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“The U.S. Current Account Deficit”

It is a pleasure to be able to appear before your Commission today to discuss an issue of great public importance. In my comments I will reflect on the causes, implications, and appropriate policy responses to the current account deficit.

The idea that current account deficits are bad is so ingrained in our language that we commonly describe an increase in our current account deficit as a “deterioration” and a decrease as an “improvement.” But this language is misleading and I hope the Commission will avoid using it. The central message I would like underscored here is that current account deficits are inherently neither good nor bad. What really matters is why they occur and how they are dealt with.

All current account deficits are not created equal. Some deficits may be associated with rising employment, increased investment, and rising incomes while others may be associated with falling employment, declining saving, and reduced incomes. The former are clearly better than the latter.

The current account will be in deficit as long as spending exceeds income. But the same aggregate number for the deficit could occur in the face of very different levels of spending and income. Those who suggest that deficits necessarily mean a drop in employment must have in mind a current account deficit in which income (and thus employment) is falling faster than spending. But what if spending exceeds income and yet both are rising? In this case, the current account deficit and employment could both be growing.

Another way of expressing the same point is that the current account will be in deficit if domestic investment is greater than domestic saving. This means that the excess investment is being financed through an increase in net foreign borrowing. Is it good or bad to get into debt? The answer obviously depends on what you are doing with the money. Again, any given aggregate number for the deficit could occur with very different levels of saving and investment. Those who suggest that increased international indebtedness reduces future incomes have in mind a current account deficit in which domestic saving falls and the country is borrowing to consume. But what if productive investment is boosted by international borrowing? In this case, a current account deficit could actually raise future incomes.

The present U.S. current account should be evaluated with these considerations in mind. In this regard I would like to make three observations on the causes of the deficit and three on its consequences.

First, the recent increases in the deficit are associated with a strong U.S. economy and weakness abroad. As indicated in Chart 1, the recent current account deficit has developed in three distinct phases. In the first period, between 1991 and 1994, the deficit increased as the U.S. economy recovered. In the second period, between 1994 and 1997, the deficit remained within a fairly narrow range as growth occurred in both the United States and the rest of the world. In the third period, however, foreign economies slumped while the U.S. economy remained strong. In this third period, the deficit has been influenced by the increased attractiveness of the United States as a location for investment. This suggests that the proximate cause of the large and recent increase in the deficit is the relative strength of the U.S. economy.

Second, the deficit reflects stronger national investment rather than weaker national saving. As indicated in Table 1, net national investment increased by 4.4 percentage points of net national product between 1991 and 1998, while net national saving was up 2.5 percentage points. This recent deficit, therefore, reflects an investment boom. In the 1980s, by contrast, the current account deficit reflected a saving bust. Net domestic investment as a percent of NNP actually declined by 1.1 percentage points while net national savings fell by 4.1 percentage points.

The different results in the two periods is not an accident. Policies in the 1990s have emphasized tight fiscal policy -- through restrained government spending -- and accommodative monetary policy. In the 1980s expansion, by contrast, the mix was the opposite: a highly expansionary fiscal policy with large tax cuts and a strong increase in government expenditures -- particularly in the defense sector -- and tight monetary policy. The 1980s policies contributed to relatively high real interest rates, declining net national saving and investment, and a large current account deficit. The 1990s policies, on the other hand, resulted in declining government deficits which kept interest rates lower than they would have been and stimulated investment spending. Although the current account has again moved into deficit in the 1990s, in contrast to the 1980s, this deficit has been associated with more vigorous investment rather than a diminished rate of national saving.

Enthusiasm for the performance in the 1990s should be tempered by awareness that personal saving in the 1990s has declined and that both net national saving and investment, though improved relative to the 1980s, remain lower shares of national income than they were in the 1960s and 1970s. Nonetheless, the data underscore the central fact that the recent expansion has been led by investment, part of which has been externally financed. It needs to be recognized that we are better off for having this investment than we would be without it. The deficit has also allowed us to maintain very high rates of investment that are in part responsible for the recovery in productivity growth we have seen since 1995.

Third, the deficit in part reflects a stronger dollar. In both the 1980s and the 1990s, a strengthening dollar contributed to the deficit. The rise has been much smaller in the 1990s than in the 1980s, so the corresponding effect on the deficit has also been smaller. But more importantly, the underlying macroeconomic sources of that strength have again been fundamentally different. In the 1980s, the dollar was boosted by the high real interest rates engendered by Reaganomics. The United States needed to borrow because of lower national saving. In the 1990s, the dollar strengthened in response to the improved relative attractiveness

of the United States as an investment location. The strong dollar has also helped to keep inflation in check thereby allowing more rapid growth and higher levels of employment:

Fourth, the deficit has been associated with strong growth in U.S. employment and output. The US is currently experiencing the longest peacetime expansion in its history, an expansion, which has seen pay-rolls rise by an additional 20 million jobs since January 1993. The coexistence of an economy at full employment and the current account deficit exposes the folly of those who use defective methodologies to claim that a particular deficit automatically raises unemployment by a given number. In fact, the deficit has allowed the economy to maintain strong spending growth without inflation by drawing on resources from the rest of the world.

Fifth, the deficit has been associated with an economy that is creating good jobs and providing higher wages to all workers. Recent analysis by the Council of Economic Advisers and the Department of Labor has found that 81 percent of new jobs are located in Industry/occupation categories that pay above median wages. And the good jobs have not gone only to the professional elite. Excluding professional occupations from our sample, we still found that 71 percent of the new jobs were in categories paying above median wages. And it is not only those with college degrees who are gaining. When we looked only at workers with a high school education, we found an overwhelming proportion of the job growth was in the categories in which these workers earn the highest wages.

In addition to creating good new jobs, the economy has been rewarding all groups of workers. In the 1980s, real wage growth was confined to high-wage workers who were typically highly educated. Indeed, real wages at the lower end of the wage distribution actually fell. But starting in 1994, workers throughout the wage distribution have experienced strong real wage gains – with those at the bottom enjoying the highest growth rates. According to the Economic Policy Institute, since 1994 the lowest decile has enjoyed a real increase in hourly wages of 8.6 percent, while wages in the top decile have increased by 5.5 percent. Since 1994, the growth in the average weekly wages of high school graduates has matched those of workers with college degrees.

These results may come as a surprise. The forces of globalization and technological change are clearly at work in this expansion. Our economy is more open than ever before. Likewise, as a share of GDP, investment in information technology stands at record levels. It has become conventional wisdom that increased global involvement and rapid technological change inevitably damage the prospects of low-wage workers. Yet, over the past five years, this has not been the case. Conventional wisdom overlooked the role these forces have played in allowing us to operate a high employment economy with less inflationary pressures. A more open economy with faster productivity growth permits higher wages without triggering price increases. And with less inflation, the economy can operate at levels providing greater opportunities for those at the bottom of the skills spectrum. Finally, increases in the minimum wage and in the Earned Income Tax Credit have helped to make work pay for workers at the bottom of the income distribution.

The old consensus that blamed technology and trade for inequality in the 1980s may provide an adequate account of what happened in the 1980s. But the recent experience suggests

it is time to reappraise the inevitability of the adverse impacts, to look at the ways in which they may actually help foster growth with equity, and to recognize that a flexible economy can adjust to these changes.

It is also quite possible that the adverse trends themselves have now been brought to a halt by other responses in the economy. As relative wages of unskilled workers decline, firms have an incentive to use more of them. Thus the pace of skill-biased change declines. As international competitive pressures increase, firms need to figure out strategies (improved technology, new products, or higher quality) by which they can compete. This means they no longer compete directly with low-wage countries and thus are less affected by competitive pressures. The result is a far more resilient economy. •

Sixth, the deficit, particularly since the Asian crisis, has been associated with considerable dislocation in the manufacturing sector. Between 1993 and 1997, despite an increase in the manufacturing trade deficit, manufacturing output grew faster than the rest of the economy -- averaging 5.7 percent annually. Even with rapid productivity growth in this sector, manufacturing employment increased by 700,000 workers between the first quarter of 1993 and the fourth quarter of 1997 (See Chart 2).

As might be expected in an investment-led expansion, these employment gains were concentrated in durable goods manufacturing, with rapid advances over this period in Motor Vehicles and Parts, Lumber and Wood Products, Industrial Machinery and Equipment, Fabricated Metal Products, and Electronic and Electrical Equipment. Even in this period, however, employment growth in non-durables was sluggish. Indeed, in the labor-intensive industries heavily engaged in international trade, such as textiles, apparel, and footwear, significant employment declines were recorded.

More recently, however, the growth pattern has changed. Weak foreign demand and declining foreign currencies have brought manufactured export growth to a halt. The volume of U.S. exports of goods and services in the third quarter of 1999 was just 4.3 percent higher than in the fourth quarter of 1997 while over the same period imports of goods and services increased by 22 percent.

Since machinery accounts for about half of all U.S. manufactured goods exports, durables goods manufacturers and their suppliers, such as steel, have clearly been adversely impacted by the export slump. Not only have they lost export sales directly, but they have also been indirectly damaged by the decline in manufacturing capacity utilization.

By contrast, manufacturers able to find shelter at home have sustained employment growth. Strong expenditures on construction have sustained employment growth in Lumber and Wood Products, Stone Clay and Glass, and Furniture and Fixtures. Similarly, buoyant demand for autos and trucks has maintained stable employment levels in motor vehicles and parts despite strong import growth.

It is clearly the case that manufacturing employment has been adversely affected by the Asian crisis and its aftermath. But it would be incorrect to simply take the employment

equivalent of the increase in the **manufacturing** trade balance as a measure of the jobs **lost** due to trade. It is important to recognize that the inflows of capital into the United States **have allowed** us to run an economy with higher levels of investment than would otherwise have been the case. This has in turn led to greater spending on both plant and equipment, creating more jobs in manufacturing and construction than would otherwise be the case. Nonetheless, this dislocation underscores the interest we have in stimulating export growth.

Simulations undertaken by the Council of Economic Advisers using the Federal Reserve's quarterly model indicate that while the primary forces contributing to the rising deficit-mainly slowing output **growth** abroad, outright crisis in some countries, and the effects of crisis on financial markets-has reduced manufacturing employment, it has also allowed interest rates to be lower, resulting in stronger spending on housing and business investment.

Adjusting the Current Account

It is hard to be precise about a desirable level for the current account. It is certainly possible to construct scenarios in which some reduction might be desirable to help those sectors of the economy, such as manufacturing and agriculture, which have been adversely affected by the Asian crisis and its aftermath. However, if such adjustment is to occur, again what really matters is how the current account is reduced rather than its specific levels. I would like to propose four guiding principles:

First, it is better reduce the current account through faster growth abroad than through slower growth at home. A large part of the current account deficit reflects the impact of stagnating markets for U.S. exports. We have an interest in policies that stimulate foreign growth. It would be highly undesirable to reduce the deficit through a recession at home.

Second, it is better to reduce the deficit through increased domestic saving than through reduced domestic investment. If there are attractive investment opportunities in the United States, we are better off borrowing from abroad than foregoing these opportunities. But our incomes would be even higher in the future if we financed these through higher domestic saving. We should have policies to make saving more attractive. Indeed, President Clinton proposed such policies in his Universal **Savings** Account proposal this year. Unfortunately, his proposal was not adopted by Congress. We also need prudent fiscal policies. Again the Administration proposals which would lead to large and growing surpluses in the decade to come are highly desirable.

Sustaining the growth strategy of tight fiscal policy and accommodative monetary policy would be the **appropriate** macroeconomic assistance to the current problems faced by the manufacturing sector. Increased national savings would result in lower interest rates and thus lead to higher domestic investment which would boost demand for equipment and construction; Increased saving would also result in higher net exports which would also raise employment in these sectors.

Third, given the requisite changes in savings and investment behavior, it *is better to complement the adjustment through opening markets abroad than by closing them in the United States*. Protectionism at home should play no part in our responses to the current account deficit. Measures such as higher tariffs and quotas make our economy less efficient. By contrast, more open large foreign markets can stimulate our exports and improve the terms at which we trade.

Finally, as Secretary Summers has emphasized, we have an interest in a strong dollar. *It is better to accomplish current account adjustment through faster foreign growth and opening foreign markets than through a decline in the value of the currency*. Everything else being equal, the stronger our international buying power, the higher our incomes will be.

Table I

U.S. NET NATIONAL SAVING AND INVESTMENT
(Percent of net national product)

	Net National Saving		Net National Investment		Employment (millions)
	Private	Government	Domestic investment	Net foreign investment, or current account	
1981	11.1	-1.7	10.2	0.2	100.4
1987	8.6	-3.3	9.1	-3.6	112.4
1991	9.3	-4.2	5.2	0.3	117.7
1998	6.4	1.2	9.5	-2.6	131.5
Change, 1981-1987	-2.5	-1.6	-1.1	-3.9	12.0
Change, 1991-1998	-2.9	5.4	4.4	-2.9	13.7

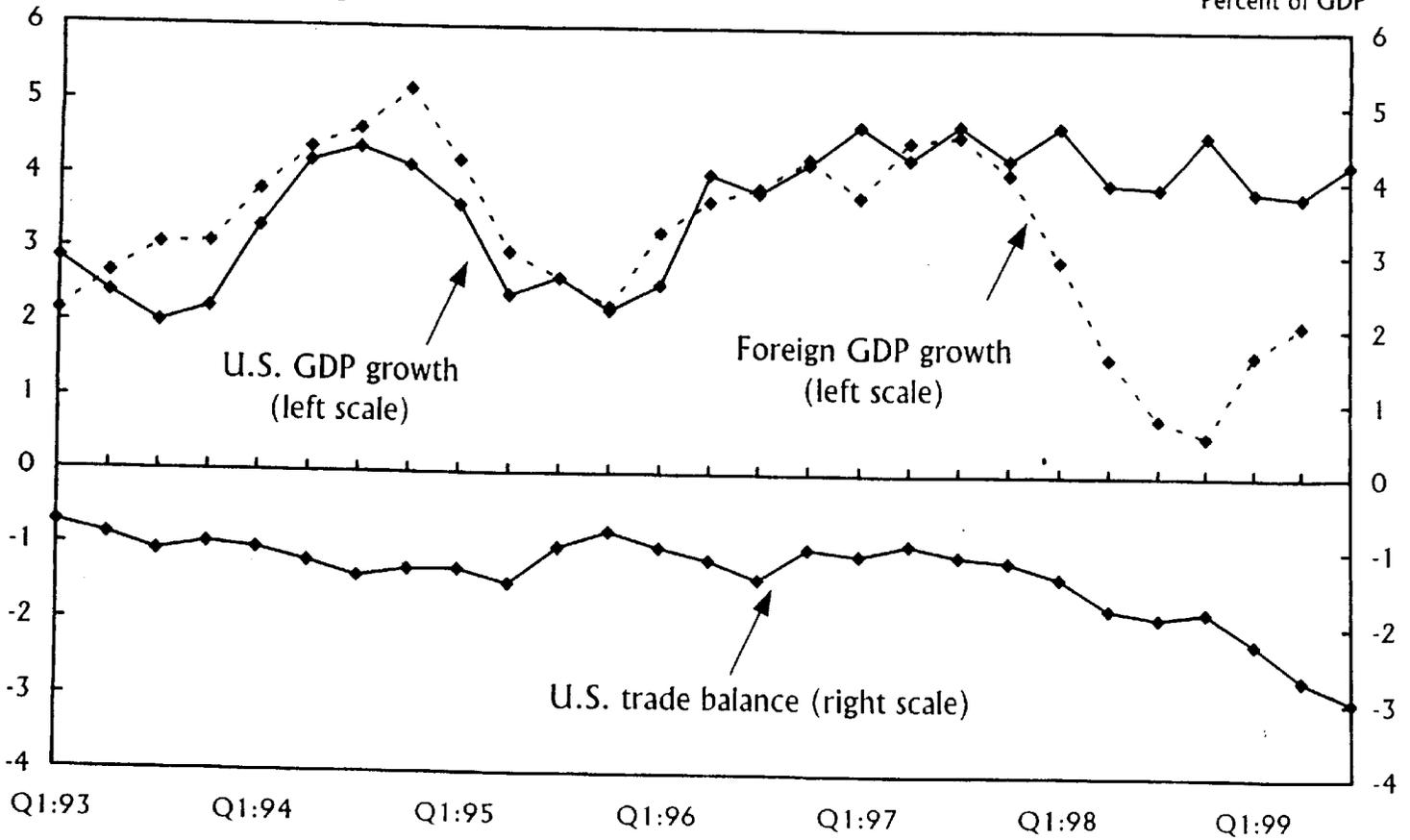
Source: National Income and Product Accounts, Bureau of Labor Statistics

Chart 1 Foreign and Domestic GDP Growth and U.S. Net Exports

The sharp slowdown in foreign growth in 1998 and continued weakness in 1999 have contributed to the growing U.S. trade deficit.

Four Quarter Percent Change

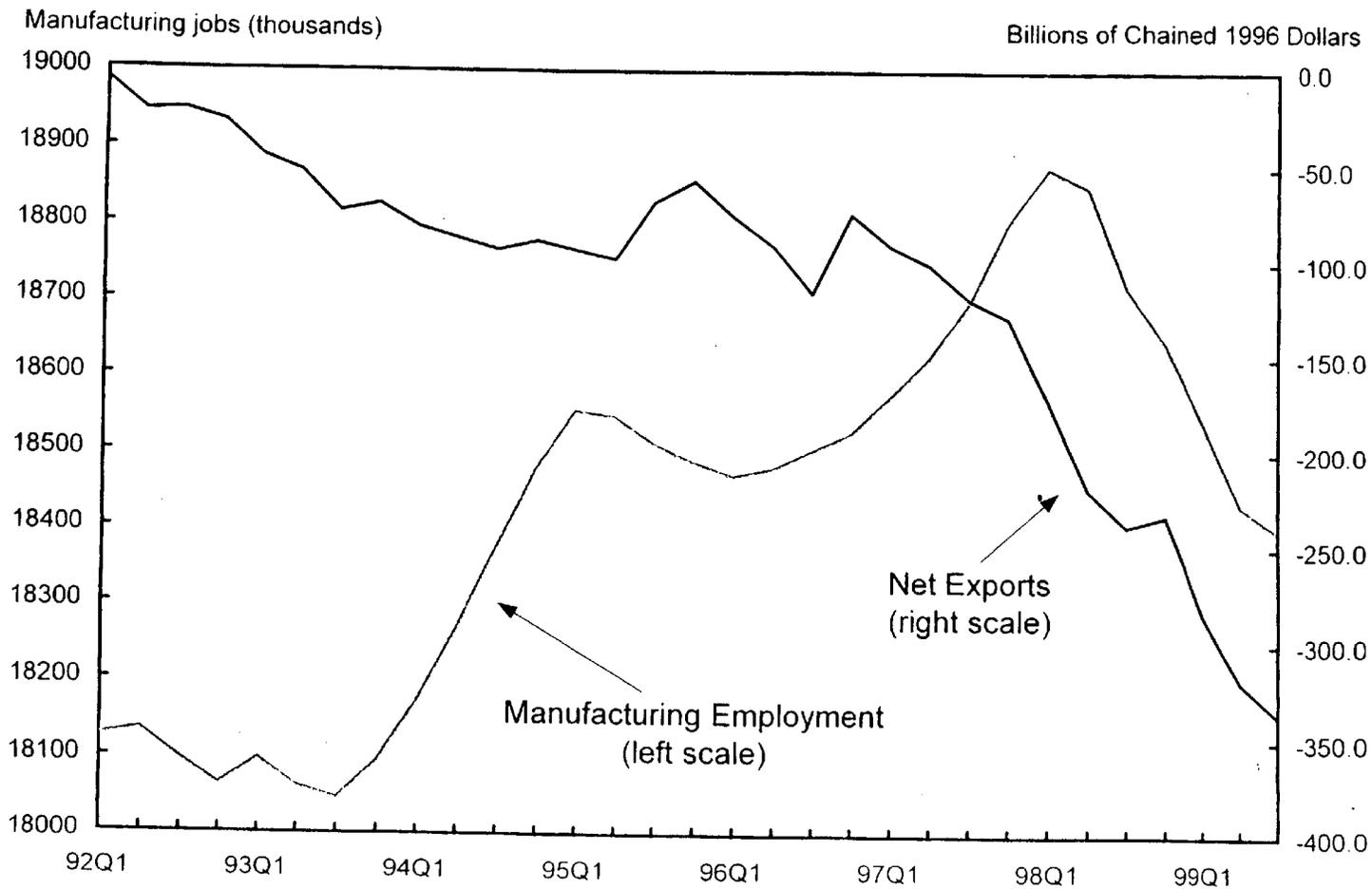
Percent of GDP



Notes: Foreign GDP growth is weighted by U.S. bilateral export shares.

Sources: Federal Reserve Board; Department of Commerce (Bureau of Economic Analysis).

Chart 2 Manufacturing Employment and Net Exports, 1992-1999



Source: Bureau of Labor Statistics and Department of Commerce