SERIES: FRONTIERS OF GROWTH

The Hot Money Trap

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SHANGHAI – The recent financial crisis has seen Asia emerge as an economic powerhouse – indeed, as a key driver of global growth. Within five years or so, Asia's total economy could be as large as that of the United States and the European Union combined.

Indeed, while Asia is rising, the rich industrial countries of the old G-7 have been drifting into a liquidity trap. As the ongoing recession exhausts the traditional instruments of monetary policy, central banks are opting for new rounds of quantitative easing (QE). And, with investors seeking higher returns, more QE – especially by the US – will drive "hot money" (short-term portfolio flows) into high-yield emerging-market economies, which could inflate dangerous asset bubbles in Asia, Latin America, and elsewhere.

The US Federal Reserve and the Obama administration remain rhetorically wedded to maintaining a “strong dollar.” But it is the dollar’s weakness that has boosted US corporate earnings since the crisis erupted, propelling the Dow Jones Industrial Average above 11,000 for the first time since May. Since early 2002, the dollar has fallen by one-third against major currencies, and recently this decline has intensified.

Since the end of August, when Fed Chairman Ben Bernanke argued for another round of QE, the dollar has plunged more than 7% against a basket of half a dozen major currencies. Inflation-protected securities are now being sold at negative yields for the first time ever.

Following the mid-term elections and the resurgence of the Republicans in the US Congress, the Fed’s decision to pump $600 billion into the economy by mid-2011 is likely to trigger similar actions in the United Kingdom, Japan, and other advanced economies. Moreover, the Fed has left the door open to more quantitative easing next year – a tacit acknowledgement that the recovery will be long and sluggish. But the effect of a new round of QE on interest rates could be small and limited to an announcement effect, as the Fed’s own research indicates.

In fact, the full impact of America’s “QE2” will not be domestic, because the net effect will be a weaker dollar as speculators bet on its decline. Successive waves of QE would amount to debasing the value of the dollar, and thus inflating away massive US debts.

Meanwhile, developing countries are moving in the opposite direction. In October, the People’s Bank of China, responding to the twin threats of inflation and asset bubbles, raised its one-year deposit and lending rates by 25 basis points, to 2.5% and 5.56%, respectively – the first increases since 2007.

In the West, concerns about the impact on Chinese growth triggered a fearful sell-off in the markets. Right before the Fed acted, the Reserve Bank of India raised its benchmark short-term interest rate by 25 basis points, to 6.25%, to fight inflation, and China’s central bank now indicates that it might raise interest rates further.

In Brazil, interest rates remain close to 11%. After the Fed’s QE move, Brazil is preparing to retaliate. “It’s no use throwing dollars out of a helicopter,” as Brazilian Minister of Finance Guido Mantega put it. Soon afterward, Germany’s finance minister called US policy “clueless,” while his South African counterpart thought that the Fed´s move undermined the G-20 leaders’ “spirit of multilateral cooperation.”

Today, a deepening global divide sets the slow-growing US against many emerging-market economies and commodity-producing countries. The worldwide impact of QE has only aggravated the chasm, reflected by the rifts among the G-20 nations. As the Fed exhausts the power of traditional monetary instruments, it is heading into uncharted territory, with the potential of unpredictable outcomes and unprecedented collateral damage.

There is also the risk of a disruptive decline in the dollar, which could prompt investors to flee US debt. In his famous 2002 speech on the potential of deflation in America, Bernanke suggested that Franklin Delano Roosevelt's 40% devaluation of the dollar in 1933-1934 shows that exchange-rate policy can be an "effective weapon against deflation."

Today, however, global economic integration and interdependence are much deeper than in the 1930's. As Chen Deming, China's Minister of Commerce, recently complained, "The United States' issuance of dollars is out of control and international commodity prices are continuing to rise." As a result, "China is being attacked by imported inflation."

The impact of the Fed's policy and hot money has been dramatic. In the third quarter of this year, China's foreign-exchange reserves increased by $194 billion, which far exceeded the country's $66 billion trade surplus and $23 billion in inflows of foreign direct investment. At least part of the difference can be attributed to "hot money."

Most importantly, a disruptive decline of the US dollar (or a disruptive appreciation of the Chinese renminbi) could hinder not only China's growth, but also global recovery. In the 1990's, emerging and developing economies were still dependent on G-7 growth. In the past decade, these countries have, as OECD research has shown, become dependent on Chinese growth. Any decline in China's growth would thus significantly undermine poverty reduction in the emerging world.

During George W. Bush's presidency, unilateral security policies left America without friends. In the Obama era, unilateral economic policies may have the same result. In a global economy, the decisions of the leading countries' central banks have global implications. And, in a world where the G-7 no longer drives global growth, printing money is playing with fire.

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