Savings. It's an almost mystical word for economists -- the Holy Grail of growth. The more a country saves, the more it has available to invest. And the more it invests -- in computers, factories, or infrastructure -- the more productive its economy becomes and the faster it can grow.

From this perspective, most economists have judged the U.S. and found it wanting. With American households putting away only 0.9% of their income in savings and with politicians apparently helpless to eliminate the federal budget deficit, the U.S. seemed to be setting itself up for years of rising interest rates, subpar investment, and sluggish economic growth.

But that's not what is happening. Long-term interest rates are falling and have now dipped below 4%. The total of residential and business investment has been rising and now stands at 16.5% of gross domestic product, well above the average for the 1990s. And there are few signs that the economy is stalling.

These surprising events are forcing economists, investors, and policymakers to think more globally than ever before. In just the past few months, they've begun to consider seriously two intertwined and heretical notions: What really matters for interest rates is the global economy, and there the problem may be too much savings, rather than too little.

Look around the world, and extra money is piling up in all sorts of places. Japanese corporations are recording record profits, but not doing much spending. Chinese companies are on an investment tear, but the country is getting so much money from exports that it has billions to spare, including $18.5 billion that China National Offshore Oil Corp. (CNOOC) bid for Unocal. The surge in oil prices -- now about $60 a barrel -- is giving oil-producing countries such as Russia and Saudi Arabia far more money than they can use right away. And the aging workers of Europe are building nest eggs for an uncertain future.

The International Monetary Fund predicts that in 2005 the worldwide savings rate should hit its highest level in at least two decades. Surprisingly, even in the profligate U.S., businesses have been accumulating huge sums as undistributed corporate profits -- running at a record annual rate of $542 billion in the first quarter -- have almost doubled in the past two years. This corporate hoarding explains why the U.S. national savings rate, which includes governments and businesses as well as households, rose to 14.7% of national income in the first quarter, up from 12.8% two years ago.

This unexpected surge of savings is like a rose with thorns. Low interest rates have the potential to power productivity, build wealth, and raise living standards throughout the world. As more and more workers in developing countries join the global economy, cheap money makes it easier to provide the equipment and infrastructure they need to prosper. Access to global savings has also enabled the U.S. private and public sectors to fund a big increase in housing construction and health-care spending in recent years, while
simultaneously ramping up military outlays. The result: guns and butter -- all without boosting inflation or pushing up interest rates.

**Skittishness**

But the savings glut is creating new risks for the global economy, which is having a tough time absorbing the unanticipated flood of funds. Instead of going into productive investments, cheap money may be overheating spending and sending asset prices soaring too high, setting the stage for a future bust. "The odds of a catastrophic scenario have gone up," says Kenneth S. Rogoff, former chief economist at the IMF and a professor at Harvard University.

History shows that excess liquidity can disappear overnight if investors start getting skittish and lose confidence, causing severe disruptions to markets that have gotten used to cheap money. A unexpected rise in inflation or interest rates could tank the bond market and burst the global housing bubble, which now stretches from Barcelona to Shanghai to San Francisco. Doubt about the U.S. ability to finance its huge trade deficit could trigger a steep downturn in the dollar and a monetary crisis. And China's factory-building spree may leave it saddled with excess capacity for years to come. Prices for cold-rolled steel and ethylene have already dropped sharply, and auto prices have fallen as much as 20% in the past 12 months. "It's going to be very tough for those guys who own factories," says Morgan Stanley (MWD) economist Andy Xie, "and a lot of them won't pay the banks."

Even if the low rates turn out to be sustainable, investors and policymakers will still face some tough decisions. The free flow of savings across national borders creates a quandary for the Federal Reserve, which may have less influence over the financial markets and the U.S. economy than ever before. Some regional Fed bank presidents believe the central bank needs to compensate for low long-term rates by pushing the short-term rates it controls much higher. But others, including some members of the Fed's board in Washington, are not so sure, since ultralow rates may not be inflationary in a world awash with savings and dominated by cutthroat competition from China, India, and elsewhere. Greenspan has confessed that the Fed doesn't fully understand what's going on. "Our economy is in unexplored territory in many respects," Federal Reserve Governor Donald L. Kohn told bankers in New York on June 15.

The global savings glut also forces investors to operate without many of the signposts they used to depend on. In the past, they could afford to concentrate their attention on what was happening in the U.S. If the Fed tightened credit or if the federal budget deficit swelled, long-term interest rates tended to rise in response. But now, in a global economy awash with savings, investors have to be much more aware of what's happening outside the U.S. If China revalues its currency, that could push up U.S. rates because it would mean that Beijing would eventually have a smaller surplus to invest in Treasury securities. If the European Central Bank eased credit, that could lead to lower U.S. bond yields -- even if the Fed were raising rates at the same time.

The rethinking of the rules governing the world economy is quite recent, although global interest rates have been low for a while. The rate on 10-year Treasury notes was below 4% for much of 2003, and interest rates on Japanese 10-year bonds actually dropped below 1% around the same time. At that time, it was conventional wisdom that the low rates were a result of easy monetary policy at the Fed and other central banks combined with a relatively weak global economy.

But this explanation for low rates became a lot less tenable after two years of central bank rate increases and a global economy growing at a robust 5.1% rate in 2004. Forecasters kept predicting that long rates would rise, and they continued to be disappointed.

It wasn't until early 2005 that economists considered the possibility that something major had changed. A Jan. 31, 2005, article in BusinessWeek noted that a "global glut of savings" could explain low interest rates. Then, in March, Fed Governor Ben S. Bernanke -- now head of President George W. Bush's Council of Economic Advisers -- unleashed the flood gates with a speech on the "global saving glut." Since that speech, 10-year interest rates have dropped about half a percentage point, and with each ratchet down, more and more economists came over to the high-global-savings point of view.

Global savings -- which the IMF estimates at roughly $11 trillion in 2005, almost the size of the whole U.S.
economy -- is the excess of the combined income of the world's nations over their combined consumption. That excess has grown fast in recent years, freeing up resources for investment. What's more, the increased globalization of capital markets has unlocked national savings, making for an easier flow from one country to another.

True, there are still plenty of skeptics. James W. Paulsen, chief investment strategist at Wells Capital Management, dismisses today's roughly 4% interest rate as a cyclical phenomenon that could quickly disappear. "The difference between being at 4% today and being at 4.75% is 90 days of surprisingly good numbers," says Paulsen. Also not buying the savings-glut argument is James T. Swanson, chief investment strategist at MFS Investment Management, who thinks that interest rates should be a full percentage point higher right now.

But for many investors, the question is not whether there is a global savings glut, but how long it will last. And on that score, there are plenty of reasons to expect it to continue for a while. First, the rise in oil prices worldwide is causing a massive transfer of wealth to oil-producing countries. Russia's trade surplus, for example, is running at $100 billion annually, up from $65 billion a year ago. Similarly, most of the Arab stock exchanges are at or near record levels. The UAE market, a combination of the Dubai Financial Market and Abu Dhabi Stock Market, is up 105% on the year. The Saudi stock exchange is up 65%. "High oil prices are producing huge liquidity," says Mustafa Abdel-Wadood, CEO of EFG-Hermes (UAE) investment bank.

For now, most of this money is being recycled to the global financial markets as savings rather than as investments in oil exploration and production or other productive uses. Many oil-producing countries are reluctant to embrace too much technical and other help from foreign multinational companies, even when it could help boost supply. That's true for Mexico, where the constitution forbids the state-owned oil company from teaming up with foreign outfits to gain expertise in finding more supplies.

In the Middle East, the conflict in Iraq and the threat of terrorist strikes across the region are also hampering energy investment, experts say. And risk-averse oil companies are simply reluctant to spend money. "It's amazing to me that even with these high oil prices they're being so conservative" with their exploration and production budgets, says Brian K. Hicks, co-portfolio manager of Global Resources Fund (PSPFX), one of San Antonio-based U.S. Global Investors' mutual funds.

Holding Back
Demographic shifts are driving up savings as well, as aging societies in Japan and Europe accumulate funds for retirement. That's holding back both consumption and business investment, as many European and Japanese companies are cautious about committing much capital to expand their domestic operations. In Japan, the combination of weak wage growth and strong exports have boosted corporate profits, with a much smaller increase in business investment. The same story also holds in Europe. "Balance sheets of European companies are strong. Cash flow is strong. Everything is fine," says Herbert Lohneiss, CEO of Siemens Financial Services (SI), the finance arm of the Munich electronics and engineering giant. "What is not fine is that they do not invest enough."

The reluctance to consume and invest is fueling enormous trade surpluses in Japan and Germany, in particular. The latest data from Japan show a current-account surplus of $171 billion for the year ended April, 2005. That's up from a surplus of $157 billion a year earlier. Germany, where domestic demand is flat and unemployment is in the double digits, is running a current-account surplus of over $100 billion over the past year.

Surprisingly, the lag in business investment extends to parts of Asia as well, outside of China. For example, a Bank of Korea survey of 5,400 of the country's companies found that they were sitting on a record cash pile of $65 billion at the end of 2004. Yet there are no signs that spending on new plants and equipment, up a so-so 3.1% in the first quarter of this year, is accelerating. Indeed, South Korea hasn't recovered from a two-year slump in domestic demand. Household spending inched up 1.3% year-on-year in the January-to-March period, and the savings rate is still rising.

And then there are the staggeringly large Chinese trade surpluses. For years, economists reassured themselves that China's trade with the whole world was pretty well balanced, even if the country had a big
surplus with the U.S. Those days are over. Now, China's trade surplus has more than tripled, to an annual rate of about $70 billion a year.

That $70 billion surplus is exactly that -- the extra income that China takes in from exports and that isn't used at home. It's all recycled as savings into the global economy, in the form of purchases of U.S. Treasury bonds and, lately, as stepped-up direct investment in U.S. companies. Analysts say CNOOC's bid for Unocal could herald a wave of Chinese takeovers of U.S. companies.

By pegging its currency to the dollar, China has kept the value of the yuan artificially low. That has boosted the competitiveness of its industries abroad, earning the country hundreds of billions of dollars in foreign exchange. But it has also held down consumption at home by keeping the price of imports high for consumers.

China has said that it plans to take steps to encourage consumers to spend more and save less in an effort to reduce its politically contentious trade deficit. "We want to use new policies to increase consumption," People's Bank of China Governor Zhou Xiaochuan told a conference of international bankers in Beijing on June 6. So far, though, nothing concrete has been done. And China shows no signs of significantly revaluing its currency or loosening its fiscal policy -- steps that some experts believe would be the best way for it to boost domestic demand. Indeed, the country is aiming to cut its budget deficit to 2% of gross domestic product this year, down from 2.4% last year.

So far, the total impact on the world economy of all the savings sloshing around has been benign. While demand is weak in some countries, cheap money is working its magic in other places, pumping up everything from investment in Chinese factories to the explosion of housing construction in Spain. Mortgage rates in India, historically a country with a high cost of capital, have plummeted from 15% five years ago to 7.5% today. In fact, the world economy racked up its fastest growth rate in three decades last year with only a small rise in inflation rates.

The surfeit of savings has spurred a flood of cross-border investment, which has the potential to restructure global business and push up productivity. The U.S. went through a restructuring wave in the 1980s and early '90s, financed in part by junk bonds. Today, the same thing is happening on a global scale, as private equity funds easily raise billions to buy up large companies around the world and reshape them into more profitable enterprises. In 2004 private equity funds invested a huge $156 billion in European companies. And the spending spree shows no sign of abating. In May a unit of London-based Terra Firma Capital Partners Ltd. stunned Europe's corporate elite by agreeing to buy Viterra, the real estate holding company of Dusseldorf-based utility E.ON, in an $8.5 billion leveraged buyout.

"Unstable Equilibrium"

In the future, cheap money also could provide potent fuel for spending on new technologies, as soon as the next wave of innovation gets juices flowing again. Already venture capital funds, flush with cash, are putting more money into alternative energy startups, an increasingly attractive investment in a world of high oil prices. It's easier for companies to spend money on research and development when the cost of capital is low. And the boom of the 1990s shows just what can happen when a technological breakthrough -- in that case, the Internet -- arrives in a period when there's ample savings.

Economists, though, worry that the good times are built on shaky foundations and wonder when they will end. "We're in a highly unstable equilibrium," says Martin Barnes, managing editor of The Bank Credit Analyst. "There are so many things that are three standards of deviation from normal."

What worries economists is that most of the savings is going to one country. According to Harvard University's Rogoff, the U.S. alone is soaking up as much as three-quarters of the excess global supply of savings. The result: a current-account deficit totaling $668 billion last year, or 5.7% of the country's GDP. And a further rise this year looks likely. Economists fret that at some point foreign investors and governments may tire of putting big sums into the U.S., triggering a steep decline of the dollar and a jump in U.S. interest rates.

So far, of course, that hasn't happened. Indeed, the dollar has risen 7% against a basket of major
currencies this year, in part aided by Europe's woes. But New York University's Stern School of Business professor Nouriel Roubini says that is only delaying the day of reckoning and sees a danger of a bumpy landing for the dollar and the U.S. economy in 2006.

It's not only the sheer size of the U.S. borrowing that could be a problem. It's also what the money is being used for. Unlike in the late 1990s, when the U.S. was tapping foreigners to help finance productivity-enhancing investment, much of today's borrowing goes to pay for the federal budget deficit and to fund a surge in house prices that many experts believe can't last.

Fueled by ultralow interest rates, house prices jumped a record 12.5% in the first quarter from a year ago, according to data compiled by the government's Office of Federal Housing Enterprise Oversight. In some of the pricier areas, the surge in prices has put homes out of the reach of the first-time buyers who are the lifeblood of the housing market. "We have real problems in the housing sector that will [eventually] cause the economy a great deal of stress," writes University of California at Los Angeles professor Edward E. Leamer in a new report.

The house price boom isn't confined to the U.S. Low world interest rates and the surplus of savings have ignited runups in many countries. In Spain, housing prices have climbed 150% since 1997, boosted by record low interest rates and foreign investment. The Bank of Spain calculates that housing prices are overvalued by between 24% and 35%. But economists at the central bank don't believe a bubble has formed. "We still think price increases will slow and then undergo a soft landing," an official says. "But the longer it takes for the market to cool, the more abrupt the landing will be."

In some countries, the housing market has begun to cool off. In Britain, the Royal Institution of Chartered Surveyors said that nearly half of its members surveyed reported price declines in May. That was the highest reading since November, 1992. Economists say that pullback eventually will take its toll on consumer spending. "The housing market is quite soft," says Michael Hume, senior European economist at Lehman Brothers Inc. (LEH) in London. "It's only a matter of time before you get a widespread consumer slowdown."

It used to be that such shifts in national housing markets were mainly of concern to the citizens of that country. But in today's world, a cutback in consumer spending in Britain -- one of the few big countries other than the U.S. that is running a trade deficit -- would raise national savings and contribute to the glut of money worldwide. That, in turn, could even further inflame housing bubbles in the U.S. and elsewhere. "There is excess savings in the world," says Lorenzo Codogno, co-head of European economics at Bank of America Corp. (BAC) in London. "Liquidity is pushing up prices of nonfinancial assets."

Policymakers find themselves coping with a peculiar situation. The usual signals -- inflation and unemployment -- are in good shape, especially in the U.S. Nevertheless, imbalances spawned by low rates -- from the global housing boom to the swelling trade deficit in the U.S. -- may have left the markets and the economy more exposed to a monetary mistake by the Fed. "A concern is that...a policy misstep could cause a quick" shift in investor attitudes, potentially disrupting financial markets and the economy, Fed Vice-Chairman Roger W. Ferguson Jr. said in a speech in Berlin on May 27.

The savings surge also means that governments are not being penalized for running budget deficits. In the not-so-distant 1990s, traders -- the so-called "bond vigilantes" -- would drive up interest rates when they saw deficits getting out of control. Today, that's not happening. Such easy money could be helpful, if government spending is going for productive long-term investments such as infrastructure, education, and research and development. The danger, though, is that cheap capital will give politicians the opportunity to waste the money on items that don't boost long-term growth.

If low rates eventually pave the way for productive investment by governments and businesses, that would benefit investors. But until this happens, they must choose between accepting lower returns or taking on added risk. "In a balanced portfolio, you should expect an average rate of return of about 5%," says Barnes of The Bank Credit Analyst.

In search of better returns, investors have piled into a host of risky assets, from high-yield bonds to credit
derivatives to emerging-market debt. If global growth slows, such indiscriminate buying could backfire. For example, the credit quality of newly issued junk bonds has declined sharply, according to Merrill Lynch & Co. (MER) A record 34% of new issue volume last year were by companies whose debt received the lowest ratings handed out by the ratings agencies, well above the previous record of 29.4% set in 2000. "The deterioration in credit quality in 2003 and 2004 could well show up in increased defaults in 2006 and 2007," says Martin Fridson, head of FridsonVision, a bond research service.

If global savings is channeled in the right ways, it can be a great boon for the world economy, enabling the sort of investment and risk-taking that fuel growth. But there’s far too much evidence right now that low rates are encouraging behavior that could cause trouble. Hold on to your hats.

By Rich MillerWith Jack Ewing in Frankfurt, Stanley Reed and Laura Cohn in London, Frederik Balfour in Hong Kong, David Henry in New York, and bureau reports

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**Most recent comments**

Nickname: fan
Review: To put things into perspective, China’s $70 billion trade surplus is only about 6-7% of its GDP. Apparently, if you are paying attention, Canada has had a trade surplus of 5-6% of GDP for years and its free floating currency was depressed for years!
Date reviewed: Jul 8, 2005 9:22 PM

Nickname: Paul
Review: With all due respect, are not your sources confusing "savings" and "profits?" Semantics aside, the problem goes to the heart of one’s conception of economic science or, rather, of political economy. Confusing both concepts sends us back to the days before Keynes and Hansen. As the Great Depression shows workfare systems supplemented by social assistance end up costing to a given Nation (be it an Empire) than those associated with a democratically-controlled welfare system based on universal social insurance networks. Big US industrial companies are already faced with this evidence. For the rest, new money has little respect for old money or "Republican" traditions. It’s the nature of the beast, to use Blake’s parlance. The problem is that by always drifting to the South en route to the West, one quickly ends up in the Orient. Just as Baraclough had predicted? Sincerely Yours, Paul De Marco
Date reviewed: Jul 6, 2005 2:52 AM

Nickname: rich m
Review: Hi all -- This is Rich Miller, author of the piece. Thanks much for all your comments -- even the unfavorable ones! A few comments, in response to some of your queries: 1) realist, hold on to your hats doesn’t mean hold on your savings, but it does mean be extra careful where you invest it. 2) Chuck, I don’t think tariffs would be a good idea. As the article tries to make clear, there are good sides to globalization as well as bad 3) MJ, yes, the current accounts net to 0, yet their lopsided nature is still a concern 4) new kid, money isn’t flowing to India et al in part because of perceived political risk, in part because their financial systems aren’t well developed 5) Chen, to keep its currency stable, China is having to buy buckets full of dollars and invest them in

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