

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

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Introduction

One of the most remarkable characteristics of the world economy today is the enormous, ever worsening deficit on the current account of the US balance of payments, accompanied by the consistent accumulation of surpluses in most other regions of the world⁽²⁾. The largest economy and main military and geopolitical superpower has therefore also become the world's biggest debtor. This has given rise to concerns in academic and political circles regarding the sustainability of the current situation and the potential risks for the global economy of a sudden, disorderly adjustment. For several years now, this issue has been at the top of the agenda in international forums such as the G7 or G20 meetings and it featured as a discussion point at many scientific colloquiums.

The first part of this article outlines the current situation and examines whether it can be considered exceptional historically and from an international perspective. In the second part, the main focus is on how the US current account deficit came about and how it is financed. Part three examines the issue of the sustainability of the deficit. Particular attention is paid to the special status of the US economy and its currency, the dollar, on the global markets. Finally, part four discusses a number of scenarios that may help bring about an improvement.

1. Is the current imbalance exceptional?

1.1 The current account

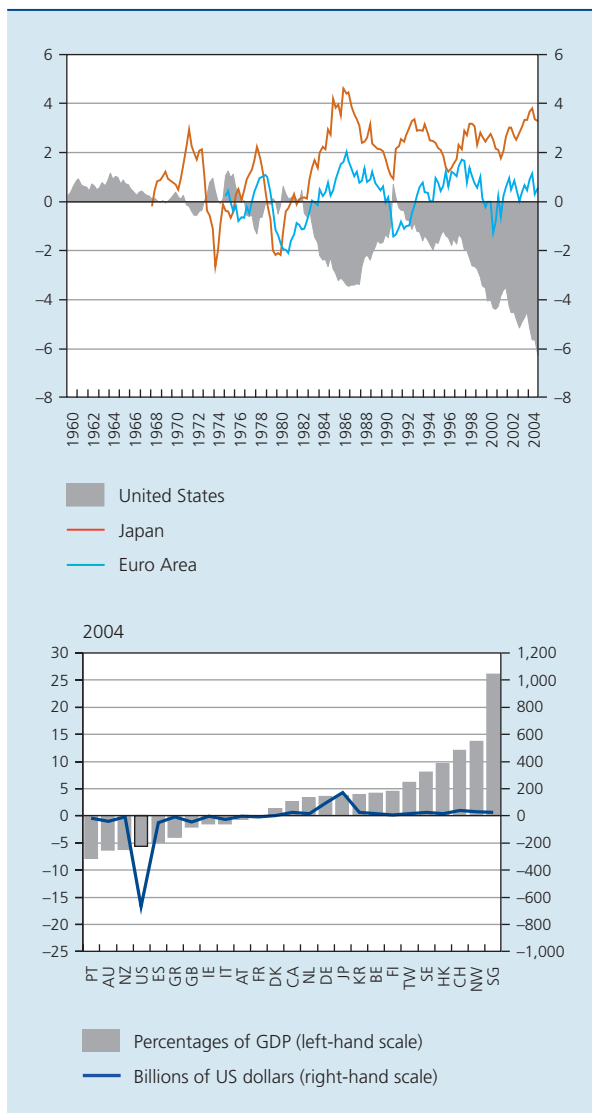
In 2004, the US current account deficit reached 5.7 p.c. of GDP, the largest deficit since 1960. In the sixties and seventies, the country was generally still generating surpluses, but this changed in 1982, when the US current account started to record rapidly worsening deficits, which provisionally peaked at 3.4 p.c. of GDP in 1987. Thanks to the implementation of various measures to which the American, European and Japanese authorities committed, in the "Louvre Agreement" in 1987, the deficit then declined continuously and actually turned into a small surplus by the first half of 1991 which was however partly due to the official transfers made by a number of foreign governments by way of a contribution to the costs of the first Gulf War. From then on, the deficit rose virtually uninterruptedly and, by the end of 1999, it exceeded the record level reached in the mid-1980s.

(1) The authors would like to thank K. Burggraeve for his contribution.

(2) The current account of the balance of payments of a country records the transactions of goods and services, receipts and payments of income, as well as transfers between residents and non-residents over a particular period of time. From a macroeconomic point of view, the current account balance equals the total financial balance of the economy. A current account deficit therefore reflects to what extent a country resorts to foreign savings and implies an increase in the net debt or a reduction in net claims towards foreign countries.

CHART 1 CURRENT ACCOUNT IN SELECTED ECONOMIES

(Balances in percentages of GDP, unless otherwise stated)



Sources : Federal Reserve, IMF, OECD.

The size of the US current account deficit is not only unprecedented in US post-war history, but it also seems to be rather exceptional from an international perspective. In 2004, of all the developed economies, only Portugal, Australia and New Zealand had a comparable deficit as a percentage of GDP. However, the US economy is the world's largest, so that the deficit in absolute terms reaches more than 600 billion dollars, while Australia's deficit for example amounts to only 39 billion dollars. Furthermore, the US dollar plays a prominent role on global financial markets. As a result of both these aspects, even a huge adjustment of the external deficit of a smaller economy would have less of an effect on the global economy and the international

financial system than a more moderate adjustment in the US current account deficit.

Historically too, the persistently large US current account deficit is remarkable. For instance, the International Monetary Fund⁽¹⁾ (IMF) came to the conclusion, based on a review of the existing literature, complemented by its own research, that current account deficits of over 4 p.c. of GDP for three consecutive years were fairly rare, and that they were limited to comparatively small open economies. Three years of large deficits are usually followed by three years of improvement by 2 p.c. of GDP. This is often accompanied by a significant depreciation in real terms of the currency involved, as well as slower growth. The Bank for International Settlements⁽²⁾ (BIS) reaches similar conclusions, both with regard to the threshold value from which an improvement occurs and the channels through which adjustments can be made.

Finally, the current situation is also exceptional in geographical terms. The US current account deficit finds its counterpart in the current account surpluses of other countries. Although current accounts already displayed marked imbalances in the eighties, the global dimension was rather limited at the time: the imbalances were mainly concentrated in the United States, on the one hand, and Japan and the main European economies, particularly Germany, on the other. Until 1987, the US deficit widened virtually in line with the increase in the surpluses in Japan and Europe, followed by a trend reversal during the remainder of the decade. From the mid-1990s, however, the US deficit finds its counterpart in the surpluses in virtually every other region⁽³⁾ and the problem has consequently taken on a global dimension.

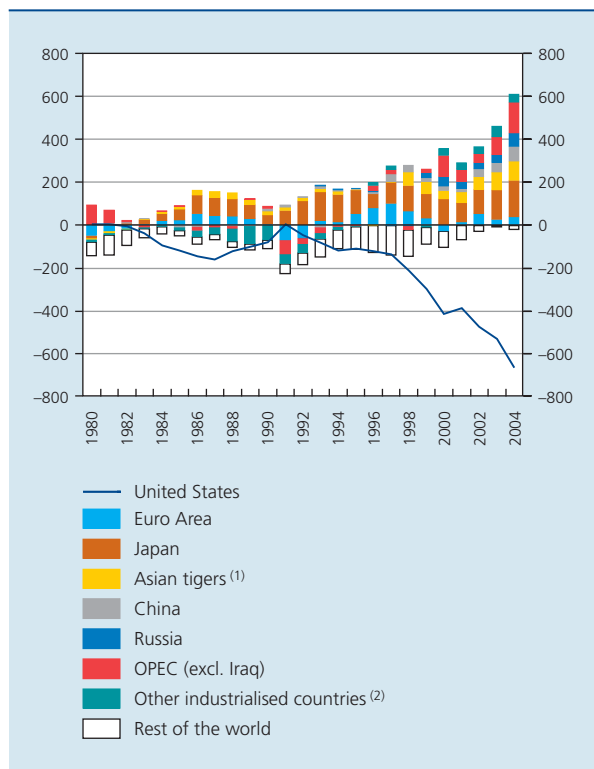
The United States, the euro area and Japan continue to play a major role in world trade. However, an increasing number of emerging economies, particularly in Asia, are becoming more and more important. The four so-called Asian tigers already recorded an appreciable current account surplus in the eighties. Since the end of the 1990s, after an interruption during the Asia crisis, their role has once again been increasingly gaining in importance. China made its entry on the world market in the mid-1990s and its trade surplus has greatly contributed to the Asian surplus over recent years. As far as the other regions are concerned, the OPEC cartel, like Russia, recorded a substantial surplus in the last few years owing to rising oil prices.

(1) IMF (2002).

(2) BIS (2004).

(3) In this respect, it should be noted that the statistics for the global economy show an overall deficit, whereas in principle, the figures for all the countries in the world added together should be in balance. As a result of the scale of gross flows recorded in the balances of payments, these statistics often contain errors.

CHART 2 GLOBAL IMBALANCES
(Current account balances in billions of dollars)



Source: IMF.

(1) Hong Kong, Singapore, Taiwan and South Korea.

(2) Australia, Canada, Denmark, New Zealand, Norway, United Kingdom, Sweden and Switzerland.

1.2 The net international investment position

As a consequence of the persistent and steadily widening current account deficit in the US balance of payments, the country's international investment position, i.e. the balance of its outstanding assets and liabilities vis-à-vis foreign countries, has deteriorated sharply. Hence, the American net external asset position at the end of the eighties turned into a net external debt position which has worsened dramatically since the mid-1990s, from 4.1 p.c. of GDP in 1995 to 24.1 p.c. of GDP in 2003.

At first sight, this does not seem exceptional. In several countries, for example Australia and New Zealand, the net external debt position as a percentage of GDP is much worse. However, of all the developed countries for which figures are available, US net debt, in billions of dollars, is about 50 p.c. higher than that of all the other net debtor countries combined.

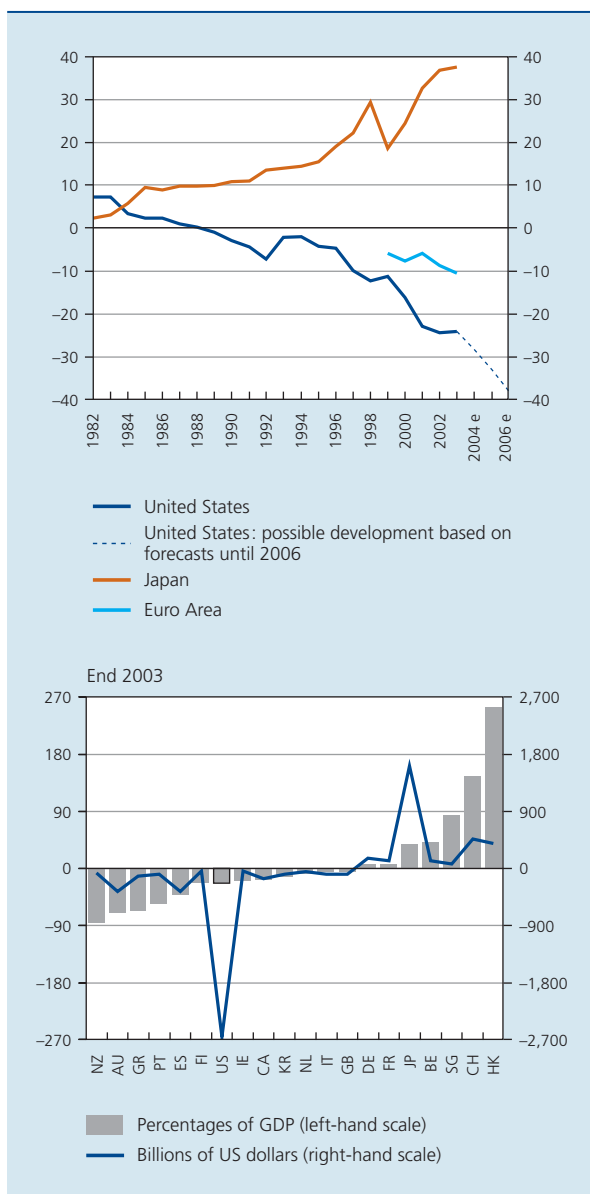
Based on data from economic forecasts made by the OECD for 2005 and 2006, there is also the possibility that the US net external debt position may actually continue to worsen substantially. Based on a mechanical accumulation of the expected current account deficits, the US net external debt would continue to rise sharply, from around 24 p.c. of GDP in 2003 to almost 38 p.c. of GDP in 2006 or, in billions of dollars, from 2650 to around 5000.

However, this simple calculation does not take into account the so-called valuation effects which may substantially slow down or stimulate the increase of the net debt. Hence it is noteworthy that the net investment position of the United States as a percentage of GDP barely worsened in 2002 and 2003, despite the huge and still growing current account deficit recorded during that period. The additional external debt caused by the US current account deficit (quantitative effect) was in effect largely offset by the positive effect of the depreciation of the US dollar (valuation effect). The depreciation of the dollar actually increased the value of the assets, mostly held in foreign currencies, of the United States vis-à-vis the rest of the world, whereas US liabilities were largely held in dollars, in view of the status of the dollar as an international currency.

Anticipating future valuation effects can be difficult since they mainly depend on developments in the dollar exchange rate which are very uncertain. Furthermore, the importance of the valuation effects should not be overestimated, since they are likely to imply "reputation costs" sooner or later. Repeated currency depreciations can after all prompt foreign dollar investors to call for higher interest rates, which may worsen the net debt position due to the negative impact on the income and current account. The current account therefore remains the main channel through which the international investment position of the United States can be improved.

Despite the substantial increase in net debt, net factor incomes have so far remained positive in the United States, and here, investment income is by far the most important factor, rather than labour income. The United States are indeed a net recipient of income from foreign direct investments (FDI) and from investments in equities, whereas it is a net payer of interest on debt instruments (largely interest payments on US government bonds). Although the combined outstanding net position of the United States in FDI and investments in equities over recent years deteriorated sharply and the outstanding net debt in the form of debt instruments grew substantially – to around 28 p.c. of US GDP in 2003 –, the income from FDI and investments in equities still exceeds interest

CHART 3 NET INTERNATIONAL INVESTMENT POSITION IN SELECTED ECONOMIES
(Percentages of GDP, unless otherwise stated)



Sources: BEA, ECB, IMF, OECD, NBB.

payments on debt instruments, since the implicit return on the external assets held by the United States is higher than that on its external liabilities. On the one hand, the average return of the FDI in the United States turns out to be significantly lower than that of the American FDI in the rest of the world. On the other hand, the return on US debt instruments has been relatively low for some time – putting downward pressure on interest payments –, although it is comparable to the return on foreign debt instruments held by US residents.

That does not alter the fact that net factor incomes, as a percentage of GDP, have been on a downward trend over the years, and that they were barely positive in 2004. In its economic forecasts, the OECD estimates that this balance will turn into a small deficit in 2005, increasing to 0.2 p.c. of GDP in 2006. This would mean that the United States would be a net payer of factor income for the first time in almost a century.

2. Underlying macroeconomic trends

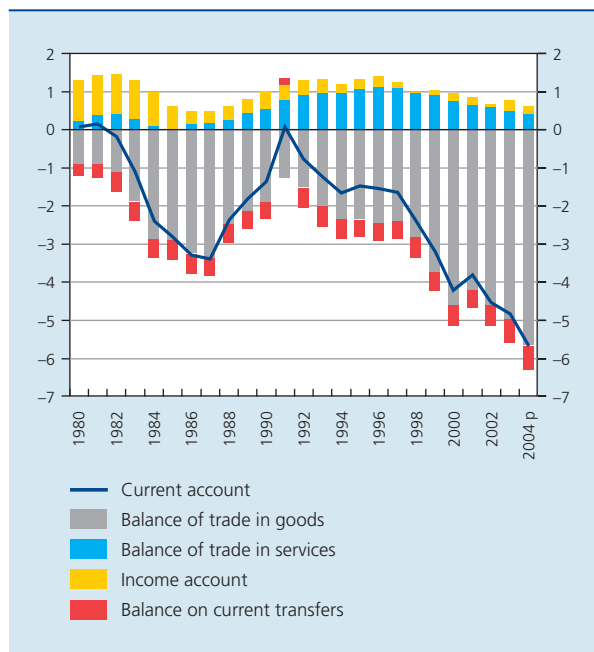
Below, we take a closer look at the macroeconomic factors underlying the US current account deficit that determined the trend and that may play a key role in future developments. In view of the macroeconomic links between an economy's external and internal balances (the current account of the balance of payments and the saving-investment balance) and between the current account deficit and the way it is financed, the issue can be approached from different complementary viewpoints.

2.1 Approach from the trade flows perspective

The increase in the US balance of payments' current account deficit in the nineties can almost entirely be explained by a deterioration in the balance of trade in goods, which recorded a rapidly widening deficit. Likewise, the surpluses in the balance of trade in services and in the income account have declined slightly over the last few years. By contrast, the balance on current transfers recorded a persistent but stable deficit, expressed as a percentage of GDP.

In geographical terms, the growing deficit in the balance of trade in goods can be traced back to, on the one hand, a large and widening trade deficit with the traditional trade partners Europe and Japan, and on the other, the increasing deficit with a number of new players on world markets, particularly China. It is often claimed that the substantially faster US economic growth, particularly during the second half of the nineties, is a possible reason for the persistently large trade deficit with Europe and Japan. Furthermore, the US economy is characterised by asymmetric income elasticities for exports and imports. Even if the US economy were to grow only as fast as that of the euro area or Japan, the US trade deficit would still worsen because American consumers seem to have more of a preference for foreign goods and services than foreign consumers do for American goods and services. The aforementioned asymmetry was first observed in 1969 by Houthakker and Magee; in economic literature, it is often referred to as the so-called "Houthakker-Magee Income Asymmetry

CHART 4 THE US CURRENT ACCOUNT: MAIN BALANCES
(Percentages of GDP)



Source : BEA.

Hypothesis". Finally, the sharp appreciation of the dollar recorded between mid-1995 and the end of 2001 can be assumed to have had a lagged effect. In real effective terms, the US currency rose in value by around 40 p.c.

Apart from Europe and Japan, the deficit also worsened with regard to China and, to a lesser extent, with Latin America. In 2004, the trade deficit with China already amounted to nearly a quarter of the total deficit in the balance of trade in goods. The growing importance of China in US trade relations is broadly indicative of the fact that part of the regional production chain in Asia has shifted from Japan and South Korea, among others, to China. Furthermore, the importance of American FDI in China has increased, i.e. within the sectors exporting to the United States.

2.2 Approach from the savings and investments perspective

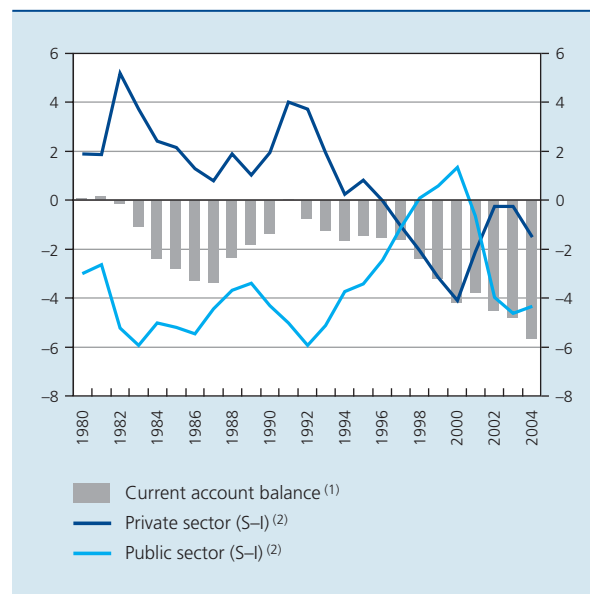
The current account balance can also be seen in terms of the difference between savings and investments in an economy, since, from an accounting point of view, that difference can be shown to be equal to the current account balance. In the nineties, the United States' growing need for foreign financing coincided with a sharp

decline in the domestic savings surplus in the private sector. Towards the mid-1990s, the surplus even turned into a deficit, which continued to widen until the year 2000. Although the government gradually dissaved less, it could not prevent the total financing deficit of the US economy from increasing. At that time, the underlying macroeconomic conditions differed substantially from those of the eighties, when the US economy was characterised by a so-called "twin deficit", i.e. a current account deficit and a budget deficit.

The increase in the private financing requirement during the nineties stemmed largely from an acceleration in investment expenditure. It all took place against a background of sustained strong productivity growth in the United States, which was generally thought to be associated with the rise of the internet and the rapid integration of new technological developments in IT and telecommunications in the production process, an important aspect of what then became known as the "new economy". Simultaneously, private savings fell, which was partly related to the improved wealth position of households, particularly as a result of rising equity prices.

However, since the start of the new millennium, the macroeconomic conditions underlying the rising external financing requirement of the United States have changed.

CHART 5 US CURRENT ACCOUNT AND SAVING-INVESTMENT BALANCE
(Percentages of GDP)



Source : BEA.

(1) For statistical reasons, the current account balance and the total financing balance show a discrepancy.

(2) S-I stands for the difference between savings and investments within a sector.

Investments in the US economy dropped sharply during 2001-2002, once the technology bubble had burst. Thereafter, investments gradually picked up again, but they were initially targeted at housing and at sectors of non-tradable commodities. This development is not unimportant. As a rule, those sectors contribute little to the export performance of an economy and such investments therefore do very little to improve the capacity of the US economy to repay its foreign debt. As for private savings, these were up slightly thanks to companies trying to improve their balance sheets, whereas the savings ratio of households continued to decline. Overall, the saving-investment balance of the private sector was more or less in equilibrium in 2002 and 2003. Tax cuts and an increase in public spending, including on defence, however rapidly wiped out the surplus in the public finances thus leading to a large deficit, which resulted in a return to the "twin deficit". Finally, in 2004, corporate investments picked up strongly, tipping the saving-investment balance of the private sector into the red as well.

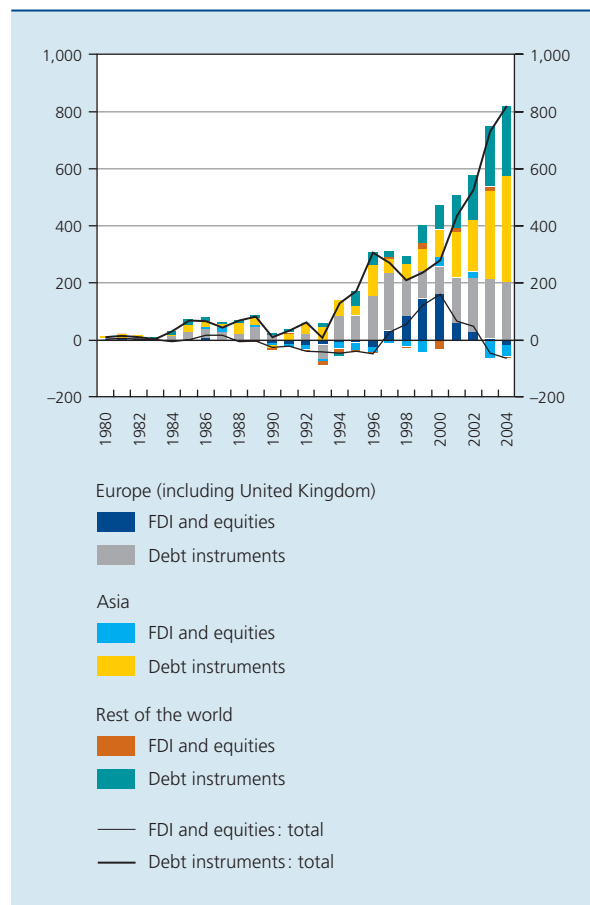
2.3 Approach from the capital flows perspective

From the mid-1990s, the increase in the current account deficit in the US balance of payments was accompanied by a number of noteworthy changes affecting the course of capital flows, both from an investment instruments perspective and in terms of their origin. Overall, from 2001 onwards a significant inflow of private FDI and investments in equities from Europe made way for investments by Asian public sector investors in US government debt instruments.

From the mid-1990s until 2000, capital flows mainly originated from European (private) investors. Originally, these were investments in debt instruments, which was partly due to the positive interest rate differential compared with the euro area during a large part of that period; in the context of the strong productivity growth achieved by the US economy, capital inflows also took on the form of FDI and investments in equities from 1997 onwards. Other factors that may have played a role in generating those capital flows, apart from the anticipated higher returns, are the relatively liquid US financial markets, a shift in the currency composition of portfolios, more particularly in the run-up to EMU, and a relaxation of legislation, for example regarding foreign investments in pension funds.

With hindsight, the expectations regarding the returns on investments in the so-called "new economy" turned out to be too optimistic. When the technology bubble burst, European investors suffered heavy losses. When

CHART 6 NET CAPITAL FLOWS TO THE UNITED STATES, BY REGION OF ORIGIN AND BY INVESTMENT INSTRUMENT
(Billions of dollars)



Source: US Treasury.

it became obvious that the anticipated returns were not going to materialise, inflows of FDI and investments in equities dried up from 2001 onwards and even turned into capital outflows in 2003 and 2004. Other things being equal, the reduced capital inflows should inevitably have led to a narrowing of the US current account deficit, especially as a result of slower US growth. However, this did not happen, since the reduced capital inflows were largely offset by substantial capital inflows in the form of purchases of corporate and government bonds. In parallel with the larger proportion of debt instruments in the financial account of the United States⁽¹⁾, the importance of Asia regarding these investments also rose.

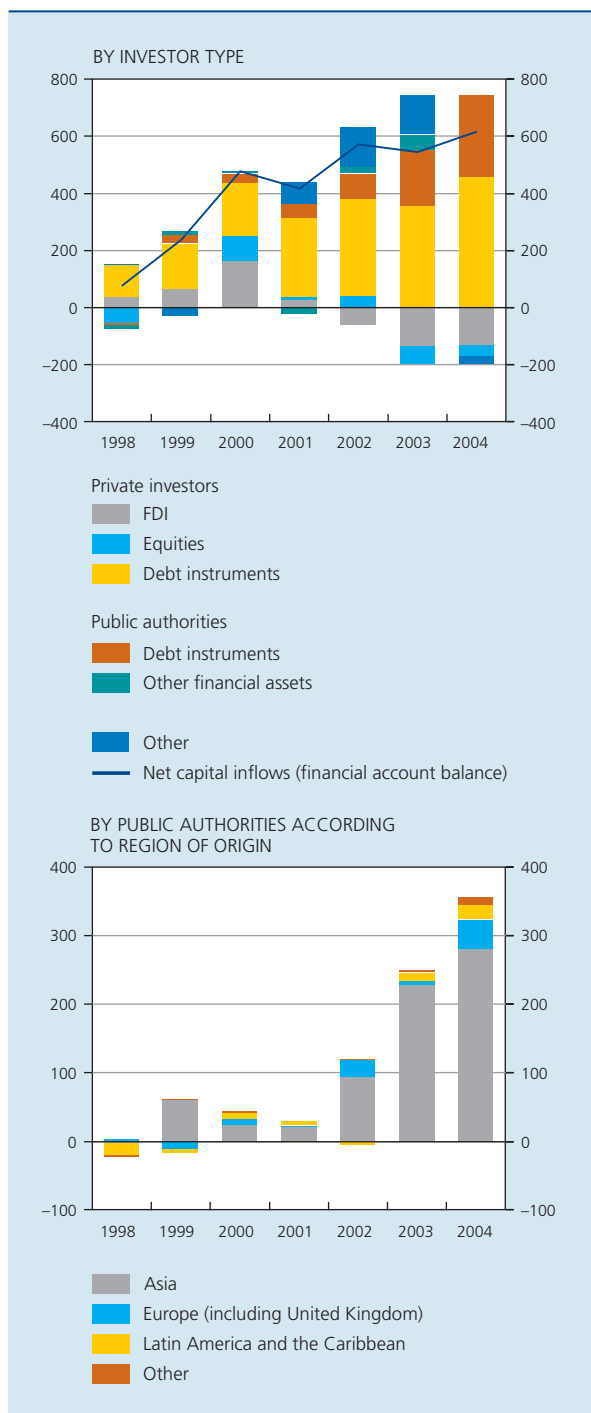
(1) It should be noted that the classification by region of origin can only be made based on the location where the transaction took place, rather than on the buyer's country of origin. This explains the prominent position occupied by the United Kingdom, for example: many transactions in US financial instruments with residents from the euro area, the OPEC countries or even Asia are likely to take place via the City of London. For the same reason, the importance of the Caribbean area has increased in recent years ("offshore centres"). Those "centres" have been included in the chart under the heading "rest of the world". The classification of net capital inflows into the United States by region of origin therefore only has an indicative value.

In terms of investor type, the larger share of debt instruments in the net capital inflows into the United States has been accompanied since 2002 by a sharp rise in financing by foreign public authorities, mainly from Asia, and largely

in the form of purchases of government bonds issued by the US Treasury.

The accumulation of substantial official reserves by Asian central banks, combined with data showing that the global increase in foreign exchange reserves in recent years can primarily be attributed to an increase in dollar reserves, is an indication that it was mainly the central banks of the countries concerned that bought these debt instruments. Japan accumulated the highest volume of official reserves, but China too has been very active in this respect. Considering that Taiwan, Korea and India carry less weight in the global economy, the reserves those countries accumulated can also be regarded as exceptional.

CHART 7 NET CAPITAL FLOWS TO THE UNITED STATES, BY INVESTOR TYPE AND BY PUBLIC AUTHORITIES ACCORDING TO REGION OF ORIGIN
(Billions of dollars)



Source : BEA.

3. Is the current situation sustainable ?

The US current account deficit has taken on huge proportions, both from an American point of view and from an international perspective. It is therefore not surprising that serious concerns have been expressed over recent years about the sustainability of these imbalances.

Neither a substantial current account deficit in the balance of payments nor a high external debt need necessarily be unsustainable, nor are they necessarily a source of instability. As long as foreign investors are convinced that their investment will be profitable and that the debtor will continue to be able to pay off his external debts, investors will be prepared to finance the capital requirements, thereby providing lasting support for the situation.

This begs the question of whether the United States is comparable to other countries. After all, the idea is now gaining ground that, unlike other countries facing similar circumstances, the United States does not need to fear a sudden decrease in the capital flows used to finance its deficit, given its prominent role in the global financial system. Not only does the United States possess very deep financial markets in which investors can readily build up a diverse portfolio in dollar assets alone, but the dollar remains the main international currency, for example for trade transactions and for currency reserves held by central banks. For those reasons, a further increase in the US current account deficit would still be capable of being financed quite easily by foreign private investors and public authorities for some time to come.

In this context, Michael Dooley, David Folkerts-Landau and Peter Garber even describe the current international monetary system as a type of "revived" Bretton Woods system in

a series of important papers⁽¹⁾. After all, there are similarities with the post-war period. Firstly, a number of Asian countries, including China, are at present formally or informally applying a fixed or quasi-fixed exchange rate against the dollar. This resembles an informal dollar standard reminiscent of the gold-dollar standard of the original Bretton Woods system. Furthermore, the accumulation of dollar reserves by several Asian countries, a consequence of the interventions needed to prevent an appreciation of their currencies against the dollar, has contributed significantly in recent years to the export-led growth strategy of those countries as well as to the financing of the US current account deficit. Just as in the original Bretton Woods system, the United States can therefore 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. However, as new countries have been integrated into the global economy, the “periphery” has largely moved away from Europe and Japan to the rest of East Asia, compared with the original Bretton Woods system.

In recent years, the exchange rate regime in the context of the “new” Bretton Woods has undoubtedly offered various world regions a number of mutual advantages. For the Asian countries, the exchange rate policy was consistent with their export-oriented strategy for growth. On the other hand, the United States has found a not insubstantial source of finance for its current account deficit in the central banks of the Asian “periphery” over recent years. Furthermore, the strong dollar ensured that import prices rose more slowly in the United States, damping down inflationary pressures. US growth could therefore consistently rely on the expansion of domestic demand, which acted as an engine for growth in the rest of the world.

It is nevertheless safe to assume that the exchange rate relations, which are artificially maintained in the “new” Bretton Woods regime, have created a number of distortions.

In the United States, some distortions may have affected spending. Exchange rate interventions by Asian central banks supported the dollar, artificially providing an additional boost for American imports, particularly of cheap Asian products. At the same time, the investments made by those central banks in US government bonds may have contributed to relatively low interest rates⁽²⁾ despite the mounting budget deficit, which would normally fuel consumption and demand for housing and therefore,

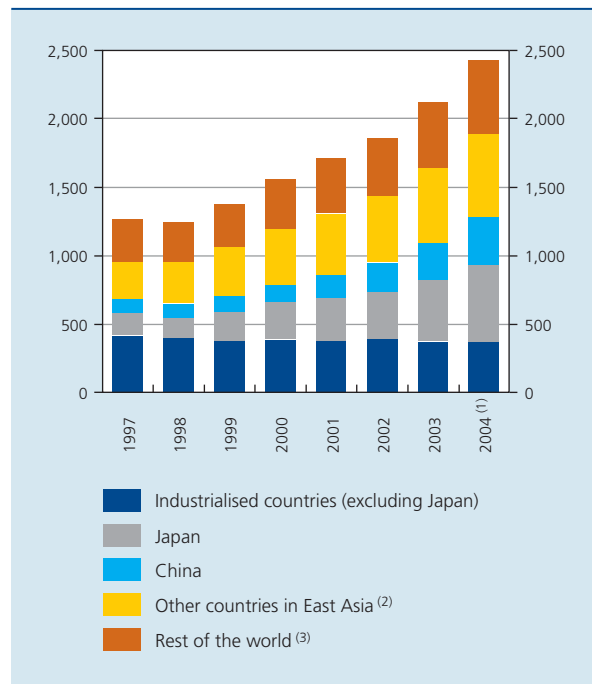
(1) Dooley, Folkerts-Landau, and Garber (2003, 2004a, 2004b).

(2) In Roubini and Setser (2005), p. 8-10, the estimates of the downward effect of these investments in dollars on US interest rates are said to diverge widely, ranging from 40 to around 200 basis points, depending on the source.

CHART 8

OFFICIAL RESERVES

(Outstanding amounts in billions of SDRs, end of period, excluding gold)



Source : IMF.

(1) September 2004.

(2) Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

(3) Non-industrialised countries of Europe, other Asian countries, the Middle East, Latin America and Africa.

directly or indirectly, contribute to a further fall in the US private savings ratio, e.g. because of wealth creation resulting from higher property prices. On the other hand, the weakened competitiveness may have curbed investments in tradable goods, which ultimately form the basis for the capacity to export and to reduce the trade deficit. Against a background of household savings reaching an all-time low, warnings are often sounded with respect to a possible sharp adjustment of the internal imbalances in the United States, for example in the event that American household wealth were to grow at a significantly slower rate compared to previous years.

Although the exchange rate regime supports export-led growth in many Asian countries, it also imposes important costs on the region. For instance, in a number of these countries, adhering to a policy of fixed exchange rates may, more or less, have led to a loss of control over broad money growth. Some observers see this as creating the risk of excessive money growth which may create a bubble, for example in real estate, with potentially serious consequences, also in view of the weak financial sector

in some of these countries. In this respect, reference is also made to Japan's experience in the late eighties and early nineties, when a speculative bubble burst in the real estate and equity markets in that country, the consequences of which are still being felt by the Japanese economy today. According to some observers⁽¹⁾, the "new" Bretton Woods regime also implies an international risk exchange whereby the Asian region, on the one hand, exports financial means that are invested in high-quality US government bonds and, on the other, imports capital that is invested in the domestic economy in higher-risk assets, for example equities and bonds of medium or low quality, or in FDI. This international risk exchange may curb the development of financial markets in those economies. Leaving aside Japan, the holding on by these countries to such huge dollar reserves may also involve high opportunity costs, since the return on risk-free US debt instruments is usually lower than that on investments in domestic assets. Last but not least, these central banks run a great exchange risk with respect to their reserves: if the link between their currencies and the dollar is suspended, they may incur substantial losses.

A number of surveys on the subject, including those carried out by the IMF⁽²⁾, show that some Asian countries have built up excessive foreign exchange reserves since the crisis in their region. In effect, the currency reserves of several Asian central banks have not only risen substantially in absolute terms but also as a ratio of imports or of the short-term external debt of the country concerned. The latter ratio is often used as a reliable indicator of the degree of vulnerability of a particular country to a financial crisis. Based on empirical research, the IMF comes to the conclusion that a ratio of reserves to short-term debt equalling 1 constitutes a critical value. In a number of Asian countries, the reserves have risen sharply in relation to the short-term debt, sometimes far above the critical value. This is the case in Thailand, India, Taiwan and especially China. From an analysis of the factors that usually justify a normal build-up of foreign exchange reserves, the IMF also concludes that the volume of the foreign exchange reserves of the Asian emerging countries between 1997 and 2001 still matched the development of the underlying explanatory variables, whereas this was no longer the case from 2002 onwards.

Given the success of the growth strategy, the Asian monetary authorities will presumably continue to pursue their current policies for some time to come, even if only to prevent a sudden appreciation of their currencies against the dollar or in an effort to protect their weak financial sectors. Nonetheless the current regime governing exchange rates and capital flows is to a considerable extent dependent on a unilateral willingness of those

authorities to continue financing the substantial US current account deficit on favourable terms. This makes the US economy vulnerable to a sudden decline in that willingness and entails a risk for the global economy that should not be underestimated. In contrast to the original Bretton Woods system, in which the value of the dollar was guaranteed by its convertibility to gold at a fixed price, no institutional agreement exists in the current regime guaranteeing that the countries in the "periphery" will maintain the current system. Furthermore, even the original Bretton Woods arrangement ultimately collapsed under the weight of the fundamental imbalances.

As B. Eichengreen⁽³⁾ observed, the world has also undergone some dramatic changes since the collapse of the original Bretton Woods system. Nowadays, the countries in the "periphery" are more numerous and diverse than at the time of Bretton Woods, which makes it less likely that they would adopt a common stance than was the case in the original system. It is therefore not inconceivable that a "free rider" problem may arise, with countries switching all (or part of) their dollar reserves to other currencies in anticipation of a depreciation of the dollar at a point in time when the dollar is still generally supported. Against a background of stringent capital controls elsewhere, investing in the United States in the fifties and sixties was virtually the only alternative for domestic investments, but a change in growth prospects or in the market climate may nowadays lead to major portfolio shifts in favour of investments in other currencies. Furthermore, the euro currently offers a viable alternative as an international reserve currency.

Exaggerated concerns regarding the sustainability of the financing of the US current account deficit can be countered with the argument that the central banks of some Asian countries are certainly not the only source financing the deficit. After all, even in 2003 and 2004, a large part was still financed by private investors. These investments are also driven by the expected returns, which in turn depend on the relative growth expectations in the various economies. Since growth in Europe and Japan is apparently still hampered by structural problems and the United States may continue to generate higher growth for some time to come, private finance may be secure. Private investors however probably also base their expectations regarding the value of the dollar, an important factor in determining their expected returns, on the attitude of the central banks in this respect. If the Asian countries were to radically change their exchange rate policy, private

(1) Including McCaulay (2003).

(2) IMF (2003).

(3) Eichengreen (2004).

investors might also become much more reluctant to hold on to their dollar assets.

In view of the undisputed mutual benefits to significant world regions offered by the new Bretton Woods, an important “exit” problem does emerge. Experience with fixed exchange rates, namely the original Bretton Woods system, however, teaches us that it is better to correct distortions in good time rather than to wait until the pressure is very high. The risks of a sudden disorderly adjustment to the US current account deficit are indeed significant, particularly in respect of a substantial fall in the dollar or a sharp rise in interest rates which would have serious implications and not just for the financial markets. Needless to say, all this could have major consequences for economic growth in the United States and in the rest of the world.

4. How can the adjustment be made ?

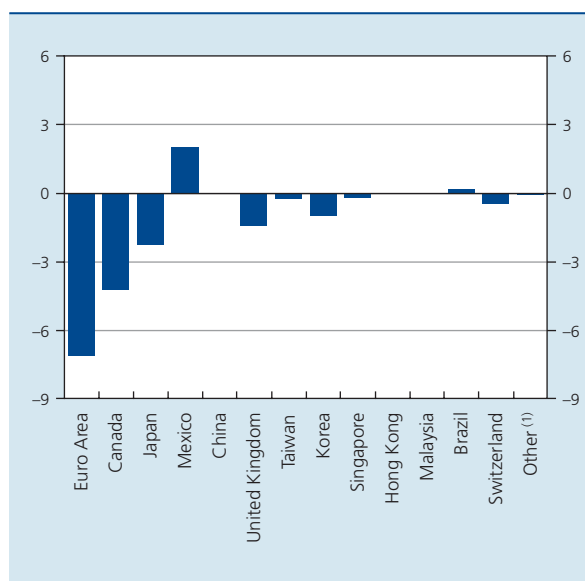
4.1 Adjustment exclusively via the exchange rate

Different scenarios are conceivable to deal with the global imbalances. One of the options (“benign neglect”) is to intervene as little as possible in the market with economic policies, but to allow the adjustment to be made as far as possible via the exchange rate. In such a scenario, the risk of disorderly exchange and interest rate fluctuations, often caused by a crisis of confidence in the dollar, cannot be excluded, particularly since markets tend to overshoot. Sudden excessive exchange rate movements disrupt the functioning of an economy because they do not give the economic players sufficient time to adapt their decision-making to the new conditions.

Furthermore, the results of simulations – such as those based on the NiGEM model⁽¹⁾ or carried out by the OECD based on its Interlink model⁽²⁾ –, indicate that a significant narrowing of the US current account deficit, when sought to be achieved solely via an adjustment of the exchange rate, would require a substantial depreciation of the dollar. For example, OECD calculations show that a nominal effective depreciation of the dollar by 22.5 p.c., spread over a wide range of currencies including the Asian currencies, would only bring about a moderate narrowing of the US deficit, namely by 1.3 p.c. of GDP after a period of six years. A complete rebalancing of the US current account, amounting to 5.7 p.c. of GDP, would consequently require a massive exchange rate shock that might dramatically affect the current economic structure and would also be quite exceptional in historical terms. By way of comparison, reference can be made to the period

CHART 9 DEPRECIATION OF THE NOMINAL EFFECTIVE EXCHANGE RATE OF THE DOLLAR BETWEEN FEBRUARY 2002 AND APRIL 2005

(Contributions made by the currencies of the main trading partners in percentage points)



Source : Federal Reserve.

(1) Argentina, Australia, Chili, Colombia, India, Indonesia, Israel, the Philippines, Russia, Saudi Arabia, Sweden, Thailand and Venezuela.

between February 2002 and April 2005, when, according to data compiled by the Federal Reserve, the weighted average exchange rate of the dollar only dropped by around 15 p.c. The depreciation of the dollar against the euro represented approximately half of this nominal effective depreciation, which means that the appreciation of the euro has already contributed greatly to the adjustment of the dollar exchange rate.

4.2 Possible economic policy measures

Adjusting exchange rates as an isolated measure therefore does not appear to be very effective in terms of dealing with the global imbalances in the current accounts. For the purpose of gradual, orderly adjustment, it is increasingly argued that the economies concerned should adopt simultaneous measures in different policy areas, such as fiscal consolidation in the US, implementation of structural reforms in the euro area and Japan with a view to increasing the growth potential of those economies and gradually allowing greater exchange rate flexibility in Asia.

(1) NiGEM is a comprehensive econometric model of the global economy, designed by the UK's National Institute of Economic and Social Research.

(2) OECD (2004).

As mentioned before, a current account deficit in the balance of payments reflects a domestic savings shortfall in the economy concerned. It is therefore not surprising that the solution to the problem of the US current account deficit is often sought by considering the restoration of the equilibrium between savings and investments in that country, and, in view of the substantial government deficit, the first measure that comes to mind is fiscal consolidation. In that context, the simulation results based on the economic models suggest that the US budget deficit will need to be drastically reduced before it can have a marked effect on the US current account. The eventual macroeconomic impact of the consolidation also depends on the reaction of private savers, since a reduction in the deficit in public savings may lower private savings even further, for example as a result of a more flexible monetary policy or due to the prospect of lower taxes. According to NiGEM, narrowing the US budget deficit by 6 p.c. of GDP over six years would reduce real net imports into the country by 1.2 p.c. of GDP by the end of this period. These results broadly match those obtained by the OECD based on the Interlink model, according to which a gradual shrinking of the US budget deficit by 6 p.c. of GDP, also spread over six years, would lead to a 2.6 p.c. of GDP narrowing of the current account deficit by the end of the period.

Since a depreciation of the dollar and US fiscal consolidation would each, as an isolated measure, involve a considerable adjustment in order to rebalance the US current

account, the case is often made in favour of combining the two adjustment mechanisms. According to OECD calculations, a scenario combining a depreciation of the dollar by 15 p.c. and a reduction in the US budget deficit by 4 p.c. of GDP would reduce the US current account deficit by 2.5 p.c. of GDP after a period of six years. Based on the NiGEM model, a comparable improvement in real net exports would be achieved by shrinking the US budget deficit by 6 p.c. of GDP and an additional currency adjustment of 25 p.c.

Finally, in part two, the strong US economic growth, which was significantly higher than in Europe and Japan, particularly in the second half of the nineties, has been highlighted as a possible cause for the deterioration in the US trade balance. A final option could be to bring about faster potential growth in the economies of these traditional trade partners of the United States. An important role therefore seems to be reserved for structural policies in those countries to increase productivity and employment. According to a number of research findings⁽¹⁾, more vigorous growth outside the United States would however contribute only to a limited extent to a reduction of the US current account deficit in the short or medium term. According to those calculations, a permanent increase in GDP growth of 0.5 percentage point in the euro area and Japan would reduce the US current account deficit by just 0.2 p.c. of GDP after a

(1) Brook, Sédillot and Ollivaud (2004)

TABLE 1 EFFECT ON THE US CURRENT ACCOUNT BALANCE

| | Shock | Effect on the US current account ⁽¹⁾ after six years |
|--|---|---|
| Depreciation of the nominal effective exchange rate of the dollar | | |
| OECD (Interlink) | 22.5 p.c. | +1.3 p.c. of GDP |
| NBB (NiGEM) | 25 p.c. | +1.0 p.c. of GDP |
| Fiscal consolidation in the US | | |
| OECD (Interlink) | +6 p.c. of GDP | +2.6 p.c. of GDP |
| NBB (NiGEM) | +6 p.c. of GDP | +1.2 p.c. of GDP |
| Combination of an exchange rate shock and fiscal consolidation | | |
| OECD (Interlink) | nominal effective USD : -15 p.c. and fiscal consolidation of 4 p.c. of GDP | +2.5 p.c. of GDP |
| NBB (NiGEM) | nominal effective USD : -25 p.c. and fiscal consolidation of 6 p.c. of GDP | +2.2 p.c. of GDP |
| More rapid growth achieved by the trading partners | | |
| Brook, Sédillot and Ollivaud (2004) | GDP euro area and Japan +0.5 p.c. | +0.2 p.c. of GDP |

Sources: Brook, Sédillot and Ollivaud (2004), OECD, NBB.
(1) Real net exports for the simulations based on the NiGEM-model.

period of six years. Before dismissing the scenario as ineffectual, however, confirmation of these findings must be obtained from other studies.

The huge effort required to significantly reduce the US current account deficit again highlights the seriousness of the problem and underlines the need for simultaneous economic policy measures in the respective economies.

4.3 Viewpoints and measures of the economies concerned

Not only are the concerns regarding the US current account deficit and the exchange rate movements the subject of economic scientific research, but they also appear at the top of the agenda of international forums, such as the G7 or G20 meetings.

For example, at the Dubai meeting in September 2003, the G7 Finance Ministers and Central Bank Governors already included the principle of exchange rate flexibility in their statement. In addition, they underlined the importance of productivity growth and employment in the G7, although without examining the responsibility of each individual economy. The sudden drop in the value of the dollar at the end of 2003 and in early 2004, mainly against the euro, was an indication that the actual intentions of the Dubai statement, namely greater exchange rate flexibility in Asia, were not perceived as such by the markets. In the statements issued at the G7 meetings in February and April 2004, it was therefore highlighted that excessive volatility on the currency markets and disorderly currency fluctuations were not desirable, whereas the desirability of greater exchange rate flexibility was more geared towards countries with a policy of fixed exchange rates, such as the Asian countries: *"we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms"*. Moreover, on this occasion, the role of economic policy – particularly with regard to US budgetary policy and structural measures to stimulate growth in Europe and Japan –, in tackling global current account imbalances, was underlined. In subsequent statements, i.e. those issued at the G20 meeting in November 2004 and the G7 meeting in February and April 2005, the importance of macroeconomic and structural policy in the rebalancing of global imbalances was given more emphasis and the message was reiterated that excessive currency volatility was not desirable but exchange rate flexibility was.

However, these common viewpoints tend, at times, to disguise diverging opinions on more specific solutions for tackling the global imbalances. The United States generally prefers to see market mechanisms play a greater role and therefore urges its Asian partners to make their exchange rates more flexible. Furthermore, the trading partners of the United States should make every effort to boost their economic growth. The US authorities are nevertheless committed to continue along the path of fiscal consolidation, and proceeded, in early 2005, to produce a draft budget for the fiscal year 2006 in which their intention was made more specific: expressed as a percentage of GDP, the budget deficit would have to be more than halved between 2005 and 2009.

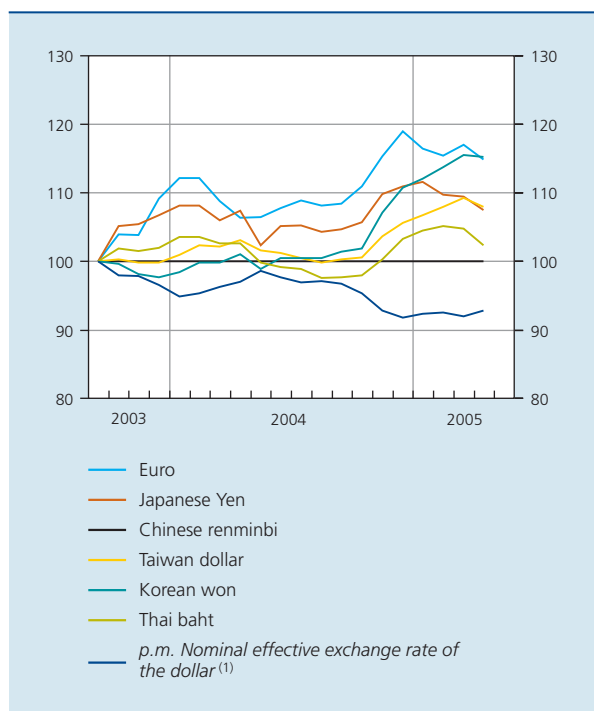
As far as Europe is concerned, the ECB stressed that the rapid appreciation of the euro against the dollar, at the end of 2004, had not been welcome and that the US could make a significant contribution to a narrowing of its current account deficit if it adjusted its budget and increased national savings⁽¹⁾.

Japan shares the concern of the Eurosystem regarding the risks of a sharp drop in the dollar, since the recovery of the Japanese economy is still very fragile. Indeed, such a drop in the dollar exchange rate would lead to a tightening of monetary conditions in Japan and therefore be at odds with the highly accommodative policy pursued by the Bank of Japan.

As for the Chinese authorities, they highlight the conditions required before steps can be taken towards a more flexible exchange rate system, i.e. a stable economic environment and a sound financial system. Measures have already been taken in that respect. For example, the process of banking sector reforms received a boost from 2003 onwards with capital injections for two of the four public commercial banks which dominate the banking sector and that had a poor financial structure, due to the sheer volume of bad loans. Fearing an increase in these loans, the Chinese authorities adopted a series of measures in 2004 to curb excessive lending. Furthermore, a number of measures have recently been taken with a view to bringing about greater liberalisation of capital movements. Yet, China does not seem to be prepared, in the short term, to adjust its exchange rate policy, arguing that the frequently made claims that the renminbi is undervalued, are debatable. Although some factors seem to indicate that the Chinese currency is undervalued to some extent, such as the size of the Chinese trade surplus with the United States and the

(1) Trichet (2004), Issing (2003).

CHART 10 EXCHANGE RATE OF THE EURO AND THE MAIN ASIAN CURRENCIES AGAINST THE DOLLAR
(Indices September 2003 = 100)



Source : Federal Reserve.

(1) Against the currencies of a broad group of major US trading partners.

massive increase in its currency reserves, this conclusion is not backed up by other facts. For example, China has a trade deficit with other emerging Asian economies, as a result of its “assembly” role in the regional production chain.

As mentioned before, most Asian economies, except Japan, pursue, like China, a strategy of (quasi-)fixed exchange rates, for fear of losing their competitiveness, above all within the region. A “first mover” problem therefore arises, which may delay the transition to more flexible exchange rates in Asia. Nevertheless, South Korea has recently allowed its currency to rise in value against the dollar; thus from January 2004 to April 2005, it was up by nearly 17 p.c., the sharpest increase among the United States’ main trading partners. Over the same period, the Taiwan dollar rose by 7 p.c. From October 2004, the Thai baht also appreciated and, at the end of 2004, the yen’s rise accelerated. Although these movements seem to suggest that these countries are starting to adjust their strategy⁽¹⁾, it is too early to conclude that they have finally

(1) Outside Asia, Russia has recently announced that it wants to abandon the dollar peg in order to bring its currency more into line with the euro.

decided on a fundamental change of policy away from accumulating currency reserves and in favour of greater exchange rate flexibility.

Conclusion

One of the most remarkable characteristics of the global economy today is the enormous US current account deficit. Its sheer size is unprecedented, not only in the United States’ own post-war history, but it is also quite exceptional from an international perspective. The current situation is also unusual because the US deficit contrasts sharply with the surpluses generated in nearly every other region, which has made this into a global problem.

The widening current account deficit in the US balance of payments throughout the nineties can be almost entirely attributed to the deterioration in the balance of trade in goods. This was partly due to the US economy growing faster than the economies of its traditional trading partners, Americans displaying a degree of preference for foreign goods, the integration of China in the world economy and presumably also the lagged effect of the sharp appreciation of the dollar between mid-1995 and the end of 2001. The US current account deficit also reflects a domestic shortfall in savings, which was initially due to a surge in investments against a background of sustained strong productivity growth and lower private savings. In 2002 and 2003, the sharp drop in investments brought about a rebalancing of the private saving-investment balances, but in the same period, the surplus in the public finances turned into a substantial deficit. It led to the re-emergence of the so-called “twin deficit”, in addition to which the private saving-investment balance turned negative again in 2004. The start of the new millennium also brought marked changes to the way the US current account deficit is financed. For example, investments by Asian public authorities in US government bonds 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. It has been claimed 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. Furthermore, 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.

These exchange rate relations may nevertheless have led to distortions in US spending, while the Asian countries have to deal with a growing exchange rate risk in terms of their official reserves and a high opportunity cost of their interventions, as well as increasing difficulties in neutralising the liquidity created as a result of their interventions. Moreover, there is no institutional arrangement in place that would provide lasting support for the existing situation, unlike the original Bretton Woods system.

Different scenarios are conceivable to deal with the global imbalances. One option is to achieve this as far as possible via an exchange rate adjustment. In such a scenario, however, the risk of disorderly currency and interest rate fluctuations cannot be excluded; furthermore, the results of model simulations indicate that a huge depreciation of the dollar would be required to achieve a significant narrowing of the US current account deficit. A mere adjustment of exchange rates therefore does not look particularly effective. Nor would isolated policy measures, such

as fiscal consolidation in the US or the implementation of structural reforms in the euro area and Japan to boost the growth potential of those economies, appear to offer an effective solution. If a gradual and orderly adjustment is to be achieved, these findings in fact seem to imply that the economies involved should simultaneously implement measures in different policy areas, including the aim of gradually introducing 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. Although the United States generally prefers to allow market mechanisms to play an important role, it did propose a budget in early 2005 with the aim of halving the budget deficit by 2009. China, for its part, made it known that a number of conditions needed to be met, namely a stable economic environment and a sound financial system, before steps could be taken, in the medium term, with a view to introducing a more flexible exchange rate mechanism. Finally, Europe and Japan committed themselves to the continued implementation of structural measures to boost the growth potential of their economies.

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