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# Emerging markets: Fixing a broken model

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As exports slow and foreign capital takes flight, developing nations must act to avert a crisis



Just under six years ago, Brazil's economy was in such robust shape that *The Economist* published a cover illustration showing the statue of Christ the Redeemer in Rio de Janeiro blasting off like a rocket. Not only were wealthy Brazilians enjoying the boom; stores selling white goods were springing up in the favelas, while budget airlines found new customers among the former poor. The “country of the future”, it seemed, was finally attaining its destiny.

But the rocket has now crashed to earth. Brazil's economy, which expanded at 7.6 per cent in 2010, is on course to shrink by at least 2 per cent this year. A trade surplus of \$20bn in 2010 has become a deficit of \$40bn in the 12 months to July. Job creation — 2m in 2010 — has turned to job destruction running at 150,000 a month.

Although several of Brazil's problems are self-inflicted, they are also

symptomatic of a broader malaise afflicting almost all emerging markets. Export-driven growth has collapsed. A credit-fuelled consumer boom has run its course, while corporate and sovereign debt levels have surged. Foreign capital, which so recently flooded in, is cascading out as emerging market currencies tumble along with commodity prices.

So serious are these frailties that a growing number of economists and investors see a fundamental reversal of fortune for emerging market countries. The dynamic economic models that allowed developing nations to haul the world back to growth after the 2008-09 financial crisis are breaking down — and threatening to drag the world back towards recession.

“The growth models are challenged overall and exhausted in some countries,” says Mohamed El-Erian, chief economic adviser to Allianz, and chair of US President Barack Obama’s Global Development Council. “It is not just that emerging market growth has slowed . . . the weakness in emerging markets disrupts the economies of the west and makes its challenges harder to face.”

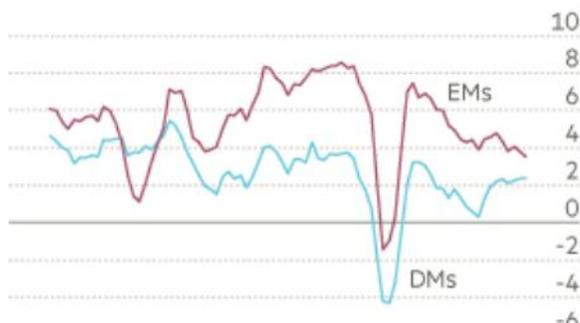
Neil Shearing, chief emerging market economist at Capital Economics, sees a similar problem. “The models of growth that served the largest emerging markets so well over the past decade have broken,” he says, naming the powerful Bric (Brazil, Russia, India and China) countries as examples.

China has become too reliant on investment and exports, he says, while failing to give sufficient support to consumer spending. Brazil has had almost the opposite experience, becoming too reliant on consumer spending at the expense of savings and investment. Russia is over-reliant on oil, while in India red tape and bureaucracy weigh heavily on investment and productivity.

Such shortcomings did not appear so critical when supplies of capital were abundant; generous inflows of funds offset a multitude of sins in debt-laden emerging markets. But following the US Federal Reserve’s cessation of its “quantitative easing” monetary programme last year, the growth in dollar liquidity has slowed. The Fed’s preoccupation with when to raise interest rates is adding to the turbulence.

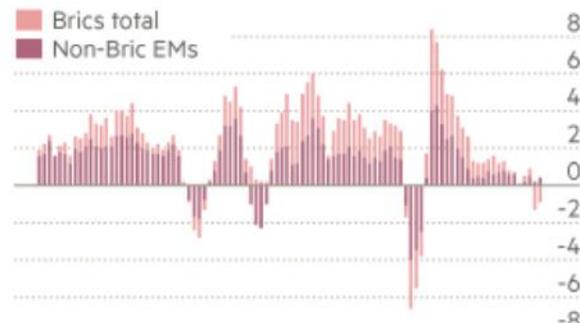
Emerging market GDP slows toward developed market levels ...

Real GDP growth  
Annual % change



... and EMs are now a net drag on global trade growth

EMs' input to trade growth turns negative  
Contribution to growth in goods trade (% points)



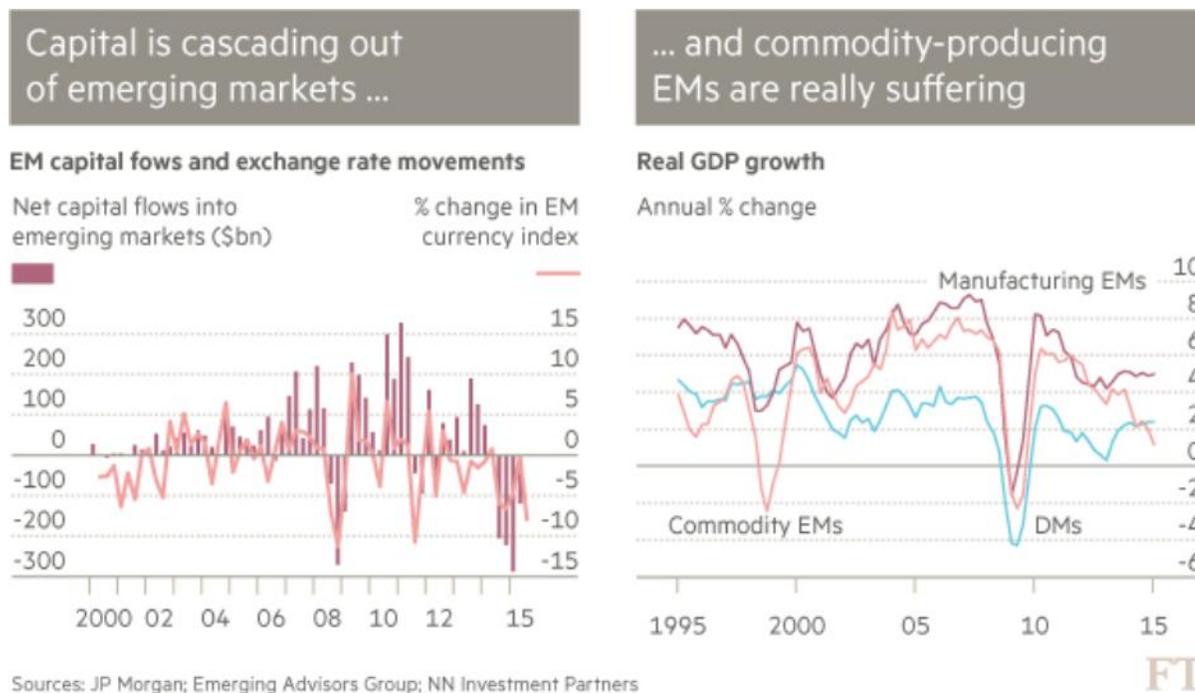
“The emerging market model is predicated on capital inflows but the cycle is now turning because US dollar liquidity growth is slowing,” says Atul Lele, chief investment officer at Deltec International Group, an asset management company. “This is pretty close to a crisis and it is going to get worse.”

## A real economy problem

The deepening malaise afflicting emerging markets — which account for 38 per cent of global gross domestic product in nominal terms and 52 per cent when calculated by purchasing power parity — derives primarily from real economic deficiencies rather than financial market stresses. For example, China’s waning growth trajectory, which has sapped global demand for commodities, is the product of Beijing’s ongoing transition from an outworn growth model that relied on investment in factories, property and infrastructure.

“Chinese policymakers accept that slower growth is a necessary consequence of their effort to rebalance the economy,” says David Lubin, head of emerging markets economics at Citi. “But that creates a problem for other developing countries, who had benefited from rapid, investment-led growth in China. Chinese growth now is neither rapid nor investment-led,” he added.

The result of these shocks is seen in dwindling growth. Oxford Economics, an advisory firm focused on economic forecasting, estimates that GDP growth this year in emerging markets will fall to 3.6 per cent, the lowest level since 2001, excluding the crisis year of 2009.



However, Oxford Economics estimates that if “real” growth in China is assumed to be 4 per cent this year — rather than the official 7 per cent — then overall emerging market growth for 2015 would fall to 2.7 per cent, the slowest since the 1997-98 Asian financial crisis (excluding 2009).

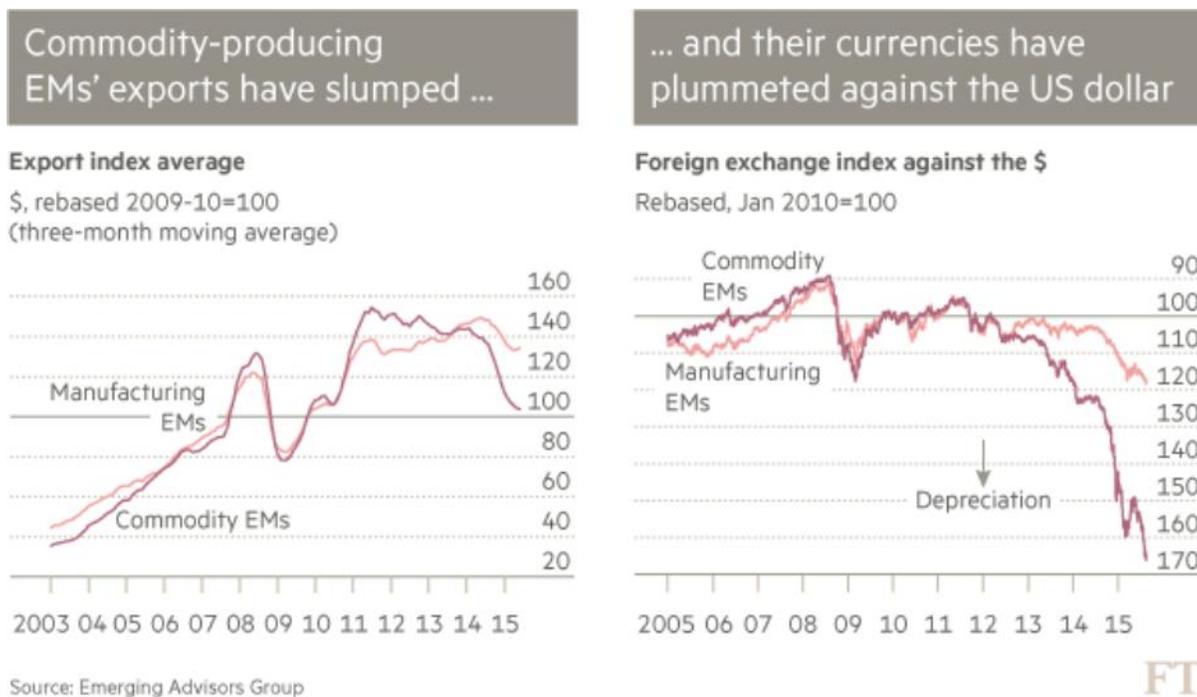
Oxford Economics is one of several research groups that estimates current Chinese growth at around 4 per cent.

“This slowdown means an important prop for world growth has been knocked away, especially as emerging markets comprise a bigger share of the world economy than they did 15 years ago,” says Adam Slater, economist at Oxford Economics. Mr Slater says that if a 4 per cent rate for China is assumed and GDP growth continues to subside in some developing nations this year, then “it is quite possible the number could end up below 2 per cent”. This, he says, would represent a lower level of global growth than in 2001-02, when the US was in mild recession.

## Trade blow

One of the main dynamics behind the downdraught is world trade. In the aftermath of the financial crisis, emerging market vigour added more than 8 percentage points to the growth in trade. However, in the first two quarters of this year emerging markets became a net detractor to global trade growth for the first time since the crisis, according to Oxford Economics.

At least part of the reason behind the waning trade performance is a vicious circle of cause and effect. Usually, the depreciation of a country’s currency helps to boost its exports by making them cheaper, but this relationship appears to have broken down this year, according to FT research, which compared the changes in value of 107 emerging market currencies with their trade volumes the following year.



The analysis found that while the sharp depreciations in most emerging market currencies have done nothing to boost exports, they have crimped imports because a depreciating currency makes imports more expensive. For every 1 per cent a currency depreciated against the US dollar, import

volumes fell 0.5 per cent on average, the FT study found.

Brazilian import volumes for the past three months are falling at a pace of 13 per cent year on year, according to estimates from Capital Economics, following a 37 per cent collapse in the value of the real over the past 12 months. Russia, South Africa and Venezuela have also seen imports fall in the wake of plummeting currencies. This phenomenon has deprived emerging market governments of the ability to export their way out of trouble, leaving commodity-exporting countries in particular at the mercy of currency tailwinds and plunging export revenues.

“The current environment is a perfect storm for those commodity exporting, current account deficit runners mostly to be found in South America, Africa and Indonesia,” says Michael Power, a strategist at Investec. “It could get worse before it improves. Hefty cuts in commodity production capacity are needed before a degree of equilibrium will return.”

The differential between those countries that rely on manufacturing and those that depend on commodity exports can be seen in the average return on equity by companies included in the MSCI Emerging Markets Index. RoE measures how much profit a company makes as a percentage of shareholder equity. Overall, the RoE of companies included in the MSCI EM Index has declined from 18.36 per cent in October 2008 to around 11 per cent, according to research conducted by Ecstrat, an asset allocation consultancy.

In commodity exporting countries, the decline is much more pronounced. For Brazilian companies, the RoE is down to 4.2 per cent from 21.9 per cent in late 2008, for Peruvian companies it is down to 12.3 per cent from 31 per cent and for Russian companies it is down to 7.1 per cent from 23.2 per cent.

By contrast, the RoE in manufacturing oriented Taiwan and Sri Lanka has risen since late 2008, while in South Korea it has moderated only slightly.

Underpinning such weaknesses is a cascade of capital gushing out of emerging economies as currencies slump in value against the dollar and the expectation of a tightening in the Fed’s monetary policy, which is expected to make US dollar-denominated investments attractive relative to those in emerging markets. Total net capital outflows from the 19 largest emerging market economies reached \$940bn in the 13 months to the end of July, almost double the net \$480bn that flowed out over three quarters during the 2008-09 financial crisis, according to NN Investment Partners, an investment bank.

Other analysts, adjusting for fluctuations in exchange rates, estimate capital outflows at much less than \$940bn, but the picture is obscured by a lack of clarity in national data on the composition of foreign exchange reserves. Nevertheless, says Maarten-Jan Bakkum, senior emerging market strategist at NN Investment Partners, “these outflows have much further to go”.

Mr Lele identifies a dynamic under which capital outflows and declining exports create downward

pressure on currencies, which then depreciate against the US dollar, increasing the cost of servicing foreign currency debts for emerging market companies. “The next shoe to drop will be defaults on emerging market corporate debt,” he says.

### Can crisis be averted?

But although the distress in emerging markets is intensifying, it would be rash to assume that a crisis is inevitable. Some emerging markets have the option to push through urgent structural reforms to cut bureaucracy, boost the private sectors’ role in the economy and provide incentives for employers. Other relatively strong economies — including China, India, Mexico, the Philippines, South Korea, Taiwan and others — have some latitude to boost fiscal spending to drive growth.

The need for new infrastructure, especially in India, China, most of sub-Saharan Africa and much of Latin America, is clear. Multilateral organisations including the new Chinese-led Asia Infrastructure Investment Bank are able to step up their programmes.

Mr El-Erian identifies four potential growth drivers: a return to pro-growth reforms; dealing with pockets of financial excess, such as in China; improving the composition of the demand side of the economy; and bolstering the global financial architecture. But, he says, it is important for the west to realise that emerging market distress is not merely a developing world problem. Developed and developing world fortunes are so interlinked that the demise of one is sure to bring down the other.

Western policymakers, Mr El-Erian says, are like worried housebuyers. “It used to be that (they) worried only about the house, while the neighbourhood was fine. Now they have to worry about both.”

### Letter in response to this article:

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