Ashmore

Lo que no nos mata nos hace mas fuertes

(What does not kill us makes us stronger)

By Jan Dehn

David Lipton of the IMF recently warned that the global economy is at a 'delicate juncture' and that policy-makers need to take urgent action to respond to slowing growth. Mr Lipton could have been more precise; specifically it is developed economies that find themselves in a growth pickle.

Using recent growth and trade data, this Emerging View shows that the only part of the global economy to have slowed structurally relative to its long-term trend growth rate since the Developed Market Crisis (DMC) of 2008/2009 is developed economies. Emerging Markets (EM) economies have grown in line with their long-term trends and are likely to continue to be the main growth engine of the global economy.

Another common perception – that trade in EM countries has suffered more than in developed countries – is also wrong. In the post-DMC period, EM countries have done better in global trade than developed economies as EM's share in global trade has gone up by 3% since 2010.

The global trade imbalances that prevailed prior to the DMC are intact. This means that EM FX reserves will resume their rise once capital outflows and USD strength begin to wane, something that may already be happening.

Growth

Detractors have been quick to point out that EM growth rates have slowed significantly in recent years. EM economies did indeed rack up very high growth rates – averaging nearly 7% – in the two years immediate following the DMC of 2008/2009. By contrast, today EM is growing at only about 4% on average.

However, it is misleading to evaluate EM's recent growth performance with reference to the growth rates of 2010-2011 that were highly atypical of EM's long-term growth rate. Growth in the years 2010-2011 were characterised by one-off 'bounce-back' effects arising from the lifting of the capital stops of 2008/2009.

Arguably, it is also misleading to draw firm conclusions about future growth based on EM's low growth rate in 2015, which was a year of significant cyclical downturns as EM countries adjusted to multiple shocks, including a crash in commodity prices, a surging USD rally and expectations of Fed hikes all of which temporarily weakened demand.

A more sensible approach for evaluating EM's recent growth performance is to compare EM's growth in the whole post-DMC, post-bounceback period with average EM growth rates over a much longer period. The most appropriate period is the epoch from the end of the Cold War in the early 1990s, because the Cold War was – and remains – the only genuine structural break in modern EM economic and political history.

The period since the Cold War is also long enough that growth rates can be calculated without unduly reflecting either the up or down legs of the many business cycles that have happened over the period, including the Asia and Russia Crises, the Dotcom Bubble, Subprime, Lehman, the European debt crisis and, more recently, the effects of the Taper Tantrum.

EM's growth premium will rise in the next half a decade and the most important driver will likely be net exports before shifting to domestic demand

Adopting this approach, the table below shows growth rates for EM countries and developed economies in the pre-DMC period (1991 to 2008), the post-DMC period (2011 to 2015) and forecasts for 2016-20 based on the IMF's latest World Economic Outlook.

Fig 1: **Real GDP growth rates**

	Developed Markets	Emerging Markets	World
1991 - 2008	2.5	5.1	3.7
2011 - 2015	1.6	5.0	3.5
2016 - 2020	2.1	5.0	3.8

Source: IMF, Ashmore.

Three points are worth highlight from this table:

- EM countries have been able to sustain growth rates in the post-DMC period that are almost identical to their long-term growth rate (5.0% versus 5.1%, respectively). Growth rates in developed economies have declined materially since the DMC, falling to just 1.6% between 2011 and 2015. This is nearly forty per cent lower than the pre-DMC period (2.5%).[1]

[1] All the long-term data is calculated using data from 1991-2015, the longest available time period covered by the trade data set.

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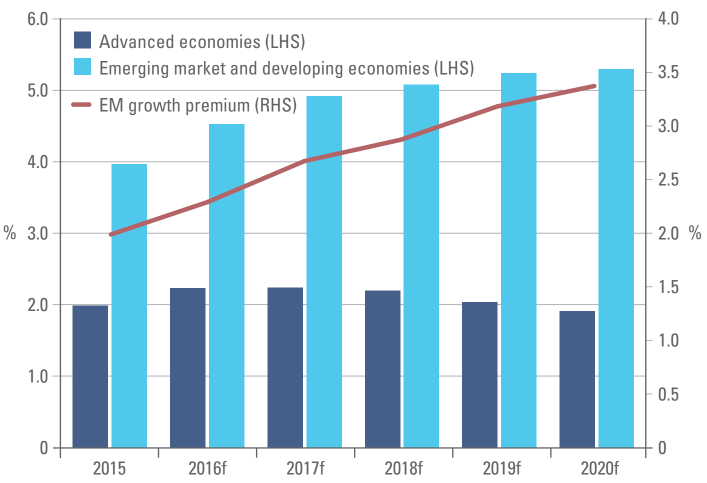
- The average global growth rate has slowed from 3.7% per annum prior to the DMC to an average of 3.5% per annum between 2011 to 2015. Whatever the resilience of global growth it has been due to EM's higher growth rates over the period and EM's steadily rising share of global GDP. Developed markets have only been a drag on global growth.
- Looking ahead, the IMF expects EM countries to maintain an average rate of growth close to their long-term trend growth rate, while developed economies are not expected to recover their pre-DMC growth rates.

The implication is that EM's growth premium will rise in the next half a decade. The most important driver of this growth premium in the next year or two will likely be net exports before shifting to domestic demand. The recent years of persistent currency weakness and declining domestic demand caused by tighter financial conditions have rendered EM countries substantially more competitive than developed market peers, especially the United States. As current accounts improve so will EM FX reserves.

Fig 2: **EM's expected growth premium (2016-2020)**



Sources: IMF, Ashmore.

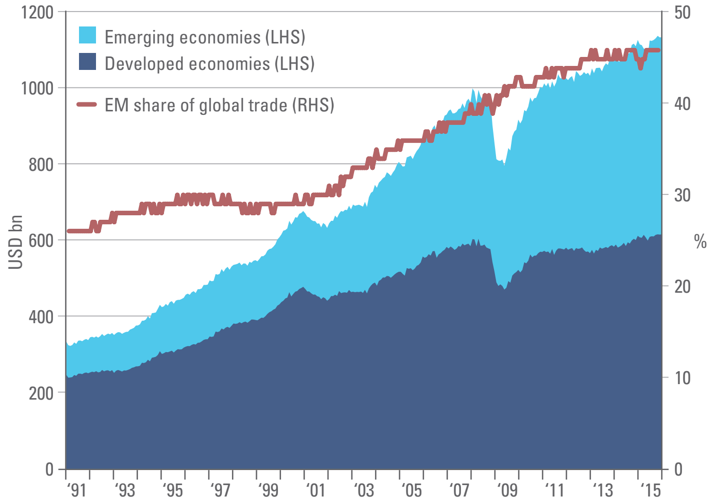
Trade

Our prediction that net exports will become a more important driver of EM's growth outperformance in the immediate future runs somewhat counter to the widely held view that EM countries are being disproportionately handicapped – relative to developed economies – by the slowdown in global trade since the DMC.

To examine this question, we analysed new trade data published by the Netherlands Bureau for Economic Policy Analysis (CPB). The CPB data set covers nearly the entire world economy and shows that global trade has indeed slowed post-DMC. But the data also shows that EM has outperformed developed economies in trade over this period.

This is illustrated in figure 3, which shows global trade volumes (in constant 2005 USD) for EM countries and developed economies. Trade volumes have increased by 32% in EM countries since January 2010 compared to just 19% in developed economies.

Fig 3: **Global trade volumes (constant 2005 USD bn)**



Sources: CBP, Ashmore.

EM's stronger trade performance has enabled EM to increase its share of global trade from 43% in 2010 to 46% as of the end of 2015. The share of developed economies has correspondingly declined from 57% to 54% over the same period.

EM's outperformance in trade has taken place against an overall more challenging environment for global trade. Global trade volumes have grown at a rate of just 3.1% per annum since the DMC, which compares poorly with the 5.3% per annum average growth rate of global trade volumes over the longer term (1992-2015).

The fact that EM has been able to increase its trade share since the DMC supports the notion that much of EM's development has deeper structural roots. This may be why the shocks of the last few years – Taper Tantrum, Dollar rally, Fed hike and commodity prices crash – have only temporarily set back the underlying convergence process, which we think is likely to continue for decades to come.

90% of the most traded EM countries have seen their current accounts swing in a positive direction as they have adjusted to tighter financial conditions and large shifts in their exchange rates. These huge adjustments are central to the restoration of EM competitiveness

Value versus volume – the role of the USD

The USD value of global trade has declined from 22.4% of global GDP to 19.2% of global GDP since the DMC. But this decline in the value of trade – as opposed to the volume of trade – mainly reflects the strong rise in the USD in recent years.

Most global trade is measured and settles in USD, which implies that in the short run, while supply and demand are relatively sticky, a stronger USD means that fewer Dollars are required to buy a given volume of goods.[2]

[2] This is the same dynamic that tends to result in a negative correlation between oil prices and the USD.

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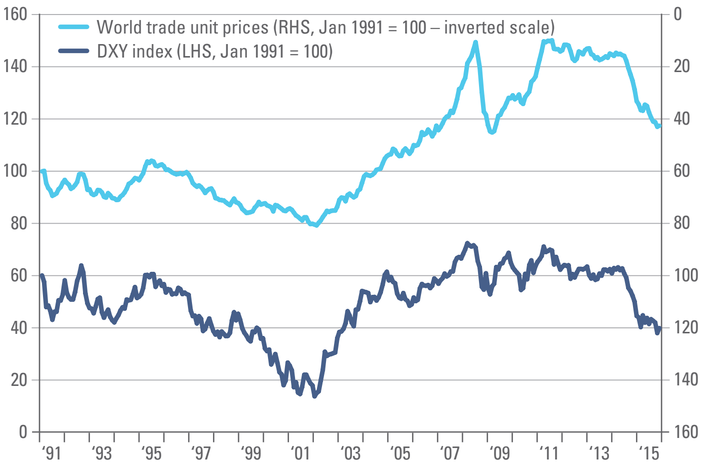
This is indeed why the correlation between trade unit prices and DXY, the broad Dollar index, is close to 80% in both in levels and first differences (see figure 4 below).[3]

Fig 4: **Unit prices and the Dollar**



Source: CPB, Bloomberg, Ashmore.

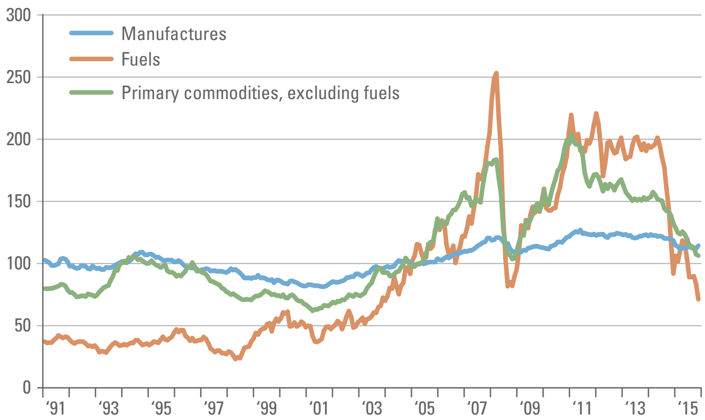
Longer-term, of course, changes in exchange rates will induce important changes in supply and demand and therefore trade volumes. There is already ample evidence that the strong USD of recent years is beginning to improve EM's external balances. In a recent publication we noted that 90% of the most traded EM countries have seen their current accounts swing in a positive direction by close to 3.5% of GDP in recent years as they have adjusted to tighter financial conditions and large shifts in their exchange rates.[4] These huge adjustments are central to the restoration of EM competitiveness, which is likely to form the basis for EM's trade-led growth outperformance in the years ahead.

Terms of trade

Terms of trade have changed significantly in the run-up to and following the DMC. Energy prices have crashed since 2014, while non-fuel primary commodities have declined nearly as much albeit at a much slower pace, while the prices of manufactured goods have declined far less and also been less volatile.

EM countries are far less commodity dependent today than 25 years ago and many are now net importers of commodities, but EM as a group is still more sensitive to commodities than most developed economies. Ultimately, however, terms of trade shocks impact trade patterns independently of FX changes and their effects on individual countries are unique depending on their precise composition of trade.[5] We now examine how terms of trade shocks, currency moves and volume changes have impacted different regions of the world since the DMC.

Fig 5: **Terms of trade – by broad product grouping (1991-2015)**



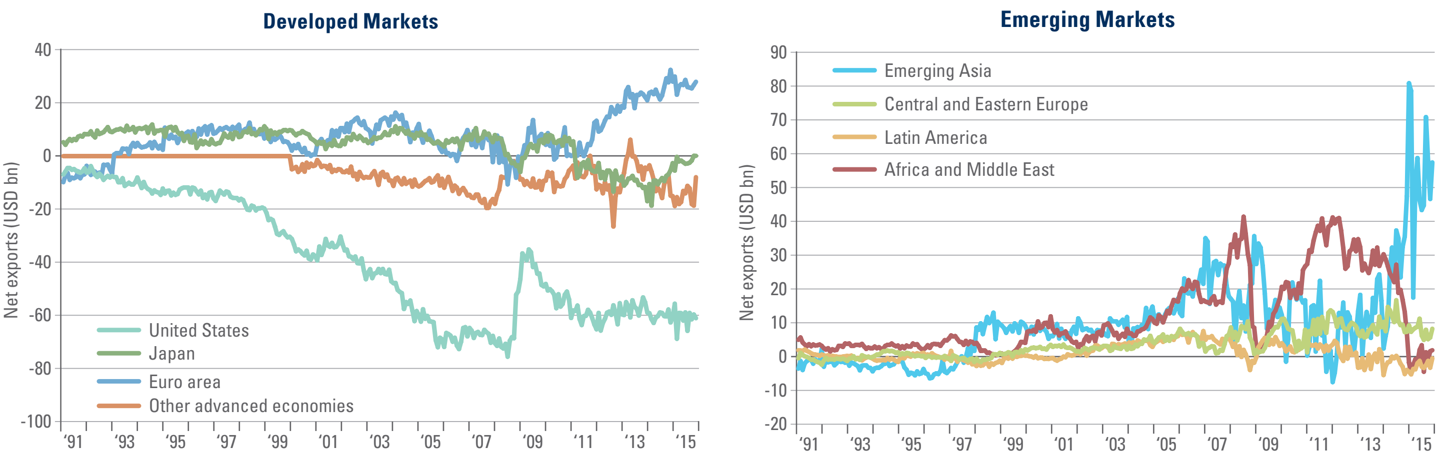
Source: CPB, Ashmore.

Regional effects

Figure 5, below, shows how trade value has changed in the main regions of the world, including the United States, the Eurozone, Japan, other advanced economies, Latin America, Asia, Africa and the Middle East and Eastern Europe.

The first point to note is that global imbalances in trade flows that existed prior to the DMC remain intact. EM regions have continued to run positive net export balances in aggregate, while developed economies have, in aggregate, continued to run negative net export balances. EM countries are therefore likely to resume reserve accumulation, especially as recent capital outflows and the USD rally of recent years begin to wane.

Fig 6: **Net exports: Main groups of EM and developed economies**



Source: CPB, IMF, Ashmore, Bloomberg.

[3] The exact correlation is 77%. It is particularly telling that the correlation is 76% after first-differencing the series. This suggests strongly that the correlation is not spurious.

[4] *"Nothing stays the same: EM's dramatic external rebalancing"*, The Emerging View, November 2015.

[5] Each individual country's experience will have been unique, because no countries are alike. One caveat in this analysis is that many countries, including many EM countries, now produce services, which are not included here. This analysis is therefore incomplete.

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The second point is that EM's trade has become more volatile, probably due to more elevated levels of terms of trade and FX volatility.

By contrast, developed market net exports have been less volatile overall, which is probably due to less extreme currency volatility and lower overall exposure to commodities. However, this may change in the future as QE currencies begin to buckle in response to monetary policies that undermine their integrity.

Thirdly, regional differences have clearly become far more pronounced since the DMC in all parts of the world, not just in EM. Emerging Asia has seen very sharp improvements in net exports due to solid growth in the net trade volumes and positive terms of trade effects, though China's Dollar peg may have been distorting numbers somewhat.[6] By contrast, African and the Middle Eastern markets have seen sharp declines in net exports on account of large negative terms of trade shocks, but a sharp pick-up in export volumes has provided some off-set.[7] In Central and Eastern Europe net export values have been stable due to a combination of deteriorating net export volumes, but positive terms of trade effects, while Latin America's net exports have declined marginally due to a combination of poorer terms of trade that have been offset by strongly rising export volumes and falling import volumes.

Equally powerful regional effects are evident in developed economies, which underlines the often underappreciated fact that shocks impact all countries, not just those in EM. In the United States, import volumes have dramatically outpaced export volumes to make the US economy the single worst net export performer in the world. At the other extreme, the Euro area has seen major improvements in net trade. Here trade volumes have been tepid, but the Euro area composition of trade – importing energy and exporting services and manufactures – has been positive for the terms of trade and the weaker EUR has helped. Japan and other advances economies have had more subdued trade changes due to offsetting effects from exchange rates, trade volumes and terms of trade.

Conclusion

The analysis above shows that EM has performed much better than developed economies in the post-DMC period when comparing growth and trade in the post-DMC period with longer-term averages – a more appropriate period for comparison than the immediate aftermath of the DMC.

Developed economies look genuinely challenged. They have failed to use the 'good' times of monetary easing to reform and undertake other fundamental improvements, including deleveraging, and they are now expensive after years of excessive monetary stimuli.

The IMF is right to worry about global growth and trade. Both have slowed relative to long-term trends, which is clearly a worry. However, the problems are predominantly found in developed markets and policy-makers and investors around the world need to wake up to this fact. The endless references to EM fragility are not just a source of irritation; they are actually harmful, because they detract attention away from the real sickness, which is lodged firmly in developed economies. By contrast, the only bit of EM that has been truly fragile is EM investor sentiment.

EM fundamentals have been surprisingly resilient in spite of many external shocks in recent years. These shocks have temporarily weakened growth in EM, but the effects have been cyclical, not structural. If anything, EM countries have become more competitive as a result of moderation in domestic demand and sharp declines in EM exchange rates. That which does not kill you makes you stronger.

This means that a significant positive wedge now exists between valuations and fundamentals in developed economies, while in EM this wedge is negative – i.e. EM assets prices are low relative to fundamentals. Moreover, investors' positioning is very heavily skewed towards developed market assets, which means that EM technicals are good. It is time to reverse the QE trades, not just in order to make money, but also to reduce risk.

[6] Trade is recorded in current USD, so China's de facto USD peg eliminates the adverse currency effects on the USD value of trade flows that show up in other countries that do not have pegs.
[7] This pick up may reflect greater output of oil from the Middle East, though our data does not provide sufficient level of detail to substantiate this hypothesis.

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