What Future For Emerging Markets?

Yes, they have been walloped, but don't discount how crucial they are when it comes to trade, climate change, peace and everything in between.

BY JEFFREY E. GARTEN AUGUST 31, 2015

Long before the current market debacle, I was confronted with a fundamental question about emerging markets. As I was finishing off my course at the Yale School of Managment on “The Future of Global Finance” this past May, a student came up to me. “You have gone to great lengths to emphasize the role of emerging markets in a changing monetary system, “ he said, “ but everything I have been reading says that the era of the Brazils, the Indias, the Turkeys, the Indonesias as up-and-comers is history. Even China seems to have lost its luster. Have you been looking backwards and not forward?”

Standing at the podium and gathering my lecture notes, all I could muster in the moment was something about how important it was to separate the signal from the noise. There wasn’t enough time to elaborate, and later I felt my response was inexcusably lame. The last few weeks of escalating crisis for emerging-market countries started to make me feel that maybe the student was more correct than I had acknowledged. But the more I think about it, the more I am convinced that is it a mistake to think that the era of emerging markets is over. In fact, it is just in its early stages.

Just who are the emerging markets?

When commentators talk about emerging markets, they could be referring to a number of groupings. In 1995, for example, President Bill Clinton's administration coined a term, "big emerging markets," consisting of 10 countries that had large populations, large markets, and substantial influence in their regional neighborhoods. They were Mexico, Brazil, Argentina, Poland, Turkey, South Africa, India, China, Indonesia, and South Korea. In 1996, a Yale research team headed by historian Paul Kennedy published articles (and later a book) proposing that Washington give foreign-policy and economic priority in the developing world to nine "pivotal states" whose fates would be central to the problems of the 21st century: Indonesia, India, Turkey, South Africa, Brazil, Mexico, Egypt, Pakistan, and Algeria. (China was excluded because, for the Yale group's purposes, it was considered a great power alongside Russia.)

Then, in 2001, Goldman Sachs, led by Jim O'Neill, then its senior research executive, published an analysis identifying four countries that would become global economic powers alongside the United States and Japan. They were labeled the BRICs: Brazil, Russia, India, and China. (Eventually South Africa was added.) Since the 1990s, however, much larger groupings encompassing countries such as Malaysia, Colombia, and Israel have been established by the United Nations, the IMF, the World Bank, Morgan Stanley, and other organizations, each list being used for different purposes, such as investment, social progress, etc. I fully agree with the Financial Times when, in early August, it described the emerging-market group as "one of the most powerful definitions in the world" and also a "capacious category" of "incongruous assets."

Heading south, for sure

This cacophony of so many competing definitions notwithstanding, virtually every category of emerging markets is now experiencing serious economic setbacks. But as my student implied, the problems are not just of the moment.

In July 2013, the Economist wrote, “The most dramatic, and disruptive, period of emerging-market growth the world has ever seen is coming to its close.” This past April, the Wall Street Journal paraphrased the IMF as stating, “Emerging markets are on course for the sixth consecutive year of falling growth rates, led by a faster-than-expected slowdown in China, a steep contraction in Russia and recession in Brazil.” In July, the IMF showed emerging markets’ collective growth decelerating from 5.0 percent in 2013 to 4.6 percent in 2014 to 4.2 percent this year. Well before the meltdown of the last several days, unemployment levels in emerging markets had been rising, and those countries’ currencies had hit 15-year lows — and that was before the Chinese devaluation of mid-August, which caused many other emerging-market currencies, such as the Indonesian rupiah and the Thai baht, to fall even further in order to maintain their competitiveness vis-à-vis the Chinese renminbi.

Emerging-market stock markets have been flat for the last six years and have given up all the comparative gains they made over stocks from developed countries. Private-sector debt in emerging markets has been soaring too. It is no wonder that outflows of funds from emerging markets have accelerated and exceeded $1 trillion in the last year. “The worry is that these problems are no longer contained within emerging market economies,” wrote Jonathan Wheatley and James Kynge of the Financial Times presciently as far back as June, “The dependable boost that the global economy has derived from the youthful dynamism of its developing countries for well over a decade … has recently become an outright drag.” They were correct, of course, as we are now seeing.

To illustrate this point another way, several of the most important emerging markets have faltered severely, not just because of economic policies but also because of political deterioration. In China, stock market and currency turbulence have raised serious questions about whether the Middle Kingdom is in for much harder times, whether the heyday of rapid growth is over, whether its fundamental economic and political model is seriously flawed, and, indeed, whether its top officials are up to the challenge. In Brazil, a broad corruption scandal and accusations that the government has illegally manipulated its fiscal accounts have not only helped stall the economy — actually it just entered into a recession — but threaten to create political turmoil of a kind not seen since the transition to democracy from military rule in the 1980s. In India, the hope accompanying the election of Prime Minister Narendra Modi has been deflated by parliamentary gridlock over essential reforms. In Russia, plummeting oil prices and Western sanctions have pulverized the economy. In Turkey, political stalemate created by a dictatorial president, a massive refugee problem, and escalating military involvement with Syria have cast a serious pall over necessary reforms. In Indonesia, the economy has slowed to levels not seen since 2009, and a new president seems unable to move critical legislation to reverse the trend. The list goes on.

Victims of too much hype

Why have emerging markets proved to be so disappointing? For starters, there was excessive exuberance in the 1990s concerning the idea that a post-Cold War new world order would emerge quickly and that China, India, and Brazil were in the vanguard. Concretely, that took the form of too many projections that were straight-lined from the outsized performance of emerging markets over several years during that decade. Such extrapolation is always ill-advised, but to make matters worse, the starting point for these projections was based on a period that included a phenomenal business expansion in the United States, exceptional optimism regarding the economy in the European Union, and China's takeoff after a half-century of stagnation, including its voracious appetite for the commodities that so many other emerging markets exported. The mid-to-late 1990s was also a high-water mark of globalization, with global trade and investment flows across borders growing at extremely fast rates. In retrospect, many projections just assumed that the highly positive global economic conditions would continue and that relatively easy policy reforms in emerging markets such as tariff reductions would be followed by much more difficult ones, such as liberalization of restrictive labor practices.

Then, from 2008 to 2009, a massive financial crisis that began in the United States rocked the global economy and has interrupted global financial connectedness for the last six years. Exceedingly low interest rates in the world's advanced countries and the cheap capital those rates spawned allowed emerging-market governments and their private sectors to go on a borrowing spree. Mounting nationalism and xenophobia in Europe cast an additional pall over the future of globalization. A slowdown in China's appetite for commodities and raw materials rocked emerging-market exporters such as Indonesia and Brazil. Tumbling oil prices caused severe slowdowns in countries such as Russia and Venezuela. No one foresaw this set of circumstances, nor could they have, but assuming only sunny skies was a horrible mistake. In 2014, Ruchir Sharma, head of emerging markets at Morgan Stanley Investment Management, minced no words when he wrote about those who had been overly optimistic about emerging-market performance: "Forecasters assumed that recent trends would continue indefinitely and that hot economies would stay hot, ignoring the inherently cyclical nature of both political and economic development. Euphoria overcame sound judgment — a process that has doomed economic forecasting for as long as experts have been doing it."

Excessive expectations have also been evident in forecasters' assumptions about political development in emerging markets. Western prognosticators seemed to have forgotten that politics in the emerging world were every bit as complex as they were in the United States, Europe, or Japan. Particularly in the United States, but not exclusively there, there was a pervasive hypothesis that if growth rates in emerging markets were strong, all else would follow: Democratic governance would evolve quickly, and deep-seated corruption would be extinguished because a rising middle class would demand it. The workforce would acquire the skills and education it would need because knowledge would be easily transferable in an ever borderless world. In fact, the long, hard road to political reform and the obstacles to establishing effective, transparent government administration were seriously underestimated.

I saw this firsthand when I was in the Clinton administration. My colleagues and I preached to emerging-market governments and their business executives that free markets for trade and investment were the key to all good things, as did the IMF and the World Bank. We implied that such measures could be taken relatively quickly, given the political will. We used our own country as an example of what emerging nations could become. Even the Asian financial crisis did not interrupt America's swagger, for during the subsequent seven years coinciding with George W. Bush's administration, Washington only intensified its flawed message. It was only when the 2008 financial crisis flared that it became obvious to everyone how illusionary U.S. economic performance and governance — the very American model we bragged about — had been.

Still, more important than ever

Let's stipulate, then, that it was never in the cards that emerging markets would become all that was hoped for in the time frame that so many politicians, economists, and other observers assumed. Let's further agree that the agenda for important economic and political reforms is long and difficult and may take decades to produce lasting results. Let's acknowledge that the fate of emerging markets, like that of so many advanced nations, can't be divorced from an increasingly turbulent global economy — and vice versa — and that we are all boats rocking in a very turbulent sea. Let's agree that the moniker "emerging markets" that lumps so many countries together is seriously flawed. And let's also acknowledge that the world economy ahead — projections for slow growth, sagging prices for oil and other commodities, rising interest rates in the United States, decelerating growth in China — is an inauspicious, if not scary scenario for most emerging markets and that there could well be many setbacks along the way. Taking all this into account, however, here is why I still believe that the original intense focus on emerging markets that gathered force some 20 years ago is still valid and why many of these countries will be at the heart of international economic and political affairs for generations to come.

When the Cold War and the two-superpower framework for geopolitics ended, we were witnessing what Fareed Zakaria labeled "the rise of the rest." It would no longer be a world dominated by the West. In this new era, which countries would gain political clout and become central to their geographical regions? Which countries would gain influence; which would drive trade, investment, and commodity cycles? From which would come many dozens of new global companies hungry to expand and innovate, not to mention nodes of ever larger global supply chains? Which would challenge the prevailing notions of how economies and political systems should be organized? Which would drive the big trends of the next few generations — the rise of the global middle class, hyperurbanization, mass migration, for example? Which would present global challenges to Western concepts of human rights, civil rights, or intellectual property rights? Which would shape the global institutions of the future?

I raised all these questions in a book as early as 1997. The answer then was that several big emerging markets would be at the center of these problems. The answer now is no different.

First of all, the current difficulties should not obscure the massive progress that has been made in many emerging-market nations in the last two decades — the transition in South Africa from apartheid to democracy; the change from communism and state-dominated economics in Poland to a vibrant democratic, market-oriented society; the astounding amount of new infrastructure that has been built in China; the epic opening up of the oil sector in Mexico; the rise of billions into the global middle class, first as workers and increasingly as consumers; the move of billions of people from the countryside to the cities, where opportunities are far greater for individual advancement; and the progress that has been made in lifting hundreds of millions of people out of poverty, plus the dramatic improvements in public health and education around the developing world. Let's remember, too, that emerging markets have not just survived two massive crises — the Asian meltdown of 1998 and the worldwide collapse of markets in 2008 — but came back stronger each time. Chalk this up to learning from mistakes, such as moving to flexible exchange-rate systems that are far less susceptible to speculative attack, or more prudent debt-management policies that reduced the extent of bankruptcies in the private sector.

Second, emerging nations are increasingly central to peace. Some of the most explosive international situations revolve around emerging-market nations — countries such as China and territorial disputes in the East and South China seas, the South Korea-North Korea border, and tensions along the India-Pakistan border, for example. Iran was never classified as a big emerging market, but with the imminent lifting of sanctions, it certainly will be and will constitute another global hot spot. The Brazils, the Indonesias, and now the Irans have emerged as regional influentials.

Next, the emerging market's share of global GDP has grown from about 35 percent in 1993 to about 50 percent in 2013 and exceeded 50 percent before the current downturn. The world's foreign exchange reserves held by emerging markets relative to reserves held by developed markets grew from approximately one-half in 2000 to roughly 2 times in 2015. Research by Vanguard shows that many emerging markets have dramatically improved their economic situations in the last decade and a half. For example, Brazil may be in a serious recession now, but its external debt as a percentage of GDP is less than 50 percent of what it was in 2002, and its reserves as a percentage of its debt are more than four times what they were in 2002. Mexico and Indonesia show similar progress on such fundamentals. In 1997, South Korea's reserves were 13 percent of its external debt, but in 2015 that percentage was 83 percent. With regard to Asia, in particular, I agree with Bloomberg View's William Pesek when he recently wrote, "For all Asia's vulnerabilities, its financial systems, debt markets and central banks are plenty capable of fending off the current global turmoil." In other words, they have come a long way since the late 1990s Asian financial crisis.

A look at the picture for foreign direct investment (FDI) — long-term investment in land, buildings, factories, transportation, and communications systems, etc. — also shows that emerging markets have traveled a great distance in the last few decades. According to the U.N. Conference on Trade and Development's 2015 World Investment Report, FDI in developing countries increased tenfold between 2005 and 2014, about 30 percent faster than it did in the advanced industrial nations. Among the top 20 FDI recipients in the world in 2014, 10 were emerging-market nations, including China, India, Brazil, Mexico, Indonesia, and Russia.

Also, take a look at the increasing number of big, dynamic companies coming out of emerging markets. "Twenty years ago," an article co-authored by a McKinsey Global Institute analyst reads, "who would have guessed that Mumbai's Tata Group would be the largest private-sector industrial employer in the United Kingdom; or that Mexican companies Cemex and Bimbo would become the United States' market leaders in cement production and bread-making, respectively; or that Beijing-based Lenovo would be on a par with Hewlett-Packard as the world's largest seller of personal computers?" According to the article, the share of companies on Fortune's Global 500 list between 1980 and 2000 that were based in emerging countries stayed flat at about 5 percent, but by 2013 the proportion had risen to 26 percent. Also, a McKinsey Global Institute database shows that while one-quarter of the world's biggest companies came from developing countries in 2013, 70 percent of the 7,000 new large firms that will be created between 2013 and 2025 will come from emerging markets.

A host of other developments demonstrates the growing importance of emerging markets. The governance of the global financial system is no longer in the hands of the G-7 industrialized nations but under the auspices of the G-20, in which emerging markets are in the majority. The most contentious issues in the Bretton Woods institutions have to do with increasing the vote of emerging markets. Failure to do so has already led to the establishment of the Beijing-based Asian Infrastructure Investment Bank, a potential forerunner to other organizations that could challenge those that have been at the center of American global influence.

China, India, Brazil, Indonesia, and others will play a critical role in the outcome of December's all-important global conference on climate change in Paris, and in every other global issue, from migration to human rights to intellectual property rights. The fact that many emerging-market countries are experiencing political and economic setbacks only puts them in the category of every other power that has emerged in history, including the United States, which was seized by one financial panic after another when it was industrializing. It makes the challenges to American foreign policy and domestic policy that much more daunting, but it doesn't make them any less central.

Emerging markets are not going away.

The next several weeks — even the next few years — may be rough ones for emerging markets, caught as they are between rising interest rates in America and a sinking appetite for raw materials and commodities in China, not to mention a slow growing global economy. All the more reason why when my classes begin later this week, I will be more nuanced about how I talk about emerging markets than I was before. I plan to introduce the subject with a story from one of my other courses a few years ago called "China in Global Markets." For years I brought 20 students to meet with top economic and financial leaders in Shanghai, Beijing, and Hong Kong. At one point we were talking to a Hong Kong real estate tycoon who had invested billions of dollars in land and buildings on the mainland. A student asked how worried he was about a major crisis in China.

"I don't stay awake thinking about that, because I just assume it will happen. After all, no nation can defy gravity,'' he said. "But what really concerns me is what emerges on the other end. Will China learn from its mistakes? Will it move to institute stronger reforms? Or will it double down on the policies that went wrong, turning inward and more nationalist? That's what keeps me up at night."

These questions of what happens after a crisis, what can be learned from it, and what can be done to put policies on a more effective plane are, of course, critical ones for China right now. But these questions are also very relevant to the broader emerging-markets story. Of course there will be crises, such as what may now be occurring and what may still get much worse. But like China in the tycoon's view, a broad group of emerging-market nations are not going away. They will be central to the world no matter what. We should fervently hope that the current crisis doesn't get truly out of hand. But the most important question is the next chapter. Will emerging markets learn to better navigate a treacherous global economy? Will they accelerate reforms that provide more resilience, such as stronger social safety nets, more flexible labor policies, expanded educational opportunities? Will they move to strengthen institutions such as the IMF or press for new kinds of arrangements? Will their growing middle classes demand cleaner governments, more transparency, and more equitable income distributions? Will their many new cities become hotbeds of innovation in such areas an environmental management? Will they become positive disrupters in such areas as mobile (smartphone) money, an industry in which countries like Kenya are at the forefront? Or, will the problems of 2015 and possibly 2016 cause them to conclude that globalization is a raw deal and force them to turn inward and regress to more nationalist and protective policies?

On the answers to those types of questions, and not on sinking stock markets, declining oil prices, and plummeting currencies, will the world turn.

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