

## *The Economy in Perspective*

*Trading places...* Many analysts believe that the U.S. economy overall will perform much the same in 2005 as it did in 2004. They expect that real GDP will grow in a range centered on 3.5 percent and that core CPI inflation will increase at roughly 2 percent. The unemployment rate is expected to fall only slightly because the number of new jobs will expand commensurate with labor force growth. But beneath the surface, individual sectors could recede and others emerge somewhat compared with the recent past.

Most economists expect consumer spending, business investment, housing, and national defense outlays to remain on a solid footing this year. But because interest rates are thought to be trending up, some analysts predict that housing markets and other interest-sensitive sectors could lose some of their vigor over the course of the year. If the overall pace of economic activity is to hold up, where might some additional thrust be found? Many eyes are focused on the external sector.

During the past 15 years, the United States' international trade and investment positions have spiraled into negative territory. Our trade deficit is now more than 5 percent of GDP, and foreigners' holdings of U.S. assets exceed our claims on foreigners by nearly \$2.5 trillion, or 20 percent of GDP. Should these trends continue, it would be increasingly difficult to finance a continuously expanding net foreign debt. The history of the industrialized countries during the last 25 years teaches us to expect that trade deficits of this magnitude will begin to reverse eventually, and that the reversal will probably be preceded by currency depreciation. That depreciation should make imports more expensive and exports cheaper, although the extent and timing of these price movements are uncertain.

In the case of the U.S., the dollar has already depreciated significantly against the currencies of many trading partners in the past two years, so it would not be surprising to see the net export sector strengthen this year relative to 2004. But the general equilibrium effects of a current account reversal are

hard to predict. After all, the financial counterpart of a large trade deficit is a large capital inflow. If the trade deficit shrinks back toward zero, the magnitude of foreign savings flowing into the United States must necessarily shrink toward zero as well. All else equal, U.S. interest rates will tend to rise because funds are scarce and will restrain such interest-sensitive sectors as housing, durable goods consumption, and business investment. If the U.S. export sector expands rapidly enough, it could compensate for a relative weakening in other domestic sectors, but how the overall economy would fare depends partly on adjustments abroad.

The export sectors of foreign economies could slow, even as an enlarged savings pool reduced domestic interest rates and stimulated their interest-sensitive sectors. Foreign countries could also take actions that would stimulate domestic consumption. Whether these forces, on balance, will promote stronger economic growth in the United States, or in foreign countries, is unknown. History provides examples of both outcomes.

The fundamental determinants of a nation's current account include such characteristics as national differences in tax, saving, investment, productivity, and trade policies. Consequently, if current account patterns are to shift in a meaningful way, some aspect of the fundamentals must shift as well. In the United States, for example, greater fiscal restraint over time would increase national saving and, other things equal, lead to less reliance on foreign saving.

Considering the movement in exchange rates, interest rates, and relative prices that can accompany current account adjustments, it is easy to see why some people might think the cure is worse than the disease. Even though fundamental current account reversals can be accompanied by employment and output expansions in some industries and locations, others might not fare as well. But if the adjustments proceed in an orderly way over an extended period, the reallocations can occur within the context of the other adjustments that take place in dynamic market systems and need not be especially disturbing.