Letter 39

Developed countries – Emerging countries : from convergence to divergence

"When the sea was calm all ships alike showed mastership in floating"
Shakespeare

Why have we been successfully overweight in developed countries compared to emerging countries for many months?

There is no doubt that emerging countries have managed to catch up tremendously in recent decades. In 1980, they accounted for just over a third of global GDP, and recently 58%. Undeniably, some have benefited from their wealth in raw materials, others have skillfully benefited from technological catch-up, others have been able to attract investment from multinational firms with their large domestic markets, all have benefited from progress in literacy and from longer life expectancy.

Nevertheless, the convergence with developed countries, observed since the 90s in terms of living standards, education, institutions, demographic trends and facilitated by the decline of economic crises, has come to a halt with the development of authoritarian regimes, capital outflows and, recently, the crisis caused by Covid. It reminds us of the relevance of ***Shakespeare's*** word in the beginning of this Letter.

Divergences are growing with developed countries : support measures have been very high in OECD countries, 25% of GDP in the United States over three years, 16% in Great Britain, 8% in France and Italy but less than 2% of GDP in Turkey, Mexico and India, and about 3% in Russia and South Africa.

The world economy has returned to its pre-crisis GDP level, and the IMF is revising global growth upwards to 6% in 2021 and 4.9% in 2022. But the recovery is mixed between Western and emerging countries, and the IMF speaks of a "great divergence".

In order to evaluate this divergence, we will try to provide political, budgetary, financial, vaccine, monetary, commercial, stock market, economic and environmental explanations.

- ***The political explanation*** :

Democracy has declined in recent years in favour of illiberal regimes, which have often mismanaged the Covid crisis. Brazil, India, Turkey, Venezuela, and others come to mind and as a result, less foreign capital is being invested in these countries.

- ***The budgetary explanation*** :

The West – Europe, the United States, Japan – were able to afford to let their deficits slip. Governments have used their status as borrowers on privileged terms, preserved household incomes, averted the risk of company bankruptcies, offered credit guarantees, and financed short-term working. These are all means of action, $12 trillion for the G7 countries, which many emerging countries are often deprived of since their measures amount to only $4 trillion according to the IMF.

This very generous budgetary support has made it possible to cushion the consequences of the crisis and to prepare for recovery. In 2020, budget deficits were 16% in the United States, 19% in the United

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Kingdom, 11% in Japan and Italy.

This year, the US deficit is expected to reach 15% of the GDP, and the public debt will rise to 128% of the GDP, 160% if we add the debt of the federal states, but there is no mistrust in relation to the $ since the 10-year rate is only 1.30%.

The cheques allocated to American households and the unemployment benefits paid in Europe explain the accumulation of savings throughout 2020. In the United States, $2.6 trillion was accumulated during the pandemic, a savings rate of more than 33% of disposable income according to the BEA. In Europe, according to ***Moody's***, exceptional savings have also reached high levels of more than 10% of GDP in the UK, 8% in Spain, more than 6% in Germany and Italy. In Japan, it is valued at $300 billion. In these countries, savings are gradually being converted into consumption, while in Latin America, savings have fallen. Globally, Moody's has estimated the global savings surplus in 2020 at $5.4 trillion, or 6% of GDP, a percentage exceeded in most developed countries and therefore not reached in emerging countries.

Guarantees to businesses, support for households, spending on infrastructure, all these measures explain the speed and strength of the recovery in OECD countries.

- ***The financial explanation*** :

There are two aspects here, injections and foreign assets.

The American, European, British and Japanese central banks have been able to inject liquidity without posing risk to the stability of the currency, because the loans are financed in local currencies and these currencies dominate the international monetary system : more than 60% for the $ and more than 20% for the Euro. In economic history, since the Second World War, there have been few, if any, financial crises in countries that borrow in their own currency, and this is a special privilege for the major countries.

A number of Western countries have assets abroad and this constitutes as an additional guarantee. As a result of years of current account surpluses, and therefore of a savings surplus, Germany and Japan can benefit from net foreign assets of more than 60% of their GDP. In Switzerland, the National Bank alone has foreign exchange reserves equivalent to more than one times the country's GDP.

- ***The vaccine explanation*** :

The exit from the crisis is faster thanks to the advance dissemination of vaccines. In Israel, Europe, and the United States, 60 to 70% of the population have received at least one dose, a percentage that cannot be compared with the low rate in emerging countries.

In the United States, consumption has already returned to its pre-crisis level and in Europe, this level will likely be restored by the end of the year. This is also the case in China and probably in several South-East Asian countries in the coming months.

- ***The monetary explanation*** :

Despite the acceleration of inflation, the amount of sovereign debt at negative rates is still $16.5 trillion. All German public debt is at negative nominal rates, French debt up to 12 years, Spanish debt up to 9 years, Italian and Greek debt up to 7 years. France was able to issue 30-years debt at 0.9%. Across the OECD, real rates are very negative. In the United States, the inflation rate is 5.4% in July, but the 10-year long rate is only at 1.30% and the March high did not exceed 1.75%.

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The ECB has purchased a large stock of debt and has been able to increase its balance sheet total from €100 billion to more than €2.5 trillion without any negative impact on the Euro since 2011.

At current interest rate levels, a 50-point increase in the debt-to-GDP ratio in developed countries would only increase the weight of real interest payments in GDP by about 0.5 percentage points.

Emerging countries cannot afford such expansionary monetary policies. Not only are inflationary pressures more pronounced – 6.2% in India, 9% in Brazil, 17.5% in Turkey – but the central banks of these countries have had to raise rates substantially on several occasions, something that developed countries have not had to do. In Brazil, we have just witnessed the fourth increase in the key interest rate to 5.25% after a low of 2% in 2020. In India, the central bank, after several hikes, is maintaining the official interest rate at 4% for the refinancing rate but will be forced to intervene. In Russia, the central bank recently had to raise the key interest rate by one point to 6.5% because the inflation rate is at 6.5%.

In comparative terms, the negative impact on the financing costs of governments and companies in emerging countries is therefore significant.

- ***The commercial explanation*** :

There are several aspects here.

While trade relations between Western countries have always been higher in value than relations with emerging countries, in the last decade, according to the American Chamber of Commerce in Europe, 57% of US investments abroad have been in Europe and, in 2020, US exports to the EU was close to $300 billion, more than double the US exports to China and higher than those to other emerging countries. The slowdown in international trade has further penalized emerging countries.

Secondly, exports from the poorest emerging countries fell by 12% in 2020 compared to 9% for world exports. Exports of services from these countries fell even further, by a third, as a result of the collapse of tourism revenues.

Thirdly, the trade dynamics observed over the last fifty years will be slowed down in the future by relocations. Relocations supported by political calculations such as Biden's desire to increase the "Buy American Act", so that the share of American components for public orders will increase to 60% from 55%, even if the price is 20% higher than that of their foreign competitors. Relocations, also motivated by a concern for technological independence and relocations facilitated by advances in artificial intelligence and robotisation.

In an example of this quest for sovereignty in sectors deemed key, the European Commission is planning to spend €1 billion each year on A.I. That is good, but it is still not much because the Americans spend $8 billion a year, but we can assume that the European figure will rise over the next few years.

Finally, the fourth aspect is the increase in protectionist measures, which are often harmful to emerging countries. According to the academic body Global Trade Alert, there were 2332 trade-restrictive measures globally in 2020, an increase of 44% compared to 2019 and it will surprise some that it is the United States and the United Kingdom that have taken the most protectionist measures.

- ***The stock market explanation*** :

In developed countries, capital raising is increasingly important and provides comparative advantages. Some like to talk about the American decline, ***Talleyrand*** liked to ironize ***"The United States, this merchant people, without aristocracy and without culture"***. Nevertheless, in the essential field of

innovation, the fluidity of the capital markets to support start-ups is unparalleled : $150 billion raised in the 1st half of the year in the United States by "unicorns" (young companies with a stock market value of more than $1 billion) and the emergence of 150 unicorns in the United States in Silicon Valley in the 1st half of 2021. This is incomparable with the rest of the world.

The best tribute paid to the American market is by the Chinese as there have been 35 Nasdaq IPOs of Chinese companies since the beginning of the year.

To finance start-ups, "Private Equity" has never had so much liquidity, $4.1 trillion before the crisis, and almost all of it is invested in developed countries.

Despite the crisis, in 2020, the number of IPOs in the United States have doubled and $160 billion was raised on this occasion.

Finally, in Western countries, many large companies have "pricing power" to pass on the increase in material costs and maintain their margins. Companies like Coca Cola or Procter & Gamble come to mind but in the 1st half of the year, we also saw groups in the automotive sector increase their prices and improve their margins. In Q1 2021, the net margin of US S&P500 companies was close to 13%, a level higher than the 11% pre-crisis.

- ***The economic explanation*** :

Here again, there are several elements, both cyclical and structural.

From an economic point of view, thanks to the various support measures, the developed economies are no longer very far from their pre-crisis GDP levels : France, Germany and Italy are between 3 and 4% below their peak, the United States has exceeded its pre-crisis GDP by almost 1%, and the recession lasted only two months. Apart from China and the countries of South-East Asia, the major emerging countries still face significant problems. Among the major countries, according to ***the OECD,*** the countries that will take the longest time to return to pre-crisis levels are South Africa, Argentina, Mexico, and Saudi Arabia.

From a structural point of view, 4 points can be mentioned :

According to the ***Boston Consulting Group***, 7 of the 10 most innovative companies in the world are American (Apple, Alphabet, Amazon, Microsoft, Tesla, Pfizer, IBM), one is Korean, Samsung, one is Japanese, Sony, and one is Chinese, Huawei.

Secondly, R&D spending in the OECD averages 2.5%, a level higher than in emerging countries. In Sweden, R&D expenditure amounts to 3.4% of GDP, in Germany 3.1%, in the United States 2.8%, in France 2.2%. These are all advantages over emerging countries – the faster innovation and its diffusion. An example here is 5G, it is a productivity factor because it will allow, among other things, increased efficiency in logistics and inventory management, increased life expectancy through the dissemination of medical applications, improved road safety, and better management of cities.

Also, in the coming years, the changes in capitalism – the fight against global warming, investment in infrastructure, training aid following the development of robotisation... – will force governments to intervene more. The developed countries have the means to do so, but the majority of emerging countries do not, and thus the competitiveness gap will worsen.

For example, the EU has defined industrial priorities and wishes to develop quantum computers, produce semiconductors locally, develop electric batteries, and promote hydrogen. These are all sectors of the future financed at favourable interest rates. These are all investments that are likely to provide developed

countries an additional comparative advantage.

- ***The environmental explanation*** :

Emerging countries are responsible for 90% of the rise in greenhouse gas emissions but they receive only 1/5th of the investments in clean energy. It would be necessary to go from $150 billion/year to $1 trillion/year to attain the objective of carbon neutrality. But these countries, apart from China and a few others, do not have the means to finance it. In Africa, it would be necessary to first close the gap in the development of electricity, but this will be detailed in our next Letter.

Conclusion :

To summarise our Letter and to qualify the divergence that has begun between developed and emerging countries, we can draw inspiration from ***Joseph de Maistre's*** words on the French Revolution of 1789 : ***"For a long time we did not understand the revolution of which we are the witnesses; for a long time we took it for an event. We were wrong: it is an era."***

From this Letter, we will retain a reflection on the strategic geographical allocation in a portfolio. Southeast Asian countries, such as South Korea, Taiwan and Singapore are included in the developed countries, while China is officially classified by the WTO (World Trade Organization) as an emerging country although this is debatable.

The nine points examined above define the business environment, the eco-system in which they evolve, the external economies available, whether they are the quality of infrastructure, the flow of financial markets, or the budgetary and monetary support for growth.

The recent crisis has led to increased involvement of the large states in the economy, massive recovery plans, measures to support research in strategic sectors, investment programmes in infrastructure, financing conditions at very low or even negative rates, and aid for relocation.

These are all measures that could increase the comparative advantage of the United States and Europe in the coming years in relation to the rest of the world. And in all of these, American superiority, so often decried, is apparent. This was evident in the paragraph on the stock exchange. It is therefore logical to pay more for the profits of American companies than those of European companies, let alone those of companies in the rest of the world.

It does not matter whether American growth is eventually lower than in other parts of the world because we invest in multinationals that can capture growth wherever they are.

The acronym BRIC, created by Goldman Sachs in the early 2000s to symbolize the rise of the major emerging countries - Brazil, Russia, India, China - has a veneer that quickly peels on analysis. There are too many differences in the trajectories of these countries to bring them together. China's GDP, $15.2 trillion in 2019, according to the IMF, was more than twice the sum of the other three, India $2.4 trillion, Brazil $1.89 trillion and Russia $1.66 trillion. We could devote a Letter to discussing the differences between them or even their contradictions. Let us remember one indisputable point : China, the greatest successful economic take-off, now accounts for 18% of the world's GDP but does not even represent 5% of the capitalization of the MSCI. Without concealing the impact of the regime's political and ideological takeover in certain sectors, this is a clear undervaluation.

Let us end this Letter on the halt of the convergence between developed and emerging countries with a short-term risk, a latent threat in the medium term, and a definite problem in the long-term for emerging countries :

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- *The upcoming risk of default by certain countries* :

To alleviate the difficulties of emerging countries, the IMF has decided to allocate an additional SDR (special drawing rights) of $650 billion. $275 billion should benefit emerging countries and the G7 countries have decided to allocate $100 billion of their SDRs to emerging countries. Nevertheless, some countries are now in a perilous situation and the IMF is highlighting Lebanon and some African countries that will need targeted and massive aid. To keep some optimism, we will recall the word of the great Lebanese poet, ***Gibran***, who died in 1931 : ***"One may not reach the dawn save by the path of the night"***.

- *The latent risk of protectionism or relocation* :

If forms of deglobalization were to prevail, the emerging countries would be the big losers, but we hardly believe in this threat. The ***CEPII,*** in a study on France, also applicable to other Western countries, has shown that a closure of borders to emerging countries would reduce the French median income by 6 to 18%. So, this policy should be ruled out. Globalization has certainly cost jobs in industry, but it has created jobs in the service sector through exports.

- *The challenge of ageing* :

The increase in the share of the elderly population, the decrease in the working population, contrary to belief, certainly does not concern Africa or India, but not simply western countries alone either. If, in a developed country like South Korea where 43% of the over-65s live below the poverty line because the country spends only 3 points of GDP on pensions, what will happen to emerging countries, the majority of which are deprived of pensions? This includes China, Russia, Eastern Europe and others.

Geneva, 17th August 2021

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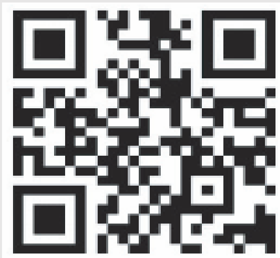

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