Advance notice of the December issue of Lombard Street Research's *Monthly Economic Review*

US external payments position is "totally unsustainable"

The next issue of our *Monthly Economic Review* will include a research paper on the USA's external payments. It will argue that the American current account deficit is totally unsustainable. Some of the themes in the work will be familiar to clients from previous faxes, but I thought it sensible to give some advance warning.

The heart of the argument can be quickly summarized. In every one of the six years to 1998 the USA's imports rose faster than its exports. If - from now on - exports, imports and GDP all grow at the same nominal rate, the current account deficit widens indefinitely. Indeed, on plausible assumptions, the USA's net external liabilities reach 50% of GDP by 2010 and the gross "debt"-to-exports ratio would be far above that found in semi-bankrupt developing countries. Obviously, this can't be allowed to happen. It follows that - at some stage in the next two or three years - the USA's exports must start growing faster than its imports.

But in what macroeconomic circumstances can that occur? Won't a squeeze on US domestic demand be needed? And what will that mean for US asset prices, including of course a stock market on an all-time record P/E multiple of over 30?

The main points of the paper are summarized on the following page, which is p. 2 of the *Review*.

Professor Tim Congdon **3rd December, 1998**

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.