Emerging Markets Evolution

How Demographics, Reform and Capital are Unlocking the Next Wave of Emerging Markets Opportunity
Author

Giles Bedford is the Emerging Markets Client Portfolio Manager at Amundi Asset Management. Giles has over 23 years’ industry experience across both debt and equity investing in emerging core and frontier markets. Educated at St. Andrews and the University of Pennsylvania, he is a noted commentator on the space.

Other Contributors:

Mauro Ratto
Global Head of Emerging Markets at Amundi Asset Management. Mauro has over 23 years’ industry experience and leads a highly skilled EMs Investment team that covers Asia, Latin America, Emerging Europe, the Middle East and Africa.

Yerlan Syzdykov
Head of Emerging Markets – Bond & High Yield at Amundi Asset Management. Yerlan has over 19 years’ industry experience and has played a key role in evolving Amundi’s EM investment capability.
Today’s EMs are wealthier than ever before. Since 2000, the developing world’s share of global financial wealth has expanded from less than 10% of the total to more than 30%. In U.S. Dollar terms, the area’s wealth stands at $75 trillion versus the developed world’s $175 trillion. GDP growth alone cannot explain this achievement. For the mature world, the emerging world’s economic expansion, and subsequent consumption, present an attractive solution to pension deficits. For the emerging world, the mature world represents a source of capital and end demand. As a result, emerging financial markets have broadened and deepened, with today’s community reflecting this development in both size and sophistication. While delivering real progress, EMs remain highly dependent on foreign capital for further growth and development.

The challenges that EM policymakers face differ in character from those in the mature world. There is no scarcity of potential growth sources. Instead, EMs are contending with issues around the management of expansion. EM savings systems’ development has sometimes lagged headline growth, to the general detriment of those populations. This lag can reflect weak policy choices, and helps to explain disappointing rates of new issuance in some markets, and weak human capital retention in others. In order to continue to attract competitively priced capital from foreign investors, developing countries need to pursue meaningful and lasting reform. However, investors also need to participate in this push toward higher standards of stewardship in both sovereign and corporate governance.
Exponential demographic growth can act as a catalyst for change. For fast growing, rapidly urbanising economies, employment growth can challenge governments to both deliver and sustain higher standards of living for larger numbers of people. Thanks to cheap technology, a rising awareness of western living standards is further elevating pressure on weaker governments. Armed with better information, populations are becoming increasingly more empowered and less tolerant of inequality than previous generations (which might have accepted weaker, less transparent local government) and thus logically seek better governance in order to secure their future.

**The Demographic Wave**

**Growing Populations Seeking Higher Standards of Living**
If there is a single common problem experienced by travellers across all EMs, it is very likely traffic congestion. Whether visiting Beijing, Mumbai, Mexico City or Sao Paolo, one must always allow plenty of time between meetings to mitigate the effect of choking traffic. This is a useful starting point for understanding the resilient nature of EM growth and the challenges that it produces. Why do EM cities suffer disproportionately from congestion?

First, let us consider some indicators and consensus forecasts:

- Between now and 2030, every child in the West reaching adulthood will be matched by six doing so in the emerging world (OECD).
- According to the IMF, there are currently more people under the age of 15 in India, China and the Brazil than there are Europeans of all ages (by comparison, the US, Europe, and Japan have 5 million more senior citizens than pre teenagers).
- Six of the largest metropoles globally are located in EMs (U.S. Census).
- China’s capital saw its population expand by 44% to 20 million between 2000 and 2010 (IMF).
- China has 64 distinct urban areas with populations over 1m that account for a combined population of 383 million people (Goldman Sachs).
- China is not home to the fastest growing urban area, however: Istanbul’s current 3.45% population growth rate is the highest of all (IMF).

EM demographic growth contrasts with that of the developed world as a whole, with global population levels expected to trend downwards over the next 25 years. This means the supply of labour in the emerging world compares favourably to the labour supply dynamics of the mature world, a feature that reflects aging populations. Aging populations challenge
growth through dependency, as care can reduce productivity. Not all emerging countries are growing populations equally: China is beginning to experience a rising dependency ratio, reflecting an aging population. This may factor in the country’s decision to abandon the one child policy (Goodhart, 2015).

Rapid population growth can drive swift urbanisation through internal migration. Because urban living is more productive than an agrarian existence, such migration can lift a growth rate and deepen an economy. Consequently, EM cities have seen substantial inward migration in the last 30 years. Many cities have experienced peak growth conditions over the last ten years. This extra productivity is globally significant. McKinsey estimates that the two billion residents of EM cities will add $25 trillion to the global economy through consumption and capital investment over the next 15 years. This means that 440 EM cities may deliver nearly half of global GDP growth over that period. EM cities currently represent 18% of global GDP; McKinsey forecast this to expand to 47%. Central to McKinsey’s argument is the relative youth of the EM population (McKinsey Global Institute, 2014).

Quickly back to the traffic problem: rapid population growth and domestic migration easily outstrips transportation infrastructure, thus driving demand for more, larger projects. As people get richer, they aspire to own cars, further clogging already congested roads. Transportation infrastructure is expensive, causing countries to underinvest; thus leading to greater amounts of time lost to traffic. Reducing the time lost previously to growth is good policy. Better infrastructure can help EMs elevate efficiency.
EMs are no Longer Poor; Resolving Inequality Presents an Opportunity

EMs have made strong progress toward the elimination of poverty in recent years. In the 20 years since the Asian currency crises, Brazil, China and Indonesia have all reduced poverty rates, while Argentina and Russia have effectively eliminated it. This does not mean that living standards have equalised for the EM middle class. Instead, there remains considerable room to reach global standards across the sample. For those earning less, social welfare is generally scarce in the developing world. The OECD notes that benefit systems “typically play a lesser role than in mature economies in easing market driven inequality” (OECD, 2011). As a result, EM quality of life – and therefore political stability – can be more sensitive to economic performance than comparable mature economies.

Demographic growth escalates the need to increase participation, creating a direct challenge for government in the process. Policymakers in EMs know that a threshold level of growth is required to sustain society and therefore support state institutions. States can fail if growth rates drop below threshold. Because it is against human nature to accept a reduction in standards of living, there is an understandable, determined unwillingness to regress where people have broken free.

The resulting policy dilemma faced by policymakers in EMs is not simple. Lower prosperity can deliver people into adult life with weaker marketable skills. Jobs that pay a living wage are critical to sustain a break the poverty cycle, but can be elusive in a world where low skilled labour is not in shortage. Policies that lift the price of labour in a developing country can render that country uncompetitive. Governments that experiment with social security and other protections have often found that their policies become too expensive to maintain. Most governments have learned that direct subsidy is bad value; furthermore, rural unemployment can be easier to resolve than urban unemployment (OECD, 2011).

Policy failure is not an appealing option. When unemployment and inflation combine, the outcome can present structural challenges to both the leadership and the system. Hungry people are rarely happy with leaders; policies that fail to address shortfalls contribute to social
tension and instability. The key to resolving the supply side of this relationship is investment. A successful policy enables people to move up the value creation curve, creating their own security as they progress. Conversely, when these policies fail, they frequently take the leadership with them. Larger failures can lead to societal upheaval through unrest.

The sheer size of the demographic wave in EMs creates a strong upward demand case for hard and soft commodities, consumer goods, and infrastructure spending. It also creates pressure on government to deliver improved policy outcomes. Closer collaboration with foreign and domestic capital can create jobs and thus deliver upward economic mobility to growing populations. Tax and investment incentives can encourage the private sector to develop local physical and human resource further. Above all, the regulation of the domestic markets that gather and allocate this capital is important, just as it is important that governments allow municipally beneficial investment to enjoy the resulting returns.

The efficiency and direction of industrial policy is an important consideration for EM investors. A successful industrial policy generates employment growth by providing a competitive platform for investment. Carefully deployed municipal capital can create good jobs and reduce slack capacity in an economy. When industrial policy fails or is badly executed, the result is an accumulation of under-utilised labour, which can be a destabilising force and raise investor risk. Policymaking that aims to protect the weakest in society while enabling the most competitive generally supports a stable government. When governments help their populations’ progress, they enjoy popular support; but when their politics deliver high unemployment and rampant inflation, that support fades to grey.

Reform: Growing a Wealthier Emerging Middle Class

Why the Middle Matters
While population growth is important, the accumulation of mass affluence matters more for investors (Edmunds, 2006). Sizing the EM middle class remains a topic of some debate. Judged against western income and wealth measures, the EM middle class remains tiny. However, when we compare this on an equivalent GDP per capita basis, the numbers that emerge are striking: Asia is home to some 525 million middle class people, 65% more than the entire population of the United States and accounting for 7% of the global population of 7.2 billion (US Census).
Per capita wealth of the EM middle class exhibits wide dispersion. Nigeria’s per capita GDP of $15,600 compares positively with India’s $4,000, while Qatars struggle to make ends meet on a per capita GDP of $95,309 per year. In Brazil, a “Middle Class” person earns between $99 and $347 per month; since the election of the Workers’ Party in 2003, around 40m Brazilians have reached this income level. From a low base, fortune can grow: McKinsey forecasts that the Chinese middle class should reach 400m people with household disposable income of $16,000 to $34,000 per year. This contributes to a 2025 consumption figure in the emerging world of $30 trillion, some 46% of the global total (McKinsey Global Institute, 2014).

Because the EM middle classes are generally less economically prosperous than their developed market equivalent, the group can under represent in certain consumption measures. Worse, weaker domestic growth can lead to a thinner wallet: the 56% of Brazilians that make up the domestic middle class today account for 33% of the country’s spending, down from 60% in 2009. (Pearson, 2015) This downward movement reflects a more challenging external environment: as local currencies have softened, imports have become more expensive, thus frustrating some middle class aspirations. Worth noting: rising prices for imported goods can create an opportunity for domestically sourced alternatives.

While this population is large and economically active, it faces many internal challenges. Accessing equity capital can be difficult in some countries. Bankruptcy and consumer credit protection can be thin and applied unequally. The pursuit of civil claims through a judicial system can be prohibitively expensive. Participating in markets, for example through mutual funds or equivalent savings products, is generally more difficult in the emerging world (Robertson, 2015)1.

Creating institutions and regulatory frameworks that encourage middle class prosperity is a desired policy outcome for emerging countries. Open financial markets are a critical tool to enable capital to access growth and vice versa; commensurate with the liberalisation of financial markets is higher quality regulation. Yet despite efforts to open markets, some countries continue to endure shallow financial systems. The level of active engagement in domestic markets by local retail investors is an important indicator for any long-term EM investor. The deepening of savings systems and subsequent growth in assets invested in financial products are indicators of a country’s commitment to competition. Retail participation is an indicator of local trust in regulation and corporate governance. While wider demographic growth creates a powerful inertial moment, a growing, engaged middle class drives greater consumption, investment and competitive improvement (Kuhn, 2015)2.

1This issue is explored in detail by a number of commentators, most recently by Charles Robertson at Renaissance Capital. Other commentators that we note include Babson College Professor John Edmunds, who has written extensively on the impact of legal system quality on EM valuation. We could easily cite both in defence of this statement.
2There is a considerable Academic literature around the engagement of retail investors with financial markets. We note considerable academic work by the IMF and World Bank around the structural needs of domestic savings industries.
Policy Reform Can Accelerate Domestic Growth

It has become popular in some circles to deride the glacial pace of EMs reform. When international policy rates are low, and liquidity is plentiful, few EM governments feel pressure to make structural reforms. This has led to accusations that the “growth model is broken”. Advocates of this view argue that EMs remain dependent on basic commodity exports, and thus have not diversified activity up the value curve. Dependence on tourism is a bad sign, because sunshine is the ultimate low value add commodity. In some countries, public spending growth has remained austere. The resulting liquidity conditions sometimes inhibit domestic growth, thus constraining middle class consumption (Lubin, 2015).

Resolving the challenges in accessing capital should be essential reform objectives for many developing countries, as these challenges help to create wealth for ordinary people. Inefficient social and economic infrastructure presents an impediment to broad wealth creation across many countries, with developing economies apparently prone to this problem. Inefficient financial services penetration, weak or ineffective enforcement of market abuse laws, and the needless empowerment of entitled groups occur more frequently in the developing world. State owned enterprises and their proxies can suppress private sector development, through scale and favourable regulation. A deep state apparatus, a frequent feature in countries where the Military has entered politics, can manifest in the services sector. Egypt’s Army is an active provider of services such as auto repair to the local marketplace. These practices crowd out private sector enterprise by raising barriers to entry. In places, the concepts of ownership and public service can have different meanings. Where present, these features undermine domestic equity markets, thus actively reducing participation. This has a real cost: low domestic participation rates in an equity market can be an expensive symptom of inefficient policy formation (Edmunds, 2006).

We note progress made in many countries, particularly around business law. As a group, EMs have improved on international developmental indicators. Contract law and dispute resolution are key areas for foreign investors, because local business standards vary. (Robertson, 2015) Transparency International calculates an annual index of this corruption perception, which shows consistently elevated results for developing economies. Where a high imbalance in wealth distribution (the Gini coefficient) combines with high corruption, weak growth, and unemployment, disruption risk rises (Newton, 2013).

To deliver growth to the middle class, emerging countries do not necessarily need to immediately transition to democracy; they just need to open themselves for business. This involves transparent property rights, and opening markets to foreign capital. As domestic asset values normalise to international norms, the resulting multiplier
effect may lift income and wealth for the wider population. Such moves tend to attract multinational interest in a lower growth world. Take as an example a recent report to corporate treasurers and CEOs from Ernst and Young, that includes this glowing assessment of EM growth prospects: “Population figures that promise both a huge consumer base and a deep reservoir of talent; a rate of growth that currently outstrips that of many more developed economies; and infrastructure needs that range from IT to healthcare systems to mass transport are just some of the opportunities” (Kuhn, 2015).

The Lewis Point: How Rapid Growth Becomes Rapid Diversification

Named for the economist Arthur Lewis, a “Lewis point” occurs when an economy grows to a point where no labour surplus exists. In many countries, agriculture can act as a kind of “labour bank”, providing productivity at certain points in the cycle, while drawing it back in others. Once reached, a Lewis Point breaks this relationship, resulting in rapid wage growth and economic diversification. In recent years, a combination of bond issuance, economic expansion, and liberalisation has tightened labour rates in many EM countries (Ranis, 2004).

To approach a Lewis point, a country must sustain an elevated period of economic growth to absorb surplus labour. Wages grow as the labour market tightens, and consumption increases. As consumption increases, a country can sustain a diversification of the real economy – most visibly in a diversifying the consumer channel. China’s rapid urbanisation presents an example of a large country reaching a Lewis point, while others are close. Russia, Brazil and India could reach it, while Nigeria, Malaysia and South Africa have potential. Private sector capital is an important accelerator towards this transition. The World Bank estimates that some 900 million people live on $2 a day; reducing this number is critical for economies that aim to transition toward a modern industrialised model (Kuhn, 2015).

 Tightening labour markets are an important indicator of progress, as rising wages help to erode inequality. Aging mature market populations will reduce the global supply of labour, logically favouring the marginal supplier. This feature could reduce the negative trend in global wage rates, leading to the relocation of manufacturing facilities and a broader distribution of inward investment. This feature suggests that EMs broadly have the ability to generate savings, and thus narrow the wealth gap with the developed world (Goodhart, 2015). What they do with these savings is a critical element of the long-term call on the asset class.

Retaining skilled workers is an important challenge for EM. Falling labour rates can lead higher skilled workers elect to leave weaker countries in favour of seeking fortune elsewhere. Losing talented people hurts countries seeking to attract inward investment, and causes job growth to lag. Not all countries can afford this lag. India needs to generate 10 million new jobs every year for the next 10 years to absorb its population
growth. This rate of job growth is higher than India has ever previously achieved, and follows a period where the country generated 2-3 million jobs per year. Raising the challenge further, some 37% of these jobseekers come from areas associated with lower literacy rates (Nandurkar, 2014).

Agriculture often acts as a labour bank, supplying workers into periods of growth, and absorbing them in recessions. The amount of labour working fields provides guidance on future growth potential. Agriculture is India’s single largest employer, accounting for 225m workers nationwide. Having previously created a third of new jobs in India, agriculture is now supplying labour to the wider economy. Over the last seven years, some 4-5 million agricultural workers have left the farm. This further increases India’s labour supply. Over the next five years, India’s industrial workforce may add 45 million new workers through demographics and further 5 million workers from farmland.

The need for India, and other countries, to create jobs to absorb the demographic wave is a key component of our thesis on long-term returns in EMs. For investors, an economy approaching the Lewis Point can offer a compelling investment case. Not all emerging countries are approaching the Lewis point, but measuring their progress maintains expectations.

Attracting Capital in EMs

Variability of return has been a consistent characteristic of EM investing. As a net importer of capital, the asset class’ valuation has generally reflected external risk appetite. This variability raises costs for EM issuers, and can impede economic development, thus raising the cost of capital. In our long-term view, we see a possibility that domestic efforts to deepen pensions and savings systems may result in less demand for external capital in the very long term, while delivering an improved governance. In the meantime, the sheer scale of EM demand for capital keeps the asset class fully engaged with foreign investors.

THE TOTAL VALUE OF THE MATURE WORLD’S DOMESTIC SAVINGS INDUSTRY COULD REACH $900 TRILLION BY THE YEAR 2020
The Domestic Asset Base is Growing Rapidly

The mature world’s domestic savings industry is an important source of capital for developing and EM countries alike. Over the last 30 years, the pooled investment vehicle has emerged as a leading tool in the race to create mature market wealth. Growth in the format has been spectacular: Bain Capital estimates that the total value of such managed assets may reach $900 trillion by 2020, representing a 10% annualised growth rate from the current $550 trillion; of this, some $199 trillion is debt. Mutual funds, pension funds, and other pooled vehicles provide most of the capital that drives EMs.

Domestic savings systems are beginning to show real progress with pooled vehicles. In Asia, insurers and pension providers have gathered $2.8 trillion in total assets (China is proportionally over-represented in this contribution, helped by elevated domestic growth rates), but there is far more to do (Deng, 2014). Over the next 30 years, EM countries own savings systems could grow to meet more of their domestic financing needs, thus reducing their reliance on foreign investor risk appetite.

The size and growth of domestic savings pools in emerging countries varies. In Brazil, the last 20 years has seen the number of domestic funds offered rise from 632 in 1992 to 14,097 in December 2013 (Rochman, 2014). In China, the story is similar: between 2008 and 2013, Chinese mutual fund managers launched over a thousand new funds, bringing the total domestic fund space to around 1,600 funds managing around $480 billion, split roughly between equity and debt. (Deng, 2014) There are also outliers: countries with high real interest rates typically experience slower fund growth. Russian equity funds have struggled to compete against lower risk deposit products that frequently offer comparable returns. There are other issues at play: on a recent visit to Russia, a local banker explained to us that Russian retail investors would rather own a physical asset than an equity because of its tangibility.

These savings pools could grow rapidly in the next 20 years. Bain Capital estimates that EMs could add $150 trillion in incremental growth and value in the next 7 years. This does not mean that the value of quoted assets will rise by $150 trillion; what it means is that the collected value of GDP and asset growth produced by banking systems can potentially increase the world’s total capital by 50% over the next five years (Kestel, 2015). To an outsider, these numbers may appear optimistic; in reality, governments need to aim this high to absorb the demographic wave (Goodhart, 2015).

Funding the economic expansion needed to absorb the demographic wave requires substantial capital. Some consultants and long-term forecasters expect the emerging world to generate around $130 trillion in asset growth between 2010 and 2020; Bain Capital forecasts $87 trillion from China alone, with Asia home to the world’s largest
population of high net worth individuals. The bigger the demographic challenge, the more robust the domestic financial system needs to be. Policy planners in EMs know that higher inequality drags down economic growth, which reduces employment and raises pressure on governments. This has led many down a reform path, as they seek to attract capital.

**In 2014, Direct Investment Exceeded Portfolio Investment**

While domestic institutions have started to meet domestic capital demand, EMs continue to import substantial capital. China’s total debt has risen from $7 trillion in 2007 to $28 trillion in mid-2014. Around half of this debt links to the country’s real estate market (Richard Dobbs, 2015). Robust foreign appetite for EM securities fuelled this market deepening. Foreign Portfolio Investment in EMs reached $217 billion in 2014, an increase of nearly $20 billion over 2013. (Koepke, 2015). Yet this level appears small versus direct investment flows. United Nations data illustrates this difference: in 2014, direct investment into EMs was $915 billion – 4.5x greater than foreign portfolio flows. (Hannon, 2014). Why this difference? Direct investment gives the investor full control of the asset, avoiding potential governance issues.

“Control” means more than just being able to sack management and collect dividends. Fully controlled companies can be tightly integrated into global supply chains, generate scale; price and tax efficiency, and better reflect business strategy. If a multinational company builds a factory in an emerging country, it is likely to supply that factory on large scale, fund its construction via offshore capital, and enjoy absolute control over the subsequent return stream. Multinational companies rarely work on an agency basis, preferring direct control of their asset base.

Successful direct investment can disrupt portfolio investment. This is because directly managed companies often introduce higher standards of competition, to the general detriment of locally quoted companies. When an international bank or retailer arrives in a marketplace, the result is an immediate pricing disruption and risk increase. Many local competitors will be inefficient, with costs of equity far greater than a competing multinational. This presents shareholders with stark choices about future returns, which can reflect in lower equity multiples and higher bond yields.

**Improved Governance will Help Deepen Local Markets**

Governance, innovation, competitiveness, and access to capital are linked. Multinationals can threaten a domestic market through competition and acquisition, local businesses can respond through innovation, attracting capital through competitiveness and governance. For many locally listed businesses, governance and competitiveness are areas for improvement.
Growing local mutual funds and pension funds helps this process in two important ways. First, an increasing amount of dedicated local capital improves domestic depth and liquidity, which in turn opens the market to larger levels of international capital. This leads directly to a second important feature: greater amounts of capital brings demand for more efficient corporate governance. Lower cost of capital and therefore more rapid growth attributes to corporates that improve governance. What is changing is that those investors are frequently pension or mutual funds rather than family groups or oligarchs. The need to respond to new, well-funded multinational competitors has required companies to seek larger amounts of capital, in effect outgrowing the domestic bank finance (Koepke, 2015).

The Long-Term Investment Case Remains Sound

Protecting Minority Investors Reduces Risk and Lowers Cost of Capital

Over the last 20 years, EM countries have moved from a period of inflexible economic policy towards a more open model. The resulting increase in trade and investment created conditions that led to the demographic wave that has now formed. If the past offers a guide to the future, then this demographic wave will increase the rate of change in these economies. Labour intensive industries will continue to migrate capacity toward more competitive input pricing on key factors of production. For this and other reasons, emerging countries need to avoid complacency and embrace reform to improve competitiveness.

What growing cities and rapid urbanisation suggest is that emerging economies are transitioning toward a future in which they remain the global swing supplier of manufacturing, but are also home to a middle class that is rapidly gathering wealth and prosperity. The diversity of demand that this trend provides is globally important.

Many multinational companies have already identified this trend, and have moved to acquire assets in the developing world. One reason why EMs look appealing to multinationals is that valuations typically reflect higher risk levels than that experienced in the mature world. Managing such risks can be fruitful.

To an organisation seeking control, EM capacity can look like a bargain, offering cheap growth. At present, EMs currently provide nearly a third of S&P 500 earnings growth, reflecting the wide difference between foreign direct investment and portfolio investment seen in the last few years.

We see evidence of improving standards of governance in some EM corporates, reflecting broader progress in sponsorship and regulation. This pool of corporates present a potential performance vector, as they
offer access to local growth, with acquisition a possible exit event. These companies are not relics of previously failed industrial policy, but are smaller, more nimble capital allocators.

**The EM Story is Not Dependent on a Long-Term Risk Subsidy**

Sustaining elevated growth in the EM space does not require mature market interest rates to remain at abnormally low levels. When taken together, both foreign direct investment and portfolio flows have remained relatively small as a percentage of total EM GDP. Instead, what the rally requires is demand, which could be sourced internally – a Chinese soft landing, for example. While relief in commodity prices might help the collective EM current account, the real shortfall is currently in global end demand. Perhaps most important, because EMs offer a deep pool of latent growth, a pickup in external demand can lead to a rapid growth rebound. Key in the current environment is that the amount of activity required for EM growth remains relatively small, and could be stimulated by policy reform.

The long shadow of Adam Smith shades the debate around the disconnection between EM economic and investment performance. Traditional economic measures use trade as an indicator of activity, with volume of trade closely associated with the creation of wealth. In developing economies, this is not always the case. Trade flows don’t automatically correlate back to wealth creation, as providers of labour frequently consume their earnings, leaving nothing in reserve. We note lower correlation between headline economic growth and market returns than an outsider might expect. The challenge to policymakers in developing countries is not to drive trade, but to create and distribute wealth.

In our view, improved governance and regulation will help diversify and deepen EM banking systems. With that, addressing pent up demand will drive growth as countries approach the Lewis point. Those countries that seek to address wealth shortfall through free market reform may experience superior growth. Many EM countries have made strong progress on the alleviation of poverty; from them comes the creation of more and better jobs, industry and greater sustainable competitive advantage. This needs to continue, while protecting ownership rights, and welcoming foreign capital.

With these changes, we see a catalyst that can cascade through an economy. Economies can become less dependent on foreign rates and flows, while governments can more sustainably stimulate consumption and domestic investment. Increasing investment improves competitiveness, while furthering an economy’s capability to grow. The deepening of the financial system accelerates this process increasing the wealth of the full population. What may result is a more stable, resilient economic model. For foreign and domestic
investors alike, this transformation offers a heterogeneous pool of opportunity, whose long-term sustainable returns appear compelling.

Developed economy mutual funds have eclipsed bank and government funding as the primary source of capital for EM countries. Foreign capital will remain the dominant source of capital for EMs, until local institutions grow to sufficient size to challenge this leadership. This dominance brings responsibility, as investors should seek to access issuers seeking to generate change.

This provides premium returns, but also delivers important social benefits that can help balance inequality. Investment is a more powerful tool than charity in this application, because the cost of capital drives superior allocation and reduces graft. Investors should not shy away from rising to the challenge of accessing this growth, and recognise the importance of imposing discipline. Improved governance can help address mature market pension funding while creating greater security and stability in our world.

Selected EMs: Corruption and Wealth Distribution

![Chart showing Perceived Corruption Index and Gini Coefficient for selected EMs]

Source: Nomura, 2013
Bibliography & Further Reading

There is a broad literature around many of the points that we discuss in this piece. We have drawn on a fairly narrow selection of material to evidence what we see changing. For a broad survey on the impact of regulatory change on middle class wealth, we suggest John Edmunds Wealthy World as an approachable primer. We also note Jim O’Neill and D. W. Purushothaman’s long-term growth projections published by Goldman Sachs.


Goldman Sachs, Global Economics Paper No. 192, The Long-Term Outlook for the BRICs and N-11 Post Crisis


Important Information

Unless otherwise stated all information contained in this document is from Amundi Asset Management and is as at 31 May 2017.

Unless otherwise stated, all views expressed are those of Amundi Asset Management. These views are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. Investments involve certain risks, including political and currency risks. Investment return and principal value may go down as well as up and could result in the loss of all capital invested. This material does not constitute an offer to buy or a solicitation to sell any units of any investment fund or any services.

Indices are unmanaged, and their returns assume reinvestment of all dividends, and unlike fund returns do not reflect any fees and expenses. You cannot invest directly in an index. Investing can involve significant risks, including the loss of principal value. Investment returns will fluctuate. You should always consider your risk tolerance and investment objectives when considering investment options.

Date of First Use: 28 June 2017.