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The Future of Emerging Markets: Prospects for Global Economic Convergence 1Q, 2014

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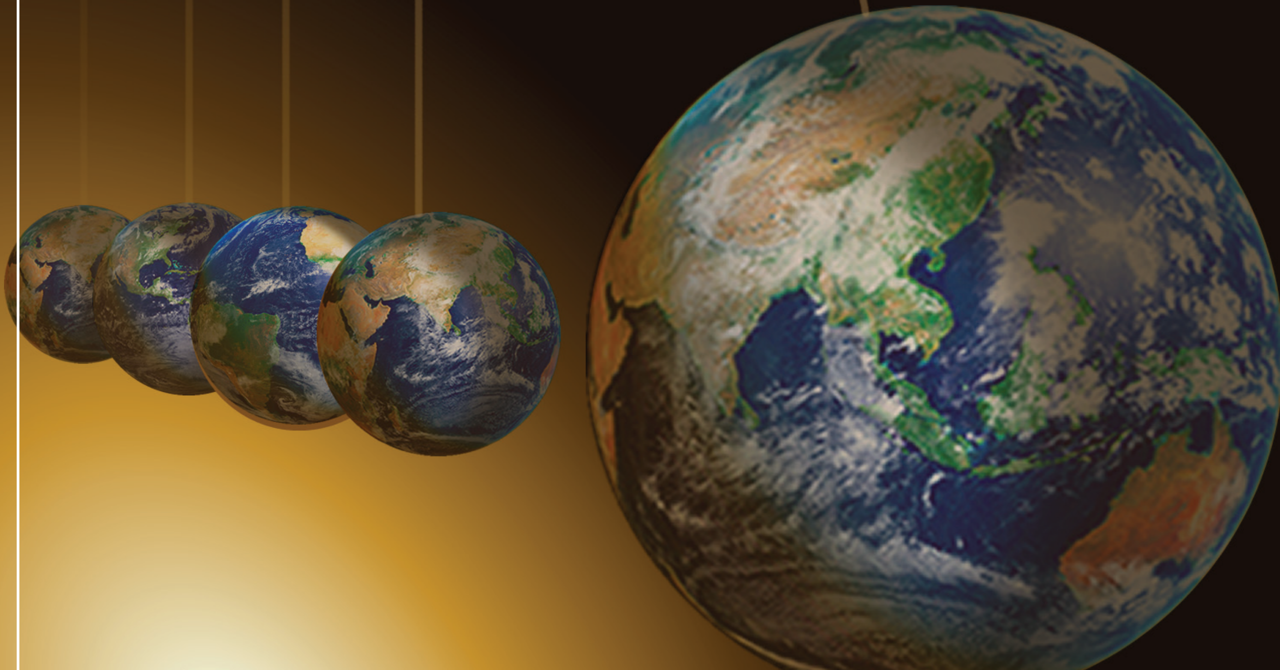

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Divergence versus Convergence: the Big Picture

The "great convergence", the closing of the gap between emerging markets and the developed economies that captured the public imagination in the past decades, has become a great deal less compelling since the 2008/09 global financial crisis. Both China's and India's real GDP growth has since dropped by half from its peak in 2007. The slowdown in growth is even more precipitous for Brazil and Russia, plunging from a peak of 6.1% in 2007 to 0.9% in 2012 in Brazil, and from 9.0% to 3.4% in Russia; and both suffered negative growth in 3Q 2013[1] . The pattern is similar for other large emerging markets such as South Africa, Turkey, Indonesia, and Poland. At best the great convergence can no longer be held up as a self-evident truth. At worst, it is seen to be on the wane and moribund. What is the future for emerging markets, and of global economic convergence?

Before the great convergence, however, there was the "great divergence". And in order to gain better clarity on what the future of convergence may look like, we need better clarity on the big picture: what created the great divergence to begin with, as well as the great convergence that followed, in the context of the last two hundred and fifty years?

To the extent that GDP and per capita GDP data can be estimated historically, different parts of the global economy appeared to be quite similar prior to the 18th century. Per capita GDP was estimated to be roughly the same between Britain, China and India over the 1500 to 1600 period[2]. By the 18th century a hundred years later, however, the great divergence started to gather momentum when Britain, followed by northwestern Europe and North America, pulled away from the rest of the world. The impact of the great divergence on global inequality is startling. Around the end of the 18th century, the average per capita GDP of the richest countries of the world was about four times that of the poorest countries. By 1950, the gap between the richest and the poorest had increased by a factor of twenty. In 1820, the per capita GDP of the West (approximated by the average of Britain, US, and Germany) was 2.2 times that of China and 2.5 times that of India[3]. By 1950, it rose to 15.5 times that of China and 11.0 times that of India. Great divergence indeed.

In the past half a century or more, however, a trend reversal happened, at first in East Asia led by Japan, then followed by South Korea, Taiwan, Hong Kong and Singapore. In 1950, per capita GDP of the West was 3.5 times that of Japan. By 1998, just before Japan slipped into its two-and-a-half-decade long stagnation, it was close to parity[4] . Alongside Japan, South Korea and Singapore are now members of OECD, among the richest countries in the world[5]
.

But it is China's rise since the early 1980s that has been the major strand in the convergence story by virtue of its population

1 IMF WEO data.
2 All historical GDP and per capita GDP data are from Angus Maddison's authoritative The World Economy: A Millennial Perspective. 2001. Paris: OECD. The currency unit used for such historical comparison is the Geary-Khamis international dollar.
3 Khamis international dollar.
4 The ratio has since climbed to 1.2 in 2012 as a result of Japan's persistent lower growth compared with Britain, US and Germany.
5 So would Taiwan and Hong Kong if they were recognized as a "country".

being the largest in the world. Between 1950 and 1998, the ratio of per capita GDP between the West and China was reduced from 15.5 to 6.8; and further to 4.6 in 2012. India, with the second largest population in the world, became part of the convergence narrative in the 1990s, and between 1998 and 2012 the ratio of per capita GDP between the West and India fell from 12.2 to 10.9. It was therefore a small step to add Brazil and Russia, with the biggest populations in Latin America and Europe respectively, to create the BRIC acronym, and spinning it into a story of the unstoppable rise of the emerging markets. Thus the great convergence arrived.

The great convergence narrative became positively captivating in the mid-2000s with China's double-digit real GDP growth, followed by record growth rates in India, Brazil and Russia. Investors jumped on the band wagon. BRIC investment funds as well as more general emerging market funds mushroomed and CEOs of multinationals scrambled to come up with their versions of a BRIC strategy. In that febrile atmosphere, few managed to keep their heads to ask some basic questions: do the BRIC countries really have anything in common, apart from their large populations? Do the BRIC countries share the same economic fundamentals in their strong growth, and if not, then what makes them a meaningful grouping and what is propelling their collective rise? Similar questions can be re-phrased for emerging markets generally. However, instead of asking these questions, for many it became an article of faith that emerging markets were destined to emerge and that the BRIC countries were the unstoppable juggernauts leading the charge in converging with the developed economies[6].

What many also forgot to take into account was the fact that, in the decade before the 2008/09 global financial crisis, it was not just the BRIC countries, or the emerging markets generally for that matter, that were fast growing. A tsunami of easy money and credit flooded every nook and corner of the global economy, pushing up growth everywhere. For example, Angola's real GDP growth repeatedly reached 18% in the mid-2000s. In fact, during that time a country had to work really hard in order not to grow at all; by 2007, only three countries in the world failed to grow – Fiji, Zimbabwe, and the Democratic Republic of Congo. In that decade, the world became one giant bubble economy and in that context the growth record of emerging markets was entirely unexceptional.

Nevertheless multinational companies and international investors were genuinely enthusiastic about the emerging markets, and to be fair, there is some justification for it. Global companies measure market size of countries in nominal US dollars, which they then adjust for inflation to compute the "real" growth. They do this because their sales are conducted in US dollars. In addition, most countries' ability to service their foreign debts is also calculated in terms of US dollar, hence their risk profile is affected by the size of their GDP expressed in US dollar. In an intriguing and insightful analysis, Ricardo Hausmann at Harvard University points out that in the decade of 2002 to 2012 the growth of emerging markets generally and

6 I have been rubbishing the very idea of BRIC since the mid-2000s with no notable success. I thought I would give it another go here.

of the BRIC countries in particular was greatly distorted when measured in US dollar (let's call it "US dollar GDP"), which in many cases bore no resemblance to real growth in output in these countries. For example, cumulative growth of "US dollar GDP" from 2002 to 2012 is estimated at 420% for Russia, 290% for Brazil, 395% for China and 206% for India. These are very impressive numbers which turned heads in corporate board rooms and business conferences everywhere. But much of this growth came from changes in their terms of trade and the appreciation of their currencies against the US dollar, as opposed to expansion in real outputs.

For instance, over this time period, it is estimated that the terms of trade improved by 154% for Russia, 48% for Brazil, and 55% for India (China is the exception where the terms of trade deteriorated by some 30% because the average price of Chinese manufacturing exports declined against that of Chinese commodity imports). Similar terms of trade improvement were seen in many other emerging markets; 190% for Venezuela, and 56% for South Africa, for example. In lockstep with improving terms of trade the currencies of emerging markets appreciated against the US dollar because of booming exports and stronger capital inflow.[7] As a result, the "US dollar GDP" of emerging markets skyrocketed.

Stripping away the effects of improved terms of trade and currency appreciation, however, the growth of real output (which is what really counts) becomes much more down to earth. It turns out that in Russia only 14% of the total cumulative growth of its "US dollar GDP" in the decade of 2002 to 2012 can be accounted for by an expansion in real output. In Brazil it is only 12%, and about half in India and two-thirds in China[8]. Since terms of trade and currency movement exhibit strong trends of means reversal (and they have been reversing since 2012), they cannot be counted on as a sustainable basis for convergence. Sustainable convergence requires that emerging markets have the ways and means to increase their real output consistently over long periods of time in spite of the ups and downs of the business cycle.

It means returning to the basics of working harder and working smarter. It means getting the economic fundamentals right.

The Four Cylinders of the Economic Growth Engine

Returning to economic fundamentals means stripping away the hype and myth of BRIC and the emerging markets to find out what really make them tick (or not tick). Interestingly, it also makes divergence and convergence easier to understand because both are driven by the same four sets of factors:

(i) Innovations. New ideas of getting things done more efficiently and productively by deploying new technologies and their successful commercialization and business knowhow. This works through two channels: the inbound knowledge transfer channel of copying and learning from more advanced countries, and the indigenous innovations channel of domestic inventions and innovations.

7 There is also the so called Balassa-Samuelson effect of faster currency appreciation associated with an increase in real GDP growth rate.

8 See a brief summary of Ricardo Hausmann's analysis in, "The end of emerging market party", August 30, 2013. Project Syndicate.

(ii) Investment. Rising investment at the levels of the firm, the economy and the society through the financing of new business formation, improving public infrastructure and raising the standard of health and education overall. This works through two channels: the foreign investment channel of attracting investment from outside and the domestic investment channel of stimulating local investment.

(iii) Market. Finding new and profitable markets for the new products and services. This works through either the domestic consumption channel of rising demand from an expanding consumption/middle class at home, or the export channel of increasing exports to overseas markets.

(iv) Governance. And, finally, the rule of law that protects private property rights while maintaining a level playing field for all to operate and compete through building credible and effective judiciary and legal institutions, a business-friendly bureaucracy and efficient regulations.

Think of these as the four indispensible cylinders of an economic growth engine. When they are all firing and working smoothly, the economy takes off whether it is called divergence (pulling ahead of others) or convergence (catching up with the leaders).

Britain led Europe in the First Industrial Revolution in spite of being a small little wind-swept island on the frigid fringe of northwestern Europe, because it excelled in being able to fire up all four cylinders of the growth engine ahead of other European countries. This was especially so in terms of establishing the rule of law (the governance cylinder) which greatly facilitated the working of the innovations and investment cylinders of the growth engine[9]. With Britain blazing the trail, France, Germany, the US followed. Copying from each other was easier between these countries (the inbound knowledge transfer channel of the innovations cylinder) than for far-flung regions in Eastern Europe, Central Asia, or Africa. Exports and cross-border-finance also proved to be great facilitators in transfer of technology and know-how while firing up the market cylinder and so, very quickly, as a group, these countries in Western Europe and North America pulled ahead of the rest of the world, creating the great divergence.

The same economic growth engine that propelled the great divergence also delivered the great convergence in the last 50 years. The East Asian front-runners in convergence chose to focus on the same growth engine, most significantly through importing technologies and knowhow from the West while exporting manufactured products to their consumers. And they succeeded.[10]They also enjoyed one notable advantage that was not available to the front-runners of the West; huge advances in information and communications technology in the past few decades made it a lot easier for East Asia, then China and India, to copy the front-runners in production technology and business practices (the inbound knowledge transfer

9 Economic historians tend to agree that it was Britain's ability to establish a better state of the rule of law (firing up the governance cylinder) ahead of all other Western European countries that explains its counter-intuitive leadership in the First Industrial Revolution. For details, see J. Appleby, The Relentless Revolution: A History of Capitalism. 2010. New York: W.W. Norton & Company.

10 Many countries failed to join the great convergence because they either failed or chose not to fire up the four cylinders of the growth engines; many chose the wrong policies such as import-substitution and self-sufficiency as in much of Latin America and Sub-Sahara Africa; or were forced to abide with USSR-directed central planning as in Easter Europe.

channel of the innovations cylinder), and in building massive supply chains that span countries and regions that accelerated global trade (the export channel of the market cylinder). This explains why the speed of convergence today has been so much faster than the speed of divergence historically.

Through the framework of the four cylinders of the economic growth engine, we can also explain why some countries managed to accelerate their growth while others failed, why the initial growth spurts in the convergence process tend to be extraordinarily fast but over time see growth rates inevitably slow, and finally why some countries could maintain a healthy pace of growth after the initial acceleration while others stagnated.

In order to get started in convergence, a low-income and under-developed country needs to fire up its innovations cylinder first in order to be more productive, usually through the inbound knowledge transfer channel as opposed to the much harder task of indigenous innovations. Once the innovations cylinder starts firing, the investment cylinder follows because new and promising investment opportunities open up as a result. To sustain the momentum created by these two cylinders, the third, the market cylinder, needs to kick in. For a low-income country, the market cylinder works best through the export channel because domestic demand is usually too small. Strong exports then provide further impetus to drive the innovations and investment cylinders faster. As these three cylinders work in a mutually reinforcing fashion, growth accelerates rapidly. This explains why in their take-off stage emerging markets in Asia typically saw their real growth rates surge to 10% a year or above for a decade or more.

But this strong growth spurt cannot last. Copying and importing foreign technology and knowhow gets increasingly difficult when the easy-to-reach low hanging fruits are harvested. And growth of exports cannot be sustained at the initial high rates as local wages rise and the penetration of overseas markets reaching diminishing returns. So the innovations cylinder has to begin to work harder by igniting local indigenous innovations and the market cylinder has to increasingly rely on the domestic consumption channel. At this point real growth rates typically slow and the fourth cylinder – governance -- becomes critically important.[11]

The governance cylinder is needed even in the beginning of growth take-off. Foreign Investors always need a certain amount of certainty before investing, however glittering the opportunities[12]. But when it comes to driving growth with indigenous innovations, domestic investment and domestic consumption, the governance cylinder takes on new and added significance. Without credible rule of law and a level playing field, local entrepreneurs and small businesses would not stand a chance competing against large and established incumbents. Nor would they be able to access the needed financing to launch

11 This stage is sometimes referred to as the "middle income trap". See an in-depth analysis and discussion by Eichengreen, B., D. Park, and K. Shin. March 2011. "When fast growing economies slowdown: international evidence and implications for China". National Bureau of Economic Research. Working Paper 16919.
12 That is why the use of "special economic zones" was common in the East Asian experience of convergence because they were very effective in providing a minimum level of rule of law sufficient to satisfy foreign investors in a confined geography.

new enterprises without strong institutions that establish and protect their property rights. So a dysfunctional governance cylinder would seriously impede the working of the innovations and investment cylinders. Furthermore, if the innovations and investment cylinders falter, then the domestic consumption channel of the market cylinder suffers as well because the expansion of the middle class is stunted and household spending power curtailed. Thus, after an initial surge, emerging markets have to get all four cylinders working together in order to sustain strong growth to converge with the developed economies and the governance cylinder now becomes the lynch pin that makes it all work.

Through the lens of the four cylinders of the economic growth engine, we can then systematically review the landscape of future global economic convergence from three perspectives: the global economic environment overall, the challenges to convergence and emerging markets' capability for convergence.

The Global Economic Environment

From the perspective of the global economic environment, the outlook is decidedly mixed. A deep source of uncertainty at this stage of economic recovery is the timing and speed of "tapering" -- the turning off of the Federal Reserve's money printing machine. Real interest rates will rise -- it is not a question of if, but when. Just how tapering will unfold will become a lot clearer in 2014. The fact that tapering is happening is in itself good news. Zero, or close to zero interest rates are not normal. They actually signify that the time value of money is zero which in turn indicates that there is no real economic growth. Part of the return to normality is to bring back positive real interest rates. Thus, the fact that tapering has started is a strong positive for global economic outlook, in spite of the inevitable shocks and dislocations that come with rising real interest rates, especially for asset markets that have been artificially propped up by cheap liquidity. My personal view is that tapering could happen faster than expected, thanks to the underlying dynamism of the US economy.

The decade prior to the 2008/09 crisis in the US was a time of severe economic distortion as a result of the government sanctioned and subsidized housing boom, which in turn fuelled a massive financial asset bubble. During this period, however, the non-financial private sector in the US, from energy to manufacturing, has been reinventing itself through innovations and technology. As a consequence, output per worker in the US grew by 1.7% per year in the past decade, outstripping growth in wages.[13] Productivity growth in the tradable sector has been especially outstanding. Cumulative productivity improvement has been such that many American firms are now re-shoring their overseas production capacity instead of off-shoring. The benefits of this process of economic reinvigoration are not equally shared, however; a sharp divide in wage growth has emerged between the highly skilled and the poorly

13 Data from Labor Bureau of Statistics

skilled. And, post-crisis, strong productivity growth has also been accompanied by low investment[14].

At present there is no question that the US economy is under-performing, and the shockingly dysfunctional American government deserves much of the blame. Real GDP growth has limped along at less than two-thirds of its speed limit (estimated to be around 3.5% per year). Over the medium term, however, the strength of the non-financial private sector will begin to tell and household consumption will steadily expand, this time more in line with rising household income instead of being debt-driven, as it was during the pre-crisis bubble period. This will allow the US economy to carry more weight in pulling the global economy forward. Laments of the decline of US notwithstanding, the US economy remains the single most important driver and innovations machine in the world in the foreseeable future.

Unfortunately the same cannot be said for the Eurozone. In spite of the crisis conditions having stabilized since the European Central Bank (ECB) introduced its "outright monetary transaction" policy in 2012 (the ECB's stance of "doing whatever it takes to prevent a collapse"), the crisis has not gone away. It will continue to simmer in the coming decade, with regular panic attacks and spiking of volatility[15]. This is because the root cause of the crisis is neither the debt issue nor the austerity measures that followed. It has to do with the deep social and economic divide between the North (Germany, Austria, the Netherlands, Sweden) and the South (the crisis countries) that emerged within the Eurozone after the launch of the common currency.[16]

At the most basic level, the economic model of the North can be characterized as based on the tradable sector, which requires products and services to be internationally competitive, which in turn built upon sustained productivity growth. The economic model of the South, in contrast, is primarily based on the non-tradable sector, which is heavily dependent on cheap credit to fuel consumer spending and rising government fiscal expenditures, with domestic businesses shielded from global competition.

The economic model of the North is embedded in a social consensus that enables private sector companies, labour unions and employers' associations to agree on and set wages guided by exports, global market shares, profitability, and companies' investment in worker training and skill upgrade. This social consensus allows the private sector in the North to adjust to global competition and succeed. In the South, however, there was no such social consensus for private sector adjustment; and for more than a decade prior to the eruption of the crisis the South's alternative was for governments to subsidize household consumption with ever-more generous fiscal spending, made possible by extraordinarily low cost of capital that became available to them as a result of becoming members of

14 According to the American Society of Civil Engineers' "report card", the gap between what is required in spending on infrastructure in order to keep pace with economic growth and the actual level of spending increased from US$1.1 trillion in 2009 to US$1.6 trillion in 2013.

15 T he planned stress tests for Eurozone banks in 2014 could result in new panic attacks.

16 France uniquely occupies a position that is a blend of the two.

the Eurozone.

Not surprisingly these two very different economic models delivered diametrically opposite results. Real wage growth in the North between 1999 and 2011 is estimated at 11%, versus 39% in the South. Productivity surged in the North but stagnated in the South. For example, Germany's productivity increased by over 1% per year over this period, whereas in Italy there was no increase, and productivity actually declined in Greece and Portugal. By 2012, manufacturing costs in real terms in Germany declined by 15% from the 1990 level, in sharp contrast with an increase of 7% in Spain and 27% in Italy.[17]

Thus, with the same currency and exchange rate, the behavior diverged between the North and the South in the Eurozone, which is the real (and very deep) cause of the crisis. And there are no easy shortcuts to bridge the divide. Germany's political economy can only work with fiscal conservatism and a competition-oriented private sector, which precludes higher wage inflation in the North to close the gap with the South. The only option left for the South is real wage deflation to regain competitiveness, which will require very deep transformations in their societies. The changes required will be a decade-long process, if not more, and there is no guarantee that they will be successful. And this means a state of persistent crisis for the foreseeable future in the Euro zone, constituting a stiff headwind for the global economy.

What about Japan? Prime Minister Shinzo Abe's programme to rejuvenate the Japanese economy, dubbed by the media as "Abenomics", is characterized by the prime minister himself as having three arrows: the first is to provide massive monetary stimulus aimed to raise inflation to hit 2% in three years' time; the second is fiscal stimulus through increasing government expenditures; and the third is structural reforms. The last arrow is arguably the most important, aiming to raise productivity of Japan's domestic economy, especially its large, and largely stagnant, service sector. This will in turn require labour market reform, intensifying domestic business competition, thereby lifting corporate investment and household income simultaneously. So it is also the most complicated and problematic in implementation.

So far, the first and second arrows have been shot and there have been some tantalizing results of incipient inflation (core inflation rose by 0.9%) and slightly better GDP numbers in 2013, even though its extraordinarily high public sector debt has also been pushed up, even higher. The third arrow, however, has remained stuck in the quiver and may never get shot at all. Without the third arrow, however, the first and second arrow will have been shot in vain. In fact, it would jeopardize Abenomics altogether. Without rising wages, an increase in inflation simply means an erosion of households' real income, hence their spending power. Higher inflation will also put pressure on Japan's rapidly

17 Estimates based on data from Eurostat.

increasing retired households living on fixed incomes, who are already coping with pricier imports due to a weaker Yen. Additionally, a 5% consumption tax is scheduled to kick-in this year, which will certainly impact on consumer spending. Under these conditions, it is far from clear that the Japanese economy is indeed on its way to rejuvenation and stronger growth.

So the bottom line is that while the global economic environment has been steadily improving since 2010, it is not out of the woods yet, to say the least. Even though we will likely see all the major regions of the global economy returning to positive growth together for the first time since the 2008/09 crisis, overall growth momentum remains weak and the headwind strong. And then there is the big question mark about China.

The China Factor

China is a key factor in the global economy today, occupying a unique position where it is simultaneously a driving force of global economic growth as well as the largest emerging market converging with the developed economies. Its strong growth in the past decades has relied heavily on the investment cylinder and the market cylinder (primarily through the export channel). For instance, during two decades from 1980 to 2011, manufacturing and construction grew by close to 12% a year, outstripping the 8.5% average annual growth in the service sector.[18] The imbalance created as a result has been widely recognized, not the least by its top leadership.

The Third Plenum of the Chinese Communist Party held in November 2013 announced that the market will play a "decisive" role in the Chinese economy, hinting at new and deeper reforms. In the weeks that followed, the slogan was slowly fleshed out by more details. It appears that the range of new reform initiatives could encompass interest rates liberalization, relaxation of the urban registration system to make it easier for rural migrants to settle in cities, pension and social welfare reforms, health sector reforms, new financing models to fund public infrastructure projects (issuing local government bonds instead of bank loans), relaxation of capital and currency controls and improving small and medium size businesses' access to financing. While it remains unclear how fast and how deep these reforms would be, there is no doubt that they are all desperately needed and will deliver rich dividends if successfully implemented. They would certainly enable China to power ahead at a speed limit of 5-7% real GDP growth a year in the remainder of this decade, hence breaking through the middle income trap sometime thereafter.

But there is also no avoiding the conclusion that the most immediate impact of these reforms collectively is a potentially dramatic slowdown in the all important investment cylinder of China's growth engine, which will lead to an overall slowdown in growth because there is the inevitable time lag before the other cylinders could gear up, as well

18 Estimate based on data from the National Bureau of Statistics, and the China Statistical Yearbooks (various years).

as structural limitations of how much they could compensate for the slowdown in the investment cylinder.

In other words, decisive reforms in China today will lead to much lower GDP growth rates in the coming years compared with the past, whereas a lack of reforms now will lead to a potential debt and banking crisis further down the road, as continued high borrowing by local governments and state-owned enterprises pushes China's credit boom to its breaking point. In the latter case, growth could come to a complete halt altogether.

Today, notwithstanding the leadership's stated intention of reform, which of these two paths China may take remains unclear. For example, the tentative steps taken to liberalize interest rates to curb credit growth in November 2013 led to rising cost of capital and a "cash crunch" in spiking inter-bank rates and bond yields. The People's Bank of China promptly took action and injected some US$49 billion of liquidity into the banking system in the week before Christmas to calm the water, thereby fueling credit growth further. Thus, instability in the financial sector could rise in the future because of the very reform effort itself. There is clearly a tug of war between the desire to control a dangerous runaway credit expansion and the fear of collapsing economic growth. Even in the best scenario of steady political nerves and a determined push in financial sector reform (a la Zhu Rongzi two decades ago), higher and volatile interest rates will likely be the norm.

Under these conditions, it is utter folly to take for granted that China will be able to sustain strong growth in future decades, let alone matching the double digit growth rates of the pre-crisis decade. So much of the recent breathless projections of China surpassing the US to become the world's largest economy in the near future (by 2020, 2025, or 2030 depending on how different analysts extrapolate past growth rates selectively) are based on a simple common assumption that somehow China's recent growth record is a sound basis for projecting the future.

In this connection, a simple calculation would be useful and sobering. In 2013, the GDP of US is US$16.8 trillion, versus China's US$8.9 trillion. If the US can grow at an average 3.5% a year in real terms in the future, which is its trend rate of growth, and if China can sustain a trend rate of growth of 5.5%, it will take 32 years for China's economy to surpass the US in size in 2045. A 5.5% real GDP growth rate for China may seem very low today, but to sustain it for the next three decades would be extraordinarily hard and indeed highly unrealistic. Should China's average future growth rate drop to 5% a year, it will take 45 years for China to surpass the US, i.e. in 2058. However, should China's average future growth rate drop below 5% a year, the gap with the US will not close at all! This is, for me, the most likely scenario.[19]

A Challenging Environment for Convergence

Given the mixed outlook in the global economic

19 Japan's average growth rate dropped to around 1% after 23 years of 8%+ growth. South Korea's average growth rate dropped to below 4% after 37 years of strong growth, in which growth exceeded 8% in 15 of the 37 years. Taiwan's growth rate dropped to below 4% after 27 years of strong growth, and in 18 of the 27 years growth exceeded 8%. By 2013, China had experienced 23 years of strong growth, and during this period growth rate exceeded 8% in 19 out of 23 years, and exceeded 10% in 11 out of 23 years. Even giving a generous allowance for China's high growth expansion to be longer lasting due to its bigger size, the future slowdown could be equally dramatic. (data from IMF WEO).

environment described above, it is not surprising that there are serious challenges facing emerging markets. First and foremost is that softer global economic growth is translating into weaker demand for exports from emerging markets, both in manufactured products and commodities. Emerging markets that have consistently depended on the export channel of the market cylinder to drive the tradable sector and stimulate the rest of the economy will find it more difficult to do so in the future.

Chronic dependence on exports for economic growth is indicated by a country's persistent surplus in its current account. China's current account surplus averaged 6% of GDP per annum between 2008 and 2010 and exceeded 10% of GDP in 2007, for instance. While China's surplus has been declining over the last few years, the decline is also matched virtually by a point-to-point equivalent slowdown in the GDP growth rate. Through the lens of our four cylinders of the economic growth engine, a persistent current account surplus means that the export channel of the market cylinder is being overworked, while the other cylinders are under-performing, a condition that is unsustainable.

The fact of the matter is that the world's current account balances must sum to zero. A country's surplus must be balanced by deficits incurred by others, willingly or otherwise. Under conditions of weak growth in global aggregate demand, it is becoming increasingly difficult for any country to run a persistently high current account surplus (or deficit for that matter). While a few emerging markets may continue to benefit from their current account surpluses, it is impossible for all emerging markets to grow this way.

Apart from weak global demand, another challenge is the deterioration in income distribution. Coinciding with the great convergence in the past 50 years, which is a case of improving income distribution between countries, income distribution has deteriorated within countries. Estimates of the Gini coefficient (the higher the coefficient, the worse the income distribution) have steadily increased in the vast majority of countries in the world over the last half a century. For example, China's coefficient rose from 29.1 (fairly equal distribution) in 1981 to 42.1 (very unequal) in 2009. Other emerging markets saw the same trend: the Gini coefficient rose in Indonesia from 30.5 in 1984 to 38.1 in 2011, in Nigeria from 38.7 in 1986 to 48.8 in 2010, in South Africa from 59.5 in 1993 to a shockingly high 63.1 in 2009. India's income distribution also worsened during this period, but only marginally, from 31.1 in 1983 to 33.9 in 2010. Turkey is an exception; its Gini coefficient actually dropped from 43.8 in 1987 to 40.0 in 2010[20].

This is not a phenomenon confined to emerging markets. Many developed economies also suffered from deterioration in income distribution. For example, Italy's Gini coefficient rose from 28.7 in 1984 to 31.9 in 2010. Similarly it rose between 1985 and 2010 in the UK from 30.9 to 34.1 and in the US from 33.6 to

20 These estimates of Gini coefficients are made by the World Bank.

38.0.[21] Such a widespread trend of deterioration in income distribution within countries across the world suggests that the benefits and costs of globalization have not been equitably shared by different segments of the population within various countries. As a result, it has helped to cement resistance to trade liberalization while putting more pressure on governments to provide subsidies and protection at a time when the fiscal position of most governments is either weak or sinking, or both.

From the perspective of the emerging markets, these global challenges mean that there is less scope for them to export their way out of the slump in the future. Meantime, the need to address the worsening conditions of income distribution at home could become existential in the coming years for many emerging market governments; rising social discontent is fermenting political instability in many countries. What, then, are the prospects of convergence?

The Future of Convergence: the Imperative of Inclusive Growth

The prospects for emerging markets to converge with the developed economies in the future should not be taken for granted, nor should it be seen as a rising tide lifting all boats phenomenon. They will stand or fall individually, depending on how well their four cylinders of the economic growth engine can operate in a balanced and coordinated way to achieve robust and sustainable growth. In this context, their way forward depends critically on inclusive growth.

Inclusive growth can be simply defined as a pattern of growth that distributes the fruits of an expanding economy equitably, benefiting not just a few large business conglomerates or cliques of elite with close ties to the government, but small businesses, entrepreneurs and the ordinary working people at large. The most common features of inclusive growth are reduction of poverty, rising social and economic mobility and an expanding, dynamic and increasingly prosperous middle class. As such, inclusive growth is the single most promising pathway of convergence for emerging markets in the more challenging future global economic environment.

In fact, inclusive growth can set in motion a virtuous circle in which the four cylinders of the growth engine become mutually supporting. When the benefits of growth are more equitably shared, income grows faster for the majority of households, making domestic consumption a more powerful channel in the market cylinder, hence more capable to counterbalance a slowdown in exports. A bigger and more dynamic domestic consumer market in turn opens up more opportunities for local entrepreneurs and small businesses to compete, especially in the service sector, thereby boosting the indigenous innovations channel of the innovations cylinder. As the pace of innovations quickens, stronger investment follows, which further drives domestic demand, including domestic consumption. Collectively indigenous innovations, growth and competition in

21 Estimates of the developed economies are made by the OECD.

the domestic consumer market and rising investment form a powerful impetus to push the governance cylinder into higher gear, putting pressure on government to reform public institutions like the judiciary, to curb corruption and to improve the efficiency of the bureaucracy. A better performing and more business-friendly governance cylinder then in turn empowers stronger performance of the other three cylinders.

However, inclusive growth does not come free of charge. Hard choices have to be made and trade-offs have to be accommodated. Incumbent elites with close ties to the government will resist it and they need to be combated. Rent-seeking monopolies need to be broken up and the market liberalized to welcome new competitive entrants. Commodity exporters will need to diversify investment away from the narrow resource sector. All these will entail dislocation and pain, and often political risks. But the alternative to inclusive growth is stagnation and failure. Emerging markets must face up to this and make these hard choices if they are to meet the demand for inclusive growth, which is the new benchmark of future success.

Table 1 summarizes my subjective assessment of the prospects for inclusive growth for a group of key representative emerging markets through the prism of the four cylinders of the growth engine. The time horizon is the next ten years. Among the BRIC countries, India is assessed to be a "positive" in spite of its current growth slowdown. In spite of its dysfunctional politics and pathetic bureaucracy, India's innovations, investment and market cylinders have shown themselves capable of forging a way forward in spite of the dead hand of the government. Its governance cylinder is also embedded in a functioning democracy, which could become more effective with improving electoral politics. This is critical as democracy reduces significantly the risks of a complete breakdown of the governance cylinder in the future.

Russia is rated a "negative", with weak innovations and governance cylinders and deteriorating investment and market cylinders.[22] Unlike India, the risks of a breakdown of the governance cylinder in Russia cannot be ruled out in the time horizon of the next ten years. Brazil and China are assessed to be "feasible", meaning that their future success is subject to implementation of new critical reforms that would fundamentally alter how the governance cylinder operates. In Brazil, a policy U-turn -- away from subsidies and socialist oriented welfare spending to public-private partnerships to stimulate investment -- will be critical. In China, building more impartial and effective legal institutions to entrench the rule of law will be critical.

In Southeast Asia, Philippines and Malaysia are assessed to be "positive". Philippines' "positive" is based on its strong innovations and market cylinders, and improving investment and governance cylinders. Malaysia's "positive" is based on its strong investment and market cylinders, an improving innovations cylinder, but it is burdened with a neutral governance cylinder. Indonesia, Thailand and

22 Apart from the impact of the ending of the commodity super cycle, capital flight in Russia has been estimated to be in the tens of billions a year in the last decade, indicating a continuous erosion of investment and business confidence. See Wood, A. and L. Shevtsova. 2011. Change or Decay: Russia's Dilemma and the West's Response. New York: Carnegie Endowment for International Peace. P. 102.

Vietnam are assessed as "feasible". Indonesia is hampered by a weak investment cylinder (outside of the narrow resource sector) and a weak governance cylinder. Both Thailand and Vietnam are seen as shackled by a deteriorating governance cylinder. Outside of Asia, Turkey is assessed to be "positive"; and Ghana and South Africa are assessed as "feasible", whereas Nigeria is given a "negative" in Sub-Sahara Africa.

The bottom line for global businesses is that emerging markets will have to be evaluated one by one. Not all emerging markets will emerge just because they are called 'emerging markets', just as the BRIC countries are no longer seen to be locked onto an automatic fast track of growth[23]. The global economy remains an open road for emerging markets to converge with the developed economies, following the earlier success of Japan, South Korea, Taiwan, Hong Kong and Singapore. But in the new global economic environment, inclusive growth becomes a crucial prerequisite. Inclusive growth is not a sufficient condition for convergence, but it is a necessary condition, and without it emerging markets will not even be in the running. It is therefore a differentiator that separates the winners from the losers among the emerging markets in the future. Accordingly, global businesses will need to develop the capacity for understanding and evaluating emerging markets with the benchmark of inclusive growth, and better still, to find ways to support and nurture inclusive growth wherever they invest and operate, since it is only with inclusive growth that their business and market potential will be the most promising.

Table 1: Assessment of Prospects of Inclusive Growth and Convergence

	Innovations Cylinder	*Investment Cylinder*	*Market Cylinder*	*Governance Cylinder*	*Prospects for Inclusive Growth*
Brazil	→	↗	↑	→	*Feasible*
Russia	↓	↘	↘	↓	*Negative*
India	↑	→	↑	↑	*Positive*
China	→	↑	↑	↓	*Feasible*
Indonesia	↓	↑	↑	↓	*Feasible*
Malaysia	↗	↑	↑	→	*Feasible*
Thailand	→	↑	↑	↘	*Feasible*
Philippines	↑	↗	↑	↗	*Positive*
Vietnam	→	↑	↑	↘	*Feasible*
Turkey	↗	↑	↑	↗	*Positive*
South Africa	↗	→	→	↘	*Feasible*
Nigeria	↓	↘	→	↓	*Negative*
Ghana	↗	↗	↑	↗	*Feasible*

(↑ = strong, → = medium, ↗ = improving, ↘ = deteriorating, ↓ = weak)

23 I was told recently by a senior executive in charge of the Asia/Pacific operations of a multinational that the BRIC acronym actually stands for "bloody ridiculous concept for investment".

GEMS

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