

SURVEY: THE WORLD ECONOMY

The great thrift shift

Sep 22nd 2005 From The Economist print edition

America is spending while the rest of the world is saving. But for how long? Zanny Minton Beddoes investigates

ON MARCH 10th 2005, Ben Bernanke—a former Princeton professor who at the time was a governor of America's central bank—addressed a gathering of economists in Richmond, Virginia, on America's gaping current-account deficit. Its causes, he argued, were to be found abroad rather than in American profligacy. In particular, Mr Bernanke mused, the world might be suffering from a “global saving glut”. The phrase immediately caught on. Like the famous remark about “irrational exuberance” by Alan Greenspan, the chairman of the Federal Reserve, it has since helped to shape the global economic debate.

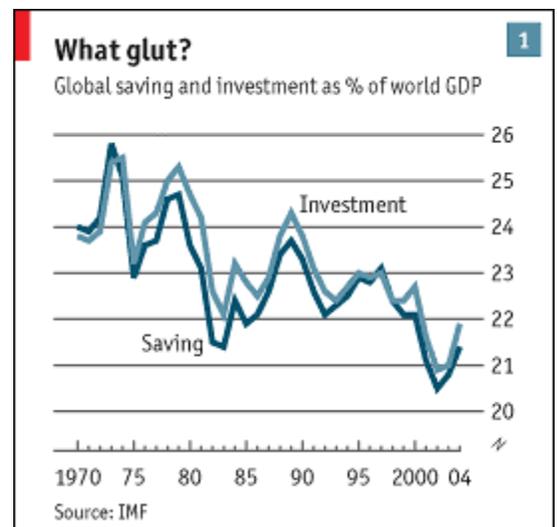
The idea's appeal lies in the way it ties together two of the most vexing questions about today's economic landscape: why are interest rates so low? And why can America borrow eye-popping amounts from foreigners with seeming impunity? According to the IMF's latest *World Economic Outlook*, the global economy will grow by 4.3% this year, slower than in 2004 but still a healthy clip. Strong economic growth is normally accompanied by higher interest rates, but long-term interest rates are at their lowest levels since the 1960s.

At the same time Americans are spending over \$700 billion a year more than their economy produces, the equivalent of more than 6% of annual output. As a share of America's economy, this external deficit has more than doubled since 1999. Yet it has had none of the dire consequences for the dollar that Cassandras have been predicting. For the first six months of 2005, the greenback was rising. Although it has slid in recent weeks, the drop has hardly been dramatic.

A “global saving glut” could explain both oddities. If savings are somehow super-abundant, the usual relationship between a strong economy and higher interest rates may no longer hold. And if the spare cash is mainly abroad, that should allow America to finance its deficit with ease. Rather than signalling American profligacy, the current-account deficit might simply be the counterpart to foreign thrift.

This idea turns much conventional economic wisdom on its head. Policymakers usually worry about too little rather than too much thrift. With populations ageing, the broad consensus has been that people need to build up nest eggs to finance their retirement. Economists reckoned that globalisation would lead to a shortage of capital and hence higher interest rates as millions of Indian and Chinese workers were absorbed into the world economy. If Mr Bernanke is right, all this will need re-examining.

His suggestion that the causes of global imbalances lie elsewhere conveniently deflects attention from monetary and fiscal decisions made by American policymakers. It suggests that Mr Greenspan's loose monetary policy and George Bush's tax cuts are not responsible for the imbalances in the world economy. That may seem a little self-serving, coming from a man who has subsequently moved from the Federal Reserve to become chairman of Mr Bush's Council of Economic Advisers. Taken at face value, the notion of a global saving glut is not borne out by the facts. “Glut” suggests an unusually large amount, as in a summer glut of strawberries. In fact, figures published in the IMF's latest *World Economic Outlook* show that the rate of global saving as a proportion of global output, measured at market exchange rates, has mostly been heading downhill over the past 30 years, with a particularly steep plunge between 2000 and 2002 (see chart 1). Although it has since risen slightly, the global saving rate is now close to its average for the past two decades, rather than unusually high.

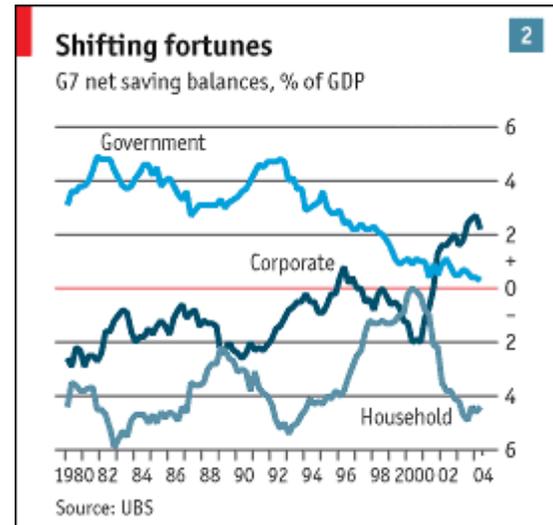


In search of a glut

But Mr Bernanke's argument is more subtle. He is saying that low interest rates imply too much saving relative to the amount people want to invest, and that the rising imbalance between America and the rest of the world suggests the discrepancy is concentrated outside America. A falling global saving rate could mask substantial divergence between regions. And even with the saving rate falling, there could be a glut of thrift if the demand for the use of those savings, ie, the demand for investment, was falling even faster. The important factors in the equation, therefore, are shifts in the appetite for investment as well as in the geography of thrift.

On both counts the world has seen big changes. Traditionally, most of the saving in an economy is done by households, whereas most of the investing tends to be done by firms. But in the past few years firms have become net savers as their profits have exceeded their investments. That change has been most pronounced and long-lasting in Japan, where corporate saving soared after the bubble economy collapsed in the early 1990s. Burdened with bad debts after a period of massive overinvestment, Japanese firms have been net savers for a decade.

The late 1990s saw a similar shift in many emerging Asian economies, where corporate investment plunged after the Asian financial crisis. After the stockmarket bubble burst in 2000, American and European firms' investment also fell. Although American firms began investing again a couple of years ago, the level of corporate investment is still relatively low, given how strongly the economy—and profits—have been growing. Firms in industrial countries as a whole are still saving more than they invest, despite record profits (see chart 2). The only significant country bucking the trend is China, where investment has been rising sharply. But saving has been growing faster still.



A weak appetite for investment might help explain low interest rates, but not the rising imbalances between America and the rest of the world. To understand those, two other factors have to be considered: differences in countries' economic structures, and differences in policymakers' reactions to the investment bust.

America is at one extreme. Its corporate thrift shift was smaller than that of Japan or other Asian economies, but policymakers in Washington reacted far more dramatically. Between 2001 and 2003, America enjoyed its biggest fiscal stimulus of the post-war period, and short-term interest rates were slashed. Declining interest rates fuelled a boom in house prices, encouraging people to borrow against their properties. Economic growth remained strong and the current-account deficit soared.

Asia's emerging markets faced a much bigger bust, and had fewer policy tools to deal with it. After the 1997-98 financial crisis, investment fell by ten percentage points of GDP. Unable to slash interest rates for fear of further capital flight, they suffered serious recessions. That left exports as their main source of growth. To protect exports and to build up vast war chests of reserves, many East Asian governments kept their currencies cheap for years after the financial crises. Firms stayed reluctant to invest, the saving surpluses remained large and the foreign-exchange reserves piled up.

Japan and Europe lie between those two extremes. Politicians in Tokyo tried stimulative policies and talked of structural reform, but proved notoriously ineffective at dealing with their investment bust. The economy fell into deflation and Japan, already the world's biggest exporter of savings, became an even bigger one. Its current-account surplus rose from 1.4% of GDP in 1996 to 3.7% last year.

In Europe, the record has been mixed. Some countries, such as Germany, resemble Japan, with rising saving surpluses and weak domestic demand. Others look more like America. In Britain, fiscal and monetary policy became looser. Spain's current-account deficit is almost as big as America's. Broadly, the countries that saw the biggest rises in house prices also saw the biggest drops in saving.

In short, a good part of the rising imbalances of the past few years can be explained by a series of investment busts—after periods of overinvestment—and sharp differences in the way policymakers responded to them. But particularly since 2000, two other factors have also become important: more saving in China, and the soaring price of oil.

China's investment rate, at 46% of GDP, is the world's highest by far and has been rising fast, but its saving rate has been rising even faster. Between 2000 and 2004, China's national saving rate rose by an extraordinary 12 percentage points of GDP to 50% of GDP. The country has kept its currency cheap and exported ever more capital to the rest of the world.

At the same time, high oil prices have brought a financial windfall to the world's oil exporters which so far they seem to have chosen to save rather than spend. As a group, the oil-exporting countries are now the biggest counterparts to America's current-account deficit (see chart 3).

These shifts have been large and complicated, and they have had important and unusual consequences. The first is that capital now flows primarily from poor countries to rich countries. In 2004, emerging economies, including the newly industrialised economies of East Asia, sent almost \$350 billion to rich countries. Yet according to the economic textbooks, capital seeking the highest returns should flow from rich (and capital-intensive) countries to poorer ones that have less of it.

The second consequence is that outside China, less saving by households rather than investment by firms has become the engine of global economic growth. The world economy continues to hum because consumers, particularly American ones, are content to become ever more indebted. That willingness appears closely related to the rapid rise in house prices across much of the globe.

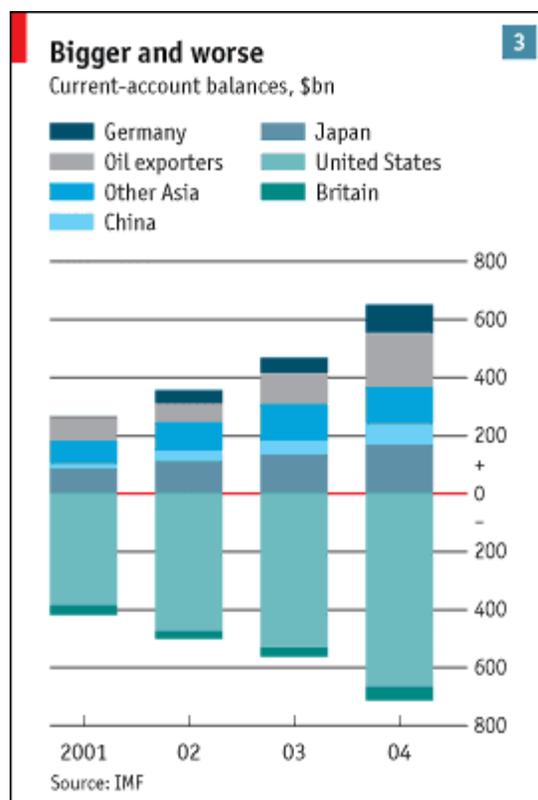
These patterns are a long way from historical norms. Can they last? In the long term, the answer is clearly no. Household saving cannot keep on falling, and America's foreign borrowing cannot keep on rising. The question is when and how the tide might turn.

One camp argues that the saving glut Mr Bernanke has identified is a temporary and largely cyclical phenomenon. As investment recovers in Japan and Europe and strengthens further in America, interest rates will rise. If the investment recovery is concentrated outside America, the surplus savings sloshing in its direction may quickly dwindle. If foreign investors then start fretting about America's dependence on foreign funds, those savings could drain away even more rapidly, sending the dollar down sharply and interest rates up. That would be the classic "hard landing" commentators worry about.

But a growing group of analysts now suggests that the "saving glut" is the result of long-term structural shifts and is likely to last for years, perhaps decades. Some argue that ageing populations in rich countries will mean lower interest rates, because older economies with mature workforces will need less capital and their citizens will save more in preparation for retirement. Others reckon that the Asian economies will continue to export their savings for many years, for mercantilist reasons (keeping their currencies cheap to create jobs in export industries) as well as demographic ones (China, for instance, is ageing faster than America).

If the "saving glut" really is here to stay, there are two main possibilities. The first is that America's consumers will continue to barrel along and the imbalances between America and the rest of the world will increase further. The second is that Americans themselves will start saving again, perhaps because the housing market falters or because high petrol prices begin to bite. With the rest of the world still determined to save too, that would send the global economy into a tailspin.

This survey will try to determine whether the shifts that have caused the "saving glut" are likely to be temporary or more long-lasting. It will conclude that the recent shifts in global saving and investment patterns are not permanent, but nor are they likely to be reversed overnight. Although Japan's economy is looking perkier, and China adjusted its currency regime in July, the surplus of saving from Asia, and from the oil-exporters, is unlikely to fall sharply in the near future. Nor is it likely that the central banks that have been piling up dollar assets will suddenly stop, let alone



dump their greenbacks in a hurry. Both factors suggest that America's creditors will probably allow the global imbalances to persist for a while.

All the same, these imbalances are weakening America's economy. They cannot increase indefinitely and will be hard to unwind without sending the world economy into recession. Nudging global saving and investment patterns into a healthier balance will require new thinking, both inside and outside America. Policymakers bear more responsibility for the thrift shifts, and the global imbalances, than Mr Bernanke cares to admit.

Anatomy of thrift

Sep 22nd 200m The Economist print edition

What causes people to save and invest?

AT FIRST sight, the idea of a “saving glut”—an excess of saving over investment—seems odd. According to the economics textbooks, saving and investment are always equal. People cannot save without investing their money somewhere, and they cannot invest without using somebody's savings. Saving and investment are two sides of the same coin.

And indeed that is true for the world as a whole, but it is not true for individual countries. Capital can flow across borders, so the amount an individual country saves does not have to be the same as the amount it invests. The difference between the two is the amount borrowed from or lent to foreigners; this is called the current-account deficit or surplus. If a country's current-account surplus rises, it means that either its saving has increased or its investment has fallen, or both. Either way, that country has generated an excess of saving which it has exported.

Moreover, whereas it is true that at a global level saving must equal investment, the fact that saving and investment end up in balance does not mean that millions of households and individuals spontaneously desire to save and invest in equal measure. To use the language of economics, saving and investment are an “ex-post” identity, but the world's “ex-ante” appetite to save and invest may well be out of balance. Actual saving and investment must be equal. Desired saving and investment may not be.

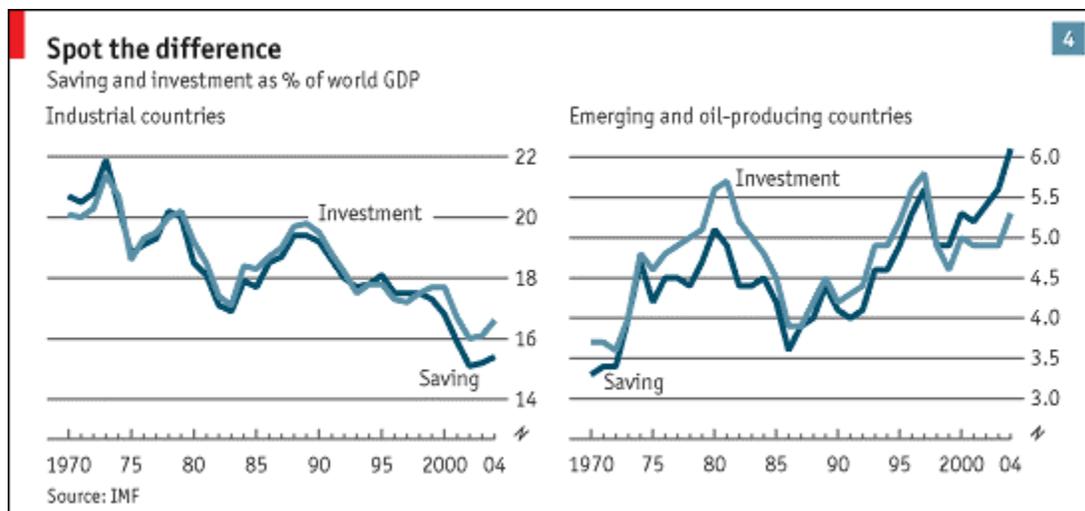
Most of the time, mismatches between the desired levels of saving and investment are brought into line fairly easily through the interest-rate mechanism. If people's desire to save exceeds their desire to invest, interest rates will fall so that the incentive to save goes down and the willingness to invest goes up. Across borders, exchange rates have a similar effect. If a country has a saving deficit, its currency will fall to the point where its assets are cheap enough to lure foreign savings in.

But there is some uncertainty about how smoothly these adjustments are made. Classical economic theory suggests that interest rates automatically bring saving and investment into a productive balance. The central principle of Keynesianism, however, is that this alignment between saving and investment is not always automatic, and that a misalignment can have serious consequences.

If an economy is not running at full capacity, John Maynard Keynes wrote in his “General Theory” in 1936, more saving might, paradoxically, result in less output rather than more. Companies' decisions to produce depend on the demand they expect for their products. More saving means less spending and hence less demand. Hence the idea that you can have too much thrift, and that there is a place for “Keynesian” government spending policies to boost demand.

It's all true

The modern consensus is that both classical and Keynesian theory can be right, but over different time frames. In the long term, saving and investment will be brought into line by the cost of capital. But in the short term, firms' appetite to invest is volatile, and policymakers may need to step in to shore up demand. Thus, although saving and investment are equal ex-post, economic theory leaves plenty of room for an ex-ante saving glut. This glut could be caused by long-term changes in people's desire to save or firms' desire to invest, or it might be caused by short-term cyclical deviations from normal saving and investment patterns. In either case, the size and duration of mismatches can be influenced by government policy.



What might change people's desire to save or invest? That is a question about human behaviour which economists cannot answer with total confidence. Still, they have made some progress in explaining what motivates investment, and a little more in explaining what drives saving.

The most influential theory of household saving is the “life-cycle hypothesis”, pioneered by Franco Modigliani, an Italian economist. It suggests that people try to smooth consumption over their lifetime: they save little or nothing when young but more in their middle years if they have a good income. They then draw down those savings in retirement. It follows that demographic shifts and economic growth are the most important drivers of thrift.

Another theory suggests that people save for “precautionary reasons”, in case they need the money for a rainy day. This implies that people will save more if their income is variable. It also suggests that they will be more inclined to save if they have no access to credit.

A third possibility is that people save because they want to leave assets to their children, either because they love them or as a way to bribe the children to look after their parents in old age. (Economists are always reluctant to believe in altruism.) Whatever the motive, the bequest theory of thrift suggests that savings might not actually be drawn down in retirement.

A final possibility is that people save in response to their government's actions. This theory, known as “Ricardian equivalence”, suggests that people save more if government saves less because they expect higher taxes later on.

How well do these theories fit with what has actually happened in the past? Saving rates differ dramatically between countries and over time, giving economists plenty of statistical ammunition with which to test their theses.

Inevitably, there are differences among academics about which hypotheses are best supported by the data. But, in general, the following factors seem to play a role:

- Demographics.** Although it is hard to confirm Modigliani's hypothesis by studying individual households, it seems to hold for entire countries. Saving rates do rise when the ratio of children in the population falls (as in China), and decline when the proportion of pensioners rises (as in Japan). Given that the world's population as a whole is ageing but, in most countries, most people are still working, global saving should currently be rising.

- Economic growth.** Especially in poorer countries, saving rates rise as economies grow. That is probably because people do not adjust their consumption patterns as quickly as their income rises. Rapid growth was an important reason behind the big rise in saving rates in East Asia in the 1970 and 1980s. It may account for much of the rise in saving by emerging economies today.

- Terms-of-trade shock.** If a country's exports suddenly go up in price, its saving rate tends to go up too, at least temporarily. Oil exporters, for example, put on a saving spurt if oil prices rise. This effect also helps to explain the recent increase in saving in many emerging economies.

- Financial development.** As an economy's financial system becomes more developed, saving rates tend to fall because people find it easier to borrow. This seems to be true for both rich and poor countries. It suggests that saving rates may be lower in countries with more sophisticated financial systems, such as America.

•**Capital gains.** In rich countries there is increasing evidence that capital gains influence saving rates. If the stockmarket or house prices rise, people feel richer and save less. A study by the OECD published late last yearsuggests that housing wealth has a bigger effect on saving than financial wealth, and that this effect is stronger in economies with flexible mortgage markets and high rates of home ownership.

•**Fiscal policy.** In some countries, people do appear to behave as Ricardian equivalence theory suggests: they save more when budget deficits expand, perhaps because they expect higher taxes in the future, although private-sector saving rises by less than the rise in budget deficits. The big exception is America, where the impact of fiscal deficits on private saving appears to be weakest.

Some of these factors work in opposite directions, and gauging which matters most is difficult. But there are indications that in rich countries the biggest disincentives to saving have been capital gains and the ability to borrow. National saving rates in rich countries have been falling gradually for more than two decades, and particularly steeply since the mid-1990s (see chart 4, previous page). In a recent study for the *World Economic Outlook*, Marco Terrones and Roberto Cardarelli, two economists at the IMF, looked at saving patterns in 46 countries between 1972 and 2004 and found that easier credit (thanks, probably, to higher house prices), along with bigger budget deficits, were the most important reasons for the overall drop in saving in rich countries since 1997.

In emerging markets, on the other hand, the most powerful factors pushed in the opposite direction. Fast economic growth and increases in government saving, thanks partly to terms-of-trade shocks, have increased total national saving.

These opposing movements show up clearly in global statistics. Over the past 35 years, the emerging economies' share of global saving has doubled, from 15% to 30%. In 2004, emerging economies saved the equivalent of 6% of global GDP. If there is a glut of saving, it is likely to be found in emerging economies and oil-exporting countries.

The investment puzzle

If it is hard to find out why people save, it is even harder to discover why they invest. In theory, firms should invest if the expected return on their investment exceeds the cost of the capital they are using. In the short term, firms need to worry about the state of overall demand. But in the long term, returns on capital depend on how much capital an economy already has, how productively it is used, and how fast the workforce is growing. If there is little capital available or the workforce is growing rapidly, firms would usually expect a high return on investment.

The evidence supports these theories, up to a point. Statistical analyses suggest that investment rises when economies grow, when productivity increases or when the share of workers in the population goes up, and that it slows when capital becomes more expensive. The IMF's analysis, for instance, suggests that a 1% increase in the cost of capital in rich countries will lead to a drop in investment rates of 0.4% of GDP.

However, in recent years these statistical relationships have failed to hold. Both in rich countries and in emerging economies (except China), investment levels have been lower than economists had expected at the levels of interest and growth rates prevailing at the time. Much of Mr Bernanke's saving glut is due to this unexpectedly low rate of investment. This shortfall could simply be the unwinding of earlier excesses as firms repair their balance sheets, but several "structural" explanations have gained support:

•**Demographics.** A young and growing workforce boosts the level of investment, just like a mature workforce boosts the saving rate. So the world economy is likely to move through a cycle in which investment peaks first and saving peaks a bit later. With rising life expectancy and falling birth rates, the world economy may be moving into the high-saving phase. But although demographics are important, they change slowly. It is hard to ascribe the recent sharp drop in investment demand in regions such as Japan or East Asia to demographic change alone.

•**Declining capital intensity.** Firms in rich countries may not need to invest as much as they used to because the share of capital-intensive industries in their economies is shrinking. In a recent analysis, economists at UBS, a bank, pointed out that in America the share of corporate profits that is generated by investment-heavy industries (oil, gas and chemicals, for instance) has fallen from 55% of the total in 1948 to 21% in 2004. This long-term trend may have accelerated over the past decade. But it does not explain investment busts in poor countries.

•**Deflation of capital-goods prices.** In recent years prices of capital goods have fallen sharply relative to prices of other goods and services, thanks largely to cheaper computers, so companies are able to achieve the desired level of real investment for a smaller outlay. Calculations in the IMF's *World Economic Outlook* show that in real terms, the fall in average investment rates in industrial countries has been much more modest than it appears at first sight. This may help to explain some of the recent weakness in investment, particularly in rich countries. But it is unlikely to

last. Relative price shifts tend to run their course and then stop. More important, computers depreciate more quickly than other capital goods, so eventually firms will need to invest more to maintain the same level of net investment.

•**The rise of China.** This may have prompted a geographic shift in global investment patterns. As firms move their production to China to take advantage of its huge pool of untapped labour, investment elsewhere slackens. But investment flows to China from America, Europe and Japan are not yet big enough to explain the sluggish investment in those countries. Besides, the rise-of-China thesis is about the location of investment more than about changes in its global level.

In sum, none of these explanations for a structural, global decline in investment is altogether convincing. To understand the pattern of global saving and investment properly, you have to look in detail at what is going on within the world's main saving and borrowing countries. The best place to start is the biggest net saver of all, Japan.

The Viagra economy

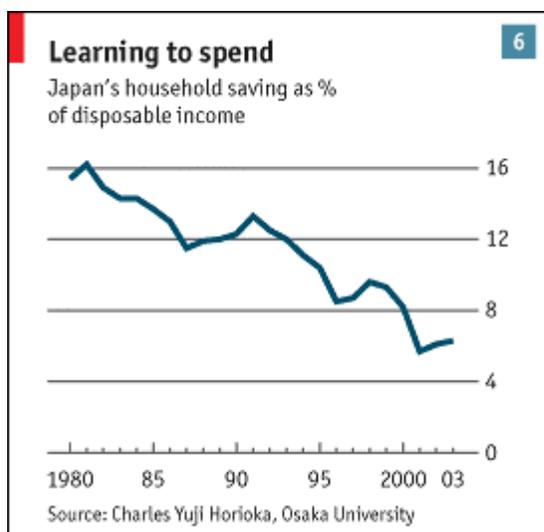
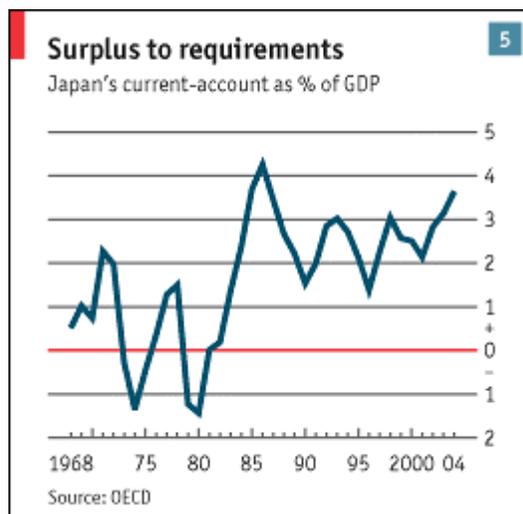
Sep 22nd 200m The Economist print edition

Japan is getting older but its economy is looking perkier. Will that mean fewer savings to send abroad?

FOR much of the past two decades, Japan has been cast as the villain of the global economy because of its large saving surplus. In the mid-1980s, when America was last running large external deficits, the Reagan administration berated the Japanese for their trade barriers and their unwillingness to consume American goods. In the 1990s, the Clinton administration lectured them for relying on exports instead of sorting out their moribund domestic economy.

Today, in contrast, there is little Japan-bashing, even though as a share of Japan's total economy the country's current-account surplus is now even bigger than it was in the 1990s (see chart 5). Instead, America's attention has shifted to China, with its soaring foreign-exchange reserves and (until recently) fixed currency. But Japan remains an important factor in the global imbalances. Its central bank still holds the largest stash of dollar reserves. A big drop in Japan's capital exports could quickly end the global saving glut. But is that likely?

With only a handful of exceptions, Japan has run a saving surplus every year since the late 1960s, but its underlying saving and investment patterns have varied a great deal. Back in the 1960s, Japan was a young, fast-growing economy, with high investment rates and even higher saving rates. Today Japan is an old, low-saving country. The trouble is that investment is even lower.



In the 1960s and 1970s, the household saving rate soared, giving rise to the idea that the Japanese were peculiarly frugal people. In fact, their behaviour was unexceptional. Charles Yuji Horioka, an economist at Osaka University, argues that the Japanese household saving rate rose sharply in the 1960s and 1970s because the country was growing rapidly; there was little consumer credit; the population was young; and there was little pension provision (Japan had only a modest state pension scheme until 1973).

None of this applies any more. Consumer credit is widely available (Japanese households' debt was 136% of their income in 2000, more than in America). The economy has been stagnant for a decade. And the Japanese have grown old. The share of pensioners in the population is surpassed only by Italy and Sweden. Not surprisingly, household saving has plummeted, from its peak of 23% of disposable income in 1976 to 15% in the 1980s, 10% in the 1990s and around 6% today (see chart 6). Twenty years ago, Japan's household saving rate was almost

twice as high as the OECD average; today it is merely average.

Given this drop in household saving rates, why has Japan's current-account remained in surplus? Again, the reasons have changed over time. In the early 1980s, firms were investing more slowly and the government's fiscal position improved. By the late 1980s, private investment was soaring, swept along by the stock and property bubble. The current-account surplus shrank, but remained positive.

Then the bubble burst. Stock prices and then property prices plunged. Investment collapsed and corporate saving rocketed. With Japan's government unable, or unwilling, to clean up the banks' loan portfolios or force restructuring of the weakest firms, Japanese firms have spent the past decade painfully working off their earlier excesses. All profits have gone into improving firms' balance sheets. In the late 1980s, firms were borrowing from households at the rate of almost 10% of GDP a year. For the past decade they have been paying down debt or building up cash balances at a similar rate.

Japan's government, in contrast, has been dis-saving for a decade. Japanese politicians like to blame failed Keynesian stimulus packages; in fact, the country's budget deficits were caused mainly by economic stagnation. With growth weak and prices falling, tax revenues plunged. For the past ten years the budget deficit has been running at an average of 6% of GDP, and Japan's levels of government debt are now by far the highest of any rich country. But even record budget deficits and falling household saving could not counteract the scale of corporate thrift. Japan's current-account surplus has been rising.

Will that change? The answer hinges mainly on whether Japanese firms start investing again. Optimists have been repeatedly disappointed over the past ten years. There were a few mini-recoveries, but they relied on export growth rather than domestic investment, and none lasted long.

Land of rising investment?

But now the mood in Tokyo is more upbeat, and for good reason. The economy has been growing at a respectable rate for two years. After ten years of painful adjustment, corporate balance sheets are looking healthy. The banking system has been cleaned up. Firms are beginning to hire again and wages are picking up. The jobless rate is at its lowest level for seven years. Even land prices in Tokyo are beginning to rise. All this suggests that domestic investment could recover. Given Japan's demographics and its firms' memory of the past decade, no one expects an investment binge, but a gradual rise is likely.

What about Japanese households? In the long term, demographic pressure will push the saving rate down further as more people retire. But in the short term, household saving could rebound, particularly if people were drawing down savings while the economy was weak. Mr Horioka thinks that demographics will prove the stronger factor, and expects the household saving rate to turn to zero or even negative by 2010. The IMF is more circumspect. In its latest analysis of Japan, it forecasts that household saving will fall to around 3.5% of GDP by 2010, a drop of about 2.5 percentage points from its current level.

Given the improved investment outlook and the secular decline in household thrift, it seems clear that Japan's current-account surplus ought to fall. But Japan's new government is adding a new factor to the equation. With public debt already so high and the population ageing so quickly, Japanese politicians are nervous about their fiscal deficits.

There has already been some fiscal tightening. Spending on public infrastructure, for instance, has fallen sharply in the past couple of years. Moderate tax hikes are slated for 2006 and 2007. Japan's prime minister, Junichiro Koizumi, has promised not to raise the consumption tax under his watch, but no one is ruling out other measures. Much depends on how strong the recovery proves to be. Paul Sheard of Lehman Brothers, an investment bank, reckons that stronger growth in Japan will trigger more fiscal tightening.

Mr Koizumi's landslide election victory on September 11th strengthens that impulse. The prime minister had called the election because the old guard of his party, the Liberal Democrats, opposed the privatisation of Japan's postal savings system, a big financier of poorly allocated public spending. This issue was code for an even larger one: reducing the size of the state, and its borrowing. Now Mr Koizumi has a strong mandate to do more of that.

A tighter fiscal policy will counteract lower household saving and higher investment, so the overall effect on the current-account surplus is hard to gauge. Most official forecasts suggest that Japan's current-account surplus will decline gradually. But Japanese technocrats seem to see things differently. When the Council on Economic and Fiscal Policy, Japan's cabinet-level steering group for the economy, released a set of long-term fiscal and economic projections in January, it actually forecast a bigger current-account surplus in 2012 than today.

The council expects a marked improvement in the government's finances, with the deficit falling from 7% of GDP to around 4%. It sees only a modest drop in Japan's private-sector saving surplus, from 11% of GDP in 2004 to 9% in 2012. If this comes to pass, the current-account surplus could rise to 5% of GDP in 2012. This is only a forecast, but it tempers hopes for a rapid turnaround in Japan's saving surplus.

The frugal giant

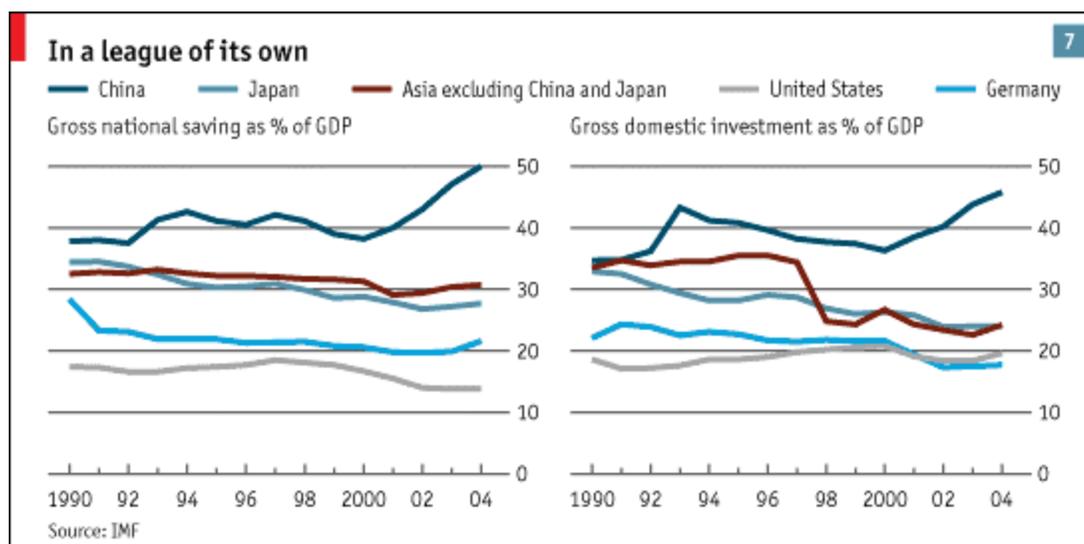
Sep 22nd 2005 From The Economist print edit

China's enormous saving surplus may rise further before it falls

IN THE Haidan district of western Beijing stands the world's biggest shopping mall. Six storeys high, with 230 escalators and over 6m square feet (558,000 square metres) of retail space, it is a temple to consumption. Over 1,000 shops sell everything from clocks to cats; the "Fantawild Hitech Family Funplex" offers entertainment; an ice-rink beckons.

Only one thing is missing: customers. On a weekday morning in early July, the place was virtually empty, and such visitors as there were seemed to be window-shopping rather than buying. Like the rest of the world, the "Golden Resources Shopping Mall" is still waiting for a big Chinese consumption boom.

Thanks to rocketing economic growth, the Chinese are spending a lot more than they used to. There are now 59 washing machines per 100 households, up from one in 1985. The number of Chinese travelling abroad rose by 43% last year, to 29m. But Chinese saving is growing even more rapidly. Since 2000, the country's overall saving rate—already the world's highest by far—has risen sharply, to nearly 50% of GDP (see chart 7). Even though China is investing at the staggering rate of 46% of GDP, it is still running a net saving surplus, and that surplus is still growing. It rose from 1.9% of GDP in 2000 to 4.2% in 2004, and shows no signs of stopping.



Noting that imports have recently been subdued, many China-watchers expect the country's current-account surplus to rise to 7% or even 8% of GDP in 2005. China may still be poor, but it has become one of the world's biggest exporters of capital. And its impact on the allocation of global capital is even bigger than its current-account surplus suggests. This is because it recycles a lot of savings from other countries and redirects those funds towards America. China is a big recipient of foreign investment (\$55 billion of net FDI in 2004), and even more speculative capital has flowed in as investors have been betting on a rise in China's currency, the yuan.

Rather than allow these capital inflows to strengthen the currency, China's central bank has chosen to pile up foreign-currency reserves, many of which are invested in American Treasury bonds. Thanks to its own saving surplus and its recycling of savings, China had \$711 billion-worth of reserves at mid-year.

On July 21st, the central bank announced that the yuan would no longer be pegged to the dollar but managed against a basket of currencies instead. After an initial 2% rise against the dollar, the yuan has barely moved, but the change is potentially important all the same. China's new currency regime could affect both its saving surplus in general and its appetite for American assets in particular.

China's capacity for thrift has long perplexed economists. A 2000 study by Aart Kraay, an economist at the World Bank, found that between 1978 and 1995 China's national saving rate was, on average, more than ten percentage points of GDP higher than the country's economic characteristics would suggest. It has since risen further. What is going on?

Thrifty habits

Household saving is the easiest to make sense of. First, Chinese households have not changed their consumption patterns fast enough to keep up with the huge rise in their incomes. The boost to saving from higher incomes has been further strengthened by a rise in income inequality: a large part of China's growing income has been going to the relatively small share of the population living in coastal areas. Richer people save more than poorer ones.

Demography, too, has played a big role, as the share of workers in the population has risen. Moreover, the one-child policy has made it harder for people to rely on their children as a source of support in old age, further encouraging thrift. Franco Modigliani and Shi Larry Cao argue in a study published in 2004 (posthumously, in Mr Modigliani's case) that these factors together explain virtually all of the rise in Chinese household saving between the mid-1970s and the 1990s.

A further incentive to saving is the weakness of social safety nets. Under the old economic regime many Chinese workers could count on health and pension benefits from state enterprises (the "iron rice bowl"). No longer. The state sector has shrunk dramatically as a share of the economy, and even those workers still employed by state-owned firms have seen their benefits dwindle.

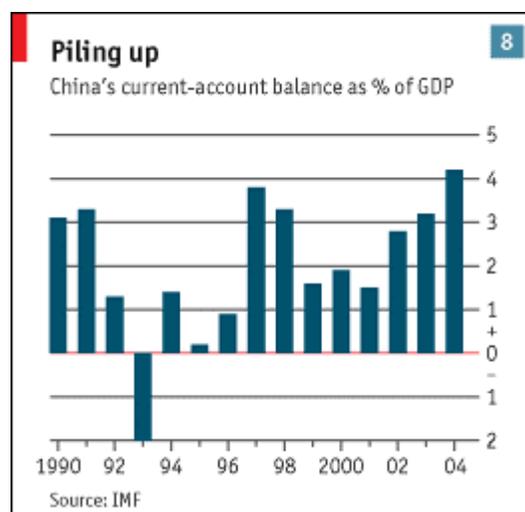
Pension coverage is low: only about 120m people pay into formal pension schemes, fewer than half the estimated 265m urban workers. Worse, pensions are organised largely at the municipal level, and are not easily portable. A migrant worker in Shanghai who plans to retire to his home village cannot assume that he will get his pension there. In rural areas, pensions are almost non-existent.

Health care is also getting more expensive. China's government spends little on public health services and has been shifting costs on to consumers. Enter the lobby of a Chinese hospital, and you might think you are in a bank. A huge electronic noticeboard flashes up the price of treatments—200 yuan for a cardiogram, 101 yuan for an abortion in one Beijing hospital. A row of tellers lines the wall. You pay cash up front. A serious operation can easily cost a year's salary. With state firms reducing their health coverage and private insurance in its infancy, that is another reason for saving.

Education, too, requires deep pockets, even with fewer children. Again, the state spends little on this, around 2.3% of GDP, much less than in Thailand, Malaysia or India. In a recent survey of people's reasons for saving, education came top.

The relative lack of credit is another factor. Although the mortgage market is growing rapidly, thanks to the government's policy of selling off state housing, consumer credit is still in its infancy. Its growth is hampered by the lack of credit-rating agencies and by the ropy banking system. Like the Japanese in the 1960s, the Chinese need to save a lot because they find it hard to borrow.

And save a lot they do. Chinese household saving, at around 25% of disposable income, is astonishingly high by international standards. But although households account for a large part of China's exalted national saving rate, they were not responsible for the sharp rise in national thrift since 2000. After falling steeply in the late 1990s, China's household saving rate has been more or less steady since 2000 (see chart 9). The recent rise in national saving was led by the government and the corporate sector. Louis Kuijs of



the World Bank has examined sectoral saving patterns in China and points out that both these sectors are far more frugal than many observers realise.

The fiscal accounts show the government's revenue to be about 20% of GDP and expenditure slightly higher, resulting in a deficit of about 2% of GDP. But Mr Kuijs argues that these numbers mask a lot of government saving and investing. The government spends only about 13% of GDP on goods, services and wages. The remainder—almost 10% of GDP—is, in effect, government saving, which is then invested, largely through direct capital transfers for infrastructure projects or to support state firms.

Chinese firms, both state-owned and private, are also big savers. Corporate profits soared after 2000, thanks to rapid growth, low interest rates, rising productivity and cuts in employee benefits. Both private and state-owned firms are flush with cash, so their saving has risen sharply. China's firms are now bigger savers than its households.

But unlike their peers in the rest of the world, they are investing their surpluses. With no need to pay dividends (state firms do not have to make any transfers to central government) and little shareholder pressure to ensure that their investment is cost-effective, Chinese firms went on a capital-spending binge, concentrated in industries such as aluminium, steel, car production and cement.

That splurge may well prove unsustainable. Profit growth has slowed sharply over the past year because of excess capacity in the most over-invested sectors, such as cement and steel. Grace Ng of J.P. Morgan, a bank, points out that whereas in early 2004 overall profits in industrial firms were expanding at the rate of 40% a year, by May 2005 the growth rate had slowed to 16%.

Slower profit growth means less corporate saving, but investment seems to be slowing even faster, at least in the most over-invested sectors. The rate of growth of China's imports of capital goods, for instance, is now less than a third of what it was in 2004. But Chinese firms are still selling the fruit of past investment on world markets. As a result, the country's external surpluses are rising. According to Arthur Kroeber, editor of the *China Economic Quarterly*, the investment slowdown will result in “at least a couple of years of blockbuster trade surpluses”.

How far a cyclical slowdown in investment translates into a rise in China's national saving surplus also depends on how consumers react. If firms create fewer jobs, or even lay people off, consumption could catch a cold—which would mean more saving and even bigger external surpluses. Nicholas Lardy, of the Institute for International Economics in Washington, DC, points out that the last time China had an investment bust, in the mid-1990s, consumption slowed sharply and the current account shifted from a deficit of around 2% of GDP in 1993 to a surplus of around 4% in 1997.

So far, consumption growth has barely been affected this time. Retail sales, for instance, show no sign of flagging. But China's current account was already in surplus when the investment slowdown started, and is rising faster than it did a decade ago, so if and when the effects feed through to consumption, the change in the current account could be much bigger than last time. A saving surplus of 10% of GDP, or even more, is not unthinkable.

Whatever the scale of the current cyclical investment slowdown, the pace of China's investment is likely to fall over the medium term. At an aggregate level, China's investment rates seem inefficiently high. Japan and South Korea, for instance, achieved similar rates of growth in the 1960s and 1980s, respectively, with investment levels that were ten percentage points lower than China's. Although investment efficiency has been improving, particularly in the growing private sector, many state firms—which account for much of the over-investment—still earn negative returns on capital. That will change as market reforms continue. Once Chinese banks, for instance, face foreign competition in 2007, they will care more about whom they lend to. Shareholders will become more active and demand higher returns on capital. The introduction of dividend policies would shift more corporate profit to households.

Will consumers wake up?

Better corporate governance will also reduce corporate saving. What happens to China's national saving surplus will depend on whether China's households will save less and spend more, thus becoming the engine of the domestic economy.

The example of Japan is sobering. Although Japanese households now save much less than they used to, their country never really made the shift from export-led to consumer-led growth. It has been running current-account surpluses for four decades. China, however, is different in important ways. Its economy is already much more open than Japan's ever was. Exports and imports add up to the equivalent of 70% of China's GDP, compared with only

20% in Japan. And if July's exchange-rate adjustment turns out to be the beginning of a gradual appreciation, China seems to be shifting away from an undervalued currency far more quickly than Japan did.

Over time, a stronger currency will encourage a reorientation of China's economy towards the domestic consumer, but this is likely to take several years. Although American policymakers may be clamouring for a rapid rise in the yuan, there is no sign in Beijing that the government plans anything of the sort. China's leaders are concerned about unemployment in urban areas as the export sector is squeezed by a stronger yuan, and they worry about unrest in rural areas as farmers have to compete with cheaper imported grain.

A government that depends on rapid economic growth to legitimise itself will not want to risk instability with a sudden rise in the currency, so a much stronger yuan seems an unlikely route to a quick reduction in China's saving surpluses. Reforms to encourage consumer credit and reduce uncertainty about pensions and health-care costs are a better bet. Some such reforms are already under way. China's central bank, for instance, intends to set up credit bureaus in seven provinces this year to help boost the development of consumer finance, and pilot schemes to improve the pension system are in progress in several provinces. Top Communist Party leaders talk a lot about shifting the emphasis of government spending from investment to social safety nets, and recently they promised free nine-year education for children in rural areas. But the government's overall fiscal position has actually tightened this year.

Redirecting an economy as big as China's towards domestic consumption takes time. China's saving surpluses will not last forever, but nor will they disappear overnight. And trying to move too fast can be disastrous, as the mess in Asia's other emerging markets shows.

Reversal of fortune

Sep 22nd 2005 From The Economist print edit

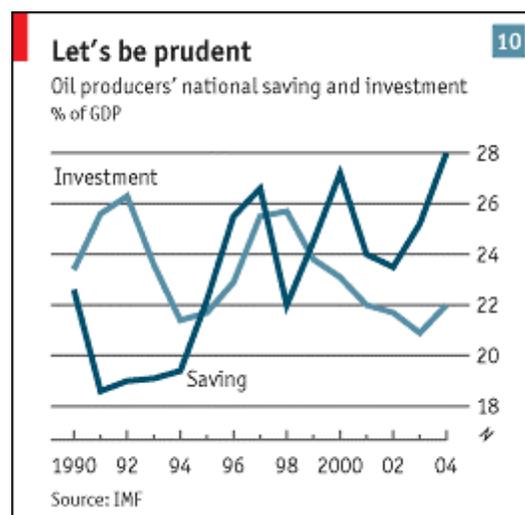
Why oil exporters and East Asians are reluctant to spend

JAPAN and China may be the whales amongst the world's savers, but their surpluses add up to only about 40% of America's saving deficit. The rest comes from a shoal of smaller fish. Most are emerging economies, particularly in Asia and the Middle East. These countries are piling up current-account surpluses for different reasons. Saving in oil-exporting countries has soared, and private-sector investment in emerging Asia outside China has collapsed.

The role of oil prices in today's global imbalances is often overlooked, but surplus saving in oil-exporting countries, as a group, is now the biggest counterpart to America's deficit. In 2004, when the oil price averaged \$40 a barrel, oil exporters ran a collective saving surplus of \$207 billion, almost three times as much as in 2001. So far this year, oil prices have soared, and the IMF now expects the oil exporters' collective surpluses for 2005 to be almost \$400 billion. That should not come as a surprise. A sudden windfall of wealth from a "terms-of-trade shock" initially tends to be saved not spent, and national saving rates in oil-exporting countries have recently shot up (see chart 10).

But the oil-producing countries are being unusually frugal. Their investment rates have actually fallen since the late 1990s. Why? First, they believe today's elevated prices to be temporary. If oil prices are likely to fall back to, say, \$30 a barrel, it is prudent not to spend the extra revenue. Second, they are determined not to repeat the mistakes made in previous oil booms, when excessive profligacy left many oil producers high and dry as prices fell. In the late 1970s, Nigeria was swimming in petrodollars; by the mid-1980s, it was going cap in hand to the IMF.

This time around the oil-rich countries have created rules to encourage prudence. Several of them now have "oil stabilisation funds" into which windfalls should flow. Others have been shoring up fiscal positions that were looking rather unhealthy at the end of the 1990s, after a long period of cheap oil. Saudi Arabia's government, for instance, has been paying back the debt accrued over 17 years of budget deficits. Russia is paying off its external creditors.



This prudence may not last. Many oil-exporting countries, particularly in the Middle East, have young populations and a huge need for physical and social infrastructure, so investment is likely to rise. But with memories of past oil busts still vivid, that shift may not be sudden.

Where are the tigers now?

The saving surplus in East and South-East Asia is the legacy of a bust both more recent and more spectacular than the 1970s oil shocks: the Asian financial crisis in 1997-98. A decade ago, the regions' economies, from the more developed (such as South Korea) to the poorer ones (such as Thailand), were in the midst of an investment binge, particularly in property. Several of them became big importers of savings, running current-account deficits of 4% of GDP or more. When the crisis came, investment plunged, from around 35% of GDP to less than 25%. Although it has recently risen a little, it is still extremely low. Overall, the investment rate in East and South-East Asia is now close to the average in Japan, a much richer country.

East Asia's saving surplus, in short, has little to do with increases in saving. National saving rates in the region have remained relatively stable. While corporate saving has risen, household saving in many places has fallen, thanks both to demographics and to government efforts to boost consumption. In 1998, South Koreans saved 24% of their incomes; by 2003, the figure was down to 4%. Thailand's household saving rate fell from 15% of GDP in 1998 to 6% in 2003.

The puzzle is why domestic investment has not recovered more. A big bust was always going to entail a prolonged period of balance-sheet adjustment, and investment rates had never seemed likely to return to their excessive pre-crisis levels. Even so, seven years after the crisis, and with growth in the emerging East Asian countries now strong, it seems odd that investment is still so weak.

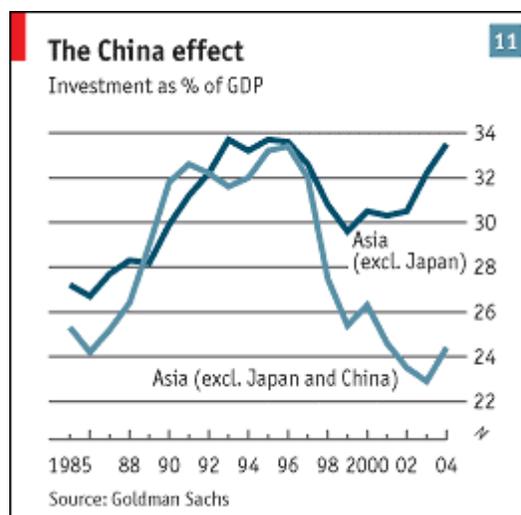
One explanation may be that China's rise has resulted in a bigger shift in investment demand in the rest of Asia than elsewhere in the world. Investment in export sectors, in particular, may simply have shifted to China. Sun-Bae Kim of Goldman Sachs, an investment bank, points out that investment rates in emerging Asia as a whole, including China, look much healthier than in the region outside China (see chart 11).

But emerging Asia's biggest investment weakness is outside the export sector. The mystery is that rapid export growth has not translated into higher domestic-sector investment, especially as real interest rates in the region have been low or even negative for much of the past three years.

Most analysts blame Asia's currency policies. They argue that, just as a cheap yuan has recently distorted China's economy, and a cheap yen distorted Japan's in the early 1980s, so the rest of Asia is cursed by its addiction to export-led growth. The proof lies in the region's growing accumulation of reserves, which is a measure of Asians' efforts to hold down their currencies. According to the Bank for International Settlements, emerging Asia outside China increased its reserves by \$147 billion in 2003 and \$157 billion last year.

Not everyone agrees with this argument. Jonathan Anderson, an economist at UBS, maintains that Asia's central banks are holding their currencies down not in order to boost exports at the expense of domestic consumption, but rather because domestic demand is so weak.

Whatever their motivation, there is no doubt that Asia's central banks worry about the strength of their currencies. The exact circumstances differ from country to country. Except in Hong Kong, no currencies are now tied directly to the dollar. Malaysia abandoned its peg as soon as China did. Nonetheless, most currencies have moved relatively little against the dollar (see chart 12). There is a widespread fear of moving too far, too fast.



Emerging Asia's governments are also leery of other quick fixes to boost domestic investment or spur consumption. It was, after all, excessive domestic investment—thanks partly to rash liberalisation of the financial sector—that got them into the crisis in the first place. And there have been other fiascos since. In 2000-2002, South Korea tried to stimulate consumption by encouraging consumer borrowing on credit cards. But supervision and credit-rating turned out to be inadequate, so the credit-card boom quickly turned to bust.

Nonetheless, there are some tentative signs of an upturn in domestic demand. The region's stockmarkets have risen by \$1.6 trillion since 2001, equivalent to one-third of nominal GDP. Residential property prices have picked up. Several economies in the region have already seen their current-account surpluses shrink. Thailand's current account even moved into deficit this year. As these countries are oil importers, high oil prices will also reduce the region's surpluses. Emerging Asia's willingness to send its savings abroad may have peaked. But given the region's recent history, the odds are that the adjustment will be gradual.

The hare and the tortoise

Sep 22nd 2005
From The Economist print edition

Why have the world's savings gone to America rather than to Europe?

THIS survey has argued that the supply of global saving—relative to desired investment—has grown in recent years, thanks largely to shifts in Asia and in emerging economies. These shifts may help to explain why global interest rates have been low. But they do not explain the geography of current-account deficits. Why has most of this capital been absorbed by America and, to a lesser extent, other Anglo-Saxon economies such as Britain, rather than continental Europe? After all, the euro area's economy is four-fifths the size of America's; its capital markets are liquid; its currency is stable; and its legal protections are as strong as those anywhere in the world.

Yet far from absorbing the rest of the world's capital, the euro area in 2004 ran a small saving surplus (\$36 billion) of its own. Whereas America's foreign borrowing has accelerated, especially since 2001, the euro area has remained a lender. Though interest rates are low in both regions, the effect seems to have been very different. Is this evidence of Europe's sclerosis and America's dynamism, or of Europe's prudence and America's profligacy?

One answer is that European aggregates mask big differences between countries. For example, in Spain the economy has been humming and the current-account deficit has soared. Italy has been mired in recession, but thanks to its ageing population its household saving rate has plummeted and its current account is in deficit. At the other extreme, Germany has become a large exporter of savings.

More broadly, though, Europe's thriftiness, relative to America's, results from a mixture of demographics, structural rigidities, policymakers who don't much believe in Keynes and financial systems that are less consumption-friendly.

Twenty years ago, saving patterns in America and Europe were not all that different. In the mid-1980s, American households saved, on a net basis, around 9% of their disposable income. The British figure was 7%, the Spanish 8%, the French 9% and the German 12%. Despite big statistical problems in comparing household saving rates, the ranking is probably about right.

In the 1980s and 1990s, household saving rates fell both in Anglo-Saxon economies and (to a lesser extent) in many continental European ones. Germany saw only a small decline; Italy, with its burgeoning number of pensioners, the largest. But the drop in household saving in America was far bigger than in most of Europe, for two reasons: bigger capital gains and more financial innovation.

Thanks to the long bull market in stocks, particularly after the productivity boom of the mid-1990s, Americans felt richer. A study by Annamaria Lusardi, Jonathan Skinner and Steven Venti of Dartmouth College found that capital gains explain most of the total decline in America's personal saving since the late 1980s. Thanks to a more sophisticated financial system than, say, Germany's bank-dominated arrangements, Americans could also borrow money more easily. Financial innovation has made a huge difference to Americans' access to credit in the past 20 years. Today there are over 1.3 billion credit cards in America, or more than 11 per household.

But whereas household saving rates in the two regions diverged, government saving kept overall national saving rates closer than they would otherwise have been, at least during much of the 1990s. Public finances improved on both sides of the Atlantic, but by more in America. As a result, in 2000, America's overall national saving rate, at 18% of GDP, was not far below the European average of 21% of GDP.

Since 2000, however, the gap has grown much larger. After the stockmarket bubble burst, corporate investment fell on both sides of the Atlantic. That sent Europe's big economies into a trough from which they have not really emerged, whereas in America growth was underpinned by more government and household spending. America's drop in household saving has accelerated, whereas European households, on average, have become slightly thriftier.

Americans now save less than 1% of their disposable income, compared with a euro-area average of 10%. America's budget moved sharply into deficit, whereas Europe's public finances have seen less change. As a result, America's national saving rate is now below 14% of GDP, compared with over 20% for the euro zone.

Old Europe's troubles

One important reason is demographics. "Old Europe" may not like the label, but in the demographic sense it is accurate. Europeans have fewer children than Americans and they allow much less immigration, so European societies are ageing much faster. Relative to America, this reduces Europe's allure as an investment destination and increases its citizens' desire to save.

An analysis in 2000 by PricewaterhouseCoopers, an accounting firm, suggests that demographic changes alone will push up continental Europe's private-sector saving rates by 2-3% of GDP between 1995 and 2015. There is some evidence that the impact of demographics on saving has accelerated recently.

But demography is not quite destiny. Economic reforms could do a lot to make "old Europe" a more attractive place for investment, offsetting the effect of ageing societies. With an average unemployment rate of 9%, the euro area has plenty of spare workers.

Europe has, in fact, made significant progress on economic reform in recent years. Germany's labour market has become more flexible and the country's social benefits have been trimmed. France's pension system has been overhauled. The trouble is that the reforms will take time to translate into economic growth. In the meantime they are making things worse. People save more because they are worried about the future. In Germany, in particular, there is evidence that the uncertainty created by economic reform has boosted the household saving rate. The more people save, the less they spend. The lack of consumer demand, in turn, reduces the incentive for firms to invest.

Yet continental Europe, by and large, has provided far less macroeconomic stimulus than America. Although the euro area's overall budget position went from a surplus of 0.1% of GDP in 2000 to a deficit of 2.7% of GDP in 2004, almost all of this deterioration was due to economic weakness rather than deliberate loosening of the fiscal reins. Allowing for the automatic deterioration in the budget that comes from a slowing economy, the euro area saw no change in its fiscal stance at all, compared with a structural loosening worth 5.5% of GDP in America and 4.5% of GDP in Britain.

So why did Europe hold back? Respect for rules is one reason. The Stability and Growth Pact, which in theory limits the size of euro members' deficits to 3% of GDP, has been severely weakened, but it still restricts the euro-zone governments' room to run big deficits. More important, European policymakers tend to regard fiscal expansions as reckless and ineffective.

That is partly because their long-term fiscal outlook is so dire. Thanks to their generous social safety nets and rapidly ageing populations, Europe's governments face a bigger debt problem than America's, and because their tax rates are already high, this will be trickier to resolve. Italy is in the worst shape: its government already owes the equivalent of 120% of GDP. France's debt ratio is 73%, Germany's 70%. According to projections by the European Commission, by 2030 Germany's debt will more than double, to 157% of GDP, thanks to demographics alone.

In America, in contrast, the underlying fiscal position—prior to the recent loosening—was much more favourable. In 2000, the bean-counters in Congress were predicting budget surpluses as far as the eye could see. America, in other words, had much more room to be Keynesian.

Some European economists claim that fiscal policy is ineffective on their home ground. They argue that European households are more "Ricardian" than Americans, tending to make up for bigger government deficits by saving more themselves. In a study of saving patterns in the 1990s, the OECD concluded that fiscal shifts had a greater effect on private saving in Europe than in America. When budget deficits fell, as they did in the late 1990s, so, too, did private saving, although not at the same rate. Thus, Europeans argue, even if they had taken the Anglo-Saxon route, they might not have got much out of it.

Money isn't everything

If the reluctance to use fiscal stimulus is understandable, the effect of monetary policy is more puzzling. Initially, the European Central Bank (ECB) cut short-term interest rates more slowly and reluctantly than did the Federal Reserve. Now, thanks both to the ECB's rate cuts and the global surfeit of saving, European interest rates are at record lows. Yet the effect on spending has been much less dramatic in Europe than in America, and seems to have been getting weaker. Calculations by economists at HSBC, for instance, show that the stimulus to output from a 1% cut in short- and long-term interest rates has been falling steadily (see chart 13).

European monetary union is one reason. The single currency has had the effect of translating the same low nominal rates into different real, ie, inflation-adjusted, interest rates in different countries. Where inflation is lower than average, as in Germany, real interest rates are higher and monetary conditions therefore tighter.

A more important reason for the relative ineffectiveness of monetary policy in Europe compared with America has to do with the interaction of interest rates, house prices and consumption. In America, lower interest rates fuelled a house-price boom. Flexible mortgages allowed consumers to tap some of their housing wealth. Rising house prices boosted consumption more than higher share prices did in the 1990s, partly because far more people own houses than shares, partly because Americans regarded house-price gains as more permanent than similar gains in share prices.

Germany is at the other extreme. Lower interest rates failed to translate into higher house prices, and even if they had done so, the effect would have been much smaller because far fewer people own their own homes, and restrictive mortgage contracts make it much harder for consumers to refinance their loans at a lower rate.

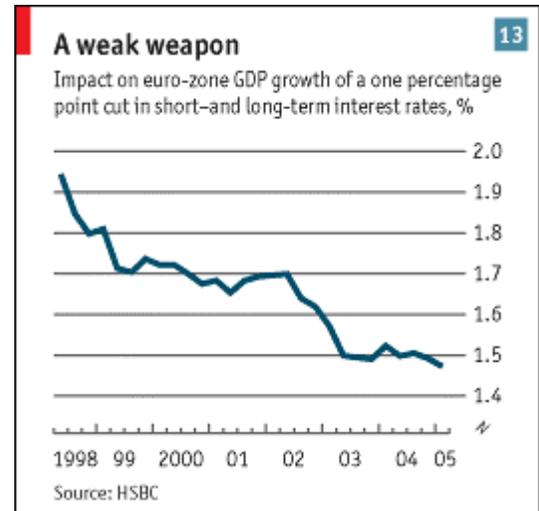
The rest of the euro area lies in-between. Spain, for instance, looks similar to America. House prices have soared, consumption has boomed and the country is running a large current-account deficit. France has seen house price appreciation, but less of that has been translated into consumption, and the current-account deficit is smaller than Spain's.

In sum, continental Europe had weaker policy levers with which to respond to a drop in investment demand, and it used those levers more reluctantly. As a result, it has been caught in a low-growth, high-saving equilibrium, at least compared with America. An optimist might argue that the euro area has avoided the excesses of America's profligacy while gradually hammering away at its own structural rigidities. If that is correct, today's stagnation should eventually give way to faster growth—and a smaller saving surplus.

There is some evidence to support this view, particularly in Germany. Although that country's economy is still looking weak, with output flat in the second quarter, there have recently been signs that it could be poised for an upturn. After several years of cost-cutting and financial restructuring, German firms have become leaner and more profitable. Unemployment has been falling slightly, although from a high level, and indicators of business optimism have been rising. If Germany were to turn, the whole region would start to look much more cheerful.

But the failure of the German election on September 18th to produce a clear-cut result has dampened any optimism about that country. A government without a strong popular mandate will find it much more difficult to continue with those much-needed economic reforms. So the more pessimistic, and probably realistic, view is that Europe is doubly vulnerable. Germany is still addicted to foreign demand. Some countries, such as Spain, have become reliant on rises in house prices. Italy remains stagnant. And the lack of growth in Europe is taking an increasing political toll.

Within recent months, the French and Dutch voted “no” on the European constitution, plunging the European Union into a bout of self-doubt. Italy's prime minister, Silvio Berlusconi, has called the euro “a disaster”, and several of his cabinet members have suggested that Italy should leave. None of this inspires confidence that continental Europe will do much to rebalance the world economy in the near future, or that countries with surplus saving will rush to invest their money in euros.



Forever free

Sep 22nd 2005
From The Economist print edition

Can America go on borrowing abroad indefinitely?

“IF SOMETHING is unsustainable, it will stop.” This phrase, coined long ago by Herb Stein, an economic adviser to Richard Nixon, has become a staple of the debate on America's current-account deficit. Officials at the Federal Reserve began to fret about America's “unsustainable” imbalances in 1997, when the deficit was less than 3% of GDP. There was much hand-wringing in 2003 when the deficit passed 5% of GDP, a widely accepted indicator of things going seriously awry. Today, the deficit stands at more than \$700 billion, well over 6% of GDP, and is set to rise further. The world is still going round. Is it time to stop worrying about the sustainability of America's foreign borrowing?

High time, argues a growing band of optimists, most of them American. They offer a variety of reasons. First, they believe that the current-account imbalance is a sign of American strength not weakness: it is caused by foreigners rushing in to share in the proceeds of the country's highly productive and efficient economy. Second, they dismiss the current-account deficit as insignificant in relation to America's total wealth. Who cares about borrowing an annual \$700 billion from abroad when American households are worth more than \$30 trillion?

Some of these arguments are plainly wrong-headed. If foreigners were keen to share in the gains of American productivity, they would be investing in American shares and factories. That is what happened in the late 1990s. But since 2000, growth in net foreign investment in American shares as well as foreign direct investment in America has slowed sharply. The growing surplus of saving abroad is mainly flowing into American bonds, especially government bonds. Foreigners are lending America money to consume.

The comparison with household wealth is misleading. Most of the recent rise in America's household wealth has come from house prices, and if there is indeed a bubble in the housing market, some of this wealth will turn out to be illusory. Even if the gains are real, they cannot easily be turned into income with which to service America's external debt. Eventually, America will need to export more than it imports to pay its external creditors.

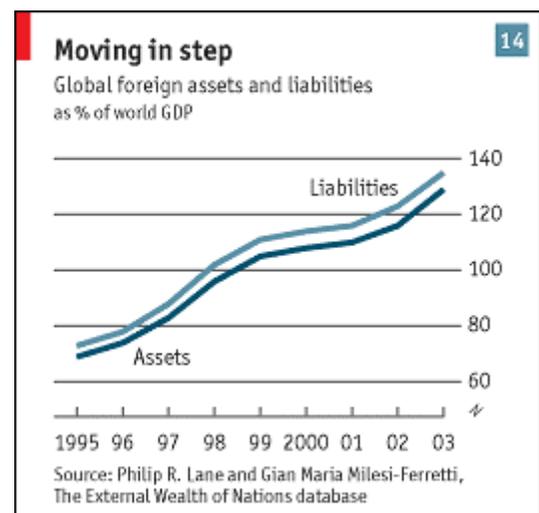
Still, the growth in global capital flows does call for some rethinking about America's current-account deficits. Both foreign assets and foreign liabilities have mushroomed as people across the globe have invested in each other's economies on an unprecedented scale. Gian Maria Milesi-Ferretti of the IMF and Philip Lane of Trinity College, Dublin, have built the world's best database of foreign assets and liabilities in over 120 countries, accounting for more than 99% of world GDP. They found that the stock of all foreign assets owned by these countries was worth the equivalent of 130% of world GDP at the end of 2003, double its level in 1995. The figures for foreign liabilities move roughly in parallel with the ones for assets (see chart 14).

A bigger pool

This rise in cross-border portfolios has had several effects. First, it means that net saving surpluses or deficits are now the balance of much larger gross flows. Given that the pool of internationally mobile capital is much bigger than it used to be, individual countries might be able to run larger imbalances for longer than they used to. According to Messrs Milesi-Ferretti and Lane, America's foreign liabilities as a share of foreigners' overall holdings of foreign assets have fallen in recent years, thanks mainly to a drop in the dollar. In 1999, America accounted for 34% of the rest of the world's foreign-asset holdings. By 2003, that share had fallen to 27%. This does not seem excessive: it is below America's share of the global economy.

Second, the greater volume of cross-border investment means that market fluctuations in the value of a country's gross assets and liabilities can have a bigger effect than new debt. Even if a country is borrowing 6% of GDP a year, the new borrowing can be dwarfed by changes in the value of its stock of cross-border assets and liabilities.

That is exactly what has happened in America recently. At the end of 2003, America's net external debt position—the difference between the value of America's foreign assets and its foreign liabilities—was \$2.4 trillion, or the



equivalent of 22% of GDP. In 2004, America ran a current-account deficit of almost 6% of GDP, suggesting that the debt stock at the end of the year should have risen to 28% of GDP. In fact, it rose by only \$170 billion, or less than 2% of GDP, because valuation gains in America's overall portfolio of foreign assets and liabilities offset much of the current-account deficit.

Why did American investments abroad perform so much better than foreign investments in America? The main reason is the dollar. It is the world's reserve currency, and America—unlike many other debtors—can issue bonds in its own currency. Virtually all America's foreign liabilities are denominated in dollars, whereas around 70% of its foreign assets are in foreign currencies.

Most of America's foreign assets are in Europe, so when the dollar falls against the euro and sterling, as it did in 2004, America's balance sheet strengthens as the value of its debt falls and the dollar value of its assets rises. According to Pierre-Olivier Gourinchas, an economist at Berkeley, and Helene Rey, of Princeton, this valuation effect is worth about 5% of GDP for every 10% drop in the dollar. That suggests the shift in America's current-account balance needed to stabilise the country's debt profile may be smaller than many people seem to think.

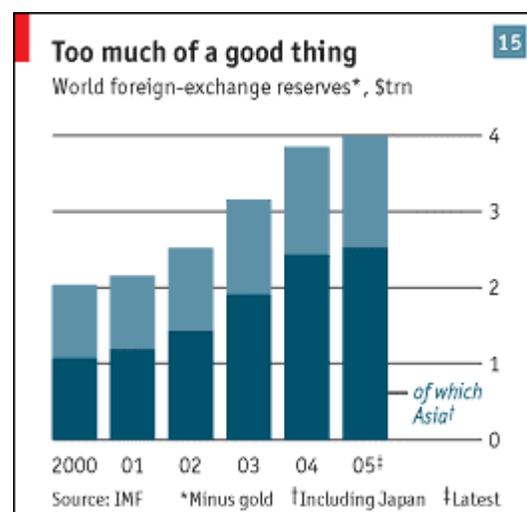
There is a catch, however. At some point, foreign lenders should be demanding higher interest rates to make up for the risk of the dollar falling. According to Messrs Milesi-Ferretti and Lane, foreigners have suffered negative returns on their investments for the past four years. Why have they not balked yet? One reason is the thrift shift that this survey has described. Thanks to a highly unusual constellation of circumstances, surplus saving in the world outside America has risen in recent years.

Trust central bankers?

But that is not all. A second reason for unusually low interest rates is that a large chunk of those surplus savings has been under the control of central banks, particularly in Asia. Thus far, these banks have cared less about risk-adjusted returns than about stopping their currencies from rising. The sustainability of America's deficit and the risk of a hard landing depends on whether they will continue to do so.

Central banks have been amassing foreign-exchange reserves on a huge scale. The world's central banks have increased their foreign-exchange reserves by some \$2 trillion since 2000, three-quarters of it in Asia. As chart 15 shows, this reserve accumulation is still continuing apace.

Exactly what share of these reserves flowed into American assets is a matter of whose statistics you look at. Official American figures show that central banks bought \$280 billion of American assets in 2003 and \$395 billion in 2004, or around 50% of all American bonds bought by foreigners in those years. But these numbers exclude any bonds that central banks buy in secondary markets abroad, so they surely underestimate the total. The BIS reckons that central banks bought \$440 billion-worth of dollar assets in 2003. The official numbers for 2004 are not out yet, but the BIS total is likely to be similar.



Whichever numbers you choose, central banks' increases in dollar reserves have been large compared with overall foreign purchases of American bonds, and huge compared with the size of the current-account deficit. Although central banks hold a small share of the stock of America's external liabilities, they have become big marginal buyers. In 2003, they financed the equivalent of 50% of the current-account deficit according to American numbers and 80% according to the BIS. In 2004, the level was 60-70%.

This explains the popular argument that the yield on America's Treasury bonds is determined in Beijing and that America is locked in a "balance of financial terror" with communist China. Estimates of the effect of Asian reserve accumulation on America's interest rates differ wildly. Economists at Goldman Sachs reckon it is worth around 0.4 percentage points; research at the Federal Reserve suggests it could be between 0.5 and 1 percentage points. At the other extreme, Nouriel Roubini and Brad Setser, of Roubini Global Economics, think that American interest rates could rise by up to 2 percentage points if Asian central banks stopped their intervention.

But is that likely? Those in the gloomy camp, epitomised by Messrs Roubini and Setser, put forward several reasons why it will happen sooner rather than later. First, they argue that China is finding itself increasingly alone as a buyer of dollars as other central banks grow wary of a currency that must at some point depreciate. Second, China will have to stop buying because the losses it will face when the dollar eventually falls will be prohibitive (perhaps over

20% of China's GDP by 2008, according to one calculation). Third, large-scale currency intervention will eventually cause inflation in China to rise, forcing a change in policy.

So far, this has not happened. Although the pace of reserve accumulation in China has increased this year, there is no sign of rising inflation. The country has made a first move towards changing its exchange-rate regime, which might eventually imply fewer reserves overall as well as some diversification away from dollar reserves, but nothing suggests that it is in any hurry. And the pessimists probably put too much weight on the “irrationality” of China accumulating reserves on which it will eventually incur losses. China's government appears to worry much less about such losses than about stability in the domestic economy. No doubt its politicians will eventually wean the economy off its heavy reliance on the debt-laden American consumers, but not overnight.

For the past few years, central banks have been acting as cushions. When private investors have little appetite for American assets, as in 2003 and 2004, central banks buy a lot in order to stop their currencies from appreciating too much against the dollar. When private appetite rises, central banks buy fewer. That is what seems to have been happening this year. Although China has been accumulating reserves at a rapid rate, few of these appear to have been American bonds and short-term Treasury bills. According to Mr Setser, foreign governments may have bought only about \$20 billion-worth of those in the first six months of 2005—and yet the dollar strengthened. Even if that understates the real picture, it suggests a sharp drop in central-bank purchases of American bonds compared with 2004.

This survey has argued that Japan, China and the oil states are likely to continue piling up saving surpluses for some time yet. If Asia's central banks also remain willing swing purchasers of the dollar, that may seem cause for relief: it suggests that things will go on much as they are, avoiding a hard landing. But relief would be the wrong reaction. As long as America can get cheap money from abroad, it has little incentive to rebalance its economy. So when those global economic imbalances are eventually unwound, it will hurt that much more.

The price of privilege

Sep 22nd 2005
From The Economist print edition

Too much foreign money is bad for America's economy

WHEN Mr Bernanke launched the discussion about the saving glut, Mr Bush's economic officials enthusiastically embraced his speech. His message that the sources of America's current-account deficit were not “made in the USA” seemed to imply that there was nothing much for America to worry about.

But the truth is that the growing imbalances are weakening America's economy, not only because of the extra foreign debt the country has taken on, but because of the domestic toll of being the world's consumer of last resort. America is saving too little and not investing enough in productive assets, especially in the export sector. Its economic health depends too heavily on housing wealth.

That is partly a cyclical story. Firms spent the period from 2001 to 2003 working off the excesses of the 1990s investment binge. In 2003 industrial capacity shrank in real terms. To some extent, things have improved over the past couple of years. Capital spending has been growing at a healthy 9% a year. Nonetheless, corporate spending as a share of GDP is still well below its average for the past 25 years. Productivity growth has recently slowed, so the lack of investment may be starting to take its toll.

Moreover, this cyclical story conceals a more serious problem. To generate the exports that will eventually be needed to service its foreign debt, America needs to invest a lot more in sectors that produce goods and services that can be sent abroad. Yet exports make up less than 10% of America's economy. Whereas the world's surplus savers—China, Japan, Germany—have too many resources devoted to exports and too few to expenditure at home, America has the opposite problem.

In principle, the global saving glut ought to help by keeping capital cheap. But because the excess saving hails from abroad, it keeps the dollar strong, so low interest rates continue to have a bigger impact on America's property market than on its export sector.

Since 2000, the rise in house prices has accelerated sharply. Average American house prices are increasing by around 13% a year, the fastest rate for 26 years. Signs of speculative excess abound, particularly in the “hottest”

markets on the country's east and west coasts. Everyone agrees that the current frenzy cannot continue forever, and even Alan Greenspan now acknowledges that house prices could fall.

Yet gains in house prices have been underpinning America's continuing consumption boom. Over the past four years, consumption and residential investment together accounted for over 90% of the rise in America's GDP. Even more striking, 40% of all new private-sector jobs have been in construction, mortgage-brokering and other areas related to housing.

With interest rates low and the equity in their houses easily accessible, Americans have given up saving out of current income altogether. Five years ago they still saved more than 2% of their post-tax earnings; in July this year the household saving rate was minus 0.6%, the lowest on record (see chart 16). Economic studies show that housing wealth reduces saving by more than other kinds of financial wealth. Nonetheless, the pace of decline has surprised most economists.

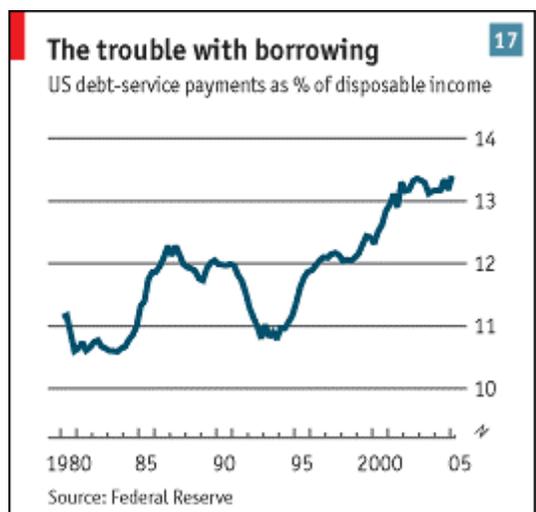
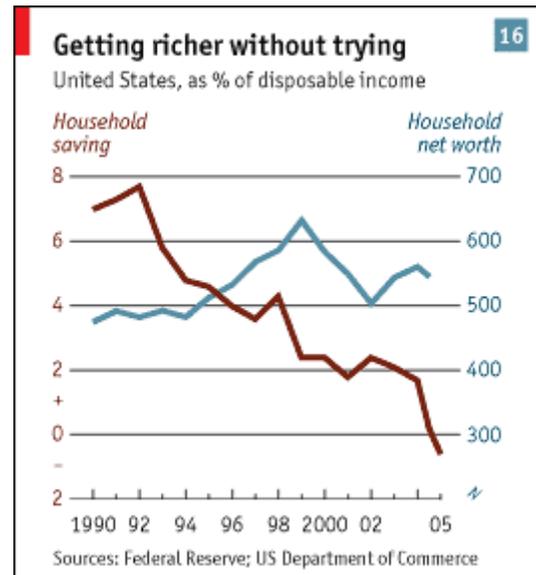
Rather than saving, many Americans are borrowing merrily. Even with interest rates historically low, the share of disposable income devoted to debt service is at a record 13.4% (see chart 17). And there is other evidence that consumers are heading for trouble. A rising proportion of new mortgages are interest-only, and are linked to short-term interest rates. Financially stretched borrowers account for a growing share of consumer debt. All this suggests that America's consumers are now less able to cope with financial shocks than they were five years ago.

Lastly, America's public finances have become weaker. Not only has the budget swung sharply from surplus to deficit, but the policies that caused the shift will have far bigger consequences in the future than they have had so far. Thanks to robust growth—and strong corporate profits—tax revenues have been unexpectedly high this year. As a result, the budget deficit looks set to fall below 3% of GDP. But many of the big fiscal decisions on Mr Bush's watch, such as the introduction of a prescription-drug benefit under Medicare, will hurt the government's finances far more in the future. The aftermath of Hurricane Katrina may reduce the chances of fiscal discipline. In sum, America's role as the global consumer of last resort has left it vulnerable. Low interest rates have fuelled a property boom, lulling consumers into thinking that there is no need to save and persuading politicians that it is possible to have both guns and butter.

Some might argue that these weaknesses seem a small price to pay for holding up the world economy in the face of unprecedented thrift shifts. Compared with the mess in much of the rest of the world, the American economy still looks pretty sound. Productivity growth is still faster than in many other parts of the rich world, and corporate investment has picked up more than elsewhere. For all the speculative frenzy in the hottest markets, property in America as a whole is not yet as overvalued as in many other countries.

But the longer America acts as global consumer of last resort, the more dangerous these domestic weaknesses become. The longer the economy concentrates on non-tradables, for instance, the harder it will become to produce the exports that America will soon need. Moreover, the foreign saving glut removes America's incentive, and to some extent its ability, to reduce its domestic distortions.

Monetary policy has become harder to conduct. Initially, Mr Greenspan's decision to slash short-term interest rates in 2001 and then keep them low meant that American consumers went on spending when American firms did not. But although since June 2004 Mr Greenspan has raised short-term interest rates by well over two percentage points, long-term rates, which matter much more to the mortgage market, are still lower than they were 15 months ago. Thus, despite the central bank's efforts to tighten financial conditions, the housing frenzy continues.



The surplus of saving outside America is not the only reason for this. The lack of concern about future inflation has also played a big part. But there is little doubt that the thrift shift has altered the relationship between short-term and long-term rates and made life harder for America's central bankers. If they keep short-term rates too low for too long, they will add to the excess liquidity in the world economy. If they raise short-term rates too far, too fast, debt-laden consumers will buckle.

Moreover, the abundance of foreign thrift makes it unnecessary for American politicians to tackle their country's own fiscal challenges. America may have better demographics than Europe, but its current spending policies on pensions, and particularly on health care for the old, are clearly unsustainable. Yet when long-term interest rates are low, there is no incentive for change. America's big fiscal improvement in the 1990s owed a great deal to politicians' fear of the bond-market vigilantes.

These days, although Washington's politicians talk a lot about fiscal discipline, they do little about it. In the past few months they have, among other things, doled out vast subsidies to energy producers and promised hundreds of billions of dollars for transport projects. Such profligacy may not matter much when interest rates are so low, but it sets America up for much bigger problems when the saving glut eventually disappears.

Simply carrying on as before also carries a more imminent risk: that America's role as the global consumer of last resort will become unsustainable before the rest of the world works off its saving surplus. One trigger might be petrol prices. Sharp rise in fuel costs, particularly in the wake of Hurricane Katrina, might prompt American consumers to tighten their belts. Another would be a house-price bust. American houses, overall, are less overvalued than those in some other countries, but Americans are more reliant on their housing wealth than others.

There are worrying precedents. In the Netherlands, a slowdown in the rate of property appreciation from 20% a year in 2000 to zero in 2003 sent consumption plummeting and the economy into recession. In Britain and Australia, a mere flattening of house-price rises has slowed consumption sharply. Most American economists reckon that if house-price increases levelled out, consumer-spending growth would lose pace, slowing the economy but not by enough to push it into recession. Yet the giddier the prices become, the greater the risk of a far nastier tumble.

Another trigger could be protectionism. The counterpart to America's foreign borrowing is a rising trade deficit. America's lawmakers are convinced that this trade deficit is the result of "unfair" trade, particularly from China with its "undervalued" currency. That country's shift to a currency basket in July has temporarily lowered the political temperature in Washington, but probably not for long. Legislation that allows America to impose countervailing tariffs in retaliation for China's "subsidised" currency is already making headway in Congress.

Things are likely to get much worse. As China's economy slows and its current-account surplus rises further, the calls for protectionist tariffs and quotas will become louder. Individually, any new tariffs might be no more than irritants, but a broad push in Washington towards more blanket protection cannot be ruled out. That would cause serious disruption.

At the same time, the furore over China's failed bid for Unocal, a mid-sized Californian energy company, showed that American politicians are in two minds about the consequences of a rising Chinese saving surplus. They seem to think it is fine for China to buy Treasury bonds, but not other assets. If there are any more high-profile bids from Chinese firms for American ones, Congress might resort to a flurry of protectionist measures.

These risks are real, and growing. They suggest that, regardless of foreigners' willingness to maintain the status quo, America itself may not be able to cope with current patterns of global thrift for much longer. So what should it do?

Rebalancing act

Sep 22nd 2005
From The Economist print edition

How to tame the thrift shift

IF THE first step towards finding a solution is to agree on the problem, the world's policymakers are still a long way from solving the global imbalances. European politicians blame American profligacy, urging Mr Bush's government to cut its budget deficit. Chinese politicians echo those sentiments.

Yet for American lawmakers on Capitol Hill, there is only one villain: China and its undervalued currency. The analysis in the White House is more sophisticated, but still tends to Mr Bernanke's view that America's current-account deficit is not "made in the USA".

Moreover, within both the White House and the Federal Reserve, it has become fashionable to argue that a smaller budget deficit would do little to reduce America's external imbalances anyway. American policymakers lapped up a recent study by the Federal Reserve which suggested that a 1% cut in the budget deficit would improve the current-account deficit by only 0.2%. But this is not uncontested: a report by the IMF, for instance, has estimated that an improvement in America's fiscal position of 4% of GDP would cut the external deficit by 2% of GDP.

All of this misses the bigger picture. The current pattern of global imbalances is the result both of thrift shifts abroad and of American actions. Had American saving rates fallen as they did, with no change in foreigners' desire to save and invest, interest rates would have risen. Had foreigners' shift to thrift not been matched by Americans' spending, the world economy would have plunged into recession. With much of the world determined to save more and invest less, America's stimulative fiscal and monetary policies, coupled with its penchant for consumerism, have kept the global economy humming.

But, as this survey has shown, that global growth has come at a price. America's current rate of borrowing is excessive. Despite the advantages of having the world's reserve currency, an enviable rate of productivity growth and the world's most liquid capital markets, America cannot continue to borrow at an accelerating pace forever.

More important, America's easy access to cheap money is pushing its economy in the wrong direction. Most of that foreign money is going into consumption and housing rather than boosting investment in productive American assets. Building houses does not raise long-term economic growth in the way that equipping a factory does. And the current rate of consumption, fuelled by housing wealth, leaves many indebted consumers at risk. The world as a whole may have savings to spare, but many Americans do not.

Unfortunately, there is little sign that anything will change very quickly. If oil prices stay around \$60 a barrel, the oil-exporting countries could see current-account surpluses of up to \$500 billion in 2006. China's saving surplus is heading higher. Although the saving surpluses in other emerging Asian countries are falling, there is little sign of a broader shift away from foreign thrift, and America's current-account deficit looks set to rise faster still.

Over the medium term, things will change. Japan's current-account surplus could well fall over the next few years—unless its politicians take fiscal consolidation to extremes, or the expected investment recovery proves ephemeral.

Eventually, oil producers will start spending some of their wealth, and China will gradually pay more attention to its domestic economy. Just as American politicians fret about being dependent on communist China, so Chinese officials will grow ever more nervous about relying on American consumers for their growth.

This turnaround could occur quite naturally. As the foreign saving surplus abates, the dollar could fall further, prompting higher interest rates in America, less domestic spending and a greater emphasis on exports. But there is a substantial risk that the decline in foreign thrift will come too slowly. America's consumers could buckle, or its politicians turn protectionist, before the rest of the world is weaned off its addiction to American demand. So it makes sense to nudge the process along.

Start here

What, then, needs to be done? For a start, recognise who has to be involved. Given the size of their saving surpluses, oil-exporting countries should be at the centre of the discussion. Yet they are rarely even invited to G8 summits and other global policy pow-wows. The rich countries have understood the importance of including China in their gatherings. Wen Jiabao, China's prime minister, attended the most recent G8 summit in Scotland. But when politicians are discussing global imbalances, they will have to broaden the guest list further.

More important, their “to do” list needs to be revised. Reducing China's saving surplus is about more than simply calling for a stronger yuan. It means creating the conditions that encourage more efficient investment and reduce the need to save quite so much. That requires more emphasis on corporate and financial reform: creating incentives for firms to pay dividends, and the infrastructure that makes it easier for people to borrow.

It also means persuading China's government to spend more on social safety nets. Although its population is ageing, China's fiscal situation is healthy. It has plenty of scope to spend more. Higher public spending—on hospitals, schools and helping the poor—will itself reduce China's national saving rate, and creating better health, education and pension systems will reduce the incentive to save so much. Japan's example suggests that there is no particular Asian propensity for thrift. Create social safety nets and develop consumer finance, and saving rates will fall.

Europe, too, would do well to adopt a less hair-shirt attitude towards policy stimulus. The European Central Bank remains too reluctant to cut interest rates. Europe does not need, and cannot afford, a fiscal binge of American proportions, but the recent lesson from Japan is that if economies stagnate, government debts spiral.

If the rest of the world could do with a less puritan take on thrift, America needs to be reminded of its virtues. Even if the Federal Reserve's boffins are correct, and cutting the budget deficit by itself would do little to reduce America's external borrowing, less government borrowing is still the most certain route to higher national saving. A smaller deficit would also reduce the squeeze on ordinary Americans: when the dollar falls, interest rates would need to rise less if the budget deficit was shrinking.

Convincing the American people to save more is trickier. The best-known route—subsidising saving through the tax code—generally does not work. America loses more in tax revenue on its panoply of saving incentives than they generate in new household saving.

Rather than try to boost saving directly, America should reduce the huge subsidies its tax system offers to anyone buying a house, which along with low interest rates have helped to fuel Americans' recent love affair with property. Mortgage-interest payments are tax-deductible, and capital gains up to \$500,000 on a house sale are tax-free. Putting an end to both these subsidies, or at least sharply reducing them, would help to encourage more investment in productive assets.

These policies will not reverse the shifts in global saving and investment entirely. Nor should they. There are plenty of reasons for America to carry on borrowing from abroad. It has better demographic prospects than the rest of the rich world, and indeed than many Asian emerging markets. It has nimble and productive firms. Once investment has shifted back into productive assets, America might sustainably run a current-account deficit of, say, 3-4% of GDP for many years yet.

But the present deficit is excessive and dangerous. Left alone, it could end in a global recession, rampant protectionism, and even a disastrous financial crash. That is why policymakers need to act soon. With his “saving glut” speech, Mr Bernanke focused attention on the scale of the global thrift shift. Now, as one of Mr Bush's top economic advisers, he should persuade his boss of the importance of making the thrift shift safe.