

[Back to previous page](#)



document 1 of 1



## The Ever-Emerging Markets: Why Economic Forecasts Fail

Sharma, Ruchir. **Foreign Affairs** 93.1 (Jan/Feb 2014): 52-56.

---

Find a copy



[http://sfxhosted.exlibrisgroup.com/nps?url\\_ver=Z39.88-2004&rft\\_val\\_fmt=info:ofi/fmt:kev:mtx:journal&genre=unknown&sid=ProQ:ProQ%3Aabiglobal&atitle=The+Ever-Emerging+Markets%3A+Why+Economic+Forecasts+Fail&title=Foreign+Affairs&issn=00157120&date=2014-01-01&volume=93&issue=1&spage=52&au=Sharma%2C+Ruchir&isbn=&jtitle=Foreign+Affairs&btitle=&rft\\_id=info:eric/&rft\\_id=info:doi/](http://sfxhosted.exlibrisgroup.com/nps?url_ver=Z39.88-2004&rft_val_fmt=info:ofi/fmt:kev:mtx:journal&genre=unknown&sid=ProQ:ProQ%3Aabiglobal&atitle=The+Ever-Emerging+Markets%3A+Why+Economic+Forecasts+Fail&title=Foreign+Affairs&issn=00157120&date=2014-01-01&volume=93&issue=1&spage=52&au=Sharma%2C+Ruchir&isbn=&jtitle=Foreign+Affairs&btitle=&rft_id=info:eric/&rft_id=info:doi/)

---

### Abstract (summary)

In the middle of the last decade, the average growth rate in emerging markets hit over 7% a year for the first time ever, and forecasters raced to hype the implications. Today, more than five years after the financial crisis of 2008, much of that euphoria and all those acronyms have come to seem woefully out of date. The average growth rate in the emerging world fell back to 4% in 2013. As the hype fades, forecasters are left reconsidering the mistakes they made at the peak of the boom. Their errors were legion. Prognosticators stopped looking at emerging markets as individual stories and started lumping them into faceless packs with catchy but mindless acronyms. Above all, they made the cardinal error of extrapolation. 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.

---

### Full Text

In the middle of the last decade, the average growth rate in emerging markets hit over seven percent a year for the first time ever, and forecasters raced to hype the implications. China would soon surpass the United States as an economic power, they said, and India, with its vast population, or Vietnam, with its own spin on authoritarian capitalism, would be the next China. Searching for the political fallout, pundits predicted that Beijing would soon lead the new and rising bloc of the brics-Brazil, Russia, India, and China-to ultimate supremacy over the fading powers of the West. Suddenly, the race to coin the next hot acronym was on, and civets (Colombia, Indonesia, Vietnam, Egypt, Turkey, and South Africa) emerged from the mist (Mexico, Indonesia, South Korea, and Turkey).

Today, more than five years after the financial crisis of 2008, much of that euphoria and all those acronyms have come to seem woefully out of date. The average growth rate in the emerging world fell back to four percent in 2013. Meanwhile, the brics are crumbling, each for its own reasons, and while their summits go on, they serve only to underscore how hard it is to forge a meaningful bloc out of authoritarian and democratic regimes with clashing economic interests. As the hype fades, forecasters are left reconsidering the mistakes they made at the peak of the boom.

Their errors were legion. Prognosticators stopped looking at emerging markets as individual stories and started lumping them into faceless packs with catchy but mindless acronyms. They listened too closely to political leaders in the emerging world who took credit for the boom and ignored the other global forces, such as easy money coming out of the United States and Europe, that had helped power growth. Forecasters also placed far too much predictive weight on a single factor-strong demographics, say, or globalization-when every shred of research shows that a complex array of forces drive economic growth.

Above all, they made the cardinal error of extrapolation. 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.

#### SINGLE-FACTOR SYNDROME

History shows that straight-line extrapolations are almost always wrong. Yet pundits cannot seem to resist them, lured on by wishful thinking and fear. In the 1960s, the Philippines won the right to host the headquarters of the Asian Development Bank based on the view that its fast growth at the time would make the country a regional star for years to come. That was not to be: by the next decade, growth had stalled thanks to the misguided policies of the dictator Ferdinand Marcos (but the Asian Development Bank stayed put). Yet the taste for extrapolation persisted, and in the 1970s, such thinking led U.S. scholars and intelligence agencies to predict that the future belonged to the Soviet Union, and in the 1980s, that it belonged to Japan. Then came the emerging-market boom of the last decade, and extrapolation hit new heights of irrationality. Forecasters cited the seventeenth-century economic might of China and India as evidence that they would dominate the coming decade, even the coming century.

The boom also highlighted another classic forecasting error: the reliance on single-factor theories. Because China's boom rested in part on the cheap labor provided by a growing young population, forecasters started looking for the next hot economy in a nation with similar demographics-never mind the challenge of developing a strong manufacturing sector to get everyone a job. There were the liberals, for whom the key was more transparent institutions that encouraged entrepreneurship- despite the fact that in the postwar era, periods of strong growth have been no more likely under democratic governments than under authoritarian ones. And then there were the moralizers, for whom debt is always bad (a bias reinforced by the 2008 credit crisis), even though economic growth and credit go hand in hand.

The problem with these single-factor theories is that they lack any connection to current events or an appreciation for the other factors that make each country unique. On the one hand, institutions and demographics change too slowly to offer any clear indication of where an economy is headed. On the other, those forecasters who have argued that certain national cultures are good or bad for growth miss how quickly culture can change. Consider Indonesia and Turkey, large Muslim-majority democracies where strong growth has debunked the view of Islam as somehow incompatible with development.

Sweeping theories often miss what is coming next. Those who saw geography as the key factor failed to foresee the strong run of growth during the last decade in some of the most geographically challenged

nations on earth, including landlocked countries such as Armenia, Tajikistan, and Uganda. In remote Kazakhstan, rising oil prices lifted the economy out of its long post-Soviet doldrums.

The clarity of single-factor theories makes them appealing. But because they ignore the rapid shifts of global competition, they provide no persuasive scenario on which to base planning for the next five to ten years. The truth is that economic cycles are short, typically running just three to five years from peak to trough. The competitive landscape can shift completely in that time, whether through technological innovation or political transformation.

#### HERE AND NOW

Indeed, although forecasters hate to admit it, the coming decade usually looks nothing like the last one, since the next economic stars are often the last decade's castoffs. Today, for example, formerly stagnant Mexico has become one of the most promising economies in Latin America. And the Philippines, once a laughingstock, is now among the hottest economies in the world, with growth exceeding seven percent. Dismissed on the cover of *The Economist* five years ago as "the world's most dangerous place," Pakistan is suddenly showing signs of financial stability. It had one of the world's top-performing stock markets last year, although it is being surpassed by an even more surprising upstart: Greece. A number of market indices recently demoted Greece's status from "developed market" to "emerging market," but the country has enacted brutal cuts in its government budget, as well as in prices and wages, which has made its exports competitive again.

What these countries' experiences underscore is that political cycles are as important to a nation's prospects as economic ones. Crises and downturns often lead to a period of reform, which can flower into a revival or a boom. But such success can then lead to arrogance and complacency-and the next downturn. The boom of the last decade seemed to revise that script, as nearly all the emerging nations rose in unison and downturns all but disappeared. But the big bang of 2008 jolted the cycle back into place. Erstwhile stars such as Brazil, Indonesia, and Russia are now fading thanks to bad or complacent management. The problem, as Indonesia's finance minister, Muhammad Chatib Basri, has explained, is that "bad times make for good policies, and good times make for bad policies."

The trick to escaping this trap is for governments to maintain good policies even when times are good-the only way an emerging market has a chance of actually catching up to the developed world. But doing so proves remarkably difficult. In the postwar era, just about a dozen countries-a few each in southern Europe (such as Portugal and Spain) and East Asia (such as Singapore and South Korea)-have achieved this feat, which is why a mere 35 countries are considered to be "developed."

Meanwhile, the odds are against many other states' making it into the top tier, given the difficulty of keeping up productivity-enhancing reforms. It is simply human nature to get fat during prosperity and assume the good times will just roll on. More often than not, success proves fleeting. Argentina, Greece, and Venezuela all reached Western income levels in the last century but then fell back.

Today, in addition to Mexico and the Philippines, Peru and Thailand are making their run. These four nations share a trait common to many star economies of recent decades: a charismatic political leader who understands economic reform and has the popular mandate to get it enacted. Still, excitement should be tempered. Such reformist streaks tend to last three to five years. So don't expect the dawn of a Filipino or a Mexican century.

#### BALANCING ACT

If forecasters need to think small in terms of time, they need to think big when it comes to complexity. To sustain rapid growth, leaders must balance a wide range of factors, and the list changes as a country grows richer. Simple projects, such as paving roads, can do more to boost a poor economy than a premature push to develop cutting-edge technologies, but soon the benefits of basic infrastructure run their course.

The list of factors to watch also changes with economic conditions. Five years after the global financial crisis, too much credit is still a critical problem, particularly if it grows faster than gdp. Indeed, too much credit is weighing down emerging economies, such as China, which have been running up debt to maintain economic growth. Once touted as the next China, Vietnam has in fact beaten China to the endgame, but not the one it expected: Vietnam has already suffered a debt-induced economic meltdown and is only now beginning to pick up the pieces and shutter its insolvent banks.

To keep their economies humming, leaders need to make sure growth is balanced across national accounts (not too dependent on borrowing), social classes (not concentrated in the hands of a few billionaires), geographic regions (not hoarded in the capital), and productive industries (not focused in corruption-prone industries such as oil). And they must balance all these factors at a point that is appropriate for their countries' income levels. For example, Brazil is spending too much to build a welfare state too large for a country with an average income of \$11,000. Meanwhile, South Korea, a country with twice the average income of Brazil, is spending too little on social programs.

Many leaders see certain economic vices as timeless, generic problems of development, but in reality, there is a balancing point even for avarice and venality. Inequality tends to rise in the early stages of economic growth and then plateau before it begins to fall, typically at around the \$5,000 per capita income level. On this curve, inequality relative to income level is much higher than the norm in Brazil and South Africa, but it is right in line with the norm—and therefore much less worrisome—in Poland and South Korea. The same income-adjusted approach also applies to corruption and shows, for example, that Chile is surprisingly clean for its income level, while Russia is disproportionately corrupt.

#### ASK A LOCAL

No amount of theory, however, can trump local knowledge. Locals often know which way the economy is turning before it shows up in forecasting numbers. Even before India's economy started slowing down, Indian businesspeople foretold its slump in a chorus of complaints about corruption at home. The rising cost of bribing government officials was compelling them to invest abroad, although foreign investors still poured in.

There is no substitute for getting out and seeing what is happening on the ground. Analysts who focus on dangerously high levels of investment in emerging nations use China as a test case, since investment there is nearly 50 percent of gdp, a level unprecedented in any developed country. But the risk becomes apparent only when one goes to China and sees where all the money is going: into high-rise ghost towns and other empty developments. On the flip side are Brazil and Russia, where anemic investment levels account for grossly underperforming service sectors, inadequate roads, and, in São Paulo, the sight of ceos who dodge permanently clogged streets by depending on a network of rooftop helipads.

Economists tend to ignore the story of people and politics as too soft to quantify and incorporate into forecasting models. Instead, they study policy through hard numbers, such as government spending or interest rates. But numbers cannot capture the energy that a vibrant leader such as Mexico's new president, Enrique Peña Nieto, or the Philippines' Benigno Aquino III can unleash by cracking down on monopolists, bribers, and dysfunctional bureaucrats.

Any pragmatic approach to spotting the likely winners of the next emerging- market boom should reflect this reality and the fundamentally impermanent state of global competition. A would-be forecaster must track a shifting list of a dozen factors, from politics to credit and investment flows, to assess the growth prospects of each emerging nation over the next three to five years-the only useful time frame for political leaders, businesspeople, investors, or anyone else with a stake in current events. This approach offers no provocative forecasts for 2100, no prophecies based on the long sweep of history. It aims to produce a practical guide for following the rise and fall of nations in real time and in the foreseeable future: this decade, not the next or those beyond it. It may not be dramatic. But the recent crash high- lighted just how dangerous too much drama can be.©

#### **AuthorAffiliation**

RUCHIR SHARMA is head of Emerging Markets and Global Macro at Morgan Stanley Investment Management and the author of Breakout Nations: In Pursuit of the Next Economic Miracles.

Copyright Council on Foreign Relations NY Jan/Feb 2014

#### **Indexing (details)**

<b>Subject</b>	Emerging markets; Economic forecasts; International; Errors
<b>Classification</b>	1110: Economic conditions & forecasts 9180: International
<b>Title</b>	The Ever-Emerging Markets: Why Economic Forecasts Fail
<b>Author</b>	Sharma, Ruchir
<b>Publication title</b>	Foreign Affairs
<b>Volume</b>	93
<b>Issue</b>	1
<b>Pages</b>	52-56
<b>Number of pages</b>	5
<b>Publication year</b>	2014
<b>Publication date</b>	Jan/Feb 2014
<b>Publisher</b>	Council on Foreign Relations NY
<b>Place of publication</b>	New York
<b>Country of publication</b>	United States
<b>Publication subject</b>	Political Science--International Relations
<b>ISSN</b>	00157120
<b>CODEN</b>	FRNAA3
<b>Source type</b>	Scholarly Journals
<b>Language of publication</b>	English
<b>Document type</b>	Cover Story
<b>ProQuest document ID</b>	1468448017
<b>Document URL</b>	

[http://libproxy.nps.edu/login?  
url=http://search.proquest.com/docview/1468448017?  
accountid=12702](http://libproxy.nps.edu/login?url=http://search.proquest.com/docview/1468448017?accountid=12702)

**Copyright** Copyright Council on Foreign Relations NY Jan/Feb 2014  
**Last updated** 2013-12-17  
**Database** 4 databases [View list](#)

---

Copyright © 2014 ProQuest LLC. All rights reserved. [Terms and Conditions](#)