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Magic Capital Ride
By R. Glenn Hubbard
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In the eyes of many, the relatively strong recent U.S. economic growth is the silver lining in a cloud of global imbalances in flows of capital that are seen to threaten the international financial system. But the sources of our growth offer an economic-policy recipe by which to maintain the silver lining, while dissipating the dark cloud.

As a business school dean, I remind students and business audiences that business school developments in management practices, well-functioning financial markets for risk capital, and a stable tax policy, are all factors on which the structural acceleration in U.S. productivity has relied in the past decade. At the same time, many analysts observe that this rapid growth in the U.S. is occurring with widening imbalances in world financial markets, with too much global saving flowing to the U.S. -- and not to emerging-market economies.

The facts paint the picture. The U.S. economy, forecast to grow at 3.7% (just above estimates of potential GDP growth) in 2005 -- compared to 1.5% in the Eurozone and 1% in Japan -- is also generating unprecedentedly large current account deficits. The cumulative effect of these deficits is a large increase in external liabilities, raising concerns about future debt service, the value of the dollar, and U.S. interest rates. At the same time, emerging economies as a group are attracting foreign direct investment in response to promising investment opportunities. But they are also accumulating large stocks of international reserves, principally in dollars. As a consequence, they are running large current account surpluses. Indeed, the emerging market countries' current account surplus in 2004 was about half the size of the U.S. deficit.

Such imbalances have raised calls for protection -- as seen in the most recent round of China-bashing by Congress -- and calls for immediate currency revaluation in China. While the subject of Chinese exchange rate policy is an important one -- and one which China for its own interests will likely address soon -- it is not the principal key to the present imbalances in the flows of funds among nations. Indeed, revaluation of the yuan would solve little of the U.S. current account imbalance.

Instead, the central U.S. policy steps must be to raise -- gradually -- national saving at home, while encouraging greater productive domestic spending in emerging economies. Done gradually, this rotation is unlikely to validate the "financial crisis" forecasts of some observers. And the steps to do so are in close concert with the Bush administration's economic policy ideas, though those ideas could be more forcefully linked to the global economic outlook.

Policy steps at home are clear. While fiscal adjustment alone will not resolve the U.S. contribution to global imbalances, it is essential. Serious discussions of fiscal challenges move quickly to entitlement programs -- Social Security and Medicare -- whose growing unfunded liabilities are cause for worry. Pre-funding some of these liabilities through personal accounts, while scaling back the growth in benefits, is essential. Failure to do so implies a path of rising taxes that will diminish investment, productivity growth, and equity values -- and lead to a larger buildup of global imbalances in the next several years. (Recent market movements suggest the awareness by market participants of this possibility.)

The Bush administration's championing of the need to shore up Social Security -- and, one hopes, taking reform lessons to Medicare as well -- is sensible as a path to an entitlement reform

with lower future government spending. But it is also vital to American leadership in the global economy. The same can be said for tax reform that would shift resources from domestic consumption to business investment, another Bush administration policy. But U.S. fiscal consolidation is not the whole story of global imbalances, or even the largest part, as recent research at the Federal Reserve by Christopher Erceg, Luca Guerrieri and Christopher Gust shows.

The steps abroad are more significant -- and clear as well. Key emerging-market economies like China need to absorb more of their domestic savings. Arithmetic makes a powerful case here. Last year, if reserves-rich emerging-market economies had run current account deficits equal to their inflows of foreign direct investment, the aggregate swing in their current account position would have eliminated much of the U.S. current account deficit. And given the spotlight now being cast on China, it is worth noting that such a shift for China alone would have offset about one-sixth of the U.S. current account deficits.

But economics is more than arithmetic. To increase domestic spending in a way consistent with long-term growth, domestic financial systems must be able to allocate capital to its most valued use, improving consumers' ability to borrow and the efficiency of business investment. Such capital-market efficiency cannot be taken for granted. Consider Japan's decade-long struggle with nonperforming loans and its current battle over cross-border M&A and the privatization of the slumbering Japan Post. More to the present situation, consider China's massive and mounting nonperforming loan problem, as state-owned enterprises devour credit better used by entrepreneurs.

Herein lies a clue to the puzzle. If capital markets around the world matched the effectiveness of those in the U.S., one would expect capital to flow on balance from the U.S. and Europe to emerging economies like China. That flow, of course, is not materializing. In a recent economic study, Charles Himmelberg, Inessa Love and I found that weak institutions and capital-market imperfections in emerging economies can lead to very high costs of capital for productive investment at home. In this context, using American leadership to focus on exchange rates alone misses a bigger opportunity -- to tackle the much larger need for financial reform that will permit imbalances to ease.

In its focus on improving the financial capacity for growth in the poorest nations of the world, the Bush administration's Millennium Challenge Account rightly seized upon the centrality of underpinnings of financial markets for economic growth. But the same themes are useful in tackling the problems of large emerging economies which figure more prominently in the movement of funds in international capital markets.

The world economy's imbalances are not simply the fault of U.S. policy, but serious discussion of the way forward must begin in Washington. And it must begin soon.

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