Morgan Stanley

INVESTMENT MANAGEMENT

Tales From the Emerging World

The Pandemic's Silver Lining

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | MACRO INSIGHT | 2020

The shadow over emerging markets grew a bit thicker this month. The International Monetary Fund (IMF) revised its 2020 growth forecasts for developed economies upward, and emerging economies downward, based largely on the fact that richer countries are spending much more heavily on stimulus during the pandemic. This will only fuel widespread talk about the "end of convergence," the idea that fast-growing emerging countries are destined to catch up with developed ones.

AUTHOR

RUCHIR SHARMA
Head of Emerging Markets and Chief Global Strategist

Moments like this are a reminder to stay calm in the rain. We have pointed out for years that convergence has always been difficult and rare; few emerging nations have ever caught up over the long haul. But hot decades are common, particularly after cold ones, as the economic cycles turn. The reasons to expect a good decade for emerging economies in the 2020s are numerous, particularly now that expectations are so low and sentiment so negative.

Digital revenue is growing much faster as a share of Gross Domestic Product (GDP) in emerging markets than developed markets.[1] Commodity producers cut so much excess supply over the last decade, global commodity prices are now poised for a rebound.[2] Even as global trade slows, a few emerging economies are still rising on the strength of export manufacturing. Emerging Market (EM) valuations are beaten down after a tough decade. And good decades are particularly likely after a crisis pushes nations to reform. The bigger the crisis, the greater the push. The underappreciated fallout of the pandemic is that it is forcing economic reform in many hard-hit developing nations.

1 Statista, IMF. Data as of October 2020.

2 MSIM.

One of the most powerful drivers of superior equity returns in emerging markets is a rising GDP growth differential.[3] When emerging economies are growing faster than developed economies, market returns have followed, historically. While the heavy spending on stimulus is currently easing the downturns in the developed world, the resulting increase in deficits and debt will slow growth going forward. Emerging countries are moving in the opposite direction: unable to borrow and spend, they are being forced to accelerate reforms, which will boost productivity and growth in the years ahead.

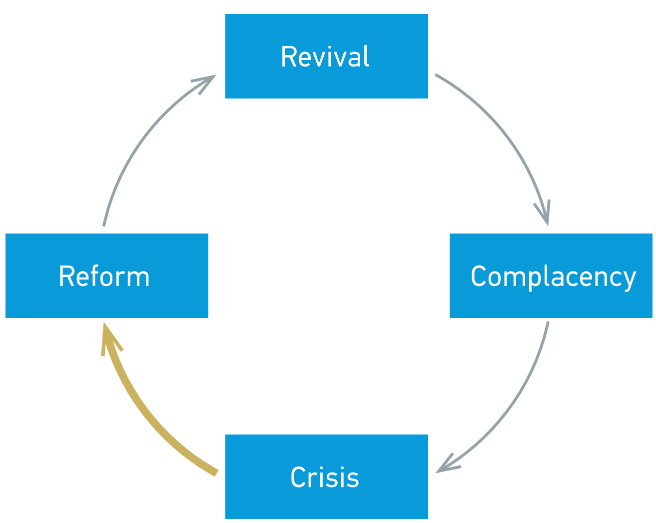
The depth and sweep of reform campaigns across the emerging world has been widely overlooked. One of the more striking examples is India, where Narendra Modi came to power in 2014, touted as a potentially radical reformer, but for the most part he has tinkered at the edges instead. Lately, however, with growth cratering, Modi's government is feeling the heat and starting to take decisive steps.

After cutting corporate taxes last year, New Delhi has moved in recent months to ease controls on the sale, pricing and storage of agricultural goods, which have protected Indian farmers from market forces for decades. Along with many state governments it has also changed some of the most cumbersome labor laws in the emerging world.[4]

It's hard to know which reform campaign will provide the biggest boost to growth. Academic research is inconclusive about which types of reform have the biggest economic impact, and at times questions whether there is any impact at all. But anyone who has traveled in emerging economies has seen how an energized government with ambitious reform plans can fire up animal spirits in an economy. And we now see the ambition of EM reform plans growing.

DISPLAY 1

Bigger Crises Inspire Bigger Reforms



Source: MSIM Global Emerging Markets Team.

Under pressure from weak growth and rising debts, big emerging markets were making tough reforms even before the pandemic hit, and are still pushing ahead now. Going back to 2017, Indonesia had sharply cut fuel and energy subsidies, streamlined the paperwork hurdles to hiring foreign workers and set up a one-stop shop that processes new business licenses in three hours. Then last month, it topped all that when parliament, despite union protests, passed a bill with the stated aim of boosting investment and creating jobs through a sweeping reduction in red tape, easing labor laws, and cutting taxes on corporations and domestic dividends.[5]

Brazil is overhauling its cripplingly expensive pension system, aiming to cut spending by more than $140 billion over 10 years, in part by raising the retirement age for both men and women.[6] In traditionally insular Saudi Arabia, the government is granting new rights to foreigners, including the right to own 100 percent of publicly traded companies in sectors from real estate to health and education, and to obtain (for a hefty fee) permanent residency permits, which include legal authority to purchase property and hire housekeepers. It has also implemented fiscal reforms to compensate for the collapse in oil revenues.[7]

All these efforts represent the kind of wrenching change that governments rarely contemplate unless their backs are up against the wall. Since the pandemic hit, more than 80 countries—the vast majority being frontier markets like Pakistan and Nigeria—have sought financial relief from the IMF. Even though the IMF is waiving its usual demands for reform as a condition of aid, some key frontier markets have continued pushing ahead anyway. Egypt has sharply cut fuel and energy subsidies, bringing the deficit under control and stabilizing its currency, with no sign that it will lose discipline during the pandemic.[8]

[3] MSIM, Bloomberg, FactSet, Haver.
[4] CSIS, BBC, Reuters, as of September 2020.
[5] OECD July 2019, Financial Times, as of October 2020.
[6] Mercer, as of December 2019.
[7] PricewaterhouseCoopers, Reuters October 2019, Gulf Business, as of March 2020.
[8] Bloomberg as of June 2019, IMF, MSIM.

Pakistan has cut government spending and reduced subsidies to lower its deficit, and devalued the rupee to make it more competitive.[9] Several others are still rising as export powers, despite the decline in global trade, and the rise in trade barriers. The leading example is Vietnam, which recently closed a landmark trade deal with the European Union.

In developed countries, massive stimulus is providing a growth sugar rush. The United States, in particular, seems increasingly complacent, confident that it can print enough money to spend its way out of a downturn, without long term consequences. Emerging countries don't have that luxury. They are being forced to reform, to solidify national finances, streamline government and be open to global market forces in ways that could help sustain faster growth for many years. Economic reform is the pandemic's silver lining: It is not the only reason to expect that the 2020s could be a stronger decade for many emerging economies, but it is one of the most overlooked.

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9 Bloomberg as of June 2020, Bloomberg as of November 2018, MSIM.

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CRC 3317372 10/31/2021 9930554 Lit-Link: EMEWRLDBRO 11/10/20