Talking point

The long view in EM – middle-income trap, demographics and economic growth

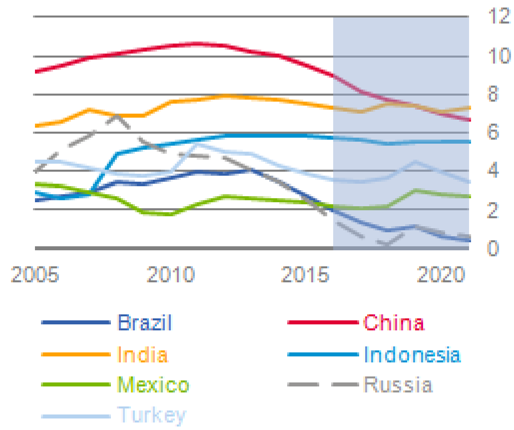
April 13, 2016

A number of factors, including the decline in commodity prices, sizeable corporate foreign-currency debt, a strengthening dollar and the prospect of higher US interest rates, are weighing on the economic and financial outlook in the emerging markets (EM). The relative lack of reform combined with a weakening of some of the structural factors that underpin growth has raised concern about the medium-term outlook in many, but not all EM.

If the IMF is to be believed, the economic growth gap between the major Asian EM and the rest will remain significant (chart). The gap has always existed, but – leaving aside China – it seems to be widening. In part, this is due to the economic slump in Brazil and Russia, two countries hit particularly hard by the commodity slump. But broader structural trends are at work, too. Per capita income levels and demographic trends favour India and Indonesia over all other major EM. Here is why and how.

EM Asia vs EM rest

Real GDP growth, %, 10Y average



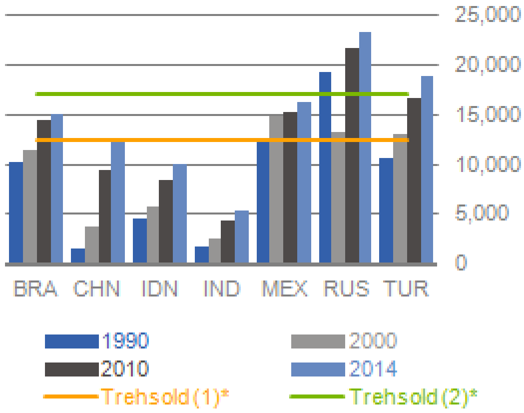
Source: IMF

First, per capita incomes in India and Indonesia remain low, compared to the other major EM. According to the conditional income convergence hypothesis, poorer economies have a greater growth potential than richer ones due to their ability to generate productivity gains more easily by way of capital accumulation and total factor productivity increases. Convergence is of course conditional in the sense that it relies on countries pursuing reasonable economic policies. The fit between per capita income and economic growth (past and future) is pretty good in the case of the larger EM.

Second, all the major EM – with the exception of India and Indonesia – have reached per capita income levels associated with the so-called middle-income trap. According to Eichengreen & al (2013), there are two income levels at which significant growth decelerations tend to occur (chart, critical levels adjusted). Viewed from this perspective, China may indeed be facing a tricky next few years. Similarly, Brazil, Mexico and Turkey may also hit speed bumps as they approach the second, higher income threshold. Interestingly, if the data are to be believed, Russia may already have passed the critical thresholds. Or, more likely, the commodity boom helped mask until recently the decline in Russia's underlying growth potential due to the middle-income trap.

Middle-income trap

Per capita income, 2011 USD



* Adjusted. Eichengreen levels in 2005 USD

Sources: World Bank, Deutsche Bank Research

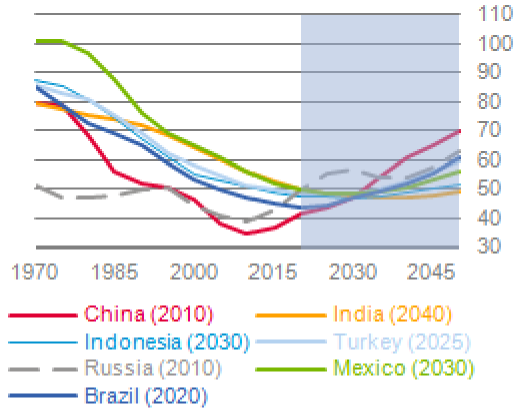
Third, the demographic outlook also varies greatly across the EM, but is most favourable in India and Indonesia, in addition to Mexico (chart), where dependency ratios are falling and the working age population is expanding rapidly in absolute terms. This contrasts sharply with what China and Russia are experiencing. Not only have dependency ratios bottomed out there, but the working age population is declining in absolute terms in both countries. In Brazil and Turkey demographic trends are somewhat more favourable, but even here the so-called demographic window will be closing within the next decade or so.

Admittedly, growth accounting suggests that rapid economic growth is primarily due to capital accumulation and an increase in total factor productivity rather than labour supply growth. In this sense, demographic trends would seem to have little to do with an economy's growth momentum. However, research suggests that the demographic dividend (falling dependency ratios) explains around 1/3 of East Asia's (per capita) economic growth in 1965-2000, mostly via their impact on savings and investment. Viewed from this perspective, the near- and medium-term deterioration of the demographic outlook in the EM is bound to matter.

Neither the middle-income trap nor demographic drag will be constraining economic growth in India and Indonesia for the foreseeable future. Unlike China, where adjusting to slowing productivity growth and unfavourable demographic trends is proving challenging, not least due to its economy's global systemic importance, India and Indonesia are facing a much simpler task, policy-wise. A combination of macro-stability and moderately supportive policies aimed at raising the physical capital stock, including infrastructure, should suffice to maintain high economic growth rates.

Demographic outlook varies greatly

Dependency ratio* %, [year when ratio reaches trough]



* Total Dependency Ratio ((Age 0-14 + Age 65+) /Age 15-64)

Source: UN

Naturally, this does not mean that concerted reform efforts would not help raise economic growth in the other EM. It certainly would, at least in the medium- to long-term. Interestingly, Eichengreen & al (2013) also find that it is education that allows EM to overcome the middle-income trap. This makes intuitive sense. Building a reasonably productive capital stock is easier (though not necessarily easy) and less time-consuming than building a quality educational system and human capital. Again, this is not meant to suggest that, for example, infrastructure in places like Brazil is not a major growth constraint. It undoubtedly is. But it is far less of a problem in places like China, Mexico or Turkey. In this respect, at least, China would seem far better positioned to deal with the middle-income trap than Brazil, Mexico or Turkey, countries that have seen much more limited progress in terms of human capital accumulation than China in recent decades. None of this is meant to suggest that broader, productivity-enhancing reform would not be desirable in terms of raising potential growth in the EM – just that important structural factors will favour India and Indonesia over the other EM for the time being.

Author: Markus Jaeger +1 212 250 6971

more information on **Emerging Markets / Country Risk**
Talking Point - Archive