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VOLATILITY OF CAPITAL FLOWS IN EMERGING EUROPEAN ECONOMIES: LESSONS FROM ASIA

UDK / UDC: 339.727.22(4)
JEL klasifikacija / JEL classification: F30, F32, F43, O16, P33
Pregledni rad / Review
Primljeno / Received: 31. prosinca 2012. / December 31, 2012
Prihvaćeno za tisak / Accepted for publishing: 10. lipnja 2013. / June 10, 2013

Abstract

Low interest rates in advanced economies contributed to massive private capital flows around the world in search of higher rates on investment in the final decades of the past century and the beginning of this one. Emerging market economies in Europe became an attractive destination for significant amounts of that capital, most notably foreign direct investment, given their political and economic reforms, including opening up and liberalization of their capital accounts. Closing the gap between domestic saving and investment in those countries the FDI received helped improve the growth performance of those economies. However, it also contributed to the formation of large current account deficits. The global financial and economic crisis of 2008-2009 changed the push factors in the advanced economies and the previously abundant capital flows to the emerging European economies slowed down significantly. That immediately affected the growth rates but the current account deficits remained large.

The aim of this paper is to investigate how the emerging European economies reacted to the sudden stop in international capital flows and what are the consequences. The inspiration is to look at the Asian economies that after their financial crisis of 1997-1998 emerged stronger

than before, running persistent current account surpluses and becoming major creditors in the world. The analysis is based on the IMF World and Regional Economic Outlook databases, the Eurostat, the Asian Development Bank sources and the National Banks' data in European countries.

Keywords: international capital flows, financial liberalization, emerging market economies, global imbalances

1. INTRODUCTION

One of the most salient features of the global economy in the past two decades has been the emergence of a group of low to middle income countries in Asia, Europe, and Latin America that comprise around 40 percent of world's population. With their high rates of growth they asserted themselves as players with an increasing role in the world market. Coupled with the rapid global trade and financial integration since mid-1980s, the emerging markets' share in the world's gross domestic product (GDP) has risen steadily from just about 17 percent in the 1960s to close to 40 percent in 2009. Their contribution to world output growth rose from 30 percent in the 1973-1985 to 47 percent in 1986-2007. For comparison, the advanced economies' share in the world output growth in the observed periods fell from 60 to 49 percent (IMF, 2010). To a large extent it was the emerging markets' growth, particularly in Asia, that led the world out of the global recession in 2008-2009. This has caused a shift in economic power in the world economy.

Emerging economies in Europe and those in Asia share a lot of common characteristics. In addition to prospects for high growth it is their market dynamism due to economic and political reforms or transition to a market economy, higher risks and returns than advanced economies, and usually high volatility. The similarities were greater before the Asian financial crisis in 1997-1998, when Asian emerging economies ran current account deficits, had insufficiently developed domestic financial systems, and experienced massive capital inflows with a pronounced short term component. The European emerging economies displayed similar characteristics before they were hit by a different crisis, the one in 2008-2009. However, the crisis proved devastating for most of the European emerging economies because, unlike their Asian counterparts, they were not in the position to deal with the consequences of the built up large external vulnerabilities that exploded with the sudden stop in capital inflows. Growth in Asian emerging economies, however, resumed shortly after the financial crisis 1997-1998 and intensified later on. The global financial crisis 2008-2009 caused the Asian emerging market economies' growth to slow down only a little bit. The emerging European economies displayed high growth rates before the crisis 2008-2009 but the recovery from the deep recession the crisis caused is very slow and uneven.

The aim of this paper is to compare the two groups of emerging market economies and learn what lessons the European emerging economies can draw in terms of policy choices and structural changes that were responsible for the Asian emerging economies' quick and impressive recovery from the financial crisis in 1997-1998 as well as how that translates into their remarkable resilience to the detrimental effects of the latest global financial crisis in 2008-2009 and potential recovery in 2010. Our focus rests mainly on the smaller Asian emerging market economies that are comparable in size and to some extent structure to the European emerging economies. However, we included also China that, due to its size, is almost as much of an outlier in Asia as Poland is in Europe. Consequently, in the first group of countries that we call Asia 6 we look at China, Indonesia, Malaysia, Korea, Philippines and Thailand. The second group we call Europe 11 and it is made up of the 10 latest members of the European Union (namely, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, Slovenia, and Romania and Croatia (since it will become a member on July 1, 2013).

The paper consists of four parts. In the first part we document the pre-crises similarities between the two groups of countries as well as their differences. The second part elaborates on the Asian financial crisis, the reactions of the Asian emerging economies, and their results. Part three describes the conditions in Europe and the reactions and results of the European emerging economies. The fourth and concluding section summarizes the lessons that could be learned from the Asian experience and actions that could help the European emerging economies lead themselves out of the current recession and embark again on the high rates of growth for which they have the potential.

2. PRE-CRISIS EMERGING MARKET ECONOMIES IN ASIA AND EUROPE: SIMILARITIES AND DIFFERENCES

In early 1990s Asian emerging economies were undergoing a transition to market economies much like the European emerging economies after the fall of the Berlin Wall in 1989. In both groups restructuring and reforms were happening against the backdrop of a not yet well developed, mostly bank-centric financial system. Also, emerging market economies on both continents developed similar characteristics right before „their“ crisis hit them, only about ten years apart, such as experiencing rapid growth, large capital inflows, current account deficits, rising external and internal debt, inflexible exchange rate regimes.

Rates of real GDP growth are shown in Chart 1. While growth rates in Asia have gone unsurpassed, the European emerging economies experienced first a transitional recession at the onset of economic and political reforms in early 1990s reflecting major reallocation of resources and restructuring.

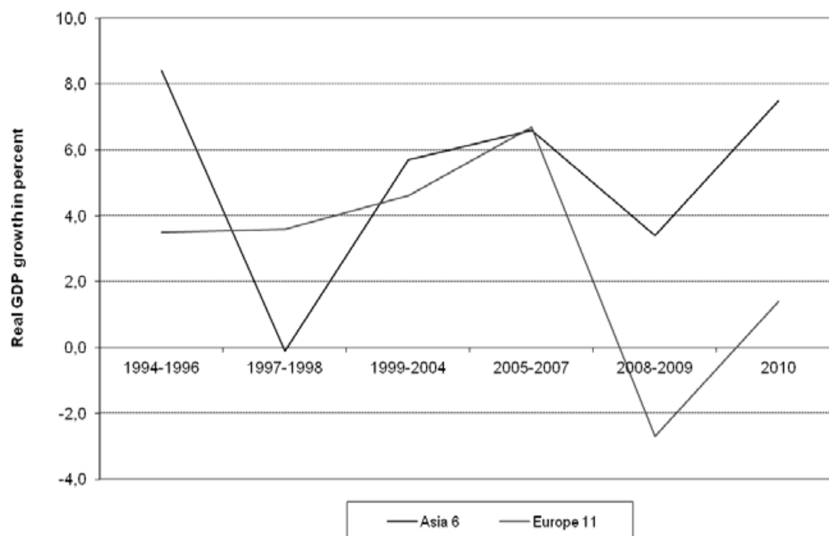

Chart 1 Real GDP Growth Rates in Asia 6 and Europe 11 (period average)

Source: IMF-IFS, March 2012

Even during the worst of the Asian financial crisis, growth in the Asian emerging economies did not fall drastically. It also rebound very quickly and once the crisis was over it took off at an impressive scale again. Growth in the European emerging economies did not show such elasticity. Rates of GDP growth were not as high as the Asian ones even during the best of times and once they plunged during the global financial crisis, they either remained low or are still in the negative territory. An especially dramatic example and exception is Latvia whose growth rate before the crisis 2008-09 soared to more than 10 percent only to plunge down to -10.5 percent when the crisis hit.

As is shown in Chart 2, both groups of countries in the pre-crisis periods also ran current account deficits, some quite pronounced such as in Thailand and Malaysia, -7.1 percent of GDP. Korea, and the Philippines had a somewhat lower current account deficits of -2.1 and -3.5 percent of GDP respectively. The picture was not homogeneous, however. For instance, Singapore ran record current account surpluses of 15.4 percent of GDP in the year preceding the crisis and the first year of the Asian financial crisis.

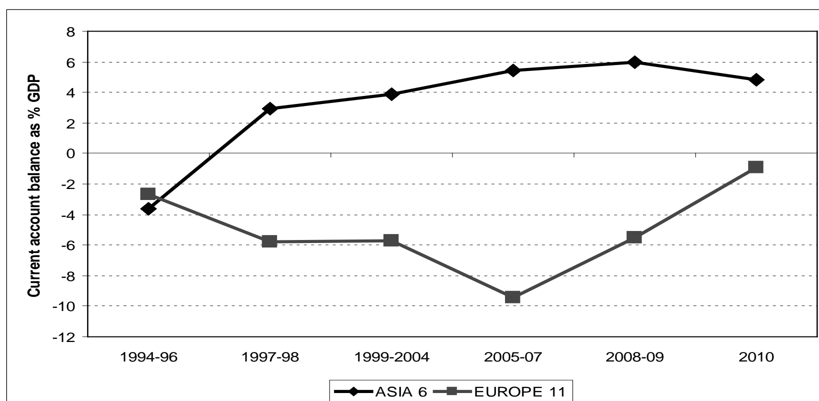

Chart 2 Current Account Balances in Asia 6 and Europe 11 (period average, as % of GDP) 1994-2010

Source: IMF-WEO, April 2012

In Europe the average current account deficits in the pre-crisis periods were -9.4 percent of GDP with the Baltic states and Bulgaria and Romania running exceptionally high ones like -19.2 in Latvia or -18.2 in Bulgaria.

Rates of investment to GDP prior to 1997 were big, at least 1/3 of GDP, and in some countries like China, Korea, and Malaysia even higher. In Europe prior to 2008 they were a little lower but also in the 1/3 of GDP range, and especially high in Estonia, Latvia, and Bulgaria. Chart 3 shows total investment in Asia 6 and Europe 11.

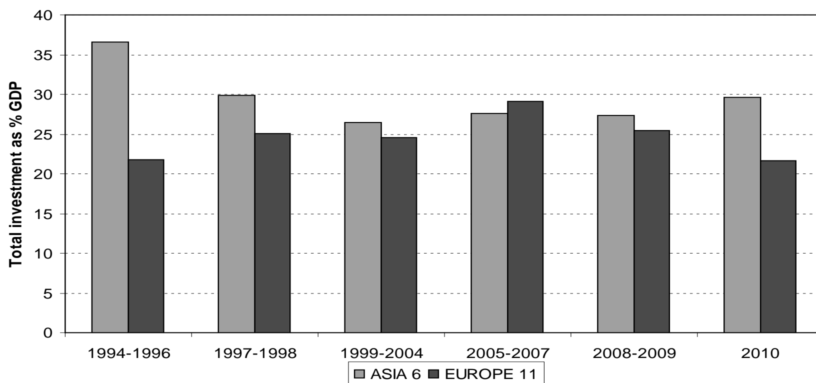

Chart 3 Total Investment in Asia 6 and Europe 11 (as % of GDP) 1994-2010

Source: IMF-WEO, April 2012

Domestic savings to GDP were almost twice as high in Asia than in Europe in their pre-crisis periods. They ranged from 41.5 percent GDP in China to 26.0 percent in the Philippines. European rates of domestic savings to GDP averaged at 29.1 percent (Chart 4).

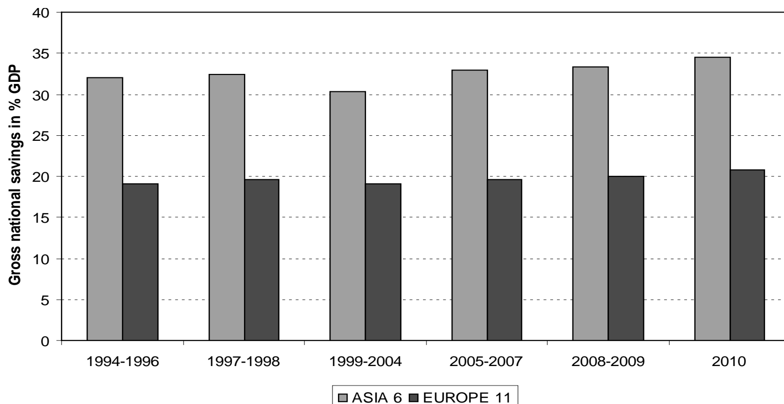

Chart 4 Gross National Savings in Asia 6 and Europe 11 (as % of GDP) 1994-2010
Source: IMF-WEO, April 2012

In the early 1990s both push and pull factors activated a large volume of capital flows to emerging markets in both regions. Low interest rates and returns in advanced economies on one hand and strong growth prospects with growing degree of financial openness and profitability of firms in emerging markets generated massive cross-border capital inflows into both regions. Capital inflows to emerging market economies of Asia and Europe are shown in Chart 5.

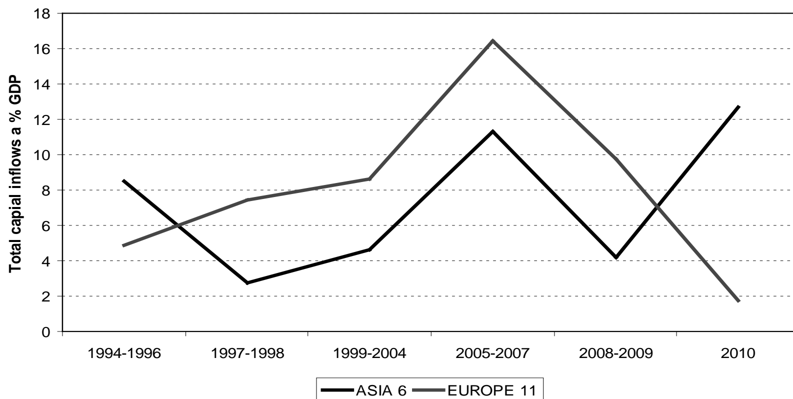

Chart 5. Total Capital Inflows in Asia 6 and Europe 11 (as % of GDP) 1994-2010
** missing data for Slovenia 1994, Slovak Republic 2001 and some categories for Malaysia 2010, replaced by zeroes during calculation of period averages*
Source: IMF-IFS & IMF-WEO, April 2012

The composition of capital inflows expressed as percent of GDP in pre-crises periods in both regions reveals the nature of the external vulnerabilities that developed over time. The following three tables illustrate the shares of foreign direct investment, portfolio, and other investments in the total capital inflows to both regions.

Table 1.

FDI Inflows in Asia 6 and Europe 11 (as % of GDP) 1994-2010

	1994-1996	**1997-1998**	**1999-2004**	**2005-2007**	**2008-2009**	**2010**
ASIA 6	**3,7**	**4,7**	**3,7**	**5,9**	**5,2**	**5,8**
China	11,8	10,3	8,7	14,1	12,8	14,0
Indonesia	2,0	1,0	-0,9	2,0	1,4	1,9
Korea	0,3	1,0	1,1	0,4	0,3	0,0
Malaysia	5,1	4,0	3,1	3,8	2,0	3,9
Philippines	1,9	2,3	1,3	2,0	1,0	0,9
Thailand	1,2	4,6	3,7	4,6	2,5	3,0
EUROPE 11	**2,7**	**4,1**	**4,8**	**8,5**	**5,8**	**-1,3**
Bulgaria	1,0	4,4	7,7	23,2	13,2	4,9
Croatia	1,1	3,5	5,3	6,4	6,9	0,7
Czech Republic	3,3	4,0	7,5	6,2	2,2	3,4
Estonia	5,8	7,8	7,0	14,7	8,6	8,1
Hungary	6,8	7,9	5,3	25,4	25,1	-32,9
Latvia	5,2	6,8	3,6	7,0	2,2	1,5
Lithuania	1,4	5,9	3,5	5,1	2,1	2,0
Poland	2,4	3,4	3,7	4,9	2,9	1,9
Romania	1,0	4,1	3,8	7,2	4,9	1,8
Slovak Republic*	1,5	1,7	6,2	5,7	1,7	0,6
Slovenia	0,7	1,3	2,4	2,1	1,1	0,8

** missing data for Slovak Republic 2001, replaced by zeroes during calculation of period averages*

Source: IMF-IFS & IMF-WEO, April 2012

As data in Table 1 show, the FDI inflows in both regions were significant at all times. In Asia they did not falter even during the crisis. In fact, they even grew and slowed down by only a little bit in the year immediately after the crisis. In Europe, however, the drop in FDI the year following the crisis was highly noticeable.

Table 2.

Portfolio Investment Inflows in Asia 6 and Europe 11 (as % of GDP) 1994-2010

	1994-1996	1997-1998	1999-2004	2005-2007	2008-2009	2010
ASIA 6	**2,0**	**0,8**	**1,2**	**2,4**	**0,9**	**2,8**
China	0,7	1,0	0,9	3,0	1,7	2,4
Indonesia	2,1	-1,6	0,1	1,9	1,3	2,2
Korea	2,8	1,4	2,3	1,8	1,5	4,1
Malaysia*	-1,0	0,1	0,5	2,1	-3,2	0,0
Philippines	3,3	0,1	1,5	3,7	-0,7	4,9
Thailand	2,1	1,7	0,0	2,6	0,0	2,7
EUROPE 11	**1,1**	**1,2**	**1,8**	**1,6**	**1,1**	**3,5**
Bulgaria	-0,6	0,3	1,5	1,3	-0,6	-0,2
Croatia	0,9	1,4	2,7	0,2	0,8	1,5
Czech Republic	2,1	1,9	1,7	0,8	1,4	3,7
Estonia	1,6	4,2	4,2	-3,1	-4,2	-1,0
Hungary	3,3	1,0	3,4	4,5	-1,3	0,4
Latvia	0,1	-0,1	1,4	0,7	0,2	-0,1
Lithuania	0,7	0,7	2,4	2,1	2,8	6,7
Poland	0,3	0,9	1,7	1,8	1,4	5,7
Romania	0,2	0,9	0,2	0,6	0,2	1,1
Slovak Republic*	0,8	2,1	2,1	1,0	1,8	2,1
Slovenia*	1,0	0,9	0,6	1,8	7,4	6,7

** missing data for Slovenia 1994, Slovak Republic 2001 and some categories for Malaysia 2010, replaced by zeroes during calculation of period averages*
Source: IMF-IFS & IMF-WEO, April 2012

Portfolio investments, both debt and equity (Table 2), didn't show great oscillations or dramatic change in both regions, other than would be expected in the pre- and post-crisis times. However, „other“ investments (Table 3) that contain the element of short-term debt show an increase in Asia shortly before its crisis in 1997. They also rose significantly in Europe in their pre-crisis period.

Table 3.

Other Investment Inflows in Asia 6 and Europe 11 (as % of GDP) 1994-2010

	1994-1996	1997-1998	1999-2004	2005-2007	2008-2009	2010
ASIA 6	**2,9**	**-2,6**	**-0,3**	**3,3**	**0,4**	**5,5**
China	0,5	0,5	1,7	6,0	1,7	14,2
Indonesia	0,1	-4,5	-1,5	-0,6	0,7	0,6
Korea	3,7	-3,1	-0,3	3,5	-0,5	-0,5
Malaysia*	0,4	1,1	0,6	-1,4	-0,9	0,0
Philippines	5,2	1,4	-0,8	0,8	-1,8	2,5
Thailand	8,3	-14,0	-6,5	1,5	-0,5	5,1
EUROPE 11	**1,1**	**2,2**	**2,3**	**6,9**	**4,0**	**0,6**
Bulgaria	-3,6	-1,5	3,1	12,5	9,6	-3,1
Croatia	2,3	5,7	6,3	8,2	6,8	0,0
Czech Republic	9,4	2,6	0,8	2,8	1,3	0,6
Estonia	5,0	8,4	5,2	20,5	1,3	-7,1
Hungary	-1,7	0,6	3,4	8,4	10,5	-0,8
Latvia	10,1	7,5	11,9	29,8	0,7	0,9
Lithuania	7,2	6,2	3,1	13,2	-0,5	-8,0
Poland	-3,4	1,4	1,0	3,2	3,5	2,8
Romania	2,3	0,6	3,5	9,3	2,9	1,0
Slovak Republic*	5,3	7,5	-0,2	4,8	7,2	1,4
Slovenia	1,8	1,7	4,9	17,0	-1,8	-7,5

** missing data for Slovak Republic 2001 and some categories for Malaysia 2010, replaced by zeroes during calculation of period averages*

Source: IMF-IFS & IMF-WEO, April 2012

The dominance of short-term credit in the Asian economies generated pressures on domestic financial system that they could not sustain without a major realignment whereas the painful dependence on foreign equity flows to finance their growth destabilized the European emerging economies when those funds stopped flowing in.

Consequently, both groups of countries were in fundamental ways vulnerable to a sudden stop and/or reversal of the capital flows that inevitably accompanied „their" crises. For the Asian economies that happened in 1997 and for the European economies it came in 2008.

3. THE ASIAN FINANCIAL CRISIS

The early warning signs of a crisis about to happen in Asian economies did not show in their textbook form. Current account deficits were present but not glaring. Also, most budgets in the region were either balanced or nearly balanced. There was slow inflation and manageable government debt. Before the Asian financial crisis a lot of attention was paid to the government external finances as a possible source of instability while private debt stocks were for most part neglected. However, given the large amonts of private capital flows that got generated in the 1980s the significance of that aspect of international finance increased hugely.

The pegged exchange rates coupled with heavy inflows of foreign capital produced inevitable tensions as the open economy trilemma would suggest (Obstfeld and Taylor, 1998). The exchange rate regimes differed some across the region. For instance, Indonesia and Korea had more flexible (crawling) pegs than Malaysia and Thailand (Eichengreen – Leblang, 2002). But there was not enough exchange rate flexibility for them to prepare the economies to the changing environment.

Massive capital inflows raised the general level of liquidity by creating large lending booms that, in turn, led to high corporate debt-to-equity ratios. As Table 4 shows, in Thailand debt-to-equity ratio was a high 236 percent while in Korea it was even higher and measured 355 percent. In 1997 those numbers climbed even higher. Clearly, those ratios were unsustainable.

Table 4.

Selected Indicators of Corporate Financing* in Asia 6 in 1996

	Debt-to-Equity Ratio	Ratio of short-term to Total Debt
ASIA 6	**1,97**	**0,58**
China & Hong Kong	1,56	0,60
Indonesia	1,88	0,54
Korea	3,55	0,57
Malaysia	1,18	0,64
Philippines	1,29	0,48
Thailand	2,36	0,63

Note: Data are derived from a sample of 5,550 Asian firms.

Source: Claessens, Djankov & and Lang (1998)

In the Asian economies prior to its crisis private banks and non-financial companies borrowed large amounts from foreign banks, predominantly in US dollars, and their governments implicitly guaranteed those loans thus turning private debt stocks into public liabilities. At the same time domestic banks were lending to domestic companies in local currencies. Consequently, liabilities were denominated in US dollars and assets mostly in domestic currency. This created great mismatches in the currency denomination of external and internal debt.

Moreover, in the first half of 1997 capital flows did not slow down but increasingly took the form of short-term interbank loans. Consequently, liabilities were predominantly short-term and assets for most part were long-term or illiquid. This added significant maturity mismatches to the external and internal debt in an environment where the exchange rates were pegged to the US dollar.

As Chart 6 indicates, rising short-term indebtedness led to worsening ratios of short-term debt to central bank reserves. In 1996 this ratio was 162 percent in Indonesia and in 1997 it was 194 percent in Korea.

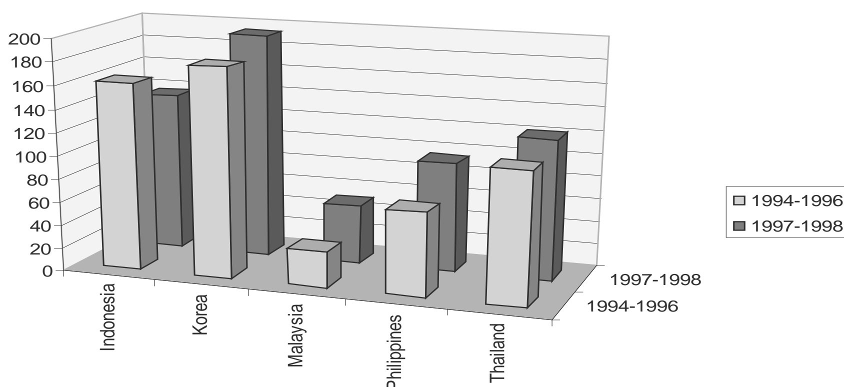

Chart 6. Short-term debt in Asia 6 and Europe 11 as percent of total reserves in 1994-2010

Source: World DataBank (online), TradingEconomics.com (online), ADB-SDBS Online (for Korea) and Croatian National Bank Bulletin

Such unfavorable ratios were clear indicators of the dramatic state of their external foreign currency liquidity. These developments were evidence that trying to provide domestic liquidity while defending a currency peg is bound to lead to loss of reserves. Moreover, the dynamic of capital flows in the region changed considerably resulting in net capital outflows of around 12 percent of the combined GDPs of Indonesia, Korea, Malaysia, Philippines, and Thailand (Asian Development Outlook, 1999).

The crisis was set off by speculative attacks on the Thailand's bakht in 1997 and quickly spread to other Asian emerging economies, whose currencies also collapsed. Only Hong Kong and China managed to protect their currencies by intervening directly in the stock market (Hong Kong) or by immediately imposing capital controls (China). The result of the asset values having declined seriously relative to liabilities, coupled with the disappearance of foreign credit which followed immediately, caused the non-performing loan ratios to increase dramatically and most banks had to be recapitalized by their governments. That led to big government deficits and the need for the IMF involvement.

The IMF hands-on involvement was based on the assumptions that reckless monetary and fiscal expansion together with structural weaknesses in corporate governance and the financial system were at the core of the Asian financial crisis. The IMF sponsored reforms called for tight monetary policy with high interest rates to restore investors' confidence, stop capital outflows, and stabilize the currencies. Tighter fiscal policies recommended by the IMF had the goal to facilitate current account adjustments and create funds necessary to recapitalize the insolvent banks. Both sets of reforms met with a great deal of

criticism and not all countries followed strictly all recommendations. Structural reforms were aimed at correcting domestic weaknesses in the crisis affected countries. They involved a number of measures designed to contract, consolidate, and restructure affected financial systems, particularly banking. Insolvent financial institutions were suspended or closed, which in some cases like Indonesia caused public panic. Reforming domestic financial systems and equipping them with adequate prudential regulation and supervision was an imperative in bringing the Asian economies back up on their feet. Also, there is clear tendency in the region towards greater exchange rate flexibility although the diversity in the exchange rate regimes persists.

Growth rates in the Asian emerging economies are high again, higher than anywhere in the world, in spite of the recent global financial crisis of 2008-09. Their investment-driven and export-oriented growth policy was successful in the aftermath of their financial crisis to a large extent because the environment on the world market was such that it could absorb their exports. With the global financial crisis of 2008-09 and the recession that ensued, the world export markets shrunk. That lowered the exports of Asian economies thereby slowing down their growth to some extent and creating the need to rethink growth strategies in smaller Asian emerging economies as well as in such large ones as China and India. The new situation on the world market is also negatively affecting the European emerging economies that are still struggling with the consequences of the recent crisis.

4. REFLECTIONS OF THE GLOBAL FINANCIAL CRISIS ON THE EUROPEAN EMERGING ECONOMIES

As was shown in Charts 1-5 both Asian and European emerging economies shared some general macroeconomic characteristics in their pre-crisis periods. Both groups of countries experienced high GDP growth rates, current account deficits, pegged exchange rates, and massive private foreign capital inflows. However, the ways in which foreign capital entered both regions was different and that determined its impact on those economies. In European emerging economies the volatility of capital flows proved more important for the sustainability of economic growth mainly due to its composition.

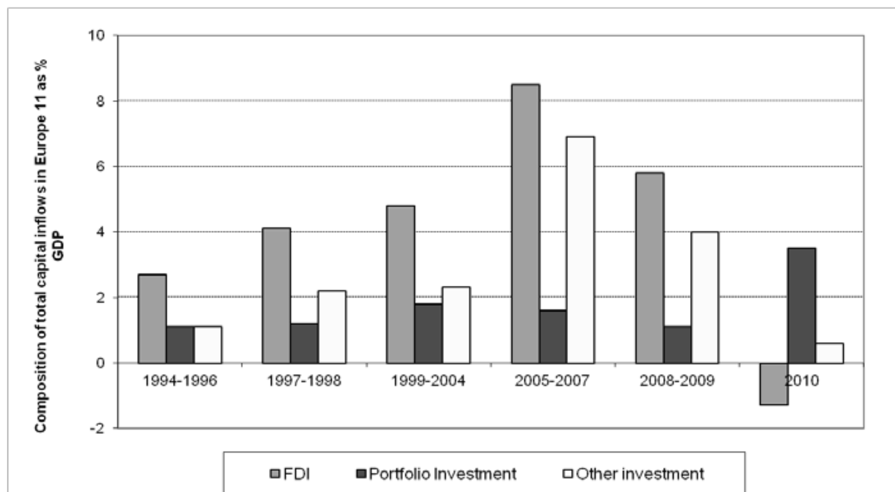

Chart 7. Composition of total capital inflows in Europe 11 in 1994-2010 as % GDP

Source: IMF, *International Financial Statistics* and *World Economic Outlook,* April 2012

Capital flows to the European emerging economies played a significant role in financing their growth as was reflected in its maturity structure (Chart 7). Because of the non-existing financial markets during the first years of their transition to a market economy, foreign capital entered those economies largely through mergers and acquisitions or taking other forms of foreign direct investment. Equity flows were more prominent than debt flows although banks there also borrowed short-term on international capital markets. In the absence of impressive domestic savings in emerging European economies, foreign savings made up a big part of the gross fixed capital formation in those countries creating significant dependence on external financing (Chart 8).

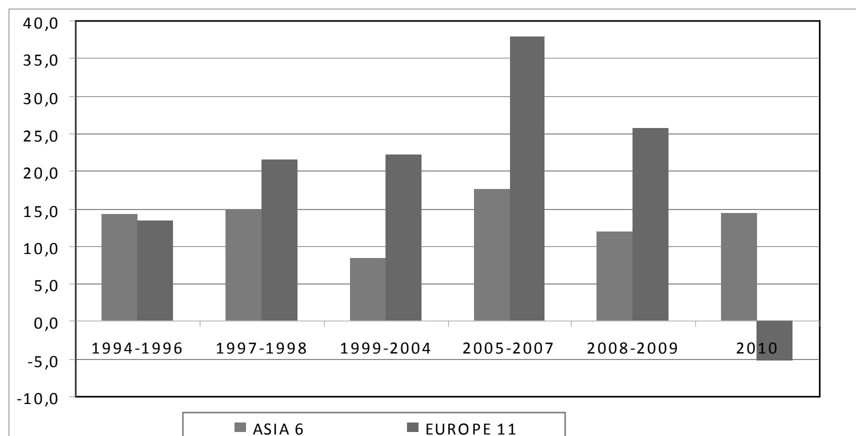

Chart 8. Share of FDI in Gross Fixed Capital Formation in % in Asia 6 and Europe 11

Source: own calculation based on IMF-IFS & IMF-WEO, April 2012

In the years before global crisis, namely 2001-2007 growth dynamics between individual European emerging market economies was uneven. For instance, the highest growth recorded in the 2001-2007 period in Estonia, Latvia and Lithuania was dramatically reversed in opposite direction in 2008 and 2009: those countries recorded the largest negative GDP growth comparing to the rest of observed countries, varying from -6 % (Lithuania) to - 10,5% (Latvia). Other countries recorded a moderate fall in GDP, while Bulgaria, Poland, Romania, and the Slovak Republic continued with slow but positive growth. Over the period 2001-2007 the European emerging economies grew at an average rate of 7 percent.

With the collapse of the Lehman Brothers in 2008, the economic growth in overheated emerging European market economies dropped significantly. However, as Chart 9 shows, not all countries showed the same sensitivity: some countries reacted more strongly, for instance the Baltic states, and others, like Poland, had to endure more modest hardships. In 2009, Hungary's output dropped 6,7 percent. In Slovenia the drop was 8,1 while in Romania it was 7,1 percent. The countries experiencing the largest decline were the Baltic states. The leader in output loss was Latvia with an 18 percent decline followed by Lithuania and Estonia with 14,7 and 13,9 percent decline respectively. The only country that experienced no negative growth in spite of the financial crisis was Poland. In 2009 its output dropped by modest 2 percent.

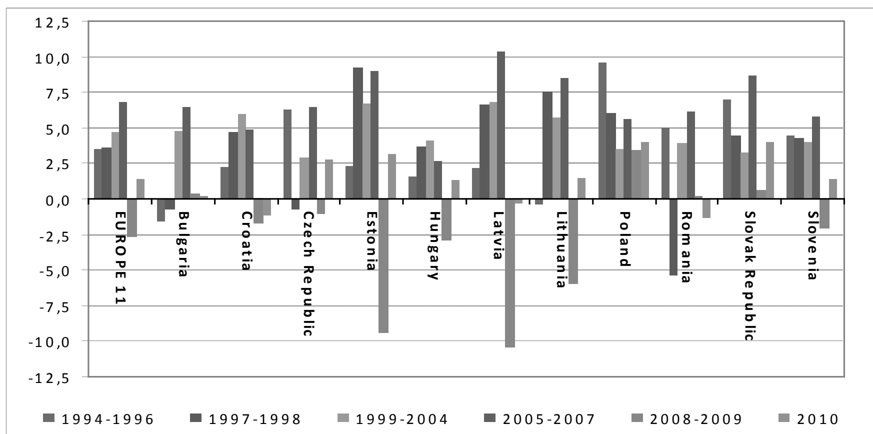

Chart 9. Real growth of GDP in Europe 11 in 1994-2010 (period averages)

Source: IMF - IFS database

Even the EU growth rates slipped into the negative territory by 2 percent. China's growth slowed down by less than 2 percent and continued in an almost two digit positive territory. During their financial crisis, the AEEs lost on average almost 8 percent of their output but their recovery was "V" shaped, rapid and sustained.

Due to the global financial crisis in 2008 and 2009 the share of investment in GDP in many European emerging economies declined. The majority of key foreign investors postponed or cancelled planned investments in the EEE area. Government investment also declined due to the need to reduce huge budget deficits in those countries. That, in turn, increased gross external debt.

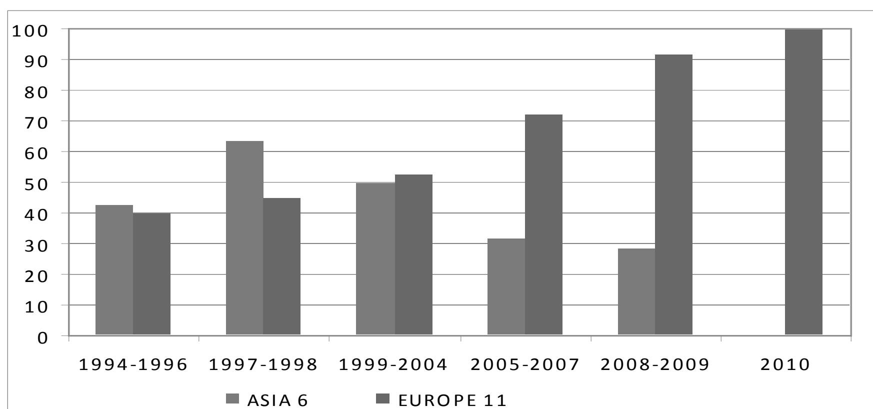

Chart 10. Gross External debt (in % GDP) in EEE 2000-2009

Source: WIIW Handbook on Statistics, CNB for Croatia, Trading Economics.com for China

As Chart 10 shows, in spite of the case of negative GDP growth in 2008 and 2009 in the majority of EEE, external borrowing continued. Since its rate was higher than GDP growth rate, that resulted in increasing the share of external debt in GDP and, consequently, in worsening of the sovereign rating grade.

The average share of household consumption in EEE countries and Croatia was quite high comparing with China and other Asian emerging economies. In majority of cases household consumption was the main driver of GDP growth of EEE countries and Croatia, what is consequently reflected in high current account deficits and external debt of those countries (Chart 11).

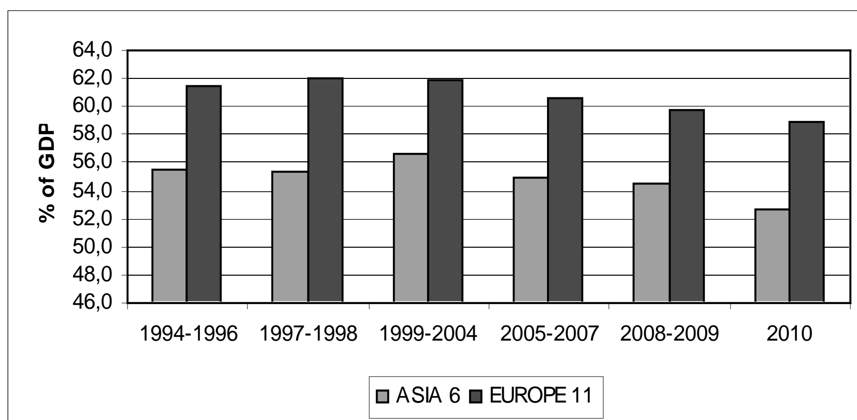

Chart 11. Household Consumption Expenditure (in % of GDP)

Source: IMF-IFS, March 2012

The natural response of most EEEs was a reduction in the household consumption component of the GDP. The share of government consumption in GDP fell somewhat in Bulgaria but in the majority of EEE government consumption share rose reflecting the lack of commitment of governments to implement serious cuts on the expenditure side of the state budget in the face of a GDP decline (Chart 12). Many governments in EEE, where the GDP growth was consumption driven in 2001-2007 period, have tried to maintain the consumption component as a source of growth even during the recession.

In the same period 2001-2009 household consumption in China was relatively modest at around one third of GDP, which is noticeably lower than in the European emerging economies while its government consumption, although lower, did not differ much (Chart 12).

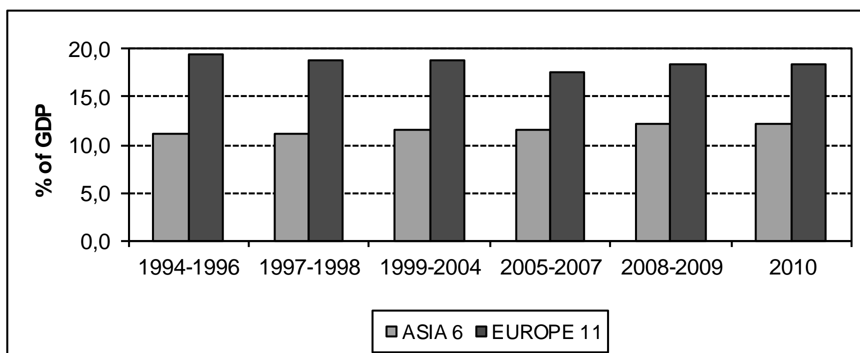

Chart 12. Government Consumption Expenditure (in % of GDP)

Source: IMF-IFS, March 2012

With the investment contributing to about one half of China's growth, it can be said that its growth strategy has been largely investment-driven.

The global financial crisis brought about needed current account adjustments for some European emerging economies even though they happened for the „wrong reasons“, namely through a reduction of imports due to the reduced purchasing power of citizens and the postponement of huge infrastructure projects based on imported intermediate and investment goods. A rising unemployment and interest rates on loans caused additional fall in imports.

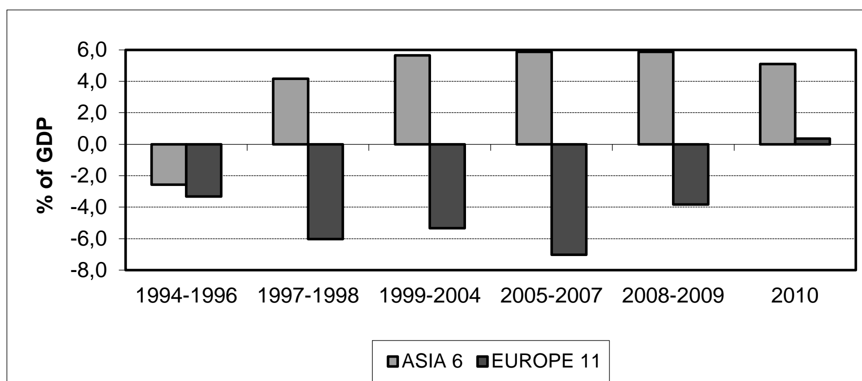

Chart 13. Net exports of goods and services (in % of GDP)

Source: IMF-IFS, March 2012

The reduction of imports and mild improvements of exports of EEE also resulted in the lowering of the current account deficit in EEE in 2008 and 2009. The "internal devaluation" in Estonia, Latvia and Lithuania, countries mostly affected by the global financial crisis, increased their cost competitiveness and turned their large current account deficits into surpluses. A huge reduction of imports *vis-à-vis* exports also contributed to this outcome. Croatia reduced its current account deficit to 5,5 percent in 2009, but at the same time, the budget deficit increased.

Current account surplus in Asian emerging economies was significantly reduced in 2008 and 2009, but other key aspects of its economy remained unchanged. In addition to the low household consumption, reliance on investment, and net export to drive their growth gave rise to significant current account surpluses and, consequently, low levels of gross external debt as percent of GDP.

Regarding exchange rate regimes, the European emerging economies pursued different models. For instance, some countries like Poland and the Czech Republic had pure floats. Until November 2008 Hungary had a banded exchange rate. Bulgaria and the Baltic countries operated currency boards. Consequently, currency mismatches that developed in the European emerging economies were the result of different forces. While in Asia pegged exchange rates induced borrowers to ignore the currency risks and easily take on short-term loans denominated in foreign currency, in Europe taking foreign exchange denominated loans was encouraged by the trust in the continuing convergence process that will ensure a lasting appreciation of the local currency *via-a-vis* that of the trading partner.

The exchange rate depreciations in European emerging economies due to the 2008-09 crisis were mild in comparison to the exchange rate depreciations that happened in Asia as a result of the Asian financial crisis. The Asian currencies lost in real terms over 40 percent of their value. In Europe that number is under 20 percent and many currencies remained at stronger levels than their long run average. Also some of the European emerging economies are members of the euro-zone and use the euro as their currency. In terms of the macroeconomic policy trilemma, they gave up exchange rate flexibility.

5. LESSONS FROM ASIA

It has now been decades that sound policies, effective governments, and openness to foreign trade and new technologies in Asian emerging economies led to their sustained rapid economic growth. It has resulted in raising living standards and alleviation of poverty in those countries. In addition, it led to a new balance in global economic power by producing a shift between advanced and emerging economies. It is mostly the Asian emerging economies who are responsible for that shift. The European emerging economies are still struggling

with the effects of the latest global 2008-09 crisis and recession that followed. The current crisis in the eurozone adds to the uncertainty.

It is, therefore, useful to examine the Asian experiences, especially since the pre-crises structures and situations were in some major aspects remarkably similar. In addition to the general aspects, in this paper we focus in particular on the scale of capital that flew into both the Asian and the European emerging economies, its composition, and the consequences and effects of its volatility on economic performance of the countries that received it.

The massive capital flows that during the past two decades entered the Asian and European emerging economies brought with them both the benefits but also the seeds of destruction at the time of their sudden reversal. High growth rates in both regions were accompanied with credit boom leading to high liquidity, asset price bubbles, appreciation of currencies, and other indicators that a crisis would be imminent. The composition of capital flows showed higher ratio of short term debt in the case of Asian and equity investment in the case of the European emerging economies (Kawai - Lamberte, 2010). Consequently, the main sources of instability for Asian countries were the currency and maturity mismatches in the external debt largely denominated in foreign currency. In the case of the emerging European economies it was the fact that their rapid growth was to a large extent financed through cross-border capital flows.

The first resolution came with the Asian financial crisis in 1997-98 that did a lot of damage to some Asian emerging economies, most notably Thailand, Korea, Indonesia, and Malaysia (Eichengreen, 2003). However, their recovery was quick and the resumption of growth took the shape of a „V". High growth rates resumed almost immediately after the crisis and reasonable stability returned to the region. Sharp real exchange depreciations and an export oriented economic structure formed a big part of the quick recovery that was helped by the favorable environment on the world market. However, another important component were policy actions carried out by local governments and structural reforms primarily those aimed at stabilizing the financial system. It is those latter aspects of the Asian successful recovery that deserve attention from the troubled European emerging economies trying to recover from the global financial crisis of 2008-09.

Rapid recovery and the „V" shape growth of the Asian emerging economies suggest that they were also quick to draw lessons from their own experience. Today their current accounts show surpluses, foreign capital flows in again, and there is a significant pool of international central bank reserves. At the end of 2008 Asian emerging market economies had more than a half of the world's total reserves to protect themselves from any sudden capital flow reversals in the future. The open economy policy trilemma is solved by moderation on all three ends, exchange rate regimes, monetary policy, and openness of the capital account. Comprehensive structural reforms introduced modern prudential regulation and supervision of the financial systems that were sorely missing in the period before the crisis. The Asian emerging economies

barely felt the global financial crisis 2008-09. Moreover, it was their growth that pulled the world economy out of recession following the recent crisis.

The Asian growth model is investment and export driven, with a large proportion of investment financed by domestic savings. The growth in the European emerging economies has been consumption driven and largely dependent on external financing. In order to soften the considerable global imbalances that resulted, both models need to converge to each other. There had been a lot of talk about rebalancing the drivers of growth especially in China but another rebalancing only with a different sign is necessary in the European emerging economies.

In addition to growth rebalancing, an important policy option is to make fiscal policy countercyclical to be in the position to use public finance to revive growth in difficult times. Currently the European emerging economies are so much under heavy burden of both external and internal debt that this policy option is painfully lacking. What is pursued in most of them are the austerity measures that are supposed to induce growth.

Even though they can learn from it, the European emerging economies can not simply emulate the Asian experience. In spite of the fact that there were many similarities in the economic structures of both regions before their own crises, there are other aspects of the world economy that are different now. For instance, after the global crisis 2008-09 the international environment is no longer conducive to large external demand for goods from the European emerging economies. Also the international financial system has been significantly weakened.

An additional challenge to the European emerging economies and their growth prospects is the current eurozone sovereign debt crisis. It is once again threatening the stability of European banks largely exposed to the huge external debt of some of the EU periphery countries. The eurozone crisis is likely to further hurt the Europe 11's exports and growth. It is also producing additional financial instability thereby undermining their further recovery and a new take off.

6. CONCLUSIONS

In conclusion it can be said that, with intense flows of international capital across borders following capital account liberalizations in many countries, the problem of financial and economic crises has grown more acute. That is especially the case when the financial authorities of countries involved lack the proper network of financial development and regulation. The observed cases in the emerging Europe and Asia both prove that point.

However, through one recent crisis after another in the world markets and the restructuring they inevitably inspire, global imbalances got spontaneously

somewhat reduced and further convergence in growth models is likely to happen. In the light of this, when one tries to assess what general and specific lessons European emerging economies and, for that matter the rest of the world as well, can draw from the Asian financial crisis of 1997-98 and measures undertaken to fight it, it appears that they are twofold. On the global level, it highlighted several important aspects of the world economy that needed special attention. In addition to the need to reassess and strengthen the world financial architecture it is to focus attention on how to identify and utilize crisis indicators in order to prevent full blown crises form happening as well as how to successfully manage capital accounts and their liberalization. Managing capital flows in a financially highly integrated world is one of the most pressing issues in efforts to prevent the destabilizing effects of large swings in capital inflows and of their unfavorable composition. On a country level, however, the Asian experience suggests that productivity growth coupled with open markets and a high savings rate to finance investment are still the safest recommendations for a resilient growth rate in a changing world.

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VOLATILNOST TOKOVA KAPITALA U RASTUĆIM EUROPSKIM GOSPODARSTVIMA: LEKCIJE IZ AZIJE

Sažetak

U posljednjim desetljećima prošloga i početkom ovoga stoljeća niske kamatne stope u razvijenim gospodarstvima pridonijele su masovnom dotoku privatnog kapitala diljem svijeta u potrazi za višim stopama za investicije. Rastuća tržišna gospodarstva u Europi postala su atraktivna destinacija za značajne količine tog kapitala, osobito izravnih inozemnih ulaganja, s obzirom na njihove političke i gospodarske reforme, uključujući otvaranje i liberalizaciju njihovih kapitalnih računa. Zatvaranje jaza između domaće štednje i investicija u zemljama s izravnim inozemnim investicijama pomoglo je poboljšati rast tih gospodarstava. Ipak, to je pridonijelo stvaranju velikih deficita tekućih računa. Globalna financijska i gospodarska kriza 2008.-2009. promijenila je čimbenike poticanja u razvijenim gospodarstvima te su se prethodno obilni tokovi kapitala u rastućim europskim gospodarstvima značajno usporili. To je odmah utjecalo na stopu rasta, ali su deficiti tekućih računa ostali veliki.

Cilj rada je istražiti kako su rastuća europska gospodarstva reagirala na naglo zaustavljanje međunarodnih tokova kapitala i koje su posljedice. Pogledat ćemo azijska gospodarstva koja su ojačala nakon svoje financijske krize 1997.-1998., imaju trajne suficite na tekućim računima i postala su glavni vjerovnici u svijetu. Analiza se temelji na MMF-ovim bazama podataka Svjetskog i Regionalnog gospodarskog pregleda, Eurostatu, izvorima Azijske banke za razvoj i podacima nacionalnih banki u europskim zemljama.

Ključne riječi: međunarodni tokovi kapitala, financijska liberalizacija, rastuća tržišna gospodarstva, globalne neravnoteže

JEL klasifikacija: F30, F32, F43, O16, P33