

U.S. Economic Imbalances A Barrier to Growth



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Our baseline forecast for the U.S. represents a compromise between favorable and less favorable paths the economy could take. A favorable scenario is one in which current economic imbalances do not reverse during the forecast period, whereas in an unfavorable alternative the adjustment process takes place rapidly. In our baseline forecast, the adjustment advances slowly, implying a slower pace of domestic demand growth than the consensus forecast.

Our baseline forecast assumes that employment has already embarked on a clear path of recovery, following an exceptionally long slump that began in early 2001. This will help sustain relatively strong growth in private consumption. Investment will gradually take on the role of driver of demand growth, as utilization rates begin to rise and particularly since high-technology equipment purchased earlier is aging rapidly. Firms will also begin to build their inventories from extremely low levels. The dollar's depreciation will bolster export growth and dampen imports, although the latter will be buffered by strong domestic demand growth. As such, the risk of further and significant dollar depreciation remains high, since the current-account will continue to run wide deficits.

Economy Expected To Continue Expanding, But...

The economy will continue to expand relatively rapidly in the closing quarter of this year, although growth will inevitably slow from the ro-

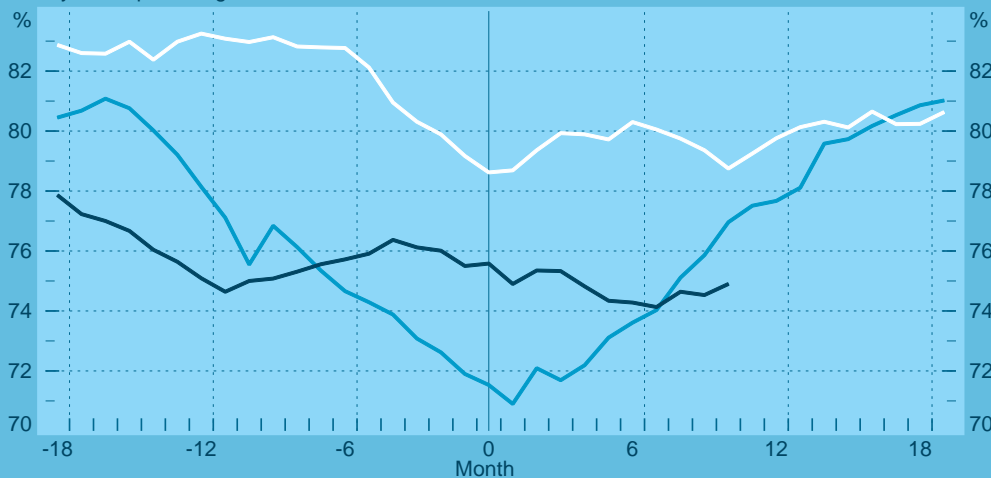
bust 8.2-percent pace recorded in the third quarter. Firming consumer confidence will help sustain growth in consumption by highly indebted households, supporting overall economic growth at least in the near term.

However, looking further out on the horizon, it becomes extremely unclear whether the economy can be able to maintain high growth rates. Capacity constraints will not restrain growth, since utilization rates are very low despite the economy having emerged from recession already in November 2001. The output gap – the percentage deviation of real output from its potential level – will stand at around two percent this year. This is reflected in the exceptionally low capacity utilization rate seen in industry, which stood at only 75 percent in October, well below its long-run average of 80 percent. The last time the utilization rate was this low was during the difficult recession of the early 1980s.

Ample production capacity will thus temper the pace of the investment recovery. Strong investment growth will have to wait until later, at least in industry, even though profits are rising favorably. Firms will be able to increase production to meet future demand using existing resources. Where investment will increase rapidly is in information technology equipment, which ages quickly and thus needs to be replaced often. Lean inventories should encourage greater inventory investment and the weakening of the dollar will support foreign trade.

U.S. Industrial Capacity Utilization Rate in Three Business Cycles

Cyclical upturn begins at month 0



Sources: BEA, ETLA.

— 1982/11

— 1991/3

— 2001/11-

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Real disposable income will have to increase if consumption is to continue growing as it has. Improvements in the employment situation are critical in this respect, since tax cuts will no longer support demand during the course of the winter. Moreover, the positive impact of falling interest rates and mortgage refinancing activity on consumption will also fade. Total non-farm employment has been rising since August, but only at a sluggish pace so far. In November, establishment employment was still down more than 700,000 compared to its level in November 2001. Manufacturing employment continued to contract in November, with job losses during the same time period amounting to 1.3 million.

...Domestic and Foreign Investor Behavior Poses Risks

How consumers and foreign investors behave is crucial to the sustainability of output growth. Foreign investors are becoming wary of America's deep current-account deficit, which is widening to more than five percent of GDP this year. Deficits of this magnitude have typically

been associated with sharp exchange rate movements and economic slowdowns (see, for example, Freund 2000). The current-account adjustment could be triggered by greater caution amongst investors and households in their investment and spending behavior. A marked pull-back of investment would immediately be felt in higher interest rates and a weaker dollar. If households were to raise their saving significantly, consumption and overall growth prospects would weaken from those forecast. This would also redirect foreign investment away from the U.S., and result in higher interest rates and dollar depreciation.

The dollar depreciation would be particularly large against the euro if China and several other countries were to maintain their dollar pegs. Pressure on the dollar has so far been mitigated by, for example, investment inflows from China, which have hitherto helped finance part of the U.S. current-account deficit.

Sectoral Imbalances Have Widened Further

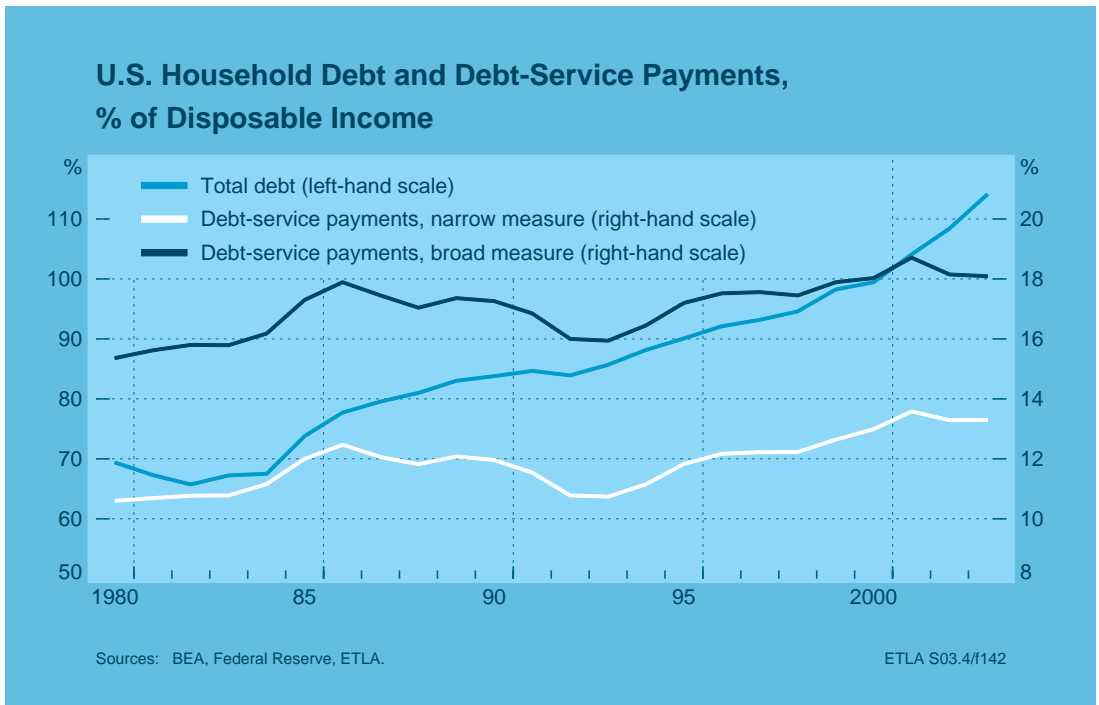
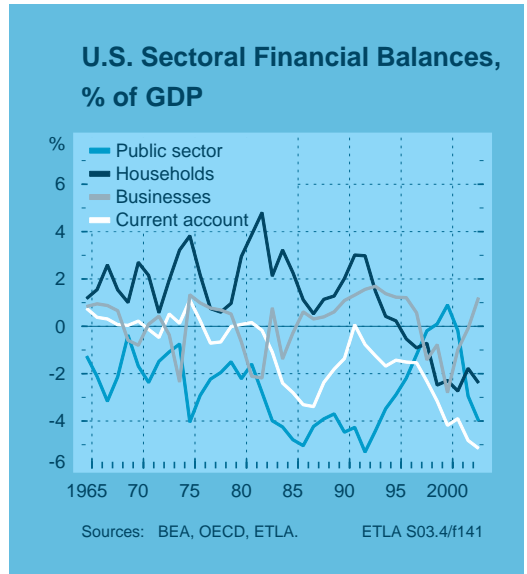
The economic boom of the 1990s led to a widening in U.S. economic imbalances. Although

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the recession of 2001 slowed growth in corporate sector debt, households and the overall economy continued to rapidly build up debt, fueled by the sharp decline in interest rates and the associated home price appreciation. The corporate financial balance has improved quickly in recent years through reduced investment activity.

The adjacent figure breaks the private sector financial balance (after-tax income minus expenditure) into its household and corporate components.¹ The figure shows that developments in household and corporate sector financial balances have diverged considerably at times. The deficit in the external deficit reflects the fact that total domestic investment exceeds saving.

The corporate sector financial balance is projected to move into surplus this year. Tax cuts



¹ The total private sector financial balance was calculated by subtracting the public sector balance from the current balance. The household balance was derived by subtracting residential building investment from household saving. The corporate balance, in turn, is the difference between the total private sector balance and the household balance.

have prevented further deterioration of the household balance, but due to swift spending growth it has nevertheless remained wide. There is a substantial risk that households will begin to save more in order to reign in growth in their debt, especially if employment growth remains subdued. The saving rate bottomed out in October 2001. Since then it has been rising appreciably. The public sector deficit is increasing at an unsustainable rate. With the private sector balance moving into balance as a result of corporate balance sheet improvements, the current-account deficit has been the result of public expenditure exceeding revenue. The current-account deficit implies that the U.S. saves less than it invests, needing inflows of foreign capital to settle the balance. As a result, the U.S. is becoming increasingly indebted to the rest of the world.

Current Account Deficits and the Dollar

The U.S. current account deficit has been rising steadily since the early 1990s, and has widened dramatically since 1997. At 5.1 percent of GDP, it is currently at its highest level ever, and is expected to continue rising over the next few years according to many forecasts. The balance in goods trade has been the main contributor to the increase in the current-account deficit. The U.S. has typically recorded a surplus in services trade, although this has declined from

a high of more than one percent of GDP in the mid-1990s to 0.6 percent currently. The small surplus in the balance on income has diminished in past years, falling to a level close to zero. Unilateral transfers have generally been a deficit item, averaging around 0.5 percent of GDP.

Due to the nearly persistent deficit in the current account since the early 1980s, the U.S. net foreign asset position has weakened substantially over the last two decades, reaching an alarming negative 25 percent of GDP at the end of 2002. With a current account deficit in excess of 5 percent of GDP, foreigners are now accumulating U.S. assets at an exceptionally fast rate, namely 550 billion dollars per year or around 2.2 billion dollars each business day. Since these assets represent claims on future output, the U.S. international investment position as a percent of GDP cannot continue to deteriorate without limit.

The sheer size of America's external debt poses risks to the dollar, particularly since foreigners own major shares of liquid assets. For example, D'Arista (2003) notes that foreigners own 37.6 percent of all U.S. Treasury holdings, 17.4 percent of corporate bonds, and 10.3 percent of corporate equities. At some point foreigners might become cautious about increasing their holdings of U.S. assets. To continue attracting foreign investment, then, U.S. asset prices would have to fall in terms of foreign currency, for example through dollar depreciation and higher interest rates. Dollar depreciation would have a direct impact on the trade balance while higher interest rates would dampen domestic spending, both thus contributing to a current-account adjustment towards balance.

Freund (2000) studied the relationship between current-account adjustments and currency depreciations across industrialized countries over the period 1980-1997. The author finds that large current-account deficits typically begin to reverse themselves when they reach 5 percent of GDP and reverse almost completely to balance three years after reaching this peak. According to the study, the currencies of the countries examined typically begin to depreciate one year before the deficit peaks and continue depreciating for three years, with a total depreciation of 19 percent in real terms and 42 percent in nominal terms. If the U.S. follows the typical experience of industrialized



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countries, then the current account deficit could be near its peak. In this case, the study suggests that the effective dollar exchange rate, which has fallen by an average of 5.5 percent, in both nominal and real terms, compared to its average level in 2002, could continue to depreciate over the next three years, with the current account deficit moving closer to balance.

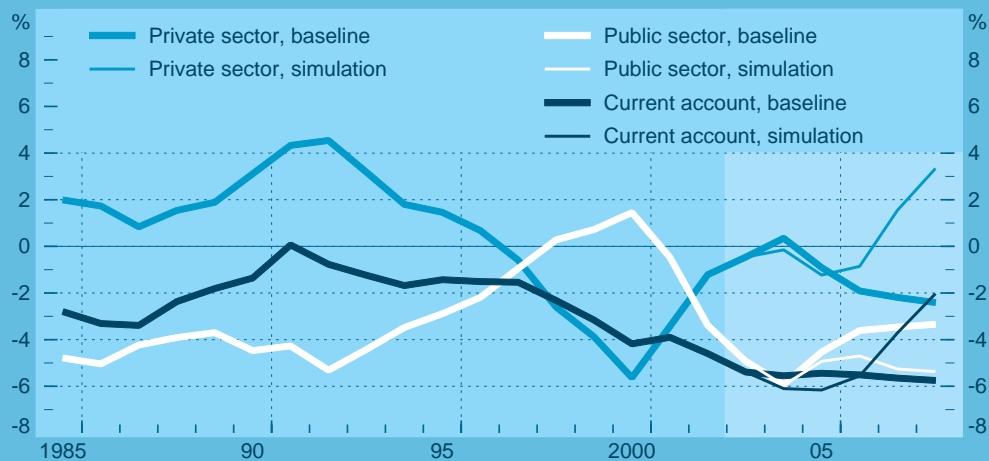
Correcting Sectoral Imbalances: An Alternative Scenario for the U.S. Economy in 2004-2010

As outlined above, the baseline forecast assumes that the U.S. current account deficit will not decline even in the medium term since domestic demand will continue to grow swiftly relative to that in important trading partner economies and dollar depreciation will be limited. The chart below depicts our baseline, showing that the improvement in the private sector balance next year is just transitory; with the government deficit assumed to decline in the medium term (due to, among other things, the phasing out of recent tax cuts beginning in 2005), private sector spending must expand

faster than income in order to generate the GDP growth embedded in the forecast. This raises the question, is the trajectory sustainable since it implies renewed growth in borrowing by households and businesses. With household debt already at an alarmingly high level, and interest rates no longer likely to decline, debt service payments would surge without limit. At the same time, the massive current account deficit implies large financial inflows, with the negative net international investment position as a share of GDP rising sharply in the baseline forecast to almost 35 percent by 2006 and 54 percent by 2010. Servicing the external debt would become increasingly burdensome, putting upward pressure on interest rates and reducing asset prices and the dollar's external value.

An alternative scenario, then, is one in which the dollar depreciates more rapidly than in baseline to alleviate some of the imbalances in the economy. To assess the possible impacts of such a scenario, we employ the NiGEM global econometric model where an assumption is made that the effective dollar exchange rate starts to depreciate in the fourth quarter of 2003, falling by a total of 30 percent by

U.S. Sectoral Financial Balances, % of GDP, Baseline Forecast and Simulation



Sources: BEA, OECD, ETLA.

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yearend 2006. The dollar exchange rate then stabilizes in 2007-2010. Despite increasing pressure from the U.S., China has so far succeeded in maintaining its peg against the dollar. In this simulation, we assume a status quo situation in this respect, so the Chinese renminbi does not appreciate vis-à-vis the dollar. Naturally, this implies that other currencies appreciate by more than the decline in the dollar effective exchange rate.

The dollar depreciation generates inflationary pressures through higher import prices, prompting the Federal Reserve to start raising interest rates already in the first quarter of 2004. By 2006, inflation accelerates to slightly more than 6 percent and long-term interest rates rise above 10 percent compared to a baseline level of 5.5 percent. Total private sector investment contracts reflecting higher borrowing costs while private consumption growth slows as higher inflation reduces household purchasing power. As a result of curbed spending, the private sector financial balance eventually moves into surplus, thereby facilitating a reduction in debt. The current account deficit initially deepens as a consequence of the so-called J-Curve Effect. It then begins to slowly improve in the later years of the simulation, falling to 2 percent of GDP by 2008, which helps stop the decline in net foreign debt as a percent of GDP. Total output growth starts slowing compared to baseline in the second half of 2004, and for the 2004-2008 period as a whole averages 1.5 percentage points less per annum.

The dollar depreciation also has significant medium-term impacts on the rest of the world economy. Output growth in the Euro Area falls by 0.5 percentage points in 2005 and by one percentage point in 2006. The European Central Bank responds to the fall in inflation and growth by lowering interest rates in 2005, with short-term interest rates settling at slightly more than two percent in 2006-2007. Japan suffers more, partly reflecting loss of market share in China, its second largest export market after the U.S., due to the fixed renminbi exchange rate vis-à-vis the dollar. Moreover, the monetary policy stance cannot be eased as much as in the Euro Area given interest rates already close to zero. Over the longer term (2008-2010), however, Euro Area and Japanese GDP growth accelerates to rates exceeding

those in the baseline forecast. One explanation for this is that the countries' appreciated currencies allow for larger increases in imported investment goods than would otherwise be the case, which in turn raises the capital stock and thus also long-run growth.

Concluding Remarks

The recent U.S. recession did not lead to significant adjustments in economic imbalances accumulated during the boom of the 1990s. Admittedly, the private sector financial deficit has declined noticeably. However, this is mainly due to spending restraint by businesses, whose financial balance has recently moved into a small surplus. Households, on the other hand, are still spending much more than they are earning, supported by low interest rates and home price appreciation. As a result, personal debt has increased at an accelerated pace in recent months (D'Arista 2003), despite it already being at a record high level. At the same time, America's current-account deficit is already reaching proportions that have typically been associated with currency depreciation and a slowdown in income growth (Freund 2000).

It is impossible to say for certain when these imbalances will reverse. However, it is clear that debt levels cannot rise without limit. At some point, the burden of servicing the debt will become too great, resulting in a period of spending restraint and debt reduction. There are various channels through which the adjustment process could take place. Faster growth in the rest of the world could help to boost U.S. exports and income, thus facilitating a reduction in the current-account and private sector deficits. However, due to the sheer size of the U.S. trade gap, exports would have to increase dramatically faster than they did in the 1990s just to stop the deteriorating trend in the trade balance, raising doubts as to whether such an outlook is plausible. In addition, the persistent widening of the U.S. trade balance with respect to China, for example, also suggests that faster growth abroad may not suffice to reduce the imbalance. In this paper, we focus on dollar depreciation as the trigger that helps reduce these imbalances.

The simulation shows that even a considerable depreciation of the dollar would foster a re-

versal in some of the imbalances that aggravate the U.S. macroeconomy. The dollar depreciation would raise inflationary pressures in the U.S., leading to higher interest rates and a noticeable slowdown in private sector spending in the medium term. Growth in the rest of the world would also slow in the medium term. In the longer term, however, when the imbalances have been reversed, the opportunity emerges for more sustained growth in the U.S. Growth in the rest of the world also accelerates in the longer term. This reflects, among other things, the fact that the improvement in the rest of the world's terms of trade allows for more imports of capital goods and thus a higher capital stock.

A U.S. current-account adjustment would also bring other longer-term benefits. The current gap in the trade deficit, particularly with respect to China, has put the free-trade agenda at jeopardy. The U.S. gave Japan much heat in the 1980s and early 1990s for its trade deficits of the day. Today, much of the blame is being placed on China, the latest example of which emerged in November when the Bush Administration imposed quotas on several Chinese textile products. Maintaining free trade on a global scale would be much easier if some of these external imbalances were corrected.

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