Emerging Markets:

The Time has Come?

The FT's Emerging Markets Editor, **James Kynge**, traces the rise and changing nature of EMs, and what might 'spoil the party' for them

Emerging markets are at a historical inflexion point today. In 2017, they accounted for well over half of both global GDP (~58 per cent, up from 42 per cent in the mid-1990s) in PPP terms, and of world GDP growth (60 per cent) in nominal terms. What was once the periphery has become the core: the hub of all action, and the dynamo of growth. Contrary to common perception, this is not just a 'China story', though China does have a very considerable part to play, with an 18 per cent share of global GDP, and a 70 per cent share of the growth emanating from emerging markets. What is now underway is an EM boom that includes China, but which draws its impetus from outside China.

This shift in the world's economic 'centre of gravity' gathered steam during the Global Financial Crisis. At the time, it was really the EMs – and especially China, with its huge, 22 trillion Renminbi stimulus programme – that saved the world from falling into deep depression. Yet there were limits even to what China could do, and eventually, it slipped from its 10 per cent + growth rates, pulling down the commodity-dependent EMs with it. Emerging-market fortunes hit a nadir in 2015, when a commodity super-cycle in terminal decline, and the so-called 'Taper Tantrum', threatened to drag EM growth below that of the advanced economies. The crisis passed, and in the last few years, EMs have again pulled away, led by a definitive shift towards a new, more diversified, less commodity-dependent growth model. The upshot is EMs are far less volatile than even a few years ago. With the West slowly coming to terms with this shift, EMs are fast becoming the centre of action in terms of both direct and portfolio investment.

> The GFC accelerated the shift in the world's economic centre of gravity to EMs, with China's massive stimulus package pulling the globe away from the brink of depression

GROWING ECONOMIC HEFT...

The IMF projects that in 2018, world GDP growth will rise from 3.9 per cent to 4.1 per cent, with the advanced economies growing at 2.4 per cent (up slightly from 2.3 per cent in 2017), and the EMs at a much-faster 5.4 per cent (5 per cent last year). Within the EM world, Latin American growth will jump from 1.1 per cent to 2.5 per cent, led by a reviving Brazil, while the Europe, Middle East and Africa region is expected to remain steady at about 2.5 per cent. However, as it has for over a decade, and as it probably will well into the future, it is Asia, growing at 6.2 per cent, that will lead the way – the 'star' within this 'hub' of world growth. India, with 7 per cent forecast growth – higher than China's 6.5-6.6

per cent – will likely be the world's fastest-growing major economy in 2018. Consequently, after years of being burdened with the cliché about being the 'elephant' to China's 'dragon', it is at last being viewed as a major, sustainable engine of growth. Like with the China of the late 1990s, people now realise that India is no 'flash in the pan' – and despite its many challenges, it has finally become an investment magnet that no one can ignore.

...AND CHANGING GROWTH MODELS

Looking beyond growth rates and economic heft, what is most striking today is the changing nature of EM growth models. For decades, Africa, Latin America and large parts of Asia rose and fell with commodity prices, but today, they are no longer as beholden to the commodity cycle. Simply put, they have managed to diversify, becoming more consumer- and service-oriented, highly entrepreneurial, more gender-inclusive, and at the forefront of innovation, including on green and digital technologies. From Sub-Saharan African solar power companies like Mobisol, which sells cheap solar panels on monthly instalments to users in remote villages, and Thai sharing-economy start-ups like Good Meal Hunting, to Chinese firms like Bright Foods that source and build billion-dollar domestic brands around high-quality French milk or obscure Bulgarian probiotics, they are revamping their business models and supply chains. Strikingly, EMs are deriving much of their growth not so much from foreign demand, but internally, and moreover, a rising share – about 40 per cent today – of their trade is with other EMs.

> Emerging market MNCs are not only revamping their business models and supply chains, but also deriving much more of their growth from foreign demand

There are important structural driver, too, such as better governance – particularly in terms of economic reforms – and infrastructural spends. This is apparent everywhere from South-East Asia to East Africa, with countries like Ethiopia, Kenya, Tanzania and Rwanda witnessing an investment boom. Crucially, as well, there is a major ongoing supply-chain diversification away from China. Led as much by hedging strategies as by market-size and cost considerations, both Chinese and Western MNCs are now moving capacity out of China. Vietnam is the clear winner in this regard, followed by places like Cambodia, Laos, Indonesia, Bangladesh, Thailand, the Philippines, and India.

The Rise of EM-MNCs

At the company level, there are equally profound shifts underway, with emerging-market MNCs expanding and globalising far more rapidly than their peers from the advanced economies. A BCG study finds, for instance, that between 2009 and 2014, the revenues of EM companies within the top 100 global firms across 63 sectors – a list that includes 16 Indian firms – grew far more rapidly (13 per cent CAGR) than that of their advanced-economy peers (4 per cent). From 18 per cent of the total, their share jumped to 25 per cent in just 5 years. As importantly, between 2005 and 2014 these 'global challengers' managed to quadruple their international revenues, from USD 236 billion to USD 944 billion. Significantly, despite a major downturn in 2015, they have vastly outperformed on the stock market, recording to a five-fold rise, compared to a doubling of share prices for mature-market MNCs. Being the world economy's 'best story' today, they can expect to attract far more investment capital from the West.

...LED BY TECHNOLOGY...

A big change-driver is the great technological 'jump' that is taking place in EMs. By 2025, China will have more trained STEM (science, technology, engineering and math) workers than all the OECD countries combined – and similar trends are visible in India. This will allow them to become the technology 'dominators' of the future. China, in particular, has fully embraced the digital economy, with its share of global e-Commerce sales rising from less than 1 per cent in 2005 to over 42 per cent in 2016, more than either the US (24.1 per cent) or the rest of the rest of the world (33.5 per cent). Alibaba alone recorded sales of USD 25 billion during its recent 'Singles Day'. Chinese mobile payments, meanwhile, were worth USD 790 billion in 2016 – ten times that of the US. Most interesting, in terms of

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both number (34 per cent, compared to 47 per cent) and value (43 per cent and 45 per cent), China's share of the global 'unicorn' (start-ups worth over USD 1 billion) market is approaching America's. Places like Shenzhen are now competing with Silicon Valley as global hubs for technology, sometimes creating the sorts of things – self-flying single-person taxi drones that will soon have a test-run in Dubai– that may not even receive regulatory approval in the West. As a result, they are, in many ways, starting to bypass the developed world, innovating faster, better and cheaper, and finding new ways to boost commercial margins.

...AND A 'GRASSROOTS GROUNDSWELL'

While the idea of a huge EM middle-class has captured everyone's imagination, equally important to long-term growth are the people who fall one level below – those who are becoming middle class. These 'grassroots' consumers have left behind subsistence living, and are now taking the first steps towards discretionary spending. In China, the ranks of the affluent, the middle-class and the 'emerging' consumers (those with annual incomes of 54,000 Renminbi – about USD 8,000 – or more in 1995 prices) will swell, the latter by 100 million. Meanwhile the number of people who fall below the lowest of these thresholds will, having already halved from about 400 million in 1995, will halve again, to about 100 million in 2025. In short, between 1995 and 2025, some 300 million people will have moved from subsistence to discretionary spending. BCG forecasts similar trends for India, where the share of 'strugglers' – households with incomes below USD 2,300 – is expected to drop from 31 per cent in 2016 to 18 per cent in 2025. Across the emerging world, this trend is gaining momentum, and once started, it is unlikely to slow. Eventually, it will drive both consumption and growth. People who could never have imagined owning anything are renting houses and buying mobile phones and cars – and in turn, using those to start and run small businesses. India's affordable housing boom is a case in point, as are the some 625 million Sub-Saharan Africans without electricity who might, in the next 5-10 years, get a power connection, possibly solar-powered, for the first time in their lives. All of this feeds into the strength and stability of domestic demand, and decreases volatility.

CAN IT LAST? TWO DARK CLOUDS...

A receding tide of liquidity?...

There are two main threats to an otherwise upbeat picture of emerging market growth. The first is the huge infusion of liquidity created by central banks since the GFC, and what might happen when this recedes, particularly if it happens too quickly. So far, this tide of liquidity has lifted all boats, but there are serious downside risks to the scenario, with the US Fed having raised rates 5 times in 18 months, and likely to do so 3-4 more times this year. The Bank of England is also seeing an uptick in inflation, while the ECB plans to raise rates sooner if not later. The 2015 Taper Tantrum, and more recently, the

turmoil in global financial markets over US inflation and interest rates, are a foretaste of what might happen if investors pull out of EMs to shift to 'safer' or 'higher-return' US equities and bonds. Especially vulnerable are countries with low growth, high foreign debt, and large current account deficits (CADs).

Yet, there is another, more positive side to this picture. Not many realise that China accounts for most of the ~USD 40 trillion of new money that has come into the global system since the GFC, with the Western central banks creating 'only' about USD 11 trillion on net. Panicked by the loss of some 33 million Chinese manufacturing jobs in just three months at the end of 2008, Beijing launched a stimulus that single-handedly prevented the world economy from collapsing. The money it created has been going into infrastructure spending, and towards buying up companies all over the world. Since then, it has had to ride this monetary 'tiger', which has given rise to all sorts of issues, including problems with shadow and curb-side finance. Its debt-GDP ratio has swollen to 260 per cent, and it is now by far the world's most heavily indebted economy. Normally, this might signal an impending crisis, but in China's case, most of its lending is 'within the family' – from the state, to either state-owned or quasi-state enterprises. The biggest chunk of debt – 170 per cent of GDP – is held local-government finance vehicles. There is virtually no chance that China will 'call in its debt', and in fact, it can continue to lend at the current, ~10 per cent YoY rates, for another 10 years. Given that China also heavily controls its stock and bond markets, the risks of a serious crisis are very low.

At the same time, EMs themselves have become much more resilient since the GFC. Realising the dangers of large foreign-currency borrowings – which can quickly

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turn against them if the domestic currency depreciates sharply – they have become much more disciplined about currency exposures. In the last few years, they have borrowed massively, but mostly in the local currency, and via the bond markets. (India, for one, would no longer count among the 'Fragile Five', as it did when the last crisis hit.) Resultantly, even if US or European interest rates move up quickly – which is unlikely, since it would constrain Western demand, bring down inflation, and thus be self limiting – investors may still prefer to stay invested in the EMs. Given their stronger growth trajectories, after all, the potential longer-term returns are much greater.

...and a retreat from globalisation

The second main risk to the EM growth story is the West's darkening mood towards globalisation. Since World War II, the number of democracies and trade as a share of global GDP have risen in lock-step, creating wealth and income on a global scale like never before. (Democracies tend to have more open trading regimes, which generates more income from trade.) Today, however, this happy trend may have peaked, especially with Americans and Europeans becoming increasingly disenchanted with their lot – reflected in Brexit, the rise of Donald Trump, and anti-globalisation. What is driving this, at heart, is that, for as much as 70 per cent of the population in these countries, there has been no increase in real income since 2005, with some people even seeing declining incomes. Instead of getting rich, the middle class is getting slightly poorer each year – at least in relative terms. The risk is that this will cause the advanced economies to shrink away from globalisation, perhaps even from the idea of democracy as something sacrosanct. New barriers to trade and immigration, the possibility of a trade war, particularly with China, and more 'self-inflicted' damage, such as a break-up of the common currency, may eventually yield a balkanised, less prosperous world.

One possible safeguard that may prevent matters from spiralling out of control is that China knows all of America's big pressure points, and it is not afraid to press them. It may not resort to dumping vast quantities of US Treasurys – after all, that would create a global crisis that would suck China in, too – but it could target US goods, including those, such as sorghum, that are produced in American states vital to Donald Trump's power base. It will also exert pressure on the business interests of the US President, his family and his administration. Mr Trump himself may prove to be a paper tiger when it comes to trade policy – and has even hinted at reversing his stand on the TPP. Hopefully, all of this will limit the damage to some nasty rhetoric, without triggering a full-blown trade war. ■

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