

LOMBARD STREET RESEARCH

Monthly Economic Review

No. 114, December 1998

Contents	Page No.
Commentary on the economic situation	1
Research paper - Topic: "Totally unsustainable"	3

The *Lombard Street Research Monthly Economic Review* is intended to encourage better understanding of economic policy and financial markets. It does not constitute a solicitation for the purchase or sale of any commodities, securities or investments. Although the information compiled herein is considered reliable, its accuracy is not guaranteed. Any person using this *Review* does so solely at his own risk and *Lombard Street Research* shall be under no liability whatsoever in respect thereof.

Gerrard Group PLC

Gerrard & King Limited

Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2800
Fax: 0171 337 2801
e-mail: enquiry@gerrard.com

GNI Limited

Cannon Bridge,
25 Dowgate Hill,
London EC4R 2GN
Tel: 0171 337 3500
Tlx: 884862
Fax: 0171 337 3501
e-mail: enquiry@gni.co.uk
www.gni.co.uk

Lombard Street Research Ltd.

Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2975
Fax: 0171 337 2999
e-mail: lsr@lombard-st.co.uk
www.lombard-st.co.uk

Greig Middleton & Co. Limited

30 Lombard Street,
London, EC3V 9EN
Tel: 0171 655 4000
Fax: 0171 655 4321
e-mail: enquiries@greigm.co.uk
www.greigm.co.uk

Greig Middleton Financial Services Limited

30 Lombard Street,
London, EC3V 9EN
Tel: 0171 655 4000
Fax: 0171 655 4343

Has the Federal Reserve blundered?

Data show a credit craze, not a credit crunch

Controversial cuts in Fed funds rate

The three cuts in American interest rates this autumn have become controversial. They were announced despite above-trend growth in demand in the USA over the previous two years, a tight labour market, a current account deficit of unprecedented size and rapid growth in the money supply. Although apparently justified by the turmoil in financial markets from July to September, the Federal Reserve's comment on "unusual strains" in capital markets has puzzled many commentators. It may have been a reference to wide spreads in the high-yield debt markets, but such spreads are of limited macroeconomic significance. There is no recognized theory of national income determination in which the volume and terms of bond issuance play an important role. (They are, of course, very important in determining the incomes of investment bankers working in the high-yield area.)

Extremely rapid growth in bank credit and money recent weeks

The blockage in the high-yield bond market encouraged the newspapers to talk about a "credit crunch". But the Fed's own weekly data show that bank credit was unaffected. In the 13 weeks to 9th November US bank credit rose by 4.6% or at an annualized rate of 19.8%, with the growth in bank credit to industrial and commercial borrowers being particularly rapid. Media stories about the supposed "crunch" were at their most shrill in October, but in the four weeks to 26th October bank credit jumped by 2.2% or at an annualized rate of 29.5%. The increase in bank assets has of course been matched by the same increase in bank liabilities, including deposits which are the dominant constituents of the money supply. In the 13 weeks to 16th November US M3 increased by almost 3.9% or at an annualized rate of 16.3%. M3 minus M2, which is one measure of wholesale money, climbed in the same period by 5.2% or at an annualized rate of 22.3%.

USA's international payments situation is totally unsustainable

Recent weeks have been exceptional, but the situation is surely better described as a credit craze than as a credit crunch. Excess money creation has obvious relevance to the continuing bubble in American asset prices. A case can be made that in early 1998 dollar interest rates were too low and US money growth too high to be sustainable in the long run. That case could be valid, even conceding that an easy American monetary policy had become necessary for global economic health. But the charge of unsustainability can be pressed more forcefully now. The clearest symptom is the USA's plunge into deficit on its external accounts. The current account deficit in 1998 will probably be over \$225b.; the figure in 1999 is likely to exceed \$300b., equivalent to 4% of GDP. In all countries the eventual results of excessive money supply growth are rising inflation and a large balance-of-payments deficit. The bubble and boom of Mr. Greenspan's second term at the Fed have been wonderful while they lasted, but they cannot last forever.

Summary of paper on

"Totally unsustainable"

Purpose of the paper

The US Federal Reserve has reacted to recent financial market turmoil by cutting interest rates, in the belief that the a buoyant American economy could act as spender of last resort in a deteriorating world economy. This research paper asks whether the policy easing is sustainable.

Main points

- * **Despite media comment about a "credit crunch", US broad money growth has accelerated in the last three months and is running at an almost double-digit annual rate. (See p. 8.)**
- * **Excess liquidity since late 1994 has led to sharp "multiple expansion" for US corporate equities and is the most compelling general explanation for the apparent over-valuation of the stock market. (See p. 9.) Domestic demand growth has boomed since early 1996, partly in response to positive "wealth effects" from the over-valued stock market. (See pp. 10 - 11.)**
- * **Excess demand growth has led to a widening in the current account deficit, which is likely in 1999 to reach a new peak as a share of GDP. The widening has been most pronounced since the start of the Asian crisis in summer 1997. (See pp. 12 - 13.)**
- * **Making the neutral assumption that the USA's exports, imports and GDP all grow at the same rate from now on, the current account deficit widens indefinitely because of a deterioration in the investment income account. (See p. 14.)**
- * **Making the same neutral assumption, the excess of the USA's foreign liabilities over assets slides to 30% of GDP by 2003 and to 50% of GDP by 2010, similar to figures found in semi-bankrupt developing countries.**
- * **The USA's balance-of-payments situation, and the bubble and boom of Mr. Greenspan's years at the Federal Reserve, are therefore totally unsustainable. (See p. 15.)**

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

Totally unsustainable

Will the world's largest-ever payments gap wreck its biggest-ever bull market?

US current account deficit has widened sharply in 1998, as expected

Although 1998 has been a strange year for the world economy, one feature has been easy to forecast and has unfolded much in line with predictions. This is the widening of the USA's current account deficit to the highest-ever levels. The February issue of this *Monthly Economic Review* suggested that "in ballpark terms, the USA's current account deficit may be \$70b. to \$100b. higher than in 1997". Numbers are now in for the current account deficit for the first and second quarters (the Q1 and Q2 deficits were of \$46.4b. and \$56.5b. respectively), and the trade deficit in July and August. The current account deficit for the year as a whole is clearly headed towards the \$230b. - \$250b. area, \$75b. - \$95b. higher than last year's \$155b.

1999's deficit will be highest-ever in nominal terms and perhaps as a share of GDP in the US case

In nominal terms a payments gap of approaching \$250b. is by far the largest ever recorded. The USA also set the previous record, of \$167.4b. in 1987. It is true that, relative to national output, 1987's deficit was larger than 1998's. (1987's deficit was 3.6% of GDP, whereas 1998's will be roughly 3%.) But the trend is still for deterioration. The current account deficit in Q4 will probably be of the \$70b. order, which will be about 3 1/2% of GDP. In 1999 the deficit is likely to be both the highest ever seen in nominal terms by any nation and could be the highest in the 20th century as a share of the USA's GDP. The purpose of this *Monthly Economic Review* - which follows related analyses in the February, April and July issues this year - is to ask why the slide into deficit has occurred, to give projections, and to review some of its consequences for both the American and world economies.

Booming demand in the USA main reason for widening deficit

In one sense the reason for the deficit is obvious. There is a clear contrast between, on the one hand, booming demand in the USA and, on the other, sluggish or contracting demand in Japan and many emerging economies, particularly in Asia. The charts on pp. 8 - 9 show that - contrary to the repeated forecasts of a slowdown in the American economy - domestic demand has been growing at an above-trend rate since early 1996 and was still doing so in Q3 1998. In the first half of 1998 domestic final sales were rising faster than at any other time in the 1990s.

Boom has happened against background of rapid money supply growth, despite scares about "the credit crunch"

But this raises the question of why spending in the USA has been so strong. The argument here is that the boom is readily interpreted as the result of excessive money supply growth. Broad money growth was low in the early 1990s, but rebounded in 1995 as the banking system once again became profitable and well-capitalized. Despite hundreds of press reports about "the credit crunch", money supply growth has accelerated in recent months. In the three months to end-October, M3 jumped by 3.7% or at an annualized rate of 15.9%; in the month of the alleged "crunch" itself (i.e., October) M3 went up by 1.6%, i.e., at an annualized rate of 20.5%. (See the chart on p. 8.)

Excess money has supported an acquisition spree and the greatest bull market in history

The over-supply of liquidity has been particularly marked in the corporate sector, where it has led to the biggest acquisition spree in history, and in the financial system, where inflows into mutual funds have run at unprecedented levels. The excess demand for corporate equity has pushed up prices, with the S & P 500 index more than doubling between the end of 1994 and November 1998. The capital gains enjoyed by the American public in this period amount to over a half of the USA's GDP and are not much less than one year's personal income. In December 1996 Mr. Alan Greenspan, chairman of the Federal Reserve, warned about "irrational exuberance" in stock market valuations, but investors brushed this aside. Over the following 18 months the S & P index soared by more than 60%. (See p. 9.)

The bubble and the boom can be fairly attributed to Greenspan

A case can be made that the rapid money supply growth of recent years has been the dominant cause of the world's greatest-ever bull market. Further, the over-valuation of equities can be seen as the driving-force behind the buoyancy in the USA's domestic demand, as people try to convert their stock-market winnings into different assets, such as houses, other forms of real estate and consumer durables. More concisely, the boom in the economy is a by-product of the bubble in asset markets and, at a further remove, of unduly high money supply growth. At the moment Mr. Greenspan enjoys a high reputation for the sagacity of his decisions on interest rates and his skill in protecting the solvency of the American banking system. (Amazingly, in the late 1980s he was also known as a "monetarist".) However, he must at the same time take responsibility for the money supply excesses of recent years and - whether he likes it or not - for the continued froth in US asset markets. It is perfectly fair to refer to the Greenspan bubble and boom.

Asian crisis has deferred rise in inflation

How will it end? If the current business cycle were to follow a standard pattern, the USA ought by now to be suffering from higher inflation. The tight labour market has in fact led to an upturn in pay increases, with the employment cost index rising in Q3 by 1.0% (i.e., at an annualized 4.0% rate). But overall the inflation figures remain good. This appears anomalous and is widely attributed to "the new paradigm" of never-ending inflation-free growth. However, a good case can be made that the USA and the Federal Reserve have been lucky, with international developments deferring the onset of inflation trouble. In particular, the Asian crisis since mid-1997 has been helpful in two ways. First, it has undermined commodity prices, including the oil price. Secondly, it has diverted excess demand from the USA to suppliers in the rest of the world. Without the Asian crisis the USA's inflation rate, and of course that in other industrial countries, would now be higher.

and instead led to a vast payments deficit

The Asian crisis has had the benign effect of postponing the rise in inflation that ought to have followed the Greenspan bubble and boom. But the deflection of the USA's excess demand to other countries has aggravated the USA's payments deficit. Indeed, simple spreadsheet work shows that the American payments position is totally unsustainable. The current account can be split into three parts, the deficit on trade in goods and services, the investment income

account and the remaining payments (which include items like government transfers).

If it is assumed that

If exports and imports now grow at the same rate, the deficit widens to 4% of GDP by 2004 and to 5% of GDP by 2010

- i. the current account deficit in Q4 1998 is \$70b., and
- ii. from Q4 1998 onwards exports and imports rise at the same rate of 1.25% per quarter (i.e., at roughly a 5% annual rate), and
- iii. the investment account deteriorates every quarter by 1.25% of the previous quarter's current account deficit (i.e., that the annual rate of return on investments in the USA is 5%),

and the USA's net external "debt" slides to 50% of GDP by 2010

the current account deficit widens relentlessly over the next decade. (See p. 14.) By 2004 the deficit is 4% of GDP and by 2010 it has reached 5% of GDP. Even more dramatic is the outlook for the USA's international balance sheet. At the end of last year foreigners owned more assets in the USA than Americans owned abroad. The negative balance on the USA's external assets and liabilities at the end of 1997 has been officially estimated at over \$1,300b. or 16% of GDP. On the assumption that the negative international asset position changes in line with the current account deficit (i.e., ignoring asset revaluations), it increases to 30% of GDP by 2003 and to 50% by 2010.

This is unsustainable, because debtor nations must have trade surpluses to pay the deficit on investment income

Some analysts might say "so what?". They might claim, for example, that the Japanese demand for foreign assets is a fact of life, and that only the USA has an economy large and stable enough to meet their investors' requirements. The difficulty here is the manifest long-run unsustainability of the trends once they are extended to, say, 2015 or 2020. A possible theoretical objection is that some countries - such as Australia - have had current account deficits ever since their establishment and that they remain internationally solvent. But, in all such countries, a surplus on trade in goods and services is required in order to cover a deficit on investment income. (Of course, the deficit satisfies the income needs of the foreign investors. They would not have invested in the first place, if they were not eventually to receive a return in the form of profits or dividends.) Unfortunately, on the projections made in this research paper, the USA has a deficit on *both* the investment income account *and* on its trade in goods and services. At some point its exports must rise faster than its imports to transform its trade deficit into a trade surplus, but p. 7 in the July issue of the *Monthly Economic Review* showed that imports had risen faster than exports in 20 of the 24 quarters to Q1 1998. This record now needs to be extended to 22 of the 26 quarters to Q3 1998. (See p. 10.)

Unsustainability of the present situation is far more obvious than in the late 1980s,

A perspective is given by recalling some analyses of the American trade position in the late 1980s, when the Washington-based Institute for International Economics voiced concern about the long-run consequences of never-ending external deficits. A 1989 study by William Cline on *American Trade Adjustment: the Global Impact* asserted that "far more needs to be done to

when the Institute for International Economics expressed great concern

reduce the US external deficits to sustainable levels" and proceeded to quantify a sustainable deficit as "being in the range of \$50b.". Cline argued that, if the deficit were curbed to that level by 1992, the ratio of external debt to GDP would stabilize at about 14% and the USA would retain a surplus on investment income in the 1990s. Now - almost a decade later - Cline's 14% limit has been breached, the USA has a deficit on investment income, and a current account deficit of almost \$300b. is causing the debt/GDP ratio to increase by 3% a year. The situation today is evidently much worse than that in the late 1980s, which at the time caused so much anxiety among American economists.

The USA has benefited from lower oil prices

An important detail here is the deficit on oil trade. In the early 1970s the USA was virtually self-reliant in energy, but over the next few years it began to import oil on a large scale. The increase in imports paused in the early 1980s, but since the big oil price drop in 1986 imports have risen steadily and now amount to about 10m. barrels per day. (See p. 16.) It follows that a \$5-a-barrel change in the oil price affects the USA's external payments by almost \$20b. If the oil price were to return to the same levels (in real terms) as in the early 1980s, the hit on the current account would be over \$150b.; if - more plausibly - the oil price rises from \$12.50 a barrel today to \$25 a barrel five years from now, the adverse current account impact would be of the \$50b. order.

How could the USA stabilize its debt/export ratio at 20% next year?

Table shows one example in which the path of imports and exports is changed to stabilize net external liabilities at 20% of GDP from Q3 1999. Actual figures are in normal case, Lombard Street Research projections are in italics. Imports, column A, assumes that they grow by 1 1/4% per quarter. Imports, column B, shows a path of imports sufficient to stabilize the ratio of net external liabilities to GDP.

	Imports \$b.		Net external liabilities \$b.		Net external liabilities as % of GDP	
	A	B	A	B	A	B
Q1 1998	271	271	-1372	-1372	16.4	16.4
Q2 1998	274	274	-1435	-1435	17.0	17.0
Q3 1998	278	278	-1498	-1498	17.6	17.6
Q4 1998	283	283	-1568	-1568	18.2	18.2
Q1 1999	287	287	-1639	-1639	18.8	18.8
Q2 1999	209	209	-1713	-1713	19.4	19.4
Q3 1999	294	294	-1788	-1788	20.0	20.0
Q4 1999	297	247	-1865	-1815	20.6	20.0
Q1 2000	301	246	-1944	-1837	21.2	20.0
Q2 2000	305	249	-2024	-1860	21.8	20.0
Q3 2000	309	252	-2107	-1883	22.4	20.0
Q4 2000	313	254	-2191	-1907	23.0	20.0

Projection assumes that net external liabilities increase by the change in the current account balance during the relevant period. So asset revaluations are ignored.

Sources: Bureau of Economic Analysis, Lombard Street Research projections.

To stabilize the debt/GDP ratio, US exports must grow faster than imports

To repeat, the USA's external payments position is totally unsustainable. 1999 and 2000 will see increasing reluctance on the part of international investors to hold dollars, unless interest rates and bond yields rise to attract capital inflows. Over a period of years a lower dollar will be needed to stimulate exports. Sooner or later the USA's exports must rise faster than its imports, in order to stabilize the negative external assets ratio at a reasonable ratio of GDP. If the dollar's decline is insufficient for this purpose, a squeeze on domestic demand will be required. Instead of domestic demand rising faster than the trend rate of growth of GDP, it will have to grow more slowly or even contract.

How could the debt/GDP ratio be stabilized?

The numbers in the table on p. 6 show an example of the macroeconomic changes required to stabilize the USA's net external liabilities (or "debt") at 20% of GDP next year. It is a crude exercise and bears to no precise relationship to any expected reality, but it does convey a sense of orders of magnitude. The projection in the table follows the same assumptions as that on p. 14 until Q3 1999, when "policy" (i.e., higher interest rates, tax increases) changes to prevent the debt/GDP ratio exceeding 20%. All the burden is assumed to fall on imports, which slump from \$294b. in Q3 to \$247b. in Q4 or by 15%. This is equivalent to about 2% of US domestic demand.

Need for squeeze on domestic demand,

A 2% fall in domestic demand would not be particularly frightening by the standards of past US recessions. In 1980s domestic demand contracted by 1.6% and in 1991 by 1.8%. A more alarming number is generated if it is remembered that domestic demand would normally have to decline by a multiple of the required shift in the balance of payments, because imports are only a fraction of national expenditure. Further, if it were judged that US national output is at present 2% above trend and that this positive output gap must be reduced to nil to stop inflation rising, the disinflationary agenda becomes rather drastic. Domestic demand would over a period of some quarters have to be curbed, relative to the trend rate of output growth, by over 5% of GDP.

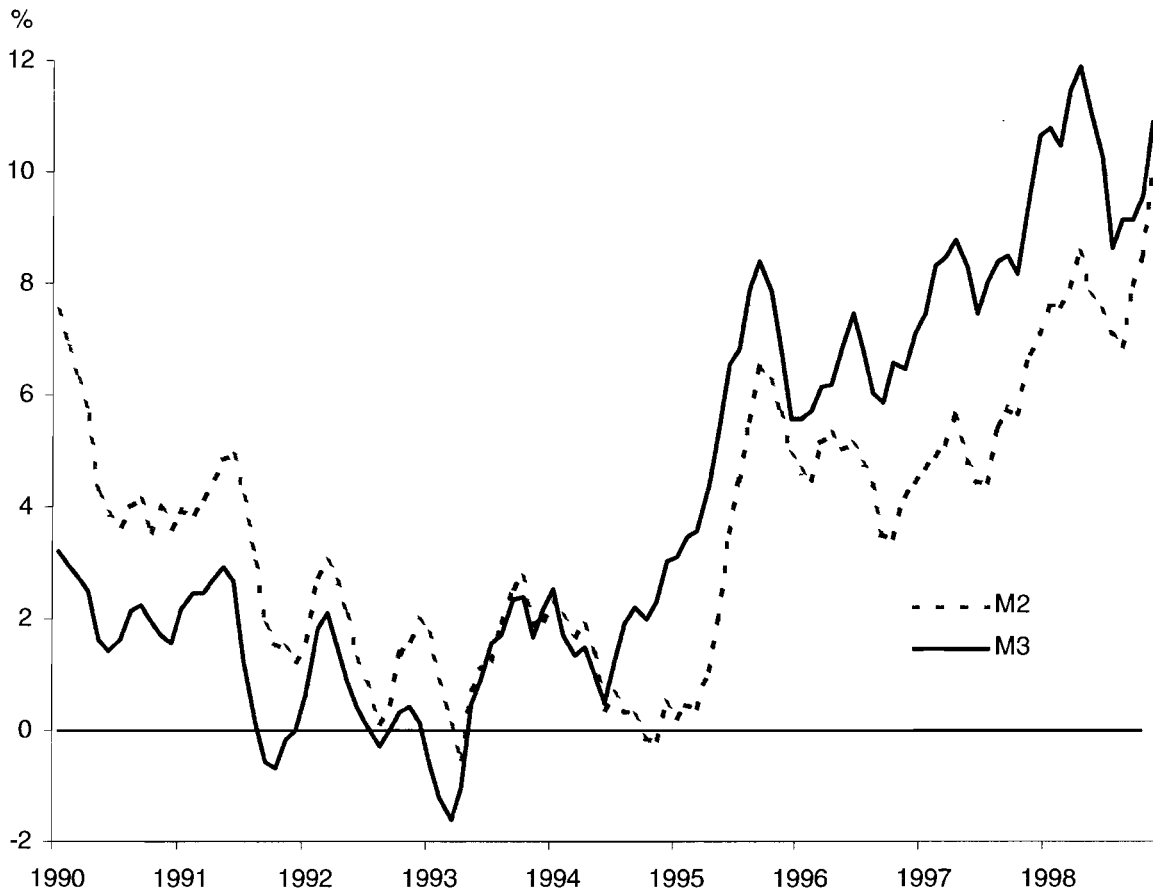
which will not happen while asset values - including the stock market - are excessive

And now comes the punch-line. A squeeze on domestic demand will simply not happen while consumers' balance sheets are bolstered by an over-valued stock market. While share prices remain at such ambitious levels, the American people will continue to try to convert their stock market equity into houses and other things that they can enjoy. (Mortgage applications to buy houses were at peak levels in September and October.) They will save very little of their income (or even dis-save, as they did in September). It follows that the correction of the world's largest-ever balance-of-payments deficit will necessitate the bursting of its biggest-ever stock market bubble. The precise mechanism and sequence of events is, as always, difficult to forecast. But the scale of the external deficit suggests - as an obvious pattern - that a weak dollar will have to be countered by a rise in US interest rates and, hence, in bond yields, which then undermines stock market valuations.

The Greenspan bubble

No evidence of a “credit crunch” in money supply data

Chart shows six-month annualised growth rates of M2 and M3. Official monthly average data to October 1998, Lombard Street Research estimate for November 1998.

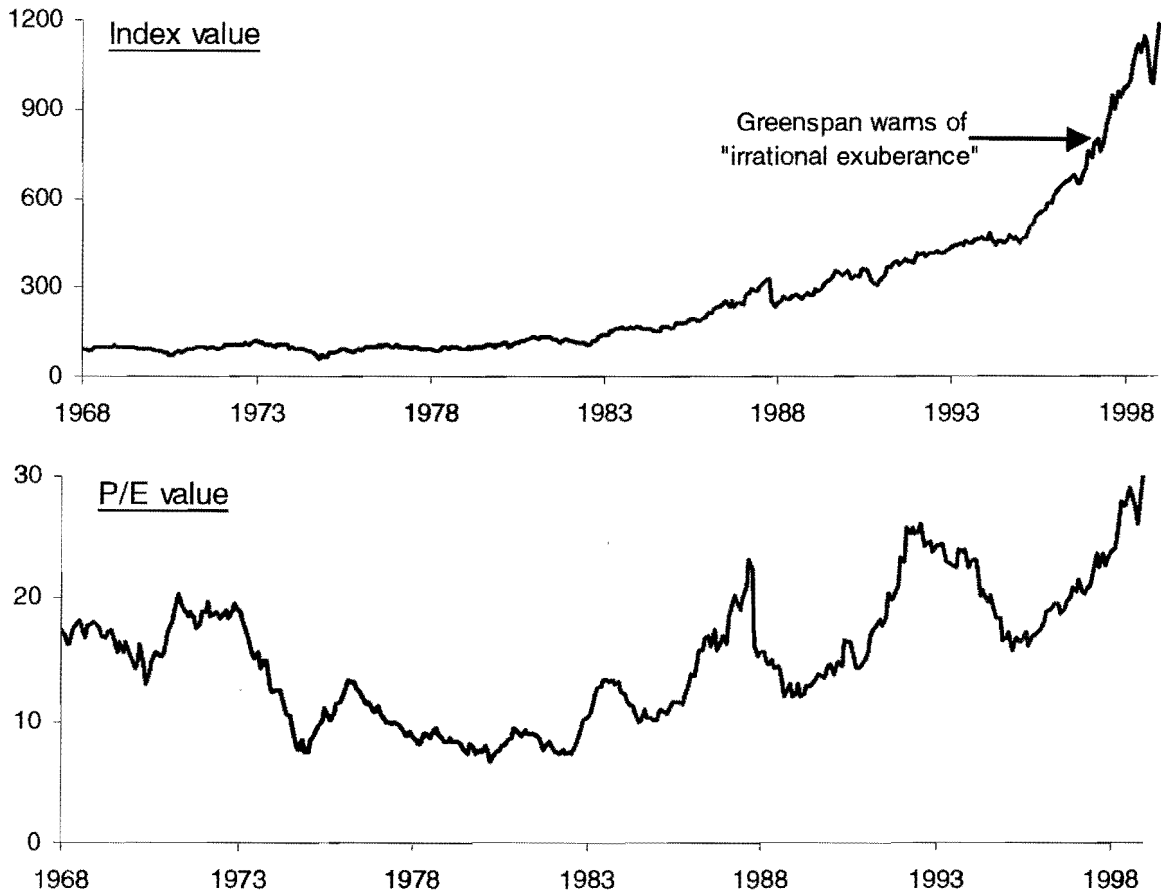


Sources: Federal Reserve database, Lombard Street Research estimates.

The financial turmoil in August and September led to paralysis in the high-yield corporate and sovereign bond markets, and so to much media talk about an alleged “credit crunch”. In fact, the great majority of US commercial banks were unaffected by the turbulent capital markets. As they had ample capital after several years of good profits, they could readily fill the gap in credit supply created by the temporary breakdown in the bond market. Bank lending to commercial and industrial borrowers soared at an annualized rate of 22.8% in the two months to 26th October. M3 growth - which had already been very high in early 1998 - has therefore accelerated recently. In the three months to mid-November it ran at an annualized rate of over 14%.

60% equity surge from “irrationally exuberant” levels

Upper chart shows the index value of the S&P 500, lower chart shows the price/earnings ratio using historical earnings. Monthly average data to October 1998, current for November 1998.



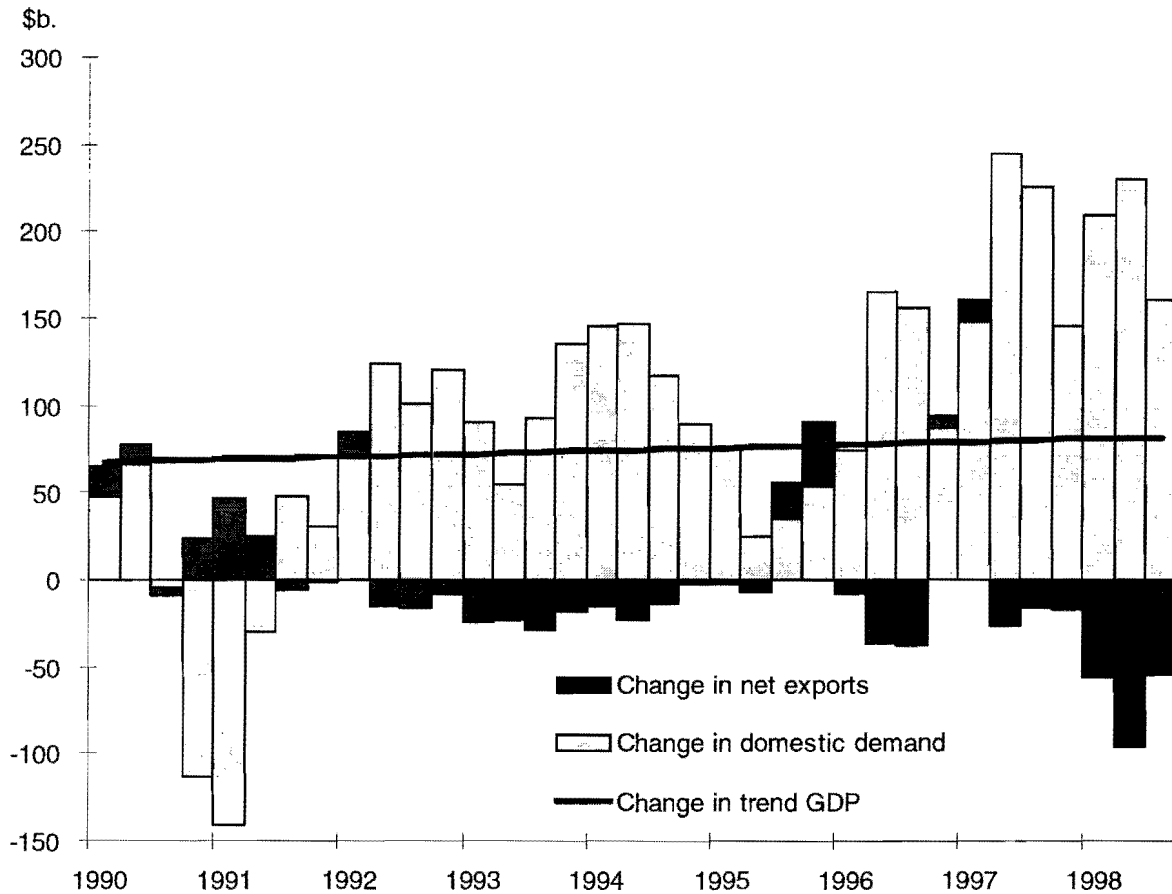
Sources: Federal Reserve database, Wall Street Journal.

The US stock market was lower in late 1990 than in the summer of 1987. But since early 1991 the bull market has been almost continuous. (The September dip this year was too brief to count.) This bull market has been based more on the revaluation of corporate earnings (or “multiple expansion”) than on earnings growth. In the eight years to November 1998 the annual rate of appreciation on the S & P 500 has been 18.4%, of which 10.0% has been due to the increase in the P/E ratio and 8.4% to earnings growth. The dependence on multiple expansion has been most pronounced since 1994. In the four years to November 1998 the annual rate of appreciation was 26.2%, with 13.8% due to multiple expansion and 12.4% to earnings growth. The burst of multiple expansion in this period coincided with the rapid monetary expansion.

The Greenspan boom

Above-trend growth in domestic demand for 10 quarters to Q3 1998

Chart is of quarterly data. It shows the influence of the change in the last two quarters of domestic demand and net exports on GDP growth, constant 1992 \$. The continuous line shows the estimated trend increase in GDP, which is assumed to run at 2¼% a year.

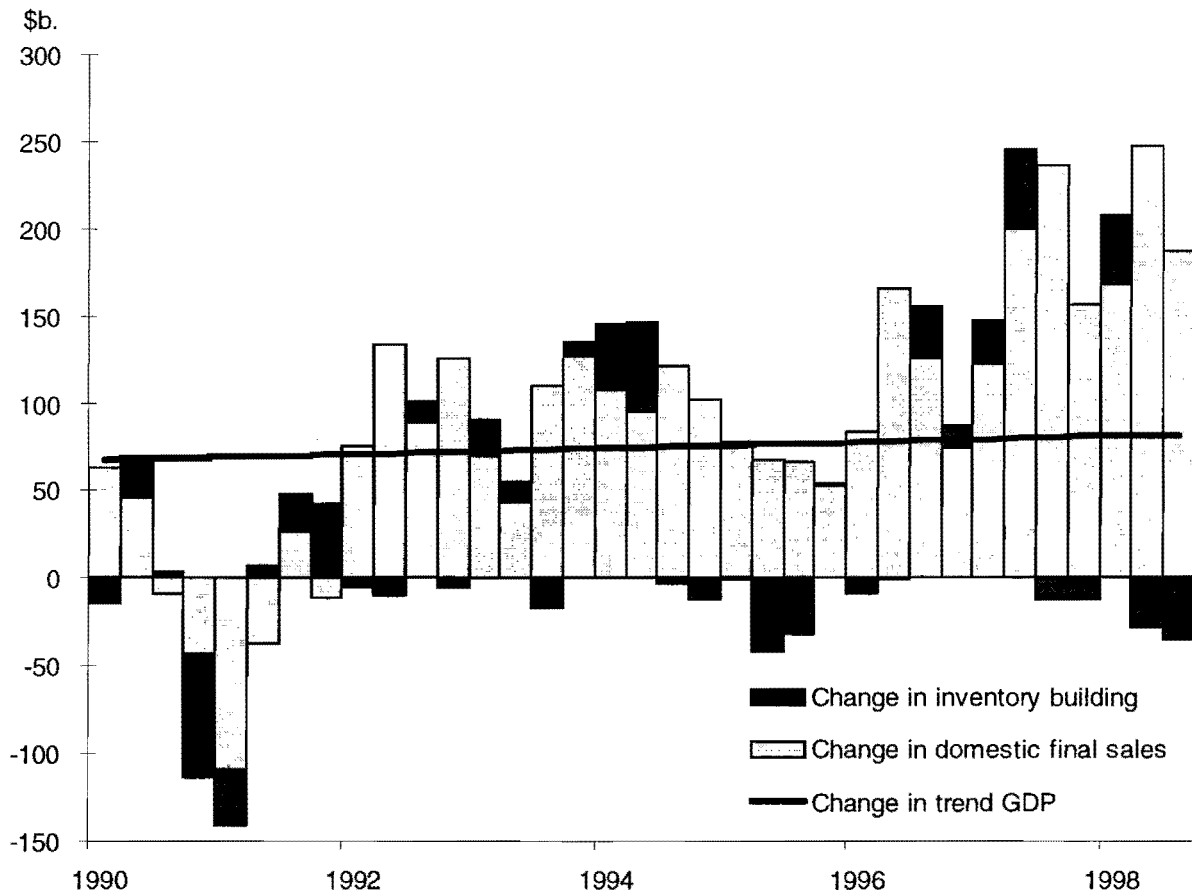


Sources: Bureau of Economic Analysis, Lombard Street Research estimates.

Between 1992 and 1994 the US economy recovered from the recession of the early 1990s. As the chart shows, the growth in domestic demand since early 1996 has been much stronger than during the recovery phase. With output hitting capacity in some sectors, excess demand has been met partly by foreign suppliers. Negative net exports have been a virtually continuous drag on output growth, an effect which has been most powerful since the onset of the Asian crisis in the summer of 1997. Because the adverse change in net exports has dampened output growth, some observers have been misled into talking about a “slowdown in demand”. Q3 1998 appears to be weaker than the first half of 1998, but note that the same pattern was found in the three previous years, suggesting possible problems with seasonal adjustment.

Domestic final sales still booming in 1998

Chart is of quarterly data. It shows the influence of the change in the last two quarters of domestic final sales and inventory building on GDP, constant 1992 \$. The continuous line shows the estimated trend increase in GDP, which is assumed to run at 2¼% a year.



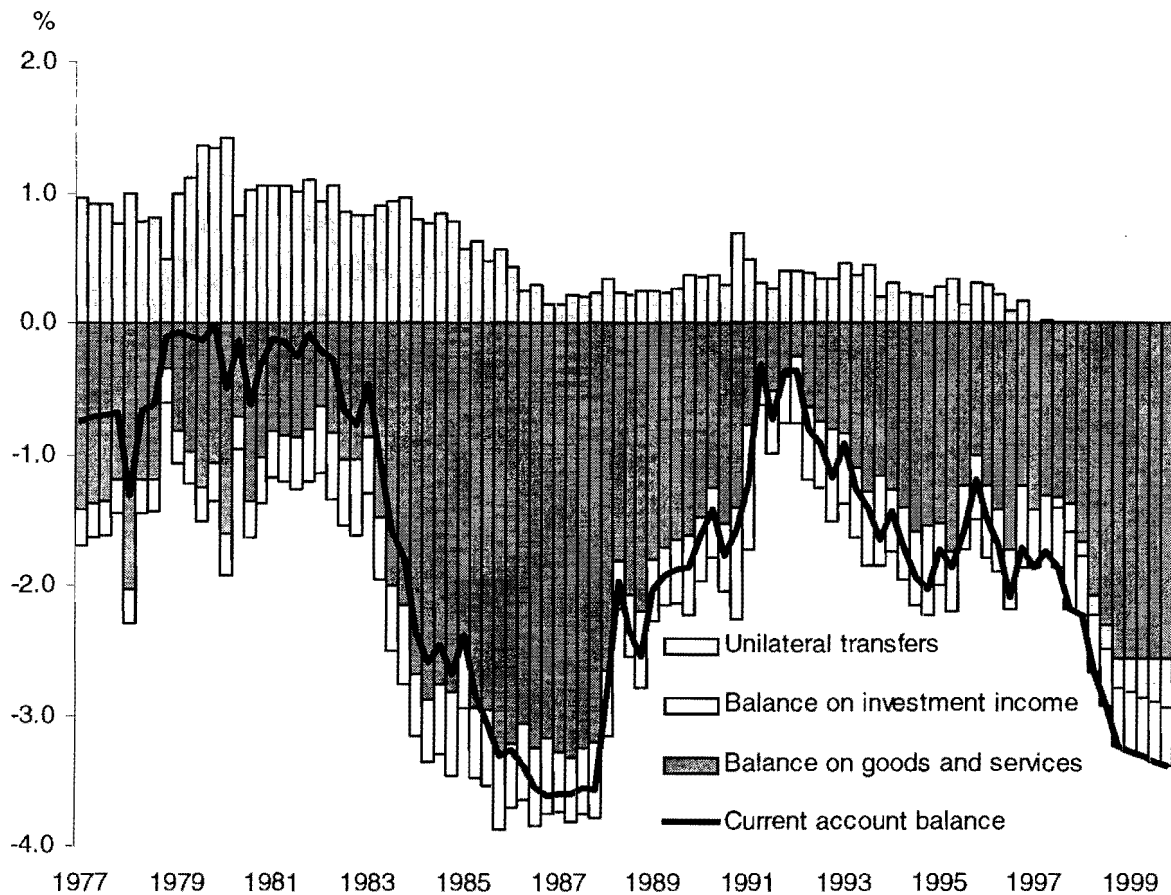
Sources: Bureau of Economic Analysis, Lombard Street Research estimates.

The increase in domestic demand can be split between the increase in domestic final sales and the change in inventory building. As inventory building is erratic, the behaviour of final sales ought to attract most interest. The chart shows that - apart from a few quarters in 1995 after the Federal Reserve's monetary tightening of 1994 - the increase in domestic final sales has been at an above-trend rate since early 1992. It has been particularly rapid in the last few quarters, although it appears to have slowed in Q3. But the Q3 slowdown may have been related to deferred automobile purchases due to the GM strike. Retail sales jumped by 1% in October as car registrations recovered, while recent figures for mortgage application suggest that the housing market will reach a new peak of activity in Q4. The boom is not over.

US payments deficit back to previous peaks

Continuous deficits cause negative balance on investment income

Chart shows split of the current account position between the balance on goods and services, the balance on investment income and unilateral transfers as a %age of GDP, quarterly data. Official data to Q2 1998, Lombard Street Research projections thereafter.



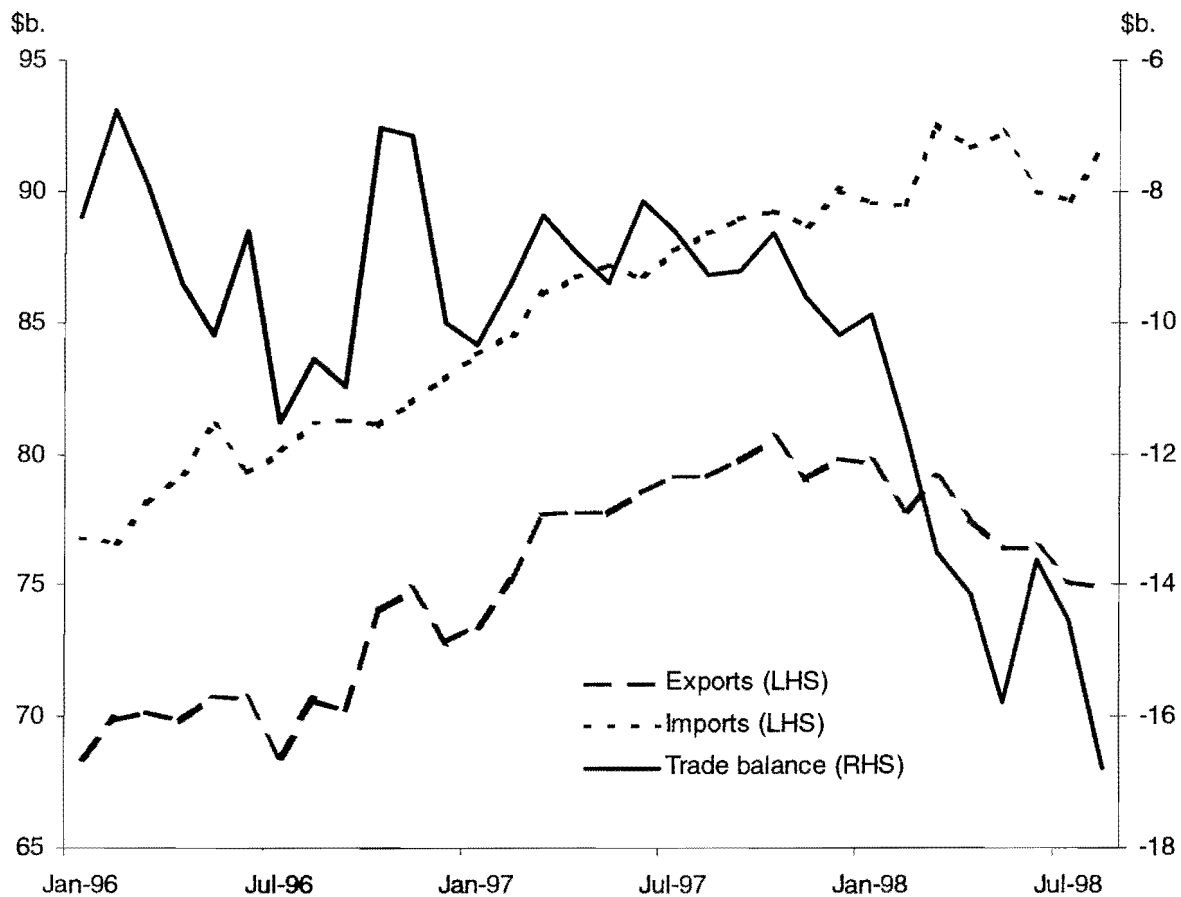
Source: Bureau of Economic Analysis.

The USA has had a continuous deficit on the current account of its balance of payments since the 1970s. In the 1990s the evolution of the deficit bears the clear imprint of fluctuations in domestic demand. The recession of 1990 and 1991 cut the deficit sharply, the recovery from 1992 to 1994 caused it to widen, and the slowdown in 1995 stabilized it for a few quarters. Since early 1997 the plunge into deficit has accelerated under the dual impact of excess domestic demand and the Asian crisis. It is almost inevitable that in 1999 the deficit, expressed relative to GDP, will go above the previous peaks in 1986 and 1987. The persistence of the deficits has made the USA a large net debtor. (See p. 15.) The investment income account, still in surplus in the early 1990s, is now into the red.

Plunge into deficit since mid-1997

The Asian crisis, not the “new paradigm”, restraining US inflation

Chart is of monthly data. It shows exports from, imports to and the trade balance for the USA.



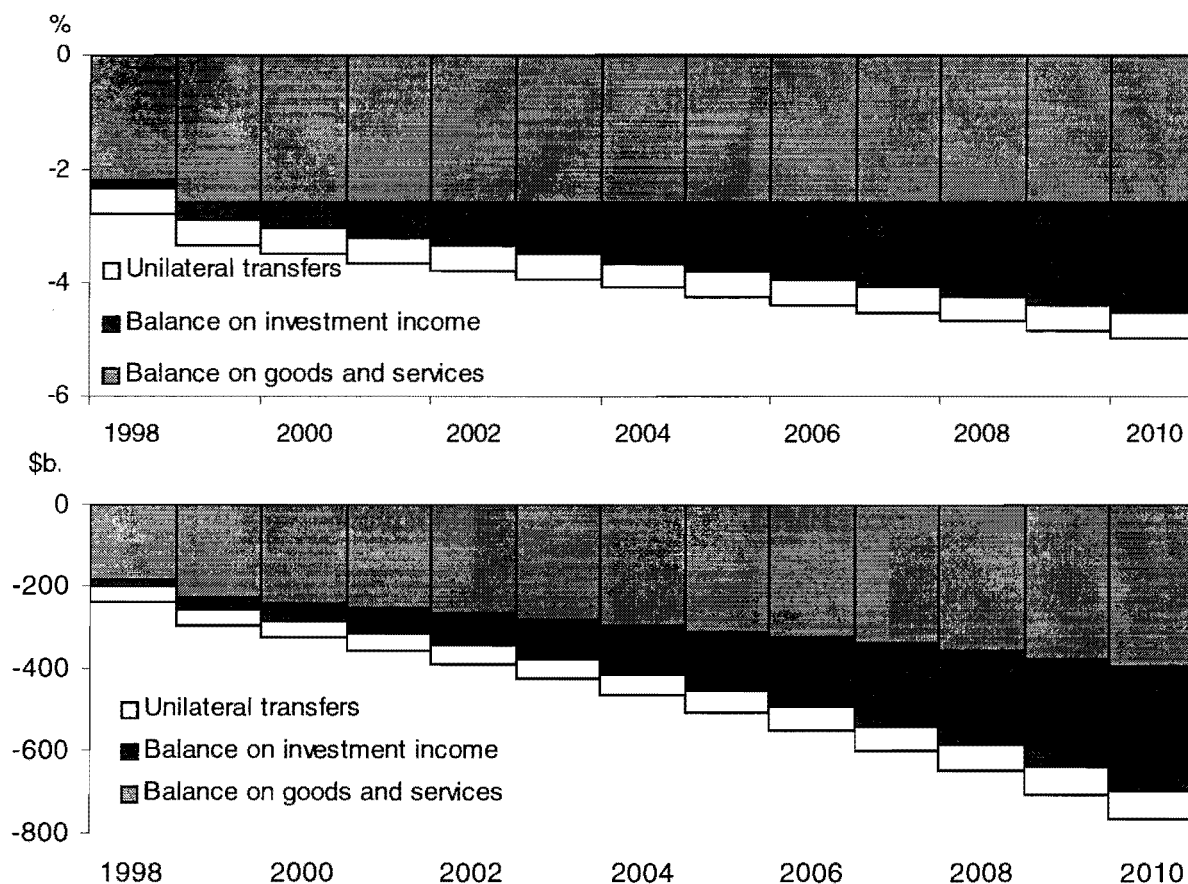
Source: Bureau of Economic Analysis.

The Asian crisis has halted the growth of the USA's exports, while booming domestic demand continues to suck in imports. The trade deficit had been broadly stable from early 1996 to mid-1997, but the deterioration thereafter is clear and dramatic. (The starting-point of the Asian crisis is usually dated in July 1997, with the devaluation of the Thai baht.) Roughly speaking, the trade deficit doubled in the year to mid-1998. Although the USA is a big country less affected by international forces than any other, the Asian crisis is fundamental in understanding its ability to contain inflation despite four years of high money supply growth, bubbling asset prices and booming demand. Not only have imports become cheaper, but also excess demand has been diverted abroad.

Deficit to rise indefinitely?

Exports must rise *much* faster than imports to halt the deficit increase

Upper chart shows projected influence of balance on goods and services, balance on investment income and unilateral transfers on the current account deficit as a %age of GDP, lower chart in US \$. Forecast assumes that GDP, imports, exports and unilateral transfers grow by 1¼% per quarter. Negative balance on investment income increases by 1¼% of the rise in the current account deficit in the previous quarter.



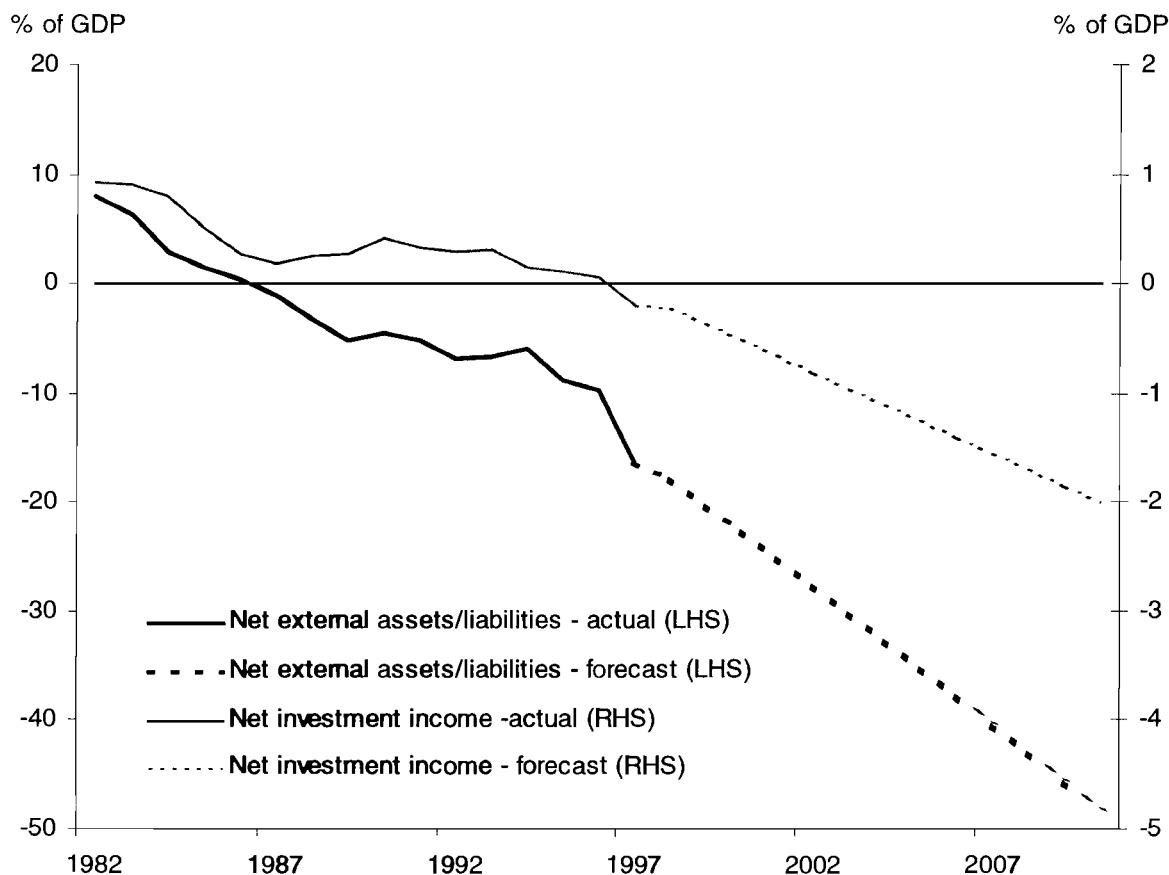
Source: Lombard Street Research projections.

The chart projects the USA's current account deficit on two neutral assumptions, that from now on exports, imports, GDP and international transfers all grow at the same rate of 1¼% per quarter (i.e., about 5% a year) and that the return on investments in the USA is 5% a year. With these assumptions the ratio of the trade deficit to GDP stabilizes at 2½% of GDP, but the current account deficit widens relentlessly because of the deterioration in the investment income account. By 2005 it is running at about \$500b. a year. It needs to be heavily emphasized that the assumptions put the USA's external accounts in a favourable light. Imports will almost certainly keep on increasing faster than exports in 1999, while the USA cannot continue to rely on lower commodity prices, notably a falling oil price. (See p. 16.)

Total unsustainability

Trade surplus will be needed to cover investment income deficit

Chart shows actual and forecast net international investment position and income for the USA as a %age of GDP. Forecast assumes that the change in the net international investment position equals the current account balance during the relevant period and that investment income changes by 1¼% of the change in the current account balance during the previous quarter.



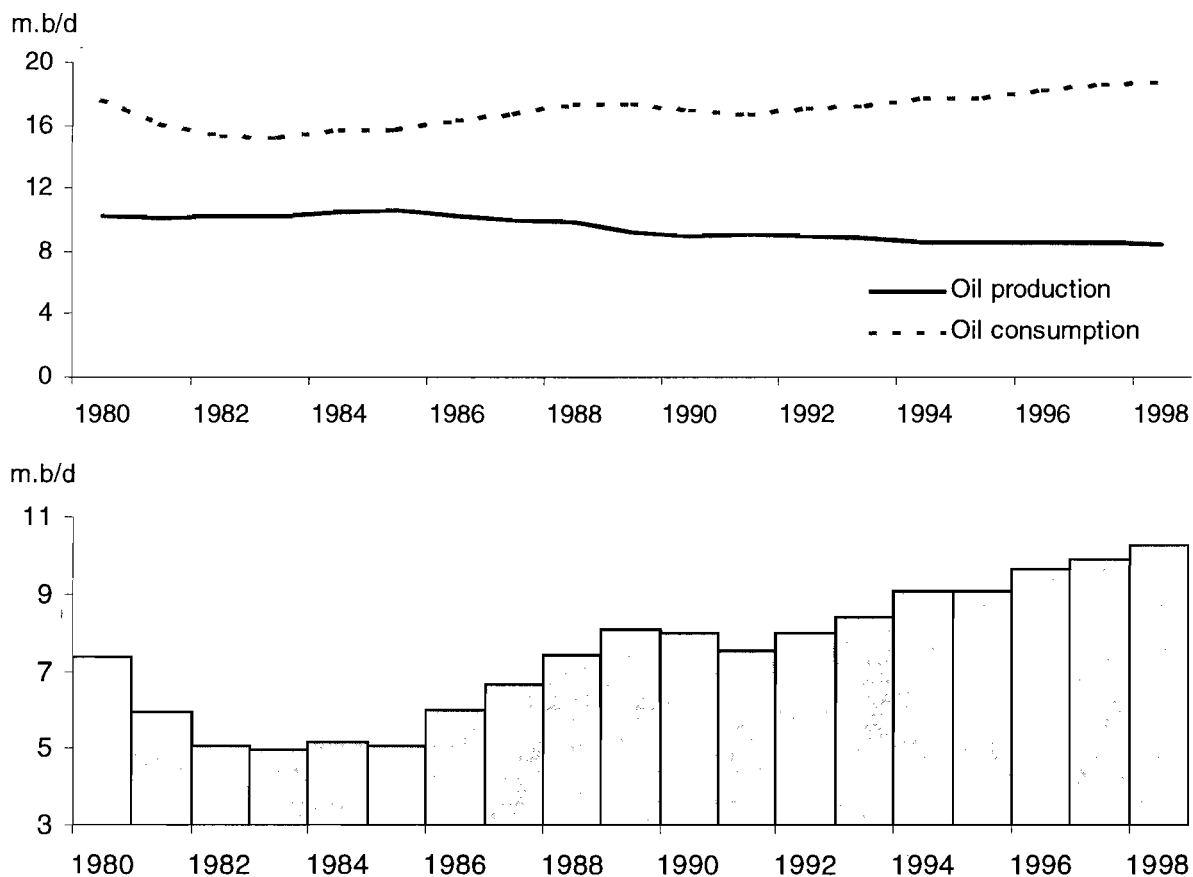
Sources: Bureau of Economic Analysis, Lombard Street Research projections.

This chart adds the projections on p. 14 to the official estimate of the excess of international liabilities over assets at the end of 1997 (i.e., “the USA’s net debt”, but note that the “debt” includes foreign portfolio investment in the USA). By the end of the next decade the net debt amounts to 50% of GDP, while foreigners’ gross claims on the USA would be more than six or seven times its exports. If a developing country had a gross debt/export ratio of this size it would be categorized as semi-bankrupt. The comparison is artificial, but demonstrates the need for adjustment. There is nothing wrong with the USA being a favourite destination for international investors, but eventually a trade surplus will be required to cover the widening gap on investment income.

US payments deficit helped by falling oil price

But very vulnerable if oil price now starts to rise

Upper chart shows oil production and consumption in the USA, lower chart shows oil imports into the USA, millions of barrels per day.



Source: International Energy Agency.

The trends reviewed in the last few pages may have seemed alarming, but it should be noted that the USA has benefited enormously in the 1990s from lower prices of its imports. In particular, as the USA is the world's largest oil importer, it has gained disproportionately from the drop in the oil price. Its net imports today run at about 10m. b/d, with an annual cost at \$12 a barrel of almost \$45b. If the oil price were \$24 a barrel (which it touched as recently as 1996), the current account deficit would be \$45b. a year higher in year one, while projections for later years would have to be adjusted upwards because of the consequent weakening in investment income. If the oil price were to return to where it was in real terms in the early 1980s, the hit to the current account would be roughly \$150b. in the first year.