

Emerging markets are up and running

Out of the traps

The Economists

Oct 7, 2017

After a rocky few years, emerging markets have become more mature and resilient, says Simon Cox. But along with the drama, some of their dynamism has gone

IN 1875 THE Ottoman Empire defaulted on half its foreign debt, a victim of the “first major debt crisis of the developing world”, according to one account of the mess. Its creditors, led by the Imperial Ottoman Bank, forced the empire’s grand vizier to accept a humiliating solution. Rather than wait to be repaid out of tax revenues, they won the right to collect half a dozen taxes themselves, including stamp duty and duties on alcohol. After 15 years of tax farming, the Imperial Ottoman Bank was comfortable enough to build impressive new headquarters in Istanbul, neo-orientalist in style on one side and neoclassical on the other.

Since long before the term was invented, emerging markets have provided a rich source of both peril and profit. That financial crisis in 1875 was followed by many others, including a hatful in Turkey. And like the Imperial Ottoman Bank, investors with strong stomachs have often profited the most from emerging markets at their worst. Hedge funds that bought impaired Argentine debt for roughly 20 cents on the dollar after its default in 2001 extracted a handsome settlement from its new government last year, worth perhaps ten times what they paid, according to some estimates.

The more recent history of emerging markets has also tested plenty of stomachs. Within days of Donald Trump's election victory his populist promises raised American bond yields, sending the price of emerging-market assets the other way. Trading partners winced at his tweets threatening American companies planning to shift their production abroad. This "Trump tantrum" appeared to be the latest in a grim sequence of setbacks for emerging markets. It followed China's botched devaluation of the yuan in 2015, the collapse in oil and iron-ore prices in 2014 and the "taper tantrum" in 2013, when mere talk of a slowdown in asset purchases by America's Federal Reserve threw emerging markets into turmoil. The Trump tantrum came on top of political risks arising in emerging markets themselves, including Russia's invasion of Ukraine, the Philippines' war on drugs, a successful coup in Thailand in 2014 and a failed one in Turkey in 2016, the removal of an unpopular president in Brazil for a fiscal misdemeanour, and the survival of embattled rulers in South Africa and Malaysia.

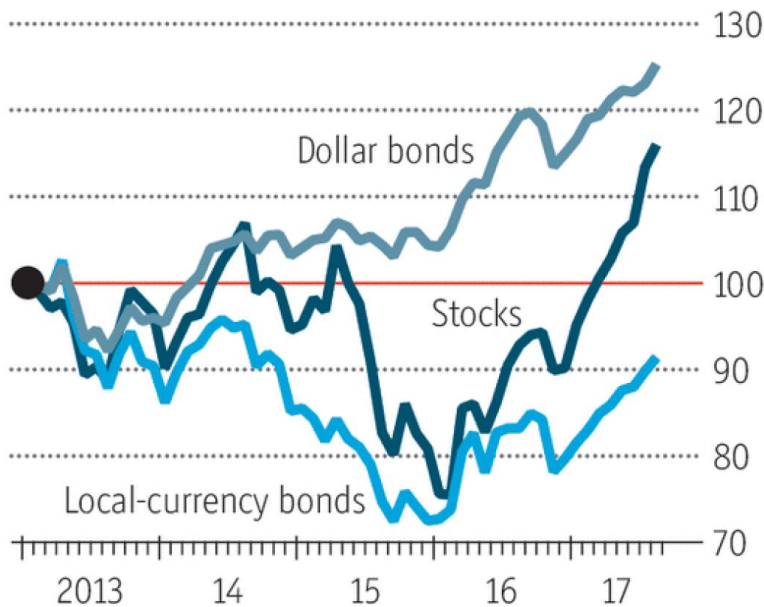
The presidency of Mr Trump, an avowed opponent of "globalism", has coincided with a noticeable recovery in globalization. Strange as it may seem, though, the presidency of Mr Trump, an avowed opponent of globalism, has coincided with a recovery in globalisation. In the first half of this year the volume of emerging-market exports was 4.6% up on a year earlier, the fastest growth since 2011, according to the Netherlands Bureau for Economic Policy Analysis, a government agency. The growing demand for semiconductor chips and sensors lifted South Korea's and Malaysia's electronics exports; the recovery of the oil price bolstered Russia; and a favourable turn in the weather benefited Brazil's harvest of soyabeans and corn.

Higher exports have helped lift GDP. In the first half of 2017 the four biggest emerging economies (Brazil, Russia, India and China, known as the BRICs) all grew simultaneously for the first time in three years. Emerging-market growth still cannot match that in the miracle years of 2003-06, but it has been equally broad. So far 21 of the 24 countries in the MSCI emerging-markets index, the most popular stockmarket benchmark, have reported GDP figures for the second quarter

of this year, and all of them were up on the previous quarter. Not since 2009 has growth been positive in every member that publishes quarter-on-quarter numbers.

Pointing the right way

Emerging markets, total returns, \$ terms
January 2013=100



Source: Thomson Reuters

Economist.com

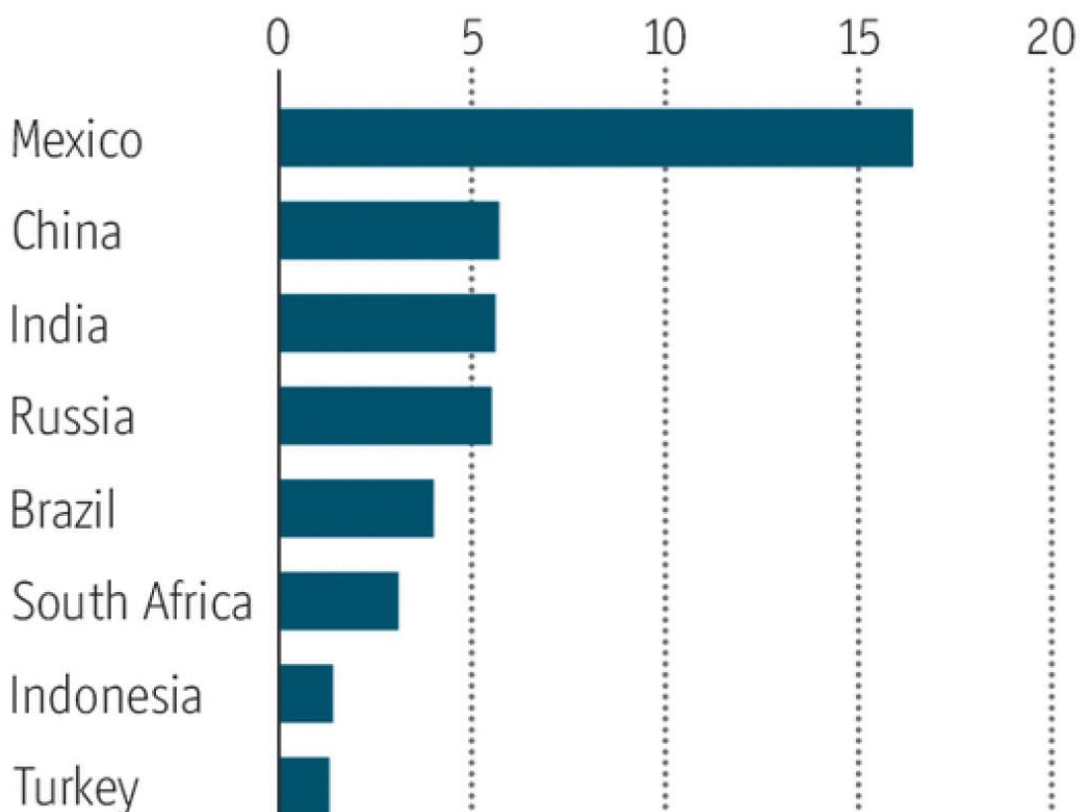
This improvement in emerging-market growth has been accompanied by renewed enthusiasm for their currencies, bonds and shares (see chart). In August these countries recorded their ninth month in a row of capital inflows from portfolio investors, the longest streak since 2014, according to the Institute of International Finance. An index of emerging-market exchange rates compiled by MSCI has risen by 14% since its trough in January 2016. It has enjoyed its best 18 months since 2011. Even ill-favoured currencies such as the Russian rouble, Mexican peso and Chinese yuan have defied their doubters, strengthening against the dollar this year (see chart below).

The price of emerging markets' "hard-currency" dollar bonds rose by over 6% in the first half of the year, according to J.P. Morgan. And bonds denominated in their own, hardening currencies did even better, rising by double digits. But nothing has been as eye-catching as their stockmarkets. The MSCI EM index rose above 1,000 in May from below 700 in January 2016, an annualised gain of about 33%.

Strength in numbers

Currencies against the dollar

% increase Dec 31st 2016-Sep 20th 2017



Source: Thomson Reuters

Economist.com

The strength of the rally makes many old hands nervous. The history of emerging markets is full of imprudent investors as well as improvident borrowers. The delusion of those parting with their money often matches the myopia of those squandering it. In 1895, for example, a stockmarket boom prompted one big international bank to nearly triple its loans in two years. The bank's own manager peddled South African mining shares such as the Transvaal Consolidated Land and Exploration Company. When the shares crashed, the bank suffered a run, turning to the government and its London owners for a bail-out. This reckless financial institution was none other than the Imperial Ottoman Bank that had grown rich from tax farming a few years earlier.

Pessimists can find a number of reasons to worry, some traditional, others more novel. Classic emerging-market crises often begin in Washington, DC, when the Fed raises interest rates or tightens monetary policy in other ways. So nerves will jangle if an uptick in American inflation pushes the Fed to increase rates faster than the market now expects. And for a new variation on this old theme, investors can fret about the Fed's recent decision to begin trimming the assets it bought after the global financial crisis.

The commodity cycle is another time-tested source of instability. The halving of oil prices in the second half of 2014 inflicted great pain on Russia and other crude exporters. Conversely, costly oil in the years before 2014 added to the chronic trade deficits and inflation suffered by countries such as India and Pakistan. The Latin American debt crisis in 1982 was caused by a combination of a commodity shock and a Fed shock. The petrodollars earned by Gulf exporters during the oil-price spikes of the 1970s were deposited in American banks, which lent them incautiously to Latin American governments. These loans then became impossible to repay when the Fed raised interest rates sharply in 1979-81.

The have-nots

Countries not blessed with commodities have worries of their own. The only natural resource in many emerging markets is manpower, but a growth model based on labour-intensive manufacturing now faces two unaccustomed threats. One is automation. The growing versatility and user-friendliness of robotic technology may be eroding the advantages of cheap labour, resulting in what economists call “premature deindustrialisation”. Post-industrial rustbelts are common in rich economies like America. The fear is that emerging-market industries will turn rusty before their people grow rich.

Another threat is protectionism. Emerging economies have always relied on access to the world’s biggest markets for their exports. But the Trump administration is keen to reduce America’s trade imbalances, and has become more active in imposing anti-dumping duties and other tariffs on goods it considers too cheap. It has so far opened investigations into 65 potential cases of dumped or subsidised products (from Chinese staples to Colombian citric acid), compared with 44 in the same period of 2016.

As some countries worry about exporting to America’s market, others worry about importing its politics. In both Brazil and Mexico, the candidates for the next presidential election include outspoken populists who draw strength from battling with Mr Trump or mirroring his provocations. Emerging markets have traditionally had a strong comparative advantage in populism. But that is another imbalance Mr Trump seems keen to correct.

This special report will examine each of these dangers in turn. It will argue that emerging economies in recent years have become more resilient, albeit less vigorous, losing some drama as well as some dynamism. That should allow their recovery to continue despite the threats they face.

A lot of emerging-market investors are “waiting for the good old-fashioned crisis”, said Mark Dow, a money manager and former IMF economist, in a podcast interview late last year. In their experience, “it always ends with a blow-up...it’s happened so many times for so many of the old wizened EM hands that they are conditioned to believe it has to be like that again.”

It does not, but plenty of doubters remain. In particular, the failure of emerging markets to deal effectively with earlier shocks (such as higher oil prices in the 1970s, tighter Fed policy in 1979-81 and mightier Chinese manufacturing in the 2000s) has contributed to a lingering concern that middle-income countries are more likely to become “trapped” as they develop, marooned somewhere between poverty and prosperity.

If the “middle-income trap” were found to be real, it would pose a more serious problem than ever before. Countries at that intermediate level of development account for a growing share of the world’s GDP and its people. The global economy could not prosper if such an enormous part of its population and production were to become thus ensnared. Fortunately, as this report will argue, the trap is a myth.

This article appeared in the Special report section of the print edition under the headline "Out of the traps"