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Current account balances, financial development and institutions: Assaying the world "saving glut"

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Abstract

We critically assess several of the key assertions underlying the global saving glut hypothesis. First, we investigate whether the behavior of the U.S. current account is anomalous in light of previous industrial country experience. Second, we determine whether East Asian current account balances are predictable using standard macroeconomic variables, augmented with institutional factors. Finally, we investigate whether higher levels of financial development in key East Asian economies would result in smaller current account surpluses. We find that a 1 percentage point increase in the budget balance would increase the current account balance by 0.10–0.49 percentage points for industrialized countries, and that the U.S. current account performance over the last four years is borderline anomalous. While more developed financial markets would lead to smaller current account balances for countries with highly developed legal systems and open financial markets, for key East Asian countries, greater financial development would cause *higher* saving. Asian current account surpluses seem to be driven by depressed investment, not excess saving.

JEL classification: F32; F41

Keywords: Current account; Net foreign assets; Saving glut; Investment drought; Panel regressions; Capital controls; Institutional development

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1. Introduction

The development of enormous and persistent current account imbalances over the past decade has been the topic of intense debate in academic and policy circles. The 2006 U.S. current account to GDP deficit of 6.1 percentage points is unprecedented by historical standards, and high in comparison to other developed economies.

A number of explanations have been forwarded for this phenomenon. At the risk of oversimplification, the explanations can be categorized as either domestic or international in nature. Some argue that the main reason for the increase in U.S. current account imbalances is the decline in U.S. saving, especially public sector saving, since 2002. In this "twin deficits" argument, the current Administration's expansionary fiscal policy bears the greatest blame. Greenspan (2005a,b), Ferguson (2004) and others have, on the other hand, argued that the impact of fiscal policy on the current account balance is small.

A "global saving glut" explanation has been expounded by Bernanke (2005), Clarida (2005a,b), and Hubbard (2005). This argument views excess saving from Asian emerging market countries, driven by rising saving and collapsing investment in the aftermath of the financial crisis (and to a lesser extent Europe), as the cause of the U.S. current account deficit. More recently, the burgeoning surpluses of the oil exporters, ranging from the Persian Gulf countries to Russia, have moved to the fore as sources of excess saving. From this perspective, the U.S. external imbalance is a problem made abroad, and amenable to a solution only in the longer term, as better developed and more open financial systems mitigate this excess saving problem.

Surprisingly, despite the popularity of the saving conjecture in American policy circles, there has been little empirical work that takes seriously the global saving glut thesis.[1] In this paper, we remedy this deficiency by analyzing the determinants of current account balances for industrial and developing countries, while controlling for differences in institutional environment across countries. The data set we employ covers a large and heterogeneous group of countries (19 industrial, 70 developing) over a relatively long time span (1971–2004).

Our empirical approach relies upon the methodology developed by Chinn and Prasad (2003). Their study provided a broad empirical characterization of the medium-term determinants of current account balances for a sample of industrial and developing countries from the perspective of longer-run saving–investment balances. This paper updates and extends their work by incorporating a potentially important factor identified by Bernanke (2005), namely the effects of legal and institutional development.

Whether one takes the twin deficits or global saving glut argument, the effect of legal and institutional development cannot be dismissed a priori. In addition to macroeconomic attributes such as the stage of development, the demographic profile, and the government budget balance, the legal environment and the level of institutional development should also be important determinants for saving and investment decisions since they affect the rate of returns from these activities.

The extent of institutional development should enhance the effectiveness of financial development and other policy measures such as financial opening. Hence, this paper also devotes

[1] One exception is Gruber and Kamin (2005). Roughly contemporaneously with us, they have written a paper closely related to this one. They examine different aspects of the "saving glut" and "Bretton Woods II" (Dooley et al., 2003) hypotheses. General discussion of global savings and investment patterns is contained in IMF (2005), CBO (2005), Higgins (2005) and the Economist (2005).