



Taper versus governance

BRICs at most risk of 'classic' EM crisis based on dysfunctional relationship between state and companies

Micro structural factors threaten EM economies more than Fed taper

There is increasing discussion about the possibility of a financial/economic crisis in one or more emerging markets, based on purely macro considerations, namely the impact of tighter Fed policy on those countries with high external financing requirements. We are sceptical for two reasons. First we believe that the Fed will be extremely cautious in tightening policy, largely because of the potential impact on emerging economies and financial markets which will then feed back into dampening growth prospects in the US. Second, the taper concerns reveal an excessively one-dimensional focus on a single macro-economic aggregate whereas the history of EM shows that more micro related factors around the corporate sector are ultimately the key drivers of EM economies and financial markets. The sudden break in correlation between DM and EM equities at the start of 2013 preceded talk of Fed tapering by several months and was the direct result of investors beginning to discount more favourable structural factors for the US against the bulk of the EM universe. Going forward, the greatest potential for an EM-style financial crisis resides in those countries with the most dysfunctional relationship between the state and the corporate sector. Our conclusion is that at least three of the four BRICs economies, with the possible exception of India, are eventually more liable to a 'classic' EM-type crisis compared to Indonesia, South Africa or Turkey, though we accept that there is a risk with Indonesia in particular that predictions of a crisis, which lead to a rapid run-down in FX reserves, could become self-fulfilling.

BRIC economies most vulnerable because of failure to implement reforms

Emerging economies and financial markets have historically been highly cyclical and prone to boom-bust cycles largely because the mechanisms to impose a hard budget constraint on enterprises are generally underdeveloped. The result is the accumulation of imbalances that become visible at a micro level some time before they begin to influence the macro-economic statistics. Financial markets are very influential in forcing policy responses, but the history of emerging markets suggests that a crisis or near-crisis situation is often necessary to force policymakers to implement structural reforms. The current cycle has now shifted from the widespread hubris which was so evident among EM investors and policy makers three years ago, to one of concern at the visible deterioration in growth rates and financial markets across the majority of the EM universe. Unfortunately whilst this concern is manifested in policy rhetoric, there is little evidence of a concerted attempt at implementation across the BRIC markets in particular.

We write about **China** at greater length later in the report, but our view post-Plenum is basically unchanged, namely that the mooted reforms fail to address the real driver of the deteriorating rate of productivity in the Chinese economy, namely the blurred boundaries between the state and private sector, which is the root cause of the widespread misallocation of capital. The result is that it requires an ever-increasing amount of finance to maintain growth rates of 7% which suggests that both the economy and equity market are extremely