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Policy Note

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SOME UNPLEASANT AMERICAN ARITHMETIC

WYNNE GODLEY

Is it sufficiently realized how intractable those U.S. imbalances—and how dangerous their potential consequences at home and abroad—have now become?

Recall first that, as all students of the national income know, the deficit of the general government (federal, state, and local) is everywhere and always equal (by definition) to the current account deficit plus the private sector balance (the excess of private saving over investment). In the first quarter of 2005, the deficit in the U.S. balance of trade—the difference between exports and imports—was 5.7 percent of GDP, implying that the current account deficit, which includes both the trade deficit and certain forms of cross-border income, was at least 6 percent. In the absence of major policy changes (and assuming output growth is sustained), many people think that the current account deficit will increase further during the next four years. Suppose optimistically, however, that the deficit remains at 6 percent while output growth remains high enough to stop unemployment from rising.

The private sector balance was *negative* 2.2 percent in the first quarter of 2005—some 4 percent below its long-term average—mainly because there has been a furious housing boom financed by exceptionally high borrowing. It is noteworthy that between 1952 and 1997, there was not a single whole year during which the private sector balance was negative. If, during the next four years, the private sector balance were to recover halfway to normal (i.e., to zero), implying a

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WYNNE GODLEY is a Distinguished Scholar at the Levy Institute and a senior visiting research scholar at the Cambridge Endowment for Research in Finance.

large fall in private expenditure relative to income, and if the deficit in the current account remains at 6 percent, the general government deficit must rise to equal the current account deficit, that is, it must rise to 6 percent. This number follows arithmetically because, as already pointed out, the budget deficit is equal, by definition, to the current account deficit plus the private sector balance. If the private sector balance were to return to its long-term average (plus 1.8 percent), as might easily happen if the housing boom were to collapse, the government deficit would have to rise to nearly 8 percent of GDP.

Neither of these figures for the budget deficit is credible, given the administration's firm commitment to cut the federal deficit in half during the next four years. Yet without such renewed fiscal stimulus, the United States will, at best, encounter a prolonged growth recession under the (conservative) stated assumptions about international trade and the private sector balance.

The current account problem, examined from the viewpoint of aggregate demand, would not necessarily be solved just if exports were to rise more than imports, because this could simply be a manifestation of recession in the United States. Sustained and balanced growth in the future requires that exports rise faster than *full-employment* imports. Such a rise is a necessary condition for achieving a reduction in the budget and current account deficits simultaneously, without recession. But the obstacles to sufficient export growth are daunting, because the value of imports is now (in the first quarter of 2005) 57 percent higher than exports. Suppose that the volume of imports rises at 8 percent per annum (the average growth rate during the last 15 years) indefinitely, and that there continues to be no change in the non-oil terms of trade. (The terms of trade are the dollar prices of imports relative to those of exports.)

In this case, the volume of exports would have to rise at an annual average rate in excess of 10 percent during the next four years—60 percent above the long-term average in the past—*just to prevent the balance of trade from deteriorating as a share of GDP.* To bring about a 3 percent (of GDP) improvement in the balance of trade, sustained growth in exports would have to exceed *16 percent per annum,* which is very much faster than in any previous four-year period.

Arithmetic by itself obviously will not tell us how much export growth would be required to improve the deficit by 3 percent if there were a further devaluation of the dollar that caused the terms of trade to deteriorate and import penetration to fall. I have simulated the future, using a range of assumptions, and I find that any credible configuration requires a sustained rise in the volume of exports at a rate well in excess of 12 percent per annum—that is, faster than during any previous four-year period. But where, in any case, would these exports go? And does the United States now have sufficient manufacturing capacity to supply them?

A 3 percent improvement in the current account balance as a share of GDP would also require an equivalent reduction in domestic demand for goods and services—in other words, significantly reduced private consumption and investment. Are the U.S. government and the U.S. public prepared for the large rise in taxation and cuts in public services that are implied?

Finally, how is the rest of the world to manage, should their main motor for growth—their growing trade surplus with the United States—turn negative? Are they collectively able and willing to generate adequate growth at home to compensate for the loss?

What is going to force the strategic issue? It is not obvious that a large enough change in exchange rates will occur soon or spontaneously. Perhaps the loss of U.S. manufacturing jobs will be the straw that breaks the camel's back, but let's hope the Gordian knot isn't cut by inaugurating a new era of piecemeal protectionism. Martin Wolf (2005) was right when he claimed that global imbalances require a global solution.

References

Wolf, Martin. 2005. "Imbalances Will Require Global Solutions." *Financial Times,* April 26.

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