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Emerging markets*

by

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UCSC and the NBER

Abstract

The club of high-performing emerging markets is fairly concentrated in East Asia. Their TFP growth may not be extraordinary, though their growth rate is unprecedented. Factors argued to promote growth include trade, investment, external financing, and good governance. The importance of external financing is overrated – higher growth induces higher saving rate, allowing investment to be self-financed. Institutional changes as the key for take-off remains debatable – India and China took off without any prior major institutional overhaul. Allowing newcomers to challenge incumbents and the capacity to adjust policies to shocks may be the keys for sustainable growth.

‘Emerging markets’ are countries or markets that are not well established economically and financially, but are making progress in that direction. The growing focus on emerging markets follows exciting developments during the second half of the 20th century – the emergence of a growing class of (formerly) poor countries that took off, and managed to close half of their income gap with the OECD countries within a generation or two. Remarkably, from 1960 to 1989 seven high-performing Asian economies (HPAEs) experienced unprecedented growth rates of the real GDP per capita in the range of four to seven per cent. This phenomenon has been the focus of a notable research report by the World Bank (1992), whose title *The East Asian Miracle* suggests a possible, though controversial, interpretation. The big story of recent years has been that the two most populous countries, China and India, joined the HPAE club. With few exceptions (such as Chile and Botswana), the club of high-performing emerging markets is fairly concentrated in East

* S. N. Durlauf and L. E. Blume, *The New Palgrave Dictionary of Economics*, forthcoming, Palgrave Macmillan, reproduced with permission of Palgrave Macmillan. This article is taken from the author's original manuscript and has not been reviewed or edited. The definitive published version of this extract may be found in the *complete New Palgrave Dictionary of Economics* in print and online, forthcoming.

Asia. The HPAEs' remarkable growth rates during recent decades imply a sizable drop in global poverty rates, also entailing greater concentration of the incidence of extreme poverty, mostly in Africa (see Fischer, 2003). Yet the emerging markets phenomenon goes well beyond Asia, encompassing a growing share of developing countries that are closing, though at a lower rate than the HPAEs, their income gap with the OECD countries.

These developments were in sharp contrast to the pessimistic predictions made in the 1950–60s by several influential economic growth models (for a review, see Easterly, 1997). The HPAE experience dispelled most of these fears. The superior performance of the HPAEs illustrated that the fast growth option is viable, raising pertinent questions, and stirring a lively debate. While the World Bank (1992) dubbed the experience of the HPAEs a 'miracle', Young (1995) questioned this 'miraculous' interpretation, arguing that it is in line with Solow's growth model. Specifically, he reasoned that most of the growth has been the outcome of very high rates of investment in tangible and human capital, and a sizable increase in labour market participation. Controlling for these factors, Young found that the HPAEs' total factor productivity growth is in line with the historical experience of other countries. The debate about the role of accumulation in accounting for the HPAE experience is not over, yet the large drop of the growth rate of Japan in the 1990s, and the East Asian financial crisis of 1997, somehow deflated the 'East Asian miracle' hypothesis, suggesting the onset of Solow's growth convergence. Even if Young's thesis is correct, the speed and relative smoothness of the convergence of the HPAEs to the OECD's development level are without precedent. It raises questions about the obstacles preventing other countries from accomplishing this task, and about the ways to facilitate the take-off process in other regions.

The HPAE take-offs have been associated with fast growth of exports climbing, over time, the technology ladder of trade. This led to a lively debate about the importance of exports as the engine of growth: is the dominant causal association from exports to growth or vice versa? Earlier studies inferred that trade liberalization enhances growth (Ben-David, 1993; Edwards, 1998), a point disputed by Rodriguez and Rodrik (2001). Several authors revisited this issue, applying better controls, inferring strong growth effects of trade openness. Frankel and Romer (1999) applied measures of the geographic component of countries' trade to obtain instrumental variables estimates of the effect of trade on income. They inferred that ordinary least square (OLS) estimates understate the effects of trade, and that trade has a significant large positive effect on income. The contrast between the economic performance of the Soviet Union and that of China in the second part of the 20th century suggests another advantage of export orientation: it imposes a powerful market test on

domestic output. Since exports must meet the quality and pricing tests of the global market, export-led growth limits potential distortions induced by ‘growth promoting’ domestic policies. Specifically, it prevents Soviet Union-type superficial economic growth induced by forced investment, growth that may result in inferior products that would be wiped out in the absence of protection. Export-oriented growth also forces countries to move faster towards the technological frontier in order to survive competitive global pressures.

Some of the obstacles preventing countries from taking off arise from political economy factors. Specifically, as growth is frequently associated with the emergence of new sectors and new elites, incumbent policymakers opt to block development in an attempt to preserve their rents and their grip on power. This phenomenon was vividly illustrated at the micro level by De Soto (1989), and was shown to be a major impediment to growth (see Parente and Prescott, 2004). As the burden of the low growth would mostly affect future generations, the low growth equilibrium may persist with limited opposition. Proponents of this view point out that free commerce, both internal (between provinces or states in a union) and international, provides a powerful constraint on an incumbent’s ability to block development.

The importance of external financing and financial integration in the development process remains a hotly debated topic. Advocates of financial liberalization in the early 1990s argued that external financing would alleviate the scarcity of saving in developing countries, inducing higher investments and thus higher growth rates. In contrast, Rodrik (1998) and Stiglitz (2002) questioned the gains from financial liberalization. Indeed, the 1990s experience with financial liberalization suggests that the gains from external financing are overrated – the bottleneck inhibiting economic growth is less the scarcity of saving and more the scarcity of good governance. This can be illustrated by tracing the patterns of self-financing ratios, measuring the share of tangible capital financed by past national saving (see Aizenman, Pinto and Radziwill, 2004). Higher self-financing rates of the nation’s stock of capital are associated with a significant *increase* in growth rates. Remarkably, the wave of financial reforms in the 1990s led to deeper diversification, where greater inflows from the OECD financed comparable outflows from developing countries, with little effect on the availability of resources to financetangible investment.

These findings are consistent with several interpretations. The first deals with risk: agents in various countries may react to exposure to financial risk differently. The desire to diversify these risks may lead to two-way capital flows, with little change in net positions (see Dooley, 1988). The ultimate obstacles limiting external financing may be related to acute moral hazard and agency

problems – sovereign states, decision makers and corporate insiders pursue their own interests at the expense of outside investors (see Gertler and Rogoff, 1990; Stulz, 2005). An alternative interpretation follows Carroll and Weil (1994), who found that statistical causality runs from higher growth rates to higher saving rates. They conjectured that the growth-saving causality may be explained by habit formation, where consumers' utility depends on both present and past consumption. 'Habit formation', however, may be observationally equivalent to adaptive learning in the presence of uncertainty – in countries where private savings are taxed in arbitrary and unpredictable ways, credibility must be acquired as an outcome of a time-consuming learning process. In these circumstances, a higher growth rate provides a positive signal about the competence and the intentions of the administration, increasing saving and investment over time. Consequently, agents in countries characterized by greater political instability and polarization would be more cautious in increasing their saving and investment rates following a reform. Hence, accomplishing take-offs in Latin America may be much harder than in Asia, explaining Latin America's relatively low growth rate. (Various studies pointed out that policy uncertainty and political instability reduce private investment and growth; see Ramey and Ramey, 1995; Aizenman and Marion, 1999).

I close this review with an outline of open issues. The positive association between the quality of institutions and growth is well documented, yet the precise role of institutions in the development process remains debatable. Acemoglu et al. (2002) inquired how the colonial history of a developing country affects the quality of institutions, concluding that distortionary macroeconomic policies are more likely to be symptoms of underlying institutional problems rather than the main causes of economic volatility. Yet this interpretation does not satisfactorily explain the role of institutions in the growth process. The remarkable take-offs of China and India in recent decades, episodes directly affecting about a third of the global population, cannot obviously be explained by reference to institutional changes. This suggests that there is no simple correspondence or causality between growth and institutions. A tentative answer is provided by Rodrik (1999), who identifies a non-linear interaction between shocks, polarization of a society and the quality of institutions. This argument suggests the key importance of the capacity of societies to adjust policies to shocks. A deeper understanding of the interaction between history, geography, polarization and institutions remains a challenge awaiting future research.

The exciting developments associated with the emergence of a growing class of (formerly) poor countries that took off implies that the rewards for adopting the proper growth incentives are

high. A remaining challenge is how to facilitate the widening of the emerging market club, and how to minimize the prospects of new conflicts associated with the emergence of new economic powers like China and India.

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See also Asian miracle; development economics; growth and governance; growth and human capital; growth and institutions; growth and international trade

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