The US current account deficit: will there be a hard landing?

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Key indicators for the US economy

- GDP growing at annual rate of 3.5%
- Current account deficit at $635 billion – 6% of GDP
- Fiscal deficit $412 billion – 3.6% of GDP
- US inflation rate rising
- Interest rate – 4%, 10 year bond yields – 4.6%, US$ at two-year high
Current account deficit

Bigger and worse
Current-account balances, $bn

- Germany
- Oil exporters
- Other Asia
- China
- Japan
- United States
- Britain

Source: IMF

2001 02 03 04

400 600 800
US inflation rate

Climbing again
Consumer prices
% increase on a year ago

Correlation between inflation and change in unit labour costs

1965-79 1991-2004
0 0.2 0.4 0.6 0.8 1.0

Britain
Japan
United States
Germany
Italy
France

G7 economies

Sources: OECD; US Bureau of Labour Statistics; BIS
Is the deficit “made” in China?

- Politicians see China as the culprit
- Yuan pegged to US$ for past decade, but peg was abandoned in July 2005
- Yuan would have to appreciate by 5-10% over next 12 months to even dent deficit
- China accounts for only a fraction of US trade deficit
Freeing up the Yuan

**Little appreciated**
Chinese yuan against the dollar

<table>
<thead>
<tr>
<th>Month</th>
<th>Inverted scale</th>
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<tbody>
<tr>
<td>July</td>
<td>8.08</td>
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<tr>
<td>August</td>
<td>8.09</td>
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<td>September</td>
<td>8.10</td>
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<td>2005</td>
<td>8.11</td>
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<tr>
<td>2005</td>
<td>8.12</td>
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</table>

Source: Thomson Datastream

**Not guilty**
US trade deficit as % of GDP by region

Source: UBS
A lack of US savings?

- Net national saving at 2% of GDP – lowest since the Great Depression
- Personal savings rate is negative
- Consumers borrowing against increasing house prices – 13%/year
- Debt service at a record high
US savings rates

A picture of decline
Net national saving rates as % of GDP
- Japan
- Germany
- Italy
- France
- Britain
- United States

Sources: PricewaterhouseCoopers; OECD

Come tomorrow
Net household saving rates as % of disposable household income
- Italy
- Germany
- Japan
- United States
- France
- Australia

Source: OECD
*Estimate
Getting rich quick..........
Or is it “Bernankeconomics”

- Dismisses “twin-deficits” argument
- Lack of US savings more likely due to external factors
- A “global savings glut” – helps finance US trade deficit
- Link between growth and interest rates may not hold
US treasury bond yields

Rock ‘n’ roll yields
American bonds and growth

- Bond yield, ten-year Treasuries, %
- Nominal GDP, % change on a year earlier

Sources: HSBC; Thomson Datastream
Where is the glut though?

**What glut?**
Global saving and investment as % of world GDP

**Shifting fortunes**
G7 net saving balances, % of GDP

Source: IMF

Source: UBS
Investment vs. savings

- Low investment rates may explain low interest rates - but not imbalance between US and world

- Explanation lies in differing economic structures and policies:
  - fiscal/monetary stimulus in US since 2001
  - Asia has built up foreign-exchange reserves
  - China’s savings rate and rising price of oil
Frugal China

In a league of its own

Gross national saving as % of GDP

China  Japan  Asia excluding China and Japan  United States  Germany

Gross domestic investment as % of GDP

Source: IMF
Asian tigers and oil exporters

**The China effect**
Investment as % of GDP

- Asia (excl. Japan)
- Asia (excl. Japan and China)

Source: Goldman Sachs

**Let’s be prudent**
Oil producers’ national saving and investment % of GDP

- Investment
- Saving

Source: IMF
Where’s the money gone?

- Increased foreign exchange reserves
- 50% of US bonds purchased by foreign central banks in 2003/4
- In 2004 – central banks financed 60-70% of US trade deficit
- US treasury bond yields determined in Beijing – a “balance of financial terror”
Foreign exchange reserves and US bonds

Too much of a good thing
World foreign-exchange reserves*, $tn

<table>
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<tr>
<th>Year</th>
<th>2000</th>
<th>01</th>
<th>02</th>
<th>03</th>
<th>04</th>
<th>05†</th>
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<td>Asia†</td>
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</tbody>
</table>

Source: IMF
*Minus gold
†Including Japan
‡Latest

Waning appeal
Global increase in reserves and foreign central-bank purchases of US Treasuries, $bn

- Increase in reserves
- Purchases of Treasuries

Source: Brad Setser, Roubini Global Economics

2005-06 Policy & Outlook Program
What is a hard landing?

- Trade deficit → crash in US$
- Domestic inflation → nominal rates of return have to rise
- Inflation → interest rates rise
- Inflationary expectations → bond yields rise due to risk premium
- House price “bubble” bursts
Might there be a crash?

- Decline in purchase of US bonds causes US$ to depreciate
- Short-term rates and bond yields rise
- End result – global recession
- Policy implications:
  - reduce savings surplus in China
  - encourage savings in US
  - reduce US budget deficit
  - EU should ease interest rates
Is this too pessimistic?

- Purchases of US bonds have fallen in 2005, yet US$ has appreciated
- Recent currency depreciations followed by falling bond yields
- Investors believe inflation has been tamed by monetary authorities
- Greenspan may be right – US imbalances will adjust gradually
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