

## General Discussion: Perspectives on OECD Economic Integration: Implications for U.S. Current Account Adjustment

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*Chair: Anne Krueger*

*Ms. Krueger:* We now have time for questions. Let's start with Allen.

*Mr. Sinai:* In your framework analysis, which I actually don't agree with though I do agree with the risk of a dollar crash as something we need to be aware of on this large and growing current account deficit, I have the following question. Shouldn't the source of the current account deficit improvement be taken into account? For example, let me give you a couple of caricature cases. Suppose the current account deficit improvement is all in exports, an increase in exports, would that crash the dollar? Let me give you another example. Suppose the current account improvement occurs from a large decline in consumer spending and in the growth of consumer spending, because we have a lot of imports that we bring in from consumer spending, which is part of the current account deficit; we have an increase in the personal savings rate from the half percent or so that we have now to maybe 3 percent, that that was the source of the current account improvement, would that crash the dollar? Suppose we have a third possibility for improvement; a huge drop in IT spending, technology spending, equipment spending, investment spending—that's actually been a leader in our growth in the last decade—suppose that was the source of the current account improvement, wouldn't you get a different result? And finally, suppose we

had—and I think this is your case and I agree with this case in the direction of movement—some sort of crash of the economy and crash of imports, tremendously lower growth, whether that comes from a stock market crash or some other source like that. I think that could crash the dollar. And I would also ask you, in your analysis of the dollar reaction, which I find distinctly real sector and not at all financial system oriented, I don't believe the dollar is really set the way you calculate the response of the current account deficit in your model. I think the model's wrong. Though it's right analytically, I think it's wrong in reality.

There's another side of the dollar. It's what goes on in the other side; what goes on in the euro side and you don't really talk about that. So, I think, on the paper, I'm asking these questions but also suggesting to you that the paper ought to have some more qualifications and caveats because the conclusion upfront is so striking and so attention getting, which I don't mind, I just don't think you've put enough qualifications in the paper analytically and otherwise to properly present it.

*Ms. Krueger:* Bill Poole.

*Mr. Poole:* When I was in graduate school forty years ago, Milton Friedman pounded into me that it's a mistake to start with an exogenous change in an endogenous variable, and I think that that's essentially what we've got going here. And so I question the underlying rationale of the whole approach. It seems to me that we need to start from some policy mistake, change in technology, or something that sets the system in motion and then analyze together what's going on in the trade and capital accounts. But just to say that there is a cessation of capital flow into the United States for some reason unanalyzed seems to me not to be a right way to get moving on this subject. And so, I think that I would agree with the thrust of the points that Allen Sinai was making—that you have to go back and talk about what is it, what kind of policy error, for example, that might set the system in motion.

*Ms. Krueger:* John Makin.

**Mr. Makin:** Like Bill, I guess Milton Friedman pounded some things into me many years ago. But, I think this is a very interesting paper. Frankly, I think this paper, in effect, runs in reverse the Asian crisis. The Asian crisis involved the export of a lot of deflation from Asia because of a collapse of capital inflows. Well, here we're asking what would happen if there was a collapse of capital inflows to the United States and the United States started to export a lot of deflation through a sharp depreciation of the dollar, which, of course, is a large appreciation of the yen and the euro, and I certainly don't believe that European authorities would be happy to see the euro back at 120, notwithstanding all the chitchat we heard about it a year or so ago. So, I think one of the reasons this paper—by suggesting that global capital and commodity markets aren't as integrated as they might be and, therefore, that eliminating a 4 percent U.S. current account deficit would imply a 25 to 35 percent depreciation of the dollar—suggests exactly why it's sustainable. Foreign central banks are not going to sit back. Can you imagine the Bank of Japan sitting back? Well, maybe you could. God knows what they'll do, but the yen would go to 75. Japan already has deflation of between 1 and 1 1/2 percent, so you'd be imposing a massive deflationary shock on Japan and raising some very interesting possibilities for what the Bank of Japan ought to do. Likewise, the ECB; likewise, central banks in Latin America and this would be one way to rescue Argentina, I guess, but it's the hard way. Anyway, I think by suggesting plausibly how much of a dollar depreciation/appreciation of most foreign currencies would be required to eliminate the current account deficit of the U.S. You really suggest reasons for its sustainability and if you want to complete the analysis, I think probably what you need to do is build in a reaction function by foreign central banks and what they might do under these circumstances.

**Ms. Krueger:** Bob Heller.

**Mr. Heller:** If we'd been sitting here just a few years ago, we probably would have been talking probably only about the government deficit as a cause of the trade deficit. The "twin deficits" in those days were the most popular explanation of the current account imbalances. Today, the word wasn't even mentioned. The government

budget is in huge surplus. What has gone wrong in the adjustment process?

*Ms. Krueger:* Over there, Mr. Schoenholtz.

*Mr. Schoenholtz:* Just two related questions. Does the financing and use of the current account deficit matter? Would it not matter if we are borrowing in the form of equity to finance capital deepening and productivity gains or borrowing in the form of debt to finance increased consumption? Related to that, there is anecdotal evidence of a change in the home equity bias—certainly increasing trends in buying foreign equities. In addition, we are witnessing a massive capital inflow into the U.S. in the form of direct investment in addition to portfolio flows. Shouldn't that matter?

*Ms. Krueger:* Okay. Now we're going to go way over to the back, Mr. Darby.

*Mr. Darby:* Following up on Bill's original theme of you got to start with an exogenous shock, it seems to me that the shocks, if you're really talking about a long-run change in the deficit, have to either be something like we switch to a consumed income tax and drive up personal saving in the U.S. or we have a big new tax on capital in the U.S. or something that changes the risk premium on the U.S. relative to foreign securities. It seems to me that that's really where you have to start and then the timing changes dramatically. Ignazio's chart, you can sort of look at the usual two-year lag between the change and the real exchange rate and the change in the deficit, and I think that's a more plausible way to start.

*Ms. Krueger:* Michael Mussa, over here.

*Mr. Mussa:* Well, I am much more sympathetic to the approach taken by the authors in this paper. It seems to me that, relative to the standard macro model, what they add is a rationale for why the long-run relative price elasticities of the trade account to changes in the real exchange rate should be substantially larger than the shorter run elasticities. And I think that's something that probably is right

and accordingly—that a more gradual adjustment of the current account balance would probably involve a less dramatic change in the exchange rate. And I think that’s right as well. But, I don’t think we need to know everything about the sources of the change in the current account—to, nevertheless, rely on what seems to be a reasonably robust empirical relationship that relates the current account thought of, basically, as the trade balance to changes in the real exchange rate. And there is very little doubt that in order to adjust substantially downward the U.S. current account deficit 4 percentage points of GDP, there needs to be a substantial downward adjustment to the real foreign exchange value of the dollar. And that is a robust conclusion that arises from a variety of different models. I think it’s a sound conclusion also, but if this occurs relatively rapidly, it is likely to be more disturbing than if it occurs relatively more gradually.

And I would note two further things. One, we had the hard landing scenario of the dollar in the mid-1980s, and the U.S. economy did not seem to suffer catastrophic damage from a 50 percent downward correction in the real multilateral foreign exchange value of the dollar. And so, perhaps, we shouldn’t worry excessively about this issue though there are certainly some important concerns to keep in mind.

Second, as was suggested by Bob Heller, there is an important difference this time from last time, and this goes to the point raised by Bill Poole and others. This time, the counterpart of the current account deficit in terms of the savings investment balance is a massive disequilibrium in the private sector savings investment balance rather than the public sector savings investment balance. In order to correct the current account deficit on this occasion, somehow, some way private consumption and private investment spending are going to need to grow significantly less rapidly for a period of time than real GDP in the United States. If that happens primarily as a result of a slow down of investment where net investment now in the United States, physical capital is about 50 percent financed by foreign saving, then some of the rapid productivity growth that we’ve seen in the U.S. economy recently could be at risk because some of that rapid productivity growth is a result of capital deepening, which has been

financed to a substantial extent in recent years by net inflows of foreign saving.

**Ms. Krueger:** There's a question way back over here on the left, Mr. Chandross.

**Mr. Chandross:** On the issue of home bias and equity investment, I think one issue—and Kim Schoenholtz really alluded to this—that you're underplaying is the fact that for many investors, particularly in the U.S., rather than investing in foreign equities, they're just as happy to invest in shares of American companies that have large foreign operations. They just feel more comfortable with that. And I think you'd find the same occurring now from Europe to the U.S. where you have some of these very massive multi-billion dollar purchases of U.S. companies by foreign companies. And, therefore, you really need to adjust in some way the numbers you have in your paper about holdings of foreign equities by U.S. and foreign investors.

**Ms. Krueger:** Okay, Gordon Thiessen.

**Mr. Thiessen:** I wondered whether a mitigating influence that you might take into account isn't the degree of integration that's going on in North America, where Canada and Mexico are the United States' largest trading partners. And there's a degree of integration going on where you've got cross-border arrangements within companies to an increasing extent. And as you see things like business to business internet-related commerce taking place, it's taking place in a North American environment where shifts across borders seem to be less and less important. So, I would suggest that perhaps both trade costs and trade biases within North America are less than they might be when you look elsewhere and I think that could be a significant mitigating influence.

**Ms. Krueger:** Could you please pass the microphone right behind you to Mr. Eisenbeis?

**Mr. Eisenbeis:** I have three simple questions, and maybe this blends into the next session. First, what should be done, in terms of policy, based on the points that you've made?

Secondly, who should initiate these policy changes? The implication is the Federal Reserve is a player, but actually Treasury is a significant player in this whole area as well.

And finally, when should these policy moves be initiated and based on what criteria?

*Ms. Krueger:* Okay, over here. Second row, Mr. Hale.

*Mr. Hale:* I think part of the problem with this discussion is the language we're using. On Chart 7, you have the term "U.S. Net Foreign Debt." I think a more accurate term would be the U.S. Global Investment Deficit. Because, if we examine each of the countries on your table here, we'll see that the preconditions for crisis very much reflected the composition of the capital account, not the actual stock of debt. Let's just look at history.

In the U.S. in 1894, almost 95 percent of that so-called foreign debt was debt. It was British purchases of U.S. railway bonds. For Argentina, Brazil, and Mexico, the overwhelming component of that deficit was short maturity bank lending, dollar denominated as well. If we then go to Australia and Canada, we'll see a much larger share is, in fact, foreign direct investment—though Australia, in the mid-1990s, had a crisis briefly because it relied very heavily for a year or two on the sale of bonds to American investors who didn't really understand the exchange rate consequences of falling commodity prices; the same with Ireland. That was a huge government deficit funded by a mixture of bond sales and bank lending.

The fact is, if you decompose the U.S. capital account, you'll see that the composition of the capital flows right now is totally contrary to situations that produced crises in the past. We had, for example, last year \$250 billion of foreign take-over bids for U.S. companies out of total merger activity in the U.S. of 1.7 trillion dollars. On the European continent, total merger activity last year was only 500 billion dollars, almost half of that was in the U.K. It's quite possible, because of recent changes in German tax law, there'll be, in two or three years, an M&A market in Europe as big as in the United States

and that would then lead to a major transformation in the direction of capital flows. But, the fact is, it's hard to be as alarmed about FDI capital flows, especially M&A activity, as it would be about just selling bonds or relying on short maturity bank lending.

So, to get a sense of what causes a crisis, we really have to get into the details of the capital account and what defines this component—U.S. or global foreign investment deficit.

**Ms. Krueger:** Let's take one more question back over here, Mr. Brinner.

**Mr. Brinner:** I'd just like to reinforce some of the earlier comments about cause and effect because, to me, this current account deficit data point is just a data point in search of a problem. I think that if you look at the differential cyclical positions of the U.S., Europe, Japan, you can explain at least half of that. Just using kind of an estimate that the U.S. is 1 percent below the unemployment rate, which would be 2 1/2 percent of GNP and that the rest of the world is 3 percent higher on unemployment so 6 to 7 percent on GNP. Thank you.

**Ms. Krueger:** Okay. I'm going to turn it over to Ken and Maury for their response and then ask Ignazio if he has anything to add. I'd like to just add one question, which follows up on some of this, and that has to do with whether it makes a difference whether it's capital inflows that are driving the real exchange rate or whether, instead, it's the current account that's driving the real exchange rate in terms of the way you go. I raise this because some of us have been hearing quite a bit and I think Chairman Greenspan referred yesterday to the risk of a backlash in the protectionist sense here and that has to do with the degree to which the current account deficit is with the driver behind the real exchange rate.

**Mr. Obstfeld:** Okay, I can't possibly deal with all these questions in the time available, so I apologize to you in advance if I miss yours. Let me first thank Ignazio Visco for his comments and respond to a few of the points he raised.



On the point he raised about cyclical balances, certainly a lot depends on where you think full employment is for the United States and how much of an increase in the unemployment rate one would expect to see in an adjustment. And that's something that's quite hard to tell. Where the natural rate is is a subject of great controversy. Obviously, it goes without saying that there are caveats and standard errors on any such estimates relating to such uncertainties. On the other hand, there are also uncertainties that might cut the other way in terms of some of our parameters. But, within the range of estimates that he has given us from the OECD and ours, there's a considerable gap. But we have to recognize that there are uncertainties of estimation that make broad standard errors probably advisable. I agree with him and with several other commentators that the evolution of economic integration will continue. And as it does, the need for exchange rate adjustments, in the case of current account changes, will decline. The transfer problem is certainly going to be mitigated. What is surprising is the extent to which we still have a long way to go in terms of attaining the type of ideal of perfect economic integration that we like to build into some of our macroeconomic models. We could not, of course, in this paper, trace out the sort of scenarios and implications that one might want to do in a more detailed macro model. The OECD, the IMF have attempted to do this, so we sort of stood off in the paper from trying to think about what the implications might be—something that also relates to the comments Mike Mussa made.

A number of people talked about the source of the shock here. It's important to emphasize that we're looking at something here that's quite general in terms of our long- to medium-term scenario, which is just the implications for balance in the market for tradables versus non-tradables based on some very simple parameters. To the extent that we can cut the calculation down to something that's simple and hopefully quantifiable, we can at least know what exactly we are talking about. So, we deliberately tried to keep this simple and focus on one simple relationship in the goods market.

Now, is this a good model for thinking about short-run exchange rate determination? Of course not. We've tried to introduce into the

discussion some of the frictions and segmentation issues that might affect the exchange rate in the short run. But certainly, as we've tried to make explicit in the paper, much in the short run, particularly, would depend on the reaction of policy. We focused on Fed policy as being of primary importance to the dollar. The point is well taken that Central Bank policies in foreign countries might also play a role.

A number of commentators looked at, or mentioned the composition of the capital account. David Hale talked in particular about the composition of the net foreign investment position of the United States. And he is certainly correct that the composition of the net position is extremely important for thinking about vulnerability to crises. Vulnerability to crises, however, is not primarily what this paper is about. We're not really about liquidity crisis of the U.S. Certainly, to the extent that one has equity financed capital flows, longer term bond finance, obviously the risk of crisis goes down. But here we're simply saying what is the effect of a current account reversal? What is the effect of bringing spending into line with income? And we're not really taking a strong stance on why that occurs. One might think some sort of crisis scenario is likely or unlikely. It's obvious less likely, given the composition of net foreign debt, than if we had total short-term bond finance as something many developing countries had in the past.

On the point Gordon Thiessen raised, I think the predictions are that integration is going to continue. And it's certainly true in the empirical studies of U.S./Canada that if one moves from the late 80s into the 1990s, one sees a noticeable and very dramatic fall in the trade home bias and, certainly, this is something we would expect to continue as, hopefully, trade barriers continue to come down. I think I'll stop there and turn it over to Ken.

**Mr. Rogoff:** We are, of course, not looking at the sources of the shocks here. In part, we mentioned some. We feel this could happen across a broad range of models. I should say the models we have in mind are modern international macro models. And it's true that some of the 1970s style models that you may have learned earlier may not give exactly the same results, especially distinguishing the short run

from the long run. And finally, we're not making a firm prediction that the dollar's going to fall by 45 percent next week, but this is an Achilles heel in the Cinderella U.S. economy.

*Ms. Krueger:* Ignazio?

*Mr. Visco:* I think it is important to identify what triggers the correction. What are the terms of the correction as the policy responses are necessarily different? I agree that a current account adjustment cannot be treated as if it was an exogenous adjustment. On the other hand, it seems to me that it is a convenient and instructive exercise to identify the required change in exchange rate, provided that we use these as a reckoner for a further exercise—a higher level exercise, that examines the effects of the real source of the correction.

On Michael Mussa's point, I am not convinced that macro models in the Mundell/Fleming/Dornbusch tradition, i.e. the empirical counterpart of this theoretical model, do not allow, in principle, a return to a much lower required exchange rate adjustment, given the current account adjustment. In order to do the exercise correctly, one has to ensure that the model allows for the possibility of both full employment and price stability being maintained over time. One therefore needs overall stable conditions that allow for this possibility and a proper response on the part of monetary policy, knowing that in the long run the Philips curve is basically vertical. This is assumed in the paper rather than obtained by a clear policy reaction function. But I do not think that there is a major difference, in this respect, between standard macro models and the Obstfeld and Rogoff approach.