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Revisiting Growth Patterns in Emerging Markets

Recent studies document that emerging markets are rather similar in their growth patterns despite profound differences in starting conditions and productivity fundamentals. This challenges the common view on productivity as the main growth engine. The crucial role of the external environment for emerging markets emphasized by numerous studies adds to this doubt. I argue that productivity fundamentals still matter and remain the core driver of sustainable growth. However, external factors are crucial for understanding deviations from the trajectory of sustainable growth, i.e. episodes of growth accelerations/decelerations.

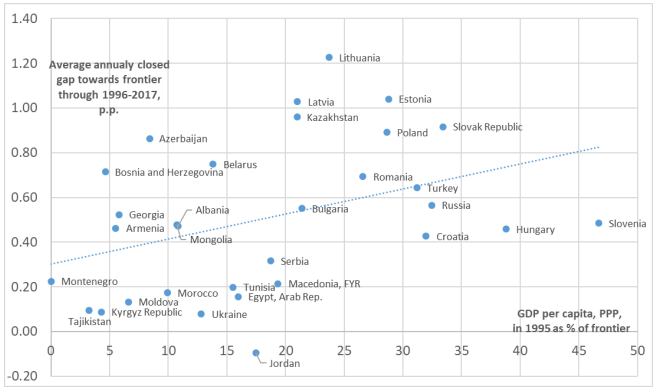
Challenges for Understanding Growth in Emerging Markets

As we enter the 4th decade of economic transition in Central and Eastern Europe (CEE), the causes and directions of causality of long-term growth in emerging markets might need to be reconsidered. Some recent studies emphasize that growth trajectories in emerging markets are pretty similar, i.e. average growth rates do not differ too much, while jumps and drops in growth rates are synchronous for the bulk of emerging economies (e.g. Fayad and Perelli, 2014). For instance, a decade ago the level of GDP per capita (in 2011 international $) in Macedonia was roughly 45% of that in the Slovak Republic, which likely reflected the productivity (measured through the Global Competitiveness Index) gap between them. During the last decade, Macedonia has roughly closed this productivity gap. Growth theory would postulate that this should have transformed into faster output growth in Macedonia vs. Slovak Republic closing well-being gap. However, the two countries' had throughout the decade roughly equal average output growth and the well-being gap today is still the same as it was ten years ago.

Such observations seem to conflict with existing theoretical views. First, this is a challenge to the well-being convergence concept that results from growth theory. Moreover, if we measure growth in terms of the speed of closing the well-being gap with respect to the frontier (the US economy), one may argue even for divergence. For instance, Figure 1 presents a scatter-plot for a sample of emerging markets relating the initial conditions – well-being level in 1995 (GDP per capita relative to one of the US economy) – and the average speed of well-being gap (vs. the US economy) closing throughout 1996-2017 (measured in p.p. of corresponding gap).

Second, the evidence that productivity gains do not automatically trigger output growth challenges a common view that productivity is the major driver for sustainable growth.

Figure 1.Starting Conditions and Well-Being Gains



Source: Own computations based on data from World Development Indicators database (World Bank).

What are possible explanations for the observed similarity in growth rates of emerging markets?

A study by the IMF (2017) suggests a response: growth in emerging markets is similar and synchronous due to the external environment. This study emphasizes the crucial dependence of medium-term growth in developing countries on the following factors: growth of external demand in trade partners, financial conditions, and trade conditions. Moreover, it states that these factors are dominant in explaining the episodes of growth strengthening/weakening.

Does this explanation change the growth nexus for emerging markets? Can one state, that while external factors are crucial for growth and growth in developing countries is rather homogenous, the productivity gains are not so important anymore?

I would say no. First, for better understanding of growth patterns we must clearly compare the relative importance of productivity gains vs. external factors in affecting the growth schedule. Second, we must separate relatively short-term fluctuations in GDP growth from sustainable growth.

Detecting Relative Importance of Growth Drivers

To answer the question about the relative importance of productivity fundamentals and growth factors, I study a panel of 34 emerging market economies (EBRD sample netted from 3 countries for which the data is not available) for 11 years (2007-2017).

To evaluate the relative importance of productivity and external factors, I use a standard approach of running panel growth regressions with fixed effects. At the same time, I make a number of novelties in the research design.

First, for measures of productivity, I engage a unique database – Global Competitiveness Indicators by World Economic Forum (WEF). Although this database provides an insightful perspective on productivity fundamentals at the country level, it is rather seldom a 'guest' in economic research. From this database, I extract a number of individual indicators in order to detect which ones among them that have the strongest growth-enhancing effect. For an alternative specification, I use principal components of 9 individual indicators from this database as proxies for productivity gains.

Second, for external factors, I use an approach similar to the IMF (2017) and calculate variables representing external demand growth, trade conditions, and financial conditions (such as a measure of capital inflows) for each country. Moreover, in respect to external demand growth, I use different competing measures (based on either imports of GDP growth of trade partners) and choose the best one in each individual equation. By doing so, I allow this dimension of the external environment to be represented in each model to the largest possible extent.

Third, I depart from using output growth as the only measure of economic growth and response variable in growth regressions. I argue that for international comparison purposes it is worthwhile to consider also the speed of closing the gap towards the frontier (the US economy). On the one hand, this measure is strongly correlated with the traditional output growth rate. On the other hand, this measure, in a sense, nets out the growth rate of a country from global growth, thus capturing something more unique and peculiar just to individual countries' gains in well-being. Furthermore, I argue that in the discussion about the factors behind growth, one should distinguish between relatively short and long term growth. Annual growth rates, especially at relatively short time horizon, are too dependent on fluctuations, which may be interpreted in terms of growth rate strengthening/weakening. However, to emphasize the property of growth sustainability, we should get rid of 'unnecessary noise'. For this purpose, I also introduce a trend growth rate measured in a most simple way as the 5 year moving average (following the discussion in Coibion et al. (2017), show that the bulk of measures of 'potential' growth are not good enough to get rid of demand shocks and these measures are pretty close to simple moving average measures).

I apply this definition of trend growth both to 'standard' GDP growth rate and to the speed of closing the gap towards frontier. So, finally I have 4 response variables: 'standard' growth rate, the speed of closing the gap to frontier, and two corresponding measures of trend growth.

Sustainable Growth Mainly Depends on Productivity

Having short-term (annual) growth rate as response variable (either 'standard' or the one in terms of closing the gap) provides results close to those in IMF (2017). It may be interpreted in a way that the external environment is more important than productivity factors. If dividing all regressors into two broad groups of factors – external and productivity - the former is responsible for up to 70% of the growth effect, while the latter for about 30%. Among external environment factors, the

most important one is financial conditions. Its relative importance is roughly 50% of the group of external factors' total.

Among productivity fundamentals, an important contributor to short-term growth is the quality of the macroeconomic environment. According to the methodology of WEF (2017), this indicator encompasses the fiscal stance, savings-investment balance, the external position, inflation path, debt issues, etc.

When refocusing from short-term growth to the growth trend as a response variable, the relative importance of the factors behind growth changes. Productivity fundamentals in this case drive up to 80% of growth effect, while external factors are responsible for the remaining 20%. It is worth noting here that the proportion in favor of productivity factors is higher for the concept of closing the gap to frontier rather than for 'standard' trend growth rate. This evidence may be interpreted as additional justification for treating this measure of growth as 'good' at reflecting individual properties of a country in a global landscape.

Furthermore, the role of individual variables also changes. Among external factors, the most important role in driving sustainable growth belongs to trade conditions and external demand growth, while the role of financial conditions is either miserable or insignificant at most. Among productivity factors as drivers of trend growth, the quality of the macroeconomic environment seems to play a special role, as well as the efficiency of the goods market and the financial system.

Conclusions

The evidence showing rather similar and synchronous growth in emerging markets and recent evidence on the crucial importance of external factors for emerging markets should not lead us to incorrectly believe that productivity fundamentals do not matter anymore. Productivity fundamentals are still the core driver of sustainable growth. At the same time, we should keep in mind the important role of the external environment for emerging markets. However, changes in the external environment are more likely to generate relatively short-term growth rate fluctuations, while having a modest impact on the sustainable growth trajectory. Hence, a country aiming to secure sustainable growth should still first of all think about productivity fundamentals.

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