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‘Deficits, Debt, and the Dollar’

2005 OXONIA Inaugural Lecture

by

Martin Wolf (Financial Times)

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Mr. Wolf began by outlining two puzzles of the current global economy – high savings and low long-term interest rates – and argued that they are in fact mirror images of each other. He then discussed the causes of these puzzles, the possible negative consequences of continuing along the present course, and feasible remedies. He concluded that some kind of deal between the USA and emerging Asian economies would be the best way to eliminate the large current imbalances.

First, why are long-term real interest rates so low compared to historical levels? Index-linked government bond yields in the US and UK have fallen from around four per cent to closer to one and a half per cent. And the IMF estimates that the world real rate of interest has fallen from six per cent to two per cent in recent decades. Second, why is there a global savings glut, offset by a large savings deficit in the United States? The US now plays a role of the ‘spender and borrower of last resort’; its current account deficit is about 6.5% of GDP, compared to a position close to balance during most of the period from 1920 to 1980. In the period for which we have reliable data, no large economies have experienced sustained current account deficits even close to this magnitude.

These puzzles have come about as the result of a move into surplus of saving over investment in a wide range of countries. Japan has had a large savings surplus for the last twenty years, while the euro area now runs a small surplus. Developing countries are also running surpluses; East Asian economies have run substantial surpluses since the fall of investment following the 1998 crisis. China is especially interesting, running substantial surpluses since 1997, and saving around fifty per cent of gross domestic product – surely the highest saving rate ever recorded in an economically significant country, and made doubly surprising by the country's relative poverty. Finally, oil producing countries now have large saving surpluses too (about five per cent of GDP), as a result of rising oil prices. The US mops up most of these surpluses. Only two other (much smaller) regions have significant deficits; the Anglophone zone (UK, Australia and New Zealand), and Eastern Europe. In the US, investment has remained relatively constant at about twenty per cent of GDP, but the savings rate has fallen substantially, to below 14 per cent; this is mainly the result of weak household and public sector saving.

According to Mr. Wolf's analysis, we can divide the 'saving' countries into two broad groups: first, there are mature high-income economies with slow growth and chronic excess savings, such as Japan and the euro area. Second, there are the main emerging market economies, which have moved from a big deficit in the mid-1990s to large surpluses now.

The first group is perhaps not too surprising, but the second is. And examining the figures more closely we discover very large accumulation of reserves in these economies. For instance, China's reserves are now about $800 bn, or around forty per cent of GDP, mostly held in US government bonds; this is 'the largest reverse aid programme in history'. Middle Eastern oil producers and Russia also appear to have accumulated large reserves recently; in total there has been about $2 trillion of foreign currency reserve accumulation in the last 3½ years, constituting about half of total foreign currency reserves.

In many cases, this has been driven by intervention to hold down exchange rates; while the euro has appreciated significantly against the dollar, for instance, many emerging market currencies have remained remarkably fixed in recent years. Sterilisation has been massive; reserve growth minus base money growth was about eight per cent of GDP in China in 2004.

So the rest of the world is generating large savings surpluses and parking them in the US. Emerging Asian economies, in particular, have looked for export-led growth since 1998, and the US, as spender of last resort, has accommodated the external imbalance imposed by other countries. By seeking internal balance in the US, the Federal Reserve generates internal balance in the rest of the world too, but at the expense of large external imbalances.

On current trends, US net liabilities would be around 120 per cent of GDP by 2014; a big turnaround in the current account position would be needed even to stabilise the present level of liabilities. For this to happen, of course, there would have to be a large real exchange rate adjustment; perhaps a 25 to 50 per cent depreciation of the dollar relative to other currencies.

Is it plausible that surpluses elsewhere will begin to shrink? Not in Japan and Western Europe, since these are natural surplus regions. In the oil-exporting economies, yes, even though they are unlikely to spend their windfalls all at once. The crucial players are Asian emerging economies. There are good reasons for them to change their policies, since real returns on US treasuries are low and likely to fall, making this a very expensive export-subsidy regime. China, for instance, might have given away half of the value of its exports by the time it gets round to spending its money. But they also see advantages in the status quo; including a monetary anchor, export competitiveness, and a de facto Asian monetary system.

A key decision-maker in this process is China. For now, it seems prepared to buy an acquiescent US, even at the cost of investing huge amounts in unprofitable US government bonds. And policymakers do not know if they could manage an appreciation against the dollar well, nor what the best exchange rate regime for China would be.

The US position is also complicated; it enjoys a huge transfer of resources, larger than the fiscal deficit, and larger than the entire military budget, enabling it to enjoy both guns and butter. But there are drawbacks to the current position: 1. Weakened tradable goods and services sectors, resulting in protectionist pressure 2. any reduction in the fiscal deficit would require even greater private borrowing 3. crucially, a credit cut-off could lead to a collapse of the dollar, high inflation, high interest rates, and a serious recession. And the USA’s creditors are not necessarily friendly. Moreover, the longer the delay the greater the final adjustment required. A deal between the US and emerging Asian economies, involving a gradual depreciation of the dollar, would probably be the best approach, but this currently looks unlikely to occur.

Mr. Wolf answered several questions from the audience. In his answers, he emphasised the perverse outcomes of the current situation. For instance, China’s consumption is very low, despite the extreme poverty of many of its citizens; the country’s poor current selves should be more generous to themselves, and less generous to rich future generations. China’s export-led growth also produces large regional inequalities, which could have harmful social effects.

Mr. Wolf also argued that the description of current imbalances as the result of a savings glut, rather than irresponsible consumption in the US, is more accurate; if the latter story were correct, we would expect to see high and rising real interest rates, not incredibly low ones.

Turning to the US domestic position, Mr. Wolf felt that adjustment, even if well-managed, could be quite painful. Because the US is a relatively closed economy, there would need to be large real exchange rate moves, and a big turnaround in consumption. Moreover, changes in the production structure might be necessary, towards those goods that the US is able to export in significant quantities. Any adjustment that wasn't smooth and mutual could potentially be sensationally messy.

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