

## **Villains and victims of global capital flows**

By Martin Wolf

Published: June 12 2007 19:19 | Last updated: June 12 2007 19:19

Fast growth, huge current account “imbalances”, low real interest rates and risk spreads, subdued inflation and easy access to finance characterise the world economy. Is this party about to end? Probably not. But to identify the risks we must first decide what drives the strange world economy we see around us.

The two interesting alternative explanations are the “savings glut” and the “money glut”. Both share common themes: globalisation; the revolution in finance; the rise of China; low inflation; and macroeconomic stability. Beyond this, however, they diverge. In particular, they reverse the role of victim and villain: in the savings-glut story, the thrifty are the villains and profligate the victims; in the money-glut story, it is the other way round. This is a contemporary version of the old Keynesian versus monetarist dispute.

The “savings glut” hypothesis is associated with Ben Bernanke, now chairman of the Federal Reserve. But the idea was floated earlier by others. Brian Reading, of Lombard Street Research, lays out the line of argument in a recent note\*. A substantial excess of savings over investment has emerged, he says, predominantly in China and Japan and the oil exporters (see chart). This has led to low global real interest rates and huge capital flows towards the world’s most creditworthy and willing borrowers, above all, US households. The short-term effect is an appreciation of real exchange rates and soaring current account deficits in destination countries. To sustain output in line with potential, domestic demand in those countries must also be substantially higher than gross domestic product. A country must choose fiscal and monetary policies that bring this result about.

Not only has the US absorbed 70 per cent of the rest of the world’s surplus capital, but consumption has accounted for 91 per cent of the increase in gross domestic product in this decade. Thus excess saving in one part of the world has driven excess consumption in another.

What Mr Reading calls a “liquidity tsunami” is the result of the savings glut. Low nominal and real interest rates encourage robust credit growth, a worldwide shift into risky assets and compression of risk spreads. Hedge funds and private equity boom as investors seek high returns, though buoyant asset prices and low real interest rates decree the opposite.

In the savings-glut world, governments are responsible for much of the capital outflow. This is either because domestic residents are not allowed to hold foreign

assets (as in China) or because most of the export revenue accrues to governments (as in the oil exporters). Either way, governments end up with vast foreign currency assets as the counterpart of domestic excess savings.

In this world, the US is passive victim, excess savers are the villains and the Federal Reserve is the hero. In the money-glut world, however, the world's savers are passive victims, profligate Americans are villains and the Federal Reserve is an anti-hero. In this world the US central bank is a serial bubble-blower, has distorted asset markets and visited excess monetary emission on trading partners around the world, above all, on those who seek monetary stability through pegged exchange rates.

This is the line of argument of Richard Duncan, a well-known financial analyst\*\*. The argument is that US monetary excess causes low nominal and, given subdued inflationary expectations, real interest rates. This causes rapid credit growth to consumers and a collapse in household savings. The excess spending floods across the frontiers, generating a huge trade deficit and a corresponding outflow of dollars.

The outflow weakens the dollar. Floating currencies are forced up to uncompetitive levels. But pegged currencies are kept down by open-ended foreign currency intervention. This leads to a massive accumulation of foreign currency reserves (up \$3,445bn between January 2000 and March of this year). It also creates difficulties with sterilising the impact on money supply and inflation.

In this view of the world economy, savings are not a driving force, as in the savings-glut hypothesis, but a passive result of excess money creation by the system's hegemonic power. Profits (and so measured corporate savings) rise simply because of increased exports and output under economies of scale. Governments of countries that possess the huge trade surpluses then follow the fiscal and monetary policies that sustain the excess savings needed to curb excessive demand and inflation.

It is no surprise that the Federal Reserve is a believer in the savings-glut hypothesis. But many Asians blame their present predicament on "dollar hegemony", which is the core of the "money-glut" hypothesis. The big questions, however, are which is true and whether it matters.

My answer to the first is that the savings-glut hypothesis is truer, for several reasons. First, monetary growth in the US is not unreasonably high. Second, inflationary expectations in the US have remained contained, as real interest rates have started to rise. Third, the weakness of the US dollar looks modest, though that is distorted by the interventions. Fourth, it is hard to believe that the soaring savings in Asia and the oil exporters are passive responses to excess

demand from outside, rather than deliberate choices. Finally, the pegged rates themselves are policy choices.

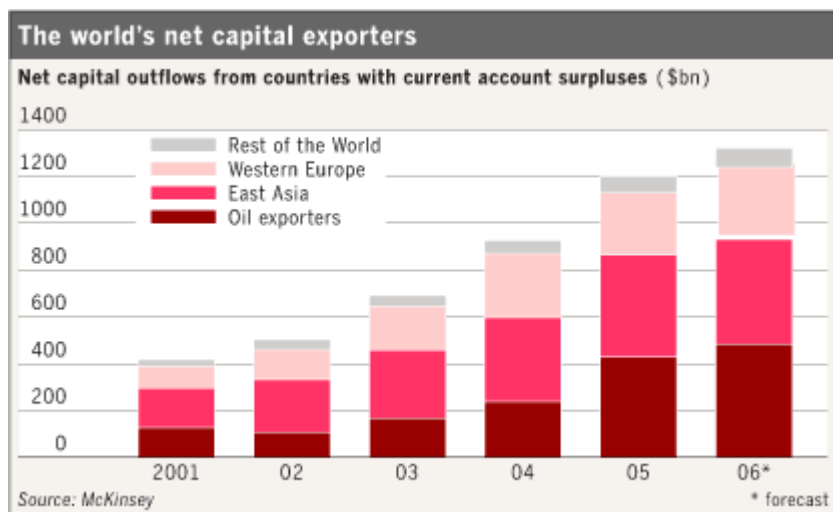
My answer to the second is that indeed it does matter. If we live in the savings-glut world, the US current account deficit is protecting the world from deep recession. If we live in the money-glut world, that very same deficit is threatening the world with a dollar collapse and, ultimately, even a return of worldwide inflation.

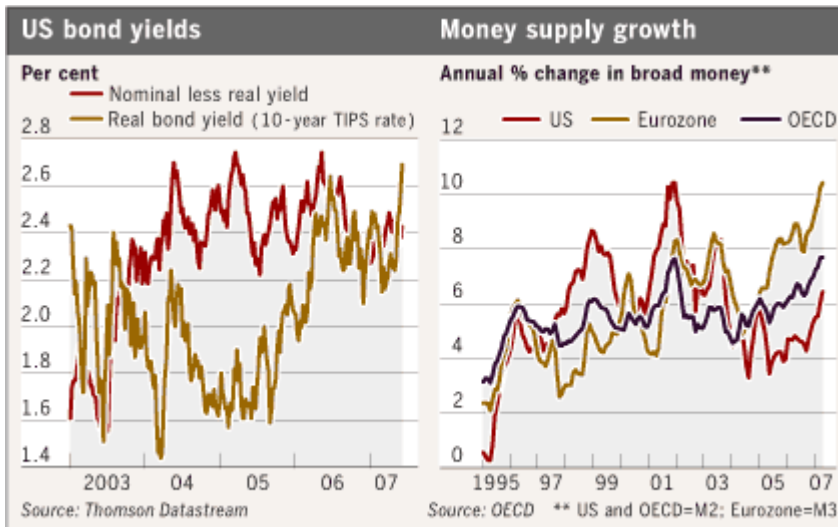
The savings-glut view is far more comforting. Excess savers will learn to spend, in the end – sooner rather than later, if US spending were to weaken dramatically. But if we live in the money-glut world, the great gains in monetary stability of the past quarter century are at risk.

Either way, the present world cannot continue indefinitely. Moreover, either way, it makes little sense for emerging-market economies to write a blank cheque to the US. The era of massive currency intervention and dependence on excess spending by US households must end. Might that end be nigh?

\*Monthly Review 216, June 2007, [www.lombardstreetresearch.com](http://www.lombardstreetresearch.com) (subscribers only) \*\*The Dollar Crisis: Causes, Consequences, Cures, John Wiley & Sons, 2003

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