

China, Japan and the Underwriting of the US: How Long?

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By EDUARDO PORTER

America's unprecedented and growing dependence on foreign capital to finance its ballooning trade and budget deficits periodically merits a piece in the business pages. Readers shake their heads, and then forget about it. Even academic economists tend to shy away from the issue, at least in print. Most recognize that a severe crisis is brewing, but they are wary of looking foolish by writing about it and then watching nothing happen in the short run. And plenty of business economists, convinced that America's deficits and their precarious financing are the pillars of a robust economy, rudely dismiss any cautions as hyperventilating. But some staunchly market-oriented analysts are worth heeding, including Morgan Stanley's Stephen Roach. During America's stock-price bubble, Roach was one of the first to bell the cat. Being a skeptic in an era of blind faith and herd instinct takes guts, but he turned out to be right. For some months Roach has been warning that the US dependence on the inflow of money from Asian central banks is showing dangerous signs of reaching its limits. He points to the increasing role of central banks as the buyer of last resort, and its worrisome parallel in the Black Monday stock market collapse of October 1987. He's warned for months (<http://www.morganstanley.com/GEFdata/digests/20040823-mon.html>) that a serious crisis is unfolding, especially as it's fed by such ancillary forces as skyrocketing oil prices and the erosion of trust in America. The pangloss crowd dismiss this of course, but reports

indicate that Warren Buffet, the world's most savvy investor and its richest man, has already pulled his fortune out of American-dollar investments. If Asian central bankers back off too, we will all painfully relearn that - as economist Herbert Stein used to say - if something is unsustainable, then someday it will stop.

The flow of foreign capital contracted in August as private investors lost some of their appetite for American stocks and bonds, underscoring the United States' increasing dependence on financing from central banks in Asia.

The Treasury Department reported yesterday that net monthly capital flows from the rest of the world fell for the sixth time this year, declining to \$59 billion from \$63 billion in July. Private investment from abroad fell by nearly half - to \$37.4 billion in August from \$72.9 billion the month before. Investors appear to be concerned over cooling growth and a rising American trade deficit.

The only reason that the contraction was not more pronounced was that official financing, mainly from Asian central banks, jumped to nearly \$23 billion in August from just over \$6 billion in July.

Washington has demanded that China end a policy of buying dollars to reduce the value of its currency, the yuan, and make its exports more competitive in American markets. But the new data accentuated how dependent the United States has become on purchases of dollar securities by the Chinese and other Asian governments with links to the dollar.

"Foreign central banks saved the dollar from disaster," said Ashraf Laidi, chief currency analyst of the MG Financial Group. "The stability of the bond market is at the mercy of

Asian purchases of U.S. Treasuries."

Net foreign purchases of United States Treasury bonds fell 35 percent, to roughly \$14.5 billion, an 11-month low. Foreign governments left a particularly large footprint in this market, stepping up their net purchases to about \$19 billion even as private investors sold about \$4.5 billion worth.

Holdings of Treasury bonds by Japan, where the central bank has also been intervening to keep the value of its currency from rising, increased by \$26 billion in August, to \$722 billion. Chinese official holdings rose more than \$5 billion, to \$172 billion.

The decline in foreign investment seems to have unsettled some investors in the bond and currency markets, who have been on tenterhooks as the American trade deficit has soared to nearly 6 percent of the nation's economic output, requiring foreign investment to finance it.

Through the first quarter of the year, financial flows into the United States exceeded the trade deficit by well over 50 percent. Last month, they barely covered the \$54.2 billion deficit.

As private capital flows declined, the American financial balance has been poised precariously. As private financing dwindled, most of this coverage has been provided by foreign government finance.

"If all we have funding our current account imbalance is the good graces of foreign central banks, we are on increasingly thin ice," said Stephen S. Roach, the chief economist at Morgan Stanley. Of Washington's call for China to stop interfering in currency markets, he cautioned, "That could come back and bite us."

Not all economists are that worried about the growing shortfall in the current account, the broadest measure of trade, pointing out that it is sustainable as long as Asians continue on a path of export-led growth that requires cheap

currencies against the dollar.

Many economists stress, however, that this symbiotic balance between Asian and American economies will eventually come to an end.

Jeffrey Frankel, an economics professor at Harvard University, said: "The Asians are going to go on buying Treasury securities for a while, preventing the dollar from depreciating and helping keep U.S. interest rates low, which is a good thing. But not forever."

Morris Goldstein of the Institute for International Economics remarked, "This can be a story for one year or two years, not for 10 years."

If the United States were to temper its appetite for foreign money, the Chinese and Japanese could curtail their purchases of American securities without causing financial havoc. The dollar could then drift lower against Asian currencies, benefiting American exporters and manufacturers that compete with Asian imports.

But this would require Americans to increase their rate of savings. Household savings have plummeted to only 1.5 percent of personal income, from 11 percent 20 years ago. With the federal government running a budget deficit of 3.5 percent of the nation's output, the public sector hardly contributes to savings.

A disorderly situation would occur if foreign money dried up suddenly when the United States still needed it. Then, the adjustment in American savings might happen involuntarily. Interest rates would rise sharply, and the dollar could fall abruptly. This could induce a sharp economic contraction, even stagflation.

"The longer we wait," Mr. Goldstein said, "the more likely we'll have the adjustment anyway. But the adjustment will be more chaotic and sharper."

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