

I. ECONOMIC ENVIRONMENT

(1) MAIN ECONOMIC DEVELOPMENTS

1. During the period under review (1996-98), U.S. economic performance has continued to be outstanding, even in the wake of the financial turmoil that erupted in Asia in July 1997 and subsequently spread to other parts of the world. Since 1991, the United States has enjoyed the second longest period of sustained economic growth since records began in 1854, with real GDP growth averaging over 2.8% during the years 1992-96 before accelerating to 3.9% in 1997 and 1998 (Table I.1). The main factors contributing to this impressive growth have been private consumption and especially investment, both of which outstripped GDP growth in 1998, thereby drawing in imports. In real terms, imports too grew much faster than GDP, not only in 1998, but in the previous two years, while exports, after experiencing similarly rapid growth in 1996 and 1997, barely increased in 1998. In addition, the unemployment rate fell to 4.3% at the end of 1998 (having remained below 5% for the previous 18 months) and consumer price inflation to 1.6%¹, their lowest levels since the 1960s. These extremely beneficial economic developments have followed the considerable trade and investment liberalization that resulted from the Uruguay Round Agreements and the North American Free Trade Agreement (NAFTA) with Canada and Mexico.

2. This outstanding macroeconomic performance has been greatly facilitated by a large and growing current account deficit, which, in 1998, reached a record level of US\$233 billion (2.7% of GDP), thereby exceeding the previous record of US\$168 billion in 1987 (3.6% of GDP).² The trade deficit has enabled the U.S. economy to sustain its strong rate of growth in the face of domestic constraints on its productive capacity and a labour market that is at its tightest for nearly 30 years. Imports, often at lower prices, have provided a safety valve, helping to satisfy domestic demand. They have also contributed to lower domestic prices and wider choice for U.S. consumers. U.S. producers too have benefited from lower costs and wider choice of inputs, thereby increasing their competitiveness, which has resulted in more jobs and higher wages, especially in exporting activities, where average wages are higher than for other jobs. Competition from imports also helps enhance productivity. Indeed, labour productivity grew at an average annual rate of 2.4% during the period 1996-98, more than double the rate of improvement in 1990-95; total factor productivity (TFP) increased by an average annual rate of 1.2% in 1996-97, compared to 0.1% per annum during the period 1990-95.³ In general, imports have helped subdue inflationary pressure that might otherwise have emerged as a result of the very strong growth of domestic demand and low unemployment rate, thereby supporting low market interest rates.

¹One of the main reasons for the recent marked decline in the CPI is the external supply shock involving a sharp fall in energy prices. If energy and food are excluded from the CPI, the core CPI has stopped falling. Another reason for the recent decline in the CPI involves methodological changes made from 1995 through 1998, which reduced the annual rate of CPI inflation by 0.44 percentage points; changes to be introduced in 1999 and 2000 will reduce it by a further 0.24 percentage points. According to the GDP deflator, inflation is currently as low as 1%.

²The size of the deficit is apparently over-stated. The Foreign Trade Division of the U.S. Bureau of Census readily admits that export statistics are inaccurate. The Bureau estimates that 3% to 7% of the value of U.S. exports is missed because exporters fail to file a key document known as the Shippers Export Declaration, which means that exports are under-reported by US\$19 billion to US\$44 billion a year. The Commerce Department estimated that in 1997, U.S. exports were underestimated by one third owing to mis-measurement of fast-growing areas of trade such as services and electronic commerce.

³TFP reflects the efficiency with which all factors of production, including labour and capital, are used. It should be distinguished from labour productivity, which is the amount of output per employee (or per hour). Among the determinants of improvements in labour productivity are changes in the volume of investment and TFP. Investment contributes to improvements in labour productivity by increasing the amount of capital that employees have to work with.

Table I.1
Selected macroeconomic indicators, 1990-98
(US\$ billion and per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Real economy (changes in per cent)									
Real GDP	1.2	-0.9	2.7	2.3	3.5	2.3	3.4	3.9	3.9
Real domestic demand	0.8	-1.6	2.8	2.9	3.9	2.1	3.6	4.2	5.0
Private consumption	1.7	-0.6	2.8	2.9	3.3	2.7	3.2	3.4	4.9
Gross private fixed investment	-3.1	-8.0	5.7	7.6	8.6	5.5	8.8	8.3	11.4
Public consumption and investment	3.0	0.6	0.5	-0.9	0.0	0.2	1.1	1.3	0.9
Real exports of goods and services	8.5	6.3	6.6	2.9	8.2	11.3	8.5	12.8	1.5
Real imports of goods and services	3.9	-0.7	7.5	8.9	12.2	8.8	9.2	13.9	10.6
Prices (changes in per cent)									
CPI (end of year)	5.4	4.2	3.0	3.0	2.6	2.8	2.9	2.3	1.6
GDP deflator (implicit)	4.3	4.0	2.8	2.6	2.4	2.3	1.9	1.9	1.0
Employment/unemployment									
Employment (changes in per cent)	1.2	-0.9	0.7	1.5	2.3	1.5	1.4	2.2	1.5
Unemployment rate (end-year)	5.6	6.8	7.5	6.9	6.1	5.6	5.4	4.9	4.3
Productivity (changes in per cent)									
Labour productivity	0.7	0.6	3.4	0.1	0.5	0.4	2.7	1.7	2.4 ^f
Capital productivity	-1.6	-3.5	1.4	0.7	1.6	-0.5	0.4	0.3	..
Total factor productivity	-0.4	-1.5	1.9	0.1	0.5	0.1	1.7	0.7	..
Money stock (end of year, per cent change)									
M1	4.7	8.7	14.2	10.2	1.8	-1.9	-4.1	-0.6	1.5
M2	3.8	3.1	1.6	1.5	0.4	4.2	4.8	5.8	9.0
M3	1.5	1.3	0.3	1.6	1.8	6	7.3	9	11.3
Interest rates (per cent)									
Treasury Bill Rate (3-months)	7.5	5.4	3.5	3.0	4.3	5.5	5.0	5.1	4.8
Treasury Note Rate (10 year maturity)	8.6	7.9	7.0	5.9	7.1	6.6	6.4	6.4	5.3
Exchange rate^a									
Nominal effective exchange rate (1973=100)	88.4	86.9	85.4	87.7	86.2	81.4	85.2	91.9	96.5
<i>Per cent change</i>	-4.3	-1.7	-1.7	2.7	-1.7	-5.6	4.7	7.9	5.0
Real effective exchange rate (1973=100) ^b	85.1	83.4	82.3	85.0	84.6	80.8	85.8	93.2	98.3
<i>Per cent change</i>	-3.4	-2.0	-1.3	3.3	-0.5	-4.5	6.2	8.6	5.5
Fiscal balance (per cent of GDP)									
Total government fiscal balance ^c	-1.3	-2.0	-3.1	-2.5	-1.3	-0.9	0.2	1.4	2.6
Federal government fiscal balance	-2.7	-3.3	-4.5	-3.8	-2.7	-2.4	-1.4	-0.3	0.9
<i>(excluding social security contributions)</i>	-10.7	-11.5	-12.6	-11.9	-10.7	-10.4	-9.4	-8.2	-7.2
State and local government fiscal balance	1.4	1.3	1.4	1.3	1.4	1.5	1.6	1.7	1.8

Table I.1 (cont'd)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Structural balance ^{d, e}	-2.7	-2.1	-3.1	-2.3	-1.4	-1.1	-0.5	0.1	0.6
Saving and investment (per cent of GDP)									
National saving (gross)	15.7	15.8	14.5	14.5	15.5	16.3	16.6	17.3	17.2
Private	15.0	15.7	15.5	14.9	14.8	15.2	14.5	14.1	12.8
Personal savings rate (% of disp. income)	5.1	5.6	5.7	4.4	3.5	3.4	2.9	2.1	0.5
Public	0.7	0.1	-1.1	-0.5	0.7	1.1	2.1	3.2	4.4
Domestic investment (gross)	17.4	15.8	16.0	16.5	17.5	17.4	17.8	18.4	18.9
Private	13.9	12.4	12.7	13.4	14.5	14.4	14.8	15.5	16.1
Public	3.5	3.4	3.3	3.1	3.0	3.0	3.0	2.9	2.8
Balance-of-payments									
Current account (billions of \$US)	-91.6	-4.4	-51.4	-86.1	-123.8	-115.3	-134.9	-155.2	-233.4
Current account (per cent of GDP)	-1.6	-0.1	-0.8	-1.3	-1.8	-1.6	-1.8	-1.9	-2.7
Balance on goods (billions of \$US)	-109.0	-74.1	-96.1	-132.6	-166.2	-173.7	-191.3	-198.0	-248.0
Balance on services (billions of \$US)	27.9	43.2	57.4	60.7	65.3	73.8	82.7	87.7	78.9
Balance on goods and services (billions of \$US)	-81.1	-30.9	-38.7	-71.9	-100.9	-99.9	-108.6	-110.2	-169.1
Net investment income (billions of \$US)	24.2	21.5	22.5	23.9	16.5	19.2	14.3	-5.3	-22.4
Net transfers (billions of \$US)	-34.7	5.0	-35.2	-38.1	-39.4	-34.6	-40.6	-39.7	-41.9
Exports of goods and services (per cent of GDP)	9.7	10.2	10.2	10.0	10.4	11.3	11.4	11.9	11.3
Imports of goods and services (per cent of GDP)	10.9	10.5	10.7	11.0	11.7	12.4	12.6	13.1	13.0

.. Not available.

a Major currencies index (includes G-10 countries plus Spain, Ireland, Austria, Finland, Portugal and Australia).

b Adjusted for changes in CPI.

c Data on a budget basis.

d The structural budget balance is defined as the actual budget deficit (or surplus) less the effects of cyclical deviations of output from potential output.

e International Monetary Fund (1998), *World Economic Outlook*, October.

f Preliminary estimates reflects annual rate of change in the 3rd quarter of 1998.

Source: Survey of Current Business (available from: <http://www.bea.doc.gov/bea/pubs.htm>), Bureau of Labour Statistics (*Monthly Review* and website: www.bls.gov) and Council of Economic Advisors (1999), *Economic Report of the President*, February.

3. On the other hand, the widening of the trade deficit has provoked allegations in the United States that some foreign producers are engaging in "unfair" trading practices to the detriment of U.S. producers. Such allegations have, in turn, led to a certain protectionist pressure from some sectors, aimed at persuading the U.S. Government to implement unilateral measures to curb imports of some products from specific countries and to move to further open foreign markets to U.S. exporters; by and large, the Administration has resisted their pressures, much to the benefit of the multilateral trading system.

4. However, the trade deficit merely reflects the gap between national saving and domestic investment (see Box I.1). That gap has widened since 1995 as national saving has failed to keep pace with investment. While national saving rose as a proportion of GDP from 16.3% in 1995 to 17.2% in 1998, domestic investment climbed from 17.4% to 18.9%. National saving has risen despite the sharp decline of personal saving as a consequence of U.S. consumers increased willingness to spend. After its steady decline from 5.7% in 1992, a rate that was already low by international standards,

personal saving as a percentage of disposable income is now close to zero; indeed, it was negative in the latter part of 1998. The current, historically low personal saving rate is probably due in measure to the positive "wealth effect" of the rise in the value of personal equity portfolios relative to personal incomes owing to the rise in U.S. stock market prices to record levels. The "wealth effect" involves the tendency for consumption to rise by a fraction of the capital gains on existing assets owned by households; as unrealized capital gains add to wealth but are not included in income or saving, properly measured personal saving may not have fallen as dramatically as would appear. In any event, the decline in personal saving has been more than offset by stronger corporate saving and the turnaround in the government budget position from a persistent deficit (government dissaving) to a surplus (government saving) in 1998. At the same time, business investment in plant and equipment has been up sharply as a consequence, among other factors, of the ready availability of external financing owing to the dramatic reduction in government borrowing, which has left more resources available for private use.⁴

5. An additional source of funds for domestic investment has been capital inflows from abroad. Indeed, the shortfall of national savings relative to domestic investment was made up by foreign investors who have continued to be attracted to the United States by its liberal investment regime, profitable investment opportunities and its attractiveness as a safe haven following the financial crisis that erupted in Asia. Foreign investment has thus enabled the U.S. economy to grow faster than would have been the case had it relied solely on domestic saving. Foreign investment has also contributed to the recent marked improvement in labour productivity, which remains higher than most other countries, thus reflecting the extremely efficient nature of the U.S. economy. As a consequence, average living standards in the United States, as measured by a per capita GNP of US\$28,740, are the second highest in the world (after Singapore).⁵

6. Since 1995, services' shares of GDP and, to a lesser extent, total employment have continued to grow, mainly at the expense of manufacturing (especially manufacturing of non-durable goods), whose shares of GDP and employment have both declined (Table I.2). Much of the growth of services' share in GDP has occurred in finance, insurance and real estate; the latter's share of employment has remained unchanged, however, which suggests a relative improvement in this particular service sector's labour productivity. The shares of other services in both GDP and employment have also grown substantially.⁶ As regards other sectors, the shares of construction in GDP and total employment have risen slightly, while the shares of agriculture, forestry, fishing and mining have hardly changed.

⁴Council of Economic Advisers (1999).

⁵World Bank (1999), p. 191.

⁶Services other than transportation and public utilities, wholesale and retail trade, finance, insurance and real estate.

Box I.1: Accounting for the United States' current account deficit

In an open economy, the total output of goods and services available for purchase consists of gross domestic product (GDP) plus imports (M). Total expenditure consists of domestic demand, which is the sum of consumption (C), investment (I) and government purchases (G), together with foreign demand, namely exports (X). As the value of total output must equal total expenditure, the equilibrium condition for GDP is:

$$\text{GDP} = C + I + G + X - M. \quad (1)$$

Gross national product (GNP) is GDP plus net income received by domestic residents from abroad. Net income from abroad (NIA) consists of interest and investment earnings received on foreign assets (net of payments on foreign liabilities) plus net unilateral transfers abroad. It follows that

$$\text{GNP} = C + I + G + X - M + \text{NIA}. \quad (2)$$

Thus, whereas exports add to the GNP of the U.S. economy, imports do not do so directly; imports add instead to the GNPs of foreign countries.

The net trade position of a country is commonly summarized by the current account (CA), which is the difference between export and imports of goods and services (X-M) plus net income from abroad (NIA); that is

$$\text{CA} = X - M + \text{NFI}. \quad (3)$$

When the imports exceed exports plus NIA, a country has what is known as a current account deficit (CA-). By contrast, when exports plus NIA exceed imports it has a current account surplus (CA+).

The difference between government purchases of goods and services (G) and taxes (T) is known as the government budget (or fiscal) balance; a budget deficit arises when G exceeds T, while a budget surplus, or government saving, occurs when T exceeds G.

As GNP is, by definition, equal to disposable income (DI), which can be either consumed or saved, plus taxes (T) collected from households and firms,

$$\text{GNP} = C + S + T. \quad (4)$$

It follows from the GNP identity (2) and equations (3) and (4) that:

$$\text{CA} = X - M + \text{NIA} = S + (T - G) - I \text{ or } \text{CA} = \text{NS} - I, \quad (5)$$

where national saving (NS) is the sum of private saving (S) plus government saving (T-G). In other words, the current account deficit (CA-) must be equal to the amount by which investment exceeds national saving. This equation highlights the close relation between the current account deficit and the gap between investment and national saving.

As the sum of the current and capital accounts tend to zero under floating exchange rates,

$$\text{CA-} + \text{Net Capital Inflow} = 0, \quad (6)$$

which, when substituted into equation (5) gives:

$$I - \text{NS} = \text{Net Capital Inflow}. \quad (7)$$

The last equation demonstrates that if U.S. savers (including the Government) do not save enough to meet domestic investment needs, then the gap must be bridged by foreign savers. The resulting inflow of capital into the United States tends to drive up the exchange rate leading to a current account deficit. As federal and state governments are currently running an overall budget surplus, the fundamental cause of the present wide U.S. current account deficit is the fact that investment exceeds private saving. It follows that measures to increase national saving could reduce the current account deficit and help to defuse protectionist pressures.

Source: WTO Secretariat.

Table I.2
Shares of GDP and employment by sector, 1990-97
(Current US\$ billion and per cent)

	1991	1992	1993	1994	1995	1996	1997	1995-97 (%) ^a
Share of GDP								
Total (US\$ billion)	5916.7	6244.4	6558.1	6947	7269.6	7661.6	8110.9	5.6
Agriculture, forestry and fishing	1.7	1.8	1.6	1.7	1.5	1.7	1.6	9.7
Mining	1.7	1.5	1.4	1.4	1.4	1.5	1.5	10.5
Construction	3.9	3.7	3.7	3.9	3.9	4.1	4.1	7.1
Manufacturing	17.4	17.0	17.0	17.5	17.6	17.1	17.0	3.7
Durable goods	9.4	9.2	9.4	9.8	9.8	9.6	9.7	5.0
Non-durable goods	7.9	7.9	7.6	7.7	7.8	7.5	7.3	2.1
Services	75.1	75.3	75.4	75.3	75.9	76.1	76.5	6.0
Transport and public utilities	8.6	8.5	8.6	8.6	8.5	8.5	8.3	4.7
Wholesale trade	6.6	6.5	6.5	6.7	6.8	6.8	6.9	7.0
Retail trade	8.7	8.7	8.7	8.9	8.8	8.8	8.8	5.5
Finance, insurance and real estate	18.3	18.4	18.6	18.2	18.7	18.9	19.4	7.4
Other services	18.7	19.2	19.3	19.4	19.9	20.2	20.4	7.1
Government	14.2	14.0	13.8	13.4	13.2	13.0	12.7	3.3
Other ^b	0.2	0.7	0.8	0.2	-0.4	-0.4	-0.7	...
Share of employment^c								
Total (million)	117.5	118.0	120.0	123.0	124.6	127.0	130.0	2.1
Agriculture, forestry and fishing	1.6	1.6	1.6	1.6	1.6	1.6	1.6	3.2
Mining	0.6	0.5	0.5	0.5	0.5	0.5	0.5	1.1
Construction	4.1	4.0	4.0	4.2	4.3	4.5	4.6	5.1
Manufacturing	15.8	15.4	15.1	15.0	14.9	14.6	14.4	0.4
Durable goods	9.0	8.8	8.6	8.5	8.6	8.5	8.5	1.5
Non-durable goods	6.7	6.7	6.6	6.4	6.3	6.1	5.9	-1.1
Services	78.0	78.6	78.8	78.8	79.1	79.2	79.3	2.3
Transport and public utilities	4.9	4.9	4.9	4.9	5.0	5.0	5.0	2.3
Wholesale trade	5.2	5.2	5.0	5.1	5.2	5.2	5.2	2.0
Retail trade	16.9	17.0	17.0	17.2	17.6	17.5	17.4	1.7
Finance, insurance and real estate	5.8	5.7	5.7	5.7	5.6	5.6	5.6	2.2
Services	25.7	26.5	27.2	27.3	28.2	28.8	29.2	3.9
Government	19.3	19.3	18.9	18.5	17.6	17.3	17.0	0.3

a Annual average growth rate over the period.

b Statistical discrepancy.

c Full-time and part-time employment based on 1987 Standard International Classification (SIC).

... Not applicable.

Source: WTO Secretariat estimates based on Council of Economic Advisors (1999), *Economic Report of the President*, February, Table B-12 (p.342) and U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (various issues).

(2) MACROECONOMIC POLICIES

(i) Monetary and exchange rate policies

7. The twin objectives of U.S. monetary policy are to ensure price stability and high employment. When the unemployment rate fell below 5% and wages began to accelerate in mid 1997, there was widespread concern that the Federal Reserve would have to tighten monetary policy in order to restrain demand and thereby slow the U.S. economy. In the event, the onset of the

financial crisis in Asia, and the decline in world oil and commodity prices, obviated the need for such tightening. The crisis also increased the flow of liquidity into U.S. financial markets, thus contributing to a further rise in equity prices, which in turn boosted domestic consumption. In the autumn of 1998, when the crisis spread to Russia, U.S. financial market experienced considerable instability as liquidity dried up, leading to increased risk premia and sharp falls in share prices. However, an easing of monetary policy involving three cuts of 25 basis points in the federal-funds rate to 4.75% between the end of September and mid November largely restored financial stability. Subsequently, share prices returned to their previous record highs. Falling nominal interest rates and rising share prices during the period under review have reduced the cost of capital and thus stimulated investment. Nonetheless, as a result of the decline in inflation, depending on the price index used, real short-term interest rates are still in the range of 3-4%, which is slightly higher than the average of the past 15 years.

8. After rising during the period under review, the U.S. dollar exchange rate declined in the fourth quarter of 1998 as short-term interest rates fell. The depreciation in the dollar amounted to around 5% of both the real and nominal effective exchange rates; it followed a marked appreciation in both these rates since 1995 (Table I.1). This downward adjustment in the last quarter of 1998 may be related to expectations of lower returns in U.S. markets and the possible increased risk that it might not be possible to continue to finance the current account deficit at current interest rates.⁷ Indeed, the net asset position of the United States has become increasingly negative; that is, foreign asset holdings in the United States exceeded U.S. holdings abroad by 16.3% of GDP in 1997 compared to 7.4% in 1995.⁸ Moreover, net investment income turned negative in 1997 and 1998 and looks set to decline even further (Table I.3).⁹ While foreign investors have hitherto been more than willing to purchase U.S. assets (particularly since the onset of the Asian financial crisis), because of their relative liquidity and safety, and thereby contributed to the strength of the U.S. dollar, their attitude could change.

(ii) Fiscal policy

9. U.S. fiscal policy has complemented monetary policy in exerting a stabilizing influence on the economy during the period under review. Since 1992 the federal budget deficit has fallen steadily from 4.5% of GDP, with a surplus amounting to 0.9% of GDP emerging in 1998, only the second surplus in the past 30 years. The marked improvement in the budget position has moderated the rise in the current account deficit and contributed to the fall in interest rates. Although some of this fiscal consolidation has been due to the strength of the economic recovery since the 1990-91 recession, policies implemented in connection with the Omnibus Budget Reconciliation Act (OBRA) of 1993 and subsequent legislation, including the Balanced Budget Act 1997, have also been major contributing factors.¹⁰ Somewhat less than half of the improvement was cyclical. Almost half of the improvement in the structural budget deficit was the result of a higher than expected increase in tax revenues.¹¹ A large part of this increase was due to the unexpected growth of the economy; rising

⁷OECD (1999a), p. 28.

⁸OECD (1999a), Table 4.

⁹The fact that net investment income of the United States turned negative only in 1997, several years after its net asset position became negative, may seem incongruous. However, it reflects the fact that U.S. investments abroad earn higher rates of return than foreign investments in the United States, which suggests that U.S. investments abroad may be either under-valued or used more efficiently than foreign investments in the United States.

¹⁰IMF (1998a).

¹¹The structural fiscal balance refers to that part of the balance that would have existed had GDP been maintained at its potential level. In other words, the structural balance eliminates the part of the balance that is attributable to the stage in business cycle.

real incomes have raised federal and state tax revenues, as marginal tax rates are well above average tax rates. The high level of share prices, which caused a surge in tax receipts from realized capital gains, also contributed to the increase in tax revenues. The remainder was due to cuts in defence and non-defence spending. Almost all States are also running substantial budget surpluses, which in aggregate were equivalent to 1.8% of GDP in 1998. As a result, net federal public debt, which reached a peak of 46.7% of GDP in 1995, had fallen to 42.8% in 1998.¹²

Table I.3
Current and capital accounts
(US\$ billion, annual rate)

	1993	1994	1995	1996	1997	1998
Current account balance	-86	-124	-115	-135	-155	-233
Exports of goods, services and income	770	862	999	1,064	1,179	1,174
Imports of goods, services and income	818	946	1,080	1,158	1,295	1,366
Net unilateral transfers abroad	38	39	35	41	40	42
Balances:						
Goods and services	-72	-101	-100	-108	-110	-169
Goods	-133	-166	-174	-191	-198	-248
Non-factor services	60	65	74	83	88	79
Net investment income	24	17	19	14	-5	-22
Official transfers	-21	-20	-15	-19	-16	-17
Private transfers	-17	-19	-20	-21	-23	-25
Capital account balance (+ inflows)	85	134	138	195	255	237
U.S. investment abroad, net (increase) ^a	-195	-171	-327	-369	-479	-305
Foreign investment in the United States, net (increase) ^b	280	305	465	563	733	542
Official assets balance	71	39	100	134	15	-30
Other foreign assets in the United States	15	89	38	61	240	267
Statistical discrepancy	-1	10	-23	-60	-100	-4
Memorandum:						
Current account balance as a percentage of GDP	-1.6	-1.8	-1.9	-2.9

.. Not available.

a Capital outflow (-).

b Capital inflow (+).

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various issues.

(iii) Saving-investment gap

10. Fiscal consolidation and the emergence of a federal budget surplus have eliminated government dissaving, a major factor that has long contributed to the relatively low rate of national saving in the United States. Nevertheless, investment has remained strong; indeed, fixed investment currently accounts for much more GDP growth than in previous long expansions (such as in 1961-69 and 1982-90). This strong investment growth is the consequence of, *inter alia*: strong GDP growth (via the accelerator effect); the low cost of capital owing to declining interest rates and higher stock market prices; and strong corporate profits and therefore the availability of retained earnings for new investment. It may also be related to the economic collapse in Asia and elsewhere, which has enhanced the attractiveness of the United States to foreign investors. The boom in investment has included purchases of relatively short-lived computer equipment, partly due to considerably lower

¹²OECD (1999a), Table 10.

prices, but also possibly motivated by the desire to replace old equipment susceptible to the year 2000 bug. National saving has failed to keep pace with investment, however, owing to the apparent collapse in personal saving, which is probably related to the surge in share prices to record levels. (The decline in the personal saving rate is somewhat exaggerated because it does not take into account saving in the form of unrealized capital gains; such gains have added to personal wealth, thereby raising wealth in relation to income.) The outcome is that national saving fell short of domestic investment by an amount equivalent to 1.2% of GDP in 1998. The resulting excess of investment over national saving is manifested in a current account deficit (Box III.1), which grew to 2.7% of GDP in 1998. This aspect of globalization has been especially beneficial for the United States economy because it has allowed it to invest heavily in capital equipment and thus to maintain its high growth rate despite the relatively low national saving rate.¹³

(3) MAIN DOMESTIC STRUCTURAL POLICY ISSUES

(i) Taxation

11. While the personal saving rate's decline has clearly helped the world economy in the wake of the Asian financial crisis, the United States' traditionally low rate of saving has also caused widespread domestic concerns over its adverse implications, not just for the current account, but for investment, growth and productivity, not to mention the financial security of individual households. These concerns have prompted calls by several prominent tax experts and congressmen for a shift away from corporate and personal income taxes to a broad-based consumption tax.¹⁴ It is argued that comprehensive income taxation results in savings being taxed twice; first saving is usually made out of after-tax income, and then returns on such saving, when they are realized, are taxed again. Such double taxation constitutes a potential disincentive to save, which would not arise under a broad-based consumption tax. However, double taxation only affects about one half of total personal saving. This is because contributions to individual retirement accounts (IRAs), Keogh plans and 401(k) plans are deductible from personal tax; contributions plus any returns are instead taxable upon withdrawal.¹⁵ This tax treatment is similar to that under a consumption tax, such as the RST or VAT.¹⁶

12. As the treatment of much of current saving is similar to that under a consumption tax, the negative effect of the present tax system on saving is less than often supposed. Furthermore, there is some ambiguity about the size of the behavioural response to after-tax rates of return on saving.¹⁷ Consequently, it is unclear whether a shift to consumption-based taxation would raise saving substantially. Even if it did, this would not necessarily result in a reduction of the current account deficit. The shift to a consumption tax would reduce taxes on income from capital and thus likely increase the attractiveness of the United States as a destination for foreign investment, at least in the short run.¹⁸ Insofar as foreigners actually pay U.S. income taxes, a switch to a consumption-based tax

¹³Council of Economic Advisers (1999).

¹⁴Among the academics, see Bernheim (1997). The main proposals by congressmen that have been introduced as legislation include the Arney-Shelby flat tax, the Shaefer-Tauzin and Lugar national retail sales taxes, and the Nunn-Domenici unlimited savings allowance (USA) tax. For more details concerning these and other proposals, see USITC (1998).

¹⁵Also contributing to the low overall taxation of saving is the tax exemption of the implicit rental income of owner-occupied housing, the deferral of taxes on accruing capital gains (together with selective loss realization) and the recently enacted preferential tax rate on realized capital gains.

¹⁶Under the "unlimited saving allowance" (USA) tax, proposed by Senators Nunn and Domenici, such treatment would be extended to all new saving.

¹⁷Much current evidence, including that reviewed by the OECD (1994a), suggests that aggregate saving may not be sensitive to the after tax return.

¹⁸USITC (1998).

system would attract foreign equity investment to the United States as well as encourage U.S. multinational enterprises (MNEs) to locate projects in the United States that might otherwise have gone abroad. On the other hand, it could also encourage U.S. MNEs to shift debt capital to other countries. While the net outcome of these two effects is theoretically ambiguous, most studies suggest that net capital inflows are more likely. The consequent rise in net capital inflows would tend to widen the current account deficit, which would mitigate, if not outweigh, the reduction in the deficit brought about by any increase in savings induced by the switch to consumption taxation. Nor are the border tax adjustments tied to a destination-based consumption tax likely to have a long-run effect on the trade balance because this effect would ultimately be offset by a real appreciation of the U.S. dollar. Hence, if the present gap between national saving and domestic investment, and thus the current account deficit, is indeed a concern, perhaps a more viable way of reducing the gap might be for the Government to run an even larger budget surplus or increase the funding of social security (see below).

13. While a switch to a broad-based consumption tax would not necessarily reduce the saving-investment gap, it is likely to increase the total U.S. capital stock, with a significant part of this increase arising from inflows of foreign investment attracted by lower taxation of income from capital. The rise in U.S. capital stock would, in turn, contribute to higher wages as a result of increased labour productivity and higher GDP. The switch would also be expected to change the composition of U.S. trade, increasing net exports of capital-intensive goods relative to those of labour-intensive goods.

(ii) Social security and related measures

14. Another potential drag on national saving, particularly in the long term, involves the social security system. According to official projections, social security pension payments and health care costs for the elderly are likely to expand considerably during the next four decades leading to the exhaustion of the Social Security Trust Fund by 2032 and, as a consequence, contribute to an eventual deterioration in the budget position. In order to address this situation, in his State of the Union message in January 1999, the President outlined proposals to ensure that the Fund would have sufficient resources to provide benefits until 2050. The proposals involve allocating 62% of projected budget surpluses during the next 15 years (nearly US\$2.8 trillion) to the reserve Fund. Clearly, maintenance of such budget surpluses and their allocation to the Social Security Trust Fund would not only improve the financial position of the social security system, but add to national saving. Furthermore, in an attempt to raise the returns on the Fund's assets, roughly 15% of the Fund would be invested in the stock market (a practice already followed by state and local government pension funds, which currently own about one tenth of listed stocks); this proposal has raised issues of corporate governance, particularly fears of political interference in investment decisions. In order to allay such fears, equity investments would be managed independently, and without political interference, by private sector managers selected by competitive bidding procedures. Equity investments would be broad-based, neutral and non-discretionary as in widely used equity index mutual funds. The Fund's equity holdings would represent less than 4% of the U.S. equity market on average over the next 40 years.

15. An additional 12% of the projected annual budget surpluses (US\$536 billion) over the next 15 years would be used to provide a progressive tax subsidy for voluntary contributions, particularly by low income groups, to newly created "universal saving accounts", (USA)¹⁹ thus expanding the scope of tax incentives for saving; these tax incentives already include individual retirement accounts

¹⁹The tax subsidy involves a refundable tax credit for USA contributions together with a matching of such contribution by the Federal Government. Universal saving accounts should not be confused with the "unlimited saving allowance" (USA) tax proposed by Senators Nunn and Domenici.

(IRAs) and Keogh plans, which currently cost the Federal Government US\$10.8 billion and US\$3.7 billion, respectively, in annual tax revenue losses (Chapter III(4)(i)). Notwithstanding these existing incentives, which were introduced in the 1970s, the personal saving rate not only remained low by international standards, but virtually disappeared in 1998, thereby casting some doubt on the effectiveness of such incentives.

(iii) Labour market policies

16. Clearly, the continued strong growth of the U.S. economy throughout the period under review has been the main reason for the increase in the number of jobs. The continuing growth in employment and the decline in the unemployment rate to 4.3% of the labour force at the end of 1998 is also a reflection of the labour market's high degree of flexibility in the face of globalization.²⁰ Part of this flexibility is perhaps due to the success of welfare reform, undertaken since 1996, in increasing labour force participation. Such reform includes in particular the Personal Responsibility and Work Opportunity Reconciliation Act, which replaced the previous open-ended federal entitlement to welfare assistance with a block grant to states to provide time-limited benefits. As a result of this reform and various tax incentives, such as the Earned Income Tax Credit (EITC) together with Work Opportunity Tax Credit and Welfare to Work Tax Credit, 1996, both of which were prolonged by the 1998 OBRA, the number of welfare beneficiaries has fallen markedly with many people finding work.²¹ As well as encouraging welfare recipients to work, the Government has taken steps recently to lower the barriers that the low-skilled and the disabled face in finding employment.²² In 1998, Congress re-authorized "Head Start", a programme aimed at improving the quality and availability of child-care services, thereby helping one-parent families to work. Another 1998 Act overhauled and consolidated federal job training programmes into state-administered block grants, thus extending vocational rehabilitation programmes serving over one million disabled persons. Furthermore, the private sector has developed voluntary networks aimed at facilitating the transitions from welfare to work, and school to work.

17. Policies that further opened up the U.S. economy to foreign trade and investment have contributed to higher wages as jobs related to exports pay wages or salaries that are 10-15% higher than jobs unrelated to trade, while foreign investment raises labour productivity. The resulting booming economy has greatly improved job opportunities for marginal/low-skilled workers. While trade liberalization appears to have caused little, if any, reduction in the absolute level of unskilled wages, by raising skilled wages it seemingly contributed to the rise in wage inequality during the period 1973-93.²³ However, the bulk of the increase in wage inequality during this period probably arose from skill-based technological change, with additional significant contributions from declining

²⁰The present unemployment is well below the non-accelerating inflation rate of unemployment (NAIRU), which is estimated at 5.3%. The (presumably temporary) fall in the unemployment rate below the NAIRU may be attributed, *inter alia*, to external shocks in the form of the recent sharp falls in the import prices of oil and other commodities and the jump in labour productivity.

²¹The EITC has become a major weapon in the fight against poverty. According to the latest estimate by the Bureau of the Census, the credit lifted 4.3 million persons – workers themselves and family members – out of poverty in 1997. The EITC is *refundable* so that any amount of the credit in excess of the family's tax liability is returned in the form of a cash payment. With nearly 20 million beneficiaries, costing the federal government US\$6.4 billion in 1998 (Table III.14), the EITC is the largest cash-transfer programme for lower-income families with children. Advocates of the credit argue that redistribution occurs with much less distortion to labour supply than that resulting from other elements of the welfare system. In particular, the credit is thought to encourage labour force participation, although some recent evidence suggests that it may be effectively subsidizing married mothers to remain at home (Eissa and Hoynes, 1998).

²²OECD (1999a).

²³Kline (1997).

real minimum wages and the drop in trade union membership. It follows that the threat of unskilled wage reduction posed by trade liberalization is grossly exaggerated. The basic policy implication is that trade liberalization needs to be accompanied by an array of domestic structural policies that enable society to evolve in an equitable rather than an inequitable direction. Interestingly, there has been no increase in income inequality since 1993 (judging from the Gini coefficient).²⁴ On the contrary, recent evidence shows that, in 1998, wages at the bottom end of the wage distribution grew more quickly than those in the top end.²⁵ This may be partly explained by the success of labour market policies, including those mentioned above.

(iv) Competition policies

18. A fundamental feature of U.S. structural policy is its reliance on competition, particularly antitrust policy, which applies to multinational as well as to domestic companies. In this regard, antitrust authorities have increased their enforcement activity during the period under review, paying particular attention to those sectors, such as information technology and communications, where so-called "network effects" can impair competition.²⁶ Largely as a consequence of the surge in merger activity, the number of merger investigations (under the Clayton Act) rose sharply in FY 1996 (October-September) and FY 1997 (Chapter III(4)(viii)). These included several high-profile cases, one of which resulted in defence contractors Lockheed-Martin and Northrop Grumman abandoning a proposed merger that was challenged by the Departments of Justice and Defense. Moreover, although the number of investigations of anti-competitive practices (under the Sherman Act) in FY 1997 was lower than in each of the previous six years, the amount of criminal fines collected by the Department of Justice jumped to US\$205 million, five times as much as the previous high (the figure for FY 1998 was higher, US\$265 million); most of these fines related to international price fixing.²⁷ Particular attention has been paid to the high-technology sector, where the Department of Justice has been involved in an ongoing case against Microsoft, and the Federal Trade Commission initiated a more narrow complaint against Intel (which was settled in March 1999 on the eve of the antitrust trial).²⁸

(4) TRADE PERFORMANCE

19. During the period under review (1996-98), the United States ran a merchandise trade deficit, which stood at US\$248.0 billion in 1998; this contrasts with the surplus in services of US\$79 billion.²⁹ Continuing the trend observed since the beginning of the decade, the ratio of both exports and imports of goods and non-factor services to GDP increased during the period to reach 11.3% and 13% respectively. Since 1995, imports of goods and services in the United States have grown more rapidly than exports, reflecting rapid growth in private consumption and fixed investment. In 1996, export growth slowed to a rate of 8.5%, before rising to 12.8% in 1997. However, 1998 figures show a considerable slow-down in the growth of exports of goods and services, to 1.5%, while imports grew by 10.6% in the same period. The slow-down can be attributed to weaker demand, especially by Asian economies, in the aftermath of the crisis in the region. Lower export growth has contributed to the rise in the current account deficit.

²⁴OECD (1999b).

²⁵OECD (1999a).

²⁶Network effects arise in a market where a consumer's demand for a product is positively related to the consumption of others owing to either technological constraints or market dynamics (OECD, 1999a, p. 53).

²⁷In each of the years, nearly half of the total involved fines on single companies.

²⁸Microsoft is accused of predatory and exclusionary practices. Intel was accused of not sharing intellectual property on prototype computer chips and technical information with three customers (Intergraph, Compaq Computer, and Digital Equipment Corporation) in an attempt to obtain access to their technology.

²⁹U.S. Department of Commerce (April 1999).

(i) Composition of merchandise trade

20. The shift in the composition of U.S. merchandise trade away from primary products towards manufactures has continued during the period under review. U.S. exports of primary products as a percentage of total exports declined from 19% in 1995 to 15.8% in 1997. By contrast, exports of manufactures rose from 76.4% to 79.9% (Table AI.1).

21. Machinery and transport equipment continue to be the United States' most important merchandise export, accounting for 50% of total exports of goods in 1997 (Chart I.1). Nevertheless, exports of other products such as office machines and telecommunication equipment have grown at a faster rate (11%) since 1995. Exports of automotive products and transport equipment, after a substantial slow-down in 1995, increased in 1996-97; growing at 12.2% and 24.5%, respectively, in 1997.

22. The share of manufactures in U.S. merchandise imports has undergone a slight decline since 1995, from 78.9% to 77.8% in 1997. There has been a corresponding increase in the share of primary imports from 17.7% to 18.5%. Machinery and transport equipment continue to be the most important U.S. merchandise import, with a share of 44.9% in 1997, down from 46.4% in 1995. Growth in imports of manufactures has been led by chemicals (11.2%), and other electrical machines (10.6%) (Table AI.2).

(ii) Pattern of merchandise trade

23. During the period 1995-97, there was no substantial change in the destination of U.S. exports, nor in the origin of U.S. imports. The main destination of exports is the Americas, especially Canada and Mexico whose combined importance has slightly increased, attracting 31.6% of total U.S. exports in 1997.³⁰ Over the period, Canada's share remained relatively constant, at an average just over 20%, but that of Mexico rose at a higher rate after the 1995 crisis, to exceed its pre-crisis level (10.6%) in 1997. Other main destinations for U.S. exports are East Asia and Europe both of whose shares decreased. The main suppliers of imports in 1997 were Canada, the European Union (EU), Japan and Mexico. The relative importance of Asia as a source of imports declined throughout the period, while that of Mexico increased slightly (Tables AI.3 and AI.4).

24. NAFTA's share in U.S. trade remained relatively unchanged during the period under review. However, in terms of value, exports to Mexico increased from over US\$40 billion in 1993, to US\$68 billion in 1997. Thus Mexico has displaced Japan as the second largest market (after Canada) for U.S. exports. Imports from Mexico and Canada have also increased in value terms since 1993. The increase in trade between Mexico and the United States is partly due to NAFTA preferences, but also to the existence of production-sharing operations, which is a consequence of the deeper integration between the two countries.

(iii) Composition of trade in services

25. In 1997, U.S. cross-border sales (exports) of services grew more slowly, at 7%, than U.S. cross-border purchases (imports) of services, at 10%. In contrast, over the decade 1986-96, U.S. sales grew much faster than purchases, averaging 11% annually versus 8%.³¹ This longer term pattern seems consistent with the United States' comparative advantage in the provision of services, as evidenced by the growing surplus in trade in services each year since 1985. Despite the faster growth in purchases in 1998, this surplus reached US\$79 billion. The largest surplus was in royalties and license fees, which represent receipts and payments for intellectual property rights, such as patents, trade-marks, and copyrights (Chapter III(4)(iii)). Large surpluses were also recorded for travel,

³⁰In 1996 Canada and Mexico purchased 29.9% of total U.S. exports compared to 28.9% in 1995.

³¹U.S. Department of Commerce (October 1998).

business, professional and technical services; financial services and education. Transportation, including travel, passenger fares, and other transportation remains the most important export earner, accounting for 45% of total services earnings in 1998. Transport (defined in the same way) is also the predominant element on the import side, with a share of some 56.7%.³² Royalties and license fees, even though a small share of service imports, have grown since 1995. As shown, in Chart I.2 the composition of trade in services has remained stable since the previous U.S. Review.

26. Further evidence of the United States' competitive position in the provision of services is provided by the amount of services sold abroad through commercial presence, which reached US\$221.1 billion in 1996 up from US\$190.1 billion in 1995. In 1996 the value of services sold abroad through commercial presence exceeded the value of services sold in the United States through commercial presence, resulting in a surplus of US\$60.1 billion. In the same year, U.S. exports of services through commercial presence increased by 16%, while purchases increased by 8%. Cross-border transactions used to be the most common mode of trading services in the United States; however, sales through the two modes (cross-border and commercial presence) were about equal in 1996.³³ While some services can be delivered equally well through either mode, in other instances the mode of delivery may be largely determined by the nature of the services. For instance, in the insurance sector commercial presence is a more important mode of trade than cross-border trade; exports of insurance through commercial presence were US\$41.3 billion, while exports through cross-border supply accounted for US\$1.9 billion.³⁴

(iv) Direction of trade in services

27. U.S. exports of services to Japan continued to substantially exceed those to any other country, accounting for 14.2% of total services exports in 1997. The United Kingdom and Canada are the next largest destinations, with shares of 9.9% and 8.6% respectively. The United Kingdom is also the single most important source of U.S. imports of services, with imports increasing at a faster rate than those of any other country. On a regional basis Western Europe continues to be the U.S. predominant trading partner in trade in services, followed by Asia and the Pacific (Chart I.2).

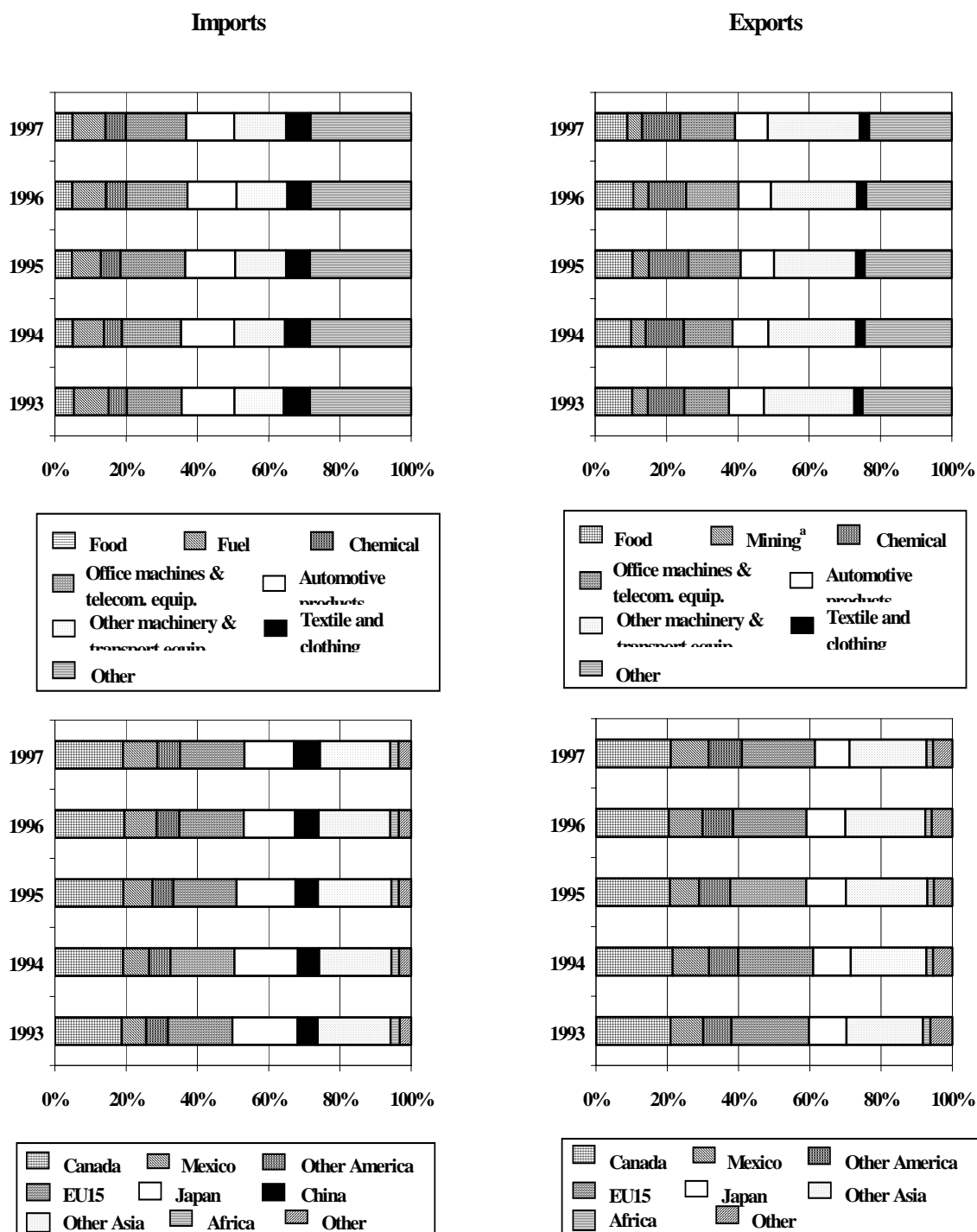
³²U.S. Department of Commerce (April 1999).

³³Exports through cross-border supply amounted to US\$224.2 billion in 1996, while exports through commercial presence reached US\$221.1 billion in the same year. Imports through commercial presence are higher at US\$161 billion than those through cross-border supply at US\$142 billion.

³⁴However, for specific services, it is difficult to assess the relative importance of the two channels because the available data on U.S. cross-border transactions are generally classified by type of service, whereas data on sales of services through commercial presence are classified by primary industry.

Chart I.1

Composition and direction of merchandise trade , 1993-97

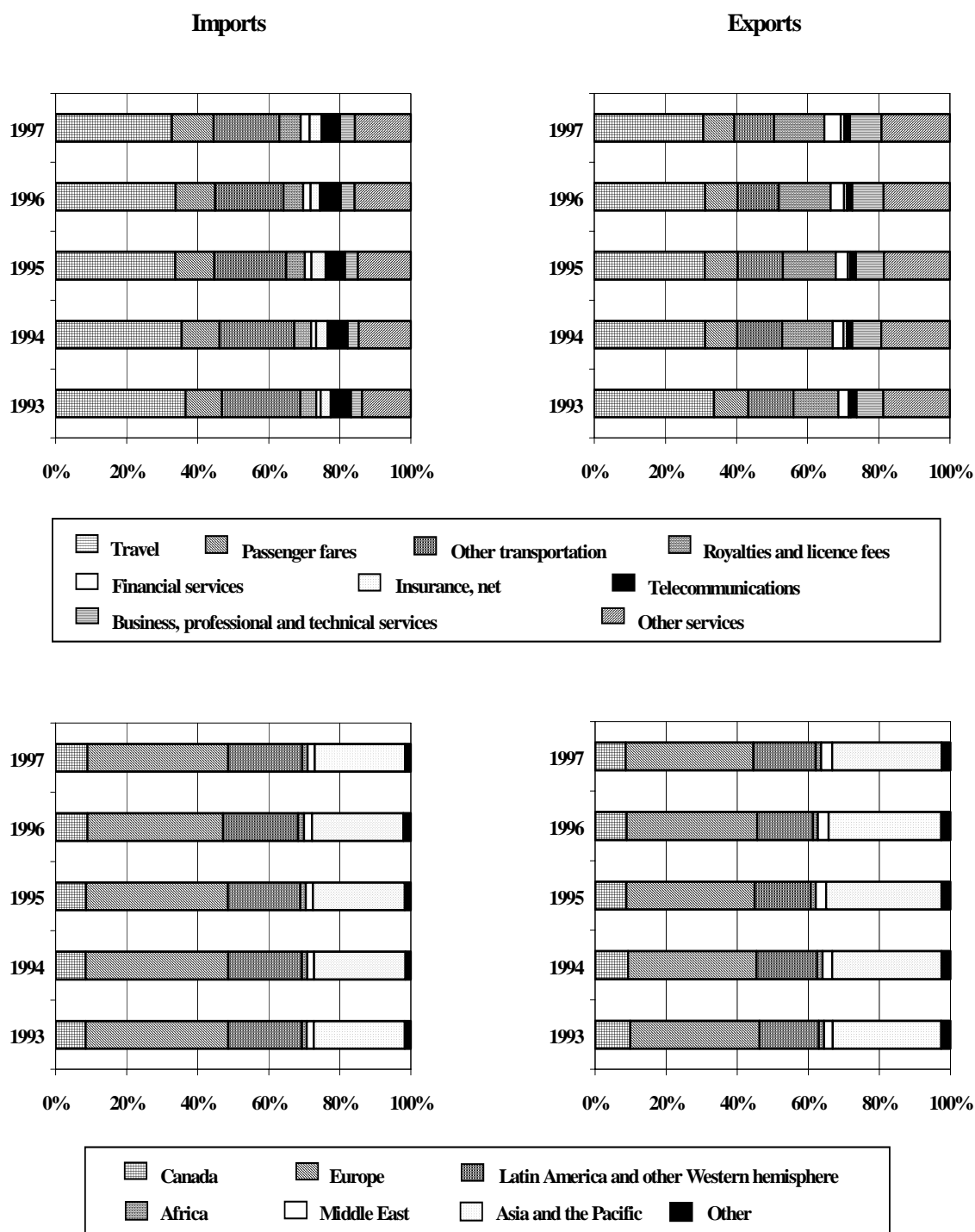


a Mining includes fuels, ores and other minerals and non-ferrous metals.

Source: UNSD, Comtrade database.

Chart I.2

Composition and direction of trade in services, 1993-97



Source: U.S. Department of Commerce (1998), Bureau of Economic Analysis, *Survey of Current Business*, October.

(v) Foreign direct investment

28. The United States has traditionally been an attractive destination for foreign direct investment (FDI), due to its bilateral regime, the large size of its market, labour market flexibility, deregulated services and good infrastructure, as well as strong intellectual property protection and competition policy. In 1997, the United States recorded US\$90.7 billion in FDI inflows and US\$114.5 billion in outflows³⁵; inflows were 19% higher than in 1996 and outflows 53% higher. The European Union continued to be the most important partner of the United States, both for inward and outward investment. However, its share in inward FDI declined in 1997 to 55.4% from 62.9% in 1996. Japan's share also declined, while Switzerland's share both of inward and outward investment more than doubled in 1997. Developing countries inward investment amounted to 10% of the total. However, these countries attracted more than 30% of the United States' outward investment in 1997. Among developing countries, Latin America and the Caribbean as a region, attracted some 21% of U.S. outward investment in 1997 (Table I.4).

29. Historically, the manufacturing sector has attracted most foreign capital, followed by the services sector. In 1997, some 40% of total inward investment was in manufacturing; however, the relative importance of manufacturing as a destination for investment continues to decline, while that of services, particularly financial services, continues to increase. U.S. direct investment abroad has a similar pattern; the share of investment in manufacturing has declined substantially since 1995, when it stood at 48%, to reach 28% in 1997, while investment in financial services in the same period increased from 25% to 42%. In contrast, the share of wholesale and retail trade in total outward investment declined during the period, to 3% in 1997.

Table I.4
Inward and outward FDI flows, 1995-97

Item	Inward FDI			Outward FDI		
	1995	1996	1997	1995	1996	1997
Total (US\$ billion)	58.8	76.5	90.7	92.1	74.8	114.5
By industry (percentage)						
Petroleum	6.6	11.6	4.9	0.7	6.8	10.0
Manufacturing	48.9	45.1	39.9	48.3	33.6	28.2
Wholesale and retail trade ^a	13.4	14.1	13.9	9.6	7.6	3.0
Finance and insurance ^{b, c}	25.0	16.2	24.3	25.0	32.8	42.2
Other industries	6.1	13.0	17.0	16.3	19.2	16.6
By country/region (percentage)^d						
Developed countries	92.9	96.5	89.7	75.8	62.5	65.0
Canada	8.2	10.8	10.4	9.3	9.7	9.4
European Union	59.8	62.9	55.4	53.0	43.3	46.2
Other Western Europe ^e	7.8	4.7	10.8	3.7	4.8	6.7
of which: Switzerland	6.9	4.0	9.1	2.0	1.1	4.4
Other developed countries	17.2	18.2	10.8	9.4	4.7	2.8
of which: Japan	13.8	13.4	10.4	2.5	-0.4	0.7

Table I.4 (cont'd)

³⁵It follows that the United States is a net exporter of FDI; therefore, net capital investment is attributed to portfolio investment.

Item	Inward FDI			Outward FDI		
	1995	1996	1997	1995	1996	1997
Developing countries	7.1	3.5	10.3	26.9	34.8	34.3
Africa	-0.2	-0.6	1.1	0.1	0.7	2.3
Latin America and the Caribbean	4.9	4.3	6.5	17.4	21.5	20.8
West Asia	-0.6	0.7	0.1	1.0	0.7	1.0
South, East and South-East Asia ^f	3.0	-0.9	1.7	6.2	11.9	10.3
of which: China	-	-	-	0.3	1.3	1.1
Central and Eastern Europe	-	-	-	1.0	2.0	1.3

a For outflows, distributive trade includes only wholesale trade (excludes retail trade).

b Finance and insurance includes depository institutions.

c For outflows, finance and insurance includes real estate.

d For outflows, totals do not necessarily add up to 100 per cent due to investments in international affiliates that are not classified under specific countries.

e Includes developing Europe. For inflows, includes also Central and Eastern Europe.

f Includes the Pacific.

Source: Based on data from the United States, Department of Commerce, Bureau of Economic Analysis webpage (www.bea.doc.gov., (undated)) [18 and 19 June 1998].