

Is the boom in the emerging markets over?

by Michael Heise

For many years the emerging markets were seen as the epitome of high economic growth and hence as an important driver of the world economy. In recent months, however, there has been a flood of bad news: disappointing growth rates, mass demonstrations, political unrest and then the surge in capital outflows since late May.

So are we witnessing the end of the protracted emerging market boom and is the global economy set to lose its leading growth driver? My answer is “no”. Looking at the next 10 to 20 years, the emerging markets will still provide a key boost to the global economy. These countries will continue to grow faster than the industrial countries. The large gap in earnings between the industrial countries and the emerging markets still exists and is unlikely to be eliminated for decades, even given a buoyant catch-up process. Emerging economies will still shape the division of labor and international specialization patterns; they have huge reserves of deployable labor at their disposal and manifold investment openings. In the established successful emerging markets the product spectrum will become increasingly sophisticated. But new locations for simple and labor-intensive production will emerge elsewhere. The transfer of capital will no longer take place unilaterally into emerging markets, rather the latter will gradually also become the providers of capital in other emerging markets, but also in the industrial countries themselves. In other words, the interlacing of the emerging markets in the world economy will rise further – a process that, as earlier crises have shown, can of course be disruption-prone.

Indeed, at present we are observing that growth rates in many emerging markets are heading south and capital is being withdrawn. This is partly a reflex response to expectations of a somewhat less expansionary monetary policy, lowering risk tolerance among investors, and in part also reflects weaker demand growth and the manifold consolidation needs in the industrial countries themselves. However, in a whole series of emerging markets the economic slowdown has above all “home-made” causes. In Russia, for instance, the investment climate has worsened appreciably in recent years, likely due not least to the lack of legal security. In Brazil the government has ditched elements of its stability-oriented economic policy, thus forgoing some of its political credibility. In addition, urgently needed

investment in the areas of infrastructure, education and health are being tackled only sluggishly, if at all. China faces profound changes to its growth model. Private consumption is to be strengthened and the reliance on the export sector scaled down. At the same time, economic growth in the future is meant to become more sustainable and more balanced. The challenges this involves are enormous. Although China is up to the task, we must bid farewell to the idea of double-digit GDP growth rates. In the medium term I see economic growth hovering more around 6½% a year.

All told, the group of emerging-market countries is likely to grow on average by around 5% a year in the coming ten years. For comparison: in the boom years 2003 to 2007 the annual increase was slightly more than 7%. But even with lower growth rates they will still make the largest contribution to global expansion. As their share in global output is now much higher than it was just six years ago for instance (2007: 29.6%, 2012: 38.1%), the emerging markets are actually contributing somewhat more to annual global growth than previously despite their lower momentum.

There are also positive surprises, namely countries which, thanks to their robust economic development in recent years, have become new growth drivers. Among others, these include Indonesia, the Philippines, Chile and Peru. The Philippine economy, for instance, grew by almost 7% in 2012. The increase in 2013 and 2014 is unlikely to be much lower. The southeast Asian country is benefiting from what is now a substantially more sound fiscal policy, which has emphatically improved the investment climate and which now gives the government leeway for a credible anti-cyclical fiscal policy.

As regards the substantial capital flows since May 2013, in my view these were first and foremost not the result of any change in the assessment of these countries' fundamentals. The trigger was rather an abrupt swing on the financial markets from risk-on to risk-off mode. This shift in sentiment was the direct upshot of statements by the US Fed about the possible timing of its exit from ultra-loose monetary policy. After many quarters in which liquidity flowed from the industrial countries to the emerging markets in search of yield, some of these funds are now being withdrawn again. I do not view these capital outflows as an alarm signal for the long-term outlook – at least as far as most of the countries are concerned. The emerging-market “growth story” remains fundamentally intact. The correction on emerging-market financial markets will therefore prove short-lived. Given the growth potential outlined above, these economies will remain attractive for investors in the future as well. To this extent, the present consolidation phase could well provide some interesting openings in the months ahead.