The US current account deficit: dark matter or black hole?

"Globalization Outlook: Its Impacts and our Region's Response"

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Key indicators for the US economy

- GDP growing at annual rate of 3.3%
- US inflation rate rising ☞ 3.6%
- Interest rate ☞ 4.75%, 2 year bonds – 4.79%, 10 year bonds ☞ 4.78%
- Fiscal deficit $427 billion ☞ 3.7% of GDP
- Current account deficit $805 billion ☞ 6.8% of GDP (2006 ☞ $1 trillion)

What is the US current account?

- **Current account balance =**

Trade Balance		Investment Income
Exports - Imports	+	Return on Assets - Liabilities

International Investment Position

= Assets – Liabilities (adjusted for capital gains)

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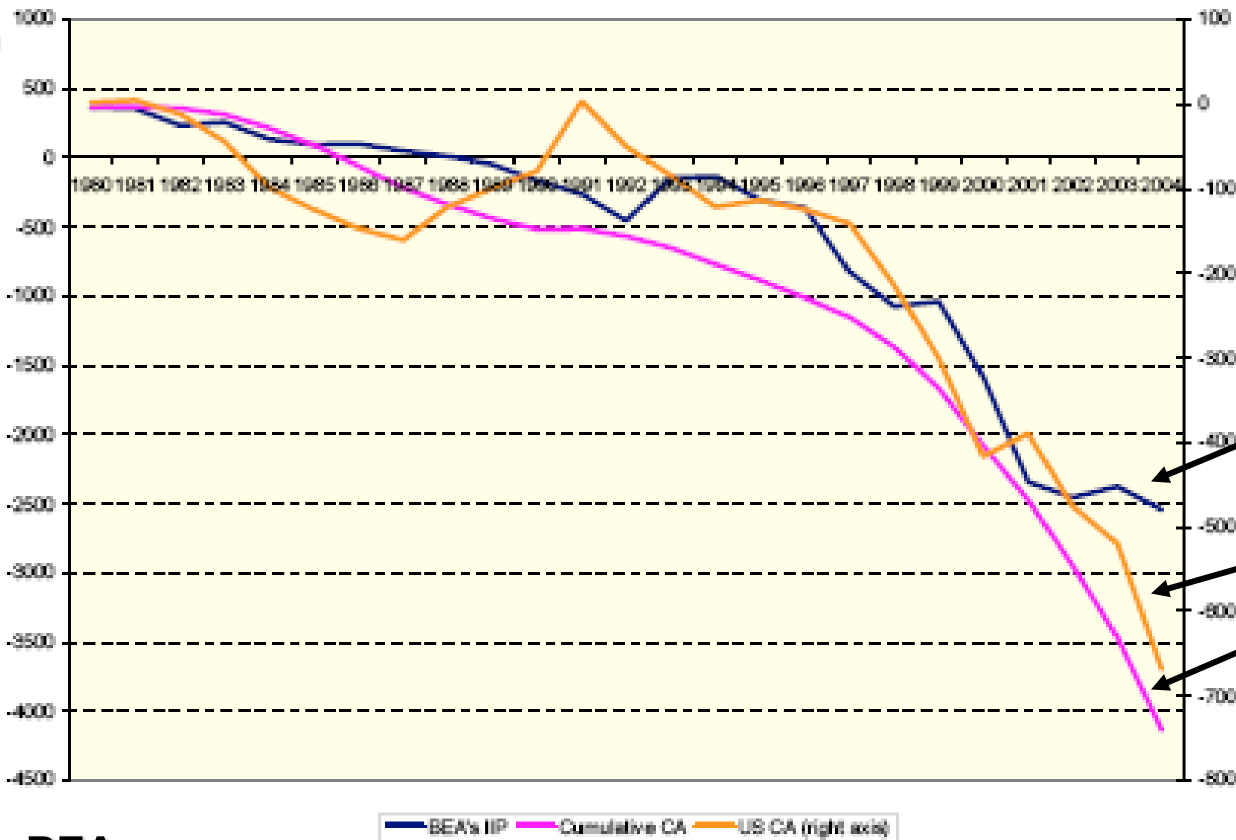
The cumulative deficit……

US Current Account and International Investment Position

($ billion)

($ billion)



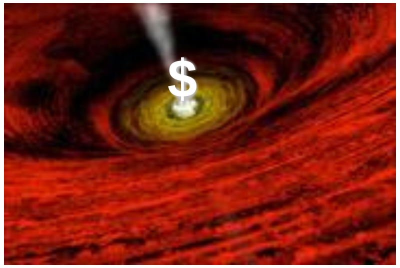
Net foreign assets

Current account

Cumulative current account

Source: BEA

A black hole?



- **External debt generating significant concern:**

  ☞ **“the US is now on the comfortable path to ruin” (Martin Wolf, *Financial Times*, 2004)**

  ☞ **“any sober policymaker ought to regard the US current account deficit as a sword of Damocles over the global economy” (Maurice Obstfeld and Kenneth Rogoff, 2005)**

- **Others claim:**

  ☞ **“this is just confusion caused by an unnatural set of accounting rules” (Ricardo Hausmann and Federico Sturzenegger, 2005)**

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Is there dark matter?

- Net foreign assets ☞- $2.5 trillion in 2004
- Yet US earned +$36.2 billion on assets in 2004 ☞ implying net foreign assets of +$724 billion given a 5% rate of return
- Income flow steady since 1980 ☞ net foreign asset stability, i.e., "dark matter"
- Dark matter results in current account stability

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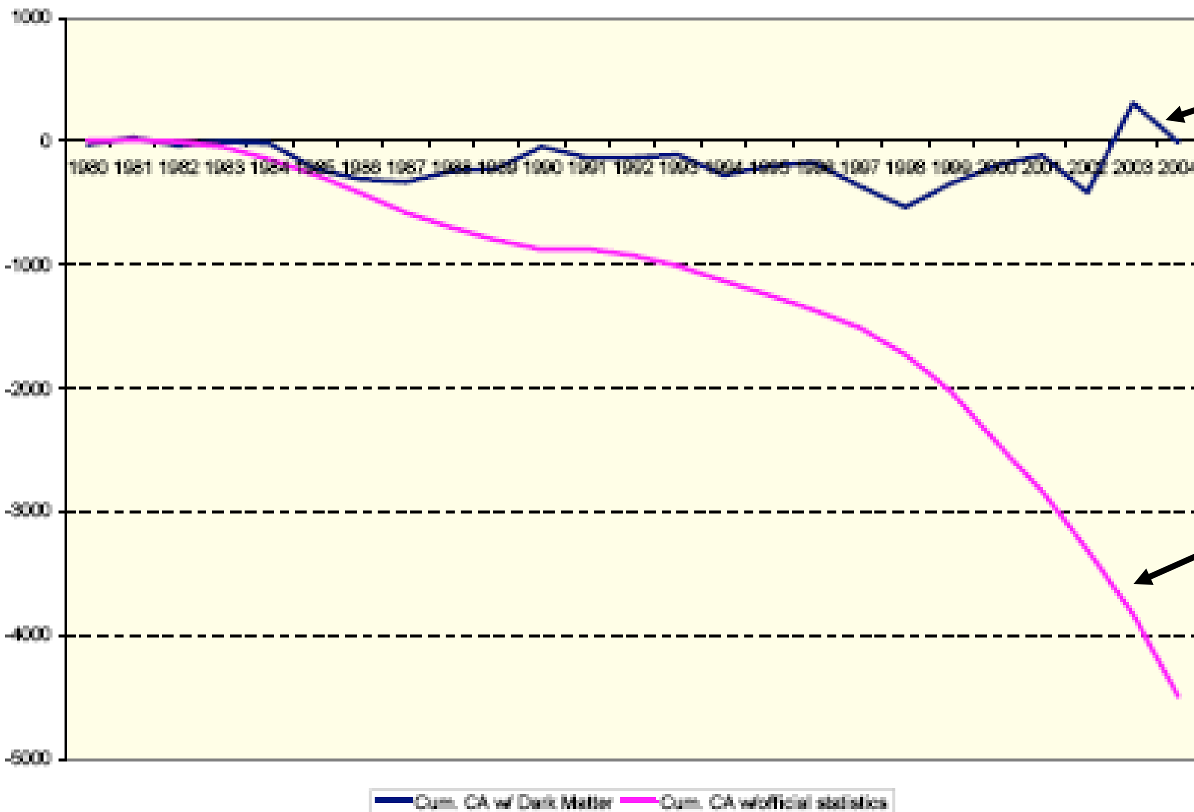
Effect of dark matter

Current account with and without dark matter



Current account with dark matter

Current account without dark matter

Source: BEA/IMF

What is dark matter?

- Difference due to “dark matter”:
  - returns to US “know-how”
  - provision of liquidity
  - US earns a risk premium
- Story has serious problems:
  - analysis sensitive to fixed rate of return
  - $724 billion of assets in 2004 smaller in relation to overall economy compared to 1980
  - dark matter actually very unstable

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Is the deficit “made” in China?

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

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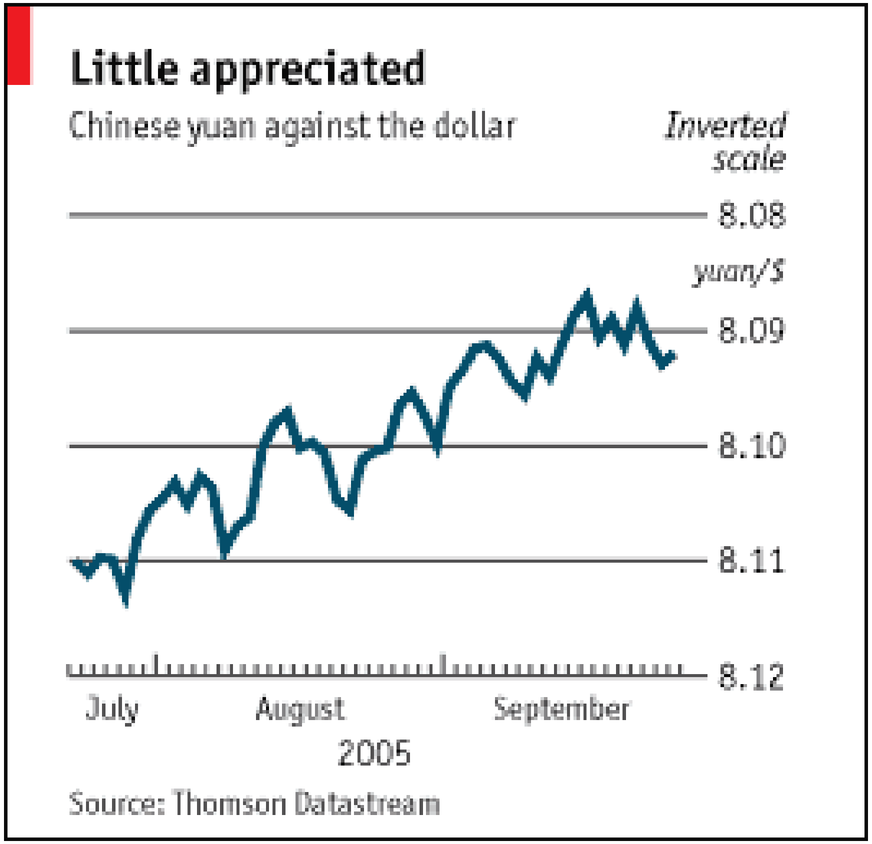
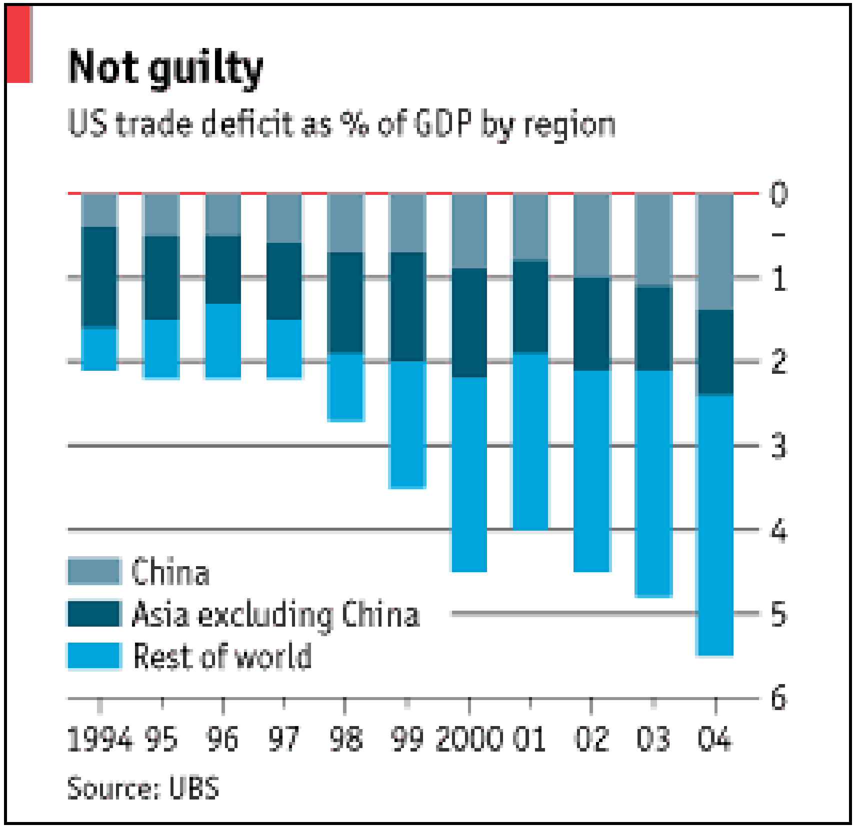
Freeing up the Yuan





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

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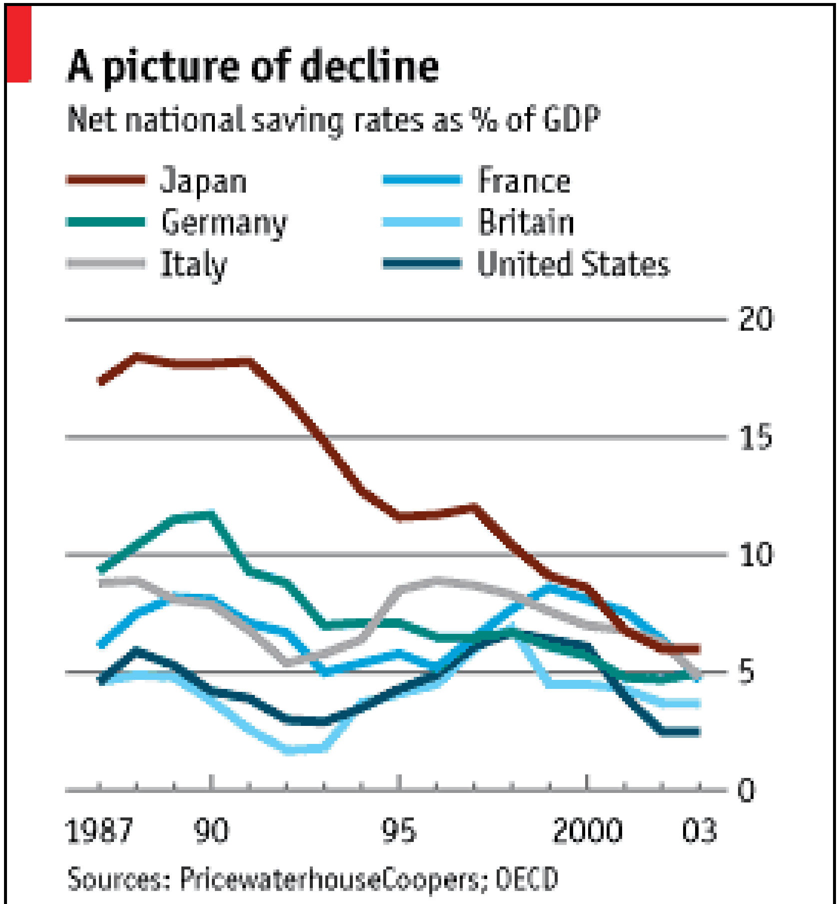
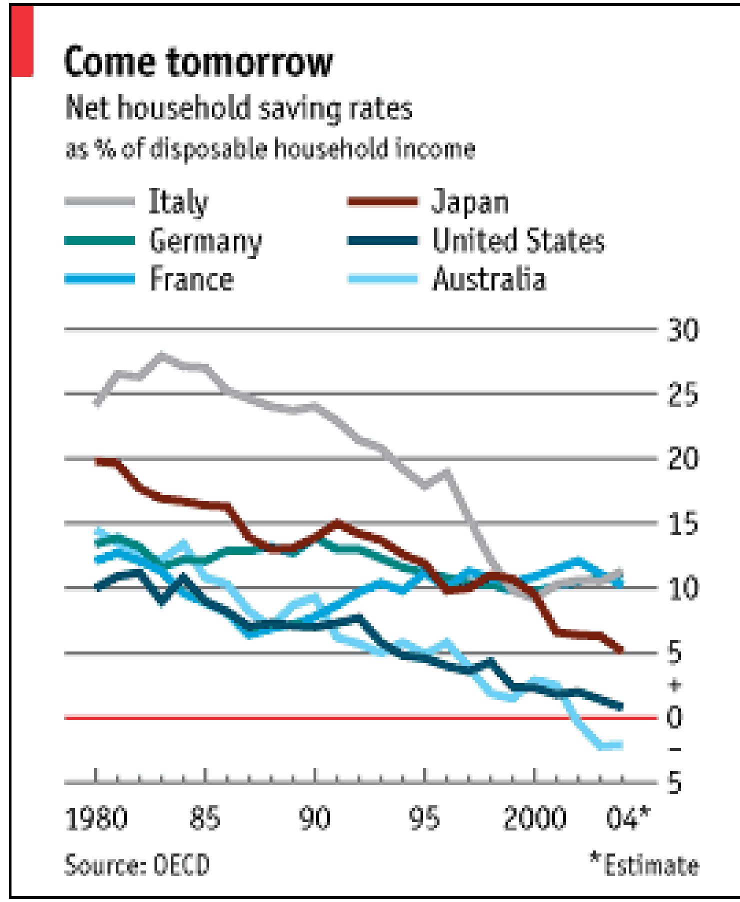
US savings rates





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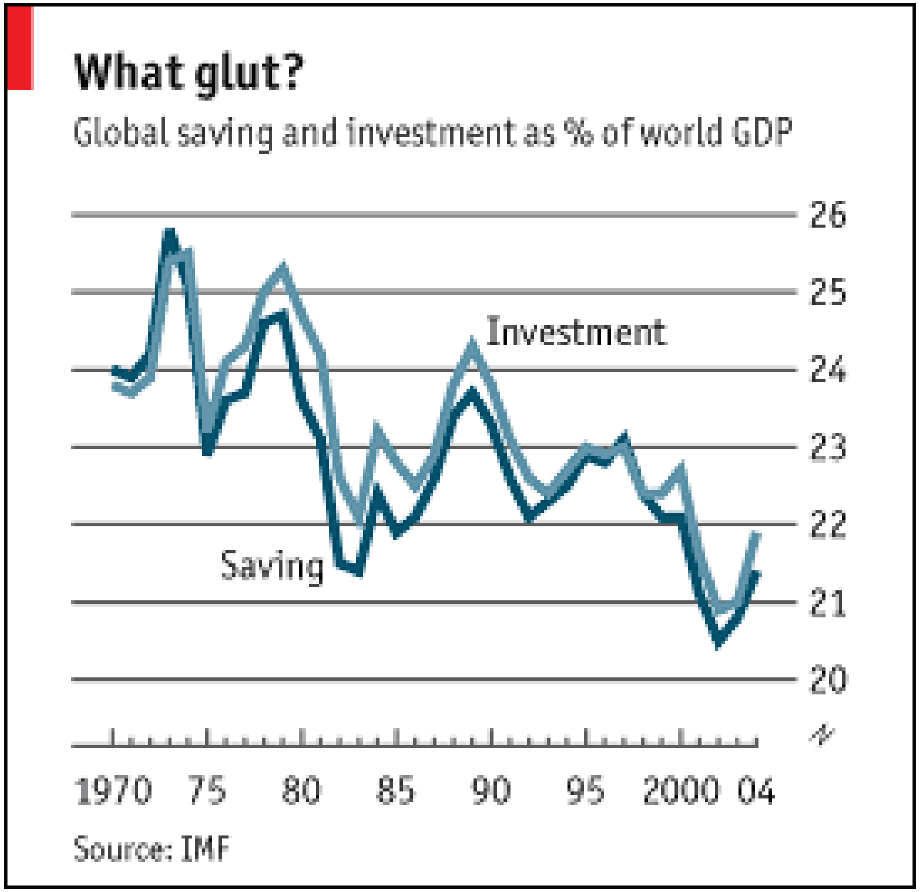
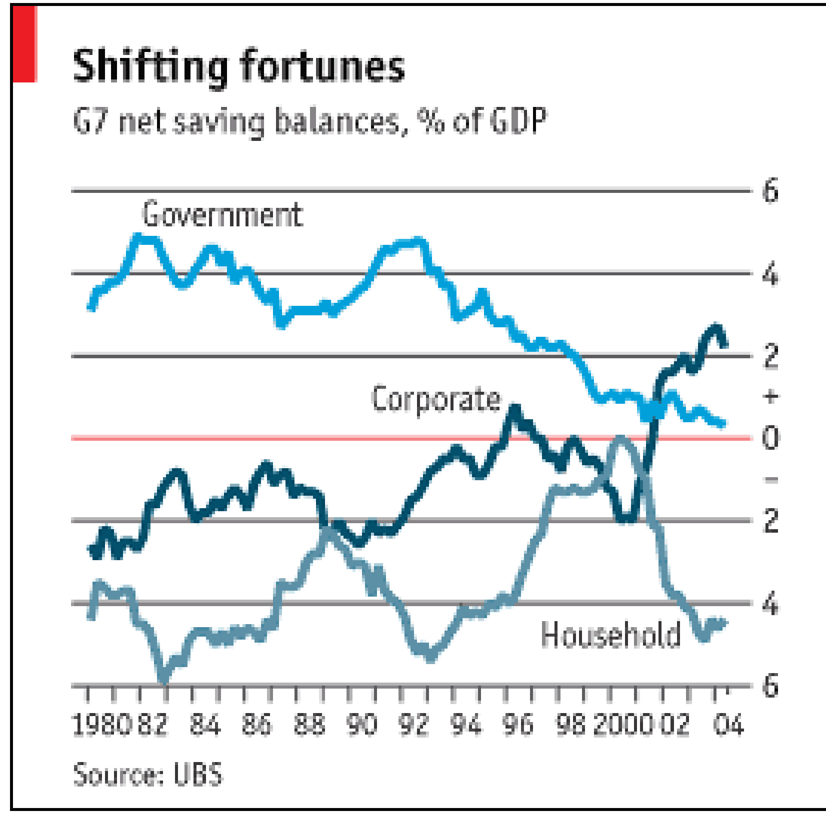
Is it “Bernankeconomics”?

- 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 at present

Where is the glut though?





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
  - China's savings rate and rising price of oil
  - Asia has built up foreign-exchange reserves

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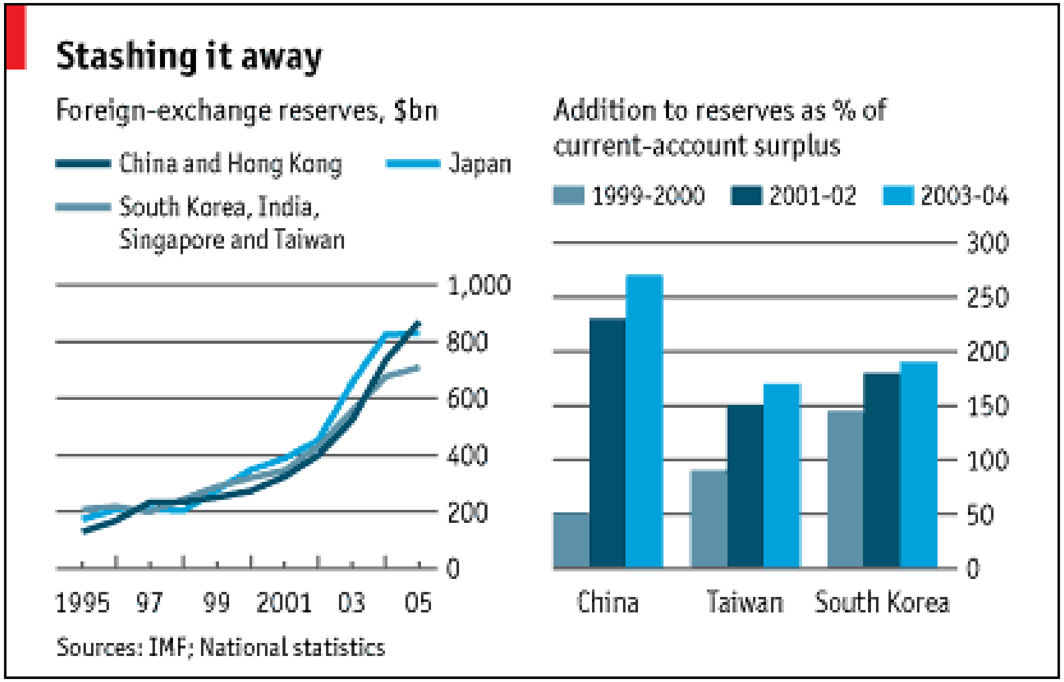
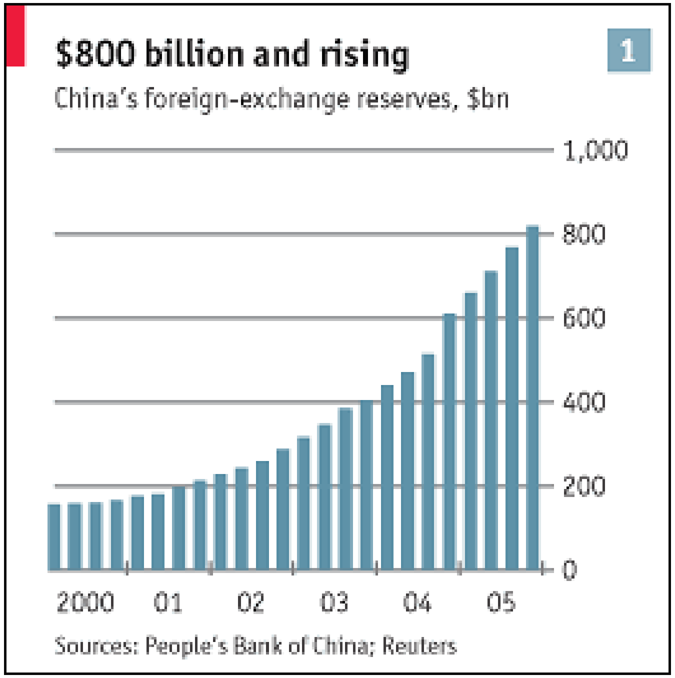
Foreign-exchange reserves and US bonds

- Increased foreign exchange reserves
- 50% of US bonds purchased by foreign central banks in 2003/4
- In 2004 ☞ foreign central banks financed 60-70% of US trade deficit
- US treasury bond yields determined in Beijing ☞ a "balance of financial terror" (Larry Summers, 2004)

Foreign exchange reserves





Why the build-up of reserves?

- 1997-98 Asian financial crisis
- Policies of export-led growth and pegged currencies in Asia
- Absorption of large Chinese labor force with high savings rate
- Weak domestic banking systems in Asia
- Need for international financial intermediation ☞ currency reserves provide protection against capital "flight"

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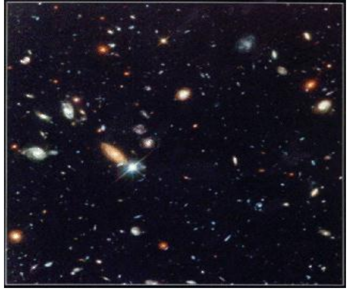
A “big bang”?



- Asian central banks face huge risk by holding reserves in dollar-denominated assets
- Decline in purchase of US bonds would cause US$ to depreciate
- Short-term rates and bond yields would have to rise
- End result ☞ global recession

Too pessimistic?

- Purchases of US bonds fell in 2005, yet US$ 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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