

THE SUSTAINABILITY OF THE US EXTERNAL DEFICIT

IS THE US CURRENT ACCOUNT DEFICIT SUSTAINABLE?

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Many have argued that the clear answer to the title question is negative. The US current account deficit, around \$600 billion a year and over five percent of US gross domestic product (GDP), is without precedent in size, and indeed is so large that it dominates the world economy. Although it is not actually the case, every other country in the world could be experiencing a current account surplus, and many in fact are running surpluses.¹

Three meanings

Since some confusion surrounds what exactly people mean when they say the current account is unsustainable, it is useful to distinguish three different intended meanings: 1) The current high level of the deficit cannot continue indefinitely. 2) A deficit running at five percent of GDP, or higher, cannot continue indefinitely. 3) Recent trends in the current account deficit, which has gradually risen as a percentage of GDP, cannot continue indefinitely. The first statement is false; the third is true; and the second depends on some quantitative details.

It is easiest to deal with the third statement. The US current account deficit is a measure of the extent to which foreigners are buying claims on the US economy – stocks, bonds, operating businesses, real estate and the like – net of purchases by Americans of similar claims on the rest of the world. Although the US physical capital stock, as it is conventionally measured, has not been rising relative to GDP, total financial claims within the United States have been rising somewhat more rapidly than GDP as financial

markets have become more refined and discriminating among assets, and as assets get packaged in various ways to provide alternative packages of liquidity, risk, and return to both ultimate and intermediate purchasers (e.g. pension funds) of those packages. But presumably such financial claims cannot rise more rapidly than GDP indefinitely, and foreigners can never own more than 100 percent of such claims, so at some point the foreign acquisition of claims must slow down. QED.

But if this is what analysts mean when they say the US deficit is unsustainable, they should say that recent trends are unsustainable, not, as is usually said, that the deficit is unsustainable.

Consider by contrast the first claim above, that the large US deficit of, say, \$500 billion a year cannot last indefinitely. To examine this claim, suppose the US economy has a trend rate of growth in nominal GDP of five percent a year, about three plus percent in real terms and two percent inflation. On official data at the end of 2002, foreigners had total claims on the US economy of \$2.6 trillion, net of American claims on the rest of the world. Given this initial situation, what are the implications of our two assumptions of five percent growth in nominal US GDP and an indefinite current account deficit of \$0.5 trillion? The ratio of net external claims to US GDP – a ratio many economists look at in assessing sustainability – will rise for some years, but it will reach a peak of 46 percent in 16 years (up from 25 percent in 2002), and then will begin to fall indefinitely thereafter.

Foreigners will by then own more of the US capital stock – just under a fifth (net of US claims abroad) if all the ownership were direct. But as noted above, the United States has several layers of financial assets above the capital stock, financial assets which foreigners typically buy, by now over three times the capital stock and still growing, so foreigners would own under ten percent of US financial assets. The yield on these assets would represent claims on US output, reducing the income of Americans relative to what it would be if more of the claims were owned by Americans, but almost certainly leaving American



Recent trends
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¹ A country's current account measures its exports of goods and services to the rest of the world, less imports of goods and services, plus net investment income and unilateral transfers, such as remittances.

incomes higher than they would have been had the rest of the world made fewer investments in the US economy (it depends on how much Americans would have invested on their own).

The deficit, while by assumption constant in dollar terms, will fall steadily as a share of (constantly growing) GDP, reaching 2.2 percent in 2018, the year in which the foreign claims/GDP ratio reaches its peak, and falling further thereafter. Does this trajectory look unsustainable? It may not come to pass, but it does not explode into unsustainability.

The current account deficit in 2004 rose above \$500 billion, indeed above \$600 billion, inflated in part by a sharp increase in oil prices which may recede in the next few years. The United States imports 12 million barrels of oil and oil products a day (600 mmt a year). An increase in oil prices of \$10 a barrel thus adds \$44 billion a year to the US import bill. But the logic above applies even if the US deficit were to stay constant at \$600 billion a year. Clearly this deficit is “sustainable,” although foreign earnings may be expected to rise with increasing ownership of US assets, so a constant current account deficit implies a declining trade deficit. Whether the deficit will in fact continue at this level remains to be seen. Whether it is desirable depends on what are the feasible alternatives, on which more will be said below.

The truth of the second statement depends on quantitative details. Consider, as above, that nominal US GDP grows indefinitely at five percent a year, and that the current account deficit is a constant *share* of five percent of GDP. Then net foreign claims on the United States will continue to grow indefinitely, eventually reaching the equivalent of US GDP. Thereafter both GDP and net foreign claims will continue to grow at five percent a year, and the ratio of foreign claims to GDP will remain constant at unity. While a large number (although exceeded today by the debt/GDP ratio of several dozen developing countries), it does not explode into unsustainability. If the average yield on the foreign claims equals five percent, however, trade in goods and services must be in balance to preserve the equilibrium. A yield lower than five percent would permit some continuing trade deficit.

If, however, nominal GDP grows at five percent and the current account deficit exceeds, say, ten percent of GDP, the pattern is not sustainable: foreign net

claims grow more rapidly than GDP, and this is a process that cannot go on indefinitely.

The discussion above has focused exclusively on the United States. But the US deficit is two-sided; it intimately involves the rest of the world. Do developments there compel a markedly different assessment? The world outside the United States generates some \$6 trillion in savings, growing from year to year. Most of this saving of course is invested at home. The US current account deficit implies, however, that the rest of the world is also investing its savings in the United States – around ten percent on a net basis, more if allowance is made for the fact that Americans are also investing some of their savings abroad.

The US economy accounts for over a quarter of the world economy in output (valued at market exchange rates, as it should be when cross-border investment is being considered) and about half of the world’s marketable financial assets. Furthermore, it provides higher real returns to capital than do Europe or Japan, and returns that are more reliable and secure than those offered by emerging markets. Property rights are well established and dispute settlement is impartial by comparison with many other countries. Markets are well developed and relatively liquid. Is it inconceivable, in today’s globalizing world, that savers around the world will want to put 10 to 15 percent of their savings, a share that would fall over time in the scenario of a constant deficit, into the United States?

The large and rapidly growing savings in China and India have hardly been tapped, being bottled up by the exchange controls both of those countries still maintain. Investment opportunities in the United States would be highly attractive to many newly rich Chinese and Indians. It is conceivable that the US deficit could even grow over time as investment opportunities are made available.

Is a continuing US deficit desirable?

Even if a continuing large US current account deficit is sustainable, is it desirable? In some abstract sense, it seems undesirable that Americans should be selling assets (as opposed to goods and services) to sustain their current private and public consumption. But we do not live in a world of abstraction. What are the feasible alternatives, and would the conse-

As long as the current account deficit as a share of GDP does not exceed the growth rate of GDP, it is sustainable

quences of serious actions to reduce the deficit be more desirable than its continuation?

One course of action widely recommended, to which I subscribe, is that the US government should take serious steps to reduce the federal budget deficit, likely to exceed \$400 billion in 2005 – not by proposing cuts in expenditures on public programs with wide public support, as President Bush did in early February, many of which are unlikely to pass muster with Congress, but by raising taxes to pay for the programs that the public wants and for the national security expenditures that the President wants. President Bush is unlikely to support serious tax increases, so this natural fiscal adjustment will unhappily have to wait for a few years. In any case, a sharp and significant increase in taxes would risk aborting the continuing recovery, so it should be firm but gradual. The assumption is that investment will not decline even as public and private consumption are restrained. This assumption may be warranted by the expected improvement in the US trade balance brought about by the dollar depreciation of 2002 to 2003 and by improved economic growth abroad compared with the early years of the decade.

The focus here has been on sustainability, not whether it will actually occur. Suppose private investors around the world choose not to invest \$500 to 600 billion in the US economy, even though heavy net private investment occurs. The dollar will depreciate. Indeed, this was the case in 2002 to 2003, not just against the euro and the yen, but also against the British pound, the Canadian dollar, and indeed many other currencies during 2004, such as the Korean won, the Thai baht, even the Indian rupee. Some adjustment from the very strong dollar of 2000 to 2001 was welcome, not least by US businesses, which felt the competitive pressure created by a strong dollar, both in the United States and in export markets. But extensive depreciation of the dollar was not welcome by countries that see their economic health closely tied to export performance, which is the case for many countries. Some economies – Malaysia,

Hong Kong – formally link their currencies to the dollar. Others, most notably China, do so in practice, at a rate of 8.28 rmb to the dollar since 1995. Still others allow some movement in the exchange rate, but resist too strong or too rapid an appreciation of their currencies by official intervention in the foreign exchange market. Indeed, this is the case for most countries. The European Central Bank on behalf of the 12 countries of euroland is the main exception.

The consequence of these exchange rate policies has been a huge accumulation of official foreign exchange reserves over the period 2003 to 2004: \$800 billion. Countries do not publish the currency composition of their reserves, but the IMF reports that as of the end of 2003 60 percent of total official reserves were in US dollars, and over 90 percent of the new purchases of foreign exchange during 2003 were in US dollars.

In effect, then, official foreign investment in the United States substitutes in part for private investment, since central banks typically buy US Treasury securities to compensate for the shortfall in (still extensive) private purchases of claims on the United States.

Why is this happening? The short answer is that countries do not want to lose export markets, especially to the United States, because of currency appreciation. But why not? Part of the answer lies in the disruption that large and unpredictable swings in exchange rates cause. Once established in a major market, firms prefer to protect their positions there rather than yield ground and then re-enter whenever currency values temporarily make the market unattractive or attractive. Large gyrations in currency values such as the world has experienced in the last decade between the yen and the dollar and between the euro and the dollar make business planning difficult.

But another part of the answer is the perception – certainly in emerging markets, but even in some mature economies such as Japan and Germany – that economic well-being depends particularly on exports, and if exports falter the economy will falter. This view, in turn, is based partly on habitual thinking formed in the past but carried into the present, but partly on a lack of adequate domestic demand to sustain economic growth. Contrary to the teaching of most economists these days, where output is con-

The building-up of foreign exchange reserves means high official foreign investment in the United States

Exchange rates, 2000–2004

End of Period	2000	2001	2002	2003	2004
Euro/\$	1.07	1.13	0.95	0.79	0.73
Yen/\$	115	132	120	107	104
Br.£/\$	0.67	0.69	0.62	0.56	0.52
Can\$/	1.50	1.59	1.58	1.29	1.20

strained solely by capacity to produce, which in turn depends on the available labor force, capital stock, and production technology, this view involves the “Keynesian” recognition that in some, perhaps many, circumstances additional production can be brought forth by additional demand, not only in the short run but even in the long run as additions to capacity respond to the growth in demand. Export demand, which produces foreign exchange that can be translated into imports of modern investment goods, can call forth new investment and more productive employment of labor. Indeed, this perception provided the basis for a successful development strategy in Japan, South Korea, Thailand, and many other countries. Hence many countries are reluctant to have too strong a currency.

Even though the euro, pound, and yen have appreciated significantly against the dollar over the past three years, US import prices for manufactured goods have not risen correspondingly. For instance, prices of US imports of manufactures from the European Union rose only 11 percent over the period 2000 to 2004, despite a 46 percent appreciation of the euro and a 29 percent appreciation of the British pound against the US dollar over this period, plus some modest inflation in Europe. The US market is sufficiently important to many foreign suppliers that they squeeze their margins to retain sales rather than raise prices to cover the appreciation of their home currency against the dollar. This process of course cannot go on indefinitely, not least because US anti-dumping rules make failure to adjust prices after 60 days following a currency appreciation actionable if the price of sale in the US market is below the price in the market of the exporting country.

It should be noted in passing that a depreciation of the dollar attenuates the connection between the current account deficit and the net accumulation by foreigners of claims on the United States. This occurs because Americans have substantial claims (\$6.5 trillion at the end of 2002) on the rest of the world, and the dollar value of these claims rises with depreciation of the dollar, thus in part offsetting the net acquisition of foreign claims on the American economy arising from the current account deficit.

Finally, and perhaps most fundamentally, at present there seems to be an excess of private savings in many countries, both rich and emerging. That is, private savings exceed the effective domestic demand for investment. In continental Europe and Japan,

private savings continue to be high, in part because post-war baby-boomers are now in their peak earning and saving years and low birth rates mean spending on children is much reduced. Investment opportunities are relatively low, as the capital-labor ratio is already very high in industry, and new household formation is low, thanks to low birth rates over recent decades, so demand for housing is not what it would be if new households were growing at earlier rates.

In China, investment opportunities are many, and indeed the rate of investment has been extraordinarily high – too high in 2003 to 2004, according to China’s authorities. But the savings rate, remarkably, is even higher, and China’s nascent capital market does a poor job of allocating China’s high savings to its most productive investment opportunities. The main role of foreign capital in China is not so much to augment scarce capital resources as to surmount the imperfections in China’s financial system, as well as bringing foreign technical, managerial, and marketing skills.

The manifestations of these high net savings in many countries are large budget deficits and significant net foreign investment. That is, domestic savings, lacking attractive domestic investment opportunities, are invested in government securities or abroad. Budget deficits within Europe are constrained to three percent of GDP by the Stability Pact, and Japan’s deficit is widely considered to be unsustainably high. But if the savings are not to be placed, directly or indirectly, in government securities, and cannot in full be placed in domestic investment, where are they to go? Either they go abroad in the form of an export surplus, or they get dissipated by slack economic activity, even recession. If private parties prefer domestic instruments, out of familiarity or desire to avoid currency risk, and dollar depreciation would lower real returns to export-oriented domestic investment, the government can intermeddle by inhibiting currency depreciation and by, in effect, absorbing the currency risk by holding higher foreign exchange reserves. The practical alternative, it needs to be stressed, is sluggish growth at best or perhaps even recession.

The textbook resolution to the problem of “excess” savings is that real interest rates will fall and this will possibly reduce saving and certainly increase investment. Whatever its merits in other settings, this resolution is simply fanciful in slow-growing, aging soci-

Excess savings
of many countries
seek investment
opportunities abroad

eties such as Japan and parts of Europe. Business will not invest in new capacity no matter how low the borrowing rate if it cannot sell the resulting product. Japan has experimented with exceptionally low interest rates during the past few years, both short-term and long-term, without stimulating significant domestic investment. Japan has found it expedient to intervene heavily in the foreign exchange market to prevent the yen from appreciating too far too rapidly. Low rates of new household formation hold down the demand for housing, the most sensitive component of demand to long-term interest rates. The equilibrators in the presence of excess saving is not lower interest rates, but government deficits and/or investment abroad leading to export surpluses – with Americans obliging by being willing to absorb the surpluses from the rest of the world in high consumption and in higher investment.

If Americans invest the funds they receive from abroad, and pay out less than they earn, everyone benefits, given the low returns in Europe and Japan. Obviously this does not work if instead Americans are providing government securities, financing the difference between what the government spends and what it receives in taxes, rather than building productive capacity for the future. Thus Americans should be concerned, not about borrowing from abroad, but about borrowing from abroad to finance large budget deficits rather than domestic investment. The budget presented by President Bush in February for the fiscal year 2006 slightly cuts nominal discretionary funding for health, education, and non-defense research and development, government consumption that arguably builds future capacity. Increases in salaries mean real cuts will be significant.

European and Japanese private saving will presumably fall over the next two decades, as those born after 1945 retire in increasing numbers and they are not replaced fully by people moving into the high saving ages. The United States will thus experience smaller inflows of funds, unless growing prosperity in China, India, and other emerging markets produces savings in excess of desired investments in those countries, and especially as such countries increasingly relax the controls on the outflow of resident capital and Chinese, Indians, and others find new and attractive investment opportunities in the United States.

In sum, the current level of the US current account deficit is not unsustainable, and indeed may continue

for a number of years. Surprisingly, that may even be desirable for the world economy, given the current level of excess savings in the world outside the United States and a few other countries, such as Australia and Britain. One can imagine a world economy with a more satisfactory configuration of saving and investment across countries, but we have no easy way to get there.