

Financial Times Reports:

US Faces Flood of World Savings Cash

By Charles Dumas

Fed may face choice of fostering growth or checking fresh bubbles

United States real assets are increasingly the only major game in town. Investors with global reach looking for security and return have few options as attractive, and none on the same scale. The world could soon see the kind of cash flow to the US that underpinned the late-1990s stock market boom, culminating in the tech bubble.

Too much saving means too much investment for the world as a whole: no export surplus can serve as a safety valve, as it can for individual countries.

World savings were just under a quarter of gross world product last year, matching 2007's all-time high ratio. But in 2007 the world's baseline real interest rate – the inflation-adjusted yield of US 10-year [Treasuries](#) – was just under its long-run average of about 2.5 per cent. By 2012, the real 10-year Treasury yield was minus 0.5 per cent.

World investment necessarily equalled world saving, but was only spurred to that level in 2012 by a negative real cost of capital. This implies a negative risk-adjusted return on capital. Without that, world investment last year would have been lower, and with it growth, income, and therefore

saving.

This year the real yield of 10-year US Treasuries has bounced to plus 0.5 per cent. Scarcely a huge hurdle rate for the return on capital, you might think. But already enough to stall the growth of US housing starts, and to tip some developing countries with trade deficits into restrictive policies. Meanwhile, the eurozone's "recovery" has relapsed and Japan's competitive devaluation scoops demand out of the rest of the world.

Undervalued currencies

Most emerging markets have overvalued **currencies**. How do we know? Because the measured real exchange rates of most advanced countries are undervalued. The OECD's measure of relative unit labour costs has the US undervalued by 15 per cent, the eurozone by 10 per cent, Japan by more than 20 per cent and Britain by nearly 20 per cent – all relative to the 1973-2012 post-Bretton-Woods average.

These advanced countries have three-fifths of the world's GDP. But the world as a whole cannot be undervalued. So emerging markets are way overvalued, notably China, Russia and Brazil.

While developing countries in deficit suffer as bond yields rise, those in surplus, heavily dependent on exports, face advanced country undervaluation. Their export-led growth model has used the US as the market of first resort. But this no longer works, with the US real exchange rate at its lowest since the second world war, and its private and public borrowing now constrained.

Meanwhile, the eurozone has its own, southern "submerging markets". Spain has achieved some "internal devaluation",

but France, Belgium and Holland have drifted into “internal appreciation”. Germany looks convincingly cost-competitive – but needs it least. Germany’s exports, largely of capital goods, are traditionally price-insensitive. But their growth since 2007 has been largely to emerging markets, which are now themselves vulnerable. So relapse of the much ballyhooed eurozone recovery to near-stagnation could persist.

Not only is European weakness a big change from the late-1990s – [Japan](#) is another. No longer in major recession, its escape depends heavily on competitive devaluation. Japanese investors, facing minimal interest rates and deliberate stimulus to inflation, have every reason to seek assets abroad.

Growth to accelerate

When it comes to growth, the US is the world’s major positive story; and its firms are highly profitable, aided by undervaluation. Assuming federal budget disputes get resolved by late-winter, growth should accelerate to more than 3 per cent from next spring onwards.

This is hardly boom-time by late-1990s standards, but relatively restrained growth may postpone interest rate hikes, possibly also bond yields. Burgeoning energy output is cutting energy costs, enhancing undervaluation. It is hard to see how the dollar can avoid rising fast: inflation, already minimal, should be contained or even lowered.

The other big change from the late-1990s concerns China. While the “Tigers” that suffered the Asian crisis look stable now, China was protected by 30 per cent undervaluation in 1997-98 – but is 30 per cent overvalued now on Lombard Street Research’s estimates.

Reforms announced recently included removal over the next few years of controls on private capital outflows. Chinese annual savings are about one-quarter of world savings. Its private investors are likely to prefer US real assets to almost anything else the world has to offer.

Booming real estate, housing and stock market values could soon present the [Federal Reserve](#) with a painful choice between fostering growth and checking fresh bubbles.