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The US Current Account Deficit: Stocktaking and Remedies

In 2004, the US current account deficit widened to US $668.1 billion and 5.7 per cent of gross domestic product (GDP). These numbers, unprecedented both in absolute and relative terms, have led many observers to doubt the stability of the status quo. To avoid a major crisis resulting from a disorderly adjustment, questions must be answered concerning appropriate policy initiatives to ensure a more benign correction of external imbalances.

While public debate has centred on contemporary deficits, the deterioration of the US current account is in no way a new phenomenon. As Figure 1 illustrates, the current account swung into deficit in 1982 and has remained there nearly ever since. Nevertheless, different trends are revealed across time. Thus, the current account first bottomed out in 1987 and went on to improve to the point of virtual balance in 1991. From there, it resumed its fall which accelerated toward the end of the millennium.

Two factors can be identified behind these developments. First, relative prices exert a clear influence on the US external position. This was obvious during the initial worsening at the beginning of the 1980s as well as from 1996 onward. At other times, the relationship becomes less straightforward, especially from 1985 to 1987, where there is evidence of a strong J-curve-effect, and after that during the period of comparative exchange-rate stability in the first half of the 1990s. Second, the impact of relative prices is complemented by the discrepancy between real GDP growth in the USA and in the rest of the world (RoW). Thus, high US growth tends to exacerbate deficits via strong import demand, whereas outright recessions (such as in 1991) lead to an improvement in the current account. Interestingly, exports respond to exchange-rate changes in a much more muted way than imports. This empirical finding, known as Houthakker-Magee asymmetry, implies that, in the absence of growth differences, the dollar will have to fall steadily if a more equilibrated trade balance is to be maintained.[1] US imports now amount to more than 150 per cent of exports, so that the latter will have to grow much faster for the trade deficit to narrow. Therefore, without any major adjustment in relative prices or growth patterns, the US current account deficit is set to widen further.

This raises a string of questions as to which currencies the dollar should depreciate against and which countries should either enhance or dampen economic growth. Figure 2 offers a first clue by showing the regional counterparts to the US trade deficit.

The overall picture is clear: while the deficit increased against virtually all trading partners in recent years, this effect is most pronounced in the data for Europe and Asia around its trade hub China. However, the intraregional structure of current account surpluses must be recognised, too. Thus, even though China shows the highest contribution to the worsening US current account, it is running deficits with most other Asian countries because of its outstanding growth performance. This will have to be respected in order to avoid inappropriate policy measures.

Costs and Benefits of Global Codependency

Clearly, the USA is at the centre of the current constellation. Basic national accounting identities remind us that net exports represent a part of GDP alongside consumption, investment and government expenditures, which together constitute domestic absorption. The current account consists of net exports, factor income and transfers. Adding the last two categories to GDP yields gross national income (GNI). The ballooning trade deficit thus signifies a reduction in GDP while the current account deficit eats away a portion of GNI. However, this does not mean that deficits hurt growth.

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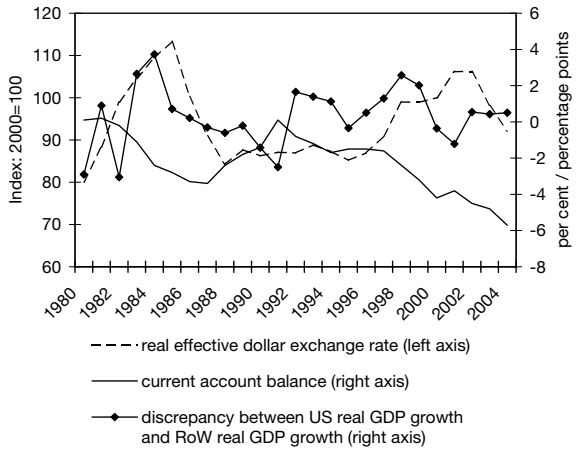
[1] This asymmetry was first diagnosed by H. Houthakker and S. Magee: Income and Price Elasticities in World Trade, in: Review of Economics and Statistics, Vol. 51, 1969, pp. 111-125. P. Hooper, K. Johnson and J. Marquez: Trade Elasticities for the G-7 Countries, Princeton Studies in International Economics, No. 87, 2000, observe a slight increase in income elasticities but confirm the persistence of the original findings.

Figure 1
The US Current Account, Relative Prices, and Relative GDP Growth, 1980-2004

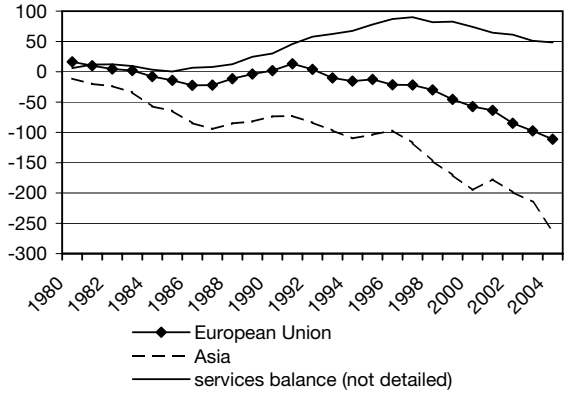


Sources: US Bureau of Economic Analysis, World Bank, JPMorgan.

During the last decade, US real GDP has grown by an average 3.4 per cent on an annual basis so that other components must have compensated for the lack of external sources of growth.

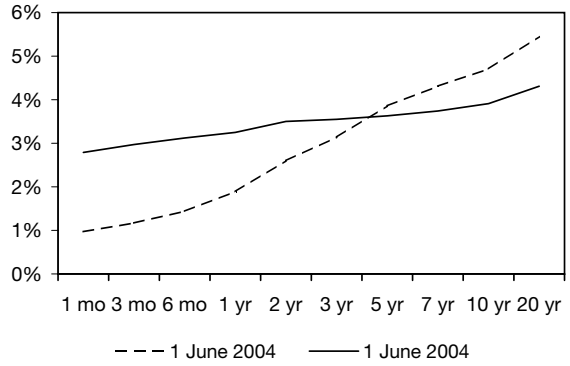
Indeed, the same forces that depress export gains are bolstering investment and consumption. To see why, recall that the current account basically corresponds to net foreign investment. One consequence of the sustained capital inflows are chronically low US interest rates. Figure 3 shows what has recently been entitled the "interest rate conundrum": foreign purchases of US long-term securities keep a lid on interest rates despite the monetary tightening induced by the Federal Reserve. The result is a basically flat yield curve. In other words, due to the US dependence on net capital inflows, the Federal Reserve has lost influence on interest rates.

Figure 2
Regional Distribution of the US Trade Balance, 1980-2004
(US$ billion)



Sources: UN COMTRADE Database, US Bureau of Economic Analysis; Asia includes: China, Hong Kong, Japan, Korea, Singapore, and Taiwan.

Figure 3
The Flattening US Yield Curve



Source: US Department of the Treasury.

Losses in the export sector notwithstanding, US consumers and enterprises benefit from cheap import goods and credit at lower interest rates than otherwise. The flipside is a growing addiction to these advantages. Thus, although there is no strict ceiling for sustainable external deficits, studies analysing current account dynamics in industrial economies conclude that reversals usually take place as deficits reach about 5 per cent of GDP.[2] So far, the USA has been in a privileged position as yields on its foreign liabilities remain much lower than returns on foreign assets. Yet once international investors start to shun US assets, both the private and the public sector will face tighter financing constraints. Therefore, it is worth noting which factors might reduce the appetite for US assets abroad.

The Surplus Regions

In the aftermath of the currency crises at the end of the 1990s, Asian economies turned their back on domestic growth strategies and opted for export-led growth instead by pegging their currencies to the dollar. Their success was reflected by high, and in some countries rampant, real GDP growth rates. However, in order to keep exchange rates stable, central banks have to pile up huge amounts of foreign reserves. Ta-

[2] The results of the seminal study by C. Freund: Current Account Adjustments in Industrialized Countries, International Finance Discussion Paper No. 692, 2000, Board of Governors of the Federal Reserve System, have recently been confirmed by H. Croke, S. Kamin and S. Leduc: Financial Market Developments and Economic Activity During Current Account Adjustments in Industrial Economies, International Finance Discussion Paper No. 827, 2005, Board of Governors of the Federal Reserve System, as well as by G. Debelle and G. Galati: Current Account Adjustment and Capital Flows, Bank for International Settlements Working Paper No. 169, 2005.

Table 1
Foreign Official Reserves, Asian Central Banks, 1998-2004
(US$ billion)

	annual change							amount outstanding
	1998	1999	2000	2001	2002	2003	2004	February 2005
China	5.1	9.7	10.9	46.6	74.2	161.8[1]	206.7	642.6
Hong Kong	-3.2	6.6	11.3	3.6	0.7	6.7	5.0	123.9
Japan	-4.7	74.5	69.5	40.5	63.7	201.3	171.5	820.5
Korea	32.3	21.7	22.2	6.6	18.3	33.7	43.7	201.3
Singapore	3.5	1.9	3.4	-4.8	6.5	13.6	16.5	112.6
Taiwan	6.8	15.9	0.5	15.5	39.4	45.0	35.1	246.6
other[2]	15.7	18.1	-0.7	0.6	12.8	17.4	28.9	167.4
total	55.5	128.5	116.7	108.5	215.8	479.6	507.4	1931.0

[1] includes US$ 45 billion in reserves transferred from the People's Bank of China to two state-owned banks.

[2] includes: Indonesia, Malaysia, the Philippines and Thailand.

Source: BIS Annual Report 2004, p. 100, BIS Annual Report 2005, p. 86.

ble 1 shows that foreign reserve positions increased considerably in recent years, a trend which clearly exceeds what could be explained as an effort to insure against speculative capital flows.

Maintaining stable and undervalued exchange rates in this way provokes two negative side-effects. First, interventions in the foreign exchange markets increase domestic liquidity and threaten to overheat the economy. Monetary authorities may try to sterilise the additional money supply, but this effort fails if the private sector is reluctant to absorb assets issued to this purpose. Quasi-fixed exchange rates therefore weaken the ability of monetary policy to pursue internal equilibrium. Second, the long-term US securities acquired have been shown to be extremely low-yielding. Furthermore, gross dollar positions have risen drastically in the past years, even if a growing portion of central bank portfolios has been diversified into other currencies like the euro. Should the dollar depreciate sharply, foreign holders of dollar positions will incur capital losses: consecrating considerable amounts of GDP to such risky investment seems to be far from prudent.

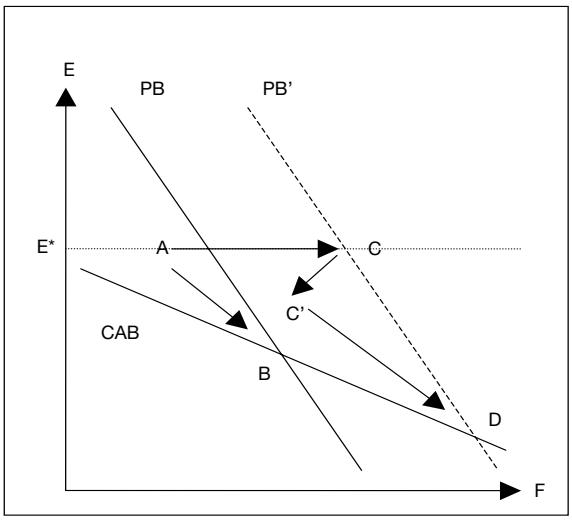
For these reasons, the economic authorities of Asian surplus countries are making a bargain with the devil. While profiting from booming export sectors today, both internal concerns and currency risks will eventually lead to a breakdown of the present dollar cartel. At this point, substantial capital losses will be inevitable.

The members of the European Monetary Union and those economies whose currencies are tied to the euro in one way or another constitute the third major block in the current constellation. As in the case of Asia, this block has registered external surpluses which rely heavily on the US market, even if their contribution to the US trade deficit has not risen as dramatically. Yet unlike Asia, European authorities have not committed to export-led growth strategies nor has the European Central Bank pursued any explicit exchange-rate policy so far. Instead, one main reason for the good trade performance can be seen in Europe's anaemic economic growth, which lags far behind US rates. The euro area's economic heavyweight, Germany, stands at the centre of these dismal growth figures because domestic demand remains moribund due to overly moderate wage increases.[3] The resulting dependency on the stimulus granted by overseas import demand explains the general uneasiness at the beginning of 2005, when the euro appreciated to values beyond US $1.35. In a way, Europe will have the most to lose: if Asian central banks stick to holding dollar rates constant while diversifying their portfolio by moving into the euro, the latter is doomed to bear the brunt of dollar depreciation.

Overall, none of the three regions involved should be interested in prolonging the current situation as long-term risks exceed short-term advantages. As the issuer of the world's predominant reserve currency, the USA bears special responsibility for financial market stability. Thus, an important incentive to promote a smooth correction of global imbalances is the possibility of a disorderly adjustment, which cannot be ruled out. Although a weaker dollar exchange rate is part of the normal adjustment process, potentially disastrous sentiment-driven corrections should clearly be avoided. To this end, both deficit and surplus regions will have to take appropriate policy measures.

[3] For an analysis of wage policy in the European Monetary Union see V. Hallwirth: Beschäftigungsorientierte Lohnpolitik, in: Wirtschaftsdienst, Vol. 5, 2005, pp. 295-303.

Figure 4
The End of Pegging



Risks of Financial Market Instability

Omitting unilateral transfers, the current account balance is the sum of the trade balance and net revenues from foreign assets and liabilities. Net revenues depend on net foreign debt (F) and the corresponding interest rates at home and abroad, whereas, for the sake of simplicity, the trade balance is taken to be determined by the exchange rate (E). For current account balance to hold (see CAB-curve in Figure 4), there must be a negative relationship between F and E: if net foreign debt rises, the trade balance will have to improve via a depreciation.

An increase in US net foreign debt raises foreign wealth, thereby changing the structure of international portfolios abroad: the share of dollar denominated assets rises while the share of assets denominated in domestic currency decreases. Assuming that international portfolios initially satisfied the risk-return preferences of investors, the higher share of dollar denominated assets leads to a higher portfolio risk which will have to be compensated by a higher return. One way to increase returns in domestic currency is to bring about an expected future dollar appreciation by a preceding overshooting depreciation. Therefore, an increase in net foreign debt leads to a depreciation of the dollar and the PB-curve representing portfolio balance will also be downward-sloping.

Starting from a current account deficit at A, the dollar should depreciate until the new equilibrium is reached at B. In the present situation, however, Asian central banks are holding the dollar stable. To maintain the peg at E*, central banks will have to increase their dollar reserves so that the portfolio balance curve (PB) shifts to the right. However, reserve accumulation will eventually stop if internal imbalances in surplus countries increase. At this stage (C), demand for US assets will fall short of supply, depressing asset prices, raising interest rates and leading to an immediate depreciation of the dollar. Due to valuation effects (see below), this initial fall in the exchange rate reduces US net foreign debt until C' is reached. From there on, the adjustment process follows a trajectory to the new equilibrium at D. Overall, pegging has two implications for the adjustment process. First, it results in longer lasting US deficits. Second, the longer the pegging episode, the higher the initial depreciation caused by a stop in reserve accumulation will be.

The critical part of the adjustment process takes place during the first depreciation phase after the peg is abandoned, i.e. the movement from C to C'. In theory, depreciation will stop as soon as increasing interest rates compensate for the expected further fall of the exchange rate. The problem is that expectations need not be rational and asset preferences may become endogenous as an abrupt reassessment takes place. Thus, investors holding large positions of dollar denominated assets will not place their faith in the rational behaviour of market participants: rather, they will dump even more US assets to cover risks of capital losses, thereby contributing to a further fall of the dollar and soaring interest rates. The likelihood of a run on the dollar increases with the magnitude of depreciation in the wake of a breakdown of the peg. Ending the latter will therefore be less painful the sooner it takes place.[4]

The Role of Valuation Effects

Some observers argue that the USA will profit from its privileged position as the issuer of the world's leading reserve currency to ensure a comparatively smooth and painless adjustment of its unprecedented current account deficit. They point out that the traditional adjustment channel – a depreciation of the domestic currency leading to an improving trade balance via cheaper exports and costlier imports – is supplemented by a financial channel. This financial channel is reflected by the stabilising effect of the US income balance which remains in surplus even though the USA became a net debtor as far back as 1989.

[4] For a detailed analysis of the adjustment process see O. Blanchard, F. Giavazzi and F. Sa: The US Current Account and the Dollar, National Bureau of Economic Research Working Paper No. 11137, 2005.

Table 2
Gross Positions of US Assets and Liabilities, selected years
(US$ billion)

	1980	1985	1990	1995	2000	2004
Assets	755.4	1302.7	2294.1	3964.6	7393.6	9972.8
Liabilities	389.9	1205.8	2458.6	4270.4	8982.2	12515.0

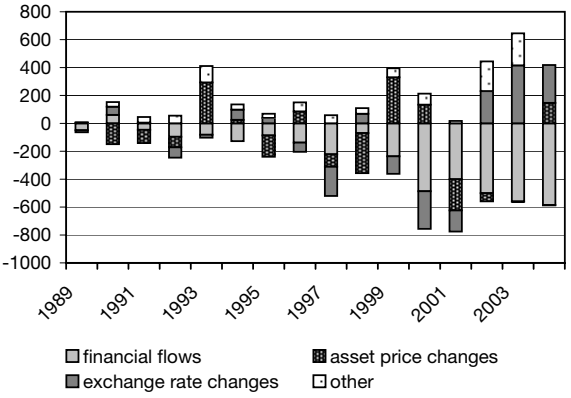
Source: US Bureau of Economic Analysis.

With US foreign liabilities vis-à-vis the rest of the world now exceeding assets by roughly US $2,500 billion (cf. Table 2), this implies higher yields on assets than on liabilities.

Yet the US financing privilege does not stop here because the returns of assets and liabilities are subject to valuation effects on stocks, too.[5] They result from changes in asset prices in the USA and abroad, as well as from exchange-rate movements. The latter factor has been especially important during the most recent episode of dollar depreciation. In this way, foreign assets held by the USA (which are largely denominated in foreign currencies) increased in US dollars worth, while liabilities (which are almost exclusively dollar denominated) remained unchanged. The resulting exchange-rate gains helped hold US net foreign debt virtually constant since 2001 despite large current account deficits. As Figure 5 clearly depicts, valuation effects have to be taken into account to explain the net external position of the US economy.

On the other hand, US exchange-rate gains must turn to losses once the dollar reverses its slide. Therefore, even a strong depreciation of the dollar is not the key for the sustainability of net foreign debt in the long run. Nevertheless, a study by Pierre-Olivier Gourinchas and Hélène Rey shows that the USA has registered positive annual returns on its net foreign position averaging 3.32 per cent of US GDP over the entire period following the demise of the Bretton-Woods-System.[6] Even more strikingly, these returns increase over time, despite the increasingly bleak US external performance.

Figure 5
Changes in the US Net International Investment Position, by Category, 1989-2003
(US$ billion)



Source: US Bureau of Economic Analysis.

Table 3
Indicators of Internal and External Balance, 2004

	Unemployment	Annual real GDP growth	Inflation	Current account balance
USA	5.5%	4.4%	2.7%	-5.7%
Euro area	8.8%	2.0%	2.2%	0.6%
Newly industrialised Asian economies[1]	4.1%	5.5%	2.4%	7.1%
China	4.2%[2]	9.5%	3.9%	4.2%

[1] includes: Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.

[2] official data from the National Bureau of Statistics of China.

Source: International Monetary Fund: World Economic Outlook, April 2005.

Lastly, long-run effects may not be the most important feature of the US financial privilege. Rather, it is the current timing of US exchange-rate gains which could not be more convenient. Thus, a weaker dollar reduces US net foreign debt exactly in the context of external adjustments, which are needed right now.

Choosing Remedies to Correct Global Imbalances

While there can be no doubt that a smooth correction of global imbalances will have to be realised through adjustments in relative prices and absorption, the main difficulty is the identification of policy measures tailored to the specific economic circumstances of the countries and regions mostly involved. Table 3 offers a brief view of the internal and external performance of the three economic regions under scrutiny.

In the light of these figures, it is quite easy to localise Europe and the USA. The USA starts from virtual internal balance and a huge and increasingly unsustainable current account deficit. Consequently, it could use a fall of its exchange rate which would have to be complemented by reduced absorption to avoid overheating. Quite contrarily, Europe has no compelling

[5] This aspect has been emphasised by P.-O. Gourinchas and H. Rey: From World Banker to World Venture Capitalist: The US External Adjustment and the Exorbitant Privilege, National Bureau of Economic Research Working Paper No. 11563, 2005, as well as by Ph. Lane and G. Milesi-Ferretti: Financial Globalization and Exchange Rates, International Monetary Fund Working Paper No. 3, 2005.

[6] P.-O. Gourinchas and H. Rey, op. cit., pp. 9f.

Figure 6
Internal Balance

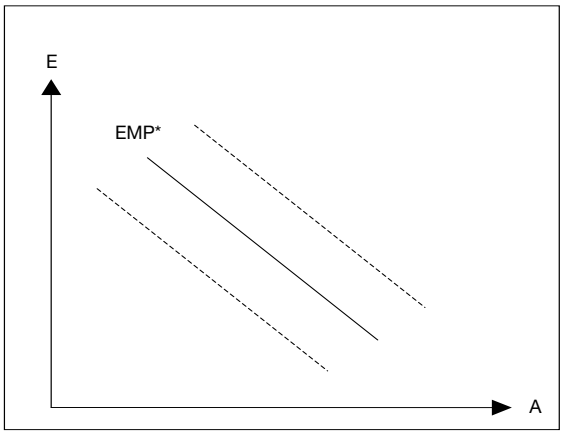
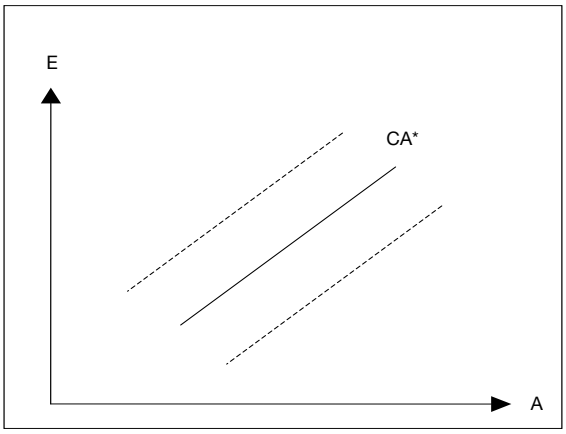


Figure 7
External Balance



reason to worry about its external balance but remains far away from full employment. Consequently, it would benefit from higher internal absorption, even taking into account a slightly stronger euro.

While recommendations for these two economies are clear-cut, defining an appropriate approach for Asia comes with more risks, because it shows proof of both internal and external imbalances, and reliable information on unemployment and inflation rates is scarce. The danger of overheating, which is most pronounced in the non-tradables sector, seems to be evident. Therefore it could be appropriate to recommend currency appreciation accompanied by reduced internal absorption. However, it cannot be denied that some countries, especially China, need to integrate a vast pool of the workforce, not accounted for by official unemployment statistics, if political stability is to be maintained. Whether appreciation of Asian currencies should be accompanied by either restriction or stimulation of internal demand cannot be verified beyond doubt. Acknowledging that external conditions should serve internal goals and not vice versa, priority has to be accorded to avoiding recessionary risks.

Internal and external balance are determined by absorption (A) and the exchange rate (E) as a proxy for international competitiveness.[7] Figure 6 depicts combinations of A and E for specific levels of employment. These loci, labelled EMP-curves, are downward sloping as both higher competitiveness and higher absorption contribute to rising employment. Thus, a shortfall in domestic demand can be compensated by a weaker exchange rate. EMP* represents full employment and therefore internal balance. Above EMP* economies face a situation of unemployment whereas under EMP* there will be excess labour demand fuelling inflationary tendencies.

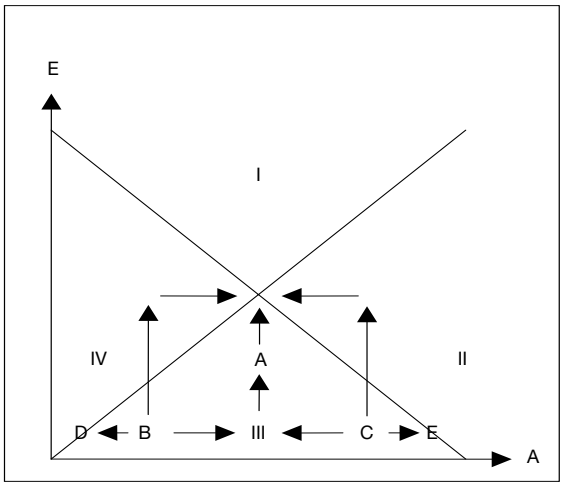
External equilibrium is represented by combinations of international competitiveness and absorption in accord with a certain current account balance (cf. Figure 7). These CA-curves are upward sloping as higher internal demand will make necessary a lower exchange rate to maintain the initial level of the current account. One specific CA-curve will correspond to external equilibrium (CA*), while curves below or above imply either too low or too high a current account respectively.

One would welcome a situation where both the desired current account balance and full employment are realised. In reality, neither condition needs to be satisfied. In Figure 8, zones I to IV stand for combinations of suboptimal levels of employment and the current account.

Yet, identifying the correct zone does not suffice to determine the optimal policy mix of adjustments of exchange rates and absorption, nor their appropriate direction and sequence to achieve internal and external equilibrium simultaneously. To see why, compare three points in one zone, such as A, B, and C, all characterised by unemployment and current account deficits. As is plain to see, depreciation directly paves the way from A to the final goal. By contrast, appropriate adjustment measures starting from either B or C call for actions in the field of absorption, i.e. stimulation in one case but restriction in the other. These difficulties in assessing the precise situation of the economy can

[7] This model was outlined by T. Swan: Longer Run Problems of the Balance of Payments, in: H. Arndt and W. Corden (eds.): The Australian Economy: A Volume of Readings, pp. 384-395, Melbourne 1963.

Figure 8
Disequilibrium Zones and Identification Problems



lead to inadequate policy decisions. If anything else, these uncertainties speak in favour of a gradual approach instead of abrupt initiatives to avoid a disastrous outcome.

What Is To Be Done

The necessary corrections of global imbalances are bound to be painful even if financial turbulences can be circumvented. Any adjustment must include changes in relative prices and absorption, thereby recognising global codependency, centred around its main protagonists, the USA, Asia and Europe. There is no choice between changes in exchange rates or absorption: two goals, two instruments. The general direction of measures to be taken by the three regions can be summed up as follows.

- Europe should greatly profit from an expansion of domestic demand, which will have to result from a coordinated effort of macroeconomic policies to foster economic growth. Indeed, the Stability and Growth Pact designed to constrain public spending has already come under pressure to reform as it has proved too rigid. In an environment of negligible inflation rates and inflation forecasts, monetary policy could contribute to economic recovery by sticking to an expansionary course. Finally, the excessively moderate stance of wage policy in member countries, first of all in Germany, should be abandoned to avoid deflationary spillovers.
- To move toward external equilibrium, the USA should strive for a lower exchange rate combined with careful measures to raise private savings and reduce public deficits. Monetary policy has already set out on a more restrictive path. More action is needed on the side of fiscal consolidation. As a significant amount of public spending is tied up in military expenses as well as in the looming reforms of the social security system, initiatives will have to concentrate on the revenue side of the public sector. However, the authorities should refrain from excessively curtailing absorption in order to avoid recessionary tendencies which could lead to a world-wide slowdown, given the dominance of the US economy on a global scale.
- Asia should undertake changes in its exchange-rate regime. The key to these changes is the reform of China's decade-old peg which would ease pressure on other countries in the region to maintain competitiveness. While the recent revaluation of the yuan marks a step in the right direction, further adjustments are needed. However, given the described uncertainties, it would not be prudent to abandon the peg completely. Rather, monetary authorities should aim for a revaluation which both discourages speculative inflows and respects internal equilibrium. In the light of China's bilateral deficits with trading partners in Asia, unilateral appreciation of the renminbi is not an appropriate option. Exchange rate flexibility vis-à-vis the dollar should not result in intraregional volatility, both monetary and real. Therefore, exchange-rate reforms will have to involve all regional protagonists if movements in the foreign exchange markets are not to spiral out of control. A multilateral agreement is needed: revaluation of the yuan against the US dollar, while maintaining pegged rates against other Asian currencies. This is the case for regional currency areas.

Things would be easier, if the exact extent to which relative prices and absorption have to adjust across the globe were known. However, this seems to be an overly demanding task. Even more, knowledge concerning the effects of policy measures is limited: important variables such as the degree of exchange-rate pass-through cannot be pinpointed.

History offers examples of corrections of global imbalances, some of which – such as the Asian episode of 1997-98 – ended in regional crises and an upsurge in protectionism harming trade growth and welfare. But there are other examples where catastrophes have been avoided. Thus, any coordinated approach is obviously superior to isolated measures to cure world-wide imbalances: this may be the right time for a second Plaza Accord.