Is this the end of easy inflows for the US?

As the euro sinks lower, the euro-zone is in current account deficit. The result, says Giles Keating, is that easy inflows will no longer power the the US economy.

Economists used to think of the current account as being determined by domestic and external demand and supply, and then having to be financed by capital account flows. That paradigm may still be roughly appropriate for some less developed countries. But for today's key economies with open, sophisticated capital markets, the causation can run in both directions.

During the 1997–98 Asia crisis, the diversion of capital flows into the US helped reduce mortgage rates and boost stock prices. This stimulated demand and imports, and so created the larger current account deficit needed to match the increased capital account surplus.

From the start of 1999, and until recently, there was a similar effect as European investors exported capital to the US, to diversify their portfolios following the creation of the euro. This boosted the dollar against the euro.

In addition, as during the Asia crisis, it helped to push US stock prices up and mortgage rates down, boosting US consumer spending and therefore causing the US to run an even larger current account deficit.

FIGURE 1

Chaning patterns

This pattern now seems to be changing (*see Figure 1*). There is strong evidence that the capital inflow to the US has stopped increasing, and that its nature is changing, towards arguably 'lower quality' flows. The diverse data sources in the US, Europe and elsewhere have to be put together to complete the jigsaw – single sources such as SDC merger and acquisitions (M&A) figures ignore offsetting financing flows and exclude portfolio investment.

Overall flows from the euro-zone to the US were buoyant earlier this year. But with the zone now running a current account deficit, these flows are being financed by borrowing, short-term inflows and sales of long-term assets elsewhere in the world. As a result, they do not look sustainable.

European Central Bank data shows total euro area long-term outflows (FDI, equities and bonds over a year's maturity) to all nations reached some €300bn on a rolling 12-month total. By the third quarter, that had fallen to about €120bn and was still declining.

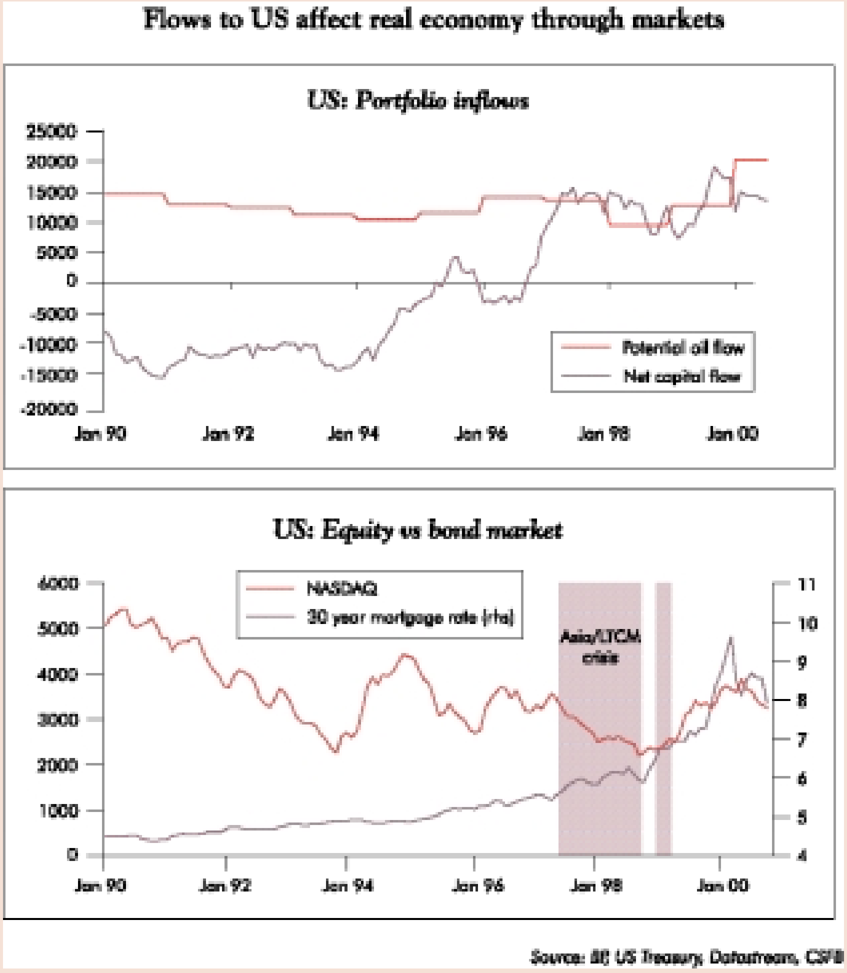

Giles Keating

Smoothing over the cracks

As European inflows to the US decrease, the gap appears to be being filled by recycled oil revenues, which have risen steeply as the oil price has surged (*see Figure 2*). As a result, capital inflows to the US have not fallen, although they do seem to have broadly stopped increasing and, consistent with this, the US current account deficit also seems to have stopped growing. In short, a big global macro-economic shift seems to be under way.

Moreover, the recycled oil revenues are probably flowing into debt repayment and lower risk assets, notably agencies and therefore mortgages. By contrast European money tended to go into stocks and corporate bonds. Some of the recent turmoil in US equity and credit markets may reflect the resultant reshuffling of ownership.

FIGURE 2



Consumers still enjoy a stimulus to their spending via the mortgage market, but businesses lose out. External flows are no longer holding down the cost of corporate capital, and this will adversely affect old economy investment. The new economy, critical for the current investment and productivity boom, has more internal finance and should be less affected.

Effect of oil prices

Any source of capital flow can alter rapidly, but the recycled oil revenues are particularly volatile because of their link to oil prices (*see Figure 3*). We expect these to fall below $28 in the first half of next year, signalling the end of the era of easy capital inflows.

Japanese investment into the US might fill the gap, but it is unlikely to be big enough to put inflows back on a rising trend. This implies that US current account deficit will have to stabilise, perhaps even edge down, and there may be downward pressure on the dollar.

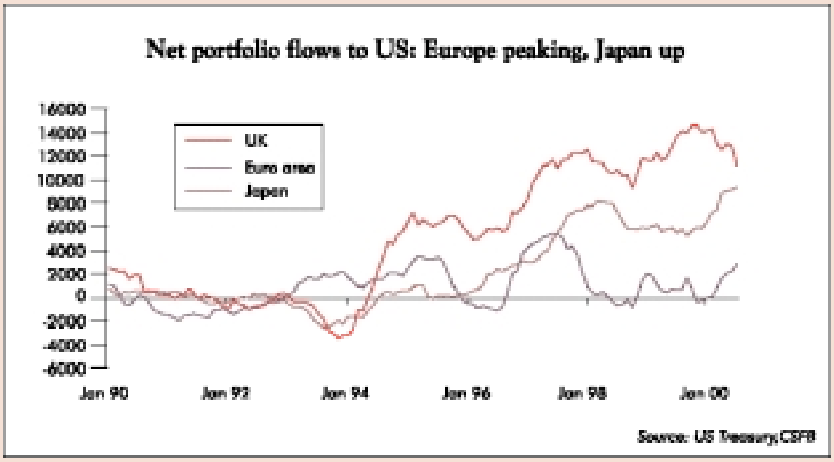
Current account adjustment will be much easier if demand is buoyant outside the US. Fortunately, 2001 will see a surge in domestic demand in Europe. Fiscal expansion in Germany, France and elsewhere ahead of elections in 2002, and big investment plans by telecomms companies holding 3G mobile phone licences, add about 0.75% to euro-zone domestic demand next year. Rising real wages should help as well.

A significant part of this will spill abroad, boosting demand for US exports. Meanwhile, technology investment should push Japan to a self-sustaining 4% growth late next year, and domestic demand also appears robust in most other key Asian economies.

So the prospects are fairly good for a switch in demand in 2001, away from the US and towards Europe, with capital flows into the US softening, the dollar correcting modestly perhaps to the mid to high 90s against the euro, and the US current account deficit stabilising or even fractionally narrower.

This would be a benign outlook, supportive of a soft landing for the world economy, but it may yet be frustrated if the political situation in the Middle East starts to create global economic instability. ■

FIGURE 3



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Six Wise Men

Giles Keating, and our five other regular contributors, give their predictions for the coming year. Six Wise Men starts on page 56.