Talking point

BRIC outlook: Structural growth drivers favour China and India

July 4, 2008

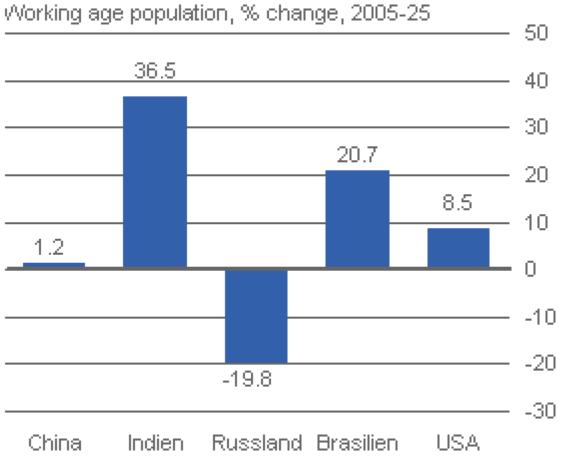
The resilience of economic growth in emerging markets has increased due to their much reduced vulnerability of emerging markets to global financial market conditions and due to the greater reliance on demand from domestic and emerging markets rather than developed markets. (Some slowdown in EM growth seems inevitable, but growth figures will remain solid.) If anything, most if not all BRIC countries currently seem to be at risk of overheating. There is of course a cyclical component to strong domestic demand growth, but there are also structural factors at work that bode well for the medium-term growth prospects of the BRICs. These factors can be captured in a simple growth accounting framework. Economic growth can be broken down into several components, namely changes in labour and capital inputs, and total factor productivity which captures technological progress and/ or efficiency gains and is the residual that is not explained by changes in labour and capital inputs. Growth accounting provides an analytical framework to assess medium-term economic growth dynamics. The BRIC economies differ greatly in terms of their growth prospects.

Labour supply dynamics will remain favourable in Brazil and India thanks to demographic trends and/or low urbanisation ratios. In Brazil and India the working age population will continue to expand until the middle of the current century, while in China it will decline after 2015 and in Russia it is at risk of collapsing. (The UN projects Russia's working age population to decline from 97 m in 2005 to 47 m by 2050!) A low urbanisation ratio of 40% in the case of China may help counteract the projected decline in the working age population by allowing for the transfer of labour from the countryside into the more productive urban economy. In Brazil, not much should be expected from further urbanisation, as the country is already more highly urbanised than many of the developed countries in the world. But thanks to a relatively favourable demographic profile, Brazil will benefit from a 20% increase in the population of working age between 2005 and 2025. This should help support economic growth. The Russian population of working age is already in decline and little help will come from "surplus rural labour" due to a high urbanisation ratio. From a purely demographic point of view, India faces the most promising prospects, combining solid population growth and a low degree of urbanisation. While this may pose challenges of its own (in terms of urban development and infrastructure), it will be supportive of growth dynamics.

Recent capital accumulation trends favour China and India. Assuming that investment ratios do not change dramatically over the next few years, China and India will face much brighter prospects than Brazil or Russia. Currently domestic investment ratios amount to around 40% and 30% of GDP in China and India, respectively, versus an investment ratio of 20% of GDP (or less) in Brazil and Russia. Although it is difficult to project future investment (and savings) ratios, any changes will probably be gradual. Russia will probably increase its investment ratio thanks to large savings generated by the commodity boom. Brazil, having experienced a more modest increase in domestic savings, will likely see a moderate uptick in investment ratios. In China both investment and savings ratios will decline over the medium term, but are likely to stay at very high levels over the next few years. What seems certain is that Chinese and Indian capital accumulation will proceed at a much faster pace than in Brazil and Russia. If one adds the fact that China and India are growing faster than Russia and Brazil, it becomes clear that investment growth is faster still than suggested by the difference in investment-to-GDP ratios. (We are assuming for simplicity's sake that the higher gross investment ratio leads to a faster increase in the net capital stock.)

Russia's shrinking labour force

Working age population, % change, 2005-25

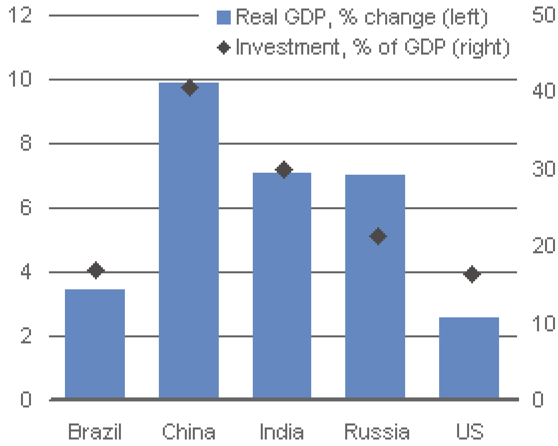


Source: UN

Total factor productivity (so-called Solow residual or TFP) is difficult to project. This all the more problematic as TFP is generally responsible for the bulk of economic growth in fast-growing emerging markets. If we take the World Bank's Doing Business assessment as a proxy for the quality of the institutional and micro-economic environment and the efficiency with which labour and capital are used, it becomes clear that all BRIC countries have massive scope to improve TFP levels. China ranks 83rd and is the only BRIC country in the top-100! If the BRIC governments manage to implement reforms aimed at lifting TFP, all of them will be in a position to ”over-compensate” the negative contribution from adverse labour or capital input trends. The necessary economic and technological “catch-up” depends on the right set of economic policies and these are difficult to predict. But if, again for simplicity's sake, one takes the level of per-capita income as a proxy for “catch-up” potential (potential TFP growth), then the relatively low GDP per capita incomes in China (USD 4,700) and India (USD 2,500) suggest that their TFP growth potential is greater than Brazil's (USD 9,000) and Russia's (USD 13,200).

Investment ratios favour China & India

Investment, % of GDP, 2000-07



Source: IMF

Growth accounting “accounts” for rather than “explains” economic growth. One major difficulty, shared with many other growth models, is that one crucial variable, namely TFP growth, is very difficult to project. The other problem is that even favourable labour supply and capital accumulation trends do not automatically translate into higher growth (e.g. increasing labour supply remains stuck in the low-productivity rural economy). But favourable changes in labour supply and capital certainly underpin an economy's growth potential. Low per-capita income favours “catch-up” in low-income countries, even if the realisation of the TFP growth potential depends on the right set of economic policies. (This is why economists like to talk about “conditional catch-up”.) It is interesting that Brazilian and Russian TFP growth has been low over the past decade and half (even though it has started to pick up recently), lagging behind Chinese and Indian TFP growth. Unless Brazil and Russia experience a productivity revolution, their economic growth rates will remain below China's and India's. The projected changes in the factors underpinning an economy's growth potential also suggest that the China and India economies will continue to grow much faster than Brazil and Russia over the medium term.

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