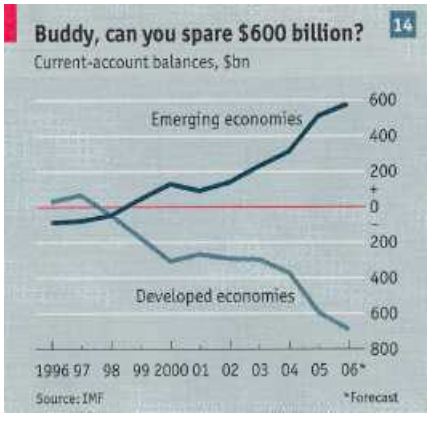
A topsy-turvy world

How Long will emerging economies continue to finance America's spendthrift habits?

MANY economists have long been expecting America's widening current-account deficit to cause a financial meltdown in the dollar and the bond market. The main reason why this has not happened (yet) is that emerging economies have been happy to finance that deficit. In 2005 this group of countries ran a combined current-account surplus of over $500 billion (see chart 14). A large chunk of that was invested in American Treasury securities, in what Ken Rogoff of Harvard University has called "the biggest foreign-aid programme in world history".

The flow of capital from poor countries to the richest economy in the world is exactly the opposite of what economic theory would predict. According to the textbooks, capital should flow from rich countries with abundant capital, such as America, to poorer ones, such as China, where capital is relatively scarce, so returns are higher. This is what happened during the globalisation of the late 19th century, when surplus European saving financed the development of America. Between 1880 and 1914, Britain ran an average current-account surplus of 5% of GDP. In contrast, America today has a deficit of 7% of GDP. It seems perverse that poor countries today prefer to buy low-yielding American government bonds when they could earn higher returns by investing in their own economies.

So why are they doing it? One explanation is the so-called "Bretton Woods 2" thesis put forward three years ago by Michael



Dooley, David Folkerts-Landau and Peter Garber at Deutsche Bank. (Bretton Woods was the system of fixed exchange rates that prevailed for a quarter of a century after the second world war.) They argue that Asian economies are pursuing a deliberate policy of currency undervaluation to ensure strong export-led growth. To hold their currencies down, Asian central banks have been buying lots of American Treasury bonds. This reduces interest rates and supports consumer spending in the United States, allowing Americans to buy lots more Asian exports-which, the authors argue, suits both Asia and America.

Furthermore, they say, opening its doors to foreign direct investment (FDI) has helped China to build a world-class capital stock. Emerging economies with poorly developed financial markets are not good at allocating capital, so they buy Treasury bonds and let American firms do the domestic investment for them. Admittedly the return on Treasury bonds is lower than the return on FDI, but this, the authors reckon, is a small price to pay for more efficient domestic investment and hence faster long-term growth.

The bottom line of this theory is that the main blame for America's deficit lies with Asia's emerging economies, rather than with America itself. And because the arrangement is in those Asian countries' economic interest, the theory suggests, they will go on financing America's deficit for a good many years.

Lost in the woods

However, Morris Goldstein and Nicholas Lardy, at the Institute for International Economics in Washington, DC, argue that Bretton Woods 2 does not explain China's behaviour in the past, and it certainly would not be in China's interest to go on behaving that way in future. The first flaw in the theory is that America takes only one-fifth of China's exports, with Europe a close runner-up. So if China were trying to keep the yuan undervalued, it would surely do better to hold down its real trade-weighted exchange rate, which rose by 35% during the dollar's climb from 1994 to 2001.

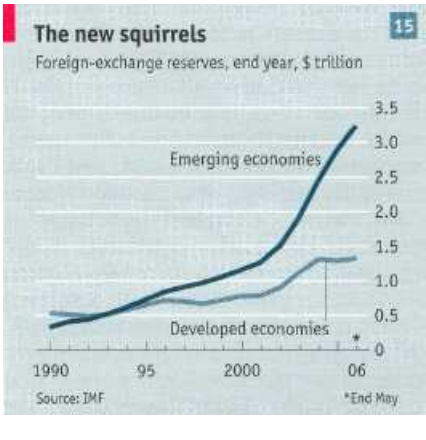
China's main motive for tying the yuan closely to the dollar has been financial stability, not crude mercantilism. But now a rigid exchange rate looks as though it might become a source of instability. The

large build-up of reserves that has resulted from currency intervention is creating excess liquidity, with its attendant risks of inflation, asset-price bubbles and a serious misallocation of capital.

The dollar "peg" has forced China to adopt an excessively lax monetary policy. Real interest rates of 3% are far too low for an economy growing at 10%, but there is little room to raise rates because that would attract more inflows of short-term capital and so require even greater intervention, further boosting liquidity. China needs a more flexible exchange rate so it can regain control of its monetary policy.

Another reason why building up yet more reserves is not in the interest of Asian central banks is that it would expose them to large future losses when their currencies do eventually appreciate against the dollar. Emerging economies hold 70% of global foreign-exchange reserves (see chart 15), mainly in dollars, and account for four of the top five holders of reserves (China, South Korea, Taiwan and Russia). By the end of this year China's reserves are likely to reach $1 trillion. Messrs Roubini and Setser calculate that a 33% rise in the yuan-which is quite possible over several years-would imply a politically embarrassing capital loss of 15% of China's GDP. The longer that countries accumulate reserves, the bigger the potential losses.

A third defect in the Bretton Woods 2 theory, according to Messrs Goldstein and Lardy, is that in recent years FDI has financed less than 5% of China's fixed investment, clearly nowhere near enough to have helped create a world-class capital stock. The only way that China can ensure a better allocation of capital is by reforming its domestic financial system and by using higher interest rates to cool over-investment. Again, that suggests it is now in China's own interest to allow more flexibility in its exchange rate, which means buying fewer Treasury bonds.



All this suggests that China now needs to set its currency free for the sake of its own economy, rather than America's. Indeed, a revaluation of the yuan by itself probably would not make much of a dent in America's current-account deficit, because it would not solve the structural imbalance between saving and investment. America has a huge deficit largely because it saves too little. Politicians, however, prefer to blame China.

The final nail in the coffin of Bretton Woods 2 is that the increase in China's external surplus has been much too small to account for America's deficit. Estimates for 2006 suggest that China's current-account surplus has widened by $140 billion since 1997, whereas America's deficit has expanded by $720 billion. By far the largest counterpart to America's deficit today is the group of emerging oil exporters, which have moved from rough balance in 1997 to an estimated surplus of $425 billion this year-much larger than emerging Asia's total surplus of $250 billion.

Oil exporters are determined not to repeat their mistakes after previous oil-price jumps. They have been much more cautious in spending their revenues, saving a larger share than in the past. So far, the bulk of petrodollars has probably gone into relatively liquid dollar assets. But these countries have greater reason than Asia to invest in non-dollar currencies, because they trade much less with America. And petrodollars are mostly managed by investment funds that aim to maximise returns, so oil exporters' assets are more footloose than those of Asian central banks and could quickly shift out of the dollar if it starts to slide again.

Too much of a good thing

Mr Bernanke has argued that America's deficit is the innocent by-product of a saving glut in emerging economies. If the rest of the world saves more than it invests (ie, runs a current-account surplus), then America has to run a deficit. The implication is that America's deficit is more sustainable than generally thought. But this still begs the question of why emerging economies have excess saving when their return on investment is higher than in rich countries.

A paper presented by Raghuram Rajan, chief economist of the IMF, at this year's annual symposium of the Federal Reserve Bank of Kansas City offers a tentative explanation. Mr Rajan argues that fast-growing poor countries tend to generate more saving than they can use because of their underdeveloped financial systems.

Thus when a country experiences rapid productivity growth, consumers save much of their income gains. But the opportunities for transferring those savings into domestic investment through the financial system are limited, so saving typically exceeds investment and the country runs a current-account surplus. This also explains the unexpected finding that emerg- >

> ing economies that rely least on foreign finance tend to enjoy the fastest growth. Faster-growing economies simply generate more domestic saving.

But this means that capital flows to the United States are sustainable only as long as emerging economies' domestic financial systems remain immature and unable to offer the usual range of financial instruments; and such shortcomings have a clear economic cost. In the years ahead, as these countries' domestic financial systems develop, their current-account surpluses are likely to disappear.

How long might that take? Consider China, the thriftiest of them all, which saves almost 50% of its annual GDP. Many people believe that this is because Chinese households need to maintain a large financial cushion to make up for the lack of a social safety net and the absence of consumer credit. However, Louis Kuijs, an economist at the World Bank, says that China's household saving rate, at 16% of GDP, is not abnormally high; in fact, it is lower than India's. Whfat pushes the overall rate to such exalted levels is huge saving by companies and by the government. State firms do not pay dividends, so high profits in recent years have pushed up their saving. Government saving is also unusually high.

On the basis of current policies and expected changes in income and demographics, Mr Kuijs predicts that China's saving rate will fall only modestly over the coming years, still leaving a substantial current-account surplus in two decades' time. But if the government implements reforms, forcing firms to pay dividends, liberalising financial markets and spending more on health and education, then China's current account could be brought into rough balance by 2020, he says.

However, another World Bank paper, by David Dollar and Aart Kraay, suggests that China could be running sizeable deficits by then. The authors say that it does not make sense for China to be a large net supplier of capital to the rest of the world when its productivity is growing rapidly and its capital-labour ratio is only one-tenth of that in America. They put this distortion down mainly to extensive capital controls that prevent residents from borrowing abroad and foreigners from investing in China. If all capital controls were scrapped and the government pushed ahead with economic and financial reforms, China would run a current-account deficit of 2-5% of GDP, they reckon.

Capital-market reforms should also bring down net saving in other emerging economies. In other words, at some time in the future, emerging economies may no longer provide capital to the rest of the world, but instead run current-account deficits. This will increase the global cost of capital, especially in America.

But before that happens, emerging economies' investment in foreign assets is likely to change its composition, favouring corporate assets rather than low-yielding Treasury bonds. The snag is that American politicians are most reluctant to allow Chinese, Russian or Middle Eastern firms to have a controlling interest in American firms: witness the failed attempt by China's CNOOC, a state-owned oil company, to buy Unocal last year, and Dubai Ports World's aborted takeover of several American ports this year. As long as America depends on foreign capital, it needs to be less picky.

The world's present external imbalances are neither desirable nor sustainable. Those who argue that poor countries will continue to finance America's current-account deficit long into the future seem to forget that one day it will have to pay back the money.

Nor are the current arrangements in the long-term interest of America's economy. By buying dollar assets, Asian central banks are subsidising American consumers, encouraging too little saving, too much spending and excessive investment in housing. Asia's central banks have turned off the usual market signal of rising bond yields which should be telling America to put its house in order. As long as America can get cheap money from abroad, it has little incentive to rebalance its economy.

When global imbalances are eventually unwound, the process will hurt even more. Unless America reduces its deficit before emerging economies lose interest in accumulating reserves, the dollar, Treasury bonds and the whole American economy are likely to suffer a hard landing. •

Fonte: The Economist, v.380, n.8495, p.24-26, 16 Sept. 2006.