New Macroeconomic Challenge for Emerging Economies

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Three Required Policies

The rise of emerging economies is a dynamic force that changes the global economic structure. But we must also remember that a very small number of non-Western latecomer countries have soared to the highest level of income (say, per capita income of well above $10,000) in world history. Japan from the late 19th century and Korea and Taiwan in the more recent past are prime examples, but we cannot think of many others. Singapore and Hong Kong are amazing performers but they are city economies without farmers or regional conflicts. Countries with small populations and lots of mineral resources are naturally rich, but their results depend on luck rather than effort. Achieving middle income (say, per capita income of over $1,000) is relatively easy: liberalization, privatization and integration will usually suffice. But climbing further calls for more demanding capabilities on both industry and government and sophisticated cooperation between the two. *(Chart 1)*

Generally speaking, three categories of policy are required if emerging economies are to continue to rise and eventually join the rank of advanced countries. First, a drive for productivity and innovation must be launched and then institutionalized for generating internal value instead of relying on natural resource revenues or foreign capital inflows. Second, new problems caused by fast growth such as income gaps, environmental damage, rural-urban migration, traffic jams and cultural change must be properly tackled. Third, a new and more complex macroeconomic management must be installed to reduce shocks associated with freer flows of international goods and capital. Unless emerging economies achieve all of these, they will be caught in a "middle-income trap" in which growth slows down before reaching the high-income level. They will eventually enter the stage of aging population and heavy social security cost without reaching high productivity.

Global Purchasing Power Movement

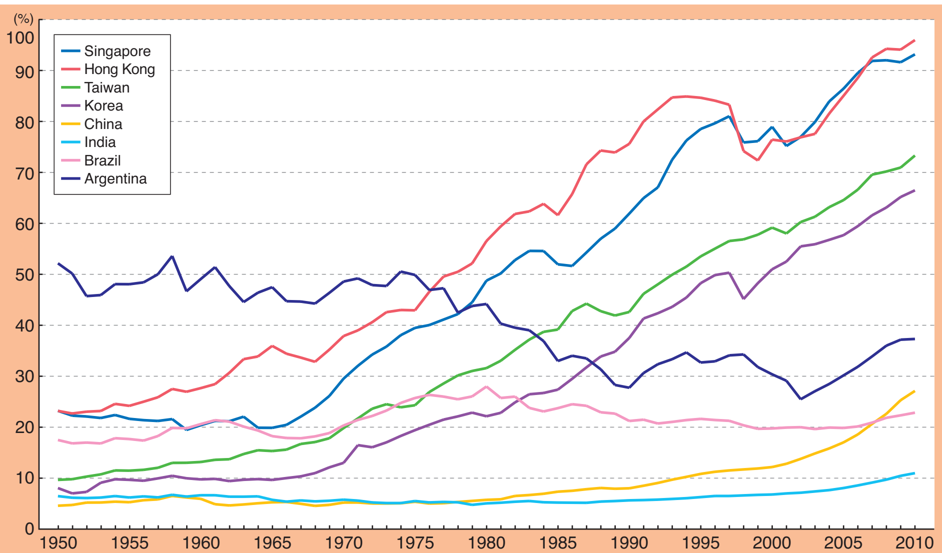
Unfortunately, the global capitalism that has prevailed in recent decades makes it harder for emerging economies and developing countries alike to meet these challenges effectively. In particular, rampant capital movement into and out of these economies has become a big shock to their macroeconomies. Moreover, this externally generated shock is further amplified by the existence and growth of internal asset markets of these countries.

Until the 1980s, economic crises in low- and middle-income countries were typically caused by the lack of macroeconomic policy discipline. After spending too much and facing its inability to service public debt, a distressed government often knocked on the door of the International Monetary Fund (IMF). Lending countries and their bankers usually demanded fiscal and monetary austerity, currency devaluation, and economic liberalization and privatization in exchange for a debt rescue package. These problems do occur even today, but they are no longer the only or dominant macroeconomic problems afflicting the developing world.

The world is more complex today due to free capital movement covering virtually the entire planet. The relationship between international finance and real economy is also more diverse. If properly handled and managed, finance supports production and investment in both developed and developing countries. But financial activities are also prone to self-propagation and high volatility, which are unrelated to the real economy. Huge purchasing power races across currencies, stocks, bonds, commodities, real estate—and their derivatives—of any country in instantaneous response to fleeting expectations on investment returns and risks. There are times when the self-motion of global capital badly harms the global real economy, as we have learned at great cost through the Lehman Shock and the ongoing European crisis.

CHART 1

Per Capita Real Income Relative to USA
(Measured in 1990 international Geary-Khamis dollars)



Source: Angus Maddison (2003), and IMF, World Economic Outlook Database, April 2010 (for updating)

Amplification of Speculative Money

From the viewpoint of emerging economies and developing countries that are on the receiving end of global capital, this means that huge purchasing power relative to their GDPs can come in and go out at any time. Such flows are sometimes the result of policy mistakes, but most of the time they are independent of domestic policy stance. Inflows and outflows of global purchasing power can occur for different reasons and take various forms. In the Asian currency crisis of 1997-'98, short-term bank loans lent to Thailand, Korea and Indonesia were suddenly withdrawn, leading to the collapse of their currencies and a severe contraction of domestic demand. Similar crises were observed in Mexico (1994), Russia (1998), Brazil (1998-'99), Turkey (2000-'01) and Argentina (2001-'02), but the kinds of money that entered and left were not always the same. In addition to these financial shocks, emerging economies and developing countries are also battered by traditional shocks arising from global business cycles, export market contraction, and commodity price instability. Countries with a small economic size and without sufficient policy tools are easy victims of global financial ebb-and-flow.

The external vulnerability of countries with heavy dependence on the export of crude oil, copper, coffee, and the like is well known and still present. For example, the nominal incomes of Russia, Gulf states, Venezuela, and other oil-exporting economies are highly correlated with the price movement of crude oil. Growth acceleration in African countries observed in recent years has been generated more by soaring commodity prices than by progress in industrialization or improvement in productivity. Such prosperity is destined to evaporate when the market turns downward.

More recently, flows of global purchasing power into stocks, bonds and real estate of emerging economies that have achieved a certain level of financial development have become prominent. These inflows and their eventual reversals seriously impact the business cycles of these economies as well as those of international financial centers in London or Dubai that mediate such flows. China is a special case in which a domestic liquidity glut is produced by strong earnings of manufactured exports, receipt of FDI, and the People's Bank purchase of USD in the foreign exchange market. Together with active public investment, China has gone through repeated waves of overheating and macroeconomic tightening.

It should be noted that borderless capital entering emerging economies is magnified by the domestic asset markets of these economies. Large purchasing power relative to economic size does not usually go to long-term investments in factories or farms; it is typically invested in urban properties and landmark projects that can generate short-term profits in land inflation. Capital gains earned by speculators will add more fuel to the national economy, which ignites and sustains construction booms, consumption booms and surging imports, common symptoms of receiving too much foreign money. Land and stock markets serve as the amplifier of excess purchasing power. Once started, they will expand domestic demand through the usual Keynesian multiplier mechanism. Purchasing power is thus doubly activated in emerging economies through both asset bubbles abroad and asset bubbles at home.

Photo: author

A skyscraper in Hochiminh City, Vietnam

At present the world economy is in a recessionary phase. Two things are worth noting about the current situation in comparison with the past. First, global cycles are more widespread and synchronous in the sense that they affect not just the economies of the US, EU and Japan but also emerging economies such as China, India, Brazil and Russia, which were supposed to be the alternative locomotive of the world economy. Second, the cycles of global inflation and recession seem to have shortened, with the two occurring within a few years' interval instead of decades apart. Both phenomena are likely to have something to do with the dynamics of global financial flows.

Vietnam a High Performer?

Let us look at Vietnam, an East Asian country that has achieved fast growth in the last two decades with the per capita income jumping from $98 in 1990 to $1,200 in 2010. By the World Bank income criteria, Vietnam joined the lower-middle-income group in 2008. This feat was achieved mainly by domestic liberalization, or *doimoi*, which officially started in 1986, and external integration beginning in the early 1990s. New trade opportunities and inflows of ODA, FDI and remittances initially stimulated the Vietnamese economy. But the country was financially isolated from the rest of the world in the 1990s, and the Asian currency crisis of 1997-'98, which devastated neighboring countries, affected it only slightly and indirectly. Inflation rates in the second half of the 1990s remained at a single-digit level. However, in the 2000s, Vietnam became more vulnerable to external shocks with the creation of stock exchanges, progress in financial liberalization, expansion of regional trade, and accession to the World Trade Organization in 2007. With deeper financial integration, asset market bubbles and chronic inflation became inherent characteristics of the Vietnamese economy. The estimated annual inflow of foreign money including private remittances, FDI, investment in stocks and real estate, ODA, and spending of foreigners visiting or residing in Vietnam is in the order of $20-30 billion, or 20-30% of GDP. The movement of foreign money targeting Vietnamese stock and land markets is particularly volatile.

Not Interested in Manufacturing

In 2007, foreign money worth $6.2 billion (9% of GDP) poured into the tiny stock exchanges of Vietnam, pushing up the stock market and then the land price, and driving the Vietnamese people into a money game craze. The asset bubbles cooled down somewhat in the wake of the global Lehman Shock, but inflation in land and goods resumed around 2010 to make Vietnam the country with the highest inflation in East Asia—with consumer price inflation at 18.1% in 2011. For foreign visitors, including Japanese, Vietnam

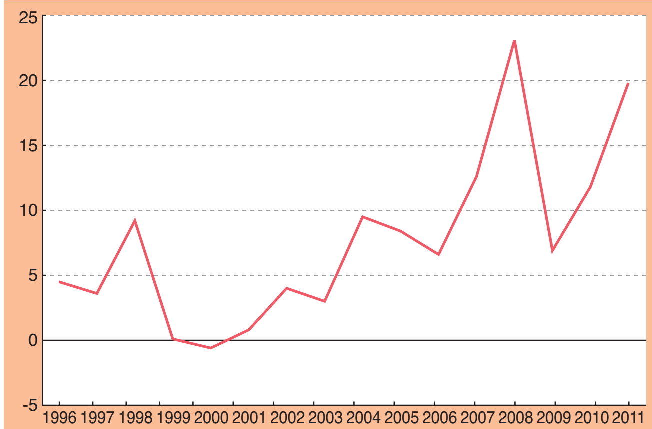
Photo: author

Construction boom in the center of Hochiminh City

CHART 2

Vietnam: Consumer Price Index

(Percent per annum)



Source: General Statistics Office, Vietnam

was a country of extremely low prices in the 1990s. This is no longer true today. What rose most was the price of land in and around the two big cities, Hanoi and Hochiminh City. In 2010, Vietnam's income per head of $1,200 was only 2.8% of Japan's, but urban property prices in Hanoi are equivalent to those in the suburbs of Tokyo. A family that builds a four-story house on land of 70 square-meters deep in a narrow alley of Gia Lam, a new urban sprawl across the Red River from the center of Hanoi, must part with 25 million yen ($325,000). Where does this money come from? The best guess is that money amplified by asset speculation is either directly or indirectly reaching the housing market of ordinary people. In the process, some (if not all the) money smeared by corruption and insider trading is also circulating. *(Chart 2)*

Asset transaction being disproportionately large relative to GDP, the interest and attention of the Vietnamese people naturally go to the timely buying and selling of stocks and properties rather than long-term effort in acquiring industrial technology or improving product quality. This is the fundamental reason why Vietnam's local industry continues to suffer from a lack of competitiveness or productivity despite the fact that the country has achieved rapid growth by inviting foreign money and investors.

Vietnam was a relatively equal country up to the 1990s, sharing poverty across different segments of the population. However, it is quickly becoming a country of unequal asset holdings between the urban rich, who are endowed with land and can participate in the money game, and others—migrant workers and rural residents—who are without such privileges. The former send their children to study overseas while the latter scrimp and scrape but still face declining living standards. This is a new crisis that Vietnam, an emerging industrial country, must resolve. Its leaders are well aware that Vietnam lacks "quality of growth" and organize many meetings and seminars contemplating the problem, but have not been able to come up with concrete counter-actions.

Revise Free-market Doctrine

International financial organizations do analyze these problems at the research and policy levels, but their operational work on the ground with individual member countries has not changed much since the 1980s. Emerging economies and developing countries facing new macroeconomic instabilities are given the traditional policy package featuring tight budgets and money, economic liberalization, and more flexible exchange rates. But these are old medicines for old problems and have limited effect on the new problems. To put it another way, the painful lessons of the Asian currency crisis have not been digested or embraced to revise actual policy formulation. A different set of policies is needed when the crisis is generated by unstable private funds rather than inadequate policies of the government.

Tackling this new kind of crisis must start with statistics. Systematic collection of relevant data must be encouraged and taught, concerning inflows of foreign purchasing power, detection of asset market bubbles, and distribution of national wealth and income over different groups. We admit that the data quality of developing countries is less than perfect, but this should not be used as an excuse for inaction. Even rough estimates should be produced, and the IMF's surveillance data, the BIS standards for prudential regulation, and other early warning signals must be amended to highlight statistics most suitable for the purpose.

Second, some regulations to curb overheating must be introduced in a formal manner. They include temporary restrictions on stock and real-estate transactions and related bank loans as well as conditional control on the capital account. Many countries already practice these measures out of sheer necessity, but there should be a more systematic approach rather than leaving individual countries to muddle through on their own. To absorb unearned gains, a series of taxes, such as tax on real estate transactions, fixed property tax and inheritance tax, should be introduced in realistic steps for each country. Policing of and penalties for illegal asset transactions must also be strengthened. Macroeconomic tightening is necessary to cool an overheated economy, but this tool should be applied in moderation and together with the microeconomic measures mentioned above.

Third, international groups such as the G-20 and international organizations such as the IMF and the World Bank should set new policy guidelines, create a forum to share experiences, and devise standard policy tools to tackle the common problems of our age instead of always administering the policy prescription of the 1980s without closely examining the patient. Policy direction should be a balanced one of encouraging the market to work effectively but regulating it when necessary to avoid its volatility and deviation. Unilateral promotion of the free market is no longer an acceptable proposition in the 21st century. JS

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