# Jean-Claude Trichet: The growing importance of emerging economies in the globalised world and its implications for the international financial architecture

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Tenth L K Jha Memorial Lecture, organised by the Reserve Bank of India, Mumbai, 26 November 2007.

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## I. Introduction

Ladies and gentlemen,

It is a great honour for me to give this lecture to pay tribute to the memory of the late Shri Lakshmi Kant Jha.

L.K. Jha was a man of many talents: a distinguished administrator, a diplomat and an eminent economist. He was the first Chairman of the General Agreement on Tariffs and Trade in the late 1950s and Governor of the Reserve Bank of India in the late 1960s. He held several important positions in the Government of India. In the course of his career, L. K. Jha also became a respected member of the Brandt Commission. As some of you perhaps remember, this commission advocated a new world economic order in which the developing countries, including India, would have a more equitable share. L. K. Jha sadly left us about 20 years ago. However, if he and other members of the Brandt Commission were to look at the world economy today, they would be probably surprised to see how much it has changed. And one of the most important of these changes is precisely the growing share of the rapidly developing economies, which we now term the emerging markets, in the global economy. India represents one striking example of this success. Together with other emerging markets, India is playing a crucial role in the process of globalisation of the world we live in.

Some might think that this is a new phenomenon. It is not. India has been at the core of globalisation since its very outset. Let us just remember how it all started. Globalisation did not start 20 years ago, when capital controls around the world began to be lifted. It did not start 50 years ago, when multilateral discussions on trade were launched. Nor did globalisation start 150 years ago, with the industrial revolution. Nor did it start 600 years ago, with the voyage of Christopher Columbus to America. Of course, this voyage marked the linking of two continents, Europe and America. But there is one thing which we tend to forget. Christopher Columbus did not want to travel to America. He wanted to reach India! His ambition was not to discover a new continent. It was to open an alternative route to India using knowledge about the spherical nature of the earth to sail directly west across the “Ocean Sea“, i.e. the Atlantic. India was part of the globalisation process from its very historical outset, as much as it is part of it today.

In this lecture, I would like to share some of my thoughts on the growing importance of India and other emerging economies in the globalised world. This group of economies is not easy to define, I admit. The term “emerging markets“ was coined by the World Bank more than a quarter of a century ago, but it only started to become popular in the mid-1990s.[1] From a handful of such economies, mostly in East Asia, the circle has gradually expanded to include several countries in Latin America, central and eastern Europe, and the Middle East, as well

[1] The term was coined in 1981 by Antoine W. van Agtmael of the International Finance Corporation of the World Bank.

as a few countries in Africa.[2] India, alongside Brazil, China and Russia, is among the largest of the emerging markets, which are expected to become the giants of the twenty-first century. But I would also like to offer some reflections on the implications of these changes. Not only are emerging markets becoming larger players in the global economy. They will also need to assume growing responsibilities in a global context. This means that the rules of the game must develop accordingly. And this is notably reflected in important developments over recent years in the international financial architecture, the network of institutions and fora which are involved in the governance of the world economy in macroeconomic and financial matters.

I will therefore elaborate on these two aspects: first, the importance of the emerging markets, which is already significant and is likely to grow further; and second, on the implications of this growing role for the governance of the world economy in macroeconomic and financial matters.

## II. The growing importance of the emerging markets in the global economy

The growing importance of the emerging markets is striking in several respects: in demographic terms, in economic terms – both at the macroeconomic level and at the microeconomic level – and, perhaps even more promising, in cultural and scientific terms.

### *Demographic importance*

Consider first population. Emerging market countries are home to over half of the world's population. India, with a population of more than 1.1 billion, is evidently one of the world's two population giants, together with China. But it is also a young giant, which is still growing! Indeed, expected demographic trends suggest that India could overtake China as the world's most populous country within the next two decades, according to projections by the United Nations.[3] Moreover, due to the profound economic transformations that are ongoing, many of the emerging markets are faced with rapid urbanisation and massive migrations from rural areas to cities. Cities in emerging markets have therefore grown in size considerably. At present, seven of the ten largest metropolitan areas in the world are located in emerging markets. Mumbai – where I have the privilege of speaking today – is the world's sixth largest city. Its population – about 18 million – compares with that of some industrial countries in their entirety; for instance, it is close to the population of Australia.

### *Economic importance: macro and micro evidence*

The numbers are startling in terms of population, but they are also increasingly impressive in terms of economic size. Emerging markets account for almost 40% of world GDP at purchasing power parity, although still only 20% at market value. While these economies are already large, they continue to grow vigorously, at more than 7% per annum on average over the past six years, over 2% percentage points above the world average. India has been growing even more rapidly, at close to 8% per annum over this period. The emerging

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2 For the purposes of this lecture, the term "emerging markets" refers to a group of economies selected from the EU's neighbouring regions, Latin America and Asia, in line with the article entitled "Financial flows to emerging market economies: changing patterns and recent developments" published in the January 2005 issue of the ECB's Monthly Bulletin (pp. 59-73). These economies comprise, on the European fringe, Russia and Turkey; in Latin America, Argentina, Brazil, Chile, Colombia, Mexico and Venezuela; and in Asia, China, Hong Kong SAR, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand. This definition may in some instances be slightly modified depending on data availability, however.

3 The period of "demographic dividends" – characterised by faster labour force than population growth, a support to economic activity - is therefore expected to end in China, but not in India. See R. Cooper , "How integrated are Chinese and Indian labour into the world economy?", mimeo, February 2006.

markets have therefore become one of the main engines of world growth, with a projected contribution of over a half this year.[4] The vigour of growth in emerging markets and its resilience are good news for all of us. It suggests that the world economy may be better able to rely on the dynamism of these economies, in particular should growth in other regions lose some momentum.

Emerging countries' citizens have reaped the benefits of such rapid development with higher standards of living. Over the last decade, GDP per capita has risen by 30% on average, to reach over USD 9,000. In India, the rise has been even faster, with a doubling of real GDP per capita in the last ten years. The integration of emerging economies into global markets for goods and services has been similarly swift. If you look at world exports of goods and services, the combined share of emerging markets doubled between the early 1990s and 2006, to reach roughly 30%. Again, the integration of India into global markets has been even faster. India's share in world exports of goods and services tripled between the early 1990s and 2006, to close to 1.5%, with a notable acceleration in the last three years, due to dynamic exports of services, of course including IT and IT-enabled services.

Let me turn now to the *microeconomic* evidence for the growing importance of the emerging markets, which is perhaps even more striking. Here are a few examples. Four companies among the world's 20 largest in terms of market value originate from emerging markets.[5] Two oil and gas firms, one Russian and one Chinese, rank in the top ten. Moreover, according to Forbes, seven of the 20 richest individuals in the world are from the emerging markets, with three from India alone.[6] The number of millionaires (in terms of US dollars or euro) is rapidly rising; Forbes estimates that there were some 80,000 in India in 2005.[7] Of course, that is not to say that the challenges posed by income distribution are not among the highest priorities of most emerging market countries, including India. Eliminating poverty is at the top of the agenda.

### *Long-term economic outlook*

The present looks promising for emerging market economies, but the future seems even brighter. The projections for long-term growth, based on demographic trends and models of capital accumulation and productivity, tell us that emerging markets are likely to become even weightier in the world economy tomorrow than they are today. Of course, projections at very distant horizons are somewhat speculative, but they do offer an insight into possible secular developments. In this respect, one study found startling results regarding the growth prospects of emerging markets. India, together with Brazil, Russia and China, could be over half the size of today's six largest industrialised economies by 2025, and in less than 40 years they could overtake them.[8] Looking ahead to 2050, China would be the world's largest economy and India would be its third largest, behind the United States. A similar picture emerges from other studies, with some nuances.[9]

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4 See IMF, "World Economic Outlook", September 2007.

5 See Forbes' Global 2000 list (http://www.forbes.com/lists/2007/18/biz_07forbes2000_The-Global-2000_Rank.html).

6 See Forbes' list of billionaires (http://www.forbes.com/lists/2007/10/07billionaires_The-Worlds-Billionaires_Rank.html).

7 See Merrill Lynch and Capgemini, "World Wealth Report, 10th Anniversary", 1996-2006.

8 See D. Wilson and R. Purushothaman "Dreaming with BRICs: the path to 2050", Global Economics Paper No 99, Goldman Sachs, 1 October 2003.

9 See e.g. J. Hawksworth "The world in 2005: how big will the major emerging market economies get and how can the OECD compete?", Price Waterhouse Coopers, March 2006; S. Poncet "The long-term growth prospects of the world economy: horizon 2050", CEPII Working Paper No 2006, 16 October 2006.

If history is any guide, these developments are unsurprising. It suffices to recall how significant India's weight in the world economy was two millennia ago, when the Middle Kingdoms were ruling in India and the Roman empire was ruling in Europe and North Africa. At that time, India was by far the world's largest economic power, accounting alone for about a third of world output.[10] Moreover, at par with China, it subsequently remained the largest economy in the world for several centuries, until the eve of the industrial revolution. Seen from this long-run perspective, the rapidly growing importance of India in today's world economy seems to be a return to normality. The developments we observe today are therefore likely to be the precursor of a profound rebalancing in the distribution of world output tomorrow. These developments call for constant monitoring and cooperation in the international community, however. It cannot be excluded that this process of rebalancing might be "non-linear", with episodes of discontinuity, perhaps also including economic and financial crises somewhere down the line.

### *Cultural and scientific importance*

But allow me to also consider the emerging markets from a different angle, which you will perhaps find surprising for a central banker. We central bankers are known to look at countries through the unexciting lenses of numbers, facts and figures. This is entirely true. But we are convinced that economic figures are closely associated with the scientific overall level of one particular society and that cultural developments and influence are closely related to economic success. It is therefore not surprising that emerging countries are rapidly growing in influence, importance not only economically but also culturally.

Speaking of the cultural and scientific importance of a nation which has historically been at the source of European languages, literature and mathematics is paradoxical!

Turning to the present times, there are a vast array of indicators that underscore the growing influence of the contemporary culture and science of emerging economies in general and of India in particular. Being here in India, I am bound to mention film-making as a first example. As you will know, India is the largest world producer of films, with over 900 in 2005, ahead of the European Union, with about 800, and the United States, with about 700.[11] Of course, this is due to the success of "Bollywood", a label now well-known across the world. Other emerging markets, such as China and Russia, rank among the top ten film producers. Take the internet as a second example. The internet plays a crucial role in making the world more globalised, and here too the weight of emerging markets is already impressive. There are almost as many internet users in India (close to 40 million) as the entire population of a country such as Spain.[12] Asia is the region with the highest number of internet users, even when Japan is excluded, with over 310 million. It is ahead of North America, with 230 million users. Last, consider my final example: the number of Nobel prizes awarded. Here again, emerging market countries are rapidly growing in importance. In the ten years starting from 1980, 24 nationals from emerging market countries were awarded a Nobel prize. Within only six years of the new millennium, this figure is already almost as high (22). All in all, the growth in the economic weight of emerging market countries and the rise in their cultural importance are very much developing in a synchronised manner.

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[10] See A. Maddison *The World economy: Historical Statistics*, OECD, 2003.

[11] See European Audiovisual Observatory, "World film market trends – focus 2006" (http://www.obs.coe.int/oea_publ/market/focus.html).

[12] See Internet World Stats (http://www.internetworldstats.com/stats.htm).

### *Euro area perspective*

Before I move on to the implications of the growing importance of emerging countries for the governance of the world economy in macroeconomic and financial matters, let me briefly tell you how we in the European Central Bank see the growing role of the emerging markets. To us, the message is clear: the growing role of the emerging markets is good news for the euro area, the group of 13, soon to be 15, European countries, with 320 million fellow citizens, that share the euro as their single currency. In particular, vigorous growth in emerging markets increases the demand for those goods and tradable services where the euro area has comparative advantages. Emerging market competition also strengthens the incentives to make further progress in terms of structural reforms in our economies, which are, in any case, needed.

The euro area, in addition, has the potential to take advantage of the new opportunities that the development of the emerging markets creates. Our exports and imports of goods and services account for around one-fifth of GDP, more than in the United States or in Japan. In this respect, the euro area is also increasingly open to the emerging markets. Our trade relations with emerging Asia, Russia and with central and eastern European economies have strengthened noticeably over time. The share of emerging markets, taken together, in euro area trade has grown from about one-third, when the euro was introduced in 1999, to more than 40% today. Trade relations with India have equally strengthened over time. The euro area is also largely open financially. If I focus on emerging markets, perhaps one of the most interesting developments in recent years is that the euro area has become an increasingly attractive destination for foreign direct investment from the largest of these economies, although starting from very low levels. Indeed, between 1999 and 2005 the stock of foreign direct investment from Brazil, Russia, India and China in the euro area tripled, to reach around €12 billion. This is good news, as these investments represent a new source of capital, with potentially beneficial effects on euro area growth. Moreover, they might help European firms access emerging markets more easily than on their own.

The bottom line of my brief overview is: emerging market countries are increasingly important global players in all dimensions, be they economic, financial, cultural or scientific. This is a welcome, systemic, development. In turn, this has important implications for the governance of the global economic and financial system. What are indeed these implications? This is the second issue I would like to address today.

## III. Implications for the international financial architecture

It is evident that the systemic evolution we are witnessing in the global economic and financial system calls for systematic changes in the global policy framework. There are new players. They are gaining in importance. This means that they also have more responsibilities in the global arena and that the rules of the game need to adapt in order to keep pace.

But there is another reason. Globalisation has put all economies around the globe in the same boat. Something that happens in one economy is often no longer a mere domestic event. Its implications can sometimes extend to the entire global system. Remember how 12 years ago the Tesobonos crisis in Mexico developed from a local phenomenon into an issue for the international financial community.[13] Remember the Asian crisis.[14] Remember how the

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[13] See, for instance, S. Edwards, "On crisis prevention: lessons from Mexico and East Asia", NBER Working Paper, No. 7233, July 1999.

[14] For an overview of the lessons to be drawn from the Asian crisis, see T. Ito et al., "Ten Years After the Asian Crisis: What Have We Learned or Not Learned?", Editors' Overview, *Asian Economic Policy Review*, June 2007 - Vol. 2, issue 1, pp. 1-17.

global system had to digest crises in Russia and Argentina as well as the bursting of the technology bubble around the turn of the millennium.[15] All economies which have a systemic importance should therefore be involved in discussing and participating in the collegial response of the international community to issues of global relevance.

This is why the governance of the world economy in macroeconomic and financial matters has been changing rapidly in terms of both format and substance.

### *Implications for the format*

Consider first format. The various international institutions and fora which are involved in international policy dialogue on macroeconomic and financial affairs have strived over the past ten years or so to better integrate emerging markets. Let me take three examples. One of the most important of these fora is the Group of Seven or G7, where finance ministers and central bank governors of the seven most important industrialised nations of the world meet several times a year to discuss issues of mutual interest. The G5, soon to become the G7, was created as an informal forum in the 1970s. It is sometimes criticised for not reflecting the political and economic realities of the twenty-first century. I have had the privilege of attending all its meetings over the past 18 years. My experience is that the G7 meetings have proven an invaluable forum for cooperation on macroeconomic policies and for giving, when appropriate, signals to market participants. The G7 is adapting to the new political and economic realities through what is termed “outreach“. The G7 countries have acknowledged the necessity of involving other players in their discussions. In particular, it is now standard practice for finance ministers and governors from emerging economies – and sometimes also from developing countries – to be invited to join these discussions. This is the case for oil-producing countries, in particular. For instance, in spring 2006 finance ministers from certain oil-exporting countries joined the G7 in a discussion on global imbalances.

At the level of heads of state and government another important step was made a few months ago. A new form of informal cooperation between G8 members (i.e. the Group of Seven and Russia) and important emerging economies has been launched. Challenges have become global. Global challenges require global solutions. And global solutions cannot be found without the active participation of important players, from both mature and emerging market economies. India is of course part of these important emerging economies, as are Brazil, China, Mexico and South Africa. At their meeting in Heiligendamm last summer, the G8 countries and these important emerging economies committed to embark on a high-level dialogue on issues of global dimension, issues which will be at the top of the agenda in the years ahead. They include, for instance, cross-border investment, research and innovation, energy efficiency and development. The Heiligendamm process is a very welcome one.

The creation of the informal grouping of the G20 in 1999 is a major change in global governance, fully taking into account the structural transformation associated with the growing importance of the emerging economies. It was created to examine major economic and financial global issues at the time of the Asian crisis, fully recognising that all economies that had a systemic influence should be partners at the global level.

Since 1999 the G20 has turned out to be a very important international policy forum for dialogue and consensus-building among systemically important economies, both industrialised and emerging. India held its presidency in 2002. I have a very vivid memory of this meeting in Delhi where, for the first time, the international community through the G20 endorsed the idea of the voluntary “Principles“ for prevention and solution of sovereign crises, which I had myself suggested when it appeared that the “SDRM“ was not workable. The G20 has facilitated consensus on crucial policy issues of the international reform

[15] In particular, on the Russian crisis see e.g. B. Pinto, E. Gurvich and S. Ulatov, “Lessons from the Russian Crisis of 1998 and Recovery, Managing Volatility and Crises: A Practitioner's Guide”, 2004, draft.

agenda. It has organised several workshops to deepen the understanding of issues of global relevance and has engaged in a process of peer review to promote countries' implementation of market-based economic systems. In the early years of its existence, the G20 put special emphasis on financial stability and crisis prevention, including aspects such as prudent debt management, domestic financial deepening and exchange rate regimes. Its agenda has widened since then. It now includes also the global policy challenges ahead of us, such as development, energy and climate change. In my view, it is the format of the G20 which makes it a success. Not too large, not too small! Its composition and size strike a balance between giving the G20 a high degree of legitimacy while at the same time also allowing frank dialogue between the members. In recent years, the G20 has also played an active role in contributing to the reform of the Bretton Woods institutions, the International Monetary Fund (IMF) and the World Bank. It has been committed to strengthening their credibility, effectiveness and legitimacy. It has also followed closely the progress made with policy and internal governance issues.

Alongside the G7 and the G20, significant reform efforts are indeed under way at the IMF to adapt the institution to a new environment and a new set of players. This is my last example of the substantial developments that the governance of the world economy is experiencing in terms of format. The key issues here are quota and voice, two important elements defining the representation of Fund members.[16] In addition, the way the IMF carries out its policy work is changing. For instance, last year saw the launch of the first multilateral consultations, an innovative approach that aims to bring together countries with a shared responsibility for global issues. These first multilateral consultations were dedicated to one of the key risks weighing on the world economy, namely global imbalances. The consultations involved both mature and emerging economies, including the euro area, the United States, Japan, China and Saudi Arabia, again illustrating the fact that large current imbalances are no longer an issue for mature economies only, but a truly global issue. We at the ECB welcomed these discussions as a way to foster the implementation of the agreed strategy to address global imbalances. Evidently, these discussions are also of relevance to India. Large current account imbalances worldwide go hand-in-hand with sizeable cross-border capital flows. India has been confronted with challenges posed by strong capital inflows. This is why addressing imbalances is in the interest of the international community as a whole.

### *Implications for the substance*

Not only the form but also the substance of the governance of the world economy in macroeconomic and financial matters is changing. This will be my last point. The macroeconomic and financial situation in emerging economies today looks strong. But we know it was not always so. We have seen both good and bad times. This is why many initiatives have been taken to strengthen the resilience of countries' macroeconomic and financial performance and policies following the string of crises of the 1980s and 1990s. Reforms can obviously take many forms. But there are three guiding principles which, in my view, should always be kept in mind: transparency, good practices and dialogue.

Allow me to take transparency first. Investors, borrowers, lenders and economic agents in general cannot make proper decisions without adequate information.[17] Easy access to information facilitates investment decisions, the management of risk and market discipline. This in turn gives appropriate incentives in the conduct of macroeconomic and structural

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16 See, for instance, M. Skala, C. Thimann and R. Wölfinger 'The search for Columbus' egg – finding a new formula to determine quotas at the IMF', ECB *Occasional Paper*, no. 70, August 2007.

17 For recent – more formal – treatment of the role of information and transparency see, e.g., D. Kahneman, "Maps of Bounded Rationality: Psychology for Behavioral Economics", *American Economic Review*, 2003, 93 (5), pp. 1449-75 or S. Morris and H.S. Shin, "Social value of public information", *American Economic Review*, 2002, 92(5), pp. 1521-1534.

policies. Easy access to information also allows investors to better differentiate across economies, borrowers and companies. Ultimately, this helps to lessen herding behaviour and contagion when market volatility increases. This is why transparency is so crucial. And in recent years, a lot of progress has been made to enhance transparency and to facilitate access to information as well as its dissemination to market participants. I give you one example. Ten years ago, the nature of economic and financial data and the way they were reported varied significantly across countries. Even simple concepts, such as debt, could be understood very differently around the world. This severely constrained our ability to compare financial vulnerability across countries. But thanks to work carried out at the IMF, the special standards for dissemination of economic and financial data have become a widely recognised benchmark to which a large and increasing number of countries adhere. Of course, there are still areas where more work needs to be done. One of them, for instance, is the reporting to the IMF on the currency composition of countries' foreign exchange reserves. But overall, things are moving in the right direction.

Adopting good practices is a second principle which should continue to guide our efforts in reforming the governance of the world economy in macroeconomic and financial matters. Here again, there have been a number of achievements. A large array of standards and codes for macroeconomic and data transparency, banking supervision, corporate governance, accounting, and payment and settlement systems have been subject to international agreements. Such standards bring together what is widely considered as good practice or guidelines in a particular domain. They enhance domestic and international stability. In this respect, the IMF and the Financial Stability Forum – the only forum for cooperation among national and international entities in charge of supervision – have singled out 12 of these standards as being of particular importance for a sound and stable economic and financial system. But the work of the international community has gone beyond standard-setting. It now also focuses on implementation. Progress has been made towards publicly examining countries' compliance with standards and codes. And there is one important lesson that we can draw from this experience. The international community does not always need to rely on rules and unilateral enforcement to make progress on certain fronts. Goodwill and, at times, peer pressure, can also work.

Closely related to this is the need to maintain a constant dialogue between the public and private sectors, the last principle to bear in mind in reforming the international financial architecture. Principles agreed by all relevant players on a voluntary basis can at times be preferable to rules decided and enforced unilaterally by public authorities. This proved to be particularly true for the "Principles for stable capital flows and fair debt restructuring in emerging markets" that – as I already mentioned – were endorsed by the G20 in Delhi in 2002. Following defaults on the part of several emerging market borrowers, the international community realised the need to resolve financial crises in a more orderly fashion and to improve sovereign debt restructuring mechanisms. Debtor countries and private investors agreed on best practices and guidelines for information-sharing, dialogue and close cooperation both in normal times and in periods of financial distress. Since I suggested myself such a voluntary code of conduct at the IMF Annual Meetings in 2001, I am glad to see that these principles are increasingly recognised as an important framework for cooperative action by debtors and creditors. But looking ahead, they might also serve as an example in other domains. One such domain, for instance, could be the sector of highly leveraged and non-regulated entities – which could develop as actively as possible voluntary benchmarks for good practices, as also recommended by the Financial Stability Forum.

## IV. Concluding remarks

Ladies and gentlemen,

New continents are not discovered every day. When Christopher Columbus died in 1506 in Valladolid, he was still convinced that his journeys had taken him to the coasts of India, and not to America. It is indeed always difficult to identify change, especially when such change is systemic. What we have seen in the last 20 years since L. K. Jha left us is such systemic change. And we have learned that we have to be ready for it.

We have learned indeed that the world economy is changing constantly. The emerging economies, which played a relatively modest role in the global economy 20 years ago, occupy a far more important place today, but one which will be dwarfed in importance by their role in the future.

We have further learned that, since the world economy is evolving constantly, the rules of the game have to be continuously adapted. International institutions and fora are changing and adjusting. Many initiatives have been taken and implemented. Altogether this should help make the global economic and financial system more resilient.

But we have also learned that it is never time for complacency. The next crisis is always different from the previous one. Both industrialised and emerging countries have to continue to work to keep up with new developments and challenges. Efforts to ensure global stability and prevent crises have to be made constantly, by all of us, and should be guided by the principles of transparency, good practices and dialogue between relevant players.

In this context, I am confident that mature and emerging economies, among them India, will continue to work in close cooperation in the years ahead to ensure that these important goals are met.

I thank you for your attention.