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Convergence, global imbalances, and the role of infrastructure in EM

The macroeconomic case for Emerging Markets infrastructure

By Jan Dehn

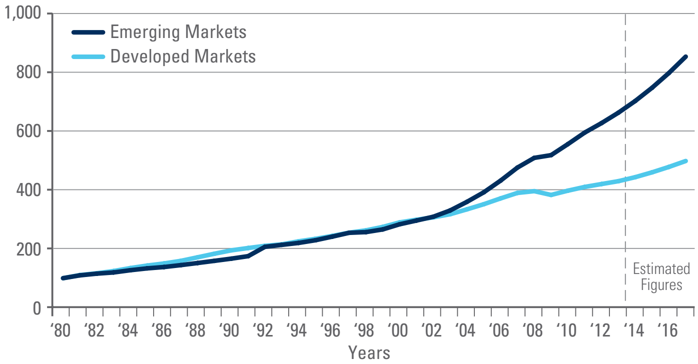
Many Emerging Markets are beginning to exhaust 'low hanging' sources of growth as they approach middle income status.

The unwinding of the global imbalances in the coming years will also require Emerging Markets to change their growth strategy away from exports to more domestic growth sources. These structural and cyclical headwinds are inevitable and in overcoming them Emerging Markets will have no choice but to adapt. Adapting requires not just greater economic flexibility, but also more investment and a more efficient use of capital. Infrastructure investment will play an important role within this process, alongside capital market development and supply-side reforms. How well each individual Emerging Market adapts to the new global reality will largely determine who succeeds and who does not.

The gradual re-emergence of structural growth challenges in Emerging Markets

Emerging Markets have experienced rapid absolute and relative income convergence with richer countries over the past 15 years. Their strong performance over this period was made possible by the dramatic economic and political improvement, which took place in the 1990s following the end of the Cold War in November 1989.[1]

Fig 1: **GDP per capita (rebased, 1980=100)**



Source: World Economic Outlook, IMF.

Emerging Markets were able to grow strongly for the most part simply by adopting sensible macroeconomic policies, such as prudent fiscal policies, inflation targeting, flexible exchange rates, reserve accumulation, and by setting up pension systems. So great was the latent growth potential within Emerging Markets that few if any supply-side policies were necessary.

But many Emerging Markets are now entering into a stage of their development, where they begin to face fresh challenges on their path of convergence to rich country status.[2]

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First, many Emerging Markets countries are exhausting the scope to grow strongly simply by using up slack (underutilised factors of production). An analysis of the reasons for strong Emerging Markets convergence in the past 15 years shows that it was achieved mainly through the adoption of better macroeconomic policies. But this is an improvement you only make once.[3]

Second, many Emerging Markets simply need to invest more. Countries which have successfully transitioned to high income status have typically invested between 30%-40% of GDP during the stage where their GDP per capita was in the range from $2,000-$15,000. Today, the Latin American average investment ratio is around 22% of GDP. Eastern Europe is about 21%. Asia is 37%. The average in Emerging Markets is 32%.

Thirdly, some Emerging Markets are now approaching the so-called 'Middle Income Trap', a tricky stage in the growth process, where growth drivers change from factor accumulation to total factor productivity growth.[4]

Finally, as their economies gain sophistication and they invest more in machinery and engineering than buildings and basic structures, technical progress becomes more important as a growth driver in Emerging Markets. This greater sophistication combined with greater resource scarcity means that capital intensity inevitably increases.[5]

While these challenges do not pose imminent threats to growth in Emerging Markets they do suggest that Emerging Markets will have to change. They will have to become more flexible so they can adjust quickly, and they will have to invest more efficiently in order to continue to grow strongly.

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1 See discussion of the importance of the end of the Cold War in *"Convergence in the time of imbalances"*, The Emerging View, November 2012.
2 Offsetting this effect somewhat is the large number of new Emerging Markets issuers from the Frontier Markets. They tend to have much lower income per capita and are therefore less prone to the challenges considered here – see *"Price and Prejudice"*, The Emerging View, March 2013.
3 "On The Convergence Road", Global Economics Paper, Number 217, Goldman Sachs, December 19 (2012).
4 See *"Growth slowdowns and the Middle Income Trap"* by S. Aiyer, R. Duval, D. Puy, Y. Wu, and L. Zhang, IMF Working Paper, March 2013.
5 *"How To Capitalise On Rising Capital Intensity"*, Fortnightly Thoughts, Goldman Sachs, April (2013).

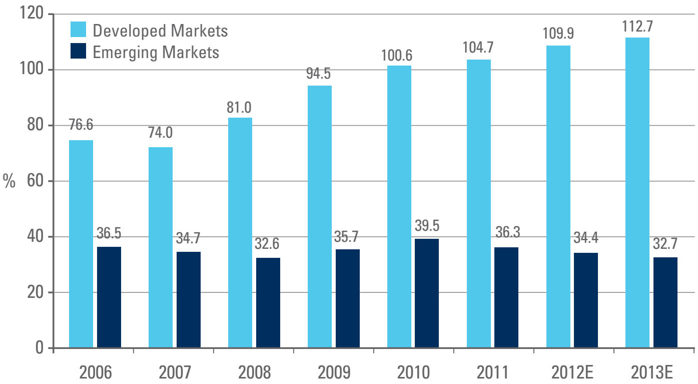
More immediate cyclical challenges

The global economy is a state of deep and stubborn disequilibrium as evidenced by very low interest rates, very low growth rates, and very low inflation rates despite high stocks of debt and extremely easy monetary policy. Even so, some of the HIDCs (Heavily Indebted Developed Countries) are slowly healing, and within the next couple of years we expect both growth and inflation to return as the most serious structural drags on HIDC growth begin to ebb.

The return of growth and inflation will bring the world face to face with the issue of HIDC debt – a subject it has been able to ignore on account of still very low interest rates. But HIDC debt will be impossible to ignore once debt service costs begin to rise.

Indeed, the question at the heart every debt crisis the world has ever known is always the same: Who is going to pay? Those who borrowed too much or those who lent them the money?

Fig 2: **Gross government debt (% GDP)**



Source: World Economic Outlook, IMF.

The answer to this question is of course intensely political. Will the HIDC governments inflict pain on their own populations with years of fiscal austerity and high real interest rates, or will they seek to pass some or all of the cost onto future generations and foreigners?

Historically, developed economies have not defaulted outright on their debt. Instead, they have defaulted by devaluing their currencies and inflating away the real value of their obligations. Today's HIDCs are already following this pattern again: Japan is openly engaged in currency manipulation. ECB is talking about negative interest rates. And a correction of the US Dollar is likely once inflation returns. We believe this will happen around the middle of this decade as a result of the dovish stance likely to be adopted by the Fed at that point.[6]

Emerging Markets exporters benefitted from excess demand in the HIDCs. Not only is that demand now going to be weaker, but the use of inflation and devaluation by the HIDCs to exit their excessive debt burdens will also pose broader macroeconomic challenges to Emerging Markets, including:

- Rising nominal yields and weaker HIDC currencies will erode the value of foreign exchange reserves unless Emerging Markets central banks diversify away from HIDC exposures. Fewer reserves will require Emerging Markets to restrain their domestic demand if they wish to retain the same degree of control over exchange rates as they have today.
- Stronger Emerging Market currencies will make it harder to export. Emerging Markets must therefore turn more to domestic demand if they wish to maintain current growth rates. But such transformations typically usher in a transition period with softer growth.
- Opposition to currency strength from squeezed exporters and voter dissatisfaction with lower growth risks raising the overall level of political noise.
- Slower economies and stronger currencies will translate into lower inflation, which means that central banks will cut rates further – the unwinding of global imbalances is disinflationary for Emerging Markets but good for local currency bond markets.

China is an excellent example of what to expect: China's transition to domestic demand led growth is involving all of the above – weaker growth, lower inflation rates, narrower external surpluses, and rising domestic political noise.

Again, the conclusion is the same as for the longer-term challenges: Emerging Markets will have to change. They will need to make their economies more flexible so they can adapt, and they will need to increase their productivity.

Flexibility: The return of supply-side policies[7]

Addressing permanent problems with short-term fixes is akin to peeing in one's pants to keep warm. For example, seeking to replace a loss of export momentum resulting from a permanently stronger currency with fiscal stimulus of the domestic economy without also addressing the supply-side of the economy merely results in inflation and/or unsustainable current account deficits. Similarly, resisting currency appreciation with central bank intervention and controls if the currency adjustment is permanent only creates inflation and/or bubbles, besides undermining business confidence. Either way the result is weaker growth.

The starting point for policy-makers should therefore be to recognise the inevitability and the permanence of the global adjustments that are about to occur. The good news is that the right policies can significantly ameliorate the difficulties of the coming transition. Measures to increase flexibility can help economies transition from export-led to domestic demand-led growth smoothly by enabling resources to move quickly from less to more productive uses. The potential damage is greatest if no action is taken, so the prudent approach is to act, and to act early. Most Emerging Markets are likely to make the required adjustments, because losing growth momentum in a meaningful way is simply not politically sustainable in most Emerging Markets, where governments are now regularly called to account to domestic populations, which have little if any access to inflation hedges, unemployment benefits, or other means of hedging macroeconomic volatility.[8]

Even so, Emerging Markets is a universe of some 160 countries and each is unique and will respond in its own way. Some are already on the right track and others will get there, some will get there late, and others yet will not get there at all. Global capital flows will disproportionately be available to those that make the right policy choices. And vice versa.

[6] See, *"Disequilibrium and the Dollar"*, The Emerging View, May 2013.
[7] Supply-side reforms were a key feature of the so-called Washington Consensus in the 1980s.
[8] Domestic political accountability is a crucial difference from the Cold War period.

Productivity enhancement: The role of infrastructure

Measures to raise productivity reduce production costs in the private sector. They make it possible to increase domestic demand in the face of headwinds to exports without running into capacity constraints. This in turn reduces inflation risks and preserves the integrity of external balances. And of course they directly help exporters to maintain competitiveness even as currencies rise.

Infrastructure investment plays an important role within a broader package of productivity enhancing measures, which, in addition to the supply-side measures discussed in the previous section, should have three core elements:[9]

- Domestic corporate bond markets
- Private infrastructure investment
- Public infrastructure and education

In the private sector in Emerging Markets, the main challenge is usually not a lack of good investment opportunities. Rather, the problem is how to identify sufficient financing. Until recently only governments were able to tap global capital markets. This is now changing, but capital is still only just beginning to flow into the sub-investment grade sector, while term financing for small and medium sized companies is still hard to come by. Global banks are scaling back and local banks are often not equipped to replacement them. The biggest bang for the buck is likely to be realised by helping to unlock large-ticket, long-term investment space. This space can best be reached by developing the domestic corporate bond markets, particularly in local currency. For utility-type investments, such as private road, ports, and energy the best way forward is by encouraging private infrastructure financing.

[9] Infrastructure is identified as a significant cause of slowing growth in Middle Income countries is *"Growth slowdowns and the Middle Income Trap"* by S. Aiyer, R. Duval, D. Puy, Y. Wu, and L. Zhang, IMF Working Paper, March 2013.

What are the most important challenges?

First, the financing needs are substantial. As mentioned earlier, sections of Emerging Markets need to boost their investment ratios by a whopping 10% of GDP. This is well beyond what can be realistically be financed and executed by governments. Investment of this scale can only be financed with the involvement of large pools of capital, many of which are from overseas. Governments should therefore stop blocking inflows of capital from global capital markets. Many foreign pools of capital are currently heavily exposed to HIDC debt, which is likely to inflict substantial losses in the future. The challenge in order to get this money to flow into Emerging Markets infrastructure involves overcoming both prejudice and, more recently, regulatory impediments. One opportunity to push on this front is to support the UK's push within the G8 to ease the regulations for HIDC pension funds to investment more in Emerging Market infrastructure. Other financing targets should include Sovereign Wealth Funds, the recently established BRICS bank, and Emerging Markets pension funds all of which require long duration yielding assets.

Finally, Emerging Markets governments need to exercise strong leadership. Governments keen on infrastructure are often motivated by political objectives and end up promoting bad projects. Governments fearful of infrastructure investment often over-regulate to the point that too few projects make it. Weak governments give in to vested interests and corruption. What is needed is strong enlightened government. A strong enlightened government realises it is not very good at picking projects, managing them, or even financing them. A strong enlightened government realises that inflows are a blessing and that their challenge is to enable these flows to find their most efficient use within the economy. A strong enlightened government recognises that the best way forward is to adopt good objective standards and clear, stable regulatory framework, and then to get out of the way so that the private sector can get on with the work at hand.

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