

*SAVING FOR THE 21<sup>ST</sup> CENTURY:  
IS AMERICA SAVING ENOUGH TO BE COMPETITIVE  
IN THE GLOBAL MARKETPLACE?*

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## *DUAL DEFICITS: LARGE AND GROWING*

Is America saving enough to be competitive in the global marketplace? The short answer is no. America is not saving enough to be competitive or secure in the fast moving global economy.

The American economy has undergone a remarkable turnaround in the last 5 years -- taking a historical surplus and turned it into record deficits. A lot of people ask, quite reasonably, "Why should that matter?" So far, we have had our cake and eaten it too, in the form of low inflation, cheap borrowing, and low interest mortgages. The question is whether it can go on. I strongly believe the answer is no.

Foreign borrowing has enabled our consumption binge. Continued addiction to foreign capital at these levels is one of the greatest risks to the global economic outlook and to America's competitiveness.

It is foreign borrowing, pure and simple, which has enabled our binge. Last year alone, the nation borrowed \$800 billion or 6.3 percent of our income from foreigners. Of course, we have borrowed heavily in earlier periods. But at that time, we were still net creditors. What is different now is that we already owe a lot of debt to the rest of the world, and with the baby boom retiring, the nation should move further in that direction.

Between 2000 and 2005, debt to GDP went from 14 to 25 percent of GDP. That puts us smack in between Brazil and Argentina on the eve of their financial crises in 2001, with debt to GDP ratios of 18 and 33 percent respectively. The full awkwardness of our situation can be best appreciated in light of the historical observation that until now, hegemonic powers have been net suppliers of capital to the rest of the world, not a net drain as the US is today.

A Brooking conference concluded that there is NO historical precedent. There have been advanced economies with similarly large borrowings relative to their GDP, such as Australia and New Zealand, but none comes close to the size of the US—the world's largest economy and the world's largest borrower.

The "don't worry be happy" crowd will reply: So what is the problem? Judging from interest rates and ongoing appetite for US assets, the rest of the world seems eager to finance our borrowing.

That is true, but should not be fully reassuring. In fact, private investors' appetite for U.S. securities has cooled. The ongoing strong demand for U.S. securities – especially Treasury securities – and consequent benign interest rates owe in great part to foreign official lenders who have stepped in to maintain the enormous appetite for US securities as private investment interest has moderated. Over the last few years, there has been a big shift away from private investors in Europe and elsewhere buying US corporate securities towards central banks in Asia buying US Treasury Securities. Net private capital inflows as percentage of total net capital inflow fell from 97 to 83 percent between 2000 and 2005, while inflows of foreign official assets rose from 4 to 17 percent.

Contrary to the administration's reassurances, the US is not the best investment in the world, when you take into account the risks of substantial further dollar depreciation and the growth slowdown necessary for turning around the trade deficit.

### *DANGER AHEAD*

So what are the dangers? Our borrowing poses risks both to our economic competitiveness and our economic security.

The hard landing scenario is the one that gets the most attention. There is a sudden rush to the exits, people dump dollar assets, the Fed is forced to sharply raise interest rates and growth both here and abroad is sharply curtailed.

But the alternative is not so good either: it amounts to delaying the pain. But time is not our friend. This course is equally troubling, although in subtler and thus perhaps more dangerous ways. If we awake to this issue later rather sooner, which is to say if foreign central banks continue to indulge our consumption binge in order to preserve their export binge, it will be much more painful to fix it. Over time, the cost of servicing the debt will eat up a larger share of our export earnings, so that it will require an even greater turnaround in our trade balance to stabilize the debt to GDP ratio. Indeed, as Nouriel Roubini and Brad Setser have shown, net debt is on track to reach 50 percent of GDP by 2008.

Now some of the "don't worry" crowd will tell you not to worry based on the logic of double jeopardy. They point out that China will be deterred from

selling by the prospect of large losses on their dollar portfolio holdings. I don't find the logic of mutual deterrence enormously reassuring in the world of international finance.

### *TAKING ACTION*

So far, whether by default or design, the Treasury appears content to approach this problem as one for the markets to work out on their own. The current policy of leaving it to the market can be quite unsettling to the market and begs the difficult question of global burden-sharing in the adjustment process. So far, those countries with market rates – Europe, Canada, Australia, and Latin America - have taken a disproportionate share of the burden, while China and Japan have essentially taken a free ride.

If we wanted to manage the problem rather than hold our breath and react, there are several historical episodes that point the way. And the solution starts at home. The surest policy lever to materially improve U.S. national savings and lower foreign borrowing is to return to fiscal responsibility. America must commit to taking serious action on its fiscal imbalances, pressure China to act responsibly on its exchange rate, and gets commitments from Japan and Europe on stimulating domestic growth. Unfortunately instead of getting countries around a negotiating table to nail down commitments, and taking hardheaded action on the budget at home, the current policy is to hope for and plan for the best.

We stand at a time when the global competitive landscape is shifting at a breathtaking pace, when hundreds of millions of workers from low wage countries are entering into the global labor force, when even higher skilled services jobs are being buffeted by the forces of technology and trade, and when the nation's energy security is at stake. There is no doubt that Americans can compete successfully in the hyper competitive global marketplace of the 21<sup>st</sup> century. But this will require proactive policies to invest in skills for the 21<sup>st</sup> century, the game changing technologies of the 21<sup>st</sup> century, sustainable energy supplies, and a competitive health care system. Add into this mix the imminent retirement of the baby boomers, and it should be clear this is not a moment to hold economic policy hostage to sudden shifts in world financial markets, to depend on the continued indulgence of Asian central banks, or to tie our hands on making critical infrastructure, education and innovation investments because we have squandered our savings.