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Global imbalances through the prism of savings and investment

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The so-called 'global imbalances', their source and remedy have been a frequent topic of debate through the years leading up to the global financial crisis and more recently. This article contends that the debate should focus less on the role of the exchange rate in influencing trade flows, and more on savings and investment imbalances. In particular, the reasons behind the 'uphill' flow of capital deserve greater consideration. A long-term solution to the global imbalances will require not only some exchange rate adjustments, but also changes to saving and investment patterns in both surplus and deficit countries. This is achievable, but it will not be an overnight process.

1| What are the 'imbalances'?

The term 'global imbalances' is generally interpreted as referring to large current account positions, with opposite signs, across countries. The current account position can be viewed in several ways: as the difference between a country's income and its absorption; as the difference between the goods, services and income it sends abroad and those it acquires from abroad; or as the difference between its saving and its investment (that is, its net absorption of financial capital). These concepts all measure the same thing. In the years leading up to the recent financial crisis, a number of key countries were running large current account positions –some positive and some negative.

Large current account positions –or, put another way, large cross border flows of capital– are not historically unusual. What has generated concern has been the size and persistence of these current account positions over the past decade or so and the fact that they involve some of the world's largest economies. Over this period, the emerging Asian economies along with Japan, Germany and the oil exporting countries have tended to run large current account surpluses while the United States and a number of other advanced economies, particularly English-speaking ones, have run persistent current account deficits.

2| Are they really 'imbalances'?

The term 'imbalance' implies that the situation described is either undesirable or unstable. However, there is nothing intrinsically wrong with either cross-border flows of goods and services or of capital and there is nothing inherently virtuous about having a current account position of zero –or 'in balance'. Indeed, a benefit of globalisation is that savers can seek the highest return, allowing for risk, on their savings available in the global market. The corollary of this is that capital is able to flow to where it will be most productively employed, leading to higher global growth than otherwise.

What is unusual about these capital flows is that they do not seem to have flowed in the direction of greater potential returns. As some have put it, the capital has flowed 'uphill' from the emerging or developing economies to the advanced economies. In particular, East Asian economies experienced significant capital outflows while the United States and a number of other English-speaking advanced economies experienced very large capital inflows. This article focuses on developments in saving and investment in the emerging economies of East Asia –not because these were the only economies with large current account positions, but because these positions were both large and of the opposite sign to that predicted by economic theory.

3| Why did the imbalances occur?

Much of the debate concerning the reasons for the existence of global imbalances focuses on exchange rates. The argument runs that a key group of current account surplus countries have reached that position by following a mercantilist strategy of maintaining an undervalued exchange rate in order to promote exports. Proponents of this view argue that the impressive growth in the foreign exchange reserves of East Asian central banks is indicative of efforts to prevent appreciation of their currency.

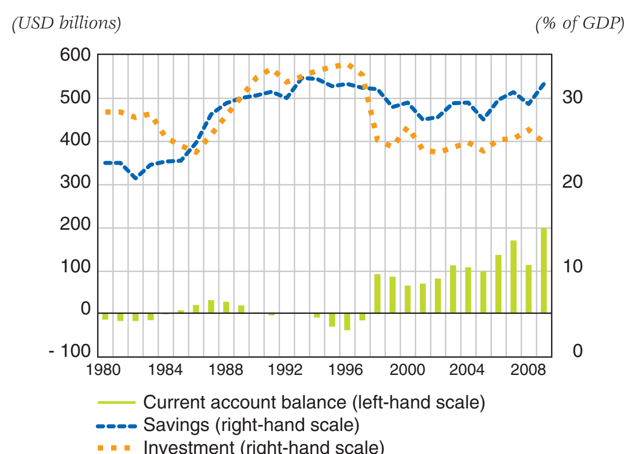
Exchange rates and intervention unquestionably played a role in the build-up of these imbalances to the extent that the current account imbalances would have been neither so large nor so persistent if exchange rates had been allowed to respond freely to the supply and demand forces implied by the current account.

But focussing on the role of exchange rates in influencing countries' export competitiveness ignores another aspect of this story. It is also important to consider the role of saving and investment behaviour.

Developing countries tend to have high saving rates due to a number of factors, including minimal social safety nets and underdeveloped financial markets providing limited opportunities to invest household savings. From a growth perspective, developing countries would ideally employ these savings and any extra funds available from overseas to boost investment (or indeed consumption, where this is particularly low). This was the case in eastern European countries in the years leading up to the financial crisis, where a rise in investment was funded largely by capital inflows.

The economies of East Asia have historically had high rates of saving. In the years leading up to the Asian financial crisis, the high share of saving was matched or

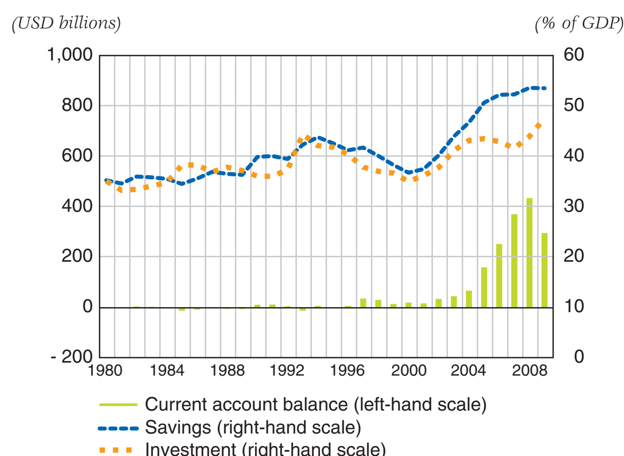
Chart 1
Asia a) – Savings and Investment



a) Developing and newly industrialised Asian economies excluding China and India.

Sources: IMF, RBA, World Bank.

Chart 2
China – Savings and Investment



Sources: IMF, RBA, World Bank.

even exceeded by strong investment (Chart 1). During and immediately after the crisis, however, investment dropped substantially as a share of GDP in a number of East Asian countries and has remained well below total saving in the years since. In retrospect, it seems that earlier levels of investment were not sustainable, or that some of the investment was of the wrong kind.

The fall in investment (in both absolute terms and as a share of GDP) in most East Asian economies –largely a result of the crisis– combined with little change in saving ratios was reflected in persistent current account surpluses from 1998 onwards. Policies played a role too because many countries decided –and were advised– to build higher levels of reserves as a form of self-insurance against volatility in capital flows. But more understanding is needed of why investment rates have remained so low.

In China, the story is somewhat different. Having not been badly affected by the Asian crisis, Chinese investment exhibited a steep upward trajectory over the period 2000 to 2005 (Chart 2). Thereafter it fell back slightly as a share of GDP as signs of overheating in domestic property markets encouraged authorities to introduce measures to curtail dwelling investment, amongst other things, but has since surged even higher. This rise in investment has, however, been surpassed by the increase in its saving ratio, which reached a peak of over 50 per cent of GDP in 2008. This sharp rise in saving is explained by higher saving rates across all sectors of the economy: a number of structural reforms encouraged increased saving by households; strong profits in the state-owned enterprises (which were not required to pass dividends on to the government) led to higher corporate saving; and government saving also increased. The notable divergence in Chinese saving and investment ratios in the period from 2005 onwards opened up a significant current account surplus. In the three years since 2004, the current account surplus tripled as a percentage of GDP.

In the period from the end of the 1990s, for differing reasons, therefore, East Asian saving ratios exceeded investment ratios. The 'excess' saving was in the order of 5 per cent of GDP for much of East Asia, though it increased to around 10 per cent of GDP in China in the year before the global financial crisis. This substantial increase in domestic saving over investment in East Asia, supplemented by sizeable excess saving in Japan, Germany and various oil exporting countries led to an ex ante excess of global saving over investment.

The substantial accumulation of foreign exchange reserves by East Asian economies in the five years or so leading up to the financial crisis exerted downward pressure on the yield of 'safe' assets, particularly in the United States. The very easy monetary policy stance of the major advanced countries that characterised some parts of the past decade was also of course a factor in lowering interest rates. Excess savings from surplus countries flowed to markets where demand for it was most sensitive to interest rate changes –that is, the United States and some other mainly English-speaking countries.

Unfortunately, much of this capital was not well used. The prolonged period of low interest rates drove investors in search of higher returns while the apparent stability of the low interest rate environment worked to convince investors that these higher-return investments were in fact less risky than they were. This tendency grew to the point where investors were purchasing complex products without understanding the associated risks –or indeed the composition of those same products. The seemingly endless supply of cheap capital also encouraged investors to take on greater leverage in the hope of enhancing their returns.

Compounding these difficulties, there was poor regulation and supervision of financial institutions in a number of countries. The growth of perverse incentives relating to financial products went unchecked: credit was extended to households that could not afford to pay it back and investors were sold products that had been created by parties with vested interests. Moreover, financial institutions in a number of countries grew so large that the cost to the home government of bailing them out placed severe pressure on public finances.

Ultimately, this ended badly. The explicit costs relating to the financial crisis are obvious, but when we consider the opportunity cost of this use of capital, the cost is even greater. Much of the capital appears to have ended up fuelling asset bubbles in some of the advanced economies, while it could have been used to boost productivity and thus standards of living in developing or emerging economies.

4| Where to from here?

To some extent, these 'imbalances' have been reduced over the past few years. Households in the United States have recently been saving a greater portion of their income, spending less on goods and services for immediate consumption (including imports). The increase in public spending has, however, outstripped the increased saving of households and led to an ongoing fall in aggregate saving. In Asia, and especially in China, private consumption has held up strongly despite the weakness in key export markets, providing evidence that these economies may be becoming a little less export-dependent and a little more self-reliant in sustaining growth. There has also been some currency appreciation in these countries since the crisis, although in a few cases Asian currencies remain below their pre-crisis levels. These developments have worked to reduce the current account positions of China and the United States in particular from their elevated levels (in absolute terms) of the immediate pre-crisis years.

This reduction in imbalances has, however, occurred in an environment where many countries in the advanced world have fallen a long way below full employment. Some of the effects mentioned above are potentially transitory in nature and may reverse once there is evidence of sustained growth. For example, although households in the United States appear to have saved more during this crisis, the important question is whether, once growth picks up, households will become less cautious and resume their previous spending behaviour. The task then is to try to have a more balanced allocation of saving around the world at a position of full employment.

A long-term solution will require a higher degree of international co-operation than was observed in the past. It will require more flexibility in exchange rates for key emerging market countries such as China. It may require lower saving from disposable income in some Asian countries, possibly through higher wages. But it would be desirable for it to involve higher investment rates in some cases. Finally, it will also require higher rates of saving out of current income than a few years ago in key advanced economies, including by households in some cases and by governments in most cases.

So it is likely that a full resolution of the imbalances will take quite some time. Deep-seated attitudes to the desirable rate of saving, degree of exchange rate flexibility and extent of financial account openness are likely to be slow to change. A sustained fall in saving ratios in East Asia will depend to some degree on further increases in living standards and the extension of social safety nets. Moving towards more exchange rate flexibility and financial account openness will require the continued development of domestic financial systems to allow for the appropriate management of risk and the channelling of capital to productive rather than 'speculative' ends. A sustained increase in American household saving that endures into the next boom period will require a distinct change in attitudes to consumption; an increase in public saving in the United States will also be needed. These changes are not impossible to achieve –but it will not be an overnight process.