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Economic Watch

EAGLEs

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Economic Analysis

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Inclusive growth in emerging markets? Rapid poverty reduction but increasing inequality[1]

Growth has been bringing impressive cuts in poverty rates led by Asia

Sustained high growth is taking a large share of population out of very low income levels. Gains in labor income, supporting demographics and redistribution policies are behind this process. Absolute poverty rates have fallen dramatically in Asia and Latin America, while readings in Emerging Europe are modest and Africa remains lagging.

China behind radical change in poverty reduction

The number of poor people remained relatively stable between 1990 and 2000. During the first decade of the century more than 400 million people transitioned out of poverty to low income levels or even middle class. Three quarters of this change are explained by China. Supportive factors will keep in place the coming years.

Demographics deter progress in South Asia

Population pressure is very strong in some areas compensating reductions in poverty. The number of poor people rose in India by 45 million between 2000 and 2010. Multidimensional poverty and deprivation levels are worrisome across South Asia, one of the poorest regions in both international and relative terms.

Inequality, a by-product of rapid growth, eventually becomes a hurdle

While poverty reduction is key, inequality exacerbates the development gap; not only because of uneven income distributions but also due to differences in education and health access, especially in Asia and Africa. These gaps reduce the likelihood of social mobility and getting out of the poverty trap. On the macroeconomic side, an excessive degree of inequality can eventually damage efficiency and growth in the long-term (the main source of poverty reduction) both in emerging but also in developed countries.

Income distribution much more uneven in China but also elsewhere

Few countries have been able to combine rapid growth with less uneven income distributions. Brazil and Turkey are among the successful stories, although progress has been limited and inequality still significant. The most negative readings are found in China, where the Gini index increased by more than a third between 1990 and 2010. Interestingly, income distribution has worsened also in the G7 countries during the last 20 years notwithstanding the much stronger redistribution policies than in the emerging world.

Success in poverty reduction turns attention to strengthening the middle class

National definitions of poverty become more relevant as absolute deprivation declines and the target changes to social inclusion and cohesion. The negative picture doesn't change much for Asia and Africa, but it's an issue for Latin American economies like Mexico, Colombia and Peru, and to a lesser extent in Emerging Europe.

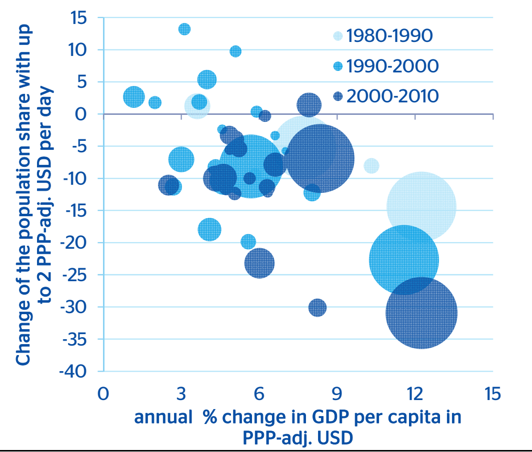
[1] BBVA EAGLEs (Emerging and Growth-Leading Economies) is the group of countries which will contribute to world growth more than the average of the G6 countries in the next 10 years. Read more about the EAGLEs and the Nest group at www.bbvaresearch.com/KETD/ketd/ing/nav/geograficas/eagles/index.jsp

East Asia leads poverty reduction thanks to high growth

Emerging economies are keeping now for some decades a sustained and strong growth, leaving behind successive crisis periods. This has allowed a rapid decrease in poverty due to several factors:

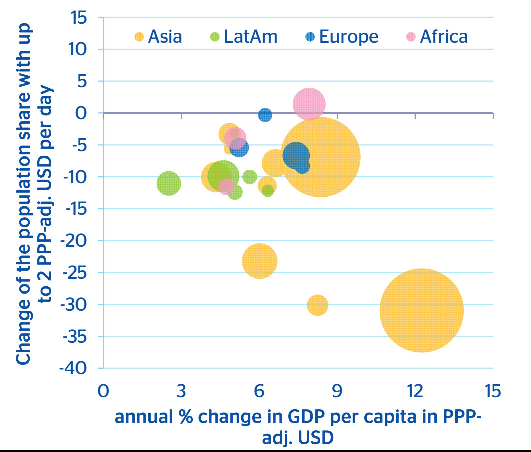
- The main reasons behind poverty reduction are overall growth in purchasing power of workers and job creation[2]. Income per capita in PPP-adjusted terms has climbed by around a 6% annual rate since 1980. Asia has led this process, followed by Emerging Europe, while Latin American and African countries lag somewhat behind. Productivity gains have translated into the increase of real wages and labour markets have tightened considerably in many countries.
- On demographics, working age population has been climbing steadily, reducing the share of dependent population. Furthermore, as countries enjoy a higher GDP per capita, the size of households also falls, increasing the share of income for each family member.
- Last, but not least, distribution policies have been in place and improved the purchasing power of the poor. The scope of these policies has been undoubtedly benefited by better macroeconomic fundamentals and improved fiscal positions.

Chart 1
Income per capita growth and poverty reduction during the last decades (bubbles' size is proportional to end-of-period population)



Source: BBVA Research, WB, IMF and UN

Chart 2
Income per capita growth and poverty reduction between 2000 and 2010 (bubbles' size is proportional to end-of-period population)



Source: BBVA Research WB, IMF and UN

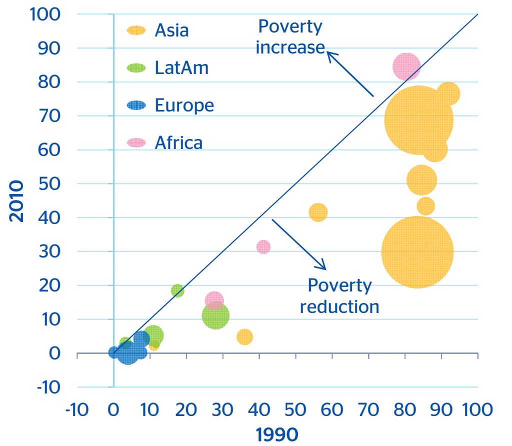
According to international measures, the increase in the average purchasing power of the population has generally translated into poverty reduction (Charts 1, 2 and 3). The share of people with an income up to 2 PPP-adjusted USD per day has declined by 25 percentage points since 1990 for the aggregate of EAGLEs and Nest countries[3]:

- The largest relative reductions have been recorded in Asian countries, especially in China, Vietnam, Indonesia, Thailand and Pakistan (Chart 4).
- Progress has been also significant in some Latin American and African countries. Brazil, Peru and Egypt have cut the poverty by around 15pp since 1990 and Chile and South Africa by almost 10pp.

[2] In this line, the World Bank estimates the contribution of different factors to poverty reduction in 16 emerging countries, highlighting labour income as the primary source in the majority of them: http://siteresources.worldbank.org/EXTPREMNET/Resources/EP97.pdf
[3] The EAGLEs group consists of 9 members: China, India, Indonesia, Korea and Taiwan in Asia, Brazil and Mexico in Latin America, and Turkey and Russia in Emerging Europe; the Nest group is made of 15 members: Bangladesh, Malaysia, Pakistan, the Philippines, Thailand and Vietnam in Asia, Argentina, Chile, Colombia and Peru in Latin America, Poland and Ukraine in Emerging Europe and Egypt, Nigeria and South Africa in Africa.

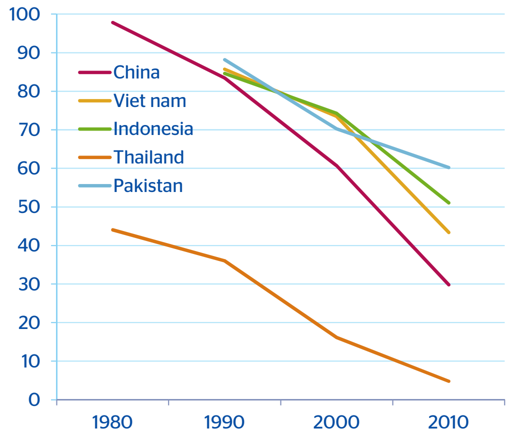
- The starting point was relatively low in Emerging Europe with poverty rates below 10% in all cases.

Chart 3
% of population with up to 2 PPP-adj. USD per day in 1990 and 2010 (bubbles' size is proportional to population)



Source: BBVA Research, WB and UN

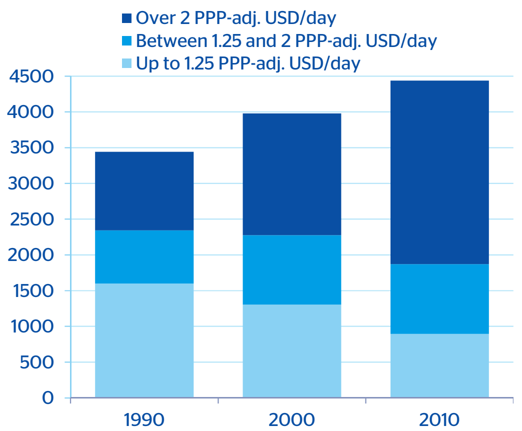
Chart 4
% of population with up to 2 PPP-adj. USD per day in countries with the fastest poverty rate reduction



Source: BBVA Research and WB

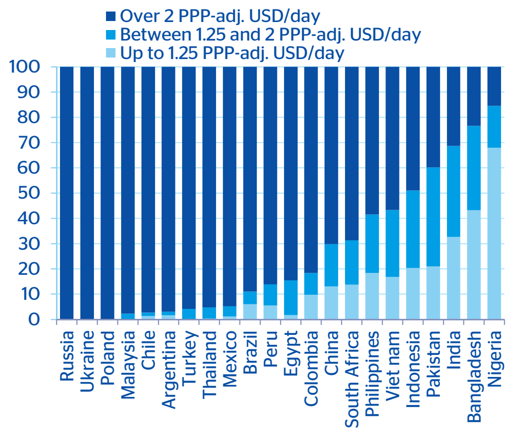
In gross terms, the number of people with income below the poverty reference remained almost constant between 1990 and 2000 when some emerging markets were hit by severe crisis. Since then, after one decade of sustained growth the number of poor people has declined by more than 400 million (Chart 5). At the same time, the population over the threshold has more than doubled and has increased by 1.5 billion people since 1990, including the birth of an incipient but fast-growing middle class[4].

Chart 5
Population in EAGLEs&Nest countries with respect to poverty benchmarks (million people)



Source: BBVA Research, WB and UN

Chart 6
Distribution of population with respect to poverty benchmarks (in %, 2010)



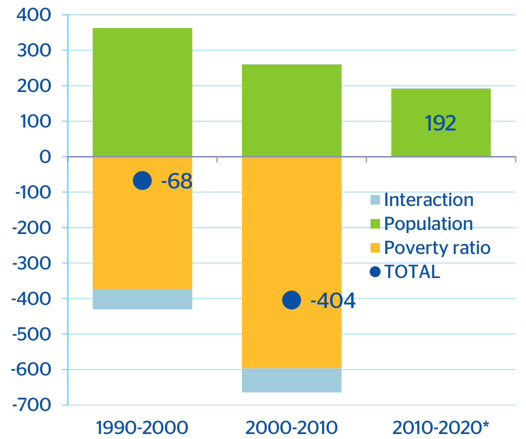
Source: BBVA Research, WB and UN

[4] We will be distributing soon an Economic Watch with our own estimations of middle classes in emerging economies.

Despite widespread poverty reduction, the number of people living with less than 2 PPP-adjusted USD per day remains very high in some areas. This is especially the case of South Asian countries with more than 1 billion people under this threshold (Chart 6).

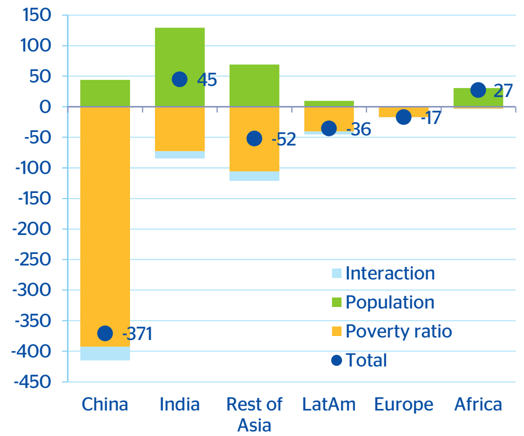
Dynamic demographics constitute a great challenge and in some cases are making insufficient efforts to reduce poverty when we look at gross levels. This was the case for: the aggregate of EAGLEs and Nest countries between 1990 and 2000 (Chart 7) and for India and African economies in the sample during the last decade (Chart 8). Demographic pressure has been also intense in South Asian countries with the exception of China, which together with Latin American countries show the recent most successful stories in poverty reduction (Chart 8).

Chart 7
Change of population below 2 PPP-adj. USD per day in EAGLEs&Nest countries by determinant during the last decades (million people)



*Only the population determinant is computed assuming poverty ratios don't change
Source: BBVA Research, WB and UN

Chart 8
Change of population below 2 PPP-adj. USD per day in EAGLEs&Nest countries by determinant between 2000 and 2010 (million people)



Source: BBVA Research, WB and UN

Beyond demographic pressure, South Asia faces poverty challenges in non-monetary areas. Income per capita cannot be alone an indicator of inclusive growth and therefore other dimensions should be considered, such as living conditions, health or education.

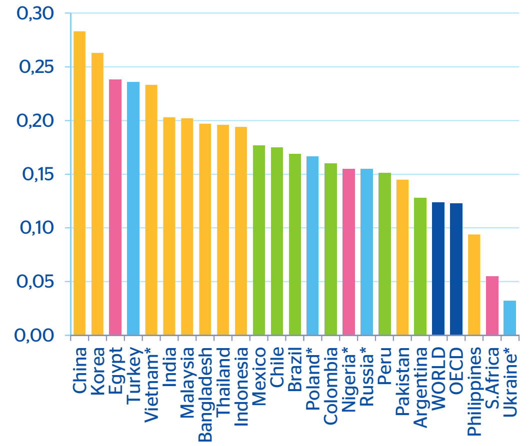
According to the UN Human Development Index (HDI), which includes life expectancy and years of schooling together with income per capita[5] (Chart 9):

- Widespread poverty reduction in Asia mirrors a general improvement in development conditions since 1980.
- Advances have been significant as well in Turkey and Egypt.
- Latin American countries have also won relative positions with respect to the world and the OECD economies.

Focusing on the most basic needs, the UN Multidimensional Poverty Index (MPI), which adjusts poverty by education, health and living conditions, confirms that South Asia accounts for the worse situation, with a large share of population suffering deprivations (Chart 10). The rest of the countries are in a much better situation, especially in Latin America and Emerging Europe, with room for improvement in East Asia.

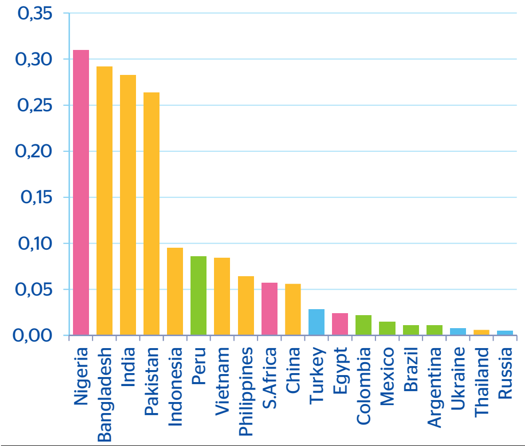
[5] Complete information available at http://hdr.undp.org/en/statistics/hdi/ with comprehensive technical notes at http://hdr.undp.org/en/media/HDR_2011_EN_TechNotes.pdf

Chart 9
Change of HDI between 1980 and 2011*



*Extrapolated to the whole period using data since 1990 for Ukraine and Vietnam, since 1995 for Russia and Poland and since 2005 for Nigeria
Source: BBVA Research and UN

Chart 10
Multidimensional Poverty Index in 2011 (index min=0 to max=1)



Source: BBVA Research and UN

Looking forward, poverty reduction will keep a positive track as supporting factors will still be in place;

- Labour productivity is expected to keep on rising due to further capitalization and increasingly due to improving abilities and knowledge of the workforce.
- Despite some labour markets are already tight, the share of working age population will not reach a peak until the next decade in most of the countries and there is margin for increasing participation rates especially in the female segment.
- The size of households will also keep a declining trend as purchasing power increases.
- Under contained vulnerabilities, further fiscal reforms could both increase the amount of revenues and improve expenditure efficiency in order to reinforce redistribution policies and, what is more important, contribute decisively to avoid poverty traps.

The demographic challenge is not negligible. Near to 200 million people will add to the poor between 2010 and 2020 if poverty rates are not further reduced in the emerging economies sample, most of them in South Asia (Chart 7). However, according to the baseline scenario, real GDP will keep rising at a fast race in the following years and middle classes are expected to extend its boom. This is particularly relevant for the South Asian region, for which we have seen that deprivation levels are still worrisome. India is expected to add soon to China in the race of building a new social class key to break vicious circles in poor economies.

Inequality, the new challenge for inclusive growth

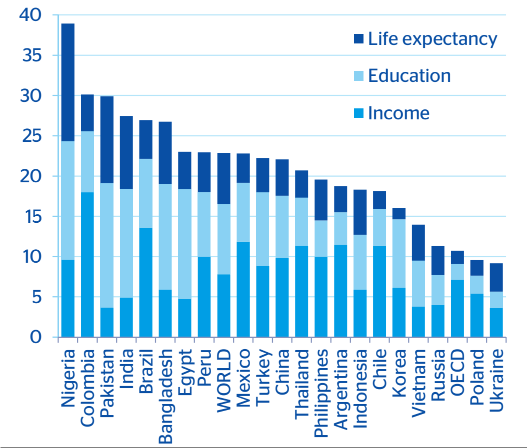
Poverty reduction has been a remarkable achievement among emerging economies especially during since 2000, with not only declining poverty rates but the fall in the amount of poor people. Development gains may hide however an uneven distribution of resources among population. The Kuznets curve tells us at which extent income inequality is a by-product of growth for developing countries as urbanization and industrialization increase the gap with rural areas and the capital share rises. Theory also explains that the process continues up to a point and then starts reversing due the extension of welfare systems. However, recent evidence may signal that instead of an inverted "U" shape we are really facing a non-linear "N" shape[6].

[6] See related story in this article of The Economist: www.economist.com/node/21564414. Research on the reasons of increasing inequality could be found at "An overview of growing income inequalities in OECD countries: main findings", OECD 2011 (http://www.oecd.org/els/socialpoliciesanddata/49499779.pdf) and in Part II of the ILO Global Wage Report 2012/13 (http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_194843.pdf).

Beyond its dynamics, a different and intensive debate is about positive and negative implications of inequality on growth, with literature showing that arguments are valid on both positions but conditional on the degree of inequality we are considering[7]:

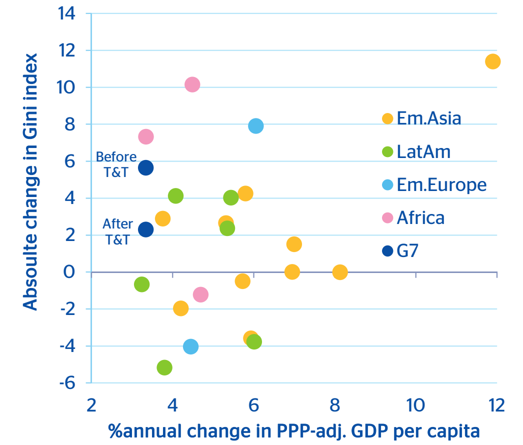
- For some authors, a certain degree is inequality is required to foster competition and effort among workforce, as well as risk-taking behavior, increasing education, productivity and hence progress and welfare. In poorer economies, inequality also helps to build up a demand for certain goods that require a minimum purchasing power (e.g. cars).
- However, excessive inequality will be damaging for efficiency and limit potential growth for several reasons
  - Uneven distributions reduce the likelihood of social mobility and the chances of getting out of the poverty trap. This is even truer for inequality of opportunities, especially on education.
  - The income distribution is very relevant in defining access to financing, assets and consumption-saving patterns, which all have a macroeconomic impact (e.g. the effects of inequality on China´s low consumption share and its implications[8]).
  - Effects of inequality accumulate through the life-cycle. In order to smooth consumption, poor people could have incentives to move to the informal economy, especially when social protection is low as in many emerging markets.
  - A high degree of inequality could lead to social and political tensions with the potential to eventually turn into unrest and seriously damaging future growth.

Chart 11
Impact of inequality in development by component (% difference between headline HIS and adjusted IHDI; 2011)



Source: BBVA Research and UN

Chart 12
Income per capita growth and change in income distribution between 1990 and 2010*: emerging economies and G7 average (before and after taxes and transfers)



*As continuous data for the Gini index is not available, averages are computed around the starting (1986-1990) and ending point (2006-2010).
Source: BBVA Research, WB and OECD

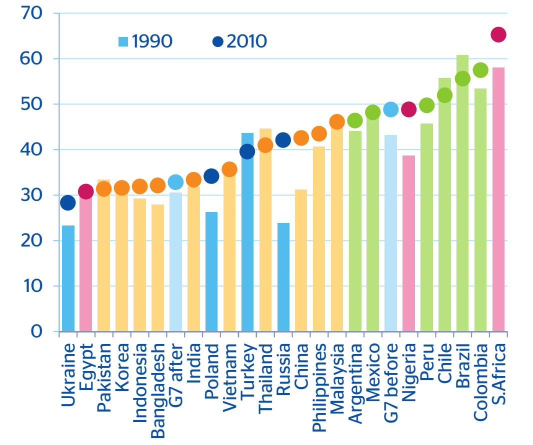
According to the inequality-adjusted HDI index (IHDI), uneven income distributions dominate in the OECD countries, but in emerging economies they are on a par with education inequality, while it is also very significant in life expectancy for the poorest countries (Chart 11):

[7] See for example "Inequality and unsustainable growth: two sides of the same coin?", IMF Staff Discussion Note, April 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf. Moreover, an interesting approach on the non-linear relation between inequality and growth can be read at "Inequality and growth: what can the data say?" by Banerjee and Duflo (2003), available at http://economics.mit.edu/files/753

[8] The ratio of consumption share also draws a U-shaped relation with demand effects according to estimations for China in "Pattern and sustainability of China's economic growth towards 2020", Wang, Fan and Liu (2007), http://draft.cerdi.org/uploads/sfCmsContent/html/203/FanGang_alii.pdf

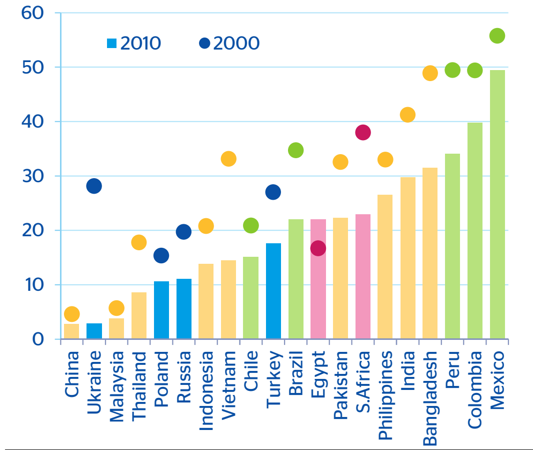
- Once inequality is considered, development conditions worsen more than average for South Asian and African countries on non-monetary factors (especially on education).
- In Latin America uneven income distributions explains the bulk of the difference.
- East Asia shows a more moderate adjustment.
- Emerging Europe is around OECD references except for Turkey.

Chart 13
Gini index in 1990 and 2010*: emerging economies and G7 average (before and after taxes and transfers)



*As continuous data for the Gini index is not available, averages are computed around the starting (1986-1990) and ending point (2006-2010).
Source: BBVA Research, WB and OECD

Chart 14
Poverty headcount ratio at national poverty line in 2000 and 2010 (% of population)



Source: BBVA Research and WB

Unfortunately, the IHDI does not provide dynamics for each inequality component, so we have to rely on a classical measure for income, i.e. the Gini index. Data since 1990 show that (Charts 12 and 13):

- Few countries have been able to sustain high growth rates and reduce income inequality at the same time. This is the case of Brazil, Turkey, Chile and Thailand, although achievements in terms of inequality have been also limited and the Gini index still remains well above the average in the two Latin American countries.
- On the opposite side, some economies have combined high growth rates with increasingly uneven income distributions. China is the extreme case, combining a 12% annual growth of its PPP-adjusted GDP per capita and the climb of the Gini index by more than a third. Russia, Nigeria, Poland and South Africa have also increased significantly the degree of income inequality in the last decades.
- The generalized increase in inequality is not exclusive of emerging economies. The average for the G7 countries shows that in the last 20 years the income distribution has turned more uneven both before and after taxes and transfers. The difference between both levels speaks for the potential of redistribution under a developed taxing system, but increasing inequality hints to limitations, especially considering the pace of exit from the crisis.

Income inequality is linked to relative poverty. In the first section we focused on absolute measures, defined by an international reference. However, "as countries reduce extreme absolute poverty, concerns of social inclusion, better represented by relative poverty lines, become increasingly relevant"[9]. This has of course implications for policy goals and implementation, especially as relative measures have a subjective component in its definition.

[9] "On the relevance of relative poverty for developing countries", C.Garroway and J.R. de Laiglesia, WP 314, OECD, September 2012: http://bit.ly/RcQKVC. The paper includes a very thorough analysis and reflections on poverty measures, discussing the use of consumption or expenditure based indicators, the linkages between absolute and relative rates and the most convenient benchmark for relative poverty.

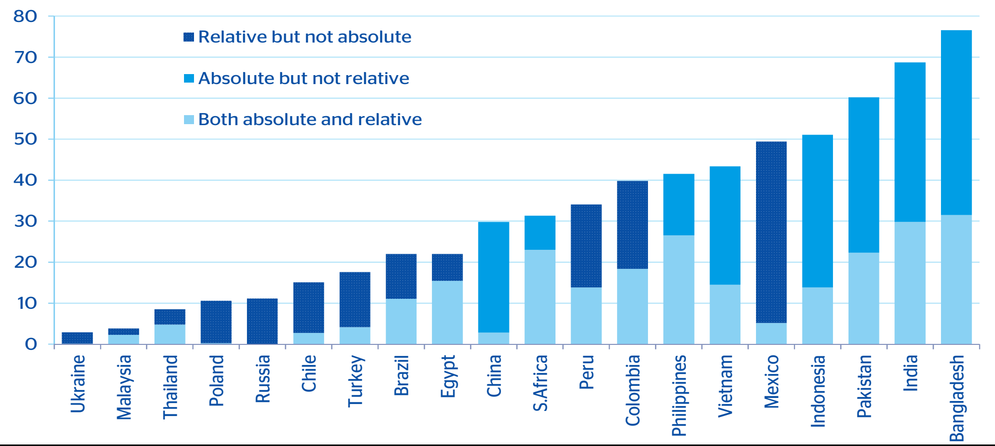
Relative poverty is measured with respect to a national income benchmark. Here we use poverty headcount ratios as a percentage of total population gathered by the World Bank's WDI database. The comparison between 2000 and 2010 figures give us a general picture of improvement, with significant advances in a variety of countries. However, the geographical pattern is not as clear as in the case of absolute poverty reduction (Chart 14). Some Latin American countries present the highest relative poverty rates, above South Asian and African references. At the same time, Some East Asian countries record some of the lowest ratios, similar to those in Eastern Europe.

If we combine absolute and relative poverty measures we can have a better diagnosis on poverty, combining the size and the degree of the challenge. For doing so we define as absolute poor the people with up to 2 PPP-adjusted USD per day and relative poor those below the national poverty line. Then we distinguish the share of population which is both absolute and relative poor, absolute but no relative poor and relative but not absolute poor (Chart 15). We can group countries according to these criteria:

- South Asia, the Philippines and South Africa show high poverty ratios both in international and domestic standards.
- Least developed East Asian countries, Indonesia, Vietnam and China, come off badly in absolute terms but not relative to the national poverty line.
- The contrary happens with Egypt and Latin American countries, especially in Mexico, all of them with higher poverty in relative terms but successfully reducing absolute poverty.
- Low readings in Chile, Turkey, Eastern Europe and the most developed East Asian countries (Thailand and Malaysia) are mainly explained by relative poverty.

Summing up, the last decade has been successful in poverty reduction for emerging economies. However, inequality is still a key issue to tackle especially if we take into account the negative effects it could have on potential growth and therefore in further poverty reduction.

Chart 15
An estimation of absolute and relative poor (% of total population) (2010)



Source: BBVA Research and WB

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