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Why Growth in Emerging Economies Is Likely to Fall

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Abstract

Emerging-market growth from 2000 to 2012 was untypically high. This paper highlights the many reasons why emerging-economy growth is likely to be lower going forward. Much of the catch-up potential has already been used up. The extraordinary credit and commodity booms are over, and many large emerging economies are financially fragile. They have major governance problems, so they need to carry out major structural reforms to be able to proceed with a decent growth rate, but many policymakers are still in a state of hubris and not very inclined to opt for reforms. They are caught up in state and crony capitalism. Rather than providing free markets for all, the West might limit its endeavors to its own benefit. Economic convergence has hardly come to an end, but it has probably reached a hiatus that is likely to last many years. The emerging economies need to improve their quality of governance and other economic policies substantially to truly catch up. For a decade or so, the West could take the global economic lead once again as in the 1980s.

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Keywords: growth, slowdown, middle income trap, energy, financial crisis

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INTRODUCTION

Large emerging-market economies, especially the BRICS (Brazil, Russia, India, China, and South Africa), have been unstoppable in the last long decade 2000–12.[1] From 2000 to 2012, they grew on average 6.2 percent a year, while US growth was 1.9 percent a year on average[2] (figure 1). An influential Goldman Sachs paper of 2003 predicted extraordinary BRIC growth until 2050 (Wilson and Purushothaman 2003). The high growth rate of the emerging economies has become widely accepted as the new normal. A new conventional wisdom has arisen, that economic convergence between the developed and the emerging economies is all but inevitable and that China will soon overtake the United States economically and rule the world. Books such as *Eclipse: Living in the Shadow of China's Economic Dominance* (Subramanian 2011) and *When China Rules the World* (Martin 2012) have become staples.

However, the two preceding decades, 1981–99, offer a sharp contrast. Emerging economies grew only at an average of 3.6 percent a year during those decades, while the US economy grew at 3.4 percent a year. Considering that the initial US economic level was so much higher, no economic convergence occurred between the United States and the emerging economies during those two decades.

Before the Industrial Revolution started in the late 18th century, GDP per capita was similar in most of the world, and the two biggest economies were China and India simply because they had the largest populations (Maddison 2001). In the 19th and 20th centuries, three great forces of separation took hold. The first was benign, the Industrial Revolution, which involved the evolution of good governance that eventually became democracy, rule of law and private property rights, technological development, and education, and enabled the leading countries to take off economically. The second force was malign, namely colonization. It kept down most of the world until around 1960. The third force was also malign, namely socialism, which kept the former Soviet Bloc and much of the Third World in poverty and isolation until 1990.

GDP per capita should converge again if countries are independent, have equally good governance, pursue similar economic policies, have similar capital and resource endowments, and use the same technology. However, this is a tall order. These requirements are not easy to fulfill, and even if they are real economic convergence would take decades.

The hypothesis of this paper is that the emerging market growth from 2000 to 2012 was atypically high and we might be back in a situation that is more reminiscent of the early 1980s. The growth of the last 12 years was neither sustainable nor likely to last. Several cycles that are much longer than the

1. The BRIC concept was invented by Jim O'Neill at Goldman Sachs in 2001 as a marketing devise. It took on a political life of its own, and the first BRIC summit was held in Russia in 2009. In 2010, it was extended to BRICS, including South Africa, in 2010.

2. IMF, *World Economic Outlook*, October 2013.

business cycle exist. One is the credit cycle, which Claudio Borio (2012) assesses at 15 to 20 years. Another is the commodity cycle, which last peaked in 1980 and might last 30 to 40 years (Jacks 2013, Hendrix and Noland forthcoming). A third is the investment or Simon Kuznets cycle, which appears related to both the credit and commodity cycles (Kuznets 1958). A fourth cycle is the reform cycle, which might also coincide with the Kondratieff cycle (Rostow 1978).

The purpose of this paper is by no means to prove the existence of these cycles and even less to discuss their length. My argument is much more limited: A large number of emerging economies seem to be close to a turning point in all these four cycles. The credit, commodity, and investment cycles have peaked out, while reforms on the contrary have tended to occur during crises and need to be restarted. It usually takes a decade or two to embark on, design, and implement new reforms. I offer seven arguments why high emerging-economy growth is over:

1. One of the biggest credit booms of all time has peaked out. Extremely low interest rates cannot continue forever. A normalization is inevitable. Many emerging economies are financially vulnerable with large fiscal deficits, public debts, current account deficits, and somewhat high inflation.
2. A great commodity boom has peaked out, as high prices and low growth depress demand, while the high prices have stimulated a great supply shock.
3. The investment or Simon Kuznets cycle has peaked out, as the very high Chinese investment ratio is bound to fall and real interest rates to rise.
4. Because of many years of high economic growth, the catch-up potential of emerging economies has been reduced and growth rates are set to fall *ceteris paribus*.
5. Many emerging economies carried out impressive reforms from 1980 to 2000, but much fewer reforms have taken place from 2000 to 2012. The remaining governance potential for growth has been reduced. Characteristically, reforms evolve in cycles that are usually initiated by a serious crisis, and after 12 good years complacency has set in in the emerging economies.
6. Worse, the governments of many emerging economies are drawing the wrong conclusion from developments during the Great Recession. Many think that state capitalism and industrial policy have proven superior to free markets and private enterprise. Therefore, they feel no need to improve their economic policies but are inclined to aggravate them further.
7. Finally, the emerging economies have benefited greatly from the ever more open markets of the developed countries, while not fully reciprocating. The West is likely to proceed with selective, regional trade agreements rather than with general liberalization.

For these reasons, we should expect much lower growth rates in the emerging economies over the next decade, while the mature economies, many of which have been in crisis, should recover. The United

States is returning to its old normal, while many European countries have already suffered a severe crisis and therefore undertaken far-reaching structural reforms, such as reforms of labor market policies, taxation, public administration, and social transfers.

My purpose in this paper is exploratory—to establish the important variables and developments we should watch. I shall also suggest how they are likely to evolve on the basis of current levels and historical precedents, but I shall abstain from making exact predictions or quantifications.

I shall focus on seven large emerging economies, the BRICS plus Indonesia and Turkey. The reason for choosing the BRICS is evident, the four first being the biggest emerging economies. The addition of Indonesia and Turkey is motivated by Deutsche Bank and Morgan Stanley naming Brazil, India, Indonesia, Turkey, and South Africa the Fragile Five. The growth rates of several peaked out in 2010 (China, India, and Brazil). All had less growth in 2012 than in 2011 and seem to be doing worse in 2013 than in 2012 (figure 2).

THE BIGGEST CREDIT BOOM OF ALL TIME

From 2000 to 2008, the world went through one of the greatest credit booms of all time. It was prolonged for half a decade from late 2008 to 2013 by quantitative easing in mature economies, flooding both them and emerging economies with cheap financing. Deleveraging has occurred only in the United States.

After a decade of infatuation, investors suddenly turned their backs on emerging markets in May 2013. In the BRICS and other emerging economies growth rates had already fallen and current account balances deteriorated. The catalyst was the prospect of a rise in the interest rate in the United States, which started on May 22 with US Fed Chairman Ben Bernanke talking about "tapering" or reduced quantitative easing. The US ten-year treasury yield surged by at most 135 basis points, although the US Fed continues with quantitative easing. The bond yields have moderated and tapering has been delayed, but the general expectation is that they will rise much more later on, and bond yields of vulnerable emerging economies have surged by over 300 basis points. Rationally, investors have expected all along that the zero US interest rates would eventually normalize, though it may take several years. Given that the Fed inflation target is 2 percent, and a real ten-year bond yield of 3 percent used to be the average, we would expect the bond yield to rise to something like 5 percent. By comparison, when the US Fed started raising interest rates at the end of the 1970s, the ten-year bond yields quickly swung up by 6.5 percentage points from 1977 to 1981 (figure 3).[3]

3. The absolute level of the yields will be different today because the underlying inflation is so much lower, but the swing is likely to be similar.

Financial markets are signaling that several major emerging economies may be approaching crisis. Deutsche Bank and Morgan Stanley have named Brazil, India, Indonesia, Turkey, and South Africa the Fragile Five, because they suffered particularly large currency outflows in May and June 2013 and their floating exchange rates plummeted. Their common characteristics are that they received excessive volumes of short-term international financial inflows, which enticed them into accepting excessive current account deficits for too long. India and South Africa have substantial budget deficits, and Brazil and India have public debt of two-thirds of GDP, which is a dangerous level for an emerging economy in bad times. India has reached double-digit inflation. High economic growth of the past has made their governments complacent, while rising exchange rates undermined their competitiveness. But now their growth rates have fallen (table 1 and figure 2).

The delay in tapering gives them an opportunity to make amends, but so far none of them has done so. Sensibly, the large emerging economies have accumulated large foreign reserves, but they are not likely to help them. Russia illustrates the problems. In 1998, it ran out of reserves and had to cut enterprise subsidies sharply, which leveled the playing field and was a major factor behind the fast Russian economic recovery (Åslund 2007). In 2008–09, by contrast, the Central Bank of Russia spent $200 billion of its ample reserves. Essentially these funds went to inefficient state and oligarchic enterprises, which crowded out better smaller companies. Thus, the reserves contributed to the decline in Russia's growth rate (Davydova and Sokolov 2012).

What good can reserves do? If emerging economies defend their exchange rates with their reserves, these will shrink fast. If they do not defend the exchange rates, currency outflows are likely to accelerate, quickly diminishing reserves, and with a plummeting exchange rate the danger of inflation increases. Admittedly, a lower exchange rate should make the emerging economies more competitive, but most of them also suffer from multiple bottlenecks so the production and infrastructure capacity required for larger exports might not be at hand. Thus, the floating exchange rates are a considerable improvement but they and the large reserves may not be a panacea. In either case, the emerging economies can easily encounter a sudden stop of international financing.

An additional risk is the possibility of a financial bubble in China. By any ordinary standard, its banks appear overleveraged (Walter 2012). The comparable financial measure most easily available that contains bank assets is M2. Other major emerging economies have an M2 of 40 to 80 percent of GDP, while China's M2 in 2012 amounted to no less than 190 percent of its GDP (figure 4). Three arguments are raised in defense of China's extensive bank lending. One is that China also has the highest savings in the world, but they can fall as the financial system inevitably becomes more liberalized with economic development. A second argument is that China's banks are well capitalized, but that is true of most banks until many loans turn out to be nonperforming loans. Third, the increase in bank loans has been relatively

moderate, but at some stage the level could become just too high. Yet, it is impossible to predict when the Chinese financial bubble will burst. It may persist for years, giving the government time to alter policy.

Borio (2012) has explained the nature of the financial cycle. The financial cycle is long, lasting 15 to 20 years. Its length is not predetermined but depends on the policy pursued. A financial boom builds up causing debt and capital stock overhangs, which leads to misallocation of both capital and labor. Eventually, the boom turns into a bust and asset prices fall, while debts force economic agents to cut expenditures to repair their balance sheets. Peaks of financial booms are associated with systemic banking crises and real estate crises. While the West has gone through its financial crises, the emerging economies might be approaching theirs, since they overcame the global recession of 2008–09 with large fiscal stimulus. Of the seven emerging economies I focus on, all but Russia appear potentially vulnerable.

Charles Kindleberger and Robert Aliber (2005, 90) have summarized the nature of a boom and bust:

> The standard model of the sequence of events that leads to financial crises is that a shock leads to an economic expansion that then morphs into an economic boom; euphoria develops and then there is a pause in the increase in asset prices. Distress is likely to flow as asset prices begin to decline…. A panic is likely and then a crash may follow.

Carmen Reinhart and Kenneth Rogoff (2009, 224) have measured the dimensions of financial crises, "asset market collapses are deep and prolonged. Declines in real housing prices average 35 percent stretched out over six years, whereas equity price collapses average 56 percent over a downturn of about three and a half years." A financial crisis often involves a banking crisis, and "the aftermath of banking crises is associated with profound declines in output and employment…. Output falls…more than 9 percent on average." In the end, the "government debt tends to explode; it rose an average of 86 percent" in real terms in major financial crises after World War II.

Several emerging economies are clearly vulnerable, and the consequences of a financial crisis tend to be horrendous. The East Asian countries survived their crisis of 1997–98 quite well, but usually such crises are more damaging.

A GREAT COMMODITY BOOM HAS PEAKED OUT

The long commodity cycle is best illustrated by the price of the most important commodity—oil. After decades of staying low, oil prices skyrocketed in 1973 and stayed high until they peaked in 1980. To everybody's surprise, oil prices fell steadily from 1981 until 1986. The main reason was that investment in energy saving had been more successful than anticipated, and the high energy prices had stimulated supply. Oil prices were rather low for two decades from 1981 until 2003. Then, they started rising once

again, reaching a new summit in 2008. Disregarding the sharp peak in July 2008 and the drastic fall in the fall of 2008, oil prices have hovered at a high level of $100 to $120 per barrel (figure 5).

Once again we are in a similar situation as in 1981.[4] Global oil and commodity prices rose sharply from 2003 until 2008 and then stayed high throughout 2012 because of the loose global monetary policy, which prompted both more investment and speculative investment in commodities. After such a long period of high energy prices, energy savings are likely to increase thanks to new investment and new energy-saving standards. In 2013, most commodity prices have fallen significantly because of less demand and more supply.

In parallel, energy production has gone through multiple technological revolutions with shale gas, tight oil, deep-sea drilling, and liquefied natural gas, generating a far greater supply effect than in the 1980s, since these innovations are of so much greater significance (Verleger 2013). The new unconventional gas reserves are assessed at three to five times prior global conventional natural gas reserves. The cost of production remains an issue, but such costs almost invariably fall with more innovations.

Figure 6 shows the evolution of oil production and consumption from 1970 to 2012. Naturally, both vary much less than prices, but after oil prices doubled with the revolution in Iran in 1979, global oil consumption decreased through 1983 and only in 1993 did it return to its 1979 peak, although global real GDP has risen 26 percent meanwhile. Judging from the precedent, oil and commodity prices are likely to be low for the next couple of decades.

Economists who have studied commodity supercycles have found four such cycles from the 1860s lasting for 30 to 40 years regardless of whether they have focused on oil or nonoil commodities (Jacks 2013, Erten and Ocampo 2012). All indicators suggest that the peak has passed and the decline in commodity prices is likely to continue.

TOO HIGH OR TOO LOW INVESTMENT RATIOS

Investment ratios as a share of GDP reveal what is wrong with the large emerging economies. Ideally, a quickly developing economy should have an investment ratio of 30 to 35 percent of GDP. India and Indonesia do have such sound investment ratios.

China, by contrast, overinvests (Lardy 2012). Its investment ratio has risen from a sound rate of 35 percent of GDP in 2000 to an extreme level of 48 percent of GDP in 2009 and 47 percent in 2012 (figure 7). This boost was caused by an extraordinary fiscal stimulus. Such a high investment ratio cannot be economically sustainable, and it is bound to fall by at least one-tenth of GDP. But China's high economic growth has been predicated on its large investment, and it is not evident that China will be able to transition from "extensive" to "intensive" growth, in the words of Soviet leader Leonid Brezhnev.

4. Ed Morse of Citibank is the current lead writer on the commodity supercycle in his private Citi briefings.

In recent years, China has accounted for a large share of global investment and 40 to 50 percent of global consumption of major commodities.[5] In addition, the global investment ratio is bound to decline significantly for years to come as real interest rates rise, and demand for commodities is bound to decline with less investment.

Four other large emerging economies, however, invest too little especially in infrastructure (figure 7). Brazil, South Africa, Turkey, and Russia have low investment ratios of 18 to 21 percent of GDP, leading to multiple bottlenecks. Moreover, they all seem more interested in white elephants than in infrastructure. The Olympic Games tell it all. In 2008 Beijing beat all prior games with an expenditure of $43 billion. Russia is spending $51 billion on the 2014 Sochi Winter Olympics compared with $6 billion spent on Vancouver's in 2010. India's organization of the Commonwealth Games in 2010 was catastrophically poor, which aroused great popular derision. Brazil's recent protests were, in part, about the cost of the 2014 soccer World Cup and 2016 Olympics. Apart from China, most other large emerging economies are neglecting infrastructure. Russia has not expanded its paved road network by more than 6 percent since 1994.[6] Only in 2018 is a highway finally expected to connect Moscow to St. Petersburg—and merely because it will be Russia's turn to host the World Cup.

The low investment ratios in these four large emerging economies have many implications. They do not have much free capacity left, and bottlenecks, notably in transportation, are likely to impede their growth for at least the next decade. They all have more savings than investment, which reflects a poor business environment discussed below. As global interest rates are set to rise, it is unlikely that vulnerable countries will be able to raise their investment ratios.

THE MODERATION OF CATCH-UP GROWTH OR THE MIDDLE-INCOME TRAP

Much of the catch-up potential has been used up. Russia's growth rate of 7 percent a year from 1999 to 2008 cannot be maintained in such a rich country. The same is true of Brazil. Both have been major beneficiaries of the commodity boom, but commodity prices are now leveling out.

The reduction of the catch-up potential and the neglect of governance may be combined into a so-called middle-income trap that Barry Eichengreen, Donghyun Park, and Kwanho Shin (2011) warned of in a seminal paper. They found that countries tend to experience a sharp growth slowdown when GDP per capita reaches about $15,000, which is approximately the current level in Russia and Brazil. Eichengreen, Park, and Shin only carried out a statistical exercise, not discussing the possible causes of this middle-income trap.

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5. See www.docstoc.com/docs/158105406/Goldman-Sachs—Evolution-of-the-super-cycle.

6. Russian Statistical Yearbook, 2011, www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/publishing/catalog/statisticCollections/doc_1135087342078.

In an ambitious econometric study, a group of IMF economists defined middle income as GDP per capita (in 2005 purchasing power parity) in the range of $12,000 to $16,000 and confirmed that middle-income countries are more likely to experience slowdowns then richer or poorer countries (Aiyar et al. 2013).

Interestingly, they also econometrically tested a large number of potential causes of the middle-income growth slowdown. They single out five major groups of causes. Among institutions, they find that poor rule of law, disproportionately large government, and severe regulation impede growth. A couple of demographic variables slow down growth as one would expect. Several macroeconomic variables, matter, notably gross capital inflows, investment share, trade openness, and public debt. Economic structure matters as well, as the easiest way of raising productivity is through urbanization. When unskilled workers migrate from labor-intensive agriculture to manufacturing, productivity rises sharply (Kuznets 1958). In Brazil and Russia, this source of growth is long exhausted, while it continues in China. Finally, for trade, distance and regional integration are important to overcome the middle-income trap. Curiously, the IMF economists do not find any significant impact of infrastructure, possibly because they handle investment ratio separately (Aiyar et al. 2013).

In more general terms, the middle-income trap may be seen like this. In poorly developed countries plenty of free or underutilized resources—labor and natural resources—are available. It is relatively easy to mobilize them. After a major crisis, such as the Cultural Revolution in China or the collapse of communism in the former Soviet Bloc, large free production capacity exists that can be mobilized for economic growth for a decade or so. A capacity ceiling may be hit all of a sudden, leading to a sharp deceleration of economic growth.

In order to proceed, a different development strategy is needed. Rather than the extensive use of relatively free resources, a more intensive exploitation and nurturing of existing resources is needed, that is, large structural changes are needed to overcome the middle-income trap. This means closing simple industries such as textiles, steel, and chemicals to proceed to more advanced manufacturing and services. Often the old system of governance does not allow the development of new enterprises and industries. This is clearly the case in Russia and Brazil.

Countries such as South Korea, Taiwan, and Singapore have shown that real economic convergence is possible, but their limited number also indicates how difficult it is to achieve. In order to make it, emerging economies need to attain a higher quality of governance.

NEW REFORMS ARE BADLY NEEDED

The 1980s and 1990s was a dramatic period for many emerging economies. For Latin America the 1980s was the "lost decade" because of public and foreign debt defaults. Bolivia, Nicaragua, Peru, Argentina, and Brazil experienced hyperinflation in the 1980s because of irresponsible macroeconomic policies (Hanke

and Krus 2012). Their big public debts were aggravated by the US interest rate hikes starting in 1979, leading to their debt crisis in 1982. Only after the United States had decided to conditionally write off a substantial part of their debt through the Brady Plan in 1989 did they start recovering. The Latin American governments threw populist hyperinflationary policies, fixed exchange rates, and protectionism over board, opting for responsible fiscal policies, inflation targeting with floating exchange rates, and opening their economies. And adopting democracy enabled them to do so (Dornbusch and Edwards 1991).

The most dramatic transformation occurred in the Soviet Bloc. The whole region was stagnating in the 1980s and the economic and political systems collapsed in 1989–91. Central and Eastern Europe succeeded in transitioning to a market economy relatively fast within a few years, while most of the former Soviet Union, notably Russia, Ukraine, and Kazakhstan, struggled to do so until they encountered a new financial crisis in 1998. Thanks to the very devastation of their economies, these countries undertook more radical macroeconomic and structural reforms than Latin America, which resulted in higher growth rates averaging at 9 percent from 2000 to 2008 (Åslund 2012).

In parallel, the East Asian tigers boomed. China launched its market economic reforms in 1978 and has grown tremendously thanks to the introduction of a market economy and opening to the world, while pursuing high saving and investment ratios. In 1991, India launched serious reforms to combat red tape and reduce its extreme protectionism. Turkey launched major reforms with the conclusion of its customs union with the European Union in 1995. Finally, after three decades of economic decline, much of Sub-Saharan Africa started opening up its borders to more trade in the 1990s.

For the world as a whole, the 1980s and the 1990s amounted to a period of substantial economic liberalization. From 2000, however, structural reforms stagnated (Gwartney, Lawson, and Hall 2013). In the seven large emerging economies, few structural reforms occurred after 2005 (figure 8). Brazil even saw a significant deterioration.

Returning to the middle-income trap, a common view is that different forms of governance are most beneficial for economic growth at different stages of economic development. In a theoretical paper, Daron Acemoglu (2003) analyzes the problems of property rights in an oligarchic versus democratic society. He defines an "oligarchic society" as a "society where political power is in the hands of the economic elite," and he compares the trade-off between the distortions of such a society with those of a democracy, where political power is more equally distributed. The large emerging economies are more or less oligarchic.

Acemoglu (2003) argues that the typical pattern is that an oligarchy first becomes richer but later falls behind a democratic society in economic development. His explanation is that oligarchs favor low taxes and free labor markets, which benefit their economic interests, but they also promote economic growth at a low level of economic development. The problem with an oligarchic society is that it offers a less level playing field because oligarchs do not mind corruption, which they can handle, but it limits entry of new competitors, generating rents for the incumbents.

At a certain stage of economic development, when structural change is needed for economic growth, the costs of high corruption and the ensuing insecure property rights outweigh the benefits of low taxes and free labor markets. This coincides with the diversification of the economy, the rising importance of innovation for economic growth, and the rise of a large middle class. Then, many old companies need to be forced out of existence and replaced with new firms. At that stage, democracy becomes more beneficial to economic growth. Democratic countries tend to have higher taxes and more regulated labor markets. Democracy impedes rent seeking and promotes good governance, including the rule of law and strong property rights. Democracy is nearly a requirement for a highly developed and greatly diversified economy.

Democratic breakthroughs take place at different levels of economic development, but relatively well-developed countries that have not democratized earlier tend to do so when they have reached a middle-income level. Examples are Taiwan in 1986, South Korea in 1987, Chile in 1988, and Mexico around 2000. The obvious candidate for a democratic breakthrough today is Russia. At present, only Singapore and several small petrostates (Saudi Arabia, United Arab Emirates, Brunei, Kuwait, and Oman) are richer than Russia and still authoritarian, according to Freedom House (figure 9), while all the other most developed countries are democratic.

Yet democracy is not sufficient for good economic governance. The BRIC countries stand out for poor business environment. These countries rank very low in the Ease of Doing Business Index, which the World Bank and International Finance Corporation (2013) compile for 185 countries: Russia ranks 92, China 96, Brazil 116, and India 134. Russia has set the long-term goal of rising 100 ranks and it has advanced from the rank of 120. Characteristically, China is lobbying the World Bank to abolish this index. The surprise is that countries with such poor governance grew so fast for so long.

All these countries are quite corrupt. Transparency International (2013) ranks 176 countries on its Corruption Perceptions Index, and Brazil ranks 69, China 80, India 94, and Russia 133. It is surprising that the BRIC countries have done as well as they have with their poor business environment. Various econometric studies have shown that the correlation between business environment and economic growth is strong in the long run but limited in the short run (Gwartney, Lawson, and Hall 2013).

Because of their outstanding dynamism in the 2000s, the BRICs and many other emerging economies felt little need for economic reforms. They did not take advantage of the good years to carry out necessary structural reforms to improve their economic systems. Therefore their growth is likely to be lower for a protracted period. They have allowed state and crony capitalism to thrive, locking them into a middle-income trap. Others that have undertaken sound reforms are likely to do better. Central and Eastern Europe, Chile, Mexico, Peru, and Colombia come to mind.

Eventually, after making sufficiently many mistakes, suffering emerging economies are likely to carry out necessary reforms, but it is likely to arouse major conflicts and take time. Latin America's transformation involved democratization, liberalization, macroeconomic stabilization, and privatization, which took at least a decade. Reform is hard, but without it little success is likely.

STATE AND CRONY CAPITALISM

The global recession has been a crisis of the West. Arguably, it was caused by foolish financial policies of leading Western economies, but interpretations vary. Many in the emerging economies argue that the crisis showed that the Western economic system with free markets and predominant private ownership does not work and that state capitalism is preferable.

As Robert Kagan (2012, 43) puts it: "Today, the sub-prime mortgage crisis and the Great Recession, combined with the financial crisis in the European Union, have again raised doubts across the world and led many to ask whether the Chinese model of heavy state involvement may be preferable." It is all too similar to the 1960s and the 1970s, when the Non-Aligned Movement argued that a socialist economic model was superior to the capitalist model.

Because of their recent economic successes and the Western financial crisis, emerging-economy policymakers increasingly see state capitalism as the solution and private enterprise and free markets as problems. Many prominent academics have taken that position. Alexander Gershenkron (1962) argued that the state was a major modernizing force in economies catching up and therefore the state had to be bigger and more resourceful in such countries. Especially in Russia and Brazil, influential circles call for a greater role of the state, although the corrupt state is their key problem.

Russia's President Vladimir Putin is the most outspoken of the BRICS leaders in his criticism of the West. He persistently blames Russia's economic problems on the European Union and the United States; "all know that the downturn we are observing in the global economy, especially in the eurozone, has quite a serious impact on us, because Europe is our main trading partner…. In the end, it affected us directly."[7] He also argues that Russia and other emerging economies must not follow Western models: "We need to realize that there are probably countries and even entire regions that cannot function according to universal templates, reproducing the patterns of American or European democracy."[8]

In contrast, Putin praises Russia's low unemployment and real wage growth, saying that these, plus the growth of consumer spending and bank lending, are the basic factors stimulating the country's

7. See http://eng.kremlin.ru/news/5328.

8. See http://eng.kremlin.ru/news/6007.

economy. But Russia needs the exact opposite. The greatest economic concern is that large, inefficient state corporations are monopolizing large chunks of the economy, precluding both domestic and foreign private companies. Interest rates are high because of the oligopolization of bank lending by a few large state banks. The number of small and medium enterprises is quickly declining because of a deterioration of business conditions, especially as a result of the recent sharp increase in social security contributions.

The situation is quite similar to policymaking at the end of the Soviet Union. Soviet leader Leonid Brezhnev succeeded in staying in power until his death in 1982 by consistently giving in to the collective elite. In his book *Collapse of an Empire: Lessons for Modern Russia,* late Russian Prime Minister Yegor Gaidar (2007) showed how the commodity cycle influenced the Soviet leadership. During the oil boom in the 1970s, Soviet leaders thought they were geniuses, neglecting badly needed economic reforms. When commodity prices declined in the 1980s, Soviet leaders were incompetent, uninformed, and unprepared, having faced too few problems for too long. The natural outcome was the collapse of the Soviet political and economic system.

During their years of plenty, leading emerging economies did not have to make hard choices. Today, their entrenched elites seem neither inclined nor able to do so. Their lives have been too good. All have large state sectors and are relatively protectionist.

Even if the BRIC political leaders were to face up to reality, their giant state corporations rule the roost. They hold an iron grip over energy, transport, and banking. Regardless of official government policies they can extract cheap financing from the government and monopoly rents from the weaker private actors in the economy.[9]

Brazil and Russia are currently facing a serious growth slowdown, taking both countries close to stagnation. President Putin's approach is telling. Since April 2013, he has expressed great concern over the slowing growth and has held repeated brainstorming sessions with his chief economic advisors. His main policy conclusions, however, have been to propose ever more giant infrastructure investments, which involve the most corruption. In order to finance his infrastructure projects, he is intent on using Russia's National Welfare Fund.

Usually serious reforms are only brought about by a crisis and require new thinking and new political leaders (Williamson 1994). Among the seven large emerging economies I have selected, all have governments that have lasted nine years or more. Only China has new leaders, but they come from the old Communist Party, rendering it dubious that they have a mandate of reform.

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9. This critical discussion has probably been most extensive with regard to Russia, e.g., Åslund, Guriev, and Kuchins (2010) and Åslund (2007).

WILL GLOBALIZATION TURN INTO REGIONALIZATION?

All too often, the current global system of free shipping, relatively free trade, and reasonably free capital flows is taken for granted. In reality, we have been thriving in *Pax Americana*. The United States has paid for these global public goods as long as it has benefited more than the rest of the world from its large military expenditures. For decades, the large emerging economies have been free riding these public global goods. But the US public is no longer happy with the situation because it appears to have benefited other countries with values alien to US values to too great an extent. Many signs indicate that the United States is becoming ready to put down its feet.

In his book *The World America Made*, eminent political thinker Robert Kagan (2012) emphasizes that the current "liberal economic order is by a choice, not the inevitable product of evolution." "The global free-market economy we know today was created by British power in the nineteenth century, and when Britain faltered between the two world wars, that liberal economic order…collapsed…. It was only when the United States took on the task of creating and sustaining a liberal economic order after World War II that it took hold…." (p. 38). They did so in their national interest, "both nations stood the most to gain from open markets and free trade" (p. 39).

Kagan continues: "Historically, a liberal economic order has flourished under only one set of conditions—a great power with a globally dominant navy and a profound interest in a free-trade, free-market international system, the situation that existed in the latter half of the nineteenth century under British naval supremacy, and again after World War II, under American naval supremacy" (p. 78). By contrast, "China's system is more like the mercantilism of previous eras…in which governments amassed wealth in order to secure their continued rule and pay for armies and navies to compete with other dynasties and other great powers" (p. 82). Moreover, "multipolar systems have historically been neither particularly stable nor particularly peaceful" (p. 83).

Indeed, the move from one set of powers and institutions to another is usually connected with war. "The notion that the world could make a smooth and entirely peaceful transition from the present configuration of power to a new configuration reflecting an entirely different distribution of power is wishful thinking" (Kagan 2012, 90). In the end, "What has been true since the time of Rome remains true today: there can be no world order without power to preserve it, to shape its norms, uphold its institutions, defend the sinews of its economic system, and keep the peace" (p. 139). While Kagan advocates a vigorous role of the United States, his warnings appear more relevant. The reduced role of the US military in international affairs is all too obvious, and there is no indication that the Chinese or Indian navies will keep the high sea open to international seafaring.

Since 2009 the BRIC countries have held summits. They have focused on the need for greater international representation of the BRICS and their role rather than on global public goods. Their first summit in Yekaterinburg called for "a more democratic and just multipolar world order based on the rule of international law, equality, mutual respect, cooperation, coordinated action, ad collective decision-making of all states" (Pant 2013, 92). More than anybody else, Putin favors BRICS. In March 2013, he adopted an official Concept of Participation of the Russian Federation in BRICS making clear his priorities: "The BRICS authority in the international arena is based on the growing economic power of the participating states, importance of their activities as a major driving force of the global economy, their significant share of the world population and their rich natural resources."[10] Ideals, such as freedom, free trade, and democracy, are spectacularly missing.

Global cooperation is stalling, most obviously in trade policy, as the World Trade Organization (WTO) Doha Round launched in 2001 has fizzled out without outcome. The United States blames India, Brazil, and China for this failure. As a consequence, the United States is instead focusing on two regional free trade agreements among friends, the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) with the European Union. In addition, the United States is negotiating two plurilateral agreements with friendly nations within the WTO—an International Service Agreement and an International Technology Agreement. The US endeavor is clearly to opt for agreements with like-minded countries rather than with the BRICS.

The West also blames Brazil, China, India, and South Africa for the failure of the United Nations Summit on climate change in Copenhagen in 2009. Russia and China have persistently vetoed Western proposals on Iran and Syria.

The West is not without fault either. The United States and the European Union are unilaterally imposing far-reaching, truly draconian financial regulations on international financial interaction. While they present these as actions against criminals and fat cats, they amount to financial protectionism. Most extreme is probably the US Foreign Account Tax Compliance Act (FATCA), which has prompted many foreign banks to drop US citizens as clients around the globe.[11]

CONCLUSIONS: LOWER GROWTH IN EMERGING ECONOMIES MIGHT IMPEDE CONVERGENCE

The key conclusion is that emerging economies are set to have lower growth than in 2000–12. The reasons are many. Much of the catch-up potential has already been used up. The extraordinary credit and commodity booms are over, and many large emerging economies are financially fragile. They have major

10. See http://eng.news.kremlin.ru/media/events/eng/files/41d452b13d9c2624d228.pdf.

11. "Overtaxed and Over There," *Economist*, October 12, 2013, 38–41.

governance problems, so they need to carry out major structural reforms to be able to proceed with a decent growth rate, but many policymakers are still in a state of hubris and not very inclined to opt for reforms. They are caught up in state and crony capitalism. Rather than providing free markets for all, the West might limit its endeavors to its own benefit. Therefore, the emerging economies as a group are likely to have a lower growth rate than in the early 2000s, though it might still be higher than that of the mature economies.

It is true that emerging economies have a far better macroeconomic situation than some Latin American countries did in the 1980s, when Argentina, Bolivia, Brazil, and Peru had large budget deficits and pegged exchange rates, leading to hyperinflation and default. Today, major emerging economies have low inflation, limited budget deficits, mostly floating exchange rates, and large international reserves. But that was also said about the United States and Europe before the Great Recession.

In the early 1980s, the world saw the same two critical trends—rising global interest rates (both nominal and real) and lower commodity prices—which hit poorly managed emerging economies and are likely to be hit again.

In the short term, emerging economies with large current account deficits, foreign indebtedness, budget deficits, public debts, and high inflation look vulnerable. These countries are Brazil, India, South Africa, and Turkey but also many countries not discussed here, such as Belarus, Ukraine, Venezuela, Argentina, Bolivia, Ecuador, and Nicaragua. Next, large commodity exporters, such as Russia, Brazil, and South Africa, will probably suffer. China, by contrast, would benefit from lower commodity prices, but it appears overleveraged with its huge bank credit that amounts to twice its GDP and could face a domestic financial crisis.

The US Fed announcement of a possible tapering last May and the ensuing delay offered vulnerable countries time to make amends. Strikingly, hardly any improvement in policy has occurred. Often, the most vulnerable countries escape crises by taking action. A superficial impression is that the current economic policy discussion appears sensible in India, China, and Indonesia, while the opposite is true of Russia, Brazil, South Africa, and Turkey. Moreover, democratic elections in 2014 may bring change to India and Indonesia.

The combination of higher US bond yields and relatively better growth in the mature economies is likely to lead to a large flow of money from emerging economies to the United States and probably also to the European Union. As in the early 1980s, the US dollar exchange rate is likely to rise for several years. It was this combination of high US interest rates and a rising dollar exchange rate that brought about the Latin American debt crisis in 1982. A similar development is likely to occur again.

For all the reasons mentioned here, economic growth will probably moderate in the emerging economies as a group. The mature economies, by contrast, have gone through severe financial crisis. They

have undertaken fiscal consolidation and substantial structural reforms, which should boost their growth rates. While their growth rate is likely to be lower than that of the emerging economies, the economic convergence of 2000–12 can easily be impeded or even somewhat reversed because the rich economies are so much richer to begin with. The United States may proceed with a normal growth rate of 2 to 3 percent a year, while the average growth rate in emerging economies can easily decline by two percentage points from 6.2 percent a year toward 4 percent a year.

If so, economic convergence may halt for a decade or so measured in GDP at current exchange rates, because in 2012, 35 advanced economies as defined by the IMF accounted for 37.7 percent of global GDP at current exchange rates. That is, the emerging economies have to grow 1.65 times faster to keep up with the advanced economies. If not, the West could take the global economic lead once again as in the 1980s. Measured in purchasing power parity, on the contrary, the advanced and emerging economies each accounted for exactly half of the global economy in 2012, so the West had to grow as fast as the rest to keep up, which appears unlikely. But what is the West? The IMF definition excludes eight of the current EU members, as well as the most advanced Latin American economies. If the "West" is expanded, the catch up of the rest will obviously be more difficult.

This is not to say that economic convergence has come to an end, only that it might have reached a hiatus. If such a pause occurs it is likely to last for many years. Meanwhile, emerging economies have an opportunity to change political regime, reconsider their economic policies, consolidate their public finances, improve their quality of governance, and carry out a variety of structural reforms. These are big tasks. If they succeed in doing that and if the globalization of trade and finance persists, emerging economies have a chance of truly catching up.

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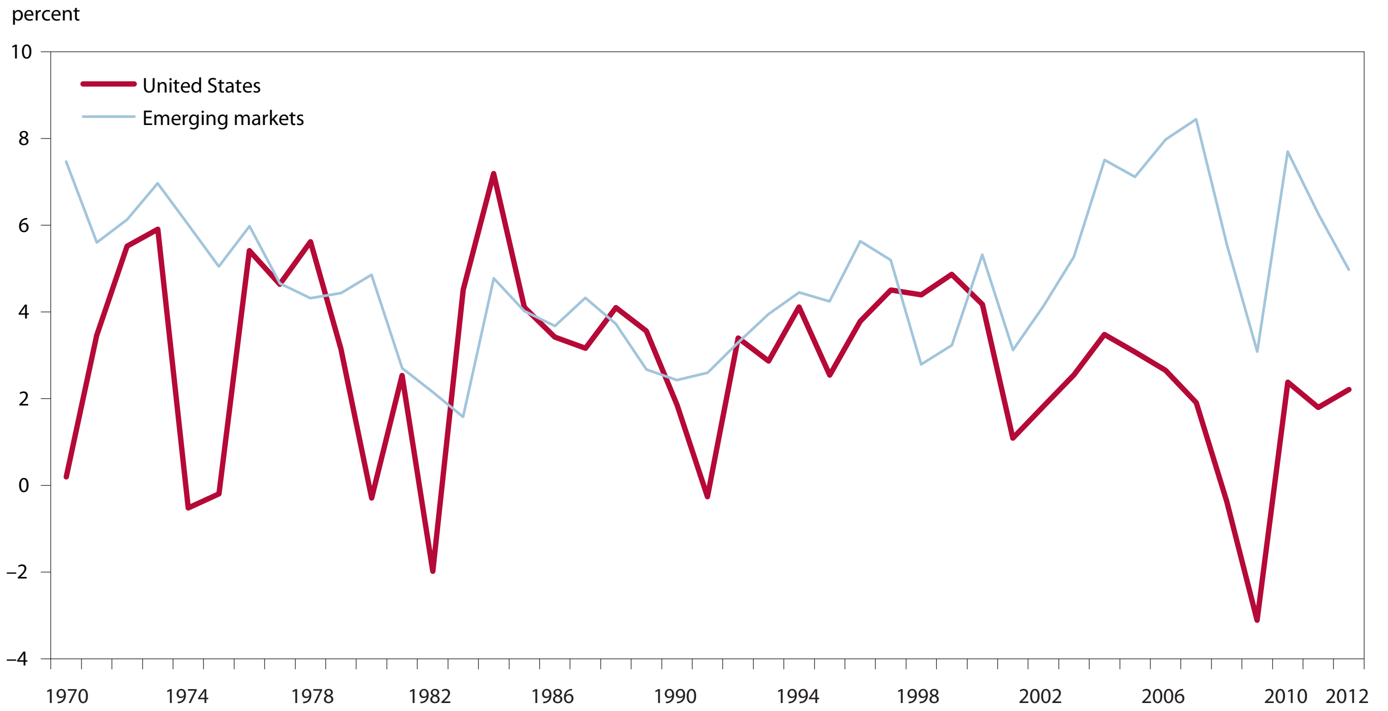
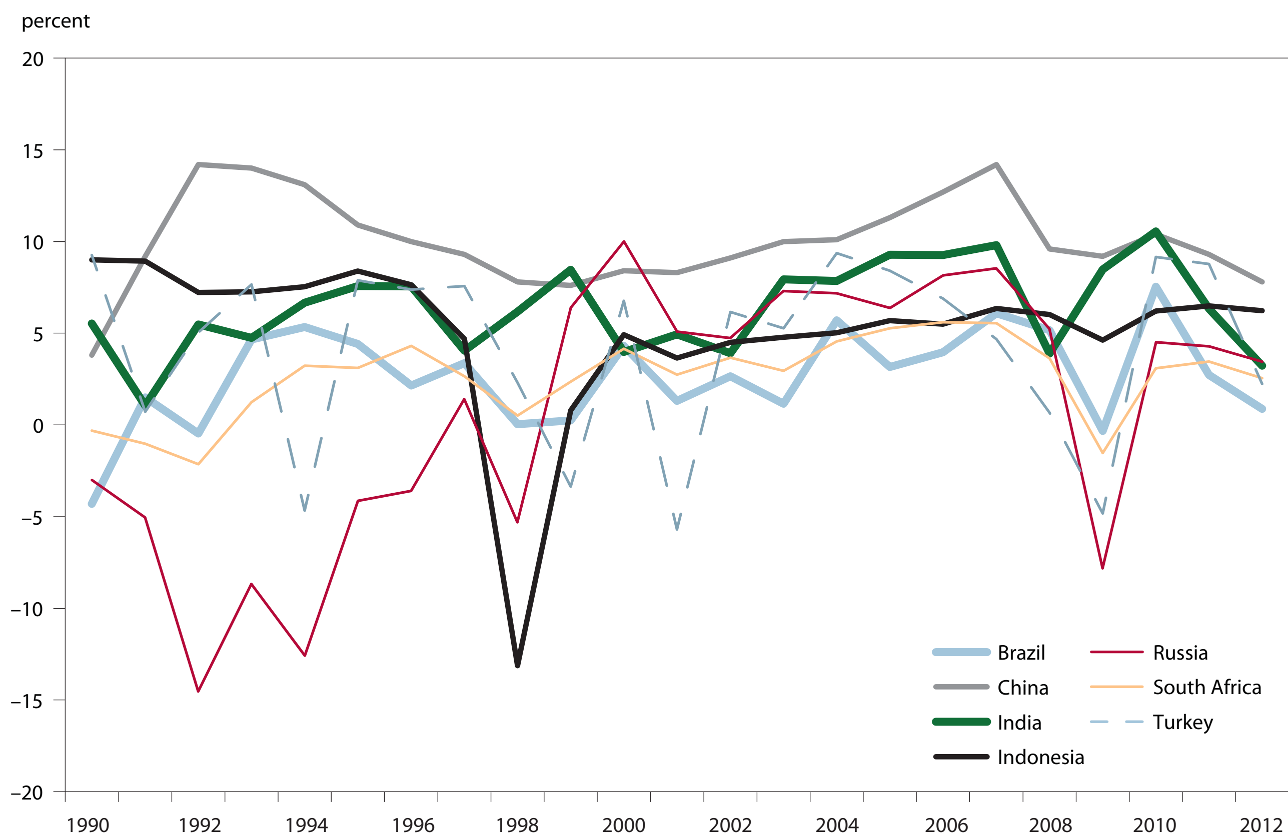
Figure 1 US versus emerging economies growth, 1970–2012



Source: World Bank Data Catalog, http://datacatalog.worldbank.org.

Figure 2 GDP growth rates, 1990–2012



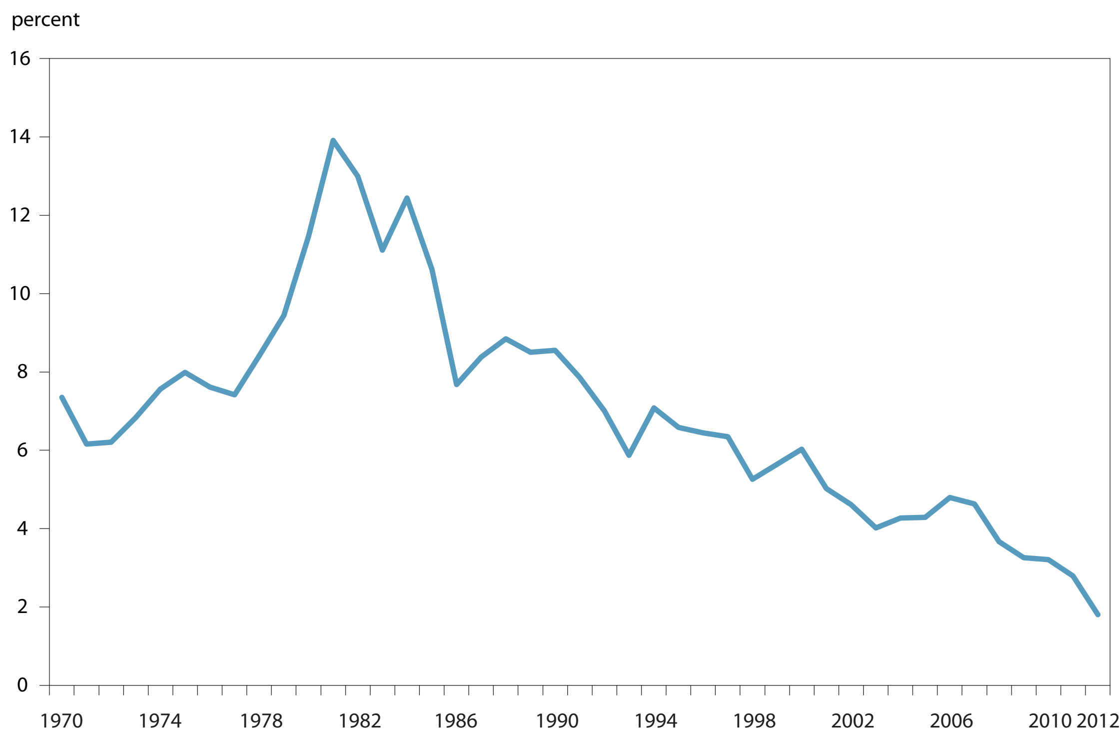
Source: World Bank, *World Development Indicators*, databank.worldbank.org/data/GDP-Growth-Rates/id/1b481612 (accessed on October 21, 2013).

Table 1 The Fragile Five, 2012

Country	**Gross public debt** (percent of GDP)	**Current account balance** (percent of GDP)	**Expected budget deficit** (percent of GDP)	**Total external debt** (percent of GDP)	**Inflation** (percent)
Brazil	68	–2.4	2.7	21	5.8
India	67	–4.8	8.0	21	11.4
Indonesia	25	–2.7	1.7	24	4.3
South Africa	42	–6.3	4.8	34	5.6
Turkey	36	–6.1	1.6	45	6.2

Source: IMF, *World Economic Outlook*, October 2013, www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx (accessed on October 25, 2013).

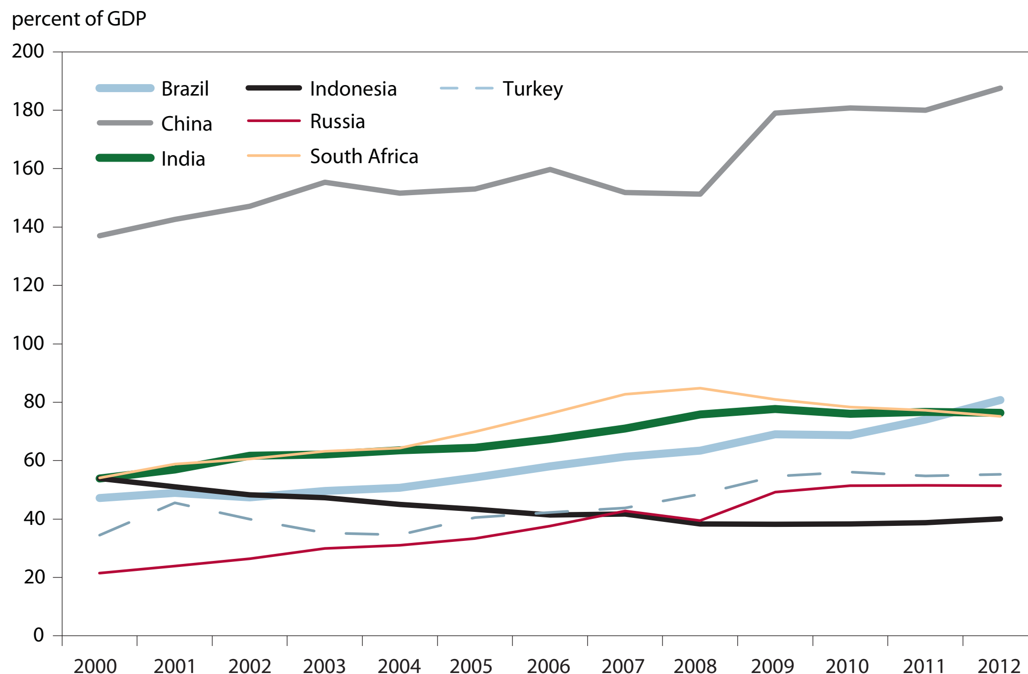
Figure 3 US 10-year treasury yields, 1970–2012



Note: Adjusted to constant maturity.

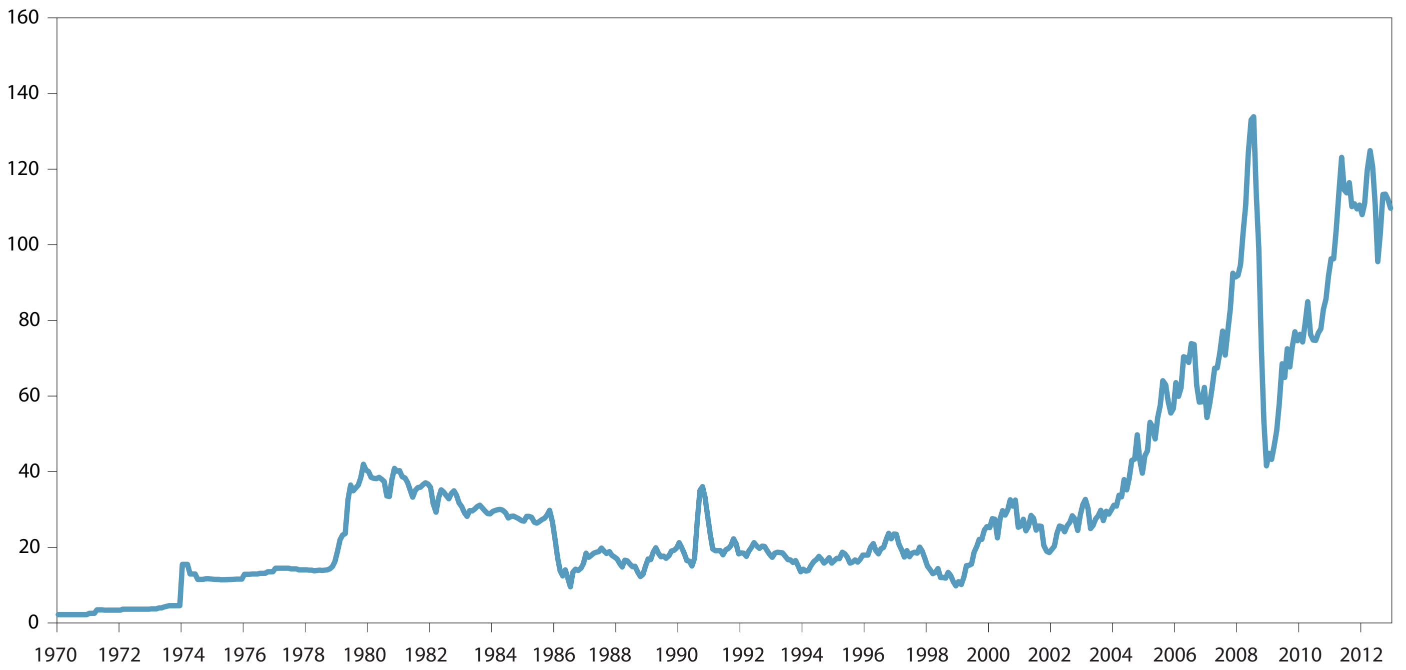
Source: Datastream, https://forms.thomsonreuters.com/datastream.

Figure 4 M2 as a percent of GDP, 2000–2012



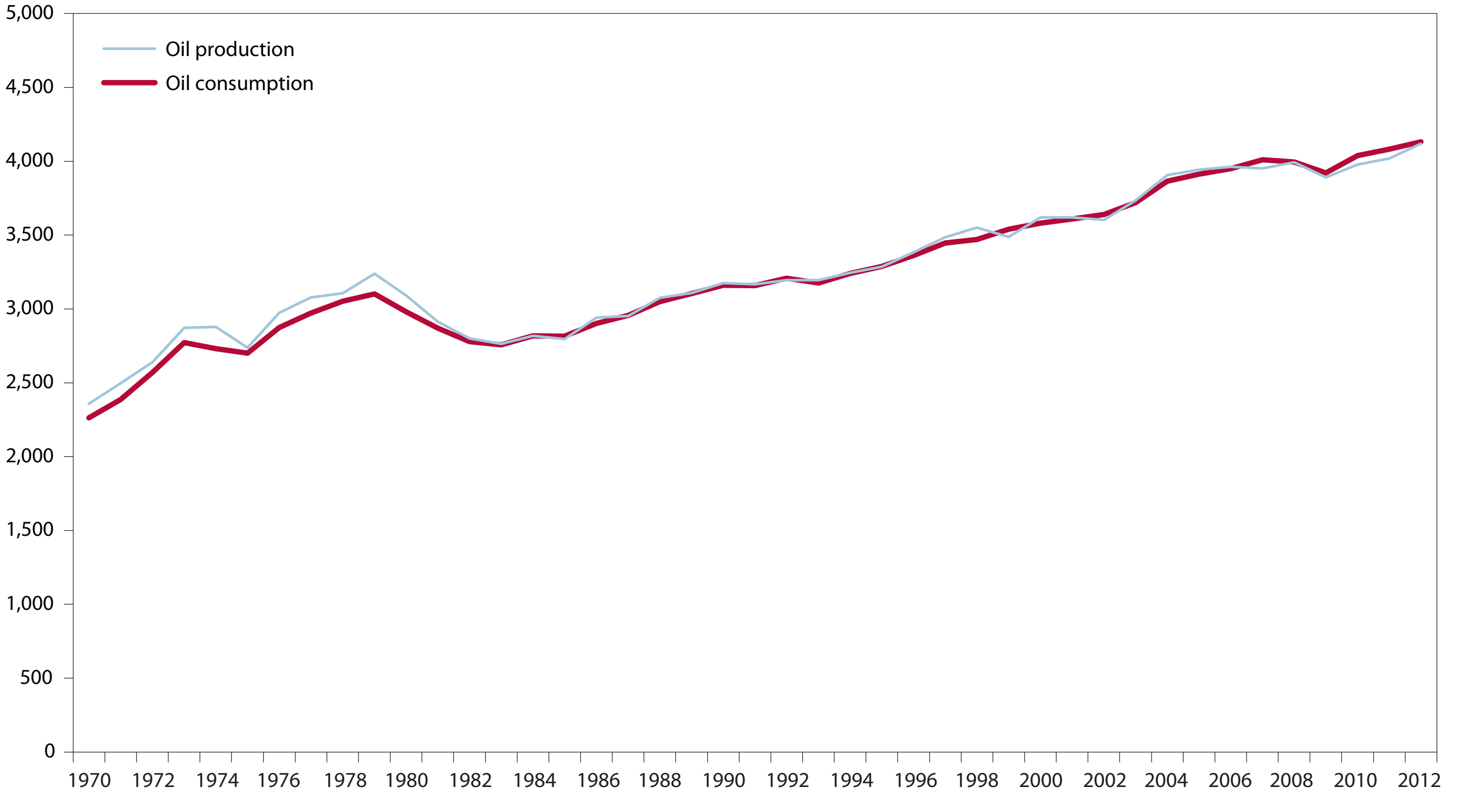
Source: World Bank, *World Development Indicators*, databank.worldbank.org/data/BIITS-China-M2/id/820ed555 (accessed on September 12, 2013).

Figure 5 Oil price, 1970–2012



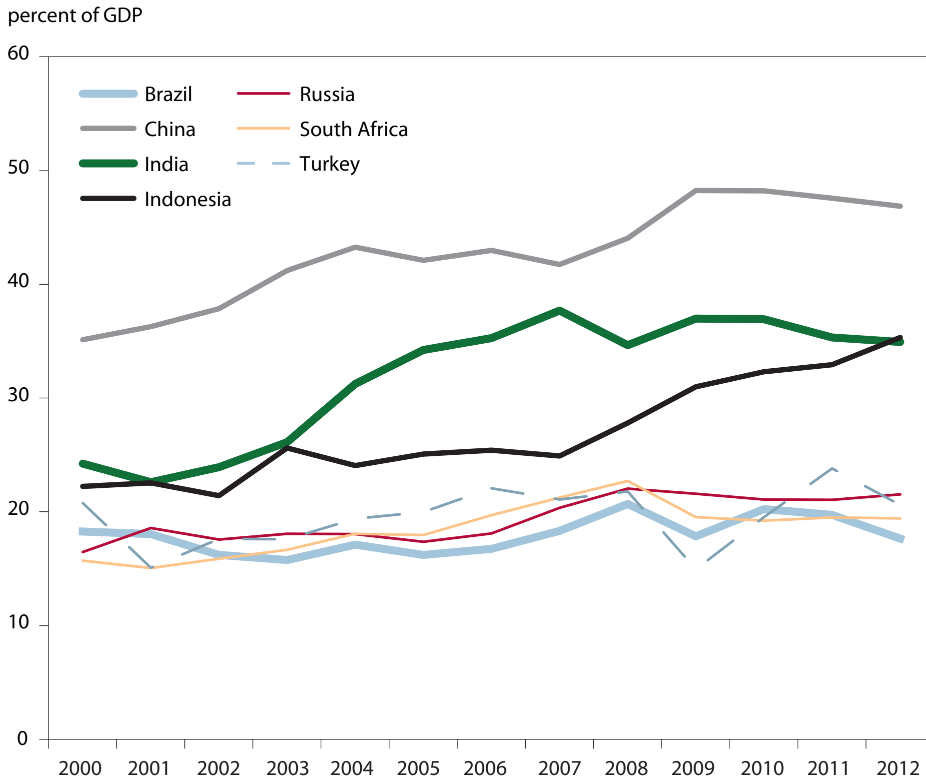
Source: IMF, *International Financial Statistics*, August 2013 (accessed on September 13, 2013).

Figure 6 Oil production and consumption, 1970–2012



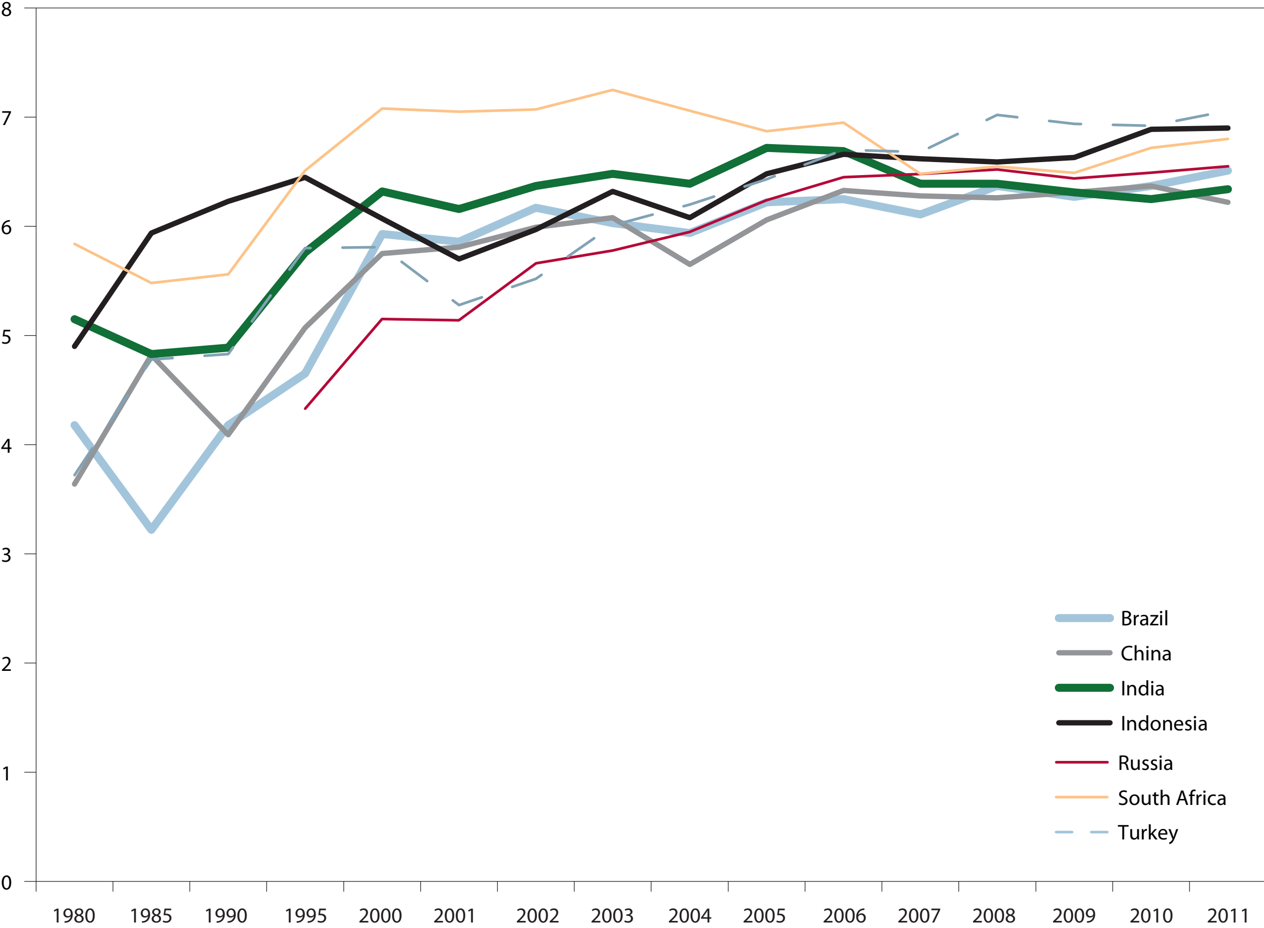
Source: BP Statistical Review, www.bp.com/en/global/corporate/about-bp/statistical-review-of-world-energy-2013/statistical-review-1951-2011.html accessed on October 21, 2013).

Figure 7 Investment ratio, 2000–2012



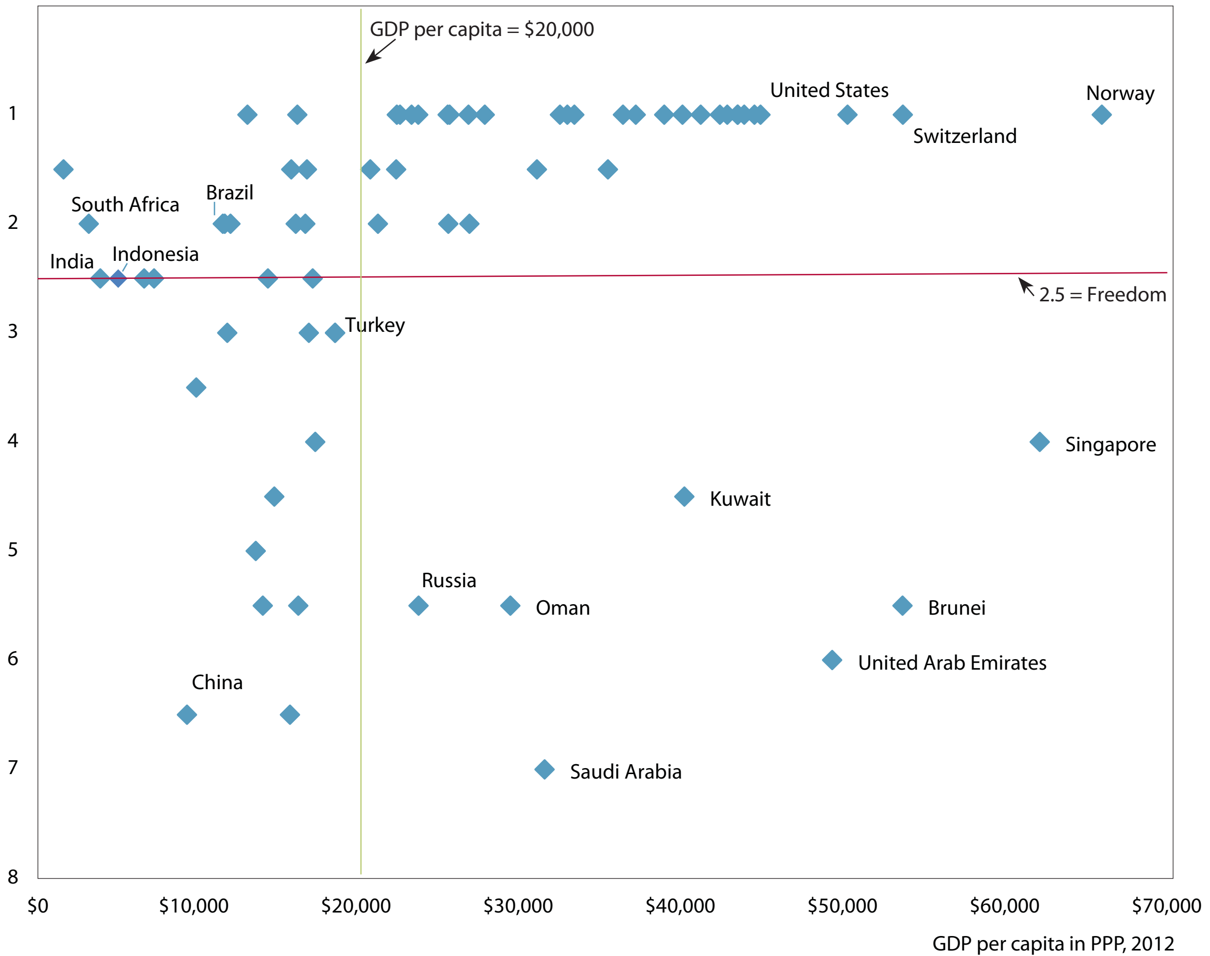
Source: IMF, *World Economic Outlook*, 2013, www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx (accessed on September 13, 2013).

Figure 8 Economic freedom of the world, 1980–2011



Source: Fraser Institute, Economic Freedom of the World 2013, www.freetheworld.com/release.html (accessed on October 23, 2013).

Figure 9 GDP per capita and democratic freedom



PPP = purchasing power parity

Restrictions: Countries with more than 1 million inhabitants and with a GDP per capita in 2012 greater than $10,000. GDP per capita exceptions illustrated are China, India, and Indonesia.

Sources: World Bank data, http://databank.worldbank.org/data (accessed on September 12, 2013); Freedom House, 2013 Freedom in the World, www.freedomhouse.org/report-types/freedom-world (accessed on September 12, 2013).