Emerging market economies – an ever more important driver for the global economy

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* The views in this commentary represent those of the authors and cannot necessarily be attributed to Norges Bank.
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Growth has picked up again in the emerging market economies (EMEs) of Asia, and especially in China and India. Higher imports in these countries will contribute to higher GDP growth in the rest of the world, partly through trade balance improvements in advanced economies. However, consumption in the Asian EMEs remains relatively low. Most trade is within Asia, and exports to EMEs account for only a small share of advanced economies’ total exports. Although EMEs will contribute to higher growth in the rest of the world, they are not yet sufficiently large to alone drag advanced economies out of the current economic slump.

They are nevertheless expected to become ever more important for world trade and global growth. Favourable economic and financial balances, demographics and catch-up potential relative to advanced economies spell opportunities for further strong growth. If Asian EMEs are to fuel higher growth in the rest of the world, their growth will need to become increasingly domestically driven.

The outlook for the global economy in the wake of the financial crisis is one of low economic growth and high unemployment. Norges Bank projects growth of 1¼ per cent for Norway’s trading partners next year.1 For the world as a whole, the IMF is forecasting contraction of 1.1 per cent in 2009 and growth of 3.1 per cent in 2010.2 Growth in EMEs, especially in Asia, is expected to be higher. The IMF expects growth in advanced economies to remain moderate through to 2014.

In the short term, growth in the global economy is being driven largely by expansionary economic policies and a turnaround in the inventory cycle. The G20 countries have introduced economic support packages equivalent to 2 per cent of their GDP in 2009 and 1.6 per cent in 2010.3 However, this expansionary fiscal policy will gradually be phased out, and the effect from stockbuilding will fade. In the longer term, growth in the global economy will need to come from other, more sustainable sources. Higher private demand will be required as the effects of the public support packages fade. This commentary discusses whether EMEs will make a greater contribution to growth in advanced economies in the future.

Strong growth in EMEs in the past decade

Since the late 1990s, economic growth has been higher in EMEs than in advanced economies. Even during the financial crisis, Asian EMEs have combined recorded positive growth, whereas GDP has fallen in Latin America, Eastern Europe and the OECD (see Chart 1)4. Eastern Europe has been hit hard by the financial crisis and has contracted furthest.

EMEs and the OECD countries have mirrored one another in terms of growth in manufacturing production, but at different levels (see Chart 2). In the Asian EMEs, manufacturing production increased by 7.3 per cent from June 2008 to June 2009, while in the OECD countries it decreased by 14.5 per cent.

2 World Economic Outlook, October 2009.
3 Budgetary cost of crisis-related discretionary measures as a percentage of GDP relative to 2007.
4 The aggregates in the charts are based on data for the largest EMEs in each region. Asia: China, India, Indonesia, Malaysia, the Philippines and Vietnam. Latin America: Brazil, Mexico, Argentina, Colombia, Venezuela, Chile, Peru and Ecuador. Eastern Europe: Russia, Poland, the Czech Republic, Romania, Hungary, Slovakia, Slovenia, Bulgaria, Estonia, Latvia and Lithuania. Vietnam has been omitted from the aggregate in the charts for GDP and Vietnam and Ecuador from the charts for industrial production, in both cases due to a lack of data.

Sources: Thomson Reuters, IMF and Norges Bank.
EMEs are exposed to fluctuations in the rest of the global economy through variations in trade, financial flows and market confidence. The various regions have mirrored one another closely when it comes to trade, and 12-month export growth has been negative in all regions since November 2008 (see Chart 3). Although industrial production has increased in some regions, there are few signs of recovery in export growth. The downturn in trade has been exacerbated by reduced confidence between exporters, importers and their banks, and the availability of trade credit has declined since last autumn.

When world trade plummeted in autumn 2008, many expected EMEs to enter into a long and deep economic downturn, as growth in these countries over the past decade has been largely export-driven. However, domestic demand increased in some EMEs. In China, the easing of lending restrictions combined with large public support packages have led to record growth in investment and credit over the past six months (see Chart 4). Retail sales have also accelerated in China and other Asian economies in recent months.

Potential for strong growth in the coming decade

Key preconditions for economic growth include sufficient supply of labour and capital, and economic and political stability. A number of these factors may indicate further strong growth in EMEs in the coming decade.

A high proportion of the labour force in these countries is still employed in the agricultural sector. In 2008, 43 per cent of the labour force in China and 60 per cent in India were employed in the agricultural sector, compared to 0.6 and 5.6 per cent respectively in the US and the EU. The transfer of labour into manufacturing will continue to result in substantial productivity gains, as seen historically in advanced economies. It is expected that around 160 million people in China will migrate from rural to urban areas between 2005 and 2015. The labour force also accounts for a larger share of the overall population in EMEs than in advanced economies, and has grown rapidly in recent years and is expected to continue to grow.

As EMEs generally have labour-intensive production, there is much to be gained from technology transfer and new capital investment. Production technology in EMEs is still lagging behind advanced economies’ high-tech production methods. Substantial efficiency gains could, for example, be achieved through increased use of information technology in production.

1 CIA World Factbook.
Many emerging economies have high investment rates (see Chart 5). India and other EMEs have investment rates of more than 30 per cent of GDP, which is substantially higher than the rate of around 20 per cent for advanced economies. High levels of investment, especially in infrastructure and other productivity-boosting projects, are paving the way for further growth. The investment rate in China is no less than 40 per cent of GDP, which is slightly higher even than in Japan and South Korea during their periods of rapid growth and catch-up. In many EMEs, the financial infrastructure is not particularly well-developed. If banking systems and financial markets evolve further, the supply and distribution of capital could improve.

EMEs have made a number of structural changes that make them more robust than before. The external sector of the economy has improved substantially over the past decade. EMEs in Asia and the Middle East in particular have built up larger current account surpluses and foreign exchange reserves (see Chart 6), while foreign debt has been reduced. The share of borrowing in local currency has also risen, which may reflect the development of more stable financial systems. The EMEs of Eastern Europe depart from this picture, however, having seen a substantial deterioration in the current account even before the crisis.

The various factors cited above translate into catch-up potential relative to advanced economies and are therefore important factors for future growth. Purchasing power parity (PPP) GDP per capita is low in Asia (see Chart 7). If GDP per capita in the US is indexed at 100 in 2008, China and India have a GDP per capita of 13 and 6 respectively in 2008, and Russia and Brazil 34 and 22 respectively. Although the conditions are in place for continued rapid growth in Asia’s EMEs, there are limits to how fast an economy can expand. There may, for example, be bottlenecks associated with migration, infrastructure and supply of raw materials. It will therefore take time for the standard of living in EMEs to catch up. The OECD predicts that GDP per capita in China will be around 34 per cent of that in the US in 2030.7

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Could EMEs contribute to higher growth in advanced economies?

The four largest EMEs (Brazil, Russia, India and China, collectively known as the BRIC countries) have made a larger contribution to global economic growth since 2001 than the G7 economies. China is the country that has contributed the most during the period (see Chart 8). Growth in China has been largely export-driven. China’s share of global exports has increased over a number of years, and China exported roughly as much as Germany in 2008 (see Chart 10). India’s contribution to global growth during the period has been on a par with that of the euro area.

Based on purchasing power parity (PPP), EMEs and developing economies account for around 45 per cent of global GDP (see Chart 9). Excluding the BRIC countries, EMEs and developing economies account for as large a share of global output as the US. Measured in this way, the Chinese economy is roughly half the size of the US economy. According to the UN’s projections, China will surpass the US as the world’s largest economy between 2025 and 2030. When considering EMEs’ importance for advanced economies in terms of demand for their exports, it is more appropriate to use market exchange rates, as international trade is based on these rates. In terms of market exchange rates, EMEs and developing economies account for a third of global GDP.

![Chart 9 Share of world GDP 2008](image)

EMEs have contributed to increased purchasing power in advanced economies through low production costs and low prices for their export goods. In the future, it will increasingly be EMEs’ demand for advanced economies’ goods and services that will contribute to growth in advanced economies. Chinese imports have grown considerably in recent years, and China is now importing roughly as much as Germany (see Chart 10). A large share of Chinese imports comes from other Asian countries, which means that a relatively small share of advanced economies’ goods are exported to China. US exports to China grew by an average of 20 per cent per annum from 2000 to 2008, but still accounted for just 3.8 per cent of total US exports in 2008. Similarly, China accounted for only 4.2 per cent of the euro area’s total exports in 2008.

In the past, EMEs have been able to grow rapidly thanks to high exports to advanced economies – as reflected, for example, in China’s trade surplus, which tripled in USD terms in the period from 2005 to 2008 to around USD 300 billion, or more than 8 per cent of Chinese GDP. By way of comparison, the US ran a trade deficit of around 5 per cent of GDP in 2008. The IMF forecasts moderate growth in advanced economies over the next few years. If EMEs are to sustain the rates of growth they had before the crisis, growth will have to rely increasingly on domestic demand. Consumption in EMEs has grown at a rapid pace in recent years, but the household consumption

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8 Seven of the world’s richest countries: Canada, France, Germany, Italy, Japan, the UK and the US.
9 Purchasing power parity (PPP) exchange rates are calculated by finding the amounts of currency needed to buy the same quantity of goods in different economies. PPP exchange rates reflect differences in price levels between countries better than market exchange rates, because they also take account of price levels for goods and services that are not traded internationally.
10 This is based on estimated growth rates for the past 60 years: 4 per cent per annum for the US and 9 per cent per annum for China. Source: UN University press conference, “On Poverty, Growth and Inequality in China,” Department of Public Information, 5 June 2008, New York.
rate in China is still substantially lower than in advanced economies. GDP, consumption and imports per capita are very low in both China and many other EMEs. At the same time, many EMEs have large populations, which is very important for their overall demand. Together, China and India account for almost 40 per cent of the world’s population.

Higher domestic demand and increased imports will reduce Asian economies’ trade surpluses. If the Chinese trade surplus were to halve to around USD 150 billion, this would correspond to an increase in Chinese imports of around 13 per cent, assuming that Chinese exports remain at 2008 levels. If the whole of this increase in Chinese imports is attributable to goods and services from the US, total US exports would grow by 9 per cent. In isolation, this would improve the US trade deficit by around 25 per cent. Other things being equal, the direct effect would be an increase in US GDP of more than 1 percentage point.

Increased consumption in Asia will, however, require further structural reforms. The Chinese Renminbi (CNY) has been pegged to the USD and has been criticised for being undervalued. Appreciation of the CNY could make foreign goods relatively cheaper and result in higher imports. At the same time, a poorly developed social safety net means that the saving rate in China is very high relative to other countries. Pension and social security schemes, stronger labour protection legislation and support for education could help to reduce saving. In 2008, China proposed a new social insurance law covering health, unemployment and maternity. This proposal is a step towards the development of a social safety net.

Rapid economic growth and urbanisation have resulted in large regional discrepancies in infrastructure and average income per capita, as well as growing disparities between urban and rural areas. The rural population accounts for 60-65 per cent of the total population in China, but for just 10 per cent of China’s total GDP. Imbalances of this kind can lead to social unrest, while weak property rights, environmental problems and limited access to energy may also restrain growth.

EMEs have considerable catch-up potential and are expected to continue to contribute to higher growth in the rest of the world in the coming years, but they are still not sufficiently large to alone drag advanced economies out of the current economic slump.

11 Household consumption accounted for 33 per cent of GDP in China in 2006, compared with 70 per cent in the US and 67 per cent in Japan (World Bank World Development Indicators).
12 China’s trade surplus has already shrunk by 25 per cent so far this year relative to the same period last year, due to reduced exports. During the same period, the US trade deficit has improved by more than 50 per cent.
13 For more information, see http://www.mallesons.com/publications/2009/Jan/9770887w.htm