

Statement to the Congressional Trade Deficit Review Commission

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The large and growing U.S. current account deficit is a complex phenomenon that reflects the interaction of forces at work in the U.S. economy and in the rest of the global economy. Before commenting on the specific questions posed for this hearing, it is important to emphasize both the generally positive developments (from the perspective of the United States) that have been associated with the recent rise of the U.S. current account deficit and the future challenges and risks likely to arise from the need to reduce this deficit in coming years.

First, it is essential to recognize that in most important respects, the rise of the U.S. current account deficit reflects the remarkable success of the U.S. economy, both in absolute terms and relative to that of other countries. High rates of investment, substantial gains in productivity, and strong employment growth have sustained a record long economic expansion in the United States during a decade when growth has been disappointing in most other industrial countries and when many emerging market economies have experienced periods of severe economic and financial difficulties. Rising real incomes in the United States, boosted by the effects of persistently rising household wealth associated with booming U.S. equity markets, and strong demands for domestic investment have propelled U.S. demand for goods and services upward even more rapidly than domestic output. This rapid

¹ The views expressed in this statement and any additional testimony to the Commission are those of the author and do not necessarily reflect the views of the International Monetary Fund.

growth of domestic demand, fortunately, has not resulted either in a rise of domestic-⁴ inflationary pressures or in sharp increases in domestic interest rates that might have choked off the U.S. expansion. Rather, with demand growth relatively subdued in much of the rest of the world economy, the strong growth of U.S. domestic demand (relative to U.S. output growth) has been absorbed by increases in U.S. imports that have outstripped increases in U.S. exports-and thus in the rising U.S. current account deficit. This rising U.S. current account deficit has been financed by prodigious inflows of foreign capital into the United States, motivated mainly by the desires of foreign owners of capital to take advantage of the attractive returns on investments located in the United States. These desired flows of private capital to the United States have contributed to the strengthening of the U.S. dollar in foreign exchange markets. The strengthening of the dollar has helped keep U.S. inflation low and has benefited American consumers and businesses that purchase imported products, including material inputs and capital equipment. The strengthening of the U.S. dollar has thus been a key mechanism through which some of the very rapid growth of domestic demand in the U.S. has been deflected from generating overheating pressures at home and into supporting growth elsewhere in the world economy where demand growth has generally been deficient. In the circumstances of recent years, this has been beneficial both for the United States and for the rest of the world economy.

Second, while the recent rise of the U.S. current account deficit has been not simply benign but broadly beneficial in the context of other global economic developments, it is essential to recognize that this deficit cannot plausibly be expected to keep on rising. Indeed, that some significant reduction of this deficit from the neighborhood of about 4 percent of U.S. gross domestic product will probably be needed in coming years. How the needed adjustment from a rising to a declining U.S. current account deficit is achieved (and at what speed) will determine whether this reversal process is generally beneficial, benign, or economically damaging. To achieve the best possible outcome, from both a U.S. and a global economic perspective, it is clear that two things must happen simultaneously at the global macroeconomic level: the growth of domestic demand in the U.S. economy must slow to

somewhat less than the growth of potential output in the United States; and simultaneously the growth of demand elsewhere in the world must speed up to somewhat above potential output growth. The objective here is to keep demand growth at the global level sufficient to absorb gradually the levels of slack that still exist in many economies, while shifting the distribution of global demand growth away from those economies (most importantly the United States) where slack is limited or negative. Fortunately, recent economic developments and policy adjustments in many countries do suggest that events are now moving in the direction of this desirable adjustment process. There should be no illusion, however, that policy makers have either the tools or the wisdom to keep this process of global macroeconomic rebalancing on a completely even keel.

In addition to the necessary rebalancing of rates of demand growth in different regions of the world economy, adjustments of exchange rates will likely need to be part of the process of correcting unsustainable current account imbalances. In particular, it seems likely that the U.S. dollar will need to adjust downward on a real multilateral effective basis and will need to adjust downward bilaterally against the yen and the euro over the medium term. In the case of the yen, significant upward adjustment against the dollar has occurred since the spring of 1998; and the persistent weakness of private demand growth in Japan argues that further near-term strengthening of the yen would be counterproductive from the standpoint of securing sustainable recovery in that country. In the case of the euro, recent weakness against both the dollar and the yen seems less well justified on the grounds of medium-term and cyclical economic fundamentals. Strengthening of growth and growth prospects in the Euro area, along with some evidence of slowing growth in the United States, should be expected to contribute to reversal of the depreciation of the euro that has occurred since its inauguration in January 1999.

Turning now to the specific questions posed for this hearing, let me first indicate as a general comment that these are not questions that admit precise, quantitative answers. In the end, they are more matters for speculative, but hopefully informed, judgment.

On the capacity of the United States to continue to attract substantial net inflows of foreign capital, I would not be overly pessimistic. The United States has been and seems likely to remain an attractive environment for business investment, probably at levels that will somewhat exceed what can be financed from our net national savings. Foreign investors, I believe, will continue to want to avail themselves of attractive investment opportunities in this country. That said, however, continuing foreign net capital inflows on the order of 3 to 4 percent of U.S. GDP (or higher) seem implausibly high. True, there are some countries that have enjoyed capital inflows of this relative magnitude for periods of twenty years or more, but with the U.S. economy accounting for more than one-fifth of world output the absolute size of such relative inflows seems implausibly large. Capital inflows of 1 percent or even perhaps as much as 2 percent of U.S. GDP, however, seem to me to be potentially sustainable for a considerable period. Recall that the United States, in contrast to most other industrial countries, still has a rising labor force due to natural population increase and immigration.

Concerning the possible effect of a falling dollar on foreign capital flows to the U.S., expectations of future declines in the foreign exchange value of the dollar tend to make it less attractive, other things equal, to hold investments denominated in U.S. dollars. However, the effects on incentives to hold equity investments are less clear. If a lower dollar is expected to make U.S. based corporations more profitable, this would tend to increase the attractiveness of U.S. equities to both domestic and foreign equity owners. Moreover, a fallen dollar is quite different from a falling dollar. Once downward adjustment of the dollar is thought to be complete, the continuing effect of this adjustment is likely, other things equal, to make U.S. investments attractive to foreigners. If a fallen dollar is associated with weaker performance of the U.S. economy, however, other things would not be equal.

The relationship between interest rates, exchange rates, and the adjustment process is complex and not easily predictable. In past few weeks and months, in an environment of surprisingly strong U.S. economic growth, actual and prospective tightening actions by the

Federal Reserve have pushed up near- and medium-term U.S. interest rates and have” probably tended to strengthen the dollar. Once it becomes clear that the Federal Reserve has done enough to curb potential overheating risks for the U.S. economy—and perhaps before—I suspect that we will begin to see some downward correction of the dollar. Assuming that the Fed is successful in its strategy to produce a soft landing for the U.S. economy, I expect that path of short-term interest rates, both in the tightening and subsequent easing phases, will be relatively gradual. Movements in the dollar exchange rate may well be more abrupt.

This relates to the question concerning possible exchange rate overshooting—a concept that is tricky to define and even more difficult to measure. The fact is that exchange rates between the U.S. dollar and other major international currencies sometimes move by quite large amounts over relatively brief time periods. For example, the Japanese yen appreciated to just below 80 yen to the dollar in the early spring of 1995. It subsequently depreciated to more than 145 yen to the U.S. dollar by the late spring of 1998. Movements of the euro (or its predecessor national currencies) have been only modestly smaller. Whether such wide swings in major currency exchange rates constitute “overshooting” is a matter of some dispute. Whatever the answer, experience during the past quarter century of floating exchange rates suggests that exchange rate fluctuations on this scale are likely to continue to be a fact of economic life.

Does overshooting in foreign exchange markets or other financial markets pose a significant threat to U.S. economic performance? Here, I believe that the answer is possibly yes, and especially so if economic policies fail to respond appropriately. Consider the case of U.S. equity markets which many economic analysts believe to be significantly overvalued relative to fundamentals. When the U.S. stock market crashed in 1987, it posed an immediate threat of broader market collapse and potentially of deep recession. Monetary policy responded promptly and aggressively to avoid market meltdown, and the U.S. economy felt only a mild one-quarter impact on growth. On this occasion, the market over-valuation may be greater and a larger and more prolonged correction may be appropriate. However, judicious use of

monetary (and perhaps fiscal) policy should be able to avert major economic disruption—although not necessarily all risk of recession.

Concerning the potential damage from possible exchange rate overshooting, experience does not suggest that the U.S. economy as a whole is particularly vulnerable. In the 1980s, much concern was expressed by some economists about the “hard landing scenario” arising from the need to correct what appeared to be a substantial over-valuation of the U.S. dollar by early 1985. The downward correction of the U.S. dollar did occur between early 1985 and late 1987, but the predicted disastrous effects for the U.S. economy did not materialize. Of course, a sharp drop in world oil prices in early 1986 helped to cushion the domestic inflationary effect of dollar depreciation; and the margins of slack available to U.S. industries to exploit the benefits of a cheaper dollar were probably larger in the mid- 1980s than presently in the U.S. economy. Also, in Japan, the reverse effect of yen appreciation depressed economic growth in 1986-87; and there would now be some concern that a large rapid fall of the dollar might hinder growth in countries that are less advanced in their expansion. Nevertheless, the episode of the 1980s suggests that large exchange rate changes among major currencies need not have catastrophic consequences. That said, sudden large changes in major currency exchange rates can clearly create problems for exposed sectors of the economies of major countries and can create significant difficulties for other countries in the world economy.

Finally, while it is relevant to recognize that the adjustments necessary to accommodate a meaningful reduction in the U.S. current account deficit should be achievable without widespread damage to the U.S. or the global economy, some slowing of the pace of advance of either U.S. consumption or U.S. investment will inevitably need to be part of this process. From the end of the mild recession of 1990-91 through the end of 1999, U.S. real GDP is estimated to have advanced by more than \$2.3 trillion. Real domestic demand (consumption, investment and government spending) rose by this amount plus an additional \$300 billion. Over the next four or five years, even if productivity growth remains relatively high, it seems

unlikely that U.S. real output can expand quite as rapidly as in most of the 1990s as opportunities for cyclical recovery appear now to be exhausted. Meanwhile, to accommodate some narrowing in the U.S. current account deficit, domestic demand must grow somewhat less (perhaps \$100 billion to \$200 billion less) than the growth of real GDP. If this necessary downward adjustment in the growth of real domestic demand falls largely on investment, the consequence will be to slow the growth rate of the U.S. economy-where recent productivity gains have clearly been related to high level of private investment. Thus, in the end, reduction of the U.S. current account deficit must be accompanied by some moderation of the rate of increase of real consumer spending.