

Foreword

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THE YEAR 2007 WILL PROBABLY BE REMEMBERED AS A LANDMARK YEAR FOR EMERGING MARKETS. AS A GROUP, THESE ECONOMIES ACCOUNTED FOR MORE THAN TWO-THIRDS OF GLOBAL GROWTH IN 2007, AND, FOR THE FIRST TIME IN MODERN HISTORY, CHINA, THE LEADING EMERGING ECONOMY, CONTRIBUTED MORE TO GLOBAL GROWTH THAN THE US. THE VOLUME OF NET PRIVATE FINANCIAL FLOWS TO THESE COUNTRIES ALSO REACHED RECORD-HIGH LEVELS. RELATED, 2007 WITNESSED AN INTENSIVE DEBATE WHETHER EMERGING MARKETS COULD DECOUPLE FROM A SLOWING US AND SUSTAIN THEIR ROBUST GROWTH. SUCH A DEBATE WAS UNIMAGINABLE NOT LONG AGO CONSIDERING THE HISTORY OF FREQUENT FINANCIAL CRISES IN MANY OF THESE COUNTRIES.

While 2007 may be especially memorable, emerging markets have already been going through some profound structural changes over the past two decades. These changes have transformed the nature of linkages between industrial countries and emerging markets and made many emerging markets more resilient to cyclical fluctuations in industrial countries. What types of structural changes have emerging markets been going through during the past two decades? And what are the implications of these changes for the recent debates about decoupling? To address these questions, this foreword first briefly reviews these structural changes. It then analyses the potential effects of a US slowdown for emerging markets in light of these changes as well as lessons from previous slowdown episodes.

New engines of global growth

Mainly driven by emerging markets, the world has seen a dramatic shift in the distribution of countries' economic sizes over the past two decades.² During the period 1960–1985, industrial economies on average constituted more than 70% of world output while the share of emerging markets was roughly 25%. However, during the past two decades, the average share of emerging markets increased to roughly 35%, while industrial economies' share decreased to nearly 60%. This change reflects the vibrant growth in emerging markets, with their average growth rate more than two times that of industrial countries over the same period.

On the back of these developments, emerging markets today contribute prominently to global growth. During the past two decades, the average contribution of emerging

markets to global growth rose to more than 50%, exceeding that of industrial countries (45%). This is a true sea change compared the 1960s when industrial countries accounted for 74% of global growth, but emerging markets only for 22%.³

Substantial changes in sectoral structure and growth of trade flows

Rapid economic growth in emerging markets has been driven by large changes in their sectoral structures and trade linkages with the global economy. Many emerging markets have pursued aggressive industrialisation policies based on export-led growth strategies over the last two decades, accompanied by substantial reallocation of resources from agriculture to industry and services. Owing to these changes, the average growth of exports from emerging markets was twice that of industrial countries. And trade openness for emerging markets, measured by the ratio of total international trade to GDP, rose from less than 30% to almost 80%.

Emerging markets' increased trade linkages have also led to seismic shifts in the direction of global trade flows. While industrial countries remain the dominant destination of global trade flows, the share of total world trade directed towards emerging markets has significantly increased over the past two decades, from less than 15% to more than 25%. Emerging markets are now an important market for industrial countries, increasing their share from 13% of the total trade of the latter group to more than 20%. Moreover, the intensity of intra- and cross-group trade linkages between emerging markets and industrial countries has changed. For example, intra-group trade as a share of total trade of emerging markets has nearly doubled since the mid-1980s. Over the same period, the share of their trade with industrial economies has declined from roughly 70% to 50%.

Dramatic growth of financial flows

International financial flows have grown much faster than trade flows in the last 20 years. While the level of financial integration is much higher for industrial economies, emerging markets have registered substantial increases.

The gross stock of assets and liabilities of emerging markets has seen a more than fivefold increase since the mid-1980s and is now an order of magnitude larger than that of other developing countries.

The composition of financial inflows to emerging markets has also changed. In particular, debt as a share of gross stocks of foreign assets and liabilities of emerging markets has declined from 80% to 50%, while the share of foreign direct investment (FDI) and portfolio equity has risen from a total of 13% to 40%. This shift in composition away from riskier debt flows to more stable FDI and portfolio equity flows, has reduced some of the chronic vulnerabilities of these economies associated with the sudden stops of foreign inflows.

Financial linkages among emerging markets and other developing countries have also been getting stronger. FDI flows between these two groups of countries have increased by threefold over the past decade, and the share of emerging markets in total FDI flows to other developing countries has risen more than twofold. These flows have mainly been concentrated in services, with banks from emerging markets now penetrating markets of other developing countries, and extractive industries.

Strengthened macro policy frameworks

Although the recent wave of financial flows sweeping through many emerging market economies has been associated with favourable global economic conditions, in many cases it reflects strengthened domestic policy frameworks. In particular, a number of emerging market economies have improved their external debt positions, achieved better fiscal outcomes and maintained flexible exchange rates. In addition, many emerging markets have strengthened their banking systems, including through foreign bank entry, revamped their corporate governance frameworks, and enhanced the quality of their capital markets.

The recent wave of foreign inflows also differs from the one in the nineties which ended abruptly with financial crises in some emerging markets. In particular, the recent wave has

taken place in the context of much stronger current account positions for most (but not all) emerging market countries and substantial accumulation of foreign reserves. Moreover, the recent surge in financial inflows has been accompanied by a sharp increase in outflows.

Changing nature of global linkages

The conventional wisdom has characterised the linkages between industrial economies and developing countries as forms of unidirectional dependence. This view implied that growth fluctuations in emerging markets were determined primarily by developments in industrial economies, but no such linkages vice-versa existed. The asymmetry in relations between these two groups was argued to arise from the fact that developing economies were considered a homogenous group specialising in the production and export of a narrow range of primary commodities, while industrial economies were considered the main producers of manufacturing goods.

However, the structural changes documented above suggest that the old conventional wisdom of asymmetric interactions between these two groups might not be relevant anymore. For one, the group of developing economies is no longer homogenous. In particular, emerging market countries have diversified their economies, attained much higher growth rates, and increasingly become important players in the global economy. As a result, the nature of economic interactions between industrial economies and emerging markets has evolved from one of dependence, to multidimensional interdependence. And while some emerging markets and other developing countries still match closely the old paradigm of producing and exporting a narrow range of primary commodities, they have benefited in recent years from sharply higher commodity prices, allowing them to increase their imports, and, in some cases, to become large exporters of capital.

This structural transformation has also been associated with changes in the nature of global growth linkages. Growth fluctuations within the groups of industrial and emerging market countries have become more closely

“The world is experiencing one of the biggest revolutions in history, as economic power shifts from the developed world to China and other emerging giants.”

The Economist, November 15, 2007

correlated over time, implying stronger intra-group growth spillovers. At the same time, and perhaps surprisingly, growth fluctuations across these groups have been less correlated, suggesting economic activity in emerging markets has started to diverge from that in industrial countries.⁴ Consistent with these changes, both industrial and emerging market economies have started to exhibit more intensive intra-group growth spillovers over the past two decades and the average impact of industrial countries' growth on the performance of emerging markets has declined.

Implications for decoupling

There has been a vigorous debate, starting in early 2007, about the ability of emerging market economies to decouple from a potential recession in the US. On the one hand, the conventional wisdom suggests that the fortunes of emerging markets depend on developments in large industrial countries, and that globalisation has only increased such cross-border economic interdependence. On the other hand, in light of the impressive growth performance of a number of emerging markets in recent years, a different perspective has surfaced, suggesting that emerging markets have become independent drivers of global growth. In this view, emerging markets, particularly large ones like China and India, have been able to decouple from the business cycle fluctuations in the US and other industrial economies.

The changes documented above suggest that business cycle dynamics in emerging markets are no longer as tightly linked to industrial country business cycles. Because of structural changes, the nature of interactions between emerging markets and industrial countries has become

more diverse, the relationships between the two groups more symmetric and interdependent, and the size of growth spillovers from industrial countries to emerging markets less since the mid-1980s.

However, these findings should not be interpreted as a blanket endorsement of the decoupling view. First, the secular changes documented above apply to a large set of industrial countries, not just the US. Second, the growth interactions analysed here mainly focus on real economic linkages, but leave out financial ones. In other words, these findings do not speak to the possibility of financial decoupling (or lack thereof). The global turmoil in financial markets in the last half year has clearly shown that, in an age of closely linked financial markets, it is highly unlikely to see a prolonged period of financial decoupling.

Moreover, the decoupling potential of emerging markets heavily depends on the duration and severity of a US downturn. Past episodes of business cycles suggest that a deep and protracted US recession can have relatively larger spillovers than a mild and short one. Since 1970, the US has experienced five recessions and two midcycle slowdowns.⁵ Past US recessions have often been accompanied by declining growth rates in most other countries. In industrial countries, growth rates have, on average, decreased by two percentage points, roughly half of the US average decline in growth.

Emerging market economies have also been adversely affected by past US recessions, but the impact of previous slowdowns has been minor. Among emerging market economies, those of Latin America have tended to experience the largest declines in growth, with median growth declines of 1.7% during US recessions. Growth in Asia has also tended to decline during US recessions, while the impact on growth in Africa and the Middle East has been fairly small. The two mid-cycle growth slowdowns (in 1986 and 1995) were associated with negligible slowdowns elsewhere. The median growth decline in industrial

countries was 0.1%, while median growth in emerging market economies actually increased slightly.

Emerging markets might well experience a new era of stable growth, but this does not necessarily generalise to all emerging markets, since they are far from a homogenous group. Although the structural changes documented above suggest that emerging markets as a group are now probably more resilient to adverse developments in the US and other industrial countries than ever before, it is useful to remember the substantial differences among emerging markets. One important lesson of past US recessions is the significant variation in growth performance across emerging markets during these episodes. A global slowdown triggered by developments in the US, along with a sudden deterioration in global liquidity conditions, could have adverse implications for emerging markets with large current account imbalances. Ultimately, the question of how a US recession could affect a particular emerging market would depend on a broad set of factors including its initial conditions, economic vulnerabilities and policy responses.

Notes:

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2. The stylised facts about the structural changes reported here are based on a partial list of emerging markets in the MSCI Emerging Markets Index. The main differences are that the transition economies are excluded because of limited data availability; and Hong Kong SAR, Singapore and Venezuela are included.
3. For an extensive review of these structural changes, see C. Akin and M. A. Kose, 2008, 'Changing Nature of North-South Linkages: Stylized Facts and Explanations', *Journal of Asian Economics*, vol: 19, 1-28.
4. For a discussion of these changes, see M. A. Kose, C. Otrok and E. Prasad, 2008, 'Global Business Cycles: Convergence or Decoupling', Forthcoming, IMF Working Paper Series.
5. For the implications of past US recessions and slowdowns, see International Monetary Fund, 2007, 'Decoupling the Train: Spillovers and Cycles in the Global Economy', *World Economic Outlook*, April, 121-160.