



Emerging Markets in Transition

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It is a great pleasure to be here this morning for a dialogue on the state of emerging economies and their future prospects. I am also honored to be part of a distinguished panel with valuable policy experience in managing large emerging economies, as well as deep knowledge of their history and challenges.

I hope my presentation will set the stage for a good debate on the prospects and challenges for EMs.



Outline

EM long-term convergence to continue, but...

- **Process can stall or be derailed**
- **Managing transitions requires global cooperation**
- **EMs must also do their part**
 - ✓ **Address vulnerabilities**
 - ✓ **Shift drivers of growth**

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My presentation is organized as follows:

First, I'll present some evidence on the convergence of emerging economies. I'll show that the future of convergence is not guaranteed; that it will depend both on an external environment conducive to growth, and "good" domestic policies and institutions.

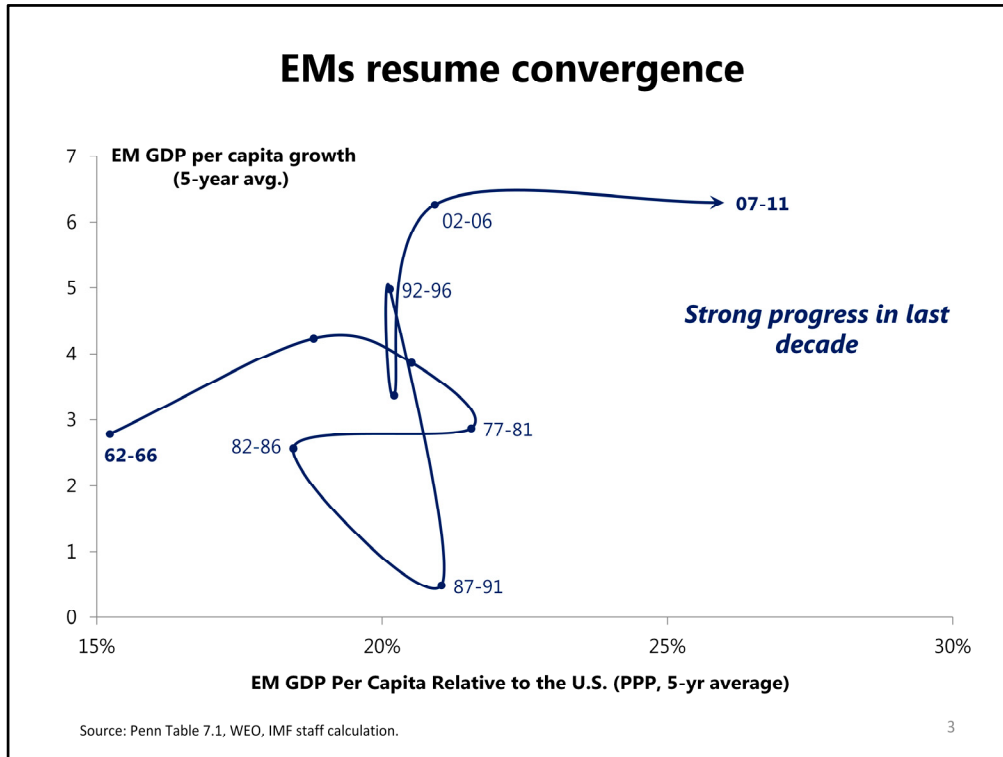
Second, as the Managing Director mentioned last week, the global economy is going through important transitions that need to be properly managed. This will require not only country-specific efforts but also increased policy coordination and cooperation.

One key transition, but not the only one, will be the normalization of monetary policy in advanced economies. Ensuring that this process takes place in an orderly fashion will require careful management, communication and coordination.

Another transition is the reform of the global financial system. While there has been progress in making our financial systems safer, more work is needed, including in areas of derivatives, shadow banking.

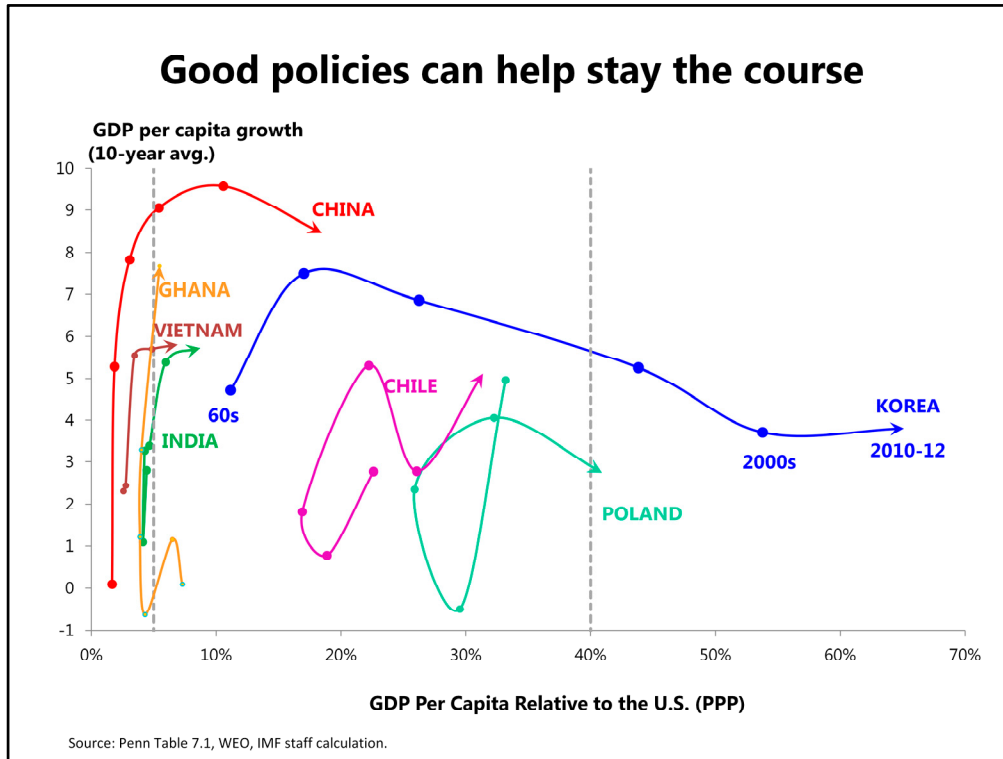
Third, I discuss how these **transitions will pose important challenges for EMs.** Some EMs need to address growing vulnerabilities, to ensure macro stability is not compromised. Others need to shift their drivers of growth. As external conditions become less favorable, they must rely more on structural reforms to rebalance their own economies and boost productivity.

Let me now move to the first issue of EM convergence...



Today's emerging markets are much stronger than in the past, having come a long way since the crises of the 80's and 90's —with stronger policy frameworks, more flexible exchange rates, higher reserves, and lower external debt.

In the chart you can see the interruption of growth and GDP convergence during the 1970s and 1980s; and the rapid growth and strong progress over the last two decades.



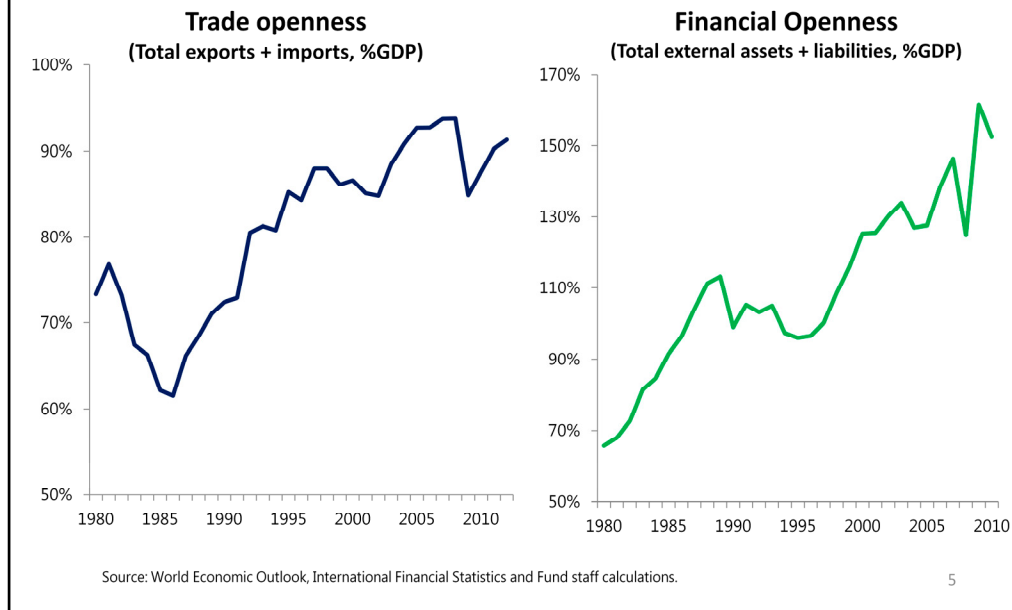
For any given country, the natural trend we would expect to see over a long horizon (and abstracting from shorter-term volatility) is relatively high growth rates at lower income levels propelling convergence (movement to the right) and then growth rate subsiding as income rises.

In the early phase of EM convergence growth rates of 5 percent or above can be sustained. Indeed, a number of EMs have followed this path. Countries tend to grow faster in earlier stages of development, and growth rates settle to lower levels as economies mature.

Countries that have been able to stay the course have been able to do so in part through trade and financial integration, benefiting from supportive global conditions, and by managing domestic economies well, including through good crisis management to shield the economy from adverse shocks.

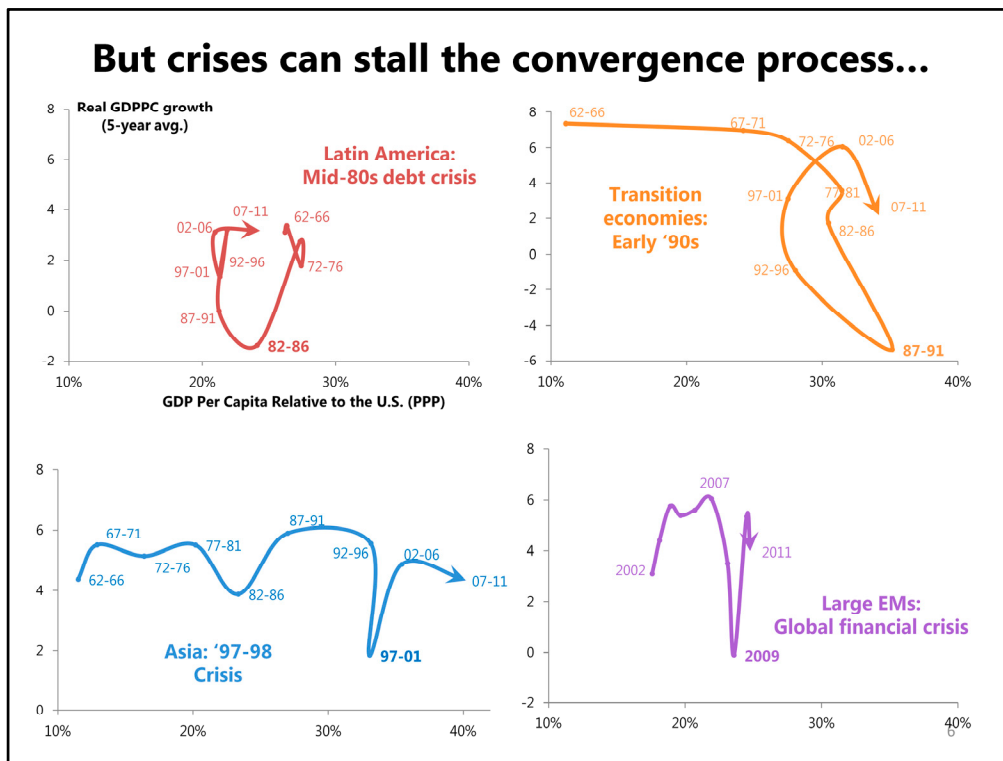
Notes: The lines show decade averages of growth and income per capita in PPP terms relative to the U.S. Each country's chart begins from the 60s, except for Poland which begins with the 70s. The last point is the 2010-11 average. Data source is Penn World Tables (v.7.1). Dotted vertical lines are the 5 and 40 percent thresholds for low-to-middle and middle-to-high income level, respectively.

Trade and financial integration have contributed



On the first point, globalization based on increased trade and financial openness, have broadly supported growth in EMs, mainly in countries that opened while putting in place the needed reforms to ensure that the risks that come with more open economies are well managed.

In fact, the global financial crisis was one strong reminder that “safe” liberalization is key to reaping the benefits from having more open economies.



But not all countries have followed the natural convergence path. Crises or other disruptive events can stall, or worse, derail the convergence process. These crises can be due to global developments, like the global financial crisis was for EMs, or home grown. Either way, they can have lasting effects on economies and development.

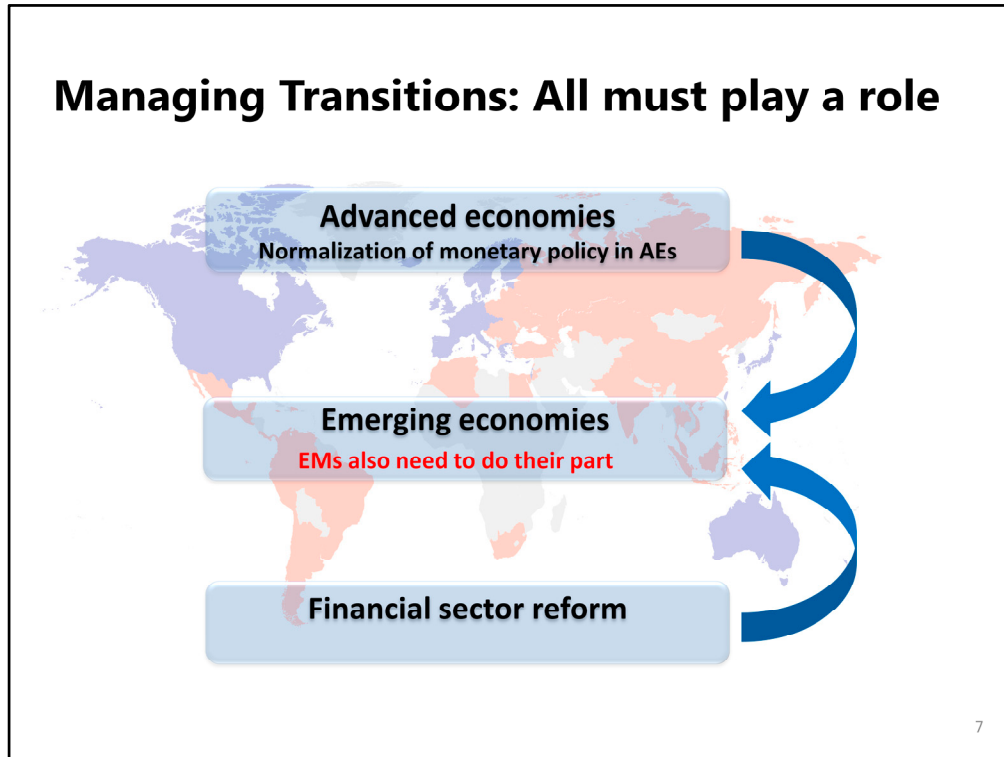
The **debt crisis of the mid-80s** was one of the heaviest crises in terms of winding back the clock of development for Latin American countries. In the upper left chart we see the average income per capita and growth rates of Latin America through the decades. Economic progress before the crisis was not entirely smooth either, but the 80s debt crisis set back development severely, and after several years of sustained growth Latin America is only now getting back to the average income levels it had before.

The **breakup of the Soviet Union** was for Eastern Europe and the CIS a severe shock. As seen in the upper right chart, average growth rates had declined sharply following the breakup of the Union, taking a toll on income convergence. Growth rates bounced back in the mid 1990s, allowing them to recover most of the lost ground in about a decade.

The **Asian crisis** was also a severe crisis with respect to the growth rate, as seen on the bottom left chart. That said, Asian economies managed to recover relatively quickly and broadly continue along the convergence path toward higher income levels.

The **global financial crisis** was even more severe in terms of hurting growth. But strong balance sheets and countercyclical policy response across most EMs helped shape a quick recovery. In fact, except for Eastern Europe, most regions had returned to trend growth by 2010.

Managing Transitions: All must play a role



Although the global outlook remains subdued, prospects of advanced economies are finally improving. This means that **monetary policy in advanced economies will eventually need to gradually normalize**. Ensuring this process remains orderly will require this normalization be implemented in an orderly way, linking it to the pace of recovery and employment. In addition, it will need to be clearly communicated; and conducted in concert with others.

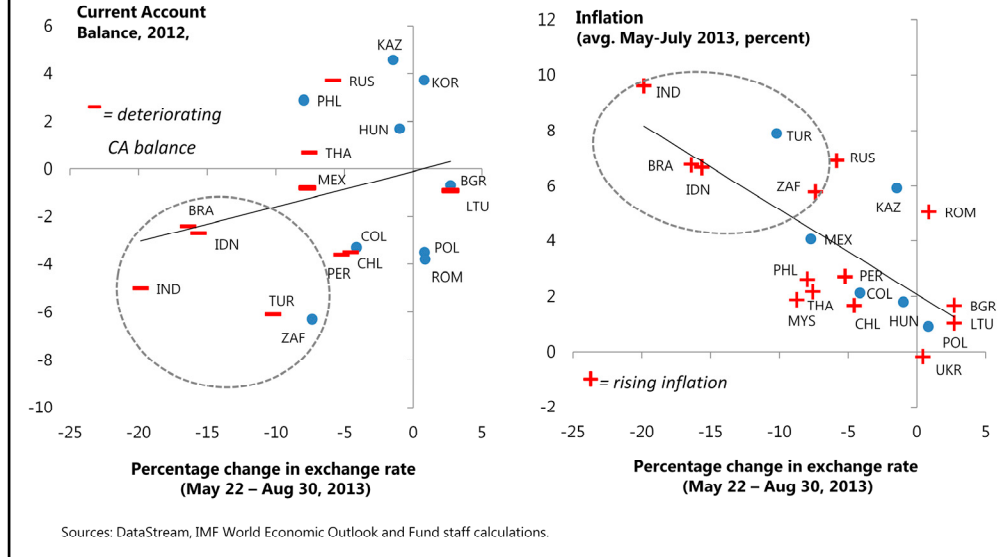
Advanced economies face other challenges as well: The US and Japan need to formulate and implement medium term fiscal consolidation plans to put debt on a sustainable plan; Europe needs to repair financial fragmentation and create improved financial architecture.

The **second fundamental transition** is in the global financial sector, where there has been significant progress in improving capital and liquidity standards, and identifying systemically-important financial institutions. But more work needs to be done. And as the new rules lead to safer bank behavior and less risk taking, we'll need to understand the impact of banks' responses to the new rules on the economy.

All that confronts EMs with a transition of their own. Growth is slowing from the highs of the last decade towards more sustainable levels. I will turn next to discuss how EMs can prepare themselves to react to global developments and manage these transitions they face; As well as how EMs will need to do their part to ensure growth is sustained going forward, and that they stay on a rapid convergence path.

Managing tighter global financial conditions

Markets to discriminate on fundamentals and policies

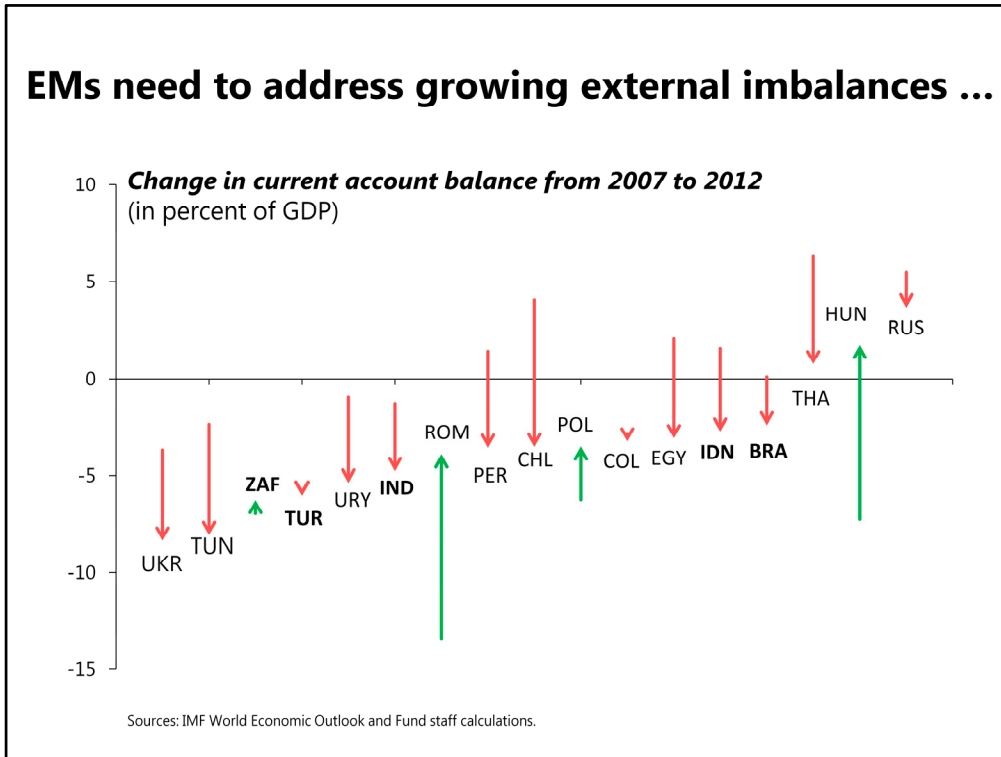


The projected tightening of global financial conditions poses important challenges for EMs. Not least because this transition will likely be accompanied by bouts of financial volatility.

This will require countries to focus on improving their fundamentals and policy frameworks to secure stability. As seen earlier this summer, it was countries with larger vulnerabilities and less credible policies that were more affected by the tapering talk in May.

As the panel on the left shows, countries with larger current account deficits saw their currencies weaken more. Similarly, as shown in the panel on the right, countries with higher inflation and more limited monetary policy space were also more affected by the recent sell off in EMs.

EMs that came under market pressure this summer, need to adjust their macroeconomic policies, as markets will continue to differentiate on the basis of fundamentals and policies. In addition, it will be important to improve policy communication and avoid policy missteps that could exacerbate funding pressures.

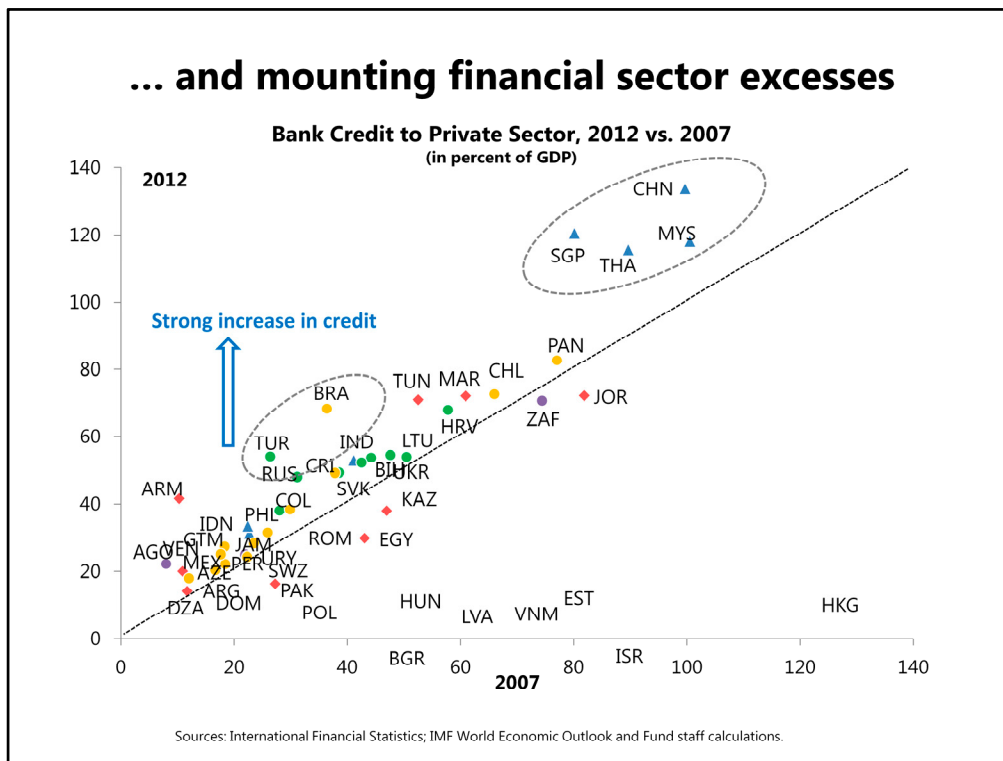


In light of the potential risk of a sudden stop, countries will need to arrest large and growing current account deficits.

On this chart we plot current account deficits in key EMs. The bulk of countries, those with red arrows, have seen a sharp deterioration in their external positions since 2007, and some (like Brazil and Indonesia) have moved from having surpluses to having deficits. Exceptions are a few eastern European countries, those with green arrows, where import compression in the post-crisis period resulted in sharp CA adjustments.

It is also worth noting that in many EMs, an increasing share of the CA deficit is being financed through short-term debt creating flows and not FDI. As a result, these EMs have become increasingly exposed to a sudden stop. Including those with moderate current account deficits, like Brazil and Indonesia.

Reducing these external imbalances will require a combination of tighter fiscal policy, and macro-prudential measures to tame rapid credit growth. The recent depreciation will help some countries: those with overvalued exchange rates.



In addition, many EMs will need to contain the buildup of financial vulnerabilities.

As shown in the chart, bank credit has been growing very rapidly for some time in some Asian countries (like China, Malaysia and Thailand). The same holds true for Brazil and Turkey, although from a lower base.

The problem is accentuated by the fact that an increasing share of the credit in some countries is channeled through unsupervised nonbank entities (shadow banks in China).

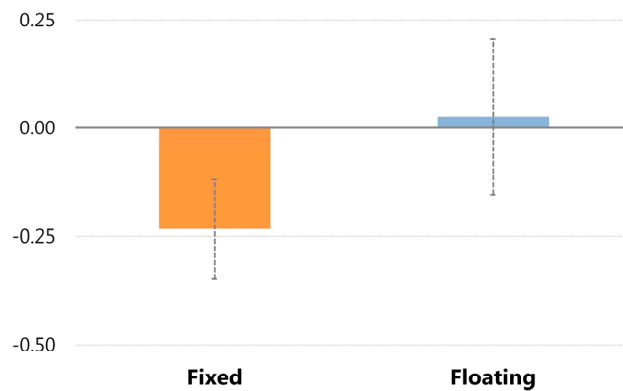
Moreover, corporates are increasingly borrowing directly from the market and in foreign currency. While this is a welcomed development, it also entails risks, particularly if the borrowing is taking place by unhedged firms. A sudden stop could expose these corporates, with potential knock on effects on the financial system. Unfortunately, in many countries, we just don't know enough about the health of corporate and household balance sheets.

Going forward, it will be important to strengthen financial oversight and work to address the above mentioned data gaps. Macroprudential policies may also need to be tightened to contain rapid credit growth in some sectors.

Strong policy frameworks will help

Exchange rate flexibility is key to cushion impact of tightening and volatility

Median growth impact of 100bps increase in LT US interest rates



Sources Fund staff calculations.

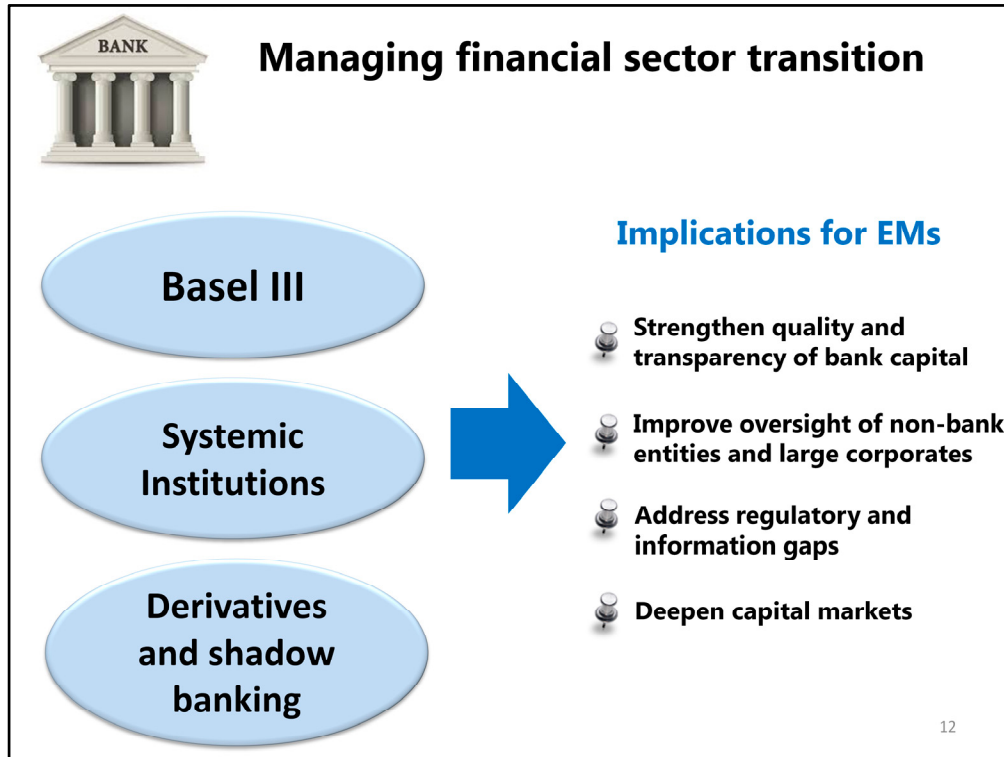
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Tighter financing conditions could also weigh on the growth outlook of many EMs. Just as easy financing conditions boosted investment, credit growth and asset prices in EMs through bank and portfolio flows, and contributed to higher growth, tighter financing conditions could weigh on investment and growth prospects.

However, the impact of tighter financial conditions need not be uniform. While financially open economies will naturally be more affected, the impact can largely be mitigated in countries with strong monetary anchors and flexible exchange rate regimes.

As the chart shows, while growth in countries with fixed exchange rate regimes is projected to fall with a rise in long-term US interest rates (by an average of $\frac{1}{4}$ percentage points over a 5 year for every 100 basis point increase in LT US interest rates), the impact is muted in countries with floating exchange rate regimes. These results are consistent with those in the literature and our previous work on the issue.

Notes: For the median EM, with external assets and liabilities constituting 114 percent, the semi-elasticity of GDP growth w.r.t. real U.S. interest estimated between 0.3 and 0.5. This is in line with literature range of 0.2-0.77 (Reinhart et al. 2001, Frankel and Roubini 2001, di Giovanni and Shambaugh 2006). 2013 Spillover Report (G35-S): 1.2 (short-term reaction). The Fall WEO had a similar result: that the impact was less, and statistically insignificant, for countries with flexible exchange rate regimes.



Moving to the next transition, the reform of the global financial systems will impact financial intermediation trends in EMs. Although the impact of this transition will not be immediate, countries will need to adapt accordingly:

For one, banks in EM countries will need to increase and improve the quality their capital buffers, as well as reduce concentrated lending. These reforms, however, could have the unintended consequence of shifting risk to underregulated markets.

Therefore, improving the oversight of nonbank financials and large corporates will become critical. The growth in lending activities by underregulated shadow banks in China highlights this point.

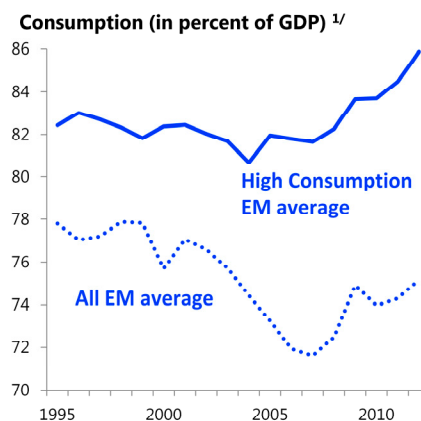
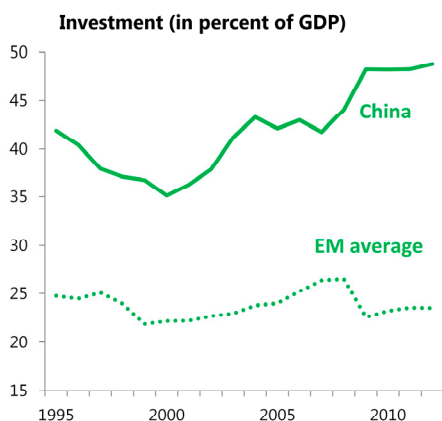
In the same vein, and as mentioned previously, countries will need to address information gaps to ensure the proper measurement of risks. Improving the monitoring of corporate and household balance sheets will be key.

In addition, legal and regulatory frameworks require modernization to ensure the safe deepening of capital markets.

EMs must also secure sustainable growth through internal rebalancing ...

*In some EMs (e.g. China) policies are needed to **reduce reliance on investment**...*

*... in others policies are needed to **reduce reliance on consumption***



Source: IMF World Economic Outlook and Fund staff calculations.

^{1/}High consumption EMs include: BRA, TUR, ZAF, UKR, DOM, TUN, MAR, EGY, CRI, URY, GTM, SVN. Countries with consumption to GDP ratios near 80 percent in 2005.

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Securing stable and sustainable growth requires that some EMs rebalance their economies.

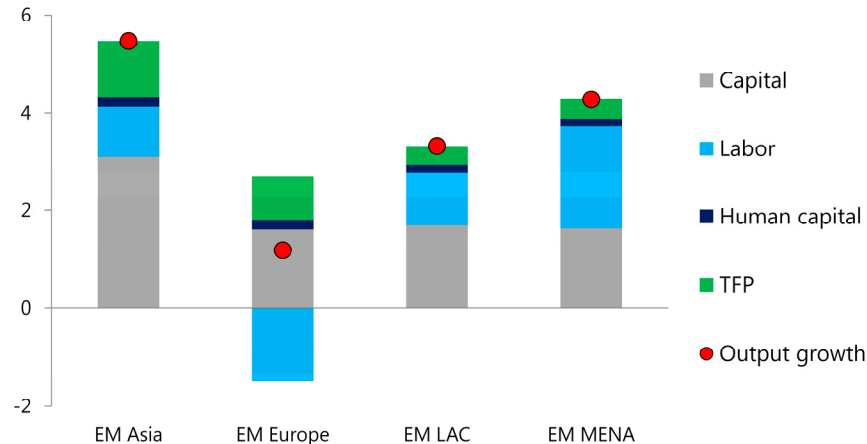
As we have been saying for some time, China needs to rely less on investment to avoid problems down the road.

Others, like Brazil and Turkey, need to do the opposite, and rely less on consumption, and more on domestic savings to finance much needed investment.

... and reforms that enable investment and productivity ...

Emerging Markets: Sources of Output Growth, 1990-2010

(annual average, percent)



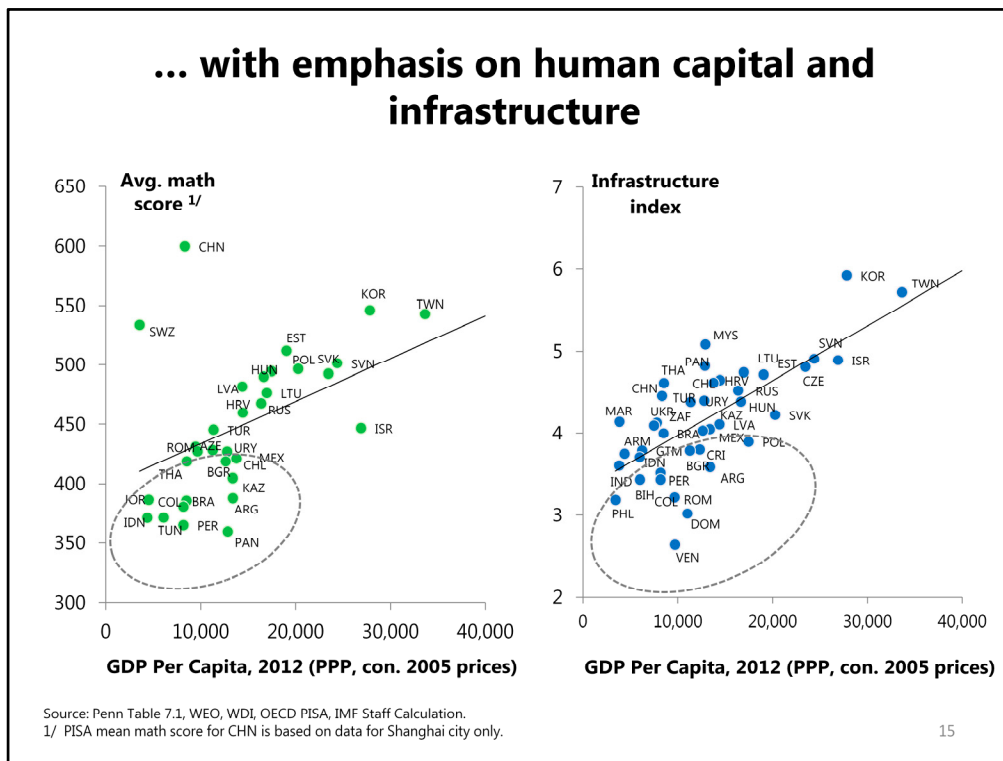
Source: The Conference Board Total Economic Database™, January 2013

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Over the last two decades, growth in emerging markets has been largely based on factor accumulation, particularly capital accumulation. The high investment rates seen in many EMs, supported by their improved growth outlook, financial deepening and lower borrowing costs, have raised capital stocks and boosted growth.

Productivity growth has also played a role, but to a lesser extent. Emerging Asia saw a larger gain in productivity growth than other regions. This is partly because Asian countries have been developing new manufacturing and services sectors. In the early phases of such transformations, productivity gains tend to be high, but diminish as the new sectors mature. Sustaining growth will require that further efforts be made in boosting productivity in all sectors, including services.

At the same time, factor accumulation needs to continue. And even though capital accumulation has been the main driver of growth, more investment in physical and human capital is needed. This investment will also help propel productivity.

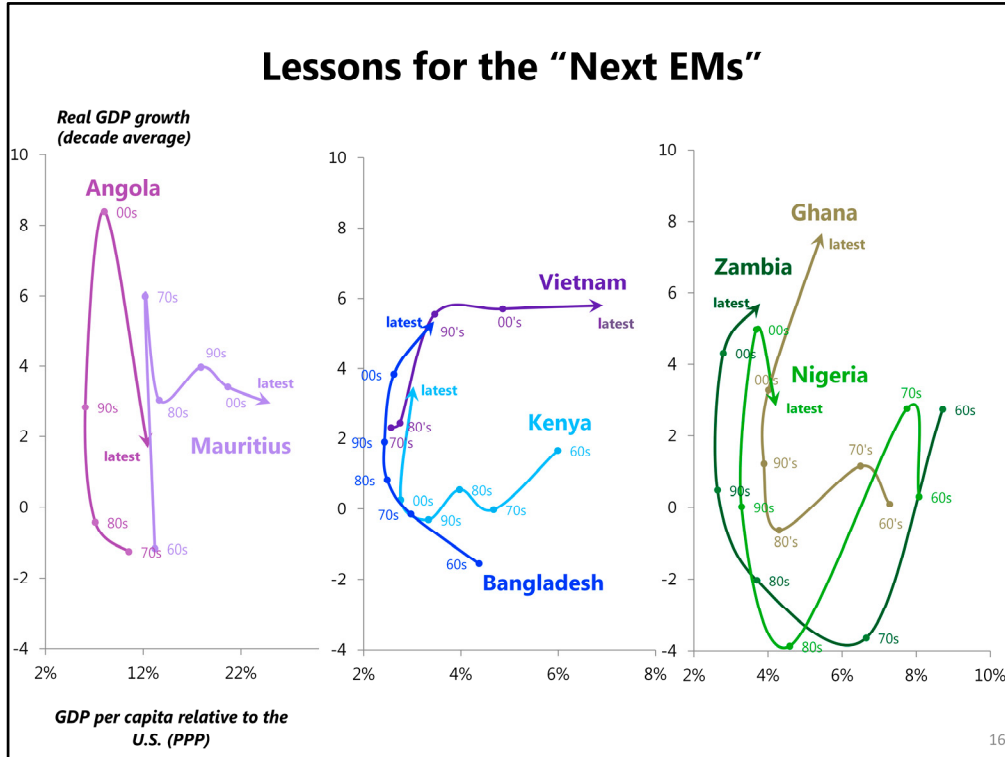


Let us look at the importance of human capital and infrastructure.

The left panel shows average math scores by income level. We can think of this measure as a proxy for in the quality of human capital. As expected, this **quality rises** with income levels. The causality likely goes in both directions – richer countries are able to provide better education, and countries with better education, and therefore higher human capital, become richer. What is more striking about this chart, though, is that a number of EMs, especially in Latin America, are well behind their peers when it comes to providing its citizens with high quality education.

When looking at **infrastructure**, we see similar results. Higher income brings better infrastructure, and many EMs, again mostly from Latin America, are lagging when it comes to building infrastructure.

Why focus on these two indicators? Because improvements in the quality and quantity of human and physical capital not only directly contribute to growth, but also can enhance productivity.



Let me say a few words about the EMs of tomorrow, the frontier LICs. In each panel, you can see how poor performance and back tracking has recently given way to rapid growth the potential for convergence.

Vietnam and Mauritius have been growing fast and for a long period, allowing them to make progress on income convergence.

Others have been able to overcome periods of decline, and the challenge for them now is to continue to make progress on convergence.

The lessons from EMs apply to these Frontier LICs. They need to address vulnerabilities and maintain good domestic policies so that they can ensure sustainable growth and manage the transition to middle income, while the global economy is going through transitions.

Key Messages – Managing the Transition

- 📌 **Convergence is not guaranteed**
- 📌 **Global transitions require cooperation**
 - ✓ Normalization of monetary policy in AEs
 - ✓ Reform of global financial system
- 📌 **Transitions will pose challenges for EMs**
- 📌 **EMs have a role to play**
 - ✓ Address vulnerabilities
 - ✓ Shift drivers of growth

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What are the key takeaways?

First, EM convergence is not guaranteed. Experience shows that this convergence requires a global environment conducive of growth but also strong domestic policies and institutions.

Second, the two major transitions—economic and financial—will require international collaboration. As the MD mentioned, “Mutual help is the best form of self help.” This in turn means that the Fund needs to be more helpful than ever before.

Third, EMs will need to do their part by addressing vulnerabilities, strengthening policy frameworks, but also by engaging in reforms that help to rebalance internal growth and create an environment that enhances investment and productivity.

Thank you.



Thank you