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The Greenspan boom reaches its crescendo

1999 and 2000 to be difficult years of adjustment for the US economy

Neglect of the USA's growing payments deficit

International financial commentators have become so obsessed with Japan's various failures that a very serious macroeconomic disequilibrium now emerging in the USA has been almost unnoticed. A standard line has been "the American economy will slow down when the full effect of the Asian crisis comes through". This is tantamount to saying that "the American economy will slow down because the balance of payments is moving heavily into the red". Indeed, the deficit on the current account of the USA's balance of payments in 1998 will be the largest that the world has ever seen. Hardly any concern is being expressed by governments or in financial markets about the medium-term implications of this development.

By end-2000 USA's net debt could be $2,000b., twice the value of its exports

The scale of the deficit would be remarkable even if the USA were a substantial creditor nation. But, in fact, foreign-owned assets in the USA exceeded the USA's foreign assets by over $1,300b. at the end of last year. The current account deficit in the first quarter (Q1) was $47b. and will undoubtedly increase, perhaps towards $60b., in Q2. The current account deficit may be $230b. - $250b. in 1998 and a rather higher figure of, say, $300b. in 1999 and 2000. The USA's negative position on its international investments ("its net debt") may by the end of 2000 be almost $2,000b., which would be more than twice the value of its exports. There is little question that the USA will also have a large and widening deficit on investment income. (See pp. 8 - 9 of this *Review*.) To prevent the external debt running out of control, exports will need to grow faster than imports for an extended period. But this will require a drastic wrench to the growth pattern enjoyed over the last six years. Net exports were a negative influence on GDP in 20 of the 24 quarters to Q1 1998.

Extended period of beneath trend growth in domestic demand will be needed

What form will this wrench take? Plainly, the growth of domestic demand will have to run at a beneath-trend rate also for an extended period. But how likely is that in late 1998 and early 1999 after three years of high money supply growth, vast capital gains from the asset price bubble and an extremely buoyant housing market? (See p. 5, p. 7 and p. 12.) Also helpful would be a lower dollar. Sooner or later a fall in the dollar is inevitable, but it probably will not happen in late 1998. The favourable interest rate differential compared with other leading currencies (apart from sterling) protects the dollar and will widen further when the Federal Reserve tightens. The resolution of the USA's external disequilibria will begin to become part of policy-makers' agenda only next year and thereafter. But the longer the deficit persists, the greater will be foreigners' accumulation of claims on the USA and the worse the eventual problem of adjustment.

Professor Tim Congdon 8th July, 1998

Summary of paper on

"The international consequences of the Greenspan boom"

Purpose of the paper

The US Federal Reserve has not tightened monetary policy in 1998, despite rapid money supply growth, perhaps because of concern about the effect of higher dollar interest rates on Asia's financial crisis. The research paper considers the medium-term consequences of the drastic widening in the USA's current account deficit.

Main points

* **High money supply growth has arguably been the main cause of the asset price bubble and wider economic boom in the USA since 1995. Money growth increased again in late 1997 and early 1998. (See p. 5.)**

* **US national output may now be 2% above trend, although the figure would be nearer 4% if the change in net exports had not been negative in recent quarters. (See pp. 6 - 7. A deterioration in net exports absorbs excessive growth in domestic demand.)**

* **Foreign-owned assets in the USA exceeded the USA's foreign assets by over $1,200b. at the end of last year. The "net debt" figure will probably move towards $2,000b. by the end of 2000, with a deficit on investment income running at an annual rate of over $50b. (See pp. 8 - 9.)**

* **To prevent the USA's external debt running out of control, US exports will need to grow faster than US imports for an extended period. But in 20 of the 24 quarters to Q1 1998 imports grew faster than exports. (See p. 11.)**

* **Beneath-trend growth in domestic demand will be required to make a large resource shift into the balance of payments, but rapid money growth, sky-high equity prices and buoyant housing all suggest continued above-trend growth in domestic demand over the next few quarters. (See p. 12.)**

This research paper was written by Professor Tim Congdon, with help from Mr. Alexander Skinner in the preparation of the charts.

The international consequences of the Greenspan boom

Serious US medium-term internal imbalance as well as domestic overheating

"New paradigm" ascendant,

The last few months have seen continued euphoria about the American economic outlook. Low unemployment and strong economic growth has coincided with the best inflation figures since the early 1960s, apparently validating claims that the USA can now enjoy a "new paradigm" of never-ending inflation-free economic growth. The purpose of this research paper - which extends the analyses in the February and April issues of the *Monthly Economic Review* - is to argue that the excellence of the macroeconomic performance is largely illusory.

but excellent macro numbers rely on slide into external payments deficit

The central points can be quickly summarized. The USA has been able to combine low unemployment with modest inflation because the rise in the dollar has reinforced foreign competition and curbed American companies' ability to increase prices. But the result has been a marked excess of import over export growth, so that substantial current account deficits over the next three or four years are inevitable. The cumulation of these deficits will make the USA by far the largest international debtor that the world has ever seen. Moreover, in 1999 and 2000 the emerging balance-of-payments problem will interact with the need to prevent domestic overheating.

Excessive money growth behind asset price bubble

The starting-point of this argument is a review of money supply growth on p. 5. It shows a clear break in monetary trends in early 1995, with the annual increase in the M3 money measure moving up from 1% in the five years before that to 8% subsequently. Balance-sheet strength throughout the economy has been transformed, while asset prices have soared. Wholesale money balances are climbing at about 20% a year.

and boom in domestic demand

In normal circumstances money supply growth at these rates ought - after a period of three years - to have led to an upturn in inflation. Vigorous increases in domestic demand and output ought to have taken output above its trend level, causing inflation to increase. There has certainly been a boom in domestic demand, as demonstrated by the chart on p. 7, and the USA's national output may now be 2% or more above trend. (See p. 6.) In line with the argument, service-sector inflation is increasing.

However, the inflationary pressures have to a large extent been diverted abroad by a widening in the current account deficit of the balance of payments. The deterioration in external payments began in 1992 in the early phase of the recovery, but has become much more pronounced since Q2 1997. If excess demand had not been siphoned off in this way, output might today be 4% or so above trend. The implied overheating would be comparable to that at the cyclical peaks in 1967, 1973 and 1979, and rather worse than that in 1989. (See p. 6.)

Above-trend growth in domestic demand to continue

The future path of domestic demand is a matter of debate. The persistence of rapid broad money suggests that the economy is still characterized by excess liquidity. One symptom is the valuation of the stock market, which remains extremely ambitious by past standards. The housing market - a classic leading indicator for demand as a whole - is having a superb year. Mortgage applications to buy houses have been at record levels. The latest data (see p. 12) suggest that new home sales and turnover in existing homes will increase to fresh peaks in the autumn, as people try to convert capital gains on the stock market into more housing equity. On this basis the increase in domestic final sales is likely to remain at above the trend rate in late 1998 and even in early 1999. (Note that "domestic final sales" differs from "domestic demand", because it excludes inventory building. Inventory building will indeed drop in Q2 from an extraordinarily high figure in Q1, but domestic demand is ultimately dominated by domestic final sales.)

***Either* output goes further above trend *or* payments gap widens**

If domestic demand keeps on growing at an above-trend rate, there are two possible consequences. First, national output will go even further above trend, implying more intense overheating. Secondly, the current account deficit will widen again. Yet the implications of another widening in the current account deficit are frightening.

US net investment position to be negative by $2,000b. by end of 2000?

The chart on p. 8 shows that the excess of foreign-owned assets in the USA over the USA's assets abroad (i.e., the "net debt") was over $1,300b. by the end of last year, while the USA has started to incur a deficit on its investment income account. Three years of current account deficits in the $250b. - $300b. range would take the net debt to roughly $2,000b. and the deficit on investment income to over $50b. The increased deficit on investment income would itself add to the current account deficit. To prevent the net external debt running out of control, US export growth would for an extended period have to run well ahead of import growth.

Domestic demand growth will have to be curbed,

But that would be quite different from the pattern in the 1990s. The chart on p. 7 shows that imports rose faster than exports in 20 of the 24 quarters to Q1 1998, while the chart on p. 11 demonstrates that the plunge into deficit has accelerated in the last few quarters. (Incidentally, the trade deficit would be $25b. a year higher if the oil price was $20 a barrel instead of $13 a barrel.) Over the next few years the main corrective options will be,

- measures to restrict the growth of domestic demand to well beneath its trend rate,
- a dollar devaluation, or
- some combination of demand restriction and dollar devaluation.

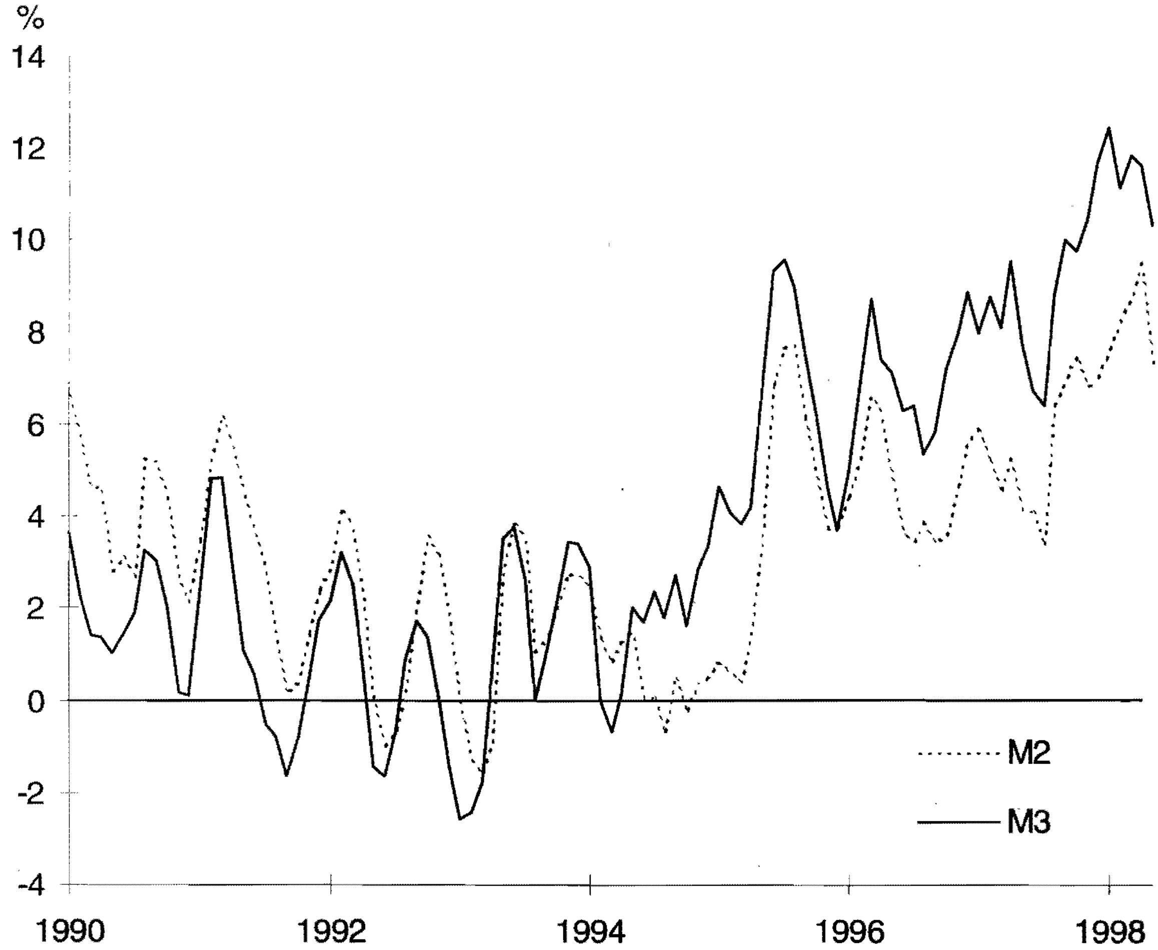
with timing determined by international capital flows

The necessary action can be postponed while capital inflows into the USA (see p. 10) are on their present massive and bizarre scale. But the longer the capital inflows continue, the more severe the macroeconomic imbalances will become and the worse will be the eventual problems of adjustment.

Money growth still rising

High money growth the main cause of the Greenspan boom

Chart shows six-month annualised growth rates of M2 and M3.



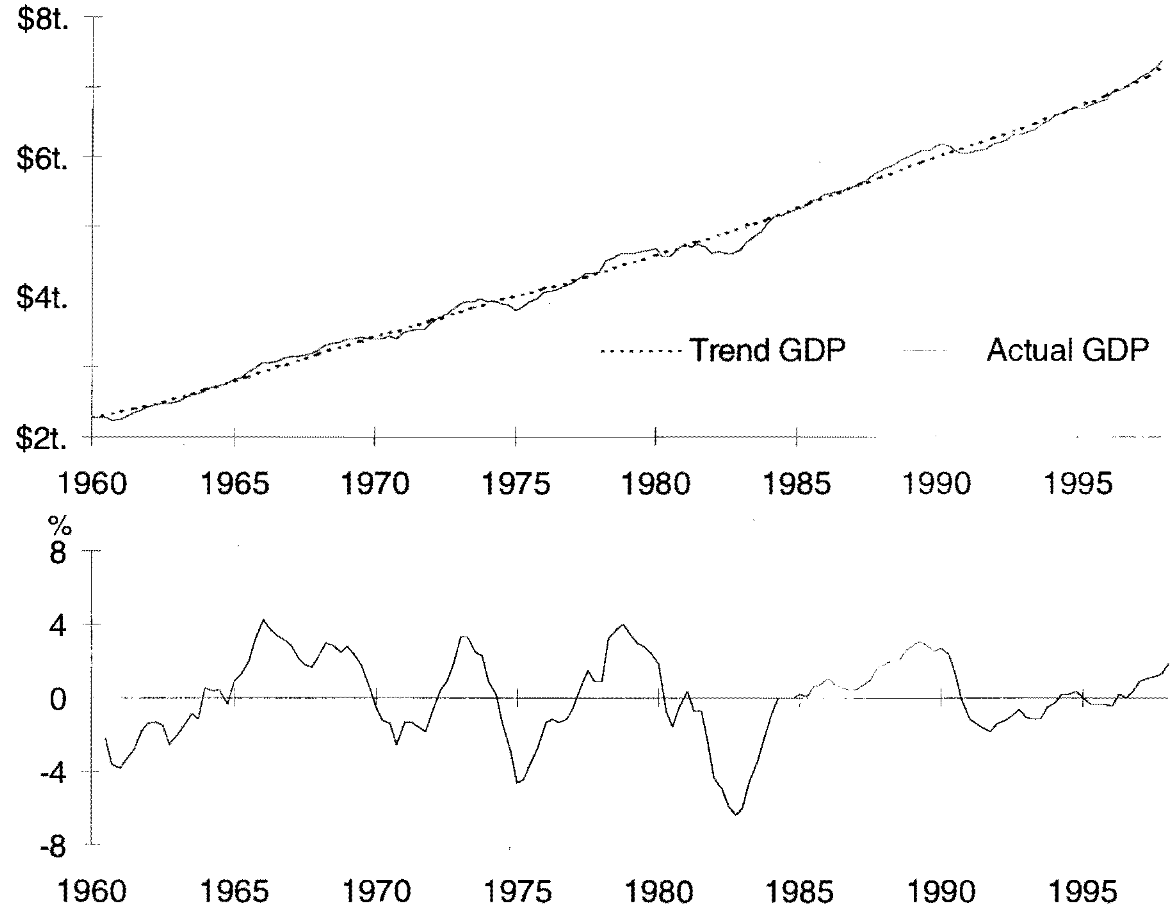
Source: Federal Reserve.

US money supply growth accelerated sharply in 1995. Whereas on the very broad M3 measure it had been between about 1% a year in the five years to end-1994, it has been 8% a year since then. The chart shows that late 1997 and early 1998 saw the fastest rates of increase in the current cycle. The excess liquidity created by the high money supply growth has been the dominant reason for the asset price bubble now evident in the USA. A strong argument can be made that, because of the associated "wealth effects" on consumption and investment, high money growth has also been the principal cause of the wider economic boom. In the six months to May the wholesale money balances which count only in M3 (i.e., "large time deposits, institutional money funds, repurchase liabilities and Eurodollar deposits of US addressees") rose at an annualized rate of 21.8%.

Output may be 2% above trend

Stability of mid-1990s gives way to overheating

Upper chart shows actual GDP relative to trend. Lower chart shows the level of the output gap, a measure of the level of output relative to trend.



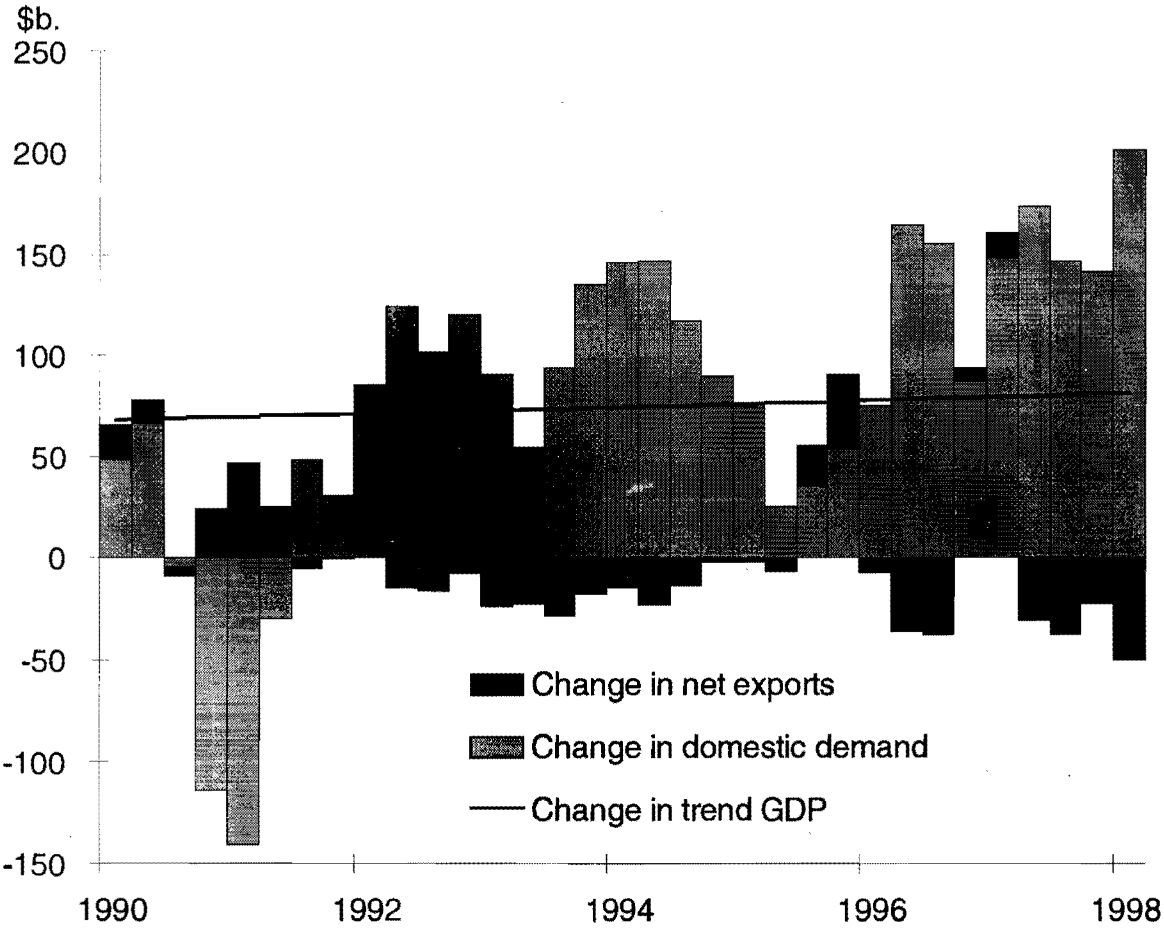
Source: Economic Indicators, Lombard Street Research estimates.

A fundamental idea in Lombard Street Research's analyses of all economies is that the change in inflation depends on the level of the "output gap", where the output gap is the difference between trend and actual output. (One equation for this relationship in the USA suggests that consumer inflation rises by 1/2% a year for every 1% of positive output gap; the coefficient is reduced if import costs and oil prices are also independent variables.) As US output has probably been above trend since late 1996 inflation ought by now to have started to increase, but cost pressures have been contained because of the drop in commodity prices, particularly the oil price. With output today perhaps 2% above trend, domestically-generated inflation ought to be rising. In fact, the labour market is very tight and service inflation is undoubtedly going up.

Unsustainably rapid growth in demand

Without negative net exports, output would now be 4% above trend

Chart shows influence of change in domestic demand and net exports on GDP. The continuous black line shows the estimated trend increase in GDP.



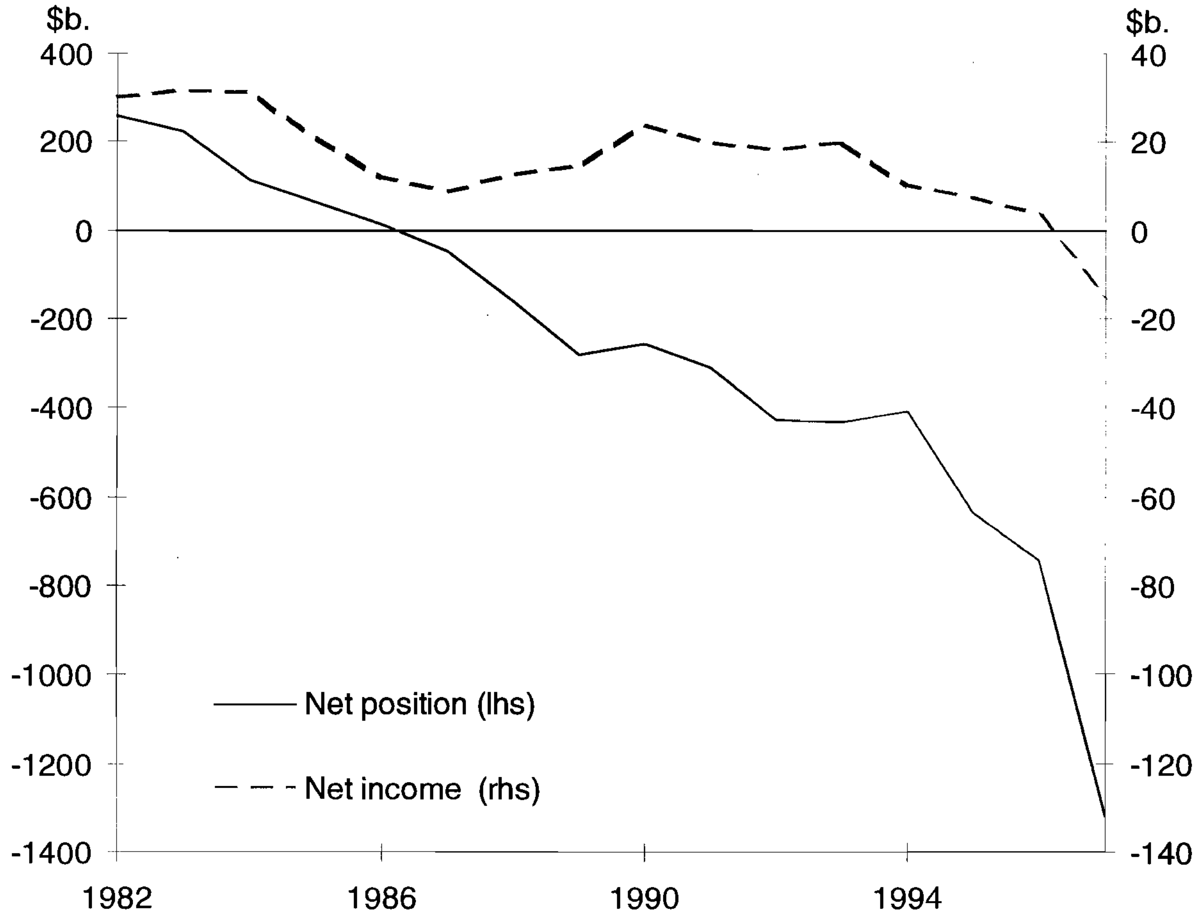
Sources: Bureau of Commerce, Lombard Street Research.

The increase in domestic demand exceeded the trend rate of US output growth in 18 of the 24 quarters to Q1 1998. (Trend growth is assumed to be 2.3% a year.) The excess growth of domestic demand was absorbed in two ways, by transforming a negative output gap in 1992 to a positive output gap in early 1998 and by a marked widening in the external payments deficit. In fact, the change in net exports was a negative influence on GDP growth in 20 of the 24 quarters to Q1 1998. The most salient period of buoyant domestic demand has been in the last 18 months, despite repeated forecasts from the Federal Reserve and others throughout this period that the economy was about to slow down. If the payments deficit had not acted as a "safety valve" for excess demand, US national output would today be 2% to 3% further above its trend level (i.e., the positive output gap would be 4%), implying a persistent increase in inflation of about 2% a year.

Does anyone care?

1. U.S. nebt "debt" exceeds $1,000b. and investment income in deficit

Chart shows U.S. net international investment position and income. Note that revaluations have important effects, notably in 1997 when foreign owned assets in the U.S.A. increased because of the stock market boom.

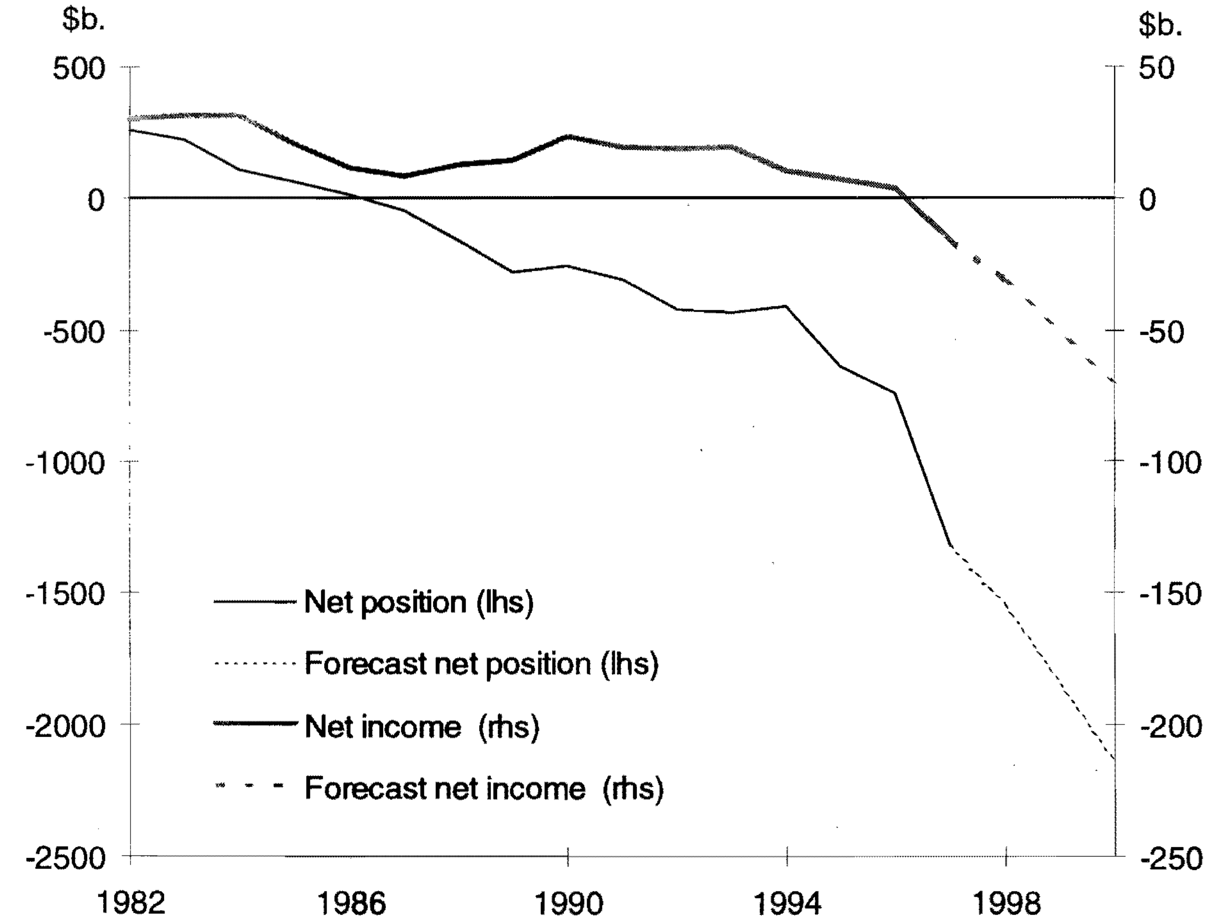


Source: Bureau of Commerce.

The USA became a net debtor in the mid-1980s, following the large current account deficits of the early 1980s. These deficits were widely attributed to the budget deficits created by President Reagan's tax cuts. Nevertheless, the USA continued to have a surplus on international investment income, reflecting the historical success of its foreign investments. The early 1990s saw a sharp reduction in the budget deficit (mainly because of cuts in defence spending), but since 1995 foreign purchases of US Treasury debt has been on an unprecedented scale, exceeding $200b. a year. These purchases have been the principal capital flow covering the renewed large current account deficits of the last few years. Unhappily, the interest cost on the foreign holdings of US Treasuries is rising steeply. The USA now has an annual deficit on investment income, which could exceed $50b. by 2000.

2. U.S. net "debt" to reach $2,000b. (almost 25% of GDP) by 2000

Chart shows actual and forecast U.S. net international investment position and income. Forecast assumes further deterioration in the U.S. current account to 2000.



Sources: Bureau of Commerce, Lombard Street Research projections.

The last three years on the chart above are projections, and assume a current account deficit in 1998 of $230b. and in 1999 and 2000 of $300b. (The investment income account weakens each year by 6% of the current deficit, matching an assumed yield on US debt.) Admittedly, the procedure here is sketchy and *ad hoc*. Much of the past deterioration in the net investment position was due to revaluations of capital assets and did not correspond numerically to the current account position. Despite these qualifications, it is clear that the USA's external liabilities (including equities and direct investments held by foreigners in the USA) will be more than $2,000b. greater than its external assets by the start of the next century. In other words, the net "debt" will be approaching 25% of GDP and growing by about 3% - 5% of GDP every year.

What are the crucial capital inflows?

Foreign buying of U.S. Treasuries less significant recently

The table shows the key items in the U.S.A.'s balance of payments, in $b.

	1996	1997	1998 Q1
Current account	-134.7	-155.2	-47.2
Capital account items:			
U.S. gov. assets inc. reserves	6.0	-1.2	-0.9
Increase in U.S. private assets abroad	-374.8	-477.7	-43.9
Increase in foreign assets in the U.S.A.	563.4	733.4	90.9
of which			
- claims on U.S. banks	22.2	170.0	-43.0
- U.S. Treasuries and gov. secs.	270.7	143.8	10.6
- other claims	270.5	419.2	123.3
Discrepancy	-59.6	-99.7	-1.1
Net Position	Nil	Nil	Nil

(The net position is the sum of the current account position and all the items in the capital account)

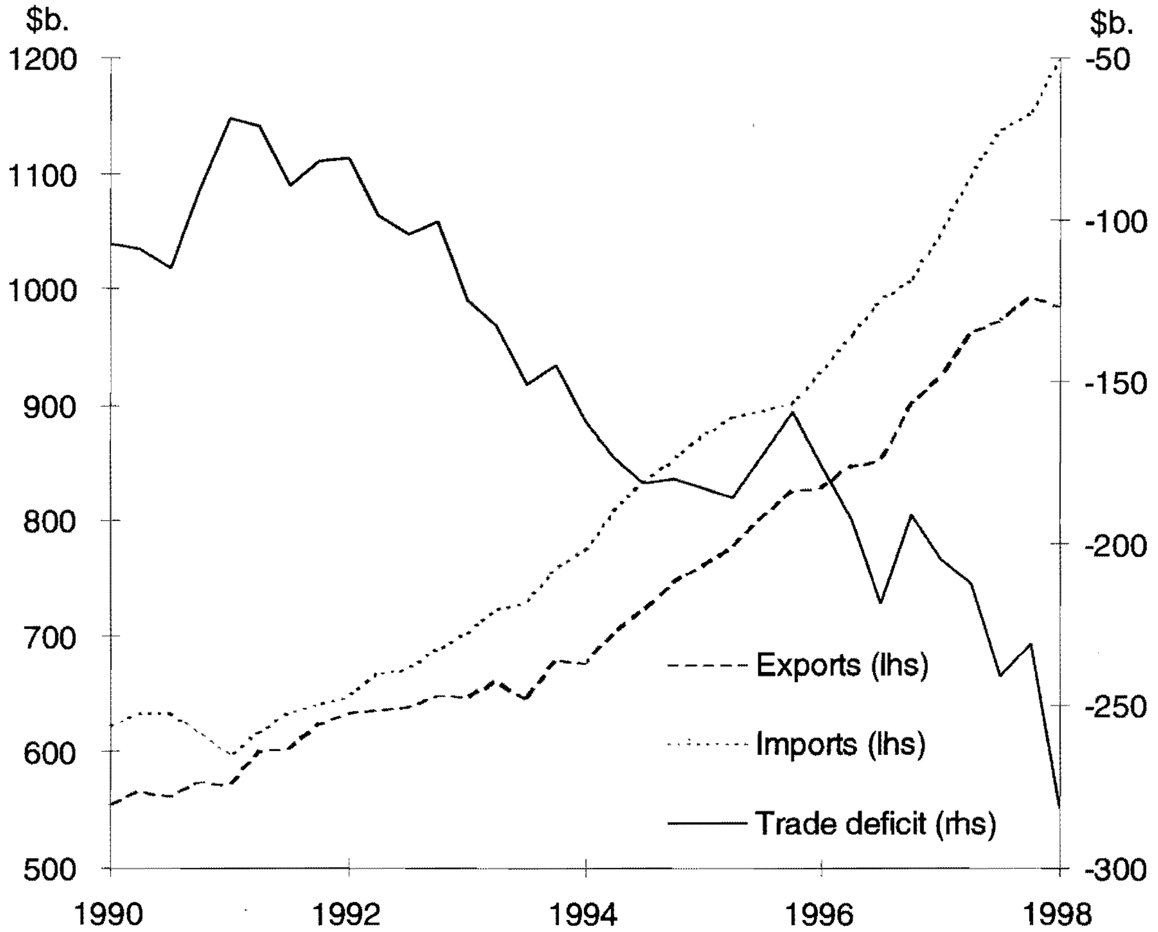
Source: Federal Reserve Bulletin.

So far the USA's current account gap has been easy to finance. Indeed, in the last two years the USA has been able to combine a large current account deficit with a wave of international acquisitions by its leading multinationals (i.e., a deficit on these capital account items). The key has been enormous capital inflows from abroad, particularly foreign buying of US Treasuries. (See the research paper "Unsustainable" in the February 1998 issue of this *Monthly Economic Review* for further discussion.) The table shows that foreign buying of US Treasuries slowed down in Q1 1998, although this may have been only a temporary interruption of a longer-term trend. Foreign buying of other US assets was extremely buoyant in early 1998. In fact, foreign buying of US equities was $29b., the highest quarterly figure ever.

Plunge into deficit is accelerating

How will the investment income deficit be covered?

Chart shows U.S. imports and exports of, and trade balance on, goods and services on a national accounts basis, annualised quarterly data, in constant 1992 prices.



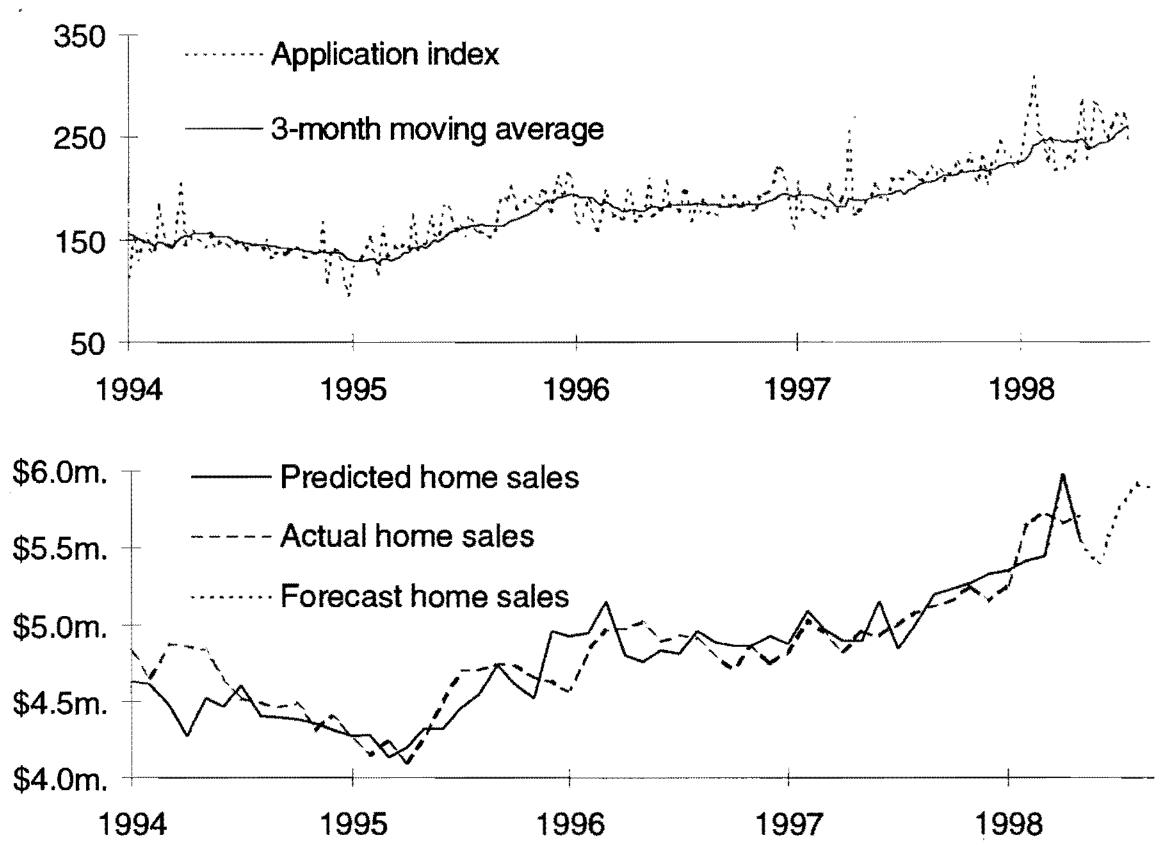
Source: Department of Commerce.

The US trade position was been sliding into deficit throughout the 1990s, but the chart shows a marked acceleration in the trend in the last few quarters. This has reflected the strengthening of the boom since 1996 (see p. 7) and the Asian effect since last summer. As the investment income account seems likely to move into a deficit of over $50b. a year by 2000, the trade gap will need to narrow in order to prevent the current account deficit becoming even larger. With the value of imports of goods and services running almost 25% higher than exports, that will be possible only if exports grow at a significantly faster rate than imports. But at present imports are growing much more rapidly than exports. A nasty wrench - involving a clamp on domestic demand growth, a fall in the dollar or both - will eventually be needed.

U.S. housing market still buoyant into the autumn

Boom in domestic demand will continue

Upper chart shows M.B.A. mortgage application index, 16th March 1990 = 100. Lower chart shows actual and forecast total home sales in the U.S. (saar). The figures for predicted and forecast home sales are based on an equation with mortgage applications as the independent variable



Sources: Department of Commerce, Mortgage Bankers' Association, National Association of Realtors, Lombard Street Research.

This year Lombard Street Research has used the weekly series on mortgage applications as direct evidence of roaring domestic demand in the USA. (Our exercise correctly forecast the surge in home sales in early 1998, from which it was a reasonable surmise that sales of household durable goods - and indeed consumption as a whole - would be buoyant.) The main point from the latest data is that another and even stronger burst of housing market activity lies ahead in the late summer and autumn. The underlying behaviour of domestic final sales (i.e., excluding the effect of inventories) will be difficult to identify over the next few months, because of the strike at General Motors and the high inventory accumulation in Q1. But - if present levels of interest rates, bond yields and the stock market persist - forecasts of a slowdown to beneath-trend growth in the next two quarters will again be wrong.