SPEECH

Emerging Markets: Managing The Good Times

September 2, 2008
Posted September 4, 2008

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Remarks at Central Bank of Argentina Money and Banking Seminar

It is a pleasure to be here among so many friends, including many fellow veterans of past episodes of stress in the emerging world, to enjoy the gracious hospitality of Governor Redrado and the Central Bank and to have the benefit so many thoughtful presentations.

The title of this section of the program is, in itself, a remarkable sign of the times. To an old hand like me, the notion that we might be discussing "managing the good times" in the emerging world, given the decidedly "not-so-good" times prevailing in the advanced economies…well, that certainly encapsulates how the world has been turned on its head of late.

To be sure, not everything is rosy in the emerging world. But the basic picture still is one of remarkable resilience, especially by historical standards.

- Although emerging market growth is slowing, it is to rates that are still expected to remain generally close to potential.
- Recent emerging market financial developments generally remain well within the realm of the manageable. While equities have declined this year, and capital inflows have eased a bit, spreads are still quite low—they have widened by much less than high yield—most currencies have appreciated over the past year, and authorities generally are not having their hands forced by market developments.
- Indeed, the emerging world—which for so long was seen as a seemingly endless source of instability, fragility and chronic shortages of capital—is now an important part of global resilience. It is no small irony that, in recent quarters, emerging market entities have invested more in the capital of financial institutions in the US and Europe than Asia received in financial support from the official community a decade ago.

The Changing Landscape

As we know, the emerging world's recent resilience is no accident. It is the product of considerable efforts by policy makers to strengthen balance sheets, to improve policy and risk management frameworks and to take on board lessons from past crises.

This progress has helped position countries and companies to benefit from opportunities that the recent period of benign global conditions provided, and to weather the recent emergence of difficult financial conditions, and softer demand from the advanced economies.

The dimensions of this progress are familiar to everyone here, [but no less remarkable for that familiarity]:

- Ten years ago, most emerging economies were dependent on foreign currency debt inflows to finance current account deficits. Reserve cushions were often threadbare, covering but a few months' debt obligations. Monetary policy was dependent on fragile exchange rate pegs. Fiscal burdens were rising, often to unsustainable levels; and weak banking systems were in crisis, or headed that way. All of these factors left countries at the mercy of shifts in global financial and goods markets—booming in the good times, and struggling mightily at the least sign of stress.
- Today, external debt burdens generally are declining, and are down dramatically across Latin America. Primary fiscal balances have strengthened significantly; and countries are funding themselves much more in local currency on attractive terms. Currency flexibility and more robust monetary arrangements have taken firm root in many countries. Massive investments have been made in financial sector rehabilitation, leading to renewed profitability and robust credit growth. And reserve and other foreign asset holdings have grown so large that EM investment preferences have come to be seen as an important factor influencing global yields and valuations. (Russia, which was basically insolvent a decade ago now holds more than twice the reserves of the entire Eurozone; China's reserves will soon top $2 trillion; and Brazil's public sector now has a net long foreign

currency position, with more foreign exchange assets than foreign currency denominated debt. These developments would have been unimaginable a few short years ago).

- The emerging world has accounted for three quarters of global growth over the last five years and likely even more this year and next. And the likelihood is that, before the end of this decade, the emerging world will surpass the advanced economies in terms of share of global output and exports.
- Massive shifts are taking place on the financial side as well.
- Emerging market economies have been providing the bulk of the financing for the US current account deficit.
- As part of that process, emerging market official reserves have swelled to some $5. 5 trillion—larger than marketable stock of US Treasuries—and sovereign wealth funds, with some $3 trillion in assets now have [nearly twice] as many net assets under management as the global hedge fund community.
- As emerging market economies grow to rival in size the largest of the advanced economies, so too will their leading corporations. Indeed, nine of the eighteen largest companies in the world are now resident in the emerging markets.

In essence, what we are seeing today is not just cyclical resilience across the emerging world, but a profound secular change—a shift in the economic center of gravity—from the advanced economies to the emerging markets.

This is all heady stuff. It bespeaks incredible opportunities, but also important challenges and adjustments into the medium term—a theme I will come back to in a few minutes. But countries also face some significant near-term tests.

The Challenges: Familiar and Unfamiliar

From 2002 to 2007, the emerging world had the wind at its back, benefiting from an expanding global economy and trading system, limited price pressures, and growth friendly financial conditions. The seas do not look to be nearly as smooth just ahead.

Going forward, policymakers across the emerging world will need to navigate their way through some tricky macroeconomic cross-currents. They will need to cope with increasing drag from the advanced economies and moderating growth in the emerging markets, shifting risk preferences on the part of investors and a surge in inflation that has brought headline rates well above targets globally. They will also need to manage their economies across an increasingly uncertain outlook for commodities, both for the near and longer term.

Let me say a few words about each of these tasks.

- With regard to the global backdrop, it is important to recognize the fundamental nature of the adjustment processes facing the financial systems of the US and Europe.

- It is not just a question of figuratively swapping out a flat tire for a spare and then hopping back into the same vehicle—extensive repairs are needed. The current crisis has revealed fundamental shortcomings in the prevailing credit origination and distribution model, shortcomings that will require significant institutional change. Efforts to date have helped contain what could have been much worse, but the fact is, it will take more time and it will take more capital to complete the ongoing de-leveraging, workout, and institutional strengthening process.
- In the meanwhile, headwinds to growth in the advanced economies will be considerable. In the US, the fading of the tax rebate stimulus, the continuing slide in house prices, and the ongoing financial stress leave near-term momentum very much in question. The likelihood is that, in the second half of this year, growth in the advanced economies collectively will be below potential for the first time since the start of this decade. In other words, at least for the near-term, the emerging world probably cannot count on strong demand growth from Europe to counterbalance weaker export growth to the US. Even Germany—the leader of Europe's recent growth run—contracted in Q2. Japan too is contracting.
- [Deterioration in the global macro environment (should it occur), can be expected to weigh on financial markets, pressure equity markets and risk appetites, and make funding more difficult. In such an environment, borrowers [public and private] will face greater scrutiny, and the premium for less credible policy trajectories will be significantly higher than in the recent Goldilocks period.]
- Inflation in most countries is running well above authorities' objectives and, in most cases, the gaps are still widening.
- It has taken Latin America a long time to stabilize inflation. In the 1980´s, low single digit inflation was something talked about

mostly in monthly terms (the annual average in the 1980's was about 150%); in the early 1990's, references to single-digit inflation frequently meant the weekly rate. Overcoming inflation has been a *major* accomplishment. That accomplishment is being seriously threatened at present.

- There is a view out there that this is mostly a commodity story in the emerging world, leaving little role for policy. But countries cannot afford to just count on a turn in the commodity cycle to durably rebalance their economies.
- Yes, surges in the prices of grains and oil have played an important role in surging headline rates across the advanced and emerging economies, and food generally has a higher weight in emerging market consumption baskets.

- But strong demand and sustained above-trend growth also are playing an important role as well. And this is particularly important when we talk about risks and the challenge of containing second-round and expectational effects.
- The fact is, a number of countries across the emerging world have enjoyed a run of unusually high—indeed in some cases even near China-like—rates of growth, but without corresponding rates of investment or prospects for sustained rates of productivity growth. (Emerging Asia, for instance, saves more than forty percent of income…double that of Latin America). Such disconnects provide sure-fire recipes for demand-led inflation.
- I don't need to tell this group that the stakes in the current inflation battles are quite high. Policymakers need to bring inflation back to targeted levels. And they need to do it with sustainable monetary and fiscal policy mixes that build on the hard-won credibility earned in recent years and increase options going forward.

- As we know from experience, failure to get control over inflation risks hard landings, setbacks for local fixed income market development and political backlash that erodes support for recent policy progress. And short-term success through inconsistent heterodox approaches will likely prove just that: temporary, and costly in terms of the impact on future growth potential, credibility and market development.

- On the commodity front, I have no crystal ball—and neither does anyone else. The most certain thing seems to be ample uncertainty.

- Commodity exporters cannot afford to assume that strong growth in Asia will necessarily guarantee them an escalator ride to prosperity. At the same time, commodity-consuming countries can ill afford to take lightly the possibility that the respite from rising prices that we have experienced recently may prove temporary.
- In the near term, commodity prices seem to be caught up in an uncertain tug of war between, on one side, limited spare capacity and low grain and metal stocks in the face of strong demand growth in much of the emerging world, and, on the other, signs of worsening conditions in the advanced economies.
- The uncertainties only compound as horizons extend. It seems reasonable to suppose that demand growth from a rapidly expanding emerging world will continue to provide support to commodity prices. But on the other hand, the longer the horizon, the easier it is to imagine (though hard-to-forecast) how shifts in policy or technology, and market responses to price incentives might radically alter the global supply/demand balance.
- In this context, commodity-producing countries cannot be sure whether recent windfalls will persist, grow further or reverse as quickly as they first materialized—and would be well-served to build both caution and flexibility into their policy frameworks:

- Caution in avoiding spending plans and patterns that may prove too hard to adjust should export and fiscal revenues prove different from expectations, and

- Flexibility to adjust to changing circumstances, such as through a flexible exchange rate regime and credible, transparent monetary and fiscal policy frameworks.

While the near-term priority should be to bring growth better in line with potential and to proceed cautiously with respect to the

risks and opportunities posed by commodity price developments, over a longer horizon, there is much that can be done to raise potential growth rates.

The fact is, improvements in macro policy and vulnerability reduction can only deliver so much, mostly in the form of steadier, but not necessarily stronger trend growth. Of course, it won't even bring that if the speed limits on growth are not observed. Raising trend growth rates requires complementary progress on the micro side. And the time to make that improvement is while growth is good.

- Unmet structural challenges in areas such as regulatory and energy policy, labor legislation, pension reform, improvements in public services such as education, and the legal and judicial infrastructure are holding potential growth in check in some countries, limiting job creation and real incomes, leaving them vulnerable to the global commodity cycle—and to erosion of domestic political support.

- This is a familiar litany and, to be sure, none of this is easy: structural reforms are complex and generally politically contentious. But without a broad distribution of the benefits of reform—and by that I mean better growth in employment prospects and real incomes, less inequality, better institutions, better public services—stability is by no means assured.

Of course, the foundations to strong and sustained growth are not just internal. There is also an important external, systemic dimension. Much of the emerging world's recent economic success can be traced to countries' strong trade performances. Robust export growth, both nominal and real, has bolstered employment opportunities, financed expanding domestic activity and supported balance sheet improvements through lower debt ratios and higher international reserves. And trade performance will no doubt be important going forward as well. Let me offer a few observations in this regard:

- First, success in maintaining and enhancing competitiveness will be a crucial factor determining relative performance in the emerging world. Some countries will thrive and climb the value added ladder toward higher per capita incomes; others will find themselves constantly playing defense, their industries at risk of losing share at home and abroad. Countries that raise their productive growth rates through micro reforms while maintaining stable macro frameworks will improve the odds of being among the former rather than the latter.
- Second, the emerging world's recent collective reliance on export led growth must, by necessity, give way to the pursuit of more balanced growth trajectories. At present, forty percent of the world's population is trying to come on-stream, emulating a model perfected by a country that was three or four percent of the world's population at the time. As the emerging world becomes a progressively larger part of the global economy, and moves from the periphery to an essential part of the core, it clearly is not feasible for it to rely as much as in the recent past on growing exports more than imports.
- Third, the emerging world will have a progressively greater stake, and therefore must take a greater leadership role in ensuring that global trade continues to grow and prosper. In particular, the leading countries in the emerging world have to develop stances on systemic issues related to trade policy and monetary arrangements that reflect their integral stake in the system more generally, that transcend narrow interests, and that find the common ground that benefits the system as a whole—thereby enabling their own growing role within that system.

To the extent that countries meet the foregoing challenges, they will be paving the way for more prosperous futures. But, of course, no good deed goes unpunished, and success will bring its own challenges.

- A number of countries have enjoyed record gross inflows of capital in recent years, which at the same time have been largely recycled into record gross outflows, often in the form of reserve build-ups. Going forward, it is reasonable to assume that parts of the emerging world will attract even greater inflows, particularly in those economies and markets that continue to perform strongly relative to the mature economies—in other words, those that manage the current macro-financial challenges well.

- These flows will inevitably involve some of the familiar north-south patterns of flows. But it seems quite likely that they will be supplemented by increased flows from within the emerging world as well. These so-called "south-to-south flows, which are already evident, will further deepen the linkages and interdependencies that are progressively intertwining outlooks across the emerging world in new, and often surprising ways.
- In this environment, policymakers would do well to not only be cautious and forward-looking in managing the level and structure of public borrowing, but vigilant about detecting and defusing potential build-ups of vulnerabilities in the private sector as well (and, as our unfortunate experience shows, off-balance sheets as well as on). Given the recent pace of domestic

> credit growth in a number of countries—indeed rapid credit growth is more the rule than the exception today—there is little room for complacency. History provides few examples where sustained rapid domestic credit expansion has not led to costly future difficulties.

For too many years, economic policymaking in the emerging world was about crises: managing to *get into* crises, managing to *avoid* them, and managing to *recover,* to *get beyond* crises. It is heartening that the "crisis" overlay has faded for many countries, though perhaps still not enough in some.

Much of the emerging world now faces challenges, not of overcoming adversity, but, of achieving and nurturing higher levels of sustainable prosperity. These challenges are clearly more welcome, but no less difficult for that reason. Complacency is always a risk in good times, and no less so now, as we approach what is likely to be a decidedly more challenging global context.