

- Paris June 22nd, 2009 -

Long Term Investments
The European Answer to the Crisis

**A NOTE ON THE LONG TERM FINANCIAL FLOWS BETWEEN EMERGING
AND INDUSTRIALIZED COUNTRIES**

Edmond ALPHANDÉRY

In this conference, I think it is worth raising the question of the post-crisis flow of savings that will be available in the long run to finance private investments. No doubt that the industrialized world will have to suffer the drawbacks of the absorption of the private savings used to finance the huge increase in public deficits. Moreover one has to question the evolution of the flows of saving presently coming from Emerging markets. Big current account surpluses in East Asia and in oil and gas producing Countries have so far been matched by a net outflow of capital which in a country like the US made the financing of its economy easier. Will this flow pattern last in the future? If not, what will be the impact on the financing of emerging markets themselves? These are the questions that I would like to explore briefly with you thanks to an analytical framework that has been used by two economists working for the ECB: Sabine Hermann and Adalbert Winkler, in the ECB “Occasional Paper Series” of June 2008¹.

1. Emerging Europe versus Emerging Asia

Comparing the impact of the current crisis on Emerging Europe (comprising EU member States, the Candidate and potential Candidate Countries) with Emerging Asia (China, South Asia, Asean-5 and newly industrialized Asian economies), these two economists make a striking observation: in 2009, an expected drop of GDP in

¹ Sabine Hermann & Adalbert Winkler, Real Convergence, Financial Markets, & the Current Account: Emerging Europe vs Emerging Asia – Occasional paper series, June 2008.

Europe of -3.7% compared to an expected growth in Asia of 3.3%². Furthermore emerging Asia is posting current account surpluses while Emerging Europe is facing deficits. And this is true for the great majority of the economies concerned in each of these two parts of the world. Explanation of this discrepancy may give some clues as to the future of the financial flows between emerging and industrialized countries.

² IMF World Economic Outlook – April 2009.

	Real GDP				Consumer Prices ¹				Current Account Balance ²			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Emerging Asia³	9.8	6.8	3.3	5.3	4.9	7.0	2.5	2.4	6.6	5.5	6.3	5.8
China	13.0	9.0	6.5	7.5	4.8	5.9	0.1	0.7	11.0	10.0	10.3	9.3
South Asia⁴	8.7	7.0	4.3	5.3	6.9	9.0	7.7	4.5	-1.4	-3.4	-2.6	-2.7
India	9.3	7.3	4.5	5.6	6.4	8.3	6.3	4.0	-1.0	-2.8	-2.5	-2.6
Pakistan	6.0	6.0	2.5	3.5	7.8	12.0	20.0	6.0	-4.8	-8.4	-5.9	-4.9
Bangladesh	6.3	5.6	5.0	5.4	9.1	8.4	6.4	6.1	1.1	0.9	0.9	-0.1
ASEAN-5	6.3	4.9	0.0	2.3	4.3	9.2	3.6	4.5	4.9	2.8	2.2	1.5
Indonesia	6.3	6.1	2.5	3.5	6.0	9.8	6.1	5.9	2.4	0.1	-0.4	-0.7
Thailand	4.9	2.6	-3.0	1.0	2.2	5.5	0.5	3.4	5.7	-0.1	0.6	0.2
Philippines	7.2	4.6	0.0	1.0	2.8	9.3	3.4	4.5	4.9	2.5	2.3	1.6
Malaysia	6.3	4.6	-3.5	1.3	2.0	5.4	0.9	2.5	15.4	17.4	12.9	10.7
Vietnam	8.5	6.2	3.3	4.0	8.3	23.1	6.0	5.0	-9.8	-9.4	-4.8	-4.2
Newly industrialized Asian economies	5.7	1.5	-5.6	0.8	2.2	4.5	0.4	2.0	5.7	4.4	6.3	6.1
Korea	5.1	2.2	-4.0	1.5	2.5	4.7	1.7	3.0	0.6	-0.7	2.9	3.0
Taiwan Province of China	5.7	0.1	-7.5	0.0	1.8	3.5	-2.0	1.0	8.6	6.4	9.7	10.7
Hong Kong SAR	6.4	2.5	-4.5	0.5	2.0	4.3	1.0	1.0	12.3	14.2	7.2	5.2
Singapore	7.8	1.1	-10.0	-0.1	2.1	6.5	0.0	1.1	23.5	14.8	13.1	11.2

IMF, *World Economic Outlook*, April 2009.

	Real GDP				Consumer Prices ¹				Current Account Balance ²			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Emerging Europe	5.4	2.9	-3.7	0.8	6.2	8.0	4.7	4.2	-7.7	-7.6	-3.9	-3.4
Turkey	4.7	1.1	-5.1	1.5	8.8	10.4	6.9	6.8	-5.8	-5.7	-1.2	-1.6
Excluding Turkey	5.9	4.1	-2.9	0.3	4.5	6.5	3.3	2.5	-9.0	-8.8	-5.6	-4.4
Baltics	8.7	-0.7	-10.6	-2.3	7.3	12.2	3.6	-1.0	-18.0	-11.6	-5.4	-5.4
Estonia	6.3	-3.6	-10.0	-1.0	6.6	10.4	0.8	-1.3	-18.1	-9.2	-6.5	-5.4
Latvia	10.0	-4.6	-12.0	-2.0	10.1	15.3	3.3	-3.5	-22.6	-13.2	-6.7	-5.5
Lithuania	8.9	3.0	-10.0	-3.0	5.8	11.1	5.1	0.6	-14.6	-11.6	-4.0	-5.3
Central Europe	5.4	3.8	-1.3	0.9	3.7	4.6	2.4	2.6	-5.2	-6.1	-4.3	-3.8
Hungary	1.1	0.6	-3.3	-0.4	7.9	6.1	3.8	2.8	-6.4	-7.8	-3.9	-3.4
Poland	6.7	4.8	-0.7	1.3	2.5	4.2	2.1	2.6	-4.7	-5.5	-4.5	-3.9
Southern and south-eastern Europe	6.1	6.1	-3.6	-0.2	5.1	8.4	4.9	3.2	-14.2	-13.8	-8.2	-5.5
Bulgaria	6.2	6.0	-2.0	-1.0	7.6	12.0	3.7	1.3	-25.1	-24.4	-12.3	-3.6
Croatia	5.5	2.4	-3.5	0.3	2.9	6.1	2.5	2.8	-7.6	-9.4	-6.5	-4.1
Romania	6.2	7.1	-4.1	0.0	4.8	7.8	5.9	3.9	-13.9	-12.6	-7.5	-6.5
<i>Memorandum</i>												
Slovak Republic	10.4	6.4	-2.1	1.9	1.9	3.9	1.7	2.3	-5.4	-6.3	-5.7	-5.0
Czech Republic	6.0	3.2	-3.5	0.1	2.9	6.3	1.0	1.6	-3.2	-3.1	-2.7	-3.0

IMF, *World Economic Outlook*, April 2009.

In order to explain this “*current account puzzle*”, the authors start from an insightful analytical monetary framework.

In emerging Asian economies, the **US dollar serves as the main anchor** upon which “*these countries keep their exchange rate in a fixed or quasi-fixed peg*”.

In emerging European economies, the Euro (due to close economic ties and high degrees of commercial and financial integration) when it is not already the currency in circulation plays **an increasing role as the nominal anchor**, either because that

currency is more or less pegged to the Euro, or for the floaters, because of the ever increasing stability of their currencies against the Euro³.

In the same way as we use the concept of a “**Dollar area**” for the US and emerging Asia (the Bretton Woods II hypothesis), we can speak of a “**Euro area**” for the Euro zone and countries of emerging Europe. These are two “*convergence clubs*” of “*periphery countries*” around “*core countries*”, respectively the US and the Euro zone.

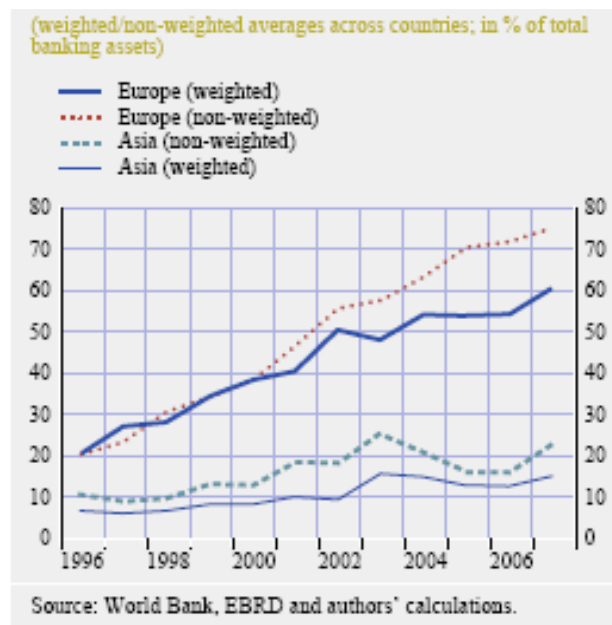
Why have countries in emerging Asia been running significant current account surpluses, whereas in emerging Europe they have been facing large current account deficits?

First explanation: impact of the external environment or of exogenous shocks. The 1997 financial crisis in Asia has been as **a trigger for a shift towards policies of “structural” surpluses** of current accounts, which appeared as the best weapons against currency crises and financial instability. On the other hand, **European integration improved the “quality”** of the financial sector in emerging Europe. **Enhanced confidence** which went with it led to economic growth driven, contrary to many Asian countries by domestic demand, mainly investments, partly financed by inflows of foreign savings.

Second explanation: **financial integration is much more pronounced in Europe than in Asia**. Over the last years, there has been a massive entry of core European countries banks into the emerging European banking sector. The share of their assets has been steadily growing.

³ The Euro share in foreign exchange reserves is much higher in emerging Europe than the (US) Dollar, as are the foreign currency loans and deposits denominated in Euros – György Szapáry, Euro area neighbouring countries, unpublished paper – to be published by the Peterson Institute “the Euro at Ten”.

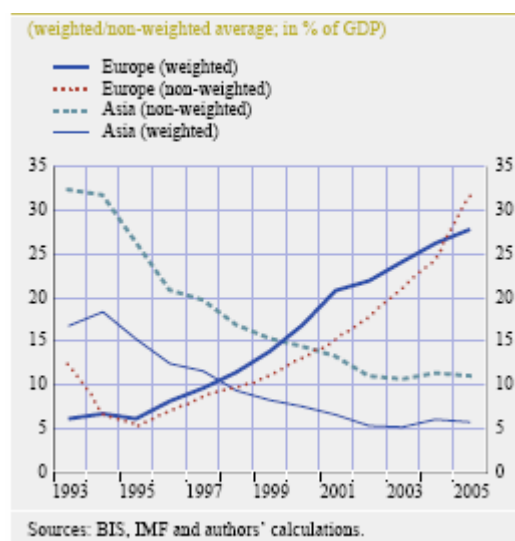
Foreign bank assets in emerging Europe/Asia – 1995-2006



Source: Sabine Herrmann and Adalbert Winkler, *Op. cit.*

Claims of foreign banks related to GDP have continuously **increased** in emerging Europe, while by contrast they have **decreased** in emerging Asia.

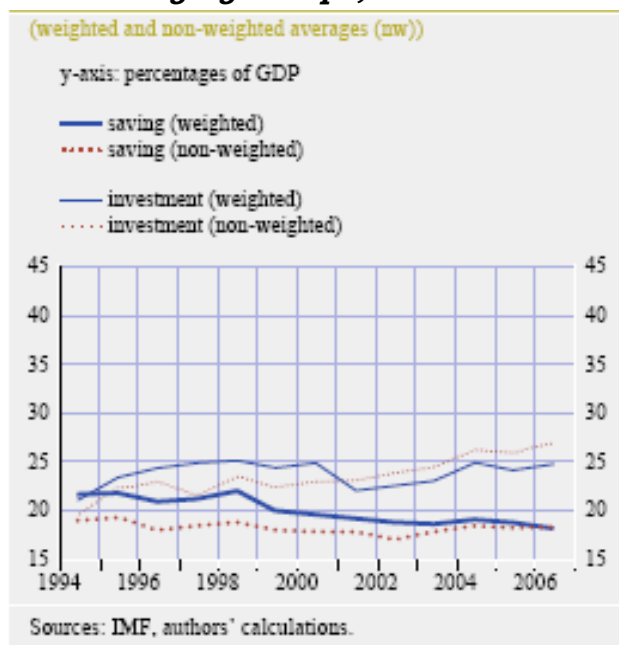
Consolidated euro area/US bank claims in emerging Europe/Asia (1993-2005)



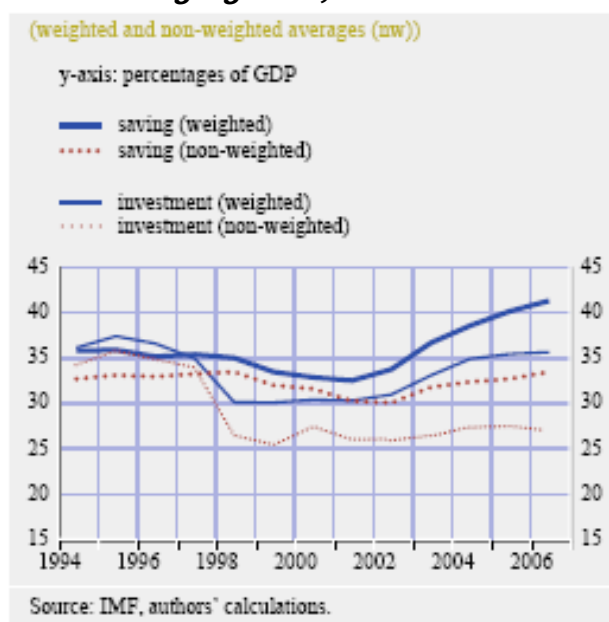
Source: Sabine Herrmann and Adalbert Winkler, *Op. cit.*

Emerging Europe's current account deficits are therefore associated with rising investment, while in Asia current account surplus was due to a decline in investment and a rise in saving (mainly in China).

Saving and Investment rates in emerging Europe, 1994-2006



Saving and Investment rates in Emerging Asia, 1994-2006



Source: Sabine Herrmann and Adalbert Winkler, *Op. cit.*

2. Prospective comments

In the post-crisis era, three factors at least may have a serious impact on these financial flows:

- 2.1) Improvement and development of the financial sectors in countries of emerging Asia may enhance the financial intermediation process inside these countries themselves financial markets abroad as much (mainly the US). Evolution already witnessed in emerging Europe is a good prefiguration of what might happen in emerging Asia.
- 2.2) It is dubious that the mechanism of the “pseudo-dollar area” with more or less pegged exchange rates to the dollar, will last long. With the “greenback” raising more and more interrogation about its long run value and the

accumulation of reserves which begin to be a source of concerns for more and more surplus countries, we may raise some doubts about the long run sustainability of this Bretton Woods II system.

- 2.3) China which is the main reserve accumulating country among emerging Asia is already shifting its aggregate demand from exports to domestic consumption and public expenditures. The trend towards more investment and less savings will jeopardize the outflow of capital going mainly to the US.

This analysis raises some fundamental questions concerning the financial flows that in the pre-crisis area helped finance industrialized countries, mainly the US. Because, even though the outflow coming from raw materials producing countries is not affected, the current flows which are managed by public institutions (foreign reserves or sovereign wealth funds) could well fade out in the future.

Industrial countries like the US which relied on these inflows of capital to finance their economies will have to find a new equilibrium. If, for example, China is reducing its current account surpluses, what will be the impact on the American economy? Do we have to expect a long run increase in the rate of savings in the US? If this were the case, would not it have an impact on the duration of the current crisis? Or taking into account the fact that American savings will have to finance a huge increase in public deficit and also the raising financing costs, do we have to expect a drop in the long run trend of the private investment rate, with a lasting impact on economic growth?

As for emerging countries, we might expect that their investment opportunities in industrialized countries will be affected? Will we observe more and more financial flows between emerging markets themselves?

I am aware that this prospective analysis raises many controversial macroeconomic questions at the world level about global imbalances, rates of economic growth, exchange rates and other political or socio-economic variables. This Paris conference for Long Term Value and Economic Stability is probably one of the best fora to study the evolution of these financial flows worldwide in this era of

globalization, and I should look forward for Caisse des Dépôts et Consignations and its Long Term Investment Club to take the lead in this regard.