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THE ROLE OF EMERGING MARKETS IN THE NEW WORLD ECONOMIC ORDER

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P R O C E E D I N G S

MS. BEDDOES: Good afternoon. Welcome to Brookings. I am Zanny Minton Beddoes of *The Economist*, and I'm delighted to welcome you to this afternoon's discussion about really set around this excellent book, *Emerging Markets: Resilience and Growth Amid Global Turmoil*.

The emerging markets, you don't need me to tell you have, as this book says in its first sentence, become a dominant presence in the world economy. I think when we look back at the first decades of this century that will be the really big transformation in the global economy. Already over the past two decades the emerging economies share of you name it -- global GDP, private consumption, investment and trade -- has almost doubled, and that share is going to increase. And it's not just the growth of the emerging economies that's been so spectacular but in this past couple of years their resilience to the extraordinary crises and turmoil and recessions that we've had in the advanced economies has been equally spectacular.

And I was just thinking this morning and was struck in fact by something which brings this home to me. I was looking, as I'm sure many of you are, at my Bloomberg Terminal where I read the U.S. Labor Market Report, you know, unemployment rises to 9.8 percent. And then you can scroll down and look at other economy headlines. And the other ones were Brazil raises reserve requirements, China moves next year from prudent to prudent monetary policy and another piece on whether Indian growth would exceed Chinese growth over the next decade. So the top stories on the news service are really one about the U.S. and three about big emerging economies. And that struck me as being pretty indicative of the kind of world we're in now and it's the kind of world that this book helps explain.

So without further ado, I'm going to ask Ayhan Kose, who is one of the authors of the book -- just one second, I'm going to introduce the panelists first, sorry -- to describe the book. But before that I'm going to introduce to you the rest of this top notch panel and I'm going to go from my right, I guess your left. Not that any of these people frankly need any introduction. But Don Kohn, who is now -- and actually, Don, what is your official title here at Brookings? I can't seem to find it.

MR. KOHN: Senior fellow.

MS. BEDDOES: Senior fellow at Brookings.

MR. KOHN: Very, very senior.

MS. BEDDOES: Senior fellow here at Brookings. Here, I found it now. As you all know, formerly vice chairman of the Federal Reserve and a 40-year career at the Federal Reserve, much of it interacting with fellow central bankers and increasingly fellow central bankers from the emerging world. So that's Don.

Next to Don is Kemal Dervis, also now here at Brookings since 2009, February 2009. Before that, Kemal was head of UNDP. Again, intimately involved with relationships with the big emerging economies.

Ayhan here is at the IMF, assistant to the director. I've got my papers here in the wrong order. Another IMF -- gosh, we've got a lot of IMFers here.

SPEAKER: That's the problem.

MS. BEDDOES: To my left here, Zhu Min, who is special advisor to the managing director of the IMF, formerly from the People's Bank of China. And here, Eswar Prasad, co-author of the book. So we have really, I think, a pretty stellar --

MR. ZHU: Former IMF.

MS. BEDDOES: And former IMF. That's absolutely right. A stellar cast of characters to discuss this book. And Ayhan, without further adieu, now to you.

MR. KOSE: Thank you. Okay. So everybody can hear me.

MS. BEDDOES: A little louder.

MR. KOSE: So what about now? You can hear me? Thank you. Thank you for coming Friday afternoon. It's real cold outside.

Let me thank Brookings Institution for production of the book and organizing the event. At the same time we thank all of those who contributed to the ideas in the book. Some of them are here in the audience. Our co-authors, over the years we were able to work with a number of excellent economists in the Fund and outside of the Fund.

So since I am still a bureaucrat I have to show you this slide. So the views we have in this book and in the presentation are our own views, not the views of the institutions we are affiliated with.

Now, my job is to summarize this book. It's a little bit long, not that long. It's around 200 pages. I'm supposed to do that in 15 minutes or so, and then I'm hoping that, you know, since I summarize the book you ask all the difficult questions to Eswar. I think that was the arrangement.

Now, let me start with this question and create a little bit of suspense, if I may. So let's look at this quote. The quote is, the idea is there for the past 100 years the rate of growth of output in developing world has depended on the rate of growth of output developed world. And the developed world grow fast, the developing grow fast and then the developing slowed down, the developing slowed down. So is this linkage inevitable? We think that this is the question for the new century. But who said this and when he said it, I'm going to tell you at the end of the presentation.

So we thought it would be good to ask four questions to basically tell you the summary message. Each of these questions can take a long time to answer, so my answers are highly stylized. So the first one is what was the debate about emerging markets before the crisis? The second question, what happened during the crisis? The third one, what explains the resilience of emerging markets? And the fourth one, what lessons and what challenges these countries face going forward.

Now, what was the debate before the crisis about emerging market economies? The major debate was: were emerging market economists becoming less reliant on advanced countries? This debate was centered around this buzz word, decoupling or divergence or whatever the phrase you would like to describe the emerging -- the spectacular growth of emerging economies over the period 2003 to 2007. That period was an interesting period because the global economy actually enjoyed its highest rate of growth since the early ’70s thanks to the performance of emerging market economies.

One of the messages in this book is basically let’s take a step back and think about this divergence or the coupling issue, not in the short-term discussions, you know, whether these economies decouple this year, decouple next year, they decouple next year. But think about the gradual structural change we have observed in these economies over the past 50 years. And in light of that gradual change, what we learned during the crisis in terms of the resilience. So there it’s useful to think about the growth gap between emerging market economies in advanced countries.

So this growth gap was around 2 to 3 percentage points in the ’60s, ’70s, ’80s, even the ’90s. Over the period of 2003 to 2007, the growth gap reached to a rather high number, around 5.5 percentage points and that triggered this discussion about the coupling. Before that a number of important changes have already taken place in emerging market economies. What were those changes? Of course, these countries over the years have become more integrated into the global economy with much stronger trade linkages and financial linkages with advanced countries.

But at the same time they have a much more diverse production base and the trade base. This is an important issue. Why? Because as these economies become more diverse they're able to spread the shocks they receive across different sectors that increases their resilience to the shocks coming from outside of the world. The numbers are actually rather dramatic. In the '60s, you know, emerging market economies, when they sell goods to the rest of the world, 80 percent of those goods were primary goods. Now, you come to '86 to 2007 period, 80 percent of the goods they sell to the rest of the world, merchandise exports, was manufacturing goods. So this is the first observation.

The second observation is that when we think about this decoupling and divergence discussion we always think about the linkages between advanced and emerging market countries. One of the messages we will like to basically give in this book, we need to think about the linkages within the group of emerging market economies. In that dimension there is also an important change. So in the '60s, 80 percent of their trade, emerging market economies' trade, was with advanced economies. You come to 2000, 2007, the 80 percent number went below 60 percent and when they had 10 percent of the exports with other emerging market countries over the 2000s that number increased more than 40 percent, close to 50 percent.

This is an important observation because in addition to increasing intra-group financial linkages, having these very rapid increases in intra-group trade linkages created a self-reinforcing growth dynamic within the group of emerging markets. The extreme example of that we see nowadays of course, commodity exporting countries and commodity importing emerging market countries, how they basically feed off of each other's growth and are able to put very impressive growth numbers.

Now, when you have a group of countries having stronger trade linkages having financial linkages, what happens over time is that they start to display their own business cycle characteristics. This does not mean that they are independent of the business cycles in advanced economies; it just means that their business cycle is becoming less sensitive to business cycles in advanced countries. And that's exactly what happened in the context of emerging market economies.

Now, what is the cumulative impact of all of these changes? The cumulative impact of all of these changes is that the share of global growth due to emerging market economies increased rapidly. Again, in the '60s, close to 80 percent of global growth was due to advanced economies. Over this period of 2002 to 2007, that number went down more than a half so the advanced economies' share in terms of explained global growth becomes less than 40 percent and emerging market economies' share went up from 20 percent to close to, you know, 65 percent. During the crisis that number actually was much larger because advanced countries were contracting.

Now, what happened during the crisis? There are a number of narratives out there. The important observation here we make is that crises spread very rapidly in the fourth quarter of 2008 and the first quarter of 2009. During those two crises, a number of emerging market economies suffered and suffered quite dramatically. But at the end of 2009, we needed up with a very pleasant surprise. Emerging market economies as a group weathered the global financial crisis much better than the advanced economies. Moreover, most emerging market economies bounced back rather strongly since mid-2009. What was very surprising is that how the growth gap between emerging economies and advanced economies has changed during the crisis. So I said that over 2003 to 2007 period the growth got close to 6 percent. In 2008, the growth got widened. And in 2009, you know, the deepest global recession during the modern era, you had the historically record number for this growth gap which was larger than 7 percentage points.

Now, at the same time you come to 2010. What you see is that emerging market economies bounced back rapidly and now are putting growth numbers very similar to even higher than those numbers they put up in 2008. Now, of course, the question is what explains the resilience of emerging market economies? So there are a number of reasons for that. The first reason we think is the structural transformation story -- changes in the nature of trade linkages, changes in the production structure, changes in the nature of business cycles. But in addition to that, especially after the Asian financial crisis and the crisis we observed in early 2000 in emerging market economies, there were important changes, policy changes, these countries undertook.

What were those changes? They became less dependent on foreign finance. They tried to shoot away from foreign currency denominated external debt, the type of basic financial inflow you would like to avoid as much as you can because it's the most volatile type. And they start accumulating large buffers of foreign exchange reserves. It's important to understand that these large buffers are good. It's an insurance mechanism. But at the same time it can be quite costly to carry.

Now, above and beyond all of this there was a dramatic change in terms of policy space. Emerging market economies came to this crisis with enhanced policy flexibility. The basically unfortunate history of policy in emerging market economies, they tend to employ procyclical policies during bad times. In the latest episode they had the policy room on the fiscal front as well as monetary front so they were able to stimulate their economies with these policies because they had the room to in a sense counteract adverse shocks from the advanced countries.

Okay. Emerging market economies as a group have done remarkably well but there are differences across emerging market economies in 2009. Some of them did rather well; some of them were hit very hard. Here, Asian economies did very well. Emerging Europe, as you know, was hit very hard. Latin-American economies contracted as well but when you think about the history of Latin-American economies and how these countries went through a very deep crisis when advanced economies had problems, this episode was totally different. And again, thanks to the policy space they had, they were able to counteract.

So there is large literature why, you know, these different emerging market economies were able to respond differently. We think that it's a good idea to think about poor opposites and have a kind of case study approach here, even though we discussed this list largely with richer.

Now, so if you look at Asia and emerging Europe and think about what were the major differences between the two. In the case of Asian economies, they had less exposure to foreign finance. At the same time, they had less exposure to troubled segments of financial markets. Emerging European countries, of course, they had significant exposure to foreign banks. Exposure to foreign banks can generate a variety of benefits, but in this particular instance these banks were -- played the role of, you know, channels of transmission bringing the crisis from advanced economies to emerging

European countries. In the case of Asian countries, we observe high saving rates, large current account surpluses, and massive accumulation of foreign reserves, all of them basically were helpful in terms of reducing the vulnerability of these economies to crisis.

In the case of Europe, what we had is a high dependence on external finance and large current account deficits. When things go tough, we know that these are not the futures you would like to carry around. And then, as I said, Asian economies had the policy room to counteract and they did counteract. But in the case of Europe they had to suddenly stop. They had a credit crunch. And we know that, you know, when these episodes, recessions, combine with credit crunches can be very deep. And if you don't have the policy flexibility to counteract, you can end up with a very bad equilibrium. That's exactly what happened in the case of emerging European countries.

Now, what are the lessons? I think the lessons we learned from this crisis and the ability of emerging market economies are not different than the lessons we learned from the previous episodes. In a sense you might say these lessons are somewhat boring. But at the same time it tells you the importance of fundamentals when we think about economic policies. What's the first lesson? Create room for policy during good times. It's an important lesson for emerging market economies because, let's face it, this is the first time they had the room and they were able to counteract. The question is that going forward whether they can have that room to in a sense respond during bad times.

Embracing financial globalization is good. Financial globalization can create direct benefits, as well as indirect or collateral benefits. So it's important to enjoy those benefits of financial flows, but at the same time, once again from this crisis we learned that emerging market economies had to be very cautious when it comes to short term foreign currency denominated debt. Now, carrying these massive reserves can be a useful tool; can be a useful insurance mechanism. You would like to defend the currency because the currency movements can have implications for all types of balance sheets. But at the same time these large reserves come with costs. It's important to understand the costs and benefits of these reserves as well.

Now, having a growth strategy between domestic and external demand is an important issue. It's not just the lesson we got from the 2008 fourth quarter, 2009 first quarter. It's going to be an important issue going forward given the weak growth expectations in advanced countries. And, you know, we used to say having a deep and well regulated financial system is important. I think from this crisis we learned that you would like to have a deep financial system but you would like to at the same time have an effectively regulated financial system.

Now, so I said there's a new question for the new century. And who said this? This was Arthur Lewis actually in 1979. In his Nobel Prize lecture he said it, 30 years before the, you know, the global recession we had in 2009. And during the global recession, as I showed you, the growth gap between emerging economies and advanced economies registered at unprecedented levels.

Now, what are the new challenges and the risks going forward? Now, there are a number of risks and we basically discussed those in the book. But it's useful to think about this transformation in emerging market economies and understand, you know, the current environment. This differentiation between emerging economies and advanced economies reached a new level. It's not just about business cycles. It's about policy space as well.

What does that mean? Going forward we expect emerging market economies to do well in terms of their growth prospects. In the case of advanced economies, in all likelihood the growth is going to be weaker than what it used to be during the past two, three decades. This is not surprising. This was the big divergence debate before the crisis. It became, you know, much sharper after the crisis. What is surprising is that the decoupling of the policy spaces in emerging economies and advanced countries. On the one hand, in advanced economies policy space is pretty much exhausted. In the case of emerging economies, that policy space is there with, you know, smart in a sense employment of policies. That policy space can be even expanded.

Now, emerging market economies are becoming more important players in the global economy and maturing rather rapidly. Of course, with maturity comes new responsibility. That's a really big challenge we think for emerging market economies. Whether these economies with this, you know, growing voice and, you know, the larger responsibility in international organizations, international (inaudible), and the IMF, whether they can use this unique opportunity they got because of the crisis and take on in a sense more responsibility for formulating policies that can shape the global financial stability and economic stability.

Thank you.

MS. BEDDOES: Thank you, Ayhan. That was an excellent overview. Thank you. (Applause)

MS. BEDDOES: Straight to you, Min. What's your reaction to the book, to those comments, and I'd be particularly interested in your reaction to the policy prescriptions.

MR. ZHU: First of all --

MS. BEDDOES: In six minutes.

MR. ZHU: In six minutes. Okay, five. I will take one minute for the courtesy. First of all, thanks for the invitation from Brookings. It's a great honor to speak to this distinguished audience and also this invitation brings me a free lunch. You know, this is amazing. Typical, classic Brookings. A chicken lunch, which is very good I have to say. And also bring me a free copy of the book which you also get. And almost -- it's taken me to read the whole thing which is also good because I really enjoyed the book. I think the book is excellent because the book actually is really two portions.

The first issue is a very good literature review. It's very good. And classical theory, how to, you know, forecasting the emerging economy and whether it works or not works, the consequences obviously are very controversial. But it's absolutely interesting. I would encourage everyone to read it. It's very good. The second, they have their own data. They do a lot of data things. Everything in the slides. I would say this is very clear.

Now, let me move a little step further from what the author said, but before that I have to say this is only my personal view, not necessarily represents the Institute's because we have two IMF here. Also, one of our executive directors here who is my real boss so I've got to be very careful.

The crisis is really divided into two parts -- an advanced world and emerging economy. This is exactly what the book tries to say. Yes, the world is always into two parts -- the advanced economy and emerging market -- yet this time is different. I think the book tells us the world is firmly divided into two parts. But if we move -- if we're looking further -- if you're looking for the next five years, the really -- in the advanced economy it's much associated with high financial debts burden, high fiscal debts, high unemployment rates, and low interest rates and low inflation expectations and a weak growth. And if we're looking for the emerging market, it's associated with a rather lower financial burden, lower fiscal debts, and with the lower employment rates with high interest rates, high inflation expectation, and strong growth.

Because everybody talks about fiscal burden today, today in advanced economies, fiscal burden roughly averages 92 percent of GDP. Five years on the horizon in 2015, it will be 115. So things will be even worse in the next five years. The reason is very simple, because there's no growth. There's the revenue side and entitlements (inaudible). On the whole macro space for advanced economies it's rather limited. For the emerging market they have a macro policy space and they still have a labor demand as long as they can switch the external demand to the internal demand, the growth model will maintain.

Usually this is pivotal because this year on emerging market at a low income country, account PPP measure 50 percent of global GDP. We forecast in the next 5 years advanced economies roughly growth of 2 to 2.7 to 8 percent of GDP growth in 5 years. Emerging market growth of roughly around 6 percent of GDP growth rates, 2 to 2-1/2 times of the advanced economies' growth rates. If that's the case, in 6 to 7 years the emerging markets and low income countries will account for 60 percent of global GDP. Never, ever that happened before.

That will change the whole structure of the global economy. But there's no guarantee. The whole issue is, I mean, the book tells, describes everything that happened before. But if we're looking forward, I think it's happening today even more dramatic. But there's no guarantee.

Emerging markets are facing a lot of challenges. The top three challenges I think are number one, the weak external demand because the advanced economies have such weak growth rates so they have to change the growth model. The second issue is the emerging market in the past few years, two years; they will be able to do that because they put the hugest stimulus package into the areas and will substitute external demand so we boost the economy. The whole idea is that the advanced economy had a crisis, everything dropped down so they pull the stimulus package. They tried to manage this in very difficult areas. After two years, the advanced economy picks it up and we follow. But now after two years the advanced economy does not pick it up, the story is very different.

So next year, for all the emerging markets, the big question is to stimulate or not to stimulate. And if you stimulate, the fiscal situation has been deteriorating already and inflation pressures are there. The variables for India are roughly around 10 percent today and interest rates are also way high. In Indonesia it's 8 percent today.

The third issue obviously many people talk about that; that we saw a lot of capital (inaudible) move in. In the past, the capital in and out (inaudible) kept the flow into emerging markets always fluctuating. And it's a very cynical move. From the peak to the shore can be as big as 5 percent of local government's -- local GDP. It's not easy for emerging market managers. Five percent of GDP flows in and out in a short horizon. So there can be the issue. Because the capital inflows is always good if you use infrastructure investments, if you use it to expand financial sectors, but it can cause adverse effects because if we move in and move out quite quickly. So there's really a challenge to that.

So when -- I think what I'm trying to say is, yes, we (inaudible) sort of a decoupling with (inaudible) language, but the pattern is there. We even can foresee in the future the tool what probably will probably go to two directions. The stew is not all clear. The not all clear is whether in the next few years emerging markets will be able to sort of decouple more or less if not (inaudible) advanced economy and move into the other way, which is a very big challenge.

What we thought -- this is two interesting points -- what we thought in the past 10, 15 years, all the things behind the data is what really happens is my (inaudible) emerging market what happened is because globalization, it goes through the diversification process. The capital flow, trade flows, promotes the expanding production base (inaudible) grows. Meanwhile, in advanced economies it's really further specialization process, particularly in Europe and also in the United States, though. So the next question is whether the emerging market will continue (inaudible), how much is room for the diversification, whether it will go to the specifications process. If the emerging markets go to the specification process, it will go back to the global picture. I think that's really the big issue, is to see how the real GDP economic flow moves.

The second issue is really the financial flow. Today as I said, the PPP measures -- the emerging market and advanced economy are half and half today. But if you're looking for the financial sector, the advanced economies still account for 81 percent of global financial assets. I mean, equity and bonds and a few other little things without the (inaudible). What we thought today is we saw the liquidity of capital move into the emerging market but we also observed the starting point of a global portfolio relocation, which would have a huge impact on money market. So what we thought today is still two separate pictures. The pictures on the economy side (inaudible) different ways on the financial sector, still more or less the one dominated by the advanced economy. So there's a reason the book made it very clear on both rates, the global factor impact on the emerging market is relatively small, but the financial market, they move almost the same direction. (inaudible) very high, almost 80 percent. So the question is will the structure change? Will the financial market change in the next five years? Well, it depends on what the global economic structure will have in the next five years.

I'll stop here.

DR. BEDDOES: Thank you. You've raised a lot of very interesting points.

Don, let's turn to you now. Your reactions.

MR. KOHN: Thank you, Zanny. It's a pleasure to be here and a pleasure to be able to participate in this panel.

I found the book very interesting. I learned a lot. Now, I started from a relatively low base. To be sure, I don't know as much as I should about this subject, but I do recommend the book very highly. I thought the summary of work to date, the extension in a systematic, rigorous way of testing these hypotheses was very useful, and then the last part, the examination performance in the crisis. So I found this, I think given the importance of the emerging market economies, policymakers and other observers like myself cannot afford to be as ignorant as I was about some of these interactions. And this book really was very, very helpful. I recommend it very highly.

I have four comments, many of them overlap. Some of the comments that have already been made. I think the perspective through much of the book, though not so much in the presentation but the book was are the emerging market economies resilient to shocks from the advanced economies? And I just want to underline the points that were made. I think this was the second to the last slide that we saw in the presentation, which is as the emerging market economies become bigger and bigger and bigger, that feedback mechanism goes in both ways. And the emerging market economies, these large economies, need to be aware of their effects on the rest of the world, both as it feeds back on them and as was emphasized, how they can participate in setting global agendas in meeting global objectives for more sustainable and sustained growth in a less dangerous world that we live in. So there are no responsibilities and need feedback mechanisms that come with the rise in emerging market economies.

The second observation has to do with the financial flows we were just talking about. The book documents very nicely the integrated -- increasingly integrated financial markets and certainly we've seen in the last month or so concerns from the emerging market economies about spillovers from easing monetary policy in the advanced economies, most especially including the U.S. but most advanced economies have very easy monetary policies these days that highlight the role of capital flows to emerging market economies, transmitting shocks and conditions in the advanced economies to the emerging market economies. And the book notes the different character, the inflows to Eastern Europe versus to the Asian countries. This is a very critical topic. And the key here is, of course, what the inflows, the capital inflows are used for and the form in which they take and the regulatory environment in which they land in as they come in.

I think the U.S. -- the U.S. in the 2000s is a good example of what you shouldn't do with inflows of capital. So we basically use the inflows that came with that current account deficit to fund unsustainable credit financed rise in consumption and in residential construction. That the inflows financed the buildup of debt in the government sector so we didn't have as much space to move when the crisis came. The government -- the buildup of debt occurred in part because of the tax cuts which helped to finance more consumption in the U.S. and they financed a huge buildup of debt in the household sector borrowing against rising house prices at increasingly easy terms. So I think if you want to see what not to do with an inflow of capital, listen to what we say, not what we do in the U.S. unfortunately. And we've learned our lesson, I hope.

On the form of the inflows, obviously this was noted. Shorter term inflows are more easily reversed. Vulnerabilities also arise from currency and maturity mismatches. And I think there was a lot of that in the crisis that contributed to the funding pressures that were felt, particularly in Eastern -- well, throughout Europe, but particularly in Eastern Europe. And dependence on whole funding outside the country as was highlighted for Eastern Europe. And I think emerging market economies are right to be concerned about the use and the character of these inflows and what will happen when they're reversed. I think we need to be careful about the responses here. One issue is the exchange rate flexibility. I do think the lack of exchange rate flexibility is probably in some areas is probably contributing to the pressures and capital flows. There are too many one-way bets still out there in the financial markets. And I think it's also critical as was pointed out to strength both micro prudential regulations and to develop macro prudential tools to address systemic risks that might come with these inflows.

I think we need to be careful to both in the advanced and the emerging market economies as we develop those tools to make sure that those tools don't interfere with the efficient allocation of capital. And I do worry to some extent about the development of things like insisting on banks have the subsidiarization of banks, that banks have subsidiaries rather than branches everywhere. There is something -- there is countries, home countries or host countries can control the subsidiaries better than they can the branches, I agree, but you're losing something in the credit allocation process and I think every country needs a variety of different branches, different financial institutions so that risk is diversified. And I also am concerned about the reliance on capital controls and taxes. I can see the argument for short term targeted, relatively small taxes and capital controls with these macro prudential but I would hope that's a last resort after you've strengthened your domestic financial institutions and that domestic financial regulation and that they're not allowed to persist and interfere with the efficient flow of capital over time.

I was troubled a little bit about the book's -- moving onto another topic now -- troubled a bit about the book's observation, which we just saw that current account surpluses helped to insulate Asian emerging -- Asian economies from spillover while current account deficits made Eastern Europe more vulnerable. I understand -- I understand the arguments there, but I suspect it wasn't so much the surpluses and the deficits but rather the character of the inflows and how they were being used -- the discussion I just had. And I think it's not in the interest of those economies or the global economies to have everybody try to run surpluses in order to protect themselves against shocks. It can't happen. For all the reasons everybody knows we can't all export ourselves out of a recession. The U.S. needs to get back to full employment with less consumption, less residential investment than we had before, and more net exports and more investment -- business investment than we had before.

We need more domestic demand from the emerging market economies and the associated shifts in production. As was noted, they have the policy space to do this, to help bring the global economy out of this weak patch that it's in. This weak, very weak situation that it's in that the advanced economies don't have. So I hope that people don't take that -- that countries don't take the lesson that they need to be running surpluses to protect themselves against shocks from other countries because not everybody can do it, it's not going to work, and it's not in the interests of either the global economy or the individual countries to be constantly seeking exports.

And my final point is I think we need to remind ourselves to some extent of the larger picture here. The success of the emerging market economies has given -- is giving literally hundreds of millions of people a chance to pull out of poverty, to raise their living standards. And this is a marvelous development. It's a wonderful -- it's a miracle almost. Not really a miracle because I think there are good reasons for it, but it's a wonderful development that's happened in the last 20, 25 years, very, very gradually. I think that success has arisen from a couple of sources, but a very important one is the spread, in some cases the introduction of market-based systems for the incentive -- for incentives and for the allocation of resources. We see this both internationally with reduction of trade and capital barriers, capital flows barriers, and certainly domestically in countries like India, China, Eastern Europe after the fall of the Berlin Wall. Markets play a much higher, much larger role in allocating resources, and I think it's that role of markets that has enabled the takeoff of these emerging market economies against the background of good, sound fundamental policies that enable that to happen. I think in the last few years, naturally we've tended to concentrate on the problems with market. Market failures, externalities, regulatory shortcomings, but we shouldn't lose sight as we think about the problems we've had in markets with the fundamentally beneficial effect that markets have played in lifting people out of poverty.

Thank you.

MS. BEDDOES: Thank you, Don.

Kemal, let's turn to you now.

MR. DERVIS: All right. Well, I kind of will pick up from Don's last point. I think development, economists growth theorists for many decades, '50s, '60s, '70s, were struggling, you know, with the kind of contradiction that growth theory fundamentally says that there should be convergence and yet there was not convergence for a long time. From the mentally, why should there be convergence? Because their diminishing returns to capital so the rich countries being much more capital intensive, the return to further investments should be lower than what's happening in the developing countries which have much less capital. And over time that should lead to convergence of income.

And the other factor of convergence is technology transfer. The frontier economies, you know, it's more expensive, more difficult to move ahead with technology. You have to invent new things. When you are in a developing country in an emerging market, to a large degree you can import the technology and these two things should have led to convergence, and yet they didn't. They didn't basically until the '80s, early '90s. And I think the fundamental reason was that the institutions weren't there in the emerging economies. The institutions that allowed much more efficient use of capital and much, much easier technology transfer. No doubt the information revolution has also apart from the institutional aspect made it easier to import. It's easier to find technology after the information revolution that we've had -- technology revolution we've had in the last 20 years.

So I think that's a fundamental fact. Ayhan started with that, the growth gap. He showed us GDP figures. If you look at GDP per capital, in fact, it didn't start until the '90s. The '80s were still not a period of convergence in per capita income because, of course, population growth was still very rapid in the emerging markets. That's a third factor. Population growth went down. So when we look at it in per capital terms now, there's almost 1 percentage point there that emerging markets have gained by lowering their population growth. Not everywhere in the world but almost everywhere in the middle income countries.

So there's a very fundamental shift. We now have a growth rate. The growth rate of potential output, the supply side determined growth rate, long term growth rate if you like in the emerging markets, which is somewhere between two and three times faster than the advanced countries. And I think that will continue. There are debates, of course, particularly focused on China, given the capital intensity of China now, whether, you know, Chinese growth will slow down or not. I've seen quite a few studies that show that the return to capital in China is still close to 20 percent. So there's no reason to believe that in the short run, the next 10, 15 years, there should be a major slowdown.

So that's my first point. And, you know, very much in line with what the authors say in the book.

Now, let me say two things which are, you know, complementary, and I think maybe interesting. One is I think we're generalizing a little bit too much by talking about emerging market countries. There are very significant differences, okay, in many dimensions. First of all, emerging Asia led by China but now joined by India and other emerging Asian countries, has grown significantly faster than the other emerging markets, than Latin America, for example. And I put my own country Turkey and the Philippines also more in Latin America than Asia. The Philippines I just realized was in the constituency and the governance was actually with, I think Brazil or something like that at the World Bank. And I think the fundamental difference here is that the emerging Asian countries save anywhere between 30 and 40 -- China, of course, is an outlier, but many others also save more than 30 percent of their income, whereas the Latin American countries and many Mediterranean countries save 20 percent. You have 10 percentage point difference in the savings rate, and I think that, you know, that is something to watch, something important and that will allow emerging Asia to grow quite a bit more rapidly than the other emerging countries.

A reflection of that, coming again to Don's point also and to Zhu Min's point is that the current accounts are very different actually. It's not true -- well, it has been true for a while that the emerging countries as a whole were running significant current account surpluses and most of them did, but actually we now have a different situation. The current account surpluses are concentrated in East Asia and particularly in China, and many other emerging markets are actually already in 2010 running significant current account deficits. India is heading for a 4 percent of GDP deficit. Turkey, 5 percent of GDP. Brazil something probably close to 3-1/2 percent of GDP. These are very important deficits. I think if they can be managed well -- a good thing because these countries need capital and, you know, the famous Lucas paradox, why is capital flowing uphill? It should be going where it's scarcer and where the return is high and where there's lots of need for it.

Nonetheless, I do believe that the dangers here of again excessive capital flows, bubbles building this time in these countries are quite significant, and I would be very careful if I was, you know, concerned with national management in some of these countries. The 3 percent deficit of current account of GDP I think is quite manageable. When you get to the 5, 6, 7 percent ratios, I think history has shown that you get very -- you become very vulnerable. So in that sense, that story, I would like to add -- and it's a recent story. It didn't really exist a year ago but I think it's developing very fast and I think one should be very careful about that.

The last point I'd like to make is the point in the book which is excellent and very good and I think one of the really important messages in the book is that there is a business cycle now kind of inside the emerging market countries. The trade shares that they have with each other have increased much more rapidly than their trade share with the advanced countries. The mutual dependence within the emerging markets has increased, and the factor analysis -- it is one of the chapters; I forgot the number of the chapter -- shows that I think very clearly and is a real original contribution to the analysis. So we have, you know, we have within the overall global business cycle we have a synchronicity within the emerging markets and a mutual dependence in the emerging markets which is quite important.

That is not to say, however, that there is no longer a global business cycle. And here I would like to suggest that, you know, there are all kinds of mythological issues but if one correlates the deviations from the growth rates rather than the growth rates, and if one somehow tries to detrend the data and it's not that easy to do that, then I think there still remains a lot of synchronicity globally. And in that sense I don't think one should go overboard. The trend growth rate of the emerging markets will be significantly and sustainably higher than the advanced economies. But I don't think one should jump from that to the conclusion that severe difficulties in the advanced economies or very slow growth rate in the advanced economies will not be a problem or will not lower the growth rate in the emerging markets. I think the advanced economies still are very important to the emerging markets and there is definitely a mutual interest in supporting one another's growth. It's not quite the case that the emerging markets are now, you know, living in a different planet and can just grow and not be affected at all by what's happening in the advanced economies.

Thank you.

MS. BEDDOES: Thank you. Thank you all of you. We have half an hour, which I'm going to split somewhat unequally between discussion between the panelists and then I'm going to open it to Q&A in a few minutes.

But Eswar, since you got off scot-free so far, I'm going to try and bring together a couple of the panelists points, a couple of points that have come up several times. In one of Ayhan's slides you explained why the emerging economies have been resilient. And one of the points you made was less exposure to the troubled parts of the rich world financial markets. And the second was, particularly in Asia, and this was just repeated again, high savings rate, large current account surpluses, big foreign exchange reserves.

Now, as we think forward, how do those two sources of strength in your view, what do they imply for the question that Min raised about the, you know, will we see an integration of financial markets that we haven't seen thus far nearly as much? And secondly, what happens in a world where we don't have the kind of demand that we used to have in the rich world? And so can the things that made the emerging economies strong, particularly the Asian ones pre-crisis continue?

MR. PRASAD: Thank you. First of all, let me thank the other panelists for their kind words. I think this is the first time a chicken lunch has had such a good payoff, so I'm happy to repeat it if necessary.

MR. ZHU: The next time we need (inaudible) on that.

MR. PRASAD: The questions you raise, Zanny, are important ones. And I think the way I would frame it is that this crisis in some sense has reaffirmed the importance of what we used to think of as macroeconomic orthodoxy. And what used to be the case was that the advanced economies are much more the proponents, as well as the practitioners of macroeconomic orthodoxy. And somewhere along the way, as Don pointed out, it seems that the advanced economies went astray. And the emerging markets on the other hand, thanks in part to the many crises that it experienced in the past, seem to have absorbed the lessons of macroeconomic orthodoxy. As Ayhan pointed out, they've created much more policy space for themselves. They have undertaken the rights out of structural reforms that are necessary to promote growth. So I think this is where we are seeing the results paying off, not just in terms of long term growth but during a very difficult period for the global economy.

But it is a very different kind of macroeconomic orthodoxy because if you think about the countries that Kemal pointed out that are doing very well, like China and India, it's not that they have completely liberalized financial markets or completely open capital accounts; they're going about it in a very structured way and they're trying to build up institutional frameworks that can support much more liberalization. But I think the endpoint very much remains the same. And in fact, I think that there is going to be a bit of a convergence between the advanced economies where I would characterize financial markets essentially having gotten a bit ahead of themselves and advanced economies now have become more of a matter of restraining financial markets. But in the emerging markets there are still very big challenges as Min Zhu pointed out. If you think about financial market development, yes, they did better during the crisis because they were relatively more insulated, but countries like China and India have actually significantly made progress in financial market reforms because they know that in order to support the growth process, in order to make it much more inclusive which you need for social stability, you need much broader and deeper financial systems.

So in a sense I think we are converging to the notion that you do need good macroeconomic fundamentals, and that I think is one of the key lessons of the crisis. That fundamentals ultimately are going to play a very important role. And I think if you want to take a lesson out of the crisis, we're going to arrive at a convergence between the emerging markets and the advanced economies with, as Don pointed out, the two sets of countries learning a bit from each other.

MR. BEDDOES: Can I just push you a little bit on the second part of it? The, you know, in a world where we're not going to see huge aggregate demand growth in the advanced economies, the kind of approach that the East Asians in particular had of large current account substances as Min said, there has been a shift. They substituted domestic public sector stimulus as external demand fell off. What happens going forward? Do we see this big shift that I guess you, Min, were hoping for towards private, more private domestic demand in big emerging economies?

MR. PRASAD: That is the hope. I don't think we are quite there yet. I mean, during this crisis China has, of course, kept itself, the emerging world, and much of the world economy riding along on it is back but it's been through a largely investment fueled boom and I'm not completely sure that this is sustainable because I don't think domestic private demand, household demand, has really picked up.

And the point you make raises a very important concern in my mind. I think the long-term interests are aligned. As Kemal pointed out, we're all in this together and we can't separate out emerging markets in advanced economies. But in the short run I see a very important conflict developing between the emerging markets and the advanced economies simply because they are very different growth projectories, very different policy conundrums, and very different amounts of policy space. So in the U.S. there are concerns about deflation. There are concerns about getting employment growth going. In China and India it's more a matter of sustaining growth and sustaining inflation.

Now, the problem is that the key policy tool here is monetary policy. The emerging markets are now much bigger. The monetary policy actions they take have spillovers, but at the same time the U.S. imposes QE2. It has implications for the rest of the world.

So this fundamental tension now between what the advanced economies want to do, what they can do, and what emerging markets are trying to do, it's going to be very difficult to resolve. And I think this could actually make it even harder for us to get to this harmonious longer term goals where we would all like to be cooperating.

MS. BEDDOES: I think we have to turn then to the two people who have been closely involved with monetary policy here. Min, what do you make of this tension? Over the past few months we've heard an awful lot of complaining in the emerging world on precisely the monetary policy course that the U.S. has taken. Do you think this distinction that there is now between growth rates and monetary policy responses is sustainable or is it going to be making life so much harder for the emerging world?

MR. ZHU: That's -- I have to pay the respect to (inaudible), but let me --

MS. BEDDOES: That doesn't mean that you can't respond.

MR. ZHU: Right.

SPEAKER: Representing Brookings, I would add.

MR. ZHU: Brookings. Yes, yes. I almost forgot. Let me go back.

MS. BEDDOES: Sure.

MR. ZHU: This is very tricky and delicate part. You have a very good question.

The whole thing I would say it looks like today the world is very much divided in two parts. And all the information says the world goes to a different way in (inaudible) the next five years. However, the very current challenge is how do we provide the demand in a given (inaudible) exactly you said, right? So the few things, whether the government will be able to provide a further stimulus because the fiscal conditions are deteriorating already. But they may. But another idea you want to move to the private sector demand pick it up. It's not all clear today whether we'll be able to do a small transfer for emerging market from the public demand move to the private demand. You really need a lot of policy to stimulate that.

But there is also another tricky point. The tricky point is if you move to the private sector demand, always followed by the private financing. The private financing quite a bit challenge historically financed by external funding. So then the first defense the emerging market should be resilient because they have less stats, they have the higher (inaudible) it is not deteriorated (inaudible) because then the capital flow will move in. But that's what increased.

So then we will be in a very different situation. So I will say it's a very delicate macro situation when you move, say, into -- from public demand, move into a private demand. You will see those things. But how do we manage the macro situation? It's a very delicate challenge for next year.

MS. BEDDOES: Do you think -- and Don, I'm going to ask you the same question in a minute. Do you think that in this world that we're now in with very divergent situations between the emerging and the advanced world, that there is a tension in the appropriate -- things that the appropriate policy here may not be appropriate for the emerging world. And if so, who is it incumbent -- who needs to adapt? Should, you know, Don's former colleagues take the emerging world's health into account when they decide what they're doing? Or should what the policy prescriptions in emerging economies -- what they should be doing?

MR. ZHU: Don, you (inaudible). (Laughter)

MS. BEDDOES: All right. Okay.

MR. ZHU: I'll follow, yeah.

MS. BEDDOES: Don, to you.

MR. KOHN: I agree that I think both sets of countries have some very significant challenges given the disparate cyclical positions that they're in and the disparate policy positions that they're in. In a more ideal world, the U.S. would have already figured out how to have a long -- how to make sustainable it's long run fiscal position. And which we haven't done. And having a better long run trajectory for our debt-to-income ratio, we would have some room to use monetary -- to fiscal policy rather to help pull the economy out of this very deep recession. But because we haven't done that and many European countries are just beginning to do that, there's really very little room and very little appetite, at least in the short run, for using fiscal stimulus to get the economy out of the recession. So it is dependent here, Europe, U.K., Japan, basically on monetary policy. It's not a place where you'd want to be if you designed the system but that's where we are.

And I do think that it is in no one's interest to have a weak -- prolonged weakness in the U.S. economy. It's certainly, and from the U.S. perspective, of course, it's losing lots of output. There's a risk that the cyclical unemployment becomes more structural as people are without jobs lose attachment to labor force. I think from a global perspective there is an unfortunate risk of protectionism. If this thing keeps going like it is or at least resistance to further easing of trade barriers, that's not in anyone's interest. And obviously, the U.S., even when we have more balanced growth, will be a good export market for a lot of countries. So I think it's in everyone's interest to have a stronger U.S. economy. And the U.S. has just this one instrument to accomplish that.

And I certainly did not interpret the Federal Reserve's intentions to, with easing this instrument, simply to export their problems to the other countries. I think there are a number of channels for which easy monetary policy works. Lower exchange rates is one of those channels or one of those channels. But also, higher equity prices, lower interest rates. So it's not -- there was no intention just to shift our problem to the rest of the world. I think the intention was to get a stronger U.S. economy through a number of channels.

This does present issues, problems, for the rest of the world to some extent. But I also think that the way the system is supposed to work, that in a system with more flexible exchange rates, individual countries can pursue the best interest of their country, and the other country, the trading partners, have the ability to use monetary and fiscal policy to offset any adverse effects. I think one problem here is the lack of flexibility in some exchange rates. I think also there isn't as much conflict between the long run objective of more balanced growth and the short run cyclical objective as some are portraying it. After all, what is true is that the limited policy space in the advanced economies and the much greater policy space in the emerging market economies means that given the difficulties, which I agree, there can be more domestic demand in those emerging market economies, in those circumstances are going to need to let their interest rates and probably exchange rates rise to dampen any resulting inflation pressures. But this more domestic demand in emerging economies not only helps get the global economy out of its cyclical fix, but advances the long-run objective of more sustained growth, smaller deficits in the U.S., smaller surpluses elsewhere.

So I'm not quite sure I see as much conflict. I see difficulties, both in the U.S. and in the other countries as Zhu Min talked about. Shifting demand from one sector to another is not -- cannot be done overnight. But I think ultimately we can, in both areas, move towards a better place with good policies.

MS. BEDDOES: You wanted to add something. We'll get beyond monetary policy in a second, but please (inaudible).

MR. ZHU: The whole policy, though. You talk about the policy. It's very interesting. It seems to me in the advanced economy they have a less (inaudible) fiscal policy, a little more room on monetary policy.

MR. KOHN: Yes, I agree.

MR. ZHU: It's very clear.

MR. KOHN: Yeah. Yeah.

MR. ZHU: In emerging markets they have more room on the fiscal policy, less room on the monetary policy. Still have (inaudible) given the inflation pressures, even the potential (inaudible) things. So, I mean, currently, two economists view a very different policy cycle. One is loose, one is tightening. Really the key issue is how do we manage this kind of policy regime and move into the next regime, maintain the global stability and facilitate growth for both groups. I think that would be the key challenge.

Given current emerging markets still have space for fiscal policy given the substitute demand is not easy. So we tend to see in the next year, for example, few years, and the emerging markets will still tend to use the fiscal policy to stimulate and support a little bit of a demand. I think meanwhile try to shift it to the private sector as you mention.

But the whole thing, if you're looking for the U.S., yes, 50 percent (inaudible) say this on two accounts. But more than 50 percent, the U.S. accounts roughly half. And another 50 percent, this is so many different countries. And China accounts for only roughly 20 percent, less than 20 percent. So if we go back to country based, the policy impact can be quite different. The U.S. consumes a total amount 10.2 trillion U.S. dollars. China is roughly 2.1 trillion. So 2 percent increase in U.S. consumption and 10 percent or 15 percent of increase, China is consuming almost the same.

MR. KOHN: Right.

MR. ZHU: So if U.S. can have 1 more percent consumption increase, it will contribute to the global demand quite a bit.

MR. KOHN: Right.

MR. ZHU: So what I'm saying is our say on the monetary policy of the advanced economy in the next year, particularly over a 12 to 18 months, would still be the dominant policy for the global arena because this really generates the demand. But in the emerging market, the fiscal policy will maintain that. But most of the challenge is how do we manage the transition from the fiscal more to the private sector, more to (inaudible) things. I think that's quite a big challenge.

MS. BEDDOES: Thank you. I have a ton of questions here but I think it's time to open the questions to the audience. If you could just put your hand up if anybody has a question. Nobody? Nobody has a question? Gentleman right there in the green jacket. There's a microphone coming. If you could just identify yourself. We've got very little time so keep the question reasonably brief.

MR. MARCELLA: I'm Bill Marcella from the Export-Import Bank.

There was a lot of discussion about capital flows. And I know this is a controversial issue, but the IMF seems to be changing their attitude about capital controls. I wonder, I guess it's a question mostly for the authors but anybody on the panel could approach this. Could you give me some examples of what you think are effective and productive capital controls and conversely those that are not so effective and productive?

MS. BEDDOES: Ayhan, I think this is a question for you as the member of the panel who is still actually at the IMF.

MR. KOSE: That's a very difficult question.

MR. ZHU: Also from his department.

MR. KOSE: I think that the change in the kind of IMF policy in some circles understood as kind of revolutionary, it's just evolutionary. We always though actually capital controls should be part and parcel of the policy package. But at the same time you know that whatever measure you use as a capital control, it has to be temporary. It cannot be seen as a kind of permanent fix. So it's a kind of Band-Aid solution if you want to use that term. So that's the first observation. I mean, respective of whatever you use as a control.

But the second observation I think we tried to communicate in the book, the importance of using these fundamental policies, when countries are faced with large capital inflows; they need to look at, you know, the surrounding environment. The fiscal policy space, their monetary policy space, what they can do in terms of macro prudential policies on the domestic front, rather than on the border. So we know that in a number of emerging market economies, since they have that space now, maybe it might be a good time to think about seriously using fiscal policy to get the economy in a much better, you know, policy position. In terms of monetary policy, it's going to be very difficult because of a variety of reasons. It can end up, you know, backfiring because you can increase the interest rates and then attract more flaws. But, you know, capital controls can be good for some economies under certain circumstances.

MS. BEDDOES: Can you give an example? Give a couple of examples where you think it was good and has been effective.

MR. KOSE: You know, most people will give the example of Chile as a good one, but even there there were a number of, you know, micro costs associated with that because of, you know, the small firms funding Qatar because of these capital control measures. So it is -- it's very difficult. But in some cases when you end up with, you know, the tsunami of these inflows, you have no choice but to think about, at least in terms of changing the, you know, composition of these flows, you would like to target these short term flows and in a sense try to move them to kind of the longer term better natured flows.

MR. ZHU: Let me help my fellow a little bit. I have to clarify. The first thing, it's not IMF policy. I have to say that. We produce what we call staff possessing notes even though they're paper notes. We encourage the stuff be creative, to think in general all these ways and on the personal base (inaudible) good beliefs, and is a generous report. Certainly, within the system we also circulated the (inaudible) welcome, all the debating to contributing at the end of the day our human wisdom. I think this is the purpose. It is the individual stuff.

MS. BEDDOES: Okay. So the IMF hasn't changed its views.

MR. ZHU: It's not IMF's view; let me say that, even though it goes that far. Okay?

The second issue is there are two types of -- if you talk about capital control, we saw in the previous -- we saw in the Asian financial crisis and Malaysia, we saw Chile, Brazil did actually you see after (inaudible) the taxes you will see the capital flows slow down, the reserves slow down. U.S. exchange rates also slow the whole thing. This is very short term because we don't have enough information to assess the long term -- the impact of the market (inaudible) create a bit of uncertainty. But how to imagine the uncertainties the technically, fundamentally it's quite a big challenge though. But further to this issue, the more the people don't call it capital control; they call macro potential measures. Right? And because you saw capital move into Egypt quite a bit in the past few months. South Africa. Asia. Everywhere. Singapore, Philippines, Thailand, Indonesia. They really put a lot of pressures. So there are several ways to dealing with that, and exactly (inaudible) this is a new issue I think given it will be even big amount of capital flow we forecast to see that way we need a new (inaudible).

MS. BEDDOES: Thank you. Kemal, you had -- you've been in this situation.

MR. DERVIS: Well, yeah, I fully agree with what Min said. I think it's very true. I think one exaggerates a little bit the dividing line between capital controls and macro prudential policy and banking supervision. I mean, at the end of the day, if one is worried about extreme capital volatility, exchange rate risk and things of that sort and one tries to have prudential policies for the banking sector, one has to deal with these things. And there are many ways to deal with it. And by the way, it's not only the open position of the banking sector that becomes a problem but it's the position of the corporate sector. If the corporate sector is highly indebted in foreign exchange, vis-à-vis, its actual domestic operations, you know, all that has happened is that the financial risk has moved to the corporate sector. But if it gets hit, the banking sector will be also hit.

So one has to deal with these issues. And unfortunately, exchange rate flexibility can help but it can't entirely, you know, abolish the problem. I mean, extreme volatility in the exchange rate creates quite a bit of risk. And also, deadweight losses in industrial sector. So one has to address this issue. And instead of, you know, saying should one have capital controls or should one not have capital controls, I would say the right way. And I think this is what Mr. Min was also saying, to approach this is how do we deal with these risks in terms of an overall macro prudential policy that has a fiscal component and it has a more detailed banking supervision component.

MS. BEDDOES: Don, you were somewhat skeptical in your response about capital controls.

MR. KOHN: Well, I was just expressing -- I can see the points that Kemal just made, that you have a risk, you need to deal with it, and but I think I was expressing much the same kind of concern that I've also heard that these not become permanent; that they not be relied upon in an extended way; that the first priority is to strengthen the domestic financial system and the risk controls the domestic financial system.

MS. BEDDOES: How much do they risk being -- we have time for one more question after this, but how much do they risk being a (inaudible) thy neighbor policy? I mean, if there's capital at once seeking higher returns in the emerging world and one emerging economy puts up controls, then it goes somewhere else. And then they put up controls and it goes somewhere else. I mean, how much is it actually doing to solve the overall problem?

MR. ZHU: This is also the key issue we are carefully studying the whole thing because domestic issues are international issues as well. Because the money we're moving around, how much are the rebound? This is where the next project is probably associated (inaudible) another book.

MS. BEDDOES: Okay, another book. Another discussion at Brookings.

Another question. Gentleman here.

MR. AMIN: (inaudible)

MS. BEDDOES: Could you just wait for the microphone so that everyone can hear your question?

MR. AMIN: Magdi Amin, IFC.

With respect to emerging markets and the question of fiscal policies that might stimulate consumption over time, what weight do you put on urbanization which in East Asia is already rising naturally quite rapidly but in East Asia it's a policy matter and it's going, I think, what, 40 to 60 percent in a decade? A huge amount of new urban residences which will have ideally high consumption rates?

MR. ZHU: For me or for --

MS. BEDDOES: Sure. Both of you. Eswar, why don't you start and then --

MR. PRASAD: Okay. I think raising private consumption is actually important in some economies. Like in China, I think it's an important issue and it suggested there are some structural imbalances in the economy of the ratio of consumption to GDP is declining. Urbanization is a phenomenon that I think certainly helps but urbanization does come with its additional problems as well as especially in terms of the social pressures that get collected into the urban areas. So I don't think as a policy it's a major solution. There's a much deeper set of policies. And in some of my own research and in the case of China, for instance, I want to give a couple of things that are really important. Other financial systems that give people a better return on their savings that allow them to diversify their income risk. And additionally in China's case, there are issues related to the social safety net, the medical care expenditures. It turns out that in China the very real thing is the young save a lot and the old save a lot. Everybody saves more and they've been saving more and more over time.

But I think urbanization as a phenomena by itself is not going to deal with the consumption issues that are much deeper issues. And the financial system, maybe ultimately what threads all of this together if you think about rebalancing growth, if you think about absorbing capital flows, if you think about how to make policy more important, I think the financial system really is at the crux of all of this. And this is exactly what Mr. Min Zhu is in charge of for the IMF.

MR. ZHU: Yeah, I think you raise a very important question. Urbanization is clearly a main driving force for the growth in the emerging market. And you also mentioned Asia. But there's a few different dimensions. I would divide urbanization in the emerging market into two different phases. The first phase I call roughly just people move into urban -- statistically called urbanization, support the basic infrastructure -- roads and highways, apartment buildings and those types of things. It's happening in China in a lot of Asia regions.

But further there's people moving to the urban -- not necessarily means enjoy all the urban utilities because a lot of people in the (inaudible), for example, in China mobile labor does not necessarily enjoy the health care, the education, all the utilities -- water, sanitation, all those things. So the second phase for the urbanization is really to provide all the sanitation, water, utilities, all the education and (inaudible) as Eswar mentions. The urbanization rate has dropped. In China in the past 30 years, urbanization growth rates average 1.26 percent, which is quite a bit. Every year 1.26 percent moving away from rural to the urban. We expect that number to jump to roughly 74 percentage points so there were roughly cut in half. But meanwhile, when the people move from the rural to the urban are slowing down, but the real urbanization picked up. So I would say (inaudible) complete different policy sets.

So urbanization will continue being the main driving force for Asia we observe, and the second phase is more important today for most Asian emerging economies. And then the first phase, because the richest so-called urbanization, 60, 65 percent already; in China, still 49 percent.

But the second phase is important. They need more and more policy. Also have a financial implication because there's a public-private partnership issue there. They were further enhanced expand the financial market globalization.

MS. BEDDOES: I think we have time for one more question at the expense -- yes. The lady in the blue shirt in the back. At the expense, we will finish slightly late. Yes, right there.

MS. PRUITT: Yes. I just wanted to pick up.

MS. BEDDOES: Could you introduce yourself, please?

MS. PRUITT: Oh, I'm Prea Pruitt. I'm an attorney at law.

I was very interested in one of the comments on the ways in which one can determine risk in the financial system. And sort of wanted to get the views of the panel on the recent EU versus the U.S. reforms, not on the economic side but on the regulatory side. Because it seems to me that in terms of better systemic risk management, the U.S. has got a real challenge in terms of the continued fragmentation in regulatory oversight, especially in certain non-bank financial systems, for example, the insurance sector which is very much state by state. And just was curious as to what the panel felt were the implications of (inaudible).

MS. BEDDOES: We'll do it very briefly because it's slightly separate to the topic of the day right now. If you'd like, Don, if you have just a second --

MR. KOHN: Well, I think the U.S. has made some tremendous steps in the direction of making the -- or is in the process of taking, more accurately, tremendous steps in making the system more resilient and (inaudible) too big to fail. Is it going to solve all the problems? Probably not. But I also think be careful about continuing to think of this as a fragmented system because there are some mechanisms in place to identify problems that might be even outside the regulated sector, particularly for systemically important financial institutions and go increase the regulation, the oversight of those institutions. So has Dodd-Frank, Basil-3, et cetera, solved all the problems? No, undoubtedly not. But I think don't minimize the steps that have been taken.

MS. BEDDOES: Thank you. We'll have one more question so we finish on an emerging market.

MR. KOHN: Another lady there.

MS. BEDDOES: Yeah, lady in the dark print.

MR. KOHN: I saw the previous you meant -- it's that lady, right?

MS. BERGER: Theresa Berger with Cortland Capital.

I believe you said that emerging markets accounts for 50 percent of global GDP but only 20 percent of global financial instruments. And I'm wondering if you can say a word about the implications of that, perhaps capital flowing upwards, asset bubbles in financial instruments, et cetera. Thanks.

MS. BEDDOES: That is a very broad question and a good one to end on. Let's start with Eswar.

Eswar. Okay. Eswar. So, what is the -- you make this -- you point this out in your book. What's the consequence of it?

MR. PRASAD: I think the reality is that in emerging markets there is going to be a continued impetus for inflows to come in because the reality, as we've discussed on the panel, is that the emerging markets are going to be growing a lot faster. Many of them have high saving rates, like the ones in Asia. But the financial systems are not quite up to the market in terms of intermediatating domestic saving into the domestic investment that they need. Plus there is a lot of impetus for foreign capital. So I think the realities of these markets have to develop.

And the remarkable thing, as I mentioned earlier, is that even in the midst of the crisis the countries like India and China, that are relatively under developed financial systems, have in fact been moving forward in financial reforms. You have derivatives markets being set up in China and India. India introduced credit default swaps a few months ago because ultimately, although we've ended up demonizing finance, finance is really very important to the modern market economies.

And I think in terms of many of the issues we've been talking about, developing more and deeper financial systems and broader financial systems is really going to help the emerging markets get more stable growth time, contribute more to this global demand which I think eventually they're going to do.

MS. BEDDOES: What about the question about asset bubbles? I mean, what are the odds that the next asset bubble is going to be in these emerging economies?

MR. PRASAD: The financial systems are the key sources of fragility I think in emerging markets. They've effectively defended themselves against the traditional sort of crisis that emerging markets have particularly experienced in the past. Currency crashes, sudden stops of capital inflows, and so on. But the reality right now is that with the different growth rates, I think this is where the potential source of futility lies. And there again, I think getting financial systems fixed, although it means something very different in emerging markets, is really a key priority.

MR. ZHU: This is a very good question. Ours, the whole emphasis, was shifted from the real economy growth to the financial sector in the next few years. In emerging markets, the country accumulated more wealth (inaudible) growth. I think that's one thing. And there were -- goes through more financial sector reform and being more open. And the global portfolio relocation would be maintained and the Wall Street will reach out. Obviously, it's associates allowed volatilities and the risk.

MS. BEDDOES: I think that's a wonderful place to end up. Huge potential opportunity but a lot of risk.

I'm sorry for those of you whose questions I didn't get to, but as you can see, this is a terrific book, generates lots and lots of debate. I recommend it. Thank you all for coming.

(Applause)

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