FROM THE
FOUNDER

The Yellen/Summers Brawl

As of this writing, supporters of former Obama economic advisor Larry Summers and Federal Reserve Vice Chair Janet Yellen are engaged in a surprisingly public brawl to see which candidate will be left standing to succeed Fed Chair Ben Bernanke. Standing on the sidelines is capable former Vice Chair Don Kohn. He and former Treasury Secretary Tim Geithner are possible compromises in the event this slugfest becomes too bloody.

A lot of commentary has focused on personalities, qualifications, and personal finances. Yet the question that should be asked is this: Which candidate is best qualified as a global crisis manager? For all practical purposes, the Fed chairman is central banker to the world, and the world looks increasingly challenged.

The specific question: In the event today's $85 billion per month in U.S. quantitative easing is steadily reduced, or "tapered," assuming the U.S. economy rebounds stronger than expected, which candidate will best manage any global fallout from the unwinding of the so-called "dollar carry trade"?

The dollar carry trade is the pool of cheap money that serves as the world's highly liquid source of funds for trading and investment. A decade ago, the yen carry trade was the center of attention because of the Bank of Japan's historically low interest rates. Now it's the dollar carry trade as a result of the Federal Reserve's extraordinarily loose monetary policy.

In recent years, a number of emerging market economies have experienced capital inflows from this cheap money source. Many experienced substantial increases in foreign exchange reserves while their current account deficits rose.

Now simply the fear of more expensive money has sent concern rippling throughout global markets. Since May, when Chairman Bernanke merely hinted at "tapering," India has experienced an almost 40 percent currency collapse. Foreign capital that had earlier moved in started moving out. The economy has slipped.

In Indonesia today, almost 100 percent of the domestic economy is financed by external money. Half of the Chinese economy is now financed by foreign sources.

Here's the problem. The world is interconnected. Once the dollar carry trade starts to steadily unwind, problems in emerging markets could intensify.

China is of particular concern because its economy has gone from being heavily export-dependent during the height of the globalization period to now heavily invest-

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THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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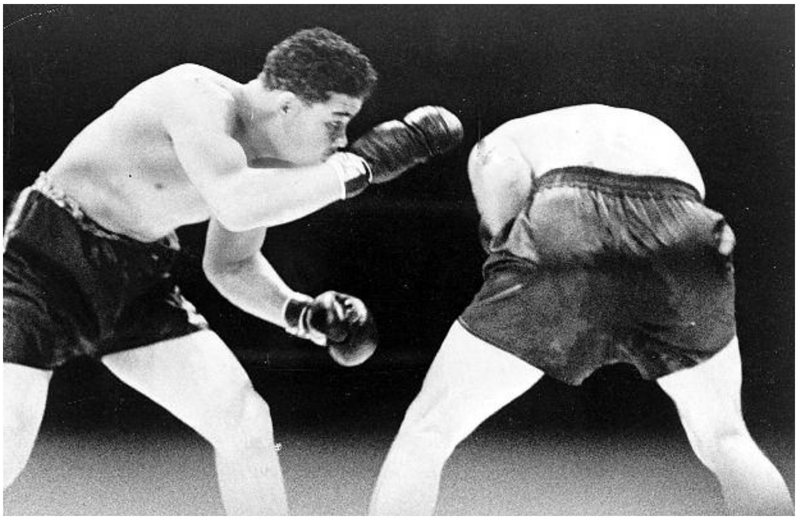

Take that, you QE doubter! *Joe Louis looks for an opening during a boxing match with Max Schmeling, 1936.*

ment-dependent for GDP growth. In the first decade of this century, China built new industrial space and housing equivalent to 322 Manhattans, according to the *Wall Street Journal.* Sounds impressive, but is China now experiencing a shortage of income in the midst of all this investment? Almost one-third of China's GDP is the result of infrastructure investment that produces no return. The same can be said for investment to prop up dubious real estate prices.

Lack of adequate returns poses the question of the viability of China's risky shadow banking system. Developers are taking out new loans to cover old ones, a practice called "extend and pretend," according to the *Wall Street Journal.* The unknown is whether external financing has quietly become China's financial opium.

The bottom line is that if India, China, and other large emerging markets weaken further, global commodity prices will further tumble. This will put ugly pressure on those emerging markets that rely on commodity exports for GDP growth. The fear is the threat of a global sinkhole of disinflationary pressure.

The upshot: If the twentieth century was the American Century, this may be not the Asian Century as everyone thought, but "Nobody's Century," as former U.S. National Security Advisor Zbigniew Brzezinski has warned.

So the next head of the Federal Reserve will likely face one of the great wagers in the history of finance. Taper aggressively and emerging markets could see further capital flight. China's shadow banks alone could become a global headache. But send the dovish message that quantitative easing is permanent policy, and those same frightening Chinese shadow institutions could grow larger. In the United States, equity and bond prices could balloon to unsustainable levels. Talk about a potential Catch-22 situation.

That's why President Obama doesn't just need an economist running the Federal Reserve. The institution already has six hundred of them milling around. He needs an expert in global finance with a keen understanding of the sensitivity of capital flows. If the global bond market bubble grows larger, this will have happened at a time when a generation of young bond market traders has no experience confronting a bear market. I was there for the 1994 bond market debacle. It was ugly.

The next Fed chief will take over at a precarious macroeconomic time as well. In the last five years, world governments have spent an amount equalling almost one-quarter of global GDP on bailouts, guarantees, and stimulus packages. Central banks have produced an ocean of newly printed money, the significance of which we are not entirely sure.

We may have avoided a depression. But so far most growth rates are moving in the wrong direction. Why would any sane person want this job?

And what's been the result? So far the world economy has actually slowed, and central banks and governments are now out of ammunition. We may have avoided a depression, and it is always possible the global economy picks up. But so far most growth rates are moving in the wrong direction.

Which poses this question: Why would any sane person want this job?

—DAVID M. SMICK
Founder and editor, TIE, *and author of* The World Is Curved: Hidden Dangers to the Global Economy