

State of the Union /

By Jonathan M. White

Don't Blame the Unit of Account

On Jan. 1, the fifth anniversary of the introduction of euro notes and coins, Slovenia became the currency club's 13th member. Recent opinion polls, though, show that a majority of citizens in the larger euro-zone countries don't feel like celebrating. They believe the euro has damaged their national economies, and more than half want their former national currency back. And there is still a perception that the euro has led to price rises even though inflation is below 2%.

In reality, the euro is finally delivering on its promises and is playing a positive role in the current European recovery. Business cycles are more synchronized, and growth and inflation ranges across euro countries are roughly consistent with those across the U.S. According to the OECD, the common currency has increased euro-area trade by 5%-15%. Cross-border mergers and acquisitions are on the rise. For the second year in a row, euro debt surpassed dollar-denominated issues as borrowers world-wide raised capital in euros at an unprecedented pace. Some Asian and Mideastern governments are diversifying their assets out of dollars and into euros, adding to this trend.

If the euro hasn't yet fulfilled all its promises, it's not the currency's fault. The euro eliminates exchange-rate risks, enhances price transparency and provides a more stable environment for trade and investment. Intra-euro area foreign direct investment (FDI) rose to 24% of euro-zone GDP in 2004 from nearly 14% in 1999. Almost one-third of global FDI goes to the euro area, generating jobs, trade and growth. The problem is that uneven progress on domestic reforms and the single market leads to uneven euro benefits, holding back Europe's growth potential.

The euro-zone economy is estimated to have expanded by about 2.6% in 2006. That's better than in previous years but modest by OECD standards. And this year euro-zone growth is estimated to fall to 2.2%. Despite the ability to compare prices across the euro area and an increase in trade within the currency zone, a bias for domestically produced goods still persists. Trade in services remains particularly low. The expected investment boom resulting from economies of scale and lower capital costs that would come with a truly integrated financial market has not materialized yet. That's because a truly integrated financial market has not yet materialized either.

This mixed performance has led some to blame the euro for their economic woes. In summer 2005, former Italian welfare minister Roberto Maroni went so far as to urge a temporary reintroduction of the lira, as if pre-euro Italy were an economic success story.

Nobel Prize economist Robert Mundell first explored the trade-offs that come with joining a currency union. The most significant change is that policy makers lose exchange and interest rates as economic tools. In a currency union, it is the mobility of goods, services and people that provide the answer to asymmetric shocks, which affect some geographic areas of an economy more than others. European economic integration and domestic reforms can provide this mobility. Implementing the directive on Markets in Financial Instruments this coming November will help to forge an EU-wide capital market. But the EU Services Directive fell short of opening up the rest of Europe's service industry. A more ambitious services liberalization, as well as structural reforms in labor, product and financial markets, would widen the single currency's benefits by magnifying competition, mobility and growth.

Upon Slovenia's adoption of the euro, Joaquin Almunia, the EU commissioner for economic and monetary policy, said greater wage flexibility and higher labor productivity growth will be critical to enhancing Slovenia's competitive position and adjusting to asymmetric shocks. This is good advice for euro newcomers and veterans alike.

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By Niall Ferguson
And Moritz Schularick

Global markets boomed last year—and nowhere was the euphoria more pronounced than in the initial public offering of Industrial and Commercial Bank of China, the biggest IPO in history. But Chinese banking stocks were only the extreme example of a general surge in asset prices that also manifested itself on global bond markets, real-estate markets and even art markets.

A popular explanation for this unusually correlated upward trend in nearly all asset valuations is "excess liquidity," usually blamed on the lax monetary policy before and after the dotcom bubble. But is that view correct? Probably the best measure of excess liquidity is the so-called "Marshallian k", i.e., the ratio of a narrow or broad monetary aggregate to nominal GDP. If the world is really experiencing excess liquidity, the supply of money in major economies (e.g., M3) should be outstripping the demand for money (as measured by nominal GDP) by a significant amount. In the U.S., however, the ratio of M3 to GDP has been stable at around 80% since 2002.

Another vogue theory is that there is not an oversupply of liquidity but a shortage of assets. Certainly, many corporations have been buying back their own stock, while private equity partnerships have been taking companies out of the public markets. But equity valuations do not suggest that this alleged shortage is very acute. The price/earnings ratio of the S&P 500 is one standard deviation below the long-term average. In our view, the rapid increase of stock buy-backs and leveraged buyouts is a symptom, not a cause, of something more fundamental.

The defining feature of the current world economy is not an excess of liquidity or a shortage of assets, but the gap between company profits and the level of real interest rates. This wedge between the return on capital and the cost of capital is in large measure attributable to the spectacular rise of what we call "Chimerica": the sum of China, the world's most rapidly growing emerging market, and America, the world's most financially advanced developed economy.

As is well known, the rapid integration of the biggest economies of East and South Asia into the global economy has had profound effects on the relative returns on the two main inputs of global production—capital and labor. With two billion people entering the global work force, the pool of available labor has almost doubled. By comparison, the global capital stock has increased only by a small amount. This has resulted in a massive shift in the relative rewards to capital and labor. Company profits to GDP have risen across the globe and are at record highs in almost all markets.

The novelty is that higher returns on capital have not gone hand in hand with a higher cost of capital. On the contrary, the cost of capital, as measured by global real interest rates, has actually gone down. According to our calculations, the global long-term real interest rate has averaged around 4% since 1991. Current real rates are about 130 basis points lower. Given the recent increase in the return on capital, we estimate that real rates are between two and four percentage points lower than economic theory says they ought to be.

That the price (not the supply) of money is the real conundrum of our times is perfectly illustrated by the relationship between nominal GDP growth and the yield of 10-year U.S. bonds. Defying all that theory would lead us to expect, long-term nominal interest rates in the U.S. have been considerably below nominal GDP growth for an extended period.

Under these circumstances, it is hardly surprising that growth- and risk-sensitive

assets have become extremely attractive for investors. The combination of depressed real rates and buoyant corporate profitability makes it smart to borrow money and to buy earnings streams. Small wonder we have seen record low spreads in the corporate bond market. Small wonder there has been a boom in private equity investment and leveraged buy-outs.

Of course, low real interest rates and high company profits are difficult to reconcile over the long term. This is the idea behind the "Fed model"—the basic macroeconomic model the Federal Reserve uses to judge the information conveyed by stock-market valuation. It compares the earnings yield of the S&P 500 (the inverse of the P/E ratio) with the 10-year bond yield. Over longer time horizons, extreme divergences are corrected. The Fed model correctly indicated stock-market overvaluation ahead of the crashes of 1987 and 2001.

What the Fed model has been telling investors for some time is to prefer stocks to bonds because earnings yields are much higher than bond yields. And to some extent that advice is finally being heeded. Yet there is reason to think that the bond market may not correct by much this time around. For something is working to prevent real rates and corporate profitability reverting to their traditionally close relationship. And that something is Chimerica.



To understand the current and persistent disconnect between returns on and the cost of capital, think of a single Sino-American economy. Chimerica accounts for only 13% of the world's land surface, but a quarter of its population and fully a third its GDP. What's more, it's accounted for over 60% of the cumulative growth in world GDP over the past five years.

West Chimericans are wealthy and hedonistic; East Chimericans are much poorer (even adjusting on the basis of purchasing power parity, their per capita income is around 16% of that in West Chimerica). But the two halves of Chimerica are complementary. West Chimericans are experts in business administration, marketing and finance. East Chimericans specialize in engineering and manufacturing. Profoundly West Chimericans cannot get enough of the gadgets mass produced in the East; they save not a penny of their income and are happy to borrow against their fancy houses. Parsimonious East Chimericans live more humbly and cautiously. They would rather save a third of their own income and lend it to the West Chimericans to fund their gadget habit—and keep East Chimericans in jobs.

Under this arrangement, East Chimericans generate massive trade surpluses which they immediately lend back to West Chimerica. By channeling all these surpluses through government hands into government paper, East Chimerica depresses the key long-term interest rate in West Chimerica. And thanks to artificially low interest rates, financial and real assets in West Chimerica and its satellites are booming.

To be sure, Chimerica is an economic but not a monetary unit: East Chimericans have the renminbi, West Chimericans the dollar. Nevertheless, the scale of the financial transactions between the two halves is comparable with the flows that traditionally have occurred within nation states rather than between them.

Over the past years, China's currency reserves increased by an annual rate of almost 200% and now equal more than 40% of its GDP. That is almost identical to the amount of net new issuance of U.S. Treasury securities and agency debt: \$220 billion in 2005 and \$195 billion in 2006. Given that total outstanding U.S. Treasury and agency debt at the end of 2006 was about \$6 trillion, and assuming that Beijing holds 90% of its currency reserves in American assets, China may already own as much as 15% of the total stock of U.S. official paper.

Conventional wisdom holds that Chinese households are the archsavers of Asia. Measures to increase Chinese household consumption have become the latest patent remedy for resolving global imbalances. However, the personal savings rate has already fallen quite significantly over the past decade. In fact, most of the rapid increase in surplus savings has come from the Chinese corporate sector in the form of undistributed profits. Between 2000 and 2005 these increased to 21% from 16% of Chinese GDP and are now much higher than household savings which remained roughly constant at 16%. In 2006 corporate savings may have approached 25% of GDP.

The proximate cause of this surge in corporate saving is that Chinese companies have made enormous gains in market share both at home and abroad, leading to record company earnings.

But the real explanation is that, despite some upward pressure on the Chinese currency, Chinese manufacturers have continued to make massive gains in price competitiveness. Although it is inherently difficult to construct, a productivity-adjusted measure of the real exchange rate between the dollar and the renminbi suggests that the renminbi is cheaper today than ever before.

This is the key to the future of Chimerica. East Chimerica is providing West Chimerica with lower real interest rates than returns on capital would lead us to expect. But the other side of the deal is that East Chimerican manufacturers are enjoying an unbeatable advantage on world markets.

We see two potential threats to the future stability of Chimerica. First, for the sake of short-term political advantage, American legislators may continue to press for protectionist measures against China. The danger is that the Democrats' new dominance of Congress may finally turn rhetoric into reality.

There are risks on the other side of Chimerica, too, as China progressively liberalizes its financial system. So far, the People's Bank of China (PBoC) has been highly successful in controlling the domestic money supply and inflation through a mix of administrative and market-based measures in a tightly regulated banking system. If the PBoC loses its grip on the system, however, the inflationary pressures already visible on the Chinese stock market could finally spill over into consumer prices.

If either U.S. trade policy or Chinese monetary policy goes awry, then the Fed model could return to the bond market with a vengeance. Then, and only then, will it be possible to dismiss Chimerica as—a chimera.