

Exchange Rates and The Balance of Payments

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Outline

Forecasters see a possible disorderly correction of the U.S. current account deficit as a key risk to the global outlook.

Why has the U.S. current account balance deteriorated?

- accounting perspective
- structural perspective

Are recent trends in the U.S. current account sustainable?

Requirements for substantial improvement

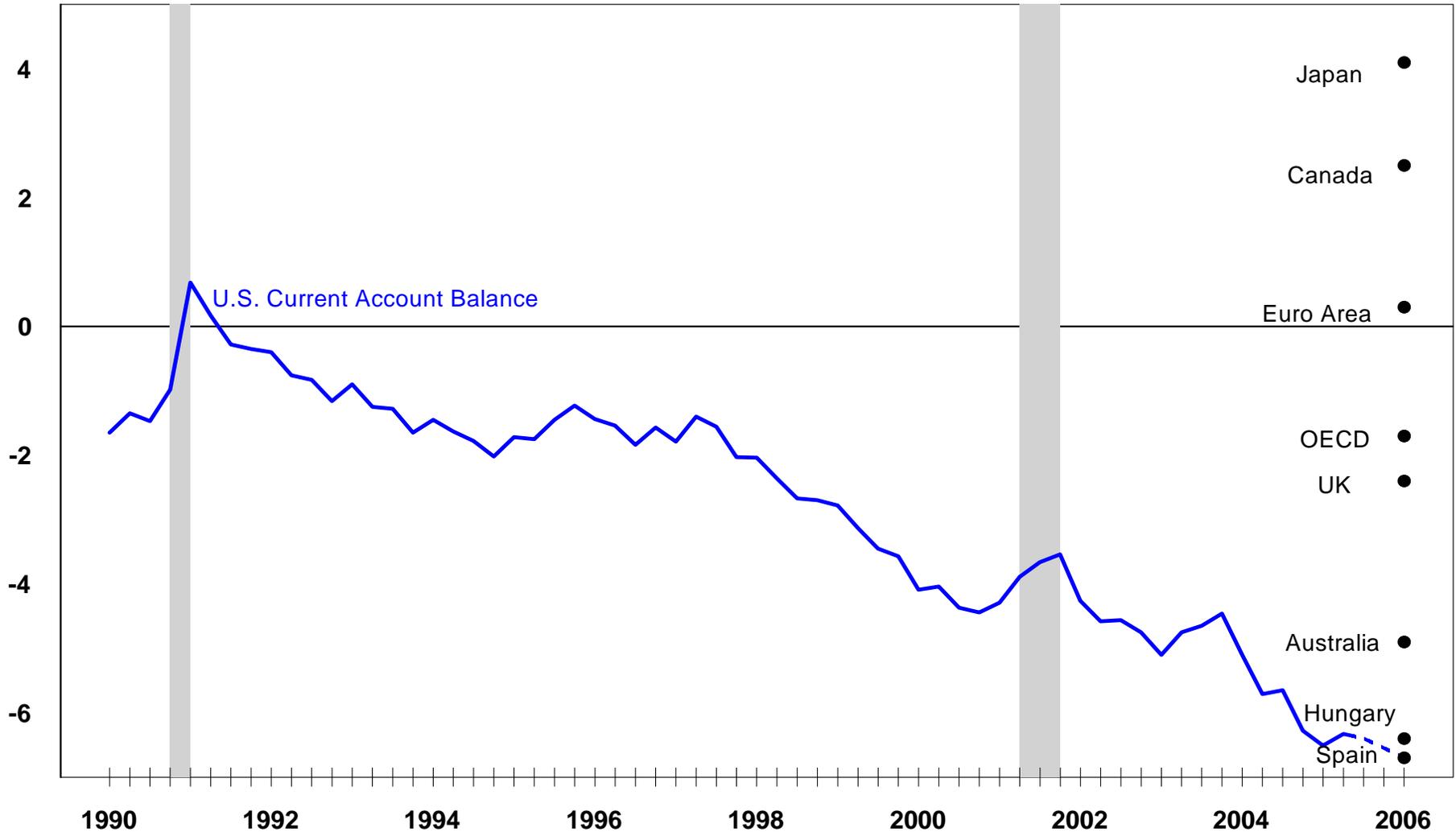
- a pick up in foreign demand growth and/or
- further dollar depreciation and/or
- increasing U.S. saving relative to investment

Policy choices here and abroad

- monetary policy is a blunt instrument
- fiscal restraint can be focused on consumption
- thus, fiscal policy is the tool of choice for increasing savings without curbing investment
- ongoing structural change in foreign economies could help

The U.S. current account deficit, forecast to hit new records relative to GDP, represents a key risk to the global outlook.

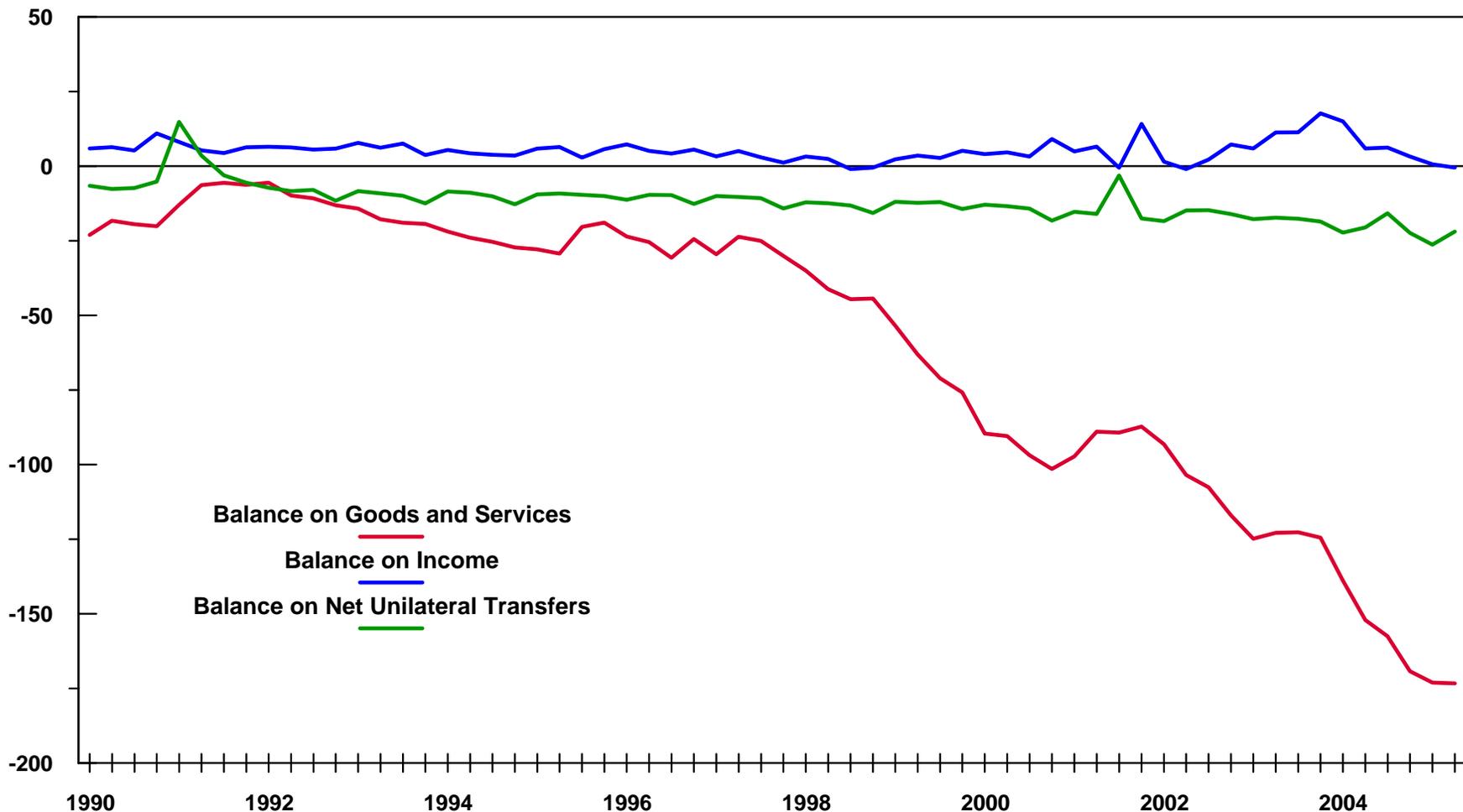
Percent of GDP



Source: Bureau of Economic Analysis.
Forecast: OECD Economic Outlook, No. 77, June 2005.

The decline in the U.S. current account largely reflects trends in the trade balance. In future, net income flows are likely to turn negative too.

Billions of USD*

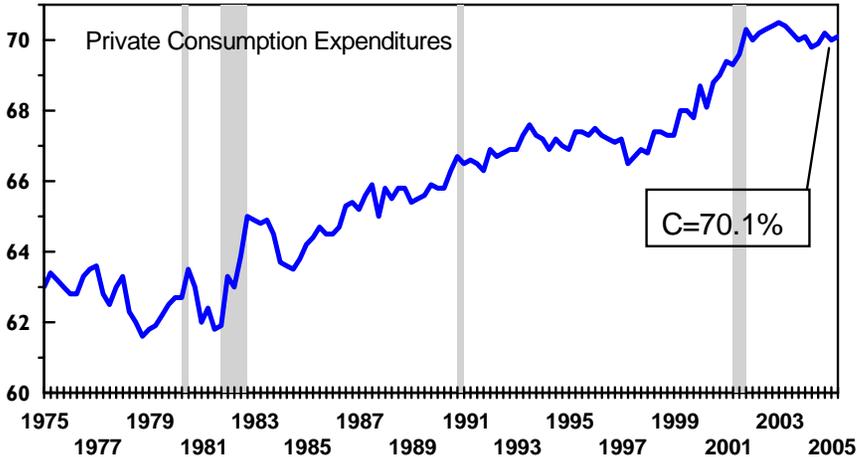


* Quarterly data, seasonally adjusted.

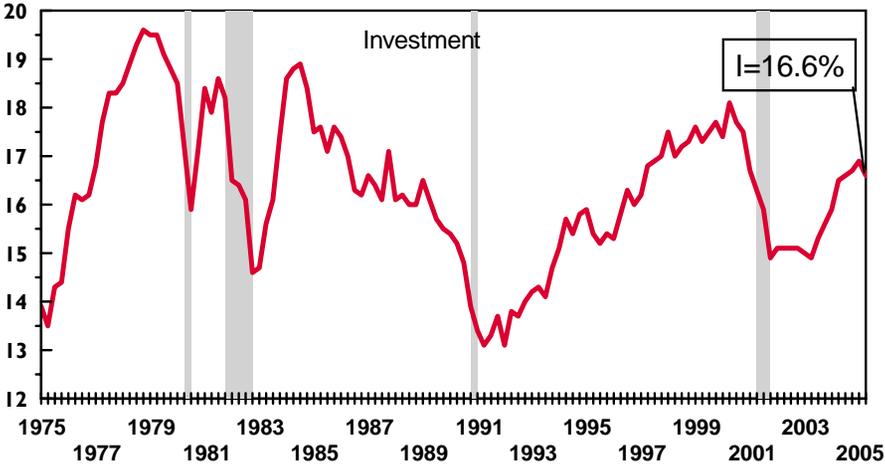
Source: Bureau of Economic Analysis.

Why has the current account worsened? Because U.S. consumption and investment have grown faster than U.S. output, and foreigners have lent us funds for imports to fill the gap.

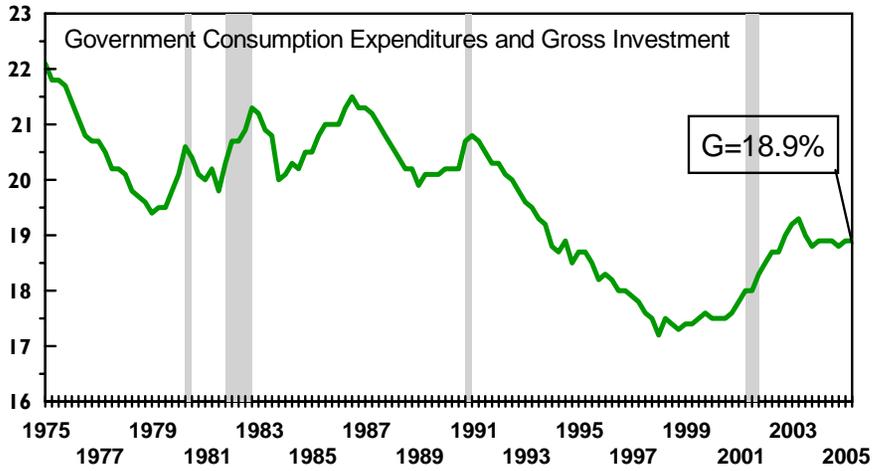
Percent of Nominal GDP



Percent of Nominal GDP



Percent of Nominal GDP



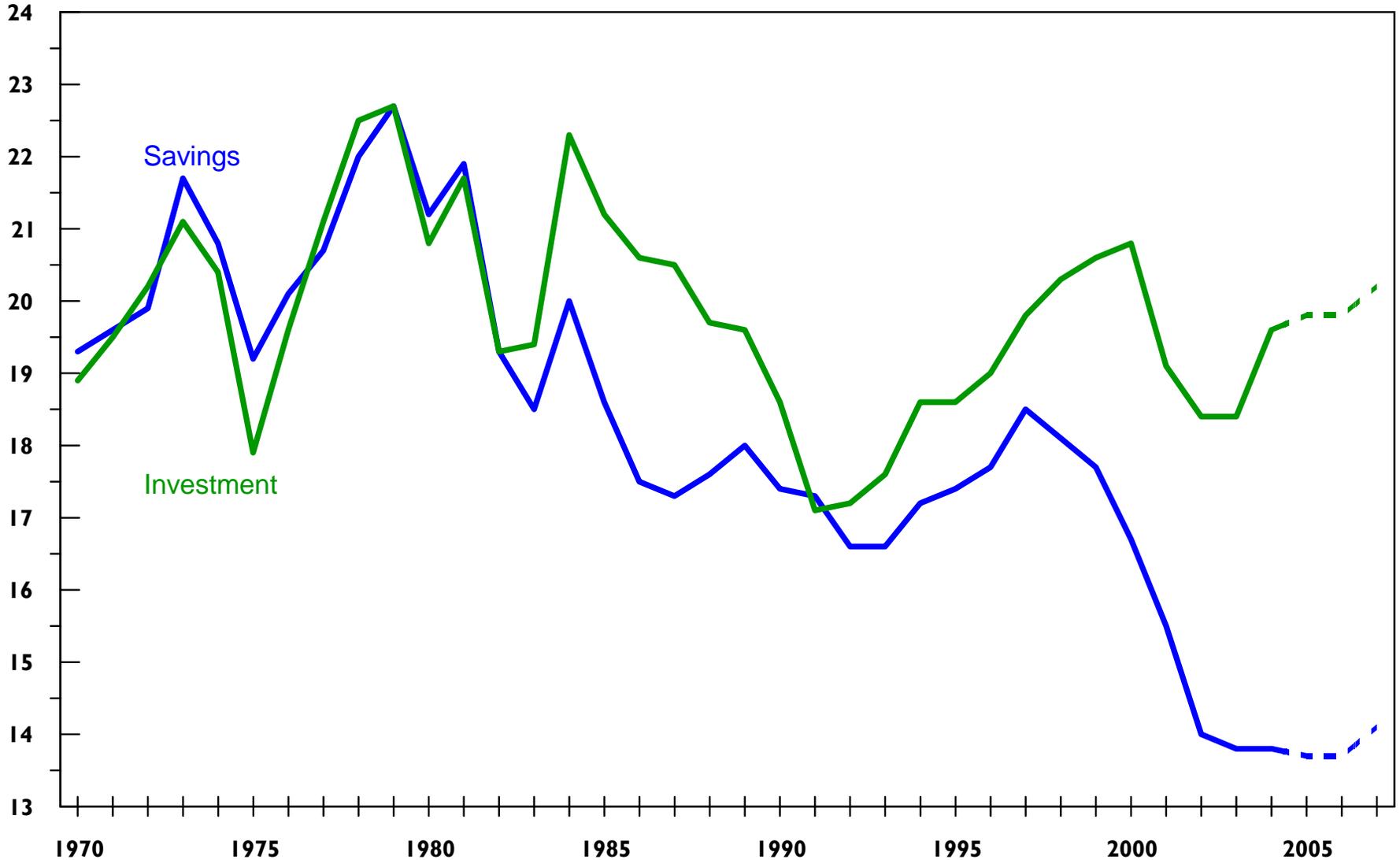
Percent of Nominal GDP



Source: Bureau of Economic Analysis.

Equivalently, U.S. investment increasingly exceeds U.S. saving...

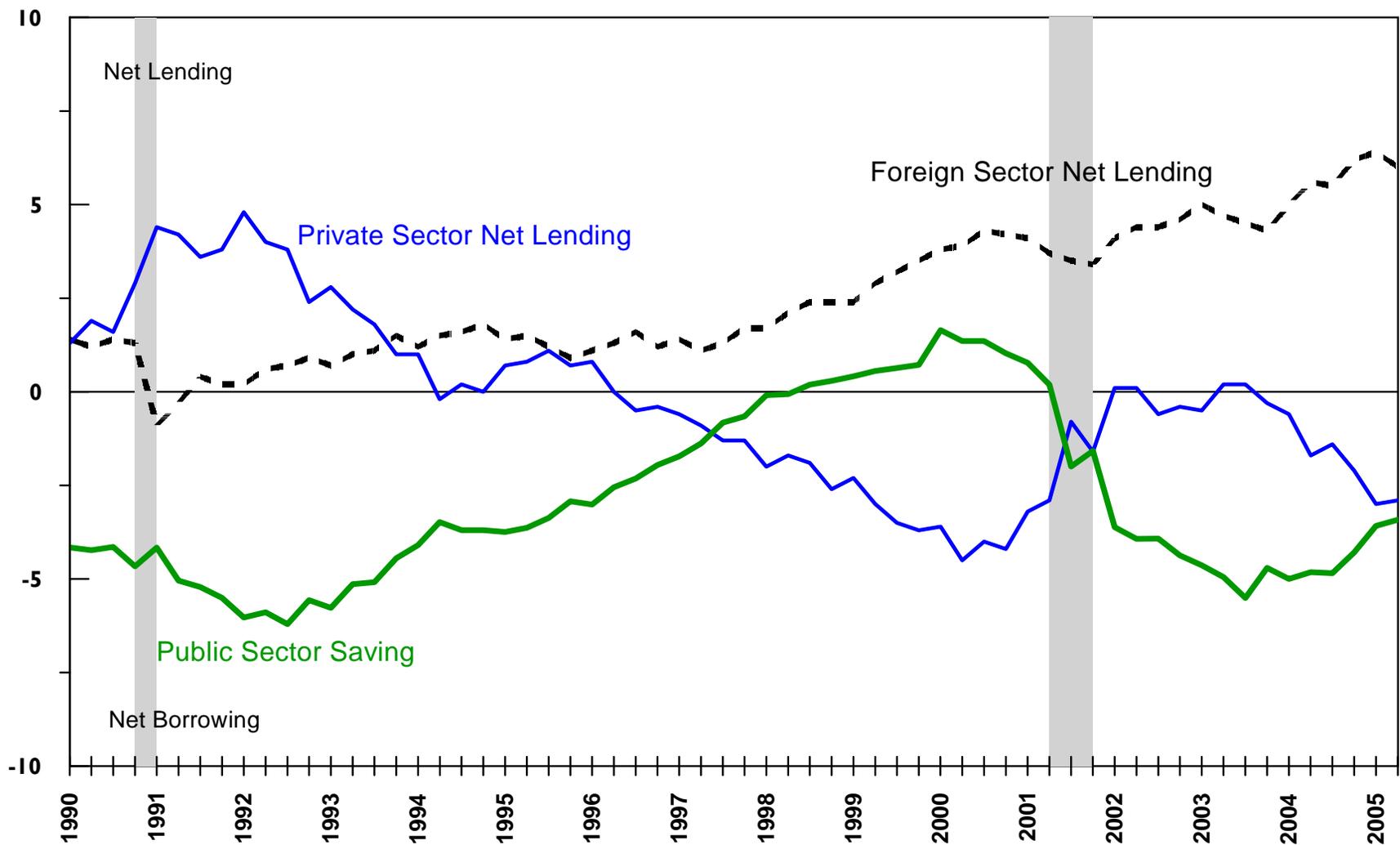
Percent of GDP



Source: IMF, *World Economic Outlook*, September 2005.

as foreigners have willingly financed a growing fiscal deficit plus modest net borrowing by the private sector --

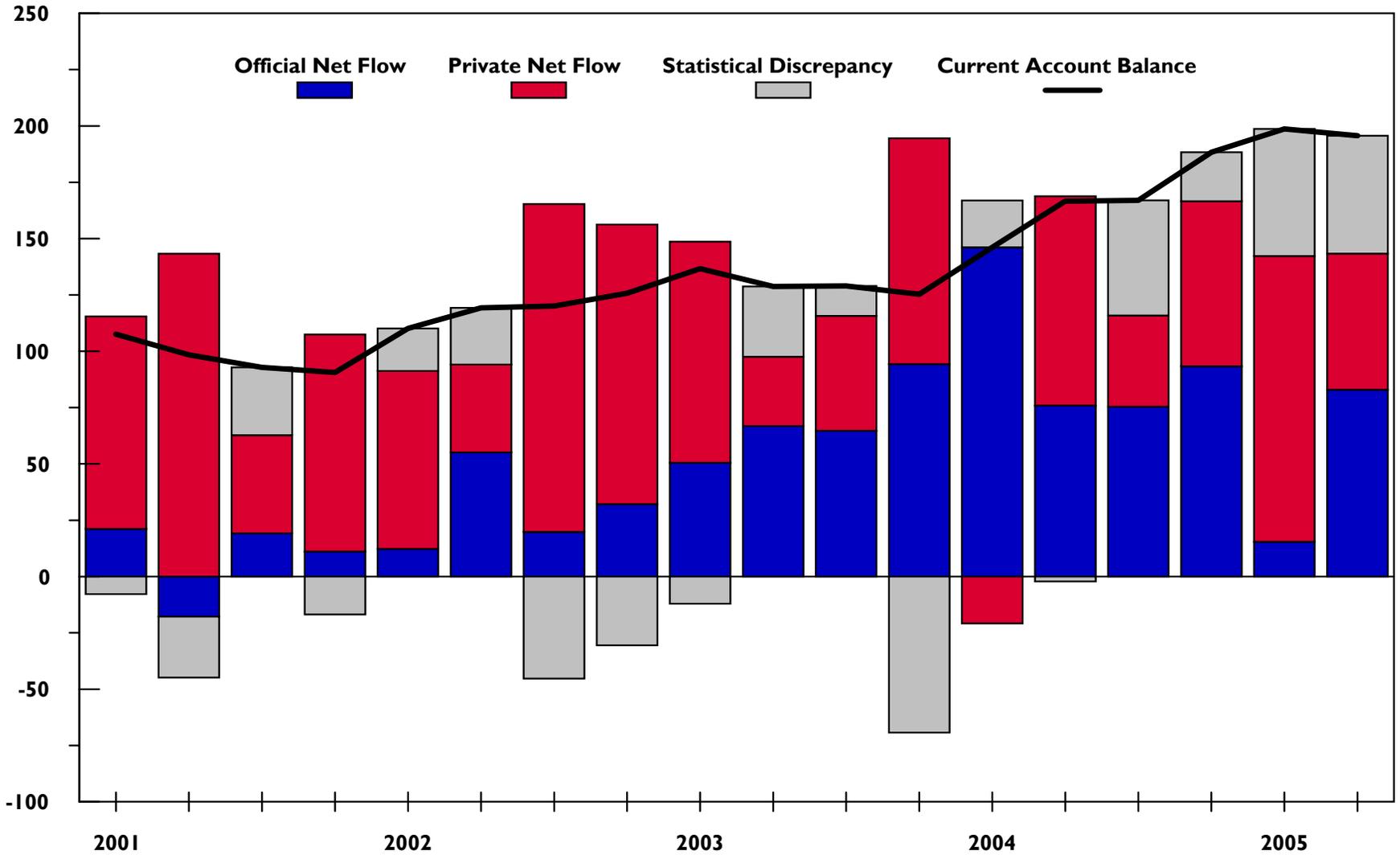
Percent of GDP



Source: Federal Reserve Board.

...although in recent quarters official investors have played a larger role than before.

Billions of USD

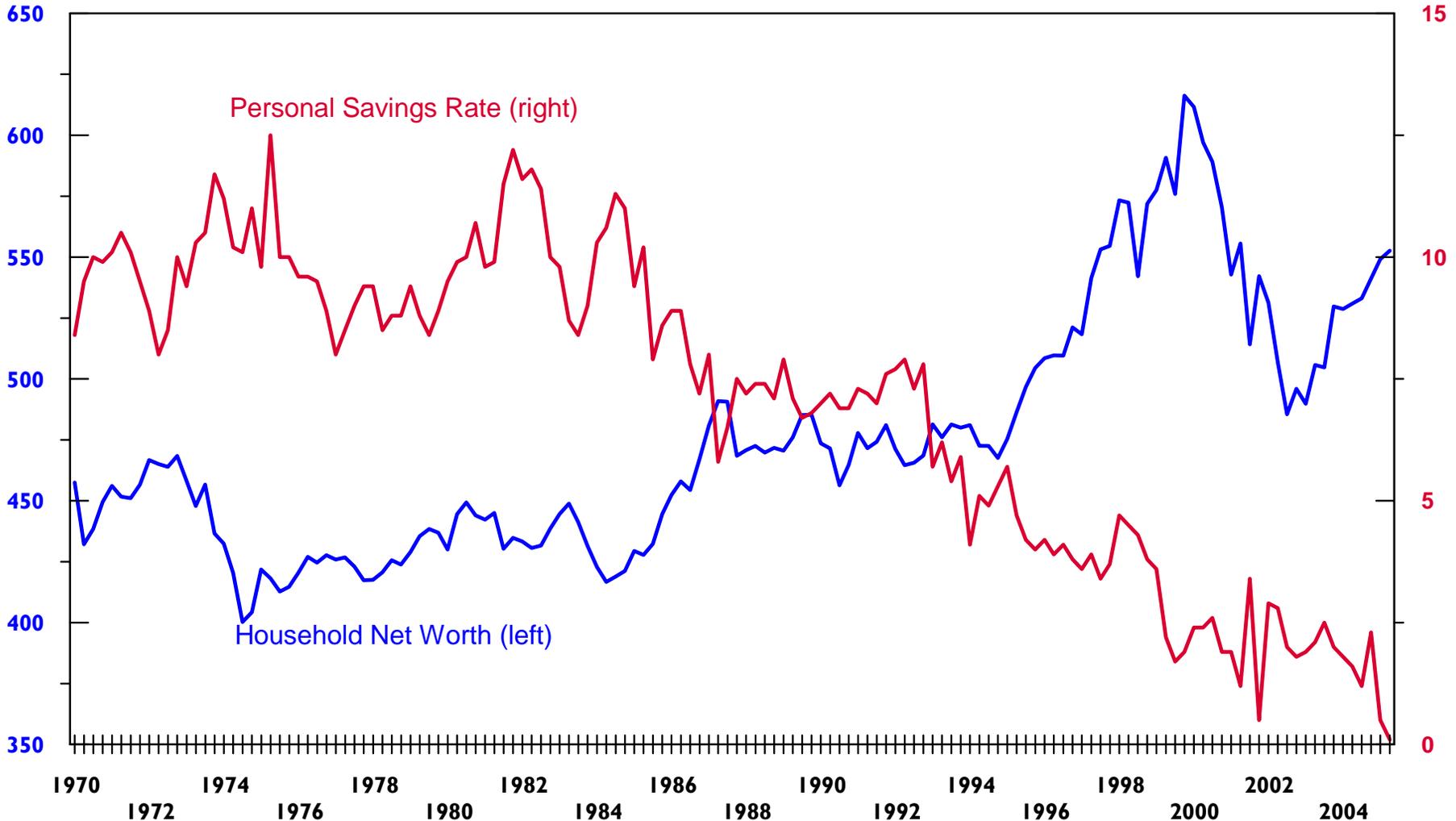


Source: Bureau of Economic Analysis.

Why has the personal savings rate declined? One important reason may be the rise in housing wealth and financial innovations that let home owners tap into it.

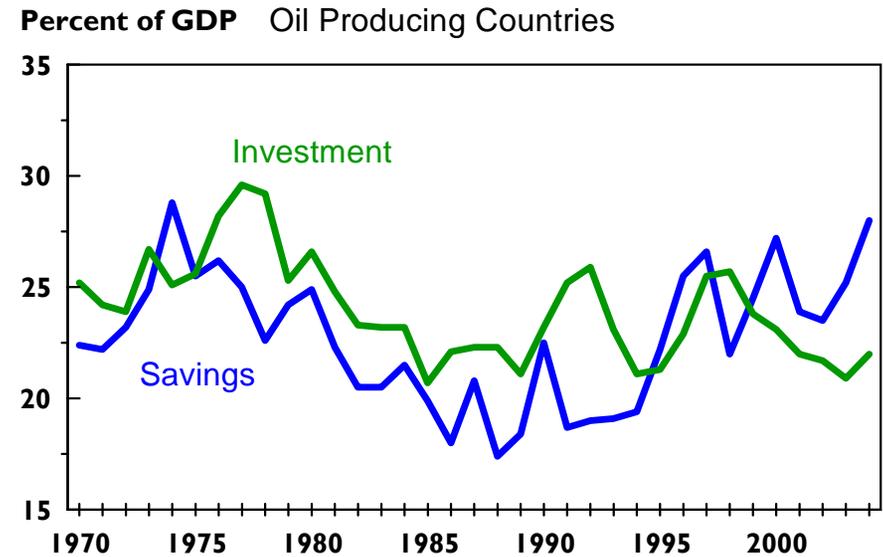
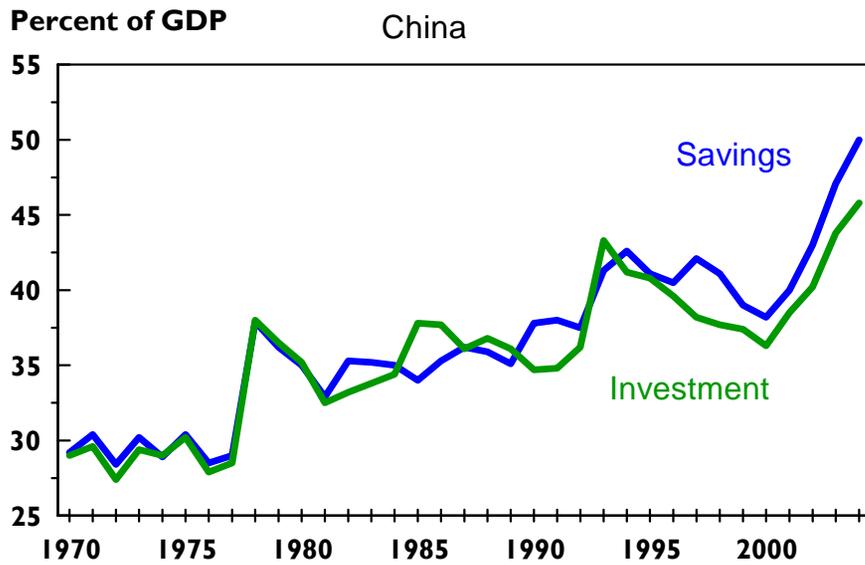
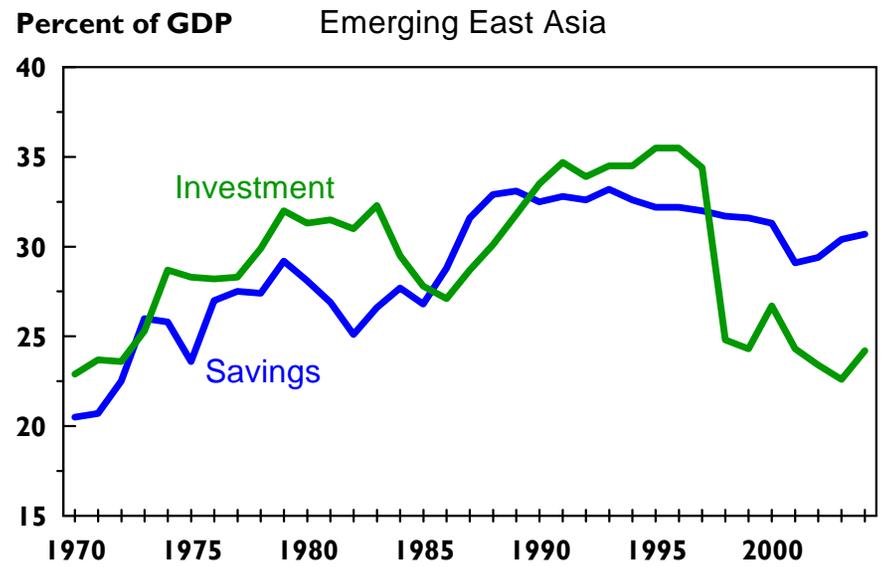
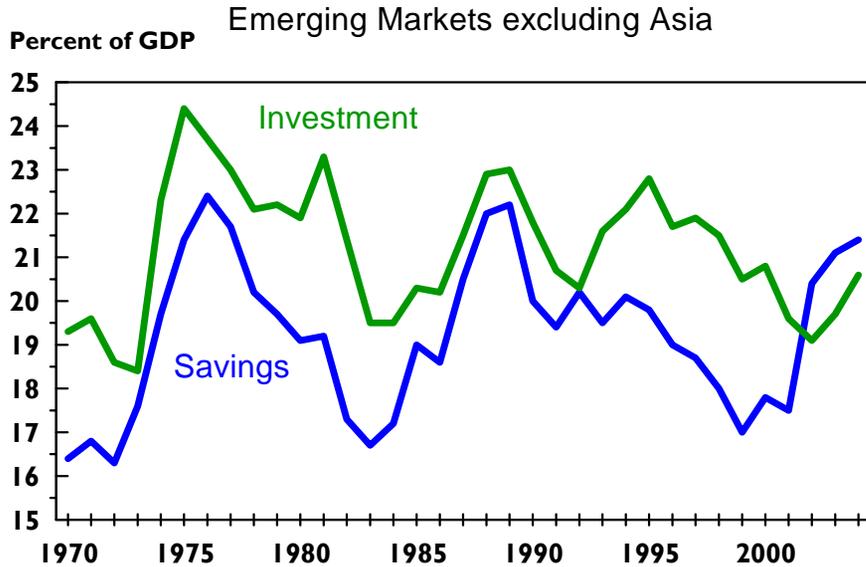
Household Net Worth: Percent of DPI

Personal Savings: Percent of DPI

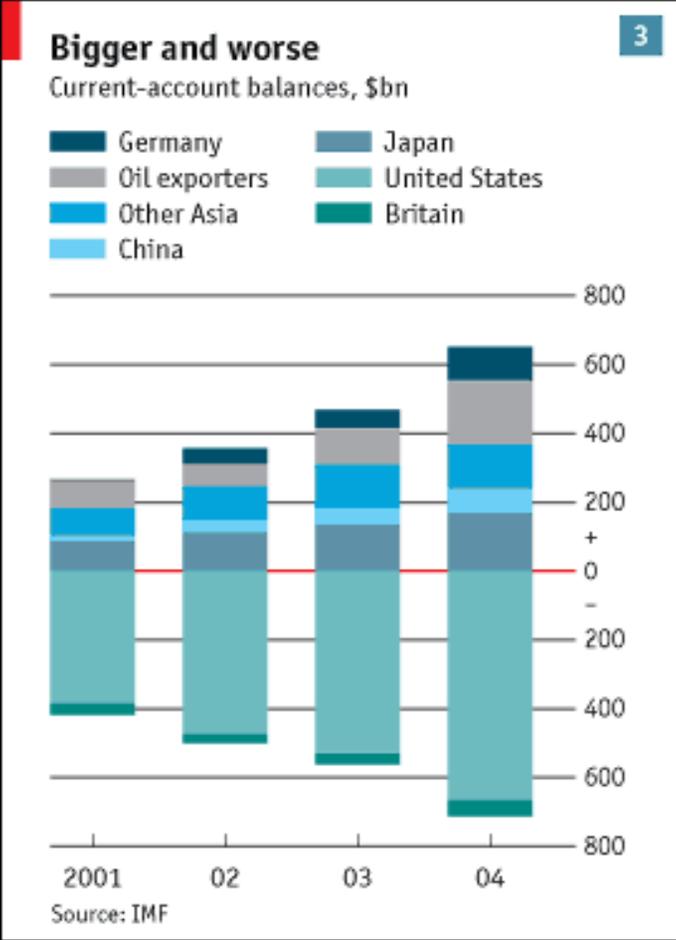


Sources: Federal Reserve Board, Bureau of Economic Analysis.

By contrast, saving has risen relative to investment in much of the world outside of the U.S.

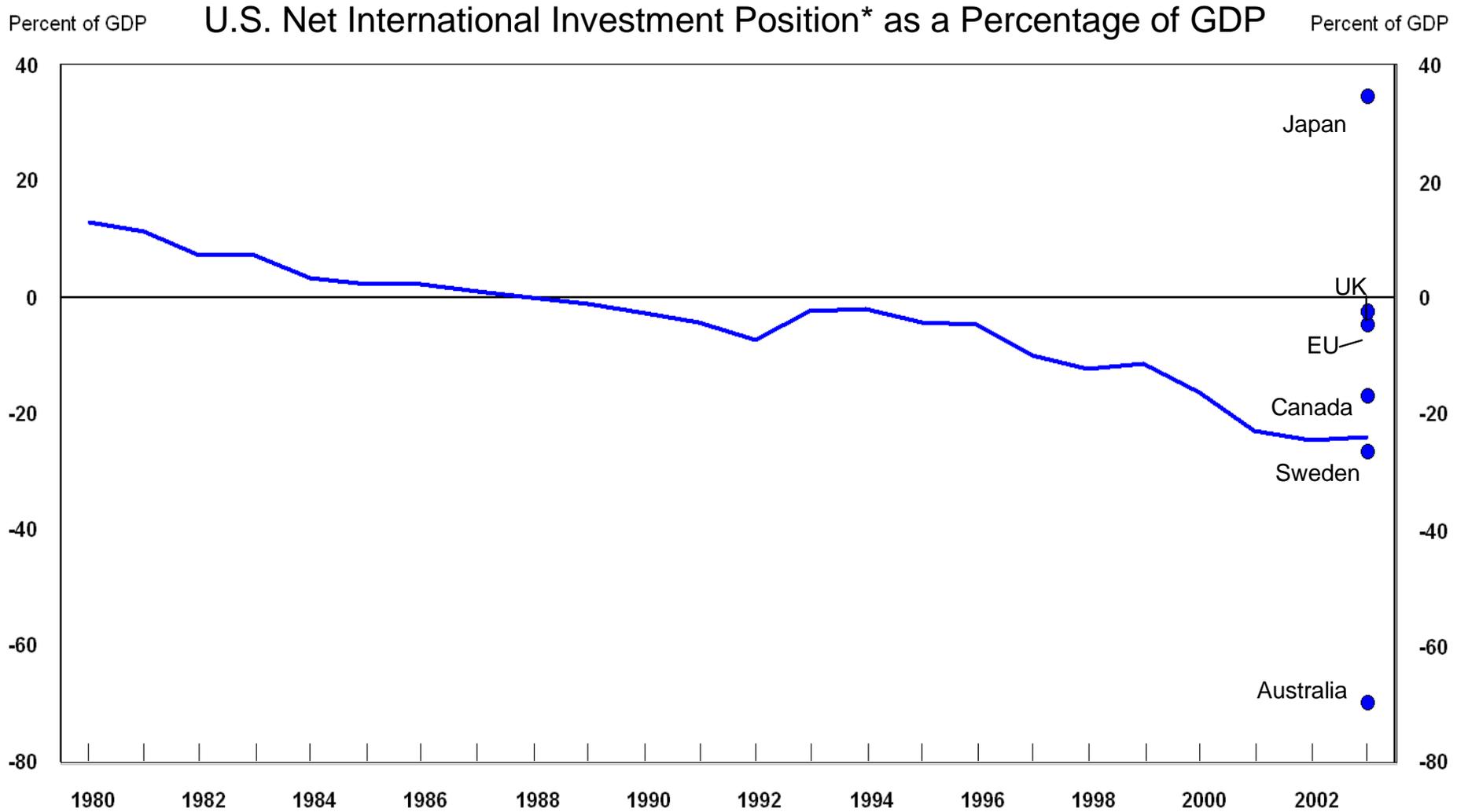


The result has been a sustained deterioration in the U.S. current account with reciprocal surpluses in many other regions.



Source: *The Economist*, September 24th, 2005.

And U.S. net debt to foreigners has grown to almost 25 percent of GDP - an unusually big share for a large, wealthy country.



* Direct Investment Positions at Market Value

Source: Bureau of Economic Analysis; International Monetary Fund, Balance of Payments Statistics, 2004.

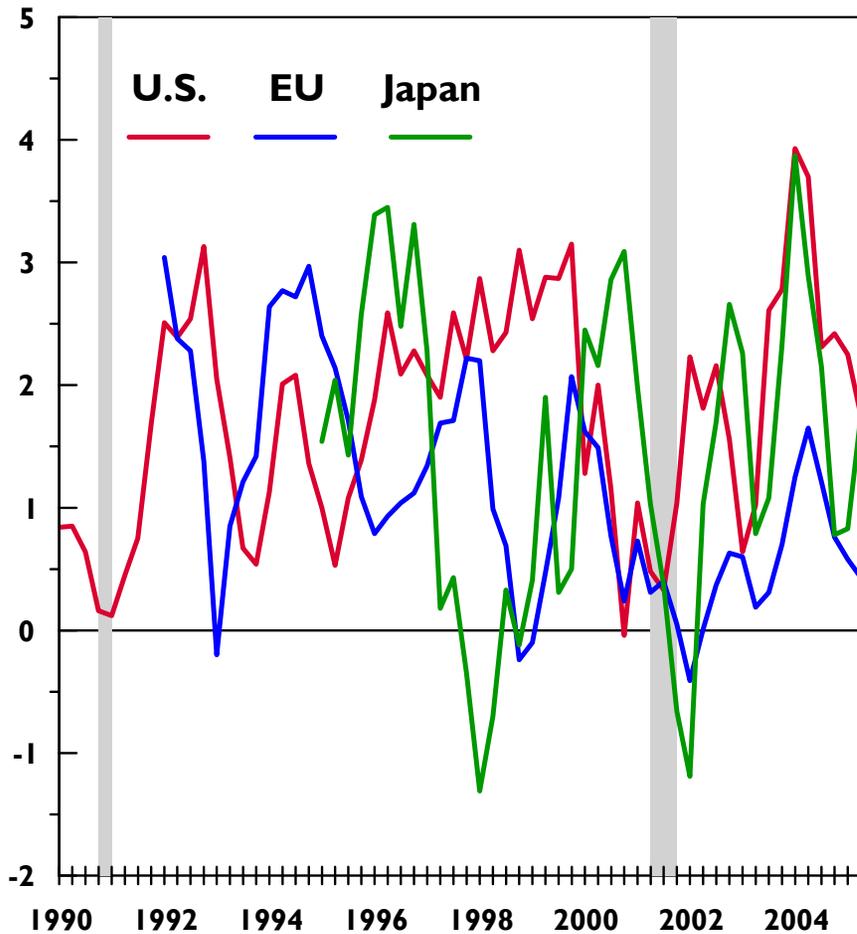
Correcting the U.S. current account imbalance will require some combination of:

- **Significantly faster foreign growth, and thus, more U.S. exports.**
- **Additional dollar depreciation, shifting production to the U.S. and consumption overseas.**
- **Raising U.S. savings relative to U.S. investment.**

The first outcome is desirable but unlikely, given recent trends in productivity and population growth that suggest that U.S. potential growth will outstrip that in other G-10 countries over the medium term.

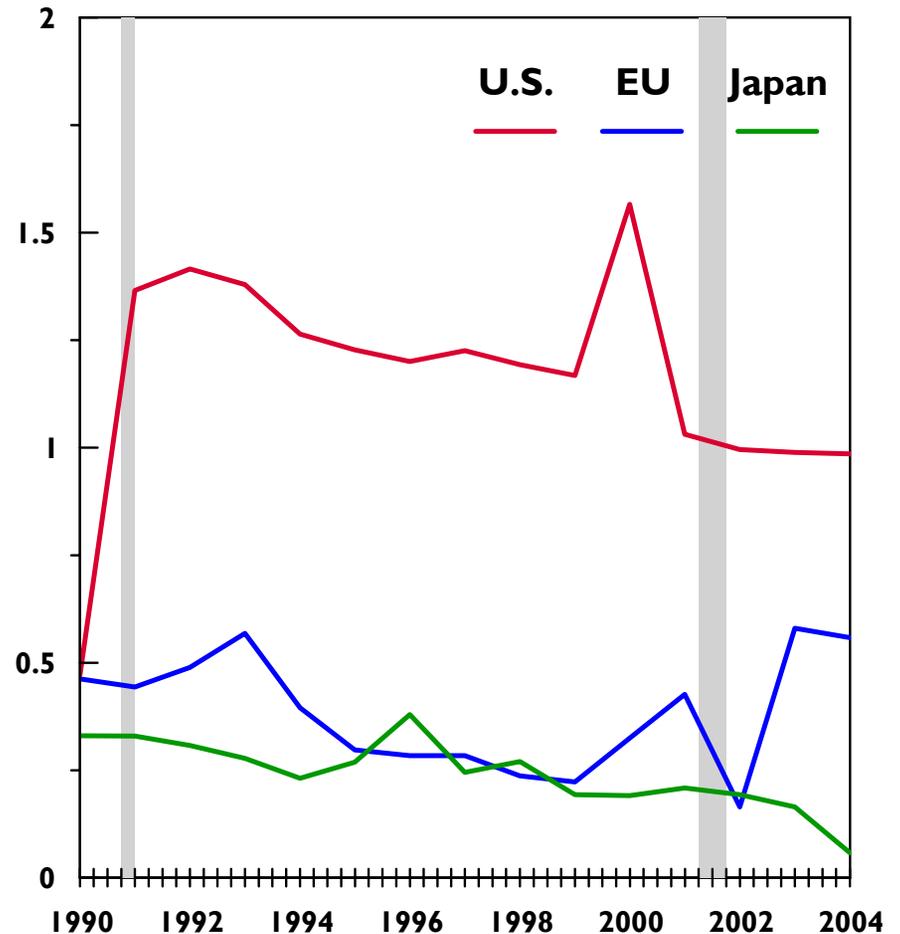
Productivity Growth

Year-over-year Percent Change



Population Growth

Year-over-year Percent Change

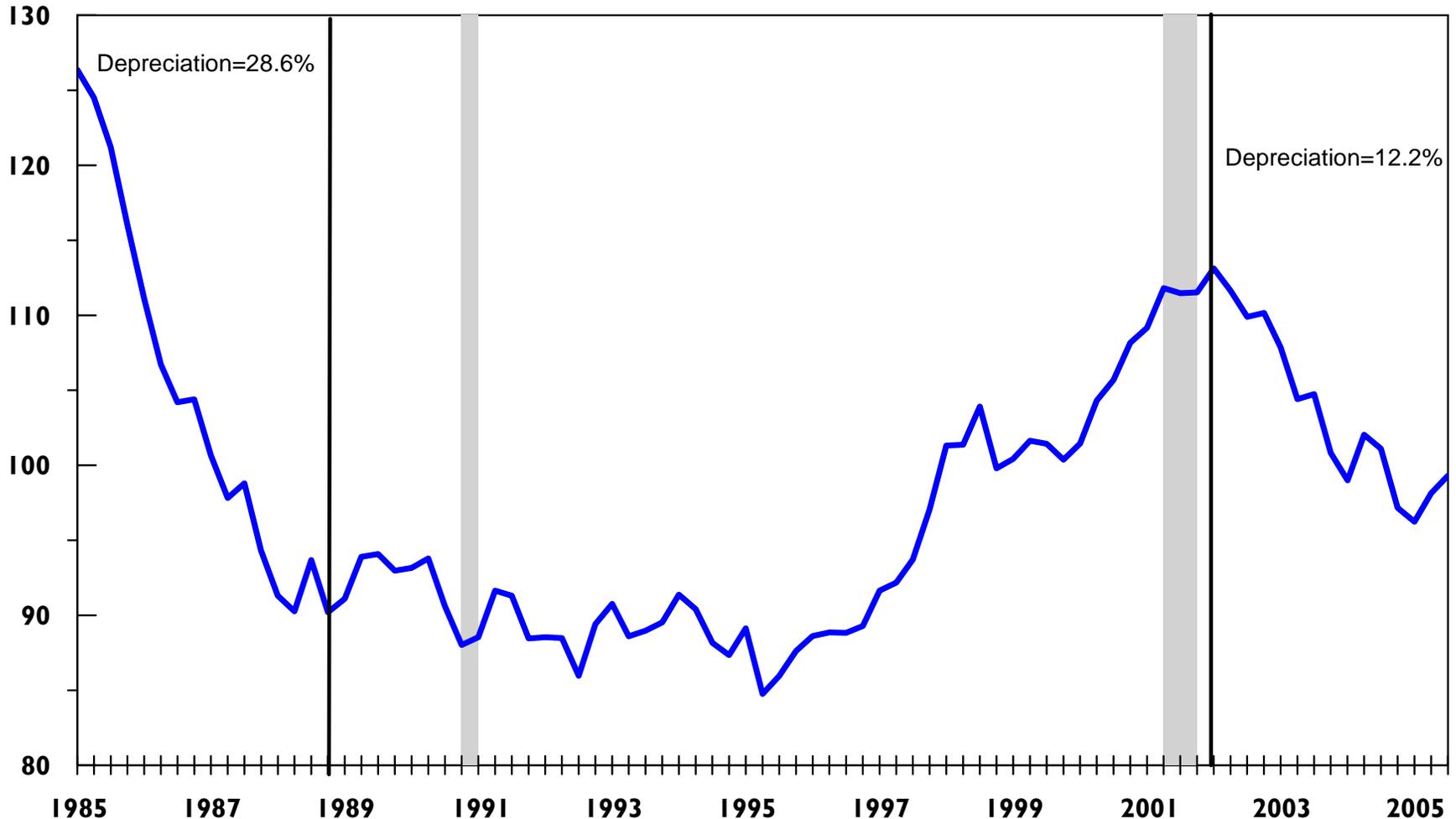


Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Statistical Office of the European Communities; Japanese Cabinet Office; Eurostat; MIC.

Turning to the exchange rate, the trade-weighted dollar has fallen by about 12 percent since its recent peak in early 2002 - far less than its decline in the 1980s.

Index: Mar 1973=100

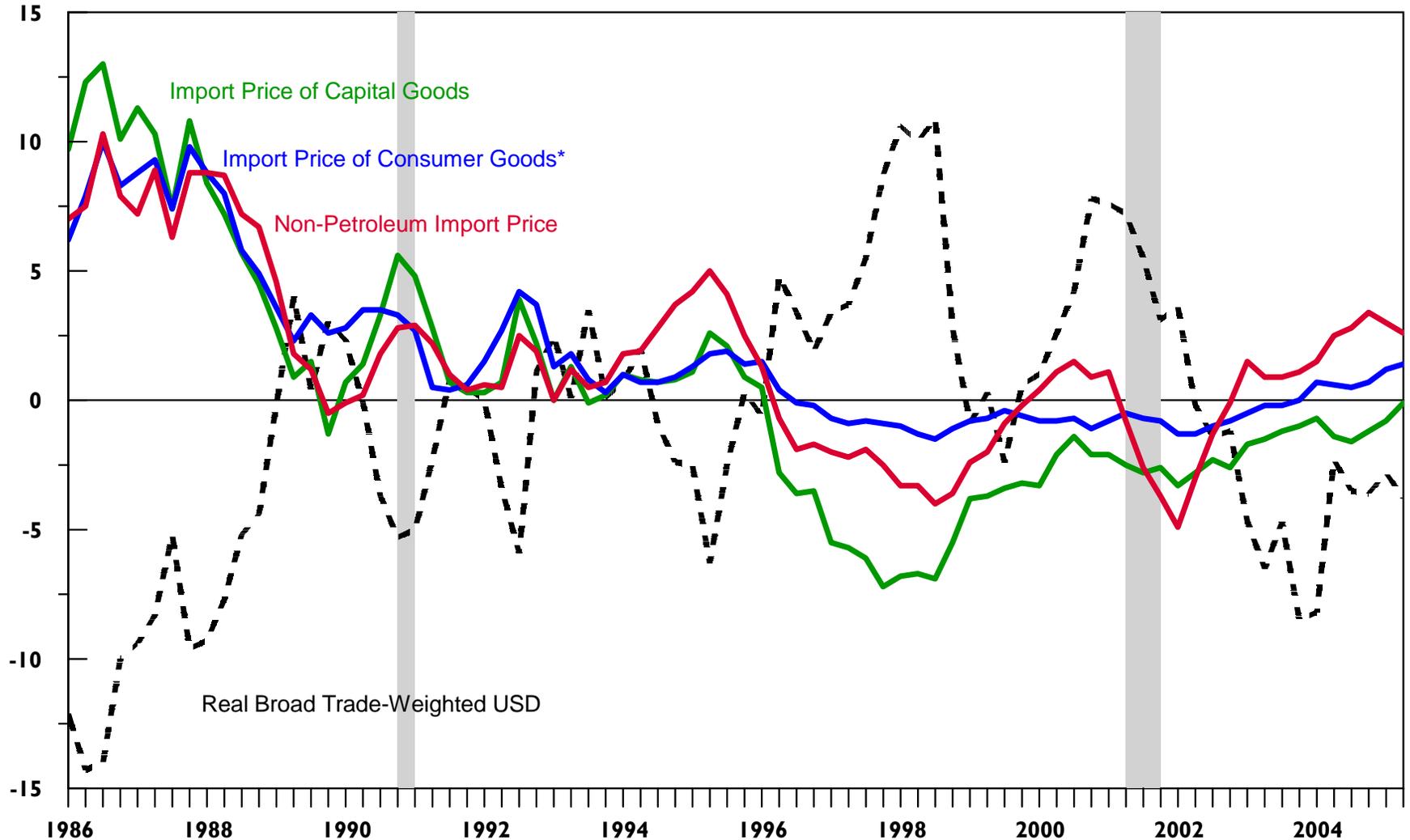
Real Broad Trade Weighted Exchange Value of the USD



Source: Federal Reserve Board.

In addition, the "pass through" of the impact of dollar depreciation to import prices seems to have declined over time...

Year-over-year Percent Change

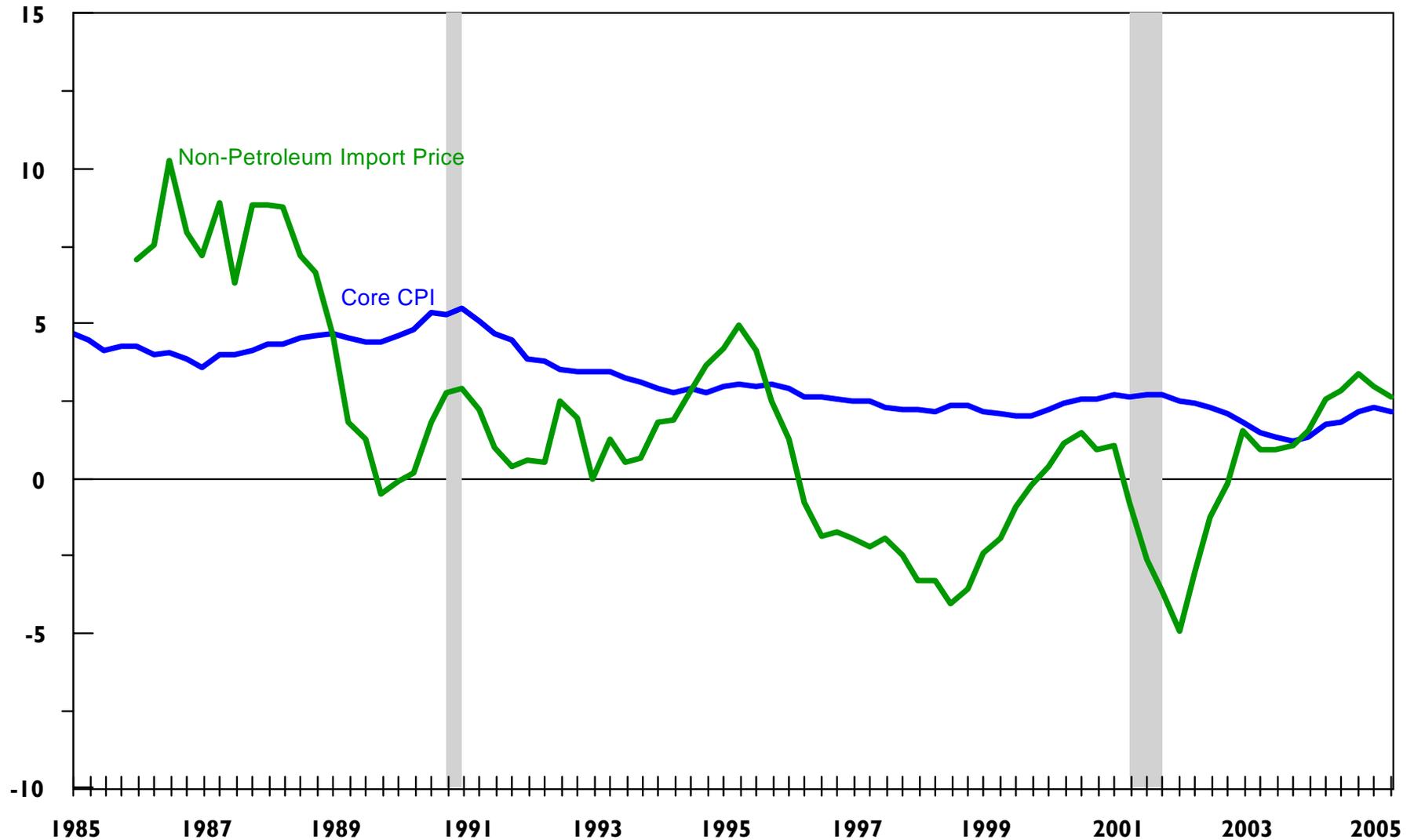


* Consumer Goods excludes automobiles.

Source: Federal Reserve Board.

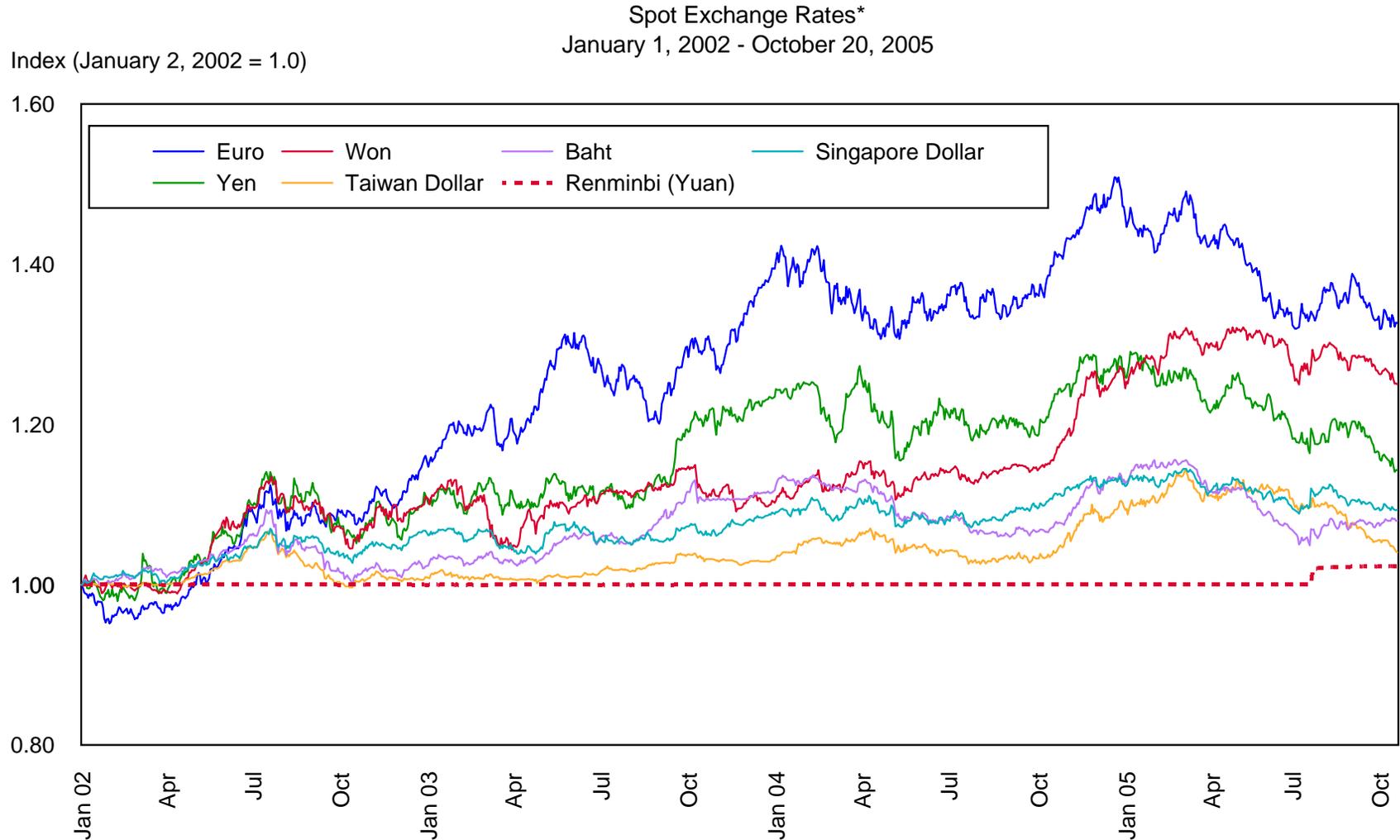
...while the impact of non-oil import prices on core inflation is very muted.

Year-over-year Percent Change



Source: Bureau of Labor Statistics.

Still, as other countries let their currencies rise notably against the dollar, China's dollar peg came to be seen as a major impediment to correcting the U.S. trade deficit.



* US\$ / Foreign Currency Unit

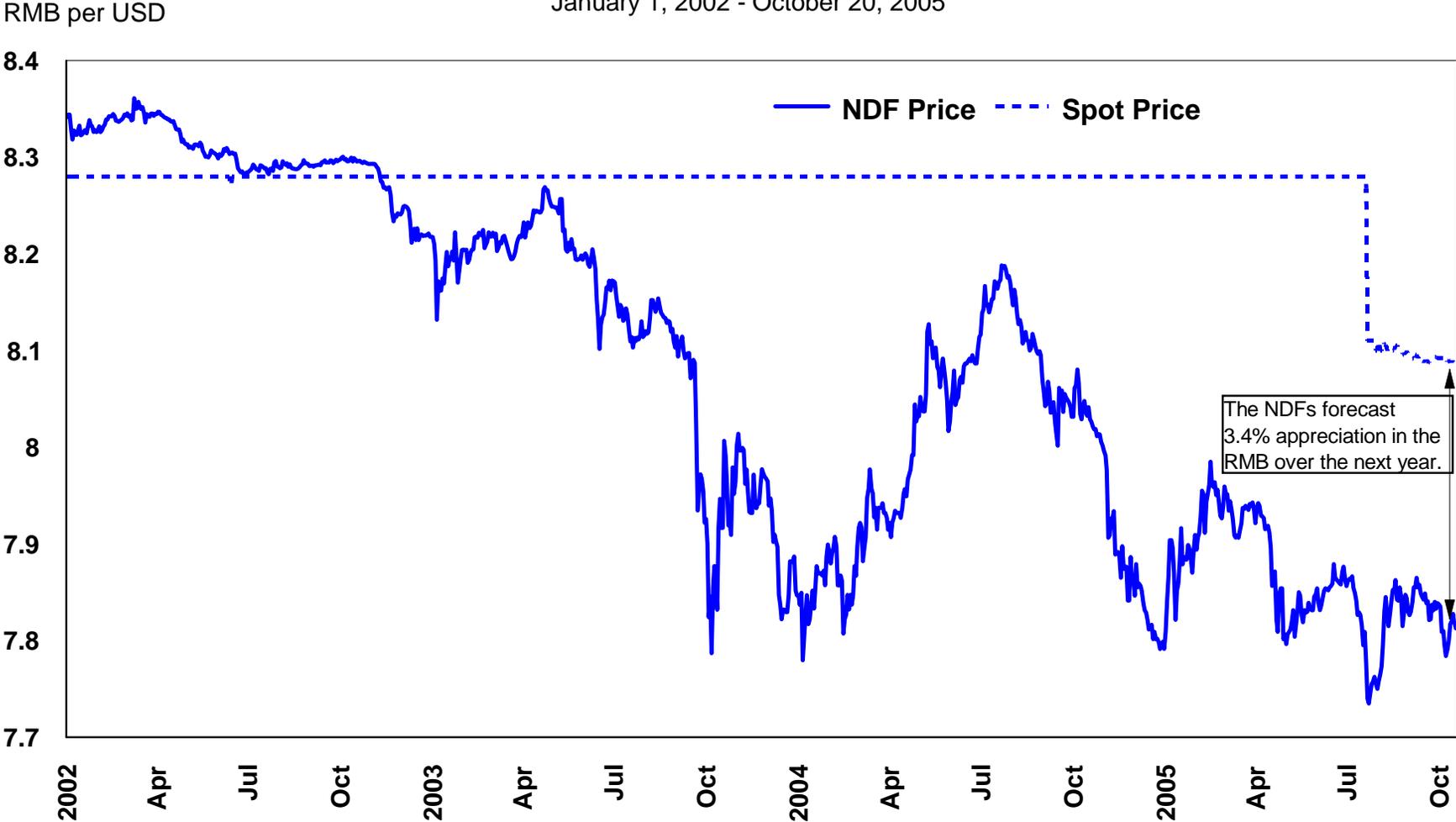
Source: Board of Governors of the Federal Reserve System.

On July 21 China Announced a New Foreign Exchange Regime

- De facto dollar peg became a "managed float" based on a basket of currencies
- RMB revalued by 2 percent against the U.S. Dollar
- Exchange rate can move up or down by 0.3 percent per day from its central rate
- Each day's closing rate becomes the next day's central rate.

While some analysts anticipated significant RMB appreciation under the new regime, the forward markets have been taking a more conservative view.

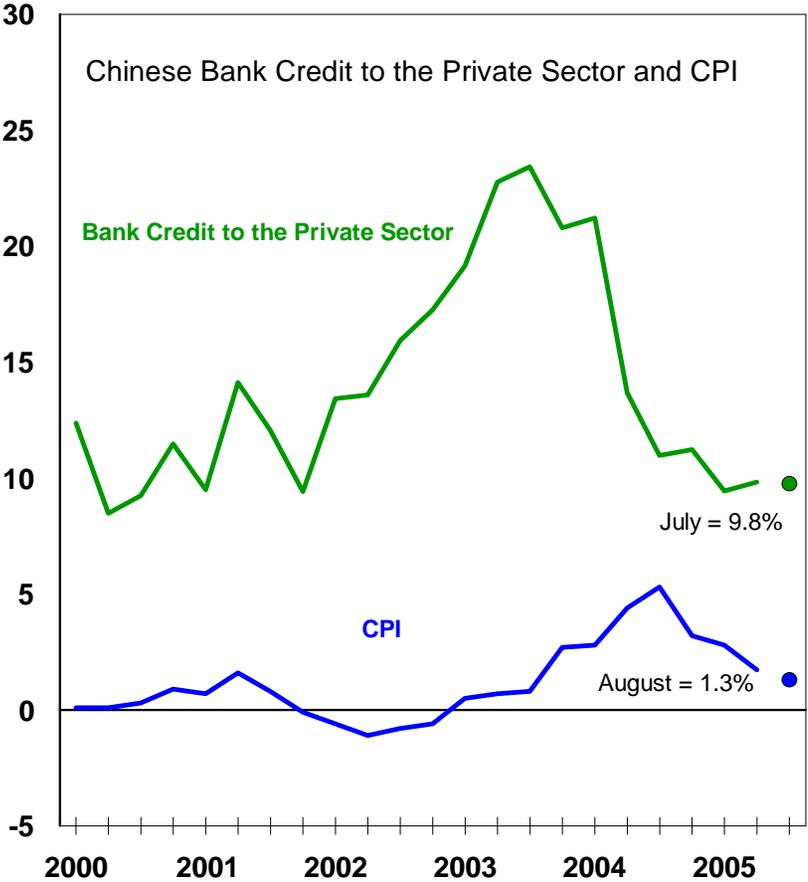
RMB Twelve-Month Non-Deliverable Forwards and RMB Spot Price
January 1, 2002 - October 20, 2005



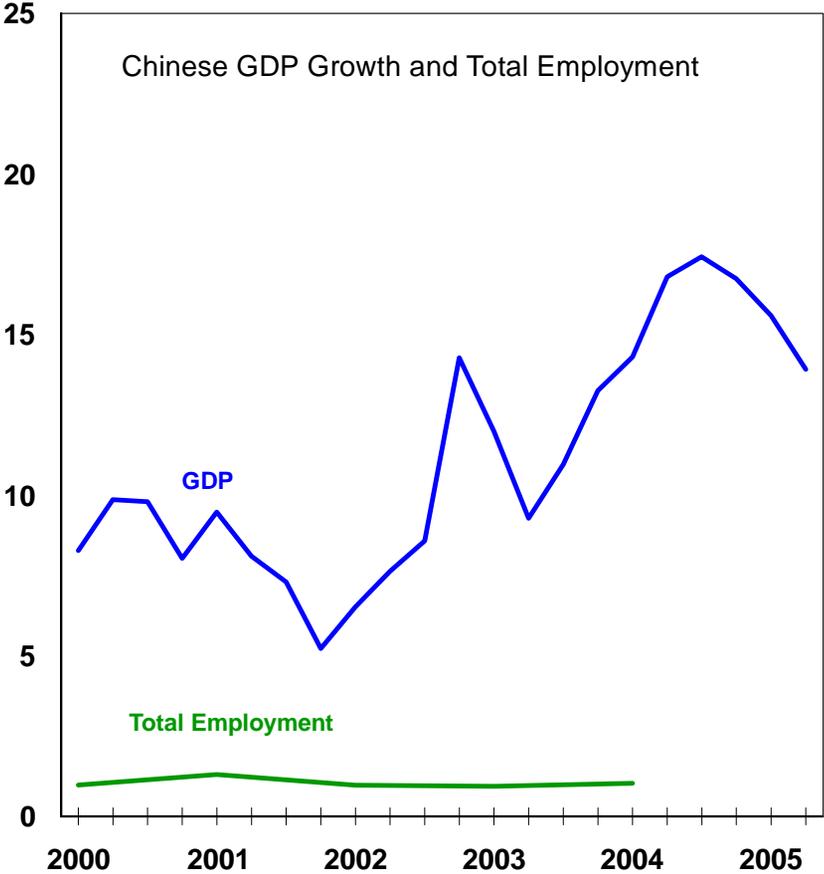
Source: Bloomberg

China's cautious approach to exchange rate change probably reflects the leaders' overriding concerns about its pool of surplus labor.

Year-over-Year Percent Change



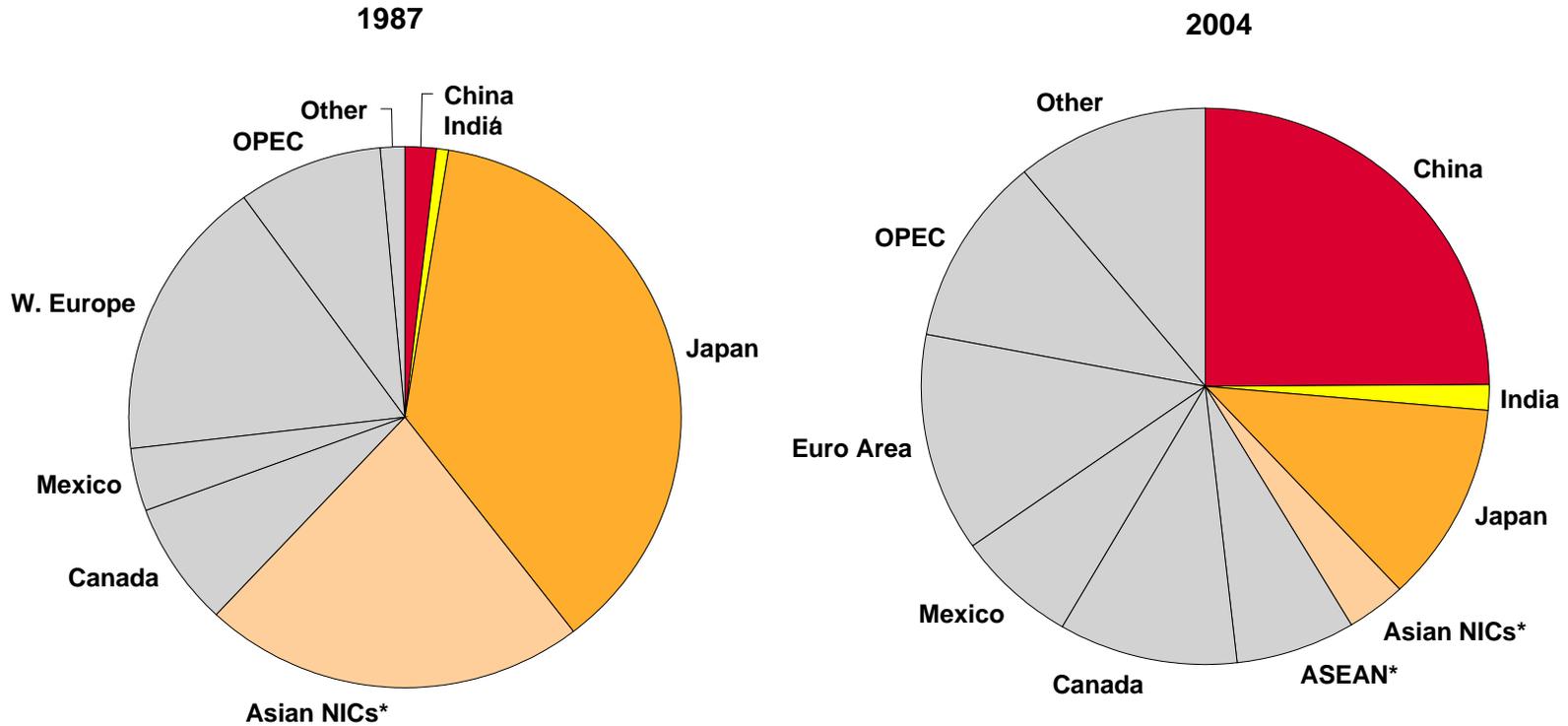
Year over Year Percent Change



Sources: International Monetary Fund, OECD, World Bank.

To affect the U.S. trade balance notably, a larger RMB revaluation will need to be widely shared in Asia. Otherwise, China's export business will simply shift to its suppliers.

Shares of the U.S. Trade Deficit*

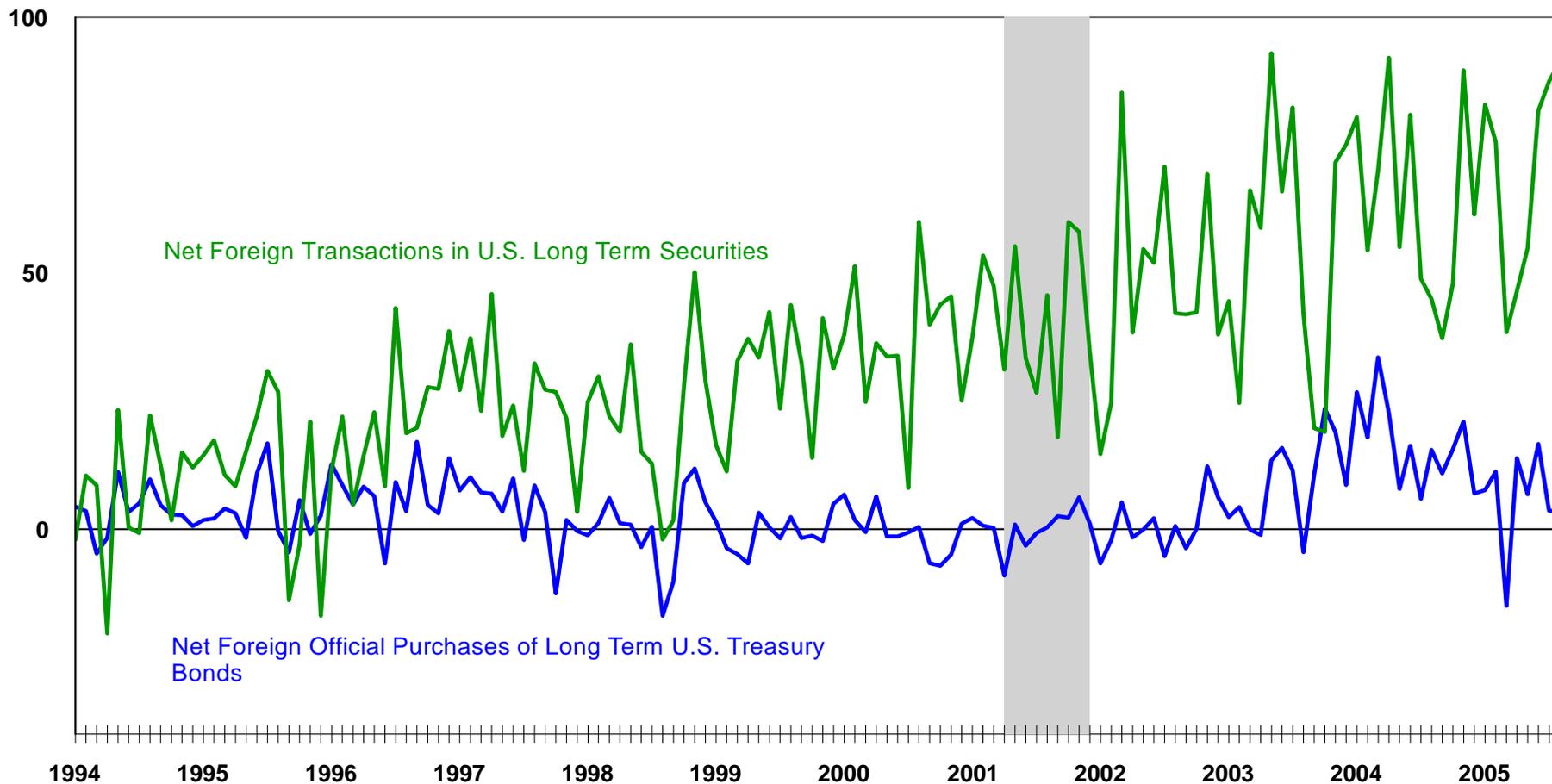


*Asian NICs include Taiwan, Korea, Hong Kong and Singapore.

ASEAN includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand and Vietnam.

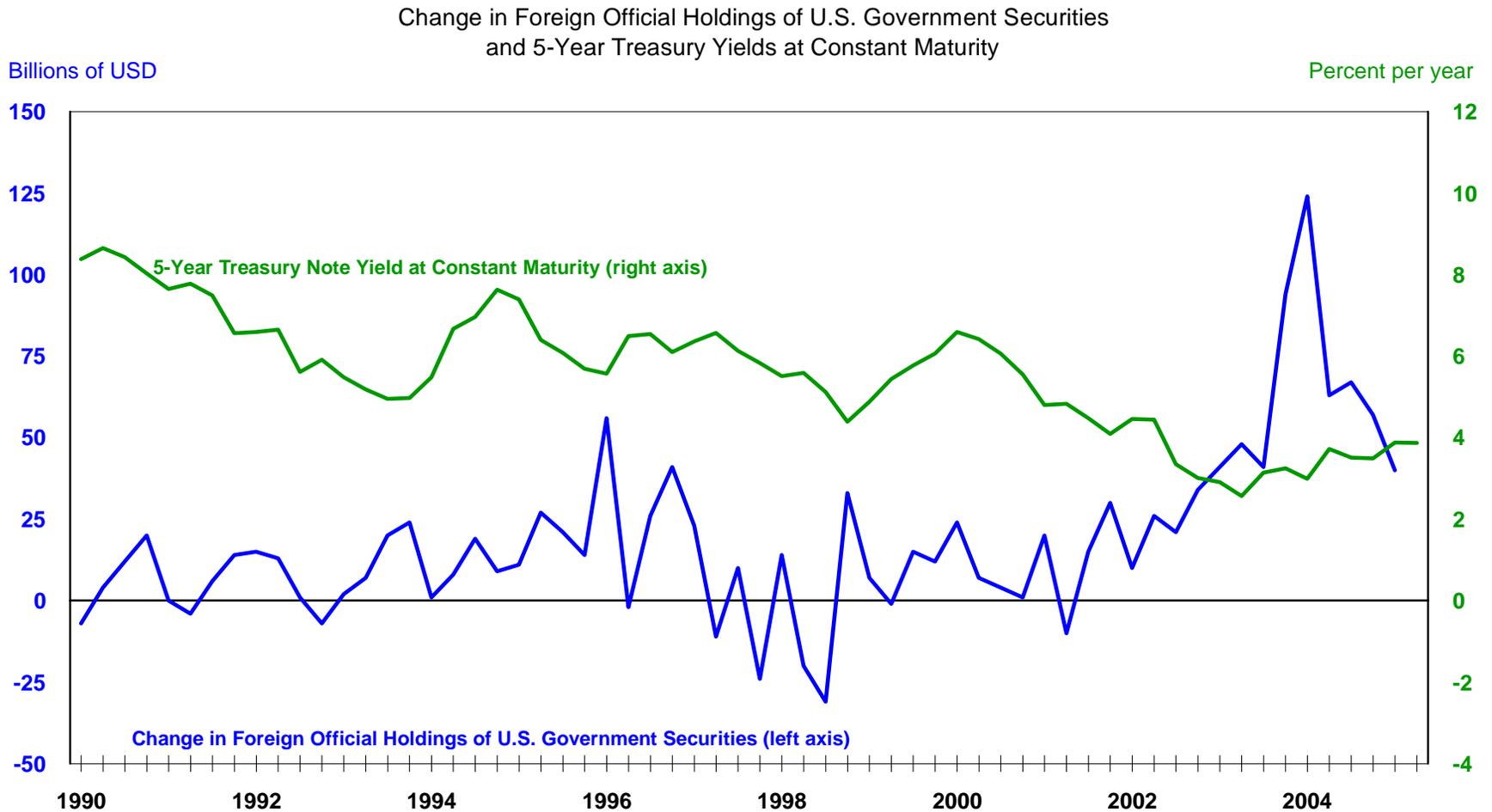
Some analysts fear that China's float could curb foreign official demand for dollar assets, raising interest rates on those instruments. But active management of official reserve assets is nothing new.

Billions of USD



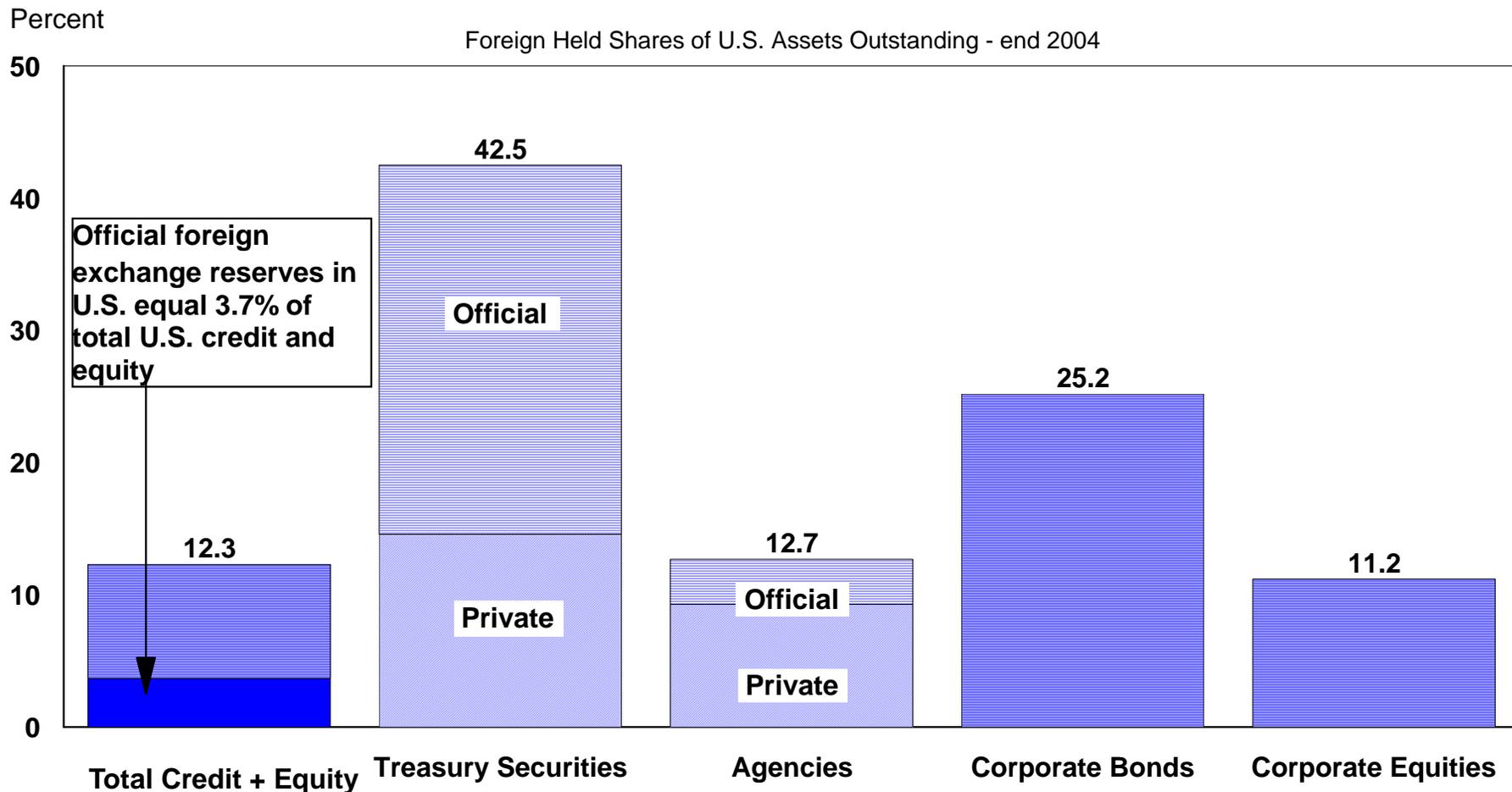
Source: US Treasury

While changes in foreign official holdings of U.S. Treasuries appear to have an inverse relationship with interest rates on those securities, such a link is statistically hard to find, modest and the direction of causality is not clear.



Source: Bureau of Economic Analysis, Board of Governors of the Federal Reserve System

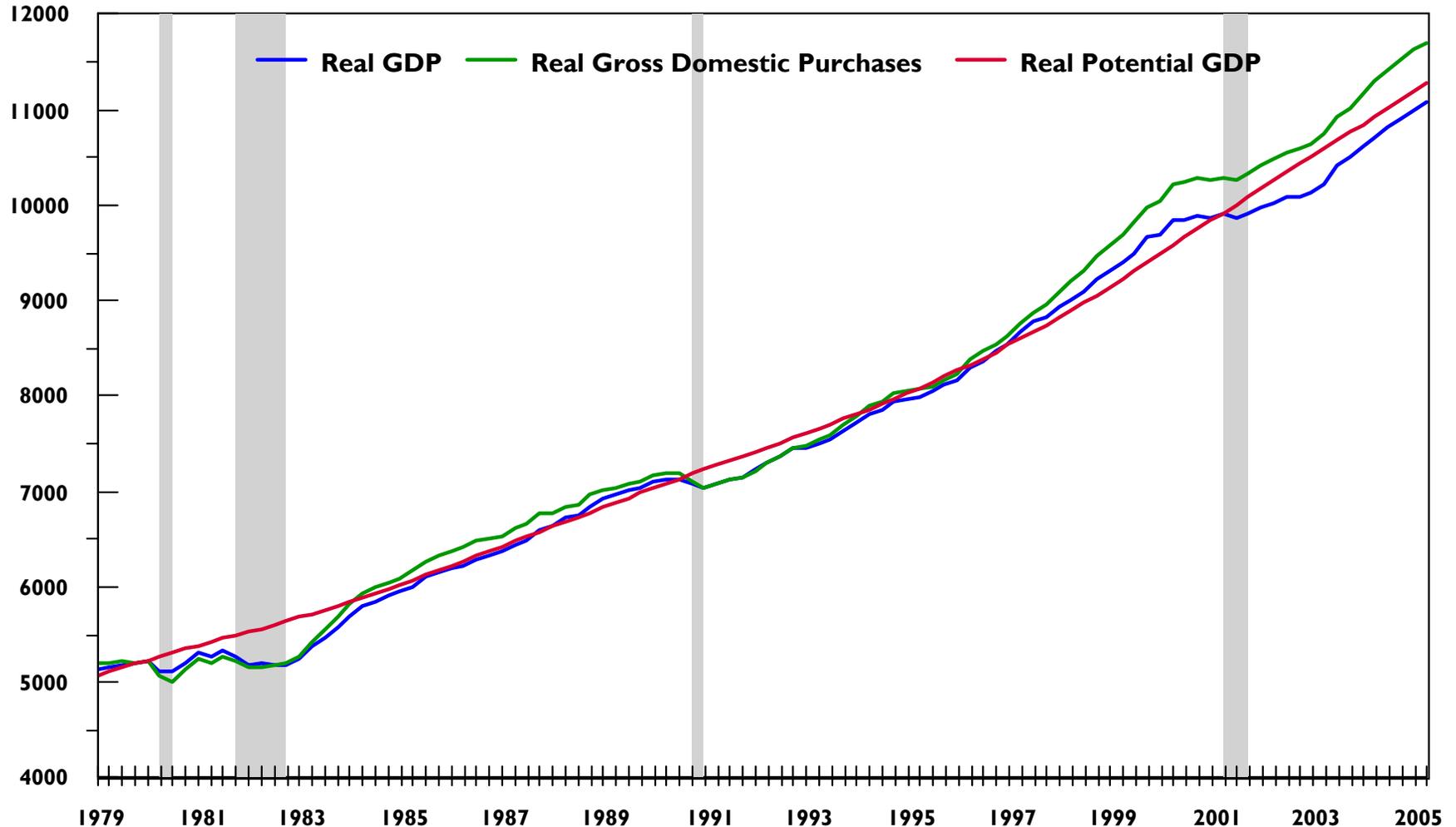
Overall, foreign official assets represent too small share of total U.S. credit and equity outstanding for net foreign official purchases or sales of U.S. securities to have a major impact on interest rates in highly liquid U.S. financial markets.



Source: Board of Governors of the Federal Reserve System

With output growth approaching potential, how can U.S. policy action narrow the trade gap without re-opening the output gap? Monetary policy is a rather blunt instrument, affecting both consumption and investment.

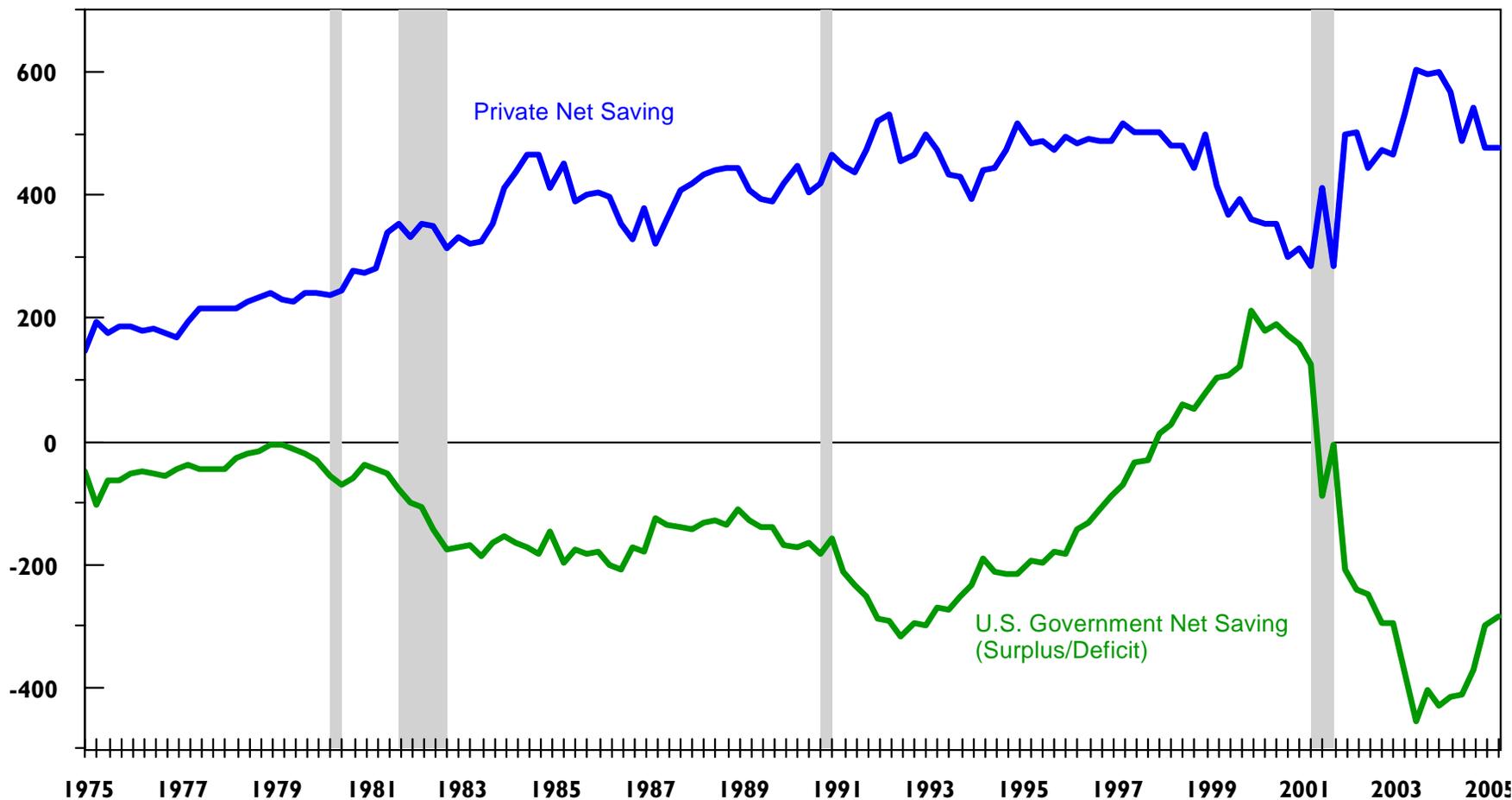
Billions of USD



Sources: Bureau of Economic Analysis, Congressional Budget Office.

By contrast, fiscal policy can directly target consumption and encourage saving - via a consumption tax, say. Or the government can reduce its own dissaving. Despite private sector offsets, the outcome is more likely to be higher savings, not lower investment.

Billions of USD



Source: Bureau of Economic Analysis

Possible Policy Options for Other Countries

Advanced Countries

Continue to:

Introduce greater labor market flexibility

Encourage greater labor force participation

Reinterpret EC Treaty on inflation target and Stability and Growth Pact

Emerging Countries

Continue to:

Embrace greater exchange rate flexibility

Develop social safety networks

Invest in human capital

Adopt market-based financial systems

Encourage institutional development

Key Points

Today's large payments imbalances reflect major mismatches in savings and investment in the U.S. and abroad.

Correcting these unsustainable imbalances in an orderly fashion represents a major challenge to world policy makers.

With potential growth expected to remain higher in the U.S. than abroad, a pickup in foreign demand growth is unlikely to provide the primary solution.

And while increased exchange rate flexibility in emerging Asia could prove widely beneficial, by itself, further gradual dollar depreciation is unlikely to correct the U.S. current account deficit.

Since fiscal restraint can be targeted to affect consumption and specific types of investment, like housing, tighter U.S. fiscal policy represents a promising route to adjustment.

Elsewhere, ongoing structural reforms – to encourage greater labor force participation in Europe and Japan, say, or to develop a social safety net in China – could also make important contributions.