

M&CO Newsletter

IMF Worries: “Global financial imbalances simply can’t go on forever...”

A recent International Monetary Fund meeting in Singapore came at a time of increasing worry about the sustainability of global financial imbalances: For how long can the global economy endure America’s enormous trade deficits - the United States borrows close to US\$3 billion (AUD 4Bn) a day – or China’s growing trade surplus of almost US\$500 million (AUD 666Mn) a day?

Last year was the 20th year in a row in which the U.S. came out a net debtor. By that measure, the U.S. was last a net creditor nation in 1988. The country is like a consumer with a platinum card. Big bills aren’t a problem as long as there is enough income to service them. For a consumer, that means a reliable and sufficient paycheck. For a country, that means economic growth that is fast enough to generate the returns those foreigners are looking for when they lend it money or build a plant that is effectively a claim on future U.S. production.

The problems come if growth in the U.S. slows relative to other countries, and foreigners look elsewhere for returns. “The way to think of that is if your income growth slows down, the creditors are going to stop lending to you and demand repayment,” said Andrew Bernard, professor of international economics at the Tuck School of Business at Dartmouth College in New Hampshire.

If that happens, the worst-case scenario is that interest rates will surge in the U.S., the dollar will weaken and growth will slow even more sharply. “The key for the U S is if our growth rate and productivity-growth rates slow down, we’ll have large repayment obligations,” Prof. Bernard said.

The Organization of Economic Cooperation and Development (OECD) reported that the U.K. last year surpassed the U.S. as the world’s largest recipient of direct investment. The U.K. drew in \$164.5 billion in direct investment, compared with the \$109.8 billion that went to the U.S. in the No. 2 spot.

The United States points its finger at China’s undervalued currency, while the rest of the world singles out the huge American fiscal and trade deficits. To its credit, the International Monetary Fund (IMF) has started to focus on this issue after 15 years of preoccupation with development and transition.

Treating the symptoms could actually make matters worse, at least in the short run. Take, for instance, the question of China’s undervalued exchange rate and the country’s resulting surplus, which the US Treasury suggests is at the core of the problem.

Even if China strengthened its Yuan relative to the dollar and eliminated its US\$114 billion-a-year trade surplus with the United States, and even if that immediately translated into a reduction in the American multilateral trade deficit, the United States would still be borrowing more than US\$2 billion a day: An improvement, but hardly a solution.

Meanwhile, because a stronger Yuan would make imported American food cheaper in China, the poorest Chinese – the farmers – would see their incomes fall as domestic prices for agriculture dipped. China might choose to counter the depressing effect of America’s huge agricultural subsidies by diverting money badly needed for industrial development into subsidies for its farmers. China’s growth might accordingly be slowed, which would slow growth globally.

As it is, however, China knows well the terms of its hidden “deal” with the US: China helps finance the American deficits by buying Treasury bonds with the money it gets from its exports. If it doesn’t, the dollar will weaken further, which will lower the value of China’s dollar reserves (now in excess of US\$1 trillion).

Any country that might benefit from China’s loss of export market share would put its money into a strong currency, like the euro, rather than the unstable and weakening dollar – or it might choose to invest the money at home, rather than holding more reserves.

In short, the US would find it increasingly difficult to finance its deficits, and the world as a whole might face greater, not less, instability.

Nothing significant can be done about these global imbalances unless the US attacks its own problems. While there may be sermons aplenty about why Americans should save more, no one has devised a fail-proof way of ensuring that they do so. The common wisdom is that there is but one alternative: Reducing the government's deficit.

Imagine that the Bush administration cut expenditure, as raising taxes is unlikely for an administration that has been arguing for further tax cuts. The expenditure cuts by themselves would lead to a weakening of the American and global economy.

There is one way out of this seeming impasse: Expenditure cuts combined with an increase in taxes on upper-income Americans and a reduction in taxes on lower-income Americans. Because poor individuals consume a larger fraction of their income than the rich, the "switch" in taxes would, by itself, increase spending. If appropriately designed, such a combination could simultaneously sustain the American economy and reduce the deficit.

Underlying the current imbalances are fundamental structural problems with the global reserve system. John Maynard Keynes called attention to these problems three-quarters of a century ago. His ideas on how to reform the global monetary system, including creating a new reserve system based on a new international currency, could, with a little work, be adapted to today's economy.

Until we attack the structural problems, the world is likely to continue to be plagued by imbalances that threaten the financial stability and economic well being of us all.

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Private equity Implications

The hot topic in investment markets has been the emergence of Private Equity firms taking large interests in some of our leading enterprises. We have seen Coles sell the Myer Department store group to US private equity and issue highly leveraged Myer notes to the public. Coles itself rejected a conditional Private Equity bid. Rebel Sports Ltd has been acquired by private equity. Qantas board has approved a private equity bid however the takeover for Qantas is yet to be completed. Alinta is subject to a bid by private equity. In most cases senior management has an equity stake and golden handcuffs to stay and run the businesses. This raises corporate governance issues as to whether senior management represent themselves or the existing shareholders, since senior management will always have information that is confidential and not in the public domain or available to shareholders. It is difficult to assess the implications of Private Equity takeovers, however in most cases the bids are highly leveraged with several layers of debt. The lowest levels are the secured loans at lower interest rates and the higher levels are usually unsecured or mezzanine and can be argued to really be "fixed return equity" rather than debt. Our concern is that some of these "equity dressed up debt" securities, eg Myer notes, are offered to the public, which cannot properly assess their credit-worthiness.

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