A Paradox of Interest
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The increasing attention paid to growing U.S. current account deficits has bred nightmare scenarios of a sharp decline in the foreign-exchange value of the dollar and rising U.S. interest rates. Financial markets, by contrast, appear more sanguine. Inflation-indexed bonds in the U.S. are yielding only about 1.5% in real terms, and the IMF's estimate of the long-term world real interest rate is about 2%. Capital markets rightly estimate low current real rates of interest, though the outcome affords little comfort.

Alan Greenspan has termed the fall in long-term rates in the presence of a rising federal funds rate a "conundrum." The Fed chairman intuitively and correctly identified global forces at work. Interest rates on default-risk-free debt instruments such as U.S. Treasury securities are determined in an international capital market. And the international capital market determines the world real interest rate by equilibrating global desired saving and desired investment.

At the center of the saving-investment imbalance is the large U.S. current account deficit. While the U.S. is not the only economy running a current account deficit -- among industrial economies, the U.K. and Australia are as well -- the large increase in the U.S. current account deficit in recent years has mirrored large increases in current account surpluses in the rest of the world, principally in Asia. Over the same period, world real interest rates have declined.

Many economists' thinking about savings imbalances harkens back to Keynes's "paradox of thrift." In "The General Theory of Employment, Interest, and Money," he reasoned that what seems sensible for an individual may be bad for the economy as a whole. It is possible for the private sector's desired saving to exceed its desired investment. This intuitive argument has not gone out of fashion, with discussions of a "global savings glut" appearing in official and journalistic reviews of the bond market and the economy. And levels of global savings from emerging economies are, indeed, high.

Global savings as a share of world GDP have increased since the late 1990s, reflecting in part demographic considerations and increased economic uncertainty. But a closer examination of the sources of increased saving reveal another consideration. The rise in the global saving rate is more than accounted for by a higher saving rate in emerging economies, particularly in Asia. I say "more than accounted for" because the U.S., the world's largest economy, reduced its national saving over the same period. This pattern suggests more than a global savings surplus -- in particular, it is weaknesses in domestic financial systems in emerging economies that have led to excess savings.

With this additional consideration in mind, making the transition from a global savings glut to a policy prescription requires delicacy. Taken seriously, this argument can be used to justify fiscal "pump priming" of high-saving economies. Increases in public spending or temporary tax cuts, in this view, stimulate consumption and investment, absorbing excess saving while increasing aggregate demand. Recent experience suggests some skepticism -- think about the U.S. exhortation to Japan in the late 1990s to increase public spending. While Japan's fiscal deficit in 2004 soaked up about 60% of the nation's household and business saving, fiscal ease provided little kick to Japanese output growth. Korea's consumer-credit boom absorbed domestic savings, but two years ago left the economy on shaky footing.

The Japanese case illustrates a general point absent from a discussion of a savings glut. The Keynesian reasoning assumes a simple black box between desired saving and investment -- the financial system at home and abroad costlessly transforms lenders' funds between savers and borrowers. A weak financial system -- reflecting an underperforming banking system, poor investor protection and corporate governance, or fragile securities markets -- yields a high cost of financial intermediation. For any given return on an investment project, savers' net return is lowered by the high costs of intermediating funds. More broadly, regulatory restrictions in goods markets and labor markets reduce returns on domestic investment.

In a closed economy, high costs of financial intermediation increase the relative attractiveness of liquid, safe government obligations. (Again, household purchases of JGBs in Japan come to mind.) In an open economy, the international capital market offers the possibility of investing domestically generated savings in countries with a low cost of financial intermediation and/or a safe nominal anchor in government bonds -- the U.S., for example.

A decade ago, capital inflows were welcomed in emerging Asian economies, though the financial system's high cost of intermediation reduced possibilities for efficient growth. The Asian financial crisis of 1997-98 exposed significant weaknesses in domestic financial systems. Just prior to the onset of that crisis, emerging Asian economies were running current account deficits as capital flowed in from abroad. In the post-crisis period, structural reform of domestic financial systems has taken a back seat to mercantilist trade policies, with export-led growth and large accumulations of international reserves, principally in dollars.

The efficient financial system of the U.S., liquid bond markets, and a stable nominal anchor have attracted large international capital flows. These inflows have financed large U.S. current account deficits. And this arrangement has been particularly strong between emerging Asian economies and the U.S.

While the U.S. needs to raise domestic saving gradually to fund entitlement promises in Social Security and Medicare, getting America's fiscal house in order provides little short-term solution to global saving and investment imbalances. Increases in U.S. saving, with unchanged investment opportunities or financial system efficiency around the world, puts further downward pressure on the world real interest rate.

To address the global saving and investment imbalance meaningfully, domestic financial systems must be able to shift capital where it can be most profitably employed. Only then can consumers' ability to borrow and business's ability to finance result in efficient investment.

Mercantilist trade policies in emerging Asian economies have played a large role in sustaining high domestic saving in those economies. Official sector acquisition of dollar assets has contributed a substantial share of recent financing of the U.S. current account deficits. Government-led strategies to promote export growth combined with direct intervention in credit markets have limited the domestic economy's ability to absorb its own savings.

Asian economies consider the strategy a reach for safety to maintain economic growth through rising exports, while accumulating international reserves as a precaution in the event of a financial crisis. But such policies sacrifice long-term growth. Essentially, relatively poor citizens of China and other emerging Asian economies are lending funds to the more affluent U.S., where lower interest rates can facilitate a property boom. With a high cost of financial intermediation at home, this outcome may be sensible, but like Keynes's paradox of thrift, it is unsustainable.

The U.S. financial system stands as a beacon for the possibility of a virtuous relationship between capital markets and sustainable economic growth. American leadership has rightly questioned European economies' emphasis on safety, with high social spending and inefficient markets for risk-taking limiting demand growth. But the bigger immediate challenge is to address the imbalance of saving and investment in international capital markets by encouraging the development of efficient banking and securities markets.

Herb Stein was right that "If something cannot go on forever it will stop." The U.S. cannot continue indefinitely to absorb larger and larger volumes of global excess saving. And very low world real interest rates can lead to unbalanced growth. But the resolution needn't end badly. After all, financial reform in emerging Asian economies won't be done in the interest of global imbalances, but with the realization that sustainable improvements in living standards require a financial system as modern as one of the region's new airports.

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