

NBER WORKING PAPER SERIES

THE 2006 ECONOMIC REPORT OF THE PRESIDENT:
COMMENT ON CHAPTER ONE (THE YEAR IN REVIEW)
AND CHAPTER SIX (THE CAPITAL ACCOUNT SURPLUS)

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Working Paper 12168
<http://www.nber.org/papers/w12168>

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April 2006

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JEL No. E0, F3, F4

ABSTRACT

This paper is an analytic comment on two chapters of the Economic Report of the President for 2006. Chapter One deals with the economy in 2005 and the outlook for the future. The chapter provides a detailed analysis of the expansion in 2005 but not an explanation of why the expansion occurred despite the sharp rise in oil prices. I discuss the role of easy money in stimulating mortgage borrowing which generated negative savings in 2005. Looking ahead, I comment on the risk to inflation implied by the rising unit labor costs over the past four years. Chapter six deals with the international position of the United States. It provides a useful analysis of capital flows to the United States and the reasons why other countries have current account surpluses. It does not deal with the role of the dollar or the nature of the adjustment that might occur to reduce the US current account deficit. I present some comments on those issues.

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The 2006 Economic Report of the President:
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and Chapter Six (The Capital Account Surplus)

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Chapter One: The Year in Review and the Years Ahead

In 2005 the U.S. economy enjoyed a year of remarkably strong economic growth. The 3.5 percent rise in real GDP was noteworthy because it came despite two massive hurricanes and, more significantly for the economy, a doubling in the price of oil between 2003 and 2005 when it reached more than \$60 a barrel. Because the United States imports some 4.7 billion barrels of oil a year, that rise in the price of oil reduced the real incomes of Americans by \$140 billion, more than one percent of GDP. Previous episodes of oil price increases were followed by severe slowdowns or economic downturns. Why was 2005 so different?

Chapter one of the Economic Report of the President provides a careful review of the behavior of the major components of aggregate demand in 2005: consumer spending, residential and non-residential investment, government outlays, and net exports. The chapter then goes on to describe the developments in employment and in productivity, the behavior of prices and wages, and the conditions in financial markets. Looking ahead, the Report presents the official forecast of real GDP that serves as the basis for the administration's budget projections. There is

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also a brief description of the expected path of interest rates and of the future composition of GDP. For anyone seeking an overview of the economy in 2005 and a baseline for the future, this chapter is an excellent place to start.

But while the chapter provides a detailed description of what happened in 2005, there is very little attention to why the economy behaved as it did. In particular, there is no discussion of the impact of monetary policy or of earlier fiscal policies. Monetary policy was in fact a key reason for the economy's strong rate of expansion in the face of the higher energy prices. Because of the Federal Reserve's fear of deflation back in 2003, the Fed had reduced the federal funds interest rate to just one percent in 2003 and then increased it only very gradually in 25 basis point steps even though the GDP price index and other measures of inflation rose to about 3 percent by early 2004. The very low federal funds rate and the promise that rates would rise only very slowly (in "measured steps") caused long term interest rates to come down and to remain low. The rate on conventional new home mortgages fell from more than 7 percent in 2001 to 5.75 percent in the last half of 2005 before it began to rise in line with other rates.

This behavior of mortgage interest rates was significant because it led to an unprecedented volume of mortgage refinancing. Individuals who replaced old mortgages with new ones not only lowered their monthly mortgage payments (the result of the lower interest rate and the longer amortization period of the new mortgage) but were also able to extract cash at the time of their refinancing. Because of the previous rise in home prices, the amount of equity available to be withdrawn was often considerable.

While some of the cash extracted in this way was used to reduce other debt or to invest in financial assets, much of it was used to finance consumption. The refinancing process thus

permitted those individuals who refinanced mortgages to increase cash outlays more rapidly than their incomes, i.e., to dissave. The overall household saving rate fell from an already low 2.5 percent of disposable personal income in the third quarter of 2003 to a negative -1.1 percent in the second half of 2005.

This sharp decline in the personal saving rate was equivalent to about 2.5 percent of GDP. This was enough to pay for the increased cost of energy and at the same time to raise overall consumption of domestically produced goods and services. It was therefore the mortgage refinancing boom that sustained consumer spending in 2005 and permitted the strong overall growth of the economy.

Viewed in this way, the Report's comment that the increase in energy prices contributed to the growth of consumer spending (page 28) seems very strange. Higher energy prices reduced real incomes and that per se depressed real consumer spending.

The Report's discussion of the impact of government spending is also puzzling. The chapter notes first (page 33) how much federal government purchases and transfers contributed to GDP growth, implicitly assuming no crowding out of other spending. But it then concludes (page 34) that "Future outlays are projected to shrink by 0.7 percent of GDP in 2007. The shrinking of the Federal Government's claim on resources should allow private economic activity more room to grow."

The employment situation in 2005 was very good. Nonfarm payroll employment rose 2.0 million during the 12 months of 2005 while the unemployment rate estimated by the household survey fell from 5.4 percent to 4.9 percent. The Report might have noted that the ratio of employees to population rose to a very high 62.9 percent. This is significant because it showed

that the declining rate of unemployment was not the result of decreased labor force participation.

In its discussion of productivity, the Report points to the rise in productivity growth from 1.5 percent a year before 1995 to 2.5 percent from 1995 through 2001, followed by a remarkable acceleration of productivity growth to a 3.5 percent annual rate of growth from 2001 to 2005. There is no discussion, however, of the reasons for the slowdown in productivity growth that began in 2002. Productivity increased 4.0 percent from 2001 to 2002 but then 3.8 percent in the next year followed by 3.4 percent and 2.7 percent. Without a clearer understanding of why productivity growth slowed in this way, it is hard to judge the appropriateness of the CEA's forecast that productivity growth will average just 2.6 percent a year during the six year period of the budget projection. Since the Report notes that the acceleration in productivity growth after 2001 relative to earlier years was not due to capital deepening but to "factors that are more difficult to measure ... such as continued improvements in technology and in business practices," (page 37), it remains possible that productivity growth will again rise in the years ahead.

The slowdown of productivity growth in the most recent four years and the concurrent acceleration of nominal wages produced a series of annual increases in unit labor costs. Compensation per employee hour in the nonfarm business sector rose from 3.5 percent from 2001 to 2002 to 4.0 percent in the next year followed by 4.5 percent and 5.2 percent. The result has been an increase in the rise of unit labor costs over the four year period from - 0.5 percent to 0.2 percent, 1.1 percent and 2.4 percent. This path of rising unit labor costs can be expected to put upward pressure on product prices. This is already visible in the path of the implicit price deflator for the nonfarm business sector which rose 1.1 percent from 2001 to 2002 and then increased by 1.3 percent, 2.1 percent and 2.8 percent in subsequent years.

These figures present a less optimistic picture of wage and price inflation than the Chapter's conclusion that "trend unit labor costs have barely changed" (page 39) and that "labor costs do not appear to be putting upward pressure on inflation." (page 39) The CEA forecasts that the CPI inflation rate will stabilize at 2.4 percent during the next several years, a figure that is roughly compatible with a rate of increase of the Federal Reserve's preferred inflation measure (the core PCE index) of slightly below 2 percent, the upper end of what Federal Reserve Chairman Ben Bernanke has called his "comfort zone". There is, however, no discussion of the assumed future Federal Reserve policy that will be required to prevent further increases in inflation, an important omission at a time when the Federal Reserve is shifting from a clear path of removing excess accommodation to one in which it will need to balance very carefully the risks of inflation and of inadequate demand.

The CEA's long-term forecast is the basis for the Administration's budget calculation's since tax revenue and some expenditures depend on the pace of GDP growth and the level of prices. The CEA's forecast is relatively conservative, with real GDP growth declining gradually from 3.5 percent in 2005 to 3.1 percent from 2009 until the final year (2011) of the forecast period.

Although the CEA uses the interest rates quoted in the financial futures market to project short term interest rates through 2011, the forecast for the interest rate on 10 year notes calls for a rise to 5.6 percent for 2009 and beyond, a substantially higher figure than implied by the very flat long-term yield curve at less than 4.75 percent out to 30 years.

There is no discussion of the risks to the forecast in either the near term or the more distant future. While a basic forecast is needed for the budget projections, it would be useful to

know what the CEA regards as the various risks to the basic forecast and the policy options that might be considered if those risks were to materialize.

Chapter 6: The U.S. Capital Account Surplus

This chapter provides an unusual but useful approach to discussing the current international situation of the American economy. Instead of focusing on the trade imbalance or the current account deficit, it frames the discussion in terms of capital flows. Since the U.S. current account deficit is equal to our capital account surplus, i.e., to the net inflow of funds from the rest of the world, the emphasis on the capital account surplus leads naturally to a discussion of the role that capital outflows from other countries play in the U.S. balance of payments.

Because of its focus on the capital account, the chapter provides a useful discussion of the relation among the trade deficit, the current account deficit and the different components of the capital inflow. There is also a very informative analysis of the different reasons why other countries have excessive saving to send abroad: the recent surge in oil revenues in the oil producing countries, including Russia as well as the OPEC nations; the high personal saving rate in countries like China with underdeveloped social safety nets; and the European countries with relatively low desires to invest domestically.

But there is little discussion of why the large volume of international saving comes to the United States rather than to other countries. Nor is there an examination of what could eventually end the current account imbalance. Most surprisingly, there is almost no mention of the dollar

exchange rate and its role in shaping the current account deficit.

The U.S. trade and current account deficits are enormous, without precedent among major industrial countries, and growing very rapidly. In 2005, American imports exceeded our exports by \$725 billion or 5.8 percent of GDP. That's twice the trade deficit we had in 2001 and more than four times the trade deficit that we had in 1998.

To finance this trade deficit, the U.S. has to borrow from the rest of the world or sell American assets like stocks, businesses and real estate to the rest of the world. In addition to paying for our trade deficit, we must also borrow to pay the net interest and dividends that we owe on the amounts that we previously borrowed or on the assets that we previously sold to foreign buyers. Until recently, the fact that U.S. investment abroad earned a higher rate of return than foreign investment in the United States meant that this net flow of investment income was a positive amount in favor of the United States that helped to finance our trade deficit. This came to an end in 2005, implying that the net investment flow to the U.S. is no longer positive.

A variety of other payments, including U.S. foreign aid and personal remittances, brought the current account deficit in 2005 to a record \$805 billion or 6.4 percent of GDP. In the final quarter of 2005, the current account deficit reached an annual rate of \$900 billion or 7 percent of GDP.

Where is this money coming from, why does it come to the United States, and how long will it continue to come? While the chapter emphasizes the global nature of the capital market, it also notes that the U.S. attracted 70 percent of the total global flow of capital in 2004, up from 33 percent in 1995. To explain why it comes to the United States, the Report asserts that almost all of the capital inflow is coming from private investors who are attracted by the high earnings of U.S.

businesses. Although this explanation was true in the 1990s, neither aspect of this statement is correct today.

In the 1990s, most of the funds from abroad came in the form of equity, as private investors around the world thought that the risks of cross-border investing in the United States were outweighed by the higher potential return. That is no longer true. The equity share of the total capital inflow to the United States fell from 54 percent of the total capital inflow in 1999 to only 12 percent in 2004. More than half of that small equity inflow was in the form of foreign direct investment rather than portfolio equity. And in recent years the outflow of equity investments from the United States to the rest of the world exceeded the inflow of equity funds to the United States.

Equity inflows are almost completely done by private investors since governments are generally reluctant to invest in equities. But now that almost 90 percent of the capital inflow is in the form of fixed income, it is likely that those funds are coming from governments or from other public institutions like the Saudi Arabian Monetary Authority.

The chapter's statement that public funds accounted for an average of only 14 percent of the capital inflow is misleading because it focuses on a very narrow definition of "official" capital inflows. It is in fact impossible to know exactly how much of the capital inflow is coming from governments or institutions acting for governments. The monthly Treasury International Capital report is not helpful because it does not distinguish between the U.S. securities purchased by private buyers like foreign banks for their own account and the securities that they purchase as agents for foreign governments or other public institutions. Thus when an OPEC government buys U.S. bonds through a British bank, the inflow is classified as a private purchase.

Although there is no way to know who is providing the very large capital inflows, I think it is likely to be foreign governments and public organizations. This change in the nature of the capital inflow – from private investments in equities and direct investments in US businesses to government investments in bonds – is important because it means that the inflow of funds may be less reliable in the future. The OPEC countries are currently parking their surpluses in dollar bonds until they decide how to spend those funds. When they start spending, they will sell the bonds and may not direct a large portion of their purchases to the United States. The Chinese are large buyers of dollar bonds because they want to prevent a significant appreciation of the renminbi. But the goal of the Chinese government is to eliminate their trade surplus over the next few years, substituting an increase in domestic consumption for exports as a way of maintaining domestic employment. As part of that transition, the Chinese will no longer need to be such large buyers of dollar bonds.

Even before these major official buyers reduce their demand for dollar bonds, private investors could conclude that the small extra yield on dollar bonds relative to euro bonds or yen bonds is not enough of a compensation for the risk of a major dollar decline. That potential role of the dollar exchange rate and of expectations about changes in the exchange rate make the omission of any discussion of the dollar a serious shortcoming of the chapter.

The only way to shrink the U.S. trade deficit (and therefore the current account deficit) is a substantial decline of the dollar. While it is also necessary to increase domestic saving or reduce domestic investment, the price mechanism that converts this change in the saving-investment gap into a smaller trade deficit is a fall in the dollar. Although no one can be sure of just how large such a dollar decline must be, experts like Maurice Obstfeld and Kenneth Rogoff estimated (at a

time when the current account deficit was 5.4 percent of GDP) that it would take a trade-weighted dollar decline of between 20 percent and 40 percent to rebalance the U.S. current account. Back in the mid-1980s, when the U.S. last faced what seemed like a large trade deficit (equal to three percent of GDP in 1985), the dollar fell by 25 percent in 12 months and a cumulative 37 percent between April 1985 and the end of 1987.

Faced with the prospect of a similarly large and rapid adjustment in the future, portfolio investors could now decide at any time that the small interest differentials – about 1 percent for Euro bonds and 3 percent for yen bonds – is not enough compensation for the risk of a major dollar decline.

The chapter predicts that the current account deficit will decline but there is no discussion of how and why that will happen. The statement that the capital inflow could decline quickly (page 145) is not correct. In the short run, the U.S. must attract the funds to finance its current account deficit. Only after the decline of the dollar causes the trade deficit and the current account deficit to shrink, can the actual capital inflow decline.

Until then, the markets must provide the incentive for investors to continue to hold the existing portfolio of dollar bonds and to add to it by an amount equal to the annual current account deficit. That incentive means higher interest rates on dollar bonds and a fall in the value of the dollar. The lower value of the dollar reduces the risk of a further decline and therefore reduces the need for a large compensating interest differential. It would have been useful if the chapter had examined these adjustments.

The chapter asks the question of whether the U.S. can continue to receive net capital inflows and run current account deficits “indefinitely”. It answers with the optimistic assertion

that “U.S. capital inflows can continue indefinitely” (page 145) and notes that “the key issue concerning U.S. foreign capital inflows is not their absolute level but the efficiency with which they are used. Provided capital inflows promote strong U.S. investment, productivity, and growth, they provide important benefits to the United States as well as to the countries that are investing in the United States.” (page 144)

It is of course difficult to know the extent to which the capital inflows cause investment to be higher than it otherwise would have been. If consumption and government expenditures were not changed by the capital inflow, the entire inflow would be an addition to investment. But the capital inflow helps to keep long-term interest rates down, thereby encouraging mortgage borrowing, housing construction and household consumer spending. The lower interest rates may also relieve pressure on the government to reduce fiscal deficits. In any case, it is worth noting that between the year 2000 and the year 2005, the share of private investment fell from 17.7 percent of GDP to 16.8 percent of GDP while consumption expenditures rose from 68.7 percent of GDP to 70.1 percent of GDP. Government spending also rose as a share of GDP.

An increasing ratio of the U.S. external debt to U.S. GDP makes it increasingly difficult to service that debt and makes the debt increasingly risky to foreign bondholders. The current account deficit can therefore continue indefinitely only if the resulting growth of the external debt does not exceed the growth of GDP. The change in the size of the external debt is the sum of the “balance on income” (i.e., the difference between U.S. interest and dividend payments to foreigners and U.S. receipt of such income from foreigners) and the deficit on trade and unilateral transfers. Since the rate of return on assets exceeds the growth rate of the economy, the growth of the external debt will remain less than the growth of GDP only if the deficit on trade and

unilateral transfers is actually a surplus. In short, a current account deficit can continue indefinitely but only if a part of the resulting interest and dividends owed to foreigners is financed by a trade surplus.

So even if global capital markets permit the current account surplus to continue indefinitely, the dollar must eventually decline to a level that leads to a trade surplus.²

The chapter concludes with useful suggestions about the actions that the U.S. and other countries might take to reduce the global imbalance of trade and capital flows. While each of these actions would indeed be desirable (e.g., more saving in the U.S. and more consumption in China), it is not correct to assert that “no one country can reduce its external imbalance through policy action on its own. Instead, reducing external imbalances requires action by several countries.” (page 146) Consider what might happen in the U.S. unilaterally increased domestic saving. If domestic investment remained unchanged (either with or without supporting domestic monetary and fiscal policy action), the trade deficit would decline (because saving minus investment equals exports minus imports). No action in other countries is needed for the U.S. to reduce its trade deficit.

If the increase in the U.S. saving rate were accompanied by a decline of the dollar, the reduced trade deficit could involve a rise in U.S. exports and a shift of U.S. consumer spending from foreign goods to American made goods and services, thus sustaining the overall level of U.S. GDP. If the dollar does not decline, however, the rise in the U.S. saving rate would reduce

²This can be expressed in a simple case as follows: If B is the net external debt of the United States and $ch(B)$ is the change in that debt, then $ch(B) = iB + TD$ where iB is the interest on that debt and TD is the trade deficit. Since the interest rate exceeds the growth rate of GDP, $ch(B)/B$ is less than the growth rate of GDP only if TD is less than zero.

aggregate demand in the United States.

In either case, a reduced trade deficit in the United States would mean a reduced trade surplus in the rest of the world. This in turn would decrease aggregate demand in other countries. If they do not change their policies in response to that reduction in aggregate demand, their growth of GDP would slow. They could prevent that slowdown by policies to stimulate domestic demand and improve market flexibility. While such policy responses would be good for the countries involved, they are not a requirement for the U.S. to reduce our trade deficit. That is up to us.

March 2006