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Remarks by

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I am pleased to join my central bank colleagues in appraising an increasingly important issue--the globalization of trade and finance. I should emphasize that I speak for myself and not necessarily for the Federal Reserve.

Among the many aspects of the euro addressed in today's discussion, we should include its role in the ongoing globalization of economic activity. The euro ties together a sizable share of the world economy with a single currency and, by doing so, lowers transaction costs associated with trade and finance within the region.

More generally, globalization of trade in goods, services, and assets continues to move forward at an impressive pace, despite some indications of increased resistance to that process and the evident difficulties in completing the Doha Round. The volume of trade relative to world gross domestic product has been rising for decades, largely because of decreasing transportation costs and lowered trade barriers. The increasing shift of world GDP toward items with greater conceptual content has further facilitated increased trade because ideas and services tend to move across borders with greater ease and speed than goods.

Foreign exchange trading volumes have grown rapidly, and the magnitude of cross-border claims continues to increase at an impressive rate. Although international trade in goods, services, and assets rose markedly after World War II, a persistent dispersion of current account balances across countries did not emerge until recent years. But, as the U.S. deficit crossed 4 percent of GDP in 2000, financed with the current account surpluses of other countries, the widening dispersion of current account balances became more evident. Previous postwar increases in trade relative to world GDP had represented a more

balanced grossing up of exports and imports without engendering chronic large trade deficits in the United States, and surpluses among many other countries.

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Home bias--the propensity of residents of a country to invest their savings disproportionately in domestic assets--prevailed for most of the post-World War II period. Indeed, Feldstein and Horioka found a remarkably high degree of home bias in their seminal 1980 study<sup>1</sup>. Through most of the postwar period up to the mid-1990s, the GDP-weighted correlation coefficient between domestic saving and domestic investment across countries accounting for four-fifths of world GDP hovered around 0.95.

That bias, however, diminished rather dramatically over the past ten years, arguably in large measure because of the acceleration in productivity growth in the United States. The associated elevation of expected real rates of return relative to those available elsewhere increased investment opportunities in the United States. The correlation coefficient accordingly fell from 0.95 in 1993 to less than 0.8 by 2002. When one excludes the United States, the correlation coefficient's decline was even more pronounced. Preliminary estimates for a smaller sample of countries over the past two years indicate a continued decline on net.

Basic national income accounting implies that domestic saving less domestic investment is equal to net foreign investment, a close approximation of a nation's current account balance. The correlation coefficient between domestic saving and domestic

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<sup>1</sup>Martin Feldstein and Charles Horioka (1980), "Domestic Saving and International Capital Flows," *The Economic Journal* (June), pp. 314-29.

investment varies inversely over time with the dispersion of current account balances across countries. Obviously, if the correlation coefficient is 1.0, meaning that every country allocates its domestic saving only to domestic investment, then no country has a current account deficit, and the variance of world current account balances is zero. As the correlation coefficient falls, as it has over the past decade, one would expect the near algebraic equivalent--the dispersion of current account balances--to increase. And, of course, it has. Over the past ten years, a large current account deficit has emerged in the United States matched by current account surpluses in other countries.

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How far can the decline in home bias and the increase in the variance of current account balances be expected to proceed, and where will it lead?

Current account imbalances, per se, need not be a problem, but cumulative deficits, which result in a marked decline of a country's net international investment position--as is occurring in the United States--raise more complex issues. The U.S. current account deficit has risen to more than 5 percent of GDP. Because the deficit is essentially the change in net claims against U.S. residents, the U.S. net international investment position excluding valuation adjustments must also be declining in dollar terms at an annual pace equivalent to roughly 5 percent of U.S. GDP.

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The question now confronting us is how large a current account deficit in the United States can be financed before resistance to acquiring new claims against U.S. residents leads to adjustment. Even considering heavy purchases by central banks of U.S.

Treasury and agency issues, we see only limited indications that the large U.S. current account deficit is meeting financing resistance. Yet, net claims against residents of the United States cannot continue to increase forever in international portfolios at their recent pace. Net debt service cost, though currently still modest, would eventually become burdensome. At some point, diversification considerations will slow and possibly limit the desire of investors to add dollar claims to their portfolios.

Resistance to financing, however, is likely to emerge well before debt servicing becomes an issue, or before the economic return on assets invested in the United States or in dollars more generally starts to erode. Even if returns hold steady, a continued buildup of dollar assets increases concentration risk.

Net cross-border claims against U.S. residents now amount to about one-fourth of annual U.S. GDP. A continued financing even of today's current account deficits as a percentage of GDP doubtless will, at some future point, increase shares of dollar claims in investor portfolios to levels that imply an unacceptable amount of concentration risk.

This situation suggests that international investors will eventually adjust their accumulation of dollar assets or, alternatively, seek higher dollar returns to offset concentration risk, elevating the cost of financing of the U.S. current account deficit and rendering it increasingly less tenable. If a net importing country finds financing for its net deficit too expensive, that country will, of necessity, import less.

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It seems persuasive that, given the size of the U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point. But when,

through what channels, and from what level of the dollar? Regrettably, no answer to those questions is convincing. This is a reason that forecasting the exchange rate for the dollar and other major currencies is problematic.

Our analytic difficulty is that the forces driving the current account deficit are more, perhaps far more, visible than those determining the ex ante financing of the deficit. The former are captured by reasonably reliable estimates of income- and price-driven trade imbalances and net interest income; the latter by the considerably more amorphous assessments of international portfolio choices.

The inability to anticipate changes in supply and demand for a currency is at the root of the statistically robust finding that forecasting exchange rates has a success rate no better than that of forecasting the outcome of a coin toss.<sup>2</sup>

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U.S. policy initiatives can reinforce other factors in the global economy and marketplace that foster external adjustment. Policy success, of course, requires that domestic saving must rise relative to domestic investment. Policy initiatives addressing individual components of domestic saving in years past appear to have had significant effects on total domestic saving, even though changes in the individual components are not wholly independent of one another.

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<sup>2</sup>The exceptions to this conclusion are those few cases of successful speculation in which governments have tried and failed to support a particular exchange rate. Nonetheless, despite extensive efforts on the part of analysts, to my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin. I am aware that, of the thousands who try, some are quite successful. So are winners of coin-tossing contests. The seeming ability of a number of banking organizations to make consistent profits from foreign exchange trading likely derives not from their insight into exchange rate determination but from the revenues they derive from making markets.

Reducing the federal budget deficit (or preferably moving it to surplus) appears to be the most effective action that could be taken to augment domestic saving. Significantly increasing private saving in the United States--more particularly, finding policies that would elevate the personal saving rate from its current extraordinarily low level--of course would also be helpful. Corporate saving in the United States has risen to its highest rate in decades and is unlikely to increase materially. Alternative approaches to reducing our current account imbalance by reducing domestic investment or inducing recession to suppress consumption obviously are not constructive long-term solutions.

It is of course possible that U.S. policy initiatives directed at closing the gap between our domestic investment and domestic saving, and hence narrowing our current account deficit, may not suffice. But should such initiatives fall short, the marked increase in the economic flexibility of the American economy that has developed in recent years suggests that market forces should over time restore, without crises, a sustainable U.S. balance of payments. At least this is the experience of developed countries, which since 1980, have managed and eliminated large current account deficits, some in double digits, without major disruption.<sup>3</sup>

Flexibility, as history persuasively shows, enables an economic system to better absorb and rebound from shocks. In the United States, for example, real output contracted very little during our most recent cyclical episode despite having been subjected to a number of shocks: the bursting of the technology bubble, the terrorist attack of September 2001, and

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<sup>3</sup>Caroline Freund (2000), "Current Account Adjustment in Industrialized Countries," Board of Governors of the Federal Reserve System, International Finance Discussion Paper No. 692, December.

the corporate governance scandals. Indeed, the U.S. economy has exhibited a degree of resilience in the face of these adversities not evident in previous decades. Presumably, the rise in product and labor market flexibility in the United States and in a number of other countries over the past quarter-century is continuing to pay off. If such flexibility can be achieved more fully on a global scale, adjustments to the future current account imbalances of both developed and emerging economies could be rendered significantly less stressful than in the past.

An admittedly exceptional example of how a flexible system adjusts even with fixed exchange rates is seen at the state level in the United States. For more than two centuries, the United States has experienced largely unencumbered interstate free trade. Although we have scant data on cross-border transactions among the separate states, anecdotal evidence suggests that over the decades significant apparent imbalances have been resolved without precipitating interstate balance-of-payments crises. The dispersion of unemployment rates among the states--one measure of imbalances--has tended to spike up during periods of economic stress but has then rapidly returned to modest levels, reflecting a high degree of adjustment flexibility. That flexibility is even more apparent in regional money markets. Interest rates, which presumably reflect differential imbalances in states' current accounts, and hence cross-border borrowing requirements, have exhibited very little interstate dispersion in recent years. This observation suggests either negligible cross-state-border imbalances, an unlikely occurrence given the pattern of state unemployment dispersion, or more likely very rapid financial adjustments.

Although we have examples of the efficacy of flexibility in selected markets and evidence that, among developed countries, current account deficits, even large ones, have been defused without significant consequences, we cannot become complacent. History is not an infallible guide to the future. We in the United States need to continue to increase our degree of flexibility and resilience. Similar initiatives elsewhere will enhance global resilience to shocks.

Many steps have been taken in the euro area to facilitate the free flow of labor and capital across national borders, and considerable progress is being made to enhance competition in product, labor, and financial markets. But more will need to be done in Europe as well as in the United States to ensure that our economies are sufficiently resilient to respond effectively to all the shocks and adjustments that the future will surely bring.