IV – Does the US current account deficit represent a significant risk to the global economy?

Introduction

The US is currently the main engine of global economic growth but it is also the main source of imbalances in the global economy. This is well illustrated by the US current account, which summarises the country's transactions with the rest of the world. At the moment, the US is running a huge and widening current account deficit, implying that the country is consuming more than it produces, the difference being purchased from abroad. This deficit totalled a record $531 billion in 2003, equivalent to 4.8% of US GDP. Latest data indicate that this deficit rose further to around 5.5% of GDP in the first three quarters of 2004.

Given the magnitude of this imbalance, there is increasing concern about the likely impact on both the US and the wider global economy of any possible future adjustment. If there were to be an abrupt shift away from dollar assets, this could precipitate a sharp decline in both the dollar exchange rate and US financial asset prices. The effects of such a disorderly US current account correction on the global economy would be severe, bringing with it the risk of a financial crisis and global recession.

The US current account deficit is thus a truly global concern. This article examines more closely the underlying sources of this imbalance, investigates whether an adjustment is necessary and asks whether the current account deficit can be narrowed sufficiently to generate a soft landing for the world economy. The discussion is structured as follows:

IV.1 – A brief history of the US current account

IV.2 – The current account deficit as a savings-investment imbalance

IV.3 – The composition of US trade flows

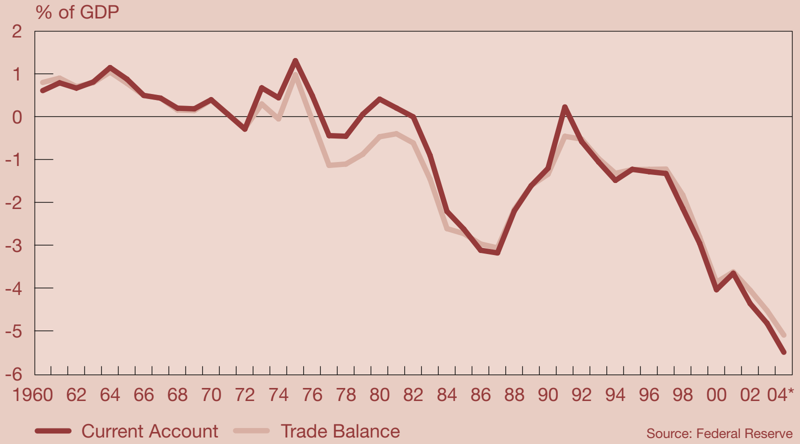
IV.4 – Is a current account adjustment necessary?

IV.5 – How can a current account adjustment be achieved?

IV.6 – Estimating the impact of a US current account adjustment

IV.7 – Conclusions

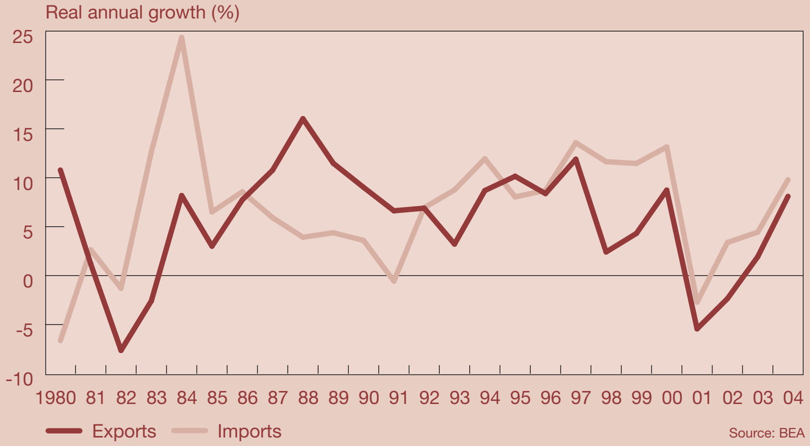
Figure 4.1 – US current account and trade balances



Source: Federal Reserve

*2004 data refers to first three quarters of the year

Figure 4.2 – US trade growth



Source: BEA

IV.1 – A brief history of the US current account

The US has not always run a current account deficit in modern times. As illustrated in Figure 4.1, the first time during the period shown that a significant deficit emerged was during the early 1980s. The current account deteriorated significantly from 1983, with the deficit peaking at 3.2% of GDP in 1987. The current account moved briefly back into surplus in 1991, reflecting the effects of a US economic recession combined with a weak dollar. During 1992-1997, US current account deficits were relatively minor, remaining below 1.5% of GDP, but from 1998 the deficits started to widen rapidly again, reaching record levels in 2004.

The current account has three main components: trade in goods and services, net income from international investments, and net transfers[1]. The balance of trade (exports minus imports) is by far the largest component and accounts for the vast majority of the current account balance, as illustrated by Figure 4.1. Periods when the current account balance has sharply deteriorated therefore correspond with periods where import growth has exceeded export growth, as illustrated in Figure 4.2. Furthermore, once a large trade deficit emerges, simple arithmetic implies that exports must grow significantly faster than imports just to keep the deficit constant[2].

[1] Net investment income is the difference between income generated by domestic ownership of foreign assets and that generated by foreign ownership of domestic assets. Net transfers are the difference between transfers (foreign aid and remittances) abroad and those received from abroad.

[2] At present, for example, US imports are around 50% higher than US exports, so if imports grow by (say) 5% per annum, exports must grow by around 7.5% per annum just to keep the US trade deficit constant.

The shifting patterns of trade described above are determined in large part by the relative growth rates of US income and the income of the rest of the world (as discussed below, exchange rate movements can also be important). US exports pick up when the income of the rest of the world grows faster, while imports expand more rapidly when US income grows faster. When the US economy fell into recession in the early 1980s and again in the early 1990s, imports slowed. World growth remained comparatively strong, however, so exports expanded and the trade balance improved. Following the 1991 recession, the US enjoyed a long period of healthy expansion while growth in Japan and Europe remained sluggish. Consequently, US demand for foreign imports rose more strongly then did foreign demand for US exports.

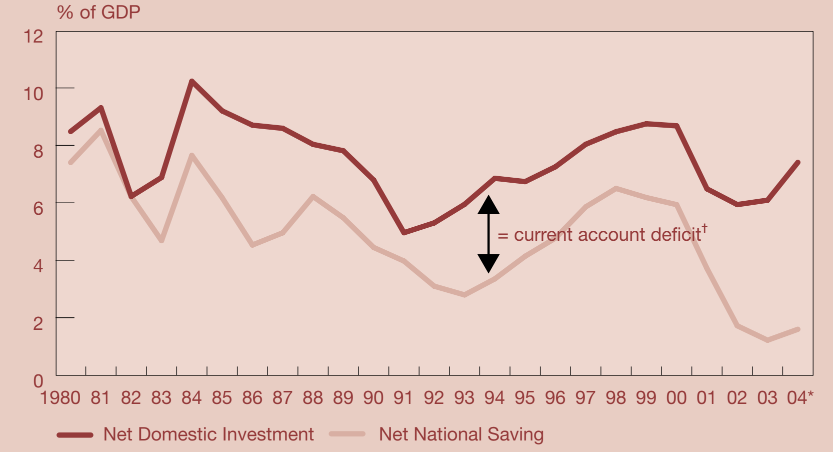
In 2001 the US economy slowed sharply relative to other economies, prompting the current account deficit to narrow. But the improvement in the trade balance was not nearly as marked as during the 1990-91 recession. This was partly because the US economy did not slow as sharply relative to foreign economies in 2001, but it was also due to the resilience of US consumer spending (discussed further below) and the strength of the dollar exchange rate, which was much higher during 1997-2001 than during 1987-1991 (see Figure 4.3).

The dollar exchange rate both reflects and influences trade and capital flows. Developments in the foreign exchange value of the dollar were an important factor underlying the sharp deterioration in the trade balance from 1997. In the late 1990s demand for dollar assets surged as high productivity growth in the US boosted the expected rate of return on investments, while further liberalisation of capital controls around the globe allowed investors to access the US market more fully. A number of financial crises in emerging markets may also have contributed to the attractiveness of the US as a 'safe haven' for funds. Following the 1997-98 Asian financial crisis, demand for US dollars from many Asian economies also rose strongly as governments in that region increased their foreign exchange reserves. These factors combined to produce a significant appreciation of the dollar, the real trade-weighted value of which rose by 19% between January 1997 and December 2000; this of itself contributed to the widening of the US current account deficit.

Figure 4.3 – Trade-weighted real dollar exchange rate

Source: Federal Reserve

Figure 4.4 – US Saving and Investment



†Published data includes a statistical discrepancy, so this may not always exactly correspond with the official deficit figure
*2004 data refer to first three quarters of the year
Source: BEA

Since 2001, however, the dollar has depreciated, with demand for US assets from private foreign investors waning as they have become increasingly concerned about diversifying their portfolios amid the perceived risk of a more significant drop in the value of the dollar linked to the widening current account deficit. But although the dollar has fallen by over 30% against the euro since 2001, the trade-weighted dollar index has declined by much less because of heavy intervention by Asian central banks[3] seeking to hold down the value of their currencies against the dollar in order to maintain export market shares in the US.

In order to better understand the inter-linkages between foreign capital flows and the US current account balance, it is helpful to investigate the underlying domestic sources of the deficit, to which we now turn.

IV.2 – The current account deficit as a savings-investment imbalance

As a matter of national accounting, the current account deficit can be explained either in terms of domestic demand exceeding domestic output, or as domestic investment exceeding domestic saving, as illustrated by Figure 4.4. When investment exceeds savings, a country must borrow from abroad to fund the excess and it therefore runs a current account deficit.

Figure 4.5 compares the shortfall in domestic savings relative to investment of the private sector and the government. When the current account deficit widened in the 1980s, this was largely driven by a steep increase in the federal budget deficit (i.e.

[3] China, Malaysia and Hong Kong maintain an explicit fixed exchange rate with the dollar, but other central banks in the region have also intervened heavily to prevent their currencies appreciating against both the dollar and the Chinese renminbi.

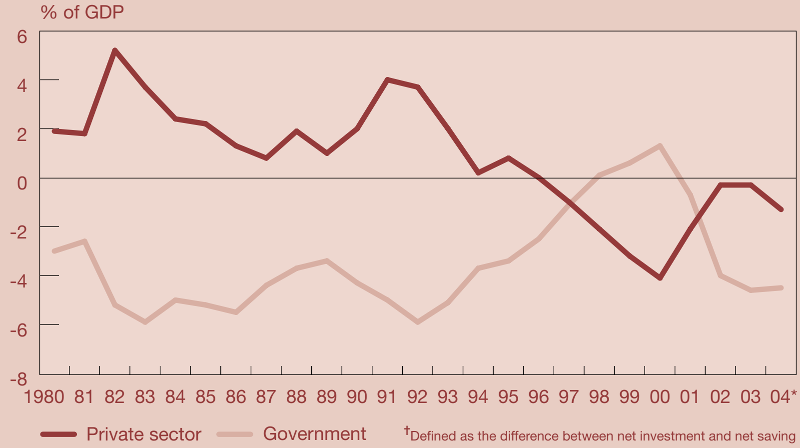
lower public savings). The current account started to improve from 1987 as the budget deficit narrowed at the same time as households increased their savings and cut back on residential investment. Private investment then contracted during the 1990/91 recession and the current account was pushed back into surplus.

In contrast to this previous episode, the deterioration in the current account deficit during the 1990s arose principally as a result of a boom in private business investment. Private savings were weak during this period, reflecting increased household wealth due in particular to capital gains on stock market investments, but the federal government finances witnessed a marked improvement as the economy boomed, boosting total national savings. This rise in national saving was still insufficient to meet the demand for domestic investment, however, so foreign capital inflows filled the gap, attracted by rapid productivity growth and the promise of high returns.

Things changed after the bursting of the IT bubble in 2000. The consequent fall in private investment could have led to an improvement in the current account, but the deficit actually widened due to an even steeper decline in national savings. This fall in national savings was mainly caused by a sharp deterioration in the government finances, which went from a surplus of 1.6% of GDP in 2000 to a deficit of 4.8% of GDP in 2003. The current account deficit thus no longer reflected strong private investment as it was now financing the federal government deficit. This is the so-called "twin-deficits" problem. Latest data indicate that the government sector remained the principal source of the domestic investment financing gap in 2004, although there was a modest improvement in its financial position reflecting the acceleration in GDP growth. In contrast, there was an increase in the savings shortfall in the private sector, reflecting a further decline in household saving rates and higher mortgage debt.

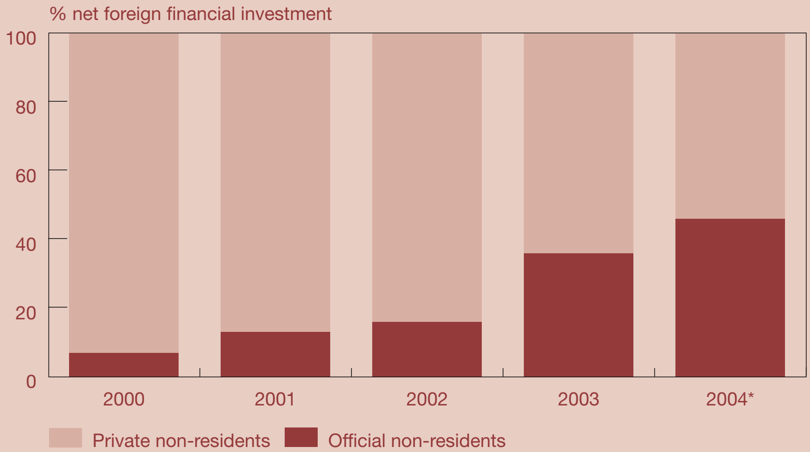
As illustrated in Figure 4.6, official sources of foreign capital inflows have become increasingly important in funding the US current account deficit since 2002, as central banks have been more willing than private investors to purchase the growing quantities of relatively low-yielding US debt, particularly Treasury bills, supplied to the market. Whereas private investors will usually seek a good return on all their investments, central banks are principally motivated by policy considerations such as influencing movements in the foreign exchange rate. Latest data from the US Treasury and the Federal Reserve indicate that just over half of all US Treasury securities outstanding are now held abroad, with foreign central banks accounting for approximately 60% of this total. Asian

Figure 4.5 – Sources of the US domestic investment financing gap†



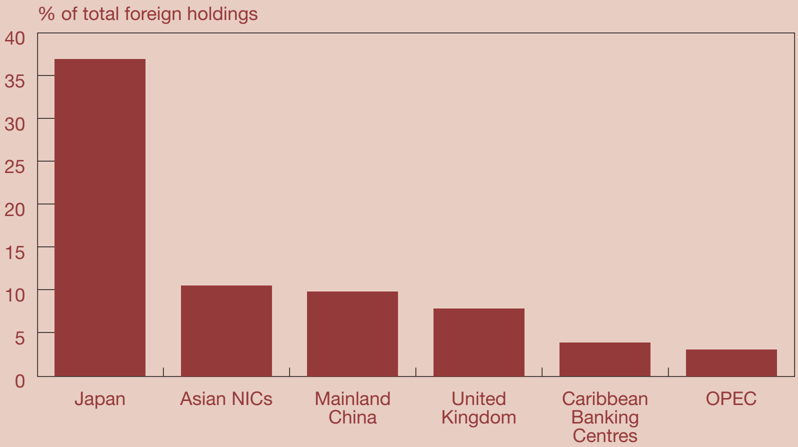
†Defined as the difference between net investment and net saving
*2004 data refer to first three quarters of the year
Source: BEA

Figure 4.6 – Financing sources of the US current account deficit



*2004 data refer to first three quarters of the year
Source: Federal Reserve

Figure 4.7 – Major foreign holders of US Treasury securities



Source: US Treasury (November 2004)

central banks have been particularly voracious in their appetite for dollar assets because by funding the US current account deficit they are effectively maintaining US demand for their exports, thereby providing a significant stimulus to their economies. As illustrated by Figure 4.7, Asia is now by far the largest foreign holder of US Treasury securities.

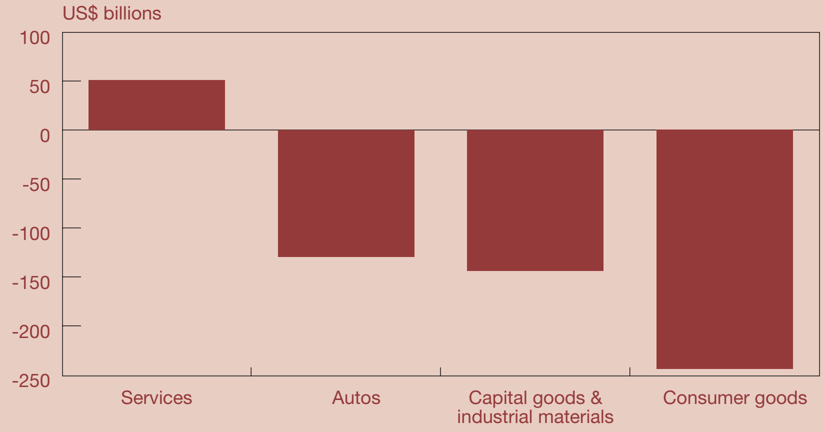
IV.3 – The composition of US trade flows

The domestic sources of the US current account deficit also help to explain the composition of external trade. As illustrated by Figure 4.8, consumer goods and autos together account for a large proportion of the overall trade deficit. This is a long-term trend that was magnified by the strength of consumer spending in the US during the economic boom of the 1990s, as well as by the aggressive fiscal easing that has helped to support the US consumer since the stock market bubble burst in 2000.

Clearly the US consumer appears to have a massive appetite for foreign products. But this deficit also reflects the fact that the US manufacturing sector has relocated much of its capacity abroad, so the US consumer now imports a significant volume of goods with US trade-marks. The manufacturing sector has increasingly relocated production outside the US because producing goods abroad is far cheaper. For example, in 2002, the average hourly compensation for a production worker in manufacturing was over eight times higher in the US than in Mexico. Moreover, these potential cost savings have been magnified by the strength of the dollar in recent years, particularly vis-à-vis Asian currencies. This has contributed to a decline in the share of manufacturing output in US GDP from 17.2% in 1988 to 12.7% in 2003. According to BEA data for 2000, sales by US manufacturing firms based abroad represented more than twice the exports of manufacturing firms based in the US, and this ratio seems likely to have increased further since then.

Meanwhile, the US has continued to run a healthy surplus on trade in services. Indeed, it is the strong expansion of the non-manufacturing sector that has allowed

Figure 4.8 – Major components of the US trade balance in 2003



Source: BEA

GDP growth in the US to outpace growth rates in most other developed nations, in turn attracting large inflows of foreign investment. Rapid job creation in the non-manufacturing sector has supported household incomes in the US, while the cost savings achieved in the manufacturing sector have raised the overall purchasing power of US households.

Considered from this perspective, the net effect of this process has been positive for the US, resulting in more rapid economic growth, higher incomes and cheaper products. But this is also an additional factor explaining why the US trade deficit has widened so rapidly. The relocation of US manufacturing abroad has withdrawn many of the domestic alternatives to imported products that were previously available to US consumers, contributing to a relatively high import elasticity with respect to demand in the US[4]. Estimates from the OECD's Interlink model indicate that the elasticity of imports of goods and services with respect to total final expenditure is significantly higher for the US (around 2.2) than for an average of EU countries and Japan (between 1.5 and 1.75). Moreover, the income elasticity for US imports is estimated to be larger than the weighted average of foreign income elasticities for US exports (around 1.8), which implies that the US trade deficit would deteriorate even if the economies of US trading partners were growing at the same rate as the US economy.

On the other hand, there is evidence that this elasticity asymmetry applies only to trade in goods. Focusing exclusively on trade in services, the OECD estimates the income elasticity of demand for US exports to be higher than the income elasticity of demand for imports. This would be consistent with the view that the US has a greater comparative advantage in the production of services than in the production of goods.

IV.4 – Is a current account adjustment necessary?

There is no simple basis on which to determine whether a current account deficit has become unsustainable, although history shows that for industrialised economies a current account adjustment will typically take place when the deficit reaches around 5% of GDP.[5] Much depends, however, on how long foreigners remain willing to fund the US deficit by accumulating the country's debt and equity. In this respect, the sustainable level of the US current account deficit may be significantly higher than for any other country, partly because of the special status that the dollar enjoys in asset markets. The dollar is the most important global currency, with the majority of international transactions in goods, services and assets denominated and settled in dollars. So long as this remains the case, there will always be a much greater global demand for US dollars than for any other currency and this demand is likely to continue rising with increased globalisation and financial integration.

In addition, the US currently attracts a significant proportion of the world's surplus savings largely because, since the early 1990s, economic growth and productivity gains in the US have generally been more

[4]Other factors that may have contributed to the high import elasticity of the US may be a relatively young population, which generally tends to consume more imports, compared to the EU and Japan in particular, and the growing non-price competitiveness of the dynamic Asian economies.
[5]Caroline L. Freund, *"Current Account Adjustment in Industrialised Countries"*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 692, December 2000.

rapid than in other major industrialised economies. The US also has a record of low inflation and low transaction costs in its capital markets. In short, the US has been an attractive place to invest because of the favourable balance between risk and return. Looking forward, potential GDP growth in the US is projected to remain significantly above that of other major developed economies in the short to medium term.[6] In the absence of more attractive investment opportunities, this again suggests that the US current account deficit could well persist for longer than history might suggest.

But it is also important to look at the position of the US as a debtor to the rest of the world. The accumulation of current account deficits financed by foreign borrowing has resulted in a steep rise in the US net international investment position (NIIP)[7] from 5% of GDP in 1997 to 24% at the end of 2003. As the stock of external debt increases, so do future funding requirements, raising the perceived riskiness of the US as an investment destination. Nonetheless, by comparison to other large industrialised nations, US net foreign liabilities remain relatively low. Moreover, despite being an increasingly large net debtor to the rest of the world, the US has not yet had any problem in meeting the financial payments on its external debt. As its assets have so far had a significantly higher rate of return than its liabilities, the US actually earned more on its external assets than it paid on its liabilities in 2003. This is largely explained by the relative composition of US and external debt, with the US holding comparatively more risky assets with higher returns.

As the country's debt level increases, however, the cost of servicing this debt will also grow. Net income payments will soon turn negative, further adding to the current account deficit. If present trends persist, Roubini and Setser[8] have calculated that net foreign liabilities are likely to reach around 50% of GDP by 2008, while the current account deficit will have widened to more than 8% of GDP. With foreign direct investment into the US dwindling, Asian central banks have so far been willing to fund an increasing proportion of the US current account deficit by acquiring low-yielding US assets with little protection against the risk of a further decline in the value of the dollar. But it is unlikely that they will have the capacity to fund ever larger current account deficits in the future, even if they wished to do so.

At some point, it must be expected that creditors will start to demand higher yields on US assets to compensate them for the greater risk of capital losses associated with lending to an increasingly large debtor with ongoing structural trade deficits. This switch could occur quite suddenly, as evidenced by past emerging market crises. While the dollar's position as the world's hegemonic currency and the depth of US financial markets may help to sustain demand for dollar assets for some time, this delay may just raise the eventual cost of adjustment.

This still does not define at precisely what level the US current account deficit or NIIP would be perceived as 'unsustainable'. Indeed, no amount of macroeconomic analysis can predict the timing of what will inevitably be a market-led event. But it seems clear that the US cannot continue indefinitely on its present course.

IV.5 – How can a current account adjustment be achieved?

According to traditional economic theory, a depreciation of the currency should lead to an improvement in the trade balance. But a dollar 'correction' has already been underway for the past three years and the US trade deficit has continued to hit new highs. The US economy appears to have a relatively low sensitivity to fluctuations in the dollar exchange rate.

In part, this may be explained by the fact that the dollar has not declined by the same extent against all currencies. In particular, exporters in Asia have been able to maintain their relative price competitiveness. But it also seems likely that the dollar depreciation is not being completely passed through to end prices. Foreign exporters may be willing to keep prices to US consumers constant so as to maintain market share. A recent study by Gagnon and Ihrig[9] indicates that this pass-through rate is limited to just 40% in the US. Moreover, an additional factor highlighted by the previous discussion on the relocation of the US manufacturing sector abroad is that domestic alternatives to many imported products no longer exist. So it may often simply not be possible for consumers to swap from imported goods to domestically produced goods.

As the US current account balance is not particularly sensitive to exchange rate movements, so the US dollar is likely to continue its descent. A recent paper by Obstfeld and Rogoff[10] has suggested that, as the US current account rebalances, the trade-weighted value of the dollar will need to decline by at least another 20%, with the potential for a 40% decline in the event of a sharper correction. With Euroland so far bearing the brunt of dollar depreciation, a move to more flexible exchange rates in Asia is required. There have been rumours that Asian central banks may soon seek to diversify their reserves, but so far there has been little concrete evidence that this is the case. Indeed, China seems likely to maintain some form of link to the dollar[11] for some time, albeit perhaps with greater flexibility than before, as it is waiting for its banking system to be sufficiently strengthened to be able to withstand the fluctuations that would accompany a floating exchange rate regime.

As argued by Obstfeld and Rogoff, even a very substantial depreciation of the dollar is unlikely on its own to be able to rebalance the US current account position. The adjustment must come from fundamental shifts in consumption. The key underlying problem that needs to be addressed is the severe dearth of domestic savings in the US. National savings have steadily declined from an average of about 11% of GDP in the 1960s to 9% in the 1970s, 6% in the 1980s, less than 5% of GDP in the 1990s and just 3% of GDP on average in 2000-03. A smooth adjustment of the US current account deficit is much more likely to be achieved if economic policies are geared towards tackling the shortfall in domestic saving. The Bush administration will need to commit to a strict programme of fiscal consolidation in order to bring the government finances back towards balance, while providing households with

[6] Although this can largely be explained by divergent demographic trends between the US and other developed economies, rather than faster expected US productivity growth.
[7] The NIIP (defined as the difference between foreign-owned assets in the US and US-owned assets abroad) is also affected by developments in prices, exchange rates and other adjustments.
[8] Nouriel Roubini and Brad Setser, *"The US as a Net Debtor: The Sustainability of the US External Imbalances,"* November 2004 (available at www.stern.nyu.edu/globalmacro).
[9] Joseph E. Gagnon and Jane Ihrig, *"Monetary Policy and Exchange Rate Pass-Through"*, Federal Reserve Board of Governors, International Finance Discussion Paper, June 2004
[10] Maurice Obstfeld and Kenneth Rogoff, *The Unsustainable US Current Account Position Revealed"*, NBER Working Paper No. 10869, November 2004
[11] Or possibly a basket of major currencies in which the dollar would still have the largest weight.

an incentive to save through the tax code. Meanwhile, as the Fed continues to raise interest rates gradually back towards more 'normal' levels, this should help to boost levels of private saving and temper the decline of the dollar.

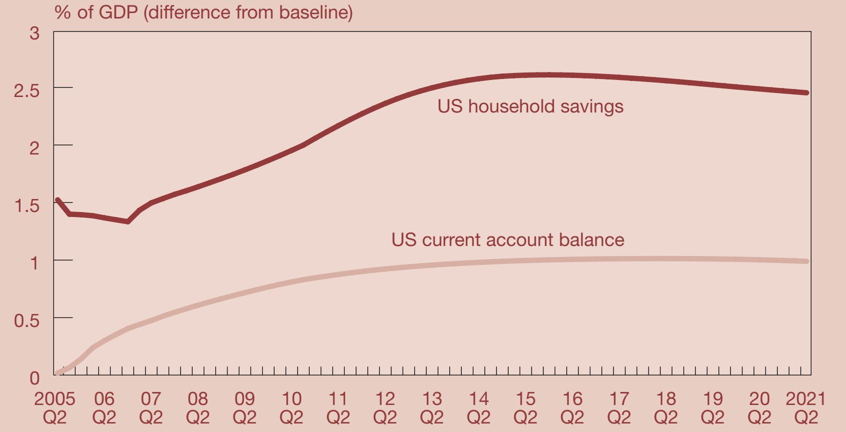
The longer this rebalancing process is postponed, the greater will be the eventual cost of adjustment, as well as the risk of a more abrupt correction occurring that could potentially destabilise the world economy. If US policy-makers do not take adequate measures to correct these imbalances, then financial markets will eventually take over. In this respect, the shifting mix of foreign capital inflows from private to official funding is worrying, as the last time it happened in the context of a current account problem was in the months leading up to the stock market crash of 1987. When the US trade deficit widened in mid-1987, the dollar came under sharp downward pressure, bond yields were driven higher, and this ultimately spilled over into the stock market, contributing to the crash of October 1987.

Looking at the longer term picture, if the US external balance is to become sustainable, there needs to be some re-balancing of the sources of global growth. US trading partners (particularly Euroland and Japan) need to generate stronger domestic sources of demand so that their economic expansions can become self-sustaining. This will be facilitated by pressing ahead with the ongoing process of structural reform in these countries. Even if potential growth rates are not able to match the US fully because of divergent demographic trends, greater liberalisation of international trade in services, where the US has a comparative advantage, would help to prevent such huge global trade imbalances from arising again in the future.

IV.6 – Estimating the impact of a US current account adjustment

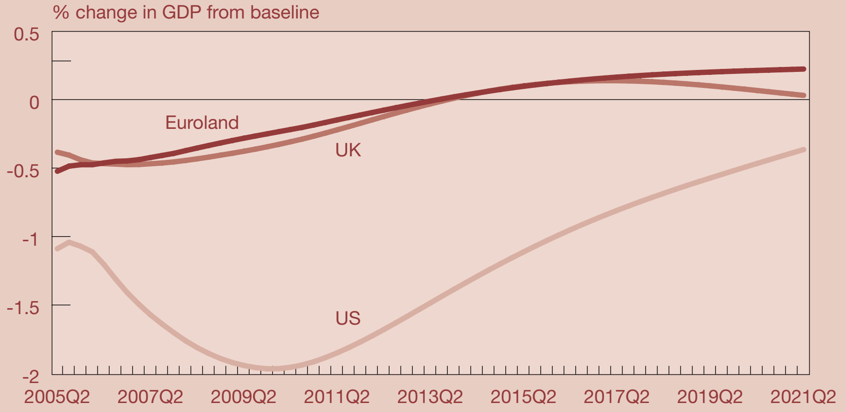
On the whole, a relatively smooth adjustment of the US current account deficit remains the most likely scenario, but even a gradual correction would have implications for the global economy. As already discussed, such an adjustment

Figure 4.9 – Adjustment of US savings and implications for the current account



Source: PricewaterhouseCoopers simulation using NiGEM

Figure 4.10 – GDP impact of US savings adjustment



Source: PricewaterhouseCoopers simulation using NiGEM

would necessarily involve an increase in the national savings rate in the US. As a hypothetical exercise, we have therefore considered the likely economic impact of a rise in the national saving ratio of US households using the National Institute's Global Econometric Model (NiGEM)[12].

As illustrated in Figure 4.9, we have considered the effect of a hypothetical exogenous shock that raises US household savings by just under 1.5% of GDP on average in 2005-06. In subsequent years there is an assumed further gradual increase in the savings ratio, which eventually settles at around 2.5% of GDP above the baseline forecast path. The chart also shows the implications for the US current account balance. Our NiGEM simulation suggests that the current account would witness a gradual improvement to around 0.8% of GDP after five years, before settling at around 1% of GDP over the long term. The model indicates that this adjustment would be associated with a decline of around 5% in the US dollar trade-weighted exchange rate, although after five years the depreciation would gradually start to be reversed.

Figure 4.10 illustrates the estimated impact on the level of US, Euroland and UK GDP in terms of deviations from the baseline forecast path. As shown in the chart, the impact is largest in the US, where GDP is estimated to be around 2% lower after four years. This negative impact subsequently starts to fade, although even after fifteen years GDP is still estimated to be around 0.5% lower than the baseline. There is also a negative impact on output in both Euroland and the UK in the short run, with the initial shock causing GDP in both economies to be around 0.5% lower. This initial decline results from the combined impact of lower US demand and a stronger exchange rate against the dollar. The initial negative impact is gradually reversed, however, and after around eight years the level of GDP in both the UK and Euroland moves above that in the baseline forecast.

[12] This simulation builds on the work of Ali Al-Eyd, Ray Barrell and Olga Pomerantz in *"Dollars and Deficits – The US Current Account Deficit and its Exchange Rate Consequences"*, National Institute Economic Review No. 191, January 2005

This is because world real interest rates will be lower in this scenario, raising the supply capacity of the global economy.

This model simulation illustrates that even if the US current account follows a relatively benign adjustment path, there are likely to be significant negative repercussions for the global economy in the short term, although the effects of this adjustment would be positive in the long run.

IV.7 – Conclusions

The unprecedented size of the US current account deficit is the direct manifestation of lopsided global growth since the early 1990s. The US has been borrowing increasing amounts from abroad to fuel domestic demand growth, while the rest of the world has so far been willing to provide cheap financing by acquiring relatively low-yielding US assets. In contrast to the position in the late 1990s, these capital inflows are no longer mainly supporting increased productive investment in the US, but are now financing a huge federal government deficit and propping up consumer spending growth.

This is an unsustainable path for the US economy. As the country's external indebtedness rises and US assets occupy an increasing share of global portfolios, it must be expected that at some point investors will start to demand higher yields on their investments. When this happens, US spending on foreign goods and services will need to match more closely the level of foreign spending on US goods and services. This adjustment is likely to be smoother if economic policies are geared towards tackling the shortfall in domestic saving in the US. The longer this rebalancing process is postponed, however, the greater will be the eventual cost of adjustment, both for the US and the global economy.