

The U.S. Current Account Deficit and The Dollar

Olivier Blanchard

paper available on web page

The basic facts

The U.S. current account deficit:

- Large and getting larger: -5.7% in 2004, -6.2% in 2005?
- Unprecedented historically. The Reagan deficits peaked at 3.5%.
- Large absolutely. \$670 billion in 2004. About 12% of non-US gross saving, about 50% of non-US net saving.

The appreciation and depreciation of the dollar:

- Appreciation against major currencies by 34% from december 95 to february 02, then depreciation by 31% from february 02 to april 05.
- Against the euro by 40% from december 95 to march 02, then depreciation by 39% from march 02 to april 05

The forces behind the deficits

Two main forces at work.

- An increase in the U.S. demand for foreign goods.
Partly higher U.S. growth, mostly relative demand shifts.
- An increase in the foreign demand for U.S. assets.
Different assets/investors since the mid 1990s.
From equities to bonds. From private investors to central banks.

The dynamics at work

- An increase in the U.S. demand for foreign goods.
Trade deficit, depreciation, and then more depreciation as U.S. net foreign debt accumulates.
(Net foreign debt requires trade surplus. Trade surplus requires depreciation.)
- An increase in the foreign demand for U.S. assets.
Appreciation, triggering trade deficit.
But then depreciation as U.S. net foreign debt accumulates.

We saw the appreciation until 2001. Now in the depreciation phase. How much depreciation to come?

A back of the envelope computation

At the current level of net debt, required depreciation to achieve sustainable current account balance?

- Current account deficit. 6%.
- Built in J-curve? 1% (probably less)
- “Sustainable” current account? say 1%
- So a 4% adjustment in the current account
- How large a depreciation?

A back of the envelope computation, continued

- Effect of the real exchange rate on the trade balance:
Range from macroeconomic equations to Rogoff and Obstfeld.
Reasonable? 15% real depreciation for reduction of 1% of GDP.
- Effect of the real exchange rate on gross asset positions, and so on net debt and net interest payments.
Net debt position: \$ 2.7 trillion
U.S. holdings of foreign assets: \$ 8 trillion
Foreign holdings of U.S. assets: \$ 10.7 trillion
15% depreciation: Decrease in net debt of 10% of GDP. Decrease in net interest payments of 0.4% of GDP.
- Putting things together: 42% (4% times 15% divided by 1.4%)

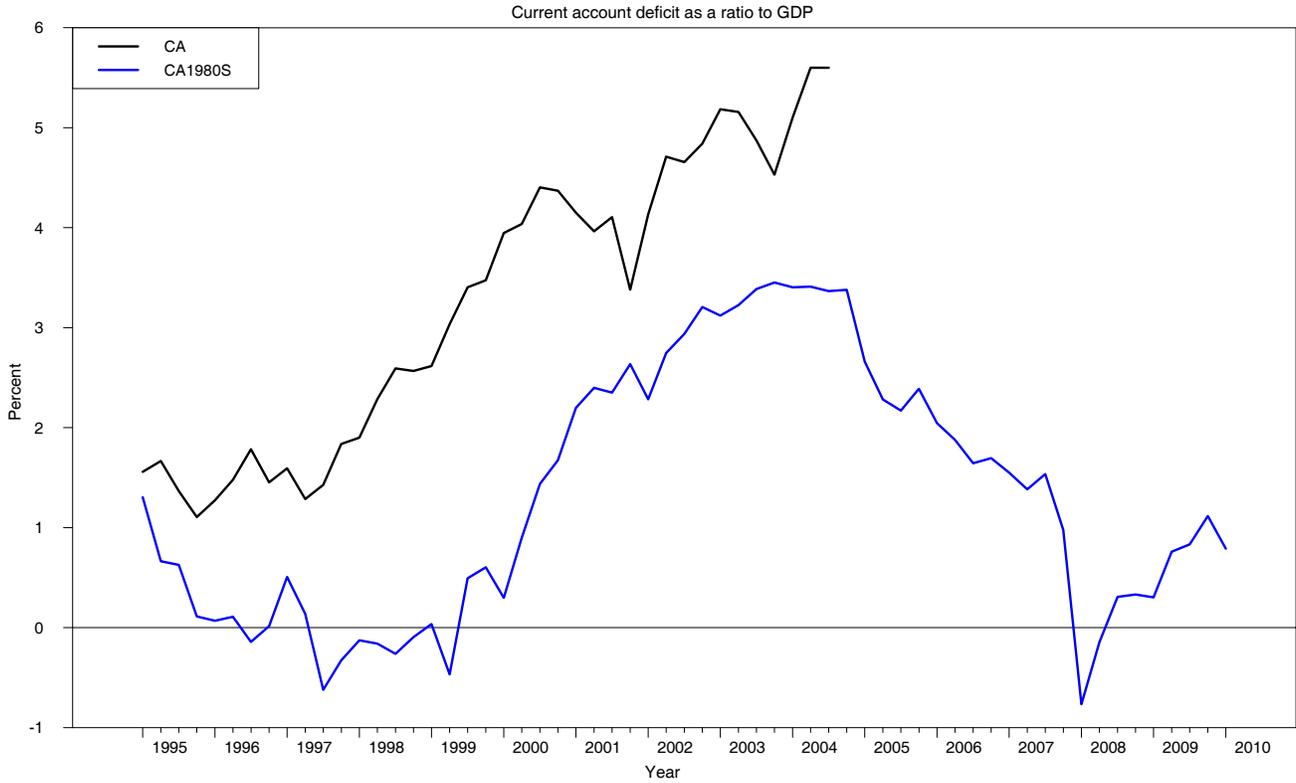
A back of the envelope computation, continued

- Too pessimistic. Surely does not need to happen overnight.
- Too optimistic. The longer we wait, the larger the net debt position, the higher the required trade surplus, the larger the eventual depreciation.
- Absent surprises: A slow/steady depreciation. At what rate?
If foreigners want to maintain a constant share in U.S. assets, depreciation of 3% a year. (No Roubini-Setser meltdown.)
- There will be surprises. Only the sign is unknown.

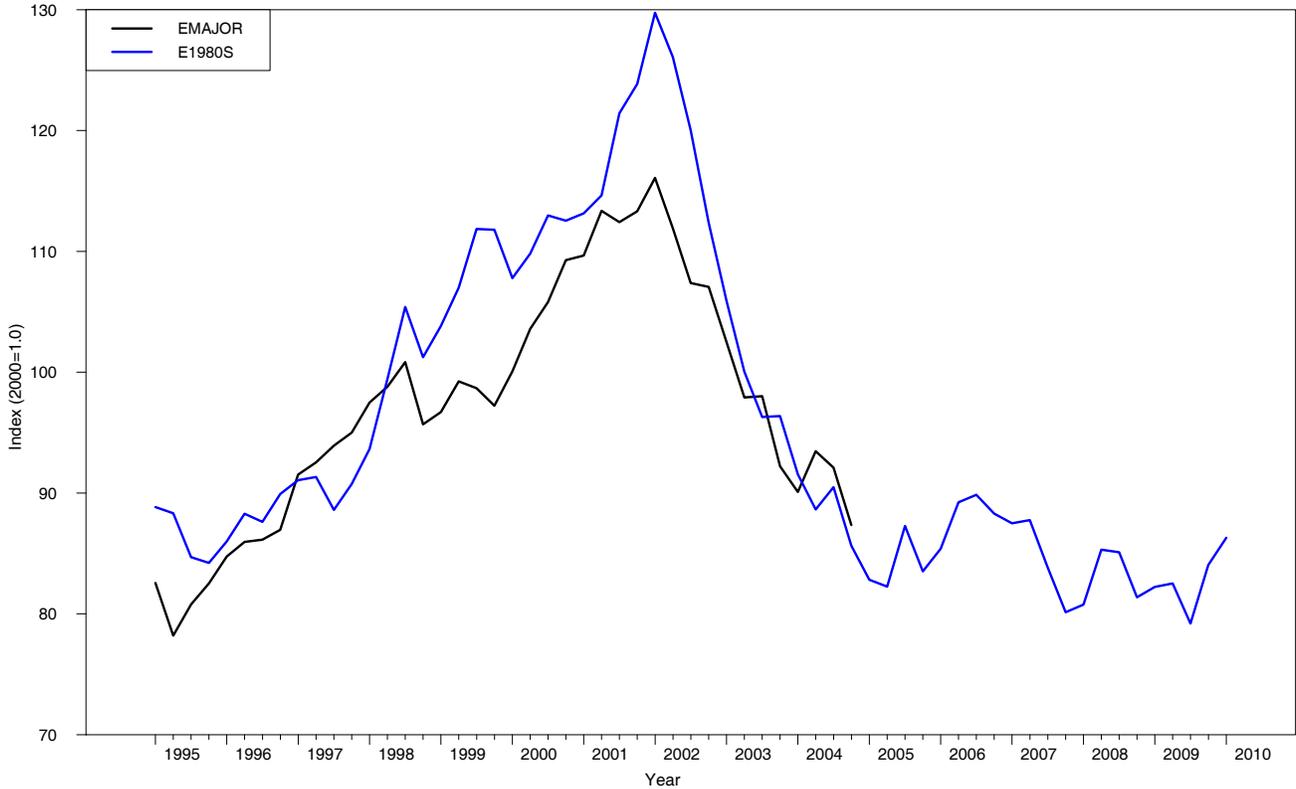
Potential surprises. I. Can the trade deficit go away on its own?

- Sources of the increase in the trade deficit? (non oil, goods, up by \$327 from 1998 to 2004)
- Exchange rates and activity (higher U.S. growth, not much without Houthakker Magee effects): About 60%.
- Shifts in imports/exports. About 40%.
- The depreciation since 2001 and the J-curve. Comparing with the 1980s.
- A very optimistic assessment: 2% built in already. In which case, depreciation needed goes down from 42% to 32%.

Figure 4. A comparison of 1979-1994 and 1995-?



U.S. Multilateral Real Exchange Rate, 1995:1 to 2004:3



Potential surprises II. Asian investors and central banks

- Continuing favorable shift in foreign investors' preferences?
To avoid dollar depreciation would require 2.5 percentage points annual increase in the share of U.S. assets in foreign portfolios a year. Unlikely.
Good news? (good news for the dollar now, bad news for later)
- If diversification of CB reserves, substantial shift in relative demands.
From 100% to 50% dollar assets in BOJ and PBC portfolios, a 2 percentage point decrease in share of U.S. assets in foreign portfolios. Upper bound: 10% depreciation.

Potential surprises III. U.S. interest rates—and the U.S. budget deficit

- Dollar depreciation needed to achieve external balance
- Decrease in spending needed to maintain internal balance. Either through reduction of budget deficits, or higher interest rates.
- If higher interest rates to maintain internal balance, then less (although some) depreciation.

Good news for the dollar now, but bad news for later (more net debt accumulation).

Budget deficit reduction is not a substitute for the depreciation. They are both needed.

Absent surprises, slow and steady budget deficit reduction is enough.

The Euro, the yen, and the renminbi

- Outcome depends on bilateral current account balances and portfolio preferences.
- 2004 U.S. trade deficit in goods \$652 billion. Of this: \$160 with China, \$75 billion with Japan, \$71 with the Euro area. Think 50%, 25%, 25%.
- What implications for the Euro (the yen) ?

The Euro, the yen, and the renminbi, continued

- Even if all trade deficit was with Asia, appreciation of the Euro vis a vis the dollar (and depreciation vis a vis Asia). (no change in the Euro real effective exchange rate.)
- Given actual structure of deficits, and absent renminbi peg, appreciation of the renminbi, and (less) yen and euro
- If renminbi peg and dollar reserve accumulation by PBC, less appreciation of the euro and the yen: PBC is an investor with extreme dollar preferences.

If end of peg, or/and diversification of reserves, shift away from investor with extreme dollar preferences, so appreciation of the euro and the yen.

Conclusions

- Two shifts. Assets/Goods.
- Steady but slow anticipated depreciation.
- Surprises? Sure.
Good news on the dollar: bad news for the dollar eventually.
- Against the renminbi, but also the euro and the yen
- Potentially bad news for Japan and Europe rather than the United States.