From flywheel to fanbelt: the growing importance of emerging markets

Emerging markets are no longer acting as an "flywheel on industrialized country growth. They are playing an increasingly powerful role in world trade, and their burgeoning demand has softened the impact of the last recession in industrialized countries. Emerging markets now account for a significant portion of US multinationals' profitability. Wall Street offers a growing "emerging market" play.

No longer a flywheel

Emerging markets have traditionally been regarded as a "flywheel on the G7 economic engine" - in other words, they are only able to grow when the industrialized countries are growing. The evidence shows that this view is no longer valid in recent years. In fact, during the last G7 recession, not only did emerging market demand expand - both in absolute and relative terms - but for the first time it contributed significantly to keeping industrialized countries' export sectors alive.

Chart 1 below tracks the real growth of exports from industrialized countries over the past 30 years. Until last year, there has been a very tight correlation between the growth of trade among industrialized countries and the growth of trade from industrialized countries to those currently defined as "emerging markets." The two great inflationary shocks to trade among industrialized countries - related to the oil crises of 1973-75 and 1979-82 - had a chilling impact on demand in emerging markets especially on those who were not commodity exposers.

The period since 1990 shows an even harsher collapse in inter-industrialized country trade, reflecting the deflationary shock of the massive expansion in cheap manufacturing capacity in emerging markets. For the first time in 30 years, real exports among industrialized countries have fallen in absolute terms. However, exports to emerging markets have shown rapid growth at the very moment that trade among the industrialized countries has collapsed. Emerging markets have helped to lead industrialized countries out of the last recession, and the disinflationary impact of their competitive manufacturing sectors may well be acting as a "fanbelt" which restrains cyclical overheating tendencies in the G7.

Leading the G7 out of recession?

As Chart 4 on page 5 shows, over the last four years, half of the real increase in exports from industrialized countries has been attributable to rising demand from emerging markets. Since the 1991 recession hit the industrialized countries, the impact of emerging market demand has been even more significant. Between 1991 and 1993, trade among industrialized countries declined by 5% in real terms. However, their overall exports remained constant, mainly because of burgeoning demand from emerging markets.

(continued on page 6)
The export sector in industrialized countries has been growing in importance in recent years. IMF data show the export sector’s share growing from an average of 1.8% of GDP for all industrialized countries in 1985-89 to 9.7% of GDP in 1990-93. (Needless to say, imports as a share of GDP have also been growing during this period.) The acceleration of exports from industrialized countries to emerging markets has therefore come at precisely the time when exports are playing a more significant role in industrialized countries’ GDP growth.

Exports to emerging markets in 1993 were the equivalent of 2.2% of industrialized countries’ GDP. Exports between industrialized countries declined by 8% in real terms between 1991 and 1993, while their overall exports remained constant in real terms. Therefore, the growth of their exports to the rest of the world (which Chart 4 on page 9 shows is dominated by their exports to emerging markets) was the equivalent of 0.6% of industrialized countries’ GDP.

A turning point

Although the overall share of industrialized countries’ exports to emerging markets is now not much higher than was the case in 1993, there appears to have been a secular turning point in recent years. Asian developing countries have been an increasingly important market for industrialized countries’ exports since the late 1970s. Between 1976 and 1993, their share of industrialized countries’ exports has more than doubled from 2.9% to 13.3%. For most of that time, they have been gaining at the expense of other emerging markets. However, since 1991, exports to other emerging markets began to pick up. Chart 3 below shows that in 1993 all regions (even the oil exporters) accounted for a growing share of industrialized countries’ exports.

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However, just as the recycling mania of the 1970s permitted a temporary increase in purchasing power in Latin America, the current booming demand for industrialized countries’ exports is being stimulated by manic capital flows to emerging markets. Is this flow as fickle as that of twenty years ago?

The evidence suggests not. OPEC and Latin American import demand in the 1970s was related almost exclusively to infrastructure and consumption-related sectors. Imports by emerging markets since the mid-1980s have been dominated by capital goods destined to expand their export capacity. The corollary is that foreign direct investment (FDI) flows to emerging markets have increased dramatically, which implies that a growing portion of the profits accruing to multinational corporations now come from emerging markets.
4: Exports from industrialized countries, 1989-93
(1990 constant $)

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports to other countries</th>
<th>Exports to emerging markets</th>
<th>Exports to industrialized countries</th>
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<tr>
<td>1989</td>
<td>$2.5bn</td>
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<tr>
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</tbody>
</table>

Source: Various sources

5: US corporate profit after taxes

- **Domestic Operations** (left scale)
- **Foreign Operations** (left scale)
- **Foreign Operations as a Share of Total** (right scale)

Source: Citibase, Survey of Current Business
The multinationals' profitability

Over the past half century, US-based multinational corporations (MNCs) have been drawing an increasing share of their net earnings from affiliates outside of the United States. This impact is evident in Chart 5 on page 9. Expressed in real terms, domestic earnings over the 1948-94 period have grown only marginally, rising at an average annual rate of about 1%. Foreign profits, on the other hand, expanded almost ten times as fast, growing at a brisk rate of 9.9% per annum. The consequence was that the share of net corporate profit coming from foreign operations surged to over 25%, up from only 7% in the late 1940s.

This relative ascent was not linear, of course, with notable declines occurring in the early 1960s, in the late 1970s, and most recently during the late 1980s and the early 1990s. Downturns in this ratio were invariably associated with cyclical profit upswings in the US causing domestic earnings to rise faster than foreign ones. Since foreign profits continue to increase, their share in the total will likely resume its upward trend once the current US expansion starts running out of steam. Until the late 1970s, the shift
toward foreign profits was primarily the result of expansion by US MNCs into other industrialized countries, mainly in Western Europe and Canada. Since the early 1980s, however, the growth rate of profits from affiliates in these countries started to decelerate and, from the late 1980s onward, was surpassed by the much faster rise in earnings coming from emerging markets. So far, the heightened significance of emerging markets comes not from a differential growth in their sales (which since 1982 remained remarkably stable at around 7.5% of the worldwide total for US MNCs), but rather from rapidly expanding profit margins.

Chart 6 on page 10 focuses specifically on US MNCs and shows the striking divergence in net profit margins (computed as a ratio of net profit after taxes to sales revenues). The data here aggregate parent and affiliate operations in the industrialized countries (North America, Western Europe and Japan), and contrast these with affiliate operations in emerging markets. Since 1982, the combined profit margin for the industrialized countries fluctuated mildly between 3.2% and 5.6%. Affiliates in emerging markets, on the other hand, have seen their own margins rise from 5% to over 9% in just a few years. The result of this divergence, charted in Chart 7 on page 10 was that the contribution of emerging-markets affiliates to total US MNCs profits has doubled, rising to an estimated 18% in 1994 from only 9% in 1988.

The reasons behind this development are manifold. Partly, it is a consequence of cheaper labor and other direct costs in emerging markets, but it also reflects lower taxation, lax government regulations and environmental standards, and in many cases also weaker competitive pressures. These factors usually do not change very quickly. Profitability, however, is also subject to other considerations -- such as exchange rate and monetary policies, or political upheavals -- which in emerging markets tend to be more erratic and less predictable. The upshot is that although earnings from emerging markets are likely to continue and grow in significance, this growth will probably be more volatile than the earlier expansion of affiliates in the industrialized countries.

**FDI**

With capital following the profit compass, it is hardly surprising that emerging markets have taken the lead in attracting US foreign direct investment. Chart 8 above shows that while current US investment in Canada, Western Europe and Japan is not much different from what it was in 1985, direct capital inflows into emerging markets have risen more than six fold over the same period. In 1992, US foreign direct investment in emerging markets rose for the first time to surpass similar investment in the industrial countries, making emerging markets the largest current recipients of US productive finance.

So far, the geographic distribution of profits was mainly affected by disproportionately higher profit margins in emerging markets, but with capital spending now increasingly skewed in favor of emerging-markets affiliates, their share in total MNCs sales is bound to rise, too. Thus, as long as
the profit-margin differential does not fall, continued
direct investment should push up sales by emerg-
ing-markets affiliates, making them even more
important for their parents' bottom line.

Japanese earnings still domestically driven

Compared with their counterparts in the US,
Japanese corporations are still in the early stage of
their global expansion. Despite recent hype around
Japanese foreign investment, in 1992 Japanese
manufacturing affiliates abroad accounted for a
mere 6.2% of the total sales by Japanese manufac-
turers -- up from 4.3% in 1984. US companies
achieved a similar proportion by the late 1950s.
Currently, German manufactures produce 20% of
their output abroad, while US foreign subsidiaries
account for 28%.

Moreover, in contrast to the US case, Chart 9 above
shows that Japanese foreign operations are less
profitable than domestic ones (although the gap
must have narrowed during the recent Japanese
recession). The reason may be rooted, first, in the
widespread use by Japanese companies of
“dumping” and “predatory pricing” as a means of
penetrating new markets abroad and, second, in
protectionism and a tight oligopolistic structure at
home.

The sales and profit-margin data suggest that only
3% of Japanese manufacturing profits come from
foreign operations, which implies that the share of
emerging markets proper is no more than 1-2%.

The strong Yen now exerts a relentless pressure on
Japanese companies to relocate production facilities
abroad, particularly to South-East Asia. However,
this transition will take time and its effect on overall
corporate profits in Japan will likely be limited for the
next few years, particularly if the domestic economy
recovers.

Investment conclusions

• The rapid expansion of export manufacturing
capacity in emerging markets will continue to exert a
disinflationary effect on industrialized countries.
Emerging markets could very well come to be seen
as the “fanbelt” which helps to cool off the inflationary
consequences of rapid growth such as has been
seen in the US this year.

• The high rates of return available on FDI flows into
emerging markets will continue to bid up the price of
capital elsewhere, including emerging equity and
bond markets. The latter are reliant on foreign port-
folios capital inflows and are therefore vulnerable to
such global tightening.

• Investments in such US indices as the S&P 400
Industrials have a built-in “emerging market play” of
approximately 20%. This implies that the greater
volatility of emerging markets may well begin to spill
over into US stocks, which would therefore warrant
higher risk premiums and P/E ratios.

• Japanese stocks do not yet offer an emerging
markets play, except insofar as Japanese subsidiar-
ies and affiliates are independently listed in
emerging markets.

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The impact of oil

Over the past 30 years, two huge shifts in world trade have taken place as a result of changes in oil prices. The current changes taking place as a result of the growing importance of emerging markets are fundamentally different. However, the history of the two oil-related cycles helps to put present developments in context.

Chart 2 below demonstrates the powerful impact which oil prices have had on patterns of world trade in recent years. The 1960s had witnessed a remarkable expansion in world trade as a result of the Kennedy Round of tariff reductions. The principal beneficiaries of this trend were the industrialized countries, whose exports among themselves expanded by an average of 10.7% per annum in real terms between 1963 and 1970. Consequently, their trade became increasingly concentrated to reach a peak in 1970, when 76% of their exports were to each other.

The rise in oil prices which began after the Tehran and Tripoli agreements in 1970 and 1972 created significant export demand outside the industrialized countries. For the next decade, the oil exporters (including those developing countries which never joined OPEC) were a significant market for industrialized countries’ exports, accounting for an average 14.8% of their total exports between 1974 and 1982. The collapse in oil prices during the mid-1980s greatly diminished this export market.

A large part of the change in trade patterns during the 1970s and 1980s can therefore be attributed to shifts in the terms of trade. During most of the period, the share of industrialized countries’ exports going to emerging markets has been in decline or has remained relatively constant, as indicated by Chart 2 below. The share of industrialized countries’ exports to emerging markets (excluding oil exporting developing countries) was in secular decline until the mid-1970s.

Two temporary factors resulted in emerging markets’ ability to import more from industrialized countries after the first oil shock. The first was the policy of détente with the Soviet Union and China, which for the first time since the second world war permitted substantial trade in such items as American wheat for Soviet gold, diamonds and oil.

The second factor was the vogue for “recycling” oil revenue, whereby western commercial banks lent money with no strings attached to developing countries. Latin America’s ability to import from industrialized countries was therefore temporarily increased until such time as its debt servicing burden increased faster than its export capacity, which is what triggered the 1982 debt crisis.