Directional Economics

Emerging and Converging Markets

The opportunity of “sub-prime” lending

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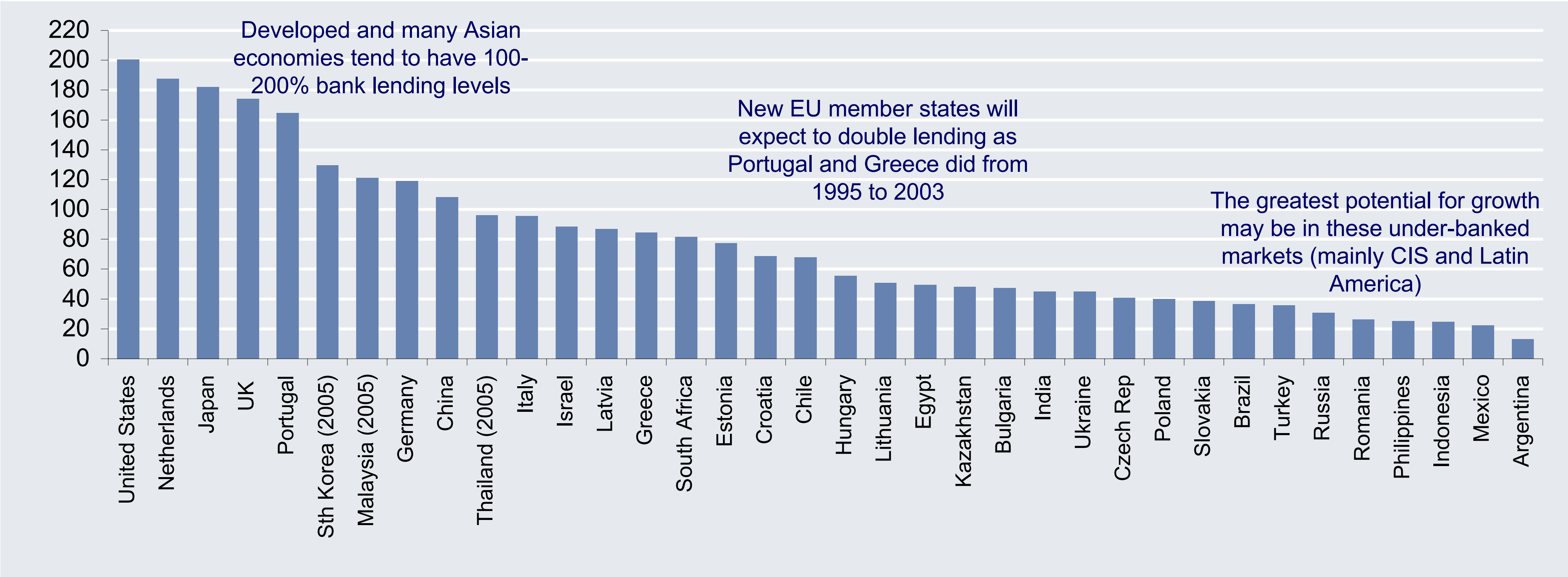
Bank lending – good prospects for EM

2006 bank lending to corporates/households (% of GDP)



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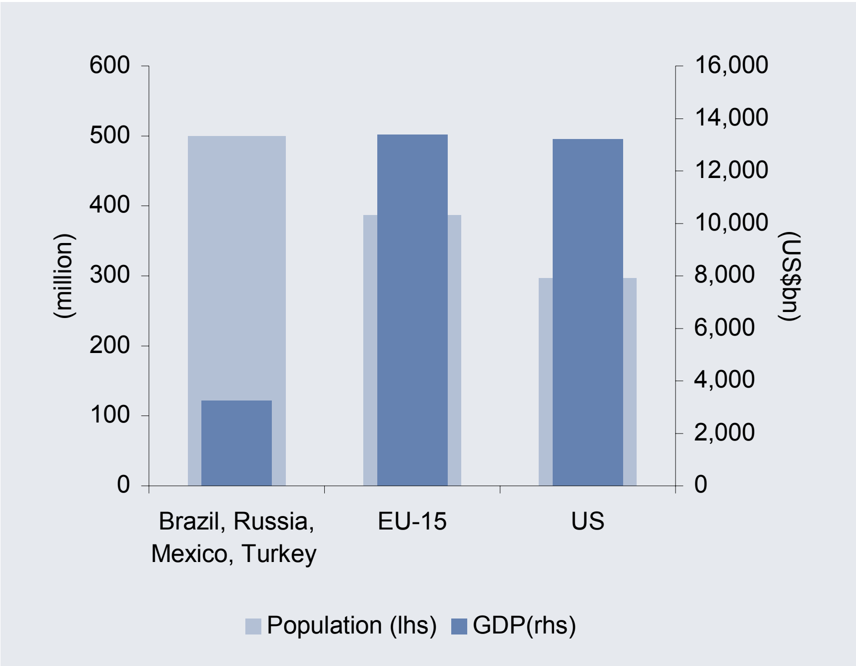
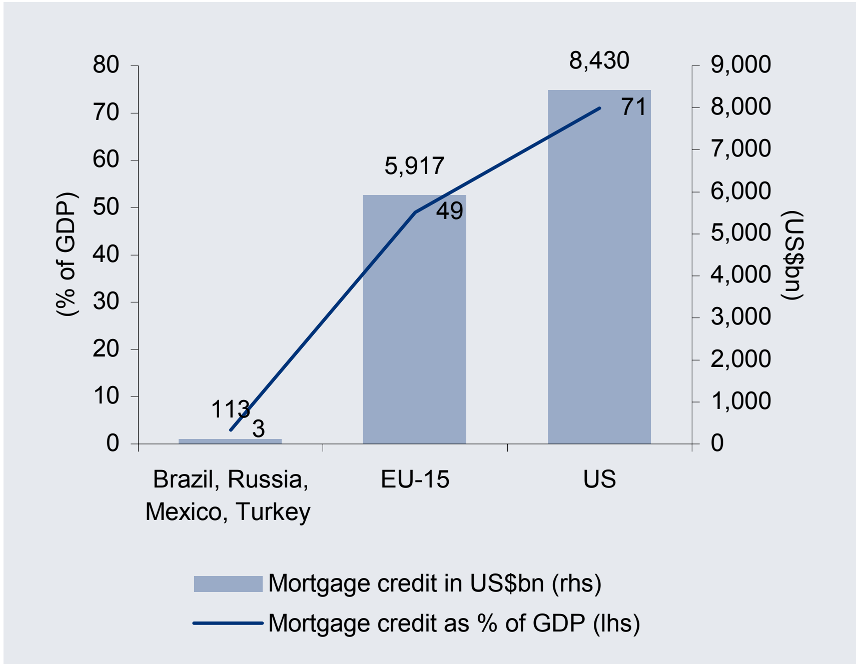
High debt might imply high wealth

GDP and population (2006)



Mortgage credit (2006)



The biggest emerging markets in the debt world – accounting for 60% of the EMBIG – have per capita GDP in the US$5,000-10,000 range – and very little debt. Their populations are bigger than the EU-15 and nearly double that of the USA, but their total GDP is ¼ of the USA's.

One reason may be a lack of "sub-prime" lending. Mortgage debt is roughly US$100bn and just 3% of GDP in these countries vs US$8 trillion and 71% of GDP in the USA. Less debt = less wealth.

If mortgage levels rise by 20 percentage points of GDP in the coming 10 years – to 21% in Russia, 22% in Brazil, 23% in Turkey and 28% in Mexico – mortgage credit would increase by half a trillion dollars in Russia, Brazil and Mexico and US$200bn in Turkey, helping double their GDP.

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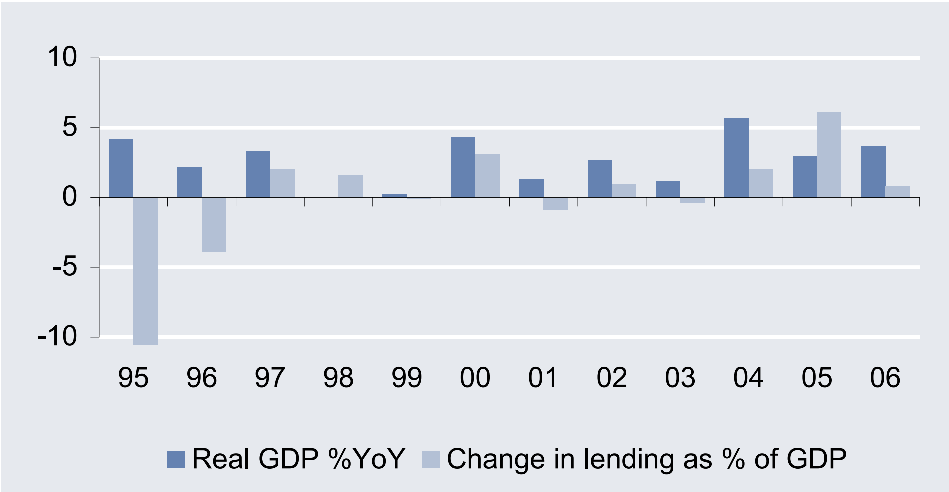
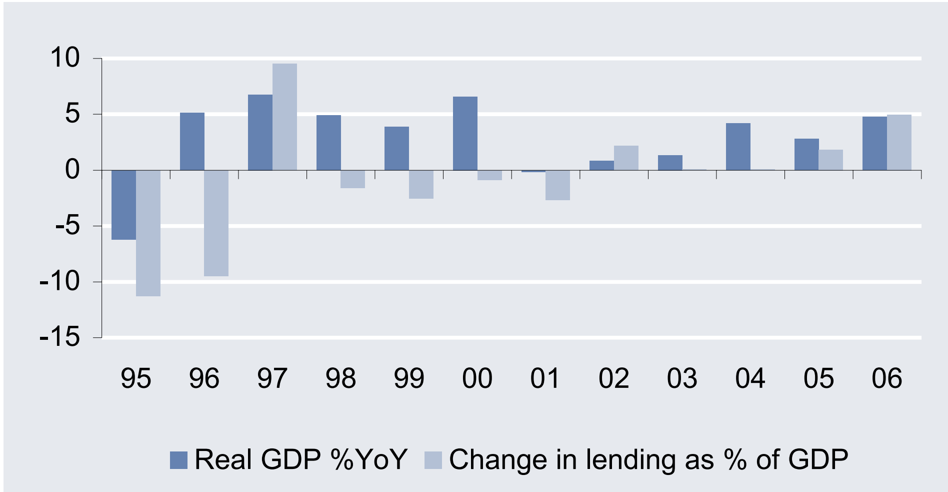
Bank lending – low lending explains low growth

Brazil lending data



Mexico lending data



- Latin America has generally performed weakly in terms of economic growth and this may be closely linked to low levels of bank lending. Credit injection has been no more than 2% of GDP in the past 5 years in Mexico or Brazil.
- But consumer credit in Brazil (now 7% of GDP and rising fast) and mortgage lending in Mexico (+80% real YoY growth in 2005) may help diversify economic growth.

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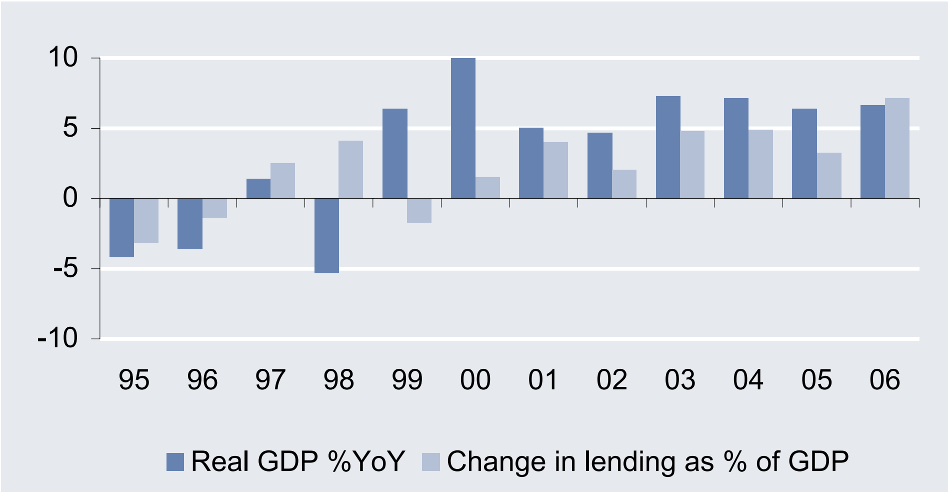
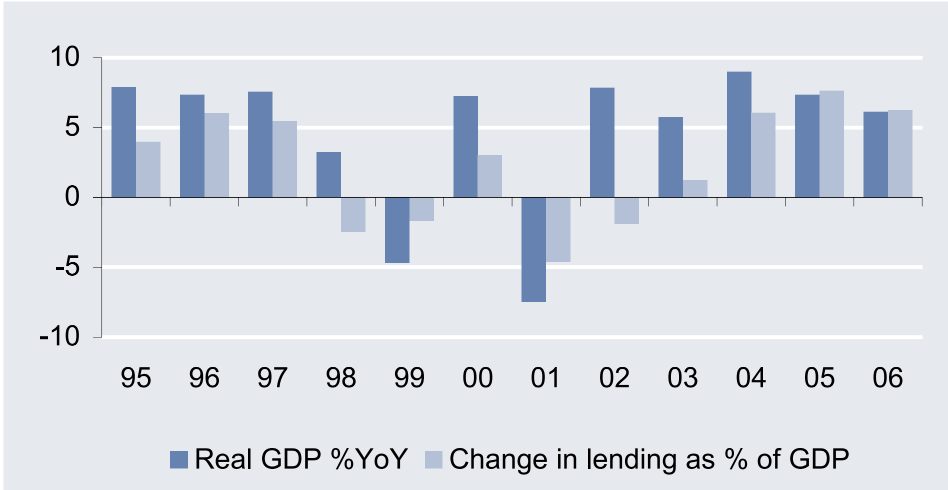
Bank lending – on the rise in EEMEA

Russia lending data



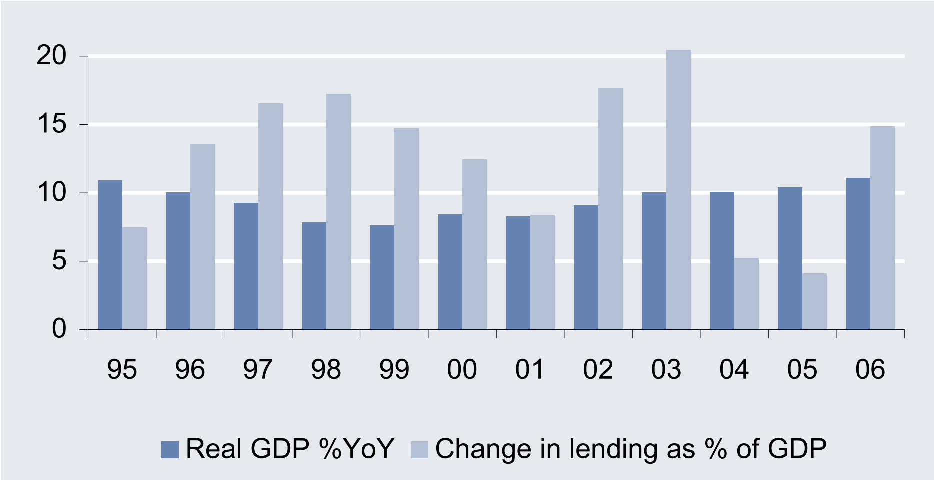
Turkey lending data



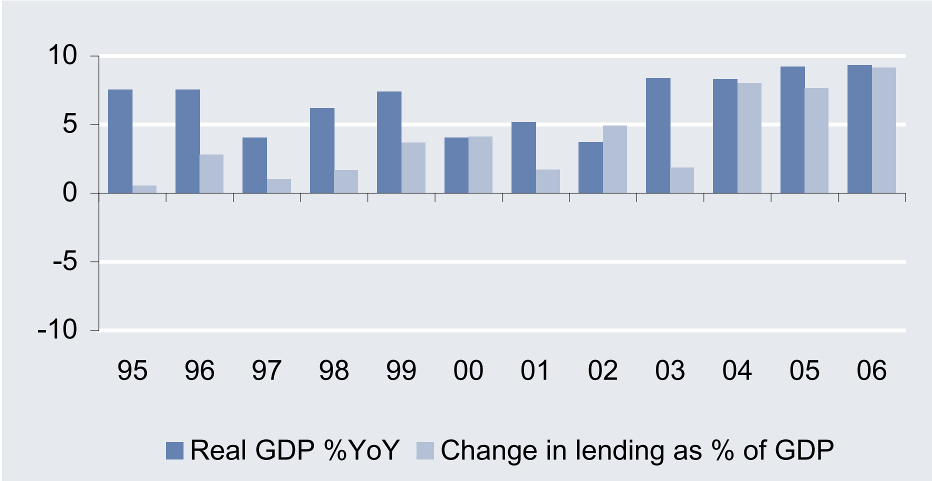
- Russian banks have not been protected by legislation, which has deterred them from lending. However credit growth is now rising by some 100% annually which again may help diversify growth. This is pushed by the Kremlin and state-owned banks.
- By contrast, in Turkey it is private sector banks that are renewing lending after the last crash in 2001. Scope for long-term growth means foreign ownership is rising from 2% of assets to 22% (early 2007).

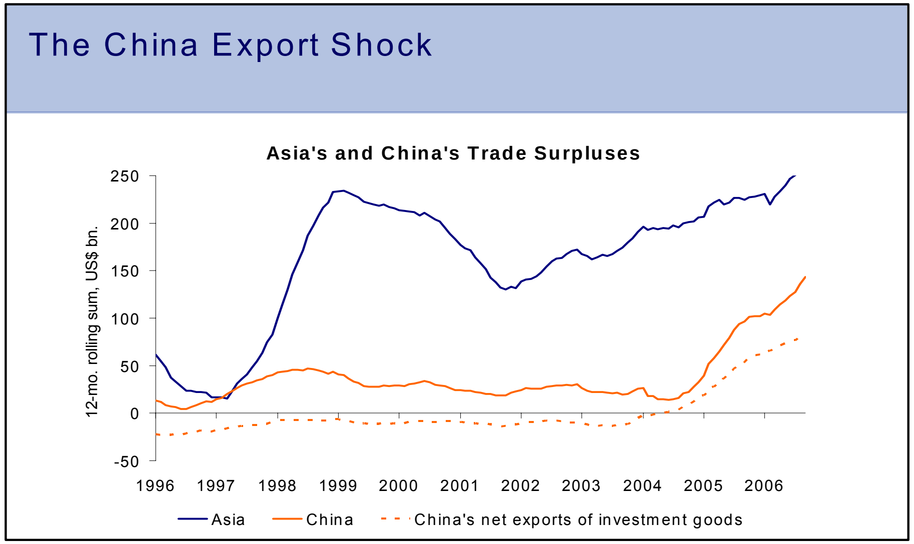
Bank lending – China and India

China lending data



India lending data





- Revised GDP data for China show that bank lending growth was not quite so unsustainable as it previously appeared. The stock of lending remains worrying. But the slowdown in 2004, the sale of stakes to foreign groups/equity investors and a more realistic lending rate policy are helpful factors. The undervalued pegged exchange rate is a further support.
- China is more dependent on net exports than previously; a US slowdown could have a big impact.
- India seems to be experiencing a credit boom, with considerable potential to sustain growth in a 7-10% range over the medium term.

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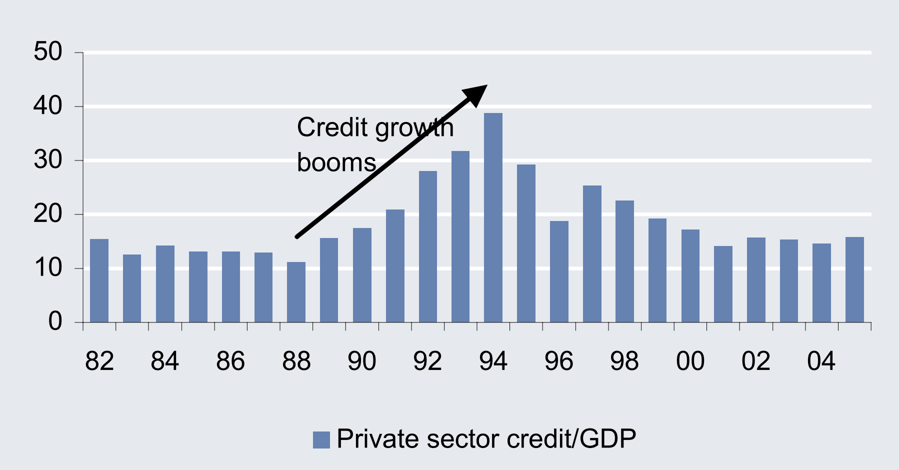
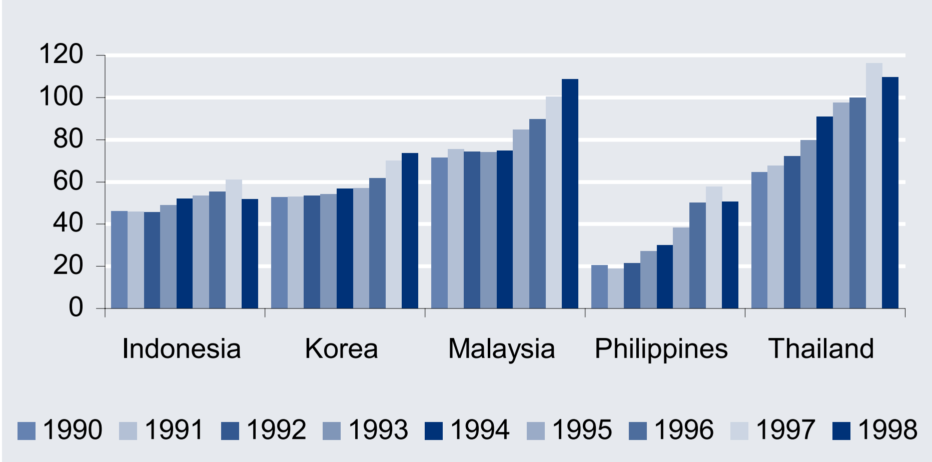
Too much bank lending – Tequila and Thai crises

Mexico – The Tequila crisis



The Thai crisis and Asian contagion



- Excessive bank lending contributed to both the Mexican "Tequila" crisis and to the Asian crisis of 1997-98. Post-communist banking crises have been seen in Russia (often), Bulgaria (1996) and the Czech Republic (1997). In all cases, the banking sectors were dominated by local operators and were poorly regulated. Up to half the loans in Bulgaria and Czech Republic were seen to be "bad" lending – a similar figure in China would be the equivalent of US$1 trillion.

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The external debt trigger

100% usually a threshold for a crisis

External debt due to foreign banks within 12 months as % of fx reserves (excl gold)

	1Q07	4Q06	4Q05	4Q04	4Q03	4Q02	4Q01	4Q00	4Q99	4Q98	4Q97	4Q96	4Q95	4Q94	4Q93	4Q92	4Q91	4Q90
Argentina	*25*	29	26	42	85	126	**194**	154	134	137	154	139	152	133	114	144	167	154
Brazil	*35*	43	50	44	55	61	90	103	99	93	96	73	65	68	97	111	262	298
Ecuador	*105*	126	72	101	101	124	90	93	66	138	98	82	86	102	114	185	169	194
Mexico	*30*	34	28	32	46	46	59	63	73	92	93	138	154	528	104	121	130	183
China	*7*	7	7	7	7	7	9	11	12	21	23	25	31	34	69	72	26	30
HK	*60*	64	56	53	53	44	55	65	76	104	**181**	268	376	430	409	409	480	534
India	*25*	25	24	20	16	9	14	24	26	28	31	35	43	37	43	71	88	269
Indonesia	*49*	52	53	46	38	43	62	71	72	104	**212**	188	201	175	167	164	163	180
Korea	*42*	35	25	25	29	31	30	34	47	57	**289**	198	166	157	145	156	174	138
Malaysia	*24*	24	22	23	19	20	26	25	25	36	**69**	41	33	26	27	24	27	21
Philippines	*45*	45	64	60	61	46	49	50	57	93	**163**	77	64	53	50	71	99	347
Thailand	*16*	17	22	19	20	19	32	32	42	83	**147**	121	121	106	87	78	74	66
Bulgaria	*57*	57	42	29	20	18	11	14	13	15	35	**207**	46	70	660	520	1586	NA
Czech	*47*	41	37	22	21	23	40	44	41	60	**56**	38	28	27	24	NA	NA	NA
Croatia	*112*	106	122	78	74	65	42	58	45	48	56	34	23	13	16	0	NA	NA
Estonia	*225*	213	242	223	160	204	147	110	141	42	42	13	4	2	2	0	NA	NA
Hungary	*82*	83	78	85	76	65	51	47	44	61	46	47	26	41	31	50	68	240
Latvia	*244*	216	176	91	99	62	43	46	28	23	8	5	5	1	NA	NA	NA	NA
Lithuania	*86*	89	101	72	52	47	57	58	50	28	15	20	6	6	1	0	NA	NA
Poland	*40*	36	39	32	38	42	39	28	25	22	18	14	14	28	92	89	96	73
Romania	*135*	144	52	42	35	33	43	49	76	53	33	55	76	35	58	50	40	44
Slovakia	*38*	51	38	24	22	19	44	35	56	87	69	38	22	19	18	NA	NA	NA
Russia	*18*	17	26	23	33	33	45	44	129	**226**	251	235	142	432	142	NA	NA	NA
Kazakhstan	*51*	57	77	38	47	48	45	28	32	34	21	19	20	17	2	NA	NA	NA
Ukraine	*33*	36	22	16	14	15	22	31	39	71	45	19	18	40	133	0	NA	NA
Georgia	11	12	13	25	24	20	40	48	28	23	9	16	16	NA	NA	NA	NA	NA
Egypt	*39*	35	28	22	26	28	31	32	27	23	15	14	15	16	16	22	55	111
Israel	*21*	17	17	17	22	19	17	13	16	13	14	18	27	27	25	33	30	34
South Africa	*51*	62	40	72	136	149	160	182	212	284	292	1157	369	513	643	743	667	683
Turkey	*64*	71	74	82	56	55	**100**	117	91	107	87	70	72	102	182	128	139	128
Iceland	*632*	**589**	833	355	378	600	635	531	430	375	223	187	241	202	141	157	135	138
US	*2080*	1933	1592	1027	842	806	975	938	764	0	0	0	0	0	0	0	0	0
New Zealand	*85*	102	141	196	182	131	178	135	144	179	145	83	96	87	126	155	157	84

Bold is crisis year. Shading indicates a number >=100%. Source: JEDH

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Emerging Markets safer than some developed markets

The great EM disasters of the 1990s were usually the consequence of poor policy choices by EM governments, with the crisis occurring when foreign financing for these bad policies disappeared. The triggers came when:

1) Governments could no longer borrow money (Russia in 1998, Argentina in 2001, Turkey in 2001, Brazil in 2002).

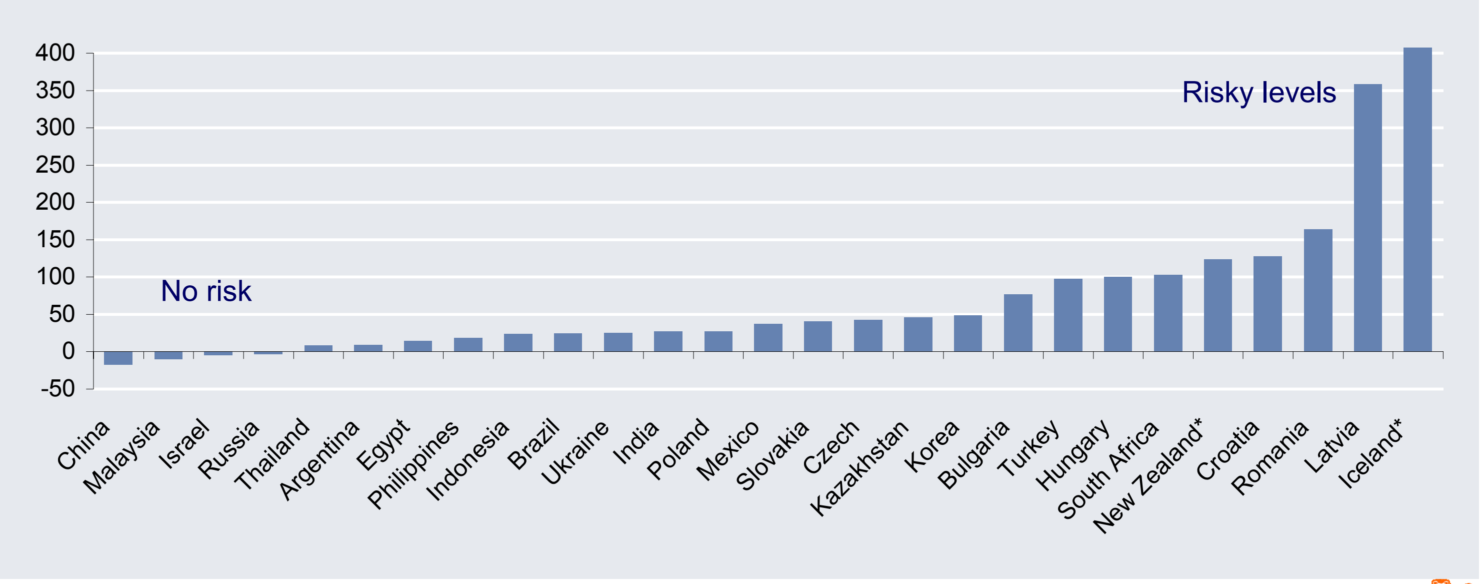
2) Foreign banks would not roll over private sector external debt (Korea in 1997, Mexico in 1994, Brazil in 2002).

3) The current account position made them vulnerable (Turkey in 2001, Mexico in 1994, Thailand in 1997).

Now governments do not borrow money – or not much. Short-term external borrowing is low. The current account + FDI picture is much improved.

External debt due in 12 months + FDI + C/A, all as % of fx reserves in 2007

The chart shows the total of the external debts due within 12 months + the C/A + FDI, as a ratio of fx reserves. Ie, it would take South Africa and Turkey a year to run out of reserves if they could not roll-over any debt. But it would take Iceland just 3 weeks (Iceland is off the scale of our chart). Russia's reserves would still grow!



** Iceland is at 1,051%*

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Foreign bank ownership

Poland	% of assets (2005)	Assets (€bn)
Unicredito (Bank Pekao - Bank BPH)	20	31
PKO BP	16	23.8
ING (Bank Slaski)	7	10.9
Commerzbank (BRE)	6	8.6
Citigroup (Handlowy)	6	8.5
AIB (Bank Zachodni WBK)	5	7.7
Hungary	**% of assets (2005)**	**Assets (€bn)**
OTP	19	14.2
KBC (K&H)	10	7.5
Bayerische Landesbank (MKB)	9	6.5
Intesa (CIB)	8	5.8
Erste	8	5.7
Raiffeisen	7	5
Unicredito (HVB)	5	4
Czech Republic	**% of assets (2005)**	**Assets (€bn)**
KBC (CSOB)	25	25.4
Erste (Ceska Sporitelna)	22	22.6
Soc Gen (Komercni)	17	17.8
Unicredito	7	7.4
Commerzbank	4	3.6
Raiffeisenbank	3	2.7

Bulgaria	% of assets (2005)	Assets (€bn)
Unicredito (Bulbank, Hebros, Biochim)	21	3.5
OTP (DSK)	14	2.3
NBG (UBB)	10	1.6
Raiffeisen	9	1.4
First Investment Bank	8	1.3
EFG Eurobank (Bulgarian Post Bank)	5	0.9
Romania	**% of assets (2005)**	**Assets (€bn)**
Erste (BCR)	26	9
Soc Gen (BRD)	15	5.2
Unicredito	9	3.1
Raiffeisen	9	3
ING	5	1.8
EFG Eurobank	4	1.6
CEC	4	1.5

OTHER EMEA

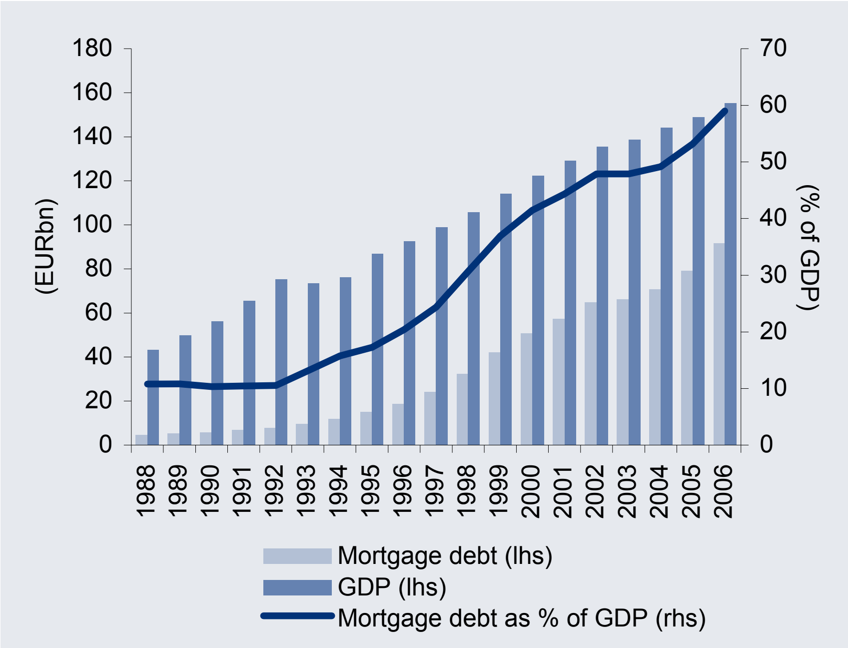
Russia	% of assets (2005)	Assets (€bn)	
Sberbank	26	73.7	
Vneshtorgbank	6	18.4	
Gazprom	4	12.4	
Alfa	2	6.8	
Uralsib	2	6.7	
Bank of Moscow	2	6.5	
Rosbank	2	5.9	
Ukraine	**% of assets (2005)**	**Assets (€bn)**	
Privatbank	11	4.2	
Raiffeisen (Aval)	8	3.3	SG was reportedly interested
Prominvestbank	6	2.4	
BNP Pari. (UkrSibbank)	6	2.3	SG was reportedly interested
Ukreximbank	5	2	State
Unicredito (Ukrsotsbank)	5	1.9	
Oshchadbank	4	1.5	State
OTP	3	1.3	Was Raiffeisenbank
Nadra	3	1.2	Possible take-over target
Finance and Credit Bank	2	0.8	Possible take-over target
Turkey	**% of assets (Jun-06)**	**Assets (€bn)**	
Is	15	35.1	Isbank Pension fund 45%, CHP 28%, free-float 27%
Ziraat	15	33.8	State onwer. IPO 25% and 75% to strategic investor possible in long-term.
AK	12	28.1	Sabanci and Citigroup (20%)
YKB	10	23.8	40% owned by Koc, 40% by Unicredito, 19.8% free-float
Garanti	10	23.4	Dogus Group and GE (25.5%)
Vakif	7	16.9	State 59% and may sell in 2008, employees 16%, free-float 25%
Halk	7	16.3	State IPO'd 25%, then 75% possible (US$4-5bn) in 2008
NBG (Finansbank)	4	8.6	NBG owns 87% with strat stake (46%) + after buying shares
ING (Oyakbank)	4	5.3	ING bought 100% in Dec-07
Dexia (Denizbank)	2	5.3	Dexia owns over 95%

Source: National sources

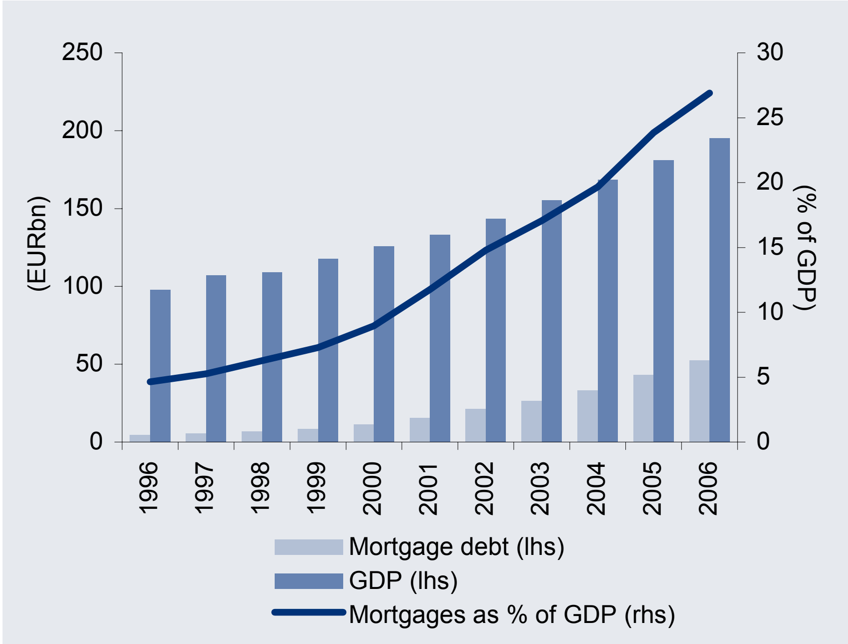
Just 1% of the Mexican banking sector was foreign owned in 1994, 16% in 1997 and 82% in 2004. Just 2% of Turkey's banking sector was foreign owned in 2004, but around 40% now.

The precedent of Greece and Portugal

Portugal: mortgages and GDP



Greece: mortgages and GDP



- Portugal was a typical emerging market in the early 1990s – when mortgage lending was just 10% of GDP. It soared along with Euro adoption in 1999.
- Greece has lagged Portugal due to high transaction taxes on property (roughly 25% of property value) but has risen five-fold in 10 years.

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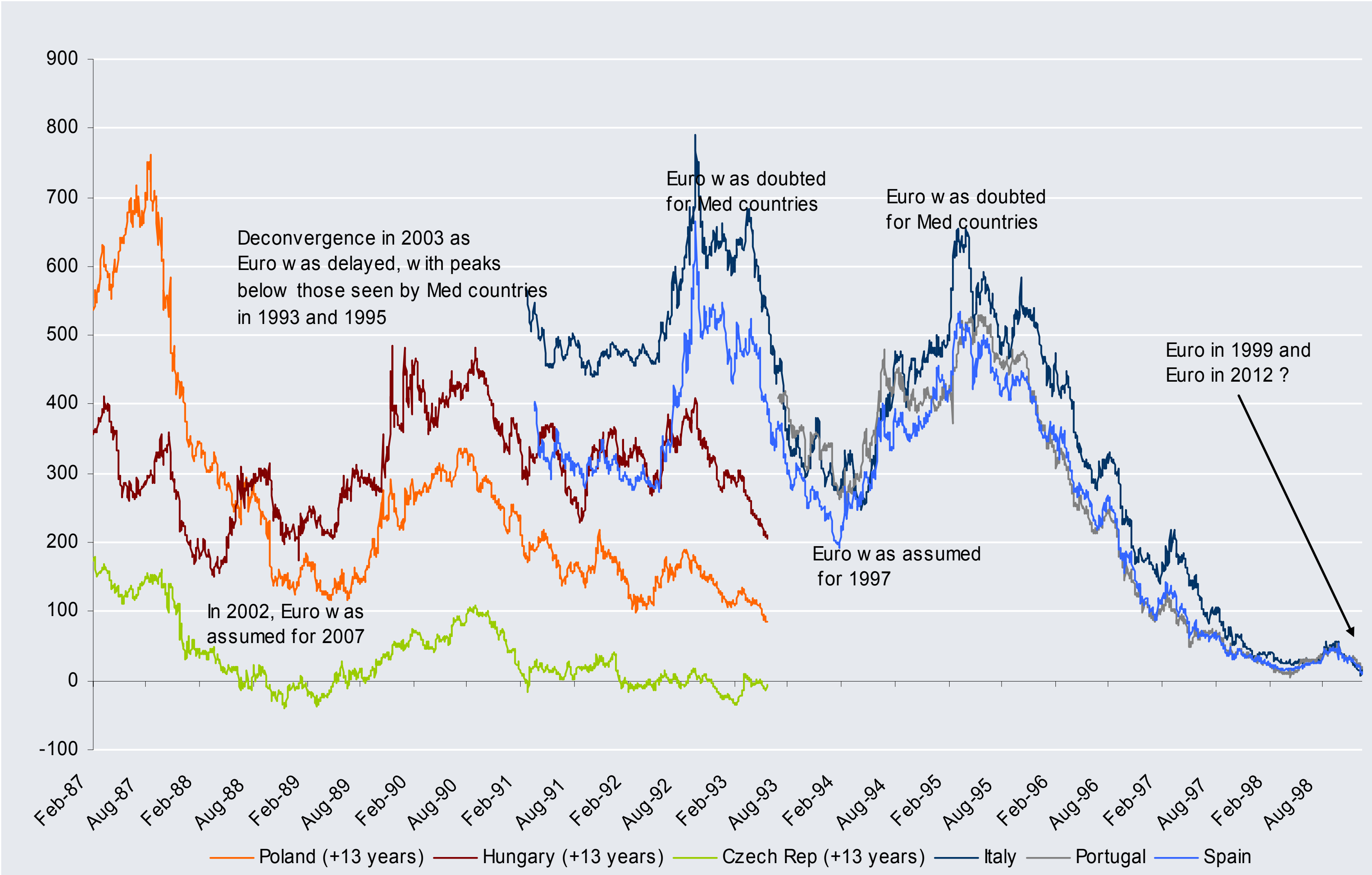
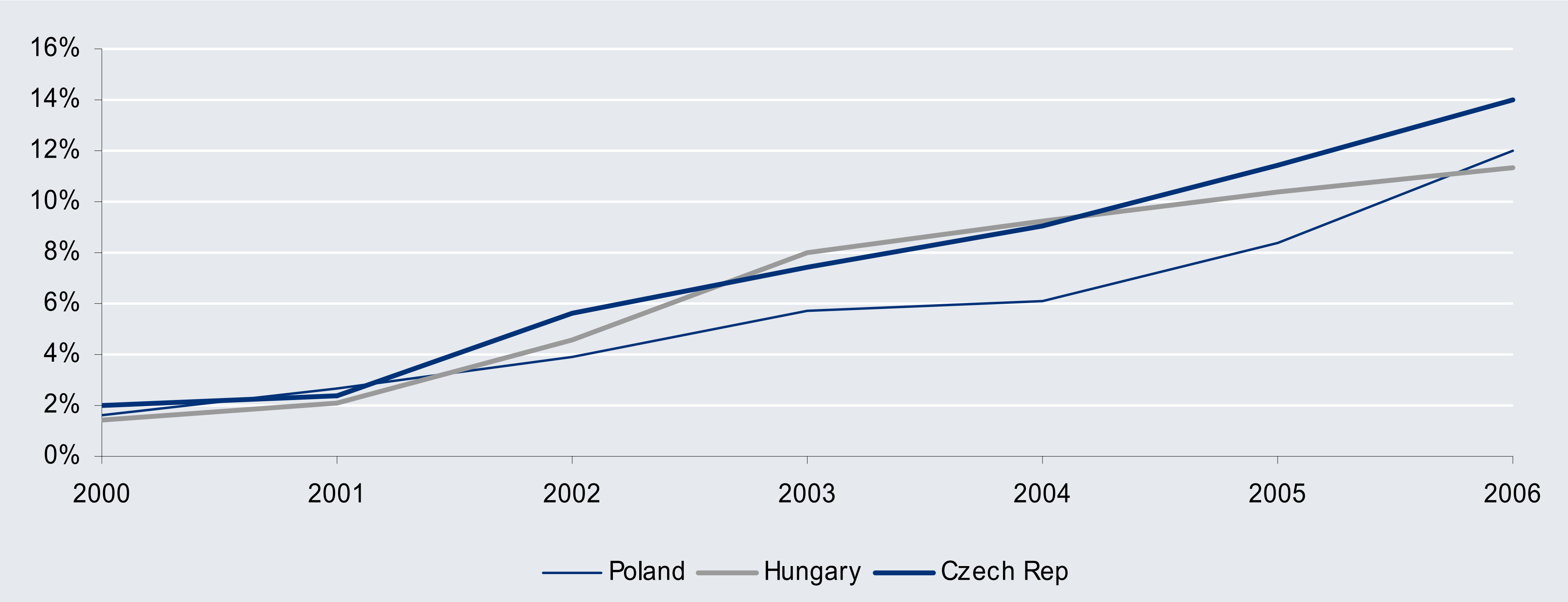
Nominal convergence but not yet



Note: CE4 data lagged by 13 years

Central Europe – steady convergence

Mortgage levels as % of GDP

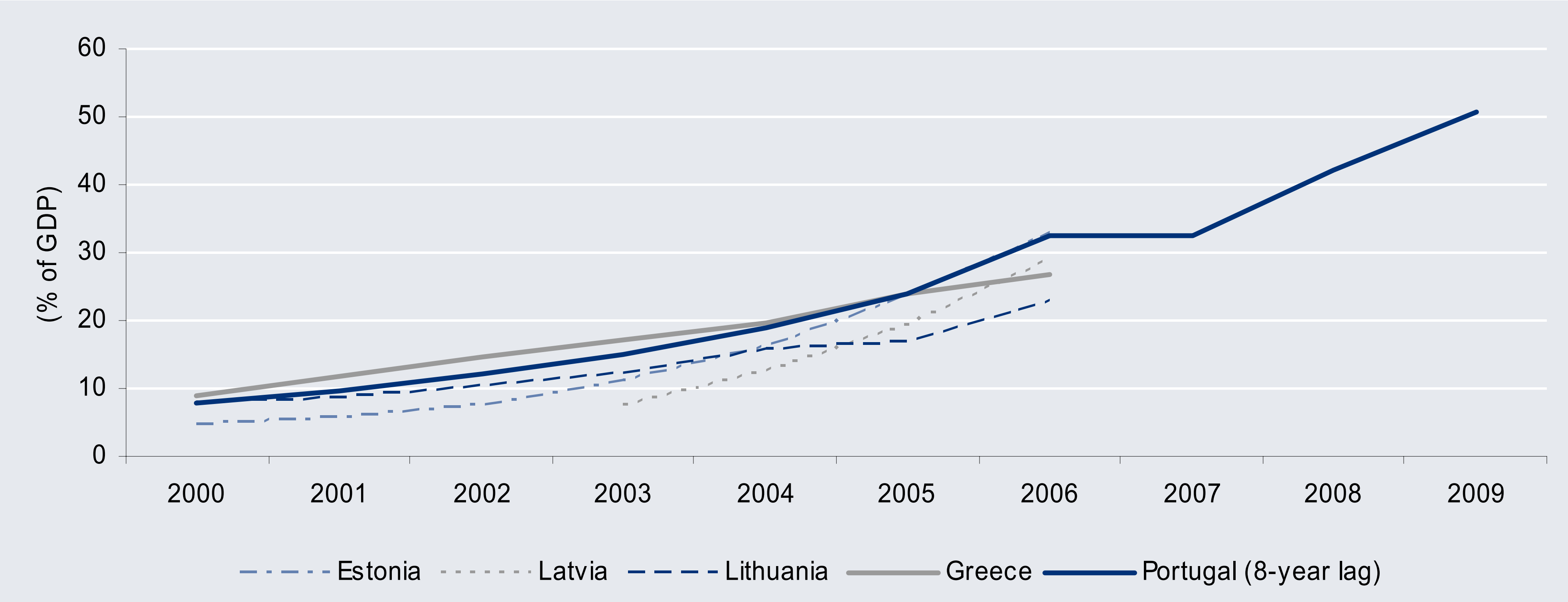


By contrast, central Europe's mortgage growth seems limited, sustainable and on course to continue converging with other EU member states.

We assume fx borrowing has an inbuilt protection mechanism – which is that the greatest risk (of HUF devaluation) should be avoided by interest rate hikes which would encourage more fx borrowing rather than less. However, forced sale of assets and repayment of loans means significant economic problems cannot be totally discounted.

Baltic states – mortgage levels similar to Greece

Mortgage levels as % of GDP



Mortgage levels in the Baltic states echo that of Greece, and Portugal with an eight-year lag. Portugal's economy hit a brick wall in 2001 and stopped converging with Germany. Deconvergence lasted some 4-5 years as Portugal grew at just 1% a year. This precedent suggests the Baltic states will hit difficulties in 2009 and have to face either stagnation or devaluation.

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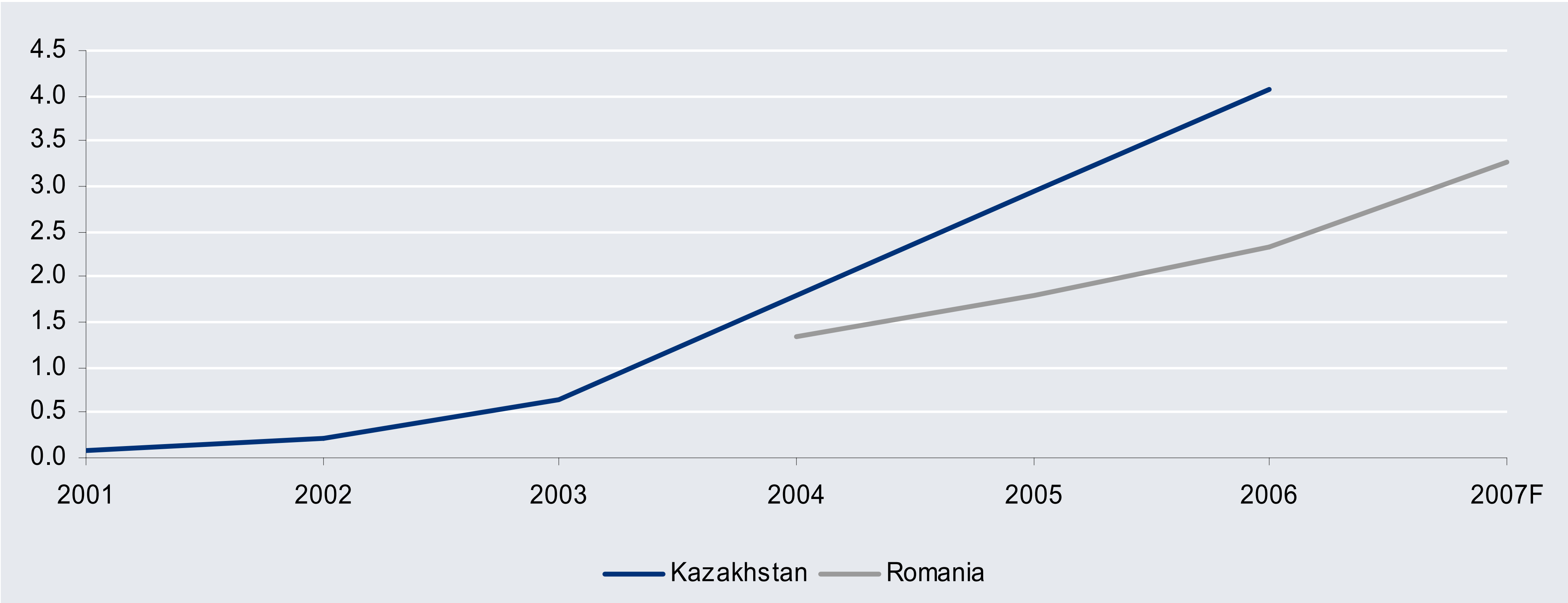
Frontier markets have much potential

Mortgage levels as % of GDP



- In Kazakhstan and Romania by contrast, mortgage levels seem very modest. But rapid growth in lending has led to excesses in both countries – as seen in the Kazakh crisis in October 07 and Romania's C/A deficit.

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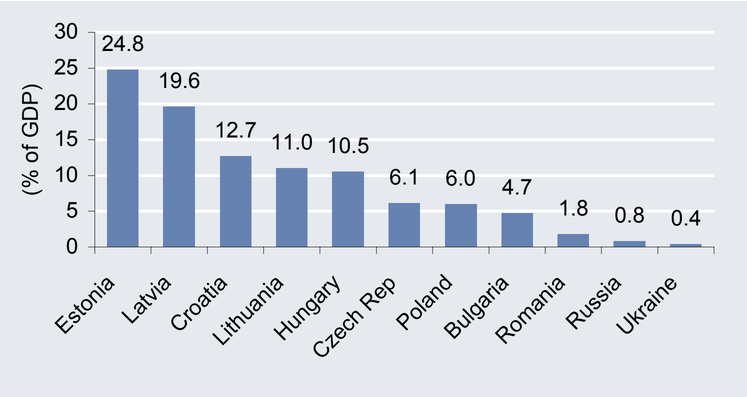
The outlook for mortgage lending and C/A risks

Mortgage comparison (2005)

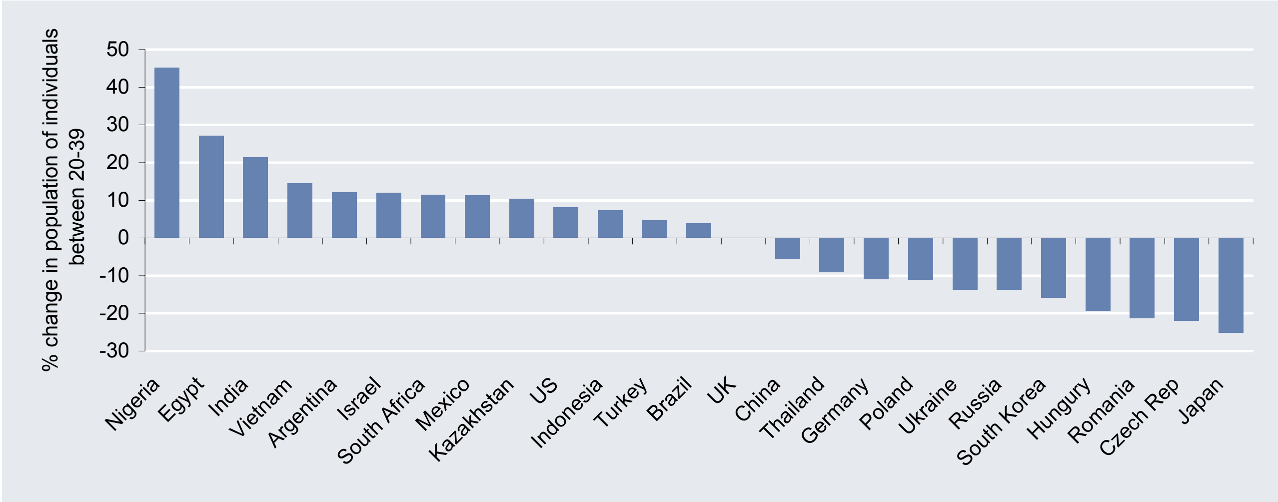


Mortgage lending and other consumer credit growth is a key factor behind the booming C/A deficits in emerging Europe.

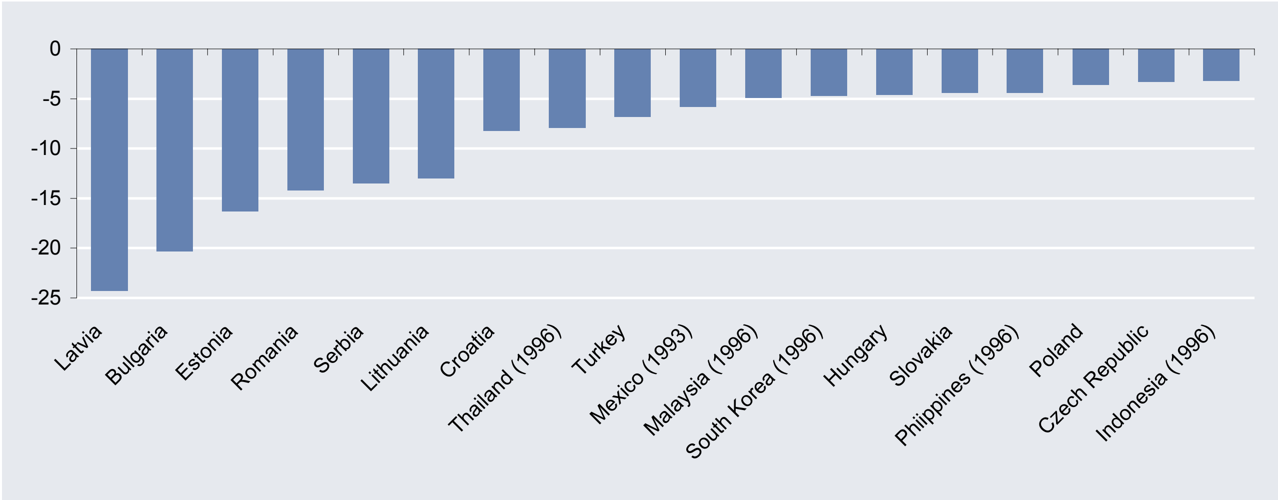
Compared to one year ago, we have more concerns because:

1) ERM membership has not been extended to Bulgaria
2) Foreign ownership of the banking sectors could be a threat
3) The markets are less forgiving of excessive risk-taking
4) Current accounts keep rising

Projected %ch in 20-39-year-olds from 2005 to 2020



Current account deficits breaching 7% of GDP danger level (2007F)



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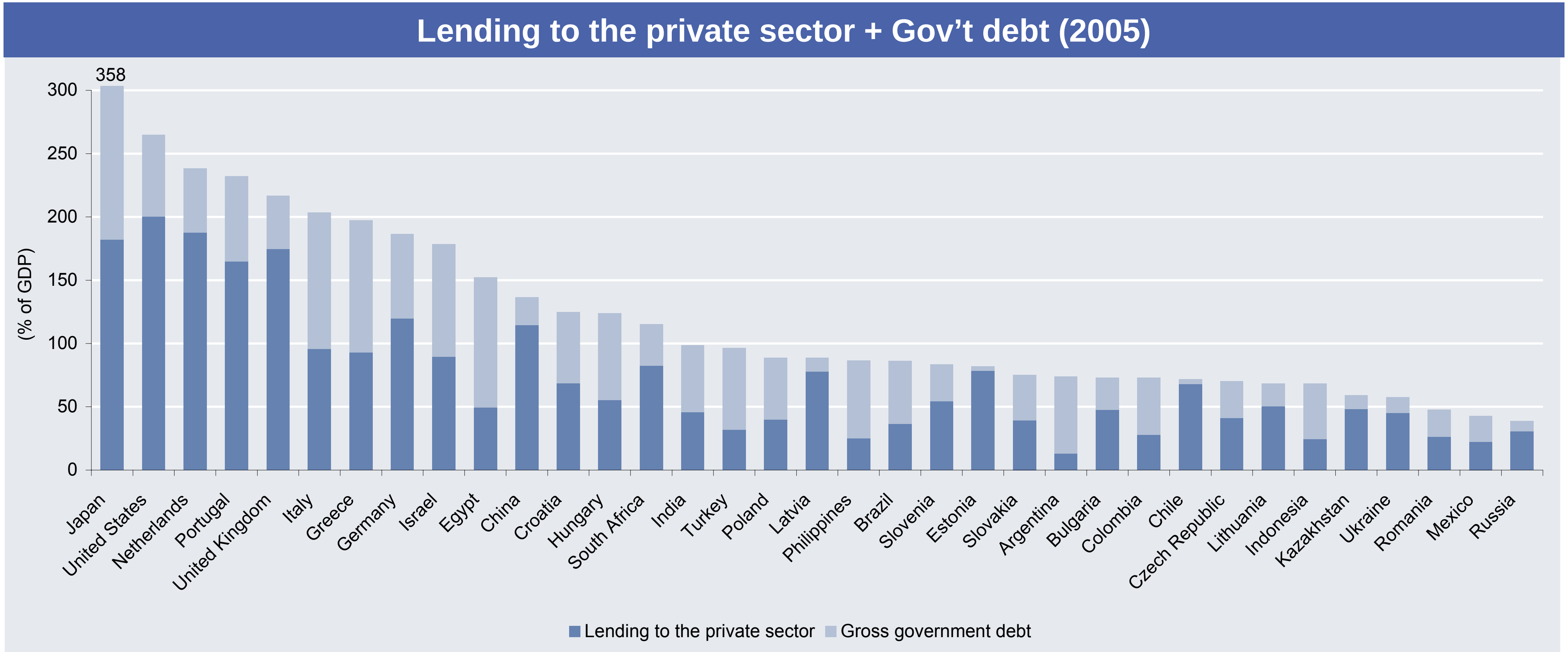
No risk of a crisis in EEMEA (*but see latest thoughts*)

- The external debt trigger is a fairly reliable signal of problems – but not perfect (see Czech Republic in 1997). It suggests only the Baltics and Balkans are at risk.
- The Baltics and Balkans do not offer contagion risk to EEMEA in the same way that Thailand did for other Asian countries, but Hungary and Turkey may be vulnerable.
- EU member states have an exit strategy from a currency peg – they can adopt the Euro, *but not if inflation misses the target by 0.1%.* Mexico and Thailand could not adopt the US dollar.
- ERM-2 member states are protected from very significant devaluations by the ECB, *but see Bulgaria's rejection by Trichet.*
- Banks are (hopefully) better regulated and better run than they were in Mexico in the early 1990s or Asia in the mid-1990s. Foreign ownership is much higher. *This might however carry its own risks given the credit crunch since August 2007*.
- Ukraine carries long-term risk that can easily be removed by widening its currency bands anytime in the next 2-3 years.
- Lastly – note that economists can be particularly bad at forecasting an end to currency regimes. Most investment bank reports as late as 4q1994 predicted Mexico would not be forced to devalue!

Most high debt countries not growing fast



- Countries with the best outlook are on the right-hand side of this chart and include former Soviet countries as well as Romania and Mexico.

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