Many unhappy returns
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While rich-world investors struggle to make decent returns, investors from emerging markets are lending to America as never before

WHAT links the ludicrous price of property in London with financial markets? One answer is obvious: the buying power of the City shilling, or rather many millions of them. But there is another answer, less obvious, perhaps, but probably more powerful: that prospective returns from financial assets in general are now so low everywhere in the rich world that people have turned instead to real assets in the form of bricks and mortar. Though the British love affair with houses is legendary, the fact that this is happening everywhere except Japan (where house prices have been falling for 13 years) suggests that some powerful forces are at work.

One reason for the paucity of returns the world over comes from the inflation-adjusted level of short-term interest rates in America, which, despite three rises this year, are still abnormally low by historical standards. Thus have investors plonked their money in anything else that might earn a decent crust: longer-term Treasuries, corporate debt, emerging markets, you name it. So much money has found its way into riskier assets of one sort or another that there are now only paltry returns to be had over and above the meagre risk-free rate (ie, government bonds), a rate which has become steadily more meagre even as oil prices have risen sharply. The poverty of Treasury yields says a lot about the outlook for the American economy. It might also say a lot about the unwillingness of investors in emerging markets to invest in their own countries, suggests David Goldman, head of global markets at Banc of America Securities.

Economic theory would suggest that capital should flow from developed to developing countries, for the simple reason that the latter need the money and the former need the returns. And investors from rich countries have indeed increasingly invested their savings in emerging markets in recent years. According to the Institute of International Finance (IIF), capital flows into emerging markets will this year amount to $226 billion, an increase of 81% from the dog days of 2002. Much of this will be in the form of direct investment; portfolio flows, says the IIF, will fall by a quarter.

Intriguingly, however, the wave of money flowing in will be more than matched by a veritable tsunami...
of money flowing out: outflows, says the IIF, will be higher than inflows by around half. Emerging countries will lend a net $74 billion this year, 90% more than last year.

But the main way in which emerging countries are in effect lending to rich countries—or rather one rich country, America—is by amassing foreign reserves, which are then invested mainly in Treasuries. The IIF expects emerging countries, led by China, to increase their foreign-exchange reserves by $246 billion this year, and by a further $225 billion next year. As Mr Goldman puts it: “As long as a rich Chinese won’t lend money to a poor Chinese unless the poor Chinese first moves to the United States, the lion’s share of the savings of billions of productive and thrifty Asians will find their way to the United States.” The effects, of course, are to support America’s current-account deficit, the dollar, Treasury bonds and risky assets of all sorts.

The export of capital from young, growing economies to old, mature ones is a recent and unusual phenomenon. The IMF, for one, thinks it unlikely to last, in part because there are costs to accumulating such huge foreign-exchange reserves, since they are likely to be inflationary. Perhaps so, but the causes of this export of capital are deep-seated: the trend can be traced back to the Asian financial crisis of 1997, which destroyed the savings of many investors there. The result is that Asian investors are content to lend money to the American government at 4% or thereabouts because they are confident of getting it back. To this extent, buying Treasuries is a strategy of diversification. It also allows rich Americans to spend more than they would otherwise do—and, of course, to invest in higher-yielding, emerging-market assets.

The accumulation of foreign-exchange reserves and generally better economic policies have presumably made emerging economies more stable than they were. That is why the credit ratings of such countries have improved a bit in recent years. How confident governments are that this will continue will be reflected in their willingness to let their currencies drift up against the dollar. The Chinese are reluctant to let the yuan, which is pegged to the dollar, rise for now, despite much foreign pressure; at some stage, when confidence in China and other Asian countries rises, so will their currencies.

A question mark also hangs over such things as property rights and robust legal frameworks. The absence of these is the reason why many emerging markets remain just that—and why people in them want to salt their money away in more stable places. Think, for example, of the immediate reaction of Russians to the travails of Yukos, a Russian oil company, which the government is taking away from its owners: capital flight.

Such countries are unlikely to become stable, western-style democracies overnight; indeed, many may never do so, whatever the wishes of rich-country investors. On the other hand, there comes a point where the opportunity cost for those in emerging markets of investing in US Treasuries—issued by a country which has the economics, perhaps even the politics, of an emerging market—becomes too great; and the risks of keeping so many of their eggs in this particular basket become similarly discomforting.

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