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Real convergence, financial markets, and the current account – Emerging Europe versus emerging Asia

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ABSTRACT

Global financial integration has been associated with divergent patterns of real convergence and the current account in emerging markets. While countries in emerging Asia have been running sizeable current account surpluses, countries in emerging Europe have been facing large current account deficits. In this paper we test for the relevance of financial market characteristics in explaining this divergence in the catching-up process in Europe and Asia. We assume that the two regions constitute distinct convergence clubs, with the euro area and the United States respectively at their core. In line with the theoretical literature, we find that better developed and more integrated financial markets increase emerging markets' ability to borrow abroad. Moreover, the degree of financial integration within the convergence clubs – as opposed to the state of financial integration in the global economy – and the extent of reserve accumulation are significant factors in explaining the divergent patterns of real convergence and the current account in the regions under review.

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Over the past decade, the process of financial globalisation has been associated with strongly divergent current account patterns in emerging market economies engaged in a rapid catching-up process. While countries in emerging Europe and emerging Asia have been receiving substantial gross financial inflows, the two regions have differed significantly with regard to direction and size of net capital flows. Most countries in emerging Europe, in keeping with standard economic theory,[2] have been reporting substantial current account deficits over the past ten years (Bussière et al., 2004; Hermann & Jochem, 2005). Growth has been driven by domestic demand, in particular by investment, partly financed by foreign savings. By contrast, in emerging Asia – as described by the so-called *Lucas paradox*[3] – the convergence process has been associated with current account surpluses, while periods of expansionary domestic demand and deteriorating net exports proved to be indicators of an ensuing crisis (Asian Development Bank, 2005).[4]

There is a large body of literature on the determinants of current account balances, globally, in both advanced and emerging market economies. From this literature, a broad consensus has emerged that the state of financial development and international financial integration plays a key role in explaining why emerging economies' current account patterns contradict standard theory (Prasad et al., 2007) or conform with predictions based on consumption-smoothing behaviour (Blanchard & Giavazzi, 2002; Abiad et al., 2007). Against this background, this paper analyses the relationship between real convergence and current account developments in emerging market economies in Europe[5] and Asia.[6] It aims at shedding light on the extent to which financial market characteristics have been at the heart of the strikingly different current account patterns observed in two emerging market regions experiencing a rapid catching-up process. In doing so, we test for the significance of different types and dimensions of financial integration, namely an overall as well as an intra-regional form of financial integration. To this end, we employ the concept of *convergence clubs*, with two peripheries (the two regions) and two cores. The United States is identified as emerging Asia's core, while the euro area/EU15 is the core of the convergence club in Europe. Finally, we go beyond identifying statistically significant determinants and reveal the extent to which these variables actually contribute to the level of the current account balances.

Our analysis suggests that financial markets and financial integration are important factors in determining current account balances and their dispersion in the two regions. At the same time, the *overall* state of financial development and integration does little to explain the divergent patterns of real convergence and the current account in emerging Europe and emerging Asia. Rather, the differences reflect the different ways financial integration *with the respective core* has been proceeding. Moreover, different financial integration methods may reflect strong differences in the two convergence clubs' overall approaches to integration between core and periphery.

It should be stressed that these results are not to be seen as a contribution to the debate on the causes and roots of global imbalances, i.e. the causes and roots of global configurations of current accounts. The paper does not aim to answer the question of whether and to what extent current account surpluses in emerging Asia have been reflecting conditions outside the region, for example a

[2] Standard economic theory suggests that the process of income convergence will be accompanied by capital flows from rich to emerging economies, reflecting return differentials and economic agentsĭ preferences for consumption smoothing, see e.g. Obstfeld and Rogoff (1996).

[3] According to Lucas (1990) capital seems to flow *uphill* from poor to rich countries contradicting the prediction of standard neoclassical growth models. Empirically, Lane and Milesi-Ferretti (2001) confirm that low income levels seem to be correlated with low investment inflows. Likewise, Prasad et al. (2007) conclude that emerging markets do not rely on capital inflows from rich countries, as they generate more savings than they invest. Similarly, Schularick (2006) identifies a wealth bias on the part of international investors.

[4] For a detailed account of growth processes in both regions, see Schadler et al. (2006), Crafts (1999), Arratibel et al. (2007).

[5] The emerging European countries are the new EU Member States Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia as well as the candidate (Croatia, FYR Macedonia and Turkey) and potential candidate countries (Albania, Bosnia & Herzegovina, Montenegro and Serbia) for EU accession.

[6] The emerging Asia group refers to developing Asian countries such as China, Indonesia, Malaysia, Philippines and Thailand, as well as the newly industrialized Asian economies, i.e. Hong Kong, Korea, Singapore and Taiwan. India and Vietnam are also part of the sample.