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Acceptance Speech

Germán Bernácer Prize

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It is with great emotion and great pleasure that I wish to thank the Germán Bernácer Prize selection committee and its sponsors for awarding me this young, but already very prestigious award.

It is a great honor!

I also wish to thank the Observatorio del Banco Central Europeo, as well as the Banco de España for their hospitality and warm reception.

I am also very pleased that the committee singled out almost all my research projects: from my work on global imbalances, to my work on the gains from financial integration, and my work on precautionary and life-cycle saving motives.

This is pretty much the complete edition of my research to-date! Apparently, there isn't anything the committee did not like, and I am grateful for that too, for academics are a bit like parents, and we try to like our research projects equally!

Needless to say, over the years, my research involved many close collaborators and friends, and I would like to acknowledge here their contribution:

Jonathan Parker, my classmate at MIT, now at Northwestern University, with whom I did most of my work on consumption theory;

Olivier Jeanne, from the IMF, with whom I studied the benefits of financial integration for developing countries;

Ricardo Caballero from MIT, and Emmanuel Farhi from Harvard, with whom I study external imbalances from a global equilibrium perspective;

And finally, my long time collaborator, H el ene Rey, from London Business School, who is certainly not a stranger to you, since she was rewarded with the 2006 Bern acer prize, in part for our joint work on external adjustment.

In fact, this made me feel as if my work was rewarded twice! A very nice feeling indeed!

This occasion also gave me an opportunity to do something we seldom do in our profession nowadays: a little bit a history of economic thought.

In the past few days, I went back to the work of Germ an Bern acer, at least the work published in English, especially Money and Freedom (Kyklos, 1950), but also Dennis Robertson's commented

translation of Bernácer's 1922 seminal work "La teoría de las disponibilidades", (Económica, 1940), as well as Henri Wallich's review of "La Doctrina Funcional del Dinero" (The Review of Economics and Statistics, 1947).

As I said, this is an exercise we seldom do, and I am certainly not an expert in the history of economic thought. We, economists, understand all too well the benefits of specialization and of narrowly climbing onto the nearest giant's shoulder!

But beyond the change in language since the 1920s, especially the generalization of the Fritsch-Slutsky impulse-propagation approach to the study of macroeconomic dynamic, or the introduction of a formal mathematical language to model economic constraints, behavior and expectations, one is struck by the very modernity of many of the themes covered in Bernácer's work, from the determination of interest rates, to the concept of money demand through a cash-in-advance mechanism –by which households and firms need first to obtain liquid monetary balances before they can engage in spending activity, or with his concern for the potentially destabilizing role of financial markets.

This last insight seems especially prescient in light of the recent and ongoing financial crisis.

In short, Germán Bernácer was undoubtedly ahead of his time, and it is my privilege to have my name now associated with his.

The point of tangency between us, if there is to be one, lies in a common focus on the role of financial factors, in influencing aggregate or –as they came to be known- macroeconomic fluctuations.

For instance, my work on global imbalances aimed to provide a grid of analysis for the growing – and often puzzling-- external imbalances of the United States, with a current account deficit that peaked at 6.2% of output in 2006, before declining to 5.7% in 2007.

These imbalances are often perceived with a certain degree of alarm, both in the US, as well as in the rest of the world –in Spain, too, I would venture, despite the fact that the Spanish current-account deficit has now reached 10% of output.

It is sometimes argued that these deficits reflect the spendthrift nature of American households, or of their government. Indeed, US personal saving are very low, at 0.7% of disposable income in 2007.

But the key observation, that allowed me and my co-authors to get a handle on what was happening, was the observation that these deficits appeared in the context of low and declining world real interest rates.

In other words, unlike the external deficits of the early 1980s, occurring in a context marked by an expansionary fiscal policy that depressed US national saving and raised world interest rates, the situation that developed after 1990 occurred in a context of increased world liquidity.

We argued that this excess liquidity could be traced back to two major developments. The first development was the collapse of the Japanese stock market and housing bubble of the early 1990, followed by the 1997-1998 Asian financial crises.

Both crises revealed that these countries' supply of sound, safe and liquid financial assets was inadequate and domestic households consequently reallocated their savings away from domestic investments. The result was a surge of capital towards the United States, perceived as a financial powerhouse, in a context of robust economic performance and a general decline in interest rates.

The second factor –similar in nature-- was the coming on-line of manufacturing China, in a context, once again where economic development proceeded far apace of financial development.

The twist, in the case of China, was that domestic households and investors were not able to invest directly abroad, given the existing set of barriers to capital mobility. Yet, households found a way, indirectly and collectively, to hold US treasury bills, through the rapid accumulation of international reserves by the People's bank of China, reserves subsequently sterilized by the issuance of the so-called 'sterilization bonds'.

Some of the recent increase in international reserve holdings, then, should not be interpreted, as some would argue, solely as the emergence of a new mercantilism aiming to maintain artificially low exchange rates in order to conquer new markets abroad and to preserve a competitive edge at the expense chiefly of the manufacturing industries of the industrialized world.

Instead, this accumulation of reserves should be perceived also as the necessary counterpart of the growing demand by local households for safe financial instruments largely unavailable domestically.

The second implication of the emergence of China as a major economic player was the growing demand for commodities and energy. This growing demand implies that many commodity or energy producing countries also found themselves with growing income and the need for safe stores of value.

This general equilibrium approach allowed us to capture the stylized evolution of external imbalances, both in the US, the EU and Asia. Far from concluding that the world was on the brink of extinction, we established that the pattern of imbalances reflected the growing scarcity of real

assets available to investors, itself a consequence of disequilibrium in the relative speed of economic and financial development in the emerging world.

It also put in perspective the role of currency movements in the necessary global rebalancing that would occur eventually, as emerging countries developed their financial markets.

In effect, we argued, the world economy is responding to this disequilibrium by using U.S. financial markets as a global financial intermediary.

In some ways, this is not a new development. Back in 1966, Charles Kindleberger, together with Emile Despres and Walter Salant, famously argued in *The Economist*, that the U.S. was the 'World Banker', lending mostly at long and intermediate terms and borrowing short, thereby providing loans and investment funds to foreign firms and liquidity to foreign asset holders.

Since then, the U.S. has become an increasingly leveraged financial intermediary. It is now mostly borrowing in short medium and long term fixed-income instruments, and investing in equity and direct investment abroad. Hélène Rey and I argued that perhaps a better term now, is to think of the U.S. as the "venture capitalist" of the world.

As we showed, this unique position allows the U.S. to earn an exceptional rent that relaxes significantly its external constraint. This intermediation rent, takes the form of a wedge between the low return the U.S. pays on its external liabilities, and the high return it earns on its external assets.

We estimated that over the post-Bretton Woods period, this excess return averaged about 330 basis point per year!

Of course, such a situation is not without dangers. While I will keep most of my remarks on the current crisis for the roundtable this afternoon, let me just mention that the current situation is one where the U.S. is quite leveraged, with gross external assets and liabilities close or in excess of 100% of GDP.

And leverage comes with risks. Any change in the global environment that leads to a rapid de-leverage could have significant and real consequences for the US and the world economy.

In conclusion, an equilibrium approach to global financial development is needed more than ever, and through this award, I wish to thank the organizers of the Bernácer Prize for recognizing the importance of these questions.