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Rebalancing act

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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.

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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.