Investment **Research**

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EMs: Riding the commodities' roller coaster

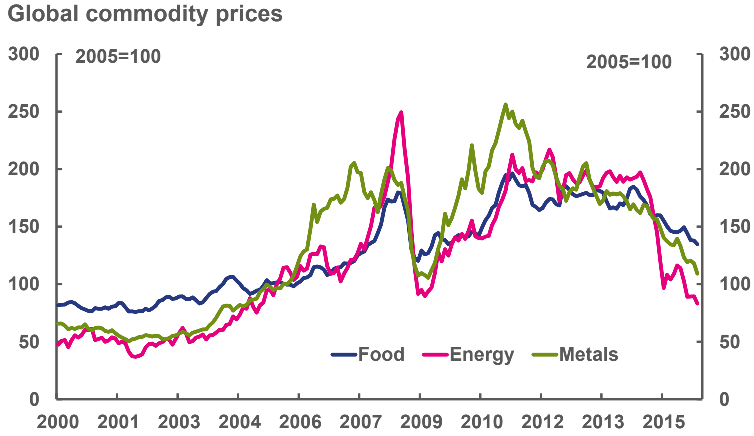
There will be casualties

Key points

- International commodity prices have been falling at double-digit rates since mid-2014, with long lasting consequences for EM commodity exporters' growth.
- Most EM commodity exporters failed to differentiate their economies and save the commodity windfall for a rainy day.
- Slowing productivity growth is weighing further overall growth, which is heading south as inflation goes north, thus requiring tighter monetary policy relative to non-commodity exporting EMs.
- Monetary conditions will tighten more sharply for commodity exporting EMs because their long term interest rates rise more than those of non-commodity exporters when commodity prices fall.
- Political/social stability is at risk in several EM commodity exporters due to rising inflation and a looming fiscal consolidation that will reduce social transfers funded by royalties.
- Pegged exchange rates reduce policymakers' leeway to use currency reserves to sustain stability, thus requiring more debt issuance.
- Highly leveraged EM commodity exporters with limited buffers are facing the risk of a sovereign downgrade. The sovereign ratings of less leveraged producers could also be challenged.

Exhibit 1

Commodities are falling off a cliff



Sources: International Monetary Fund (IMF) and AXA IM Research

Exhibit 2

Resilience / fragility indicators when commodity prices fall

	Net international investment position % of GDP	Fiscal expenditure % of GDP	General government debt % of GDP	Commodity exports % of GDP
Algeria	86.0%	36.8%	10.2%	29.0%
Angola	7.9%	40.7%	57.4%	47.5%
Argentina	13.6%	35.4%	52.1%	8.0%
Brazil	-33.6%	38.6%	69.9%	6.1%
Chile	-13.8%	23.8%	18.1%	25.3%
Colombia	-30.8%	29.2%	50.9%	11.6%
Indonesia	-47.4%	19.1%	26.5%	11.7%
Kazakhstan	-16.3%	20.2%	18.3%	32.6%
Malaysia	-0.3%	28.4%	55.6%	26.2%
Nigeria	-11.0%	13.3%	11.9%	16.6%
Peru	-30.1%	21.5%	22.4%	13.8%
Russia	16.7%	38.2%	20.4%	21.3%
Saudi Arabia	106.6%	38.0%	6.7%	40.5%
South Africa	-7.5%	31.8%	48.4%	12.3%
Ukraine	-48.3%	48.1%	94.4%	18.9%
Uruguay	-18.1%	31.8%	64.1%	12.2%
Venezuela	75.5%	38.1%	53.0%	34.7%

Note: Green = resilient; red = fragile

Sources: IMF, United Nations Conference on Trade and Development (UNCTAD) and AXA IM Research

Testing gravity

International commodity prices have been falling off a cliff since mid-2014. According to the International Monetary Fund (IMF) index of prime commodity prices, energy prices fell by 58% during June 2014-November 2015, metals by 33% and food by 25%. A mix of demand and supply factors spurred these falls. On the demand side, a less benign Chinese economic outlook implies softer demand for commodities. On the supply side, the oil price has fallen because some conventional oil producers have seized the opportunity to increase market share while shale oil production is still in its infancy. Dollar strength ahead of expected Fed tightening further reduced demand for oil, which is priced in the greenback. The price decline accelerated when Iran returned as a global oil supplier. Previously banned because of sanctions (Iran) or conflicts (Iraq and Libya), oil producers are eager to start pumping again in order to fund their ailing economies.

Falling commodity prices do not bode well for emerging market (EM) commodity exporters, particularly those with poorly differentiated economies. Several are experiencing fiscal and external break-even prices, i.e. the price required to balance government and current account balances, respectively, well above the current spot price.[1] Sustaining macroeconomic balances could be further challenged if commodity exporters have taken unfavourable international investment positions, spent the windfall revenues earned in good times and failed to differentiate their economy and improve the quality of institutions – a time-consuming quest in and of itself.

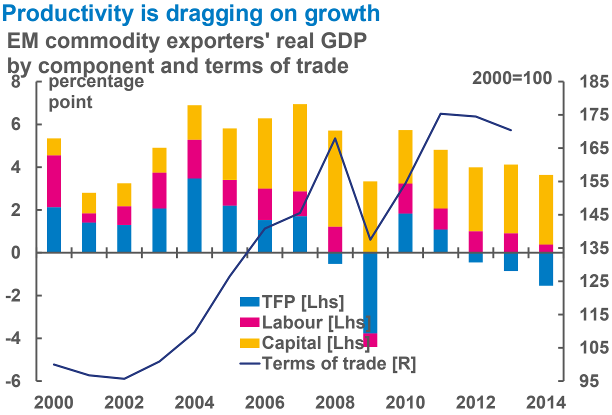
The purpose of this note is to flesh out where EM commodity exporters stand in terms of macroeconomic fundamentals. We also attempt to shed more light on the impact of low commodity prices on the economic growth and sovereign ratings of EM commodity exporters.

Commodity prices and GDP growth

EM commodity exporters' economic growth is closely related to international commodity prices, since high prices imply high export proceeds. The impact on economic growth would be positive assuming that exports rise faster than import prices. This results in higher terms of trade (ToT), defined by the ratio of export to import prices. We see in *Exhibit* 3 that real GDP growth and ToT move closely together.[2] Economic growth accounting reveals that EM commodity exporters are facing an acute decline in the contribution of total factor productivity to the growth mix, which accelerates the fall in economic activity due to weaker commodity prices. *Exhibit 3* implies that the declining trend picked up steam on the eve of the 2013 market tantrum. Extrapolating the decline in total factor productivity contribution to growth in the next half- decade, and assuming that labour and capital continue contributing to growth in the same average proportions as they have done since 2000, the growth potential of EM commodity exporters would be 3.5%, more than one percentage point lower than the 2000-2012 average.

Exhibit 3

Productivity is dragging on growth

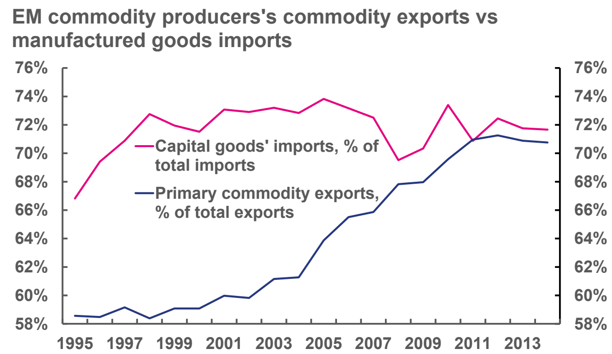


Source: Conference Board and AXA IM Research

EM commodity exporters did not take advantage of rising prices before 2013 and use the revenue windfall to differentiate their economies away from the "mono-culture" of producing commodities exclusively. Differentiating their economies would have helped them to weather falling commodity prices and sustain economic growth. The share of primary commodities in total exports rose steeply between 2000 and 2014 while the ratio of capital goods to total imports remained almost stable, implying that investment in differentiation and in the extraction sector were limited (*Exhibit 4*).

Exhibit 4

No diversification achieved



Source: UNCTAD and AXA IM Research

The fall in commodity prices, plus the ensuing foreign exchange depreciation, resulted in higher inflation in EM commodity exporters with flexible exchange rates, since low commodity prices imply low FX commodity proceeds and consequently weak demand for local currency. High inflation ate further into economic growth as it eroded the purchasing power of the private sector. *Exhibit 5* illustrates the deterioration post-2013 in the real GDP growth-inflation trade-off, with inflation heading north and GDP growth south). Hence, EM commodity exporters will have to raise interest rates by more than their non-commodity counterparts in order to fight inflation.

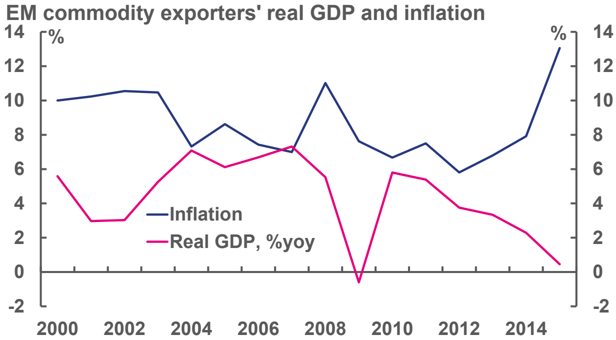
[1] Chaney, E. and Davradakis, M., "50 dollar oil: a game changer", AXA IM Research, 15 January 2015.

[2] The EM commodity exporters' aggregates used in the text are the weighted averages of the major EM commodity exporters, including Algeria, Angola, Argentina, Azerbaijan, Brazil, Chile, Colombia, Costa Rica, Guatemala, Indonesia, Kazakhstan, Malaysia, Nigeria, Peru, Russia, Saudi Arabia, South Africa, Ukraine, Uruguay and Venezuela. The weighting scheme used is GDP based on purchasing-power-parity share of world total.

Commodity exporters in Latin America (Colombia, Chile, Peru) have already started hiking rates, unlike their non-commodity EM peers in Asia (India).

Exhibit 5

The crocodile's mouth is wide open

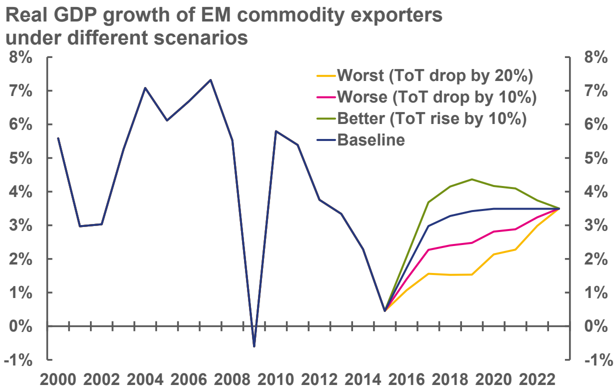


Source: IMF and AXA IM Research

In *Exhibit 6* we illustrate the impact of different ToT shocks to the IMF's real GDP growth baseline forecast for EM commodity exporters.[3] We see that a drop in growth due to a fall in the ToT would take four years to bottom out and then another three to dissipate. A 10% decline in the ToT would result in a one percentage point drop in EM commodity exporters' growth. For reference, the 38%yoy fall in real commodity prices in 2015 is equivalent to a 13%yoy decline in ToT. Import prices also decreased due to weaker domestic demand and the depreciation of EM commodity exporters' currencies, thus containing the decline in ToT. Economies that export more than one commodity have a more precarious growth outlook than their peers that export a single commodity. Indonesia, Kazakhstan, Malaysia and Russia are the most exposed in this regard as they export agricultural goods, metals and oil.

Exhibit 6

Long-lasting consequences of a fall in commodities



Note: The baseline is the IMF's forecast for commodity exporters
Source: IMF and AXA IM Research

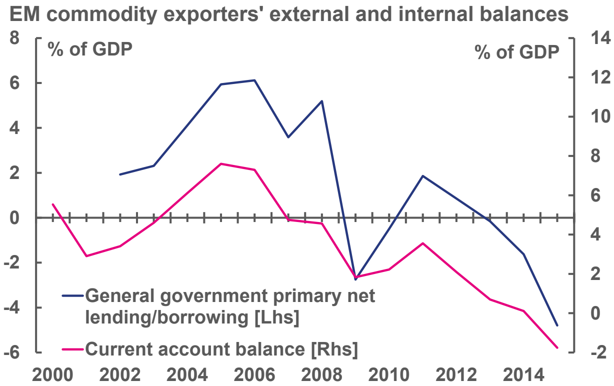
Like all EMs, EM commodity exporters are exposed to the tightening of US monetary policy as the portfolio flows they received after the three rounds of quantitative easing in the US unwind. The latter propels local currency yields, impeding economic growth even further. One thing that has gone unnoticed is that commodity exporters also face higher local currency yields when ToT decline. The negative relationship between yields and ToT is statistically significant, implying that EM commodity exporters would face even higher yields than non-commodity exporting EMs.[4]

Battle for survival and stability

Waning commodity prices are casting doubts not only on the economic outlook but also overall macroeconomic stability. Falling ToT trigger a deterioration in the current account and government budget balances as proceeds from commodity exports dwindle. We see in *Exhibit 7* that EM commodity exporters face widening deficits on the current account and government budget balances. Rectifying these twin deficits will not be an easy task. To bring down the current account deficit a currency depreciation is needed, which would worsen the unfavourable economic growth/inflation trade-off shown in *Exhibit 5*. Importantly, this solution would be contrary to the pegged exchange rate policy implemented by several EM commodity exporters.

Exhibit 7

Twin deficits get wider



Source: IMF and AXA IM Research

Fiscal consolidation is needed to shrink the fiscal deficit. This, in turn, would adversely affect the growth/inflation trade-off. According to the IMF's research,[5] fiscal and export commodity-related proceeds fall faster for oil exporters than for metal exporters during a commodity price downswing. Moreover, EM commodity exporters' fiscal policy is procyclical; it turns expansionary during commodity upswings and restrictive during downswings. This procyclicality is attributable to the optimism during upswings that prices will remain high for a long time, thus persuading EM commodity exporters to hike expenditures excessively. Once prices start falling these expenditures are cut as abruptly as they were phased in. Countries with weak institutions tend to favour rent-seeking during windfalls, which results in higher spending.

[3] The impact on economic growth of each ToT shock is derived from the product of the impulse response function of EM commodity exporters' growth to a 10% drop in ToT calculated in IMF's World Economic Outlook, Chapter 2, October 2015, and from the size of the shock. The impact is then added to the baseline EM commodity exporters' real GDP growth forecast during 2015-2020 cited in the same IMF publication.

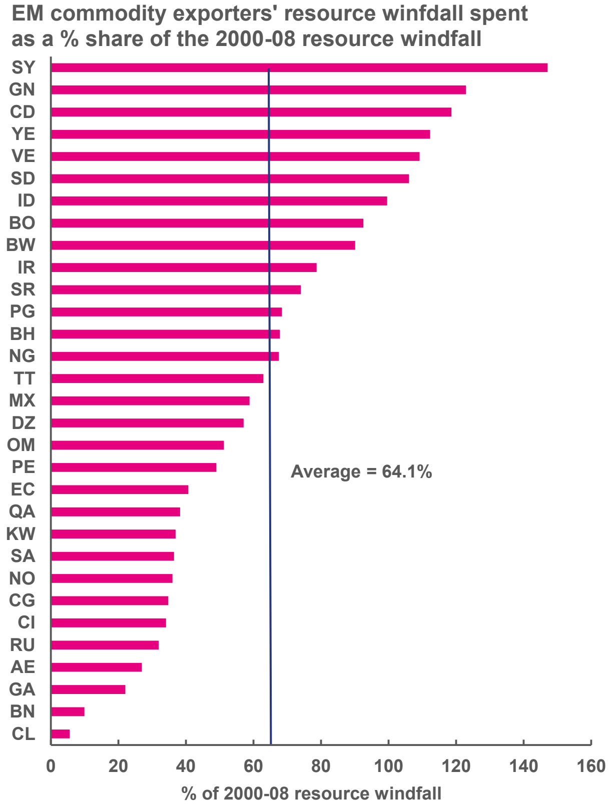
[4] Ibid.

[5] International Monetary Fund, Fiscal Monitor, Chapter 1, October 2015.

Combined with weak buffers, fiscal procyclicality points to an inability to sustain economic growth when commodity prices start declining. Several EM commodity exporters have used more than two-thirds of their windfall resources realised during the 2000-08 commodity boom (*Exhibit 8*). In fact, some of them, notably Venezuela, Yemen, Sudan, Syria, Guinea and Democratic Republic of Congo, have even overspent their windfalls. EM commodity exporters that have been prudent enough to save part of their windfall are expected to weather falling commodity prices.

Exhibit 8

Few saved for a rainy day



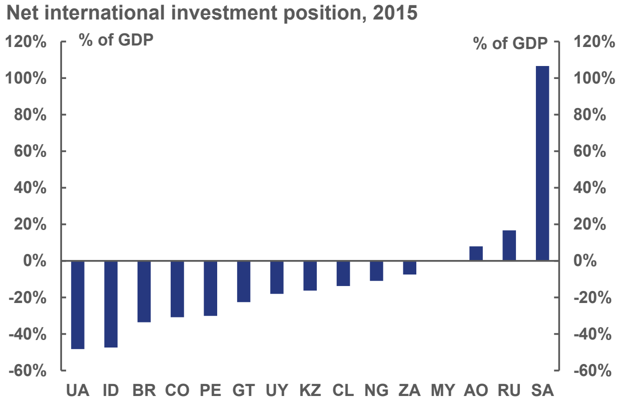
Source: IMF and AXA IM Research

To maintain social stability, several EM commodity exporters have introduced a welfare state that includes generous social aid programmes, housing and subsidised energy consumption. Scrapping these programmes because of fiscal consolidation would accelerate already high inflation and disrupt social stability. This risk is greater for countries with weak buffers and high subsidy bills. Venezuela is a case in point. It has used the oil windfall solely to finance the populist policies of the late president, Hugo Chavez, and his successor Nicolás Maduro. With inflation projected at 200% in 2016 and the risk of insufficient funding for the welfare state, there is a likelihood of social instability. Venezuela is currently in a political crisis following the last general election, and it relies on China for financing via credit lines. Other EM commodity exporters may adopt a more aggressive foreign policy in an attempt to mobilise and distract domestic public opinion from the economic malaise caused by falling commodities. Russia and Iran both fit this profile.

EMs' net international investment position improved from -10% of GDP in 2007 to -5% in 2014. Yet, several of these countries still have net foreign liabilities, implying that they will have to use a significant portion of their FX reserves to repay external debt. Among EM commodity exporters, those with strong net foreign investment positions will fare better than the others. Unfortunately, however, they are few and far between (*Exhibit 9*). Only Saudi Arabia has a very strong foreign investment position, with market financing channels unobstructed by sanctions (contrary to Russia) or domestic instability (contrary to Angola).

Exhibit 9

Unreassuring investment position



Source: IMF and AXA IM Research

EM commodity exporters with pegged exchange rates will also experience more pressure than their peers with flexible exchange rates because they have to use a significant portion of their FX reserves to support the peg. Yet, most EM commodity exporters are witnessing a decline in FX reserves following a deterioration in the current account balances that deprives them of ammunition to support a FX peg. In the year to 2015q2, EM commodity exporters lost US$250bn in FX reserves (excluding gold), which now stand at US$2.2tr. Several EMs with pegged exchange rates have already devalued (Azerbaijan: -33.6% vs the USD, Algeria: -25.4% and Nigeria: -26.6%), while others have opted either to adopt more flexible exchange rates (Russia and Kazakhstan) or to sustain the peg (Gulf Cooperation Council) by running down their FX reserves.

The time of easy investment grades is over

Fiscal deficits will have to be financed either by issuing more debt or by tapping FX reserves. Yet, the latter solution is harder due to pegged FX rates so the only other option available is to issue public debt. EMs with very low general government net debt are more likely to follow that route. Saudi Arabia (general government debt 2015: the first issue since 2007 – in order to finance the fiscal deficit. This is a departure from the normal procedure of running down FX reserves to cover the deficit (estimated at US$130bn or 22% of GDP in 2015). The drop in reserves from US$732bn in 2014 to

US$654bn in the second quarter of 2015 has alarmed the authorities.

Other EM commodity exporters will try to issue more debt, but this will coincide with the Fed's hiking cycle, making new debt less attractive. EM commodity exporters with already high public debts and plagued by political uncertainty will risk their investment grade (Russia and South Africa). Brazil has already been downgraded to junk by Fitch and Standard and Poor's and was kicked out of the JP Morgan EMBI investment grade index. New issuers with low general government net debt would initially face a manageable risk to their investment grade. Yet, the risk to the sovereign rating would gradually increase as public debt dynamics deteriorate. For example, Saudi Arabia's general government net debt is expected to grow to 44% of GDP in 2020 from -41.4% in 2015. Fiscal consolidation would be more closely monitored by rating agencies, even for investment graded sovereigns.

Recent research[6] suggests that a sharp drop in oil prices may result in oil exporters' sovereign ratings being downgraded more than would be the case for a deterioration in fundamentals. According to the same research, the sovereign rating could drop by at least two notches if oil prices continue falling. This conclusion could be extended to all commodity exporters because commodity prices are closely correlated.

In conclusion, we recommend not investing in commodity exporters, particularly those that are already highly leveraged and are running low on buffers (*Exhibit 2*). EM commodity exporters have not managed to diversify their economies and have spent the windfall from the 2000-2008 commodity boom, while high inflation is undermining social stability.

[6] Breuinig R. and T.C. Chia (2015) "Sovereign ratings and oil-exporting countries: the effect of high oil prices on ratings", International Review of Finance, 15:1, pp. 113-138.

Country codes used in the text:

Algeria: DZ; Angola: AO; Bahrain: BH; Bolivia: BO; Botswana: BW; Brazil: BR; Brunei Darussalam: BN; Chile: CL; Colombia: CO; Congo, Democratic Republic of: CD; Congo, Republic of: CG; Côte d'Ivoire: CI; Ecuador: EC; Gabon: GA; Guatemala: GT; Guinea: GN; Indonesia: ID; Iran: IR; Kazakhstan: KZ; Kuwait: KW; Malaysia: MY; Mexico: MX; Nigeria: NG; Norway: NO; Oman: OM; Papua New Guinea: PG; Peru: PE; Qatar: QA; Russia: RU; Saudi Arabia: SA; South Africa: ZA; Sudan: SD; Suriname: SR; Syria: SY; Trinidad and Tobago: TT; Ukraine: UA; United Arab Emirates: AE; Uruguay: UY; Venezuela: VE, and Yemen: YE.

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