TheCityUK

EMERGING MARKETS, FINANCIAL VOLATILITY, AND OPPORTUNITIES FOR UK FINANCIAL AND RELATED PROFESSIONAL SERVICES

INDEPENDENT ECONOMISTS GROUP

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TheCityUK

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INDEPENDENT ECONOMISTS GROUP

TheCityUK's Independent Economists Group (IEG) was established in 2012 as a forum to bring together leading economists in financial and related professional services. The IEG meets quarterly with the aim of providing independent and informed analysis of macroeconomic issues as well as key issues that the industry is facing both in the UK and internationally. Analysis incorporates implications of these issues for financial and related professional services and for authorities in the UK and EU.

Members

Dr Andrew Sentance	Senior Economic Adviser	PwC
Anjalika Bardalai	Chief Economist and Head of Research	TheCityUK
Barry Naisbitt	Chief Economist	Santander UK plc
Ian Craston	Group Investment Director	RSA Group
Ian Stewart	Chief Economist	Deloitte LLP
Dr John Llewellyn	Partner	Llewellyn Consulting
Justin Urquhart Stewart	Head of Corporate Development	Seven Investment Management
Kitty Ussher	Managing Director	Tooley Street Research Ltd
Dr Laura Davison	Head of Research	City of London Corporation
Mark Cliffe	Chief Economist	ING Bank N.V.
Mark Gregory	Chief Economist	UK & Ireland EY
Melanie Baker	UK Economist	Morgan Stanley & Co. International plc
Miles Celic	Chief Executive	TheCityUK
Alderman Nick Anstee	Senior Director	King & Wood Mallesons LLP
Paola Subacchi	Research Director, International Economics	Chatham House
Patrick Foley	Chief Economist	Lloyds Banking Group
Philip Rush	UK Economist	Nomura International plc
Sarah Hewin	Chief Economist, Europe	Standard Chartered Bank plc
Stephen Boyle	Head of Group Economics	Royal Bank of Scotland
Willem Buiter	Chief Economist	Citigroup

Economic consultant to the IEG: Kilbinder Dosanjh.
Mr Dosanjh provided the analysis underpinning the IEG's discussion and drafted the final report.
Kilbinder Dosanjh is an Independent Consultant with 20 years' experience evaluating credit risks and investment strategies on behalf of global financial institutions. Former roles have included Macro Economist at The Economist Group and Sovereign Risk Analyst at Moody's Investors Service.

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FOREWORD

Our experience over the course of 2016 has provided a stark demonstration of the speed with which perceptions of economic risk and opportunity can change. The first half of the year was dominated by concerns about slowing growth and financial volatility in emerging markets, particularly China. Since June, however, the UK's vote to exit the European Union has provided a new source of risk for the UK and indeed the global economy. The IMF, for example, has noted that "market reaction to the Brexit shock was reassuringly orderly" but that the broader economic impact of the vote remains uncertain.

TheCityUK's Independent Economists Group met shortly before the EU Referendum and discussed financial and economic developments in emerging markets, and the challenges and opportunities they provide for UK financial and related professional services. Emerging markets have been a crucial source of global demand in recent years, in the context of relatively slow growth and persistently weak economic fundamentals in many developed markets since the 2008-09 crisis. A sharp emerging market slowdown could therefore have direct effects on advanced economy financial markets. Meanwhile, in the wake of the Brexit vote, the opportunities presented by emerging markets have taken on a renewed importance, given the possibility that the UK will need to be more reliant on trade and investment relationships with economies in the Americas, Asia-Pacific, and the Middle East and Africa. By virtue of its economic weight relative to other developing economies, China is the dominant player among emerging markets. Indeed, our new research emphasises the point that "emerging markets" may be a convenient label, but that as a group, these countries display significant diversity in terms of economic size, economic structure, demographics, wealth and openness. Asian countries are likely to be central to commercial opportunities, as evidenced by the UK's leading role in, for example, offshore reniminbi trading and offshore rupee-denominated bond trading. The UK's pre-eminence as a global financial centre leaves it well placed to lead in financial-services development in other major economies, and also to take advantage of niche opportunities in a range of other countries. In this way, the UK financial and professional services sectors can help maintain their competitiveness and growth amidst the current wave of political and economic uncertainty.

Andrew Sentance

Andrew Sentance
Chair, TheCityUK Independent Economists Group

EXECUTIVE SUMMARY

- Economic liberalisation, geopolitical factors and globalisation will provide **growing opportunities for financial services companies operating in emerging markets, particularly in Asia**.
- **The UK's role as a leading international financial centre places it in a good position to lead** in areas such as offshore renminbi trading, infrastructure financing and provision of services and advisory work for emerging market corporates and sovereigns.
- **China will continue to dominate the emerging markets story** through economic, trade and, increasingly, financial channels; the country has been a major contributor to global growth since the 2008-09 global crisis.
- "BRICS" is more relevant as a marketing concept than as economic analysis. China dominates the grouping; **India is the only other country among the BRICS that is not experiencing weak or recessionary conditions**, and the designation excludes a number of other emerging markets with similar potential.
- A reliance on Chinese growth has increased vulnerabilities for the global economic and financial system given the **mainland's deteriorating demographics, growing debt burden and economic transition**.
- **Commodity-dominated economies are particularly vulnerable to an economic slowdown in China** owing to an increased reliance on demand from its construction and manufacturing sectors.
- Broader global economic weakness, financial market volatility and over-capacity in many industrial segments are all **increasing risk for emerging-market corporates and sovereigns**.
- **Developed economies are vulnerable to problems in their emerging-market counterparts** given the latter have in recent years become important sources of demand and in some cases investment.

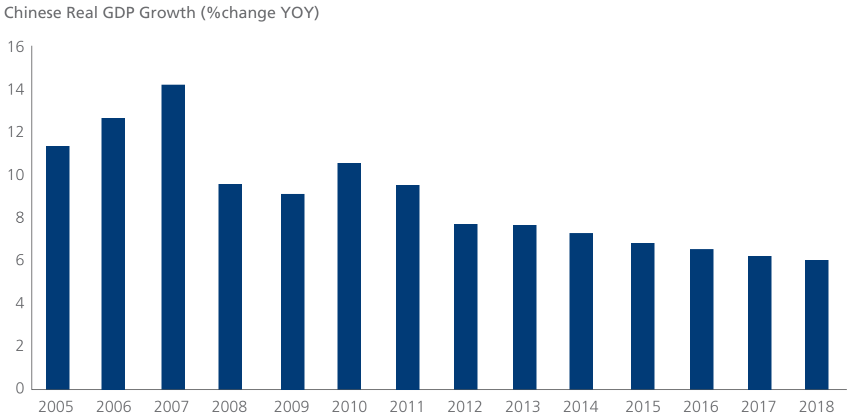
1: CHINA DOMINATES THE EMERGING-MARKETS STORY

China will remain the dominant emerging-market economy

China's economic and merchandise import growth (in US dollar terms) averaged a significant 10% and 20%, respectively, during 2000-15 as its economy opened up and as rising domestic incomes increasingly saw the country act as a source of final demand, trends that have placed it at the centre of the so-called "South-South" trade story (See: Figures 1 and 2).

The large size of the Chinese economy means that even moderating rates of growth will result in substantial incremental demand – a growth rate of 6% today represents $340 billion of GDP (at market prices) compared with the $260 bilion added when China was growing by 10% ten years ago. In effect, in 2015 China contributed more than one-third of world GDP growth, greater than the combined contributions of the US, Europe and Japan.

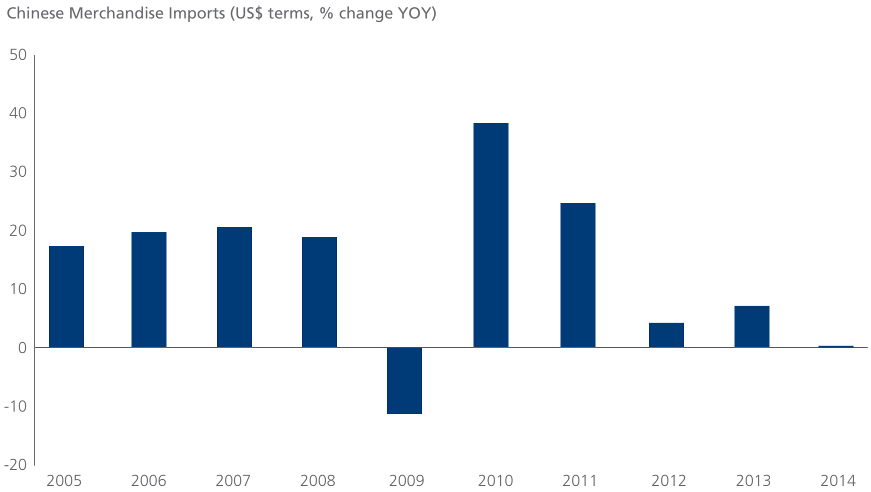
Figure 1
China's economic growth is slowing but remains healthy



Source: IMF World Economic Outlook.

Indeed, the number of countries counting China as their main export market increased from five in 2000 to 43 in 2014. Over the same period the US saw an equivalent fall from 53 to 31 countries.

Figure 2
Chinese merchandise import demand increased sharply in the 2000s but is weakening

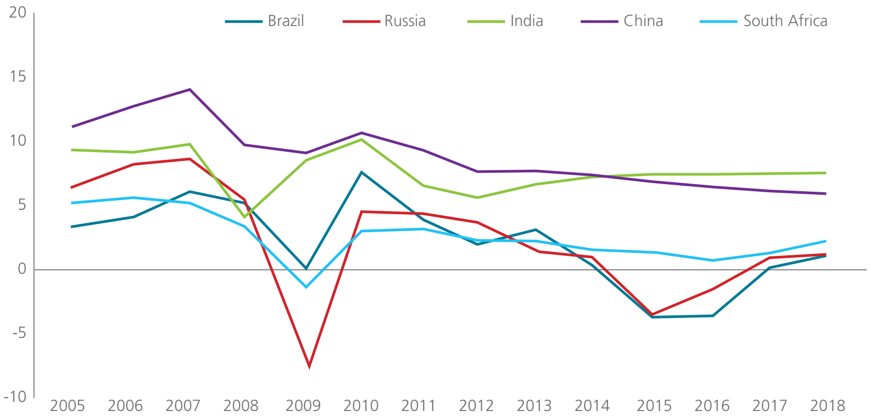


Source: IMF Direction of Trade Statistics.

The 2008-09 global crisis increased China's role as a pillar of world economic activity as that country pursued a major programme of fiscal and monetary stimulus and as the US – historically another major driver of global economic growth – and other Western economies entered a lower growth trajectory.

Figure 3
China and India are the only BRICS economies to show consistently robust growth

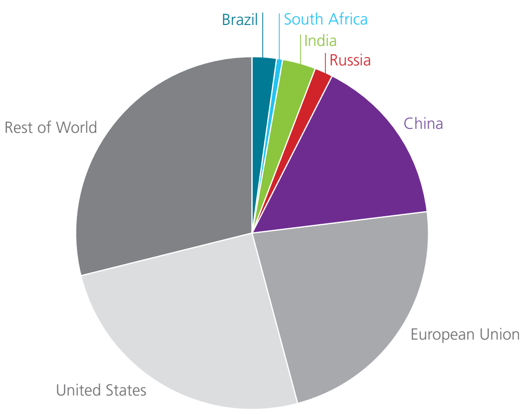
BRICS Real GDP growth (% change YOY)



Source: IMF World Economic Outlook.

Figure 4
China's economy dominates BRICS

BRICS share of world GDP



Source: IMF World Economic Outlook.

"South-South" trade has become increasingly important

Trade between developing countries has expanded rapidly owing to final demand within these markets as well as increasingly widespread integrated supply-chains; trade between developing countries currently represents around 25% of world trade, compared with around 12% in 2000. Yet China's current economic slowdown, coupled with the changing composition of its growth, is likely to slow this trend. It should also be noted that supply-chain dynamics have complicated trade patterns given that many final products are processed in the "South" yet are still destined for developed countries. Moreover, this shift in global trade patterns has been exaggerated by weakness in these same developed markets since the 2008-09 global crisis.

Placed in a broader context, China's economic weighting enables it to dominate BRICS; in 2015 its economy represented around two-thirds of the BRICS' combined economic size at market prices (See: Figures 3 and 4). The country will continue to dominate for decades, despite the gradual economic slowdown evident since 2014.

Other BRICS members remain relatively small

The economies of Brazil, Russia and South Africa, like many other countries with large commodity sectors, as well as that of India (a net importer of commodities), benefitted both from a booming global economy (pre-crisis) that resulted from a combination of loose monetary policy and China's rise. Equally, they suffered when the global economy entered recessionary conditions, albeit to different degrees and depending on internal dynamics[1].

Of the grouping, only China and India are set to support the global economy during the next five years; according to the IMF, China is expected to record an average growth rate of 6.1% during 2016-21 and India 7.6% over the same period. This will do little, however, to support other emerging markets that have thus far benefitted from China's stimulus measures and existing economic structure. Moreover, other countries with similar profiles to BRICS in terms of large populations and favourable demographic profiles – notable examples including Indonesia, Turkey and Mexico – also lack the size or economic dynamism, even collectively, to supplant China as new growth poles over the next decade. Like their smaller peers in BRICS these economies face myriad challenges such as fiscal and balance-sheet constraints and political difficulties which undermine the authorities' ability to implement difficult and far-reaching reforms.

[1] *Russia, for example, first benefitted from a sharp rise in global oil prices but has been suffering from weak economic conditions owing to a combination of low oil prices evident since 2014 and geopolitics (most prominently the response of the international community to Russia's involvement in Ukraine).*

2: ECONOMIC UNCERTAINTY IS ON THE RISE

Economic uncertainty will persist

China's lower growth trajectory will increase vulnerabilities in its economic and financial system that stem from high and rising leverage. According to the Bank for International Settlements, the mainland's credit-to-GDP ratio currently stands at approximately 250%, having risen by 100 percentage points since 2008. Around 70% of this increase has originated from the corporate sector and there are concerns that Chinese firms will face problems servicing their debt amid slowing growth and excess capacity (in heavy industries). While the Chinese authorities maintain the fiscal space to prevent a systemic financial crisis, high debt levels will increasingly undermine private investment in the coming years.

China is also seeing a deterioration in its demographic profile in the form of growing labour supply constraints and an ageing population. Various estimates suggest that its working-age population began to shrink in the early 2010s, a trend that will lower China's growth potential. Indeed, the country's deteriorating international competiveness in recent years indicates that the Lewis Turning Point[2] has been reached. Efforts to move industries up the value-added chain and boost innovation (and thus raise productivity) are unlikely to compensate for the negative impact of worsening demographics on the mainland's potential economic growth rate. However, the country's declining working-age population will, over the coming decades, bring with it opportunities (opening up of capital markets to develop pension funds, for example). More broadly, the government has in recent years been modernising the regulatory environment--for example, by improving private-sector access to bank loans.

While much of the investor focus has thus far been on China's economic slowdown, the real risks and opportunities for businesses and trading partners stem more from future trends in the composition of growth, which will be felt through a variety of channels. Asian countries in particular will be impacted by slower growth in investment and associated imports. According to the IMF, China's merchandise imports (volume terms) fell by 1% in 2015 – the first fall in 18 years following average annual growth of around 11% during 2005-14.

The nominal value of merchandise imports fell by around 14% last year, driven largely by a negative terms-of-trade shock for commodity producers.

State-owned enterprises still represent a substantial economic distortion

For decades China's state-owned enterprises (SOEs) were at the centre of a manufacturing story that provided employment for the millions of new entrants to the labour force. While state-owned and linked companies remain an important economic segment their success has been achieved in part through heavy state intervention – both direct as well as indirect subsidies, such as artificially cheap financing – that has increasingly burdened the authorities and Chinese commercial banks. The government has long recognised that this model has caused a large-scale economic misallocation of resources. At the same time the private corporate sector has become the main driver of economic growth (particularly the investment and export components), innovation and employment. As a result, the authorities' reform efforts have taken a two-pronged approach; restructuring SOEs and levelling the playing field[2] for domestic private companies. Yet the government will retain a cautious approach to lowering support (including through bank financing) for SOEs given deep concerns that such measures would risk a rise in social tensions if carried out too rapidly.

[2] *The Lewis Turning Point refers to the loss of labour surpluses in the rural sector that consequently lead to labour shortages and a sharp rise in urban wages.*

China's shift away from investment and towards consumption is also having a negative impact on countries exporting capital goods to China. Within this context, the Philippines, for example, has thus far been relatively insulated given that its main exports to the mainland are agricultural- and consumer-goods based.

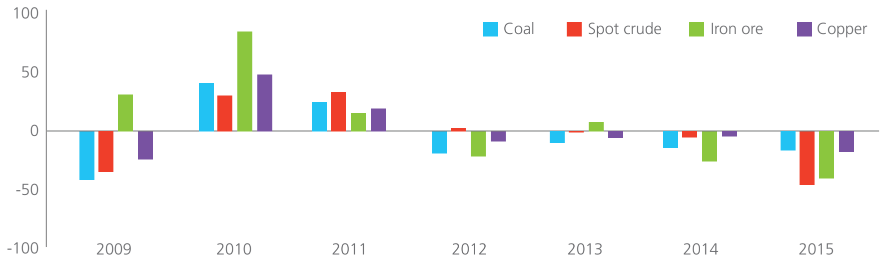
The authorities' existing growth policies since the 2008-09 crisis centred on domestic debt expansion of both local government and the private sector that supported rapid manufacturing and infrastructure growth. Commodity-producing countries had until 2014 recorded improvements in both their external and fiscal accounts owing to the composition of China's growth and Quantitative Easing (QE)[3].

China's efforts to shift away from a dependence on investment and manufacturing for growth[4] will more generally have a greater negative impact on this class of emerging markets than is implied by the modest deceleration witnessed in its headline economic growth rates. Its demand for commodities has weakened and has had a price and volume effect across a range of commodities, reducing income and trade flows that have in turn resulted in worsening economic performances for commodity producers (See: Figure 5).

Not only is the slowdown in China's industrial sector resulting in lower demand for commodities, the over-capacity in its heavy industries is creating greater price competition abroad; overseas steel makers are facing greater competition from Chinese companies as the latter seek new markets amid dwindling domestic demand, for example.

Figure 5
Commodity prices will remain weak

Medium Term Baselines for Selected Commodities (US$ terms, % change YOY)



Source: IMF Primary Commodity Prices.

[3] *Although there are several schools of thought on the impact of QE on commodity prices, so-called "easy money" has played a role in attracting investors seeking higher returns into this asset class, exaggerating commodity price trends, particularly where there were existing demand-supply imbalances.*

[4] *The authorities have long-been attempting to shift the drivers of growth away from investment and industry to consumption and services; past efforts have failed but the current government of China has placed renewed emphasis on achieving this adjustment, a trend that will be supported by rising per-capita incomes and wages.*

3: EMERGING MARKETS SHOW SIGNS OF DIVERGING (AT THE MARGIN)

'Taper Tantrum Part II' has had a more varied impact than Part I

What has been noticeable since the so-called 'Taper Tantrum' in mid-2013 is reduced herding behaviour by international investors. In 2013 hints that the US Federal Reserve would start to tighten monetary policy saw investor sentiment turn negative towards myriad emerging markets. Investor sentiment and the herd instinct in response to signs that US monetary tightening[5] would continue were more nuanced in 2015-16. The different response two years on is attributable to a number of factors.

First, and importantly, is the changing political landscape, particularly in India and Indonesia, as both countries saw reformist leaders take office in 2014[6]. This has bolstered foreign investors' confidence in their economic outlooks even as the global economic outlook has deteriorated.

Beyond the positive outlook for India and Indonesia, other large emerging markets are already weakening or highly vulnerable. Argentina, Brazil and Mexico are suffering from a combination of weak commodity demand, slow global economic growth and country-specific headwinds. Turkey has potential owing to its large size, demographics, and relatively diversified economy. Yet, again, country-specific risk is large, with fiscal and external accounts both vulnerable and rising political risk undermining investor confidence.

China's slowdown has been good for India

Secondly, there are continental-sized economies and commodity consumers that have been insulated from global trends. Again, India's economy has proven relatively resilient in the face of increased uncertainty over the global economic outlook and the shocks transmitted into capital markets by China's domestic financial system during the second half of 2015. This reflects (among other things) the fact that in addition to the confidence boost provided by the reformist Narendra Modi's becoming prime minister, the country has been one of the main beneficiaries of the Chinese slowdown.

[5] *After an increase in the US federal funds rate in December 2015 – the first in almost a decade – the US central bank has retained a cautious approach to monetary tightening owing to a range of factors, including uncertainty over the health of the Chinese economy and the outcome of the UK's EU referendum on 23 June, as well as weak domestic inflationary conditions.*

[6] *India saw the Bharatiya Janata Party win an unexpected majority in the April-May 2014 general election, following which Narendra Modi became Prime Minister; Indonesia saw businessman Joko Widodo elected president in July 2014.*

India's lack of manufacturing sector competitiveness, reliance on commodity imports and inefficient subsidy programmes meant that the rise in global commodity prices during China's period of rapid economic expansion had an adverse impact on India's external and fiscal accounts during much of the 2000s. The global economic slowdown and financial volatility post-2008 resulted in India suffering from weaker external demand for its services even as QE and Chinese demand for commodities drove up India's import and subsidy bills.

Conversely, the drop in key global commodity prices evident since 2014 has reduced pressure on India's trade balance, supporting its broader external position, as well as its fiscal position (by reducing the subsidy bill). Together, these factors have reduced the country's vulnerability to external shocks both by improving economic fundamentals and providing the Reserve Bank of India with more space to ease monetary policy via: (1) reduced downward pressure on the external value of the rupee that has reduced import inflation and (2) the broader fall in commodity prices that has had a direct impact on containing domestic inflationary pressures.

India's economic growth potential is set to rise over the next decade as its working age population rises sharply – over the next 10 years around 1 million workers will enter the job market each month – as infrastructure investment rises and as economic liberalisation continues, albeit in fits and starts. The rising working-age population evident in India is mirrored across a range of emerging markets; as mentioned above, China is the notable exception. Although the Indian economy's small size relative to China underscores the limits of its growth story in the global context, its financing needs will be critical in both providing opportunities for foreign portfolio and direct investors as well as encouraging further liberalisation.

India's demographic dividend comes with risks

India's young demographic profile – the country is expected to have a larger working age population than China before 2030 – comes with the potential to raise economic growth through the so-called "demographic dividend". The Modi government is aware of the need to improve the business environment and develop India's social and physical infrastructure in order to create jobs for the millions of workers coming online over the next decade. Some progress has been made, notably in a greater commitment to economic liberalisation, infrastructure development and improving the broader business environment. But the risk of a demographic dividend turning into a demographic time bomb in the event that job creation remains insufficient to absorb the new entrants into the labour force remains pronounced. India's ranking in the World Bank's Ease of Doing Business Index improved from 134 in 2014 to 130 in 2015, but this is still poor in absolute terms and also when compared with China's position of 84 last year. Domestic politics will continue to hinder the changes needed to create an operating environment conducive to boosting domestic and foreign investment.

Indonesia will also continue to offer new opportunities

Economic growth in Indonesia, which decelerated to a six-year low of 4.8% 2015, was still respectable and is set to remain at around this level over the next two years. Moreover, since coming to power President Joko Widodo has driven several economic liberalisation measures[7]: in February the government announced plans to ease foreign direct investment (FDI) rules in several sectors, building on opening measures taken in 2014 in areas such as health and logistics (although the all-important oil and gas sector remains protected).

Commodity producers will continue to bear the brunt of the global downturn…

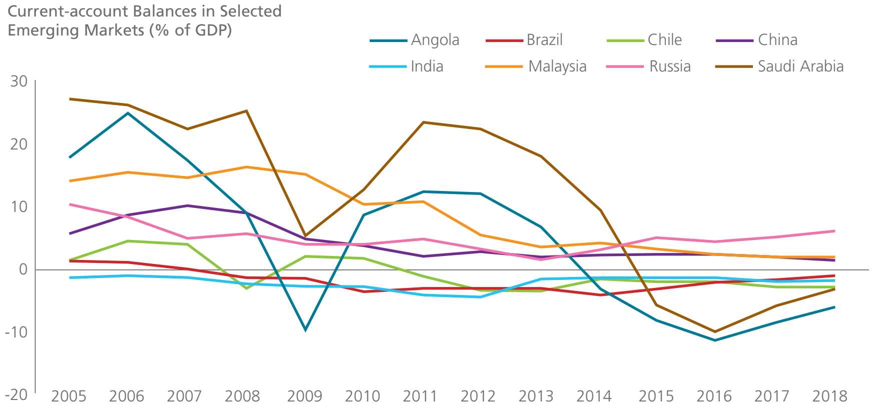
Commodity-dominated economies – ranging from oil to iron ore producers – that in the 2000s became increasingly reliant on demand from China's construction and manufacturing sectors have borne the brunt of the mainland's slowdown and weakness in other large economies. Both factors have resulted in rising commodity price volatility and greater vulnerability to shocks across Latin America, Africa, the Middle East and Asia (See: Figures 6 and 7). Indeed, few emerging markets with large commodity-producing components have the level of economic diversification needed to provide a buffer against a sustained drop in commodity prices[8].

Emerging markets are not a generic grouping

Emerging markets are diverse in terms of economic size and structure, demographics, level of economic development (per capita income, size of middle class, business environment, infrastructure needs) and openness. This is exemplified by the Association of South-East Asian Nations (ASEAN), where growing economic integration, centred on the ASEAN Economic Community (AEC), will provide significant market opportunities despite the fact that the bloc includes countries with vastly diverse population sizes, levels of economic development and regulatory standards. For example, the IMF's World Economic Outlook estimates Indonesia's population in 2015 at 255 million, compared with around 0.5 million in Brunei. Per-capita income (current prices, US dollars) stood at $52,888 in Singapore compared with $1,168 in Cambodia in the same year.

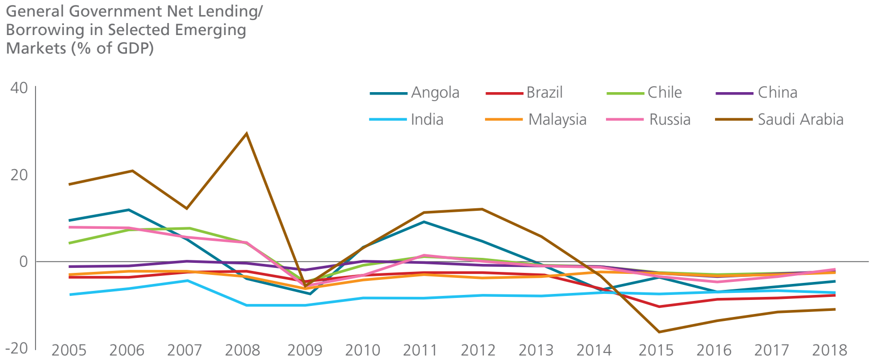
[7] Economic liberalisation has different connotations depending on the country but generally we refer to an opening of the capital account, reforms of state-owned enterprises, privatisation and broader deregulation.
[8] Brazil, Malaysia and Russia have more diversified economies than Saudi Arabia but have seen deteriorating economic metrics owing to a combination of volatile commodity prices, broader global economic weakness and domestic political uncertainty.

Figure 6
Current-account balances have deteriorated in many emerging markets over the last two years



Source: IMF World Economic Outlook.

Figure 7
Government balance sheets of commodity producers are particularly vulnerable

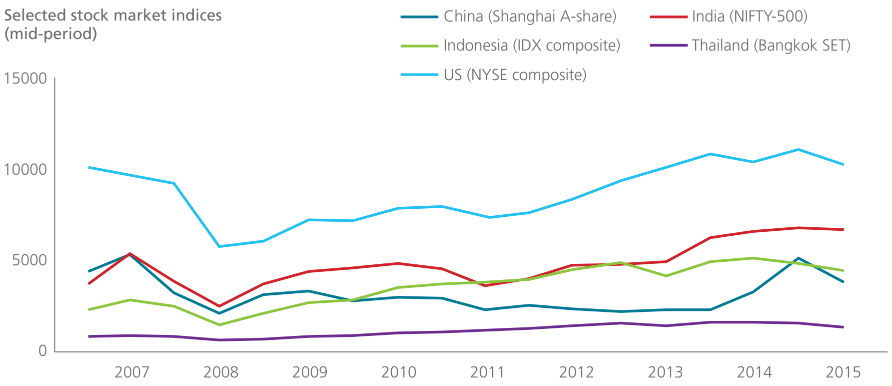


Source: IMF World Economic Outlook.

…but second-round effects raise broader concerns

Deteriorating investor confidence, whether again stemming from perceived policy mishaps in developed economies or signs that the Chinese government lacked the resources to support its economy, would transmit shocks throughout the global financial system. This was evident in the latter part of 2015 when India saw its equity and currency markets weaken amid stock market declines in China despite the fact that, as a commodity consumer, it has thus far been a beneficiary of commodity price falls and so insulated relative to many of its peers (See: Figure 8). Sustained and sharp falls in global economic output and/or global financial market volatility would leave all economies vulnerable.

Figure 8
Stockmarket uncertainty increased since 2015



Source: Thomson Reuters DataStream.

Oil producers such as Kuwait and Saudi Arabia, which used the recent boom in oil prices to enhance their foreign-exchange reserves and sovereign wealth funds (SWFs), are already at risk. Despite these buffers, the combination of lower income inflows stemming from oil price drops and greater volatility in returns on financial assets amid broader capital market declines have called into question the sustainability of their fiscal policies. Saudi Arabia is believed to have spent over $150 billion from reserves since 2014 (when oil prices started recording dramatic declines) and at current oil prices some analysts have suggested that a further $200 billion will be spent by 2018. Both countries announced reforms in 2016 to help reduce their dependence on oil, although there are concerns regarding their capacity to implement these reforms[9]. The countries with fledgling sovereign wealth funds across Africa and Central Asia have already shown the limits of using such funds to offset revenue declines, having in many cases already exhausted these buffers. Although a range of factors determine sovereign ratings, the table below highlights the impact of lower commodity prices on the credit-worthiness of selected emerging markets.

Table 1:
Moody's Sovereign Ratings; Trajectories of Selected Emerging Markets

Country	Economic structure	Last rating decision before weaker commodity price environment	Latest rating decisions
Angola	Commodities producer	Ba3 Positive (August 2012)	B1 Negative (April 2016)
Argentina	Diversified, important commodities component	B3 Negative (September 2012)	B3 Stable (April 2016)
Azerbaijan	Commodities producer	Baa3 Stable (April 2012)	Ba1 Negative (April 2016)
Brazil	Diversified, important commodities component	Baa2 Stable (October 2013)	Ba2 Negative (February 2016)
China	Diversified, large commodities consumer	Aa3 Stable (April 2013)	Aa3 Negative (March 2016)
India	Diversified, large commodities consumer	Baa3 Stable (January 2004)	Baa3 Positive (April 2015)
Kuwait	Commodities producer	Aa2 Stable ((August 2010)	Aa2 Negative (May 2016)
Nigeria	Commodities producer	Ba3 Stable (November 2012)	B1 Stable (April 2016)
Russia	Diversified, important commodities component	Baa1 Negative (June 2014)	Ba1 Negative (April 2016)

Source: Moody's Investors Service

[9] *Saudi Arabia published Vision 2030 in April 2016, which includes, among other things, a goal of increasing the private sector's share of GDP to 65% from 40%. Kuwait announced economic reforms in March 2016, including a 10% tax on corporate profits and cuts to state spending on subsidies.*

QE and domestic stories are – for now – driving investors into high-yield markets

The return of investors into Argentina's sovereign debt market despite concerns over the health of the global economy further exemplifies the importance of domestic factors in determining capital flows. Mauricio Macri's presidential election victory in November 2015 resulted in a move to resolve differences with bond holders. This resolution, policies such as a currency devaluation and lowering subsidies, and low yields in developed markets saw the country issue its first sovereign bonds in 15 years in April 2016, raising US$16.5bn at a rate of around 7.5% (the issue was more than three times over-subscribed).

4: DEVELOPED ECONOMIES ARE VULNERABLE TO SHOCKS IN EMERGING MARKETS

Developed markets are also more vulnerable than they were before the global crisis

With developed markets still feeling the effects of the 2008-09 global crisis – as evidenced by large private-sector debt levels, weak sovereign balance sheets and lower economic growth trajectories – emerging markets, again with China at the fore (both as a source of growth for these other emerging economies and as a source of final demand for developed economies), have provided important sources of demand and a positive boost to investor sentiment. Weakness in emerging-market economies and a broader deterioration in the outlook for capital markets since 2015 has thus had the opposite effect, resulting in rising risk aversion over the last year in particular.

Most immediately, the impact of rising risk aversion is being felt through exchange rates. The yen has strengthened against the US dollar since August 2015 despite the Bank of Japan's (BoJ) programme of monetary easing[10] (See: Figure 9) and Japan's weak public sector balance sheet[11]; the latter has led to a gradual deterioration in the country's sovereign credit ratings[12]. The currency's broader safe-haven status despite Japan's weak public finances reflects in large part the country's position as a large net creditor[13], the loose monetary policies of the BoJ's peers (including continued dovishness by the Fed) and broader volatility in global capital markets.

A repeat of the sharp yen strengthening experienced during and after the global crisis would have greater negative repercussions for Japan's economy this time around; yen appreciation was less of a problem after the global crisis since Chinese demand supported Japan's corporate sector, but a sharp rise in yen strength in the absence of such strong Chinese demand would raise the risk of another recession in Japan and put further pressure on its fiscal position.

Increased uncertainty in global markets could also impact other currencies. Sterling suffered a sharp increase in volatility at the height of the global crisis in part as financing options in its commercial banking system nearly closed altogether.

[10] *Japan's Prime Minister, Shinzo Abe, adopted "Abenomics" that included a new programme of Quantitative Easing being initiated from April 2013.*

[11] *Japan's general government debt stock currently stands at around 250% of GDP, the highest level of all advanced economies – for comparison, Greece has a general government debt stock of 178% of GDP.*

[12] *Fitch placed Japan's sovereign debt rating at A negative from A stable on 13 June; the last time all three of the biggest ratings agencies gave Japan's government debt a top rating at the same time was in the 1990s.*

[13] *Japan has recorded continuous current account surpluses since 1981, enabling it to build $1.2 trillion in foreign currency reserves as of April 2016 (second only to China), while its net international investment position stood at $2.9 trillion at end-2015, the largest in the world.*

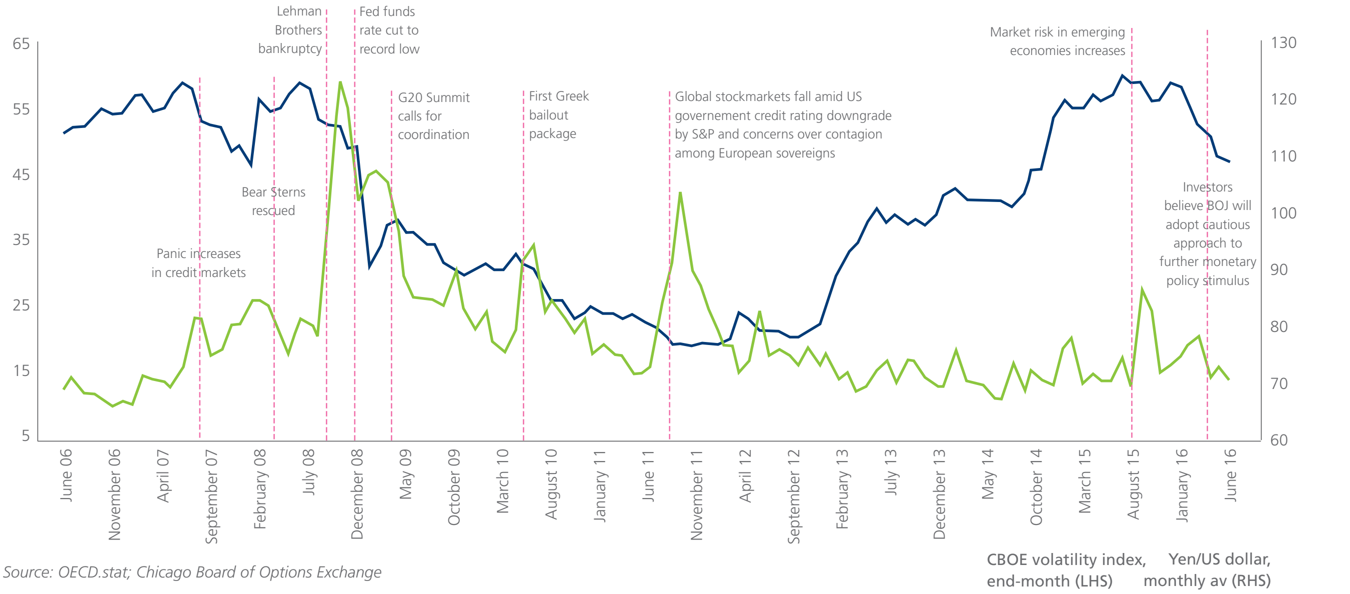
The direction and magnitude of sterling's movement in international foreign exchange markets in 2017 will more generally depend on: (1) the UK's domestic economic strength; (2) interest rate differentials (particularly relative to the European Central Bank, which is carrying out a significant QE programme, and to the US Federal Reserve, which is poised to tighten monetary policy); and (3) any renewed global financial volatility. All of these factors will in turn depend on political and financial-market developments in the aftermath of the 23 June vote in favour of ending the UK's membership in the EU. For example, sterling had seen increased volatility in the run-up to the Referendum on EU membership, but has depreciated significantly since 24 June when the Referendum result became clear[14]. Similarly, the UK economy has been seen as more resilient than many of its peers, despite a raft of weak economic data in the first half of 2016 and a mixed – and often better-than-expected – picture since the Referendum. The extent to which the Leave vote will impact short-term real GDP growth remains unclear, but downside risks have risen[15]. Structural and regulatory issues such as the availability of euros for UK-based financial institutions and a potential disruption to UK trade with the EU and between the UK and non-EU countries that have free-trade agreements with the EU may also affect the value of sterling.

[14] In the immediate aftermath of the vote, sterling dropped more than 10% against the US dollar. The pound continued its slide in subsequent days, hitting its lowest levels against the dollar for over 30 years; it remained near these levels in the subsequent weeks, trading at around $1.3:$1. Since early October sterling has depreciated still further, leaving the exchange rate against the US dollar around 18% lower than before the Referendum; by mid-November sterling was near a record low on a trade-weighted basis. Additional downward pressure (albeit much more modest) was exerted by the Bank of England's decision to lower the benchmark interest rate to a record low and expand its QE programme on 4 August.

[15] For example, in its November 2016 Inflation report, the Bank of England revised its forecast for real GDP growth in 2017 up to 1.4% from 0.8% in its August forecast--through this still implies a sharp slowdown from growth of 2.2% in 2016. The Office for Budget Responsibility's latest forecast, published on 23 November, also anticipates a significant economic slowdown based on weaker growth in investment and private consumption.

Figure 9

Yen/US dollar rate highlights the Japanese currency's safe-haven status



Source: OECD.stat; Chicago Board of Options Exchange

5: GLOBAL ECONOMIC AND FINANCIAL INTEGRATION WILL PROVIDE CONTINUED COMMERCIAL OPPORTUNITIES

Asia will be central to commercial opportunities

Risks to the global economy and financial system will remain significant, particularly over the next two years, and increased financial volatility would in turn represent a barrier to international investment flows.

Yet there is a growing recognition across a range of countries, particularly in Asia, that economic and financial liberalisation measures are needed to compensate for slowing growth in China and continued economic weakness in developed countries. Growing economic integration, liberalisation and trade across Asia will be a dominant story in emerging markets; these forces will bring greater demand for transaction banking and foreign-exchange services. Although the prospect of ratification of comprehensive, inter-regional agreements like the Trans-Pacific Partnership has diminished in line with political developments in 2016, the open nature of most Asian economies suggests that further bilateral trade agreements in the region are likely.

Reforms in emerging markets will therefore be a key driver of commercial opportunities over the next decade[16]. Most prominently, despite the lower growth trajectory and recent domestic financial-market volatility in China, opportunities there will continue to grow. Indeed, China's geopolitical agenda combined with its economic weighting will provide an important source of demand for financial services through a range of factors.

The UK is already benefiting from the internationalisation of the renminbi

The Belt and Road Initiative (previously "One Belt – One Road"), a Chinese scheme with geopolitical underpinnings, is an effort to boost infrastructure and related links in the region. Meanwhile, the China-backed Asian Infrastructure Investment Bank, a body modelled on the Bretton Woods institutions, is designed to promote infrastructure investment across emerging markets. Both are part of China's efforts to increase its economic influence at the global level. The renminbi joining the dollar, the euro, sterling and the yen as a Special Drawing Right currency – as a reserve asset the renminbi will be

[16] *For a more detailed analysis of economic reform in China, see, for example, TheCityUK, Reform of the Mixed Economy: a Comparison with International Practice. China Free-Trade Zones Discussion Paper, September 2014.*

treated as a hard currency – are part of China's efforts to internationalise the renminbi[17]. Internationalisation of the currency will go in hand-in-hand with (cautious) capital-account liberalisation and provide opportunities across the financial services sector, ranging from clearing services to renminbi deposit-taking to currency trading.

The UK in particular is already an important Western centre for offshore renminbi trading – it is the second-largest clearing centre for such trading, after the Hong Kong SAR – and will increasingly benefit from global issuance of renminbi-denominated bonds by the Chinese authorities as they seek to increase foreign investor access to renminbi-denominated assets. Indeed, in May the Chinese Ministry of Finance announced that it would issue Rmb3 billion (around $500 million) of bonds in the UK's offshore renminbi market, the first such overseas issuance since 2011. Moreover, decoupling of the renminbi from the dollar – another important step towards the opening of the capital account – will increase foreign access to the domestic market over the long-term.

These opportunities will arise even as China's economic transition is likely to transmit shocks through banking and investment channels (given the large holdings of its assets held by foreign investors and lenders and as the mainland's companies have become increasingly active overseas), and despite the potential for volatility in China to reduce investor confidence in other markets[18].

UK financial services will also benefit from liberalisation in other countries

While producers of primary and intermediate goods, particularly in Africa, are likely to see sharply slower growth over the next five years, the Asia growth story is likely, for the reasons discussed above, to provide opportunities to UK-based financial institutions.

India's large and growing economy combined with liberalisation will open significant new opportunities. For example, the UK financial services sector's

[17] China's important position in the global merchandise trading system combined with its government's efforts to slowly internationalise the role of the RMB have helped the Chinese currency to become the fifth most used currency in international transactions.

[18] TheCityUK-China Britain Business Council China Market Advisory Group is prioritising specific areas in which the UK financial services industry can work with China, including green finance, mutual recognition of funds, and the promotion of London as a regional hub for Chinese firms.

established track record in developing Public Private Partnerships (PPP) and financing could help kick-start India's own PPP agenda, which is being revamped after having slowed down significantly since the global crisis. The creation of the National Investment and Infrastructure Fund (NIIF), implementing the recommendations of the Kelkar Committee[19] and the opening up of the insurance sector to FDI will all create new commercial opportunities[20]. Similar patterns will be evident across the emerging markets space: several studies suggest that emerging-market infrastructure shortfalls stand at around $1 trillion a year and PPP currently represents a small fraction of this gap. A lack of domestic resources to push their infrastructure development agendas across the emerging markets space will also drive demand for project finance and syndicated lending. As emerging markets increasingly seek sustainable development models they will also aim to expand the role of renewable sources of energy in their fuel mix. A number are, for example, increasing investments in solar power. Within this context City of London's launch, in January 2016, of the Green Finance Initiative will strengthen London's position as a source of financing in this specialised segment. The UK is also the hub for Islamic Finance in the West and the growth of this form of financing will bring opportunities as the supply of Islamic financial structures for investment and finance continues to develop and as demand for Sukuk assets continues to expand.

A combination of capital market development (which will be driven by financing needs and bring opportunities for a spectrum of companies that include pension, insurance and reinsurance providers), capital-account liberalisation as well as financing constraints – as commodity producers face lower revenues and as global monetary conditions tighten – will increase the opportunities and need for emerging-market sovereigns and corporates alike to attract overseas investor interest. UK-based financial institutions have long played a role in Ratings Advisory and so are well-placed to benefit. Moreover, cross-border advisory opportunities will increase amid two-way FDI flows: China- and India-based companies in particular will continue to expand into developed markets, while capital-account liberalisation in emerging markets in general will enable greater FDI into this segment[21]. UK-based financial

[19] The Kelkar Committee's finding were used to establish new rules, designed to encourage renewed private sector infrastructure investment through the PPP framework, ahead of the FY2016-17 budget. For a more detailed discussion, see Infrastructure Funding in India Creating Success, TheCityUK, January 2016.

[20] TheCityUK is supporting the India-UK Financial Partnership launched in 2014 and is designed to increase collaboration between the UK and Indian financial sectors.

[21] China is becoming a major exporter of direct investment; outward FDI from China grew by an average of almost 30% over the last ten years.

institutions investing in emerging markets bring with them skills, resource and technology transfers that would bolster the development of capital markets in host countries, creating further sources of demand for these institutions' services over the long-term.

Rising incomes, urbanisation, ageing populations, reforms and increasing use of technologies will increase demand for wealth and asset management services, as well as for pension and insurance products. On balance, reforms, economic growth (both a driver and being driven by a rapidly expanding middle class) and underdeveloped domestic financial systems will bring with them opportunities across a wide spectrum of financial services.

THECITYUK RESEARCH

For further information about TheCityUK Research, please contact:

Anjalika Bardalai, Chief Economist and Head of Research
anjalika.bardalai@thecityuk.com, +44 (0)20 3696 0111

TheCityUK, Salisbury House, Finsbury Circus, London, EC2M 5QQ

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