A World Out of Balance

How A Spending Addiction in the Developed World and a Saving Glut in the Developing World Undermines Global Economic Stability

By David Beckworth

A Deceptively Robust World Economy

The world economy has had an exceptional run over the past five years. Since 2002 economic activity across the globe has grown on average about 4.5 percent a year, a rapid pace by historical standards and one that is all the more remarkable given the significant surge in oil prices, the continuing conflicts in the Middle East, and heightened uncertainty over terrorism. This economic expansion is generally attributed to the productivity gains arising from ongoing technological innovations as well as the entry into the world economy of many formerly closed economies—and the billions of people they represent—in east and south Asia.

Lurking underneath these economic fundamentals, though, is a growing imbalance between how the economic activity of the world is being produced and consumed. The developed world, specifically the United States, has become the demand engine for the global economy with a voracious appetite for goods and services that exceeds its own productive capacity. This excess demand has created a boon for developing countries, particularly in Asia, that depend on exports to the United States to maintain their own economic growth. The strong spending coming out of the U.S., however, has exceeded not only its productive capacity, but also its national income. Consequently, to maintain its robust consumption the U.S. has had to borrow from abroad. Fortunately for the U.S., the same developing countries that have fed its spending addiction with their exports have been more than willing to finance it by extending credit.

The mechanics of this arrangement are straightfoward. Central banks in Asia and other participating developing countries buy up U.S. dollars in foreign exchange markets to keep their own domestic currency competitively undervalued. The central banks buy up the U.S. dollars with their own currency which they can create without limit. This exchange serves to lower the price of, and increase the demand for, their exports in the United States. In turn, the central banks, not wanting to sit on idle cash, take their new U.S. dollars and buy U.S. debt instruments. This purchase of U.S. debt effectively channels their saving to the United State and, in turn, puts downward pressure on U.S. interest rates.

This global vendor financing arrangement, while supporting growth in the world economy over the past five years, is also planting the seeds of its own destruction as it has generated large U.S. trade deficits, an overvalued U.S. dollar, and a growing level of U.S. indebtedness, making the U.S. economy susceptible to economic shocks. Moreover, it requires that developing countries maintain excess saving—or equivalently a reduction in their own consumption—so that they are able to fund the great American consumption binge. Developing nations will not subsidize the United States this way forever, especially as they grow richer and depend less on American export markets. For now, however, this arrangement continues to underpin the global economy.

The Extent of the Global Imbalances

One way to get a sense of these lurking imbalances is to take a look at an indicator called the current account balance—a measure of the dependence a country has on foreign funding. If a country is spending more than it earns, essentially living beyond its means, it will be borrowing from abroad and running a current account deficit. If, however, a country is spending less than it earns and actually saving, it will be lending abroad and running a current account surplus.

To be sure, running a current account deficit is not a bad thing in itself and depends on the purpose of the borrowing. Just as there is a difference between an individual taking out a loan to start a business versus taking out a loan to go on vacation, countries simiarly can make judicious choices between using foreign funds to invest domestically or consume domestically. Even with judicious choices, though, a nation that consistently runs current account deficits is a perpetual debtor and runs the risk of becoming a credit risk. Figure 2 shows the current account balance for the United States since 1980 in both dollar terms and as percent of the total economy, as mesured by Gross Domestic Product (GDP). This figure reveals the U.S. has been consistently running a current account deficit—indicated by negative numbers—since the 1990s.

The current account deficits of the mid-to-late 1990s are viewed by many observers as benign since they served to finance major investments in informatin technology that could generate future earnings. The subsequent current account deficits, however, have been more troubling since they generally are percieved to have funded U.S. consumption in both the private and public sectors that has little, if any, future potential earnings. It is hard to believe that foreigners will want to continue to provide funding to the United States over the long run at the levels they have over the past decade when it is being used soley to sustain consumption. Nonetheless, for now foreigners seem content to continue funding a massive U.S. shopping spree that in 2006 was on the order of almost $900 billion.

Figure 3 provides the current account balances of major regions in the world as a percent of world GDP. This figure vividly illustrates the global economic imbalance problem by revealing that the only major region of the world to systematically run significant current account

How Indebted is the United States to the Rest of the World?

The net international investment position (NIIP) is a measure of a country's foreign assets minus its foreign liabilities. Because the United States has been running current account deficits for so many years, it was as of 2005 indebted at almost $2.7 trillion to the rest of the world.

This is the largest foreign debt owed by any country in the world and led former Treasury Secretary Lawrence Summers to say, "[t]here is something odd about the world's greatest power being the greatest debtor" (2004, p.48).

Figure 1

Average Annual Growth Rate of the World Economy

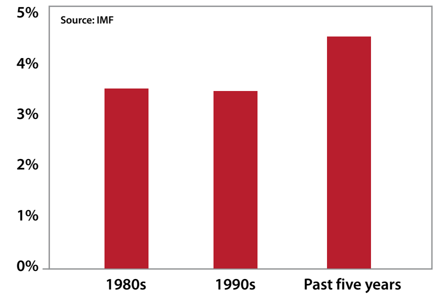


Figure 2

US Current Account Balance

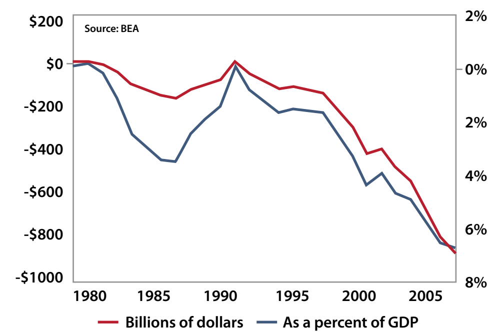


Figure 3

Current Account as a Percent of World GDP

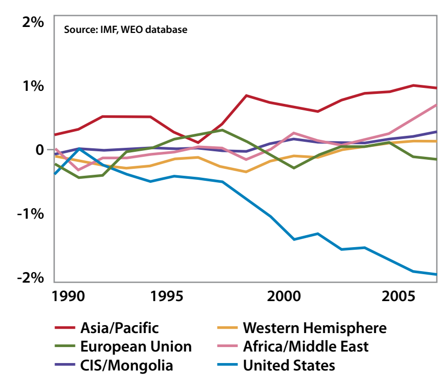
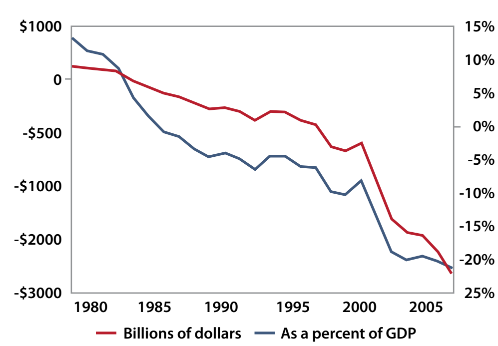


Figure 4

US Net International Investment Position



deficits is the United States. Meanwhile, the following regions—Asia/Pacific, Africa/ Middle East, and the Commonwealth of Independent States (the former Soviet Union) plus Mongolia—have consistently run current account surpluses since at least 2000.

An important question is why do these regions spend less then they earn? One answer already suggested is that they are dependent on the U.S. market for their exports—whether it is manufactured goods from Asia/Pacific or oil from Africa/Middle East and the CIS/Mongolia—and therefore need excess saving to provide vendor financing to the United States. Another answer suggests that these developing regions simply do not have enough domestic investment opportunities given their saving preferences, and so end up with a saving glut. Since this saving glut has to go somewhere, why not send it to the United States given its huge capital markets? This viewpoint regards the U.S. not so much as a global demand engine by choice, but by default.[1]

Another important question is why does the United States spend so much more than it earns? The first answer is that American consumers take economic prosperity for granted and therefore see little need to cut consumption and save. This belief is understandable given the past two and half decades of remarkable economic growth in the U.S., growth that has been interrupted by only mild downturns. This economic confidence has been manifested in a net negative saving rate—net saving divided by GDP—for households.

The other big dissaver in the United States is the federal government. Here the negative saving rate reflects the series of federal budget deficits that have arisen from increased federal spending coinciding with a series of tax cuts. Since households and the federal government are the biggest dissavers they are the main beneficiaries of the foreign saving subsidy. Foreigners, therefore, are not only helping to fund bigger homes and better cars for American consumers, they are also helping to fund federal government spending including the wars in Afghanistan and Iraq.

Unwinding the Global Imbalances

These global economic imbalances at some point must unwind. The United States cannot indefinitely run trade deficits and incur foreign debt. Similarly, the developing world will not hold U.S. debt forever, effectively subsidizing the American dream. There is an endgame and it can take two forms. The first form is a "soft landing" where the United States begins to voluntary balance its government budget and foreigners begin to gradually allow their currencies to appreciate and the dollar to depreciate. Both of these developments would nudge up the U.S. saving rate and reduce the dependence on, and availability of, foreign saving. Foreigners would gradually consume more of their income. Over time, this process would restore balance to the global economy.

The second form is a "hard landing" that would occur if no changes were made and the global imbalances were allowed to keep growing until they burst. Under this scenario, foreigners at some point in the future would begin to question the credit worthiness of the U.S. economy. Eventually, some trigger would cause other nations to start dumping their dollar asset holdings en masse and begin cutting off their line of credit to the United States. Here, the dollar would quickly plunge, U.S. interest rates would spike, and the U.S. economy would go into a recession with potential negative spillovers for the world economy.[2] Whether the unwinding ultimately turns out to be orderly or disorderly depends on how serious the world is about getting its economic house in order.

But for now, it appears to be business as usual.

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Footnotes

1 Under this view, it is as if the United States is saving the day by providing the missing consumption needed in the global economy. For more on this perspective, see Bernanke (2005).

2 Foreign nations with large dollar asset holdings would certainly be harmed as the dollar plunge would impose upon them a major capital gain loss.

References

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What Does All of This Mean for Andrews Alumni?

For Andrews alumni living in the United States, the most important implication of the global economic imbalance story is that at some point in the future they may face a period of significantly higher interest rates and slower economic growth. In real terms, such a development would mean higher interest rates on credit cards, car loans, and mortgages and an accompanying decline in personal spending. If the "hard landing" scenario outlined above were to unfold, then U.S. alumni could also see their personal incomes fall and even face a bout of unemployment.

International alumni most likely would also suffer under the "hard landing" scenario, as the spillover effect from a decline in economic activity in the United States—the world's largest economy—should adversely affect incomes and spending in their own domestic economies. However, under the more benign "soft landing" scenario international alums should actually fare better as their home countries would see an increase in domestic consumption that provides a stimulus to economic activity.