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Christiane Brück*

The US Current Account Deficit: A Fundamentally Flawed Development?

The American current account deficit has once more become the subject of public debate. The size of the deficit is seen by some observers as the main cause of the recent decline in the exchange rate of the dollar. Can the latter be taken as confirmation of the increasing warnings that, in view of the dependence of the US economy on capital imports, adjustment processes such as a dramatic slump in the dollar exchange rate are imminent? What fundamental developments lie behind the US current account deficit, and do they give cause for significant adjustment reactions?

In addition to exports and imports of goods and services, the current account also includes transfers and payments from investment income. Together, these sub-balances provide information on the difference between the "current" expenditures and income of a particular country. In the USA, the current account has been in almost continual deficit since the early 1980s (Figure 1). This was due to the fact that imports of goods were persistently higher than goods exports. Only between 1987 and 1991 was there an appreciable reduction in the balance of trade deficit; this was primarily due to a depreciation of the dollar amounting to almost 30% in real effective terms, which led to an improvement in the price competitiveness of US exports on the world market and to more expensive imports for the USA. In the 1990s, the deficit grew in the wake of the long-running economic boom, exacerbated in the second half of the decade by the real effective appreciation of the dollar. The balance of trade deficit has partially been offset by surpluses in the investment income balance¹ and in the services balance (Figure 2), although the latter too has shown a slightly downward trend in recent years.

Only in 1991, in the wake of recession and transfer payments from the Gulf War allies, was the US current account as a whole on an even keel. There has been little significant contraction of the deficit during the latest recession; last year, a balance of trade deficit of US\$ 427.2 billion, a services surplus of US\$ 68.9

billion, net transfers of US\$ -49.5 billion and an investment income surplus of US\$ 14.4 billion together added up to a current account deficit of US\$ 393.4 billion. In relation to the country's gross domestic product, it currently lies around 4.2% of GDP, and as the US economy picks up and is expected to lead a global recovery, a renewed increase to more than 5% of GDP is probable by the end of this year.² Against this background, awareness once again focuses on the problems of financing, on a sustainable basis, the increase in foreign debt that goes hand in hand with persistent current account deficits, as well as on the accompanying danger of a decline in the exchange rate of the dollar, of higher risk premiums – i.e. interest rates in the USA – and, as an ultimate consequence, of a threat to recovery itself.

Current Account Deficit and Capital Flows

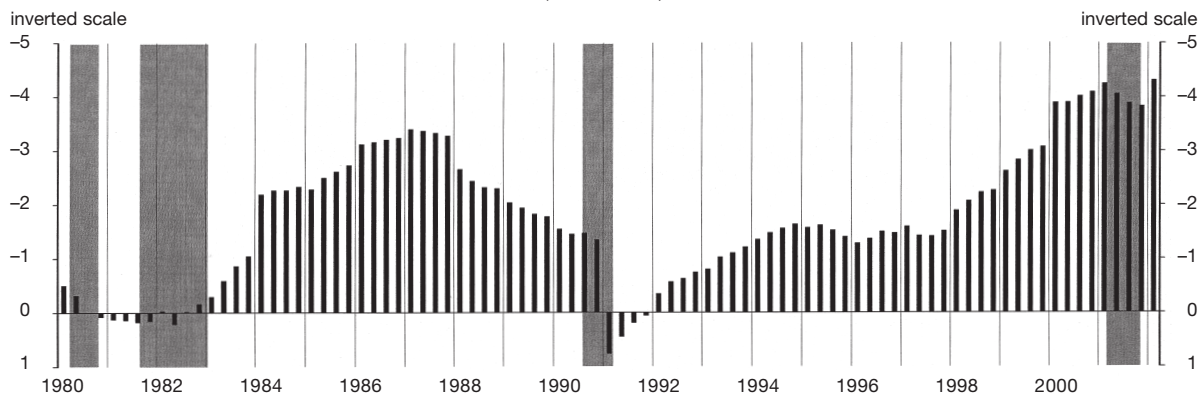
In order to be able to judge the potential danger inherent in the size and persistency of the American

¹ Estimates of the US net international investment position have been revised in June 2002. They now incorporate updated source data., especially the US Treasury Department's Benchmark Survey of Foreign Holdings of US Portfolio Assets as of March 2000. Prior to this revision, the investment income balance had shown to be in deficit as of 1997.

² Studies have shown that a critical threshold for the size of the current account deficit of an industrialised country can be identified at around 5% of GDP; as a rule, adjustments set in above this threshold which tend to reduce the deficit via currency depreciation, accelerated inflation and a decline in domestic demand. Cf. also Caroline L. Freund: Current Account Adjustment in Industrialized Countries, IFDP No. 692, December 2000 (internet: www.bog.frb.fed.us).

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Figure 1
US Current Account Balance¹
(as % of GDP)



¹ Shaded areas: Recessions (NBER definition; 2001: not yet officially fixed); 2002/1: partially estimated.

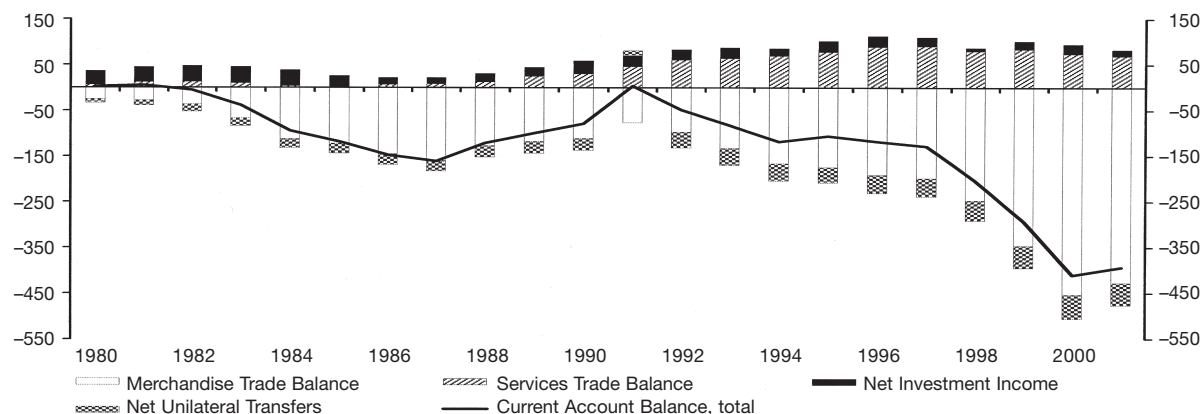
Sources: Federal Reserve Board of Governors; US Department of Commerce, Bureau of Economic Analysis.

current account deficit, we need to analyse the underlying capital flows. From the system of national accounts equations we can derive that the current account balance corresponds to the difference between domestic saving and domestic investment – the so-called savings gap – and that this in turn corresponds to the balance of a country's capital imports and exports. A country posts a current account deficit when its domestic expenditures exceed domestic income; the country then absorbs more in the form of private consumption, investment and government expenditure than it produces itself. Imports of goods and services fill the real economic gap between absorption and production, while imports of capital or foreign savings fill the gap between domestic saving

and investment. Altogether, a current account deficit thus corresponds to a net inflow of foreign capital,³ which is linked to corresponding claims on the country's future output.

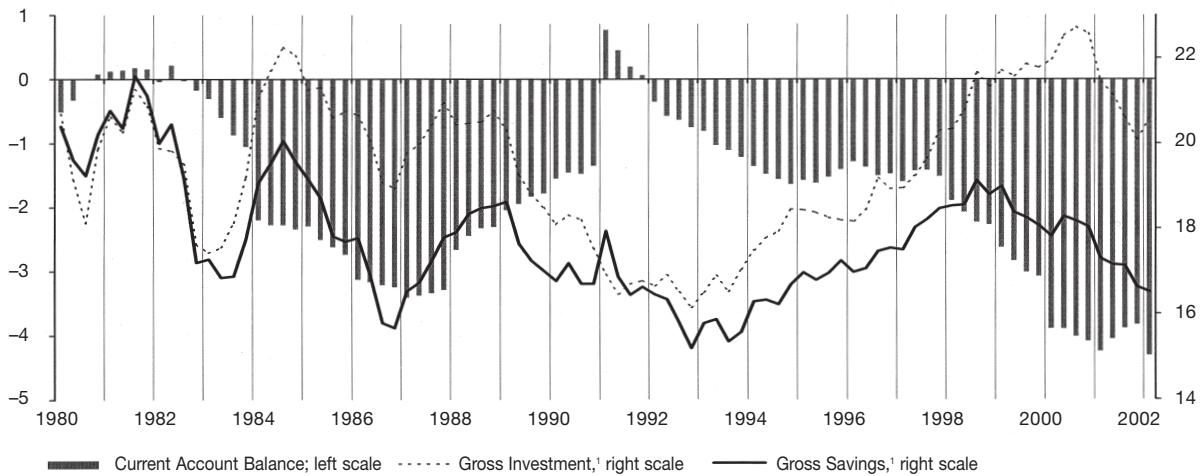
When it comes to examining the necessity of adjusting a country's current account, conclusions may be drawn from the domestic use to which foreign savings are put. If capital imports are primarily used to further increase domestic investment, then they effectively finance an increase in the domestic capital stock and so enable a higher level of per capita output than would have been possible without capital imports. In this case, servicing the foreign debt is unlikely to lead to difficult adjustment processes; in such cases, persistent current account deficits cannot

Figure 2
Components of US Current Account
(US \$ billion, annual rates)



Source: US Department of Commerce, Bureau of Economic Analysis.

Figure 3
Current Account, Savings, and Investment
 (% of GDP)



¹ Due to measurement errors the savings gap is not identical to the current account balance.

Sources: US Department of Commerce, Bureau of Economic Analysis; Federal Reserve, Flow of Funds Accounts March 2002.

only be financed on a sustainable basis, they also document the economic strength of a country. However, if capital imports are predominantly accompanied by a fall in domestic savings and serve primarily to raise the level of domestic consumption above that which would have been possible without the inflow of capital, then the country lives "beyond its means" and the servicing of the resulting foreign debt will sooner or later force a reduction in consumption via adjustments in interest and exchange rates.

Financing Consumption or Investment?

How should the American current account deficit be judged against this background? Figures 3 and 4 demonstrate that behind similar developments in the current account during the past two decades and up to the present day we find completely different economic developments. Domestic investment in general exceeded domestic saving throughout the entire period, resulting in a net import of capital, i.e. a current account deficit. Up to the start of the 1990s there was a continual declining trend in the proportion of GDP accounted for by both domestic saving and domestic investment, and this during a period in which the investment-GDP ratio fell at a faster rate; capital imports thus tended to help expand

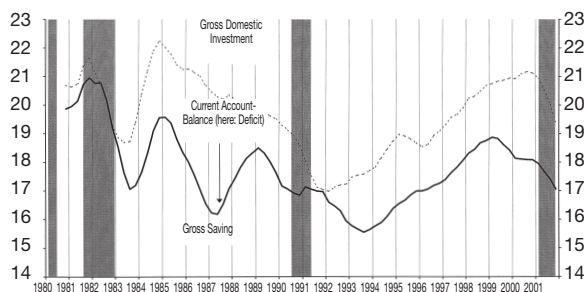
consumption. The 1990s, however, were largely characterised by a converse development: both aggregates increased, accompanied by a faster growth rate on the part of investments; capital imports thus tended to support investment expansion and so helped finance exceptionally dynamic investment growth over a number of years, facilitating the longest economic boom in the post-war period.

Comparatively unfavourable developments in other regions of the world, such as in the non-industrialised countries following the Mexican and Asian crises or the poor growth situation in Japan and the euro area, probably further favoured the relative appeal of the USA for capital investments. Finally, in the past two years both fundamental economic aggregates appear to have returned to a course that is not dissimilar to the former development described above. As from 1999, the proportion of domestic savings in GDP has been on the decline once more, and investment growth in particular has fallen drastically since the middle of the year 2000, a factor that has contributed substantially to the cyclical downturn.

If only because of the short time span, however, it is too early as yet to judge whether this development is really the expression of a new trend, and whether current doubts regarding the sustainability of the current account deficit are justifiable; indeed, there are a number of arguments which currently suggest

³ In the statistics, however, the equivalence between the two relationships is partly obscured by recording and measuring errors.

Figure 4
The Current Account
as Savings Gap¹
 (% of GDP²)



¹ Shaded areas: Recessions (NBER definition; 2001: not yet officially fixed).

² Four-quarter moving averages; due to measurement errors the savings gap is not identical to the current account balance.

Source: Federal Reserve, Flow of Funds Accounts March 2002.

that a trend of this kind is unlikely to establish itself. For example, private household saving can in fact be expected to increase once more,⁴ and there are also signs that investment is beginning to stabilise. On the other hand, it is relatively certain that public sector saving will continue to decline in the wake of further expected budget deficits.

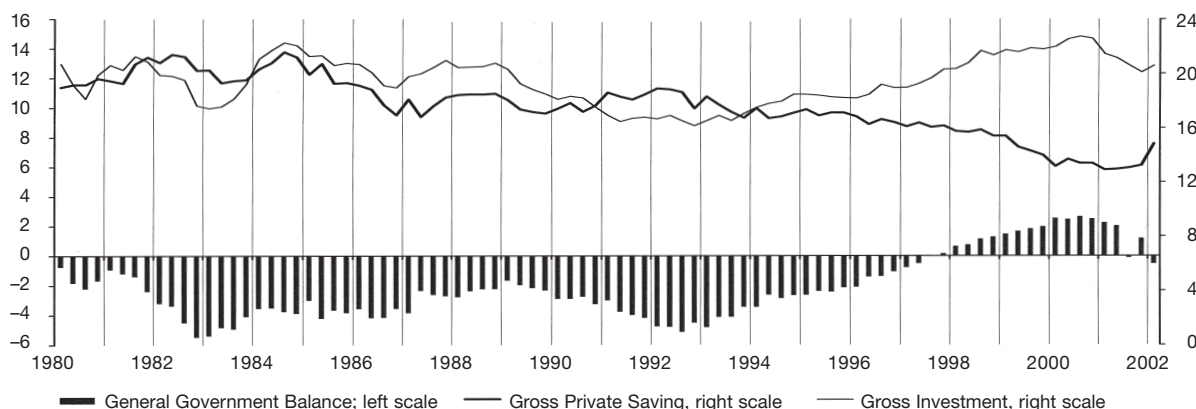
Twin Deficits

Analysis of the relative development of saving and investment can be supplemented by additional

insights into the “danger potential” of the current account development gained from a breakdown of the various components that make up total savings: Figures 5 and 6 demonstrate that over long periods of time the decline in the domestic saving ratio has been determined by public sector dissaving. Not until a sustained fiscal consolidation course was adopted in the early 1990s was a brake put on the advancing level of government debt, marking a turnaround – the credibility of which was increasingly recognised by the markets – in the development of public saving in the following decade.

Increasing deficits in the federal budget had previously been caused primarily by expenditure growth and led in particular to an expansion of consumption beyond what could be regarded as “normal levels”; via increased imports of goods and services, part of this additional demand led to a rise in the balance of trade deficit and ultimately caused the current account deficit to increase. This development can also be explained by examining the capital flows: ultimately, the budget deficit stimulated not only import demand, but also led to a rise in US interest rates that was even more marked than the economic situation would otherwise have warranted, thus increasing the inflow of foreign capital. However, since this phase – in contrast to the course of the 1990s – tended to result, not least in the public sector, in higher consumption levels and so ended unproductively, we can conclude for the 1980s that the USA did at times live “beyond its means”, leading to a conse-

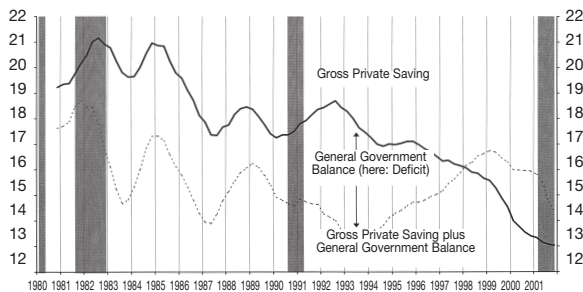
Figure 5
Private and Public Saving, Investment
 (% of GDP¹)



¹ Due to measurement errors the savings gap is not identical to the current account balance.

Sources: US Department of Commerce, Bureau of Economic Analysis; Federal Reserve, Flow of Funds Accounts March 2002.

Figure 6
Private Saving and Government Balance¹
 (% of GDP²)



¹ Shaded areas: Recessions (NBER definition; 2001: not yet officially fixed).

² Four-quarter moving averages; no corrections for statistical discrepancy.

Source: Federal Reserve, Flow of Funds Accounts March 2002.

quent need for adjustment and to corresponding corrective developments, for instance via the exchange rate of the dollar.

In the 1990s on the other hand, the two deficits now ran in different directions as the “new” fiscal policy took hold: while the current account deficit grew from around US\$ 50 billion in 1992 to over US\$ 444 billion in 1999, the budget moved from a deficit of around US\$ 290 billion to a surplus of just under US\$ 240 during the same period. This achievement was largely due to rapidly rising receipts spawned by the booming economy, but also to a concurrent consolidation of outlays, supported in particular by appreciable cuts in defence spending.

Although the private savings ratio – particularly against the background of the stock market-induced wealth effect – continued to fall appreciably in the 1990s, the markets evidently did not regard this as being particularly problematic in view of the consolidation of government finances. In addition, changes in the composition of the total savings gap that continued to exist favoured a stronger expansion of the current account deficit, for, at 17%, the import intensity of government demand is considerably lower than that of private consumption (around 58%) or that of investment (around 50%).⁵

Since last year, finally, the development of public saving appears to be returning to pre-consolidation patterns. The weaker expansion of government

receipts in the wake of the country’s economic downturn was enough to reduce the budget surplus by a considerable amount during the course of the year 2000. Above all, however, in view of the sea change in government defence spending, which was increased again substantially following September 11, a return to budget deficits as early as during the present fiscal year is unavoidable. This change in the country’s “fiscal stance” awakens memories of the 1980s, particularly since there are as yet no signs of a return to the investment growth seen in the boom years of the 1990s.

Summary

The developments behind the past expansion of the current account deficit can indeed be characterised as problematic at times. This was especially true of the 1980s because of their “consumption bias”. In contrast, the expansion of the current account deficit in the 1990s was accompanied by a marked increase in the capital stock in the USA, and thus held fewer risks and so less need for adjustment; this was demonstrated not least by the unbroken readiness of foreign capital investors to intensify their involvement in the USA, resulting in a marked real effective appreciation of the dollar.

A slower expansion of capital flows into the USA due to a change in the relative assessment of the profitability of American capital investments implies that the exchange rate of the dollar should come under pressure. Whether or not the current development, in particular that of the exchange rate of the dollar, is already the result of a justifiable, more problematic judgement of the current account deficit cannot be answered conclusively here. While the expected relative profitability of capital investments in the USA is certainly suffering at present from the change in the country’s “fiscal stance”, which has moved into the forefront of the markets’ awareness following September 11, a number of temporary factors have also been instrumental in the change of appraisal. What is probably of more importance at the moment is the lingering uncertainty that clearly remains particularly with regard to the timing and dynamism of the country’s economic recovery and so too with regard to profit and earnings expectations, as well as the fact that stock market developments are correspondingly muted. In addition, ongoing revela-

⁴ Cf. inter alia David Milleker: Renaissance des Sparens in den USA?, in: Dresdner Bank USA Aktuell, April 2002.

⁵ Cf. Catherine L. Mann: Is the USA Trade Deficit Sustainable?, Washington 1999.

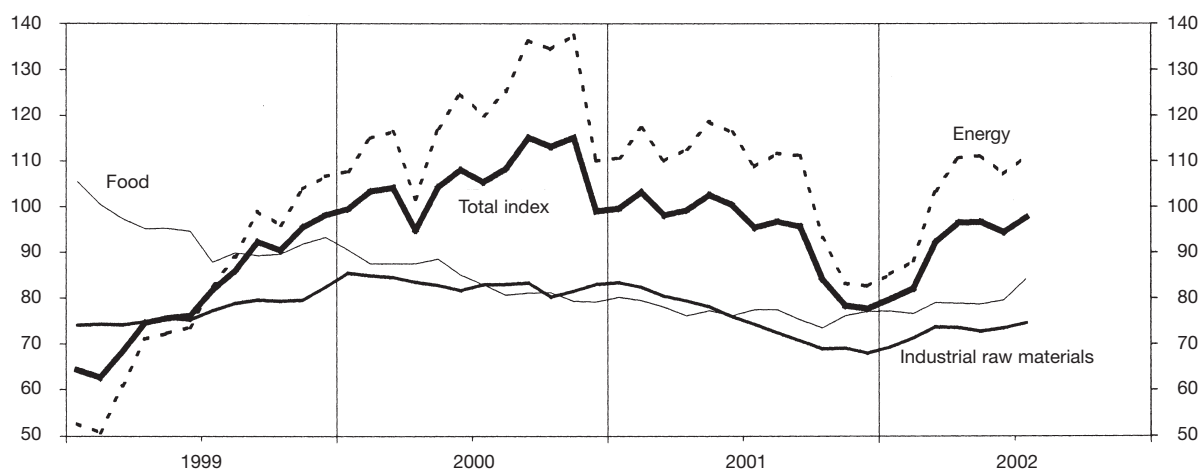
tions in the wake of the Enron affair are having an unfavourable effect on perceptions of the USA as a first rate investment location. Finally, it is also unclear as to how far the current development represents a correction of a previous over-estimation.

Should these factors be the reasons behind the current dollar development, then any further depreciation of the dollar will probably remain limited. From

an American point of view such depreciation would even be welcome, since the price competitiveness of US exports would benefit, while in view of what remains a favourable productivity situation there is little reason to expect the emergence of a price spiral triggered by import prices. A limited depreciation of the dollar would by no means represent a problem to the US, nor indeed to the global economy.

HWWA Index of World Market Prices of Commodities¹

(1990 = 100)



Commodity Groups ¹	2001	Jan. 02	Feb. 02	Mar. 02	Apr. 02	May 02	June 02	July 02 ²
Total Index	94.3 (-10.9)	79.8 (-19.9)	82.1 (-20.5)	92.3 (-6.0)	96.6 (-2.7)	96.7 (-5.8)	94.5 (-5.9)	97.7 (2.3)
Total, excl. energy	75.8 (-9.2)	71.4 (-13.6)	72.7 (-11.0)	75.1 (-6.0)	74.9 (-4.7)	74.3 (-4.7)	75.1 (-1.3)	77.1 (2.5)
Food, tropical beverages	77.1 (-8.6)	77.3 (-3.7)	76.7 (-3.6)	79.0 (1.2)	78.9 (3.5)	78.7 (1.8)	79.6 (4.4)	84.3 (8.7)
Industrial raw materials	75.3 (-9.4)	69.4 (-16.9)	71.4 (-13.4)	73.8 (-8.4)	73.6 (-7.4)	72.8 (-6.9)	73.6 (-3.3)	74.6 (0.4)
Agricultural raw materials	73.7 (-10.2)	65.9 (-20.3)	69.0 (-15.6)	71.8 (-10.5)	71.7 (-9.4)	70.6 (-7.0)	71.0 (-4.1)	73.0 (0.3)
Non-ferrous metals	72.7 (-12.4)	69.2 (-15.8)	69.6 (-14.0)	72.0 (-7.2)	71.4 (-6.6)	70.4 (-10.1)	71.7 (-3.9)	71.2 (0.1)
Energy	106.4 (-11.7)	85.3 (-23.0)	88.2 (-24.8)	103.6 (-5.9)	110.7 (-1.8)	111.2 (-6.3)	107.2 (-7.9)	111.2 (2.2)

¹ On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

² Up to and incl. 26th July.

Further information: <http://www.hwwa.de> → Commodity Price Index