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The rise of emerging countries : changes in the dynamics of world financial power

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The financial world is more and more integrated and capital movements between emerging and "advanced" countries have become huge.

What are the medium term consequences of such an integration ? To what extent has the world financial power already shifted from the industrialized to the emerging countries in current account surplus ?

I shall organize my remarks around three main themes :

1. the accumulation by emerging countries of spectacular current account surpluses over the last years has significantly contributed to major changes in the distribution of international reserves ;

2. the impact of these changes on world "financial power" are complex and should be carefully gauged ;

3. the international monetary system is far from being adapted to the present world financial conditions.

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I. The spectacular accumulation of current account surpluses in emerging countries :

1. The magnitude of the phenomenon :

The following table gives an idea of the major changes that have taken place over the last decade in the distribution of current account deficits and surpluses.

(in billion $)	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 (prév)
Adanced countries	**- 107.9**	**- 265.7**	**- 204.5**	**- 211.1**	**- 208.9**	**- 220.6**	**- 431.6**	**- 508.8**	**- 499.8**	**- 550.2**
Of which USA	- 299.8	- 417.4	- 384.7	- 459.6	- 522.1	- 640.2	- 759.9	- 811.5	- 784.3	- 788.3
Of which Japan	+ 114.5	+ 119.6	+ 87.7	+ 112,6	+ 136.2	+ 172.1	+ 165.7	+ 170.4	+ 195,9	+ 195.1
Emerging countries	**+ 37.8**	**+ 125,3**	**+ 88,9**	**+ 133,9**	**+ 226.3**	**+ 295.9**	**+ 518**	**+ 681.6**	**+ 684,2**	**+ 710.6**
Of which China	+ 21.1	+ 20.5	+ 17.4	+ 35.4	+ 45.8	+ 68.6	+ 160.8	+ 250	+ 380	+ 460

The sign – shows a current account deficit.
The sign + shows a current account surplus.
Sourrce : IMF.
To explain the residual world imbalamce, see IMF : World Economic Outlook, Oct. 2007.

These figures are of considerable economic importance : the US deficit in 2006 has reached 6.2 % of GDP (5.7 % estimated for 2007). As for the Chinese surplus, it has amounted to 9.4 % of GDP in 2006 (11.7 estimated in 2007).

These orders of magnitude represent record highs and reflect a paradoxical situation. Indeed, traditionally, the surpluses emanated from industrial countries which used to export their capital to developing countries. Today, we witness a reverse phenomenon : the emerging countries have become the creditors, if not of all the industrialized countries (indeed, the European Union is in balance, and Japan in surplus), but of the United States whose current account deficit is entirely financed by capital flows from emerging markets.

2. Emerging countries hold three quarters of world reserves :

The increases in emerging countries external reserves over the last decade (in great part, because of the succession of current surpluses) are spectacular :

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Increase in emerging countries reserves (in US Billion $)	98.1	137.6	122.6	195.4	359.7	509.2	595.3	754.2	1.085.3
Of which Asia	45.3	84.8	59.4	85.8	154.7	236	340.1	288.9	624
Of which Middle East	0.8	31.2	11	3.1	33.4	45.7	106.5	125.3	115.9
Of which CIS	- 6.6	7	- 1.9	- 1.6	33	22.3	32.4	48.6	113

Source : IMF – World Economic Outlook, october 2007

Thus, the total amount of reserves held by emerging countries exceeds 3 trillion dollars[1] (against less than 1 trillion in 2000) and amounts to 72 % of world reserves (against 59 % in 2000).

China holds today more than 1.4 trillion dollars and that figure increases by close to 40 billion monthly. This country has therefore become the first single investor of the world.

This is a profound change in the balance of international finance. The US is now a net debtor whilst countries like China hold a strong creditor position.

3. These changes provide, to a large extent, significant advantages to emerging countries :

[1] End 2006, world external reserves (in billion $) had the following distribution :

Industrialized countries (without Japan)	334	= 1.209	Total :
Japan	875		
China	1.066	= 3.142	= 4.351
Remaining Asia	1.151		
Middle-East	178		
Russia	295		
Latin America	271		
Central Europe	181		

Source : Annual Rapport - BIS – 2007.

- these massive reserves ensure a liquidity cushion that had lacked East Asia during the 1997 financial crisis ;
- in allowing for the repayment of debt, large reserves have loosened the external constraint which had limited the room for manoeuvre of many of these countries (and often forced them into “IMF conditionality”)[2] ;
- high reserves have strengthened financial market stability in emerging countries (their exchange rates had been very sensitive in the past to volatile capital flows when reserves were low) ;
- this greater financial stability explains, in part, -while the economies of industrialized countries and notably of the United States start slowing down- that emerging countries continue to enjoy high rates of growth. Indeed, emerging markets growth seems less dependant today on the economic cycle of industrialized countries than was the case seven or eight years ago. Indeed, the rise of middle classes and the high potential growth of domestic consumption in these countries make their economies less directly coupled to the external conjuncture. It remains however that a deep recession in the US would have significant consequences on emerging economies given the reduction in US imports that it would entail ;
- high reserves also provide emerging countries an instrument of power, and even of pressure, through the different modalities that govern the allocation of their surpluses (investment in US Treasury bonds or acquisition of different classes of assets on financial markets in advanced economies). I will come back to this later.

However, in spite of these benefits, the fact that these countries are immobilizing a large part of their savings in the form of reserves that yield a rather weak return, presents a relatively high opportunity cost. If they were to invest a significant part of their surpluses in their own economies which are experiencing high growth rates, that would be, in a longer perspective, advisable[3] and would, by definition, reduce current surpluses.

4. Reasons for this shift in current account positions :

They can be summarized as follows :
- the United States has, on the whole, pursued, over the last ten years or so an expansionary monetary policy which has resulted in low interest rates and has encouraged domestic consumption. Thus, domestic savings (especially household savings) have not ensured the financing of the investment needs of the country. This lack of savings (which is reflected in the US current account deficits) has required

[2] The short term debt/reserves ratio has evolved from 1994 as follows :

	1994	2007
Middle-East	2.8	0.4
Asia	1	0.2
Emerging Europe	1.8	0.5
Latin America	3.7	0.3

[3] Furthermore, sterilizing their interventions (buying foreign currencies by Central Banks), represents for these countries a significant potential cost.
More generally, one has calculated the “excess” of reserves held by Asian Central Banks by reference to more traditional holding norms (i.e. reserves covering four months of imports or 100 % of external debt maturing in less than a year). This “excess” of reserves would amount, for emerging Asia, to about 800 billion $ (i.e. an opportunity cost of 100 billion for 2006, equivalent of 1 % GDP). See : “New Power Brokers”, Mckinsey, Global Institute, October 2007.

financing by external capital flows. These flows have mainly come from Japan and emerging countries which, for their part, have experienced a surplus of savings ;

- but if emerging countries have been able to accumulate surpluses, it is also because they have improved significantly their own economic management. In fact, over the last years, a number of emerging countries have put some order in their public finances and also strengthened their banking systems while they were embarking on structural reforms aimed at increasing their productivity. These actions have borne their fruits : the chronic indebtedness of many of those countries has been considerably reduced as the result of primary budgetary surpluses. Furthermore, a growing evolution of some of these countries toward flexible exchange rates –especially in Latin America- has helped to avoid exchange rate crises which had so often hampered their economic growth ;
- however, a less favourable factor is related to exchange rate policies of other countries, notably in Asia (China and Japan, in particular). The exchange rates of these countries are, de facto, largely pegged to the dollar (the Yen until the summer of 2007 because of close to zero interest rates and the Yuan because of the authorities' policy to keep, through massive interventions, a competitive currency[4]). This undervaluation of some emerging currencies has obviously pushed their exports (and therefore their trade surpluses) whilst introducing a strong bias in the normal functioning of exchange rate markets ;
- lastly, the rise in energy prices (influenced in particular by the increase of Chinese demand) explains the enormous surpluses experienced by oil and gas producing countries. These countries -especially the OPEC- hold, even more than in the past, a position of strength in their relations with energy importing countries that are more and more dependant on energy imports.

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II. The impact of these changes on the global « financial power » :

A few observations can be highlighted.

1. The rapid economic growth of emerging countries leads to a significant "catching up process" :

As we know, emerging countries have been the main beneficiaries of globalization. With the opening of trade borders -in the framework of WTO-, these countries have been able to export on world markets more and more goods and services, thus taking advantage of their low wages.

This growth[5], mainly export-led, has strengthened the weight of these countries in the world economy.

[4] Evolution of the trade surplus of China since 1999.

In billion of US $	1999	2000	2001	2002	2003	2004	2005	2006	2007
	35.9	34.4	34	44.1	44.6	58.9	134.1	217.7	321

Source : Institute of International Finance

[5] On average, the annual growth of GDP of emerging countries since 2003 has reached 7.6 % (against to 2,6 % for the "advanced" countries, i.e. close to three times more).

Even if the GDP per capita levels of most of the emerging countries are still well behind those of advanced countries, their share in the global world GDP[6] has moved up to 48 % in 2007 (USA : 19.7 % ; European Union : 18 % ; Japan : 6.3 % ; China : 15.1 % ; India : 6.3 % ; Latin America : 7.6 %....).

It is estimated that if their present growth rates were to be sustained over a long period, China and India would represent in 2050 an economic power of the same order of magnitude (26.6 %) as that of the United States.[7]

2. However, the increase of reserves held by emerging countries does not give them total freedom of manoeuvre :

Indeed, emerging countries have only relatively limited options as for the way they invest their reserves. In order to ensure adequate liquidity of their external assets, they have to use the deepest and most secure international markets. But these markets -equity or debt- are those of the United States, Europe and Japan. This is all the more true that the financial markets of emerging countries are still relatively underdeveloped (although they have significantly strengthened over the last years).

Given the predominance of U.S. financial markets and the international role of the dollar as a reserve and transaction currency (65 % of world foreign reserves are held in dollars, against 24 % in euros although the share of the euro is gradually rising), it is not surprising that the bulk (around 70 %) of the reserves held by emerging states are denominated in dollars.

Therefore, it would not be in the interest of Central Banks in emerging markets to engage in an aggressive policy of reserve diversification. The amount of their assets in dollars (mostly invested in US treasury instruments[8]) is such that any precipitous action could only accelerate the fall of the US currency and lead to significant losses on their own assets.

In fact, until 2005, the Central Banks of emerging countries have not much diversified the composition of external assets.

But, since then, things have started to change.

3. A trend towards some diversification of external assets of emerging countries is manifest :

Given the opportunity cost suffered by emerging countries because of the excessive magnitude of their reserves, it is not surprising that these countries should wish to diversify their external assets in order to increase the returns they can earn on their portfolios. This move towards diversification was first achieved by the acquisition of long term US Treasury bonds and of corporate bonds. But this trend is also manifest in the decisions taken by certain states -and recently by China- to allocate a more significant part of their surpluses in equity, notably through "sovereign funds".

[6] Computed in terms of purchasing power parities. See : IMF, "World Economy Outlook", Oct. 2007.
[7] See : CEEPI : « Long term perspective of the world economy. Horizon 2050". The economic distribution of the world -between "North" and "South"- would then be more in line with what it was in the early XIXth century.
[8] With their 3 trillion reserves (of which two are invested in dollars), the Central Banks of emerging Asia hold one third of the total liabilities of the US Treasury

The creation of these sovereign funds goes back to the 60-70s with the institution of "oil funds" (Kuwait Investment Authority, Abu Dhabi Investment Authority, followed by Oman, Brunei, Iran, Russia…). Alongside these oil stabilisation funds, Singapore has created two funds destined to manage more actively the balance of payment surpluses of this country (TEMASEK Holdings in 1974, and the Government of Singapore Investment Corporation –GIC- in 1981). In 2003, China has established a fund for the recapitalization of its domestic banking system (Central Hujin Investment). After Korea in 2006, China has decided in 2007 to create an internationally oriented fund, the China Investment Corporation (CIC), endowed with an initial capital base of some 250 billion dollars financed by the foreign reserves of the Central Bank.

According to the most recent information, emerging Asian countries stand ready, over the next years, to increase by 480 billion their existing funds which already amount to some 1 trillion dollars[9]. These sovereign funds often invest through foreign private equity funds, but they tend more and more to invest directly in companies and could well establish their own equity funds. They are thus competing with the large "buy-out funds" of the West[10].

This rise of funds invested in stock markets or in direct acquisitions has started to raise concerns. Indeed, some industrialized countries are worried that an "active" management of emerging foreign reserves present some potential dangers. They are concerned, in particular, that foreign governments could use these funds to take controlling positions in strategic companies. They are fearful that such funds might be tempted to use their assets for "political" objectives (access to new technologies, competitive advantages…). They also observe that some emerging countries that are in the process of making significant acquisitions abroad, are still very restrictive when it comes to accepting foreign investments in some sectors of their economies.

Up to now, these funds have been, on the whole, managed professionally and have not led to such deviations. This is in particular the case of the GIC which has always been governed by long term investment criteria and has not led to controlling positions (open or disguised)[11].

Some developed countries, like the USA, have started to react by subjecting to control foreign investments of a "strategic" nature (Germany is about to adopt legislation that would oblige foreign investors to notify their projected acquisitions to the Ministry of Finance).

One can recall, in this vein, defensive reactions taken against certain projected take-overs launched by some emerging countries corporations (but not sovereign funds). For example, CNOOC of China was not allowed to acquire the US UNOCAL, and the take-over by the Ports of Dubai of the UK P&D led to significant difficulties in the United States.

But there is no doubt that such direct investment initiatives will intensify in the future.

It seems to me that one should, in this field, act with caution. The trend towards a gradual diversification of emerging countries assets is part of a normal process and is consistent with the open economy principles that underlie our international system. Besides, putting heavy-handed controls on funds which amount only to slightly more than 2 % of global financial

[9] See : « New Power Brokers », McKinsey (referred to above).
[10] See Financial Times Nov. 14, 2007 : « US buy-out reign under threat".
[11] The chairman of TEMASEK, in response to such concerns, has just stated that this fund would avoid investing in "iconic" companies overseas. See : Financial Times, November 24, 2007.

assets, could encourage protectionist forces and could also hamper capital mobility which is an essential factor of economic growth.

It would therefore be desirable, in order to avoid the dangers of protectionist actions, to agree on a “code of good conduct” for sovereign funds. Such a code -that could be facilitated by the IMF or the World Bank- would call for more transparency and for procedures that could reassure host-countries on the intentions, the functioning and the governance of those funds. In this regard, the long term, non controlling investment policy followed by GIC could be an example.

Furthermore, more openness to foreign investments by countries deploying sovereign funds would also be helpful.

4. Emerging countries, in spite of their current surpluses, still remain significant net importers of private capital from industrialized countries :

One of the paradoxes of the present situation is that, in spite of their current surpluses, emerging countries continue to import massive foreign capital in order to promote their own growth. They also export long term capital, in particular to Africa and Latin America, to ensure access to commodities. But, in net terms, emerging countries are heavy importers of foreign private capital.

Thus, although the current surpluses of a group of main emerging countries (not including the CIS) have reached 420 billion dollars in 2007[12] (the bulk coming from Asia), the net flows of capital towards these countries will have amounted to 620 billion[13], which helps to explain the high increase in reserves (756 billion) which they have registered during that year.

Out of these 620 billion of foreign capital imported in 2007 by this group of countries, 265 billion were in the form of direct and portfolio investment and 355 in the form of credits.

This shows, that in spite of the rise of their foreign reserves, the emerging countries -whose domestic financial markets are still relatively limited- are dependant on the “world financial system” and, in particular, on investments by large corporations and financial institutions of the “advanced” world.

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We are thus observing a shift in financial power towards emerging countries, but not a substitution of their financial engineering to that of the advanced countries. However, we have to be conscious that this competitive advantage of the West will tend to be reduced over the years, with the rise of local financial institutions of emerging countries (some Chinese banks have already become “giants” of world finance[14]).

[12] These figures have been computed by the Institute of International Finance : their definition of emerging markets is limited to some 30 countries, while the data on current account surpluses given above (table page 2) cover all emerging countries.
[13] See : Institute of International Finance (IIF) : « Capital flows to emerging markets », October 2007.
[14] The Industrial and Commercial Bank of China which had attracted 22 billion dollars of equity in its 2006 IPO, has stated that it intends acquiring 20 % of Standard Bank of South Africa for 5,5 billions dollars. This is an illustration of Chinese financial power and of its influence in Africa.

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III. What do these changes imply in terms of systemic challenges ?

I will make two remarks in this regard.

1. The huge acquisitions of financial assets by emerging Central Banks have contributed to low interest rates and to the expansion of liquidity over the past years :

A recent study[15] has shown that the acquisition of financial instruments by emerging countries have had a significant impact on the low interest in the United States. Two thirds of this impact comes from Asian Central Banks.

To the extent that these capital flows tend to reduce long term interest rates, this lessens the efficiency of monetary policy (or increases its expansionary nature) in industrialized countries.

This is one of the explanations of the famous "conundrum" of Western Central Banks of the last few years (why, in spite of a tightening of monetary policy, long term interest rates remain systematically low ?), as well as it has been an important factor behind the increase of liquidity. But we have to remember that the abundance of global liquidity has been at the source of the present turmoil in financial markets. Indeed, too much liquidity, therefore low interest rates, has enticed investors and financial institutions to look for higher yields through complex products to the detriment of a proper evaluation of the risks incurred. We know that this underevaluation of risks and the euphoria of very liquid markets have been at the root of the crisis. In a climate of excessive indebtedness and "easy money", the defaults observed over the last months on the US subprime mortgage markets have been the trigger of the investors loss of confidence and therefore of the credit crunch.

The influence of emerging countries monetary policies on the building of this situation should not be underestimated.

If one looks at the evolution of M2 over the last four years or so, one sees that this aggregate has grown fast in advanced countries (5.5 % per year in median terms), but that it has been explosive in emerging countries (between 15 and 20 % per year).

This increase of money aggregates and of credit can be explained by a number of reasons (among which the expansion of securitization which has increased the rotation of banks balance sheets). But, some of these factors are linked to the "transfer of financial power" that I have been analysing above :

- the pegging of their exchange rates to the dollar -and even more so to a declining dollar- has enhanced the export competitiveness of many emerging countries and has thus contributed to their trade surpluses ;

[15] « International capital flows and US interest rates », by Francis and Veronica Warnock, NBER Working Paper 12560-2006. In the hypothetic case where the acquisition by foreign states of US Treasury instruments were to fall to zero during one year, long-term interest rates in the United States would increase by 100 basic points (see : NBER-Digest, Nov. 2006).

- the asymmetric functioning of the floating exchange regime has concentrated the impact of the downwards adjustment of the dollar essentially on the euro zone which doesn't normally intervene on the exchange markets ;
- the difficulties encountered by emerging Central Banks in their efforts to sterilize monetary creation stemming from their interventions, have given an expansionary "bias" to their monetary policies (to which one can add the impact of the growing banking networks of these countries).

The current account surplus paradox has therefore not been neutral. It has had, and continues to have, serious consequences on the world. The weakness of the dollar, the artificial pegging of a number of currencies, excessive accumulation of foreign reserves, all converge to weaken the international monetary system and to amplify macroeconomic risks.

If the abundance of liquidity which has been, in part, the result of this evolution has not yet led to strong inflationary pressures, it is to a large extent, because of the low costs of emerging exports. But it must be noted that the high growth rates of these countries, coupled with the monetary effects of the undervaluation of some of their currencies, are starting to produce over-heating and bubbles[16]. One should take into account the increases in energy prices and, more recently, of food, that are directly linked to the explosion of demand in emerging countries. The increase in the price of commodities, if it were to continue, could end up seeping into consumer prices and therefore could tilt Central Banks policies to a more tightening mode, with the inevitable consequences that this would have on the world economy.

2. The second point is related to the functioning of the international monetary system :

As I have already underlined, developing countries are representing a growing share of the world economy and finance.

The international monetary system should therefore adjust to these new circumstances and to the "multipolar" character of the present world.

It is precisely in this context that we need strong multilateral institutions. No "great power" can nowadays impose its will on another large player. A new balance of power is developing. It is all the more apparent today if one takes into account the financial crisis in "advanced" markets, given that this turmoil has, for the first time, spared emerging markets and has contributed to instil doubts about the financial leadership of the West.

This situation calls for action.

Is it normal that some countries continue to intervene massively in order to maintain the undervaluation of their currencies, so as to foster their competitive advantage, while their trade surpluses have literally exploded over the last three years ? (see note 4 above)

Is it normal that "multilateral" surveillance of exchange rates, which is a fundamental statutory mission of the International Monetary Fund, is enforced in such a timid way ?

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[16] The « exuberance » of the Shanghai stock exchange explains that five Chinese corporations are now on the list of the ten largest world capitalisations (only three for the United States). On can mention, as an example, "Petro-China", listed in Shanghai and whose market capitalisation has reached about 1000 billion dollars (i.e. about twice as much as that of "Exxon Mobile").

Of course, one may state that a precondition for proper answers to these questions, is the restoration of the authority and credibility of the international monetary system and therefore an adaptation of the structure of the relevant multilateral institutions.

It is clear, in this regard, that the distribution of the IMF's capital among member-states - which is still in large part influenced by the post war situation- does not reflect the present structure of the world economy. The emerging countries -who amount to almost 50 % of the world GDP- hold only 40 % of the Fund's equity. It is therefore necessary to finalize a significant reform of the quotas. These reforms will have to be achieved, in great part, at the expense of European countries.[17]

As far as the world governing forum of the G7-G8 is concerned, it seems natural that it be extended to China, India and Brazil, as a number of observers are recommending.

But these institutional changes will not be sufficient by themselves. Political will must also be present. Will the United States, China and Japan -the three main sources of world financial imbalances- be ready to abide by multilateral rules and to take into account IMF recommendations ?

Up to now, the experience has been rather disappointing. But the world being more integrated, the stakes higher, and the "nuisance potential" more evenly distributed, isn't it time to engage in a meaningful monetary governance (not to speak of the necessity to fight, in a coordinated way, against pollution and climatic changes), and therefore to accept some domestic policy adjustments in order to preserve a sounder global balance ? This fundamental question is urgent because time lost today will be much more costly to catch up tomorrow.

If the answers to this question were to be negative, it is to fear that protectionism and systematic reciprocity would become the name of the game, to the detriment of economic growth, environment, international cooperation and world political stability.

[17] Europe holds 30 % of IMF votes and represents 20 % of world economy. China has voting rights comparable to those of the Netherlands.