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

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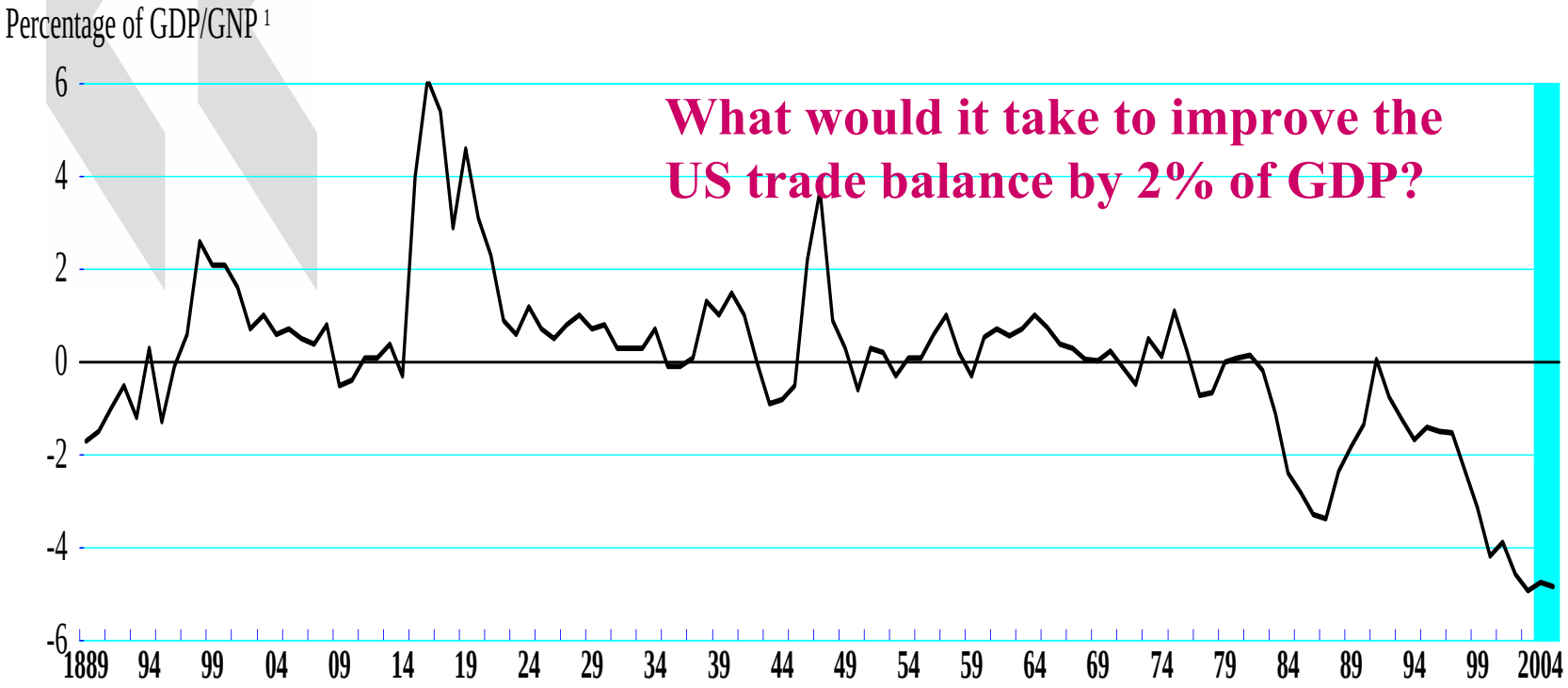
The US current account deficit – at record levels



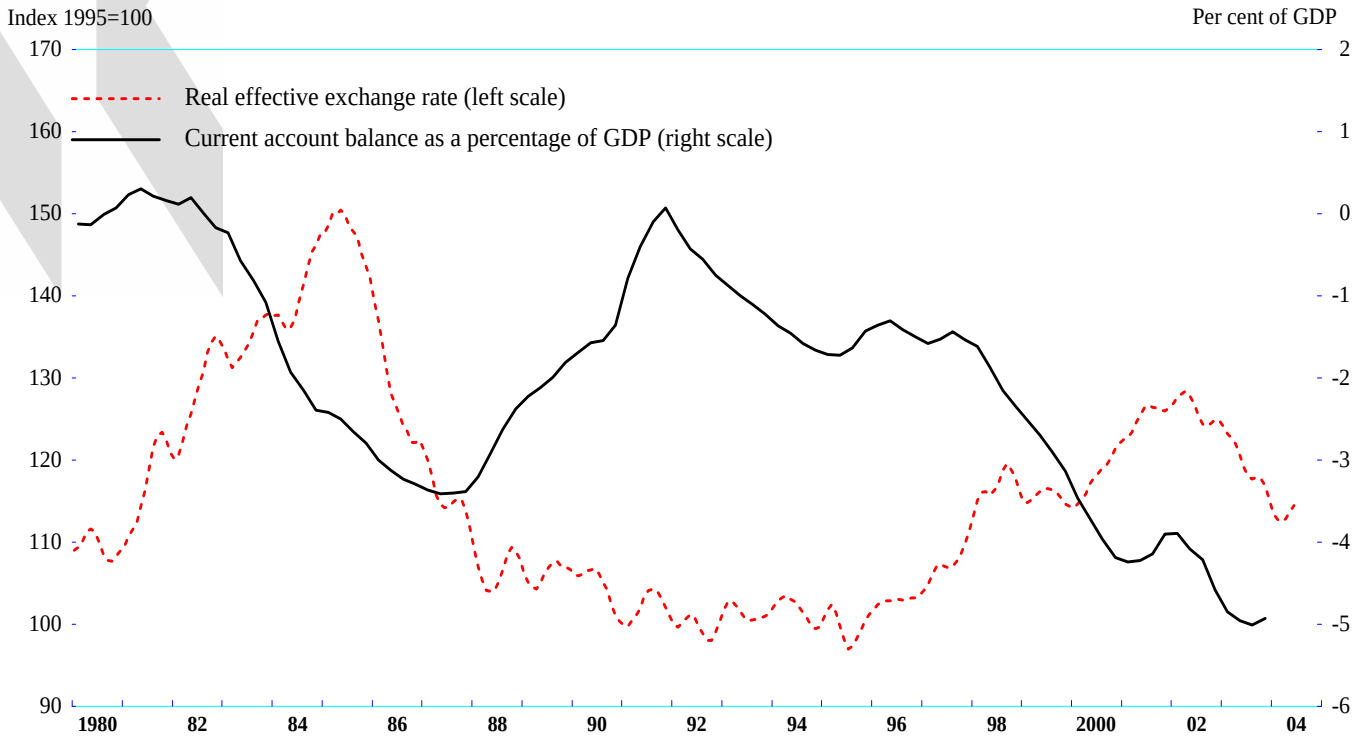
Outline

- 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- Based on the OECD's December 2003 medium-term baseline (2003 – 2009) – now out of date, especially for Japan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



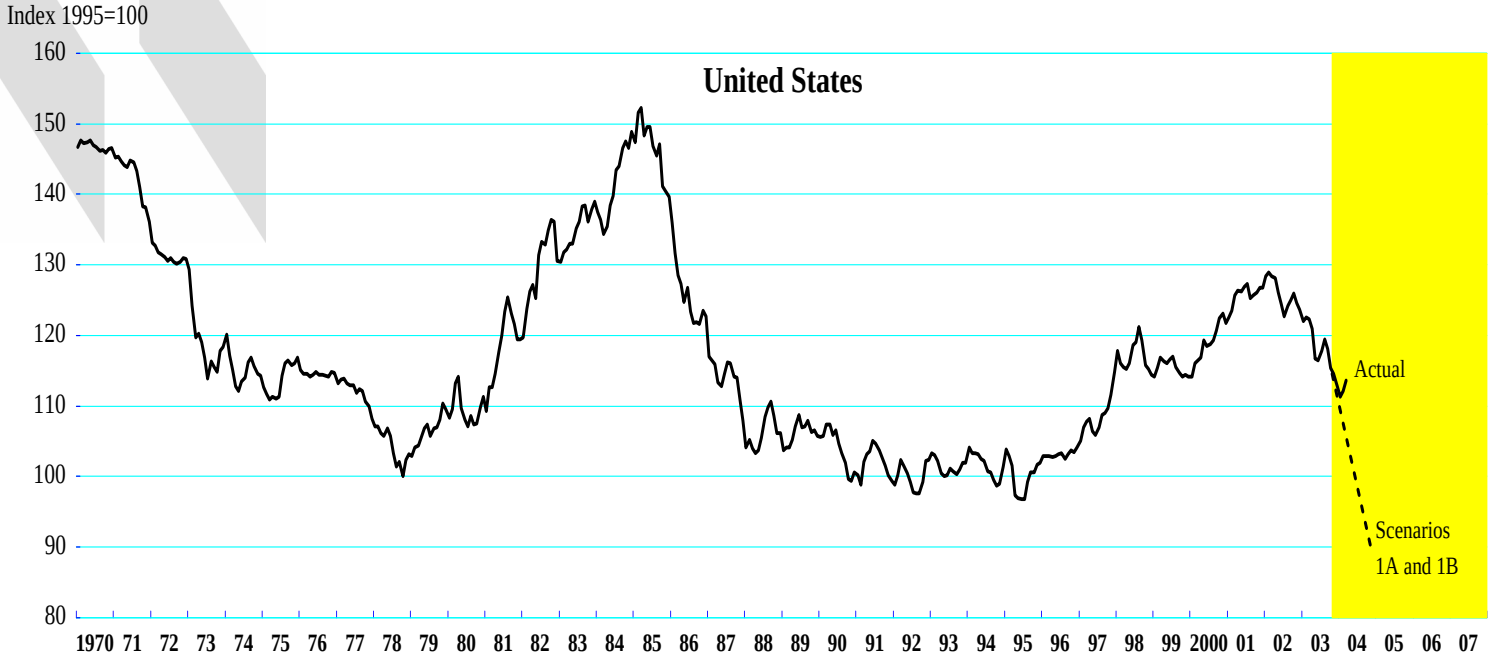
Factors mitigating the impact of the exchange rate on the current account

- 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

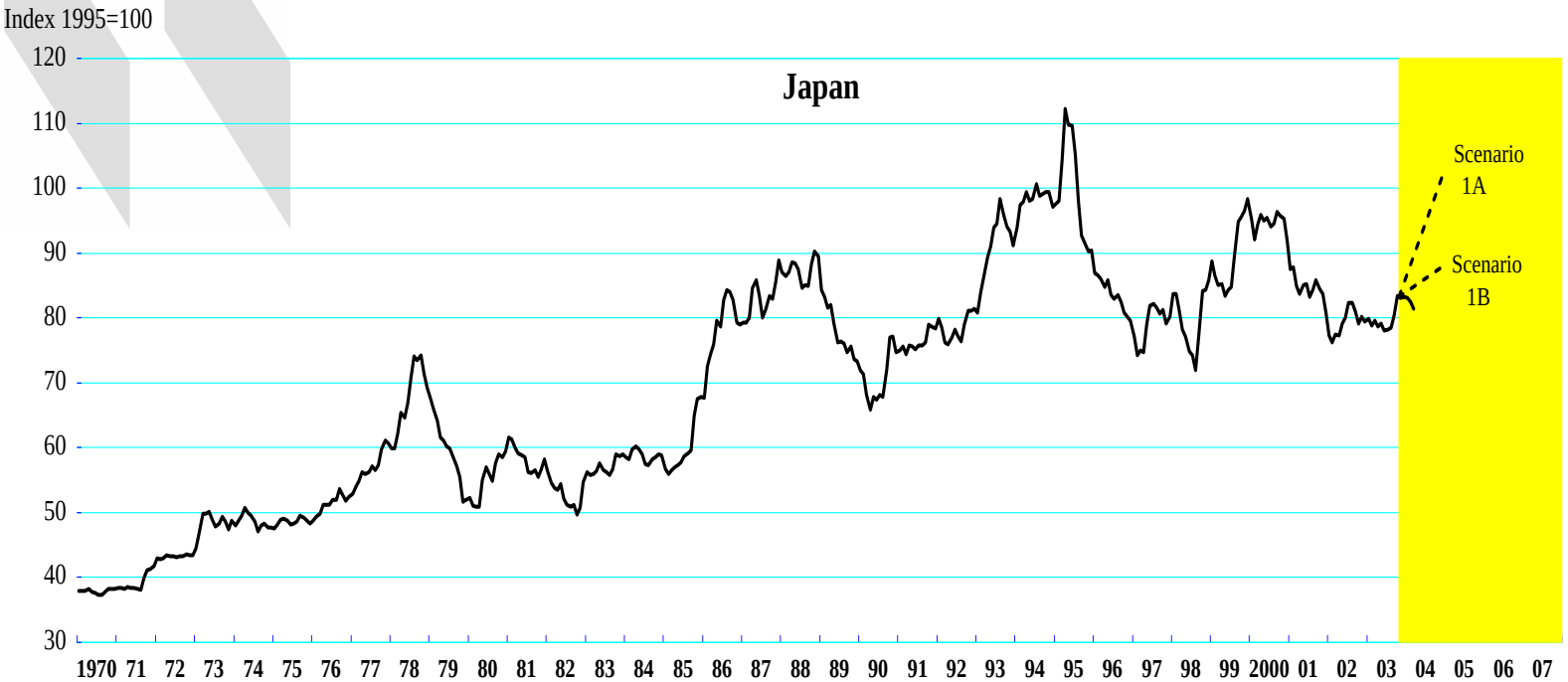
22.5 per cent nominal effective dollar depreciation

- 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



Yen real effective exchange rate



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 i creates a deflationary risk

Is a 6% fiscal consolidation plausible?

	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**

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 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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