# 2 STABILIZE EMERGING ECONOMIES

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## What's at Stake

Recent events in financial markets, as well as the prospect of a recession in the U.S. and other industrial economies, have created new challenges for emerging countries. Avoiding major set backs in reducing poverty and inequality should be one of the issues to be discussed at the G-20 meeting. For reasons that are not entirely under their control, many emerging countries have a long record of pro-cyclical policies that, if pursued again, will potentially create social unrest and political instability.

In contrast, the U.S., Europe, and now China, are rapidly adopting counter-cyclical policies to offset the decline in aggregate demand. Central banks have lowered interest rates while the executive and legislative branches have moved fast in terms of providing fiscal stimulus. The debate in OECD countries is not on issues of substance, but on fine- tuning questions such as how much to lower interest rates and finding the right combination of lower tax rates and higher government expenditures.

Unfortunately, with few exceptions like Chile and China, in emerging countries little is being done to stabilize demand and output. No doubt the inability to adopt counter-cyclical policies in part reflects the countries' own institutions and policy preferences, but the workings of global financial markets also play a role. The upcoming meetings of the G-20 offer a unique opportunity to fix that part of the problem.

Emerging economies have already been impacted by the global financial crisis. Notwithstanding the lack of up-to-date information on capital flows, the IMF recently estimated that global portfolio flows to emerging markets are retracting at an accelerating pace. New issues of emerging countries' debt fell to $80 billion during the third quarter of the year from nearly twice that figure in the second quarter. Not surprisingly, EMBI spreads are on average 400 basis points higher than a year ago.

For commodity-dependent countries, especially in Latin America and Africa, the reduction in commodity prices has been another piece of bad news. Relative to a year ago, prices of industrial metals are down by 45 percent, energy prices by 32 percent, and agricultural prices by 24 percent. Although prices were above their trend levels, the magnitude of the decline has put pressure on the current accounts. Low demand in the U.S., Europe, and Japan is affecting other non-commodity exports as well, while the decline in economic activity is affecting workers' remittances, which are a significant source of income for certain regions of the world, such as Central America.

Therefore, it is not surprising that the output gap—measured as the difference between potential and actual growth—is already positive throughout the emerging world, and next year is expected to be close to two percentage points. In Latin America alone, the output gap is likely to be higher. The important point is that, with some coordination, there are ways to narrow the gap and minimize its negative consequences on social progress.

## What Should Be Done

An important number of emerging countries have adopted inflation targeting as the framework for monetary policy, in which central banks announce a target for inflation and make use of all the information and modeling available to set the interest rate in a way that is consistent with that goal. Although the explicit numerical target increases the central bank's accountability in controlling inflation, it also reduces the degrees of freedom of monetary policy, especially in cases where credibility is low.

Even if monetary authorities know that in the medium- to long-term inflation will be consistent with the adopted targets, in the short run inflation can be higher for reasons not entirely under their control, such as high food prices or a depreciation of the currency. For example, Mexico's annual inflation rate rose to a seven-year high in October (5.8 percent), led by electricity, gasoline and food, while Brazil's annual inflation rate rose to a three-year high last month (6.4 percent), after a 26 percent depreciation of its currency (relative to a year before). Under these circumstances, central bankers fear an exacerbation of inflationary expectations and are thus reluctant to cut interest rates, even if the output gap would justify it. In other words, monetary policy is not helping to smooth out the negative external shock.

The contrast with the U.S. monetary policy could not be sharper. Inflation is expected to be close to 4 percent by the end of the year, a full one percentage point higher than in 2007. That has not been an obstacle for the Federal Reserve to cut its rate by 350 basis points during the last year, mainly because inflation is expected to fall to 2 percent in 2009 due to the recession.

So what can be done about inflation targeting in emerging countries? There is a considerable debate, especially in Asia, on whether inflation targeting is the right framework for emerging countries. In Latin America, which still needs to consolidate low inflation, the question is how to make inflation targeting work well. In that spirit, G-20 countries should ask the IMF to recommend that Latin America and Caribbean countries focus on medium-term inflation, and not on short-term targets. One way of doing this is by encouraging countries to adopt wider ranges for the inflation target, on the order of two percentage points in each direction. The IMF could also help reinforce the credibility of central bankers in emerging countries by producing country reports that explain why exceptional international circumstances cause inflation to be temporarily above the target.

In the case of fiscal policy, it is well known that emerging countries tend to behave pro-cyclically. In particular, fiscal deficits go up during booms and down in recessions, while the opposite happens in OECD countries. One reason is that in bad times, credit supply dries for emerging countries limiting the capacity to run deficits. Of course this is related to the fact that in good times developing countries do not save enough, reflecting deeper institutional problems. One popular explanation is that in good times the common pool problem becomes more severe and there is more rent extraction. But regardless of what that fundamental explanation is, in practice the IMF reinforces the pro-cyclical pattern by advocating fiscal adjustment in response to the reduction in credit supply.

There are no easy solutions to the challenges posed by pro-cyclical fiscal polices. Without doubt, country level actions are indispensable. Political and fiscal institutions need to provide the incentives and constraints that result in credible and flexible fiscal policies. But there are steps that the international community can take as well.

One priority is the development of a regional bond market. With deeper regional capital markets, financing countercyclical fiscal policies will become less of a constraint.

What G-20 countries need to do is to ask multilateral banks and foreign government agencies to issue bonds in these markets, and encourage countries with large levels of reserves to invest in them. The Asian Bond Market Initiative is a positive step in this direction which could be expanded and implemented in other regions, such as Latin America.

The IMF announced a short-term liquidity facility to countries that "have been assessed very positively" with "track records of sound policies, access to capital markets and sustainable debt burdens." Although well intentioned, there is a significant risk that, if pursued according to past practices, this strategy will basically provide funds to countries that do not need them. What needs to be done is to coordinate actions so that central banks in emerging countries begin lowering interest rates soon, and steps are taken so that in the future countercyclical fiscal policies can be adopted. Although this would require institutional reforms at the domestic level, regional capital markets must be developed for countries to be able to borrow in the bad times. The new financial architecture should emphasize these arrangements, rather than pursuing the strategy of strengthening one particular entity.

## The Bottom Line

Current policies in developed and emerging economies reflect two profound asymmetries. Countercyclical fiscal policies are a luxury of countries that have a fluid access to international financial markets, while only a few central banks are able to lower interest rates without losing credibility. There are some concrete steps that G-20 heads of state could take to ameliorate these problems, allowing emerging countries to stabilize their economies more effectively.

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