Development Finance in Emerging Markets

This paper discusses the challenges and relationships that emerging markets face in this current period of global volatility, the need for Development Finance Institutions to full the funding gap between public and private investment and the various factors that are in play that influence emerging market growth. A South African perspective will also be investigated, which will explore the strengths and weakness of the country's economy and prospects. Influencing factors on emerging markets such as the oil price, commodities, public and private partnerships, established markets, underdeveloped private finance sectors, Multinational Institutions, landlocked countries and Brexit will also be explored further.

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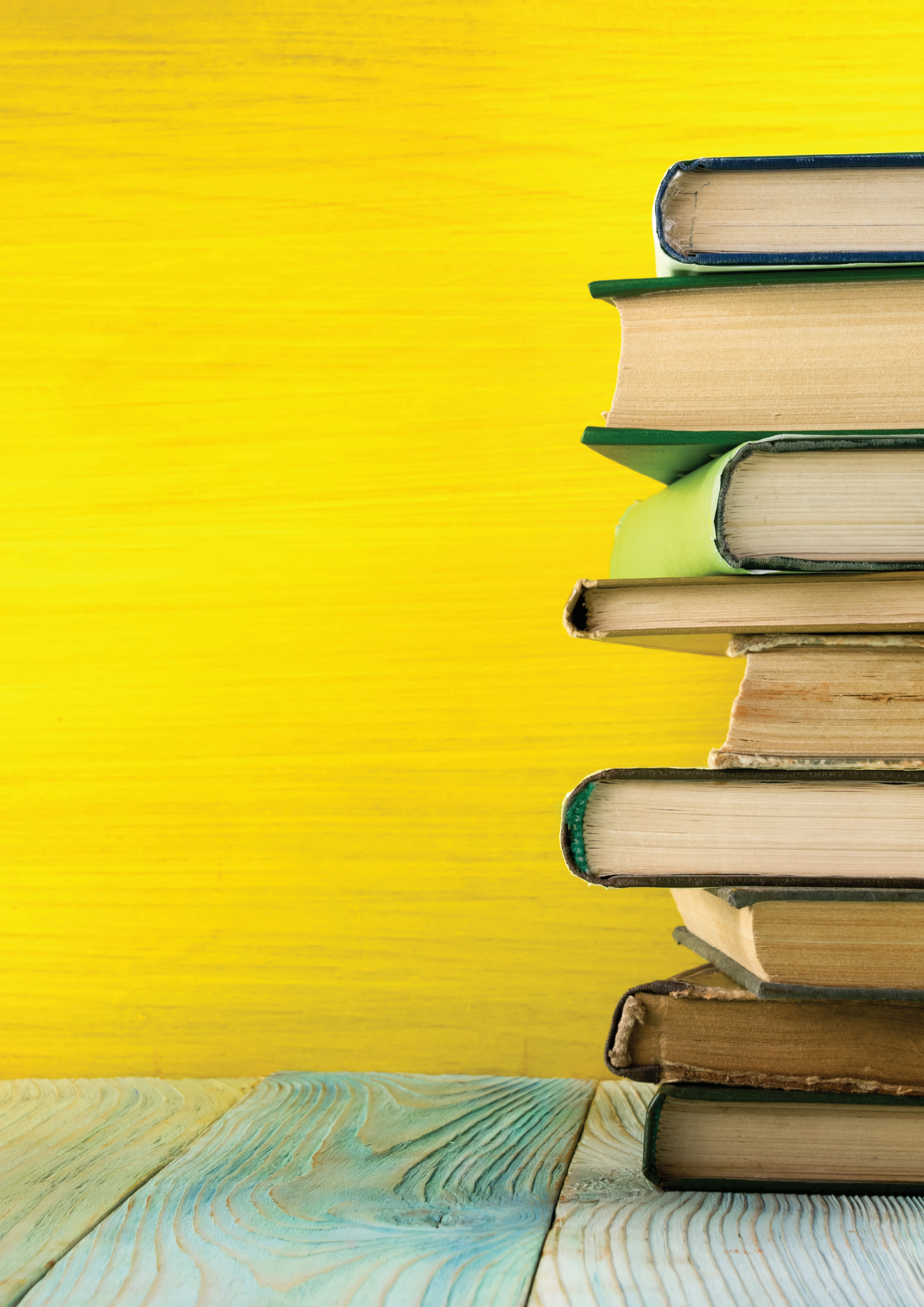

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Introduction

Emerging markets have long been seen as the key driver of economic growth in the global economy. The reason is that due to their smaller GDPs, they can achieve faster growth than developed markets. In order to achieve this growth, emerging markets need development and infrastructure finance. However, emerging markets are currently experiencing stagnation, as they become the first to suffer when volatility hits the market and risk averse investors flee to safer shores.

This paper aims to highlight the causes of the inverse relationship between investment in emerging markets and periods of volatility globally. Volatility is defined as the effect of the US Federal Reserve interest rate and the US government bond yields on global markets. Secondly, this paper will also look at emerging market investment cycles and what steps can be taken to ensure the investment in emerging markets becomes more robust and less sensitive to volatility pressure. The future of emerging markets, trends and the effect of Brexit will also be discussed.

Global Volatility

There are numerous negative economic factors at play in the market, all of which are contributing to volatile markets. This volatility in turn causes stagnation amongst the emerging market economies. The key question is – what causes this relationship and why does it happen?

In a recent research working paper called Corporate Investment in Emerging Markets: Financing vs. Real Options Channel published in December 2015, the IMF examined how firm and country heterogeneity shapes the response of corporate investing in emerging markets to changes in interest rates and volatility (Li, D., Magud, N., And Valencia, F., (2015)). The paper identified the existence of two channels of investment preference, namely (i) a financing channel originating from changes in the costs of external borrowing and (ii) a real options channel—reflecting firm's option values to delay investment in the face of volatility (Li, D., Magud, N., and Valencia, F., (2015)).

The results of the research concluded that weaker firms with weaker balance sheets, tend to reduce investment by more in response to higher interest rates or volatility, while firms with stronger balance sheets become less willing to invest after volatility spikes, and adopt a "wait-and-see" approach and ride out the volatility. In both instances firms decrease their investment and as a result the emerging markets suffer less investment. Furthermore, factors such as a country's lower public debt, higher foreign reserves, or deeper financial markets lessen the intensity of these channels and allows one country to be less affected by volatility than another. The paper tracked the Chicago Board Options Exchange (CBOE) Volatility index (VIX) from 1990 to 2013 and mapped it against the median investment ratio across the emerging market firms. The result was an undeniable inverse relationship, when investment in emerging markets was high, the VIX was low and vice-versa (Li, D., Magud, N., and Valencia, F., (2015)).

Under the first channel, the finance channel , firms with lower cash flows or more leverage reduce their investment more aggressively in response to higher interest rates or volatility because their average cost of capital will be affected to a greater extent. This increased sensitivity to volatility can be seen as an increase in the marginal propensity to invest (MPI) out of cash flows in response to higher interest rates or volatility. Under the second channel, real options or 'wait-and-see channel', firms with stronger cash flows can afford to wait out the volatility, and thus have a lower MPI when uncertainty increases, opposite to the financing channel. This paper defined volatility as changes in U.S government bond yields in the global market. (Li, D., Magud, N., and Valencia, F., (2015)).

In order to distinguish why some emerging market countries perform better than others, factors such as a country's lower public debt, higher foreign reserves, or deeper financial markets where investigated. It was found that in countries with higher public debt, lower foreign reserves and shallow financial markets are more susceptible to downgrade risks, which increases their sensitivity to higher interest rates through the financing channel. Conversely, countries with stronger economic fundamentals are less sensitive to higher interest rates because such countries offer alternative opportunities for firms to substitute domestic financing for external financing. In the face of higher interest rates, global investors also rebalance their portfolios towards firms in countries with stronger fundamentals. Another factor is that firms in countries with stronger government ability to conduct strong macroeconomic policies in the face of global financial tightening, perform better (Li, D., Magud, N., And Valencia, F., (2015)).

In light of the IMF working paper research, there is no doubt that global volatility has been the cause of the decrease in emerging

markets currencies and growth since the 2008 financial crisis. In the face of this prolonged global volatility, emerging markets require a mechanism to full the funding gap in countries that do not have good credit ratings and thus lack exposure to private investors who are risk seeking. This is where Development Finance Institutions (DFIs) come in to play, as they occupy the space between public aid and private investment. They are financial institutions which provide finance to the private sector for investments that promote development. They focus on developing countries and regions where access to private sector funding is limited. These institutions are usually owned or backed by the governments of one or more developed countries (Griffith, R., and Evans, M., (2012)). It is thus imperative that DFIs invest in emerging markets correctly and continue to do so in the face of high global volatility. Thus this highlights the importance of DFIs in the global economy, as they are the key to driving growth in emerging markets.

The last peak of the emerging markets cycle was in 2010 when China achieved a 12% GDP growth rate. This spurred on growth in other BRICS nations because China is a big consumer of commodities from other emerging markets (Rovnick, N., (2016)). Together with USD weakness and accommodative economic policy from the Federal Reserve in the U.S, China's 12% GDP growth rate enabled emerging markets to grow due to the availability of cheap debt (Anon, The Economist, (2016)). However, Bloomberg forecasts that China will achieve a 6.5% growth in 2016 (Rovnick, N., (2016)). As China had been pumping credit into the economy to boost infrastructure growth, the country now faces a slowdown due to over capacity. Many see this as a crisis, however, this was predictable as the investment in infrastructure could not have gone on forever as China is merely at the next stage of their development. Xi Jinping, the General Secretary of the Communist Party of China, is now trying to rebalance the economy from infrastructure growth to consumer spending. As a result, China is consuming less commodities and is negatively affecting the other emerging markets. This resulted in the "China slowdown/sell-off" at the end of 2015 (Rovnick, N., (2016)).

With the market stabilising in 2016, we saw glimpses of a resurgence from the emerging markets in the first quarter, driven by commodities. When mapping the MSCI Emerging Markets index growth vs. the MSCI World growth from 31 December 2015 to 8 April 2016, we see that the world decreased by 1.1%, whereas the emerging markets increased by 3.3% (Subramanian, R (2016)). However, digging deeper into this rebound, not all emerging markets experienced growth, with stocks in Greece and Egypt decreasing by 16% and 3% respectively, while Russia, South Africa and Turkey gained 16.3%, 10.6% and 19.8% respectively (Subramanian, R (2016)). This growth was spurred on by the fact that the Federal Reserve in the U.S had been adopting an accommodative economic policy with no interest rate hikes since 2006, but finally increased the rate by 25 basis points (0.25%) to 50 basis point (0.5%) in December 2015 (Cox, J., (2015)).

Thus far we have discussed a global perspective of volatility, the key role that DFI's play in emerging markets, the unique effect of China on emerging markets and the stabilisation of emerging markets in the first quarter of 2016. South Africa has emerged over the past decade as a strong player in the emerging markets, with its own unique characteristics and challenges which will be explored further.

A South African perspective

South Africa is ranked second globally behind Latin America and first in Africa on the SeedStars Index (SSI) of Global Emerging Markets Ecosystems. The SeedStars Index interacted with 54 ecosystems in 2015 and ranked each country/ecosystem according to three pillars, namely, Culture, Environment and Opportunity. This shows tremendous potential for South Africa and Sub-Saharan Africa, with a lot of growth potential still on the cards for the emerging market (Thomas, S., (2016)).

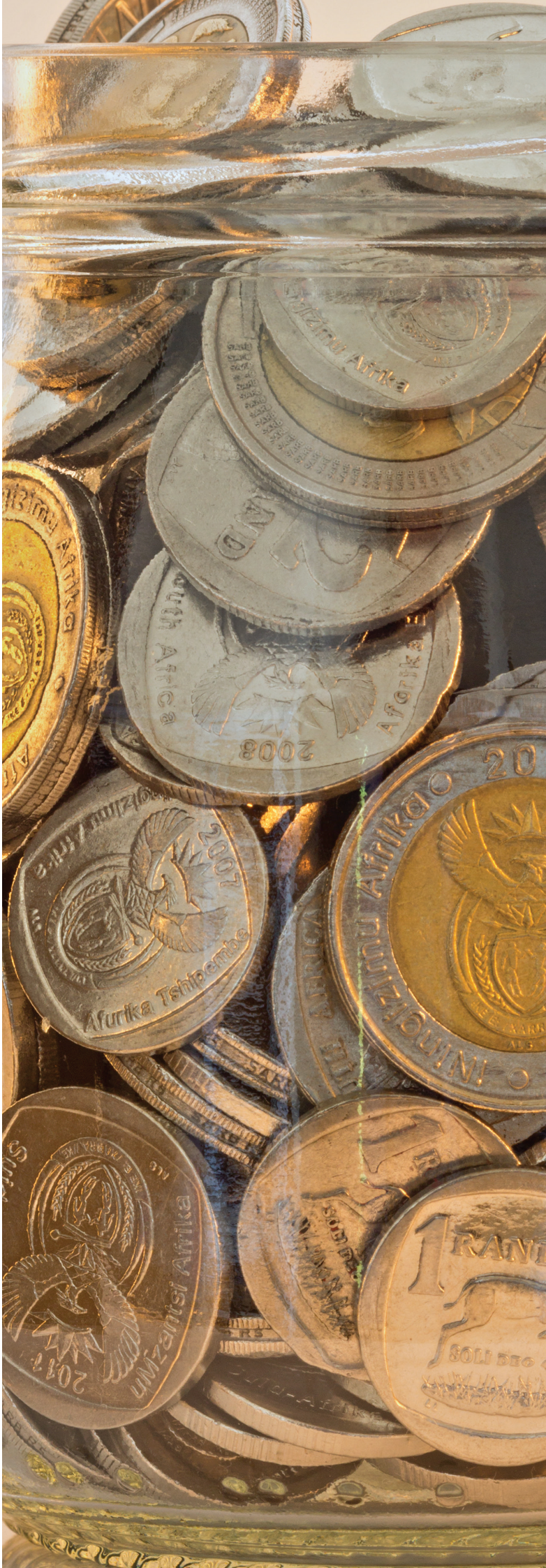
In March 2016, the BRICS nations (Brazil, Russia, India, China and South Africa) set up the New Development Bank (NDB), formally known as the BRICS Bank, which will become an additional DFI for the BRICS countries. The NDB will allow the emerging markets to increase investment in the BRICS countries and spur growth in the regions, as the bank is planning to give priority to projects aimed at developing renewable energy sources. The bank is also aiming to finance at least one project from each member state with the money it has raised from its first bonds issue. The bank will not compete with other DFI institutions such as the International Monetary Fund (IMF), the World Bank, Asian Infrastructure Investment Bank (AIIB) etc., but rather compliment and support emerging market investment together with the existing DFIs. Each founding member initially contributed $10 billion to pool funds of $50 billion, which will increase to $100 billion in the future. The bank will allow new members to join, but the founding member's membership cannot fall below 55%. The NDB has started establishing their Africa Regional Centre in Johannesburg, which will be the first branch of the bank outside of China (Anon, South African Government News Agency, (2016)).

It is evident that South Africa can be its own enemy at times, when it comes to growth and investor sentiment. Having recently just escaped downgrade by the three big rating agencies, Fitch, Moody's and Standard & Poor's, the rating agencies still gave "negative"

outlook and warned that South Africa had to take active measures to avoid downgrade at the next ratings decision in December. If South Africa does not take these active measures and if downgrade occurs, it would slow inward investment. This is because when the South African government want to raise money on the international finance markets, a higher credit rating leads to higher risk and thus a higher interest rate payable. This in turn reduces the number of willing international investors, as many are risk averse in the current volatile market, thus decreasing investment in the emerging market. South Africa has a lot of potential, but is seen as not worth the hassle by international investors (Masie, D., (2016)). Factors such as corruption in government, parliament's disruptions, the future of the ANC, a collapsing education system and the view that it is a difficult place to do business due to bureaucracy and an instable labour market, all lead to making Kenya and Nigeria more favourable investment destinations (Masie, D., (2016)).

In order to win back international investor confidence, South Africa needs to pull up its socks and show the world that it can restore faith in the government, reduce corruption and bureaucracy, strengthen the education system, stabilise the labour market and adhere to a strong economic policy. If these key areas are addressed by South Africa it would lead to a strengthening of the economic fundamentals of the country and decrease its sensitivity to volatility, as evidence by the IMF working paper above.

Circling back to a global perspective, there are a number of factors and variables that affect emerging markets in a variety of ways, which will be discussed below, namely the oil price, commodities, public and private partnerships in emerging markets, established markets, underdeveloped private finances sectors in emerging markets, landlocked emerging markets and the importance of Multilateral Institutions.



The oil effect on emerging markets

The price of oil has declined significantly since July 2008, where it traded at a high of $151.72 per barrel (Anon, Macrotrends.net, (2016)). This decline bottomed out at $28.50 per barrel in January 2016 (Anon, Macrotrends.net, (2016)). Oil has a major effect on emerging markets and investment, but it affects various emerging markets differently. Within the emerging markets there are net exporters (Russia, Nigeria, Saudi Arabia, Venezuela etc.) and net importers of oil (South Africa, China, Brazil, Egypt, Turkey etc.). In light of that, when oil prices decline, the revenue from oil for the net exporters decline, whereas the net importers face cheaper oil imports and thus face positive effects on their currencies and in their markets. The positive effects include reduced input costs, lower fuel subsidies and increased consumer spending. However falling oil prices still tend to bring down emerging market asset prices because of their commodities exports. This is because oil is a significant cost in the production of commodities, so when oil prices are low, commodities suffer lower prices too. A further side effect of lower oil prices is that the net exporting countries suffer currency depreciation, which in turn makes their other non-oil exports cheaper, meaning that they can then compete on a price basis with other emerging markets who sell the same non-oil exports, creating an oversupply and thus driving the prices down further (De Quinsonas, C., (2016)). With the recent moderate increase in oil prices in 2016 we saw the corresponding resurgence in the emerging markets as mentioned previously.

Emerging markets and Commodities

There are many international investors who believe in staying away from countries and companies that rely on commodities for their wealth, even when they are oversold, such as Mr Gave of Gavekal, one of the world's leading independent providers of global investment research. They believe that the world is currently experiencing a commodities cycle downturn, which could last for up to 30 years (Rovnick, N., (2016)). Taking this into account and the fact that most emerging markets are commodities exporters, there is a need for emerging markets to start to diversify export portfolios, and move away from commodities and resources to a retail as well as service based economy. Retail and service based economies export ideas and require skilled human capital. This can be evidenced by the Asian economies after the 1997 financial crisis, where Asian economies had to cut rent-seeking to attract talent and capital and improve institutions to become more efficient and robust. Some emerging economies have lost their way and countries like Brazil, Russia, and South Africa needs to follow this path if they want to enter the next phase of economic development (Borin, M., (2016)).

Roles of public and private partnerships

Emerging markets represent an exciting frontier for private finance in infrastructure. However, a combination of lack of funds, inadequate planning, and unstable political and ecological environments have often limited the flow of projects that could attract private money in emerging markets. Public-private partnerships (PPPs) are in their infancy in the majority of emerging markets and they are usually dominated by domestic providers with a strong understanding of and links with local authorities, businesses and regulators. Most foreign direct investment and development finance goes into extracting natural resources such as coal, ore, oil and gas (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)). Thus we need to promote the establishment of PPPs in order to increase development investment in emerging markets.

Emerging markets vs. established markets

In order to understand the workings of an emerging market, we need to understand what makes them different from the established markets. The different systems of infrastructure deployed around the world are all similar in terms of the services they offer a society; namely, water, power, healthcare, transport, and so on. What varies from country to country are the quality of services, private or public ownership, technology and the cost of developing, delivering and maintaining the underpinning infrastructure. Emerging markets are frontier markets for private investment in infrastructure, and those with perhaps the greatest untapped potential. Many emerging markets have sizeable, young and growing populations and rapid urbanization. Energy and infrastructure are the building blocks for the strong middle class necessary to drive economic growth, yet, with a modest tax base, governments will have to prioritize projects carefully. This requires a credible national infrastructure plan and funding sources to back it, which most of these emerging markets desperately lack. The majority of the private finance in these emerging markets come from domestic providers as they have clear advantages in understanding local issues and regulation. Some emerging markets may simply not have the economic scale to attract international investment while others may face political hurdles that limit access to foreign private capital. These countries have less experience with PPPs, and typically lack the political structures and institutional frameworks needed to attract international private finance in infrastructure. One thing potentially separating the more advanced of these countries from those in the smaller established markets is execution and having a track record for delivering projects with private investment (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)). Thus it is vital that emerging markets take steps and ensure that political structures and institutional frameworks are employed to attract investment and investor confidence.

Underdeveloped private finance sectors

Most of the smaller and newer emerging markets do not have well thought-out, long-term infrastructure strategies for supporting private finance, or established frameworks for procurement and contracting. Without a co-ordinated policy that is clearly defined, new laws and rulings are constantly emerging from these markets, which are unsettling to private sector developers and investors and can even threaten the viability of business plans. Large PPP transactions in emerging markets are extremely complex and difficult to deliver. The first step in creating a healthy environment for partnership is identifying the correct roles for the public and the private sector. This may vary from country to country, depending on the regulatory environment as well as local resources. One of the main barriers to progress is the dearth of public sector talent in engineering, IT, purchasing, project management and planning. Projects can easily get stuck in the development pipeline if governments lack the skills and expertise to prepare them for the private sector market. One notable challenge is that skilled workers in these areas have chosen higher-paying jobs in the private sector. The brain-drain has affected these markets as skilled workers have also taken their skills abroad to access a wider pool of global opportunities. As a result, many of the projects that have been successful or progressive are those where the development has been led and supported by the private sector. However, the government's role remains critical. The key to a project's overall success is defining the public and private sector roles and ensuring that both sides have access to the correct expertise (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)). If these critical factors can be set in place and run effectively and efficiently, corporate and DFIs will have greater confidence, which means that they will invest more money into emerging markets.

Another issue facing emerging markets is the limited track record on infrastructure projects. Without this proven track record, investors are right to show caution. When it comes to long term projects of 20 years or more, the risk is extremely high for investors due to undeveloped regulations, incomplete capital markets, limited budgets and a lack of political continuity. This is why fast-growth sectors such as telecommunications are often a more reliable option, as initial capital expenditure is lower and the payback period is shorter. On the other hand, mining and energy investments are highly dependent on good offtake agreements for future purchases of the extracted materials, this is to assure a strong revenue stream (Findt, K., (2014)).

It is a similar story for freight rail developments, where a pit-to-port line with proper long-term arrangements should give greater certainty of a return. Passenger or multi-purpose rail construction carries a much greater risk, as most fares are highly discounted, which can leave a funding gap that must be addressed by government. Highway infrastructure, on the other hand, tends to have a faster payback than rail, however, the limited potential for tolling means governments will have to look at alternatives such as petrol levies or vehicle tax to repay the debt. In high growth markets, circumstances can change quickly, so investors should try, where possible, to create flexible contracts. Ultimately, any capital is subject to the winds of political change, and factors such as resource nationalism must be considered ahead of any investment decision. If the great potential of many of these developing markets is to be realised, the answer will be found in political stability, multilateral support and identifiable and durable revenue streams. This is not an easy task, but is vital for emerging markets to succeed and enter the next phase (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014).

The importance of Multilateral Institutions

Not all the emerging countries lack private finance in infrastructure. Iran and Venezuela had the world's 21st and 30th largest GDPs respectively in 2014. The richer countries in this list either have no need for private and foreign direct investment in infrastructure, or they actively restrict it. However, most countries in this category have a relatively small public pot from which to fund infrastructure projects, and they rely heavily on support from multilateral finance groups during both the development and implementation phases. Development banks, export-import banks and other International Financial Institutions (IFIs) such as the Multilateral Investment Guarantee Agency in the World Bank Group have significant influence with governments and foreign investors. They provide transparency and international support to mitigate political risks and resolve fairly any issues that may come up. But multilateral organisations do not just provide finance or manage issues like currency risks; they also bring much-needed knowledge and discipline to increase budgetary and project efficiency, minimise corruption and manage environmental and social impacts. They can also help address the aforementioned skills gap, by establishing centres of excellence or technical training institutes. More recently, some have set up specific project preparation facilities which are designed to help fund development costs on a semi-commercial basis, with the reimbursement of project preparation costs borne by the winning concessionaire upon successful financial close. IFIs and Multilaterals are essential for collaboration across international borders. The establishment of trade corridors by multilaterals support regional stability and having suitable infrastructure in place makes it cheaper for countries to export goods and resources to international markets (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)).

For example, the US$11 billion North-South Africa Corridor is an ambitious attempt to connect eight African countries with more than 10,000 kilometres of roads. Stretching from South Africa to Zambia and the Democratic Republic of Congo, as well as from Botswana to Malawi, the route will boost cross-border trade and tourism. Bidding for tenders started in mid-2014, with the overall project run by a 'tripartite' of the Common Market for Eastern and Southern Africa, the East African Community and the Southern African Development Community. Funding is likely to come from a wide variety of development partners including national governments and the World Bank. An equally bold but as yet unrealised dream is the New Silk Road from China to Western Europe via Kazakhstan and Russia. Over 8,400 kilometres long and costing an estimated US$7 billion, this new economic corridor aims to open up new trade opportunities to encourage regional stability, the concept is particularly important to China and Russia. Multilateral institutions already have a stake in different sections of this project, with some considering the added value of integrating other types of infrastructure (such as solar energy) into a broader Silk Road Economic Belt (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)).

Landlocked emerging markets

In order to increase exports from African landlocked emerging markets, infrastructure needs to be built to the coast, as landlocked countries pay up to 84% (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)) more to export their goods than coastal countries. If trade barriers could be lessened in these countries and trade routes established to the coast, future economic growth and development finance investment would increase in these markets. Some projects are underway, like the Mombasa-Kigali Railway which will link the port of Mombasa in Kenya with Tanzania and landlocked Rwanda and South Sudan, helping to transport coffee, tea, other agricultural products, minerals, and machinery. The line will be built in sections by different Chinese engineering and construction companies, with loans provided by, among others, China's Exim Bank, and paid for by public funds from the countries involved (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)).

For every success story about a country that has rebounded from conflict to attract new investment, there is a Syria or Ukraine, who were once stable economies that have descended into social and economic chaos. Infrastructure investors are in it for the long-term, and seek political stability and assurances against resource nationalism and corruption (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)).

Frequent changes of government policy can be unsettling, however, a strong base of institutional civil servants can give more consistency through different administrations. Those countries making progress are leveraging international expertise to deliver better and more comprehensive services (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)).

Governments, on the other hand, have to up their game in terms of procurement and transparency, to bring the kind of discipline and professionalism that international investors expect and appreciate. Political risk is never too far away, and regimes that can ring-fence infrastructure from changes of government have a better chance of sustained growth (Diko, A., Maier, T., Tun, K., and Uddin, S. (2014)).

Brexit

On 23 June 2016, Britain voted in a historical referendum to leave the European Union. What followed was a short period of unrest and high volatility where global investors where left scrambling to move their investments to perceived safe havens. In this chaos, emerging markets initially took the brunt of the hit and the MSCI Emerging Markets Index went sliding. However, this decline was short-lived and was quickly followed by a resurgence of emerging markets. This was evidenced by the MSCI Emerging Markets Index finishing off the second quarter at 6.6% growth return, evidently far superior to the MSCI World Index, which only finished off the second quarter with 1% growth return. In essence, Brexit exposed the fact that political risk does not only lie in emerging markets, but also in established markets too. As such, Brexit could end up making emerging markets a more favourable long term destination as uncertainty surrounds Britain and the post Brexit effect on the established economy (Mobius, M., (2016)). Only time will tell exactly what effects Brexit will have on the global economy and emerging markets, but as the dust settles there will certainly be winners and losers.

In conclusion, it is very testing times for emerging markets, with a multitude of variables that can affect the progression of their economies. However, in order to best adapt and respond to these global variables, emerging markets need to equip themselves with the correct governance structures and focus on core monetary economic policy, such as strong economic fundamentals, which will enable these emerging markets to withstand the global pressures. Diversification of export goods should be implemented and these economies should start focusing on developing human capital in order to increase their retail market potential. Development finance and the use of IFI's as well as multinationals, are of the outmost importance when it comes to strengthening regions and breaking down barriers of trade.

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