Hot Markets, Solid Ground

Why emerging nations are a new force for stability in the world economy, not a new crisis-in-the-making.

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Jan. 9, 2006 issue - I have generally been a worrier when it comes to thinking about risks in an ever-shrinking global economy. But not now, not on one of the critical questions facing the world in 2006: whether countries such as China, India, Turkey, Russia and other emerging markets will continue to boom, or go bust, just as they did in 1997. After all, in July of that year a seemingly insignificant event in the global scheme of things—a devaluation of the Thai baht—led to a financial crisis that spread from Indonesia to South Korea and eventually enveloped countries as far away as Russia and Brazil. Growth collapsed in those countries. Capital flows dried up. Poverty soared. A global financial meltdown was narrowly avoided. All this occurred against a background of enormous capital flows to emerging markets and great optimism about them in the world's capitals and financial centers—conditions that seem to mirror those of today.

Yes, that great optimism is back. Most analysts are painting rosy scenarios for the world economy, particularly in emerging markets. In December Morgan Stanley said the global outlook for 2006 "is as sweet as it gets." Goldman Sachs estimated that emerging markets would have another great year, with growth of 6.6 percent, compared with 6.7 percent in 2005. The Institute of International Finance forecasts capital flows to emerging markets of well over $300 billion, 50 percent higher than those of a few years ago.

Of course, any broad show of optimism only provokes a counterreaction. It's no surprise, then, that some experts are pointing to any one or a combination of events, none by themselves implausible. Interest rates could shoot up in the United States and suck out money from all over the world. Growth could slow in the United States and China, clobbering the vital exports of developing countries. Oil prices could turn up once more and hurt key energy-importing emerging markets. A few big corporate-governance scandals in emerging-market multinational companies could shake investor confidence. A flu pandemic could shut down world trade. In truth, a crisis never comes from where it is expected, but there is no lack of scenarios.

These concerns are reinforced by a sense that as 2005 ended, global investors had become too lax in their evaluation of emerging-market risk. Questions were being raised as to whether the emerging-market boom was based mostly on the huge amounts of cheap money sloshing around the global economy seeking any decent return, reinforced by the herd mentality of financial markets, and therefore easily subject to a major reversal. Exhibit A was the premium on Third World debt, lower in some cases than that on junk bonds in the United States, lower than those many developing countries had received since the 19th century. Kristin Forbes, an MIT economist and a former member of George W. Bush's Council of Economic Advisers, captured the spirit of the pessimists. "I worry that there is a perfect storm coming from emerging markets," she recently told The Washington Post.

Nevertheless, odds are that the pessimists have it wrong. Sure, parts of Latin America are looking shaky, and other countries, such as Turkey and Thailand, bear close watching. But the likelihood of a serious, across-the-board downturn in emerging markets is remote. The reason is not just that there is so much capital going into their stock markets, or that credit-rating agencies have given high marks to these countries. All that can be easily reversed. And it's not just that most emerging markets have vastly improved their economic policies, including maintaining more flexible currencies and fiscal discipline, even amassing trade surpluses that are being lent to developed nations. Let's face it, in most cases there is still much more to do in vital areas like financial regulation and corporate governance.

The most important reason for bullishness is that emerging markets have moved from the periphery of the global economy to the center. They have become integral to international production, trade and finance. Based on figures from the World Trade Organization, I calculate that over the last 10 years the emerging-market share of international trade has increased from about 27 percent to more than 33 percent. With emerging markets growing two to three times faster than advanced economies, that share is sure to increase. Links between the emerging and developed worlds will only get stronger, helping to limit any downward spiral. Of course, if the entire global economy goes into the tank, all bets are off. But a generalized crisis in the emerging world alone is not in the cards. That's a relic of history.

The differences between 1997 and today are perhaps best reflected in the private sector. More impressive than the amount of capital going into these countries is the fact that the nature of these flows is changing. This is not a story about quicksilver bets on stocks and bonds, as it was in the 1990s. Between 1994 and 1996 net private direct investment, meaning long-term purchases of plants and businesses, was 1.5 times greater than investment in stocks and bonds, according to the IMF. Now it is eight times greater. Between 1994 and 2005, net foreign direct investment increased 92 percent, whereas net investment in stocks and bonds actually decreased slightly. Bottom line: new classes of investors are digging in for the long haul.

Traditional multinationals have not only stepped up their activities but re-oriented their fundamental strategies. Several months ago, for example, General Electric announced that 60 percent of its revenue growth would come from emerging markets such as China, India, Russia and Brazil over the next decade, and that its sales to these countries would grow in 2006 at twice the rate of growth in the United States and Europe. Wal-Mart's trajectory is equally amazing. It entered Brazil in 1995, now has 259 stores there and is planning an additional 12 this year. It entered China in 1996, has 51 stores in the Middle Kingdom today and is planning to open dozens more in 2006.

Throughout the 1990s, companies such as United Technologies and Honeywell International would have left most of the infrastructure building in developing countries to the World Bank. Now they and others are diving into projects for roads, ports, telecommunications, water purification—anticipating some $3 trillion worth of potential business in the next decade. Outfits such as Procter Gamble and General Motors have never before gone to such lengths to restructure their operations in order to build distinct products that are *not* designed and priced for the middle class in the West but aimed squarely at lower-income consumers in developing countries. Two examples: cheaper shampoo in tiny packages, and world-standard cars—not shoddy imitations—in the $5,000-to-$10,000 range.

Western firms long ago moved some of their manufacturing abroad, although the trend continues. But the idea of sending sophisticated services offshore—not just call centers but tax accounting, investment research and medical diagnosis—was hardly considered a decade ago. For companies like JPMorgan or KPMG, not only is it now routine to outsource to developing countries, but we've probably seen just the beginning of more such activity. It's true that some forecasters are downplaying the extent of this offshoring in the future, but I believe they are woefully underestimating the trend, in part because many companies are downplaying their plans for public-relations reasons. But with skilled workers from India, Mexico, the Czech Republic, the Philippines and many other countries working at a fraction of the wages in the United States and western Europe, and with the explosive growth of technology transfers, offshoring is, in my view, one of the inexorable trends of our times. Case in point: the establishment of research-and-development facilities in emerging markets with the scope and momentum that are now shown by the likes of Microsoft and Nokia.

Add to all this the growth of new classes of investors in emerging markets, all far more committed than the short-term speculators who helped roil the waters back in 1997. Private-equity firms are now active all over Asia and Latin America; in 1997 the volume of such business was infinitesimal. In 2005 more than $12 billion was raised for private-equity investments, compared with $5.1 billion the year before. In the last quarter alone, the Carlyle Group invested $410 million in China's third largest insurance company, China Pacific Life, and $375 million in China's Xugong Group Construction Machinery Co. As of mid-2005, there were more than 100 private-equity firms operating in emerging markets.

Likewise, today for the first time venture-capital firms such as Sutter Hill Ventures and Kleiner Perkins Caufield & Byers see themselves as long-term players in China. Intel recently committed $1 billion to back new ventures in India. Most important may be the move into emerging markets by institutions such as the California State Pension Funds and the Yale and Harvard endowments—savvy, long-term investors that normally set the pattern for others.

Another key change is the growth of indigenous multinational companies, which were a rarity as recently as the late 1990s. Now, from South Korea's Samsung (electronics) to Brazil's Embraer (aircraft), Russia's Gazprom (natural gas), South Africa's SABMiller (beer), China's Huawei (telecom equipment) and Slovenia's Gorenje Group (household supplies), there are more than 1,000 emerging "blue chips," each with sales of more than $500 million. They have access to global capital, technology and talent. Some of these companies will bring us products and services at lower costs. Some will bring innovation. Many will link up with Western companies to create seamless global organizations. And as a new class, they will tie emerging and mature markets closer together.

To be sure, in 2006 there will be much to worry about in emerging markets. Will China and India dominate investor attention to the detriment of other countries such as Malaysia or Mexico? Will the surge in production of steel, paper products, auto parts and other goods in emerging markets create huge surpluses around the world? Can emerging markets turn their growing reserves into productive investments at home, reducing their dependence on exports? Among such questions, the one that should preoccupy us the least is whether emerging markets have a brighter future today than they did in 1997. That one is a no-brainer.

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