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Economic Analysis

Emerging Economies

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Tackling excessive inequality as a critical ingredient for sustainable development in the emerging world

- **Complacency cannot substitute for policy action in an inclusive agenda**

Unprecedented growth and poverty reduction have taken place at the expense of more uneven income distributions in large Asian economies and only slow smoothing of high inequality in Latin America. However, if Korea's experience were to be replicated (as well as that of many developed countries previously) a more equal distribution may be reached at a later stage of development – i.e. following the Kuznets curve -. In any event, the negative effects of excessive inequality on growth require policy action under a comprehensive development agenda. Coordinated reform momentum is needed to enhance productive capabilities, remove bottlenecks and avoid social unrest throughout income transition.

- **Fiscal reforms needed to implement redistribution policies**

Redistribution policies in developed countries have proved to be effective in reducing inequality (the GINI index is 15 points lower on average after taxes and transfers, as opposed to before them), while they are almost non-existent in emerging economies. For this purpose, fiscal revenues may need to be increased from their current low levels, particularly in Asia, Mexico and the Andean countries (around 20% of GDP, compared with 40% in G7 economies). At the same time, social expenditure should become more relevant, especially when targeted (e.g. moving away from regressive subsidies in some countries).

- **Social protection still to be deployed from current limited coverage**

Pension systems are generally underdeveloped in emerging countries, particularly in Southeast Asia, as well as Mexico, Colombia and Peru in Latin America, where recipients of pensions number barely 20% of the population above retirement age. Unemployment benefits and other social protection programmes also generally fall short and lag behind standards in the developed world; in fact, some of them are non-existent in some countries. A poor welfare system strengthens intergenerational linkages and increases the likelihood of falling into poverty traps.

- **In-kind policies to foster growth and increase equality of opportunities**

Education and health gaps play a significant role in explaining inequality in emerging countries, and are on a par with income factors in less developed economies. At present, and despite recent improvements, both education and health expenditure are very limited. Better education and health conditions are expected to increase contemporary productivity at the same time as increasing the chances of future income mobility. Minimum living standards are also required and housing policies are critical in the inclusion agenda.

- **Aging demographics to add pressure on social needs**

The share of people aged 65 years and over is going to almost triple in emerging countries in the coming decades and to reach developed world standards in some of them (e.g. in China and Eastern Europe). The demographic transition is set to increase retirement and health needs, expanding the future challenges for the currently underdeveloped welfare systems and limited fiscal potential.

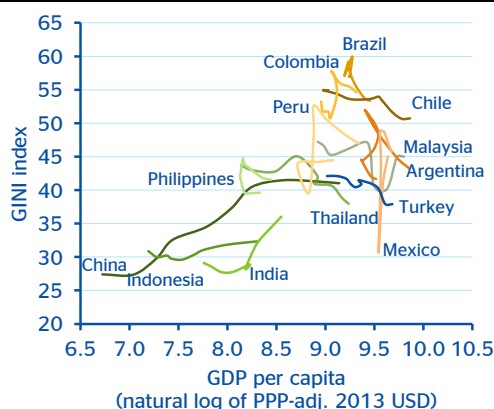
Inequality paths and concern over inclusive growth

Unprecedented growth in emerging economies during the last 15 years has brought an impressive reduction of poverty and a boom in the middle classes¹. However, as shown in a previous analysis², income convergence with the developed world - i.e. a decline in global inequality - has taken place at the expense of more uneven income distributions in large Asian economies and only slow smoothing of high inequality in Latin America (Figure 1). As a result, concerns have arisen over inclusive growth and potential negative spill-overs on development sustainability and social unrest.

At this point, we recall the **Kuznets curve**, which expects the relation between income and GDP per capita to have an inverted U shape. According to this theory, **income inequality** would be a **by-product of growth** in early stages of development as urbanisation and the shift to more productive activities increase the gap with rural areas, and the capital share rises. Thereafter, this upward trend is stabilised and eventually reversed at some point, following transition to medium-high income levels. Korea mimicked this pattern quite accurately in the second half of the 20th century (Figure 2).

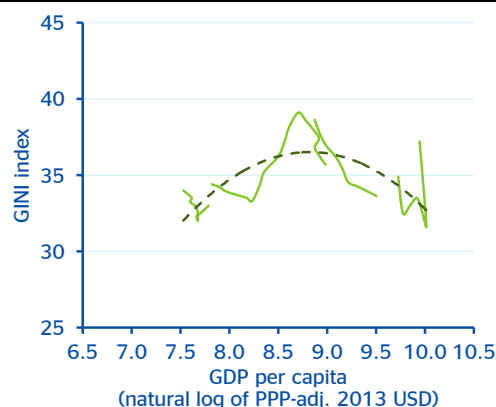
Despite this sort of deterministic inequality path, economic policies should not take it for granted or underestimate the challenges and risks entailed by uneven income distributions. Monitoring and action are required. In addition, recent developments in developed economies warn about factors beyond the Kuznets curve that are worrisome for the inclusive agenda (see Box 1). In this sense, the literature is conclusive on the negative impact of excessive inequality on growth³, which could end up reversing the aforementioned achievements in income transition.

Figure 1
GDP per capita and income inequality in emerging economies (1980-2010)



Source: IMF, WB and BBVA Research

Figure 2
GDP per capita and income inequality in Korea (1953-97)



NB: Data and estimates correspond to different surveys; the dotted line shows the quadratic adjustment.
Source: UNU-WIDER and BBVA Research

The traditional focus in developing countries to tackle inequality has been on subsidies and transfers for the poor. However, urbanisation, the growing middle classes, population aging and world rebalancing (i.e. correction of excessive (insufficient) saving (consumption) in China⁴) are turning the attention to the building of a **welfare system** in the emerging world.

Avoiding vicious circles requires determined efforts to reduce intergenerational poverty traps, as well as sustaining reform momentum to enhance productive capabilities and remove growth bottlenecks. This comprehensive approach may ultimately include fiscal reforms to increase revenues and efficiency in social expenditure.

1: "Middle-class in 'fast track' mode", January 2013.

www.bbva.com/BBVAResearch/KETD/fbin/mult/EWMiddleClasses_v24jan13_tcm348-371705.pdf?ts=652014.

2: "Inclusive growth in emerging markets? Rapid poverty reduction but increasing inequality", January 2013.

www.bbva.com/BBVAResearch/KETD/fbin/mult/130107_EW_EAGLES_Inclusive_Growth_tcm348-364126.pdf?ts=652014.

3: "Inequality and growth revisited", R.J.Barro, Working Papers on Regional Economic Integration, No.11, ADB, 2008; "Inequality and growth: the neglected time dimension", D.Halter, M.Oechslin and J.Zweimüller, Journal of Economic Growth, Volume 19 (1) pp 81-104, 2014; "Redistribution, inequality, and growth", J.D.Ostry, A.Berg and C.G.Tsangarides, IMF Staff Discussion Note 14/02, 2014.

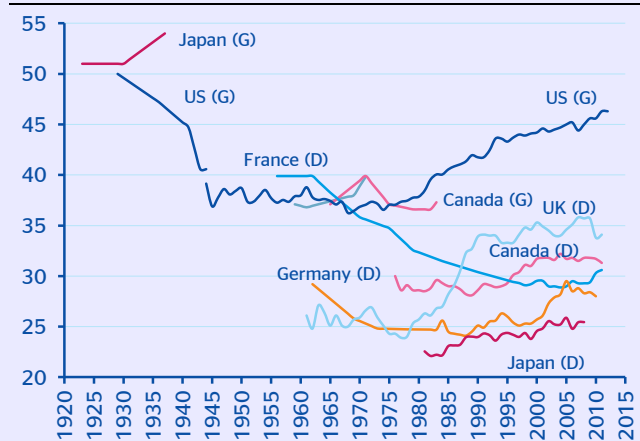
4: "Pattern and sustainability of China's economic growth towards 2020", X.Wang, G.Fan and P.Liu, 2007.
www.cerdi.org/uploads/sfCmsContent/html/203/FanGang_alii.pdf.

Box 1: Inequality in developed countries: from an inverted U to an N-shaped curve

Income inequality was high in advanced economies at the beginning of the 20th century and increased in some cases up to the aftermath of the Great Depression. It then generally followed a downward trend as middle-high income levels were achieved and welfare state measures deployed (Figure 3). The inequality path was drawing the expected Kuznets curve.

However, since the last quarter of the 20th century, income distributions have become more uneven in developed countries despite the softening effect of redistribution policies (Figure 4). As a result, the inverted U-shaped inequality curve has turned into an N-shaped one⁵.

Figure 3
GINI index on household income in G7 economies (1920-2012)



NB: "G" refers to gross income and "D" to disposable income; missing observations have been linearly interpolated
Source: Chartbook of Economic Inequality

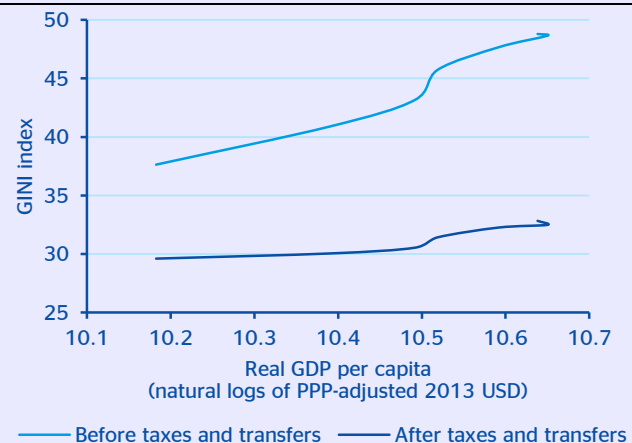
Determinant factors are diverse according to suggested explanations in related literature⁶:

- Globalisation
- Trade liberalisation
- Technological progress
- Labour market deregulation
- Lower union density

A framework resulting from the combination of all these factors could be summarised as follows:

- As protectionism fades away, large numbers of low-skilled workers in manufacturing industries of the emerging world have entered global competition, and are exerting downward pressure on salaries in developed countries. Simultaneously, new high-skilled profiles have been created and are receiving an increasing share of income in the developed world.

Figure 4
GDP per capita and income inequality in G7 economies (mid-70s to mid-00s)



NB: Simple average for G7 countries.
Source: OECD and BBVA Research

5: www.economist.com/node/21564414.

6: "An overview of growing income inequalities in OECD countries: main findings", OECD 2011: <http://www.oecd.org/els/socialpoliciesanddata/49499779.pdf>
Part II of the ILO Global Wage Report 2012/13: http://www.ilo.org/wcmsp5/groups/public/-dgreports/-dcomm/documents/publication/wcms_194843.pdf.

The role of redistribution policies

Regardless of optimal considerations, redistribution policies in developed countries have proved to be effective in reducing inequality (Figure 5). The GINI index after taxes and transfers - i.e. measured over disposable income instead of market income - is 15 percentage points lower on average than the non-adjusted measure for developed economies in the OECD. This gap is much lower for emerging countries in the OECD, with the exception of Hungary, which shares extensive distribution with other EU members.

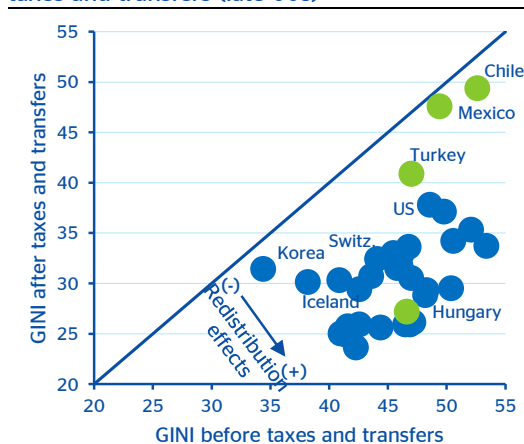
Korea stands out among developed countries with a limited impact of taxes and transfers on inequality. This result, together with low starting levels of the GINI index and the trace of the Kuznets curve shown in the previous section, suggests to us that other forces are at work in defining the inequality path, possibly related to the growth pattern followed by the Korean economy; this issue is beyond the scope of this report and further analysis is required.

For those emerging countries in need of redistribution policies to tackle excessive inequality, as well as to closing up education and health gaps (see specific sections later on), reforms are required to increase **fiscal revenues**, which are well below the figures in developed countries (Figure 6):

- This is particularly true in the case of Southeast Asia as well of Mexico and the Andean countries in Latin America, where fiscal revenues are around 20% of GDP compared to 40% in G7 economies.
- The starting point for Eastern Europe and Turkey is higher in terms of fiscal revenues than in other emerging regions.

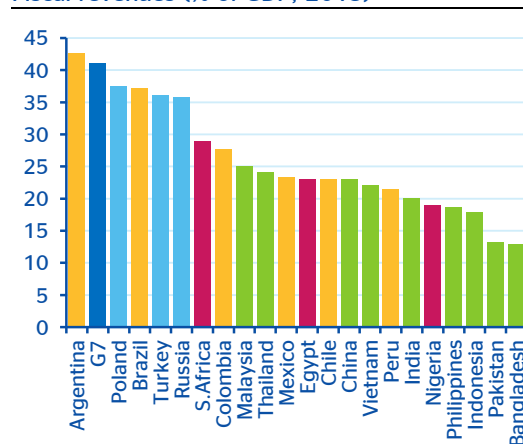
In all cases, any realistic programming also needs to take into account the impact of future ageing, as current discussions in European countries suggest to us.

Figure 5
GINI index in OECD countries before and after taxes and transfers (late 00s)



Source: OECD

Figure 6
Fiscal revenues (% of GDP, 2013)



Source: IMF and BBVA Research

Social protection to develop a welfare system

At the same time income transition is accelerating in the emerging world, and as a result of it, concern is growing over building a welfare system, covering a wide range of social protection programmes⁷.

- In many developing countries, basic assistance to poor people relies heavily on **subsidies** (namely for fuel and food) **and cash transfer programmes**. The first option, employed in Asia and the MENA region, is considered to be regressive as the population enjoys benefits regardless of the income level⁸, while the second targets a specific group but could eventually have no lasting effect if no adequate incentives are provided. An improved version of cash transfers pioneered in Latin America is represented by conditional programmes, in which families have to fulfil education and health criteria related to their children (e.g. school attendance ratios). If well-defined, these transfers could increase social mobility and release the targeted population from lifetime dependency on public assistance programmes⁹.
- **Pension systems** have a limited reach in emerging countries, particularly in Southeast Asia as well as in Mexico, Colombia and Peru in Latin America, where recipients of pensions number barely 20% of the population above retirement age (Figure 7). In countries where coverage is low, the elderly finance their consumption mainly through the use of assets and private transfers from their children¹⁰. The development of safety nets would soften this intergenerational linkage.
 - Protection for retirement will gain relevance as the emerging world faces **demographic aging** in future decades¹¹ (Figure 8). In fact, the share of people aged 65 years and over is going to triple between 2010 and 2050 and is already growing fast in some of them, such as China and Poland.
 - The IMF estimates that the costs of maintaining **living standards after retirement** will increase in emerging economies by 4-7pp of GDP per year between 2010 and 2050¹². This range more than doubles the estimate for current levels at 2-3% of GDP. However, the real fiscal challenge is higher as the IMF assumes that all individuals aged 65 and older are already covered, which as we have just pointed out is far from being true in some areas. We also have to add health expenditure to the bill, due to its positive correlation with aging.

7; Data on pension systems, unemployment benefits and other social protection programmes can be found in "Social Security Report. Providing coverage in times of crisis and beyond", The International Labour Organization, 2010.

www.ilo.org/public/english/protection/secsoc/downloads/policy/wssr.pdf.

8; This is particularly the case of energy subsidies. With respect to food subsidies, the assessment should take into account the stage of development and poverty headcount, as well as the negative effect of food inflation on purchasing power (prices of cereals have almost tripled since 2000).

9; A very complete analysis on the rationale and the impact of conditional cash transfers is "Conditional cash transfers- Reducing present and future poverty", World Bank Policy Research Report, 2009:

http://siteresources.worldbank.org/INTCCT/Resources/5757608-1234228266004/PRR-CCT_web_noembargo.pdf.

On the dichotomy with respect to subsidies, recent discussion applicable to the MENA region is available at:

<http://www.imf.org/external/pubs/ft/survey/so/2012/car051412b.htm>.

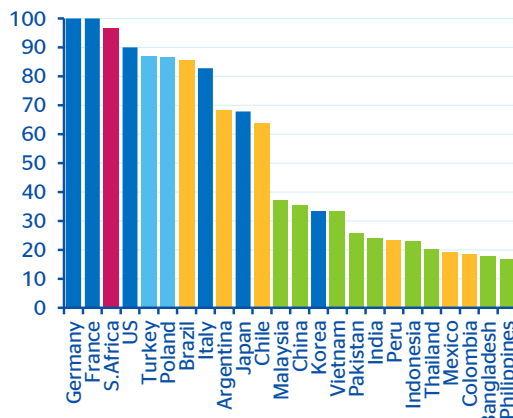
10; "The economic consequences of population aging", NTA Bulletin, December 2011, Number 3:

www.ntaccounts.org/doc/repository/NTAbulletin3Final.pdf.

11; "Demographic transition in the EAGLEs: A premium and a challenge at the same time", BBVA Research Economic Watch, June 2012, www.bbva-research.com/KETD/fbin/mult/120601_EW_Population_Premium_Risks_tcm348-331759.pdf?ts=16102012.

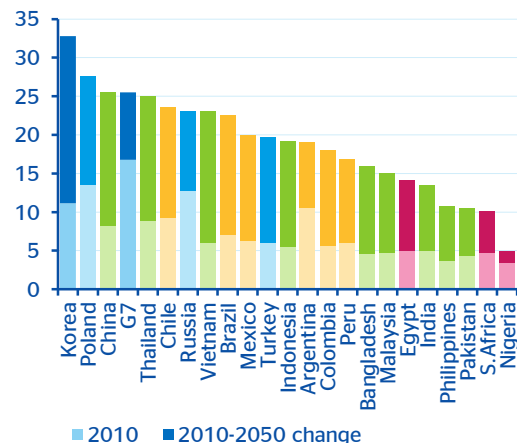
12; "The Financial Impact of Longevity Risk", Chapter 4, IMF WEO April 2012: www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/c4.pdf.

Figure 7
Old-age pension recipients (% of population above retirement age, mid-late 00s)



Source: ILO and BBVA Research

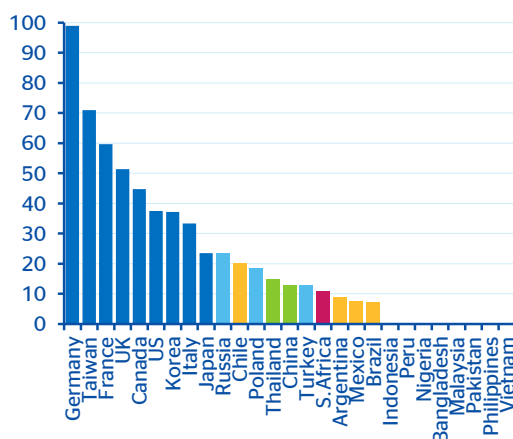
Figure 8
Share of population aged 65 years and over in 2010 and 2050 (% of total population)



Source: UN and BBVA Research

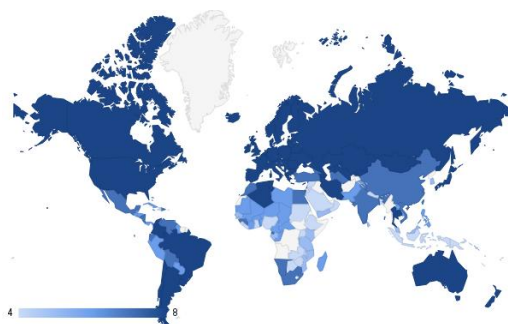
- **Unemployment coverage** is another pillar of the welfare system in developed economies (Figure 9). In contrast, around half of the emerging countries in the sample have no such social protection programme, with most of them located in Asia, while for those with some coverage, the average is lower than 15% of total unemployed, which is quite limited compared with developed economies (above 50%). As most emerging countries are currently enjoying low unemployment rates, a real challenge to this pillar has not yet arisen, which in fact makes it more important to reassess current conditions.
- **Social security programmes** cover other pillars in the welfare system such as invalidity, maternity and employment injury. An extensive approach shows that the global picture again highlights general shortages in Emerging Asia and Africa, as well as in many countries of Latin America (Map 1).

Figure 9
Unemployment effective coverage (% of unemployed, mid-late 00s)



Source: ILO and BBVA Research

Map 1
Number of categories covered in at least one programme of social security (late 00s)



NB: There are eight categories considered: sickness, maternity, old age, disability, surviving spouse, family allowances, employment injury and unemployment; the number 4 covers four categories or fewer.

Source: ILO and BBVA Research

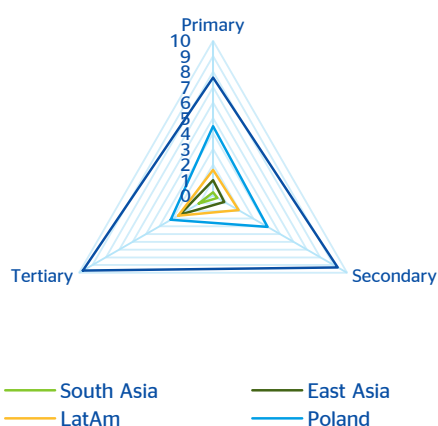
In-kind policies for equality of opportunities

Inequality is usually measured on an income basis. However, as shown by the UN Human Development Index, education and health dimensions are very relevant as well and they are even on a par with monetary factors when explaining inequality in less developed countries¹³. Gaps are exacerbated for the female population through gender inequality, which is quite significant in many emerging countries¹⁴.

Both education and health are crucial to guarantee equality of opportunities today, which is a critical element in increasing the chances of income mobility in the future (see related considerations for housing policy in Box 2):

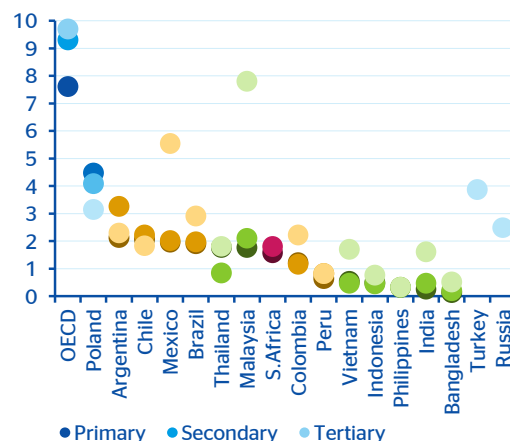
- **Education** gaps are determinants of both potential and inclusive growth. On the one hand, higher educational levels contribute to the increase of total factor productivity, which will be a key driver of potential growth as a population ages¹⁵. And on the other hand, education inequality is not negligible and is more important than uneven income distributions in some countries. Education policies can play a significant role in these two dimensions:
 - **Public expenditure** in education in emerging countries is **very low compared with developed standards** (Figures 10 and 11). Expenditure per student is less than 10% in South Asia and around 20-25% in East Asia and Latin America. On average for the three education levels, we find the highest references in Poland, while expenditure is above average in Mexico, Brazil and Malaysia. Partial data also suggest that Russia and Turkey are outperforming.
 - A simple regression shows a **positive relation between public expenditure per student in secondary education and test performance** at that level, as measured by the PISA results¹⁶. As the expenditure gap with respect to OECD standards is highly correlated with the GDP per capita, we could expect a convergence period to be under way. However, the education road-map also needs to include efficiency considerations and a well-targeted strategy.

Figure 10
Public expenditure by education level ('000s of PPP-adjusted USD per student) (2006-10 avg)



Source: WB, IMF and BBVA Research

Figure 11
Public expenditure by education level ('000s of PPP-adjusted USD per student) (2006-10 avg)



Source: WB, IMF and BBVA Research

13; Vid. footnote 2.

14; As measured by the UN Gender Inequality Index: <https://data.undp.org/dataset/Table-4-Gender-Inequality-Index/pq34-nwq7>.

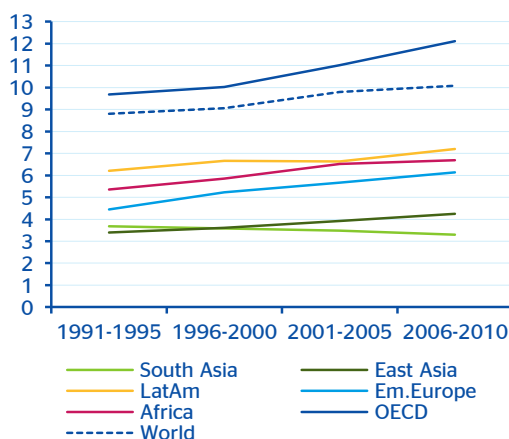
15; Vid. footnote 11.

www.bbva.com/KETD/fbin/mult/120601_EW_Population_Premium_Risks_tcm348-331759.pdf?ts=16102012.

16; The OECD Programme for International Student Assessment: www.oecd.org/pisa/aboutpisa/.

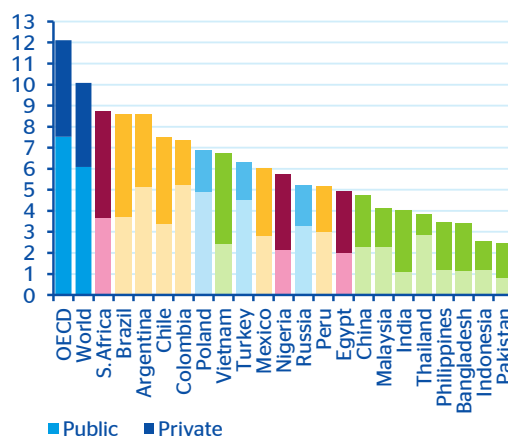
- **Health** conditions are strong determinants of basic capabilities to struggle out of the poverty trap and transition to the middle class. In less developed countries, better health conditions allow children to attend school and parents to have more resources for other expenditure such as food or education. As in the case of education, emerging economies clearly lag in terms of health expenditure (Figure 12):
 - **Asian countries show the lowest readings** with around 4% of GDP, although we see an upward trend in East Asia during the current century and a slight decrease in South Asia. Latin America, Emerging Europe and Africa are above those levels at 6-7%. However, these are three points below the world's average and account for only a half of OECD standards, which by the way are recording a steeper growth.
 - It is worth noting that more than half of the emerging markets in our sample show a **private share in health expenditure above 50%** (Figure 13), above the world and OECD's average of 40%. In fact, the highest readings are present in the countries with the lowest income per capita, such as India, Bangladesh, Pakistan, the Philippines, Vietnam and Nigeria.

Figure 12
Total health expenditure during the last two decades (% of GDP, area avg)



Source: WB and BBVA Research

Figure 13
Health expenditure by sector (% of GDP, 2006-10 avg)



Source: WB and BBVA Research

Box 2: Inclusive challenges for housing

Housing access and conditions are also a very relevant part of inclusive growth, as they are related to basic needs and living standards of the population.

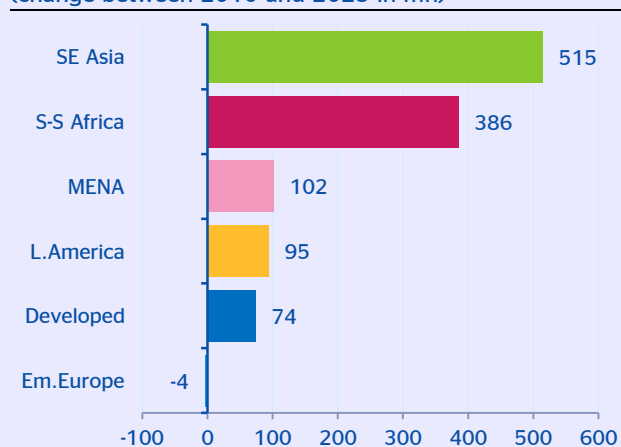
A collection of regional studies was published in 2011 and 2012 by the UN-Habitat agency about land and housing¹⁷. According to these reports, emerging economies share affordability problems, financial access restrictions and the extension of slums and informal settlements, with the scale of these problems being higher in urban areas.

Demographic pressure and rapid urbanisation are also a concern, especially in Asia and Africa (Figures 14 and 15). The experience of densely urban Latin America could offer important lessons for these two regions currently undergoing a similar process.

Problems related to housing can be policy-influenced in many dimensions:

- A primary policy objective is to provide **basic infrastructure**, including sanitation, electricity and water. The share of families living in poor-quality houses is significant in some countries, adding insecurity, overcrowding and poor materials to inadequate infrastructure. The upgrading of slums should go hand in hand with a multidisciplinary programme covering economic, social and environmental issues¹⁸.

Figure 14
Total population by region
(change between 2010 and 2025 in mn)

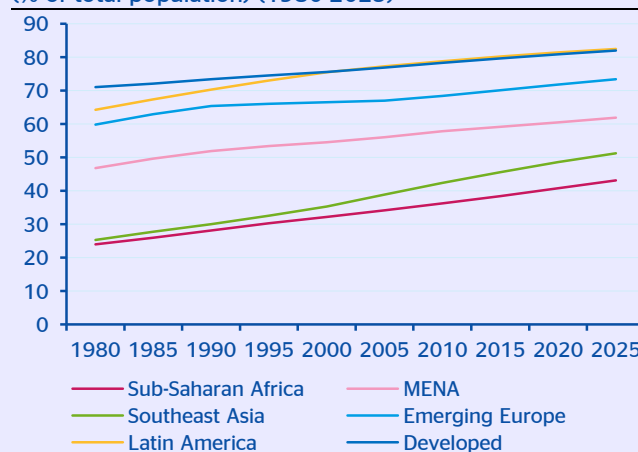


Source: UN and BBVA Research

A second key policy area is **financial deepening**. The purchase of a house without credit usually entails a large down-payment and preliminary high saving rates. This process distorts efficiency in life-cycle decisions, especially for low-income households. Despite the recent boom in some countries, housing loans to GDP ratios are still far below those in developed economies¹⁹.

- The third main area is related to **housing policy** itself, including legal framework, land provisioning, urbanisation plans, social housing, tax breaks and subsidies, measures impacting developers and households as well as purchase and rental options. Needs are very diverse among emerging economies, so solutions need to be well targeted.

Figure 15
Urbanisation rates by region
(% of total population) (1980-2025)



Source: UN and BBVA Research

17: Available at: <http://www.unhabitat.org/pmss/Publications.aspx?page=ByTheme&categoryID=277>. A book recently published by the IADB also makes a very thorough analysis of housing markets in Latin America: "Room for Development: Housing Markets in Latin America and the Caribbean", April 2012. See executive summary and interesting graphs at <http://www.iadb.org/en/research-and-data/dia-publication-details,3185.html?id=2012>.

18: The UN-Habitat report on Asia highlights some successful experiences on this field.

19: See a broad comparison in the book "Housing Finance Policy in Emerging Markets", The World Bank, 2009: http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/HousingFinanceforEMs_Ebook.pdf.

Comprehensive reform momentum to tackle excessive inequality for sustainable development

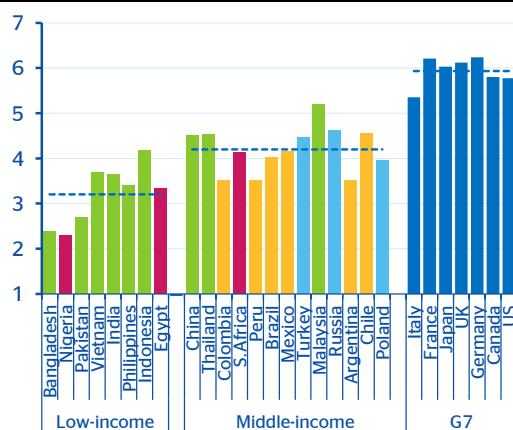
Tackling inequality is founded not only on social grounds but, as pointed out in the first section, to avoid negative spill-overs on growth. Exactly for this reason and as a result of associated risks, fighting inequality should not be an isolated target and requires policies that are closely linked under a consistent and comprehensive growth strategy. Building a welfare system and addressing fiscal issues needs a coordinated reform momentum to enhance productive capabilities, remove bottlenecks and avoid social unrest throughout income transition.

Here, we would like to draw attention to two areas that, as noted in the case of education, are crucial for both potential and inclusive growth:

- **Infrastructure** allows products, people and information to move and to do so more efficiently. In less-developed countries, education and health facilities are key determinants of living conditions, while market access is critical for rural workers. For middle-income economies, the lack and poor quality of infrastructure harm competitiveness and may eventually become a serious bottleneck for further growth (Figure 16).
 - The challenges to develop infrastructure are huge, given the low fiscal revenues, leading necessarily to consideration of alternative financing sources such as Private-Public Partnership (PPP), regional banks or portfolio diversification by global lenders²⁰.
- **Financial access** helps to smooth saving-investment patterns in all stages of development, enabling entrepreneurial behaviour in less-developed economies and loan provision for housing and durable goods as people reach a middle class status. In the same way that excessive credit could lead to episodes of boom and bust, insufficient access could become a hurdle for development; financial deepening needs to follow a healthy path (Figure 17).
 - The relation between income inequality and financial deepening could be bi-directional²¹, and therefore coordinated policies would be much more successful in tackling shortages in these areas.

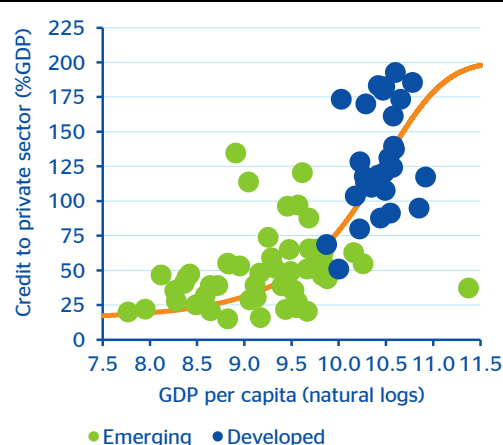
A realistic approach is in any case required to achieve sustainable development, as challenges and risks differ according to the income stage of each country.

Figure 16
Quality of overall infrastructure (1-7)
(2013-14)



NB: Countries are ranked according to their real PPP-adjusted GDP per capita in 2013
Source: WEF and BBVA Research

Figure 17
Credit to the private sector and GDP per capita
(2013)



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