Globalization and the U.S. Economy

Statement before the U.S.-China Commission

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New York, May 19, 2005

Increased economic interdependence with the rest of the world has many dimensions. I will focus today mainly on financial interdependence, although as we shall see that also has important implications for trade. World exports of goods and services now amount to around $8 trillion a year. The foreign exchange markets clear around $1.2 trillion per day. Hence most transactions across currency markets are purely financial, and these transactions determine the value of floating exchange rates in the short and even medium run.

The rich world – especially Europe and Japan – is ageing, both because of increased longevity and because of declining birth rates. The latter imply eventually declining labor forces, unless offset by immigration, and declines in new household formation. The demand for housing, a large user of capital in all economies, will remain low in these ageing societies, especially in Japan and Germany, the second and third largest national economies after the United States. A decline in the labor force also implies less need for capital investment to equip new workers; some capital for labor substitution will occur, but that will push returns to capital even lower than they are now. The excess of savings over investment in these countries helps to explain the low real long-term interest rates around the world. Some of the excess savings is absorbed in government deficits, which are relatively high in both Japan and Germany, but much of it goes into investment abroad, resulting in the large current account surpluses of these two countries, which together amounted to nearly $300 billion in 2004. This is in fact a sensible disposition of savings if people want to save for their retirement when returns to domestic investment are low.

Much of this excess saving in the rest of the world comes to the United States; it exceeds investment abroad by Americans, and accounts for the large current account deficit of the United States, now running at over five percent of GDP. Why does this saving come to the United States rather than going to emerging markets, where returns should be expected to be higher? The answer is complex. Some of it does go to emerging markets, but those countries at present, as a group, also have excess saving. Since the financial crises of the 1990s, risk-averse investors, especially in Japan and Europe, have been reluctant to invest significantly in emerging markets outside central Europe, which has largely joined the European Union. Returns in emerging markets are not only volatile, but on the basis of recent experience in Russia and Argentina, may be insecure from political or legal action as well. Also, some emerging markets, notably

China, have high domestic savings rates themselves, more than enough to cover their requirements for domestic investment.

The United States in contrast has investment opportunities that produce higher yields than Japan and Europe, and that are more secure and reliable than investments in many emerging markets. Moreover, the US economy is large, accounting for a quarter to a third of the world economy (depending on the exchange rate used for adding up GDPs in national currencies around the world), and has especially well developed financial markets, accounting for half of the world's marketable securities. It is not surprising, then, that funds from all around the world are invested in the United States (although Australia, Britain, and Canada, while much smaller than the United States, share some of its other desirable characteristics, and are also destinations for much foreign capital).

When private foreign investment slackens, as it did after 2001, foreign official investment often takes up the slack. There has been a huge build-up of foreign exchange reserves in 2003-2004, especially in East Asia but also elsewhere, such as India and Russia, as a by-product of exchange rate policy or more generally of macroeconomic policy in those countries. Budget deficits have reached practical limits in Japan, and are constrained by the Stability Pact in Germany (and France and Italy), which has exceeded its three percent of GDP limit for several years. China is over-heated, and requires some fiscal tightening, despite large infrastructure needs. That would tend to increase China's already high national savings and modest current account surplus, not reduce it. Private savers in Japan are highly risk averse. The Bank of Japan is in effect providing foreign exchange cover for private sector savings, which from households continue to go heavily into the low-yield postal savings system. In China, residents cannot legally invest abroad without specific authorization (which is increasingly given for foreign direct investments). Again, official investment abroad through the People's Bank of China occurs when private investment cannot take place. But the latent demand among China's newly well-to-do citizens for overseas investment, especially in the United States, is undoubtedly high.

These are consequences of financial globalization. These inflows into the US economy are often said to be "financing" the US current account deficit, which reached $666 billion (on preliminary figures) in 2004. That is true only in an accounting sense. The motivation, certainly for the private flows, more controversially for the official flows, is investment in the United States. Americans have accommodated this excess saving abroad by importing much more than they export. Although eventually the savings in Japan and Europe will probably fall, as those societies increasingly age, the current configuration can endure for many years (see my paper on the sustainability of the current account deficit). They are mutually beneficial so long as the United States generates productive assets for sale to foreigners, in financial forms that yield less than the underlying investment yields. The problem at present is that the United States is producing in abundance financial claims, in the form of US Treasury securities, that are attractive to foreign institutions but that do not support an increase in the productive assets of the United States. They thus represent a claim on the unaugmented future income of Americans. If we want to reduce these claims, increase national savings, and encourage greater private investment, we need to take serious steps – more serious than simply proposing cuts in programs with strong Congressional and public support – to reduce the federal budget deficit.

In summary, the United States has a revealed comparative advantage in today's increasingly globalized world in producing highly desired financial claims, to the mutual benefit of foreigners and Americans alike so long as Americans invest the proceeds in productive assets.