Economic Watch

EAGLEs

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Economic Analysis

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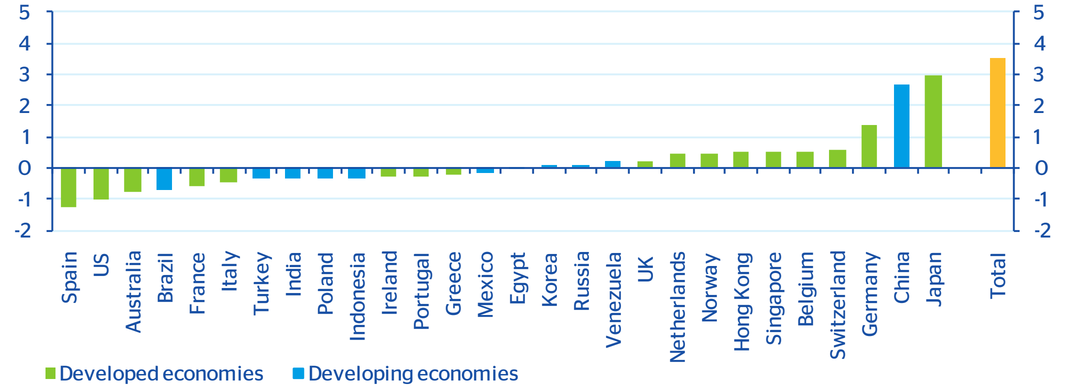
China is the only global creditor within BBVA EAGLEs

In recent years, we have witnessed the rise of Emerging Markets (EM) to the point that some of them have become members of the top 10 largest economies. In this new reality, it is worth wondering if those changes have been reflected in the balance sheet of the world economy[1]. As BBVA Research, of even more interest is assessing what is the position of those we have defined as the most promising emerging markets, namely the EAGLEs.

A quick glance at the dynamics of the international investment position (IIP), during 2005 and 2010 concludes that China is the only global creditor within the EAGLEs. Together with Japan and Germany, China has become the world's largest creditor. As long as other EAGLEs continue with their developmental process, it is not likely they will become world creditors, although their IIP is expected to become less negative. At the same time China will continue to strengthen its influence on EM by providing funds for their investment projects.

- **The myth of shifting wealth to EM:** Most of the largest emerging markets are actually net debtors in IIP terms. China is the single major net creditor out of the BBVA EAGLEs
- **Globally other than Asia,** only Germany stands out as a large net creditor
- **Free trade is not to blame for China becoming such a large net creditor,** it is the huge savings rate
- **China will further increase its influence on other EM since it will need to diversify its positive IIP away from reserve assets to FDI** and away from the developed to the emerging world. This, again, gives a great opportunity to BBVA EAGLEs, other than China, as potential recipients of Chinese FDI.

Chart 1
Change in the net International Investment Position (between 2005 -2010, as % of the aggregate GDP of these economies)



Source: BBVA Research and IMF

1: It is also important to highlight that the sample of economies analyzed, does not include the Gulf Cooperation Council (GCC) economies, where big oil exporters are also expected to be big savings exporters mainly through their sovereign wealth funds (SWF).GCC includes: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

A cursory glance at the International Investment Position (IIP): the easiest way to measure external wealth

The IIP is the balance sheet of an economy with the rest of the world. It summarizes the international assets and liabilities an economy holds. They are grouped within five categories: foreign direct investment (FDI), equity and debt portfolio investment, financial derivatives, other investments (mainly short term credits) and reserve assets. The difference between assets and liabilities is the "net position" which can be either positive or negative, indicating whether a country is a net creditor or debtor with the rest of the world. Creditor economies can use their net assets to fund current account deficits in the future without increasing their external vulnerabilities. On the other hand, debtor countries must implement policies such that their current account deficit path is "sustainable", in order to avoid reaching a negative IIP that is unbearable. Special attention should be taken on the deficit in the net portfolio investment flows, since this means an economy is more dependent on external savings to fund their excessive expending.

The myth of shifting wealth to EM: Most of the largest emerging markets are actually net debtors in IIP terms. China is the single major net creditor out of the BBVA EAGLEs

Within the EAGLEs[2], China is the biggest supplier of credit whereas Brazil, Mexico, Turkey and Indonesia are the biggest debtors. The net position of the EAGLEs is negative, which is not surprising considering they are developing economies which require external funding to finance their current investment projects (charts 2 & 3).

All other EAGLEs are net debtors, except for Russia whose surplus is negligible. They have all followed the same strategy of accumulating reserve assets, but it has not been enough to offset the increasing debtor position in FDI and portfolio investment (chart 4). However, this trend confirms the interest in these economies given their expected high growth rates. At the end their revenues will increase remarkably contributing to reduce their current debtor status.

One interesting case is Korea who is the only EAGLE holding an FDI positive net position. This is a consequence of the reallocation of the manufacturing production process which has happened in recent years. It is also evidence that Korean corporations are in a new stage of developmental process becoming transnational world players.

Globally other than Asia, only Germany stands out as a large net creditor

The highest increase in IIP from 2005 up to 2010 was observed in the Asian economies as they generally maintained high savings rates (charts 5 & 6). In terms of world GDP[3], the net IIP of the region almost doubled. In addition to China, Japan, Singapore and Hong Kong have increased their net IIP the most either by augmenting their net portfolio holdings (equity or debt) or by raising their reserve assets (chart 7). As a consequence, this situation has created an interesting paradox, since at the same time some of the Asian economies (China, Hong Kong and Singapore) are main recipients of FDI inflows but also massive savings exporters. It is also worth highlighting the fact that Japan holds the largest net FDI surplus in the region and the second highest within the sample of 62 economies, which is also a result of its own reallocation of manufacturing strategy in Southeast Asian economies.

Western Europe[4] is still a net debtor, although it has reduced significantly the negative net IIP and in 2010 was close to be in equilibrium (charts 5 & 6). This is the result of an asymmetry between the increases in debtor position in most of the peripheral countries (resulting from the rise in private and public debt during the pre-crisis years) and core economies (i.e. Germany, Switzerland, Belgium, Norway and the Netherlands) which maintained low consumption rates during that period. This is clear evidence of the need of rebalancing within Europe as part of the solution to the current crisis.

2: EAGLEs is a grouping acronym created by BBVA Research to identify all emerging economies, whose expected contribution to world gross domestic product (GDP) in the next ten years is expected to be larger than the average of the G7 economies, excluding the United States.
3: A sample of 62 economies whose aggregated GDP represents almost 93% of Word GDP in US dollars according to IMF database. Given the lack of data on IIP, GCC economies are not considered.
4: Western Europe includes: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK.

Free trade is not to blame for China becoming such a large net creditor, it is the huge savings rate

Economic literature[5] has identified as determinants of the net IIP the following variables: GDP per-capita, the public debt level as percentage of GDP and the old-age dependency ratio (population above 65 years old). The use of the latter is justified on the life cycle hypothesis, which characterizes age groups according to their consumption, investment and saving patterns. People at retirement age should have the highest net asset position, with both real and financial assets and marginal liabilities, in contrast to younger people at the start of their working life. However, an aging society could eventually reduce its aggregate net foreign assets position as people will tend to use their savings and also be less able to leave inheritance. Other variables should also be considered determinants of the external balance, such as: the terms of trade, reallocation of manufacturing and precautionary savings.

When considering the change in the net IIP between 2005 and 2010, it is clear Asian economies have become the most important savings exporters' worldwide. However, regional aggregations hide other important results. Japan, China and Germany were the economies which increased the most their net IIP during those years, as a consequence of their impressive current account surpluses (charts 8 & 9), which are part of what is known as the global imbalances. Germany is similar to Japan in the sense it has increased its net FDI, but has also become the largest supplier of short term credits.

The reallocation process of manufactures production does not seem to be the main driver when trying to explain the change in net IIP. All G7 economies, except Germany, have reduced their shares of manufacturing exports in the last decade (chart 10). On the other hand, in the case of China, this process is clearly behind its huge trade surplus which ended with the impressive growth of its international reserves (chart 11).

The savings rate of the economy seems to be one of the most relevant determinants. When comparing the G7 and the EAGLEs (charts 12 & 13), China, Japan and Germany have the highest rates. When trying to understand what explains this behavior other factors should be considered, for instance the current stage of development and the quality of social protection networks which may stimulate a higher rate of precautionary savings. Excluding China, although all other EAGLEs economies have larger savings rates than Japan and Germany (except Mexico, Brazil and Turkey), the resources required to finance their current growing process are larger and thus the change in their IIP is negligible or even negative.

There are many reasons behind the Asian high savings rates. In the case of China, State Own Enterprises (SOEs) hold large reserves to fund their investment projects, households have been advised to hold precautionary savings given income inequality and lack of safety; hence consumption rates still remain low in China. In the case of Japan, the already high private savings rate has increased further, raising the Ricardian equivalence hypothesis among households and corporations given the inconvenient public debt and deficit.

Concerning the rise of commodity prices, in particular for energy like oil (chart 14), it is true there is a sensitive income transfer from households living in net import to export economies; however this shock has been more than offset in the cases of Japan and Germany.

China will further increase its influence on other EM since it will need to diversify its positive IIP away from reserve assets to FDI and away from the developed to the emerging world. This, again, gives a great opportunity to BBVA EAGLEs, other than China, as potential recipients of Chinese FDI

The EM will also rebalance their pattern of savings and investments. Emerging Europe will intensify the adjustment towards a sustainable growth path with lower investment rates. Turkey`s rebalancing should imply a correction of its current account deficit through higher savings rates and current short term finance should be replaced by FDI inflows. In Latin America, Brazil and Mexico are expected to maintain their strong fundamentals, (fiscal and external balances) and their net IIP will start to increase as long as their transnational companies accelerate their expansion strategies, thus increasing their FDI outwards.

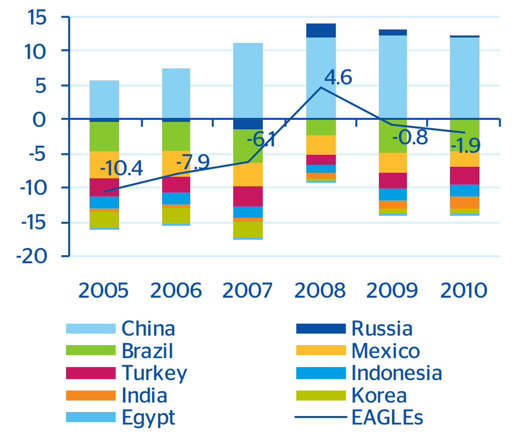
As long as EM, in particular EAGLEs, continue their development process, it is not likely they will become the world's creditors, with the exception of China which will continue playing in a

5: Philip R. Lane and Gian Maria Milesi-Ferretti, (2001) Long-Term Capital Movements. NBER Macroeconomics Annual 2001, Volume 16
Philip R. Lane and Gian Maria Milesi-Ferretti, (2000) External Capital Structure-Theory and Evidence， IMF Working Paper No. 00/152.

league of its own. For the moment, Asian economies (and for sure oil exporter countries) have the largest investment pools in the world. (Chart 15)

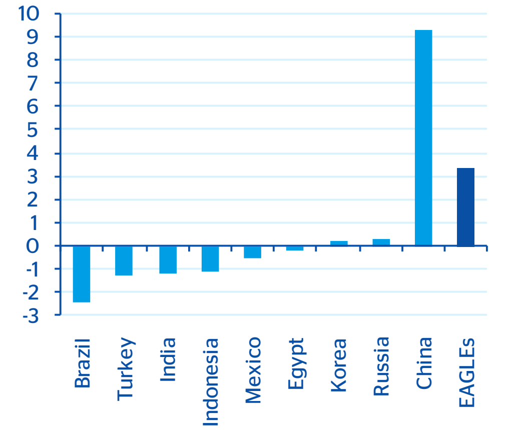
It is also expected a portfolio rebalancing towards higher FDI in the case of China at the expense of a decline in their reserve assets. Also change can not be ruled out in the currency composition of those reserves. On the other hand, their household consumption may rise faster if the ongoing pension reform has the desired effects of creating an efficient social protection network[6]. Concerning EM, the Chinese portfolio reallocation should benefit them by increasing the funding available to finance investment projects, in particular infrastructure, in order to consolidate their development process through higher FDI and also portfolio investment..

Chart 2
EAGLEs: net IIP (as % of EAGLEs' GDP)



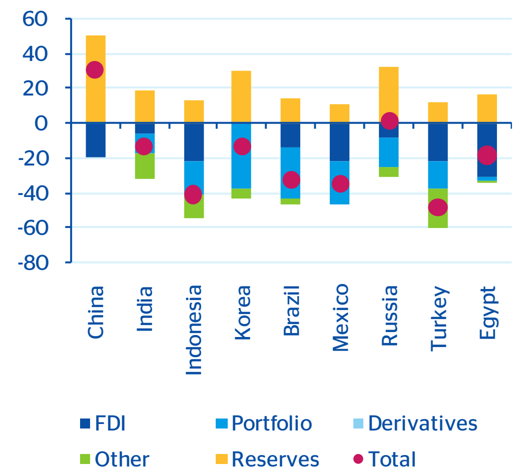
Note: No data for Taiwan
Source: BBVA Research and IMF

Chart 3
EAGLEs: change in net IIP (between 2005-2010, as % of EAGLEs' GDP in 2010)



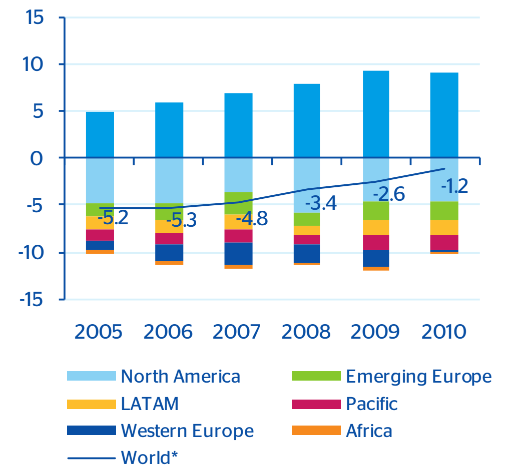
Note: No data for Taiwan
Source: BBVA Research and IMF

Chart 4
EAGLEs: net IIP in 2010 (as % of GDP)



Note: No data for Taiwan
Source: BBVA Research and IMF

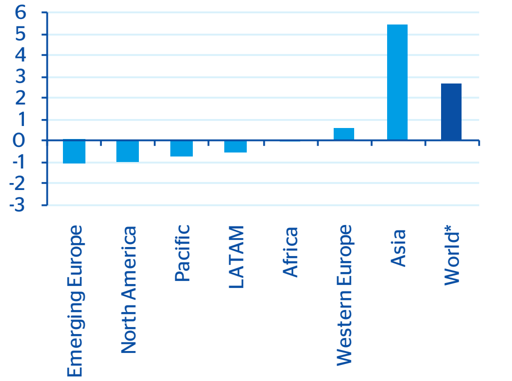
Chart 5
World*: net IIP (as % of World*'s GDP)



* World: sample of 62 economies whose aggregated GDP represents almost 93% of Word GDP in US dollars according to IMF database. Given the lack of data on IIP, GCC
Source: BBVA Research and IMF

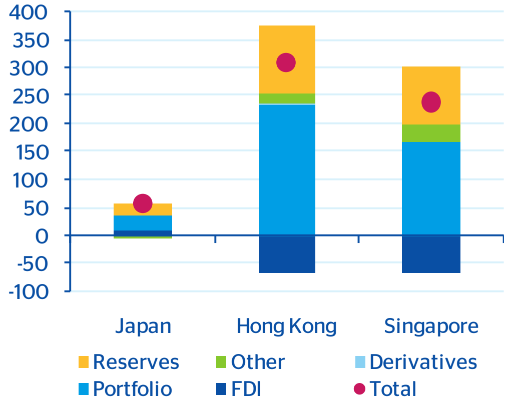
6: Zhigang Li and Minqin Wu, Estimating the Incidences of the Recent Pension Reform in China: Evidence from 100,000 Manufacturers, BBVA Research 2011, working paper.

Chart 6
World*: change in net IIP (between 2005-2010, as % of World*'s GDP in 2010)



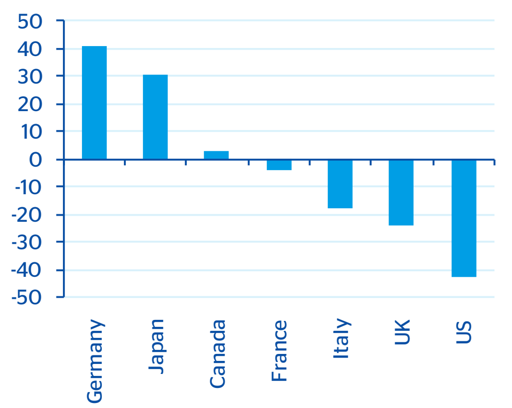
* World: sample of 62 economies whose aggregated GDP represents almost 93% of Word GDP in US dollars according to IMF database. Given the lack of data on IIP, GCC
Source: BBVA Research and IMF

Chart 7
Asian economies: net IIP in 2010 (as % of GDP)



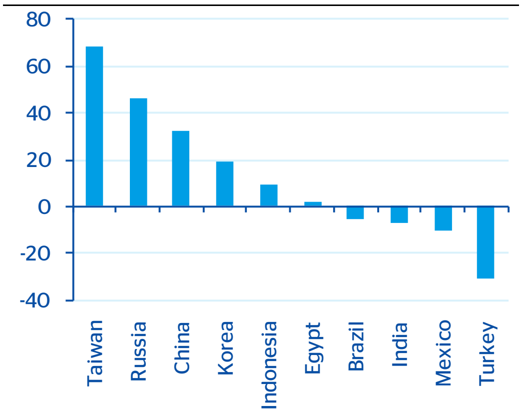
Source: BBVA Research and IMF

Chart 8
G7: accumulated current account balance 2000-2010 (as % of 2010's GDP)



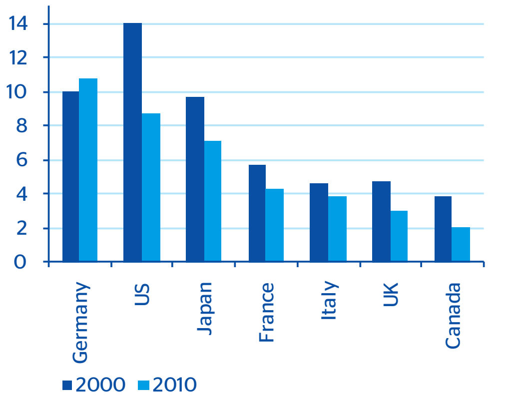
Source: BBVA Research and IMF WEO

Chart 9
EAGLEs: accumulated current account balance 2000-2010 (as % of 2010's GDP)



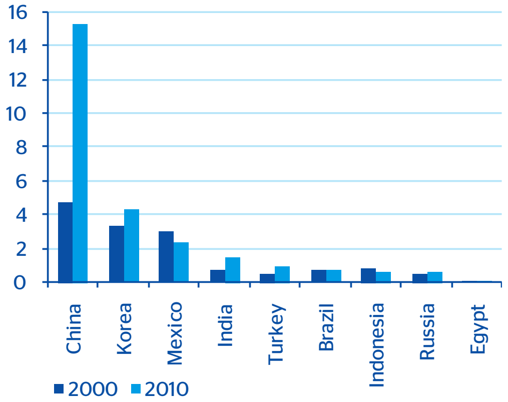
Source: BBVA Research and IMF WEO

Chart 10
G7: share in world manufactured exports (%)



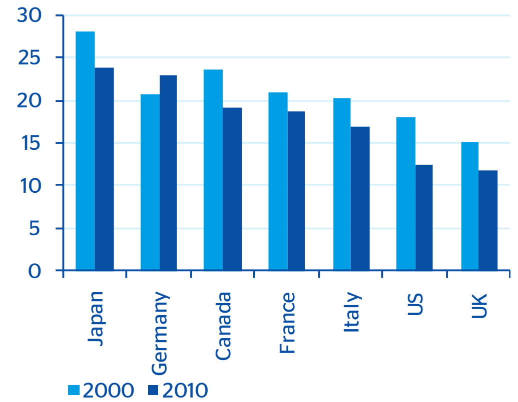
Source: BBVA Research and WDI

Chart 11
EAGLEs: share in world manufactured exports (%)



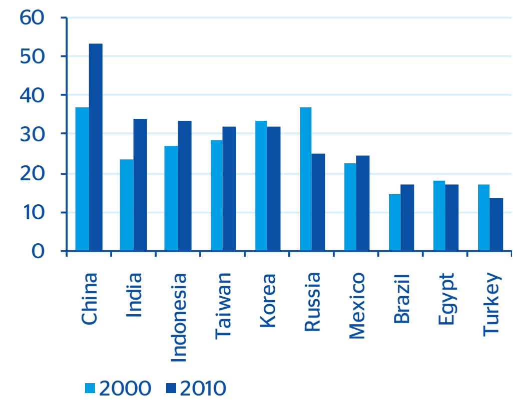
Note: No data for Taiwan
Source: BBVA Research and WDI

Chart 12
G7: gross national savings rate (as % of GDP)



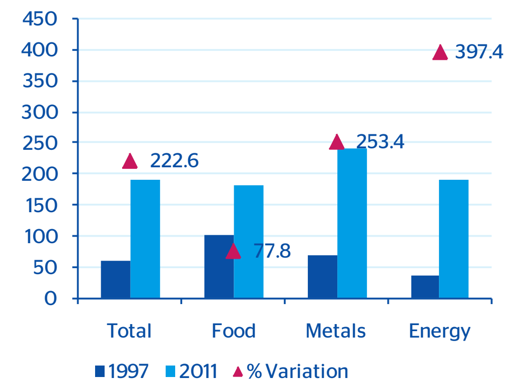
Source: BBVA Research and IMF WEO

Chart 13
EAGLEs: gross national savings rate (as % of GDP)



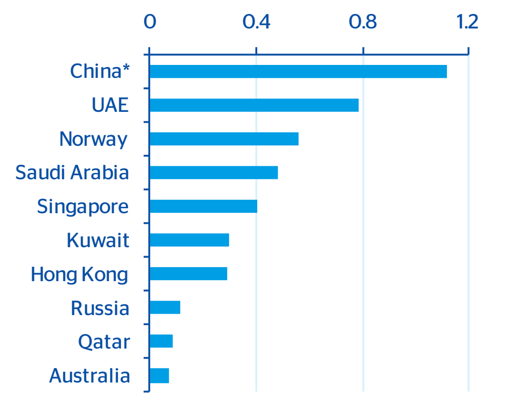
Source: BBVA Research and IMF WEO

Chart 14
Commodities price index (2005 = 100, accumulated % variation)



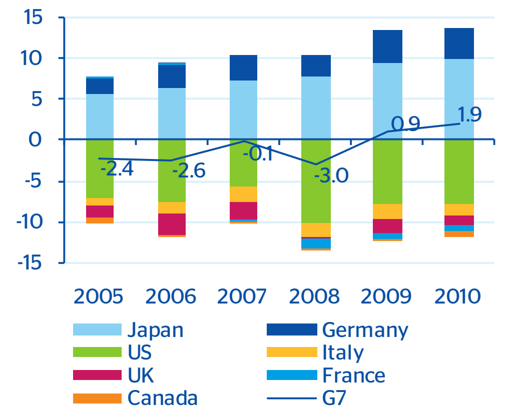
Source: BBVA Research and IMF

Chart 15
Sovereign Wealth Funds (Assets 2011, trillion USD))



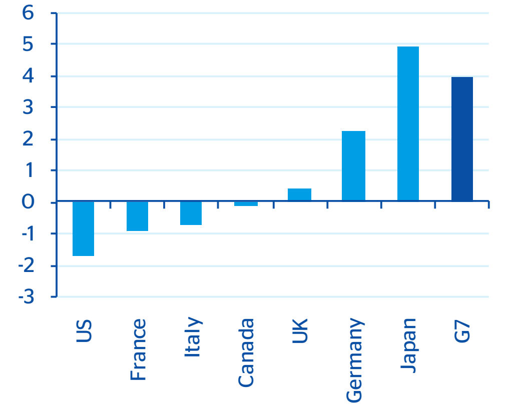
*2011 Estimate
Source: BBVA Research and Sovereign Wealth Fund Institute

Chart 16
G7: net IIP (as % of G7's GDP)



Source: BBVA Research and IMF

Chart 17
G7: change in net IIP (between 2005-2010, as % of G7's GDP in 2010)



Source: BBVA Research and IMF

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