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A Time of Upheaval: Why Emerging Markets Will Lead the Global Recovery

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KEY CONCLUSIONS

- The emerging market countries are now poised to lead the global economy. The OECD countries will have trend growth rates in the 1.5%-2.5% range during the next decade compared to growth rates three to five times as high in the emerging market countries.
- The financial crisis has hurt emerging market countries in four major ways: it reduced trade, it depressed commodity prices, it slashed capital flows, and it produced large stock market declines and wealth losses.
- The emerging market countries were better prepared for this crisis than previous ones. They had nearly $5 trillion in forex reserves. Their banking systems had higher capital ratios and less leverage than in past crises.
- China has emerged from the crisis as a clear winner. Its fiscal and monetary policies will boost growth back to 9-10% next year. It has take advantage of declining commodity prices to make nearly $80 billion of new investments in natural resource assets around the world.

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There is now far greater optimism about both the global economy and the emerging market countries than prevailed just three months ago. It appears that US output growth could be as high as 4-5% during the third quarter because of the unwinding of inventory liquidation, rising home starts, and the Obama fiscal stimulus. There was a modest uptick in German and Japanese output growth during the second quarter. Many Asian countries also recorded healthy turnarounds during the second quarter after severe declines in output late last year.

There is still caution among forecasters about the intermediate-term outlook in developed countries because of the financial legacy of the recent crisis. The US household sector is in the midst of deleveraging and the personal savings rate could rise further next year. If it does, there will be only a modest revival of consumer spending and the US economy could follow a W-shaped growth pattern. Spain, Ireland, and Britain will also be constrained by the unwinding of property booms and deleveraging. Japan's new government intends to pursue populist spending policies, but it cannot escape the fact that Japan's public debt will soon exceed 200% of GDP.

The emerging market countries fared far better in the recent financial crisis than most analysts would have expected on the basis of past history. The previous major emerging market crises were in 1994 (Mexico), 1997-98 (East Asia, Russia), 1999 (Brazil), and 2001 (Argentina). The current crisis did not start in the developing countries. It, instead, was centered on the US financial system and specifically high risk mortgage lending.

The major role played by the developing countries in the crisis was to create surplus liquidity, which helped to nurture property inflation and greater risk taking by fund managers three years ago. During the period 2004-2008, the developing countries ran an aggregate current account surplus of $2.5 trillion. These surpluses depressed global bond yields despite rising short-term interest rates in the US. The low bond yields encouraged mortgage borrowing in the US, and increased the risk appetite among fund managers. Wall Street satisfied this demand by securitizing a large volume of US subprime mortgage loans. Federal Reserve Chairman Ben Bernanke and Alan Greenspan have tried to assign much of the blame for the recent crisis on the excess saving of developing countries in order to lessen criticism of US monetary policy. There is little doubt that excess saving played a role in creating the crisis, but it does not absolve the Federal Reserve from taking responsibility for low interest rates and highly permissive bank regulation.

The financial crisis has hit the emerging market countries in four ways:

Firstly, it generated a major downturn in global trade. The WTO is currently estimating that global trade could decline 10% this year which is more than during any business cycle since World War Two. The high growth emerging market countries of East Asia depend heavily upon foreign trade.

Secondly, it set the stage for a major downturn of commodity prices. Latin America and Africa depend heavily upon exports of base metals and agricultural commodities. Russia and the Middle East depend very heavily upon the exports of oil. The African growth rate could dip as low as 1.5% this year from growth rates in the 5-6% range during the past four years. As a result of falling diamond sales, Botswana’s economy could contract by 10% this year following three decades of 7-8% real GDP growth.

Thirdly, the crisis has jeopardized capital flows. The IIF estimates that capital flows to developing countries will fall from $887 billion in 2007 to $140.5 billion this year. The developing countries entered the crisis with over $5 trillion of forex reserves. The East Asian countries had especially large reserves because of their devastating experiences during 1997-98. But the Baltic countries entered the crisis with large current account deficits after several years of rapid credit growth and robust consumption financed by the Swedish banks. Beginning in 2007 and intensifying with the onset of the financial crisis in 2008, the Swedish banks panicked over the large deficits and cut them off. As the Baltic countries have pegs to the European currency, they have had to pursue highly deflationary monetary and fiscal policies. Their real GDP has been contracting at a 20% annual rate. Bulgaria has also suffered from its currency board peg to the euro.

Finally, the crisis produced large stock market declines and wealth losses in the emerging market countries. At the peak in 2007, the emerging markets had an aggregate stock market capitalization of over $17 trillion or nearly as much as New York. During the year through March, many suffered larger declines than New York. In China, stock market capitalization fell from $3.7 trillion to $368 billion. In Bombay, it fell from $1.8 trillion to $610 billion. In Brazil, it fell from $1.4 trillion to $593 billion. In Hungary, it fell from $56 billion to $12.6 billion. There have been major rallies in many countries since March, but the declines of late 2008 and early 2009 were still devastating for many investors. They had hoped that the emerging markets would decouple from New York, not fall by more.

Iceland had a major crisis last year because the failure of Lehman set the stage for a run on its three largest banks. They lost access to wholesale funding and declared bankruptcy in October. The causes of this crisis were not just financial. They were also geopolitical and turned Iceland into an inadvertent casualty of the end of the Cold War.

The US occupied Iceland in 1942 and built a major air/naval base there. After the war ended, the base played a major role monitoring Soviet naval operations in the North Atlantic. The US closed the base three years ago. There is an old tradition that countries with major US military bases never default. This principle was last demonstrated in South Korea during 1997. There was a run on South Korea’s banks which depleted the country’s forex reserves. Default appeared imminent, but the US intervened. The IMF immediately offered loans. Treasury Secretary Robert Rubin and Fed Chairman Alan Greenspan called global bankers to request that they roll over South Korea's loans. Citibank protested the low yields on South Korean loans, but in the end obliged.

If the US military base in Iceland had remained open through 2008, history would have taken a very different turn. Investors would have remembered South Korea and taken some comfort from the fact that Iceland had a major US military base. The IMF would have offered loans as soon as Iceland's currency began to weaken. Treasury Secretary Hank Paulson would have called European bankers asking that they maintain Iceland's credit lines. The Pentagon would have informed Her Majesty's Treasury in London that they should not invoke a terrorism law to seize the assets of Iceland's largest bank. Iceland should try to regain the US base even if it would no longer have any military function. The lesson for investors from the Iceland experience is to pay attention to which countries have large US military bases. They could help to compensate for a country running large current account deficits.

The developing countries were better prepared for this crisis than previous ones because they learned from the East Asian experience of 1997-98 and greatly strengthened their banking systems. The only developing country which has experienced major banking problems this year is Nigeria. The Nigerian banks helped to finance a stock market boom last year through a large increase in margin lending. When the market cracked, their non-performing loans skyrocketed, and the government recently felt compelled to seize five major banks. Many developing countries also benefitted from the fact that foreign institutions now control a large share of their domestic financial system. In Eastern Europe, the foreign market shares run 60% to 90%. Croatia also imposed a tax on bank lending growth which exceeds 25%. This tax prevented the kind of lending excesses which occurred in the Baltic countries.

The crisis has produced a major shift in the global balance of power in the banking sector. In 1999, 29 of the world's 50 largest banks were from the US, 11 were continental European, 7 were British, and 6 were Japanese. The world is very different today. The US now has only 11 of the top 50 banks. China has 6, Brazil has 3, Russia has 1, India has 1, and Hong Kong has 1. Britain has 3 and continental Europe still has 11. Canada and Australia both have 9. The three largest banks in the world by market capitalization are now Chinese.

The developing countries responded to the crisis with monetary and fiscal easing. There have been large interest rate declines in Chile and Brazil. Several Asian countries, including Singapore, South Korea, Taiwan, and Malaysia, have pursued more expansionary fiscal policies. Their central banks have also cut interest rates. India could not pursue a highly stimulative fiscal policy because it already had a large budget deficit, but the central bank did ease decisively. The East Asian countries have the potential to pursue highly expansionary fiscal policies because they have large forex reserves. They are not constrained by large external deficits as was the case ten years ago.

The emerging market countries will be very sensitive to any upturn in global trade. Their ratio of exports-to-GDP grew from 10% in 1960 to 36% last year, but they do not depend solely on the old industrial countries. The ratio of trade with US, Europe, and Japan is only 16% of GDP compared to 20% for other emerging market countries. The countries which depend heavily upon trade include Singapore (120% of GDP), Malaysia (90%), Slovakia (70%), Czech Republic (65%), Thailand (60%), and Estonia (45%). The countries which did not suffer serious downturns this year typically relied less on trade. They included Poland and Indonesia.

There is little doubt that the major winner from the crisis so far has been China. China has been successful at stimulating growth through fiscal and monetary policy. China announced a major infrastructure spending program in late 2008 which is now unfolding. China eased credit and monetary policy after clamping down on property loans during 2008. The results have been dramatic. Bank lending grew by over $1 trillion during the first half of this year. There has been a major upturn in home sales. Most analysts are now projecting that China will return to 9-10% output growth in 2010.

China also has been taking advantage of the crisis by making large natural resource investments. In the early months of 2009, it announced government to government deals for oil investments worth $25 billion in Russia, $10 billion in Brazil, $10 billion in Kazakhstan, $5 billion in Ecuador, and $4 billion in Venezuela. China has also been making bids for public companies in Canada and Australia. It has been purchasing companies with large oil reserves in Syria, Iraq, and West Africa. It has been buying base metal and coal mining companies. It nearly invested $18 billion in the Anglo-Australia mining group RTZ. Ironically, China's bidding for base metals in March and April pushed up commodity prices and caused a sharp rally in the RTZ share price. The management decided to cancel the China deal and instead raise capital through a rights offering.

The total value of China's deals during the past nine months is nearly $80 billion. China's leading oil company also just announced that it has obtained $30 billion from the China Development Bank to pursue further global expansion. This announcement suggests that China will be making new bids for raw material companies during 2010.

There is now a general expectation among economists that the emerging market countries will have to play a growth leadership role for many years to come. It will be difficult for the US to regain its former status as a growth leader. Its household sector is deleveraging. The government is running multi-trillion dollar deficits which will someday require some combination of large tax hikes or deep spending cuts. Japan also has massive fiscal deficits while the country's population is shrinking. The most Japan can hope to achieve is 1.5% growth. The

European economy will also be constrained by large fiscal deficits in the short term and declining populations in the long term. The Bundesbank believes the long-term trend growth rate of the German economy can be only 1.5%.

The emerging market countries have several clear advantages over the old industrial countries.

First, their labor force growth will be 1.5-2.0% higher than the OECD countries. Their populations are still 40% rural, so there is a great deal of surplus labor which can be redeployed.

Second, the emerging market countries have an investment rate averaging 27% compared to 21% in the OECD countries. The numbers are quite diverse on a country basis, but they are generally higher than the old industrial countries. In China, the investment-to-GDP ratio is over 45%, and in India it has climbed to nearly 35%. In Malaysia, it has fallen from nearly 40% before the East Asian crisis to less than 30% today.

Third, the emerging market countries have enjoyed higher productivity growth rates than the OECD countries. East Asia has averaged 6.0% for many years compared to 2.0% in the OECD. Eastern Europe has averaged 3.0% since the end of communism while Latin America has been only 2.0%. The laggard is Africa at 1.0%, but there has been a major improvement in the performance of the African economies since 2003, which should boost this number in the future.

The emerging market countries must still confront many governance issues. China is not yet democratic. Thailand has a history of coups. Argentina often succumbs to populism. Venezuela has fallen under the control of an authoritarian populist. The Philippines could easily elect another movie star as president. These governance issues reflect each country's historical circumstances. Latin America suffers from tremendous income inequality and a dependence upon raw material exports which produces a rent collection mentality. The East Asian countries have become democratic after a long history of benign dictatorships and political immaturity.

The final legacy of the recent crisis will be attempts by governments to strengthen regulation of banks and improve risk management. There is a general consensus that banks should hold more capital and reduce leverage. Switzerland imposed a rule that its leading banks can only be levered twenty times. Two years ago, UBS was levered sixty times.

There are also demands from many politicians that banks should reduce the bonuses and salaries of their employees. The fact that many banks have had to accept capital from governments has made them a natural target for political criticism. The issue has also become heated in the US because of the failure of the legal system to put more financial criminals in jail.

In the late 1980's, the US had a major crisis in its thrift industry. 1,023 S&L's with over $500 billion of assets failed. Many failed because of real estate loans which involved fraud and corruption. The government had to spend over 2.1% of GDP cleaning up the mess. In the next four years, the government put over 3,500 bankers in jail. One thousand of them were senior insiders. The government has been far less effective this time. It has indicted a few hundred people, but it has not convicted any senior insiders. The main problem is inadequate resources. After the 9/11 attacks, the FBI transferred 500 agents from white-collar crime to anti-terrorism. As a result, there are now only 240 FBI agents focused on mortgage-related crimes compared to 1,000 working on the S&L scandals twenty years ago. US banks have filed criminal referrals against 62,000 of their borrowers for mortgage fraud. Nearly half of them are in California. They cannot be prosecuted, however, because California has no prison space. As a result of the state's fiscal crisis, it is about to close prisons and release thousands of convicts. The failure of the US legal system to cope with the consequences of the recent crisis will incite politicians to continue making attacks on bankers.

The great concern of emerging market countries is how increased government regulation or actual takeovers of banks might influence credit policy. There is a risk that some banks will turn inward and reduce their international activities. The Royal Bank of Scotland is now divesting its East Asian operations. Citibank recently sold its Japanese equity division, and there is speculation that it could pull out of Mexico. Global banks have reduced their emerging market lending from $398 billion in 2007 to negative $92 billion this year.

There is little doubt that emerging market financial institutions will now have to play a greater role as intermediaries for global capital flows to their regions. The Chinese banks clearly have the critical equity power to play a greater global role. There are now banks in Brazil, India, and South Africa with sufficient size and management depth to also play a role outside of their home regions. Standard Bank of South Africa is now busily expanding in many emerging markets, not just Africa. It is likely that future historians will look back upon the recent crisis as the event which accelerated this transition.

The conclusions for investors are therefore clear. They should not only give a high weighting to emerging markets in their portfolios. They should also expect to increasingly interact with emerging market financial institutions as they seek out opportunities for obtaining research and equity trading. The monopoly of New York and London on global financial intermediation is now clearly over, and new centers will soon rise to rival them.