WARWICK
EMERGING
MARKETS
SOCIETY

The Emerging Times

Issue 1, 2014

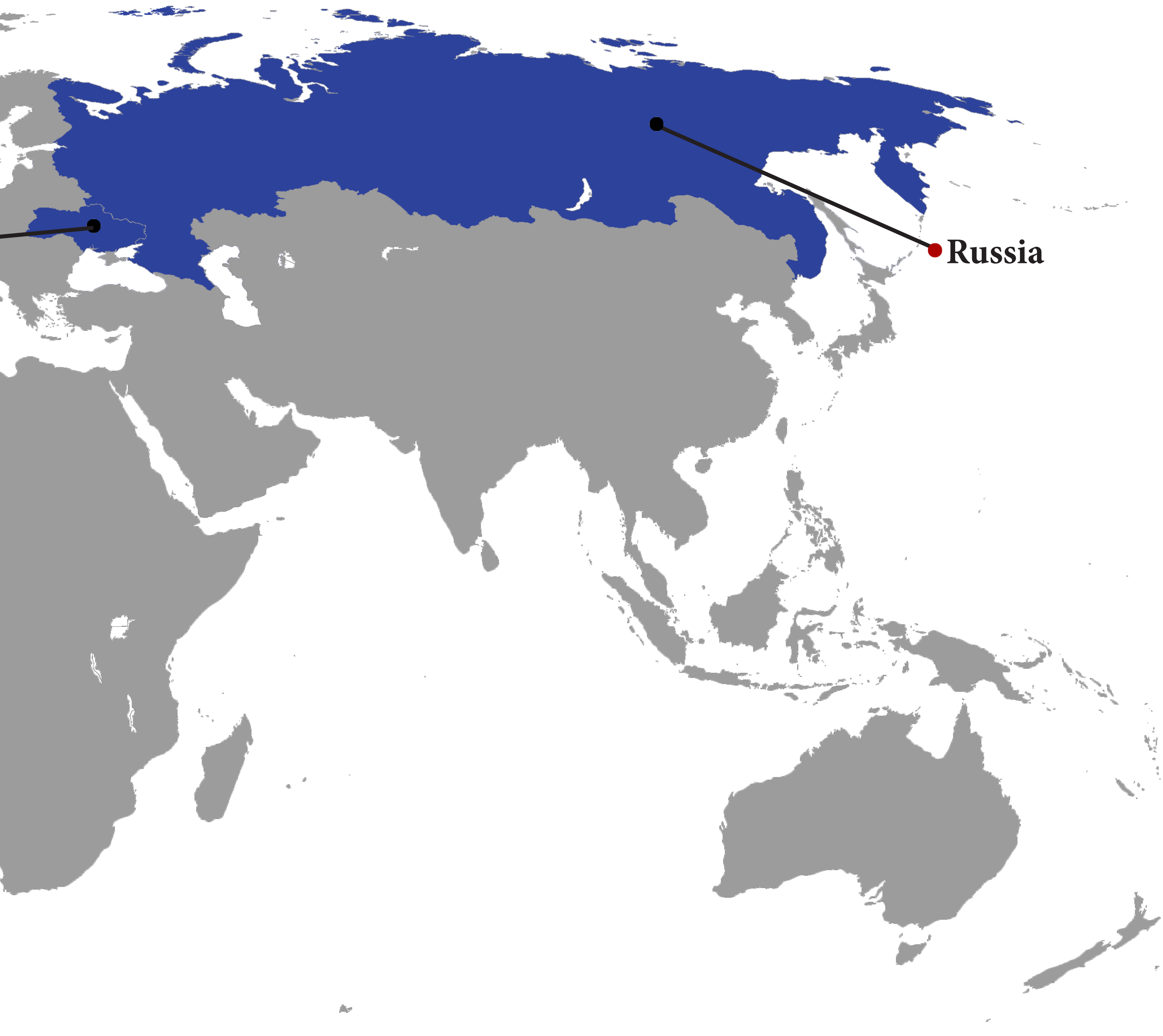
Tracking our path around the world...

In this issue:

Introduction

Overview of EMs

The Emerging Times aims to take you on a journey around the world with us. Have a look at our map below to find out which emerging markets are featured in this issue. Be sure to pick up future issues to continue the journey with us and explore other countries.



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Emerging Markets (Latin America)

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Emerging Markets (Ukraine-Russia)

Welcome to The Emerging Times!

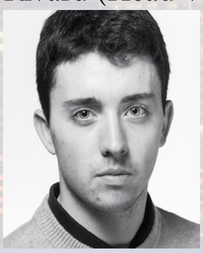
It is with greatest pleasure that we welcome you to Warwick Emerging Markets Society's inaugural magazine: *The Emerging Times*. This magazine is the product of an ambitious executive committee with a fine knowledge of current affairs and a strong passion to share their interest in the wonders of emerging markets with others and hopefully encourage others to do the same. With this magazine, we hope to equip you with information about the society and the world around you, trigger thought and most importantly, encourage you to share your new set of information and opinion with others - be it among friends in a casual conversation over dinner, at the Warwick Emerging Markets Forum and panel discussions with experts in the field later this year or even at job interviews.

Like the big bang all those years ago, our first edition is jam-packed with life, intrigue and potential. We cover a host of exciting topics in this edition. To name a few: we travel to the heart of Latin America and include in-depth articles on Venezuela and Brazil, covering a host of issues ranging from subsidies, $27 trillion worth of oil reserves and World Cup glory (or catastrophe?); we provide a comprehensive overview of the Ukraine-Russia conflict and it's likely ramifications for regional stakeholders and much, much more. Apart from that, we have also included a whole section analysing emerging markets as a whole, it's progress so far and what we can expect in the future. Of course, a magazine is not complete without including some information about the society and the WEMS executive team, including a Q&A with the Co-Presidents.

Undoubtedly, a huge amount of gratitude is due to all the people who have made this first issue possible. The society's Co-Presidents, Abs and Jonny, for their endless support and encouragement, the society's creative director, Andor Jakob, who has done a tremendous amount of work, all the writers who took time off their summer holidays to submit articles, as well as the rest of the WEMS exec for all their help putting this together.

The articles don't stop here though! For more amazing articles and 'uniquely-Warwick' material, checkout our website at www.warwickemf.com and have a read of our new blog! **And, if you like what you're reading and wish to find out how you can contribute to future issues of the magazine as well as the blog, please email Anisha at a.primalani@warwickemf.com.** Don't forget to look out for our next issue where we will continue exploring emerging markets and include more information about our upcoming events!

Happy reading,
Anisha Primalani (Editor-in-Chief) and Nicolas Rivard (Head Writer)



Introducing the Society

Warwick Emerging Markets Society (WEMS) aims to provide a diverse platform encouraging the exchange of knowledge and ideas on the developing countries between professionals and students.

We look to bring new, interesting and alternative insights into the emerging economies of the world. Issues from the BRICs to the MINTs are going to dictate our lives tomorrow and so our goal is to educate, inform and interest our students about this changing global landscape.

To give our members a comprehensive view on the study and understanding of emerging nations, we make sure to tailor our events and articles to cover a diverse range of issues, including those relating to the political, economical, financial, legal, social, technological and entrepreneurial environment. We do this through our annual flagship Warwick Emerging Markets Forum (WEMF) - which brings together a range of leading professionals, academics and governmental representatives and will be held on the 7-8th of November this year - as well as through smaller events, such as our distinguished speaker series and Term 2 panel debate. Furthermore, in-order to ensure our members are fully equipped to compete on a global scale, we arrange additional talks, CV skills sessions & networking opportunities with our sponsors and workshops, as well as posting articles on our online blog and termly magazine.

Announcements

Events this term:
17 October: WEMS Launch Party
Our launch party promises to be a great one for you to meet everyone in the society as well simply have a good time with us - be sure you don't miss it!

7-8 November: Warwick Emerging Markets Forum
Start saving the date in your diary! This year's forum is set to be bigger and better so don't forget to get your tickets when they are released!

Term 1, Week 8: Start of Distinguished Lecture Series
An interesting event for you to gather opinions from experts in their fields. Look out for more details soon!

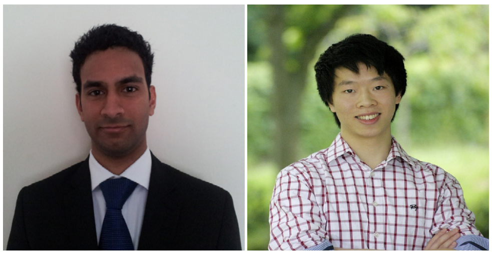
Freshers' Reps Recruitment:
Whether you want to make new friends, or just try something new, with lots of events coming up, this promises to be a great experience! You would work with the Events and Internal Marketing Teams throughout the year. An interest in the emerging markets and a sense of responsibility are all we need. Freshers from ALL disciplines are encouraged to apply.
If you're interested in being part of a dynamic team and contributing actively to our society, upload your CV and answer the questions below on our website now. (www.warwickemf.com)

1) Why do you want to be a part of WEMS?
2) What would make you a good freshers' rep?

Deadline of Application: 14 October (Tuesday) 23:59
Interview Date: 16 October (Thursday)

Meet The Co-Presidents. . .

Our team had a chat with the masterminds behind the society this year, Abhilash Dubbaka and Jonathan Chu, to find out more about them as well as their plans for the society.



Introduce yourself to our readers

AD: Hi! I'm Abs, currently in my final year on MMORSE. An interesting fact about me is that I bungee jumped over a lake in Interlaken, Switzerland during my gap year. Next year I will be joining the Investment Banking Division graduate programme with Barclays.

JC: Hi guys! I am Jonny, a final year Economist. My hobbies are rather boring - long distance walking and singing: I climbed Kilimanjaro last summer, and I am also Vice President of the University Chamber Choir. I will be joining the investment bank Lazard next year as a full time M&A analyst.

What made you want to become a Co-President for this year's WEMS?

JC: WEMS is about the only genuinely multi-disciplinary society at Warwick that operates on a substantial scale. As an Economics student and someone who enjoys catching up with what the world is up to, this society offers me exactly that kind of platform for me to do so. But the main reason is that I believe WEMS is beneficial for any Warwick student, evident from the wide range of degrees our exec members are doing. As Co-President with Abs, we hope to ensure more and more students can benefit from our events year after year.

AD: Having been on the team last year, I felt that I could help the Society grow further by taking on this role. I have several ideas on how to make WEMS one of the best societies, and WEMF one of the best events on campus. Together with Jonny's ideas, this is a real possibility.

Having already started in this role since February, what has been the biggest chal- -enge so far?

AD: Biggest challenge... Ensuring communication is flowing in the team and everyone is sticking to deadlines. This year, though, we have a very sociable and efficient team that wants the society to succeed and so everything is running rather smoothly anyway.

What differentiates Warwick's emerging markets society as compared to emerging markets societies in other universities?

AD: The Forum was established only four years ago and the society aspect is still growing so we are a very young society but this means we have so much potential. The members in the society range across different disciplines and due to the reputation of the university, we attract highly influential speakers to present in our events. Both of these traits mean that as a society, we put on high quality events with a diverse range of members attending and making them a success.

JC: Just want to emphasise on two points: First, we keep costs to a minimum, so that as many students at Warwick can take part in our events as possible. This is not something you will see at other universities, especially the London ones. Second, we maintain a strong multi-disciplinary principle whereby we resist the temptation to focus solely on finance related topics, as many do. What we want to achieve is a balanced perspective on the emerging world as a whole.

Which EM interests you the most and for what reasons? Have you travelled to or are planning to travel to any EM countries in the near future?

JC: Born and bred in Hong Kong for 15 years, SE Asia is more familiar to me. Last summer, I have also been to Africa, and Eastern Europe to visit my girlfriend in Bulgaria. With that, I would say South America is my next destination.

AD: I lived in India when I was young and have been there several times. Other than that I have not really travelled to any other EM, but the tour that we are organising at the moment to take place next year will change that. We all heard about BRIC, so for me I want to know more about new EM, such as South Africa and SE Asia. In particular, I am very interested in the impact of the introduction of the ASEAN Economic Community next year on the global economy.

Why did you decide to create a magazine and organise a trip this year, and what are your long-term objectives with these initiatives?

JC: WEMS is still a young society, with a lot of room to expand our remits. Magazine and tour are just the natural next steps for us, although for the tour abroad, who doesn't like a holiday!? In the long term, these two initiatives are just two of the many steps we envisage the society to take in the years ahead. We are already one of the bigger societies on campus, and let's hope we are right at the top with other most established societies in the future.

Anything else you would like to tell our readers?

JC & AD: Welcome to Warwick if you are a fresher, you will have a great time here! If anyone wants to talk to us personally about anything, not just about WEMS, drop us a line or come and talk to us at the launch party!

. . . and the rest of the Executive Committee

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MINT: Unfolded

Yes, we have all heard the term BRICS several times in the last decade. For those of you who have preferred to refrain from the economic world during your teenage years or after GCSE results, here is a quick fact. BRICS – Brazil, Russia, India, China and South Africa is what it stands for. British economist Jim O'Neill, a former Goldman Sachs executive first coined the acronym BRIC in 2001 with South Africa later gaining entry in 2010.

However, lately it seems like there is more to the emerging markets than just the BRICS. After creating BRICs, Jim O'Neill popularised MINT- Mexico, Indonesia, Nigeria and Turkey, a term originally coined by Fidelity Investments. O'Neill spent time in these countries while working for a BBC radio series about four emerging economies that could be in the top 10 global economies by 2050. So what is special about these countries? It is their growing population, geographical location and economic prospects that unite these countries, factors that many developed countries and also two of the BRICS desire.

Burritos and Sombreros instantly remind us of Mexico, but the vast economic opportunity there is what Mexico is now becoming famous for. One of the biggest advantages for Mexico is that it lies at the doorstep of the United States, with the States being Mexico's main import and export partner. The young and vibrant population under the leadership of the young president- Enrique Peña Nieto and his reforming government is massively changing the "image" of Mexico. The country is rapidly overcoming its widespread poverty and crime and implementing educational, fiscal and energy reforms.

Andrew Karolyi , director of the Emerging Markets Institute at Cornell University said, "Mexico is affirming the confidence of the foreign investor", by relaxing its oil and gas markets. The relaxation of its major markets and increase in the quality of growth are factors that are advancing Mexico into the world market with Mexico becoming a strong contender of China. As we look at the supply and demand side in economics, Mexico is improving on both sides.

Going to the other side of the world is Zamrud Khatulistiwa (Emerald of the Equator) - Indonesia. A relaxing summer in Bali and experiencing the cultural diversity in Jakarta is what attracts us all to Indonesia. It is your holiday in Indonesia that has now become one of the major sources of income for the country. According to the World Travel and Tourism Council's (WTTC) 2014 Economic Impact Research Report, Indonesia had the highest growth in travel and tourism sector in all of G20 economies last year. Its diverse and abundant natural resources are a major asset.

Demographics, like in the other MINT countries, are a key reason for the economic growth of Indonesia. Although, hard to believe that a country not very large geographically, is the fourth most populous country in the world after China, India and the United States. A large proportion of the population being under 30 and a relatively stable government show that there is a substantial potential for increased productivity in Indonesia.

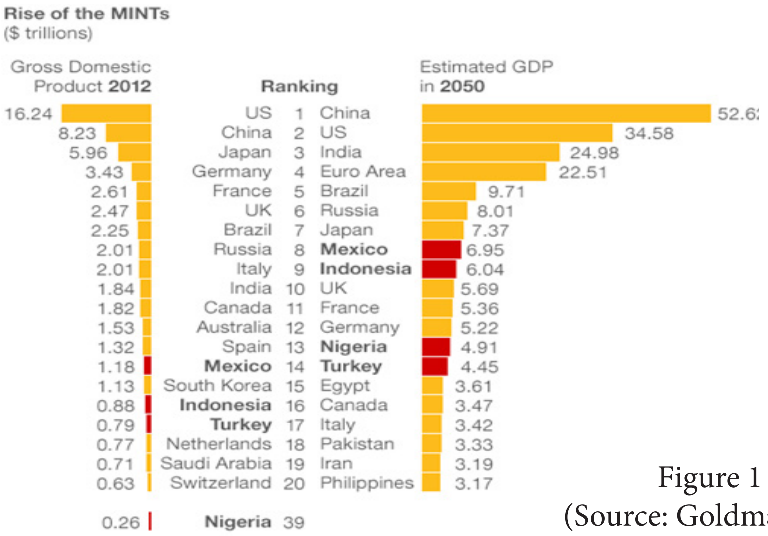


Figure 1
(Source: Goldman Sachs, World Bank, 2014)

You might feel a little unconcerned after reading the above facts in Figure 1 about these countries. However, a country that despite its structural problems -poor education system, power shortages, corruption and violence by groups like Boko Haram has managed to improve its economy is definitely worth your attention. You're right; it is Nigeria that has optimistically been trying to achieve steady economic growth.

Africa's most populous nation is now the largest economy of the continent. Unlike the other MINT countries Africa does not have a geographical location advantage. Nevertheless, along with Mexico, Nigeria is seen as a primary source of energy because of the large oil reserves in both these countries. Nigeria and Mexico have both launched energy policy reforms which if put in action can speed up their growth rates. The country has been growing at a rate of 7% with almost no power, said Africa's richest man in an interview with O'Neill. Nigeria could accelerate the rate to about 10% and double the size of its economy aif it corrected its energy problems.

about 10% and double the size of its economy if it corrected its energy problems.

Turkey has made the most of its location trading in both east and west over the years, selling to merchants through the famous Silk Road. The geographical location of the country remains significant till today as Turkey has become an important aviation hub linking it to oil and gas markets and tourists around the world. After all, the Antalya beaches and Turkish Delight (personally not a big fan) do attract many of us. Manufacturing and construction form a principal part of the Turkish economy with steel, timber etc. emerging immensely due to technological improvements. Turkish Airlines is a result of this as it is the world's fastest growing airline.

Many economists have done their apparent job of predicting the future of MINTs. BRICs have been known to investors ever since O'Neill coined the acronym however they have not emerged up to the expectations of investors who have hence preferred to invest in countries looking at the their individual performance. This is why some fear that since the BRICs haven't "emerged" to their targets, MINTs will lag behind for many years.

We can argue about the future of these countries and our inner economists can keep predicting but looking at the potential of MINTs based on the facts above, it is really what you interpret of all this data. I believe that these countries have remained in obscurity because of their political institutions and their identity created by our ignorance. These markets have potential, which hopefully we will all soon learn to realise and appreciate.

By: Manavi Garg
Manavi is a 2nd year Economics Student.

The Slow Down of Giants: The Recoupling and Decoupling Debate

So what does 'decoupling' and 'recoupling' mean? In short, decoupling refers to a decrease in correlation between economic indicators in different markets, where as recoupling means the converse, an increase in correlation. More specifically, when we talk about decoupling and recoupling in terms of Emerging Markets (EM's) and Developed Markets (DM's) we look at the relationship and trends between GDP growth rates in EM's, relative to the growth rates seen by DM's. We would say an EM is experiencing decoupling when growth rates in EM's do not fully follow those seen in DM's. This can be typified by the strong GDP performance of EM while DM's are exhibiting sluggish growth.

The Birth of Decoupling

The notion of decoupling between EM's and DM's came up in the early 2000s against the backdrop of strong economic performance of countries like China and India, relative to the United States and Europe. It was thought that EM's had deepened and broadened to the point where they were no longer dependent on DM's for growth. However, in an era of globalisation it was difficult for these episodes of decoupling to be sustained in the long term given the economic integration between EM's and DM's. The economic resilience of EM's in the early stages of the 2008 global financial crisis rekindled the interest in the link and dependence between EM's and DM's, reinforcing the concept of truly independent, decoupled EM's. Nevertheless, the notion of decoupling was soon replaced by recoupling once the EM's began to sink along with the DM's in late 2008 and 2009. This was no surprise since most EM's rely on exports to lead economic growth.

Despite many DM's plunging into recession, EM's were quick to recover and many never saw negative growth. For example, highly populated EM's like China, India and Indonesia never tipped into recession; they merely suffered slower growth. The Asian Tigers and Brazil experienced a fall in output, but quickly bounced back. (Figure 1 below)

Figure 1

We can look to China as an example of why EM's reacted well to the crisis. Even though-China's exports to America took a hit, those to other EM's surged (Figure 2). Now, more than half of China's exports go to other EM's.

This means that despite EM's like China being integrated in the world economy, negative demand shocks from DM's impact exports to a lesser extent.

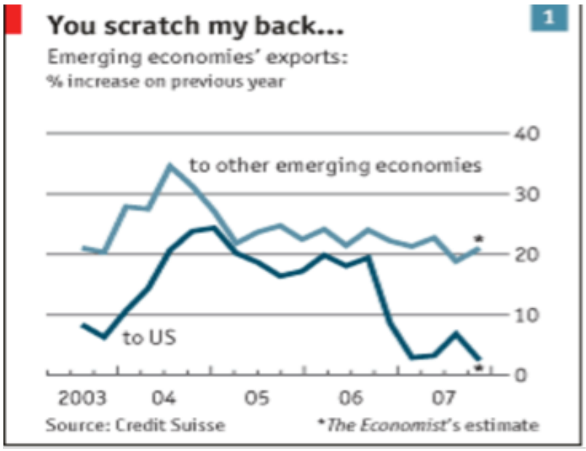
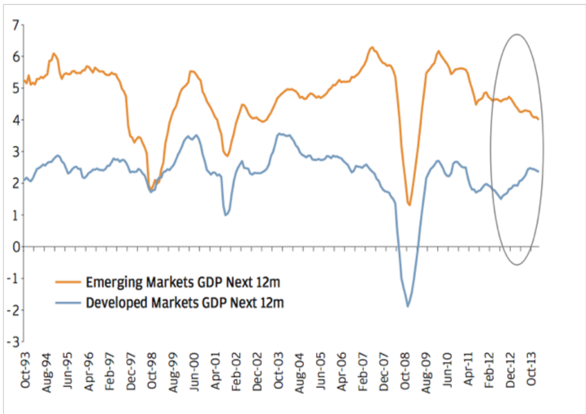


Figure 2

The Future of EM's and 'selective recoupling'

In the last couple of years we have seen a widening of the gap of economic performance between EM's and DM's as some EM's have been struggling relative to DM's. This has created an evermore difficult setting for EM's to flourish with increasingly more limited scope for exporting.



Source: J.P. Morgan Asset Management, Consensus Economics; data as of 30 June 2014.

Figure 3

Figure 3 shows us the GDP growth of EM's vs DM's for the past 12 months. We can see that in recent years EM growth as a whole has decelerated, where as DM's growth rates have strengthened. This sign of decoupling between EM's and DM's is the reason for the recent slowdown of EM profits and decline in relative market performance.

International trade is an important aspect to consider when analysing a possible recoupling of EM's with DM's. In the last few decades trade linkages have strengthened, with trade accounting for 32%-33% of global GDP in 2010. However, in the last year the trade multiplier (proportion of income spent on imports) has fallen sharply to unusually low levels for the modern era. This has created an evermore difficult setting for EM's to flourish with increasingly more limited scope for exporting.

Despite overall EM trade growth being relatively disappointing there is good news for certain exporters. A shift in the industrial cycles of DM's has created an opportunity for 'selective recoupling'.

Figure 4 makes the comparison between EM's whose exports are predominantly manufacturing-intensive, compared to commodity intensive EM exporters.

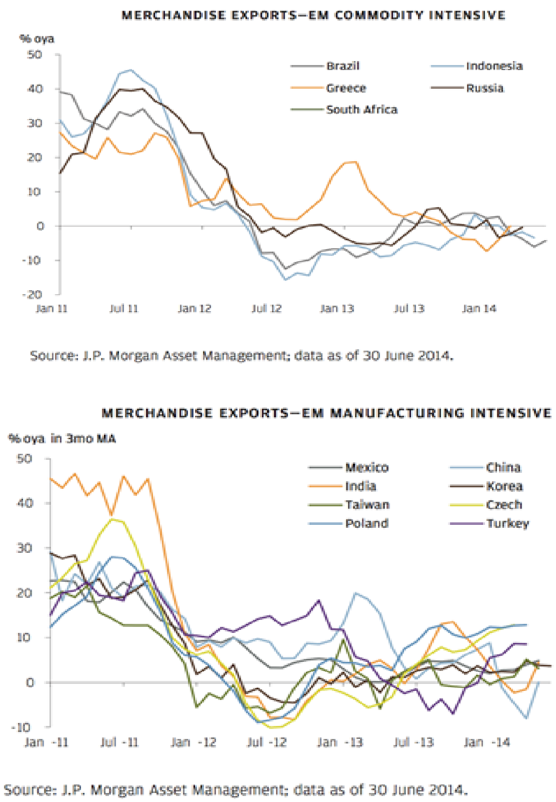


Figure 4

We can see that manufacturing-intensive EM exporters, such as Mexico and Poland are benefiting from the increase in demand and have started to show signs of life. On the other hand, we have struggling commodity driven EM's such as Brazil and South Africa, which are achieving minimal, if no export growth. However, this can partly be accounted for by a fall in commodity prices.

Moreover, for the time being the EM recoupling story is selective, with manufacturing-intensive exporters set to be the first to experience recoupling with DM's. This is set to happen as the increased incomes and employment in DM's translate into higher domestic demand growth and therefore greater export growth.

In conclusion, even though average EM growth rates seem to have partially decoupled from DM's we can seem optimistic about the future. We have learnt from the past that these decoupling episodes cannot be sustained in a setting of global capital flows and intensified global trade. EM exports, mainly manufactured exports look to lead the way to a recoupling with DM growth, with other EM exports set to follow as increased DM income feeds through into increased demand for EM exports.

By: Shakir Hassan
Shakir is a 3rd year Economics Student.

Why Emerging Markets should not travel in packs: The fallacy of uniformity

'BRICS', 'CIVETS', 'PIGS'… Economists in recent years have developed a striking affection for clustering 'similar' economies together for ease of reference. And although these kinds of acronyms are effective in hastening casual conversation, they promote a dangerous tendency to mentally homogenise the very *individual* members of these groups.

An obvious example is in the differences between Goldman Sachs' protégés: The BRIC economies. Having contributed colossally to global GDP levels at the turn of the millennium and with access to favourable demographics, Jim O'Neill claimed in his initial 2001 report that Brazil, Russia, India and China would become the four most dominant economies by 2050. Since, some have attached South Africa to the ranks to make these economic building-blocks magically multiply into 'BRICS'.

Yet despite O'Neill's lexicon snowballing in colloquial popularity over the last decade (I flashback to an Economics teacher actively shame-facing class members who couldn't name the quintet) the political and economic similarities between BRICS members have been melting away. It seems somewhat obsolete to create a collective identity between: Two immense, industrial powerhouses (strikingly, the NIFTY index has shown a consistent bullish trend for over a year now); One stalling, South American workshop in which stagflation threatens as business confidence fell to a five-year low in July alongside inflation at 7%; One gapingly unequal society teetering close to recession and one geopolitically suicidal, kleptocratic oil machine whose stock market is down over 15% on December last year (points to those who decipher the subtle caricatures).

Yet the BRICS phenomenon has penetrated past being just jargon to provoke new politics: July's annual BRICS summit in Fortaleza, Brazil, announced the establishment of their "New Development Bank" (NDB) and "Contingent Reserve Arrangement" (CRA) which are essentially their attempted alternatives to the World Bank and IMF. But these institutions are far from capable of their obvious objectives. The current capital deposits in the NDB are around $50 billion with a potential to double once including non-BRICS contributions. This, to tackle the likes of an estimated $2.5 trillion needed for investments in South Asia alone over the next ten years is clearly futile. Furthermore, the countries' leaders can scarcely agree on basic founding rules such as Global Headquarters or who should hold the first 5-year presidency. Under the guise of solidarity that the 'BRICS' title provides, these institutions are ostensibly promising. But there is underlying ideological incompatibility to be overcome, and we should not allow the illusion of uniformity under an acronym to warp our judgement on how well these individuals can interact.

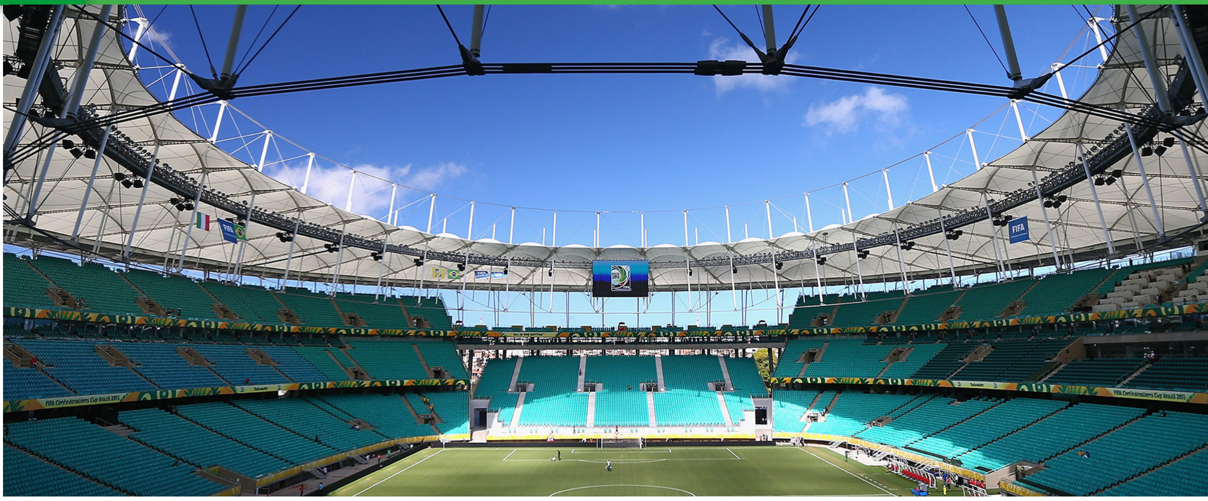
Another generalisation arises in the broader use of 'Emerging Markets' itself. A country's appeal as an investment opportunity can be thoroughly misrepresented if it is cast under the shadow of other, poor-performing emerging markets. For example, in the spring of last year the MSCI Emerging Markets stock index plunged 15% when whispers of a US interest rate hike caused investors to withdraw capital from the emerging markets. But this statistic negates to convey that South Korea, one of the emerging markets listed on this index, contradictorily experienced vast investment inflows thanks to its strong current account surplus (and therefore strong foreign currency reserves which would have sustained economic activity even if liquidity moved to the US). The overall movement of the 23-economy index may provoke the wrong assumptions about what is actually going on within.

In the same way you would not scratch Morrison's from your portfolio because the FTSE100 has experienced a slump, it is inefficient for decisions on capital allocation to be influenced by the aggregate performance of emerging economies' peers. Each country has a complex, unique risk environment and development path which deserves its own due diligence and evaluation.

Hence, we must be aware of when we are interlinking emerging economies together in our minds. Just as a wolf pack would not rank its Alpha with its Omega; the powerhouses and the newly industrialised are by no means aligned.

This is especially true as we never seem to apply this same affection for acronyms to our own highly developed countries: I would infact revel in levelling the playing field by discussing the imminent growth in the most advanced economies on the planet; of countries such as Japan and the US, the UK and Germany and of the Nordic marvel, Sweden. Yes, if we are going to hear so incessantly about the BRICS and PIGS and MINTs; I cannot wait to also hear about the imminent growth of my 'JUUGS'.

By: Kasia Chodurek
Kasia is a 2nd year Economics student.



A Trophy Worth Losing? How The 2014 FIFA World Cup Has Affected Brazil

"We lost the trophy, but Brazil won the World Cup."

This was the upbeat message delivered by Brazilian president Dilma Rousseff's chief of staff, Aloisio Mercadante, in a statement regarding the various impacts of hosting the 2014 World Cup. Indeed, Brazil's campaign ended in humiliation on the pitch, with two damning defeats destroying the hopes of an optimistic nation who viewed their team as favourites going into the tournament. There was a similar widespread feeling of positivity about hosting the event, with the government hoping for an economic boost through investment and tourism, and the public keen to welcome the world and put-on an unforgettable spectacle. However, just as the national team's campaign failed to meet expectations, the socioeconomic impact of hosting the world's biggest footballing competition may also be seen as an anticlimax.

The reasons for optimism were understandable. In a country where the distribution of income is certainly not shared whilst a passion for football is, hosting the biggest tournament of its kind might have helped unite the Brazilian people and restore some much-needed faith in Rousseff's government. Others were more cynical, with the vast amounts of money spent on stadiums and infrastructure – close to $15 billion – despite the glaring problems of inequality further alienating much of the population.

Economic Boost?

Although the figures for economic output (GDP) over the World Cup period are not yet available, the general consensus is that the data will be underwhelming. Brazil's economy actually fell into recession in the three months to June, with GDP contracting by 0.6%. Latest statistics also show that although the tournament attracted over a million foreign tourists, its impact on many sectors of the economy was negative. Industrial production for July fell to its lowest monthly level since 2010, perhaps owing to the 'days-off' granted by some cities to their workers when matches were played in local stadiums. Civil construction, manufacturing and investment were the sectors most badly hit.

As for the labour market, the Brazilian government claims one million jobs were created either directly or indirectly through the World Cup. However, many independent analysts refute these figures, claiming jobs such as building stadiums were only temporary and will not contribute to sustained economic growth. Indeed, the country's official payroll database shows just 25,363 jobs were created in June as job creation fell to its slowest rate since 1998. It is this news, together with the slowdown in industry and fall in investment, which suggests the World Cup had a disappointing economic impact. Despite a short-term boost to service sectors, there has been no real increase in production capacity as opportunities to invest in long-lasting infrastructure, other than stadiums, seem to have been wasted.

Social Issues Persist

Despite the protests over the money spent preparing for the competition, many Brazilians were proud to play the hosts. They certainly gave a positive impression of themselves and the country, with 95% of foreign tourists saying they intended to return, according to the government. This is good news for the tourism industry, especially with the upcoming Olympic Games to be hosted in Rio de Janeiro in 2016.

Nonetheless, there is a sense that like any economic benefit, the positive social impacts were limited and temporary. Over half of Brazilians in a recent poll believe hosting the World Cup was a bad idea. Dissatisfaction with the government remains high, and although rapid economic growth over the past decade has lifted millions of Brazilians out of poverty, many feel that hosting the tournament served the interests of the political and economic elite rather than the ordinary Brazilian.

Lessons for Rio '16?

One obvious advantage of hosting the Olympics so soon after the World Cup is that much of the required infrastructure, most notably football stadiums, will already be in place. From a logistical point of view however, Brazil as a country will have learnt how to cope with a mass influx of national and international tourists. There must be greater investment in transport systems, but with a long-term focus on using this opportunity to increase Brazil's productive potential rather than just doing enough to cope with hosting the games.

Looking Forward

It is always difficult to predict the effects such sporting events will have on the host country. Barcelona has enjoyed a tenfold increase in the number of tourists it receives since hosting the Olympics in 1992. On the other hand, Olympic sites in Athens remain deserted a decade after the 2004 games. Brazil is undoubtedly on a path of narrowing inequality, and whilst hosting the World Cup certainly lifted the spirits of its people and provided a short-term economic stimulus, there is still work to be done in improving the country's infrastructure and funding prolonged investment that will increase production capacity and push Brazil into a new period of sustained growth.

By: Matthew Pratt

Matthew is a 3rd year Economics student.

A House of Cards: How long can subsidies fuel Venezuela?

Home to the largest proven oil reserves in the world (298.35 billion barrels), Venezuela is one of the biggest producers of crude oil. Unfortunately, an abundance of natural resources never assures prosperity; as in the case of Venezuela, which grabbed headlines lately for all the wrong reasons – closing its border with Colombia to prevent rampant smuggling of the country's highly subsidised gas and daily necessities, while raising a public furore by mandating a biometric system for grocery shoppers to combat food shortages.

Generous subsidies have provided Venezuelans with cheaper goods, notably petrol, which – after adjusting for the street value of the Bolivar currency – amounts to less than half a penny per gallon. Economics, however, taught us that subsidies are stop-gap measures and never permanent solutions, especially one fuelled by the country's own coffers.

Unheeded by late President Hugo Chávez, he dictated a populist approach of channelling revenues from the country's state oil company, Petróleos de Venezuela S.A. (PDVSA) to fund welfare subsidies. Fundamentally unsustainable, it resulted in PDVSA's lack of reinvestments and cash flows, crippling growth prospects and threatening to derail the country's cornerstone that constitutes around 95% of export earnings and 25% of GDP.

Yet, this may just be the tip of the iceberg for an ailing Venezuelan oil industry. In 2006, Chávez nationalized oil exploration and production projects in Venezuela, mandating a renegotiation of present joint ventures to a minimum 60% PDVSA share in the project. This shook investor confidence, with ExxonMobil and ConocoPhillips leading the exit, and its ripple effects resonate today as political turbulence and high costs induced Petronas to pull out in 2013 while Petrovietnam halted its Venezuelan operations in 2014. It deters much-needed foreign investment to reduce capacity constraints and offset recent production declines, illustrated by the steady fall in Venezuelan oil production between 2001 and 2012 in Figure 1 below.

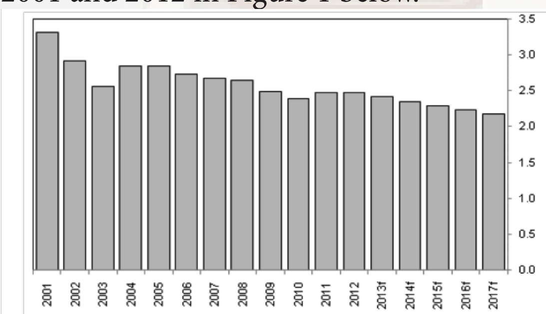


Figure 1: Venezuela's Oil Production, million b/d (Source: BMI Oil & Gas Research, BMI Venezuela Petrochemicals Report 2014)

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Let's examine PDVSA's beleaguered state. PDVSA currently repays its Chinese debt with about 200,000 b/d worth of oil, and its Petrocaribe agreement delivers about 500,000 b/d of deeply subsidized oil to the likes of Cuba, Jamaica, Haiti and Nicaragua. Include an alleged 100,000 b/d of oil illegally siphoned from Colombia, and the 800,000 b/d sold domestically at a huge loss – that's 1.6 million b/d; nearly 65% of PDVSA's daily production in 2012 being sold at an uneconomical rate!

Furthermore, import price-push inflation stemming from the loss of confidence in the Bolivar increases oil production costs, creating a profit squeeze beyond imagination. After funnelling most of its paltry profits to welfare initiatives, a pittance remains for PDVSA's actual operations. At status quo, it is irrefutably only a matter of time before the nation's crown jewel stares at the brink of economic collapse.

According to Reuters, Venezuela's credit default swaps are already at five-year highs with some issues yielding over 20%, the kind of "levels associated with a nation at or near default." Venezuela's government debt as a percentage of GDP stood at 51.6% and its need for short term cash appears to be forcing PDVSA to sell its refinery arm Citgo, while incumbent President Nicolás Maduro relented to raising domestic oil prices – although discontinuing oil subsidies that have indulged a generation of Venezuelans with cheap gas will draw public ire; a political cost that no Venezuelan government so far had been willing to assume.

Defaulting however is not a viable option. In May 2014, Venezuela had already reneged on selective domestic debt valued over US$14 billion, albeit keeping up its instalments on PDVSA's debt to avoid the similar asset seizures experienced by Argentina when it failed to pay US creditors. Allowing a sovereign debt default would be the last straw for many investors, leaving a cash-strapped Venezuela to fend for itself; a scenario where a country which imports almost everything it consumes (other than oil) cannot allow happen.

A bold, deep-seated reform is required – the Venezuelan government must review the unsustainable socialist policies that are alienating foreign interests and eroding the Bolivar value; and perceptions must change as citizens remove their blindfolds on artificial price controls and begin paying for what they really need. A short term suffering is on the cards but even in the event of a default, a resource-rich Venezuela with proven oil resources worth over US$27 trillion (at today's oil prices) will not be written off like its debts; for like the phoenix, it must burn to emerge.

By: Benjamin Chua
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The Ukraine crisis and its influence on regional governments and institutions

The name 'Ukraine' is derived from the Old Russian word for borderlands and this reflects how the nation was traditionally seen as a boundary between the Eastern and Western World. It is arguably due to this pivotal location that the nation has been the ground for many conflicts, which sowed the seeds of the current crisis, the most relevant of these conflicts being the Cold War. Rising political tensions have threatened Ukraine ever since its independence from the USSR in 1990 and, occasionally, these tensions have spiralled out of control - most notably in the Orange Revolution of 2014. However political instability in Ukraine is now, almost undoubtedly, at its highest point since 1990.

The former Ukrainian President Yanukovych abandoning a trade agreement that would have led to closer ties with the EU in November of 2013 triggered the situation. Protests turned into riots, which escalated into an organised resistance against government crackdowns. By February of 2014 Mr. Yanukovych had left the country. Heavy Russian involvement exacerbated the crisis significantly, particularly Moscow's annexation of the Crimea in mid-March.

The impact of the crisis has been huge and the full repercussions have not been felt yet. While conflicts in the Middle East are often claimed to be proxy wars between the USA and Russia, this crisis has led to a clear political power struggle between the two nations, reminiscent of the Cold War. More importantly, military conflict between the Ukrainian army and pro-Russia rebels has led to a rising death toll - reaching over 2000 lives at the time of writing. Even when the political and economic wounds of the conflict heal, as confidence in the Ukrainian economy and political system is restored, the social wounds may not.

The regional economic impacts of the crisis have been immense as both Russia and Ukraine's economies have been impaired. S&P estimated that nearly $60 billion left Russia in the first three months of 2014, and the Russian stock market and rouble both fell as a result of sanctions. Economic indicators worsened after Moscow's annexation of Crimea; S&P cut Russia's sovereign debt rating by one step to its lowest investment grade, BBB, in April of 2014. One could argue that S&P could have been biased as an American financial services company due to the political backdrop of the Ukraine crisis. However, the Bank of Russia, which has no such pro-American bias, rapidly rose its base rate by 2.5 percentage points from February to April of 2014 as shown in the graph above. This rate rise suggests that Russian policy makers anticipate the economy potentially facing higher inflation and economic instability. The Russian government faces the longer term challenge of gaining new customers for its energy market as Europe is becomingly increasingly aware that Russia is an unreliable supplier of almost one quarter of its oil and gas. A transformed energy market could be a reality surprisingly soon as, in May of 2014, China signed a $400 billion 30-year agreement with Moscow to be one of its future gas suppliers whilst there is increasing scope for fracking in Europe and America has experienced a shale boom.

Figure 1: Bank of Russia base rate (2013-14) (Source: Global-Rates)

Ukraine's situation is far more depressing than Russia's as the nation was already facing dramatic fiscal problems long before the crisis escalated, requiring a $15 billion conditional loan from the IMF in 2010. The crisis has exaggerated Ukraine's economic woes. Dwindling central bank reserves, which tumbled from a high of $40 billion in 2011 to approximately $12 billion in March 2014, forced the central bank to abandon its fixed exchange rate in mid-January. Its currency, the hryvnia, was fixed at 8:1 with the dollar and currently trades at close to 13:1 (according to the 9/09/14 conversion rate). Whilst this depreciation was necessary, it does not help Ukraine's biggest economic issue – its debt crisis. Currency depreciation increases Ukraine's debt burden significantly as roughly half of Ukraine's public debt is in foreign currencies, which will now require more hryvnia to pay off. The Federal Reserve's $10 billion tapering of its asset purchasing program this April could not have come at a worse time for Ukraine as it has reduced capital inflows further and made debt financing even more difficult. The Ukrainian central bank faces difficult decisions on interest rates and monetary easing. The central bank has been wary of monetary easing ever since Ukraine suffered hyperinflation in the early 1990s and inflation could now be spiralling towards this; the Ukrainian Finance Minister Oleksandr Shlapak estimated a few days ago that inflation in Ukraine would accelerate to 19-20 percent in 2014. However, significant seigniorage may be necessary for the country to raise the $25 billion needed to satisfy its current account deficit and foreign creditors. I feel that a Ukrainian bond default is a realistic possibility due to the nation's low foreign-exchange reserves and the market seems to agree with me on this front, with short term Ukrainian government debt offering interest rates as high as 15% for the risk-taking investor.

A crisis as severe as this one has no simple solution but rather a variety of more complex potential solutions. In such times, the main priority of governments and institutions is to induce stability. Short-term stability may be reached by calming the political storm but in order for longer term sustainable stability to be reached underlying economic issues must be addressed.

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