CRS INSIGHT

Emerging Markets: Is Slower Growth Temporary?

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Emerging market (EM) countries as a group are facing growing vulnerabilities to their economies due to declining global trade, depreciating currencies, sharply lower commodity prices, volatile equity markets, and deeper economic reforms. In addition, anticipated changes in U.S. monetary policy and differences in economic performance and monetary policies between the United States and other developed economies are creating uncertainties for EM economies.

Table 1. Annual GDP Rates of Growth, Real and Projected

	2014	2015	2016
World Output	3.4	3.3	3.7
Advanced Economies	1.8	2.1	2.3
United States	2.4	2.5	2.8
Euro Area	0.8	1.5	1.6
Japan	-0.1	0.8	1.3
United Kingdom	2.9	2.4	2.1
Canada	2.4	1.5	2.3
Emerging Markets	4.6	4.2	5.0
Russia	0.6	-3.4	1.8
China	7.4	6.8	6.3
India	7.3	7.5	7.5
Latin America	1.3	0.5	2.1
Brazil	0.1	-1.5	2.3
Mexico	2.1	2.4	3.0
Middle East	2.7	2.6	NA

Source: International Monetary Fund, August 2015.

For some EM countries, the current slowdown in economic growth likely is temporary, reflecting cyclical fluctuations, but for others it could mark a structural transition to slower growth. Given the interconnected nature of economies through trade and financial markets, an economic slowdown in EMs has implications for the United States and the global economy. Forecasts by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) point to a slowdown in EM economies in Asia, except India, and Latin America through the second half of 2015, but to a modest recovery in 2016. The OECD estimates that the advanced economies are improving slowly, despite a decline in global trade and volatile financial conditions. Economic conditions, however, have worsened for many EMs since these forecasts were released in August 2015. Some estimates indicate that the risks of a global recession may be growing.

Recent Developments

In August 2015, indicators pointing to a weakening in China's economy and China's move to devalue its currency added to other issues that triggered a global selloff in equities and a new round of depreciation in a large number of EM currencies. Most equity markets in developed economies have stabilized, but equity, foreign exchange, and commodity markets in EMs remain volatile as concerns persist over deteriorating economic conditions. Many EMs are experiencing capital outflows and a drop-off in foreign investment, and credit rating agencies have downgraded Brazil's and Russia's sovereign debt securities to junk bond status; South Africa, Turkey, and other EMs potentially face a similar fate. Also, China is experiencing continued pressure on its currency and uncertainty persists about the health of its economy and its commitment to implementing economic reforms. Under a robust global economic recovery, China's economic slowdown likely would be supported, but in the current environment the slowdown is adding to other forces, inhibiting the ability of the EM economies to achieve higher rates of growth and potentially stalling the nascent recovery in developed economies.

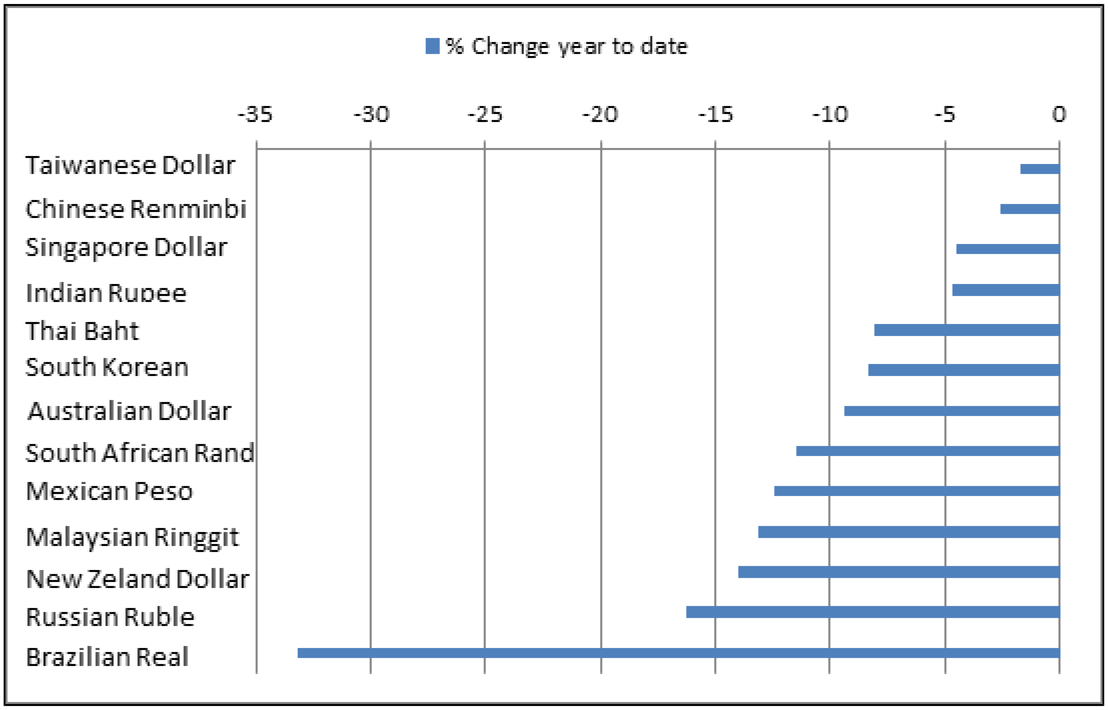
Commodity Markets

Over the past year, oil, metals, and other raw materials prices have dropped sharply, benefitting commodity-importing countries and consumers, as demand from China and other EMs fell below expectations and created large surpluses. A boom in commodity exports and rising prices from 2002 to 2013 fueled economic growth in EMs as commodity producers in Asia, Latin America, and Africa ramped up production to meet anticipated demand. From mid-year 2014 to mid-year 2015, however, oil prices dropped by half, benefitting oil-importing nations, but reducing export earnings of oil-producing countries and negatively affecting investment, production, and employment in the energy sector. Declining oil and commodity prices also raise concerns about spillover effects onto major trading partners of EMs that depend on such exports.

Foreign Exchange Markets

Since mid-year 2014, the dollar has appreciated against a broad basket of currencies, reflecting a combination of factors, including a drop in commodity prices and differences in growth rates and monetary policies. The sustained appreciation of the dollar concerns some U.S. exporters over the international competitive position of their products, and some domestic producers may face more competitively-priced imports. Since most agricultural products, oil, and other commodities are priced in dollars in international markets, an appreciation in the exchange value of the dollar reduces the price competitiveness of U.S. agricultural and other exports, but boosts the incomes of foreign producers in local currencies and may spur foreign production. Although opinions vary, some economists argue that currency devaluations have lost some of their potency as a tool for increasing export sales, largely due to the growth in global supply chains in which imports of intermediate goods are used as components in producing finished goods for export. Other analysts argue, however, that such economic fundamentals as GDP growth rates, commodity prices, and country-specific factors drive movements in exchange rates and trade.

Figure 1. Percent Change in Selected Currencies Relative to the Dollar



Source: Board of Governors of the Federal Reserve System.

Notes: Percent change in currency exchange rates relative to the dollar from January 2015 to mid-August 2015.

The depreciation of EM currencies is reinforcing a downward cycle that is depressing global trade. Currency devaluations have not increased exports for EM countries as would be expected, but has raised import prices, which has reduced overall demand for imports, eroding total income for exporting countries, which reduces their demand for imports and contributes to the downward cycle in trade. Many EM governments have improved their fiscal positions and reduced their exposure to exchange rate risk, but foreign corporations borrowed heavily in dollar-denominated debt when their currencies were stronger and increased their exposure to exchange rate risk.

Impact on the United States

Through its global economic role, the United States affects and is affected by developments in the global economy and in EM countries. For instance, the Federal Reserve, citing concerns over the global economy, opted against raising interest rates for now at its September 17, 2015, meeting, likely forestalling a similar decision by some EMs. Weaker raw material and oil prices likely will reduce inflationary pressures in the U.S. economy, but the sustained appreciation in the dollar, weaker foreign demand, and lower commodity prices are negatively affecting U.S. exports to EMs. Continued weaknesses in EMs could lead to further appreciation in the dollar. Congress has longstanding interest in the foreign exchange value of the dollar and the overall performance of and impact of trade on the economy. Members of Congress may also consider potential trade liberalization agreements with certain Asia-Pacific nations and Europe and have encouraged economic reforms in EMs that potentially could spur global economic growth by removing trade barriers and improving efficiency.