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Can Developing Countries Continue to Lead Global Growth?

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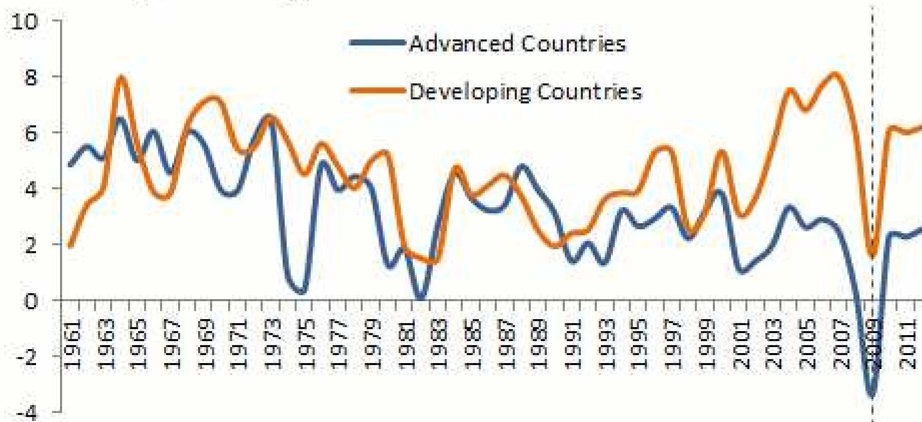
While advanced economies are still recovering from the Great Recession, developing countries are emerging as the new engine of global growth. Four sources of growth—capital accumulation, technological catch-up, growing consumption, and natural resource availability—are pushing developing economies forward. This success has led to new challenges, however, such as volatile capital inflows and asset price bubbles. Going forward, developing countries will only be able to drive world growth if their policy makers succeed in tackling these new challenges while also maintaining the policies that helped them navigate the financial crisis.

From Coupling to Switchover[1]

The economic cycles of developing and advanced countries have not decoupled—rather, they have tracked each other closely for decades and will continue to do so. Their long-term growth trends, however, began diverging almost twenty years ago, when developing nations began to grow at their own, much faster pace.



Sources: World Bank WDI and DEC Interim Forecasts, April 2010.

As a result, developing countries have played a greater role in the global economy since 2000. Most GDP projections expect the trend to continue, with advanced and developing economies likely to eventually reverse positions in absolute size. Although developing Asia is leading this dynamic, other developing regions are also seeing their shares of global GDP rise. Developing countries are projected to account for more than 60 percent of world growth over 2011 and 2012, as they have in recent years.

Autonomous Sources of Growth

Even if growth in advanced economies continues to slow or remain stagnant, four tracks—or “autonomous” sources of growth—will enable most developing economies to continue growing.

First, the balance sheets of both the public and private sectors in most emerging economies are in good shape.

While advanced economies continue to deleverage, many developing countries will be able to explore untapped investment opportunities, most glaringly in infrastructure. Higher savings and investment rates in emerging economies and their relatively low capital stocks mean that capital accumulation will contribute significantly to their growth—more so than in advanced countries.

Second, the opportunities for latecomers to learn new technologies are increasing. Developing countries have yet to acquire, adopt, and adapt a large inventory of technologies and—thanks to breakthroughs in information and communication—transferring those technologies to developing countries is becoming cheaper and safer.

Furthermore, decreased transportation costs and the break-up of the global production chain in many sectors are allowing poorer countries to insert themselves into the chain where capital, technology, and human capital requirements are not high. Labor input will also grow more rapidly in developing countries and, as they absorb technologies and people move from unproductive activities to participation in trade, labor's productivity will rise.

Third, as a middle class emerges in many developing countries, domestic consumption and investment may rise relative to production potential in those countries. A similar process occurred in Europe and Japan after World War II, when the economies' consumption (and technology) caught up to the U.S. frontier, enabling Europe and Japan to sustain long growth cycles.

More recently, however, truncated poverty reduction efforts limited growth in Latin America in the 1950s and '60s, while, even more recently, Asian countries looked to developed countries, rather than their own citizens, to consume a significant portion of their output. Developing countries may now need to better match their increases in production with increases in consumption. Provided that South-South trade is reinforced, smaller countries may see a new round of successful export-led growth.

Finally, natural-resource intensive developing countries, such as Brazil, Russia, and many countries in Sub Saharan Africa, may benefit from the likelihood that relative demand for commodities will stay strong in the medium term—to the extent that world growth comes to depend on developing countries, where demand is more commodity-intensive. As long as countries put in place appropriate governance and revenue-administration mechanisms—particularly to avoid rent-seeking behavior—natural resource availability may turn out to be a blessing.

Most developing countries were already moving along these four tracks before the global financial crisis, owing largely to policy improvements they had made over the preceding decade, which enabled them to respond well to the Great Recession's shocks.

Those sources of "autonomous" growth and rising global GDP shares may allow developing countries not only to escape from a negative "recoupling" with advanced economies, but to partially rescue those economies as well.

Advanced countries and developing countries depend on one another for growth through trade and corresponding investment prospects, as well as net factor incomes generated abroad—the return on foreign assets and remittances. The crisis has pushed advanced countries to a lower growth trajectory, hurting developing countries as well. However, if the "autonomous" sources of trend growth can be tapped to boost the growth trajectory of developing countries, those economies can grow as much as—if not more than—before, and mitigate the effects of the crisis on advanced economies.

Overshooting May Be Deadly

While developing countries are poised to drive the global economy going forward, the possibility of overshooting asset prices there poses a major threat to the engine transfer. Prices inevitably adjust in response to shifts in relative growth prospects and perceptions of risks but, because the creation of new assets in developing countries will be slower than the sudden increase in demand for them, the prices of existing assets—stocks, bonds, real estate, and human capital—in developing countries are likely to overshoot their long-term equilibrium values.

Recent history is full of examples of the negative effects of such asset price overshooting. Each of the recent

booms and busts—in Latin America, Asia, and Russia in the 1990s, and in Eastern Europe, Southern Europe, and Ireland more recently—shared some combination of unsustainably low financial costs, asset bubbles, over-indebtedness, wage growth unwarranted by productivity gains, and domestic absorption in excess of production. In every case, these imbalances were fueled by easily identifiable periods of euphoria and sudden increases in asset prices.

True, external factors, such as foreign liquidity, were conducive to—or at least permissive of—such periods. Twin current account and fiscal deficits and/or currency and debt-maturity mismatches were the rule. Today, near-zero interest rates in advanced countries are making similar conditions possible.

But powerful forces that drive up asset prices may be unleashed even without massive liquidity inflows. Brazilian firms, banks, and government agencies, for example, do not need liquidity from abroad to generate asset pyramids. The scramble for available assets and a dangerous euphoria may occur through purely domestic mechanisms.

Such overshooting of asset prices may already be taking place. According to World Bank data, developing countries' stock market indexes are now more than double their 2000–2007 average level. In India, inflation continues to accelerate—it reached 8.4 percent in December (y/y)—despite the central bank's six increases in the benchmark interest rate over the last year. Similarly, home prices in China's 70 major cities rose for an eighteenth month in November, notwithstanding new measures to curb the rise.

Policy

Clearly, the challenges economic policy makers in developing countries face have grown more complex following the crisis. In addition to maintaining the economic policies that supported their growth before and during the crisis, developing countries must now consider a new set of challenges arising from their success—such as asset price bubbles and volatile capital inflows.

Direct capital controls can only work temporarily and under certain conditions.[2] Their effectiveness depends on their reach, the country's capacity to enforce them, and the incentives investors have to circumvent them. The more sophisticated the country's domestic financial markets and the greater the role of foreign savings in the country's growth, the less useful the controls will be. Prudential regulation of the domestic financial system —combined with oversight to guard against excessive non-financial corporate leverage—have emerged as the main tools for curbing volatile capital inflows and avoiding domestic euphoria.

However, facilitating and strengthening the creation of new assets is the most important task for policy makers in developing countries. Fortunately, they have a number of options available. They can take advantage of the currently upbeat spirits of asset buyers to build contestability, transparency, and institutional quality around markets in which private investors can build new factories and/or stores and generate new jobs (e.g., engage in greenfield investment). They can also ensure that their investment rules are consistent with and favorable to funding projects with long maturities. And they can invest in their own capacity for project selection and design.

These and other internal reforms would moderate the furious rise in the prices of developing country assets. For this reason, they also constitute the best way to ensure that the next locomotives of global growth—and all of the economies that they pull—stay on track.

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1. See Otaviano Canuto and Marcelo Giugale (eds.), "The day after tomorrow – a handbook on the future of economic policy in the developing world", World Bank, 2010, available at www.worldbank.org/prem.

2. See Milan Brahmbhatt, Otaviano Canuto and Swati Ghosh, "Currency wars yesterday and today", *Economic Premise* n.43, December 2010, available at www.worldbank.org/economicpremise.

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