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

“Globalization Outlook: Its Impacts and our Region’s Response”

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OSU AED Economics
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)
The cumulative deficit......

US Current Account and International Investment Position

Source: BEA

7/3/2013

2005-06 Policy & Outlook Program
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)
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
Effect of dark matter

Current account with and without dark matter

Source: BEA/IMF

2005-06 Policy & Outlook Program
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
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
Freeing up the Yuan

**Little appreciated**
Chinese yuan against the dollar

<table>
<thead>
<tr>
<th>Date</th>
<th>Yuan/$</th>
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<tbody>
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<td>July 2005</td>
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<td>August 2005</td>
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<td>2005</td>
<td>8.12</td>
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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

<table>
<thead>
<tr>
<th>Year</th>
<th>Japan</th>
<th>Germany</th>
<th>Italy</th>
<th>United States</th>
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</table>

Sources: PricewaterhouseCoopers; OECD

Come tomorrow
Net household saving rates as % of disposable household income

<table>
<thead>
<tr>
<th>Year</th>
<th>Italy</th>
<th>Germany</th>
<th>Japan</th>
<th>United States</th>
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<td>2004*</td>
<td>0</td>
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</tbody>
</table>

Source: OECD

*Estimate
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?

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

Stashing it away

Foreign-exchange reserves, $bn

- China and Hong Kong
- Japan
- South Korea, India, Singapore and Taiwan

Addition to reserves as % of current-account surplus

- 1999-2000
- 2001-02
- 2003-04

China, Taiwan, South Korea

Sources: IMF; National statistics

$800 billion and rising

China’s foreign-exchange reserves, $bn

Sources: People’s Bank of China; Reuters
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”
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