Implications of Rapidly Growing Emerging Markets for the World Economy

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It is an honor and a pleasure participating in this conference in honor of Vittorio Corbo. He has been a major contributor to the thinking on economic theory and policy with respect to development as an academic, as a World Bank official, as a consultant, and as Governor of the Banco Central de Chile. I first met Vittorio in connection with a comparative study that was then about to start analyzing foreign trade regimes and economic development. Vittorio's (with Patricio Meller) enthusiasm for the project and his contributions to it—in addition to those needed for the volume on Chile—were truly impressive. We have known each other as friends and colleagues ever since, including the time he spent at the World Bank, at several conferences, and on other occasions. I consider him as a friend and colleague, and cannot adequately express my esteem. All the praise bestowed upon him here is very well deserved.

My assigned topic is the implications for the international economy of the increasing share of the emerging markets. It is fitting as a topic to honor Vittorio both because of his participation in the emergence of these countries and because of his own support for, and contributions to, the multilateral system. Initially, I thought I would start by considering whether the relative importance of emerging markets will continue to increase over the next half-century or century as it has in the past. There are too many cases in the world of countries growing rapidly for a period of time and then gradually sinking back into relatively low-growth status. Argentina, regarded as one of the richest countries in the world around 1900, comes to mind. But even in more recent times, there have

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been many instances of a growth spurt during which optimism about the future abounded, only to be followed by poor performance. Pakistan and the Philippines, each of which was regarded as having much more potential than India, are cases in point. Even those examples pale in comparison to consideration of the sorry state of the economy of Myanmar and of several African countries whose standards of living are below those of a half-century ago.

I do not think we can assume that present trends are guaranteed to continue. The history of economic advance is one in which progress has entailed both advances and new challenges. Those challenges, in turn, must be met if growth is to be sustained. As is all too painfully evident at the present time, the advanced economies themselves must rethink a number of aspects of financial regulation and sovereign debt if they are to resume healthy growth.

But for this talk, however, I will assume that the share of emerging markets will continue to increase, both with above-average growth of those countries already deemed emerging markets, and with the success of some additional countries that are now low income (although it is difficult to say which).

For that rapid growth to persist however, it will require changes in virtually all the dimensions of interdependence between countries that affect trade flows: trade policy itself, capital flows, ideas, international organizations, environment, and migration. I will present the challenges of each of these later, although I will spend most of my time on the first four.

The first question is how smoothly the emerging markets can be integrated into the world trading system as their share of trade and world output increases. To answer that, it is useful to remember how much change has happened in the past half-century, and how it was accommodated. That can give some insight as to the magnitude of changes that can be expected in the future, and their likely impact.

Let me start with trade. In 1950, world exports were US$57 billion, of which industrial countries accounted for US$36 billion. Developing countries' share was 37 percent of total world trade. Over the next two decades (by 1970), their share fell to 22 percent and then rose to 34 percent (primarily because of increases in oil prices) over the next decade before falling to 25 percent in 2000 but rising to 39 percent by 2010. Surely, these numbers conceal a lot: East Asia's share of trade —first Japan and then the so-called "Asian tigers"—was rising after 1960 even as the overall share of developing countries was still falling. Moreover, the composition of emerging and developing countries'

exports has changed with a much higher percentage of manufactured products and a smaller fraction of agricultural commodities.

However, even with those qualifications duly noted, the first observation to be made is that shares have fluctuated considerably across countries and regions while, at the same time, world trade has grown rapidly. Manufactured exports have grown at approximately twice the rate of growth of world GDP.

As such, trade has certainly served as an “engine of growth” of the international economy.

In the late l940s, the United States accounted for almost 30 percent of world exports. By l953, the share had fallen to 21 percent. By 2009, it had fallen to 8.6 percent. What is important to remember is that, during that same time, despite occasional (and deplorable) lapses, the American economy remained fairly open, and tariffs—on manufactures at least—fell from an average of more than 40 percent in the late 1940s to less than 5 percent by the turn of the century.

The ability of emerging markets to access the international market and to open their economies was an important factor enabling their rapid growth. What is less frequently noted is that world markets were increasingly opened during that period by the very countries that were losing share. Surely, there were protectionist pressures, but for the most part, they did not achieve much and trade barriers actually fell in the countries that were losing share (but nonetheless growing fairly rapidly).

When the emerging markets accessed the international economy, they had Europe and Japan as importers, as well as North America. When the next economies begin emerging, they will have all of those areas plus, it is hoped, the currently emerging markets as export destinations. Indeed, if the EMs do not embrace the newcomers, they will be unable to realize their own growth potential and will simultaneously reduce the potential of those countries that have not yet emerged from low-income status.

While Japanese exporters were challenged by those from South Korea and Taiwan, and those from South Korea, Taiwan, Hong Kong and Singapore were challenged by new entrants, especially including China and India, a crucial part of the growth process has been the shifting from lower to higher value-added activities. As comparative advantage has changed, the more advanced economies have shifted away from unskilled labor-intensive activities toward things that use their accumulated human and physical capital. The same now seems

to be starting as Chinese wages rise and factories are beginning to shift to Vietnam, Indonesia, and elsewhere.

If countries are unwilling to contemplate such shifts, they will not only thwart their own growth but that of the remaining low-income countries. Because there are always frictions in such shifts, the role of the World Trade Organization will be more important than ever. But, as I shall discuss below, with the increased importance of the emerging markets, they will need to play a more active and constructive role in the WTO (and other international organizations) than they have in the past, recognizing their stake in a healthy, well-functioning WTO and not only their own short-term self interest.

Capital flows are a second major facet of the international economy. The world economy cannot become increasingly integrated without fairly open capital markets. Capital controls cannot be very binding without beginning to affect trade because there are too many ways in which trade invoices can be adjusted, and the authorities take some time to approve "legitimate" trade transactions.

The challenges of maintaining a sufficiently open international capital market to support world economic growth and simultaneously achieve a regulatory and supervisory framework to strengthen financial stability are daunting. All countries have an interest in finding the appropriate framework, and there are clearly international dimensions: any country that significantly tightens its regulatory and supervisory standards on its own may well find that its financial institutions are at a disadvantage in international competition. There are also issues of cross-border ownership, supervision, and responsibilities for overseas branches and subsidiaries, and much more.

Before concluding that any tightening of supervision and regulation is desirable, it should be borne in mind that the financial system plays a crucial role in any modern, growing economy. Enabling savers' resources to finance the appropriate array of risk-adjusted assets is central to economic growth; many poor countries initially have very low saving rates and need to access international markets in order to raise their investment rates once appropriate macro and microeconomic policies are in place. It is often forgotten that South Korea's net capital inflow averaged around 10 percent of GDP during its first decade of very rapid growth. Its saving rate in 1960 was close to zero; it rose rapidly with growth. But that growth needed financing in its early stages. Interestingly, most of the capital inflow was in the form of debt obligations assumed by the government, but the debt-to-GDP ratio did not rise because growth was sufficiently rapid.

Appropriate changes to oversight of the international financial system are needed and will happen, but it is crucial for the prospects of those countries not yet embarked on rapid growth that they be able to access international capital markets when there are high risk-adjusted return opportunities. Benefits of open capital markets to the emerging markets themselves should not be underestimated.

There are also issues surrounding the possibility of discriminatory capital flows as has already happened in some of the Free Trade Agreements (FTAs). It would be much in the interest of emerging markets to support enhanced purview over capital flows in the multilateral system. It is difficult to envision the consequences of a world economy with truly discriminatory capital control regimes as envisaged in some free trade agreements.

The third area is ideas. It is seldom listed as one of the key ways in which countries are interdependent, yet it is striking how rapidly ideas spread across national borders. Ideas such as inflation targeting are transmitted among countries very quickly and affect policies in many countries. One of the areas where, in my judgment, emerging markets have yet to contribute sufficiently is in the realm of ideas. Too often, contributions to op-ed pages, policy and academic journals, and other fora, have consisted of critiques of the international economic system with little by way of constructive alternatives.

It may be (possibly legitimately) objected to that the industrial countries' influence has been so great that contributions from policy makers, academics, and others in developing countries would have been or were ignored. But even so, as the relative importance of emerging markets in the international economy increases, the world will need a greater participation from emerging markets. It needs to take two forms: new ideas, but also effective communication of the role and interests of emerging markets. To take but one example of the latter, it is striking how often most Americans view most emerging markets as having "graduated," while most in emerging markets view their countries as still struggling to achieve that status. Even with respect to new ideas, the media representation of spokesmen from emerging markets is relatively sparse.

This brings me to the fourth concern: international organizations. Arguably, small countries have a much greater interest in the ability of international organizations to oversee trade, capital flows, and much more, than the large countries do. Yet, from World War II until the end of the century, the industrial countries not only took the lead in the multilateral organizations but were also, generally, their

strongest supporters. Emerging markets and the least developed countries have taken international organizations as given, and been free riders without much regard for the preservation or strengthening of the system as a whole.

When the industrial countries accounted for two thirds or more of world trade and capital flows, a relatively small group of countries could, for all practical purposes, lead those organizations. Moreover, most of the then developing countries generally opted out. They did not actively negotiate tariff reductions and the removal of quantitative restrictions under the GATT/WTO but instead used the balance of payments provisions of the GATT to maintain their inner-oriented regimes. They benefitted enormously from the growing international market and from the reductions of trade barriers among industrial countries (which were done on an Most-Favored Nation basis).

They were generally recipients of IMF support when balance of payments crises arose and, as such, were perhaps not in much of a position then to play a leadership role. Their chief contribution in the realm of policy dialogue was to criticize the status quo rather than to develop feasible constructive proposals for strengthening the system in a manner consistent with their interests.

That has now changed in two important ways. On one hand, the advanced countries no longer hold a dominant share in the international economy. Whether discussing trade, behavior of reserves, or capital flows; emerging markets are important players and the multilateral institutions cannot function effectively without their increased participation and support. On the other hand, emerging markets bear a strong responsibility for assuming a highly supportive role for multilateral solutions and governance.

To date, there has been little more than lip service to the Doha Round as emerging markets have either objected to aspects of possible deals or have been silent. Yet its completion is urgent, even more so in the interests of emerging markets than low-income countries and advanced countries. More generally, emerging markets need to take much more responsibility for protection and support of the open multilateral system.

A number of new issues—preferential trade arrangements, discriminatory capital flows, and the environment—must be addressed. Yet, as long as the Doha Round is not completed, the legitimacy of the WTO is undermined and it does not seem possible to address the new issues. As more and more policy makers give up on the possibility of a successful conclusion of Doha, there is an increasing resort to FTAs. Within a multilateral framework (which should be strengthened),

increased FTAs can be a step toward more open multilateral trade and addressing the new issues. But without that framework, which languishes with the passage of time and no Doha agreement, there are significant risks of economic and political differences emerging from FTAs. Yet the voice of the emerging markets urging the closure of Doha is little heard. Worse yet, NGOs' support of emerging markets and least developed countries continue to believe that open trade is not in the interests of those countries, and there is almost no pushback from policy makers and academics from there.

The last two items, migration and the environment, are also key issues for emerging markets, and other countries. In the case of migration, it is difficult to foresee any significant relaxation of the existing national regimes in the near future. Within the WTO, it should be possible to negotiate temporary work visas for construction and other services, but that awaits the conclusion of the Doha Round. Beyond that, one has to hope that when the rate of world economic growth picks up, the current political climate of hostility toward migration will diminish. Indeed, at least in the United States, there are already signs that some are beginning to recognize the benefits of immigration. With concerns about aging populations and increased ratios of dependents to working-age population, it is likely that stances will soften and perhaps reverse, but for now it is likely that there will be no multilateral regime and no significant changes in the status quo with regard to international migration. But voices from emerging markets could support progress and improved policies on these issues, even if the likelihood of achieving a Pareto-optimal regime is small.

Issues concerning the environment are much more divisive than issues concerning trade and capital flows between emerging markets and advanced economies. Certainly, conflicts between those viewing the stock of pollutants as the basis on which policy should be made and those regarding the flows of emissions being critical and in the interests of all must somehow be resolved. I have little to say about that, except to say that the emerging markets bear responsibility for participating in dialogue and helping reach workable arrangements.

However, in that resolution, there are dangers for the trading system and the international monetary system. It is all too easy for producers in any country to claim that their costs are higher because of environmental taxes or regulations. Sometimes they may be telling the whole truth, but it is tempting to use the environment as a basis for achieving competitive advantage. Some surely do so. It will be important for the global economy that environmental agreements are

reached that avoid enabling the emergence or reemergence of strong protectionist pressures. While environmental issues must surely be addressed, it would be a tragedy if that happened in a way that enabled a reversal of the integration of the international economy, the gains in living standards, and reductions in poverty that that has accomplished. Again, constructive voices and ideas from emerging markets are needed more than ever to assure that environmental objectives can be achieved without undermining the open multilateral trading system.

Let me try to summarize. Forecasts for the future are always hazardous and it is by no means assured that the international economy and individual countries will progress as they did in the past. But the past sixty years have witnessed rising life expectancies, literacy rates, nutrition standards, and other aspects of well-being unprecedented in history. With appropriate policies, these gains can be entrenched while those still left out can be brought into the prosperous world, and emerging markets can achieve further gains.

One forecast puts the share of developing and emerging economies in world trade rising from less than 30 percent in 2006, to just over 70 percent in 2050, while advanced economies' share falls in like amounts. Of that increase, much is expected to come from the very large emerging markets. Trade among emerging markets will increase and the emerging markets will become much larger trading partners of the now poor countries.

With that increase, the role of emerging markets in the international economy and in multilateral institutions must grow. The emerging markets need to take on a larger role and heightened responsibility for the maintenance and preservation of an open multilateral trading system as a whole, a well-functioning international financial system, and even preservation of the environment.

Much has been said to the effect that the emerging markets deserve more representation at the multilateral institutions. That is surely so. But the low-income and advanced countries deserve more support from emerging market countries for preservation and strengthening of multilateral institutions. The advanced countries may have looked after their self-interest disproportionately over the past half-century, but they did maintain the open multilateral trading system with little support from emerging markets, and liberalized their own trade policies enabling the acceleration of growth in emerging markets. Emerging markets can no longer play the *free riders*' role on the system, and need to look not only at their narrow self-interest but also at their interest in the effective functioning of the multilateral system as a whole.