THE MYTH OF A GLOBAL SAVINGS GLUT

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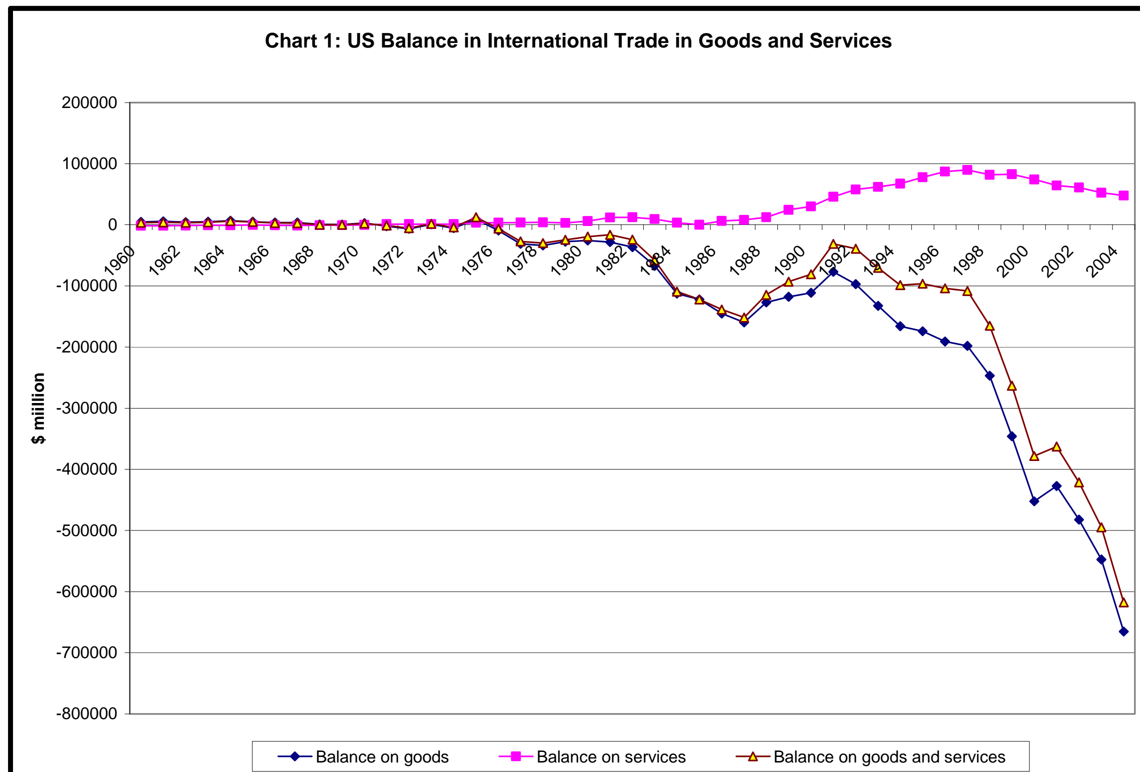
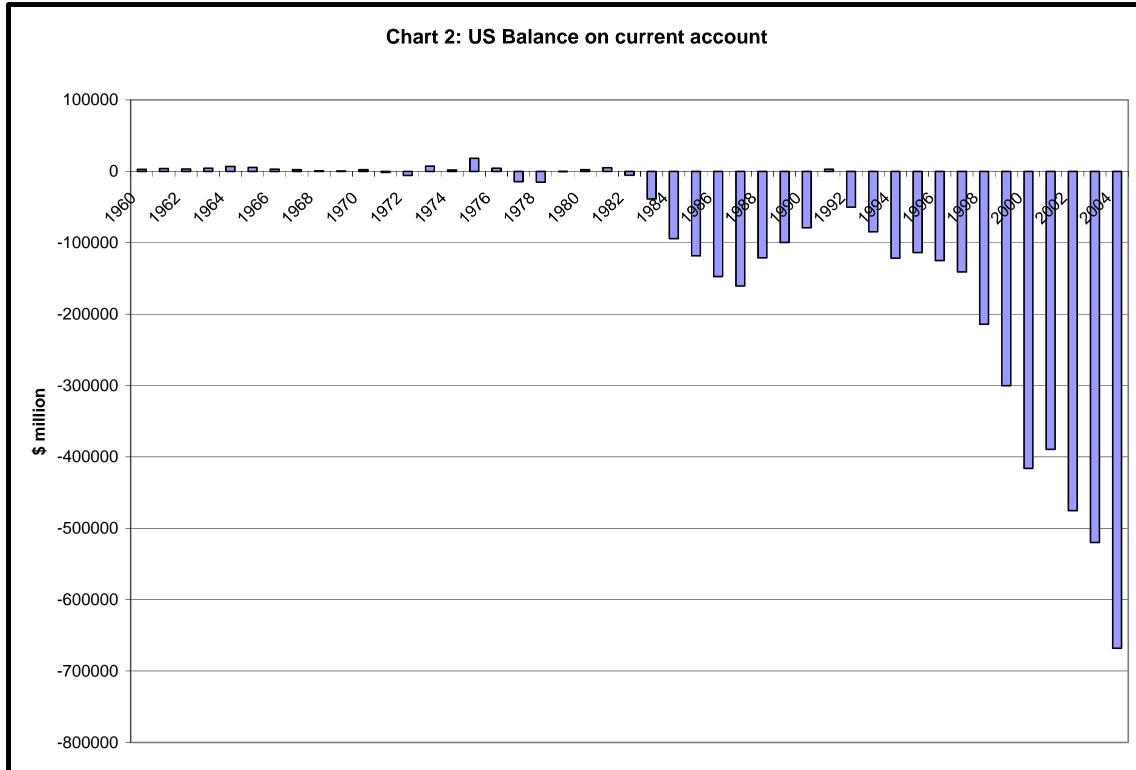
The revival of growth in the US when the rest of the developed world performs indifferently or poorly is a source of some surprise. From around the mid-1970s the US has lost its competitiveness in commodity production, which has resulted in an increasing deficit in its balance of trade in goods. Hence, despite a growing surplus till quite recently in its trade in services, the overall balance of trade in goods and services has been negative and sharply rising (Chart 1).

Yet this weakness has now become the basis for the revival in growth. A concomitant of the loss of competitiveness has been the fact that the current account deficit of the US which has to be financed with capital flows has been widening in recent years, to touch a record $668 billion in 2004. This year, the US current-account deficit is forecast to widen even further to over $800 billion.





This massive increase in the current account deficit implies that despite its loss of competitiveness, the US has been able to keep domestic demand rising. GDP growth which was down from 3.7 per cent in 2000 to 0.8 in 2001, rose to 1.9 per cent in 2002, 3 per cent in 2003 and 4.4 per cent in 2004. In June 2005, unemployment fell to 5 per cent, the lowest rate since September 2001. It is now widely accepted that this buoyancy in domestic demand and the consequent growth in output and employment has been the result of a combination of deficit financed spending by the US government and debt financed spending by American residents. From a high of 6 per cent of GDP in 1992, the US fiscal deficit had declined continuously and turned into a budget surplus in 1998. The budget surplus rose to touch 1.3 per cent of GDP in 2000. However, after the recession of 2001, the deficit climbed again to 4.6 per cent of GDP in 2003 and 4.3 per cent in 2004, which helped the recovery and the recent buoyancy.

But it was not merely government spending that was responsible for the revival, which was triggered by consumption spending by households as well. According to *The Economist*, on an annualised basis in June 2005, US households disposed of all but $1.9 billion (0.02 per cent) of the over $9 trillion in disposable income they earned. This obviously keeps retail sales going. Households save less and consume more, because the value of their wealth accumulated in the past has been rising. In particular, during the year ending March 2005 the value of their houses rose by $2.3 trillion, according to the Fed. The housing boom is reflected in two tendencies. First, new residential investment at more than 6 per cent of GDP is at a 50-year high. And existing house sales, which had peaked at just under 10 per cent of GDP in 1979, surpassed that level in 2002, and is now at over 13 per cent. The former, triggers demand for construction material and labour and

has its multiplier effects. The latter pushes up prices and, through the wealth effect, triggers consumption spending, Home prices rose by almost 15 per cent in the year to June 2005, the fastest in decades.

The wealth effect is not new to the US. During the years of stock market boom of the second half of the 1990s, the relatively wider dispersion of direct and indirect stock ownership in the US implied a substantial increase in the wealth of American citizens. The consequent "wealth-effect", which encouraged individuals to spend because they saw their "accumulated" wealth as being adequate to finance their retirement plans, was seen as a major factor underlying the consumer boom and the fall in household savings in that phase.

A major factor responsible for the stock boom was the massive inflow of capital into the US during that period. Higher US interest rates, confidence in the dollar because of creditable growth and the "flight to safety" explained that flow of capital into the US. The same is not true today. The deficit on the balance of payments has created a fear that the dollar may collapse and all efforts of the G-8 are geared to ensuring a" soft landing". Though the trade-weighted index of the dollar stabilised during early 2005 and even appreciated somewhat thereafter, it has once again been sliding and is currently still close to the low it reached at the end of 2004. Further, US interest rates can hardly be considered high. Bond yields in the US are not only low by the standards prevailing since the early 1980s, but are far less than the rate of economic growth that they are expected to roughly reflect. Put all this together, and the US would not be considered a favoured and safe haven.

Yet capital has indeed been flowing into the US to finance the current account deficit. This must come from countries that were registering a surplus on their current account. Consider for example 2003. In that year, 52 out of the 126 countries for which data was available recorded surpluses on their current account, while 74 recorded deficits, with the US recording the largest deficit of $531 billion and Japan the largest surplus of $136 billion. From the data it emerges that the surpluses of the top 17 surplus earning countries would have been necessary to cover the United States deficit. The surpluses of these 17 countries accounted for as much as 86 per cent of the surpluses earned by the countries that recorded a surplus. On the other hand, the US alone accounted for 72 per cent of the total deficit recorded by the 74 deficit countries.

Thus there is indeed a fundamental imbalance in the global balance of payments. But this imbalance does not just lie in the concentration of deficits and surpluses. It is also reflected in the fact that the US deficit was not being financed largely by the surpluses of other developed countries or, prior to the current spike in oil prices, by surpluses in the oil exporting countries. While Japan and Germany are the two largest surplus earners, the surpluses of these two countries accounted only for 30 per of the aggregate surplus of all surplus earners and 35 per cent of the US deficit. Even among these two, Japan accounts for $136 billion of their combined 188 billion surplus. Further, Germany's surplus of over $51 billion is implicitly being absorbed by deficits in other countries of the Euro area, with the surplus of the Euro area as a whole estimated at only $23.5 billion.

The net result of all this is that developing countries and countries in transition have become important sources of surpluses to finance the US deficit. If we take the top ten

developing and transition economies in terms of the size of their surpluses, their aggregate surplus accounts for 39 per cent of the US deficit. If we leave out oil exporters and take the top 10 among the remaining developing countries, their surpluses account for 28 per cent of the US deficit. China's surplus alone accounts for 8.6 per cent of the US deficit., whereas net surpluses from the Euro area amount to only 4.4 per cent of that deficit.

Developing countries have been even more important at the margin. As Federal Reserve Governor, Ben Bernanke has pointed out, the $548 billion increase in the U.S. current account deficit between 1996 and 2004 was not matched by surpluses in the other industrial countries as a whole. The collective current account of the industrial countries declined by $441 billion between 1996 and 2004, implying that, of the $548 billion increase in the U.S. current account deficit, only about $106 billion was offset by increased surpluses in other industrial countries. The bulk of the increase in the U.S. current account deficit was balanced by changes in the current account positions of developing countries, which moved from a collective deficit of $90 billion to a surplus of $326 billion--a net change of $416 billion-- between 1996 and 2004.

It is because the surpluses of the rest of the world, especially the developing countries, was being "voluntarily" recycled to the US that interest rates there did not have to rise to attract capital to finance that country's rising current account deficit. Low interest rates in turn have helped finance the housing boom, which according to Alan Greenspan is not a speculative bubble but just "froth". Whether bubble or froth, most economists agree that the easy money that has financed it has been crucial to the economic recovery since 2001. According to one estimate, housing has contributed over 40 per cent of employment growth since then. And housing expansion plus real estate inflation have accounted for 70 per cent of the increase in household wealth over this period. And this as noted earlier has triggered an expansion in consumer spending. Thus, capital inflows have once again helped finance growth in the US, even if mediated this time by the real estate rather than the stock market. The US, because of its political and military clout, has protected the dollar and sucked in capital from the rest of the work to crank its weakening economic machine.

Recently, however, Federal Reserve Governor Ben Bernanke took issue "with the common view that the recent deterioration in the U.S. current account primarily reflects economic policies and other economic developments within the United States itself." In his view, a satisfactory explanation of the rapid rise of the U.S. current account deficit requires a global perspective that takes account of the fact that "over the past decade a combination of diverse forces has created a significant increase in the global supply of saving--a global savings glut--which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today."

What accounts for this so-called global saving glut? According to Bernanke, important among the reasons "is the recent metamorphosis of the developing world from a net user to a net supplier of funds to international capital markets." The shift, in his view, occurred because of developments in the developing countries themselves, especially the financial crises many of them faced since the mid-1990s. These crises are seen to have occurred because net capital imports into the developing countries in the early and mid-

1990s were not always productively used but absorbed for the wrong reasons. In some developing countries, governments borrowed to finance budgetary deficits and avoid necessary fiscal consolidation. In other countries, these funds were not allocated to projects promising the highest returns because of "opaque and poorly governed banking systems". The resulting loss of lender confidence, together with other factors such as overvalued fixed exchange rates and reliance on short-term debt denominated in foreign currencies resulted in financial crises that led to capital outflows, currency depreciation, sharp declines in domestic asset prices, weakened banking systems, and recession. Such was the experience, according to Bernanke, in Mexico in 1994, in a number of East Asian countries in 1997-98, in Russia in 1998, in Brazil in 1999, and in Argentina in 2002.

Thus the transformation of developing countries from net importers to net exporters of capital is seen as a voluntary or enforced response to these crises, created by wrong policies or institutional inadequacies in the developing countries. In the wake of the crises, these countries either chose or were forced into strategies that implied a current account surplus. In practice, there are two reasons why this could have occurred: crisis-induced deflation that restricted imports and generated a current account surplus or unusual success as an exporter of goods and/or attractor of foreign capital. While China and India may be countries that fall in the latter category, most other developing countries recorded surpluses because of deflation. In fact, trends in the fiscal deficit in developing countries do suggest that an important reason why developing countries record a surplus on their current account is the deflationary fiscal stance adopted by their governments. Growth is curtailed through deflation so that, even with a higher import-to-GDP ratio resulting from trade liberalisation, imports are kept at levels that imply a trade surplus.

But going against the evidence, Bernanke opts for the latter explanation, and argues that the outcome reflects conscious efforts to engineer a current account surplus in pursuit of a policy of reserve accumulation to deal with likely future capital outflows. This was ostensibly true of East Asian countries, such as Korea and Thailand, which began to build up large quantities of foreign-exchange reserves and continued to do so even after the capital inflows that had dried up after the crises were restored. Even countries that had escaped the worst effects of the crisis such as China and India are seen to have built up reserves to serve as "war chests". It is for these reasons that developing countries have been transformed from borrowers on international capital markets to large net lenders. However, the reasons for the reversal have been misread, leading to the "made in USA" perspective.

This perspective is misplaced, because it is partly based on the "popular argument" that focuses on the burgeoning U.S. federal budget deficit when explaining the decline in national saving and the rise in the current account deficit in the US. But that argument, in his view, cannot be sustained for two reasons: first, the US was recording a rise in current account deficit even during 1996 to 2000 when it was recording budgetary surpluses; second, there is no necessary relationship between a budget deficit and a current account deficit—countries such as Germany and Japan continue to run large current account surpluses despite government budget deficits that are similar in size (as a share of GDP) to that of the United States.

What that ignores is that, the reason why a budgetary deficit leads to current account deficit is that the excess of government investment over government savings it implies is not matched by an excess of private saving over private investment or is accompanied by an excess of private investment over private saving that aggravates the deficit. Such an excess of private investment over saving is what the housing boom financed by debt implies. American households are not saving enough to finance the country's investments.

Yet, using his "conclusion", Bernanke builds a two-step argument to explain the US current account deficit. First, while there is a necessary correspondence between the excess of investment over saving and the current account deficit, the causation really runs from the latter to the former. That is because there is a global savings glut, the US can sustain an excess of investment over saving. Second, the excess of investment over savings arises because of the effect that the savings glut has on interest rates, asset prices and exchange rates, although the pattern of asset-price changes was somewhat different before and after 2000, shifting from stock price inflation to real estate price inflation.

Thus the real argument is that the global savings glut *creates* the excess of investment over savings in the US. Between around 1996 and early 2000, it did this by affecting equity prices. The US was well placed to mediate these effects because of the development and adoption of new technologies that delivered increases in productivity, which together with low political risk, strong property rights, and a good regulatory environment, made the country exceptionally attractive to international investors during that period. As a result "excess savings" flowed into the US.

According to Bernanke, after 2000 global excess saving lowered interest rates, making it, rather than high equity prices, the principal cause of lower US saving. Low mortgage rates have supported record levels of home construction and strong gains in housing prices. The asset price effects of this housing boom has once again encouraged consumption spending as the increase in housing wealth not only reduces the desire to save but provides access to credit to finance consumption. Thus, events outside the US, especially the internally induced financial crises in emerging-market countries have, through their effects on equity values, house prices, real interest rates, and the exchange value of the dollar, widened the current account deficit in the US.

There, of course, remains the question as to why the current-account effects of the increase in desired global saving were felt disproportionately in the United States relative to other industrial countries. Given his argument, Bernanke cannot but point to the technology boom in the US and the ostensible "depth and sophistication" of its financial markets as factors that make it an attractive investment destination. But he too cannot ignore the role played by the status of the US dollar as the leading international reserve currency to explain why the saving flowing out of the developing world has been directed relatively more into dollar-denominated assets such as U.S. Treasury securities. However, what the first of the arguments manages to achieve is to obfuscate the puzzle as to why the dollar remains the reserve currency despite the loss of US competitiveness.

If not obfuscated, the only way to unravel that puzzle would be to refer: (i) to the crucial role played by US markets in the growth process of many countries, including China, India and much of East Asia; and (ii) to the strategic and military dominance of the US

and its aggressive expansionism. The first allows the US to demand a quid pro quo for access to its markets. The second provides the basis for the confidence that despite the widening current account deficit, the US economy and the dollar are unlikely to experience a cumulative downward descent into recession. In the event, the US government faces no national budget constraint allowing it to use deficits to finance its global military misadventures and US households come to believe that they face no constraint in borrowing their way to prosperity in the belief that the notional values of their wealth, which rises because of speculation, will persist. As a result, the US experiences growth with a widening deficit, even when many other developed industrial economies are faced with slow growth or recession.

The problem of markets delivering unexpected outcomes, however, does not go away, since the possibility that the low interest rates that underlie the present situation may not continue. Interest rates can rise for two reasons. First, foreign investors may fear that the dollar cannot continue to be sustained at anywhere near current levels and thus reduce their holding of Treasury bonds and other dollar-denominated assets. The consequent decline in the prices of those assets would imply a rise in interest rates. Second, any decline in the value of the dollar would trigger price increases because of the 16 per cent share of imports in US GDP. To deal with that price increase the Fed may have to raise interest rates. A rise in interest rates because of either of or both these causes can bring the housing boom to an end, lead to a sharp fall in consumption and precipitate a recession. This is the denouement that global managers in search of a “soft landing” have increasingly come to fear.