## ASIAN STOCK EXCHANGES MEETING

## "Policy Challenges and Scenarios for the Western World: Can Emerging Economies Decouple?"

**Istanbul, 6 September 2012**

Reflecting the title of our session, I will divide my intervention in two parts, beginning with the first part of that title – "The Policy Challenges and Scenarios for the Western World" – and specifically on those for the euro area. The euro area crisis is, of course, very much on everyone's minds, and the reason is, clearly, because of the question in the second part of the session's title: "Can Emerging Economies Decouple?" I will cover that in the latter part of my intervention.

First, then the "policy challenges and scenarios for the euro area." As to the scenarios, let me immediately say that one can in all honesty only *attempt* to delineate them. Predictions vary from "manageable" (mostly European officials), to possibly "quite messy" (many market participants), to "unimaginable and catastrophic" (Malaysia's central bank Governor Zeti Aziz). The fact is that predicting developments in Europe has always been difficult for an economist, because politics need to be factored into the equation, and with a heavy weight. It is *politics* that has dominated euro area crisis management, for good or ill, and it is *politics* that will ultimately decide the fate of EMU. Angela Merkel herself has often stressed that "the common currency is not just a monetary project, but above all a political project."

Charles Goodhart, primarily an economist himself, put it very clearly: "Understanding the euro requires political economy, not just economics." And he added: "just as [the euro's] original introduction was a matter of political will, rather than the result of an economic cost-benefit exercise, so any dissolution would follow from a conscious political act of separation, not from purely economic strains." Though economic strains are no doubt present, the essence of this interpretation is correct, and leads one to deem that, despite all the difficulties, the euro project will ultimately survive – and possibly even with all of its original members, simply because the investment of political capital is so large and the related political stakes so high.

That said, this prediction has to be heavily nuanced, because matters are further complicated by the fact that the formation of the "political will" driving Eurozone fortunes is no longer in the hands of, if you want, establishment politicians – whose reaction

function is more or less predictable – but has shifted to the population and to new parties expressing a novel (and still confused) political orientation.

More generally, the month of September is full of key and potentially fateful events for the euro area, each of which will need to mark steps forward – beginning first and foremost with the meeting of the ECB's Governing Council in Frankfurt, taking place today, as we speak here in Istanbul. One thing for certain: for a continuation of the relative calm observed on the markets this summer, i.e. since ECB President Mario Draghi's end-July 2012 commitment to "do whatever it takes to preserve the euro," today's meeting will need to yield substantive results. First, faced with a deepening recession and the absence of inflationary pressures, a further reduction of ECB interest rates should be on the cards. Second, and most importantly, the details of the ECB's securities intervention program should be decided and announced – rather than, as some report, await the ruling of the German Constitutional Court on the ESM. Actions must be shown to follow words, and within a short time span. So this ECB meeting cannot be one of further deferment, of passing the buck from Frankfurt to Karlsruhe, the site of the Constitutional Court. Or else Draghi's reassurance on the ECB's plan – "believe me, it will be enough" – will lack the very credibility it invoked.

For now, all we know with certainty is what was decided on this program at the ECB's meeting in July 2012. The ECB then basically laid down two signposts: first, that the beneficiary countries should explicitly request access to the mechanism via the EFSF/ESM and, second, that the latter set its conditionality. Per se, these requirements should not be problematic, and are in any case needed to disarm Bundesbank opposition. But they must be accompanied by two related prerequisites. First, that countries under pressure not hesitate to request activation of the facility. And, second, that its conditionality not stand in their way.

The expectation that countries seeking support for their government securities markets should explicitly request it is actually a prerequisite for its success. Securities purchases that were to fall from the sky, as a sort of heaven-sent manna, would not enjoy the essential ownership of the beneficiary country, remaining detached from the nation's political consciousness and that of its government – as indeed happened in August 2011. But it will be important, once the mechanism is actually operational, not to procrastinate requests for access if bond spreads remain high.

But, lest it be so, Europe will itself have to recognize that a mechanism that seeks to correct market excesses cannot impose a burdensome conditionality on countries that have already done much and remain solvent. It should in other words be consistent with the mechanism's raison d'être: the correction, in the ECB's own words, of a "severe malfunctioning in... the bond markets of euro area countries." In other words, to correct a market distortion that is not in itself ascribable to the affected countries, as recognized

also by the IMF, who estimates at 200 basis points the excess of Italian and Spanish spreads over those justified by fundamentals. As outlined by the European Council in June 2012, a renewed commitment to already issued EU recommendations should suffice. That is, a confirmation of commitments already made, without new obligations.

Apart from today's ECB meeting, the other potentially fateful event in September is in less than a week's time, on September 12, when the German Constitutional Court is due to pronounce its decision on the ESM. Most observers expect a positive ruling on the constitutionality of the fund as such, but this in itself is unfortunately insufficient. It will also be important that the Court avoid subjecting the fund's activation to such a maze of political controls by the Bundestag as to render its mobilization prolonged and demanding, if not downright impossible. The Court should bear in mind what German law already allows for the workings of the International Monetary Fund, where the weight of Germany's vote stands at only 5.81% (against 27.15% in the ESM). Recognizing the EMS's constitutionality, while at the same time undermining its functionality and effectiveness, would be not only duplicitous and futile, but also fatal to the future of the eurozone. On the same day, as mentioned, general elections will be held in the Netherlands. Should a markedly anti-European result join an unsatisfactory ruling by the Court in Karlsruhe, September 12, 2012 will go down as a calamitous day for Europe.

In the hope of prevailing unscathed over these key events of the first half of September, others are on tap for later. Among them, the Eurogroup and Ecofin meetings at mid-month which should, inter alia, advance toward unified banking supervision, necessary to unlock support for Spanish banks, and the issuance of the troika's report on Greece in either late September or early October. So there is no shortage of obstacles on the path toward this year's autumn. But they are not insurmountable. With even slight progress at each of September's rendezvous, and with an early start of the new ECB securities purchase program, one can aspire to extending this summer's calm, and be en route for a gradual resolution of the euro crisis. This will of course require other major steps to complete Europe's unfinished economic and monetary union. It will not be easy, but there is now at least a hint of greater confidence that the effort will continue.

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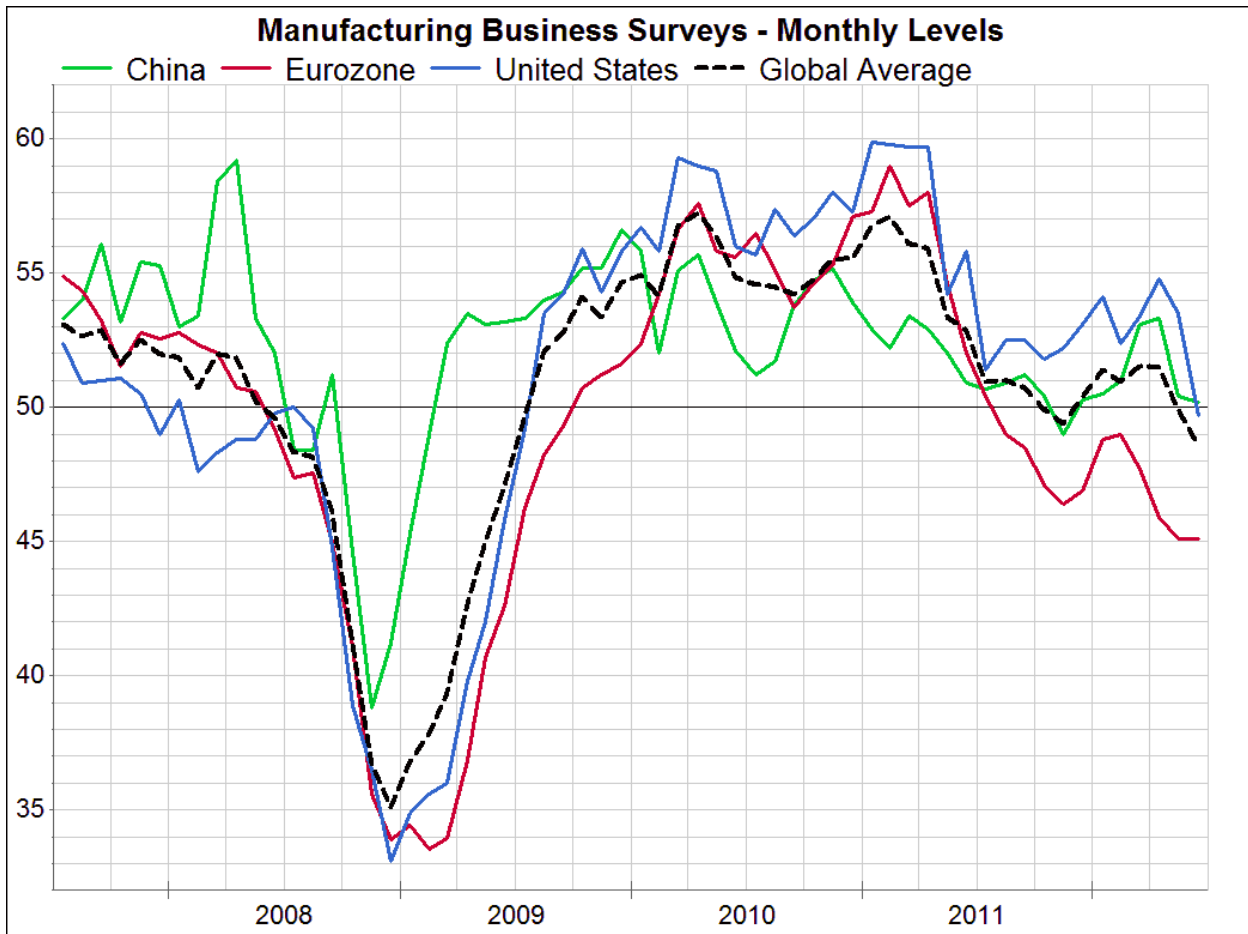
Let us turn then to the second part of our session's title: Can emerging markets decouple from all of this? In examining the whole issue of decoupling, observers come to at times diametrically different conclusions, as these two quotes from 2008, in the midst of the post-Lehman recession, demonstrate:

- “You either believe in decoupling or globalization – but not both” (Stephen Roach, Financial Times, January 23, 2008)
- “You can have both decoupling and globalization at the same time” (The Economist, March 8, 2008)

So, which of the two is it? Basically, the confusion arises from the fact that people tend to speak of two different things when looking at linkages and interdependencies. In brief, it is important to distinguish between cyclical dynamics and longer-term trends. In a nutshell, cyclical movements in the world remain inevitably linked. It is long-term trend growth rates – or so-called potential growth – that have in contrast decoupled over the last 20 years, with emerging economies enjoying much higher potential growth rates.

One can see the short-term linkages quite clearly in the movements of a much-watched cyclical index, that of manufacturing business surveys, considered to be an important leading indicator (see chart below). This indicator for China, the Eurozone, the US and globally, has been moving very much in tandem during the current crisis, reflecting a strong business cycle synchronization. Clearly, we are not in the same depths as those of post-Lehman 2008, but it is also clear that the index has been declining everywhere for the past 18 months, pointing to a synchronized slowdown in global growth, likely to persist at least through early 2013.




But the manufacturing business surveys are a *level* index, and as such shed no light on differences in growth *rates*. A perusal of annual percentage changes in real GDP growth confirms that short-term growth rates are also highly interdependent and display a pronounced comovement – or, to use the terminology employed in a recent article by Kermal Derviş, economies all tend to "dance together" in the short term.

This is unsurprising, since a world of closely linked markets and highly correlated risks is a world ripe for spillovers, from which no one can just simply "decouple." Indeed, it is in awareness of these linkages that the IMF has begun producing so-called "spillover reports" that examine the external effects of domestic policies in five systemic economies on the rest of the world. And, in these reports' downward scenarios, no one escapes unscathed, essentially because of two transmission channels that make for intertwined economies.

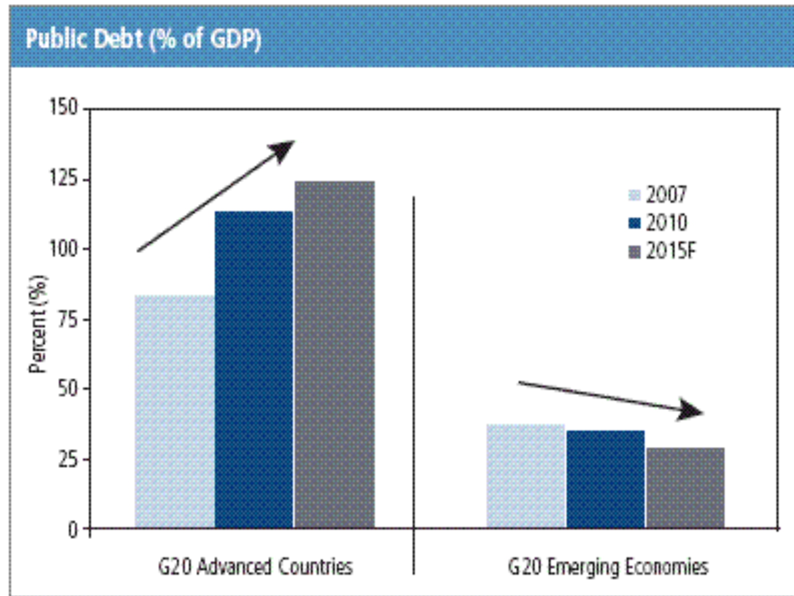
First, clearly, a trade and demand channel. Here, many emerging markets – and Turkey among them – continue to rely heavily on final demand from the euro area. Although, in Turkey's case, it must be said that it has been quite successful in export diversification,

and that a remarkable boom in exports to the Middle East and Africa has raised their share toward that of the EU, and more than offset the drop in exports to Europe. Second, a financial channel: European banks have substantial claims on many emerging economies, and deleveraging by these banks could have a significant impact on credit supply and asset prices in several countries. The main concern is that trade finance could be particularly affected, as European banks are important providers of such finance, and not easy to replace.

So we are bound to witness a cyclical slowdown this year, with much lower rates of growth in Turkey and other emerging markets, as export momentum weakens in response to the EU crisis. But even if no one can be insulated or immune in this interconnected world, there certainly are different degrees of resilience, depending on fundamentals and policies. And certainly, since 2000 or so, emerging economies have become much more resilient to shocks originating in advanced countries.

Most emerging economies emerged from the crises of the 1990s and early 2000s, as well as from the 2008 financial meltdown, with their global standing enhanced, their policy frameworks improved, and their fundamentals strengthened. Suffice it to say that none of the largest emerging markets (Argentina excluded) stands on the edge of a dramatic financial precipice, like some euro area countries, or of a fiscal cliff, like the U.S. All in all, emerging countries have weathered the global recession much better than the advanced economies.

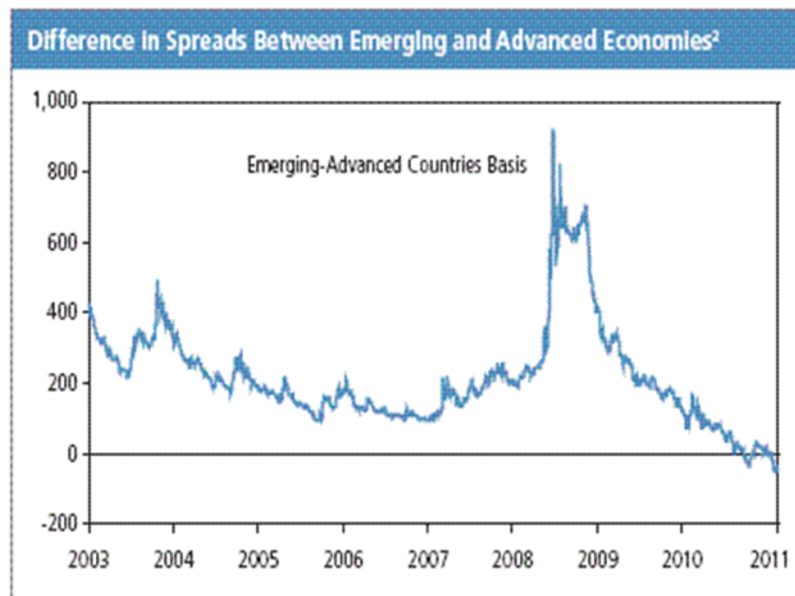
There has, in sum, been a shift in the locus of global growth away from advanced economies to emerging markets, from West to East. This is exemplified in two developments. First, there have been diverging levels and trends of public debt as a percentage of GDP, with advanced countries' high debt ratios constraining their macroeconomic policies to a much greater degree.




Source: International Monetary Fund

Figure 3

And, second, this has been priced in by markets, with a dramatic narrowing of spreads between emerging and advanced economies (to the point of actually becoming negative). As to Turkey itself, it was just recently reported by Fitch Ratings as possibly on its way to investment grade rating, which would of course imply a further easing of borrowing costs.

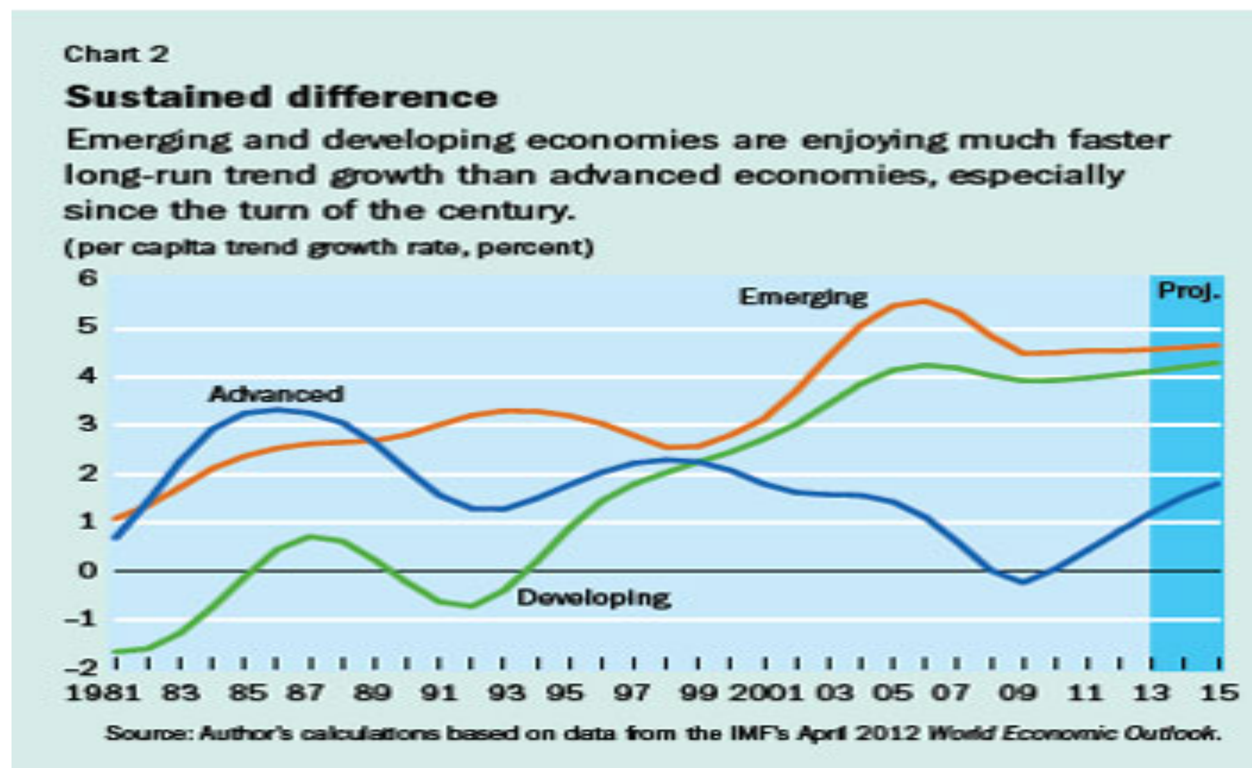



Source: PIMCO

Figure 4

So, to sum up with respect to **short-term linkages**: there continues to be a clear cyclical interdependence, linked to short-term demand-side factors, so one cannot expect decoupling as such. But emerging markets' greater resilience to external shocks certainly makes for lesser vulnerability to short-term fluctuations and cyclical slowdowns.

Where the decoupling is however apparent is, as mentioned, in **long-term trend growth** rates, or rates of potential growth, as shown below. The emerging markets' much faster long-run trend growth is evident, most particularly since 2000. This is due to a number of supply-side factors, including technological catch-up and demographics that favor the much younger emerging countries Thus, over the next two decades, Asia is set to become the largest economic region in the world, with its economy amounting to half the size of all the G-20 combined. China will certainly be the largest economy in




in the world, and the economies of Brazil and India will be considerably larger than those of France or the UK. Turkey itself will continue climbing in the economic leagues, aided inter alia by its demographic advantage, with a young, dynamic and well-trained population:

* over 60% of the population is under the age of 34 (approx. 45 million)

* a very low average age (28.8 years)

* an increasingly educated workforce (500,000 university graduates per year).

Indeed, Turkey's target of becoming one of the world's top 10 economies by nominal GDP by 2023 (the centenary of Turkish republic) is not necessarily beyond reach. The term "emerging economy," already of doubtful significance, will be devoid of any meaning in what will be a multipolar world economy.

While this is all good news for emerging markets, there is a risk of over-confidence. As the IMF has pointed out, the last decade or so may have "generated overly optimistic expectations about potential growth" and, though projections are always difficult (especially of an estimate such as potential output), we may witness a steady erosion in coming years in long-run trend growth. This is because much of the catch-up in manufacturing growth has already occurred, while manufacturing itself has become more skill- and capital-intensive. For their part, high productivity services also require complex skills and institutional infrastructure. It follows that emerging market growth will be more dependent on human capital, institutions and governance than in the past. Growth will thus be slower and more difficult than many investors had assumed, and rapid growth in emerging markets should not be taken to be part of the so-called "new normal." In short, performance of the past dozen years is unlikely to be repeated, and policies, investment strategies, and portfolio allocations will need to be planned accordingly.