Emerging economies

Climbing back

The economies of what used to be called the “third world” are regaining their ancient pre-eminence

Since their industrial revolutions in the 19th century, the rich countries of the “first world” have dominated the global economy. By one measure at least, that era may be over. According to estimates by The Economist in 2005, the combined output of emerging (or developing) economies rose above half of the global total.

This figure has been calculated from the International Monetary Fund’s World Economic Outlook database. We have adjusted the IMF’s numbers in two ways. First, we have taken account of China’s recent upward revision of its GDP by 17%. Second, we include the newly industrialised Asian economies (South Korea, Taiwan, Hong Kong and Singapore). These countries might well now be classed as developed, but should surely be counted in any estimate of the long-term success of developing countries. If you exclude countries once they prosper, developing economies’ share will never increase.

We have used the IMF’s method of converting national GDPs into dollars using purchasing-power parities (PPPs) instead of market exchange rates. The latter can distort the relative size of economies, not only because currencies fluctuate, but also because prices are lower in poorer economies (so a dollar of spending in China, say, is worth a lot more than it is in America).

The prices of traded goods tend to be similar to those in developed economies, but the prices of non-tradable products, such as housing and haircuts, are generally much lower. As a result, converting a poor country’s GDP into dollars at market exchange rates could understate the size of its economy and its living standards. This is why the IMF uses PPPs, which take account of international differences in prices of the same goods and services, to provide a more accurate measure of the purchasing power of each country’s inhabitants.

It makes a big difference. Measured at market exchange rates, developing economies’ share of global output has fallen over the past quarter-century, to just 26% last year. Measured at PPP, it has (more realistically) risen, to just over half. Perhaps the best evidence of the flaw in current-dollar figures is that they suggest developing Asia’s share of world output was barely higher in 2000 than in 1980, even though it had been by far the world’s fastest-growing region. The effect of growth was distorted by currency movements.

Admittedly, calculating PPPs is tricky. They are based on surveys of prices around the world. But as Keynes used to say, “It is better to be roughly right than precisely wrong.” Using PPPs provides a more realistic estimate of the balance of output between rich and poor countries. But they are not always appropriate. Trade and financial flows, which, unlike the bulk of GDP, are transacted at market exchange rates, should be converted at those rates into dollars. For businesses too, market exchange rates are relevant for converting foreign revenues and profits into dollars.

But even when measured by market exchange rates emerging economies are flexing their muscles. Last year, their combined GDP grew in current dollar terms by $1.6 trillion, more than the $1.4 trillion increase of developed economies. And there is more to this than just China and India: these two countries together accounted for only one-fifth of the total increase in emerging economies’ GDP last year.

Of course, with half the world’s output but five-sixths of its population, emerging economies still have incomes per head far lower than the rich world. But by a wide range of gauges they are looming larger (see chart 1). Their share of exports has jumped to 42%, from 20% in 1970. Over the past five years, they have accounted for more than half of the growth in world exports. Emerging economies are now sitting on two-thirds of the world’s foreign-exchange reserves and they consume 47% of the world’s oil. On the other hand, their stockmarkets still account for only 14% of global capitalisation.

Emerging economies have also become increasingly important markets for com-
panies from the rich world. Developed economies’ trade with developing countries is growing twice as fast as their trade with one another. Over half of the total exports of America, the euro area and Japan now go to emerging economies. The EU exports twice as much to them as it does to America and Japan combined.

As you were
The growing clout of emerging economies is in fact returning them to the position they held for most of history. Before the steam engine and the power loom gave Britain its industrial lead, today’s emerging economies dominated world output. Estimates by Angus Maddison, an economic historian, suggest that in the 18 centuries until 1820 they produced, on average, around 80% of the total. But they were then left behind by Europe’s technological revolution. By the early 20th century their share had fallen to 40% (see chart 2).

The term “emerging market” was coined 25 years ago by the International Finance Corporation, the private-sector arm of the World Bank. For much of the time since, “submerging” has been more apt: look at the succession of crises, from Latin America to East Asia and Russia, in the past decade or so.

Now emerging economies are on the rebound, enjoying their best performance for decades. All 32 economies tracked each week by The Economist (see pages 100-102 and our website) grew in 2005, for the second year running. In every previous year since the 1970s, at least one emerging economy suffered a recession, if not a severe financial crisis. In the past three years, their growth has averaged more than 6%, compared with 2.4% in rich economies. The IMF forecasts that in the next five years they will roll along at just under 6%, twice as fast as developed economies. Extrapolation is risky, but if this relative pace were sustained, in 20 years’ time emerging economies would account for two-thirds of global output. Is this likely?

It stands a good chance. Most emerging economies are today in much stronger health, leaving them better able to withstand adverse global shocks. Their economic policies have matured: most have cut inflation, thanks to stricter monetary and fiscal policies; they have generally shifted towards more flexible exchange rates; and many are now running current-account surpluses and have built up healthy foreign-exchange reserves. Structural reforms to open up markets and to strengthen financial systems are also helping to improve the efficiency of investment.

This week the Institute of International Finance, a bankers’ association, said that net private capital flows to emerging markets hit a record $358 billion in 2005. But most countries no longer need this money to finance current-account deficits. Unlike many previous booms, their current expansion has been financed largely by domestic saving rather than debt: their average ratio of foreign debt to exports has fallen from 174% in 1998 to 82% last year.

Beware of hiccups
However, some of the recent boom in emerging economies is due to three factors that may be unsustainable. First, rising commodity prices have given a fillip to producing countries, such as Russia, Brazil and South Africa. Second, low interest rates have reduced debt-service costs—especially important for Latin America, where the debt-to-export ratio is twice as high as the average for emerging economies. And last, exports have been boosted by America’s strong import demand. This favourable environment cannot last: interest rates are rising, and American consumers cannot keep spending more than they earn. Emerging economies’ energy-intensive heavy industries are also vulnerable to high oil prices. A saving grace is that these risks partly offset each other. A slump in American demand would reduce both interest rates and oil prices.

Perhaps the biggest risk is that the boom may encourage complacency and reform fatigue. Yet further action is needed, from greater fiscal discipline to more flexible exchange rates.

The future expansion of emerging economies will not follow a straight line. It is unavoidable that emerging economies are more prone to economic ups and downs and financial bubbles, as America was during its entry on to the global stage in the late 19th century. However, the long-run prospects for emerging economies as a whole look excellent, so long as their move towards free and open markets and sound fiscal and monetary policies continues. Get these basics right, and developing countries ought to outpace advanced economies. Because they start with much less capital per worker than developed economies, there is huge scope for boosting productivity by importing western machines and know-how.

Confirmation that emerging economies are grabbing a bigger slice of global output will frighten many people in the rich world. It shouldn’t: living standards depend on absolute not relative growth. Emerging economies’ spurt is boosting global output, not substituting for growth elsewhere. Their vim is fuelling growth in the rich world just when grey populations might otherwise cause it to slow—not only by importing from developed countries, but also by supplying cheaper consumer goods, by allowing multinational firms to exploit bigger economies of scale, and by encouraging a better allocation of resources through increased competition. It is surely better for today’s rich countries to have a smaller share of a fast-growing global economy than a bigger one of a stagnant world.