

America's rocketing external deficit faces a shortage of fuel

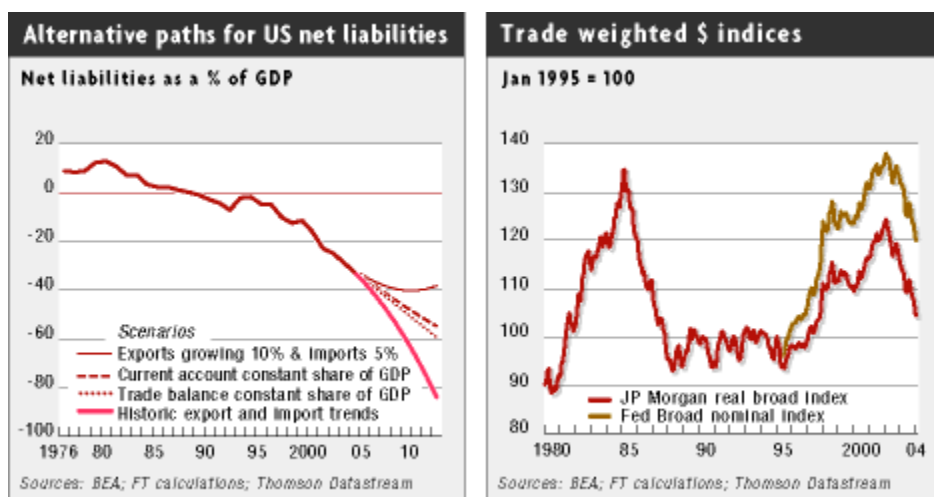


After the first world war, the US became the world's dominant creditor nation. Since the end of the cold war it has turned into its biggest debtor. As a share of global gross product, last year's US current account deficit of \$550bn (£290bn, €440bn) was the largest such imbalance in recorded history. As the late Herbert Stein, chairman of the council of economic advisers under President Richard Nixon, once famously remarked, what cannot go for ever will stop. The questions are only when and how these deficits will turn round.

Until the early 1980s, US current account deficits were modest. Then, under the presidency of Ronald Reagan, the current account deficit rose rapidly, to peak at 3.4 per cent of GDP in 1987. But a steep fall in the dollar, unsustainably rapid growth abroad and a recession in the US eliminated the deficit by 1991.

In the 1990s the current account deficit exploded again, but this time more durably and on a far greater scale. By 2000, the deficit had reached 4.2 per cent of GDP, while net liabilities were 16.2 per cent. Then a strange thing happened: the deficit continued to rise, in spite of a sharp economic slowdown. The current account deficit shrank slightly, to 3.9 per cent of GDP in 2001, to rise to record levels of 4.6 per cent in 2002 and 5 per cent last year. By the end of 2002, net external liabilities had reached 25 per cent of GDP.

So what might happen now? Between 1990 and 2003, US exports of goods and services, in constant prices, grew at a trend rate of 5.7 per cent a year. But imports grew at almost 9 per cent. If exports and imports continue to grow at the same rate (and returns on assets and liabilities remain the same as in 2002 - a relatively favourable assumption), the current account deficit will be almost 13 per cent of GDP by 2012, while net liabilities will reach 84 per cent. Even Ireland, a record-breaker among members of the Organisation for Economic Co-operation and Development, had net liabilities below 80 per cent of GDP at their peak.



The chart shows three further projections. In one, the trade balance remains a constant share of gross domestic product. Under this assumption, net liabilities still rise to 60 per cent of GDP by 2012. In the second, the current account balance stabilises as a share of GDP. Net liabilities then reach 55 per cent of GDP by 2012. In the last, exports are assumed to grow twice as fast as imports. Under this favourable assumption, net liabilities reach 40 per cent of GDP by 2009, before falling.

The trends of the past decade are evidently unsustainable. Yet net liabilities to GDP would continue to rise, even with a sizeable improvement in trade performance. So how big are the claims that the rest of the world might be willing to accumulate? Does the US have an open-ended credit line. The answer is No.

The optimistic view, put forward by Andrew Smithers, of London-based Smithers & Co,* is that returns on US assets are higher than in other high-income countries. Moreover, even with an unchanged current account deficit, as a share of GDP, the proportion of US assets owned by foreigners would be only 15 per cent five years from now. Mr Smithers concludes that the chief obstacle to continued deficits, at this level, is only the high prices of US financial assets.

This argument is open to challenge, on at least five points.

First, stabilising the current account deficit requires a big improvement in trade performance and so a real exchange rate depreciation.

Second, while net foreign ownership of US assets would be only 15 per cent by 2009, it would be almost a quarter of non-residential assets.

Third, by 2009, foreigners would hold gross claims on more than half of US fixed assets, apart from housing.

Fourth, because the US borrows in its own currency, foreigners are vulnerable to a devaluation. A 6 per cent devaluation would make a year's current account deficit a "free lunch" for the US, but a correspondingly expensive gift for its creditors.

Last, large depreciations are plausible when - or if - the current account deficit has to shrink, because of what economists call "the transfer problem".

Professors Maurice Obstfeld, of the University of California, at Berkeley, and Kenneth Rogoff, of Harvard, made the point in a paper published in 2000.** They argued that the real exchange rate change needed to redress a large

US current account deficit would have to be substantial, given the costs of shifting domestic resources into the balance of payments.

Mindful of this, sophisticated foreign investors will seek rising risk premiums on US assets, to protect themselves against the exchange rate risk. The current high prices of (and so low prospective returns on) US equities and bonds have, for this reason, made reliance on foreign official financing inevitable: in the first three quarters of 2003, foreign official sources financed just over a third of the current account deficit. Equally inevitable has been the depreciation. So far the dollar has fallen, on the Federal Reserve's broad index, by 13 per cent from its peak. This will probably still not be enough to allow the US to combine full employment with a smaller current account deficit. But adjustment has begun. The question is how it ends.

* *The US Current Account: Too Small Rather Than Too Large? January 15 2004, Report No. 207,*
info@smithers.co.uk;

** *Perspectives on OECD Economic Integration: Implications for US Current Account Adjustment,*
<http://www.kc.frb.org/Publicat/sympos/2000/S00rogo.pdf>