ON GLOBAL TRADE AND CAPITAL IMBALANCES WITH BRAD SETSER

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Last week on our podcast, I spoke with Brad Setser, Senior Fellow and Acting Director of the Maurice R. Greenberg Center for Geoeconomic Studies at the Council on Foreign Relations.

A starting point for our conversation centered on the causes of the low-interest-rate environment we have today. A number of people seem to believe the central banks are artificially keeping interest rates low.

Professor Jeremy Siegel weighed in with a review of something he calls the "greatest myth on Wall Street." Siegel discussed the fundamental economic forces he believes pushed rates toward zero: low inflation; low economic growth; high risk aversion; great demand for bonds, including from global demographics; and high global savings.

Setser's View of International Economic Policy

Setser reviewed his background, which included time at the U.S. Treasury, where he studied emerging market financial crises, and that led to his co-authoring a book with Nouriel Roubini. Setser became very interested in China's contribution to global capital flows and how capital flows from emerging markets were financing the United States. Setser saw flows from emerging markets as a major contributor to the U.S. and European financial crisis.

On the economic policy front, we started off with another discussion on the border adjustment tax (BAT), continuing the conversation we had with Alan Auerbach the week before. Setser believes implementing this BAT is much more complex than Auerbach does. Setser likes the element of the BAT that would remove the incentive of technology and pharmaceutical companies from locating abroad more, but he is worried about removing a source of revenue from future exports. Setser believes the BAT will have a regressive impact by making imports costlier, as he is skeptical the exchange rate would adjust fully to offset the import tax hike, as Auerbach claimed. He also believes it could introduce new distortions where firms overstate their export revenue (which would be untaxed) and thus not generate as much revenue as implied.

Why Are Interest Rates So Low? A Global Glut of Savings from Europe, Asia

We then turned our conversation to how Asian and European surplus savings are one of the key factors depressing global interest rates, as these regions export their excess savings to the world.

Setser pointed to a lack of investment coming from Europe as a critical factor in Europe's excess savings. He thinks there is a strong case for more public investment that needs to come from Europe—particularly Germany. Unfortunately, we do not see signs of that movement today, even though Setser pointed to evidence that Germany is underinvesting in public infrastructure.

In Asia, excess savings comes from extraordinarily high levels of savings relative to its economic footprint. There are high levels of investment there as well, but the extreme level of savings is the bigger issue. For example, China saved 48% of its gross domestic product (GDP) in 2015. So even though China invested 40% of its GDP, it still was exporting its savings to the world.

Setser believes this poses a risk. China's level of investment—at 40% of GDP—has many observers worried there will be bad loans to its banking system.

Setser's prescription for China is to cut back its savings without negative spillovers: It should dramatically increase spending on social insurance programs.

We also talked with Setser about steps China is taking to stem outflows and various implications for the Chinese currency.

Setser raises a number of interesting points about global capital flows and the risks that come from these flows. We appreciated the opportunity to speak with him on these issues.

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