COMMENT & ANALYSIS: The paradox of thrift: excess savings are storing up trouble for the world economy
By Martin Wolf
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Strange things are happening in the world economy: falling interest rates on long-term securities, declining spreads between returns on safe and riskier assets, large fiscal deficits and huge global current account "imbalances" should not, in normal circumstances, coincide. So what is going on?

Alan Greenspan, chairman of the Federal Reserve, admits that he is puzzled. He has referred to the decline in interest rates on long-term bonds at a time of rising short-term rates as a "conundrum". He returned to the issue last week when he remarked that "the unusual behaviour of long-term rates first became apparent almost a year ago."* Markets tried to push long-term rates up early last summer and again in March this year, but in both cases "forces came into play to make those increases short-lived. But what," continued Mr Greenspan, "are those forces? Clearly, they are not operating solely in the United States."

Mr Greenspan is correct. The changes are global. So, then, must be the forces at work. What are they? The answer, in a nutshell, is a global excess of desired savings against the background of weak investment, low inflation and ever more integrated economies.

Mr Greenspan's former colleague, Ben Bernanke, has already referred directly to excessive savings in explaining the explosive growth in the US current account deficit.** In doing so, he took issue "with the common view that the recent deterioration in the US current account primarily reflects economic policies and other economic developments within the United States itself". Instead, he developed what he called an "unconventional" perspective that seeks the explanation in the emergence of a "global savings glut". He was right to do so.

To understand the present we need to go back to the 1930s. The "paradox of thrift" was the most counterintuitive and, to the classically trained economist, morally, theoretically and practically objectionable idea in John Maynard Keynes' General Theory of Employment, Interest
and Money, published in 1936, in response to the Great Depression. It is possible, he argued, for the private sector to want to save more than it wishes to invest. That is the paradox: what is good for individuals can be bad for an economy. Today, at the beginning of a new millennium, Keynes' warning is again apposite.

Unfortunately, in certain circumstances, even lower interest rates may fail to clear the market for investible funds. This is particularly likely if inflation is low - and still more likely if it is negative, as has been the case in Japan for many years. Large fiscal deficits may then be needed to mop up the excess savings, as has also been the case in Japan. Otherwise, the economy may fall into a slump.

We are living once again in such a Keynesian world. How then does the argument work? What is the evidence to support it? What are the consequent dangers for the world economy? And what needs to be done?

Let us start with the economic argument. One likely outcome of a world of excess desired private sector savings will be high fiscal deficits. These emerge partly in response to cyclical weaknesses and partly to "kick start" sluggish economies. In these circumstances, however, fiscal deficits will not crowd out private spending, but rather crowd it in, by sustaining current income and expenditures.

Another likely outcome will be "reaching for yield". High desired savings will lower real rates of interest, and so real return on capital, below "normal" levels. In response investors are likely to move towards riskier assets. If the riskiness of previously high-risk investments is also believed to be lower, perhaps because of success in stabilising inflation at low levels this tendency will be strengthened.

Again, if high desired private sector savings are not offset by monetary or fiscal policy action, current account surpluses will emerge in some economies. Attempts to keep the exchange rate down will support this outcome. These are, in the language of the 1930s, "beggar thy neighbour" policies. Some trading partners will then need to tolerate offsetting deficits. In effect, deficit countries act as spenders of last resort in the world economy.

Now turn to our second big question: how well does the evidence fit the story? Remarkably well, is the answer.

We can identify only realised, rather than desired, savings. Yet we can note that the global savings rate ran at the exceptionally high level of 25 per cent of global output last year (see chart). The striking features are the extraordinarily high, and rising, savings rate of the emerging market economies and the low, and falling, savings rates of the US (and the UK).

The private sectors of the eurozone and Japan, which generate one-third of world gross domestic product at market prices between them (22 per
cent from the eurozone and 11 per cent from Japan), are running substantial surpluses of income over expenditure (see chart).

In both, the principal offset to high private sector financial surpluses has been government deficits. Japan's fiscal deficit absorbed just over 60 per cent of the country's private sector surplus in 2004 (with the rest going into the current account), while the eurozone's fiscal deficits absorbed over 80 per cent of the private sector surplus.

Despite the fiscal deficits, rough and ready estimates suggest that real long-term interest rates are below 2 per cent in Japan and Germany. But real interest rates are low worldwide. According to the International Monetary Fund's latest World Economic Outlook, they have not been this low since the 1970s (see chart). Then, real interest rates were low because of unexpected inflation. This time, however, low real interest rates are expected: US and UK government index-linked government bonds are yielding only 1 1/2 per cent, which is less than half their level prior to the late 1990s (see chart). Moreover, inflation risk premiums have fallen since the late 1990s in both the US and UK.

Default risk premiums on emerging market and riskier corporate debt have also declined (see chart). Since October 2002, spreads over US treasuries of emerging market debt have fallen by 600 basis points, according to the JPMorgan index. This reflects not only the reaching for yield, but also an understandable perception of greater stability in these economies: inflation is down, balance of payments positions are stronger, as we shall see, and the last worldwide emerging market financial crisis ended some six years ago.

Finally, there are those notorious external imbalances. As Maurice Obstfeld of the University of California at Berkeley and Kenneth Rogoff of Harvard point out, "incredibly, the US current account deficit is currently soaking up about 75 per cent of the combined current account surpluses of Germany, Japan, China and all the world's surplus countries".*** Meanwhile, the rest of the world is running a surplus of savings over domestic investment of around one-eighth of its gross savings.

Consider the structure of the global balance of payments in 1996 and 2004 (see chart). Between these years, the US current account deficit rose by $549bn, to $666bn. A few other countries also had increases: Australia, Spain and the UK are examples. Between these years, the aggregate current account surpluses of Japan, the eurozone, Denmark, Norway and Sweden rose from $189bn to $316bn, a rise of $127bn. But the rest of the world's current account moved from a deficit of $99bn to a surplus of $329bn, an enormous swing of $428bn.

Particularly striking has been the shift for the emerging market economies as a group (see chart). Prior to 1997, they ran sizeable current account deficits, financed by private capital inflows. Since then they have moved
into enormous current account surpluses, combined with huge private capital inflows.

Why has this turnaround happened? The most important explanation was the financial crises of the late 1990s, which made everyone more cautious. Two-thirds of the Asian emerging market economies' swing from current account deficits to huge surplus occurred between 1996 and 1998 alone. The crises have cast long shadows. Also significant, however, have been the recent oil price rises: the Middle East's current account surplus jumped from $29bn in 2002 to $113bn in 2004.

The US has been accommodating the excess savings of the rest of the world, while attempting to run its economy in line with potential. One way of thinking about this is that in a global economy with no global government, the most important regional power - the US - has been following the Keynesian recommendation by offsetting excess desired savings elsewhere. The US authorities did not intend to do that. But that is what they have had to do to generate a decent recovery at home.

Foreign governments have, moreover, played a huge part in sustaining their domestic excess savings. According to statistics on the US "balance of payments, 42 per cent of the net funding of the US current account deficits between 2002 and 2004 came from official sources. But these flows are the result of official intervention, combined with sufficiently tight monetary and fiscal policies - and direct intervention in credit markets - to sustain the domestic savings that are the counterpart of the official flows. In other words, the excess savings are in part a policy choice, except in Japan, where they are happening more naturally.

Yet another way of seeing the same thing is in accumulations of foreign currency reserves. In just the three years from 2002 to 2004, foreign currency reserves rose by $1,680bn to reach a total of $3,730bn.

This analysis allows us to turn to our third big question: what are the dangers of this way of managing the desired excess savings? The answer is: large.

The reason for this is that the solution the world has found to the excess desired savings involves an explosive increase in US current account deficits and net external liabilities (see chart). If current trends for imports and exports continued for another 10 years (without further declines in the dollar), the current account deficit would be well over 10 per cent of GDP and net liabilities would exceed 120 per cent of US GDP, even without any adverse shift in the cost of servicing US liabilities. Even if the current account deficit were to stabilise at the current ratio to GDP (itself demanding a big improvement on recent trends), the ratio of net liabilities to GDP would rise towards 100 per cent.

As Sebastian Edwards of the University of California at Los Angeles has
pointed out, New Zealand - a very small economy indeed - is the only industrial country to have had a net stock of liabilities of more than 100 per cent of GDP. The only industrial countries to have run current account deficits of over 5 per cent of GDP for more than five years have been New Zealand and Ireland. The scale of US current account deficits and prospective liabilities is unprecedented for a large industrial country. To believe that this will be sustainable is to hope that investors are prepared to make an open-ended commitment to holding assets that are unhedged against the foreign exchange (and other) risks created by just one jurisdiction.

True, the huge current account deficit gives the US the happy combination of guns and butter in the short run. Since the external deficit is bigger than the fiscal deficit and also bigger than the amount that the US is spending on its armed forces, either of these can be regarded as a free lunch, if only for the moment. But even before the market imposes a reversal, via a sharp decline in the dollar - delayed perhaps by the tide of troubles to afflict the euro - there is the danger of rising protectionism in the US. Moreover, the longer the correction is delayed the bigger it will ultimately have to be.

Finally, what needs to be done? The most important conclusion of the analysis is: reduce the excess saving, particularly in emerging market economies.

It cannot make sense for these relatively poor countries to devolve the task of borrowing and spending on to the vastly richer US. If the people of emerging economies are to lend on a vast scale to any governments, it should surely be to their own governments, which should be able to find better use for the funds now being poured into foreign currency reserves. As the rest of the world starts to shrink its excess savings, the US should expand its savings as well, largely by reducing the structural fiscal deficit.

In the short to medium term, the best way for surplus countries to reduce their excess savings is via fiscal expansion. In the long run, however, what is needed is financial sector reform that encourages their citizens to spend a little more enthusiastically.

Large exchange rate changes will also be needed, to facilitate the adjustment process. All academic analyses of global balance of payments adjustment conclude that this will require large changes in relative prices or, to put it more precisely, in real exchange rates. Under plausible assumptions, the required adjustment is two times larger than the real depreciation of the dollar that has occurred so far (see chart). Some estimates are much larger still. Precisely how much of a depreciation will be needed depends on how large a US current account deficit and net liability position proves sustainable.

To summarise, excess savings in about 60 per cent of the world economy largely explain today's low real interest rates, somewhat manic reaching
for yield, persistent fiscal deficits and growing and dangerous global imbalances.

The policies that are playing a part in generating such excess savings are partly a response to the pain inflicted by past financial crises. But a way out must be found. Every year additional US liabilities amount to about half its total exports. The world economy cannot be balanced indefinitely - perhaps even for very long - by pushing its borrower and spender of last resort into ever-rising liabilities on such a scale.

The world must find a co-operative solution involving adjustments in spending and saving together with supportive changes in real exchange rates. Such adjustment will be both painful and risky. But it will not be nearly as painful and risky as blaming one another, while continuing to do nothing, instead.


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