The great thrift shift

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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.

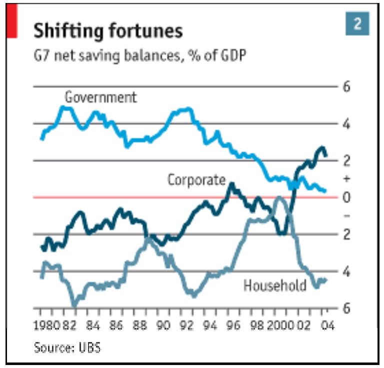
Taken at face value, the notion of a global saving glut is not borne out by the facts. “Glut” suggests an unusually large amount, as in a summer glut of strawberries. In fact, figures published in the IMF's latest *World Economic Outlook* show that the rate of global saving as a proportion of global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

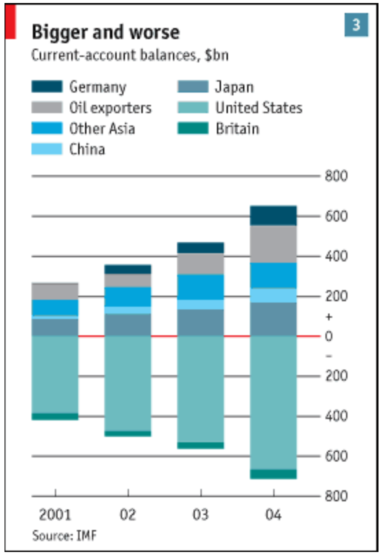
Japan and Europe lie between those two extremes. Politicians in Tokyo tried stimulative policies and talked of structural reform, but proved notoriously ineffective at dealing with their investment bust. The economy fell into deflation and Japan, already the world's biggest exporter of savings, became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

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.

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.

The economics of saving

The shift away from thrift

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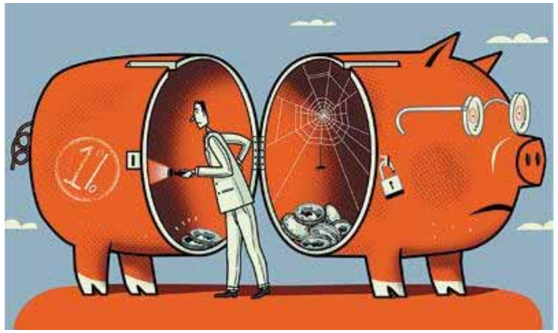


Across the rich world, people are saving less. Does that matter?

IT MAY be a virtue, but in much of the rich world thrift has become unfashionable. Household saving rates in many OECD countries have fallen sharply in recent years. Anglo-Saxon countries—America, Canada, Britain, Australia and New Zealand—have the lowest rates of household saving. Americans on average, save less than 1% of their after-tax income today compared with 7% at the beginning of the 1990s. In Australia and New Zealand personal saving rates are negative as people borrow to consume more than they earn.

Other countries with rapidly greying populations—especially Japan and Italy—have also seen their personal saving rates plummet, though from a higher level. The Japanese today save 5% of their household income, compared with 15% in the early 1990s. A few rich countries, notably France and Germany, have bucked the trend away from thrift. Germans saved around 11% of their after-tax income in 2004, up slightly from the mid-1980s.

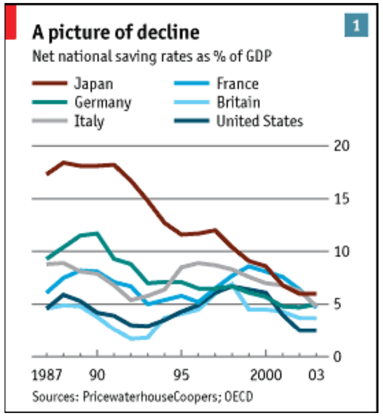
These shifts raise important questions. Are people saving too little? What are the consequences of falling saving rates? Should governments try to encourage people to save more, and if so, how?

One school of thought, led by Ben Bernanke, a prominent American central banker, suggests that the world suffers from too much rather than too little saving. Mr Bernanke, who was nominated to be head of George Bush's Council of Economic Advisers on April 1st, points out that long-term interest rates are extremely low across the globe. He attributes this, in large part, to high saving by Asian economies. If this “savings glut” argument is correct, then presumably there is little need to worry about falling thrift in the rich world.

Others argue that declining thrift is a sign of economic vigour. Thanks to high returns from shares and, more recently, from house prices, people can achieve their financial goals with less discretionary saving. The sophistication of financial markets in Anglo-Saxon economies allows people to tap their wealth more easily, by refinancing their mortgages, for example. For people who live in bank-dominated systems, such as Germany, that is much harder. Higher saving rates in Germany, according to this logic, are the result of poor returns and underdeveloped financial markets.

Pessimists, in contrast, fret that the shift away from thrift is dangerous. The demographic profile of Japan or Italy may explain their falling saving rates, but other rich countries, including America, should have been saving more as the baby-boomers entered their peak earning years. Instead, people are putting aside far too little money to pay for their retirement, relying on unfulfillable promises from bankrupt government pension plans and absurdly rosy assumptions about capital gains from their shares and houses. This myopia greatly reduces the pool of capital available for investment and also worsens existing imbalances in the global economy.

The truth is more complicated. For a start, both the right measure of saving and the appropriate rate of saving depend on whether you are looking at individuals or economies.



From a macroeconomic perspective the right measure is the national saving rate: the sum of private saving (which is household saving and corporate saving, or companies' retained profits) and public saving (ie, a budget surplus) or dis-saving (a budget deficit). It does not matter who in an economy is doing the saving. What matters is how much in aggregate is being set aside to finance the investment that supports economic growth.

During the mid-1990s national saving rates rose in many OECD economies despite the decline in household thrift, thanks to improved public finances. (Japan, where national saving has been falling since the early 1990s, is a big exception.) In some Anglo-Saxon economies, such as New Zealand, healthy budget surpluses still dampen the impact of low personal saving. But in America, the dramatic shift from budget surplus to deficit since 2001 has amplified the effect of falling household saving. Not only is household saving close to a record low, but net national saving (at around 2% of GDP) is at its lowest rate since the Great Depression.

Does this matter? The relationship between thrift and economic growth is complicated. High rates of saving do not guarantee rapid economic growth (think of Germany). Nor, as global capital markets integrate, must investment be funded by domestic saving alone. Countries can borrow cheaply from abroad and run current-account deficits. Most low-saving Anglo-Saxon economies do just that: America's current-account deficit has reached a gaping 6.3% of GDP. Low long-term interest rates do imply that, for now, global savings are more than adequate relative to investment opportunities.

The true cost of borrowing

But is this sustainable? Even in a more global capital market, there are limits to foreign borrowing. The debts incurred must be serviced, capping how big the current-account deficit can become. More important, today's “saving glut” has less to do with a structural surplus of saving than a shortfall in investment that may prove temporary. Despite its plummeting national saving rate, Japan still exports capital to the rest of the world because its investment rate has fallen even more.

Nor have Asia's economies—with the exception of China's—seen a substantial rise in saving. In some countries, such as South Korea, whose population is ageing rapidly, national saving rates are falling. These countries have become net lenders because their investment rates plummeted after the financial crises of the late 1990s. If investment rises, the savings glut will quickly disappear. Over the longer term, demographic trends suggest

national saving in rapidly greying countries (Japan, South Korea, Italy, etc) will continue to fall, further reducing the prospect of surplus saving to finance the Anglo-Saxon deficits.

Furthermore, America—despite its huge external borrowing—itself has a relatively low investment rate. To maintain high productivity growth, investment rates probably need to rise. Add together the need for greater investment and the likelihood of less easy access to foreign borrowing, and the conclusion is clear: Anglo-Saxon economies with low national saving rates, particularly America, need to save more.

Economists agree about the surest way to do this: focus on the government's finances. Alan Greenspan recently called greater fiscal discipline “the most significant vehicle we have” to raise national saving. However, some budgetary prudence may be offset by lower private saving. A theory called “Ricardian equivalence” holds that increases in public saving are cancelled out by falls in private saving as individuals anticipate future tax cuts.

A recent OECD study of 16 rich countries between 1970 and 2002 finds that, on average, around half of any improvement in public finances is offset by lower private saving in the short term, and around two-thirds in the long term. But the most extreme case of low national saving (America) had the weakest offset. A change in America's fiscal stance had no statistically significant impact on private saving, suggesting fiscal discipline will be particularly effective. But even in other low-saving economies, budgetary prudence is the surest route to higher national saving.

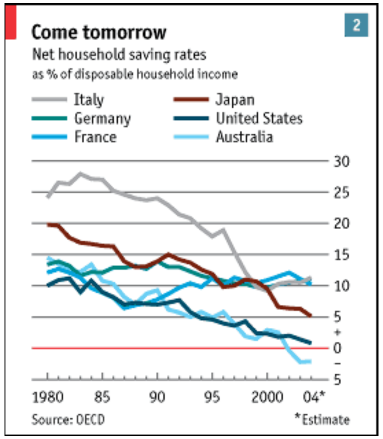
That does not mean private saving rates are irrelevant. Encouraging higher private saving would clearly help raise national saving. Moreover, the adequacy of personal saving is important from the perspective of individual welfare. Even if a country overall is saving adequately to fund future economic growth, savings might be distributed in a way that leaves certain groups with insufficient wealth.

But the concept of “adequate” saving is tricky. People have many reasons to save: as a precaution against a sudden drop in income; to smooth their consumption over their lifetime; or to leave assets to their children. Gauging whether people are setting aside enough from their current income depends on what you assume those people will want to consume or bequeath in future, what wealth they have already accumulated and what returns on those assets will be.

Measurement problems bedevil this process. The household saving rate is calculated by subtracting consumption spending from after-tax income. But the definitions of both income and spending that statisticians use in the national accounts often bear little resemblance to what people think of as saving and spending. Realised capital gains, for instance, are not included in income, even though the taxes paid on capital gains are deducted from income. And differences between countries' tax structures and government services can mean the same basic saving behaviour can yield quite different measured saving rates.

Mind the gap

Adjusting for these problems, however, does not change the basic picture. A study by the OECD and European Central Bank shows that, once adjusted for different tax and pension structures, the saving gap between America and continental Europe widens further. Martin Barnes of the Bank Credit Analyst, a consultancy in Montreal, reckons that, once adjusted for measurement problems, America's personal saving rate was relatively stable until 2001. Since then, however, it has plunged.



But does less saving mean too little saving? The most extensive academic work on individuals' savings adequacy has been in America. Ironically, economists there have become more sanguine even as measured saving rates have fallen. In the mid-1990s a slew of academic papers fretted about inadequate saving rates. In particular, work by Douglas Bernheim, an economist at Stanford, suggested a dramatic undersaving by most households.

A second group of studies, pioneered by Eric Engen of the Federal Reserve, Bill Gale of the Brookings Institution, and Cori Uccello of the Urban Institute, built more sophisticated models of optimal saving, and painted a less gloomy picture. The most recent, and optimistic, study, published in January 2004 by John Karl Scholz and Ananth Seshadri of the University of Wisconsin, and Surachai Khitatrakun of the ERS Group, a consultancy, argues that 80% of American households have more accumulated wealth than they need.

But these studies make a number of rosy assumptions. First, they include individuals' equity in their house as part of their financial assets. That may be a mistake not just because the recent run-up in house prices could prove to be a bubble, but also because houses are lumpy assets. Not all old people will want to sell their house to finance their retirement consumption. If only half an individual's house equity is included, the most optimistic study suggests that just under 60% of American households have adequate savings—a dramatic change.

Second, these studies assume that future state pension benefits will be paid as promised. Given the budgetary pressures posed by the baby-boomers that looks unlikely. If Mr Bush succeeds in passing social-security reform (a big “if”, at present), some form of benefit cut is almost certain to be part of it. For poorer Americans, any cut in promised pension benefits would sharply reduce the adequacy of their saving today. Projected payments from social security exceed the value of all other financial assets for the bottom one-third of the income distribution.

A look at Britain, where the government's level of pension provision is set to replace a much smaller proportion of earnings than in America makes the point. A recent report by Britain's Pension Commission argued that, given downward trends in the occupational pensions provided by employers and the erosion of state pensions, 60% of workers over 35 are not saving enough.

A return to saving?

In all of these analyses much depends on assumptions about the rate of return on savings. In recent years, the biggest difference between high-saving and low-saving OECD countries has been the return on assets. As a recent report from the McKinsey Global Institute points out, between 1975 and 2003 asset appreciation was responsible for almost 30% of the increase in the value of household financial assets in America, whereas in Japan high saving rates made up for negative returns on assets. Based on current rates of return and saving patterns in big industrial economies, the McKinsey study takes a dim view of the adequacy of global wealth accumulation. But it notes that more saving is an unhelpful prescription for countries that already save a lot, such as Germany. The answer there is to raise returns on saving, through financial and corporate restructuring, greater competition and so forth. In other words, these economies need to become more Anglo-Saxon.

In low-saving Anglo-Saxon economies, by contrast, raising people's saving rate must be part of the mix. But how, if at all, can governments encourage people to save? Monetary policy is one tool, albeit a blunt one. In recent

years, unusually low interest rates have encouraged borrowing and caused asset bubbles, particularly in Anglo-Saxon economies. While this consumption in the short term supported the global economy, it has accelerated the saving decline. A return to more normal levels of interest rates ought to boost saving.

Another approach is simply to force people to save more, for instance by introducing compulsory contributions to new pension accounts. Australia and Switzerland have both done this. (In Australia's case the impact on saving is not clear cut: the saving rate has fallen nonetheless, though arguably by less than it would have done without the mandatory component.) While compulsion may be an important possibility for extreme low-savers, it is decidedly illiberal and most countries have tried to encourage rather than compel more saving.

Their main route has been the tax code. Income-tax systems deter saving by taxing the returns twice (first when the company makes a profit and again when an individual receives the investment income). From the perspective of maximising the incentive to save, the best policy would be a wholesale shift to a consumption-based tax system.

But no OECD country has done this, although many raise some revenue from consumption taxes. Instead, policymakers create incentives for saving within the income-tax system. Most industrial countries offer some tax-sheltered retirement-saving accounts. One OECD study suggests the typical rich country offers a subsidy worth 20 cents for every dollar in these retirement accounts. America, with a subsidy of 27 cents on the dollar, is 10th highest. This subsidy costs over 1% of GDP in forgone tax revenue, considerably more than the country's total personal saving. These subsidies make sense only if they are encouraging saving that would not otherwise take place. The evidence for this is mixed, at best. Studies suggest tax-favoured retirement accounts essentially divert existing saving or encourage only modest new saving.

By giving a break on progressive income taxes, these accounts give a fatter subsidy to richer people who are more likely to save anyway. In most countries, the tax system discourages poor people (who are more likely to be low savers) from thrift. In America, eligibility for welfare assistance such as food stamps is phased out if a couple has assets over $3,000. In Britain, the means-tested pension credit, designed to help pensioners, has the perverse result of making saving for workers on moderate incomes a foolish idea. For every pound of savings income they can incur marginal tax rates of at least 40%.

Housing is another area where the tax code distorts saving behaviour. Mortgage-interest deductions and exemptions from capital gains for residential property both favour excessive saving in property. John Makin, an economist at the American Enterprise Institute, reckons that America's tax breaks for property will cost around $1 trillion over the next five years, a huge drag on the budget and hence national saving.

Decisions, decisions

Rather than focusing on tax incentives, recent economic research suggests politicians ought to look harder at what stops people saving. A slew of studies by behavioural economists suggest people are deterred from thrift by the decision-making involved. Poorer people, for instance, are more likely to be enrolled in private retirement plans if that is the employer's default option than if workers have to elect to enrol. In one study by Brigitte Madrian of the Wharton School, University of Pennsylvania and Dennis Shea of the United Health Group, shifting to automatic enrolment raised participation among poorer workers from just over 10% to 80%. Other studies suggest that people will raise their saving rate as their earnings increase, provided these increases are automatic. Behavioural economics suggest many intriguing policy ideas, such as encouraging employers to make membership the default option for pension plans.

None of these changes will dramatically increase household saving rates. But they will make it easier and more attractive for those who are saving least to put aside some money, while at the same time reducing the fiscal burden of misplaced tax subsidies to the rich. Poorer people, government budgets and national saving rates would all see some benefit.

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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.

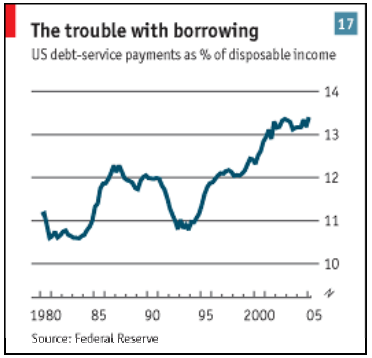
In principle, the global saving glut ought to help by keeping capital cheap. But because the excess saving hails from abroad, it keeps the dollar strong, so low interest rates continue to have a bigger impact on America's property market than on its export sector.

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-broking 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 unprecedent 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?

The frugal giant

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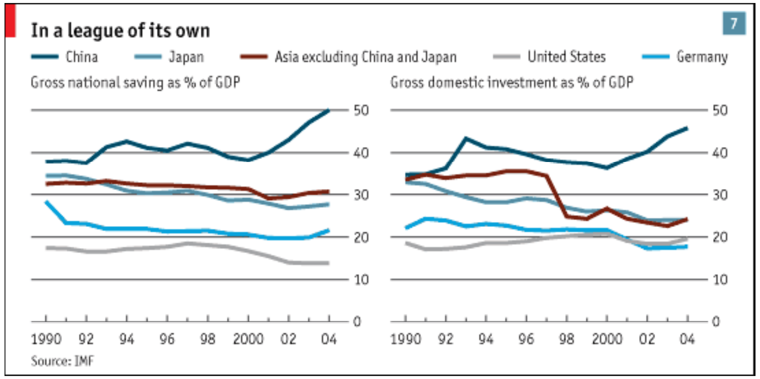
From The Economist print edition

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.

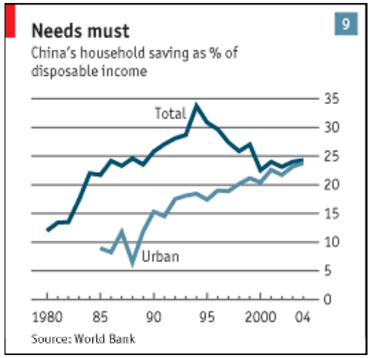
Piling up
China's current-account balance as % of GDP
Source: IMF

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.



Needs must
China's household saving as % of disposable income
Source: World Bank

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.

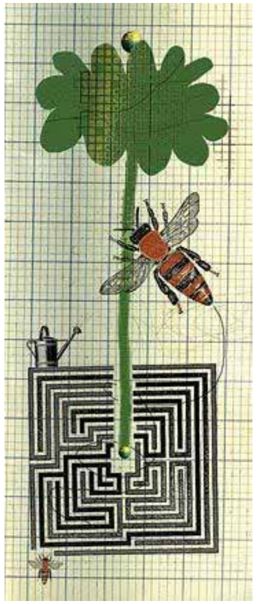
A government that depends on rapid economic growth to legitimise itself will not want to risk instability with a sudden rise in the currency, so a much stronger yuan seems an unlikely route to a quick reduction in China's saving surpluses. Reforms to encourage consumer credit and reduce uncertainty about 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.

Anatomy of thrift

Sep 22nd 2005
From 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.

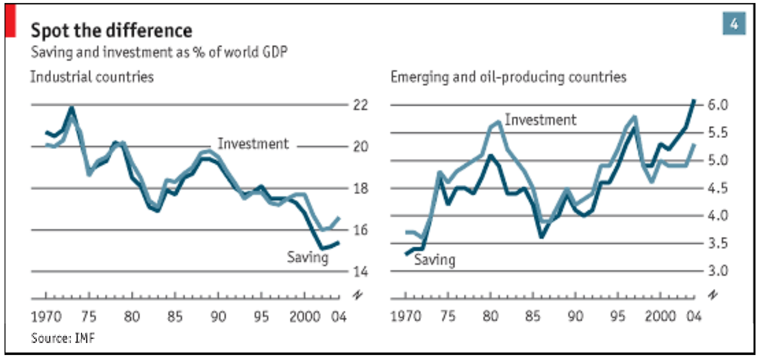
Most of the time, mismatches between the desired levels of saving and investment are brought into line fairly easily through the interest-rate mechanism. If people's desire to save exceeds their desire to invest, interest rates will fall so that the incentive to save goes down and the willingness to 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.

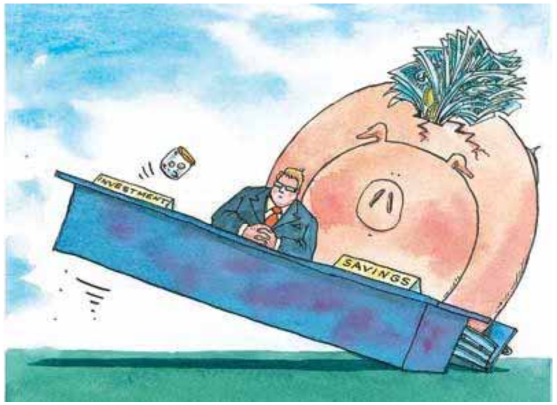
In sum, none of these explanations for a structural, global decline in investment is altogether convincing. To understand the pattern of global saving and investment properly, you have to look in detail at what is going on within the world's main saving and borrowing countries. The best place to start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

Economist.com FINANCE & ECONOMICS

Saving by companies

The corporate savings glut

Jul 7th 2005
From The Economist print edition



Companies, not emerging economies, are leading the global shift to thrift

THE anti-globalisation protesters at this week's G8 summit have long argued that companies make too much money. As it happens, economists also think that firms have "excess profits"—although not in the sense that the protesters would recognise. Basically, managers don't know what to do with their cash. For the past three years, while profits have surged around the globe, capital spending has remained relatively weak. As a result, companies in aggregate have become net savers on a huge scale. Their thrift may explain why bond yields are now so low.

Not that there is any shortage of explanations on offer for why real bond yields have fallen in recent years. Some people suggest that they reflect expectations of a slowdown in growth, or a lower inflation-risk premium or, perhaps, pension funds' increased appetite for fixed-income assets. But the theory that is currently all the rage holds that yields have been depressed by a global savings glut.

Ben Bernanke, a former governor of America's Federal Reserve who is now chairman of George Bush's Council of Economic Advisers, argued earlier this year that excess saving by emerging economies was to blame for both America's large current-account deficit and lower bond yields. Following a series of financial crises, these economies slashed investment and swung from a combined current-account deficit of $93 billion in 1996 to a surplus of $336 billion last year. Since bond yields should reflect the demand and supply for funds, this increase in net saving could indeed have reduced yields. However, a new study by economists at J.P. Morgan concludes that in recent years an increase in saving by companies in developed countries has been far more important than emerging economies' thrift.

Over half of emerging economies' huge swing from external deficit to surplus had occurred by 2000. However, American bond yields were roughly the same in that year as in 1996; the big decline in yields is more recent. Since

2000, the corporate sector has stood out. Companies in the main developed economies have switched, as a group, from being big borrowers to being net savers: ie, their profits exceed their capital spending. The total increase in companies' net saving in the past four years has been more than $1 trillion, 3% of annual global GDP and five times the increase in net saving by emerging economies over the same period. J.P. Morgan estimates that about half of the gap between the current real yield on American ten-year Treasury bonds and its average since 1960 is due to this increased corporate saving.

It is striking how similar companies' behaviour has been despite big differences in countries' growth rates. The economies of America and Britain have boomed, while those of Japan and the euro area have stalled, yet in all of them firms are now running a financial surplus, using their spare money to repay debts, buy back shares or build up cash. This is odd, because normally companies are net borrowers, investing to boost future output and incomes, while households as a group are net savers, providing firms with the capital to invest.

Firms have been net savers for the odd year in the past, but a run of several years is highly unusual. Since 2002 American firms have had an average net financial surplus of 1.7% of GDP, compared with an average deficit of 1.2% of GDP in the previous two decades (see chart). Corporate Japan has run an average surplus over the past three years of no less than 6.2% of GDP, compared with an average deficit of 2.3% in the 1980s and 1990s. In fact Japanese firms have been in financial surplus since 1994, desperately trying to reduce the debts they built up during the bubble economy in the late 1980s. Corporate cost-cutting—in both capital spending and new hiring—has been a persistent drag on Japan's growth rate. The good news is that corporate debt as a percentage of GDP has fallen to the level of the mid-1980s, before the bubble really inflated.

Now American and European firms seem to be following in the footsteps of the Japanese, having been forced to cut back on borrowing after a binge in the late 1990s. It is also worth noting that a large chunk of the rise in corporate saving in America in recent years has come from the financial sector, where profits have soared.

The recent increase in corporate saving in the euro area has been more modest than in America or Britain, but it has made a bigger dent in growth, because the single-currency zone, unlike the other two economies, has not been cushioned by either an increase in government borrowing or a fall in saving by households.

Hey, big saver

Alan Greenspan, chairman of the Federal Reserve, has called the fall in bond yields while short-term interest rates are rising a "conundrum". In light of the increase in corporate saving, says Chris Watling of Longview Economics, a consultancy, the real conundrum is not that bond yields are so low, but that firms are saving and not investing when profits are strong and money is cheap. If it is because of over-investment in the bubble years of the late 1990s, then investment should recover and bond yields rise, once balance sheets have been repaired and spare capacity has been used up. Mr Watling points to some tentative signs that firms are starting to borrow and invest again as evidence that this is happening: in America, bank lending to firms is now growing faster than consumer lending for the first time since the late 1990s. J.P. Morgan agrees that companies' behaviour should return to normal relatively soon, and therefore predicts that the yield on ten-year Treasuries will rise from 4% to 5% by the end of 2005.

In contrast, the economics team at HSBC expects corporate investment to remain weak. Japanese firms' decade-long efforts to repay debt provide a sobering lesson. America's pick-up in investment last year may have been spurred by accelerated depreciation allowances which have merely encouraged companies to bring forward spending from future years. If company bosses recognise that the current consumer boom is built on shaky foundations—in particular, rising house prices—they are likely to be reluctant to invest. If firms continue to save and consumer spending slows, as house prices level off or even decline, then weaker growth will lie ahead. Could it be time, perhaps, to dust off the works of Keynes, and swot up on the "paradox of thrift"?

Economics focus

A saving grace

Jul 3rd 2003
From The Economist print edition

Japanese households have lost their appetite for thrift

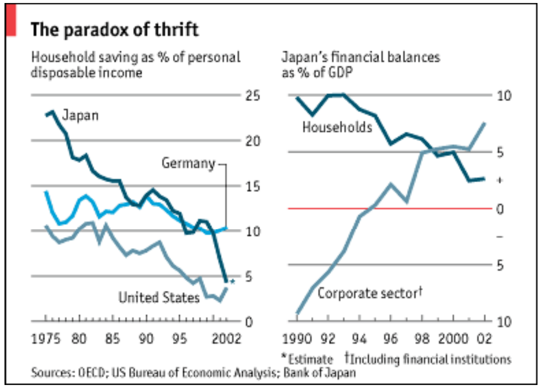
Get article background

THE profligacy of American households is legendary: their eagerness to spend and spend has been the main motor of the American economy in recent years. The Japanese, in contrast, are renowned for their thrift. It is often claimed that one reason for the country's economic stagnation is that consumers, fearful of deflation and unemployment, insist on keeping their wallets firmly shut. Yet it is a myth. Although in the early 1980s Japanese households were among the world's champion savers, they are so no longer. Indeed, their saving rate is now roughly the same as that of spendthrift Americans.

Recently revised figures show that Japanese household saving fell from 23% of personal disposable income in 1975 to 14% in 1990, and then to 6.9% in 2001 (the latest official figure). Osamu Tanaka, an economist at Morgan Stanley, thinks the ratio fell to 4% last year and to a piffling 2% in the first quarter of 2003. If so, Japan's household saving rate is now below America's (at present 3.5%) for the first time in 50 years. It is also well below rates in the euro area, which are typically above 10%.

Thanks to the decline in saving, Japanese consumer spending has outpaced the growth in incomes. Over the past couple of years it has continued to rise even as incomes have shrunk. Such a sharp fall in saving seems puzzling: a popular argument has it that deflation causes people to put off buying things in the expectation that they will be able to get them more cheaply next year. In addition, Japanese households have suffered from a slump in asset prices, and thus a loss of wealth. So they should be saving more to rebuild their nesteggs. And there is a third reason why you might have expected higher, not lower, household saving in Japan: the big increase in government borrowing in the past decade. According to a theory known as Ricardian equivalence, households should now be anticipating higher future taxes to repay the extra government debt, by saving more today. Yet ordinary Japanese are saving less.

Why? Perhaps the best explanation for the fall in saving over the past two decades lies in a theory called the life-cycle hypothesis. This supposes that during their working years individuals spend less than they earn, and thus accumulate wealth, which they plan to draw on once they retire. So the more retired people there are in relation to the number of workers, the lower the saving rate will be. The ratio of Japanese aged over 65 to those of working age rose from 15% in 1980 to 28% in 2000. It is forecast to increase to 38% by 2010 and to 50% by 2020.



A study by Peter Morgan, an economist at HSBC, finds that this demographic shift can explain half of the fall in Japan's saving rate over the 20 years to 2000. Much of the rest of the decline may be related to inflation. When inflation soared in the 1970s, the erosion of the real value of wealth prompted households to save more to rebuild their assets. As inflation fell, they needed to save less to maintain their real wealth.

But neither demographic change nor inflation can explain the steep fall in the saving rate since 2000. One possible cause, suggests Mr Morgan, is the maturing in 2001 of a lot of high-yielding, ten-year postal savings deposits. As households replaced these with assets yielding lower returns, their interest income fell. If they save largely out of investment income and consume largely out of their wages, this could reduce the saving rate.

Another clue is that most of the fall in the saving rate is accounted for by those over 60. The elderly, who often have fixed incomes, no debts and hold their wealth mainly in bank accounts, are the one group with nothing to lose from deflation. Their money goes further, so they spend more.

Starving the piggy bank

The recent plunge in the saving rate could be reversed over the next few years, but the long-term trend is surely downwards, because Japan's population will continue to age. Mr Morgan reckons that the saving rate could drop by another five percentage points from its 2001 level, to 1.7% by 2010. In contrast, many economists forecast that over the next few years America's saving rate will rise to at least 6% as consumers are forced to trim their debts.

Japan's high rate of saving used to be the main reason for its large current-account surplus. (The current-account balance is equal to the gap between domestic saving and investment.) So if Japanese households continue to save less, will Japan's current account move into deficit? Not necessarily. That depends on total national saving—ie, saving by companies and the government as well as households.

In recent years the government's hefty borrowing has contributed to a fall in national saving. However, the behaviour of households and government has been offset by a marked increase in saving by firms. The corporate sector is running a big financial surplus, because firms have slashed investment and started to repay debts. Non-financial companies and financial institutions together ran a surplus of 8% of GDP last year (see right-hand chart). In 1990 they were net borrowers to the tune of 9% of GDP. As a result, Japan's total national saving has stayed high relative to investment, keeping the current account in surplus.

But what if business investment rebounds? Would the current-account surplus then vanish? The answer is not a simple Yes, because changes in the financial balance of one sector can cause offsetting shifts elsewhere. For instance, the fall in borrowing by firms in the recent past has helped to push down interest rates; lower interest income has then reduced household saving. When companies begin to borrow again, interest rates will rise, possibly boosting household saving. Moreover, once firms have finished cutting costs and reducing debts, there will be less need for a large budget deficit to support demand. A stronger economy would lift government revenues, narrowing the deficit. So total national saving might not shrink much. It could be premature to say *sayonara* to Japan's current-account surplus.

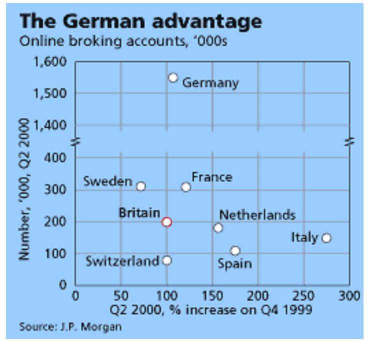
Economist.com FINANCE & ECONOMICS

Online stockbroking

Don't e-mail Sid

Aug 10th 2000
From The Economist print edition

FOLLOWING the explosive growth of Internet stockbroking in America in 1996-99, it was natural that American online brokers would start expanding into Europe. Natural, too, that their eyes should alight first on good old Britain: English-speaking, Internet-hip and, since the privatisations of the 1980s, home to a broad-based "shareholder culture". Yet Britain is proving slower to embrace online investing than are continental countries, supposedly so much more leery of the American way of capitalism. Britain is now behind a number of places—notably Germany—in the number of online share-dealing accounts (see chart). Some of the American brokers who plumped for Britain as their stepping-stone to Europe must be wondering if they made the right choice.



According to a new report by J.P. Morgan, an investment bank, Britain has one-third of Europe's shareholders but only 7% of the continent's online-broking accounts. It cites a number of reasons for this, including the low savings rate in Britain (4% of disposable income as opposed to 12-13% in most of Europe). And young Britons, who might be expected to use the Internet if they started investing in shares, tend to invest so much money in their homes that they have little left for the stockmarket. In Germany, by contrast, equity investment is taking off at the same time as the Internet. Online broking has been further boosted by the splurge of companies listing on Frankfurt's technology-dominated Neuer Markt.

But Huw van Steenis, the report's author, thinks the most important reason for Britain's relatively slow switch to online investing is "the arcane and expensive clearing and settlement system". The costs include the government's "stamp duty" tax of 0.5% levied on all share purchases. More significant is the reliance on bits of paper. Some three-quarters or more of all retail share-deals in Britain are settled by the transfer of physical share-certificates rather than electronically, through nominee accounts. "Certificated" trading is a cumbersome, expensive service that few online brokers offer.

Many investors became accustomed and attached to certificated trading during the privatisation boom of the 1980s. Blanket advertising campaigns urged the masses to "tell Sid" to buy shares in state-owned utilities. Sid ended up with a lot of paper, and more when a number of building societies (thrifts) shifted from mutual to shareholder ownership. Since then, the stock exchange has switched to "dematerialised", book-entry share-ownership, which new buyers of shares accept but Sid dislikes. The transition will take time.

Too bad for Britain's online brokers. Three of the top five are American: TD Waterhouse, DLJ and, biggest of all, Charles Schwab, which now claims more than half of British online accounts. Did they make a mistake in locating their European bases in Britain? Of course, none will admit as much. Indeed, they point out that, having doubled in six months, the British market for online transactions is expanding at a phenomenal rate. But Bob Dusté, chief executive of Charles Schwab Europe, does concede that, with hindsight, his firm might have concentrated harder on other markets in Europe. He is also disappointed that it is proving harder than expected to develop cross-border business within the European Union, despite the EU's attempts to create a pan-European market in the securities business.

No American firm has a big share of any continental European market. Nor, with the partial exceptions of ConSors, of Germany, and Bipop, from Italy, have European brokers had much success outside their homelands. Indeed, outside Britain, it is striking how much local firms dominate their national markets. So for Americans, in one respect at least, it is still good old Britain.

Economist.com GLOBAL AGENDA

Plumbing the depths

Dec 30th 2004
From The Economist Global Agenda

The dollar has hit another record low against the euro. It is set for further falls against major currencies in the coming year, even though American interest rates will rise

Get article background

FORECASTING exchange rates, warns Alan Greenspan, the chairman of the Federal Reserve, has a success rate no better than calling the toss of a coin. But the dollar keeps coming up tails. At the start of 2004, holders of America's currency had to part with $1.25 to buy a euro. At year's end, they must fork out nearly 12 cents more. In New York trading on Thursday December 30th, it cost almost $1.37 to buy a euro—a record low for the greenback for the sixth consecutive trading session.

The cause of the dollar's decline is hardly a mystery: private investors have become less eager to finance America's huge current-account deficit. The deficit widened slightly in the third quarter of 2004, to a record $165 billion, or 5.6% of GDP in that period.

These record deficits are adding to America's foreign debts at an alarming rate. But as yet, America still earns more from its foreign assets than it pays on its foreign liabilities. That is about to change. As interest rates rise, refinancing America's debt will become more costly. Goldman Sachs forecasts that net foreign-investment income is likely to shift to a sizeable deficit during 2005, growing thereafter. The investment bank estimates that, if America's current-account deficit remains steady as a share of GDP and interest rates average 5% in future, net foreign debt-service payments will reach 4% of GDP by 2020—a significant drag on American living standards.

To avoid shelling out such large sums to foreigners, America will, ultimately, have to rely more on its own savings and less on savings imported from abroad. The country as a whole saved just 1.7% of national income in the first nine months of 2004. Households saved just 0.7%.

The dollar's decline may force America to embrace thrift, argues Goldman Sachs. As the dollar falls, foreigners will demand more American goods. This will put pressure on America's manufacturers, which are already operating at 78% of capacity. As supply is stretched, inflationary pressures will build. The Federal Reserve will raise interest rates, curbing domestic demand, and thus creating room for an export boom. The higher interest rates will thus promote the saving America has so sorely lacked.

This process has barely begun. Over the past two years, the dollar has lost almost 23% against the euro. But it has shed less than 13% against a broader basket of currencies (see chart), and it has not lost a cent against China's yuan. As a matter of official policy, the Chinese currency has remained within a tight range around 8.28 to the dollar for the past decade. Forecasting the intentions of China's policymakers may actually be harder than calling a toin coss. But many are trying. Offshore markets, for example, allow speculators to make a bet on the value of the yuan in 12 months time. At the moment, punters reckon you will get just 7.8 of them for your dollar this time next year.

Against the yen, the dollar is actually slightly stronger than it was in late November. The Bank of Japan has not intervened in the foreign-exchange markets since March, but the threat to do so remains. Japan's finance minister, Sadakazu Tanigaki, gave warning this week that his country's authorities would monitor foreign-exchange markets over the New Year holiday, a time when trading is thin and official buying can make a big difference.

If Japan's finger is on the trigger, the European Central Bank (ECB) seems prepared to sit on its hands. Jean-Claude Trichet, president of the ECB, has lived with strong currencies before. As president of France's central bank in the years before euro entry, he was dubbed "the ayatollah of the *franc fort*" for his unflinching support of a strong national currency. Indeed, for much of 1995, a weighted basket of the franc and the 11 other currencies that formed the euro was worth almost as much against the dollar as it is now.

In his press conferences, Mr Trichet has made it clear that recent rises in the single currency are unwelcome. But he has dwelt at greater length on the danger of rises in energy prices. His chief duty, as he sees it, is to convince firms and workers that inflation will remain well contained, despite the oil price spike of the autumn. It is a confidence game: if he can convince them an inflation spiral won't happen, then it won't. The strong euro will actually add to his credibility, by curbing the price of imports.

Besides, the hard men of hard money believe that weak currencies make life too easy for firms and politicians. Devaluing the currency provides an unsatisfying alternative to deregulating and restructuring the economy. An overvalued currency, on the other hand, leaves uncompetitive firms and tentative politicians with "no place to hide", as Eric Chaney of Morgan Stanley puts it. They must reform or perish.

"You cannot devalue your way to prosperity," says John Snow, America's treasury secretary, somewhat hypocritically. The year to come may reveal whether Europe can revalue its way to the same end.

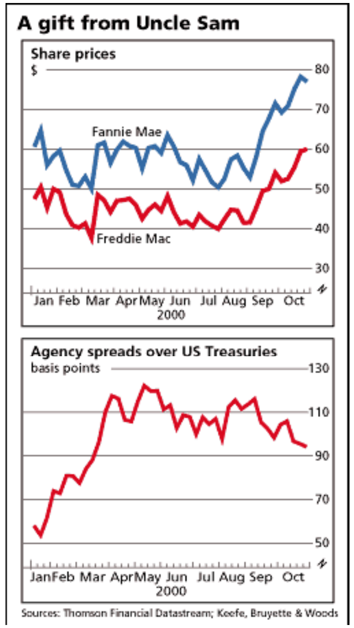
Economist.com FINANCE & ECONOMICS

Fannie Mae and Freddie Mac

Capital winners

Nov 2nd 2000 | NEW YORK
From The Economist print edition

AT A time when the stockmarket is showing only fitful enthusiasm, the share-price performance of two companies stands out: Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation). This is not because there has been a sudden boom in home construction. It is a result of their brilliant dexterity in prevailing upon Congress to condone what is, in essence, a rip-off of taxpayers. In the past two months, each has seen its share price climb by about 50%; and the spread between their debt and Treasury bonds, which had widened to 1.2 percentage points, shrank by 30 basis points—a big move in bond-market terms.



Fannie Mae and Freddie Mac straddle an interesting line between what America seems to represent around the world (free markets) and what everyone in Washington, DC, really loves most (free money for a favoured group). Each was founded as a public institution to provide a way for mortgages to be shifted from the small banks and thrifts that issued them to the capital markets, thus reducing the risks borne by lenders and giving them the liquidity to lend again. This is a function that many private firms are now well able to perform.

Although both Fannie Mae and Freddie Mac are now quasi-private, with shares that trade on the New York Stock Exchange, the home of American capitalism, they retain powerful legacy rights, such as an exemption from state and local taxes (which in the case of Washington, DC-based Fannie Mae costs the beleaguered capital city hundreds of millions of dollars annually), and from oversight by the Securities and Exchange Commission, America's main markets regulator. Their debt can be used as collateral by banks for tax deposits. And, unlike other corporate loans or bonds, banks can hold as much of it as they like without making warning lights flash on their, or the regulators', risk management systems. Five members of each company's board are appointed by the president of the United States.

Thanks to all these privileges, it is widely assumed in the bond markets that the federal government stands behind the debt of these companies, notwithstanding frequent denials, and would never let them fail. The result is that they can issue debt for almost a percentage point less than other big financial firms, a huge advantage in bringing in business. Collectively, the two agencies hold over $1 trillion in outstanding loans, to say nothing of the vast amounts more that they have syndicated to the markets, but still have some exposure to.

Earlier this year, a congressional committee headed by Richard Baker, a Republican congressman, took aim at this preferential treatment. It was seemingly aided by none other than Alan Greenspan, chairman of the Federal Reserve, who in August wrote to Mr Baker noting that "subsidies accorded ...are, of necessity, at the expense of other federal or private-sector initiatives and hence are ultimately financed by householders, either through taxes or through the reduced accumulation of wealth."

Oddly, soon after Mr Greenspan's comments, optimism about the prospects for these agencies began to increase, on the presumption that no radical change would ensue. The reason soon became clear. Towards the end of October, a complicated and relatively empty six-point agreement between the agencies and Mr Baker's committee was reached, emphasising disclosure but making no fundamental difference to the privileged status of Fannie and Freddie.

"This is a solution only if you consider that privatisation is out of reach, and even then, it is still not a solution," says Peter Wallison, resident fellow at the American Enterprise Institute, reflecting an ideological perspective that Mr Greenspan might share. From the more immediate perspective of shareholders in Fannie and Freddie, "a cloud was removed," summarised David Graifman, an analyst at Keefe, Bruyette & Woods, an investment bank.

The two agencies have agreed to more transparency over interest-rate and default sensitivity, to subject themselves to review by the main rating agencies, to retain three months' worth of liquidity in case of a protracted panic, and to bolster their capital by issuing a subordinated bond that will theoretically be more responsive to market credit concerns. In reality, it may take a default for this new bond to be taken seriously.

At the annual convention of mortgage bankers on October 31st, Armando Falcon Jr, director of the surreal-sounding Office of Federal Housing Enterprise Oversight, which watches over the soundness of Fannie and Freddie, said, "currently all (of their) securities carry an explicit statement that they are not backed by the full faith and credit of the US government. Yet the market treats these securities as though they are government-guaranteed. How and why would the markets treat sub debt any differently?"

Answer: it probably will not. Although Mr Baker has vowed to continue his fight next year, there are questions about whether he will retain his chairmanship, for any number of reasons, including the possibility of a Democratic Congress, a bigger assignment for him, or even a lost election. Politicians, after all, come and go. Fannie and Freddie just continue to grow.

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?

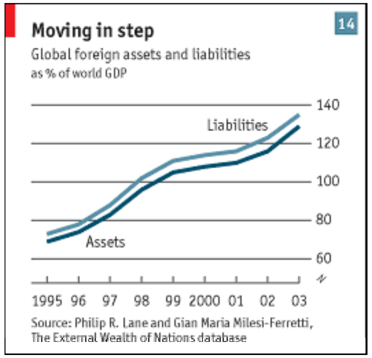
Some of these arguments are plainly wrong-headed. If foreigners were keen to share in the gains of American productivity, they would be investing in American shares and factories. That is what happened in the late 1990s. But since 2000, growth in net foreign investment in American shares as well as foreign 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.



Source: Philip R. Lane and Gian Maria Milesi-Ferretti, The External Wealth of Nations database

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?

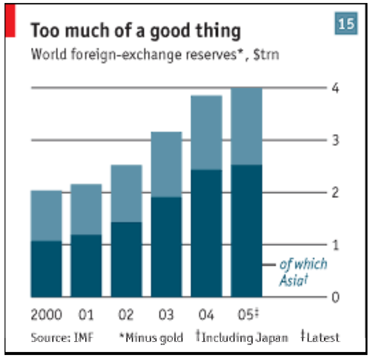
But that is not all. A second reason for unusually low interest rates is that a large chunk of those surplus savings has been under the control of central banks, particularly in Asia. Thus far, these banks have cared less about risk-adjusted returns than about stopping their currencies from rising. The 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%.



Source: IMF *Minus gold †Including Japan ‡Latest

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.

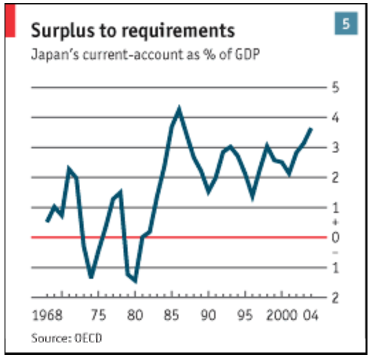
This survey has argued that Japan, China and the oil states are likely to continue piling up saving surpluses for some time yet. If Asia's central banks also remain willing swing purchasers of the dollar, that may seem cause for relief: it suggests that things will go on much as they are, avoiding a 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 Viagra economy

Sep 22nd 2005
From The Economist print edition

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

Get article background



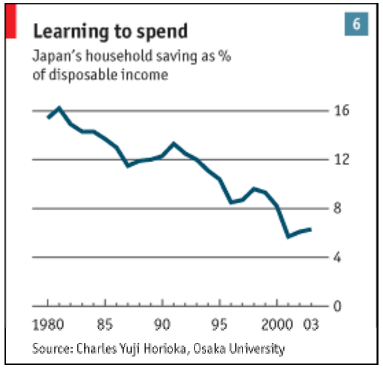
FOR much of the past two decades, Japan has been cast as the villain of the global economy because of its large saving surplus. In the mid-1980s, when America was last running large external deficits, the Reagan administration berated the Japanese for their trade barriers and their unwillingness to consume 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-acount 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.

Acknowledgements and sources

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All figures for national saving and investment are drawn from the September 2005 World Economic Outlook and are aggregated using market exchange rates. Where possible, OECD data is used for household saving.

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