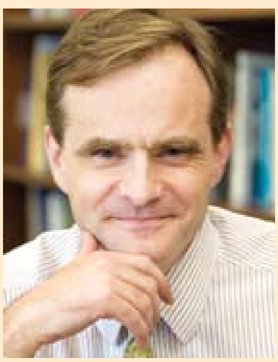
STRAIGHT TALK

Emerging Markets Emerge

Emerging markets are now a key determinant of global growth. This is good news—and a potential problem

TWENTY years ago, "emerging markets" was the label for countries that were just starting to interest a broader class of investors worldwide. These countries were perceived as having strong (but unrealized) prospects while being somewhat peripheral to the main functioning of the global economy. Ten years ago, many of these emerging markets faced major crises. They had clearly become big enough to shake the financial world, at least in some disturbing moments in 1997–98. The label "emerging markets" meant instability, or at least some form of volatility.



Simon Johnson is the outgoing Economic Counsellor and Director of the IMF's Research Department.

Today, emerging markets—or, perhaps more descriptively, middle-income countries—have emerged as a major determinant of global prosperity. Over the past five years, these countries have accounted for between one-quarter and one-half of global growth (depending on how it is measured). They have also weathered the recent global financial disturbance well and, through growing financial and trade linkages, have helped keep advanced economies from slowing down. And, now, the way emerging markets handle the latest round of inflation challenges will have profound effects on growth and inflation around the world.

How did emerging markets become so economically influential? What are the implications? And—from a global macroeconomic perspective—are there potential future costs, as well as benefits?

What happened?

Remember that there have always been a lot of people living outside what we call the developed countries. Of today's roughly 6 and a half billion people, only about 1 billion live in relatively rich countries. But for a long time, for various reasons (related to colonialism, communism, and common policy mistakes) most of the world's poor countries experienced relatively little economic growth.

This began to change in the 1960s as a range of developing countries put in place economic policies that produced growth, and the world economy experienced a sustained boom. Many fast-growing developing countries experienced serious bumps, or even the derailing of growth, in the 1970s and 1980s; in fact, this is when the IMF seriously entered the business of lending to emerging markets. The 1980s were for some countries—particularly in Latin America—a "lost decade," with little growth.

Relatively few countries have sustained high rates of growth since the early 1960s—probably no more than a dozen. But by the early to mid-1990s, many more governments had figured out how to run their economies with sustainable budget deficits (or even surpluses), moderate inflation, and avoid overvaluation of their exchange rates. Also, some countries moved to adopt better institutions, either bringing more political stability or a better environment for investment, or both.

The last crisis

Just when things seemed finally to be going well for emerging markets, many or even most of them were hit by a major crisis in the late 1990s. Some of the most affected countries were in Asia, which had escaped the problems of the earlier decades; as well as some countries in Latin America, which had experienced repeated problems since 1980. More broadly, any emerging market that had borrowed capital (for the private or the public sector) was vulnerable.

This time there was a rapid bounceback, sound economic policies quickly prevailed, and existing debt levels turned out not to put a brake on growth. Again, emerging market policymakers learned some important lessons. Many of them took the view that their countries should carry more foreign exchange reserves, particularly as they opened up to financial flows of all kinds. It is increasingly hard to avoid substantial financial flows when things go well, and this was an understandable view to take.

Some policymakers also took the view that exchange rates should err more on the side of being undervalued. Whether this was ultimately such a good idea remains to be seen, but there is no question that it contributed to at least half a decade of strong growth across a wide range of emerging markets.

Role reversal

Emerging markets have grown fast during the past 10 years. They have sustained this growth, in the face of substantial financial turbulence in advanced economies during the past 12 months, for three main reasons.

First, although emerging markets are highly connected to the world in terms of goods flows, they are not (yet) fully connected in terms of financial flows. The banks in emerging market countries perhaps became more cautious after the problems of the 1990s. Or perhaps they just had better opportunities at home. In any case, emerging markets were generally not exposed to any significant degree to the problems in U.S. subprime mortgages or associated financial instruments.

Second, emerging markets have continued to maintain sound economic polices. Unlike during some previous booms, they did not throw fiscal caution to the wind. And problematic behaviors, such as various forms of rent-seeking or corruption, seem to have been controlled much more effectively in this boom compared with past booms.

Third, global trade remains strong and so-called south-south trade (not involving advanced economies) has proved resilient. Countries understand that throwing up trade barriers should be avoided at all costs. The global trading rules have held up so far under considerable pressure. This has been of great benefit to emerging markets.

As a result, over the past year, it is emerging markets that have played a relatively stabilizing role, helping to offset repeated waves of financial concern (and even capital flight from entire classes of securities) in advanced economies. This is a reversal of the usual roles; it is also the first time in recorded history that emerging markets have played such a role.

For whom the bell tolls

No good deed goes unpunished, and the same is true for economic policies. It is precisely the resilience of emerging markets that now underpins high commodity prices, including for energy, food, and industrial inputs. This adds an inflationary shock to the mix facing all countries.

This inflationary shock comes at the same time as, and in spite of, a slowdown in the United States and in some other advanced economies. Again, this is a great reversal compared with the past 20 years, during which time low prices for manufactured goods helped keep down inflation in developed countries. Now the effect of emerging market prosperity is to increase prices in advanced economies, rather than decrease them. Also, energy intensity has declined, and food comprises a relatively small share of consumer expenditures in advanced economies.

Avoiding stagflation

There are many good reasons to believe that developed countries can avoid the slowdown in growth and acceleration of inflation that plagued the 1970s. Their economies (and real wages) have become more flexible, and they are able to adjust in the face of higher energy prices. Monetary policy has established greater credibility, and central banks are more focused on controlling inflation, communicating their intentions, and moderating expectations. Exchange rate flexibility, though sometimes a mixed blessing, in general makes it easier to manage the macroeconomy of rich countries.

On all these dimensions, emerging markets are more vulnerable. They may not face stagflation per se—this will depend on their policy responses. But they are certainly at risk of higher inflation. Price expectations in many of these countries are not well measured, and this means it is hard to know if they are still, in central bank parlance, "anchored."

Some emerging market countries have adopted forms of inflation targeting, in which they explicitly say what they want inflation to be and then back that up by tightening monetary policy as needed—preferably moving early and decisively, rather than waiting until inflation is higher and bigger interest rate moves are required. At the very least, the latest round of commodity price increases is a test for central banks in emerging markets. Many of these banks have become independent over the past two decades. But how much of a difference this will make, we are about to find out.

And then there is exchange rate policy. This is an Achilles' heel for some emerging markets: if you tie your exchange rate to the U.S. dollar (the most common form of peg) and you are reasonably open to capital flows, then your interest rates will be roughly those of the United States. Think this through: the U.S. Federal Reserve has cut interest rates substantially over the past year, to help the U.S. economy as it struggles with problems in the housing market, and the U.S. policy rate is now at 2 percent. But this is also the interest rate in emerging markets whose currencies are pegged to the dollar. In other words, these emerging markets have eased their monetary policies at the same time as their economies have continued to grow fast—for oil producers, actually faster. This is not a good idea.

The crisis next time?

The emerging market crises of the 1980s were about high levels of public external debt, unsustainable budget deficits, and, in some instances, borderline hyperinflation. The crises of the 1990s and early 2000s were more about private sector borrowing and vulnerabilities created through large current account deficits. Of course, there can always be a crisis of an "old" type; for example, through financing a current account deficit with private capital inflows, and then finding out suddenly that the private investors want to go home. But if there is a new kind of potential crisis lurking for emerging markets, what would that look like?

Most likely it would be centered again on a failure to control inflation, except through raising interest rates late and in dramatic fashion. This might coincide with a broader global slowdown that would affect trade. The danger is that emerging markets could now be perfectly positioned for negative experiences very much akin to those seen in richer countries during the 1970s. Luckily, drastic negative outcomes are avoidable, particularly if key emerging markets act quickly to slow down their economies and—most important—move to allow more exchange flexibility, which will allow them to run independent monetary policies appropriate for their own conditions. ■