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

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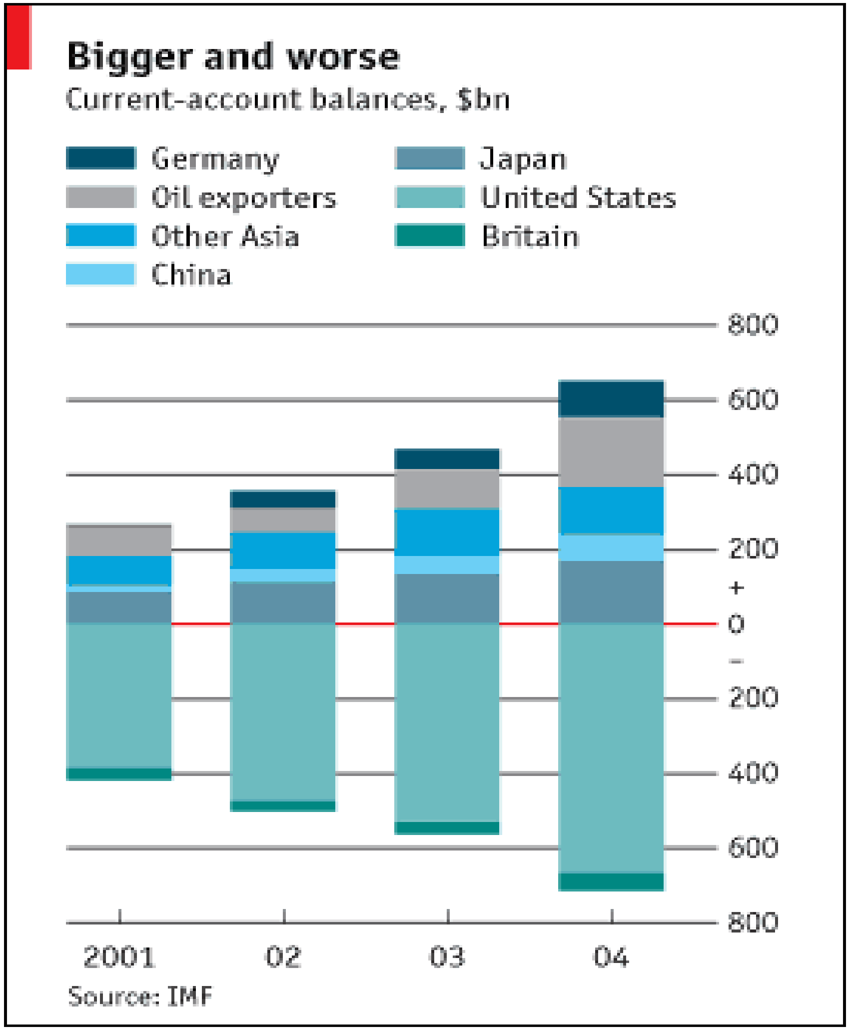
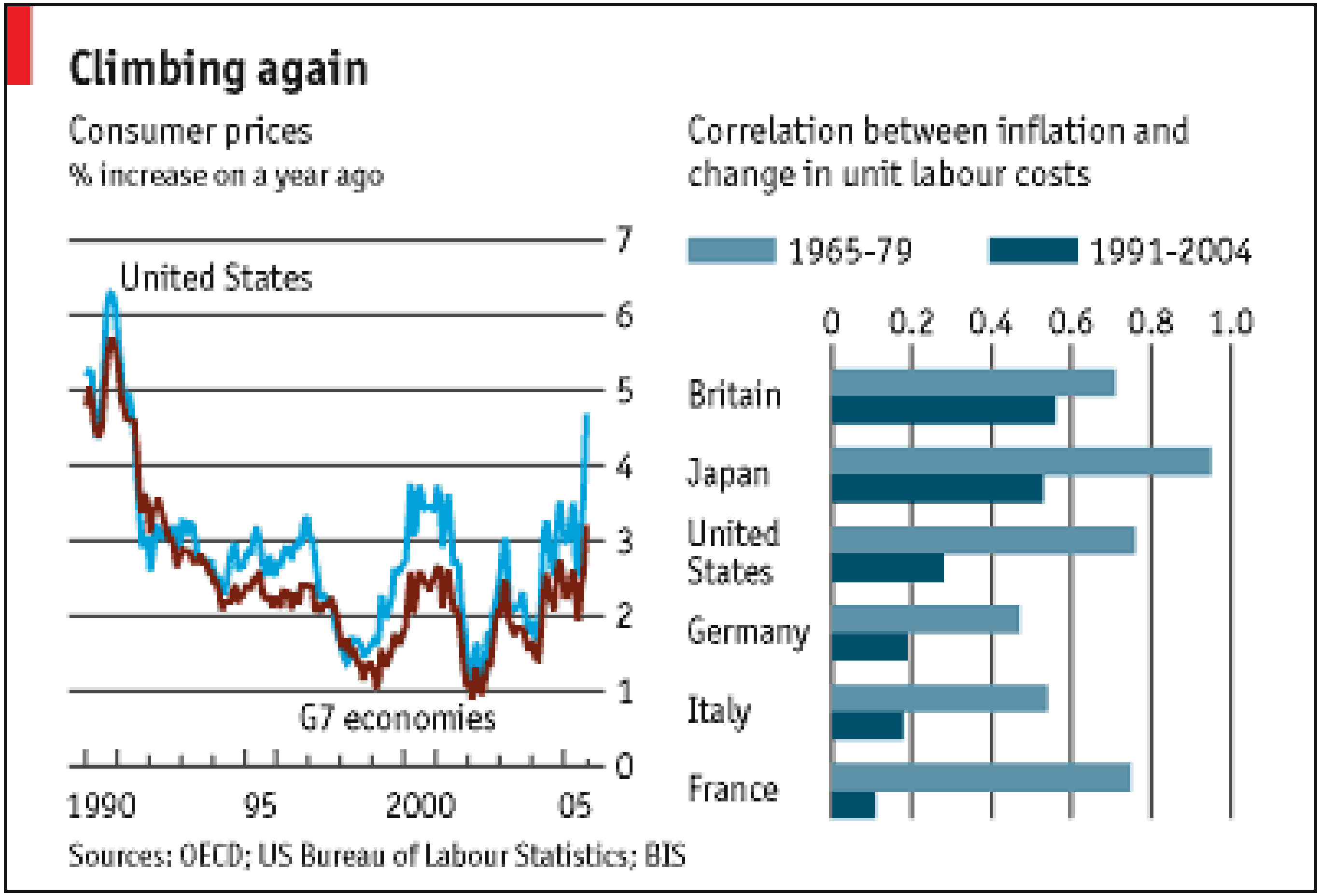
Key indicators for the US economy

- 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



US inflation rate



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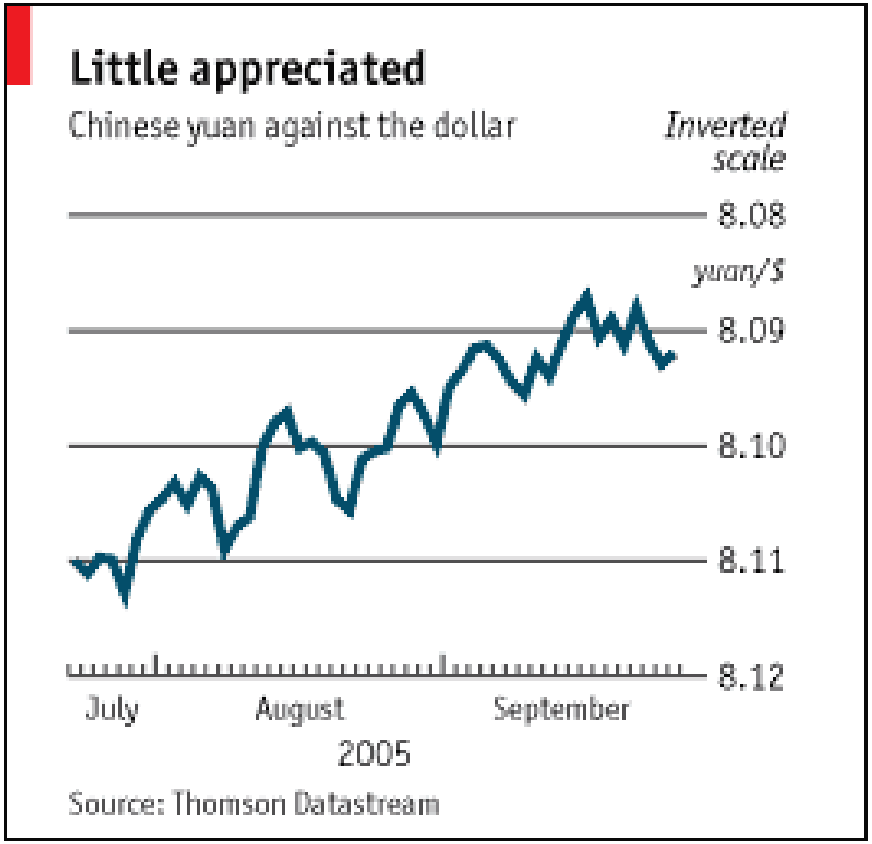
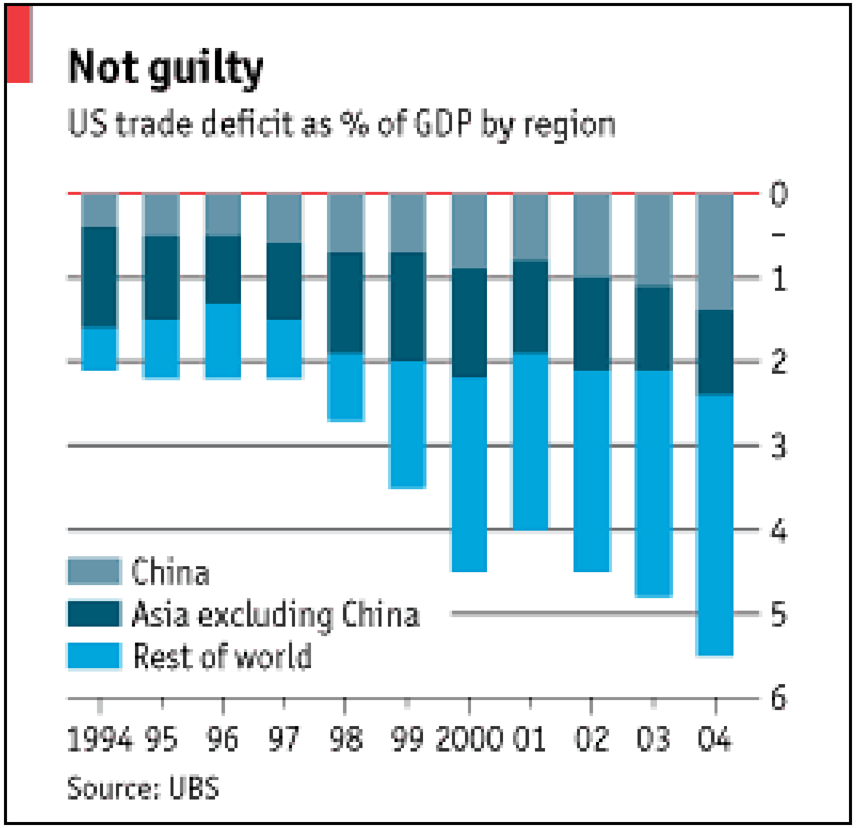
Is the deficit "made" in China?

- 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





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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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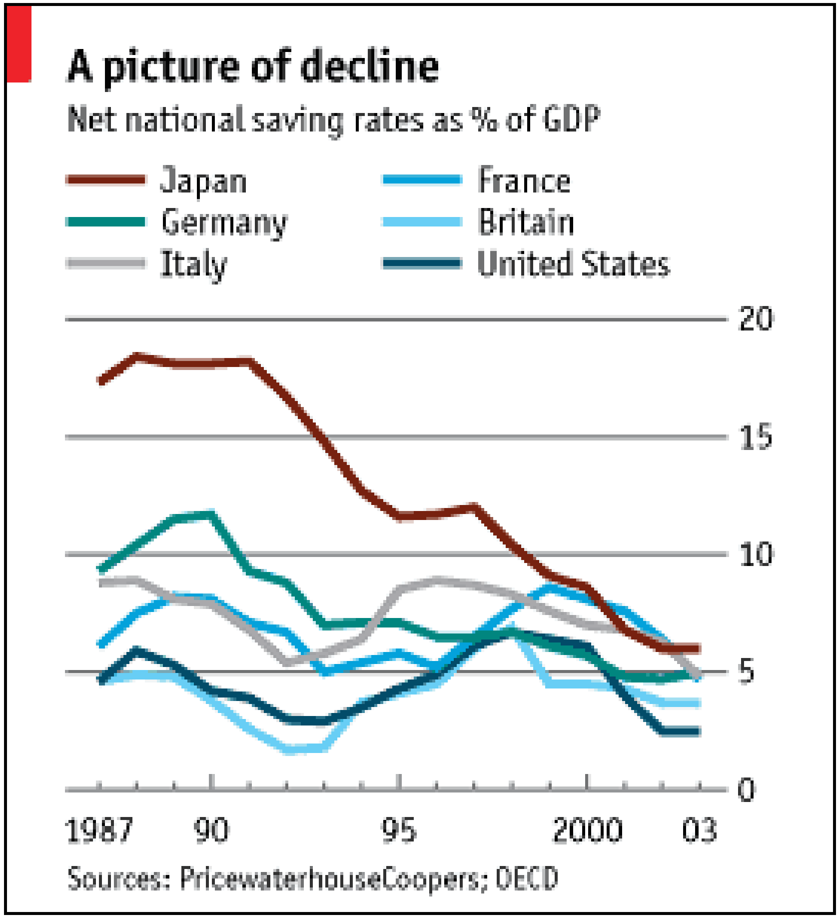
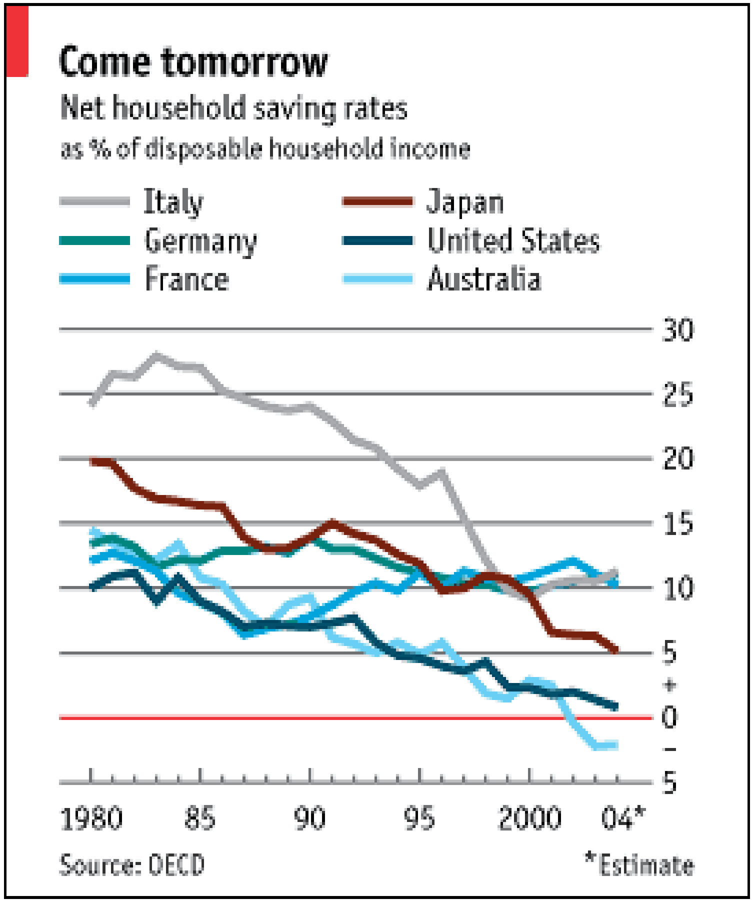
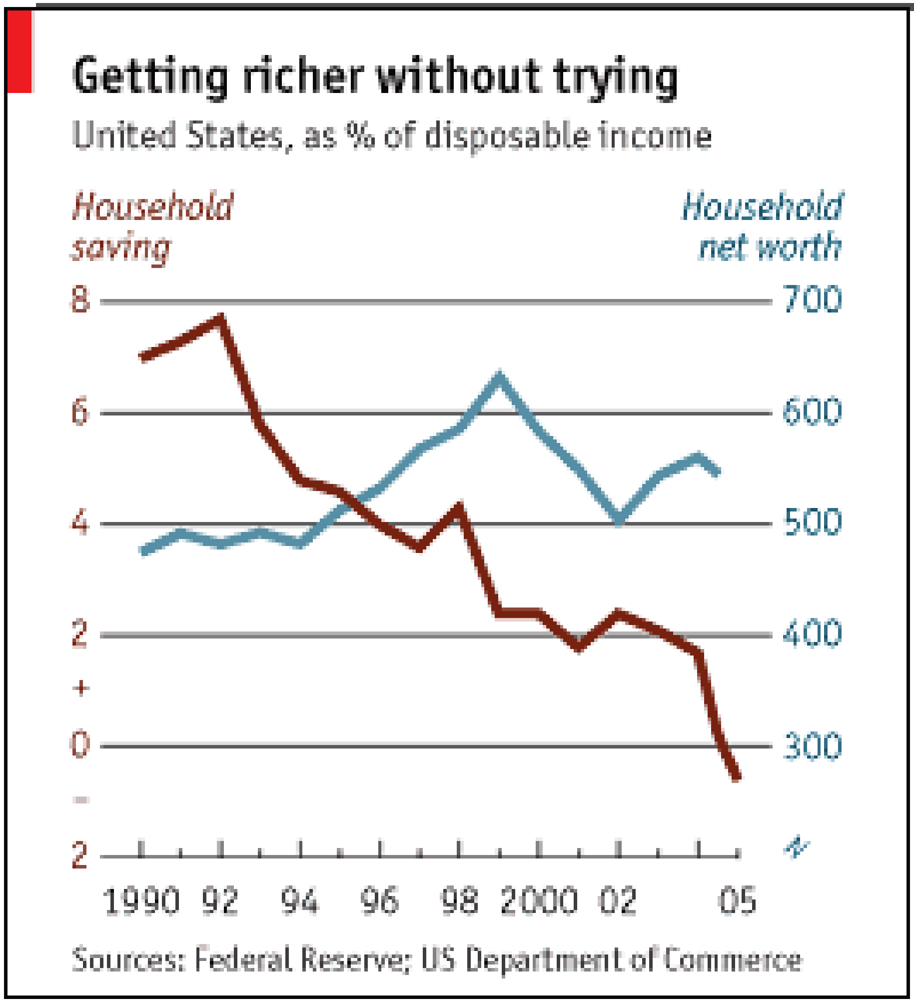
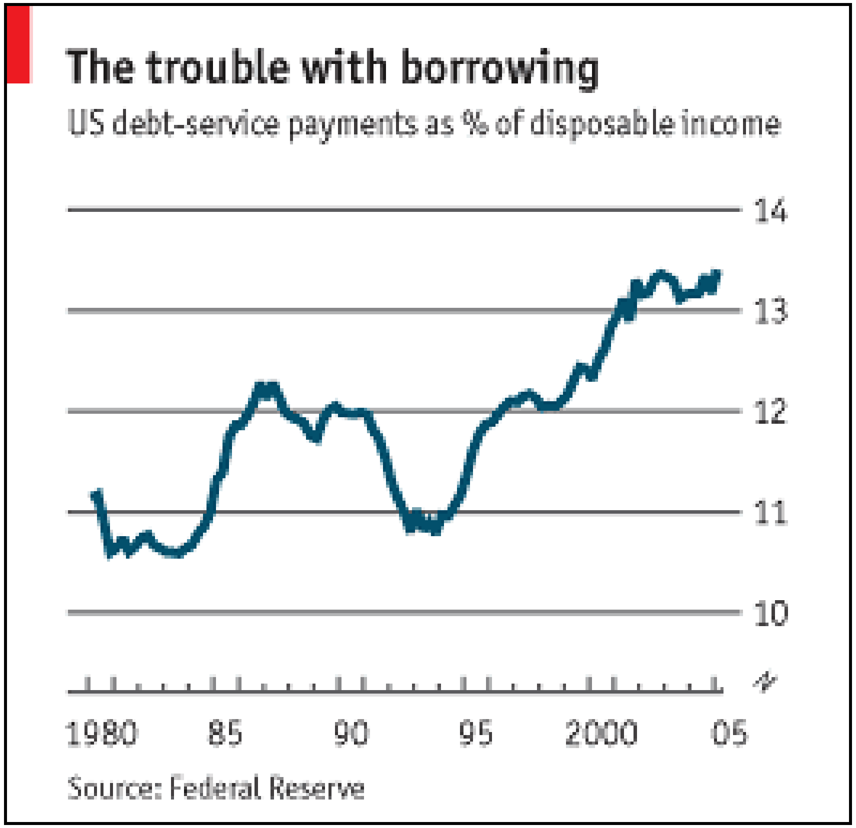
US savings rates





Getting rich quick……….





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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

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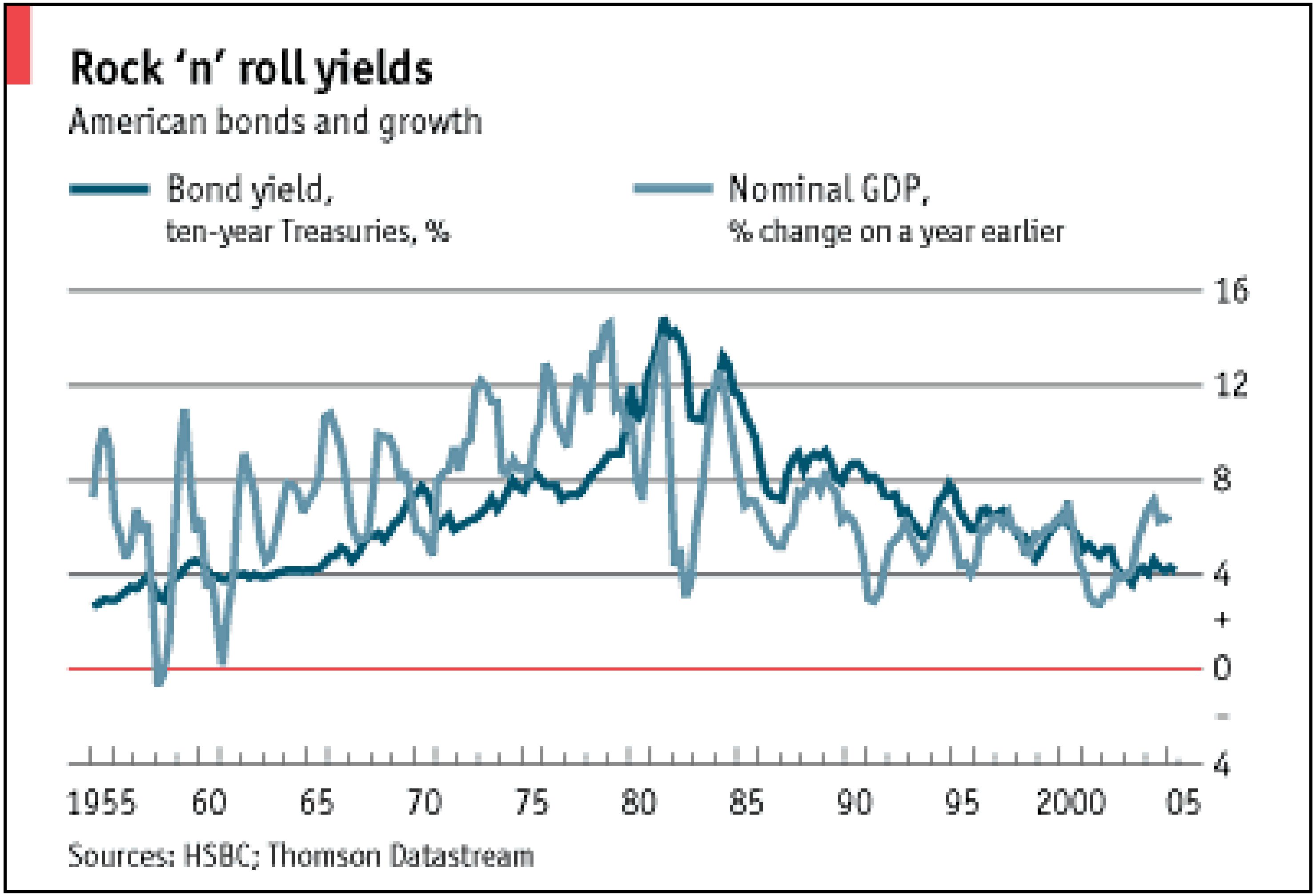
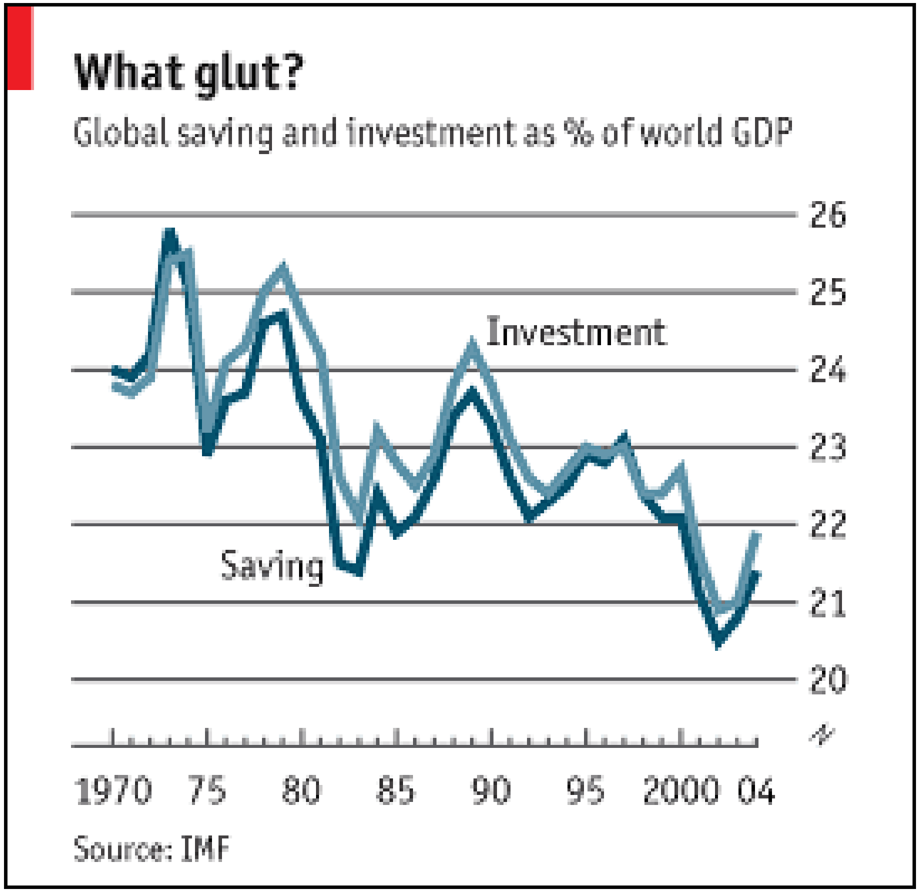
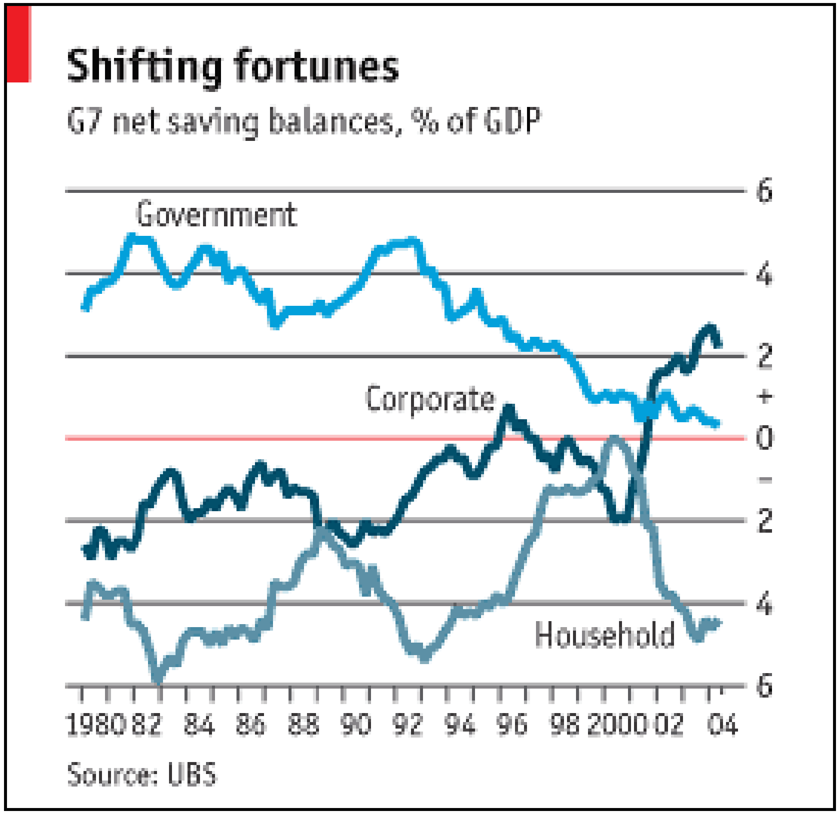
US treasury bond yields



Where is the glut though?





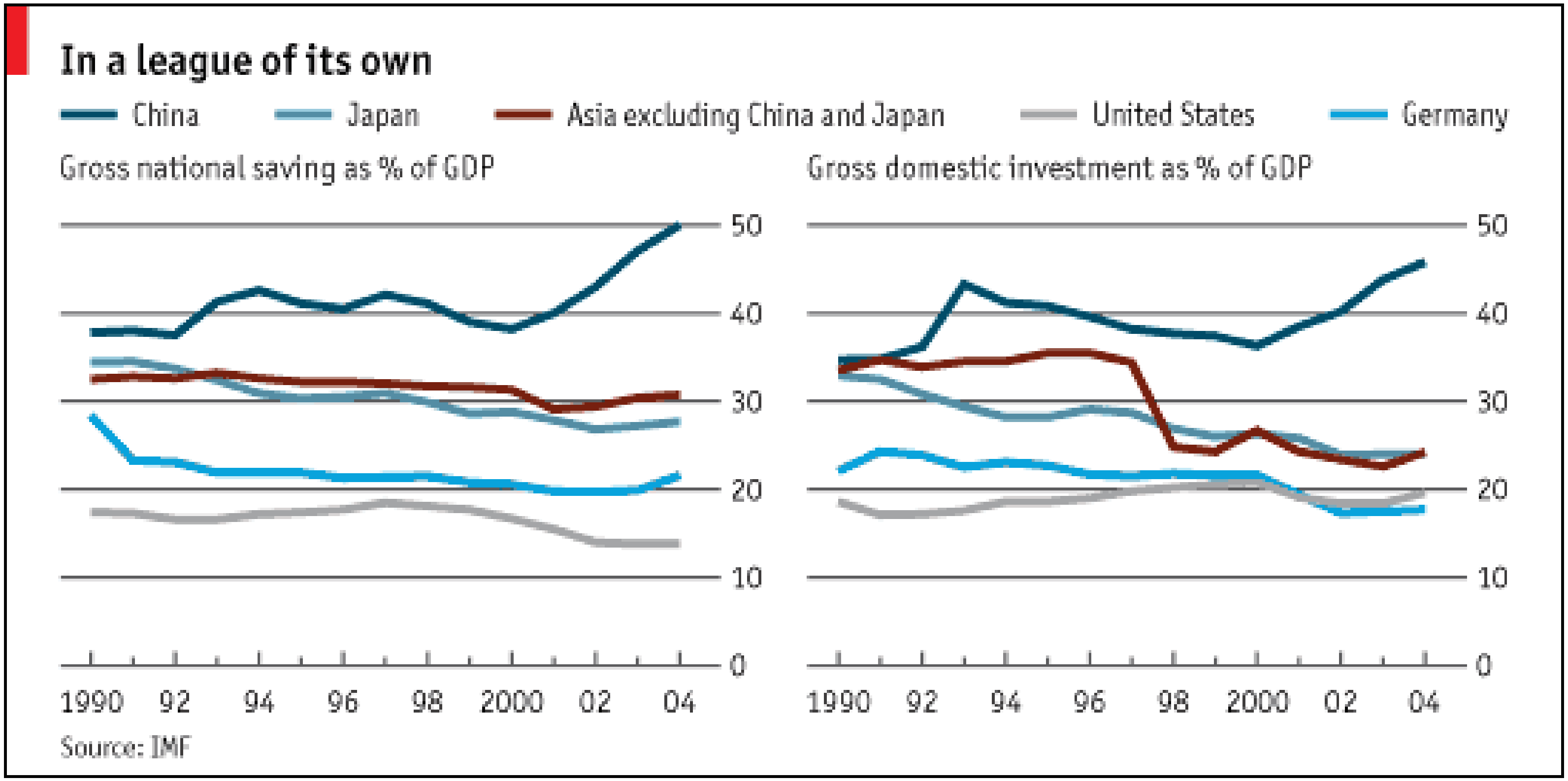
Investment vs. savings

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

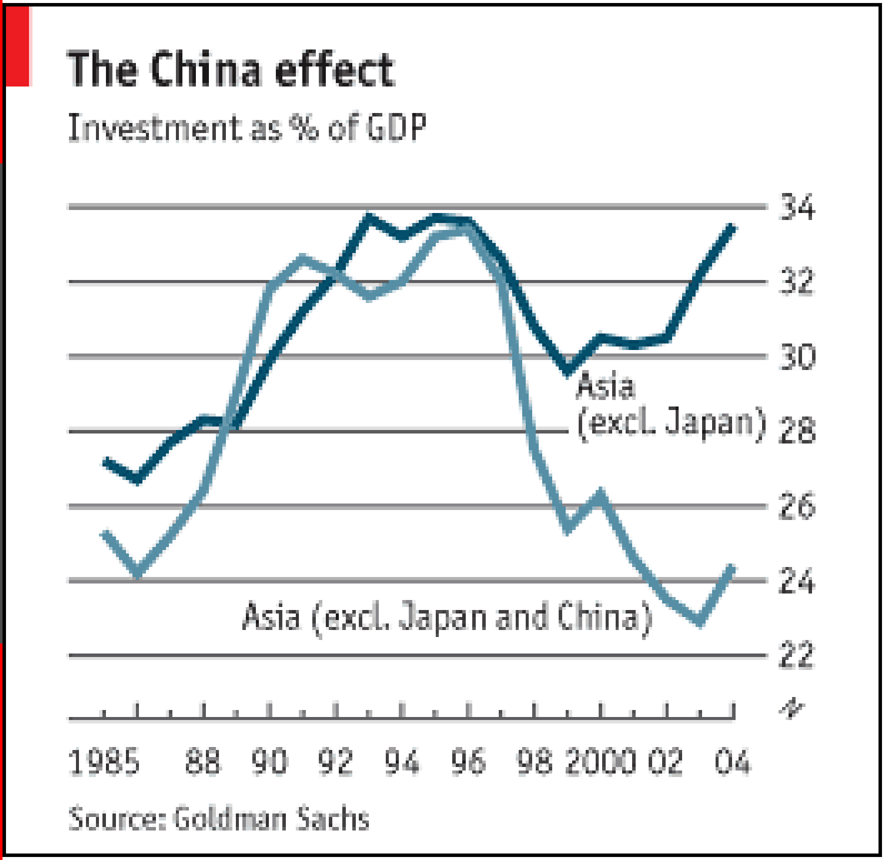
- Explanation lies in differing economic structures and policies:

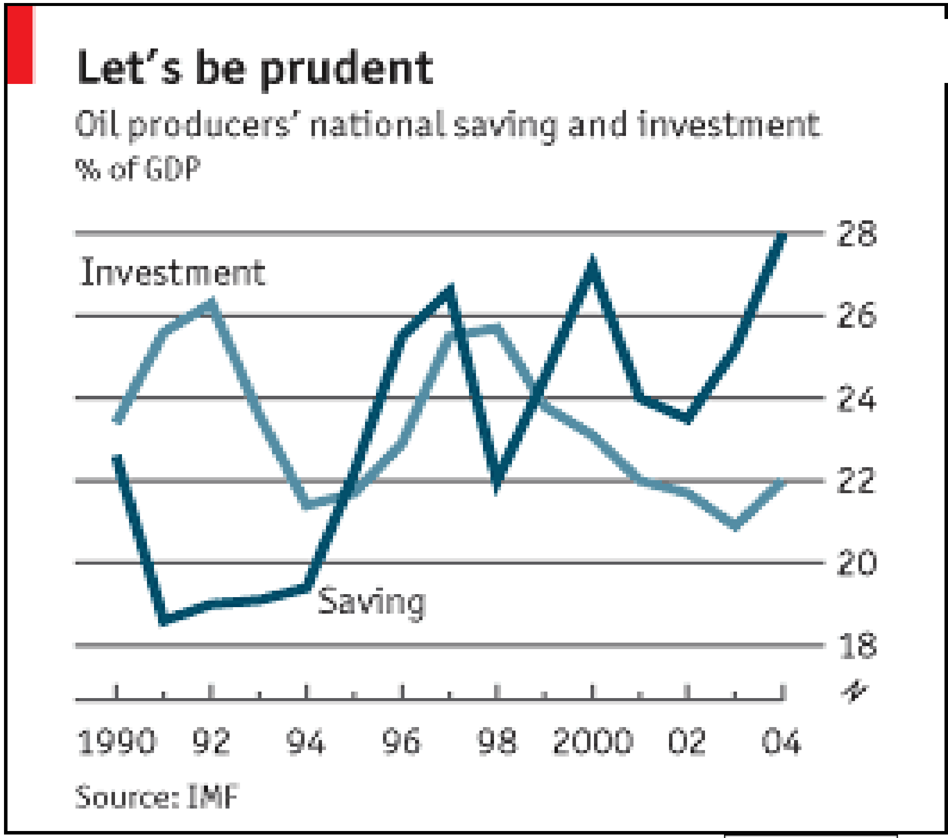
  - fiscal/monetary stimulus in US since 2001
  - Asia has built up foreign-exchange reserves
  - China's savings rate and rising price of oil

Frugal China



Asian tigers and oil exporters

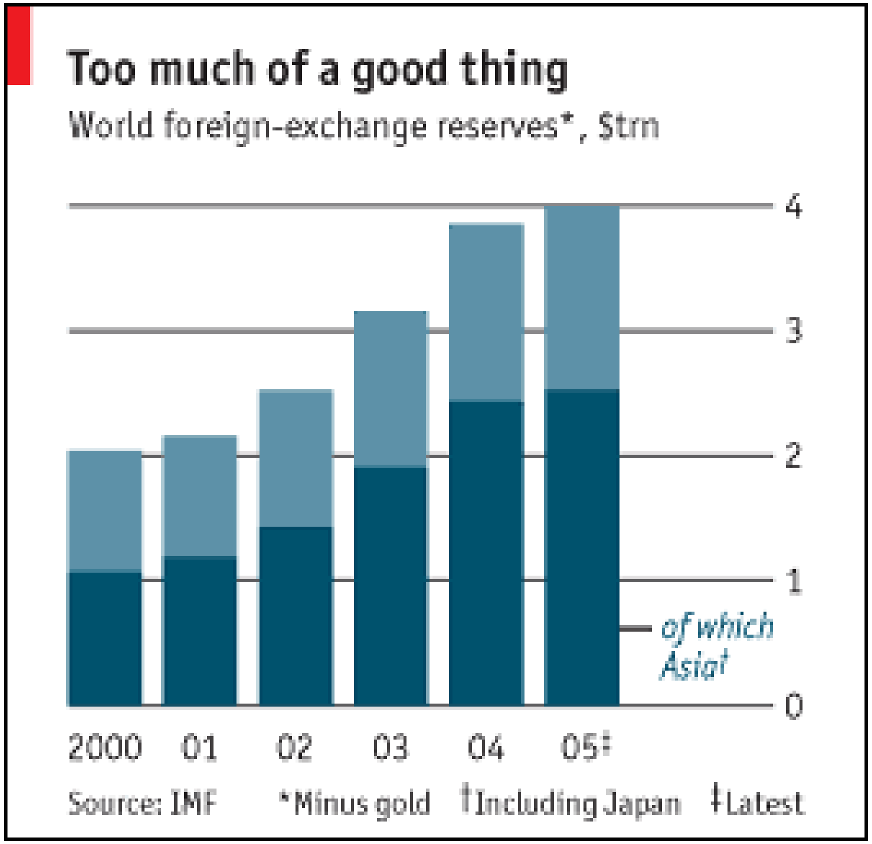




Where's the money gone?

- 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



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

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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

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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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