Central banker points to US deficit worries

Nick Beams
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A leading member of the US Federal Reserve Board has given one of the clearest indications yet that alarm bells are starting to ring in US financial circles over the impact of the stock market bubble on the American trade deficit and the growing international indebtedness of the US economy.

In a speech to the Japan Centre for Economic Research in Tokyo on Thursday, March 30, New York Fed President William McDonough said: "As a central banker ... I cannot help but register concerns about some recent developments."

"Signs of imbalance or strain have begun to appear in the US economy, especially in relation to the world economy," he commented. McDonough told his audience of economists and business leaders that "imbalances" in both the trade position and consumer demand needed to be corrected.

According to recent testimony by Fed chief Alan Greenspan to the US Congress, these "imbalances" are being fueled by rising share values which are boosting consumer spending and imports.

McDonough said the rising trade deficit required a "macro economic adjustment," adding that the earlier it was made the "more coordinated the policy response" would be. In other words, action should be taken sooner rather than later, lest the widening trade gap causes financial problems and the imposition of emergency measures.

The latest statistics show that the current account deficit reached an all-time high of $339 billion last year, a more than 50 percent increase over 1998, followed by a record trade deficit of $28 billion for January this year.

This growing trade gap is being funded by the inflow of funds from the rest of the world, sending the US deeper into debt. Net obligations to foreign creditors were 18 percent of Gross Domestic Product (GDP) at the end of 1998 and are now estimated to be more than 20 percent of GDP. In 1997 they amounted to 13 percent of GDP and stood at zero a decade ago.

One way of reducing the trade deficit and debt is to slow the US economy. But this would have major international repercussions. It is estimated that since the Asian economic crisis of 1997-98 the US has provided about half of the total increase in world demand. But there are limits on how long this can continue.

As McDonough told his Tokyo audience: "The United States cannot indefinitely be the engine of growth for the world economy—the importer of first and last resort—and sustain ever-mounting current account deficits without running the very real risk of economic and financial difficulties that could well weigh on many of the world's economies. No one wants that."

These "difficulties" arise from the possibility that the deficit may grow so large that at a certain point foreign investors lose confidence in the value of the US dollar and start withdrawing money as fast as they have been investing, leading to a crisis in US and global financial markets.

McDonough said the Fed wanted to reduce "excessive demand" while ensuring that consumer confidence was "strong" but not "euphoric". "Therefore, we are tightening monetary policy, with interest rates going slowly up, and we have made it very clear that we will continue that policy until we are successful in achieving our goals," McDonough said.

While offering the scenario of "soft landing" for the US economy on the one hand, this prospect was contradicted on the other by McDonough's assertion that the Fed's goal was to reduce the trade deficit from its current level of 4 percent of GDP to around 2 percent.

Such a turnaround would have major implications for the US economy and according to one recent report would mean a recession. Calculations by the London-based Lombard Street Research show that a cut in the current account deficit from 4 percent of GDP to 2 percent over two years would require that domestic demand grow by only 0.5 percent. Given that for the past three years it has been expanding at around 5.5 percent per annum, such an outcome would mean the US economy “hitting a brick wall”.

If the US trade deficit widens still further—and all the indications are that it will—the Federal Reserve may increase its hikes in interest rates. According to the minutes of the February meeting of the Federal Open Market Committee (FOMC) released last week, there was considerable pressure for a half-percentage point increase.

In the end those pushing for a bigger increase went along with the decision to lift rates by 0.25 percentage points as the option for a bigger rise was on the table for later this year.

The chief proponent of the quarter percentage point rises appears to be Federal Reserve chief Alan Greenspan, who is fearful that too rapid a rise could lead to a crisis on the stock market. But with the five rises since last June seemingly having little impact on the stock market bubble, and with concerns growing over the balance of payments deficit, a larger rise may be imposed when the FOMC next meets in May.