

**Testimony of**

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**“The Economic Outlook”**

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I want to thank Chairman Saxton and the Joint Economic Committee for the opportunity to testify. My remarks will focus on one particular aspect of the economic outlook--but a very important one--the payments deficit the United States is running with the rest of the world. I will make five key points:

- The US current account deficit has reached an unprecedented size for a major economy. Barring a sharp fall in oil prices, this deficit is likely to continue to increase in the next year, in part because of rising interest payments on the United States growing external debt.
- The US external deficit is a reflection of policy decisions, both here in the US and abroad, not just private saving and investment decisions. Both the large US fiscal deficit and the unwillingness of many economies to allow their currencies to appreciate against the dollar have contributed to the United States' large deficit. Net private flows have not been large enough to finance the United States current account deficit.
- Trade deficits of nearly 6% of US GDP are not sustainable over time. They imply a rapid increase in the US external debt to GDP ratio and a growing current account deficit.
- The availability of sufficient financing to sustain deficits of this size at current US interest rates should not be taken for granted. The larger the deficit, and the longer adjustment is delayed, the greater the associated risks.
- Policy actions, both at here and abroad, can help first to stabilize and then to reduce the US external deficit. The needed policy steps are by now well known, but no less urgent. A reduction in the US fiscal deficit would increase national savings, and thus reduce the United States' need to draw on the world's savings. Our trading partners need to show greater willingness to allow their currencies to appreciate and to take policy steps to encourage domestic consumption growth.

#### The current account deficit looks likely to continue to grow in 2006

The current account deficit is the sum of the trade deficit, the balance on transfer payments, and the balance on labor and investment income. This deficit totaled \$395 billion in the first half of the year, largely because of the \$346 billion trade deficit. The trade deficit is set to widen further in the second half of the year on the back of higher oil prices and the disruption to US oil production and refining created by Katrina and Rita. The current account deficit has until now largely tracked the US trade deficit, but this is likely to change going forward. The balance on investment income turned negative in the second quarter, and further deterioration is to be expected as higher short-term rates work their way through the US external debt stock. A surge in incoming transfer payments as European re-insurers make Katrina-related claims may offset some of this increase.

The 2005 trade deficit is likely to approach \$720 billion and, in conjunction with a transfers deficit of \$85 billion and a negative income balance, push the current deficit to around \$815 billion, or about 6.6% of US GDP -- up substantially from the \$520 billion (4.6% of GDP) deficit of 2003 and the \$668 billion deficit of 2004 (5.7% of GDP). In

dollar terms, the 2005 deficit will be about twice as large as the \$413 billion deficit of 2000, the peak deficit of the .com investment boom.

If both the US and the world continue to grow at close to their current rates in 2006, the current account deficit is likely to continue to widen in 2006. The recent increase in the trade deficit has been driven almost exclusively higher oil prices; monthly non-oil imports have been roughly constant since January. Subdued non-oil imports combined with strong export growth to lead the non-oil trade deficit to fall ever so slightly in the second quarter. However, this improvement in the non-oil balance is likely to be difficult to sustain in 2006. Strong export growth in 2005 reflects the lagged impact of falls in dollar/ euro in 2003 and 2004, plus a cyclical recovery in demand for civil aircraft. By 2006, the recent rise in the dollar is likely to begin to slow export growth. The slowdown in the growth of non-oil imports is therefore partially a reaction to the exceptionally rapid growth of these imports at the tail end of 2004. So long as the US economy continues to grow as expected, it is reasonable to expect growth in non-oil imports to resume, though at a lower rate than 2004.

The balance on investment income is likely to continue to deteriorate. Remember, the US will take on \$800 billion in new external debt over the course of 2005 to finance its ongoing external deficit. If that debt only carries an average interest rate of 5%, it implies an additional \$40 billion in external payments. The full impact of the Fed's recent tightening on short-term rates will also begin to manifest itself in 2006, as existing short-term debt is refinanced at a higher rate. The resulting 2006 current account deficit is likely to top \$900 billion, and exceed 7% of GDP.

The current account deficit essentially measures of how much we have to borrow from the rest of the world to support the amount we consume in excess of our income. It consequently is equal to the gap between what the US saving and US investment. The US budget deficit – a drain on national savings – is likely to increase in 2006 on the back of Katrina. Barring a fall in investment or rise in household savings, so the overall gap between overall national savings and investment is likely to continue to widen. Put differently, savings imported from the rest of the world will finance an increasing share of domestic US investment.

	2003	2004	2005 (f)	2006 (f)
Trade balance	-495	-618	-720	-780
o/w oil	-130	-175	-241	-260
Non-oil trade balance	-365	-443	-479	-520
Transfers balance	-71	-81	-85	-90
Income balance	46	30	-10	-65
Current account	\$520	\$668	\$815	\$935
(% of GDP)	(4.7%)	(5.6%)	(6.6%)	(7.1%)

## Policy choices in the US and abroad have contributed to the increase in the deficit

Current account deficits of this magnitude are without precedent for a major economy. As Dr. Bernanke has emphasized, these deficits have, to date, been financed at remarkably low interest rates. Indeed, current US interest rates seem, on their face, insufficient to compensate the central banks of the emerging market economies now financing the United States for the risk of further dollar depreciation. Consequently it is interesting to review the forces that have led to the emergence of such a large US external deficit.

The US current account deficit, by definition, has to be matched by a current account surplus in rest of the world. The fall in savings relative to investment in USA necessarily has been matched by a rise in savings relative to investment in rest of world. The US external deficit started to widen in the late 90s, as investment in the US surged and investment in certain Asian economies fell sharply. The US external deficit, surprisingly, did not fall when US investment fell sharply in 2001 and 2002, largely because changes in tax policy – along with an upturn in expenditure growth – turned a small structural fiscal surplus to a structural fiscal deficit of around 3% of GDP.<sup>1</sup> Since the fiscal deficit peaked as a share of GDP in 2004, the recent deterioration in the US current account deficit has been driven by a fall in household savings and a rebound in investment. This reflects a surge in investment in residential property, and, as Chairman Greenspan has emphasized, rising house prices also seem to be closely linked to the fall in US household savings.

Dr. Bernanke has noted that the main counterpart to the recent rise in the US current account deficit is not found in either Japan or Europe.<sup>2</sup> The eurozone's current account surplus fell between 1997 and 2005.<sup>3</sup> The roughly \$60 billion rise in Japan's current account surplus between 1997 and 2005 is far too small to account for the much larger rise in the US current account deficit. Rather, rising US deficits have been matched by rising surpluses in emerging and developing economies.

These surpluses have different causes. Emerging Asia's surplus has increased since 1997, driven first by the Asian crisis and, more recently, by the surge in China's current account surplus. Setting China aside, the savings rates in most Asian emerging economies have been constant. Their surpluses reflect a fall in investment, which fell (from quite high levels) during the crisis and have yet to recover. China is a different story: its national savings rate has soared to over 50% of its GDP, with most of the increase occurring recently. It is hard to find evidence of a global savings glut, but it is

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<sup>1</sup> IMF, 2005. See Table of 14 of the statistical appendix of the WEO. William Gale and Peter Orzag have reached a similar conclusion; see <http://www.brookings.edu/views/articles/20050214galeorszag.pdf>

<sup>2</sup> Ben Bernanke, "The Global Savings Glut and the US Current Account Deficit," The Homer Jones Lecture, April 14, 2005. <http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm>

<sup>3</sup> The eurozone's surplus fell from \$96 billion in 1997 to an estimated \$24 billion in 2005; Japan's surplus rose from \$97 billion to an estimated \$153 billion in 2005. The surplus of the Asian NICs rose from \$6 to \$80 billion, and a \$85 billion deficit in "other emerging markets and developing economies" turned into a \$410 billion surplus in 2005. IMF data and estimates.

hard to deny the presence of savings glut in China. Latin America has shifted from a deficit to a surplus, largely because improvements in the fiscal position of most Latin governments have pushed national savings rates up. Finally, rising oil prices have led to higher savings in the world's oil exporters.

It is important to note that private capital flows have not carried the savings surplus of emerging economies to the US. Rather the large scale flow of capital from emerging economies to the US is a function of policy decisions on the part of many emerging economies to resist pressures for currency appreciation – pressures stemming, in some cases, from rising current account surpluses and, in other cases, from private capital flows. In 2004, IMF data shows that private investors put \$150 billion more into the emerging world than they took out. Such private flows potentially could have financed a substantial current account deficit, or at least allowed emerging economies to reduce their large current account surpluses. However, in aggregate, these economies maintained current account surpluses, in some cases, quite large surpluses even as private flows picked up. Consequently, private flows to emerging economies generally have financed faster reserve growth, and thus have been recycled back to the US and Europe.

IMF data indicates that reserve accumulation by emerging economies has gone from \$116 billion in 2001 to \$517 billion in 2004.<sup>4</sup> In 2003 and early 2004, Japan also intervened heavily to prevent the dollar from depreciating against the yen. According to official US data, central bank financing of the US rose from \$116 billion in 2002 to \$278 billion in 2003 and \$395 billion in 2004 – and US data almost certainly understates total dollar reserve growth, and thus foreign central bank's indirect role in the financing of US deficits.

US data shows a substantial reduction of central bank flows so far in 2005. This data needs to be interpreted with some caution. Reserve accumulation, once adjustments are made for the falling dollar value of euro reserves, is still running at a roughly \$600 billion annual pace. Overall, global growth has not fallen, but the composition of countries adding to their reserves certainly has changed. Japan has stopped intervening, while reserve growth in both China and the world's oil exporters has picked. Almost all of Japan's increase in reserves showed up in the US data. However, recorded Chinese purchases of US debt in both 2004 and 2005 have equaled only about 40% of China's reserve increase. OPEC and Russia combined to run a current account surplus of perhaps \$200 billion in the first half of 2005, but – at least according to US data – they only purchased only \$5 billion in US long-term debt (and \$1.5 billion in US stocks). There are several ways to reconcile this data: China and the oil exporters may account for some of the increase in “onshore” central bank dollar deposits in the second quarter; they may have added to their offshore dollar deposits; they may have purchased US securities via intermediaries (inflows from the UK have been strong); or they may have built up their holdings of euros – driving down yields on European bonds and thus encouraging private capital to flow to the US.

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<sup>4</sup> The 2004 increase was inflated by perhaps \$60 billion as a result of the rising dollar value of euro reserves.

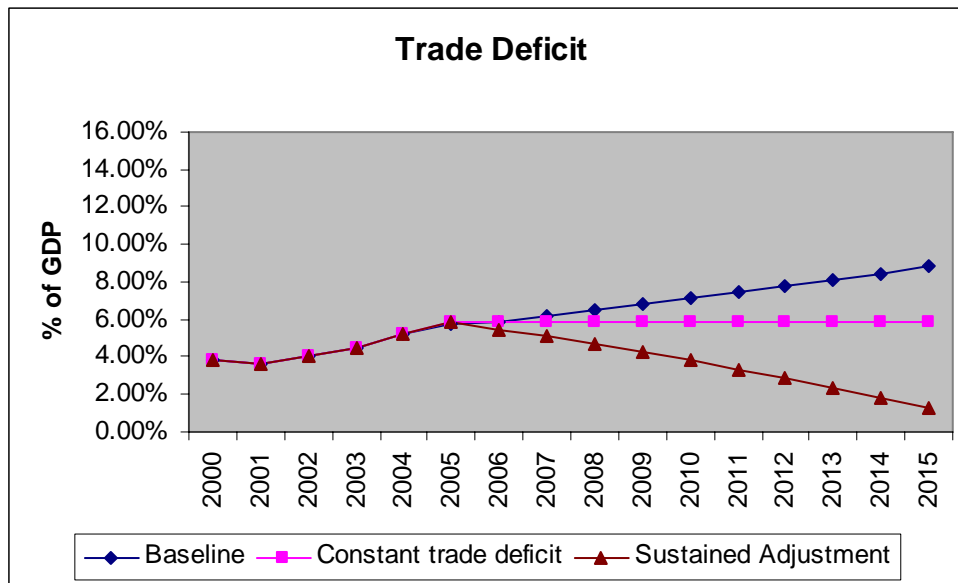
Consequently, in my view, rapid reserve growth my emerging economies continues to be a key reason why the US has been able to finance its current account deficit without difficulty.

Large trade deficits are not sustainable over time

The current US position differs from the US position in the 1980s in two key ways: the underlying deficit now is substantially larger, and US is by now a substantial net debtor. The 2005 current account deficit, combined with the reduced dollar value of American assets in Europe, is likely to lead the US net external debt<sup>5</sup> to increase to around 30% of US GDP at end of 2005.

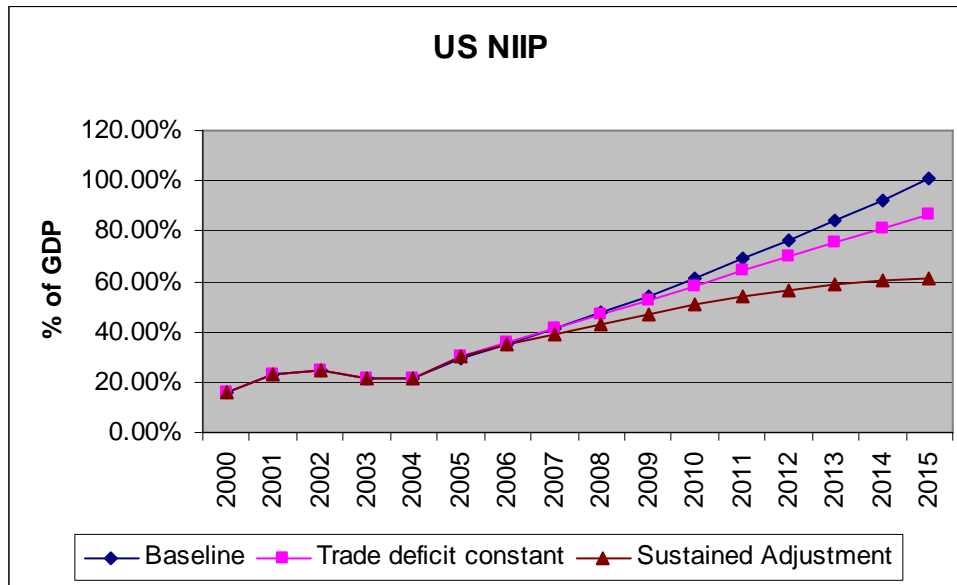
Basic external debt sustainability analysis implies that sustained trade deficits of the current level will lead to the United States net external debt to rise relative to GDP. Sustained trade deficits also imply a rising current account deficit, as the current account deficit includes interest payments on external debt. Stabilizing the US net external debt-to-GDP ratio at between 50-60% of US GDP (a relatively high level) requires the elimination of the trade deficit over the next ten years. Even in that scenario, the US current account deficit is likely to remain close to 3% of US GDP. If this adjustment is delayed, US external debt-to-GDP will stabilize at higher levels, net interest payments will be higher, and the US could eventually need to run substantial trade surpluses to avoid ongoing increases in its external debt-to-GDP ratio.

US trade deficit as a share of GDP: scenarios



<sup>5</sup> I am using net external debt as shorthand for the United States Net International Investment position. The international investment position includes US equity investment abroad, and foreign equity investment in the US. Since US equity (FDI and portfolio equity) investment abroad is worth more than foreign equity investment in the US, the negative US Net International Investment position is entirely the product of a large negative net debt position.

## Evolution of US net international investment position: Scenarios



Note: no adjustments for valuation gains associated with future dollar depreciation; dollar depreciation, particularly against the euro, pound and Canadian dollar, tends to increase the value of US external assets, and thus reduce US net debt

Relying on foreign savings to finance a substantial share of investment in the US implies that, over time, more and more of the income earned on investment in the US will need to be sent abroad. Here is one way to think about it: a Chinese company believed that the future income of Unocal, a US oil company, was worth about \$20 billion. Financing this year's current account deficit would therefore require selling off the future income of 40 Unocals. Since next year's deficit is larger, it would require selling off the future income of another 50 Unocals. The US has been financing its external deficits by selling debt not equity, but the basic principle is the same.

International experience also suggests that deficits associated with fiscal deficits and low levels of national savings are of greater concern than deficits associated with high levels of investment. The recent shift in composition of investment toward residential property is not particularly encouraging either: housing is not an obvious source of future export income.

### Short-term risks can be reduced with coordinated policy action

Even if the trade deficit stabilizes in 2006 and begins to fall in 2007, the US is likely to still need between \$900 billion and a trillion in financing from the rest of the world in each of the next two years. In the long-run, failing to make the adjustments needed to raise national savings and bring the US trade deficit down over time poses real risks to the US economy. In the short-run, though, the biggest risk is that market conditions will change suddenly. Should the market's demand for adjustment exceed the capacity of the US economy to adjust smoothly, US growth could slow – perhaps significantly. The dollar would fall and interest rates would rise, and the drag on the economy from

higher interest rates would exceed the stimulus to the US export sector from a falling dollar. US trade and current account deficits have built over time; we do not want to be forced to get rid of those deficits over night.

The combination of market forces and policy decisions that will bring about the necessary adjustment in the US trade deficit is subject to substantial uncertainty. But there is no doubt that the adjustment, when it comes, will require substantial changes in the drivers of growth, both in the US and among our trading partners. In the US, consumption must grow more slowly than overall income, generating an increase in savings. Some sectors of the economy that currently are doing well may do less well, and resources will likely shift into the production of tradable goods and services. As Former Treasury Assistant Secretary and long-term director of the Federal Reserve's international staff, Edwin Truman has emphasized, overall US growth could slow even during a relatively orderly adjustment process. Conversely, countries that until now have relied heavily on US demand growth to spur their own economies will have to find new motors to propel their own growth. Just as the composition of growth must change here in the US, so too must it change abroad. After a period of time when US imports have grown faster than US exports, the world is likely looking at an extended period when US exports will grow faster than US imports.

Recent studies by the staff of the Federal Reserve Board offers hope that the adjustment process will prove to be relatively smooth, and need not involve either a sharp rise in interest rates or a large slowdown in growth. However, caution is still in order. The US is in many ways operating outside realm of historical experience. The US current account deficit now is far bigger than the deficit of the 1980s. The US trade deficit is exceptionally large relative to the US export sector. In 2004, the US exported more "debt" than "goods." The US is starting the adjustment process with very low long-term interest rates. The US has significant assets abroad, which can help ease the adjustment process, but also very large gross external debts. Any sustained increase in US interest rates could have a significant impact on the size of US external interest payments. The adjustment process in the world's largest economy will have far larger impacts on the rest of the world than past adjustments in smaller economies.

International experience certainly suggests one clear lesson: as a country's external debt grows, it becomes more, not less, important to maintain fiscal policy credibility. Reducing the US fiscal deficits is the easiest and most certain way to bring about the needed increase in US national savings; it is likely to prove central to maintaining the confidence of the United States external creditors during what could be a long period of adjustment. Work by the IMF and OECD suggest that a \$1 reduction in the fiscal deficit would lead to a forty to fifty cent reduction in the US current account deficit.

Just as policy changes here in the US can help to increase US savings relative to investment, policy changes in the rest of the world can raise their consumption growth relative to their income growth, raise their imports relative to their exports and reduce their savings relative to their investment. China, Malaysia and many oil exporting countries need to be willing to allow their currencies to appreciate against the dollar. All



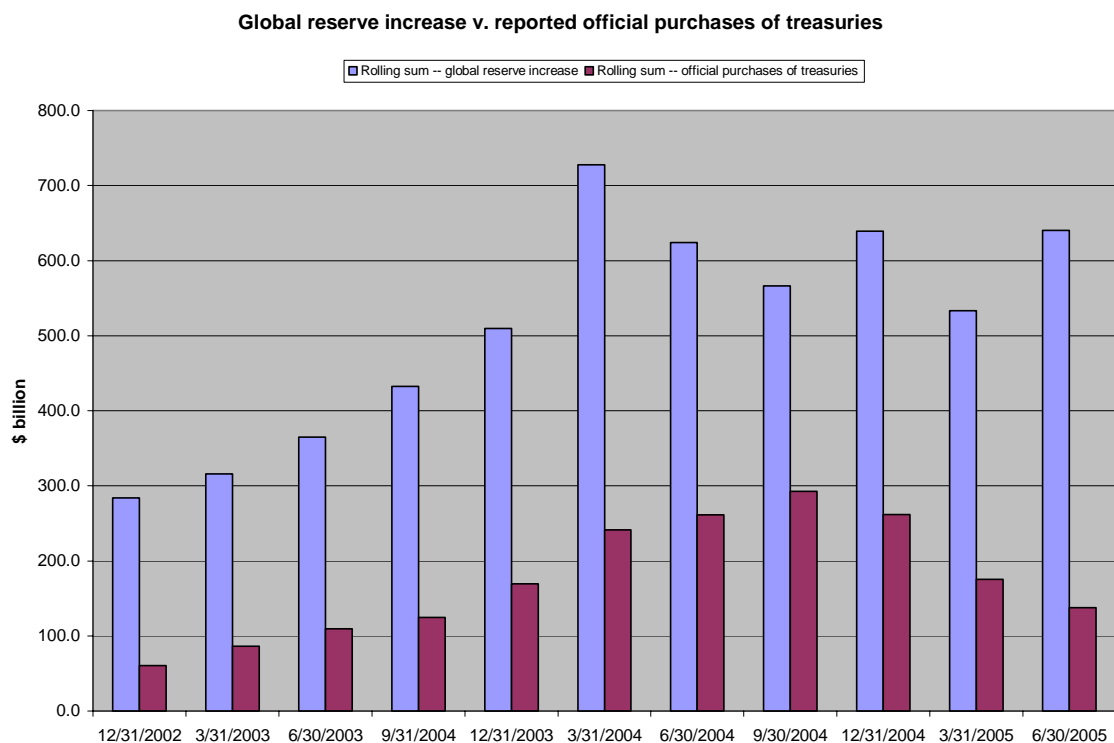
these countries are now running large current account surpluses, and countries with big surpluses cannot peg, or otherwise tie their currencies tightly to dollar, without impeding effective adjustment in the global balance of payments. If higher oil prices are sustained, oil exporters will need to spend more and save less. The low level of consumption in China relative to Chinese GDP suggests that there is substantial scope, with appropriate policies, for strong consumption growth in China to replace strong consumption growth in the US as the driver of global demand growth. Continental Europe needs to direct its domestic macroeconomic policies toward supporting domestic demand during the adjustment process.

The expansion of the US trade deficit reflects mutually reinforcing policy choices, both here in the US and abroad. The stabilization and eventual fall of the US deficit will also be far smoother if this process is supported by appropriate policy changes. No doubt, market forces will eventually demand adjustment even in the absence of policy changes. But, as both New York Federal Reserve President Timothy Geithner and former Treasury Secretary Robert Rubin have emphasized, without supportive policies, the needed market moves are bigger and the risks of disruptive market moves are substantially higher.

## Central bank financing of the US current account deficit

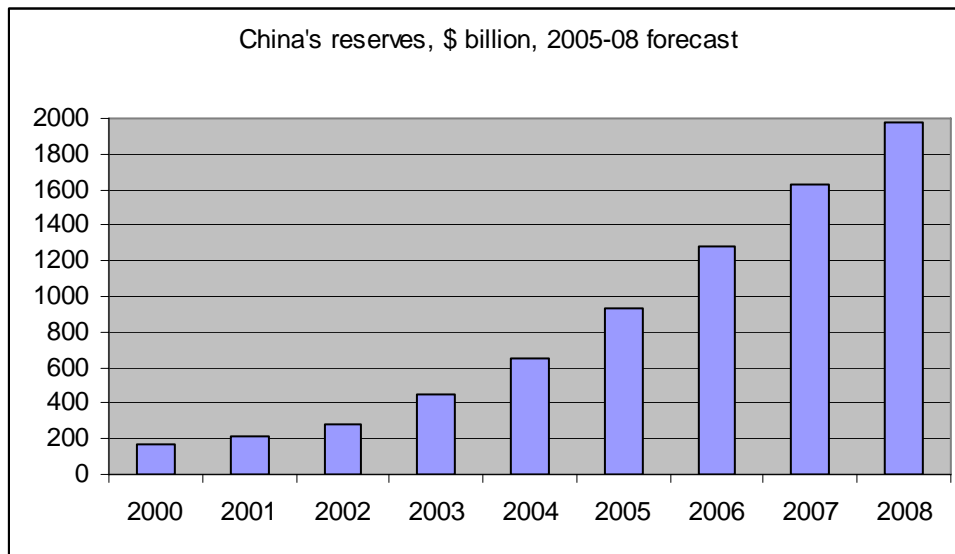
	2002	2003	2004	2005 (f)
US current account deficit	475	520	668	815
Central bank financing (BEA data)	116	278	395	205
As % of deficit	24%	53%	59%	25%
BIS estimate for increase in dollar reserves <sup>6</sup>	187	423	498	?
As % of US deficit	39%	81%	75%	?
Memo: global reserve increase, all currencies (Setser estimates, based on IMF data with adjustments for valuation changes)	285	510	640	600

Four quarter sum of increase in global reserves v. four quarter sum of central bank purchases of US Treasuries.



<sup>6</sup> Includes the increase in central banks “offshore” dollar deposits reported in the international banking system. See Robert McCauley, “Distinguishing global dollar reserves from official holdings in the United States,” BIS Quarterly Review, September 2005. For more on different measures of central bank financing of the US, see Matthew Higgins and Thomas Klitgaard, “Reserve accumulation: implications for global capital flows and financial markets,” Current Issues in Economics and Finance, Volume 10, no. 10. Federal Reserve Bank of New York. September-October 2004.

Chinese Reserves, including reserves transferred to state banks



Recorded Chinese Purchases of US assets v. Chinese Reserve accumulation

	T-bills	Treasuries	Agencies	Corp. Bonds	Foreign	Total in US data	Estimated change in reserves (adjusted for valuation)	%
2002	0.2	24.1	29.3	6.1	3.5	63.1	74.5	85%
2003	0.3	30.1	29.4	4.5	4.0	68.4	157	43%
2004	17.3	18.9	16.4	12.1	3.0	67.4	194	34%
Jan-June 2005	2.5	17.3	11.3	13.2	4.3	48.7	137	35%
2005 f						110	275	40%

From: derived from Prasad and Wei (2005), updated to reflect 2005 TIC data. See <http://www.hbs.edu/units/bgie/seminarpdfs/Prasad%20IFC%20Supplement.pdf>