

## Highlights

- **U.S.** – A budget deficit of 4% of GDP in 2004 will likely be balanced by large current account deficits resulting in low domestic savings. The economy will need larger domestic savings for a robust and sustained economic expansion.
- **Japan** - Large increases in domestic net financial assets suggests a vigorous expansion to come.
- **Euro-zone** - The size of the private balance is improving, however, regulatory and structural inhibitors to large deficits still pose a threat to the health of the economy.
- **UK** - Lack of significant increases in net domestic financial assets could stall current economic expansion. Efforts to cut current budget deficits would only worsen matters.
- **Australia** - The current economic expansion is not sustainable given the continued destruction of domestic savings and historically high levels of household debt service.

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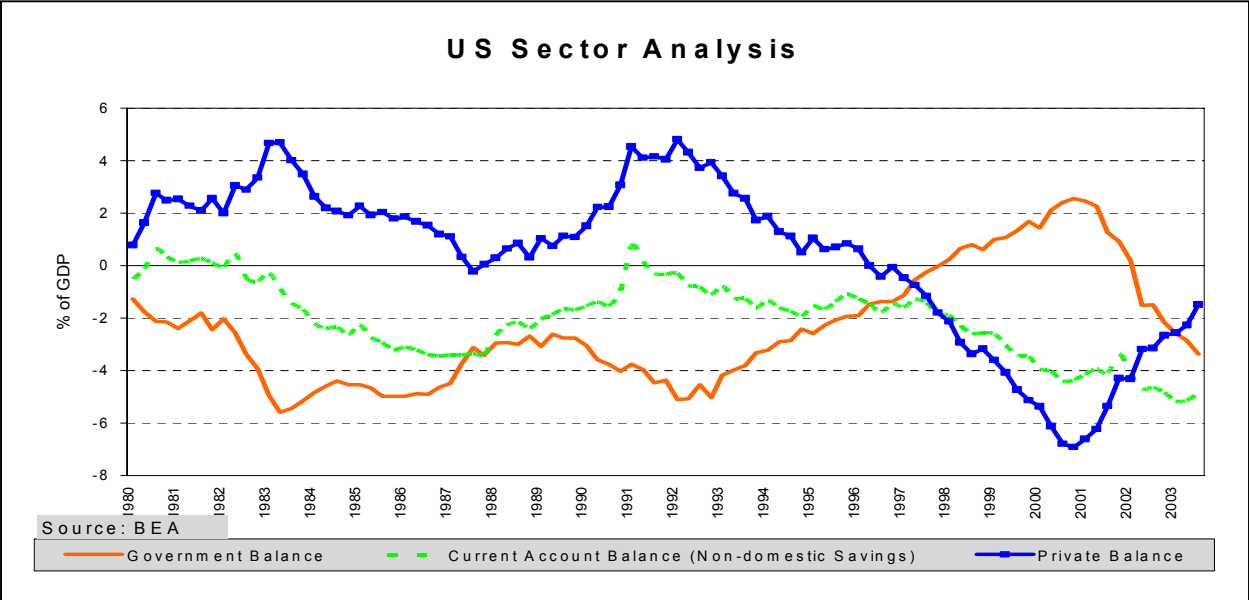
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# United States

Current consensus 2004 projections of the budget and current account deficits are 4.1% and 4.9% of GDP, respectively. This suggests that the change in domestic net financial assets, equal to about -1% of GDP, is still not large enough to support a robust and sustained economic expansion. Efforts to cut the deficit from currently projected levels could cause the nascent recovery to stall or reverse.



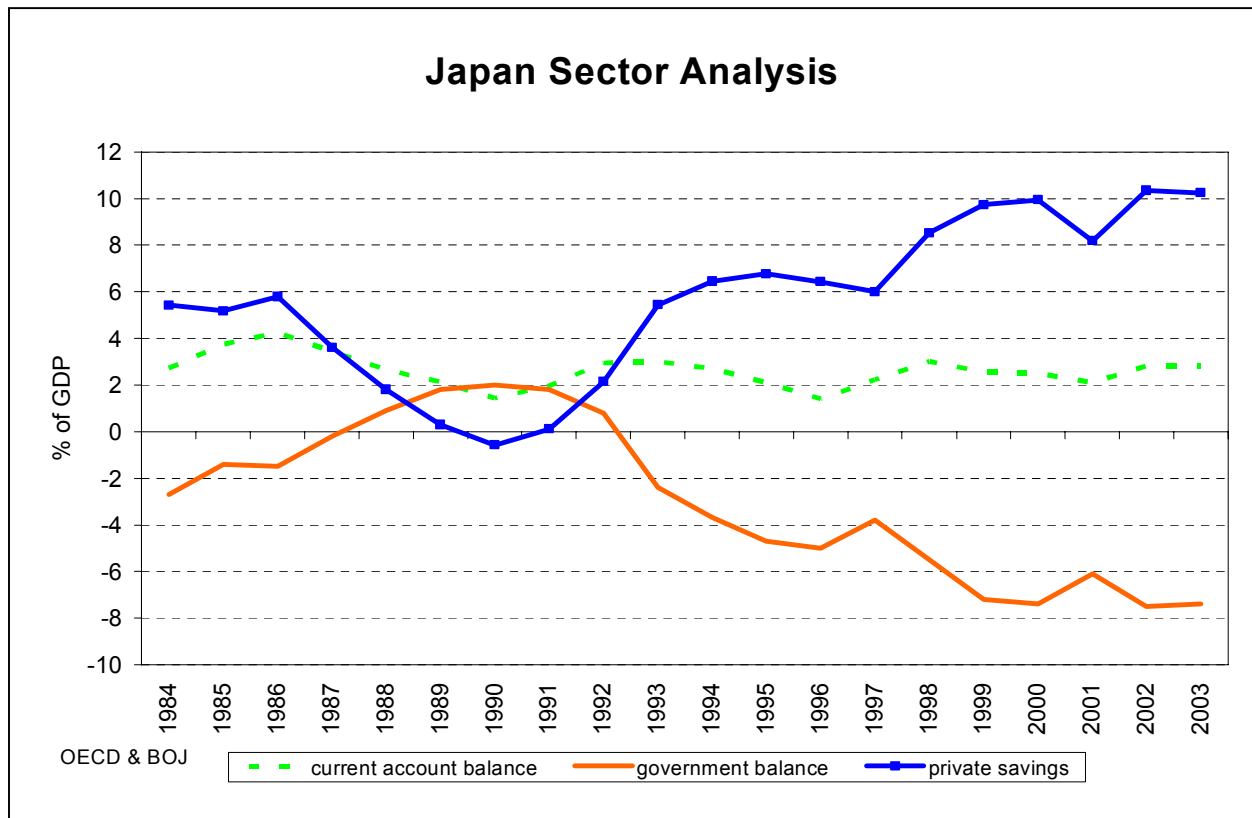
In FY 2003 the U.S. had a **budget deficit** totaling approximately \$375 billion or 3.4% of GDP. Most forecasters project the deficit to widen during FY 2004, due to tax cuts and increases in spending for defense and homeland security. The Congressional Budget Office estimates a deficit of \$477 billion, the President’s more conservative budget anticipates a deficit of \$521 billion, and the current Wall Street consensus is \$482 billion (4.1% of GDP). The average of these forecasts assumes GDP growth in 2004 of 4.6%, with slower growth corresponding to a higher deficit. Additionally, unbudgeted military and homeland defense expenditures have the greatest potential for a large budget variance. But, with Bush pledging to cut the deficit in half in 5 years and Democrats trying to do it even sooner with tax increases, the near term deficit could prove to be somewhat smaller than expected.

The **current account deficit** in 2003 will likely total \$550 billion or 4.9% of GDP, according to consensus estimates. OECD expects increases in both imports and exports of about 9% and a current account deficit of \$576 billion. The following are a few variables that could alter these outcomes: Continued dollar depreciation may reduce imports and increase exports resulting in a somewhat lower than expected current account deficit. Domestic economic recovery in Japan and other parts of Asia could increase US exports, but is expected to be offset by domestic weakness in the Euro area. Lastly, increased political pressure on China and Japan to import more products from the U.S. could have an impact.

**Domestic savings** of net financial assets have been stabilizing after the 1997-2001 U.S. surpluses. Although the budget deficit is expected to increase to over 4% of GDP, non-resident savings will likely remain around 5% of GDP. Thus, the budget deficit will not be large enough to restore domestic savings to a level high enough to support sufficient growth to reduce the output gap. In other words, a credit-based expansion is not likely given that households have not de-levered significantly, as evidenced by the high Financial Obligation Ratio (the ratio of fixed payments including interest, principal, rental and mortgage payments to disposable income). The nascent economic recovery will stall without plans for further fiscal “stimulus”.

# Japan

Current 2004 OECD projections of the budget deficit and current account surplus are 6.8% and 3.6% of GDP, respectively, while private savings is forecasted to rise to 10.4% of GDP. Continued growth in worldwide demand (especially Asia) is expected to help boost GDP growth by 1.8% and aide Japan's current recovery.



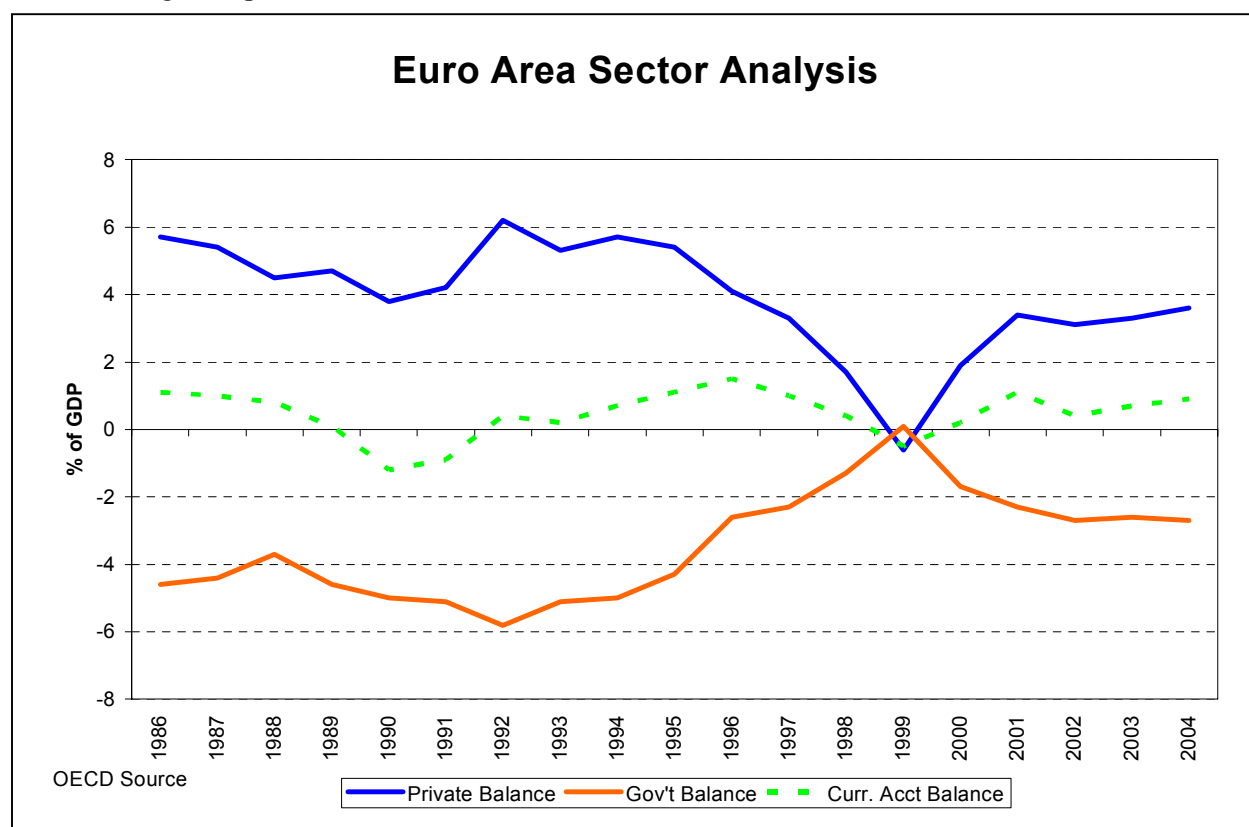
The **government deficit** is forecasted by the OECD to fall from 7.4% of GDP in 2003 to 6.8% of GDP in 2004. The deficit had been rising for the past 3 years but with an improving economy, is expected to fall slightly in 2004. As long as the economy continues to recover, tax revenues should remain stronger than they were last year. On the expenditure side, government spending is being driven by increasing pension and health care costs for Japan's aging society, and measures are underway to reform the entire system. In addition, the MoF has a goal of reaching a government surplus by 2015 and have attempted to cut as much non-essential spending out of their budget as possible.

The **current account balance**, which has been steadily increasing since 2000, is expected to expand further to 3.6% of GDP in 2004. This is an increase from 2.9% in 2003. The Japanese recovery has yet to produce strong import growth and until it does, the current account and trade balances should both continue to widen.

**Private savings** is expected to rise slightly in 2004 to 10.4% of GDP, up from 10.3% in 2003, as a result of the expected increase in the current account balance and should further fuel Japan's domestic recovery.

## Euro Area

The Euro area's general government financial balance in 2003 was -2.7% of GDP and forecasted by the OECD to increase to -2.6% of GDP in 2004. The current account surplus decreased to 0.4% of GDP in 2003 from 1.1% in 2002 and is forecasted by the OECD to increase to 0.7% of GDP in 2004. The private balance has increased to 3.1% of GDP in 2003 and is forecasted by the OECD to increase to 3.3% of GDP in 2004. The private balance has increased to 3.1% of GDP in 2003 and is forecasted by the OECD to increase to 3.3% of GDP in 2004, though consumer spending has remained weak. The Euro Area's growth rate is estimated to have decreased to 0.5% in 2003, though it should pick up in 2004 and 2005, as long as exports continue to rise and world trade continues to increase.

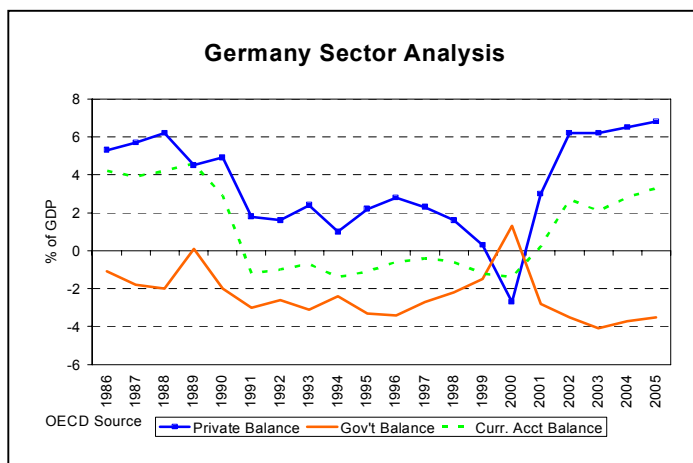


The Euro area's general **government financial balance** in 2003 was -2.7% of GDP, a deficit which has grown continuously since 2001. The government financial balance is forecasted by the OECD to increase to -2.6% of GDP in 2004, then decrease to -2.7% of GDP in 2005. The OECD forecasts Euroland GDP growth to increase 1.8% in 2004 and 2.5% in 2005, as exports increase due to continued global growth and imports remain low due to dampened consumer spending. The **current account surplus** decreased to 0.4% of GDP in 2003 from 1.1% in 2002. In 2004, the current account surplus is forecasted by the OECD to increase to 0.7% of GDP and in 2005 to 0.9% of GDP. Using the OECD data, the Euro area's **private balance** has increased to 3.1% of GDP and increasing since 2001, and should continue to increase; 3.3% of GDP in 2004 and 3.6% of GDP in 2005. However, it still remains well below levels that marked the beginning of previous domestic expansions. With institutional barriers to deficit expansion still in place, however diluted, the future prospects for a strong domestic recovery appear fairly bleak.

# Euro Area: Germany & France

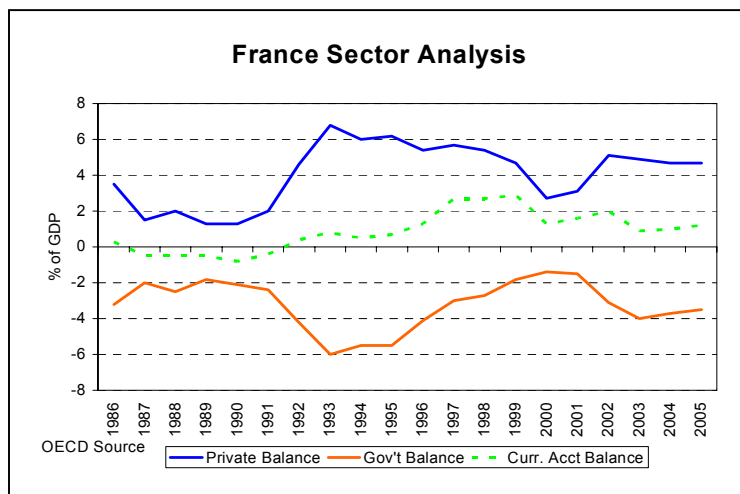
## Germany

The German **general government balance** was -4.1% of GDP in 2003. The OECD forecasts this to move to -3.7% of GDP in 2004 and -3.5% of GDP in 2005. The German government has proposed Agenda 2010 which aims to permanently lower barriers to employment, continue the fiscal consolidation process and provide short-term stimulus for growth. The plan proposes a fiscal consolidation package for 2004 consisting of revenue-raising measures, as well as, spending restraints. At the same time, legislation has been proposed to bring forward tax reductions totaling €15 billion to 2004, from 2005, and another €7 billion in tax cuts to follow in 2005. As a net result, these are estimated to amount to 0.7% of GDP for fiscal consolidation. The **current account** was 2.1% of GDP in 2003; and forecasted by the OECD to rise to 2.8% in 2004 and 3.3% in 2005. This will likely be due to continued reliance on the growth of exports, and minimal growth in imports as a result of low consumer spending. Using OECD data, the **private balance** in 2003 was 6.2% of GDP and using OECD forecasts, it is likely to rise to 6.5% in 2004 and 6.8% in 2005, as the current account balance and government balance spread increases.



## France

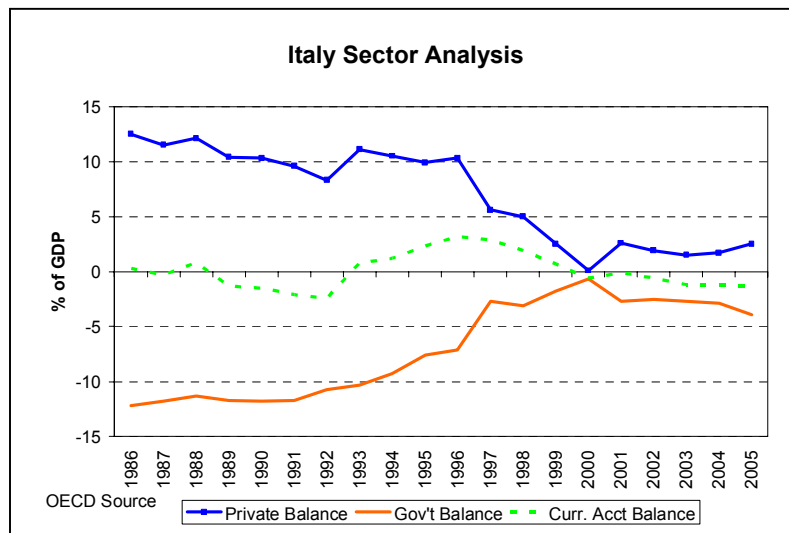
The French **general government balance** was -4.0% of GDP in 2003; the OECD foresees a reduction in the general government deficit to -3.7% of GDP in 2004 and -3.5% of GDP in 2005. The increase should come due to a substantial tightening of fiscal policy. In 2003, the **current account surplus** was 0.9% of GDP and is forecasted by the OECD to increase to 1.0% of GDP in 2004 and 1.2% of GDP in 2005. This increase would primarily be due to lackluster employment levels and weak consumer demand that would affect imports. Using OECD data, the **private balance** was 4.9% of GDP in 2003. The OECD forecasts this to fall slightly to 4.7% of GDP in 2004 and 4.7% of GDP in 2005, as the current account balance and government balance spread decreases.



# Euro Area: Italy & Spain

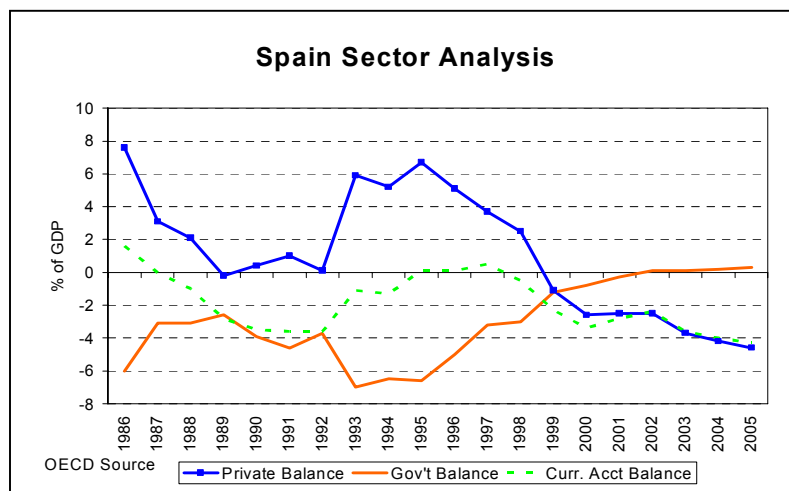
## Italy

The Italian general **government balance** was -2.7% of GDP in 2003 and the OECD foresees the deficit to grow to -2.9% of GDP in 2004 and -3.9% of GDP in 2005. The **current account** in 2003 was -1.2% of GDP. The OECD forecasts this to remain at -1.2% of GDP in 2004 and increase to -1.4% of GDP in 2005. The current account is seen as experiencing minimal growth due to marginal changes in exports/imports. Using the OECD data, the **private balance** was 1.5% of GDP in 2003 and is set to increase to 1.7% of GDP in 2004 and 2.5% of GDP in 2005. Similar to other Euro countries, the private balance is improving modestly but remains well below levels historically associated with domestic expansion.



## Spain

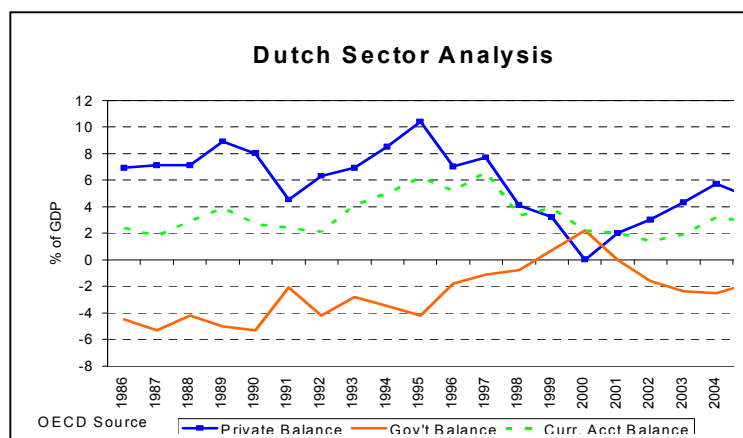
Spain's general **government balance** was 0.1% of GDP in 2003 and the OECD forecasts a move to 0.2% of GDP in 2004 and 0.3% of GDP in 2005. For 2004, the government will once again aim towards a balanced budget. The **current account** in 2003 was -3.6% of GDP. The OECD forecasts this to increase to -4.0% of GDP in 2004 and -4.3% of GDP in 2005. Using the OECD data, the **private balance** was -3.7% of GDP in 2003. The OECD forecasts this to increase to -4.2% of GDP in 2004 and -4.6% of GDP in 2005.



# Euro Area: The Netherlands & Sweden

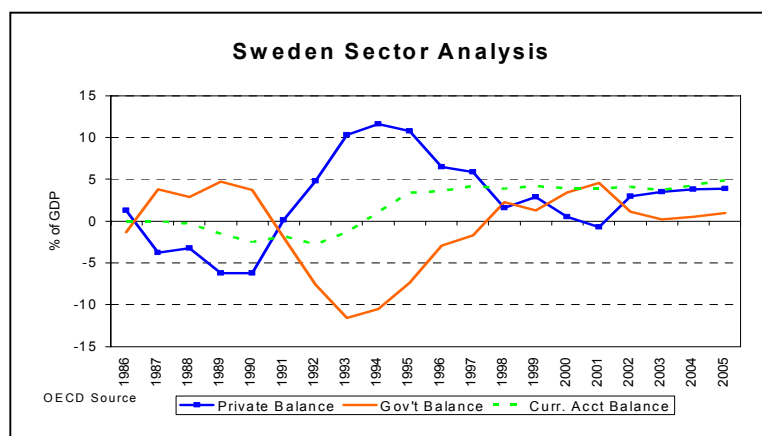
## The Netherlands

The Dutch general **government balance** was -2.4% of GDP in 2003 and the OECD forecasts the deficit to be -2.5% of GDP in 2004 and -1.8% of GDP in 2005. The stance of fiscal policy became restrictive in 2003 and will remain tight until 2005. The cumulative effect of all the packages introduced on the structural balance amounts to 1.4% of GDP in 2003, 2.5% in 2004 and about 3% in 2005. Whereas, part of this is achieved through revenue increases; the main focus is on expenditure reductions, which include the freeze in public sector contractual wages in 2004 and 2005 and thus the social benefits linked to them. Furthermore, the growth in health care expenditure will be controlled by higher co-payments and deductibles and a reduction in the public health insurance package. The actual balance will again deteriorate slightly in 2004, as structural consolidation is outweighed by further cyclical deterioration. The **current account** in 2003 was 1.9% of GDP. The OECD forecasts this to rise to 3.2% of GDP in 2004 and 2.9% of GDP in 2005. This would result in the **private balance** being 3.5% of GDP in 2003; using OECD data, it is projected to be 5.6% of GDP and 5.4% of GDP in 2004 and 2005.



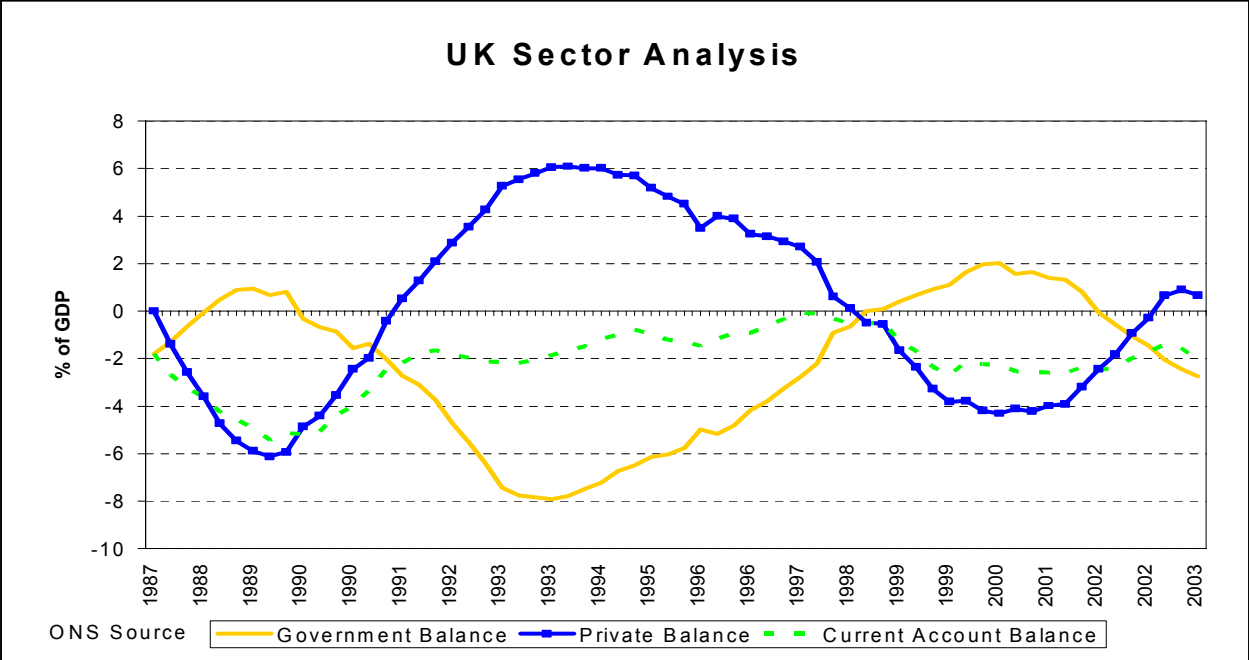
## Sweden

Sweden's general **government balance** was 0.2% of GDP in 2003, brought about by automatic stabilizers and falling revenues from corporate and capital gains taxes, reducing the surplus from 1.1% in 2002. The OECD forecasts a government balance of 0.5% of GDP in 2004 and 1.0% of GDP in 2005. The **current account** surplus in 2003 was 3.7% of GDP and the OECD forecasts a rise to 4.3% of GDP in 2004 and 4.9% of GDP in 2005. This growth is brought about by a continuing increase in exports based on an assumed global economic recovery. Using the OECD data, the **private balance** was 3.5% of GDP in 2003, and is projected to be 3.8% of GDP in 2004 and 3.9% of GDP in 2005. It is approaching levels historically associated with domestic expansion.



# United Kingdom

In the U.K., the Government budget deficit and the current account deficit stood at 2.7% and 2.1 % as a % of GDP in Q3 2003. However, in its 2003 pre-budget report, the government cites that it anticipates achieving a budget balance in the fiscal year 2006-2007, and a budget surplus thereafter. While private savings have been improving for the past few years, they are still well below previous cyclical highs.



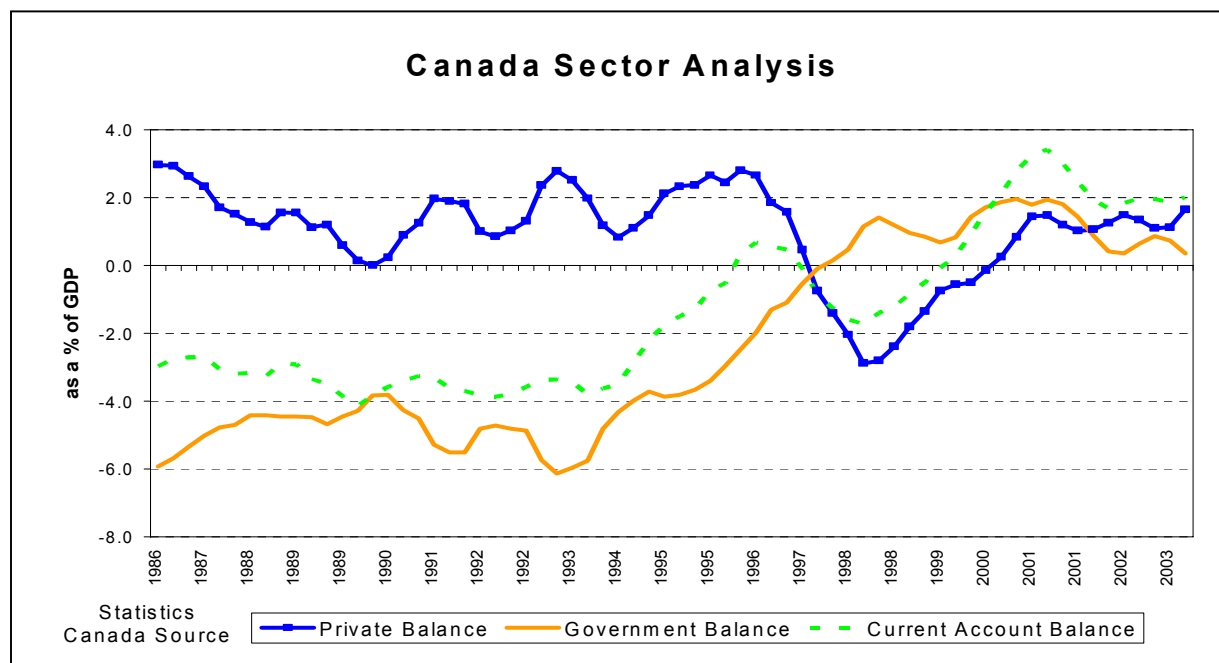
The **government balance** has declined from a near balance budget in Q1 2002 to a deficit of 2.7% as a % of GDP in Q3 2003. The Government in its 2003 pre-budget speech has estimated a budget deficit of 1.7% as % of GDP for 2003–2004 and anticipates a budget deficit of 0.7% as a % of GDP in 2004–2005, which is much smaller than the OECD’s estimate of -2.9% in both 2004 and 2005. This widening of the deficit reflects a combination of higher public spending aimed at improving the performance of public services in health care and education. A decline in the tax to GDP ratio, from both cyclical weakness and lower equity prices, has also had an impact on the deficit. The Government anticipates a balance budget in fiscal year 2006-2007, which will then move into a surplus for at least the next two fiscal years.

The UK has maintained a persistent current account deficit for over 19 years, most recently due to sluggish European growth. The **current account** balance in Q3 2003 was -2.1% as a % of GDP. The negative balances on the trade of goods have continued to overshadow the positive balances on the trade of services. Based on an assumed global economic recovery and a projected pickup in world trade, the OECD forecast that UK’s exports will begin to recover in the near future. Meanwhile, the OECD continues to forecast deficits in the current account balance: -2.7%, -3.5%, -3.6% as a % of GDP in 2003, 2004 and 2005 respectively.

Using the OECD forecast figures for the current account balance and the budget balance, the **private balance** was projected to be 0.2% as a % of GDP in 2003. Thereafter, domestic savings is expected to return to the red with a balance of -0.6% as a % of GDP in 2004 and -0.4% as a % of GDP in 2005. If the governments’ forecast of a budget surplus in 2006-2007 proves accurate, then domestic savings will significantly decrease.

# Canada

According to the OECD, Canada will generate a budget surplus of 0.7% in 2004 after 7 straight years of surpluses that averaged 1.2% of GDP. The OECD also forecasts the current account balance to be 1.9% of GDP in 2004 and 2005, the same as 2003. Forecasts for a decrease in the budget surplus and a stable current account balance results in the private balance reaching 0.5% of GDP. This result suggests continued economic stability for Canada.



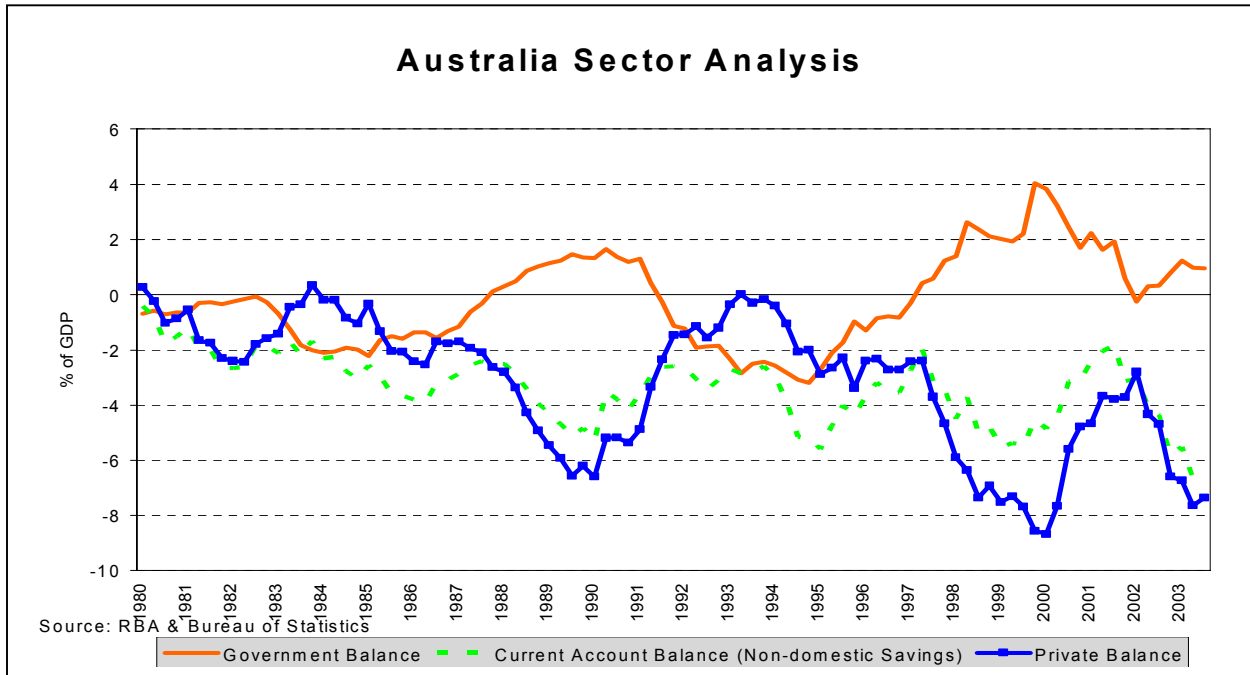
Canada's **Government financial balance** has been in surplus for the past 7 consecutive years averaging around 1.2% as a % of GDP. The budget surplus in 2003 was 1.0% as a % of GDP according to the OECD figures, and is expected to narrow to 0.7% and 0.8% in 2004 and 2005, respectively. In its 2003-2004 projection, the Department of Finance outlined that the private sector tax revenues are expected to increase only 1.6%, primarily reflecting the weakness in the economy in 2003. Thereafter, private sector tax revenue growth is expected to grow inline with nominal GDP, largely due to the end of the \$100 billion five year tax reduction plan, which matures in 2004-2005. Program expenses are expected to increase by 6.5% (\$8.7 billion) in 2003-2004, primarily reflecting incremental funding for additional defense, affordable housing, and infrastructure. Subsequently, total expenses are estimated to increase broadly in line with the increase in nominal GDP. The Government of Canada remains committed to running budget surpluses.

Canada's **current account** as of Q4 2003 has remained in surplus for 17 consecutive quarters averaging over 2% of GDP. The rapid appreciation of the Canadian dollar vis-à-vis the US dollar (14% in 2003) however, has created a drag on the overall growth of aggregate foreign demand for Canadian goods and services through sharp fluctuations in exports and lower import prices. The OECD forecasts the current account balance to be 1.9% as a percent of GDP in 2004 and 2005, the same as the 2003 balance. But risks appear to the downside.

Using the OECD figures, the **private balance** is calculated at 0.2% as a % of GDP in 2003 and is expected to be 1.2% as a % of GDP in 2004 and 1.1% as a % of GDP in 2005. The key to private savings growth in Canada appears to stem from current account surpluses offsetting budget surpluses. Risks to that outlook stem from a stronger C\$ and a weaker U.S. economy.

# Australia

Current 2004 projections, by the both the Australian government and the OECD, for the budget and current account deficits are -1% and 6% of GDP, respectively. Budget surpluses and current account deficits have mirrored significant decreases in net financial assets for the last ten years. The large destruction of net domestic financial assets is not consistent with long-term economic expansion.



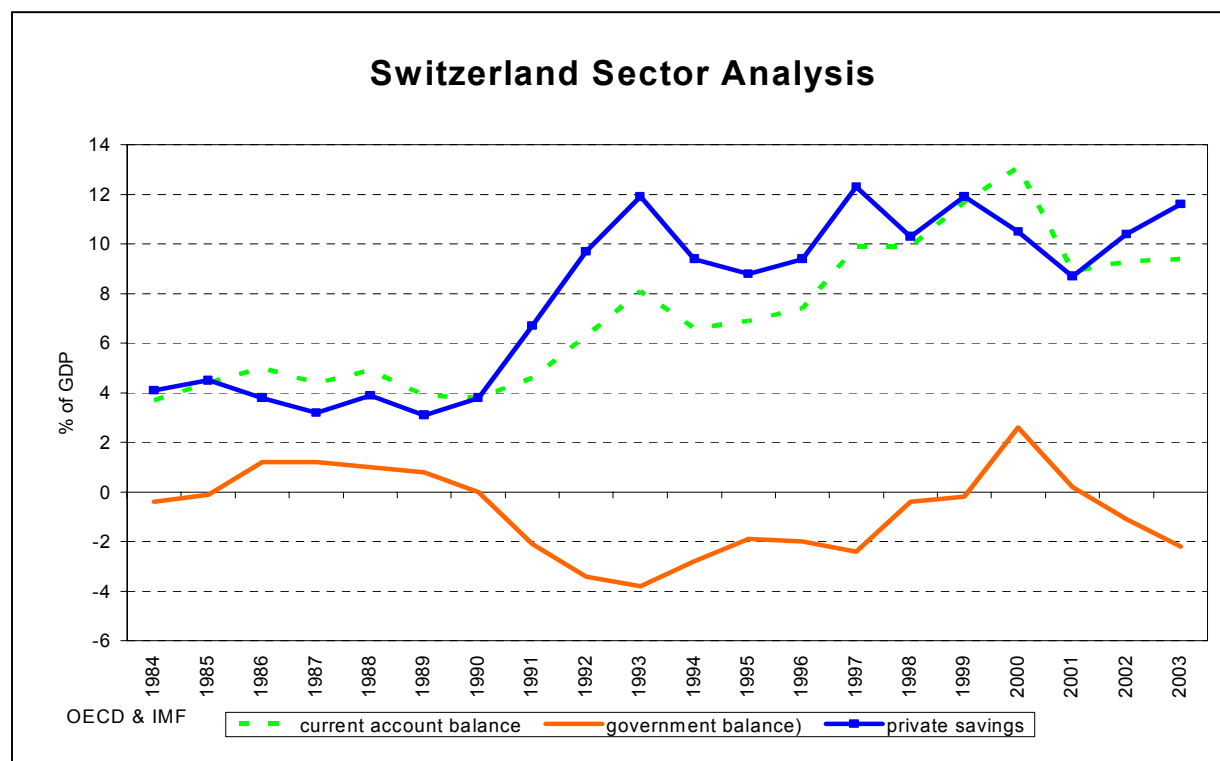
In FY2003 Australia ran a **budget surplus** of approximately A\$7.3 billion or 1% of GDP. In fact, Australia has had a budget surplus since FY1998 that at times reached as high as 2% of GDP. The current government forecast is for surpluses all the way out to FY2007. Higher than expected corporate tax revenues and the end of the drought has more than offset increased spending on defense.

In 2003 the Australian **current account balance** will be about -6% of GDP or A\$-45 billion, according to OECD. Weak exports the first half of 2003, due to drought, are currently recovering. Both government forecasters and the OECD forecast imports and exports will increase slightly in 2004, and projections are for an A\$46 billion current account deficit (5.8% of GDP). The strengthening Aussie dollar raises concern of a wider current account deficit.

Budget surpluses and current account deficits mirror decreases in **domestic net financial assets** for the last ten years. Such a large destruction of the domestic financial equity that supports the credit structure is a major risk to both the forecasted surpluses and the economic health of Australia. Mortgages have increased dramatically along with home prices and the affordability index has now dropped from 180 in 2001 to 100 in 2003. Interest payments as a percent of disposable income have increased from 6% in 1990 to 9% in 2003, as high as the last peak in the late 1980s. The last peak in household coverage ratios also coincided with large negative domestic savings as a % of GDP and led to the economic weakness that followed. While some of the increase in interest payments is merely a substituting of mortgage payments for rental payments, and the household debt service burden may indeed increase for some period of time, the process is nonetheless unsustainable. More credit expansion or strong demand from Asia could temporarily allow Australia to grow, but the large destruction of net domestic financial assets demanded by the tax structure as the price of growth is not sustainable.

# Switzerland

Current 2004 OECD projections of the budget deficit and current account surplus are 2.3% and 8.9% of GDP, respectively. We expect private savings to rise to 11.1% of GDP. A pickup in export demand and a recovery in domestic demand would ease ongoing deflationary pressures.



The 2004 Swiss **government balance** is expected to post a deficit of approximately 2.3% of GDP, slightly larger than the 2.2% deficit run in 2003. The MoF budget expects a deficit of 3,468 Billion Francs as government expenditures are expected to increase slightly; in addition, revenues are expected to fall due to lagging tax revenues. If domestic demand and spending recovers as some have predicted, tax revenues may prove stronger than expected and within reason, cut into the planned deficit. The rise in spending is being driven by a 4.4% expected increase in social welfare costs. Despite the yearly increase, the deficit is part of a plan intended to eventually create a balanced budget.

The **current account** balance is forecasted to fall to 8.9% of GDP in 2004 (by the OECD), down from 9.4% in 2003. Along with recovering export demand to the Euro area and the U.S., domestic demand is forecasted to grow at a relatively brisk rate in 2004.

**Private savings**, which has averaged around 10% of GDP since the early 90's, is expected to fall to 11.1% of GDP, down from 11.6% in 2003, due to the expected drop in the current account balance.