

## **Erkki Liikanen: Southern engines of global growth – China, India, Brazil and South Africa**

Opening remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the UNU-WIDER Conference, Helsinki, 7 September 2007.

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### **Introduction**

Thank you for your kind introduction Professor Shorrocks, and good morning, Ladies and Gentlemen,

It is a great pleasure for me to be here to open this conference on Southern Engines of Global Growth.

China, India, Brazil and South Africa – together with many other emerging market countries – are playing an increasingly important role in the global economy. Their growing importance is being felt in many areas, including growth, trade, international finance, global governance, and geopolitics.

As a backdrop, let me say first just a few words about the global economy. The ongoing global economic expansion is exceptionally broad in terms of geography. The strong growth in emerging market and developing countries is reducing the number of people living in extreme poverty, and the gap between average incomes of developing and developed countries is narrowing. These positive developments are clearly visible even for a casual observer, as I had the chance to witness earlier this year when I was traveling in Sub-Saharan Africa and Latin America.

However, despite these very favorable developments, there is no room for complacency.

The extended period of rapid global growth has resulted in a build up of some tensions which, if left unaddressed, pose a threat to continued global growth in the longer term. One source of concern is global current account imbalances and the risk of their abrupt and disorderly unwinding. Another source of concern is the uneven distribution of benefits of globalization within countries, which risks eroding support for globalization.

These two concerns are closely linked to the rapid rise of emerging market countries.

### **Growth and trade**

As a small northern country with high per capita income, Finland is quite different from the CIBS-countries that are all large, southern, and still relatively poor. Nevertheless, some of the factors behind Finland's transformation from a poor agrarian economy to a modern advanced economy bear relevance to the current challenges of the CIBS, or any other country that seeks to put in place conditions for sustained economic growth.

First is a proactive attitude toward the internationalization of the economy, importantly through foreign trade.

Second is the importance of sound macroeconomic policies. That is, sound money, sustainable government finances and sustainable external position.

Third is a stable institutional environment in which contracts can be enforced and property rights can be established.

In all these areas, the CIBS have made significant, albeit uneven, progress. But much more remains to be done. Moreover, these preconditions for growth alone cannot guarantee growth in the longer term.

In the longer run, a country's economic performance is increasingly determined by how well it can harness its human potential. Therefore, a key challenge for the CIBS will be to ensure that all people have a reasonable chance to fulfill their potential and aspirations.

I emphasize here equality of opportunity. It implies that individuals are not excluded from education, health care or employment on the basis of immutable traits. Equality of opportunity is about making the playing field more level, but it does not, and even should not, guarantee equality of outcome.

The most pressing problems arising from inequality vary greatly between different CIBS-countries, but they are formidable in all of them. China has the widening gap between its booming cities and stagnant rural areas, India's potential is constrained by the rigidity of the caste system, Brazil suffers from very wide and deeply entrenched inequality, and South Africa is yet to rid itself fully from the negative legacy of apartheid.

These are extremely complex problems and their remedies will need to take into account many culture specific aspects. However, there seem to be some factors that have universal relevance. One such is the crucial importance of education as a means of ensuring better equality of opportunity and securing sustainable economic growth.

Equality in terms of gender, region, and social-economic background has been a long-standing guiding principle of Finland's education system. Compulsory basic education was one of the first reforms implemented after Finland became independent 90 years ago. In the 1970s, implementation of the comprehensive school, together with other reforms, further improved equality in opportunity to pursue education.

Educated labor force is a pre-requisite for innovation and to the capacity to absorb new technology, and thereby it fosters economic growth. This shows that – even in the face of globalization – an economic model that emphasizes equal access to education, can be a source of strength rather than an impediment to economic growth.

I would also like to make a couple of remarks about growth and trade from a central banker's perspective.

The increased role of the EMEs in global growth and trade pose interesting challenges for central bankers. In particular, the increasing weight of the EMEs in world trade has been changing the domestic inflation process in the advanced economies, including in the euro area. It has contributed to a lower worldwide inflation rates in recent years. The questions of how big this dampening effect has been, and whether it will persist going forward, are among the most important and hotly debated questions in central banking.

## **International finance**

Next, I would like to discuss briefly another main theme of the conference, that of international finance. First, I want to acknowledge upfront that the causal link between financial integration and growth is far from being straightforward. However, it seems irrefutable that better allocation of global resources allowed by deepening financial integration has been an important factor in supporting global growth.

The role of the EMEs has increased in international finance. Many EMEs have also made great strides in developing their domestic financial markets, but much remains to be done. Here I want to underscore the need to proceed with caution.

This is because capital market liberalization involves not only benefits but also risks, both to countries in question and investors that invest in these countries. We have ample experience of how things can go wrong, for example, the Asian crisis in the late 1990's, and the series of crises in Latin America around the turn of the millennium. And, also Finland has first hand experience from a severe banking crisis that took place less than 20 years ago.

There are many lessons to be drawn from these crises. Here I want to highlight just two.

First is the importance of sound macroeconomic policies. Prudent fiscal policy and stability oriented monetary policy make an economy more resilient to shocks. In some cases, more flexible exchange rates could help prevent unsustainable developments.

Second is the need for careful sequencing of liberalization and coordinating capital account liberalization with structural measures that strengthen domestic financial systems.

I would like to highlight a couple of issues in international finance that are particularly relevant for central banks.

First, as shown clearly by recent market volatility, global financial integration has made different countries and markets more interdependent. Consequently, domestic asset prices are increasingly determined by global factors. For instance, the question of to what extent the investment of China's current account surplus has reduced long term interest rates in advanced economies, most notably in the US, has been studied extensively in recent years. The results are not clear-cut but it seems that the impact has been substantial. For central banks this increased interdependency means somewhat reduced leverage to influence domestic longer-term interest rates.

Second, global imbalances have featured on the top of the central banks' agenda already for a number of years. This is because their abrupt and disorderly unwinding could result in financial instability and have negative impact on world growth. Therefore, an orderly reduction of global imbalances is a shared responsibility. To this end, as part of the recently concluded multilateral talks organized by the IMF, China announced plans to reduce external imbalances, including by boosting domestic demand, by speeding up financial reform, and by further improving the exchange regime in a gradual and controllable manner.

China's plans are most welcome, as the tensions arising from its large trade surplus have potential to stoke protectionist sentiments in other countries, with potentially harmful effects on the world trade and growth.

## **Global governance**

Global governance is sometimes defined as "collective efforts to identify, understand, or address worldwide problems that go beyond the capacity of individual states to solve."

There are a number of different informal and formal fora that fit this description. However, one that clearly stands apart in terms of its truly global reach and importance is the International Monetary Fund.

The ongoing reforms aim to ensure that the IMF will remain an effective and representative forum of global governance. All the key reforms at the Fund are somewhat linked to the changes in the global role of the emerging market economies.

The IMF surveillance framework and modalities have been, and are still being adapted in response to challenges of an increasingly open world economy, where the large emerging market countries have become major players in trade and finance alike.

The steep decline in the IMF's lending activities as a result of reduced loan demand from large emerging market countries, such as Brazil, necessitate fundamental reforms in the way that the IMF finances its activities.

There are ongoing discussions on a new liquidity instrument for market access countries that would better respond to potential borrowing needs of emerging market countries.

However, the most crucial aspect of the reform in terms of global governance is the so called quota and voice reform. One key question is how to ensure that dynamic emerging market economies will have an adequate say in the internal governance of the Fund, and thereby also in global governance in the areas of the IMF's competence. To achieve this, quota

shares need to be adjusted to better reflect the relative weight of members in the world economy and voice and participation of low-income countries need to be enhanced.

This reform is now nearing a decisive stage. Difficult concessions from all parties are necessary to reach a balanced compromise. Finland will continue to work constructively for a predictable and rules-based system of determining voting shares so as to ensure that the distribution of power at the IMF better reflect prevailing economic realities.

## **Geopolitics**

Lastly, I would like to touch upon one CIBS-related issue that is gaining in geopolitical importance.

Competition for strategic raw materials is intensifying. Related to this, there has been increased interest in Africa, including from large emerging market countries such as China and India. The increased activity of EMEs in poor but resource rich African countries reflects changing balance in geopolitics. It is also of particular interest to the IMF, given that a number of these countries just recently benefited from the Multilateral Debt Relief Initiative.

Specifically, non-concessional lending to countries with a recent history of unsustainable debt should be avoided. Although the prime responsibility of maintaining debt sustainability rests with the borrowing countries themselves, creditor countries should adhere to the principles of prudent and responsible lending and keep their terms of credit transparent.

## **Conclusions**

To conclude, the Southern Engines of Growth are one way or another linked to all most topical issues in international economics. It reflects the fact that as a result of globalization, the fortunes of all countries are becoming inextricably linked.

This increased interdependency means that both positive and negative spillovers will be stronger. Consequently, the continued favorable developments in the CIBS are not only essential for improving living standards in these countries, but are in the interest of us all.

Fortunately, the outlook for continued favorable developments is fundamentally good. At the same time, CIBS face formidable policy challenges as they seek to become ever more integrated with the international economy. In this process, sound macroeconomic policies and strong institutions are indispensable. Studying the experience of other countries may offer some clues for what to do and how to avoid pitfalls.

In the longer run, economic performance of the CIBS countries will be increasingly determined by how well they can harness their human potential. To this end, one cannot overemphasize the importance of ensuring increased and more equal access to education.

The increasing weight and role of the emerging market countries in the global economy must also be better reflected in global governance structures. This is essential for the effectiveness of such multilateral structures as their efficiency derives from the legitimacy that they enjoy among the members of international community.

In conclusion, I would like to thank WIDER for bringing together here in Helsinki such an impressive group of researchers and other experts. The issues that you will be discussing during the next two days are, I believe, of critical importance, not only for the CIBS countries themselves, but also for the global economy as a whole. I wish you many stimulating discussions and a successful conference.