

# The Downsizing of Growth in Emerging Markets: Cyclical, Structural, Real or Fictive?

by

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# The Downsizing of Growth in Emerging Markets: Cyclical, Structural, Real or Fictive?

- I. Motivation
- II. Downsizing Factors in the Real Sector
- III. The Contribution of Volatile International Financial Markets on Lower Growth
- IV. Lower Growth: Equivalent to Middle-Income Trap?
- V. Trade as the Most Cyclical Factor in EM Growth
- VI. Conclusions

# The Downsizing of Growth in Emerging Markets: Cyclical, Structural, Real or Fictive?

## I. Motivation

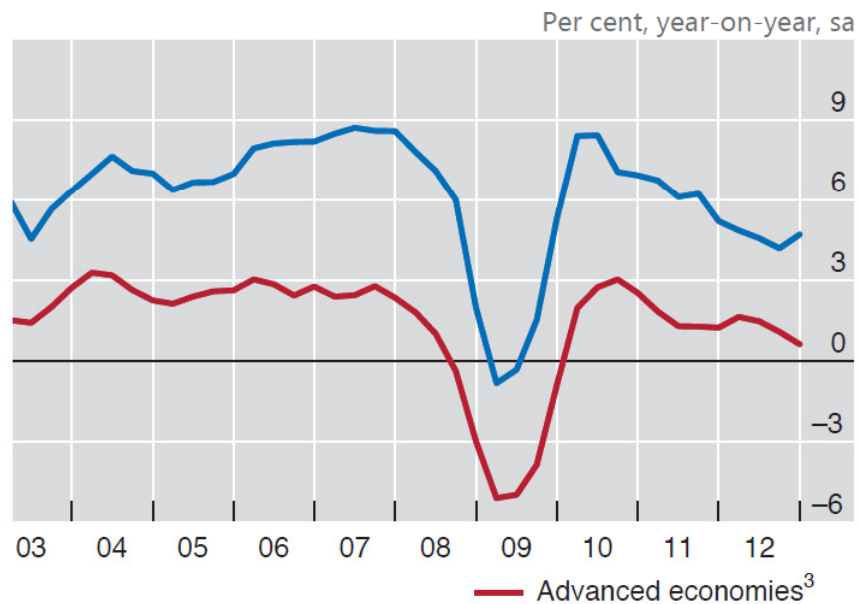
- The end of the myth of “decoupling”
- Neither in real terms ...

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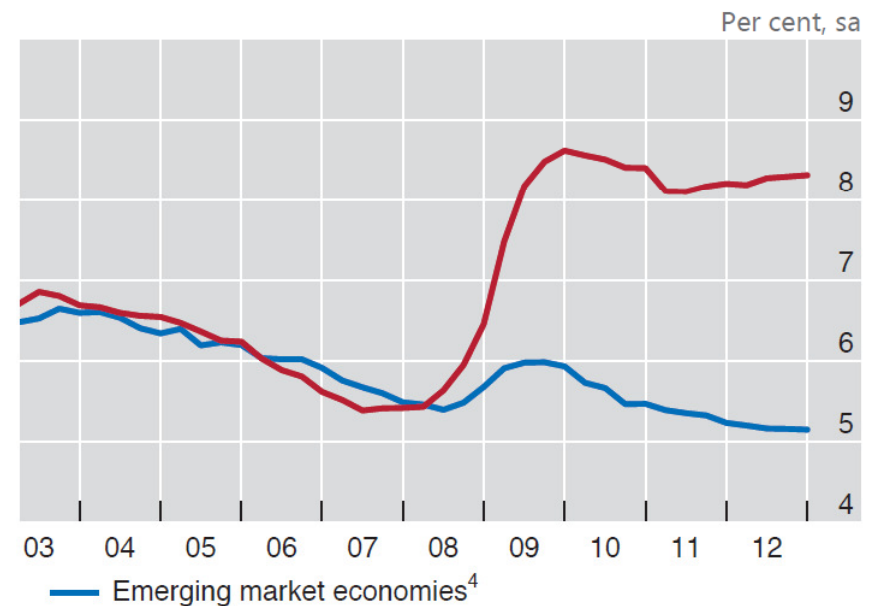
Global economic activity

Graph I.1

GDP growth<sup>1</sup>



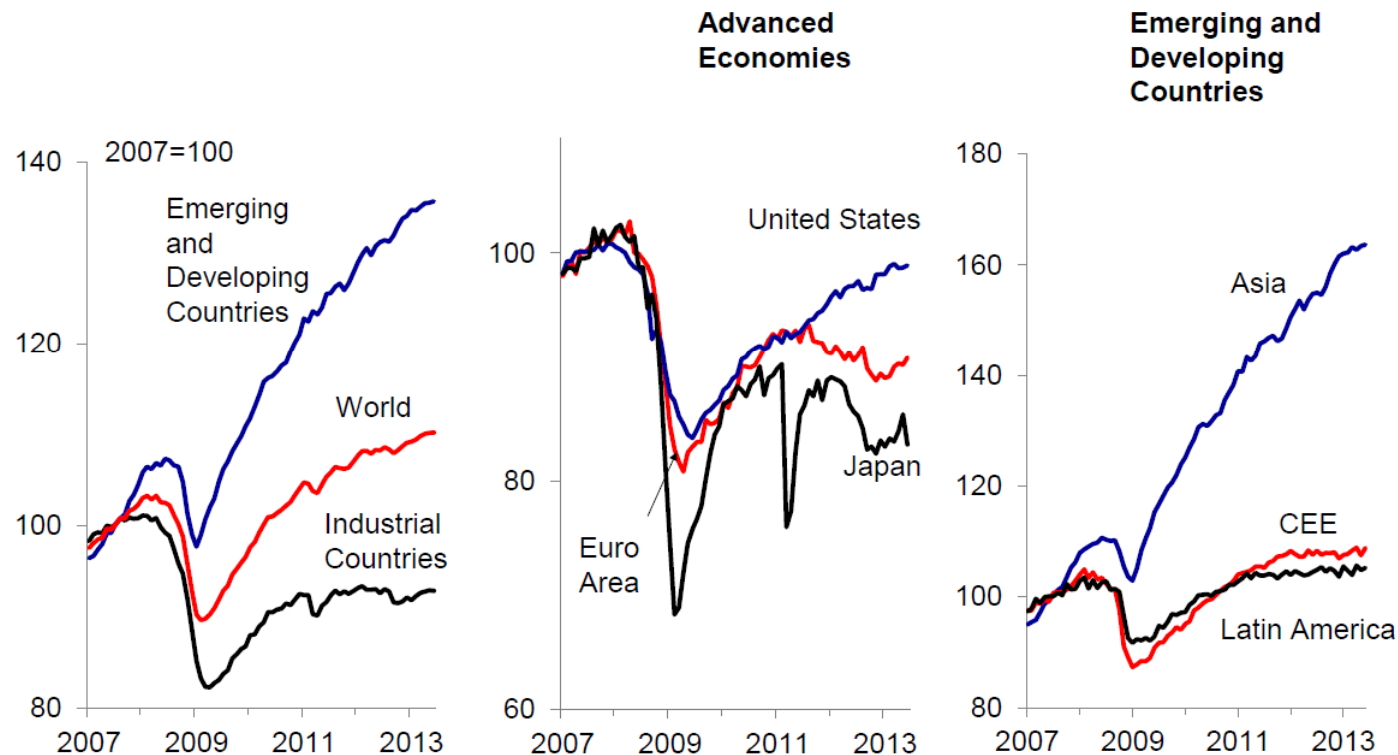
Unemployment rate<sup>2</sup>



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... and industrial production has been sluggish



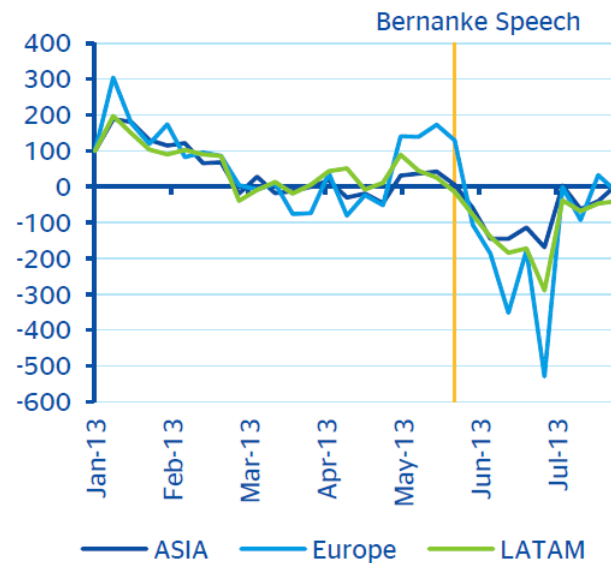
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- ..... nor in financial terms. See reactions after Bernanke speech May 22, 2013, Joint Economic Committee Testimony

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Chart 5  
Capital flows in emerging markets  
(index January 2013 = 100)



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Chart 7  
Sovereign spreads in emerging markets  
(EMBI) (index January 2013=100)

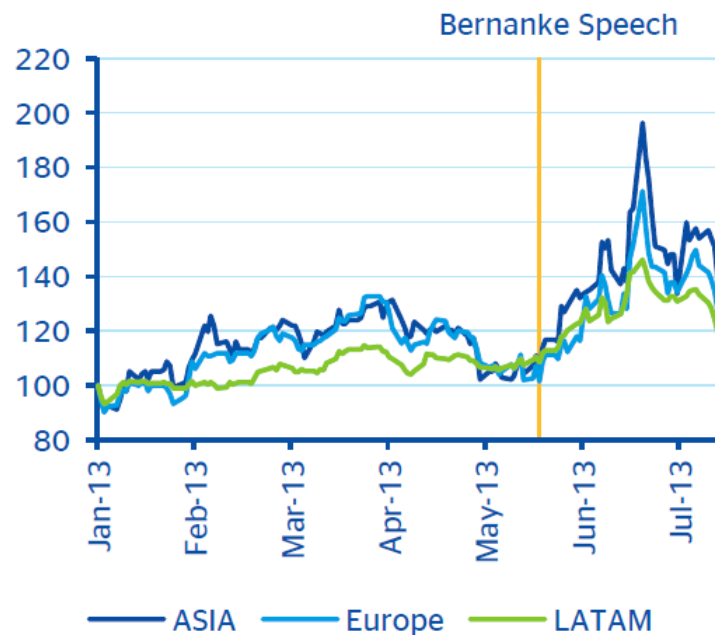
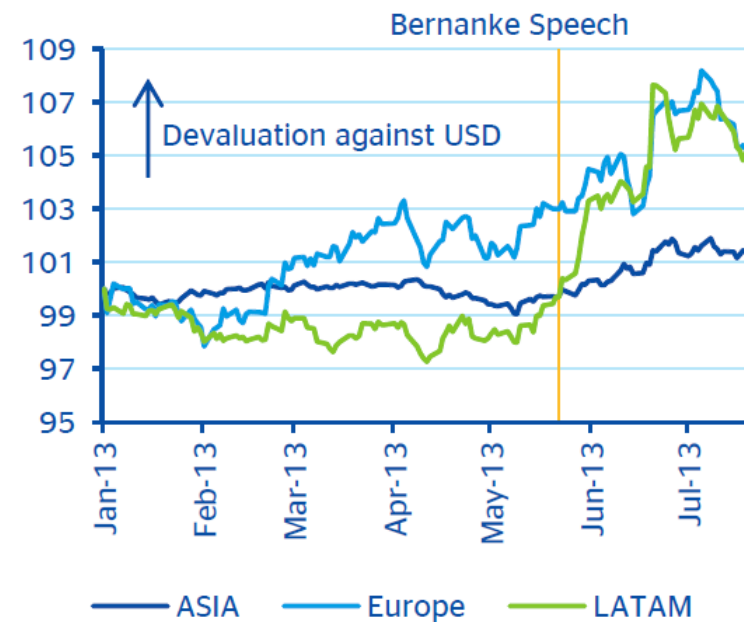


Chart 8  
Exchange rate vs. USD in emerging markets  
(index January 2013=100)





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- Capital exodus after Bernanke Speech resulted in massive exchange rate depreciation in capital account open economies (not China!)

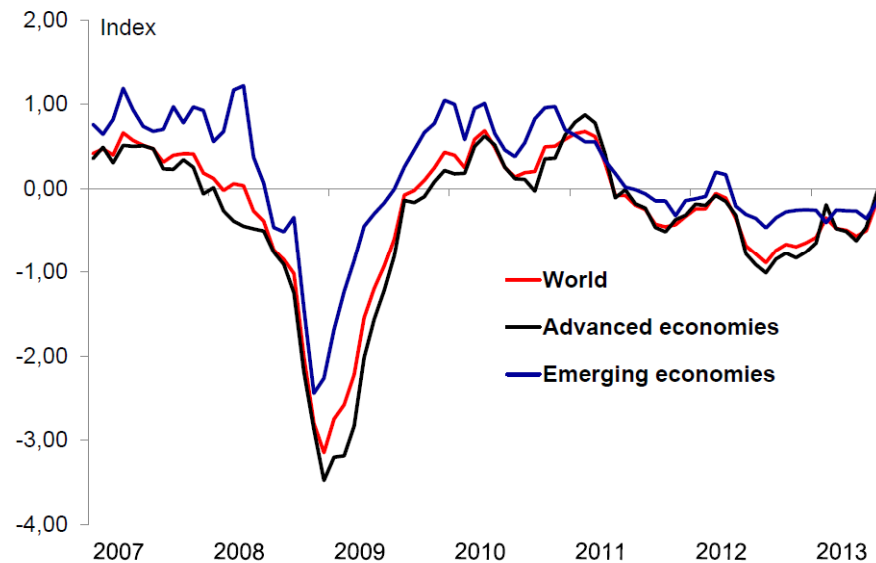
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Sentiment indicators see emerging markets lagging behind advanced economies



Emerging economies lag advanced economies in terms of economic sentiment

Global sentiment indicators according to country groups



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## II. Downsizing Structural Factors in the Real Sector

- Declining average and marginal productivity of capital ( rise of ICOR)
- Bottleneck factors to growth have become more binding ( human capital shortages, distorted financial markets, lack of social security networks, environmental damages, excessive urbanization)
- Demographic changes ( time of doubling old age population share accelerates, today less than 20 years)
- Transition from investment-driven (catching up) growth to innovation-driven growth is time-consuming, i.a. because of mismatch between labor supply and demand
- Bad news for export-oriented emerging markets: negative price effect (real appreciation) and negative income effect (slower growth in the world economy) coincided before Bernanke speech

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## III. The Contribution of Volatile International Financial Markets on Lower Growth

- One driver of volatility: accommodating monetary policies of advanced countries, carry trade,
- Another driver of volatility: Incoherent monetary anchors of EMs, the trinity impossibility of autonomous monetary policy, exchange rate targeting and free capital flows: lessons from 1997 “original sin” problems have not been fully learnt

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## South Korea Trinity Configuration, 1970-2009, by decade

Figure A1. 1970-1979

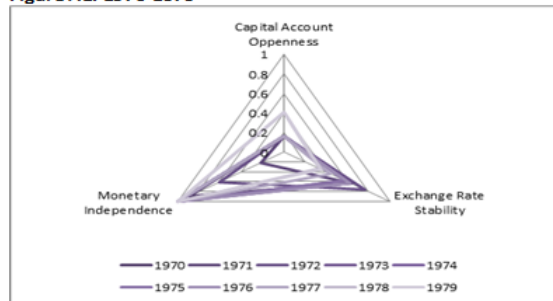


Figure A2. 1980-1989

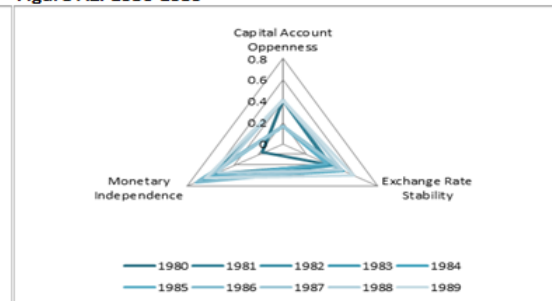


Figure A3. 1990-1999

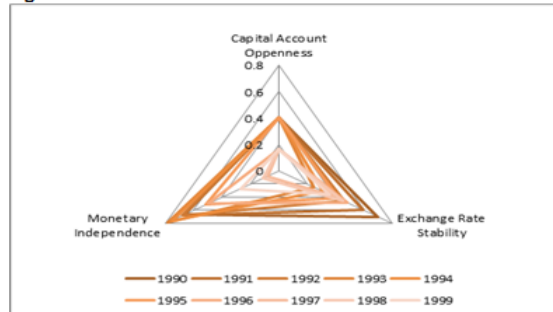
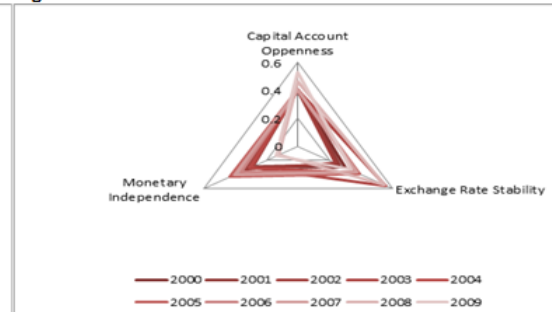


Figure A4. 2000-2009



Source: Chinn-Ito Index: [http://web.pdx.edu/~ito/Chinn-Ito\\_website.htm](http://web.pdx.edu/~ito/Chinn-Ito_website.htm)  
Via The North South Institute

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## China Trinity Configuration, 1984-2009, by decade

Figure B1. 1984-1989

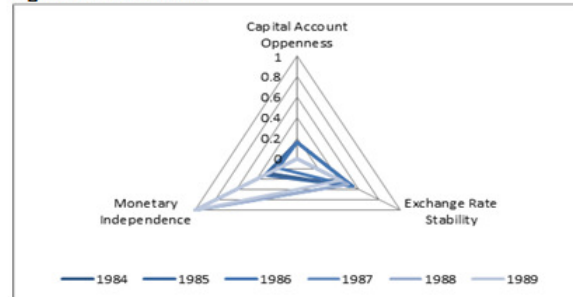


Figure B2. 1990-1999

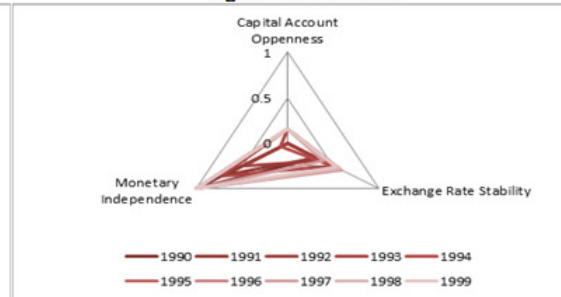
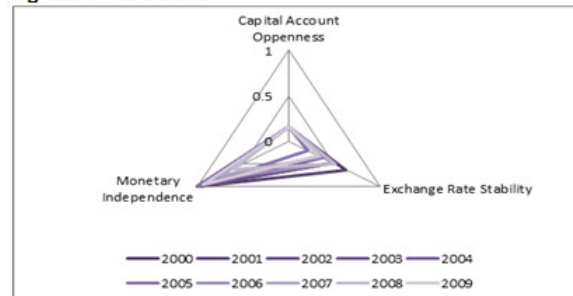


Figure B3. 2000-2009

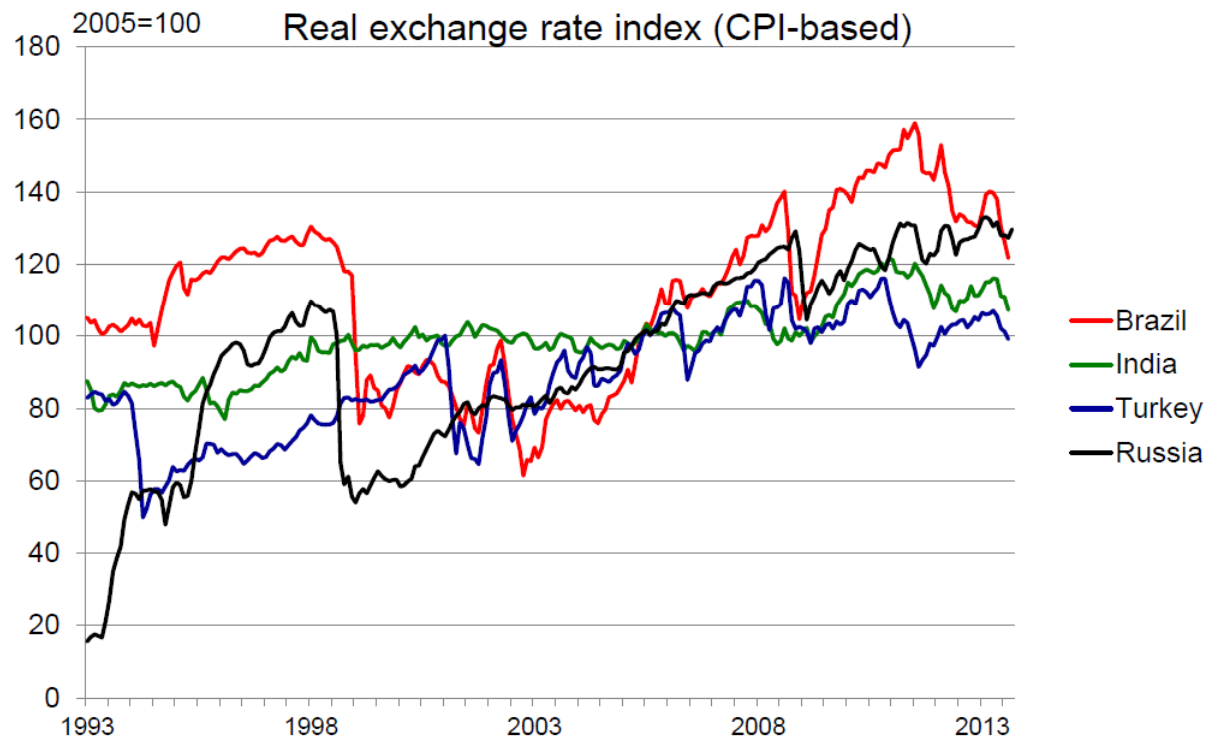


Source: Chinn-Ito Index: [http://web.pdx.edu/~ito/Chinn-Ito\\_website.htm](http://web.pdx.edu/~ito/Chinn-Ito_website.htm)  
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But real exchange rates do not yet look seriously undervalued



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- Speed of real appreciation after capital inflows could not be contained or sterilized by capital account interventions; Balassa-Samuelson Effect materialized; Result: allocation and spending effect pushed real appreciation

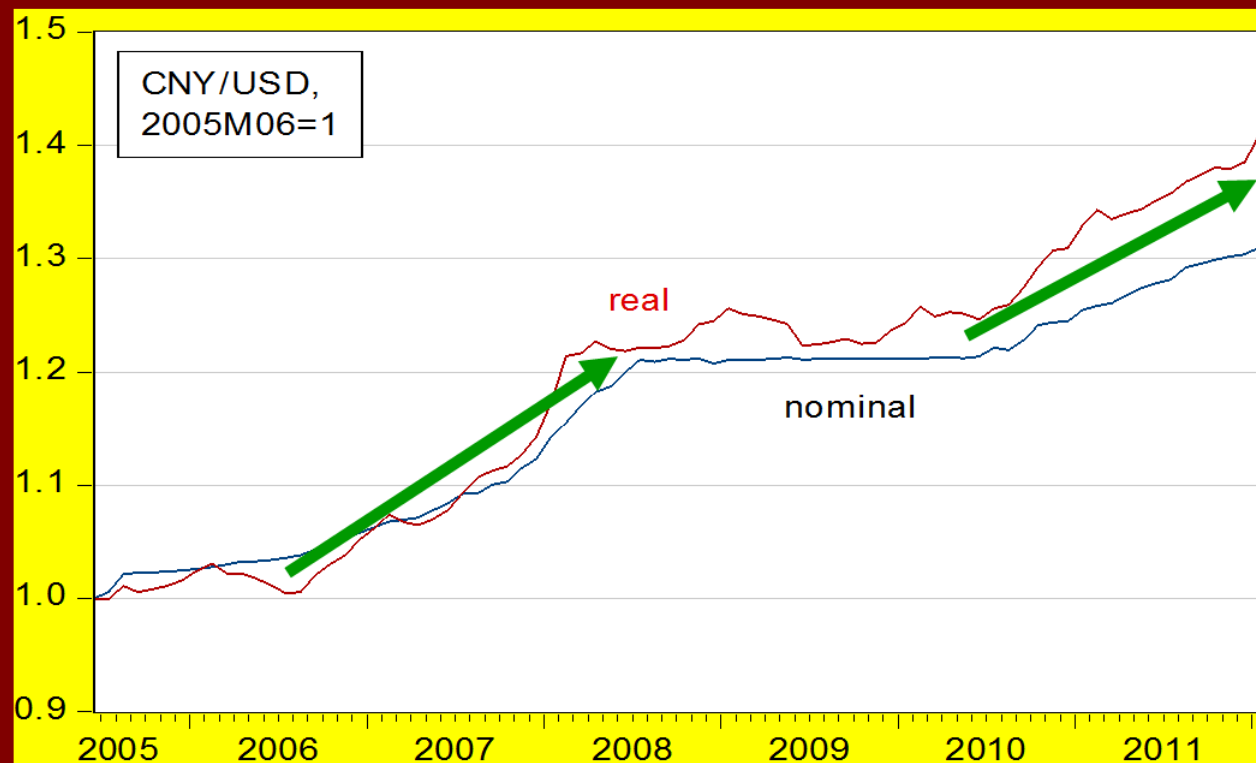


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- Typical “Dutch Disease” driven real appreciation has been relevant for commodity-oriented emerging markets (Russia, Brazil)
- China: a special case of managed exchange rate flexibility (basket peg instead of single currency peg : but also real appreciation until 2012)

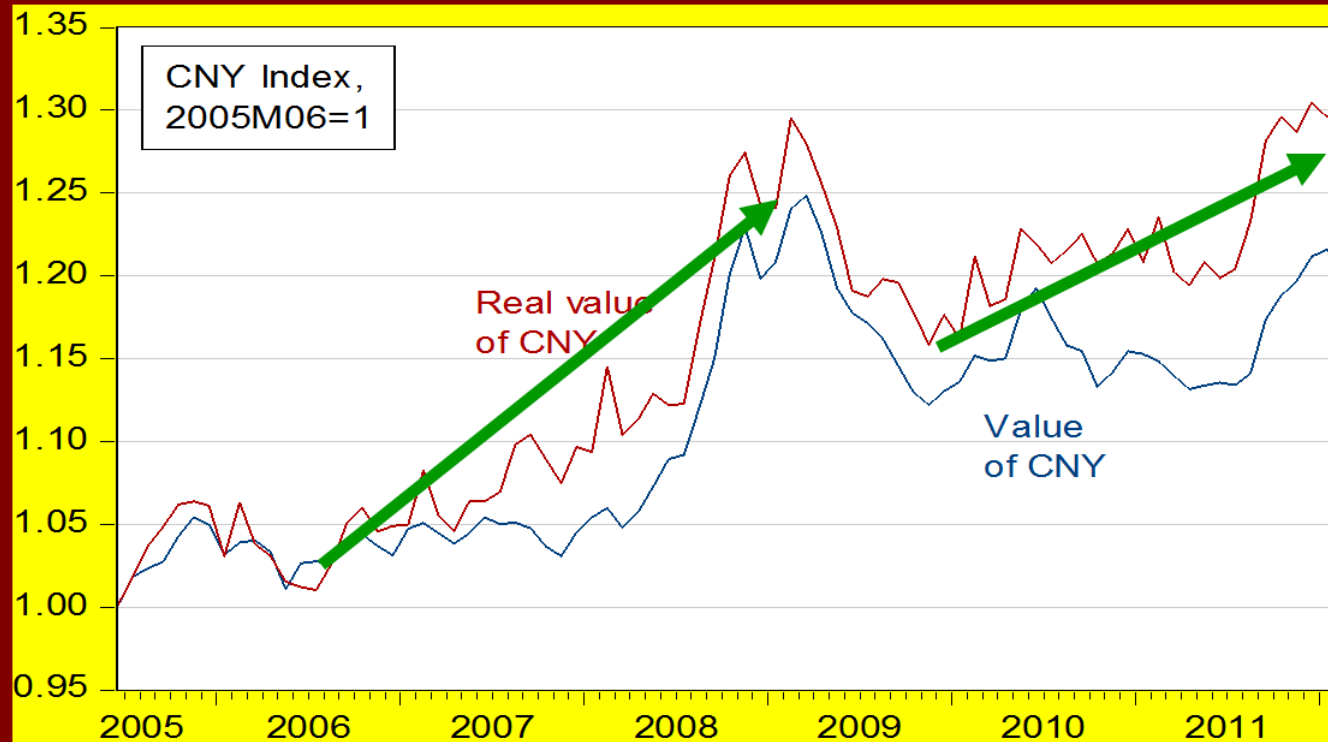
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## Appreciation versus the US \$, 2005-12



# The Downsizing of Growth in Emerging Markets: Cyclical, Structural, Real or Fictive?

## Appreciation vs. index of currencies, 2005-12



# The Downsizing of Growth in Emerging Markets: Cyclical, Structural, Real or Fictive?

## IV. Lower Growth: Equivalent to Middle-Income Trap?

- The middle-income trap is a fact. In the past, only very few countries achieved a jump to a stable high-income equilibrium
- As real income convergence within regions of countries seems to have declined, few regions in emerging markets have escaped the middle-income trap ( in China few coastal provinces, for instance)
- Lack of labor mobility (in China, the rural migrants worker registration system (Hukou), for instance) impede real income convergence among regions

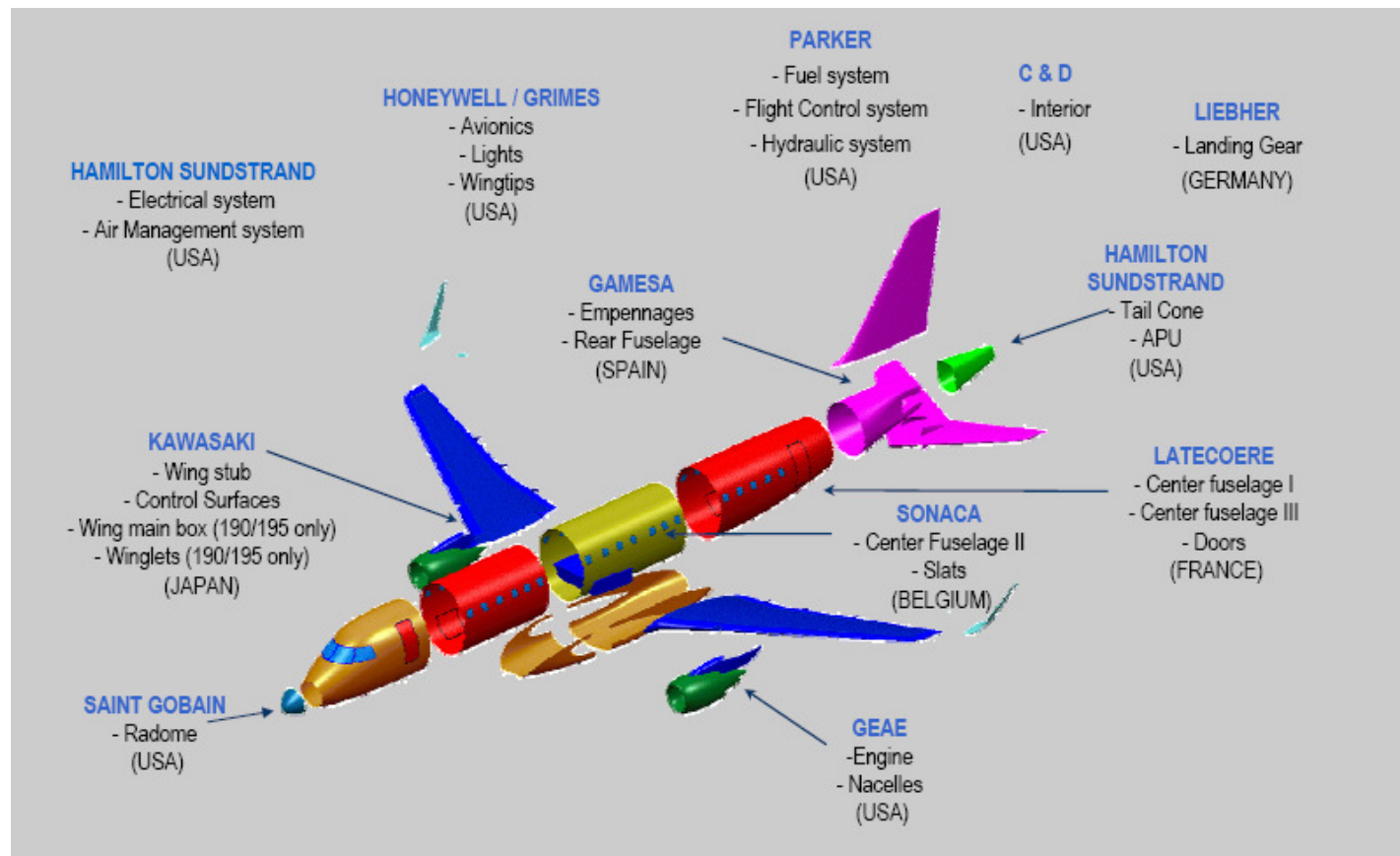
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## V. Trade as the Most Cyclical Factor in EM Growth

- Extending the cross-country supply chains has fuelled trade in intermediates and has also increased cyclical volatility
- For supply and demand reasons, cross-border supply chains widen over boom periods and shrink over recession periods
- Emerging markets in Asia are most exposed and vulnerable to cyclical changes in cross-border supply chains

# The civil aviation industry is one example of an international production network

## Some of Embraer's international suppliers for the production of aircraft in the ERJ 170-190 family



**Source:** P. Figueiredo, G. Silveira and R. Sbragia, "Risk sharing partnerships with suppliers: The case of EMBRAER", Journal of Technology, Management and Innovation, 2008, Volume 3, Issue 1.

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## VI. Conclusions

- The downsizing of growth in EM is real, normal and structurally driven. World economic growth in the years to come will be about 1 percentage point lower than in the 2000-2008 period
- Cyclical volatility comes from trade
- Real sector disturbances are partly rooted in the real exchange rate effect of unsterilized capital inflows and incoherent monetary policies of EM, primarily, however, in super-expansionary monetary policies of advanced economies of unprecedented length of time
- The transition to “normal” monetary policies could become costly for EM because of rising non-performing loans and overindebted parastatal constituencies (including municipalities)