Javier Guzmán Calafell: A growth reset for emerging markets

Remarks by Mr Javier Guzmán Calafell, Deputy Governor of the Bank of Mexico, at the "2016 Astana Economic Forum", Flagship Session on "A growth reset for emerging markets", hosted by the Government of the Republic of Kazakhstan, the Economic Research Institute (Kazakhstan), the Reinventing Bretton-Woods Committee and ISPG/International Strategy Partners Group. Astana, Kazakhstan, 25 May 2016.

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The views expressed in this document are strictly personal.

First of all let me say I am very honored to participate in this session of the 2016 Astana Economic Forum. I would like at the outset to express my gratitude to the organizers for the invitation to speak at this event.

During the years preceding the global financial crisis, Emerging Market Economies (EMEs) showed a remarkable performance, with the pace of GDP growth increasing in the period 2000–2007 to nearly 7 percent per year, a sharp contrast with the figures of 3.3 and 3.7 percent observed during the eighties and nineties, respectively. Naturally, this had important consequences for the composition of the world economy. Thus, the share of EMEs in global output (in PPP-adjusted terms) increased from 43 percent in 2000 to around one half by 2007. Moreover, this accelerated growth in EMEs had a significant impact on the well-being of these economies' populations, as their nominal GDP per capita (also in PPP-adjusted terms) rose by nearly 70 percent during that period, thus narrowing the gap with respect to the advanced economies (AEs).[1] Naturally, this performance supported the expectation of a much faster convergence between the two groups of economies.

Following the economic difficulties deriving from the global financial crisis of 2008–2009, the risk of an abrupt end to this process arose. Nonetheless, EMEs displayed resilience to this shock, and even though their output growth decelerated in 2009, the outcome was far better than the outright contraction observed in the AEs. Moreover, the subsequent rebound in economic activity fed the expectation that EMEs could again perform as strongly as they had prior to the crisis, and hence resume the increase in income per capita towards AE levels.

Unfortunately, the pace of economic activity in EMEs has been on a downward path since 2011, and 2016 could well mark the sixth consecutive year of declining output growth in these economies. Even if the expectation of a slight increase in EMEs GDP growth for this year materializes, the differential vis-à-vis the AEs would still narrow to levels not seen since the early 2000s. It is important to emphasize that the recent performance has so far only slowed, but not reversed or even stopped, the global convergence process. However, the persistent deceleration of EMEs over a time span of several years, and its generalization across countries and regions, certainly raise important concerns.

Not surprisingly, these developments have given rise to a lot of debate on the possible factors behind them. Many observers have stressed the role of external conditions. In particular, the rate of expansion in the AEs has remained since 2011 significantly below its pre-crisis long-run average (1.6 percent in 2011–2015 vs 2.8 percent in 1980–2007). In addition, the volume of global trade of both goods and services has decelerated sharply in recent years, as its growth rate during 2011–2015 (3.9 percent annual average) fell well below its pre-crisis long-term average (6 percent in 1980–2007). Also, the terms of trade for the EMEs have severely deteriorated since mid-2014, essentially due to the fall that

1 According to IMF data, per capita GDP in the EMEs (in PPP-adjusted terms), as a share of the corresponding figure in the AEs, increased from 14.5 percent in 2000 to 18 percent in 2007.

commodity prices, especially oil, have displayed. Lastly, capital flows to EMEs have not only declined, but are significantly more volatile with respect to previous years.

How important are external conditions for economic growth in EMEs? The IMF has recently attempted to answer this question, on the basis of a study for 16 of the largest emerging market economies, accounting for a large share of the group's output and spanning a broad spectrum of economic and structural characteristics.[2] The conclusion is that external factors (including, but not limited to, growth in the AEs) contribute as much as or more than other factors in explaining deviations from estimated average growth during the period 1998–2013.

Irrespective of the precise figures, it is unquestionable that external factors have played a decisive role in EMEs growth performance in recent years. However, I am of the view that the main challenge for this group of countries in coming years is of a domestic, not of an external, nature.

In this respect, it is worth to consider the following.

First, the above-mentioned IMF study finds considerable differences across time and countries. In particular, it notes that internal factors contributed more to deviations from estimated growth during the slowdown observed after the global financial crisis. Other studies reach a similar conclusion. For instance, according to research carried out by World Bank staff, although the recent EMEs slowdown was driven initially by external forces, domestic factors have increasingly weighed on growth.[3] In fact, this study estimates that the growth slowdown in EMEs since 2011 has predominantly reflected slowing total factor productivity (TFP) growth. The significant decline in TFP growth in EMEs in recent years has also been stressed by other analysts.[4]

Furthermore, the evolution of economic growth in EMEs in coming years will be affected by demographic trends. Since 2010, working-age population growth has slowed from pre-crisis rates in all EME regions. In addition to the resulting slowdown of labor market inputs, this may adversely affect innovation, productivity growth and savings.[5]

Second, a substantial recovery of the world economy in coming years is still out of sight. Some analysts have expressed concern about the possibility of chronic low growth in the advanced economies, be it as a result of factors on the demand (a long-lasting excess of saving over investment pulling down growth, inflation and real interest rates) or supply (ageing and low productivity growth among them) sides.[6] Regardless of whether or not these fears prove valid, it will be, in all likelihood, a long time before we see again rates of growth in the AEs similar to those observed before the global financial crisis.

It is also important to note that the transition to a new consumption-services based economic model in China, coupled with the nature of other challenges currently faced by its economy

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2 See International Monetary Fund (2014): "On the Receiving End? External Conditions and Emerging Market Growth Before, During, and After the Global Financial Crisis", Chapter 4 of *World Economic Outlook*, April.

3 See Didier, Tatiana et al. (2015): "Slowdown in Emerging Markets: Rough Patch or Prolonged Weakness?", *World Bank Group Policy Research Note*, December.

4 See for instance International Monetary Fund (2015): "Where Are We Headed? Perspectives on Potential Output", Chapter 3 of *World Economic Outlook*, April.

5 See Didier, Tatiana et al. (2015): "Slowdown in Emerging Markets: Rough Patch or Prolonged Weakness?", World Bank Group Policy Research Note, p. 29, December.

6 See, for instance, Blanchard, Olivier et al. (2015): "Inflation and Activity – Two Explorations and their Monetary Policy Implications", *IMF Working Paper* No. 15/230, November; as well as the chapters by Lawrence Summers ("Reflections on the 'New Secular Stagnation Hypothesis'") and Robert Gordon ("The Turtle's Progress: Secular Stagnation Meets the Headwinds"), among others, in Teulings, Coen and Richard Baldwin (2014): "Secular Stagnation: Facts, Causes and Cures", a VoxEU.org eBook.

(high levels of debt, overcapacity and financial fragility, among others) are already affecting this country's growth potential.

In this context, it is hardly surprising that, after recording last year their sharpest decline since 2009, the terms of trade of goods and services for the EMEs as a group are projected to continue falling, although at gradually moderating rates, throughout 2021.[7] Furthermore, the perspective of a normalization of monetary policy in the United States and the overall situation of uncertainty in international financial markets point to the continuation of challenging external financing conditions for several years to come.

To sum up, both the nature of the recent deceleration of economic growth in EMEs, and the structural transformation of the external environment these countries are facing, underline the need to reinforce the internal sources of growth. In other words, without disregarding the importance of international economic cooperation, the fundamental challenge is domestic, not external.

What should EMEs do to meet this objective?

The first requirement is of course to ensure macroeconomic stability. This is not an area of much controversy. The empirical evidence shows clearly the benefits of strong public finances, low inflation and in general a solid macroeconomic environment for the achievement of sustained and adequate rates of economic growth. However, implementation has proved to be a more challenging issue, as we continue to see high fiscal and current account imbalances, as well as excessive debt levels, in a number of EMEs. The reasons are varied: inadequate diagnoses, external shocks, restrictions of a political nature, improper timing of policy implementation, poor coordination of different policy instruments, and so on. In fact, macroeconomic policy slippages explain partly the poor economic growth results observed in several EMEs in the last years. A frequent recommendation for these countries is to use fiscal and monetary stimulus, whenever this is feasible, to support growth. But the fact is that most of them lack the room to implement expansionary demand management policies under present circumstances.

As stressed by the experience of the global financial crisis, financial stability is a second requirement to lay the basis for sustained growth. The standard recommendation here is the use of macroprudential policies, with simultaneous and coordinated efforts at the macroeconomic and microprudential levels. To this, one must add the need to ensure the availability of more and better statistics, an appropriate analytical capacity and the creation of a suitable institutional framework. Although the international community has devoted a lot of energy to enhance our understanding of the policy framework needed to ensure financial stability, we still have many theoretical and empirical gaps in this field. Under these circumstances, the safest approach seems to be to adhere as closely as possible to the state of knowledge, with proper consideration of domestic conditions and an emphasis on prudence.

The third crucial requirement to foster growth in EMEs is structural reform. Indeed, the deceleration of TFP growth in recent years and the relevance of this factor in explaining the lower rates of economic activity in EMEs, clearly point to the need for action on the supply side. The crucial role of structural reform is underlined when taking into consideration that many EMEs face the risk of falling into a "middle-income trap".[8] At lower levels of development, the availability of a substantial amount of underutilized resources and easy productivity gains (stemming for instance from importing foreign technologies or mobilizing

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7 See International Monetary Fund (2016): *World Economic Outlook*, April.

8 See Eichengreen, Barry et al. (2012): "When Fast-Growing Economies Slow Down: International Evidence and Implications for China", *Asian Economic Papers* 11 (1): 42-87; and Eichengreen, Barry et al. (2013): "Growth Slowdowns Redux: New Evidence on the Middle-Income Trap", *NBER Working Paper* No. 18673.

resources from agriculture to manufacturing) allow the achievement of high rates of economic growth. As the opportunities brought about by starting from behind dilute with increased levels of income, potential growth declines.

Unfortunately, the efforts of structural reform in EMEs stagnated in recent years. To some extent, this is a result of the high rates of economic growth observed in this period. In view of the dynamism displayed by their economies, the authorities of many emerging market countries saw little need for economic reform. Thus, notwithstanding the opportunity provided by a favorable external environment, they did not carry out the structural measures needed to increase productivity and the potential for growth. The global financial crisis may have even worsened the situation, as one of its side effects has been a reversal in the reform effort in a number of areas, with only a few countries announcing comprehensive reform plans, China, India and Mexico among them.[9]

Naturally, this situation has to change if economic growth in EMEs is to continue at a reasonable pace. Reform priorities vary from one country to another, and therefore it is not possible to recommend specific measures that may be applicable on a generalized basis. However, on the basis of the international experience, a few general principles can be underlined:

- Economic reforms that reduce barriers to the efficient functioning of markets, fuel competition, stimulate innovation and the adoption of new technologies, and encourage the accumulation of human and physical capital, including infrastructure, are associated with higher productivity growth.
- Policy reforms may have non-linear effects related to the quality of political and economic institutions. Therefore, a broad range of institutional factors need to be taken into consideration in a process of reform.
- Reforms in different areas interact. These synergies must be taken into account to maximize the impact on productivity growth.
- A proper transition to a greater influence of market forces, and therefore an adequate sequencing of reforms, is critical for the success of these efforts.
- The drivers of productivity growth may vary along the development path. The "middle-income trap" hypothesis points to different policy requirements at different levels of development.
- Approval of long-ranging reforms may take a long time, among other reasons because of obstacles of a political nature. Also, the impact of reforms on productivity will normally be slow. As a result, the payoff of an early move in this direction will be usually very high.

To conclude, let me say a few words about the recent efforts of structural reform in Mexico, as my country's experience can provide some additional insight on the intricacies of this issue. During the period 1990–2011, Mexico's economy recorded an average annual rate of growth of around 2.8 percent, too low for the country's needs. In the presence of a demographic dividend, the main factors behind this performance were a relatively low investment rate and, particularly, a negative contribution to growth of total factor productivity.

As a response to this situation, the Mexican authorities embarked since late 2012 on a far-reaching structural reform effort, aimed at increasing the economy's growth potential. The

[9] See World Bank (2015): "Latin America Treads a Narrow Path to Growth: The Slowdown and its Macroeconomic Challenges", Semiannual Report of the Office of the Regional Chief Economist, April; and Organisation for Economic Co-operation and Development (2016): "Economic Policy Reforms 2016: Going for Growth Interim Report", February.

reform package encompassed a wide range of sectors, as well as a significant strengthening of the institutional setting.

The structural reform measures are still under implementation, and the full gains from this transformation will take a long time to materialize. However, some results are readily visible. I would like to highlight in particular the evolution of inflation. As of the first half of May, the annual inflation rate in Mexico stood at 2.5 percent, below the 3 percent target. As a matter of fact, we have been observing figures consecutively under the target since May 2015, an unprecedented achievement. This is of course the result of many factors, the implementation of strong macroeconomic policies the most prominent among them. But structural reform has also played a major role in these developments. For instance, the competition brought about by reform in the telecommunications sector has resulted in significantly lower prices for these products, with beneficial effects on inflation.[10] This has also been supported by a reduction in electricity prices, partly the result of reform in the energy sector.

The recent performance of economic growth in Mexico is also worth noting. During the years before the eruption of the financial crisis (2000 to 2007), the Mexican economy showed an average annual rate of growth of around 2.7 percent. The figure for 2011 to 2015 is similar (2.8 percent), notwithstanding the fact that the rate of GDP growth of our main trading partner, the United States, fell by 0.6 percentage points between these two periods,[11] and that the economy was hit by a number of other external shocks, including a sharp decline in oil prices. It is also worth noting that Mexico is one of the few EMEs where a deceleration of growth is not observed during the two periods under consideration. Although it would be very difficult to isolate the different determinants of this performance, there is clearly a possibility that the structural reform process begun in 2012, is one of the factors behind the resilience of the Mexican economy’s rate of growth to the difficult external environment.

All in all, on the basis of an adequate macroeconomic management and a comprehensive package of structural reform, in a context of financial stability, the Mexican economy has been able to successfully weather the turbulent times of recent years. The task, however, is not complete yet. To start with, the role of the reforms in setting the economy’s pace over the long term is heavily dependent on their adequate implementation. Furthermore, structural reform is a dynamic process and therefore additional measures may be needed. Finally, it is also important to remember that, as in the case of other EMEs, the country’s macroeconomic position and financial stability are still subject to challenges, particularly in what is likely to remain an uncertain and volatile external environment.

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[10] The annual rate of growth of the prices of telephone services fell from 13.7 percent in December 2013 to minus 14.5 percent in December 2015 and minus 12.8 percent in the first two weeks of May 2016.

[11] The US economy grew at an average annual rate of 2.6 percent during 2000–2007. After the crisis, its pace of expansion declined to 2.0 percent per year, on average, during 2011–2015.