CEEMEA Business Group

Emerging Markets in 2016-17

Special business and economic paper

by Nenad Pacek
Co-Founder CEEMEA Business Group and President, Global Success Advisors
Nenad.Pacek@GlobalSuccessAdvisors.eu

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Contact: Nenad Pacek, President and Founder, GSA Global Success Advisors GmbH; Co-founder and Co-CEO, CEEMEA Business Group
M: +43 676 646 0607 E: nenad.pacek@globalsuccessadvisors.eu www.ceemeabusinessgroup.com

*a joint venture between
DT-Global Business Consulting GmbH, Address: Keinergasse 8/33, 1030 Vienna, Austria, Company registration: FN 331137t and
GSA Global Success Advisors GmbH, Hoffeldstraße 1, 2522 Oberwaltersdorf, Austria, Company registration: FN 331082k

About the author

Nenad Pacek
President and Founder, GSA Global Success Advisors
Co-CEO and Co-Founder, CEEMEA Business Group

Nenad and his businesses currently advise global and regional directors of over 400 multinational corporations. He is founder and president of Global Success Advisors (global business and economic advisory) and co-founder of the CEEMEA Business Group corporate service (advisory for regional executives running Central Eastern Europe, Middle East and Africa). The advisory focus is on helping executives understand economic/business/political outlooks for virtually all countries around the world and on helping companies build strategies for sustainable growth in emerging markets.

Nenad is the author of "The Future of Business in Emerging Markets: Growth Strategies for Growth Markets" (2012), "The Global Economy" (2012), lead author of "Emerging Markets: Lessons for Business Success and Outlook for Different Markets" (2003, 2007), and a contributor to the book "The Future of Money" (2010). He is one of the world's leading authorities on economic and business issues that concern multinational corporations seeking faster growth internationally. He performs on average two speeches/advisory sessions every week at various corporate meetings on issues ranging from global, regional and country level economic/business outlooks to best business practices for outperforming competition internationally. In corporate circles he is well-known for not using any notes or power point slides while speaking and engaging in discussion.

Nenad is former Vice President of The Economist Group (Economist Intelligence Unit) where he spent almost two decades advising multinationals on economic and business issues and managing several business units in Europe, Middle East and Africa and one business unit globally. He chaired over 100 Economist Government Roundtables with Prime Ministers/Presidents and their cabinets throughout Western Europe, Eastern Europe, Middle East, Africa and Latin America.

Nenad was a board member of the Center for Creative Leadership (globally no. 1 provider of leadership education). He is guest faculty at Duke Corporate Education (globally no. 1 provider of corporate education), Notre Dame Executive MBA and a number of corporate universities.

He was educated in Austria where he studied international business, finance and economics. Nenad lives with his wife and three daughters near Vienna, Austria. He spends his rare free time mostly with his family, but occasionally sneaks out to play basketball, tennis, golf and to ski and swim.

Contact: nenad.pacek@globalsuccessadvisors.eu

Section 1 Executive summary

- Executives should have more conservative and prudent budgets for emerging markets in 2016 and most probably for 2017 too. This particularly applies for all markets that are heavily dependent on exporting commodities (most of Latin America, most of Africa, most of Russia/CIS, most of the Middle East, and Indonesia and Malaysia). Executives should also count on softer sales prospects in China mostly due to the changes in the economic structure (see later).

- Sales outlook is better for 2016 and 2017 for most of Central Europe (except South East Europe) and still large parts of emerging Asia. In other words, the outlook is better for markets whose exports are not dependent on commodities.

- There are five fundamental reasons for the current economic slowdown in many emerging markets (which is likely to persist in 2016 and possibly in 2017):
    - Outflow of (speculative) portfolio capital from emerging markets
    - Outflow of (speculative) capital from commodity markets
    - Worries about corporate debt in emerging markets
    - Questionable economic policy responses once commodity prices started to fall
    - Market panic about the above four points, contributing to even more speculative outflows (vicious cycle)

- The commodity prices slump is deep and recovery of prices could take between one and three years depending on the commodity category. In the paper, I explain (often surprising) reasons for the commodity price slump. In the appendix there are more details on oil price.

- The good news for medium and long term planning for multinational companies is that this emerging markets downturn is temporary and cyclical. The vast majority of markets will bounce back in the coming couple of years (see regional outlooks later).

- Emerging market fundamentals are still much better than news headlines and corporate results indicate at the moment – this downturn is different than those that prevailed in emerging markets in the 1990s. Most emerging markets have good economic fundamentals (relatively low debts, relatively low deficits) and enough foreign exchange reserves to defend their currencies if they choose to do so. The trouble for corporate sales in the short-term is that many countries seem to wish to preserve forex reserves and let their currencies lose some value. This is not a bad strategy from a macroeconomic standpoint, but it does hurt domestic demand and corporate sales in the short-term.

- Competition continues to be as tough as ever (from multinationals, emerging market multinationals, SMEs from the developed world and rising local companies). And it is likely to get worse in the next decade.

- With cheaper currencies in many locations and some assets in distress, there are certainly multiple acquisition opportunities at the moment within the emerging markets arena. It seems like a good time to acquire some local competitors, local markets shares and brands.

- Despite the short-term softness and sometimes outright sales declines across many emerging markets, any multinational serious about its long-term health and the sustainability of its global earnings over the next decade or two must continue to treat emerging markets with the utmost seriousness, with significant upfront investment in building the necessary local infrastructure, local capabilities and competencies in order to regularly outperform rising competition. Many of our clients are keen on “not wasting a good crisis” – the goal being to improve market shares when times are tough.

- It is a dangerous corporate strategy to totally derail and postpone emerging markets expansion plans due to the short-term disturbances caused by volatile portfolio flows in and out of emerging markets or commodities. These things will happen in the future too and no solid long-term emerging markets corporate strategy should be affected by the continued madness of financial and commodity markets.

Section 2 Introduction

This is how some of our senior clients have described emerging markets to me so far this year:

"Not a priority anymore."
"Off the radar screen."
"Not as sexy as before."
"No new investments going there next year, we will just milk them for earnings."
"Behind budget almost everywhere."
"Beginning to cut costs in most affected markets."
"The developed world is growing again, this is where our focus is now."
"Still having growth in emerging markets, but far from where we wanted to be."
"We are managing earnings growth in emerging markets at all costs, even if we lose market share."

And it goes on and on.

I have to go through my meeting and phone conversations notes with a fine tooth comb to find positive statements about emerging markets this year. Some statements are fatalistic too. One executive said at a recent meeting in Switzerland: *"This is the end of the emerging markets hype. Now it is clear we cannot treat it as a priority anymore. The emperor is naked."*

Business is indeed slower this year, but how bad are the emerging markets really? What is actually behind the current economic and business slowdown in so many of them? Is the slowdown going to be a lasting phenomenon, or is it just temporary and cyclical? What is the medium and long-term future for emerging markets and what does all this mean for corporate strategy?

These are just some of the key questions I will answer for you in this special business/economic report.

Section 3 Reasons for the Emerging Market slowdown in 2014-15

The slowdown is sharper and more visible in countries that depend on exporting commodities. Those countries that are *not* commodity driven are holding up reasonably well although they have seen some pressures too (mostly unwarranted outflows of portfolio capital).

Overall, there are five principal reasons for the current economic slowdown in most emerging markets.

1. **Outflow of (speculative) portfolio capital from emerging markets.**
2. **Outflow of (speculative) capital from commodity markets.**
3. **Worries about corporate debt in emerging markets.**
4. **Questionable economic policy responses once commodity prices started to fall.**
5. **Market panic about the above four points, contributing to even more speculative outflows (vicious circle).**

All five reasons are remarkably linked to each other, but each one requires a separate explanation (see below). The curious thing about this emerging markets slowdown is that it comes at a time when the US economy will grow some 2.5-2.8% this year, when western Europe is on the way to achieving its best growth rates since 2008 (expecting 1.5% this and next year) and Japan is continuing with its massive stimulus program which will result in modest GDP growth this year of around 1%. These three entities account for over half of the global economy (when GDP is calculated at market exchange rates). So why are these three large entities not pulling emerging markets up by providing more export opportunities for emerging market economies? And why is growth in the developed world not pulling commodity prices up – surely, better growth should result in greater consumption of commodities? Let's take a look at the principal reasons behind the emerging market slowdown and answer these questions along the way.

1. Outflow of (speculative) portfolio capital from emerging markets

Following the global crisis in 2009, the world was awash with freshly printed money. The money was generated through the so-called quantitative easing programs, mainly in the United States and the United Kingdom. Between 2010 and 2014 these two countries printed over $5.5 trillion dollars, in a successful and necessary step to avoid another Great Depression. Part of the newly created money was used for fiscal stimulus programs (a good idea when the private sector is scared and unwilling to buy). But the money partly ended up cleaning the balance sheets of many financial institutions (which, as you may notice, dislike the government when times are good, but love it when they need to be bailed out). In the US, the Federal Reserve took over banks' "garbage" liabilities and gave them fresh dollars, with the idea that they might lend to Joe Smith in Alabama to grow his small business. But instead of lending domestically, many financial institutions predominantly bought things that were giving them higher yields or were fashionably going up in value. For example, they bought Turkish government bonds, Indonesian treasury bills, South African currency, Brazilian stocks, all sorts of commodities and related commodity futures. Interestingly, they also started to extend highly risky loans and junk bond financing to new shale oil/gas players in America, enabling their rise (and creating global oil supply that previously did not exist – more on oil in the Appendix I). They also lent cheap money to various hedge funds, which joined the speculative game of buying assets in emerging markets and commodity futures. All these yield-hunting activities contributed to the build-up of asset prices in emerging markets, often pushing their currencies to unnatural overvaluations. **Between 2010 and 2013 gross capital inflows into emerging markets were averaging $1.1 trillion per year, up from $0.5 trillion annually in 2001-2007 period.**

This was good for multinationals and their business growth in emerging markets between 2010 and 2013 (for some slightly longer). Overvalued currencies suddenly made imports cheap. Banks and companies borrowed abroad where interest rates were lower than at home. But they sometimes borrowed in foreign currencies, exposing them to risk in case of local currency depreciations (more on these problems later). Banks lent like crazy to domestic consumers, companies and local governments. In an environment of easy global liquidity, growth was easy to achieve, resulting in high domestic demand and good business for multinationals.
When the US announced the end of quantitative easing in mid-2013, many players (especially those that had borrowed cheap and weak US dollars to invest in high yielding stuff in emerging markets or in commodities) started to sell off their profitable positions in emerging markets and commodities. They started to cash in on their profits, but also rushed to return their dollar loans, fearing that the dollar would appreciate (as it did). When someone starts a sell-off, others usually join in and panicky herd behavior takes over. Emerging market assets and currencies are then sold almost indiscriminately. The "hot money" or the "wall of money" that came into emerging markets and commodities was suddenly leaving in panic.

To sum up, the speculative money flowed into emerging markets for almost four years (pushing prices to historically high and unsustainable levels) and in the last two years it has been leaving. In 2015 emerging markets will record the first new outflow of capital since 1988. The outflow has resulted in weaker currencies (especially against the rising dollar) across many emerging markets (especially those that are heavily dependent on commodity exports). This reversal of financial flows has truly affected growth, domestic demand and sales/profit performance of multinational companies, especially in markets where exports depend on commodities.

Headline news about emerging markets in the last two years has often been alarming, comparing the recent sell-off episodes with the crisis in Mexico in 1994, with Asia in 1997, with Russia in 1998, with Brazil in 1999 or even Argentina in 2001. Some senior leaders of multilateral organizations and financial institutions called it an "emerging market crisis" and immediately called on central banks of the affected markets to increase interest rates to stop currency depreciations and to incentivize foreign portfolio capital to come back (which, by the way, is the wrong policy advice when it comes to medium-term macro stability, because it simply encourages countries to have overvalued exchange rates).

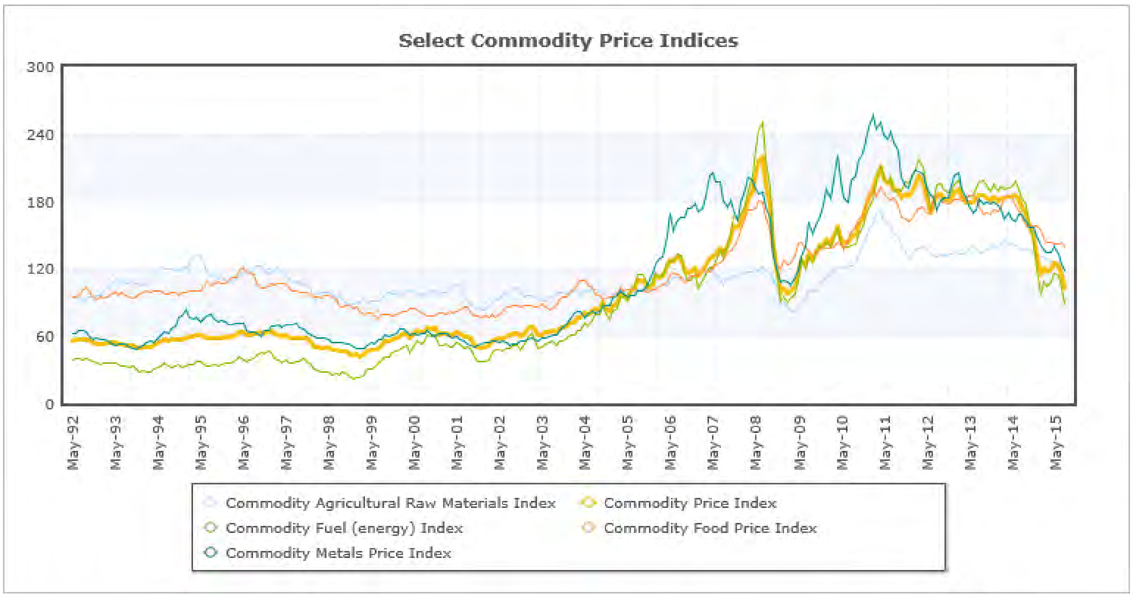
But the markets' diagnosis that this is yet another serious emerging market crisis is largely wrong. The outflows are not as fundamentally worrying as those in the 1990s. I will explain this later when discussing economic fundamentals and outlook for each region.

2. Outflow of (speculative) capital from commodity markets

Commodity prices are sharply down, affecting business in all markets that heavily rely on earning foreign exchange through sales of commodities. Almost all of Africa and the Middle East fall into that category and so does most of Latin America and Russia/CIS. Even a few emerging Asian economies such as Indonesia and Malaysia are partly exposed.

Just in the *last 12 months* the commodity price index (including all commodities) has gone down an unbelievable 41%, pretty much matching the rapid panic sell-off recorded in 2009 (when the world was in recession and today it is not). The crude oil price index has gone down 54% in the last 12 months, natural gas and metals are down by 29% and agro raw materials are down 21%. Many metals and agro prices (so important for African nations for example) are down over 60% since the 2011/2012 peak. We are living through the second largest commodity sell-off since World War II and both sell-offs have occurred in the last six years! In the last 12 months only the price of tea, olive oil, sorghum and (worryingly!) uranium, have gone up.

Select Commodity Price Indices 1992-2015, **Index,mundi**



The key question is why commodity prices have declined so quickly. I believe that this can be traced to five issues. They are:

a) The impact of quantitative easing and its aftermath
b) The rise of financial speculation in commodity trading
c) Oversupply in many commodities
d) The economic slowdown in China
e) A temporary negative loop in emerging markets

Let's look at each of these issues (which are interconnected) in more detail.

a. The impact of quantitative easing and its aftermath

Just like the freshly printed money flowing into emerging market assets (see point 1. above), it also flowed into commodity futures, pushing prices up. As commodity prices rose, all commodity- dependent emerging markets started to generate record amounts of foreign exchange. This encouraged them to spend and borrow more, pushing growth and domestic demand. This was good for multinationals selling in those markets. But when the flow reverses, commodity futures are usually sold off in quick, panic transactions because holders of various commodity futures do not want the price to hit the price on which they placed a bet (if it does, they would have to take a physical delivery of that commodity, but financial speculators do not want physical commodities). The speculative money flowed into commodity futures and now it has left. The bad news for businesses operating in commodity-dependent emerging markets is that the money will not return much in 2016. The good news is that the money will start returning into commodities probably (and gradually) already in 2017 and onwards as supply across various commodities starts to tighten. And supply will start to tighten as commodity producers cut their production, capital investments and some go bankrupt (the latter will particularly apply to those oil producers whose costs are high, such as shale oil players, see Appendix I).

Commodity prices have to rise again eventually. The global demographic boom continues. The world's population has doubled since 1965. It is growing by 6.4m people per month (of which 6.1m are in emerging markets). Two thousand years ago, the world had 200m inhabitants. Today it has 7 billion. The population has risen more from 1950 to today, than in the 2 million years before that. By 2068 - 2070 the world will most likely have some 14 billion people. If anyone doubts that commodity prices will rise, they should think again. Most commodities are now oversold and so are many emerging market assets.

b. The rise of financial speculation in commodity trading

In the words of one older generation commodity trader I talked to in Switzerland: *"Until about 2004-2005 we knew what we were doing! We knew roughly what the supply and demand was and was likely to be. Pricing was based on physical markets. Today, pricing has shifted from the physical to the futures paper market. This is casino style betting. And to make things worse, it is leveraged betting, which means that price movements up and down can be absolutely massive. We had instances when multi-billion dollar bets were placed in the morning on a certain commodity, and then reversed in the afternoon. It is the futures markets that determine the prices of commodities. Regulation is light or non-existent."*

This (together with point a) above) explains the two large boom and bust trading periods in just the last decade. The worrying part is that the last two mega sell-offs were just five to six years apart. Boom and bust cycles will inevitably happen again. But this should not derail long-term corporate strategies for emerging markets (more on this later when I discuss *Some advice for corporations*).

c. Oversupply in many commodities

As freshly printed money poured into commodities futures between 2010 and 2013 pushing their prices up, this prompted mining, oil and agro companies to increase investment and production. Easy financing conditions (due to quantitative easing and ultra-low interest rates) enabled an investment and production boom. But when demand slowed, this expanded output was suddenly not needed anymore, creating an oversupply. When futures traders see oversupply or even the threat of it, they start to sell-off futures contracts in a panic, further creating a negative loop, or a vicious cycle.

And this is where we are today. In most commodities, including crucially oil and gas, the physical markets are currently oversupplied. The crude oil market alone is oversupplied by some 2.5m b/d. But as various commodity producers now start to cut investment, jobs and output, oversupply across various commodities will start to gradually shrink somewhat in 2016 and more so in 2017. When futures traders see that supply is coming back closer to demand, they will start betting that prices will rise, and they will!

d. The economic slowdown in China

Following the global 2009 recession, China engaged in the largest fiscal stimulus program the world has ever seen (as a % of GDP and in terms of the speed of spending) and it went on for over five years. This was good for businesses operating in China. The structure of the Chinese economy enabled this spending spree. The central bank, which is not independent, created a new monetary emission, which was given to the largest state owned banks. The banks gave freshly printed renminbi to state owned companies as loans. Those borrowers then went on a huge, unprecedented spending binge – for which they needed various commodities. Until recently China has accounted for over a third of all global investment spending, flooding the country with new infrastructure, but also overcapacity in many industries. This fueled growth in China, but the structure of growth became unusual and unsustainable when compared to other countries. Today, almost 50% of Chinese GDP is driven by investment spending. In "normal" economies, 60-70% of GDP is driven by household spending.

China realizes that it has overcapacity in many sectors and that it has to substantially slow down the pace of investment spending. When it recently told the world that it has to restructure the way it generates its GDP growth (from investment spending to household spending), commodity traders realized that global demand for commodities was bound to slow down sharply. This prompted a further sell off in commodity markets in recent months, adding more speed and panic to the already rapid and nervous sell-off process. China then allowed the renminbi to weaken slightly, prompting yet another round of global panic around commodity prices (as traders started to expect there would be more renminbi depreciations in the near future).

China will continue the process of shifting growth to household spending from investments, but this is not something that can be achieved in a year or two. Especially since the average Chinese citizen still does not enjoy universal health care coverage, universal access to education or pensions. Therefore, consumers will continue to be reluctant to spend as much as the authorities would want them to. They will continue to save money until they feel more secure. The net result of this will be slower growth in China in the coming years and slower demand for commodities.

“Western” multinationals should count on Chinese companies becoming more aggressive in international markets in the coming months and years. They need new markets so that they can sell the surpluses they generate at home and they need to urgently fill manufacturing overcapacities in many industries. Gaining larger market shares internationally will be a priority and will be supported by official Chinese diplomacy (and money). More deals such as the recent one with Pakistan (a $48bn package of investments and trade co-operation) can be expected throughout the emerging world. The losers from such deals will tend to be “western” multinationals as Chinese firms gain preferential access to business opportunities.

e. Temporarily negative loop in emerging markets

A decline in commodity prices has negatively affected many emerging markets that are large commodity exporters, including countries in Latin America, MEA, Russia-CIS and even some in Asia. Although this slowdown is temporary and cyclical, these countries are currently generating less income and foreign exchange from their export activities. This means their growth and domestic demand have slowed down. They will invest less than in previous years, and use fewer commodities for their own investments and consumption -- this is the negative loop. It is also negative news for global commodity prices in the short-term. When commodity prices start to rise, the loop will go from negative to positive, from vicious to virtuous cycle.

3. Worries about corporate debt in emerging markets

The freshly printed money in the US and the UK was made available to emerging market governments, corporates, banks and households via US and UK financial institutions including those in the so called shadow banking arena. They were looking to earn high yields somewhere in the world, rather than buying low-yielding securities in the developed world or lending at home. They readily helped corporates in emerging markets to raise new international debt, either via bond issuance or bank loans. US and UK financial institutions also gave loans to banks in emerging markets which passed them on (for a nice profit) to local households, government and corporates. Corporations in emerging markets saw this sudden abundance of cheap financing as a wonderful opportunity to strengthen their strategic positions at home and increasingly abroad. Ever since this liquidity party started, our typical multinational clients have complained about how financially strong some of their emerging market competitors are and how hard it is to compete with them. Many emerging market corporates decided to venture out regionally and globally, suddenly feeling rich on the back of newly borrowed funds. But borrowing in foreign currencies is always risky business, especially if sales are predominantly generated in domestic currencies.

As the “hot money” started to leave emerging markets the dollar began to strengthen, exposing those emerging market corporates that borrowed in dollars. Suddenly, they faced substantially higher principal, but also larger debt servicing payments. They continue to be exposed to the fact that the US dollar will probably strengthen further as the US Federal Reserve starts to normalize its monetary policy (read: finally increase interest rates) and this will happen in the coming months (earliest December and latest in H1 2016). Many emerging market companies sell their products and services predominantly in domestic currencies and frequently in other emerging markets (where currencies have also lost value). This looks like worrying forex exposure for many emerging market corporates.

But how big is the actual exposure to non-financial corporate debt? The headline news about this in recent months has been quite alarming, contributing to the sell-off of commodities and all kind of emerging market assets. It was widely reported that non-financial corporate debt in emerging markets went from $4 trillion in

2014 to $18 trillion today. But the headline news and various articles do not explain the background. How does that differ by country? How does it compare to the developed world? Is it too much as a % of each country's GDP? Let's take a look at some interesting facts.

In the Eurozone, non-financial corporate debt is 138% of the area's GDP. In Japan it is 136% of GDP, in the UK 118% and in the USA 89% of GDP. The mentioned $18 trillion dollars of non-financial corporate debt in emerging markets is actually some 73% of emerging markets GDP (if GDP is calculated at market exchange rates). As you can see this is far less than key developed markets and in fact far less alarming than recent headlines suggested. A further breakdown reveals something else. $11 trillion out of the $18 trillion is actually in China! All other emerging markets hold "just" $7 trillion in EM non-corporate financial debt. This is actually less than 35% of their GDP. And only 25% of the $7 trillion is actually denominated in foreign currencies! Emerging markets (both government and companies) learned their lessons from the 1990s – you do not want too much debt exposure in foreign currencies.

As you can see this is far from non-corporate debt levels in the developed world. Why then all the alarming headlines about emerging markets? I do not want to belittle the problem, but it does not deserve all the panic we have witnessed in the last months.

On the other hand, it sounds like China is really in trouble with $11 trillion dollars in non-corporate financial debt. But is it? A glance at the total *foreign debt* figure in China shows that total foreign debt is some $770bn of which $490bn is actually private foreign debt. The figure includes both non-financial and financial corporate debt. The simple explanation is that over $10 trillion of the total $11 trillion non-financial corporate debt is China is actually denominated in renminbi, not dollars or euros! Therefore, Chinese non-financial corporate debt denominated in foreign currencies accounts for less than 5% of Chinese GDP! In other words, the massive spending program between 2009 and 2014 was largely financed with domestic loans denominated in domestic currency. This was smart economic policy. If any of the big state owned banks run into non-performing loans, their balance sheets will surely be cleaned by the central bank which will print enough renminbi to clean them (just like the Americans and the British did since 2009 with their own banks). As we mentioned before, the central bank in China is not independent (another smart element of economic policy which all emerging markets need to adopt if they want to accelerate their economic development – this is another topic in itself).

As you can see, all this panic about emerging markets' non-financial corporate debt is largely "much ado about nothing". However, I do not want to be naïve about this problem. Some corporates in emerging markets who have taken out forex loans and have not diversified their sales outside domestic markets will have difficulties servicing debt. Also, as these corporates begin to have difficulty servicing forex loans, they might eliminate some employees (who will buy less) and will buy less equipment. At the same time, if corporates borrowed from domestic banks, some of those banks could suddenly have larger non-performing loan portfolios which could create some problems in terms of lending dynamics in those markets. 78% of all non-financial corporate debt borrowing in emerging markets comes from local banks so there is clearly an element of potential exposure to corporate debt defaults. Some of your leveraged distributors and key customers might be affected too when interest rates in the developed world start to rise.

So which countries have elevated levels of non-financial corporate debt? Companies should be more careful in Russia, Turkey, Brazil, Chile, India, Peru, Mexico, Thailand, Indonesia, Columbia and South Korea, where we have witnessed the largest increases in non-corporate borrowing since 2008. But, as I will demonstrate later, even in the above mentioned markets, total foreign debt ratios are actually still relatively low when measured against international benchmarks.

Another interesting fact is that $3trn out of the $18 trillion (which, as I demonstrated above, is not really dollars, but mostly dollar equivalents) was borrowed through corporate bonds, 75% of which are denominated in domestic currency.

If one puts it all together, it is clear that non-financial corporate debt in emerging markets is not only much smaller as a % of GDP than in the developed world, but also the vast majority of debt is actually denominated in domestic currencies. The fact that debt is predominantly in domestic currencies is good news because in the event of a threat of corporate and banking system problems, local central banks and governments will find it much easier to dig themselves out of the hole, without having to beg foreign creditors for help.

Based on all this my word of advice for senior executives responsible for emerging markets is the following: make sure you understand the financials of your key customers and your key distributors. Make sure you understand their level of leverage and potential exposure to foreign and domestic loans or corporate bonds. The last thing you want is to make a shipment somewhere and then your distributor goes under and you never receive the money. Also, the last thing you want is to set an ambitious target for your B2B sales, say in Turkey or Russia, when corporate debt there has skyrocketed to almost $200bn and $500bn respectively and where both the lira and the rouble have fallen like rocks. In markets like these there will surely be trouble for some corporates in the next two years.

4. Questionable economic policy responses once commodity prices started to fall

The following is what I call a "death sequence": imagine a market whose exports are driven by commodities. Commodity prices fall and hurt export revenues. This leads to a drop in foreign exchange earnings. Foreign funds (which were parked in commodity- driven markets for high yield) start to sell off their holdings in the country, assuming that lower forex earnings means a higher current account deficit and soon-to-come currency pressures. As funds leave, the domestic currency is dropped into the market, causing depreciation. A falling currency creates higher import prices and starts to push inflation up. The central bank panics and moves interest rates higher to a) arrest the outflow of foreign funds and b) keep interest rates positive in real terms (above inflation). Higher interest rates hurt all borrowers, leading to the postponement of investments. As borrowers get hurt, they buy less, causing domestic demand to fall. Falling domestic demand means lower GDP growth. Lower domestic demand and lower GDP growth lead to falling tax revenues. The minister of finance then panics and says "we do not have enough revenues, we must cut costs urgently. Austerity is what we need." As austerity kicks in, government consumption falls in addition to already slowing private and corporate consumption. As government spending falls, growth slows further, leading to even lower tax revenues, which then prompts more austerity. Since no one wants to buy anything anymore, companies panic and start firing people. They lose confidence and reduce purchases. As consumers reduce purchases, corporate sales slowdown further, causing further drops in corporate investment and even more layoffs. The private sector as a whole loses confidence. Banks do not want to lend into an environment of slowing growth and uncertainty and start calling in some outstanding loans, putting pressure on highly leveraged corporate borrowers (who then go into more panic and lay off more people who stop going to shops completely). While this vicious spectacle is unfolding, credit rating agencies talk about "the country not doing enough to cut its spending" and threaten to cut the credit rating to junk if the government does not go into even deeper austerity and if the central bank does not increase interest rates even further. Phew!! It is painful just writing this paragraph in one breath. But you see how a simple, temporary and cyclical fall in commodity prices can cause this "sequence of death."

How can countries avoid this vicious circle?

If you are from a country that is doing the above, please pass the following paragraph to any of your politicians: Do quantitative easing when there is a threat to growth. Sell government bonds in domestic currency to your own central bank (all the developed world has been doing this to get out of the slump) and use the proceeds to expand government spending temporarily (while the private sector is losing confidence and not buying). Do not listen to the words of advice coming from developed markets. Do what they are doing. You cannot allow domestic demand to fall. If you go for austerity, your accumulated government debt will actually rise (see what happened in the Eurozone since 2009 until the start of quantitative easing). Cut interest rates and keep them negative in real terms until there is an entrenched recovery of domestic demand (what the US and Europe are doing right now). And if you depend on selling commodities, for God's sake you have to improve your competitiveness as quickly as possible! No country has even gotten rich without developing a robust high-value-added industry, ideally in a combined strategy of nurturing domestic champions and pushing them abroad, while at the same time attracting new foreign investments. See what South Korea has been doing since the 1970s. Do you think any of Chinese infrastructure was built with IMF or World Bank help?

Conclusion of Section 3

All in all, as you can see, the emerging markets slowdown that we are currently going through is largely a temporary, cyclical phenomenon. We advise multinationals to be prudent with budgeting for 2016 and even 2017. When commodity prices start to rise, the negative sentiment will turn positive and markets that are struggling will start with recovery. And because this is a temporary phenomenon, smart companies should not lose sight of the medium- and long term and should strategize accordingly. Companies should use the current downturn to gain market share, rather than be obsessed with quarterly earnings.

Section 4 Business performance and top business challenges in emerging markets

After participating in many corporate meetings and talking to many senior executives this year, I think there is a strong consensus view regarding the most important business issues in emerging markets. Here they are:

1. **Business in emerging markets this year is slower than budgeted/planned for most companies**. This is particularly the case in markets that depend on exporting commodities which is pretty much all of Latin America, most of MEA, Russia & CIS and some countries in Asia such as Indonesia and Malaysia. Even in some non-commodity driven markets, business is also slightly softer than companies anticipated (since their currencies also fell in a broader emerging market panic sell-off).

2. **Most companies will miss their emerging market budgets/targets this year, especially their top line**. Many are now scrambling to protect promised earnings growth, usually by cutting costs, including marketing costs. Some are very visibly re-sizing and restructuring their emerging market offices to reflect softer revenues. Some are raising prices to protect earnings, and losing market share in the process. Some are protecting market share at all costs, which has produced a number of price wars across various emerging economies. A minority are using the slowdown to grow their market share, "using a good crisis" to boost market presence that will be rewarded in the medium and long term.

3. **Competition in emerging markets is worse than ever and will get even worse**. This is not only due to the larger and deeper presence of multinationals, but a stellar rise of emerging market multinationals which are going global in growing numbers. A decade ago, there were almost no emerging market companies on the global Fortune 500 list: today, 132 out of 500 are emerging market companies. Local family businesses are rising on the back of greater access to debt and equity finance, but also good internal reserves built up over the years. Medium sized firms from Europe and the US have also rapidly expanded to emerging markets in recent years. Since very few companies are actually pulling out of emerging markets, the competition dynamics remain very intense even during this economic slowdown. In the next decade, I believe that competition will get worse as more companies arrive and the existing ones go deeper into various countries. A new economic upturn (once commodity prices rise) means that more competitors will be attracted to emerging markets.

4. **The relatively bright spots in terms of business performance are recovering markets in central Europe, primarily Poland, Hungary, the Czech Republic, Romania and Slovakia (and to some extent Bulgaria, Slovenia and the Baltic States)**. They are finally recovering after a prolonged six year period of sub-growth and even occasional recession. Also, **there is still robust growth throughout most of emerging Asia,** with more pressures visible in China, Indonesia and Malaysia. Emerging markets that are not much dependent on commodity exports are doing relatively well. Also, those that are globally competitive and diversified are doing better than others. Central Europe and large parts of Asia fall into that good category of strong diversification, good industrialization and global competitiveness. They additionally benefit from lower oil prices which helps real wages and consumption.

5. **The softness of the commodity-driven emerging markets business is creating all sorts of problems for regional directors.** They are turning into genuine CEOs (Chief Explanation Officers, a term I originally coined for heads of CEE operations several years ago) and having to explain what is wrong with their region, their countries, their teams and sometimes themselves. Until recently the heads of Middle East Africa were not in the CEO category, but they are now as some 80% of companies will miss their revenue targets in 2015, the worst score since 2009.

6. **The current focus in many multinationals that are still hostage to stock market quarterly short-termism is to squeeze and sweat emerging markets for more earnings**, now that the top line is behind plan. Regional directors of such firms have complained to me that their companies were shooting themselves in the foot. Growth initiatives are being put on hold, and much needed expansion of local infrastructure, capabilities and competencies is being delayed. These executives see that companies that take a longer-term view are using this slowdown as an opportunity to strengthen the business, to increase market share and to position the business to deliver sustainable top and bottom line growth that can outperform competition in the future.

7. **Until recently, corporate expectations about emerging markets were in the irrational stratosphere.** At many global headquarters I have visited recently, CEOs and boards are finding it hard to accept that their regional teams are suddenly missing targets, sometimes by a wide margin. But this is really a new normal that will last as long as commodity prices stay low. Companies need to adjust to this by having less ambitious targets for the next two years, but at the same time never lose sight of a good medium and long-term outlook. One of our clients summed this up well: *"My global guys just do not want to listen to what I and other regional heads are saying. They do not want to understand that we have more competitors than ever, that our product portfolio and pricing needs to evolve and change, that demand is really much slower than before, that operational costs are rising faster than ever as more competition increases the cost of people, that margins are being squeezed. We just need a new dose of reality in our three year strategy, planning and budgets."*

8. Competitive pressures are constantly pushing **operational costs upwards**. Finding and retaining talent is one of the most frequently mentioned challenges, and the cost of people continues to rise above inflation in many markets. This is also the case in markets that are not necessarily booming for business and it is simply the lack of adequate supply and rising demand that continue to push prices up. To minimize the impact of rising staff costs, many firms are now engaged in optimizing other costs related to their overall supply chain or corporate structures.

9. More and more companies are thinking of **acquiring** their "annoying" competitors before they become too big and too powerful. We will most likely see a surge of new acquisition activity compared to recent years. Many currencies in emerging markets are now oversold in my view and this is a good window of opportunity to acquire some good local brands and competitors. Some might become distressed assets in the coming months if they have borrowed too much in foreign currencies.

Having all of the above in mind, **multinationals have to accept that emerging markets have their limits in terms of how much business can be squeezed from them in the coming year or two**. More than ever in the last 5-10 years, companies must be prudent in the way they plan and budget for short-term growth in emerging markets. No one wants to miss budgets in any corporation and complacent top-down imposition of massive stretch budgets will increasingly backfire. **To win business and generate sustainable growth every single company will have to become extremely locally relevant and locally resilient.** Those that don't make investments to achieve this deep local relevance and resilience will struggle in the coming years (more on this in the last section of this paper).

Section 5 Why is the slowdown not as alarming as business results and headline news indicate?

There are several items to keep in mind here.

First, during the 1990s many emerging markets were struggling with low foreign exchange reserves and much larger debt than is the case today. Today, most emerging markets have good, very good or excellent economic fundamentals (with a few exceptions, as you will see later in the text).

Second, most of the current economic slowdown in emerging markets is influenced by lower commodity prices, the outflow of (speculative) portfolio investment, and to some extent, weaker export growth to developed markets (exports from EM to developed markets grew on average 5.8% in 2014-2015, compared to 12% p.a. in 2004-2008). Today, the developed world is growing reasonably well and should create more export opportunities for many emerging markets (especially now that so many emerging market currencies are weak and supporting exports).

The quick conclusion is that the emerging markets slowdown is largely a temporary and cyclical phenomenon rather than a fundamental problem *(you will see the details on fundamentals in the coming pages).* **This ultimately means that companies should continue and sustain their medium and long-term growth initiatives in emerging markets.**

Emerging markets' bounce-back potential and future resilience is there because most emerging markets have **no sizeable debt** (see the next pages); they actually have **record accumulations of foreign reserves** (which serve as buffers if countries choose to defend their currencies), and most **banks in most emerging markets continue to lend** (which enables private and corporate investment). **Emerging markets now hold over 80% of global foreign exchange reserves, they buy half of the world's exports and have more than 80% of global population (which is also increasing by over 70m people each year, vs the developed world where the population is expanding by just 3.6m per year, all of it in the United States and all of it through immigration). At purchasing power parity, they also account for just over half of global economic output, for the first time in 160 years.**

In the future, emerging markets will continue to go through temporary inflows and outflows of portfolio capital and through commodity booms and busts, but these disruptions will be temporary and markets will bounce back. Due to high foreign exchange reserves and relatively low debts, they are fundamentally far more resilient than during the turbulent 1990s.

The impact of the developed world on emerging markets during 2012-2013 was significant and negative. The factors were: the chronic Eurozone recession, fiscal drag/sequestration/tax increases in the US, stubborn weakness in Japan, and the austerity-bitten UK. **However, emerging markets should benefit in 2016 from gradual recovery in the developed world.**

The key question today is whether the stronger developed world will pull emerging markets out of the slump or if struggling emerging markets will pull down the developed world.

On aggregate, I lean towards the idea that it will be the developed world pulling emerging markets slowly up. Why? Because the developed world is now growing and so are parts of emerging markets that are not commodity exporters. These countries put together account for a larger share of the global economy than those emerging markets that are currently suffering.

Emerging market fundamentals continue to be very good. Accumulated foreign debt as a percentage of GDP is low at just 24%. Accumulated government debt is 46% of emerging markets' GDP. Contrast that with government debt in the developed world: 94% of GDP in the Eurozone, 74% in the United States, 90% in the UK, 249% in Japan, 87% in Canada. In the developed world only Australia, New Zealand, Scandinavian markets and Switzerland are not highly indebted when it comes to government debt.

Emerging Asia

a. Fundamentals

At the moment many of our clients report that emerging Asia is growing in terms of sales but in many markets sales growth is somewhat slower than anticipated/budgeted. Needless to say, this is putting pressure on regional heads running Asia. Despite the current relative softness and worries about China, I believe that companies should not have fundamental worries about emerging Asian economies. The economies are stronger than the news headlines or market panic suggest. Executives should keep in mind vastly improved economic fundamentals since the unhappy events of the late 1990s.

First, emerging Asia has very low **foreign debt** accumulation and the debt has actually been falling in the last 12 months as a % of GDP. It dropped from 16% of GDP in 2014 to 15.2% of GDP at the time of writing. Remember that during this time the news headlines were talking about "collapsing Asia" due to rising foreign debt! Chinese accumulated foreign debt has also fallen to just 7% of GDP from 9% in 2013.

16% of GDP is low by any international benchmarks. It is the lowest regional foreign debt accumulation in the world and far below the crisis benchmark of 70% of GDP. It indicates that markets and private entities do not need to deleverage much and *can* engage in corporate and private investments. In other words, emerging Asian markets can bounce back faster from any slowdown than most countries around the world. And they will bounce back once the dust settles around the news that China will keep changing its economic model and when global capital flows start to return to emerging markets and commodities.

Foreign debt as a % of GDP, regional weighted average and a selection of countries, 2014-2015

	2014	**2015**
Emerging Asia weighted average	**16.0**	**15.2**
China	8.6	7.0
India	23.2	23.5
Indonesia	33.1	33.0
Malaysia	32.1	33.6
Philippines	31.6	39.0
Taiwan	24.2	24.5
Thailand	36.0	38.0

Secondly, **government debt** is 51% of regional GDP (much less than developed world markets) and like foreign debt it has been falling as a % of GDP. Anything below 60% of GDP is considered sustainable and rarely requires serious deleveraging. This also shows that countries can afford to run temporary budget deficits to help growth (in emerging Asia the notable exception is India where government debt is somewhat elevated but not critical).

Government debt as a % of GDP, regional weighted average and a selection of countries

	2014	**2015**
Emerging Asia weighted average	**51.6**	**51.0**
China	54.0	52.7
India	66.9	66.4
Indonesia	23.7	23.2
Malaysia	53.0	54.0
Philippines	48.7	47.0
Taiwan	49.0	52.0
Thailand	44.0	45.0

Thirdly, **foreign exchange reserves** in emerging Asia are robust despite the recent fall in China (see table below). In 2014 they were just shy of $6 trillion (this figure excludes Japan and some small markets like Sri Lanka or Bhutan). Foreign exchange reserves have doubled since 2007 and emerging Asia now holds some 70% of all foreign exchange reserves held by emerging economies (which hold over 80% of global foreign exchange reserves). This is a massive increase since the late 1990s and the last big Asian crisis when reserves were tiny.

This indicates that unlike in the 1997 Asian crisis, authorities in most emerging Asian markets can now intervene to defend their currencies in case of speculative outflows. But as we have noticed during the last 12 months, many governments have chosen to let their currencies lose some value in order to keep their exports competitive and to preserve accumulated foreign exchange reserves. They are letting the currencies find a more realistic value after their value was inflated by large speculative inflows in 2010-2013. Indonesia and Malaysia are the ones that look more vulnerable as long as commodity prices are low.

Foreign exchange reserves, $bn

	2014	2015
Emerging Asia (excl. Japan and smaller markets)	**5,970**	**5,570**
China	3,830	3,410
India	321	350
Indonesia	109	98
Malaysia	114	95
Philippines	73	73
Taiwan	423	430
Thailand	150	147

Fourthly, emerging Asia runs a **current account** surplus which will exceed 3% of GDP this year, up from 1.9% surplus in 2013. All the larger emerging Asian markets run a surplus, except India and Indonesia, but even in those markets current account deficits are very low by international standards indicating more underlying currency stability than can be explained by recent currency movements. Current account surpluses show the underlying demand for domestic currencies. So at current prices most emerging Asian currencies are actually undervalued and should be strengthening in the next few years.

Finally, the regional **budget deficit** is acceptable at a low 2.8% of GDP, and only in India and Malaysia is it higher than it should be compared to international benchmarks. India's budget deficit is over 6% of GDP (actually similar to Japan) and Malaysia's is just over 3% of GDP. Only in India is the number somewhat worrying and in the coming years it will be resolved either through faster growth or some austerity. It will probably be higher growth in the coming years (see below).

b. Economic outlook

Emerging Asia is currently the **fastest growing region** in the world, just like in recent history. Growth is slightly slower than in previous years, but on aggregate it is still going to be around 6% this year, down from 7.4% in 2011. If we take into account some questionable statistics in China and perhaps in India, real growth in emerging Asia will probably be around 5.5% this year, which is still respectable by any global or historic standards. In the next two years, regional growth should stay roughly where it is today. China will gently slow down, while at the same time India will accelerate (and so will Indonesia and Malaysia when commodity prices start to rise). Emerging Asia will benefit from modest growth in the developed world and a gradual shift to domestic demand-driven growth. It is a myth that emerging Asian consumers are not spending more than before. In the last eight years, retail spending grew by 72%, and this solid growth trend will likely continue and even accelerate in the future. The good news in emerging Asia is that growth is increasingly broad-based and rests on good fundamentals.

Despite the current softness in business reported by multinationals, executives running global and regional operations should continue to be bullish about economic and business prospects in the region, but at the same time have more prudent budgets for 2016-2017. Down the road, the good fundamentals will ensure that most currencies gradually appreciate (although as mentioned earlier there could be some temporary problems with currencies once the US Fed starts raising interest rates). **Strategically and especially in a long-term perspective, it makes perfect sense for companies to treat emerging Asia as the biggest priority in emerging markets for new business development investment** and to go deeper into exploring all sales, acquisition (especially now when currencies are cheaper) and manufacturing opportunities.

Real GDP growth, %, selected countries in emerging Asia

	2014	2015	2016	2017
Emerging Asia	6.4	6.0	6.1	6.4
China	7.3	6.8	6.5	6.2
India	7.3	7.5	7.8	8.0
Indonesia	5.0	4.6	4.9	5.4
Malaysia	6.0	4.8	4.4	4.8
Philippines	6.1	6.1	6.3	6.2
Thailand	0.9	2.0	3.1	4.2

China

See more on China in the discussion of China's recent impact on commodity prices. In a nutshell, China will continue to shift its economic model towards more domestic household spending, rather than relying too much on investment spending. The authorities will continue to cut interest rates and minimum reserve requirements for banks in order to maintain the pace of lending (which is still growing at 11% this year -- slower than before but better than most markets). The authorities will not allow the renminbi to appreciate and could allow small, sporadic devaluations to keep exports competitive. The renminbi would be much stronger if it were floating freely in international markets, but the free float and the opening of the capital account are unlikely in the next two years. It seems that the new currency policy is to have a *de facto* peg to a basket of currencies, rather than the strengthening US dollar. The central bank is not independent and would cover any problems with loans denominated in domestic currency (which is the vast majority of all loans). State owned enterprises will be partly restructured, but pushed to compete abroad (with government help) to sell the goods surpluses that the current manufacturing overcapacity can generate. Multinationals should expect much more aggressive Chinese competition in international markets in the coming years. Companies should also count on more difficult domestic market as local companies gain even more access to business opportunities at the expense of multinationals (so they can place the production capacity surpluses at home). The anti-corruption campaign is likely to continue. Investments will continue too, but at a much slower pace than in the past few years. Massive local government debt (luckily mostly denominated in renminbi) will be rolled over and will not be allowed to undermine overall economic stability. China keeps adding about 7m people to its population every year (the total population next year will reach 1.38 billion). A hard landing will likely be avoided, but companies should count on softer sales and earnings growth in the coming years.

India

Although there are questions about India's growth statistics, India is and will remain one of the fastest growing economies in the world. Its population will hit 1.3bn people next year and it keeps growing by 15m people every year. Many things look encouraging regarding growth prospects in the coming years. Prime Minister Modi is a reformist and if he manages to capture the majority in parliament in a series of upcoming local elections (which seems likely), he will be able to push through major changes that will accelerate growth and business opportunities. Currently, reforms are stuck because they are being blocked by the opposition that controls parliament. At the same time, the central bank is run by a very safe pair of hands, with the primary goal reducing chronic inflation (but not at the expense of growth). The lower oil price is benefiting India currently too by pushing inflation lower than usual, which should enable further cuts in interest rates that will help growth.

The current account deficit is small and net FDI inflows now exceed $30bn per year. This means that the rupee is now somewhat undervalued and if reforms start to accelerate, we will see steady currency appreciation in the coming years. Lending will expand this year by 9% while domestic demand could expand around 6% in 2016 and 6.5% in 2017.

Indonesia

Although growth has continued to slow and the currency has been under heavy pressures, this year's expected growth rate of 4.6% is still respectable by global standards. Domestic demand has continued to expand this year at around 4%. The population has reached 255m people and by 2050 the population will reach 370m (it will be the 5th most populous country in the world). The slowdown is largely linked to lower commodity prices and outflows of capital, which has hurt the rupiah. But as indicated above, fundamentals remain solid, while domestic credit continues to expand by 11% per year. Reserves have dropped recently but they are still more than double the level Indonesia had in 2007, let alone 1997. The cheaper currency has actually reduced the current account deficit further, bringing it this year to just over 2% of GDP, which is very good and not dangerous anymore for the currency. At the same time, net FDI inflows this year will be over $15bn, almost fully covering the current account gap (and helping rupiah). The rupiah is now in our view fairly valued, while two years ago it was overvalued on the back of strong commodity exports and commodity prices. The currency adjustment is actually healthy for macroeconomic stability in 2016. One area of concern is that private debt denominated in foreign currencies is some $150bn, which exceeds official forex reserves. In sum, companies should expect softer than usual demand in the next 12 months and perhaps some stress among leveraged domestic conglomerates.

Latin America

a. Fundamentals

Softer business in Latin America in 2014 turned even softer this year. Brazil in particular has been disappointing in terms of sales growth (with many firms recording declining sales) and “corporate performance vs. corporate plans”. A further slide in commodity prices has hit the key markets hard. Dependency on commodities is huge. In Brazil, Chile, Argentina, Colombia and Peru commodities account for 60-80% of total exports, one of the highest degrees of dependency on commodities in the world. In Mexico, commodities account for about a quarter of all exports and from this perspective the economy is much more resilient. This overall large dependency on commodities is the root cause of the current slowdown, which was then further exacerbated by questionable policy response in several markets (see earlier Section on Reasons for emerging markets slowdown), notably in Brazil. Despite the current slowdown, economic fundamentals in key markets remain good to very good and any weakness should be temporary/cyclical with the exception of Venezuela and to some extent Argentina (whose future depends on the outcome of the second round of presidential elections coming up in November). Brazil’s fundamentals have gotten worse too, but they are not as bad as some headlines recently suggested (see below).

Let’s look at the fundamentals first and then the economic outlook.

Firstly, the continent’s **foreign debt** is not high, just 32% of GDP (economic history tells us that countries usually start to default or run into problems when their foreign debt reaches 70% of GDP). This foreign debt has risen from a very low 22% of GDP in the last two years, but the overall figures are far from alarming. However, some highly leveraged companies that borrowed abroad could have difficulties servicing debt in the next two years, now that most Latin American currencies are cheaper. The only market where foreign debt is elevated and could affect growth more seriously in 2015-2017 is Chile (see table below). During the commodity price boom which pushed currencies to overvaluation it was indeed tempting for local banks, companies and governments to borrow more in foreign currencies (at very low interest rates). For commodity producers (miners, agro firms) it was tempting to borrow and boost production during the time of high commodity prices.

Foreign debt as a % of GDP, regional weighted average and a selection of countries

	2014	2015
Latin America weighted average	27	32
Argentina	28	26
Brazil	21	22
Chile	56	62
Colombia	27	37
Mexico	22	26
Peru	32	33

Secondly, **government debt** is 49% of GDP, half of levels in the Eurozone and the vast majority of the developed world. At least on this criterion, most Latin American economies qualify to join the Eurozone – unlike most Eurozone members, which do not. Brazil’s government debt is now too high according to international benchmarks (but still far below west European markets or Japan or even United States), largely because of the “sequence of death” that I described in Section 3, point 4. Other relevant markets are far below any danger zone.

Government debt as a % of GDP, regional weighted average and a selection of countries

	2014	2015
Latin America weighted average	48	49
Argentina	45	42
Brazil	59	66
Chile	15	16
Colombia	43	43
Mexico	43	44
Peru	20	22

Thirdly, **foreign exchange reserves** have increased more than threefold in the last 10 years and are now over $700bn. Reserves have dropped from $740bn to $720bn this year as some countries used some of the reserves to ease depreciation pressures. Even with a recent loss of some reserves, they are close to historically high levels and central banks can use them to guard against further depreciation (if they choose to do so). However, since massive inflows of capital into Latin America between 2010 and 2013 overinflated the value of Latin American assets and currencies, some governments and central banks will want to see their currencies lose value for two reasons. Firstly, to keep exports competitive and secondly, to bring the macroeconomic imbalance into balance which is important for economic stability. At the same time, by not intervening too much in the currency markets, they are preserving hard earned foreign exchange (see the table below). Of the bigger markets, the only worrying fall of reserves to low levels is visible in Argentina and Venezuela. Next year Venezuela will completely run out of reserves and it had some $35bn back in 2007.

Foreign exchange reserves, $bn

	2014	2015
Latin America	740	720
Argentina	29	23
Brazil	373	370
Chile	40	39
Colombia	46	45
Mexico	187	176
Peru	62	60

Fourthly, the regional **current account** deficit is still manageable at 3.2% projected for this year. And because of currency depreciations this year, it will fall to just 2.4% of GDP next year, which is below any danger zone (in other words, the deficit will be small enough to be mostly covered by foreign direct investment). This means that currencies should start to stabilize (and strengthen when commodity prices rise).

Fifth, the **budget deficit** has deteriorated in the last two years and will be around 5% this year (when you exclude Venezuela which has a budget deficit of 17% of GDP). The average is really pushed down by Brazil which in our view has engaged in the “death sequence” economic policy (see Section 3). The usual consequence of this economic policy is a deterioration of the budget deficit (which just two years ago was only 3% of GDP). The average is slightly ruined by Argentina which will record a 6% of GDP budget deficit. The best way to get out of budget deficits is through pro-growth policies rather than austerity. Smart governments engage in structural spending cuts when times are good, not when times are bad. Cutting government spending at a time of low private demand and shaky private confidence makes recessions worse.

b. Economic outlook

Latin America grew very well between 2010 and 2013, during the time of high commodity prices and massive inflows of speculative money into various Latin American securities. Growth was 4.3% on average during that period. But last year growth was just 1% and there will be a mild recession this year, primarily because of recessions in Brazil and Venezuela. When one excludes Brazil and Venezuela, the other key markets will still grow 2.5% this year on aggregate. Latin American growth started to slow when commodity prices began to decline, also prompting an outflow of speculative portfolio capital out of the markets (see Section 3). When commodity prices start to rise, all markets will bounce back. As Europe and the United States continue to grow in 2016, exports to those destinations should gradually improve especially now that most Latin American currencies are cheaper (more fairly valued and more in line with fundamentals).

We are expecting a small pick-up in growth next year, but overall it will only reach 0.5%, while Brazil will still remain in recession. Regional growth should exceed 2% in 2017 and Brazil should finally exit the recession by then.

In the coming decade most Latin American markets will remain too dependent on exporting commodities so we will surely have at least one or two boom/boost cycles through 2025. Companies will have to learn how to operate in such circumstances and adjust corporate planning accordingly.

Executives should be aware that Latin America is still a popular playground for portfolio investment, much of which is purely speculative in nature. If currencies get too strong on the back of such speculative inflows, this would increase current account deficits, foreign debt would begin to rise and local exports would start to die (the previous over-appreciation of the Brazilian real has certainly hurt manufacturing exporters). At the same time, there will be periods of outflows of capital as in the last two years, when currencies return to more fair valuations.

Real GDP growth, %, selected markets in Latin America

	2014	2015	2016	2017
Latin America	1.0	-0.3	0.6	2.2
Argentina	0.5	2.2	2.5	2.7
Brazil	0.1	-3.1	-1.7	1.3
Chile	1.9	2.1	2.4	3.2
Colombia	4.6	3.2	3.5	4.0
Mexico	2.1	2.3	3.0	3.3
Peru	2.4	3.0	3.5	4.1

Brazil

Prior to the current recession Brazil's growth was positively influenced by solid commodity prices, economic stabilization achieved prior to president Lula, but also Lula's solid mix of fiscal expansion and pleasing the markets (which enabled the reduction of interest rates). As commodity prices rose, so did the Brazilian real. It went from 3.5 to the dollar 10 years ago to an all-time high of 1.54 three years ago. Commodity prices fueled the rise in the exchange rate (killing other exports due to the overvalued exchange rate), but Brazil also became a popular destination for yield seekers from the developed world. High yields on government bonds and still high interest rates caused massive "hot money", portfolio inflows pushing the value of the real even higher. An overvalued exchange rate also helped to reduce inflationary pressure. Imports were suddenly seen as cheap. All this resulted in credit-driven consumption which was fueling top line growth and multinational companies' business. Banks extended more loans than ever. Private institutions borrowed abroad in foreign currencies to take advantage of lower interest rates. Private foreign debt (including intercompany loans) is now $410bn, up from $150bn in 2006 and $300bn in 2010. An overvalued exchange rate boosted domestic consumption, but hurt industrial and agro exporters.

As commodity prices started to fall and "hot money" started to flee, the exchange rate started to fall, going from 2.20 to the dollar in early 2014 to over 4 recently (it is 3.9 at the time of writing). Fearing inflation as a result of depreciation, the central bank moved interest rates up and that hurt borrowers and their spending. What followed was the death sequence economic policy described in Section 3, pushing Brazil into a fairly deep recession this year and will surely cause another, shallower recession also in 2016. This will be the first time in over 80 years that Brazil will have two consecutive recessionary years.

Brazil is not only hit by its over-reliance on commodities, but also by its labor laws, bureaucracy and red tape, while the cost of doing business remains among the highest in the world. In addition, the current internal political crisis and paralysis is unhelpful, adding another element of uncertainty to an already challenging outlook.

The gradual recovery of export markets, the expected gradual recovery of commodity prices and the gradual return of portfolio investment will help Brazil exit recession by 2017. Its current account deficit will fall below 3% of GDP by 2017 and the real should be much more stable and even gain some strength by then. In fact the real stabilization and even strengthening could come even sooner since FDI inflows already cover most of the current account gap this year, which is a healthy development. In other words, there is little reason for the real to fall from current levels. Higher interest rates will make holding Brazilian assets more attractive and this could bring new fresh inflows of portfolio funds from abroad.

Companies should still count on a very difficult 2016 for business (and this weakness will remain to some extent through 2017). This two year period will not be great for sales for those companies who do not manufacture locally.

Mexico

This year's slowdown is largely the result of weaker export demand, the impact of the lower oil price, and overall negative sentiment about emerging market assets (which resulted in capital outflows even from fundamentally solid Mexico, pushing the peso down). Markets have overreacted about Mexico and stronger growth will return faster than in other parts of Latin America. The US's good growth trajectory will help Mexico's manufacturing exports and will keep growth closer to 3% in 2016. The peso seems oversold at the moment and is likely to appreciate in 2016 when capital flows to emerging markets start to reverse. Portfolio capital flows will first return to emerging markets like Mexico, which is not just a commodity exporter. In other words, the current slowdown is very much a short-term phenomenon. Low levels of debt, strong forex reserves, a lower current account deficit and a low budget deficit will ensure good foundations for future growth.

In the next two years household spending will grow at around 3% per year, while corporate spending is likely to grow around 3.5-4%. The good news, unlike in Brazil, is that the central bank has not overreacted to the depreciation of the peso and has not pushed interest rates too high as a response. Interest rates remain just above 3% and are still supporting growth.

Central and Eastern Europe (CEE)

For more details about each CEE market, including their fundamentals, please refer to our extensive CEEMEA Business Group country reports.

Two years ago it was Russia and the CIS markets leading the way in terms of revenue and profit growth in CEE, while Central Europe was struggling. The geopolitical games around Russia/Ukraine plus a decline in commodity prices have changed the picture. Central Europe is now recovering quite well, while Russia and the CIS markets are in trouble. But because Russia accounts for a large volume of business in CEE, companies are finding it hard to hit their 2015 budget targets – the improvement in business in Central Europe is simply not enough to compensate for shortfalls to the east.

With the sharp slowdown in Russia for most companies and a meltdown in Ukraine (plus devaluations in Kazakhstan and Azerbaijan), CEE regional executives are now putting more business focus on recovering markets in core CE such as Poland, the Czech Republic, Hungary, Romania and Slovakia. Turkey is also in strategic focus, but with the corporate realization that Turkey will be a relatively sluggish market in the coming year or two (see later).

Regional executives have been frantically trying to explain to their global heads why 2015 will be yet another weak year for their overall CEE business. It is highly unlikely that we will see a return to strong revenue growth rates in Russia and Ukraine in 2016. Russia will continue to be hit by a combination of low commodity prices as well as the impact (direct and indirect) of economic sanctions. Companies have prepared very prudent budgets for Russia and CIS markets for 2016, in line with the new reality (which could become chronic in Russia due to global geopolitical games).

The economic outlook for CEE markets in 2016-2017 is far from homogenous. Differences between countries are perhaps more pronounced now than at any time in the last 20 years. It is therefore extremely important for companies to be even more careful about country resource allocations and make sure that scarce resources are allocated to markets that will provide more predictable returns, especially in the short-term.

In short – the outlook for Central European markets is encouraging, except for parts of the Adriatic region. However, **the outlook for Russia/CIS markets will continue to be uncertain and difficult**.

What is the impact of Eurozone quantitative easing on CE markets?

The European Central Bank (ECB), with a long 5-6 year delay, finally started its own version of quantitative easing in March of this year. The program will run until September 2016. Some 1.1 trillion euros will be printed by then, with the idea to encourage growth. The program is much smaller as a % of GDP than similar programs in the United States, UK and Japan. The program is also different. Because of legal limitations about buying primary bond issues from governments, the ECB program buys government bonds in the secondary market, mainly from commercial banks.

The impact on the Eurozone has already been positive. First, it pushed the euro lower against the dollar, helping European exporters. Second, the cheaper euro has made imports more expensive which should prevent the occurrence of chronic deflation (this is dangerous because people expect prices to fall and do not buy, while the value of debt in real terms goes up). Third, by giving banks more freshly printed euros, it encourages lending. Lending is finally growing modestly in the Eurozone after six long years of decline. Fourth, the program indirectly helps governments raise money at lower premiums, which then enables governments to be less obsessed about austerity programs (which have killed so much growth in recent years). All in all, the program is relatively small, but it is partially changing the dynamics of the Eurozone economies. As growth picks up, this should encourage large corporations (which hold over 1 trillion euros in cash reserves) to finally start investing. The continuation of this program also means that monetary policy will remain exceptionally loose in 2016 and 2017, which is good for economic recovery.

Needless to say, all this is good for the industrialized nations of central Europe, considering how closely integrated they are into west European demand and supply chains. More relaxed banks in western Europe means they are also more relaxed about extending loans in CE. And they are also more relaxed about buying government bonds in CE.

Central Europe

It makes sense for companies to put more-than-usual focus on core central European markets in the coming two years. The current emerging markets slowdown has not affected them deeply for two reasons. First, key markets in CE are globally competitive with robust high-value added industries and export-oriented sectors. Second, unlike Russia/CIS, Latin America, or MEA, their economic growth is not dependent on commodities. This is also good news for their medium and long term future. Globally competitive economies usually bounce back faster from any economic slump than those that are ranked low in global competitiveness rankings. The fact that core central European economies are well diversified and industrialized almost guarantees that their future over the next 5-10 years is more predictable and sustainable.

Central European markets will grow reasonably well in the coming two years, driven by a number of factors: some recovery in the Eurozone (on the back of benefits created by quantitative easing and loose monetary policy), some recovery in overall exports (especially to developed markets), gradual return to lending growth (which has been largely missing since 2009), the benefit of the cheaper oil price which means no inflation, which in turn improves real wages and household consumption (and allows central banks to keep interest rates at historically low levels), continued flows of EU funding which are likely to gradually accelerate, and an ongoing gradual pick-up in foreign direct investment. Also, private debt (which has been higher than in other emerging markets as a % of GDP) has partly been deleveraged, enabling some pick up in household and corporate spending. Central European governments are also finding it easier to raise financing domestically and internationally, which has allowed them to be less obsessed with austerity programs. Furthermore, a rise in small and medium sized family businesses in the region is more visible than ever. This is encouraging from an economic development point of view (because so far the region has largely relied on foreign investment for growth, and this strategy has its long term risks). However, the rise of domestic family businesses is creating a new dimension in terms of competitive pressures in the region. All our multinational clients report how hard it is to compete against stronger and stronger domestic players, who are increasingly becoming mini-multinationals and aggressively pushing exports abroad (not only within CEE but wider).

Before readers get too excited about Central Europe's economic prospects it is worth remembering that overall Central Europe's GDP growth rates will be between 2.5 and 3.5% in 2016-2017, a far cry from the 6-7% growth rates recorded in the boom years of 2006-2007. Still, growth rates are encouraging considering economic underperformance during 2009-2014. Growth in Poland and Romania will exceed 3% during the next two years and this could also happen in the Czech Republic and Hungary.

Poland, the steadiest and perhaps most predictable market in CEE, is on a **solid and gradual economic expansion path** (although some of our clients worry about the impact of recent parliamentary elections which has put the conservative Eurosceptic party in power). **Polish growth will average** 3.5% in 2016-2017. The good news with the Polish story is that growth is well balanced and driven by a good combination of household spending, investment spending and exports. It is likely that household spending will exceed 3% per year in 2016-2017, but investment spending will rise at least 5-6% per year. **Two risks that companies should be aware of:** first, now that every company is trying to compensate for shortfalls in Russia and Ukraine, executives should expect that an already competitive Polish market will see further rounds of price wars, severe market share battles and shifting customer loyalties. Competition will get worse. Second, any kind of nervousness about emerging markets could see some speculative portfolio funds leaving Poland (such funds hold some 40% of Polish government bonds). In case of a panic outflow, there is some temporary depreciation risk for the zloty (despite otherwise solid economic fundamentals). This risk might materialize if the increase in interest rates in the United States (most likely in December 2015) causes another round of panic about emerging markets.

The Czech Republic, a business disappointment in 2012-2013, finally started to turn around in 2014 (2% growth) after two years of misguided and unnecessary austerity that kept the country in recession. The government is now reversing austerity, the crown was pushed down by the central bank to help exporters and prevent deflation, public investments are rising, and exports and industrial production are growing. Growth will hover between 2.5 and 3.5% in 2016-2017. Economic fundamentals are strong and unlike in other CEE markets, Czech households and companies have low exposure to forex loans. Household spending will grow between 2 and 2.5% in the coming two years while corporate spending will be between 3.5 and 4%. The risk of another small overnight devaluation will rise only in case of a further deflationary threat (which finally seems to be subsiding). The crown is likely to be kept artificially low by interventions until the 2H of 2016, after which it will likely strengthen over the medium and long-term. There is some upside potential to the above forecasts too.

Hungary, for many years a disappointment for business, actually turned the corner in 2014 when it grew 3.7% after sub-par and even recessionary years since 2009. The turnaround is a result of monetary and fiscal easing (which strangely, some commentators have called unorthodox). The unorthodox part of economic policy was taxing banks, telecoms, and retailers, but this was done to preserve macro stability (at the expense of selected foreign firms). Because of its pro-growth policies, I believe that Hungary will continue to perform better than current consensus views. So instead of growing around 2% (which most economists expect), Hungary has a strong chance of reaching around 3% growth in 2016-2017, with some upside potential. With half the banking sector now in domestic hands, the lending revival in Hungary could be more solid than elsewhere in CEE and this should drive growth. Household spending will expand by at least 2-2.5% in the coming two years and exports will continue to do well. The forint does have some risk built in, with some 40% of government bonds owned by foreigners (who can leave in search of higher yields elsewhere or in another emerging market panic). However, there is no fundamental reason for the forint to lose value (the country is running a current account surplus and continues to attract good amounts of export-oriented FDI.)

Slovakia, after years of disappointing domestic demand, has finally started to contribute to corporate revenue growth. Real GDP grew by 2.4% in 2014 and it will grow 3% this year. Growth will be around 3% in 2016-2017 driven by a good combination of export growth and domestic demand. Household spending is likely to grow 2.5% in the next two years, while corporate spending will expand by 3.5-4% per year.

Romania’s outlook looks more solid and more predictable than in recent years. GDP growth was 2.8% in 2014 and is likely to expand by 3.5% in the coming two years. Household spending will expand by 4-4.5% and corporate spending by around 5% per year. Economic fundamentals are solid, interest rates are falling and the leu is now a much more predictable/stable currency than in the past 20 years (the current account deficit is small and covered by FDI inflows). Corporate attention is increasingly focusing on Romania as an FDI location.

These five countries should be on corporate radar screens in the coming years as the markets with the most predictable and steady performance (although mostly in single digits) in terms of revenue growth relative to other CEE markets. Competition will, however, get worse and growing earnings in the next few years could be a very sizeable problem as companies engage in price wars and market share fights. Interestingly, the CEEMEA Business Group’s last corporate survey indicates that a surprising number of companies are planning to cut staff and other expenses in these five markets despite their growth. This is largely linked to the corporate desire to milk CE markets for short-term earnings now that revenue and earnings growth is under so much pressure in Russia/Ukraine.

The Baltic States will on average grow 2.5% in 2016-2017 which is below their potential. Exports to Russia/CIS and Finland have been under pressure for some time. Still, most exports go to a recovering Eurozone plus the rest of Scandinavia and this will be good for the three Baltic States. The markets have gone through some deleveraging from the high foreign debt they accumulated prior to 2009 and this should encourage domestic demand to some extent.

South East European states are still mostly under economic and business pressure (just as they have been in recent years). The outlook is not particularly bright either. Slovenia, with its more diversified industrial base and robust exports, is turning the corner with an export driven recovery and will grow around 2% in the next two years. However, domestic demand will be slow to pick up. On the other hand, heavily deindustrialized Croatia, Serbia and Bosnia are struggling to generate growth and domestic demand. Croatia will finally start growing this year after a long six year recession and growth is increasingly being driven by industrial production and very robust tourism. Serbia, in the short-term, will be under more pressure in terms of domestic demand due to a sizeable new austerity program. But it will grow modestly in the coming two years mostly on the back of good export expansion. Very few companies are putting business development emphasis on these weak south East European markets. And many companies have closed offices and moved back to the distributor-driven route-to-market in order to save fixed costs amid flat revenues.

Why is Central Europe unable to go back to its stellar 6%+ growth rates enjoyed prior to 2009?

1. Global and west European growth is not as good as it was before 2009 and therefore demand for CE exports is lower.
2. Credit growth is slow to come back and prior to 2009 the CE region was one of the major beneficiaries of the global credit bubble. The banking systems are dominated by foreign banks which have been deleveraging in the region on a massive scale and replenishing vulnerable balance sheets at home. The process is largely over now that the ECB is doing quantitative easing and replenishing the balance sheets of major European banks with fresh euros.
3. Foreign debt accumulations in the region are much higher than in other emerging market regions, indicating a large leverage problem among households and companies (not so much governments which are less indebted than their west European counterparts). Household and corporate deleveraging has partially happened, but it is far from over. This is preventing a larger bounce back of domestic demand.
4. FDI inflows boomed prior to 2009 and are now much slower on aggregate. Large companies are not investing as much as prior to 2009 in new production capacities due to low global visibility and many are choosing to sit on their record cash reserves. The FDI boom on a scale seen in 2007 is unlikely any time soon.

Russia and CIS

The 2016-2017 economic/business outlook for **Russia** is the one of uncertainty and economic weakness. The vast majority of corporate results are now behind plan and companies are bracing themselves for another complicated year or two. If this would be just a normal economic slowdown in Russia I would be shouting to all our clients to use a good crisis to boost market share now and lay the foundations for faster and sustainable growth in the future. However, I am afraid that this is not just a normal, cyclical economic downturn and this is where Russia differs from most other commodity-driven emerging markets. The Russian economic and business downturn is also caused by geopolitical issues which will not go away any time soon.

In my modest and (maybe wrong) view, **the most likely root cause of the Russia/Ukraine issue is** that the United States does not seem to want several things: it does not want its global geopolitical primacy endangered and it is very keen on preserving a world with as little multi-polarity as possible. The United States also does not seem to want to sit aside and witness the rebuilding of some kind of replica of the Soviet Union and especially not under the leadership of Vladimir Putin. Also, control of the overall Eurasian space is something that the US has strategically been trying to achieve for decades and that aim has most likely not changed (this seems to be partly also about containing China's global influence now and in the future). *Take a look at the book The Grand Chessboard by Zbigniew Brzezinski*. While there have been attempts to bring Russia into some kind of geopolitical alliance with the West in recent years, this has all probably finally fallen apart with Vladimir Putin's decision not to side with the west regarding Syria. The west was keen to contain Hezbollah in southern Lebanon and Iran, and eliminating President Assad in Syria was a prerequisite. In Syria, Putin became an outright enemy of the west and the proxy war on the ground has killed hundreds of thousands of people. It seems that the United States has finally concluded that it cannot do business with Putin. Therefore, it seems to me that the next months and years will be marked by what seems like continued US and western attempts to produce a change of leadership in Russia (which could take many years and might prove impossible). It also seems that Ukraine was largely chosen by the United States as a conduit or a medium to ultimately create economic weakness in Russia. The US support for the revolution against president Yanukovich (a close ally of Russia) in Ukraine was almost public and obvious, with high ranking foreign policy officials visiting the country and providing direct support to the protesters in Kiev.

Ukraine is probably the easiest conduit for creating economic weakness in Russia. Game theorists in the US have probably calculated that if Yanukovich has been successfully replaced, Putin will feel threatened geopolitically and militarily and will probably react or over-react. And when he does react and over-react, this will give the US an excuse to push for economic sanctions against Russia. The next stage then would be to simply sit and wait until economic weakness and uncertainty brings Russia to its knees and then, eventually, produces a change of leadership. It seems the game theorists in the USA were right. Putin did react and is now facing massive economic problems at home despite pro-Russian rebels winning a few battles and territories in Ukraine. One could say that Putin is winning a few battles but he is ultimately and strategically losing. As some of our clients say, there are many factories in eastern Ukraine that produce critical spare parts for the Russia military. The game theorists probably calculated accurately that Russia will have to move in to protect its critical military supply chain and this probably was an important US calculation in the whole game. Russia is now trying to dig itself out of a geopolitical hole by a more visible military intervention in Syria. As one Russian analyst said "Putin and his advisors believe the only language that Americans understand is the language of military force. Therefore, recent actions by Russia in Syria is an attempt by Putin to force Americans to talk and then compromise also in Ukraine and especially regarding economic sanctions." It is very questionable if this strategy will work. Russia does not want the west to control the entire Middle East and it certainly does not want to lose its only naval port in the Mediterranean (which is in Syria). Russia's relationship with Iran and the Shias in the area goes back to the days of Russian czars. It seems to me that in the coming years the Middle East will have more visible dividing lines between Shias and Sunnis, with the former supported by Russia and the latter by the US and its allies.

Because all this is a broad and deep geopolitical game (to which real and clear answers will only be known in the distant future when classified files are declassified), it could go on for some time and Russia could be under some form of sanctions for years to come. The west does not seem keen to lift economic sanctions. From a western perspective, keeping sanctions on Russia and waiting for economic weakness to erode Putin's popularity seems like a preferred choice of action. The west does not have an incentive to find a face saving solution for Putin, unless it is forced to do so by Putin's military action in Syria. On the other hand, Putin seems to have fallen into a trap with no easy way out. He cannot just abandon Ukraine – it is too much in its sphere of geopolitical influence. Leaving Ukraine and letting it go into NATO (like the Baltic States) is something that is not acceptable to Russia. Because Russia will not give up on its goals in Ukraine and neither will the US, the game is on and it could last for several years. And this game is clearly going to hurt the Russian economy more than western economies. The game is on also regarding Russia as a supplier of oil and gas to Europe. Europe, with the US push, is building new LNG port terminals and will seek to shift its natural gas buying away from Russia and toward other suppliers such as Norway, Qatar or Algeria. This will further hurt the Russian economy in the coming years. Poland is already beginning these days to buy oil from Saudi Arabia.

What does all this mean for business in Russia? *For more details see our extensive CEEMEA Business Group papers and surveys on Russia.* The economy is likely to shrink by some 4% in 2015 and hopes for recovery in 2016 are slim. The chances for another shallow recession are quite big. Household and corporate spending will shrink by at least 7-8% this year. The low oil price (see appendix) is, together with the indirect impact of sanctions, the primary reason behind uncertainty, low confidence, the weak currency and low visibility for business. The decline in the oil price has exposed the underlying low competitiveness of the Russian economy. With some two thirds of Russian exports linked to hydrocarbons and with about half of the Russian budget dependent on hydrocarbons, a sharp decline in the oil price has clearly exposed economic vulnerabilities. The sanctions, although not wide and deep, are adding to uncertainty and what is now almost a chronic lack of domestic and foreign investment. The economic outlook therefore totally depends on the political issues related to Ukraine, but also on the price of oil. No one can predict where the political discussion and geopolitical games will lead, but the prospects for a quick resolution still seem low. On the other hand, a massive oversupply of oil in global markets, the panic sell off in the oil futures market, and Saudi Arabia's refusal to cut production are all likely to keep the price under pressure during at least 2016 (as high price producers leave the market, the supply will shrink and come closer to actual demand in 2017). The long-term vulnerability of Russia and other hydrocarbon dependent economies around the world is clear. Companies are bracing themselves for weak business and volatility in 2016-2017 in Russia.

Ukraine has always had built-in vulnerabilities in its economy. Its exports have been dominated by commodities and semi-finished products and its competitiveness ranking has been among the worst in CEE. It has been dependent on energy supplies from Russia. The war in the east of the country has devastated the economic landscape. The economy fell by 7% in 2014, with gross fixed investments shrinking by over 23% yoy. The industrial heartland in the east, which has seen significant fighting, has seen industrial production shrink in double digits. At the moment the economy is down over 14% yoy and GDP will shrink this year in double digits and so will household and corporate spending. The lack of exports and the need to protect the currency has practically exhausted its already low forex reserves. IMF support is preventing default, but it is only enough to pay back western private creditors. The recent debt restructuring deal is a joke compared to other emerging market debt restructurings. It helps Ukraine avoid default, but after 10 years, western creditors will still make good money. The haircut is too small when compared to similar debt restructurings around the world. The problem for the economy is that the IMF deal comes with conditions of austerity (like requiring an increase in energy prices for an already impoverished population). Austerity usually pushes economies deeper into recession in the short-term. Ukraine will be in another recession in 2016 and there are small chances for small growth in 2017.

Kazakhstan, until two years ago an important growth market for companies operating in CEE, has also slowed down sharply due to lower oil and other commodity prices. As currencies in key export markets fell, Kazakhstan devalued its currency in 2014 and as we predicted, did it again this year. Growth has almost disappeared this year and the market will struggle as long as commodity prices are low.

Other CIS markets are under more pressure than usual and their currencies will also stay under pressure as long as the rouble and hryvna are struggling. Even Azerbaijan has abandoned its currency peg (as we predicted) and the currency was devalued. Belarus remains one of the weakest and most vulnerable economies in the world (it still has not abandoned the idea of a "command economy").

Turkey

Turkey is going through a below-potential growth period which started back in 2012 and will surely continue in the next 18-24 months. Still, Turkey will grow around 3% in 2015. And this slower patch will continue also in 2016-2017, until Turkey manages to correct its current account deficit. To correct the chronic and large current account deficit (and to eliminate dependency on short-term borrowing from abroad) and to help exports, the authorities have been letting the Turkish lira fall for years. From 1.15 to the dollar in 2008 to 2.92 today is a sharp and steady depreciation. Considering a sizeable current account deficit (and not enough FDI flows to cover the gap), the lira is still vulnerable to more depreciation in the coming two years. With the weaker lira, imports are much more expensive than before. Therefore, households and companies are buying less. Also, there are new limits on consumer spending while Turkish companies are struggling under the burden of almost $200bn in corporate debt (and their revenues are mostly in lira). Political risks are more visible than ever (see our Turkey country report) and have already affected domestic confidence and demand. All in all, companies should count on: below potential growth, more currency weakness, slow single digit sales growth (but huge competition and massive pricing pressures), but also more political clouds on the horizon despite recent clear elections outcome (which promises similar economic policy to continue).

Middle East Africa

Note: this is the summary of overarching issues affecting MEA economies. For details, forecasts and fundamentals take a look at our CEEMEA Business Group extensive country reports on 30 MEA markets.

Up until about a year ago (and in some industries even up until six months ago) it was hard to find a multinational company that did not have strong double digit growth in MEA. Almost every company enjoyed not only strong top and bottom line growth, but also kept meeting or exceeding growth targets. **The Middle East business, executives often said at our meetings in Dubai and in Europe, was the one with the fastest revenue and earnings growth globally, with the quickest returns on investment, the best margins and the best KPIs.**

The party is now mostly over. The majority of companies continue to grow, but slower than before. Most are trailing behind their 2015 targets/budgets so far. **The MEA region has entered a *new normal* which will surely be with us in 2016 and most likely in 2017. There are two main underlying reasons for the emergence of the new normal.** First, the decline in commodity prices (see explanations above) and second, the partial end of massive fiscal stimulus programs (designed to prevent the spread of Arab spring revolutions) across the hydrocarbon exporting nations in MENA. Lower commodity prices have affected the ability of most countries to generate enough foreign exchange, prompting currency depreciations (particularly across Sub Saharan Africa, but also in Algeria), lower spending, lower investments, lower confidence, some forex shortages in certain countries and overall lower growth (*see our detailed country by country outlooks*).

The region will start growing at a faster pace only when commodity prices start to rise again. This will happen when current oversupply in many commodity categories shrinks, which will then prompt futures traders to start betting that prices will rise (and they will).

These are not easy times for MEA regional directors. Global headquarters are accustomed to MEA being the fastest growing part of the world. They expect even more from MEA today since China, Russia and Brazil continue to struggle. **MEA is still seen as the region that can keep compensating for various earnings shortfalls around the world. Well, this view needs to change.** The reality, as explained above (and in our country outlooks), is different and will be different as long as there is no meaningful recovery of commodity prices on which MEA markets depend.

Realistic corporate budgets are needed for 2016-2017

As one of our clients recently said: ***"It is not only about managing expectations, but about setting a realistic budget for the next financial year."***

The truth is that no one in a corporation wants to miss their numbers, including your global CEO. The last thing a CEO would want is to explain to stock analysts that promised earnings numbers were missed because of the MEA region falling behind target.

The reality is that the economic and business outlook for MEA markets is now tougher than in the previous years. The outlook is subdued for the reasons explained above. It is time to have realistic, prudent and achievable budgets in place. And **budgets need to take into account rising competition and rising costs** in the area, which have affected margins and earnings growth during 2015 and will continue to affect operations in the coming years. **Competitive pressures will intensify further** in all sectors since many newcomers (particularly emerging market multinationals and SMEs from Europe and the US) are keen on growing their MEA business (many have set up offices in Dubai in the last two years to co-ordinate business expansion across the region).

The message to global headquarters should be as follows:

We are in a temporary slowdown which will be with us as long as commodity prices are low. We need to have realistic budgets for the next two years, in line with the external reality. However, at the same time, competition has intensified and we need to treat the region strategically. We should not allow this slowdown to shift us internally into a short-termist mode. We need to stay focused on MEA for the medium-term. We need to stay invested ahead of the curve and make sure we are locally relevant and resilient against rising competition across this challenging geography. When the markets bounce back, we need to be ready. And during these slower times, we need to focus on growing market share."

Here is the summary of the main reasons why every multinational should be very prudent when budgeting in MEA for the next two years, and particularly for 2016.

1. The lower oil price has changed the dynamics of business in key oil exporting nations. The oil price is unlikely to rebound in 2016. Other commodity prices will most likely stay low during most of 2016, keeping many African nations and their currencies under pressure. See appendix regarding oil price.

2. Earnings growth will continue to be under pressure:
   - Competition in recent years has increased to unprecedented levels and continues to rise across MEA. Things on this front will only get worse as multinationals, emerging market multinationals, medium sized firms from the developed world and domestic regional family businesses expand their reach and depth in MEA;
   - salaries are rising far above inflation in large strategic markets (including Dubai) and will continue to rise as demand for people far outstrips supply (as rising competition boosts the demand for highly qualified people);
   - rental costs and housing allowances in the Gulf are likely to continue rising, utility costs are rising in a number of markets and there will be more increases;
   - companies feel they need to spend more on marketing activities and building deeper local presence to counteract rising competition (and that costs money). This need will be greater in the coming years as competition gets tougher than ever;
   - companies expect that there could be some new taxes introduced in many Gulf markets in the coming year or two – corporate taxes of up to 10% seem quite likely (and VAT of 5% is being discussed)

3. Even wealthy countries in MEA are now facing sizeable budget deficits. Many oil exporting nations are already postponing projects, delaying payments, asking for discounts and sequencing projects so that they take longer to complete. Even Saudi Arabia is delaying basic maintenance of some oil field equipment (according to two of our clients), and contrary to earlier statements, the country has also started to cut investments even in education and health care. Problems with receivables will be very visible throughout MEA and in many markets this could get worse in 2016 than it is today.

4. Due to lower commodity prices, there will be less government spending, so growth will be lower than in previous years in all countries that export commodities.

5. Even in markets that are not dependent on commodities (and actually benefit from lower commodity prices) like Morocco, growth will be OK but will not boom. Egypt will struggle to generate enough foreign exchange, forex shortages will persist and the pound will gradually weaken. Tunisian growth has come to basically zero following a slump in tourism and security problems. Lebanon has stopped growing due to political and economic problems, while Jordan remains sluggish as always. On the African continent, Morocco, Kenya and Ethiopia are more resilient than other markets, but can hardly make up for slowdowns elsewhere in the region. A relatively industrialized South Africa is flirting with recession.

6. In the Gulf, governments will prioritize spending on public sector wages, but are unlikely to increase them in the next two years. Also, any extra bonuses (like two extra salaries and pensions paid to Saudis this year) will not happen in 2016 or 2017. More money will be spent on defense in all Gulf nations, which will take the money away from other projects. Many B2G projects will be postponed in 2016.

7. It seems increasingly likely that governments will start cutting subsidies across the Gulf and in other parts of the MENA region. UAE, Morocco and Egypt have started and others are talking about it. As governments

save money by cutting subsidies, households and companies will be hit by rising costs and less disposable income. Fuel will be hit first, while the cutting of food subsidies will be more politically sensitive and take longer.

8. Foreign exchange shortages, now visible in places like Egypt, Nigeria, Iraq, Angola and Algeria (just to name a few) will continue as long as commodity prices are low (or in Egypt's case until they are able to start generating more forex from other activities).

9. Protectionism could increase in more markets than is currently the case. Due to shortages of foreign exchange (or to preserve existing forex reserves), more countries could start limiting imports via import quotas, import restrictions, peculiar rules or by simply continuing to allow their currencies to fall (without even attempting to intervene in foreign exchange markets). The extreme case of this today is the difficult Algerian market, but others struggling to earn forex could partially move in this direction (like Nigeria recently).

10. The discount frenzy will continue in many countries (both in the government and private sectors), including in the wealthy Gulf markets. This will particularly affect B2B and B2G companies.

11. Lending growth will decelerate somewhat (from very high levels) in the next two years as governments take deposits out of banks to pay for budget deficits (caused by the lower oil price) and as deposit growth slows, banks will have less liquidity for fast lending growth. They will also be pickier than usual about whom they lend to and for which purposes. Traders and distributors could be affected perhaps more than manufacturers. We are already seeing the first signs of this in Saudi, UAE, Qatar (where lending is the slowest since 2007) and Bahrain (where it is falling). This could affect some of your leveraged distributors and partners so some extra vigilance regarding this issue will be needed in the coming quarters.

12. Interest rates will rise across the Gulf as the US Fed increases rates (probably as of December this year or early 2016) due to currency pegs. Local partners and distributors will have higher costs of capital and highly leveraged ones could have more serious problems. Local companies and consumers will also gradually face rising debt servicing costs.

13. New indirect taxes and corporate tax in the GCC (including VAT) seem increasingly likely. The discussions are about 5% VAT and 10% corporate tax.

14. A good and growing chunk of growth in oil-exporting nations has been coming from non-oil exports in recent years. However, most of these exports are now under pressure due to the emerging markets slowdown. For example, non-oil exports from Saudi Arabia are now down over 20% yoy. There is no improvement in sight regarding non-oil exports for 2016.

15. Even when nuclear sanctions against Iran are suspended this will not result in an immediate boost for business. The suspension of sanctions is likely only in Q1 in 2016 and it will take some time until growth picks up. Iran has never been an easy market to operate in and it has a significant history of protectionism (including sizeable import duties). Competition will accelerate quickly as sanctions are gradually lifted and massive numbers of players will fight for a market that is about 40% of the size of Turkey (despite similar population numbers). Iran will also try to force foreign companies to engage in JV versions of local manufacturing and to transfer technology. (See our last *Iran special paper* for details).

16. Confidence among companies and consumers is hitting lows and it is unlikely to bounce back in 2016. Even in a non-commodity market like Turkey, consumer confidence is at a 6-year low.

This slowdown in MENA is temporary -- markets will bounce back and you have to be ready for the medium and long-term.

Before we look at medium to long-term prospects in MEA, **here is some relatively good news in the short-term.** Although the Gulf faces a clear economic slowdown and less demand than usual in the next two years, the key countries can live through the period of lower oil prices without major difficulty. In other words, companies should count on a Gulf slowdown, not a meltdown. Countries in the Gulf are sitting on a mountain of cash and liquidity (for example, over $640bn in Saudi, $850bn in the UAE, $500bn in Kuwait, and $240-300bn in Qatar). They also have low debt. They can use the reserve to plug budgetary gaps and they can borrow

domestically and internationally for the same purpose (borrowing has already started). When the oil price war is over and prices rise, the Gulf producers will be large beneficiaries.
Banks in the Gulf are in good shape, unlike in 2009, but are beginning to lose government deposits (governments need money to plug budget deficits). Despite the fact that we expect a deceleration of lending in key markets, solid banks with good capital ratios will continue to expand lending to the private sector, but in single digits (until very recently, lending growth was in double digits).

Even when the US starts to raise rates, monetary policy will remain loose in 2016 in most countries, helping markets to avoid outright recessions.

The medium term future in MEA has a number of bright spots despite short-term softness, and here are some good reasons for multinationals to keep investing in the region for the medium and long term.

1. This is a temporary and cyclical downturn, caused by lower commodity prices and it will not last forever. Commodity prices will rise again and so will these countries. The Gulf oil exporters will be the winners of the current global oil price war because producers with higher production cost will be forced to shut down production. The rebound will also mean more currency stability in markets that have experienced deep depreciations.
2. **Saudi** will increase its oil production capacity (probably to 15m b/d in the next years) to remain the top exporter of crude, to feed its vast petrochemical ambitions and future non-crude exports) and to have enough for domestic consumption. Loose monetary policy, lending and vast reserves will help in the short-term. The country is increasingly diversifying, first around the oil core, but will increasingly bring more manufacturing to the country.
3. **Abu Dhabi** is not only expanding its oil production capacity, but is putting more emphasis on diversification than ever in its history. With close to $1 trillion in reserves and sovereign wealth funds, the future must be good.
4. **Dubai** will rise as a MENA or even emerging markets hub and will shift to a Singapore-style model of economic development, going after innovation, R&D and manufacturing of all sorts (including high-tech).
5. Most growth in **Qatar** comes from non-hydrocarbon activities already and this will further accelerate in the coming years.
6. **Oman** is diversifying its economy and the process will accelerate further in the coming years.
7. **Egypt's** new rulers will prevail over the unhappy Brotherhood-linked groups and individuals and security will gradually improve. They will gradually restore better access to forex and after the pound loses some more value in the coming quarters, its exports will be more competitive. A number of projects promised at the Sharm El Sheikh conference will materialize (but of course not all of them). In the short-term, the regime will be kept afloat by generous grants and loans from friendly Gulf markets. Growth will gradually accelerate.
8. **Morocco** will continue to provide a relatively stable and predictable environment and its latest industrialization plans will most likely accelerate growth and reduce dependence on agriculture in the coming years.
9. **Algeria**, once oil and gas prices show some recovery and once it attracts more bidders for its vast oil and gas reserves (on-shore, off-shore and shale) with more incentives, should have more money than it currently has. The currency will then recover and growth/spending will return to levels companies enjoyed prior to the decline of the oil price. Current import restrictions could be partly lifted as the country again starts to grow its hydrocarbon revenues. There is also some chance that the authorities will gradually start restructuring an economy that is totally dependent on oil and gas.
10. **Tunisia** should gain some momentum as well, as the new government reaches a bit of cruising speed. Vast bilateral and multilateral financial help should restore stability and growth in the coming years. And hopefully, acute security problems will not become chronic.
11. **Jordan** will continue to be supported by bilateral and multilateral aid and business will avoid nasty surprises.
12. **Pakistan,** with a population boom that is adding over 4m people every year, will remain a corporate priority and business will generally be better than any official statistics would suggest, especially for consumer goods companies but also for select B2B and B2G firms.
13. **Nigeria** is also adding some 4m people every year and by the end of this century it will have 1bn people. A country no one can ignore despite short term troubles due to low oil price.
14. **Ethiopia** is cutting and pasting the Chinese model of economic development which has a good chance to push it out of poverty in the coming decade or two. In 20 years it will have larger population than Russia.

15. Gulf markets plus Algeria still have massive forex reserves and sovereign fund accumulations. At some $2.5 trillion for MENA, they are not only just shy of an all-time high, but also second only to emerging Asia in the emerging world.
16. The oil exporting nations have low foreign and public debts.
17. Demographic trends are positive with sizeable population increases expected in the coming years and decades.

Section 6 Some budgeting and strategic advice for corporations

1. Have prudent, conservative and achievable budgets for 2016 and 2017, in line with the challenging temporary reality in most countries.
2. Be patient in 2016 – in most emerging markets business will be slow, volatile and operationally difficult – and it will not bounce back in the next 12-18 months.
3. Proactively manage internal expectations.
4. Do not despair about emerging markets – this is a temporary and cyclical slowdown (with Russia perhaps being an exception), so treat emerging markets in a strategic way despite short-term difficulties.
5. Use this temporary economic slowdown to increase market shares across various countries (and adjust executive compensation accordingly).
6. Make sure your emerging market business is set up in such a way that it will last and outperform rising competition year after year.
7. Stay invested ahead of the curve.
8. Close gaps in sales, marketing, local presence, government relations, local capabilities and local competencies.
9. Increase local relevance and local resilience in a systematic way, with long-term planning.
10. Move with urgency, flexibility and speed against rising competition.
11. Make sure product portfolios are relevant to local markets.
12. Keep building your brands and relationships.
13. Proactively seek local acquisitions – there will be more distressed assets in emerging markets than ever since 2009. Currencies are cheaper almost everywhere – good time to buy out local competitors or distributors.
14. Seek to expand manufacturing and the R&D footprint in emerging markets and accelerate the supply chain. Land acquisition will get cheaper and governments will be desperate to attract new investors.
15. Attract and retain the best people, especially as short-termist competitors begin to shed talent.
16. Retain entrepreneurial spirit within emerging market teams.
17. Decentralize decision-making enough without having to go to the global corporation for approvals of all kinds of things.
18. Have contingency plans in place.
19. Get even closer to customers than usual.
20. Take another look at internal processes and eliminate some unnecessary “fat” that has accumulated in your organization during boom times.

For a comprehensive list of best business practices for emerging markets take a look at my book “The Future of Business in Emerging Markets”.

Appendix I - Oil price realities and the outlook

A few facts

1. The oil price has not made much sense since at least 2004. It has steadily behaved out of line with fundamental supply and demand. The vast majority of annual consensus forecasts (including from prominent oil industry experts and associations) in the last decade have been horrifically wrong and this has also been the case in 2014 and 2015.

2. Oil was trading at under $10 per barrel back in 1998, and for years the consensus view was that it should not be more than $20-25 (where it was trading until about 2004). With the invention of various exchange trade funds, leveraged betting in the oil futures markets and coupled with the biggest global credit bubble in 80 years (which prompted and enabled leveraged betting), the oil price zoomed to almost $150 per barrel by mid-2008 (for no real fundamental reason). It then fell quickly to almost $30 during the global crisis in 2009, prompting many oil speculators to write "I told you so" papers saying "this is the real oil price". The oil price then jumped to over $80 with the beginning of the Arab spring and the exit from global recession. When Israel threatened to drop bombs on Iran it zoomed to over $110, where it stayed for an unusually long time (obviously benefiting all oil exporting nations).

3. The funny thing is that during the last 15 years of wild oil price movements, the annual increase in oil consumption has been around 1.4% per year and in fact this increase will be smaller and smaller in the coming years considering falling oil consumption in the developed world (and slower growth in many emerging markets as well, particularly in China).

4. Physical oil supply and demand plays a role in how the oil price is set but this physical side has been increasingly sidelined during the last decade. Massive speculative inflows into the oil futures market (which is usually 6-8x bigger than the physical market) has been the primary determinant of the oil price. When the number of bets that the oil price will rise exceeds bets that it will fall, the price goes up. When the number of bets that the oil price will fall exceeds the number of bets that says it will rise, the price falls. Like in other speculative trading activities of any other assets, markets can overshoot in both directions with overwhelming fear driving prices down and overwhelming greed driving prices up. Traders go "long" and "short" with their positions and this exacerbates price movements in both directions. Herd behavior is part of the trading game and this will not change. Commodity trading is also not well regulated.

5. In a panic sell off, traders are usually unwinding their positions quickly for fear that they will actually have to take a physical oil delivery.

6. Several oil majors have said over the years at our meetings in Dubai and elsewhere in Europe that they feel the real oil price is probably not more than $50-55 per barrel and that everything above that is due to speculation in oil futures. Some oil majors, interestingly, have given up on forecasting the oil price internally.

The oil price has fallen sharply – why now?

So why is oil futures betting suddenly going in this downward direction, pushing the oil price down? The underlying reasons are those described above in the section entitled "*Why have commodity prices declined so quickly*?" Oversupply in the crude oil market is substantial and it will stay so in the next 12-24 months. The timing of this current decline is peculiar, but like with all bubbles that burst, the burst is usually triggered by something and the herd psychology takes care of the rest (I sell because everybody else is selling and I buy because everybody else is buying). In addition to the general commodity factors described above, I think there are several specific factors at play with the current oil price decline.

The official excuse for downward betting in the oil futures market is that markets realized suddenly that the **oil supply really does exceed oil demand**. The number is around 2.5m b/d of extra supply (up from 1m per day back in late 2014). The rise of US shale oil production (financed by easy money and junk bonds in the USA) has rapidly changed the global supply balance. US shale players produce over half of the 9.5m barrels that the US pumps every day. The demand side of the equation does look challenged with falling oil consumption in the developed world and slower demand in emerging markets. In a way, what is happening now is that oil futures markets are finally following the developments of the physical oil market (its actual supply and demand).

Saudi Arabia, the world's most influential producer and the holder of the largest spare capacity, is keen on preserving its global market share. **It is also keen to put out of business all expensive producers such as shale players or Canadian tar sands.** The authorities do not want to repeat the mistake they made in the 1980s when Saudi Arabia cut its output by 75%, trying to keep the global price high in the wake of abundant global supply. But even though Saudi cut its production, prices still plunged to around $10 per barrel. Others continued to pump and gained market share, while Saudi Arabia lost it. The result for Saudi Arabia was devastating. Prices stayed low for over 15 years and Saudi had a decade and a half of severe budget deficits, ending up as one of the most indebted markets in the world. Today, the official priority for Saudi "is to tolerate the lower oil price in order to retain market share". At the same time, this strategy will also force higher cost oil producers (especially many highly indebted US shale oil and gas producers) out of business or to force them to close sites temporarily. Other more conventional oil companies are already cutting their capital investments and closing various sites, especially off-shore. Many Saudi (and the Gulf) fields are profitable at just $5-10 per barrel (operating and capital costs), which is not the case for off-shore rigs around the world and certainly not the case for shale producers (which are usually profitable when the oil price is at least $70-80). When one looks at bit of history, it is then clear why Saudi Arabia refused to agree to the OPEC production cut at the last meeting in Vienna, prompting a further sharp drop in the oil price.

To sum up, the cheap producers are trying to price out the most expensive ones and force them into bankruptcy. They will succeed and this has implications for the oil price in the coming two years.

What next for the oil price?

Since the number of shale oil rigs in America has dropped from some 1,600 to under 600 in the last nine months, the supply of US shale oil will soon start to shrink. Since global supply currently exceeds global demand by 2.5m b/d, any fall in supply in the US will bring global supply closer to demand in the next 12-24 months. As other players cut production and capital investments, supply will continue to shrink gradually. It will take some time though for Saudi and other low cost Gulf producers to force shale oil players to withdraw. Many shale players have locked in high oil prices with derivative contracts for 2015. However, as of 2016 most shale players will have to start selling oil at current low prices. This will then accelerate their demise. Despite their well-publicized productivity gains, they can never match the cost enjoyed by the Gulf players.

So global production will start to gradually shrink in 2016, but at the same time, we expect more new oil from Iran to hit the markets by the summer of next year. We expect an additional 1m per day to come from Iran in 12 months from today. So what the world loses from shale and other players will most likely be compensated by Iran during 2016. The net effect is that we will probably be still some 2m per day in oversupply come late 2016. This is obviously not good news for the oil price in 2016 and not good news for business in oil-exporting nations.

Beyond 2016, supply from shale players and other more expensive sources will continue to shrink further. Iran will not be able to quickly increase production (massive investments are needed for many years to come) and the same goes for Iraq (problems paying servicing fees to oil majors which are now decelerating investments and even production has fallen in recent months). Therefore, it is reasonable to assume that supply will come much closer to demand sometime during 2017. This could then prompt oil futures traders to start betting that the oil price will rise (and then it will).

Because oil trading accounts for half of all commodity trading in the world, when oil price starts to rise, various commodity funds will start buying other commodities slowly but surely. Commodities today are probably already oversold, but markets will take some time to realize that. If supply continues to shrink as we believe it will in the coming 12-18 months, oil price could creep up again to $60-75 range by the second half of 2017. This would be acceptable news for multinationals operating in MEA.

Appendix II - Back to School: why "hot money" inflows and outflows happen and why they will keep happening

"*The freeing of financial markets to pursue their casino instincts heightens the odds of crises...Because unlike a casino, the financial markets are inextricably linked with the world outside, the real economy pays the price.*"
Lawrence Summers

Did you know that west European markets started to fully liberalize their capital accounts (particularly short-term capital movements) only in the early 1990s, some 45 years after the World War II and when GDP per capita was well over $20,000? I live in Austria and I remember you could not buy Austrian schilling just for fun and speculation in the old days. You could buy it if you wanted to build a factory and that was about it. The various European governments understood during that time that allowing fully open capital accounts was an invitation for speculators and that sudden inflows and outflows of portfolio capital would make it very hard to run an economic policy, that currencies would very often go from too much strength to too much weakness, and that too early liberalization would also mean major disruptions to economic growth and exports.

But over the last 25 or so years, the IMF, World Bank and the US Treasury, heavily influenced by major financial institutions pushed full capital liberalizations onto emerging markets, although they were far from ready to absorb and manage such inflows. The financial industry was salivating over the prospects of making tons of money by buying and selling government securities and making fabulous yields. And they still do.

From that perspective, not all aspects of globalization are positive on aggregate. **Premature opening of portfolio capital flows, especially short-term capital flows, has continued to create huge problems for economies around the world.** The fact that you and I can buy any currency, T-bill or government bond that we like might sound like a good idea from a private selfish point of view (why would not I be able to put my savings into Turkey and earn 9% or why do I care if a market is run so badly that it always has to borrow?). But this premature opening of short term flows has created more difficulties for economies and business than almost any other issue over the last couple of decades in emerging markets. I can easily link most emerging markets crises (Mexico 1994, Asia 1997, Russia 1998, Brazil 1999 etc) in some shape or form to the premature liberalization of the capital account.

Now imagine many people (actually mostly large funds) want to make 7% return in South Africa (they actually do!). And many keep buying South African rand and government debt securities to achieve their short term yield goals. Buyers do well as long as there is no panic sell-off. What does that kind of foreign "hot money" inflow do to the receiving economy? First, it could push the currency to appreciate beyond its trade and foreign direct investment fundamentals. This would make import cheaper and make people feel richer. They would buy more imports. The banks would feel good and would lend to richer population. Banks would borrow from abroad short-term and give out long-term loans creating a dangerous mismatch in case of reversal of fortunes. But exports would suffer. The resulting current account deficit would increase foreign debt. If this goes on too long, the country will probably end up with a high foreign debt and the need to deleverage. And any deleveraging always comes at the expense of growth and purchasing power. Business and growth would suffer when the capital decides to flee. (For a more detailed description of how hot money influenced several emerging market crises in the 1990s please refer to my earlier book "*Emerging Markets*" from 2007).

If hot money inflows and sudden outflows can cause so many problems for economies and for businesses then we have to ask who pushed the idea, why are they still around and are future crises possible? Light regulation and liberalization doctrine that started to dominate global economic thinking several decades ago was the fertile ground for pushing capital account liberalization onto countries that were not ready to do so (see my recent executive book *"Global Economy*", the feature on *Partial Failure of Economics*). So partly the push for capital account liberalization was ideological. West European economies after the World War II only gradually liberalized their capital accounts after reaching a certain level of wealth, stability and global competitiveness. In other words, many west European economies were able to develop without facing the risk that speculative capital inflows and outflows carry for the real economy. But ideology is not the whole story. Jagdish Bagwhati from Columbia University argued in his excellent book *In Defense of Globalization* that it was the "power elite" of Wall Street, US Treasury and the IMF and "energetic lobbying" of financial firms that pushed the liberalization of the capital account on countries that were not ready. They saw the business interest in pushing for unlimited movement of capital around the world.

Sadly, the doctrine is still around and "hot money" inflows and outflows are an ongoing threat to the health of many exposed economies, even those that are reasonably well managed and that have good economic fundamentals (acceptable debts and deficits, solid reserves).

In all this financial madness, the good news that executives should keep in mind is the following. Many emerging economies have learned their lessons and have beefed up their foreign exchange reserves which now serve as a buffer against sudden outflows which can lead to currency depreciations. Many also corrected their economic fundamentals by reducing the size of their public and foreign debts (see economic analysis by region and market later). And many are increasingly borrowing in domestic currencies.

However, for businesses operating in the international arena, the risk of sudden excessive appreciation of currencies and then sudden depreciation is still here. The good news is that such episodes in the future will be shorter than in the past in most economies, simply because many markets today have significantly stronger economic fundamentals.

Still, companies and executives need to pay ongoing attention to this risk of temporary outflows by following economic fundamentals of the countries in which they operate, by assessing the size of hot money parked in the country, by assessing the size of current account deficits (and how they are being financed), by estimating the worst case scenario in case of outflows and most importantly, by communicating the risks upward to the headquarters to manage expectations (and to protect careers). **The last thing an executive wants is to be blamed for sudden weak results which are a result of an unexpected depreciation.**

Recently we have seen several countries like Brazil imposing taxes on hot money inflows, trying to discourage them. This is the right thing to do. Those who argue that such taxes reduce foreign direct investment are either wrong or have the vested interest to say so. There is enough scientific evidence that shows that excessive hot money inflows and outflows hurt economies and business and no country should be a hostage to the narrow interests of a few bankers and economic ideologues. There is one thing that countries can do too. They can borrow more domestically and can run sustainable economic policies with low deficits and debts (thereby reducing the need for external borrowing). When outflows happen, they can allow their currencies to depreciate in line with their current account deficits and FDI flows (just like Turkey is trying to do now). They can also have their central banks buy some of their government debt during economic downturns since this typically does not cause inflation rate to rise.

What are the chances that at least some capital controls will become entrenched as a normal part of economic policy of all countries around the world? A few months ago, my answer was "very slim". But now, with the latest endorsement of the IMF for more capital controls, the chances are better that common sense will eventually prevail. But **I wouldn't bet too much of my money on it** though simply because of the lobbying power of the financial institutions who have a vested interest in keeping the portfolio capital flows fully open.
If some capital controls would be introduced, what would be the implications for business? If capital controls are more widely used, currencies would not appreciate beyond their fundamentals, the risk of sudden depreciations and economic meltdowns would subside and business predictability and sustainability would be easier to achieve. Non-financial companies should lobby hard for more capital controls as a way to avoid massive volatility and sudden losses in markets around the world.

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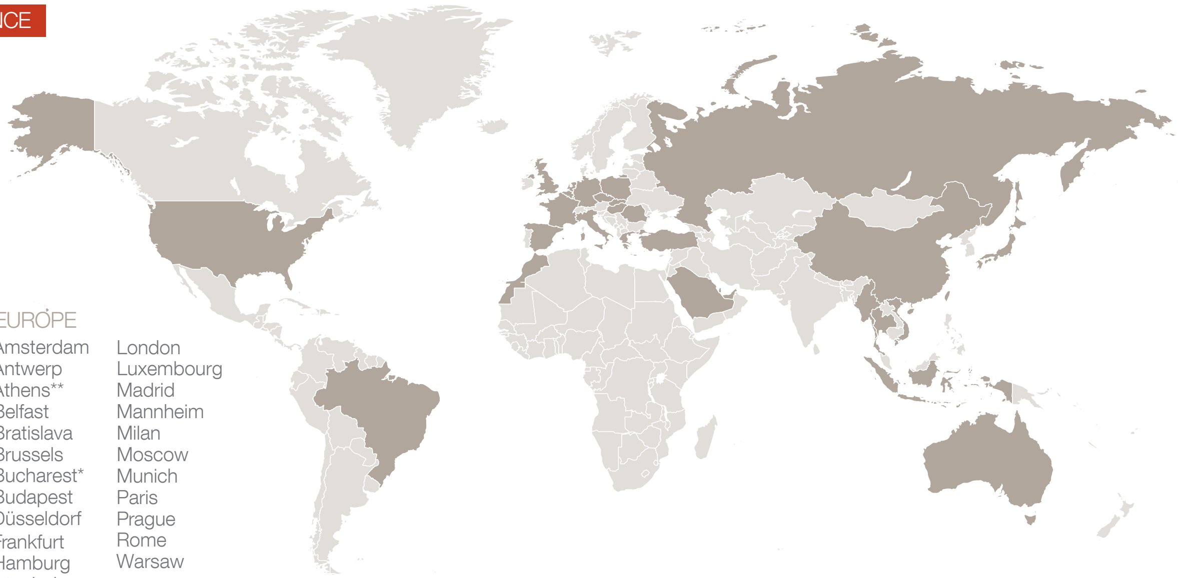

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IFLR 1000, 2014

Deal of the Year Award
PFI Middle East & Africa Industrial, 2014

"A first port of call for international companies setting up in local joint ventures, as well as servicing a number of investment firms"
(Corporate and Commercial, UAE)
Chambers Global, 2014

Contacts

Borys Y. Dackiw
Co-Managing Partner, UAE
Tel (Direct): +971 4 423 0072
borys.dackiw@bakermckenzie.com

Tim Meredith
Director of Business Development, Gulf Offices
Tel (Direct): +971 4 423 0089
tim.meredith@bakermckenzie.com

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