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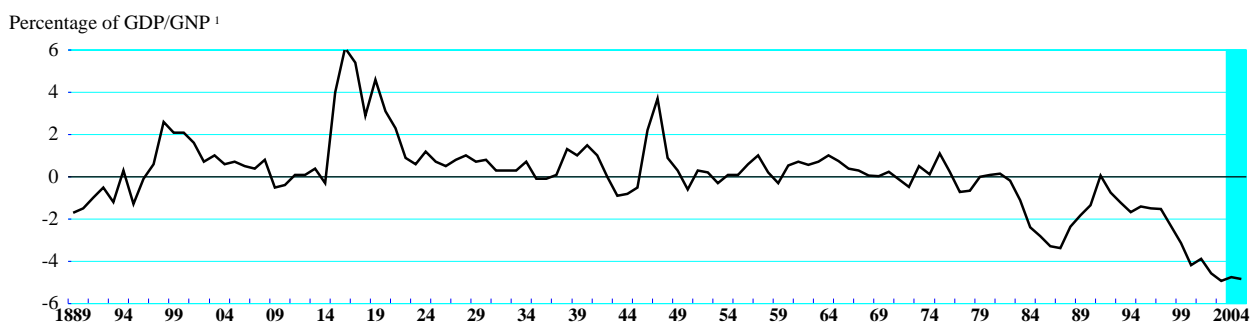
V. THE CHALLENGES OF NARROWING THE US CURRENT ACCOUNT DEFICIT

Introduction

The pattern of current account imbalances may not be sustainable...

The US current account deficit has recently reached its highest level ever recorded (Figure V.1) and OECD projections suggest that it will remain high over the next few years. The counterparts to this deficit are spread across several countries and regions (Figure V.2), with significant surpluses (as a percentage of GDP) in a number of Asian countries and in some European countries.

Figure V.1. The US current account in historical perspective



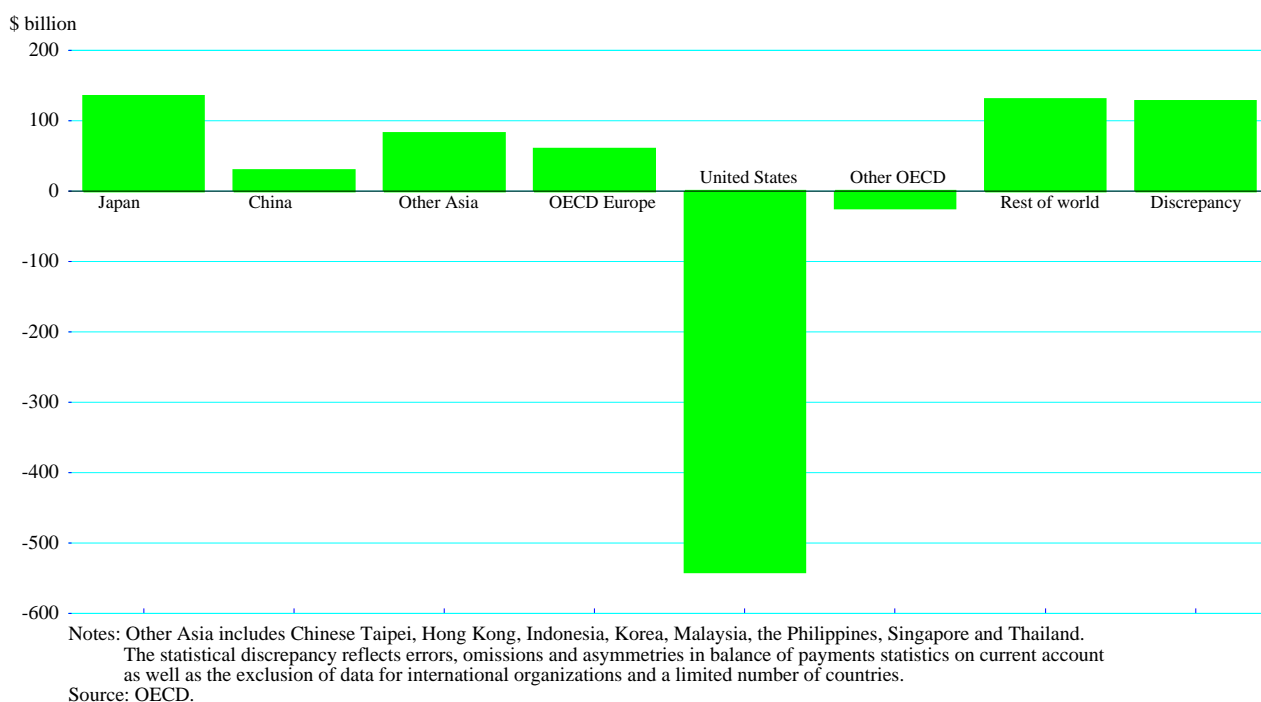
1. GNP before 1929.

Source: OECD, US Bureau of Economic Analysis; and for the pre-1946 period Bureau of the Census: Historical Statistics of the United States, Washington DC, 1975.

... and eventual adjustment will have world-wide repercussions

If, or when, a narrowing in these global current account imbalances occurs, it will have implications not only within the United States, but also for other countries, with specific effects depending on how adjustment is achieved. Three mechanisms for bringing about such adjustment are considered below: changes in exchange rates, national saving rates, and non-price export competitiveness. Based partly on simulations conducted using the OECD's INTERLINK model, this chapter discusses the likely implications of narrowing the US current account deficit through each of these forces.

Figure V.2. Global current account balances in 2003



Some key conclusions from this analysis are as follows:

Even a modest narrowing would require large changes...

... to exchange rates...

... fiscal policy...

... or competitiveness

It would also tend to damp growth outside the United States...

- When any one channel for narrowing the US deficit is considered alone, it seems that a relatively large change in the relevant economic variable would be required to achieve a modest reduction of the deficit. For example, model simulations suggest that in order to produce an improvement in the trade balance of 2 percentage points of GDP over a six-year horizon, shocks of around the following magnitudes would be required:
 - a 20-25 per cent nominal effective depreciation in the dollar, or
 - a swing in the US fiscal position of some 6 per cent of GDP, or
 - an improvement in the non-price competitiveness of US producers, corresponding to an approximate 2 percentage point increase in the US share of world imports.
- A narrowing of the deficit also poses significant risks to growth in US trading partners -- not least in Japan, given the limits that the authorities face with respect to using monetary or fiscal policy to offset any contractionary pressures.

... although the extent would depend on Asian exchange rate flexibility

- The impact of dollar depreciation on US trading-partner economies depends importantly on the flexibility of exchange rates in the Asian region. If the renminbi and other currencies remain tied (either formally or informally) to the dollar as it falls, then the costs to Japan and other OECD economies will be greater than if the dollar is permitted to fall against all other currencies.

Too much domestic contraction could be risky

- If adjustment were to occur through tightening US fiscal conditions, the appropriate monetary policy response, *ceteris paribus*, would be to lower short-term interest rates. However, current starting points suggest a greater-than-normal risk of short-term interest rates being pushed close to the zero nominal interest rate bound. Such a risk would, however, be mitigated if the fiscal consolidation were to occur in conjunction with dollar depreciation, provided the latter had an inflationary effect.

Improved export competitiveness would be preferable

- An autonomous gain in US non-price export competitiveness *via* structural change on the supply side of the economy would represent a benign outcome for the United States, and the least costly for other OECD countries.
- More generally, it seems difficult to imagine a scenario that would significantly narrow the US current account deficit without imposing some costs on the rest of the world.

There is no simple metric of sustainability...

Of course, it is also natural to ask whether such changes are necessary. Is it not possible for the present level of the US current account deficit to persist at current levels? And if not, then by how much would it need to shrink? In this chapter, the implications of a 2 per cent of GDP narrowing of the trade deficit are discussed. Whether this would be necessary or sufficient is more difficult to discern as there is no simple metric of sustainability.¹

... which would depend on the attractiveness of non-US assets...

Essentially, the question of sustainability can be analysed from two perspectives. First, from the perspective of global investors, a deficit of this magnitude for a large economy like the United States absorbs a significant proportion of total world savings and implies an increasing share of US assets in foreign investors' portfolios. While the United States remains an attractive investment destination in many respects, it is uncertain for how long foreigners will continue to accumulate debt and equity claims against US residents at the recent pace. Clearly, the answer will depend on a variety of factors including the share of dollar assets in total portfolios that potential investors consider appropriate. This will in part depend on the relative attractiveness of other investment destinations. Thus, it is possible that further structural reform in US trading partners may result in a larger range of attractive investment opportunities. Several Asian central banks have been

1 . For example, see Greenspan (2003, 2004), as well as Mann (1999, 2002) who provides further discussion of the concept of sustainability.

another important source of demand for US dollar assets, as reflected in the run-up of official reserves, and there are also questions about how long this trend will continue.

... and the riskiness of the US economy

Second, from the perspective of the United States as the borrower, the current account deficits add to the stock of outstanding debt and increase future funding requirements. In turn, this increases the perceived riskiness of the United States as an investment destination. However, it is not clear at what point the run-up in debt would be judged to be unsustainable. At present, US net foreign liabilities are equal to around 25 per cent of GDP, which is relatively low by comparison with many other OECD countries. If the current account deficit were to remain at 5 per cent of GDP each year, with nominal GDP growing at an annual rate of 5 per cent in the baseline, net foreign liabilities would steadily rise, eventually stabilising at around 100 per cent of GDP in the long run. If instead the current account deficit were to narrow from 5 per cent to 3 per cent of GDP, net foreign liabilities would stabilise at around 60 per cent of GDP. Of course, the results of such calculations are very dependent on the assumption for GDP growth, and still do not answer the question of what level of current account deficit, or net international investment position, would be sustainable.

The adjustment may be postponed but that would also carry risks

At present, there is little evidence of stress in funding the US current account deficit; interest rates in the United States remain relatively low, demand for new US debt securities is quite strong and exchange rate changes have been orderly to date. Yet, ongoing signs of trade protectionism -- in the United States and elsewhere -- suggest that there may be unforeseen costs of continued significant imbalances and corresponding benefits of adjustment.² However, in the absence of significant changes in key economic determinants of the current account, such as those assumed in the simulations discussed in this chapter, the adjustment process may be drawn out, and could be driven by a gradual decoupling of domestic incomes and demand from production in the wake of a steadily rising share of value added accruing to foreign investors.

Background to the simulations

The simulations assess a range of adjustment channels...

In the past, large current account deficits have been typically unwound through a combination of real exchange rate depreciation and fiscal consolidation. Thus, these channels were chosen as two of the three forces for current account adjustment that are considered in the simulations. The third channel, an autonomous improvement in the non-price competitiveness of US exports, is intended to capture the role of supply-side determinants of US export market share. Although the specific policies that might influence non-

2. Any new protectionist initiatives are particularly dangerous in the context of wide current account imbalances, at which time the flexibility of the global economy becomes even more important (Greenspan, 2003, 2004).

price competitiveness are less clear-cut than for the first two channels, it provides a useful framework for considering some of the additional determinants of US trade performance that are not captured in the first two channels and thereby also for assessing the possibility that adjustment may occur without recourse to the first two channels.

... each designed to improve the US trade balance by 2 per cent of GDP

In the case of each channel, simulations were overlaid on the OECD's December 2003 medium-term baseline³ to achieve an improvement in the US trade balance of around 2 per cent of GDP after six years. The impact on the current account balance differs between the simulations depending on the path of interest rates and the implications for debt-servicing payments that accrue to non-residents.⁴ The implications of each scenario for key economic variables in the United States, Japan and the euro area are summarized in tables throughout this chapter.⁵ The simulation results are not intended to represent projections but rather to provide a framework for tracing through cross-country linkages.

Channel 1: The role of exchange rate depreciation

Exchange rate changes are an important adjustment mechanism...

Exchange rate changes have long been perceived as perhaps the key mechanism for achieving current account adjustment. In economies with floating exchange rates, the process is typically driven by market participants. As foreign investors become less willing to fund the increasing shortfall between total saving and total investment at existing exchange rates, there is downward pressure on the currency. In the United States, this has happened to some extent since the dollar peaked in February 2002, although pressure has been mitigated by the significant capital flows from Asian central banks, motivated, in part, by a desire to prevent significant exchange rate movements relative to the dollar.

... although experiences differ across countries

Historically, the observed bilateral relationship between countries' exchange rate and their current account balance has differed considerably. In some cases, large exchange rate depreciations have been associated with a significant reversal of current account deficits. For example, after the real effective exchange rate of Canada fell by around 25 per cent over the 1990s, the Canadian current account balance swung from a persistent deficit to a surplus of around 2 per cent. Similarly, as the real effective exchange rate of

3. See Downes *et al.* (2003). Note that this baseline differs from the medium-term baseline published in this edition of the *Economic Outlook*. For many economies the two baselines do not differ markedly. However, for Japan, the more recent baseline incorporates stronger growth, significantly higher inflation, and positive short-term interest rates from 2006 onwards.

4. In the simulations, a simplified rule of thumb was used, that one third of the rise in US government debt servicing accrues to non-residents. On that basis, if a shock (such as exchange-rate depreciation) requires higher domestic interest rates, the US current account deficit will improve by significantly less than the trade balance. However, another effect, not captured here, is the fact that dollar depreciation would raise the dollar-denominated return on US foreign-currency assets. This effect would improve the investment income balance, mitigating the impact of higher debt-servicing costs.

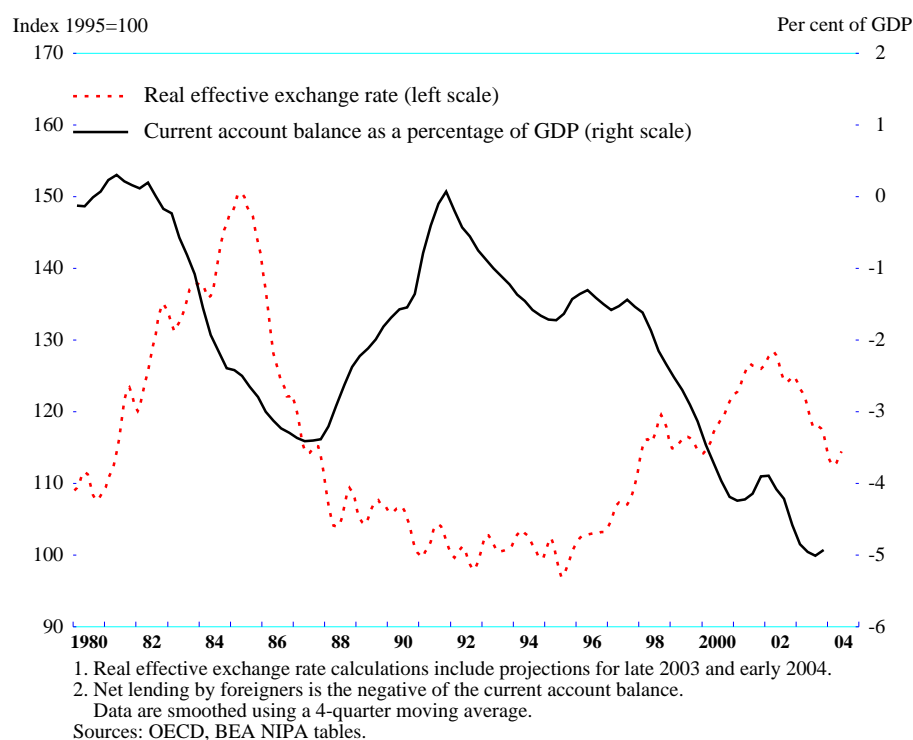
5. The results of the simulations are also discussed in Brook *et al.* (2004).

Sweden fell by over 20 per cent after 1992, the current account balance swung from a deficit of more than 3 per cent of GDP to a surplus of around 4 per cent. Over the same period, however, both countries underwent substantial fiscal consolidation that may also have affected the external balance. In other cases, large exchange rate changes have not been accompanied by much adjustment. For example, in economies where inflation expectations have been poorly anchored, persistent real exchange rate depreciation has proved difficult to achieve, with nominal exchange rate depreciation being offset by higher inflation relative to that in trading partners.⁶

***A dollar depreciation
would tend to improve the
US current account...***

In the United States, the observed historical relationship between the exchange rate of the dollar and the current account balance is negative (Figure V.3). The causal relationships driving this feature of the data are multiple, however. For example, relative buoyancy of US domestic demand may at times have been associated with both a large deficit and substantial capital inflows. But direct links from the exchange rate to the external balance probably also played a role. There are, however, a number of factors,

Figure V.3. Real effective exchange rate and the current account balance in the United States



6. For example, although the Italian lira fell by almost 20 per cent over the 1980s and 1990s, neither the real effective exchange rate nor the current account balance had any real trend.

that limit the extent of current account improvement in response to exchange rate depreciation. First, the link between the two involves a delay. Second there is evidence that pricing to market is significant. Indeed, evidence suggests that exchange-rate pass-through into import prices is relatively low compared with other OECD countries.⁷

... but would be partly offset by reduced demand in US trading partners

Third, since any dollar depreciation will be mirrored by exchange rate appreciation elsewhere, there will be a contractionary impact on the economies of US trading partners creating a negative feedback effect on demand for US exports. In current circumstances, this effect is likely to be particularly strong for economies such as Japan that are limited in the extent to which they can offset the negative demand shock with more stimulatory monetary or fiscal policy.⁸

... and by the effects of higher US interest rates...

Finally, depending on the extent to which a fall in the dollar pushes up inflation, monetary policy will have to respond, and interest rates would rise.⁹ Higher interest payments on foreign-held debt would then suggest that the improvement in the current account deficit would be less than that in the trade balance.

... as illustrated by model simulations

These factors are illustrated by two exchange rate scenarios which evaluate the impact of a 22.5 per cent nominal depreciation in the effective dollar exchange rate -- sufficient in the INTERLINK model to achieve an improvement of 2 per cent of GDP in the US trade balance over six years.¹⁰ In one scenario this depreciation is made up of a 30 per cent decline relative to other OECD exchange rates, and no change relative to exchange rates in the non-Japan Asia region. In the other, the dollar depreciation is spread more evenly: around 22 per cent against all currencies. The implication of each shock for the effective exchange rates of the main OECD regions is summarised in Table V.1. Adding column A to column C or D provides the implied *total* depreciation or appreciation, since the peak in the dollar in February 2002.

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7. This is true for both short- and long-term pass-through elasticities (Campa and Goldberg, 2002).
 8. The Japanese authorities have been using quantitative targets to ease monetary policy beyond the level suggested by zero interest rates, but this channel is not captured in the simulations. Thus, the simulations also do not capture any possible impact on the yen from quantitative easing.
 9. Higher short-term policy interest rates would tend to push up bond yields also, and this could be expected to have a downward impact on US house prices and share prices. However, such asset price effects are not explicitly taken into account in these simulations.
 10. The depreciation is assumed to occur over the first year of the projection horizon. The scenarios should be viewed as primarily illustrative for a number of reasons. First, the depreciation is simply imposed in a clinical fashion, without regard to any specific event, or series of events, which may prompt the depreciation and which would have additional impacts of their own. Second, it is (unrealistically) assumed that the dollar moves equally against all currencies. Another simplification is the assumption of no wealth effects outside of the United States, related to capital losses on bond portfolios (foreign holders of dollar denominated securities being hit by exchange rate valuation changes in addition to lower bond prices).

— Table V.1. Implied effective exchange rates in dollar depreciation scenarios —

	Effective exchange rates (percentage appreciation)			
	from \$ peak (Feb 2002) to 3 Nov 2003	from \$ peak (Feb 2002) to 16 Apr 2004	OECD exchange rates adjust ^a	All exchange rates adjust ^a
Dollar	-10.1	-11.6	-22.5	-22.5
Yen	10.9	12.3	22.0	5.5
Euro	16.3	18.9	11.0	4.0

Note: The cut-off date for exchange rate movements for the baseline was 3 November 2003 (published in the *OECD Economic Outlook*, No. 74, December 2003).

a) Both scenarios involve a 22½ per cent effective dollar depreciation. In the first scenario (inflexible non-OECD Asia exchange rates) this is achieved through a 30 per cent dollar depreciation relative to OECD currencies, and in the second scenario (full exchange-rate flexibility), the 22½ per cent depreciation is spread evenly across all currencies.
Source : OECD.

The simulated fall in the dollar is large but not unprecedented...

While large, the extent of dollar depreciation assumed is not unprecedented. For example, between 1985 and 1988 the effective US exchange rate fell by 32 per cent, with a very gradual further decline after that taking the total depreciation to 36 per cent by 1995, a decline broadly similar to the shock imposed in the simulated dollar depreciation (Figure V.4).¹¹ However, whereas the depreciation in the 1980s pushed the dollar back to previous lows, a drop of this magnitude from the peak of the exchange rate cycle in February 2002 would take it to new record lows, although this could be consistent with the trend deterioration in the current account balance. Other researchers, using very different models, similarly conclude that the exchange rate changes required for a significant improvement in the US current account position could be substantial.¹²

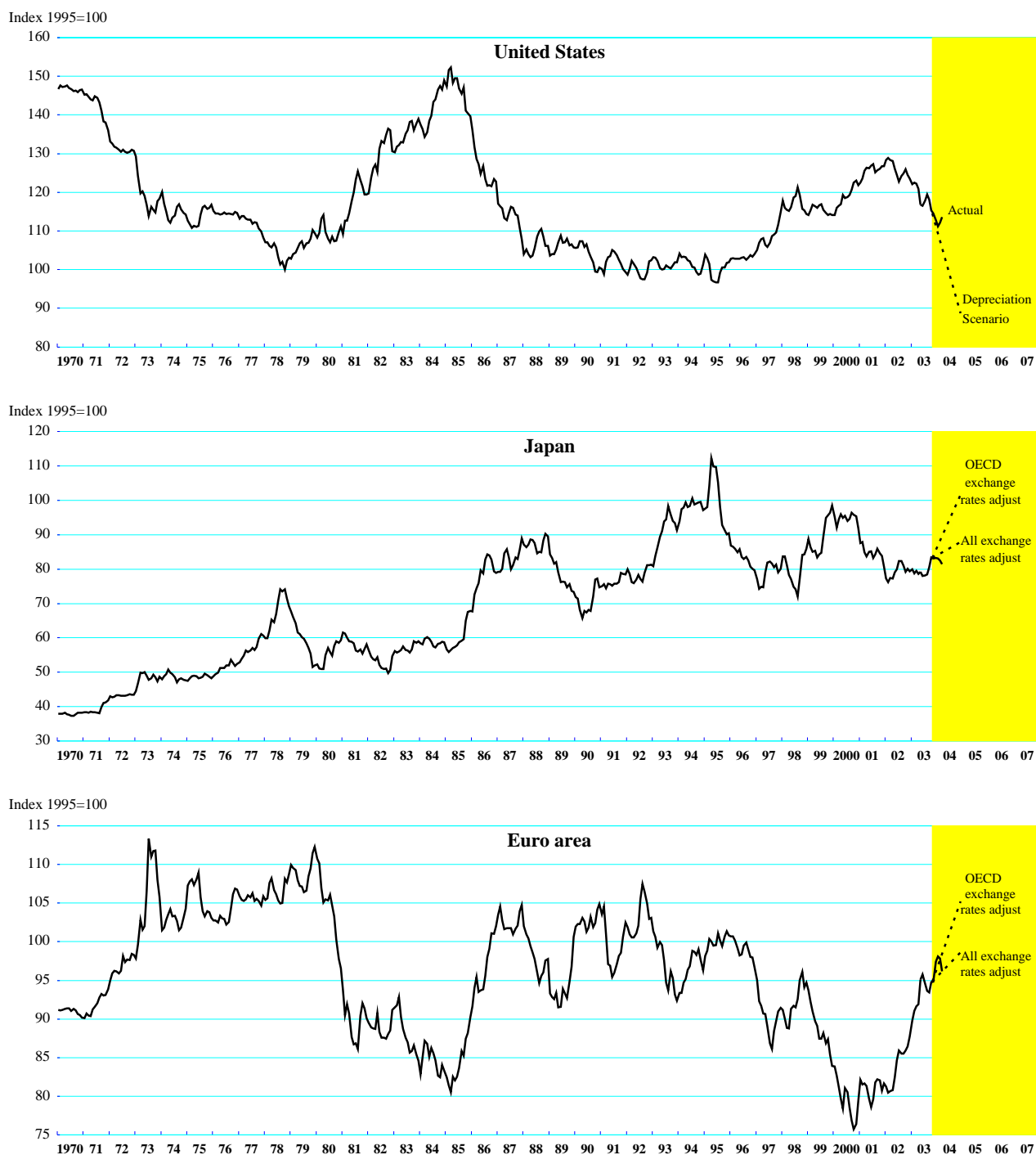
... and requires higher interest rates to offset inflationary pressures

The economic impact of the two shocks is very similar for the United States, reflecting that the same magnitude of effective depreciation occurs in both cases. In the short term, the sharp dollar depreciation pushes US inflation up to around 3 per cent, although a 300 basis point tightening of monetary policy ensures that inflation gradually declines back towards baseline, with long-term inflation expectations stable. The US trade balance slowly improves, with corresponding deteriorations in the trade balances of other regions (Table V.2).

11 . Note that Figure V.4 combines the assumed *nominal* effective exchange rate change from the scenario with historical data for the *real* effective change rate. However, movements in the *real* effective exchange rates over the projection period would differ depending on domestic inflation rates relative to inflation rates in trading partners. For example, the extent of real dollar depreciation would be somewhat eroded by higher inflation in the US relative to that in non-OECD countries.

12 . See, for example, Obstfeld and Rogoff (2000).

Figure V.4. Real effective exchange rates and scenarios



Note : Calculations of the real effective exchange rate (based on relative CPI inflation) include projections for 2004. The effective euro area exchange rate prior to 1999 is synthetic.

Note that these figures combine the assumed 'nominal' exchange rate shocks from the two Scenarios with the historical path of the 'real' effective exchange rate. However, movements in the real effective exchange rates over the projection period would differ depending on relative inflation differentials. For example, the extent of real dollar depreciation would be somewhat eroded by higher inflation in the United States relative to that in other countries.

Source : OECD.

Table V.2. Dollar depreciation scenarios: key results

	Average 2004-09			End point (2009): scenario relative to baseline	
	Medium-term baseline	OECD exchange rates adjust ^a	All exchange rates adjust ^a	OECD exchange rates adjust ^a	All exchange rates adjust ^a
United States					
Real GDP (growth/ level) ^b	3.3	3.3	3.3	-0.5	-0.3
Prices (inflation/ price level) ^b	1.3	2.6	2.2	7.6	5.1
Trade balance ^c	-4.7	-3.4	-3.4	2.0	1.9
Current account balance ^c	-5.1	-4.2	-4.3	1.4	1.3
Short-term interest rates ^d	3.9	6.9	6.9	3.0	3.0
Japan					
Real GDP (growth/ level) ^b	1.6	1.3	1.4	-2.1	-1.4
Prices (inflation/ price level) ^b	-0.2	-1.2	-0.5	-5.7	-1.7
Trade balance ^c	2.6	1.6	2.7	-1.8	-0.6
Current account balance ^c	5.0	3.6	4.7	-2.0	-0.8
Short-term interest rates ^d	0.0	0.0	0.0	0.0	0.0
Euro area					
Real GDP (growth/ level) ^b	2.3	2.3	2.3	-0.2	-0.1
Prices (inflation/ price level) ^b	1.6	1.4	1.5	-1.2	-0.6
Trade balance ^c	2.5	1.1	1.7	-2.2	-1.6
Current account balance ^c	1.0	0.1	0.7	-1.5	-1.0
Short-term interest rates ^d	3.6	2.1	3.1	-1.5	-0.5

a) Both scenarios involve a 22.5 per cent effective dollar depreciation. In the first scenario this is achieved through 30 per cent depreciation relative to OECD currencies, whereas in the second scenario the 22.5 per cent depreciation is spread evenly across all currencies.

b) Numbers in first three columns are annual rates of change; numbers in last two columns show the *level* in 2009 relative to baseline. Prices refer to the consumption deflator.

c) In per cent of GDP.

d) Per cent.

Source : Downes *et al.* (2003) and OECD.

The shock is contractionary for US trading partners...

The corresponding exchange rate appreciation would also be dramatic for the yen and euro, although on an effective basis they would not breach historical peaks. The impact of any dollar depreciation would depend on two opposing factors: the exposure of the economy to the United States and (in the case where other key exchange rates in Asia are inflexible) to non-Japan Asia; and on the scope that policy-makers have to adjust interest rates in response to the contractionary impact of the exchange rate change.

... especially those most exposed to the United States and non-Japan Asia...

On both counts, Japan would be hit harder than the euro area, though the recent tendency for deflation to abate and OECD projections of positive inflation in Japan suggest that the simulations, based on a baseline where deflation continues until 2009, could be unduly negative. If the counterpart to dollar depreciation is confined to the OECD currencies, this would imply about a 22 per cent appreciation in the effective yen exchange rate. However, if all Asian currencies were also to appreciate against the dollar, the effective yen appreciation would be just 6 per cent. Indeed, the simulations suggest

that the impact on growth in Japan would be particularly pronounced in the situation where Japan loses competitiveness relative to other Asian economies.

... although an easing of monetary policy can be used to maintain demand

In the euro area, the impact is milder than in Japan for two reasons. First, the euro area is less exposed to the United States and non-Japan Asia. In fact the effective euro exchange rate appreciates by only 11 per cent in the first scenario and by just 4 per cent in the second. Second, the euro area monetary authorities have the room to cut policy rates sufficiently to offset the contractionary impulse in both scenarios.

Channel 2: Higher national savings via fiscal consolidation

Fiscal policy effects would be partly offset...

Based on national accounting identities, the current account deficit is equal to the shortfall of national saving relative to domestic investment. Thus, an increase in the national savings rate, *ceteris paribus*, would be reflected in a narrowing of the external deficit. The specific impact on the current account deficit of an increase in net government saving (a fiscal consolidation), however, depends on the extent to which increases in government saving are offset by declines in private saving. There are a number of channels *via* which this offset may occur. For instance, there is *ex post* financial “crowding in” from lower real interest rates. Since a large fiscal consolidation has negative effects on activity and inflation, a significant drop in short-term interest rates would normally be required to stabilise output and inflation, all else equal. This in turn would prompt a decline in the private saving ratio or boost private investment, offsetting some of the gain in public saving.

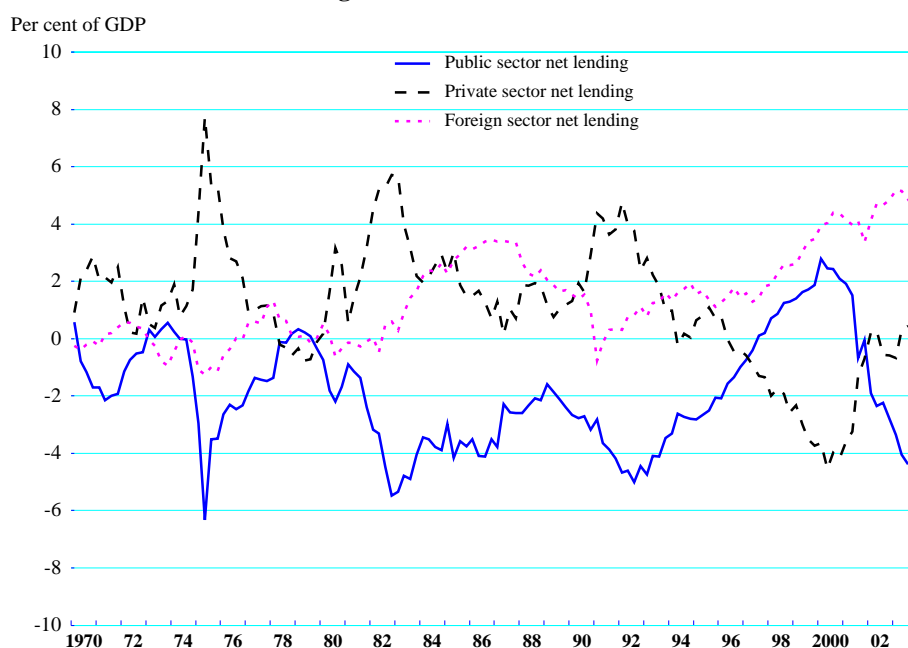
... even where Ricardian equivalence does not hold...

Other factors could also lead private saving to move in the opposite direction from public saving, such that fiscal consolidation does not reduce the external deficit one for one. These may include *ex ante* declines in private saving related to gains in confidence or “Ricardian equivalence” effects associated with the fiscal consolidation.¹³ Although the conditions for full Ricardian Equivalence are unlikely to be realised in practice, there is still evidence that private saving moves to at least offset a significant part of changes in public saving.¹⁴ This negative relationship between private and public saving is easily visible in the data (Figure V.5).

13 . Ricardian equivalence refers to the situation where an increase (reduction) in public savings is fully offset by lower (higher) private sector savings, due to economic agents discounting the lower (higher) taxes which will be needed to pay for government borrowing, thus leaving net private sector wealth unchanged.

14 . For evidence, see de Mello *et al.* (2004), and de Serres and Pelgrin (2003). In the work reported by de Mello *et al.*, a correlation of -0.6 is found between changes in private saving and the cyclically-adjusted budget balance in the United States. They also find that fiscal actions are subject to diminishing returns in the sense that the larger the fiscal impulse, the larger the private saving offset. Similarly, de Serres and Pelgrin also find that private-sector savings rates respond significantly to changes in public-sector savings, although again the degree of offset is estimated to be considerably less than unity.

Figure V.5. Negative correlation between public and private saving rates in the United States



Note: Net lending by foreigners is the negative of the current account balance.
Source: BEA NIPA tables.

... so the simulation required a large change in fiscal policy...

For these reasons, a relatively large improvement in fiscal positions is normally required to achieve a noticeable effect on the current account balance. This is illustrated by the fiscal consolidation simulation, which assumes a 6 percentage point improvement in the fiscal deficit, relative to baseline, phased in gradually over the six-year horizon.¹⁵ As with the other scenarios, this shock improves the trade balance by 2 percentage points of GDP.

... although no larger than fiscal consolidations in other countries

The magnitude of fiscal consolidation assumed is large, although it does not take the fiscal balance into uncharted territory. Indeed, the experience of both the United States and other countries since the early 1990s suggests that consolidations of such a magnitude have not been particularly unusual (Table V.3). In some of the previous cases of large fiscal contractions, the consolidation was achieved over a slightly longer time period than the six-year horizon in this scenario, although there are still several examples of very large improvements in the fiscal position over a six-year horizon.

15. In the simulation the fiscal balance was assumed to improve from a deficit of almost 5 per cent of GDP in 2003 to a surplus of 1.7 per cent of GDP after six years. In the baseline, the deficit was expected to narrow only slightly to 4.2 per cent of GDP by 2009.

Table V.3. Episodes of large fiscal consolidation and interest rate levels

	Government cyclically-adjusted balances (as a percentage of GDP)			Short-term interest rate	
	At start of period	Change over 6 years	Total change	At start of period	Maximum fall in interest rate over 6-year period ^a
Australia (1992-1999)	-4.7	5.1	6.1	6.5	1.5
Austria (1995-2001)	-5.2	4.8	5.0	4.6	1.6
Belgium (1992-2002)	-8.5	8.0	9.0	9.4	6.4
Canada (1992-2000)	-7.0	7.7	9.3	6.6	3.0
Greece (1990-1999)	-15.7	10.0	15.1	23.0	14.1
Ireland (1990-2000)	-4.3	4.8	6.8	11.3	8.3
Italy (1990-2000)	-12.4	6.1	10.4	12.2	9.3
Netherlands (1990-2000)	-7.6	5.4	6.5	8.7	5.7
New Zealand (1986-1995)	-8.4	8.5	10.8	19.1	3.5
Norway (1993-2000)	-6.6	5.1	6.5	7.3	12.8
Portugal (1991-1997)	-9.4	5.7	5.7	17.7	12.0
Spain (1995-2002)	-4.9	5.2	5.2	9.4	6.4
Sweden (1994-1998)	-7.0	9.0	10.3	7.4	3.3
United Kingdom (1993-1999)	-5.8	6.9	6.9	5.9	0.5
United States (1992-2000)	-5.3	5.1	6.2	3.8	0.5
United States Fiscal Scenario (2003-2009)	4.9	6.6	6.6	1.1	1.1

Note: For each country, the period of analysis (in parentheses) was selected on the basis of the most recent episode of fiscal consolidation defined as the years over which changes in the cyclically-adjusted budget balance remained positive.

a) The maximum fall in the short-term interest rate is calculated as the difference between the interest rate at the start of the period and the lowest interest rate over the following 6 years (using annual frequency data).

Source: OECD.

Higher public saving is almost fully offset by lower private saving

In the simulation the private-sector saving offset stems primarily from the monetary policy response. Since the fiscal shock is contractionary, it is assumed that short-term interest rates would be cut significantly, providing some offsetting stimulus to domestic demand. Also, given the reduction in the future supply of US bonds, portfolio allocation factors would likely reduce long-term interest rates by more than short-term rates.¹⁶ Thus, although household disposable income falls by around 10 per cent relative to baseline, consumption only falls by about 7 per cent, with a drop in the private saving rate of nearly 4 per cent of disposable income. With corporations in a similar position, the total private saving rate falls by close to 4 percentage points of GDP, relative to baseline, offsetting almost two-thirds of the increase, relative to baseline, in public saving (Table V.4). In terms of saving and investment balances, therefore, most of the improvement in the

16. It is also possible that a credible fiscal consolidation could result in lower risk premia on long-term interest rates.

current account balance is achieved *via* an increase in total saving, although a slight fall in total investment also plays a role. The significant negative correlation between public and private saving rates that has been observed historically persists.¹⁷

The low starting point for interest rates could pose a risk of deflation...

Importantly, because of the very low starting point for inflation and interest rates in the United States, there would also be a risk of deflation in response to such a large fiscal contraction, and this might impose limits on the extent to which fiscal policy can be tightened, even aside from political considerations. Of course, this problem would be mitigated to the extent that there is “crowding in” from the private sector or “Ricardian” type effects.¹⁸ But if the private saving rate fully offsets the rise in the public saving rate, then there will be no improvement in the trade balance. It is interesting to note that other countries that have achieved large fiscal consolidations all started with significantly more room for easing monetary policy than the United States has at present. In practice, of course, the extent to which this room for monetary easing has been used has varied (see right-hand column in Table V.3) depending on the nature of the fiscal contraction and the extent to which other economic drivers offset any contractionary effects from fiscal policy.

... unless combined with a dollar depreciation...

Since these deflationary risks would most likely be mitigated if fiscal consolidation were to occur in conjunction with significant dollar depreciation, this makes up the second fiscal consolidation scenario. In this scenario the fiscal deficit is assumed to improve by 4 percentage points of GDP by 2009¹⁹ (*versus* a 6 percentage point improvement in the scenario of fiscal consolidation alone), and the dollar to depreciate by 15 per cent relative to other OECD currencies.²⁰ In this situation, the required magnitude of depreciation and fiscal consolidation is less compared with a situation in which each of these was the sole driving factor. In addition, the expansionary impact of the depreciation offsets much of the contractionary impact of the fiscal tightening, obviating the need for a strong monetary policy response in either direction.

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- 17 . The degree of offset in private saving in response to the rise in public saving may differ according to the composition of changes to expenditure and taxes. In general, however, the experience of OECD economies suggests that fiscal restraint has an offsetting impact on private saving regardless of whether it is driven by expenditure cuts or tax increases (de Mello *et al.*, 2004).
- 18 . In the simulations, no additional allowance was made for confidence effects, or for “Ricardian” behaviour.
- 19 . The fiscal contraction in the combined scenario is achieved by a cut in public expenditures and an increase in direct tax revenues, each equivalent to 2 percentage points of nominal GDP.
- 20 . The less flexible exchange rates of the Asian region are assumed to remain tied to the US dollar. This exchange rate shock is therefore equivalent to a shock of half the magnitude imposed in the exchange rate depreciation scenario.

Table V.4. Fiscal consolidation scenarios: key results

	Average 2004-09			End point (2009): scenario relative to baseline	
	Medium-term baseline	Fiscal scenario only ^a	Fiscal plus exchange rate ^b	Fiscal scenario only ^a	Fiscal plus exchange rate ^b
United States					
Real GDP (growth/ level) ^c	3.3	2.6	2.8	-4.5	-3.2
Prices (inflation/ price level) ^b	1.3	1.6	1.8	1.5	3.1
Government net lending ^d	-4.7	-0.9	-1.7	5.9	4.2
Primary government net lending ^d	-2.6	0.2	-0.4	4.4	3.1
Private saving ^d	14.2	11.6	12.7	-3.8	-1.9
Private investment ^d	16.1	16.0	16.1	-0.4	-0.3
Trade balance ^d	-4.7	-3.7	-3.4	2.1	2.1
Current account balance ^d	-5.1	-3.8	-3.6	2.6	2.5
Short-term interest rates ^e	3.9	0.0	1.3	-5.4	-3.0
Japan					
Real GDP (growth/ level) ^c	1.6	1.3	1.2	-2.0	-2.2
Prices (inflation/ price level) ^b	-0.2	-0.7	-1.1	-2.7	-5.0
Trade balance ^c	2.6	2.2	1.9	-1.3	-1.8
Current account balance ^d	5.0	4.5	4.0	-1.3	-2.0
Short-term interest rates ^e	0.0	0.0	0.0	0.0	0.0
Euro area					
Real GDP (growth/ level) ^c	2.3	2.2	2.2	-0.4	-0.5
Prices (inflation/ price level) ^b	1.6	1.7	1.5	1.0	-0.4
Trade balance ^d	2.5	1.9	1.4	-1.4	-1.9
Current account balance ^d	1.0	0.3	0.0	-1.5	-1.8
Short-term interest rates ^e	3.6	2.5	1.7	-1.5	-2.3

a) The "fiscal only" scenario involves an increase in direct and indirect tax revenues of 3 and 1.5 per cent of nominal GDP respectively; and a cut in public expenditures of 1.5 per cent of real GDP.

b) The "fiscal plus exchange rate" scenario involves a 15 per cent dollar depreciation relative to OECD country exchange rates; an increase in direct tax revenues of 2 per cent of nominal GDP; and a cut in public expenditures of 2 per cent of real GDP. Prices refer to the consumption deflator.

c) Numbers in first three columns are annual rates of change; numbers in last two columns show the *level* in 2009 relative to baseline.

d) In per cent of GDP.

e) Per cent.

Source: Downes *et al.* (2003) and OECD.

... although that would be more costly for US trading partners

For US trading partners, however, the combination scenario would imply not only a fall in US demand for their exports, but also additional effects from the exchange rate change. Thus, these economies would suffer more negative effects on output and net exports than in the case where the same improvement in the US trade balance was achieved through fiscal consolidation alone. For the euro area, the simulation results show that an assumed cut in interest rates helps to maintain domestic demand despite the fall in net exports. In Japan, if the baseline was one of continued deflation and zero interest rates, there would be no room for manoeuvre on monetary policy and the implications would be more severe, with lower growth rates and a worsening of deflation.

Channel 3: Increase in US export share *via* supply-side improvement

The elasticity asymmetry and the persistent deficit are due in part to...

An important explanation for the trend deterioration in the US trade deficit is the seemingly greater appetite that US consumers have for imports relative to foreigners' appetite for US exports. This feature shows up in the estimated income elasticities for US imports of goods and services which are typically larger than the foreign income elasticities for US exports of goods and services (Table V.5). As long as this elasticity asymmetry persists, the US trade deficit will continue to deteriorate even if the economies of US trading partners are growing at the same pace as the US economy. Indeed, this trend is a large part of the reason why many other possible channels for improving the current account balance have so little apparent impact.

Table V.5. Selected estimates of income elasticities for the United States

	Data period	Exports of:		Imports of:	
		Goods	Services	Goods	Services
Pain and van Welsum (2004) ^a	1987-2000		1.7		
Mann (2003) ^b	1976-2000		2.1		1.5
Wren-Lewis and Driver (1998)	1980-1995	1.21	1.95	2.36	1.72
Houthakker and Magee (1969)	1951-1966	0.99		1.51	
		Exports of goods and services		Imports of goods and services	
Mann (2003) ^c	1976-2000		1.4		2.2
Hooper, Johnson and Marquez (1998)	1960-1996		0.80		1.80
Cline (1989)	1973-1987		1.70		2.44
<i>Memorandum item:</i>					
Elasticities in OECD Interlink Model ^d			1.8		2.2

a) This number is calculated as a weighted average of Pain and van Welsum's estimates of elasticities for individual categories of services. Their estimates use total world trade in non-government services as the measure of foreign demand rather than foreign GDP (as used in the other studies). However, the number quoted in this table has been scaled up to reflect the relatively slower growth in world GDP *versus* world trade in services. Thus this number is comparable with the others in the table.

b) These numbers are calculated as a weighted average of Mann's (2003) estimates of the income elasticity of *Other personal services*, and the estimates by Stern *et al.* (2001) of income elasticities for the *Travel, Passenger fares* and *Other transportation* components of total services.

c) These numbers are a weighted average of Mann's income elasticities for services and Wren-Lewis and Driver's (1998) estimates of the income elasticities for goods.

d) Note that the export elasticity in the OECD model is normally quoted as 1.0, based on a weighted average of growth in foreign imports as the measure of foreign demand, rather than foreign GDP. However, the number quoted in this table has been adjusted for the effect of the denominator in order to ensure comparability with the other numbers in the table.

Source: OECD.

... US demographics ...

There are at least four possible explanations for the elasticity asymmetry in the United States, several of which also suggest possible channels for reversing it and thereby the trend in the deficit. One explanation stresses the role of demographics. Younger populations tend to consume a relatively higher proportion of imports, and fewer domestic services such as health

care, while immigrants tend to maintain their tastes for products from home.²¹ Indeed, there is some evidence that when the age distribution of domestic residents and the proportion of immigrants are incorporated as explanatory variables, the income elasticity for US imports is reduced.²²

***... high export quality
and variety from dynamic
trading partners...***

A second explanation stresses the role of supply factors in the exports of the United States' dynamic trading partners (*e.g.* in Asia). There is a tendency for countries with higher growth rates to produce a greater variety and quality of goods for export, which in turn increases the foreign demand for those countries' products (or, observationally equivalent, the elasticity of demand for imports from those countries).²³ This supply effect is sufficiently important that it might account for around half the magnitude of estimated income elasticities of US import demand. When the supply effect is subtracted, the "unbiased" income elasticity of US import demand is estimated to be less than one.²⁴

***... rising import
penetration...***

Third, there are a number of other factors that also help to explain the rise in US import penetration over time. These include the role of production relocation and vertical integration, and improvements in global and regional market access. Indeed, there is some evidence that when these additional factors are captured by a time trend, the income elasticity is estimated to be close to one.²⁵

***... and relatively less
trade in services, where
the US has an advantage***

The fourth explanation focuses on the composition of trade, and the differences in estimated elasticities across sectors. While the range of estimates reported in Table V.5 is wide, there is some evidence that the elasticity asymmetry is present only for trade in goods. For total services the effect is reversed, with estimates of the elasticity of demand for exports of services consistently higher than estimates of the elasticity of demand for imports of services.²⁶ The implication seems to be that the United States has more of a comparative advantage in the production of services (particularly new economy services),²⁷ than goods. If this is true then further liberalisation

21 . Immigrants also tend to contribute to the current account deficit by sending home remittances.

22 . See Marquez (2002).

23 . This was first documented by Krugman (1989).

24 . Using a standard model of trade elasticities, Gagnon (2003) estimates a US income elasticity of demand for imports of 1.5. However, when the model is re-specified to exclude the supply effect the estimated elasticity drops to 0.75. Even accounting for the fact that Gagnon's initial estimate is at the low end of the range of estimates (see Table V.5 for others), this explanation has the potential to account for a large proportion of the asymmetry, if not all of it.

25 . See, for example, Pain and van Welsum (2004) and Pain and Wakelin (1998).

26 . See estimates in Table V.5 by Mann (2003) and Wren-Lewis and Driver (1998).

27 . See Mann (2003). New economy services are those professional services (such as architecture, engineering and consulting) that information technology increasingly allows to be traded across borders.

of trade in services, together with deeper investment in new economy services by US trading partners, would increase the size of this sector within US trade and thus narrow the overall asymmetry.

The future path for the United States will depend on many factors...

In terms of import elasticities, the range of explanatory factors makes it difficult to extrapolate from future income growth to future import growth. For example, the first three explanations for the elasticity asymmetry (for trade in goods) suggest that to some extent the estimated coefficients may just be picking up other effects, such as the role of supply factors abroad. If so, then the future path of US imports may depend at least as much on the non-price competitiveness of the dynamic Asian economies, than on the growth of income in the United States.

... but a focus on trade in services, plus further productivity growth...

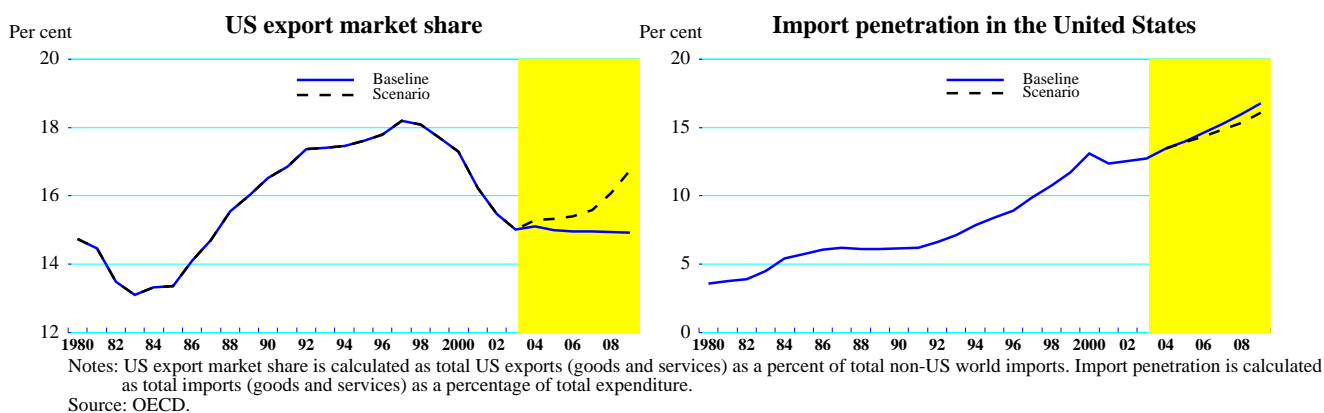
Despite posing difficulties in interpretation, these explanations suggest two main channels for narrowing or reversing the elasticity asymmetry. The first would involve the US economy continuing to build on its comparative advantage in the production of many “new-economy” services, where the elasticities are more favourable for the United States. The second would involve continued US out-performance in productivity growth, relative to most other OECD economies, resulting in a pick-up in the variety and quality of goods and services for export. Such outcomes would imply improved competitiveness for the United States and would reverse the recent decline in US export performance.

... could enable the United States to regain lost market share...

In the simulations, it was found that a 2 per cent of GDP improvement in the trade deficit, achieved solely through non-price-driven gains in market share, would require that the share of US goods in world imports increase by around 2 percentage points over the next six years. There would be as well a corresponding reduction in the US import penetration ratio (Figure V.6). This shock would also be equivalent to a reversal of the asymmetry in elasticities of demand, with the new elasticities being phased in gradually over a six-year horizon.²⁸ The left-hand panel of Figure V.6 shows the extent of increase in US export market share. The fact that the new export market share would remain lower than it was in the mid-1990s may reflect the fact that the real exchange rate remains at a higher level in this scenario.

28. The export elasticities in the OECD model relate export sales to market demand as calculated by a weighted measure of *import volumes* in US trading partners. Thus, the simulation was conducted by doubling the foreign demand elasticity of US exports (from 1.0 to 2.0) and halving the US income elasticity of imports (from 2.2 to 1.0). However, the export elasticities from the other studies quoted in Table V.5 use the slower-growing foreign GDP as the measure of market size instead. When scaled up to represent comparable numbers, the OECD simulation therefore implies a doubling of the foreign income elasticity of US exports (from 1.8 to 3.6).

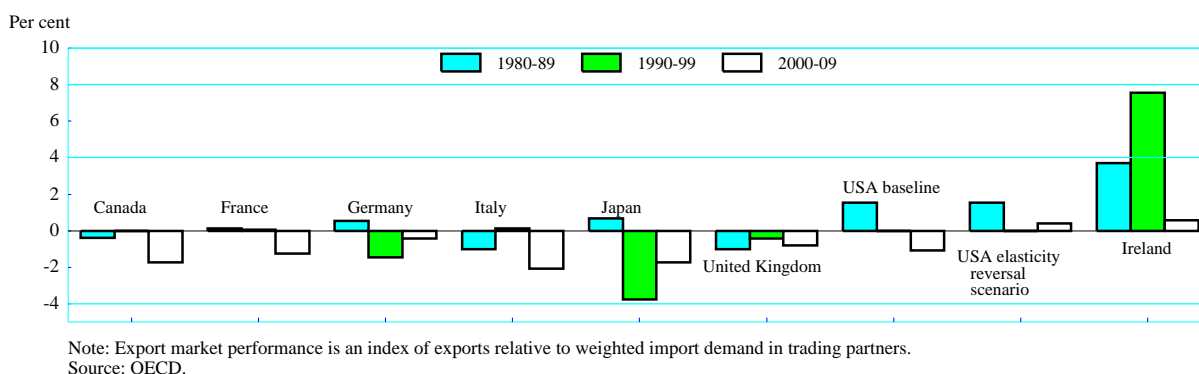
Figure V.6. US market performance



... and continue to perform well relative to other major economies

Although the United States has lost export market share over recent years, it has tended to perform quite well in this area relative to the other major seven economies. The United States experienced positive growth in market performance over the 1980s and remained static over the 1990s, as opposed to losses in market share over these two decades in other major economies. However, much faster growth in market performance is recorded for economies that are “catching up”, such as Ireland (Figure V.7).²⁹ Thus,

Figure V.7. Growth in export market performance for G7 countries and Ireland
(Average annual growth rates)



29 . The market performance index that is utilised to calculate the growth rates in Figure V.7 varies slightly from the measure of export market share that is illustrated in Figure V.6. Export market share is calculated as a percentage of (non-US) world imports whereas the export performance indices use a weighted average of imports in trading partners.

while the assumed recovery of US export market share would distinguish US performance relative to other similar economies, it would not be implausible in the context of strong growth in services exports and strong productivity growth driving continued innovation in both goods and services exports.

This scenario would be the least costly adjustment for other economies...

The boost to US net exports in this scenario is expansionary, leading policy rates to be tightened by up to 100 basis points. Although the export competitiveness of US trading partners is hurt, the impact of this is partially offset by increased demand from a stronger economy. In addition the simulations suggest that the ability to use monetary policy to bolster domestic demand (policy rates in the euro area are assumed to be reduced by 50 basis points) could compensate for the fall in externally-led growth, although there would obviously still be a significant change in composition away from externally-led growth and towards domestic demand. Indeed, this is the least costly scenario for US trading partners (Table V.6).

Table V.6. Elasticity reversal scenario: key results

	Average 2004-09		End point (2009): scenario relative to baseline
	Medium Term Baseline Scenario ^a	Elasticity reversal ^b	Elasticity reversal ^b
United States			
Real GDP (growth/ level) ^c	3.3	3.6	1.6
Prices (inflation/ price level) ^c	1.3	1.7	0.0
Government net lending ^d	-4.7	-4.7	5.9
Primary government net lending ^d	0.0	0.2	4.4
Trade balance ^d	-4.7	-3.9	1.8
Current account balance ^d	-5.1	-4.3	1.8
Short-term interest rates ^e	3.9	4.7	1.0
Japan			
Real GDP (growth/ level) ^c	1.6	1.4	-1.2
Prices (inflation/ price level) ^c	-0.2	-0.6	0.0
Trade balance ^d	2.6	2.2	-1.1
Current account balance ^d	5.0	4.6	-1.0
Short-term interest rates ^e	0.0	0.0	0.0
Euro area			
Real GDP (growth/ level) ^c	2.3	2.2	-0.7
Prices (inflation/ price level) ^c	1.6	1.6	0.0
Trade balance ^d	2.5	2.0	-1.0
Current account balance ^d	1.0	0.5	-0.9
Short-term interest rates ^e	3.6	3.1	-0.5

a) Downes *et al.* (2003).

b) Foreign demand elasticity of US exports raised from 1.0 to 2.0; income elasticity of US imports lowered from 2.2 to 1.

c) Numbers in first two columns are annual rates of change; numbers in last column show the level in 2009 relative to baseline. Prices refer to the consumption deflator.

d) In per cent of GDP.

e) Per cent.

Source: OECD.

But there are risks to this scenario, especially from trade protectionism

There are, however, a number of risks to this scenario. Importantly, further liberalisation of trade in new economy services, where the elasticities seem to be favourable for the United States, may be hindered by protectionist pressures. Indeed, efforts to restrict international outsourcing of low-skilled services may prompt international retaliation in the area of trade in new economy services. Another risk, from the perspective of the trade balance, is that deeper integration of new economy services could enable US trading partners to produce a greater variety and quality of goods for export. In other words, a new economy and accompanying “Krugman-type” elasticity effects in Europe or Japan could directly offset the assumed supply-side improvement in US export performance.³⁰

Strong growth in US trading partners would only provide limited help

Of the possible scenarios not discussed here, there could also be some help from a rapid closing of negative output gaps in Japan and the euro area. However, this improvement would only be of limited magnitude. An acceleration of structural reform in these economies would result in more flexible and resilient economies which would allow them to better withstand shocks in the event of any disorderly adjustment to the current global imbalances. However, it would not provide much assistance to the US trade balance directly, since stronger productivity growth in US trading partners may prompt the production of more competitive export products from those countries. Even in the absence of such supply-side effects, the high US import elasticity would limit the extent of improvement to the trade balance.³¹

30 . Although in Mann (2003) the combined impact of a narrowing in the elasticity asymmetry and higher productivity growth in US trade partners is considered, the possibility of “Krugman” effects in those countries is not analysed. Only the additional demand-side boost to US exports from higher trading partner growth is considered.

31 . This result is supported by the final simulation in Brook *et al.* (2004), which suggests that stronger growth in US trading partners would make only a very small improvement to the external deficit.

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TABLE OF CONTENTS

	<i>Page</i>
IV. Housing markets, wealth and the business cycle.....	5
V. The challenges of narrowing the US current account deficit	29
VI. Asset price cycles, “one-off” factors and structural budget balances.....	53
VII. Enhancing income convergence in Central Europe after EU accession.....	81