Background Comments to Testimony provided by Prof. Jan Kregel to the Trade Deficit Review Commisslon, August 19, 1999.

Good morning. My remarks this morning a divided in three parts. The first suggests that in approaching the problem of the Trade Deficit it is necessary to consider both the current account and the capital account of the balance of payments in an international context. Since these factors are simultaneously determined, it is inappropriate to ignore the behaviour of the rest of the world. In the current context this means the adjustment to the Asian crisis, so that the second part of my remarks looks at the behaviour of US goods and services trade in the context ofthc global adjustment to the Asian crisis. Finally, the last part of my remarks deals with the sustainability of the US payments position and possible consequences for exchange rates and levels of activity.

I. Introduction: If Balance Sheets Always Balance, Why Worry About the Balance of Payments?

Every economic exchange is a two-sided activity: for every seller there must be a buyer. But, it is also the case that every seller is at one and the same time a buyer of what is received in exchange for what is sold and vice versa. This second affirmation is often used in the explanation of international exchange, where exports, the sale of domestically produced goods and services to non-residents, also represent the demand and means of purchase for imports offoreign goods and services produced by non-residents. Since there must be a buyer for every seller and since every seller is also a buyer thus leads to what appears to be the logical conclusion that imports and exports of goods and services should be equal.

This idea is reinforced by the way we do economic accounting, which is a zero sum game with every credit entry balanced by a debit entry. The current account of the US balance of payments

is the sum of a series of debits representing values received in the form of imports of goods and services and payments for the service of non-resident factors of production, and credits representing values given in the form of exports of goods and services and the sale of the services of resident factors to non-residents. But, even on a pure accounting basis the sum of credit and debits may not be equal since international exchanges also include financial transactions between residents and non-residents, that is borrowing and lending that is recorded as value received and value given in the form of financial capital. Further, these capital account transactions are linked to the current account because the interest and dividend flows to which they give rise are included in current account payments for factor services.

In simple terms, a debit representing imports may be balanced by a debit representing borrowing from non-residents and credits representing exports may be balanced by foreign lending to non-residents. These are recorded as capital account transactions. The zero sum game that is represented by balance of payments accounting is in fact between the current account balance and the capital account balance under a fixed exchange rate regime, with changes in central bank reserves acting as the balancing item. While the current account balance and the capital account balance must be equal and offsetting under such a regime (i.e. of opposite in sign) there is nothing in economics or accounting that suggests that the current or the capital account separately should be in balance; or in surplus or in deficit for that matter. What is much more important, and most often forgotten in balance of payments discussions, is that they must be considered together, and that it is wholly inappropriate to consider one separately from the other. Nor is it appropriate to consider one as the active, and the other as the passive balance, in the sense of one determining the other.

Since the Keynesian revolution came to dominate economic thinkingafter the second war, it

has become commonplace to concentrate on the current account balance since it represents the basic determinants of income flows, but before the turn of the century it was just as common to concentrate on the capital account as the active force that determined adjustments in the current account of the balance of payments. Thus, outflows flows of capital from the developed countries, such as the UK, served to finance the import of UK manufactured goods by developing countries. A country that wanted to sell its goods abroad had to be willing to provide the finance for the purchasers to buy them. This reinforces the idea that the two components of the accounts have to be considered simultaneoulsy.

Since Keynesian theory was primarily interested in the determination of domestic income levels, the debits and credits included in the current account were interpreted as follows. Since sales in the form of values given to non-residents represent demand for domestically produced output this is beneficial for domestic economic activity, while purchases by US residents of non-resident production is a substitute for demand for domestic output. Looked at in this way, the current account represent the contribution (positive or negative) of foreign operations on the level of domestic demand, economic activity and thus income and employment. A surplus increases demand and income and employment, while a deficit reduces demand and income and employment.

Somewhat later, in the late 1950s and 1960s, when the dollar price of gold was under pressure the interpretation was rather different. Values received in the form of imports can be considered as claims by non-residents on US residents for payment in their domestic currency and the claims of US residents on non-residents as demands for payment in dollars. If the two sets of claim do not offset each other, the net position on the current account regislers the potential payment to non-residents in foreign exchange and the payments by non-residents to residents in dollar. This gives the potential

supply and demand for dollars and thus determines supply and demand in the foreign exchange markets. Under the Bretton Woods systems ofiixed exchange rates, a surplus indicated an increasing level of foreign exchange reserves (which in a floating rate system would produce an appreciation of the currency), while deficits suggest losses of reserves (or a depreciation in a floating system). This suggests that the balance of payments cannot be considcrcd independently of the exchange rate regime that is adopted, as well as policy concerning the proper level of the exchange rate, An imbalance in foreign payments may be due to an inappropriate exchange rate as much as it is due to inappropriate foreign or domestic economic policies.

From either of these points of view it is easy to conclude that a current account surplus is preferable since it boosts domestic demand and employment and provides a strong exchange rate. But, since a surplus in any one country must be balanced by deficits in the rest of the world, this means that the current account of the balance of payments is not something that. can be looked at in isolation from the behaviour of non-residents. as representing the behaviour of the capital account, and of the exhcange rate, and as such is not completely under the control of US policy. A policy to encourage a current account surplus requires the acceptance of the rest of the world to run a current account deficit. Alternatively, it says that all countries cannot decide that surpluses are preferable to deficits and decide to adopt policies to that effect, since it is mathematically impossible that all countries should succeed. Indeed, such uniform policy behaviour would mean that the income and employment benefits of a surplus would be lost and all countries would have lower income and employment than they would otherwise have had,

Indeed, there is no difference between a policy to encourage current account surpluses and one to encourage capital account deficits under a fixed exchange rate system, or a policy to

encourage current and capital account surpluses and an appreciating exchange rate under a floating rate system. Thus, we might just as well be discussion the problems that result from the excessive US capital account surplus, rather than the problems associated with an excessive deficit on the current account balance. Alternatively, discussing the strength or weakness of the dollar exchange rate under a flexible exchange rate system is no different from a discussion of the strength or weakness of the net position of the current and capital account balances.

II. The Behaviour of the US Balance of Payments in the Aftermath of the Asian Crisis

Against this background, the recent increase in the US current account deficit as a per cent of GDP is not necessarily a cause for concern, looked at. from the point of view of the compatibility of global economic policy. First, because the US economy is growing as rapidly as seems desirable by policy makers. and the existence of the imports represented in the current account deficit act to increase available resources and goods supplies and thus keep demand from running ahead of supply. At the same time, the deficit has not been a cause of weakness of the dollar. This is because, as mentioned, the current account represents the potential demand and supply of dollars, but if foreigners choose not to be paid in their own currencies, but instead lend to the US to finance the deficit, this increases the demand for dollars and strengthens the exchange rate. This is the present condition in the US. with the capital account surplus more than offsetting the current account deficit, so the current account deficit is not producing downward pressure on the dollar.

It is also the case that the government budget is currently in surplus, so that the payments position is not the result of excessive government stimulus, but ofprivare sector decisions. This is not to suggest that the deficit is any more sustainable for this reason, as suggested by the Lawson

Doctrine (named for the former British Chancellor of the Exchequer who first proposed it), but simply that the determinants are different, being primarily private consumption and investment expenditures.

Finally, after the outbreak of the Asian crisis, most forecasters suggested that US deficits of around 250 billion and up on an annual basis would be necessary to allow the crisis ridden economies to repay their international indebtedness and restructure their economies. To the extent that the US deficit contributes to this process it is not only desirable, it is inevitable.

However, the increase in the US deficit that was originally expected has come much later than originally forecast, and is somewhat larger since it is not being shared equitably amongst the non-crisis countries. There is also some reason to believe that the US contribution to this process has reached it maximum and that further increases in the deficit may not be desirable on global grounds. To understand why it is necessary to look the determinants of the current position. Chart 1 (Current Balance of Payments as a Percent of GDP) shows that the current account balance as a percentage of GDP has returned to levels similar to those experienced during the crisis of the 1980s. Thus, the magnitude of the deficit is not historically large, but is at levels which have in the past been considered as unacceptable and led to the Plaza and Louvre decisions to reduce the value of the dollar. Again, it is not clear that the devaluation of the dollar in itself was sufficient to reverse the deficit, but it was probably necessary.

There are two opposed factors that have been at work in the current deterioration. The first is that the behaviour of imports has been dominated by the current historically long expansion. Chart 2 (Imports of Goods & Services as a Percent of GDP) shows that imports have generally exhibited reasonably long plateaus, determined by the offsetting rises and falls of economic activity. The volume

of imports was roughly constant from 1972 to 1984, the level then jumped to another plateau from 1988 to 1992, but from that point on import volumes have increased steadily. Thus, the volume of imports has been driven by the internal conditions of the economy. Chart 3 (Exports of Goods & Services as a percent of GDP) shows the behaviour of exports, where the evidence is rather different, and the volume share of exports in GDP has risen steadily since the Plaza Accord in 1985, However, in 1997 the figures turn down sharply, as a result of the crisis in Asia. Thus, the impact of the Asian crisis on the volume of US foreign trade has been to reverse the increase in the export share.

However, as already mentioned, this impact has come more slowly than expected, The main reason for this is that while US import volumes have continued to rise, the prices of imports have not, indeed the value of exports, that is the volume measured in terms of unit values have only increased marginally. The US has increased its volume of imports as a share of GDP without spending a higher share of GDP to pay for it. 'Looking at Chart 3, the value of exports have more or less tracked volume figures, which means that prices of exports have been more or less constant, This relative increase in the price of exports relative to imports is traditionally called an improvement in the terms of trade, and represents an increase in income in the same sense that an increase in the purchasing power of money from a decline in prices increases domestic incomes. Thus, the US has benefitted from higher incomes as a result of the increasing trade deficit. Chart 4 (Terms of Trade) shows changes in the US terms of trade for goods and services excluding and including oil. It is interesting to note the sustained improvement in the terms of trade excluding changes in oil prices which starting in 1996 well before the Asian crisis. and slows in 1997, just as oil prices start their decline. It is likely that this is the result of the recovery in the US dollar, which also played an important role in reducing the competitiveness of Asean exports. Nonetheless, since the outbreak of the Asian crisis the

improvement in the US terms of trade is in the range of 4%; changes of this magnitude have only been experienced in the turbulent 1980s. The impact is thus substantial, and again it appears to be sustained, rather than a cyclical move. Of course, there is a negative side to this movement in primary commodity and agricultural prices in the form of the decline in prices and incomes of US producers of agricultural goods. Thus, US farmers are also paying some of the costs of the financial instability created by the adjustments to the crisis in Asia.

Of course, the behaviour of the terms of trade suggests that there is something wrong with the adjustment process in the crisis countries, for the gains in the US are the counterpart of the losses suffered by exports who have reduced incomes and employment. This provides part of the explanation of the fall in the volume of US exports, since the crisis countries can buy fewer US exports per dollar spend, and they are trying to accumulate dollars to repay debt, not spend on more imports from the US. It also explains why the expectations that the US would be plunged into recession as a result of the deluge of cheap goods from the Orient has not taken place, as the fall in the price of imports has increased domestic incomes to in part offset the negative impact of the higher deficit on domestic demand. The important role played by the decline in the price of oil has reinforced this impact, for it has a direct impact on disposable incomes as lower prices at the pump instantly translate into more dollars in the consumers' pocket.

As a result of these changes in the terms of trade,, the US foreign balance has deteriorated much less rapidly than originally expected, and only recently has the monthly deficit reached levels that had originally been forecast as the likely outcome of the adjustment process required in the crisis countries, without taking into consideration the impact of the changesin the terms of trade. However, the original forecast was that the burden of adjustment would have been shared amongst the rest of

the world. Instead, the US has remained the only economy with growth that is sufficiently strong to contribute fully to the adjustment process. Chart 5 (Bilateral Balances with the US) shows the bilateral trade balances in trade in manufactured goods for the US with selected regions, Trade in manufactures closely mirrors movements in the overall US balance, and is important to the Newly Industrialising Countries in SE Asia. Since the crisis two factors stand out. One is the clear deterioration in the balance with Asia (excluding China, but including India) and the other is the similar, but less pronounced, movement in the balance with China. China was not directly affected by the financial crisis, but did experience a loss of competitiveness in the region and a decline in overall exports, which has in part been offset by exports to the US. China is also undergoing a process of internal systemic restructuring, largely based on exports. The balances with the other two major regions, Japan and Europe have remained roughly stable, so that the decline in the US external account is largely due to the support that it is giving to Asian ndjustment.

Chart 6 (Balance of Trade in Goods as proportions of US GDP) shows the current account balances of various regions as a share of US GDP. The vertical bar represents the extent of current data and plots tier that date show forecasts made by Professor Wynne Godley of the Jerome Levy Institute based on his global model, The shift from a small deficit to a surplus in Asia is clearly of similar magnitude to the deterioration of the deficit in the US. Japan has also improved its foreign position, while Western Europe's adjustment has been much less pronounced than that of the US. More importantly, Western Europe remains in large surplus, roughly equivalent to Asia and China. Clearly if Europe were running a smaller surplus. it is more than likely that the US position would be much better. Thus, while the main point I would like to stress is that the decline in the US current account position has been inevitable and desirable from the point of view of providing adjustment in

Asia, it need not have been as large as it has been if the burden had been shared among developed countries, in particular in Europe and Japan. It is also meant to reinforce the point that *unless* European policy changes, it would be counter-productive to attempt to undertake policies to sharply reduce the US deficit.

III. Is the Balance of Payments Position of the US Sustainable Over Time?

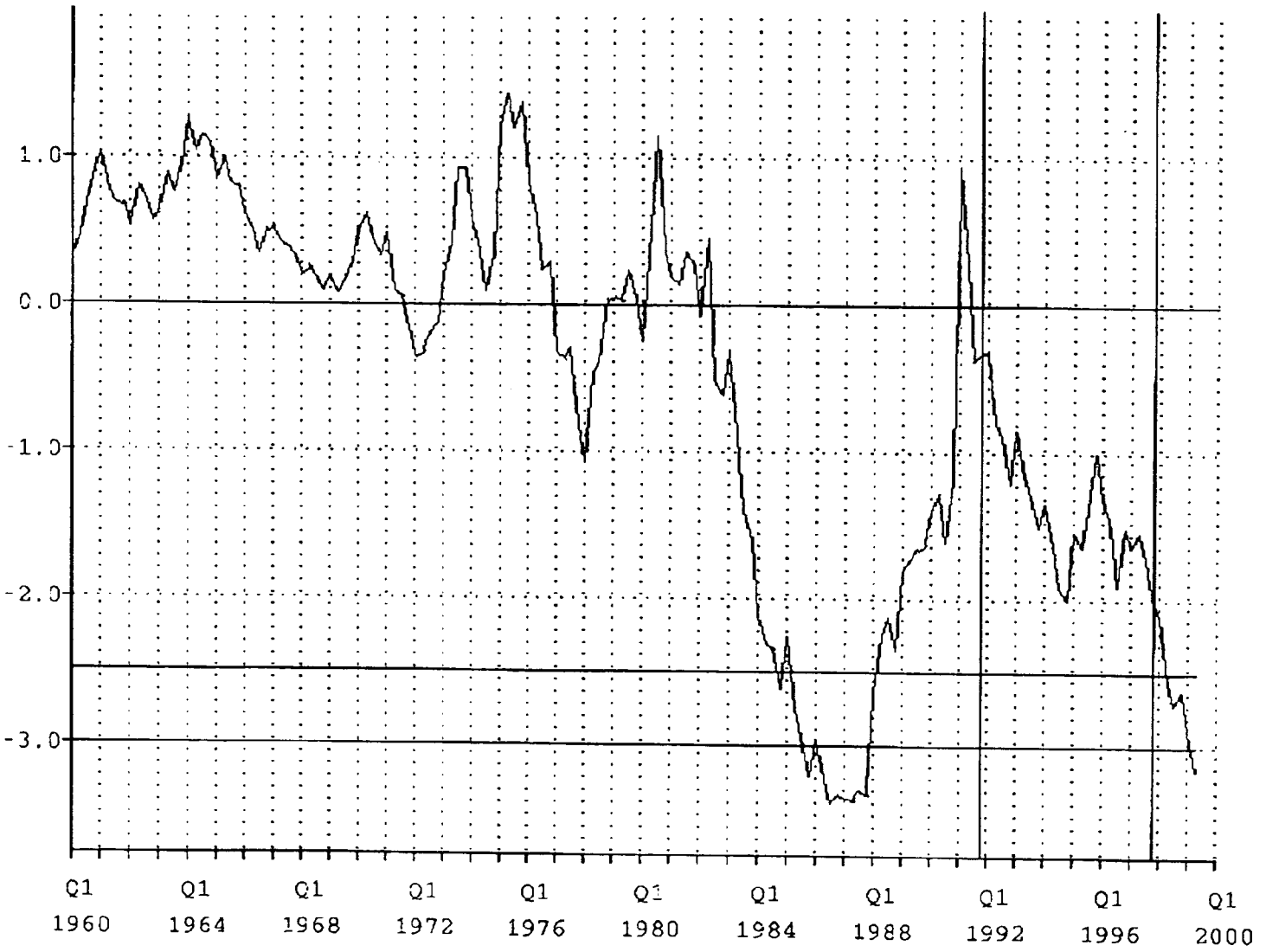
Finally, it is clear that the US has reached the limits of its ability to contribute to the global adjustment process. First, because the penetration ofimports into US markets has reached a level in certain sectors such that domestic producers are requesting protection from foreign competition, creating protectionist pressure that can only jeopardise the ability of developing countries to adjust. On the other hand, if the US economy continues to grow at present rates (i.e. in the range of 3% to 4%), partly as a result of the beneficial influence of the crisis in terms of trade effects and lower foreign production costs for US producers operating abroad, it is likely that monetary policy will be tightened, raising interest rates. This will have a sharply negative impact on developing countries by increasing debt service costs and diverting capital flows back to US financial markets. While this might reduce US imports it would have a further negative impact on exports.

Recall that we started with the idea of accounting balances requiring a global view of problems. While the US current account balance may bc positive or negative, it must be offset by and equal and opposite balance in the financing or capital account, or by an exchange rate adjustment. As noted, a US deficit creates non-resident claims on the US, which are lending to the US, or capital inflows. The US deficit as it accumulates over time is financed by the accumulation of the ownership of US financial assets by non-residents. This financing feeds back into the US current account balance

in the calculation of factor incomes payable to non-residents relative to those earned by residents. The most important factor income is capital borrowed and lent. Chart 6 (Factor Income Flows as a Percent of GDP) shows the US receipts and payments for factor incomes. In simple terms were are looking at the earnings of assets held abroad by US residents (receipts) versus the payments made to non-residents derived from the earnings of US assets that they own. The result of the sustained current account deficit in the US has been to turn the net receipts figure negative, which is recorded as an outflow in the current account balance. In a word, the US now requires non-residents to lend to us in order to pay the interest that is due them. This is equivalent to a firm that engages in what the late Hyman Minsky, Distinguished Scholar at the Jerome Levy Institute, called "Ponzi finance". The firm has no earnings to pay interest to the bank on the money it has borrowed, so it borrows more just to meet the interest payment, without increasing its productive capacity. Such a position is sustainable only as long as non-residents are willing to continue to lend. Now, the net balance depends on a number of factors, such as relative rates of return and exchange rates, and data in this area is probably less reliable than in other aspects of the foreign accounts. Nonetheless, if non-residents do not continue to lend their only alternative is to try to convert dollars into their own currency and the dollar comes under pressure. It is a matter of conjecture whether a sharp fall in the dollar could take place without a sell off in the stock market as well. The continued current account imbalance could thus also be considered as a capital account imbalance in which the US is becoming a bigger and bigger debtor. This in itself is not serious, except that it is likely to make financial markets much more volatile, and increase the risk of financial instability in the US. While any decline in the dollar would probably be beneficial for developing countries, financial instability is not, since the immediate impact is to cut off capital flows to these countries which means that they have to find

alternative sources of financing, usually by increasing internal funding and thus reducing expansion, impeding adjustment. In addition this will reduce global demand, once again aggravating the difference between US growth and that in the rest of the world and causing additional difficulty in the US external balance. This brings us back to the necessity of looking at the combined current and capital account balance. Ifdeveloping countries are to expand at rates that allow convergence with their per capita incomes ofdevelopcd countrics, they will have to borrow from abroad, which means that they will be running current account deficits financed by capital inflows. But, if global capital is flowing to the US, it means that there will be increasing differences in income levels across the globe. Some consider this as inevitable, but if the US wants to remedy its current account deficit, it can only do so if the rest of the world has income levels that are high enough to allow them to purchase US goods, Just as Henry Ford recognised that his workers had to be paid enough to buy the Ford cars they produced, the rest of the world has to have income levels high enough to buy enough US goods to keep its payments in balance.

CURRENT BALANCE OF PAYMENTS (NIPA) AS PERCENT OF GDP



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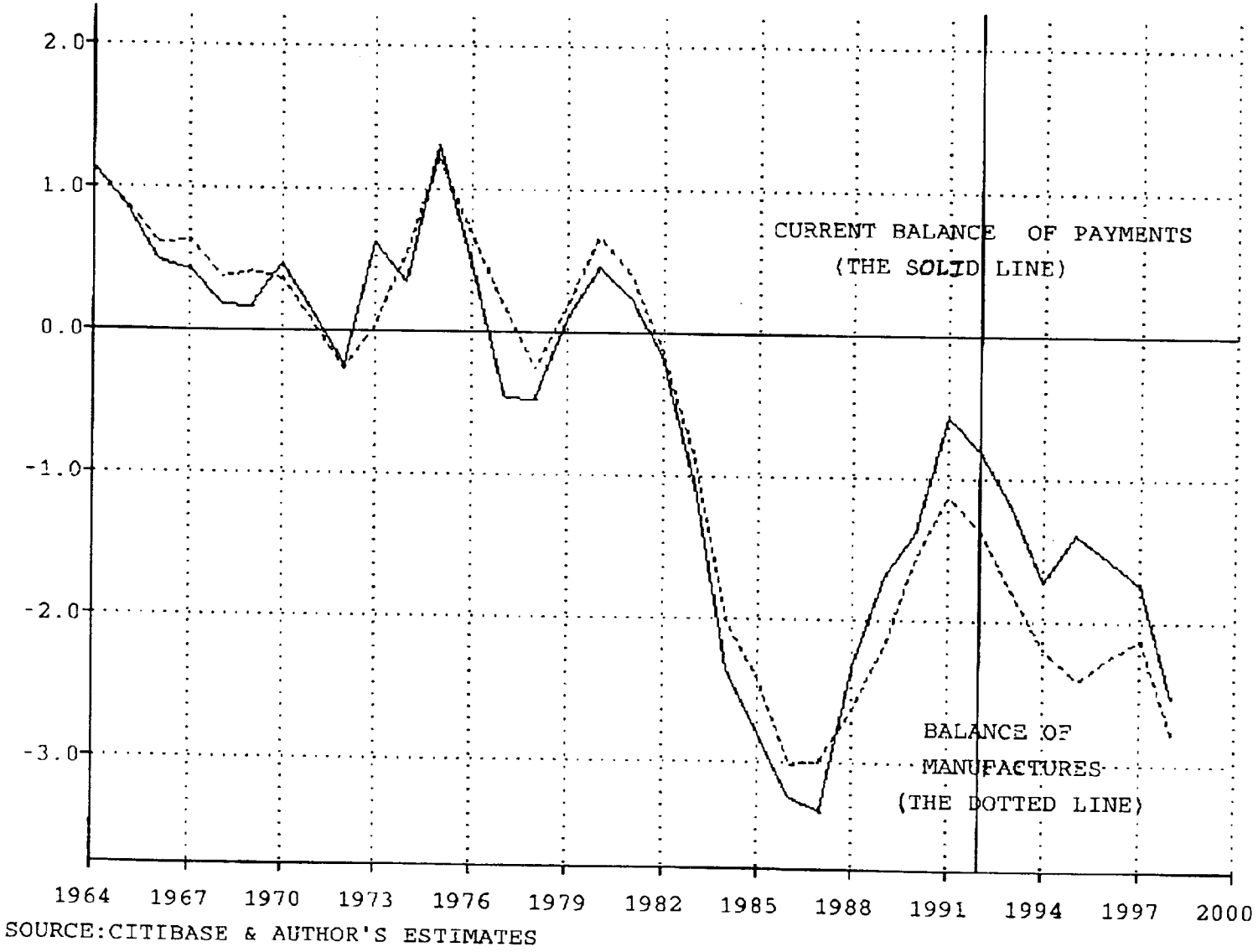
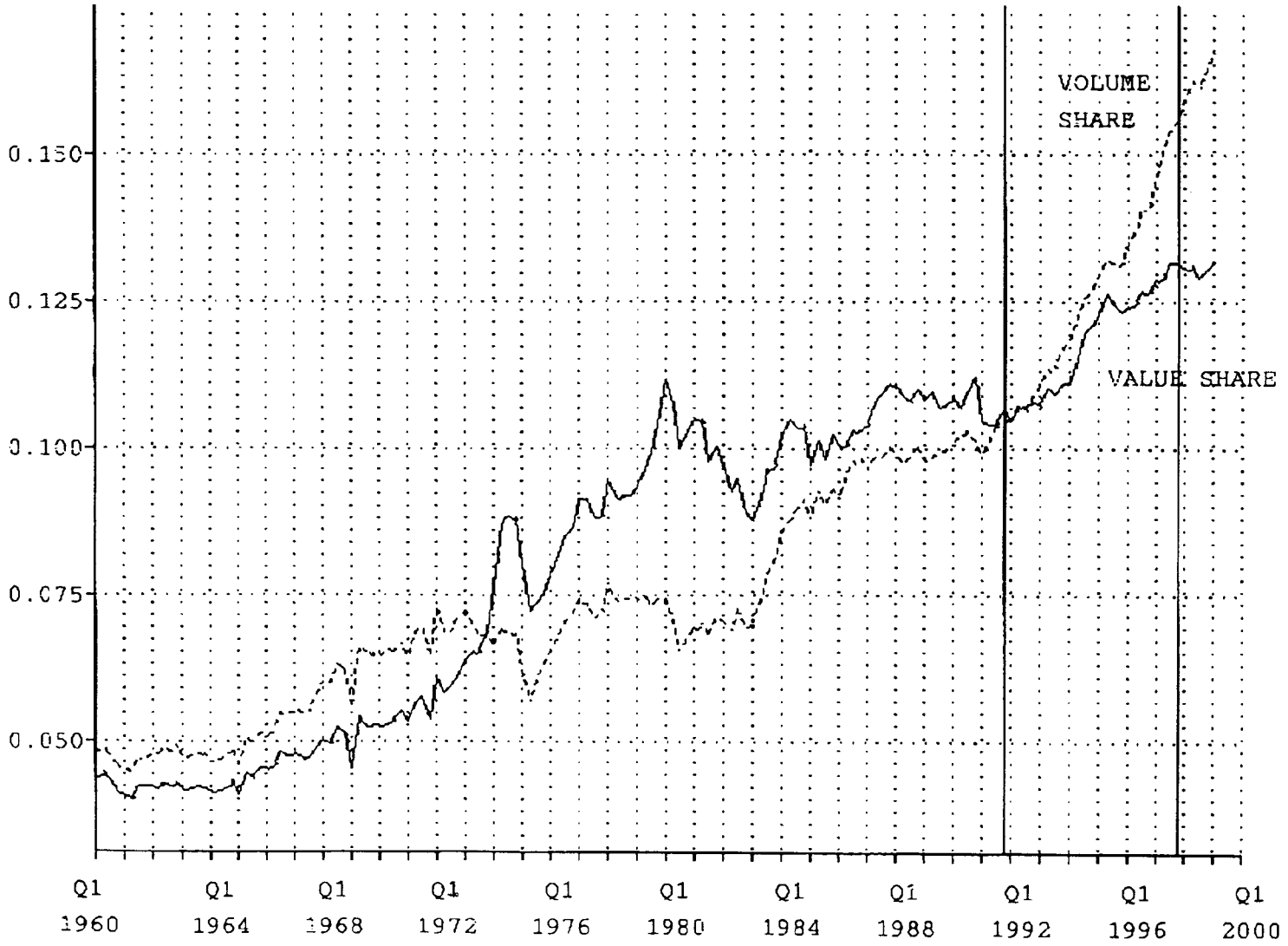
THE CURRENT BALANCE OF PAYMENTS & THE BALANCE OF TRADE IN MANUFACTURES
(PERCENTAGES OF GDP, 1998 PARTLY ESTIMATED)

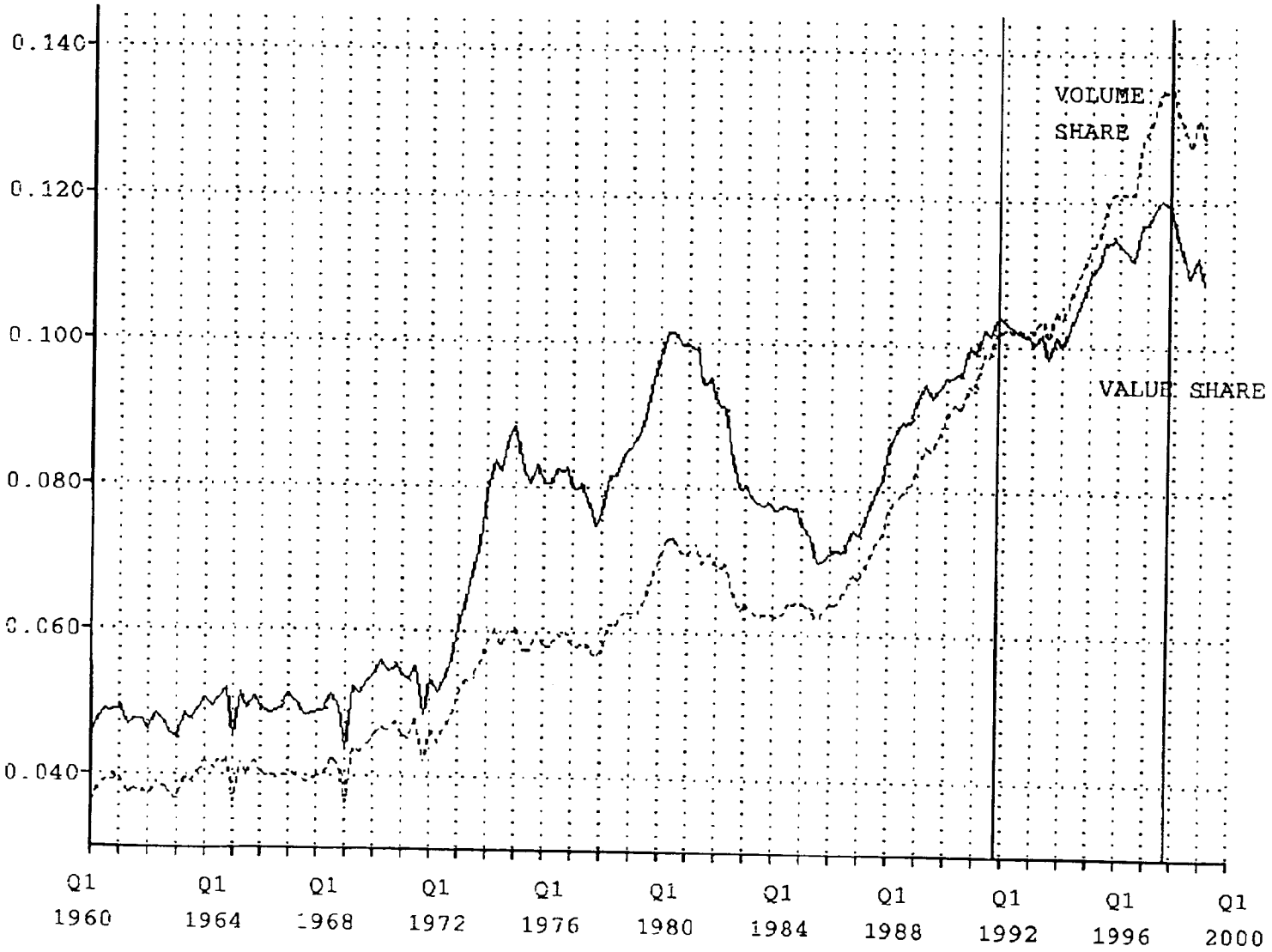


SOURCE:CITIBASE & AUTHOR'S ESTIMATES

IMPORTS OF GOODS & SERVICES AS PERCENT OF GDP (VALUES & VOLUMES)



EXPORTS OF GOODS & SERVICES AS PERCENT OF GDP (VALUES & VOLUMES)



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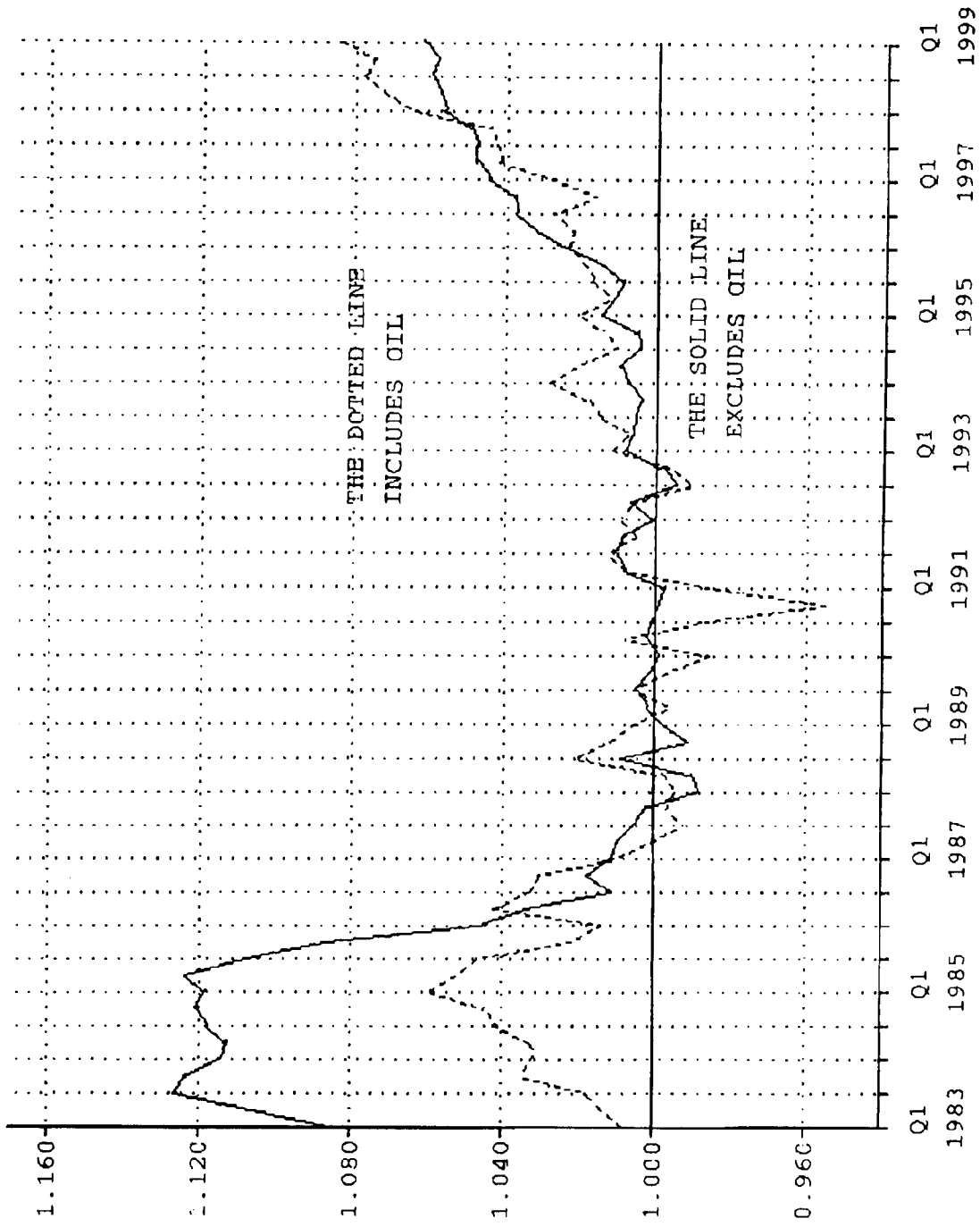
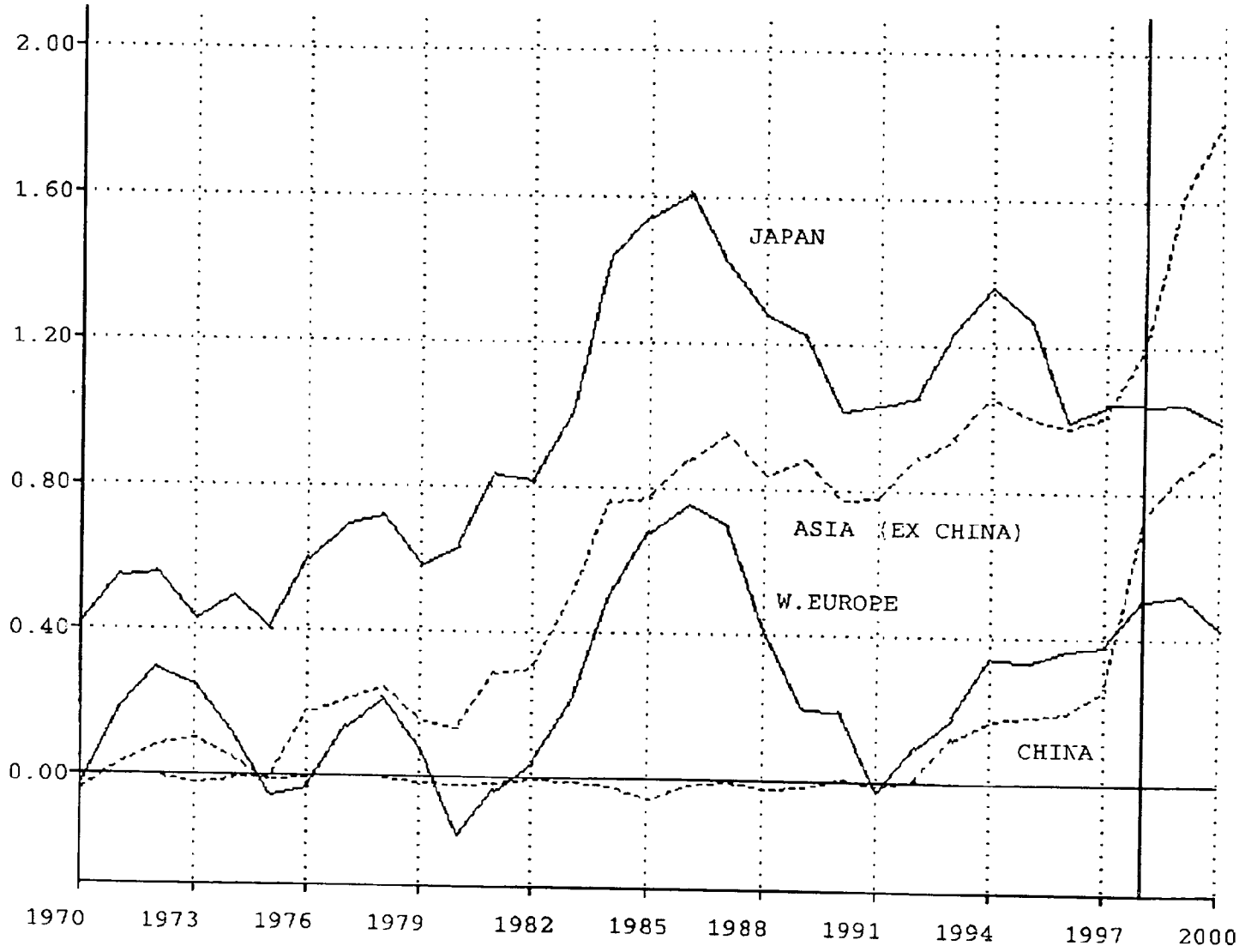
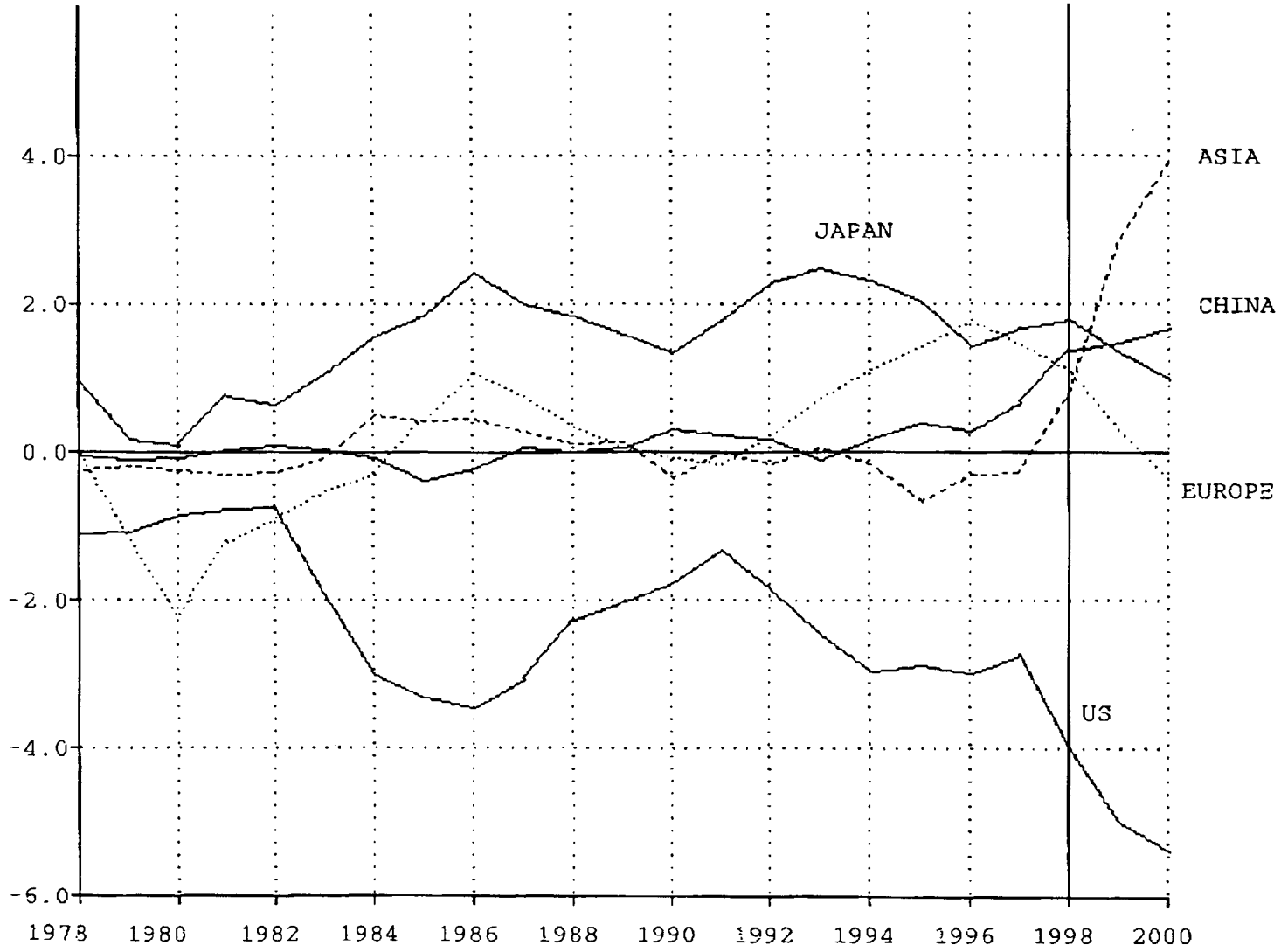
TERMS OF TRADE EXC. & INC. OIL



BILATERAL BALANCES WITH THE US: TRADE IN MANUFACTURES
(AS PERCENT OF US GDP)



BALANCE OF TRADE IN GOODS (INC ENERGY & MATERIALS)
(AS PROPORTIONS OF US GDP)



FACTOR INCOME FLOWS
AS PERCENT OF GDP