NEW MINERVA REPORT

Bernanke's Paradox Explained

It's not America's fault! According to Ben Bernanke, America's large current account deficit and the lower bond yields that are Alan Greenspan's conundrum, are in fact the fault of excess savings in Emerging Economies. Bernanke, who was a governor of the Federal Reserve, has now become chairman of George Bush's Council of Economic Advisers. He is even being tipped as Alan Greenspan's (who retires next year) successor. The instincts of most commentators to his assertions are to be dismissive. However, in part he is correct. The worry that stems from his assertions is that he could advise George Bush that it is not America's problem, and the solution therefore has nothing to do with the US. So how is he partially correct?

The answer to this was first postulated by John Maynard Keynes in his book 'General Theory of Employment, Interest and Money' in which he describes the 'Paradox of Thrift'. This book was written in 1936 after the Great Depression. The 'Paradox' is that when the Private Sector wants to save more than it wishes to invest, you get economic trouble. What may be good for the individual can be bad for the economy. In economic terms: 'savings' are the difference between 'income' and 'consumption'. 'Private savings' are the sum of 'personal savings' and 'corporate savings'.

In an insular economy, excess private savings would normally result in two things. Firstly, you will find that the country will usually have a large fiscal deficit. This is because the government will try to stimulate the economy by either lowering taxes, or increasing its spending. Secondly, the excess savings will seek yield and returns. This means that interest rates and risk in markets will fall. In an open economy within the world, you will find that in high savings countries you have current account surpluses, and visa versa. Any exchange rate policy to stop your currency appreciating will just exacerbate the surplus. Japan has been a good example of the 'Paradox of Thrift' in our modern times.

Now, if you take a step back from looking at this from just a country basis, you can see how this affects the global economy as a whole, and why Bernanke is partially correct. He points to the Asian currency crisis in 1997, and how since then, many emerging economies have became over cautious. They have cut back sharply on investment, and caused their current accounts to swing round into surplus. In an open global economy it is not necessary for emerging economies to run up their fiscal deficits because, by exporting goods, their economies grow at acceptable levels. The exception to this was Japan, who had an earlier crisis, which pushed it into excess savings and whose economy was too big for it to rely on the rest of the world to bail it out. So it has a huge fiscal deficit, which soaks up some of their excess savings. The problem is that in order to create economic growth at home, the US has been soaking up the excess savings elsewhere. This was not intended. It is also not something that can go on indefinitely. It is estimated that if the current account deficit stabilises at the current ratio to GDP, the ratio of net liabilities to GDP would rise to 100%. New Zealand is the only industrial country to have had a net stock of liabilities of more than 100% of GDP. The consequences of an industrial country the size of America doing the same are very undesirable.

There is one other point that Bernanke forgets in his analysis, and that is 'corporate saving'. Whilst he has

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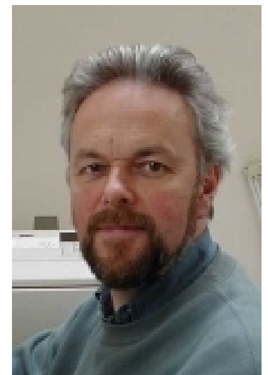

incorporated this in his assessment of the excess savings in emerging economies, he has forgotten to include the corporate savings in the US. Arguably this is just as important as the emerging economies. Since the TMT crisis, corporate America has been repairing its balance sheet. From 2002 American firms have had an average net financial surplus of 1.7% of GDP. This compares to an average 1.2% deficit of GDP in the previous two decades. This is just as important to Alan Greenspan's conundrum. Over half the emerging economies' swing from surplus to deficit occurred before 2000. But from 1996 to 2000, the yields on US Treasury Bonds was roughly the same. The big fall in bond yields occurred after that, at the same time as companies moved from deficit to surplus.

Global Solutions

These problems will have to be sorted out on a global basis. How it is resolved will have long term implications to markets for years to come. The US will not be able to do it on its own, and blaming others will not help. In fact, it could have the disastrous effect of inducing protectionism. This was the policy response that created the 1930's Great Depression. There have been growing signs of this by US politicians in the past year. Emerging economies will have to find a way of inducing a reduction in private savings. It makes no sense for relatively poor countries to lend to America so they can borrow and spend. Initially, governments should start to increase their deficits to soak up excess savings. This money can be invested in sought after infrastructure. They should also think of ways of getting their consumers to increase their spending. As the excess savings is lowered, the US should start to reduce its fiscal deficit, thus increasing savings. The current high price of oil is causing a slight shift of excess savings towards oil producers, particularly the Middle East and Russia.

US Housing

It looks as if the UK is showing the US the problems that lie ahead. As the UK property market has cooled, so too has consumer spending. According to Alan Greenspan, the US is currently experiencing, not a property 'bubble', but property 'froth'. Just as in the UK, this has added to the amount of spending that consumers have been prepared to make. The median existing house price has risen 22% per annum in the last six months, a rise not seen even in the 1970s. At the same time, new home prices have fallen by 5%, because a flood of new properties has hit the market. 'Investment' buyers now represent 23% of all home purchases. Many of these have bought with adjustable rate mortgages. As many of these have initial fixed offer periods, or annual interest rate adjustments, it will be some time before the Fed's interest rate increases affect them. There is, however, the potential for the consumer to pull back from spending when house prices flatten. If they actually fall, then the US and the world economy will be in big trouble. Effectively the US consumer will start to save again, being hit by a distress situation in the same way that the Japanese did after the stockmarket boom-bust, Asian countries did after their currency crisis, and US companies did after the TMT crisis. The only problem is the US consumer has become the spender of last resort, upon whom everyone is relying.

Chinese Revaluation

We warned that momentum for the Chinese to revalue the Yuan was building. It is all part of the adjustment needed as described above. The Chinese authorities finally relented, but in their own inscrutable way, in a manner no-one really expected. They have shifted their currency peg away from only the US dollar, to a basket of currencies. In so doing, their currency appreciated 2.1% against the dollar. There will now be a daily announcement by the People's Bank of China of the exchange rate. The make-up of the basket of currencies is not known by the markets. Chinese officials insist that the revaluation we have seen is all there will be. We suspect the Chinese will allow their currency to appreciate a little over the coming year, but will wait and see how the new regime 'beds' in. There may be a little further upward adjustment prior to the Chinese President's visit to the US in September. There has been a lot of Chinese money moving into China, speculating on this revaluation. It is possible that too greater an appreciation could see some of that leave, as profits are taken. That could produce downward pressure on the Yuan in the future.