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PANORAMA

MARCH 2016

Companies in emerging countries: Can we once again believe in the Phoenix miracle?

COFACE ECONOMIC PUBLICATIONS

By Coface Group Economists



Halved growth between 2010 and 2015, sharply increasing debt, increased exposure to currency risk, growing scarcity and increased cost of credit, falling export revenues: the nerves of companies in a great many emerging countries were severely tested in 2015. The origins of this shock are now well known: the Chinese slowdown and its impacts on other emerging countries, falling commodity prices since the summer of 2014, reversal of US monetary policy, many supply-side constraints weighing on companies, etc.

But while this accumulation of bad news in the emerging world is unprecedented since 2003, such crises occurred already in the 1990s and until after the turn of the century. After these financial crises that

already at the time were reflected by massive capital outflows, emerging economies regularly surprised all observers positively by rapidly recovering, to the point that there was talk about “Phoenix miracles” for these economies that thereby seemed to rise from their ashes. Even though many emerging economies are still now in a difficult situation, the question whether they will recover again is arising: can we see this recovery on the horizon or, in other words, is another Phoenix miracle possible in the present situation? And if the answer is yes, in which countries?

In order for companies in troubled emerging economies to rapidly restore their ability to invest and thereby “rise from their ashes”, three factors must in our opinion be taken into account. The first is found in price competitiveness: companies are

encouraged to invest after a crisis if they become more competitive. In the case of emerging countries, a depreciation of their currencies is probably the most effective way to succeed in this respect in a short period of time. The second is their borrowing capacity: do their initial debt levels give them leeway to run up more debt? And, lastly, a country may not benefit from these two possible rebound factors if the recovery is hampered by significant political uncertainty.

All in all, we see, based on a detailed analysis of these three criteria, that the Phoenix is an endangered species: very few emerging economies, among our sample of 34, can currently easily “rise from their ashes”. The list is limited to Czech Republic, Chile, Thailand and Poland.

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RESEARCH PAPER

March 2016

COMPANIES IN EMERGING COUNTRIES: CAN WE ONCE AGAIN BELIEVE IN THE PHOENIX MIRACLE?

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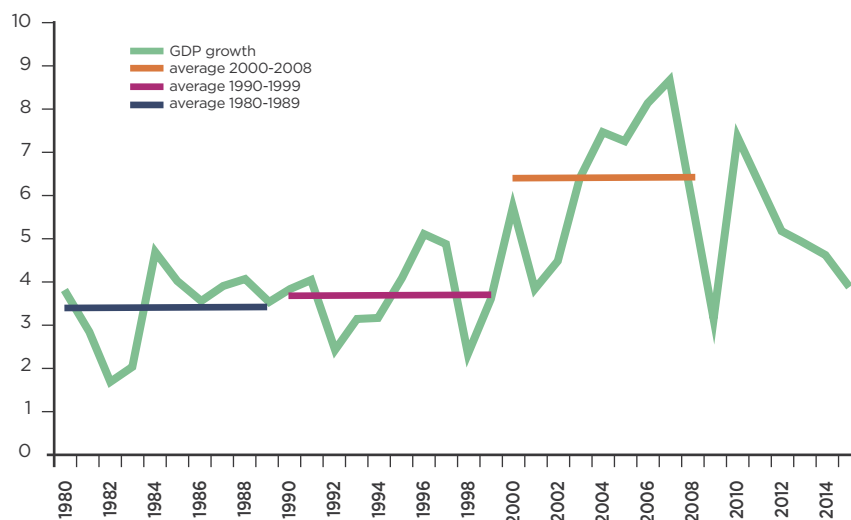
1 AFTER A CRISIS, EMERGING MARKET ECONOMIES USUALLY RAISE RAPIDLY FROM THEIR ASHES

Growth in emerging countries was more than halved between 2010 and 2015. The outlook for 2016 is hardly more encouraging (growth lower than 4% expected by Coface). The reasons for this shock are now well known: the Chinese slowdown and its impacts on other emerging countries, falling commodity prices since the summer of 2014, reversal of US monetary policy, many supply-side constraints weighing on companies, etc. The depreciation of most flexible emerging currencies and the capital outflows since the summer of 2013 are partly the consequence of these growing concerns about emerging countries' health.

An observation of past growth trends in emerging countries shows that the current crisis is not an isolated phenomenon. Before the period of strong growth in the 2000s (see *chart n°1*), the rate of growth in activity was similar to the current level throughout the 1980s and 1990. And, as is occurring today, emerging countries have gone through

episodes of capital outflows, some of which have led to financial crises. For example in the early 1990s, massive capital inflows in most Latin American countries, whose economic fundamentals yet varied very significantly from one country to the next at the time, triggered the 1994 Mexican crisis. So, after the US Federal Reserve's surprise decision to raise its key interest rate, Latin American countries, with Mexico in their lead, were hit by sudden capital outflows weakening their currencies, thereby hurting economic agents with dollar-denominated debt. The companies affected at the time then were forced to reduce their investments. The banks affected by the increase in the value of their foreign currency-denominated liabilities tightened their lending conditions to households and companies. In the same way, governments reduced their spending. All in all, a sometimes drastic growth adjustment followed these episodes of capital outflows.

Chart n° 1
GDP Growth in emerging countries (%)



Source: IMF

But in the 1990s and until after the turn of the century, these financial crises also ended with a rapid upswing in activity. This mystery of a rapid recovery in activity, without any obvious reason, has been highlighted by Calvo, Izquierdo and Talvi⁽¹⁾. They looked at this recovery phase in emerging countries just hit by financial crisis reflected by sudden capital outflows. They concluded that these recoveries generally are rapid and occur despite a lack of rebound in credit. Companies are, accordingly, able to invest without resorting to additional borrowing. They find forms of financing other than formal banking credit. They also restore their financial margins by cancelling sometimes superfluous investment spending decided prior to the crisis period.

Calvo therefore qualifies these sudden and rapid recoveries as a "Phoenix miracle": an economy "rises from its ashes" after a production collapse caused by a sudden stop to capital inflows. The economy generally returns to its previous level of production in two or three years. However, its

level of long-term growth remains lower for a long time. The authors lastly emphasise that this type of rapid recovery without an increase in credit is also seen in the case of some crises in advanced economies, such as the Great Depression in the 1930s in the United States.

In order for companies in a troubled emerging economy to rapidly restore their ability to invest and thereby to "rise from their ashes", three factors must in our opinion be taken into account in the current context. The first is found in price competitiveness: companies are encouraged to invest after a crisis if they become more competitive. In the case of emerging countries, a depreciation of their currencies is probably the most effective way to succeed in this respect in a short period of time. The second factor is their borrowing capacity: do their initial debt levels give them leeway to run up more debt? And, lastly, a country may not benefit from these two possible rebound factors if the recovery is hampered by significant political uncertainty.

2

FACTOR 1: GAINS IN PRICE COMPETITIVENESS

Price competitiveness gains make it easier for emerging countries and their companies to rebound or to be more resilient.

In the short term, price competitiveness gains are obtained mainly by exchange-rate depreciation⁽²⁾. The effectiveness of this depreciation depends on the weight of manufactured products and market services in production and exports. It also depends on the weight of value added locally in exports. High inflation expectations and, obviously, a fixed exchange-rate regime are obstacles to such a depreciation.

In the short term, competitiveness can be improved by a depreciation of the exchange rate

UA depreciation is in principle positive for a rapid increase in exports, insofar as it results in a reduction in export prices, and negative for imports whose prices increase. However, an observation of this depreciation must not be limited to how the exchange rate moves against the dollar, which is generally the preferred method, but must also factor in how it moves against the currencies of all the countries the country trades with, in terms of

imports as well as exports. Accordingly, for example, a depreciation only against the dollar would be mistakenly positive for a Latino-American company that mainly exports to Europe.

The trend in domestic prices, insofar as it is passed on to export prices, must also be taken into account to put the trend in the exchange rate into perspective. A depreciation, via the increased cost of imports, is automatically accompanied by rise in domestic prices (imported inflation). The additional inflation varies according to economic agents' expectations. When inflation has been low for an extended period, expectations are generally low and the leeway for depreciation without a risk of major runaway inflation is high. In the opposite case, the increased cost of imports is rapidly transmitted to domestic inflation. In addition, it results in an increase in domestic production costs that gradually cancels out the advantage generated by the depreciation. Availability of manufacturing and food production capacity makes it possible to limit the inflationary risk. However, we will see below that manufacturing and food production capacity may have been neglected or even reduced in a commodity price boom period⁽³⁾.

(1) Calvo, Izquierdo, Talvi (2006): "Phoenix Miracles in Emerging Markets: Recovering without Credit from Systemic Financial Crisis" NBER Working paper n°12101

(2) Productivity gains also pave the way for competitiveness gains, but they are slow as they depend on long-term structural reforms. It is, furthermore, difficult to find such up-to-date data for all emerging countries

(3) European Commission, October 2014. Quarterly Report on the Euro Economy (volume 13 n°3) pages 27 to 33: Member State vulnerability to changes in the euro exchange rate

The trend in the real effective exchange rate, which takes into account all these factors, should be the preferred measuring instrument. Lastly, an analysis must not be limited to an observation over a short period, but rather over a quite long period, as the depreciation may take place from a (very) high exchange rate level, which puts its positive impact into perspective.

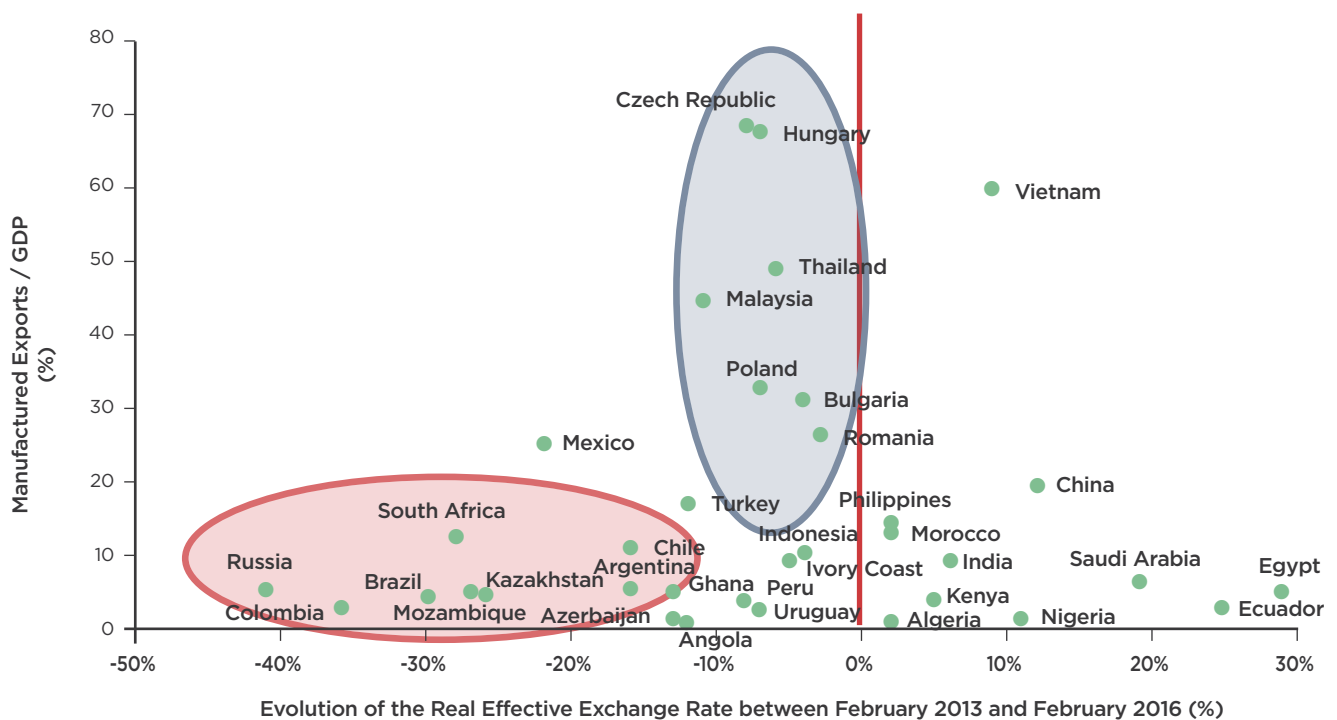
The positive impact of a depreciation varies according to a number of factors. First, the diversification of national production beyond commodities determines the leverage effect of a depreciation⁽⁴⁾. The depreciation has an impact on exports and imports of manufactured goods and certain services. It has hardly any impact on trade in commodities, for which prices are global or regional and demand and supply are to a large extent inelastic to changes in their prices. It is therefore useful to know the weight of manufacturing activity in exports and the weight of manufactured exports in total value added. The share of potentially exportable market services is difficult to estimate and has therefore not been taken into account.

Countries that primarily export commodities therefore benefit little from the positive effects of a depreciation of their currencies, especially as a country's capacity to increase manufacturing production to meet an increase in domestic and exter-

nal demand resulting from a depreciation is often limited. The commodity price boom and the resulting appreciation of exporting countries' currencies in the 2000s put non-commodity exports at a disadvantage and favoured imports of consumer goods. Many commodity-exporting countries have tended to neglect the manufacturing sector and services by not - or hardly - investing in them. This is the famous "Dutch disease". The same causes have also had the effect of discouraging subsistence farming and local processing to the benefit of exports of raw agricultural products (tropical and oleaginous products, etc.) and substituting them for imports of food products. As a result, the depreciation cannot have a rapid impact on imports as the agricultural infrastructures cannot meet local demand. National or foreign investment is a way to develop manufacturing and agricultural capacities, as well as market services. It will notably depend on the political environment (see *Factor 3: political risk, page 10*).

Quite logically, the steepest depreciations have been seen for countries exporting a lot of commodities (and therefore relatively few manufactured products), which have suffered the most and recorded the largest capital outflows (see *chart n°2*, countries in the red bubble), while those specialised in manufacturing and service exports have, in the best case, posted only moderate depreciations (countries in the blue bubble).

Chart n° 2
Real Effective Exchange Rates and Share of Manufactured Exports in GDP



Sources: BIS, World bank, ITC

(4) IMF, October 2015. World Economic Outlook: Adjusting to lower commodity prices

The proportion of value added of foreign origin in exports must also be taken into account. The higher it is, the more it reduces the positive impact of a depreciation, as part of the increase in exports does not benefit domestic companies. It is difficult to substitute - at least in the short term - domestic inputs for those imported to take into account the increased cost of the latter. That is all the more the case for an economy or a company integrated in an international value chain, where the flow of goods is rather inflexible. This shortcoming is generally less important for services, such as tourism, which often include a small imported component by comparison with manufacturing industry. However, available figures have to be taken with a grain of salt for the countries in which the weight of commodities in exports is significant and which, by nature, include imported inputs to a limited extent. Moreover, the invoicing currency for these imported inputs is not indifferent. If it is the importer's currency (or a currency moving in tandem with this currency), the depreciation does not increase the cost of imports and the problem is smaller ⁽⁵⁾.

The effects of a local currency depreciation on exports for a firm also depend on the trade-off between an increase in their margins by keeping their prices in foreign currencies, without an increase in the volume of their exports, and a reduction in their export prices, with an increase in the volume of their exports. However, contrary to the previous factor, companies will gain in both cases, with the gain being based either on an increase in prices expressed in local currency, or on an increase in volumes. We sense that the choice between the two branches of the alternative will depend on their pricing power in the export markets, itself linked to the trend in external demand, the type of goods (pricing power is generally stronger for capital goods and services than for consumer goods) and the level of product sophistication, as well as the level of margins. In cases where the margins will be comfortable, a price cut may be favoured.

The integration in a regional bloc and the pegging to a "locomotive" country are also competitiveness factors in the long term (see *Inset page 7*).

Chart n°3
Locally Added Value in Exports



Sources: OECD & World Bank (2011)

(5) - Swarnali Ahmed, Maximiliano Appendino and Michele Ruta, (August 2015). "Depreciations without Exports? Global value chains and the exchange rate elasticity of exports", World Bank, Policy Research Working Paper n°7390
The OECD-WTO trade in Value-Added data base, Paul Schreyer (OECD), Geneva, 16 January 2013

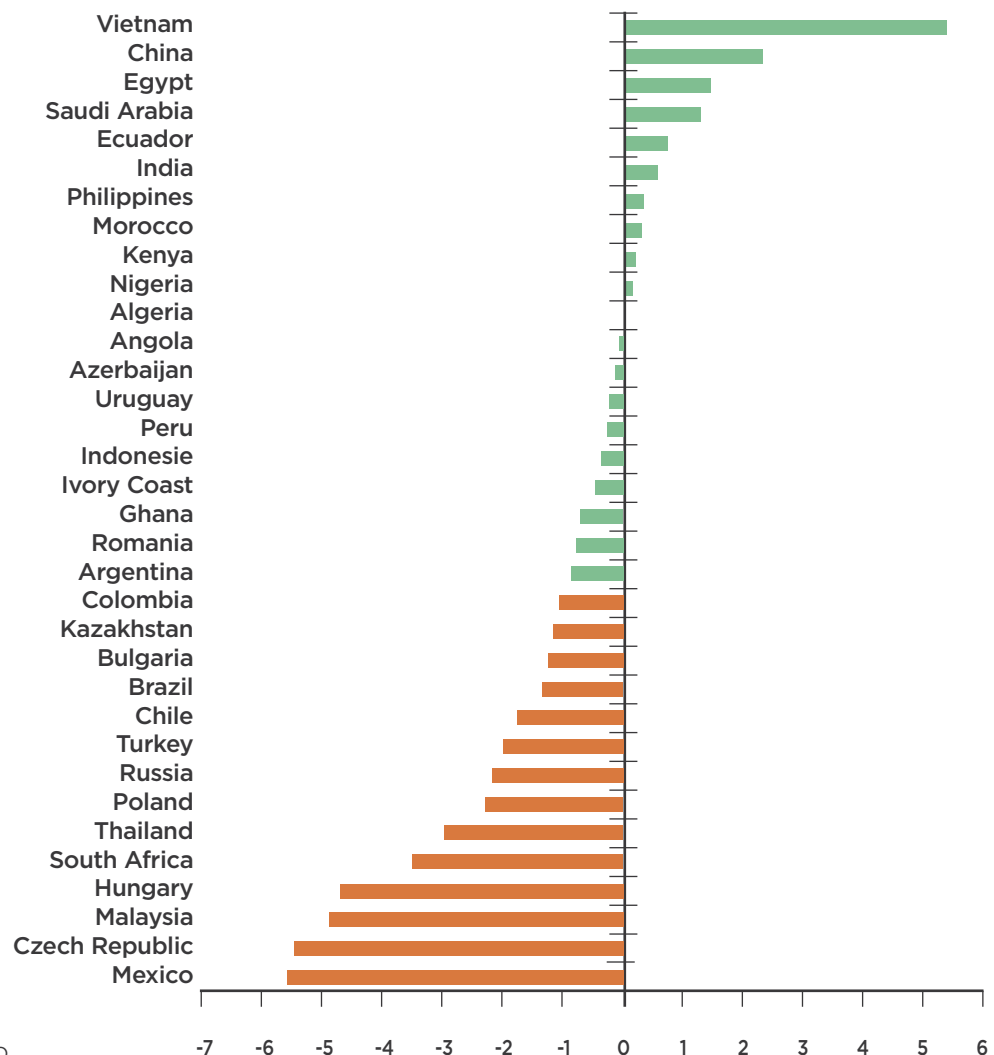
All in all, if we choose the real effective depreciation and the share of manufactured exports in GDP as the key competitiveness factors, it is possible to define the best and worst placed countries. No country specialised in exports of manufactured products has recorded a steep depreciation of its currency since 2013. This observation is not surprising, insofar as the depreciations of emerging currencies are particularly due to the effects of the fall in commodity prices. But while no country has the "ideal profile", two types of economies currently seem to be able to benefit from the positive effects of a weak currency:

- 1) those whose currency has depreciated only moderately since 2013, but which predominantly export manufactured products (*countries in the blue bubble in chart 2 page 4*);
- 2) those primarily exporting commodities and whose currency has fallen markedly (*countries in the red bubble of the same chart n°2*).

Chart n°4, which measures the product of the change in the real effective exchange rate since February 2013 and the share of manufactured exports in GDP (*i.e. the two axes in chart n°2 page 4*), highlights the countries that ought to benefit the most from these recent trends in the foreign exchange market. 14 countries (in orange) have an index higher than 1: **Mexico, Czech Republic, Hungary, Malaysia, South Africa, Thailand, Poland, Russia, Turkey, Chile, Brazil, Bulgaria, Kazakhstan and Colombia**.

At the other end of the scale (*countries in green in chart n°4*), the countries whose currency has appreciated in real effective terms are the main losers. Unsurprisingly, we here find **China, Vietnam, Ecuador, Egypt and Saudi Arabia**, which use a third-party currency or have a fixed or inflexible exchange-rate regime against the dollar which limits their leeway for adjustment⁽⁶⁾.

Chart n° 4
Index Gains in Price Competitiveness Index (Coface calculations)



Sources: BIS, IMF, World Bank, UNIDO,
Coface calculations

⁶⁾ These regimes sometimes exist for a long time and are often guarantees of economic policy soundness for the population. It is therefore not easy to reconsider them without calling confidence into question

Inset

The integration in a dynamic regional bloc or links with a locomotive country can help the recovery

Manufacturing, commercial and financial integration in a dynamic regional bloc and proximity with an advanced locomotive country can help a country pull out of the crisis, if the context is buoyant. Accordingly, the Baltic countries have benefited from their integration in the European production chain, especially the German one, from the solidity of Scandinavian banking groups which hold a substantial part of local banking assets, and from trade freedom

in the European Economic Area. Likewise, Mexico benefits from its industrial and commercial proximity with the United States. Thailand and Vietnam benefit from the presence of subsidiaries of South Korean and Japanese groups, in industry as well as in finance. By contrast, the effects on Argentina and Uruguay of the proximity with Brazil are recessionary because of Brazil's problems. In the long term, this is also the way to rise up the value chain more

easily. The integration in a regional value chain leads to technology transfers from parent companies to their subsidiaries, which generate a move up the value chain. This has been seen especially in Central European countries (Czech Republic, Hungary, Poland, Slovakia).

3

FACTOR 2: CORPORATE BORROWING CAPACITY

Companies in emerging countries are currently faced with the problem of their growing debt burden. It was multiplied by a factor of 4.5 between 2004 and 2014 in absolute value. Relative to GDP, it increased by 26 percentage points during the same period. This upward trend involves most of the major emerging countries, although the extent of the increase differs from one country to another.

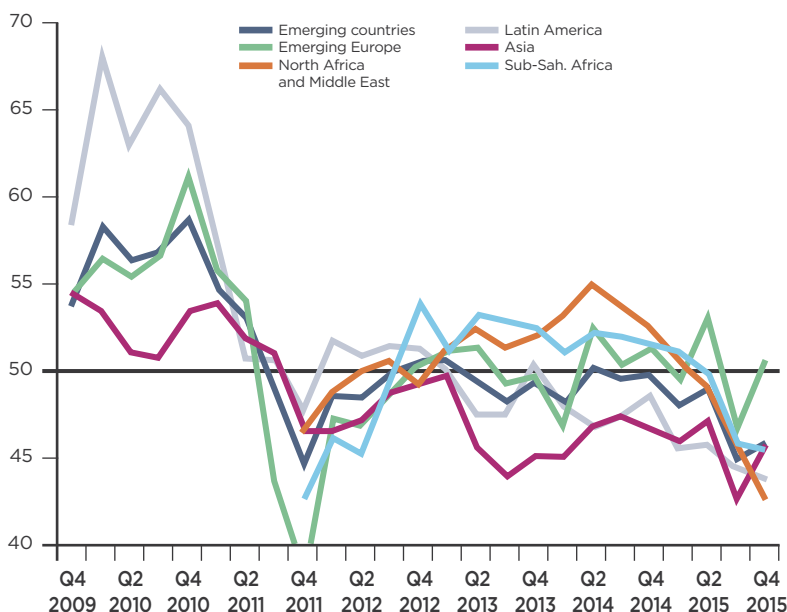
How do we explain this trend? First of all, the expansionary monetary policies decided upon after the Lehman Brothers bankruptcy eased bank

lending conditions in emerging countries. The deepening of local financial markets and, in particular, the development of bond markets during the 2000s also contributed to the increasing debt levels of companies in emerging countries. Although bank loans still account for the largest share of this debt, the weight of bonds has increased rapidly (from 9% in 2004 to 17% in 2014).

Increased debt is not necessarily bad news, given that it makes it possible to finance further investment and therefore fosters stronger growth. However, the recent period has shown that borrowing and growth do not necessarily go hand in hand, since growth decreased from 7.2% in 2010 to 3.4% in 2015 for emerging countries as a whole! Beyond a certain threshold, high debt means greater interest expenses and therefore less ability to invest. The IMF agrees with this conclusion, emphasising that crises preceded by excessive private debt are deeper and the recovery slower than for the others⁽⁷⁾, insofar as it is not accompanied by credit recovery since economic agents already have an excessive debt burden.

We can currently see a tightening of lending conditions associated with these increased debt levels. The quarterly survey on bank lending conditions in emerging countries undertaken by the Institute of International Finance (IFI)⁽⁸⁾ confirms this trend: it shows a marked tightening of these conditions in the fourth quarter of 2015. Lending conditions deteriorated for the 11th consecutive quarter (apart from one exception in the second quarter of 2014). This trend towards a tightening of lending conditions (illustrated by a score of less than 50 in the chart below) can be seen in all regions, with the exception of emerging Europe.

Chart n° 5
Bank Lending Conditions in Emerging Countries



Source: IFI

(7) Bornhorst F. and Ruiz Arranz M. (2011): "Growth and the Importance of Sequencing Debt Reduction across Sectors", Jobs and Growth: Supporting the European Recovery, Chapter 2, International Monetary Fund

(8) Institute of International Finance: "EM Bank Lending Survey Conditions - Q4 2015", published on 8 February 2016

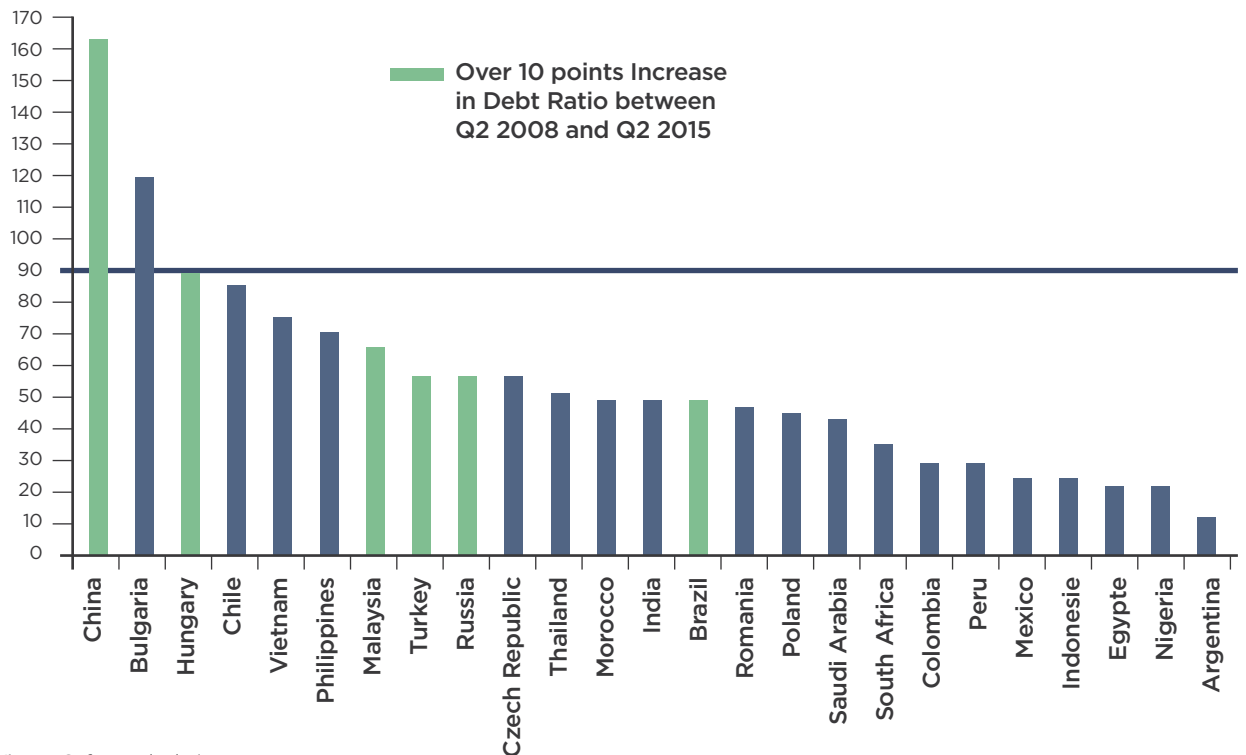
It concerns loans both to households and to companies. Note, lastly, that this tightening is explained both by lower demand for loans and more restrictive supply, according to the 102 banks surveyed. The recent growth in the corporate debt load is without any doubt one of the reasons explaining this tightening: a bank tends to restrict the amount of loans granted to over-indebted companies, while these companies may also reduce their demand for loans in order to deleverage.

However, this widespread trend towards a tightening of lending conditions does not mean that it applies to all emerging countries. As it is not possible to precisely determine in which countries lending conditions are tightening and, accordingly, hampering a possible upswing in activity, we have identified the countries "at risk" in this respect, by listing those whose stock of corporate debt exceeds 90% of GDP. This "alert threshold" is the one highlighted in the literature

(see for example the analysis from BIS⁽⁹⁾). Three countries exceeded or reached this threshold in June 2015: China, Bulgaria and Hungary. We have also included those whose debt level is lower than this threshold, but which has increased by more than 10 percentage points since mid-2008. Among these countries we find in particular Turkey, Brazil, Malaysia and Russia⁽¹⁰⁾.

All in all, among the 14 countries likely to enjoy substantial gains in terms of price competitiveness, 6 are suffering from a high risk in terms of corporate debt which is likely to hamper their recovery process. This concerns **Brazil, Hungary, Malaysia, Turkey, Bulgaria and Russia**. After this second filter, it appears that 7 countries⁽¹¹⁾ benefit from substantial gains in price competitiveness and do not show excessive debt of their non-financial enterprises: **Mexico, Czech Republic, South Africa, Thailand, Poland, Chile and Colombia**.

Chart n° 6
Corporate Debt in % of GDP (mid-2015)



Sources: IIF, McKinsey, Coface calculations

(9) Cecchetti, S.G., M.S. Mohanty and F. Zampolli (2011) : "The Real Effects of Debt," Bank for International Settlements Working paper n°352

(10) In addition to the level of the stock of debt in 2015 and its change since 2008, companies' degree of vulnerability depends on the structure of this debt load, and especially its foreign currency denominated share. But in the absence of available data for all the countries studied we have been unable to take this indicator into account

(11) We do not have the level of non-financial companies debt for Kazakhstan

4

FACTOR 3: POLITICAL RISK

High political risk could slow down the recovery in activity even if the previous economic conditions are met. When political uncertainties are high, companies are actually encouraged to postpone their investment decisions. The notion of political risk includes both geopolitical risk of external conflict and internal risk of political upheaval resulting from a social protest movement. While the former currently seems to be relatively low for all countries identified in the first two sections, the latter deserves all our attention.

The reason is that following an extended period of deteriorating economic conditions, the question of its consequences in terms of social frustration arises. Increasing cost of living, rising unemployment and slower standard of living growth are, indeed, symptoms of sluggish activity that may generate increased social frustration.

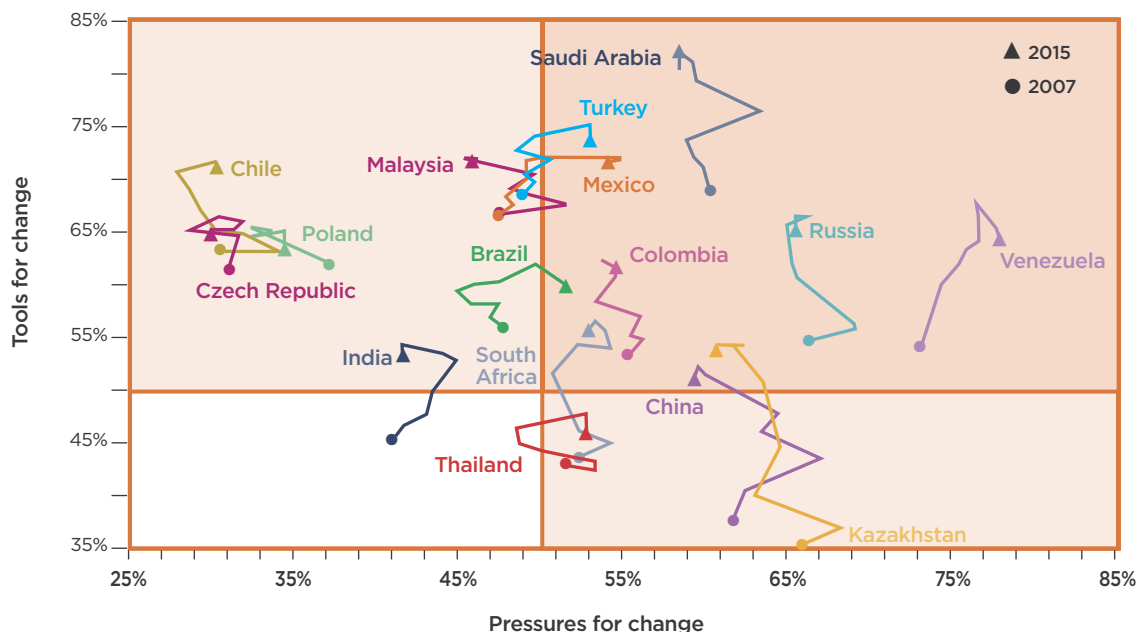
We believe political risk indicators are based on two factors⁽¹²⁾: the pressure for change can be measured by variables that translate the degree of intensity of economic, social and political frustrations: inequalities, scale of unemployment, political freedoms or corruption give rise to such frustrations. But the existence of such pressures does not inevitably mean that there will be turmoil. The capacity of societies to transform these pressures into actual change depends on an ability to develop instruments that by themselves enable expression, channelling and mobilisation of discontent. The development of such instru-

ments, which by nature are rather cultural, has played a key role in the Arab countries. They include the level of education, the increase in internet access, urbanisation, the fertility rate and the participation rate in the workforce for women. In our analysis, these cultural developments measure a society's ability to transform frustrations into political action.

Political risk must therefore combine the two types of modules, pressures for change and instruments of change, which are made up of six and seven indicators, respectively. In the "pressures" module we find the level of unemployment, corruption, freedom of expression ("expression and responsibility"), the Gini coefficient (measuring income inequalities), inflation and per capita GDP. The proportion of young people, the participation rate of women in the workforce, the secondary education, the adult literacy, the internet access, the fertility and the urbanisation rates make up the "instruments of change" module.

Among the countries remaining after using the filter of the first two criteria (price competitiveness and corporate debt load), we have therefore eliminated those whose political risk is excessive. More particularly, these are the countries whose score for each of the two modules exceeds 50% (i.e. the average of the 158 countries rated) and tended to increase between 2007 and 2015. Mexico, South Africa and Colombia are in this group, and also Kazakhstan for which leverage information is not available (see chart n°7).

Chart n° 7
Coface Index of Political Risk



Source: Coface

(12) See Coface Overview spring 2013: "The transformations of emerging country risk", Yves Zlotowski and Julien Marcilly

5 THE PHOENIX IS AN ENDANGERED SPECIES

After considering, in turn, the price competitiveness gains resulting from a depreciation, non-financial companies' debt load and the political and social environment, few emerging countries among the sample of the 34 countries studied slip through the net and fully meet all the criteria in terms of providing their companies with a good and rapid capacity for rebound or resilience. Only four countries meet these criteria: Czech Republic, Poland, Chile and Thailand. They account for less than 2% of global GDP but have in common the fact that they are relatively industrialised, they have overcome the middle-income trap, and they do not export too much to the worst hit emerging markets. Besides, their economic fundamentals are good: low inflation, low (Chile, Czech Republic) or moderate (Thailand, Poland) public debt and they don't suffer from high current account deficit. But there are sources

of vulnerabilities in these countries: political and social risk exists in Poland, Thailand and Chile, even though it is moderate. Chile has a significant dependence on copper.

Note nevertheless that their capacity to benefit from lower currencies will depend on the future dynamics of both global GDP growth and trade⁽¹³⁾. If both stay weak, this will limit the potential benefits generated by possible depreciations.

On the other side, this study confirms some countries have little room for rebound in the short-term: China, Saudi Arabia, Egypt and Ecuador have been suffering from an appreciation of their currency (mainly because of a lack of flexibility of their exchange rate) and an elevated political risk. Problems even pile up for China, insofar as its corporate debt level is very high.

(13) Sébastien Jean, September 2015. The slowdown in global trade heralds a trend change, The CEPII letter n°356

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