Save or spend? Crunch tests

We published an article by Linda Lim, a professor of strategy at the University of Michigan's Ross School of Business on July 20, arguing that Asian economies should save less and spend more. The article spawned an exchange between Professor Lim and Prof Tommy Koh, chairman of the Centre for International Law at NUS, which we ran last week.

Today, we conclude the debate with contributions from Prof Augustine Tan of Singapore Management University and Prof Lim.

**By Augustine Tan**

Both professors Tommy Koh and Linda Lim made excellent points. I would like to add a few thoughts:

**Cheap money**

I agree with Prof Lim that cheap money helped to fuel "financial innovations" such as sub-prime mortgages.

Undoubtedly, greed was at the root of the risky investments but, as Prof Lim rightly pointed out, greed has always been around despite the compensation not to covet. Governments cannot eliminate greed but they can and should help to contain excesses.

The problem is that governments themselves face constraints in their ability to raise taxes to cover expenditures and often allow expenditures to grow out of control. Here populist policies and misapplication of Keynesian economics are to blame. Also, bailouts and stimulus deficit spending to cope with the financial and economic crises of 2008-09 have shifted some of the private debt into public hands, resulting in the escalating sovereign debt crises.

Central banks have yet to learn to anticipate and forestall asset bubbles. Their inflation-targeting policies were inadequate because the traditional measures of inflation, such as the Consumer Price Index, could not and did not provide warnings of asset bubbles.

Indeed, lulled into complacency by the traditional measures of inflation, new or excess liquidity was allowed to channel into asset markets, even as central bankers believed they had tamed inflation.

Meanwhile, rising asset prices – of houses, stocks, bonds and other financial instruments – were treated as a reflection of the real wealth being created in the so-called "New Economy." Financial innovations, such as collateralised debt obligations (CDOs) and credit default swaps (CDSs), were developed by clever, highly paid finance graduates, using complicated mathematical models, to purportedly reduce risks and maximise returns. Indeed, as we all know now, the result was the near collapse of the global financial system.

It is important to understand that these problematic, highly risky instruments were the result of financial alchemy. Add to that the discriminatory role of the ratings' agencies that gave AAA valuations to the dubious products and one has a very bad witches' brew.

Moreover, the incentive system for financial institutions' relationship officers, whereby they received commissions of 1.5 per cent or more upfront, made them behave like traditional snake-oil salesmen.

Here is where the greed that Prof Koh referred to surfaces, among both the sellers and purchasers of such instruments, including in Singapore. What a colossal misuse of talent.

In the "global savings glut," Prof Koh is right to debunk the Bob Rubin-Ren Bernanke argument that excessive savings in East Asia and elsewhere led to the under-pricing of risk and excessive consumption in the West, particularly the United States.

The Rubin-Bernanke argument is that, because the US is so attractive as an investment location, the excess savings of other nations are parked there, resulting in cheap capital and thus high consumption and de-industrialisation in America.

Unfortunately, Prof Lim buys this fallacious argument.

The truth is that prof- lificy requires financing. The capital inflows are funded either by the central bank printing money and/or by borrowing from other countries. The US trade deficit merely mirrors its borrowing from other countries.

It is true nevertheless that in times of trouble – for example, in the Middle East, or more recently, in Europe’s sovereign debt crisis – money does flow into the US, however, this does not validate the Rubin-Bernanke-Lim hypothesis.

The export surpluses of countries like China cannot be easily converted from the euro, dollar or yen without a major devaluation of these currencies – hence the dollar reserves of these countries tend to build up faster than they would like. We may be sure that China is very uncomfortable about its huge dollar holdings.

Prof Koh is also right that surplus countries like China should not merely consume more, as the Americans do, but invest wisely in the future of their citizens by spending more on education and infrastructure.

**East Asian savings**

I agree with Prof Koh that East Asians are culturally attuned to saving but Prof Lim is also right that demographics like a rapidly ageing population can alter the landscape.

More importantly, I would emphasise structural issues: the concentration of huge savings in corporations, governments and government-linked entities in East Asian countries, plus the thinness of their social safety nets, tend to result in high savings, especially in rapidly growing countries like China.

If any reduction in savings is to be achieved, it would more likely take the form of spending on infrastructure, education, the acquisitions of resource-based companies abroad and so on, rather than in consumption leading to more imports.

**Regulation**

The repeal of the US Glass-Steagall Act in 1999 allowed American banks to set up structured investment vehicles and to engage directly in riskier investment banking activities. The result was the accumulation of toxic assets, converting the huge government bailout of banks.

To China’s credit, its banks, long insulated by state control, emerged virtually unscathed from the crises and are now global players. The financial reforms that the US has undertaken since the crisis are not deep enough. Hence, I fear, more problems on the horizon.

**Exchange rates**

I am in agreement with Prof Koh that getting China to revalue its currency will not reduce America’s trade deficit. Despite the Plaza Accord which forced the Japanese to revalue the yen by 50 per cent, Japan still has a trade surplus with the US.

However, the Plaza Accord did eventually result in a huge asset bubble, which, when it burst in 1990, mired the Japanese economy for close to two decades.

The Chinese are not so foolish as to allow a similar major realisation of their currency; instead, they will revalue in slow stages.

Meanwhile, what the Americans find more expensive to buy from China, they will buy from elsewhere. That is, unless, they spend less and save more.

Finally, a word of warning: A global re-balancing is desirable in the medium as well as long term, as Prof Lim argues. However, in the short run, increased saving by consumers and public austerity measures may cause a double-dip recession or worse.