

## America's chance to kick its Asian addiction

*di David Pilling*

Did America hang itself with Asian rope? I put this to a Chinese official last week and, quick as a flash, he responded: "No. It drowned itself in Asian liquidity."

Asia's part in America's financial downfall has been two-fold. First, shiploads of cheap goods from China and other low-cost producers helped keep a lid on US prices. That lulled the Fed, with its tight focus on the consumer price index, into thinking it could have it both ways: high growth with low inflation.

Second, Asian bank reserves of \$4,300bn (£2,400bn, €3,000bn) – enough to fund Treasury secretary Hank Paulson's bail-out six times over – combined with petrodollars to provide the US with almost endless liquidity. This poured into US Treasuries and Fannie and Freddie bonds, suppressing US interest rates, inflating the housing bubble and funding buy-now pay-later consumption.

Western banks and hedge funds used Asia, particularly Japan, as an enchanted pool of money. Through the so-called carry trade, they dipped their ladles into its ultra-low interest rate waters and splashed the proceeds around on exotic, high-yield instruments. For a while it all worked beautifully. You know the rest.

In one sense, this is a story of Asian prudence versus US recklessness. By accumulating vast savings – China and Japan alone boast 40 per cent of global central bank reserves – Asians have lived below their means so that Americans could live beyond theirs. Asia bankrolled US budget and trade deficits and provided the cash for banks and individuals to go on a spending spree and for Washington to fight wars in Afghanistan and Iraq.

"Arguably, the US overextended itself in international relations and in the management of its domestic situation. It spent way beyond its means," says Fang Xinghai, director general of Shanghai's Financial Services Office. "For a while, the US thought this was great and that this trade could go on forever."

While it lasted, China and others were able to grow at supercharged rates by lending to Americans so that they could import its products. Now that wheeze is over, Asia will suffer too. But even if China, which grew at 12 per cent last year, loses 4 percentage points of growth, it will still be clipping along at 8 per cent. If the US or Europe loses the same amount, it will be deep in recession. Wall Street's 9/11 could thus turn out to be an important milestone on the road to Asia's century. US presidential candidates invoked that possibility last week in their debate. Barack Obama referred to China's recent space walk as a sign that it was catching up while America floundered. John McCain, attacking waste in Washington, said: "We owe China \$500bn." Mr Obama went one better, saying (more accurately) China "now holds \$1,000bn of our national debt". Linking finance with power, he added: "There has never been a country on earth that saw its economy decline and yet maintained its military superiority."

There has been a cautious reappraisal in parts of Asia too. "More people understand that America is not as great as it was 10 years ago," says Shen Dingli of Fudan university in Shanghai. "This is not a time for China to be on a par with America. But the relative shift of the centre of gravity does bring China more confidence."

For the moment, though, the fates of Asia and the US remain more aligned than opposed. Chinese, Singaporean and other Asian investors have lost billions on their stakes in failing western institutions. Asian governments have insisted on the need for a US bail-out to protect their sovereign investments.

US woes bounce back in other ways, too. In August, Japan recorded its first seasonally adjusted monthly trade deficit in a quarter of a century after shipments to the US slid 22 per cent. Net exports are not expected to contribute anything at all to Chinese growth this year. “China feels the same pain as America,” says Prof Shen. “It is not a case of: ‘Your loss is my win,’ but rather: ‘You lose, I lose.’”

More fundamentally, the pattern of flows from Asia to the US and other deficit countries could change. If the US can wean itself off what has been an unhealthy addiction, the shock could yet turn out to be to its long-term advantage. It has already started increasing exports and importing less.

In another sign of change, the big gap between returns that drove Japanese capital to the US has narrowed sharply for bonds and disappeared altogether for equity, says Peter Tasker of Kleinwort Dresdner. “This could be the crumbling of the configuration that has seen capital surplus countries funding US consumption,” he says.

For that to happen Asians would have to start spending more at home. That could be brought about by a deep recession, which would oblige them to run down savings. Alternatively, Asian governments could encourage their citizens to break savings habits and go on a US-style binge.

Chinese citizens, whose consumption accounts for a measly third of national output – against 70 per cent in the US – could certainly spend more. But Beijing, which has already taken steps to prick the housing bubble, appears in no hurry to encourage reckless spending.

Says Mr Fang: “I’m not sure you should encourage people to borrow in order to spend. That is what bankrupted the US.”