

Reversal of fortune

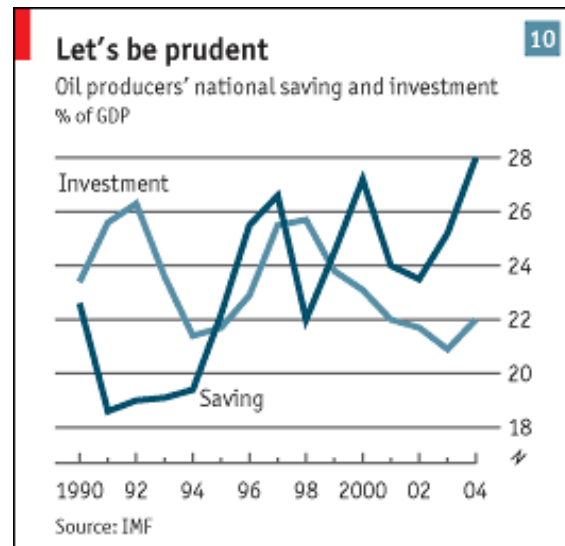
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Why oil exporters and East Asians are reluctant to spend

JAPAN and China may be the whales amongst the world's savers, but their surpluses add up to only about 40% of America's saving deficit. The rest comes from a shoal of smaller fish. Most are emerging economies, particularly in Asia and the Middle East. These countries are piling up current-account surpluses for different reasons. Saving in oil-exporting countries has soared, and private-sector investment in emerging Asia outside China has collapsed.

The role of oil prices in today's global imbalances is often overlooked, but surplus saving in oil-exporting countries, as a group, is now the biggest counterpart to America's deficit. In 2004, when the oil price averaged \$40 a barrel, oil exporters ran a collective saving surplus of \$207 billion, almost three times as much as in 2001. So far this year, oil prices have soared, and the IMF now expects the oil exporters' collective surpluses for 2005 to be almost \$400 billion. That should not come as a surprise. A sudden windfall of wealth from a "terms-of-trade shock" initially tends to be saved not spent, and national saving rates in oil-exporting countries have recently shot up (see chart 10).



But the oil-producing countries are being unusually frugal. Their investment rates have actually fallen since the late 1990s. Why? First, they believe today's elevated prices to be temporary. If oil prices are likely to fall back to, say, \$30 a barrel, it is prudent not to spend the extra revenue. Second, they are determined not to repeat the mistakes made in previous oil booms, when excessive profligacy left many oil producers high and dry as prices fell. In the late 1970s, Nigeria was swimming in petrodollars; by the mid-1980s, it was going cap in hand to the IMF.

This time around the oil-rich countries have created rules to encourage prudence. Several of them now have "oil stabilisation funds" into which windfalls should flow. Others have been shoring up fiscal positions that were looking rather unhealthy at the end of the 1990s, after a long period of cheap oil. Saudi Arabia's government, for instance, has been paying back the debt accrued over 17 years of budget deficits. Russia is paying off its external creditors.

This prudence may not last. Many oil-exporting countries, particularly in the Middle East, have young populations and a huge need for physical and social infrastructure, so investment is likely to rise. But with memories of past oil busts still vivid, that shift may not be sudden.

Where are the tigers now?

The saving surplus in East and South-East Asia is the legacy of a bust both more recent and more spectacular than the 1970s oil shocks: the Asian financial crisis in 1997-98. A decade ago, the regions' economies, from the more developed (such as South Korea) to the poorer ones (such as Thailand), were in the midst of an investment binge, particularly in property. Several of them became big importers of savings, running current-account deficits of 4% of GDP or more. When the crisis came, investment plunged, from around 35% of GDP to less than 25%. Although it has recently risen a little, it is still extremely low. Overall, the investment rate in East and South-East Asia is now close to the average in Japan, a much richer country.

East Asia's saving surplus, in short, has little to do with increases in saving. National saving rates in the region have remained relatively stable. While corporate saving has risen, household saving in many places has fallen, thanks both to demographics and to government efforts to boost consumption. In 1998, South Koreans saved 24% of their incomes; by 2003, the figure was down to 4%. Thailand's household saving rate fell from 15% of GDP in 1998 to 6% in 2003.

The puzzle is why domestic investment has not recovered more. A big bust was always going to entail a prolonged period of balance-sheet adjustment, and investment rates had never seemed likely to return to their excessive pre-crisis levels. Even so, seven years after the crisis, and with growth in the emerging East Asian countries now strong, it seems odd that investment is still so weak.

One explanation may be that China's rise has resulted in a bigger shift in investment demand in the rest of Asia than elsewhere in the world. Investment in export sectors, in particular, may simply have shifted to China. Sun-Bae Kim of Goldman Sachs, an investment bank, points out that investment rates in emerging Asia as a whole, including China, look much healthier than in the region outside China (see chart 11).

But emerging Asia's biggest investment weakness is outside the export sector. The mystery is that rapid export growth has not translated into higher domestic-sector investment, especially as real interest rates in the region have been low or even negative for much of the past three years.

Most analysts blame Asia's currency policies. They argue that, just as a cheap yuan has recently distorted China's economy, and a cheap yen distorted Japan's in the early 1980s, so the rest of Asia is cursed by its addiction to export-led growth. The proof lies in the region's growing accumulation of reserves, which is a measure of Asians' efforts to hold down their currencies. According to the Bank for International Settlements, emerging Asia outside China increased its reserves by \$147 billion in 2003 and \$157 billion last year.

Not everyone agrees with this argument. Jonathan Anderson, an economist at UBS, maintains that Asia's central banks are holding their currencies down not in order to boost exports at the expense of domestic consumption, but rather because domestic demand is so weak.

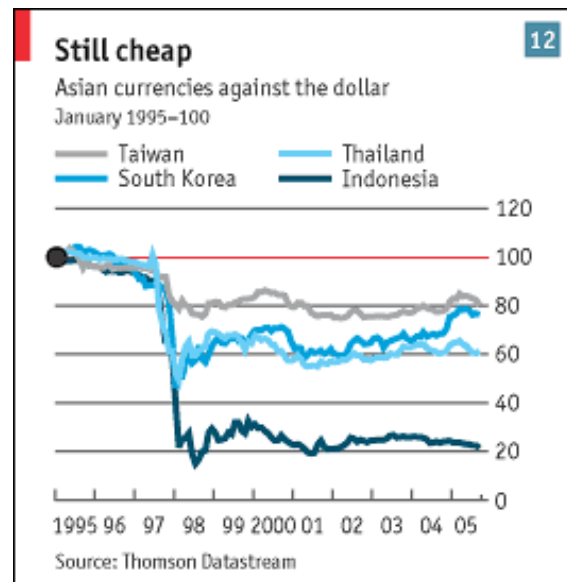
Whatever their motivation, there is no doubt that Asia's central banks worry about the strength of their currencies. The exact circumstances differ from country to country. Except in Hong Kong, no currencies are now tied directly to the dollar. Malaysia abandoned its peg as soon as China did. Nonetheless, most currencies have moved relatively little against the dollar (see chart 12). There is a widespread fear of moving too far, too fast.

Emerging Asia's governments are also leery of other quick fixes to boost domestic investment or spur consumption. It was, after all, excessive domestic investment—thanks partly to rash liberalisation of the financial sector—that got them into the crisis in the first place. And there have been other fiascos since. In 2000-2002, South Korea tried to stimulate consumption by encouraging consumer borrowing on credit cards. But supervision and credit-rating turned out to be inadequate, so the credit-card boom quickly turned to bust.

Nonetheless, there are some tentative signs of an upturn in domestic demand. The region's stockmarkets have risen by \$1.6 trillion since 2001, equivalent to one-third of nominal GDP. Residential property prices have picked up. Several economies in the region have already seen their current-account surpluses shrink. Thailand's current account even moved into deficit this year. As these countries are oil importers,



high oil prices will also reduce the region's surpluses. Emerging Asia's willingness to send its savings abroad may have peaked. But given the region's recent history, the odds are that the adjustment will be gradual.



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