With a Steady Hand

Essays on Long-Term Investing

Number 11

From crisis to crisis

By Karl-Heinz Thielmann

Speed Read:

- Two groups of countries have emerged in the global economy: nations that accumulate deficits due to high ongoing capital imports, and countries funding these nations with money generated by their export surpluses.
- The principal reasons for the excessive capital imports are corruptive structures or real-estate bubbles in the debtor countries as well as naivety in the creditor countries.
- For almost 200 years, investors have been making the same mistake: buying assets in countries with structural deficits. Financial crises have become a common method to devalue debts when repayment is impossible.
- Despite the evidence, many fund managers and rating agencies still ignore the role of sustained current account deficits and continue investing in problem countries. Therefore, we will continue moving from crisis to crisis.

Here we go again. The crises are back. Not in Greece, Spain or Ireland this time, but in Turkey, Indonesia and India. And, once again, a lot of economists and fund managers are surprised. However, these current developments actually follow a familiar pattern. For many years the international financial markets have financed the current account deficits of countries with structural problems. Eventually, however, the capital flows reverse and the debts cannot be repaid. This triggers great lamentation.

And this time we should have known yet again: sustained current account deficits are unhealthy. And they are particularly unhealthy when coupled with corruption-prone governmental machinery or inflated property markets.

While money tends to be increasingly wasted by the corrupt elites in emerging markets (as well as in Greece and Italy), out-of-hand property markets are causing the debacle in western democracies (with the exception of Greece and Italy). The other cause is the foreign investors, who - attracted by optimistic economic forecasts and high interest rates - are financing the whole nonsense.

This is nothing new. In 1825, the first wave of capital exports to South America came to an end with a great stock market crash. However the frequency of these crises has increased in recent years. With the Latin-American debt crisis and the US savings and loans crisis in the 80s, the EMS crisis at the beginning of the 90s, the Asia and Russia crisis at the end of the 90s, the US subprime crisis in 2007 and, more recently, the Euro-crisis, the crisis carousel is rotating faster and faster. And all of the crises clearly have one factor in common: capital imports that have been unproductively wasted in the recipient countries. This simple truth has, however, been persistently ignored by the major rating agencies and many of the fund managers responsible for international investments. For this reason they have been making the same mistakes over and over again for decades.

Some weeks ago, there were heated debates about German export surpluses in the international media. However most of the articles failed to mention that these high exports of goods have also led to high exports of capital. As a result, there is a permanent requirement for foreign investments in Germany and similar exporting countries.

Unfortunately, the Germans in particular do not tend to wisely invest their capital abroad. This has given rise to the expressions "stupid German money" or "dumb German money" in the international financial sector. The Berlin-based German Institute of Economic Research (DIW) has estimated that the total losses of German investors abroad were € 400 billion between 1999 and 2012. This makes them the preferred financiers of crisis states and other money wasters. The export champion likes to gamble away its hard-earned money in problem countries. And it isn't alone; indeed, in this respect, it stands shoulder-to-shoulder with Japanese financial institutions, Russian oligarchs and Arabian oil sheiks.

The succession of financial crises is therefore the reflection of the export successes of Germany and several other countries with structural surpluses. These are the exporters of basic resources such as the Gulf States, Russia or Nigeria. Examples of the developed economies, other than Germany, are countries like Switzerland or Sweden, which are specialised in high-quality products. I will refer to this group of countries as those that "generate surplus capital" (abbreviated to GSC countries) here. These countries finance the deficits of others with their export surpluses. However, this does not necessarily have to result in losses. The Scandinavians, in particular, have found a way of investing their surplus capital profitably by putting it into their national pension funds (the largest and best-known fund is the Norwegian fund).

The other side of the coin is the countries that have a permanent lack of investment capital and, as a result, have to turn to foreign investors, who will never see the full amount of their money returned again. I will refer to these countries as those that "burn other people's money" here (BOPM countries).

These are, on the one hand, some of the Anglo-American countries such as Australia, USA or the United Kingdom, which successfully cultivate a capitalist image and have, as a result, been attracting foreigners who have had enough of bureaucracy and over-regulation in their home nations. These naive newcomers are relieved of their money with attractively marketed real-estate investments, financial innovations, movie financing or resource extraction projects. It is interesting that the service sector plays a dominant role in the economies of all these countries. And especially the financial service sector is delighted to guide foreigners towards making bad investments. Nevertheless, these countries have not yet destroyed money excessively - not even with the occasional real-estate bubbles - and have therefore not seriously upset anybody on the international financial markets.

On the other hand, there are a number of countries that attract money with optimistic growth forecasts, based on the fact that their economies are lagging behind and have to catch up with the developed world. However, the crucial economic reforms are a sham or only implemented half-heartedly. It is chiefly the corrupt elites that grow rich on the capital imports, while productivity and international competitiveness suffer. These are countries such as Greece, Turkey, India, Brazil and Indonesia.

But the plight of these BOPM countries is not without hope either. South Korea transformed from a BOPM country into a GSC country after the 1998 crisis. But it has remained an exception. Japan, on the other hand, has had enough of its role as a GSC country and is currently heading in the opposite direction.

At the moment we have a global economic balance: the export success of some nations is generating value, which is in turn squandered by other countries. To prevent the donor countries from becoming too rich, which would give rise to an large imbalance, the recipient countries have to devalue their debts on a regular basis, taking either the "soft" route by devaluing their currency or it happens "the hard way" through a financial crisis.

Main drivers of economic development

	Emerging markets	Developed economies
Sustained capital importers (BOPM-countries)	India, Turkey, Brazil **Need to catch up**	Australia, USA, United Kingdom **Services**
Sustained capital exporters (GSC-countries)	Russia, Gulf Staates, Nigeria **Basic resources**	Germany, Switzerland, Sweden **Product quality**

Every couple of years, there is a massive wake-up call in some region of the globe - the debtors have gone bust and need to be "rescued". However, this rescue mainly consists of complex debt restructuring, with the creditors ending up paying more. The fact that real changes - such as for example in South Korea - have been few and far between has not stopped investors from being taken in by an almost 200-year-old trick when making international investments. In this respect, we can expect idiotic capital flows to continue alternating with crises over the next years.

From a GSC-country point of view, this is a rather gloomy prospect. It might help if part of the surplus capital could be diverted into a professionally managed national pension fund, like in Norway for example. And of course the financial industry could also start making offers to their clients that are not based on overoptimistic forecasts, and therefore no longer provide investors with an incentive to continue pumping their capital into BOPM countries.

But people in BOPM-countries should worry even more. The persistence of value-destroying investment methods points to a serious structural flaw in the allocation of resources. The recurring crises hurt the local population and efficient capital formation even more than the foreign investors.

A conclusion that can be drawn for individual investors is that long-term investments only in the bonds and currencies of developed economies with current account surpluses appear to be relatively safe. Stock-market investors can also find interesting investment opportunities in developed BOPM countries or resource-rich countries; however, they should be aware that they involve a greater degree of risk. Especially Australia looks quite vulnerable right now.

On the other hand, investments in countries that are lagging behind and have accumulated current account deficits are ruinous in the long term. Nevertheless, in the coming years, these countries will continue to attract investors who are not willing to listen to reason. Unfortunately we can continue to assume that many fund managers will carry on playing a major role in this regard, in particular in major asset managers.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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Sources:

DIW Wochenbericht Nr. 26 2013 http://www.diw.de/documents/publikationen/73/diw_01.c.423458.de/13-26.pdf

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