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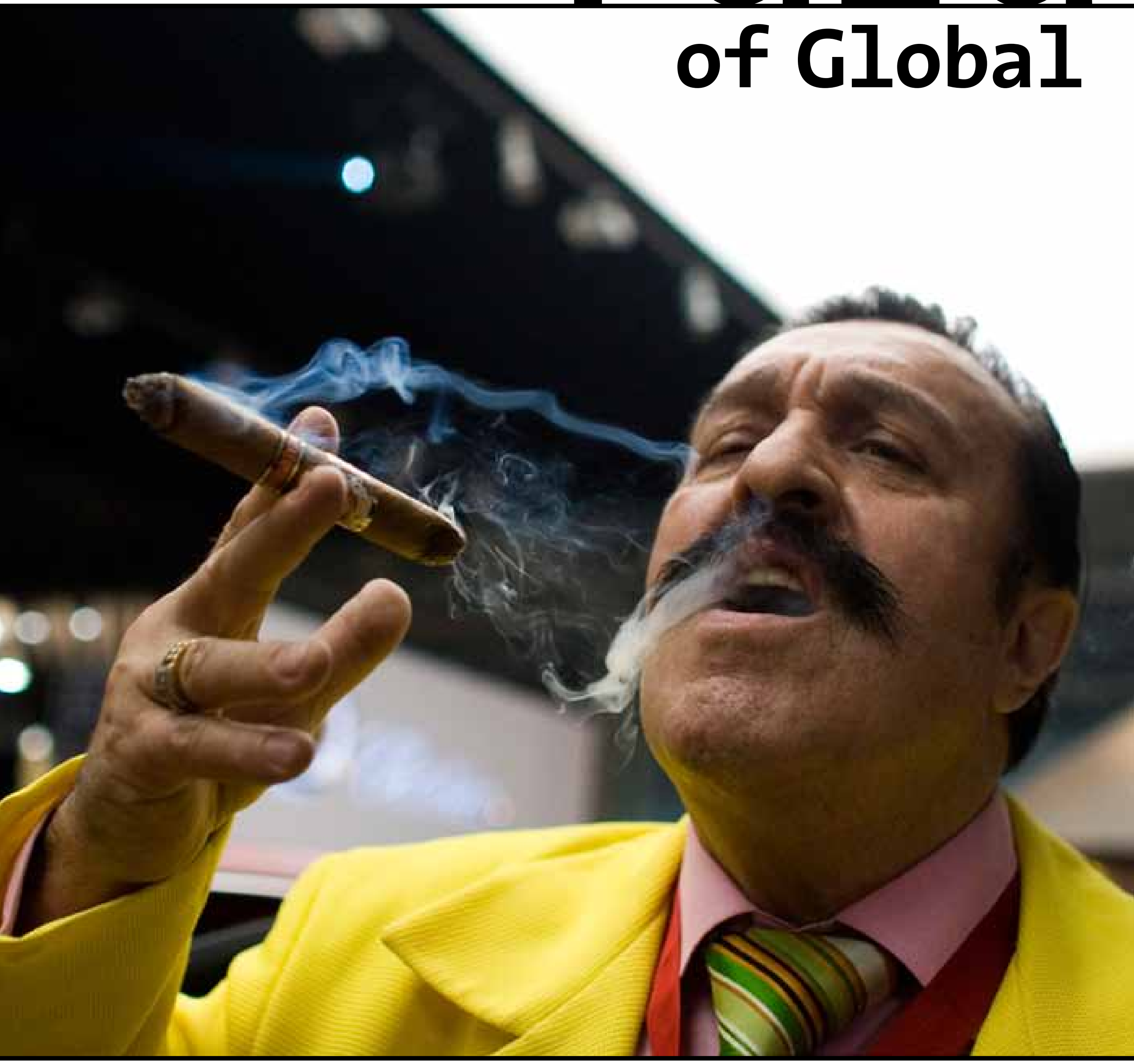

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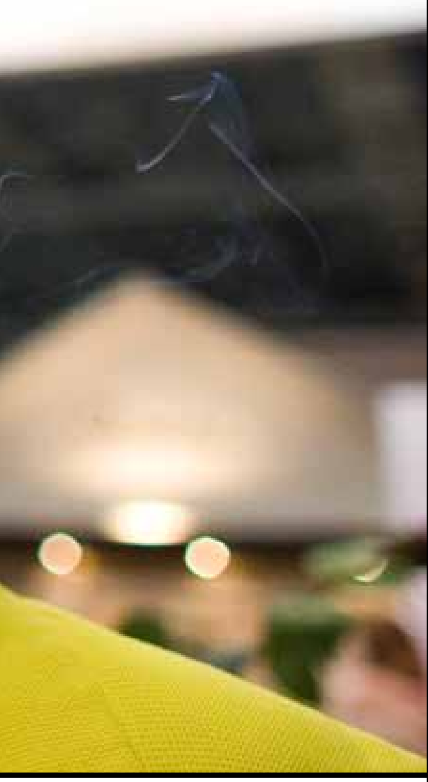
Economic Convergence

BY ÇIĞDEM AKIN



The global economy of the past century was dominated by the United States and Western Europe. When they sneezed, the old joke goes, the rest of the world caught a cold. But that dominance is now being challenged by the rise of rapidly growing emerging market economies. And the shift is changing the dynamics of trade and capital flows in profound ways. Here, I outline the consequences of this evolving world economic order – in particular, how it is decoupling the business cycles of the economies of the North and South while simultaneously tightening other bonds between them that must be managed well to ensure prosperity.

THE PHOENIX RISES

For the purpose of this analysis, it's useful to distinguish among three groups of economies. At one end, are advanced economies: the United States, Canada, Western Europe, Australia, New Zealand and Japan. At the other are the economies of the developing South, some 60 countries that are poor and largely lack the institutional infrastructure for sustained growth. In between are the emerging market economies (EMEs), some two dozen, mostly middle-income countries led by China, India, Russia and Brazil that are plainly on the move. (A few economies, notably Korea and Taiwan, fit awkwardly in the EME category because they have become very rich, but only recently.)

The rise of the EMEs is neatly captured in the changing distribution of world GDP, measured in terms of purchasing power. In the 1960s, the advanced economies generated four-fifths of all goods and services, with the United States alone accounting for one-third of the world's GDP. Since then, however, the share of the advanced economies' output has slipped to about two-thirds, with the output of the United States barely topping one-quarter of the total. Meanwhile, the share of the EMEs has climbed from 17 percent to 31 percent. Since the financial crisis, the advanced economies have dipped further; they now account for just 57 percent of global GDP while EMEs augmented their share to 39 percent. (The developing economies, by contrast, have accounted for 3 to 4 percent of world GDP across the entire period.)

The EMEs' remarkable rise has been driven by extremely high growth rates; their contribution to world growth collectively reached around 40 percent during the globalization period. And just three countries in the EME group – China, India and Brazil – dominate the statistics, no matter how you slice and dice them. In 2008-9, their output constituted 23 percent of world GDP, which was greater than the percentage generated by the original 15 European Union countries and only slightly less than that of the United States. China is the giant among giants, having grown at an average rate of 10 percent annually for the past two decades.

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HOW THEY DID IT

In the traditional North-South paradigm, the developing economies' role was determined by both an abundance of inexpensive labor and the existence of large agricultural sectors supplying raw materials to manufacturers in advanced economies. But as a result of export-driven industrialization, production in the EMEs is now far more diversified. From 1960 to 1972, agriculture in the EMEs represented 22 percent of GDP. From 1986 to 2008, this figure dropped to 12 percent, while the share of industry grew to 34 percent from 28 percent.

EMEs are vaulting past the stage in which cheap labor is everything; they now produce a range of higher-value-added products – everything from petrochemicals to automobiles to electronics – that use highly skilled labor and even some home-grown technology. Along with generating income, diversification into manufacturing and services has served as a buffer against shocks caused by rapid changes in the prices of raw material exports.

Trade links have also changed radically during globalization. Barriers to trade – tariffs and quotas on the one hand, transportation and communication costs on the other – are much lower than they were in the 1960s, opening the EMEs to imported inputs at competitive market costs and facilitating export-led growth. The new openness facilitated the creation of intricate transnational production networks by multinational corporations that has helped to expand intraindustry trade. The components of a new car assembled in Germany or the United States may come

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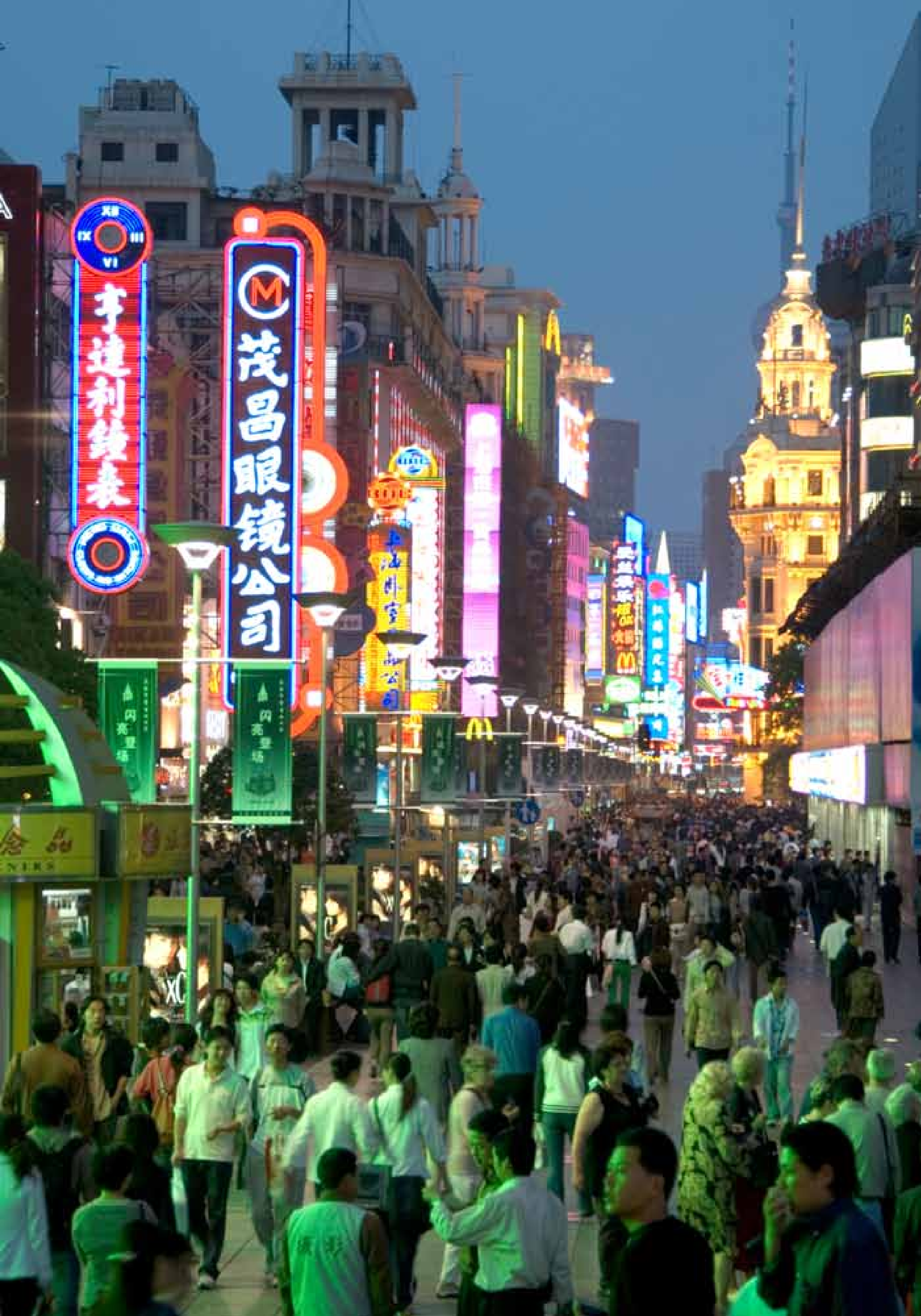
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from a half-dozen other countries, increasing international trade within the auto industry.

Note, too, that the EMEs are trading more among themselves; the share of intragroup trade has increased from 9 percent of total EME trade in 1960 to 35 percent in 2005. And this trend is expected to continue as the EMEs exploit comparative advantages. For example, Brazil, which is rich in resources ranging from iron ore to soybeans, is likely to become a key trade partner for resource-poor China. China has already displaced Germany as Russia's biggest trading partner, thanks to the expansion of oil and gas fields in Siberia.

The privatization of state-owned enterprises, the removal of restrictions on the acquisition of assets by foreigners, the liberalization of domestic banking systems and stock markets, as well as the gradual establishment of liberal capital account regimes have generated a massive growth in capital flows toward the EMEs. These "pull factors," coupled with the "push" from advanced economies seeking higher returns on investments, have helped the EMEs to become more integrated into global financial markets.

During the same period, South-South financial integration has also accelerated. The EMEs have increasingly built financial linkages among themselves and with other developing countries.

Note, too, that the globalization period marked a shift from debt to equity financing. Debt as a share of the gross foreign assets and liabilities of the EMEs decreased from 80 percent to 50 percent; meanwhile, foreign direct investment (FDI) and portfolio equity rose from 13 percent to 40 percent of the total. This has been very important in keeping the emerging market economies on the growth track: FDI typically generates technology transfer and skill spillovers in the host countries, while portfolio equity flows have helped to deepen stock markets. The reduction of debt liabilities has also contributed to macroeconomic stability in the EMEs; debt flows tend to exacerbate the business cycle and are prone to sudden stops, destroying market liquidity when it was needed most.

ECONOMIC INTERDEPENDENCE 2.0

The patterns of connection generated by global integration are more complicated than one might have guessed. My own research with M. Ayhan Kose of the IMF suggests that the synchronization of growth between the advanced economies and the EMEs has declined sharply, even as the advanced economies became more interdependent. In the pre-globalization period, a one percentage point change in GDP growth in the advanced economies led on average to a 0.75 percentage point change in the EMEs. Since then, this interdependence has fallen by more than half: a one percentage point change in the North is now associated with only a 0.34 percent change in the EMEs. (For other developing countries, the growth spillover effects from the North have not been significantly altered.)

This pattern is largely explained by two factors. First, the incidence of shocks that affect the entire global economy have declined since the oil crisis of the 1970s and the spike in interest rates in the early 1980s as the advanced economies struggled to contain inflation. Second, the trend toward integration within the advanced economies and within the EMEs has proceeded more rapidly than intergroup integration. As a result, the business cycles within groups have converged while intergroup ties have weakened or decoupled as economies have begun to resemble those within their own group.

This new reality can best be seen in the performance of the EMEs during the global financial crisis of 2008-9. The EMEs were initially hit by the recession because of the spillover effects from trade and integrated capital markets. As a group, however, they have weathered the crisis far better than the advanced economies and experienced faster, stronger recoveries.

Emerging Asia performed best, with China and India in the vanguard. Latin America, led by Brazil, also did relatively well (though Mexico was heavily hit by a decline of exports to the United States). By the same token, EMEs in Africa and the Middle East got through the recession with minimal loss of GDP, probably because of their relatively modest exposure to trade and financial flows from advanced economies. Only the emerging economies in Europe, which are disproportionately dependent on exports to the euro zone, experienced harsh recessions.

All the commodity-exporting EMEs, it's worth noting, were partially buffered by strong demand from China. China has established itself as the catalyst behind a complex but sophisticated production network that spans Asia, and it is the driving force behind commodity export growth. Indeed, because of China's size and degree of global integration, shocks to its economy now affect the rest of the globe about as much as shocks to the United States economy.

Note, too, that the EMEs are reaping the fruits of prudent macroeconomic policies adopted in the wake of capital market convulsions in the 1990s. After the East Asian crisis in 1997, Asian central banks used current account surpluses and high domestic savings rates to accumulate foreign exchange reserves as rainy day funds. In fact, by 2009, China had amassed more than $2 trillion in reserves. For Brazil, the devaluation of its currency, the real, during the 2008-9 crisis was cushioned by the international reserves accumulated thanks to improvements in terms of trade in earlier periods. As a result, both countries were able to cut taxes, greatly increase government spending and ease monetary policy without spooking global capital markets or raising expectations of inflation.

Last but not least, policies that were designed to deepen capital markets, tighten financial sector regulation and limit foreign bank financing have partially insulated the EME's domestic financial systems and prepared them to better endure shocks from the global capital markets. For example, the successful EMEs in Asia continued to enjoy foreign direct investment and portfolio inflows after 2008 because they were less exposed to the troubled segments of financial markets (think mortgage derivatives) and not at great risk from foreign-currency-denominated external debt.

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Financial prudence extended beyond Asia, moreover. Governments across Latin America had better debt management capabilities in place when the crisis hit. They have used windfall export revenues to balance their books and reduce government debt. They have paid off a lot of foreign currency debt, substituting domestic debt not vulnerable to exchange rate fluctuations. And they have reduced their exposure to interest rate fluctuations by issuing longer maturity fixed-rate bonds.

Most Latin American EMEs now have flexible exchange regimes, which are less vulnerable to shocks. Brazil also put capital controls into effect, preventing capital flight during the crisis.

By contrast, the European EMEs suffered a much harder blow from the one-two punch of the subprime mortgage crisis in 2008 and the sovereign debt crisis in the euro zone in 2010-11. Unlike their counterparts in Asia and Latin America, they were highly dependent on foreign currency financing and have current account deficits that are poorly buffered by foreign exchange reserves. Eastern European countries with fixed exchange rate regimes were exceptionally vulnerable. Their exposure to foreign banks, combined with bubble-like credit expansion in the years preceding the crisis, led to the collapse of the European EMEs once foreign bank financing dried up.

CHANGING PLACES?

Looking at the state of the world economy through the lens of recent economic history, the changes since the 1990s seem incredible. In the 1990s, after all, some EMEs suffered devastating financial crises (in East Asia, Mexico, Russia and Argentina) and had to be rescued by the advanced economies and multilateral lenders. This time around, they remained relatively unscathed in the wake of the meltdown of the financial markets in the United States and the near collapse of the euro zone.

Indeed, the crises have revealed the growing vulnerabilities of the advanced economies, not least of which is ballooning sovereign debt. The IMF estimates that the advanced economies' debt-to-GDP ratio in 2014 will be 36 percentage points above the 2007 level. While the United States is in no immediate danger of being unable to turn over dollar debt, much of southern Europe is in precarious shape in this regard. Consider, too, that because this debt overhang has to be managed through increased taxation and spending cuts, it will probably consign many advanced economies to sluggish growth for decades to come.

This moves the ball to the EMEs' court. In my view, they could play a critical role in stabilizing a badly shaken world economy. First, the EMEs could help to readjust world financial markets by pursuing a gradual, coordinated approach in diversifying their foreign exchange portfolios. In the middle of 2011, official foreign exchange reserves of the top 20 central banks exceeded \$10 trillion – five times what they were in 1997. Accumulation has been particularly rapid in China, Korea, India, Malaysia, Russia, Taiwan and many of the oil-exporting economies.

China (with reserves exceeding \$3 trillion) plans to diversify its holdings and to inch the renminbi into the role of a reserve currency by allowing it to be used to settle trade bills. But managing this transition without creating major disturbances in the international monetary system will be a challenge – especially in the face of ongoing questions about the stability of the dollar and the euro.

Second, the EMEs have considerable leverage in addressing global imbalances in the distribution of savings and investment. One way or another, they must shift their development strategies away from export-led growth and toward expansion fueled by domestic demand. In one sense, this should be easy: middle-class consumers in the EMEs, who are often driven by potent government incentives to save very large fractions of their incomes, have huge unfulfilled demand for goods and services ranging from housing to education to health care to transportation.

Exchange rate policy is the key to an efficient market-driven transition of this sort.

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Allowing currency appreciation would increase the purchasing power of consumers and lower the cost of both imported consumer goods and imported inputs for producers. Exchange rate flexibility would also serve as a buffer against inflation. Indeed, by holding the line on appreciation and dampening consumption, China is asking for trouble in the form of asset bubbles.

A cautionary note here.

Looking forward a decade or more, one might expect a situation in which the advanced countries provide the savings that allow the EMEs to converge in terms of income, even as they give their own citizens more leeway to consume. But slower growth and aging populations in the advanced economies will make it very difficult for them to fill the savings hole left by the transition from export-led growth in the EMEs. So, all told, the combination of ever-growing demand for capital and lower global savings is likely to raise the cost for capital. And that, in turn, will generate conflict between EMEs that are no longer willing to export on credit and advanced economies that are unwilling to live within their means.

This, of course, makes it all the more urgent to tame the growth of consumption in advanced economies. But it should also be a warning to the EMEs that they can no longer allow massive distortions in capital allocation. Because capital will soon be scarce, the EMEs need to work toward promoting the efficient use of domestic savings, even as they tighten oversight of their financial markets.

TAKING THE LEAD

The growth of the EMEs has brought them more power and influence, and thus more nuanced interdependence with advanced economies. But with power ought to come responsibility and pressures within multilateral institutions – notably the UN, IMF, World Trade Organization and less formal settings like the G-20 meetings – for the emerging market economies to think and act beyond narrow self-interest.

There is no shortage of high-priority issues requiring leadership from the EMEs. One is the completion of the current round of reforms under the aegis of the WTO. The EMEs are quite rightly fighting for an end to agricultural subsidies and the way-too-durable remnants of manufacturing quotas (though this will make more of a difference for very poor countries). In return, the advanced economies are seeking to liberalize trade in service sectors, which, looking ahead, could benefit the EMEs greatly in terms of building efficient, globally competitive service industries and facilitating technology transfers.

Another priority is the development of a coordinated macroeconomic strategy that better reflects the increasing importance of emerging market economies. The EMEs' push for a voice and representation at the International Monetary Fund suggests that they are willing to step up. This is a welcome prospect because the chance of restoring stability and growth in the advanced economies depends on coordination with the EMEs.

For example, the Federal Reserve's efforts to fight deflation by massively expanding liquidity is generating destabilizing short-term capital inflows for the EMEs, increasing the risk of real estate and stock market bubbles. Yet the EME's inclination to respond by imposing capital controls is not constructive. Without monetary and exchange-rate policy coordination, it will be all the harder to sustain price stability in the fast-growing EMEs – and all the harder for Europe and the United States to dig their way out of the economic doldrums.

Another area in need of policy coordination is financial regulation. Inconsistent standards and indifferent oversight distort capital flows and increase the prospect of regional financial crises that morph into global crises. The Basel Committee on Banking Supervision (a part of the global Bank for International Settlements) is considering several reforms in these areas. But their efficacy will depend on the willingness of participant nations to share information and delegate authority.

Yet another item for coordination that belongs on the short list: containing the environmental spillover from rapid EME growth. Climate change is, of course, the priority issue here. But there are a variety of other issues to consider, ranging from health standards for traded goods to ocean pollution to sustainable fisheries.

WIN-WIN?

The rise of the EMEs ought to be welcomed by everyone. For the EMEs, it means an end to poverty for billions and the arrival of middle-class amenities that are taken for granted in Europe and America. For the advanced economies, it means better terms of trade as the EMEs provide cheap products and services ranging from rice to flat-screen TVs to medical tourism. But the transition is bound to create dislocation, as economic integration becomes more complicated and the EMEs claim a voice in the process. It's clear that the global economy is changing rapidly. The big question is whether the ability to manage change will keep pace.