Rebalancing the U.S. Economy in a Post-Crisis World

Submitted by: University of Michigan
Rebalancing the U.S. Economy in a Post-Crisis World

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The Problem: Major Global Imbalances

- Large, persistent US external deficits
  - Shift from Creditor to major Debtor
- Matched by surpluses in Asia and OPEC
- Gradual adjustment underway in 2007-08
- Financial Crisis erupted in late 2008
  - Severe global recession
  - Trade collapse temporarily reduced external deficit
- Prognosis for rebalancing in recovery?
Figure 4.1. Global Imbalances
(Current account balance in percent of world GDP)

Global imbalances narrowed sharply in 2009 owing to both cyclical and more lasting developments. Imbalances are projected to widen once again as the global recovery takes hold.

Source: IMF WEO April 2010

Figure 1: U.S. External Balance, 1980-2010
Two Perspectives

• Expenditure Switching - RER Depreciation
  – CA ≈ X-M = f(Y_f, Y_d, RER)
  – External Balance - Focus on trade, exchange rates, openness

• Expenditure Changing – Raise Nat’l Saving
  – X-M = (S_{private} + S_{gov}) – I
  – Internal Balance - Focus on national income vs. spending, saving vs. investment
  – Generally assumes full employment

Figure 7:
Exports and Imports, 1980-2009
- Exports: a similar % of GDP: 1980 & 2000
- Imports: steady rise (pre-crisis)
US Trade Deficit- Why So Persistent? 
(External Balance Perspective)

- US Openness – Mainly Imports
- Traditional ‘elasticity pessimism’:
  - low price elasticity: 10-15% real depreciation for 1 pp of GDP decline in deficit
  - Houthakker-Magee: imports more sensitive to US income growth than exports to ROW income
- GOOD NEWS more recently:
  - Price elasticities of trade increased (need 8-15%)
  - Income asymmetry has disappeared
- BUT – ‘Export Pessimism’?
  - Shift: A given trade balance requires a weaker $
  - US ‘under-performs’ as an exporter

Figure 2:
Real Exchange Rate Measures: 1975-2010
-Large swings
-Strong (lagged) inverse correlation with trade
**Figure 3. Correlation of Non-oil Trade Balance and Real Exchange Rate, 1980-2008**

- Strong Inverse Correlation: RER and Trade Balance
- BUT Evidence of shift since early 1990s

**US an Export Under-Performer?**

Gravity Trade Models for US, Japan & EU

<table>
<thead>
<tr>
<th></th>
<th>Exports/GDP</th>
<th>Imports /GDP</th>
</tr>
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<tbody>
<tr>
<td>Weighted Distance</td>
<td>-1.123</td>
<td>-1.007</td>
</tr>
<tr>
<td></td>
<td>(-63.4)</td>
<td>(-38.6)</td>
</tr>
<tr>
<td>United States</td>
<td>-0.609</td>
<td>0.012</td>
</tr>
<tr>
<td></td>
<td>(-25.1)</td>
<td>(0.3)</td>
</tr>
<tr>
<td>Log Avg. RER</td>
<td>-1.119</td>
<td>0.586</td>
</tr>
<tr>
<td></td>
<td>(-8.7)</td>
<td>(3.1)</td>
</tr>
<tr>
<td>adj_R2</td>
<td>0.849</td>
<td>0.762</td>
</tr>
<tr>
<td># Observations</td>
<td>10570</td>
<td>10433</td>
</tr>
</tbody>
</table>

regressions also control for population, GDP per Capita, etc)
II. Internal Balance Perspective

- Strong US performance pre-crisis
  - Job growth, productivity, low inflation
  - External balance improving (soft landing)
- CA deficits reflect: \( \text{AD} > \text{Y} \); \( \text{S} < \text{I} \)
  - Driven by surge in private consumption
    - Secular decline in household saving
  - Crisis: decline in CA deficit associated with
    - Investment collapse
    - National saving turned negative: Gov’t deficit
- Focus: Household Saving & Fiscal Policy

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**U.S. Net Saving and Investment by Sector**

Percent of National Income

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<thead>
<tr>
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<tbody>
<tr>
<td>Saving</td>
<td>10.9</td>
<td>6.5</td>
<td>5.4</td>
<td>3.6</td>
<td>-0.2</td>
<td>-2.8</td>
</tr>
<tr>
<td>Private</td>
<td>10.9</td>
<td>10.0</td>
<td>6.9</td>
<td>5.3</td>
<td>5.3</td>
<td>7.5</td>
</tr>
<tr>
<td>Government</td>
<td>0.0</td>
<td>-3.6</td>
<td>-2.4</td>
<td>-1.7</td>
<td>-5.4</td>
<td>-10.1</td>
</tr>
<tr>
<td>Investment</td>
<td>11.1</td>
<td>9.4</td>
<td>7.9</td>
<td>8.4</td>
<td>6.2</td>
<td>1.5</td>
</tr>
<tr>
<td>S-I</td>
<td>-0.2</td>
<td>-2.9</td>
<td>-2.5</td>
<td>-4.8</td>
<td>-6.4</td>
<td>-4.3</td>
</tr>
<tr>
<td>Current Account</td>
<td>0.4</td>
<td>-1.8</td>
<td>-1.7</td>
<td>-5.5</td>
<td>-5.6</td>
<td>-3.5</td>
</tr>
<tr>
<td>Statistical Discrepancy</td>
<td>0.7</td>
<td>1.1</td>
<td>0.8</td>
<td>-0.7</td>
<td>0.8</td>
<td>1.5</td>
</tr>
</tbody>
</table>
**Private Saving Decline**

- Secular decline in saving is a primary factor behind external imbalance
  - Extends over quarter century from mid-1980s
  - Concentrated in household sector: WHY???
    - Rise in Wealth (~ 5-7 pp to saving decline)
    - Housing market innovations: easy to borrow
      - But baby-boomers should have raised saving
- Wealth-income ratio rose despite saving fall
  - Surge in capital gains
  - Corporate equities and residential real estate

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**Household Wealth as a Ratio to Income, 1970-2008**
Rise in wealth may have contributed to consumption boom

![Graph showing Household Wealth as a Ratio to Income, 1970-2008.](graph.png)
Private Saving: Trend Decline Reversal? Uncertain

• **YES:** Save to restore desired wealth ratios (Life-cycle model)
• **NO:**
  – Expect dissaving as baby boomers retire
  – Public pensions vs. retirement accounts
• Any reversal likely to be modest
• National Saving recovery will require fiscal adjustment

US Fiscal Balance

• Financial crisis has had a dramatic effect on fiscal outlook
  – Prior deficits were small, but
  – Rising cost of Middle East wars
  – Growing future costs of health care for elderly
  – Baseline budget assumes repeal of Bush tax cuts (politically unlikely)
• Huge fiscal stimulus assumed temporary
  – Obama initiatives comparable to 2nd stimulus
• CHALLENGE: Balance Deficit Reduction vs. Unemployment Reduction
Federal Revenues and Expenditures, 1980-2019
Percent of GDP

www.fordschool.umich.edu
III. Post Crisis Outlook (1)

- Expectations of a slow recovery
  - Financial crises tend to last longer than normal recessions
    - Damage to financial system
    - Deleveraging of financial institutions
    - Limited lending capacity
    - Households rebuilding balance sheets
  - Weak investment outlook
  - Employment lags GDP
    - Major concern: long-term unemployed
Post Crisis Outlook (2)

• Weak domestic demand – more stimulus?
  – 2 fiscal stimulus scenarios generate employment, but unsustainable fiscal and external deficits.
    • Fiscal deficit would be financed through the external sector (Both deficits already too large)
• U.S. recovery will need export component
  – Corporate tax reform & competitiveness?
  – National export initiative?
• Limited US tools to achieve rebalance
• Global rebalance: requires adjustment from surplus & deficit economies

Post-Crisis Outlook (3)

• Current outlook: external deficit in range 3-4% GDP
  – Weak US growth containing imports
  – Need continued weak RER for export growth
  – Gradual internal rebalance
    • Requires fiscal adjustment
    • But from a more distorted S & I position post-crisis
• Risks:
  – Global competition for markets – trade frictions
  – Increased reliance on capital controls as means to influence current account.
  – Uncertain exchange rate outlook
    • European financial concerns
    • Renewed capital inflows?
  – Challenging US fiscal transition