Global Imbalances

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1. Executive Summary

The United States has run trade deficits for nearly thirty years. As a result, the US current account has been in deficit every year but one since 1982.[1] In 2004 the deficit (as a percentage of GDP) soared to 5.1. This is significantly larger than any of the deficits (as a share of GDP) of the mid 1980s and is probably the largest in US history. In this note I ask the following: Why did this imbalance arise? Is sustainable? What is the likely impact on Euroland? What is the proper policy response?

2. How did the US current account deficit arise?

Summing the budget constraints of the government and all of the households and firms resident in a country yields the within-period budget constraint for a country as a whole:

$$\begin{aligned} & \text{net exports of goods and services + net investment income received from} \\ & \text{foreigners + net unilateral transfers (or gifts) received from foreigners} \\ = \ & \text{the change in home holdings of foreign assets - the change in foreign} \\ & \text{holdings of home assets} \end{aligned} \tag{1}$$

The left-hand side of the above expression is the *current account* balance; the right-hand side is the negative of the *financial account* balance.[2] The above equation is consistent with two sharply different views of the US current account deficit. First, the right-hand side suggests that the current account deficit is a result of global investors finding the United States an attractive place to invest. This is often the view of Bush administration officials; Under Secretary of the Treasury John Taylor [5] provides an example, saying, "Perceived high rates of return on U.S. assets, based on strong productivity growth relative to the rest of the world, combined with an efficient and secure U.S. capital market attracts foreign investment." Second, the left-hand side says that the United States is buying more from the rest of the world than it is producing; perhaps smoothing its consumption or perhaps living beyond its means.

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[1] A small, but positive, current account balance in 1991 was the result of transfers to the United States following the first Gulf War.

[2] Until recently, the right-hand side was known as the *capital* account. As it includes changes in central bank claims on foreigners it includes changes in official reserves. More precisely, the current account is the sum of net exports of goods and services (the trade balance) plus net (wage and investment) income plus *current* unilateral transfers. Unilateral transfers such as debt forgiveness, inheritance taxes, and the transfer of migrants' assets are now part of the (newly defined) capital account. Thus, the left-hand side is the sum of the current account and the capital account, ignoring wage income. This is unimportant for the United States; the capital account and wage income balances are relatively tiny.

3. ARE US CURRENT ACCOUNT DEFICITS SUSTAINABLE?

It is clear that there is feedback from the right-hand side of equation (1) to the left-hand side. Suppose that a country starts out with positive net foreign asset holdings and then runs sustained current account deficits. According to equation (1), this causes net foreign asset holdings to decline. As a result, net investment income on foreign asset holdings falls, tending to make the current account deficits even larger. Up until perhaps sometime in the mid 1980s – depending on how things are measured – the United States had strictly positive net holdings of foreign assets. US trade deficits were partially, or even more than, offset by sizable positive balances on the investment income account. However, accumulated current account deficits led to an estimated net US international investment position of *negative* $2,431 billion at the end of 2003. This has caused the investment component of the current account to fall from $30 billion in 1980 to near balance in the first half of 2004.[3] When net investment becomes negative, the United States will have to run trade surpluses to balance its current account.

Mathematically speaking, equation (1) is a difference equation. If we rule out the scenario where the United States runs a Ponzi game where its current account deficits grow in an explosive fashion and it satisfies equation (1) by borrowing ever-increasing amounts from abroad, then equation (1) can be solved to yield the following result. The value of the current net US international investment position must equal the present discounted value of all future net exports of goods and services and unilateral transfers from foreigners to the United States. In per capita terms, this can be expressed mathematically as

$$f_0 + \sum_{t=0}^{\infty} \prod_{s=0}^{t} \frac{1+\gamma_s}{1+r_s} c_t = 0, \tag{2}$$

where f_0 is the current US net international investment position as a fraction of GDP, c_t is net exports of goods and services plus net unilateral transfers received as a fraction of GDP in year t, r_t is the interest rate in year t and γ_t is the growth of GDP in year t. Thus, the sustainability of current deficits depends on current and future interest rates and growth rates of GDP.

It is clear from the *intertemporal budget constraint* in equation (2) that the United States can run current account deficits for years and still satisfy its budget constraint as long as future surpluses are large enough. But, at some point feasible future surpluses become too small to finance further deficits. It is difficult to say, however, at what point this is; one needs to predict the future capacity of the United States to generate surpluses, future interest rates and the growth of US GDP. Mann [3] suggests that a ratio of the current account to GDP of about four or five percent generally induces some change in economic forces which causes the deficit to decline.

Examples of countries that have run sustained current account deficits are not hard to find: both the United Kingdom and Canada ran significant deficits for about two decades; Australia has run deficits of about four percent of GDP for thirty years. It is clear from equation (2) that a country's ability to run prolonged deficits depends on its current net international investment position. At present, United States has a negative net international position as a share of GDP of around 25 percent. This is not unusually high for an advanced economy: the corresponding figure is 30 percent for the Netherlands, 40

[3] The investment account may remain positive when the net investment position is negative because rates of return may vary across countries and because some investments – such as equity – do not lead to regular payments.

percent for Finland, 60 percent for Australia and 80 percent for New Zealand. Nevertheless, deficits that would have been sustainable for the United States when it was a large international creditor are not sustainable now that it is a large international debtor.

4. What is the likely impact of the US current account deficit on Euroland?

If the United States continues to run sizable current account deficits, then at some point the negative net international position of the United States will become large enough that world investors will decide that the portion of their portfolios allocated to dollar-denominated assets is too high. As a result, the dollar would depreciate. This would lower the price of US goods relative to foreign goods, boosting US competitiveness and improving the US trade balance. This would reduce the left-hand side of equation (1) and the US current account deficit would decline. The size of the required decline in the dollar is debatable. Both Bergsten [1] and Obstfeld and Rogoff [4] have suggested that a further depreciation of at least 20 percent may be necessary. In addition to the decline in the dollar, the US - non-US interest rate differential would rise and this would decrease US investment relative to US savings, reducing net net capital flows into the United States, and reducing the right-hand side of equation (1).

The implications for Euroland of the above scenario are loss of competitiveness relative to the United States and to other countries that peg their exchange rate to the dollar and a decline in US demand for Euroland exports. These effects would be dampened if a more restrained US fiscal policy produced an increase in total US savings; if growth outside the United States led to an increase in demand for US exports; if increased flexibility of Asian exchange rates decreased the role of the euro/dollar exchange rate in restoring sustainability. The effects may be worse if the response is abrupt rather than orderly, or as Obstfeld and Rogoff [4] suggest, there is significant overshooting of the exchange rate.

An additional and indirect effect of the US current account deficits for Euroland and the rest of the world is increased protectionist pressure in the United States. Examples of this are the protectionist sentiments that were voiced by nearly all of the Democratic primary contenders in the US Presidential election and the recent furor over outsourcing.

5. What is the correct policy response?

In a frictionless world inhabited by rational market participants, current account imbalances are no cause for concern or policy intervention. Instead, imbalances are the desirable result of consumers optimally smoothing their consumption by borrowing from and lending to the rest of the world or of investors optimally allocating their savings across countries. If a country's export revenues vary because of changes in the world price of its export goods then it is sensible for that country to run current account imbalances. Large current account deficits may finance growth, as they did in Korea in the 1970s. In proposing any policy response then, it is important to ask exactly what friction, or market failure, is responsible for the current account imbalance.

The right-hand side of equation (1) can be rewritten as

> change in home holdings of foreign assets + change in home holdings of home assets - change in foreign holdings of home assets - change in home holdings of home assets = home savings - investment in home assets

In this view, the current account deficit is a result of investment in the United States exceeding savings. Savings in the United States hovers at historically low levels. Net private savings in the United States (as a fraction of NNP) has declined steadily in the past couple of decades, falling from about 10 - 12 percent at the start of the 1980s to below six percent in 2002. It is not completely obvious however, that this is a result of a market failure, or if it is, what the market failure is.

Alternatively, the right-hand side of equation (1) can be written as

home savings - change in foreign holdings of home assets - change in home holdings of home assets = home savings - private domestic investment - change in home and foreign holdings of home government bonds = home savings - private domestic investment - home government budget deficit

Under this view, the current account deficit is associated with either high private domestic investment in the United States or with large US government budget deficits. The first explanation fits the scenario of the mid-late 1990s when government budgets were low and private investment was strong. The second explanation fits the present. Since 2001, government budget deficits have ballooned. If we view net national savings as savings less the government's budget deficit (government dissaving) then net national savings (as a fraction of NNP) rose from about three per cent in 1993 to over seven percent in the mid 1990s and has now fallen to about one or two percent in the past year. The obvious policy response is for the United States to pursue entitlement reform with a view toward reducing its government budget deficit.[4]

Are too-high US current account deficits associated with suboptimal imbalances elsewhere in the world? It may be that current account balances outside the United States are too low because investment is insufficiently attractive outside of the United States. This may be a result of distortions and market failures in other countries. The appropriate policy response to this is for governments outside of the United States to pursue reforms. Examples of possible restructurings include labour-market reform in Euroland and financial-sector reform in Japan.

The right-hand side of equation (1) can also be interpreted as net capital inflows. It is then interesting to ask where these inflows are coming from. Higgens and Klitgaard [2] estimate that increases in the dollar reserves of emerging Asian central banks and the Bank of Japan in 2003 were equal in size to about 71 percent of the 2003 US current account deficit. This leads to the perhaps disturbing conclusion that US current account deficits are being financed by Asian central banks following the beggar-thy-neighbour strategy of improving their countries' short-run export performance by either pegging their exchange rates or intervening in foreign exchange markets to keep their currencies at artificially low levels, and thus, accumulating dollar-denominated assets. If this strategy is sufficiently successful a potential danger is that the United States will react to what

[4] In a frictionless model with infinite-lived forward-looking market participants, budget deficits – or the timing of taxes – have no effect on any real variable in the economy. Realising that the government must balance its intertemporal budget, households do not view a current tax cut as having any effect on the discounted present value of their tax liabilities. I assume that there exist distortions, such as liquidity constraints, that cause budget deficits to matter.

it sees as protectionism via the exchange rate with trade-restricting legislation that will damage Asian economies and the rest of the world in both the short and the long term. The appropriate policy response to this is greater exchange rate flexibility in Asia.

References

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