Emerging Markets Forum

Emerging Market Economies: Out of Favor but Not Out of Steam

Claudio Loser
President, Centennial Group Latin America

The last year has not been kind to emerging markets. Stock markets have performed poorly, with a few exceptions; commodity prices have trended down by 4 percent on average (10 percent since early 2012); currencies have been hit hard in recent times; and investors have panicked, withdrawing money from emerging markets as monetary conditions tighten, at least in relative terms. Some international financial gurus are proclaiming the end—if not a long interruption—of the previous emerging markets boom. This worrisome picture throws doubt on the optimistic views expressed by many in the past.

But are the doomsayers right? The answer is a qualified but strong no. Medium-term scenarios and projections are inherently stylized, skip short-term difficulties, and tend to be seen as naïve and over-optimistic by short-term analysts. In contrast, shorter-term assessments predict either booms or busts based on the months prior to the projection. Accordingly, as emerging economies have shown some weaknesses, market analysts and traders have reduced their positions in emerging markets, waiting for circumstances to improve.

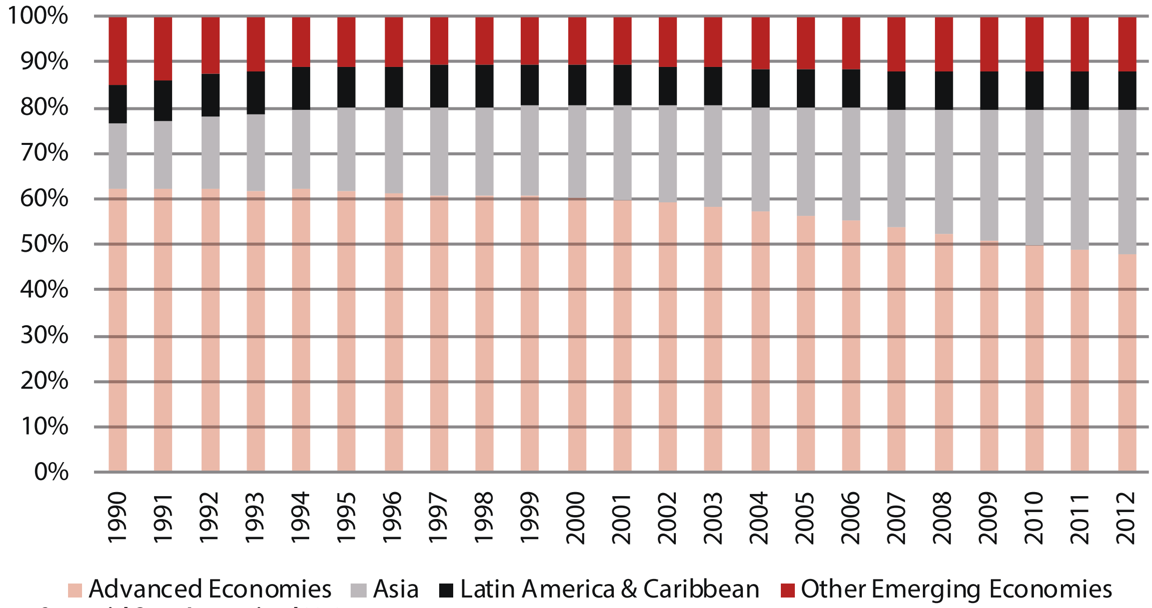
These movements are a healthy and necessary aspect of the market mechanisms that have brought prosperity to the world and in the end have helped attain a smoother adjustment. However, there is a clear tendency for these views to result in over- and undershooting of specific market indicators, be it share prices or exchange values.

Historical perspective provides powerful evidence that emerging economies are growing on a positive trajectory. In the last thirty years we have witnessed a sharp increase in the income of emerging and developing economies and, as a consequence, a rapid increase in the share of these economies in global wealth and GDP. In 1990, the share of the traditional advanced economies (i.e., excluding the Newly Industrialized Countries of Asia, or NICs) was 62 percent, on the basis of purchasing power parity (PPP) calculations. By 2013, these numbers had changed drastically, and this same set of advanced economies represented less than 50 percent of the total (Figure 1). At market exchange rates, advanced economies now represent 60 percent of the total, but had amounted to 80 percent in 1990. Such enormous change in output composition cannot be disregarded as a short-term or temporary phenomenon.

Nor can this change in output composition be attributed only to China, even though the country's share of world GDP jumped from 4 percent in 1990 to 15 percent in 2013 on a PPP basis. In fact, during the same period, GDP in emerging economies excluding China rose from about 40 percent of the value of output in the advanced countries to 70 percent last year. Such changes have been broad-based, including countries like India, Thailand, Malaysia, Indonesia, Chile, Colombia, Peru, and Turkey. A number of countries in Eastern Europe and Central Asia have been true game changers, and the world economy today looks very different than 30, not to mention 50, years ago.

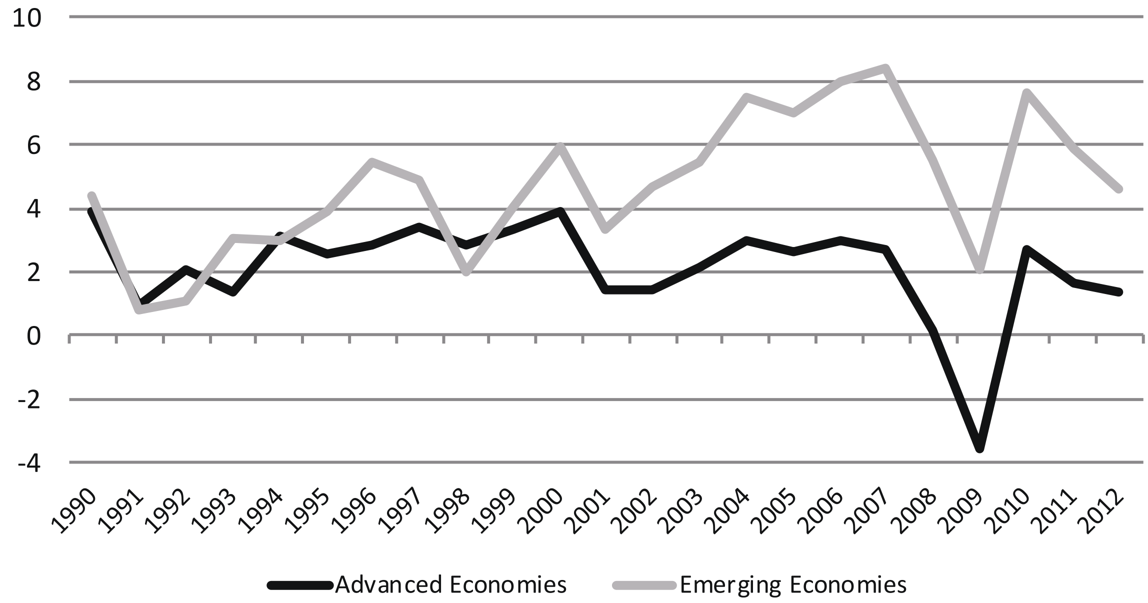
The change in the structure of the world economy has made the distinction among groups of countries less relevant. However, emerging and advanced economies still show dynamic differences. Emerging economies' growth rates have surpassed advanced economies' (Figure 2) and have contributed to lifting a significant portion of the world's population out of poverty. The number of individuals in extreme poverty (incomes below $1.25 a day) declined from about 1.9 billion in 1981 to 1.1 billion in 2010, or from 42 percent of total population to 15 percent. In addition, higher rates of investment, total factor productivity growth, and population growth all bolster emerging economies' growing global strength.

Figure 1: Share of World GDP (percent of total, PPP)



Source: Centennial Group International 2013

Figure 2: Advanced and Emerging Countries (GDP growth rates)



Source: Centennial Group International 2013

Emerging economies have weathered storms before and will face them again. The Latin American crisis of 1994-95, the Asian crisis of 1996-97 (with its subsequent repercussions for Russia), and the Latin American crisis of 1998-2002 were traumatic events that left an imprint in the collective memory of emerging economies. At the same time, these crises resulted in significant improvements in macro-economic policies for many emerging countries, improvements less frequently implemented in advanced economies.

The current short-term outlook, therefore, does not signal a complete turn-around in emerging economies' fortunes. However, the factors that are contributing to both perceived and real change in emerging economies are important to examine.

First, economic growth in emerging economies has been far from even, with rapid and sustained growth in East Asia (including China) and the NICs, and a much more halting pace in Latin America, Africa, the Middle East, and other parts of Asia. These regions have fallen into the middle-income trap: They are too rich to compete with low-wage countries and insufficiently advanced to compete technologically with the more advanced countries of the world. Thus, a significant number of emerging economies have fallen behind not only the advanced economies but also the more rapidly growing countries in their cohort.

More importantly, commodity prices and improvement in terms of trade have driven emerging economies' growth in recent years.[1] The emergence of China, the growth of income, the enormous reduction of poverty, and the emergence of the middle class, particularly

1. See also "Commodity Terms of Trade in Emerging Markets: A Fragile Blessing" by Claudio M. Loser in the *Global Journal of Emerging Market Economies* 6 (22): 99-115.

in Asia and Latin America, all helped the emerging world. But commodity prices also provided a significant boost, especially recently. Commodity prices, which had declined on a secular basis for 20 years, experienced a powerful recovery in the early 2000s that reached its peak in 2010-11. This sustained increase in commodity prices provided the fuel for strong growth in GDP and in disposable income, explaining one-third to one-half of the total growth rates for commodity exporters. This improvement in terms of trade also partly explains the increase in the countries' share of the global economy, even though some of the emerging economies—primarily China—experienced terms of trade losses.

The increase in terms of trade gave many countries a false sense of security, based on the assumption that they had delinked their economies from the perceived volatility of advanced economies. They believed that the expansion of global demand was of a permanent nature, rather than the result of growing imbalances in the advanced world. Thus, policy makers and analysts thought that growth would continue to be strong and investment opportunities almost riskless in many emerging economies. GDP continued to rise much faster than in the past and in the advanced world, and countries became complacent.

The Great Recession of 2008-09 and the accompanying standstill of financial markets was a rude awakening. Global wealth declined by the equivalent of one year of world GDP, distributed among virtually all regions of the world. Commodity prices plummeted, and many of the emerging economies were afraid that they would suffer on a long-term basis. In many regions, including Europe, there has been no full recovery from the crisis even today.

The combination of a strong policy foundation in Asia and many places in Latin America and the impact of expansionary monetary policies in Europe and the United States, helped arrest the problem. Showing greater resiliency than advanced countries, emerging economies became the favorite destination of investors, and commodity prices began to rise again. The belief that emerging economies had delinked themselves from the crisis-ridden advanced economies resurfaced as well, and complacency showed its deceiving face again.

Recent changes in global economic conditions indicate that this complacency is misguided. First and foremost, the apparent delinking of emerging and advanced economies is a myth, even though intra-emerging markets trade and finance have boomed. Advanced economies represent more than 60 percent of world GDP in current dollars, which is the relevant measure in terms of international trade, and finance remains concentrated in the advanced world. Second, China continues to be one of the main engines of growth, but its pace has declined and China's impact on costs and prices is vanishing, even as it moves up the technological ladder. Furthermore, a secular shift in the prices of commodities is likely taking place: The increasing emphasis on services, lower basic investment, the tepid pace of the advanced world recovery, and new sources of supply are hitting commodities. All these elements can only suggest a decline in the growth rate of commodity-rich emerging economies, as has been observed very clearly in Latin America and Africa, and in some of the advanced commodity exporters. Even the more recent recovery of the advanced world brings with it the inevitable slowdown in monetary expansion (with few exceptions, like Japan) that influences growth in the emerging economies. There has been a decline in the growth rate of emerging economies of some 2.5 to 3 percentage points in the last two years. However, this is not cause for panic; rather, it is in line with the observed slowdown in the advanced world (see Figure 2).

Neither short-term gloom and doom nor unequivocal optimism based on a long-term vision should cloud our judgment. Given changes in the global economy, two conclusions emerge. First, policy makers have to address the imbalances in macroeconomic policies to reflect current conditions, and second, there is a need to introduce or deepen, as the case may be, the structural reforms needed for sustained economic growth.

Regarding macroeconomic policies, the economic and political elites of many countries again became overconfident and allowed demand to increase well beyond a sustainable level, resulting in increasing foreign borrowing and inflationary pressures. The current market shocks reflect these problems, but for most of these countries, after the initial turbulence, conditions should stabilize. Some countries may still not want to recognize the need for adjustment, but in the end they will engage in the needed correction in either a systematic or a more chaotic and disorganized manner.

Most importantly for the long-term well-being of the emerging economies, the current circumstances bring to the fore the messages of the *Global Journal of Emerging Market Economies* and of the work of the Emerging Markets Forum and Centennial Group. The potential for growth, which goes well beyond that of the advanced economies in the medium term, is enormous, but it is not a foregone conclusion. The agenda for change will vary for different regions and countries and will cover different areas, be it education, technology, infrastructure, internal competition, finance, inclusion, competitiveness, fiscal reform, governance, or many others. The required work will be hard, and further challenges will emerge with respect to issues like demographic pressures, urbanization, the environment, or global warming. But the importance of fulfilling the potential of emerging economies and breaking away from the middle income trap remains.