

The mojo is back

The Fed's ultra-loose monetary policy may not be helping the US, but is supercharging growth in many emerging markets



Ruchir Sharma

ONCE a soufflé collapses, it rarely rises again. That has indeed been the experience of most developed economies following the global financial meltdown, with economic growth still flattish and equity markets on seemingly a long road to nowhere.

But the fluffy stuff is not just back in many emerging markets, it is puffing up to levels last reached at the height of the 2003-07 economic boom. Capital flows are running at nearly the same record pace as in 2007 when emerging markets outside west Asia attracted more than \$500-billion net. In fact, portfolio inflows this year have already surpassed the 2007 peak of \$89 billion with emerging market debt and equity products so far pulling in more than \$100 billion in fresh money.

At least in some parts of the world then, abundant liquidity has helped recreate last decade's golden era of economic growth. India, Indonesia, Turkey and Brazil are among the countries where analysts now believe that the 2003 step-up in economic activity was actually a trend for the foreseeable future. The pace of expansion in emerging markets doubled to 7.2% a year from 2003 onwards following a long period of lacklustre growth that averaged 3.6% on an annualised basis between 1980 and 2002.

The surge in their growth trajectory stalled after the economic meltdown of 2008 as export growth directed to the freely-spending US consumer took a hit, as did the easy access to cheap capital. Strong exports and the global credit bubble were significant factors behind the growth leap in the developing world; it was no coincidence that the levitation act of emerging markets began in earnest from mid-2003, once the US economy started to sharply recover as the Fed aggressively cut interest rates.

It was natural to assume that unless a V-shaped economic recovery occurred in the US following the Great Recession, growth rates in emerging markets would downshift this decade with external demand contributing less to growth and capital flows possibly slowing on account of lingering investor caution. In reality, the recovery in the developed world has been U-shaped and exports are not providing developing countries as big a boost to their growth, as in the 2003-07 period. Growth rates in the industrialised economies are likely to be a full percentage point less in the coming years due to structural problems related to the debt overhang.

There has indeed been some fallout from the New Normal in the developed world. Consensus estimates suggest that average growth in emerging markets as a whole will settle at a trend rate of 5.5% — lower than the annualised 7.2% rate of 2003-07. But that is still far above what prevailed in the 1980s and 1990s, and the higher growth is being facilitated by the capital that comes gushing back in, once again reducing the cost of funding to record low levels.

Furthermore, the composition of the emerging market growth mix has changed. The developing countries that gained mostly through the trade channel in the 2003-07 era are now experiencing the slowest recoveries; their trend growth in the years ahead should be relatively slower compared to the previous boom period. The fastest bounce-back is in those emerging market economies where capital inflows played a major role in propelling growth higher and

where domestic demand prospects are exciting. As long as global financial market conditions remain benign, growth momentum in the latter group of countries is likely to remain strong.

Trend growth is settling at a lesser rate in Russia, South Africa and even China. The current account surplus in Russia and many other oil-exporting countries is much smaller now, thereby pitching in less substantially to economic growth. China's current account surplus has halved as a share of its economy from near double-digit levels of 2006 and 2007. Although current account positions have deteriorated across emerging markets, the impact on growth is most strongly felt in countries that are either export-dependent or have less promising domestic demand prospects due to a weak banking system and an unappealing demographic profile.

On the other hand, countries such as Brazil and India that are running the largest current account deficits — each at about 3% of GDP — in their recent history are easily funding them and then some more with massive capital inflows. Economist Carmen Reinhart's recent study, *Capital inflows and reserve accumulation*, shows that a surge in capital flows in non-industrial countries over the past few years has consistently boosted their money supply and, in turn, fuelled credit growth. The same dynamic is at work this year

countries for some reason are compelled to pursue growth-unfriendly policies or if an event takes place that causes major global risk-aversion. The biggest threat to the emerging market story is inflation. While the positive side to the ultra-loose monetary policies is increased capital flows, the negative aspect is the difficulty in directing liquidity that can often end up finding the wrong home. Recent examples include the oil price bubble in the first half of 2008 and traces of an echo bubble in some commodity and property prices in late 2009 and early 2010. Policymakers in emerging markets were forced to respond to such misbehaviour, especially in China that needed to crack down on the local property market earlier this year.

Policy tightening steps have so far not dented any of the growth enthusiasm in developing countries as they have been gradual in nature. A retreat in commodity prices during the spring and summer months also dimmed the spectre of inflation. However, ever since Federal Reserve chairman Ben Bernanke made his intentions clear in late August that he would do whatever it takes to reflate the US economy, commodity prices have again cut loose.

The 30% surge in agricultural-based commodity prices over the past quarter is seriously worrisome given the high weight of food in the



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with loan growth rising sharply in the emerging markets that are getting strong capital inflows.

In effect, some degree of decoupling in growth rates and even asset prices has happened between emerging markets and developed countries — a phenomenon that was hard to imagine during the depths of the financial crisis in 2008. However, it is important to note that decoupling is still partial in nature. While some emerging markets with naturally-buoyant domestic demand can continue to grow at the new-era growth rates of 2003-07, even as the developed world settles into a lower growth paradigm, countries from India to Turkey are still dependent on external flows to fund a part of their growth.

But will the current frenetic pace of flows continue into emerging markets and keep the good times rolling? The obvious answer is that as long as the Fed and other developed-country central banks keep real interest rates low, capital will just flow to the best growth opportunities available. The Fed, for its part, seems only more intent to keep pushing on a monetary string and its intentions to engage in another round of quantitative easing over the past few weeks have only sent more money rushing into emerging markets.

The risks to capital flows are if developing

emerging market consumer's basket. Core inflation in many developing countries has anyway been inching higher and — at nearly 4% currently — is already at levels similar to the later stages of the previous boom.

On a related point, whenever the price of oil has reached close to \$90 a barrel, it has always posed a problem for the global economy. Another potential blow to capital flows is a sovereign debt problem in one of the bigger European nations. Spreads on Greek, Irish and Portuguese debt continue to widen but the market has been able to largely ignore this of late because the size of these economies is relatively small at around \$300 billion each. But a more pronounced effect on risk appetite and capital flows is possible if the situation in a trillion-dollar economy such as Spain, which too has terrible debt dynamics, begins to spin out of control.

Until any of these risks materialise, money will keep flooding into emerging markets and nurture the impression that the growth levitation act of 2003-07 in the developing world was not just a fluke but the start of a new era.

(The author is head of emerging markets at Morgan Stanley Investment Management)

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