

# think piece

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## Be prepared for successes, trials and tribulations in regional economic recoveries

*Rodrigo Delgado Aguilera*

### Summary

- While there seems to be a multi-speed recovery globally, with the US fairing relatively well, Europe lagging behind and the developing world bouncing back strongly; the developing world is seeing a multi-speed recovery of its own. It will remain the main contributor to world growth, however risks arise from the potential of fast-growing economies overheating, and the ongoing debt crisis damaging economies elsewhere.
- Asia made a particularly speedy V-shaped recovery on the back of strong Chinese domestic demand and a revival of high-technology trade. Asian economies were also stood in good stead by their previous efforts to correct the mistakes which led to the 1997/8 crisis.
- In contrast, Emerging Europe has been the most severely affected region in the world despite having some of the world's fastest moving economies in pre-crisis years. It's reliance on external capital and excessive leverage will require years of adjustment, knocking back growth prospects. Recovery will also be impeded by unfavourable market conditions for exports.
- Latin America, the Middle East and Africa all had a relatively mild recession, without the volatility of Asia or depression of Emerging Europe. The recovery of commodity prices suggests a positive short-term outlook for these regions although structural impediments could restrain growth in the longer term.
- Downside risks for the developing world include a possibly sharp slowdown in China, excessive currency appreciation due to capital inflows in Latin America and oil price volatility. Weak demand in the US and Europe will also hinder the recovery in trade.
- Nevertheless, the short-term outlook is very favourable and the recovery should be sustained over the course of the following years barring any further exogenous shocks.

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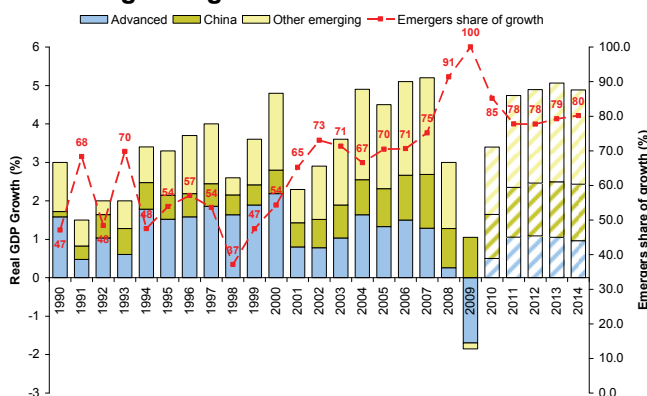


**CII Introduction: The post-crisis recovery across the developing world will see some varying regional performances. Our overall conclusion is that the developing economies should continue to expand strongly. However risks arise from both the potential for the fastest growing economies such as China to overheat; and from the ongoing debt crises damaging prospects for parts of Emerging Europe. Specific country risk factors need to be carefully monitored given the lack of homogeneity within as well as across regions.**

Growth is rebounding sharply across the developing world, just as it did in Asia after the 1997-98 crisis. While the crisis may have knocked back the long-term growth potential of the advanced economies, for the developing world as a whole, the recession appears to have been nothing more than a particularly severe cyclical shock, causing only limited damage to future prospects. Although the advanced economies are now edging towards recovery, the developing world is still by far the largest contributor to global growth, with its share remaining higher than it was before the crisis started. This trend is expected to continue over the coming years: up to three-quarters of global growth is likely to come from developing economies (see Figure 1).

Nevertheless, performance over the course of the global crisis has been very uneven. Emerging Europe was unquestionably the hardest-hit part of the world economy while other regions have fared relatively well, suffering only moderate slowdowns (e.g. Latin America, Middle East and Africa) or bouncing back strongly after a sharp initial contraction as the trade shock struck in late 2008 (e.g. Asia). It is important to understanding the reasons why certain regions have performed better than others as this offers insights into the sources of vulnerability and how these may be addressed in order to avoid future bouts of instability.

**Figure 1: Developing countries the main source of global growth**



Source: IMF (PPP shares of GDP)

Many countries, for example the Baltic states and some other East European economies, had achieved extraordinary growth rates during the pre-crisis years only to spectacularly collapse in the weeks after the Lehman bankruptcy. In retrospect,

many of the catalysts of growth during the boom years, such as capital inflows and a surge in consumer credit, became the triggers for recession once external conditions reversed financial flows. Addressing these vulnerabilities will not be easy - it will involve a lengthy adjustment period and correction of imbalances. As a result, regional recoveries among developing countries will not be an even process and may even be unstable. Overall, the tradeoffs revealed between growth and stability could serve as an incentive to drive changes in domestic economic policy in the coming years – just as the Asian crisis served as a wake-up call to Asia.

## Asia Leading the Way

**Asian economies made strenuous efforts to correct the mistakes from the 1997/8 crisis, which has stood them in good stead over the last two years.**

Over the course of the last decade, Asian economies made strenuous efforts to correct the mistakes which led to the 1997/8 crisis: this has stood them in good stead over the last two years. Principally, the banks were recapitalised, public and private sector finances were strengthened and a hefty cushion of international reserves was built up to counter any potential shock. Current account surpluses increased as the region benefited from the boom in global demand, which fuelled a surge in exports. By the time the 2008 shock hit, most Asian economies had resilient public finances and banking systems, with the latter largely avoiding direct involvement in the markets that caused the most damage to the Western banking system, such as US sub-prime debt and derivatives.

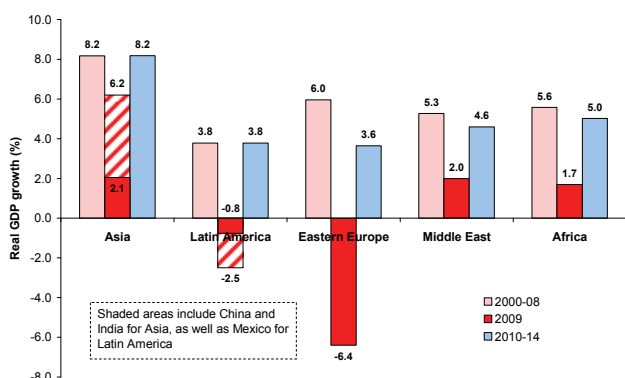
Nevertheless, Asia was unable to escape the effects of crisis contagion through trade as Asian exporters were particularly vulnerable not only through their degree of openness but also due to the particular mix of exports in which they specialized, mainly cyclical manufactured goods such as vehicles, machinery and IT equipment. As a result, economies such as Hong Kong, Singapore and Taiwan suffered exceptionally sharp downturns in late 2008 - exceeding even the losses experienced among export-led advanced economies such as Germany.

**Considering its exposure to the trade cycle, Asia's performance in 2009 has been quite extraordinary.**

Considering its exposure to the trade cycle, Asia's performance in 2009 has been quite extraordinary, managing to offset the losses in exports to the extent that most economies registered mild growth over the course of 2009. Overall, Asia's GDP growth in 2009 was above 6% - only a couple of percentage points below the region's pre-crisis trend. However, much of this regional growth figure was due to China and India's unique resilience: excluding these two rising powerhouses, growth in developing Asia was only slightly above 2% (about in line with the Middle East and Africa), still respectable given the magnitude of

the global crisis but not as spectacular as the aggregate figure would suggest.

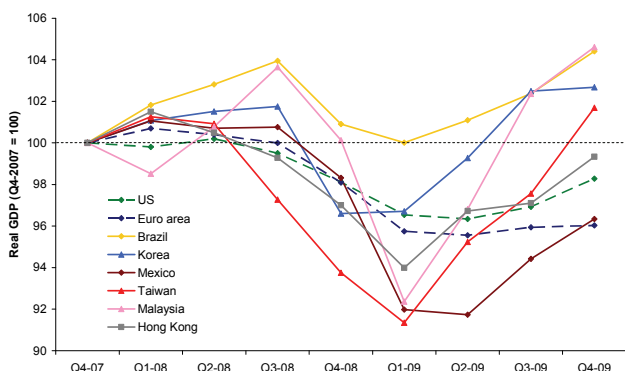
**Figure 2: Developing region performance since 2000**



Source: IMF

What accounted for this resilience? Partly it was due to the ability of China to implement a massive fiscal stimulus package (at over 13% of GDP, this was proportionally the largest of any G20 economy, although it was spread over two years) and looser monetary policy, which resulted in an unprecedented expansion of credit. Year-on-year GDP growth surged from just 6.1% at the first quarter of 2009 to 10.7% in the last quarter. While China's imports dropped sharply along with exports at the start of 2009, imports subsequently recovered to stand only 9% below the pre-crisis peak by the end of the year. The regional spillovers from this growth in China were significant, providing a target destination for Asian exports while markets in advanced economies such as the US and Europe remained depressed. Trade with China was unable to completely make up for losses elsewhere but countries which traded more extensively with China generally fared better than others.

**Figure 3: Strong recovery in developing economies**



Sources: OECD, National statistics agencies

The other element which contributed to Asia's strong recovery was the large share of high-technology goods - such as IT - in exports. Although these goods are highly cyclical and were dragged down alongside other exports during the initial collapse in trade, their shorter life-spans and relatively low unit

prices have meant that they were among the first categories of manufactured goods to revive once spending began to pick up among firms and households. Unsurprisingly, the major IT exporters - mainly Malaysia, Singapore, Taiwan and Korea - saw some of the strongest and earliest economic recoveries: all of them escaped recession by the second quarter of 2009 (the Korean recovery even began earlier, in Q1, albeit after a dismal 5% contraction in the previous quarter).

Asian forecasts are optimistic for 2010, with apparently few downside risks except for China. Ironically, after China coming to the rescue of global growth in 2009, a major cause for concern is now the possibility of China overheating: this could lead to a rapid tightening of policy followed by a sharp slowdown in growth. Already some steps have been taken to cool the expansion of credit, such as the increase in prudential reserve ratios imposed on the banks. Markets have become increasingly jittery about the possibility of a bubble-bust scenario in the world's second-largest economy as property and stock market prices have been driven up over the last year, largely by the flush of liquidity. Consumer price inflation has also ticked up, adding to concerns about overheating and policy reactions. The risk may not be too serious but after a massive global crisis has rocked confidence, any disturbance is seen as potentially dangerous. And a drop in growth to around 8% would feel chilly to the presently hot Chinese economy, possibly leaving some speculative elements in the economy exposed, including asset prices.

**Much of Emerging Europe is slowly emerging from the brutal shock which made it the most severely affected region in the world.**

A slowdown in China will not be so critical for global growth if the recovery in the US and Europe is firmly underway by the end of the year but, unfortunately, this is still very uncertain. If China flops at the same time as the recovery in the US and Europe stalls, then the world could be dragged into a double dip recession. It is not out of the woods yet although the probability of this worst case scenario is fairly low.

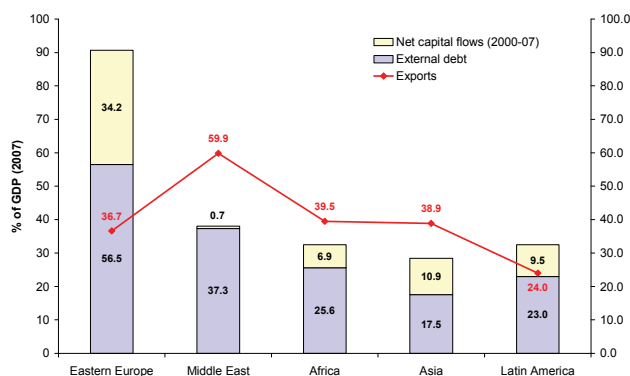
**Emerging Europe's recovery from catastrophe**

In contrast to Asia's success in escaping recession, much of Emerging Europe is only slowly emerging from the brutal shock which made it the most severely affected region in the world, primarily because it was vulnerable to the sudden outflow of capital, at the same time as various countries - mainly the Baltics - saw ballooning property markets collapse. The effect was severe enough to result in a swing from double-digit growth to double-digit recession for some economies. Some also required the intervention of the IMF to avoid an even greater calamity (80% of all IMF bailouts during the crisis have been to Emerging Europe). Overall, the region's mistake was to rely on excessive credit-

fuelled growth, with most of this credit being denominated in foreign currencies, mainly euros and swiss francs, and fuelled by Western European banks through their subsidiaries. This degree of external vulnerability was well beyond that of any other region, perhaps the closest parallel being Latin America during the 1980s debt crisis.

***[Emerging Europe]'s growth prospects have dropped from being the best in the world outside Asia to the worst among the emergers.***

**Figure 4: External exposure was greatest in Emerging Europe**



Source: IMF

The particular nature of the Emerging European recession therefore makes a return to 'business as usual' highly unlikely. The region's growth prospects have dropped from being the best in the world outside Asia to the worst among the emergers. Whereas countries that suffered from trade shocks can quickly recover lost ground, the consequences of deteriorating public and private finances are considerably more long-term and are exacerbated by the region's current account deficits, particularly in goods. Certain regional economies are already undertaking radical restructuring programmes (IMF-led for those with bailouts) in order to improve competitiveness. And they are collaborating with European banks to maintain support for their domestic banking sectors in order to avoid further financial turbulence, which was a considerable concern in 2009.

Although trade was not the main reason for Emerging Europe's deep recession, the outlook for regional exports is critical for recovery from the current crisis as well as for the long-term prognosis. Most Emerging European economies had been running current account deficits in pre-crisis years and these must be reduced or reversed. Unfortunately, the main export market, Western Europe (mainly Germany), is expected to remain weak and the export mix of these countries is broadly similar, implying that they will be competing among themselves for sales into a stagnant market. Export prospects are not encouraging. In addition, much of the East's export industry is linked to West European manufacturing through intra-industry partnerships, serving as a component of larger

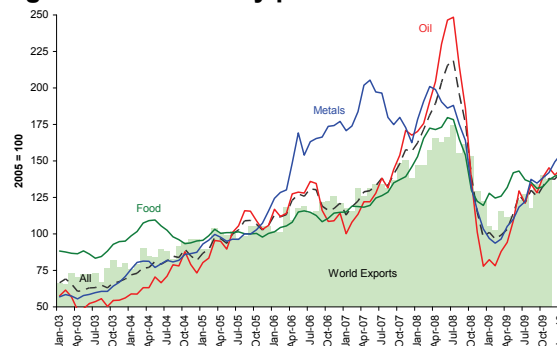
supply chains in industries such as automobiles - which means that any increase in output results in a flood of imports. It is questionable whether trade balances can be radically improved except by keeping domestic demand weak.

Unfortunately, policy options are limited, certainly in the short-run: currency devaluation (for those that have floating rates) and downward adjustments in wages will be of some help in boosting cost competitiveness but this will be of limited value given the problems described above. Emerging Europe faces difficult questions about how it is going to achieve future growth and stability given its insufficient export diversification and reliance on weak European markets along with the urgent need to shore up finances.

**Latin America and the Middle East escape the turmoil**

On aggregate, the remaining regions in the developed world had a relatively mild crisis. For the most part, the spread of financial stress from the US and Europe was felt but was much more contained - stock markets dropped but quickly rebounded, as did exchange rates. Banking systems, on the other hand, were relatively well insulated despite the presence of many subsidiaries of US and European institutions. More importantly, commodity prices weakness proved to be short-lived, imposing less of a burden than was originally feared given the reliance of these regions on commodity exports. In addition, commodity exporters had built up their fiscal resilience during the boom-years, leaving them ample room for manoeuvre when the crisis hit.

**Figure 5: Commodity prices on the rebound**



Source: IMF

***The pre-crisis boom years undoubtedly helped economies strengthen their macroeconomic fundamentals.***

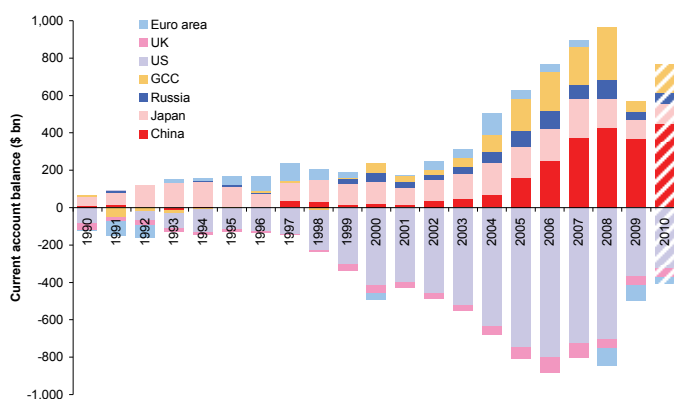
Latin America's resilience was perhaps the greatest surprise, given the region's past history of severe financial crises. The pre-crisis boom years undoubtedly helped economies strengthen their macroeconomic fundamentals, particularly in the areas of fiscal resilience, reduced external debt and accumulation of international reserves to soften any potential external shock. As a result, Latin American countries were mostly well prepared and escaped

with only mild recessions (or even low growth) and are now in the midst of a swift and sustained recovery. This is the case even for Mexico, the one country which did suffer a more severe crisis, largely on account of its uniquely close links with the US. For the rest, the rebound in commodity prices has been a boon, as was the possibility of partially refocusing trade towards Asia - particularly China. In fact, during 2009, China overtook the US as Brazil's most important single trading partner, while increasing its share in Argentina where it already was first. The importance of Chinese trade in Latin America can be evidenced by Argentina's establishment of a currency swap with China - worth \$10 billion - in the midst of the crisis.

Latin America, therefore, should bounce back strongly in 2010 - consensus forecasts point towards 4-5% growth this year with few downside risks. Among these, the return of capital flows into the region has raised fresh concern, due to the resulting currency appreciation. But with commodity prices expected to remain high, risks to growth are limited. And strong consumer demand in Brazil should help keep South America's largest economy fired up, leading the region towards another growth spurt.

The Middle East also escaped relatively unscathed. Oil exporters braved the effects of falling oil prices thanks to a hefty cushion of financial reserves, which softened the blow to 2009's revenue stream. These countries maintained high rates of public investment to avoid a more serious slowdown. Oil importers, on the other hand, had the temporary benefit of lower fuel prices which relieved pressure on their balance of payments as well as on consumer price inflation. Recovery scenarios for the Middle East as a whole are positive, helped by the return of high oil prices spurred by demand from developing economies. On the other hand, the Middle East has not been immune to some localized shocks, such as the Dubai debt crisis which emerged late in 2009. Although the crisis has dissipated soon enough (thanks to a bailout from Abu Dhabi), the precarious state of Dubai's real estate sector was yet another example of the dangers of asset bubbles and reliance on external financing to fuel growth.

**Table 6: Surpluses among the GCC contracted heavily in 2009**



Source: IMF

## Conclusion

***The developing world is actually running a multi-speed recovery of its own, with Asia forging ahead of the pack, Latin America, the Middle East and Africa performing well, albeit at a slower pace, and the outlook for Eastern Europe starting to improve but remaining far from certain.***

The recovery that has emerged in the global economy can be characterized as a multi-speed phenomenon in which developing countries are bouncing back strongly, the US economy is faring relatively well and Europe is lagging behind given weak domestic demand and the impact of the Greek debt crisis on confidence. However, the developing world is actually running a multi-speed recovery of its own, with Asia forging ahead of the pack, Latin America, the Middle East and Africa performing well, albeit at a slower pace, and the outlook for Emerging Europe starting to improve but remaining highly uncertain. In fact, Emerging European growth may turn out to be similar to Latin America but this would be well below the rates achieved in the pre-crisis years and risks still loom large. Unlike Emerging Europe with its host of debt and trade issues still left hanging, other regions have their external and domestic finances in relatively good shape leaving them well prepared for recovery but also able to weather any further bouts of volatility.

An overall assessment of the state of recovery across the developing regions is summarised in the table over the page. The consequences of excessive reliance on foreign funding - both by the public as well as the private sector - have proved yet again to be a recipe for disaster in developing economies as they have been in previous decades. Certainly the experience of Europe during the crisis has served as a reminder that, even in the best of times, conditions can quickly turn sour when the external financing environment deteriorates. The repercussions in the smaller emerging market economies of a major reversal in global capital flows were significantly worse than the impacts on advanced economies with deeper and more liquid markets. For Emerging Europe, the price of such failure was high, with growth rates tumbling from pre-crisis highs. Other developing economies would be wise to avoid adopting the same route to short-term growth - it represents a very dangerous trade off between rewards and risks.

However, the overall outlook remains very positive for the developing world. Downside risks are present but will not derail the strong performance expected in 2010, which will probably continue into 2011.

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**Table 1: Summary of Regional Recovery Prospects**

	Asia	Latin America	Middle East	Emerging Europe
<b>Growth</b>	8-9%	3.5 - 4.5%	4-5%	< 4%
<b>Trade</b>	China's import recovery is helping regional exports. IT and other high-tech goods are the major drivers of an export rebound	Commodity prices to remain high, terms of trade favourable. Shift of trade from US/EU to Asia to continue.	Oil prices back to a comfortable range for exporters and investors – this will help rebuild reserves and widen current account surpluses	Trade deficits to continue and weak demand in Europe will be a drag. Exchange rate and wage adjustments only temporary help.
<b>Domestic</b>	Strong domestic performance to continue, led by China and India. But small economies should also make a larger contribution to regional growth in 2010.	Brazilian consumer boom on-going, and conditions to improve elsewhere. Long-term risks exist due to low productivity and competitiveness.	Energy investment put on hold during crisis as low oil prices make costly investments unprofitable. Dubai problems may make region less lucrative for expansion in business services	Heavily indebted households and firms to continue deleveraging, hurting consumption and investment. Recession could continue in 2010 in many countries
<b>Financial</b>	Financial systems in good shape, Singapore and Hong Kong profiting from NY and London woes. China banks reducing credit growth due to tighter policy and risk of rising NPLs	Banking sectors relatively insulated, stock markets and currencies recovering. Brazilian banks performing strongly	Dubai property and financial market woes will take time to recover. SWFs likely to make up losses and profit from pre-crisis acquisitions and new inflows of funds.	Major systemic crisis averted with IMF/EBRD support but subsidiary banks still weak. Exchange rate competitiveness to be reviewed as part of structural adjustment.
<b>Downside risk (short-term)</b>	Possible overheating in China might lead to policy tightening and a sharp slowdown in growth.	Return of capital inflows may generate excess currency appreciation, hurting exports	Oil price volatility could damage energy investment. Property markets also uncertain.	Weak demand in Western Europe will limit an export-led recovery. Domestic weakness to linger.

Source: Author's own analysis



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