



# ***Emerging Markets: Prospects and Challenges***

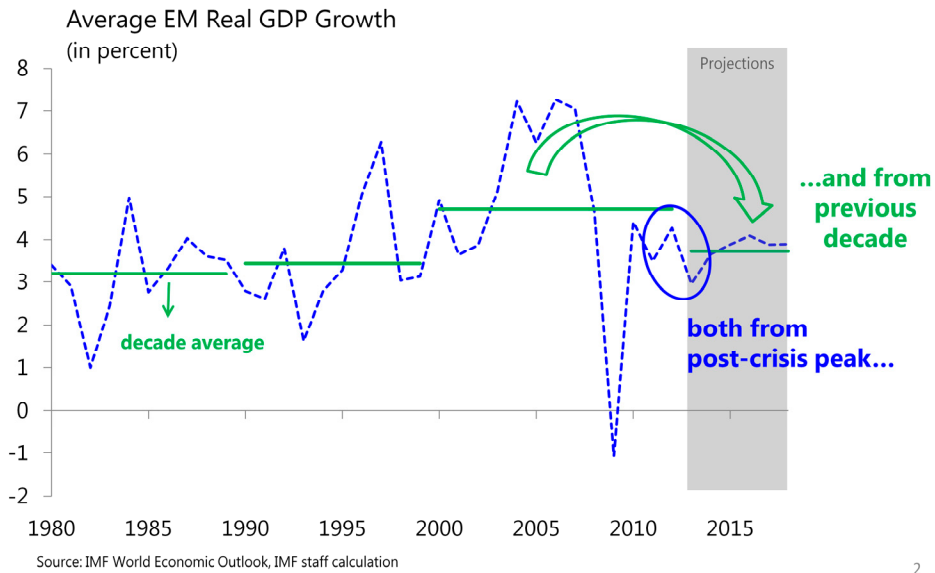
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The conference and this study are part of our efforts to **engage our EM constituency** more closely, **increase the relevance of Fund surveillance** for this core membership, and to prepare for the next Triennial Surveillance Review (TSR) due to be completed in October 2014.

The idea is to take a **step back from the near term** issues which tend to dominate our discussions and **focus on the longer term**. More precisely, we wanted to understand the drivers of growth in EMs over the past decades and assess their growth prospects. This is crucial for formulating our policy advice for the near and medium term to sustain, or in some cases, revive growth.

We started this work a few months ago when EMs were clearly slowing down. And now that some key EMs have been coming under pressure from markets, this seminar is all the more timely. We intend to issue a paper later in the fall drawing on today's discussion and feedback.

## After an exceptional decade, EM growth is slowing



Emerging markets are now entering a period of slower growth. After a decade of high growth, EM's suffered a short-lived slowdown in the immediate aftermath of the GFC, followed by a swift rebound, (except in Eastern Europe). Now three years on, emerging markets are seeing slower output growth and more recently some large EMs are experiencing capital outflows and market turmoil.

Growth in EMs is now lower than the post-crisis peak of 2010-11,...as well as the rates seen in the last decade before the crisis.

This raises the question of whether EMs can bounce back to the growth rates seen in the last decade, or whether their prospects are dimmer than we thought a few years ago. Is the latest market turmoil symptomatic of more trouble to come? Is the slowdown here to stay? And what can policy makers do to weather the storm and what should their policies focus on to prepare their economies for the coming years? These are the questions we would like to raise here today.



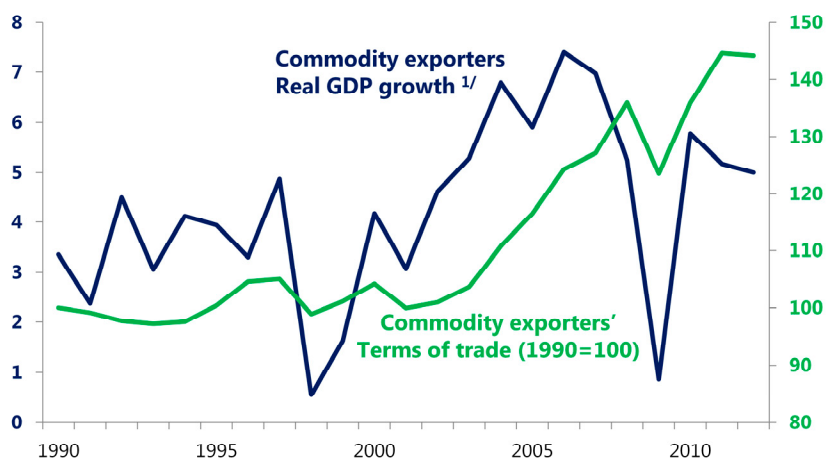
## Outline

- 🎤 **Why did EMs do so well?**
- 🎤 **What is behind the slowdown?**
- 🎤 **What are the growth prospects going forward?**
- 🎤 **How can policies improve prospects?**

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Key questions we will touch upon are as follows...

## Tailwinds: Unprecedented sustained increase in commodity prices



Sources: IMF World Economic Outlook, Fund staff calculations.

1/ Commodity exporters include Algeria, Angola, Argentina, Azerbaijan, Brazil, Chile, Colombia, Costa Rica, Guatemala, Indonesia, Kazakhstan, Malaysia, Nigeria, Peru, Russia, South Africa, Ukraine, Uruguay, Venezuela, and Vietnam.

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To understand better how emerging markets got to where they are today, it is useful to revisit the **past decade** and understand why EMs, by and large, grew so strongly until the global financial crisis and how they rebounded swiftly from it.

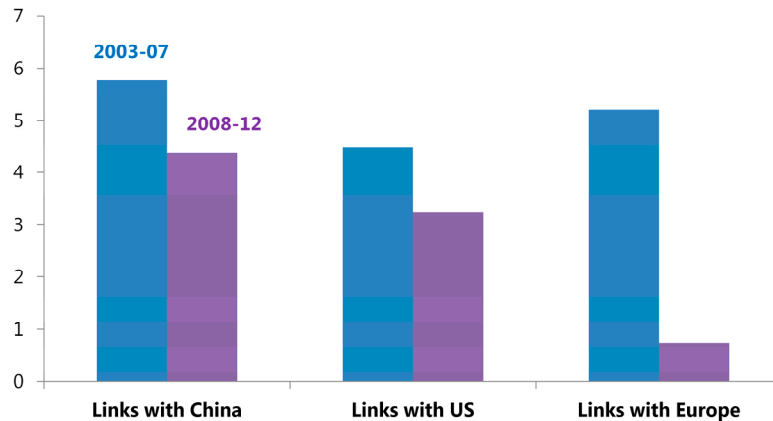
The period before the crisis provided **strong tailwinds** for emerging markets, and when combined with **good policies**, they helped economies grow robustly and build resilience. However, not all countries used these tailwinds wisely, and those that allowed vulnerabilities to be built were hit harder by the crisis.

The tailwinds were mainly in the areas of commodities, trade and financing conditions.

Commodity exporters benefitted from an unprecedented sustained increase in commodity prices, which helped to boost incomes and spur investment in these economies.

## Tailwinds: Increased trade and openness

EM Non-commodity exporters: Real GDP growth (average, in percent)



Sources: IMF World Economic Outlook, Fund staff calculations

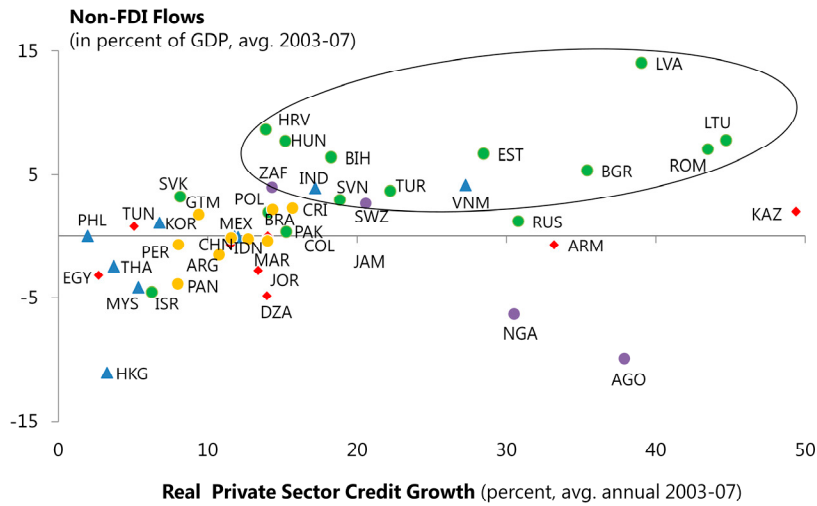
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Strong growth in trading partners and developing supply chains brought higher growth through trade and specialization to EMs that are more open to trade.

Here we note how **non-commodity exporters** countries trading with China, grew faster than those trading with advanced economies.

## Tailwinds: Easy financing conditions (double edge sword)

In some EMs, external flows financed credit expansion that proved unsustainable

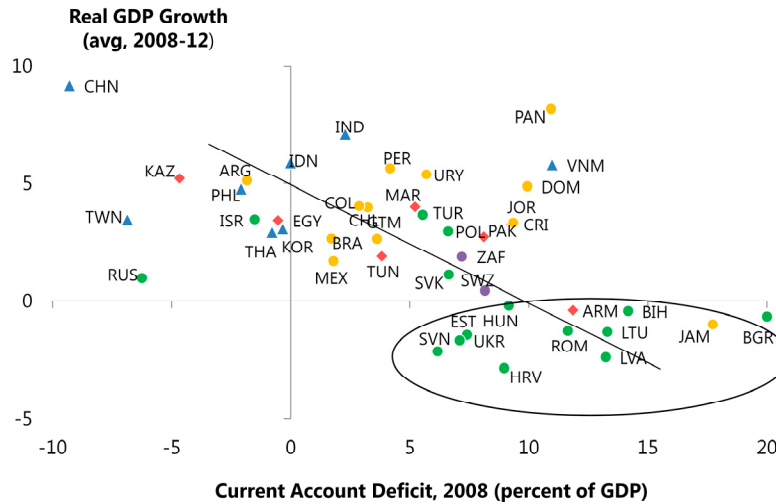


Many countries also benefitted from easy external financing conditions, particularly those that are more financially open.

However, access to this cheap and readily available external credit was not well managed in some countries. In those cases, credit and investment expanded briskly, asset prices became inflated, and the currency risk on the balance sheets of banks and corporates grew sharply.

As you will see, these vulnerabilities later exacerbated the effects of the crisis and lowered the growth prospects more sharply in these economies. (next slide)

## Policies matter: Those with external imbalances experienced sharply lower growth post-crisis



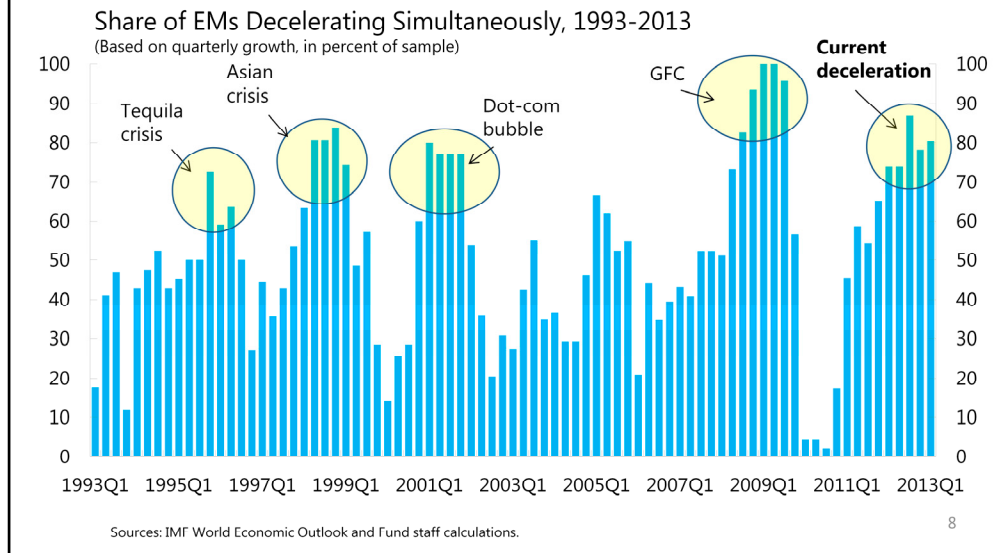
Sources: World Economic Outlook and IMF staff calculations.

(from previous slide)

Countries that entered the crisis with large external and financial imbalances, like those in Eastern Europe, have taken longer to recover. These economies are now going through a painful deleveraging process, where governments, households and firms to different degrees must now focus on repairing balance sheets.

## Since 2011, most EMs have been slowing

### 80 percent of EMs are now decelerating



Let's now move to more recent developments

The post-crisis recovery peaked in 2010-11. The 2010-11 peak reflected the rebound from low or negative growth during crisis. Since the post-crisis peak of 2011, EMs have been slowing. In fact, 80 percent of EMs have been seeing declining growth rates over the last two years. Growth in EMs is now 1½ ppts on average lower since 2010-11.

This generalized and synchronized slowdown in EMs is comparable to previous episodes following crisis, but the difference this time is that the acute phase of the crisis is well past us. Part of the slowdown is the normalization of domestic demand, visible in both consumption and investment data. The widespread incidence points to external factors, such as lower external demand, playing a role. However, the persistence of the slowdown (again, in the absence of crises) suggest that *structural* factors may also be playing a role.

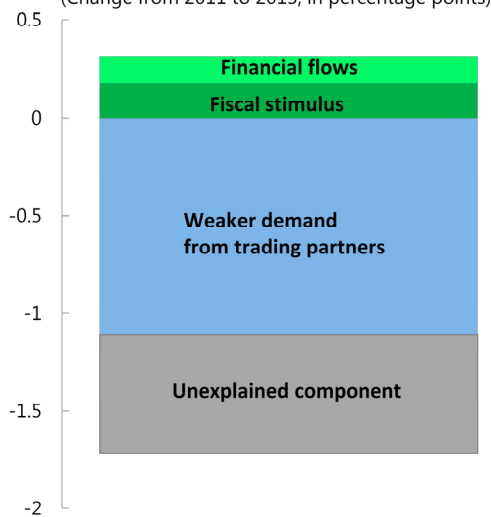
We hope to shed some light on these questions in what follows.



## Role of external and domestic factors?

### Contributions to slowdown

(Change from 2011 to 2013, in percentage points)



Source: Fund staff estimates.

### Key results:

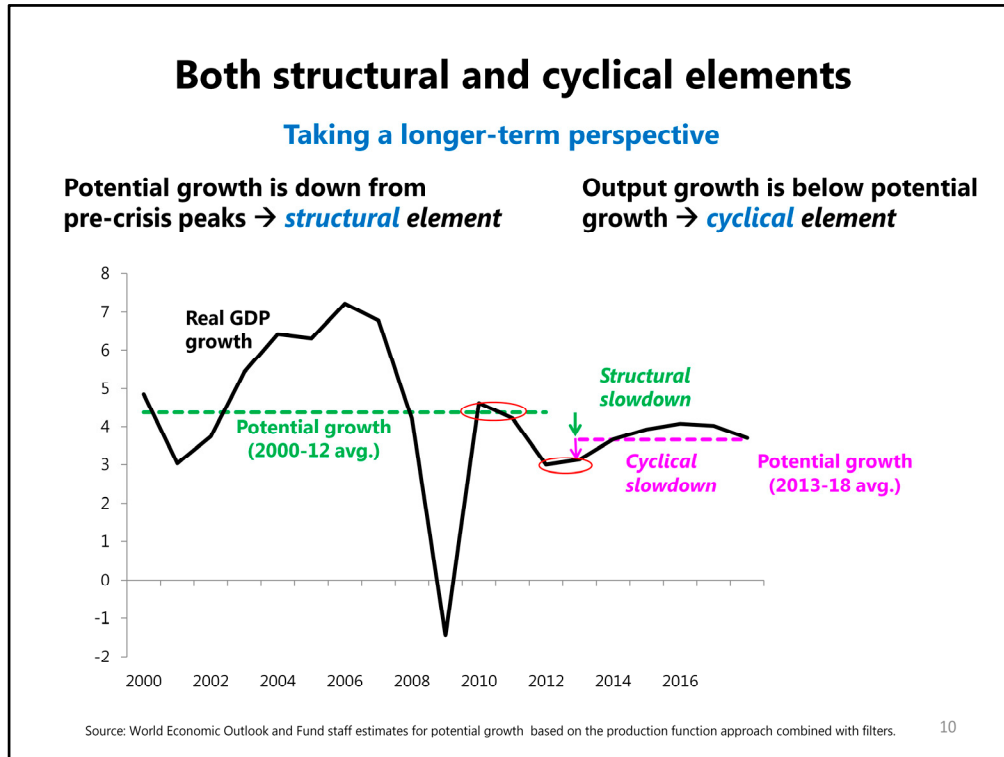
- Weak external demand weighs most
- Fiscal policy mildly supportive on average
- Financial conditions actually beneficial
- Large unknown: Idiosyncratic (domestic) factors e.g. *pre-slowdown output gap*

Our analysis suggests that a good chunk of the slowdown can be attributed to weaker external demand. On average, fiscal policy since 2011 has **actually** been slightly stimulative, and contributed to higher demand and growth. The same holds true for financial flows, which have increased in recent years (likely reflecting growing current account deficits).

However, there is still a fairly large unexplained component that can be attributed to idiosyncratic factors, such as initial conditions (size of output gap pre-slowdown), and policy frameworks.

While not documented in the slide, we also found that changes in terms of trade and their interaction with commodity exports, as well as global risk aversion (change in VIX index) were not significant. The same holds for the role of monetary policy, which we measured by the change in policy rate.

Our baseline regression attributes EM deceleration to lower trading partners' growth, including other EMs. However, the increased importance of EM-EM trade introduces a potential circularity problem. We verified the robustness of our results to disaggregating total trading partners' import demand into that of AMs and EMs and including them separately in the regression.



How long the slowdown will last depends on how much of the slowdown is *structural* (longer-lasting changes in potential growth) vs. *cyclical* (temporary deviation from potential growth)

Estimating the exact potential output levels and growth rates is subject to much uncertainty.

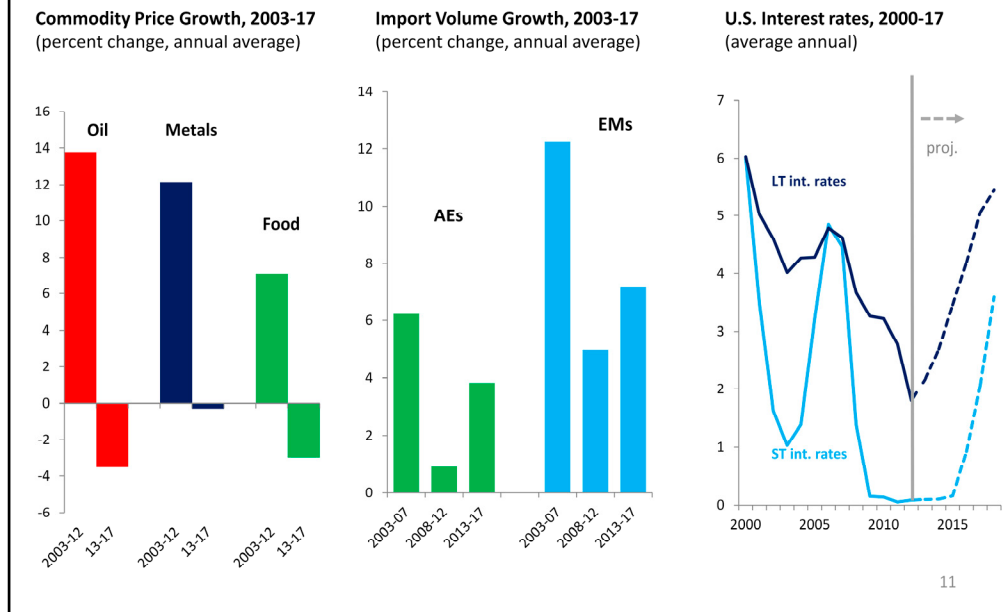
Potential growth is time-varying concept and is often influenced by cyclical factors. During periods of favorable external conditions (high commodity prices and cheap external finance), potential growth estimates tend to rise, mainly because investment increases. The new capacity adds to potential output. Similarly, as tailwinds fade, potential output growth may be lower.

Charts suggest that the slowdown has a cyclical component (as suggested to by the slowdown in external demand in the previous slide), but also a strong structural component, suggesting the slowdown in EMs is here to stay.

It is important to emphasize that this finding is not all negative. Some EMs may be slowing to more sustainable and balanced growth rates. Achieving those sustained and balanced growth rates, in the context of the global transitions discussed by Mr. Lipton, is the core challenge facing all EMs.

Next we turn to the specific challenges that EMs will need to face in the period ahead.

## Going forward - Tailwinds of last decade fading

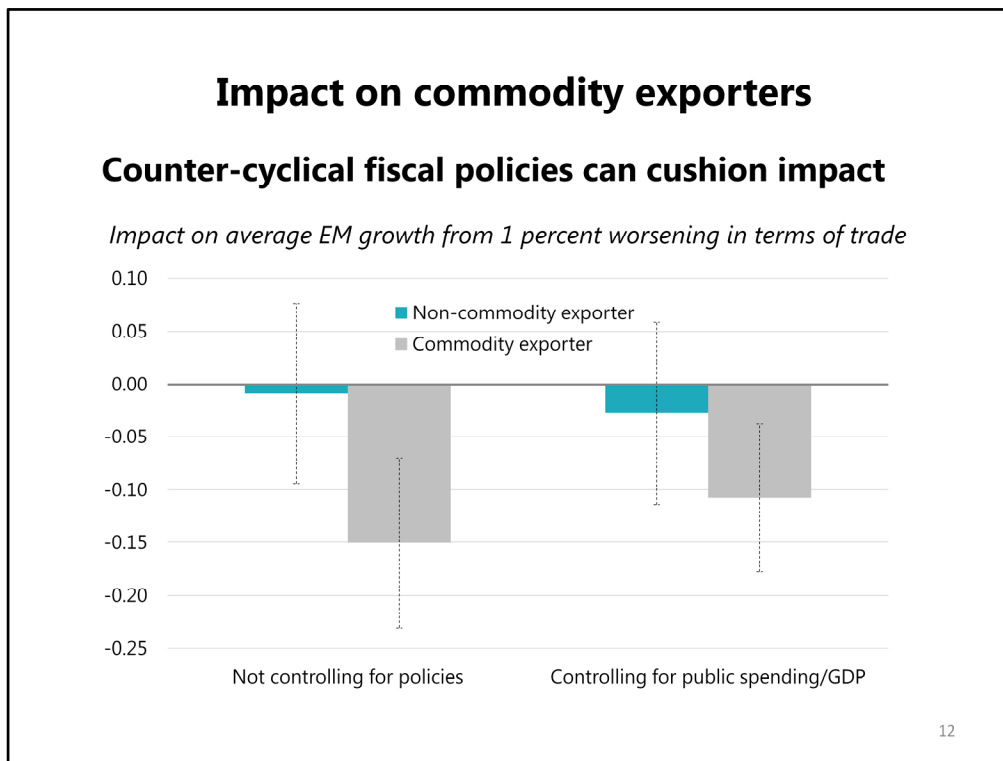


The near term outlook is weaker than that of previous decade and is mired with uncertainty.

Although trade with advanced economies will continue to recover (as will emerging markets), we do not expect them to go back to the debt-fuelled high growth rates seen before the crisis.

Thus, commodity prices are likely to soften somewhat, but will likely still remain near historic highs.

The recovery in advanced economies will come with tighter global financial conditions, and likely increased capital flow volatility if not properly managed (as discussed in the previous presentation).



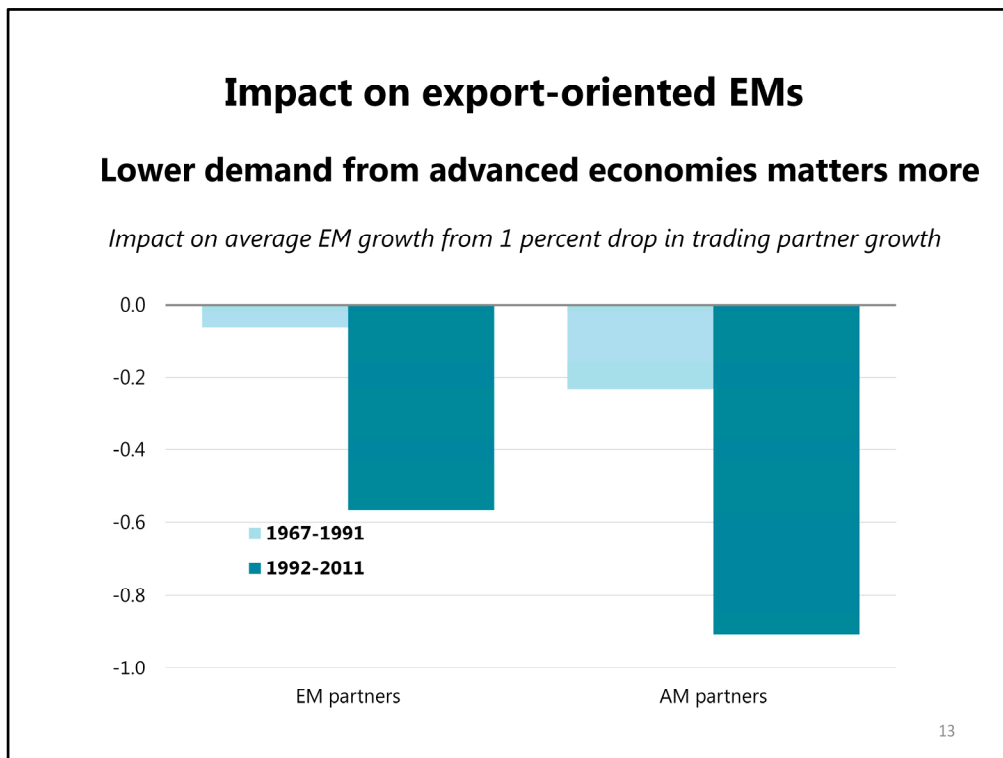
#### How will these fading tailwinds affect EMs? **Impact of lower terms of trade**

We use long-term growth regressions to estimate the historical impact of these three sources of tailwind on EM growth: terms of trade, trading partner growth and international financing conditions.

We start with terms of trade. The chart shows that the elasticity of growth with respect to ToT is positive, and increases with dependence on commodity exports.

For non-commodity exporters, the elasticity of growth w.r.t. terms of trade is around zero, and it is around 0.15 for commodity exporters. However, the growth elasticity for commodity exporters drops by around one-third once we control for fiscal policy. This suggests that fiscal policy plays an important role in determining the degree to which terms of trade shocks affect growth. One potential explanation is that procyclical fiscal policies risk amplifying the commodity boom-bust cycle.

*Notes: Builds on Arora and Vamvakidis, IMF Staff Papers, 2005; Fixed effects growth regressions covering the period 1967-2011; 66 EMs in the sample, of which 50 non-commodity exporters*



Next we turn to assess the **impact of lower trading partner growth**

The payoff of export-led growth, the dominant development paradigm for EMs, depends strongly on the growth in trading partners. External demand is expected to pick up but not go back to 2000s' levels. What does this mean for EM growth?

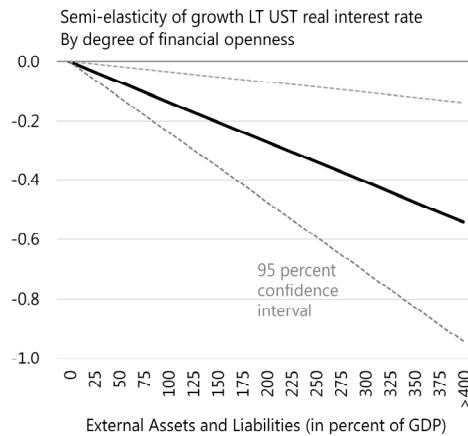
The chart shows that the elasticity of growth with respect to trading partners increases with the export/GDP ratio. For the median EM, the trade partner growth elasticity is around 0.7.

The chart also shows that the dependence on external demand has been increasing over time.

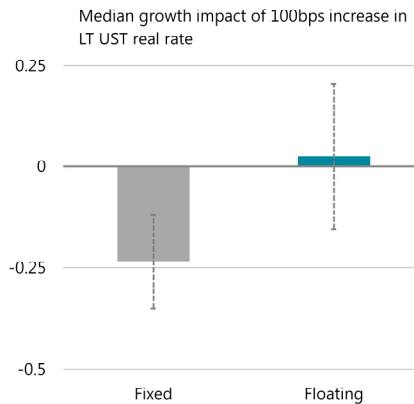
Now let us compare the impact of AM vs. EM trading partners. We see that the elasticity of EM growth with respect to EM partners has increased faster – from zero in the pre-globalization period to 0.6, in line with the increase in EM-EM trade. However, AM demand still remains more important – a one percentage point increase in AM growth is associated with a 0.9 percent higher growth in the EM.

## Tightening global financial conditions

Will weigh on EMs, particularly the more financially open economies ...



... but exchange rate flexibility helps



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Finally, what is **the impact of tighter global financial conditions?**




Tighter financing conditions will weigh on EM growth (keeping all else constant) in the coming years. Just as easy financing conditions in AMs boosted investment, credit growth and asset prices in EMs through bank and portfolio flows, and contributed to higher growth, tighter financing conditions will weigh on growth.

Our analysis shows that more financially open economies would be affected more, not surprisingly.

This is especially the case of countries with fixed exchange rates. This highlights the role of the flexible exchange rate in mitigating the effects of external shocks on the real economy. The WEO had the same result that the impact was less, and statistically insignificant, for countries with flexible exchange rate regimes.

*Notes: For the median EM, with external assets and liabilities constituting 114 percent, the semi-elasticity of GDP growth w.r.t. real U.S. interest estimated between 0.3 and 0.5. This is in line with literature range of 0.2-0.77 (Reinhart et al. 2001, Frankel and Roubini 2001, di Giovanni and Shambaugh 2006). 2013 Spillover Report (G35-S): 1.2 (short-term reaction).*

## Restoring growth in the absence of tailwinds?

-  **Structural reforms** to facilitate internal rebalancing, address impediments to factor accumulation and boost productivity.
-  **Prioritized by country-specific characteristics:**
  - Infrastructure, human capital, and labor markets where gaps exist
  - Gains from sectoral shifts vs. within sector productivity
-  Reform **priorities evolve** as economies develop

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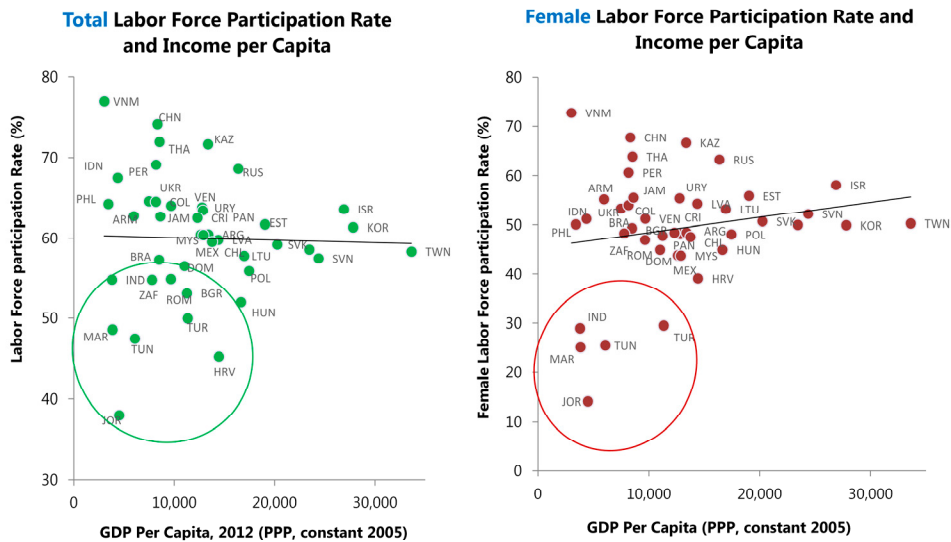
Going forward, in the absence of tailwinds, countries will need to rely both on good macroeconomic policies aimed at avoiding imbalances, and structural reforms to sustain or restore growth. The key issue will be identifying the most pressing reform priorities, depending on a country's level of development and the most binding bottlenecks to raising income levels.

As mentioned before, the crisis and its aftermath revealed the importance of adjusting macroeconomic policies and carrying out reforms in “when the sun is shining, so to speak”

Avoiding a build up of excess demand is one of the priorities to more sustainable growth paths. This calls for different policies and focuses in different countries. In China, it requires reducing investment to more sustainable levels, factoring in permanently lower external demand in the tradable sector, and increasing domestic consumption.

For others with growth models built on high public or private consumption financed through external borrowing, the priority is to reduce consumption, increase savings, which would also reduce external structural deficits and reduce the risk of boom bust cycles.

## Some EMs need to address labor market rigidities



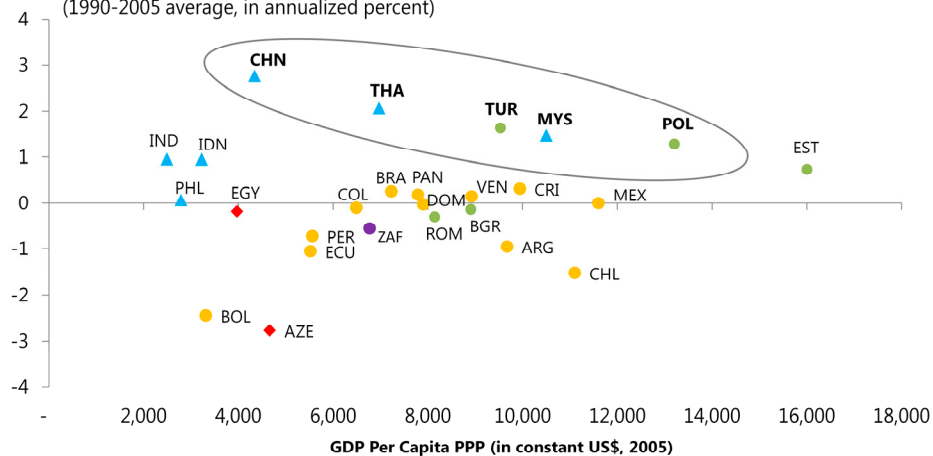
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For example, EMs that have structural impediments that keep labor force participation low, including by women, would benefit from addressing them. This is a stronger argument for countries with shortage of labor. For those that have high unemployment, the priority is to focus on impediments to job creation. For all countries, it will be important to get to the deeper causes of low labor force participation—for example, it could be arising from lack of access to education, and labor and time saving infrastructure, or from a tax and expenditure system that skews the playing field.



## In some EMs, high growth and productivity reflected *sectoral shifts*...

**Contribution of Sectoral Shifts to Aggregate Productivity Growth**  
(1990-2005 average, in annualized percent)



Sources: UN National Accounts database, ILO, WDI, Groningen Growth Development Center (GGDC) database.

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Our analysis shows that the high growth rates of the last decade reflect large gains in productivity.

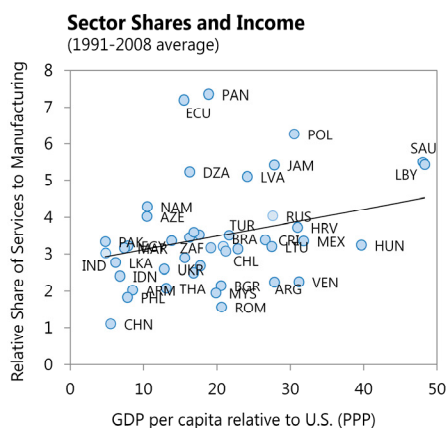
Most of this growth has been driven by higher productivity within individual sectors, but in some EMs (CHN, THA, MYS, TUR, POL) productivity gains also reflect structural transformation—the process by which labor shifts out of low productivity agriculture into higher productivity manufacturing or services.

At lower levels of income, this is not a surprising finding. As economies start from a lower base, productivity gains and therefore higher growth can be achieved by factor accumulation. The shift from lower to higher-productivity activities (e.g. agriculture to manufacturing, and in some cases, directly to services), creates a gain in productivity and boosts growth.

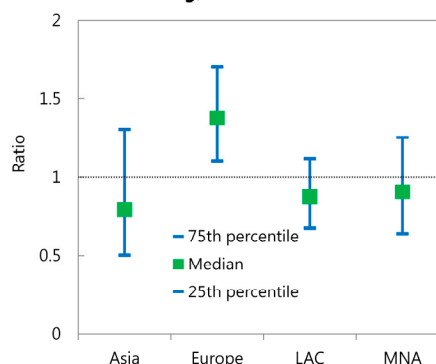
## ...going forward these will be more difficult to sustain

As incomes rise and economies become more services-based...

...productivity and growth may naturally decline



**Productivity of Services Relative to Manufacturing, 2005**



Sources: UN National Accounts database, ILO, WDI, Groningen Growth Development Center (GGDC) database.

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Going forward as EMs develop and converge to advanced countries, gains from structural transformation will decline because of diminishing returns to factors of production and declining inter-sectoral productivity gaps.

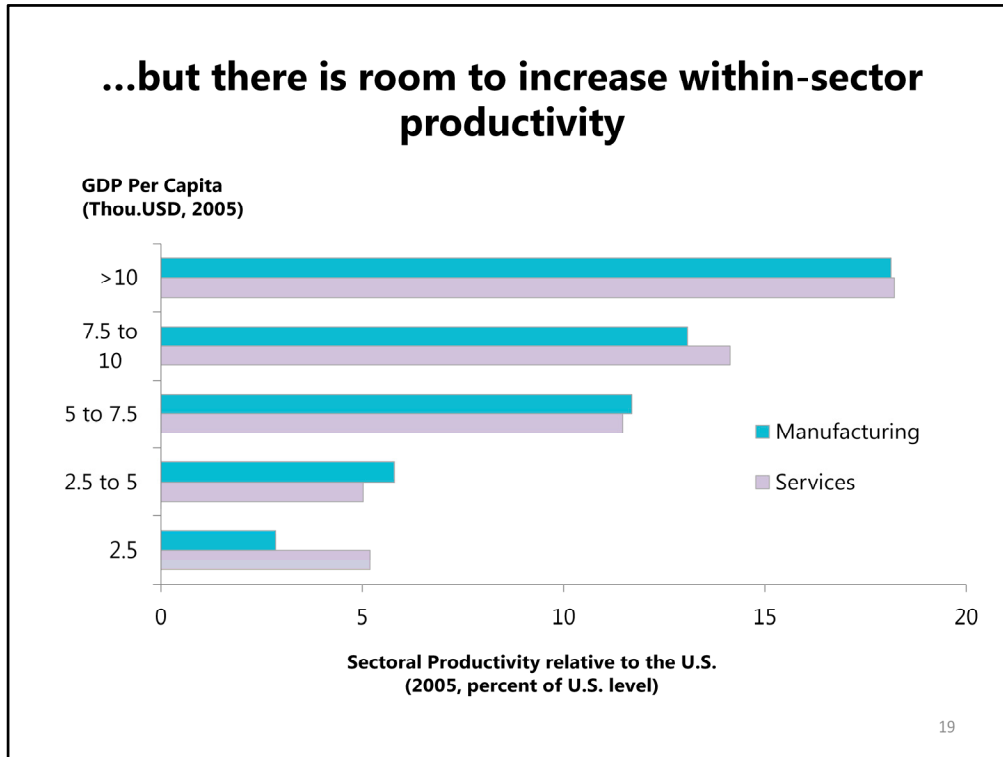
As the chart on the RHS shows in most EMs inter-sectoral productivity gaps between services and manufacturing are high with services less productive than manufacturing. As countries develop, manufacturing becomes more capital intensive and labor shifts into to services, total productivity and growth could slow (part of natural convergence story).

It is important to recognize this possibility so that policymakers do not to over-stimulate their economies and instead focus on structural reforms that can facilitate the transition and prepare the economy for the next stages.

To provide some country specific context, in Poland for example, the potential slowdown from becoming a more service based economy could be lower as close integration with advanced Europe, has resulted in relatively high services productivity. In where the services sector is still small [chart on the LHS] productivity in services has increased. However, with continued labor shifts into services, productivity growth is likely to slow.

Though the slowdown is part of the expected development path policies can play an important role in facilitating the transition and preparing the economy for the next stage of development. In some countries this natural slowing calls for policy makers to implement structural reforms rather than focus on stimulating the economy.

So focus on structural reforms depends on where countries are in the transition process and the level of income.



The good news is that there is room to increase productivity within sectors.

The chart shows productivity gaps in both the manufacturing and services sectors with advanced countries (with the frontier given by the US) are strikingly large (even in EMs with higher income per capita) and point to considerable catch-up potential.

Policy efforts through targeted reforms could to boost labor productivity within sectors could have significant positive consequences for closing aggregate productivity gaps and increasing growth.

## SUMMARY

- 🎤 **EMs enjoyed a decade of strong growth...  
...but tailwinds that helped are fading**
- 🎤 **Now EMs are slowing and vulnerabilities are on the rise  
Sustaining growth will require policy action**
- 🎤 ***Renewed emphasis on old challenges:***
  - **Addressing macroeconomic imbalances (morning)**
  - **Advancing structural reform agenda**

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In short, emerging markets are entering a phase of lower growth, when the favorable tailwinds of the last decade are fading and in some cases, even turning to headwinds.

The crisis and its aftermath brought to light how policies in good times determined performance in difficult times.

Now, once again, we see markets differentiating among EMs by how well policymakers are managing the transition to this new era.

In the absence of favorable external conditions, and facing volatile financial markets, it will be all the more important for policy makers to remain vigilant; holding tight the reins on their economies while swiftly advancing structural reforms that can boost productivity and unleash growth potential in the coming decade.



**THANK YOU**