America is now on the comfortable path to ruin

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Since the emerging market financial crises, the financial surplus of foreigners with the US has exploded. What has changed, however, is the domestic counterpart. During the boom of the 1990s, the US private sector financial balance shifted from a surplus of 6 per cent of GDP in the first quarter of 1992 to an unprecedented deficit of just under 6 per cent. Thus, the spending of the US private sector grew by 12 percentage points of GDP faster than its income. The huge boom this unleashed allowed the public sector to move into temporary surplus. Then, after the stock market crash, the private sector moved towards balance, as the corporate sector retrenched. The counterpart of this shift has been the growing deficits of the public sector.

The starting point must be with the current account deficit. The paper is rather optimistic on this: world output is assumed to rise at a real rate of 4 per cent a year between early 2004 and the end of 2008; the US economy grows at a rate of 3.2 per cent over the same period; and the exchange rate remains 9 per cent below its peak in early 2002, on the Federal Reserve's broad index. On these assumptions, the trade deficit reaches a peak of 6 per cent of GDP, before stabilising. But the net liability position of the US continues to deteriorate while domestic interest rates rise. On plausible assumptions, the combined effect is to create a deficit on net investment income of about 2 per cent of GDP by 2008. The current account deficit then reaches 8 per cent of GDP by that year.

This seems outlandish. But note that even if the private sector were to move back towards a financial deficit of 3 per cent of GDP, the fiscal deficit would still need to be 5 per cent of GDP to sustain demand at levels needed for full employment in the context of a leakage of 8 per cent of demand into the current account deficit.

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It takes two to tango. But there can be only one leader in the dance. In the dance of global macroeconomics, the US is not leader, but led. In aggregate, the countries of the world are offering the US a surplus of output over spending (or exports over imports) of Dollars 600bn (Pounds 404bn) a year. In its response, only one consideration matters to the US: jobs. These two facts - the rest of the world’s surplus output and the US goal of full employment - explain the global macro-economic picture.

I argued last week that the governments of Asian emerging market economies have been determined to run strong current account positions at least since the financial crises of 1997 and 1998. Given their countries’ extraordinarily high rates of private savings, it is quite easy for them to do so. Japan and Germany, the world’s second and third largest economies, are also generating very large surpluses: this year, according to the latest Consensus Forecasts, they will run an aggregate current account (or savings) surplus of Dollars 256bn. Other, smaller players are also joining in.

Where does this leave the US? With vast deficits is the answer. From 1996 to 2003 US real demand has grown faster than real gross domestic product in every year (see chart). When demand has grown slowly, as in 2001, output has grown even more slowly. Thus, the US authorities had to generate faster growth of demand than of potential output, with the difference spilling over on to the rest of the world via growing current account deficits.

To understand the implications, consider the US financial balances: the difference between income and spending (or savings and investment) of foreigners, the government and the private sector (see chart).

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These are identities. They do not tell us what is driving the economy. But the answer to that question seems reasonably clear. The current account deficit has risen during boom and recession. It is driven by the macroeconomic behaviour and exchange rates policies of the rest of the world. Meanwhile, the US private and public sectors have supported domestic demand, in turn.

Was the fiscal slide inevitable? No, but it could have been avoided only if the US had been prepared to accept a slump. Yet no US administration would have tolerated this outcome. If Al Gore had been president, the fiscal position would still have deteriorated hugely, in a different way.

For the same reason, the desire of both presidential candidates to reduce the fiscal deficit in coming years is meaningless without change in the external position. The point is powerfully made in the latest in a series of papers authored by Wynne Godley and associates for the Levy Economics Institute and the Cambridge Endowment for Research in Finance.*

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Now consider the domestic counterparts. In the paper, the authors assume that any increase in spending by corporations is offset by some retrenchment by households. This generates a move by the private sector into a modest financial surplus of 1 per cent of GDP, still below the historic average of just under 2 per cent. If that were to happen, the fiscal deficit would, on their assumptions, have to climb towards 9 per cent of GDP four or so years from now.
This seems outlandish. But note that even if the private sector were to move back towards a financial deficit of 3 per cent of GDP, the fiscal deficit would still need to be 5 per cent of GDP to sustain demand at levels needed for full employment in the context of a leakage of 8 per cent of demand into the current account deficit.

Let us be blunt about it. The US is now on the comfortable path to ruin. It is being driven along a road of ever rising deficits and debt, both external and fiscal, that risk destroying the country's credit and the global role of its currency. It is also, not coincidentally, likely to generate an unmanageable increase in US protectionism. Worse, the longer the process continues, the bigger the ultimate shock to the dollar and levels of domestic real spending will have to be. Unless trends change, 10 years from now the US will have fiscal debt and external liabilities that are both over 100 per cent of GDP. It will have lost control over its economic fate.

What cannot last will not do so, as the late Herb Stein famously remarked. But we can choose how it changes. The US authorities can allow things to take their course or they can develop a policy to reverse these trends. The essence of the needed changes is quite clear: a further substantial devaluation of the dollar, together with a sizeable rise in domestic demand, relative to potential output, in almost all other important economies of the world. Politicians wait until crises hit. Statesmen foresee and then act to prevent them. What is the chance of such an economic statesman emerging after the election? Almost none, I fear.

* Godley, Alex Izurieta and Gennaro Zezza, Prospects and Policies for the US Economy: Why Net Exports Must Now Be the Motor for US Growth, www.cerf.cam.ac.uk martin.wolf@ft.com