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Imbalances, Illusion, Investment Prospects

■ Imbalances

Wider US external and fiscal deficits and more rapid debt accumulation can be sourced to many factors including unbalanced global growth and 'guns and butter' programmes. But the heart of the matter is the structural fall in national savings. Bigger deficits, forecast at 7-9% GDP by 2008 are hard to believe only because markets and/or politicians would most likely intervene before they became reality.

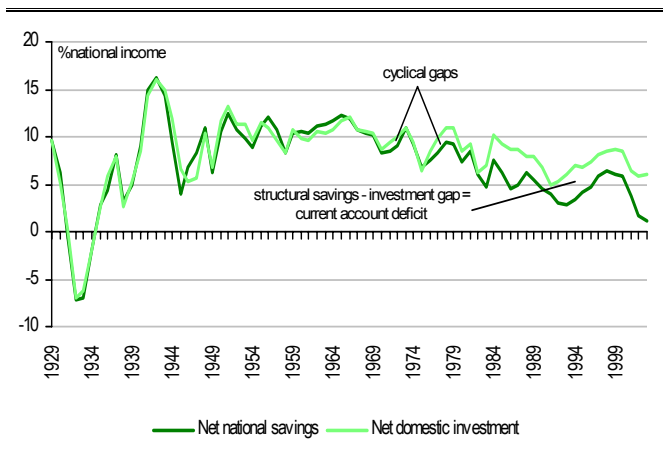
■ Illusion

For the time being, Asian central bank financing continues to suppress tensions and sustain anomalies in the USD and generic fixed income markets. To some, this is a 'revived' Bretton Woods system with a long shelf-life. To others, including ourselves it is an illusion if expedient for both the US and Asia - and liable to weaken or crack in the next 1-2 years. Markets will probably reprice in anticipation.

■ Investment prospects

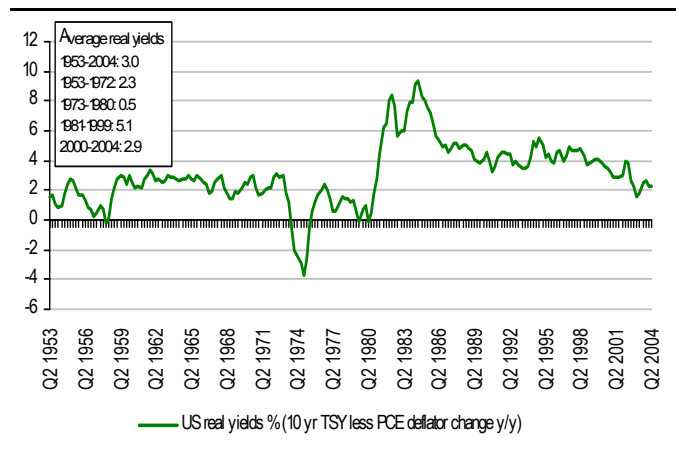
We see gradual moves towards increased Asian currency flexibility and higher real exchange rates and increasing frustration at the US imbalances outlook. The forecast is for an eventual 20-30% fall in the USD in nominal effective terms, a roughly 1% rise in real yields and the risk of a more marked cyclical economic slowdown. Higher real yields need not entail much higher nominal yields for long, if at all. But fixed income market anomalies would clearly be shaken in this environment.

US structural savings investment gap



Source: Bureau of Economic Analysis/UBS

US real yield trough...?



Source: UBS/CBO

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Imbalances, Illusion and Investment Prospects

Summary and outline

For much of 2004, financial markets have proven to be tricky, if not treacherous for investors and other market participants. Stock markets and the main USD exchange rates have lacked direction. The consensus bear view of fixed income markets, even as recently as the summer, has been stranded by stable or lower intermediate and long-term yields*. The lack of market volatility has been bemoaned in many quarters. Some have capitulated, arguing that Asian capital flows, the depth and breadth of US capital markets and the paucity of viable alternative investment opportunities mean that the status quo is likely to persist for maybe years to come. This then seems like a good moment to question that view. For this state of affairs to last, you'd have to believe that the world economy and financial flows are in some sort of equilibrium, which, sadly is very far from the truth. At the end of the research note, we will lay out how and why we expect the USD to decline, perhaps by a further 20-30% in nominal effective terms and why real yields, suppressed as they are today, are likely to rise by maybe 1-1.5% over the next years. The issue is whether the balance of adjustment lies more with the nominal yield or with inflation.

The note looks in some detail at the financial imbalances that lurk beneath the world economy's headline-making news. Although the main focus is on the US, this is not to dismiss the big sectoral imbalances that obtain in Japan and Europe, nor the important issue of reforms required in both regions to develop faster economic growth and productivity performance in the face of high levels of unemployment and the demographic challenges ahead. But the truth is that it is the US financial imbalances that matter most and so we shall look at the salient and structural characteristics of the US budget and current account imbalances. As mentioned above, financial markets seem otherwise preoccupied or distracted but the probability that US net foreign liabilities will continue to grow rapidly during a period in which the fiscal issues will become progressively more difficult lends credence to those that believe that the USD will continue to fall and that real interest rates are too low currently. These, in turn, have slower domestic economy implications but these are not the main focus of this paper.

Context is important as we start by assessing the imbalances in a political economy framework. The great issues with significant financial implications that have been coming into ever-sharper focus in the last 2-3 years, not to mention since the start of the 1990s are national and international security, the effects of demographic changes and the growing economic and financial role of Asia.

Markets lacking direction and volatility but USD and real interest rate changes overdue

Main focus is on US fiscal and external deficits and debt

Security, demographics and Asia are the key issues for imbalances

* To some considerable degree, the role of \$45-55 oil prices in influencing lower growth expectations and the persistence of benign core inflation should not be underestimated here. (See for example Oil: Waiting in the Wings? *Global Economic Perspectives* 5 August 2004). However, oil is not central to this paper's focus on (real) yield determination.

Addressing the imbalances and financial market implications has become more difficult since 2001 because of the ways in which international relations have changed. US relations with France and Germany, for example, have been under some stress whilst those with several countries in Asia and the Middle East have received greater attention. In spite of the regularity of G7 and other international meetings, even the recently revived Doha trade round negotiations, international economic relations at the highest level needed to debate and commit to the kinds of structural reforms required for the financial health of the world economy appear to be playing second fiddle.

But fundamentally, there is a crucial US economic dimension to this, specifically the structural decline in national savings to levels not seen since the 1930s and in relation to national investment. The savings-investment imbalance, reflected as the current account deficit is at an all-time high and is likely to continue to grow. At times, widening budget deficits are less important if they are either largely cyclical or if private savings suffice to keep the imbalances from growing too far or for too long. In 2004, neither is the case. The general government budget deficit stands already at nearly 5% of GDP at a time when, cyclical variations aside, the national security-cum-geopolitical and demographic calls on the public purse are poised to begin a long and costly escalation. And the private sector as a whole is no position to help out as its net financial position is in balance whereas typically it has been in significant surplus. The savings the US economy needs originate from foreign investors, in particular foreign central banks recently. And as the deficits accrue, so the outstandings of liabilities, domestic and external, will continue to grow rapidly in relation to GDP but with little comfort for creditors that any turnaround is in sight. It is possible to show, as we do, how these imbalances might evolve. Some of the outcomes, in which one or both of the deficits increases to almost 10% of GDP, would probably never happen as financial markets and/or politicians intervened long before they became a reality. But that's why the content of financial imbalances is not about some undefined-in-time scenario but a context for financial markets in the next 12-24 months.

Having looked at the major issues as regards the imbalances, the paper moves on to consider why the world economy isn't responding now to what is a quite unstable financial background. One major reason is the existence of what some have called a revived 'Bretton Woods' system in the global economy. This basically likens America's economic and financial linkages with Asia to those that bound the US to Europe after World War II. In short, America's deficits can in fact be sustained for a decade or more without USD or other financial market disruption or economic adjustment because there is an almost limitless source of funding from Asia. The Orient is a region of high and rapidly growing reserves resulting from robust current account surpluses, which, in turn derive from export-led growth, which is based on undervalued and de facto fixed exchange rates. If this system is what its proponents argue, then investors should assume that the USD would be stable or stronger, that real yields would fall further and that some of the apparent anomalies in credit and instrument spreads would be validated by further developments. Risk asset markets should perform strongly.

Addressing the issues has become more difficult

US structural savings decline lies at the heart of the imbalances

The so called revived Bretton Woods system of US – Asian financing lies behind recent developments

Of course, if your scribe believed this, a rather different research offering would have been considered. More to the point, we echo the belief of many others, specifically that this way of understanding the world is an illusion, not dissimilar to the kind of new economy or new age theorising of a few years ago. It is of such importance to protagonists, antagonists and financial markets that it needs careful assessment and judgement. Some have even cast it as a 'pact with the devil'. Even though the Bretton Woods II system (BW2 as we shall call it) has an appearance that has one rushing to make BW1 comparisons, the institutional, political and economic differences are in fact quite stark. Moreover, the commitments of both the US and Asia, especially China and Japan, to permanently rigid exchange rates are not even close to those that sustained BW1 through thick and thin for not much more than 13 years. In fact, we set out to demonstrate how and why either side is likely to 'break ranks' on a 1-2 year view. Again this is not as long a period for markets as it might seem on the formal calendar. The conclusions clearly are quite different in that the status quo is simply untenable for any length of time.

In theory and *in extremis*, there are two solutions to what we see as a life-support mechanism of limited duration. One might be an Asian consumption boom, in which Asian real exchange rates would rise and at some risk to the flows underpinning low US (and European) government bond yields. The economic effect of such a boom would be to cause a major shift towards more balanced US current and capital account transactions with Asia. Higher Asian real exchange rates would presumably be officially sanctioned as an important handmaiden of quite different development strategies and goals. An alternative solution would involve re-balancing occurring but this time with the US as the driver. It might be a US recession that would lead to renewed declines in interest rates and a sustained fall in the USD from which not even Asia might be able to hide. The reduction of imbalances would occur via much weaker US demand growth, allowing private savings to pick up. There are different ways in which such a slowdown in demand could be generated and it would be preferable from a medium-term point of view if it could be directed by the Administration as a part of the structural treatment of public finances.

In reality, more likely solutions appear far more pedestrian and involve either inaction or slow-motion progress with setbacks on the way. Inaction would allow imbalances and agitation to grow, fuelling the inherent tensions in the BW2 system, possibly spilling over into occasionally troublesome financial instability and increased protectionism. The slow-motion option foresees a little of everything, a veritable pot-pourri of slower US growth and higher domestic savings, a tendency towards faster Asian domestic demand growth and the adoption of more flexibility in exchange rate matters, a weaker USD across the board and higher long-term rates (initially at least). In an ideal world, there would be a co-operative effort by the G3 regions plus China and other major emerging nations to implement the structural reforms needed for the kind of adjustment that would lead to sustained economic expansion.

In the meantime, investors and governments remain players and agents in a financial game, which is likely to exhibit growing tension and friction. The anomalies in exchange rates, interest rates and spreads are likely to persist and

But we think its an illusion, liable to crack in the next 1 to 2 years

Resolution could take the form of an Asian consumer boom or US recession...

... or more likely, in action or a little of everything but lower USD looks inevitable

possibly intensify. But history teaches us that such tensions will be resolved one way or another only when the root causes in the global economy are addressed, hopefully before some sort of crisis is precipitated. In this paper, we will try to demonstrate how these issues have remained suppressed and why they are quickly moving centre-stage.

Imbalances: fiscal and current account deficits

Context

Stepping back from the immediacy of financial markets, it is instructive to see the evolution of US fiscal and external imbalances in the context of developments since the late 1980s and the early 1990s, in fact since the collapse of the USSR – *the* defining moment of our slice of history. To some extent, this event and its aftermath unleashed political and economic forces that have ended up as contributors to today's imbalances. Defence and national security spring to mind as one obvious area. The problem of dealing with a 'greying' population and the global economic consequences of the rise and rise of Asia only date from that time. Coincidence certainly as regards the demographics, though it might be argued that the economic course that Asia embarked on in the early 1990s was related to the 'animal spirits' that were freed by the economic mood of that time.

The strictly defined defence budget as a share of GDP is of course starting to rise again but this is too narrow a focus and should include homeland security and additional financial costs arising in Iraq and Afghanistan. And the prospective costs of meeting anticipated military and homeland security demands plus the financial costs of engaging allies, let alone any future military conflicts, will clearly impose a large and continuing burden on the economy and on public finances for the foreseeable future.

The ageing population phenomenon of course is neither geopolitical nor unique to the US and was but a talking point 15 years ago. But during these last years, the inevitably foreseen demographic changes have evolved. Today they can already be seen at work in countries such as Japan, Italy and Germany and within the next 3-4 years, they will become more noticeable in the US and the UK. Neither is China and many other emerging nations spared this problem though for them the critical time lies rather further in the future. But the continued growth of public spending on social security and healthcare at rates that are bound to exceed underlying GDP growth constitutes an additional large drain on the Federal budget in years to come.

In any event, the confluence of events over the last several years that now sees strong upward pressure on defence, security and age-related expenditures is what matters. If government savings had been achieved elsewhere or private savings been encouraged to recover, the financial position today would not look as worrying. And by extension, the balance of payments deficit would not be at a record 5.7% of GDP (in Q2 2004). 'Guns and butter' programmes (named after the costs of trying to finance the Vietnam War and civil rights programmes in the 1960s with growing recourse to foreign creditors) are back and, not for the first time, they've been made problematic in the light of the tax cuts of recent years and the depletion of national savings.

USSR collapse marked a turning point for today's concerns

Defence and security spending rising again

Demographic burden on public finances intensifying

The return of 'guns and butter' programmes

Asia represents a rather different conundrum. In a rather circuitous way, you might argue that with the economic emergence of Asia in general, China and India in particular, the US is at risk of competitive disadvantage. This has nothing to do with exchange rates or prices. It has to do with the non-price competitive issues in a modern economy, such as education, the production of graduates with relevant skills, research and development and the provision of modern and adequate public infrastructure. In short, yet more demands on government funding. More immediately, the region can certainly not be accused of being behind the problem of imbalances, particularly the fiscal deficit. But it has developed the economic and financial muscle to be in a position where it is allowing, maybe even passively encouraging, the imbalances to be financed without too much problem or interruption. In terms of the mechanics of adjustment, it is interesting that while the US has principled objections to sustained Japanese foreign exchange intervention and to the RMB regime, for example, there seems not to have been a concerted campaign to 'force' alternative domestic and/or external economic policy changes. Whether or not this changes with the next Administration in 2005 remains to be seen.

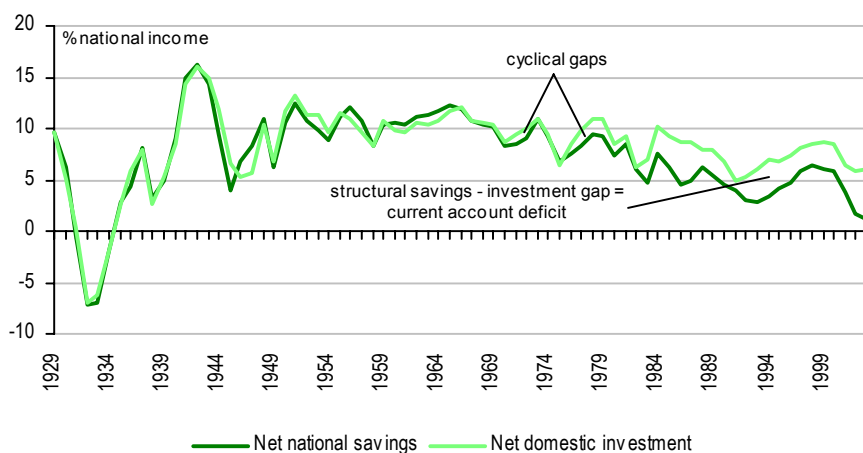
Asia presents new challenges

Balance of payments, foreign debt and fiscal perspectives

We can begin by showing the historical relationship between savings and investment in data that begin in 1929. Two major observations stand out: the first is that the net national savings rate has been falling steadily to rival the lows last seen in the mid-1930s; and that for the first time, something more than a temporary cyclical gap has opened up between net savings and investment.

Net national savings at record low

Chart 1: US structural savings investment gap

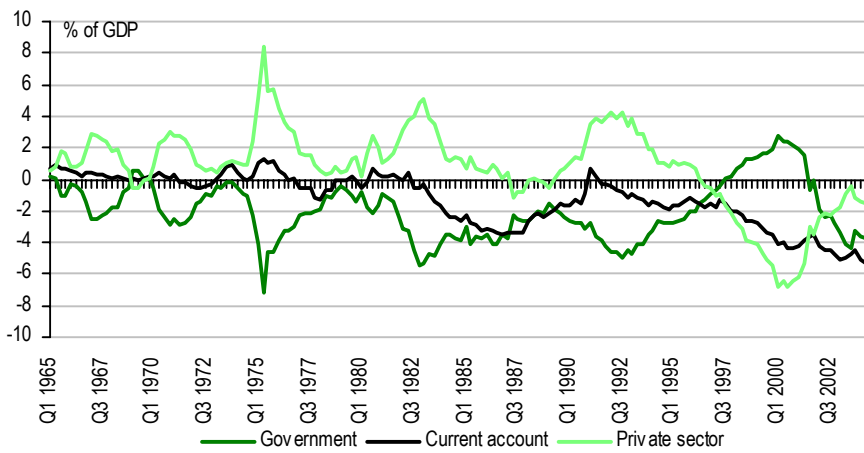


Source: Bureau of Economic Analysis/UBS

This gap stands at roughly 5% of GDP. This, as stated above and widely understood is what has to be borrowed overseas and is reflected in the current account statistics. In order to complete the picture, Chart 2 below shows the relationship between and evolution of the fiscal and current account savings-investment balances, formally the government and rest of world financial balances, along with the private sector's financial balance. That these balances necessarily sum to zero is of importance but only from the standpoint of understanding what's driving them.

Savings-investment gap at record high

Chart 2: US 'twin deficits' have increased steadily



Source: UBS/Thomson Financial Datastream/OEF

In this chart, there are three noteworthy features. The government deficit and the current account deficit (rest of world surplus) are approximately equal by virtue of the fact that the private sector's financial position is in balance.

The private sector's balance is the result of a corporate surplus and a household deficit of equivalent magnitude of roughly 2% of GDP. It's not often that companies sustain a financial surplus, though the examples of Japan, and even Europe more recently, offer a reminder that they can. But it is unprecedented that the private sector's financial balance should have fallen as far as it has done and that, three years after the last mini-recession, the household sector continues to run a fairly large deficit. Typically the sector's balance tends to average about +2-3% of GDP. We will not dwell on the historical reasoning here but note only that the absence of a private sector savings contribution makes the so-called 'twin deficits' important nowadays when in the past it may have been less so.

It follows then, if we just focus on the recent past, that while the private sector's balance has been stable, the dissaving that has contributed to the widening of the current account deficit must have arisen from the deterioration in the fiscal position. What happens next is what we will attempt to answer at the end of this section.

Growth imbalances, elasticities widen the bop deficit

For reasons that have been analysed in these pages and elsewhere many times, US domestic demand growth has been racing ahead of that in other major regions. And to the extent this is true, the assertion that the US has an elasticity asymmetry is particularly relevant. Cognoscenti will know this as the Houthakker-Magee asymmetry, an empirical observation that goes back several decades. To be precise, it is that the sensitivity of imports into the US with respect to US income growth is greater than that of US exports to the rest of the world with respect to its income growth.

Private sector balance normally in surplus but no longer

US demand growth racing ahead of others

Estimates from the US Federal Reserve suggest that US imports are more than twice as sensitive than US exports to additional growth in aggregate incomes and demand. This stands in contrast to most major economies (except the UK) where import and export elasticities are broadly similar.

Trade elasticities twice as high for imports than for exports

Table 1: Long-run import and export demand elasticities

	Imports	Exports
US	1.8	0.8
Japan	0.9	1.1
Germany	1.5	1.4
France	1.6	1.5
Italy	1.4	1.6
UK	2.2	1.1

Source: Board of Governors of the Federal Reserve System. 'Trade Elasticities for G7-Countries', Hooper, Johnson, and Marquez, April 1998.

The implication here is that US domestic demand has to grow at a rate that is considerably below overseas demand to stop the deterioration in the trade and current account deficits. Using a simple calculation

$$(H = (X/M * EX/EM) * W)$$

where H is US domestic demand growth, W is overseas demand growth, X and M are the value of exports and imports and EX and EM are the relevant elasticities), my colleague Andy Cates has calculated that overseas demand has to grow three times as fast as US domestic demand for deterioration to stop. Since this out-turn seems as distant as ever, it is an unsurprising conclusion that for as long as the US is willing and able to generate trend or above trend growth the trade imbalance is set to continue to widen.

Foreign demand need to grow three times as fast as US demand

Table 2: US domestic demand outpaces world

	1992	1995	1998	1999	2000	2001	2002	2003	2004 F
US	100.0	110.3	126.4	133.1	138.9	139.9	143.8	148.6	155.3
ROW	100.0	104.1	110.9	113.8	117.1	117.8	119.3	121.2	123.8
US/ROW	100.0	106.0	113.9	116.9	118.6	118.7	120.6	122.6	125.4

Source: OEF/UBS. Indices 1992=100 of real domestic demand. ROW is the OECD excluding the US.

From Table 2 above, we can observe that in 2004, the level of US domestic demand relative to the rest of the world is set to be about 25% higher than it was in 1992, the last time, roughly, the US current account was in balance. If, strictly hypothetically, US domestic demand were to collapse and remain unchanged for the foreseeable future and the rest of the world's domestic demand were to grow no faster than in the last 1-2 years, it would take over a decade to eliminate the 'gap'.

The imbalance between growth rates, comparing the US with a weighted construct for the rest of the world can be seen quite clearly. The standing forecast at UBS is that the US will grow by 3.2% in 2005 compared with 1.7% in both Japan and the Eurozone and that domestic demand growth in Asia will

On current forecasts...

ease back down again from this year's estimated 5.6% to just under 4.5% in 2005. The inner forecasts do not reveal any significant changes in net export contributions. Having regard for this persistent growth imbalance and the fact that the USD has risen really only appreciated significantly against the EUR, GBP, CHF and so on, it is less surprising to see that bilateral US current account and trade imbalances haven't really narrowed much, if at all.

Table 3: US current account balances with selected regions, 00-04 (USD bn)

	2000	2003	Q1 2004 ann rate
EU	-53.1	-92.8	-81.6
Canada	-28.7	-32.1	-34
Mexico	-29.2	-45.6	-44
Japan	-90.5	-73.6	-80
China*	-83.8	-124.1	-137
Korea*	-12.5	-13.1	-18

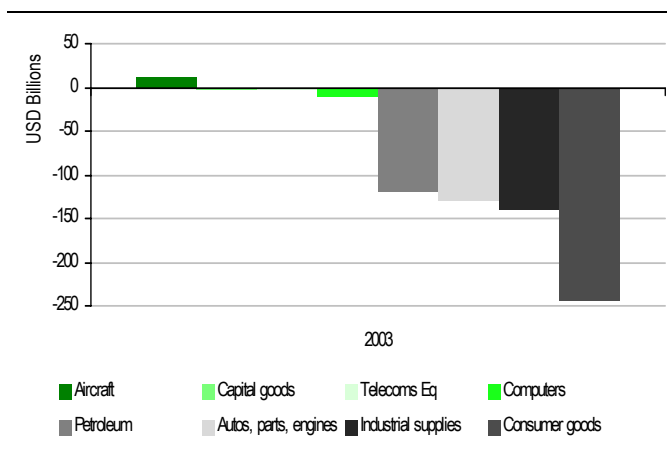
* Trade balance data only

Source: Census Bureau, Foreign Trade Stats

A feature of the US external imbalance that merits note is the way in which the disaggregated trade balance reveals other more macroeconomic characteristics of the economy. For example, as shown below in Chart 3, the structure of the trade balance comprises small surpluses or balanced trade in aircraft, capital goods excluding autos and telecommunications equipment and increasingly large deficits as regards petroleum, autos and parts, industrial supplies and consumer goods.

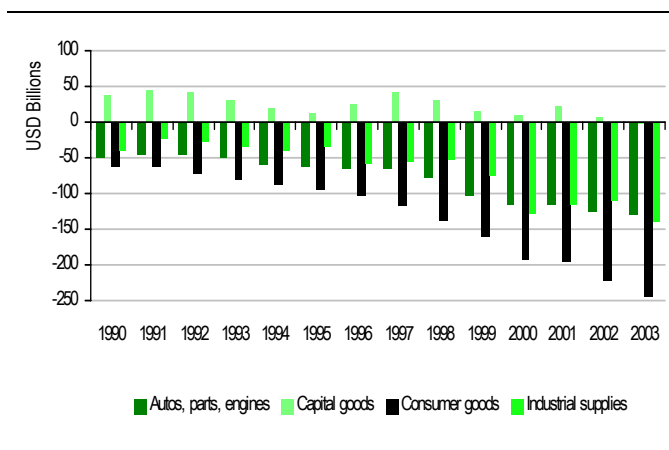
... little change in bilateral balances

Chart 3: US trade structure 2003



Source: Thomson Financial Datastream

Chart 4: Deteriorating consumer trade



Source: Thomson Financial Datastream

In and of itself, this structure reveals nothing out of the ordinary. Why shouldn't a sophisticated, modern economy have a trade structure that derives from its comparative advantage and disadvantage? However, the data series going back to 1990 are shown in order to demonstrate the evolution of some of the main contributors to the trade deficit and it is the consumer goods component that really catches the eye. This, of course, should come as no surprise having regard to both common knowledge and the preceding observations here. The increasing proclivity to import consumer goods and autos can be associated obviously with the secular decline in the household savings rate and similarly with the secular

Trade structure reflects savings and consumption trends

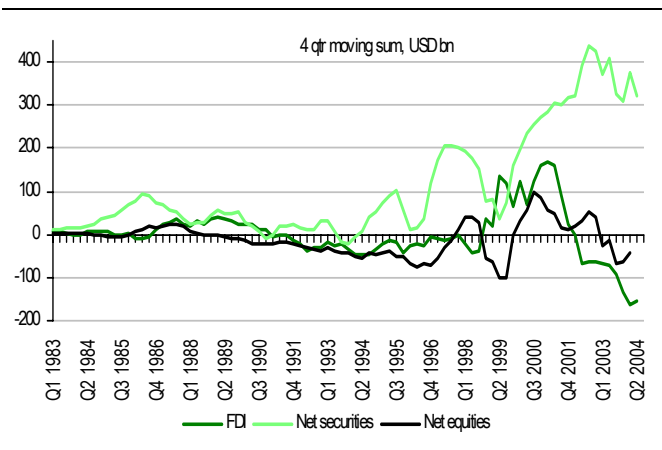
fall in the household sector's financial balance, i.e. its persistent net borrowing. In other words, the preponderance of the consumer goods-related parts of the deficit is significant because of what it shows in conjunction with balance sheet changes in the broader economy and suggests that it will be difficult to turn one around without the other.

Financing the current account deficit

Occasionally in financial markets, the comment is made that capital inflows to finance the current account deficit may be inadequate from time to time. In fact the balance of payments is so called for rather obvious reasons. There is always enough financing – but the composition of that financing and the financial terms under which it occurs, i.e. the USD and other financial asset prices, can vary a great deal. Charts 5 to 6 show recent performance of the current account balance along with the principal forms of financing.

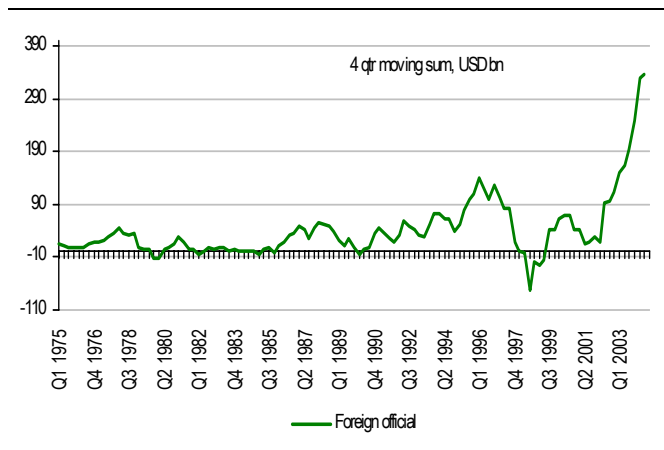
Capital inflows always sufficient: it's the composition that is more revealing

Chart 5: Financing the external deficit, private flows



Source: Thomson Financial Datastream/UBS

Chart 6: Official flows



Source: Thomson Financial Datastream/UBS

Historically, the changing composition of financing is quite clear with the emphasis on FDI and equities in the late 1990s shifting towards fixed income markets and official financing in more recent times. There are at least a couple of key points that flow from this observation. The first is that returns-oriented capital inflows, while an essential part of the theoretical understanding, seem to be taking something of a back seat in the current environment. The fact that the net flows as regards FDI and equities are outward would suggest that rate of return arguments in favour of the USD and stable current account financing are a bit fanciful. The lion's share of the capital inflow is coming from investor buying of relatively low yielding fixed income securities and from the major purchases of US government paper by foreign, mainly Asian, central banks. As the chart shows, these latter purchases have remained between a third and a half of total financing for some time.

US dependency on large inflows into low yielding assets and on foreign central banks

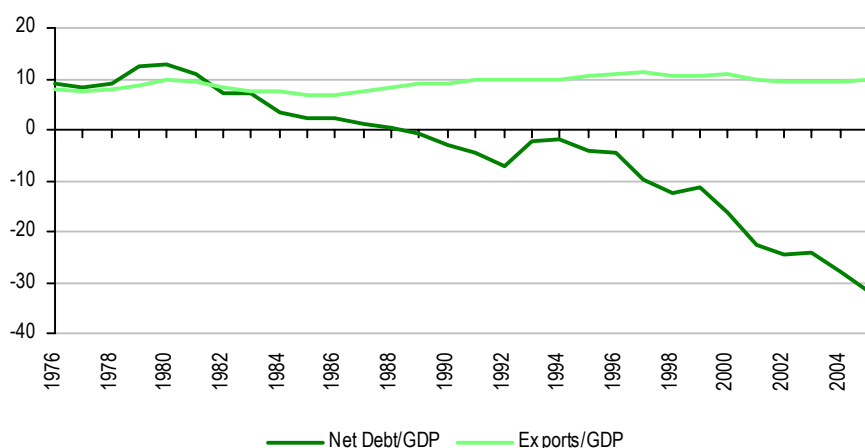
Whereas equity investors supposedly always acknowledge the 'risk' element in the securities they purchase, fixed income investors would seem to be taking on gigantic risk that isn't quite transparent. It is doubtful that the USD would be as stable or that real interest rates would be at current levels without the steady purchases of US Treasury bills and bonds by central banks. Were these to wane, the risks would become all too apparent.

Steadily increasing foreign debt

So far, we have been looking at a series of flows in the trade and current accounts and in financing arrangements. However, it is important also to consider what is happening to the stock of foreign liabilities for an important reason. Ultimately, the prices at which financial assets transact can only be sustained if there is investor confidence that the sums being lent to finance the external deficit will be repaid and in relatively constant value or appreciating currency.

The quarterly report on the Net International Investment Position (NIIP) reveals the detail and shows that US net foreign liabilities stood at about 25% of GDP at the end of 2003.

Chart 7: Mounting foreign debt but low export base



Source: Thomson Financial Datastream/UBS

The calculation of foreign debt to 2010 is not as straightforward as projecting annual current account deficits for various reasons. For example, net interest expense, which still registers small surpluses or deficits on a quarterly basis, are bound to rise if interest rates rise further and as the stock of foreign debt increases and will therefore aggravate the current account deficit while a weakening USD over time will ameliorate it as the USD value of US assets held abroad rises. But a simple extrapolation of the current account deficit rising towards 6.5% of GDP and staying there with nominal GDP increasing at about 5% indicates that net foreign liabilities would double as a % of GDP in the next 5-6 years to about 50%.

A sharp rise in net foreign debt might sit more comfortably in a macroeconomic context if the export base of the economy was growing commensurately, so that the ability to generate revenues with which to service the debt and eventually reduce it could be taken for granted. But as the chart above shows, the export share of GDP is low at about 10% for a long time and there is no reason to believe at the moment that the US stands at a point where the sectoral composition of GDP is about to shift significantly towards exports.

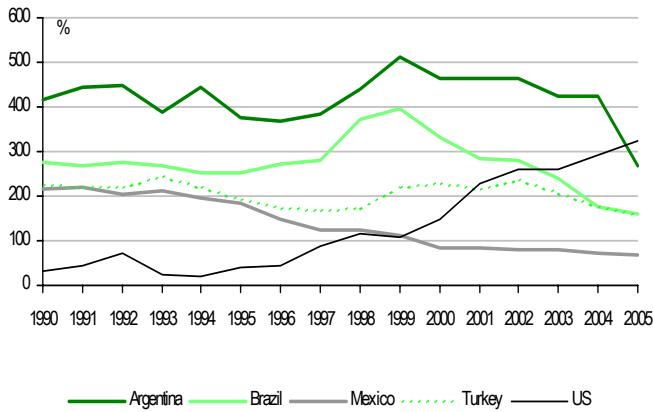
Half of debt stock is also key to asset prices

Net foreign debt about 25% GDP, on course to double

Important because of low export base

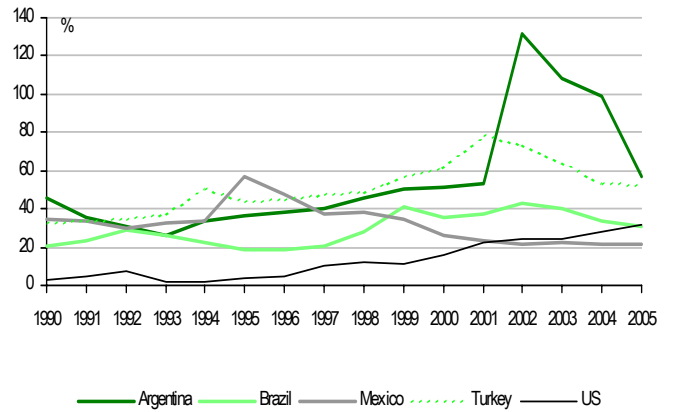
The unique position of the US in the international economy and monetary system mean, at least that comparisons of the US financial position with other major foreign debtor nations have to be treated with care. It is nonetheless of some interest to do so. The charts below show such comparisons for the US alongside Argentina, Brazil, Mexico and Turkey.

Chart 8: US has high debt:export ratio



Source: UBS

Chart 9: ... and rising debt:GDP



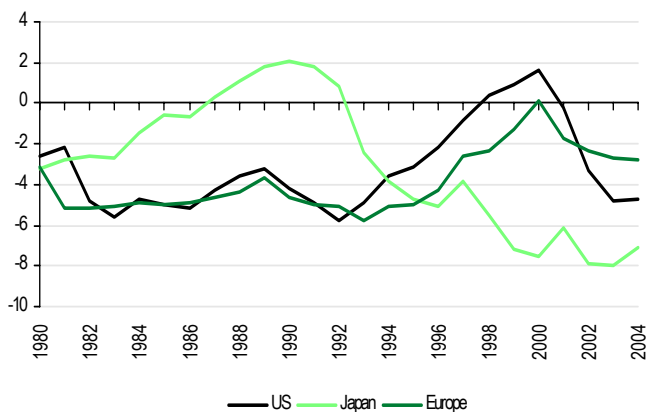
Source: UBS

While America’s net foreign debt doesn’t really register major misgivings (yet) on a comparative basis, it is clear that from the debt to exports ratio that the US is carrying markedly more debt for every dollar of exports than its debtor peers.

The fiscal ‘twin’

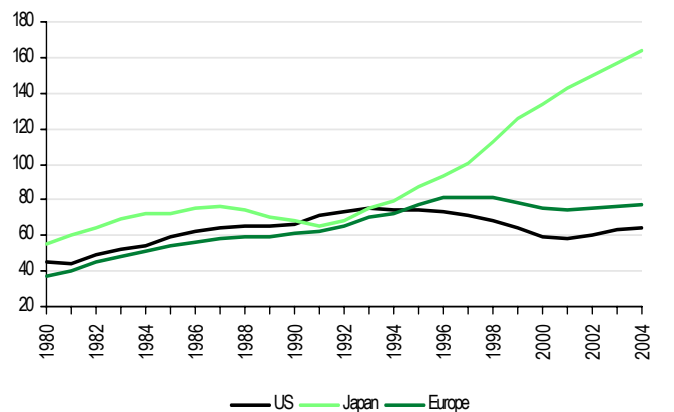
We have already shown how the budget deficit turned from a surplus of 2% GDP at the turn of the millennium in to a deficit of about 4% of GDP in 2004. In general government terms, the US deficit is now bigger than that in the Eurozone although the ratio of debt to GDP in the US remains modest for the time being.

Chart 10: General government financial balance as % GDP



Source: OECD

Chart 11: General government debt as % GDP



Source: OECD

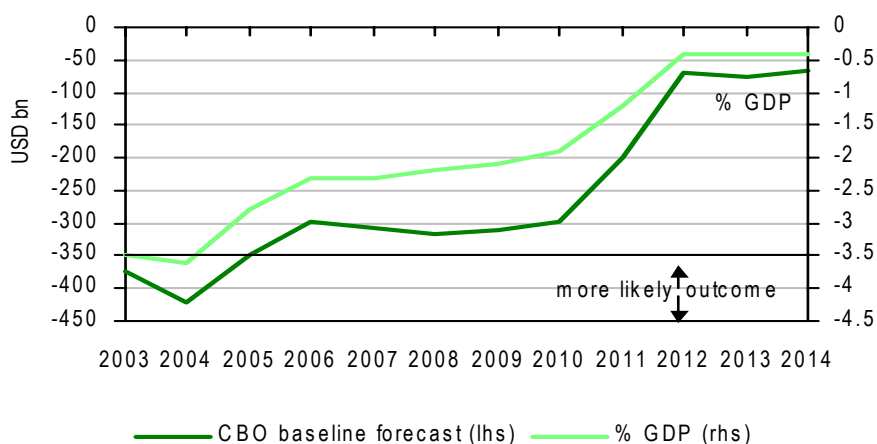
Nevertheless, the main features of the US fiscal position are that it remains weakened by the overall policy stance with respect to taxation and by the fact that almost every major discretionary spending category has grown and will continue to grow faster than GDP. Together with a particular focus on the future financial burdens of the demography and some estimates of future national and homeland security expenditures, this has prompted several observers to paint distinctly gloomy pictures of the fiscal outlook over the next 5 years, let alone into the next generation. On which note, the scariest numbers around about the intergenerational fiscal crisis provide for a current dollar financial imbalance of some USD47 trillion (4 x today's GDP). This estimate (US fiscal policies and priorities for long-run sustainability by Martin Muhleisen and Christopher Towe, IMF Occasional Paper 227) argues that closing the gap would require an immediate and permanent 60% hike in the Federal income tax yield or a 50% cut in Social Security and Medicare benefits).

Tax policies, discretionary spending pressure and a \$47 trn prospective financial imbalance

But let us stick to a nearer future. Chart 12 below shows the USD amounts and % of GDP of the budget deficit baseline forecast according to the Congressional Budget Office (CBO, January 2004) along with a rather more sober assessment as to where the deficit is liable to lie in the future as things stand today.

Unrealistic CBO baseline

Chart 12: Officially, narrower deficits ahead but...



Source: UBS/CBO

In a nutshell, the CBO is forecasting a 10-year cumulative budget deficit of USD4712 bn., which, offset by the surplus in the Social Security Trust Funds, reduces to USD2294 bn. These latter deficits diminish from over USD400bn this year to less than USD100bn by 2012. We have drawn a 'more likely' range on the deficits of between 3.5-4.5% of GDP per annum. In effect this could about double the 10-year costings by the CBO and end up with a budget deficit that averages about USD400bn per year (give or take). This is a rather different proposition – and here's why.

More likely outcome is 3.5-4.5% GDP

First, the budget deficit is rising at a time of economic recovery and robust growth (and we don't mean undershooting the Administration's overestimate). This isn't in the script and highlights some of the structural nature of the deterioration in the deficit. Secondly, there is a menu of factors that aren't included in the CBO's estimates, for example, the full cost of extending the

Deficit shouldn't be this big and CBO leaves out much detail

recent tax cuts beyond their ‘sunset’ provisions and of fully funding the Administration’s multi-year defence plan. Allowing for these, the CBO argues for deficits that are meaningfully higher, above \$400bn per year on average. There are other factors that are liable to bloat the deficit in years to come. Specifically, reform of the Alternative Minimum Tax in order to prevent its explosion in to increasingly broad swathes of the middle class could add around USD500-750mn according to some observers. Less specifically, it is likely that there will be increasing demands for spending on national and homeland security. This is not to say that all the demands for funding will be met. But many will and these include extra troops, equipment upgrades in all services for fighting a new enemy, financial costs of engaging or sustaining allies (old and new), providing improved security at ports, airports and other infrastructure and improving medical and first-attender preparedness.

And the pressure points on the deficit are not exhausted yet. The above CBO and other estimates assume that discretionary spending remains flat in real terms, i.e. it grows in line with inflation but not necessarily in line with population or in line with the compositional shift in population (ageing specifically) which is placing the biggest demands on some of the most-expensive-to-deliver public services.

As Fed Chairman Greenspan recently and perhaps now regularly reminds us, the leading edge of the baby boomers will reach the ripe old age of 62 in 2008 and become eligible to draw Social Security retirement benefits. Three years later, these individuals will be 65 and be eligible for Medicare by which time the ‘waves of grey’ will be increasing.

Thus, it is by no means inconceivable that this average USD400bn per year will be increased still further by allowing for positive real terms growth and by the still uncertain – but probably not underestimated – financial implications of ageing. In any event, the purpose of this attention was not to make specific forecasts of the budget deficit but to highlight that the outlook remains skewed strongly towards bigger than small deficits and that they are increasingly structural because of the ‘guns and butter’ dimension.

Without the prospect of fiscal policy reforms, it seems quite unlikely that there will be any material change in current account performance and, as we shall see below, if that’s the case then the household sector adjustment may be some time in coming but come it must. But there are other clearly domestically and politically important reasons why fiscal reforms and changes will be needed but these are for another expertise. We have made no attempt here to factor in the next recession nor any military missions beyond those currently known.

Suffice to say though, from a global macro position, sustained large deficits with or without Asian financing, will involve higher real interest rates for the US and the rest of the world. To that extent, we all have a vested interest in the fiscal outlook in the US. As US public debt outstanding climbs from its current 50% of GDP, the upward pressure on global real yields will continue. Rising public debt to GDP ratios have long been recognised as the single most important phenomenon behind changes in the trend of real yields. Recently the IMF

No allowance for real discretionary spending increase

Even \$400bn deficits could be exceeded

No fiscal reforms, no external improvement

Real rates will have to rise eventually

estimated that a 15% rise in America's public debt to GDP ratio over 10 years would raise real interest rates by 1-1.5% -in both the US and global capital markets.

So – where to for the imbalances in the next 2-4 years?

Earlier we made the self-evident point that the financial balances within the economy, the differences between savings and investment, necessarily sum to zero. We also said that the interesting issue is not that they do but *how* they do so. In the preceding pages, we have also looked at various aspects of the trade, current account and fiscal balances, concluding that in the absence of more radical policy changes, both the fiscal and external deficits are liable to continue increasing. This is a subject that has grabbed gurus more than it has moved markets – so far.

Former Treasury Secretary Larry Summers has called the outlook for the twin deficits the 'balance of financial terror'. His predecessor, Robert Rubin, has talked of the coming fiscal disarray arising from the Administration's fiscal policies juxtaposed against the prospects arising from national security and demographic changes. Former Nixon Administration official and now President of the Concord Coalition (among other positions) Peter Peterson has recently published a book called 'Running on Empty: How the Democratic and Republican Parties are Bankrupting Our Future....' In which he takes politicians to task for exacerbating America's future fiscal and demographic difficulties. At the Institute of International Economics, Fred Bergsten, Catherine Mann and Edwin Truman have explored the issues pertaining to the nation's external deficit, estimating that the current account deficit might grow to anywhere between 8 and 13% of GDP over the next few years.

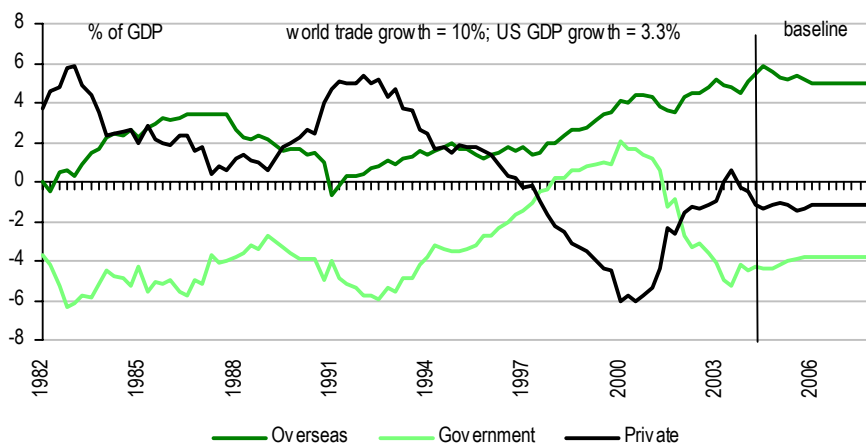
At UBS, we recently ran some basic simulations designed to ask how large the imbalances might become and over what period of time and reproduce the conclusions here (see *Global Economic Perspectives*, America's Catch-22, 26th August 2004).

Assuming that the pace of GDP growth is a given at roughly 3.25% per annum, we can trace what happens to the major balances in a simulation that is probably implausible and the most benign one possible. We assume additionally that the rest of the world grows slightly faster than the US, that there is no change in the trade-weighted value of the USD, that Fed tightening proceeds more or less in line with market expectations and there is no post-election fiscal tightening. The results are shown below and indicate little change in the basic structure: the current account deficit (overseas surplus) is stuck at around 5% of GDP, the private sector deficit at about 1% of GDP and the government deficit is glued to about 4% of GDP.

Imbalances have grabbed gurus more than moved markets

Making generous assumptions, imbalances stuck out to 2007

Chart 13: Baseline financial balance arithmetic

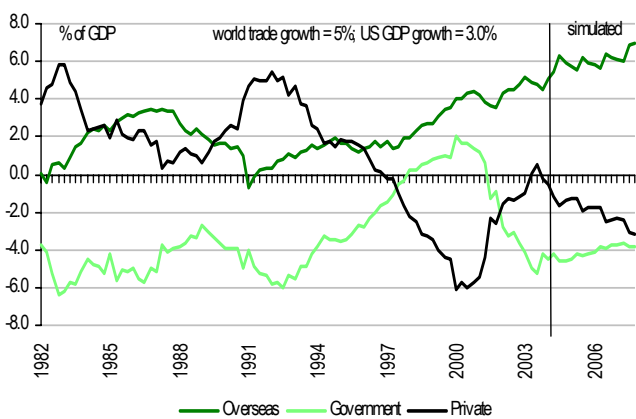


Source: UBS/OEF

Two variants on the above baseline were explored. In the first, we were struck by the fact that a stable current account deficit at 5% of GDP required export demand for US goods and services to grow by 10% per annum, which felt like a bit of a stretch. To compensate, we halved this to 5% per annum. Now the current account deficit widens out to 7% of GDP by 2007, the Fed lowers interest rates in the face of weaker world trade and this allows the private sector to accumulate more debt to compensate for the weaker foreign sector – always bearing in mind that we are trying to sustain a trend GDP growth outlook.

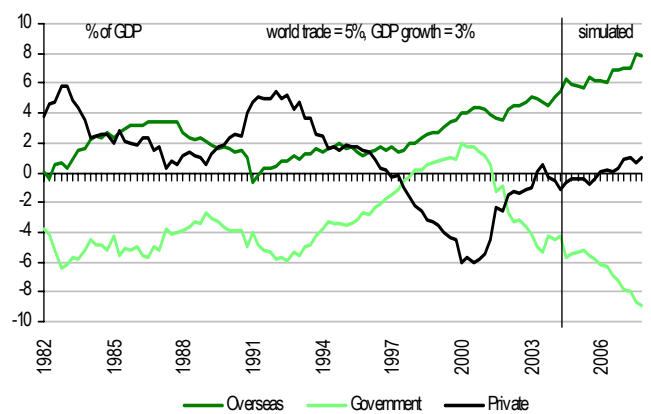
More cautious assumptions see external deficit at 7% GDP

Chart 14: Weaker world trade simulation



Source: UBS/OEF

Chart 15: Higher private savings simulation



Source: UBS/OEF

Of course, if the private sector were unwilling to accommodate the wider current account deficit, trend GDP growth would falter, interest rate expectations would decline significantly and the USD would depreciate without too much fuss.

The above chart also shows a second variant in which we relax the constraint on the private sector, namely that it will adjust to increase its indebtedness and implicitly spending to compensate for the drag arising from a wider current account deficit. But suppose the private sector returns to where it normally belongs, i.e. running a small surplus? What if the surplus rises to 1% of GDP (historically 2-3%) by 2007? The answer is evident from the chart, namely that

Allowing private savings to rise, government deficit at 9% GDP

the government sector would then be the major balancing item, its deficit forced to expand to about 9% of GDP. In other words, faced by an increased drag from the overseas sector and this time also from the private sector (as household savings rise), the government would have to ease the fiscal policy stance.

As we have stated before, the likelihood of a scenario in which the fiscal and external deficits end up at 7,8 or 9% of GDP is considered to be fairly slim. But what we have tried to show in the preceding pages is that, on current policies and circumstances, these numbers are quite plausible by way of extrapolation. The issue is whether the intervention of financial markets or politicians will come first in order to stop such developments in their tracks.

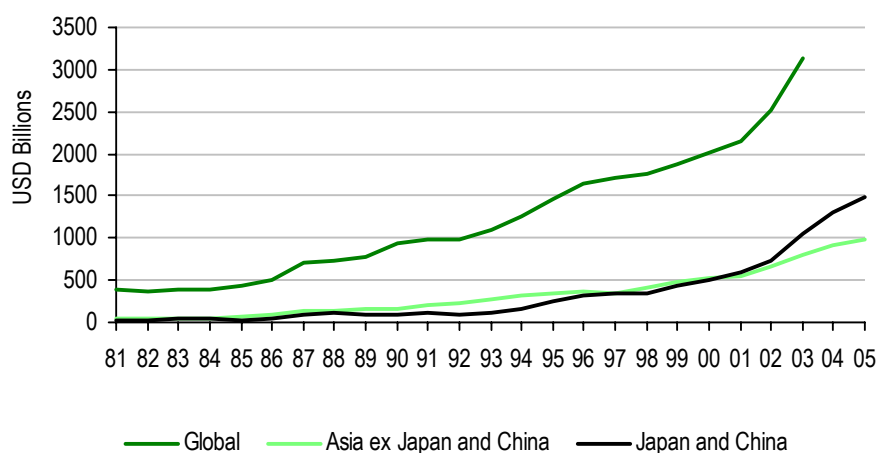
As Catherine Mann at the Institute of International Economics has put it, only a combination of structural change in the US and abroad along with USD depreciation will suffice to work towards global re-balancing. Put another way, she argues ‘...it will become ever more difficult to untangle the global co-dependency (between the US and Asia) without precipitating a crisis in currency markets, the international exchange of goods and services and domestic and global growth’. And so it is to this ‘co-dependency’ that we now turn.

**Implausible outcomes but will markets
or politicians intervene first?**

Illusion: US, Asia and Bretton Woods?

There is little doubt that the broad stability of the USD and the still relatively low levels of nominal and real yields in US and global capital markets owe much to the capital flows emanating from Asia. The foreign exchange reserves of Asia, including Japan have grown from much less than USD1,000bn in 1999 to about USD2,300bn in 2004. And for those inclined to extrapolate, the next few years will see even faster growth. For example, assuming the US current account deficit runs at about USD600bn per year and that central banks finance about half of this, Asian foreign exchange reserves would increase to almost USD4,000bn by 2009, the lion's share of the increase accruing to China and Japan.

Chart 16: Asia's rising FX reserves



Source: UBS/CEIC

Asian official capital flows have clearly displaced autonomous private sector flows to a significant degree and the status quo is one in which both sides appear to have strong vested interests to sustain. Superficially, at least, Asia gets to export cheaply to the largest and fastest-growing economies in the world as a foundation for economic development; the US gets to remain the fastest-growing developed region in the world thanks to the capital inflows, largely coming from Asia. In short, this 'arrangement', according to some, has the hallmarks of a revived Bretton Woods system. It is of the greatest of importance to investors as to whether this is for real or just more 'new economy' theorising. As we shall argue, there are some superficial resemblances to the original Bretton Woods system but, for the most part, today's version is an illusion.

Bretton Woods – the revival argument, investor implications

The case for has been advanced most notably by Michael Dooley, David Folkerts-Landau and Peter Garber in a series of working papers that are accessible at the NBER website (www.nber.org/papers/), in particular 'An Essay on the Revived Bretton Woods System'. These papers comprise well-argued and sometimes compelling theoretical discussion that seeks to a) liken the current period to the original Bretton Woods System b) explain the repercussions for financial markets in both the US and Asia and c) justify the long-term survival

Crucial role of Asian reserve increases

A 'revived' Bretton Woods is important for investors, whether it really exists or not

Mutual vested interests

prospects of this arrangement, foremost among which is China's imperative to absorb over 200 million unemployed and under-employed rural workers into a modern, urban economy without social tension when the absorptive capacity may be little more than 10-12 million a year with the economy growing at 8% per annum.

The authors argue that this new Bretton Woods system is stable and sustainable in a world divided up nowadays into trade and capital account regions, the US belonging to the latter and Asia to the former, that Asia wants to maintain undervalued exchange rates so as to deliver export-led growth and that Asian countries are content to acquire USD without limit, financing any resulting imbalances. In the modern period, then, Asia has displaced Europe and Japan but for the post-WWII nations, as for Asia today, acquiring USD is part of the serious process of economic and trade expansion. And we could add that, post-Asia crisis 1997, the requirement to not only replenish lost USD reserves but also build a cushion as protection against any future crisis, has been quite forceful.

If this were true of course, the implications for private investors are significant. Specifically, their fears about risks in lending to increasingly indebted US government and private sectors, by definition, would have to be misplaced to the extent that the US is, de facto, being underwritten by Asian central bank reserve flows.

So notwithstanding what appear to be relatively low levels of real interest rates in the US, and given the limited breadth of USD depreciation, the anomalies in interest rate, yield curve and spread trades would in fact not only persist but probably intensify. Normally, we would expect private investors to 'win' this sort of clash, i.e. where government or official actions were creating what we supposed to be market distortions. However, the authors are at pains to point out that this is a very specific challenge, which private markets may or may not confront, one that is characterised by historically unprecedented intervention in the foreign exchange and other financial markets. They argue in fact that whilst real long-term US rates tend to an average of about 2.8% and in fact approximate to just that currently (4.2% on 10-year Treasuries less 1.5% core PCE deflator), they 'ought' to be about 1% lower, while short-term Treasury bond yields will remain low relative to other, comparable maturity instruments. Think about this: real yields falling to maybe 1.5-2% with a stable currency in an environment of high and growing government and external debt and deficits? A new investment challenge, if ever there was one.

Bretton Woods or bust?

The parallels with Bretton Woods (we'll call them BW1 and BW2), though, don't appear nearly as compelling as the authors and others would claim. And if that's the case, then everything else breaks down sooner or later. It is true that this system has a core (the US), which is unchanged from BW1, and a periphery that has changed (now Asia, then Europe). But it is quite fanciful to state that BW1 lasted for 25 years, implicitly suggesting that it just happened to stop functioning towards the end. The truth is that while the Bretton Woods system for managing exchange rates was indeed conceived at the UN Monetary and

Stable and sustainable and like Europe post WW2

Market anomalies would remain, real yields still lower, USD safe

But reality is different, the original Bretton Woods experienced mounting tensions

Financial Conference at Bretton Woods in July 1944, it cannot really be said to have come into being as a working system until current account convertibility was restored – and this didn't happen until the end of 1958. Further, even the next 14 years until its demise were characterised by anything but smooth and uneventful times. In fact, from 1961 onwards and increasingly so towards the end of the 1960s, BW1 was sustained by a sequence of band-aid solutions designed to stop inherent political and economic tensions from bubbling over. Ultimately, it could not be sustained and a reversion to floating exchange rates was the only possible way of dealing with the imbalances that had accumulated under BW1 in the 1960s.

In the 1960s, the US trade and current account balances were in modest surplus and the US was a net investor in the rest of the world. Over time, though, the USD acquired by Europeans led to disquiet and instability. This was the product of two things. First, fears that USD devaluation might result from the tensions within the US, torn as it was between its commitment to exchange rate fixity (and deflation therefore) and its predisposition to improved growth (even with a bit more inflation). Secondly, US gold reserves fell sharply during the 1960s. Initially this was welcomed as a part of the problem of maldistribution immediately after WWII, but gradually it acquired increasingly hostile political undertones beginning with the Suez crisis and aftermath in 1956, and culminating in the Vietnam War era. In the end though, the imperative of delivering economic growth – especially for the US – came to supersede the commitment to defend the USD and sustain the system. America's problem was that she could only maintain gold convertibility via deflationary policies (raising the real value of monetary gold stocks and foreign official USD balances). This the US was patently unwilling to do, and by 1968 the writing was on the wall for BW1, and it took less than 3 years to disintegrate.

US was a major saver and capital exporter then

How can we assess today's prospects in the light of that admittedly abbreviated history? We'll look at 5 separate issues*.

First, there is no gold or gold exchange standard but, by the same token, the commitment to a system of fixed parities is really non-existent. The US may have an expedient interest in maintaining the status quo for the moment but there's no question of a fixity commitment. Asia, as my colleague Jonathan Anderson has pointed out, cannot possibly be seen as having embraced pegged exchange rates, not least because non-Japan Asian currencies have generally been falling against the USD since 1980. Such 'pegging' as has occurred dates only to the post-1997 crisis period, has certainly been about reserve replenishment, and is likely to last only until the recovery in domestic demand and capital spending is more secure.

Limited if any commitment to fixed exchange rates

Secondly, Asian nations today lack the cohesion and community of interests that bound Europe and the US and Japan together after WWII. Back then, Europeans and Americans worked tirelessly together in all sorts of fora that are now

Not the same cohesion or political infrastructure

* For a fuller review and argument, see Barry Eichengreen, Global Imbalances and the Lessons of Bretton Woods, NBER May 2004

common parlance – the European Community, G10, OECD, BIS and IMF meetings – in order to build or re-build a global economy after WWII. Peer pressure, surveillance mechanisms, and sanctions all comprised mechanisms for enforcing the discipline needed to sustain BW1. Trying to find such a community of interests among a seriously heterogeneous group of nations at various extremes of economic development, and where potential political conflict rarely lurks too far beneath the surface, is quite a different ordeal.

Of course, there is an economic cohesion that links Japan's stagnant population and the deployment of its manufacturing capacity to China, which in turn receives the industrial and technology inputs for industrialisation and access to Japanese capital. But these two nations share a mixed and sometimes difficult history, memories and lessons of which are kept alive to this day. We propose to leave it at that, other than noting the issues of relations between China and Taiwan, between Japan and S. Korea, of N. Korea's nuclear aspirations. The point is that Asia today throws up quite a different picture from the spirit with which and the ways in which European countries sought to resolve their past some 40-50 years ago.

Thirdly, as stated above, in the 1960s the US was running current account surpluses, was a net creditor nation (as befits a war victor and superpower) and was the source of inevitable capital outflows that filled the coffers of European and Japanese central banks. How ironic. In those days, Europeans feared a USD devaluation when the US was in this healthy financial position and when there was never any question at all that America might have recourse to a devalued USD because its foreign debt dynamics were poor. Today, when the US is running major fiscal and external deficits, is the world's biggest net debtor with a poor outlook, and when repayment terms really can be called into question, Asian central banks seem content to accumulate any amount of USD assets, playing down the (inevitable) risk of depreciation and/or higher interest rates, either or both of which promise sizeable capital losses on USD asset holdings.

Fourthly, the 1960s and the '2000s' could not be more different when it comes to the financial environment. More or less open capital accounts nowadays mean that Asian economies have to carry out more extensive and probably more costly sterilisation and intervention operations than their European counterparts of 40 years ago.

Moreover, years of financial market liberalisation will have brought mixed blessings for Asia. Specifically, countries with undervalued exchange rates and high savings run the risk that through their intervention and sterilisation operations, credit expansion leaks into the non-traded goods sector as well as the investment- and export-generating sectors. Of course, what we're referring to is property and real estate, noteworthy examples having abounded in Asia in the years leading up to the 1997 crisis and currently up and down coastal China. This is a particularly sensitive issue in China today because in an economy where capital spending has been growing at 30% per annum and the share of investment in GDP has reached 45%, it has been noted that much of the loan growth and profitability in the economy derives from construction, materials, property and finance.

Strong economic links but underlying political tensions

Investors today fear USD depreciation less than they did 40 years ago

More or less open capital accounts

Financial deregulation has opened door to financial instability

Fifthly and finally, in the 1960s, there was the USD and not much else for investors or foreign central banks to acquire. Today, the USD without question remains the linchpin of the world monetary system. But unlike the 1960s, there is an alternative currency, the EUR, which already accounts for about 20% of global foreign exchange reserves and which is the currency in which an increasing proportion of capital market transactions is undertaken. According to the ECB's December 2003 Review of the International Role of the Euro, the EUR accounts for between a quarter and two-fifths of the global stock of debt securities (depending on definition), about a third of new bond issuance, about 40-55% of cross-border loans from euro- and non euro-area banks to non-bank borrowers outside the euro area, and about 43% of global foreign exchange turnover.

Summarising, today's parallels with BW1 look rather superficial. There is no commitment to currency fixity. There is not much in the way of Asian institutional infrastructure to support a BW parallel and the mixture of interests in and tensions between Asian countries are in marked contrast to the steely resolve of Europe of 40-50 years ago. The US is running large deficits today and depending on the rest of the world, in effect, to finance 'guns-and-butter' programmes while creditors are running big risks of capital losses arising from a lower USD and higher nominal (or real) rates. Thinly distributed capital controls, if any, and financial deregulation – neither of which were present before the 1980s – have increased the potential for financial instability in Asian economies, to the extent the current regime persists. Finally, unlike the 1960s, the core country's creditors don't have to invest the funds accruing to the reserves only in the currency of the core country – today's EUR markets offer Asian central banks a viable alternative.

Investment Prospects

So, what if the BW2 system is actually an illusion, a construct made to fit some rather important and sometimes curious global financial market phenomena but a system that derives from temporary expedience only?

To address this concluding section, we have reproduced verbatim on pages 25-28 parts of a recent research paper by Jonathan Anderson, in which he attempts answers from an Asian perspective (The Bretton Woods Illusion, Asia Weekly Focus, 27th September 2004). In the paper, he makes the point that it's incorrect that Asia is a chronic 'pegger' and that for much of the last 20 years, Asia ran current account deficits, only returning to surplus after the Asian crisis in 1997. Moreover, the argument is not that Asia woke up to a new undervalued foreign exchange rate development strategy in 1998, but that Asia has only slowly been coming to terms with the aftermath of what was a cyclical downturn of unprecedented proportions. It follows that Asia's so-called foreign exchange strategy is good for as long as domestic demand and credit remain 'sotto voce'.

There are other arguments in favour of the idea that Asia will adopt greater flexibility towards its exchange rate relations vis-à-vis the US before too long – by which we mean 1-2 years. In the very long term, we imagine that real exchange rates in Asia will have to be allowed to rise to promote more balanced growth between traded goods and non-traded goods and service sectors, to

And then... the EUR as an alternative asset

What if it is an illusion?

The Asia view has been well put separately, and is reproduced below

Real exchange rates in Asia will rise

promote more robust developments in education, housing and infrastructure. And assuming that inflation will not be the preferred way of advancing real exchange rate gains, nominal rates will more likely than not be permitted to be flexible upwards.

In fact, there is an argument advanced by senior IMF officials that this kind of flexibility would be a significant contribution to the development of faster domestic demand and resolution of the world's imbalances as a consequence. They point out that governments in the periphery have little control over the real exchange rate anyway. If Asian currencies are undervalued, then success in the export sector will lead to the adoption of new technologies, which will raise productivity and real wages. These will spill over into domestic and non-traded goods sectors, which, without the productivity offset, will tend towards higher inflation. Thus, even a fixed nominal exchange rate will tend to rise in real terms. Of course, governments can suppress those inflationary impulses via price controls, sterilisation and capital controls in the short run. In the longer-run, they will simply act as a drag on potential growth. Moreover, capital account transactions in China are being liberalised slowly and there are probably limits to both sterilisation and the absorptive capacity of the monetary system with respect to reserves. Sooner or later, inflationary tendencies would be released and the real exchange rate would rise – but perhaps Asian economies would also allow the nominal rate to take some of the strain.

For the US, one suspects, there is recognition as to the objective function of what is purported to be a sort of BW2. The availability of what appears to be limitless financing of the fiscal and external deficits out of excess savings and current account surpluses overseas (perhaps Asia is incidental in this regard), is clearly welcome to some extent. It sustains the current structure of GDP, which is patently over-weighted towards consumer spending. It allows the national savings rate to fester at all-time lows of less than 2% of GDP and it permits the sustainability of large and growing financial imbalances, a steady currency and abnormally low real interest rates because of the on-tap foreign savings supply. But there is a basic tyranny about where the US imbalances are headed, as we have tried to show, and it is believed that even if Asia endeavoured desperately to cling to some 'fixity' agreement, the evolution of the imbalances as anticipated would prove a bridge too far for financial markets. But, as we have shown, Asia's interest in the status quo is probably fleeting, expedient and not all that long for this world, as we might say.

In any event, there is no more poignant a note than that struck by Nobel prize winner Robert Mundell writing in the Wall Street Journal as long ago as 1998. He noted that: 'It would be a mistake to ignore that in the last 15 years, US current account deficits have turned the US from the world's biggest creditor to its biggest debtor... The low savings rate high debt problems will one day come home to roost... There will come a time when the pile up in international indebtedness makes reliance on the dollar as the world's only main reserve currency untenable... The fact that the bulk of international reserves is held in dollars makes the currency a sitting duck in a currency crisis'. (Continued on page 29).

Governments can't control real exchange rates anyway

For the US, a revived BW is expedient but tenuous

Verdict of a Nobel prize winner

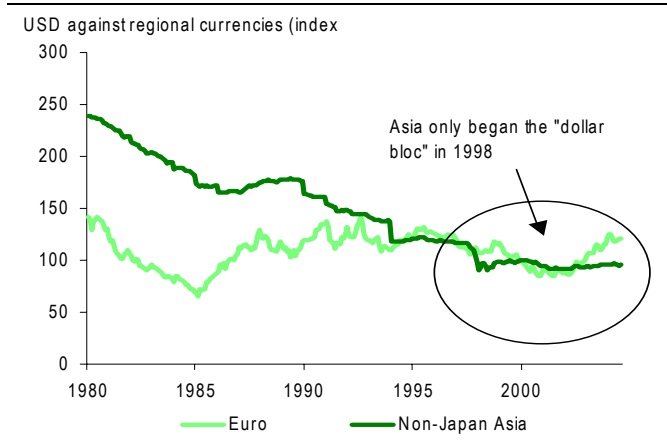
Asia Focus: If only it were true

BW2 is a very compelling view of how the world works, and how Asia fits into it. There's only one slight problem: it doesn't fit the facts.

To begin with, the picture of an emerging Asian region chronically pegging exchange rates in order to run current account surpluses turns out to be completely wrong. Just look at Chart 17; with the exception of a brief interlude in the late 1980s, in the 25 years until 1998 non-Japan Asian currencies depreciated consistently against the US dollar. In fact, the cumulative nominal adjustment was orders of magnitude greater than that of developed currencies such as the euro area. 17

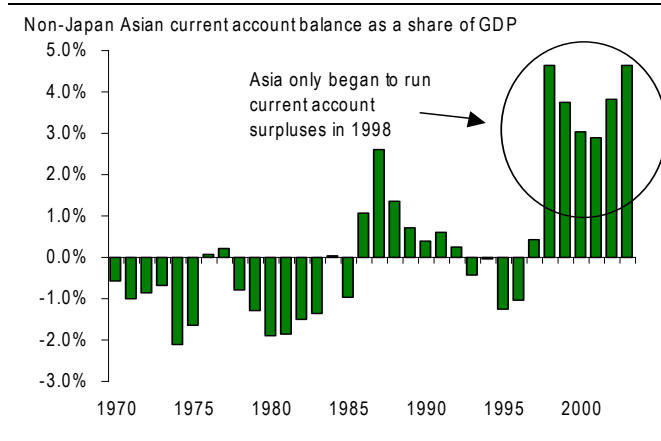
More important still, over the same 25-year period (again with the exception of the brief late-1980s interruption) emerging Asia ran current account deficits—not surpluses (Chart 18).

Chart 17: Where are the pegged rates?



Source: CEIC, UBS estimates

Chart 18: Where are the surpluses?



Source: CEIC, UBS estimates

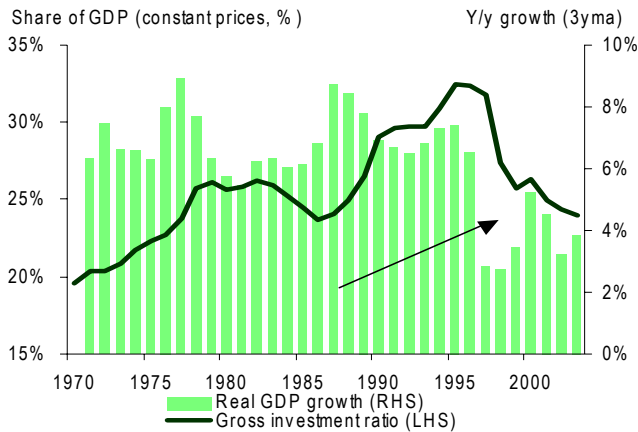
Of course, the game has clearly changed since 1998; as the charts above show, Asian exchange rates have barely budged against the dollar over the last half-decade, and the region has been recording current account surpluses of unprecedented magnitude. But is this because Asian policymakers suddenly woke up five years ago and decided to embrace a radically new long-term growth strategy?

Hardly. What Asian policymakers did wake up to five years ago was a cyclical downturn of unprecedented proportions. Chart 19 tells the story for the smaller Asian export economies (i.e., emerging Asia excluding China and India, as the latter countries do not provide constant-price GDP series by expenditure category; we look at China and India separately further below): After years of overheated activity, investment demand collapsed by nearly 10pp of GDP the

¹⁷ Of course Asian currencies were much more stable in *real* terms; indeed, real non-Japan Asian exchange rates appreciated over the period, as average domestic inflation was higher than the rate of nominal depreciation. But the Bretton Woods story depends on a nominal bilateral peg—and thus Chart 17 shows the path of nominal bilateral exchange rates.

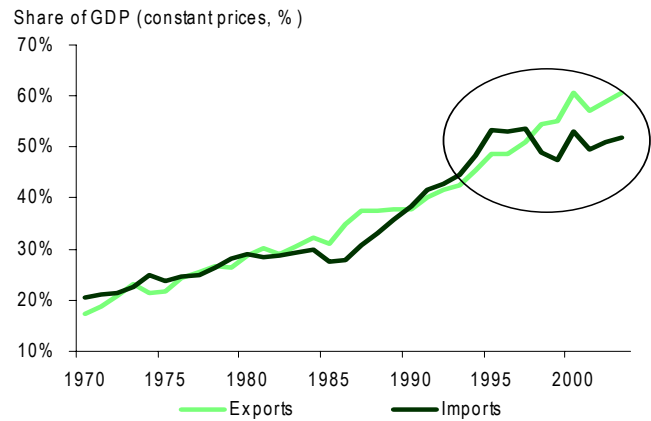
wake of the 1997 financial crisis, dragging regional economic growth down to a mere fraction of the historical trend. And no sooner did it appear that domestic demand was recovering than the region was hit with by the global IT downturn, which depressed activity even further.

Chart 19: The investment and growth collapse



Source: CEIC, UBS estimates; data are for NJA excluding China and India

Chart 20: The import collapse



Source: CEIC, UBS estimates; data are for NJA excluding China and India

How did this affect the trade account? Simple: with the sharp decline in investment demand, real import demand peaked in 1998 as a share of GDP, and has never fully recovered (Chart 20). Meanwhile, the export sector continued to grow, even in the aftermath of the 2001 downturn. The result has been the record trade and current account surpluses we saw in Chart 18 above.

Depression economics

Now, pause for a moment and think about the problem regional central banks and planners have been facing over the past several years. On the one hand, weak import demand has caused the trade balance to soar—which means strong upward pressure on Asian currencies. On the other, the reason Asia has weak import demand in the first place is precisely because domestic economies have not fully recovered from the negative shocks of the past, with low capacity utilization, moribund investment growth and (until very recently) widespread deflationary pressures. If the authorities were to let currencies appreciate, it would only exacerbate the domestic downturn by hurting exporters' margins and further pushing down prices at home.

In this situation, there's really only one acceptable solution, i.e., fight to keep the exchange rate stable and wait for things to pick up again at home. And this is exactly what Asian policymakers have done.

How does it work? Central banks intervene in foreign exchange markets to buy up the current account surpluses (as well as any stray capital that might find its way into the economy)—which means rapidly rising official FX reserves. It also means large base liquidity injections in domestic currency, but with weak credit demand and low interest rates central banks have had very little trouble mopping up that liquidity if need be through offsetting sterilization operations (we provide a full description of the exchange rate/liquidity mechanism, with all the

gruelling details, in *The Asian Liquidity Primer, Asian Economic Perspectives, March 29*).

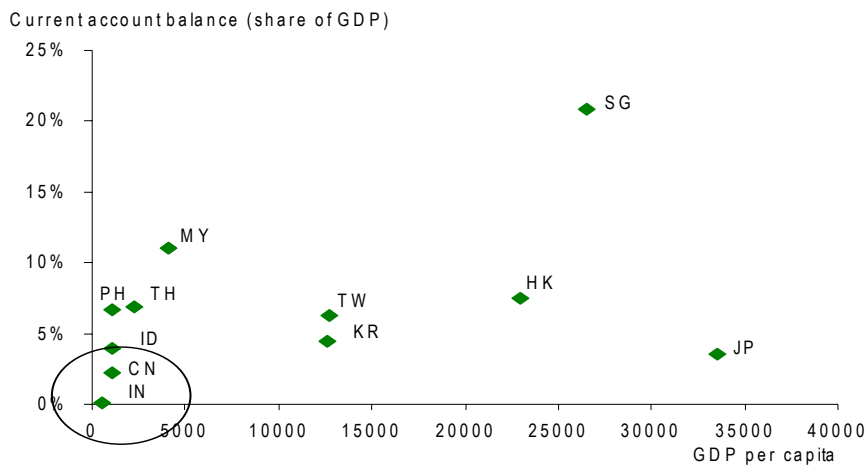
But this is not the New Bretton Woods. Rather, this is a cyclical defense mechanism, a straightforward application of the Keynesian internal/external balance problem—or, in layman’s terms, “depression economics”. Once domestic demand and capacity utilization are fully back on track, there’s no longer any reason to bother keeping exchange rates rigidly stable against the dollar. And as we show below, with the current pace of recovery this is a matter of a few years—not decades.

Even more arguments

Still not convinced? Fair enough. After all, we haven’t even touched upon China and India, which certainly do not fall into the same camp as their emerging neighbors; they came through the last five years relatively unscathed and are both enjoying extremely vibrant domestic growth. Moreover, according to the logic of Dooley et al, these are the two countries that have the strongest incentive to hitch up their carts, as they fall into the lowest income class, and between them share the world’s largest pool of excess rural labor.

But if this is the case, then doesn’t it strike you as odd that China and India, which in addition to the above factors also maintain extremely restrictive capital regimes, actually have the lowest current account balances in Asia (Chart 21)?

Chart 21: Asian current account balances (1999-2003 average)



Source: CEIC, UBS estimates

In fact, we can dismiss India altogether; it doesn’t maintain anything close to a fixed exchange rate regime, and the rupee has seen the most nominal volatility of any emerging Asian currency over the past few years. And despite the common characterization of China’s renminbi policy as a targeted strategy to maximize market share, the facts of the matter are quite the reverse. As we show in *The New RMB Handbook (Asian Economic Perspectives, September 15)*, China adopted its quasi-peg in 1997 to prevent renminbi depreciation in the face of large capital outflows; the recent FX reserve growth spurt has been as much a surprise for the authorities as it was for most other observers—and is due by capital inflows, not to a rising trade balance.

Let's dispel another myth while we're at it. If Asian central banks are making a conscious and concerted effort to revive the Bretton Woods system, they should behave as Europe did, i.e., doggedly recycle FX reserves into US dollar assets come what may. Indeed, Dooley and his co-authors make this a cornerstone of their analysis.

But is that what we see in the data? Not at all—just look at what happened over the last 12 months. With the bursting of the US bond bubble in mid-2003, the dollar came under significant weakening pressure as portfolio investors sold in favor of the yen and the euro; at the same time, Asian equities began a strong rally that pulled even more funds out of developed markets. The result was a sharp rise in Asian central banks' FX reserves.

Well, we are now six years on, and everything Mundell said then is writ large today, except of course that ‘the coming home to roost’ has clearly not happened yet. He can be excused for not having then anticipated the way in which US-Asian financial relations would evolve. But we’ve tried to show that it’s rather myopic to consider the issues purely from a theoretical-cum-economic perspective. The real Bretton Woods (historical) experience teaches us that things are quite different today and the incorporation of political issues should warn that resolution of the tensions faced in global financial markets cannot be considered in isolation.

Economic and exchange rate issues

The major economic issues are the timing and manner in which global financial imbalances are reduced. The major financial market issues are likely to remain the determination of the USD and the level of real yields. While by no means exclusive, we suspect that these, ultimately, will drive a host of other financial asset values and spread relationships. As we noted at the beginning of this paper, there are three possible macroeconomic outcomes: accelerating Asian economic growth, based on much stronger consumption activity, much slower US domestic demand growth or possibly a recession or inaction/slow progress. The last may be the most likely as far as professional, quantitative forecasting is concerned. Either nothing much happens other than the continued expansion of the imbalances and indebtedness, in which case one might imagine that financial markets would rumble the implications before long, with possible hard-landing implications; or slow progress will be made through some combination of Asian exchange rate flexibility and the local encouragement of domestic demand growth, slower US demand growth and the rebuilding of private savings and possibly the attention of the political class towards structural reforms as they affect fiscal and other adjustment issues.

Under all circumstances, it is hard to avoid the conclusion that the USD will continue to fall over the next 1-2 years. We don’t think USD depreciation is the be all and end all of the adjustment process, but it is an integral part, and studies that we have done ourselves and found elsewhere suggest that a further depreciation of 20-30% in the nominal effective rate is a rough order of magnitude required to bring down the current account deficit by about 2% of GDP and stabilise the external liabilities position (see *USD In The Twilight Zone, Global Economic Perspectives*, 10 June 2004). The standing forecasts at UBS are for the USD to drop to about EUR/USD1.40 and USD/JPY 105 in 2005 but these could, of course, be overtaken by events, should they start to unfold sooner than we might guess today. In any event, part of the key to success as regards resolution would not be to burden Europe with more currency appreciation per se, but to allow a broader USD depreciation, in particular against Asia.

Deja-vu?

Dealing with Asia and exchange rates is hardly virgin territory for US Administrations. Marcus Noland, writing in the *Financial Times* (‘It is time for a new economic stance on China’, 29th September 2004) recalls how in 1983, US-Japanese talks resulted in the liberalisation of capital outflows from Japan and

Three possible outcomes

USD would fall under all circumstances, maybe 20-30%

Caveat may be 1983-85 JPY example, but end-game was no picnic

contributed a state of financial well-being in the US that facilitated the re-election of Ronald Reagan. By 1984, the JPY had fallen by nearly 15%, and by February 1985, the USD had peaked and was about to begin a sustained depreciation. Fast forward to 2004 and the US Administration is encouraging China to liberalise capital outflows and integrate US financial services firms into China. At the same time, legislation has been tabled (presumably dormant until after November) to threaten China with WTO and IMF sanctions if it doesn't float the RMB.

We can't say exactly how policy will evolve after the elections, but two courses of action would appear possible. As things stand, the tension between the US and China over the exchange rate could intensify, resulting, as 20 years ago, in short-run upward pressure on the USD, though this would almost certainly (and again) be followed by a rather substantial decline on a 1-2 year view. Alternatively, the new Administration might engage in talks designed to either bring forward some 'flexibility', extending possibly to a one-off revaluation of the RMB. This is to put to one side China's own preferences and wishes of course, which we presume favour the former and certainly not the latter. But there are negotiations and there is horse-trading and it is quite conceivable that the exchange rate could be part of broader discussions.

All eyes on post-election policy stance

Interest rate and real yield issues

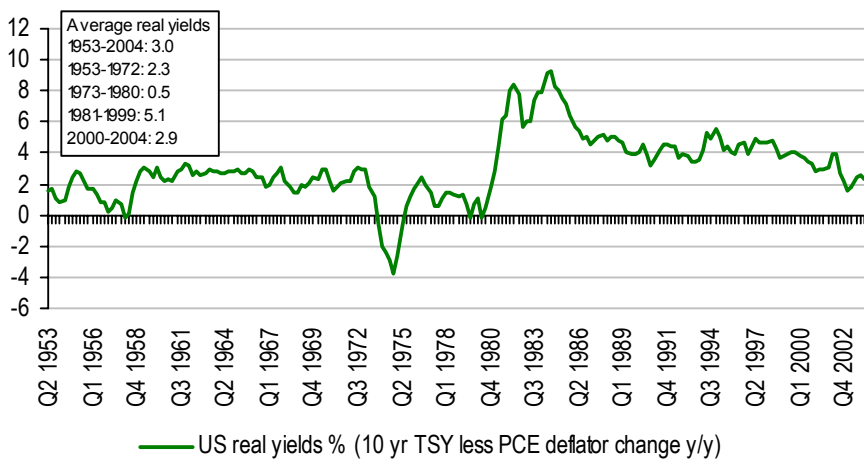
Furthermore, in interest rate markets, there has been much consternation this year about the refusal of bond yields to 'behave', by which analysts mean 'rise with the tightening of Fed policy'. And this has driven a host of anomalies in fixed income markets generally. Trading in a range of 3.68-4.87% so far in 2004, the 10-year Treasury bond is now at its late-January level of roughly 4.2%, in spite of the Fed having raised short rates by 75 basis points with the markets expecting more soon. The reasons for this 'stunning' performance are quite clear: much has to do with Asian flows as discussed in this paper, the rest is about quiescent inflation and the markets' expectations about the lower growth likely to derive from high oil prices. Leaving oil prices aside, the core CPI rose by 1.2% per annum in the June-August period after a spring, oil-related acceleration and the PCE deflator, while rising to 2.2% year-on-year in Q2 2004 doesn't look to be worse than stable at the moment.

Bond yields have been 'misbehaving'

But while investors are captivated by nominal yields and the key inflation and monetary policy issues that drive them, an equally important factor from the point of view of asset prices and the global economy is real yields, where indebtedness, savings and flow factors come into play. Consider, as we conclude, the following long-term evolution of US real yields, defined as nominal 10-year Treasury yields less the annual change in the PCE deflator.

Real yields are as important as nominal

Chart 22: Have US real yields troughed?



Source: UBS

The long-run average has been about 3%, to which the last 4 years have gravitated on average. The extremes, of course, occurred during the inflationary 1970s, when real yields were driven down and to sometimes negative values, and again after the 1970s, initially in deference to the anti-inflation regime of the period, subsequently a reflection of real and productivity changes in the economy as well. More recently, we can see how real yields have been falling, so that in Q2 2004, they were certainly below their long-term average at about 2.3%. If the PCE deflator was broadly unchanged in year-on-year terms in Q3 2004, then the implied real yield would have fallen further to about 2%. And this, of course, in spite of the deterioration in the imbalances.

Looking forward, it seems to us totally plausible that real yields will rise to reflect the latter point and the USD depreciation that we expect. It is doubtful that real yields would have to rise as high as the average during the 1980s and 1990s. At the very least, something approximating the long-run average or perhaps a little more might seem appropriate. If 2.5%, for example, were a 'normal' rate in this environment and the debt dynamics in the fiscal and external arenas here played out as suggested, the implication is that real yields might be 100-150 basis points greater, i.e. approaching 3.5-4% over time.

But real yields can rise in a couple of ways of course: higher nominals, lower inflation or a combination. In the event that the US economy were to slow down, or even go through some period of stagnation or recession in the next 1-2 years, it's quite likely that today's inflation (1-2%, depending on one's measurement preferences) will fall. At 1% inflation, a 3.5% real yield would make today's bond market fair value. At zero inflation – and this may well happen during the next economic downturn – today's bond yields would represent rather good value. The bottom line, then, is that while flux and change in the USD and in Asia's financial relations with the US might well be compatible with a spike in nominal yields at some point, this would most likely be temporary. Real yields would rise to reflect the debt and financial fundamentals (unless domestic savings rose significantly) and this would certainly impact economic performance, but it need not be a recipe for permanently higher nominal yields.

Long-run average is 3%, current reading is 2% despite debt and deficits

Real yields most likely to rise

The question is how? Higher nominals, lower inflation, or a bit of both?

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