Jean-Claude Trichet: Charting a new global landscape – the growing impact of emerging markets on the world economy

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 75th anniversary of the Central Bank of the Republic of Turkey, Ankara, 1 June 2007.

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I. Introduction

Ladies and gentlemen,

Today is an important day. We are here to celebrate the 75th anniversary of the Central Bank of the Republic of Turkey. Let me congratulate you warmly on this occasion. But today is an important day for me too, as my institution, the European Central Bank, is also celebrating its birthday! Well, we are a bit younger…we are turning nine. This means that next year it will be our turn and pleasure to host events in Frankfurt to mark our tenth anniversary! Perhaps one issue of common interest we could discuss today is how our two institutions may, in the words of Cicero, "support the burden of advancing age"![1] But this is not the homework you had assigned me to do. I have come here today to talk about the world economy. We are all witnessing its rapid development, the profound changes it is undergoing. And one of the most important changes, the consequences of which still remain to be understood fully, is the growing role of emerging countries.

This group of economies is not easy to define, I admit. The term "emerging countries" 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.[2] This is hardly a coincidence. Following the debt crises of the 1980s, a number of rapidly developing economies gained, or regained, access to international financial markets. These economies have liberalised their financial systems, at least in part, and have become broadly accessible to foreign investors.[3] From a handful of such economies, in particular in East Asia, the circle has gradually grown to include several countries in Latin America, central and eastern Europe, the Middle East, as well as a few countries in Africa. Since the turn of the millennium, new acronyms have appeared, such as "BRICs", which refers to the largest emerging markets, to the economies that are expected to become the giants of the 21st century, such as Brazil, Russia, India and China.[4]

Turkey is, in turn, one of the most important emerging market countries as illustrated by its participation in the Group of Twenty. Turkey is also one of the main players in emerging financial markets. For instance, its international debt is among the most liquid, accounting for as much as 10% of the emerging bond market.[5] The strong capital inflows that Turkey has attracted over the past few years, some USD 100 billion since the turn of the millennium, underline the interest of foreign investors in the economy's record.

When discussing emerging markets nowadays, it is an attempt to understand how the global economy is changing. Therefore, it is also an attempt to understand what the world will be like tomorrow. I would like to share some of my thoughts on these developments with you, with particular regard to three aspects: first, the weight of the emerging markets, which is already significant and is likely to grow further; second, the implications of the rise of the emerging markets for the world economy, some of which is already in evidence; and third, the implications of this rise for us, in the euro area. I shall now review these three aspects in turn, before drawing some conclusions on the governance of the global economy.

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1 Cicero (106 B.C. - 43 B.C.), "On Old Age", Harvard Classics, Vol. 9, Part 2, para. 2.

2 The term was coined in 1981 by Antoine W. van Agtmael of the International Finance Corporation of the World Bank (see http://www.investopedia.com/articles/03/073003.asp).

3 This definition draws from the IMF's glossary of financial terms (http://www.imf.org/external/np/exr/glossary/index.asp).

4 In this speech, emerging markets refer to a group of economies selected from the EU 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 ECB's Monthly Bulletin of January 2005 (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 be slightly modified depending on data availability, however.

5 This figure corresponds to Turkey's weight in April 2006 in JP Morgan's EMBI+ index, a standard market benchmark.

II. Current and prospective weight of the emerging markets

Consider first the economic weight of emerging market countries. As we know, it is significant, increasingly significant. These countries constitute over half of the world's population, with China and India alone accounting for over one third. Due to the profound economic transformations ongoing, many of these economies are faced with rapid urbanisation. To date, seven of the ten largest metropolitan areas in the world are located in emerging markets. The combined population of three of these metropolitan areas, Mexico City, São Paulo and Mumbai, is as large as that of my home country, France. And we know that Istanbul ranks among the largest cities in the world, with a population of over 11 million.

The numbers are also increasingly impressive in terms of economic size. Emerging markets account for almost 40% of world GDP at purchasing power parity, and 20% at market value. And if these economies are already large, they are also growing rapidly, at about 7% per annum on average over the past five years. Turkey has been growing at a similarly rapid pace, while the most economically vigorous region of the world, emerging Asia, has been growing even faster, at close to 8% per annum. This makes emerging markets one of the main engines of world growth, with a contribution of over one half last year. 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. The integration of emerging economies into global markets of goods and services has been similarly swift. If you look at the world exports of goods and services, the combined share of emerging markets doubled between the early 1990s and 2006, to reach roughly 30%.

But these are well-known macroeconomic facts. Perhaps even more striking is the microeconomic evidence of the economic success of both companies and individuals in emerging markets, which is sometimes unprecedented in terms of rapidity. Let me give you a few examples. Four companies among the world's 20 largest in terms of market value originate from emerging markets.[6] 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.[7] In 2005, there were more than 300,000 millionaires (measured in US dollars or in euro) in China. This seems to be already more than in Canada or in Australia.[8] However, that is not to say that the challenges posed by income distribution are not among the highest priorities of most emerging market countries. As we know, eliminating poverty is on the top of the agenda for developing countries, in particular for Africa.

If the present looks promising for emerging market economies, their potential future seems even brighter. What do the available projections for long-term growth, based on demographic trends and models of capital accumulation and productivity, tell us? The answer is no surprise: emerging markets are likely to become even weightier in the world economy tomorrow than they are today. Of course, any projection, even in the short term, is surrounded by uncertainty. Projections at very distant horizons are, therefore, somewhat speculative. Yet, they might capture possible secular developments. A number of studies found startling results regarding the growth prospects of emerging markets. According to one such study, Brazil, Russia, India and China could account for over half the size of today's six largest economies by 2025 and, in less than 40 years, they could be larger.[9] Other studies convey similar messages, notwithstanding some differences.[10] Therefore, the developments we observe today are likely to be the precursor of a profound rebalancing in the distribution of world output tomorrow. Of course, it cannot be excluded that this process might well be "non-linear", with episodes of discontinuity, perhaps also including financial crises somewhere down the line. Therefore, the current developments call for constant monitoring and cooperation in the international community.

But let me also look at emerging markets from a different angle, an angle which is more uncommon for a central banker. These countries are not only growing in importance economically, but also culturally – a

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[6] See the list of Forbes' Global 2000 (http://www.forbes.com/lists/2007/18/biz_07forbes2000_The-Global-2000_Rank.html).

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

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

[9] See Wilson, D. and R. Purushothaman "Dreaming with BRICs: The Path to 2050", Global Economics Paper No. 99, Goldman Sachs, 1 October 2003.

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

dimension which is, for sure, interlinked with the economic one. Take film-making as an example. In 2005, the largest world producer of films was India, with over 900 films, ahead of the European Union, with about 800, and the United States, with about 700.[11] Other emerging markets, such as China and Russia, ranked among the top ten film producers. Turkey was within the top 20, with 27 films. Consider the internet as a second example. The internet plays a crucial role in making the world more global, and here too the weight of emerging markets is already impressive. There are already around 16 million internet users in Turkey, corresponding to about one fifth of the population. Excluding Japan, Asia has the highest number of internet users, with over 310 million users, ahead of North America, with 230 million users.[12] There are almost as many internet users in China and India (close to 180 million) as in the United States (some 200 million). Take finally the number of Nobel prizes awarded, which reward the highest achievements in science, literature and peace. Here again, emerging markets seem to be growing in importance. Back in the 1980s, 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 economies and nations and the rise in their cultural importance are very much synchronised.

III. The implications of the rise of the emerging markets for the world economy

Consider now my second point: the implications of the rise of the emerging markets for the world economy. Of course, this impact is multifaceted. It spans two areas of immediate interest for central bankers, namely global inflation and global capital flows.

Take inflation first. The integration into the global economy of a massive pool of low-cost, skilled workers from emerging markets has tended to exert downward pressure on import prices of manufactured goods and on wage demands in mature economies.[13] Indeed, in a very short space of time, the available labour force in the global economy has doubled from 1.5 to 3 billion, reflecting the opening up of China, India and the former Soviet bloc.[14] As a consequence, the price of a wide range of manufactured goods has declined. In addition, through various channels, this process of wage moderation and reduced inflationary pressure in the manufacturing sector has affected wage dynamics also in the services sector, mainly as a result of outsourcing. Altogether, these effects have helped dampen inflationary pressures. This is what the figures seem to tell us: on the basis of a simple accounting method, the ECB's staff estimated that the larger imports from low-cost countries had a dampening effect on overall euro area manufacturing import prices of around two percentage points per annum, on average, between the mid-1990s and mid-2000s.[15]

Yet there are other, opposing forces. Certain resources have become relatively scarcer given the increasing demand from emerging economies. In particular, the strong growth seen in some of the largest economies, notably China and India, has likely contributed to recent increases in the prices of energy and other commodities, as well as of food products. Accordingly, this may have been a source of upward pressure on inflation over the past few years. Arguably, it is difficult to make an exact assessment of this contribution, as commodity prices are also affected by supply conditions and geopolitical factors. However, according to one study, the rapid growth in emerging countries and their increasing share in world trade and GDP may have contributed to an increase in oil prices by as much as 40%, and real metal prices by as much as 10% in the first five years of the new millennium.[16] This illustrates why it is important for central bankers to do what is needed to avoid what are known as "second-round effects" and to anchor inflation expectations through forward-looking monetary policies.

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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).

13 On this issue, see also the speech by L. Papademos entitled "Globalisation, inflation, imbalances and monetary policy", delivered in St. Louis on 25 May 2006.

14 Freeman, R. (2006), "The Great doubling: The challenge of the new global labour market", August 2006.

15 See the box entitled "Effects of the rising trade integration of low-cost countries on euro area import prices", ECB Monthly Bulletin, August 2006, pp. 56-57.

16 See Pain, N., I. Koske and M. Sollie (2006), "Globalisation and inflation in the OECD Economies", Economics Department Working Paper No. 524, OECD, Paris (November).

All in all, it is difficult to measure accurately the total impact of emerging markets on inflation. For instance, the IMF's staff has estimated that globalisation, through its direct effects on non-oil import prices, has reduced inflation by a quarter of a percentage point per year, on average, in mature economies.[17] However, the overall impact is more difficult to estimate and disentangle from other factors that reduce inflation, for instance the increases in productivity growth and the stronger credibility of monetary policy.

Take now international capital flows, the other dimension for which the growing role of emerging markets has a clear global effect. Certain emerging markets, notably in Asia and among oil exporters, have become the "financiers of the world". They are indeed large net savers, with hefty current account surpluses, in the order of USD 800 billion last year. Interestingly, the net capital outflows from these emerging markets finance the deficits of a number of mature economies, the United States, in particular. Of course, many emerging economies remain external borrowers, Turkey being one of them. But for the first time in modern history, the "southern hemisphere" is overall financing the "northern hemisphere": capital is flowing from the "poorer" economies to the "richer" economies. This looks abnormal both from an economic standpoint and from a moral standpoint: according to standard economic theory, capital should flow in the opposite direction, i.e. from "richer" to "poorer" economies, where the expected rate of return of capital is higher; and it would be more appropriate for the wealthiest economies to save more and consume less, in proportion, than the poorest. There is much debate among economists as to how to explain this "paradox", which is sometimes referred to in connection with the 1995 Nobel prize winner in economics, Robert Lucas.[18] Of course, there are many factors to consider. One recent explanation is that the current constellation of global financial flows is partly due to the still "incomplete" nature of globalisation.[19] Trade integration has indeed preceded financial integration, particularly in emerging markets. A sound and deep financial system cannot be created overnight. If you look at mature economies, even there financial technology and infrastructure have taken a very long time to develop so as to overcome thorny problems posed by information asymmetries.

Now, one implication of the absence of a modern financial system in many emerging markets is precisely that it helps explain the current "unorthodox'' constellation of global financial flows. Since the locally underdeveloped financial systems are not sufficiently capable of channelling savings internally, this gives rise to net capital flows from emerging to mature economies. According to this view, an important factor in the adjustment of the existing global imbalances therefore resides in the deepening of financial systems in emerging markets.

According to another interpretation of the "Lucas paradox", which would certainly complement the previous one, the majority of emerging economies are still taking out insurance against the risk of financial crisis of the type that they encountered over the past 25 years. During the Mexican crisis in 1982, and the global crisis of sovereign emerging borrowers in Latin America, Africa, the Middle East and the Soviet Union in the 1980s and early 1990s, as well as the Asian crisis at the end of the 1990s, emerging economies were exposed to sharp and abrupt financial crises calling for challenging macroeconomic adjustments of their domestic policies. In the same period, the industrialised countries were protected from any such domestic crises. Substantial current account deficits were very easily financed, such that the external financial constraint did not materialise in those economies in any significant fashion in the period under review. This may also help to explain why mature economies, as a whole, accept, ex ante, significant current account deficits whereas emerging economies, as a whole, envisage current account surpluses. Let me add that what holds true for the industrialised countries, as a whole, is not the case in the euro area, which is posting, by and large, a balanced current account.

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17 See IMF, "Globalisation and inflation", World Economic Outlook, April 2006, Washington D.C.

18 See R. Lucas (1990), "Why doesn't capital flow from rich to poor countries?" American Economic Review, 80, pp. 92-96.

19 On this aspect, see Caballero, R. (2006), "On the macroeconomics of asset shortages", NBER Working Paper Series, No. 12753, December; Caballero, R., E. Farhi and P.-O. Gourinchas (2006), "An equilibrium model of "global imbalances" and low interest rates", NBER Working Paper Series, No. 11996, January; Mendoza, E., V. Quadrini and J.-V. Rios-Rull (2007), "Financial integration, financial deepness and global imbalances", NBER Working Paper Series, No. 12909, February. See also the speech by L. Bini Smaghi entitled "Global capital and national monetary policies" and delivered at the European Economic and Financial Centre in London on 18 January 2007.

IV. Implications for the euro area

And now to my last point: what are the specific implications of the growing role of emerging markets for the euro area? The answer is clear, this is good news. For instance, strong 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 reform our economies and make further progress in terms of structural reforms, which are, in any case, needed.

The euro area has the potential to take advantage of the new opportunities. In trade terms, the euro area is actually more open than other major economies. Our exports and imports of goods and services account for around one fifth of GDP, more than in the United States or in Japan. The euro area is open to the emerging markets. Our trade relations with emerging Asia, Russia as well as with central and eastern European economies have strengthened noticeably over time. Taken together, the share of emerging markets 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 Turkey have also strengthened over time, to surpass 2% of euro area trade in 2006.

Perhaps less well known is the fact that the euro area is also very open financially. Consider the international balance sheet of the euro area. Its assets and liabilities vis-à-vis non-residents account for over 120% and 130% of euro area GDP, respectively. This is more than in other large, mature economies, such as the United States, where the corresponding figures are 90% and 110% of GDP. Not only that: we are becoming increasingly open. Since the euro was created, in 1999, the size of euro area's external assets and liabilities has grown by around 40 percentage points. And again, if I focus on emerging markets only, perhaps one of the most interesting developments in recent years is that the euro area has become an attractive destination for foreign direct investment from the largest of these economies, although starting from very low levels, of course. Indeed, between 1999 and 2005 the stock of foreign direct investments from Brazil, Russia, India and China in the euro area tripled, to reach around €12 billion. Again, this is good news, as these investments represent a new source of capital for the euro area.

V. Conclusions

Ladies and gentlemen,

The bottom line of my talk today is that emerging markets have become an increasingly larger player. This means that the rules of the game should develop accordingly. Given their growing importance in the world economy, emerging countries also have more responsibilities. Not only is the world economy changing, but also its governance should adapt.

The creation of the Group of Twenty in 1999 was a milestone in this respect. Its aim is to give major emerging markets, such as Turkey, a significant role in the process of informal discussions ongoing in the international community. I have participated in the G20 meetings from the very beginning. I regard them as a remarkable forum for serious dialogue on a wide range of highly relevant issues such as exchange rate regimes, prudent debt management, domestic financial deepening, and international codes and standards to prevent and resolve financial crises. For this reason, I look forward to the discussions at the G20 workshop on “Fiscal elements of growth and development” to be organised in early July in Istanbul.

But I do see other examples of the growing role played by emerging markets in the governance of the international monetary and financial system. The G7 has also reached out to a growing number of systemically important countries. It has invited representatives from major emerging countries, including Brazil, Russia, India, China and South Africa, to some of its meetings to exchange views on issues of relevance to global macroeconomic and financial stability. Useful initiatives have also been launched by the Bank for International Settlements as regards meetings at the Governors' as well as experts' level. Most recently, the Governor of the Central Bank of the Republic of Turkey was invited to the Global Economy Meeting, the most important forum for central bankers in the world, which I have the privilege to chair. Last but not least, the internal governance structure of the International Monetary Fund is currently under review. One aim of the reform efforts is to ensure a fair and adequate voice for all members of the IMF by aligning the distribution of quotas with countries' relative positions in the world economy.

Ladies and gentlemen,

Today we are celebrating the 75th anniversary of the Central Bank of the Republic of Turkey. I wonder what the world economy will look like in 2073, when my institution, the European Central Bank, will celebrate its own 75th anniversary. Of course, it is nearly impossible to tell. There is one certainty, however: the emerging markets of today will play a key role in shaping the future.

Thank you very much. [Tesekür ederim]