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ECONOMICS

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Back to Fundamentals in Emerging Markets

CAMBRIDGE – Following 15 years of hype, a new conventional wisdom has taken hold: emerging markets are in deep trouble. Many analysts had extrapolated rapid growth in countries such as Brazil, Russia, Turkey, and India into the indefinite future, calling them the new engines of the world economy. Now growth is down in almost all of them, and investors are pulling their money out – prompted in part by the expectation that the US Federal Reserve will raise interest rates in September. Their currencies have tumbled, while corruption scandals and other political difficulties have overwhelmed the economic narrative in places like Brazil and Turkey.

With hindsight, it has become clear that there was in fact no coherent growth story for most emerging markets. Scratch the surface, and you found high growth rates driven not by productive transformation but by domestic demand, in turn fueled by temporary commodity booms and unsustainable levels of public or, more often, private borrowing.

Yes, there are plenty of world-class firms in emerging markets, and the expansion of the middle-class is unmistakable. But only a tiny share of these economies' labor is employed in productive enterprises, while informal, unproductive firms absorb the rest.

Compare this with the experience of the few countries that did emerge successfully, "graduating" to advanced-country status, and you can see the missing ingredient. South Korea and Taiwan grew on the back of rapid industrialization. As South Korean and

Taiwanese peasants became factory workers, the economies of both countries – and, with a lag, their politics – were transformed. South Korea and Taiwan eventually became rich democracies.

By contrast, most of today's emerging markets are deindustrializing prematurely. Services are not tradable to the same extent as manufactured goods, and for the most part do not exhibit the same technological dynamism. As a result, services have proved to be a poor substitute to export-oriented industrialization so far.

But emerging markets do not deserve the doom-and-gloom treatment they are getting these days. The real lesson from the collapse of the emerging-market hype is the need to pay closer attention to growth fundamentals and to recognize the diversity of circumstances among a group of economies needlessly lumped together.

For developing economies, the three key growth fundamentals are acquisition of skills and education by the workforce; improvement of institutions and governance; and structural transformation from low-productivity to high-productivity activities (as typified by industrialization). East Asian-style rapid growth has typically required a heavy dose of structural transformation for a number of decades, with steady progress on education and institutions providing the longer-term underpinnings of convergence with advanced economies.

Unlike East Asian economies, today's emerging markets cannot rely on export surpluses in manufactures as their engine of structural transformation and growth. So they are forced to rely more on the longer-term fundamentals of education and institutions. These do generate growth – and indeed are ultimately indispensable to it. But they generate 2-3% annual growth at best, not East Asia's 7-8% rates.

Compare China and India. China grew by building factories and filling them with peasants who had little education, which generated an instant boost in productivity. India's comparative advantage lies in relatively skill-intensive services – such as information technology – which can absorb no more than a tiny slice of the country's largely unskilled labor force. It will take many decades for the average skill level in India to rise to the point that it can pull the economy's overall productivity significantly higher.

So India's medium-term growth potential lies well below that of China in recent decades. A significant boost in infrastructure spending and policy reforms can make a difference, but it cannot close the gap.

On the other hand, being the tortoise rather than the hare in the growth race can be an advantage. Countries that rely on steady, economy-wide accumulation of skills and improved governance may not grow as fast, but they may be more stable, less prone to crises, and more likely to converge with advanced countries eventually.

China's economic achievements are undeniable. But it remains an authoritarian country where the Communist Party retains its political monopoly. So the challenges of political and institutional transformation are immeasurably greater than in India. The uncertainty that confronts a long-term investor in China is correspondingly higher.

Or compare Brazil with other emerging markets. Among these countries, Brazil has arguably taken the greatest hit recently. The corruption scandal surrounding the flagship state-owned oil company, Petrobras, has produced an economic crisis, with the currency tanking and growth grinding to a halt.

Yet Brazil's political crisis demonstrates the country's democratic maturity, and arguably is a sign of strength rather than weakness. The ability of prosecutors to investigate payment irregularities reaching into the highest ranks of Brazilian society and government without political interference – or the process turning into a witch hunt – would be exemplary in many advanced countries.

The contrast with Turkey could not be more striking. Corruption of a much greater magnitude there, implicating President Recep Tayyip Erdoğan and his family, has gone untouched. A probe by Turkish prosecutors against Erdoğan in 2013 was clearly politically motivated (and driven by Erdoğan's foes in the movement headed by Fethullah Gülen, a self-exiled Islamic preacher), which gave the government the cover needed to quash the investigation. Turkey's economy has not suffered nearly as much as Brazil's, but its rot will cause greater long-term damage.

Cheap external finance, plentiful capital inflows, and commodity booms helped hide many such shortcomings and fueled 15 years of emerging-market growth. As the world economy generates stronger headwinds in the years ahead, it will become easier to distinguish countries that have truly strengthened their economic and political fundamentals from those that have coasted on false narratives and the tenuous strength of fickle investor sentiment.

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