Evaluating Emerging Markets In The Post-Crisis Period: A New Methodology

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I. Introduction

The 2008-2009 global recession and ongoing financial crisis have transformed the global economy. Conventional wisdom is that while the developed nations have clearly come out of the crisis significantly weakened, both economically and financially, the emerging markets (EMs) have sailed through the crisis with little collateral damage. But is this really the case? This paper argues that the five-year global crisis (2007-12) has been equally critical for much of the emerging world.[1]

> Basel III and other financial regulatory regimes promise to significantly tighten banking credit this decade

Collectively, the EMs have enjoyed a period of unprecedented expansion over the last decade. After limping along with an average real GDP growth of only 3.7% during the 1990s, average growth soared to 6.2% in 2000-12.[2] Over this same period, the EM growth advantage over developed countries widened from a narrow 1% to a gaping 4.4%.[3] Economic expansion was broad-based throughout the EMs, ranging from a high of 8.2% in Asia to a low, but still respectable, rate of 3.5% in Latin America.[4]

Some of this improvement in macroeconomic performance can be attributed to the structural reforms that many developing economies put in place following the EM crisis that commenced with the 1997 East Asian financial crisis and ended with Argentina's sovereign default in 2001.

While economic liberalization can be credited for some of the growth seen over the last 10 years, at least some of the surge was caused by the confluence of (at least) three factors that are unlikely to be replicated anytime soon.

Firstly, most EM countries benefited enormously from the sharp protracted rise in commodity prices. It is highly unlikely that commodity exporters will enjoy anywhere near the same favorable tailwinds over the next decade.

Secondly, global credit conditions before the crisis were unusually beneficial to developed and developing nations alike. This allowed increased borrowing at favorable rates for both consumers and businesses. As a consequence, consumer debt levels have increased markedly in some EMs, such as Brazil and Russia. To their credit, broad-based improvements in EM sovereign debt ratings contributed to lower borrowing costs, but these upgrades are very unlikely to occur with the same frequency in coming years. Moreover, at some point most EM central banks will be reversing years of easy monetary policy in order to stem inflation and deteriorating credit conditions. Basel III and other financial regulatory regimes promise to significantly tighten banking credit this decade. In addition, emerging equity markets last decade witnessed enormous gains in valuations, fueled in part by capital inflows from the developed world. While the rise in equity valuations reduced the cost of equity capital for EM firms, emerging equities are no longer considered "cheap." This implies raising equity capital may not be as easy in the near future.

Thirdly, the developed economies, a critical recipient for emerging market exports, were growing at a 2.7% pace from 2003-07, compared with an anemic 0.5% during the crisis period of 2008-12. With the deleveraging process and financial crisis far from over, growth in the developed world is widely expected to remain below trend over the next two to three years, promising to constrain EM exports.[5]

Lacking some or all of these three significant tailwinds in the coming years, EMs are unlikely

1 This paper will reference 2007-12 as the crisis period, although at the time of this paper's publication the world's economy was still growing well below trend and financial stress and deleveraging was still well under way.

2 2012 figures are IMF growth projections.

3 The EM growth advantage really began accelerating in 2003. Over this period (2003-12), EMs averaged 5% stronger growth.

4 It averaged 3.9%, 5.7%, and 5.5% in Central & Eastern Europe, the CIS region and Africa respectively.

5 According to IEMS' estimates, approximately three-quarters of EM exports are sent to the developed world.

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to receive the same "free ride" they enjoyed last decade. Economic growth is likely to be slower across the emerging world (compared with the 2000s) and also much more inconsistent across regions and countries. As a consequence, a new set of criteria will be needed to evaluate the progress of emerging economies throughout the financial crisis and the immediate post-crisis periods. Naturally, the factors that propagated EM growth last decade could return, but it does seem that their short to medium-term recurrence is unlikely.

This paper's new methodology is introduced in section II and described in detail in section III. In section IV the methodology is applied in evaluating some of the larger emerging economies.

II. The new post-crisis environment: five factors that will differentiate emerging economies

In the wake of the financial crisis, and in the midst of a global recession, it's clear that many of the developed nations face an enormous array of challenges in the years ahead. But what about the EMs? Where do they stand and what are their prospects?

Given that many, if not all of the growth drivers mentioned in the previous section will be absent in the short and medium term, EMs will have to look to new sources to generate growth and improve living standards. We believe there will be five economic drivers of distinction in the new global economic order. In no particular order, they are:

1. *Technological adaptability* There is early evidence that the "digital divide" between developed and developing nations has been quickly narrowing since the financial crisis and a "leapfrog effect" is well underway in some EMs.
2. *Commodity dependence* Much of the emerging world consists of commodity-dependent exporters. The bull market in commodity prices last decade was historically unprecedented and delivered oversized gains that are unlikely to be replicated anytime soon.
3. *Financial freedom* Deepening financial markets have always been a necessity for developing economies. Unfortunately, laissez-faire financial markets appear to be dead for the time being. The post-crisis regulatory regime is threatening to strangle financial freedom, but nations that manage to liberalize in this environment will gain enormous advantages.
4. *Credit quality* While the financial crisis has caused credit conditions to deteriorate for developed economies, the emerging nations have sailed through it reasonably well. But has this "easy ride" caused some EMs to neglect their domestic finances?
5. *Institutional reform* The quality of a nation's institutions has always been crucial for economic development and avoiding the middle-income trap. With last decade's EM tailwinds largely gone, institutions are now even more critical in sustaining economic growth.

> The confluence of drivers that propelled EM growth over the last decade will be largely absent in the near future

Why were these five factors chosen at the expense of others? Firstly, this paper argues that the confluence of drivers that propelled EM growth over the last decade will be largely absent in the near future. Secondly, the global economy has undergone significant structural changes during the protracted economic and financial crisis (the worst downturn in 80 years). While the five factors discussed in this paper have always been relatively important drivers of economic activity, the recent crisis has elevated their importance. In other words, we believe these five drivers are the most critical under current global economic conditions and will play the biggest role in differentiating EM "winners" and "losers" over the next three to five years.

III. Analysis by Segment

Technological adaptability: leaping the digital divide

One of the critical areas in which the protracted financial crisis is reshaping the global business landscape is by changing technological adaptability. The downturn has accelerated the adoption of key technologies, such as cloud computing, mobile technology and social media. These changes are transforming industries and igniting a new wave of wealth creation, particularly throughout the emerging world.

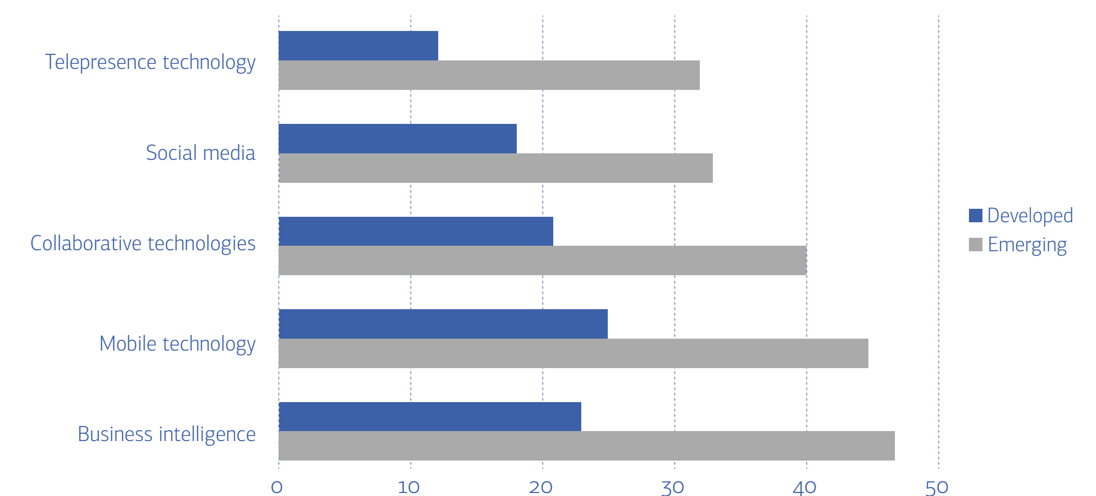
For the first time, the digital divide appears to be closing. With economic power rapidly shifting to the East, cash-rich companies in the developing world are now investing heavily in technology, while many of their western counterparts have cut capital spending for information and communication technologies (ICT).[6]

Across many ICT indicators, firms in the developing world appear more willing to adopt new digital technologies than their counterparts in the West. For example, executives in EMs are planning larger capital expenditures over the next five years in mobile technology and business intelligence.

There is also recent evidence that the usage of cloud computing, the latest technology to revolutionize many aspects of business, is being more rapidly deployed in EMs. A recent survey of 33 countries found that the use of cloud computing in developing countries was higher than in developed countries (50% versus 33%). Usage rates in developing countries, such as Thailand, Mexico, Malaysia and Peru, were significantly higher than in many mature economies.

This greater rate of ICT adoption has the potential to create the so-called "leapfrog" effect. Technological leapfrogging occurs when a new technology penetrates the market of a country faster than the technology of the prior generation, and/or when a new technology penetrates an EM faster than it does a developed market. For example, in many EMs mobile phones have higher penetration rates than landlines and mobile banking has a higher penetration rate than brick and mortar banks. There is wide-

Figure 1: Technology adoption in the emerging vs. developed world (% planning to increase expenditures by over 20% in the next five years)



Source: "The New Digital Economy," Oxford Economics, June 2012.

6 The ICT sector covers a broad and dynamic range of products and services from telecommunications equipment to IT services.

spread evidence that technological changes often lead to faster economic growth. For example, according to the World Bank, every 10 additional mobile phones per 100 people in a typical developing nation results in faster GDP growth of roughly 0.8%.

The catch-up phenomenon is also apparent in internet usage. According to Google, between 2012 and 2015, 500 million new users from EMs are expect to come online, compared with only 15 million new users from the United States.

To gauge both the depth and evolution of technological adaptability, we use the UN's well-established International Telecommunication Union's ICT Index. The index is a composite of 11 indicators and measures three factors: ICT access, usage and skills. Scores of between 0 and 10 are given, where 10 represents the highest level of ICT development. Table 1 gives the fastest and slowest ICT gainers according to the Index over the crisis period (2007-12).

Summary notes:

- CT values are twice as high in developed countries, but the largest gains over the crisis period were made primarily in developing countries.
- Sub-Saharan Africa scored the lowest in both technological depth and advances.
- ICT prices are falling much faster in the developing world, helping to make technology more affordable.
- Russia quickly improved its ICT capabilities over the crisis period. Its ICT sector is one to watch in the coming years.

Commodity dependence: what if commodity prices decline?

Last decade's commodity price shock helped resuscitate much of the developing world's commodity-dependent economies. Between 2003 and 2008, oil prices climbed by 330% (in terms of US$) with metals and minerals making similar advances (global food prices doubled from 2006 to 2008). The precipitous price rises in many of the EM's key export commodities drove enormous improvements in their terms of trade.[7] In turn, this drove up real GDP growth. In short, many EMs simply rode the commodity tidal wave that super-charged domestic growth.

There is widespread belief that the unprecedented commodity boom of last decade is just the beginning of a new era that will be characterized by commodity shortages and permanently higher prices. Demand for energy, metals and food from the EMs is expected to drive growth, as billions of new middle class consumers emerge over the next 20 years. Of course, if the EMs start consuming commodities at a similar rate to the Chinese in the past decade, then prices could easily remain elevated for some time.

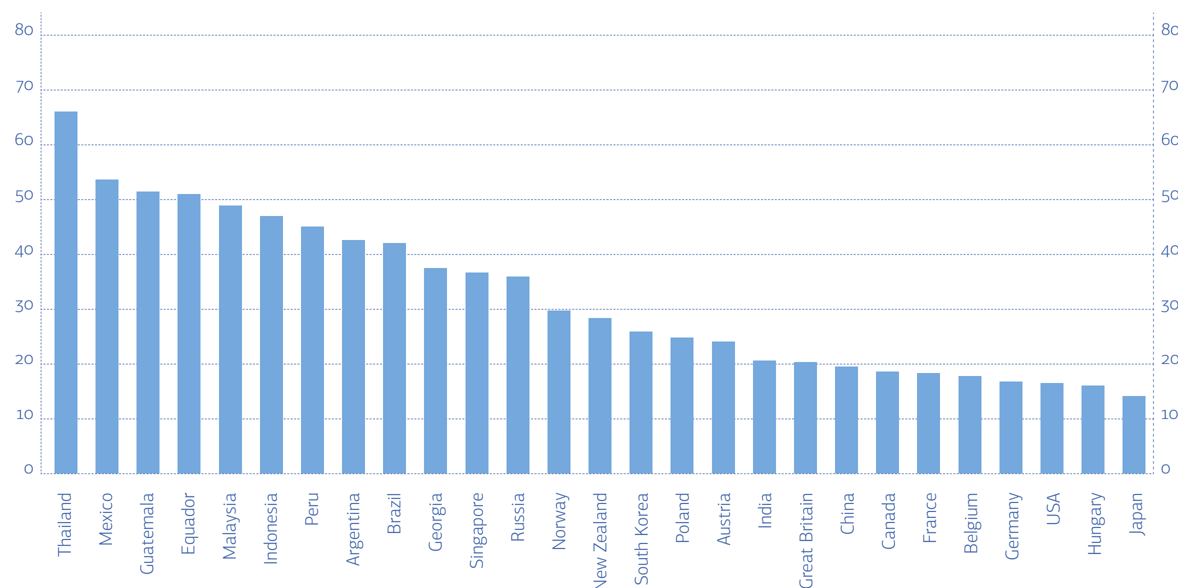
There are a number of excellent reasons, however, to expect that the bull market in commodities of the last 10 years is unlikely to be repeated in the coming decade, particularly in its amplitude and duration. Firstly, last decade commodity producers were caught off-guard by the rise in commodity demand. The surge in Chinese demand, in particular, at the beginning of the century was without precedent. Since there is a long lead time between commodity supply and demand, the next few years will witness rapid growth in the supply of many commodities.

Secondly, almost all the increase in demand from last decade was a result of the unbalanced growth in China. As China's growth slows and simultaneously becomes more balanced (i.e. more consumption and less fixed investment spending) its growth in commodity demand will continue slowing.

Thirdly, surging Chinese commodity purchases in recent years supplied not just growing domestic needs, but also rapidly growing inventory. The result is that commodity inventory levels in China are now too high to support what growth there will be over the next few years.[8]

More importantly, a number of long-term trends suggest that the main factors driving commodity demand will begin decelerating. Over the next two decades, annual global population growth is expected to slow significantly, from 1.2% during the 2000s, to a projected 0.8%

Figure 2: Cloud computing usage by country (2012)



Source: BSA; The Software Alliance; Ipsos Cloud Survey

Table 1. The fastest and slowest ICT gainers according to the Index over the crisis period (2007-12)

Noteworthy advances		Lackluster advances	
Russia	2,2	Venezuela	0,59
Kazakhstan	2,1	Philippines	0,58
Oman	1,93	Nigeria	0,57
Saudi Arabia	1,67	Algeria	0,51
Macedonia	1,65	Syria	0,5
Azerbaijan	1,62	India	0,48
Serbia	1,55	Cambodia	0,43
Lebanon	1,46	Thailand	0,38
Georgia	1,33	Pakistan	0,3
Uruguay	1,28	Cuba	0,15
Poland	1,24		
Brazil	1,23		

7 The "terms of trade" are the price of a country's exports divided by the price of its imports. An improvement in a nation's terms of trade (an increase in the ratio) is considered healthy, because a nation can buy more imports for any given level of exports.

8 As an example, in 2012, China's stockpiles of copper were double the average of the past four years and iron ore stocks were about a third higher than their recent historic average. The Chinese have also been stockpiling large quantities of rice.

over 2015-30.[9] Global per capita income growth is also projected to slow, mainly because incomes in the largest developing countries are expected to rise less rapidly than they did from 1990 to 2010.

The changing composition of GDP should also moderate commodity demand as the global service sector grows faster than the more commodity-intensive manufacturing sector. This will happen in both developing and developed countries. And lastly, technological change, while impossible to predict, typically slows demand because of increased efficiency in commodity production. China aside, the commodity "intensity" for most products has been rapidly declining.

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In this paper, commodity dependency is defined as commodity exports as a share of GDP.[10] Generally speaking, an EM is considered commodity dependent if its share of commodity exports exceeds 10%. Given the historical volatility of commodity prices, a 30% annual decline in the price of a nation's commodity exports is not unusual.[11]

Table 2 lists the most and least commodity dependent EMs (see the appendix for a comprehensive listing).

Summary notes:

- Rapid industrialization and urbanization have made East Asian, Pacific and South Asian nations the least resource dependent, with commodity exports comprising just 6% and 3% of GDP respectively.
- China and India, as large net importers of commodities, are poised to reap significant gains in a period of declining commodity prices.
- As a region, sub-Saharan Africa's dependency on commodity exports has only increased during the crisis, standing at an estimated 20% in 2012.
- Most of the Gulf States are probably an exception here. While lower oil prices would obviously greatly impact energy revenues, most countries have proportionately large sovereign wealth funds endowed with significant foreign assets to shield them from short to medium-term price declines.

Table 2: Commodity exports (share of GDP in 2011)

Low dependency notables		High dependency notables	
China	2%	Argentina	12%
India	4%	South Africa	12%
Philippines	4%	Ukraine	13%
Brazil	6%	Thailand	15%
Mexico	7%	Venezuela	16%
Poland	7%	Russia	20%
Georgia	7%	Vietnam	23%
Armenia	8%	Malaysia	27%
Kenya	10%		

9 UN projections.

10 Commodity exports consisted of agricultural raw materials, energy, food and ores, and metals.

11 A 30% annual decline, holding everything else equal, would reduce GDP growth by 3%.

Financial freedom: a very difficult environment

One of the most pressing and critical issues currently facing the emerging economies is the continued development of their financial sectors.[12] The banking sector dominates EM financial intermediation, but many are state owned and poorly allocate capital. Most emerging stock markets, if they exist, are essentially illiquid. Corporate bond markets are nonexistent in most emerging economies (as of 2011, only 12 EM nations had active corporate bond markets) and many EM consumers have no access to credit.

Unfortunately, the global financial crisis has led to a sweeping re-evaluation of financial market regulation. The Basel III, for example, which mandates significantly higher capital and liquidity requirements for banks, was largely designed for western institutions. The accord, which will be fully implemented by 2018, was designed to curtail financial excesses in Europe, Japan and the United States. It is expected to have a disproportionate impact on financial development and economic growth for the emerging economies.[13] Moreover, the ongoing G20-proposed financial regulations cover a wide range of issues, from the compensation practices of financial institutions to the use of financial derivatives in risk management. The current regulatory environment simply ignores the fact that emerging economies are at earlier stages of economic and financial development and will require different regulatory regimes as they deepen their financial markets and democratize credit. Moreover, a large number of EMs have entered the "upper-middle income" bracket for the first time, reaching a stage that requires a movement towards a more market-based financial system (as opposed to bank-based).

With financial laissez-faire economics dead, at least for the foreseeable future, the standouts against this backdrop will be EMs which manage to preserve or implement financial sector reforms that lead to greater financial freedom and,

Table 3: Change in financial freedom (2008-12)

Beneficiaries in financial freedom		Losers in financial freedom	
UAE	30	Equador	-20
Brazil	20	Ukraine	-20
South Africa	20	Venezuela	-20
Thailand	20	Argentina	-10
Algeria	10	Georgia	-10
Azerbaijan	10	Kazakhstan	-10
Costa Rica	10	Lebanon	-10
India	10	Lesotho	-10
Malaysia	10	Malta	-10
Oman	10	Nigeria	-10
Panama	10	Romania	-10
Saudi Arabia	10		-10
Poland	10		

12 The relationship between economic growth and financial development is well documented. See, for example, see Shan et al. (2001), and Khan and Senhadji (2003) for overviews, as well as Levine (2005) for a comprehensive review. McKinnon (1973), Shaw (1973), and King and Levine (1993) argue the link from financial deepening to growth; Gurley and Shaw (1967) and Goldsmith (1969) support the opposite direction. On the two-way causality between financial development and economic growth, see Luintel and Khan (1999) and Shan et al. (2001), provided by Billmeier and Massa (20048).

13 Research by BBVA estimates that if Basel III capital requirements were fully implemented, GDP per capita would decline by 1.6% for a broad set of countries and fall by 2.5% for emerging countries. They found similar results for higher liquidity requirements.

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in turn, financial development. Banking and financial regulation by the state that goes beyond the assurance of transparency and honesty in financial markets will impede efficiency.

The Heritage Foundation's Index of Financial Freedom is used to account for any significant shifts since the financial crisis. The index ranges from 0 to 100, with higher scores indicating more financial freedom (a detailed description of the index is provided in the Appendix). During 2007-12, average global financial freedom declined from 52 to 48.6. Those experiencing the biggest gains and losses are listed below.

Summary notes:

- The financial crisis was not a favorable period for financial freedom. Of the 126 emerging economies in the Heritage Foundation's Index, only 22 improved their standing, while 36 experienced deterioration (68 had no change).
- The United Arab Emirates (UAE) made big gains in financial freedom. This should continue to improve its position as a regional financial hub, despite Dubai's financial difficulties during the crisis.
- China, comprising approximately 50% of EM financial assets, saw no improvement in financial freedom over this period.

Sovereign credit quality: what happened during the crisis?

The financial crisis has left in tatters the global finances and credit quality of many developed nations. In 2010 alone, 18 developed countries received sovereign rating downgrades, with none experiencing rating upgrades. During the crisis of 2008-12, the accumulated central government debt of the G7 nations rose from 80% to approximately 120%.

Table 4: Change in sovereign credit quality (2008-12)

Advances in credit quality		Declines in credit quality	
Brazil	12.7	Libya	-16
Uruguay	12.3	Pakistan	-13.1
Indonesia	11	Ukraine	-11
Colombia	10.9	Egypt	-10.1
Peru	9.8	Venezuela	-9.1
Gabon	9.6	Equador	-8.7
Panama	9	Iran	-8.6
Zambia	9	Bulgaria	-8.4
Albania	8.8	Romania	-7.9
Ughanda	8.1	Jamaica	-7.8
Bolivia	8	Kazakhstan	-5.8
Rwanda	8	Botswana	-5.4
Liberia	7.5	Guinea	-4.3
Azerbaijan	7.1	El Salvador	-4.1
Saudi Arabia	6.9	Haiti	-4.1
Georgia	6.2	South Africa	-4
Paraguay	6.2	Vietnam	-3.8
Chile	5.7	Zimbabwe	-3.2
China	5.7	Barbados	-3
Costa Rica	5.6	Honduras	-3
Philippines	5.6	Argentina	-2.8

In 2010 conversely, there were a total of 50 sovereign rating upgrades and only 11 rating downgrades across the entire emerging world. According to Moody's, approximately 60% of EM countries are currently rated investment grade, up from just 2% in 1993. As recently as the 1990s, the median EM economy had a public-debt-to-GDP ratio of more than 65%, while in the past two years the median debt has amounted to only 34% of GDP. Moreover, many EMs now have significant foreign exchange reserves, flexible exchange rates and domestic debt that is denominated in domestic currency.

Because their fiscal positions were so much stronger when the global financial crisis hit, the emerging economies' fiscal counterattack was generally quite forceful. As a consequence, the emerging economies sailed relatively well through the 2008-12 global crisis, clocking in annualized real GDP growth of 5.5% (in contrast to 0.5% for the developed economies). But as the developed economies discovered during their "Great Moderation" of the past two decades, steady economic growth (and surging tax revenues) can lead to complacency, particularly when it comes to controlling government spending.

This section examines which EMs took advantage of this period to improve their sovereign credit quality. The country credit ratings, developed by Institutional Investor, provide the probability of a sovereign debt default on a 0 to 100 scale, where 100 represents the lowest probability of a sovereign default (see the Appendix for a more detailed description of the index).

Summary notes:

- Latin American nations saw the largest improvement in credit quality from 2008 through 2012, comprising five of the top seven movers.
- Not surprisingly, countries experiencing political turmoil observed the greatest deterioration in credit quality.

Institutional reform: who reformed during the crisis?

The institutional environment is determined by the legal and administrative frameworks within which individuals, firms and governments interact to generate wealth. Whilst improving institutional quality has always been critical for emerging economies in order to avoid the middle-income trap, their importance became even more apparent during the recent economic and financial crisis.

This is true for a number of reasons. Firstly, the pro-market economic reforms adopted during and shortly after the EM crisis from last decade have largely dissipated, particularly in the larger EM economies. Few, if any, institutional-enhancing pieces of legislation have been enacted in China, India, Russia, Brazil or South Africa since the beginning of the crisis. The recent loss of momentum in many of these economies can be at least partially attributed to the cessation of structural reform.

Secondly, the state plays a relatively big role in the EM economies, particularly in terms of ownership and regulation. The state's role in some economies increased even more during the crisis, so the necessity of improving the quality of its institutions will be particularly critical.[14]

Thirdly, as this paper has stressed, at least some of the EM economic momentum of the last decade can be attributed to factors that are not likely to be replicated soon. The surest way to rekindle this growth will be by improving institutional quality. To measure this, we use property rights as a proxy. Property rights provide an assessment of individuals' ability to accumulate private property, secured by clear laws that are fully enforced by the state (see the Appendix for a more detailed description of property rights). Below are the most significant changes in property rights over the crisis period, as compiled by the Heritage Foundation's Property Rights Annual Index. The index is scaled from 0 to 100 (with higher scores indicating higher property

14 For example, China's giant state-owned banks became even more dominant as the nation's financial intermediaries. The same can be said of Russia's banking sector and its energy sector is now largely under state control.

rights) in increments of 10. The global average declined from 45.6 in 2007 to 43.4 in 2012.

Summary notes:

- The next few years may be problematic for many emerging economies in terms of generating economic growth. There was little improvement in institutional quality in the emerging world in 2008-12. Of 122 countries, only 24 posted improvements in property rights. 51 witnessed no change while 47 registered declines.
- Many countries with property rights downgrades were former Soviet Union countries and/or commodity-dependent nations.
- South Africa's unexpected drop of 20 points is damaging its short to medium-term growth prospects.

Table 5: Quality of institutions (2008-12)

Notable advances in property rights		Notable declines in property rights	
Turkey	40	Syria	-40
Uruguay	40	Thailand	-35
Colombia	20	Bolivia	-20
Georgia	10	South Africa	-20
Kazakhstan	10	Tanzania	-20
Morocco	10	Vietnam	-15
Panama	10	Argentina	-10
Poland	10	Azerbaijan	-10
Romania		Bangladesh	-10
		Equador	-10
		Kenya	-10
		Tunisia	-10
		Ukraine	-10

19 Financial Times – December 28, 2012. Beyond Brics. "Warsaw SE: Shopping center IPO masks liquidity problems."

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IV. A post-crisis evaluation: emerging market winners and losers

In this section we use the five fundamental factors introduced above to evaluate the short and medium term (2-5 years) growth prospects for a number of large EMs. The purpose of this evaluation is twofold: firstly, to illustrate how to utilize the new methodology; secondly, to identify countries where we think markets have either under- or overestimated their prospects for future growth. We begin with an evaluation of the BRICs, which are still the four largest EM economies.

Russia, India and China: mediocre grades

In terms of our five criteria, the crisis period was a lackluster one for Russia, India and China. Financial freedom, low to start with at the beginning of the crisis in all three countries, only improved in India. In China, the state maintained a tight grip on the financial system, in order to navigate its way through the financial crisis. It essentially did little to relax its capital controls, except to allow a modest appreciation of the real exchange rate. Russian state-owned banks have also strengthened their position by taking market share away from domestic private banks. To the Russian Government's credit, it imposed no capital controls during the crisis. While financial freedom improved in India, it remains low, at 40 on our scale. State-owned banks dominate the financial landscape in India, because foreign participation remains severely restricted.

The same can be said of property rights, which saw no improvement among the three countries, and actually declined from already low levels in Russia. China's weak judicial system is as vulnerable to influence and corruption as ever, and copyright infringement of intellectual property remains rampant. The nationalization of much of Russia's "commanding heights" before and during the crisis has weakened the country's property rights. Moreover, the mistreatment of political dissidents has also been on the rise recently. In India, the rule of law is still applied unevenly across the country.

On the plus side, both India and China are poised to benefit from any bear market in commodity prices.[15] Russia's commodity dependency did not diminish during the crisis period. In 2011, energy exports accounted for 67% of total export revenue, versus 61% in 2007.

Russia saw no change in its credit rating over the period. The budget is in surplus and national debt is almost nonexistent. However, in 2012, for the national budget to be balanced, the required break-even point for oil prices is US$117 per barrel, compared to just US$34 before the crisis.[16] The dramatic rise in break-even prices is largely the result of the sharp increases in government expenditure, which saw average annualized gains of 13.7% from 2007 through 2012. Government revenue from energy was an estimated 51% in 2012, compared with 37% in 2007.[17] Russia is actually becoming more energy dependent.

India's stimulus spending was not proportionately as large as Russia's or China's, but the budget deficit remains substantial and the public debt has grown to 68% of GDP. China modestly improved its credit rating over the crisis period,

Table 6: Summary statistics (2007-12)

	Russia	China	India
Change in ICT	2.2	0.85	0.48
Commodity dependency	20%	2%	4%
Financial freedom	40/40	30/30	30/40
Property rights	30/25	20/20	50/50
Credit rating	66.2/66.9	73.9/73.6	59.9/64

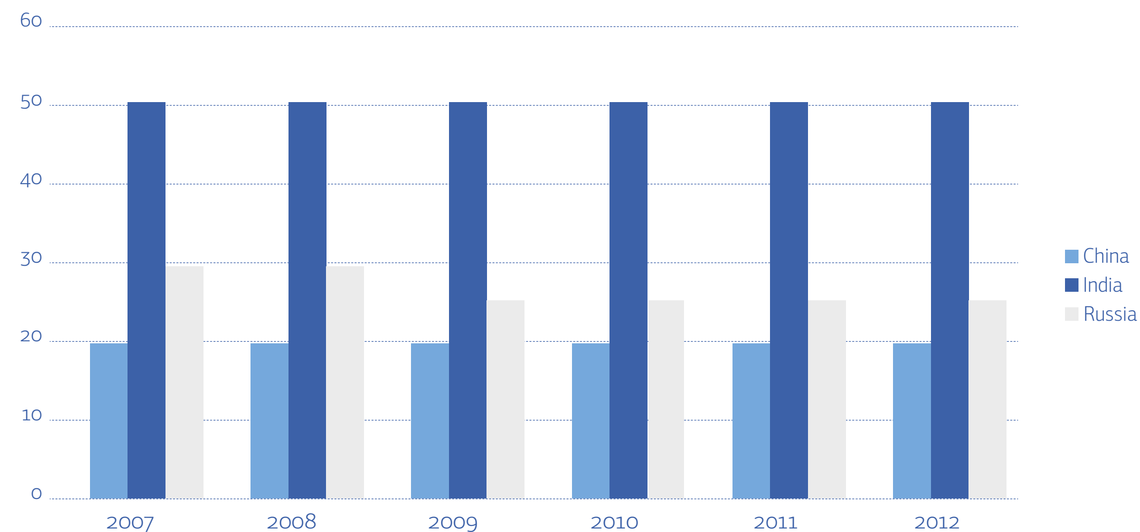
Notes: The mean change in ICT among all EMs is 0.7. The commodity dependency refers to 2011.
Financial freedom, property rights and credit ratings are scaled from 0 to 100, where higher is better (2007-12).

15 China's enormous stockpiles of some basic materials could possibly offset this impact over the short run.

16 The break-even figures were provided by Interfax.

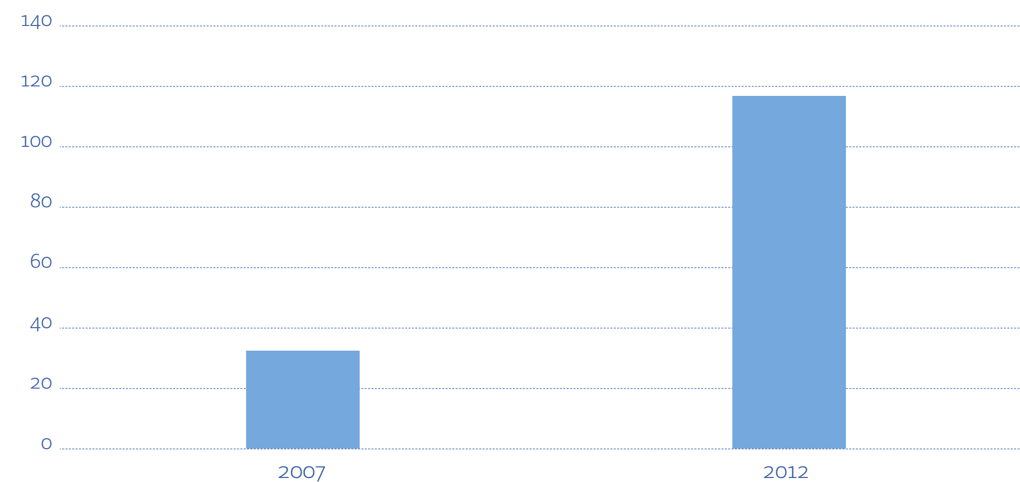
17 Russia's non-energy budget deficit was -3.3% in 2007, versus an estimated -10.6% in 2012 (figures provided by ConsultantPlus).

Figure 3: Property rights: not exactly a golden period



Source: Heritage Foundation

Figure 4: Russia: the petro state
(The average annual oil price needed to balance the federal budget)



Source: Interfax

> The pro-market economic reforms adopted during and shortly after the EM crisis from last decade have largely dissipated, particularly in the larger EM economies

largely thanks to surging tax revenues and foreign reserve holdings. Growing local government debt and the enormous state-bank led lending during the crisis, however, were offsetting factors. China's official debt (both national and local) is officially 43.5% of its GDP, but this does not include policy bank bonds, ministry of railroad debt, China's Asset Management Company debt, or non-performing loans.[18]

Russia took the EM prize for the greatest advances in ICT adaptability (2.17). With the exception of the 2009 recession, where the economy contracted by 8%, the ICT market has been growing at double-digit rates in Russia.

While Russia is obviously an energy-dependent economy, its technology sector appears to be developing well. Russia recently became the largest internet market in Europe, with internet penetration increasing from 21.5% to 47% from 2007 to 2012. Mobile phone penetration increased from 120% to 180% over the same period. IT spending by companies has also been rising briskly, with 63% of Russian enterprises now using broadband, compared to just 31% in the pre-crisis year.

While the Chinese gains in ICT adaptability were not nearly as large (0.85), anecdotal evidence points toward strong and broad-based recent growth. The ICT sector has been growing rapidly, driven by a large and growing number of internet and mobile phone users. The number of internet users more than doubled between 2007 and 2012, from 210 million to 538 million. Meanwhile, the number of mobile phone users increased from 530 million to 1.1 billion.

China is now the world's largest exporter of IT hardware, such as laptops, mobile phones, DVDs, TV sets and digital cameras. According to Forbes China, about 28% of the nation's most promising small businesses belong to the ICT sector.

Conversely, tech-savvy India achieved a below-average gain in ICT adaptability. Unlike Russia and China, India's IT export-oriented sector has been hit hard by the global slowdown in business spending. IT exports, which had been surging in the period before the crisis, have declined considerably in recent years. The broadband spectrum scandal of several years ago, which almost brought down the central government, highlights how corruption is slowing ICT development on the subcontinent.

In summary, while Russia and China have performed well in ICT development, future growth will be severely constrained by insufficient progress in financial development and institutional qualities. Additionally, Russia faces even further growth constraints in its commodity dependency that will soon jeopardize its sovereign finances. India possesses the poorest outlook, with little or no notable improvement in any of our five key factors. Real GDP growth, which has slowed significantly in recent quarters, is expected to remain lackluster over at least the next few years.

Brazil: looking better than you think

In a relatively short period of time, Brazil's economy has lost its glow. After growing at 7.5% in 2010, Brazil's growth spurt began to falter, with growth of under 3% in 2011 and barely 1% in 2012. According to the World Bank, debt as a percentage of family income has more than doubled to 43% since 2005 and defaults are running at a record level. Many critics point to its large informal economy, opaque tax structure and corruption, as liabilities too large to hurdle. However, we find Brazil's fundamentals improved during the crisis period. While rising

18 According to China's National Audit Office

iron ore and agricultural products (soybean, sugar and coffee) prices helped double Brazil's exports as a share of GDP over the past decade (currently standing at 14%), Brazil's reputation as a huge commodity exporter is somewhat exaggerated. Brazil has a substantial domestic market (with a consumption of 60% of GDP) and commodities in aggregate only represented 6% of GDP in 2011. This is not an inconsequential figure in abnormally bearish markets, but it is much smaller than widely perceived.

According to Institutional Investor, Brazil experienced the greatest gains in credit quality of any nation from 2007 through to 2012

Brazil had one of the largest gains in financial freedom over the crisis period. Rising from 40 to 60 points on our scale, Brazil's financial freedom exceeded the world average of 50 for the first time in 2012. The country's financial system has grown in size, diversification and sophistication. Brazil has made significant gains in growing its securities and derivatives markets in recent years. The corporate bond market, although still small by OECD standards, has been growing rapidly. The exchange rate regime is also flexible, which helps to absorb shocks and mitigate inflation. On the downside, Brazil did impose capital controls in the form of a foreign exchange tax during the crisis.

According to Institutional Investor, Brazil experienced the greatest gains in credit quality of any nation from 2007 through to 2012. Public debt, currently 64% of GDP, is no higher than in 2007, despite slower economic growth. Over the crisis period, Brazil received investment-grade ratings for the first time from all the major rating agencies. As of December 2012, Brazil had foreign exchange reserves of $360b and its government debt structure has limited foreign exchange exposure.

Out of 110 developing nations, Brazil was ranked 10th overall in improving ICT capabilities. Brazil is currently the world's fifth largest ICT market in the world (behind the UK, China, Japan and the US) and it has been growing at a 12% - 13% a-year pace recently. At 7% of GDP, it is one of the largest sectors in Brazil. Brazilians have traditionally been early adaptors of technology, with the century-long presence of foreign multinationals helping to disseminate technological change. Brazil is also making major inroads to cloud computing, ranking higher than many developed nations. The ICT market is highly internationalized, with a good mix of foreign and domestic players.

Property rights proved the only area where Brazil saw no improvement. Rated at 50 (no change since 2007), Brazil sits only slightly higher than the global average of 43, but relatively low compared with nations with similar levels of per capita GDP). According to the Heritage Foundation, contracts are generally considered secure, but Brazil's judiciary is considered inefficient and subject to political and economic interference. Though protection of intellectual property rights has improved, piracy of copyrighted material persists.

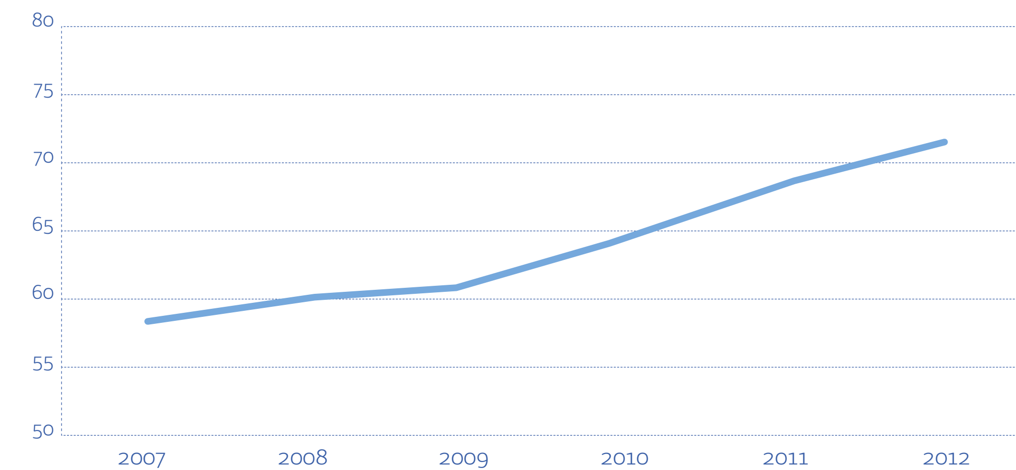
Beyond the BRICs

In this section we use our methodology to examine Poland, Ukraine, Saudi Arabia and Vietnam. We highlight two winners and two losers.

Poland: progress amid the chaos

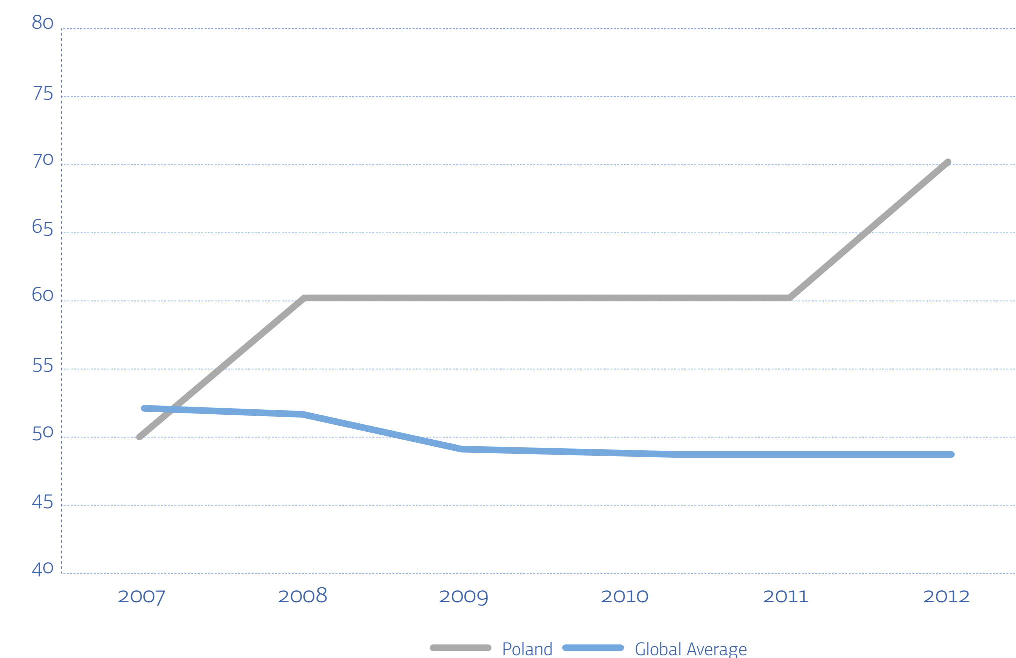
With a per capita income of US$21,000 (based on purchasing power parity) in 2011, Poland has almost reached developed market status. It clocked in economic growth of 2.5% in 2012, the highest for any EU member state and was the only member of the EU to escape recession in 2009. While already viewed as a solid success story among the transition economies (arguably it is the most successful), structural changes made during the crisis promise to make Poland one of Europe's most successful economies in the coming years.

Figure 5: Brazil's credit is good



Source: Institutional Investor

Figure 6: Poland: Eastern Europe's new financial center (Financial freedom Index)



Source: Heritage Foundation

Amid the financial turmoil of the Eurozone, Poland has made one of the largest advances in financial freedom, rising from 50 to a much more competitive 70. The country is fast becoming a major financial center for a struggling Europe, especially Central and Eastern European countries. According to the Financial Times[19], "the Warsaw Stock Exchange still has the highest volume of IPOs of any European exchange. In the first three quarters of this year (2012) it had 84 new listings, which includes its New Connect alternative market for smaller companies. The runner-up was the London Stock Exchange, with 54 new listings."

Poland is fast becoming a major financial center for a struggling Europe, especially Central and Eastern European countries

Poland's banking sector is the largest in Central and Eastern Europe and has become more competitive, with 70% of banking assets foreign owned.

Poland's commodity exports are relatively small (7% of GDP) and highly diversified. In a period where the quality of European institutions was diminishing on a broad scale, Poland's score on protecting private property increased from 50 to 60. According to the World Bank's Doing Business rankings, Poland moved seven places last year and is "one of the world's fastest-reforming economies, largely thanks to improvements in the court system and in the ease of starting a business." Thanks to recent reforms, the private sector now accounts for two-thirds of GDP.

In a period where there were both broad-based and precipitous drops in credit ratings, Poland's credit rating (Institutional Investor) did not improve, but it also did not deteriorate. This makes it the standout in the region (alongside Macedonia). According to the Heritage Foundation, thanks to a commitment to austerity during the crisis period, government spending as a share of GDP has actually fallen slightly and government debt is hovering around 55% of GDP.

The only two non-OECD countries rated higher than Poland in ICT sophistication are Malta and Qatar. Despite its already having advanced technology, Poland was ranked 10th in overall ICT improvement and ranked ahead of the US, Germany, France and Japan in its use of cloud computing.

Ukraine: moving toward the abyss

High steel and food prices helped to lift Ukraine's average annualized growth rate to 7.8% over 2003-07. The country's high dependency on commodity exports (13% of GDP) came back to bite during the financial crisis, when the economy contracted by 15% in 2009 (one of the largest recorded global declines).

Ukraine's financial system, under-developed and insular before the financial crisis, has become even more so, given the array of financial controls recently passed by the Government (it recorded one of the largest declines in financial freedom, falling from 50 to just 30 in 2007-12).

The banking system is a shadow of its former self. Most of the large private domestic banks collapsed during the crisis, while the Western banks that held out are now fleeing the country (the non-performing loan ratio is approximately 40 and rising). Small and medium-sized enterprises have little, if any, access to capital and economic growth is expected to be zero in 2013.

The entire stock market only has a capitalization of US$25b and possesses little liquidity (the stock market turnover has been approximately 20%). The central bank has recently imposed draconian foreign exchange measures, which require a mandatory conversion of hard currency earned by exporters. Individuals are also required to declare hard currency from abroad over a certain limit. These measures have only heightened capital flight, with the nation's international currency reserves declining from US$38b to US$25b in less than a year.

Not surprisingly, Ukraine has experienced a deterioration in credit quality. Among our 112 EM countries in the credit quality category, only Libya and Pakistan experienced more rapid declines. Help will be needed from the International Monetary Fund (IMF), given the nation's need to refinance US$10b in sovereign debt maturing this year. This assistance looks unlikely to arrive, however, given that the IMF froze a US$15b loan program last year amid lackluster economic reforms.

Ukraine experienced a 10-point decline in our property rights scale, dropping to 30 in 2012. At this level, Ukraine shares the same level of property rights protection as many sub-Saharan African countries. The political situation has soured considerably since the Orange Revolution of 2007. The 2012 national elections were widely considered fraudulent and the former Prime Minister is currently in jail for political reasons.

On the plus side, Ukraine achieved middling scores in terms of ICT improvement and it does have relatively fast internet connections, ranking 27th (just behind Germany and Finland) out of 180 nations.

Saudi Arabia: progress amid the chaos of the Arab Spring

The political upheavals throughout the Middle East and North Africa have taken their toll during the crisis period. The Gulf States have fared relatively well, however, with Saudi Arabia making steady progress on a number of important fronts.

Saudi Arabia remains commodity dependent, with energy-related exports comprising 50% of GDP. Oil accounts for approximately 90% of export earnings and 80% of government revenue. The commodity dependency is less of a liability given Saudi Arabia's fiscal prudence and massive stock of foreign assets. Moreover, the Kingdom is continuing to take steps to diversify its economy with several large industrial cities. Saudi Arabia exports petrochemicals, plastics, metal goods, construction materials and electrical appliances to 90 countries. The non-oil economy has been growing around 7% in recent years, the highest since the early 1980s.

Despite the volatility in oil prices and the global crisis, the Kingdom's finances are well managed, and it continued to improve its overall credit quality (it was one of the few energy dependent countries to receive sovereign upgrades after the crash in energy prices). Saudi Arabia now has a better credit rating than most developed nations, and, of the emerging nations, only Chile and China have higher credit ratings (cf. Institutional Investor ratings).

The Kingdom has been very prudent in terms of its fiscal finances during the crisis. While it did run a budget deficit during the economic crisis, it quickly returned to large surpluses, with fiscal surpluses of 13% and 16% (preliminary) in 2011 and 2012 respectively. It has a large stock of foreign assets (its sovereign wealth fund had US$532b in assets at the end of 2012) and low public debt (13% of GDP in 2011). Possessing 25% of the world's known oil reserves, the Kingdom can afford to be dovish on oil prices.

Saudi Arabia's financial sector is well developed, with large and well-capitalized domestic banks. The Tadawal stock market is the largest (US$350b market capitalization) and most liquid in the Arab world, with a healthy stock turnover rate of over 80%. In 2012, MSCI reintroduced the Saudi Indices into its rankings.

While financial freedom rose 10 points on our scale over the crisis, at 50 in 2012, the Kingdom still has plenty of room for improvement. Western standards of corporate governance carry little weight in a region where nepotism reigns free. Like the other exchanges in the region, insider trading still permeates the Saudi bourse. The Kingdom did open its market for swap investments in 2008, and subsequently allowed foreign investors to use exchange-traded funds in 2010. There has been much discussion of finally allowing foreign institutional traders to buy and invest directly into Saudi companies. If this comes to fruition in 2013, it should dramatically increase corporate transparency and, in turn, financial freedom in the Kingdom.

19 Financial Times – December 28, 2012. Beyond Brics. "Warsaw SE: Shopping center IPO masks liquidity problems."

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The Saudi ICT market has grown significantly over the past five years. It is now ranked in the top 10 in ICT among all emerging economies. During the crisis period, the Kingdom was ranked fourth in overall ICT improvement. This growth has been driven by the liberalization of the ICT market, intense local competition (i.e. falling ICT prices) and youthful demographics. Saudi Arabia accounted for 50% of the total ICT investments in the Gulf Cooperation Council in recent years. The broadband penetration rate more than doubled over this period (now at 40%) and business IT spending has been very brisk.

The Kingdom witnessed a slight decrease in property rights over the crisis period, dropping from 50 to 45 – largely fallout from the political upheavals of the Arab Spring. The property rights score is now below the world average. According to the Heritage Foundation, Saudi courts do not always enforce contracts effectively. The judicial system is slow, non-transparent and vulnerable to interference from the ruling elite.

Vietnam: big problems under the surface

Over the past decade, Vietnam has become an EM darling. With a population of 90 million, a workforce growing at one million per year, and economic growth of 6.5% since the 1990s, the country does look exciting. The question is whether economic growth of 5% in 2012, the slowest in 13 years, is a temporary blip, or the beginning of a period of stress for the nation.

Vietnam is heavily dependent upon commodity exports (they accounted for almost a quarter of GDP in 2011). China is the destination for much of Vietnam's top exports (textiles and rice), making Vietnam's export dependency even more acute.

Despite joining the World Trade Organization in 2007, Vietnam saw no increase in financial freedom over the crisis period (it is rated at 30). One of the more salient lessons of the financial crisis and its aftermath is the length often required for recovery. Financial deleveraging has recently proven to be a long and tenuous path for many developed countries. Over the past decade, domestic credit in Vietnam has expanded at a meteoric rate. Bank credit as a share of GDP more than doubled between 2005 and 2010, from 60% to 135%. This lending binge, unfortunately, was largely channeled to inefficient state-owned companies, which comprise 40% of the country's GDP, leaving the corporate sector saddled with massive liabilities. Bailouts have already started, but the nation's corporate sector is so deeply in debt that the deleveraging process will take years to complete.

Expectations of a state-led bailout of the banking system (and portions of the state-owned corporate sector) have hurt Vietnam's credit ratings (placed 17th from the bottom in changes in credit quality). In addition it received sovereign downgrades in 2010 and 2012.

There might be hope for Vietnam if it were in the process of building quality institutions. Unfortunately, this is precisely the country's Achilles heel. Vietnam's property rights rating of 15 is one of the lowest in the world and significantly behind other Southeast Asian developing neighbors. According to the Heritage Foundation, in terms of property rights, the judicial system is not independent and lacks efficiency. Property rights are not strongly respected, and resolution of disputes can take years. Infringement of intellectual property rights is common. Endemic fraud, corruption and weak corporate governance will make cleaning up the corporate and banking sectors arduous in the coming months and years.

On the plus side, Vietnam was ranked 20th among all EMs in ICT improvement. According to IDC, total IT spending (on services and software) rose from US$2b to US$3b from 2007 through to 2012. Companies have also begun experimenting with cloud computing to bring down capital expenditures, while the telecom market has reached 90% saturation. On the down side, ICT growth is not outstanding for the region (Asia has the fastest growth), while many of Vietnam's IT companies are state owned.

Concluding comments

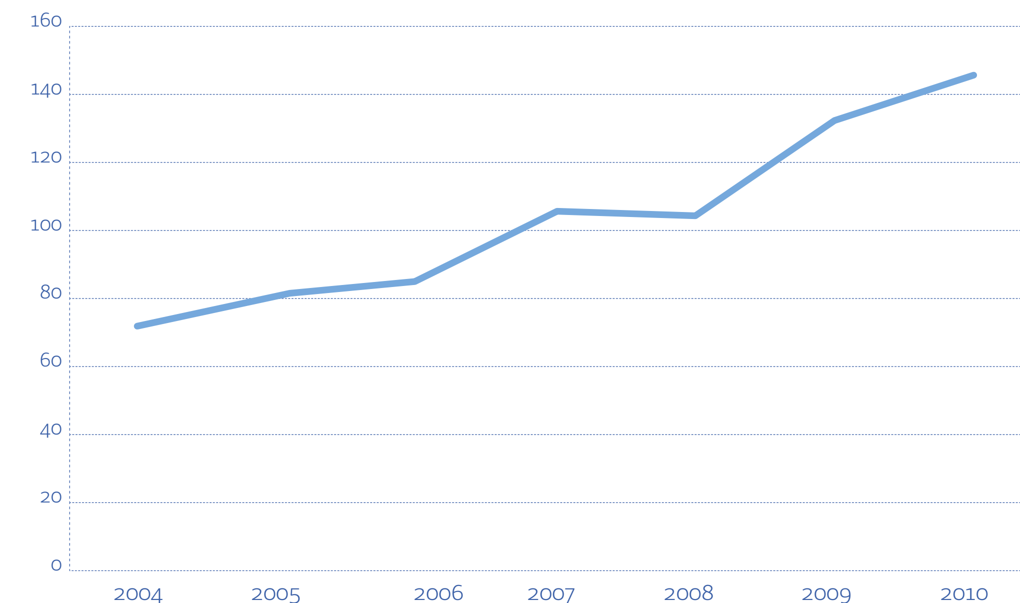
A decade ago, when the EMs were on a growth tear, very few were actually improving their "fundamentals." Sub-Saharan Africa, for instance, grew at almost 6% last decade, but only 6 of 48 nations improved their property rights and only 8 improved their financial freedom. For most, their level of commodity dependency only increased.

This paper has argued that a confluence of one-time factors gave the emerging world a "free ride" last decade. Without these tailwinds, most emerging economies will have to rely on improving fundamentals to reignite economic growth in the coming years. In this paper we have identified five factors that will be critical for growth in the post-crisis period. While each factor's importance will vary by country, collectively the five are deemed critical in an emerging world deprived of high commodity prices, easy credit and elevated global economic activity.

Historically, it has been the norm for most countries not to implement structural or significant economic reforms unless they are undergoing a severe economic or financial crisis. Reforms are rarely easy because they threaten entrenched interests. In China, for example, the opening of the capital account, which would go a long way toward liberalizing the financial sector, would mean a loss of control over capital movements (both going in and out of China) for the authorities. For Russia, oil prices in excess of US$100 have considerably eased the pressure for reforms, particularly for rules liberalizing foreign direct investment. Interestingly, however, the acute economic slowdown in India has recently pointed to a movement toward liberalizing foreign investment.

It is entirely possible that the factors propagating EM growth last decade will be present again in the coming years, which would lubricate growth throughout the developing world. At this moment in time, however, their occurrence looks unlikely.

Figure 7: Vietnam's credit bubble (Banking Credit as a share of GDP)



Source: Institutional Investor

V. Appendix

Table 7

Country Name	Commodity exports (% of GDP)	Country Name	Commodity exports (% of GDP)	Country Name	Commodity exports (% of GDP)
0–5%		Morocco	7	Zimbabwe	21
Nepal	1	Ughanda	7	Honduras (2009)	22
China	2	Armenia	8	Paraguay	22
Cambodia	2	Hungary	9	Bhutan (2009)	23
Dominican Republic	2	Maldives (2009)	9	Vietnam (2009)	23
Israel	2	Mauritius	9	Yemen (2009)	24
Samoa	2	Tunisia	9	Lithuania	25
Tonga	2	Costa Rica	10	26–30%	
Pakistan	3	Kenya	10	Nicaragua	26
Turkey	3	Senegal	10	Malaysia	27
Barbados	3	Slovakia	10	Equador	27
Bahamas	3	11–15%		Chile	29
Cyprus	3	Colombia	11	Bolivia	30
Gambia	3	Argentina	12	Mozambique	30
Lebanon	3	South Africa	12	31–35%	
India	4	Bosnia Herzegovina	12	Qatar	31
Philippines	4	Guatemala	12	Kazakhstan (2009)	32
Rwanda	4	Ukraine	13	Algeria	35
Albania	5	Uruguay (2009)	13	36–40%	
Burundi	5	Indonesia	14	Panama	36
Madagascar (2009)	5	Tanzania	14	Cote d' Ivoire	37
6–10%		Thailand	15	Nigeria	40
Brazil	6	Latvia	15	41–45%	
Romania	6	16–20%		Zambia	41
Botswana	6	Venezuela	16	46–50%	
Croatia	6	Cameroon	16	Gabon (2009)	47
El Salvador	6	Fiji	18	Kuwairt	48
Jamaica	6	Malawi	19	Azerbaijan	49
Malta	6	Peru	20	Saudi Arabia	50
Sri Lanka	6	Russia	20	Oman (2009)	51
Togo	6	Belarus	20	Mauritania	51
Mexico	7	Estonia	20	Bahrain (2009)	54
Poland	7	Ghana	20		
Egypt	7	Kyrgyzstan	20		
Ethiopia	7	21–25%			
Georgia	7	Bulgaria	21		
Jordan	7	Moldova	21		

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Financial freedom

A transparent and open financial system ensures fairness in access to financing and promotes entrepreneurism. An open banking environment encourages competition, which tends to provide the most efficient financial intermediation between households and firms, and investors and entrepreneurs.

Through a process driven by supply and demand, markets provide real-time information on prices and immediate discipline for those who have made bad decisions. This process depends on transparency in the market and the integrity of the information being made available. An effective regulatory system, through disclosure requirements and independent auditing, ensures both.

Increasingly, the central role played by banks is being complemented by other financial services that offer alternative means for raising capital or diversifying risk. As with the banking system, the useful role for government in regulating these institutions lies in ensuring transparency and integrity, and promoting the disclosure of assets, liabilities and risks.

Banking and financial regulation by the state that goes beyond the assurance of transparency and honesty in financial markets can impede efficiency, increase the costs of financing entrepreneurial activity and limit competition. If the government intervenes in the stock market, for instance, it contravenes the choices of millions of individuals by interfering with the pricing of capital – the most critical function of a market economy. Equity markets measure, on a continual basis, the expected profits and losses in publicly held companies. This measurement is essential in allocating capital resources to their highest-valued uses and thereby satisfying consumers' most urgent requirements.

Country credit rating

Institutional Investor's country credit ratings are based on information provided by senior economists and sovereign-debt analysts at leading global banks and money management and security firms. Twice a year the respondents grade each country on a scale of 0 to 100, with 100 representing the least chance of default. For more information, visit: http://www.Institutionalinvestor.com/Research/3633/Global-Rankings.html.

Property rights (as defined by the Heritage Foundation)

The ability to accumulate private property and wealth is understood to be a central motivating force for workers and investors in a market economy. The recognition of private property rights, with sufficient rule of law to protect them, is a vital feature of a fully functioning market economy. Secure property rights give citizens the confidence to undertake entrepreneurial activity, save their income and make long-term plans, because they know that their income, savings, and property (both real and intellectual) are safe from unfair expropriation or theft.

The protection of private property requires an effective and honest judicial system that is available to all, equally and without discrimination. The independence, transparency and effectiveness of the judicial system have proved to be key determinants of a country's prospects for long-term economic growth. Such a system is also vital to the maintenance of peace and security and the protection of human rights.

A key aspect of property rights' protection is the enforcement of contracts. The voluntary undertaking of contractual obligations is the foundation of the market system and the basis for economic specialization, gains from commercial exchange and trade among nations. Evenhanded government enforcement of private contracts is essential to ensuring equity and integrity in the marketplace.

The Heritage Foundation's index is scaled from 0 to 100 (with higher scores indicating higher property rights) and moves in increments of 10.

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