Economic and Financial Outlook

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Short-term economic outlook

• White House forecast: 3.4% US growth this year
• ≈ private forecasts, and is readily attainable.

But

– Jobs still lag behind US output growth since 2001
  • *Econ.Report of President* gives up goal of raising employment/population back toward end-2000 level.
    Today, ratio still < that at end of 2001 recession.
  • Real wages have stagnated too
  • => Growth is all going to profits.
  • Casts doubt on superiority of US labor market model to European model (temporarily?).

– The American consumer may finally tire.
Global growth forecast is strong

• 4.9% in 2006 (slowing to 4.7% in 2007) - IMF WEO, April 19

• Recoveries appear, at long last, to be established in Japan & continental Europe

• Booming China, et al., are newly important sources of global demand.

• But there are also substantial risks to the global outlook.
Medium-term global risks
Odds of each alone small; but cumulative odds > 1/2

• Hard landing of $: foreigners pull out =>
  $ ↓ & i ↑ => possible return of stagflation in US.

• Bursting bubbles => consumption would fall.
  – Bond market: conundrum of low LT rates 2004-05.
  – Housing market: valuations very high.

• New oil shocks,
  – e.g., from Russia, Venezuela, Nigeria, Iran, S.Arabia…

• New security setbacks
  – Big new terrorist attack, perhaps with WMD
  – Korea or Iran go nuclear/and or to war
  – Islamic radicals take over Pakistan, S.A. or Egypt
U.S. trade balance is deteriorating

Fig. 1: U.S. Trade Balance and Current Account Balance, 1960-2005

Sources: Department of Commerce (Bureau of Economic Analysis)
U.S. trade deficit

• **Deficits hit record levels in 2005:**
  – Goods & services = $726 b = 5.8 % GDP.
  – **Current account** = 6 ½ % GDP
  – Would set off alarm bells in Brazil or Turkey

• **Short-term danger:**
  Protectionist legislation, scapegoating China.

• **Medium-term danger:**
  – CA Deficit => US is borrowing from the rest of the world.
  – Dependence on foreign investors may => hard landing

• **Long-term danger:**
  – US net debt to RoW now ≈ $3 trillion.
  – Dependence on foreign central banks may =>
    loss of US global hegemony.
$ share in world portfolios rising

Share of US Assets in Rest of the World’s Output and Financial Wealth

Source: Caballero, Farhi and Gourinchas (2006)
Origins of Current Account deficits

• Trade deficits are not primarily determined by trade policy (e.g., tariffs, NAFTA, WTO, etc.)
• Rather, by macroeconomics
• Deficits are affected by exchange rates and growth rates.
• But these are just the “intermediating variables”
• More fundamentally, the US trade deficit reflects a shortfall in National Saving
The decline in US National Saving

• National Saving ≡
  how much private saving is left over after financing the budget deficit.

• US CA deficit widened rapidly in early 1980s, & more so 2001-05, because of sharp falls in National Saving
National Savings, Investment & Current Account, as shares of GDP

Net Natl Saving (% of GDP)  Net Domestic Investment (% of GDP)  Current Account (% of GDP)
Why did National Saving fall in early 1980s, and 2001-05?

• Federal budget balance fell abruptly both times
  – From 1970s deficit = 2% of GDP, to 5% in 1983.
  – From 2000 surplus = 2% GDP, to deficits >3% now.

• According to some theories, pro-capitalist tax cuts were supposed to result in higher household saving.

• But both times, saving actually fell after tax cuts.

• U.S. household saving is now < 0!

• So both components of US National Saving fell.
What gave rise to the record federal budget deficits?

• Bush Administration: Large tax cuts, together with rapid increases in government spending

• Parallels with Reagan & Johnson Administrations:
  – Big rise in defense spending
  – Rise in non-defense spending as well
  – Unwillingness of president to raise taxes to pay for it.
  – Leads to declining trade balance
  – Eventual gradual decline in global role of the $.
  – They had ignored the advice of their CEA Chairmen.
The current bout of fiscal irresponsibility is actually worse than the 1980s

- The retirement of the baby boom generation is that much closer than it was in 1981.
- The national debt is that much higher.
- We now have other new fiscal time bombs as well, e.g., phony sun-setting of tax cuts, need to fix AMT (Alternative Minimum Tax), & exacerbated Medicare shortfall.
- The current administration seems to lack ability -- which Reagan Administration and elder Bush did have -- to perceive when reality diverges from speechwriters’ script, & to respond with mid-course correction.
- To the contrary, the White House continues to propose more tax cuts
What about the “Starve the Beast” hypothesis?

• Starve the Beast claim: tax revenue↓ => spending↓. “Congress can’t spend money it doesn’t have” (!)
• History shows that the claim does not describe actual spending behavior. The pattern:
• Spending is only cut under a regime of “shared sacrifice” that simultaneously raises tax revenue (regime of caps & PAYGO in effect throughout 1990s).
• Spending is not cut under a tax-cutting regime (1980s & current decade).
• See Figure 2.
Fig. 2: US Federal Budget Deficit and Spending as % of GDP.
Further, even if the Starve the Beast hypothesis did describe actual behavior...

- It would contradict the original rationale for the tax cuts: the Lafferite hypothesis that “tax rate cuts produce more tax revenue.”

- “Starve the Beast” would then predict more government spending not less.

- Is Laffer a straw man?
  - President George W. Bush, July 24, 2003
  - Treasury Secy. John Snow, Congr. testimony, Feb. 7, 2006: “Lower tax rates are good for the economy and a growing economy is good for Treasury receipts.”
White House forecast of cutting budget deficit in $\frac{1}{2}$ by 2009 will not be met

• WH projections released in Feb. still do not allow for
  – the ongoing cost of Iraq
  – Fixing the Alternative Minimum Tax
  – Making tax cuts permanent as it has asked for
  – More realistic forecasts of spending growth, e.g., in line with population. (Actual spending growth since 2001 has far exceeded even that.)

• More likely, deficits will not fall at all.
Baseline Deficit Projections: January 2006
Fiscal Years 2006-2016

- CBO Baseline
  -$8 Trillion Deficit

- Plausible Baseline with expiration of 2001 and 2003 tax cuts
  -$3.1 Trillion Deficit

- Plausible Baseline
  -$5.3 Trillion Deficit

Fiscal Year


Billions of Dollars

$-1000  $-800  $-600  $-400  $-200  $0  $200

CBO January 2006 Baseline
Concord Plausible Baseline with assumed scheduled expiration of 2001 and 2003 tax cuts.
Concord Plausible Baseline assumes that discretionary spending grows at the rate of nominal GDP minus the 2005 supplemental appropriations, that continued operations in Iraq and Afghanistan are gradually scaled back to about a third the current level, and that all expiring tax provisions are extended with AMT relief.

Source: Congressional Budget Office, January 2006 and Concord Coalition analysis
Just as the budget forecasts were predictably overoptimistic during the first Bush term.

– Unrealistic surplus of $5 trillion+ was forecasted in Jan. 2001 over 10 years.
– Official forecasts were repeatedly proven wrong.
– Reality has since become a 10-year deficit of $5 trillion+.
White House Budget Balance forecasts had to be revised down every year.
Further, the much more serious deterioration will start after 2009.

- The 10-year window is no longer reported in White House projections
- Cost of tax cuts truly explode in 2010 (if made permanent), as does the cost of fixing the AMT
- Baby boom generation starts to retire 2008
  - => soaring costs of social security and,
  - Especially, Medicare
Then what has kept long-term interest rates so low?

- Easy monetary policy by FRB, ECB, BoJ & PBoC have kept short-term rates low since 2001 (Fig.5)
  - Carry trade => money has gone into bonds, stocks, real estate, emerging markets, & commodities.
  - Why no reversal since 2004? Maybe some bubbles.
- Foreign central banks are buying US securities
- Investors have not yet fully absorbed how bad is the US fiscal outlook is (and even worse in Europe & Japan).
- All three factors should come to an end soon.
- Prediction: long-term interest rates will rise.
The conundrum: after tightening began in 2004, long-term rates rose much less than short rates; even now the yield curve is still unusually flat.

Source: 8:40AM quotes and FRBNY Calculations

*Estimated using off-the-run Treasury securities
Fig. 5: Monetary policy since 2001 has been easy everywhere

*World and US real interest rates, 1990-2005*

Source: Caballero, Farhi and Gourinchas (2006)
Many economists have come up with ingenious counter-arguments to the concerns over the US Twin Deficits.

- But I don’t buy them.
- I.e., the low national saving that faces us now and in the future should indeed be a source of concern
7 alternative views that challenge the “twin deficits” worry

1. The siblings are not twins
2. Alleged Investment boom
3. Low US private savings
4. Global savings glut
5. It’s a big world
6. Valuation effects will pay for it
7. China’s development strategy entails accumulating unlimited $
1. “The ‘twin deficits’ view is wrong, because the budget and current account deficits do not always move in lockstep” \[^1\]

- This is a “straw man.”
- The term “twin deficits” does not mean current account & budget deficits \textit{always} move together.
  - Nobody pretends that they do.
  - Of course BD & CAD can move in opposite directions, as in US investment boom of 1990s.
- \textit{But in 1980s & the current decade, U.S. fiscal expansion led to BD and CAD.}

\[^1\] Bernanke (2005) is one of many making this point.
2. Capital flows to US due to favorable investment climate & high return to capital.

• But
  – Foreign Direct Investment is flowing out of the United States not in.
  – The money coming in is largely purchases of short-term portfolio assets, esp. acquisition of $ forex reserves.
3. “Fall in **US private saving** has been as big a part of the fall in national saving as has been the budget deficit.”

- True
- But recall that Bush tax cuts were supposedly designed to be pro-saving (abolition of the estate tax, near-abolition of taxes on dividends & capital gains, etc.).
- That was the excuse for their regressivity.
- As the private saving rate has not subsequently risen, this is a further indictment of our current fiscal policy.
- The same characterization applies to the Reagan tax cuts of 1981: were supposed to boost saving but were instead followed by a fall in US private saving rates.

• True, foreign net lending to US is determined by conditions among foreign lenders as much as in US.

• “Savings glut” misleading: Global saving & investment not up.
  – Rather, global investment is way down.
  – Japan’s household saving rate = 7% of disp.income, vs. 23% in 1975. [2]

• This pattern is inconsistent with the hypothesis that the exogenous change is an increase in saving abroad: that would have shown up as a rise in investment.

• The pattern is consistent, rather, with the hypothesis that the US shortfall is sucking in capital from rest of world.

True, Current Account surpluses in partner countries are half the story.

Source: Caballero, Farhi and Gourinchas (2006)
5. “It’s a big world.”

- Richard Cooper, Alan Greenspan, & others:
  - world financial markets are big, relative even to the $3 trillion of US debt, & increasingly integrated.
  - => Foreign investors can bail us out for decades to come.
  - After all, some have been warning about a hard landing since the early 1980s.
  - If foreign investors keep moving, even slowly, toward fully diversified international portfolios (away from “home country bias” in their investments), they can absorb US current account deficits for a very long time.
- True. **But**
  - it is unlikely that portfolios of investors will fully converge.
  - When it comes to default or country risk, GDP or exports are more relevant denominators for debt than is global portfolio size.
    - Exports are the relevant denominator for crises -- Cavallo & Frankel (2005).
- Debt dynamics => US Debt/Export ratio on explosive path.
6. “US current account deficit need not imply rising debt & debt-service; despite years of deficits, net investment income is still in surplus”

- Lane & Milesi-Ferretti (2005) compute valuation effects. Gains in $ value of assets held abroad, particularly via $ depreciation => US net debt has risen “only” to $3 trillion, despite much larger increase in liabilities to foreigners.

- US earns a higher rate of return on its assets abroad (especially FDI) than it pays on its obligations (especially treasury bills).
  - In 1960s, Kindleberger said US was World Banker, taking short-term deposits & investing long-term.

- Hausmann & Sturzenegger (2006) speak of “dark matter,” by which they mean US hidden assets of know-how that are not properly reflected in service export numbers.

- Cline (2005) calls the US an economic net creditor, though a net international debtor in an accounting sense.
Composition: US assets give more weight to high-return equity & FDI than do US liabilities

Composition of U.S. Gross External Liabilities
1952:1-2004:1

Composition of U.S. Gross External Assets
1952:1-2004:1

Source: Gourinchas and Rey (forthcoming, 2006)
These arguments rely on $ retaining its unique role in world monetary system forever

• The French in the 1960s called it the “exorbitant privilege”: the rest of the world gives up real goods and companies in exchange for pieces of paper ($).

• Arguments rely on the assumption that the $ will continue as premier international reserve currency held by central banks, and that the US treasury security market will continue to be the preferred liquid asset for private investors as well.

• Has been true since World War II, but one can no longer assume that it will necessarily always be true: € now exists as a plausible rival for the longer term.
Chinn & Frankel (2006)
Simulation of shares in central bank reserve holdings
Case 2, Scenario D:
Assumes no entry of UK, Sweden, or Denmark into €;
& continued depreciation of $ at 2001-04 rate.
7. “China’s development strategy entails accumulating unlimited dollars.”

• The Deutschebank view
  (Dooley, Folkerts-Landau, and Garber, 2005)
• Today’s system is a new Bretton Woods, with Asia playing role that Europe played in 1960s.
• I think that much is right.
• DFL ideas ingenious: China is piling up $ not because of myopic mercantilism, but as part of an export-led development strategy that is rational given China’s need to import workable systems of finance & corporate governance.
But it is not sustainable.

• It may be a Bretton Woods system, but we are closer to 1971 (date of collapse)
  – than to 1944 (date of BW agreement)
  – or 1958 (when convertibility first restored).

• (1) Capital mobility is much higher now than in 1960s.
• (2) The US can no longer necessarily rely on support of foreign central banks, either economically or politically.
• (3) China eventually will have to develop a workable domestic system of finance and corporate governance, or else suffer a domestic banking crisis.
  – The latter is perhaps the more likely outcome;
  – but either => an end to excess liquidity pouring from China to US
Addendum 1: After 1970, US job creation far exceeded European, until recently.

**Figure 1:** Employment and Real Wages in the U.S. and in the European Community 1970-1993 (Index Numbers 1970 = 100)

1. Total compensation per employee deflated by the GDP deflator.
   Source: OECD Economic Outlook database.
Addendum 2: Possible loss of US economic hegemony.

- US $ can no longer necessarily rely on the support of foreign authorities.
- China may allow appreciation of RMB, as US politicians demand.
- Even if China keeps RMB undervalued, it can diversify its currency basket out of $
  - There now exists a credible rival for international reserve currency, the €.
  - Chinn & Frankel (2005): under certain scenarios, the € could pass the $ as leading international currency.
  - US would lose, not just seignorage, but the exorbitant privilege of playing “banker to the world”
Possible loss of US political hegemony.

• In the 1960s, foreign authorities supported $ in part on geopolitical grounds.
• Germany & Japan offset expenses of stationing U.S. troops on bases there, so as to save the US from balance of payments deficit.
• In 1991, Saudi Arabia, Kuwait, & others paid for the financial cost of the war against Iraq.
• Repeatedly the Bank of Japan bought $ to prevent it from depreciating (e.g., late 80s)
• Next time will foreign governments be so willing to bail out the U.S.?
Historical precedent: £ (1914-1956)

• With a lag after US-UK reversal of ec. size & net debt, $ passed £ as #1 international currency.
• “Imperial over-reach:” the British Empire’s widening budget deficits and overly ambitious military adventures in the Muslim world.
• Suez crisis of 1956 is often recalled as occasion when US forced UK to abandon its remaining pretensions to an independent foreign policy;
• Important role played by simultaneous run on £.