GLOBAL GROWTH SLOWDOWN: DOES THE EM GROWTH STORY STILL HAVE LEGS?

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- Global growth has decelerated significantly over the past two years, both in Developed Markets (DM) and Emerging Markets (EM). As a result, EM investors face two key questions: (1) to what extent is the slowdown in EM growth cyclical or a sign that potential long-term growth has decelerated? And (2) can EM growth rebound without a significant recovery in DM growth?
- We identify six factors that we believe are responsible for the slowdown: natural fading of the post-crisis rebound, policy tightening in EMs in 2010/11, the Eurozone crisis, the sluggish US economy, weaker commodity prices, and lower capital inflows. We believe that most of these factors are either stabilizing or slowly improving, suggesting that the EM growth outlook is also gradually improving.
- However, a fast rebound in EM growth seems unlikely without a significant recovery in DM growth as the global economy remains highly integrated.
- Taking a longer-term view, we argue that EM growth potential remains high. While China's potential growth rate has likely fallen to about 7-8%, we see strong reasons to believe that it will not slow further. In particular, the most important growth drivers remain in place. Outside of China, we see long-term EM growth prospects largely unchanged.

Economic growth in Emerging Markets (EM) continues to exceed growth in Developed Markets (DM) by a large margin but the global slowdown over the past two years had a significant impact on EM economies. Especially some large EM economies (India, Brazil, and to a lesser extent China) have decelerated sharply over the past year. Not surprisingly, news stories and opinion pieces predicting a hard landing in China or BRICs hitting the wall have started to emerge. We believe many of these stories are overblown but nevertheless it seems like a good time to reassess the growth outlook for EMs. In particular, we focus on two key questions: (1) to what extent is the slowdown in EM growth cyclical or a sign that potential long-term growth has decelerated? And (2) can EM growth rebound without a significant recovery in DM growth?

Synchronized global slowdown

As usual, it's helpful to start with a look at the data. Figure 1 shows annual GDP growth for three groups of countries: the G3 (US, Eurozone, and Japan), the four BRICs (Brazil, Russia, India and China), and 15 large non-BRIC EM countries.[1] The most striking feature is the extent of the co-movement. We believe this chart supports ending the decoupling debates: from a cyclical perspective there is no decoupling between Ems and DMs. The global economy tends to move in parallel and this co-movement has even become closer in recent years. For at least the past 15 years, every slowdown in DM growth has also led to lower growth in EMs. This was the case in the aftermath of the internet bubble in the early 2000s, during the 2008/9 financial crisis, and again over the past two years.

[1] Argentina, Chile, Colombia, Mexico, Peru, Hungary, Poland, South Africa, Turkey, Ukraine, Indonesia, Malaysia, Philippines, South Korea and Thailand

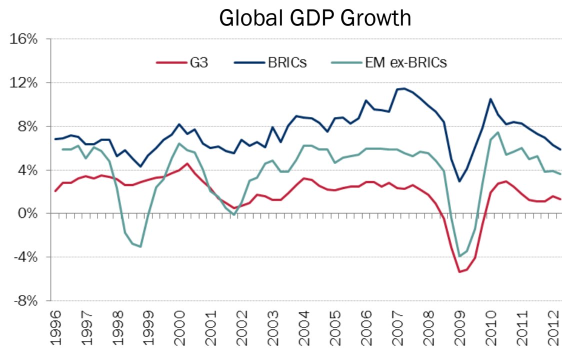

Figure 1: GDP Growth, 2003 - 2012
Source: Haver Analytics

However, just looking at broad aggregates hides important country-specific stories. This seems obvious in the developed market space as aggregation across the US, Europe, and Japan (or even within the Eurozone) is not particularly useful, in our opinion, given the often very distinct growth dynamics. We believe this equally applies in the EM space—or maybe even more so—as economic structures vary widely across EMs. A brief look at the BRICs highlights this. While China, India, and Brazil have slowed significantly since the peak of the rebound in early 2010, the slowdown in Russia has been much less pronounced (Figure 2).

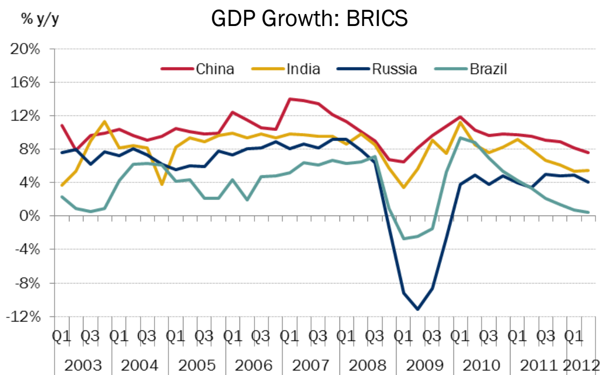

Figure 2: GDP Growth: BRICS
Source: Haver Analytics

However, in order to assess the prospects of a rebound in EM growth we need to understand the reasons for the slowdown in the first place. We think it boils down to six key factors, some global and others EM specific:

- **Natural leveling off of the 2009/2010 growth rebound.** Growth collapsed in many countries in late 2008 and 2009 creating massive spare capacity. As the global economy stabilized and many countries embarked on large stimulus programs, growth rebounded in EMs. The initial pace of such a rebound can be very vigorous as slack resources are being put to work again. However, the pace levels off over time as economies operate closer to their capacity constraints.

- **Policy tightening in EMs.** This includes both the phasing out of fiscal stimulus that was put in place in 2009 in many EMs as well as active monetary tightening. Having fallen sharply during the financial crisis, inflation in EMs has been rising again in 2010/11 (Figure 3). In response, many central banks tightened monetary policy. Inflation peaked by about mid-2011 and rate hikes stopped by about the same time (Figure 4). However, monetary policy typically affects activity with a lag of several quarters. In addition, we have seen other important tightening measures, notably in China where the authorities imposed various restrictions on real estate purchases in order to cool down the booming property market. We believe the impact has been significant in many countries.

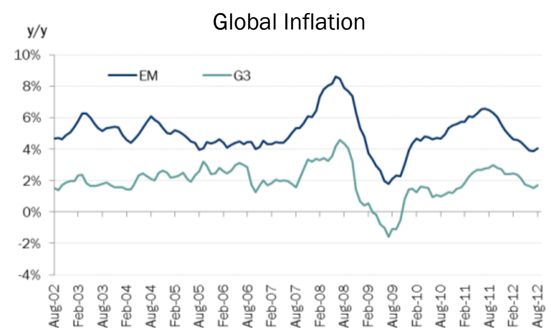

Figure 3: Global Inflation
Source: Haver Analytics

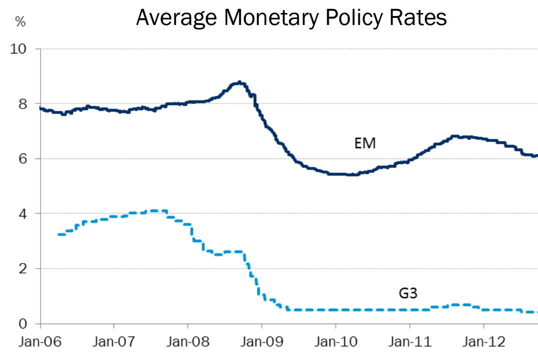

Figure 4: Average Monetary Policy Rates
Source: Bloomberg

- **Eurozone crisis.** Substantial fiscal tightening, deleveraging of banks and households, and poor confidence continue to be major drags on growth in the Eurozone. Recent policy action—especially the prospect of ECB bond purchases under the OMT program—have stabilized the situation but growth prospects remain poor. At almost 20% of global GDP, the Eurozone weakness obviously has a substantial impact on global growth and EMs. We think the key channels have been weak exports to the Eurozone and lower capital flows, especially in countries with close financial links to the Eurozone. Eastern Europe has felt the strongest impact due to close trade links and the heavy involvement of Eurozone banks in Eastern European countries.

- **Sluggish US recovery.** The US recovery has been sluggish and following a year with consistent growth rates above 2% in 2010, growth rates have been weaker since, averaging less than 2% in 2011 and H1 2012. While the feared double-dip recession has not materialized, the recovery has been too weak to allow for export-led growth in EMs (with few exceptions, e.g., Mexico). Especially in connection with poor growth in Europe, the result was that EMs had to rely on domestic demand to sustain growth.

- **Commodity prices.** While some EM countries are net commodity importers that are hurt by higher prices (e.g., Turkey, Hungary, or Poland) the majority are net commodity exporters benefitting from higher commodity prices. High prices improve export and tax revenues, income levels, and trigger more investments in the commodity sectors. Growth in 2010 and 2011 was boosted by the run-up in commodity prices which peaked in the first half of 2011. Since then, commodity prices have been trending gradually lower (with few exceptions such as soy and corn that were due to weaker harvests in key regions). While the level of commodity prices remains broadly supportive for EM economies, the recent growth impulse is smaller than in 2010 and early 2011 (Figure 5).

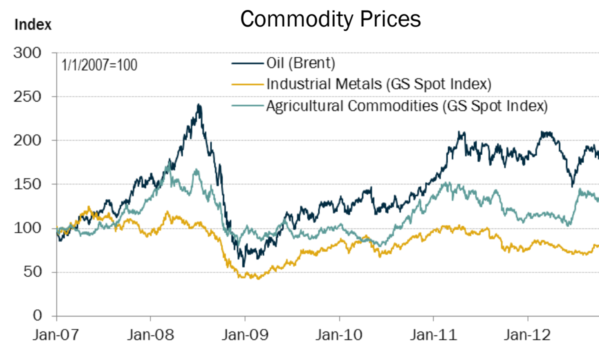

Figure 5: Commodity Prices
Source: Bloomberg

- **Capital flows.** Finally, we think changes in capital flows to EMs also played a significant role in the global growth slowing. Capital flows tend to amplify variations in economic growth in EMs. Despite exceptionally easy monetary policy in most advanced economies—with interest rates close to zero and substantial central bank balance sheet expansion—capital inflows into EMs have actually slowed down over the past year. So far, we have not seen much evidence of the "liquidity tsunami" flooding EMs (as it has been described by Brazil's President Dilma Rousseff) (Figure 6). The extraordinarily easy monetary policy in DMs has been feeding the "search for yield" and we are in fact seeing substantial inflows into EM debt. Foreign

ownership of government debt has increased in many markets. However, this has been offset by other categories, such as cross-border bank lending and foreign assets held by EM residents. Basically, we believe that the sluggish growth environment in advanced economies and more importantly the perceived large downside risks have limited the flows into risky assets including EM assets. This has been compounded in certain countries (especially in Eastern Europe) by DM banks' efforts to deleverage their balance sheets and reduce exposures to some EMs.

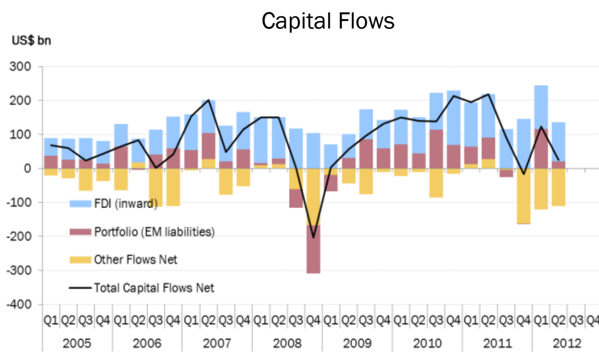

Figure 6: Capital Flows
Source: Haver Analytics

Where do we go from here?

Looking at the outlook for these key factors helps us to gauge the prospects for EM growth over the next year. We believe they are either stable or slowly improving, thus pointing towards a gradual improvement in the EM growth outlook.

- The **Eurozone crisis** has eased somewhat following important steps taken by policy makers over the past months (in particular the prospect of ECB bond purchases under the OMT program). This has reduced tail risks, but the growth outlook for the Eurozone remains poor as private sector deleveraging and public sector fiscal consolidation continues.

- The **growth outlook for the US** is better as the private sector deleveraging process is more advanced and the housing market appears to have stabilized. But the fiscal problems remain largely unresolved. Even if the fiscal cliff can be avoided, the US will have to endure years of fiscal consolidation, which means years of lower growth due to the fiscal drag. Meanwhile US households still need to reduce debt further, a process that is likely to continue even if the housing market is finally stabilizing. As a result, developed markets growth will likely be tepid even if the negative tail risks can be avoided.

- **Monetary policy in EMs** has already been eased during 2012 and we expect additional rate cuts in some countries. With inflation rates relatively close to targets, we believe monetary policy will remain accommodative for some time which should help support growth over the next 12 months.

- The direction of **commodity prices** is obviously more difficult to predict and it will depend in turn on growth in EMs, especially large commodity consumers such as China. Recent data suggests that China's economy is stabilizing which, combined with exceptionally easy monetary policy in DMs, should continue to support commodity prices.

- With respect to **capital flows** we believe that the current environment strongly favors inflows into EM assets. DM monetary policy will help sustain the search for yield and associated inflows while somewhat reduced global tail risks should help shore up appetite for riskier assets.

Cyclical vs. Structural

Based on the factors discussed above, we believe the cyclical growth slowdown in EM has mostly run its course and we should see a period of stabilization. While a strong rebound seems unlikely, given the sluggish outlook for advanced economies, the question remains whether we should expect a gradual rebound towards the higher growth rates observed in the past. On the other hand, if the recent EM slowdown also has a structural

component, a significant rebound would be unlikely and we might even slow down further.

This question applies particularly to China which has grown at about 10% annually on average over the past 30 years. Every economy in the world that has ever reached similar growth rates over significant periods of time has eventually slowed down to much more moderate levels. Thus, it seems fair to expect the same to happen in China at some point. The question is when and how fast, and whether the recent slowdown is a sign of lower structural growth going forward.

Outside of China, current growth rates are more in line with average growth during the previous two decades (Figure 7). With the exception of the EMEA region we see little reason to suspect a structural growth slowdown. In the EMEA region the situation is different. Prior to the crisis, growth in that region had been boosted by capital inflows and rapid credit expansion, resulting in high and often unsustainable current account deficits. As this source of growth is now lacking, we believe these economies will be growing at a lower rate. This is neither new nor was it unexpected. In Latin America, current growth is running slightly lower but this is mostly due to the cyclical slowdown in Brazil. Other economies, such as Mexico, are doing relatively well in our opinion. As described above, we expect a cyclical rebound in Brazil which should bring regional growth rates more in line with historical averages.

Figure 7: GDP Growth
Sources: Haver Analytics, Stone Harbor Forecasts

China remains key

This brings us back to China where we have seen the strongest drop in growth—although China is still the world's fastest-growing large economy. Chinese policy makers have lowered their growth targets over the past two years significantly. The current 5-year plan (which covers 2011-15) calls for growth around 8%. We believe that explains why stimulus measures have not been very aggressive—much in contrast to 2008/9. However, many investors fear that Chinese growth will slow much beyond the 7-8% range and that efforts to stimulate the economy in order to achieve the growth targets would fail because China's growth potential is now much lower.

So let's take a systemic look at the determinants of China's potential growth. The first factor is labor force growth. As a result of China's one-child policy, population growth has slowed sharply. Labor force growth has been lagging (as it depends on birth rates in earlier years) but is now also starting to slow. While averaging 1% during 2000-2010, it will average only 0.3% during 2010-2020 (and will actually turn slightly negative by 2020) according to ILO estimates (Figure 8). Even with unchanged per-capita GDP growth, this reduces overall potential growth by 0.7ppt.

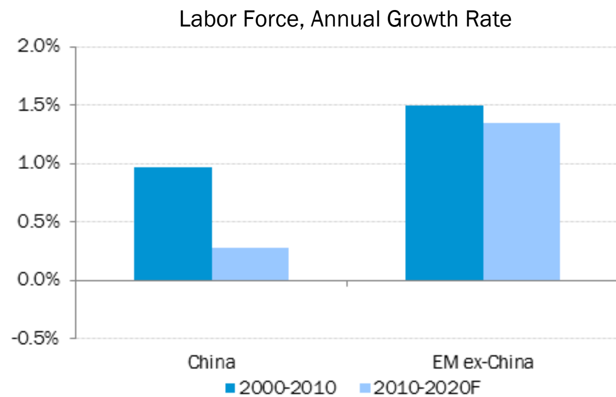

Figure 8: Labor Force Annual Growth Rate
Source: International Labor Organization

Labor force growth has not been the key demographic factor in China's rapid growth; we

believe the urbanization trend has been much more important. As workers have been moving from rural areas where labor productivity is low to cities with much higher productivity jobs, overall labor productivity has been growing rapidly. China's urban population growth has exceeded overall population growth by more than 3 ppts annually over the past 20 years. And that process of urbanization still has a long way to go. China's urbanization rate has just passed 50% in 2011. In comparison, Brazil's rate is 85%, Korea 83%, Mexico 78%, and Russia 74%. As urbanization continues productivity growth should remain high. In addition, Chinese production continues to move up the value-added chain. This process will eventually slow down as China is narrowing the technology and income gap to major advanced economies. This has happened in all Asian economies that experienced periods of fast catch-up growth: Japan, Taiwan, Korea, Hong Kong, and Singapore. However, that slowdown occurred much later when the relative income gap was already much smaller. China's per capita GDP is still less than 20% of the US level. For example, by the time Korea's growth slowed down markedly it had already reached 45% of US per capita income. In Japan this happened even later. So the outlook for strong productivity growth remains good based on continued urbanization and a large income gap.

Investment is the third key determinant of China's potential growth, and China stands out globally with record high investment rates. (Figure 9) Importantly, that rate has not dropped which means that China's capital stock continues to grow at a rapid pace. The fast-growing capital stock supports continued gains in labor productivity as the capital stock per worker expands; this includes infrastructure which is particularly important for maintaining high GDP growth potential.

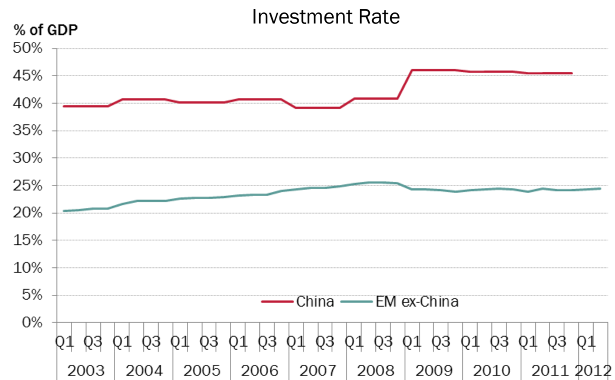

Figure 9: **Investment Rate (in % GDP)**
Source: Haver Analytics, Stone Harbor estimates

Nevertheless, we believe that China's investment rate will decline as the economy rebalances towards increased consumption. A gradual moderation of the investment rate would ultimately be a positive development, in our view, but a rapid fall would be problematic. There are many examples of investment booms (often in combination with housing booms) that came to a rapid halt resulting in a sharp recession: the peripheral European countries in the current crisis, and the emerging Asian economies prior to the 1997 Asian crisis. However, in almost all cases sustaining financing of the investment boom became the main problem. Countries did not generate sufficient domestic savings to sustain high investment rates and had to rely on foreign sources that ultimately dried up and reversed. The situation is very different in China which generates more savings than needed to support current investment. The result is the current account surplus—China's export of excess savings to the rest of the world. However, China's capital controls prevent most of those savings from leaving China. As a result, we believe China has ample and stable financing sources to support the high investment rate.

Considering the main drivers of long-term growth, we see little reason to believe that China's potential has fallen below 7-8%. Furthermore, with cyclical factors stabilizing, growth should remain in that range. Outside of China, growth potential is likely very

similar to what is was over the past ten years. Labor force growth is only slightly lower and investment rates are higher than they were ten years ago.

The bottom line

The slowdown in global growth, including in EMs, has raised concerns about the sustainability of the EM growth outlook. This includes not only China, but also EMs more broadly. Concerns range from the possibility of a deeper cyclical slowdown to structurally weaker growth. However, we argue that the growth slowdown is well explained by six key factors (natural fading of the post-crisis rebound, withdrawal of stimulus, Euro crisis, slow US recovery, commodity prices, and lower capital inflows) and these factors suggest a stable to somewhat improving cyclical outlook going forward. A strong rebound on the other hand is unlikely, in our view, unless the advanced economies start growing faster.

Looking beyond next year, we believe EM potential growth remains strong. In China lower labor force growth and somewhat slower productivity growth has likely reduced potential growth from around 10% to 7-8%, but we believe it has not dropped further than

that. Very low inflation pressures despite current growth of 7-8% support that view. Outside of China, we see less reason to expect lower potential growth in the future. Obviously, each country is different and needs to be assessed individually, but we believe labor force and investment trends as well as recent dynamics show few signs of lower structural growth. The exception is developing Europe where past growth rates were pushed to unsustainable levels by capital inflows and credit expansion. Most likely, we will not return to these rates, but that has been broadly understood for a few years already.

So what are the implications of this view? Both China and advanced economy growth remain critical for the EM outlook. But the EM growth story is still intact and we believe capital flows to EMs will accelerate gradually as growth stabilizes. Thus we believe EMs remain very attractive investment destinations. And EM debt in particular looks attractive in an environment of stabilizing (though not rapidly accelerating) growth.

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