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MARKET COMMENTARY

Convergence, Big Time!

By Jan Dehn

A new study shows strong empirical evidence in favour of Emerging Markets (EM) economic convergence, which is arguably the single most important fundamental rationale for allocating to the EM asset class. This report explains why convergence is strong in EM and why convergence is likely to continue.

There is strong new empirical evidence in favour of economic convergence between poor and rich countries; convergence is one of the main fundamental rationales for investing in EM

Strong evidence in favour of economic convergence

A new academic study provides strong empirical evidence in favour of economic convergence.[1] Dev Patel, Justin Sandefur and Arvind Subramanian show that since the mid-1990s the gap between per capita GDP in poor and rich countries has closed faster in countries with a lower starting point for per capita GDP. This implies strong convergence between poor and rich countries. The paper also shows that the so-called middle-income trap, a hypothesis that seeks to explain why convergence stops when countries reach middle income, lacks empirical support. Ashmore has argued for some time that the thesis of a middle-income trap is wrong.[2]

The reason why convergence matters

Why does convergence matter? Of all the fundamental reasons for investing in Emerging Markets (EM), none is more powerful than so-called economic convergence. The theory of economic convergence is an extension of the Solow model of economic growth, which forms the very backbone of all theories of economic development. Convergence theory states that poor countries should grow faster than rich countries, because they have lower capital to labour ratios. Therefore, returns to capital should be higher and capital should flow from rich to poor countries. The result is a gradual equalisation per capita GDP between poor and rich countries. Conditional convergence is a variation on the theme, which holds that convergence is conditional upon the quality of economic policies.

Academics lag EM investors

EM specialist investors have been acutely aware of the existence economic convergence for some time.[3] Firstly, the growth evidence was becoming quite compelling. Consider Figure 1, which shows per capita GDP for developed markets (DMs) and EM countries between 1980 and 2023 (based on actual data up to and including 2017 and IMF forecasts out to 2023). It is possible to identify three distinct phases in the evolution of relative capita GDP in EMs and DMs over this period:

1. Cold War:
   Up until the early 1990s, Superpower-sponsored dictatorships were the norm in EM countries.[4] During this period, per capita GDP declined outright in EM economies relative to per capita GDP in developed economies. This observation, which was directly contrary to the predictions of the Solow growth model, sparked a mass of empirical literature, which sought to explain why EM countries could not achieve their true growth potential. As far as we know, none of the studies stressed the importance of the Cold War per se, but many studies highlighted the importance of political instability and economic volatility.[5]

[1] See: https://www.cgdev.org/blog/everything-you-know-about-cross-country-convergence-now-wrong
[2] See: '*The High Income Trap*' The Emerging View, June 2014.
[3] For example, see: *'Is the Cold War coming back?'*, Weekly Investor Research, 15 February 2016, and *'Convergence, global imbalances, and the role of infrastructure in EM'*, The Emerging View, June 2013.
[4] During the Cold War there were dictatorships is nearly all African countries, most South American countries, all of Eastern Europe, and large parts of Asia.
[5] Yours truly did his doctorate on this question, but Lant Pritchett, a former World Bank economist, now at Harvard, made a far more important contribution. His 1997 paper '*Divergence, Big Time*' was a key motivation for many of the studies in this class of research. For more details, see Pritchett, Lant (1997) '*Divergence, Big Time*', *The Journal of Economic Perspectives*, Vol 11, No. 3, Summer 1997, pp. 3-17.

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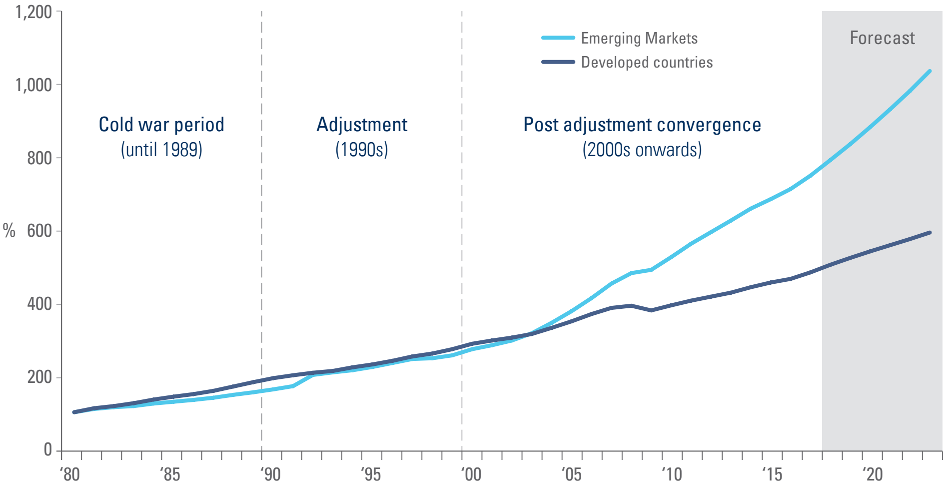
2. Adjustment:
   The immediate decade following the end of the Cold War was characterised by deep economic and political reforms in numerous countries across all regions of EM. During this period, EM per capita GDP expanded at roughly the same rate as in DMs. While EMs were no longer growing slower than DMs, the lack of even stronger growth in EM was probably due to the disruptions to growth caused by deep reforms.

3. Convergence:
   As the political and economic adjustment after the Cold War neared completion by the early 2000s, per capita GDP in EM countries began to expand at rates, which are clearly much faster than in DMs as predicted by convergence theory.

The end of the Cold War in 1989 was instrumental in bringing about convergence, although its full manifestation did not materialise until the early 2000s

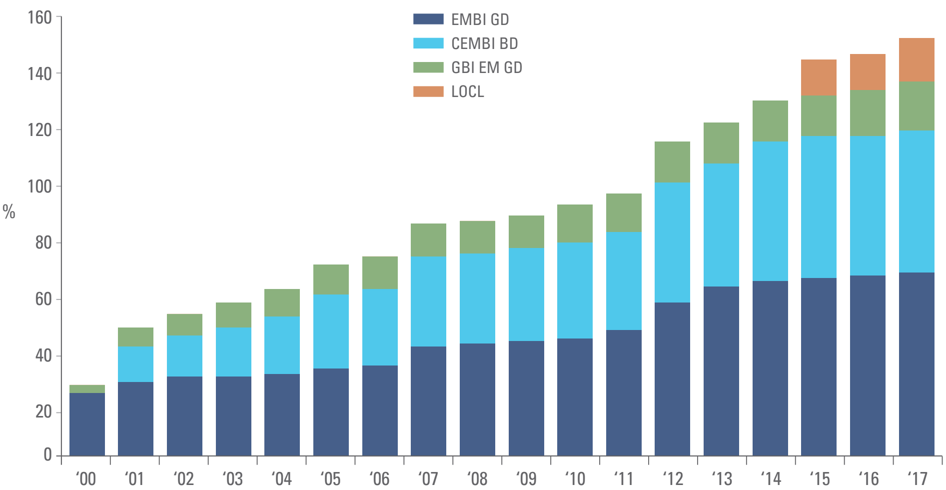
Fig 1: **Economic convergence (per capita GDP, index 1980=100)**



Source: Ashmore, IMF.

The second reason why EM investors have been convinced of the existence of convergence is that they, more so than academics, have paid attention to the rapid pace of financial sector development across EM. Figure 2 illustrates this point. The number of EM fixed income markets formally represented in the most commonly used EM fixed income benchmark indices has increased from just 25 markets in 2000 to 156 markets today. The EM bond market has grown from USD 2.6trn in 2000 (6% of global fixed income) to USD 24.3trn today (22% of global fixed income). Needless to say, economic convergence and financial sector development are closely related in EM countries, which despite the growth in EM financial markets, remain severely finance constrained.

Fig 2: **Number of EM fixed income markets represented in benchmark indices**



Source: Ashmore, ICE, JP Morgan.

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Despite rising Cold War-like tensions between the US and some large countries, there is no realistic chance of a resumption of the Cold War of old due to economic and political constraints

Why was the Cold War so important to convergence?

Undoubtedly, a vigorous debate will now erupt in academic circles about the causes of economic convergence. Our view on this question is very clear: the end of the Cold War in 1989 was the decisive factor behind EM economic convergence. The end of the Cold War explains both the intense period of economic and political reforms in EMs in the 1990s as well as the eventual acceleration in growth in EM countries by the early 2000s.

The reason why the end of the Cold War had such a profound effect on EM is that it marked the start of total regime change on a vast scale across most of the EM universe. Governments in EM changed from unaccountable Superpower-sponsored dictatorships towards locally elected administrations. This change was significant for two specific reasons. Firstly, locally elected governments are naturally more accountable to local populations. Secondly, local populations, by dint of living so close to the poverty line, have strong preferences for stability and growth. Hence, governments had to pursue better economic policies, or risk losing power.

Bottom-up pressure

As the bottom-up political pressure for stability and growth intensifies in the 1990s, EM governments *en masse* began to introduce inflation targeting, better fiscal policies, debt reduction, foreign exchange reserve accumulation and pension systems, accompanied by the development of local bond markets and the ability to self-finance. Combined, these policies ushered in a massive improvement in economic conditions, which in turn enabled EM countries to realise their inherent potential to grow faster than rich countries as predicted by convergence theory. By the early 2000s, when the last remaining economic hangovers from the Cold War and the teething problems associated with establishing new systems of political accountability were finally over, per capita GDP was already growing visibly faster than in rich countries. EM countries have been catching up ('converging') ever since, with no signs that this is going to change.

Can the Cold War come back?

The Cold War was incredibly destructive for EM and the associated human costs were immeasurable. Clearly, if the Cold War were to stage a return convergence could once again be at risk. However, we think the risk of a Cold War renaissance is close to nil. Granted, there are growing Cold War-like tensions between some of the world's largest economies, such as US and Russia and US and China, but these tensions are fundamentally different from the original 1945-1989 Cold War. The critical difference is that none of today's Superpowers can subjugate the whole of EM as they did in the pre-1989 period. Today, EM countries account for nearly half of global GDP and they obtain 87% of their financing from within their own markets. Nearly half of all trade in EM is intra-EM trade and only one third of EM countries are net commodity exporters. Perhaps most importantly of all, neither the US nor the European Union nor China nor Russia have the economic means to re-colonise a universe of 165 countries. Nor do they have the political inclination, in our view.

Cyclical drivers may reinforce the appearance of convergence in the coming years

Convergence forces may well appear to strengthen in the next few years, albeit for cyclical reasons. The years of Quantitative Easing (QE) in developed economies between 2010 and 2015 triggered massive re-allocations of capital out of EMs and into DMs. As large long positions in Dollars, US stocks and European bonds start to unwind, the resulting inflows to EM should relieve binding finance constraints to unleash materially stronger growth in EMs relative to DMs.

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