

## Viewpoints

June 2010

*This article was originally published on [project-syndicate.org](http://project-syndicate.org) on 7 June 2010.*

### **Can Emerging Markets Save the World Economy?**

By Mohamed El-Erian and A. Michael Spence

Over the past two years, industrial countries have experienced bouts of severe financial instability. Currently, they are wrestling with widening sovereign-debt problems and high unemployment. Yet emerging economies, once considered much more vulnerable, have been remarkably resilient. With growth returning to pre-2008 breakout levels, the performance of China, India and Brazil is an important engine of expansion for today's global economy.

High growth and financial stability in emerging economies are helping to facilitate the massive adjustment facing industrial countries. But that growth has significant longer-term implications. If the current pattern is sustained, the global economy will be permanently transformed. Specifically, not much more than a decade is needed for the share of global GDP generated by developing economies to pass the 50% mark when measured in market prices.

So it is important to know whether this breakout growth phase is sustainable. The answer comes in two parts. One depends on emerging economies' ability to manage their own success; the other relates to the extent to which the global economy can accommodate this success. The answer to the first question is reassuring; the answer to the second is not.

While still able to exploit the scope for catch-up growth, emerging economies must undertake continuous, rapid and at times difficult structural change, along with a parallel process of reform and institution building. In recent years, the systemically important countries have established an impressive track record of adapting pragmatically and flexibly. This is likely to continue.

With government policy remaining on course, we should expect a gradual strengthening of endogenous domestic growth drivers in emerging economies, anchored by an expanding middle class. Combined with higher trade among them, the future of emerging economies is one of reduced dependence on industrial-country demand, though not a complete decoupling.

Distribution as well as growth matter. Emerging economies still need to manage better their growing domestic tensions, which reflect rising income inequality and uneven access to basic services. A failure on this front would derail their strengthening domestic and regional growth dynamics. This is better understood today, with distributional aspects of growth strategy being firmly placed on emerging countries' policy agendas.

While emerging economies can deal with the economic slowdown in industrial countries, the financial-sector transmission mechanism is more challenging. Today's low interest rate environment is causing a flood of financial flows to emerging economies, raising the risk of inflation and asset bubbles. The hiccups in Western banks have served to disrupt the availability of trade credits and, if amplified, could destabilise local banks.

## Viewpoints

June 2010

These risks are real. Fortunately, several emerging economies continue to have cushions and shock absorbers. Having entered the 2008–2009 crisis with sound initial conditions (including large international reserves, budget and balance-of-payments surpluses, and highly capitalised banks), they are nowhere near exhausting their fiscal and financial flexibility – and hence their capacity to respond to future shocks.

Overall, emerging economies are well placed to continue to navigate successfully a world rendered unstable by crises in industrial countries. Yet, again, the decoupling is not complete. A favourable outcome also requires industrial countries' ability and willingness to accommodate the growing size and prominence of emerging economies. The risks here are significant, pointing to a wide range of potential problems.

The flow of knowledge, finance and technology that underpins sustained high growth rates in emerging economies is closely linked to an open, rule-based and globalised economy. Yet this global construct comes under pressure in an environment in which advanced countries have stubbornly high unemployment and bouts of financial volatility. The location of growth in the global economy comes to be seen as a zero-sum game, leading to suboptimal reactions.

As a result, the continued openness of industrial-country markets cannot be taken for granted. Political and policy narratives are becoming more domestic and narrow, while the international agenda and the pursuit of collective common global interests are having greater difficulty being heard.

These challenges will grow in the years ahead. And then there is the issue of global institutions and governance.

Managing a growing and increasingly complex set of transnational connections is an even bigger challenge in a multi-speed world that is being turned upside down. Such a world requires better global governance, as well as overdue institutional reforms that give emerging economies proper voice and representation in international institutions.

In the absence of such changes, the global economy may bounce from one crisis to another without a firm hand on the rudder to establish an overall sense of direction. The result is what economists call "Nash equilibria," or a series of suboptimal and only quasi-cooperative outcomes.

Where does all this leave us?

Emerging economies will be called on to play an even larger role in a multi-speed global economy characterised by protracted rehabilitation of over-extended balance sheets in industrial countries. Left to their own devices, they are up to the task. But they do not operate in a vacuum. Emerging economies' ability to provide the growth lubrication that facilitates adjustment in industrial countries is also a function of the latter countries' willingness to accommodate tectonic shifts in the operation and governance of the global economy. Let us hope that these global issues receive the attention they require.

## Viewpoints

June 2010

### About the authors:

Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, *When Markets Collide*, was a *New York Times* and *Wall Street Journal* bestseller, won the *Financial Times*/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by *The Economist*. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

PIMCO consultant A. Michael Spence is a Nobel laureate in economics, professor emeritus of management at the Graduate School of Business at Stanford University and a partner in Oak Hill Capital Partners and Oak Hill Venture Partners. He served as dean of the Stanford Business School from 1990-1999 where he was also an associate professor of economics. At Harvard University, Dr. Spence was chairman of the economics department and the George Gund professor of economics and business administration. From 1984-1990, he served as Harvard's dean of the Faculty of Arts and Sciences, overseeing Harvard College, the Graduate School of Arts and Sciences, and the Division of Continuing Education. Dr. Spence was awarded the John Kenneth Galbraith Prize for excellence in teaching and the John Bates Clark medal for a "significant contribution to economic thought and knowledge." He was a Rhodes scholar and earned a doctorate in economics from Harvard University, a master's degree from Oxford University, and an undergraduate degree from Princeton University.

### Singapore<sup>1</sup>

PIMCO Asia Pte Ltd  
501 Orchard Road #08-03  
Wheelock Place  
Singapore 238880  
65-6491-8000  
Registration No. 199804652K

### Hong Kong<sup>2</sup>

PIMCO Asia Limited  
24<sup>th</sup> Floor  
Units 2403 & 2405  
Nine Queen's Road Central  
Hong Kong  
852-3650-7700

<sup>1</sup> Regulated by the Monetary Authority of Singapore as a holder of a capital markets services license for fund management, and an exempt financial adviser. The services and products provided by PIMCO Asia Pte Ltd are available only to accredited investors, expert investors and institutional investors as defined in the Securities and Futures Act. The investment

## Viewpoints

June 2010

management services and products are not available to persons where provision of such services and products is unauthorised.

<sup>2</sup> Licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance ("SFO"). The services and products provided by PIMCO Asia Limited are available only to professional investors as defined in the SFO. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised.

Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets.

This material contains the opinions of the author but not necessarily those of PIMCO and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. This material was reprinted with permission of the *Project Syndicate*. Date of original publication 7 June 2010.