INTERNATIONAL CURRENCIES AND COMPETITIVENESS

Perspective on U.S. External Deficits

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Let me start by saying that the central hypothesis of what I will be saying to you comes down essentially to two points. The first is that by far the primary cause of the rapid growth of the U.S. current-account deficit over the last decade or so is squarely due to the pronounced differences in growth among the industrial countries over that period. The second key point I wanted to make is to emphasize the risk, however small, that the tensions we are seeing in the geopolitical sphere could spill over into the economic and financial sphere. Not only would that be bad in terms of its consequences on economic behaviour around the world, but I think it would have the added effect of making the urgently needed adjustments in global economic imbalance still more difficult to achieve in an orderly fashion.¹

To quickly talk about the Charts, the first several essentially provide data relating to the U.S. external deficits that I think you are all well familiar with over the period 1992 to the present. The year 1992 was chosen as the base point because that was the last year in which the United States’ current account deficit was roughly in equilibrium. I’m not going to go through the charts in any detail, except to make one observation relating to Chart 2, which shows nominal exchange rates over that same period. What strikes me in looking at the Chart of the nominal exchange rates is not so much the difference between the starting and ending points, but rather the extraordinary exchange rate volatility that has characterised the interval as a whole.

Chart 3 shows the deterioration in the U.S. net debtor position going back to 1982. As you can see, as of the end of 2003, U.S. net foreign liabilities were roughly in the range of 27-28% of GDP, and, to my way of thinking, that order of magnitude is in the yellow zone since it calls into question the appetite of foreign investors for U.S. assets in the future.

¹ Authors note: In the interval since this presentation was made, the U.S. external deficits – driven in part by higher oil prices – have deteriorated further with the second quarter current account deficit reaching a record 5.7 percent of GDP.
Charts 4, 5, and 6 tell a big part of the story. What is shown on chart 6, using 1992 as the base, is the sharp disparity in the cumulative growth in GDP between the United States on the one hand and Euroland and Japan on the other. To make the point a little more concrete, Charts 7 and 8 contrast the average growth in Japan and Euroland together with that of the U.S. This comparison essentially points out, as a matter of arithmetic, that if over the period 1992 to the end of 2003 U.S. growth had been the same as the average of Japan and Germany, the U.S. real GDP at yearend 2003 would be almost 2 trillion dollars less than it was, which amounts to almost 23% of the current level of the U.S. real GDP. Had U.S. growth matched the average of Europe and Japan, the U.S. trade deficit would have been smaller but so too would have been the already subdued growth of Euroland and Japan.

Current US Real GDP (2003:Q4) $10,600.1
Hypothetical US Real GDP in 2003:Q4 Assuming US Growth Equal to Europe-Japan Average $8,636.3
Absolute Difference $1,963.8
Percent Difference 22.7%

The really interesting story, I think, is Chart 7 which looks at the trade deficit in goods by major components. Often overlooked in this regard is the fact that in the capital goods sector (ex autos) the U.S. trade position is essentially in balance. On the other hand, consumer goods account for about 45 percent of the trade deficit and if – by assumption – only one-third of the deficit in petroleum products and autos are said to be attributable to consumers, more than two-thirds of the overall U.S. trade deficit in goods would be directly or indirectly attributable to consumers. This is the other side of the well know story of high consumption and low savings by U.S. consumers.

Chart 8 illustrates, going back over the last decade or so, how the U.S. current account has been financed. What is especially dramatic about this chart is the last couple of years. Following the M&A boom of the second half of the 1990s, foreign direct investment as a source of external financing has fallen from almost 2% of GDP to minus 1% of GDP. The corollary to that is that foreign official financing by central banks and other official institutions has risen to almost 2% of GDP, and the data in that chart does not capture the sharp further rise in such official financing in recent months.
Charts 9 and 10 provide overview information regarding various adjustment paths that could bring about a meaningful adjustment in the U.S. current account deficit over the next two or three years. Chart 9 stipulates that a reasonable medium term goal would be to reduce the U.S. current account deficit to about 3 percent of GDP – an outcome that will depend critically on complementary policy actions by the U.S. and its major trading partners.

Chart 9 goes on to note that adjustment in the current account deficit can only occur through some combination of (1) changes in relative prices of imports and exports; and (2) changes in aggregate demand as reflected in relative GDP growth across countries.

Changes in relative prices induced by changes in exchange rates occur with long and highly uncertain lags, especially in the current global economic setting. Indeed, given the current global structure and competitive nature of product markets, it seems highly likely that it would require very large changes in exchange rates to produce sufficient changes in the U.S terms of trade to put a material dent in the U.S. deficits. Seeking to bring about adjustment largely – much less exclusively – via the exchange rate channel would, in my judgment, result in wholly unacceptable risks of widespread financial market instability and economic dislocation on a global scale. In other words, while some further exchange rate adjustment may be needed, seeking to rely on the exchange rate mechanism to induce the needed adjustment strikes me as a recipe for potential large scale disorder if not outright crisis.

Clearly, as highlighted in Chart 10, changes in relative prices and/or relative growth can come about for many reasons, some good, some bad and some very bad. An adjustment path centering on a sharp and disorderly fall in the dollar would likely fall into the camp of a very bad scenario. On the other hand, a scenario that involves a move toward greater convergence in growth in industrial countries – which might also entail some orderly exchange rate changes – would represent something close to an optimal adjustment.

I don’t minimize the difficulties for a minute of trying to work toward that optimal adjustment path. Clearly, it will require policy adjustments among all major countries. As noted in Chart 10, I believe that something along the broad lines of the optimal adjustment path is within reach. More importantly, perhaps, I strongly believe that the worst case adjustment path must be avoided since the risks associated with such a scenario are so dire.

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**Adjustment Paths**

A reasonable medium term goal would be to reduce the U.S. current account deficit to about 3% of GDP.

– Any such outcome depends critically on complementary policies by the U.S. and its major trading partners

Adjustment can occur only through some combination of two underlying forces.

– Changes in relative prices of imports and exports.

– Changes in relative demand as reflected in relative GDP growth.

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**Changes in relative prices and/or relative growth can come about for many reasons, some good, some bad and some very bad in their implications for economic and financial prospects world-wide.**

– The most threatening adjustment path would be a disorderly fall in the dollar accompanied by adverse spillover effects on financial markets generally and a rise in protectionism in the U.S. and elsewhere.

– The optimal adjustment path would entail convergence of industrial country growth in the 3.0 to 3.5 percent range.

– The optimal adjustment path is within reach but it will require patience, wise policies and a renewed spirit of coordination and cooperation.

– The choice is ours to make

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