Standard Life Investments

Weekly Economic Briefing
Global Overview

Why emerging markets matter
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Much of the stress in the global economy right now is concentrated in emerging markets. There are many reasons why this matters to investors. Measured at purchasing power parity, the advanced economies now only account for 43% of global GDP, down from 54% in 2004. The share of emerging markets is lower when calculated using market exchange rates, but they undoubtedly exert a significant pull on the global economy. Exports from the advanced economies destined for emerging markets have increased significantly over the past two decades. In 1995 exports to final demand in emerging markets accounted for 22% of total exports in the average OECD country; in 2011 that had reached just over 33%, with exports now accounting for a larger share of GDP than they did in most countries versus 1995 as well. Financial institutions and asset managers in the advanced economies have also lent a considerable amount to governments and, in particular, banks and non-financial corporations in recent years. Emerging market bonds outstanding to foreigners stand at more than USD3 trillion, much of it in foreign currency and especially US dollar-denominated debt. Additionally, financial shocks emanating from emerging markets can destabilise financial markets in the developed economies, whether that be due to fears of economic and financial contagion or large swings in currencies. While lower commodity prices are a boon for importers, they weigh on inflation.

Of course, exposures to emerging markets vary considerably. The three advanced economies that stand out for having the largest direct exposure to emerging market growth are Australia, Japan and Korea, where exports to final demand account for more than 50% of total exports. Countries with a more modest exposure (30% of exports or less) include the Benelux and Iberian countries. While the proportion of Canadian and Norwegian exports heading directly for emerging markets is low, their practical exposure is much higher because weak emerging market demand has contributed to the large drop in oil prices since mid-2014. This is not a reason to panic, as long as emerging markets are slowing but not collapsing. However, it does help explain why advanced economy central banks are so sensitive to foreign developments.

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Europe

Trading pains

Trade is important for the Eurozone. Exports of goods and services account for 26% of GDP (extra-Eurozone transactions), which is around twice the level reported in the US, and noticeably higher than the 19% in Japan. This makes the region more sensitive to fluctuations in global trade and demand. There is significant empirical evidence that the Eurozone business cycle tends to lag that of the US, with a research paper published in 2009 by the European Central Bank (ECB) showing that this pattern has held since the 1970s (see chart 6). The relationship between the Eurozone business cycle and emerging market (EM) economic activity is empirically less clear. EMs are accounting for an increasing share of Eurozone exports. In 1995, the average member state sent 22% of its exports in terms of final demand to a non-advanced economy. By 2011, this share had increased to 33%. Is there a risk that the rising importance of EMs for Eurozone exporters could undermine the Eurozone recovery? The Eurozone has been lagging the US even more than normal, as it struggled through two painful recessions over recent years. **Could the EM slowdown push the currency union further behind, or even break this pattern entirely?**

The exposure of Eurozone member states to weakening EM activity varies significantly from country to country (see chart 7). Finland stands out as having the highest proportion of its exports going towards the emerging world. Exports, measured by final demand, to non-advanced economies account for 41% of total – up from 26% in 1995. This is partly driven by close ties with neighbouring Russia, which accounts for the largest single country share of exports (8.5%). While Finland has unusually strong ties to EMs, there are a group of larger economies which are not too far behind. Germany and Italy both send 37% of their exports to emerging economies. **This is particularly significant for the German economy given that exports account for a sizeable 45% of GDP.** Other countries have less pronounced ties: Luxembourg (21%), Belgium (25%) and Ireland (25%) all have smaller, albeit far from marginal, export exposure to EM demand.

Overall, the Eurozone economy does a material amount of business in EMs. Trade links have been increasing over recent years and this has been magnified as trade plays a larger role in overall economic activity. Headwinds from weak EM economic growth partly blunt the benefits of a weak euro and will weigh on net exports. The ECB's recent downward revision to its staff forecasts largely reflects this weaker trade backdrop. **However, the upturn thus far has been overwhelmingly driven by domestic demand with the conditions supporting this activity still in place; loose monetary policy, neutral fiscal policy and a healthier banking sector.** Furthermore, the downward leg in commodity prices should boost consumer spending. If the stress from the EM episode were to change, then these supportive foundations would become fractured. Thus far interest rates, credit conditions, confidence and lending remain supportive, but we will need to watch these data closely for signs of contagion. Overall, we would probably need to see a bigger shock in the emerging world to undermine growth, a shock that would be similarly painful for the US, making a broader decoupling less likely.

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