

*The International Economy and  
the situation of Emerging Markets*



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- A globalised, interdependent world.
- The global economy: where is it and where is it going?
- The economic situation in emerging markets.
- Economic perspectives for emerging markets.

# Aggregate Shares in World GDP

Emerging markets gaining share in world output.

Developing Asia is the biggest area by far, and increasing, thanks to push of China and, to a lesser extent, India

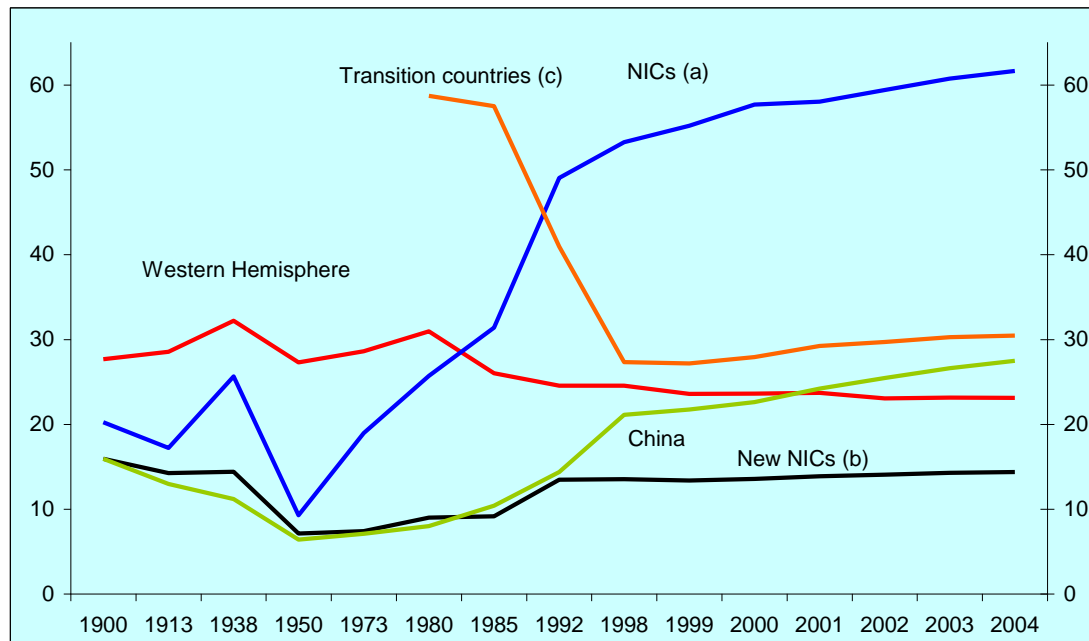
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<b>The World in areas</b>	
Shares in Aggregate World GDP, 2003	
	<u>Percent of World</u> <u>GDP</u>
<b>Advanced economies</b>	<b>55.5</b>
of which:	
United States	21.1
Euro area	15.9
Japan	7.0
Other advanced economies	11.6
of which:	
Newly industrialized countries	3.3
<b>Developing countries</b>	<b>44.5</b>
of which	
Africa	3.2
Developing Asia	23.8
of which:	
China	12.6
India	5.7
Middle East and Europe	2.8
Western Hemisphere	7.6
Central and Eastern Europe	3.3
Commonwealth of independent states	3.7

Source: IMF

## The smaller share of the Western Hemisphere is not new and to some extent it is the outcome of a long downward trend in per capita income coupled with the emergence of Asia.

DEVELOPING ECONOMIES: GDP PER CAPITA IN PPP  
(USA=100)



Source: IMF (april 2000), Maddison (1995) and WEO database.

(a) South Korea and Taiwan up to 1992, adding Hong Kong and Singapore from 1992 onwards

(b) Indonesia, Philippines and Thailand up to 1992, adding Malaysia from 1992 onwards.

(c) Eastern and Central Europe and Commonwealth of Independent States.

# A global, interdependent world

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- Links between advanced economies and emerging markets.
  - Financial channels (flows of capitals: increasing trend, volatile)
  - Commercial channels (flows of trade; increasing, sustained trend, extending beyond tradables)
- Link among emerging markets
  - Financial contagion
  - Trade competition, integration...

## *The global economy.*



# The global economy: Where is it now?

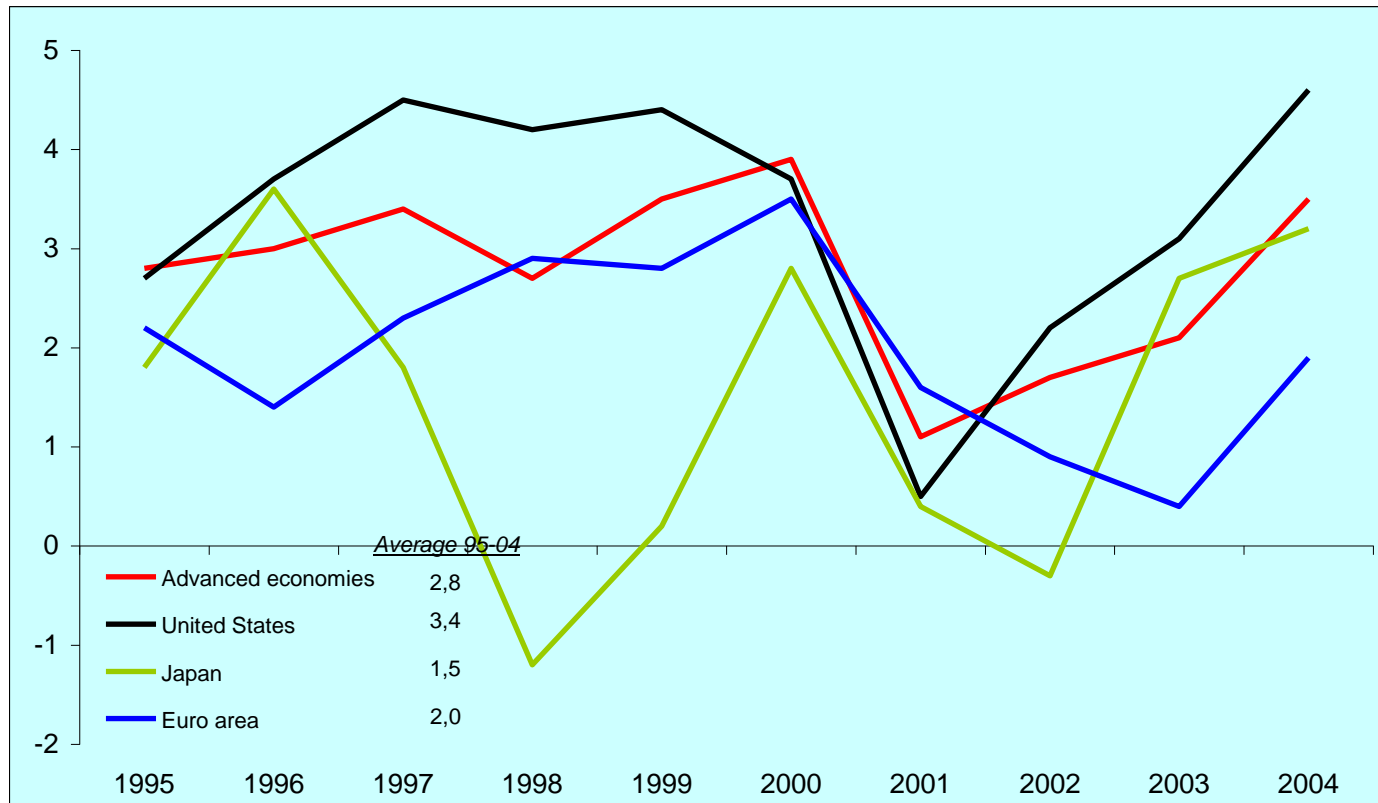
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- The current recovery exhibits the following features:
  - Broadening and consolidation
    - exception Euro area, but including, remarkably Japan
    - Awareness of new global player: China
  - Lack of inflation pressures
  - Expansionary policies (sometimes in excess)
  - Global imbalances non corrected in downturn
  - Higher oil and commodities prices
  - Ample liquidity in financial markets, caution in equities

# Summary of World Output

## Real GDP. Annual percent growth

### Advanced economies, recovery gaining strength



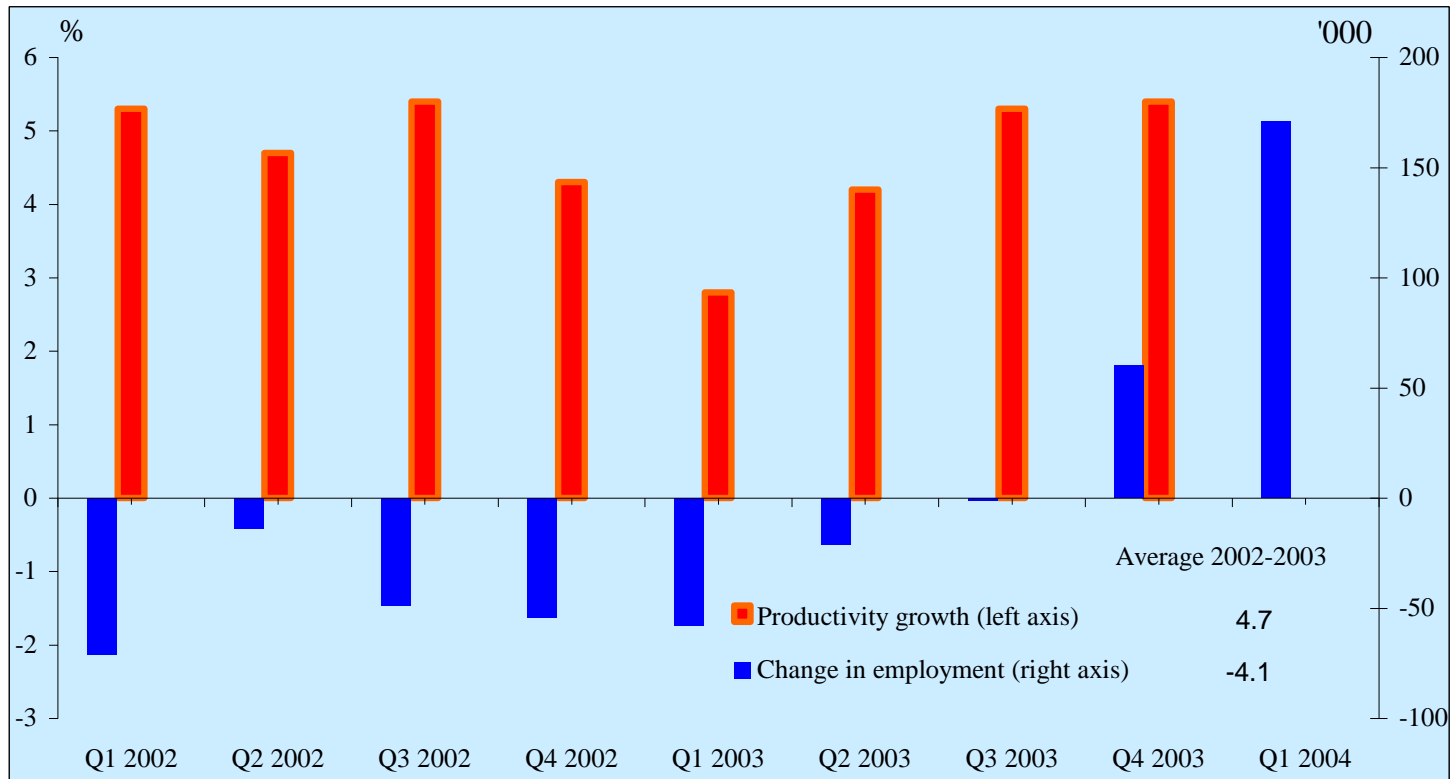
Source: IMF.



# United States

Strong recovery, sustained by policy stimulus, strong productivity. However, weakness of the job market generates some concern

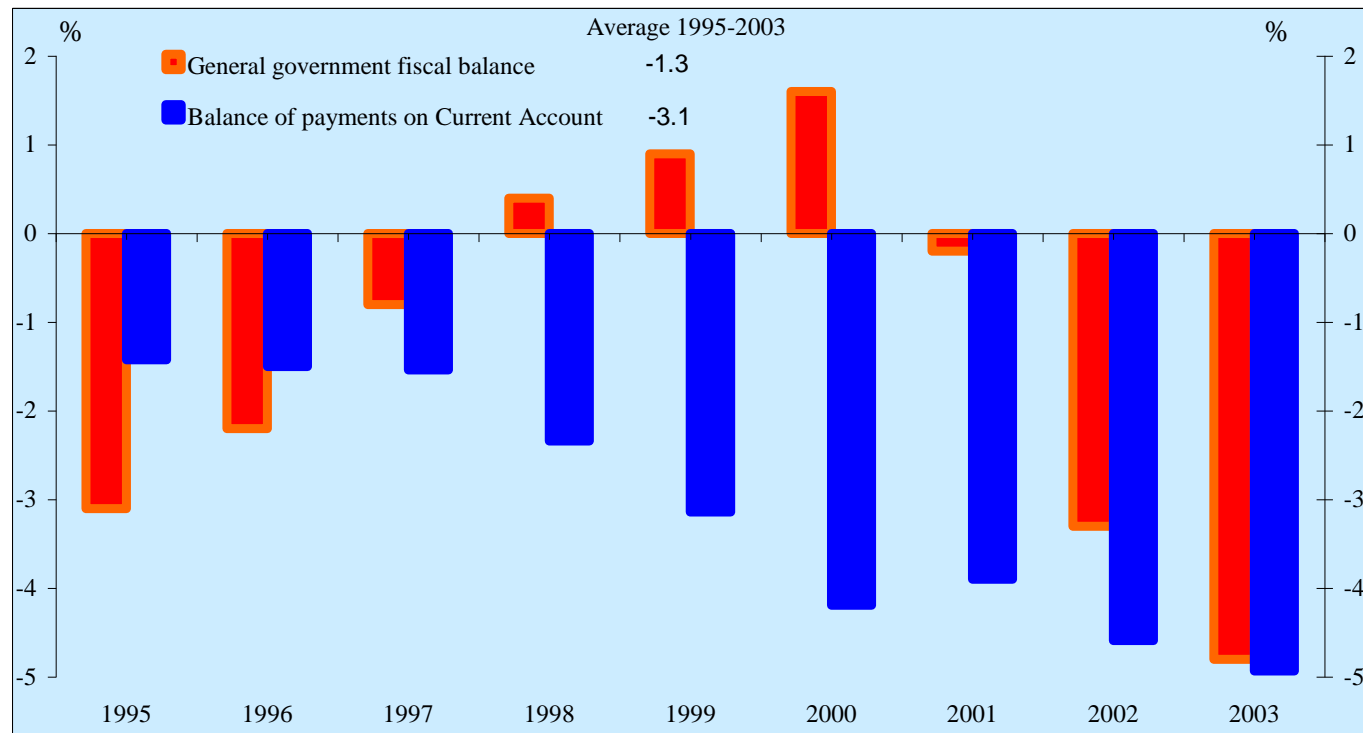
Reasons: Lags in recovery, structural change, high price of labour relative to K or productivity



Source: IMF, US Bureau

# United States

## Growing fiscal and current account imbalances: Twin deficits

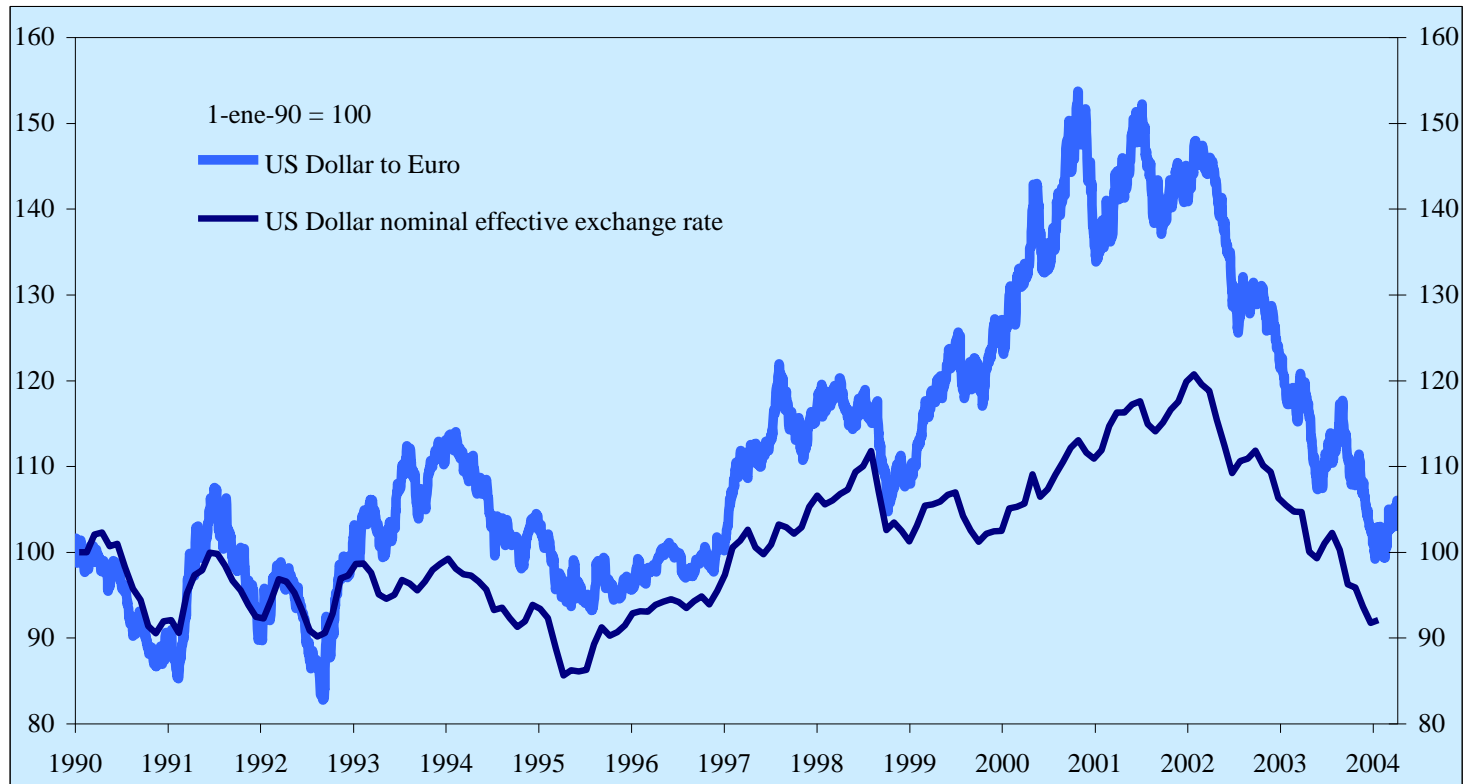


Source: IMF

# United States

Adjustment of external imbalances through exchange rate correction, but asymmetric so far: falls mainly on the euro.

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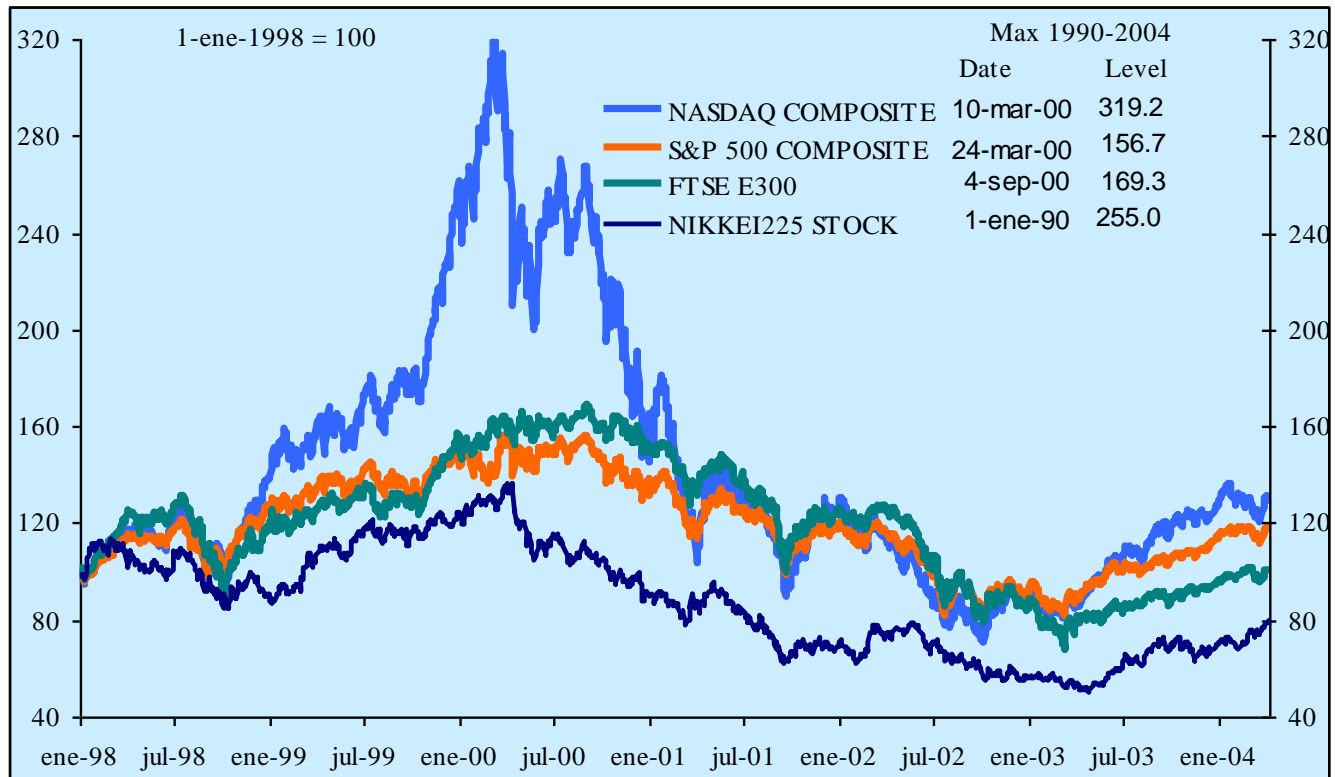
Source: IMF

# Financial developments

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- Extremely ample liquidity conditions, sustained by lack of inflationary pressures
- Interest rates at record low levels, both in the short and long run
- Certain anomaly at this phase of the cycle and given US expansionary fiscal stance. Explained by low inflation expectations (Fed stance) + Asian central banks
- Equity markets recovery, after correction of overvaluation in past three years.
  - Caution remains, although higher appetite for risk is reflected in evolution of high-yield and emerging markets bond markets

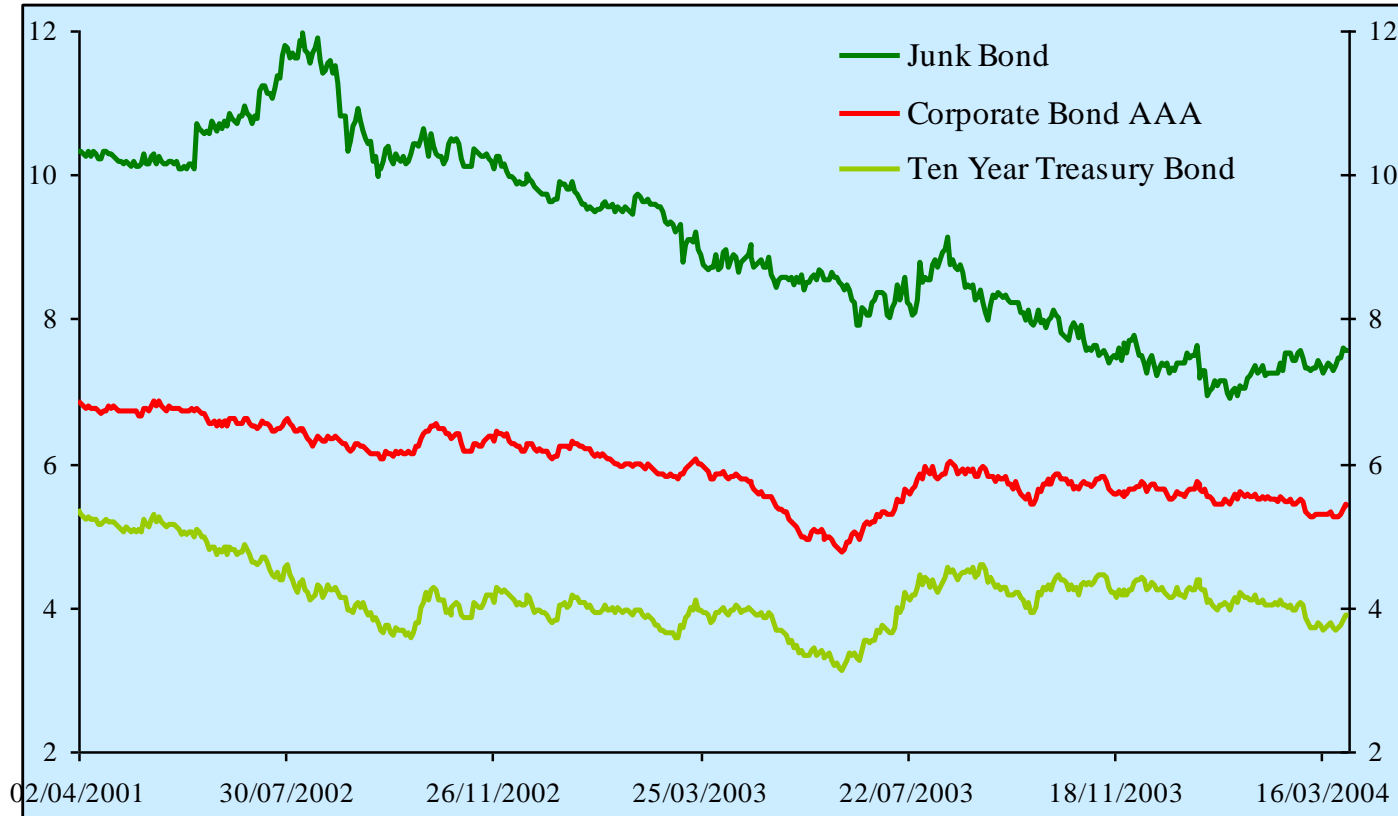
# Main equity indexes



Source: Bloomberg

# Public and Corporate Bond Markets.

For how long will low yields remain, and how sharply will they rebound?



Source: Bloomberg

# The global economy: where is it going in 2004?

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- Central scenario:
  - strengthening of recovery in 2004, stabilising in 2005
    - World output forecasts: '03:3,8; '04:4,6%; '05:4,4%
  - Containment of inflationary pressures (doubts in some EMEs)
- Risks remain
  - Economic factors: regionally unbalanced growth
    - US persistent imbalances, EU fragile recovery, Japan uncertainty, Emerging markets underlying vulnerabilities
  - ...impinging on financial variables
    - Disorderly dollar adjustment, sudden peaking of interest rates
  - Persistence of geopolitical uncertainty

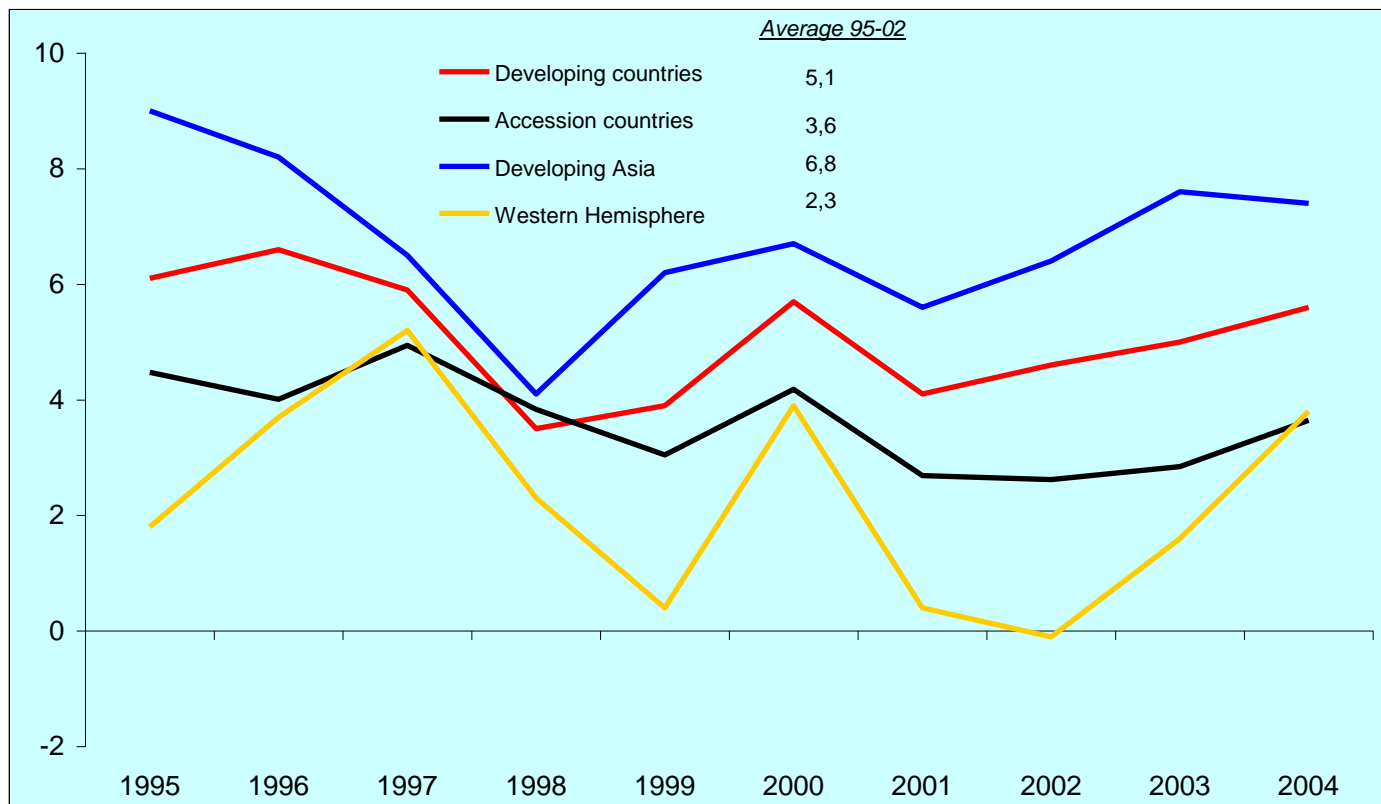
## *The economic situation in emerging markets*





# Summary of Developing Countries Output

## Real GDP. Annual percent change



Source: IMF.

# The situation in emerging markets

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- Economic growth in EMEs has been strong
  - EMEs output forecast: '03:5,9; '04:6,0%; '05:5,9%
  - NB: China systematically contributes to around 2.5 p.p (40%) to GDP growth
- Pushed by external sectors: high global demand, recovery of commodity prices.
  - Protecting external competitiveness through exchange rate intervention
- Recovery of financial flows, but remaining vulnerabilities
- Economic performance in the Western Hemisphere lags behind, due to turbulences, already overcome

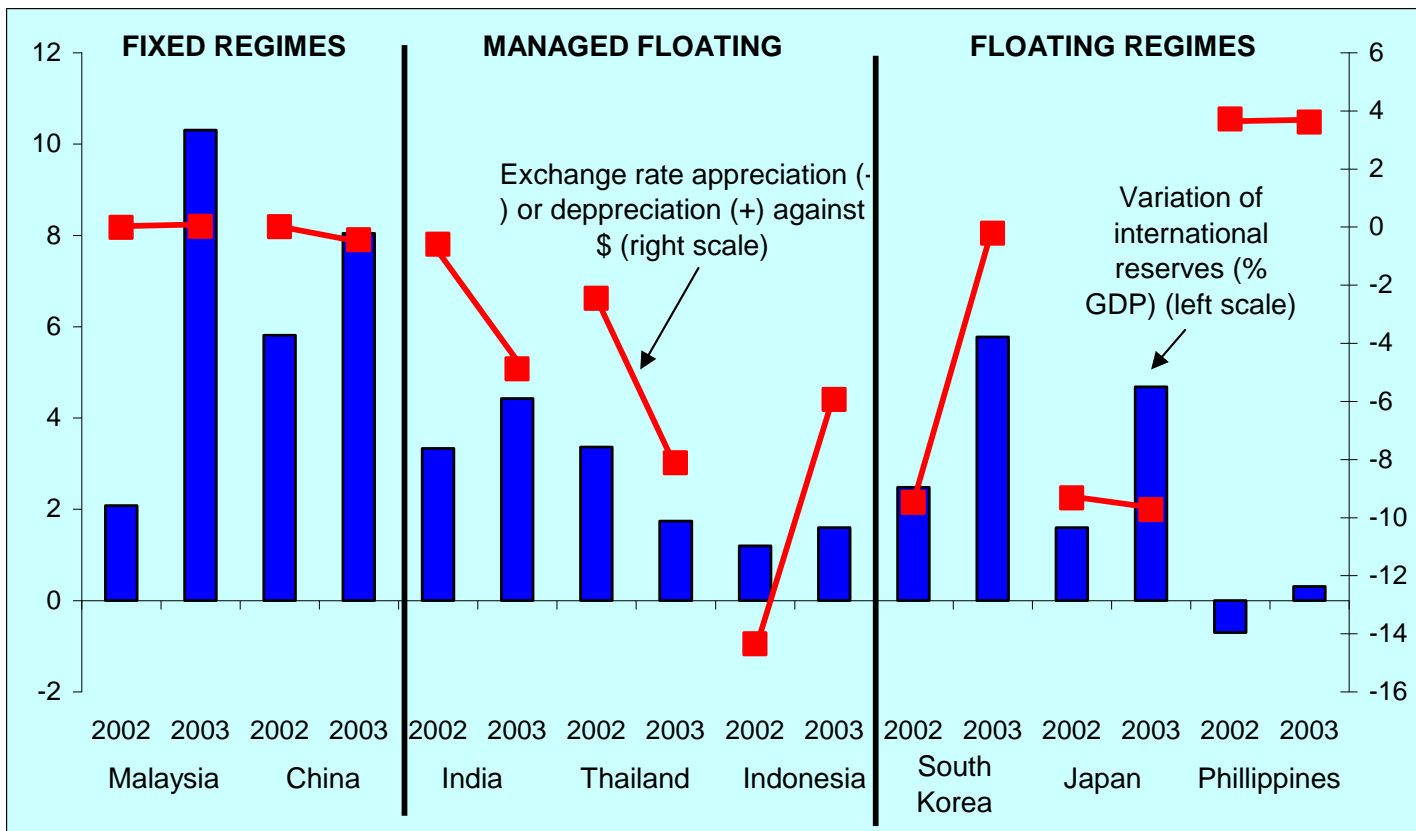
# Developments in non Japan Asia

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- Highest growing region in the world (7,5% in 2003)
- Broadly based
  - Domestic + external demand
  - Most countries grow at over 4%
- China factor
  - Strong domestic demand
    - risks of unbalanced growth, structural weaknesses
  - Pulls external demand in rest of the regions
  - OMC entry underpins export growth (4th largest world exporter)
- Importance of external sector robustness
  - Underscored by proactive intervention policies
    - Reinforces global imbalances (asymmetric adjustment of dollar, demand of US securities)

# Developing Asia

## Reserve accumulation and exchange rate variation



Source: IIF, IMF and Datastream.

# Developments in Central and Eastern European countries

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- Growth remains robust (4,1% in 2003) after resilience in past years. Strong domestic demand
- Integration in the EU plays a key role as umbrella to the international environment
- However, some relevant problems in terms of nominal convergence
  - Fiscal deterioration: increase in deficits plus deviations from targets
    - Hungary, Check Republic,...higher than 6%
  - Dilemma: expenditure control in the face of social demands
  - Widening of current account deficits
    - Not alarming as long as supporting investment and productivity convergence
    - But not always so, in particular, domestic demand
  - Exchange rate pressures and inflation deterioration in certain countries
- Feasibility of smooth transition into EMU? Fast track vs Gradualism

# Central and Eastern Europe

## Nominal convergence indicators

	Economic Growth %			Inflation, CPI %			General Government Net Lending (+) / Borrowing (-) % GDP			Long Term Interest Rates			Short Term Interest Rates		
	2001	2002	2003	2001	2002	2003	2001	2002	2003 (f)	2001	2002	2003	2001	2002	2003
<b>Czech Republic</b>	3.1	2.0	2.9	4.5	1.4	-0.1	-6.4	-6.4	-12.9	6.3	4.9	3.9	5.2	3.5	2.3
<b>Hungary</b>	3.9	3.5	2.9	9.1	5.2	4.7	-4.4	-9.3	-5.9	7.9	7.1	6.6	10.9	9.2	8.1
<b>Poland</b>	1.1	2.3	3.7	5.3	1.9	0.7	-3.5	-3.6	-4.1	10.7	7.3	5.6	16.1	9.0	5.7
<b>Slovakia</b>	3.3	4.4	5.6	7.4	3.5	8.5	-6.0	-5.7	-3.6	8.1	6.9	5.0	7.8	7.8	6.2
<b>Slovenia</b>	2.9	3.0	2.3	8.6	7.5	5.7	-2.7	-1.9	-1.8	--	--	5.5	10.9	8.0	6.8
<b>Estonia</b>	6.5	6.0	4.7	5.6	3.6	1.4	0.3	1.8	2.6	--	--	4.3	4.5	3.4	2.9
<b>Latvia</b>	7.9	6.1	7.4	2.5	2.0	2.9	-1.6	-2.7	-1.8	--	--	4.9	6.1	3.3	3.0
<b>Lithuania</b>	6.5	6.8	8.9	1.3	0.4	-1.1	-2.1	-1.4	-1.7	--	6.0	5.3	5.9	3.7	2.9
<b>Malta</b>	-1.2	1.7	0.4 (f)	--	--	1.3	-6.4	-5.7	-9.7	6.1	5.7	5.0	4.9	4.4	3.3
<b>Cyprus</b>	4.0	2.0	1.9	2.0	2.8	4.0	-2.4	-4.6	-6.3	7.7	5.4	4.7	5.9	4.4	3.9
<b>Average (non weighted)</b>	3.8	3.8	4.5	5.1	3.1	2.8	-3.5	-4.0	-4.5	7.8	6.2	5.1	7.8	5.7	4.5

Source: National statistics (for GDP growth) and European Commission.

(f): European Commission Spring 2004 Economic Forecasts

Source: ECB and European Commission

# Developments in Latin America

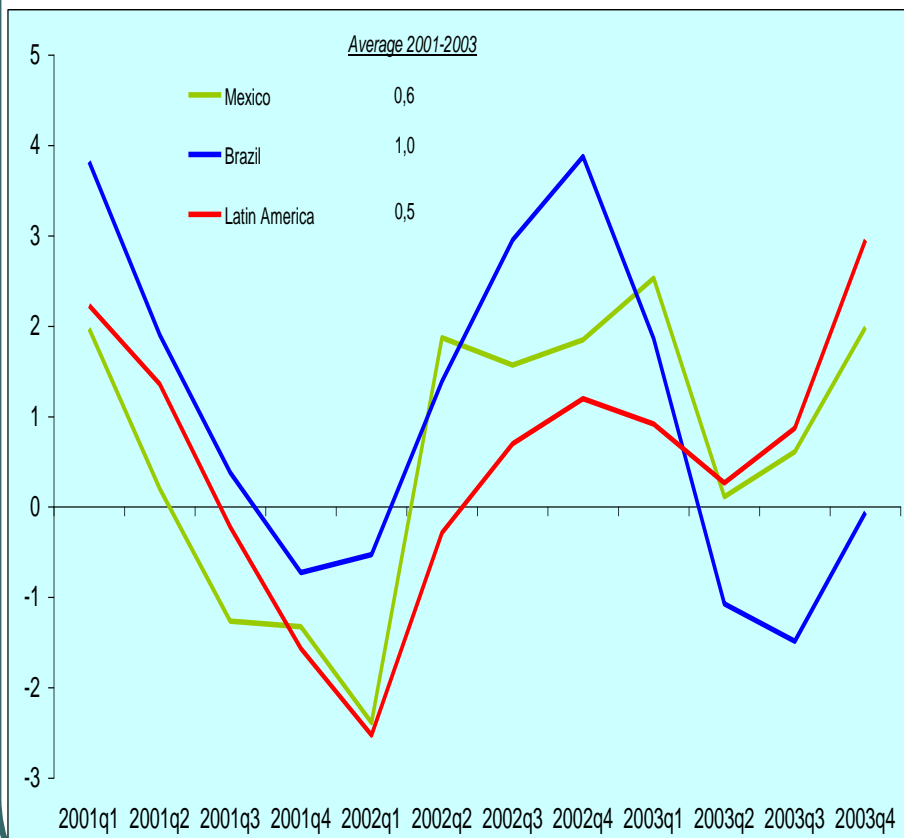
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- Latin America is hardly recovering from economic turbulences in 2001 and 2002
- Sharp improvement in financing conditions contrasts with delays in growth reactivation
  - Burden of required adjustment after sudden stops
    - Restrictive fiscal policies to recover confidence
    - Restrictive monetary policies to tame pass-through of large previous depreciations
  - Large deterioration of purchasing power of consumers (increase in unemployment, adjustment of real wages) hinders recovery
- Vulnerability remains, mainly in the fiscal side
  - Increase in debt and sensibility to deterioration of financing costs
  - Fiscal discipline to stay
- Reform fatigue and disenchantment
  - Challenges to economic policy.
  - NO shortcuts to growth, though

# Summary of Latin American Output

## Real GDP. Annual percent change

### Volatility and divergence in cyclical position

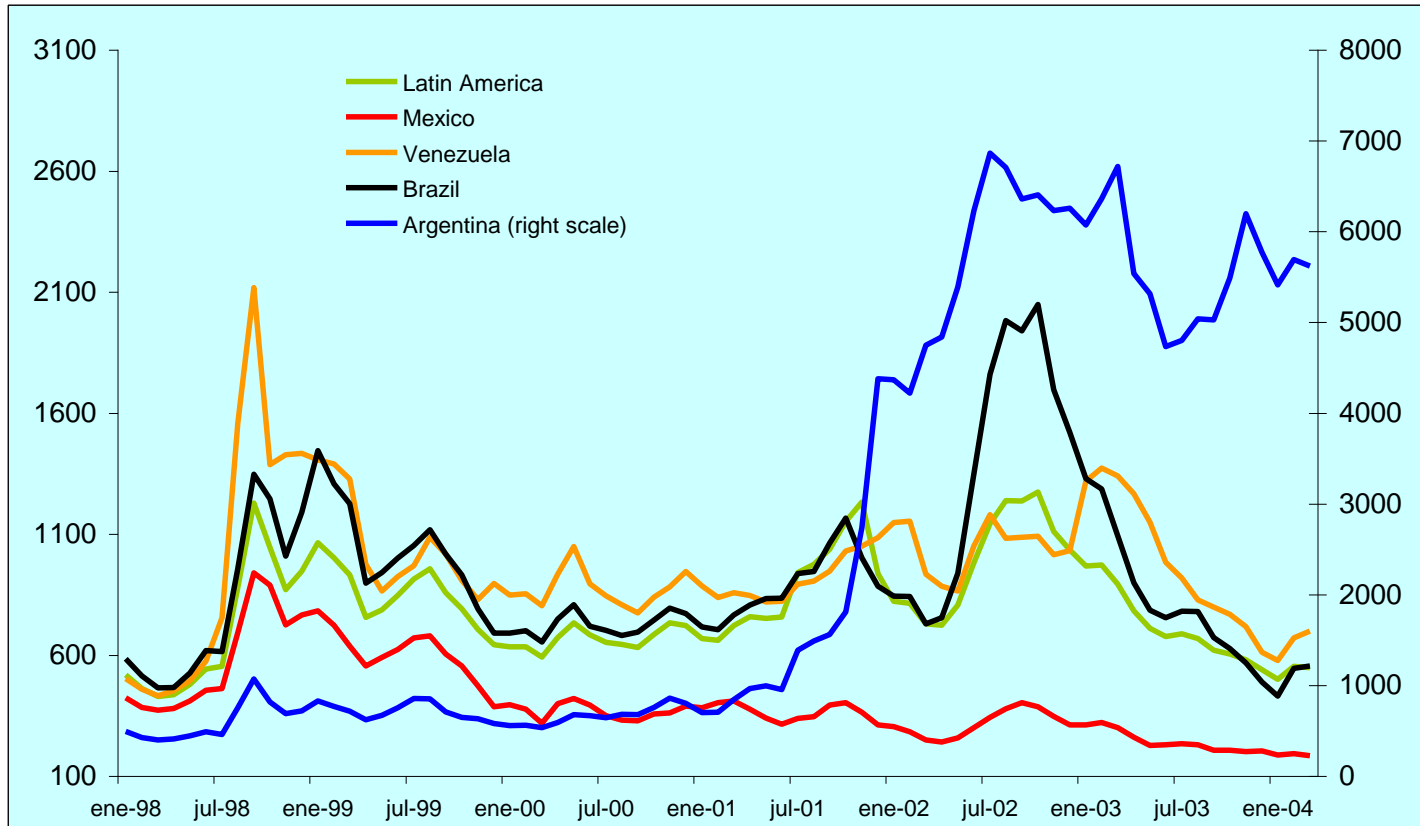


Source: national statistics.



# Sovereign spreads against US

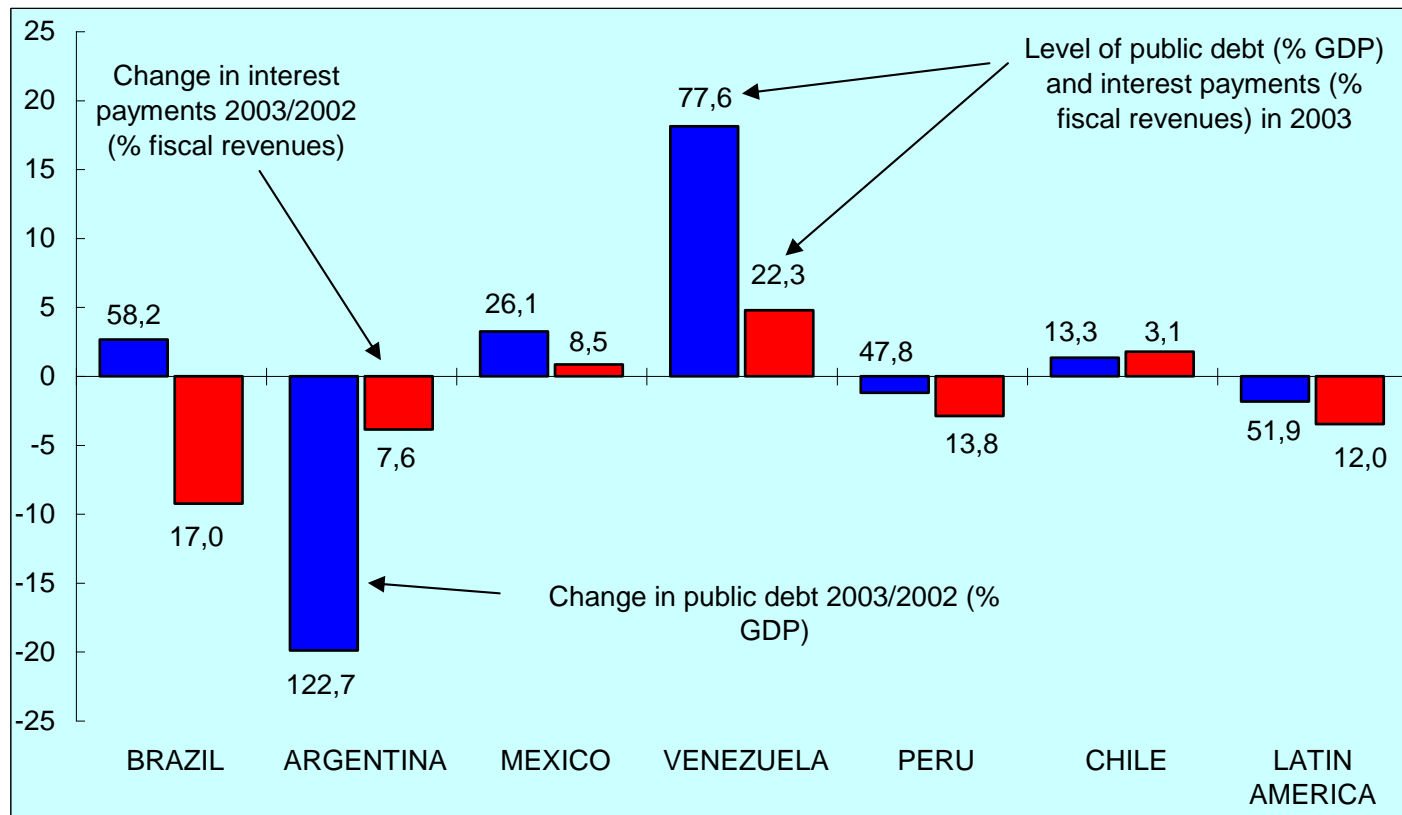
## Generalized reversion...end of correction?



Source: JP Morgan.

# Public debt (% of GDP)

## Vulnerabilities remain. Debt dynamics cause of concern



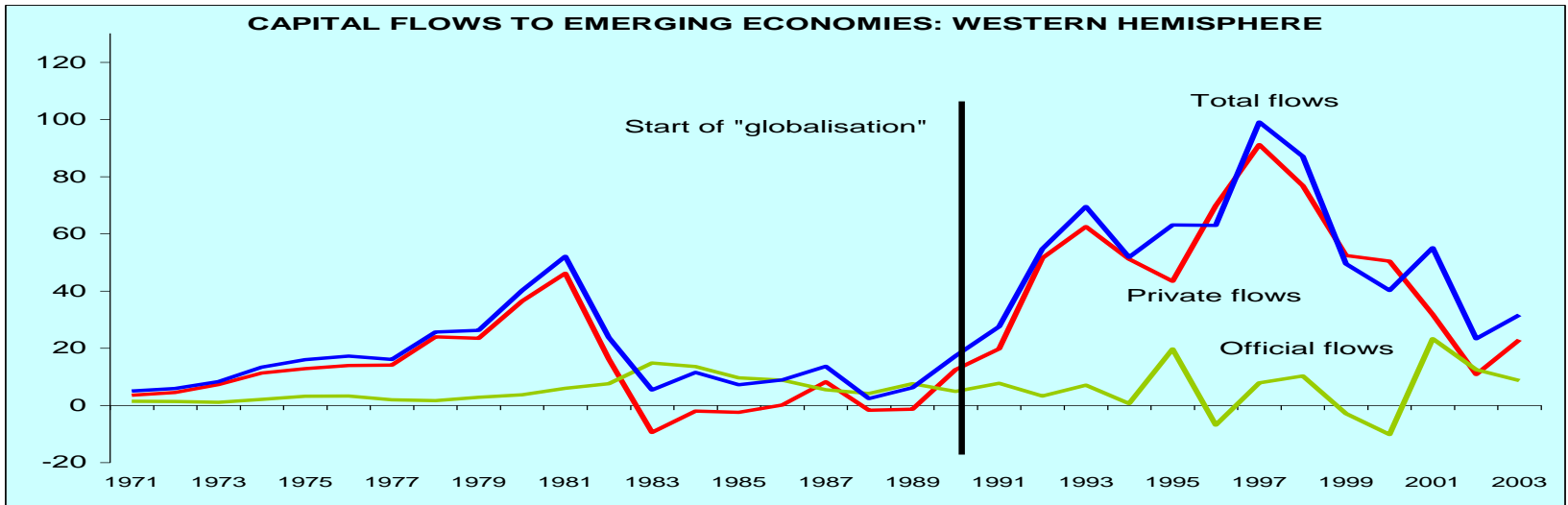
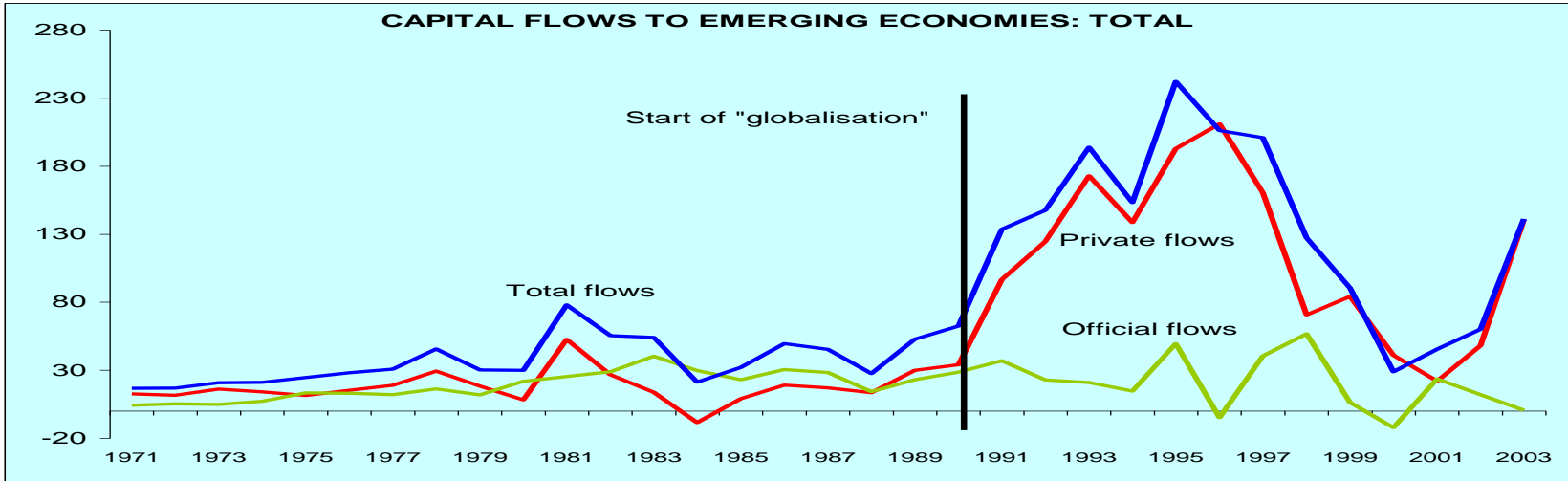
Source: national statistics.

## *Capital flows to emerging markets*



# Net capital flows to emerging markets economies.

## Nominal values in billion of US dollars



# Capital flows to emerging markets

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- Recovery of net capital inflows to levels prior to 1998, reaching 140 m.m.\$ (vs. 60 m.m. in 2002)
  - Very favourable factors
    - global recovery
    - ample liquidity, larger appetite for risk in context of low returns in developed countries
    - Overcoming of financial turbulences in some emerging markets
  - China factor heavily weighs.
    - Main target of FDI

## Capital flows to emerging markets

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Looking at the geographical composition:

- ***Non-Japan East Asia***: largest increase, from 6 m.m in 2001 to 85 m.m in 2003, due to reactivation of banking loans (95 m.m \$)
- ***Latin America***: remarkable recovery after overcoming turbulences, from 22,5 in 2002 to 31,6 in 2003, but far from levels prior to 1998. Mostly due to recovery of portfolio flows (bonds and equity) and supported by official flows
- ***EU accession countries***: stability of capital flows 38 m.m.\$.  
Pulling due to integration process might be petering out, as reduction in FDI suggests

# Capital flows to emerging markets

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By components:

- *Direct investment* continues a smoothly declining trend, but continues to be the main engine of inflows due to its resilience, averaging more than 150 m.m.\$ since 1996
- *Cross-border banking flows* end their protracted retrenchment initiated after the Asian crises. It is precisely Asia which benefits most.
- *Portfolio flows* , on the contrary, continue their retrenchment for the third consecutive year, due, again, to outflows from Asia.
- *Official flows* are zero in net terms, due to offsetting effects among regions. Africa and Latin America net recipients

# Economic perspectives for emerging markets in 2004

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- Broad based recovery sustained by maintenance of favourable external conditions
- Start of restrictive cycle of monetary policies risks having important effects
  - But central scenario contemplates late and smooth tightening cycle
- Regional differentiation:
  - Asia: autonomous recovery, but export led. China's locomotive role and risks within
  - Central and Eastern Europe: EU accession as some convergence indicators deteriorate
  - Latin-America: recovery cycle based on maintenance of investor sentiment
    - Very favourable external position, price stability, fiscal discipline
    - Persistence of vulnerabilities
    - Domestic policies and reform require strengthening in the face of disenchantment
    - Robust growth as diluter of problems....sustainable only with new leap in reforms