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## **New Labour clashes with the public sector**

### **What was the point of Mr. Brown's stop-go on public expenditure?**

**Teachers' pay and health service costs rising sharply**

The Government is plainly in a spot of bother with the public sector unions. The firemen's dispute has caught the headlines, but it is a sideshow compared with the large pay rises agreed with the health unions and the probability of similar increases for the teachers. These pay increases - which will attract workers into public sector employment and tighten the labour market - can be seen as a direct consequence of the big jump in health and education spending announced by Mr. Gordon Brown over the last two years. Indeed, sharp questions need to be asked about the wisdom of the Chancellor's stop-go on public spending.

**Brown curbed spending in first two years to create image of financial probity, but big increases now under way**

The central facts are clear. It is an easy matter to add up cumulative annual totals of the quarterly series for "supply expenditure", which constitute the bulk of central government expenditure. In New Labour's first two years the annual increase in this total averaged almost exactly nil; in the following three years (i.e., to the third quarter 2002) it averaged 8.0%. What was the point of this extraordinary stop-go? The answer seems to be that Mr. Brown wanted to persuade the markets that a Labour government could be financially responsible. This would deliver benefits in terms of lower inflation expectations and reduced debt interest costs, and in the long run would permit larger spending increases on priority areas (like health and education) than would otherwise have been possible. The trick worked. In the first three quarters of 2002 the cost of national debt service was £14.6b., compared with £20.8b. in the first three quarters of 1997. As a share of GDP, debt service costs have fallen by about 1 1/2% under New Labour.

**The stop-go in spending has saved debt service costs, but does not create extra resources**

But financial cleverness does not create new resources. For example, it does not mean that the UK has more doctors and nurses, who take years to train and then several further years to build up peak professional skills. Mr. Brown may have saved 1 1/2% of GDP by an artful manipulation of expectations in his early years, but it does not follow that the expenditure of this extra money on health and education will lead to proportionate improvement in the quality of health and education. On the contrary, because of the inevitable bottlenecks in training, skill acquisition and so on, a fair comment is that the larger the annual rate of increase in spending on these services, the lower is the marginal effectiveness of spend. Raising the growth rate of nominal expenditure from 4% to 6% leads to an increase in the real-terms growth rate of, say, 1 3/4%. But raising the growth rate of nominal expenditure from 4% to 12% leads to an increase in the real-terms growth rate of, say, only 4%. When spending plans are adjusted upwards slightly, almost nothing of the extra spending is frittered away on prices and costs. But, when they are boosted dramatically and with loud fanfare, much of the extra spending translates into pay and price increases, not extra output. Mr. Brown and Mr. Blair are finding out that the stop-go on public spending has been wasteful and badly judged. Investors in UK gilt-edged securities - who required a nominal return of 5% a year above expected inflation under the Conservatives, but now seem to need only 2% - 3% a year under New Labour - should also be warned.

## Summary of paper on

### 'Does the USA's payments deficit matter?'

#### Purpose of the paper

An obvious tension arose in the late 1990s between the USA's incurral of the world's largest-ever payments deficit and the greatest equities bull market of all time. A fundamental question - discussed in several papers in this *Review* and re-assessed here - is whether the external deficit was and is unsustainable.

#### Main points

- \* **The USA - apparently in an impregnable financial position just after the Second World War, with exports running at more than twice imports - has experienced a drastic change in its international balance sheet and trading performance over the last 57 years. (See pp. 6 - 9.)**
- \* **Whereas in 1945 the USA was the world's dominant creditor nation, it is now - according to data prepared by the US Commerce Department - the world's biggest debtor. (Again, see pp. 6 - 9.)**
- \* **The slide into deficit was particularly marked in the late 1990s. The cumulative current account deficit in the 15 years to 2001 was about \$2,500b. (See p. 10.)**
- \* **Since the Commerce Department estimates are that the USA had a negative "net international investment" position in the late 1980s, the subsequent \$2,500b. incurral of obligations ought to mean that the USA has a large deficit on flows of international investment income. (This was a key argument of the research papers in this *Review* on the unsustainability of the USA's external payments.) *But - amazingly - the USA still had a surplus on international investment income in 2001. Indeed, this surplus was the same in money terms as in 1987. (See p. 11.)***
- \* **A fall in the dollar seems to be needed to "correct the USA's external deficit". But an alternative interpretation of the deficit - that it reflects capital flows from less dynamic parts of the industrial world (notably Japan and much of Western Europe) and is part of a re-balancing of the world economy - may be correct.**

This research paper was written by Professor Tim Congdon. It draws on the argument of a study by him, *America's Deficit, the Dollar and Gold*, recently published by the World Gold Council.

## Does the USA's payments deficit matter?

### A recantation of the analysis of "unsustainability"

**Research papers in this Review have argued that the USA suffers from external "unsustainability"**

One of the big imbalances in the world economy, and one of the key imponderables in assessing its future outlook, is the USA's vast current account deficit. A tension arose in the late 1990s between, on the one hand, the unprecedented scale of the USA's external imbalance and, on the other, the remarkable strength of its stock market. A sequence of research papers in this *Monthly Economic Review* argued that the external imbalance could not be reconciled indefinitely with the bull market. The situation appeared to be unsustainable and, indeed, by early 1999 "totally unsustainable". (See the issues of the *Monthly Economic Review* for February 1998, December 1998, May 1999, December 1999, April 2000 and October/November 2000. Some of the themes in this research have recently been developed at more length by the author in a study of *America's Deficit, the Dollar and Gold*, published by the World Gold Council.)

**Some of the analysis has been right,**

The purpose of the current research paper is to review the USA's payments deficit in the light of more recent data. In one sense the analysis has been right. Not only is the bull market over, but the fall in share prices in the USA has been the most severe for over 25 years. Further, foreign buying of US equities peaked in early 2000 and is much lower now than it was then. One claim in past *Reviews* - that a period of weak or falling US domestic demand would be needed - has also been correct. However, financial markets have not really behaved as expected. A logical view is 1999 and 2000 was that the large and ever-growing current account deficit would lead to a weaker dollar on the foreign exchanges, that the weaker dollar would increase American inflation and that the higher interest rates needed to combat dollar weakness would be critical in undermining the bull market in stocks. Events have not turned out that way.

**but the dollar has remained strong**

The fall in share prices is most readily understood as a return to sanity after the extraordinary levels of over-valuation seen in 1999 and early 2000. Key triggers for the declines were, first, the tightening of monetary policy during 2000 to deal with incipient US inflation and, secondly, revelations of accounting fraud at Enron (and poor corporate governance generally) in late 2001. Dollar weakness did not really play an important role at any stage in the stock market adjustment. In fact, the dollar has appreciated against the euro and the yen since early 1999. This upward movement is made all the more striking by a comparison with the widespread enthusiasm for the newly-formed single European currency at its start on 1st January 1999.

**Dollar's resilience despite current account deficit heading towards \$500b.**

The puzzle is reinforced by the dollar's resilience in recent quarters when the recession in US domestic demand has ended and been followed by a mild economic recovery. The upturn in demand has been accompanied by a further slide into deficit on the external accounts. The current account deficit - which fell from almost \$120b. a quarter (i.e., almost \$480b. at an annual rate) in late 2000 to \$91.3b. in the third quarter (Q3) 2001 - has started to widen again. In Q1 2002 it was \$112.5b. and in Q2 \$130b. A figure of over \$500b. (about 4 1/2% of GDP) seems inevitable in 2003. But the dollar has stayed strong and, according to most estimates, is somewhat over-valued compared with the euro and the yen.

**Erosion of the USA's creditor status is a long-term story**

What is going on? As shown on pp. 6 - 9 below, the erosion of the USA's international creditor status has been a long-term story going back to the immediate post-war years. Whereas in the late 1940s the USA was the world's largest creditor nation and its exports of goods were twice its imports, today it is the world's largest debtor nation and the deficit on trade in goods is 5% of national output. Moreover, the slide into deficit accelerated in the late 1990s. How has the USA been able to maintain international respect for its currency as its prodigality becomes ever more blatant?

**Cumulative current account deficits from 1987 to 2001 of \$2,500b.**

Significant revisions to the USA's past balance-of-payments data provide part of the answer. According to estimates prepared by the US Department of Commerce, the value of foreign-owned assets in the USA first exceeded the value of US-owned assets abroad in the late 1980s. Between 1987 and 2001 the USA ran an almost continuous current account deficit, with the cumulative total of the deficits being about \$2,500b. (Note that the tiny current account surplus in 1991 partly reflected foreign payments to the USA by such countries as Japan and Germany to recognise the cost of the military effort in the Gulf War. Without this the deficits would have been continuous.)

**This cumulative deficit surely implies a deficit on investment income, perhaps of over \$100b.**

Suppose that the average rate of return on international investments is a 5% a year. Then simple arithmetic says that the cumulative \$2,500b. shortfall on the external accounts should have led to a deterioration in the USA's balance on international investment income of \$125b. In 1987 the USA had a surplus on international investment income of \$14.3b. So in 2001 the USA should have a deficit on international investment income of over \$100b. Logically, the deficit on international investment income ought itself to have become a large element in the overall current account deficit. Further, the dynamics of the international investment income account - with future liabilities to pay investment returns to foreigners possibly exploding without limit - were a central part of much research on the unsustainability of the USA's financial position. (The research papers in these *Reviews* focussed on the adverse dynamics of debt, using the well-known analytical framework in which the key debt ratio [i.e., the ratio of debt to income, exports or another flow variable] depends on the borrower's "primary" financial position and the relationship between the rate of interest and the growth rate of the borrower's income flow variable.)

2001 has now come and gone, and what in fact was the position on the USA's international investment income payments? Given the continuity and scale of the current account deficit since 1987, surely the USA must have had a deficit on this part of its balance of payments. Many authorities would say that the assumption of a 5% nominal return is too cautious and that, particularly when allowing for inflation, a 10% nominal return would be more realistic. With the cumulative current account shortfall at \$2,500b., that would mean a deficit on international investment income of over \$200b. International investments in general would have to be unconvincingly low-yielding for the USA's deficit to be under \$50b.

**But, in fact, in 2001 the USA had almost the same surplus on investment income as in 1987**

*It turns out that - on the latest data - the USA still had a surplus on investment income in 2001. Even more extraordinary, despite the \$2,500b. of cumulative current account deficits over the 15-year period, the surplus was almost identical in money terms to that in 1987. The analyses of unsustainability, and total unsustainability, based on the familiar theory of debt dynamics have been dumbfounded. Mr. Micawber - with his admonitions about the need to keep expenditure under income - would be bewildered. (See pp. 10 - 11.) How can any agent - and particularly the world's dominant economic power - allow its expenditure to exceed its output year after year, and yet still be a net recipient of income on past savings? What was the alchemy at work?*

**The USA has very successful foreign investors**

The answer is that the USA is far more successful at investing overseas than foreigners are at investing in the USA. Indeed, the gap between the rate of return on American investments abroad and that on foreign investments in the USA is so large that - in this 15-year period - it has roughly cancelled out the adverse effect of a vast cumulative deficit on investment income. Another unusual feature needs to be emphasized. Part of the explanation is that American multinationals have under-priced sales of American-made components to foreign subsidiaries, so that profits are earned by these subsidiaries rather than in the USA. The trade account has been in the red, but the investment income account in the black by at least the same amount. (Something of this sort seems to have been happening with American companies' very large investments in Ireland in the 1990s. Nowadays Ireland runs a massive trade surplus and a similarly out-sized investment income deficit, largely reflecting these companies' operations. The counterpart items in the USA's balance of payments would be debits on the trade account and credits on investment income. See pp. 8 - 9 of the August 2000 issue of this *Review* for a discussion of Ireland's remarkable balance-of-payments pattern.)

**Big fall in dollar appears to be needed, but it is implausible that this will be against the euro and the yen**

The larger message is that the implications of the USA's external "deficits" for the world economy are opaque. The author's study for the World Gold Council did conclude that the dollar needs to fall heavily against other leading currencies to restore sustainable export and import trends. But a big fall in the dollar against the yen and the euro is difficult to imagine at present, in view of the plight of the Japanese economy and the unimpressive performance of most of the Eurozone. The strains in the Japanese and German banking systems argue strongly against the emergence of a favourable interest rate differential for the yen or the euro at any point in the foreseeable future. The bull market in US equities came to an end because share prices were too high; it did not come to an end because of a collapse in the dollar. In that sense the analysis of unsustainability in past issues of this *Review* was wrong.

## Long-run trends in the USA's external payments

### 1. The balance of payments in 1946

***Current account surplus 3.9% of GDP***

		\$m.
Exports of goods	11,764	
Imports of goods	5,067	
<b>- Net merchandise balance</b>		<b>+6,697</b>
Service transactions:		
Net military	-424	
Net travel and transport	733	
Other services, net	310	
<b>- Net services balance</b>		<b>+619</b>
Investment income:		
Receipts on US assets abroad	772	
Payments on foreign assets in US	-212	
<b>- Net investment income</b>		<b>+560</b>
<b>- Unilateral transfers, net</b>		<b>-2,991</b>
<b>Balance on current account</b>		<b>+4,885</b>

In 1946 the USA's gross domestic product was \$209.2b. So the trade surplus on goods was 3.2% of GDP.

(In 1947 the trade surplus was \$10,124m. and the current account surplus \$8,992m. With GDP at \$232.2b., the trade surplus was 4.4% of GDP and the current account surplus 3.9% of GDP.)

Source: *Economic Report of the President*.

After the Second World War the USA's payments surplus was so vast and its international creditor status so overwhelming that many economists envisaged a chronic "dollar shortage". In 1946 and 1947 the USA had by far the largest trade of any individual nation, but its exports were more than twice its imports. Moreover, because the current account surplus was on such a scale, the expectation had to be that the USA would build up additional foreign assets and earn an even higher surplus on investment income. The only negative item in the balance of payments was on "unilateral transfers", payments whose scale reflected the USA's great power role. (The transfers - soon to become even larger because of Marshall Aid - were largely motivated by the US Government's geopolitical concerns.) If it had not been for such transfers, the current account surplus would have approached 5% of GDP. A sense of perspective comes from noting that in these years the USA's surplus on international payments was greater than Spain's national output.

## 2. The balance of payments in 1971

***Current account deficit 0.1% of GDP***

		\$m.
Exports of goods	43,319	
Imports of goods	45,579	
<b>- Net merchandise balance</b>		<b>-2,260</b>
Service transactions:		
Net military	653	
Net travel and transport	-2,038	
Other services, net	2,330	
<b>- Net services balance</b>		<b>+945</b>
Investment income:		
Receipts on US assets abroad	12,707	
Payments on foreign assets in U.S.	-5,435	
<b>- Net investment income</b>		<b>+7,272</b>
<b>- Unilateral transfers, net</b>		<b>-7,402</b>
<b>Balance on current account</b>		<b>-1,433</b>

In 1971 the USA's GDP was \$1,097.2b. So the trade deficit on goods was 0.2% of GDP and the current account deficit was 0.1% of GDP.

Source: *Economic Report of the President*.

All nations benefited from the post-war liberalization of trade and payments, but for most of them the stabilisation of their external obligations to the USA was a priority in the late 1940s and early 1950s. Somewhat against the spirit of Bretton Woods, the UK devalued the pound heavily in 1949. The British move was copied by most members of the sterling area, including some European economies. This exchange rate adjustment was part of the reason that European and Japanese exports out-paced American over the 20 or so years to 1971. However, it would be difficult to fault the USA's balance-of-payments position. A small deficit in trade on goods was more than offset by a big surplus on investment income. But the dollar had been weak in the late 1960s, falling - in particular - against the Swiss franc, the deutschemark and the yen. The French had also been undermining the dollar, by using their foreign exchange reserves to buy gold from Fort Knox.



## Long-run trends in the USA's external payments

### 3. The balance of payments in 1996

#### *Current account deficit 1.5% of GDP*

		\$m.
Exports	622,113	
Imports	803,113	
<b>- Net merchandise balance</b>		<b>-191,000</b>
Service transactions:		
Net military	5,395	
Net travel and transport	25,015	
Other services, net	58,757	
<b>- Net services balance</b>		<b>+89,157</b>
Investment income:		
Receipts on US assets abroad	225,846	
Payments on foreign assets in U.S.	204,859	
<b>- Net investment income</b>		<b>+20,987</b>
<b>- Unilateral transfers, net</b>		<b>-40,081</b>
<b>Balance on current account</b>		<b>-120,937</b>

In 1996 the USA's GDP was \$7,913.2b. So the trade deficit on goods was 2.4% of GDP and the current deficit account was 1.5% of GDP.

Source: *Economic Report of the President*.

This takes the story another 25 years forward. Between 1946 and 1971 the USA saw its surplus on trade in goods disappear; between 1971 and 1996 the surplus on the overall current account went as well. The USA did have six more years of current account surplus over the 25 years to 2001, but these became the exception rather than the rule and generally coincided with recessions. Analysts began to worry about the long-run effect of the deficits on the incurral of debt and so on foreigners' eventual bill for investment returns. However, a striking feature of this chart is that the surplus on investment income was higher at the end of the period (\$21.0b.) than at the beginning (\$7.3b.), despite the run of deficits. Increased holdings of US government debt - issued in great quantity during the Reagan years of budget deficits - constituted a major part of the foreign claims on the USA. By contrast, American claims on the rest of the world included many direct investments managed by American multinationals.

#### 4. The balance of payments in 2001

##### *Current account deficit 3.4% of GDP*

		\$m.
Exports	718,762	
Imports	1,145,927	
<b>- Net merchandise balance</b>		<b>-427,165</b>
Service transactions:		
Net military	-2,978	
Net travel and transport	-1,926	
Other services, net	78,779	
<b>- Net services balance</b>		<b>+68,875</b>
Investment income:		
Receipts on US assets abroad	283,771	
Payments on foreign assets in U.S.	269,389	
<b>- Net investment income</b>		<b>+14,382</b>
<b>- Unilateral transfers, net</b>		<b>-49,463</b>
<b>Balance on current account</b>		<b>-343,908</b>

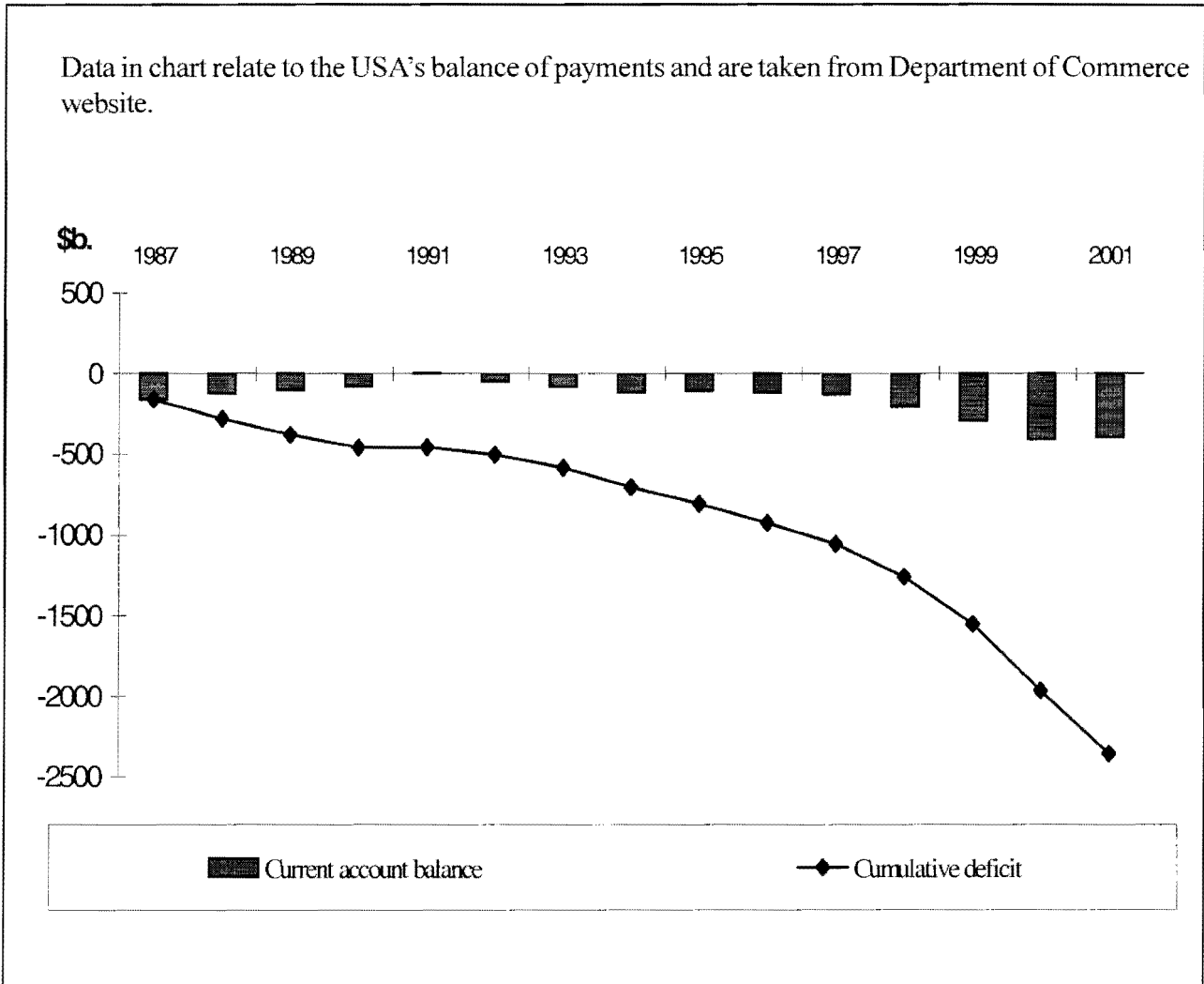
In 2001 the USA's GDP was \$10,082.2b. The trade deficit on goods was therefore 4.2% of GDP and the current account deficit was 3.4% of GDP.

Source: *Economic Report of the President*.

In the 50 years between 1946 and 1996 the USA's current account position swung from a surplus of \$6.7b. (3.9% of GDP) to a deficit of \$120.9b. (1.5% of GDP). So the average "deterioration" was about 0.1% of GDP per year. In the five years between 1996 and 2001 the move into deficit not only continued, but accelerated. With the deficit at 3.4% in 2001, it is easy to work out that the average "deterioration" ran at about 0.6% a year. It was this abrupt movement which gave a new pertinence to concern about the USA's external payments. But this concern was not new. In 1989 the Washington-based think-tank, the Institute for International Economics, had published a study (by Cline) on *American Trade Adjustment: the Global Impact*, which claimed that the limit to the USA's ratio of external "debt" to GDP was 14%. This supposed limit has been reached and exceeded by a wide margin, and still life goes on. Economists are not really sure what constitutes a "balance-of-payments problem".

## The road to perdition?

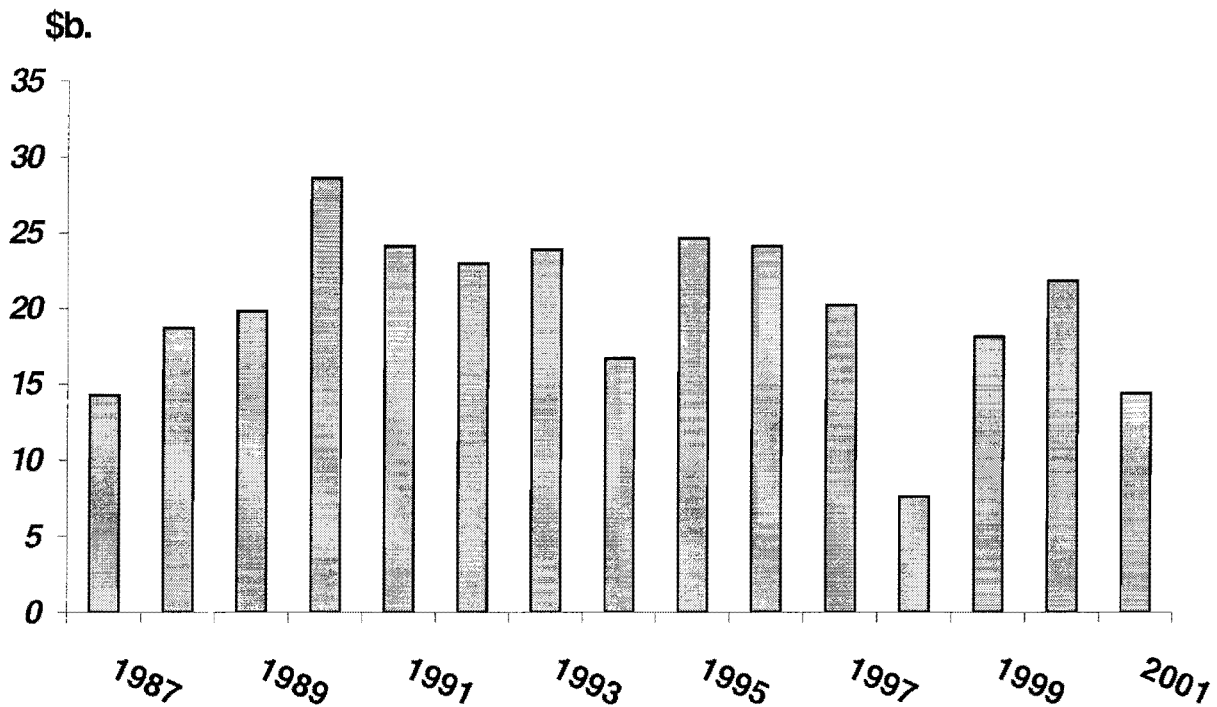
Mr. Micawber would be aghast ....



The 15 years from 1987 have seen - in the USA and elsewhere - the coming to economic maturity (with mortgages, homes and so on) of the "baby boomers". They have a big demand for imports, but it will probably be a few more years before they reach full productivity (i.e., by the build-up of workplace skills). As it makes sense to borrow in this interval, it is perhaps not surprising that the USA has had a sequence of current account deficits. A logical pattern might be for the baby-boomers, and the USA, to incur debts in the 1980s and 1990s, and then to repay them - or at least to manage them sustainably - over the next 20 or 30 years. At a very deep level, this may be the underlying rationale for the vast deficits of the last two decades. At any rate, the cumulative sum of the 15 deficits from 1987 to 2001 was about \$2,500b. Assuming a 5%-a-year rate of return, the balance on investment income should have worsened by \$125b.

... and puzzled

Chart shows the **surplus** on the USA's flows of international investment income, i.e. - the excess of the USA's income receipts from its overseas assets over the income receipts of foreign investors in the USA/



The **surplus** was the same in 2001 as in 1987.

Mr. Micawber warned in *David Copperfield*, "Annual income £20, annual expenditure £19. 19s and 6p., result happiness. Annual income £20, annual expenditure £20 ought and 6p., result misery". As the chart on p. 10 showed, the USA breached Mr. Micawber's rule by a wide margin between 1987 and 2001, opening up a huge cumulative deficit. Assuming a respectable rate of return on cross-border investment (say, 5% nominal), the investment income account should have experienced an adverse swing of about \$125b. The most surprising message from this chart is that the investment income balance was still in surplus last year and, indeed, was much the same as in 1987. How has the USA managed this extraordinary feat? The Federal Reserve conducts an annual survey of the USA's international savings and has found that the USA earns a higher rate of return on its foreign investment than foreigners earn on their investments in the USA.

## Why does Asia hold such large reserves?

### The composition of the world's foreign exchange reserves at end-2001

The following table shows that the main Asian holders of foreign exchange reserves hold almost half of the world's foreign exchange reserves, although they account for under a fifth of world output.

	Value in \$b.	% of world total
<i>All countries</i>	2156.4	
North America	90.3	4.2
Euro Area (inc. ECB)	235.4	10.9
Rest of Europe	258.2	12.0
Major Asian holders		
- Japan	394.1	
- China (Mainland)	227.7	
- China (Hong Kong)	111.8	
- Taiwan	122.2	
- South Korea	106.0	
- Singapore	75.1	
	1036.9	48.1
Rest of world	535.6	24.8

Source: *International Monetary Fund*.

One influence on the dollar's weakness in the 1970s and the late 1980s was that central banks around the world were diversifying their foreign exchange holdings. Instead of being predominantly composed of the dollar, these holdings were spread across a mix of dollars, Deutschmarks, Swiss francs, yen, sterling and other currencies. The process of diversification may have reduced the demand for the dollar and lowered its value against the other currencies. A larger question is raised, "why do central banks hold foreign exchange at all?". A case could be made that the demand for reserves is partly economic (related, for example, to nations' external debts), but also heavily non-economic. In particular, reserves are available at times of national emergency. An obvious example is an outbreak of war, when the FX reserves can be used to weapons from a dominant power. It is interesting that Asia's reserves are almost as largest as the rest of the world's put together. Non-economic factors - notably tension between Chin and Taiwan, and the need to have dollars to buy advanced military equipment from the USA in an emergency - may provide the rationale for the apparent anomaly.