**Impact of EU crisis on SAARC Countries[[1]](#footnote-1)**

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It is a matter of honour and privilege for me to be invited to share my thoughts with this august gathering of SAARC Governors. I wish to thank the Governor State Bank of Pakistan Mr. Yasin Anwar for providing me this opportunity.

I would like to begin by briefly tracing the origin of the crisis of 2008/09 and then presenting the evidence about the changing role of Emerging and Developing Economies (EDEs) in the aftermath of the crisis. I would then turn to the subset of SAARC countries and see as to how much they were affected by this crisis. Finally, I would like to end by advancing some thoughts about the future of the EU and its impact on the economies of SAARC countries.

The rationale for setting up a common currency area – was premised on the belief that “Single currency itself would bring about an endogenous convergence. As it allowed goods and labor to move around the Eurozone more freely, that convergence would make the members better able to cope with a single monetary policy and the loss of exchange rate flexibility”.

This proposition did not prove right as instead of converging, Northern and Southern Europe diverged. The crisis since 2008/09 is in fact rooted in this divergence. As member countries were stripped of currency and inflation risk, interest rates in the Southern Europe plunged to unprecedented low levels that spurred a great deal of cross border borrowing feeding construction booms in Spain, Ireland. In Italy and Portugal, lower borrowing costs propped up demand. Governments could drop the austerity they had pushed earlier to meet the fiscal entry demands. Peripheral countries lost an alarming amount of competitiveness as foreign capital poured into non-traded sectors and tradable sectors became uncompetitive.

Thus Euro crisis was born out of this boom’s excesses. In absence of safety value of devaluation, domestic wages and prices had to be lowered to attain fiscal austerity and competitiveness. The end result of these measures was high employment, declining GDP, public unrest and popular dissatisfaction with the Euro zone.

*How have the Emerging and Developing Economies fared in the post-crisis period?*

Emerging and Developing Economies (EDEs) have enjoyed robust growth during the past decade and bounced back quickly from the 2008/09 financial crisis in marked contrast to the more tepid recovery in the Advanced Economies. They now account for virtually all of global growth. While Global GDP is expected to expand about 2.2 percent this year the growth in the EDEs is projected to be around 5.1 percent.

A recent study done by the IMF confirms that Emerging market and developing economies (EDEs) are now more resilient than in the previous decade. These economies have performed better than the Advanced Economies (AEs) as they have become more diversified along many dimensions in their economic structure, trading patterns, the composition of their capital flows and also largely because policy making and economic governance have improved. Unemployment in EDEs did go up during the crisis period but was back to pre-crisis level by 2011. Inflation has fallen in most of the economies and more than 80 percent now have inflation in the single digits. Exchange rates have also become more flexible – there are fewer hard pegs than in the 1970s and 1980s. The external positions of many of these countries are much improved. More are running current account surpluses, and the median external debt has fallen from close to 60 percent of GDP in the 1990s to less than 35 percent of GDP today. Foreign exchange reserves have risen from less than 8 percent in the 1990s of GDP to 18 percent during 2010-11. Fiscal positions and frameworks have also fully recovered from the effects of the Global crisis. Structural factors – trade openness, financial openness and Income equality – have also mostly moved in the right direction. There has been a trend toward increased trade among EDEs, a greater share of FDI flows and higher trade and financial integration.

The IMF study concludes that the resilience of the EDEs has increased markedly over last two decades. Expansions have become longer and stronger while downturns and recoveries become shallower and shorter. But the above findings, while reassuring, should not make us complacent or lower our guard. There is no guarantee that another downturn in Advanced Economies particularly, the continuing problems in the EU could not derail the upturn. The question to be addressed is whether this strong performance will last. Will these growth rates persist across decades if the fundamental such as investment rates, education levels, trade, financial development and institutional quality have consistently improved? There are already indications that the two large emerging market economies – China and India – have slowed down in their rates of expansion. China has been a major buyer of commodities, components, raw materials and semi-finished goods from other EDEs boosting their economies in turn. China has also become the hub of global supply chain where the final goods are assembled in China from inputs supplied at various stages of production process by firms located in different countries. After all, China has become the World’s largest trading nation and therefore what happens to economic growth in China has serious repercussions for the EDEs. In turn, China’s dependence on exports and investment dictates that its markets overseas remain healthy and growing. China’s rapidly expanding investments have had a large positive impact on its trading partners’ growth in Asia, Africa and Latin America. The most heavily exposed countries are those within the Asian regional supply chain. The EU’s sluggish growth has been a source of major concern to China.

Some of us who believed before the 2008 global financial crisis that the EDEs have decoupled from the AEs were proved wrong. Any worsening of the situation in US, EU and Japan would also likely end up recoupling with AEs. Thus, it is advisable that the EDEs should remain vigilant and rebuild their buffers to ensure that they have adequate policy space to safeguard against unanticipated exogenous shocks emanating both domestically or externally.

*I now turn to the Economic situation in South Asia.*

South Asian countries have done remarkably well in raising the per capita incomes of their population under adverse and uncertain external environment. For the past 20 years the average growth rate has been 6 percent annually. Consequently the proportion of population living below the poverty line has declined from 61% to 36% between 1981 and 2008. GDP growth rate in 2011 was 7.3 percent. However, it has slowed down to 4.8 percent in the current year but is expected to resume its trajectory with 5.2, 6 and 6.4 percent in the next three years. The recent slowdown reflects a continued deceleration in India but also lower growth in Pakistan and Sri Lanka.

The regional trade balance deteriorated in 2012 due to weakening exports and rising demand for crude oil and other imports. Sri Lanka and India’s current account deficit widened sharply in the last two years. Bangladesh and Nepal have had comfortable current account balances while Pakistan was able to manage it. All these countries are recipients of large volumes of workers’ remittances.

I would now submit that the problems that are staring starkly in face of the South Asian policy makers are domestic in nature and not external. Unless these problems are tackled and political will is demonstrated the stop-Go cycle will continue its path. The EU Debt Crisis has had very little impact but our own policies and stances have done more harm. External risks from EU have diminished. We have to revisit these issues:

* Subsidies on fuel, goods and fertilizers not targeted and widen fiscal deficits.
* Infrastructure bottlenecks and energy shortages.
* Corruption and weak governance.
* Domestic policy uncertainties reform agenda.
* Security concerns, Social unrest
* Poor harvest in Nepal
* Capacity constraints
* Weaker investment activity.

Intensification of Euro area debt tensions in mid-2012 did cause some weakening of exports across the region. Regional exports fell by 4 percent in US$ terms in 2012. The Euro Area economy , South Asia’s largest export market contracted by 0.5 percent in 2012. Global trade began firming in the fourth quarter. South Asia’s imports also rose at a much slower pace (4 percent) compared with a 32% increase in the previous year.

Additional external demand for South Asia has to come from other EDEs which have become important destination of South Asia’s exports. The relative share of EU and the US in Asia’s trade has come down to 25 percent in 2012 from 30 percent in 2007 and this trend is likely to persist in the future. South Asia’s exports to EDEs have risen from 19 percent of overall exports in 2000 to 35 percent in 2011.

What does the future outlook for the EU look like? EU economy is expected to stabilize in the first half of 2013. GDP growth is projected to turn positive gradually in the second half of the year before gaining some traction in 2014. While the financial market situation has improved significantly and interest rates have declined, this has not yet fed through to the real economy. There are so far only timid signs of easing financial fragmentation across states and enterprise in vulnerable economies which continue to face tight credit conditions.

In the light of the constrained domestic demand, net exports are set to be the main growth driver. The reduction in fiscal deficit is set to continue. The current account of several vulnerable countries is expected to turn positive, helped by lower domestic absorption as well as competitiveness gains on the back of wage moderation and increased productivity. There is evidence that the decrease in unit labor costs in vulnerable countries has helped re-establish operating margins in the tradable sector which should help underpin the necessary reallocation of resources towards the production of tradable goods.

South Asian Countries’ exports to EU will perhaps not increase because of the stagnant demand but as most of these exports are not highly income elastic the relative impact to unlikely to be significant. The 2012 dip in exports was mainly precipitated by the uncertainty about the stability and integrity of Euro currency zone. As the actions taken by the ECB since then have brought about some calm and stability and the debt refinancing and pricing are largely under control in the peripheral countries the repetition of 2012 situation seems remote. Global trade is expanding once again and South – South trade is picking the momentum. Chine has become the leading trading partner of South Asia countries including that of India. The slack in the trade with EU may be picked up by the trade to other EDEs. The outlook for world prices of metals and minerals and commodities including oil is that of lower prices. This may also help the trade imbalance in some of the commodities import dependent countries in the region.

The other channels such as capital flows between EU and South Asia have been gradually adjusting since 2008. The European banks are cutting down their exposure to EDEs including South Asia. Portfolio equity flows to Indian and Pakistani markets has flown in because of the lower interest rates in the AEs. These inflows (about US$20 billion) do not constitute a disruptive threat even if they are withdrawn suddenly and abruptly. Market cap of companies listed on Mumbai Stock Exchange is alone $1,320 billion.

India has witnessed a downward movement in Foreign Direct Investment because of the policy uncertainty and political ambiguity about the opening up of the sectors such as Retail, Banking and Financial services etc. to foreign investors. If the policy environment becomes more clear, India due to its large market size can benefit from substantial inflows of FDI thus offsetting its chronic current account deficit. Infrastructure and Energy supply constraints can also be eased.

In the Middle East and North Africa, GDP growth has been disrupted by political and social tensions. The capital exporting countries such as GCC who are looking for alternative destinations may divert their attention to South Asia if policy and business environment become more investor friendly, transparency, continuity and predictability are assured and bureaucratic hurdles are removed.

The World Bank has highlighted several new risks that the EDEs are likely to face. Japan’s aggressive stance in stimulating fiscal and monetary policies could reduce the competitiveness of EDEs in markets in which they directly compete with Japan. A 21 percent real effective depreciation of year since 2012 has hurt many economies. The unwinding of highly accommodative monetary policy stances in the US and other AEs is raising the specter of higher borrowing costs for EDEs. Countries that have run up private and public sector debt during the low interest period could be particularly vulnerable.

Net private capital flows to South Asia now account for 4 percent of GDP compared to 3 percent on average in the past. Higher interest rates will increase debt servicing costs and could increase default rates on existing loans. Banks in countries that have enjoyed very strong growth and asset-price inflation, together with high levels of Governments in private sector debt may be at particular risk. In the longer term, higher interest rates will raise the cost of capital in EDEs and reduce the level of investments that the firms wish to maintain. As investment rates adjust to these higher capital costs, EDE investment and growth can be expected to decline as much as 0.8 percentage points per annum after three years. Abundance of global liquidity resulting from Financial Market stabilization and accommodative monetary policies in AEs has led to capital controls by many emerging countries to preserve their competitiveness.

Let me conclude by summarizing the basic argument of my presentation this morning. There is no doubt that the EU crisis did hit the SAARC countries but like other EDEs these countries were also able to rebound quickly. The economic performance of South Asia in the last two decades has been impressive and a lot of gains have been made. But in the last few years the structural weaknesses of these economies particularly the supply side constraints – infrastructure deficiencies and energy shortages, unfriendly business environment resulting in high cost of doing business, lack of fiscal control by providing untargeted subsidies, weak governance and corruption, difficulties of coalition politics and policy uncertainty have combined to slow down the economies in the region. An unfavorable external environment hasn’t helped either. But going forward the challenge is to create adequate policy space and buffers to withstand the external shocks. This can only be done if we resolve to do some cleaning up and put our house in order. Let us not forget what is ahead of us.

Over the next 20 years, one million new workers will be entering the South Asian labor force each month. Countries will need to improve their business climate and policy environment to attract the private sector investment needed for these new entrants to find productive job.

1. *Keynote address at the SAARC Governor Symposium, Islamabad on June 18, 2013* [↑](#footnote-ref-1)