The Expanding U.S. Current Account Deficit and its Effect on Exchange Rates

By Susumu Doihara

Economic Research Group

doihara@nli-research.co.jp

The current account deficit of the United States has been expanding relentlessly, and shows no signs of slowing down. The main cause is the growing trade deficit. Imports have consistently outpaced exports year after year, such that imports are now twice as large as exports. We examine structural factors of the economy that lead to the growing deficit, and explore the future of the current account balance and its impact on exchange rates.

1. Introduction

Despite all the attention that America's growing current account deficit has received over the years, it continues to expand at an alarming rate. In 2004, the deficit reached 668.1 billion dollars, or 5.7% of nominal GDP—a high level even by historical standards.

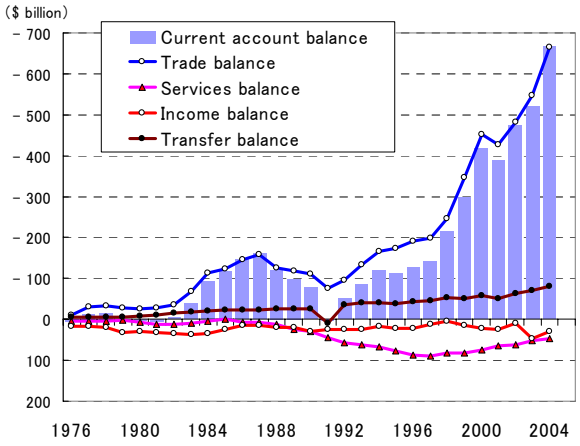
Meanwhile, since the U.S. current account deficit implies a surplus for trade partners, the U.S. economy is also increasingly contributing to and influencing the global economy. We examine the causes of the expanding current account deficit, and discuss its effect on exchange rates.

2. The Growing Current Account Deficit

(1) The Main Cause

The biggest part of the current account deficit is the trade deficit, which actually exceeds the current account deficit in most years. The transfer account deficit is also growing, while the services account is positive but flat, and the income account is positive but shrinking. However, these other components are not significant in size. As a result, we focus mainly on the trade deficit (Figure 1).

Figure 1 Current Account Balance



Source: U.S. Department of Commerce.

(2) Trend in the Trade Balance

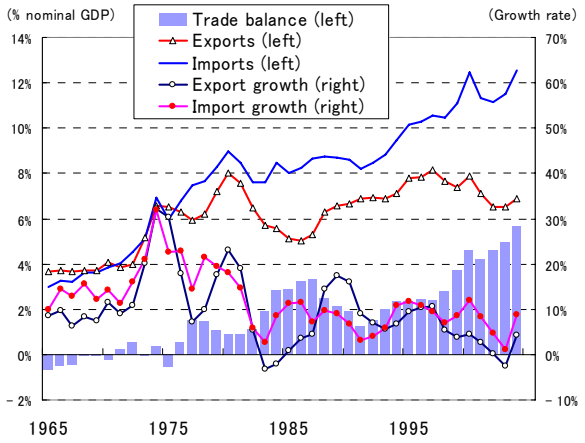
① Exports lag behind imports

Until the mid 1970s, the U.S. trade balance had occasionally posted a surplus. But imports exceeded exports for good in 1976 (BOP basis). Then in 1992, import growth outpaced export growth for the first time, and this condition has persisted ever since with the exception of 1995 and 1997. In other words, when imports not only surpassed exports but began to grow faster, the trade deficit started to expand year after year. Compared to the evenly balanced situation between imports and exports in 1976, exports

shrank to 54.8% of imports by 2004 and 53.7% in 2005 (Q1-Q3), and the ratio of imports to exports continues to approach two to one.

The trade deficit is already 86% the size of exports (cumulative, Q1 to Q3 2005). When exports shrink to one-half the size of imports, exports will equal the trade deficit in size, which means that even if exports were to grow twice as fast as imports, the size of the trade deficit will remain at the present level. But as we noted, since strong import growth has already become a fixture of the economy, unless the structure of the economy and trade change radically, the trade deficit will keep growing (Figure 2).

Figure 2　Merchandise Trade Balance

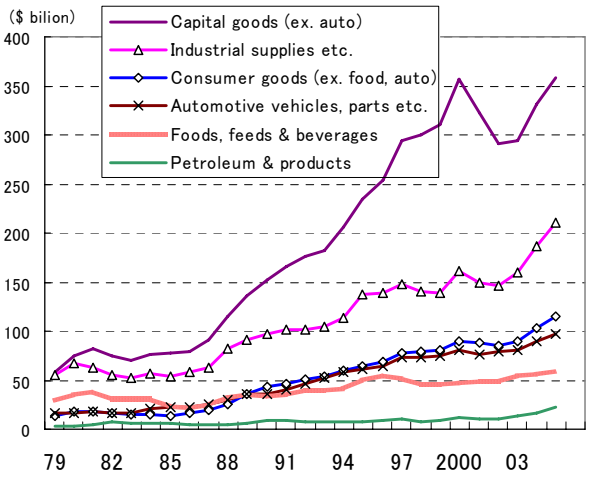


Source: U.S. Department of Commerce

② Trend by category

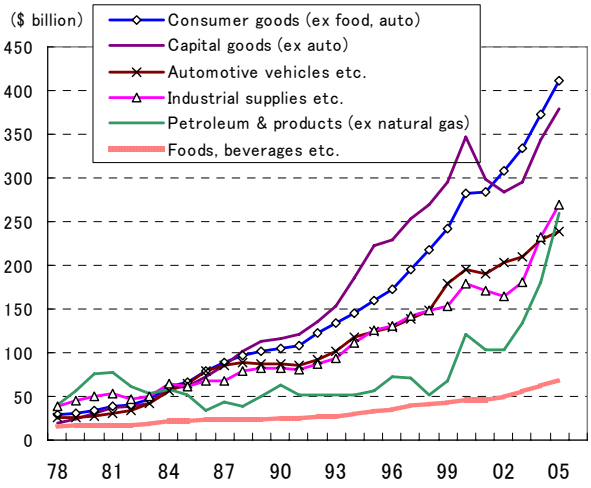
On the export side, the largest category is capital goods exports (except automotive). After plunging in the 2001 recession, capital goods exports recovered to the previous peak level of 2004. While capital goods imports also fell in the recession, they subsequently surged, pushing the capital goods balance into deficit from 2003. The same pattern also occurs for the second largest export category of industrial supplies and materials. Similarly, the smaller category of foods, feeds, and beverages turned to a growing deficit from 2002 after many years in surplus. In fact, all the major categories have turned from a stable surplus to deficit (Figures 3 to 5).

Figure 3　Exports by Category



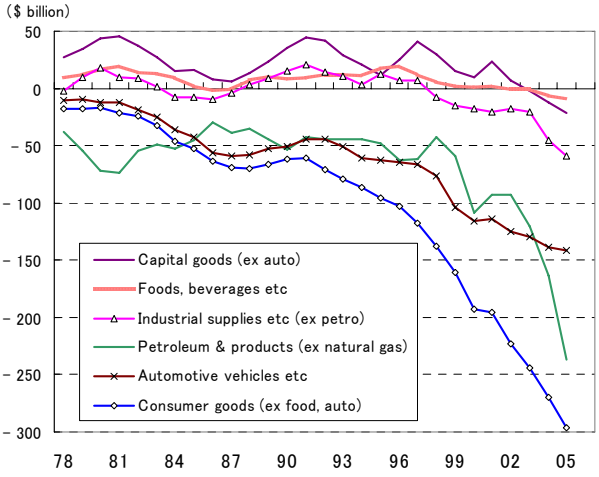
Note: Annual data, census basis.
Source: U.S. Department of Commerce

Figure 4　Imports by Category



Note: Annual data, census basis; 2005 is estimate.
Source: U.S. Department of Commerce

Figure 5　Trade Balance by Category



Note: Annual data, census basis; 2005 is estimate.
Source: U.S. Department of Commerce

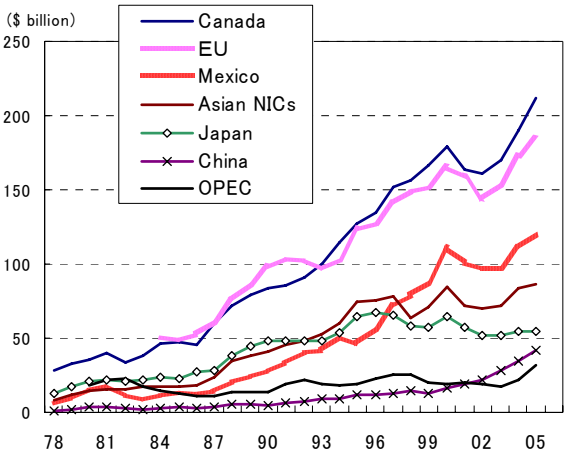
Meanwhile, the leading import category shifted from capital goods to consumer goods (non-food except automotive) in the 2001 recession. Being traditionally weak in exports, consumer goods have led the merchandise trade deficit since overtaking petroleum imports in the mid 1980s. Due to skyrocketing oil import prices, petroleum and products (excluding natural gas) have contributed almost as much to the trade deficit as consumer goods in recent years. The third largest contributor is automotive vehicles, parts and engines, whose deficit is growing slowly but steadily.

③ Merchandise trade balance by region

Imports to the U.S. are led by the EU, Canada, China and Mexico. However, since joining NAFTA in January 1994, Canada and Mexico have also received more U.S. exports, making their bilateral trade surpluses with the U.S. smaller than that of Japan.

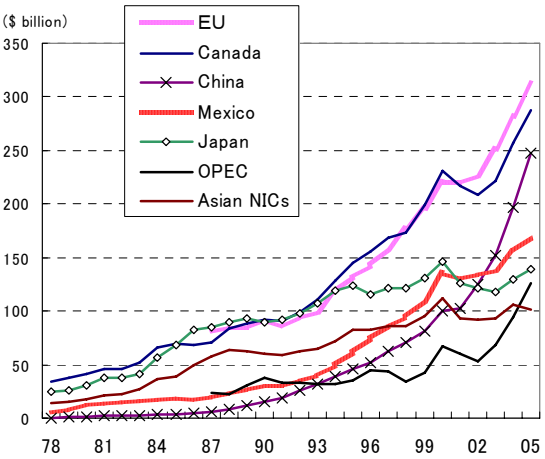
On the other hand, U.S. imports from China have surged while exports to China remain small. In fact, America's bilateral trade deficit with China surpassed the deficit with longtime leader Japan in 2000, reaching twice the size or $200 billion in 2005. By category, Chinese imports to the U.S. are mainly consumer goods such as electrical appliances, toys and shoes, which are non-cyclical and expected to grow consistently (Figures 6 to 8).

Figure 6 Exports by Destination



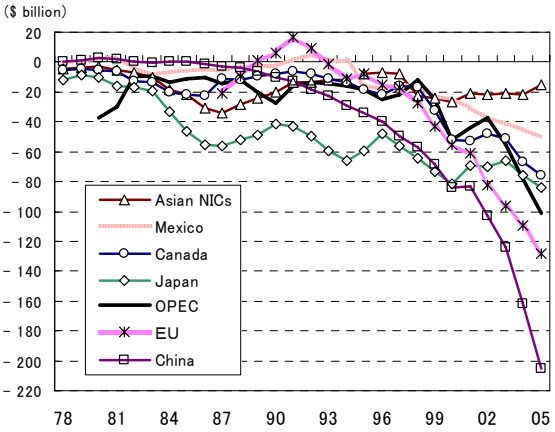
Notes: Census basis; 2005 is estimate.
Source: U.S. Department of Commerce

Figure 7 Imports by Origin



Notes: Census basis; 2005 is estimate.
Source: U.S. Department of Commerce

Figure 8 Trade Balance by Region



Note: Census basis; 2005 is estimate.
Source: U.S. Department of Commerce

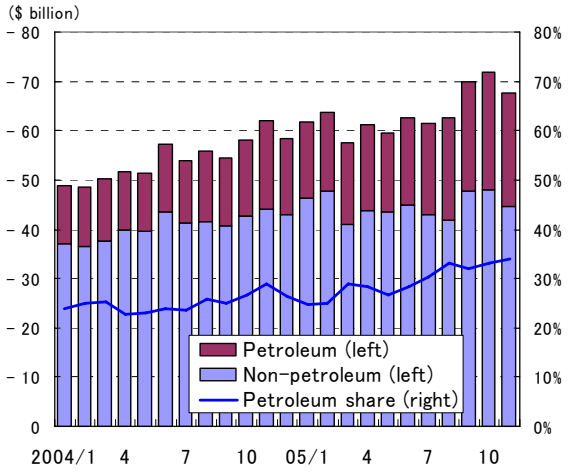
(3) Causes of the Growing Trade Deficit

Aside from China, the U.S. also has a rapidly growing trade deficit with OPEC countries due to the rise in oil prices. But unlike previous oil price spikes, oil prices are expected to remain high due to growing demand from economies such as China and India, causing the U.S. trade deficit to expand further.

The trade deficit (including services) from January to November 2005 reached 661.8 billion dollars, already topping the record annual deficit of 617.6 billion dollars in 2004. Much of the trade deficit's recent growth can be attributed not only to growing Chinese imports but to high oil

prices—petroleum product imports in the January-November period climbed 39.9% from a year ago, comprising 29.6% of the merchandise trade deficit (Figure 9).

Figure 9 Petroleum Products as a Share of the Trade Balance (monthly)



Notes: Census basis; seasonally adjusted.
Source: U.S. Department of Commerce

By region, the largest bilateral trade deficit for the same period is with China, at 185.3 billion dollars (census basis, excludes services) or 26.4% of the trade deficit. This amount is an astounding 2.4 times larger than the second largest bilateral trade deficit with Japan of 75.9 billion dollars.

To curb the growing trade deficit, the U.S. is expected to rein in the two main causes—growth of the trade deficit with China, and growth of oil imports. The U.S. contends that the 2% currency revaluation China implemented last July was insufficient, and is seeking further revaluation. China, whose official reserves are already among the world's largest, no longer has compelling reasons to maintain the dollar peg, and is expected to adjust its currency gradually in the future.

On the other hand, the energy problem is more complex. With few prospects for oil prices to decline, the U.S. government is working on long-term strategies to develop Alaskan oil fields and clean energy sources such as hydrogen, as well as pursuing short-term alternatives such as hybrid car subsidies.

2. Structural Causes of the Worsening Trade Deficit

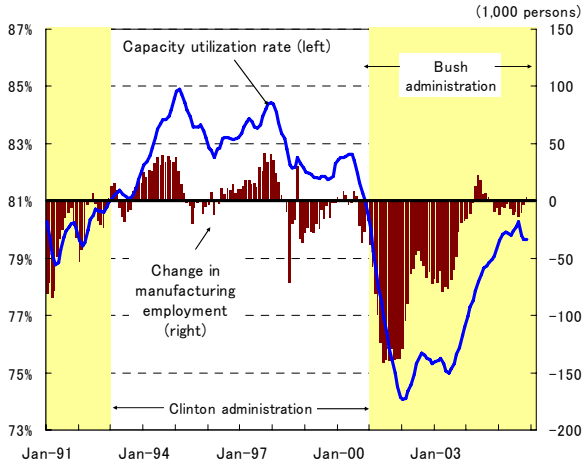
(1) Globalization

The 2001 recession accelerated the globalization process in the U.S. As cost competition intensified, U.S. companies moved offshore and outsourced production of labor-intensive consumer goods. This accelerated the shift of production bases to NAFTA trade partners and China.

Manufacturing employment has weakened following the 2001 recession, despite the subsequent recovery in production and operating rate. While this has improved productivity, the offshore shift of labor-intensive consumer goods production has exacerbated the trade deficit, particularly with China.

In the future, even if rising incomes push up wages in China, the U.S. will simply shift the procurement source to lower-cost countries, keeping the offshore procurement structure essentially intact.

Figure 10 Manufacturing Employment and Capacity Utilization Rate



Note: Capacity utilization rate and employment are 3-month moving averages.
Sources: U.S. Department of Labor; FRB

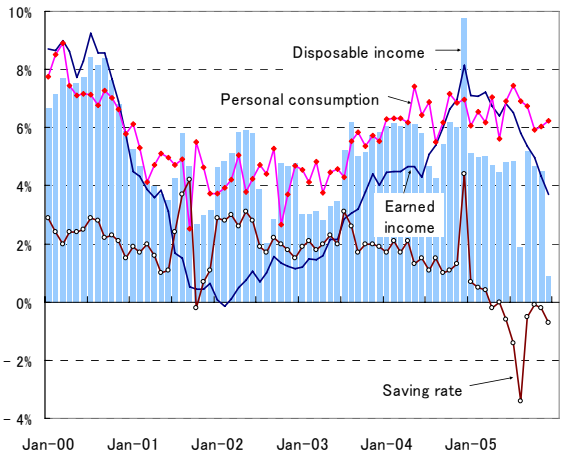
(2) Structure of Excess Consumption

Despite a major tax cut, the economy remained sluggish after the 2001 recession, in part due to weakness in employment. Another tax cut was

implemented in 2003 (which mainly moved up provisions in the 2001 tax cut), while monetary policy combated deflation by driving down interest rates to historical lows—the federal funds rate fell to 1% and long-term rates dipped below 4%. As a result, mortgage rates fell and house prices rose, which generated demand for refinancing and significantly reduced the interest burden of households.

Households took advantage of rising home equity values by refinancing mortgages and taking out home equity loans. Flush with cash, they continued to consume in excess of disposable income, sustaining the economy even as weak employment was slowing disposable income growth. However, the persistent and large consumption expenditures have created the anomaly of a negative saving rate (Figure 11).

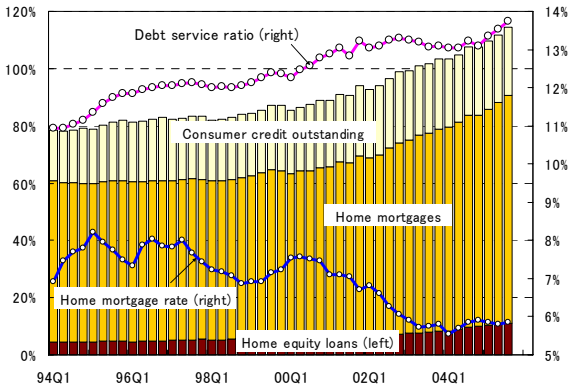
Figure 11 Consumption Exceeds Disposable Income



Note: Shows year-on-year change.
Source: U.S. Department of Commerce

Meanwhile, as household liabilities grew, the debt service ratio (ratio of debt payments to disposable income) rose persistently from 91% in 2001 Q3 immediately before the recovery to 115% in 2005 Q3, for a 24-percentage point increase. During this period, the debt service ratio at first leveled off despite the debt increase as refinancing captured lower interest rates, but turned upward after mortgage rates bottomed out in 2004 Q1. Looking ahead, the high debt service ratio will likely rein in excess consumption (Figure 12).

Figure 12 Household Debt Service Ratio



Source: U.S. Department of Commerce; FRB

3. Current Account Deficit and the Flow of Funds

The relationship between excess consumption and the current account deficit can be clarified using *Flow of Funds* data, which shows the net financial investment position of each sector. The net financial investment position of the rest of the world sector corresponds to the current account deficit. Below we examine how the rest of world keeps the U.S. economy in balance.

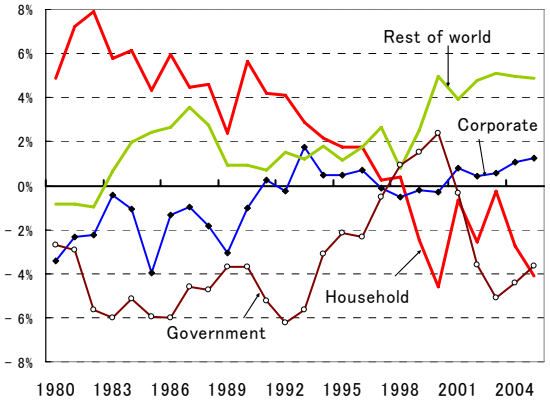
(1) Structural Shift in the Late 1990s

The current account deficit gained renewed attention with the reemergence of the twin deficit problem during the Bush administration. But already in the late 1990s, significant changes had occurred in the flow of funds by sector. With the so-called new economy growing at a spectacular 4% rate and inflation under control, vigorous investment in IT led to a financial deficit in the corporate sector. The household sector, which had traditionally posted a financial surplus, turned to deficit in 1999 as unemployment fell and consumption surged. This deficit was financed by a surplus in the government sector—which was enjoying rising tax revenues—and by capital inflows from the rest of the world.

When the recession arrived, the corporate sector made stock adjustments and posted a financial

surplus, while the government sector reverted to deficit. Meanwhile, the household sector's deficit and rest of world sector's surplus remained unchanged. This flow of funds structure—with households and the government in deficit, and financed by a surplus in the corporate and rest of world sectors—has persisted to the present day. Thus the reversal of flows between the household and corporate sectors had already occurred in 1998.

Figure 13 Net Financial Investment Position by Sector



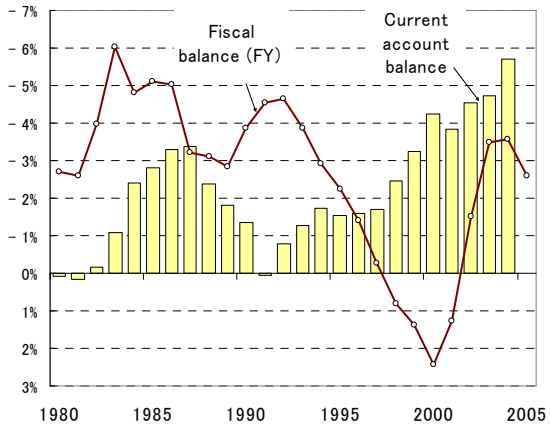
Notes: Annual data except for 2005, which includes up to 3Q.
Sources: U.S. Department of Commerce; FRB

(2) Reemergence of Twin Deficits

Meanwhile, a pattern has emerged in which the government deficit is financed by the rest of world sector. Under the Bush administration, the government sector's deficit was aggravated not only by the recession's effect on tax revenues, but by two major tax cuts. Moreover, following the terrorist attacks in 2001, defense expenditures surged to conduct military operations in Afghanistan and Iraq. As a result, the federal fiscal surplus inherited from the Clinton administration turned to a persistent fiscal deficit that, along with the growing current account deficit since 1990, surpassed 3% of nominal GDP in 2003 (Figure 14).

However, an important difference from the twin deficits of the 1980s is that today the current account deficit significantly exceeds the fiscal deficit. In the 1980s, the current account deficit peaked at 3.4% of nominal GDP in 1987, compared to 5.7% in 2004. Meanwhile, the fiscal deficit, which peaked at 6.0% of nominal GDP in fiscal 1983, stood at 3.6% in fiscal 2004, dropping to 2.6% in fiscal 2005, and predicted to rise to 3.2% in fiscal 2006 due to hurricane related spending.

Figure 14 Twin Deficits (% nominal GDP)



Sources: U.S. Department of Commerce; Department of the Treasury

Thus while today's twin deficits rival the 1980s in magnitude, the flow of funds has developed a different pattern. In the 1980s, the corporate and government sectors competed for funds from abroad, bidding up interest rates. Today, there is an ample inflow of foreign funds, long-term interest rates are low, and little criticism is heard linking the fiscal deficit and current account deficit.

4. Effects of the Expanding Current Account Deficit

(1) Effect on Exchange Rates

The large effect of the U.S. current account deficit on exchange rates makes it a risk factor for the global economy. Normally, when an economy runs a persistent trade deficit, its default risk grows as debt mounts, reducing the currency's value. But the U.S. is an exception because of the dollar's anchor currency status, which allows it to pay for imports with its own currency. In addition, trade partners are eager to accumulate dollar assets as foreign reserves as well as to bolster confidence in their currency.

Thus while an expanding current account deficit works to weaken the dollar, in reality the dollar can maintain its strength as long as the flow of funds into the U.S. remains stable.

(2) Inflationary Effect

The current account deficit is sometimes criticized as inflationary—that foreign funds are financing excessive consumption and government spending, stimulating too much economic growth. The FRB has taken a cautious stance on inflation and the current account deficit. However, to date inflation has remained stable even with rising oil prices.

If the U.S. economy were suffering from inflation and stagnation as in the 1970s, confidence in the dollar would be a pressing issue. But after the vigorous growth of the late 1990s, the U.S. now enjoys a strong position in the global economy, and confidence in the U.S. economy is not likely to falter soon. What we can say is that the current account deficit poses a threat to the global economy in the medium to long term, and warrants corrective action as early as possible.

(3) Sustainability of the Deficit

Federal Reserve Chairman Alan Greenspan recently commented that the expanding current account deficit is not an immediate problem, but cannot be sustained indefinitely.

The problem of sustainability is twofold. First, if the current account deficit remains at over 6% of nominal GDP year after year, the cumulative effect over the next decade will be equivalent to almost 100% of nominal GDP. This will greatly aggravate the default risk

Second, on the flow side, Treasury securities already comprise the bulk of foreign-owned assets in the U.S. As foreigners continue to buy more Treasury securities, interest payments to abroad will grow, worsening the income account within the current account balance. This means that outstanding foreign-owned assets in the U.S. and the current account deficit will start expanding in a vicious cycle. The problem can be contained as long as interest payments are limited, but the danger exists that interest payments and the current account deficit will start to snowball at some point.

Moreover, not all gains from stock and bond investments by foreigners will flow abroad; a portion will be reinvested as long as the economy continues to perform and enjoy strong confidence. Nonetheless, as foreign-owned assets in the U.S. grow at an accelerating rate, the net international investment position of the U.S. will deteriorate more quickly.

5. Net International Investment Position and Exchange Rates

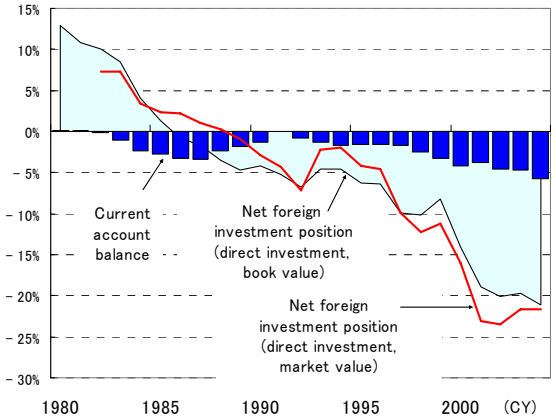
(1) Deteriorating Net International Investment Position

The current account deficit is likely to be left unattended until it affects exchange rates and inflation, or else upsets the flow of funds into the U.S. Thus the sustainability of the current account deficit becomes a vital concern.

The problem boils down to America's net international investment position. If the current account deficits continues at 6% of GDP year after year, the negative net international investment position—which is already equal to 22% of GDP—will keep growing, as will its detrimental effect on the dollar rate (Figure 15).

As we mentioned, what distinguishes the U.S. from debtor nations that have experienced a currency and debt crisis is the dollar's anchor currency status—the dollar is accumulated and transacted as a reserve currency. The acid test will be how long it can enjoy confidence as an anchor currency. The lack of historical precedence makes it difficult to pinpoint the threshold as a percentage of GDP. But there is no question that the threshold is approaching, and that the problem cannot be ignored indefinitely.

Figure 15 Net Foreign Investment Position (% nominal GDP)



Source: U.S. Department of Commerce

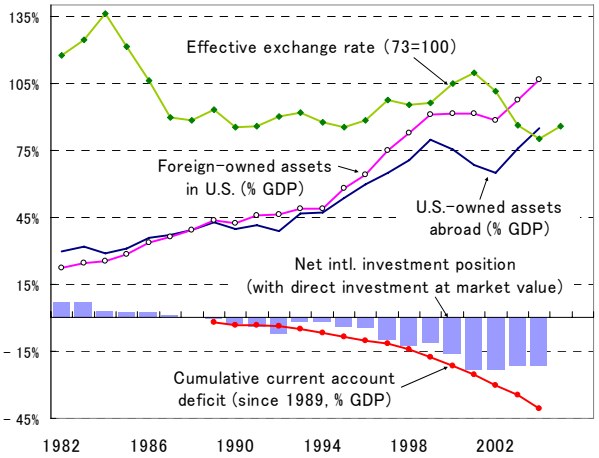
(2) Factors Affecting the Net International Investment Position

The net international investment position of the U.S. is calculated in two ways—with direct investment positions at current cost, and at market value. At the end of 2004, the market value of U.S.-owned assets abroad equaled 85% of nominal GDP, while foreign-owned assets in the U.S. equaled 107% of nominal GDP. The difference of 22% is the negative net international investment position. However, this position does not necessarily grow proportionately with the current account deficit. In fact, the net international investment position as a ratio to GDP has leveled off since peaking in 2002 (Figure 15).

This is because U.S.-owned assets abroad have grown faster than foreign-owned assets in the U.S. as a ratio to GDP. Thus despite the current account deficit, the U.S. net international investment position may not deteriorate if either U.S.-owned assets abroad increase, or foreign-owned assets in the U.S. decrease. The main cause is that the value of assets held abroad is calculated in dollars. Another possibility is for U.S. and foreign stock markets to move in opposite directions. But this is unlikely given that global financial markets are becoming increasingly integrated.

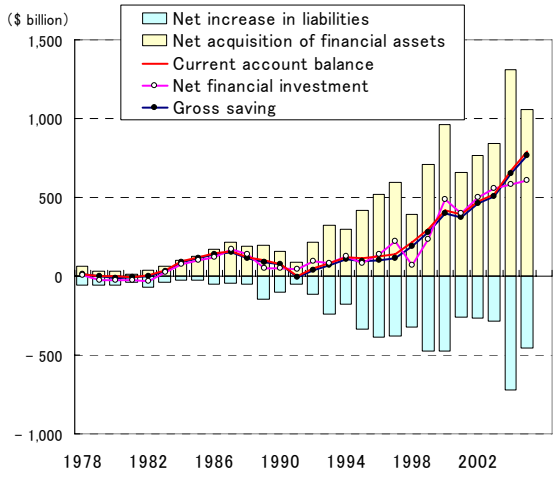
After peaking in 2001, the effective dollar rate declined, causing the value of U.S.-owned assets abroad to start growing. Meanwhile, foreign-owned assets in the U.S. have grown with the current account deficit, but not as much (as a ratio to GDP) as the dollar value of U.S.-owned assets abroad. Thus the net international investment position stabilized in this period. However, the dollar strengthened in 2005, renewing concerns that the net international investment position may deteriorate (Figure 16).

Figure 16 Net International Investment Position and Exchange Rates



Notes: Ratio to nominal GDP; annual basis; effective exchange rate at yearend.
Sources: U.S. Department of Commerce; FRB, *Major Currencies*.

Figure 17 Net Financial Investment of the Rest of the World



Notes: Annual data, 2005 is average annual rate for Q1-Q3.
Sources: U.S. Department of Commerce; FRB

In the net financial investment position of the rest of the world, funds flowing into the U.S.

greatly exceed the current account deficit, with the excess circulating back abroad as U.S.-owned assets abroad, and growing yearly (Figure 17).

(3) Early Adjustment of Exchange Rates

As we have noted, U.S.-owned assets abroad now equal 78% of foreign-owned assets in the U.S. (as of 2004). This implies that if the dollar were to depreciate by over 20%, the dollar value of U.S.-owned assets abroad would equal that of foreign-owned assets in the U.S. Stated differently, the dollar is already at risk of a depreciation of over 20%.

Indeed, since a large portion of U.S.-owned assets abroad are dollar-denominated assets, a dollar devaluation of this magnitude would create a shortage. However, the point is that at least on paper, a dollar devaluation can eliminate the negative net international investment position. This is an important difference that sets the U.S. apart from other debtor nations facing a potential currency crisis.

However, engineering a dollar devaluation is no simple matter. Trading ranges exist for major currencies, while many other currencies are pegged to the dollar. Heavy-handed tactics would also upset the flow of funds from abroad. Moreover, financial markets would react strongly to expectations of a dollar devaluation, triggering outflows of foreign-owned and domestic financial assets, and causing chaos in stock markets.

Given the likelihood of sustained and large current account deficits in the future, moderate exchange rate adjustments are called for to weaken the dollar and avert potential chaos in financial markets.

Conclusion

The twin deficits differ in an important way. The fiscal deficit is largely the result of deliberate policies that increase spending above revenue estimates. On the other hand, the current account deficit is largely a market outcome among trade partners. Criticism has thus centered on the fiscal deficit, while the current account deficit is attributed to market forces in the context of fair trade and free exchange rates. It thus follows that exchange rates and market forces can also work in the opposite direction to curb the current account deficit.

In this respect, a prevalent view in the U.S. holds that the current account deficit and the economic growth that it produced have benefited other economies as well. If America's major trade partners had stronger economies to begin with, they say, U.S. exports would be more vigorous and the current account deficit less pronounced.

On the other hand, the U.S. current account deficit is a cause for concern abroad. With both the government and household sectors dependent on foreign funds, the IMF and others frequently voice concerns about the current account deficit. However, aside from raising interest rates to avert inflation, the U.S. government apparently sees no compelling reason to curb the current account deficit by suppressing consumption and slowing down the economy, particularly with no clear crisis at hand. Perhaps they find it contradictory that the foreigners who criticize the deficit are also financing it.

Realistically, we can expect the U.S. to address factors causing the recent increase in the current account deficit by seeking devaluation of the Chinese currency and reducing oil consumption. But until the current account deficit becomes a major impediment to financial markets (through exchange rate volatility or higher interest rates), no definitive action is likely to happen.

As the current account deficit keeps expanding, the U.S. will become increasingly dependent on foreign economies—and more susceptible to their influence. Along with the associated risks, the likelihood also grows that the U.S. will eventually resort to a sudden exchange rate adjustment—as it has done in the past.