

Emerging markets: in better shape than the developed world?

Most investors regard emerging markets as highly volatile, offering the potential for both significant risk and return. Recent events have seemed to clearly support that view: emerging markets stocks, bonds and currencies slid sharply through last year's market turmoil, while their ensuing rebound has highlighted the underlying resilience of the developing world and the positive economic changes that have occurred in the last decade. But it can also be said that emerging and developed markets have been moving in opposite directions for some time now. Developed market fiscal balances, current account balances and savings rates have been deteriorating, while those in the emerging markets have steadily improved. Like the sick patient who recovers after strictly adhering to a doctor's orders whereas the prescribing

doctor falls ill by disregarding his own advice, many emerging markets are generally in better economic and financial shape than developed markets and are sustaining higher economic growth rates on the whole.

Improving fiscal balances

Many emerging markets governments started improving their fiscal accounts a decade ago following the Asian currency crisis, partly because fiscal improvement was a condition for financial aid from the International Monetary Fund. As budgetary balances improved and the need for public borrowing was reduced, interest rates started to decline, creating a virtuous circle of decreased financing costs and lower levels of debt. Furthermore, the decrease in benchmark government bond rates sent down the cost of borrowing for

corporations. This phenomenon has been especially common in Latin America.

The subsequent prudence of many emerging markets governments in recent years has provided them with the ammunition to bolster their economies throughout the financial crisis. The implementation of stimulus has been especially well timed given the need for infrastructure development in many countries, such as China and India. Other governments have managed to upgrade infrastructure without increasing fiscal debt by securing funding through the private sector, as in Mexico.

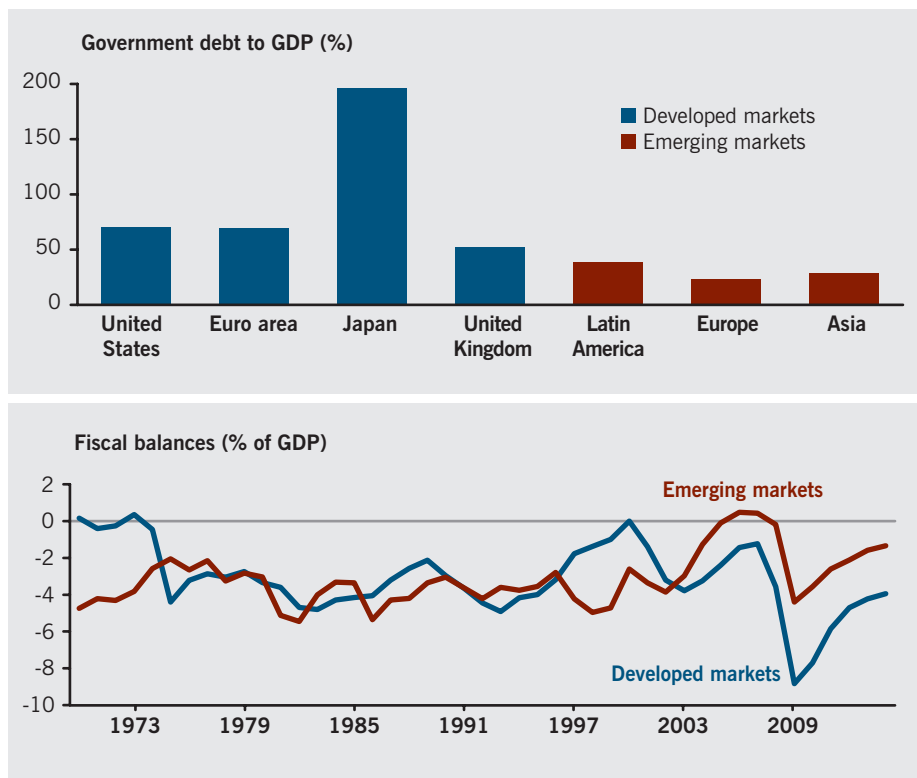
In contrast, government borrowing and public debt ratios have risen dramatically in the developed world as a result of the combined costs of fiscal stimulus, tax revenue losses and financial sector restructuring. The IMF has forecast that fiscal deficits will be nearly 8% of GDP in the developed world by 2010 — more than double that of the emerging markets — compared to 2002–2003 when average fiscal deficits in advanced and emerging economies were roughly similar.

While ballooning fiscal deficits diminish a government's ability to deal effectively with economic shocks, recent developments have shown that there is an even higher price to pay. Even though the US has much greater borrowing power than any other country, its AAA credit rating has been called into question amid concerns about the size of its deficit and increased levels of public debt.

Current account balances

Terms of trade have steadily shifted in favour of emerging markets over the past decade. China has become the world's manufacturer, while greater demand for commodities has benefited many Latin American and African countries. In addition to positive terms of trade, developing countries have amassed huge foreign exchange reserves, resulting in

Emerging vs developed markets: how the data stacks up



As of April 2009
Sources: IMF, WEO Database

positive current account balances for many countries. The most visible shift can be seen in current account balances in Latin America. Brazil and Mexico — the region's largest economies — have dramatically changed course over the last decade after previously registering chronic current account deficits. As commodity exports rose for countries such as Brazil and external borrowing came down amid reduced government spending, current account balances turned positive. This has subsequently reduced dependence on foreign capital flows — which can flow out as easily as they flow into a market — and, by extension, has deterred speculative attacks on their currencies.

Decreased reliance on foreign financing may be the most salient lesson learned by emerging markets in the 1990s — from the Mexican and Asian currency crises as well as the Russian debt default. Some

vulnerabilities still exist, however, such as the large current account deficits of Turkey and South Africa. But these remain the exception rather than the rule. Even these countries have significantly stronger banking systems and more resilient economies than in the past, which helped financial assets bounce back more quickly when liquidity returned to global financial markets. By comparison, the US current account deficit is seen as a major source of weakness for the dollar over the long term.

Higher savings rates

Asia's higher savings rates are sometimes viewed as an impediment to economic growth as consumers spend less and save more. The excessive dependence of Asian economies on exports against the backdrop of comparatively low domestic consumption has also been regarded as a weakness. These views, however, are

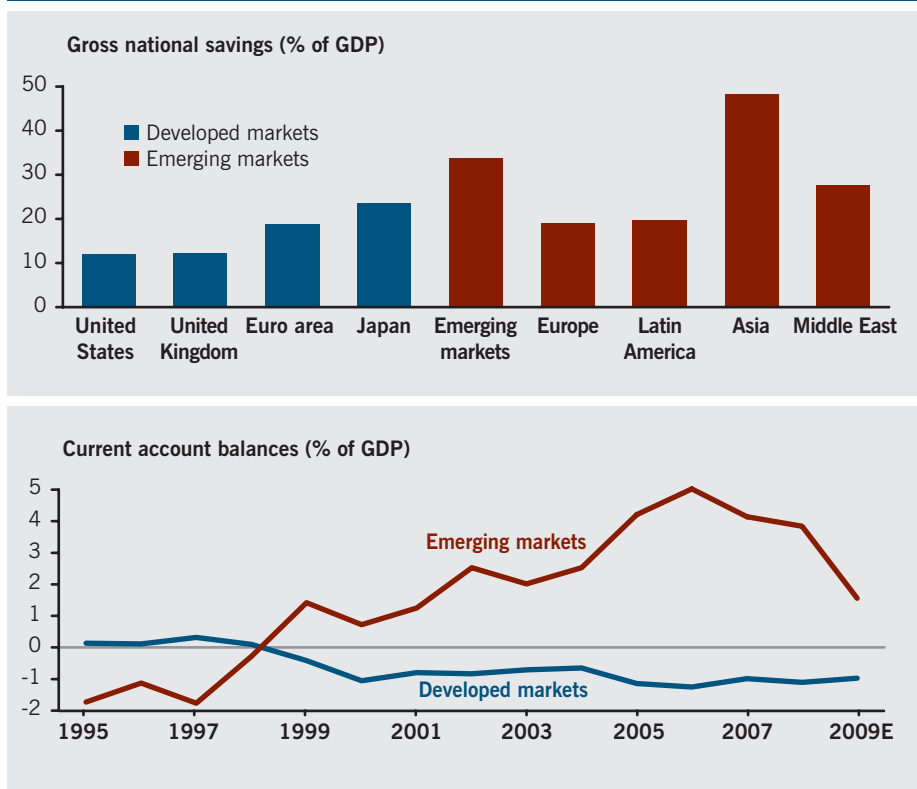
beginning to change. When wholesale funding for banks in global capital markets dried up during the financial crisis, banks in emerging markets did not suffer from the same kind of vulnerability, primarily because of their large deposit bases. A significant deposit base within the banking system gives governments and corporations an essential source of domestic market liquidity. Conversely, developed countries are now faced with the need to dramatically increase savings, which is likely to limit consumption — a significant proportion of economic growth in the developed world.

Higher savings and greater government surpluses also find their way into foreign financial assets. China, which has a relatively low level of debt, also has a substantial savings rate, a current account surplus and the largest store of foreign exchange reserves in the world (hovering around US\$2 trillion). China holds more than US\$1 trillion in Treasury securities and other US government debt, making the US vulnerable should China liquidate even part of its holdings — not entirely unlike the situation faced by emerging markets in the 1980s and 1990s.

Where does this take us?

Although emerging markets are in better shape than developed markets on several economic and financial metrics, some investors question whether the emerging markets can achieve economic growth and financial prosperity while the developed world remains weak. In our view the recent turmoil has very clearly illustrated how intricately intertwined the global economy and financial system are, and how difficult it is for one region to succeed while the rest of the world grapples with severe challenges. But we do believe that so long as the global economy moves in a positive direction, emerging markets are in a better position to sustain higher growth rates than developed markets. ■

Emerging markets: higher savings and current account surpluses



As of April 2009
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