Emerging countries

Due caution

■ **The "Trump tantrum" has left few traces on the financial conditions of emerging countries, with the exception of Mexico and Turkey. Despite higher US long-term rates, the cost of corporate financing in dollars is at an all-time low.**

■ **Oil and metal prices continue to recover and foreign trade seems to be picking up.**

■ **Even so, the IMF and the World Bank have revised downwards their growth forecasts for 2017, insisting on the downside risks more than on the gearing effect of a US fiscal stimulus.**

■ **Are they being overly cautious after years of systematic downward revisions? It is hard to be so certain given the kaleidoscope of potential risks.**

Renewed calm

Donald Trump's election in early November sent a wave of panic through emerging financial markets. Three months later, there are few traces left of the "Trump tantrum". With the notable exception of Mexico and Turkey, the main emerging currencies have been stable or have strengthened. The average risk premium on dollar-denominated sovereign debt returned to pre-election levels, while that of corporate debt has continued to decline without a glitch. Even though US long-term rates have increased, the cost of corporate financing in dollars has fallen to an all-time low.

At the same time, oil and metal prices have continued to rebound, notably due to the improvement in activity and prices in the industrial and real-estate sectors in China. From a more general perspective, foreign trade has picked up in emerging countries, notably intra-Asian trade. All in all, based on both real and financial indicators, the IIF expects the annualised quarterly growth to accelerate to about 5% in Q4 2016.

Growth forecasts are revised downwards again

Even so, the IMF and the World Bank have revised downwards their 2017 growth forecasts (from the October 2016 outlook for the IMF and the June 2016 outlook for the World Bank).

Although Chinese growth is expected to slow to 6.5% (vs. 6.7% in 2016), the two international institutions still expect average growth to rebound in the emerging countries, as Brazil and Russia both pull out of recession. In contrast, they both expect Mexican growth to slow to less than 2% due to: 1) a persistent financial shock due to the country's exchange rates and interest rates, and 2) a drop-off in exports due to uncertainty over trade relations with its US neighbour. The other big revisions concern 1) India, where the shock of demonetisation will hit growth, a priori temporarily, 2) Turkey, which like Mexico, faces financial tensions, but which are due more to domestic factors than to the Trump effect, and 3) a reassessment of the size of the slowdowns or recessions in the oil-producing countries (Angola, Saudi Arabia, Nigeria).

The World Bank does not take into account any gearing effects due to a US fiscal stimulus, while the IMF gives them cautious consideration. These gearing effects are seen more as upside risks rather than as key assumptions in a baseline scenario.

A kaleidoscope of risks

The two institutions insist, in contrast, on the numerous downside risks: economic risks, including the reduction in potential growth, high corporate debt loads and falling profitability, and the deteriorating quality of bank portfolios; financial risks, including capital outflows and US monetary tightening; and political risks, in the broad sense of the term, including geopolitics, domestic politics and economic policy.

China's financial instability still seems to be the main potential risk factor. Non-financial private sector debt (i.e. excluding the central government) reached 210% of GDP in 2016 and will be difficult to scale back. Corporate debt (120% of GDP) is levelling off, but household debt (45% of GDP) and the debt of local governments and their financing vehicles (45% of GDP) continue to rise much faster than GDP. This is also the case for debt originated through the least regulated compartment of shadow banking, which now accounts for 50% of GDP (up from 16% in 2011) according to Moody's estimates. Moreover, there are recurrent squeezes on domestic liquidity, due to capital outflows and panic movements sweeping corporate debt and local government financing instruments. In a nutshell, the potential for a corporate debt crisis continues to rise. Fortunately, unlike in late 2015, the conditions are no longer ripe for a crisis to be triggered: industry is not in deflation any longer, real estate prices have picked up, the exchange rate is more flexible and the Chinese monetary authorities are playing their role as liquidity supplier of last resort.

In terms of political risks, the World Bank economists have tried to evaluate their effects on investment in the emerging and developing countries to explain the latter's weakness since 2010. More precisely, they calculated the impact of two measures of uncertainty on two different examples: economic policy uncertainty in the nearby external environment (the EU for the Eastern European countries) and domestic political risk (in this case Brazil). They show that an increase (or reduction) in political risks can very largely offset the reduction (or increase) in financial market volatility (as measured by VIX), especially if the two sources of political uncertainty are combined.