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SchEMatics: EM vs DM – New Divisions in an Old Divide

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Old Divides, New Divisions: The traditional divide between EM and DM economies is still valid in many ways, but some EM economies have very DM-like problems now, while DM economies have picked up very EM-like characteristics. To add, the incredible structural change that we are only now on the cusp of will reverse the economic dynamics of the last three-and-a-half decades. Put the two together, and the clustering of economies into winners and losers will no longer respect the historical divisions that separated DM economies from EM.

In today's note, we argue that three divides that traditionally divided DM from EM will now cluster some DM and EM economies together as winners, and a similar mix will make up the cluster of losers. The three divides? How the returns to labour and capital will shape up in the future, (ii) how inefficiency, institutions and individuals can change the economy, and (iii) where productivity has scope for upside, and where it will remain elusive.

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I. Labour vs Capital

Bottom line: Capital was expensive in DM and labour cheap; the new division will come from demography, whether rising real rates are endogenous or exogenous, and the dispersion of local returns to capital.

Winners: US (we give them the benefit of the doubt), India, Indonesia, Africa, parts of Latin America; *Losers*: Japan, ageing Europe, UK, Australia, Canada, North Asia, ageing CEEMEA; *The jury is out on*: Russia.

The most basic difference between EM and DM has historically been that labour is cheap and capital expensive in EM, and the opposite is true in DM. DM has always preferred using the less expensive factor of production - capital - intensively while the comparative advantage of EM lies in labour-intensive products and production techniques. But then how can EM ever accelerate the accumulation of capital?

EM capital accumulation has happened at an accelerated pace whenever:

- The local price of capital has been distorted,
- Global monetary conditions are benign and direct capital flows towards EM,
- That most alluring but elusive of dynamics - structural improvements (including reforms) that raise the local rate of return on capital.

Supercharged: Every single one of these was supercharged in favour of EM in the pre-crisis decade and even in the aftermath of the crisis thanks to (i) the global decline in interest rates along with a sharp increase in capital flows that lowered the cost of borrowing in EM, (ii) global demographics tailwinds and, most importantly, (iii) China's mercantilist policy designed for capital accumulation.

New Divisions

The new divisions in the returns to capital and labour will be driven by three factors:

- *Demographics:* A change in demographic dynamics will lower growth, but it will push up real rates, inflation and wages globally. We will argue soon that real interest rates will rise because savings will fall faster than investment. Paying for the elderly will mean that wages and taxes will both have to rise, fuelling inflation. In finding winners and losers, the demographic divide will be important. Every large DM economy and a huge chunk of the manufacturing part of EM will all age, while parts of EM, particularly India, Indonesia and Africa, will move in the opposite direction. However, things are not as simple as that. The demographic 'dividend' too can turn out to be a curse if enough capital cannot be deployed to absorb that increasing pool of labour - just think of the 'Arab Spring'. Diverging demographics bear promise for asset returns where a declining labour supply is met by labour-saving capital investment, and where capital accumulation meets an increasing supply of labour.
- *Global monetary conditions vs productivity, endogenous vs exogenous?* Global interest rates are on the rise, but they will be endogenous only where productivity can rise and where debt is sustainable. That cuts a dividing line across DM and EM. Parts of DM (the US being the clearest example) and EM (India, Russia, Indonesia) have likely seen productivity and debt concerns bottom out, while others have further to go. Those on the wrong side of this divide will find higher global rates an exogenous shock.

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- *The local returns to capital* are now very widely dispersed by the level and quality of the capital stock accumulated over the two decades. An obvious distinction is the one between commodity producers and manufacturers, but it is the layering in each category that matters more. This is best examined along three dimensions: (i) Commodity producers like Australia and Canada that have not yet shaken off their Dutch Disease problem will have a very different rate of return on incremental investment compared with economies like Russia, Brazil and Indonesia that have dealt with this problem. (ii) Similarly, the level of sophistication in manufacturing varies tremendously across EM. The transformation of the US economy into a competitor for rather than a consumer of EM goods is part of a larger medium-term story - the fight for the middle manufacturing segment in the global economy. (iii) The stock and quality of infrastructure too is very widely dispersed across EM economies, and to a lesser extent within DM economies too - that will determine whether infrastructure investment has returns that justify fiscal involvement.

II. The 3i's: Inefficiencies, Institutions, and Individuals

Bottom line: DM has caught down to EM, individuals may dominate institutions; the swerve to the right in DM is based on populism but the one in EM stems from a more economically oriented platform.

Winners: US, Germany, Japan, India, Indonesia, Russia, much of Latin America; *Losers*: Europe, Turkey; *The jury is out on*: UK, Mexico, S. Africa

Institutions and Inefficiency: It is the efficiency of DM institutions that keeps growth low even though productivity is high. Why? The efficiency of the DM institutions allows labour, capital and technology - the inputs into the production function - to already be combined in an optimal way. But it IS hard to improve on a system that is already efficient. Hence, it is either increments to or improvements in the stock of labour, capital and technology that drive changes in trend growth.

By similar logic, it is the creative destruction or removal of *in*efficiency of EM institutions that creates high growth when that inefficiency is corrected, and hence the trapped productivity is released. As long as EM institutions remain less efficient than their DM counterparts, the scope for catch-up growth remains in place.

Individuals vs Institutions: Like people, weak EM institutions are all too often too frail to repair themselves without medication. Institutional weakness means that strong individuals can dominate these institutions. That's why personalities and individuals matter so much more in EM, because they have the ability to change institutions - for the better, and sometimes for the worse. While PM Modi and PM Jokowi's arrival has rightly brought in optimism, the dominance of President Zuma (until now) and President Erodgan (which will persist) have been desultory and outright detrimental to economic prospects.

Institutions usually dominate individuals in DM. That's why even US Presidents get so little done even if they are determined to drive change. If that is about to change, both upside and downside are equally possible.

New Divisions

The 3i's will now create a new global divide:

- *Inefficiency:* The one traditional divide that will persist is the one borne out of inefficiency. Reducing that inefficiency will still allow EM economies to outstrip DM growth, but the potential for raising EM efficiency (and for DM efficiency to fall) is now more dispersed.
- *Economic institutions* in the US, Germany and Japan have been the most resilient, while the biggest improvement in institutions appears to be under way in Argentina and then India. On the other side of the divide are the weak institutions in Europe and the monolithic economic-political structures that create inertia in much of North Asia, and particularly China.
- *Political institutions create a populist-economic divide:* The world has swerved to the right, on a populist agenda in most of DM and parts of EM too (Poland, Hungary, Turkey, and risks are rising with AMLO in Mexico), but it is the promise of economic change that has ushered in right-leaning administrations in EM. That could spell a better environment for the corporate sector in some economies (US, India, Indonesia, much of Latin America), and downside risks due to populism in the ones we mention above.
- *Individuals that can drive change, for the better…* Upside risks dominate downside ones in the US, Japan, India, Indonesia and Russia. Mr. Trump's revival of the corporate animal spirits is the most exciting development there in the last half-decade, but the protectionism he espouses could lead to capital misallocation. The Abe-Kuroda combination is an impressive one in Japan, but the obsession with infrastructure in an economy with such high debt worries us. India's drive to improve its administrative efficiency is impressive, but its high-handed rejection of Mr. Rajan's policies and erosion of central bank

independence is worrisome. Russia's Nabiullina has done a lot to clean up the national balance sheet, but President Putin's economic-political strategies leave much to be desired (as evidenced by the recent conviction of the leader of the opposition).

- *…and for the worse:* Downside risks dominate when it comes to: (i) President Erdogan's dominance over monetary policy in Turkey and the decline in socio-economic sentiment and investment opportunities that seems likely to deteriorate over time; (ii) Northern Europe, particularly France and Holland, where growth drivers are weak already and the rising popularity of populist platforms is not accompanied by a promising economic platform from either Le Pen in France or Dutch PM Rutte, and (iii) the Trump-May doctrine of aggressive disengagement which threatens to break supply chains, but more importantly, could generate capital misallocation by raising barriers to competition.

III. The New Productivity Divide

Bottom line: Productivity dynamics used to favour EM, but now the scope for productivity gains is mixed across DM and EM.
Leaders: US, parts of Southern Europe, India, Indonesia, Brazil; *Laggards*: Northern Europe, UK, Australia, Canada, Turkey, Malaysia; *The jury is out on*: Japan, Russia, S. Africa, Mexico.

The pre-crisis consumption surge and the housing boom in DM implicitly mean that there was no reward for productivity whatsoever. EM did much better as capital accumulation raised productivity at least initially - until that story went too far as well. Only a series of crises and the exhaustion of policy tools to fend off slower growth led to the realisation that lower potential output growth is here to stay. The only cure? Productivity.

But why hasn't it surfaced thus far? For structural and cyclical reasons. Structurally, the demographic 'sweet spot' pushed inflation and real interest rates lower for decades, until now. That raised the ability and willingness of financial institutions to supply credit and re-finance debt. It also meant that growth and support for asset prices (including house prices) was easy enough to come by, making productivity a welcome but not a necessary ingredient for both policy-makers and markets. Cyclically, excess capacity in the aftermath of the crisis, the debt overhang and the perverse incentives created by ZIRP (e.g., to buy back equities rather than invest in order to raise the ROE in the US) have all made corporates more willing to sit on cash.

New divisions

But now productivity will have to rise - because of demographics.
If the demographic sweet spot is now turning sour, then real interest rates have already stopped falling and will slowly rise, with two key implications. First, both the ability and willingness of financial institutions to supply credit will no longer be ample as it was over the last few decades. Second, the threshold for returns on investment in physical and financial capital is no longer a low one, and will rise over time. The only way to have beat tighter financial conditions and the higher threshold for returns? You guessed it, higher productivity.

Where could productivity show up? Where the long shadow of capital misallocation is fading, and the 3i's help accumulate either a higher quality of labour, or capital or their interaction. We have already dealt with the latter just above, so we concentrate here on capital misallocation:

- *Where starting points are now benign:* Even if policy-makers sometimes waste the opportunities that a crisis provides, markets don't. Where markets have enforced change, capital misallocation has been dealt with faster. The US, peripheral Europe, and parts of EM where markets can and have driven structural change (India, Indonesia, Brazil, Russia) now have benign starting points.
- *Where starting points are not yet promising:* We would have added the UK to the list above, but the new cloud that hovers over the economy makes it hard to argue for a benign starting point right now. Starting points are worrisome in Northern Europe (yes, including Germany thanks to its impending switch to consumption being the key driver of growth), the commodity-producing DM economies of Australia and Canada which have not shed their Dutch Disease problems, the EM economies of North Asia including China, and of course Turkey. The really interesting cases are S. Africa (where downside risks are abating quickly) and Mexico (where the balance of risks is being ignored by markets).
- *Starting points by themselves aren't enough - so where can benign starting points set off a productivity revival?* Where the 3i's create economic and political tailwinds, in line with our discussion above.

In summary, the divide between EM and DM still exists but new divisions have lumped many EM and DM economies in the same buckets by creating new divisions that run through each cluster of economies. Choosing winners and losers out of this differently grouped set of economies has now become much harder.

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