The perceived weakness of China’s economy has rocked global financial markets over the past year. But the storm in China’s currency and stock markets is not necessarily indicative of a brewing financial crisis, least of all one of global systemic proportions. With China committed to reform its economic model and emerging markets (EM) more broadly set to hit an economic inflection point, valuations look poised to improve.

China’s economy is losing momentum and authorities are attempting to engineer a smooth landing. Last year, the world’s second largest economy grew at its slowest pace since 1990, though it still added the equivalent of Switzerland to global GDP. The accumulation of debt over the last few years has been unrelenting. Superficial comparisons have been drawn to the run-up of the global financial crisis, but history rarely repeats itself.

Total debt as a percentage of GDP, including borrowing by the government, banks, households and the corporate sector, now stands at 282%. According to research by McKinsey Global Institute, that is far above the average for developing economies and above some advanced countries, including the U.S. and Germany. The largest driver of this burgeoning debt has been the expansion in borrowing by non-financial companies. At 125% of GDP, China’s non-financial corporate debt pile currently ranks second only to Singapore (Figure 1).

Inward Facing

However, most of China’s lending is conducted by state-controlled banks and much of it is funneled to state-owned enterprises (SOEs) (Figure 2). China controls its banks and also has the resources to bail them out. Contrary to “traditional” balance-of-payments EM crises of the past, China’s problems are largely the result of internal leveraging. The country’s debt problem, while not insignificant, could therefore prove to be relatively well contained.

Net capital outflows amounted to around $113 billion in January, according to the Institute of International Finance, marking 22 consecutive months of net outflows from China. Not all of these flows are capital flight. A case can be made that flows have materially been affected by Chinese companies repaying and hedging their dollar debt in anticipation of the yuan’s inclusion to the International Monetary Fund’s reserve currency basket in October—something which foreshadowed a depreciation of the renminbi relative to the U.S. dollar.

As China continues to shift its economy towards a consumer-led growth model, investors have been rattled by the potential impact on the rest of the world. Export-oriented economies, particularly those that are most skewed towards China, have been dealt a blow via a negative terms-of-trade shock. Second-order effects have also included a deterioration in global manufacturing data—evidence of which has emerged in Asia and parts of the developed world.

Multiple Forces at Play

There has also been a sharp adjustment in commodity prices amid the worst global oil supply glut in a decade. These combined factors have resulted in slower growth and disinflation...
Emerging markets are poised to reach an economic inflection point this year. In some cases, valuations are hovering at levels not seen since late 2009.

The prospects of Africa and Latin America are more closely aligned with the weakness in commodity markets. Latin America is dealing with a different mix of economic and second-order effects and is not experiencing the benefits of weaker inflation in the way much of Asia and Eastern Europe are. Inflation in Latin America is hurting the region's currencies, presenting investors with a different set of challenges. Economic stresses have given rise to other effects, such as political instability, particularly in Venezuela and Brazil, yet have been a factor for positive change in Argentina.

Governments that run fixed or managed exchange rate regimes are also feeling the pinch as the commodities super cycle stops turning. This has severely tested the economic models of countries in Sub-Saharan Africa, Central America and the Caribbean.

**Painful Adjustments**

EM economies are responding to these different sets of challenges with a range of policy responses, including currency adjustment and fiscal reform. The fallout from China, the slump in commodity markets and the start of the rate-hiking cycle in the U.S. will influence EM economies in diverse ways. How different regions and countries react will largely depend on how economic models have evolved over the last decade. The direction of travel has been varied.

Heading into the financial crisis of 2008, Eastern Europe was one of the most vulnerable EM regions, given its dependency on capital flows from the developed world and highly leveraged financial sector. Since then, Eastern Europe has deleveraged significantly, undergone extensive economic reform and focused on post-financial crisis austerity. As such, Eastern European economies are arguably more insulated from the current market tumult compared to other EM regions. Elsewhere, reform is underway and there are signs of progress in countries such as Mexico, Indonesia and even China.

EM countries are poised to reach an economic inflection point this year. In some cases, valuations are hovering at levels not seen since late 2009. In segments of the EM universe adjustments in economic models and fiscal reforms are still taking place, but in others a significant amount of progress has already been made. A premium for taking on EM risk has now returned and that has usually been the best time to begin adding exposure.

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**Figure 1:** Non-financial corporate debt (% of GDP)

- Singapore
- China
- Korea
- Japan
- Malaysia
- Italy
- UK
- U.S.
- Germany
- India
- Russia
- Brazil

Source: BNP Paribas, as of December 31, 2014.

**Figure 2:** Concentration of Chinese debt by firm type

- Private Firms: 22%
- Central SOE: 26%
- Local SOE: 52%

Source: IMF, as of December 31, 2013.

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