

# VAKIFBANK GLOBAL ECONOMY WEEKLY

## The Future of EM Economies: Relative Decoupling



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# What are the strengths and weaknesses of EM economies?

## Strengths of EM

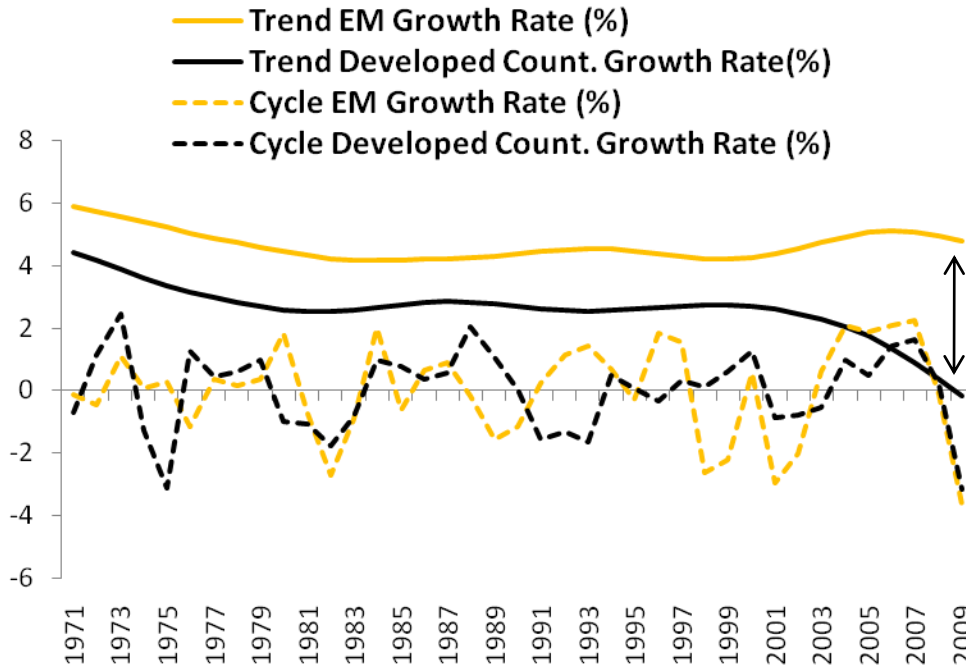
- Strong growth dynamics
- Increasing trade relations between EMs
- Flexible production methods
- Diversification of export products
- High foreign reserves

## Weaknesses of EM

- Relative weakness of domestic consumption
- Possible increase in inflationary pressures due to high growth performance
- Increase in public spending and monetary stimulus as a result of global crisis
- Possible asset bubbles due to low interest rate environment

# Strengths of EM economies

## 1 - Rapid Growth in Emerging Economies



Source: World Bank, Vakifbank

There has long been a close correlation between economic cycles (using HP filter) of growth rate in developed and EM economies. EM economies growth fell sharply in 2009 through several channels:

- ✓ Decline in exports to developed countries
- ✓ Steep falls in private capital inflows
- ✓ Domestic financial freeze as a form of contagion.



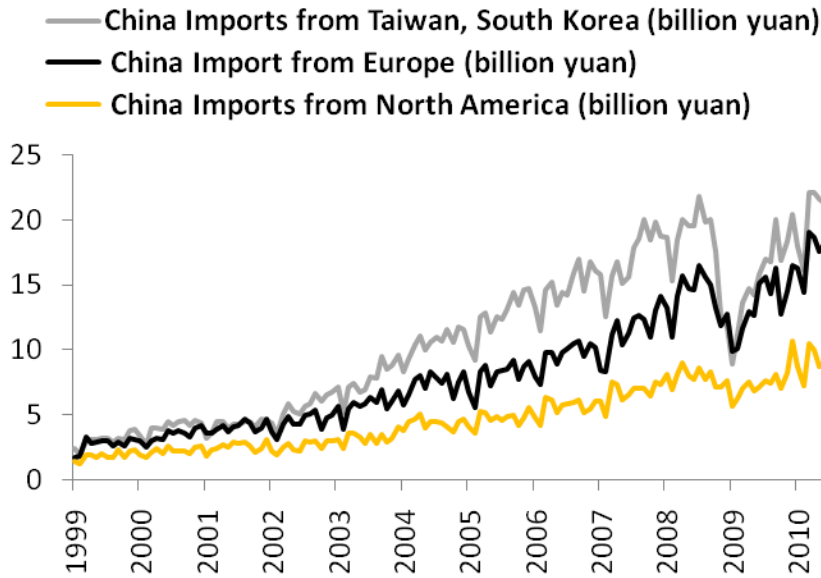
No decoupling in the cyclical component of EM economies growth.

Since early 2000s, the trend (using HP filter) synchronisation has been combined with systematically higher growth rates in EM economies relative to developed economies.

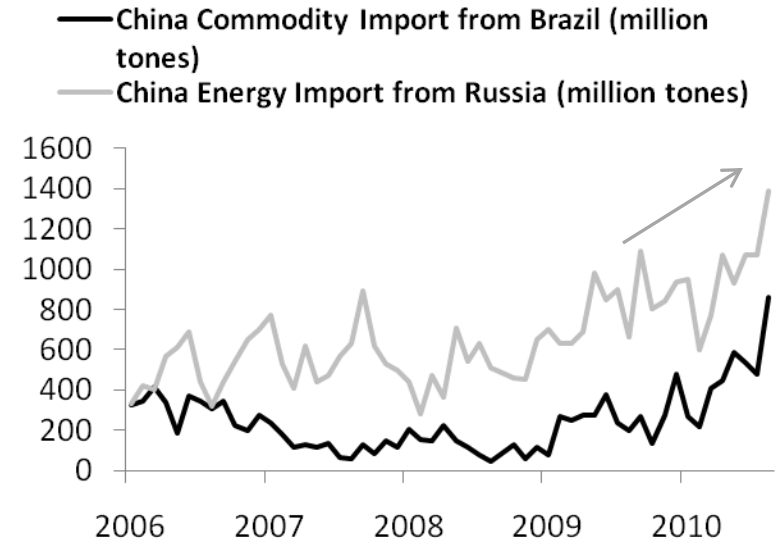


Relative decoupling in the trend component of EM economies growth

## 2 - High Trade Flows Between EM Economies



Source: Bloomberg



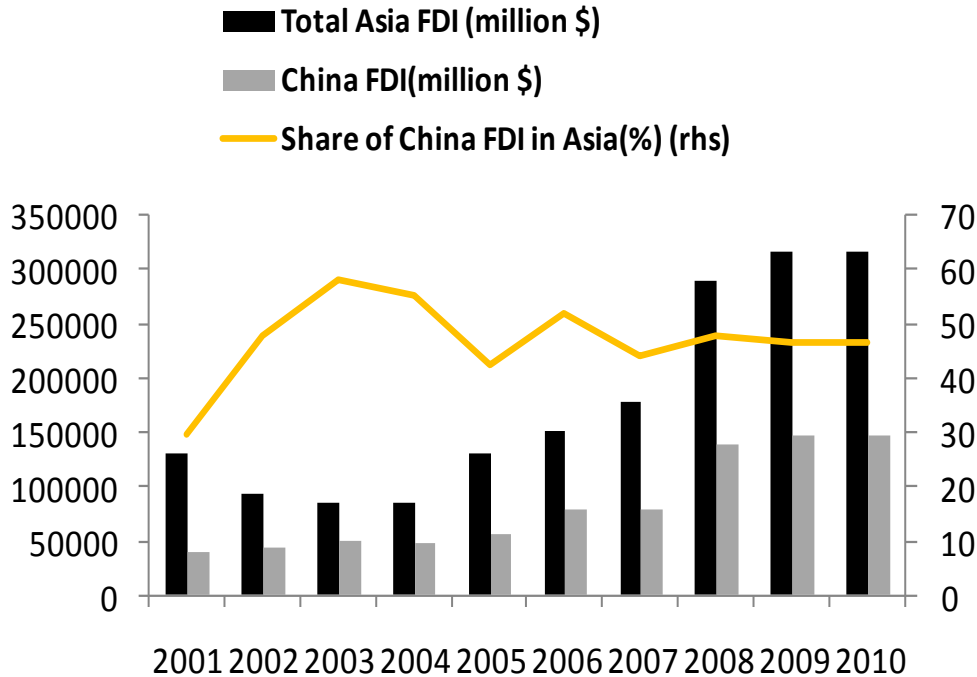
Source: Bloomberg

Internalization of supply chains and specialization of production

Large part of imported Taiwanese and South Korean intermediate products are finally designed in China

Commodity and energy imports between China and other emerging market economies have increased.

### 3 - High Financial Flows Between EM Economies








China has begun to undertake remarkable investments in many highly productive EM countries.

China gets approximately 50% of its foreign direct investment from other Asian emerging countries.

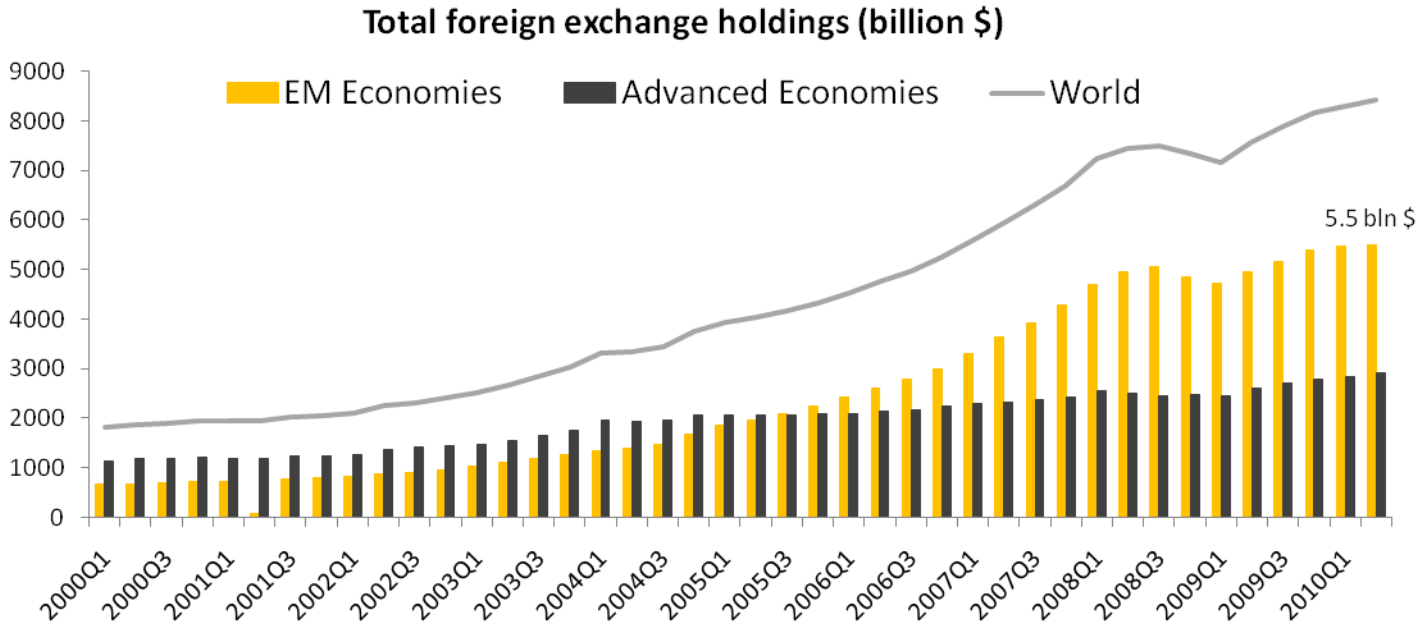
Source: Bloomberg

\*Total Asian Countries: Hong Kong, India, Indonesia, Malaysia, The Philippines, Singapore.

## 4 - Flexible production methods and diversification of export products

-  EM economies have more flexible production methods as a result of innovation and technology.
-  Also, technology transfer has gradually become cheaper and easier for EMs.
-  Many EM economies prefer to specialize in various export products and gain competitive advantages.
-  Higher resistance in the face of fluctuations in external demand.
-  The commodity exporting EM economies, prefer selling these products as manufactured or semi finished goods, and this gives an extra advantage in foreign trade.

## 5 - High foreign reserves



Source: IMF

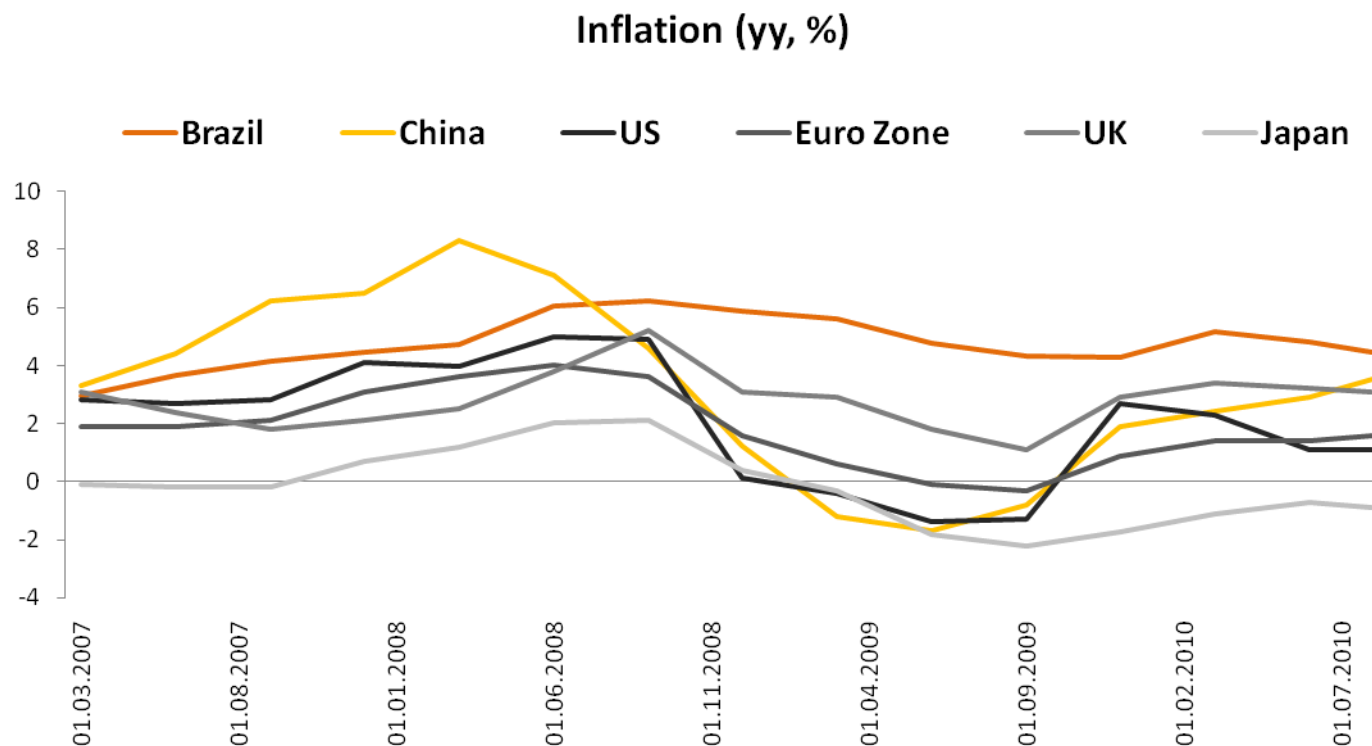
- EM economies have become resilient to shocks via high foreign reserves accumulation.
- The crisis experience of Asian countries in 1997 taught them the importance of foreign reserves as a shield against “sudden stops” of financial flows.
- Latin American countries got the similar lessons from their crisis experiences in the 1990s and 2000s.

## 1 - Domestic demand is relatively weak


- High debt ratios of American household and, slowing growth in the Europe and other advanced economies cause some market loss for EM economies after the financial crisis.
- EM economies protect themselves against the fall in foreign demand by increasing the trade with each other.
- But they are still under the risk due to the insufficient domestic demand.
- Insufficient domestic demand in EM economies would affect their future growth rate.



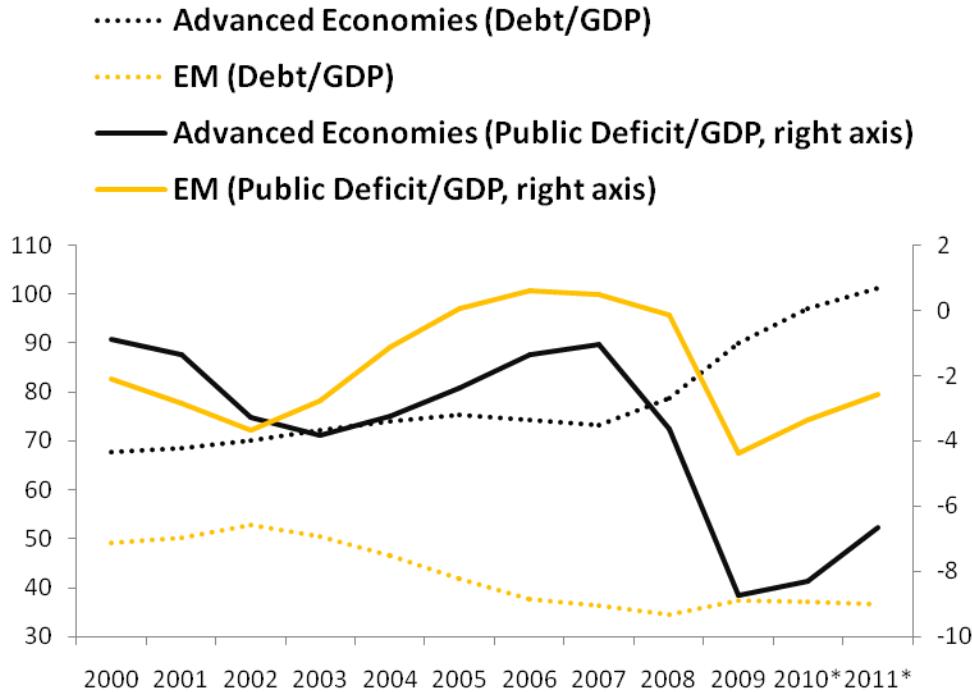
## 2 - Possible increase in inflationary pressures due to high growth performance



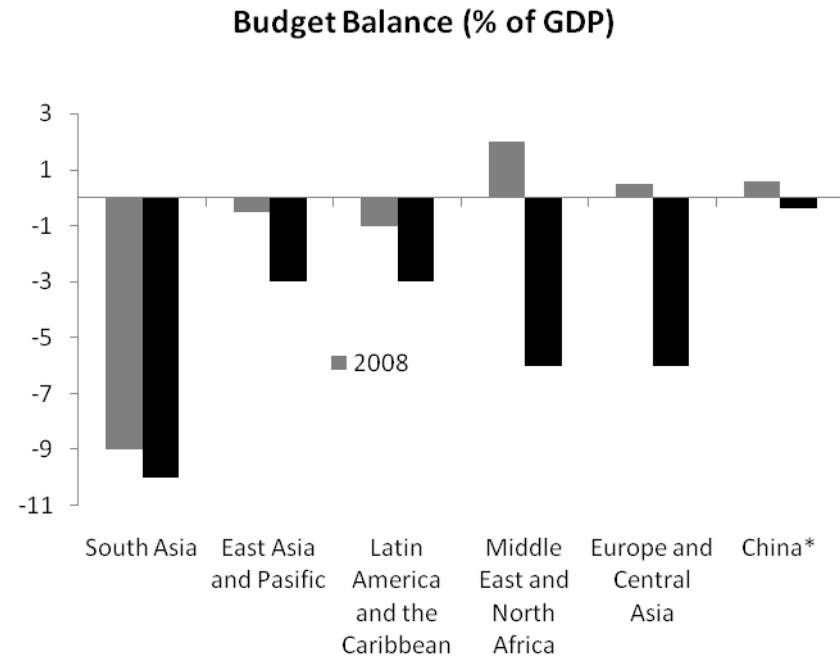
Kaynak: Bloomberg

 Higher growth performance in EM economies results in relatively higher inflationary pressures.

# 3 - Increase in public spending and monetary stimulus as a result of global crisis



Source: IMF  
\*IMF Estimate



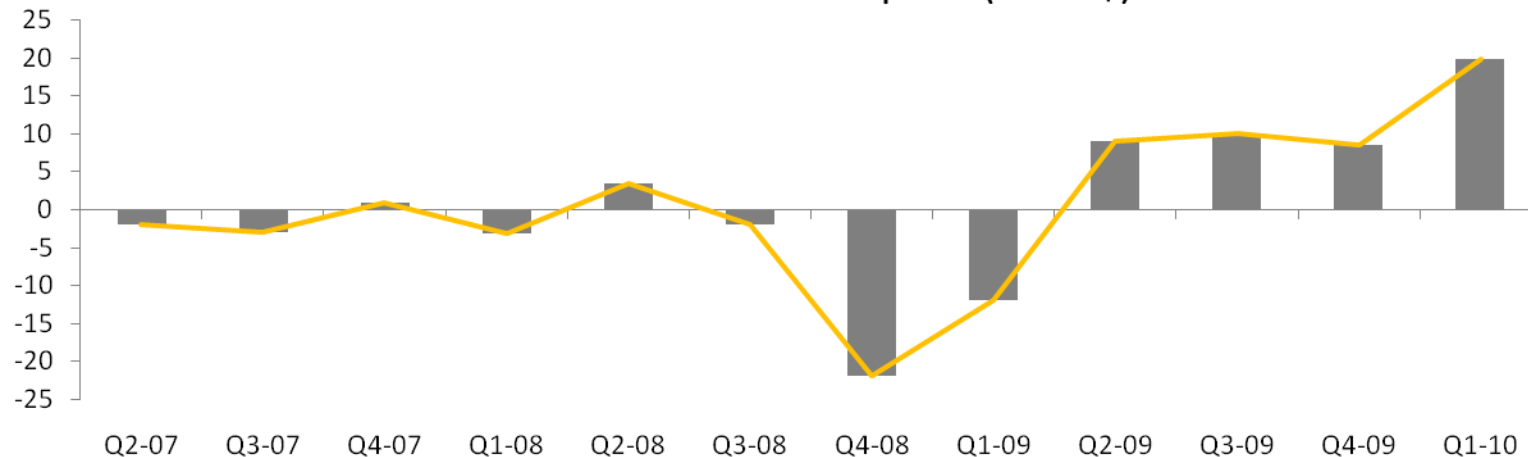
\*China, realized

Source: World Bank

While advanced economies are based on financial sector, EM economies are based mainly on real sector, that's why, the last crisis affected the advanced economies much more. Advanced economies spend their budget revenues to recover the financial sector. However, EMs spend their revenues in the areas which support their economic growth.

## 4 - Possible asset bubbles due to low interest rate environment






Demand for EM Government Equities (Billion \$)



EM includes Czech Republic, Poland, Turkey, South Africa, Ukraine, Hungary, Romania, Israel, Russia, Egypt

Source: IMF

- Capital flows to EM economies are increasing due to uncertainties on economic stability of the advanced economies. Declining interest rates in EM economies parallel to decreasing global interest rates, prepare suitable ground for asset bubbles. With more sustainable budget deficits and current account surpluses EM economies have stable public sector and more powerful private sector.

-  Despite the strengths of EM economies classified under five main titles, they have some fragilities such as weak domestic demand, increasing public deficits and possibility of asset bubbles due to low interest rates.
-  Therefore, it cannot be claimed that they are completely immune to global economic and financial risks.
-  Although the EM economies seem to be decoupling from the rest of the world, they are literally in the same pool as regards the financial turmoils.
-  But it is a fact that, the EM economies which were subject to a convergence and catch up debate prior to the global financial crisis, have in fact a clearly stronger stance in the face of the expected slow growth performance of advanced economies for the next decade.
-  Although, due to weaknesses we mentioned in this report EM economies won't be able to decouple in ABSOLUTE terms from DM economies., strengths of these countries will provide a base for them to decouple in RELATIVE terms.

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