The Washington Times
www.washingtontimes.com

Biggest foreign aid recipient

By Richard W. Rahn
Published May 10, 2006

Which country receives the most in total foreign aid from all donors? The official numbers show Iraq at the top with $3 to $18 billion in aid (depending on how you define "aid") and all the other recipient nations of the world at less than $3 billion per year. However, if you look at which nation benefits most from foreign subsidies, the U.S. would come out on top by a very wide margin.

Yes, I did just say that the U.S. is the world's largest recipient of foreign assistance. Other countries are not sending official government "aid" dollars to help the U.S. but are doing things that have the same effect. For instance, China provides the biggest single subsidy to the U.S.

Many experts argue the Chinese currency is 10 percent to 20 percent undervalued, which means the U.S. consumer is able to purchase Chinese-made goods at a lower price than if the currency traded at its true market value to the U.S. dollar. If an American can buy a Chinese-made product at Wal-Mart for an artificially low price, it means the American consumer has an increase in real income (he or she can buy more with the same income).

In 2005, the U.S. bought (imported) $243 billion worth of goods from China. If these goods were only 10 percent underpriced because of the artificially low Chinese currency, U.S. consumers received a subsidy of about $24 billion.

Other countries' consumers also received the Chinese subsidy to the extent they bought Chinese goods, but the U.S., as China's biggest customer, received the greatest subsidy. The Chinese underprice their currency because they are trying to increase exports to obtain U.S. dollars and other foreign currencies. In turn, China's government uses many of the dollars to buy U.S. government bonds to serve as the reserve for its banking system. If the Chinese had a more efficient banking and capital market structure, they would not need so many dollars.

For now, foreign ownership of U.S. government debt equals about 45 percent of that held by the public (not including U.S. government agencies). Of the little more than $2 trillion held by non-Americans, the Japanese hold about a third and the Chinese about 12 percent. If non-Americans did not buy much U.S. government debt, Americans would need to both save more and consume less to make up the deficit.

To the extent non-Americans are willing to invest in U.S. government debt and other U.S. financial instruments at less than normal market returns because they need a safe haven for their funds, they provide an implicit subsidy to American producers and consumers. Since it costs less for American businesses to borrow money because of the foreign investment, they can expand more rapidly and hire more workers. If American consumers can borrow at lower rates, they can buy bigger houses and more new cars.

There are various approaches to try measuring the size of the implicit foreign subsidy. At a minimum, it would be the difference between the normal rate of interest (approximately 3 percent plus inflation) and what foreign bond holders have been receiving in recent years, which is at least 1 percent to 2 percent below the expected normal rate.

Thus on the U.S. government debt alone, Americans have been receiving a subsidy from non-Americans in the range of $20 billion to $40 billion yearly. This does not count all the feedback effects from the higher investment in productive activities by foreigners in America because of currency flight.

Many commentators and politicians decry the size of the U.S. trade deficit and the level of foreign ownership of U.S. financial assets. Rather than bashing the Chinese, U.S. politicians should thank them for making Americans richer.

In fact, if the U.S. did not serve as safe haven for the world's capital, the world would be far more unstable, and the total global capital stock would be lower. The correct way to look at the situation is that U.S. citizens are getting paid by the rest of the world for providing stronger, more secure, and more transparent capital markets.

The correct "solution" for the problem is for the other nations to strengthen protection of property rights, reduce corruption, stop punishing capital accumulation through excessive taxation and regulation and improve their own capital markets. If this is done, the U.S. trade and capital imbalances automatically will gradually decline.

The IMF has just been given the task to work on trade and capital imbalances. It will be interesting to see if it focuses its energy on helping the capital-flight countries improve their economic policies (by lowering taxes and regulations and improving property-rights protection) or if it tries to force lower tax jurisdictions to adopt capital-destroying tax and regulatory policies.

In the meantime, the lesson is clear: Any economic jurisdiction can obtain "foreign aid," no matter how rich it is, just by providing the rule of law, secure property rights, low taxation and regulation of productive activities, and well-functioning capital markets.

Richard W. Rahn is director general of the Center for Global Economic Growth, a project of the FreedomWorks Foundation.