

## Emerging Economies and Global Capital Flows

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Thank you for that introduction. I'm pleased to kick off your conference on Globalization and Emerging Economies. You have chosen a very timely subject with which I've had some direct experience.

My direct experience includes commercial banking in the Middle East in the 1970s, country debt restructuring in the 1980s, and small and medium-sized enterprise finance in Asia, Latin America, and Eastern Europe in the 1990s. I've also worked in private equity finance in all these regions in the early part of this decade.

As I survey the room this morning, I think I can safely assume most of you are young professionals in business, finance, and law. I can also assume, I think, that you are doing business today or are interested in doing business with emerging markets in the form of trade of goods or services, investments (both outbound from the United States and inbound from these countries), or transaction services in support of these. So, although you are early in your careers, I am assuming you are well traveled, relatively knowledgeable, and somewhat experienced in emerging economies. Or some of you may just like to get up early on a Saturday morning.

If my assumptions are accurate, the most useful thing I can do this morning is to provide a backdrop to frame the big questions as a context for your narrower and more specific discussions later in the day. Let me add that the views I express are mine alone and don't necessarily reflect those of my Federal Reserve colleagues.

### Terminology too simplistic—not a two-class world

Given all the possibilities, the conference organizers were wise in using the term "emerging economies" instead of "emerging markets" or the narrower "pioneer markets." "Emerging economies" is the most general and inclusive term, but I must confess some frustration with much of the jargon used to describe today's global commercial landscape. Emerging economies or emerging markets cover about 170 sovereign states and an extraordinarily wide spectrum of countries. In these countries, market size, relative economic development, and on-the-ground conditions vary widely.

The term emerging markets has been in use for a decade or more and has coincided with the growth of cross-border equity finance. Over my career, we've migrated through the terms "third world" to "less developed countries" (or LDCs) to "developing countries" to emerging markets. None of these is quite satisfactory.

One way to group countries is OECD and non-OECD. OECD stands for Organisation for Economic Co-operation and Development and includes 30 countries, mostly in North America, Europe, and the Pacific Rim. Mexico and Turkey—two countries historically thought of as emerging—are OECD countries. Nonetheless, the demarcation is useful. The broad category of emerging economies or markets is all non-OECD countries.

Also, with the shift of so much manufacturing to so-called emerging economies, referring to established European and North American economies as "industrialized" seems out of date. Indeed, a characteristic of advanced economies today is a developed service sector, especially financial services. Manufacturing in advanced economies is increasingly an assembly of components from industrialized non-OECD countries.

Four non-OECD countries that have attracted much attention recently are Brazil, Russia, India, and China—the so-called BRIC economies. Jim O'Neill, chief global economist at Goldman Sachs, coined the acronym in 2001 and argued that the global economic story of the first half of this century may be the story of the BRICs. Since that time equity markets have risen by about 420 percent in Brazil and India, more than 120 percent in China, and nearly 840 percent in Russia.

From 2001 through early 2007, I taught courses on international business strategy at Georgetown University and Johns Hopkins. At that time, I argued that virtually every company—regardless of geographic scope—needed a China (and later, an India) strategy. My point was the necessity to consider these countries' effect on product sourcing, cost structures, service value chains, and ultimately competition—even between purely domestic rivals.

It's worth pointing out, however, that fixation on BRIC economies excludes many other significant countries, some of which you will discuss today. These include Colombia and Chile in South America, South Africa and Nigeria in Africa, and Vietnam and Indonesia in Asia.

My point is that the reality of the world is much more a spectrum than a two-class world of neat distinctions. Indeed, most emerging economies have a modern sector within a society that has somewhat wider income disparity than our own, somewhat less developed infrastructure, and somewhat less mature institutions and rule of law.

### Conventional thinking reversed

Let me turn to some points of greater import than complaints about terminology.

Much conventional thinking about emerging market economies has been turned upside down in recent years. The conventional view held that an emerging economy was not highly industrialized, and that it was commodity export-dependent, capital poor, and technology deficient. Today's reality is not so simple.

I would like to comment on three current or developing realities about emerging economies that require us to update our thinking. First is the debate on economic decoupling, which is the notion of reduced correlation between the United States and certain emerging economies. Second, I'll talk about the changing dynamics of capital flows between poorer and richer countries. Third, I will share some thoughts on sovereign wealth funds, which are an increasing force in cross-border investments.

Before looking at these developments, I would like to provide the context of the U.S. and global economic situation and outlook.

### **Economic situation and outlook**

The U.S. economy is in the midst of a pronounced slowdown, with very little growth recorded for two consecutive quarters. The weakness was initially centered in the housing sector but has become more widespread.

Consumer spending accounts for about two-thirds of U.S. gross domestic product, or GDP. Personal consumption has softened. It has been argued that to the extent the world relies on strong U.S. consumer activity, this weakness could pose a threat to continued global expansion (hence, the debate on decoupling).

Also, the United States has experienced elevated inflation levels partially driven by a run-up of energy and other commodity prices. The U.S. dollar has depreciated against the euro and on a trade-weighted basis. The export sector of the U.S. economy has benefited and remains quite strong. Export growth has diluted—but not offset—the negative trend of the U.S. economy.

Global economic growth has begun to slow after several years of very strong performance. The International Monetary Fund (IMF) projects global GDP growth in 2008 to be 3.7 percent on an annualized basis—a very solid number but about 1.25 percent lower than the growth recorded last year. The United States constitutes about 25 percent of the global economy, and most forecasters expect slow growth for 2008. The IMF's *World Economic Outlook* from April forecasts the eurozone to grow 1.4 percent. In most emerging economies, real GDP growth appears to be softening but still growing nicely coming off the very strong pace of growth earlier this decade. The larger emerging economies should continue to grow enough to keep upward pressure on oil and other commodity prices.

Price inflation in the past few years has been remarkably controlled in most economies. But recently inflation in many parts of the world has begun to pick up. I'm sure you're aware of reports of food price-related social unrest in several countries. Inflation is a growing issue for emerging economies.

### **The decoupling debate**

It used to be said that when the United States sneezes, the world catches pneumonia. A better metaphor for today would be that when the United States gets a cold, the world gets a cough and the sniffles. Questions about decoupling are frequently heard in economic discourse, and they include the following:

Will the U.S. downturn drag the rest of the world down, especially China and other consumer product exporters?

Is the rest of the world positioned to withstand a negative demand shock of some duration from the United States?

Is global growth being driven by increasingly mature, independent, and sustainable sources of economic dynamism?

Do the larger economies—BRICs included—have tools to stimulate countercyclical activity in the face of weakness on the part of the United States?

I won't discuss these questions in detail, but let me make a few observations. In the narrow sense, the decoupling debate has been about whether slower spending in the United States will lead to slower GDP growth in countries dependent on U.S. import demand. This concern is then broadened to a global slowdown or recession.

My view is the following: Global economic integration has progressed in recent years to the point that a slowdown in the United States will unquestionably be felt, but not as severely as imagined by some. Domestic growth momentum in many emerging economies will attenuate the influence of U.S. weakness. And the accumulation of foreign currency reserves by these countries—the result of trade surpluses—provides an accessible resource to stimulate their own domestic growth to offset weaker exports, should that weakness materialize.

### **Capital flows and currency reserves**

That brings me to the second issue I want to discuss, which concerns capital flows and foreign currency reserves accumulation. In the textbook version, capital—both physical and financial—is supposed to flow from mature economies where returns are low to developing countries where the fruit hangs low and risk-adjusted returns are high.

In the last few years, many emerging economies—in spite of very robust growth rates—have been accumulating foreign currency surpluses derived mostly from export earnings and inbound investment. China's official foreign currency reserves approach \$1.7 trillion. India's reserves are about \$313 billion. Estimated reserves for Brazil are \$196 billion and for Russia, \$534 billion.

These surpluses must be invested, and since the reserves are in dollars and other hard currencies, they are mostly invested in U.S. and European financial assets.

Is this a case of the poor financing the rich? How can this happen? At a high level, we can say that the earning (and investment attraction) power of emerging economies exceeds their absorption capacity in terms of both investment and consumption. In other words, they're on a roll and can't spend it all. There are many causes of this phenomenon. I'll highlight four:

deeply seated savings instincts on the part of the population in emerging nations combined with immature pension programs and official policies to discourage consumption; restrictions on foreign investment by companies and individuals; underdeveloped domestic banking systems and financial markets; and the propensity of households in the United States to undersave and overspend.

In my view, we can expect these "upstream" capital flows to continue for some time.

### **Sovereign wealth funds**

The flow of capital from emerging to developed economies is becoming institutionalized and encouraging the emergence of sovereign wealth funds. China, Russia, Abu Dhabi, Saudi Arabia, and several other non-OECD countries have established government-controlled asset management firms to professionally manage their "excess" reserves. All of these countries appear to be planning for surpluses well into the future.

These sovereign wealth funds are in the process of diversifying some portion of their total holdings in pursuit of better returns. Diversification has occurred both within a currency—the dollar—and across currencies and geographic exposures. Diversification within the dollar, for instance, may involve purchase of nongovernment, higher-risk bonds and corporate equity securities as well as direct significant minority equity investments in banks and corporations. In addition, these funds will likely invest as limited partners in private equity and hedge funds managed by professional money managers here in the United States.

These pools of capital have become a major force in the world. Some sovereign wealth funds have played prominent roles in the recapitalization of U.S. and European banks that incurred losses in the recent financial turmoil.

A movement has developed to require sovereign wealth funds to adopt a code of conduct. I believe this development is healthy, if only to improve transparency and to dampen alarmist sentiment in the West.

There has been a fair amount of handwringing recently about sovereign wealth funds accumulating U.S. assets. I believe our posture has to be realistic—one country's trade deficit (ours, in this case) is another country's investment surplus.

The increasing flow of cross-border investments helps to make the global economy even more integrated and gives emerging economies a shared stake in the success of the U.S. economy.

**Good news for the world**

And that brings me to my final point: The growth and rising prosperity of the emerging economies and their financial coupling with advanced economies—especially the United States—is good news for the world. Financial integration with successful emerging economies should ultimately make our own economic path less precarious. This process is ongoing. Beyond recent and immediate cyclical patterns of the U.S. economy, policymakers must address persistent imbalances in trade accounts and energy dependence. Add to these projected fiscal deficits related to baby boomer entitlements. Confronting these imbalances will be a key policy challenge going forward.

I applaud you for your global perspective, for caring about the fate of emerging economies, and for seeking opportunity there. I wish you the best with your conference, and I would be glad to take a few of your questions.

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