

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

Chair: Roger W. Ferguson, Jr.

Mr. Edwards: Barry Eichengreen said this is *the issue* that most concerns policymakers and analysts at this time. Let me just make a couple of points. The first one is to clarify the nature of the exercise in my paper. I was asked to look at whether there is any lesson that one can learn from the world experience for the United States. My answer to that has four parts.

The first one is every model—or most models I have looked at or worked with, including my own model in the forthcoming issue of the Brookings panel—suggests that the current situation is unsustainable, and there is a possible scenario (we don't know the exact probability) where the United States will have to go through a very large, significant current account reversal. That is number one.

The second question is, Has this ever happened before in the rest of the world? The answer is yes.

Number three: What were the consequences of similar adjustments? I have answered that in my paper.

And number four: How useful are these results for the case of the United States? My answer—and Eichengreen picked up on that—is not that useful because these are not very large countries.

I think Cathy Mann's analysis picks up precisely here in a very useful way, and she undertakes an exercise that is extremely different in nature. She goes at the macro relationships and looks at the demand and supply for cars, motorcycles, pickup trucks, and parts, and whether Delphi will continue to produce its parts in Michigan or in Mexico or in China. After going through that kind of analysis in very, very great detail, her most likely scenario that will "solve" and would revert the United States to a sustainable path suggests that would result in a kind of cost, in terms of a short-term growth slowdown, that is similar to the result that I get from my not-very-useful sample.

Another point that I cannot resist comes from Mann's discussion, and that is the large surpluses in the rest of the world that, of course, are the counterpart to the large deficits in the United States. As Cathy says, those are not desirable. But, in general, surpluses can be sustained for a longer period of time than deficits.

In the case of Latin America, which is where at least my mind spends a lot of time, the large surpluses that the region has been running during the last few years—with the exception of two countries (Mexico and Colombia)—are a result of the de-leveraging of Latin America, which had run very large external debts. Presumably, that process will come to an end, and Latin America, at some point in the next few years, will become once again a region that is a recipient of positive foreign savings. That, of course, is going to be part of the adjustment, and capital flows presumably will go back to the region. How Asia will contribute to this is an open question and one that maybe we can discuss further.

Mr. Fraga: Congratulations, Sebastian, for a very nice paper. There are a couple things I wanted to suggest or ask.

One, it would be interesting to see if there are any cases of countries that had large current account deficits for a number of years and did not adjust abruptly, perhaps countries that went through an investment boom, as the models would suggest, that worked out smoothly.

The other question that you discussed and that we think about all the time is whether the United States will adjust in an abrupt fashion or not. Here, my second point is that perhaps we could draw on the lessons from the crisis literature of the last 20 years or so. That brings to mind a couple issues. One is on the asset side of the equation—where the money went. That has never really led to very good empirical results. It is still intuitively clear that in the case of the United States, where most of the money seems to have been correlated with an increase in consumption, one has to worry. But, more important than that, in my experience both as a policymaker and as a market practitioner, is the liability side.

It would be interesting, in the case of the United States, to look at the funding of the current account. There, we see some signs that deserve some concern. First, one has the impression—and I haven't done the work in precise fashion—that the funding of the U.S. current account deficit is getting shorter in its maturity. Also, we see that the foreign direct investment numbers have turned negative.

A lot of people analyze a balance-of-payments situation like this by adding the current account deficit and foreign direct investment to see how much you need in financing. And that points to some tension in the American case.

Ms. Krueger: This is a good paper, and certainly the crisis scenario is at least a sufficient possibility, so we should look at it. As Edwards himself said and everybody recognizes, if the current account imbalances are going to lead to that, it could be a matter of years. It is not imminent. In the meantime, the big danger of the current account deficit and related items is, of course, mounting protectionist pressure. I would have thought that, in terms of worrying about the

deficits, the danger would come from increased protectionism well before the risk of any kind of financial crisis.

Mr. Iwata: I want to make one comment on the prescription to cure the U.S. current account imbalance. One main message of the Obstfeld and Rogoff paper, which is very interesting, is the importance of resource reallocation between tradable goods and nontradable goods. That implies the United States should allocate more resources to the tradable sector. But, unfortunately, the tradable sector is dominated by the manufacturing sector, where the United States does not have a strong comparative advantage. I think it will be difficult for the United States to remarkably expand its manufacturing activity over the future.

The best thing to do, then, is to expand the international trade of services where the United States has a comparative advantage. Therefore, it is extremely important for the United States to promote the liberalization process in the service trade within the framework of the WTO, which is going on now. In order to prevent the explosive development of net foreign debt to nominal GNP ratio, the current account deficit, in terms of nominal GDP, must be reduced to about 3 percent, given the current level of 30 percent, net the foreign debt-GDP ratio that was shown in Edwards' paper. To expand the 3 percent of nominal GDP in U.S. export of services seems challenging. However, I find it seems to be a more promising way to tackle this issue of U.S. current account deficit rather than relying on curtailing the consumer spending in the United States or expecting a rapid growth rate abroad.

Mr. Martin Perez Redrado: Let me praise Sebastian Edwards for a very thorough, in-depth analysis and empirical capacity. You continue to raise standards for all of us Latin American economists.

I would like to follow up on the issue of trade liberalization and its impact over the world imbalances. My main concern is the lack of conceptual linkages between trade and finance that we find in academic analyses and in policymaking. I am convinced that a successful

Doha Round could be a major contribution in solving the issues discussed in this session. Let's look at the case of services where the opening up of sectors like banking, telecommunications, or transportation will greatly benefit the developed economies. But also let me mention the case of industrial goods. We have bound tariffs in the WTO of 35 percent. Around a third of emerging market countries don't have bound tariffs since the Uruguay Round, so they can do whatever they like with tariffs.

A round of trade liberalization that will include improved market access for industrial goods and services should clearly help to correct the imbalances in the United States and to minimize the adjustment costs. However, the gatekeeper for a trade liberalization round is agriculture. Protectionism in agriculture involves three key elements: export subsidies, domestic support, and tariffs. There are two main issues—export subsidies, which, in my view, is the first of the sins in international trade, and domestic support. There are also two important players—the United States and the European Union.

There doesn't seem to be the dynamics either in academia or at the policymaking level required to push the round forward in order to make it successful. When we run general equilibrium models for Latin America simulating what trade liberalization could do in terms of lowering barriers, we reach impressive conclusions: an annual increase in GDP of around 8 percent and an increase in trade of around 28 percent.

General equilibrium models used for developed economies combining market access, liberalization for agriculture, industry, and services show remarkable improvements in social welfare globally. Therefore, a successful round of trade liberalization could be a key element in correcting the imbalances. Further academic research and policymakers' emphasis is needed to bring momentum to trade liberalization in order to contain growing pressures toward protectionism.

Mr. Crockett: One of the things that was said yesterday is that the United States is different because it is big. That is a fundamental difference, not just because of the so-called exorbitant privilege, but because you have to see the determination of the U.S. balance of payments accounts, and their adjustment, in a general equilibrium context, bringing in the rest of the world.

It is relatively easy, in broad terms, to describe what an adjustment has to involve. It has to involve an increase in savings relative to investment in the United States, a decline in savings relative to investment in the rest of the world, and a movement in the exchange rate that allows the current accounts to accommodate to the changed savings-investment patterns.

That can happen smoothly, if each of these three developments occurs gradually and simultaneously. The risks are either that they happen too rapidly or they do not happen simultaneously.

If the U.S. savings rate starts to rise before spending increases elsewhere, clearly we have recessionary tendencies. Similarly, there will be disruptive adjustments if portfolio shifts cause the exchange rate to move before savings investment balances change. There is a lot that can be said on that. I'll say that will call for a lot of careful central bank coordination in what has been termed "the mopping up phase."

Mr. Berner: I will make just two quick points. One, for any of the panelists, who will bear the burden of adjustment when and if the U.S. current account begins to adjust? It seems to me that potentially if U.S. demand growth shrinks, some of our major trading partners may bear more of the burden of adjustment than would the United States.

Second, and related to something Arminio Fraga raised, perhaps we all think about exchange rate changes and their effects both on U.S. exports and U.S. imports. We haven't seen much effect on U.S. imports because, as Edwards acknowledged, many exporters to the United States price to the market and that has long been the case.

Perhaps foreign-direct investment into the United States and the production that brings—the substitution that will bring in imports—is really the answer to that substitution.

Mr. Goldstein: I wanted to ask Sebastian Edwards to elaborate on his finding that when you get a current account reversal for large industrial countries, you also get exchange rate depreciation and a fall in economic growth. If that were to happen in a U.S. current account reversal, how will U.S. economic growth fall? Since the United States has very little foreign-currency denominated debt, there is no balance-sheet effect to be contractionary. A dollar depreciation also would improve U.S. net exports, which would be expansionary. So, it would seem to follow that the mechanism for inducing a fall in U.S. economic growth would have to be a rise in long-term U.S. interest rates. But there is also the finding in Joe Gagnon's recent paper (coming out of the Federal Reserve Board of Governors) that when you witness currency depreciation for industrial countries, long-term bond yields don't go up unless there is a threat of inflation.

This suggests to me that two scenarios could be part of the story. Scenario one: go to the middle of next year (2006) and assume there is no excess capacity left in the U.S. economy. If you then get a large depreciation of the dollar, the resulting shift in demand toward U.S. goods produces an inflationary threat. The Fed then has to raise short-term U.S. interest rates by a lot, and some of that spills over into higher long-term rates. Scenario two is the risk premium argument. Assume there is little progress in reducing the U.S. current account imbalance, slow domestic demand growth in Europe, and very limited exchange rate flexibility in Asia. You could then get protectionist forces growing stronger in the United States and elsewhere, and this could put a premium in U.S. long-term interest rates that comes on top of the effects of U.S. monetary tightening. In any case, I would be interested in the panelists' views on how long-term interest rates in the United States go up in the reduced U.S. economic growth scenario.

Mr. Levy: Just a point on sustainability: We need to consider that in the last 15 years, U.S. economic growth has consistently exceeded the euro zone by a wide margin and Japan by an even wider margin. If you look at the U.S. growth in capital spending relative to other industrialized countries, its magnitude is larger. And, if we believe in international trade and capital flows, aren't the wide trade and current account deficits in the United States a reflection of what is going on? In particular, I would note that if we look at the composition of U.S. imports, about 40 percent are industrial supplies and capital goods, even excluding petroleum. This suggests that the strong U.S. economy and the fact that capital spending is rising so rapidly are among the causes of the wide trade deficit and current account. If the United States continues to outperform the economies of other industrial nations and if expected rates of return are higher, doesn't this imply that the trade and current account imbalances are sustainable longer than currently expected?

Mr. Barnes: The papers do a good job of telling us the economic consequences of current account reversals. We all understand what needs to happen in terms of savings, investment adjustments, and exchange rates. I would like to ask the panelists if any work has been done on analyzing the triggers for the changes that are required, that is to say, whether we can make any generalizations about whether it is domestic policy actions or the actions of external investors. Not the consequences and causes, but the triggers for current account changes.

Ms. Mann: There are many different questions and comments. I will focus my comments mainly on the topic of tradable services, first their potential to change the trajectory for the trade deficit, and second, the status of services negotiations in the WTO. I also will make a comment about trade in manufactured products.

On services, just as well as goods, it is important to disaggregate. In Edwards' paper, the aggregated services trade surplus falls. However, disaggregating services trade reveals a worsening of the trade position in transportation, travel, and military transfers, but a continued posi-

tive and increasing trade balance in “other private services,” such as professional, technical, financial, and education services.

Trade elasticities for these other private services are different from that for goods. A number of years ago, I estimated the elasticities of U.S. demand for tradable services and foreign demand for tradable services. What was unique about tradable services at the time, which has been confirmed since in recent work by Jaime Marquez at the Board of Governors, was that the elasticity of foreign demand for tradable services (U.S. exports) is much higher than is the case for U.S. demand for tradable services (U.S. imports). Unlike goods in which the familiar Houthakker-Magee asymmetry puts us at a disadvantage (that is, if every country grows at the same rate, we would run a larger and larger trade deficit), the opposite is true for services, particularly these so-called other private services. In fact, the estimated elasticities reveal that a common growth rate around the world should expand our services surplus.

Unfortunately, a rapid expansion of U.S. exports of services is not likely in the future since the services sectors are the ones where the least progress has been made in previous trade rounds. Moreover, negotiations on services in the Doha Round are at a standstill. So, although services trade offers an avenue to potentially change the trajectory of the trade deficit and aid sustainability, it is not likely to do so.

A second comment is with regard to trade in manufactured goods. In contrast to one comment, U.S. manufacturing remains very internationally competitive. Despite slow growth in the major industrial country markets, and an extended period of dollar appreciation, exports of capital goods and industrial supplies and materials account for almost half of all exports of goods and services.

Mr. Eichengreen: To Morris Goldstein, who asked and answered: It is my worry that it is going to be the interest rate increase that brings about the painful adjustment. Gagnon’s results really don’t speak directly to this issue because they don’t distinguish different reasons

why the exchange rate moves. Different causes will result in different interest rate responses. If there is a sudden curtailment of financing, it is pretty clear which way the U.S. Treasury bond yield is going to move.

To Anne Krueger: I worry about the trade protection response as well. I don't think redoubling our efforts on trade liberalization, on the other hand, is going to solve the U.S. current account imbalance, which is a macro phenomenon of savings and investment grown largely at home.

Finally, could there be a smooth adjustment of this imbalance? My view yesterday and, of course, still now is the longer it continues, the less plausible that scenario becomes. The larger the U.S. debt relative to global portfolios, the less plausible sustainability appears.

A final point would be to try to bring this back to our discussion of what a risk management-oriented central bank might do or maybe should have done about this problem. One option would have been to ignore it. A second option would have been to argue longer and louder about the need for fiscal correction to raise national savings as the imbalance began to emerge. And a third option, which someone at this conference ought to put on the table, would have been to normalize the level of interest rates more rapidly starting in 2002 as a way of addressing this emerging risk.

Mr. Edwards: Arminio Fraga asked a very important question and that is whether we have seen a more orderly adjustment. Both measures I use are a 5 percent reduction over three years. Now, you may think that is abrupt, but in one of the measures I use, the first year is only 2 percent, so it would be like 2, 2, 1 percent or 2, 1, 2 percent or whatever. That is pretty gradual.

The consequences on growth in my results are that the negative consequences are smaller for the smoother adjustment than for the more abrupt reduction. If you continue to look at more and more gradual definitions of reversal, the negative effect will become smaller and smaller until it will disappear. The very fine paper done at the Board of

Governors by Croke, Kamin, and Leduc takes the definition of reversal that is quite mild (2 percent over three years), and in that case, they don't find a negative effect on growth. This is not the kind of adjustment we are talking about here. So, it is a very important question.

On the fact that foreign direct investment has become negative, I worry a little bit, but not too much. It is a two-and-a-half-year trend, which may revert in the future.

Many of the comments have to do with protectionism, and I am very concerned as well. I just want to point out that one of the interesting results of this research is that the effects on growth of a reversal become smaller in more open economies. Not only will this help the adjustment, but also, once the reversal comes, the data show that more open economies are able to rebound faster.

The risk management theme that we discussed yesterday will become very important, but not only from the point of view of the Fed. It will require risk management in a coordinated fashion across a number of central banks. Here, it is not going to be the G7 only. If one looks at the trade-weighted real exchange rate for the United States, which is calculated by the Fed, it has 26 currencies. The first five currencies include the Mexican peso and the Chinese Yuan.

Finally, Morris Goldstein asked a question and provided the answer. It will be interest rates. In my results adjusted for large countries, there is an increase in interest rates of 120 basis points associated with the reversals. If we add to that the type of risk premium increases that we have talked about, that increase may be quite significant, and that is something that we should be concerned about.