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

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

March 30, 2006, Shawnee State University, Portsmouth, Ohio

Ian Sheldon

OSU AED Economics

THE OHIO STATE UNIVERSITY EXTENSION OARDC

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

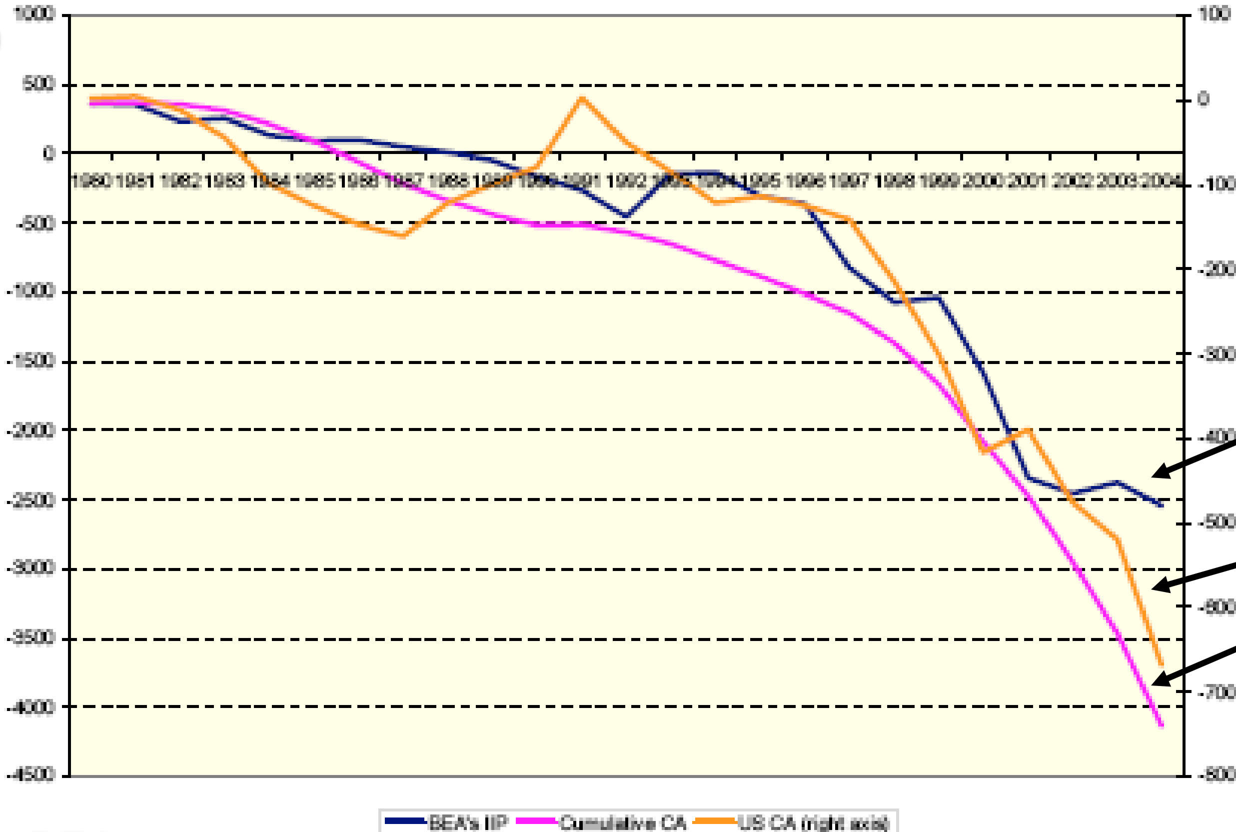
= Assets – Liabilities (adjusted for capital gains)

The Ohio State University Extension OARDC

The cumulative deficit……

US Current Account and International Investment Position

($ billion)



($ billion)

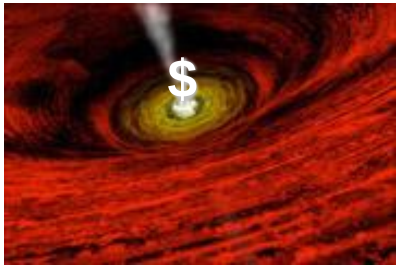
Net foreign assets

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)**

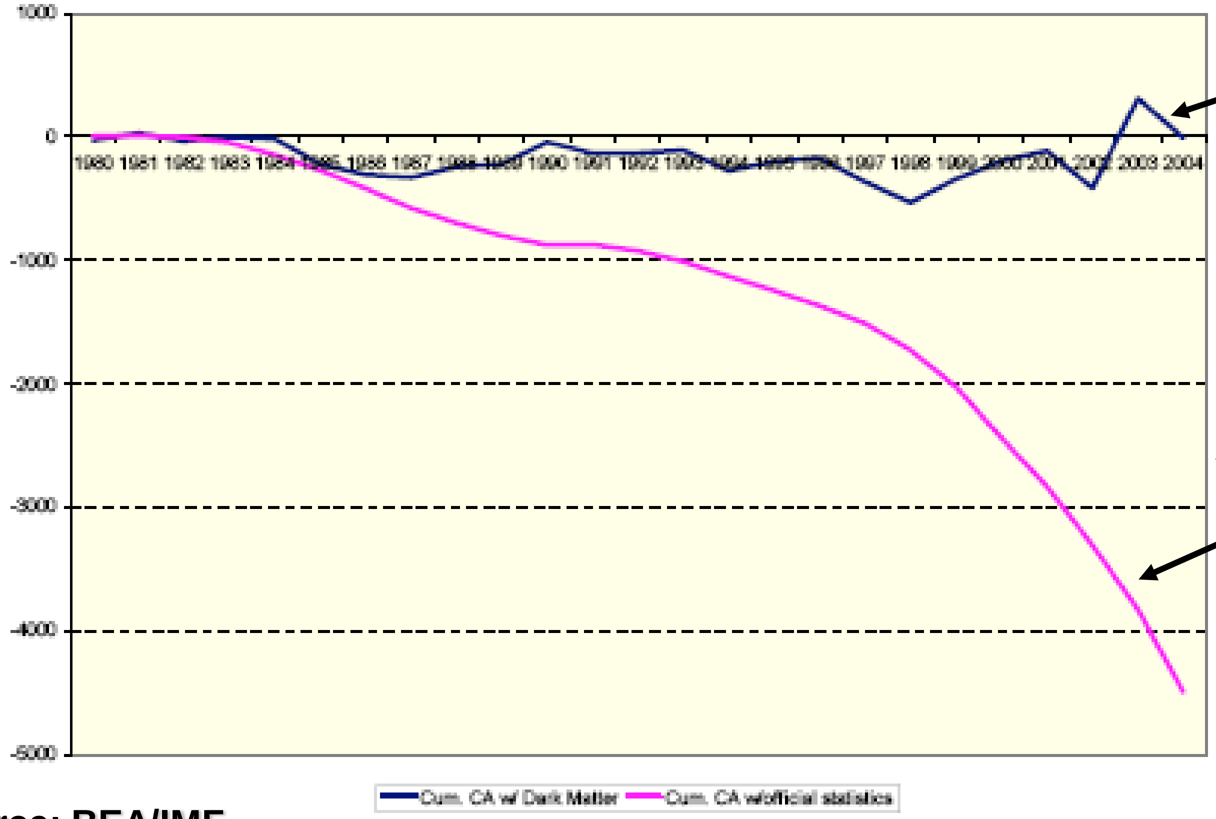
Is there dark matter?

- 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

THE OHIO STATE UNIVERSITY EXTENSION OARDC

Effect of dark matter

Current account with and without dark matter



Current account with dark matter

Current account without dark matter

Source: BEA/IMF

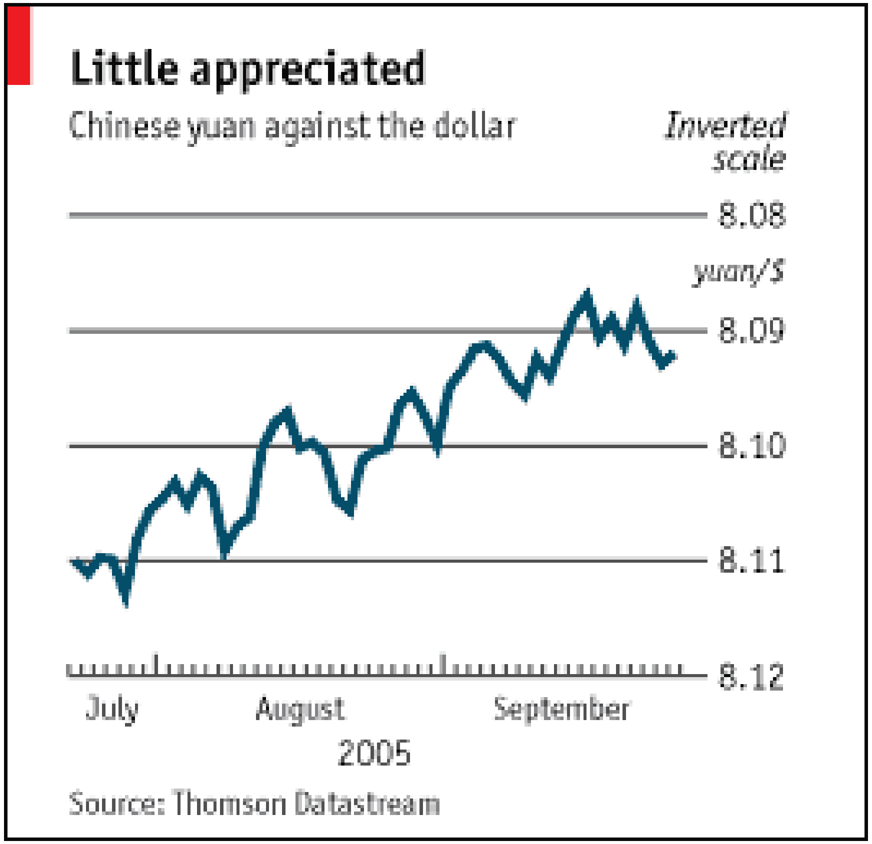
What is dark matter?

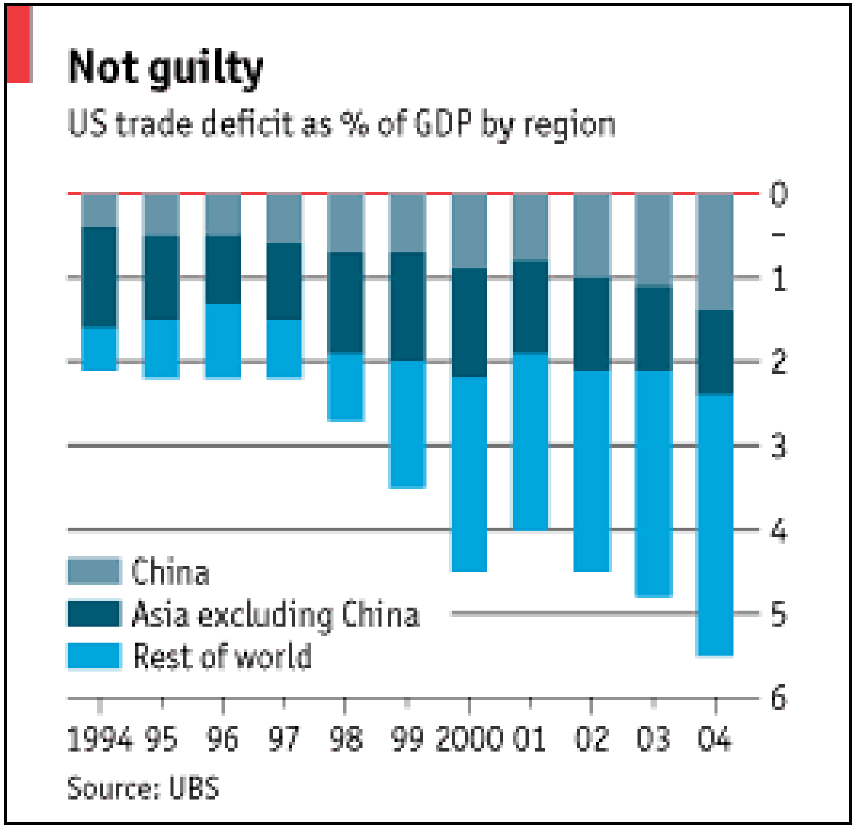
- **Difference due to "dark matter":**
  - ☞ **returns to US "know-how"**
  - ☞ **provision of liquidity**
  - ☞ **US earns a risk premium**
- **Story has serious problems:**
  - ☞ **analysis sensitive to fixed rate of return**
  - ☞ **$724 billion of assets in 2004 smaller in relation to overall economy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

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

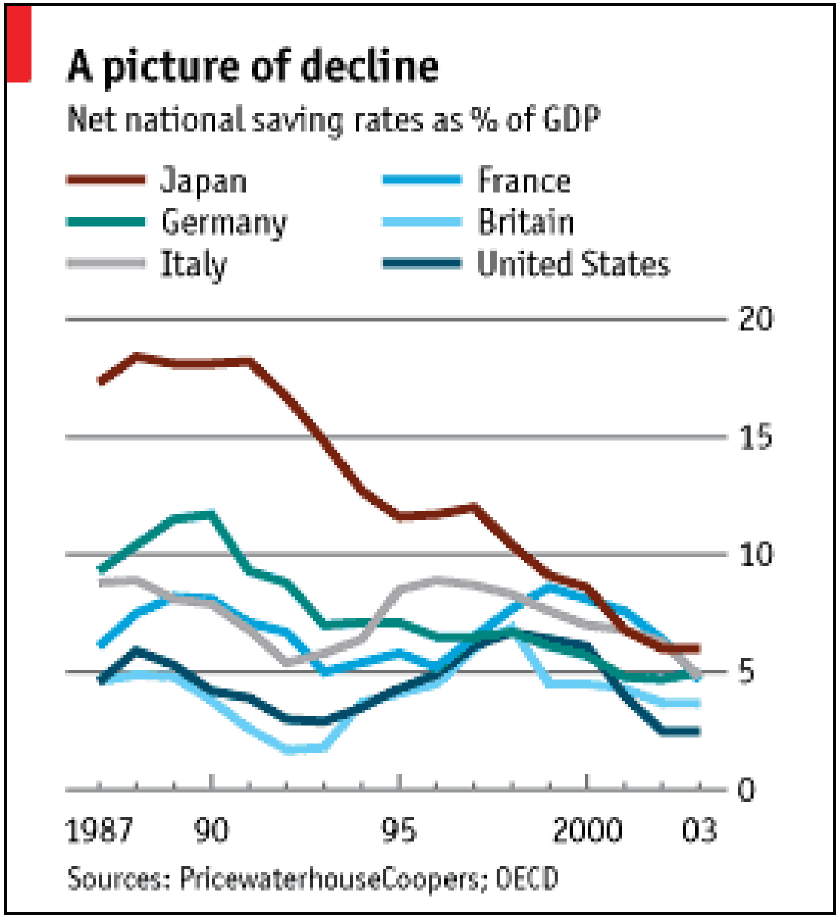


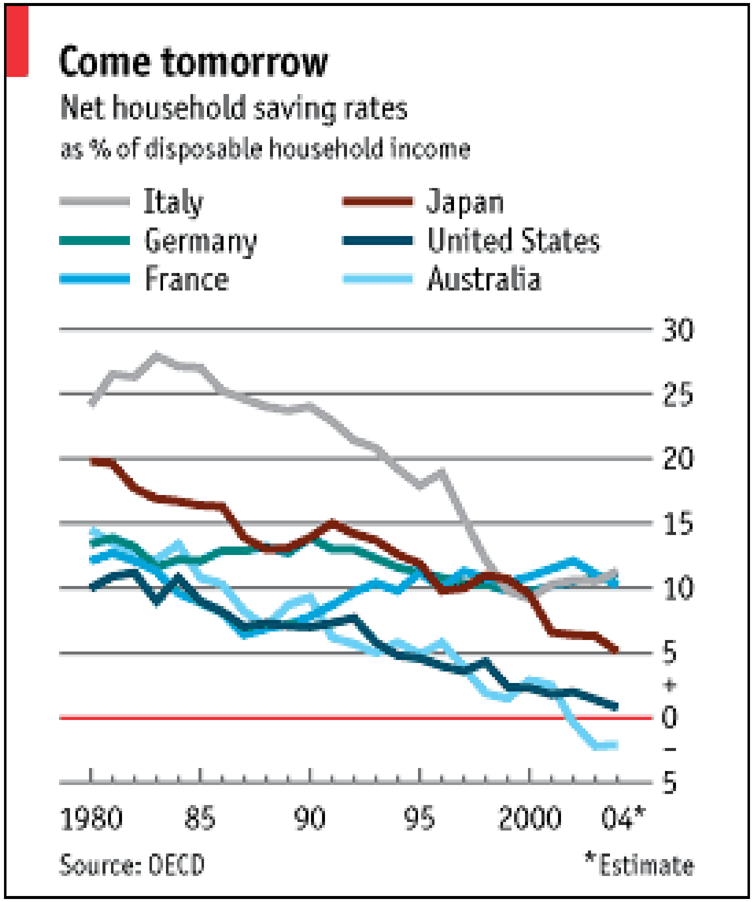


A lack of US savings?

- 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



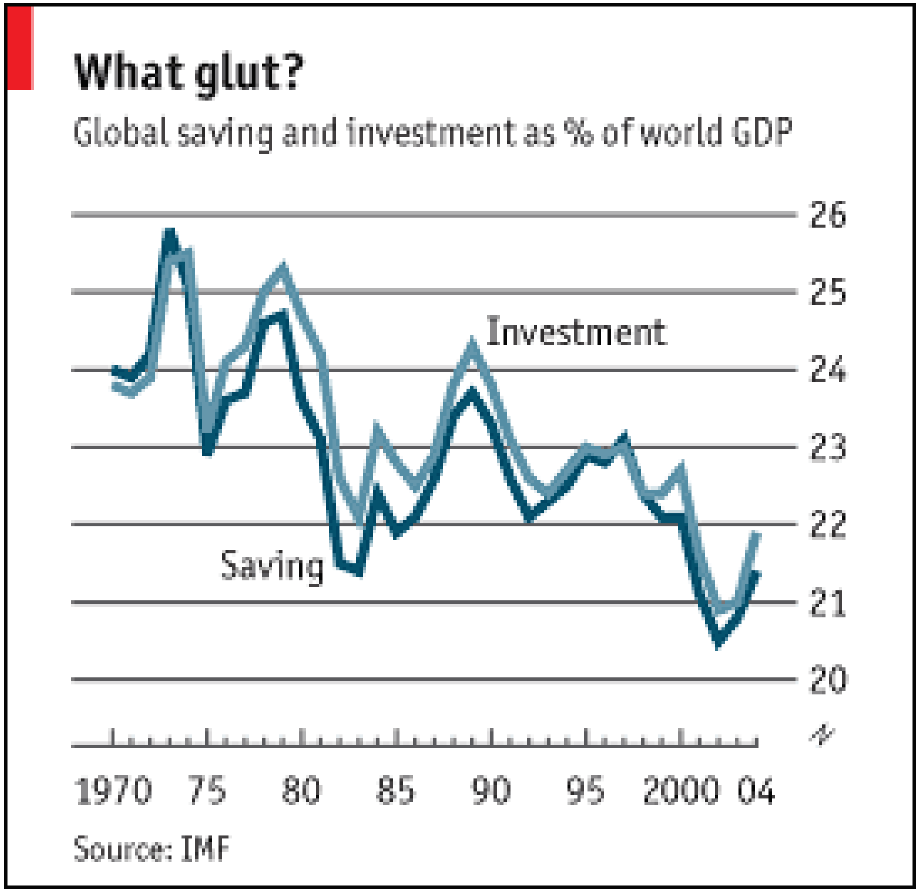


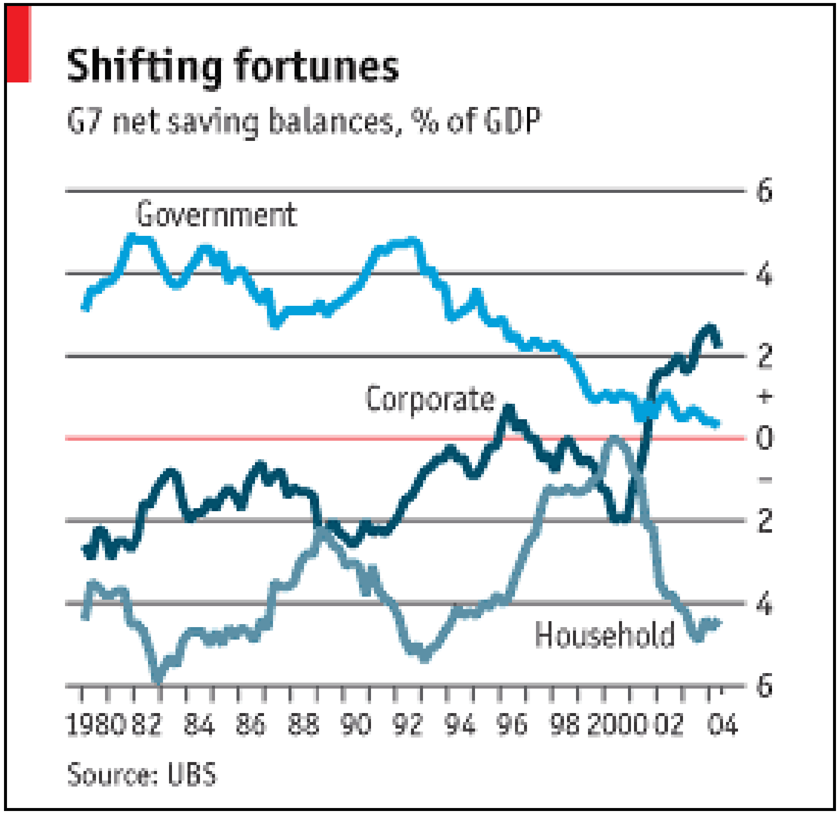
THE OHIO STATE UNIVERSITY EXTENSION OARDC

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:

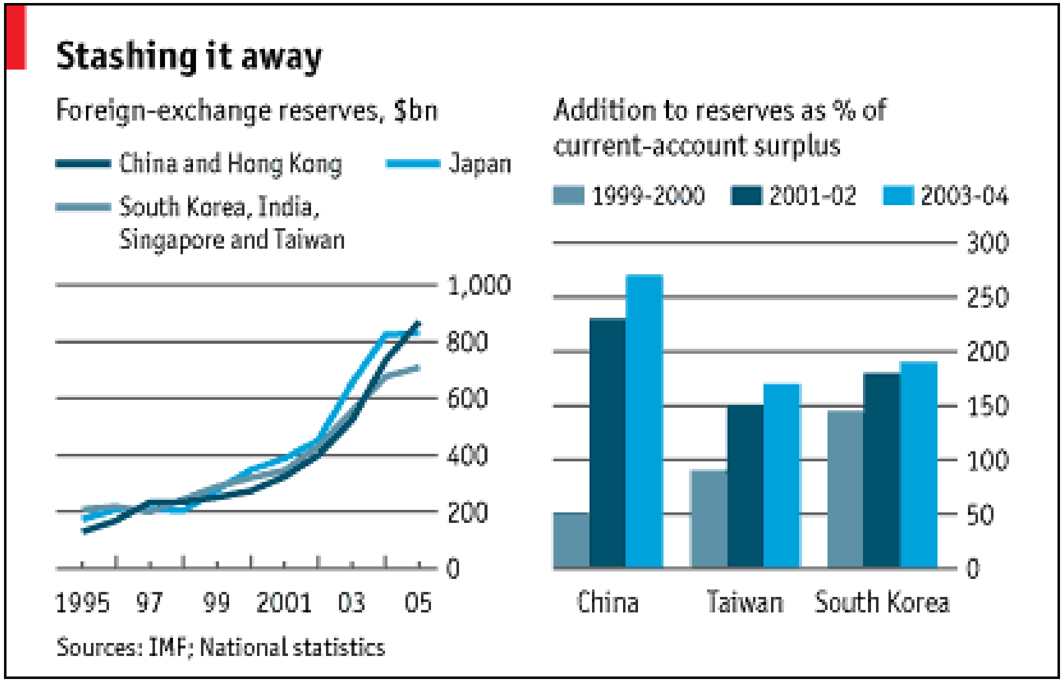
  - fiscal/monetary stimulus in US since 2001
  - China's savings rate and rising price of oil
  - Asia has built up foreign-exchange reserves

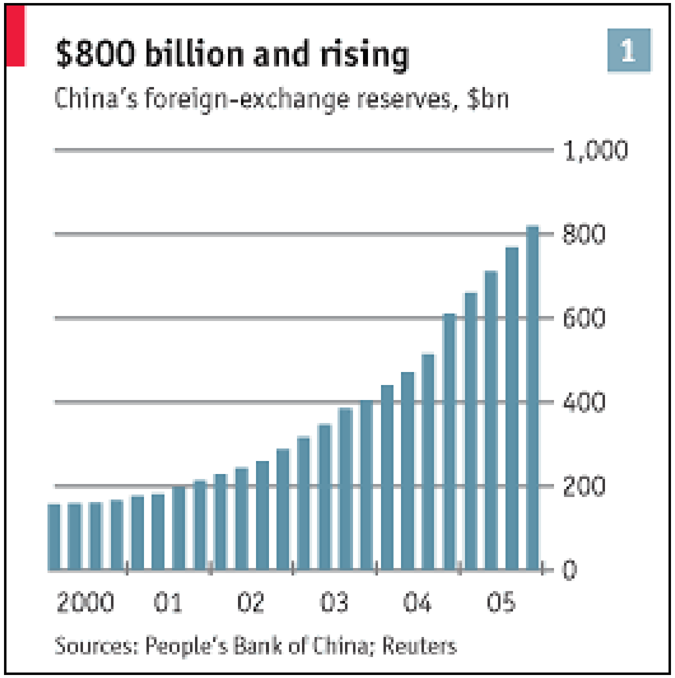
THE OHIO STATE UNIVERSITY EXTENSION OARDC

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





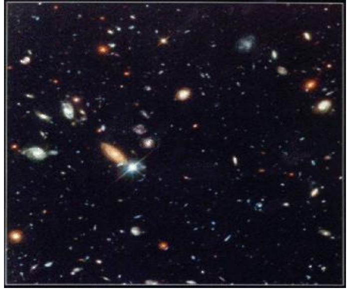
8/5/2011

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"

THE OHIO STATE UNIVERSITY EXTENSION OARDC

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**

THE OHIO STATE UNIVERSITY EXTENSION OARDC

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

THE OHIO STATE UNIVERSITY
EXTENSION
OARDC