FINANCE & ECONOMICS

The American economy

Wise men at ease

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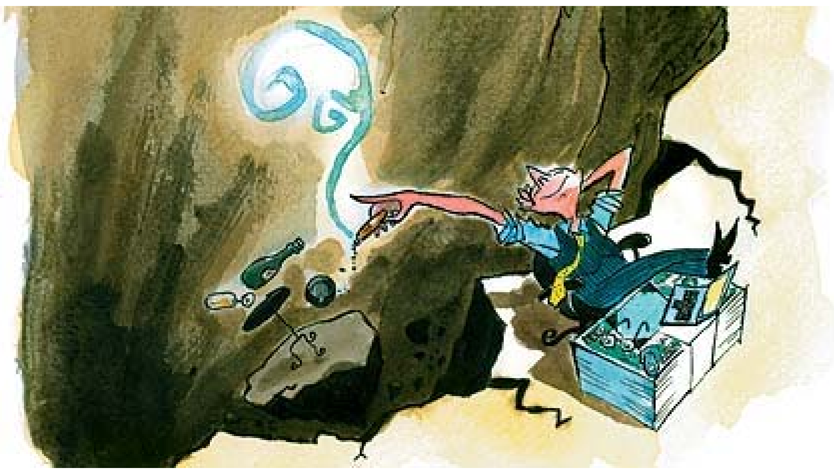


America's central bankers are relaxed about the current-account deficit. Does that mean it is time to panic?

IT LOOKS like anything but coincidence. Lately almost all the governors of America's Federal Reserve have made speeches on the country's current-account deficit, now 6.3% of GDP and rising. Several have sounded remarkably relaxed. Yes, they say, the gap's big, but it's not America's fault; most likely, it will be closed without too much trouble. One, Roger Ferguson, caught the mood well: “My sense is that the implications of current-account adjustments for US economic growth and inflation will most likely be benign.”

Not everyone is so cool. Stephen Roach, chief economist at Morgan Stanley and a veteran gloomster about America's imbalances, is fuming. He accuses the Fed governors of “attempting to rewrite conventional macroeconomics” with “revisionist theories” that shift attention from what he thinks is the real problem: America's “absurdly low real interest rates.”

Even some normally supportive analysts are worried. Ted Truman, of the Institute for International Economics, who spent more than 20 years as director of the international finance division of the Fed, wrote recently that too many Fed officials are seen as “cheerleaders” for a smooth adjustment, rather than giving warning that the process might be unpleasant. “Overconfidence”, he argued, “can undermine the credibility of monetary policy.”

Contrary to appearances, the Fed governors do not co-ordinate their speeches. And the tone varies a lot. Some, such as Edward Gramlich or Timothy Geithner, president of the Federal Reserve Bank of New York, are worriers. Mr Gramlich frets about the budget deficit and America's low saving rate. Even if the current situation is stable, he argues, “it is much more stable for the US to increase its own national saving.” Mr Geithner worries aloud about the financial system's ability to withstand sudden macroeconomic shocks.

Alan Greenspan, the Fed's chairman, takes up (as ever) a carefully nuanced position. He states plainly that the current-account gap cannot widen forever, but emphasises that these days global capital markets are so big, closely integrated and flexible that countries can run larger imbalances, and that these can be unwound without causing economic trouble.

The most sanguine views belong to Mr Ferguson, the Fed's vice-chairman, to Don Kohn and to Ben Bernanke, who was recently nominated as head of George Bush's Council of Economic Advisers. All three make two points: first, that it is wrong to say that the current-account gap was made in America or that American policy changes, such as tightening the budget, would do much to fix it by themselves; second, that there is little reason to believe that America is heading for a hard landing.

The central bankers are right to point out the global nature of America's imbalances. Foreigners have been keener to finance America's external borrowing at extraordinarily low interest rates than to invest at home. Thus America's big budget deficits and Americans' willingness to spend more than they earn have supported the global economy.

But the central bankers go further. Drawing on the Fed's internal macroeconomic model, Mr Ferguson argues that there is little quantitative evidence that fiscal deficits or a reduction in private saving caused the deficit. He and other governors cite a recent paper by Fed economists, which concludes that fiscal expansion has only a minor effect on the trade deficit. Loosening policy by 1% of GDP, says this study, worsens the current account by less than 0.2% of GDP. By implication, a reduction in the federal budget deficit would have a similarly small impact.

Few economists would dispute that budget deficits and current-account deficits are analytically distinct: in the late 1990s, the two moved in opposite directions, as the current-account gap widened while the budget deficit shrank. Nevertheless, the governors' efforts to play down fiscal policy may have gone too far. Whether or not budget deficits “caused” the external imbalance, tighter policy will undeniably make the current-account gap easier to close. A shrinking fiscal deficit makes it less likely that a falling dollar will result in higher interest rates. And all the governors imply that a weaker dollar is the key to cutting the current-account deficit.

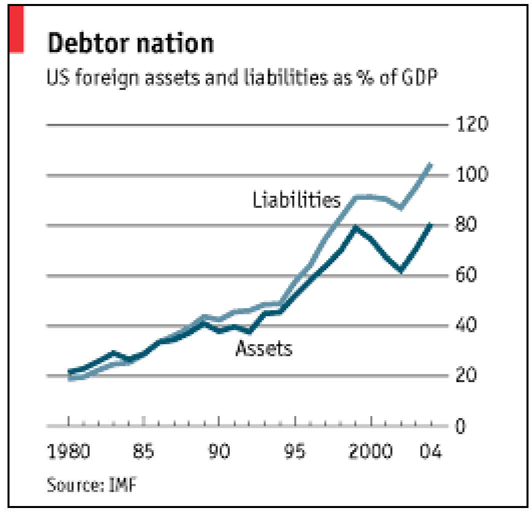
A cheaper dollar helps to reduce America's imbalances by shifting economic production towards exports. Because the economy is already near full employment, this shift can occur only if domestic demand is reduced, for instance by tightening the budget. Otherwise, a cheaper dollar would cause the economy to overheat and interest rates to rise: that would either stall the economy or limit the decline in the dollar and the rebalancing of the current account. Fiscal discipline is thus an important part of the external adjustment even if it will not solve the imbalance alone.

Others point out that a large budget deficit may itself raise the risks involved in big external imbalances. Mr Truman, for instance, fears that when both deficits are large and expanding at the same time, confidence in American economic policy may be eroded and the risk of crises may rise.

The sunny side of the deficit

The optimists consider such crises unlikely. One argument is that industrial countries tend not to suffer hard landings caused by plummeting currencies and soaring interest rates. This is supported by another recent study by Fed staff economists, covering 23 current-account adjustments in rich countries—none, admittedly, with imbalances as big in absolute terms as America's. And another new strand of academic thinking suggests that big, rich-country debtors may actually have an advantage in current-account adjustments. This focuses on the impact of unexpected currency shifts on the valuation of a country's external assets and liabilities.

Thanks to the globalisation of capital flows, America's foreign assets and liabilities have both soared (see chart). With all of its liabilities in dollars and most of its assets in foreign currencies, America gets a wealth boost when the dollar drops. Gian Maria Milesi-Ferretti, an economist at the International Monetary Fund, calculates that between 2002 and 2004 more than 75% of the increase in America's net foreign indebtedness caused by the current-account deficit was offset by changes in the value of external assets and liabilities as a result of the dollar's fall. Thus a big external deficit does not necessarily imply a commensurate rise in net indebtedness to foreigners.



Even so, although the size of gross portfolio flows allows America to run bigger imbalances and although valuation effects may make adjustment easier, these factors do not render adjustment unnecessary; nor do they eliminate the risk of a hard landing. More important, even a gradual reduction in the current-account deficit, which the sanguine governors all expect, could feel unpleasant. That is because America's domestic demand growth will have to grow more slowly than its GDP.

A recent analysis by Macroeconomic Advisers, a consulting firm, suggests that halving America's deficit over a decade, with GDP growth at its recent average, will require that annual domestic demand growth slow to 2.6%, more than a full percentage point below its average in 1994-2004. For America's consumers, that will be an unpleasant shock. Prudent central bankers should be preparing them for it.

"The United States and the World Economy" Edwin Truman. Paper delivered at Levy Economics Institute of Bard College, April 21-22, 2005

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"Financial Market Developments and Economic Activity during Current Account Adjustments in Industrial Economies" Hilary Croke, Steven B. Kamin and Sylvain Leduc. Federal Reserve International Finance Discussion paper No 827, February 2005

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