Channels for Narrowing the US Current Account Deficit and Implications for Other Economies

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Presentation for RIETI Policy Symposium, Tokyo, 17-18 June 2004
The US current account deficit – at record levels

What would it take to improve the US trade balance by 2% of GDP?
Outline

- Simulations: key assumptions
- Adjustment channels:
  - 1. Dollar depreciation
    • Relative to OECD currencies
    • Relative to all other currencies
  - 2. US fiscal consolidation
    • Alone
    • In combination with exchange rate depreciation
  - 3. Improvement in US non-price competitiveness
  - Stronger growth in US trading partners
- Key conclusions
Simulations: Background Information

- Simulations using OECD Interlink model
- Based on the OECD’s December 2003 medium-term baseline (2003 – 2009) – now out of date, especially for Japan
- Implications for current account balance depend on path for interest rates and debt servicing
- Monetary authorities are assumed to return inflation to baseline level
Scenario 1: Exchange rate channel

- Real effective exchange rate (left scale)
- Current account balance as a percentage of GDP (right scale)
Factors mitigating the impact of the exchange rate on the current account

- Time lags
- Weak exchange rate pass-through into US import prices
- Higher inflation implies higher interest rates, which deteriorates the investment income balance
- Negative feedback effect on demand for US exports
22.5 per cent nominal effective dollar depreciation

- Scenario 1A:
  - 30 percent depreciation relative to OECD exchange rates

- Scenario 1B:
  - 22.5 percent depreciation relative to all currencies.

Depreciation occurs over the first year of the simulation horizon
USD real effective exchange rate

Index 1995=100

United States

Actual
Scenarios 1A and 1B

1970 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07
Scenarios 1A and 1B: key results

- For the United States:
  - Inflation increases by 3% in short-term
  - Fed increases interest rates by 300 basis points
  - Trade balance improves gradually, reaching 2% target after 6 years

- For US trading partners the impact depends on 2 things:
  1. Exposure of economy to US and non-Japan Asia
  2. The scope that policy-makers have to stimulate the economy in response to the contractionary impact of the dollar depreciation
  - On both counts Japan would be hit harder than Europe
Scenario 2: Fiscal consolidation

- Scenario 2A:
  - 6% of GDP increase in government saving

- Scenario 2B:
  - 4% fiscal consolidation + 15% dollar depreciation relative to OECD currencies

- Fiscal tightening occurs over 6 years
- Fed cuts interest rates in both scenarios but all the way to zero in Scenario 2A
- Zero interest rate creates a deflationary risk
Is a 6% fiscal consolidation plausible?

<table>
<thead>
<tr>
<th>Country</th>
<th>At start of period</th>
<th>Change over 6 years</th>
<th>Total change</th>
<th>At start of period</th>
<th>Maximum fall in interest rate over 6-year period</th>
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<tr>
<td>Australia (1992-1999)</td>
<td>-4.7</td>
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<td>6.1</td>
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<td>United States Fiscal Scenario (2003-2009)</td>
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Scenarios 2A and 2B: key results

For the United States:

1. Deflationary risk:
   - Less deflationary risk in Scenario 2B
   - Starting point now less risky
2. Two thirds of the increase in government saving is offset by a fall in private sector saving
   - So 6% fiscal consolidation → 2% higher trade balance

For US trading partners:

- Scenario 2B (combination) is more negative than 2A
- For euro area, implications are less severe due to ability to reduce interest rates
- For Japan, the deflationary baseline limits policy makers
Scenario 3: US elasticity asymmetry

- US appetite for M > foreign appetite for US X
- Income elasticity for US imports > Foreign income elasticity for US exports

As long as this asymmetry persists, US trade balance will deteriorate, even if trading partners are growing at the same pace.

For possible explanations see Box.
Improvement in US non-price Competitiveness

- Roughly equivalent to a reversal of the elasticity asymmetry over 6 years
- 2% increase in US share of world imports
- How does the US achieve this?
  - By building on comparative advantage in ‘new economy’ services exports
  - By productivity growth in goods and services markets
Scenario 3: key results

For the United States:
- Expansionary shock requires 100 bps higher i
- Scenario 3 most positive scenario for the US

For US trading partners:
- Scenario 3 also least negative scenario for Japan and the euro area

Risks:
- Scenario 3 is very ambitious
- Trade protectionism poses a large threat
Additional Scenario: stronger growth in trading partners not a panacea

- Additional scenario suggests not plausible to achieve 2% trade balance improvement via this channel alone
- Partly due to fact that high US import elasticity limits improvement to trade balance
- Partly due to other possible impacts of growth on global competitiveness
Key Conclusions (1)

- Initial impact of shocks on trade balance offset by:
  - Domestic policy responses
  - Feed-back effects from abroad
  - High US income elasticity for imports

Thus 2% trade balance improvement requires very large changes in economic variables:
- 20-25 per cent dollar depreciation
- US fiscal policy tightening of around 6 percent of GDP
- 2 percentage point increase in the US share of world imports
Key Conclusions (2)

- All channels for achieving adjustment are costly for the rest of the world, but some more so than others:
  - Greater exchange rate flexibility in Asia would facilitate adjustment and reduce the costs for the rest of the world (especially Japan)
  - A healthy domestic economy makes it easier for policy makers to provide offsetting stimulus in the face of a negative shock emanating from the US
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