The first thing to note is that the deficit is indeed large. In 2003 it reached more than $600 billion, or 6.4% of US GDP. That's about 4% of world GDP. It was near zero in the early 1990s and has nearly doubled just since 2000 (see chart). That is not to say that the deficit is a creature of the last decade or so; already in the 1980s there were signs of trouble ahead, as increases in US domestic spending started outpacing GDP growth. A deficit that peaked at 3.4% of GDP in 1986 was reversed after a dollar decline boosted exports and dawnpaunched imports. However, a decline in the dollar since 2002 has not had the same effect.

If the US was a youthful, developing nation that needed substantial capital investment to infrastructure for instance, today's large external deficit might make more sense. But it is the world's largest and arguably most advanced economy, and most of the corresponding capital inflows are serving to finance current public and private consumption and housing, spending that will not make a significant contribution to the real economy.勒曼兄弟 in an article published by Lehman Brothers in May 2005 suggested that 'were the US an emerging market economy...which is not...[the risk indicators] would imply a one-in-two chance of a financial crisis.'

While a crisis might not be imminent, it seems clear the external balance has become a problem. One reason for this is that the deficit has been funded, which inevitably means debt. Fortunately, the US enjoys the privilege of being able to borrow in its own foreign currency—the US dollar is the world's primary reserve currency—but how long this peculiarity will allow the US to continue dodging a difficult adjustment is hard to know. In any case, net foreign debt is rising inexorably to around 2.5% of GDP, compared to 25 billion in 2004. Though the US is clearly the world's largest debtor, it is still far from being the largest in GDP terms.

In short, trade-related factors are not the only cause of the current account deficit. True, the size of the deficit reflects...
imbalance in goods traded as households and firms have been stockpiling more goods from abroad than the country exports. Indeed, many argue that Americans have a particular penchant for spending their extra income on imports compared with their trading partners. It has been known for some time that even if the US economy and the rest of the world grow at the same rate, the US trade deficit tends to widen. The result of this long-standing trend is that imports now exceed exports by 60%, and the dollar value of the deficit will continue to rise unless and until the tables are turned and export growth exceeds import increases by that same margin.

But apart from goods and services, the current account is also influenced by global market expectations of productivity and returns, asset prices, interest and exchange rates. To understand how this works, start with the basic fact—the US spends far more than it produces. This is reflected in an excess of imports over exports on the current account side, but it also shows up as the nation’s excess of investment over saving. Indeed, gross saving has fallen as a share of GDP since the 1980s.

For many experts, there is a risk that even the massive US economy will soon exhaust its “credibility range” with foreign investors.

responsible for this trend. Moreover, while the US is not alone in inflation, low interest rates and rising confidence and wealth, fiscal and monetary policies have also fuelled what might have been a shortage of domestic finance available for productive investment.

Fortunately the worst has recently been one of global excess saving, so that foreign credit has been available on reasonable terms. But while financial inflows from Asia and Europe have bolstered US investments, allowing capital to accumulate, the claims on that capital are held by residents of other countries.

Sloper decline
Current account balance, % of GDP, 1990-2005

And that means the resulting income will accrue to them.

Meanwhile, although global capital flows have risen sharply, foreigners are still more attuned to buying US assets than are Americans to purchasing foreign assets. The upshot is that by 2004 US gross foreign liabilities of around 107% of GDP surpassed its gross foreign assets of 95% of GDP. Since 2003 the US appetite for investments abroad has strengthened, but foreign demand for US assets has also surged, notably from central banks and private institutional investors. Direct investment and portfolio investment in equities were a major attraction before the stock market bubble; more recently prudence has triumphed, with the United States drawing the self-hired card: indeed, many US Treasury debt securities were sold to non-residents in 2009 to fund most of the federal government deficit that year. Now they hold nearly half of US federal government debt.

Is this a problem? For many experts, there is a risk that even the massive US economy will soon exhaust its “credibility range”, with foreign demand for higher returns to compensate for the increased portfolio risk pushing asset prices and the dollar down and interest rates up, raising the spectre of a crisis.

Despite being dismissed, most experts see the deficit widening anew, with a trillion dollar deficit now in sight and the possibility that it will reach a double-digit share of GDP in a few years down the line.

However, not everyone agrees that the current account deficit is problematic. One popular hypothesis is that capital inflows will continue to meet the requirements of a growing current account deficit because the US is such a good investment location. This idea is heard less often since the stock market plunge of 2000-03. Some new claim that it will remain in the interest of emerging-market economies to hold their dollars to absorb almost limitless amounts of surplus rural labour.

Others argue that the US line of credit with the rest of the world has no clear time frame for repayment, especially since all those central bank lenders are not having fun for profit. Then there is that recent novel argument, mentioned at the start, that the whole deficit is a mirage caused by a massive failure to record illicit exports of so-called “ CHIPs transfer” in the form of external liquidity services (marginal cost) or, less credibly, insurance services and know-how.

However reasonable or otherwise such positions may be, there is a risk that the dollar will simply lose its place as the leading international reserve currency if confidence in its value is undermined or if...

Not everyone agrees that the current account deficit is problematic.

the euro becomes more attractive. The view gaining wider acceptance is that the risk of the downgrading coming to the form of a crunch will grow with the foreseeable greater US indebtedness.

Solutions?
Can—or indeed, should—anything be done to reverse the current account deficit? There is no easy way out, but it seems clear that as the result of a plethora of decisions by individuals and firms, it will continue to be large as long as the policy environment remains unchanged. A looming dollar and...
free capital movements destroy the case for any deliberate policy to rein in the deficit, skipping the brakes on demand, for instance, would slow exports, but it would also cause heavy damage to the writer's economy, including key trading partners.

Yet the problem should not be ignored. The US authorities should at the very least avoid compounding the imbalance with budgetary decisions that fuel it. The role of budgetary policy in shaping current account outcomes has long been recognized. Correcting this is where US policy-makers must be careful. The contractionary effects of budget deficit reduction can be offset by easier monetary policy.

Thus, the federal government is aiming to cut its deficit in half by 2009 and to raise private saving through educational and health savings accounts, for example. And as the deficit is also caused by weak growth abroad, it is working with partners too, for example, through the US-Japan Economic Partnership for Growth.

But perhaps the most efficient way to raise national saving and shrink the external deficit would be to remove biases in the US tax code. Take the tax treatment of homeownership. This is probably its biggest single distortion because the deductibility of mortgage interest provides a strong incentive to borrow. In fact, half the proceeds is spent on consumption, thereby boosting the trade deficit. Eliminating this subsidy would spur saving instead. If the federal deficit could be gradually reduced while bringing the tax treatment of housing to normal over time, the dollar would depreciate, and the external accounts would ease back towards balance.

Such a policy would make overall production towards tradable goods and services. This is too big a change, since a shift of this kind will have to be extended, if the US current account deficit is to narrow. Complementary policy changes would be needed to facilitate moving to what would essentially become an new industrial structure, such as revamping business taxation and corporate bankruptcy law and upgrading employee skills. This is the area where the US is clearly lagging. More vigorous market-opening abroad, as well as growth-enhancing structural reforms in other OECD countries would also cut the deficit, though only modestly to be sure.

Whatever approach is adopted, a large real-depreciation of the dollar seems inevitable. The only way to reduce the pain of such an adjustment would be to ensure that nominal and labour costs are easily freed from non-tradeable to tradable activities—both goods and some services, such as engineering, to tradeable services. That means the government must aim at flexibility in its product and labour markets. Luckily, the US has arguably the most flexible markets in the OECD, as reflected in the fact that, despite recent shocks, unemployment has remained low.

The basic messages are simple, yet, the problem of the US current account deficit could become serious, and no, direct intervention is not the solution. Rather, the government should get its policy settings right. That means bringing down the deficit—which is prudent in its own right—while at the same time removing any anti-saving biases from policies and enhancing the capacity of the economy to shift resources to production of tradable goods and services. At the end of the day, the market, if allowed, can do the rest.

References

