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Greenspan on the U.S. Current Account

Ostensibly, Greenspan's speech topic today at the Economic Club of New York was the current account, but the underlying message was an old theme: **the importance of market competition in promoting flexibility in the global economy**. While elements of both American political parties are rushing to sell Protectionism to the voters, Greenspan appears 'presidential' in reiterating the virtues of flexibility in dealing with economic 'imbalances.' One can find the same theme of letting markets do their work in several Greenspan speeches this year.[1]

On each occasion, Greenspan does not ignore the particular "imbalance du jour" that is the "topic" of the particular speech (current account; budget deficit; insufficient domestic savings; exploding social security and medicare costs), but the common thread was the ability of markets to cope with these 'imbalances' if given sufficient time to adjust to them. The trick is to be "patient," just as the Fed wants to do with regard to monetary policy.

Each of these issues is now the rallying point for some politician or some political economist who sees a "solution" by dictating a particular outcome. Greenspan, however, has tried to defuse each of these troubling issues by looking at the conditions necessary for sustaining flexibility in an increasingly, interdependent global economy. Today's effort was no different. He is convinced markets can handle the adjustments, provided a rush to judgment can be avoided and some efforts to lessen the risk of a malign outcome are undertaken.

Today's lecture on the current account raised the level of intellectual debate because he denied that the substantial Japanese and Chinese currency market interventions are sufficient to destabilize foreign exchange rates. He also denied that these interventions were the essential source of euro appreciation that is so much the concern of Europeans. In the case of Japan, 'home bias' ensures that Japan has a high preference for its own currency assets. In Greenspan's view, it is that preference rather than the size of the U.S. current account deficit that has tended to appreciate the yen and call forth unprecedented Japanese Monetary Authority intervention to decelerate that rise. Greenspan trotted out the sterilization theme in dealing with Japanese intervention, but feels that such a process is self-limiting. The BoJ will not be able to continue such large interventions as Japan proceeds out of deflation and into a more normal state of economic affairs. Second, the Chinese interventions must come to an end because continued intervention is causing the Chinese money supply to rise even into the teeth of growing domestic inflationary pressure.

Perhaps the most extraordinary assertion was that Asian Central Bank intervention is not the likely cause of upward pressure on the euro. This is strictly contrary to a widely-held belief in some financial circles. The interventions, according to Greenspan, deprive the private market of its desired dollar balances and that private sector re-balancing will tend to "buoy the dollar even against currencies that are not used in intervention operations." As a result, he cautioned his audience from believing that once the interventions ceased, the dollar will fall.

And, he reiterated once again his belief that even the slowing of Asian Central Bank intervention against the

[1] The Bundesbank Lecture given on January 13th; the speech on "economic flexibility" given to the British Treasury Conference on January 26th in London (delivered by satellite); the intriguing discourse on intellectual property rights given at Stanford last week and the parry and response of his HH testimony on February 11/12 at the presentation of the Monetary Report to the Congress to politicians trying to find simple solutions to voter anxieties.

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dollar will result in a sharp rise in U.S. short term Treasury yields. He thinks that such an effect will be small if it is present at all, because the overall market for short-term dollar assets is so large, relative to the size of assets held by Asian monetary authorities. If the Asian Central Banks are not the driving force assumed by many analysts and traders, what is? Home Bias!

While Home Bias (the preference to hold “domestic” rather than foreign assets in the portfolio), has been diminishing in recent years, it still is substantial. The fact that it has been diminishing is the principal reason that the U.S. current account deficit has been tolerated so well.

It is the underlying decline of home bias that is the critical driver in Greenspan’s analysis. Financial markets around the world are becoming much more transparent, more open and more supportive of investor protection. With increasing communication and information, home bias declines and larger current account imbalances can be tolerated without impacting prices (or interest rates) so severely.

As in many Greenspan speeches, there is a Sherlockian Dog that does not bark. In this one, it is the fact that the U.S. current account imbalance cannot be reduced without the surplus countries allowing their surpluses to dwindle. The only other alternative would be for much slower growth and that Greenspan does not want. The issue then becomes one of time: “Can market forces incrementally defuse a worrisome buildup in a nation’s current account deficit and net external debt before a crisis more abruptly does so?” The answer lies in increasing flexibility in both domestic and international markets. And, to add a bit of twist to the Dog that does not Bark, there is also one that does: one way to reduce the U.S. current account deficit would be for the Government to save more and spend less (namely, push the budget into surplus). Unfortunately, this is a Dog whose Bite is far worse than his Bark!

Global balance can be solved by increasing flexibility, but the politicians want to do it by restricting market outcomes. In the U.S., this takes the form of ‘protection for sale.’ It is the dominating characteristic of the recent Primary Debates. That is the malignant outcome that can befall the global economy if narrow political interest dominates the ability of markets to adjust. In a political season, it is hard to fault the Chairman of the Fed for being so outspoken on public policies not exclusively monetary by nature.