THE WALL STREET JOURNAL.
WSJ.com

OPINION | JANUARY 11, 2010, 6:52 P.M. ET

Global 'Imbalances' and the Crisis

Don't blame international capital flows for the runup and crash in home prices.

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In the 1920s, capital began flowing from Massachusetts to North Carolina, a process that continued until after World War II as textile mills migrated to the South from New England. Beginning in the 1950s capital moved again as textile manufacturing moved to Mexico, India and Malaysia. Capital has long moved to where it can be used most productively, and by and large, that has been a good thing.

Whether capital moves within a country or between countries, its flow addresses imbalances between available local capital and uses for capital (otherwise known as investments). Through much of history, the major capital flows have been from rich countries to poorer ones. England financed canals in this country and railroads in Australia and India.

That's no longer the case. The most notable importer of capital in recent times has been the United States. Australia, Spain and the United Kingdom have also been importers of capital. Germany, Japan, China and Switzerland have been significant exporters of capital. Over the past 10 years, oil-exporting countries have been exporters of capital.

These facts are collectively referred to as "global imbalances." The standard view in policy circles is that they represent a serious threat to economic stability rather than a sensible market reallocation of capital. In the standard view, such imbalances are "unsustainable" and the longer they last, the more drastic and painful will be the ultimate "adjustment." After 25 years of such threats, you might think positions would change. Instead, the same people are now arguing that these capital flows were one of the root causes of the financial crisis.

In November 2008, then U.S. Treasury Secretary Henry Paulson said in a statement, "If we only address particular regulatory issues—as critical as they are—without addressing the global imbalances that fueled recent excesses, we will have missed an opportunity to dramatically improve the foundation for global markets and economic vitality going forward." The don't-just-stand-there crowd feels we have to do something about these imbalances, although what that something is isn't entirely clear.

The shorthand version of how global imbalances caused the crisis goes something like this: Capital exporting countries flooded the U.S. with savings looking for safe returns. Many of them purchased not equity or textile mills, but U.S. government and agency debt issued by Fannie Mae and Freddie Mac, for example. These flows (and loose monetary policy) kept interest rates low, making it easy for individuals and financial institutions to load themselves up with debt in the U.S., thereby fueling a runup and then a crash in home prices. In short: China made us do it.

Thus the clamor to rectify global imbalances. In the case of the U.S., doing something presumably means increasing domestic savings and dealing with our federal government's deficit. In the case of China, doing something presumably means revaluing its currency. Both are reasonable choices, in our view, but have little to do with the current account deficit (the net amount of capital flowing into the country). Throughout the 1990s, even in years of budget surpluses, the current account was growing. That suggests that something deeper is going on. But what? Why does so much of the world want to park its savings in the U.S.? Here are some reasons that deserve mention:

• *The dollar is the de facto international reserve currency*. Speculation that other currencies will replace the dollar in the near future are simply not credible. China could create a basket of currencies to peg the yuan to instead of pegging to the dollar, but that is not a practical alternative at the moment.

• *U.S. Treasurys are the deepest and most liquid market of safe securities in the world.* This was clear during the financial crisis, when investors worldwide drove interest rates on U.S. government debt to zero, even though the U.S. was ground zero for the crisis. The euro zone seems like a natural alternative, but its fractured government bond market is both less liquid and (to judge by recent credit default swap spreads) more risky than the U.S.

It seems like ancient history now, but 10 years ago there was concern that, because of budget surpluses, at some point there wouldn't be enough Treasury debt to go around. The Bush administration eliminated that concern, and the Obama administration shows no sign of changing course.

• *The U.S. has good institutions.* Despite obvious issues with financial regulation, the U.S. has one of the most investor-friendly capital markets in the world. Investors from China, Norway, and Saudi Arabia understand this.

• *The U.S. has favorable demographics.* This is a subtle, and often overlooked, reason capital flows to the U.S. Populations in the European Union, Japan and China are aging more rapidly than ours is. If young and middle-aged workers save more than the old retirees, you would expect to see them export capital initially, as they save for retirement, and import capital once enough people are retired. The U.S. population, in contrast, is aging more slowly, in part due to immigration.

Considered together, the net effect of this demographic transition is that for the next 20 years or so the current account deficit will get worse rather than better as more savings flow from the European Union, Asia and elsewhere to the U.S. These demographic forces are locked in place—there's little likelihood of large changes over the next 20 years.

• *High energy prices don't last forever.* Oil exporters know that the high prices of a couple years ago are unlikely to be permanent. They therefore decided to save some of the increased income and invest it in safe markets abroad. The U.S. is on the receiving end. We saw this in the 1970s, and again in the early part of this decade.

International capital flows have become huge, and they are arguably a more important part of the global economy in the past decade than ever before. But are they at the heart of the financial crisis, and do we need to control them?

We find it hard to buy the argument that they caused the crisis. Certainly the blame lies closer to home. More than that, the capital flows we've seen—the global imbalances that are said to threaten our economic well-being—have more benign explanations that we find more persuasive.

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