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COMMENT

Broken BRICs

Why the Rest Stopped Rising

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Over the past several years, the most talked-about trend in the global economy has been the so-called rise of the rest, which saw the economies of many developing countries swiftly converging with those of their more developed peers. The primary engines behind this phenomenon were the four major emerging-market countries, known as the BRICs:

Brazil, Russia, India, and China. The world was witnessing a once-in-a-lifetime shift, the argument went, in which the major players in the developing world were catching up to or even surpassing their counterparts in the developed world.

These forecasts typically took the developing world's high growth rates from the middle of the last decade and extended them straight into the future, juxtaposing them against predicted sluggish growth in the United States and other advanced industrial countries. Such exercises supposedly proved that, for example, China was on the verge of overtaking the United States as the world's largest economy-a point that Americans clearly took to heart, as over 50 percent of them, according to a Gallup poll conducted this year, said they think that China is already the world's "leading" economy, even though the U.S. economy is still more than twice as large (and with a per capita income seven times as high).

As with previous straight-line projections of economic trends, however-such as forecasts in the 1980s that Japan would soon be number one economically-later returns are throwing cold water on the extravagant predictions. With the world economy heading for its worst year since 2009, Chinese growth is slowing sharply, from double digits down to seven percent or even less. And the rest of the BRICs are tumbling, too: since 2008, Brazil's annual growth has dropped from 4.5 percent to two percent; Russia's, from seven percent to 3.5 percent; and India's, from nine percent to six percent.

None of this should be surprising, because it is hard to sustain rapid growth for more than a decade. The unusual circumstances of the last decade made it look easy: coming off the crisis-ridden 1990s and fueled by a global flood of easy money, the emerging markets took off in a mass upward swing that made virtually every economy a winner. By 2007, when only three countries in the world suffered negative growth, recessions had all but disappeared from the international scene. But now, there is a lot less foreign money flowing into emerging markets. The global economy is returning to its normal state of churn, with many laggards and just a few winners rising in unexpected places. The implications of this shift are striking, because economic momentum is power, and thus the flow of money to rising stars will reshape the global balance of power.

FOREVER EMERGING

The notion of wide-ranging convergence between the developing and the developed worlds is a myth. Of the roughly 180 countries in the world tracked by the International Monetary Fund, only 35 are developed. The markets of the rest are emerging-and most of them have been emerging for many decades and will continue to do so for many more. The Harvard economist Dani Rodrik captures this reality well. He has shown that before 2000, the performance of the emerging markets as a whole did not converge with that of the developed world at all. In fact, the per capita income gap between the advanced and the developing economies steadily widened from 1950 until 2000. There were a few pockets of countries that did catch up with the West, but they were limited to oil states in the Gulf, the nations of southern Europe after World War II, and the economic "tigers" of East Asia. It was only after 2000 that the emerging markets as a whole started to catch up; nevertheless, as of 2011, the difference in per capita incomes between the rich and the developing nations was back to where it was in the 1950s.

This is not a negative read on emerging markets so much as it is simple historical reality. Over the course of any given decade since 1950, on average, only a third of the emerging markets have been able to grow at an annual rate of five percent or more. Less than one-fourth have kept up that pace for two decades, and one-tenth, for three decades. Only Malaysia, Singapore, South Korea, Taiwan, Thailand, and Hong Kong have maintained this growth rate for four decades. So even before the current signs of a slowdown in the BRICs, the odds were against Brazil experiencing a full decade of growth above five percent, or Russia, its second in a row.

Meanwhile, scores of emerging markets have failed to gain any momentum for sustained growth, and still others have seen their progress stall after reaching middle-income status. Malaysia and Thailand appeared to be on course to emerge as rich countries until crony capitalism, excessive debts, and overpriced currencies caused the Asian financial meltdown of 1997-98. Their growth has disappointed ever since. In the late 1960s, Burma (now officially called Myanmar), the Philippines, and Sri Lanka were billed as the next Asian tigers, only to falter badly well before they could even reach the middle-class average income of about $5,000 in current dollar terms. Failure to sustain growth has been the general rule, and that rule is likely to reassert itself in the coming decade.

In the opening decade of the twenty-first century, emerging markets became such a celebrated pillar of the global economy that it is easy to forget how new the concept of emerging markets is in the financial world. The first coming of the emerging markets dates to the mid-1980s, when Wall Street started tracking them as a distinct asset class. Initially labeled as "exotic," many emerging-market countries were then opening up their stock markets to foreigners for the first time: Taiwan opened its up in 1991; India, in 1992; South Korea, in 1993; and Russia, in 1995. Foreign investors rushed in, unleashing a 600 percent boom in emerging-market stock prices (measured in dollar terms) between 1987 and 1994. Over this period, the amount of money invested in emerging markets rose from less than one percent to nearly eight percent of the global stock-market total.

This phase ended with the economic crises that struck from Mexico to Turkey between 1994 and 2002. The stock markets of developing countries lost almost half their value and shrank to four percent of the global total. From 1987 to 2002, developing countries' share of global GDP actually fell, from 23 percent to 20 percent. The exception was China, which saw its share double, to 4.5 percent. The story of the hot emerging markets, in other words, was really about one country.

The second coming began with the global boom in 2003, when emerging markets really started to take off as a group. Their share of global GDP began a rapid climb, from 20 percent to the 34 percent that they represent today (attributable in part to the rising value of their currencies), and their share of the global stock-market total rose from less than four percent to more than ten percent. The huge losses suffered during the global financial crash of 2008 were mostly recovered in 2009, but since then, it has been slow going.

The third coming, an era that will be defined by moderate growth in the developing world, the return of the boom-bust cycle, and the breakup of herd behavior on the part of emerging-market countries, is just beginning. Without the easy money and the blue-sky optimism that fueled investment in the last decade, the stock markets of developing countries are likely to deliver more measured and uneven returns. Gains that averaged 37 percent a year between 2003 and 2007 are likely to slow to, at best, ten percent over the coming decade, as earnings growth and exchange-rate values in large emerging markets have limited scope for additional improvement after last decade's strong performance.

PAST ITS SELL-BY DATE

No idea has done more to muddle thinking about the global economy than that of the BRICs. Other than being the largest economies in their respective regions, the big four emerging markets never had much in common. They generate growth in different and often competing ways-Brazil and Russia, for example, are major energy producers that benefit from high energy prices, whereas India, as a major energy consumer, suffers from them. Except in highly unusual circumstances, such as those of the last decade, they are unlikely to grow in unison. China apart, they have limited trade ties with one another, and they have few political or foreign policy interests in common.

A problem with thinking in acronyms is that once one catches on, it tends to lock analysts into a worldview that may soon be outdated. In recent years, Russia's economy and stock market have been among the weakest of the emerging markets, dominated by an oil-rich class of billionaires whose assets equal 20 percent of GDP, by far the largest share held by the superrich in any major economy. Although deeply out of balance, Russia remains a member of the BRICs, if only because the term sounds better with an *R*. Whether or not pundits continue using the acronym, sensible analysts and investors need to stay flexible; historically, flashy countries that grow at five percent or more for a decade -- such as Venezuela in the 1950s, Pakistan in the 1960s, or Iraq in the 1970s -- are usually tripped up by one threat or another (war, financial crisis, complacency, bad leadership) before they can post a second decade of strong growth.

The current fad in economic forecasting is to project so far into the future that no one will be around to hold you accountable. This approach looks back to, say, the seventeenth century, when China and India accounted for perhaps half of global GDP, and then forward to a coming "Asian century," in which such preeminence is reasserted. In fact, the longest period over which one can find clear patterns in the global economic cycle is around a decade. The typical business cycle lasts about five years, from the bottom of one downturn to the bottom of the next, and most practical investors limit their perspectives to one or two business cycles. Beyond that, forecasts are often rendered obsolete by the unanticipated appearance of new competitors, new political environments, or new technologies. Most CEOs and major investors still limit their strategic visions to three, five, or at most seven years, and they judge results on the same time frame.

THE NEW AND OLD ECONOMIC ORDER

In the decade to come, the United States, Europe, and Japan are likely to grow slowly. Their sluggishness, however, will look less worrisome compared with the even bigger story in the global economy, which will be the three to four percent slowdown in China, which is already under way, with a possibly deeper slowdown in store as the economy continues to mature. China's population is simply too big and aging too quickly for its economy to continue growing as rapidly as it has. With over 50 percent of its people now living in cities, China is nearing what economists call "the Lewis turning point": the point at which a country's surplus labor from rural areas has been largely exhausted. This is the result of both heavy migration to cities over the past two decades and the shrinking work force that the one-child policy has produced. In due time, the sense of many Americans today that Asian juggernauts are swiftly overtaking the U.S. economy will be remembered as one of the country's periodic bouts of paranoia, akin to the hype that accompanied Japan's ascent in the 1980s.

As growth slows in China and in the advanced industrial world, these countries will buy less from their export-driven counterparts, such as Brazil, Malaysia, Mexico, Russia, and Taiwan. During the boom of the last decade, the average trade balance in emerging markets nearly tripled as a share of GDP, to six percent. But since 2008, trade has fallen back to its old share of under two percent. Export-driven emerging markets will need to find new ways to achieve strong growth, and investors recognize that many will probably fail to do so: in the first half of 2012, the spread between the value of the best-performing and the value of the worst-performing major emerging stock markets shot up from ten percent to 35 percent. Over the next few years, therefore, the new normal in emerging markets will be much like the old normal of the 1950s and 1960s, when growth averaged around five percent and the race left many behind. This does not imply a reemergence of the 1970s-era Third World, consisting of uniformly underdeveloped nations. Even in those days, some emerging markets, such as South Korea and Taiwan, were starting to boom, but their success was overshadowed by the misery in larger countries, such as India. But it does mean that the economic performance of the emerging-market countries will be highly differentiated.

The uneven rise of the emerging markets will impact global politics in a number of ways. For starters, it will revive the self-confidence of the West and dim the economic and diplomatic glow of recent stars, such as Brazil and Russia (not to mention the petro-dictatorships in Africa, Latin America, and the Middle East). One casualty will be the notion that China's success demonstrates the superiority of authoritarian, state-run capitalism. Of the 124 emerging-market countries that have managed to sustain a five percent growth rate for a full decade since 1980, 52 percent were democracies and 48 percent were authoritarian. At least over the short to medium term, what matters is not the type of political system a country has but rather the presence of leaders who understand and can implement the reforms required for growth.

Another casualty will be the notion of the so-called demographic dividend. Because China's boom was driven in part by a large generation of young people entering the work force, consultants now scour census data looking for similar population bulges as an indicator of the next big economic miracle. But such demographic determinism assumes that the resulting workers will have the necessary skills to compete in the global market and that governments will set the right policies to create jobs. In the world of the last decade, when a rising tide lifted all economies, the concept of a demographic dividend briefly made sense. But that world is gone.

The economic role models of recent times will give way to new models or perhaps no models, as growth trajectories splinter off in many directions. In the past, Asian states tended to look to Japan as a paradigm, nations from the Baltics to the Balkans looked to the European Union, and nearly all countries to some extent looked to the United States. But the crisis of 2008 has undermined the credibility of all these role models. Tokyo's recent mistakes have made South Korea, which is still rising as a manufacturing powerhouse, a much more appealing Asian model than Japan. Countries that once were clamoring to enter the eurozone, such as the Czech Republic, Poland, and Turkey, now wonder if they want to join a club with so many members struggling to stay afloat. And as for the United States, the 1990s-era Washington consensus -- which called for poor countries to restrain their spending and liberalize their economies -- is a hard sell when even Washington can't agree to cut its own huge deficit.

Because it is easier to grow rapidly from a low starting point, it makes no sense to compare countries in different income classes. The rare breakout nations will be those that outstrip rivals in their own income class and exceed broad expectations for that class. Such expectations, moreover, will need to come back to earth. The last decade was unusual in terms of the wide scope and rapid pace of global growth, and anyone who counts on that happy situation returning soon is likely to be disappointed.

Among countries with per capita incomes in the $20,000 to $25,000 range, only two have a good chance of matching or exceeding three percent annual growth over the next decade: the Czech Republic and South Korea. Among the large group with average incomes in the $10,000 to $15,000 range, only one country -- Turkey -- has a good shot at matching or exceeding four to five percent growth, although Poland also has a chance. In the $5,000 to $10,000 income class, Thailand seems to be the only country with a real shot at outperforming significantly. To the extent that there will be a new crop of emerging-market stars in the coming years, therefore, it is likely to feature countries whose per capita incomes are under $5,000, such as Indonesia, Nigeria, the Philippines, Sri Lanka, and various contenders in East Africa.

Although the world can expect more breakout nations to emerge from the bottom income tier, at the top and the middle, the new global economic order will probably look more like the old one than most observers predict. The rest may continue to rise, but they will rise more slowly and unevenly than many experts are anticipating. And precious few will ever reach the income levels of the developed world.

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