NRI Papers No. 187 August 1, 2013

What Are Emerging Economies? —Stage Shifts

Takeshi MORI

Nomura Research Institute

NRI Papers No. 187
August 1, 2013

What Are Emerging Economies?
—Stage Shifts

Takeshi MORI

I Classification of Stages of the World's Countries and Positioning of Emerging Economies
II Stage Shift from Being a Low-Growth Developing Economy to Being an Emerging Economy
III Stage Shift Turning Points Faced by Emerging Economies
IV How Stage Shifts Vary between Large and Small Countries
V Stage Shifts and Japan

The world's countries are classified into eight economic stages based on gross domestic product (GDP) growth rate, per capita GDP and size of GDP. Among these stages, countries that have a higher GDP growth rate and a lower per capita GDP relative to the global average are defined as those in the stage of emerging economies (the eight-stage model).

In most cases, the stage shift from being a low-growth developing economy to being an emerging economy is achieved by pursuing an export-based growth scenario. Based on this scenario, the government adopts the policies needed to address issues such as the identification of strategic export industries and how to procure (1) labor, (2) capital (funding) and (3) technology that are necessary factors of production in the selected industries either from home or abroad.

A country that has grown into an emerging economy will find itself at a stage shift crossroads where it can either take one step further forward to become a growing advanced economy, or a step back to being a low-growth developing economy. If a country continues economic growth and stays at the emerging economy stage for an extended period, it is likely to gradually lose its cost competitiveness, face issues such as income inequality that ultimately suppress growth, or might experience default on external debt, which could stop economic growth in its tracks.

Therefore, the government of an emerging economy needs to create new competitive advantages, and at the same time, eliminate the factors that can suppress growth, which is a task that is much more difficult than achieving the shift from a low-growth developing economy to an emerging economy.

Japan, which is now a mature advanced economy, should encourage the growth of emerging economies with which it has mutually beneficial relationships based on common strategic interests by investing its stocks such as the assets and technologies that it has accumulated. At the same time, the perspective of aiming for Japan's own growth by increasing its return on assets (ROA) is important.

Copyright 2013 by Nomura Research Institute, Ltd.

I Classification of Stages of the World's Countries and Positioning of Emerging Economies

1 Developed countries, underdeveloped countries, Japan and Argentina

"There are four types of countries: the developed, the underdeveloped, Japan and Argentina." This view was stated by Simon Kuznets, who won the Nobel Prize in Economics in 1971. His words were based on the fact that, in the 1960s, Japan had been making the shift from a developing country to a developed country by achieving high economic growth, while Argentina had been reverting from being a developed country to becoming a developing country. At the same time, his words also imply the fixed economic position of the world's countries at that time, and that the north-south divide (the gap between the rich (developed) and the poor (developing) countries) was a major problem.

What, one wonders, would Kuznets say about the world's economy in 2013? We are living in a very different period from that of the 1960s. For example, through the efforts of the emerging economies, the north-south divide appears to have been reduced considerably. Meanwhile, in Europe, some countries are now at risk of losing their standing as advanced economies, which depends in large measure on how they handle their sovereign debt crises. Then, relative to the 1960s, has it become significantly more likely for a country to transition from one stage to another? What are the factors behind a country becoming an emerging economy by achieving a high economic growth rate? After successfully transitioning to an emerging economy, what is needed for a country to become an advanced economy? (Gross domestic product (GDP) growth is referred to as economic growth in this paper.)

In an attempt to answer these questions, in this paper, the world's countries are classified into eight stages from a purely economic perspective, and the historical transition trends between stages and the factors leading to stage shifts are analyzed.

2 Classification of stages of the world's countries

In the paper entitled "What Are Emerging Economies?" published in May (NRI Papers, No. 184), in order to simply and objectively define emerging economies, the author introduced a framework whereby each of the world's countries is classified into one of eight stages based on the GDP growth rate, per capita GDP and size of GDP. Two of these eight stages are defined as emerging economies (Table 1).

Essentially:

- Countries in which the GDP growth rate is higher than the global average, but in which the per capita GDP is lower than the global average, are classified as "emerging economies" ((3) and (4) in Table 1).

The other stages are:

- Countries in which the GDP growth rate is lower than the global average and in which the per capita GDP is also lower than the global average are classified as "low-growth developing economies" ((1) and (2) in Table 1).
- Countries in which the GDP growth rate is higher than the global average and in which the per capita GDP is also higher than the global average are classified as "growing advanced economies" ((5) and (6) in Table 1).
- Countries in which the GDP growth rate is lower than the global average, but in which the per capita GDP is higher than the global average, are classified as "mature advanced economies" ((7) and (8) in Table 1).

These four stages are further subdivided according to the size of GDP: the above names are prefixed by either "large scale" or "small scale."

An analysis of how the world's major countries have transitioned between these stages over the last 140 years (1870 to 2010) revealed some interesting features.

Table 1. Classification of the world's countries into eight stages

	GDP growth rate (as compared to global average)	Per capita GDP (as compared to global average)	GDP size (as compared to global average)	Name of stage
(1)	Lower	Lower	Smaller	(Small scale) Low-growth developing economies
(2)	Lower	Lower	Larger	(Large scale) Low-growth developing economies
(3)	Higher	Lower	Smaller	(Small scale) Emerging economies
(4)	Higher	Lower	Larger	(Large scale) Emerging economies
(5)	Higher	Higher	Smaller	(Small scale) Growing advanced economies
(6)	Higher	Higher	Larger	(Large scale) Growing advanced economies
(7)	Lower	Higher	Smaller	(Small scale) Mature advanced economies
(8)	Lower	Higher	Larger	(Large scale) Mature advanced economies

Note: GDP = gross domestic product.

Copyright 2013 by Nomura Research Institute, Ltd.

The first feature is that there are transition paths that interconnect the eight stages. As shown in Figure 1, with only a few exceptions, countries mostly followed the transition paths indicated by the arrows. For example, the low-growth developing economies ((1) and (2)) and emerging economies ((3) and (4)) are linked by double-ended arrows. These double-ended arrows indicate the possibility that a low-growth developing economy that transitioned into an emerging economy could revert to being a low-growth developing economy if a high growth rate cannot be maintained. Brazil and Mexico are examples of countries that repeat this type of transition.

Similarly, double-ended arrows are also used between growing advanced economies ((5) and (6)) and mature advanced economies ((7) and (8)), indicating cases in which a mature advanced economy could become a growing advanced economy by achieving high GDP growth. In addition, once a country reaches the advanced economy stage, there is no guarantee that it will maintain that standing, with Argentina being a good example of a country that was once an advanced economy but which subsequently transitioned back to being a low-growth developing economy. Incidentally, over the above-mentioned 140-year history, Japan is the only country that has successfully transitioned from a low-growth developing economy to a mature advanced economy ((2) → (4) → (6) → (8)).

The second feature that was observed is the fact that there are very few instances of countries transitioning from emerging economies ((3) and (4)) to growing advanced economies ((5) and (6)). Indeed, in order to make the transition to a growing advanced economy in the world in the face of the growth of the overall world economy, a country must achieve a stable, high level of growth over the long term. However, the reality is that many "traps" act as barriers to achieving such growth. While these barriers are sometimes referred to as the "middle income trap," the effect of this trap ranges from gradually lessening an emerging economy's competitiveness to putting an immediate brake on economic growth. Countries that fall into this trap inevitably fall back to become low-growth developing economies. Given these characteristics, the eight stages and the transition paths between them are together referred to as the "eight-stage model."

In this paper, focus is placed on the emerging economy stage in analyzing the following factors.

(A) Factors leading to the transition from a low-growth developing economy to an emerging economy

(B) Factors leading to the transition from an emerging economy to a growing advanced economy

II Stage Shift from Being a Low-Growth Developing Economy to Being an Emerging Economy

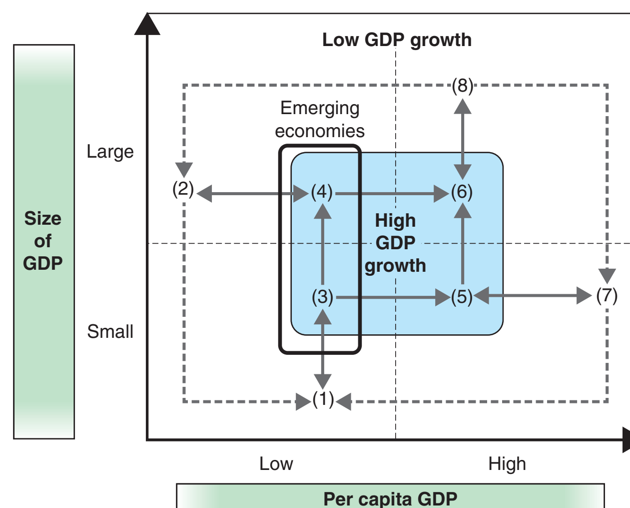
1 Factors leading to a country's transition to an emerging economy

The stage shift from being a low-growth developing economy to being an emerging economy corresponds to transition (1) → (3) or (2) → (4) in Figure 1. The transition from being a low-growth developing economy to being an emerging economy implies that the GDP growth rate increases for some reason. There are actually many examples of countries making this stage shift, to the extent that it can be said that the majority of the world's countries have experienced transitioning from being a low-growth developing economy to being an emerging economy at least once.

There have been many studies on the mechanism by which a country attains economic growth. For example,

Figure 1. Classification of countries into eight stages and transition paths

Eight-stage model: The numbers in the figure correspond to those used for classification in Table 1



Copyright 2013 by Nomura Research Institute, Ltd.

economists such as Robert Solow and Paul Romer have developed the endogenous economic growth theory, which holds that “from the medium- to long-term perspective, a country’s economy grows with an increase in the economic growth factors such as labor, capital and technology.” This theory has since been extended, with level of education, degree of development of legal systems, degree of development of infrastructure and natural resources all being singled out as economic growth factors.

Table 2 lists examples of countries that, after 1870, made the stage shift from a low-growth developing economy to an emerging economy. Between 1870 and 1913, only Japan joined the ranks of emerging economies. After World War II, countries such as China, South Korea, some Southeast Asian countries and India made the stage shift to being emerging economies. More recently, in the 1990s, some Latin American countries have made the same stage shift. However, the fact is that these countries have previously been either advanced or emerging economies, but subsequently dropped to low-growth developing economies by going through large-scale economic recessions. In the 1990s, they reverted to the emerging economy stage by again achieving economic growth. (It should be pointed out that it is not necessarily clear when these countries “first” became emerging economies because of reasons such as that they had made the shift prior to 1870 or that no data is available.) While Table 2 lists some examples of such countries, many other countries have made the shift from low-growth developing economies to emerging economies at least once, such as African countries.

Then, what factors trigger the stage shift to an emerging economy? Looking at GDP from the aspect of expenditure, the major factors are “consumption,” “investment” and “net exports (exports – imports).” What is commonly seen among countries that have made the shift to emerging economies is major growth in “investment” and “exports.” That is, the basic scenario common to all these countries is the one in which the capacity of producing goods and products (agricultural products, industrial goods, natural resources, etc.) for which the country has comparative advantages in the country is further increased by making an assortment of investments, and these goods and products are manufactured in excess of demand within the country for export. To increase exports, specific “strategic products” are identified, for which funds are secured for their production. Investments are made in necessary equipment and technology. A larger workforce is recruited for the relevant industries. Superior technology is used for the production of these products, which are sold in domestic as well as overseas markets. Furthermore, public investments are made in distribution and energy infrastructure to support the production of these products.

Strategic products have been types of industrial products in most Asian emerging economies, as was the case in Japan in the past. While these countries have been increasing the GDP growth rate by expanding the exports of their industrial products, in recent years, the exports of information technology (IT) services drive growth in some countries such as India. Furthermore, resource-producing countries such as the former Soviet Union countries, Venezuela and some countries in Africa and the Middle East are expanding the exports in which natural resources account for a large proportion.

In addition, many Latin American countries transitioned from low-growth developing economies to emerging economies in the 1990s after achieving high economic growth, as listed in Table 2. While this stage shift to emerging economies is not their first time, as described above, they achieved high economic growth as a result of expanding their exports, which was triggered by a substantial devaluation of their currencies.

In short, the key to a country’s stage shift from a low-growth developing economy to an emerging economy is how to acquire the factors of production such as labor, capital (funding) and technology so as to increase the production of strategic products and their exports. How to obtain these three factors of production depends on a country’s policies. Specifically, as shown in Figure 2, a country has two options, i.e., acquiring these factors from within its own country or looking overseas. A possible scenario is to increase a country’s production

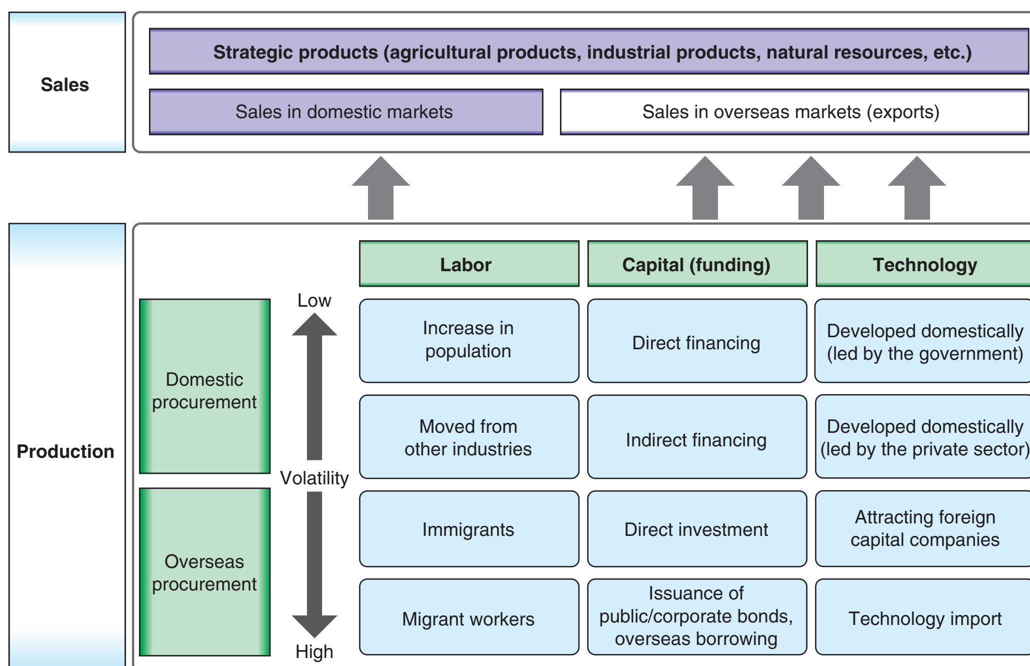
Table 2. Examples of countries that made the stage shift from a low-growth developing economy to an emerging economy

Transition period	Examples of countries that transitioned from low-growth developing economies to emerging economies
1870 – 1913	Japan
1914 – 1950	Taiwan, Thailand
1951 – 1973	China, South Korea
1974 – 1980	Burma (Myanmar), Indonesia, Malaysia, Vietnam, Egypt
1981 – 1990	Bangladesh, India, Laos, Cambodia
1991 – 2000	Argentina*, Brazil*, Chile*, Mexico*, Peru*, Uruguay*, Iran*
2001 – 2010	Bulgaria*, Romania*, Venezuela*, South Africa*, Kazakhstan, Ukraine, Uzbekistan, Belarus, Russia*

Notes: 1) Rather than being emerging economies for the first time during the relevant period, countries marked with an asterisk (*) either had previously been advanced economies or emerging economies, but which dropped to low-growth developing economies and reverted to emerging economies. 2) Years in which data were collected are 1870, 1913, 1950, 1973, 1980, 1990, 2000 and 2010.

Copyright 2013 by Nomura Research Institute, Ltd.

Figure 2. Factors leading to the stage shift from a low-growth developing economy to an emerging economy



capacity by combining these two options. The policy mix that can be adopted depends on the following three elements.

(A) The level of labor, capital and technology that is currently available within the country
(B) The required speed at which the factors of production can be procured and the required scale of such factors to be procured
(C) Whether external environments such as those in neighboring countries and throughout the world are in a situation that enables overseas procurement

For example, in the late Meiji era (early 1910s), Japan's workforce and domestic financial functions, as well as its technology, had already developed to such a degree that it was able to acquire labor, capital and most technology domestically. In many other Asian countries, given the progress of globalization and the increasing trend toward foreign direct investment, capital and technology were sourced overseas, although the labor force was mostly acquired domestically. In Latin America, there had been many immigrants, most of whom originated in Europe. Therefore, it is not surprising that the ratio of the funding and technology acquired from the home countries of those immigrants is also high. In Middle Eastern countries, it is usual for capital to be acquired locally in the form of "oil money," while labor takes the form of migrant workers from abroad, and technology is acquired from companies in the advanced countries.

Among the procurement methods indicated in Figure 2, the lower the boxes in which the methods are indicated, the higher the volatility. While the methods indicated in the lower boxes enable the acquisition of large amounts during a short period, there is a possibility that the inputs acquired through such methods might not stay long and might be lost quickly.

In the case of labor, large numbers of migrant workers can be brought into a country over a very short period. However, there is a risk that they will return to their home countries in similarly large numbers if the local economy takes a downturn. For example, in Dubai in the United Arab Emirates in the Middle East, large numbers of migrant workers came from India, Pakistan, Egypt, etc. However, in the wake of the global financial crisis in 2008, their numbers fell significantly.

In the case of capital, emerging economies are usually characterized by a domestic financial market that is not well developed. While they can raise large amounts of capital in a short period through overseas borrowing and the issuance of public and corporate bonds, these methods incur a higher risk of advanced countries rapidly withdrawing their funding if they experience a recession at home.

In the case of technology, unlike migrant workers and overseas funding, there is no way that it can be rapidly withdrawn. However, if a country's foreign currency reserves are insufficient, the country may be unable to afford to bring in the technology that it needs. Furthermore, an increase in political risk within the country could cause a company that possesses a required technology to withdraw from that country.

Furthermore, the three procurement methods shown at the bottom of Figure 2 (namely, migrant workers, bond issuance/borrowing and technology import) present a dilemma to export-oriented emerging economies. While an export-oriented emerging economy can increase its

Copyright 2013 by Nomura Research Institute, Ltd.

export competitiveness through the devaluation of its currency, reduction in currency value also has a negative impact. For example, the currency becomes less attractive to migrant workers (who look for a strong exchange rate in order to maximize the amount of money they can send home); it becomes more difficult for the country to pay off the principal and interest on its overseas borrowing; and it also becomes more difficult for it to bring in overseas technology because of high costs. As many Latin American countries experienced in the 1980s, countries with a high level of external debt might experience a withdrawal of funds due to fears that debtor countries might default of their debt. The resulting devaluation of their currency causes their principal/interest repayment burden to increase rapidly, leading to their actually defaulting on their debt. If the country is actively pursuing technology import, foreign currency reserves inevitably become insufficient, making it difficult for the country to support the buying of its own currency.

At this point, the qualitative aspects of the labor force that are not explicitly shown in Figure 2 are addressed. Although Figure 2 shows only the quantitative aspects of the labor force, in reality the quality of the workforce can be improved through education and training. However, the qualitative aspects of the labor force are not described in Figure 2 because in the early years of an emerging economy, the fact remains that the quantitative aspects of the workforce are more important than the qualitative aspects. In addition, it is very difficult to define the factors that can lead to an improvement in quality. Nevertheless, in the early years of an emerging economy, there are many cases in which a select group of people (an elite) studies in Europe or the U.S. and brings leading-edge technology and skills back to their home country. These cases make it possible to consider that the qualitative aspects of the labor force are taken into account in terms of technology.

The following section uses the case of Japan in the late Meiji era to examine in more detail the factors leading to the stage shift to an emerging economy based on the keywords explained in Figure 2.

2 Japan's shift from being a low-growth developing economy to being an emerging economy

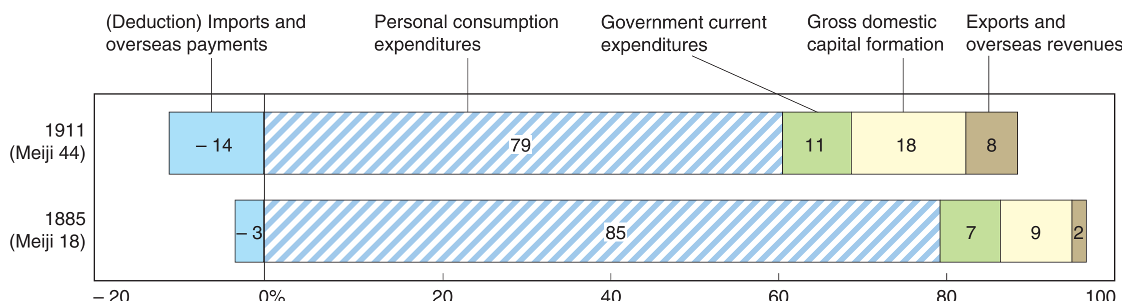
(1) Overview of the Japanese economy in the late Meiji era

Japan's period of high economic growth began in the Meiji era with the introduction of a policy to encourage new industry. In more detail, the period between the late 1880s and around the Panic of 1907 after the Russo-Japanese War is known as Japan's industrial revolution.

Figure 3 shows Japan's economic structure from the perspective of expenditure in 1885 and in 1911. In 1885, 85 percent of Japan's economic activity was "personal consumption expenditures," with very little imports and exports. Moreover, "gross domestic capital formation," which indicates investments such as public investment, capital investment and residential investment in the private sector, stood at only 9 percent. When the situation is compared with 1911, the percentages of "gross domestic capital formation" (18 percent), "exports" (8 percent) and "imports" (-14 percent) all increased considerably, while that of "personal consumption expenditures" fell to 79 percent. In this way, the increase in the percentages of capital formation (investment) and exports and the fall in the percentage of consumption are features of a low-growth developing economy shifting to an emerging economy.

Looking at the product mix of Japan's imports and exports in 1911 (Figure 4), the majority of exports were "textile fiber products (raw silk, etc.)." While the percentage was not large, "mineral products" in the form of copper and coal were also one of the important export items. Imports consisted primarily of "raw textile fibers (raw cotton, etc.), "machinery" (spinning machinery, machine tools, etc.) and "chemical products." In short, at this time, Japan's strategic products were textiles. However, because imports of machinery and chemical products were also large, Japan had a chronic trade deficit. Thus, while exports increase in the early years of an emerging economy, the required imports (raw materials, machinery, etc.) also increase to the extent that they

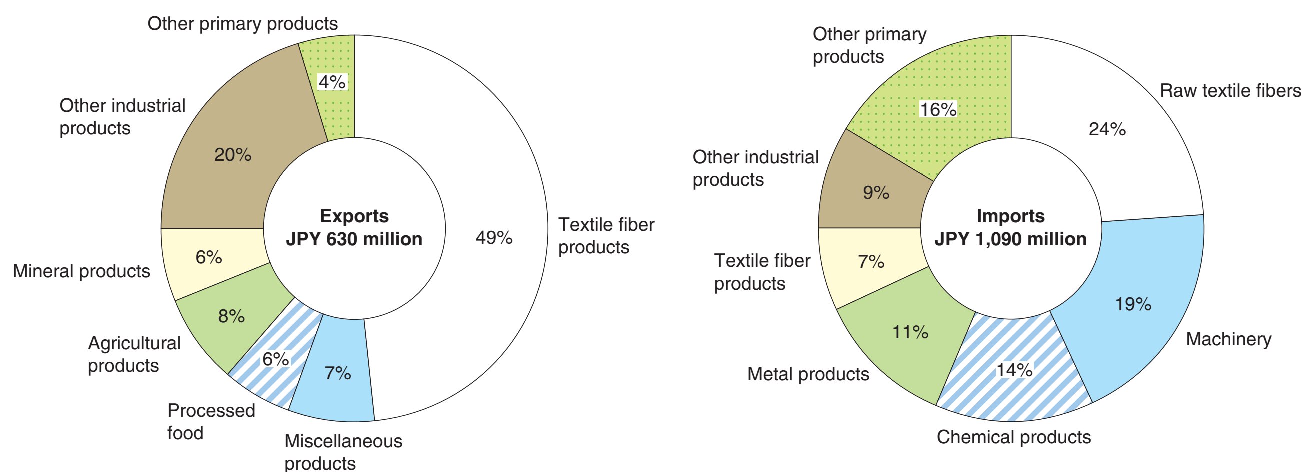
Figure 3. Change in Japan's economic structure from the perspective of expenditure (comparison between that in 1885 and in 1911)



Note: The figure indicates the percentage of each expenditure item that constitutes gross national expenditure.
Source: Kazushi Ohkawa, Miyohei Shinohara and Mataji Umemura, "*Choki Keizai Tokei* (Long-Term Economic Statistics)," Toyo Keizai Inc., 1988.

Copyright 2013 by Nomura Research Institute, Ltd.

Figure 4. Breakdown of Japan's imports and exports in 1911 by item



Source: Kazushi Ohkawa, Miyohei Shinohara and Mataji Umemura, "*Choki Keizai Tokei* (Long-Term Economic Statistics)," Toyo Keizai Inc., 1988.

exceed the level of exports, and often lead to continuing trade deficits for a country.

Furthermore, "gross domestic capital formation," indicated in Figure 3, also includes the development of infrastructure. In the years between 1886 and 1892, 14 railway companies were established and a railway network was quickly developed in Japan. At this time, motorized road vehicles were essentially unknown in Japan. Given that the production of Japan's strategic products (textiles and minerals) also flourished in the inland regions such as Nagano (Suwa), Gunma and Tochigi, railways were needed as a means of mass transportation to the ports. While, in Japan, the development of the railways preceded that of the highway networks, the opposite case has often been seen in countries that have recently become emerging economies, with road networks being established before the full-scale development of a railway network.

In addition, it was not until the 1960s that the so called Pacific belt zone was fully developed in Japan. As such, the key players in Japan's high economic growth of the late Meiji era were not all based on the coast. Rather, they were located throughout the country including the inland regions. It is often said that such nationwide proliferation is unique to Japan. During this period, large capitalist enterprises began to appear one after another, which can be seen as the symbol of the industrial revolution, with railway companies being representative of such enterprises.

(2) Acquiring the factors of production and the external environment in the late Meiji era

The following paragraphs examine how Japan acquired the three key factors of production (labor, capital and technology) in the late Meiji era, as well as the external environment surrounding Japan at the time.

① Acquiring a workforce

In the first half of the 1880s, Japan experienced a deflationary recession (known as the Matsukata deflation) that left many farmers and artisans in distress, which led to a huge potential supply of people willing to move into the capitalist labor market. As a result, one of the major premises of the industrial revolution —capital-labor relations— was established. In other words, the foundations needed to encourage a shift in the workforce from other industries to Japan's main export industries such as textiles were present.

② Ensuring funding

In the latter part of the Meiji era, Japan was very wary of the leading imperial powers such as the United Kingdom, and so promoted the development of new industry with policies that relied as little as possible on foreign capital. Both direct and indirect financing methods were used. When capitalist enterprises were established, major contributions were made by Japan's nobility. Examples of indirect financing include the network of money changers that had been carried over from the Edo period and about 2,000 banks that were established by 1900. In this way, the financing of industry was secured from within the country.

③ Development of technology

As is shown in Figure 4, although Japan was dependent on imports of raw materials such as cotton and of machinery such as spinning machinery, the domestic production of machinery had already begun. For example, those companies that had made a business out of maintaining imported machinery gradually made the move towards manufacturing machinery themselves. Other examples include small-scale, privately run rural factories producing reeling machines.

④ External environment

While Japan had adopted the silver standard in 1886, the global recession at that time and the adoption of the gold standard by one advanced country after another resulted in a major drop in the value of silver and also a fall in the value of the Japanese yen, which enhanced Japan's

Copyright 2013 by Nomura Research Institute, Ltd.

export competitiveness. Furthermore, because Western Europe and the U.S., which had relied on the cotton industry during the industrial revolution, had by this time shifted to heavy and chemical industries, Japan was able to make the best use of its cost competitiveness to export textile products to these advanced countries.

3 Growth scenario leading to the stage shift to being an emerging economy

A typical scenario whereby a low-growth developing economy makes the transition to an emerging economy involves growth that leverages exports. Specifically, a low-growth developing economy makes the best use of its cost advantage and the presence of resources and enhances its production and sales capacity as much as possible by acquiring as much labor, capital and technology as possible from both home and abroad in order to export a specific strategic product (or natural resource). Given that, in recent years, labor, capital and technology have been able to freely flow around the world, countries are not limited to acquiring the factors of production at home, and can instead acquire them from over the world, making large-scale procurement in a short period much easier than in the case of domestic procurement. How these factors of production are acquired is highly dependent on government policies and the external environment at that time.

III Stage Shift Turning Points Faced by Emerging Economies

1 Stage shifts of emerging economies since 1950

Once a country enters the emerging economy stage ((3) or (4) in Figure 1), it can make the stage shift to a growing advanced economy ((5) or (6)) by achieving high growth to the extent that its per capita GDP exceeds the global average, or it could revert to being a low-growth developing economy ((1) or (2)).

Table 3 lists countries that, since 1950, have made the transition from being emerging economies to being advanced economies, as well as those that have gone in the opposite direction, reverting to being low-growth developing economies. Those countries that have made the transition to growing advanced economies include Japan in the 1960s, Taiwan in the 1970s, South Korea and Oman in the 1980s and Poland in the 2000s. On the other hand, examples of countries that have seen their growth slow and returned to being low-growth developing economies include many countries as represented by some Latin American countries since the 1980s. Note that Poland appears in both columns of Table 3. Although its growth rate slowed in the 1980s, causing it to regress to a low-growth developing economy, since the 1990s, it again achieved high growth. Spurred on by its accession to the European Union (EU) in 2004, Poland joined the ranks of growing advanced economies in the 2000s. In both the 1980s and the 2000s, Mexico's growth rate fell, causing it to shift into the low-growth developing economy stage, although high growth rates in the 1970s and the 1990s led to its being an emerging economy at that time. Given the situation where the overall world economy (including that of advanced economies) is growing, in order for an emerging economy to make the transition to being a growing advanced economy, the country is required to exhibit high growth over a long time, which is a condition that is very difficult to attain. For this reason, countries like Mexico, which repeatedly come and go between the emerging economy and low-growth developing economy stages, only gradually move towards being advanced economies.

2 Regression from an emerging economy to a low-growth developing economy

First, let's consider the case whereby an emerging economy slips back to being a low-growth developing

Table 3. Examples of countries that made the stage shifts from being emerging economies to being growing advanced economies or low-growth developing economies

Period of transition	Emerging economy → growing advanced economy	Emerging economy → low-growth developing economy	
1950s			
1960s	Japan		
1970s	Taiwan		
1980s	South Korea Oman	Europe	Bulgaria, Romania, Poland
		Latin America	Brazil, Columbia, Mexico, Venezuela, Bolivia, Ecuador, Paraguay
		Asia	Burma (Myanmar)
		Middle East, Africa	Jordan, Syria, Nigeria
1990s			Zimbabwe, Republic of the Congo, Kenya
2000s	Poland		Mexico, Côte d'Ivoire

Copyright 2013 by Nomura Research Institute, Ltd.

economy. Considering the cases of the countries listed in the right-hand column of Table 3, it is possible to identify three main factors at work (Figure 5).

The first factor involves the fact that achieving economic growth itself gradually erodes the growth potential of emerging economies. In specific terms, this factor consists of two aspects: (A) economic growth leads to a country losing its cost competitiveness and (B) increasing income inequality inhibits growth. While neither of these aspects leads to a sudden drop in the economic growth rate, they will gradually weaken growth potential.

The second factor causes an economic downturn that significantly suppresses the economic growth rate. Typical examples include: (A) excessive dependence on external debt (capital) causes economic chaos such as any financial crisis or external debt default and (B) when growth is based on natural resources, competition for the rights to those resources could cause corruption or even civil war, such that they actually become a source of chaos, rather than growth. These cases lead to a sudden drop in the economic growth rate.

The third factor concerns deterioration of the external environment. When an emerging economy has strong economic ties with a certain, specific advanced country, if the economy of this advanced country were to suffer any major downturn, the emerging economy would also become embroiled in the crisis. This is analogous to thinking that a fire is on the other side of the river, but finding that one's house has also caught fire from that fire. The following sections discuss these factors in detail.

(1) Economic growth itself weakens the growth potential of emerging economies

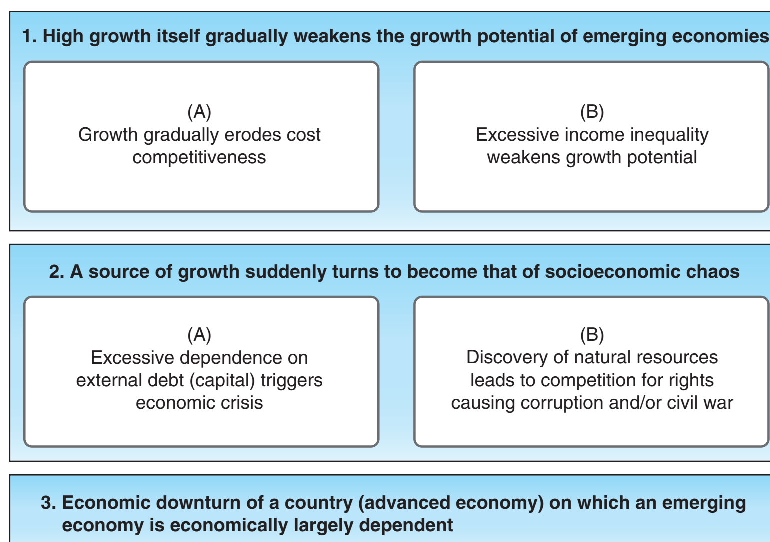
(A) Growth gradually erodes the cost competitiveness of emerging economies

Emerging economies all share one thing in common. That is, any country that remains at the emerging economy stage for an extended length of time will find its economic growth rate gradually falling. The biggest reason for this drop is that high economic growth leads to increases in a country's average income and price levels to the point where they approach the global average, such that the country's main weapon in the export battle — cost advantage— disappears in line with that growth. Furthermore, emerging economies often find that other countries, which subsequently enter the emerging economy stage, target the same industries and become formidable competitors. In strategic terms, "arbitrage superiority is gradually lost."

For the above reason, countries at the emerging economy stage have to react as their economic standard increases by adopting, as their strategic products, goods that are still beyond the production capabilities of countries that have subsequently entered the emerging economy stage, but which can still be manufactured competitively relative to the advanced economies. In Japan's case, when the country entered the emerging economy stage in the late Meiji era, the main industries were silk reeling and spinning. However, during the period of high economic growth in the 1960s, these industries had given way to machinery, led by automobiles.

After a country stays at the emerging economy stage for some time and approaches the latter part of its stay at this stage, although its capability to procure capital within its domestic market increases, there are many cases in which technology-owning companies based in the advanced economies move their factories to other lower-cost emerging economies, making it difficult for this emerging economy to acquire technology from overseas. As such, the government of an emerging economy has to decide whether to pursue a policy of making their growing domestic markets more appealing so as to continue to attract technology and funding from companies based in advanced economies, or whether to promote the improvement of technology by their own country's companies.

Figure 5. Factors hindering the economic growth of emerging economies from the long-term perspective



Copyright 2013 by Nomura Research Institute, Ltd.

(B) Excessive income inequality weakens growth potential

Another major issue is that of income inequality. As the author described in NRI Papers, No. 184, published in May 2013, the start of a period of high economic growth in a country is accompanied by the start of increased income disparity. Such disparity gradually gives rise to an economic hierarchy, which then becomes rigid. In emerging economies where welfare and healthcare systems are not well developed, a widening income disparity can also lead to greater inequalities in education and healthcare, with those in the low-income brackets finding themselves stuck in a so-called “poverty spiral,” from which it is difficult to escape. This problem is more pronounced in those countries that are multiethnic or which had a social class system while they were still in the low-growth developing economy stage.

The mechanism of this income disparity becoming rigid is as follows. If economic disparity appears in a country (or a city), the residential areas of that country or city will become separated by the level of income. As a result, it will be much more likely for people to marry persons who belong to the same income stratum. Their children will receive a level of education that is also limited by their level of income. In emerging economies, in particular, the level of education and healthcare received by a child largely varies depending on the parents’ income. Therefore, the children of the high income stratum are more likely themselves to become future high-income earners by receiving a high level of education and healthcare.

Regarding the relationship between income disparity and economic growth, some empirical research reports indicate that a widening income disparity actually suppresses economic growth. These reports go on to state that economic growth can be promoted by reducing income disparity and increasing enrollment in primary education.

The emerging economies of many Latin American countries actually have more ultra-high-net-worth individuals than do the advanced economies. Although the problem has been alleviated somewhat in recent years, the issue of income disparity is still serious. Because there is a limit to the further increase in the income level of high-net-worth individuals in these countries that is already too high, unless the income level of the low earners is increased, economic growth of the country as a whole will not occur. Furthermore, an excessively large income disparity will lead to increased social unrest and the deterioration of national security, again suppressing economic growth.

(2) A source of growth suddenly turns to become that of socioeconomic chaos

(A) Excessive dependence on external debt (capital) triggers economic crisis

One factor affecting whether a low-growth developing economy can enter a period of high growth and become an emerging economy is the amount of funding that it can procure. However, if a country is excessively funded from overseas, capital is subject to be pulled back to the home country for some reason. In addition, if the debt repayment becomes unmanageable for reasons such as interest rate increases or the depreciation of its currency, a financial or economic crisis could occur. If the economy is seriously affected to such an extent that it takes a considerable time for the economy to recover, an emerging economy may well experience a sharp drop to a low-growth developing economy.

Basically, there can be two types of financial crises, one being a “sovereign debt crisis” where a country defaults on its debt, and the other being a “banking crisis” caused by the collapse of a financial institution in the private sector. It has generally been said that sovereign debt crises are peculiar to emerging economies, while banking crises can happen at any stage in a country’s economic development, even in the advanced economy stage. However, this concept is being brought into question, with the European sovereign debt crisis of 2010 originating in Greece and Spain, both advanced economies.

Table 4 lists some of the Asian and Latin American countries that defaulted on their external debt in sovereign debt crises that have occurred since 1900. Looking at this list, we can see that there were many instances of countries defaulting on their external debt. Starting in 1900, Brazil and Chile defaulted on their external debt seven times.

Let’s consider a typical scenario leading to default on external debt by looking at Latin American countries in the 1980s. At that time, Latin America stood out as an area with a high dependence on external debt, being responsible for 36 percent of the world’s total external debt. This dependence had arisen from low domestic real interest rates leading to low rates of savings in Latin American countries, making funding from domestic sources difficult. In addition, after the two oil crises of the 1970s, the European banks were awash with cash from oil-producing countries, which was invested in the apparently promising heavy and chemical industries being promoted in Latin American countries.

Unfortunately, in the wake of the U.S. interest rate hike of 1980, international interest rates began to follow suit, meaning that Latin American countries quickly found themselves having to pay out more and more to repay their external debts. In 1982, Mexico declared default, prompting overseas financial institutions and investors to suspend investment in other Latin American countries. This situation was exacerbated by wealthy people in Latin American countries who sent their capital abroad. Subsequently, the International Monetary Fund (IMF) and the World Bank intervened, and introduced a series of economic reform packages called the “Washington Consensus” (consisting of fiscal austerity, privatization of state-owned enterprises and liberalization of trade,

Copyright 2013 by Nomura Research Institute, Ltd.

Table 4. Cases of defaults on external debts by major Asian and Latin American countries since 1900

Region	Country name	Year of default
Asia	China	1921, 1939
	Japan	1942
	India	1947, 1958, 1969, 1972
	Indonesia	1949, 1966, 1998, 2000, 2002
	Myanmar (Burma)	1948, 2002
	Philippines	1947, 1983
Latin America	Argentina	1951, 1956, 1982, 1989, 2001
	Brazil	1902, 1914, 1931, 1937, 1961, 1964, 1983
	Chile	1931, 1961, 1963, 1966, 1972, 1974, 1983
	Mexico	1914, 1928, 1982
	Peru	1931, 1969, 1976, 1978, 1980, 1984
	Venezuela	1983, 1990, 1995, 2004

Note: The above list includes cases of debt rescheduling.
Source: Carmen M. Reinhart, Kenneth S. Rogoff, "This Time Is Different: Eight Centuries of Financial Folly," Princeton University Press.

etc.). However, these measures did not actually improve the situation and resulted in many Latin American countries being unable to repay their debts for an extended period. This situation was ultimately solved by Nicholas Brady, the then U.S. Treasury Secretary, who proposed his "Brady Plan" in 1989. The plan revolved around joint debt reduction agreements by creditor banks in the private sector. Given the length of time needed to resolve this situation, many refer to the 1980s as the "lost decade" for Latin America.

(B) Discovery of natural resources leads to competition for rights causing corruption and/or civil war —natural resource trap (curse)

The discovery and export of natural resources, while seen by many as a powerful factor in promoting economic growth, has actually proven to be a disincentive to growth in some countries. This situation, typified by the case of Nigeria, is known as the "natural resource trap (or even 'curse')."

Nigeria's oil revenues have increased rapidly since the 1970s. While Nigeria's GDP grew until 1980, from 1980 until the latter half of the 1990s, GDP growth was flat or even decreased (Figure 6). The main factors behind this situation were a civil war that broke out due to disputes over oil reserves, as well as the fact that politicians and bureaucrats were lining their own pockets with the proceeds of the country's oil reserves. After 2000, GDP started to grow again as a result of a spike in crude oil prices, as well as the United States buying more Nigerian crude in preference to Middle Eastern crude in the wake of the 9/11 terrorist attacks.

In addition to the above example, there is another case of natural resources inhibiting economic growth, which is known as "Dutch disease." The Netherlands is an exporter of North Sea natural gas. At the time of the 1973 oil crisis, the price of natural gas soared and its exports sharply increased. As a result, the value of the Dutch guilder rose, making Dutch industrial products much less competitive on the international market. Generally speaking, in countries that have come to export large quantities of natural resources, the manufacturing industry that is originally export-oriented often finds growth difficult despite the expansion of the country's economy. Similarly, it is pointed out that this effect can also be seen in Russia and Australia.

(3) Economic downturn of a country (advanced economy) on which an emerging economy is economically largely dependent

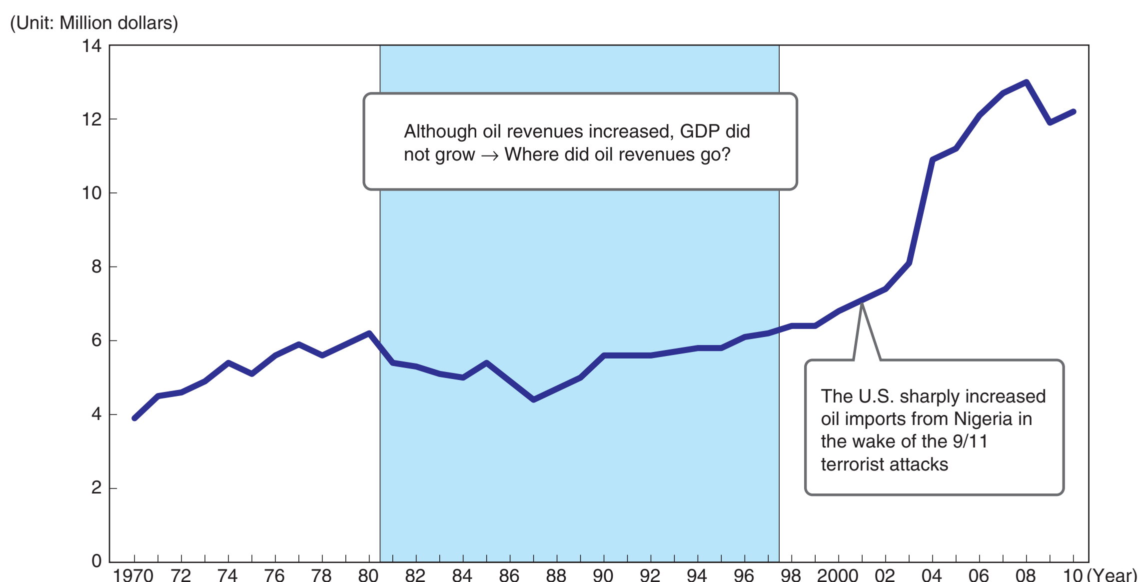
Some emerging economies are highly dependent on the economies of specific advanced countries (or regions). For example, Mexico is highly dependent on the U.S. economy, while Turkey depends on the economy of the EU. Specifically, these advanced countries provide the emerging economies with a principal destination for their exports, act as a source of funds, and provide employment to migrant workers.

Because of this, when an emerging economy is so dependent on the economy of a specific advanced country, a deep recession or a major financial crisis occurring in the advanced country will have a major secondary effect on the emerging economy. In the case of Mexico, for example, the fact that it slipped back to the low-growth developing economy stage in the 2000s had much to do with the subprime mortgage crisis and the resulting damage to the U.S. economy. For Mexico, the result of this event was that exports to the U.S. fell, as did remittances from Mexican migrant workers in the U.S., while U.S. companies with their factories in Mexico moved these facilities to China and other Asian countries.

In the 1980s, Bulgaria, Romania and Poland all suffered huge declines in their economic growth rates,

Copyright 2013 by Nomura Research Institute, Ltd.

Figure 6. Nigeria's GDP trend



Source: Compiled based on "International Financial Statistics," IMF.

putting them back into the low-growth developing economy stage. These countries were all members of the Soviet-led Council for Mutual Economic Assistance (COMECON). The failure of the Soviet Union's planned economy had a major influence on both the politics and economies of these countries.

In the era when Japan's economy was highly dependent on that of the United States, it was said that "Japan catches a cold whenever the U.S. sneezes." As such, when an advanced country experiences a recession, the effects could possibly be greater in emerging economies that are largely dependent on its economy, more so than in the country itself.

3 Making the stage shift from being an emerging economy to being a growing advanced economy

Next, let's look at some cases of emerging economies that have successfully made the transition to growing advanced economies. As can be seen from Table 3, there have actually been very few countries that have succeeded in making the stage transition from being an emerging economy to being a growing advanced economy.

The first reason for this difficulty is that it takes a considerable amount of time for an emerging economy to make the transition to a growing advanced economy. In the case of Japan, nearly 70 years elapsed from its entering the emerging economy stage around 1900 to becoming a growing advanced economy in the 1960s. Today's emerging economies are likely to need just as much time to make the transition.

The second reason relates to the fact that in order to transition from an emerging economy to a growing advanced economy, the growth strategy that was formulated in the initial phase of an emerging economy must be modified. At the same time, it is necessary to avoid the impediments (traps) that would stifle growth such as preventing the issues of income inequality and excessive dependence on external debt. It is fair to say that almost all countries experience the issue of income inequality as they go through the stage of being an emerging economy. However, in the sense that it is necessary to remove barriers to growth while aiming for further growth, this issue is difficult to overcome.

The third reason concerns the presence of countries, regions and international organizations that will support the country. The period of the 1960s, when Japan was striving to make the transition from an emerging economy to a growing advanced economy, was a tense period in the cold war between the United States and the Soviet Union, as seen in the occurrence of the Cuban missile crisis. Even under such a difficult situation, the U.S. took the political position that it was important to nurture the economic growth of Japan, and opened its market to Japan. In addition, the U.S. provided public loans to Japan in order to help boost its growth.

After the end of World War II, Japan's considerable income disparity was largely eliminated through the agrarian reform that was led by the General Headquarters of the Supreme Commander for the Allied Powers (GHQ). Under the terms of this reform, Japan's tenant farmers became owner farmers, and the income gap of farming households, which accounted for more than half of the Japanese population, was dramatically reduced. A significant reduction in income inequality is considered largely attributable to this farm land reform. It is reasonable to say that the reform was made possible simply because the initiative was taken by GHQ, which is an outsider not bound by vested rights and interests.

Copyright 2013 by Nomura Research Institute, Ltd.

Poland made the transition to a growing advanced economy in the 2000s, with the major factor behind the transition being the country's accession to the EU in 2004. After joining the EU, Poland was largely helped by structural funds that the EU provides as part of its regional policy (providing subsidies to member countries in order to eliminate regional disparities). Among EU member countries, Poland was the only country that has achieved positive growth even after the collapse of Lehman Brothers.

Unlike the stage shift from a low-growth developing economy to an emerging economy, the transition from an emerging economy to a growing advanced economy requires a considerable length of time, while presenting a much greater challenge in that while aiming to achieve economic growth, it is also necessary to eliminate the factors that inhibit growth. Furthermore, a country can take full advantage of its cost competitiveness in the early phase of an emerging economy stage. However, in the later phase of being an emerging economy, this advantage is lost. Therefore, in addition to the country's own efforts for economic growth, the existence of other economic powers (countries or regions) that the country can expect support is another important factor.

IV How Stage Shifts Vary between Large and Small Countries

While the eight-stage model shown in Figure 1 takes the scale of an economy (GDP) into account, the speed at which a stage shift occurs varies greatly depending on the scale of the economy. Specifically, smaller-scale economies make the transition much more quickly. However, such countries can be likened to a small boat on a large ocean, where a skillful captain can ride over the waves but where the boat could just as easily be capsized in an instant.

The reasons for the high volatility of the economies of small countries include that small-scale economies are inevitably highly dependent on foreign economies. In addition, because of the small scale, their industry is not diversified and they strongly rely on a specific industry, which can be likened to "flamingo (one-leg)-style batting." For example, although Luxembourg has a population of only slightly more than 500,000, it ranks at or near the top in the world in terms of its per capita GDP. In the 1960s, Luxembourg depended primarily on iron and steel production, as exemplified by Arcelor (now Arcelor Mittal). However, subsequently, the country was hard hit by a recession in the steel industry, prompting it to shift its focus to the financial industry. In the wake of the subprime mortgage crisis and the ensuing global financial crisis, it is aiming to reduce its exposure by increasing the contribution of other industries such as IT.

As listed in Table 3, in the 1980s, Oman in the Middle East made the transition from an emerging economy to a growing advanced economy. Unlike Nigeria, Oman did not fall into the natural resource trap. Oman's first oil fields were discovered in 1964, with exports starting in 1967, which took the country into the emerging economy stage. The country then went on to achieve rapid economic growth in the 1960s and 1970s. Although this growth rate declined in the 1980s with the fall in crude oil prices, the country successfully made the transition to being a growing advanced economy. Oman managed to make the transition from the emerging economy stage to the growing advanced economy stage in a mere 20 years ((3) → (5) in Figure 1). Such immensely fast transition could be partly attributed to the fact that Oman is a small country with a population of only 2.8 million.

Looking in reverse, we simply cannot see such a fast transition for large countries such as China and India. For these countries to make the transition to the growing advanced economy stage, the income levels of their massive populations would have to be raised. Given the sheer size of their populations, doing so would actually raise the global average income level, presenting a dilemma that makes it even more difficult for these countries to make the transition to the growing advanced economy stage.

V Stage Shifts and Japan

This paper has focused on the factors that lead to a low-growth developing economy transitioning to an emerging economy, as well as those that take growth one step further, from an emerging economy to a growing advanced economy. The paper also explained that the latter is much more difficult to achieve than the former. At the initial time a country becomes an emerging economy, it can take advantage of its overwhelming cost competitiveness to raise capital and obtain technology from abroad. However, such a cost advantage gradually diminishes as the country enters the latter years of the emerging economy stage. In addition, traps such as income inequality conspire to inhibit economic growth. To deal with these challenges, as a country approaches the end of the emerging economy stage, its government should act to eliminate the factors that suppress growth, while creating new area of competitiveness.

Japan made the transition from a low-growth developing economy to an emerging economy in the late 19th century, ultimately reaching its current stage of mature advanced economy after going through a period of high economic growth in the 1960s. Borrowing the words of Kuznets, Japan is the leading country that migrated from "an underdeveloped country to a developed country." However, if the downturn that has plagued the Japanese economy in recent years were to continue for an extended period and Japan were to remain at the mature

Copyright 2013 by Nomura Research Institute, Ltd.

advanced economy stage for a long time, it is not inconceivable that Japan could lose its standing as a mature advanced economy and instead find itself as a developing economy, much like Argentina did in the past. To prevent this from happening, Japan must seek out new sources of growth.

As mentioned in Chapter III, for an emerging economy to make the stage transition to a growing advanced economy, in addition to homegrown economic growth, support from larger advanced countries and regions can give a powerful boost to a country's economy. For Japan, as a mature advanced economy, it would be important to strategically choose emerging economies with which it currently has a mutually beneficial relationship and provide support to those countries, while aiming for enhancing its own economic growth. For an emerging economy, Japan's attractiveness lies in its technological ability and the funding that it can provide.

Japan is the only mature advanced economy in Asia. One of the strengths of a mature advanced economy is the huge quantity of assets (stock) that it holds. Japan now probably finds itself at a juncture where it needs to decide how to effectively leverage that stock. At the emerging economy stage, a country still has not accumulated a sufficient amount of stock. While an emphasis should be given to flow variables such as expanding exports, consumption and investment, consideration should also be given to how to increase the proceeds from accumulated stocks in Japan, which include household assets amounting to JPY 1,500 trillion, corporate assets totaling JPY 800 trillion and overseas assets of JPY 600 trillion (data are based on Financial Assets and Liabilities, Japan's Flow of Funds Accounts published by the Bank of Japan), in addition to accumulated technologies. If financial terminology is used, during the period when Japan was at the emerging economy stage, an emphasis was placed before anything else on the figures on profit and loss statements. That is, companies devoted themselves to increasing their sales (output) and profits (added value = GDP). However, now that Japan has become a mature advanced economy and asset powerhouse, it would be fair to assume that the viewpoint of how to increase return on assets (ROA) is gaining importance.

References:

1 Kanji Ishii, *Nihon-no sangyo kakumei —nisshin/nichiro senso kara kangaeru* (Japan's Industrial Revolution—Thoughts from the Sino-Japanese War and the Russo-Japanese War), Kodansha Ltd., 2012.

2 Michiko Yamashita, "keizai seicho to shotoku kakusa (Economic Growth and Income Inequality)," *Journal of JBIC Institute*, November 2004, Japan Bank for International Cooperation (JBIC).

3 Koichi Usami, Aki Sakaguchi, Tatsuya Shimizu, Nobuaki Hamaguchi, Shoji Nishijima and Yoichi Koike, *Zusetsu raten amerika keizai* (Illustrated Latin American Economy), Nihon Hyron Sha Co., Ltd., 2009.

Takeshi MORI is a senior research fellow in the Nomura School of Advanced Management.

Copyright 2013 by Nomura Research Institute, Ltd.

As a leading think tank and system integrator in Japan, Nomura Research Institute is opening new perspectives for the social paradigm by creating intellectual property for the benefit of all industries. NRI's services cover both public and private sectors around the world through knowledge creation and integration in the three creative spheres: "Research and Consulting," "Knowledge Solutions" and "Systems Solutions."

The world economy is facing thorough structural changes led by the dramatic growth of IT industries and the rapid expansion of worldwide Internet usage—the challenges of which require new concepts and improvement of current systems. NRI devotes all its efforts to equipping its clients with business strategies for success by providing the best in knowledge resources and solutions.

NRI Papers present selected works of NRI Group's 7,000 professionals through its worldwide research network. The mission of ***NRI Papers*** is to contribute new ideas and insights into business management and future policy planning, which are indispensable for overcoming obstacles to the structural changes in our society.

All copyrights to ***NRI Papers*** are reserved by NRI. No part of this publication may be reproduced in any form without the prior written consent of NRI.

Inquiries to: Corporate Communications Department
Nomura Research Institute, Ltd.
E-mail: nri-papers@nri.co.jp