Ashmore

The High Income Trap

By Jan Dehn

Introduction

Emerging Markets (EM) now account for more than 50% of global GDP and there are nearly three times as many EM countries as developed economies in the world. EM has achieved impressive convergence with richer countries over the past 25 years.

Still, what is all that wonderful progress worth if the convergence is unsustainable? Did EM countries advance by cyclical rather than structural means? Or are EM countries about to crash into the so-called Middle Income Trap[1], the notion that countries face growth challenges as they approach higher income status?

In this *Emerging View*, we give economic convergence a health check. The convergence argument remains one of the central pillars underlying the case for investing in EM. We find that convergence is in good health and that EM countries have achieved their current strong fundamental position mainly through structural improvements rather than cyclical drivers.

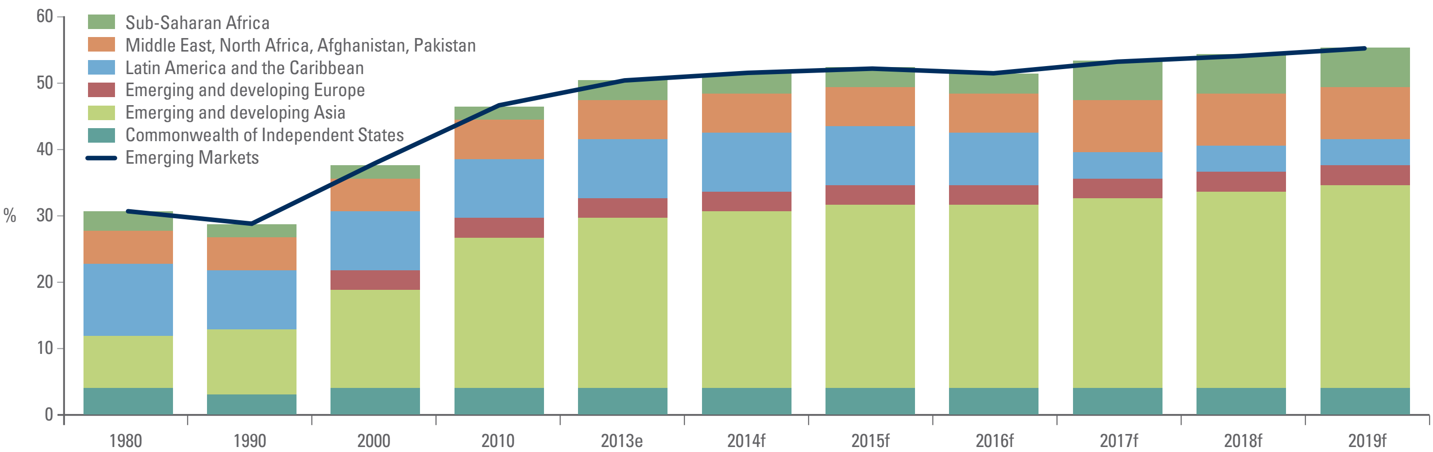
We also find that the so-called Middle Income Trap is a myth. Indeed, we see more evidence of a High Income Trap, meaning progressively lower growth rates within the group of higher income countries. This seems plausible: developed economies believe their debts to be risk free, have rigged the global regulatory system accordingly and the resulting excessive issuance gradually undermines their growth, and ultimately leads them to pursue investor unfriendly solutions, such as inflation and devaluation.

Revisiting the EM convergence argument

The convergence argument is of central importance to the case for investing in EM countries. It says that poor countries grow faster than rich countries, because they have less capital. Capital flows to EM in search of higher returns, which allows EM countries to realise higher growth rates, provided policy conditions are OK (conditional convergence). How is convergence doing?

Emerging Markets countries have managed to grow successfully even as their per capita incomes reach middle income status. The real growth challenge is faced by high income countries.

Fig 1: **EM now accounts for the majority of global GDP (PPP adjusted)**



Source: IMF WEO April 2014, Ashmore.

[1] The World Bank defines middle income as per capita incomes which range from USD 1,036 to USD 12,615.

EM countries now account for more than 50% of global GDP. This growing economic role is the result of a spectacular process of economic convergence that began with the end of the Cold War in 1989. EM per capita incomes tripled in real terms between 1989 and 2013. At the median, the 126 middle income EM countries for which we have data saw their per capita incomes rise by 382% between 1989 and 2013. This compares to per capita income increases of 225% for low income countries and 219% for high income countries over the same period.

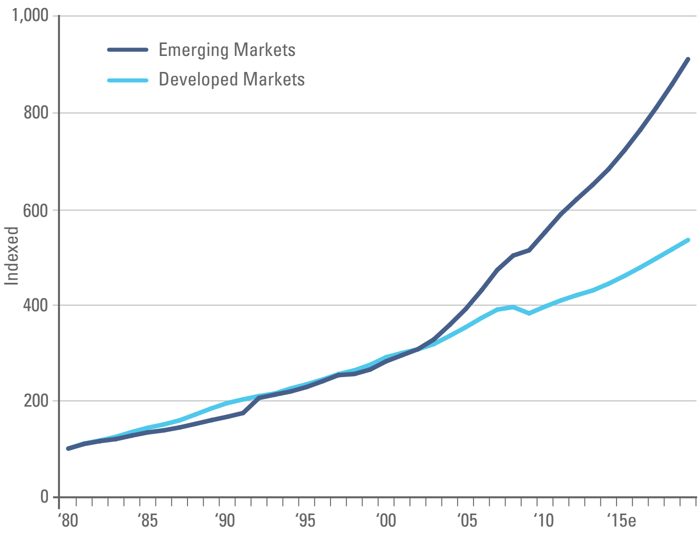
Fig 2: **Median per capita income by income category**

		Median			Coefficient of variation	
Income type	Number of countries	1989	2013	Change	1989	2013
High	27	17,219	37,881	220%	26%	30%
Middle	126	9,921	37,881	382%	126%	97%
Low	33	583	1,315	226%	37%	38%

Source: IMF WEO April 2014, Ashmore.

According to the IMF's own data, the convergence story is far from over. The IMF's latest forecasts (covering the five years to 2019) suggest that the convergence will continue in the next five years. Indeed, based on the IMF's current projections, EM countries are set to increase their share of global GDP by 0.7% per year in the next five years compared to 0.6% per year in the preceding 33 years. IMF forecasts that EM's share of global GDP will reach 54.4% by 2019.

Fig 3: **Convergence is on track (GDP PPP per capita, index 1980=100)**

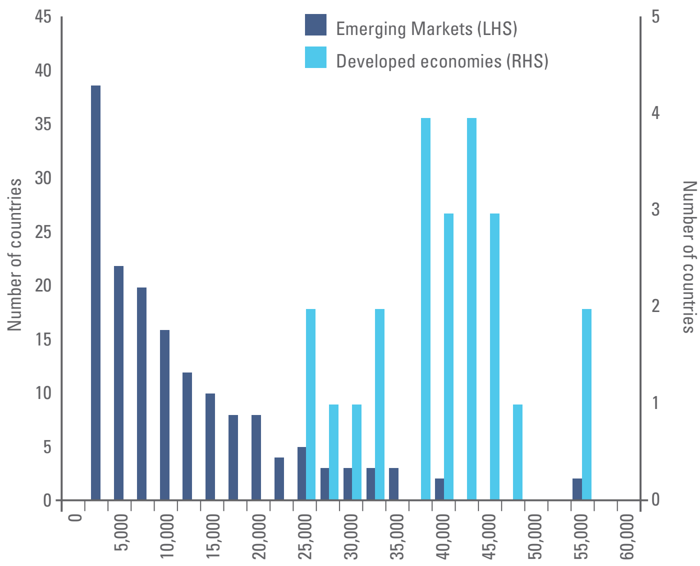


Source: IMF WEO April 2014, Ashmore.

There is no Middle Income Trap

Despite the bi-modal distribution of per capita, we do not believe there is evidence of a Middle Income Trap. Firstly, the bulk of EM countries find themselves in middle income simply because they started out with very low per capita incomes and have yet to reach the higher income threshold. For example, in 1989, nearly 80% of all EM countries had per capita incomes below the middle income threshold and 60% had per capita incomes two thirds or less than the threshold.[2] Starting out with such low incomes, it is not surprising that many EM countries still find themselves in the middle income range today.

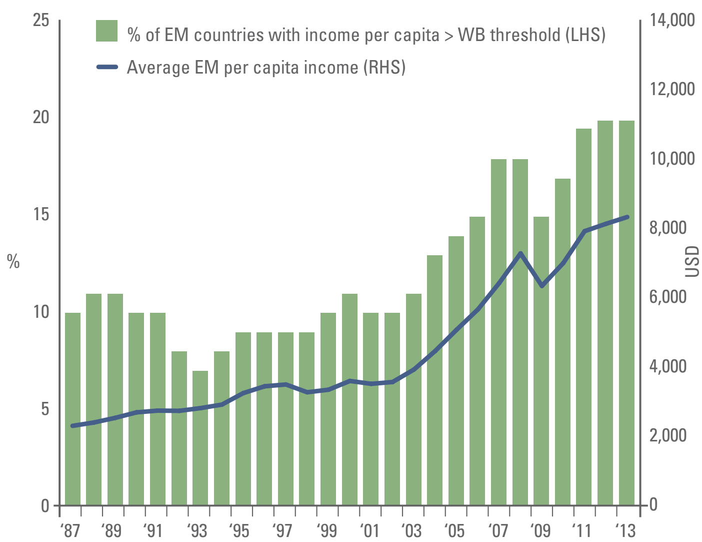
Fig 4: **Distribution of EM and developed countries' per capita incomes (2013 constant international Dollars)**



Source: IMF WEO April 2014, Ashmore.

Secondly, relatively better off EM countries have broken through the middle income ceiling once they reached it. 22 EM countries escaped middle class status outright between 1990 and 2013 and, unsurprisingly, it appears to have helped if they had access to financial markets, because 21 of the countries in the JP Morgan EMBI index are countries which have graduated from middle income status since 1993 (36% of the index members). At this pace, the EMBI index will only have high income countries by 2052.[3]

Fig 5: **EM countries have 'escaped' middle income at a decent clip**



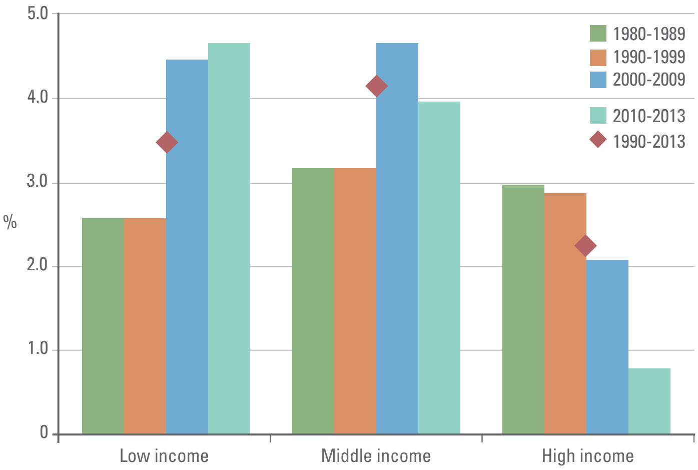
Source: World Bank (WB), IMF WEO April 2014, Ashmore.

[2] The World Bank's per capita income threshold was USD 6,000 in 1989.

[3] This is one reason why JP Morgan recently increased the per capita income threshold for graduating out of the EM asset class to more than USD 17,726.

Finally, EM countries manage to grow well within the middle income group. EM growth rates in this group have increased over time and have been consistently higher than growth rates in high income countries.

Fig 6: **Average real GDP growth rates (% change per year) – global sample**



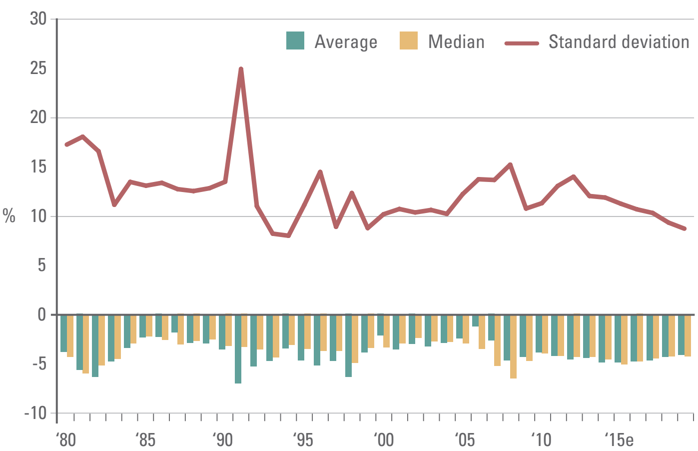
Source: IMF WEO April 2014, Ashmore.

Were the convergence gains in EM cyclical or structural?

As we have noted elsewhere, EM countries have seen their share of global finance reduce in the years since the subprime crisis and particularly since QE policies began.[4] This already suggests that growth has been driven by structural factors, not short-term cyclical drivers. This view is also supported by a broader range of economic indicators across EM. In the following section, we briefly review key macroeconomic indicators for the largest number of EM countries possible. We deliberately look beyond simple averages to medians and standard deviations in order to also give an impression of the diversity of performance across the EM universe.

- External balances: The average EM current account balance has oscillated by no more than 2% of GDP in the past 25 years since 1989. At the median, the variation has been even smaller at just 1% of GDP. Variation across EM countries has been remarkably stable, peaking in the early 1990s and currently sitting near historical lows. This suggests that markets focus too much on current account imbalances; the evidence here suggests that EM countries address external imbalances well before they get excessive.

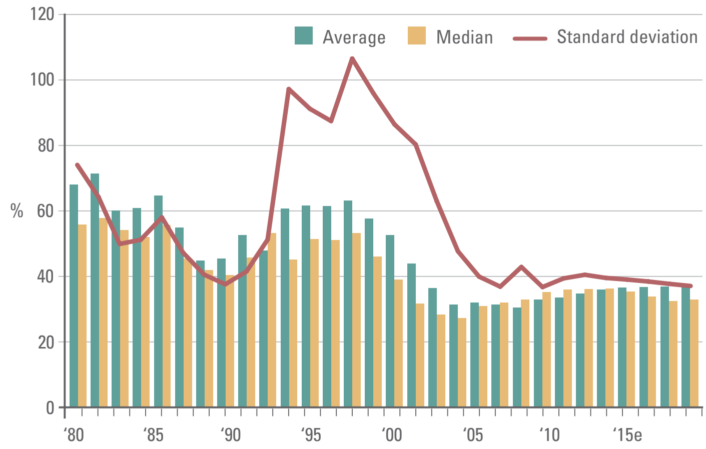
Fig 7: **Current account balances (% of GDP) – sample of 162 EM countries**



Source: IMF WEO April 2014, Ashmore.

- Government Debt: Net government debt in EM has halved since 2000. At the median, debt has fallen by one third to around 35%. The distribution of debt levels has become much less skewed, implying that EM countries as a group have become more closely clustered around a much lower level of debt. The variation across EM is close to all-time low levels.

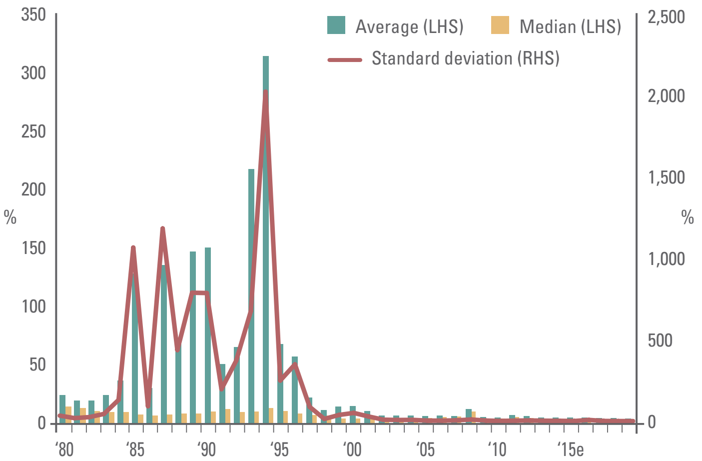
Fig 8: **General Government net debt (% of GDP) – sample of 75 EM countries**



Source: IMF WEO April 2014, Ashmore.

- Inflation: EM inflation has collapsed. Averaging 147% across EM countries in 1989 and rising further, by 2000 the average inflation rate was down to 15%, and today inflation in EM averages just 4.9%. Over the same period, the standard deviation of inflation collapsed from 795% to just 6%. It would appear that an almost uniformly held consensus exists that inflation is unacceptable. We think this can only be explained in political terms.

Fig 9: **Inflation (% per year) – sample of 164 EM countries**



Source: World Bank, IMF WEO April 2014, Ashmore.

- Investment: Investment rates have been extremely stable across EM countries at approximately 22-24% of GDP over the past quarter of a century. Average and median investment rates are almost identical, have risen slightly over time, while standard deviations across the 149 countries in the sample have declined marginally.[5] The stability of the investment rates suggests that structural rather than cyclical drivers may have been behind EM's growth performance and market developments since the end of the Cold War.

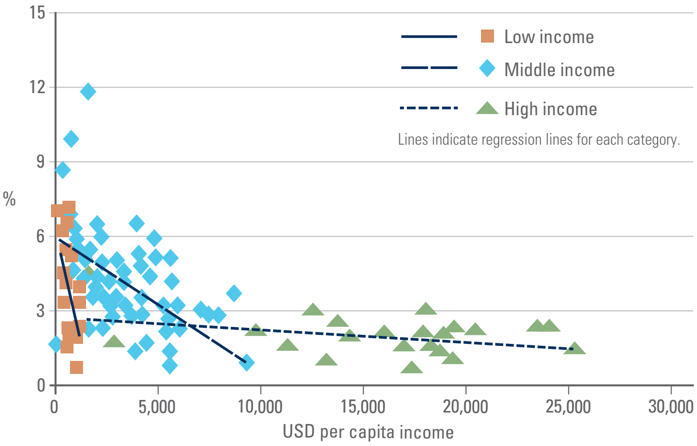
[4] Financial Divergence, The Emerging View, May 2014.
[5] Source: IMF WEO April 2014, Ashmore.

- **Real GDP growth:** At 3.6%, the average growth rate across all EM countries is only marginally higher than it was in 1989, but the variation across EM has declined significantly (standard deviations have almost halved). The averages obviously conceal important differences across countries along income lines and across time. We think that EM countries are growing very close to their trend growth rates, suggesting no major systemic cyclical departures from trend across the EM universe.

If not cyclical drivers, then what drove EM forward?

It is encouraging that cyclical drivers do not appear to have been behind EM's performance over the past 25 years but if so, what caused EM to catch up so strongly? Without belittling in any way the challenges faced by individual EM countries under specific circumstances and at particular times, the general motor behind EM's convergence appears to be EM's low starting per capita income. The relationship between starting per capita income and subsequent growth is strong and pronounced, not only across income classes but also within individual income classes, although the lowest income countries have not grown the fastest, which is probably due to their lack of access to finance.

Fig 10: **Average 1990-2013 growth rate versus 1990 per capita income: By income category**



Source: IMF WEO April 2014, World Bank, Ashmore.

Conclusion

There have mainly been structural rather than cyclical drivers behind EM's growth over the past 25 years. EM borrowers have not gorged themselves on cheap credit despite 30 years of falling global interest rates and greater access to international capital. EM countries have been able to grow without sharply higher investment rates or without widening their external deficits. EM countries have achieved convergence at a rapid pace in spite of, or rather because of, declining debt levels and falling inflation rates. And the improvements have been broad-based rather than driven by a few outliers within EM.

The Middle Income Trap is a myth. EM countries grow well as middle income countries and graduate to high income countries with apparent ease. If there is any trap, it would appear to capture high income countries. This is probably because high income countries have stimulated their economies by issuing even more debt over the last quarter of a century to the point that their growth rates now appear to be in secular decline.

Yet, banks and the media continue to depict the world as a binary place of 'risky' EM countries and 'risk free' developed economies. This is a false dichotomy. All countries co-exist on a continuum of per capita income and financial market development. The ability of each country to advance depends on the quality of its economic policies. For sure, EM countries have idiosyncratic risks, but there are many of them and they are highly diverse and pay investors for the risk. High income countries are not only more expensive, they also look frighteningly alike as most still face the enormous challenge of how to deal with their excessive debt levels. It is increasingly difficult to justify a view that EM and developed markets can be divided along risk lines as the reality, in our view, is that the situation is changing fast.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations

Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper