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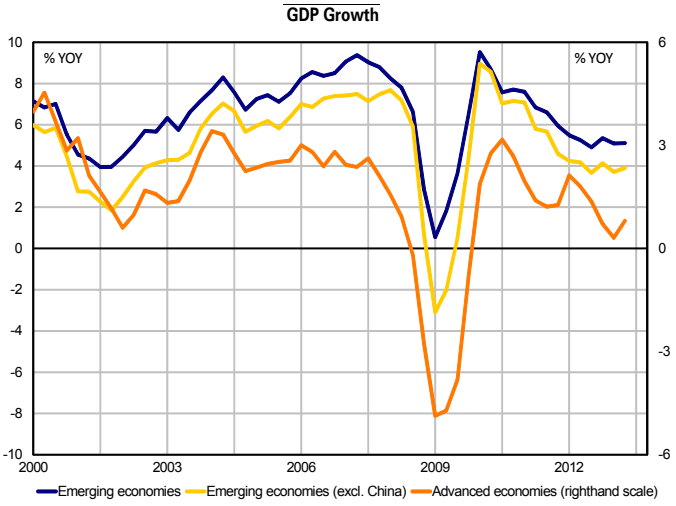
Emerging economies: heading for persistently slower growth than before the crisis

- Economic activity in emerging economies has slowed significatly since 2011, after resisting fairly well to the financial crisis. Stimulus measures in 2009 enabled their activity to bounce back in 2010, but momentum began to flag in 2011. Growth was around 5.5% in 2011-2012, versus 7.5% in the period 2003-2007.
- This slowdown is partly cyclical, due to a combination of domestic and external factors. Domestic demand has been particularly weak and the external environment has also deteriorated, with falling exports as a result of faltering demand in advanced economies. Structural factors have played their part in this slowdown as well. Emerging economies' potential growth is thought to have diminished due to a combination of demographic trends and changes in the capital stock, but also as a result of slower productivity gains as the catch-up process fades away.
- Emerging economies have little margin to support activity in the short run. In a context of weak public finances, countries such as India, Brazil and South Africa, lack the means to support activity via a fiscal stimulus. Similarly, emerging countries appear to have used up most of their leeway with regard to monetary policy.
- The emerging economies' growth models are now becoming less dependent on advanced economies. Whereas the share of exports to advanced economies had already been falling since the early-2000s, this trend has accelerated since the crisis. Moreover, due to declining exports, the crisis has increased the share of domestic demand in emerging economies' GDP.
- While robust, growth in main emerging economies looks set to trend downwards, as their growth potential declines, especially in China. Emerging economies need to implement major reforms in order to support their potential growth. These reforms should focus on: i) rebalancing growth towards greater private consumption in China; ii) tackling structural investment deficits in other countries, which are hindering supply and thus penalising growth.



Sources: National (quarterly) data, authors' calculations.

MINISTÈRE DE L'ÉCONOMIE ET DES FINANCES

MINISTÈRE DU COMMERCE EXTÉRIEUR

1. Growth in emerging economies' has ran out of steam in the after match of the crisis

1.1 Although growth in emerging economies proved to be resilient to the crisis, it began to slow markedly from 2011 onwards

Emerging economies showed a certain degree of resilience during the 2008/2009 crisis and bounced back in 2010 (see Chart p.1)[1]. Their activity slowed considerably during the global recession of 2008-2009, albeit no substantial contraction, unlike in developed economies. Important stimulus measures largely contributed to global recovery in 2010. China in particular launched a massive stimulus plan, of around 12 % of GDP over 27 months, generating powerful spillover effects for the world economy.

After the rebound in 2010, signs of slowdown began to appear in emerging economies starting from 2011, thus preceding the reversal of capital flows in 2013. Growth in these economies declined steadily, from +8.4% in 2010, to +6.7% in 2011, +5.3% in 2012 and +5.1% in the first two quarters of 2013. This slowdown concerns all of the main emerging economies, with aggregate growth lagging behind its pre-crisis level (+7.8% between 2003-2007).

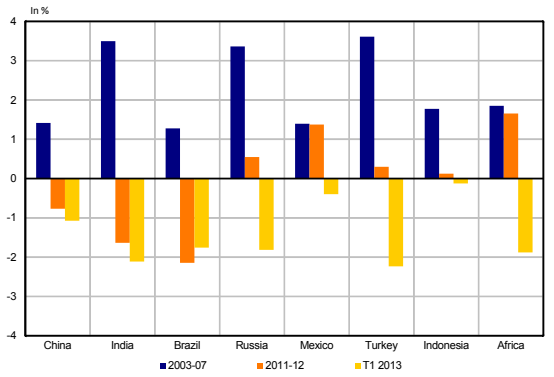
The most recently-available data show no notable shift in this trend. Globally, emerging economies saw a continuing slowdown in the third quarter of 2013: +2.2% in Brazil, after 3.3% in Q2; +1.8% in South Africa, after +2.3%; +1.3% in Mexico, after +1.6%; and +1.2% in Russia, after +1.2% in Q2. China, Korea and India, on the other hand, surprised with the rebound in their growth in Q3 (+7.8%, after 7.5% in Q2 for China; +3.3%, after 2.3% for Korea; and +4.8%, after 4.4% for India). Finally, initial information available suggests a slight upturn in activity in Q4 2013, the Purchasing Managers Indexes (PMI) reflecting improving trends in several countries (India, China, Brazil and Korea), with the exception South Africa.

This downtrend in activity is fuelling doubts as to the sustainability of their growth models. Concerns over the Fed's tapering and the publication of disappointing growth figures for Q1 2013 revived financial tensions between late-May and late-June (falling equity markets, rising sovereign spreads, and falling currencies) in some of the major emerging economies (in particular Brazil, India and South Africa). These financial tensions persisted over several weeks due to investor fears regarding US exit from quantitative easing. Investor concerns were also exacerbated by growing political and social unrest, particularly in Brazil, Turkey and South Africa, threatening institutional stability in those countries.

1.2 After a period of overheating, the present growth rate in emerging economies is thought to be below potential (the cyclical share of the slowdown)

Emerging economies as a whole are thought to have been growing below their potential since 2011[2] after having been consistently above potential before the crisis (see Chart 1). This positive output gap in the period 2003-2007 stemmed mainly from (i) strong credit growth in developed economies, fuelling demand adressed to emerging countries and supporting their exports, and (ii) vigorous domestic lending. Emerging economies continued to grow briskly in 2010-2011 (6.8% on average), especially thanks to fiscal stimuli in 2009 and to loose monetary policy in most of the emerging countries. Nevertheless, inflation above central bank targets, and positive output gap in 2010- 2011, point to overheating in several countries, including India, Brazil and Turkey. On the other hand, the most recent OECD estimates[3] show that China's economy grew in line with its fundamentals in 2013, whereas growth in other main emerging countries (India, Brazil, Indonesia, Mexico) appears to have been below potential.

Chart 1: Gap between observed and potential GDP growth



Source: OECD.

1.3 At the same time growth potential appears to be fading (the structural share of the slowdown)

While debate continues as to the respective contributions of cyclical and structural factors in the slowdown, there is a growing consensus that growth potential is falling the major emerging countries. In a still preliminary estimate of the autumn 2013 World Economic Outlook, the IMF estimated that emerging economies' potential growth average around 3.5% in the period 2013-2017, versus 4% for 1990-2012. The structural portion of the slowdown is reckoned to be particularly large in South Africa and China (−2% in 2013 relative to potential growth during 2000-2011), 1% in India and 0.5% in Brazil. In the case of India, the slowdown was prompted by weakening investment, itself the result of structural bottleneks, namely a lack of infras-

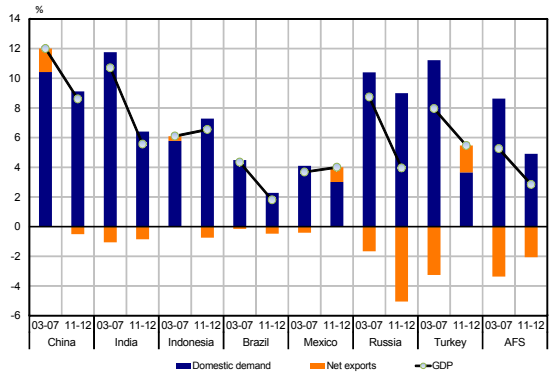
(1) The geographical coverage of this study comprises: advanced economies (United States, eurozone, United Kingdom and Japan); Emerging economies (China, India, South Korea, Indonesia, Thailand, Brazil, Mexico, Argentina, Chile, Russia, Turkey, Czech Republic, Poland, Ukraine and South Africa). The two aggregates account for three quarters of global GDP.
(2) According to OECD calculations (2013), "Long-term Baseline Projections", *Economic Outlook* No.93, June.
(3) OECD Composite Leading Indicators", Paris, 9 October 2013.

tructure. Indeed the Indian government has revised downward the country's potential growth, from 8% two years ago to 6.5% in 2013. Finally, an ageing population, an increase in capital cost, and diminishing productivity gains due to the reallocation of factors between sectors, appear to lie behind persistent slowdown in China (most analysts expect long-term growth around 6%).

1.4 Both domestic and external factors play a part in this slowdown since 2011

Domestic demand has weakened since 2011, especially in India, Brazil, Turkey and South Africa. The breakdown of growth between domestic demand and net exports in main emerging economies shows that, by comparison with the pre-crisis period, the slowdown since 2011 is primarily due to weaker domestic demand (see Chart 2). While this phenomenon appears to have affected all of the main emerging economies (apart from Indonesia), this has nevertheless been more pronounced in India, Turkey, South Africa and Brazil. Many factors account for this slowdown, namely: i) in India, Turkey[4], Russia and especially South Africa, the clear credit slowdown in the aftermath of the crisis has weighed on private consumption and investment; ii) in Brazil and India, private investment has been particularly sluggish, suffering from growing supply side bottlenecks, (in energy and transport infrastructures especially[5].

Chart 2: Average annual GDP growth rate and contributions of net exports and domestic demand

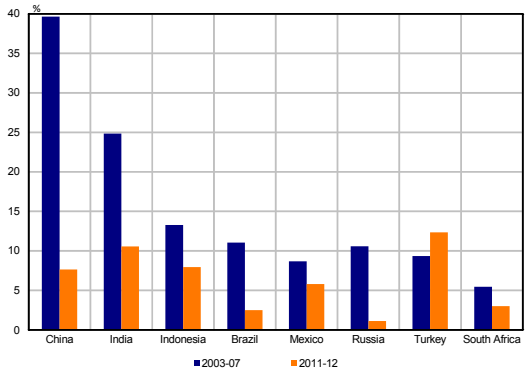


Source: National data and World Bank (real GDP); authors' calculations.

Export slowdown also accounts for slower GDP growth, particularly in more opened economies, such as China and Russia. In both these economies, the fall in the contribution of net exports accounted for almost all of the dip in growth after the crisis. This had a considerable impact due to the scale of the export slowdown (see Chart 3), essentialy as a result of weaker demand from advanced economies and the very large share of exports in these two economies (around 45% of GDP). All of the main emerging economies (with the exception of Turkey[6]) were hit by this post-crisis fall in exports. In Russia, growth has been showing signs of weakness since late-2012/early-2013 due to the sharp slowdown in investment. Moreover, the decline in exports revenue (see below) acted as a drag on private consumption and investment in all emerging economies. Finally, the appreciation of emerging countries' currencies between 2009 and 2011 accentuated the fall in export income in countries such as Brazil, Russia and South Africa, most of their commodity trade being labeled in dollars.

However Indonesia and Mexico have better withstood the slowdown since 2011. In Indonesia domestic demand has been slightly more buoyant due to credit growth, in a context with few supply-side constraints. Moreover, exports slowed less than in other emerging economies, because Indonesia's export sector benefited from resilient exports to Japan[7], the country's largest trading partner. Concerning Mexico, while domestic demand sagged, as in other main emerging economies, the decline was kept within limits thanks to the dynamic lending activity. Moreover, like Indonesia, export slowdown has been fairly mild, due to a strong pick-up in exports to the United States, on which the Mexican economy is heavily dependent.

Chart 3: Average annual export growth, in real terms



Source: World Bank; authors' calculations.

2. There is little space to support activity in the short run

2.1 Fiscal space is limited even though the situation is generally sound …

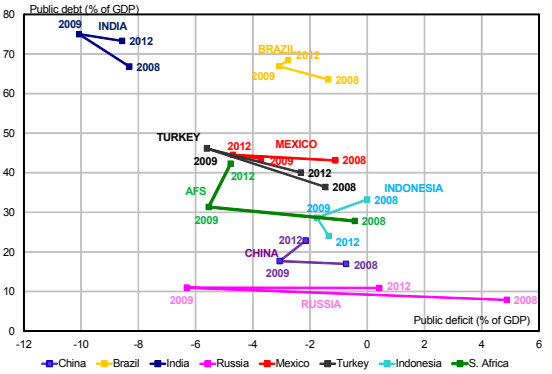
Emerging economies responded to the international crisis of 2008-2009 by adopting expansionary fiscal policies. The more rigorous fiscal policies during the 2000s allowed emerging countries' authorities to increase their reactive capacity by supporting activity, when the crisis broke in 2008-2009.

Emerging countries' fiscal deficits thus widened considerably in 2009 from relative equilibrium, to a deficit of 4.5% of GDP, due in particular to stimulus plans and to falling commodity prices. The Chinese stimulus programme, for instance, increased the fiscal deficit from 0.7% of GDP in 2008 to 3.1% in 2009 (see Chart 4). The public finances of commodity exporting countries were worse affected due to the fall in global commodity prices. Russia, for instance, saw its fiscal surplus of 4.9% of GDP

(4) Credit has recovered in Turkey since the end of 2012.
(5) Industrial output lost much of its dynamism in the aftermath of the crisis compared to the pre-crisis period, squeezing companies' profits and, ultimately, their investment.
(6) Turkey's exports grew very sharply (+17%) in 2012, largely driven by soaring exports of gold to Iran to pay for oil purchases.
(7) Driven by the various measures to stimulate domestic demand in Japan.

in 2008 slide into a deficit of 6.3% in 2009, Chile from +4.1% to −4.1%, and South Africa's deficit widened from −0.5% to −5.3%. After fiscal tightening in 2010 and 2011, most of the emerging countries' authorities relaxed their fiscal consolidation in 2012 in response to a renewed activity slowdown. Other countries such as India, whose fiscal situation had seriously worsened, have been forced to tighten their fiscal policies (at 4.8% of GDP, the deficit for the fiscal year 2012/2013 was actually less than the target of 4.9%; this performance was achieved due to sharp cuts in energy subsidies and the postponement of investment spending, which is likely to have an impact on India's economic potential).

Chart 4: Public deficit and public debt



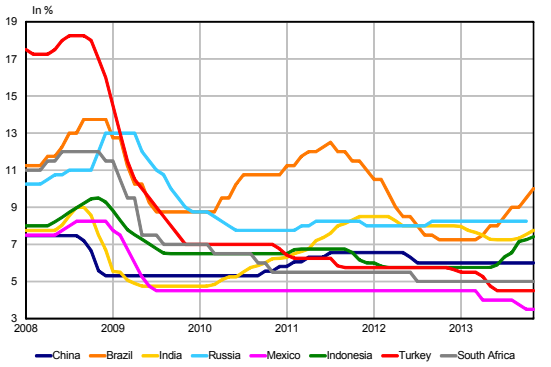
Source: IMF.

Overall, and to diffrent extent, emerging economies now appear to have limited fiscal space. This combination of high debt and deficits is sharply constraining India's capacity to extend massive support to activity through fiscal policy. This applies to Brazil and South Africa also, albeit to a lesser extent. As for economies with seemingly comfortable public finances, they remain nevertheless vulnerable, partly because of hard-to-measure off-balance sheet liabilities (e.g. the risk of over-indebtedness of local authorities in China and its potential impact on the banking sector). Finally, most emerging economies face rising constraints in the medium-to-long term as social spending rises.

2.2 ... and increasingly constrained monetary policy

Central banks responded to the international financial crisis by fully using their monetary space. To revive their faltering economies, emerging countries embarked on a major process of monetary easing in late-2008/early-2009. This featured significant cuts in short-term rates by central banks, most of which fell to historically low levels (see Chart 5). Several central banks tightened their monetary conditions (e.g. Brazil +375 bp, China +125 bp, India +50 bp, and Indonesia +25 bp) when the first signs of recovery appeared in 2010, along with inflationary tensions (in the wake of the rebound of the main commodity prices). They eased again starting mid-2011, against the background of a prolonged slowdown in activity (the sole exception being India). At the beginning of 2013, the key interest rates of central banks in emerging economies were at historically low levels, close to those seen at the end of 2009.

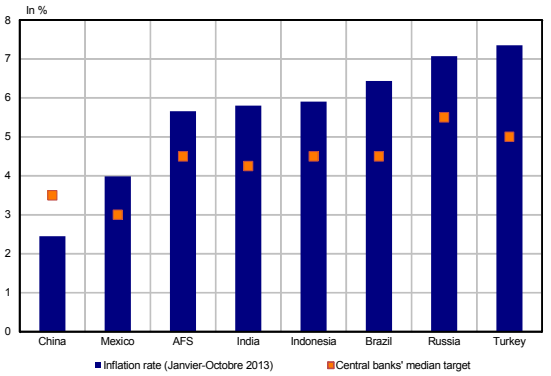
Chart 5: Key interest rates



Source: National data, most recent data point: November 2013.

The recent period has seen a new surge in inflationary tensions, curbing the capacity of central banks to support activity. Except China, the major emerging economies have had to contend with rising inflation, significatly above central banks' targets, since the beginning of 2013 (see Chart 6). These inflationary pressures generally reflect a surge in food prices, which account for a large share of the average consumer's shopping basket in emerging economies. But the rise in inflation is also occurring against a background of growing bottlenecks (e.g. in the development of transport and energy infrastructures), which is further fuelling inflation in many countries such as Brazil and India, and to a lesser extent in Russia, Turkey and South Africa.

Chart 6: Inflation rate and central banks' inflation targets



Source: National data.

Moreover, the central banks' policy space has been limited by steep capital outflows in the recent period. Fears of an earlier-than-expected exit from American quantitative easing (QE) revived financial tensions in late-May/early-June 2013, with emerging countries' floating currencies depreciating significantly. This situation led certain monetary authorities to withdraw their controls on capital inflows (particularly in Brazil). It also led most central banks to intervene on the foreign exchange markets to limit the slide of their currency.

In these circumstances, monetary authorities in emerging economies' are faced with a tough dilemma supporting growth on one hand, while fighting inflation and capital outflows on the other. For the moment, many central banks have opted to tighten lending conditions in order to curb inflation, as in Brazil,

Indonesia, India, Russia and Turkey, while others have so far kept their main key rates unchanged.

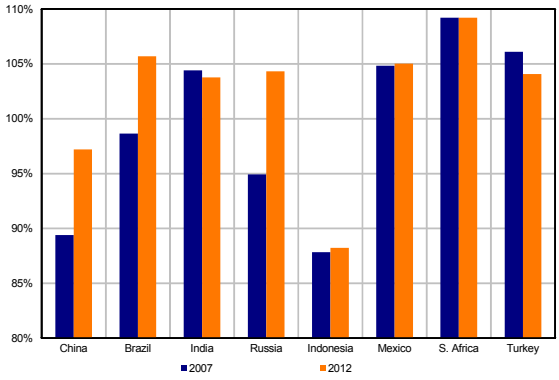
Despite relatively weaker inflationary pressures, China's central bank is not expected to adopt a more accommodating monetary stance, given excessive credit growth, the deteriorating quality of bank loans and the risks of a bubble in certain asset prices, property prices in particular.

3. Emerging economies' growth models are becoming less dependent on advanced economies

3.1 Growth more oriented towards domestic demand…

One outcome of the 2008-2009 crisis was the increase in the share of domestic demand in GDP in major emerging economies, while exports to advanced economies have considerably diminished (see Chart 7). Weaker demand from main advanced economies mechanically reduced the contribution of exports to growth in emerging economies. China, Russia and Brazil were most-affected by flagging exports. Indonesia, Mexico and Turkey suffered a relatively minor slowdown in exports, while in India and South Africa, weaker exports were offset by stronger domestic demand.

Chart 7: Share of domestic demand in real GDP



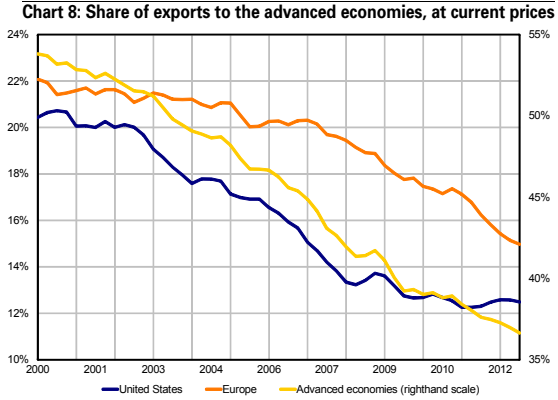
Source: World Bank, authors' calculations.

The rebalancing of emerging economies' growth in favour of domestic demand could prove to be a persistent medium to long-term trend, given the potentially durable character of weaker demand coming from advanced economies, and the endogenous development of domestic demand.

3.2 … and trade less centered on advanced economies

The share of total emerging economies' exports to advanced economies has declined since the beginning of the 2000s. Moreover, the trend has gained momentum since the crisis. This share has gone from slightly over 50% in 2000 to a little under 50% in 2007, before sliding to a just over one third in 2012 (see Chart 8). The trend for imports is similar.

Chart 8: Share of exports to the advanced economies, at current prices



Source: IMF (3 quarters moving average), authors' calculations.

This diminished trade exposure to advanced economies stems in part from the growing integration of emerging economies, centred on Asia-and China especially. While part of emerging economies' reduced exposure to advanced economies stems from flagging domestic demand in the latter, it also reflects an underlying trend towards greater trade integration between emerging markets themselves. This brings about two phenomena:

- **First, greater intra-regional integration, especialy in emerging Asia.** Trade between emerging Asian countries is increasingly integrated, with the progressive removal of customs barriers and against a background of growing power of region's giants (India, and especially China)[8]. The most noteworthy shift concerns Indonesia, whose exposure to regional exports grew by 17 percentage points between 2000 and 2012.
- **Secondly, an increase in inter-regional trade among emerging countries.** For example, whereas Brazil's exposure to advanced economies and to the Latin American region has declined perceptibly since the beginning of the decade, trade with China has surged, as Brazilian exporters' exposure to the Chinese market has soared from 2% to 17% between 2000 and 2012. Since 2009, China has become Brazil's largest trading partner, ahead of the United States. Trade exposure to China has grown sharply for other emerging economies as well, starting with the commodity exporting countries such as Chile (from 5% to 24%), Argentina (from 3% to 8%), or South Africa (1% to 12%). Russia, on the other hand, remains essentially dependent on trade with the eurozone.

(8) Caution is required in interpreting regional trade figures for Asia, however. Because of the internationalization and segmentation of production systems, some of the exports between Asian countries nevertheless have the developed countries as their final destination.

Box 1: **The catch-up process and growth in emerging economies**

The neoclassical growth model developed by Robert Solow[a] in 1956 ascribes economic growth to capital accumulation and technical progress. Moreover, the model explains growth in relatively poorer countries by a process of catching up towards advanced economies (under the convergence hypothesis). Thus, the lower the level of per capita GDP, the greater the expected growth rate. According to the neoclassical model, importing new technologies from advanced countries will boost the productivity of capital, which should further attract foreign capital. As a result, the investment rate, the key driver of growth for Solow, can remain durably high in spite of the relative decline in the marginal productivity of capital, thereby sustaining more vigorous economic growth. This implies a trend towards long-term convergence, where for a given investment rate, countries that are far-away from their equilibrium or stationary state will outgrow the rest.

This theory relies on the assumption that all countries are identical (aside from their initial capital intensity). Differences regarding their propensity to save, access to technology and population dynamics etc., confer a conditional character to the convergence process, as pointed out by Robert Barro (1991)[b]. The convergence process as described by R. Solow is represented in Chart 9 below.

Chart 10 traces the catch-up process in terms of per capita GDP in PPP dollars for the BRICs (Brazil, Russia, India and China). While convergence was particularly pronounced in China and Russia from 2001-2002 onwards, it was less so in Brazil and India. Moreover, the slowdown observed since 2010-2011 looks consistent with the neoclassical model's predictions, notably for China and Russia.

Emerging economies accelerated their catch-up process in the 2000s, a period characterised by Subramanian and Keller (2013)[c] c as one of "hyperglobalisation". Thus the share of emerging economies in catch-up phase surged from 30% in the 1990s to 75% in the 2000s, and the convergence speed is reckoned to have accelerated as well, from 1.5% to 3.3% per year, or even more for the BRICs (see Table 1). This faster pace of catch-up in the 2000s is thought to have resulted from a combination of the rise of China in global trade, which stimulated activity in many other emerging countries, as well as from credit bubbles and rising commodity prices.

On the other hand, the process of catching up among major emerging countries appears to have gradually been running out of steam since 2010, evidence of dwindling productivity gains due to factor reallocation. A fresh acceleration of growth would require major structural reforms in order to shift from an extensive pattern of growth, based on factor accumulation, to an intensive pattern, driven by productivity gains. This structural adjustment will no doubt be a protracted phenomenon

Chart 9: Productivity dynamics of in the neo-classical model

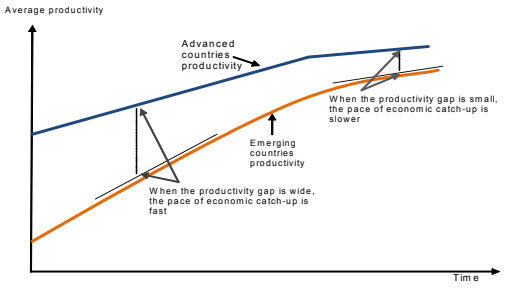
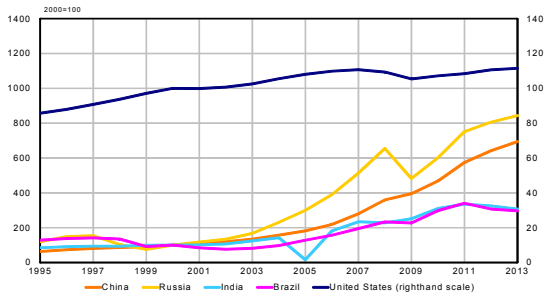


Chart 10: Per capital GDP trends



Source: DG Trésor.

Table 1: The average pace of economic catch-up for the BRICs

	1980-1984	1985-1989	1990-1994	1995-1999	2000-2004	2005-2009	2010-2014	2015-2018
BRICs	0.2%	1.9%	1.6%	1.3%	4.5%	7.9%	4.5%	3.1%

Source: DG Trésor based on IMF - World Economic Outlook October 2013 data.

NB: The pace of catch-up is the speed of reduction of the gap vis-à-vis the United States in terms of per capita GDP in PPP dollars. The aggregation at the level of the BRICs takes into account each country's share (at PPP) of global GDP.

a. Solow, R., (1956), "A Contribution to the Theory of Economic Growth", *Quarterly Journal of Economics,* Vol. 70, No. 1, pp. 65-94.
b. Barro, Robert J, (1991). "Economic Growth in a Cross Section of Countries", *The Quarterly Journal of Economics*, MIT Press, vol. 106(2), pages 407-43.
c. Subramanian Arvind & Kessler Martin, 2013. "The Hyperglobalization of Trade and Its Future", *Working Paper Series* WP13-7, Peterson Institute for International Economics.

4. While robust, emerging countries' growth is expected to remain durably weaker than before the 2008-2009 crisis

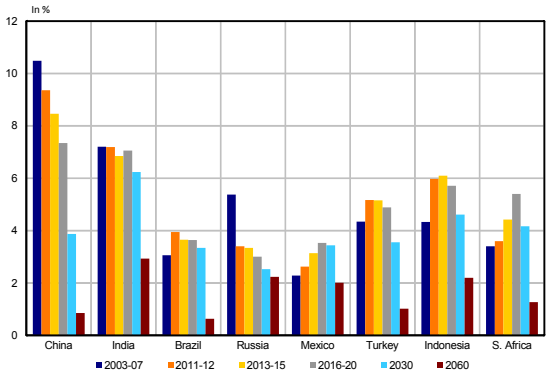
4.1 The fundamentals point to sustained medium to long-term growth, albeit on a slowing trend

The potential growth of emerging economies is expected to follow a slowing trend in the medium to long term, particularly in China. According to the OECD, the growing importance of major emerging economies in global GDP is coinciding with a gradual slowdown of their potential growth (see Chart 11). This is consistent with demographic trends and the slowing catch-up process towards advanced economies. The extent and the speed of the slowdown will depend on the country, while particularly significant in China.

Nevertheless, the medium to long-term projections emphasise the increasing role of emerging economies in global growth, due to the growth rate differential compared to developed economies. By adopting a forward-looking approach to the production function and on the basis of population projections, trends in capital

stock and total factor productivity, the OECD[9] points to a significant shift in the structure of global GDP in the coming years. All emerging economies combined[10] are expected to account for 46% of global GDP as early as 2020, rising to 53% by 2030 and 63% by 2060. The most pronounced trend concerns the major Asian powers, i.e. China and India. Indeed China is expected to account for 27% of global GDP by 2030, versus 17% in 2011, while India's share would rise to 11%, compared with 7% in 2011. According to the OECD, China and India will represent 26% and 21% respectively by 2060. These trends would occur at the expense of the main advanced economies, i.e. the United States (23% by 2011, 18% by 2030 and 16% in 2060), Japan (7%, 4% and 3%), and the euro-zone (17%, 12% and 9%).

Chart 11: Average annual growth rate of potential GDP



Source: OECD.

Box 2: **China and the golden rule of capital accumulation**

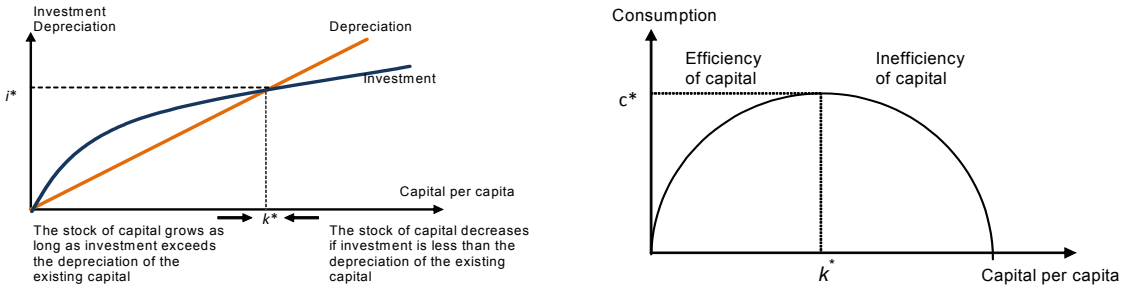
In the neoclassical growth model (Solow, 1956), capital accumulation is the main driver of growth, per capita income being solely a function of the per capita capital stock. Thus the more capital is accumulated, the more growth is generated[a].

However, capital accumulation at the expense of consumption can be prejudicial to growth. According to Phelps (1961)[b], there is an "optimal" rate of savings and investment that would allow maximization of per capita consumption at each moment in time (present and future). This principle, known as the golden rule of capital accumulation, allows the optimal allocation of revenu between consumption and savings in each period, by promoting inter-generational solidarity (consumption growth is identical for all generations). According to Phelps, per capita consumption is maximum when the marginal productivity of capital is equal to the rate of economic growth, i.e. when the savings rate equals the share of profits in national income. Consequently, any increase in saving beyond the optimal level has a negative impact on consumption.

Investment rates in China have been extremely high in the past two decades, rising from 27% of GDP in the 1980s to 47% in 2012. Beyond its structurally high level, China's investment rate was particularly vigorous in 2008-2010, owing to the Chinese government's stimulus plan enacted in the wake of the economic crisis, especially in the property and infrastructure sectors. According to the golden rule, China thus appears to be over-investing. This investment rate has systematically exceeded the share of profits in national income (around 0.5, compared with 0.3 in the period 1990-2011), suggesting that consumption has been repressed in favour of investment. Several academic studies have questioned whether China has been over-investing[c], most of them pointing to over-investment in 2008-2011, to as high as 12-20% of GDP.

Moreover, the return on capital appears to be falling also, as the Chinese economy is constrained to invest more and more in order to achieve the same growth rate (3.2 yuan on average in 1990-2007 to generate 1 additional yuan of GDP, versus 4.6 yuan in 2010-2012). Nevertheless, diminishing returns on capital are a sign of excessive investment only when accompanied by a fall in total factor productivity. This appears to be the case in China: total factor productivity fell from 4.9% a year in 2000-2007 to 2.3% in 2008-2011[d]. Although authorities have several times announced a rebalancing of the Chinese economy in favour of private consumption, this is not yet perceptible. Investment continues to outstrip household consumption (+1.5% average monthly growth, seasonally adjusted, for investment in 2013, versus +1.1% for household consumption).

Chart 12: The golden rule of capital accumulation



Source: adapted from Solow (1956) and Phelps (1961).

a. It should be noted, however, that increasing the accumulation of capital would have only a temporary effect on growth, by accelerating the transition towards the economy's equilibrium, since in the long term growth depends exclusively on technical progress.
b. Phelps, E., (1961), "The Golden Rule of Accumulation: A Fable for Growthmen", *The American Economic Review*, Vol. 51, No. 4 (Sep., 1961), pp. 638-643.
c. Il Houng, L., Murtaza, S. and Xueyan, L., (2012), "Is China Over-Investing and Does it Matter?", *IMF Working paper*, http://www.imf.org/external/pubs/ft/wp/2012/wp12277.pdf
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(10) Comprising China, Brazil, India, Russia, South Africa, Chile, Mexico, Turkey and Indonesia.

4.2 Emerging countries must tackle a number of challenges if they are to achieve the growth rates suggested by their fundamentals

Unable to rely any longer on vigorous exports to fuel their growth, the authorities of main emerging economies have understood the importance of boosting their domestic demand in order to enjoy more autonomous growth. Emerging economies could thus be able to support global growth in a context of flat demand in advanced economies, while also increasing their autonomy. The G20 members committed to this strategy within the Framework for Strong, Sustainable, and Balanced Growth working group, launched in Pittsburgh in September 2009. These commitments comprise two main points: i) in China, rebalancing growth towards private consumption; and ii) for the other major emerging economies, tackling their structural investment deficit (in infrastructure especially), which hampers supply and penalises potential growth.

4.2.1 China: the challenge of rebalancing in favour of private consumption

Bolstering household consumption would strengthen China's growth autonomy, while limiting the adverse consequences of the unbalanced nature of its current domestic growth. The private consumption share of China's GDP has been trending downwards over the past two decades and is now very low compared to other emerging economies (36% of GDP in 2012, versus 66% on average). This is especially due to low wages, insufficiently developed social protection systems, and the "financial repression" under-rewarding household savings[11]. Conversely, the share of investment in China's GDP appears to be excessive (47% in 2012), supported by public sector investement and encouraged by artificially low interest rates[12]. Domestic growth is thus largely investment-driven leading de facto to overheating, particularly in the property sector, but also to overcapacity in many industries (see Box 2).

At the G20 summit, China pledged to rebalance its growth model. This entails developing social security systems, financial markets liberalisation, reforming the labour market in a context of an ageing population and decline in low-skilled labour intensive industries. However, **the desired rebalancing looks hard to achieve in the short run,** owing to households' persistent preference for saving and still insufficiently-developed social security systems.

4.2.2 Other major emerging economies: the investment challenge

Other major emerging economies suffer from a structural investment deficit, leading to supply inefficiencies. This is particularly the case in Brazil (with an investment rate of only 18% of GDP in 2012), as well as in Turkey (20% in 2012), Mexico and Russia (21% in 2012). This under-investment results in major shortfalls in infrastructure, which breed bottlenecks and, ultimately, fuel inflationary pressures that squeeze consumption. India is a special case insofar as its relatively high investment rate (35% of GDP in 2012) is counterbalanced by misallocation, (the consequence of sub-optimal governance) and does not prevent the emergence of substantial bottlenecks.

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(11) In particular persistently low interest rates on deposit accounts restrict the profitability of these holdings.

(12) According to the World Bank, during the 30 years that followed Deng Xiaoping's reforms, investment accounted for 6-8% of China's average annual growth rate of 9.8%, while improving productivity accounted for only 2-4% of GDP.

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