The Bush Economy

TIE sat down with Richard Clarida, the Bush Treasury's former point man for economic policy, for some frank talk on deficits, rate spreads, and inflation risks. Here's how he answered our questions.

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How Big a Risk Is the U.S. Current Account Deficit?

The U.S. current account deficit is substantial, both in size and as a share of GDP. There's no single cause of the current account deficit. We sometimes talk about a "capital account" theory of the current account compared with a Keynesian, demand-side theory of the current account. I have become persuaded that there is a capital account channel that, to some extent, is now contributing to the U.S. current account deficit. But obviously, a lot of the U.S. current account deficit is homegrown—a low national savings rate, a negative household savings rate, and until recently, a high investment rate, driven by historically elevated residential investment on top of a historically average business fixed investment.

As we know from accounting, high rates of investment and low rates of saving compared to the business cycle produce a current account deficit. However, other factors—in particular the Bernanke "savings glut"—have tended to make the U.S. current account deficit larger than it would be otherwise. We're now in a situation of both large global imbalances and low global real interest rates. Looking at the markets in inflation-linked bonds, we see that both spot and forward the real interest rates are historically low.

A contributing factor is the savings glut, which I define as an excess of global saving relative to desired global investment at the interest rates that prevailed in the 1990s. It's important to distinguish between the savings glut and Bretton Woods II. These are related but distinct phenomena. Bretton Woods II is the arrangement whereby China and some of the other large emerging or emerged economies try to benefit from trade surpluses, foreign direct investment inflows, and fixed exchange rates. As we know, such a country must accumulate reserves. But the savings glut is an independent driver of low global rates, and because the United States tends to have a very interest-elastic response to low interest rates due to the housing sector, it's not surprising that our current account deficit has grown over this time. Indeed, I calculate that roughly 75 percent of the increase in the current account deficit between 2001 and 2005 was accounted for by the rise in residential investment. Note I did not say "caused," but the magnitudes of the housing boom and the widening of the current account deficit are comparable.

Do I worry about the current account deficit? Before, during, and after my stint at Treasury, I have said that a current account deficit at current levels probably will not be sustained. It's a theoretical issue whether or not it's sustainable in some abstract textbook sense. The adjustment under most plausible sce-

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narios will be orderly and will entail a weaker dollar, so I'm not in the camp of some respected scholars who think that the current account and the dollar are unrelated phenomena. But I don't see a disorderly adjustment as a baseline scenario.

Is There a Link Between Today's Sea of Liquidity and Low Interest Rates?

The argument that the low riskless real rate is being driven by excess liquidity created by global central banks has a lot of force if we are talking about the global economy circa 2001–04. What I look at is not the current real rate or the current setting of nominal interest rates, but the forward real rates which approximate where the markets think real rates are going to be in five years or so. What's striking is how stable those rates have been over the past several years, even though the Fed funds rate has moved from 1 percent to the current 5.25 percent.

From 2001 when the Fed began aggressively to cut rates until late 2005, the world has been awash in liquidity. The European Central Bank only started hiking in December 2005 and the Bank of Japan only started hiking in July 2006, and just got rid of quantitative easing in the spring of 2006. By traditional measures comparing nominal interest rates to nominal growth, that could be seen as an indication of some of the hangover from that excess liquidity. I wouldn't dismiss some of that still being around, but it's less of a factor now than it was three or four years ago.

Who Says Macroeconomic Research Never Produces Anything Useful?

At the request of NBER's Martin Feldstein, I brought together a group of leading scholars to contribute original research on the subject of *G7 Current Account Imbalances: Sustainability and Adjustment* (University of Chicago Press, March 2007). There was a broad consensus that an adjustment in the dollar will be part of the story. There was also a recognition that, given the integration of global capital markets, new channels of adjustment now exist that perhaps weren't as evident twenty years ago.

In particular, the essay by Pierre-Olivier Gourinchas and Hélène Rey points out the importance of valuation effects, not just trade flows per se from the adjustment of the dollar, but how mark-to-market changes are going to be part of the story. It essentially is a manifestation of what I call the "new exorbitant privilege"—the United States and its citizens can run a substantial net international liability almost entirely denominated in our own

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currency. When the dollar depreciates, it actually narrows our net liability position instead of increasing it and this tends to stabilize the net international liability position even in the face of large current account deficits. The U.S. Commerce Department reports that data every year, and it's striking how, notwithstanding the substantial current account deficits, the U.S. net liability position has basically stabilized in the past five years as a share of GDP because of these valuation.

Is the U.S. Current Account Deficit Starting to Narrow?

Consistently for the past twenty years the United States has earned higher returns on our assets abroad than foreigners earn here, according to the U.S. Department of Commerce's Bureau of Economic Analysis. But it's also true there is a substantial difference in composition of the assets. While U.S. investors tend to have a lot of foreign direct investment and a lot of equity, until quite recently foreigners held a lot of T-bills. There's no theory in economics that says if the United States owns foreign equities and the foreigners who lend to us buy T-bills, we will earn the same rate of return. I address this question in the chapter that I wrote for *G7 Current Account Imbalances: Sustainability and Adjustment.*

That being said, it looks as though the international investment income balance may be turning. Even though the United States had a very large net liability through the end of 2005, it still had a positive balance on its investment and dividend income. So one factor that has delayed adjustment in the U.S. current account is that through the end of 2005 it wasn't costing the United States anything to be an international debtor.

What's Your 2007 Economic Forecast?

I see the U.S. economy continuing to grow below trend. In 2001–03, mortgage refinancing and mortgage equity withdrawal was an important "automatic stabilizer" for the economy. I discussed in this in my 2003 *TIE* interview, and think I was one of the first to do so. It would seem unlikely to me that we could have a substantial contraction in housing without a period of below-trend growth extending through much of 2007.

The Fed may well be considering cutting rates in 2007. Sometimes people say is this about a hard landing or soft landing and what I point out is in the four rate hike cycles under Volcker and Greenspan, the four major ones, that there were two soft landings and two hard landings. Obviously in the hard landing in 1990 and 2001, the Fed was cutting. But looking at the two soft landings in 1985–87 and in 1995–97, within twelve months of the last hike the Fed was also cutting. I interpret that as an insurance policy. In that context, the yield right now on the ten-year bond is right about the middle of the range we'll probably be in for some time. In a stronger economy it might be higher and a softer economy it might be lower.

And the Housing Bubble?

The housing boom has reflected and created some distortions in the economy. Even allowing for demographic trends and other fundamental factors, residential investment and house price appreciation have until recently been running at a unsustainable pace.

What About the Federal Reserve's Inflation Risks?

Core inflation numbers have been above the Fed's comfort level. The Fed made the appropriate decision in August 2006 to pause, and I believe the Fed is in fact done for this rate hike cycle.

For all practical purposes, core inflation is a lagging indicator. Ben Bernanke and other Fed governors have articulated the view that they're running a forward-looking policy, and *TIE* readers know that's something a lot of central banks do. Obviously, if the inflation rate stays stubbornly high then the Fed will have to rethink where policy is later this year. But inflation is on the way down and probably as we move through 2007 we'll be at the Fed's comfort level. A funds rate of 5.25 percent is somewhat above neutral in the world in which we live.

Any Retrospective Views on the Bush-Cheney Tax Cuts?

I don't have regrets about helping to develop the Bush-Cheney tax cuts that I worked on while I was at Treasury (I arrived in September 2001 after the initial 2001 tax cut had already been enacted and did not participate in those efforts). In particular, the 2003 legislation reducing the dividend taxation and capital gains tax is good tax policy and was good economic policy at that time. Because it did turn out to be a relatively modest recession in 2001, people now forget how seriously the collapse in confidence, business investment, and exports shocked the economy in those years. These and the bursting of the equity bubble were very significant negative shocks to the economy. The Fed thought it was serious enough to cut the funds rate down to 1 percent.

I would also point out that the tax system that is in place after that 2003 legislation now is raising revenues at about 18.5 percent of GDP, or equal to the historic average for the United States in the past forty years. The remaining budget deficit reflects the fact that spending exceeds this historically average share of taxes in GDP. I don't have a good crystal ball of where fiscal policy is going, but my preference would be that an economy at full employment would aim for budget balance, and I consistently argued for such a policy when I was at Treasury.

When Will the United States Return to a Normal Yield Curve?

The yield curve now in the United States is inverted. Long rates are below short rates. That is not a normal state of affairs, and will not continue. It's a little more interesting if you look in Europe. In particular the United Kingdom may be seeing a structural inversion because of the way the pension funds are encouraged to fund their liabilities. But we're nowhere near that point in the United States.

Do Today's Narrow Emerging Markets Spreads Make You Nervous?

The fundamentals in many emerging market countries are sound and in some have been aided by strong commodity prices. Many of these countries are "emerged," not "emerging," economies. They're investment-grade. They are paying down foreign currency debt and issuing local currency debt that investors are eager to hold. The combination of historically elevated commodity prices and a robust global economy is great for a lot of these countries, so in that environment, credit spreads have narrowed.

What's striking now is the integration in global credit markets. When, for example, General Motors or Ford announce some bad numbers, not only does it hurt their bonds and other bonds in the same rating, it hurts a lot of emerging market bonds, too. So a lot of people are trading investment-grade emerging market, U.S. corporate, non-investment grade corporate, and high yield bonds all using the same strategies. There really is a global credit market and that's why we see narrow spreads across the globe: the pool of capital available to invest in these strategies has expanded.

What's the Future of Hedge Funds?

For hedge funds, the counterparties that provide the financing and execute the trading for them do impose important discipline on the system. What happened in 1997–98 was a very sobering experience for many. There may be less leverage per transaction now in the system than in the 1990s, but the whole scale is larger. There's a saying that generals are always fighting the last war, and at some point there will be a dislocation in global markets, but it probably won't look like 1997–98 or 1994. My guess is that it will happen in the vast new domain of credit derivatives.

Could the Eurozone Dis-Integrate?

Originally I, like a lot of U.S. academics, was skeptical—not of the wisdom of the European monetary union project—but of the likelihood of the Germans and the Bundesbank giving up their central role under the European Monetary System regime of 1980s and 1990s. I was proved wrong, and am pleased that I was. I didn't think it would happen in 1999 and I didn't think it would happen with twelve countries. I'm definitely in the "glass is more than half full" camp regarding the ECB. In Eurozone countries now whose credit spreads are widening, the benefits they accrue from being in the current system so vastly outweigh the alternative benefits from opting out that leaving the Euro doesn't seem a rational thing for any sovereign to do. Sometimes, of course, political leaders do very irrational things, but in any present-value calculation of the benefits and costs of being in the Euro area, the benefits are multiples of the costs.

Should the ECB Retire Its Monetary Pillar?

If you statistically look for an independent effect of money on policy beyond that of money's ability to forecast inflation or output, you don't find it. I was always skeptical about the twin pillars being a useful component to the conduct of policy. There are many pillars that help to forecast inflation, and money is just one of them. I have enormous respect for the lead proponent of the monetary pillar, ECB Chief Economist Otmar Issing, who recently retired. He felt and conveyed to me that the monetary pillar was an important communication device as well as an intermediate-term check on the ECB, and as such I thought it did little harm. But as an independent driver of policy I was always a skeptic and remain so.

It essentially is a manifestation of what I call the "new exorbitant privilege"—the United States and its citizens can run a substantial net international liability almost entirely denominated in our own currency. When the dollar depreciates, it actually narrows our net liability position instead of increasing it.

Headline Inflation vs. Core Inflation: Where Do You Come Down?

The ECB targets headline inflation while the Fed and Chairman Bernanke look at the core measure. It is arguably the most important issue now in the practice of monetary economics. Ultimately it comes down to central bank communication. The case in favor of targeting core inflation is that inflation this quarter reflects the past. Core inflation gives insight into where headline inflation will be over the horizon, during which policy can have an impact. If and when the Bernanke Fed does move towards an inflation target, it will have to be communicated that core inflation's essentially an important indicator of where headline's going to be. Ultimately the Fed will be looking at a range of factors that help forecast headline inflation. It may be a useful communication device to focus on one or two factors, but core is a good candidate. ◆