PART 3

A NEW WORLD OUTLOOK

Emerging Countries and the Changes Implied for Europe

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Following the financial crisis of the late 1990s, emerging countries quickly returned to high growth rates. But their economic achievements should not be measured solely in terms of GDP. They are also asserting their financial power, and the largest of them today are claiming a place in the international economic order in proportion to their weight. In contrast, European achievements are far more mediocre, and Europe's status in the world economy is being increasingly challenged.

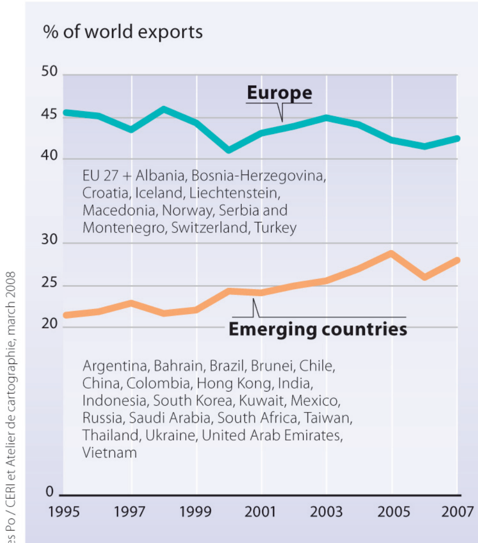
The option of export-led growth has made emerging countries new competitors with the former industrial countries, starting with Europe. High trade surpluses and highly raw-material-driven growth cause worldwide market upsets. But emerging countries have also become poles of attraction, encouraging the development of new partnerships, though in a changing context in which emerging countries demand recognition for their rank, which automatically has implications for Europe.

Emerging countries as competitors

Does emerging country assertiveness imply the relative decline of former powers, especially "old Europe", whose dynamism is often considered atrophied?

Emerging countries first stand out as trade competitors on both national and world markets. Their share in international trade rose from 21% to 29% between 1995 and 2005.

figure 60: **Share of emerging countries and Europe in world exports, 1995-2007**



Source: Compiled by Jean-Marc SIROËN, from WTO data.

These countries, with their abundant supply of cheap labour, compete with European production in the most traditional sectors. This means that European countries must either opt for sectors requiring highly skilled labour or transform traditional sectors such as the textile industry into capital-intensive high technology industries. However, even in these areas, Europe's position appears fragile. Emerging countries no longer settle for being mere subcontractors and are aiming to work their way up the added-value chain to assembly and finished goods (an example being Airbus in China), while also expecting to benefit from technology transfers. India trains an impressive number of engineers and is asserting its presence in high technology services and industries. Emerging countries also assert themselves in sectors such as petrochemicals, pharmaceuticals, computer engineering, renewable energy and aeronautical construction.

Emerging countries are generally broken down into three broad categories according to specialization: agricultural (Argentina, Brazil) or mineral primary goods (Venezuela, Gulf countries), industry (China, Vietnam) and services (India). This perspective can however be misleading: Brazil has not given up on its industry any more than India has, and China, with Hong Kong, has become the world's third-largest exporter of tradable services.

Emerging countries also seem to be competitors in world capitalism. Their firms are becoming part of world oligopolies by buying up Western and especially European companies. Emerging countries are investing in Europe. Mittal's takeover of Arcelor in 2006 earned the group, chaired by an Indian, first place in the world steel oligopoly in which another Indian firm has also made a breakthrough: in 2007 Tata Steel took over the Anglo-Dutch steelmaker Corus, trumping Brazil's CSN. The incursion of emerging countries into world capitalism is not limited to private actors. Sovereign funds—state-backed and state-controlled investment funds—of certain emerging countries such as Kuwait, the United Arab Emirates, China and Russia may also become more involved in Western firms by increasing their stakes in them and demanding a degree of management control. This change, which also affects the financial sector, has in fact prompted a rise in "economic patriotism" that is no longer characteristic only of France and the United States. Such economic takeovers indeed have a chance of increasing the political influence of certain countries.

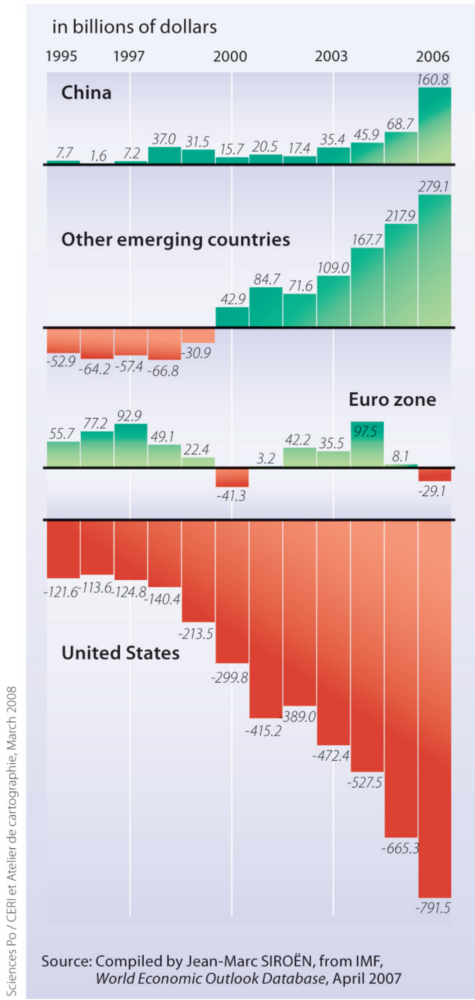
These fears should, however, be put in perspective. The increased market share of emerging countries was only marginally detrimental to the European share. Nothing can yet be taken for granted. Emerging countries are far from mastering all techniques. Quality is not always a feature of their products and services. Counterfeiting can lead to sanctions. Low wages are not necessarily enough to offset a lack of labour productivity, which remains low, even if the undervaluation of certain currencies disguises these shortcomings. Distortions are accumulating particularly in the real estate and financial sectors. The effects of the "purge" induced by the financial crisis of the late 1990s are fading, and emerging countries remain vulnerable to crises, whether these stem from their own imbalances or from those in developed countries. They did not for instance escape the summer 2007 subprime mortgage crisis.

Emerging countries as disruptive factors

Emerging countries are often seen as latecomers in a world economic order constructed without them, disrupting, voluntarily or not, the well-honed organization of markets heretofore dominated by the developed countries alone. Today the United States, Europe, and Japan are no longer the only ones that set interest rates, exchange rates and world commodity prices.

New global imbalances appeared a few years after the stabilization plans applied by most of the emerging countries in the late 1990s (Thailand, South Korea, Russia, Brazil, Argentina) to tackle the financial crisis. Restrictive policies, abundant savings, dynamic exports and rising world raw material prices have thus encouraged current account surpluses and the accumulation of foreign currency reserves. However, this spectacular evolution is also the counterpart of the twin American deficits—budget and current account—which can be ascribed to a growth model based on public deficits, consumption and debt. Since 1995, we have observed both deepening of the US current account deficit and swelling of the surplus in emerging countries,

figure 61: **Trade balances of certain economic groupings, 1995-2006**



Source: Compiled by Jean-Marc SIROËN, from IMF, *World Economic Outlook Database*, April 2007 in particular China. To a lesser degree, the usual Eurozone surplus has been reversed.

This surplus is expressed by an increase in foreign exchange reserves in emerging countries. Between 2000 and 2005, Chinese reserves grew from $166 million to $820 billion. Emerging countries thus quickly turned from debtors to creditors.

Asymmetrical imbalances between emerging countries and the United States have significant implications for Europe. The official reserves are in fact primarily placed in dollars and to a lesser extent in euros or sterling, which buoys the US currency and fosters the undervaluation of the currencies of certain emerging countries, primarily the Chinese yuan. Greater wariness towards the US currency would have undesirable effects in Europe. The collapse of the US dollar, in addition to the financial crisis that it is likely to entail, would mean a transfer to European currencies, thus amplifying their overvaluation to the detriment of European competitiveness.

Responsibility for these imbalances cannot be ascribed to any country in particular. The American model of excessive debt corresponds to the probably too austere policies practiced in emerging countries. Their mercantilist export-driven growth strategy may lead to concentrating attention on foreign demand rather than stimulating domestic demand. An appreciation of the yuan would only reduce these imbalances if the United States reduced its public deficit and saved more. The fact nevertheless remains that emerging countries, just like the United States, make do with this situation as long as growth continues on an upward trend, even if Europe has not drawn all the dividends of these consolidated imbalances.

By attracting the savings from emerging countries and Japan, the United States can thus fulfil its function as world banker by converting a low-interest debt into longer-term and higher-yielding investments. The resulting abundance of international liquidity has certainly stimulated the world economy and trade. It has also reintroduced the risk of global inflation.

For the time being, the rise in world prices is confined to raw materials. The high growth rate of emerging countries and the improvement in their purchasing power have caused a skyrocketing demand for primary goods, the supply of which is anything but elastic. This boom has on the whole benefited emerging countries which, whatever their ambitions, remain economies dependent on the primary sector. It has constituted an unhoped-for windfall for countries that export oil or agricultural products. For a country such as Brazil, this sudden rise in prices has served to reinforce its strategy of giving priority to agribusiness, and vindicate its industrial policy objective of achieving a leadership position in the entire biofuel industry.

This evolution might defuse debates on the future of the Common Agricultural Policy formerly discredited by surpluses and low world prices. For other raw materials for which Europe's self-sufficiency is not conceivable, this evolution could damage competitiveness. However, the price of raw materials remains highly volatile, and phases of higher prices do not rule out a contrasting historic long-term trend, bearish for agricultural produce and bullish for fuels.

Emerging countries as partners

Although emerging country exports in penetrating the European Union's traditional markets (Africa, the Mediterranean, Eastern Europe) may supplant the production of certain former industrial countries, the world market is increasing in size owing to emerging country growth. What is lost on certain markets can be gained in areas of expansion that offer opportunities to the firms of industrial countries: demand for consumer goods (often luxury items), investment and infrastructure goods. Between 1999 and 2005, although the share of extra-European imports from emerging countries rose from 32% to 43.5%, the share of exports also increased, albeit less significantly, from 24% to 31%. This growing asymmetry means that Europe does not take enough advantage of the expansion of emerging countries despite its specialization theoretically adapted to demand: aeronautics and transport equipment, luxury goods, capital goods, etc. All European countries do not have the same specialization and the same market power. They do not all have the same capacity to take advantage of these new opportunities. Although Germany, unlike France, was more affected than other European countries by the financial crunch of the late 1990s in emerging countries, it has also largely taken advantage of their recovery in these past years. One of the biggest economic challenges facing Europe will thus be to increase exports to emerging countries.

Although direct investment in emerging countries is often thought to bring about relocation, it is also a vehicle for European presence in the host country. In addition, it allows the EU to penetrate local markets and often generates exports that are more complementary to them than substitutable. Although investments entering Europe from emerging countries are rising parallel to investments moving towards emerging countries, the latter represent approximately 30% of extra-European investment (compared to a little more than 10% for incoming investment flows).

Europe's breakthrough in emerging countries could be consolidated by trade agreements. Some EU countries are moreover emerging countries themselves. Others, such as Ukraine, Russia, Turkey and other Mediterranean countries, are on Europe's fringe. The European Union has signed preferential trade agreements with Turkey, Mexico, Chile and Egypt. Negotiations are underway with Mercosur and the Gulf Cooperation Council, and the European Commission has been given a mandate to negotiate new agreements revolving around trade and investment with, in particular, India, South Korea, ASEAN and the Andean Community. With China, Ukraine and Russia, trade negotiations may also be engaged in the framework of partnership and cooperation agreements.

The European Union cannot escape this trade agreement race if it aims to consolidate its presence in emerging countries. Indeed, the European Union is in direct competition with the United States, each of them trying to rob the other of its traditional areas: Latin America for the United States, Africa and the Middle East for Europe. Even if India and China assert themselves as regional leaders, to the detriment of Japan, and even if interregional trade is historically increasing, this open battle raises questions about the vision of a tripolar world that had been taken for granted in the 1990s. The United States will have to get used to a European and Asian presence in Latin America, just as Africa will link itself as much (or more?) to the Asian pole as to the European one. At the same time, the proliferation of agreements contributes to sidelining multilateralism. Paradoxically, membership of the WTO, where preferential agreements are allowed, becomes the best way to negotiate bilateral agreements, even if this circumvents the founding principle of non-discrimination between member countries.

Emerging countries, bearers of a new international economic order?

More than 50 years after the Bandung Conference, emerging countries are still demanding their place in global governance. The largest of them expect recognition of their regional leadership status, which would legitimate their active participation in the political and economic condominium of great nations. The positions established after the Second World War are thus being challenged, and the old system is unable to satisfy demand from emerging countries.

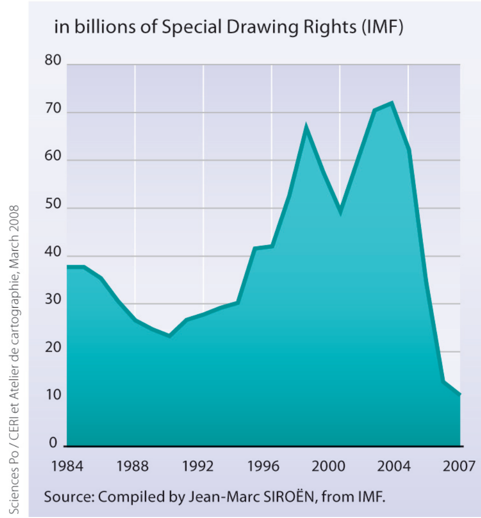
Reform of the major international institutions is late in coming. The European Union's place appears excessive: two permanent Security Council seats (United Kingdom and France), and seven of the 24 representatives on the IMF and World Bank executive board. Even after the IMF's 2006 reform that increased the quotas of four emerging countries (China, South Korea, Mexico, Turkey), the European Union still has over 32.4% of the voting rights, compared with 11.5% for Asia (17.1% for the United States); Belgium carries more weight than India or Brazil. The European Union preempts the post of IMF managing director, the United States maintaining its prerogative over the World Bank. Europe has considerable influence over the WTO. The status quo has become all the more indefensible since emerging countries have become net exporters of capital, conduct rigorous macroeconomic policies, enjoy high growth rates and bear no responsibility for the August 2007 financial crisis, which was due to the collapse of US subprime mortgages. The European and American weight is still crushing whereas the world bankers today are Japan, China and Venezuela.

The weakening legitimacy of developed countries has led emerging countries to emancipate themselves and, pragmatically, pave the way for an independent growth model. Heavily indebted to the IMF after the Asian crisis, they recently, rapidly and spectacularly disengaged themselves to the point of leaving the IMF with an abundant liquidity it cannot use.

Such financial emancipation sets the stage for ideological emancipation. The "Washington consensus", which inspired the IMF market-friendly structural adjustment programmes, has become obsolete for lack of new requests for financing.

This evolution is admittedly fragile because it is too bound up with a conjunction of favourable events that are highly unlikely to repeat themselves: exceptionally high growth rates that are probably unsustainable in the middle term, rising raw material prices, a locomotive effect created by the American deficits, and the risk of a financial and banking crisis. Countries such as Brazil are just barely coming out of a monetary and fiscal policy that exceeds IMF prescriptions. Others, such as Venezuela, are squandering the oil income windfall to the point of possibly setting the stage for a new financial crisis when oil prices turn around.

figure 62: **Value of loans granted by the IMF, 1984-2007**



Source: Compiled by Jean-Marc SIROËN, from IMF.

The fact nevertheless remains that the state of mind in emerging countries is euphoric. It is a heady euphoria that hints at the establishment of a new international order that would rehabilitate state control as well as populist and nationalistic ideologies. Even if the proposal to set up a "Bank of the South" to compete with international or regional financial institutions is unlikely to take the shape that Hugo Chávez intends for it—who is prepared to substitute Venezuela for the United States and Europe?—the question has nevertheless been raised; many emerging countries, including Russia, India and Brazil, have embarked on a strategy of conquering the keys to "world" power, whether they are in the hands of corporations, financial institutions or international organizations. The reversal has been brutal and swift. It is not certain that the European Union has perceived all of the issues involved.

Yet the European Union was called to order during the Doha Round. Neither before the failure of the Cancún Conference in 2003 nor, perhaps, even afterwards have European negotiators accepted the idea that the emerging countries of the G20, given their highly incompatible trade interests, could band together to defeat the US/EU duopoly. For emerging countries, one important issue is certainly to engage in a test of strength that would enable them to obtain more from developed countries, in other words a greater opening of agricultural markets in the European Union in exchange for less opening of industry and services markets in emerging countries. Another is to show the former powers that nothing can be done in the future without reckoning with the emerging countries or at least their leaders.

However, acting as leader also involves accepting more than one's share in the production of "international public goods". Emerging countries can certainly argue that growth in the former industrial countries was based on child labour and considerable disregard for environmental consequences. But such a line of populist argumentation only confirms the reluctance of emerging countries to assume the responsibilities of world leaders and thus, probably, the impossibility of gaining recognition for this status, at least in the near future.

In the coming years, there is no reason for the rivalry between Europe and the emerging countries to soften. As shown by the suspension of negotiations with Mercosur, trade agreements will be difficult to negotiate with core emerging countries such as Brazil, China, India and Russia. Internal European Union compromises, on agriculture in particular, moreover narrow the room for negotiation. The export-led growth strategy adopted by emerging countries will come up against European demands for "fair" competition, close monitoring of counterfeiting, sanitary norms, environmental and social concerns and dumping. Takeovers of European corporations will be all the more scrutinized when they emanate from sovereign funds. However exorbitant they are, the European Union will surrender its prerogatives all the less easily since the United States does not appear any more willing to make concessions.

But the assertiveness of emerging countries should also encourage European leaders to intensify their coordination. A more coherent macroeconomic policy that pays more attention to exchange rates should prevent the resolution of imbalances between the United States and emerging countries leading to an unjustified appreciation of the euro. Without any suggestion of a European industrial policy, which would be more likely to offer greater protection to declining sectors than to promote forward-looking activities, European education, research and infrastructure policies should be strengthened and made more coherent to get beyond mere allusion to the Lisbon strategy. Institutional progress should also allow the Eurozone, if not the European Union, to act as such in the international financial organizations.

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