Foreword

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THE YEAR OF 2009 WILL BE REMEMBERED FOR ENDORSING A STRUCTURAL SHIFT IN THE RELATIVE POSITION OF EMERGING MARKET ECONOMIES (EMEs) IN THE GLOBAL INVESTMENT UNIVERSE. COMPARED TO THE PREVIOUS DECADE THE WORLD LOOKED UPSIDE DOWN ON TWO ACCOUNTS. THE SIZE OF THE CRISIS LED ADVANCED ECONOMIES TO FISCAL DEFICITS UNSEEN SINCE WORLD WAR II AND EMEs MANAGED TO WEATHER THE DOWNTURN WITH UNEXPECTED RESILIENCE. EMEs HAVE THUS ACQUIRED A KEY ROLE IN THE OVERCOMING OF THE GLOBAL CRISIS. FURTHERMORE IT HAS BECOME CLEAR THAT THEIR POSITION AS ECONOMIC ENGINES IS INCREASINGLY MORE SUSTAINABLE AND THEIR CREDIBILITY AS INVESTMENT DESTINATION (AS ILLUSTRATED BY CREDIT RATINGS, CDS SPREADS, AND INVESTMENT FLOWS) IS GOING THROUGH A COPERNICAN REVOLUTION.

This implies a scenario of increasing opportunities, but also of considerable challenges. How to channel savings effectively into productive investments, while maintaining macroeconomic stability? How to minimise the consequences of debt overburden in advanced economies on investment flows to EMEs? How to avoid the threat of potential loss of value of EMEs' accumulated wealth (in the form of reserves) currently invested in advanced economies? Solving this equation correctly should provide grounds for a second Copernican revolution related this time to the real economy. This would mean substantially narrowing the socioeconomic gap with advanced economies, and would introduce a new way of thinking about EMEs in the global arena.

The divergent toll of the crisis between advanced economies and EMEs

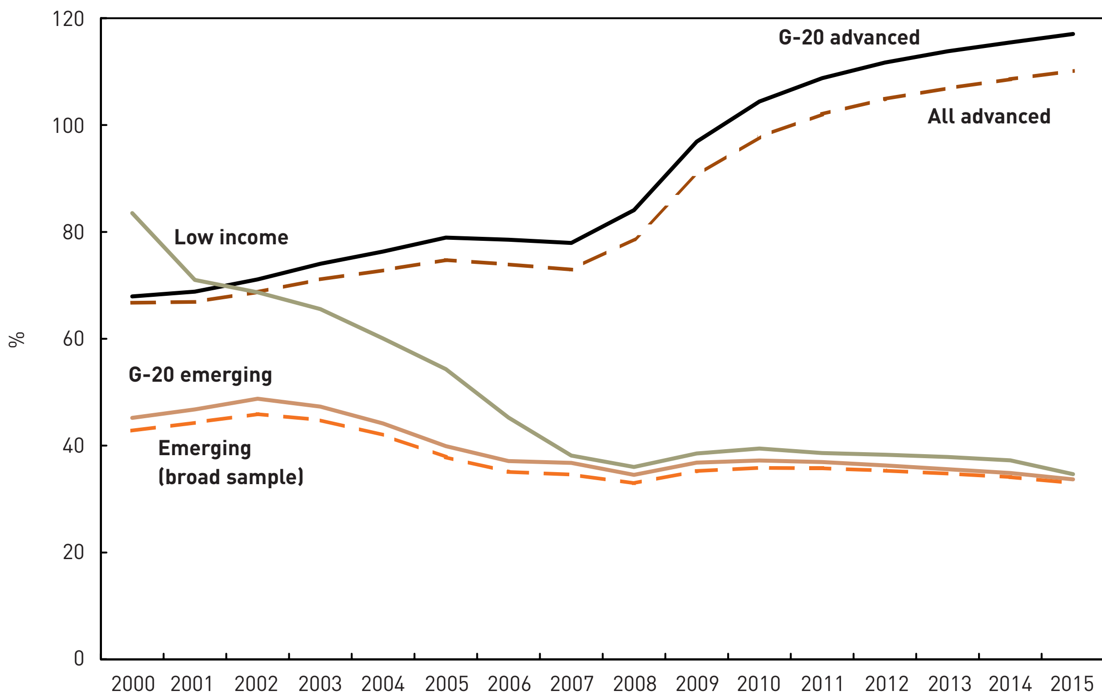
In 2009, EMEs initiated a recovery from a milder impact of the crisis while advanced economies were still struggling with the consequences of the crisis and trying to avoid a double dip recession[2]. But what made EMEs' recovery remarkable was that it came after an almost halt in trade and financial flows in the third and fourth quarter of 2008. This near freeze was triggered by the combined effect of declining commodity prices since August 2008 and the collapse of Lehman in September 2008 that unveiled the extent of the financial crisis in advanced economies. Two sides of the same coin were

shown in this period concerning EMEs: on one side that they are still vulnerable to extreme external shocks, but on the other side, their capacity to maintain financial stability and to return to growth despite the very weak demand from advanced economies once the trough had been overcome. So no decoupling took place, but instead it became clearer that EMEs had acquired an unexpected relative autonomy once the shock was over that enabled them to resume growth in spite of the sustained poor performance of advanced economies. The consequences of this shift for financial markets in EMEs will be analysed later.

What made the difference was not only the circumstance that the financial crisis originated in advanced economies, but a set of structural changes that had been building in the precedent years which will be determinant to the forthcoming destination of investments. They can be briefly summarised in four points:

First, in advanced economies, direct costs from the crisis are relatively small while indirect costs (lower revenues, fall in GDP and automatic stabilisers) explain two-thirds of the overall debt increase of almost 39 percentage points[3]. According to the IMF, it is expected that average gross public debt as percentage of GDP will rise in advanced economies from 91% as of end of 2009 to 110% in 2010, while in EMEs it is expected to decline below 40% (see Exhibit 1). Most projected deficits are structural rather than cyclical. An enormous effort will be needed in debt consolidation and for a long period that will have a negative impact on growth rates. The crisis caused a

G20 countries: general government debt to GDP ratios (2000–2015) **Exhibit 1**



Source: IMF Fiscal Monitor, May 2010

permanent loss of potential output that will make recovery of growth to previous levels unlikely in many countries[4].

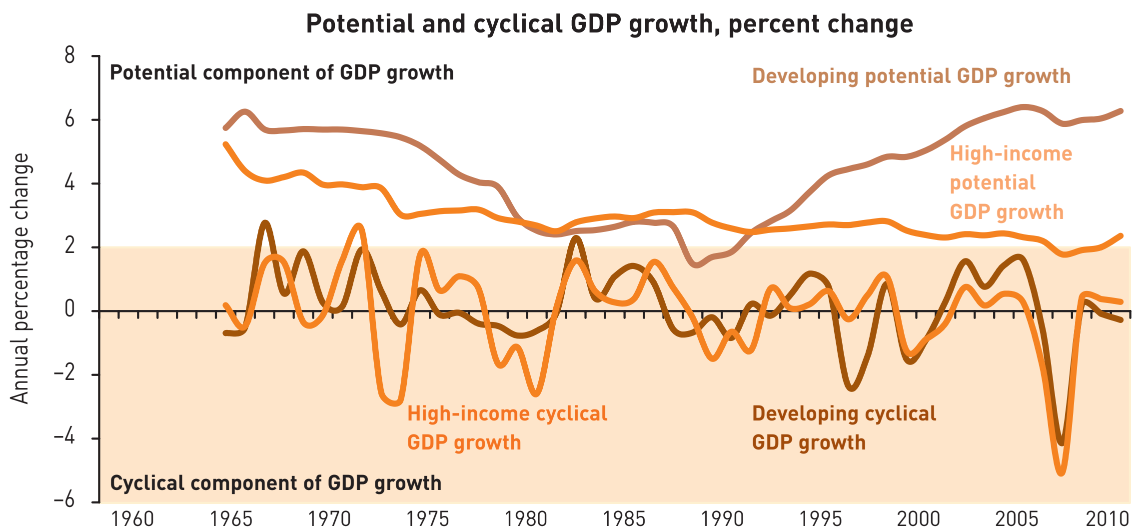
Second, although the downturn of the cycle in advanced economies did have a strong impact on developing countries, 'a trend decoupling' in underlying growth rates is becoming more evident since 2000[5]. This will place EMEs in a better position to address any downturn in the cycle. Pre-crisis prudent macroeconomic management of EMEs in all accounts provided more margin of manoeuvre to conduct countercyclical measures and still left them in manageable fiscal positions when growth rates resumed (see Exhibit 2).

Third, the improvement in growth rates in developing countries is relatively well distributed and no longer centered in China and India. Median growth rates in 2009 were 2.13% as opposed to –3.72% in advanced economies[6].

Fourth, a structural change in EMEs Government debt markets took place resulting in countries being able to finance themselves long term and in local currency; thus becoming free from the long standing trade-off between refinancing and currency risk. Far sighted debt management and market development policies, that had been initiated depending on the country five to 10 years earlier, were crucial to support issuance of long-term debt in fixed coupons. In addition, improved efficiency of local debt markets in terms of liquidity, price discovery and investor base diversifications supported the development of a whole set of new tools by Central Banks and Ministries of Finance to manage the crisis operationally[7].

No doubt that pre-crisis global liquidity conditions facilitated the overall improvement of EMEs through lower interest rates, booming export markets, and easy financing. However, had EMEs not followed prudent macroeconomic policies and conducted Government debt market reforms, the story would have been very different. Higher tolerance to weaker macroeconomic indicators explains in part the situation of outliers in the EMEs universe as shown in some Eastern and Central European countries.

Trend decoupling **Exhibit 2**



Source: World Bank, DEC Prospects Group

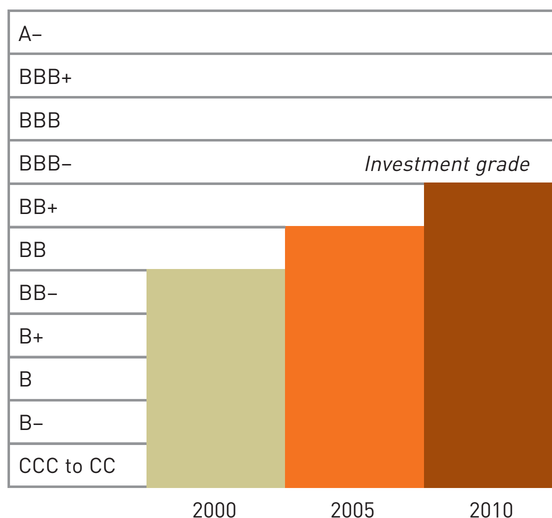
A radical shift in credibility for EMEs as investment destinations

The recovery of investment flows to developing countries in 2009 heading towards pre-crisis levels supports the idea of an underlying trend that is consolidating EMEs as a core investment in diversified portfolios. The trend started with foreign investors buying equities and local currency debt in the beginning of the 2000s. It followed with the impressive performance up to mid-2008 that made EMEs an asset class in itself, and is reaching a new qualitative level in terms of credibility after the test of the largest economic crisis since the 1930s. This is opening the opportunity to broaden the scope of capital markets products in EMEs in a new scale.

The credibility shift is supported by both qualitative and quantitative measures. On the qualitative side credit ratings provide evidence of the trend. Between January 2008 and June 2010, four developing countries obtained investment grade (Brazil, Morocco, Panama and Peru), while four notable cases in advanced economies were downgraded (Greece, Iceland, Portugal and Spain). Furthermore, during the crisis the JP Morgan Emerging Market Bond Index (JPM EMBI) average credit rating improved to investment grade. A snapshot of the average ratings for the 19 largest EMEs in 2000, 2005 and 2010 show a constant improvement reaching investment grade in average in 2010 (see Exhibit 3).

On the quantitative side measures of turnaround of investors' perception include issuance and investment volumes, the speed of the turnaround and a return to pre-crisis yield spreads. After capital markets virtually closed down in the fourth quarter of 2008, issuance volumes of EMEs sovereign debt returned to normality with Mexico's US$2bn 10-year bond in December 2008 followed by Brazil, Colombia, Turkey and the Philippines[9]. Net investment flows of what is considered 'real money' reversed between 2008 and 2009 from – US$57bn to US$87.9bn for equities and from US$15bn to US$54.8bn for medium and long-term bonds[10]. Even more remarkable is the turnaround of retail investors to net inflows in equity and bond funds investing in EMEs (see Exhibit 4). On risk

Evolution of average rating for 19 largest EMEs in GEMX[8] **Exhibit 3**



Source: Own elaboration with ratings input from Standard and Poor's

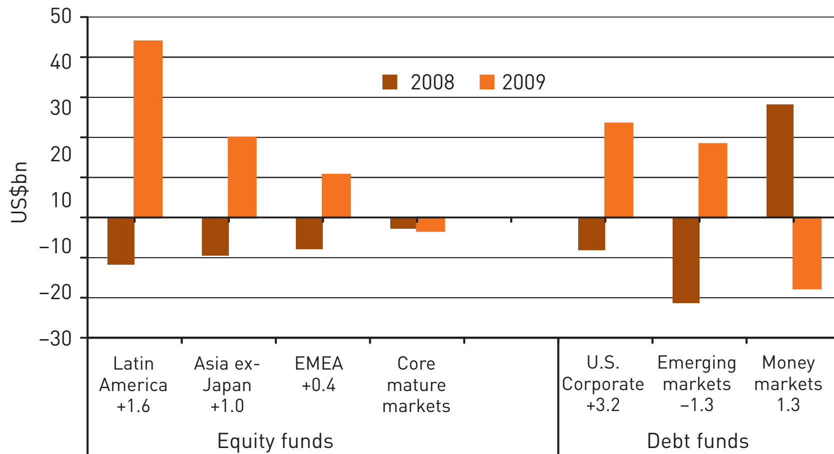
indicators, CDS and EMBIG spreads returned across almost all EMEs, with few exceptions in emerging Europe, to pre-crisis by the end of 2009 (see Exhibit 5).

There have been push and pull factors behind EMEs performance in 2009. Among the push factors are excess liquidity in advanced economies after expansionary policies, the very low interest rate yields and low growth prospects. It is estimated that in 2009 money markets funds in the US had outflows of around US$575bn as a result of their close to zero yields[11].

Pull factors are the combined result of growth resuming in 2009 across most EMEs, superior macroeconomic balances when compared to advanced economies in spite of the crisis, higher yields resulting from initial liquidity tightening and prospects of currency appreciation in countries with flexible exchange regimes. This has been reinforced by the fact that EMEs have consistently performed better than advanced economies since 2002, even in the sharper phase of the crisis (see volatility adjusted returns for equities in Exhibit 6).

Cumulative retail net flows to equity and debt funds

Exhibit 4

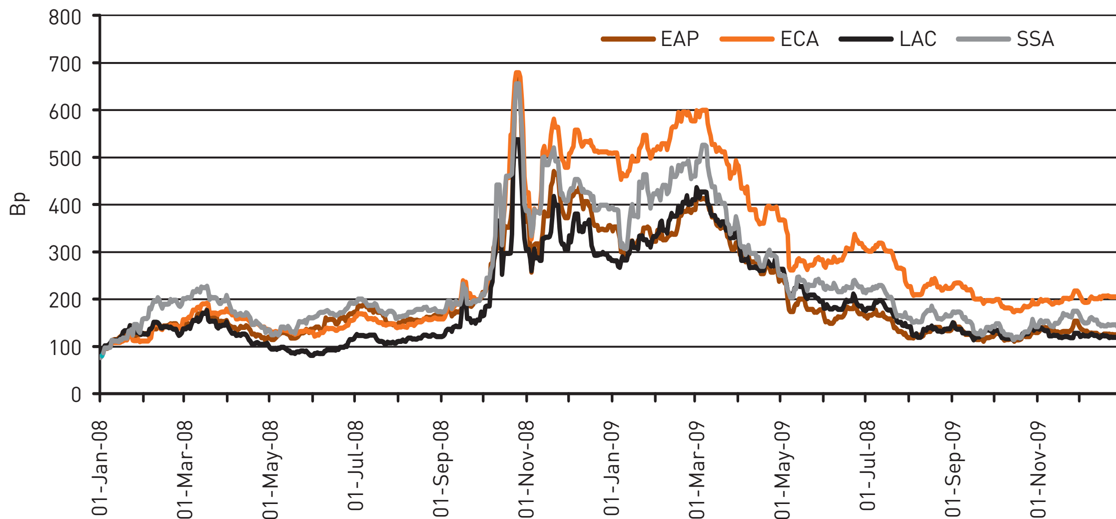


Note: Numbers underneath bars represent ratio of net flows in 2009 to those in 2008. '+'('–') when net inflows turned positive (negative) in 2009 from negative (positive) in 2008. EMEA represents Europe, Middle East, and Africa. Core mature markets include Japan, US, and Western Europe. US corporate represents inflows into US mutual funds investment primarily in corporate debt.

Source: IMF April 2010 Global Financial Stability, April 2010.

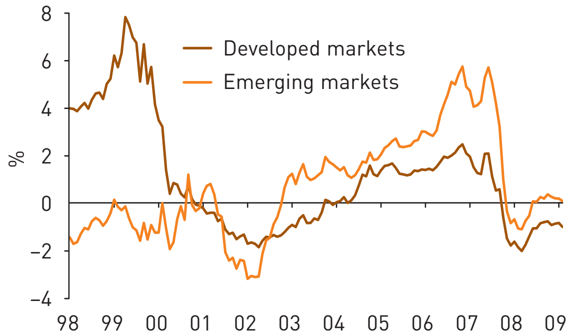
Average five-year CDS spread

Exhibit 5



Source: Bloomberg LP, Datastream

Equity returns in EMEs on a volatility adjusted basis **Exhibit 6**



Source: Bloomberg L.P.; MSCI Barra; and IMF staff estimates

What seems to be developing as a broader consensus among investors and economists is that the pull factors are reflective of a radical new scenario in emerging markets. There may still be deviations from the trend and in some cases backward steps. However, few would doubt that the impressive performance of EMEs during the last crisis is the result of sound fundamentals and their stronger position is here to stay. This well founded credibility is what was referred to at the beginning as the Copernican revolution in the investment scenario.

The challenges of the new position of EMEs to narrow the development gap

In spite of the strong fundamentals, the current position of EMEs is not without risk, particularly in a scenario with still many uncertainties on the capacity of advanced economies to resume growth while bringing debt to sustainable levels. Additionally, the risk of further shocks to the global financial system cannot be fully discarded yet. This time coming from the debt overburdened EU countries.

Challenges to EMEs may be classified in three groups.

First, the macroeconomic buffer that made most EMEs resilient to the shock needs to be reinforced. This is particularly important as countries reduced their external reserves and fiscal space for countercyclical measures, and in some cases they still need to maintain some degree of intervention. So a gradual approach is required.

Second, even in the event of no further shocks occurring, the unstable position of advanced economies poses a double threat to EMEs: lower than projected aggregate demand that would impact EMEs growth and tougher conditions to finance sovereign debt.

Third, even if global conditions remain favourable, EMEs would nevertheless need to deal with several tests:

- Dealing with large capital inflows and their impact on currency appreciation and building of asset bubbles. This will entail complex policy decisions regarding capital controls, prudential regulations and the choice of sterilisation instruments.
- Managing inflationary pressures as it has started to be experienced in some countries that have already tightened their monetary policy (e.g., Brazil and China).
- Devaluation and low returns on reserve money from EMEs that is invested in advanced economies as a result of a realignment of exchange rates and reduced yields.

EMEs capacity to navigate across this web of risks will be determinant in taking full advantage of the current benign conditions and newly acquired status. Two types of developments that are gradually being built seem to indicate the path that would enable handling the mentioned risks to EMEs advantage.

The first one is the continuous reinforcement of south-to-south links that started with trade and are now being followed by investment flows[12]. This should reduce some of the drawbacks mentioned with reference to financial dependency from advanced economies. The second one is even more challenging, because it relates to consolidating the domestic infrastructure and the institutional and regulatory framework to channel financial flows effectively. This includes not only the real economy, but also the institutional set up of capital markets so that they comply with their role of efficient resource allocation.

EMEs have demonstrated strong commitment to macroeconomic stability. This time if institutional and infrastructure development are put at the top of their agenda; we can then expect to see the second Copernican revolution that would shift the divide between developing and advanced economies.

Notes:

1. The authors would like to thank Nita Gojani and Indhu Raghavan for the 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. Growth in high income economies: G7 economies fell 0.4% in 2008 and –3.3% in 2009 and is expected to recover to 2.3% in 2010, while developing countries showed growth of 5.7% in 2008 and 1.7% in 2009 and projections for 2010 stand at 6.2%. (Source: World Bank, Global Economic prospects Summer 2010: Fiscal Headwinds and Recovery).
3. IMF Fiscal Monitor, May 2010.
4. Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, "The future of public debt: prospects and implications" in BIS Working Paper No 300, March 2010 and IMF, Fiscal Monitor, May 2010.
5. Canuto, O: "Recoupling or Switchover: Developing countries in the global economy" forthcoming in Canuto, O & Giugale, M. (eds.), "The Day after Tomorrow: A Handbook on the Future of Economic Policy in the Developing World", World Bank.
6. *Idem*.
7. Phillip R D Anderson, Anderson Caputo Silva, Antonio Velandia-Rubiano "Public Debt Management in Emerging Market Economies: Has This Time Been Different?" Forthcoming in "Sovereign Debt and the Financial Crisis," eds. Carlos A. Primo Braga and Gallina A. Vincelette, World Bank. 2010.
8. GEMX is an index managed by Markit comprising local currency government bonds from 23 EMEs.
9. Phillip R D Anderson, Anderson Caputo Silva, Antonio Velandia-Rubiano "Public Debt Management in Emerging Market Economies: Has This Time Been Different?" Forthcoming in "Sovereign Debt and the Financial Crisis," eds. Carlos A. Primo Braga and Gallina A. Vincelette, World Bank. 2010.
10. Source: WB Global Economic Prospects: Summer 2010
11. IMF, GFSR April 2010.
12. A recent research note from JP Morgan draws the attention to increasing FDI and bilateral loans from China into Latin America following trade growth between the two regions. It could be expected that capital flows would follow.