On the Causes of the US Current Account Deficit

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BODY

Thank you very much for the opportunity to brief Commission members on the causes of the US current account deficit. I understand that this briefing is the first of several that will create the basis for a consensus document of findings and recommendations on issues related to the US external accounts.

For today's discussion, I draw on my forthcoming book, Is the US Trade Deficit Sustainable?. Two chapters have been made available to you; the release date for the book is September 14. In addition to discussing the causes of the deficit, my book also investigates the implications of trade and globalization for US labor markets, for US inflation, and for US productivity growth, as well as addressing the question of whether the US deficit is "sustainable".

WHAT ARE THE FACTS

For nearly 20 years the US current account, which is the broadest measure of the net flow of trade and investment income, has been in deficit. (Figure 1) However, over that time period, there have been two clearly identifiable cycles. From 1980 to 1987 the trade deficit and current account deficit widened (the latter to $153 billion representing 3.5 percent of GDP), but then they narrowed to near balance in 1991. During the 1990s both moved back into deficit, with the current account deficit widening to $233 billion in 1998, representing a change from zero to 2.7 percent of GDP. Consequently, in investigating the causes of the deficit, we have to look to **both cyclical and structural reasons.**

The cyclical behavior of the current account comes from a large and widening deficit of trade in goods, even as trade in services in increasingly in surplus. **However, an increasingly important component of the current account dynamic is the net investment payments**. Whatever measurement techniques are used, the value of foreign assets owned by the United States is less than the value of US assets held by foreigners; the negative net international investment position is some $1.5 trillion dollars. Over a period of less than 10 years, the net investment earnings on this position turned from a positive $22 billion to a negative $22 billion.

THE FORECAST

Forecasters project that the US trade deficit in 1999 will reach about $200 billion, and the current account deficit will be more than $300 billion, or about 3.3 percent of GDP. For at least the next year or two, however, the US current account deficit will continue to grow-changing the direction of US external balance is not a simple process.

First, because the trade deficit is so large now, to actually narrow the gap between exports and imports will require a dramatic change in the growth differential. For example, one combination of changes that would narrow the gap is if import growth slowed markedly to about one-quarter the average rate of growth in the 1990s and export growth rose significantly to about four times the rate of growth in the 1990s.

Second, the net investment payments on the US net international investment position will continue to grow so long as the current account is in deficit and net foreign investment continues; these net payments add to the current account deficit and the negative net international investment position.

FRAMEWORKS FOR ANALYZING THE CAUSES OF THE CURRENT ACCOUNT DEFICIT

There are two related frameworks for investigating the causes of the external deficit. The first framework focuses on the two components of the trade imbalance-exports and imports-and how they are affected by GDP growth at home and abroad and by movements in the exchange value of the dollar. The second framework focuses on how the trade imbalance is related to imbalances internal to the US between savings and investment, that is, between production and spending. The two frameworks yield consistent views, but they put the deficit in different perspectives. Capital markets play key roles in both frameworks.

THE GLOBAL FRAMEWORK OF INCOME AND RELATIVE PRICES

From a global perspective, the dramatic widening of the deficit in the late 1990s is fundamentally of a cyclical nature, being driven by a continued robust US economy while the rest of the world stagnates or drops into recession. Moreover, the impact of the differential in rates of growth of GDP on the trade balance has been **augmented by an appreciation of the dollar from mid-1995 of some 25 percent,** which has not fully worked through to affect relative prices even as the dollar has depreciated in recent weeks against the currencies of some of its major trading partners.

In general, the relationship between GDP growth and trade is very obvious in the data, although close examination reveals the role of the exchange rate as well (Figure 2). For example, when the dollar depreciated, as in the 1977-79 and 1986-89 periods, the price of imports into the United States tended to rise, so import growth was less than would have been expected on the basis of the growth of US income (the dotted line above the solid line in top panel). The price of US exports in the destination market currency tended to fall, making US exports more attractive there, and so exports grew faster than would have been expected on the basis of world income (the dotted line below the solid line in middle panel). Similarly, when the dollar appreciated in the periods of 1975-77 and 1981-85, the growth rate of US exports was less than or fell relatively more than would have been expected on the basis of the growth of foreign income (for these years, the dotted line above the solid line in middle panel). What is clear for the most recent period is the overwhelming role for differentials in income growth in driving the external deficit.

HOW CAPITAL MARKETS AFFECT THE EXTERNAL DEFICIT

In 1997 and 1998, **the global financial crises played an important role in both dampening income growth abroad as well as in bidding up the dollar.** In addition to the obvious impact on growth, this period illustrates how capital flows are transmitted to exchange rates and interest rates to affect the trade account and thus highlights the importance of the capital accounts in understanding today's current account deficit. (Figure 3)

The series of crises started in Thailand in mid-1997 and culminated in Russia's default on its external debt in August 1998. **Foreign investors' "flight to quality assets" led them to purchase US government securities** (which increased the inflow of capital to the United States) and also shifted the US domestic investor's portfolio toward US government securities. **Interest rates fell on US government securities** (top panel). The dollar continued

to appreciate as investors bought dollars to purchase US assets (middle panel). **The appreciation of the dollar** lowered import prices further and raised export prices in the currencies of the destination markets (bottom panel). Moreover, lower interest rates bolstered US economic activity, which boosted imports, while slack demand abroad hampered exports. Both the changes in relative prices and the differences in relative income induced by the crises widened the trade deficit. Hence **the increased demand for US assets by foreigners worked through both interest rates and exchange rates to yield a wider trade deficit and a matching higher capital account surplus.**

THE US APPETITE FOR IMPORTS AND THE TREND DETERIORATION OF THE TRADE DEFICIT

The trend widening of the trade deficit is related to an enduring puzzle in the international trade data: Even when the world grows faster than the US, the US trade deficit tends to widen. This is the **consequence of what apparently is a greater appetite for imports by US consumers and business than foreigners' appetites for US exports**. This so-called Houthakker-Magee effect has been a feature of US trade for the whole of the postwar period, but the **implications for the trade deficit are more apparent since the breakdown of the Bretton Woods system of fixed exchange rates.**

These results are particularly interesting in that, although they have persisted since economists started examining the relationships in the early 1960s (with data going back to the first postwar years), they violate long-run principles. That is, in a theoretical "long-run global equilibrium," all countries will import at the same rate, since if a single country imported more than its share, it ultimately would consume the production of all other countries. There is a similar "long-run internal equilibrium" within a country by which income and imports should grow at the same rate, since if income did not keep pace a country would ultimately spend all its income on imports.

An interesting question is whether the income asymmetry might gradually disappear as the world's economies mature and spend more on services and less on manufactured goods, with some of their growing demand for services spilling over into purchases of US service exports. **Supporting this possibility is the observation that the income asymmetry is quite pronounced for US trade in goods, but is nearly absent (by one estimate even reversed) for US trade in services (Table 1).** Changes in the composition of global trade could ameliorate this asymmetry, particularly if trade negotiations focused on services.

THE NIPA FRAMEWORK OF THE "TWIN DEFICITS"

A second approach to analyzing the causes of the current account deficit takes the domestic perspective as formulated in the National Income and Product Accounts. Many people have wondered why when the federal budget moved from deficit to surplus there was not a similar narrowing of the current account deficit. This "twin-deficits" hypothesis derived from the NIPA framework, which when rearranged, highlights the relationship between the fiscal budget and the current account but also highlights the relationship between private savings and investment. [(I - Sprivate) = Sgovt + Sforeign = (T - G) + (M - X)].

This accounting identity says that if private savings and domestic investment are about equal, or at least move by about the same amount, then the fiscal and external deficits will be twins-about the same size and moving in the same way. Indeed, from 1983 to 1989, private savings and investment did move together and so the deficits were twins. But in the 1990s, the private sector relationships changed.

THE 1990'S PATTERN OF INVESTMENT AND SAVINGS AND THE CURRENT ACCOUNT DEFICIT

The twin deficits separated in the 1990s in part because private savings and business investment did not move together in the 1990s as they had in the 1980s, and in part because private savings and public savings moved in opposite directions. (Figure 4) First, in contrast to the 1980s expansion, in which investment rates generally fell, economic activity in the 1990s has been powered by a continuous rise, to nearly a 17 percent rate, in real net investment for producers' durable equipment.

Second, a disparity in behavior among the three components of national savings increased. The corporate savings rate (loosely speaking, profits) rose smartly. The fiscal position moved into surplus as growth resumed and continued robustly. Throughout the 1980s and 1990s, however, the household savings rate generally has continued to decline, and indeed it collapsed at the end of 1998.

In the NIPA framework, the external deficit equals national savings (public plus private) minus investment. So why does the composition of savings matter? Input-output accounts for the United States suggest that the import intensity of government output is about 17 percent, whereas the import intensity of consumer spending on goods is about 58 percent, and the import intensity of investment spending on goods is about 50 percent. Consequently, an increase in public savings that is matched by a fall in private savings would not wash out in the external accounts but would appear to favor imports.

Indeed, the trend decline in the private savings rate, particularly of the personal household savings rate, appears to be importantly associated with the trend widening of the trade deficit, particularly the merchandise component. (Figure 5).

HOW CAPITAL MARKETS HELP TO SEPARATE THE "TWIN" DEFICITS

Why has business investment increased as a share of GDP, but household savings dropped so dramatically, with a widening current account deficit the result? A factor common to both is the dramatic increase in the value of corporations' equity, which comes from the continued robust growth of the US economy, the low rate of inflation, and the attractiveness to domestic and foreign savers alike of the US stock markets. The unprecedented rise in the US stock market has tended to make investors more confident of the future value of their wealth, inducing them to reduce the portion of their income that they save (Figure 6). At the same time, the climate of robust consumption and low inflation has encouraged business investment, so the savings-investment imbalance has widened.

The trend decline in personal savings and the dependence on wealth for consumption creates a vulnerability for households. Their consumption path cannot be maintained unless wealth growth and foreign savings continue on their present courses, which neither is likely to do in perpetuity.

THE ROLE FOR INTERNATIONAL CAPITAL FLOWS

In addition to the accounting identities, economic reasoning suggested that the deficits responded to the same economic fundamentals. During the 1980s, expansionary fiscal policy (as measured by the growing fiscal deficit) mixed with tight monetary policy to raise interest rates sharply and then keep them high, and the exchange value of the dollar appreciated (Figure 7). The appreciated dollar made US exports more expensive for foreigners to buy. Imports rose quickly as the US economy burst out of recession with a GDP growth rate of 7 percent. Hence the external deficit grew larger on account of pressures originating from the appreciation of the dollar as well as from the robustness of the expansion. The deficits were

thus twins through the mechanism linking fiscal deficit to interest rates to exchange rate to external deficit.

This chain of causality could have unwound the same way-a smaller fiscal deficit reduces upward pressure on interest rates, the demand for dollar-denominated assets falls, the dollar depreciates, and the external deficit narrows-and indeed, it appeared that this logic held for a number of years. But as the 1990s unfolded, this apparent chain of causality broke; the fiscal deficit shrank, but interest rates and particularly the exchange value of the dollar did not come down as far. Why?

The strength of the US economy has attracted foreign investment and has increased the use of the dollar as a vehicle for making those investments. Hence as the fiscal deficit contracted (reducing upward pressure on interest rates), the dollar exchange rate initially depreciated but then appreciated. The rapid increase in US stock market valuation attracted foreign investors, who helped bid up the markets as well as the value of the dollar (Figure 8). In addition, the dollar solidified its position as the lead currency of issuance in the market for international debt securities. Hence the assumption that the reduction of the fiscal deficit would reduce interest rates, help to depreciate the dollar, and thus close the external deficit was not borne out.

IN CONCLUSION

Cyclical spending is robust, the rest of the world is growing slowly, and this is why the current account deficit has continued to widen. In addition, the widening of the deficit as well as robust investment are due in part to capital markets-the robust US equity market and the strong dollar. In comparison to the 1980s, the pattern of spending in the 1990s is better balanced between consumption and investment goods, so the cyclical widening of the deficit in the 1990s is of less concern than it was in the 1980s. For the time being, the United States is an oasis of prosperity. However, the underlying persistent trend decline in the trade balance and its association with a persistent decline in personal savings are trends that cannot continue and they will sow the seeds of change to either (or both) income or exchange rates. Hence, from the long-term perspective, the United States is living beyond its means.