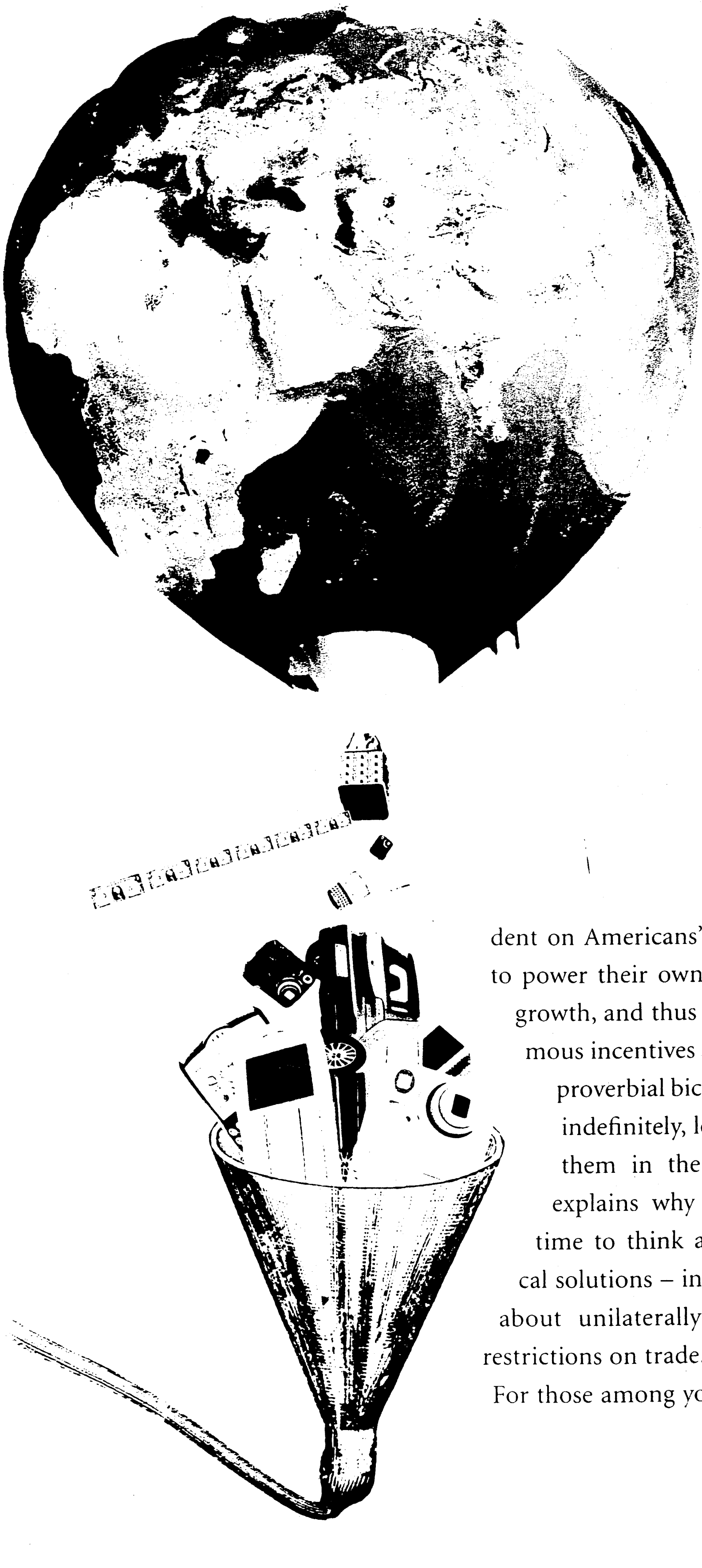
America and Her Creditors: Thinking

STEVE MUNDAY (ALL)

As everyone who even glances at the business pages of a decent newspaper knows, the United States is effectively living beyond its means, borrowing heavily from its trade partners – notably, China, Japan and the European Union. What no one really knows is how this will all end. For America's creditors have become depen-

the Unthinkable

By Wynne Godley, Dimitri B. Papadimitriou and Gennaro Zezza



dent on Americans' profligacy to power their own economic growth, and thus have enormous incentives to keep the proverbial bicycle rolling indefinitely, lest it crush them in the fall. That explains why it may be time to think about radical solutions – in particular, about unilaterally imposing restrictions on trade.

For those among you who like

to cut to the chase, our main conclusions can be stated fairly simply:

The trade deficit is likely to get worse. If output in the United States grows fast enough to keep unemployment constant between now and 2010, and if there is no further depreciation in the exchange rate of the dollar, the U.S. trade deficit is likely to reach an unprecedented 7 to 8 percent of GDP.

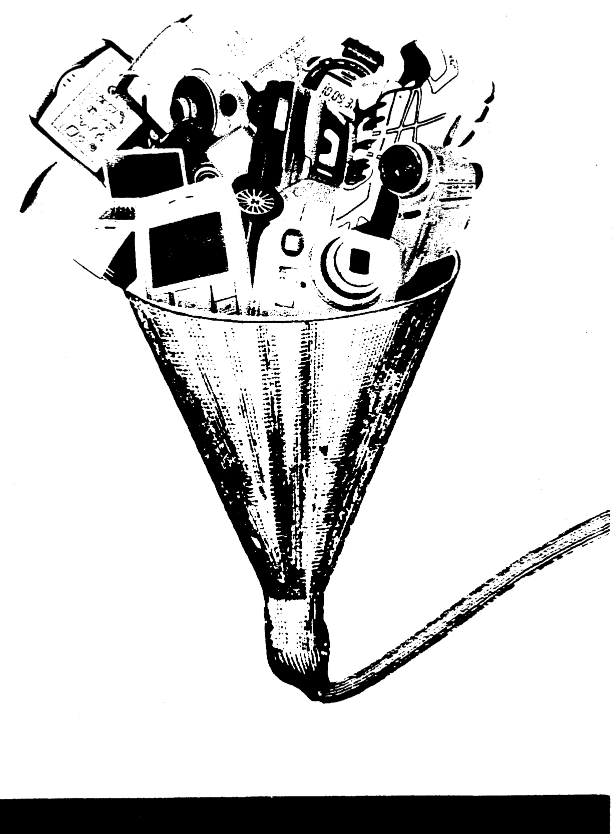
America's net income on foreign investments will turn negative. If the trade deficit does not improve, the United States' net foreign asset position will deteriorate greatly. As a result, income payments will deteriorate, and the U.S. deficit in the current account, the broader measure of our financial relationship with other countries, could top 8.5 percent of GDP.

American saving will turn positive. Net saving (saving less investment) by Americans is now negative, to the tune of 2 percent of GDP, largely because of a spectacular increase in borrowing on credit cards and against home equity. But before the decade is out, the housing market will almost certainly peak, checking the growth of personal debt. The resulting rise in personal saving will probably be enough to bring about some recovery in overall private saving, probably erasing those two percentage points of deficit.

The federal deficit will explode. If the current account deficit actually rises from 6 percent to 8.5 percent of GDP in the next five years, and if private saving rises from minus 2 percent to zero, it follows as a matter of accounting that the government's budget deficit must increase from its present 4 percent of GDP to 8.5 percent.

A recession looms. If nothing happens to increase foreign demand for American goods and services, and if Washington is unwilling to prime the pump with huge spending or tax cuts, the U.S. economy will enter a period of stubborn deficiency in aggregate demand with serious deflationary consequences at home and abroad.

A market-driven exchange-rate fix is unlikely. If the dollar's exchange rate (adjusted for inflation) was soon to fall by about 25 percent, economic growth in the United States might be sustained as foreigners spent more here and Americans switched from imports to homegrown goods. But the dollar's exchange rate has not moved decisively during the past seven years, and, as long as China and some other Asian countries continue to accumulate dollar reserves on a massive scale in order to keep their own factories humming, it is unclear that the needed devaluation will occur.



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Selective trade protection is no answer. Protective tariffs and quotas directed against countries with large trade surpluses with the United States (think China) would not solve the problem – and would certainly constitute a setback for both ongoing globalization and the long-term health of the global economy.

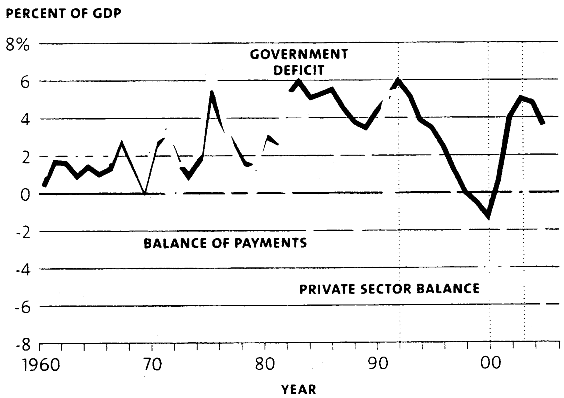
There is little immediate pressure for structural reform. An enduring solution to the problems created by the global imbalance of demand could probably be achieved only by international agreement that included fundamental changes that reduced Asia's dependence on export-led growth. But in the short run, business-as-usual means higher living standards for Americans. Meanwhile, Japan and Europe view their exports to the United States as the key to sustaining modest economic growth, while China and the East Asian tigers use America's what-me-worry stance as a means to build mighty industrial machines.

It's thus time to think the unthinkable. Given the lack of good alternatives, it would be worth considering unilateral measures that reduce the U.S. current account deficit without imposing major distortions in global economic efficiency.

RETHINKING THE WAY THE GAME IS SCORED

The current account balance – the difference between payments to foreigners and their payments to us – is, by definition, equal to the gap between savings and investment in the United States. All too often, though, people infer from this accounting identity that a current account deficit (like the one America faces today) can be cured by increasing national saving. More to the point, they assume that the most direct way to cut the foreign deficit is to reduce the government's role in reducing savings by cutting its budget deficit.

MAIN SECTOR BALANCES



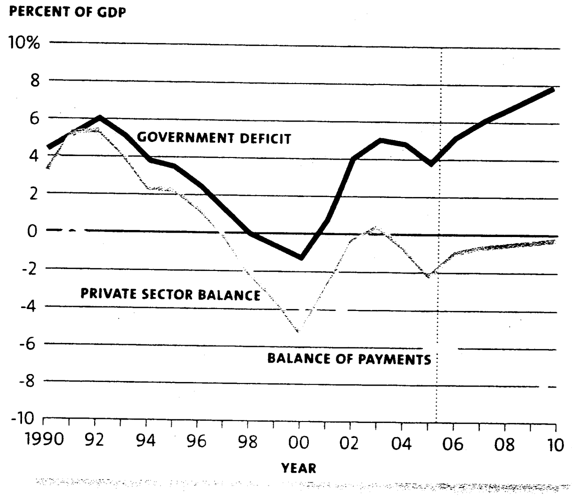
SOURCE: U.S. Dept. of Commerce and author's calculations

In fact, the accounting identity distracts from an understanding of how the myriad gears of a nation's economic machinery fit together. Any improvement in the current account balance linked to a cut in the government's budget deficit would only come about if the resulting fiscal restriction caused a recession. In any case, the balance between saving and investment in the economy as a whole is not a satisfactory operational concept; it lumps together the government and private sectors, in spite of the reality that the two are driven by very different incentives. We prefer to use the accounting identity that divides the economy into three sectors rather than two – the current account balance, the government's budget deficit, and the private sector's surplus of income over expenditure (net saving) – to bring coherence to the discussion of underlying issues.

THE STORY SO FAR

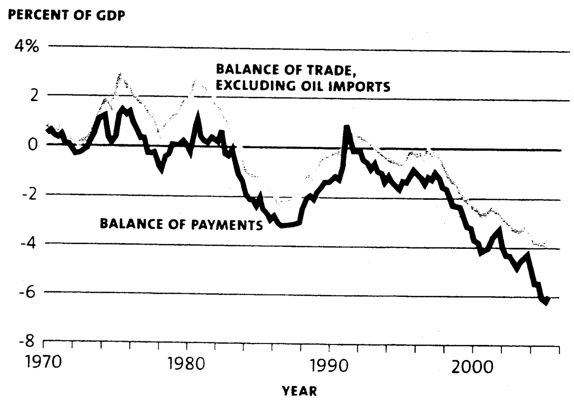
The figure above shows how the three financial balances have moved since 1960. For the first three decades, all three fluctuated within fairly narrow bounds. Since 1992, however, everything has changed.

MAIN-SECTOR BALANCES, ACTUAL AND SIMULATED



SOURCE: U.S. Dept. of Commerce and author's calculations

BALANCE OF PAYMENTS AND ITS COMPONENTS



SOURCE: U.S. Dept. of Commerce and author's calculations

The 13 years that follow divide neatly into three phases. The years from 1992 to 2001 gave us the "Goldilocks" economy, in which growth was just right to sustain both stable prices and low unemployment. But throughout the Goldilocks years, the narrowing budget deficit and growing current account deficit were bleeding purchasing power from the economy at increasing rates. Hence the long economic expansion was, by necessity, powered by ballooning private expenditures, which drove net saving into deficit.

In the second phase, from 2001 to 2002, private net saving recovered, even as the economy experienced a modest recession – a recession that would have been much more serious if Washington had not inadvertently acted like a born-again Keynesian, cutting taxes and beefing up spending.

In the third phase, 2003 to now, there has been a renewed expansion. The current account deficit has continued to grow, so private spending is once again increasing as a portion of income – and once again driving private net saving deeply into negative territory.

WHAT'S NEXT?

In the figure to the top left, we project the three financial balances (current account, government budget, net private savings) to the year 2010 on the assumption that the economy will grow at an average annual rate of 3.3 percent. This is the estimated rate at which unemployment will neither rise nor fall, and it also corresponds reasonably well with mainstream estimates.

The Trade Balance

One uncontroversial implication of this scenario is that the trade deficit will continue to rise if there is no real depreciation of the dollar and if output grows fast enough to keep unemployment from increasing.

This fits most economists' expectations – after all, the inflation-adjusted exchange rate has not changed very much since 1998, while the current account deficit has risen strikingly. There was an increase in the exchange value of the dollar of about 10 percent between 1998 and 2002, and then a slightly larger proportionate fall during the last three years.

It's worth noting that this recent fall in the exchange rate seems to have had no effect on the prices Americans paid for imports in spite of the fact that it implies foreigners are netting substantially less income denominated in their own currencies. Indeed, this price squeeze on foreign sellers in the United States may in part explain why U.S. imports have continued to rise so quickly. Equally surprising, the fall in the exchange rate of the dollar appears to have had no effect on the price of U.S. exports denominated in dollars – which helps to explain why U.S. exports have performed fairly well, too.

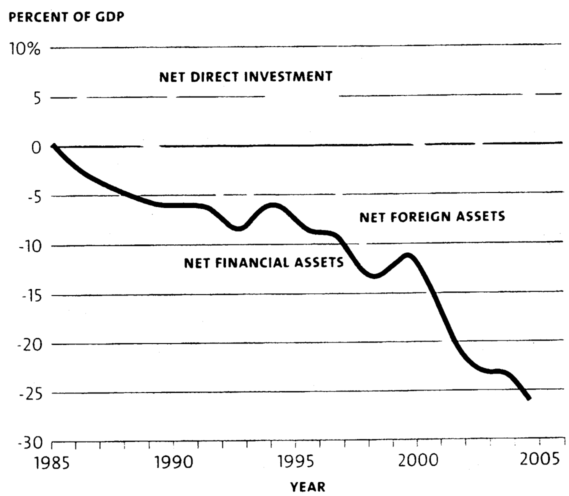
As has been widely noted, the value of U.S. imports now exceeds that of exports by a shocking 60 percent. Thus, if imports continue to rise by 8 percent annually and if the relative prices of imports and exports do not change, the volume of exports would have to rise by 12.5 percent annually just to keep the balance of trade (setting aside oil) from deteriorating further.

But why set aside oil? The rise in the price of oil over the past year has added over $60 billion to the annual import bill. In the projections here, we assumed that, in the medium-term, oil prices will fall back to the spring 2005 level. But it is entirely possible that prices will rise by 2010 – and, in that case, the trade deficit could go much higher than the 7.5 percent of GDP in the projections.

International Investment and Income Flows

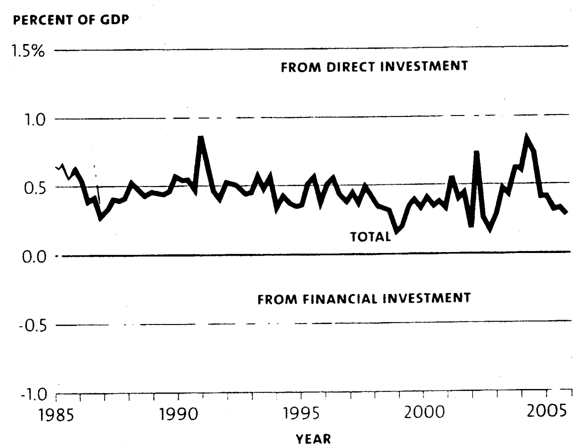
A baffling feature of the U.S. current account numbers is that, while our debts to foreigners now exceed their debts to us by about $2.1 trillion, the net flow of investment income has remained in our favor. One figure on this page shows the recent trend in America's net asset position, split between direct investments valued at market prices and financial investments like stocks and bonds. Note that almost all of the deterioration in the net asset position has taken the form of financial investment – direct investment (by U.S. corporations) is alive and well. The other figure shows the net income associated with each category of investment. Note that the growing

NET FOREIGN ASSETS



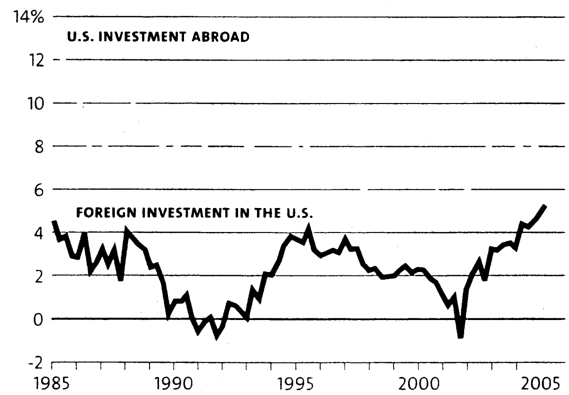
SOURCE: U.S. Dept. of Commerce and author's calculations

NET INCOME FLOWS FROM ABROAD



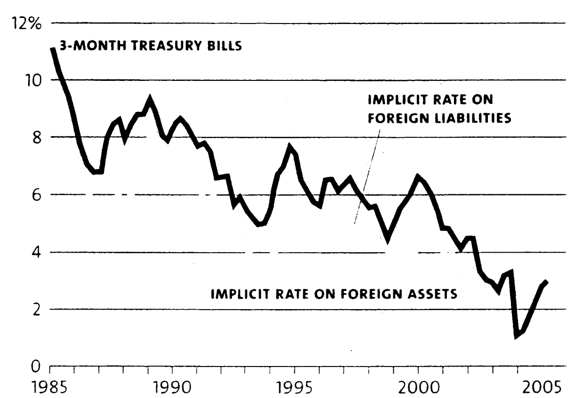
SOURCE: U.S. Dept. of Commerce and author's calculations

IMPLICIT RETURN ON DIRECT INVESTMENT



SOURCE: U.S. Dept. of Commerce and author's calculations

INTEREST RATES



SOURCE: U.S. Dept. of Commerce, Federal Reserve and author's calculations

outflow of earnings generated by financial investment was almost exactly matched by a growing inflow from direct investment.

The two figures on this page show our estimates of income from each broad class of assets. The rate of return on direct investment abroad has been much higher than that on foreigners' direct investment in the United States. But the numbers are quite the opposite for securities: foreigners' assets in the United States have consistently earned a higher rate of return than our financial investments have earned abroad.

We project a continuing deterioration in America's net holdings of financial assets abroad equal each year to the current account deficit. This implies that the net stock of all foreign assets – direct and financial – is likely to fall to minus 30 percent of GDP in 2010. Accordingly, the net income flow will deteriorate perceptibly, eventually turning from positive to negative by enough to increase the overall deficit in the current account to about 8.5 percent of GDP by the end of the decade.

Net Saving by the Private Sector

In the second quarter of 2005, private net saving was minus 2 percent. Nonetheless, we start with the assumption that over the next five years it will revert toward its historic (positive) mean – an assumption we think is justified by the cooling of the housing market and recent declines in net lending to households.

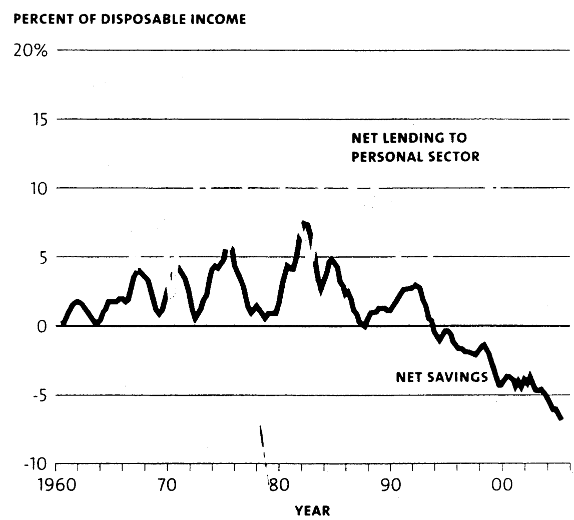
The figure opposite shows net lending to the personal sector (as a percent of disposable income) since 1960, together with total net saving, scaled in the same way. Until the early 1990s, cycles in lending and saving had an average duration of about five years, and neither series departed for long from its long-run mean. But since then, the path of both series has been vastly different from anything previously experienced. Net lending has risen rapidly while net saving has fallen rapidly – in both cases to record levels. Net lending to households is now at least 6 percentage points above its long-term mean, while net saving by households is at least 8 percentage points below its mean.

The relationship between debt and lending has given rise to so much confusion that it is worth digressing to spell out the relationships involved. The figure to the bottom right shows net lending to households since 1975. It also tracks household debt as a proportion of disposable income. The crucial point here is that a fall in lending as a percentage of income can be consistent with a continuing rise in the ratio of debt to income. Indeed, this is what happened on a grand scale in the United States from 1984 through 1990. It was only when the net lending ratio fell well below the growth rate of income – as it did in 1992 and 1993 – that the debt ratio fell, too.

Why is this important? Because, encouraged by the Federal Reserve, financial analysts commonly assume that any threat to the economy's financial stability created by a high level of indebtedness comes about only because of the consequent burden on households obligated to pay interest and repay capital. The foregoing analysis suggests there is a different and potentially very powerful source of instability, especially when net lending has been adding as much as 15 percent to household spending power. In order for there to be a fall in net lending from 15 percent of income to, say, 7 percent, all that is required is for the growth rate of debt to slow down to the growth rate of income. This is exactly what happened in the late 1980s. And it could easily happen again – say, in the (likely) event that housing prices level out.

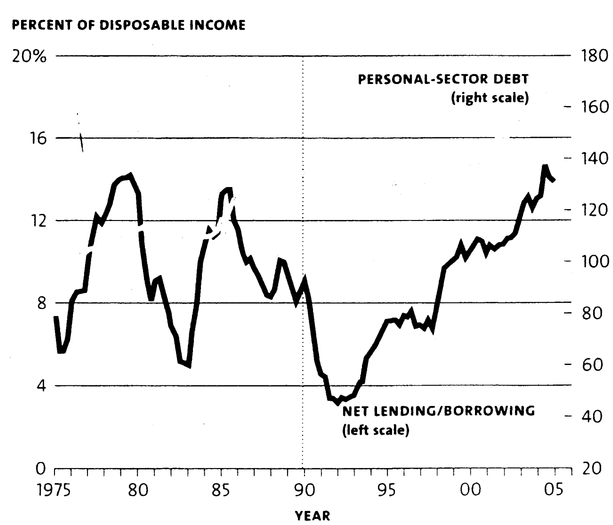
Is it possible that household habits have changed so much that lending and spending are likely to persist even if real estate prices top out? Or go a step further: Is it conceivable that house prices will increase indefinitely relative to income? If this were to happen and if people were to keep their level of indebtedness relative to housing wealth constant, the result could arguably be a permanently higher flow of lending and a permanently lower level of net saving than used to exist. Indeed, this

PERSONAL-SECTOR LENDING AND SAVINGS



SOURCE: U.S. Dept. of Commerce, Federal Reserve and author's calculations

NET LENDING AND PERSONAL-SECTOR DEBT



SOURCE: U.S. Dept. of Commerce, Federal Reserve and author's calculations

view seems to be supported by the Fed's figures for the burden on households of interest, repayments and rent, which is not significantly different from what it was in 1987 –

notwithstanding the record indebtedness.

But this is an implausible scenario. First, note that the Fed's "burden" figures describe averages, and there is plenty of anecdotal evidence that, for a significant number of borrowers, the burden is very much higher than these averages would suggest. Debts have to be serviced and ultimately repaid from income, while solvency requires that these obligations be met in a timely fashion.

Yet income is vulnerable to the vicissitudes of health and employment; moreover, there is ample reason to expect interest rates (and thus payment obligations) to rise in the future. And if house prices were to fall, heavily indebted families would likely find their equity lines of credit exhausted, leaving them with debt exceeding the property's value and thus making it impossible for them to move or even to trade down, while the obligation to service debt remained.

People are buying second homes, and even buildings not yet constructed, in the expectation of making the kind of quick profit once reserved for day-trading in stocks, bonds and commodities.

Second, the rise in lending has so far been fed by a progressive easing of loan underwriting standards that must have nearly run its course. This conclusion is reinforced by evidence that a new kind of speculative behavior has invaded the housing market: people are buying second homes, and even buildings not yet constructed, in the expectation of making the kind of quick profit once reserved for day-trading in stocks, bonds and commodities. In short, we are witnessing a classic bubble with house prices and lending rising in a self-reinforcing process.

To reach a conclusion about trends in net saving by the private sector as a whole, we must also project the behavior of corporations. Net lending to, and net saving by, corporations have been inversely related in roughly the same way as with households. Between 2001 and 2003, there was a very large rise in net corporate saving, the counterpart to the large fall in investment that was both a cause and effect of the recession. At the latest count, net saving by the corporate sector is not far from its long-run average. If there is a sustained rise in total output between now and 2010, as we assume in the baseline projection, corporate investment would probably recover – a development that could drive corporate net saving into deficit once again. It's likely, then, that the rise in net saving by households from its present extraordinarily low level will be large enough to ensure that net saving by the private sector as a whole, now about 4.5 percent below its long-run average, will rise by at least two percentage points over the next five years and possibly by much more.

THE IMPLICATIONS FOR FISCAL POLICY

Remember that if the current account balance reaches 8.5 percent of GDP and if private net saving is zero, it follows that the budget deficit must rise to 8.5 percent of GDP.

While this conclusion has been reached by logical inference from accounting identities – not from economic analysis – it still has a very clear economic meaning. Imagine a situation in which aggregate demand for domestic goods and services is rapidly bled away by higher saving and a growing current account deficit. If there is to be adequate growth in demand to keep unemployment on target, this hemorrhage needs to be offset by increasing transfusions of demand in the form of increased government spending or tax cuts.

Or think about it from another perspective. If demand is not stimulated by fiscal policy, rising personal saving and falling exports are likely to trigger a recession – one whose severity could be aggravated by feedback effects like declines in the prices of housing and other assets. As the current account deficit would tend to improve under these circumstances, policymakers may turn from worrying about increasing indebtedness to foreigners to how the economy could be stimulated. However, if a big jolt of fiscal stimulation is ruled out by worries about the already-large budget deficit, the only way left to increase demand would be through exports.

COULD EXPORTS BE STIMULATED?

The classic way to improve net export demand is through a decline in the home-currency exchange rate, making exports cheaper to foreigners and imports more expensive to locals. In a free market, this is likely to happen on its own, as asset holders insist on paying lower prices for currencies that are in glut. If the share of assets issued by the United States in the world's stock of internationally traded assets (think of stocks and bonds), as must happen if the country runs a large deficit, the price of those assets must be progressively forced down.

Such "portfolio" models of exchange rate determination hardly seem relevant at the present time, though, because they depend on the assumption that the market players are intent on maximizing the value of their assets. In fact, the central banks that are in a position to buy dollar assets in massive quantities have very different goals in mind. China, the biggest single collector of dollars these days, is far more concerned about building markets for its exporters than in reducing the cost of imports to its consumers. Likewise, Japan and Europe are content to amass dollar assets in the name of keeping corporate profits up, unemployment down and economic growth above zero.

By the same token, nothing is really driving Washington to press for a cheaper dollar. Thanks to the largesse of foreigners amassing U.S. currency, the nation is in the unusual position of being able to consume 6-7 percent more resources than it produces without suffering any inflationary pressure.

The important qualification here is that a cheap dollar and subsequently cheap imports are having a devastating effect on some U.S. industries, and this damage has already given rise to a great deal of protectionist pressure. But imposing selective tariffs – or more likely, quota restrictions like the recent moves against Chinese textiles and clothing – would no longer be sufficient to make a big dent in the current account deficit.

So while it might well happen, it wouldn't materially change the prospects for rebalancing global demand.

THINKING THE UNTHINKABLE: ACROSS-THE-BOARD PROTECTION

An often-forgotten World Trade Organization rule permits the use of import controls if there is a conflict between the objectives of full employment and current account equilibrium. Article 12 of the General Agreement on Tariffs and Trade specified that any import controls should take the form of quantitative restrictions – tariffs. But the WTO version of the rule expresses a welcome preference for "price-based" measures, by which it means "import surcharges, import deposit requirements, and other equivalent trade measures with an impact on the price of imported goods." Note, too, that Washington could impose Article 12-style trade controls without formally invoking Article 12 of the international agreement.

Currency devaluation (in a system in which governments specify exchange rates) is virtually equivalent to the imposition of a uniform tariff on all imports, accompanied by a subsidy of equivalent value on all exports. The main difference is that a tax/subsidy scheme effectively revalues assets held in other currencies along with the income they generate.

To satisfy ourselves that the use of such non-discriminatory tariffs could generate an improvement in the trade balance and to explore various other properties of such a venture, we introduced an Article 12-style tariff into our simulations. Starting from our baseline projection, we first assumed that a uniform tariff would be imposed at the rate of 25 percent on all goods except oil at the beginning of this year, generating additional revenue of $370 billion for the government. Second, we assumed that foreign sellers would absorb half of the cost themselves and pass along the other half to American consumers, implying a rise of 12.5 percent in the price of imports and in consequence a 2-2.5 percent fall in their volume. Third, we assumed that foreigners would retaliate with an average of 10 percent surcharges on imports from the United States.

The results of this exercise, shown in the figure to the right, indicate that the restriction would lead to a significant correction in both the current account deficit and the government budget deficit – without an adverse effect on the growth of total output. The positive stimulus coming from higher net exports is almost exactly balanced by the negative effect on private expenditure because of higher import prices, making additional fiscal restriction unnecessary.

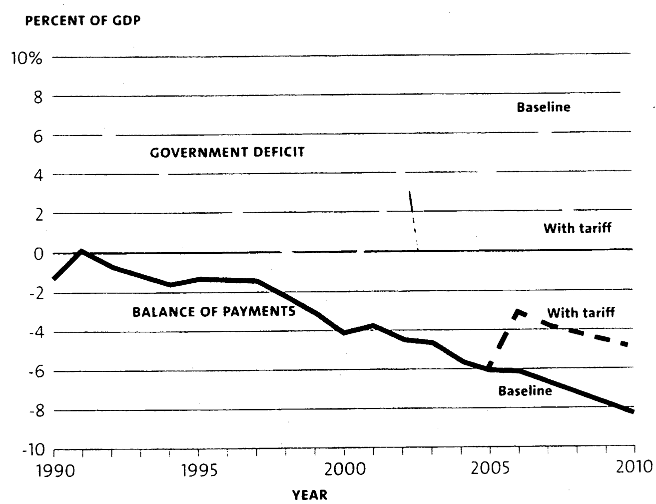
When would such a tariff be removed? When there is a global consensus on ways to balance trade and production so that both are sustainable at satisfactory levels.

FINAL THOUGHTS

The range of strategic policy for the United States is beginning to narrow. The restrictive impact on market demand at home linked to the deterioration in the U.S. current account was offset in the Clinton years by a large, credit-financed rise in private expenditure relative to income. Then, in the early years of the Bush administration, it was offset by a massive fiscal stimulus linked to big tax cuts. More recently, it was again offset by a renewed surge in private spending largely financed by household borrowing on credit cards and home equity.

But since this net lending to consumers must be close to its peak, a continued deterioration in the current account balance without a parallel reduction in aggregate demand may only be possible if the already-sky-high budget deficit is permitted to double. Accordingly, while trends in unemployment and growth seem favorable at the moment, it has become

MAIN-SECTOR BALANCES UNDER A TARIFF ON IMPORTS



SOURCE: U.S. Dept. of Commerce and author's calculation

urgently important for the United States to consider policies that will increase net export demand.

A satisfactory long-term fix that permits full employment without massive imbalances in trade probably can't happen without international cooperation. For example, it would have to include major structural changes in the Chinese and Japanese economies that allowed them to sustain high employment without running monster trade surpluses. But in the absence of such initiatives, the United States could (and, arguably, should) take a leadership role in providing a temporary fix – one that unilaterally imposes trade restrictions designed to improve the current account with only minimal impact on the efficiency of the global economy.