Roger W Ferguson, Jr: Global imbalances

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, at the European Institute Roundtable on Financial and Monetary Affairs, Washington, DC, 23 April 2004.

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I am pleased to participate in a discussion with such distinguished colleagues and to share my thoughts about some key issues confronting economic policy makers. As you are all well aware, the global economy is becoming ever more tightly knit, with national economies increasingly drawn together through trade and financial market transactions - all facilitated by continuing advances in telecommunications and related technologies. The economic slowdown that the U.S. economy entered in 2001 was shared by Europe, East Asia, and Latin America. Similarly, the revival in growth that our economy has enjoyed since the middle of last year has also shown up, to greater and lesser degrees, in other parts of the world.

Although growth rates in different regions of the global economy are somewhat synchronous, such shared movements in output do not ensure that external deficits or surpluses will remain small. With the United States now running a current account deficit equal to about 5 percent of the gross domestic product, the rest of the world must run a correspondingly large net current account surplus. And when the U.S. deficit starts to decline, then trade flows abroad will adjust as well, reducing their overall surplus.

Because of its size and persistence, as well as recent declines in the value of the dollar, the U.S. current account balance is receiving an extraordinary amount of attention at present. Observers routinely ask the following questions: Is the deficit unusually, or even abnormally, large? How long can it be sustained? How might a correction of the deficit affect the United States and its trading partners, including Europe? One must always be mindful of the possibility that the inevitable adjustment process related to global imbalances may be disorderly, but the tone of these questions is often more pessimistic than I think is warranted. Nevertheless, these questions are important, and I will devote the remainder of my remarks to addressing them.

Is the U.S. current account deficit “abnormal”?

The economics profession has no consensus model to tell us, for a given economy, what the appropriate level of the current account balance is. At best, economists can agree on some general principles. I will emphasize only two. First, current account imbalances allow countries to smooth consumption over time, for example, in response to the ups and downs of the world price of a major export. Second, current account imbalances - which represent the difference between domestic savings and domestic investment - allow savings to be allocated to those parts of the world where they can be invested most productively.

On the basis of these considerations, some analysts have argued that industrial countries should run current account surpluses and invest their abundant savings in developing countries, which, being labor-rich and capital-poor, would offer higher rates of return. However, examples of high or persistent current account deficits abound among industrialized economies, including Canada (averaging 2.5 percent of GDP from 1975 through 1998), the United Kingdom (1.9 percent of GDP from 1984 through 2003), and Australia (4.1 percent of GDP from 1974 through 2003). Global investors have confidence that in countries such as these as well as in the United States they can safely seek the highest possible return for their funds.

Some of the factors that lie behind such confidence are political stability, a legal system that effectively protects property rights and enforces commercial contracts, economic policies that promote and strengthen the role of markets, a financial system that efficiently channels resources to their most productive uses, and an educational system that produces highly skilled workers and supports rapid technological development. These elements are present in many mature economies, including those of the United States and Europe.

Rates of return on investments in the United States have also been driven by the rapid diffusion of technological innovation. Labor productivity in the United States accelerated to a rate of about

3 percent in the period 1996-2003. Over the same period, smoothing through the recent cycle, the value of U.S. equities rose about 80 percent compared with 60 percent for European equities and a decline of 30 percent for Japanese. These developments attest to the expansion of favorable investment opportunities in the United States. Thus, it is neither surprising nor abnormal that, beginning in the mid-1990s, capital flows to the United States - primarily in the form of direct investment and equity inflows - began to pick up substantially, including, importantly, investment flows from Europe. These capital inflows exerted upward pressure on the dollar and provided the financing for our widening current account deficit.

How long can the current account deficit be sustained?

To say that a current account deficit is unsurprising or explainable is not to say that it is sustainable in the long run. With the net external debt of the United States rising more rapidly than GDP, some narrowing of the deficit is inevitable. However, such shrinkage does not mean that the current account deficit will be eliminated. Moreover, to say that the current account deficit cannot stay large on a permanent basis is not to say just when or how adjustment will occur.

One can envision several developments that could trigger adjustment, many of which would be very positive for the global economy. A pickup in perceived rates of return abroad could divert capital flows from the United States to other countries and prompt adjustments in external balances. In Europe, for example, a considerable expansion in the use of information technologies in recent years has not, to date, appreciably boosted growth rates of labor productivity. It is conceivable that such high-tech investments may finally lead to higher productivity growth, further boosting investment spending, and weakening trade performance, as occurred in the United States in the 1990s. In Japan, corporate and financial sector restructuring appears to be making gains. In Latin America, improved policies and more flexible exchange rates may set the stage for renewed capital inflows. And in Asia, a revival of domestic demand could give the authorities confidence that, if they allow capital inflows to strengthen their currencies and narrow their current account surpluses, high rates of economic growth will be maintained.

Even if rival sources of demand for global capital do not emerge, another factor that would induce adjustment of the current account, if it were to occur, would be a diminishing appetite for additional U.S. assets and, therefore, a reduced willingness to finance the deficit. One cannot know whether or at what point such concerns might become pressing. However, by several measures, the imprint of U.S. financing needs on global capital markets has not been so large as to be problematic. At roughly 25 percent of GDP, the net external debt of the United States is still below that of several other industrial economies, including the Netherlands (30 percent), Finland (40 percent), and Australia (60 percent). Moreover, even though the United States has been a net debtor since 1986, the net income on the international investment position has remained positive, as the rate of return on U.S. investments abroad continues to exceed that on foreign investments in the United States. From the standpoint of investor portfolios, notwithstanding years of large current account deficits, the share of U.S. equities in global equities actually fell from 49 percent in 1997 to 47 percent in 2002; the U.S. share in the global bond market moved up only marginally during the same period, from 42 percent to 44 percent.

Finally, current account adjustment may be prompted by increases in U.S. saving. Concerns about the expanding budget deficit may prompt some reining in of fiscal policy, leading to a reduction of public sector dissaving. In the private sector, personal saving rates remain extremely low by historical standards and thus may revert to earlier norms at some point. Either of these developments would boost total domestic savings and, all else being equal, cut into the current account deficit.

Although we cannot know the time frame over which capital flows may begin to shift or U.S. demand for imports to lessen, so far there appears to have been no loss of appetite for dollar-denominated assets. The dollar has declined since early 2002, but net private capital inflows have remained strong. In the first two months of this year, net private foreign purchases of U.S. securities, which are admittedly volatile, averaged about $60 billion, well above the $33 billion monthly pace reached in 2001 and 2002, when the dollar was much higher. Moreover, while I am not privy to their plans, I note that foreign authorities, who are increasingly large holders of dollars, currently show few signs of substantially adjusting the composition of their balance sheets.

How might a current account adjustment affect the U.S. and global economies?

If a substantial current account adjustment is required, how might it take place, and what might be its effects? As to the first of these questions, three mechanisms might induce a narrowing of the current account deficit.

First, a fall of U.S. prices below foreign prices could raise our competitiveness. Prices have become relatively stable, by historical standards, in the United States and its trading partners, however, and, it is not clear how much of a dent this could put in the trade deficit. A second possibility is that an increase of foreign growth above U.S. growth could boost our exports. Between 1970 and 1995, foreign GDP growth, weighted by U.S. trade, exceeded U.S. growth by nearly 2/3 percentage point annually; since then, U.S. growth has exceeded foreign growth by 1/4 percentage point. Thus, there is some potential for foreign growth to rise relative to U.S. growth. Finally, price adjustments through exchange rate adjustment, by encouraging exports and making imports more costly, could play a role in current account adjustment.

I must emphasize that, no matter how the U.S. external imbalance is narrowed, the level and composition of demand, both in the United States and abroad, would have to change. Such a change, in turn, would require adjustments of relative prices. In the United States, to accommodate increases in exports relative to imports, changes in relative prices would be needed to shift production toward internationally traded goods and services and to shift consumption toward nontraded goods and services. By the same token, adjustment by our trading partners to a reduction in the U.S. current account deficit would require both an increased domestic demand to maintain the overall level of economic activity and an adjustment of relative prices to raise the share of nontraded goods in production and of traded goods in consumption.

The prospect of a correction in the current account is often portrayed in ominous tones, a dark storm cloud looming on the economic horizon. Yet, the economic adjustments I have just described are both feasible and, properly managed, need not lead to undue distress, either in the United States or abroad. After the dollar correction of the mid-1980s, for example, economic activity in the United States continued to expand as the growth of domestic demand eased but was replaced by strong contributions from net exports. During that period, analogous adjustments helped to maintain economic performance among our trading partners. The pace of GDP growth in the foreign G7 economies, weighted by U.S. exports, increased from about 2-1/2 percent during 1982-84 to nearly 4 percent in 1985-87 as greater domestic demand growth compensated for weaker performance in net exports.

U.S. current account adjustment could, in fact, be associated with quite favorable scenarios for the global economy. For example, the rise in foreign productivity growth that I touched on earlier could work through several channels to narrow the U.S. trade deficit as funds were attracted abroad. Strong domestic demand among our trading partners would likely outweigh any drag resulting from appreciation of their currencies, while U.S. exports would benefit from both a change in relative prices and stronger foreign growth.

Of course, the financial press frequently points to less-favorable scenarios, including the so-called disorderly correction, that is, a rapid fall in the dollar that engenders a steep falloff in U.S. bond and equity prices and that perhaps disrupts other national markets as well. I have seen little evidence to suggest that this scenario is likely, notwithstanding its popularity. The fall in the dollar since early 2002 has not disrupted financial markets, nor did the dollar's previous correction in the 1980s. Moreover, most U.S. external debt is in dollars, so currency depreciation is unlikely to lead to the balance-sheet problems that arise during financial crises in developing countries, although obviously some parties that have not taken precautions would take losses.

That said, central bankers are paid to be prudent and watchful, and we will obviously continue to monitor closely international financial markets and their effects on the U.S. economy. Looking ahead, I see no obvious indications that the external sector poses significant concerns for growth or stability. Not only has the decline in the dollar to date failed to disrupt U.S. financial markets, but most would judge that, on balance, it has had only modest effects on inflation. Consumer spending is continuing to rise strongly and, although activity in housing markets has eased a bit, on balance, from the brisk pace of late last year, both sales and construction remain at high levels. In the business sector, spending on equipment and software appears to be increasing quite strongly, although outlays for nonresidential structures have remained weak. As has been the case over the past half-year, because of sizable increases in productivity, businesses seem to be able to boost production without adding much to their payrolls. Going forward, policy makers will have to determine whether the improvements signaled in

some recent labor market measures indicate that the economy is on a sustainable path to closing the pool of underutilized resources. Although it has depressed job creation in the short run, increasing productivity is positive for the economy's long-run outlook and the creation of wealth. Due, in part, to these same increases in productivity, inflationary pressures have generally been muted. Now the process of disinflation appears to have ceased, and inflation has apparently stabilized. However, we cannot be complacent regarding inflation and inflation expectations. Should the Federal Reserve conclude that the maintenance of price stability is in jeopardy, I am confident that it will act appropriately.

Conclusion

To conclude, a change in the tone of international financial markets that required a substantial adjustment of the U.S. current account would obviously have important implications for spending and economic activity, both here and abroad. However, such adjustment, properly handled, need not derail the global economy nor cloud the bright prospects that the United States and Europe - linked by myriad ties of commerce, communications, culture, and political tradition - share.