Remarks for Yale Workshop on Global Trends and Challenges: Understanding Global Imbalances

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission’s mandate is to “take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers.”

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

The working papers, and all thematic papers and case studies written as contributions to the work of the Commission, were made possible by support from the Australian Agency for International Development (AusAID), the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the U.K. Department of International Development (DFID), the William and Flora Hewlett Foundation, and the World Bank Group.

The working paper series was produced under the general guidance of Mike Spence and Danny Leipziger, Chair and Vice Chair of the Commission, and the Commission’s Secretariat, which is based in the Poverty Reduction and Economic Management Network of the World Bank. Papers in this series represent the independent view of the authors.
Acknowledgments

Abstract

This paper argues that global imbalances in current account positions are a natural consequence of globalization of financial markets and of demographic trends, particularly in Europe and in East Asia. Those societies are aging rapidly, with declining numbers of young adults. On both counts savings should be high and investment weak, resulting in excess saving. With globalization of capital markets, this excess saving will naturally seek secure investment opportunities abroad. The U.S. economy, where demographic trends are markedly different (due in part to immigration of young adults), offers a good combination of yield, liquidity, and security for this excess savings, which in time will be liquidated to finance consumption in old age. Thus the large “imbalance” does not obviously reflect disequilibria in the world economy, but rather a current phase of intertemporal trade.
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Richard N. Cooper ¹

In these brief remarks, I want to cast doubt on two related propositions that are widely accepted as truths: that Americans save too little, and that the United States runs a current account deficit—$788 billion in 2006—that is unsustainable, one that risks precipitating a disorderly adjustment that would be damaging to the world economy in the relatively near (but usually unspecified) future. My doubts should not be treated as new truths, but as plausible alternative hypotheses about how the world works these days, and how we reached the large global imbalances.

I begin with U.S. savings because I will say less about it. It relates to the broader topic of global imbalances through the national accounts identity, which links the current account deficit to the difference between domestic investment and national savings. A current account deficit cannot be reduced without reducing the excess of investment over saving. Few argue that the United States should invest less (except perhaps in housing during the housing boom), which implies that if the U.S. current account deficit, nearly six percent of GDP in recent years, is to be reduced, national saving—the sum of private and public saving—must be increased. If, as some analysts (for example, Cline 2005) suggest, the deficit should not exceed three percent of GDP, and if investment is to be protected, saving must increase by three percent of GDP—that is, from 13 percent of GDP to 16 percent in terms of 2006 shares. (I use gross savings and investment throughout, as is appropriate in a world of rapid technological change. “Replacement” investment is typically technologically superior to its predecessor, and in any case a well-run firm will evaluate all large investments afresh, moving depreciation allowances into new activities if that is economically appropriate.)

Savings and investment in the national accounts, which were designed over 60 years ago at the height of the industrial age, are defined largely in terms of structures and equipment (although computer software was recently added). This is hardly appropriate for a so-called “knowledge economy.” Economists conceive of saving as consumption that is deferred today for the sake of greater consumption at some time in the future, perhaps by oneself, perhaps by future...

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generations. On this definition of saving, several items should be added to the “saving” as currently recorded in the national accounts. An obvious list would include educational expenditures, expenditures on research and development, purchases of consumer durables, and “intangible” investment by businesses in research, training, and branding (following Carrado, Hulten, and Sichel, 2006). Adding these items to savings and investment for 2005 raises those quantities from 13.5 and 20.1 percent of GDP as defined in the national accounts to 39 and 44 percent of augmented GDP (augmented by 15 percent to allow for the expanded concept of investment). These figures do not suggest that Americans are short-changing the future, particularly when allowance is made for the high returns to education and to research and development. Recent poll results notwithstanding, it is extremely improbable that future Americans will be worse off than the current generation in material terms. So far as I can tell, the pipeline of prospective innovations is full; we would have to have a severe catastrophe for these, and the associated investment, not to mature into higher per capita income, as they have steadily done during the past half century. Our biggest legacy to the next generation is our successful apparatus—both institutions and incentives—for innovation and technical change.

From the perspective of the household, allowance should also be made for capital gains on real and financial assets, which are increasingly mobilizable through innovations in financial markets such as home equity loans and reverse mortgages, and for expected legacies. Unlike new investment, these do not add to social returns in the future (although some part of capital gains on equities may reflect the intangible investments made by corporations), but they are legitimately “savings” from the household’s perspective. Household net worth rose by 6.5 percent a year over the period 1990–2005, and by 8 percent in 2005 alone—a year, recall, that recorded headline-grabbing negative personal savings in the national accounts.

Of course, these are aggregate figures; they do not address the issue of distribution. There are doubtless many families that would be well advised to save more in their own interests. Moreover, household net worth fell in 2008, with the decline in prices of houses and many financial assets. But that ispresumably a transitory phenomenon.

What about global imbalances? The revised calculations of saving and investment above do not affect the discrepancy between them, since saving and investment are raised by the same amount. They are meant to suggest, rather, that it will be difficult if not impossible to raise U.S. national saving further, except through the Federal budget. Private saving may rise of its own accord as house prices decline or even stabilize for any length of time; but households are not likely to be receptive to significant reductions in their consumption over the long term.

Can a current account balance in excess of $700 billion a year, over five percent of GDP, be sustained? The answer from a technical economic point of
view (as distinguished from psychological or political perspectives, which are not addressed here) is an unambiguous affirmative. Some argue that it is large without precedent, and into the “danger range” of developing countries that have in the past run into payments crises. Some argue that it cannot be sustained either because foreigners will cease to be willing to invest enough in the United States, or because the United States will run out of assets attractive to foreigners, or both. Some concede that it might be sustainable at its current high level, but that it is on a trend that cannot be sustained. Some judge it to be undesirable, not least on grounds that it permits higher current consumption but bequeaths higher liabilities to future generations. Whether it is desirable or not depends, of course, on the feasible alternatives, not on abstract considerations.

I will try to address quantitatively two questions, whether foreign saving will be adequate to finance a continuing and even rising U.S. deficit, and whether U.S. financial claims will be sufficient to satisfy potential foreign demand for them. I will also address foreign motivation to invest in the United States.

A U.S. current account deficit (which equals net foreign investment in the United States) of $788 billion in 2006 is certainly unprecedentedly large. But in fact it is smaller than the deficit that would have resulted if world financial markets were fully globalized. By full globalization of financial markets we might mean that savers around the world allocate their savings according to the relative sizes of national economies, without any bias toward domestic investments. Such a “gravity model” for world financial flows is of course a vast simplification, but it is a useful starting point.

The U.S. share of the world economy (calculated at market exchange rates, which are relevant for this calculation) was 30 percent in 2000, rising slightly in 2001–02, then declining to 27.5 percent in 2006. With no home bias the rest of the world would have invested these shares of its savings in the United States. Americans, by the same token, in 2000 would have invested 70 percent of their savings in the rest of the world, rising to 72.5 percent in 2006. Applying these percentages to savings (from the national accounts) in the rest of the world and the United States, respectively, would have resulted in net foreign investment of $480 billion in the United States in 2000, compared with an actual flow of $417 billion, rising to $1.2 trillion in 2006, compared with an actual flow of $788 billion. This number can be expected to rise over time until the slow decline in U.S. share fully offsets the rise in foreign saving; or until U.S. saving rises sufficiently sharply to overcome the annual increases in foreign saving.

This calculation takes gross saving as given and ignores actual investment opportunities, including yield, risk, and liquidity. In this respect it is similar to the gravity models of trade, which focus on economic size and distance and ignore the structure of comparative costs, hence the incentives to trade. I now turn to incentives.
Demography and the Savings-Investment Balance

Current account surpluses imply an excess of national saving over domestic investment. Why do these occur, especially in view of the budget deficits run by many countries that absorb much of the excess private saving? A significant rise in oil prices since 2002 increased government revenue of oil-exporting countries in the first instance, producing budgetary surpluses. Much of this saving will be transitory as revenues enter the income stream, and raise private incomes and import demand, or as oil prices fall. However, a number of oil-exporting countries have now emulated Kuwait and Norway in setting aside a portion of their large oil earnings, investing them in the rest of the world for the sake of future generations, so significant savings from these countries may endure for many years.

There are many reasons for high saving, related inter alia to uncertainty and even insecurity about the future, imperfect arrangements for consumer credit for large purchases, management incentives for retaining rather than distributing corporate earnings, memories of past periods of adversity, and so on. But one factor that has received too little attention, or indeed even misleading attention, is the dramatic demographic transformation that many countries are going through. Much has been written about the ageing of societies, with appropriate focus on unfunded pension and medical care commitments by governments. Ageing however is occurring for two quite different and mostly unrelated reasons: increasing longevity, which in the United States has risen on average by 8.2 years over the past half century, and in Japan by an extraordinary 30 years, and declining natality.

The increasing longevity, without a corresponding increase in working age, may be expected to increase household savings for retirement, but also precautionary savings, since lives are not only longer but also uncertain in their length. The standard model of life-cycle savings behavior, in which dis-saving occurs in older years, typically assumes a known or known expected time of death. In reality, there is much uncertainty, and thanks to steadily advancing medical technology, perhaps even increasing uncertainty about the time of death. Ceteris paribus, this should increase saving, even beyond retirement, especially in a context of growing uncertainty about the financial viability of many public pension schemes. Americans have been made aware of the future problems of U.S. social security; but public pension schemes in many other countries are in much worse shape.

Ageing of society through reduced natality has perhaps an even greater influence on the national saving-investment balance, however, by reducing investment. Low natality implies, over time, declining numbers of young adults, hence fewer new households, hence lower demand for schools and housing and all the appurtenances associated with housing, such as appliances and furniture. Less new capital is also required to equip new members of the labor force with
the average productive capital stock. In addition, young adults these days are on average the most highly educated and the most flexible members of the labor force, geographically and occupationally. A decline in their numbers will thus have a negative impact, ceteris paribus, on productivity growth in an era of continuous advances in technology and changes in the composition of demand.

Saving rates have dropped in Japan, although less than life-cycle devotees expected, but investment has dropped even more. Private saving in Germany has risen, mostly absorbed by a four percentage point increase in public deficit between 2000 and 2005, but investment fell sharply. A roughly similar pattern occurred in the newly rich Asian economies. In contrast, investment rose in developing Asia, exceeding 37 percent of GDP by 2005; but saving rose even more in these rapidly growing economies.

The projections for population in these countries, and others, are striking. Most rich countries, along with China, now have a net reproduction ratio below unity, that is, populations are not reproducing themselves. The average number of children per woman of child-bearing age is 1.4 in Germany and Japan; 1.0 in Hong Kong, China; and 1.0 in Singapore (2.1 children is required to sustain a population in the long run). The total populations of Germany and Japan have already peaked, despite increasing longevity. The number of young adults has been declining for some time, and will continue.

Among the rich countries, the United States stands out as a strong exception: while birth rates have declined, they remain above two, and the U.S. population is augmented by over a million immigrants a year, who in general are young and well-integrated over time into the U.S. labor force. The U.S. Census Bureau makes projections for the number of young adults (ages 15–29) in the world’s largest economies plus four newly rich Asian economies, whose current account surpluses together (when Germany is augmented by its two close economic neighbors, Netherlands and Switzerland) in 2006 equaled 90 percent of the U.S. deficit. (The surpluses of oil exporters equaled an additional 46 percent of the U.S. deficit. The U.S. deficit in turn equaled 70 percent of total world deficits.) Young adults decline by roughly one percent a year in China, Germany, Japan, and the four newly rich economies. In sharp contrast, the number of young adults in the United States is expected to rise by 7 percent over the next two decades, and the actual increase will probably be even greater because of conservative assumptions regarding immigration.

China of course is in different circumstances from Germany, Japan, and other rich countries. The rural population, while down 20 percentage points of total population over the past two decades, remains large, so much further rural-urban migration can be expected. The rapid growth of the urban labor force can be expected to continue, and along with it demand for housing, schools, and productive capital stock. Moreover, the incomes of Chinese have grown rapidly, and can be expected to continue, with the consequential housing boom as people not only change location but also upgrade the amount and quality of their living.
space. China’s investment rates are high. But with per capita incomes growing at over 7 percent a year, in the presence of desires for lumpy expenditures and a poor capital market, Chinese savings rates have increased, even while consumption has grown rapidly. Moreover, many Chinese state-owned enterprises (SOEs) have been modernized and downsized, improving their earnings, while others enjoy quasi-monopoly profits. Until 2008 SOEs in China did not have to pay dividends to their government owners, so as earnings have increased, so did recorded corporate savings.

Why Invest in the United States?

Given that a number of the largest and richest countries have excess savings, plus some poor countries such as China, why does it go heavily to the United States? After all, under simple neoclassical economic assumptions, excess national savings should flow to regions of the world where return to capital is highest, and those in turn are assumed to be regions with a low ratio of capital to other factors of production, most notably labor but including also arable land and specific natural resources.

This widely accepted proposition is at a high level of generalization. Discerning investors do not invest on the basis of the high levels of generalization that economists are comfortable with, indeed seem to prefer. Details are all important. Some details are increasingly being recognized. It is increasingly common to see references to “risk-adjusted” yield differentials rather than merely to yield differentials, an all-important qualification. Security of investment is important, often trumping high yields for many investors, especially those investing for retirement. Recent experience in Argentina, Bolivia, Russia, and Venezuela have reminded everyone that private investment is not always secure, especially if it is foreign private investment. Also, in the most capital-poor countries yield is often low, due to strong complementarities between invested capital and the institutional setting, interpreted broadly, including but not limited to public infrastructure and an educated, or at least a disciplined and functionally literate, labor force.

Despite these qualifications, much private foreign capital has gone into developing countries in recent years, over $500 billion (net) in 2005, mostly into East Asia and to central Europe, over $700 billion in 2006, and over $900 billion in 2007. But this compares with $1 trillion in foreign private funds invested in the United States in 2005, nearly $1.6 trillion in 2006, and nearly $1.6 trillion in 2007.

There are several reasons for foreign funds to seek the capital-rich United States as a locus for investment. First is simply the size of the U.S. economy, discussed above. Property rights are secure in the United States, and dispute settlement is relatively speedy and impartial. The United States continues to be a dynamic economy, despite its wealth, partly on demographic grounds noted
above, but also because it is highly innovative and relatively more flexible that other mature economies (and than many immature ones). Its financial markets are even larger relative to the rest of the world than is its GDP, accounting for over 40 percent of the world’s securities (stocks and bonds), and probably more than half of marketable securities if allowance is made for the nonavailability of many shares of companies in other countries (for example, because they are in government hands).

Because of its size and institutional arrangements, many marketable securities are much more liquid in the U.S. market than is true in other financial markets, increasing their attractiveness to passive investors; and the market offers a wide diversity of financial assets in terms of their risk characteristics. Finally, in recent times yields on U.S. debt instruments have been higher than those in many other rich countries, notably Japan and continental Europe. (Yields have been still higher in the United Kingdom and Australia, which share some of the other characteristics of the United States. It is perhaps not a coincidence that net foreign investment has also been high into those countries; that is, they have run substantial current account deficits relative to GDP. Canada, which might be thought to be in a similar situation, in contrast has run current account surpluses; perhaps its trade is so heavily concentrated on the United States that running a trade deficit would be very demanding; and yields on Canadian bonds, unusually, have been lower than those on U.S. bonds.)

Foreign investment in the United States is overwhelmingly denominated in U.S. dollars; indeed, it simply represents purchases of U.S. domestic instruments by people or institutions who happen to reside abroad. Most of them therefore run an exchange risk measured in their home currencies. Does not this risk overwhelm the yield differentials? Apparently not. One possible reason is that foreign investors may not be conscious of the exchange risk they are running. This seems extremely unlikely, given that most of the investors are sophisticated financial institutions, and some economists have been unsparing in pointing out the exchange risks, with more than adequate publicity.

Foreign investors must find the characteristics of their investments sufficiently attractive to overcome the exchange risks. Or they may discount the exchange risk. One possible reason is they believe there is little reason to expect movements in exchange rates large enough to overcome the yield differentials, either because they implicitly accept the structural reasons developed here for believing large current account deficits are in fact sustainable, or some other set of explanations. Or they may believe large currency appreciations would be sufficiently damaging to other economies to elicit countervailing actions by monetary authorities, so that exchange rate movements among major currencies will be limited by future central bank action.

Much has been made of the fact that some of the financing of the U.S. deficit has come from central bank purchases of dollar-denominated assets. Arguably in some of these cases central banks are simply acting as financial intermediaries on
behalf of their ageing publics, who either choose not to or are not permitted to invest directly abroad. But suffice it to say here that the inflow of funds to the United States is overwhelmingly private in origin (if not always in beneficial ownership), four-fifths of the totals for 2005 through 2007.

How Long Can the United States Provide Assets for Purchase?

What about investment possibilities in the United States? Will foreigners soon acquire so many U.S. assets that their availability will be exhausted? Not anytime soon. It is useful first to examine some simple debt dynamics, and then look at the relationship of U.S. external indebtedness to the availability of U.S. assets.

The cumulation of current account deficits affects a country’s net international investment position (NIIP). If we let D represent NIIP, $Y = \text{GDP}$, $r = \text{net return on D}$, and $B$ the deficit in trade in goods and services (excluding investment income) and unilateral transfers, then $dD = B + rD$. Stabilizing $D$ relative to GDP implies that $dD/D$ equals the growth in nominal GDP. If we suppose that the growth in nominal U.S. GDP in the coming years will be five percent, then a stable $D/Y$ would require that $B/D + r = 0.05$.

At the end of 2005, the NIIP of the United States was −$2.3$ trillion, 17 percent of U.S. GDP during 2006. The current account deficit was around six percent of GDP. What implications can we draw from this starting point for the future of the U.S. international position?

Several points need to be made about the imprecise fit between the simple debt dynamic and U.S. circumstances. First, the U.S. NIIP reflects the difference between much larger foreign claims on the United States and U.S. claims on the rest of the world. The average yield on U.S. claims significantly exceeds the average yield on foreign claims. While the NIIP turned negative in 1987, U.S. net earnings on foreign investment were still positive in 2007, 20 years later. Thus $r$ in the equation above as applied to the United States has been negative for many years, recently between one and two percent.

Second, to move from accumulated current account positions to the net international investment position requires adjustment for nontransactional valuation changes both for foreign claims on the United States and for U.S. claims on the rest of the world. These have strongly favored the United States. Thus over the period 1990–2005 the cumulative U.S. current account deficit was $4.40$ trillion, while the increase in the net debtor position of the United States was $2.04$ trillion, less than half. The main reason for this difference is rise in market value of existing claims. In other words, the “total return” on U.S. investments abroad, and on foreign investments in the United States, exceeds the earnings on those investments recorded in the balance of payments. Average annual total return on U.S. overseas investments since 1990 (including exchange
rate effects, discussed below) was 10.0 percent, compared with a total return of 6.2 percent on foreign investments in the United States. Thus if total returns are counted, the United States on average runs an even larger surplus on investment earnings than that reported in the balance of payments accounts, despite a significantly negative NIIP. The main reason for this is that equity investment, both direct investment and portfolio equity, make up a substantially larger share of U.S. claims on the rest of the world (61 percent) than is true for foreign investments in the United States (35 percent). Americans act as risk-taking intermediaries in the world economy, selling fixed-interest claims and investing in equity; they thus earn an equity premium in the world economy.

In addition, changes in exchange rates affect valuations when converted into U.S. dollars, in which the U.S. NIIP is reckoned. Most U.S. assets abroad are denominated in other currencies, whereas most foreign claims on the United States are denominated in dollars. When the dollar depreciates against other currencies, the value of U.S. claims rises relative to foreign claims, and the reverse for appreciation of the dollar. These combined valuation effects can be substantial. Thus in 2005 the U.S. current account deficit was $729 billion, but the NIIP actually increased by $200 billion, a reversal that also occurred in 1999. Remarkably, the ratio of NIIP to GDP declined from over 23 percent in 2001 to under 17 percent in 2006, despite large and growing current account deficits during this period.

Third, NIIP/GDP is far below where it would be in a “no home bias” world, where foreigners would hold nearly 30 percent of their assets in the United States, two and a half times the ratio they currently hold, so on these grounds it could still rise significantly.

How much of the United States do foreigners own? Here it is necessary to look at gross foreign investment in the United States, before netting it against American investment abroad. Total foreign claims (net claims for banks) on the United States at end-2005 were $11.1 trillion, 89 percent of GDP during that year, and roughly the same percentage of the private nonresidential fixed capital stock. The share of foreign ownership has increased steadily for the past two decades. But foreigners do not generally buy the capital stock, and their share is not rising nearly as rapidly as one might suppose based on the dollar values alone. A remarkable feature of the U.S. economy is that the total value of financial assets has risen significantly more rapidly than the underlying economy. The Federal Reserve estimates total financial assets in the U.S. economy at the end of 2006 to have been $129 trillion (this figure is of course sensitive to the system of classification used in the flow of funds accounts, and does not include derivatives), 9.7 times 2006 GDP. Total financial assets were only 4.8 times GDP 40 years earlier, in 1965. Put another way, while nominal GDP grew by 7.4 percent a year 1965–2006, total financial assets grew by 9.2 percent a year.
This phenomenon reflects among other things innovations by the financial sector, devising financial instruments to appeal to a wider variety of circumstances and tastes. This articulation of financial assets—not all of which prove to be of high quality, as the subprime mortgage debacle demonstrated—appeals to many foreigners as well as to Americans, and foreigners invest in a wide array of financial instruments. So while gross foreign investment in the United States equaled GDP in magnitude, it amounted to only 11 percent of total financial assets in the United States. The share has risen from three percent in the mid-1980s, but the rise is slow.

Total financial assets include claims by one sector on another. We can say that fundamentally the U.S. economy is “owned” by households in the United States, plus nonprofit organizations (churches, foundations, universities, and so forth), plus foreigners. The share of foreign ownership grew from seven percent in 1980 to 17 percent in 2000 to 23 percent in 2006. This ownership represents claims on future output of the U.S. economy. It remains well below the level of foreign ownership that would obtain in a “no home bias” world. It also remains well below levels of foreign ownership (relative to GDP) that have been reached in many other countries, including Australia, France, Germany, Italy, Spain, and the United Kingdom. So while the foreign-owned share of U.S. financial assets cannot grow without limit, it can grow for many years before straining the American capacity to provide financial assets.

**Evaluation**

Viewed in the context of globalization and demographic change in other rich countries, the large U.S. current account deficit is both comprehensible and welfare-enhancing from a global point of view, so long as Americans invest the funds productively. Prospective retirees around the world are making investments that they believe are profitable and secure. If this is so, strong governmental efforts to reduce the deficit significantly may be deeply misguided at best, and runs a serious risk of precipitating the financial crisis and/or economic recession that its proponents hope to forestall, as fiscal contraction in the United States fails to be matched by fiscal expansion elsewhere, and as speculative capital moves heavily into currencies expected to be revalued against the U.S. dollar.

Not so long ago it was argued that as a rich country the United States should be running a current account surplus, not a deficit. More recently it has been suggested that for sustainability the deficit needs to be reduced to no more than around three percent of GDP. Reduction of the deficit by three percentage points of GDP would require that U.S. expenditure drop, relative to output, by three percentage points of U.S. GDP, roughly one percent of GDP in the rest of the world. Foreign surpluses, taken together, would have to decline by three percent
of U.S. GDP, implying a rise in demand relative to output by that amount elsewhere in the world.

It is also usually said that to bring about the required substitutions in product demand, the U.S. dollar must depreciate, probably significantly, perhaps by 30 percent on a trade-weighted basis. So the additional demand in the rest of the world must be domestic demand. For export-oriented economies such as Japan, Germany, and China, currency appreciation is likely to discourage, not encourage, productive investment. So the additional demand must come from domestic consumers or governments. Many governments have been concerned about excessive government deficits in recent years, and are engaged in “fiscal consolidation,” that is, reducing their deficits. This is especially true for Japan and Germany, two countries with large current account surpluses. What will induce ageing consumers to spend more? Easier monetary policy, which in Euroland is outside the control of national governments, would in a world of high capital mobility tend to weaken currencies, not strengthen them. The prescription must include more stimulative fiscal policy combined with tighter monetary policy, and currency appreciation. Europe’s midterm policy focus, reflected in the Lisbon agenda of 2000, has on the contrary been on fiscal consolidation plus measures to improve productivity and output, resulting (as explicitly desired) in greater international competitiveness, not greater domestic demand.

China, which controls its exchange rate, could decide to revalue its currency, as many have urged. But even if China were to eliminate its current account surplus, only a fraction would accrue to the United States as U.S. imports from China switched to other low-income countries. That would still leave a current account deficit in excess of the targeted level. Moreover, what would an appreciation large enough to eliminate China’s surplus do to China’s economy, where processing exports has led China’s growth? Exports have not been China’s only source of growth in demand. Public and private construction has boomed; and Chinese consumption has grown in excess of eight percent a year 1989–2005, the highest growth in the world. But exports have been the driving sector.

The argument developed here suggests that the U.S. deficit can continue for some years, and even rise above its current level. Of course, a significant depreciation of the dollar might nevertheless occur. Financial markets are driven by psychological as well as by economic factors. If enough people decide to sell dollars, the dollar will depreciate. If foreigners collectively decide to invest less in the United States than the current account deficit (plus American capital outflow), the dollar will depreciate.

A large drop in the dollar would have grave economic consequences, reducing exports and depressing investment in other rich countries. For this reason, their monetary authorities are likely at some point to intervene in foreign exchange markets to limit the resulting economic downturn, in effect
substituting official for private capital investment in the United States, and thereby putting effective limits to any depreciation of the dollar.

But of course the current account deficit cannot rise indefinitely relative to GDP, nor foreign-owned assets rise indefinitely as a share of total U.S. assets. Sooner or later the process of financial globalization will slow, and eventually stop, probably well before the hypothetical state of “no home bias” is reached. Moreover, ageing societies will eventually reach the point at which they cease acquiring new foreign assets and begin to liquidate their outstanding claims. Then the U.S. deficit must decline, perhaps significantly. The trade deficit will need to decline even earlier, as foreigners begin to consume the earnings on their U.S. investments. But that point may not be reached for many years, especially if people work longer and continue to save past conventional retirement age, as many do.

As Asians and Europeans begin to consume their overseas earnings, and their assets, total expenditure in their countries will rise relative to output, and surpluses will decline and eventually disappear. This process alone will help reduce the U.S. deficit, without any depreciation of the dollar against their currencies. To what extent the dollar needs to depreciate will depend on the emerging consumption patterns in the ageing societies, in particular on the mix between tradable and nontradable goods and services, keeping in mind that these categories are themselves constantly changing, as more nontradables join the category of tradables with increased possibilities for offshoring. Even nontradables can enter the international accounts insofar as they are provided by temporary migrant workers who remit earnings to their home countries. Elder care is likely to involve both processes—diagnoses of measured symptoms in remote location, and in situ help by migrant workers, as the children and grandchildren and great-grandchildren of the aged choose to stay in the labor force.

Another possibility involves retirement of Asians and Europeans in the United States, just as some Canadians do now. Their assets would then cease to be foreign claims on the United States.

The adjustment process involves the classic transfer problem in a more complex setting. How much, if at all, the dollar needs eventually to depreciate will depend on all of these factors, and certainly cannot be foretold years in advance of the required adjustment.

The United States has a vibrant, innovative economy. Its demographics differ markedly from those of other rich countries, in that birth rates have not fallen nearly so far and immigration, concentrated in young adults, can be expected to continue on a significant scale. In these respects the United States, although rich and politically mature, can be said to be a young and even a developing country. It has an especially innovative financial sector, which continually produces new products to cater to diverse portfolio tastes. The United States has a comparative advantage, in a globalized market, in producing
marketable securities; and in exchanging low-risk debt for higher risk equity. It is not surprising that savers around the world want to put a growing portion of their savings into the U.S. economy. The U.S. current account deficit and the corresponding surpluses elsewhere, described as imbalances, involve intertemporal trade and do not necessarily signal economic disequilibria in a globalized world economy. They may well remain large for years to come.

Postscript

This paper was first presented in September 2007, updated with revised data through 2007. It did not anticipate a freezing up of parts of the financial system, especially from September 2008, both induced by and contributing to a fall in U.S. housing prices and the prices of many financial assets. Although the financial crisis originated in the United States, it quickly became global in scope, albeit with unequal incidence. It led to a deep recession as banks and other financial institutions became extremely risk averse and deleveraged their balance sheets, making credit everywhere difficult to get, despite dramatic moves by central banks to lower short-term interest rates and to increase liquidity in financial markets.

Many cross-border claims—assets and liabilities, debt as well as equity—will be reduced by the end of 2008, with the impact on the net international investment position of the United States uncertain at this time. The U.S. current account deficit dropped below $700 billion in 2008 due to the slowdown of the U.S. economy, and will perhaps drop below $400 billion in 2009 due to the U.S. recession and (especially) to a sharp drop in the price of imported oil.

These are dramatic developments. But I see no reason to alter the basic reasoning of the paper, which was long-term in its emphasis on globalization of financial markets and on differential demographic change in many countries.

Alarmed by the large global imbalances, some analysts predicted a financial crisis. A financial crisis arrived. But it was not due, as forecast, to a flight from the dollar followed by a sharp rise in U.S. interest rates. Ironically, while many U.S. securities (especially mortgage-backed securities and the collateralized debt obligations based on them) came to be shunned and illiquid, the dramatic increase in risk aversion and the flight to safety and to liquidity enhanced the attractiveness of U.S. treasury securities and led to a significant decline in their interest rates, as well as to an appreciation of the U.S. dollar in the second half of 2008.

Financial crises can have many origins. Large global imbalances were not among the origins of the crisis of 2008, except insofar as American access to excess foreign savings contributed to low mortgage rates in the United States and thus facilitated a boom in residential construction and in mortgage lending, a development that also occurred in several other countries. But low long-term
interest rates were a facilitating factor, not the main cause of the crisis. Rather, it resided in a mood of euphoria in financial markets, combined with and reinforced by financial incentives for participants based largely on short-term performance and insufficiently on longer-term risks.

References


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This paper argues that global imbalances in current account positions are a natural consequence of globalization of financial markets and of demographic trends, particularly in Europe and in East Asia. Those societies are aging rapidly, with declining numbers of young adults. On both counts savings should be high and investment weak, resulting in excess saving. With globalization of capital markets, this excess saving will naturally seek secure investment opportunities abroad. The U.S. economy, where demographic trends are markedly different (due in part to immigration of young adults), offers a good combination of yield, liquidity, and security for this excess saving, which in time will be liquidated to finance consumption in old age. Thus the large “imbalance” does not obviously reflect disequilibria in the world economy, but rather a current phase of intertemporal trade.

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