

# Republican Commissioners' Views

## Are large trade and current account deficits sustainable?

The primary goal of U.S. economic policy is maintaining a rising standard of living for the American people. Specific policies to achieve this goal are directed at keeping high levels of economic growth and low rates of inflation and unemployment. The levels of imports and exports, or the difference between the two, are generally not considered economic policy targets. Trade and current account balances and economic growth are, however, interrelated. For example, as discussed in Chapter 2, the U.S. trade and current account deficits of the 1990s were principally a consequence of the high rate of economic growth in the United States relative to other nations and the attractiveness of the United States as a destination for foreign investment. The ability to import goods and services has contributed in several different ways to keeping inflation in check. And the sustained low rates of inflation have helped maintain economic policies promoting economic growth, which in turn pushed unemployment to a thirty-year low while drawing previously discouraged workers into the labor force.

However, a continuation of the current economic performance in the United States relative to that of other countries will likely contribute to the continuation of large and possibly growing trade deficits. Because U.S. imports are so much larger than exports, if they both grow at the same rate, the absolute difference between the two will increase, and the deficit will continue to grow larger. Thus, even with some slowing in the U.S. economy and greater foreign economic growth, many forecasts for the 2000 current account deficit exceed \$400 billion.

A major concern about the large and persistent trade deficits is whether these deficits are sustainable or whether, at some future time, they might generate severe problems in the U.S. economy. Under current conditions, the deficits do not pose an immediate threat to the economy. At some future time, the increases in the current account deficit as a percentage of GDP will end—but there is no way to know with certainty whether that end will be gradual or disruptive. The experiences of the United States over the period during which the large trade and current account deficits in the 1980 shrank are instructive and encouraging. Under far less favorable circumstances than currently, the dollar declined substantially and the U.S. deficits came down without adversely affecting the U.S. economy or employment. Financial markets demonstrated considerable flexibility and resiliency in the process. Hence, there are good reasons to expect a nondisruptive adjustment.

Nevertheless, we cannot entirely dismiss the possibility that there could be a disruptive adjustment, a scenario sometimes called a "hard landing." We believe that such an event is unlikely.

However, the size of the current account deficit as a percentage of GDP, while not the largest in the world, is unprecedented for the world's largest economy. The risk is that if there were a domestic downturn in the economy at some time, we would be less able to use normal economic policy tools in response.

Answering questions about sustainability requires evaluating the implications of both the large deficits and the U.S. position as the country with the world's largest net negative international investment position.

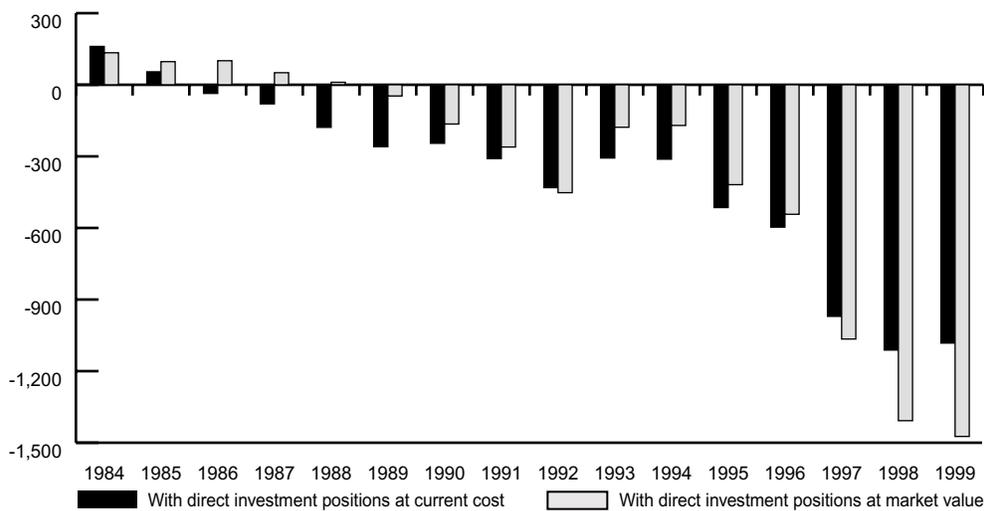
## The United States as the world's leading destination for foreign investment

A decade of large current account deficits has led to the United States accumulating the world's largest negative net international investment position (that is, the value by which foreign holdings in the United States exceed U.S. holdings in foreign nations). (See Figure 4.1.)

**Figure 4.1**

### U.S. Net International Investment Position, 1984–99

(Dollars in billions)



Source: U.S. Department of Commerce, Bureau of Economic Analysis data

The change of the United States from a positive to a negative net international investment position has often been referred to as the United States becoming the "world's biggest debtor nation." This term can be exceedingly misleading. In fact, calling the United States the "world's leading investment destination" is more accurate.

The foreign capital inflows into the United States include both portfolio investment (for example, purchases of stocks and bonds) and foreign direct investment (for example, purchases of U.S. companies and investments in plant and equipment). The implications of the two forms of foreign investment in the United States are not equivalent, yet they get bundled together in the "debtor" term. Most fundamentally, just as companies can rely upon both debt and equity to build or acquire plant and equipment, a nation can rely upon different forms of capital inflows to build productive capacity if its domestic saving is less than investment.

Furthermore, the availability of foreign capital has made possible productive investments in the United States that would not otherwise have been made. Such investments should produce a real return more than sufficient to support "debt service" payments to foreign asset holders. That is, such investments create the income stream with which to meet required interest and dividend payments.

Even the categorization of the United States as the "largest debtor" is less imposing when the numbers are looked at relative to GDP. Because the United States is the world's largest economy, the U.S. negative net international investment position relative to GDP is not a world record. At the end of 2000, U.S. net foreign debt will be about 20 percent of U.S. GDP, far lower than Australia's ratio of 57 percent.

Finally, comparing the \$1.5-trillion negative net international investment position (estimated at market value at the end of 1998) to other measures of wealth and indebtedness helps put that large number into context. At the end of 1998, households and nonprofit organizations had a net worth of over \$37 trillion, including financial assets of nearly \$31 trillion.

Nevertheless, while foreign capital has made possible a higher level of growth, we would be far better off as a nation if our national saving were higher. Higher saving would provide the basis for the economy to sustain higher levels of economic growth, to finance productive investments domestically, and to meet the needs of the increasing share of our population that will retire in coming decades.

At the aggregate level, the negative net international investment position means that the United States now pays out annually more in investment income than it receives. Thus, even if exports and imports were equal, the United States would still have a persistent current account deficit. In 1999, the total current account deficit of \$339 billion included net income payments of \$25 billion from the United States. However, by way of comparison, U.S. GDP was more than \$9 trillion, and corporate profits exceeded \$800 billion, suggesting that this net payment—while not trivial—was not large enough to significantly affect the workings of the U.S. economy or the U.S. standard of living, let alone trigger a U.S. payments problem.

## Continuing to finance the deficits

Financing sustained current account deficits, however, means that the United States must continue to attract new foreign capital, net of new U.S. overseas investment. That is, we must continue to borrow from abroad. (So, too, foreigners must continue to invest in the United States.) The attractiveness of the United States<sup>1</sup> as a destination for foreign capital has enabled this nation easily to attract the required capital in recent years. However, as the current account deficits continue to rise, growing amounts of additional foreign capital will be needed to fund those deficits.

In testimony before the Commission, several witnesses said that they do not see a significant likelihood that the foreign capital needed to finance the trade and current account deficits would be unavailable. Even if other nations grow and become more attractive places for investment than they are today, the United States will remain a desirable place to maintain current investments, and international capital markets should continue to be able to meet U.S. financing demand. Professor Richard Cooper of Harvard University, in his testimony for the Commission, offered the following explanation:

*How sustainable is the U.S. deficit? Put another way, how long are foreigners likely to be willing to invest \$300 billion a year in the United States, net of U.S. investments abroad? Gross world savings outside the United States will exceed \$5 trillion in 2000. \$300 billion will be less than six percent of this magnitude. It is not beyond imagination that foreigners will want to invest six percent of their savings in the United States, which in 1998 accounted for over one quarter of gross world product and whose stock market capitalization was nearly half the world's total ... Investments in the United States have provided, and are likely to continue to provide, returns that are both high and reliable compared with most other parts of the world...*

However, if looked at another way, the numbers are not as reassuring. The International Monetary Fund recently reported that, in 1999, two-thirds of all capital exported from countries running current account surpluses was directed toward U.S. capital markets. The U.S.' relative share of such capital has doubled over the past five years.<sup>2</sup> Whether the appropriate weighting for asset allocation is considered to be the U.S.' share of world output (which is approximately 30 percent) or the U.S.' share of financial market capitalization (approximately 50 percent), the United States is attracting a significantly larger share of world capital exports than might be expected. This relatively larger share can be explained as reflecting portfolio diversification from a starting point in which asset portfolios are too heavily weighted with home-country assets. At some point, this reallocation phase may end.

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<sup>1</sup> The balance on goods and services (that is, the trade deficit) was \$268 billion, and unilateral current transfers (U.S. government grants, U.S. government pensions and other transfers, and private remittances and other transfers) were \$47 billion. (Component sum exceeds current account deficit due to rounding error.)

<sup>2</sup> International Monetary Fund, *2000 International Capital Markets Report* (Washington, D.C.: International Monetary Fund, Sept. 2000).

## Can trade deficits continue indefinitely?

A number of witnesses testified that we cannot continue indefinitely to incur rising annual trade deficits relative to GDP. Opinions differ substantially about how long current conditions can last and under what circumstances the trade deficit will decline. Witnesses at the Commission's hearings offered a wide range of views, in part because the unprecedented levels of the U.S. foreign debt raise doubts about the usefulness of history as a guide to forecasting the economy's response to any disruption.

Many experts believe that reasonable adjustments in the exchange value of the dollar, together with economic recovery abroad, will produce a "soft landing" or a gradual decline in the current account deficits (as a percentage of GDP). In this case, the trade deficit would come down as part of a normal adjustment process that would not generate significant adverse effects on the United States. This happened in the 1980s. As foreign economies begin to grow more rapidly, the return on investing in those nations should increase. Investment in those countries would then rise. Consequently, investors will have less demand for dollars and greater demand for other currencies, leading to a depreciation of the dollar. The combination of stronger foreign growth and the dollar's depreciation, in turn, would lead to higher U.S. exports and lower U.S. imports, reducing the size of the trade deficit.

In contrast, other witnesses expressed concern that the United States could suffer a "hard landing," a rapid fall in the level of the current account that would result in a substantial downturn in the economy. An alternative scenario for a disruptive response to the large trade deficits starts with the increasingly large negative net international investment position creating a growing burden on the U.S. economy, with the debt service payments adding to the negative net international investment position.

No amount of analysis can accurately determine whether any of these scenarios—"soft landing," "hard landing," or something in between or even completely different—will occur. As Federal Reserve Chairman Alan Greenspan has commented:

*...we do not know how long net imports and U.S. external debt can rise before foreign investors become reluctant to continue to add to their portfolios of claims against the United States. At that point, the safety valve of net imports could narrow or close.<sup>3</sup>*

We cannot dismiss the possibility that external factors may cause a change—and perhaps a sudden change—in the current account deficits and that such a change could have broad effects on the U.S. economy, perhaps limiting our economic policy options.

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<sup>3</sup> Speech to the White House Conference on the New Economy, April 5, 2000.

## What might the future hold?

The Commission used econometric models of the U.S. economy to quantify how the economy would react to different situations and to examine some mechanisms for achieving a lower current account deficit. By using empirical data to estimate how the economy may react, the models provide a systematic and structured approach to assessing the reaction. These models also demonstrate how public policy decisions will affect the economy's performance.

These models have limitations, however. First, as all statistical models, they are subject to a range of errors.<sup>4</sup> Second, the models implicitly assume that the future will look like the past—even if there are reasons to expect otherwise. Third, the models must make simplifying assumptions about complex economic structures and relationships. Thus, use of these models entails both the benefits of a systematic assessment and their clear limitations. In an effort to lessen the limitations, the Commission used the two econometric models of the U.S. economy described in Chapter 2.

## Changes in economic policy

Maintaining a balance on the current account or the trade account is not a target for government economic policy, nor should it be. The modeling exercises suggest that macroeconomic policy alone would be a very costly mechanism for bringing the current account into balance.

Looking forward, the models suggest that using monetary policy to end the trade and current account deficits would be costly in terms of lost output. In general, the Federal Reserve tightens monetary policy and increases interest rates if it believes that the current level of economic activity is incompatible with its long-term goals of price stability and sustainable economic growth. Could the Federal Reserve use monetary policy to engineer a lower current account balance? Both models suggest that a significant tightening of monetary policy might lessen the current account deficit but at the expense of substantial losses in GDP and employment.

Similar modeling exercises examining the likely consequences of fiscal policy changes suggest that easing fiscal policy could lead to increased current account deficits.<sup>5</sup> The Sinai-Boston model predicts that the current account deficit would grow and that inflation would increase if fiscal policy were eased. It predicts lower unemployment and higher economic growth over the five-year forecast horizon, relative to the model's baseline prediction. The Federal Reserve Board-U.S. model also predicts that the current account deficit would grow if federal expenditures were increased.

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<sup>4</sup> A statistical model's forecast, for instance, is the midpoint of a range of likely outcomes; the size of that range depends on a number of factors. One factor is the accuracy and relevance of the data; another is the accuracy of the model's formulation. Also, the range will increase with longer forecasts—a model's forecast for next year will be more precise than its forecast for five years in the future.

<sup>5</sup> In making this statement from the context of the effects of the current account on the U.S. economy, the Commission makes no judgment on other arguments for or against any changes in government expenditures or taxes.

## Changes in foreign economic growth

Higher levels of foreign economic growth offer the prospect of lower U.S. current account deficits. Again, modeling exercises provide some guidance on how higher foreign economic growth could affect the U.S. current account, although with a warning that there could be adverse consequences for the United States.

Forecasts based on the Sinai-Boston model suggest that the effects of higher foreign economic growth would depend critically on how other economic variables, particularly inflation and the dollar's exchange rate, change. The modeling thus considered several potential scenarios for changes in these variables; these scenarios ranged from minimally disruptive to very disruptive.

In the first scenario, if foreign growth were to accelerate with no substantial change in the pace of the U.S. economy, the current account deficit would be reduced and unemployment would be lower. This would be the least disruptive outcome for the United States of the three scenarios.

In a second scenario, foreign economic growth triggers higher levels of inflation in the United States. If the Federal Reserve were to respond to counter the price increases, the current account deficits would be lower than in the previous scenario, and the U.S. economy would grow at a slower rate. The forecasts for GDP growth in 2002 and 2003 for this scenario, in fact, are lower than the baseline forecast. The dollar, which weakened slightly in the first scenario, is predicted to fall to a lower level, at least initially.

In the third and worst-case scenario, the predictions of the dollar's exchange rate are the most pessimistic, with foreign investors decreasing their demand for U.S. investments, leading to decreased demand for dollars and thus a weaker dollar. U.S. inflation would accelerate. This is, essentially, a so-called "hard landing" scenario. The Federal Reserve is assumed to tighten monetary policy to support the dollar and promote price stability. The results here, predictably, are markedly worse than in the other scenarios—GDP growth is lower, and inflation, unemployment, and interest rates are higher. In the modeling of this scenario, the dollar's decrease is the largest of the three scenarios.

Of course, we do not know which of these scenarios, if any, is the most likely. What we do learn from these scenarios, however, is that higher foreign economic growth rates may lead to a reduction in the U.S. current account deficits, but with some risk for the U.S. economy, depending in part on the responses of investors.

## Conclusions

The trade and current account deficits are not and should not be targets for economic policy. The primary policy target for economic policy should be maintaining a high and rising standard of living for the American people. In fact, if over the decade of the 1990s the Federal Reserve had conducted monetary policy in such a way as to maintain a balanced current account, the results would have been disastrous for U.S. economic performance.

However, the fact that the deficit should not be a primary target of economic policy does not mean that the deficits are not important in formulating economic policy. The impact of any economic policy change on the current account deficit may have to be considered along with the other factors that affect policy. Specifically, the size of the deficit means that there are constraints or limits placed on the formulation of economic policy that would not be there without the deficits. For example, given the current level of economic performance, large and increasing current account deficits argue against a change in fiscal policy that would lower national saving.<sup>6</sup> (This concern would have to be weighed against any argument for changing fiscal policy.)

Persistent trade and current account deficits are risk factors. While the imbalance may come down in an orderly and minimally disruptive way, much would depend on how financial markets react. If changes in the attractiveness of foreign investments relative to U.S. investments were large enough, the U.S. economy could falter. Further, the size of the U.S. current account deficits and the U.S. negative net international investment position would limit our ability to respond to a future downturn in the domestic economy, if one were to happen.

Hence, the Hippocratic admonition applies to the formulation of economic policy: "First, do no harm." The size of the U.S. current account deficits and the U.S. negative net international investment position increases the risk that any misstep in economic policy could cause costly consequences to the U.S. economy.

We can change this, however. If our domestic saving were to increase, it would enable us to maintain economic growth, fund productive investment, and meet the needs for a future with a larger retired population.

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<sup>6</sup> As noted previously, the Commission makes no judgment on other arguments that are made for or against any fiscal policy measures.