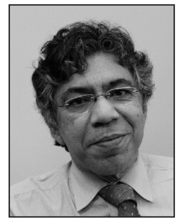
Foreword



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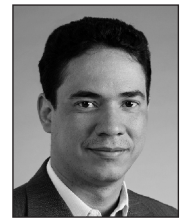

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Almost three years after the crisis, the new reality reflects the consolidation of a progressive tectonic plate shift initiated a decade ago. Emerging economies (EMEs) are now, with no doubt, at the centre stage of growth and stability in the world economy. This is already having a radical impact on the investment landscape and can be expected to continue. However, EMEs have no room for complacency, as there are two critical factors that can be expected to threaten their new position. Growth without structural reforms is concealing problems that can be seriously destabilising in the future. Globalisation has created interdependencies between EMEs and advanced economies (AEs) that are here to stay, and will continue to count heavily on the economic outcomes of both groups. Understanding and taking action on those two factors as they develop will be essential for policy makers and investors. Differentiation among EMEs in their potential for continuous growth and stability will depend on those actions.

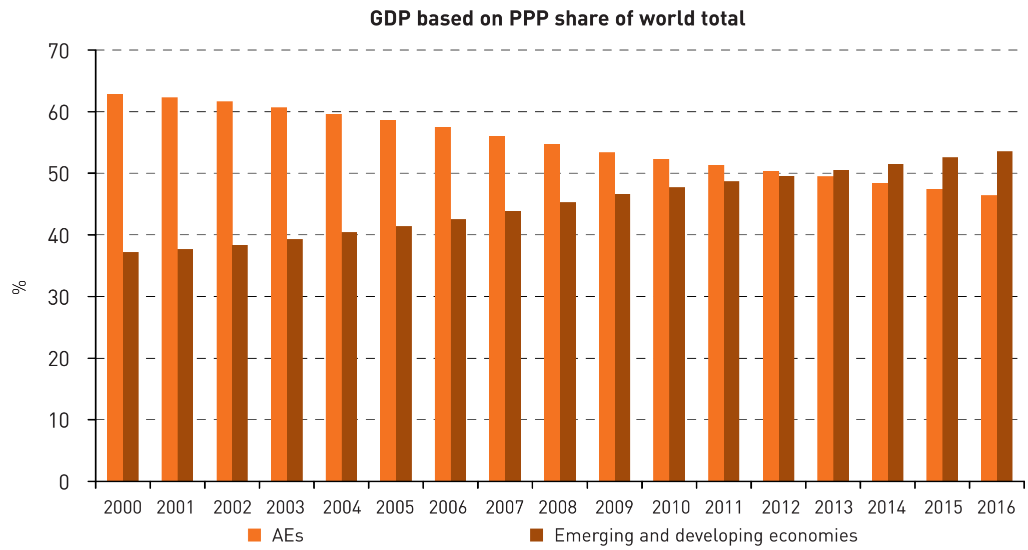
The consolidation of the tectonic plate shift

EMEs have acted as engines of global economic growth and are expected to continue increasing their share over total GDP.[2] In 2010 their share of global GDP growth was almost 70%. On purchasing power parity (PPP) terms EMEs will account for more than half of world GDP (see Exhibit 1). This is largely linked to continued EMEs support for fiscal and monetary discipline, but is also dependent on a new wave of structural reforms to increase output potential and reduce dependency on exports.

Debt and fiscal balances differentials between the two groups are a core feature of the ongoing balance shift and will support a larger margin of manoeuvre for EMEs while limiting growth potential and policy options for AEs. Gross debt over GDP in AEs is expected to be over three times larger than that of EMEs as of end-2011: 103% versus 33% (see Exhibit 2). Fiscal deficit may improve in AEs with recovering GDP growth and austerity packages but it is still expected to be more than double the size of fiscal deficits in EMEs: 6.8% versus 2.7% in 2011 and 5.3% versus 2.2% in 2012.[3]

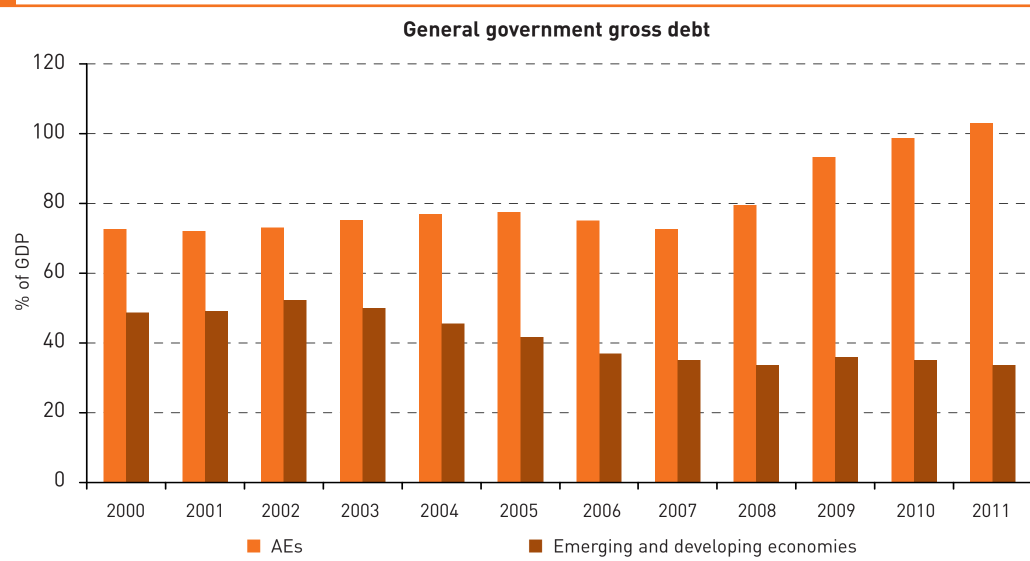
The successful and sustained growth story in EMEs is counterbalanced by higher and growing inflation pressures: 6.61% in 2010 and expected 6.51% in 2011 versus 1.88% and 2.11% for the same years in AEs. This is a symptom of risks confronted by EMEs as their successful growth story unfolds, as will be explained below.

EMEs' growing share of world GDP — Exhibit 1



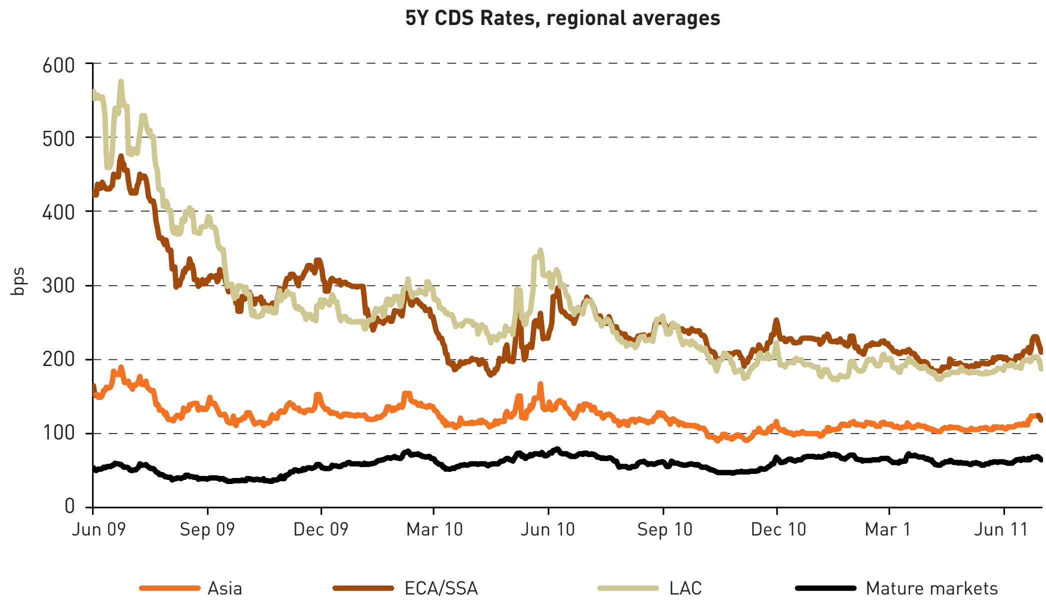
Source: IMF, World Economic Outlook Database, April 2011

EMEs' versus AEs' gross debt over GDP — Exhibit 2



Source: IMF, World Economic Outlook Database, April 2011

Narrowing credit default swaps (CDS) spreads **Exhibit 3**



* Countries included in regional index: Asia: China, Indonesia, Malaysia, Philippines and Thailand; ECA/SSA: Croatia, Hungary, Kazakhstan, Poland, Romania, Russian Federation, Slovak Republic, Turkey, Ukraine and South Africa; LAC: Argentina, Brazil, Chile, Colombia, Mexico and Peru; Mature markets: UK, Japan and Germany.

Source: Bloomberg

In all, comparisons above weigh highly in favour of EMEs. This is reflected in the large number of credit rating upgrades among EMEs since 2000 and continuous portfolio investment inflows now above pre-crisis levels.

All EMEs' indices are now investment grade and their local market segment for bonds has outperformed all asset classes since the financial crisis, except for gold (following the GBI-EM index). The last credit rating in AEs took place in 2007 whereas, since that date to May 2011, EMEs have received 102 credit rating upgrades.

EMEs' outperformance is reflecting higher yields and currency appreciation when compared to AEs. However, EMEs have also become safer destinations as illustrated by improvements in credit ratings and in narrower CDS spreads when comparing AEs and EMEs (see Exhibit 3).

The favourable landscape for EMEs is paving the way to narrow impressive gaps with AEs regarding their level of financial market development. In spite of a much faster growth over the past decade, the stock of equity and debt in EMEs accounted for only 18% of the world's total financial stock at the end of 2010.[4] These figures are set for a remarkable transformation. Emerging equity market could reach 55% of global equity market cap by 2030 (from 31% in 2010).[5] Similarly, the share of EMEs in global debt markets is expected to grow from 11% in 2007 to just over 30% by 2030 and to nearly 40% by 2050.[6]

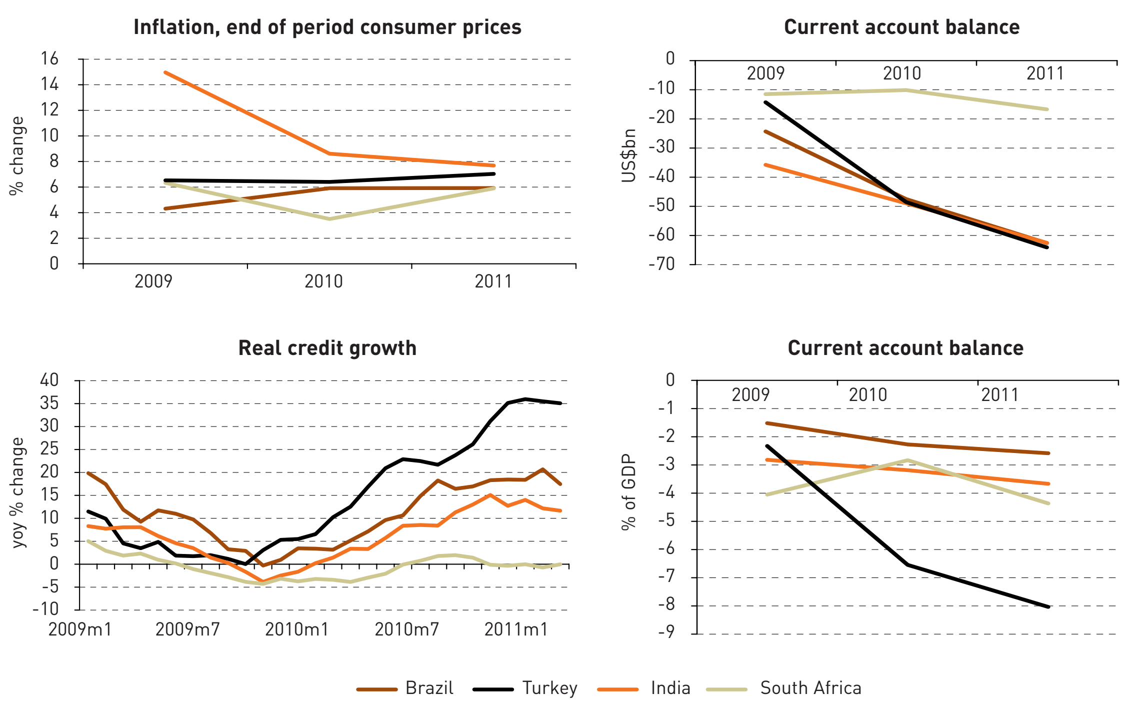
These prospects for the development of capital markets in EMEs illustrate their potential in the global financial arena. However, these are based on assumptions that EMEs will be able to efficiently tackle the significant challenges they face, such as the need for further consolidation of growth and macroeconomic balances through structural reforms and accessibility of markets. These challenges are discussed in the next section.

A warning against complacency

EMEs should not take the current situation and positive prospects as given. The ongoing rebalancing can come to a halt as pre-conditions in the macroeconomic front that have boosted investors' confidence in EMEs can deteriorate very fast, as recent experience in AEs shows.

EMEs are facing two great challenges to consolidate their position. The first one is avoiding overheating and conducting structural reforms to ensure sustainable growth. Current growth rates can conceal problems that could compromise long-term fiscal policy, price stability and competitiveness. Several EMEs are already facing important imbalances for enduring long-term growth as illustrated by higher inflation, strong credit growth and, in several notable cases, worsening current account balances (e.g., Brazil, Turkey, India, South Africa). This is aggravated by short-term policy dilemmas caused by large capital inflows that are beyond the absorption capacity of most EMEs and therefore accentuate macroeconomic imbalances (e.g., excess liquidity, credit growth, asset price pressures), but are also highly dependent on domestic policy decisions alien to capital inflows. In this context, structural reforms would be critical to increase output potential and expand the available range of investable assets, so as to elude the build-up of asset bubbles. Depending on the country, reforms should include infrastructure, taxes, further liberalisation of the economy and address pressing social needs in education and health.

The risk of overheating in EMEs **Exhibit 4**



Source: IMF, World Economic Outlook Database, April 2011

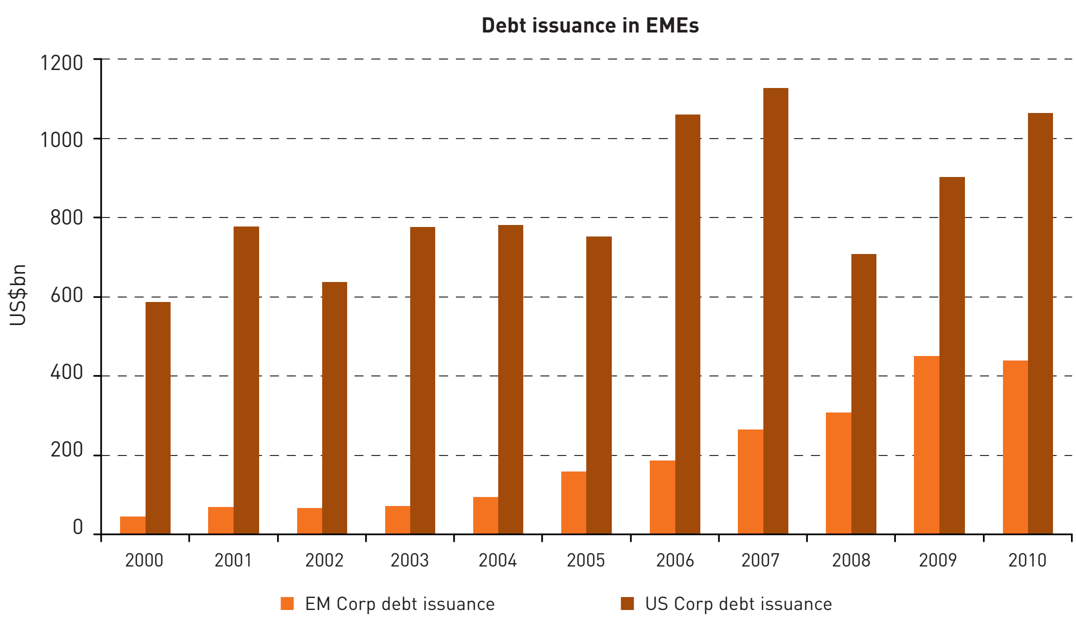
The second challenge is related to the broadly acknowledged interdependencies between EMEs and AEs, in spite of the greater autonomy of the former. The debate is no longer about the extent of decoupling but how interdependency operates as it can now be expected to be a constantly unfolding reality. This is a permanent legacy of globalisation and relates to both the financial sector and the real economy. Whereas south-to-south linkages in trading and capital flows are growing, north-south flows will still play a very relevant part in EMEs' capacity to grow. EMEs' future is also dependent on successful deleveraging in AEs and their resumption of growth. On the investment landscape side, the risk-on risk-off trading paradigm[7] based on the assumption that AEs, and the dollar in particular, are safe havens, even if the bad news is generated in AEs (e.g., eurozone or debt ceiling discussions in the US), shows that increased credibility in EMEs is not bullet-proof.

What's next for EMEs as investment destination?

GDP growth, particularly higher GDP per capita and a lower income gap, is generally associated with availability and quality of infrastructure as well as with stronger institutional frameworks (governance and enforceable rule of law). These are essential pre-conditions for increased availability of marketable assets contributing to sustainable rates of growth. How EMEs will deal with maintaining sound macroeconomic balances while conducting structural reforms and improving access, under the current period of bonanza, will determine three types of trends:

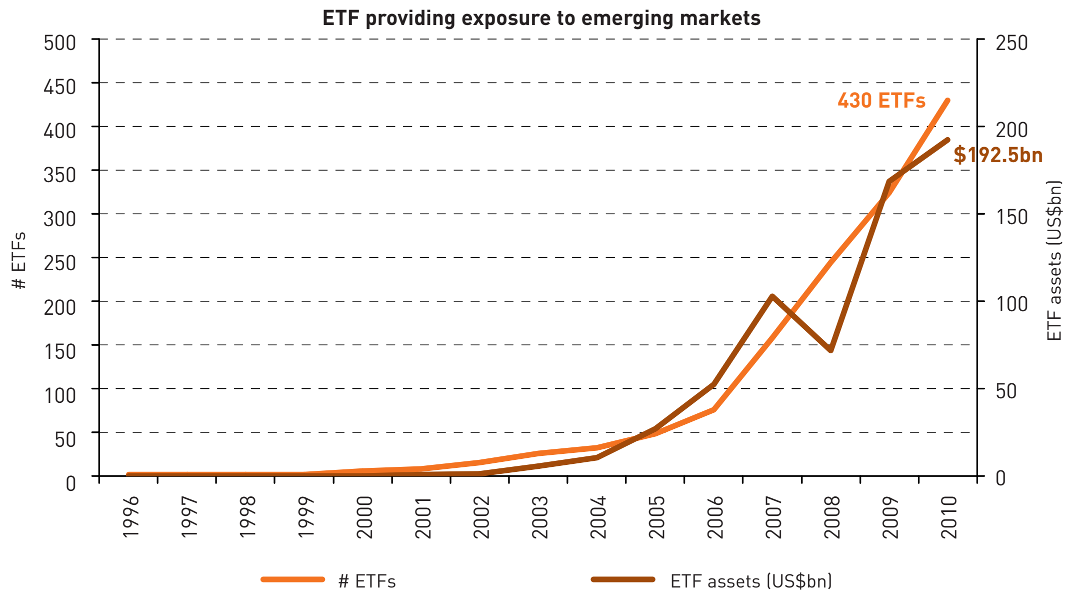
– A clearer differentiation by international institutional investors between the large, most advanced EMEs as investment destinations.

Corporate bond in EMEs **Exhibit 5**



Source: Thomson IB deals and SIFMA

Exchange traded funds (ETFs) in EMEs **Exhibit 6**



Source: Blackrock ETF Landscape, Emerging Market ETFs Industry Review, November 2010

- The expansion into new types of assets beyond equities and government bonds. For example, corporate bonds at 50% above their pre-crisis issuance volumes and ETFs with exponential growth since 2003 are already growth products (see Exhibits 5 and 6). However, their growth potential can only be reached if structural changes as mentioned above are tackled.
- The inclusion of frontier markets in the radar screen of international investors. This is already a post-crisis ongoing trend focusing on several low-income countries in Sub-Saharan Africa and Asia. Some of the middle-income economies in the Middle East and North Africa can also be expected to join this group if the new regimes address the challenges mentioned.

The tectonic plate shift in favour of EMEs is unavoidable but its outcome can be very different depending on how accompanying domestic policies are designed. Local currency capital markets would be an essential pillar to manage the multiple short and long-term challenges faced by EMEs: funding infrastructure, private sector growth and supporting financial stability. For good or bad, consequences will affect both EMEs and AEs. The recent inclusion of local currency bond market development in EMEs as a central topic in the G-20 agenda on the International Monetary System is an acknowledgment of how the future of both EMEs and AEs is tightly woven together.

Notes

1 The authors would like to thank Olga Akcadag for her excellent research support. The views expressed in this article are those of the authors and do not necessarily represent those of the World Bank or World Bank policy, nor do they commit the World Bank in any way.

2 Canuto, O. and Giungiale, M. (eds.) 2010. The day after tomorrow: a handbook for the future of economic policies in the developing world. Washington: World Bank. Available at <www.worldbank.org/prem>

3 IMF: Fiscal Monitor update, June 2011.

4 As a share of GDP, the gap is equally wide – total financial stock represents 197% of GDP in EMEs, compared to 427% of GDP in mature economies (source: 'Mapping Global Capital Markets 2011', McKinsey Global Institute. August 2011).

5 Goldman Sachs, 2010. EM Equity in Two Decades: A Changing Landscape. *Global Economics Paper No: 204*.

6 Goldman Sachs, 2010. Emerging Market Debt: From "Niche" to "Core".

7 Term coined by David Bloom of HSBC referring to correlated assets when investors increase or reduce their risk preference (risk-on versus risk-off).