

The Outlook for the US Trade Balance

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Current forecasts

The trade and current account balances have “deteriorated” dramatically since 1991. The deficits have more than doubled over the last two years alone. As a share of GDP the current account deficit in 1999 will probably tie the record set in 1987 (though not so the trade deficit). Most forecasts have the gap widening a bit more in 2000, but then reaching a plateau thereafter. Indeed, the IMF and OECD have the current account deficit as a share of GDP coming down slightly after mid-2001.

Factors in short-run forecasts

Why are forecasts for CAD to stabilize as share of GDP in 2000-01?

- Foreign recovery: reversal of differential in growth between US and RoW. Japanese recovery here at last, Korea already re-attained pre-crisis output, other emerging markets; Europe picking up...

Increases in foreign income of course raise foreign imports from us.

Then why does the leveling off not occur in the coming year?

Perhaps because the long-predicted easing of US growth shows no signs of materializing. But there are negative factors.

- Oil Prices: 1999 increase will add to oil import bill in the coming year
- Dollar: The appreciation of the dollar from mid-1995 to mid-1998 contributed to the increase in the trade deficit, and was quite natural given the amazing strength of the American economy (especially relative to Japan, and especially since the yen/\$ rate had overshot on the downside in mid-1995). I do not see as clear a story over the last year.
- Factor services: The investment income account finally, and firmly, went into deficit in 1998, so CAD will be increasingly worse than balance on goods and services. Indeed, it will be in the vicinity of the merchandise balance (with transfers plus interest payments now big enough to wipe out services).

Long run outlook

There are three reasons to fear that the current account will continue to deteriorate after 2000, notwithstanding the outside forecasts of a levelling-off.

(1) the just-mentioned deficit in factor services.

(2) Even with *Constant growth rates* of exports and imports, the trade gap would grow larger. With US exports now running around \$700 billion and imports \$1 trillion (rounding off), 6% (nominal) growth rates of each would imply a steady worsening in the difference, equal to $.06 * \$300b = \$18 b$ per year.

(3) *Houthakker-Magee* discrepancy between income elasticities. (30th anniversary of the paper.) I am aware of research at the Fed (e.g., Marquez, 1990; Hooper, Johnson and Marquez, 1998: elasticity of demand for imports with respect to US income about 2, vs. 1 for other countries imports from U.S.) suggesting that this regularity still holds, that it is robust, and that it implies an alarmingly implacable deterioration in the US trade balance over time. If real growth levels out at 3% in both the US and the rest of the world, the differential in elasticities would imply that US imports grow at 6% a year vs. 3% a year for exports. That doubles the built-in trend.¹ This may not be sustainable in the long run at a given exchange rate.

My initial suspicion was that the apparent persistence of the Houthakker-Magee finding is an artifact of the omission from the equation of a variable to capture the supply side of the equation, something to capture the growing size of our trade partners. In the gravity model of bilateral trade, which by now is relatively well-established empirically and theoretically, the size of the exporting country typically has almost as big and significant an effect on trade as the size of the importing country. (Justified by modern theories of trade based on imperfect substitutes. Intuitively, a larger country produces more varieties, and American consumers “have got to have one of each” variety.) Countries in Asia and elsewhere have grown much more rapidly than the U.S. over the last few decades, so that omitting their GDPs from the US import equation might result in a spuriously high estimate of US import elasticities [as Paul Krugman said in an EER article.] I have tried out the Houthakker-Magee in the gravity model, and have found no sign of it. But I also have found no sign of it on this data set (bilateral trade every five years) even when dropping exporters’ income. In other words I have been unable to reproduce the H-M result. So I view this as still an open question. But the Fed research has moved me about half-way from my previous prior.

Unfortunately, nobody outside the Fed is addressing the H-M question, whether to agree or disagree. Why? Academic economists have not just abandoned the art of trade balance forecasting themselves, but have in effect discouraged their students from doing it, because all theories must derive from intertemporal optimization, which has little in the way of actual predictive content (beyond the generalization that the current account should be procyclical, one of the most easily rejected empirical propositions around).

Sustainability

We heard about the hard landing scenario in the 1980s and 90s. “At some point foreigners will tire of accumulating ever-greater portions of US assets in their portfolios. Then continued lending to the US will not be forthcoming without a sharp depreciation of the dollar in accompanied by increases in U.S. interest rates and declines in US securities prices. Such a hard landing might even entail a loss of confidence and a return of

¹ When applied to current levels of imports and exports that’s $6% * \$1,000b + - 3% * \$740b + = \$60b - \$23b = \$40b/year$. TD/GDP apparently creeps up by an alarming $\frac{1}{2}\%$ of GDP per year.

stafflation.” Many of us have had such fears ever since the early 1980s, when we began running current account deficits large enough to exhaust our previous century’s accumulated investments abroad. It almost seemed to happen in 1987, but then didn’t.

It could always happen in the future. But I think it is less likely now than at any point over the last two decades. The reason is that the capital inflows have been used to finance investment and not budget deficits. National Saving and Investment have been increasing in this expansion; we are just running a current account deficit because national saving is rising faster than investment. That’s unlike the 1980s, when national saving fell as a share of GDP.

Hard-landing in financial markets?

In preparation for this meeting, I took a simple look at patterns of movement in interest rates and exchange rates over the last 20 years. Consider four possible cases. The combination of an appreciating dollar and increasing US interest rate could be called the case of strong growth or monetary tightening, and conversely for the combination of a depreciating dollar and falling US interest rate. The combination of an appreciating dollar and falling US T bill rate could be called the case of rising confidence or safe haven. The fourth possible combination, a depreciating dollar and rising US interest rate is the one that would be associated with a hard landing, fear that US debts will be inflated away, loss of confidence, or “strike” by foreign investors.

In 14 out of the last 20 years, the trade-weighted exchange rate has changed 5% or more. And in 14 out of the last 20 years the T-bill rate has changed 75 basis points or more. How often do you think the hard-landing combination has occurred, during this period, the first of the century when our international debts were rising? That is, how many years have seen a depreciation of at least 5 % together with a rise in interest rates of at least 75 basis points? None.

The answer is the same if you do it on a monthly basis. In 40 out of the last 240 months, the exchange rate has changed 4% or more, and in 48 of the last 240 months the interest rate has changed 50 basis points or more. Yet never has the dollar appreciated by 4% and the interest rate fallen by 50 basis points in the same month. When it comes to the United States, apparently investors are simply not thinking in terms of the risk that our debts will be inflated, depreciated, or defaulted away. To the contrary, when global risk-awareness increases (as late 1998), flight to quality means a flight to US treasuries, notwithstanding our ever-rising levels of international debt.

National Saving identity

The *Economist*-GoldmanSachs-Godley view focuses on *private* net saving S-I: This balance turned sharply negative in late 1990s, and is now at -5% of GDP. The concern is that some point saving will have to increase (e.g., if stock market falls), which will bring expansion to an end. It is certainly true that private saving is very low, and this is a problem for the longer term. But I don’t see what is gained, as a measure of sustainability, from subtracting off I.

The *Lawson Fallacy* focuses on public saving, the budget surplus. Lawson’s Fallacy is still a fallacy. That is the claim that if a country has a strong fiscal position, so capital inflows are financing the private sector, then a big CA deficit is not a cause for

concern. This belief came to grief in Chile in 1982, UK in 1992, Mexico in 1994, and now East Asia in 1997.

The lesson from recent *emerging-market crashes*. Worse yet than the failure of the Lawson proposition, the post-Mexico modification also came to grief in the late 1990s. This was the claim that if a country has not only strong public saving but also strong National Saving, so that the capital inflows are going to finance private investment rather than consumption (as in Mexico), then a big CA deficit is not a cause for concern.

But these countries have in common that they were attempting to maintain an exchange rate target, which the US is not. Almost by definition of our exchange rate regime, a currency crisis can't happen.

The best all-around measure is still: National Saving $NS = S + BS$. It shows whether the economy is adding to its assets, whether claims against nature (higher capital stock through I) or claims against the rest of the world (higher international investment position through CA). As mentioned, NS/GDP has been rising in the 1990s, not falling as in the 1980s, though it is still less than one would like.

Implication: Perhaps it is true that the dollar will have to depreciate over the next 10 years to reduce the trade deficit. But even so, the help from capital inflows in the 1990s in sustaining low interest rates, investment and rapid growth, means that we should be rich enough in the future, will have a high enough capital stock, to pay back the international debts and still come out ahead. It makes perfect sense that in the second half of the 1990s, when the US economy has been so strong relative to trading partners (especially in Asia), that the dollar has been relatively strong and the trade deficit relatively large. It has acted as a safety valve to release pressure from domestic demand that would otherwise have been too strong. The turnaround should come when the US economy slows.