

The Blind Man and the Elephant: Competing Perspectives on Global Imbalances *

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Thank you very much; it is a pleasure to be with you again. At least on one prior occasion Il SaKong has enticed me to give one of these breakfast talks. In the U.S. and Europe, there is a debate about working hours. We talk about how Americans on average work 1,800 hours a year, and Europeans only work 1,500 hours. The question always asked is: whose society and labor market is inefficient, given this gap? Next time I hear this debate, I will be reminded of Korea, where breakfast meetings are the norm.

My topic this morning is the familiar problem of global imbalances. This problem is a subject of several wildly different interpretations. Today I want to draw to your attention four very different interpretations of the phenomenon with very different implications for economic policy and future prospects for the world economy.

This observation that different people interpret the phenomenon differently is not original to me. There is a well-known economist at New York University, Nouriel Roubini, famous above all for his website, who an interesting paper in which he likens the existence of different perspectives on this issue to the Kurosawa film *Rashomon*. If you recall Kurosawa's scrip, a murder takes place in the forest, and four different people give their accounts of what happened. According to Kurosawa, these accounts are self-serving--they serve the interest of the person who tells the story; similarly, there may be an element of this in how different people describe the problem of global imbalances. Americans say "it's not our fault" - that global imbalances result from behavior in the rest of the world - while residents of the rest of the world argue the contrary. Roubini in his analysis concludes that there is only one accurate interpretation of the phenomenon.

My point this morning is different. I will argue that there is some validity to all four of the important interpretations of the phenomenon. Consequently I will suggest that that *Rashomon* is not the right metaphor for this problem. Instead, I prefer the fable of the blind men and the elephant. In this fable, you will recall, each of the blind men touch a

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different part of the elephant and interpret what they're feeling in a different way, where in fact they are all accurately describing a small part of the larger reality. That is similarly my view of the problem of global imbalances and its competing interpretations.

The easiest way of understanding the compatibility of the views is to recall basic balance of payments accounting, according to which a country's current account balance is simply the difference between its savings and its investment. The current account deficit of the United States is the difference between U.S. investment and saving by definition. Similarly, the current account surplus of the rest of the world is the excess of its saving over its investment, again as a matter of definition. This leads to four ways of thinking about the problem of global imbalances: in terms of U.S. saving, U.S. investment, rest-of-world saving, and rest-of-world investment.

The first view focuses on the decline in the national savings rate in the United States since the beginning of the present decade. It observes that when national savings go down, other things equal, there will be a matching deterioration in a country's current account balance. Proponents of this view observe that the sum of household savings, corporate savings and government savings has fallen to 13% of GDP on the IMF's measure, down by almost 4 percentage points from the average of 1983-2000 and barely half the levels prevailing in the rest of the world. Observers like Roubini blame the current account deficit on this decline in savings, and they attribute the latter to the deterioration in the fiscal position. They observe that a decline in public savings like that which has occurred in the U.S. in the last 5 years, during which there has been a swing in the fiscal balance from + 3% of GDP to - 4% of GDP, will lead to a matching decline in national savings and a matching deterioration in the country's current account balance, other things equal. They observe that the fiscal balance and the current account balance in the United States have deteriorated in tandem.

Critics of this view object that there is only a weak correlation in time series data between movements in the budget balance and the current account balance, while defenders acknowledge this but observe that both variables can be affected by other shocks. There is no reason, in the presence of those other shocks, why those two variables need to move in lockstep. More troubling is the fact that most of the fall of gross private savings rates in this period has reflected not changes in public saving but changes in household savings. Household savings in the U.S. on the conventional measure are approximately zero (not taking into account capital gains on assets as part of household income). More troubling

still, in a period when the government budget moves into deficit, standard economic logic -- what economists refer to as Ricardian equivalence -- suggests that household savings should go up to offset dissaving by the government, when in reality both variables have moved in the same direction. Most troubling of all, if the problem is deficient savings in the U.S., then real interest rates should be high, where instead we have the Greenspan conundrum, the fact that real interest rates are surprisingly low. Evidently, something else is going on.

The second view of the current U.S. account deficit argued by economists like Richard Cooper at Harvard and Richard Clarida of Columbia, is that the U.S. deficit reflects the attractions of investing in the United States. U.S. consumption exceeds U.S. production because Americans disproportionately benefit from the high return on investment in the country. These high returns have nothing to do with fiscal or monetary policy; rather, they reflect the fact that the U.S. has experienced a productivity miracle in the last ten years. Actually, the story is a bit more complicated. Since foreigners can accumulate claims on the U.S. without driving the current account into deficit, if Americans at the same time accumulate claims on the rest of the world, this story requires a change in investment behavior not only on the part of foreigners seeking to invest in the new economy of the U.S. but on the part of Americans as well. Here observers point to the flexibility of U.S. markets compared to Europe in particular and argue that the current U.S. account deficit reflects the capital inflows into the U.S. which are themselves a function of the attractiveness of investing.

In fact, the data provide only weak support for this hypothesis. Data since the mid-1990s do show modest acceleration of productivity growth in the U.S., both absolutely and relative to Europe, on the order of about 1/2 of 1% a year. May there is a U.S. productivity miracle, but 1/2 of 1% may just be rounding error, something that will be eliminated in subsequent data revisions. This makes it hard to say with confidence that there has been a marked acceleration in productivity growth in the U.S. relative to Europe, making the U.S. correspondingly more attractive and producing the current account deficit that we see today. In addition, there has also been a productivity acceleration in other parts of the world, China, for example, which again makes it hard to argue that the reason the U.S. can afford its current account deficits is because foreign investment in the U.S. is unusually productive and rewarding.

The third factor that can explain the U.S. account deficit is foreign savings. This is the

global savings glut view of authors like Ben Bernanke, chairman of President Bush's Council of Economic Advisors, and Glenn Hubbard, one of Bernanke's predecessor's in that position. These authors agree that demographics, rapid growth, high oil prices and financial development in the rest of the world have combined to boost savings rates outside the United States. In particular, they argue that in Asia ex-Japan, low dependency ratios are boosting savings rates, as predicted by the life cycle model. The limited availability of consumer goods results in China saving more than 50% of its GDP if one believes the conventional statistics about China. All this saving then has to go somewhere. One of the places it goes is to the U.S., which conveniently has low savings rates and can make good use of foreign saving seeking an outlet.

But here again we have an evidentiary problem. If one goes to the standard sources and computes global savings rates, one finds that these are flat over the last 7 years. As I calculate them, gross worldwide savings rates were 24% in 1997, 23% in 1999, 23% in 2001, and 24% in 2003. They may have been rising and falling slightly over time, but these fluctuations may simply be rounding error. In other words, at the global level there doesn't seem to be a noticeable shift savings rates.

In fact, the most significant factor in the emergence of Asia's large current account surplus in the last 8 years has been the fall in investment rates. (You will see that I have now moved to the fourth approach to thinking about the U.S. current account deficit, which focuses on investment in the rest of the world.) Leaving aside China, these have fallen by almost 9% of GDP. Savings rates, meanwhile, have barely budged. And to the extent that they have moved, they have moved in the wrong direction, from an average of about 33% down to about 31% in the first half of this decade in Asia ex-China-and-Japan.

A key question as we think of the sustainability of the current pattern of global imbalances is whether this fall in Asian investment rates is temporary or permanent. Some of it is clearly a temporary phenomenon associated with the Asian crisis and the extended downturn that followed, reflecting financial sector disruptions and political uncertainties in countries like Indonesia. But the fact is we are now 8 years past the crisis, and investment rates are still down. Some people would argue that significant share of investment occurring in the first half of the 1990s was inefficient and that Asia is now better off without it. Bangkok in 1996 was building skyscrapers that would never be occupied. This inefficient investment has disappeared permanently as the Asian economies mature, develop domestic demand, and obtain a better balance of

consumption and investment.

Another way of putting this is that Asian countries are now running their economies under less pressure of demand. Instead of doing whatever is necessary to sustain high levels of investment, governments are running balanced budgets and accumulating reserves. This may be a good thing insofar as it reflects the realization that the world is a risky place, that financial sectors are fragile, and that accumulating a war chest of reserves may be a prudent investment. If this is one's view, then the implication is that the decline in investment rates in Asia from the very high levels of the first half of the 1990s may be permanent.

This perspective is also known as the Bretton Woods II hypothesis. This is the idea that the trans-Pacific current account balance persists because Asian countries are happy to be in persistent surplus and to finance the ongoing deficits of the United States. Some of those who say this trans-Pacific balance can go on for 20 years or longer argue that Asian countries, China in particular, will remain dependent for the foreseeable future on exports as an engine for economic growth. China and its neighbors will wish to retain undervalued exchange rates against the dollar to stimulate their exports, and a result of that undervaluation will be persistent current account surpluses for Asia and deficits for the United States. Americans are perfectly happy with this state of affairs, because we are then able to live beyond our means.

I am not so sure. This story runs off of the importance of exports for learning by Chinese managers and entrepreneurs, who derive benefits from export-led growth. Exporting merchandise and importing FDI leads to important organizational and technological spillovers, the argument goes. But, in fact, Chinese managers and enterprises are increasingly learning how to raise efficiency in sector producing nontraded as well as traded goods. They don't need joint venture partners in order to do this. Even now, learning is not contingent on exporting to the same extent as in the past.

These, then, are the four views of the global imbalance, focusing respectively on U.S. savings, U.S. investment, and savings and investment in the rest of the world. My point is that they are really four different aspects of the same elephant. That is to say, they all contribute in some way to the U.S. current account deficit. A complete account of the deficit's emergence and persistence must include roles for the budget deficit and other policies: in addition to fiscal policy, it would have to emphasize the role of monetary

policy (the low interest rates of the last five years) in encouraging household borrowing in the United States. There is a role for rapid productivity growth, either the reality of rapid productivity growth or at least the hope that the U.S. is experiencing a productivity miracle, and therefore for the idea that the U.S. is an attractive place for foreigners to invest. There is a role for demographic, financial, and macroeconomic factors making for high savings rates in the rest of the world. There is a role for changes in investment behavior in the rest of the world.

If the U.S. deficit has no single cause, it is unlikely to have a single solution. And the fact that the causes are not just a productivity miracle that has permanently increased the appetite of US foreign investors for claims on the US economy implies that there will have to be an adjustment towards a smaller deficit in the United States sooner or later. Deficits of the current magnitude, 7% of GDP, cannot continue indefinitely. A sustainable account deficit for the US is less than half that size, and getting there will require major adjustment. It will require major changes in the price of the dollar in terms of other currencies. And this in turn may pose difficulties to financial markets, both US financial markets and global financial markets.

Ideally, this adjustment would begin relatively soon so it could occur gradually over time and its consequences can be digested smoothly. And ideally it would be smoothed by supportive changes in the rest of the world. It is likely that the demographic factors supporting high savings rates in Asia will not persist much longer. In China, for example, the share of working aged individuals in the total population will peak relatively soon - depending upon whose forecasts you believe, as early as 2010. We know that as there are more retirees, savings rates will decline. If Chinese and other foreign households consume more, which is an implication of these demographic changes, the slowdown in demand growth that will occur as a result of lower U.S. spending will be easier to absorb and it will not necessarily precipitate a global recession.

Similarly, as China and other Asian countries develop their financial markets, it will become easier for households to borrow to acquire real estate, purchase consumer durables, and finance the higher education of their children, relieving them of the need to first accumulate large nest eggs. As structural change becomes more predictable, Chinese households will have less incentive to save in order to protect themselves against the job insecurity associated with rapid structural transformation of the economy. Changes in real exchange rates that raise consumer spending power in China and elsewhere in Asia will

similarly be useful for maintaining global demand as US demand contracts. Meanwhile, investment in East Asia outside of China may now begin to rise back towards the higher levels of the early 1990s. If Japan is now truly on the verge of a sustainable recovery, both consumption and investment spending will increase. Maybe someday structural reform may even boost investment rates in Europe, which would also be a constructive development from the points of view of global growth and global imbalances.

That's the rosy scenario. It suggests that growth and demand in the rest of the world will pick up at the same time that growth and demand slow in the United States. The result will be happy for all involved.

There is also the grim scenario, where things don't turn out so happily. In this scenario, investors in the rest of the world grow worried about the external deficits of the United States and foreign financing dries up before the smooth adjustments have time to take place. This causes US bond prices to fall and long-term interest rates to rise. The dollar falls sharply, creating fears of import-price inflation that force the Fed to raise interest rates. Sharply higher interest rates suck the air out of the real estate bubble, and with housing prices stabilizing or even declining, U.S. consumption spending slows abruptly.

Some people will say that foreign central banks are too smart to let this happen, that they are too committed to stabilizing the dollar at its current level and preventing this sudden disruptive adjustment from occurring, and that they will continue to buy all the additional US treasury bonds that the U.S. government is pouring into world markets. I've argued before and am prepared to argue again this morning that this confuses their collective interest with their individual interest. As a group, Asian central banks are interested in keeping the dollar up and Asian currencies down by buying US treasury bonds. However, they each have an incentive to diversify out of dollars in order to avoid capital losses. If you recall the controversy earlier this year about whether the Bank of Korea was actively diversifying its reserves, you will recall how rumors of this excited the markets. You can also imagine how news of action by one or more Asian central banks to limit their exposure to capital losses on dollar denominated assets could precipitate a flight from US treasury bonds.

What can governments do to maximize the likelihood of the happy scenario? They can see that adjustment begins soon, before US external liabilities grow even heavier and the fall in the dollar required to narrow the current account balance grows even larger.

Emerging Asian countries need to allow their currencies to appreciate steadily against the dollar. The same real appreciation can be achieved by domestic inflation, which would not be good for stability, expectations, and investment, or it could occur through currency revaluation. I would like to see revaluation supported by expansionary fiscal policies; there is scope for this in Korea, and in China as well. The Chinese government should direct additional government toward health care for the population rather than Maglev trains from Shanghai City to the airport. It should devote more fiscal resources to social services and education. If it do, then there is room in China for expansionary fiscal policy.

Europe and Japan, for their part, need to resuscitate investment spending, continue their efforts at structural reform, and adopt more investment-friendly policies. Europe particular has the wrong policy mix of expansionary fiscal policy and restrictive monetary policy. And the ECB will relax only if governments first take action on the fiscal front.

Most importantly, the United States needs to address its fiscal problem. Even if reducing the budget deficit doesn't reduce the current account deficit one for one, fiscal consolidation can still make an important contribution to restoring international balance. Going forward, the United States will have growing expenditures on healthcare and social security for the elderly. There will be continuing homeland security and terrorist related expenditures. For better or worse, we are also fighting an expensive war in Iraq. All of those are grounds for thinking that what the United States needs is revenue enhancement. (in other words, higher taxes).

So what probabilities do I attach to the grim scenario. At the moment, my point estimate is about 0.3. On that happy note, I would be pleased to take your questions.

Questions & Answers:

Q1 As we sit far away from the U.S. economy and you sit close by it, you commented on the attractions of investing in the US. If that investing were into the real economy, it would presumably show up in the fixed investment element of GDP as a gross figure, and if one netted out the capital recovery through appreciation, (though you didn't comment if this investing in the U.S. is really going into the real economy) is it showing up in the GDP numbers as it did in Asia when these economies were over investing? Or is it simply a derivative of the fact that capital keeps flowing into the US, so we have to assume that

people want to put their money there?

Q 2 Of the four major factors that you talked about, if you pick up one strong single element of cause—U.S. deficit—which is definitely what U.S. government can execute between the administration and the congress now, you mentioned that 7% current account deficit cannot go on forever, how long do you think it can go on before it becomes a major problem?

Q 3 I have two questions: If you take the retained profit of the U.S. multi-national corporations operating all over the world including China and Asia, how does the picture come out as you described based on the four billion or so reported. And I am wondering how this retained profit of the US multi-national corporations properly is reflected in the US current account mechanism.

In 1985 we faced a similar kind of global imbalance issues between the US and Japan. The rapid Yen appreciation had not helped the U.S. to mitigate a fiscal and current account deficit issues. This time, I think with the U.S. pressure with Chinese authorities, it is very hard to revalue the renminbi, and I think China's move to revalue by just 2% is a cosmetic response to U.S. pressure. To what extent do you think China will continue this re-evaluation policy of the floating exchange rate mechanism?

A The first question concerned the behavior of investment and other components of aggregate demand in the United States. The evidence suggests that the behavior of investment in the last four years has been rather typical for the expansion phase of the cycle. What is unusual is the behavior of consumption, the high level of household consumption in particular. Advocates of the view that there is a productivity miracle in the United States say that American households consume so much because they are so rich. They live in a New Economy where they benefit from faster productivity growth; the expectation of higher future incomes leads them to live more lavishly today. As you know, I am skeptical that the New Economy exists or at least that it is of first-order importance. I don't think that current levels of consumer spending and current rates of increase in household debt can continue indefinitely. I worry that a sudden drop in housing prices could bring this to an end, which would be recessionary in the United States and bad news for all of us.

Recall also that most of the financing for the U.S. current account deficit in the last couple

of years has been foreign central bank purchases of U.S. assets. Private investors aren't buying. Evidently, they are not convinced by the New Economy view either.

How long can the current situation continue? It is traditional at this point to channel Herb Stein who says something that cannot go on forever will not. For some time now I have been arguing that the current situation can't last much longer. Sooner or later I'll be right.

Concerning returns on U.S. foreign investments, the interesting aspect of this is that U.S. foreign investments consistently yield a much higher rate of return than foreign investments in the United States. This allows the U.S. to run larger current account deficits than it could otherwise. But foreign investors will catch on to this sooner or later, so this "exorbitant privilege" is unlikely to persist. If so, this will be yet another reason why there will have to be current account adjustment.

Finally, the 64,000 renminbi question: what will China do with its exchange rate? I should divulge that I was at the Federal Reserve Bank of Kansas City's annual conference in Jackson Hole last weekend. The governor of the People's Bank of China was also there, and I had the pleasure of traveling with him all the way from Jackson to Denver, San Francisco and Beijing. Alas, I am no more certain than before about what the Chinese Government and the PBOC will do about the renminbi. Evidently, there is speculation that they will decide in favor of another step revaluation to head off the reemergence of protectionist pressure in the U.S. Congress. Personally, I think this unlikely. In China it is mainly political officials, not economists, who decide these things. Chinese officials have a preference for moving in small steps, for first seeing whether a small adjustment is consistent with continued growth. I think they will continue to move in baby steps, which may be problematic because helping to rebalance the world economy may require rapid adjustment.

Q I think our audience would be interested in hearing Alan Greenspan's comments, as I'm sure they read the report on the Jackson Hole meeting and what he said there. Already, he warned the danger of bursting the housing bubble. But since you were there, you could share Mr. Greenspan's opinion, which I think is a rather optimistic one. A few months ago, I had the opportunity to visit him, and he was saying although this U.S. current account balance is increasing and is reaching dangerous levels, he still maintained that the flexibility of the U.S. economy and resilience of the financial market adjustment

would be smooth, and I suppose he would think the same here.

My second question is regarding the mood in the U.S. Congress towards some of the governments like China. You must've read Dr. Bergsten's article in the Financial Times where he said unless China has additional 10% of renminbi appreciation, the chances are such that the U.S. Congress will impose a 5% tariff on goods coming in from China. What do you think the likelihood of this happening is?

A I can afford to be blunter than Mr. Greenspan because I am not a central banker. At Jackson Hole, he laid out the rosy scenario of smooth adjustment, which is what a responsible central banker should do. Specifically, the scenario he laid out is one in which the rate of increase of housing prices moderates. Prices simply stop rising, or they fall by at most 10% over a period of 5 years. In response, U.S. consumption spending grows more slowly. But, since it continues to grow, the current account deficit narrows without precipitating a recession. In talking up this scenario, Mr. Greenspan is attempting to increase the likelihood that it will occur. While he and his successor may succeed in engineering a soft landing, I would have preferred to see them supplement their open mouth operations with open market operations. In other words, I would have preferred it had the Federal Reserve normalized the level of interest rates more rapidly over the last three years. Now, in the wake of Hurricane Katrina, the Fed has less room for maneuver.

Turning to the mood in the U.S. Congress, it is clearly worrisome. It worries me that some of the people who are aggressively pushing for action against China, like the senior senator from New York, Charles Schumer, are not from parts of the country that are suffering from competition coming in from China. New York being a financial center, you would think that its senator would be a staunch supporter of openness. That's where the support for openness would come from. All this suggests that unhappiness with China in the U.S. Congress is quite widespread.

Q Thank you once again for your very enlightening review of the current state of debates. You assigned a role to each of the three regions of the world, but as far as you and the U.S. are concerned, the indications of some of the relative developments including the referendums fiasco in Europe and the basic positions of this current Bush government seem to indicate that none of those things that you think should happen will happen unless changes do take place which do not seem to be in the pipeline

About Japan, if anything happens, it always happens so tantalizingly slowly that we cannot expect anything tangible out of Japan in the immediate future at least. So the only key player who could play a constructive role could be China. But I worry about the efficacy of the adjustment only by Chinese governments. In other words could all these problems be solved, if only China would concede to U.S. demands for re-evaluation? I doubt that it would work. So that's my question, suppose, as requested by U.S. and European countries, China did act, even if it would act, it probably wouldn't have lasting effects on solving this global imbalance. In other words, there would have to be coordinated actions, but the coordinated actions by the three parts of the world don't seem to be coming, in that way, could we go for a much higher probability than 23%?

My second question is a bit broader one. It has been five years since the so-called Chiang Mai Initiative was launched toward financial cooperation and my general understanding of your position has been that by and large you are pessimistic about the outcome of these efforts that are in progress. And so as of today how do you assess the current state of the financial and monetary cooperation or debate on that in East Asia?

A Fiscal adjustment in the United States is the single most important factor that could enhance the likelihood of a smooth rebalancing of the world economy. That said, there is still the slim possibility of a nonrecessionary adjustment even in the absence of action on the fiscal front. As Mr. Greenspan explained at Jackson Hole, if the housing market moderates gradually, consumer spending in the US may simply grow a bit more slowly. Consumer demand won't tank, but it will grow more slowly than production, and the shrinking gap between U.S. spending and U.S. output will create room for current account adjustment. So the probability of smooth adjustment is greater than zero even in the absence of fiscal adjustment. I would be more optimistic if I saw that fiscal adjustment in the cards. Alas, I do not.

I do see the irony in the Bush Administration's view that a problem heavily grown in the United States should be solved in China. Still, there is no way around the fact that China, and Asia more generally, have to play a role in its solution. Let me give you the arithmetic as I see it. The U.S. account is going to have to shrink from 7% to 3% to restore sustainability and keep foreign holdings of U.S. assets as a share of foreign GDP from exploding. In turn this will require the dollar to fall by at least 20%. Say that half of that can occur this year, and that the other half can occur next year. In other words, the

dollar needs to drop 10% this year and 10% next year. Most of that adjustment is going to have to occur against Asian currencies, since the Asian economy is stronger and growing more quickly than the European economy. The U.S. trades roughly equally with Europe and Asia. So for the dollar to fall by 20%, it has to fall by 15% against Asia and 5% against Europe. Unavoidably, then, there is still a big adjustment of Asian currencies against the dollar to come. It will not be comfortable, but it is unavoidable

On the Chiang Mai Initiative and regional integration, I will admit to having been surprised by the speed with which monetary and financial cooperation has developed in Asia. I was skeptical about the prospects because of Asia's history of political tensions. I didn't think the political preconditions that prevailed in Europe also existed in Asia. All this suggested to me that Asia would find it harder to move forward with monetary and financial cooperation. A more positive spin is that Asia can move forward but it must do so in a different way because the political and economic context is different. Still, the fundamental question is whether Asia really has the appetite for deeper integration. The proof of the pudding is in the eating. Now that the Indonesian rupiah is under pressure, will we see activation of the swaps and credit lines of the Chiang Mai Initiative? Is regional solidarity sufficient to motivate concrete steps by other countries to support the rupiah? By the next time I am here, we may have accumulated considerably more evidence on the prospects for regional cooperation.

Thank you very much.