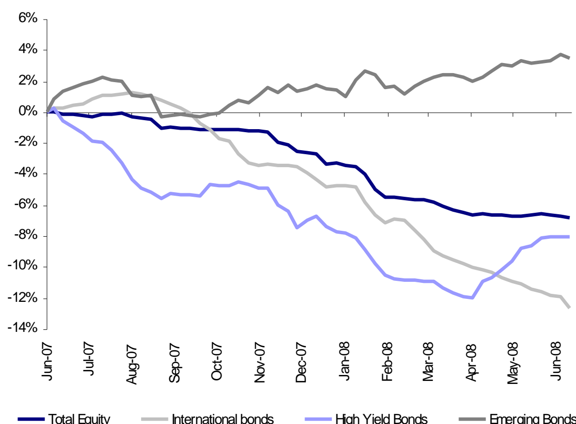
Source: Deutsche Bank

Spreads on emerging market credit default swaps have widened by about 110bps over the past year, although they are already well down from their peak in late March of this year. Still, it is impressive that emerging markets have outperformed US high-yield and cross-over credits during this period. Spreads on investment grade credit have widened by about 80bps over the past year.

The resilience of emerging markets compared with in many cases comparably rated US issuers is in stark contrast with the experience during previous global crises when investors tended to dump emerging market exposures and retrench to the "safety" of G3 markets. This newfound support for emerging markets reflects both the insignificant direct exposure to structured credit markets and the more resilient economic fundamentals in emerging markets.

Indeed, when we examine international capital flows, we can see how foreign investors have continued to invest in emerging markets debt, although not enough to prevent a modest widening of spreads. While assets have flowed out of high-yield bond funds, there have been small flows into emerging markets bond funds since the subprime crisis broke out.

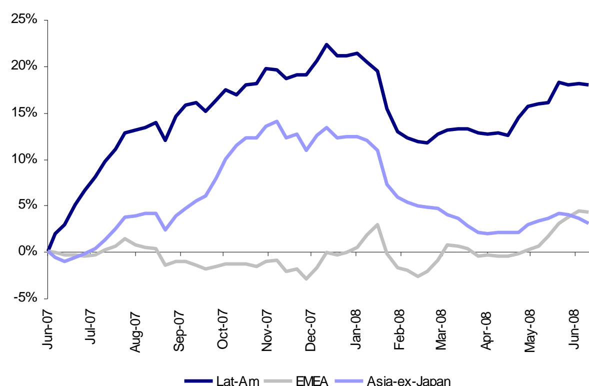
Fig. 3 Cumulative 12m flow by asset type



Sources: EPFR and Deutsche Bank

To a great extent – as we'll argue more fully below – this reflects the status of many emerging market economies as net commodity exporters. While overall emerging markets equities have seen marginal net inflows over the past year, the breakdown of these flows by regions shows how strongly investors prefer Latin American equities to EMEA or Asian equities – most likely because of the commodities base of large Latin American economies.

Fig. 4: Cumulative 12m flows of EM equity funds

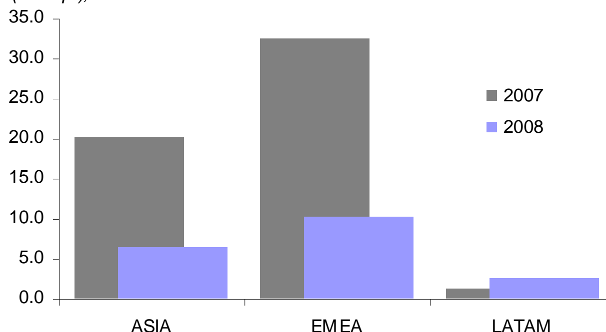


Sources: EPFR and Deutsche Bank

However, notwithstanding the positive net flows into emerging markets bond funds, there has been a sharp decline in new issuance of bonds by emerging markets issuers. Through the first four months of this year, bond issuance from emerging markets was down by about half. Syndicated loan volumes were down only a little from last year as corporates have continued to borrow (albeit at wider spreads).

Emerging market banks have borne the brunt of the decline in lending, as combined bond issuance and syndicated borrowing has fallen by 64% from last year's levels. While Latin American banks have been largely unaffected, the decline in issuance by Asian and European/Middle Eastern banks has been dramatic. This is especially worrying in the EMEA economies because banking systems remain disproportionately dependent upon foreign financing: 25% of total funding for banks in EMEA comes from external sources versus 6% for Asian banks and 7.5% for Latin American banks.

Fig 5: Credit extension to EM banks



Source: Deutsche Bank

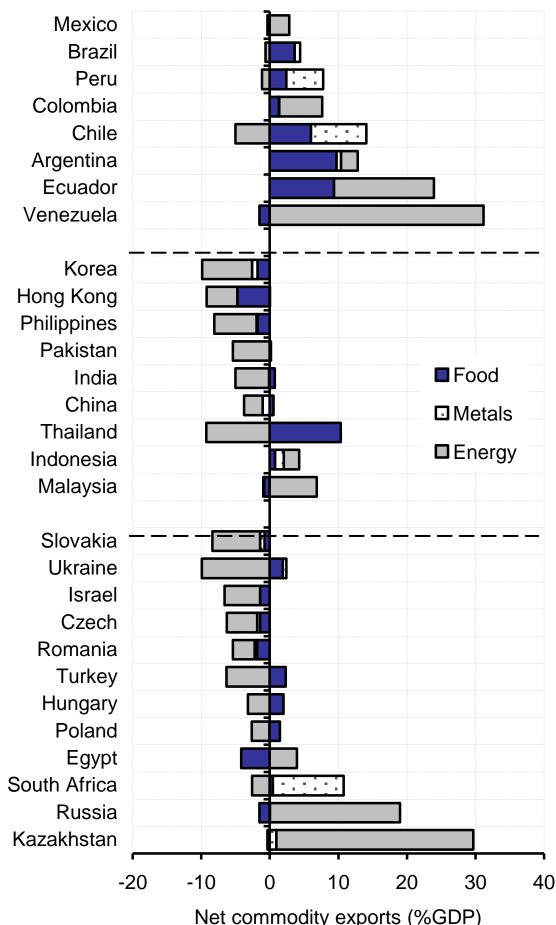
So, while the direct impact of the credit crisis on emerging market banks – and therefore on their economies – has been minor, the indirect impact through a withdrawal of credit and an increase in credit spreads has been more significant, especially in the EMEA region.

As we argue below, while the financial fundamentals of emerging market economies are much stronger than they were in 2001 even, and certainly during previous global crises, the fact that commodity prices have continued to rise even as investors fully expected a recession in the US and much weaker European growth – itself a remarkable phenomenon – has been an important source of support to emerging financial markets. We expect that slower G3 growth will eventually bring commodity prices down. Without that support, prospects for emerging markets' growth will suffer, while liquidity will dry up as growth in merchandise and commodity export values slows. This is an environment in which we would expect broad-based declines in capital flows to emerging markets.

Commodities soften the blow in Latam

The other important development over the past year – and economists and investors debate the relationship between the two – is the surge in commodity prices. Whether or not commodity prices are rising as a consequence of liquidity injections by the Fed and resulting weakness in the USD, the simple fact is that more than half of the emerging market economies – and some of the largest among these – are net commodity exporters and therefore benefit from improved terms of trade and external balances.

Fig 5. Net commodity exports by country (%GDP)



Sources: Haver, Deutsche Bank

The benefits of commodity price increases are, however, like the costs of a decline in international capital flows, unevenly distributed regionally. Most Latin American economies are net commodity exporters, whereas only four Asian economies (including Vietnam, which is not shown) and four EMEA economies are beneficiaries of rising commodity prices.

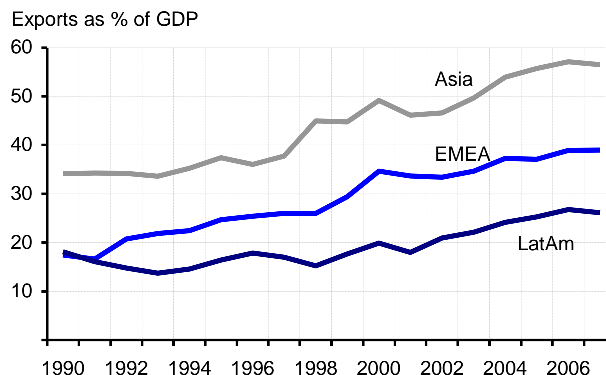
Hence, especially in Latin America, an improving terms of trade has supported incomes and therefore domestic demand in many emerging markets. However, this is of little comfort to most EMEA economies that are both commodity importers and experiencing a significant decline in external credit. For Asian emerging markets so far, deteriorating terms have trade have resulted in a decline in external trade surpluses and some weakness in currencies, but this has not yet created significant liquidity shortages.

Exports will transmit the crisis to EM

While the immediate impact of the crisis on emerging market balance sheets has apparently been very small, and to some extent cushioned in Latin America and few other economies by rising commodity prices, we think the crisis will eventually be transmitted to emerging markets through a decline in export growth.

While Asian economies capture the headlines in terms of their openness to international trade – China and India have doubled the share of trade in GDP and the other Asian economies have an average export/GDP ratio of 115% -- Latin American and EMEA economies have become significantly more open to international trade in recent years as well.

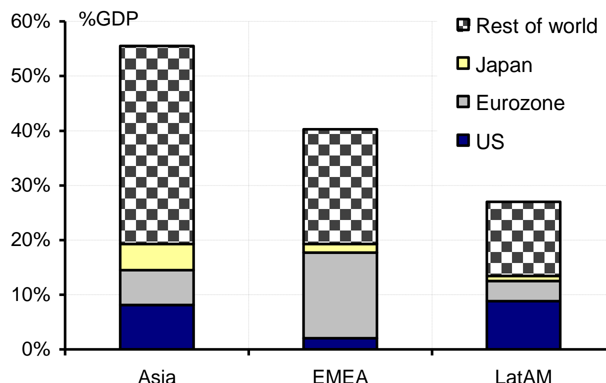
Fig 6: EM economies are still opening up



Sources: Haver and Deutsche Bank

The geographic distribution of exports from these three regions are as one might expect. While the G3 economies command similar shares of Asian and EMEA exports, Europe is much more important than the US in the EMEA while the US and Europe have similar weights in Asian exports.

Fig 7: EM export market exposures



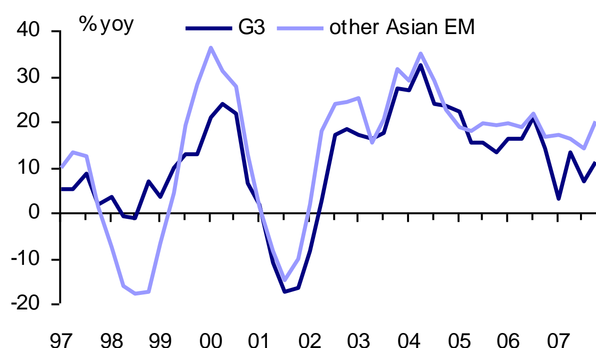
Sources: IMF and Deutsche Bank
Note: Manufacturing export shares by destination.

Latin American economies are more exposed to the US directly than either of the other two EM regions, but are less reliant on exports as a driver of growth in any event.

But what are we to make of the large share of " other" exports. We would caution against assuming this helps insulate economies from the US and EU. The issue is most pressing in Asia, where the " other" is mainly intra-regional exports that account for 38% of total exports

– i.e., more than exports to the US and Europe. However, intra-regional trade in Asia is dominated by trade in intermediate goods, inputs into production of goods that are more often than not exported out of the region. As a result, intra-regional exports are so highly correlated with exports to the G3 (a correlation coefficient of 0.94 since 2000) that they should probably be considered as reflecting G3 demand more than Asian demand. Hence, the G3 directly and indirectly "explain" about two-thirds of Asian export growth. So Figure 7 significantly underestimates the vulnerability of Asia to the G3 economies, in our view.

Fig 8: Asian exports by destination

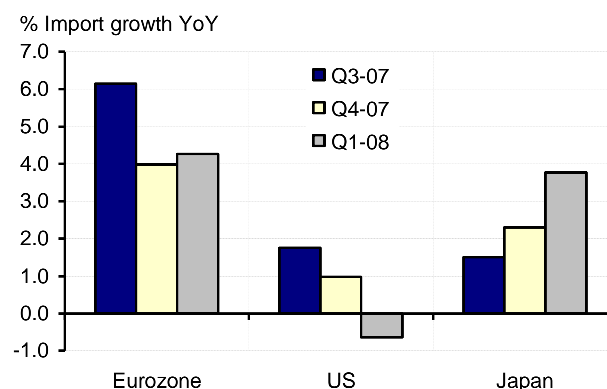


Sources: CEIC and Deutsche Bank

Outsourcing of production from G3 to emerging market economies over the last 10-20 years and the increasing fragmentation of production networks within emerging markets, particularly in Asia, has meant that emerging market economies have become more exposed to fluctuations in G3 demand over time. But an increasingly export-oriented development strategy within emerging markets has resulted in greatly improved external finances – less debt and higher foreign exchange reserves. So while emerging market capital markets have withstood the first round of the sub-prime crisis very well, they are unlikely to escape the broader economic repercussions of slowing aggregate demand growth in the US and Europe as housing markets continue to correct and labour markets soften.

That said, we have been surprised at the resilience of G3 demand. Contrary to widespread expectations of recession, the US economy expanded at a faster rate in Q1 than it did in 2007Q4, The same was true for Europe and Japan as well, with the result that measured on a year-on-year basis, growth in the G3 was unchanged between Q4 and Q1. Import volumes grew more slowly in the US, but more quickly in Europe and Japan.

Fig. 9: G3 import volumes



Source: Deutsche Bank

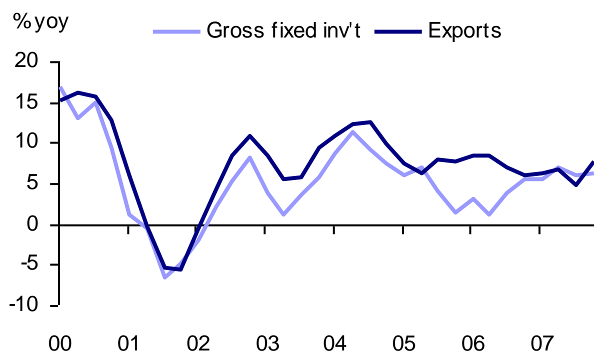
With G3 growth essentially stable in Q1, emerging markets exports slowed only very little – many Asian economies saw export growth rise in Q1 – and therefore external support for GDP growth in the emerging markets remained quite strong.

We do not expect this relatively benign G3 environment will continue. Even though we don't expect a recession in the US – monetary and fiscal easing appears to have prevented that, at least in 2008 – we see growth in the G3 economies slowing from about 2.0%yoy in Q1 to about 1% in Q4, with growth noticeably weaker in the US than in Europe.

We therefore expect growth in the emerging market economies to slow down gradually, but significantly through 2008. We think the Asian and Latin American economies are particularly exposed to the US slowdown, and while EMEA may benefit on a relative basis from its proximity to a slightly stronger European economy in 2008, the tables may be turned in 2009 if we see an earlier recovery in the US than in Europe.

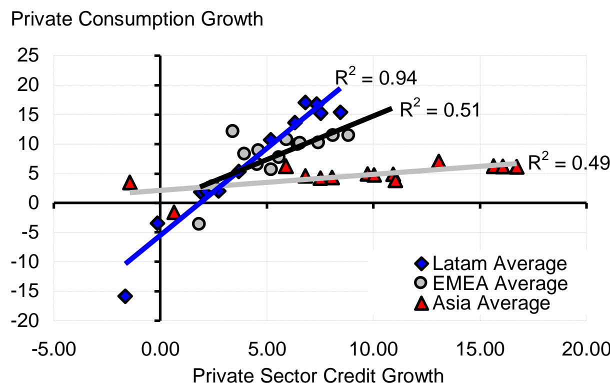
But we would caution that we do not expect G3 growth overall to be much stronger in 2009 than in 2008 (1.7% in 2009 versus 1.2% in 2008) so our expectation is of a very gradual recovery in growth in the emerging markets as well.

Fig 10. Asia-8 investment and exports



Sources: CEIC and Deutsche Bank
Note: Asia-8 is Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand.

Fig 11: Private consumption and credit in EM



Sources: Haver and Deutsche Bank

We think it is important to understand that the surprising resilience of growth in many emerging markets is not a result of stronger domestic demand as much as it is a result of surprising strength in exports to the G3. We note, for example, that as economies become more open "domestic demand" becomes more sensitive to exports – exporters are often large employers, paying relatively higher wages and accounting for a disproportionate share of investment. For the most open Asian economies, for example, as shown in Figure 9, investment growth tends to rise and fall with export growth – the exceptional period reflects the decision in Indonesia to double the price of fuel in late 2005.

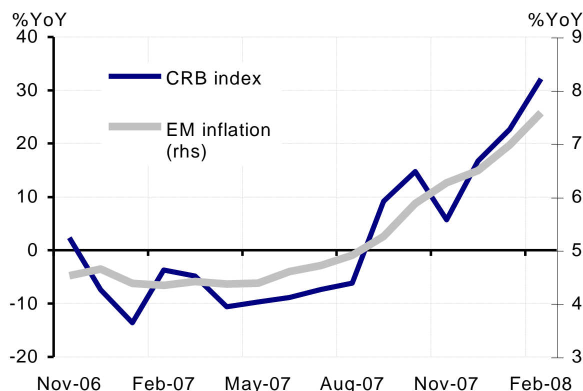
Credit growth is less export-driven than investment, although clearly a recession in the export sectors in some economies would so significantly impact incomes that consumption would eventually suffer. What seems more important, though, is the availability of credit. Interestingly, in recent years credit growth has not been a significant factor behind consumption in Asia – banks have only recently begun to expand their loan books in some economies. But in Latin America and EMEA credit growth is a significant factor behind consumption. In this respect, the tightening of international credit to EMEA banks, given their heavy reliance on international capital to fund their domestic lending, is a significant negative for the outlook for consumption growth in that region.

Inflation returns, for how long?

Inflation is widely viewed as the most important threat to emerging market economies. We're not sure this is true, but it is clear that in an environment of still reasonably strong growth in which even the G3 economies haven't opened up significant output gaps, inflation risks remain to the upside.

However, it is still the case that inflation is mainly coming from commodity prices, with relatively little passthrough to core inflation – at least so far. Remarkably, so tight is commodity supply, and so important is demand in emerging market economies perceived to be, that even when consensus opinion was strongly of the view that the US was in recession and the EU was slowing down rapidly commodity prices continued to rise. Oil prices have about doubled in the past year while the IMF's food price index has risen 38% -- both in USD.

Fig 12. Commodity prices push EM inflation up



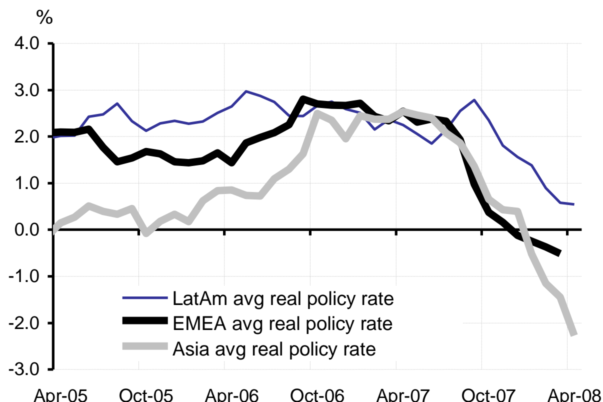
Sources: Bloomberg and Deutsche Bank

Commodity prices have a more pronounced impact on emerging markets than industrial economies because households spend a higher share of their income on commodities.

Core inflation has generally been much more subdued, although it has risen along with the higher headline inflation. This is not altogether surprising since, as we observed above, growth hasn't slowed down

enough to open up large output gaps, which would be needed to rein in core inflation. As a result of the rising inflation, real interest rates have plummeted in emerging markets.

Fig. 13: Real policy rates in emerging markets

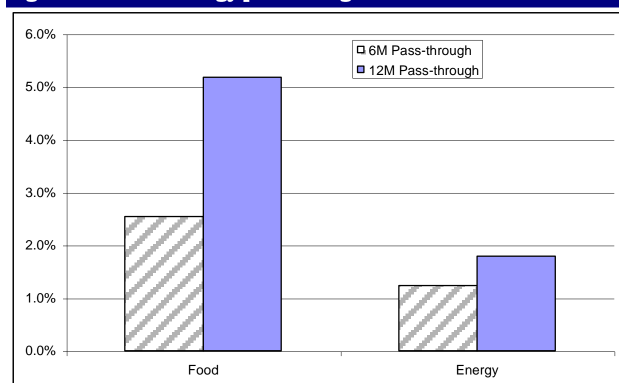


Sources: Haver and Deutsche Bank

Allowing real interest rates to fall so sharply is appropriate if the shock to headline inflation is thought to be transitory and if growth was expected to slow down sharply. There is, of course, considerable uncertainty surrounding both issues. While we are commodity bulls, we do not think this necessarily translates into a higher rate of inflation in the near-term or medium-term. Commodity prices have been rising for years without noticeable pass-through to core inflation -- operating margins were compressed as a result of firms' inability to pass on higher input prices to consumers.

But the current episode of commodity price inflation differs from previous ones in that food prices are especially important. And the experience in emerging markets has been that there is a higher rate of pass-through of food prices to core inflation than there is for energy prices.

Fig 14: Food and energy pass-through to core CPI



Source: Deutsche Bank

We therefore see the likelihood that inflation rates will continue to rise for another quarter or two. Recent abrupt increases in fuel prices in a number of Asian economies, for example, as subsidies were cut will likely take a few months to filter through the price structure of these economies.

But if the G3 economies slow down as much as we expect – we forecast GDP growth of about 1%yoy in Q4 and an average growth rate of about 1.5% next year – we think commodity prices will stabilize and core inflation will tend to decline as wage costs weaken and property prices continue to decline.

For the emerging market economies, lower G3 inflation, slower growth – due to links to the G3 economies -- and higher inflation this year that is eroding purchasing power will deliver lower inflation in 2009, in our view. While in the near-term we see many central banks raising interest rates in response to higher-than-expected inflation and rising inflation expectations, we think it possible that in 2009 some central banks may find themselves cutting interest rates.

Appendix 1

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Principal Locations

Deutsche Bank AG
London
1 Great Wincester Street
London EC2N 2DB
Tel: (44) 20 7545 8000

Deutsche Bank AG
New York
60 Wall Street
New York, NY 10005
United States of America

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Deutsche Bank AG
Japan
2-11-1 Nagatacho
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Deutsche Bank AG
Frankfurt
Grosse Gallusstrasse 10-14
Frankfurt am Main 60311
Germany
Tel: (49) 69 910 0

Deutsche Bank AG
Boston
225 Franklin Street
Boston, MA 02110
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South Tower
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Tel: (65) 6423 8001

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The Watergate Office Building, 2600 Virginia Avenue, N.W. Suite 201
Washington, DC 20037, USA. Tel: (1) 202 393 6663 Fax: (1) 202 393 6556

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