Commentary: The End of Large Current Account Deficits, 1970-2002: Are There Lessons for the United States?

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Sebastian Edwards' paper masterly reviews the consequences for GDP growth, interest rates, and currency value when current accounts that are in deficit adjust. But, for all the episodes, countries, and time periods that he examines, it remains true (as he cautions) that the United States is different from other countries. It is more closed, a larger borrower (both as a share of GDP and in level terms), and of greater importance in the global economy. Hence, examining the adjustment process of any other country has limited relevance for understanding the nature of the adjustment process that is going to take place, at some point, in the United States.

In my commentary, I rephrase and address Sebastian's question as: How will *our* current account imbalances end? A disaggregated perspective on the U.S. current account helps to better understand the nature of both the widening and potential closure of the current account. Moreover, the phrase "our imbalances" implies that we should consider both the U.S. deficit as well as the rest-of-world counterpart. At the end of this commentary, I consider the issue of current account adjustment in the context of this conference's main topic, which is "Legacy of the Greenspan Era: Lessons for the Future."

To summarize, a disaggregated perspective of U.S. trade reveals persistent trends in country and product components of U.S. trade, bilateral and global trends in foreign trade, and in current account surpluses. A new database of product- and country-specific trade flows and prices and matched expenditure components of GDP yield new estimates of growth and relative price elasticities of trade. Collectively, new estimates and data point to a significant challenge in building up from a disaggregate basis the turnaround in the trajectory of the U.S. current account predicted by many macroeconomic analysts.

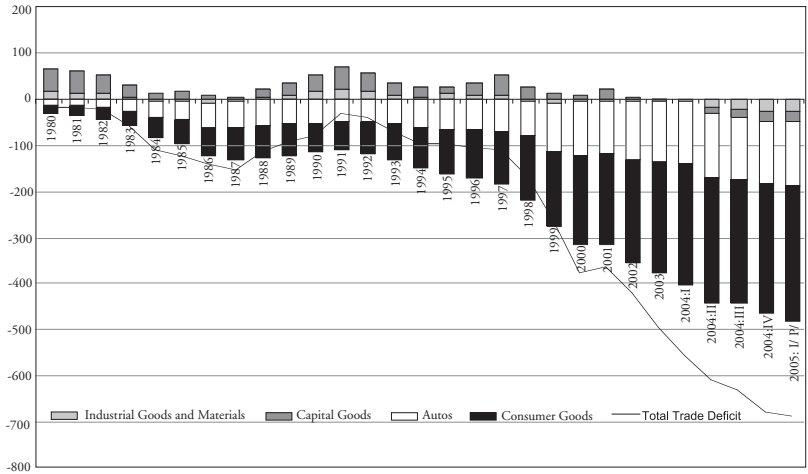
This is not a commentary that the current account trajectories should or will continue, just that macroeconomic analyses may underestimate the consequences or difficulty of realizing the turnaround in the geography of production and components of demand that "must" take place to achieve the change in current account trajectory and magnitude. Implied assumption regarding exchange rate behavior, regime change, and pass-through may be equally implausible.

Hence, the importance of policy awareness and the potential challenge of policy response are significant. The legacy of the Greenspan era may be, counter-intuitively, that policymakers are less prepared, not more so, to deal with the end of *our imbalances*.

Overview of where the global imbalances come from

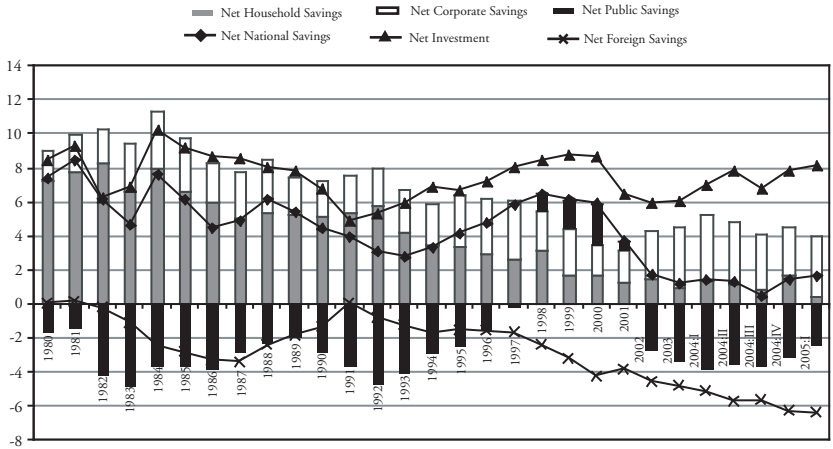
Charts 1 and 2 display, from a U.S. perspective, how we have gotten to this point of a current account deficit of about 6 percent or so of GDP. The external deficit is driven essentially by consumption habits in the United States. The last 25 years reveal a persistently widening deficit on trade in consumer goods and autos deficit that, up until the most recent increases in energy prices, have accounted for nearly the entire trade deficit and therefore the entire current account deficit as well (Chart 1). One reason for the widening of these components of the trade deficit is the persistent decline in household savings (Chart 2), which underpins consumption-based domestic demand.

Chart 1
U.S. Trade Deficit: A Disaggregated Perspective



Source: Bureau of Economic Analysis

Chart 2
NIPA: A Disaggregated Perspective



Sources: Bureau of Economic Analysis, National Income and Product Accounts; International Transactions Accounts; and Catherine Mann

Over the years, consumption has been bolstered as well by equity wealth, tax cuts, and housing wealth. If the personal income tax cuts do not sunset, additional consumption impetus will likely feed through in the future. Notably, the decline in household savings and widening of the trade deficit persists during periods of fiscal deficit and surplus. Hence, rather than the fiscal position, it appears that it is the nature of expenditure and revenue that matters.

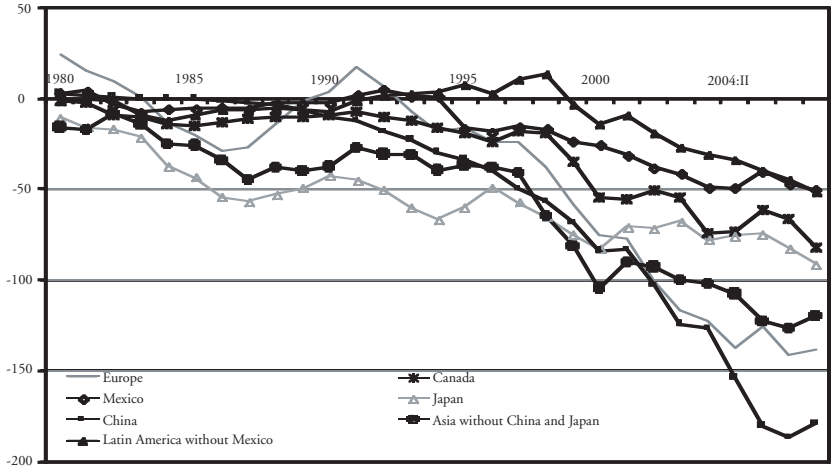
Chart 3 and Table 1 show the global imbalance from the perspective of the rest of the world. The persistent widening of the U.S. trade deficit is widely distributed around the world (Chart 3). The United States has a widening bilateral trade deficit with virtually every country and region around the world. The counterpart of the United States trade deficit is not just a deficit with respect to China, but also a deficit with respect to the countries of the European Union and just about all other countries and regions.

These bilateral surpluses by themselves do not imply that there is an imbalance in the rest of the world that has to be solved; rather, the bilateral trade positions could simply reflect the U.S. consumption boom. But the current accounts as a share of GDP (Table 1) tell the important story for the rest of the world. There is a persistent trend toward current account surplus in the rest of the world, particularly evident in Asia. So, it is not simply the case that the U.S. trade deficit is homegrown from robust consumption; it is as well a consequence of the nature of demand and production composition abroad.

This pattern of consumption-based demand in the United States and export-based surpluses abroad is a "codependent relationship."[1] The United States, for a generation-long period of time, has been able to persistently consume more than we produce (domestic demand is greater than production), and that is matched by a persistent trend toward domestic demand less than production abroad and a dependence on exports to the United States, a habit which is distributed widely, although is most obvious in Asia. It is a codependent relationship in the sense that collectively our habits balance each other out and prop each other up.

Chart 3

Bilateral Trade Deficits



Source: Bureau of Economic Analysis

Table 1

Current Account Surpluses Around the World

Current Accounts as a Share of GDP						
	1980	1985	1990	1998	2004	2005(p)
China	0.1	-3.7	3.1	3.3	4.2	4.1
Japan	-1	3.8	1.4	3	3.7	3.3
Asia/Pacific	-3	-0.4	-0.6	4.5	4.2	3.5
Western Europe	-1.3	0.6	-0.3	1.1	0.8	0.8
Latam/Carib	na	na	-0.1	-4.5	0.8	0.2

Source: IMF World Economic Outlook, April 2005

Individually these trends are not sustainable. Our current account deficit is not sustainable for the reasons that Sebastian details in his paper and that have been widely discussed as well by others.[2] Perhaps less well-acknowledged, the current account surpluses abroad should not be viewed as sustainable either. Persistent current account surplus undercuts domestic investment and development, expansion of GDP per capita, and productivity growth in the rest of the world. So, this relationship is codependent in a negative way, even as it persists and hence has a sense of familiarity and structural inevitability.

The standard approach to understanding current account sustainability and adjustment has focused on GDP as the measure of economic activity and aggregate imports and exports. The analysis presented here identifies three disaggregations that matter: type of traded product, trading partners, and type of expenditure (demand). We have developed a new data set with country-specific, product-specific, and expenditure-specific series to estimate the relevant demand and relative price elasticities for disaggregated trade flows and sustainability analysis.[3]

New estimation with components of domestic demand and disaggregated products in trade reveals the importance of the structure of economic activity and relative prices for different trading patterns in the global economy. Selected regression results for two product categories and different country groups detail some of the results (Table 2). The main result is that this more disaggregated analysis of U.S. trade gives a better view of some of the elasticities that frequently are used to project the U.S. external accounts. Using matched expenditure components reveals that elasticities differ across product and country groups. They are especially high in the short run for consumer goods, although long-run elasticities eliminate much of the Houthakker-Magee asymmetry between imports and export income elasticities. Using matched relative price (for example, real exchange rate) elasticities reveals significant and plausible values for industrial countries, particularly with respect to consumer goods (luxuries?) from industrial countries. But, the relative price mechanism to switch demand is not statistically significant for developing countries.

Using the new estimated elasticities and assumptions for consumption and investment from *Consensus Economics Forecasts* allows construction of illustrative scenarios for how U.S. current account adjustment might proceed going forward (Chart 4 and Table 3). Given the elasticities, the *Consensus Economic Forecasts*, and no additional dollar depreciation, the real non-oil trade deficit in 2006 would be about $725 billion.

Table 2
Selected Regression Results:
Two Product and Two Country Groups

Commodity group	Matched Expenditure				Matched Relative Price				Variety
	Industrial Country		Developing Country		Industrial Country		Developing Country		
	SR	LR	SR	LR	SR	LR	SR	LR	
Imports									
Capital goods	1.29**	0.77**	-0.40#	3.12	-0.31	-0.71**	-0.20	5.01**	1.42**
Consumer goods	3.55	1.32	4.16**	1.96#	-1.35**	-4.34**	0.86*	14.34**	-0.19
Exports									
Capital goods	0.67	0.70*	0.79**	0.94**	-0.38**	0.12	-0.01	0.01	5.2**
Consumer goods	0.45**	1.09**	0.69**	1.64**	-0.45**	-0.58#	0.01	0.02	-0.12

A rest-of-world investment boom and a rest-of-world consumption boom (as detailed in Table 3, where "boom" is defined as the average high value for consumption or investment over the 1980-2003 period) yield some narrowing of the trade deficit. But, since most of our capital goods exports go to mature industrial markets, whose average booms are modest, our capital goods exports do not increase that much. And, since the share of consumption goods in U.S. exports is relatively small, booming consumption abroad does little to improve the trade account. Overall, global consumption and investment booms do not play a very large role in narrowing the trade deficit because the geographical and commodity patterns of trade on the export side have been remarkably stable for 25 years.

Chart 4
Illustrative Scenarios to Close the Trade Deficit

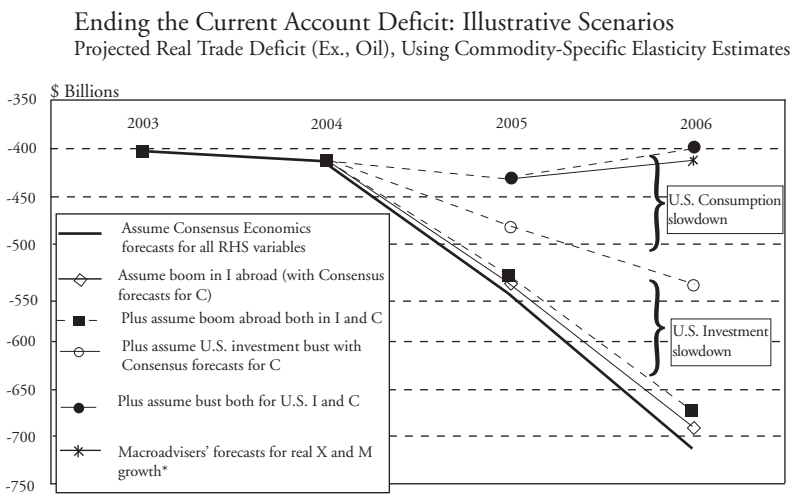


Table 3
Assumptions for Growth Scenarios

Consensus forecasts (real growth, pp)	2005	2006	Add % Points to Achieve →	Average for "Boom" in ROW/ "Realistic Slowdown" for the U.S. (Based on 1980-2003 Data)
Gross Fixed Capital Formation				
Europe and Japan	3.5	3.7	5.0	8.4
Other industrial countries	7.4	7.2	7.0	14.8
Developing countries	9.2	7.5	1.0	9.9
United States	8.8	7.5	-13.0	-6
Personal Consumption Expenditures				
Europe and Japan	1.3	1.7	7.0	8.3
Other industrial countries	3.1	3.1	5.0	8.3
Developing countries	4.9	4.4	11.0	15.2
United States	3.5	3.1	-3.0	0

Note: These scenarios assume an average boom for foreign countries but only a realistic slowdown for the United States; to achieve an "average" recession for the United States, I would fall an additional 13 pp and C an additional 3 pp.

Instead, and in keeping with what Edwards found in his exercise for largish industrial countries, investment and consumption slowdowns in the United States (dropping 13 percentage points and 3 percentage points from the *Consensus Economics* assumptions) stabilize the real trade deficit. These are modest slowdowns for the United States compared to historical cycles in the 1980-2003 period. Even so, the last time consumption growth slowed to zero was the recession of 1991-1992. If the United States had an average consumption recession—which of course we haven't seen for quite awhile—and an average investment recession (based on average cycles from 1980-2003), then the real trade deficit would be close to zero.

What do I conclude? I will make two sets of conclusions: one on the adjustment process based on the new estimation and illustrative scenarios and one with regard to the theme of the conference, the legacy of the Greenspan era.

On the adjustment process:

- The trajectory of the U.S. current account has the tyranny of imbalance, whereby exports must grow more than twice as fast as imports just to keep the deficit from worsening. It faces inexorable elements of U.S. trend robust consumption and rest-of-world trend export dependence.
- Average global booms improve U.S. net exports, but by relatively little because the United States does not export its most important products to the fastest growing markets. Why this is so is an interesting question for future research.
- A realistic slowdown for the United States dramatically narrows the trade deficit. Hence, the U.S. deficit is mostly homegrown, and absent significant changes in geography or composition of trade, any significant improvement also must be homegrown.
- What about a role for the exchange value of the dollar? Based on our estimates, the exchange rate plays an important role in expenditure switching for industrial countries, but it has little empirical significance for exports to or imports from developing countries, for which real exchange rates have moved relatively little.

- Hence, exchange rate management, magnitude of changes, and pass-through have to be different from here-to-fore observed for exchange rates to play a significant role in current account adjustment.

With respect to the legacy, our codependent relationship has been fostered by globalization enhanced by technological innovation, which on the U.S. side is reflected in productivity growth in an increasingly responsive U.S. marketplace and sophisticated financial intermediation, which have allowed our consumption habits to persist for an extended period of time. Our side of the codependency is abetted by the rest of the world favoring a production-based and export-led growth strategy. For more than a full generation, consumers, investors, and producers, and multiple generations of policymakers and politicians both here in the United States and abroad, have had, as a backdrop to their decisionmaking, a very deft handling of these forces by Chairman Greenspan's Federal Reserve.

The virtues of the Greenspan Federal Reserve are clear: rapid growth with few recessions or recessionettes, stable and reduced price inflation, and low interest rates. But, there is this glaring and very large imbalance manifested here and abroad. To at least some degree, the very deft handling on our side of the policymaking arena has taken policymakers abroad off the hook to engage their own domestic demand management and structural reforms.

Going forward, will the next Federal Reserve chairman be able to manage these forces as deftly? If not, on whom will the adjustment be most difficult? Will it be the United States, as the illustrative scenarios might suggest, or will it be abroad? Whereas the United States may well need to reduce domestic demand, the implication is that many other countries around the world will need to increase domestic demand—and it is not obvious which is more difficult to do or to adjust to. Sebastian Edwards' paper argues that history is unkind to some countries with large imbalances. But, in the case of the adjustment of *our global imbalances*, it is less clear on whom the requisite adjustment will be most unkind.[4]

Endnotes

[1]"Managing Exchange Rates: To Achieve Global Re-balancing or As Evidence of Global Co-Dependency?" *Business Economics*, June 2004.

[2]See also other analyses of sustainability from a domestic and a financial-market perspective: "Perspectives on the U.S. Current Account Deficit and Sustainability," *Journal of Economic Perspectives*, Summer 2002; and "How Long the Strong Dollar?" in *Dollar Overvaluation and the World Economy*, C. Fred Bergsten and John Williamson, eds. Institute for International Economics: Washington, 2003.

[3]"The U.S. Trade Deficit: A Disaggregated Perspective," prepared for NBER conference volume G-7 Current Account Sustainability and Adjustment, Richard Clarida and Martin Feldstein conveners (May 2005), with Katharina Plück.

[4]This is a paraphrase of "history has not dealt kindly with the aftermath of protracted periods of low-risk premiums." Chairman Alan Greenspan, *Opening Remarks*, at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 26-27, 2005.