Preface to “Global imbalances. Is the world economy really at risk?,” by Anton Brender and Florence Pisani

Olivier Blanchard

February 20, 2007

If, twenty years ago, you had asked economists whether globalization and financial integration would lead to large current account deficits in some countries, and large surpluses in others, they would have answered with a strong yes.

But they would almost surely have gotten the sign wrong. They would have predicted that poor countries, with low saving and plenty of opportunities for investment would borrow funds from richer countries, and, symmetrically, rich countries, with higher saving and fewer investment opportunities would indeed be willing and eager to lend those funds.

Nearly the opposite has happened. In 2006, the richest country in the world, the United States, borrowed close to $900 billion from the rest of the world. More than half of these funds were provided by countries in Asia and Latin America. Nearly one third came from China.

Poor countries lending gigantic sums to large countries; the United States on a spending spree. Can we make sense of it all? Will it come to a crashing end? These are the questions taken up by Brender and Pisani. Their answers: Yes, there is some logic behind the apparent madness. And, no, with a bit of luck, things will work themselves out smoothly. I agree with both answers.

How do we make sense of what is going on?

- The presumption that globalization should lead to an investment boom in poor countries was based on a simple idea: Poor countries have low wages, but large access to state-of-the-art technology. What more attractive combination could there be when firms think about where to invest? This idea has turned out to be only partly right: Many things matter beyond wage costs:

Property rights, the ability to enforce contracts, all play a central role in investment decisions, and poor countries are typically not very good in these dimensions.

Investment is a risky activity. Whether firms can get the outside funds depends on the development of the financial system, its ability to take on risk, and to diversify or eliminate it to satisfy risk-averse savers. Again, poor countries are typically not very good in these dimensions. Sometimes their financial system takes on too much risk, leading to a crisis. The crisis in turn leads it to avoid risk, and in the process reduce investment. This is very much the story of Asia, both pre- and post-Asian crisis. After having been burned in the 1990s, domestic financial intermediation institutions are reluctant to take risks, and this is one of the main reasons why investment in (non-China) Asia is low today.

So, with a few exceptions, access to the world financial markets has not led to an investment boom in poor countries.

- The presumption that saving would be low in poor countries was based on an equally simple idea. When people's incomes are close to subsistence levels, they can hardly save. And if they can save, to the extent that they expect the future to be brighter, they will save less. Again, reality does not fit this simple idea:

  China's saving rate is one of the highest in the world. One of the main reasons is high household saving. With the shift to a market economy, the safety nets which used to be provided by state firms have largely disappeared. With little protection against health risks, the loss of a job, with the need to save for retirement, the need to save for education, Chinese people are saving nearly half of their income. The investment rate in China is high, but the saving rate is even higher. The result: China as a major supplier of funds to the rest of the world.

- Now turn to the other side, the US as the major borrower in the world.

  It is usual to blame the US budget deficit for the large US current account deficit. The apparent logic is again simple: Unless domestic savers are

willing to save more, the more the US government borrows, the more the United States as a whole has to borrow abroad. But the relation between budget deficits and current account deficits is far from simple, both in theory and in practice. In practice, US current account deficits started increasing in the 1990s just as the budget deficits were decreasing. And, as a matter of arithmetic, the budget deficit in 2006 was roughly equal to only one third of the current account deficit. So, while fiscal policy in the US should surely be less expansionary, the sources of the US current account deficit must be found primarily in private saving and investment. Private saving is indeed very low. Household saving in particular is close to zero. Are US consumers wildly irrational? The evidence is unclear. On the one hand, US consumers are indeed saving little out of their income. On the other hand, the large increases in their financial and housing wealth have more than compensated for their low saving. The large majority of Americans appear to have enough to finance their retirement.
Combine this low saving with strong investment, reflecting technological progress and high profitability, and you have the other half of the equation, an excess of US investment over US saving, and the demand for the funds that the rest of the world wants to lend.

- Is there more to the story? Obviously yes. Three points are worth mentioning:

  First, and while they have less important roles, there are other players in this world game. For example, oil producers, having learned their lessons from previous episodes, are saving a large proportion of their higher oil incomes, leading to larger current account surpluses at home, and larger current account deficits in oil importing countries.

  Second, at a given interest rate, positive shifts in saving have exceeded shifts in investment, leading to a decline in the "world" interest rate: Riskless rates are low around the world, and this is what lies behind most of the increase in asset and housing prices. For the most part, what we see around the world are not speculative bubbles, but increases in fundamental values, driven by lower interest rates.

  Third, not only does the non-US world want to save more than it invests, but it prefers dollar to euro or yen assets. Why this is comes from a mix of reasons, the liquidity of US government bond markets, the depth of the US equity markets, the weight of history in determining the currency composition of central bank reserves. The result is lower required rates of return on US assets than on non-US assets. And so, despite the fact that the United States has now been for many years a large debtor vis á vis the rest of the world, it only started to pay (slightly) more in interest income to the rest of the world than it received in 2006.

- How will it all end? With a bang, or with a long whisper? The way to answer the question is to think about each of the factors behind the current configuration, and what is likely to happen to it in the future. Given the economists' record on exchange rate and other predictions, humility is of the essence. I believe however a number of things can be said:

  Sooner or later, the flows of funds to the United States will slow, and the US current account deficit will have to decrease. Indeed, eventually, the US trade deficit will have to turn into a surplus. How far in the future? My own sense is that much of it will have to happen over the coming decade:

  Chinese saving will decrease: The political pressure on the Chinese government to provide better insurance and health care is growing. As safety nets are improved, saving will decrease, domestic demand will increase. To control total demand, the Chinese government will let the RMB appreciate, reducing the Chinese current account surplus. The Asian financial system will improve, leading to higher investment. The US budget deficit will be reduced. Central banks will increase the proportion of non-dollar assets in their reserves. Euro markets will become more liquid and deeper, making Euro assets relatively more attractive for financial investors.

  All these factors will lead to a change in the configuration of saving and investment around the world, and to a decrease in US deficits. As this happens, we shall see a steady depreciation of the dollar, an appreciation of the RMB, and a likely appreciation of the euro and the yen. If this happens smoothly, central banks can handle the adjustment through interest rate changes. Will it happen smoothly, or will investors panic? One would be foolish to give an answer with much confidence, but my bet is on a slow and steady adjustment.

I hope I have given you a taste of the arguments developed by Brender and Pisani in their small and fascinating book. They give you the flesh and the details which I could not give here. They help you think about what may be the most complex and intellectually exciting economic developments of our times. I hope you enjoy your reading as much I did mine.

Cambridge, Massachusetts, February 20, 2007