CHAPTER 6
Emerging Markets in the Aftermath of the Global Financial Crisis

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1 Introduction
Emerging market economies (EMEs) have come to play a dominant role in the world economy. They now account for a large and rising share of global output and trade. Indeed, by virtually every economic indicator, the prominence of EMEs has increased over the last few decades. This chapter evaluates the empirical basis for this proposition and examines its validity in the aftermath of the worldwide recession that was precipitated by the global financial crisis of 2008–2009.

Before the financial crisis, there was a growing sense among investors and policymakers that EMEs, with their newfound economic might, had become more resilient to shocks originating in advanced economies. This notion of emerging markets decoupling from advanced economies became widely prevalent before the global financial crisis. The high and rising growth gap between the two groups, with EMEs recording consistently higher growth than advanced economies during the period 2000–2007, supported this view.

1This chapter draws on material from Kose and Prasad (2010) and Prasad (2011). I am grateful to Grace Gu for excellent research assistance.
The global financial crisis seemed to put paid to such notions of “decoupling.” As a significant fraction of EMEs followed the advanced countries into recession, the crisis called into question the notion of greater resilience of EMEs to advanced country shocks. This was not altogether a surprising outcome as past episodes of business cycles suggest that deep and highly synchronized recessions in advanced countries tend to have large spillovers to the EMEs. Nevertheless, the growth gap between the two groups had created the hope that EMEs could sustain high growth independent of growth in advanced economies, and perhaps even become the key locomotives of global growth, a hope that seemed to have been dashed by the worldwide recession.

Remarkably, however, the majority of EMEs have bounced back briskly from the global recession since mid-2009 and, as a group, the EMEs have weathered the crisis much better than the advanced economies. This is not to say that all EMEs did equally well in the aftermath of the global financial crisis. There is significant variation in the degree of resilience displayed by different groups of EMEs. For instance, Asian emerging markets, especially China and India, have done far better than the economies of Emerging Europe, while the emerging economies of Africa and Latin America were not as badly affected by this recession in advanced economies compared to previous such recessions.

Overall, the global financial crisis has proven to be a watershed event that has intensified the prominence of EMEs. There is now a striking dichotomy between advanced economies and EMEs in terms of the short-term risks and policy challenges that they face. Among advanced economies, the major concern is about weak growth and deflationary pressures, with conventional monetary policy having reached its limits and the burden of debt having risen to dangerous levels constraining the scope of fiscal policy. In EMEs, by contrast, growth has rebounded sharply. With their strong growth prospects, they now face rising inflation, surges of capital inflows that are creating risks of bubbles in asset and credit markets, and pressures of rapid currency appreciation. This points to another reality, that emerging markets are still buffeted by macroeconomic developments and policy responses in the advanced economies.

In this chapter, I first provide an overview of a number of economic indicators that point to the rising prominence of EMEs in the world economy and then discuss these economies’ contribution to world growth. I then briefly summarize the effects that the global financial crisis had on these underlying trends, followed by a discussion of what factors account for
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cross-country differences in emerging markets’ resilience to the aftershocks from the crisis. I will then discuss a looming macroeconomic problem — the growing burden of public debt in the advanced economies — and how this could affect phenomena such as capital flows and the growth bifurcation between advanced economies and emerging markets. Finally, I discuss the nature of external risks now faced by EMEs and whether the resilience they showed during the global financial crisis implies that they have become less vulnerable to balance of payments or currency crises, which had befallen many of them in previous years. The concluding section offers some thoughts on the broader role of EMEs in the global economic system.

2 Rising Prominence of EMEs

The world distribution of GDP has changed quite significantly over the past five decades. To demonstrate this, I first examine the size distribution of countries in 1960–1972 (the Bretton Woods period), 1973–1985 (the period before the recent surge in global integration) and 1986–2007 (the pre-crisis period of globalization). I then look at data for the crisis years, 2008–2010 to evaluate whether the crisis led to an intensification of the patterns detected in the three earlier periods.

Table 1 shows that, during the period 1960–1985, advanced economies on average accounted for about three-quarters of global GDP measured in purchasing power parity (PPP) adjusted current dollars. This share has declined gradually over time — by 1986–2007, it was down to 58 percent,

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Note: Major emerging market economies refer to Brazil, China and India.
a fall of more than 20 percent relative to the 1960s. By contrast, the share of emerging markets has risen steadily, from just about 17 percent in the 1960s to 26 percent during the globalization period, 1986–2007.

This trend intensified sharply during the period of and immediately following the global financial crisis of 2008–2009. Consistent with the trend of a steadily rising share, the last column of Table 1 shows that the share of emerging markets rose to 35 percent by 2008–2010, up 9 percentage points from the average level during the pre-crisis globalization period. This matches a corresponding decline in the share of advanced economies, from 58 percent in 1986–2007 to 48 percent in 2008–2010. The share of other developing economies has remained modest and steady in the range of 3–4 percent of world GDP over the last five decades, highlighting the dramatic difference in growth performance between this group and the more dynamic group of EMEs.

To examine these shifts in more detail, the bottom rows of Table 1 provide data on the relative sizes of some key countries and country groups. The US remains the dominant economy in the world, although its share has declined from 33 percent of the world economy in 1960–1972 to 22 percent in 1986–2007. The share of the core group of EU economies falls more over this period, from 34 percent to 23 percent. The most dramatic shift is for the three major emerging markets — Brazil, China and India — whose share nearly doubles in a relatively short period, from 9 percent in 1973–1985 to 13 percent in 1986–2007. A substantial part of the increase in the share of the EMEs in the world GDP has been due to China and India. For example, China’s share of world GDP has increased sharply from 3.2 percent during the Bretton Woods period to 9.8 percent in the globalization period. Similarly, the share of India has risen from 4.4 percent to 5.6 percent across these periods.

These shifts pick up pace during the crisis years. In 2008–2010, the US and EU-15 shares of world GDP continue to decline while that of the major emerging markets increases further. During this period, the main emerging markets account for 21 percent of world GDP, slightly higher than the shares of the EU-15 countries (19 percent) and close to the share of the US (20 percent). Thus, the global financial crisis has only accentuated rather than reversed or slowed down ongoing shifts in the structure of the world economy and the EMEs rising role in it.

To provide a more comprehensive picture of the distribution of global GDP, I now expand the sample of countries in the globalization period to include the emerging markets of Europe, along with a number of other
smaller developing countries for which consistent data are available only for the last couple of decades. This provides a more comprehensive picture of shifts in the world GDP distribution, although for a shorter period. Figure 1 shows the output shares of different groups of countries for 1990

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Fig. 1. Emerging Economies, Shares in the Global Economy (Percent). 
*Note:* BIC refers to Brazil, India and China.
and 2010. The top panel of this figure, which shows PPP-adjusted shares of each country or group in world GDP, clearly shows the rising importance of China and India and the relative decline of the US and other advanced economies. Compared to their shares in 1990, the emerging economies of Europe have a smaller share of GDP in 2010. The shares of the EU-15 and other advanced economies also decline during the 2000s.

The lower panel of Figure 1 shows similar calculations as the top panel but based on domestic GDP converted to a common currency (US dollars) at market exchange rates. China and India still account for a larger share of world GDP in 2010 than in 1990, but the increases in their shares, as well as that of other emerging markets, is much smaller when market exchange rates rather than PPP exchange rates are used in the calculations. The broad patterns seen in the top panel are preserved, although it is clear that the choice of exchange rate used in these calculations makes a significant difference because of the large deviations between market and PPP exchange rates, especially in the case of emerging markets.

Other economic indicators provide a broader snapshot of the rising prominence of emerging markets in the world economic order (Figure 2). While their shares of the world population and world labor force have remained relatively stable from 1990 to 2010, the EMEs have now become more important on virtually every other economic dimension. The emerging markets’ shares of world GDP, private consumption, investment and trade have nearly doubled in the space of two decades. Thus, this group now has a much larger share of the world economy irrespective of the criterion, although in some respects these shares may still be considered modest. For instance, EMEs still account for only about one-fifth of world private consumption, much lower than their shares of world GDP or world investment. The latter result is of course largely reflective of developments in the Chinese economy, where growth in recent years has been driven largely by fixed investment growth, leading to a rising share of investment and a declining share of private consumption in Chinese GDP.

Despite their economic size, EMEs still account for a smaller share of global financial flows than advanced economies. Kose et al. (2009), for instance, note that these economies account for only about one-tenth of the global stocks of gross external assets and liabilities. On one dimension, however, EMEs play a much more important role. The share of world foreign exchange reserves held by emerging markets has nearly tripled over this period, with this group of countries now accounting for a majority of global reserves and continuing to accumulate them, a phenomenon that has
implications for future global financial flows and stability and the financing
of public debt accumulation in advanced economies.

This section has provided a number of indicators of how EMEs are
now playing an increasingly important role in different aspects of the world
economy. By virtually any measure, this shift in economic power away from
advanced economies to EMEs was accentuated by the global financial crisis
and the recession that followed it. The next question is whether EMEs are
now driving world growth or if they are still being pulled along by advanced
economies.
3 The Distribution of World Growth

The spectacular growth performance of EMEs in recent decades has attracted the most attention. As a group, the EMEs have experienced far greater cumulative growth since 1960 than other developing countries and the advanced economies. Excluding Brazil, China and India — three of the most prominent large, dynamic economies — from the list of emerging markets makes the performance of this group look less spectacular, although it is still much better than that of the group of other developing countries.

I now examine the distribution of world growth, not just in terms of GDP but also in terms of the key components of final demand — private consumption and investment — with all variables measured in PPP terms. This provides an indication of the quantitative contribution of each region or country to world growth. I also look at the contributions of different countries/regions to global export growth.

The top panel of Table 2 shows the growth in world GDP, consumption, investment and exports, averaged over the periods 1960–1972, 1973–1985 and 1986–2007. The final column shows growth in GDP alone for the crisis period 2008–2010 (consistent data on the components for GDP were not available for all of the countries in the sample). The next three panels show the growth contributions to each variable coming from different regions, which add up to overall world growth of the corresponding variable.²

²The contribution of country i to world GDP growth from time t to t + 1 is given by \( \frac{\text{GDP}(\text{country } i, \text{ time } t + 1) - \text{GDP}(\text{country } i, \text{ time } t)}{\text{GDP(\text{world, time } t)}} \). The sum of the growth contributions of the three regions that constitute the world economy add up to total world GDP growth. Some small discrepancies between the sums of the three regions' contributions and world GDP growth in the latest period are attributable to data availability problems for a handful of countries.

³These growth rates are calculated using PPP exchange rates to evaluate the GDP weight of each country in world GDP. World GDP growth based on market exchange rates was lower during 2008–2009 than the number mentioned here, largely because the main emerging markets continued to post relatively strong growth during the global recession and these economies of course have a much higher PPP-based weight in world GDP.
Table 2. Contributions to Global Growth, by Group and Region, 1960–2010 (In Percent).

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growth of 10.2 percent. EMEs contributed 2.7 percentage points to world
growth during this period. During the pre-crisis globalization period, these
economies contribute about 40 percent of world growth (2.43/6.18) while
the share of advanced economies falls to about 57 percent (3.53/6.18).

Interestingly, the contribution of EMEs to global consumption growth
is much lower than their contribution to GDP growth. During 1986–2007,
this group accounted for less than one-third of global consumption growth
(0.81/3.03) and about one-third of global investment growth (1.34/3.77).
Thus, advanced economies still appear to be the key contributors to the
growth in global domestic demand.

The picture of the growth contributions of different groups of economies
shifts dramatically during the crisis years 2008–2010. The last column of
Table 2 shows how much these relative contributions shifted. During this
period, EMEs accounted for nearly 90 percent of world growth during 2008–
2009 (2.09/2.35), while the share of advanced economies was in fact negative
as many of them contracted slightly during this period. In other words, the
direct contribution of emerging markets to GDP growth has continued to
increase over time and was further accentuated during the financial crisis,
while the reverse has been true for advanced economies.

The lower panels of Table 2, which show the results for four key sets
of advanced economies and also for the three major emerging markets (the
group of Brazil, China and India) shows these patterns more clearly. The
relative contributions of the US, Japan and the set of EU-15 countries has
declined markedly in the globalization period relative to the pre-globalization
period and all of them have experienced virtually no growth during the crisis
years of 2008–2010. The EU-15 recorded negative growth on average during
these three years. By contrast, the group of three major EMEs by themselves
account for 71 percent of world growth during the crisis years.

Figure 3 shows similar calculations for world GDP growth for an
expanded group of countries including the economies of Emerging Europe
but only since 1990. This figure complements the data in Table 2 by showing
the contributions of different countries or groups as shares relative to world
GDP growth (the table shows absolute contributions rather than shares).
To highlight the general trend in the globalization period and distinguish it
from the first year of the crisis, I present growth contributions of different
countries and regions for 1990, the average for 2000–2007 and separately

The top panel of Figure 3 shows growth contributions based on PPP-
adjusted GDP data. The growth contributions of China, India and other
Emerging markets increase from 1990 to 2000–2007, offsetting a decline in the shares of the US and other advanced economies. In 2008–2010, the growth contributions of China, India and other emerging markets continue to rise, but the shares accounted for by the US and other advanced economies fall while the contribution of Emerging Europe remains steady.

The lower panel of Figure 3 shows similar calculations based on GDP converted to a common currency at market exchange rates. As was the case with the GDP levels, the patterns of growth contributions based on market exchange rates are quite similar to those based on PPP exchange rates, but
are quantitatively less favorable to EMEs. Interestingly, the growth contributions of Emerging European economies increase in 2008–2010 relative to 2000–2007 when measured on the basis of market exchange rates.

In short, EMEs not only weathered the global financial crisis relatively well but in fact their prominence in terms of driving world growth increased during the period 2008–2010. Nevertheless, it remains an open question whether EMEs have self-sustaining domestic demand that will allow them to remain decoupled from developments in advanced economy business cycles.

4 What Explains the Resilience of Emerging Markets?

Although the EMEs as a group performed well during the global recession, there were sharp differences across emerging economies in different regions.4 The economies of emerging Asia had the most favorable outcome, experiencing relatively modest declines in growth rates. China and India, which are the two largest economies in Emerging Asia and which maintained strong growth during the crisis, obviously play an important role in the performance of this group. Excluding these two countries (and also Hong Kong SAR) from the Emerging Asia group leaves that group with a less impressive but still solid performance overall.

Emerging Europe had the sharpest fall in total output during 2009, followed by Latin America. By contrast, and somewhat surprisingly, the economies of the Middle East and North Africa (MENA) region as well as those of Sub-Saharan Africa weathered the crisis better, with only small declines in output. For these two latter groups, their relatively modest exposures to trade and financial flows from advanced economies may have limited the extent of spillovers of the global shock. These countries had also improved their macroeconomic policies, giving them more space in responding to the global shock with countercyclical policy tools.

Latin America, by contrast, is more closely integrated with advanced economies, especially the US. Although Latin American EMEs did suffer growth contractions during the crisis, they have bounced back relatively strongly. This is in contrast to previous episodes of global financial turbulence (1982, 1998, 2001), during which Latin American economies proved to

4See Kose and Prasad (2010). Lane and Milesi-Ferretti (2010) also report that there are substantial differences in the impact of the crisis across regions.
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be vulnerable to currency and debt crises. Izquierdo and Talvi (2010) note the role played by strong macroeconomic fundamentals — low inflation, twin external and fiscal surpluses, a sound banking system, a large stock of international reserves and flexible exchange rate regimes — in ensuring the resilience of Latin American economies during the recent crisis.

Thus, the two sets of emerging markets that present the sharpest contrast in terms of resilience to the global financial crisis are the emerging markets of Asia and Europe. Prior to the crisis, average per capita GDP growth was highest in these two groups of emerging markets. In 2009, Asian emerging markets posted the highest average rate of growth while European emerging markets had the lowest. Based on the comparative stylized analysis of the experiences of emerging Asian and Eastern European economies as well as a reading of the rapidly expanding literature on this subject, Kose and Prasad (2010) identify a few factors that appear to have underpinned the relative resilience of EMEs as a group during the global financial crisis, and could also help explain differences in resilience across different groups of EMEs.

1) **Less dependence on foreign finance and shift away from foreign currency-denominated external debt.** As a group, the emerging markets have been net exporters of capital during the last decade. The Asian emerging markets, especially China but also others such as Russia and some of the Latin American economies, have been running significant current account surpluses in recent years. There are of course certain groups of EMEs, especially those in Emerging Europe, that have been running large current account deficits and financing their domestic investment using foreign savings. This group indeed proved most vulnerable to the crisis. More generally, Eichengreen (2010) documents that countries with large current account deficits and corresponding large financing requirements were hit harder by the crisis. The majority of emerging markets have become a lot less reliant on foreign finance, particularly external debt.

2) **Large buffers of foreign exchange reserves.** Following the Asian financial crisis of 1997–1998, emerging markets around the world have built up large buffers of foreign exchange reserves, partly as a result of export-oriented growth strategies and partly as a form of self-insurance against large exchange rate swings.

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5 See IMF (2009a, 2009b), for economic and financial developments in Latin America during the crisis.
cites associated with sudden stops or reversals of capital inflows. Frankel
and Saravelos (2010) present evidence that foreign exchange reserve lev-
els had a major impact on countries’ vulnerability to the global financial
crisis.6

3) Greater trade linkages among the EMEs have increased their resilience
as a group. In particular, commodity-exporting countries have been
shielded to some extent from the slowdowns in the advanced economies
by strong growth in the EMEs. For instance, China’s continued
rapid growth during the crisis, fueled by a surge in investment, has
boosted the demand for commodities from emerging markets such as
Brazil and Chile and has also increased the demand for other raw mate-
rials and intermediate inputs from other Asian emerging markets.

4) Emerging markets have become more diversified in their production and
export patterns, although this has, to a significant extent, been offset by
vertical specialization that has led to rising integration of some emerg-
ing markets, particularly those in Asia, through regional supply chains.
Such diversification offers limited protection against large global shocks
but, so long as the effects of shocks are not perfectly correlated across
countries (export markets), it can serve to promote resilience in response
to more normal types of shocks. Diversification of production, especially
to reduce dependence on exports of commodities and raw materials that
have long and volatile price cycles, can also increase resilience.

5) Broader divergence of EME business cycles from those of the advanced
economies. This has happened on account of the factors noted above,
along with greater intra-group trade and financial linkages. There has
also been a proliferation of trade and financial flows within the group
of emerging markets, both at the regional and inter-regional levels. This
phenomenon is partly the natural result of geographical proximity boost-
ing trade flows and of financial flows following trade. There have also
been specific policy initiatives in certain regions to promote regional
financial integration. Examples of this are the Chiang Mai and Asian

6Of course, the benefits of large reserves stocks have to be carefully considered relative
to the costs of accumulating them, both in terms of the quasi-fiscal costs as well as
the more subtle costs in terms of the constraints on domestic policies. Rodrik (2006)
estimates the social cost of self-insurance through holding reserves to be about 1 percent
of GDP for developing countries as a group. Prasad and Rajan (2006) and Prasad (2009b)
discuss how China’s currency policy that has resulted in rapid reserve accumulation has
constrained domestic macroeconomic policies and hampered financial sector reforms,
both of which could have long-term consequences for economic welfare.
Bond Fund initiatives that were set up as ways to encourage regional financial integration and financial market development among the participating Asian countries. However, the scope and scale of these initiatives have remained limited and, even for the Asian region as a whole, financial flows with the rest of the world still dwarf intra-Asian flows. Over the long run, initiatives to develop regional insurance mechanisms by pooling reserves and attempts to increase the use of major currencies such as the Chinese renminbi could serve to insulate the region better from global shocks.

6) **Better macroeconomic policies, including flexible exchange rates in a number of emerging markets.** During the Great Moderation, most emerging markets succeeded in bringing inflation under control, through a combination of more disciplined fiscal policies and more credible monetary policies. Indeed, a large number of emerging markets have now adopted some form of inflation targeting along with flexible exchange rates, which act as shock absorbers for external shocks (Rose, 2007). This has led to moderate and less volatile inflation. In turn, stable macroeconomic policies have facilitated a shift towards more stable forms of financial inflows and also made international investors less concerned about the safety of their investment in emerging markets. Prudent fiscal policies that have resulted in low levels of fiscal deficits and public debt seem to have created room for EMEs to respond aggressively with countercyclical fiscal policies to offset the contradictory effects of the crisis (Ghosh *et al.*, 2009). Economies with high credit growth rates seem to have fared worse, especially if credit expansion was largely financed through foreign capital (as in the case of many countries in Emerging Europe) rather than domestic savings (e.g., China and India).

7) **Rising per capita income levels and a burgeoning middle class** have increased the size and absorptive capacity of domestic markets, making emerging markets potentially less reliant on foreign trade to benefit from scale economies in their production structures and also less susceptible to export collapses (see Kharas, 2010). But, as noted earlier, it is still not clear that EMEs have truly become

5 **Global Public Debt and Implications for the Growth Gap**

The accumulation of reserves by EMEs has been an important feature of global capital flows and has contributed to the “uphill” flows of capital from
poorer to richer countries. As discussed in the previous section, EMEs with large stocks of reserves were less affected by the crisis. In light of ongoing global financial turmoil, these economies are likely to continue accumulating reserves in order to self-insure themselves against future crises and to avoid having to seek financial assistance from the International Monetary Fund.

The other side of this coin is related to the trajectories of government debt in advanced economies. To examine the evolution of such assets around the world, I now examine trajectories of net government debt around the world. This has implications for financial flows as well as for global financial stability if these debt burdens become unsustainable and trigger financing problems, as has already happened to some countries in the euro zone.

The global financial crisis triggered a sharp increase in public debt levels, both in absolute terms and relative to GDP. Data from the IMF’s June 2011 Fiscal Monitor show that the level of aggregate net government debt in the world rose from $22 trillion in 2007 to an expected $34 trillion in 2011. IMF forecasts indicate the level will reach $48 trillion in 2016. The ratio of world net debt to world GDP rose from 42 percent in 2007 to 57 percent in 2011, and is expected to hit 58 percent in 2016.

Since the onset of the crisis, the bulk of the increase in global public debt is accounted for by advanced economies. Relative to their GDP, debt levels in these economies are expected to continue rising in the next few years. By contrast, debt ratios will shrink for emerging markets. Indeed, advanced economies account for the bulk of the increase in global public debt since 2007, both in absolute terms and relative to GDP.

- Aggregate debt of advanced economies will increase from $18 trillion in 2007 to $30 trillion in 2011, and is expected to rise to $41 trillion in 2016. The corresponding numbers for emerging markets are $4 trillion, $5 trillion and $7 trillion, respectively.\(^7\)

\(^7\) Caballero, Farhi and Gourinchas (2008a, 2008b) argue that emerging markets' search for safe assets precipitated global macroeconomic imbalances. Mendoza, Quadrini and Rios-Rull (2010) make a related point that the greater financial depth of advanced economies attracts large inflows.

\(^8\) I focus on central government securities as those are most relevant for reserve accumulation. Net debt is preferable for the purposes of my analysis as the remaining portion of gross debt is typically held domestically.

\(^9\) The reported debt levels of emerging markets should be interpreted with caution. In China, for instance, financial liabilities of provincial governments and contingent liabilities such as nonperforming assets held by the state-owned banking system imply a much higher value of government debt obligations than indicated by official statistics.
Table 3. Net Debt to GDP (In Percent).

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2011</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>42.0</td>
<td>56.4</td>
<td>57.7</td>
</tr>
<tr>
<td>U.S.</td>
<td>42.6</td>
<td>72.4</td>
<td>85.7</td>
</tr>
<tr>
<td>Euro Zone</td>
<td>52.4</td>
<td>68.1</td>
<td>69.5</td>
</tr>
<tr>
<td>Japan</td>
<td>81.5</td>
<td>127.8</td>
<td>163.9</td>
</tr>
<tr>
<td>UK</td>
<td>38.2</td>
<td>75.1</td>
<td>73.5</td>
</tr>
<tr>
<td>Other AE</td>
<td>18.5</td>
<td>25.9</td>
<td>22.1</td>
</tr>
<tr>
<td>EM</td>
<td>29.2</td>
<td>26.1</td>
<td>21.5</td>
</tr>
</tbody>
</table>

*Source: IMF Fiscal Monitor, April 2011 and June 2011 Update; IMF WEO, April 2011 and June 2011 Update.*

- The ratio of aggregate debt to aggregate GDP for advanced economies will rise from 46 percent in 2007 to 70 percent in 2011 and further to 80 percent in 2016. The corresponding ratios for emerging markets are 28 percent, 26 percent and 21 percent, respectively.

Table 3 shows net debt to GDP ratios for some of the key countries/economic groups. In the US, the net debt to GDP ratio has gone from 43 percent in 2007 to 72 percent in 2011, and is expected to rise further to 86 percent by 2016. By 2016, debt in the euro zone and in the United Kingdom will be at about 70 percent of GDP. By contrast, the average ratio of net debt to GDP for the EMEs is expected to decline from 26 percent in 2011 to 22 percent by 2016.

There is also a stark contrast between the two groups of countries in their relative contributions to growth in world debt versus growth in world GDP. Emerging markets contribute far more to growth in global GDP than to the growth in global public debt. Some illustrative statistics follow:

- In 2007, emerging markets accounted for 25 percent of world GDP and 17 percent of world debt. By 2016, they are expected to produce 38 percent of world output and account for just 14 percent of world debt.
- In 2011 (based on IMF estimates at market exchange rates), the four major reserve currency areas together account for 58 percent of global GDP and 81 percent of global debt.

Of course, as the recent crisis has shown, advanced economy governments arguably have similar implicit contingent liabilities if their big banks were to run aground or their public pension systems were to run out of money.
Emerging markets account for 9 percent of the increase in global debt levels from 2007 to 2011 and are expected to account for 13 percent of the increase from 2011 to 2016. By contrast, their contributions to increases in global GDP over these two periods are 66 percent and 56 percent, respectively.

The two biggest advanced economies are making a far greater contribution to the rise in global debt than to the rise in global GDP. The US contributes 37 percent of the increase in global debt from 2007 to 2011 and 40 percent from 2011 to 2016. Its contributions to the increases in global GDP over those two periods are 8 percent and 18 percent, respectively. Japan accounts for 20 percent of the increase in debt from 2007 to 2011 and 34 percent from 2011 to 2016 while its contributions to the increase in global GDP are 4 percent and 8 percent, respectively.

High and rising debt levels among advanced economies pose serious risks to global macroeconomic stability that would almost certainly have significant knock-on effects on EMEs. Of course, the implications of rising debt levels and their sustainability depend to a large extent on whether these debts are financed from domestic savings or by foreign investors. In the case of the US, foreign investors — both official and private — hold about half of the outstanding stock of net central government debt. Foreign investors have played an important role in the financing of net US debt. During 2008–2010, when net debt accumulation soared to $1.3 trillion per year, foreign investors accumulated $695 billion per year, accounting for just over half of total US net debt issuance.

This ratio is lower for the UK — about one-third of its net debt is held by foreign investors — and even lower, less than 10 percent, for Japan, which has a very high domestic savings rate. It is harder to obtain a consistent picture for the euro area as available data include within-euro area holdings and do not provide a clear picture of how much euro area sovereign debt is held by investors from outside the euro area.

These figures paint a sobering picture of worsening public debt dynamics and a sharply rising public debt burden in advanced economies, along with a high level of dependence on foreign investors in search of a safe haven, especially in the case of the US. The major reserve currency economies — especially the US and Japan — face daunting trajectories of public debt and weak growth prospects. Indeed, with low levels of population growth, rapidly aging populations and rising costs of health care and other entitlement programs, advanced economies as a group could be in far worse shape.
beyond the medium-term horizon discussed in this section if they do not bring their public finances under control.\(^{10}\) In advanced economies, rising public debt levels imply significant crowding-out effects that will affect productivity growth and could generate a persistent productivity growth gap relative to emerging markets. Balance sheets of households and the financial sector in advanced economies were severely damaged by the financial crisis and are only now beginning to recover, putting a further crimp on these economies’ growth prospects. All of this implies that the growth bifurcation between EMEs and advanced economies is likely to persist well into the future. This is likely to be the case even if the major EMEs hit the middle income trap and experience growth slowdowns due to their aging populations and other factors that could constrain long-term growth in these economies (Eichengreen, Park and Shin, 2011).

### 6 Risks

Given their promising growth prospects, one remaining question is whether emerging markets still face significant risks of crises, which they were vulnerable to in the past. While these economies face a number of difficult policy dilemmas, the discussion in Section 4 suggests that they have in fact become more resilient to external shocks. I now review two aspects of these economies’ external balance sheets that imply reduced vulnerability to traditional balance of payments crises, although these countries may still be subject to the effects of capital flow volatility as they become more integrated into international financial markets.

One factor that plays an important role in affecting vulnerability to crises and also the ability to recover quickly from their aftermath is the level of international reserves held by a country (see, e.g., Frankel and Saravelos, 2011). Figure 4 shows the rapid rate of reserve accumulation by emerging markets, which peaked in 2007, declined but remained positive in 2008–2009, and then began to pick up again in 2010. Total foreign exchange reserves of emerging markets now amount to about $6.4 trillion, with China accounting for half of this stock. In short, EMEs have now accumulated a

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\(^{10}\)Cecchetti, Mohanty and Zampolli (2010) present sobering projections of advanced economies’ long-term debt levels under current policies in those countries.
large stock of reserves that provides a high level of self-insurance against sudden stops and reversals of capital inflows.

Another important consideration in determining vulnerability to external shocks to the capital account is the structure of EMEs’ external liabilities. These were once dominated by short-term foreign-currency denominated external debt, making these countries subject to currency risk as well as the risk of procyclical capital flows (and procyclical access to international financial markets, which reduced the potential risk-sharing benefit of international financial integration). This pattern has changed markedly, with foreign direct investment and portfolio equity, far more desirable forms of capital in terms of their direct and indirect benefits, now accounting for a majority of their external liabilities. Figure 5 shows that the median (median across countries) share of debt total external liabilities of EMEs has fallen from over 80 percent in the mid-1980s to below 40 percent in 2009. By contrast, the share of FDI has climbed to more than 50 percent and that of portfolio equity is now close to 20 percent.

Moreover, external debt issued by these countries is increasingly denominated in their own currencies. This structure of liabilities helps share risk across countries, with foreign investors bearing capital as well as currency risk on such investment. Even taking into account the greater volatility of portfolio equity flows relative to FDI, this implies more risk sharing with
Emerging Markets in the Aftermath of the Global Financial Crisis

Fig. 5. Key Components of Emerging Market External Assets and Liabilities (Shares, in Percent).

Notes: Stocks of foreign direct investment (FDI), portfolio equity (PE) and external debt are shown as ratios of total external liabilities (L), with each of these variables summed up across all emerging market economies. The stock of foreign exchange reserves is shown as a ratio to total external assets (A).

international investors. By contrast, portfolio debt and bank loans together still constitute the major share of advanced economies’ external liabilities.

In short, changes in the structure of EMEs’ external liabilities and the high levels of international reserves have reduced the vulnerability of these economies to balance of payments and currency crises, which had been the bane of these economies in the past.

7 Concluding Remarks

Emerging market economies have become key players in the world economy in terms of their sheer size. This phenomenon has been accentuated during the period of globalization and has further intensified during the global financial crisis as the group of emerging markets continued to expand at a relatively robust rate while advanced economies essentially came to a standstill. It is also clear that EMEs have become increasingly more important in terms of driving global GDP growth, although their contributions to the growth in global domestic demand are lower. This group of economies has essentially been responsible for most of global GDP growth during the latest financial crisis and it is likely that, even if they experience a modest growth
slowdown, there will remain a persistent and large growth gap between EMEs and advanced economies.

Along with an increase in their economic heft, EMEs are also becoming more important players in setting the global priorities. The increasing irrelevance of the G-7 and the unofficial anointment of the G-20 as the major body setting the global economic agenda have given EMEs a prominent seat at the table. The same is true in international institutions such as the Financial Stability Board and the IMF, where EMEs have a much larger say than ever before. With this change will come some new responsibilities as emerging markets need to recognize that they need to make a direct contribution to good global governance.

Emerging markets have attained a good level of maturity in terms of their economic size, domestic policy frameworks and influence on the world economy. The global financial crisis presents a unique opportunity for them to mature in another dimension — taking on more responsibility for global economic and financial stability, including strengthening global economic governance.

References


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