

Author: Ali Janoudi, Group Managing Director & Group Head Middle East and North Africa, UBS Switzerland AG

Most emerging markets were caught between a rock and hard place in recent years. Global factors such as the drop in commodity prices, tighter lending conditions, overvalued exchange rates and stagnant global trade caused some of the misery. Equally important, however, are domestic factors like the reliance on credit-driven growth, insufficiently diversified economies, and a low willingness for reforms.

Optimism will require more patience, though, despite many months of pressure and pain. Monetary policy is accommodative in many advanced countries, but liquidity conditions are set to tighten further in the course of the year. Compared to some years ago, credit spreads are higher and bank lending conditions less favorable today. Further policy rate hikes by the US Federal Reserve will add to this pressure. Countries with current account surpluses and large foreign exchange reserves will be sheltered more than those who rely on external funding. Despite the structural slowdown in China, Asia remains in a better position than the EMEA region and Latin America. Turkey, Indonesia, wide parts of Africa, including South Africa and Nigeria, and the Andeans are among the most exposed countries. Vulnerabilities have also increased in the Gulf region, but large stocks of foreign assets provide an important cushion for now.

Declining commodity prices also hobble most of these countries. This will require more fiscal tightening, but may also trigger privatizations and reforms. The rebalancing of supply and demand in commodity markets is progressing but not completed yet. Until then, commodity prices will unlikely rise on a sustainable basis.

Despite the many challenges, capital flows to emerging markets have shown signs of life recently. Stabilizing economies, receding fears of a sharp devaluation of the Chinese yuan, depreciated emerging market currencies and a more buoyant global backdrop have pushed and pulled flows to EM equity and bond markets recently. While portfolio inflows might rise in the near term, they are prone to reversals as long as company earnings decline and economic growth remains weak. A cyclical recovery looks unlikely for now, and structural obstacles cloud the outlook. The growth model of choice of many emerging economies in the 2000s relied heavily on commodity exports and on credit-fueled growth. These drivers have lost steam in recent years, not least due to the structural transition of the Chinese economy away from investment and manufacturing to consumption and services. Meanwhile, the room for monetary or fiscal stimulus is fairly limited, with China and some other markets in Asia among the few exceptions. In combination with the high indebtedness in the private sector, the economic outlook for emerging markets remains lackluster this year.

However, the picture wouldn't be complete without a silver lining. The significant exchange rate depreciations are breathing new life into some of the most vulnerable economies. Narrowing current account deficits in India or Brazil are a reflection of improving competitiveness. Reforms are another pivot point, as demonstrated by India, Mexico, or Indonesia. India is expected to grow more quickly than China in the years ahead. Mexico has lost a bit of its shine recently as reforms were largely focused on the energy sector, but the long-term outlook remains benign. Brazil requires monitoring. Political change is becoming more likely, and could pave the way for reforms and investment inflows. Finally, expanding trade with the Eurozone will likely go on supporting the economies in Central and Eastern Europe.