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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.

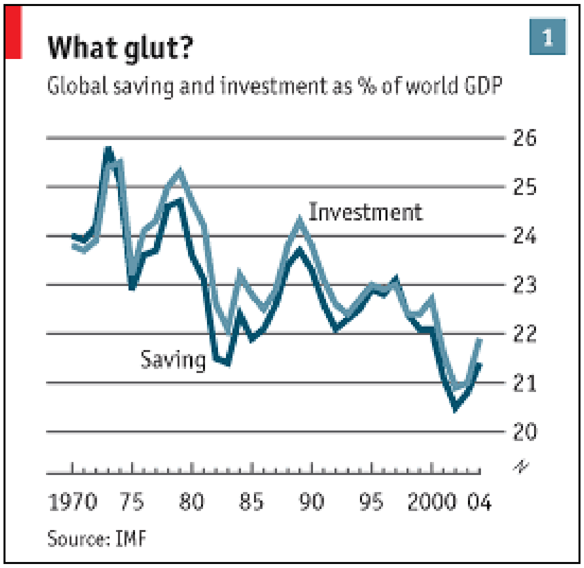
The idea's appeal lies in the way it ties together two of the most vexing questions about today's economic landscape: why are interest rates so low? And why can America borrow eye-popping amounts from foreigners with seeming impunity? According to the IMF's latest *World Economic Outlook*, the global 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.



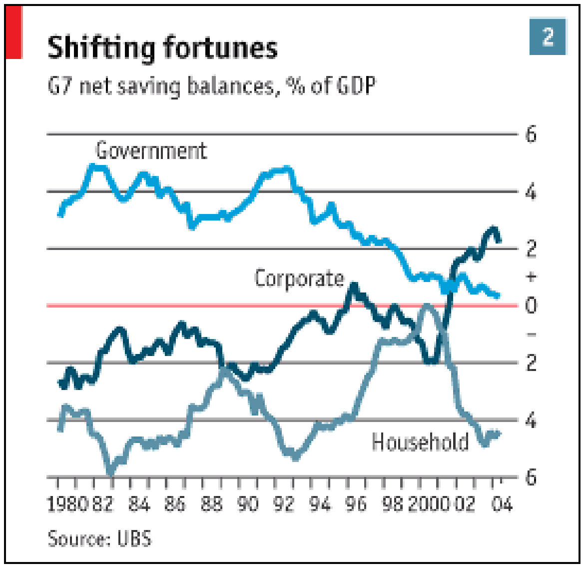
Taken at face value, the notion of a global saving glut is not borne out by the facts. “Glut” suggests an unusually large amount, as in a summer glut of strawberries. In fact, figures published in the IMF's latest *World Economic Outlook* show that the rate of global saving as a proportion of global 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.

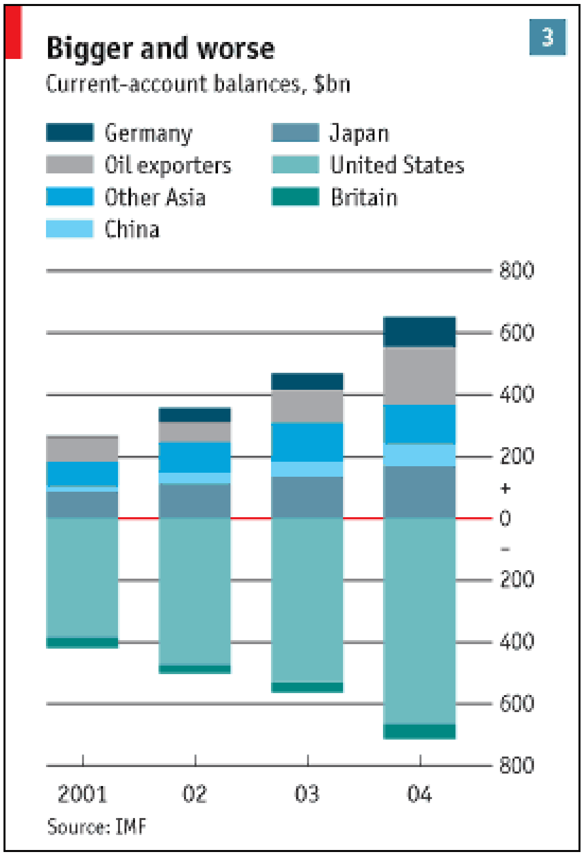
Japan and Europe lie between those two extremes. Politicians in Tokyo tried stimulative policies and talked of structural reform, but proved notoriously ineffective at dealing with their investment bust. The economy fell into deflation and Japan, already the world's biggest exporter of savings, became 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.