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It is a fact that investment in America exceeds the sum of private and public saving, with the balance being funded by foreign accumulation of U.S. financial assets. With total investment at about 17 percent of GDP, private savings of 14 percent of GDP, and a budget deficit (negative public saving) around 3 percent of GDP, a current account deficit of 6 percent of GDP is unavoidable. This is fact. But it is not an *intrinsically* interesting fact.

Three economic questions are posed by this fact.

First, would policies to raise "national saving" reduce the current account deficit and reduce or eliminate reliance on foreign creditors, and would such measures be desirable if they were available?

Second, does an inadequate "supply of saving" constrain investment, either directly or through the interest rate, and would a higher rate of investment be desirable if it could be obtained?

Third, does the accumulation of U.S. financial assets abroad pose unacceptable risks to the performance or the security of the American economy, and if so what is the nature of those risks and what might be done to reduce them?

Former Secretary of the Treasury Robert Rubin expressed the anxieties underlying these questions in the *New York Times* on May 13, writing:

> "Virtually all mainstream economists agree that, over time, sustained deficits crowd out private investment, increase interest rates, and reduce productivity and economic growth. But, far more dangerously, if markets here and abroad begin to fear long-term fiscal disarray and our related trade imbalances, those markets could then demand sharply higher interest rates for providing long-term debt capital and could put abrupt and sharp downward pressure on the dollar. These market effects, plus the adverse impact of continuing fiscal imbalances on business and consumer confidence, could seriously undermine our economy."

Clearly, the issues posed by Secretary Rubin deserve careful and systematic scrutiny.

Is There a National Savings Shortage?

Many argue that the trade and current account deficits are a product of domestic macroeconomic imbalance. This is the thesis of a "national savings shortage." A direct implication is that national saving can, *in principle*, be raised to match investment, especially by reducing the budget deficit. Those making this argument invariably assume that deficits can be cut without harm to total income, output and employment. Rubin makes this case explicitly:

> “The *first priority* should be to tackle the 10-year fiscal imbalances, which would also *be the best way to promote economic growth* and minimize the risks I have outlined.” (Emphasis added)

Unfortunately, it is not true that cutting deficits will promote growth. Consumption spending is a direct component of GDP. The growth of consumption is a direct element of economic growth. Efforts to raise “national savings” at the expense of consumption *per se* depress profits, investment, incomes and GDP. Thus policies aimed at budget surpluses – as in the late 1990s -- were and are unsustainable. They generate “fiscal drag” which brings economic expansion to an end. The drag may be masked for a time by *reduced private saving* – the borrowing against home equity and stock appreciation that was the central feature of the late 1990s and that I have elsewhere called the “Keynesian Devolution” (Galbraith 2003). But such an effect is intrinsically unstable and temporary. This the late 1990s also demonstrated.

On the other hand, policies which attempt to encourage *private savings* with incentives such as tax cuts, do not raise total national saving. Many such policies have been put in place in the United States since the late 1970s, usually justified with supposed price-incentive effects. Today’s minute *household* savings rate proves their futility. (So, for that matter, do our trade deficits.) In any event, some of any pro-savings tax cut inevitably leaks into consumption, and so the fall in public savings always exceeds the rise in private savings. Such policies may have slight positive effects on activity and therefore investment, but this is only because they *depress* rates of national saving, not because they increase them.

There is only one totally reliable way to increase private savings relative to investment without hurting growth. That is to push up private incomes, for instance with public expenditure and employment programs, *while blocking the channel of leakage to imports*. This is a tried and proven method in many parts of the world, including the United States during World War II, much of Europe during early post-war reconstruction, and Japan and Korea in more recent times. Today a country with capital controls (China) easily finances gross investment over 35 percent of GDP with internal savings! It's very simple to do so – so long as Chinese nationals have little capacity to import freely and run up a current account deficit. With free trade, however, this option isn't available, even if it were desirable, which it is not.

We can conclude four things. First, there is no way to reduce trade deficits by reducing budget deficits alone, without also slowing, not increasing, economic growth. Second, there is no known way to raise national savings with tax incentives. Third, the one reliable way to suppress the trade deficit -- protectionism -- is for the moment not under systematic consideration. Fourth, none of this matters very much. The important issue is not whether there exists, in some semantic sense, a shortage of domestic savings. There does, but as this fact leads to no useful policy, it is, practically speaking, unimportant. The important issues are instead, as according to Secretary Rubin "virtually all mainstream economists" believe, whether overall levels of investment have been limited, or will soon be limited, by reliance on external finance. And second, whether our trade deficits pose unacceptable risks of instability in the short and medium term. We next turn to these issues.

Is There a Shortage of Investment?

Does the United States need more investment? There is no *definitive* answer to this question. But there is also no evidence that the United States is short of capital investment.

The share of private fixed business investment in GDP, presently 16.9 percent, is almost a full percentage point above its long-run historical trend of 16.0 percent since 1947, in quarterly data. It is more than two percentage points above the corresponding figure for the 1950s (14.8 percent). If the 1950s were a Golden Age of American economic superiority – as in some respects they were – the difference between conditions then and conditions now has nothing to do with any fall-off in the propensity of private business to invest. Moreover, as a share of GDP U.S. investment does not compare unfavorably to the comparable share in Europe, and particularly not when consumers' durables purchases – notably for automobiles – are counted as investments, as they should be.

It is true that the investment share of GDP was higher in the late 1990s, reaching over a full percentage point higher at the peak in early 2000. This was associated with good things – a full employment, non-inflationary economy operating at a peak of optimism and enthusiasm, and a booming stock market. It was associated, also, with a remarkable degree of fantasy over technological possibilities, followed inevitably by a remarkable disillusion. It is this that prevents an early return to the boom, not any shortage of savings to be borrowed. It is therefore clear that the boom cannot be reproduced by any mechanical pro-savings policy.

The volume of business investment can be affected, of course, by the rate of interest. However, there is no evidence that public deficits are pushing up long-term interest rates in the United States at the present time. Remarkably, long-term interest rates remain well below levels of five years ago, when budgets were in surplus. Short-term interest rates are set by the Federal Reserve; long term interest rates reflect the interaction of current short-term interest rates and market psychology, dominated by expectations of what the Federal Reserve will do in the future.

The pressure of demand for investment finance plays very little discernible role in this affair, and that of government funding plays almost none at all. Despite the claim made by Secretary Rubin, efforts to find the effect of deficits on interest rates in the econometric record have been spectacularly unsuccessful so far. Gale and Orszag 2004 provide an impeccably mainstream example. An interpretation of their remarkable failure to find important effects of deficits on interest rates is given in Galbraith, 2005.

In general, the theory of investment can only be a theory of business motivation, which begins and ends with the quest for profit. In the real world, every surge of private business investment is motivated by a boom psychology, which suffuses business enterprise with confidence in the potential for profitable expansion of productive capacity. With confidence, any amount of new investment can be financed. Without it, little will be undertaken. This and little else explains the prosperity of the 1990s and the slump that followed. Should a new boom return– an improbable development that Secretary Rubin fears but that I would welcome–either public deficits would shrink or private savings would rise. In neither case would we run into “crowding out.”

The serious set of questions, plainly, has to do with the external economic environment facing the United States and the risks of the global financial system to the current privileged and predominant position of the U.S. dollar.

Does the Trade Deficit Threaten the Dollar?

The United States current account has been in deficit continuously for 30 years. The last sustained surpluses were in 1975. Why did the United States start falling into chronic current deficit at that time? The answer at first was surely the oil shock of 1974, which itself followed the devaluation of the dollar in 1971 (effectively devaluing oil, which was priced in dollars), and the collapse of the Bretton Woods system in 1973. The result after 1974 was a vast recycling of "petrodollars" through the commercial banking system, and the creation of the modern world of a dollar-reserve system of global finance, mediated mainly by private financial markets.

From 1982 onward, the new dollar system was consolidated under a regime of high interest rates and, after 1986, low oil prices. High real interest rates and domestic recession in the early 1980s destroyed vast sectors of traditional American manufacturing strength, particularly in the machinery and metalworking industries of the upper Midwest. U.S. trade deficits deepened thereafter. By the 1990s, the U.S. had become a strongly dual economy, with a high-technology sector that supplied much of our non-agricultural exports, and a vast but relatively low-paid services sector which undergirded household consumption and whose workers depended in turn on access to low-cost imported goods. Trade deficits had become structural.

The benefits of this system worldwide were very uneven. The debt crisis that started in Latin America spread around the world, inflicting vast losses on populations in Africa, and leading to profound political change in Central Europe and to the collapse, political and economic of the Soviet Union. After 1988 even Japan fell into a prolonged economic slump, although Japan's vast industrial power and first-world currency permitted it to avoid hardship in the absolute sense. South Asia and Korea prospered before the crisis of 1997, but fell into depression thereafter (though Korea has since recovered). Only China and India – with forty percent of the world's population between them – both of which were largely isolated from the new system by their long traditions of capital control, managed to grow continuously during this period.

Since 1979, China has become one of our larger trading partners, while the relative position of most other Third World countries has eroded. The concentration of our manufactures trade on China and Japan now means that those two countries now hold large reserves, and their actions can potentially determine the dollar's value. However, the actions or potential actions of other players, including Russia, India and the European Central Bank, can also have important effects.

However, having power and using it are two different things. China and Japan are constrained in their behavior by creditor's risk. If they were to sell dollars aggressively, the value of the remainder of their portfolio would plummet and they would inflict large financial losses on themselves. This consideration prompts caution. Many commentators have sought to create scenarios in which China makes aggressive use of its portfolio to inflict damage or to change American behavior – say with respect to Taiwan. But such scenarios remain implausible, since

they would undermine the basis of modern Chinese prosperity, which is the growth of export industries for the American market and stable purchasing power over food and fuel. In effect, China has recreated, for itself alone, the essential conditions of the Bretton Woods system: stable trading relationships, economic expansion, and a strong financial position built upon access to essentially unlimited reserves. India, Korea and a few others are auxiliary players in this system. None of these countries have an interest in unsettling matters. Barring a political crisis in the region – an attack on North Korea, a war over Taiwan, a disruption of world oil supplies following an attack on Iran – it remains unlikely that any of them will.

China is a success story of global development. As such it is far less, not more, of a threat than it was when in the grip of revolutionary ideologies forty years ago. It follows that the tragedy of the world financial order is not there. It lies, rather, in the countries and regions, notably Africa, Russia, Latin America and Southeast Asia, that have been left out. They must find ways forward in the face of crushing debt burdens and uncontrolled capital flight.

Apocalypse Considered

The main risk for the dollar is that of a panic, a rush to the exits, a run from the dollar and toward, say, the euro. If one major player gets wind that others may dump, then the urge to join in becomes hard to resist. This is exactly analogous to an old-fashioned run on the bank. And as with old-fashioned bank runs, timing is impossible to predict.

Some fear that we may be close to the precipice. Recently we've heard rumors of Russia trading dollars for euro, of India diversifying its reserves, of China contemplating the same. The reaction in parts of Wall Street has been a trifle unnerved. In comments relayed furiously across the Internet, Morgan Stanley economist Steven Roach apparently told clients to gird for an "economic Armageddon." At Frankfurt a few weeks ago, Chairman Greenspan appeared to signal that he shared some of these concerns.

There is, plainly, a degree of risk. But it stems from thirty years of accumulated deficits and our resulting position at the base of the world financial system. It is a fact of the system. It is an artifact of the larger instability of world monetary arrangements, which have rarely endured in any stable form for more than thirty years in the past several centuries. The instability of the system is the instability of the dollar, and vice versa. The dollar's dilemma lies, precisely, in the difficulty of stabilizing world finance in the same way that the FDIC stabilized the domestic banks in the early years of the New Deal.

What can be done now, by U.S. policy acting alone, to allay this risk? Absent a major reconstruction of world financial architecture, the answer is: almost nothing. Specifically, reducing the budget deficit cannot save the dollar. Steps to reduce the trade deficit *per se*, by discouraging imports – cannot save the dollar. A bank, hit by a panic, cannot save itself by cutting its advertising budget, raising its fees or firing its staff. If a panic gets going, moreover, higher interest rates won't stop it either.

Small interest rate hikes do normally affect exchange rates, attracting traders to currencies with an interest rate edge. But, when a player has the kind of extreme market weight now enjoyed by China and Japan, the game changes, and becomes one largely of bluff and threat. It may be that short-term interest rate increases earlier this year were aimed, mainly, at deterring the Japanese and Chinese from dumping dollars. If so, was it necessary? That is an open question; in any event the crisis some may have feared did not occur. It might not have occurred had the Fed done nothing. And if one does occur later on, interest rates raised even to ten, twenty or thirty percent could only intensify the panic. These matters are, in short, imponderable. They are largely outside what can be safely predicted by an economist.

In general terms, however, the horses are already out of the barn. The risk now is not the trade deficit, nor the budget deficit, nor a failure to move interest rates just so. It is a panic by the holders of assets that already exist, in gigantic quantities, and that cannot be made to go away.

But how big is that risk? My view is that it is probably not very large. There are too many dollars in the theater of the world economy, too few exits. No one gains an advantage from panicking. And indeed there are only a few players who matter, and they are sluggish and obese, sitting almost alone in the front seats. Given the start of a panic, they would not move fast. Before they got through the exits, they might well be discouraged from leaving by the smoke in the lobby--the soaring price of the euro and perhaps the yen. The run might then fizzle out and the audience return to the show. And the show would go on.

For this reason, unless events are driven by some ulterior motive -- for instance, war -- there is no compelling case why the declining dollar should become a panic any time soon. It might be prudent to take collaborative and multilateral steps to insure against this possibility. But even if such steps are not taken, the immediate dangers are not as great as some fear and assume. Once again, the final dollar crisis will probably wait until a political crisis sets it off. Measures that promote and stabilize trans-Pacific relationships reduce the risk. Assuredly, policies that interject instability and distrust in that relationship will increase it. Economists should perhaps focus less on trade and budget deficits and more on dangerous policies affecting Korea, Iran and Taiwan – all of which, incidentally, touch vital Chinese security interests as well as our own. The collapse of the non-proliferation regime is, in my judgment, far more likely than the trade deficit to lead to the collapse of world financial arrangements. As the bumper stickers say, one nuclear bomb can ruin your day.

Apart from *that* risk, however, in my view it is reasonable to discount the risk of financial apocalypse for the time being. Having done so, one may prudently consider less dire risks posed by the instability of the dollar system.

Other Risks, Mainly of Rising Interest Rates

Secretary Rubin expresses the fear of “sharply higher interest rates”simply on account of the sliding dollar and price inflation. But these fears, which express the “leverage” of foreign creditors over domestic interest rates, are not well-founded.

For an *inflation premium* to be built into the long-term interest rate, there needs to be higher expected inflation *on a continuing basis*. But actual inflation can rise for a long time before expectations do, and the inflation adjustment, coming (let us say) primarily through a rising dollar oil price, could come and go rather quickly. It need not get built into a spiral of wages and prices. It's also worth observing that an *inflation premium* has no consequences for real activity. It merely involves a compensation to lenders for the effects of anticipated inflation. It is not a deterrent to new capital investment.

A *risk premium* is another matter. Were a risk premium to be added to the long-term interest rate, then presumably there would be effects on real investment. But this too presupposes power that foreign asset holders do not have. To be sure, they could sell bonds for cash, in which case bond prices will fall and long-term interest rates will to rise. But why would a foreigner concerned about the dollar forego the interest available from a government bond and yet hold on to dollars in cash? Such behavior makes no sense. If, on the other hand, foreigners sell their bonds for assets in other currencies, the effect is on the exchange rate and not on the price of bonds.

So far, there is no evidence of either an inflation premium or a risk premium having been added to U.S. long-term interest rates. So far, despite a substantial dollar decline, long-term interest rates have hardly budged. All of the talk about the risk of the deficits to interest rates remains prospective, not actual. One cannot exclude the possibility that bad things will happen in the future. But deficits have been around for four years–and they haven't happened yet. One is surely entitled to ask what the markets are waiting for.

One serious risk to the international position of the United States would be a change in European policy. Should Europe shift toward a high-growth, full employment Keynesianism, that could bring a decisive shift in the world balance of economic power. Such a shift would create profits in Europe, where there presently are few. It would open up a European current account deficit, where there is presently a surplus. Soon the euro would not be a scarce currency any longer, but an international unit of account with a liquid market outside of Europe. At that point, the reduction of the dollar's reserve status could truly get underway, the situation might resemble the decline of the sterling region in the interwar years. But European policymakers don't see—and won't seize—this opportunity, and we may therefore discount it as a risk for the United States, just now.

A final possibility is that Alan Greenspan could simply take matters into his own hands, raise interest rates as Paul Volcker did in 1979, and inflict on us all a monumental "defense of the dollar." Morgan's Roach worries about this with some good reason; I've worried about it too. While sharply rising short-term interest rates could cure both inflation and the weak dollar—as they did in the early 1980s— they would soon invert the yield curve. The resulting slump might be even more disastrous than it was twenty-five years ago, because private debt levels are higher now than they were.

Such a folly is surely the most dangerous of the interest rate risks. But for now I don't expect it. It seems more likely that the Federal Reserve will continue to move cautiously while oil and some other import prices drive upward – raising short term rates gradually but by not so much as

to invert the yield curve. Given the alternatives, and the nebulous nature of all the external risks about which so many make so much heavy weather, caution is probably well-advised. If there is a worldwide portfolio adjustment underway, the dollar will therefore slide until it stops sliding-- or perhaps until European intervention decisively props it up. For all we know, for that matter, the dollar's slide may already have reached its limit for the time being.

What Should Be Done?

The above does not mean that the affairs of the country are in good order. It merely means that fixing a shortage of savings, manifested by budget and trade deficits, is the wrong way to approach the issues. The reality is that budget deficits cannot be controlled until the trade deficit is reduced. And the trade deficit cannot be reduced, at full employment, except by strategic measures over the medium to long run.

What should be done? It's a long-term project, but it's not difficult to assemble the conceptual start of a real program. Oil companies are likely to earn high profits in the turbulence ahead. Let's tax them (and other windfalls), perhaps with a variable import fee. Let's plough the proceeds back to state and local governments, so they can maintain services and vital investments. Let's allow the Bush tax cuts for the wealthy to expire -- especially the repeal of the estate tax which serves no economic purpose -- and instead cut payroll taxes for now, to help working people cope. Let's start our next technology-based expansion, focused on new energy sources and reduction in per-unit GDP consumption of oil.

On the international side, fixing exchange rates between Europe, Japan, the UK and the U.S. is unnecessary: OECD members accept each other's currency and debt instruments and will continue to do so. But the larger experiment of worldwide floating exchange rates and open capital markets, inaugurated by global monetarists in 1971, has clearly failed. The developing world was better off under the old system. Recognizing this, parts of it have gone back to that system in effect. Such is the underlying meaning of the much-maligned Chinese dollar-pegging, combined with their capital controls and large dollar reserves. One can expect similar behavior from other countries that seek to insulate themselves from financial market risk; indeed one may observe it now in India and Russia, to name two. The problem for such countries is reserve accumulation for this purpose is a waste of valuable and scarce resources, which a poor country can ill afford.

A new system on the Bretton Woods model would help developing countries, by sharply curtailing the destabilizing role of currency markets, thereby freeing up reserves for real uses.. This would probably require a new network of regional regulatory agents for the financial system, empowered to enforce capital controls and to take responsibility for successful development strategies among their members. Ultimately, we should work toward a new global financial network oriented toward the support of development and growth, which is to say with creditor adjustment, an effective lender of last resort, and policy supervision. That would also help us, by creating stronger and more stable markets for our exports, though there would be an inevitable financial adjustment. Obviously, this is no small challenge.

For such a policy to succeed, America must also change, in ways that do not often make themselves heard in economic discussions, but that are important to the role of a security commission. Our security role is important. But it is sustainable only to the degree that the rest of the world sees us as operating in their interest, as most of the world did, in fact, through the Cold War. Our present over-reliance on the unilateral application of armed force and financial power appears, on the other hand, to much of the world to be fueled by visions of dominance. For these, the rest of the world has diminishing reserves of patience and it will not agree to pay indefinitely.

We need, therefore, to combine a sustainable security strategy with an industrial strategy based on technological leadership, collective security, and smart use of the world's resources. Successful grand strategy surely requires reducing exposure to the real risks to American living standards – and not merely a program of gestures aimed at the balance sheets.

I do not judge the political realism of such a program. But in the medium term it seems to me that there is no viable alternative to action along these or similar lines. Absent an articulated strategy for financial stabilization, for energy security, and for international development, the attempt to move forward with slogans about savings, or about balancing budgets or trade, is an economic dead end. We can do better, and we should.

Thank you very much.

Appendix: Notes on the Nomenclature.

The nomenclature on which arguments that the United States faces a "savings shortage" which is then supplied from foreign sources appears to rest on the following definitions:

(1) Investment = National Saving plus Net Foreign Saving

(2) National Saving = Private Saving + Government Budget Surplus

(3) Net Foreign Saving = Current Account Deficit = "Capital Inflow"

From these definitions, it would follow that:

(4) Investment = Private Saving + Government Budget Surplus + "Capital Inflow"

So far, all is merely accounting. But the interpretations attached to this way of expressing the accounting tend to be highly misleading. Thus:

– Equation (1) is often read as implying that a higher rate of national saving would generate a higher rate of investment. But in fact businesses make investment decisions without reference to the supply of savings, either national or foreign. If after-the-fact national savings are not sufficient to "fund" investment, an offsetting trade deficit is inevitable.

– Equation (2) places private saving and government budget surpluses on an equivalent footing. This might be reasonable as a way of making that point that both activities depress economic activity are therefore to be discouraged! (But of course that is not the point on offer.)

Yet in another sense, private savings and public surpluses are not similar activities. The private sector has reasons to save because it has risks and uncertainties to allay. A government surplus serves no comparable purpose and is not "saving" in any comparable sense.

– Equation (3) is often thought to represent "flows of capital," but it simply applies alternative names to the current account deficit. Capital does not "flow" from overseas to finance American business investment. Rather, foreigners sell us goods and are paid in dollars. Once that has happened, the "loan" has been made. The mere failure immediately to purchase an offsetting value of American-made goods prolongs it. Dollar holders do then typically convert those dollars into a reserve asset, such as a bond. In this way they acquire a claim to an income stream, but conversion of cash earnings to debt or equity is not a new loan.

-- Equation (4) is therefore not a formula for increasing the national rate of investment. To confuse it with a theory of investment is a crude though common error. To repeat, the "supply of savings" has nothing to do with the decision to invest. (It also has nothing to do with the determination of the rate of interest, though that is another story.)

More useful equations for thinking about trade deficits, budget deficits and the financial balances of U.S. households are spelled out by Godley (2002, 2003, 2004) and derived in a very simple way from the fundamentals of national income accounting.

(5) National Income = Consumption + Investment + Government + Exports - Imports

(6) National Income = Consumption + Saving + Taxes

(7) Budget Deficit = Government - Taxes

(8) Trade Surplus = Exports - Imports

(9) Private Saving - Investment = Budget Deficit + Trade Surplus

Equation (9) restates Equation (4) in familiar Keynesian form, as the fundamental equation of internal and external balance. An easy way to note its practical significance is to observe that the private sector, as a whole, can only go out of approximate Savings-Investment balance for brief periods of time – historically, a few years. In the postwar period, savings have typically exceeded investment by large amounts -- say three percent of GDP or more -- only during recessions. Investment exceeded *private* savings by a large amount – say, five percent of GDP or more -- only during the unprecedented bubble of the late 1990s. A fair rule of thumb is that a *large* deviation of the left hand side from zero is likely to be reversed in a short time. Therefore, the Budget Deficit and the Trade Surplus must, normally, offset each other within a few percentage points, so that the Budget Deficit and the Trade Deficit will be twins, except during the peaks and troughs of the cycle.

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