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Global Implications of the United States Trade Deficit Adjustment

Pingfan Hong
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Pingfan Hong

Pingfan Hong is a Senior Economic Affairs Officer at the Economic Assessment and Outlook Branch/ Development Policy Analysis Division, Department of Economic and Social Affairs. The views expressed here are solely the responsibility of the author and should not be interpreted as reflecting the views of the Organization. Comments should be addressed to the author at the United Nations, Room DC2-2154, New York, NY 10017 (e-mail: hong@un.org). Additional copies of the paper are available from the same address.

Authorized for distribution by **Ian Kinniburgh**,
Director
Development Policy Analysis Division
United Nations

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Abstract

Rebalancing the large U.S. trade deficits could take different paths. Based on model simulations, the paper shows that if rebalancing is based solely on a sharp cut in the U.S. domestic demand, a recession will be inevitable for the U.S. economy, and the adverse impact for the global economy will be substantial. On the other hand, if the adjustment relies mainly on an increase in demand from the rest of the world, the impact on the U.S. economy would be minimal. But it seems unfeasible for the rest of the world to boost demand, enough to eliminate the large deficits of the United States in the short- to medium term. A feasible and benign adjustment therefore has to be a gradual process through both reducing the U.S. domestic demand and increasing demand from the rest of the world. The challenge for policy makers worldwide is to maneuver such a smooth adjustment.

Key words: U.S. trade deficits adjustment, global economic interdependency

JEL classification code: F47

Introduction

The trade deficits¹ of the United States have grown steadily since the beginning of the 1990s, reaching about \$450 billion in 2000, or 4.5 per cent of GDP, and leading to growing concern among economists and policy makers. Views, however, are split on the causes and effects of the large deficits. More recent concerns have, however, been focusing on the sustainability of the deficits and the possible consequences of a reversal in the future. Given the size of the deficits and the share of the United States in the global economy, there is justifiable concern that any abrupt adjustment of the deficits could result in drastic effects for both the U.S. economy and the global economy. As mentioned repeatedly in recent years, it would be a challenge for policy makers to guide a fairly smooth adjustment process so that the deflationary impact on the global economy could be contained.²

Forecasting a turning point for deficits is always difficult, because a reversal can be triggered by such factors as a sudden shift in the confidence of consumers and investors, and these are unpredictable. In this case, the reversal may have happened at the beginning of 2001, with the U.S. economy experiencing a sharp slowdown, accompanied by a plunge in the prices of technology equities.

The purpose of this paper is not to predict the turning points, or to identify the causes of the reversal. Instead, partially based on model simulations, the paper presents a few different scenarios for the adjustment of

the U.S. trade deficit, but beginning with a brief review of some major issues in the current debate.

Some major issues in the debate

There is a growing empirical literature on the causes and the adjustment of current-account deficits. Recent studies include those of Cashin and McDermott (1998),³ Chinn and Prasad (2000),⁴ DeBelle and Faruqee (1996),⁵ Freund (2000),⁶ and Milesi-Ferretti and Razin(1998).⁷ For example, based on a study of 25 reversal episodes in OECD countries in the last two decades, Freund reported that a typical current-account reversal would begin when the deficit reached about 5 per cent of GDP, and the reversal would be associated with slowing economic growth and a significant depreciation of the real exchange rate. The study also indicated that monetary policy would play an important role in smoothing the adjustment, but fiscal policy would almost be irrelevant to the adjustment process.

Recent studies that have focused more specifically on the trade and current-account deficits of the United States include those of Godley (1999),⁸ Mann (1999),⁹ Obstfeld and Rogoff (2000).¹⁰ In addition, the U.S. Trade Deficit Review Commission submitted a lengthy report to the President and the Congress of the United States.¹¹

The U.S. economy has had trade and current-account deficits for most of the years in the last two decades.

1 Trade deficits have been the major part of the current-account deficits for the United States. This paper focuses on trade deficits.

2 See *World Economic and Social Survey, 1999 and 2000* (United Nations publications, Sales numbers E.99.II.C.1 and E.00.II.C.1).

3 Cashin P. and C.J. McDermott, "Are Australia's Current Account Deficits Excessive?", *Economic Record*, December 1, 1998, 74(227), pp. 346-61.

4 Chinn, M. and E. Prasad, "Medium-term Determinants of Current Accounts in Industrial and Developing Countries: An Empirical Exploration", NBER Working Paper, 2000, No. 7581.

5 DeBelle, G. and H. Faruqee, "What Determines the Current Account? A Cross-sectional and Panel Approach", IMF Working Paper, 1996, WP/96/58.

6 Freund, C., "Current Account Adjustment in Industrialized Countries", Board of Governors of Federal Reserve System, *International Finance Discussion Paper*, 2000, No. 692.

7 Milesi-Ferretti, G.M. and A. Razin, "Current Account Reversals and Currency Crises: Empirical Regularities", NBER Working Paper, 1998, No. 6620.

8 Godley, Wynne, *Interim Report: Notes on the U.S. Trade and Balance of Payments Deficits*, Strategic Analysis Series 2000, and *Seven Unsustainable Processes*, 1999, The Jerome Levy Economics Institute.

9 Mann, Catherine, *Is the U.S. Trade Deficit Sustainable?* 1999, Washington, D.C. : Institute for International Economics.

10 Obstfeld, Maurice, and Kenneth Rogoff, *Perspectives on OECD Economic Integration: Implications for US Current Account Adjustment*, paper presented to the Federal Reserve Bank of Kansas City symposium in Jackson Hole, Wyoming, August 2000.

11 For example, see *Report of the U.S. Trade Deficit Review Commission*, November 2000, Washington, D.C.

In the late 1980s, when the deficits peaked at about 4 per cent of GDP, a reversal started along with a large correction of stock markets and a significant devaluation of the dollar. The deficits were eventually eliminated at the beginning of the 1990s when the economy fell into a mild recession. But as soon as economic growth started to recover, the deficits rose again, and the deficits have accelerated since the mid-1990s.

What are the causes of the persistent deficits of the United States? What are the consequences of the deficits for the U.S. economy and for other economies? Are the deficits sustainable at the current level? What could cause a reversal? What are the global implications of rebalancing the large U.S. deficits? These are major issues concerning economists and policy makers.

Causes of the deficits

Trade deficits are simply the result of more imports than exports for an economy in a certain period. But the underlying causes can be very complicated, varying period by period (and country by country). It is usually difficult to identify the causes from the effects because many factors interact simultaneously.

A commonly mentioned cause for the U.S. trade deficits in the 1990s is the differential in macroeconomic performance between the United States and other major economies. For example, during 1991-2000, the United States registered average annual growth of 3.3 per cent, while Japan registered 1.3 per cent and EU registered about 2 per cent. Therefore, the relative strength of the U.S. economy led to a substantial increase in its import demand, while the relative weakness of many other economies led to slower growth in U.S. exports.

As international mobility of capital flows increased in the 1990s, the relatively strong economic growth of the United States attracted foreign savings, in the form of more foreign investment, pursuing higher returns. The net foreign investment position in the United States increased from about \$300 billion in the early 1990s to about \$2 trillion by 2000. The increased capital inflows have played a multiple role in causing the growing trade deficits. First, they have pushed up the value of the dollar vis-à-vis other major currencies—the dollar has appreciated by more than 20 per cent

in the second half of the 1990s, as measured by the real effective exchange rate. The appreciated dollar has then stimulated U.S. import demand further, and curbed its exports. Secondly, the increased capital inflows have fueled high rates of business investment, which in turn have contributed to the rise in productivity growth and in GDP growth in the United States, extending the growth gap between the U.S. economy and the rest of the world.

In contrast to the increased absorption of foreign savings, the rate of domestic household savings in the United States was on a declining trend since the beginning of the 1990s. The rise in the propensity to consume contributed to increased import demand. The U.S. trade deficits in the 1980s were accompanied by large government budget deficits (negative public savings), while the deficits in the 1990s were accompanied by a declining household saving rate.

Some short-term factors may also have led to the trade deficits. For example, the surge in oil prices during 1999-2000 increased the payment for oil imports, adding about \$60 billion to the deficit in 2000 alone. Meanwhile, part of the foreign capital inflows in the recent past might also have been driven by some short-term, or speculative factors: the “flight-to-quality” effects during the 1997-98 Asian financial crises and the exceptionally high appreciation of the U.S. equity markets in the late 1990s, both led to more foreign capital inflows to the United States on a cyclical basis.

In the current debate, many other views exist regarding the causes of the U.S. trade deficits, although not shared by all economists. For example, some observers believe that the U.S. market is more open to imports than other economies and the high non-tariff barriers to trade in foreign markets have been an important cause of the U.S. trade deficits. Others argue that the large deficits have been caused by the loss of international competitiveness of U.S. firms because other nations have failed to adopt international labour and environmental standards.¹²

Effects of the deficits

Views have also been divided regarding the effects of the trade deficits on the U.S. economy and on other economies.

If the U.S. trade deficits are a (temporary) phase in the dynamics of increased global economic integration through the reallocation of resources across nations, and if this reallocation process is considered to be efficient, then both the U.S. economy and the rest of the world (the economies with surpluses in the same period) should benefit, at least according to classical theory. In other words, the question is not really whether the deficits are good or bad for the U.S. economy and for the other economies, but whether the increased international mobility of goods, services and capital are beneficial, and whether the prevailing global economic system results in an efficient allocation. Of course, many views in this debate are not focusing on economic efficiency, but on the political economy of the deficits, in terms of the distribution of the benefits and costs across nations and across different groups of people.

Many observers believe that the benefits have outweighed the costs for the U.S. economy as a whole. First, consumers have gained from the lower prices of imports and more choices of various goods and services than otherwise. Secondly, the increased foreign capital inflows, which are the counterpart of the trade deficits, have permitted the U.S. economy to achieve a higher rate of business investment, especially investment in information and communication technology (ICT), and thus have contributed to a longer and stronger economic expansion in the 1990s than otherwise possible. Thirdly, increased international competition in general has reduced the pricing power of U.S. firms. The increased imports have been functioning as a “safety valve” for keeping inflation contained at a time when unemployment rates reached historically low levels in the United States.

Many different views have, however, also been expressed to emphasize the costs of the large trade deficits for the U.S. economy. Some observers believe that the increased imports have directly caused the constantly declining share of manufacturing output in the U.S. economy, and have thus lead to the elimination of millions of jobs in this sector. Furthermore, these viewers also think the depressed wages for production workers, and the growing wage inequality, have been the results of the increased trade deficits.¹³

Regarding the effects on the other economies in the world, positive views consider the large U.S. trade and current-account deficits as the important supporting force for global economic expansion. In particular, during the international financial crises of the 1990s, buoyant U.S. import demand has been seen as the most important driving force to bail out the crises-affected developing economies from the recession.

In contrast, other observers consider the large U.S. deficits as indication of an unfair international economic system in which the U.S. economy benefits the most, to some extent by taking advantage of the others. First, in the current international monetary system, the U.S. dollar is one of the major international currencies, and many other economies accumulate dollars as their international reserves. These dollar reserves tend to increase along with the growing global economic integration, and the U.S. economy captures the free seigniorage from issuing an “IOU” to the rest of the world. Secondly, the counterpart to the persistent U.S. trade deficits is a steady inflow of foreign capital into the U.S. and a corresponding draining of savings from the rest of the world. This raises growth in the U.S. while reducing growth and development in many other economies, exacerbating the gap in growth and in living standards between the U.S. economy and the rest of the world.

Sustainability of the deficits and the reversal issues

No country can run a large external deficit forever. As mentioned earlier, empirical studies have shown that among the OECD economies, a reversal usually occurs when current-account deficits reach about 5 per cent of GDP. Therefore, at about 4.5 per cent of GDP, many economists believe that the U.S. deficits are probably near the turning point. But no one knows exactly when the reversal will happen.

If the major cause of the deficits has been the higher growth of the United States relative to other major economies in the world, then the sustainability of the deficits will depend on the possibility of the United States’ economy continuing to perform better than others. Ob-

servers who believe in the New Economic Paradigm and that the U.S. economy has been fundamentally changed by the long-run ICT revolution would also think that the U.S. economy could continue to perform better than many other economies for the next decade or so because of the leading edge of the United States in new technology. In their view, the large trade deficits can be sustained for the foreseeable future. Forecasts that assume this is the case, i.e. that do not believe in an immediate reversal, have estimated that the deficits will grow to over 7 per cent of GDP by 2010.

Nevertheless, even the believers of the “new economy” agree that the new economy does not mean a termination of the business cycle. The United States is experiencing a sharp cyclical slowdown currently. If this continues, along with further depressed stock markets, the cyclical driving forces behind the trade deficits will start to reverse the trend: the household saving rate will increase, foreign capital inflows will fall, and the dollar will depreciate. Some of these reversals may have already been happening.

Since the sustainability of the U.S. trade and current-account deficits will, to a large extent, depend on the willingness of the rest of the world to continue pouring their savings into the United States, some studies have focused on the ability of the United States to continue borrowing. The net foreign liabilities of the United States (its “debt” to the rest of the world), as measured by the net foreign investment position in the United States, stands at about 20 per cent of GDP. Prior to the Latin American debt crisis of the 1980s, the net foreign debt of a few large economies in that region stood at about 20-30 per cent GDP. But the ratio in several OECD economies reached 40-50 per cent, or higher, in the 1990s. So, by this ratio alone, one cannot assume that the United States has already reached the limit of its foreign borrowing. But some economists argue that since the “effective internationally traded share” of the output in the U.S. economy is small, around 25 per cent of GDP, foreign debt already constitutes about 80 per cent of the tradable GDP in the United States, an alarmingly high level.

More important than assessing the sustainability of the deficits and the timing of a reversal are the debates on the dynamics of a reversal. At issue is how the deficits will be reduced. Will they be reduced mainly through relative price adjustments, such as a large devaluation of the dollar, or through adjustment in the real sectors, such as a cut in domestic demand of the United States? Within the United States, will the adjustment be made mainly through a cut in investment, or through a rise in domestic savings? Will the adjustment be an abrupt reversal, or a smooth process? In all these different cases, what will be the macroeconomic implications for the United States and for the global economy, in terms of the impact on GDP growth, inflation, employment, relative prices, and exchange rates between major currencies? What are the policy implications? A study of some of these questions has been carried out partially based on the simulation of the LINK global modeling system, and the results are summarized in the next section.¹⁴

Different adjustment scenarios

The LINK forecast of September 2000 is used as the baseline, on which alternative scenarios are simulated and compared.¹⁵ In the baseline, the U.S. trade deficits were projected to remain at around 4.5 per cent of GDP in the medium run, with the GDP growth of the United States at about 3-3.5 per cent and the growth of world gross product at about 3 per cent.

Several important parameters of the modeling system should be noted before discussion of the results. The income elasticity of U.S. import demand is around 1, the price elasticity of import demand is about 0.5 (about 1 for imports of consumption goods), and the degree of exchange-rate pass-through is about 50 per cent. For many other countries, the income elasticities are around 1, and the price elasticities vary country by country.¹⁶

14 Introduction to the LINK model system can be found at <http://www.un.org/esa/analysis/ddpa.htm> and <http://www.chass.utoronto.ca/link/>.

15 See the *LINK Global Economic Outlook 2000* at <http://www.un.org/esa/analysis/link/index.html>.

16 See Pingfan Hong, *Import Elasticities Revisited*, UN/DESA Discussion Paper No. 10, 1999.

A sharp adjustment scenario

In the last couple of years, quite a few model simulations of a hard-landing scenario for the U.S. economy, and the impact on the global economy, have been reported.¹⁷ But the main focus of those studies was on the implications of a collapse of equity markets in the United States and in other major developed economies. The adjustment of the imbalances among major economies was part of the consequences, rather than the objective, of those studies. In the present simulation study, however, the focus is on imbalance adjustment per se.

In this scenario, a target is set to reduce the U.S. trade deficit by half in two years. The assumption is that the adjustment would be accomplished mainly by a large correction of the private sector saving-investment imbalance by reducing domestic demand in the United States. The question is what would be the impact on the U.S. economy and on the world economy. Many factors could be conceived as the triggers for this kind of a sharp reversal of the deficits, such as a further collapse of the stock markets in the United States (technology stocks have already faltered and the broader market may follow), a sudden shift of consumer and business confidence (they have declined by about 30 per cent from the peak levels of 2000), or a reversal of foreign capital inflows (that could be caused by a large downward revision in the expectation for the U.S. growth in the future). More factors could be thought of as the catalyst for the “hard-landing” adjustment in the United States; however, this paper is limited to a discussion of the consequences of the reversal.

The main results of the simulation are shown in table 1. The U.S. trade deficit is reduced by more than \$200 billion from the baseline in two years, about half of the total deficit in the baseline. The deficit reduction would be mainly induced by depressed import demand, which declines by \$224 billion. How much would domestic demand have to shrink in order to generate such a cut in import demand? Given the current structure of the modeled economy, a drop in consumption by 5.7 per

cent would occur, combined with a decrease in private investment by 14 per cent.

The results imply that the larger part of rebalancing the U.S. private sector saving-investment gap would be through cutting investment and the smaller part through raising the saving rate. This would probably be the worst case most economists would foresee because reducing investment would not only mean declining domestic demand in the current period, but a smaller capital stock, and thus a lower income growth, in the future.

The table shows a loss of GDP of about 4.6 per cent in two years, and the impact on other macroeconomic aspects of the U.S. economy would also be significant.

Through international linkages, the deflationary impact on the global economy would be significant¹⁸. As

Table 1.
A hard-landing scenario
(Deviations from the baseline)

Countries and regions	Change in two years
United States	
Trade balance (billion)	+\$206
Imports (billion)	+\$224
GDP (%)	-4.6
Consumption (%)	-5.7
Private investment (%)	-14.0
Exchange rate (%)	-15.0
Unemployment rate (percentage points)	2.0
Inflation rate (percentage points)	-2.7
World Trade (billion, -4%)	-\$307
Trade balances (billion)	
Canada	-\$39
EU	-\$47
Japan	-\$31
Developing economies	-\$75
Latin America	-\$30
South and East Asia	-\$25
World GDP (%)	-1.7
Developed economies	-1.8
Developing economies	-1.6

¹⁷ For example, *World Economic Outlook*, IMF, October 1999; and *World Economic and Social Survey*, United Nations, 1999.

¹⁸ Due to the weakness in modeling some part of the world economy in the current LINK system, for example, modeling the economies in transition and modeling international financial flows, the degree of international multiplier effects implied in the simulation might be smaller than those in the actual economy, so the global impact reported here could be considered as the lower bound.

shown in the same table, world total trade (exports) would be reduced by more than \$300 billion, or 4 per cent from the baseline. Reflecting the reduced U.S. trade deficits would be a correction of trade balances in many other economies. For example, the trade surpluses of EU and Japan would be reduced by \$47 and \$31 billion respectively. The adverse effects on many developing economies would also be considerable. While developing countries as a group would have a \$75 billion drop in their trade balance, most of this would occur in South-East Asia and Latin America. Measured by GDP, the cost for the global economy of this hard-landing scenario is a decline of about 1.7 per cent from the baseline in two years, or \$600 billion.

In this scenario, the U.S. deficit is assumed to decline only by half. If the full amount of the \$450 billion deficit were to be forced to rebalance in two years, the impact would at least be doubled, and could be much greater, taking into account the non linearity in the economic system. A simple extrapolation from the simulation suggests that the cost for the United States would be about 10 per cent of GDP, implying a severe recession for the United States and a recession for many other economies in the world.

Unfortunately, the risks associated with this scenario have been increasing since late 2000, as the U.S. economy has been experiencing a sharp slowdown, featuring a large cut in business capital spending, a plunge in consumer and business sentiments, a collapse of technology stocks, and tighter conditions for corporate financing. If this trend can not be reversed soon, the global economy will be on the dangerous track depicted by this scenario.

An over-optimistic scenario

At the other extreme, a second scenario assumes that the adjustment of the U.S. trade deficit would be accomplished mainly by an increase in foreign demand. Again, the target is set to reduce the deficits by about half in two years. The question is what would be the additional economic growth required from the rest of the world to generate enough external demand for U.S. exports to achieve this.

As shown in table 2, this hypothetical process of adjustment would not cost the U.S. economy anything—it would gain modestly. The rest of the world, however, needs to increase GDP more than 3 per cent from the base-

Table 2.
An over-optimistic scenario
(Deviations from the baseline)

Countries and regions	Change in two years
United States	
Trade balance (billion)	+\$180
Exports (billion)	+\$260
GDP (%)	+3.2
Consumption (%)	+0.9
Private investment (%)	+4.0
Unemployment rate (percentage points)	-0.7
Inflation rate (percentage points)	+1.3
Rest of the world (required)	
Trade (%)	+5.5
GDP (%)	+4.0

line in order to generate enough external demand to reduce the deficits of the United States by about half in two years, implying that EU would grow at a 4.5 per cent annual rate, and Japan would grow at 3.5 per cent for two years. Given the current economic structures of these countries, it seems infeasible for these economies to achieve such high growth. A simple extrapolation will show that a full rebalancing of the U.S. trade deficit relying purely on increased external demand will require a rise of GDP by about 8 per cent for the rest of the world. In the short to medium run, this is not attainable.

A benign adjustment process

Between the two extreme cases discussed above, there can be many alternative adjustment processes. The third scenario is just an example. In this one, the target is also to reduce the U.S. trade deficit by about half in two years. The assumption is that the adjustment would be through a combination of reducing domestic demand in the United States and increased external demand from the rest of the world.

As shown by table 3, out of about \$200 billion in reduction of the U.S. trade deficits, about half would come from reducing imports and another half from increasing exports. As a result, the cost for the U.S. economy would be a fall of one per cent from the baseline, implying annual (GDP) growth of about 2-2.5 per cent

Table 3.
A benign adjustment process
 (Deviations from the baseline)

Countries and regions	Change in two years
United States	
Trade balance (billion)	+\$216
Exports (billion)	+\$119
Imports (billion)	-\$97
GDP (%)	-1.0
Consumption (%)	-2.8
Private investment (%)	-7.0
Unemployment rate (percentage points)	+0.5
Inflation rate (percentage points)	-1.2
Rest of the world (required)	
Trade (%)	+3.0
GDP (%)	+2.0

for two years. The reduction in consumption and investment would also be less severe compared with scenario one. On the other hand, the adjustment would require the rest of the world to raise income by about 2 per cent from the baseline, implying, for example, annual growth of about 4 per cent for EU and 2.5-3 per cent for Japan for two years. These required increases in growth for the rest of the world would still be difficult, but not infeasible. If a longer period can be allowed for the adjustment, the required growth for the rest of the world would be lower and more feasible to attain.

Other issues for the adjustment

The role of the dollar exchange rate vis-à-vis other major currencies in the process of the U.S. deficit adjustment has been discussed in many studies. Some economists believe that a large devaluation of the U.S. dollar would happen prior to the reversal of the deficit, and the devaluation would actually be the cause of the reversal—as U.S. consumers would face higher import prices while the consumers in the rest of the world would face lower prices for U.S. exports. But other economists believe that the exchange rate is not a leading variable in the process—a large devaluation may not be avoidable, but it will occur simultaneously in the process along with the adjustment in the real sectors.

With the existing LINK modeling system, the simulation results support the latter view. According to the model simulation, an exogenously imposed devaluation of the dollar alone would not be effective enough to reduce the trade deficits substantially. First, as the pass-through factor is about 0.5, a devaluation of the U.S. dollar by 20 per cent, for example, would only induce a rise of 10 per cent in the prices of imports in the same period. Secondly, since the price elasticity of import demand is less than one, the devaluation would produce a “J” curve in the trade and current-account balance, meaning an increase, rather than decrease, in the total value of imports in the first couple of years, even though the volume of imports would decline immediately.

In all the simulations reported above, in order to show the “net effects”, there is no assumption of any active policies. Monetary policy and fiscal policy are assumed to react “passively” to the balance adjustment according to the policy “rules” built into the models. For example, in scenario one, in response to the severe decline in domestic demand in the U.S. economy, the Federal Reserve would cut interest rates by about 300 basis points in two years according to the monetary reaction function built into the U.S. model. At the same time, the simulation showed a deterioration in government balance by more \$150 billion from the baseline, largely resulting from the loss in tax revenues and also partially reflecting a slight increase in spending reflecting the “automatic stabilizer” for fiscal policy that is built into the model.

Concluding remarks

The large and constantly growing U.S. trade and current-account deficits of the 1990s indicate unbalanced growth among the world economies. The deficits cannot continue to grow forever; they will reverse sooner or later, and in one way or another. Can the deficits be automatically rebalanced through the market forces alone? Yes, but there is no guarantee that the reversal will be smooth. As shown by the simulation studies above, risks exist for an abrupt reversal of the deficits associated with a recession for the U.S. economy and for other economies.

Therefore, it is a challenge for policy makers worldwide to guide the rebalancing process along a smooth track. Some policy implications can be drawn, as follows.

First, there is no good solution in the short run for rebalancing the large U.S. deficits. In effect, macro-economic policies should aim at preventing any abrupt adjustment. At present, the sharp downturn in U.S. domestic demand, especially in business capital spending, should be stabilized as soon as possible. In this respect, easing monetary policy can be more effective than fiscal policy because the latter involves a long period of political decision-making.

Secondly, a desirable smooth rebalancing of the U.S. trade deficit in the medium to long run should involve both a gradual narrowing of the saving-investment gap in the U.S. private sector and a rise in economic growth in other countries. In the United States, policies, such as fiscal policy, should aim at encouraging a higher household saving rate, and should avoid depressing investment. In other economies, policies should aim at promoting productivity growth and thus raising income growth.

In the second half of the 1990s, U.S. average annual labour productivity growth rose by more than one percentage point from the first half of the decade, while most European economies and Japan registered a noticeable decline. Encouragingly, however, the diffusion of ICT and various economic restructurings, which had boosted productivity growth in the United States, have now gathered momentum in more and more developed

countries, and even in some developing economies. If more countries can start to benefit from the factors that the U.S. economy benefited from in the 1990s, then the growth differentials between the United States and other major economies will likely start to narrow – and so will the deficits.

Thirdly, imposing restrictions on trade, or resorting to any forms of protectionism, will not be a good solution for narrowing the U.S. trade deficits, as they are all counter-productive. Instead, more efforts should be devoted to trade liberalization to remove various market barriers and distortions further. For example, China's entry into WTO in the near future will increase external demand for U.S. exports, even if the amount will be relatively small.¹⁹ Meanwhile, as mentioned by some observers, U.S. export controls and export sanctions may have caused part of the trade deficits.

Lastly, increasing financial transfers to developing countries should be of long run benefit to U.S. exports. If economic growth and living standards in more developing countries rise steadily, the global demand for U.S. exports of technology-intensive and capital-intensive products will increase. If world economic growth becomes more balanced across countries, the persistent large trade and current-account imbalance should be avoided.

19 For quantitative studies of China's entry into WTO, see Daniel Rosen (1999) "China and the World Trade Organization: An Economic Balance Sheet", *International Economics Policy Briefs*, Institute for International Economics, Washington, D.C., and Li, Xuesong, and Arjan Lejour (2000) "The Sectoral Impact of China's Access to the WTO-A Dynamic CGE Analysis", mimeo, Chinese Academy of Social Sciences.

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