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PRESS RELEASE

The US current account deficit: how did it come about and what are the policy implications

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One of the most remarkable characteristics of the world economy today is the enormous, ever worsening current account deficit in the US balance of payments, which reached a record level of 5.7 p.c. of GDP in 2004. This has given rise to concerns in academic and political circles regarding the sustainability of the current situation and the potential dangers for the global economy of a sudden, disorderly adjustment. The first part of this article looks at the exceptional nature of the US current account deficit. In the following section, attention focuses on how the deficit came about, how it is financed, and whether it is sustainable. Lastly, a number of possible scenarios are discussed that may help improve the situation.

The size of the US current account deficit is not only unprecedented in American post-war history, but it also seems to be exceptional from an international perspective. Moreover, the situation is unusual because the US deficit contrasts with a surplus in virtually every other region and the problem has consequently taken on a global dimension. Due to its long-standing, steadily worsening current account deficit, the world's largest economy and main military and geopolitical superpower has therefore also become its biggest debtor.

The increase in the US current account deficit recorded in the nineties reflects an internal American shortfall in savings that was initially due to a rise in investments in the face of the sustained strong productivity growth associated with the so-called "new economy". Simultaneously, private savings diminished, which was partly related to the improved wealth position of households, particularly as a result of rising share prices. The sharp drop in investments after the technology bubble burst led to the private savings-investment equilibrium being restored in 2002 and 2003, but the same period saw a huge deficit in the public sector budget. The start of the new millennium brought notable changes in the way the US current account deficit was financed. In this respect, investments by Asian public authorities in American government debt instruments largely took over the position previously occupied by European private foreign direct investments and investments in equities.

Given the present size of the US current account deficit, it is not surprising that concern over the sustainability of the imbalance has grown considerably in recent years. Claims are occasionally being made that the US, unlike other countries facing similar circumstances, is safeguarded from an attack on its currency because of its prominent role in the international financial system. According to an influential school of thought in economic literature, the current international system can even be seen as a "revived" Bretton Woods system. Indeed, a number of East-Asian countries, including China, use a fixed or quasi-fixed exchange rate against the dollar, which brings to mind an informal dollar standard. Just like in the original Bretton Woods system, the United States can still be considered as the "core nation" enjoying the privilege of issuing the main international reserve currency, and the countries in the "periphery" are prepared to buy dollars in order to achieve catch-up growth.

During recent years, this set of circumstances has undoubtedly offered various regions in the world a number of mutual benefits. These exchange rate relations may nevertheless have caused some distortions in US spending, whereas Asian countries have to deal with a growing exchange rate risk in terms of their official reserves, and possibly also with increasing difficulties in neutralising the liquidity created as a result of the interventions.

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
BE-1000 BRUSSELS
phone + 32 2 221 46 28
www.nbb.be
VAT BE 203 201 340

Different scenarios are conceivable to deal with the global imbalances. One option is to achieve this as much as possible via an exchange rate adjustment. Yet, such a scenario does not preclude the risk of disorderly fluctuations in exchange and interest rates. Furthermore, the results of model simulations show the huge effort required to significantly reduce the US current account deficit. Once again, this highlights the scale of the problem, emphasising the need for simultaneous economic policy measures in the different economies involved, such as fiscal consolidation in the US, implementing structural reforms in the euro area and in Japan in order to boost the growth potential of those economies, and aiming to gradually introduce greater exchange rate flexibility in Asia.

The concern over global imbalances and the development of exchange rates, as well as the search for solutions, feature prominently on the agenda of international forums such as the G7 or G20 meetings. In the statements issued at those meetings, the need for a common approach to tackle the global imbalances is given priority and the belief that excessive exchange rate volatility is not desirable is underlined.

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National Bank of Belgium Ltd.
boulevard de Berlaimont 14
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phone + 32 2 221 46 28
www.nbb.be
VAT BE 203 201 340
TRB 22 300