Saving is supposedly vital for economic growth. So why are some of the world's most reluctant savers prospering as more frugal countries struggle? Just as parents encourage their children to save, so economists promote thrift as an essential ingredient of long-term growth. Economies that save more can invest more, it is argued, and so expand faster. Saving is considered a virtue, whereas borrowing is condemned as a vice. Yet virtue currently seems to earn few rewards. America, which saves less of its income than almost any other economy, is revelling in rapid growth and low inflation, while the thrifty economies of East Asia are suffering economic and financial collapse.

Why? Because with saving and investment, as with everything else, you can apparently have too much of a good thing. Saving may be important for a country's long-term growth, but the efficiency with which that saving is invested matters just as much as its scale. If savings are too ample and investment flows too freely, as Japan and the Asian tiger economies have learnt to their cost, the result may be waste, not prosperity. Criticise Americans for being less thrifty than Asians, but give them credit for one thing in recent years: they have used the money more wisely.

High saving rates were long touted as one of the pillars of East Asia's growth. In theory, so long as capital can cross borders freely, a high saving rate is not required to have a high investment rate—but in reality most capital still stays close to home. With ample domestic savings to draw on, South Korea, Malaysia and Thailand all invested around two-fifths of GDP in 1996—more than twice America's rate (see chart). Those high saving rates encouraged many economists to turn a blind eye to East Asia's large current-account deficits Yet the fact that economies with such vast saving still required huge inflows of capital to finance even higher rates of investment should have raised questions about the quality of that investment. As the region's economic miracle has come to an abrupt halt, it has become clear that the surge in investment in East Asia in the 1990s was a sign of weakness, not strength. Much of the money was wasted on speculative property deals or unprofitable industrial projects. In part the blame lies with three factors which made the cost of capital in East Asia appear artificially cheap. First, the combination of a huge pool of captive domestic savings (overseas investment by residents is restricted in some countries) and huge inflows of foreign capital produced low real interest rates. Second, the false belief that exchange rates would forever remain pegged to the dollar made foreign borrowing appear deceptively cheap. And third, some governments, especially South Korea's, forced banks to lend to favoured firms at cheap rates.

Combine artificially cheap capital with cronyism and government meddling, and the result was that money frequently went into those projects with the best connections rather than those with the best economic prospects. A recent analysis by J.P. Morgan confirms that returns on capital fell sharply in most of the tiger economies in the 1990s, most dramatically in South Korea, Thailand and Malaysia. A new study by McKinsey [available in the archive of the McKinsey Quarterly at www.mckinsey.com], a management consultancy, makes the same point by comparing the productivity of capital in four South Korean industries with productivity in the same industries in Brazil over a ten-year period. The Brazilians have a far lower investment rate, but South Korea's capital, on average, was used less than half as productively as Brazil's.

At the other extreme, the fact that Americans prefer to consume rather than save is an old story. In the 1980s, much of the blame for America's low saving was accorded to government borrowing (ie, dissaving). The government
has now virtually eliminated its budget deficit, but the household saving rate has halved to its lowest for more than 50 years. As a result, national saving was only 17% of GDP in 1997, no higher than in the late 1980s. Among the rich industrial countries, only Britain, whose economy is also thriving, saves less of its income than America.

Rattling the piggy bank.

Japan, which saves roughly 30% of GDP each year, has been able to afford a much higher rate of investment. Over the past decade Japan's investment as a share of GDP has been almost double that of America. And while America's savings have been inadequate to finance even its modest investment, forcing America to borrow from abroad, Japanese saving has consistently exceeded investment, giving it a current-account surplus (which by definition equals the difference between domestic saving and investment). As a result of these persistent imbalances, America's net foreign debt amounted to an estimated $1 trillion at the end of last year; Japan's net foreign assets are approaching the same sum.

On the surface, America's spendthrift habits might seem a recipe for disaster. Yet since 1979, Japan's economy has grown no faster than America's, on average. One reason for this lies in a truism that every individual investor readily understands: the higher the return on capital, the less one must invest today to enjoy a given amount of consumption tomorrow.

Another McKinsey study, published in 1996, found that American firms made far more efficient use of capital than those in Japan or Germany, which also invests more than America. American business earned an average real return of 9% a year in the 20 years to 1993, compared with 7% in Japan and Germany. The gap may have widened since then: more up-to-date figures from the OECD, based on a different measure, suggest that America's rate of return on capital over the past five years was roughly twice as high as that in Japan or Germany. McKinsey suggested that capital is used more efficiently in America because competition is fiercer and because shareholders demand more from managers. A higher return on capital allowed America to create more real wealth than Japan even though it saved less.

If rates of return are higher in America, then it makes sense for America to have a net inflow of foreign capital: excess savings in Japan and elsewhere can be invested more profitably in America than at home. But can America continue to attract sufficient foreign capital? Some economists reckon that the slump in demand in Asia will push America's current-account deficit to $300 billion in 1999—higher as a percentage of GDP than its peak in the late 1980s, when the dollar plunged.

This is all right so long as America's higher profitability is driving those capital inflows. But it is unlikely that the return on capital will always remain higher in America than elsewhere. If Asian and European governments carry out reforms which make their labour, product and capital markets more efficient, then the returns on capital in their economies should rise to match America's. In that case, less foreign money would flow in, and America would be able to sustain its present investment only by increasing domestic saving.

Even now, America's long-run prospects would look rosier if it saved more. Policies which depress saving, particularly a tax system which gives generous relief on home-mortgage interest and corporate borrowing, still need to be addressed. Japan's inability to use its high saving rate to its advantage has helped to support American investment and growth in the 1990s. If that inability persists, Americans will be able to sustain their vice for a little longer. But if the crisis helps Japan and other Asian countries learn to make better use of their capital, then high saving and investment will again prove to be a virtue.