Statement of
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before the
Joint Economic Committee
Congress of the United States

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NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EST), Thursday, November 5, 1987.

Mr. Chairman, I am pleased to respond to your invitation to address the Joint Economic Committee and discuss conditions under which the current account deficit might improve. The Congressional Budget Office (CBO) has been concerned for some time with continued high current account deficits. Our concern, which we have expressed in the past in testimony before the Congress, is that depending on foreign capital to finance the deficits can potentially cause major economic disruptions if foreigners lose confidence in the U.S. economy. In recent weeks, we have seen what a loss of investor confidence can do to world stock markets. If foreign investors lose confidence in the United States because the current account deficit refuses to fall, we could see similar effects on foreign exchange markets leading to possible disruptions in the world economic and trading system.

Before I discuss what alternative economic conditions might produce a turnaround in our current account balance, let me briefly review how we arrived at the present deficit. The history of the 1980s shows that the deficit is the product not of one factor alone but of several acting together. As the United States recovered from the severe recession in the early part of the decade, its growth outstripped that of most of its trading partners. Together with an open U.S. market and an exchange rate rising for almost five years, the faster growth contributed to an abnormally rapid increase in imports and stagnant exports on a National Income and Product Account (NIPA) basis. The deficit we struggle with today is the result. Analysts generally believe that to reduce this deficit we must reverse one or more of the conditions that caused it.

Today, I would like to report on some experiments we have performed at CBO in recent weeks to find out what it will take for the current account deficit to turn around and then continue shrinking. I wish to emphasize at the outset that none of these experiments represents a CBO forecast of what will happen or when it may happen. The experiments are purely hypothetical investigations designed to answer questions such as: what would happen if there were a recession or if the dollar were to fall sharply over the next year?

In our investigations we examined three developments, each of which was expected to have a positive effect on net exports, the major component of the current account balance. We then compared their effects with the baseline deficit in our August updated forecast. The time frame we chose to examine was the present through 1992. The three hypothetical situations on which we based the experiments are:

- A typical recession in the United States with continued growth abroad;
- Faster economic growth in the rest of the world combined with a change in foreigners' preferences toward greater demand for U.S.-made exports; and
- A very rapid fall in the value of the dollar.

We also combined these three elements in an experiment to see what their joint effect on the current account balance would be.

THE BASELINE FOR THE EXPERIMENTS

Before I describe the experiments, let me say a few words here about the baseline used in our simulations. The baseline we used

for evaluating all experiments was the net export path, which was broadly consistent with the CBO August updated forecast. Under this baseline forecast, the NIPA nominal net export deficit rises continuously from $110 billion in 1987 to $177 billion in 1992 (see Table 1 and Figures 1 and 2). In contrast, the real net export deficit declines from $123 billion to $84 billion over the same period.

Though the real and nominal balances in our forecast move in opposite directions, we cannot say that one of them is a more important indicator than the other. They are both valid indicators, and each tells us something different about the economy. An improvement in the real net export balance tells us that the trade-oriented part of the economy is strengthening. When the real balance improves, we are selling more goods abroad and buying fewer than previously. If we exclude from the balance agricultural exports and oil imports, two trade flows that often move erratically in the short run, the real deficit has fallen steadily for the last four quarters. Since real net exports is one of the key components of real GNP, a declining deficit adds directly to GNP growth.

Because of the fall in the value of the dollar that was needed to reverse the growth in the real net export deficit, we now pay more for many of the goods we still import. Moreover, since the dollar's fall has not reduced the quantity of imports enough to offset the rise in price, our nominal net export deficit continues to increase. The nominal balance gives us different information from the real balance: large nominal net export deficits generally mean large current account deficits that we must finance by borrowing from abroad. A continuous buildup of foreign debt from years of

large current account deficits may be taken as a signal of weakness by the world foreign exchange and capital markets, leading to the loss in investor confidence I mentioned in my opening comments.

While it is the nominal net export and current account balances that I will focus on today, we should bear in mind that the real balance is already improving. Let me now discuss what we found out from each of the experiments.

EXPERIMENT I; RECESSION

In our first investigation, we examined the effect of a typical postwar recession starting in the first quarter of 1988. During this hypothetical recession, GNP falls for two quarters and grows only weakly in the third quarter of 1988, returning to its baseline level after about five years.

The effect of the recession, which is presented in Tables 1 and 2, is to produce a sharp improvement in both the nominal and real net export balances in 1988. The real net export balance then continues to improve except for a small reversal in 1990, but the nominal balance starts to deteriorate once again in 1989 and continues to worsen through 1992. By 1992, the net effect of the recession is to decrease the nominal deficit by only $9 billion and the real deficit by $7 billion compared with the baseline.

This behavior occurs because the recession lowers U.S. income temporarily, causing lower imports and lower borrowing from abroad. During the recovery, as U.S. income returns to its baseline level, imports would also grow rapidly. But even when income has caught up with its baseline level, the total stock of debt owed to foreigners

will be about $80 billion smaller because of the imports forgone during the recession. In the long run, our interest payments to foreigners and our current account deficit will be smaller by the amount of the interest saved on the smaller debt.

From this first experiment, we conclude that a recession, unless it were of extremely severe proportions, would have only a slight permanent impact on the current account deficit.

EXPERIMENT II: FOREIGN GROWTH

In the second experiment, we investigated the effect of faster economic growth in the rest of the world. To achieve more rapid growth, we made foreign GNP increase one percentage point faster each year than we had forecast in our August report. I should point out again the purely hypothetical nature of this assumption. In fact, CBO does not consider it likely that the world will experience a permanent increase in the growth rate of such proportions. But we believe that it is useful to investigate what the net export balance would do if it happened.

In this same experiment, we also investigated the impact of a change in foreign tastes that would benefit U.S. exports. This change could arise, for example, as foreign purchasers become aware that the quality of U.S.-made goods has improved in recent years. To simulate the increased attractiveness of U.S. goods on world markets, we raised the income elasticity of demand for American exports by 20 percent. The income elasticity measures the percent-

age gain in foreign expenditures on U.S. exports when foreign incomes rise by 1 percent.

With a higher foreign income elasticity and the faster foreign growth, nominal net exports first improved slightly in 1988 but then continued to deteriorate, but at a slower rate than in the baseline (see Tables 1 and 2 and Figures 1 and 2). Real net exports improve

TABLE 1. NET EXPORT PROJECTIONS (In billions of current dollars and billions of 1982 dollars)

	1987	1988	1989	1990	1991	1992
Baseline						
Nominal net exports	-109.6	-112.9	-126.6	-144.5	-160.2	-176.6
Real net exports	-123.2	-102.1	-100.3	-101.0	-93.8	-83.9
U.S. Recession						
Nominal net exports	-109.6	-93.5	-102.7	-125.2	-145.7	-167.3
Real net exports	-123.2	-82.4	-77.6	-84.2	-82.3	-77.2
Increase in Foreign Growth						
Nominal net exports	-109.4	-108.4	-115.1	-124.5	-129.6	-133.0
Real net exports	-123.0	-97.7	-89.6	-83.3	-68.0	-48.9
Front-Loaded Depreciation						
Nominal net exports	-110.7	-113.4	-65.9	-25.0	-34.5	-55.0
Real net exports	-122.2	-65.2	30.7	77.9	75.2	66.4
Combined Experiments						
Nominal net exports	-110.7	-92.3	-34.2	10.2	6.2	-7.4
Real net exports	-122.1	-45.4	57.7	106.8	107.6	103.0

SOURCES: CBO estimates and Department of Commerce.

TABLE 2. NET EXPORT PROJECTION CHANGES FROM BASELINE (Changes in billions of current dollars and billions of 1982 dollars)

	1987	1988	1989	1990	1991	1992
U.S. Recession						
Nominal net exports	0.0	19.4	23.9	19.3	14.5	9.2
Real net exports	0.0	19.7	22.7	16.9	11.6	6.7
Increase in Foreign Growth						
Nominal net exports	0.2	4.5	11.5	19.9	30.6	43.6
Real net exports	0.2	4.4	10.7	17.7	25.8	34.9
Front-Loaded Depreciation						
Nominal net exports	-1.1	-0.5	60.7	119.5	125.7	121.6
Real net exports	1.1	36.9	131.0	178.9	169.0	150.2
Combined Experiments						
Nominal net exports	-1.1	20.6	92.4	154.7	166.4	169.1
Real net exports	1.1	56.7	158.0	207.8	201.4	186.9
Simulation Assumption Changes (Expressed as percent difference from base simulation)						
U.S. Recession						
Real GNP	0.0	-2.9	-3.1	-2.1	-1.2	-0.5
Increase in Foreign Growth						
Real foreign GNP	0.0	0.8	1.8	2.8	3.7	4.7
Front-Loaded Depreciation						
Real exchange rate	-2.2	-19.8	-25.0	-22.2	-19.4	-16.4

SOURCES: CBO estimates and Department of Commerce.

significantly in 1988 and then more slowly in subsequent years. By 1992, the nominal and real deficits would fall by $44 billion and $35 billion below the baseline values. It is worth keeping in mind that foreign tastes are not subject to U.S. policy prescription or even foreign government exhortation, as we have seen from the meager results of Prime Minister Nakasone's "Buy American" campaign. On the basis of our CBO experiments, we do not envision much help in reducing our current account deficit solely from changes in foreign tastes or even from changes in foreign income growth and tastes combined.

EXPERIMENT III; DEPRECIATION OF THE DOLLAR

The third development we investigated was a rapid drop in the real value of the dollar with respect to the currencies of our major trading partners. Over the last two-and-a-half years, the real value of the dollar has fallen substantially compared with the currencies of our trading partners in major industrial countries. The dollar has not fallen nearly as much against the currencies of our trading partners in developing countries, and evidence suggests that the disparity in the currency depreciation between the two sets of partners has caused U.S. importers to substitute imports from developing countries for imports from industrial countries.

In the third experiment, we investigated the impact on the net export balance if we speeded up our forecasted appreciation of the currencies of industrial countries against the dollar. We forced all of the appreciation to occur by the end of 1988, and then rapidly appreciated the currencies of our major developing country partners

to catch up with the appreciation that had already occurred for the currencies of the industrial countries. Following 1988, currencies of all partners in developing countries followed the normal baseline path, although they started from a higher value against the dollar. The effect of these changes was to lower the overall real trade-weighted exchange rate by 25 percent by 1989.

Of all the individual developments we investigated, the effect of faster dollar depreciation was the most powerful. After a slight worsening in 1988, the nominal net export balance improved massively in 1989 and 1990. By 1991, the reversal caused by the one-shot major depreciation had run its course, and the nominal net export deficit began to worsen. By 1992, however, the nominal deficit was still $122 billion smaller than its baseline value (see Tables 1 and 2 and Figures 1 and 2). In constant dollars, the real net export balance responded strongly to the depreciation, with the real deficit turning into a $66 billion surplus by 1992.

COMBINED EFFECTS OF ALL THREE EXPERIMENTS

The three simulations I have just discussed show that reversing the causes of the deficit--by lowering growth in the United States compared with that abroad, by reversing the preference for foreign goods over American goods on world markets, or by lowering the high dollar--cannot individually turn around the deteriorating current account balance in the medium term. But since a combination of factors produced the deficit, it makes sense to seek its reversal by examining a combination of the three experiments.

We tested this hypothesis by examining a combination of the three conditions that produced a turnaround of the net export balance. By 1990, the balance was in surplus by $10 billion, though under the influence of increased income growth in the United States, the surplus shrank to a $7 billion deficit by 1992 (see Tables 1 and 2 and Figures 1 and 2). Again, the balance I have been discussing here is the National Income Accounts net export balance. Because of interest paid to foreigners and net unilateral transfers abroad (totaling about $50 billion by 1992), the current account balance--which includes these items--is never in surplus, even in this combination of experiments (see Table 3).

TABLE 3. CURRENT ACCOUNT BALANCES (In billions of current dollars) a/

	1987	1988	1989	1990	1991	1992
Base	-150.4	-159.2	-175.5	-195.8	-214.7	-234.4
U.S. Recession	-150.3	-139.8	-151.3	-175.8	-199.2	-224.1
Increase in Foreign Growth	-150.2	-154.9	-164.6	-176.7	-185.1	-192.2
Front-Loaded Depreciation	-151.7	-160.5	-117.9	-79.2	-90.0	-112.3
Combined Experiments	-151.4	-138.5	-85.5	-43.6	-49.1	-64.8

SOURCES: CBO estimates and Department of Commerce.

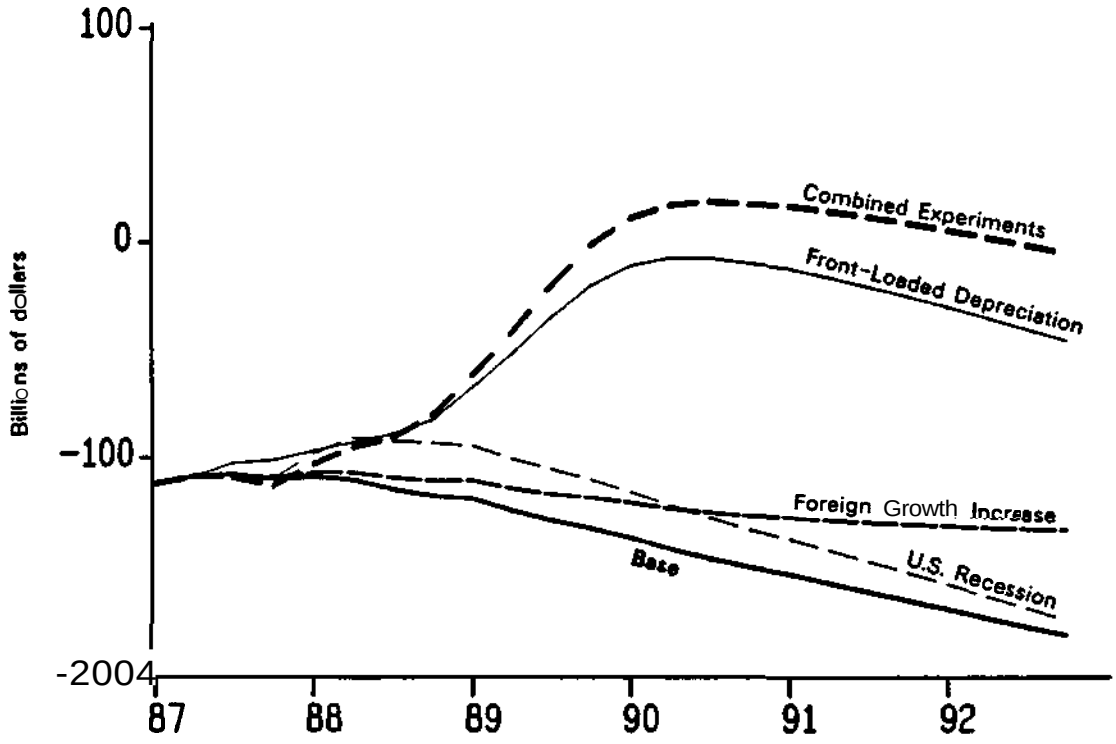
a. NIPA net export balance, adjusted to balance of payments definitions, plus net unilateral transfers (-), plus net government interest pajnnents abroad (-).

CONCLUSION

Mr. Chairman, I wish to emphasize once again that the numbers I have presented today in this testimony are not CBO forecasts but are purely hypothetical exercises designed to evaluate the effects of alternative economic conditions on our net export balance. The results of our experiments indicate that none of the factors was individually able to undo the net export deficit. In combination, however, they were able to produce a modest surplus by 1990. But because so much of our national debt is now held by foreigners, the current account would remain in deficit until 1992 even under the most drastic assumptions. Under a combination of these changes in economic conditions, our net foreign debt would rise slowly. Without these changes, as Figure 3 illustrates, the debt would surge dramatically.

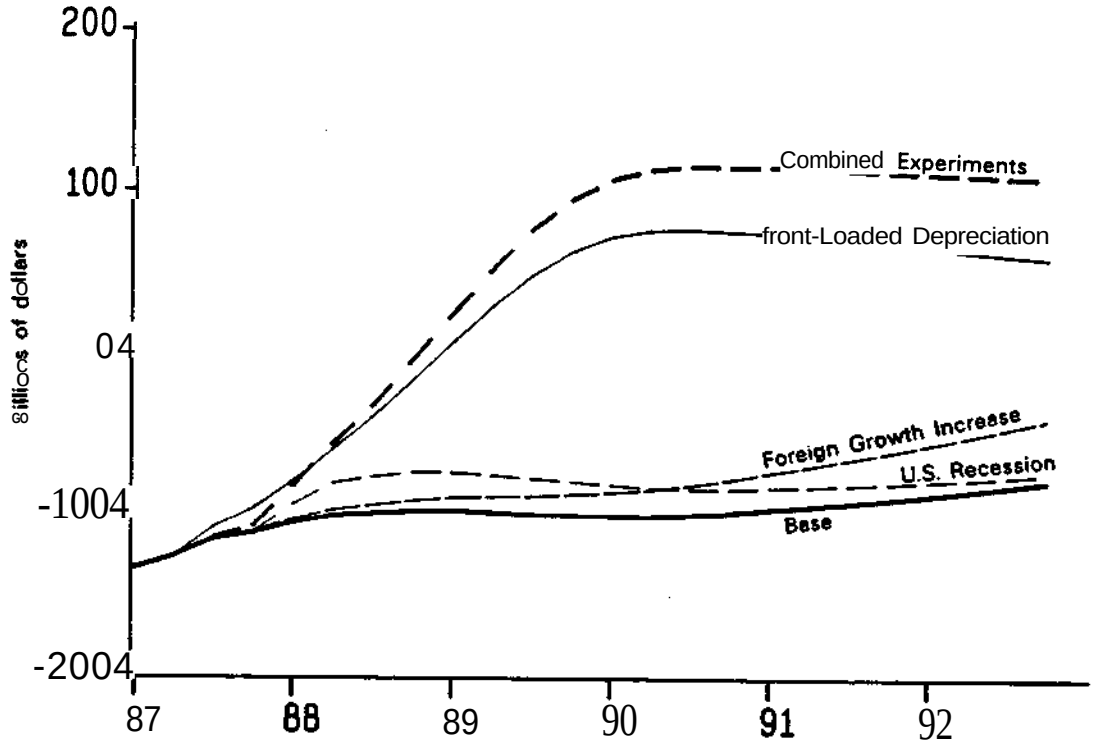
Thank you for this opportunity to present CBO's analysis of the prospects for reversing the current account deficit. I will be happy to answer any questions you may have on the subject.

Figure 1. Nominal Net Exports



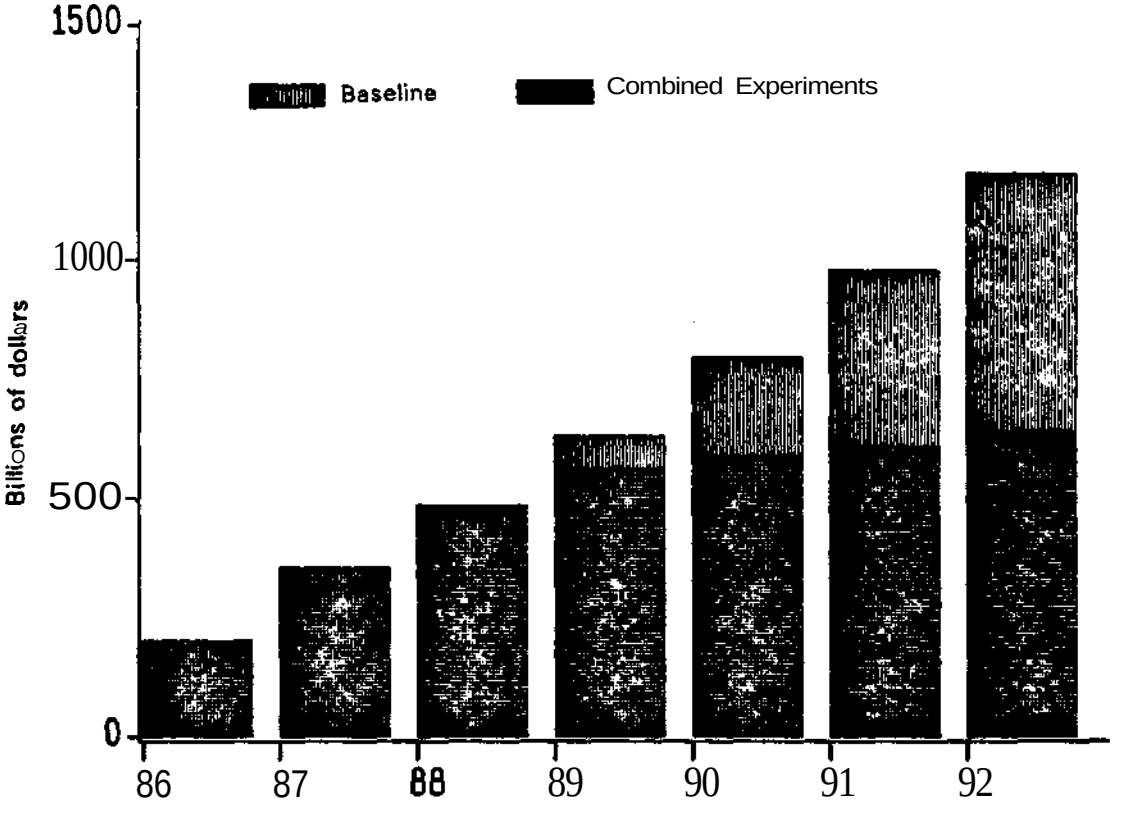
SOURCES: CBO estimates and Department of Commerce.

Figure 2. Real Net Exports



SOURCES: CBO estimates and Department of Commerce.

Figure 3. Net International Debt Position



SOURCES: CBO estimates and Department of Commerce.