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

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

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Ian Sheldon
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** =

  \[
  \text{Trade Balance} + \text{Investment Income} = \text{International Investment Position}
  \]

- Trade Balance = Exports - Imports
- Investment Income = Return on Assets - Liabilities (adjusted for capital gains)
The cumulative deficit......

US Current Account and International Investment Position

($ billion)  ($ billion)

Source: BEA

8/5/2011

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
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

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<th>Inverted scale</th>
<th>8.08</th>
<th>8.09</th>
<th>8.10</th>
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<td>yuan/$</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
- 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
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

- Government
- Corporate
- Household

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
Ian Sheldon
Dept. of Agricultural, Environmental & Development Economics
The Ohio State University
234 Ag Administration
2120 Fyffe Rd
Columbus, OH 43210-1067

sheldon.1@osu.edu
(614) 292-2194
http://aede.osu.edu/people