From hotspots to headwinds... what next for emerging markets?

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STORY HIGHLIGHTS

- Large emerging markets are facing slow growth rates, as compared to the early 2000s
- Challenges include slow recovery from the financial crisis and financial deleveraging
- Emerging markets needs to focus on innovation, says Albert Park
- Their outlook will depend on the institutional and policy reforms made by political leaders

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(CNN) - After experiencing explosive growth in the first decade of the new century, growth rates in emerging markets have slowed noticeably and perhaps indefinitely. Despite this slowdown, collectively the BRICS (a term used to describe the growing economies of Brazil, Russia, India, China and South Africa) and other emerging markets have simply become too big to be ignored, now accounting for the majority of the world's GDP and growth.

What is the nature of the headwinds they now face, and how can they steer their way forward?

During the 2000s, large emerging markets benefited from a nearly perfect storm of growth-supporting conditions. Strong economic performance in advanced economies provided robust external demand for goods and energy.

With highly mobile global capital and logistical innovations spurring rapid globalization of supply chains, trade and financial liberalization reforms yielded enormous economic benefits, supported by stable macroeconomic management by emerging market governments.

The post-financial crisis burn

In the wake of the global financial crisis, the world has changed. Slow recovery in the U.S. and especially Europe has provided relatively weak and unreliable demand, with low energy prices hurting energy producers such as Brazil and Russia.

Financial deleveraging has made capital less available and more discriminating. And challenges and distractions to sound governance have arisen or persist in key emerging market countries, including conflict or political instability (e.g., Russia, Turkey), corruption (pervasive, especially in China), large budget deficits (Brazil), and excessive regulation (South Africa, India).

Looking forward, it will become increasingly difficult to generalize about the outlook and challenges facing emerging markets due to individual country differences.

While energy producers are hurt by low energy prices, energy importers such as China and India may benefit. Population aging will slow growth in China and Russia -- and other countries in Asia and Europe -- while growth in India and African countries will benefit greatly from growing labor forces and falling dependency ratios.

Mexico and Pacific countries will benefit more from the faster recovery in America, while those more reliant on Europe will struggle -- e.g. Russia, Eastern and Central Europe, Turkey.

To successfully navigate these different headwinds, leaders in emerging market countries must steadfastly focus on the things that they can control even amidst volatility.

Tech innovation is key

Some emerging markets have become victims of their own success. As rising middle income countries, maintaining growth momentum requires that they shift from producing labor-intensive manufacturing goods to higher value-added goods and services.

This requires developing the capacity not just to transfer technology, but to innovate, which in turn requires more mature institutions -- legal, financial, regulatory -- than at earlier stages of development.

As noted above, each country also faces its own unique governance challenges. Sustained growth thus may come as much from closing institutional gaps with developed countries as from closing technological gaps.

Today, optimism perhaps is greatest for long-needed reforms in Modhi's India. This need for reform is particularly acute for China, the world's most important emerging market, whose economy is bigger than the rest of the BRICS combined.

China's challenge

China's growth headwinds blow strongly thanks to rapid population aging, rapidly rising labor costs which threaten international competitiveness of labor-intensive sectors, an imbalanced economic structure excessively reliant on investment, a declining property market, and still-immature financial and legal institutions.

The new government has made important progress in combating corruption and reducing administrative red tape.

But after two years in power, many are beginning to doubt whether President Xi Jinping is really the bold economic reformer many had hoped he would be after the promising reform agenda announced at last year's 3rd Plenum meetings.

Critical reforms must be carried out to inject new growth momentum into the economy, including accelerating interest rate liberalization and capital account opening, as well as eliminating the dominance of state owned enterprises and dismantling entry barriers in key sectors such as energy, telecommunications and finance.

As one of the two largest economies in the world, China's success in meeting these challenges carries tremendous implications for the global economy.

China and other leading emerging markets now account for a large share of global demand for energy, commodities and many goods and services. They also have the potential to play an increasingly catalytic role in supporting faster growth in less-developed countries (the future emerging markets) as countries that demand and provide foreign direct investment and technology.

The role of emerging markets in an interdependent world thus has become more complex.

Still, the outlook for emerging market countries will depend most critically on the institutional and policy reforms made by each country's political leaders.

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