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Is the U.S. Current Account Deficit Sustainable?

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Summary

America's current account (CA) deficit (the trade deficit plus net income payments and net unilateral transfers) has been rising as a share of gross domestic product (GDP) since 1991. In the first half of 2005, the CA deficit reached a record high of 5.7% of GDP.

The CA deficit is financed by foreign capital inflows. Many observers have questioned whether such inflows are sustainable and expressed concern about the economic impact should foreign capital inflows decline rapidly. Some fear that a rapid decline in the CA deficit could cause a recession because, presumably, a decline in the CA deficit would trigger a sharp drop in the value of the dollar and a rise in interest rates (which could lower asset values). However, economic theory and empirical evidence suggest that should the CA deficit decline slowly, economic activity would not be greatly disrupted because production in the trade sector would be stimulated. Thus, the main issue of interest to policymakers may be whether a decline in the deficit would be gradual or sudden.

From 2000-2002, gross foreign private capital inflows declined sharply, from about \$1 trillion to \$600 billion a year. However, this reduction did not result in a decline in the CA deficit for two reasons. First, gross private capital outflows also declined. Second, private inflows were replaced by official inflows, as some foreign central banks increased their foreign reserve holdings.

One long-term consequence of a large CA deficit has been the growing foreign ownership of U.S. capital stock. A large CA deficit is not sustainable in the long run because it increases U.S. net debt to foreigners, which cannot rise without limit. A larger debt can be serviced only through higher borrowing or higher net exports. For net exports to rise, all else equal, the value of the dollar must fall. This explains why many economists believe that both the dollar and the CA deficit will fall at some point in the future. To date, debt service has not been burdensome. Because U.S. holdings of foreign assets have earned a higher rate of return than U.S. debt owed to foreigners, U.S. net investment income has remained positive, despite the fact that the United States is a net debtor nation.

Most episodes of a declining CA deficit in industrialized countries since 1980 were associated with slow economic growth. Only two episodes were associated with a severe disruption in economic activity. Because most of the episodes involved small countries, these cases may differ fundamentally from similar episodes in the United States. Historically, a few other countries have had a higher net foreign debt-to-GDP ratio than the United States has at present; however, if CA deficits continue at current levels, the U.S. net foreign debt could be the highest ever recorded within a few decades.

This report reviews studies on the CA deficit's sustainability. The studies suggest that a dollar depreciation of 10% to 56% could eventually be required to restore sustainability. This report will be updated as events warrant.

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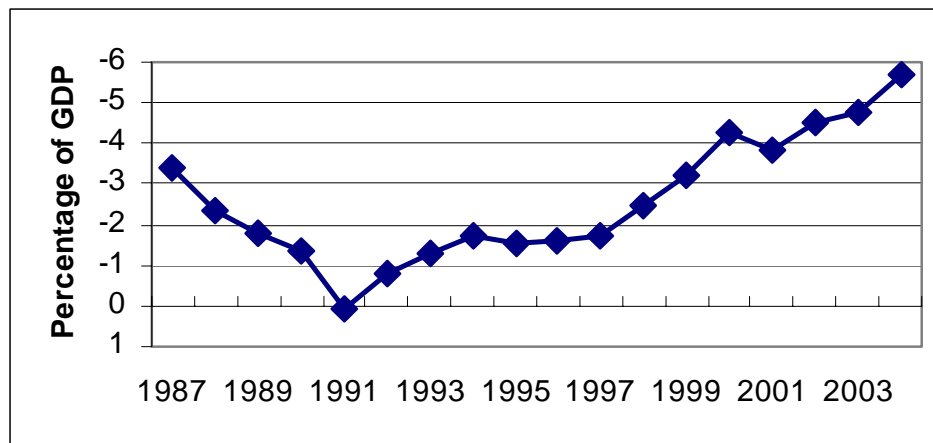
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Is the U.S. Current Account Deficit Sustainable?

America's current account (CA) deficit (the trade deficit plus net income payments and net unilateral transfers) has been rising as a share of GDP since 1991 (see **Figure 1**). The CA has been in deficit every year but one since 1982. By accounting identity, the CA deficit is equal to net inflows of foreign capital to the United States and reflects the imbalance between domestic saving and investment. In the first half of 2005, the CA deficit reached a record high of 5.7% of GDP.

Many observers have questioned whether the CA deficit is sustainable. It is not unsustainable in the sense that it directly inhibits the economy from attaining full employment — the United States has run large CA deficits for several years, yet economic growth has remained above 3% in most of those years. The CA deficit has both positive and negative effects on the economy. Production of exports and import-competing goods is lower than it would be in the absence of a CA deficit, but interest rates are also lower than they would be in the absence of foreign capital inflows. As a result, interest-sensitive spending on capital investment, residential investment, and consumer durables (e.g., automobiles and appliances) is higher.¹

Figure 1: Current Account Deficit as a Percentage of GDP, 1987-2004



Source: Bureau of Economic Analysis.

Those expressing concern about the CA deficit typically define unsustainability to mean that the CA deficit could decline very rapidly in the near future, harming the

¹ For an overview, see CRS Report RL30534, *America's Current Account Deficit: Its Cause and What It Means for the U.S. Economy*, by Marc Labonte and Gail Makinen.

U.S. economy. Basically, the CA deficit is sustainable as long as foreigners are willing to continue buying American assets. But if the desirability of U.S. assets were to change rapidly, foreign capital inflows and the value of the dollar could decline quickly; at a minimum, foreigners would require significantly higher interest rates than they do at present for inflows to continue.²

As long as U.S. assets yield a higher (risk-adjusted) rate of return than foreign assets, foreigners will presumably continue to find U.S. assets attractive. Financial markets automatically equilibrate, and if U.S. assets became less desirable, interest rates would rise to the point where they became desirable again. Ben Bernanke, who has been nominated to be Federal Reserve chairman, has argued that foreigners will continue to increase their holdings of U.S. assets in the near term because of a global saving glut that leaves them with few other desirable investment alternatives, and this makes the CA deficit unavoidable and benign.³ If both lender and borrower are rational, many economists believe that the CA deficit can be mutually beneficial — it allows the lender to enjoy a higher rate of return than could be enjoyed at home and allows the borrower to operate with a larger capital stock than could be financed from domestic saving. As long as those investments yield a high enough rate of return to service the debt, borrowing should not reduce future domestic income.

Some economists, however, doubt this interpretation and are concerned that the large CA deficit⁴ is symptomatic of wider economic imbalance.⁵ They argue that a country cannot persistently rely on foreign borrowing to finance its investment needs, so the United States must eventually raise its low saving rate. They maintain that by financing a large budget deficit and housing boom, much of the foreign borrowing is being used in ways that do not expand the economy's productive capacity, and therefore such borrowing does not enhance our ability to service foreign debt. Because foreign borrowing is not sustainable, they argue, Americans will eventually be forced to drastically increase their saving (equivalently, to reduce their consumption) and reduce their investment rates, and the U.S. economy will enter a recession. These economists see a potential tightening of monetary and fiscal policy as the appropriate response to an excessively large CA deficit, although this response would risk inducing the same recession that they fear the CA deficit may eventually cause.

² It is widely assumed that a rapid change in the current account would be caused by changes in financial markets, not goods markets. Although theoretically a rapid decline in imports could also cause the CA deficit to shrink, little empirical evidence exists that trade patterns change that quickly.

³ Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit," the Sandridge Lecture, Virginia Association of Economics, Mar. 10, 2005, available on the Federal Reserve Board of Governors website. For an analysis, see CRS Report RL33140, *Is the U.S. Trade Deficit Caused by a Global Saving Glut?*, by Marc Labonte.

⁴ For the purposes of this report, a CA deficit is considered large if it exceeds the growth rate of the economy.

⁵ See, for example, Edwin Truman, "Postponing Global Adjustment," Institute of International Economics, working paper 05-6, July 2005.

As a consequence of large CA deficits, a growing share of the U.S. capital stock is owned by foreigners and a rising fraction of U.S. income will need to be diverted overseas in the form of interest and dividends to foreigners. If the process were to continue indefinitely, foreigners would eventually hold only American assets in their portfolio, which is clearly unrealistic. But that does not mean that foreigners could not further increase their share of American assets in the near term, in which case the CA deficit would persist.⁶ One common assumption is that the CA deficit would, at most, continue until the share of American assets held in foreign portfolios exceeded America's share of world output; by this measure, foreigners still hold too few American assets. For example, citizens of the Euro Area hold an estimated 53% of their wealth in Euro Area assets and 19% in U.S. assets, whereas the Japanese hold an estimated 63% of their wealth in Japanese assets and 4% in U.S. assets.⁷ This is referred to as a "home bias" in saving because all countries hold more of their own assets, and fewer foreign assets, than optimal portfolio diversification would suggest. Most likely, this bias will never disappear entirely, so CA deficits will probably not continue until this benchmark is met. In any case, the reason why home bias would decline for foreigners but not Americans remains unclear, as continuing CA deficits would imply.

One reason that U.S. imports cannot exceed exports indefinitely (and could eventually lead to a falling dollar) is that today's CA deficits have a consequence for future trade balances. The accumulation of net debt that Americans owe to foreigners will need to be serviced in the future, which will take the form of a capital outflow from the United States. To service that larger debt, the United States must export more or borrow more to offset the outflow. But, all else equal, foreigners will only be induced to buy more exports if the dollar depreciates. Net investment income payments make up a small fraction of the CA deficit today, but economist Edwin Truman estimates that if CA deficits continued to equal 6% of GDP, net income payments would eventually reach 4.5% of GDP, leaving a trade deficit of only 1.5% of GDP.⁸ In other words, a constant trade deficit would imply a growing CA deficit because of growing net investment income payments.

The increase in the net debt explains why U.S. net income payments fell from an average of \$33.4 billion per year from 1979-1984 to an average of \$28 billion during 2001-2004. What is surprising about these data is that the United States still has positive net investment income despite its large net debt. That is because U.S. holdings of foreign assets have earned a higher rate of return than U.S. debt owed to foreigners. Between 2002 and 2004, the United States earned an estimated rate of return of 9.6% on its foreign assets and paid a rate of return of 0.9% on its foreign

⁶ Foreigners could decide to keep their holdings of U.S. assets fixed in dollar terms, which would result in a modest trade surplus because the debt service would represent a capital outflow.

⁷ Olivier Blanchard, Francesco Giavazzi, Filipa Sa, "The U.S. Current Account and the Dollar," Massachusetts Institute of Technology, working paper 05-02, May 2005.

⁸ Edwin Truman, "Postponing Global Adjustment," Institute for International Economics, working paper 05-6, July 2005.

liabilities.⁹ These estimated rates of return have prevented foreign borrowing from becoming burdensome and suggest that the U.S. net foreign debt could become significantly larger before debt payments would become burdensome.

Economic Impact of a Declining Current Account Deficit

Although a reduction in the CA deficit is inevitable (although not necessarily in the near future), it need not be sudden. It should be re-emphasized that economic theory suggests that a *slow decline* in the CA deficit and dollar would not be troublesome for the overall economy. In fact, a slow decline could have an expansionary effect on the economy, because the increase in net exports would have a more stimulative effect on aggregate demand in the short run than the decrease in investment and other interest-sensitive spending.¹⁰ Historical experience seems to bear this out — the CA deficit declined continually in the late 1980s, from 2.8% of GDP in 1986 to near zero during the early 1990s. Yet economic growth was strong throughout the late 1980s. (Of course, the adjustment required to balance the current account today is about twice as large, so historical experience may not be a good guide.)

A potentially serious short-term problem would emerge if foreigners suddenly decided to reduce the fraction of their saving that goes to the United States in the form of a capital inflow, or if they suddenly decided to repatriate part of their liquid capital. The initial effect could be a sudden and large depreciation in the value of the dollar, as the supply of dollars on the foreign exchange market increased, and a sudden and large increase in U.S. interest rates, as an important source of saving was withdrawn from the financial markets. Most likely, the *direct* trade effects of these shifts in lending patterns by foreigners would not cause a recession because the dollar depreciation would lead to a trade surplus (or smaller deficit), which expands aggregate demand.¹¹ However, the *indirect* interest rate effects, which typically offset the direct effects only partially, could cause a recession if the change is sudden. Large increases in interest rates could cause problems for the U.S. economy, as these increases reduce the market value of debt securities, cause prices on the stock market to fall, and jeopardize the solvency of various debtors. Resources may not be able

⁹ Philip Lane and Gian Milesi-Feretti, “A Global Perspective on External Positions,” National Bureau of Economic Research, working paper 11589, Aug. 2005. This also suggests that the high rate of return of U.S. assets may be more perceived than actual.

¹⁰ Truman looks at the issue from a different perspective. He argues that the CA deficit has occurred because domestic demand has outstripped supply (production). In a closed economy, this would be inflationary and would eventually lead to a decline in economic growth. But Truman believes that borrowing from abroad has allowed demand to continue to exceed supply without sparking inflation. Therefore, the CA deficit would only decline if demand growth declines, which means that the falling CA deficit would coincide with lower GDP growth.

¹¹ A sharp decline in the value of the dollar would harm standards of living because it would raise the price of imports to households. This effect, which is referred to as a decline in the terms of trade, would not be recorded directly in GDP, however.

to shift quickly enough from interest-sensitive sectors to export sectors to make this transition fluid.¹²

Is a scenario where the dollar crashes a likely one? Economic theory typically assumes that financial market participants generally act rationally. If the rationality assumption is a good one in the current context, then the potential for a sudden decline is slim. After all, foreigners would be demanding high rates of return to buy U.S. assets today if they could foresee that the foreign currency value of these assets is likely to fall sharply in the near future. However, a sudden decline in capital inflows is unlikely to occur in a purely rational context, in which case theory would have little predictive power. Given the traditional role the United States has played as an investment safe haven, sudden capital outflows seem unlikely. Another factor that makes the dollar crash scenario unlikely is its assumption that there will suddenly be few willing buyers of U.S. assets, whereas in practice, major U.S. financial markets always clear — at a high enough interest rate, buyers can always be found. This suggests that the worst case scenario is likely to be a sudden, albeit disruptive, spike in interest rates rather than a scenario where the financial system ceases to function smoothly. The Federal Reserve could mitigate the interest spike by reducing short-term interest rates, although this reduction would influence long-term rates only indirectly and could increase inflation.

One could also argue that a decline in foreign demand for U.S. assets has already occurred in recent years, with little detriment to the U.S. economy.¹³ From 2000 to 2002, gross private capital inflows fell from about \$1 trillion to \$600 billion annually. But this caused no corresponding decline in the CA deficit for two reasons. First, gross private outflows fell by a similar amount over that period. In this case, it was not U.S. assets in particular that became less attractive, but foreign investment worldwide. Second, private capital inflows were replaced by official capital inflows, as foreign central banks began financing a large portion of the U.S. CA deficit. Had these central banks not decided to increase their foreign reserves, the CA deficit might have fallen and the value of the dollar might have fallen more significantly. It is worth noting, however, that although the dollar did not experience a sizable overall decline, it did fall significantly against certain currencies without disruption to the U.S. economy. For example, it fell by one-third against the euro and one-quarter against the pound from the beginning of 2002 to the beginning of 2005.

Since 2003, private capital inflows have begun to rise again. Nevertheless, official inflows continue to account for a large source of net inflows. Because official inflows are likely financed by considerations other than rate of return, it is

¹² For a more formal explanation, see J. Bradford DeLong, “Some Simple Analytics for a ‘Hard Landing’,” working paper, University of California at Berkeley, April 2005. Interestingly, one study found that countries with larger declines in the CA deficit experienced, on average, higher GDP growth. See Hilary Croke, Steven Kamin, and Sylvain Leduc, “Financial Market Developments and Economic Activity During Current Account Adjustments,” *International Finance Discussion Papers*, Federal Reserve, no. 827, Feb. 2005.

¹³ For more information, see CRS Report RS21951, *Changing Causes of the U.S. Trade Deficit*, by Marc Labonte and Gail Makinen.

difficult to predict how sustainable they will be in the future. If foreign central banks reacted differently to a future decline in private inflows, the consequences for the U.S. economy could be quite different. But given the importance of the United States as a foreign export market, it is difficult to imagine that it would be in any country's economic self-interest to take a step that could potentially precipitate a U.S. economic crisis.

Historical Parallels

Most comparisons to historical experience abroad are limited by the fact that the United States economy is so much larger than those of other countries. As a result, economic development in the United States has ramifications for the world economy that could have feedback effects for the U.S. economy, whereas changes in the CA balance of most small countries will most likely not affect the world economy. Another difference is the role that the dollar plays as the world's "reserve currency." Because the dollar is the world's preferred currency for a store of value, medium of exchange, and unit of account, holders may be less willing to abandon it than they would any other currency. If so, the U.S. may be able to run higher sustainable CA deficits than other countries.

In the developing world, a large CA deficit has often been a leading indicator of financial and currency crisis. This was the case in many recent crises, including Mexico, East Asia, Turkey, Brazil, and Argentina. The applicability of these experiences to the United States may be limited, however, because the United States has a flexible exchange rate regime (and so does not have to defend its currency with foreign exchange reserves), is seen as a "safe haven" for investment, and, unlike developing countries, is able to borrow in its own currency (so that depreciation reduces rather than increases the burden of servicing its debt¹⁴). Therefore, historical comparisons have tended to focus on the experience of other industrialized countries.

To determine how long a CA deficit can be sustained, economists Maurice Obstfeld and Kenneth Rogoff looked at the net debt owed to foreigners as a percentage of GDP. They found that in 2003, this measure was about 23% of GDP for the United States, near an all-time high. Were CA deficits to continue at more than 5% of GDP per year, U.S. debt to foreigners would reach 70% of GDP within 30 years. Although this implies a relatively small yearly debt burden, many countries that have experienced CA reversals in the postwar period had smaller debt-to-GDP ratios, between 20-80% of GDP. Obstfeld and Rogoff identify only one country (Ireland) with a debt-to-GDP ratio that has exceeded 80%. Thus, the authors conclude that large U.S. CA deficits can not be sustained indefinitely.¹⁵

¹⁴ In dollar terms, depreciation would not affect the value of dollar-denominated liabilities. However, in foreign currency terms or in terms of the purchasing power that it conveys to foreign lenders, depreciation reduces the value of U.S. liabilities.

¹⁵ Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable U.S. Current Account Position Revisited," National Bureau of Economic Research, working paper 10869, Oct. 2004.

Economist Sebastian Edwards found that since 1970, only two other developed countries, Ireland and New Zealand, had high CA deficits that were long-lasting (seven and five years, respectively). He found that large countries that experienced sharp declines in their CA also saw per capita GDP growth decline by 3.6% to 5.0%.¹⁶

Goldman Sachs analyzed all episodes in developed countries since 1980 where the CA improved by more than 2% of GDP. It found 31 cases where the adjustment proved harmful to the economy and 13 where it proved benign. In the harmful episodes, the economy typically started from a position of overheating and the output gap (the difference between actual and potential output) worsened by an average of 3.6% of GDP, whereas in the benign episodes, the economy started from a position of excess capacity and the output gap improved by 1.9%. The fact that the economy was initially overheating in the harmful episodes suggests that causality may run in the opposite direction — the CA shift may be a symptom rather than a cause of economic slowdown. In the harmful cases, there was little real exchange rate depreciation; in the benign cases, it averaged 5.1%. In most cases, the adjustment took several years. In all cases, consumption growth was negative on average and (surprisingly) interest rates on average fell. In only two cases (Portugal in the early 1980s and Finland in the early 1990s) was the CA decline associated with a severe recession. (The recession and CA decline in Finland were widely attributed to the collapse of the Soviet Union.) Some of these cases may not be applicable to the U.S. experience, however, because the sample includes countries that had a small CA deficit or CA surplus. Only eight of these episodes involved a larger CA deficit as a share of GDP than the U.S. deficit today, and all of these eight episodes involved small countries.¹⁷

In a similar study, Debelle and Galati found little evidence that CA adjustments historically lead to significant disruption in financial markets. They found little change in the composition of capital flows before adjustment, which they argue is evidence that current account adjustment is caused by, rather than the cause of, broader macroeconomic imbalances.¹⁸

A Review of Three Estimates

Three recent academic papers address the sustainability issue. It should be noted that in all three papers, the models are not empirically derived; they are simulations based on theoretical assumptions meant to be consistent with reality.

¹⁶ Sebastian Edwards, “Is the Current Account Deficit Sustainable?” National Bureau of Economic Research, working paper 11541, Aug. 2005.

¹⁷ Dominic Wilson and Roopa Purushothaman, “Do Current Account Adjustments Have to Be Painful?” *Global Economics Weekly*, Goldman Sachs, no. 05/04, Feb. 2005. Similar results are found in Hilary Croke, Steven Kamin, and Sylvain Leduc, “Financial Market Developments and Economic Activity During Current Account Adjustments,” *International Finance Discussion Papers*, Federal Reserve, no. 827, Feb. 2005.

¹⁸ Guy Debelle and Gabriele Galati, “Current Account Adjustments and Capital Flows,” Bank of International Settlements, working paper 169, Feb. 2005.

Obstfeld and Rogoff have estimated how much the dollar would depreciate were the CA deficit to disappear. In their model, shocks to aggregate demand or shifts in the demand or supply of tradeable goods could cause the CA deficit to decline; they do not model exogenous changes in the demand for U.S. assets affecting the CA deficit. They estimate that the real exchange rate would depreciate between 14.7% and 33.6% if the CA deficit were eliminated by a change in aggregate demand, and between 9.8% and 25.5% if eliminated by a change in the supply of tradeable goods. They estimate that depreciation would be accompanied by a decline in the terms of trade between 3.9% and 7.1%. The predicted dollar depreciation is so large because about three-quarters of U.S. output is nontradeable, production cannot be quickly shifted into tradeable goods to take advantage of the depreciation, and import and export prices change much more slowly than the exchange rate. This model does not predict how much larger the CA deficit could get or how quickly it will eventually fall.¹⁹

Blanchard et al. explicitly allow asset demand to influence the exchange rate, and they assume that assets from different countries are not perfect substitutes. In their model, a CA deficit would eventually decline because demand for U.S. assets is finite. Although an increase in the demand for U.S. assets would initially cause the dollar to appreciate, they argue, it would later depreciate to finance debt service (though it would remain above its pre-appreciation value). They estimate that a 15% decline in the dollar would be associated with a decline in the CA deficit equal to 1.4% of GDP. About one-third of the decline in the CA deficit results from U.S. debt being denominated in U.S. dollars, because a depreciation reduces its value. Blanchard et al. estimate that stabilizing the net-debt-to-GDP ratio at current levels would require the dollar to immediately depreciate by 56% and the CA deficit to decline to 0.75% of GDP. However, assuming foreigners desire to maintain holdings of U.S. assets at their current share, their model predicts that the depreciation would be stretched over a few decades, depreciating by 2.7% a year, at most. If foreigners decided to reduce their holding of U.S. assets, the model predicts a larger, but still gradual, depreciation.²⁰

Edwards uses a similar model to simulate how much the dollar would depreciate depending on different assumptions about the foreign demand for U.S. assets. Unlike Blanchard et al, he projects fairly rapid declines in the CA deficit and dollar in the future. Under his optimistic scenario, in which he assumes that the U.S. net debt will rise to 60% of GDP by 2010 and then remain constant, the CA deficit would peak at 7.3% of GDP in four years, before eventually declining to 3.2% of GDP (with most of the decline occurring in the first four years after the peak). The real value of the dollar would appreciate while the deficit was increasing, but it would decline 21% in the first three years after the deficit began falling. If net debt were to decline to 50% of GDP after 2010 instead of remaining at 60% of GDP, which would still be

¹⁹ Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable U.S. Current Account Position Revisited," National Bureau of Economic Research, working paper 10869, Oct. 2004. The CA deficit was only 5% of GDP at the time of their paper, so their dollar depreciation estimates would now be larger.

²⁰ Olivier Blanchard, Francesco Giavazzi, Filipa Sa, "The U.S. Current Account and the Dollar," Massachusetts Institute of Technology, working paper 05-02, May 2005.

about double its current level, the decline in the CA deficit and dollar would be greater. Edwards calculates that the deficit would fall by 5.3% of GDP and the dollar would depreciate by 28% after three years, which would bring both measures close to their long-term projected levels.²¹

The wide dispersion of estimates on the dollar depreciation associated with a decline in the CA deficit points to the complex and imperfectly understood factors that determine the dollar's value, the lack of a consensus exchange rate model that performs well empirically, and the sensitivity of theoretical models to changes in uncertain empirical parameters. Furthermore, no model can answer the underlying question of how much and how quickly the CA deficit will potentially decline

²¹ Sebastian Edwards, "Is the CA Deficit Sustainable?" National Bureau of Economic Research, working paper 11541, Aug. 2005.