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U.S. Economic Outlook and the Current Account Deficit

Today I'm going to begin by briefly discussing the U.S. economic outlook, and then I'll look more closely at an issue that has garnered a lot of attention lately—the large and growing U.S. current account deficit. As a member of the Fed's monetary policy-making body, the FOMC, my job is to help formulate monetary policy. In the U.S., monetary policy has two statutory objectives: price stability and maximum sustainable economic growth. Now, Milton Friedman has said that monetary policy making is complex and treacherous. In his judgment, simple policies might be better than complicated ones. At one point, he said that monetary policy makers should just increase the money supply by a small percentage each year and leave well enough alone. I would certainly like to be able to do this—it would give me and my staff a lot more time to play golf. But I don't take this view; in practice, we work hard to overcome the difficulties that Friedman pointed out.

In particular, policy makers need to understand a host of factors that may influence their ability to achieve price stability and maximum sustainable growth over the long run. Some developments, such as the degree of resource pressures, are almost always at the fore of policy discussions. But others, though less pressing in the short run, are important to analyze because they have the potential to influence prices and output in the medium and long run. The current account deficit falls into the latter category.

So today I'm going to talk about the U.S. current account deficit and some of its implications for U.S. monetary policy. Of course, some of these issues may apply to the United Kingdom as well. And let me emphasize that these are only my views and not necessarily those of the Chicago Fed or the FOMC.

But first, let me talk a bit about the U.S. economic outlook. The latest economic data have been quite positive. Job growth has been solid in recent months. The unemployment rate has fallen to 4.8 percent, and manufacturing capacity utilization has risen to a bit above its long-run average. So the bulk of our productive resources that were underutilized following the 2001 recession are now back at work. At the same time, core inflation remains contained.

Of course, there is one notable exception to the good news: the low 1.7 percent figure for real GDP growth in the fourth quarter of 2005. Much of this decline, however, reflects fluctuations in government spending, imports, and motor vehicle output that look to have been temporary. Indeed, the most recent monthly indicators of activity have been favorable, and we think that growth in output is rebounding smartly from the low fourth-quarter number.

And looking beyond the near-term fluctuations, I'd say that the outlook is good: Sound underlying economic fundamentals appear to be supporting self-sustaining economic growth. Importantly, the fourth quarter aside, the underlying trends in productivity are quite solid.

In February the Federal Reserve Governors and Reserve Bank Presidents released our projections for the economy in the semiannual monetary report to Congress. The central tendency of these forecasts had real GDP increasing about 3½ percent in 2006 and in the 3 to 3½ percent range in 2007—close to many recent estimates for potential. The unemployment rate was expected to be in the 4¼ to 5 percent range in both years. With regard to inflation, the price index for personal consumption expenditures excluding food and energy was expected to increase about 2 percent this year and between 1¾ and 2 percent in 2007.

There are, of course, uncertainties to this outlook. One concerns housing, which has both upside and downside risks. There has been a good deal of discussion about froth in U.S. housing prices, and most forecasts of GDP that you see factor in some moderation in home price appreciation and residential investment. Indeed, the slowdown in housing should be an important factor in bringing growth back to potential. So far, housing has been moderating in a way that is broadly consistent with these forecasts. But if housing markets soften more appreciably, we could see a more significant negative effect on overall spending. There is also the possibility, however, that housing markets will remain solid—for example, because of support from the continued low level of long-term interest rates. This would then heighten the risk of above-trend GDP growth and the further development of pressures on resources.

Still, while housing and other factors add uncertainty to the outlook, they do not change the overall picture that the prospects for the U.S. economy over the next couple of years are good. But, as I mentioned, there are longer-term issues, and our current account deficit is one of them.

A current account deficit, as you know, means that a country is spending more than it is earning. To be more precise, the consumers, firms, and government of a country are collectively spending more than the total income that they are earning from domestic production and earnings on net investment returns from abroad. In 2005, the U.S. current account deficit reached \$805 billion, or 6.4 percent of GDP. This deficit has been growing rapidly since 1997, when it stood at just 1.7 percent of GDP. These persistent and widening deficits have translated into a large increase in the U.S. net foreign debt position. Prior to 1986, the U.S. was a net creditor to the rest of the world. During the early 1990s, the net foreign debt position stayed in a narrow range of 5 to 6 percent of GDP. Since then, however, it has widened steadily and currently stands at 21 percent of GDP.

The current account deficit can also be thought of as the extent to which national investment exceeds national saving. The 2005 U.S. current account deficit of 6.4 percent of GDP reflects a national saving rate of 13.6 percent and a national investment rate of just over 20 percent. The changes in the current account deficit over the past 10 years largely reflect a steady decline in the national saving rate; the investment share of GDP has fluctuated quite a bit, but on net it has risen only a couple of percentage points.

In order for the U.S. to run a current account deficit with the rest of the world, the rest of the world has to run a current account surplus with the U.S. This parallel accounting identity means that the combined national saving for the rest of the world has exceeded its combined national investment. This rising net saving has been financing our widening current account deficit. The key sources of this rising saving have been Japan; the developing countries of East Asia, including China; and the major oil-exporting nations.

So far, all I've talked about is accounting. But what are the fundamental economic factors underlying the large U.S. current account deficits? There are a number of overlapping questions that we need to answer. Why has the desired net saving rate in the U.S. decreased? Why has the desired net saving rate in the rest of the world increased? And why have the net savers in the world decided to invest so much of their surplus in the United States, as opposed to elsewhere? Understanding these questions is important for thinking about the implications of possible changes in the current account for future U.S. macroeconomic performance and hence for monetary policy.

Let me begin with developments in the U.S. domestic economy that may have affected our desired saving and investment. There are three sources of national saving: households, businesses, and governments. So an obvious candidate to explain the falling U.S. saving rate would be the large shift in the U.S. fiscal balance. From 1998 to 2001, U.S. governments—federal, state and local—ran fiscal surpluses of 1 to 2½ percent of GDP. Since 2002, however, they have been running fiscal deficits in the range of 2¾ to 3¾ percent of GDP.

Can these fiscal deficits explain the current account deficit? It is true that if we hold private investment and saving constant, higher fiscal deficits imply higher current account deficits as a matter of accounting. In practice, however, investment and private savings are not constant, so the historical relationship between the fiscal deficit and the current account deficit has not been one-to-one. Just look back again at the late-1990s, when the U.S. was running large current account deficits despite the fiscal surpluses. Research by economists at the Federal Reserve Board of Governors suggests that an exogenous \$1 reduction in the U.S. fiscal deficit would cause the current account deficit to decline by less than 20 cents. So, this evidence suggests the growing fiscal imbalances do not explain the bulk of the change in U.S. net saving or the current account.

Of course, that doesn't lessen the importance from the point of view of U.S. public policy of reducing these large fiscal deficits. Growing medical costs and rapidly changing demographics will at some point put an enormous strain on our ability to fund our entitlement programs. A large and growing public debt could also eventually put upward pressure on interest rates and crowd out private investment.

Another factor that may help explain the drop in net saving in the U.S. is the persistent rise in productivity growth rates that began in the mid-1990s. Higher productivity has three related effects, all of which serve to widen the gap between saving and investment. First, it raises the demand for investment because it increases the rate of return on capital. Second, higher productivity also increases households' permanent income. This means that households are willing to temporarily reduce saving out of current income in order to consume more today. Indeed, they know they can afford to do so because the higher return from a dollar's worth of investment will boost income in the future. And third, higher productivity attracts foreign saving. The increased GDP growth and higher risk-adjusted rates of return on capital enhance the attractiveness of investment opportunities in U.S. markets relative to those in slower-growing industrial countries, such as Europe and Japan. Furthermore, with the persistence of solid productivity growth and its relatively younger labor force, the U.S. could continue to experience relatively higher GDP growth and thus continue to attract foreign capital and retain domestic capital for some years to come.

As I just mentioned, economic theory suggests that a persistent increase in the level of productivity for an open economy initially causes households to increase consumption relative to current income, thereby lowering the saving rate. But over time, as higher productivity and capital accumulation boost income, the saving rate will move back up. And because of the higher income growth, this increased saving rate can be achieved while maintaining the higher levels of consumption. So how far along are we in this process? Well, it's not clear. The U.S. national saving rate has been constant over the last 4 years, so perhaps we are at the turning point, and the saving rate is about to start to rise back up to its long-term level. But it's too early to tell.

The next place to look to help explain the U.S. current account deficit is the increase in desired net saving by the rest of the world. Most of the countries or regions that have witnessed the largest increases in their net saving rates are in Asia: China, Japan, and the developing East Asian nations. The oil exporters have also greatly increased their net saving rates recently. This is a diverse group of countries, and they have increased their net national saving for a number of different reasons.

Let's start with the developing East Asian countries. A large part of their higher net saving rates likely are a response to the financial crises that occurred in 1997. These crises induced rapid capital outflows, large currency depreciations, sharp declines in domestic asset prices, weakened banking systems, and significant declines in domestic output. As a result, these countries had to switch from being net importers to net exporters in order to meet their foreign obligations. And to protect their currencies from further depreciation, they began rapidly accumulating larger reserves of foreign currency as an insurance buffer against future financial crises. Some believe that these countries will continue to accumulate reserves for some time.

The story is different in China. Their increase in net saving can probably be explained by the way they are pursuing an export-led growth strategy. The Chinese have utilized their abundant supply of labor to produce low-cost goods to export. At the same time, opportunities for domestic investment are limited by frictions in Chinese financial markets and domestic political considerations. As a result there has been a steady increase in the public sector saving rate, leading to a widening Chinese current account surplus.

It is interesting to note that the other growth miracle in Asia, namely India, has not pursued an export-led strategy that involves running large current account surpluses. India has grown at a robust pace while their current account has moved from a small surplus to a moderate deficit. Indeed, for many economists, the Indian example is more natural, since it involves capital flowing to, rather than away from, a developing country with abundant investment opportunities.

The major oil exporting nations are another story. They have experienced sizable oil profits, yet appear to have limited domestic spending. To a degree, some countries may be salting away what they feel may be relatively short-term windfalls. As a result, they have invested a good deal of money abroad.

Finally, we have Japan. Japan has a disproportionately large share of older workers compared to other industrialized nations and soon will have to pay for their retirement. Furthermore, the birth rate in Japan is very low, so the need for capital accumulation is less pressing. Accordingly, the Japanese have increased net saving, not so much by saving more, but by reducing capital investment at home. The foreign assets they are then accumulating can go toward financing their upcoming large wave of retirements.

With so many developments influencing the desired saving and investment decisions of the U.S. and the rest of the world, it's difficult to quantify the effect of any one factor as being more important than the others.

However, the low real interest rates throughout the world over the last several years suggest that the most important factors underlying the recent increase in the U.S. current account deficits have been shifts in the desired net savings by the rest of the world. Reductions in desired U.S. net saving may have played a role as well. But if a fall in U.S. desired saving was dominant, interest rates would have risen, not fallen.

Despite the large U.S. current account deficit, U.S. GDP growth and overall economic conditions generally have been good over the past decade. And the open capital markets that make such current account deficits possible have obvious economic benefits. Without them, it would have been much harder for the U.S. to accumulate the additional capital needed to exploit the increase in productivity. Instead of borrowing cheaply from abroad, the U.S. would have had to sacrifice a significant amount of current consumption in order to finance the necessary investment.

But an economy the size of the U.S. cannot run large current account deficits indefinitely. For it to do so, the rest of the world would have to run persistently high net saving rates. Eventually, these countries' portfolios will reach their desired allocations of U.S. assets. They will then want to consume or invest more in their own countries. With fewer funds available, the U.S. current account deficit would fall. So, when will we begin to see forces coming into play that result in this adjustment process? And once it does adjust, how will the situation unwind, and at what pace will it occur?

No one can say when this adjustment away from such high current account deficits will begin. But I expect that when it does, the adjustment will be gradual, without a major disruption to U.S. economic performance. One reason is that many of the forces driving investment and saving in the U.S. and the rest of the world are long-lived developments driven by fundamental economic factors. Furthermore, our debt service is low: The rates of return that foreign investors earn in the U.S. are low relative to the rates of return that we earn on our investments abroad. So with our relatively high pace of GDP growth, we will be able to service our debt largely out of growth rather than by a substantial reduction in the level of consumption. Finally, our large creditors likely would prefer a gradual adjustment of the U.S. external debt because they would undoubtedly suffer large capital losses in the event that there was a rapid unwinding of portfolio positions.

But proper risk management requires us to think about even very low probability events. And there is the possibility, however remote, that current account imbalances could unwind in a disruptive way. For example, political considerations may be more important to some countries' investment and saving strategies than classic portfolio optimization. Economic fundamentals would then have little to say about how these might change over time and how they might affect the pace at which the current account imbalance unwinds.

How might monetary policy respond to a rapid adjustment in the current account deficit? The answer to this question depends on how such an adjustment would affect the Federal Reserve's mandates to achieve price stability and maximum sustainable growth.

What factors might be in play? Let me sketch out one scenario. An adjustment in world saving will affect U.S. growth and inflation through its influence on interest rates and exchange rates. First, a drop in world saving would increase world real interest rates. These higher interest rates would lower U.S. domestic demand because they would reduce interest-sensitive spending. The potential growth rate of the economy could also fall because of the drop in capital investment. Second, a rapid decline in the net world saving invested in the U.S. would likely cause a drop in the exchange value of the U.S. dollar. The lower dollar would boost U.S. net exports. It would also cause a rise in the prices paid for imported goods and services. Putting all of this together, with regard to growth, many analysts believe that interest rate effects would dominate and U.S. out-

put would fall. This decline would probably be associated with some increase in resource gaps, although not as much as some might think because of the reduction in potential output. With regard to inflation, most think that the net effect would be an increase in inflationary pressure from the higher import prices.

Clearly, though, there are a lot of moving parts in play, and it is difficult to know how events would transpire. So the monetary policy decision cannot be mapped out ahead of time; it will depend on how the confluence of numerous factors influences the outlook for maximum sustainable growth and price stability. Our policy would respond to meet these goals.

But, as I said earlier, the most likely scenario is for a slow decline in the net saving rate by the rest of the world that would induce a gradual contraction in the U.S. current account deficit. This probably would not have a major impact on U.S. price pressures or growth, so there is little reason to think that monetary policy would need to react significantly.

As an aside, however, I am deeply concerned about one possible fallout from the large and persistent U.S. current account deficit. This is the possibility of protectionist legislation in the U.S. Such barriers to the trade of goods and services and restrictions on international investment in the U.S. would result in a substantial welfare loss, both for the U.S. and for other countries as well.

As I mentioned at the outset, issues such as the current account deficit are not always on the fore of our policy discussions. But they are an important factor in our analysis of the medium- and long-run prospects for the economy. And I want to conclude by noting that my discussion today reinforces an important principle of monetary policy.

Some people argue that, at times, policy should be adjusted with the aim of changing the value of the current account, the dollar, or certain asset prices. But such variables should not be “targets” of monetary policy. Clearly, we need to consider these important economic factors, but we should do so by evaluating how they influence the achievement of our ultimate goals of maximum sustainable growth and price stability. And as many of us on the FOMC have said, we view price stability as a prerequisite for maximum sustainable growth. So, in the end, no matter what path the current account eventually takes, the Federal Reserve will respond to the adjustment process in a manner that is consistent with our ultimate policy goals.