Ashmore

Intra-EM trade

By Jan Dehn

The view that Developed Market bonds are risk-free and that Emerging Markets (EM) bonds are risky remains deeply entrenched. Occasional bouts of volatility in EM fixed income only reinforce this perception. Episodes of market volatility are often caused by shocks emanating from outside of EM and investors' response to them. Yet EM fundamentals have proved resilient to investor panics time and time again. The resilience of EM fundamentals reflects the many material economic and political improvements, which have taken place in EM over the last few decades. Astute observers of EM fixed income markets will already be well aware of some of these, including major declines in debt levels, establishment of pension funds, better demographics, larger stock of reserves, the emergence of domestic yield curves and their integration into global financial markets, etc.

However, there are still large gaps in investors' understanding of EM when it comes to trade. In particular, many still worry that shocks to external demand for EM exports can severely impact EM countries. This fear is rooted in the perceptions that (a) EM countries are undiversified exporters of raw materials with highly unpredictable prices and (b) that EM countries only trade with a very narrow selection of developed economies and China, wherefore even modest changes in the economic fortunes of developed countries and China in particular can severely impact EM economic health.

Many of these perceptions about EM trade are outdated and incorrect.[1] We have analysed the IMF's Direction of Trade Statistics for the four major EM regions to provide insights into the least understood segment of global trade, namely intra-EM trade. We find that intra-EM trade is now a very significant part of both EM and global trade flows. Specifically, we find that intra-EM trade is:

1. **Big and fast-growing:** Intra-EM trade is the fastest growing segment of global trade and now accounts for more than 40% of all EM trade. Intra-EM trade is on track to make up nearly half of all EM trade by 2026.
2. **Broad-based and dynamic:** Intra-EM trade is growing rapidly in all EM regions with evidence of increasing specialisation across EM regions alongside significant gravity effects.[2]
3. **Stable and balanced:** Trade between EM countries is generally less imbalanced and more stable than trade between EM countries and Developed Markets. Intra-EM trade is also likely to be less risky than trade with Developed Markets going forward due to the current macroeconomic conditions and policy trends in Developed Markets.
4. **Not all about China:** China's trade with Developed Markets is bigger than China's trade with EM countries; this suggests that the China trade is not a source of potential systemic macroeconomic risk to EM as a whole. Rather, EM countries should aim to increase their trade with China, in our view.

Intra-EM trade already accounts for 41% of total EM trade – and it is not all about China

There are two investment implications arising from these observations. First, rational investors should be able to buy into bouts of temporary volatility in EM fixed income with greater confidence in the knowledge that EM economies are, if anything, even more resilient to external shocks than previously appreciated. Second, the case for making a long-term commitment to EM fixed income is even more compelling, since the rapid expansion in intra-EM trade is likely to make EM countries safer and more likely grow faster over time.

Big and fast growing

Intra-EM trade has not only grown to become a very significant part of EM trade, but is now also an important part of global trade flows. Intra-EM trade now measures USD 4.9trn (Figure 1, overleaf). This is equivalent to 41% of total EM trade and compares to just USD 322bn in 1990 (26% of total EM trade). Whereas intra-EM trade was only 5% of global trade in 1990 today it accounts for 15% of world trade.

[1] We adopt the IMF definitions of Advanced and Emerging economies. This means that Czech Republic, Israel, Hong Kong, Macao, Taiwan, Singapore and South Korea are counted within the group of Advanced Economies. The definition of EM used in this paper does not include Cuba, North Korea, various special categories and non-sovereign countries and territories. Together these omitted countries and territories account for approximately 3% of total EM trade.

[2] Gravity effects refer to factors, which lead to greater trade volumes with countries in close vicinity. Such factors include transportation, language barriers, local trade agreements, customs unions, etc.

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Fig 1: **Global trade 1990-2016 (USD bn)**

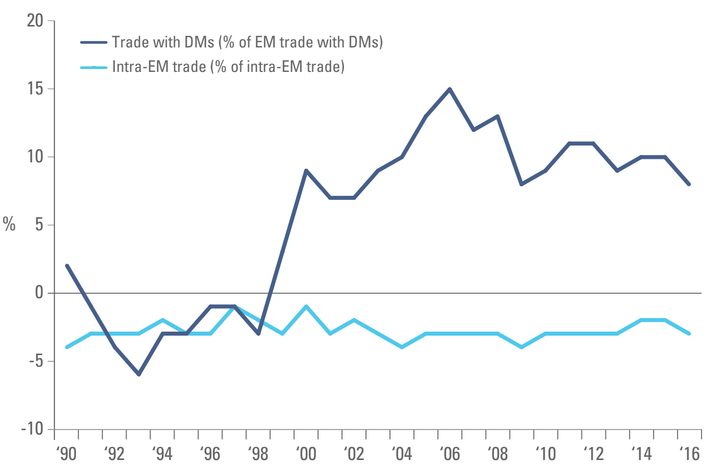
World trade	1990 (USD bn)	2000 (USD bn)	2010 (USD bn)	2016 (USD bn)
Intra-EM trade	**322**	**770**	**4,332**	**4,934**
% of EM trade	26%	26%	40%	41%
EM trade with DMs	**939**	**2213**	**6628**	**7054**
% of EM trade	74%	74%	60%	59%
Total EM trade	**1,261**	**2,983**	**10,960**	**11,987**
% of global trade	18%	23%	36%	38%
Total world trade	**6,883**	**12,995**	**30,486**	**31,932**

Source: IMF Direction of trade statistics, Ashmore.

Stabiliser

Trading with other EM countries imparts greater macroeconomic stability to EM countries compared to trading with Developed Markets. This is because trade between EM countries is far more balanced and less volatile than trade between EMs and Developed Markets (Figure 2). Between 1990 and 2016 the average difference between imports and exports in intra-EM trade – i.e. the average intra-EM trade imbalance – was 3% of total intra-EM trade compared to an average imbalance in trade between EM and Developed Markets of more than 8% of total EM- Developed Markets trade. Trade balances between EM countries and Developed Markets countries were also twice as volatile as intra-EM trade imbalances in the period from 1990 to 2016 with coefficients of variation of 1.0 and 0.5, respectively. This implies that EM countries can achieve greater macroeconomic stability by trading more with each other.

Fig 2: **EM trade balances**



Source: IMF Direction of trade statistics, IMF, Ashmore.

Trending

Trade between EM countries expanded far quicker than overall EM trade and faster still than global trade between 1990 and 2016 as shown in Figure 3. Over this period the US dollar value of intra-EM trade increased by 1431%, equivalent to a compounded annualised growth rate (CAGR) of 11%. In comparison total EM trade expanded at a rate of 9% and EM trade with developed countries grew at a rate of 8%. World trade only increased at a rate of 6% reflecting particularly stagnant intra-Developed Markets trade. Global growth has been more sluggish following 2008/2009, but intra-EM growth has held up better than other segments of global trade even during this period. Intra-EM trade expanded at an annualised rate of 2% since 2008, which is twice as fast as overall EM trade growth (1%) and EM trade with Developed Markets only grew at a rate of 0.4%. Global trade actually declined outright at an annualised rate of 0.2% since 2008. Notice how intra-EM trade has continued to expand compared to trade with and within Developed Markets since 2008. This shows that intra-EM growth is more resilient than other types of trade.

Fig 3: **Growth rates**

	1990-2016		2008-2016	
Growth	**Absolute**	**CAGR**	**Absolute**	**CAGR**
Intra-EM trade	**1431%**	**11%**	**17%**	**2.0%**
EM trade with DMs	**751%**	**8%**	**3%**	**0.4%**
Total EM trade	850%	9%	9%	1.0%
World trade	364%	6%	-2%	-0.2%

Source: IMF Direction of trade statistics, Ashmore.

Intra-EM trade is more stable and balanced than trade between EM and developed countries. Gravity effects are important

Dominant

Intra-EM trade will grow further in importance due to both structural factors and to the cyclical upswing underway in EM. We estimate that intra-EM trade could account for as much as half of all EM trade by 2026, depending on the speed of global economic recovery. For example, if global growth returns to the pre-crisis average, 49% of all EM trade will be intra-EM trade by 2026. Even if global growth does not recover in this way intra-EM trade will still reach about 45% of total EM trade in the next ten years. This means that by 2026 intra-EM trade will account for approximately15% to19% of total trade in the world (Figure 4).

Fig 4: **Trade volumes by 2026**

	USD bn based on		
Growth	**1990-2016 growth**	**2008/2026 growth**	**2016**
Intra-EM trade	**14,089**	**6,013**	**4,934**
% of EM trade	49%	45%	41%
EM trade with DMs	**14,411**	**7,279**	**7,054**
% of EM trade	51%	55%	59%
Total EM trade	**28,500**	**13,291**	**11,987**
% of world trade	49%	42%	38%
World trade	**57,617**	**31,325**	**31,932**

Source: IMF Direction of trade statistics, Ashmore.

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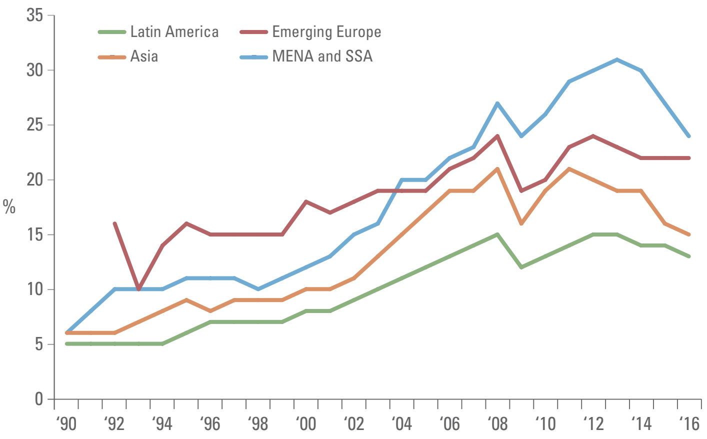
Broad-based

The growth in intra-EM trade has been broad-based. We consider four distinct EM regions: (1) Latin America and the Caribbean, (2) Emerging Europe, (3) Middle-East, North Africa and Sub-Saharan Africa (MENA/SSA) and (4) Asia. In GDP terms intra-EM trade has grown in all four regions doubling in Latin America to rising six-fold in MENA/SSA (Figure 5). Specifically, intra-EM trade increased from just 6% of regional GDP in MENA/SSA in 1990 to 24% by 2016, a huge increase. Asian intra-EM trade has also exhibited formidable growth equivalent to 9% of Asian GDP over the period. In Latin America, intra-EM trade has grown by 8% of regional GDP and in Emerging Europe the increase in EM-to-EM trade has been equivalent to 6% of regional GDP.

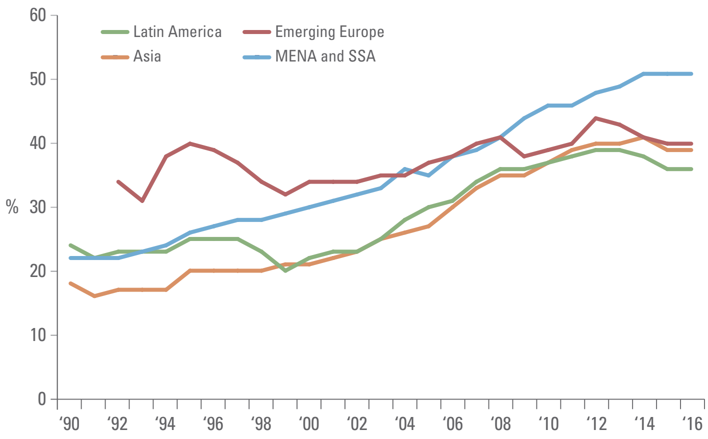
The growth in intra-EM trade has also been strong when expressed in terms of share of overall trade. Asia's intra-EM trade has increased from 18% of total Asian trade in 1990 to 40% of total Asian trade in 2016 (Figure 6). In Latin America, intra-EM trade has increased from 24% to 36% of all Latin America's trade. In MENA/SSA, intra-EM trade now accounts for the majority of all trade, that is, 51% compared to 22% in 1990. Finally, in Emerging Europe intra-EM trade is 40% of total trade compared to 34% in 1990.

Fig 5: **Intra-EM trade: regional growth – % of regional GDP**



Source: IMF Direction of trade statistics, IMF, Ashmore.

Fig 6: **Intra-EM trade: regional growth – % of regional trade**



Source: IMF Direction of trade statistics, IMF, Ashmore.

Diverse

Further unpacking the patterns of intra-EM trade we find that intra-EM trade is very diverse. All EM regions trade with all other EM regions as well as with countries within their own regions. This is illustrated in Figure 7, which ranks the trading partners of each individual EM region (shown in the column headers) in accordance with their trading partners' shares of the region's total intra-EM trade. Two conclusions emerge from this table:

- First, it is clear that individual EM regions conduct a considerable part of their intra-EM trade with other EM countries within their own regions. For example, Brazil trades a lot with Argentina and Thailand trades a lot with Malaysia. This may be due to gravity effects. The extent to which intra-EM trade is also intra-regional varies considerably. For example, more than half (54%) of intra-EM trade in Asia and in Emerging Europe is conducted with other countries within their own respective regions. MENA/SSA and Latin America also trade a lot within their own regions albeit less than the other two regions.
- Second, despite the evidence of pronounced gravity effects in intra-EM trade there is also strong evidence across all four EM regions of considerable trade with countries in other EM regions. Asia ranks number one and two in importance as a trading partner to other EM regions, indicating that Asia has been very successful in penetrating all of EM. By contrast, Latin America and Emerging Europe are located towards the bottom of the table, which means that they have been less able to penetrate other EM regions. MENA/SSA sits in the middle of the table, which suggests that the region has been reasonably successful in penetrating other EM regions. Geography may have played a part. The MENA/SSA region is located roughly mid-way between Asia and Latin America and close to Western Europe. The visionaries behind Dubai's emergence as a global trade hub may have had this precise observation in mind.

Fig 7: **Intra-EM trade: regional growth**

	Region and percentage of total intra-EM trade (%)							
Rank as trading partner	**Asia**		**Emerging Europe**		**MENA and SSA**		**Latin America**	
Top	**Asia**	**54%**	**Emerging Europe**	**54%**	Asia	47%	Asia	48%
High medium	MENA and SSA	25%	Asia	28%	**MENA and SSA**	**40%**	**Latin America**	**41%**
Low medium	Latin America	12%	MENA and SSA	14%	Emerging Europe	9%	MENA and SSA	6%
Bottom	Emerging Europe	9%	Latin America	4%	Latin America	4%	Emerging Europe	4%

Source: IMF Direction of trade statistics, IMF, Ashmore.

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Dynamism

How have intra-EM trade patterns changed over time? We find that there is considerable intertemporal variation within and between regions as shown in Figures 8a to 8d. Asia has been accumulating trade surpluses versus Emerging Europe over time, while developing deficits versus China in particular. Asia's trade balances with MENA/SSA have been heavily influenced by the price of oil while trade with Latin America has been balanced. Overall, the trade imbalances between Asia and the rest of EM have been modest in size at less than 2% of Asia's GDP.

Emerging Europe's trade deficit with Asia has grown mainly due to trade with China. Emerging Europe is also accumulating growing surpluses versus MENA/SSA. Emerging Europe gets the bulk of its energy from Russia, which may explain why intra-Emerging Europe trade balances (which include Russia) show greater volatility relative to the trend. In terms of GDP, Emerging Europe's intra-EM regional trade balances are roughly of the same order of magnitude as Asia's between +1.5% and -2.5% of regional GDP.

MENA/SSA's trade balances with other EM countries are generally more volatile and larger than other regions. They range from -1% to +4% of regional GDP. The balance of trade with Emerging Europe seems to be on a long-term deficit trend, while the trade balance with Asia has reflected the price of oil and thus fallen sharply since 2014. Trade with other MENA/SSA countries and with Latin America have been fairly balanced over time.

EM countries have been gaining a greater share in global trade as continuing structural changes push them higher up the value-added chain

Finally, Latin America is unique in that the region runs large and sustained deficits with respect to Asia almost all of which can be attributed to China. Latin American trade with other EM regions is far more balanced. Despite the big imbalance in favour of China, however, it is noteworthy that the deficit never exceeds approximately 2% of regional GDP.

Another feature of intra-EM trade imbalances is that they have generally been widening over time. We believe that there are both structural and cyclical reasons for this. Constant structural change tends to push EM countries higher up the value-added ladder from primary producers to producers of basic industrial and manufacturing goods and eventually to high tech and services. EM countries will also have been gaining market share from Developed Markets due to the increasing price of the Dollar versus EM currencies over the 2010-2015 period. All else being even this should have precipitated greater intra-EM trade at the expense of trade with Developed Markets.

Intra-EM trade imbalances: % of regional GDP

Fig 8a: **Asia with EM**

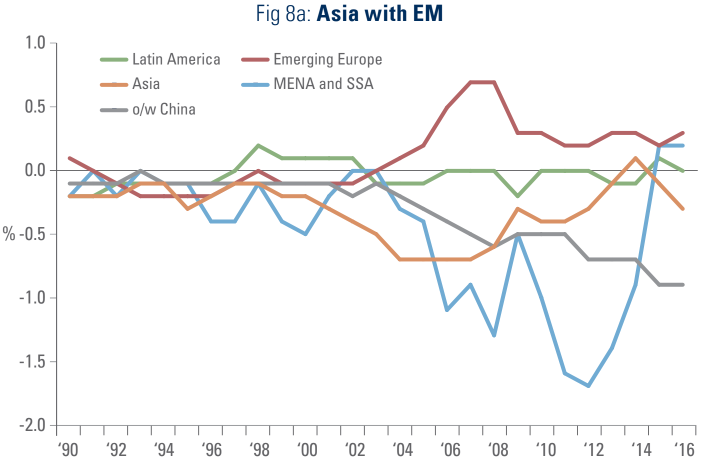


Fig 8b: **Emerging Europe with EM**

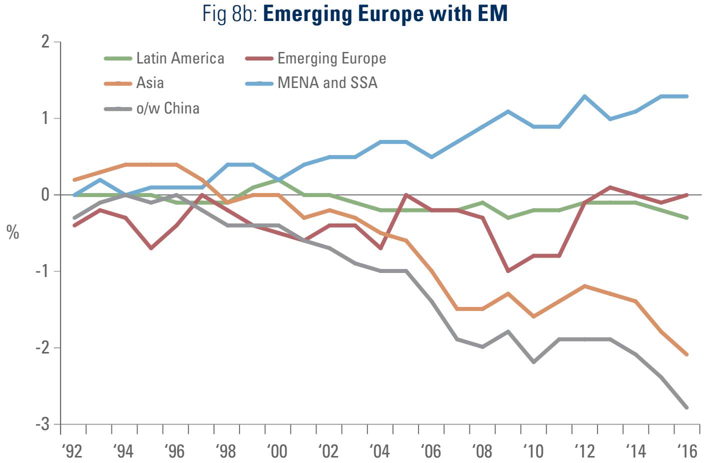


Fig 8c: **MENA and SSA with EM**

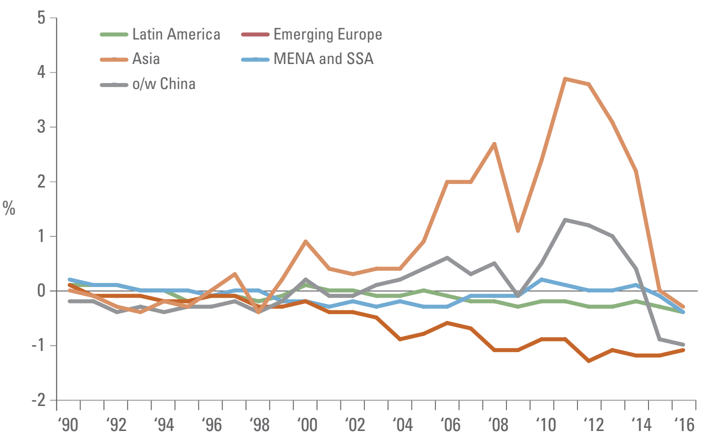
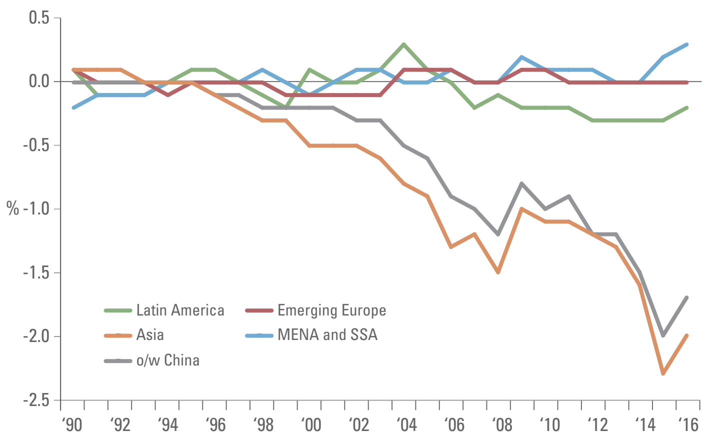


Fig 8d: **Latin America EM**



Source: IMF Direction of trade statistics, IMF, Ashmore.

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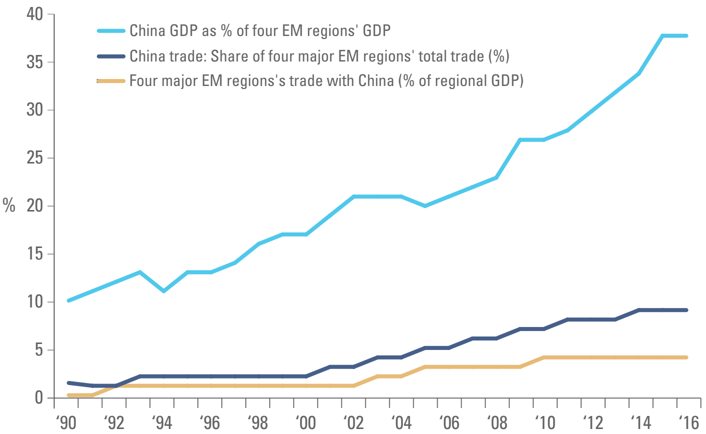
China

China is the largest and most successful export-led EM economy and now a leading trading nation on a global scale. China's trade with the four EM regions has expanded from a mere USD 17bn in 1990 to USD 1.05trn in 2016. This expansion has fed perceptions that the improvement in EM countries' economic fortunes in recent years is entirely due to the rise of China. Such perceptions are not supported by the data. Figures 8a to 8d showed that intra-EM trade patterns vary considerably across regions, so not all EM regions are similarly impacted. Furthermore, EM trade with China has been relatively modest in GDP terms, rising from less than 1% of EM GDP in 1990 to a still very modest 4% of GDP in 2016 (Figure 9). Interestingly, the value of Chinese trade with the whole world is worth 5% of global GDP, which means that Developed Markets are more dependent on trade with China than EM countries.

Fig 9: **China's economic and trade influence in EM**



Source: IMF Direction of trade statistics, IMF, Ashmore.

In general, it is important to distinguish clearly between China's economic growth and its trade with EM. China's share of total EM GDP has increased from 10% in 1990 to 38% by 2016, but the value of China's trade with EM has grown far more slowly from 1.3% of total trade in 1990 to 9% of total trade in 2016. We conclude from this observation that EM trade with China has, if anything, lagged that of other countries and also China's remarkable rise as an economic power. We expect China to continue to be a major source of global growth in the coming decades on account of its commitment to open trade and the so-called Belt and Road Initiative.[3] EM countries would be wise to seek to further increase their exposure to trade with China in years ahead.

Last thoughts

It is high time to ditch outdated views of EM countries as simple commodity producing countries, which only trade with developed countries. Intra-EM trade flows are important and highly dynamic.

The importance of the growth of intra-EM trade should not be underestimated. At the most basic level the growth of intra-EM trade imparts the usual well-known advantages associated with free trade, including enabling countries to access more and cheaper goods and services compared to autarchy. Openness to trade is also associated with greater economic efficiency and higher growth rates. Finally, financial sector development and transfer of technology are often intimately linked to trade flows.

In addition there are benefits which are specific to intra-EM trade. There are many more EM countries than Developed Markets countries, so greater intra-EM trade will automatically increase diversification and stability. Indeed, the growing reliance on intra-EM trade may have contributed to EM resilience in the face of the 2008/2009 crisis. EM economies are also healthier in terms of macroeconomic fundamentals and have far greater potential to grow than Developed Markets. The latter are becoming more protectionist, while leading EM economies, such as China, are committing to openness to trade. More intra-EM trade therefore means safer trade.

Intra-EM trade is growing across all regions of EM. Gravity effects – the tendency of a country to trade with immediate neighbours – are pronounced in all EM regions, but in addition there is strong evidence that intra-EM trade is becoming more specialised across EM regions. This probably reflects growing diversification of EM economies as they develop from simple producers of commodities to supplying (and consuming) manufacturing goods, industrial goods, high tech and services.

China is important, but trade with China does not dominate EM trade flows to an unhealthy extent. In fact, EM should trade more with China, not less. Today more than 90% of all intra-EM trade is with EM countries other than China. We expect Chinese trade with other EMs to rise over time.

One intriguing implication of the rise in intra-EM trade is that intra-EM financial flows may also be growing. We have not come across much information about intra-EM financial flows, but we suspect they too may prove surprising to many. That will be the topic of a future Emerging View.

[3] The Belt and Road Initiative aims to increase cooperation, trade and financial flows between Eurasian countries from China to Eastern Europe and the Middle East. Infrastructure investment is a key element in the BRI.

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