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Emerging markets – slowdown not beginning of end of catch-up process

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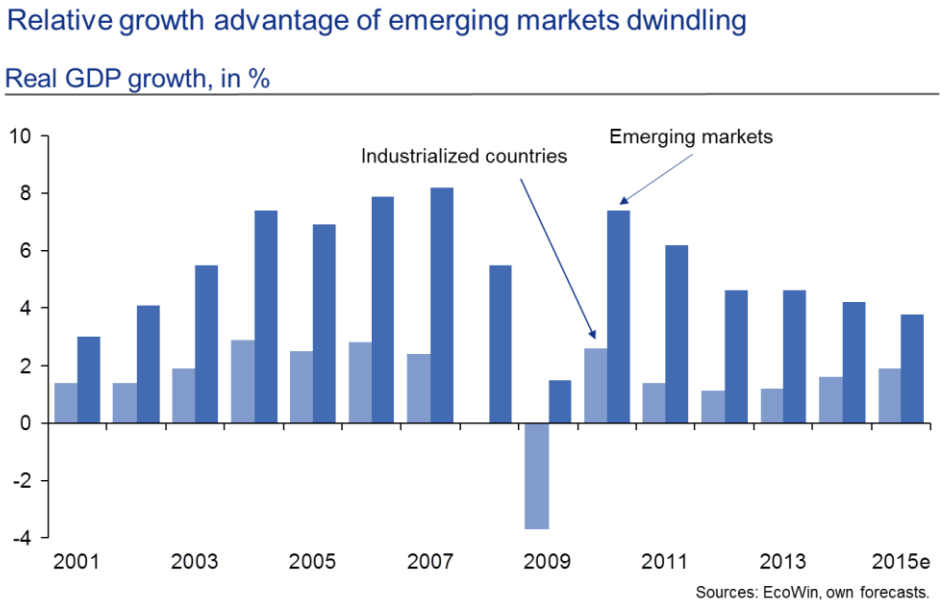
Emerging markets – slowdown not beginning of end of catch-up process

In recent years, the forces driving global economic growth have shifted back somewhat in favor of the industrialized nations. By contrast, growth in the emerging markets, previously the engines of global growth, has slowed considerably. Although the emerging markets still lead the advanced economies in the growth stakes, their lead is likely to narrow to just under 2 percentage points in 2015, compared with a gap of 3.4 percentage points back in 2013. Numerous analyses suggest that the outlook for the emerging markets has deteriorated permanently, and that this group of countries will no longer act as global economic powerhouse in the future, with the current period of weak growth looking set to persist. Low growth would be the "new normal" in the emerging markets. We consider this perspective overdone.



First of all, it is important to bear in mind that temporary factors play a key role in explaining the most recent slowdown in growth. Aside from the fact that key buyer countries have been grappling with stalling economies in recent years, exporting countries have also been hit by corrections in various commodity prices, for example agricultural commodities and industrial metals. The prices of many commodities have stabilized in recent months and are now headed in at least a slightly positive direction. This, coupled with the end of the economic slump in the world's industrialized countries, is likely to support a revival in growth. What is more, many emerging market currencies have depreciated against the currencies of major industrialized countries over the past few months, which is also likely to work in their favor. However, the outlook for capital inflows over the coming months is uncertain. The likely break with the low interest rate policy in the US will serve as a stress test for those emerging markets that rely heavily on the inflow of capital from abroad due to their external deficit.

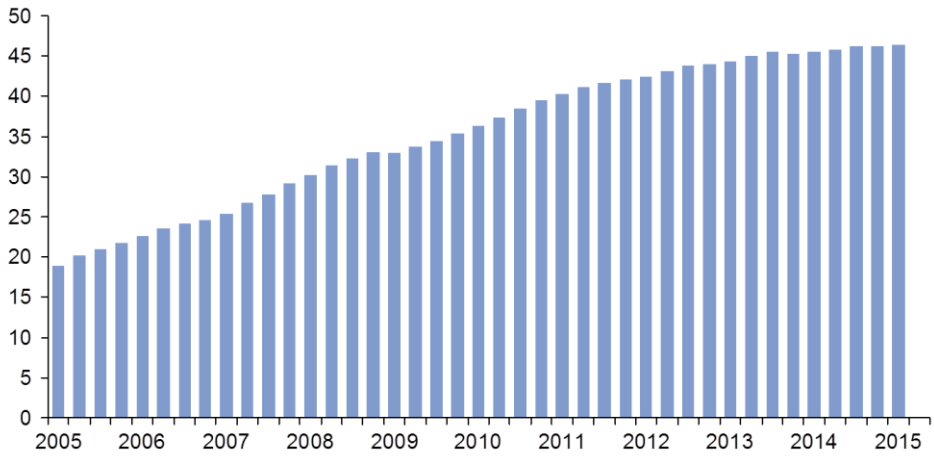
In many emerging markets the disappointing economic development seen in recent years is due less to cyclical factors and more to structural issues, such as weak productivity growth. A recent study released by the Conference Board concludes that labor productivity growth in the major emerging markets has tailed off considerably over the past few years. The figure for 2014 came in at 4.4% after averaging 5.8% in the period from 2007 to 2012. Productivity growth looks set to slow further to 3.7% in 2015. Reforms to boost growth and productivity are essential if the emerging markets want to get growth back on track in the long term as opposed to achieving a revival that is merely a blip in the

cycle. But there is no "one size fits all" solution for all of the countries in the club. In a "Staff Discussion Note" from last year, the International Monetary Fund (IMF) describes some of the measures that emerging markets could use – depending on their development level – to foster productivity and, as a result, also growth. In principle, all countries can progress further up the value chain with regard to production and exports by incorporating new technologies into their production processes, for example. The IMF advises countries that have already achieved a high level of development to strengthen their innovative clout by investing more in R&D and tertiary education in order to boost their productivity.

The question as to how quickly the emerging markets can get back on a higher growth path depends to a considerable extent on the pace of reforms in the individual countries. On the whole, it is safe to assume that this process will take quite some time. However, one factor making a return to the very high growth rates that characterized the boom years leading up to 2009 an unlikely prospect is that development is now driven less by lending. To provide just one example: for years, real private consumption in Brazil was booming. But substantial levels of debt were mounting up behind the scenes, which is why private households are now forced into consolidation. This weighs on the propensity to consume. At present, private household debt comes in at 46% of annual disposable income, compared with only 19% ten years ago.

Brazil: Debt weighing on private consumption

Private household debt, as % of annual disposable income



Source: EcoWin.

With real economic output expected to grow by 3.8% this year, the emerging markets are likely to touch the low point in the current period of weakness. Improved economic conditions in the advanced economies, currency depreciation and adjustment processes in the countries themselves will help to foster an economic recovery. In some countries, structural reforms – such as those embarked upon in India – will also start to bear fruit. In the medium term, we expect to see growth of just under 5 % a year. This would at least extend the lead that these countries have over the advanced economies in terms of growth to 3 percentage points again, meaning that the catch-up process in the emerging markets is in no way set to come to an end. With annual economic growth of around 6%, Asia will remain the fastest growing emerging market region by far, despite the continued slowdown in China. This trend will be helped along to a considerable degree by two regional heavyweights, India and Indonesia, both of which are reporting solid economic development. Latin America retains second place in the ranking of the world's most dynamic regions with GDP growth to the tune of 3½% a year, followed by eastern Europe

with an annual growth rate of just under 3%. In both regions we can see both shade and light. In Latin America, the most recent structural reforms in Mexico are fueling hopes of higher growth in the long run, whereas in Argentina and Venezuela, the current economic policy course looks ill-adapted to boost domestic growth impetus. In eastern Europe, the region's EU member states can look forward to the prospect of sustained growth impetus thanks to the economic recovery in the euro area, whereas Russia faces a prolonged period of weakness, due not only to the geopolitical tensions.

Growth rates in main economic regions

Real GDP, % change over previous year

	2011	2012	2013	2014	2015[1)]	2016[1)]	2017-2020[1)]
Asia	**7.5**	**6.1**	**6.4**	**6.3**	**6.1**	**6.0**	**5.9**
China	9.3	7.7	7.7	7.4	6.8	6.5	6.3
India	7.7	4.8	6.4	7.2	7.5	7.7	7.5
Indonesia	6.2	6.0	5.6	5.0	5.0	5.5	5.5
Latin America	4.7	3.0	2.6	0.6	0.2	2.4	3.5
Argentina	8.4	0.8	2.9	0.1	-2.0	1.5	2.9
Brazil	3.9	1.8	2.7	0.1	-1.0	1.5	3.0
Mexico	3.9	4.0	1.4	2.1	3.0	3.7	4.0
Eastern Europe	3.9	2.1	1.5	1.4	-0.6	1.2	2.7
Poland	4.8	1.8	1.7	3.3	3.5	3.5	3.0
Russia	4.3	3.4	1.3	0.6	-4.0	-1.0	2.2
Czech Republic	2.0	-0.8	-0.7	2.0	3.0	2.5	2.3
Hungary	1.8	-1.5	1.5	3.6	2.7	2.3	2.0
Turkey	8.8	2.1	4.2	2.9	3.0	3.5	4.0
Emerging Markets	**6.2**	**4.6**	**4.6**	**4.2**	**3.8**	**4.5**	**4.9**
Industrialized Countries	**1.4**	**1.1**	**1.2**	**1.6**	**1.9**	**2.1**	**1.9**

1) forecast.

The section below provides a condensed version of our assessment of the medium-term growth prospects for a number of major emerging markets.

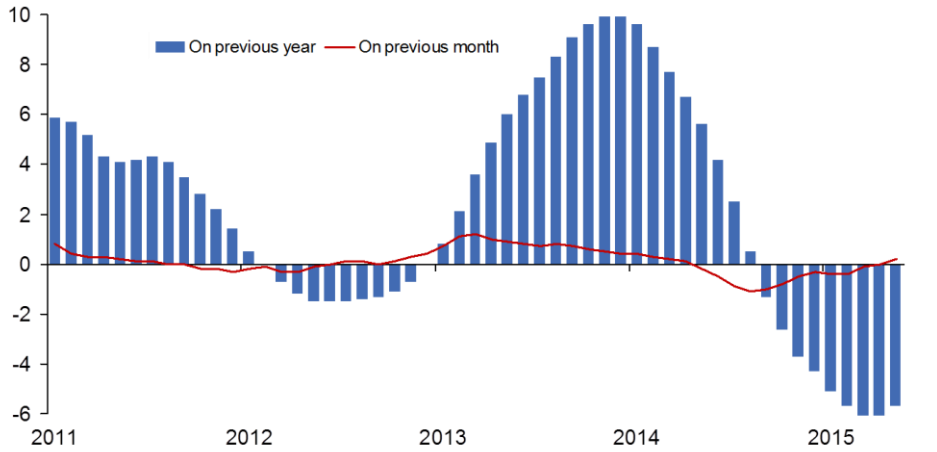
After several years of disappointing economic development, **Brazil** has actually slid into a recession this year. This is primarily due to a change of course on the economic policy front. After a prolonged period of unduly expansive monetary and fiscal policy, which seriously undermined the confidence that economic players placed in the country's policymakers, there is an urgent need for this policy shift if the country wants to return to sustainable growth. In the short term, however, the process is proving to be a painful one, because the restrictive measures are clearly putting a damper on the economy. In addition to the restrictive economic policy, the corruption scandal surrounding the oil corporation Petrobras and the extreme period of drought (particularly in the first quarter of 2015) are weighing heavily on this year's economic outlook. All in all, we expect real GDP to contract by 1% this year on average. The new economic policy stance is likely to result in a gradual improvement in sentiment over the coming quarters, which will ultimately help to gradually stabilize the economy. In the medium term, we expect to see growth bounce back to around 3% per year.

China is currently locked in a difficult process of change. The past few years have seen the pace of growth of the Chinese economy gradually slow, bringing it down to 7.4% in 2014. Structural changes and moves to reduce existing macroeconomic imbalances (such as excess capacity in industry, rampant lending practices, local property bubbles and exploding debt levels among provinces and municipalities), which stem largely from the country's former growth model, are posing huge challenges for policymakers and business alike. The risks associated with these moves are not to be taken lightly. The global economic environment, with only moderate growth overall, only makes tackling these challenges even more difficult. Given the room for maneuver available, however, we do expect the Chinese government and the central bank to succeed in stabilizing economic

development and preventing a "hard landing" for the Chinese economy. Nevertheless, we believe that a further slowdown in economic momentum is virtually inevitable. In the medium term, we predict annual economic growth of around 6.3%.

China: Price correction on real estate market easing

House prices, total, percentage change

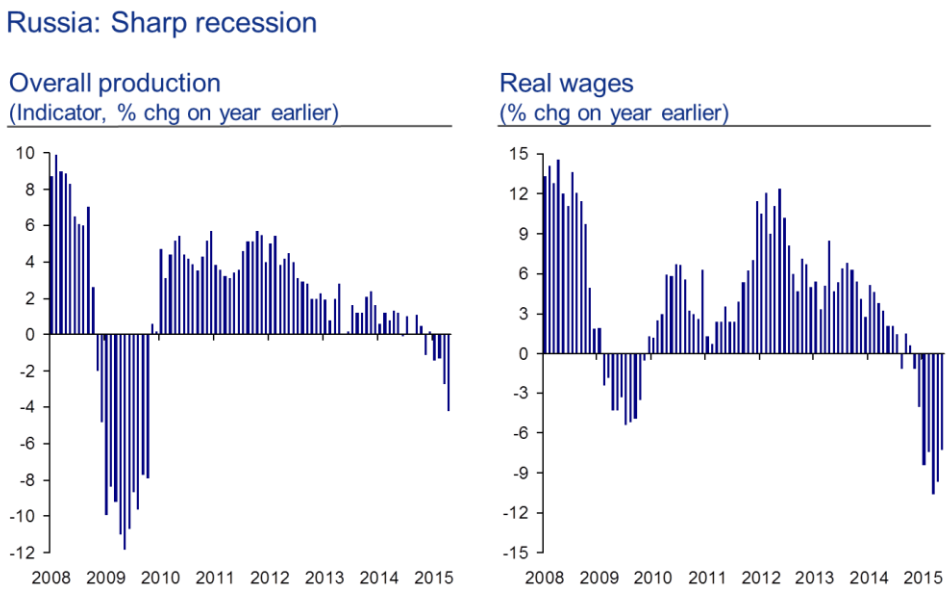


Source: National Bureau of Statistics of China (EcoWin).

India is currently one of the few countries in the world whose economic development comes as a positive surprise. The ambitious program of reforms ushered in by Prime Minister Narendra Modi, coupled with gradual monetary policy easing, budget consolidation helped along by low oil prices, and substantial capital inflows from abroad, is expected to improve the foundation for sustainable growth. This year is likely to see India outstrip China in the growth stakes. The question as to whether it can overtake China in the longer term depends primarily on whether it manages to plug its infrastructural deficits, some of which can only be described as grave. Measures to improve the business climate, reduce bureaucracy and make it easier to buy land are also at the very top of the reform agenda. All in all, we are confident that the government led by Prime Minister Modi will push ahead with all of these reforms. The process of implementing them, however, could prove to be hard-going, as the current discussion on the amendment of the Indian Land Acquisition Act shows. Assuming that a large chunk of the reform agenda described above can be implemented over the next few years, the Indian economy should be able to clock up growth averaging around 7½% a year in the medium term, putting it just ahead of China.

Russia is mired in a deep recession, largely as a result of the economic sanctions imposed on the country in connection with the Russia-Ukraine conflict and the collapse in oil prices. We expect the country's GDP to contract by 4% in real terms this year, with another slightly negative trend in economic output expected for 2016. The medium-term growth outlook depends largely on how the conflict with Ukraine develops. In our base scenario, we have assumed that the conflict will not escalate any further, meaning that the economic sanctions imposed on Russia will not be stepped up a notch either. In this sort of environment, the Russian economy is likely to start growing again in 2017, although the potential for recovery seems fairly limited overall. Even before the current crisis, economic growth was gradually slowing down as a result of deep-rooted structural problems such as a lack of economic diversification, an investment slump and shortcomings in legal certainty and in the battle against corruption. We believe that there is a risk that these problems will be put on the back burner as a result of the current crisis. In this case, the Russian economy would be at risk of a prolonged period of weak growth

coupled with high inflation. In the medium term, we expect to see GDP growth of only around 2% per year.



Turkey is a country that the financial markets are currently keeping a close eye on. Although the Turkish economy has witnessed strong growth in recent years, this development came hand-in-hand with a hefty external deficit and a sharp rise in foreign debt, making the country very vulnerable on the whole to changes in the risk appetites of international investors – which, for instance, could be triggered by an imminent end to the US zero interest rate policy. In the short term, the outlook for the Turkish economy is also hampered by the surprising outcome of the parliamentary elections in early June, which saw the AKP lose its parliamentary majority for the first time since 2002, and the associated uncertainty. We expect to see real economic growth of 3% this year. If it wants to make a return to higher growth rates in the long run, Turkey will have to address the structural causes of its imbalances. These imbalances include, first and foremost, the low domestic savings rate, deficits in the education system and insufficient corporate investment. In the run-up to the elections, the Turkish government announced an extensive program of reforms designed to remedy these deficits. For the time being, it remains to be seen whether the coalition, which is still in the making, will actually show the political will required to implement this comprehensive reform agenda. In the medium term, we expect the Turkish economy to grow by around 4% a year, approximately 1½% less than the average rate for the last five years.

Literature:

Van Ark, B.; Erumban, A.: Productivity Brief 2015. The Conference Board, May 2015.

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