INSTITUTE FOR INTERNATIONAL ECONOMICS

Habits and Policies:
For Whom Will Adjustment Be the Most Difficult?

Comments on
“The Blind Men and the Elephant””
by Barry Eichengreen

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Recapitulation of the Paper

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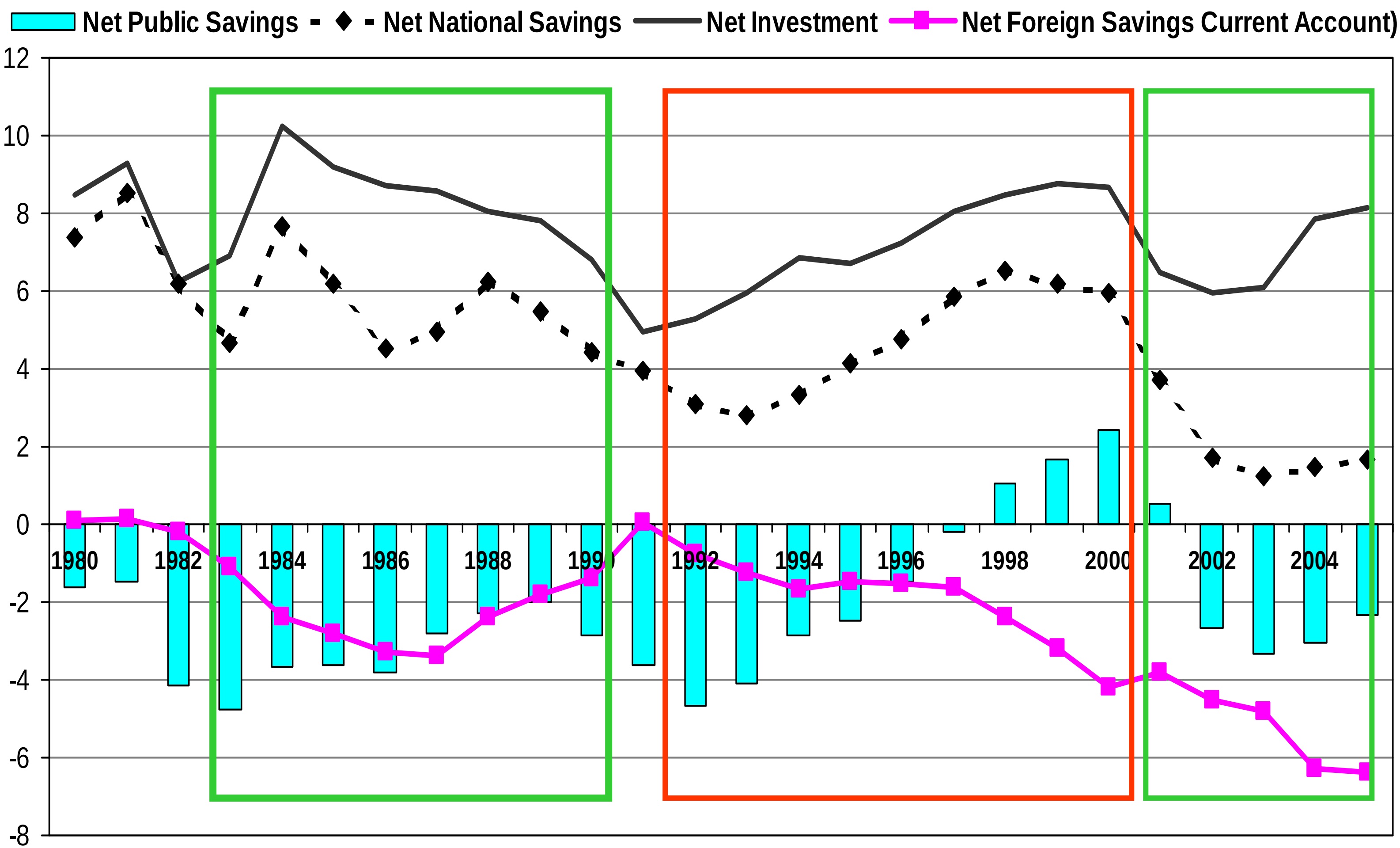
- Deficient US Savings View
  - But, fiscal/current account covariance is low
  - And interest rates are low, not high
- New Economy View
  - Productivity trends are not that different
  - Most CA financing not from private investors
- Global Savings Glut View
  - But most regions not saving more
  - And in Asia, won’t persist, because of demographics
- Sino-American Codependency View
  - 7 pages to discuss (in contrast to 2 ½, 2 ½, 3 ½ for the others)

Co-dependency of Habits and Policies

- US and foreign habits are co-dependent
  - Foreign desire to export and buy UST (and other assets)
  - US desire to consume and need to sell UST (and other assets)
  - At least at times, policy choices exacerbate the habits
- Are there vulnerabilities?
  - Financial side
  - Misallocation of resources
    - (too much US consumption, too little foreign investment in 'non-traded' services)
  - Costs of adjustment

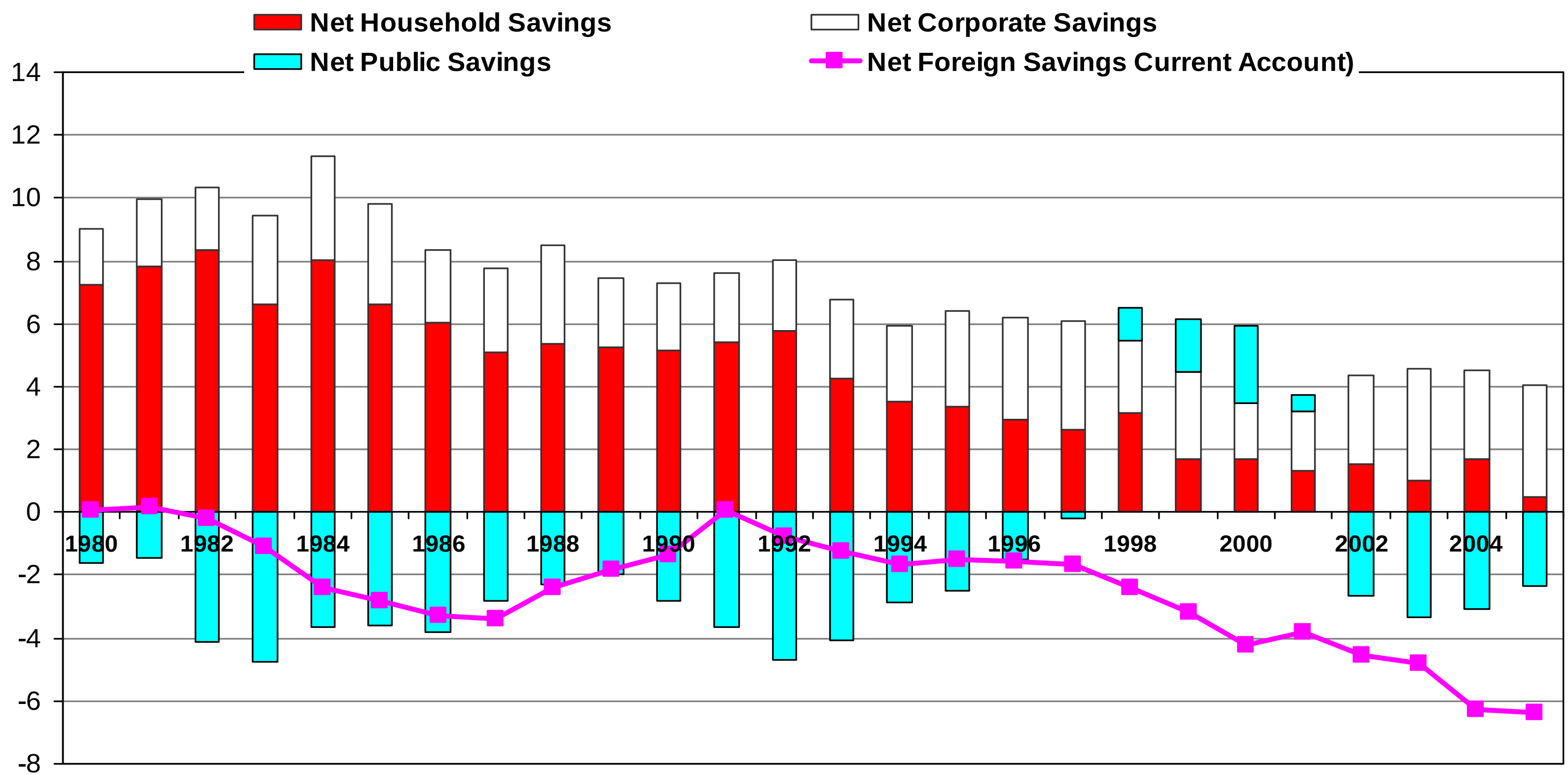
Habits & Policies: Is trade deficit due to the fiscal deficit?



There are times when the fiscal budget & trade deficits are ‘twins’ & times that they are not. Overall savings-investment is key.

US Habits & Policies Reflected in National Accounts:
Consumer spending from falling savings is augmented by tax cuts, equity & housing wealth

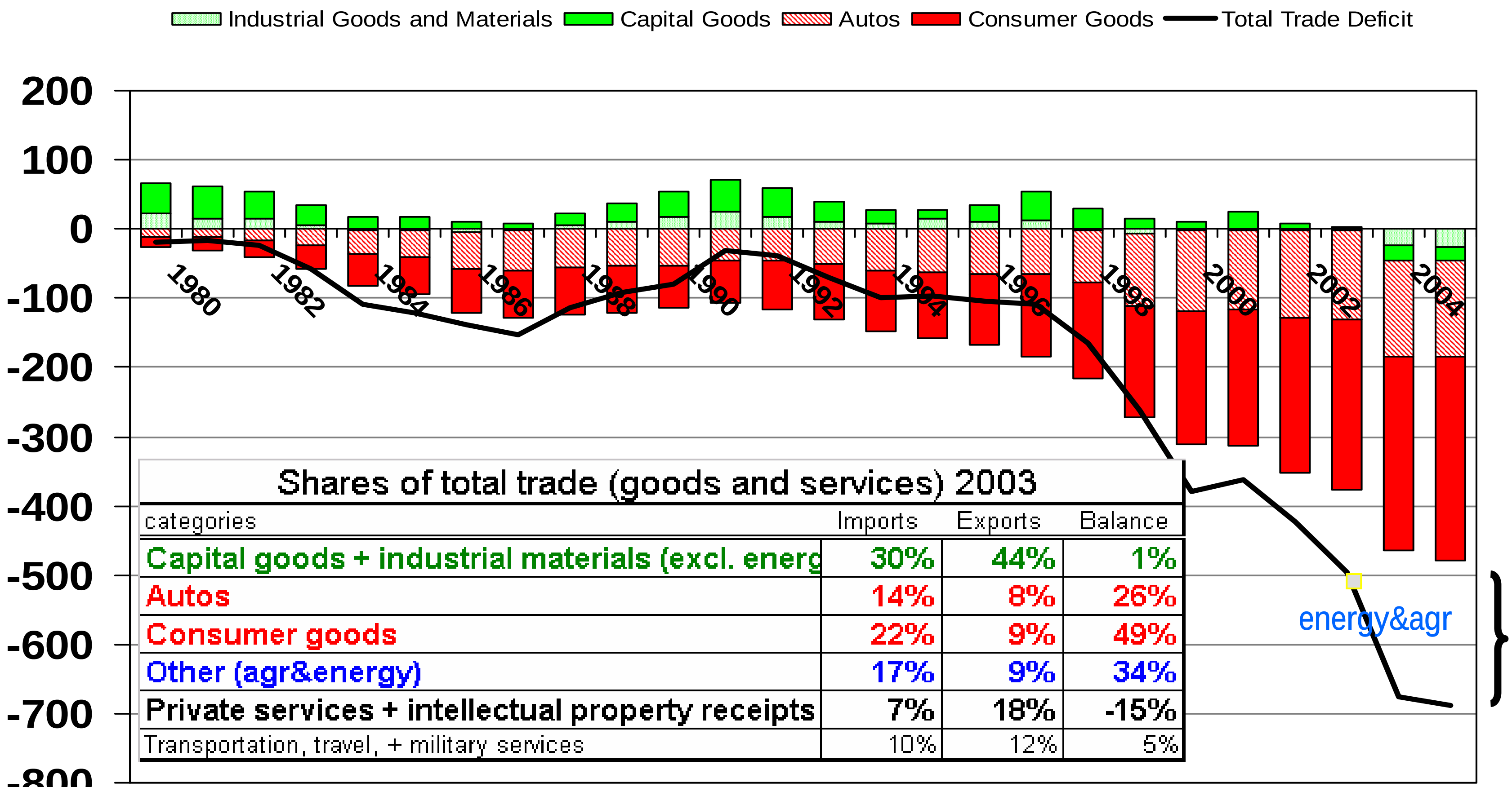
US Savings and Investment as Percent of GDP, 1980-2004



Source: Bureau of Economic Analysis, National Income and Product Accounts; International Transactions Accounts; Catherine Mann.

Not the fiscal deficit per se, but trend decline in household savings plus choice of fiscal policy that matters. Policy exacerbates habit.

Habits & Policies Reflected in US Trade Deficit:
Trends in commodity composition drive the overall trade deficit



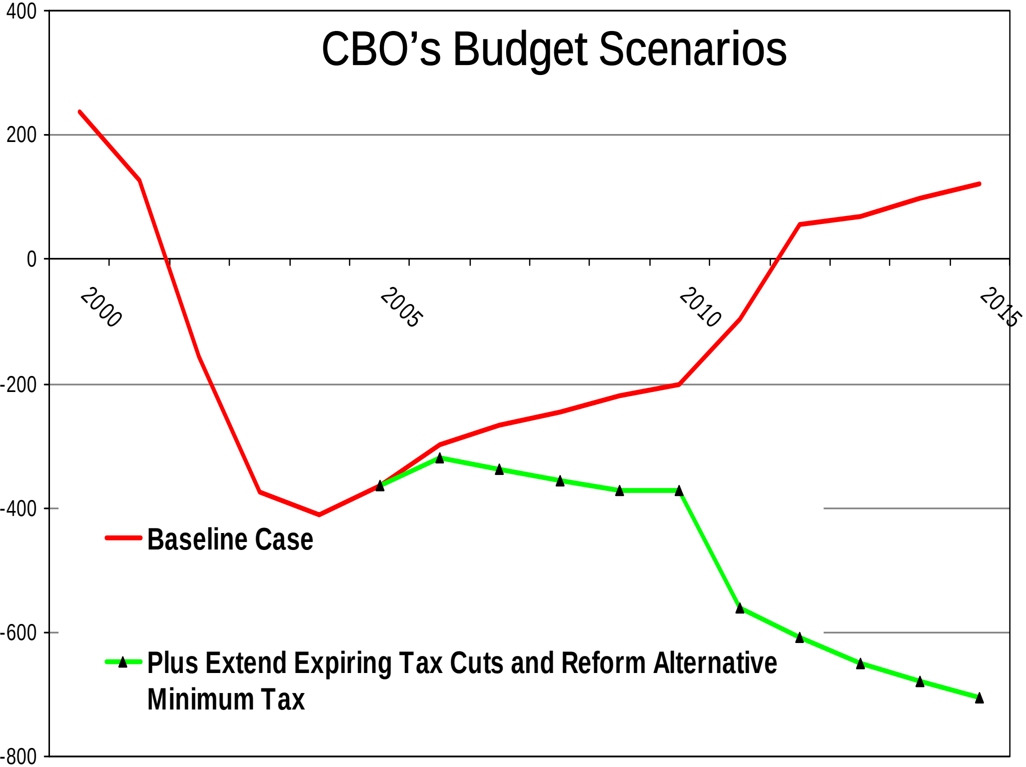
Shares of total trade (goods and services) 2003

categories	Imports	Exports	Balance
Capital goods + industrial materials (excl. energ	30%	44%	1%
Autos	14%	8%	26%
Consumer goods	22%	9%	49%
Other (agr&energy)	17%	9%	34%
Private services + intellectual property receipts	7%	18%	-15%
Transportation, travel, + military services	10%	12%	5%

Consumer goods and autos deficits dominate throughout;
Capital goods and ISM are global industrial-country cyclical;
Energy deficits are dramatic in the last several years.

Fiscal policy choice exacerbates trade deficit habit

January/March 2005 ($billions)

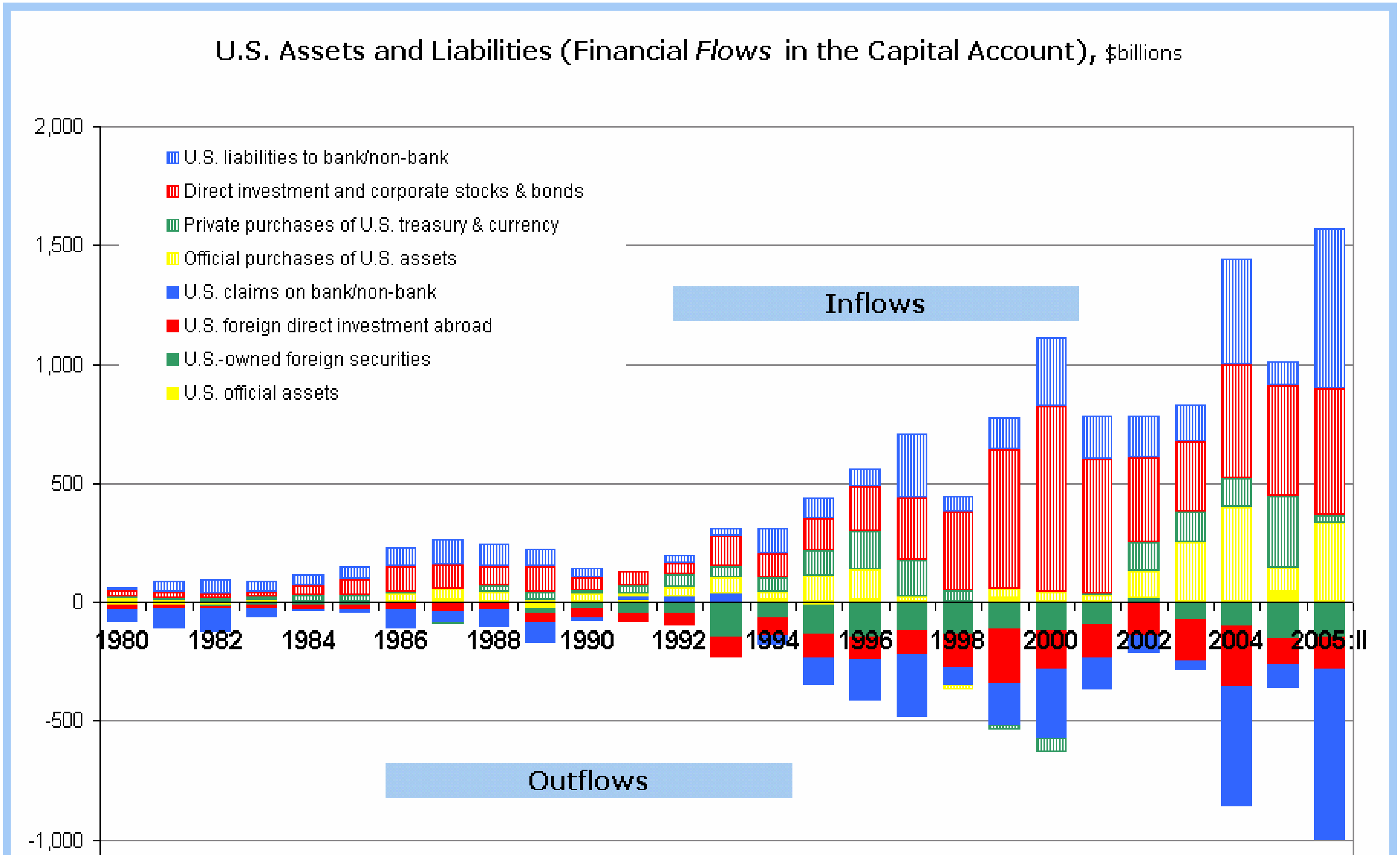


The Congressional Research Service (CRS) estimates that most of the turn-around in the budget (surplus of 2.4% of GDP in FY2000 to deficit of 3.6% of GDP in FY 2004) can be attributed to a fall in receipts from a historic high of 20.9% of GDP in 2000 to a 45-year low of 16.3% of GDP in 2004. According to CRS, 61% of changes in revenue are due to policy changes and 39% are due to economic conditions.

Source: Congressional Budget Office and Congressional Research Service of the Library of Congress.

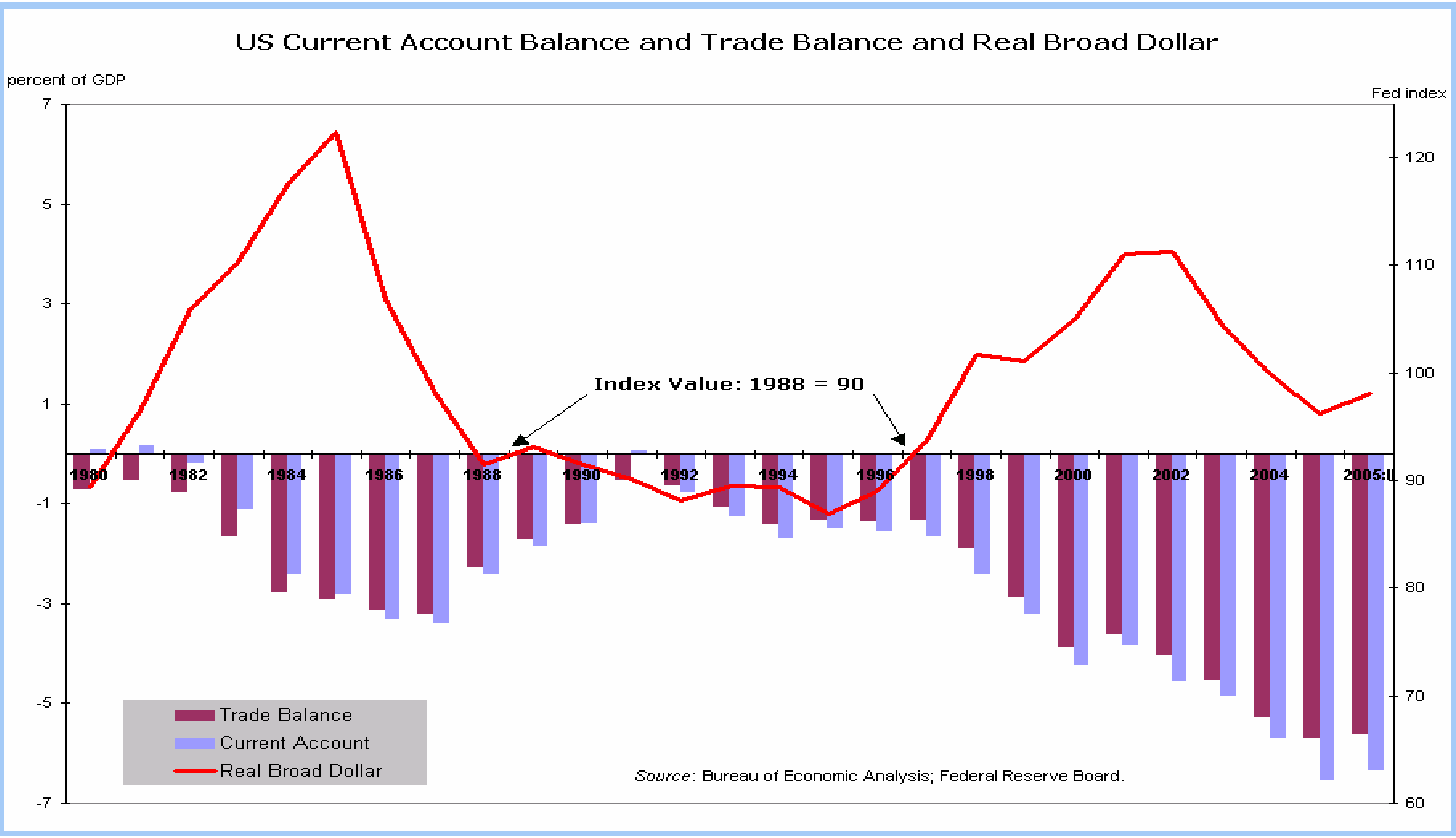
Making tax cuts permanent implies more consumption demand.
Likely to widen consumer goods trade deficit, need to sell more assets
Wider fiscal budget deficit requires more sales of US Treasuries.

Foreign Habits & Polices: Composition of Financing

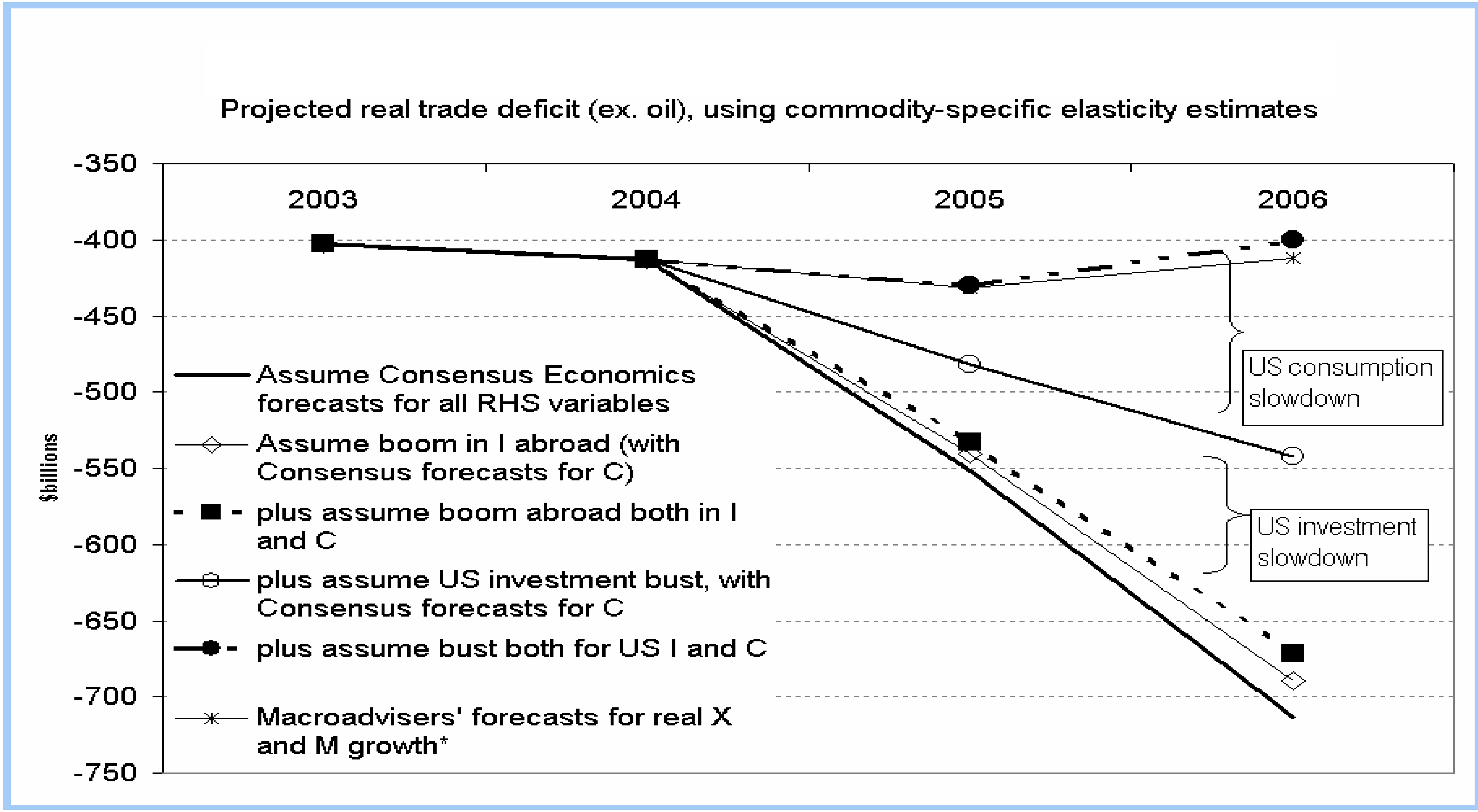


Financing is highly dependent on UST; this is common when fiscal deficit is large & when dollar is under depreciation pressure. Foreign central banks support their countries' production habits.

How to close the gap? It'll take more than XR



Depending on growth alone implies big adjustment



Sources: UN Comtrade; *Consensus Economics* forecasts; *Macroadvisers' Economic Outlook*, June 22, 2005; authors calculations from previously cited paper.

Key Elasticity Estimates

Commodity Group	Matched Expenditure				Matched Relative Price				Variety
	Industrial Country		Developing Country		Industrial Country		Developing Country		
	SR	LR	SR	LR	SR	LR	SR	LR	
Imports									
Capital goods	1.29**	0.77**	-0.40#	3.12	-0.31	-0.71**	-0.20	5.01**	1.42**
Consumer goods	3.55	1.32	4.16**	1.96#	-1.35**	-4.34**	0.86*	14.34**	-0.19
Exports									
Capital goods	0.67	0.70*	0.79**	0.94**	-0.38**	0.12	-0.01	0.01	5.2**
Consumer goods	0.45**	1.09**	0.69**	1.64**	-0.45**	-0.58#	0.01	0.02	-0.12

- Using matched relative price (e.g. real exchange rate) elasticities: significant and plausible values for industrial countries, but not significant for developing countries– esp. strong relative price effects for consumer goods from industrial countries
- Using matched expenditure components: Elasticities differ across product and country groups— esp. high SR for cons. goods; plausible LR; reduce Houthakker-Magee asymmetry; results reject assumption of constant income elasticities for imports

The challenges of global adjustment

- Habits & Policies: co-dependency for more than a generation:
  - For a generation, consumers, investors, policy-makers and politicians here and abroad (not just in China) have enjoyed the ‘stability’ of a co-dependent relationship; policies have exacerbated habits.
- Change in policies could ease us out of co-dependency
  - Sunsetting tax cuts--reduce augmentation to US consumer spending.
  - Raising interest rates—reduce augmentation of spending from housing
  - Exchange rate policy change abroad--aid switch to higher domestic demand abroad; aid switch to US products and US exports
  - But, estimated elasticities and past policy behavior are not hopeful.
- Without change in policies:
  - Option (1): Big financial accident – interest rate rise, dollar crash
  - Option (2) (more likely): Global slowdown – US consumer runs out of steam & wealth; foreign consumer & investors unable to pick up slack

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