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# Should Emerging Markets Worry About the Stock Market Correction?

*By Uri Dadush*

## Summary

The current market turmoil that began on Wall Street worries policy makers in emerging markets, who fear bad consequences on the economic expansion. Since the global economy's fundamentals remain strong, this fear seem unjustified. However, there are some other risks originating in the United States, namely protectionism and fiscal deficits, which may significantly darken the economic outlook in 2019 and beyond.

The current stock market turmoil began on Wall Street over inflation and interest worries and has spread across the world. With equity indices down nearly 10% from their peaks over in a fortnight, many are asking whether the economic expansion is at risk. Policy-makers in emerging markets, where the sensitivity of economies to the evolution of world trade and to sentiment in financial markets is greatest, are among the most worried. Without claiming to know how far equity markets will fall or rise in coming days and weeks, in this note I will argue that the global economy's fundamentals remain strong at present and that the economic expansion is likely to persist in 2018 and perhaps even strengthen further as the year progresses. I also argue, however, that the stock market jitters underscore two other big risks, both – like the stock market correction – originating in the United States, namely unsustainable fiscal deficits and protectionism. These risks may build over time and significantly darken the economic outlook in 2019 and beyond. Though I believe that the broad-based economic recovery in emerging markets is likely to continue in spite of these headwinds, the aforementioned risks will – as a minimum – be the source of increased volatility and threaten to expose those developing economies that are most vulnerable to a deterioration in the external environment.

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The world economy is in a resilient, broad-based expansion. According to consensus forecasts, or the latest IMF and World Bank forecast which are very close to the consensus, we are seeing 3%-3.3% real GDP growth in 2017-2018 (using market exchanges as weights), and world trade growth of around 4.5%. This implies a 0.5-0.8 % acceleration in global GDP from 2016 – a big jump for the huge global economy. The current phase also finally marks annual growth rates which slightly exceed the global economy's twenty-year average, ending the long stagnation that followed the financial crisis which struck nearly 10 years ago.

2018 should be a good year for growth. It will be characterized: by steady though not spectacular growth across all the large economies, with accelerations from low growth rates most evident in the Euro-Zone, Brazil, Russia, Japan and Italy; continued easy monetary policies in the Euro-Zone and Japan, and (hopefully, see below) only gradual tightening in the US; large US fiscal stimulus, with fiscal policy generally neutral elsewhere; and, perhaps most important, pent-up demand for capital equipment and consumer durables following ten years of sluggish growth in many countries.

Inflationary pressures are contained. There is plenty of underutilized capacity across the increasingly integrated global economy. Unemployment is higher than 5% in over half of the world's 60 largest economies, and, though accelerating, all 6 developing regions except for South Asia are growing at rates well below their twenty-year average and far below the rates they saw in the immediate pre-crisis years. Oil and non-oil commodity prices have recovered significantly from their lows in 2015 but remain subdued, and core inflation in the advanced countries, including in the United States, remains below the 2% benchmark used by Central Banks across the large economies.

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There are many idiosyncratic or country-specific risks, at present, but few signs of systemic risk. To quote a few examples, a hard Brexit would hurt the UK and dampen spirits in the Euro Zone, and tensions on Iran and North Korea could escalate, affecting their neighbors. However, systemic risk, which I define as events that could knock 1% or more off the world growth rate, equal to about 800 billion $, are hard to find. Historically, these events have been of two kinds – a sharp cyclical downturn of domestic demand in one or more of the mega-economies (US, China and Europe), or a major common and contagious shock, which in the post-war era occurred rarely – for example, the oil shock of 1973 and the Great Financial Crisis of 2008-09. It is difficult to see any of these scenarios – or something of that scale - materializing over the next year or so.

The current stock market correction is unlikely to represent a systemic threat. US stock markets reached very high valuations last month and a stock market correction was widely expected and is now occurring. These episodes are unsettling but they are not uncommon. Corrections of the Standard and Poor's 500 of 10% or more have occurred on average nearly every 18 months since 1957 (See http://www.businessinsider.com/history-of-10-corrections-2013-12). Based on past episodes where earnings prospects are strong and economic fundamentals are solid, the expectation of most operators is that it is unlikely to turn into a freefall. Most valuation models suggest that US equities are now priced only a little higher than the historical average, and are actually priced lower than benchmarks when taking into account today's low interest rates. Emerging markets and European equities followed US equities down in almost identical fashion.

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Yet, while US equities have doubled in value since 2008, emerging market prices expressed in terms of US dollars are hardly changed over the last 10 years and European equities also expressed in dollar terms are some 10% lower[1]. Valuation levels in the Emerging Markets and Europe are also far lower than in the US: current US price/earnings ratios stand at 24, and are at 18.4 in Europe and only at 15.8 in emerging markets[2]. Although stock prices across the world tend to move in step fashion in the short run, they can and do diverge greatly over time, so that overvaluation in the United States – if there is overvaluation - does not necessarily imply overvaluation everywhere else.

1. The appreciation of the effective exchange rate of the US dollar over 2008-2018 was about 11%, accounting for only a small part of the divergent performance of US, European and emerging market equities, expressed in US dollars, over this period.

2. The prices reported in this paragraph were accessed on 13 February 2017 and they relate to the largest exchange traded funds tracking respectively the Standard and Poor's 500, and the FTSE Europe and Emerging Market Indexes.

Risks are contained in the short-term but are more evident in 2019 and beyond. I see the short-term risks – to end 2018 – as modest either way and actually tilted to the upside, meaning that 2018 could see a significant acceleration compared to 2017; global GDP may grow somewhere closer to 3.5% than 3%. The global economy, especially when momentum is solid and broad-based, does not turn direction quickly and expectations of rising activity as evident in high purchasing managers' indexes and strong consumer confidence surveys tend to be self-reinforcing. As one probes deeper the into 2019 and beyond, however, there are two prominent sources of risk, neither of which will necessarily derail this global growth episode, but each of which will be a source of increased volatility and perhaps set the stage for some form of crisis in 2020 and beyond.

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The first risk is the looming clash between fiscal and monetary policy in the US. The tax reform package passed by both houses of Congress in December is wide ranging, but it includes three provisions which are especially significant in reducing expected tax revenue: it cuts the corporate tax rate from 35% to 21%, allows 100% expensing of capital expenditures over the next five years, and introduces new income tax brackets at which higher rates of tax (or any tax) apply. Combined with a subsequent budget compromise designed to avoid a government shutdown, which includes increased spending on defense and on social programs, it points to a large increase in the government deficit in coming years, which according to private sector economists could exceed 5% of GDP in 2018, from 3.5% in 2017. The implied fiscal stimulus will occur against a background of full employment (the US unemployment rate is currently 4.1% and expected to decline further), and of normalization of monetary policy, with the Federal Reserve expected to raise rates by about ¾ % over the next year and to continue to reduce its holdings of government bonds. Markets are justifiably worried that this combination could trigger higher inflation and a marked rise in long-term interest rates from low levels (the current term premium – the difference between short- and long-term interest rates is low by historical standards). Still, if the rise in interest rates occurs against a background of solid growth in the US and across the world, it is likely that most emerging markets – whose macroeconomic management has improved greatly since the turn of the century – will be able to navigate through this episode. Increased export earnings will outweigh increased debt service costs by a wide margin. However, if the rise in US interest rates is sharp and rapid, the ensuing financial market turmoil and reduced confidence could result with both much higher interest rates and slower growth, leaving economies with large borrowing requirements exposed.

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A resurgence of protectionism represents perhaps the greatest long-term risk. Rising protectionism resulting from a misguided "America first" view of trade policy, and manifested in a possible US withdrawal from NAFTA, as well as a sharp increase in the use of "trade remedies" (anti-dumpling, countervailing duties and safeguards), would not have an immediate effect on global economic growth, as could a sharp rise in long-term interest rates – but the damage will be more profound and long-lasting. The dampening effect on economic efficiency will be gradual, more like a slow-growing cancer rather than a stroke. If Trump decides to withdraw from NAFTA, which is a distinct possibility, Mexico – which has trade agreements with many other countries and will face relatively low US WTO-agreed tariffs, can probably manage but the signal given to the rest of the world will be chilling. It will convey the message in Latin America and around the world that the international business environment is no longer predictable, and it will be open season on trade rules for the many interests that don't like to compete with imports (See http://www.ocppc.ma/sites/default/files/OCPPC-PP1712.pdf.)

In the long run, we are not all dead. Given the demographic slowdown in the labor force in most economies over the

last twenty years, the reduction in the investment rate since the crisis, and sluggish productivity growth, it would be prudent to expect that the world economy will grow at rates well below 3% over the next 20 years, the rate achieved on average over the last 20 years. Indeed, a frequently heard warning from international institutions is that the potential rate of economic growth across the world has slowed sharply. The concern is well grounded. However, one should not rule out the possibility that, with the global recovery, investment rates will increase again, productivity (which depends in part on the willingness and ability to invest in new machines and techniques) will accelerate, and that the available labor stock will become more fully utilized. The tax reform in the US can be criticized along many dimensions, but it could trigger a significant increase in corporate investment. Trend extrapolations of productivity may be unreliable after 10 years of a slowly-unwinding financial crisis, and there are very disparate views on prospects for technological application and innovation. Micro-studies, such as those conducted in recent years by Mc Kinsey and by the Oxford Martin school, suggest that very large labor savings are likely in coming years just by applying existing technologies. So, one must take any claim that we know what long-term GDP potential growth is with a grain of salt. Potential growth calculations are especially questionable in developing countries, which are operating far inside the technology frontier and heavily underutilizing their labor. Developing countries now account for nearly half the world economy at market exchange rates, so that even if innovations at the frontier slow global growth could remain at 3% or even accelerate for a very long time. I would not necessarily bank on this scenario, but it is possible if policies are supportive.

Policy must adapt along two main dimensions. The robust economic growth expected in 2018 provides the opportunity to build buffers against the likelihood of higher interest rates and an increasingly difficult trading environment in coming years. Emerging markets that run large budget or current account deficits (in excess of, say, 5% of GDP), such as Brazil, Argentina, Turkey, Egypt and Pakistan – not to mention the unfortunate Venezuela – are clearly vulnerable. Building buffers against higher interest rates and financial and trade volatility requires persisting with a well-tested agenda, namely prudence in the management of fiscal and current account imbalances, lengthening debt maturities, developing domestic debt markets, enacting macroprudential regulations in the banking system, accumulating international reserves and adopting a more flexible exchange rate as a shock absorber. These measures have generally worked well to reduce the vulnerability of emerging markets to external shocks in recent years. Guarding against protectionism requires accelerating the negotiation of trade agreements with willing partners, lending full support to modernization and revitalization of the WTO, and ensuring that domestic inequality and disparities are contained – i.e. that the gains from trade are equitably shared – thus forestalling the populism that has taken hold in a number of economies.

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Uri Dadush is a Senior Fellow at the OCP Policy Center and non-resident scholar at Bruegel, based in Washington, DC. He is also Principal of Economic Policy International, LLC, providing consulting services to the World Bank and to other international organizations as well as corporations. He teaches courses on globalization and on international trade policy at the OCP Policy School and at the School of Public Policy at the University of Maryland. Dadush works mainly on trends in the global economy and on how countries deal with the challenge of international integration through flows of trade, finance, and migration. His recent books include "WTO Accessions and Trade Multilateralism" (with Chiedu Osakwe, co-editor), "Juggernaut: How Emerging Markets Are Transforming Globalization" (with William Shaw), "Inequality in America" (with Kemal Dervis and others), "Currency Wars" (with Vera Eidelman, co-editor) and "Paradigm Lost: The Euro in Crisis". He was previously Director of the International Economics Program at the Carnegie Endowment for International Peace, and, at the World Bank, Director of International Trade, as well as Director of Economic Policy, and Director of the Development Prospects Group. Based previously in London, Brussels, and Milan, he spent 15 years in the private sector, where he was President of the Economist Intelligence Unit, Group Vice President of Data Resources, Inc., and a consultant with Mc Kinsey and Co. His columns have appeared in leading publications such as the Financial Times, the Wall Street Journal, Foreign Affairs, and L'Espresso.

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