Edwin M. Truman

October 30, 2017

Thoughts on the US External Deficit[[1]](#footnote-1)\*

Prepared for the Leir Retreat Conference

November 3-4, 2017

Overview: The US current account deficit is largely due to the low and declining level of US national saving. Exchange rates and the exchange rate policies of other countries have had marginal effects on the US external position over the past almost four decades. The accumulated deficits and the build-up of net foreign liabilities could become a problem, but only if US economic and financial policies cease command the confidence of the rest of the world.

**Question 1: Is the US current account deficit a problem?**

**Answer:** The US current account deficit is not now a problem? The current account balance is the best measure of the US flow international economic position. (It is wrong and misleading to focus on the merchandize trade or goods and services trade balances.) The current account deficit has been less than 3 percent of GDP for six years. With nominal GDP increasing at more than a 3 percent rate, ceteris paribus, our negative net international investment position should stabilize.

**Question 2: Could the US current account deficit become a problem?**

**Answer:** Yes. If investors in the rest of the world lose confidence in our policies and prospects, relative to the policies and prospects of other countries, the US economy would become vulnerable to a run on the dollar. The relevant US policies include monetary policy and our tolerance of inflation, fiscal policy and the prospects for solvency in our governmental accounts, and importantly our policies on openness to trade in goods, services, and financial assets.

Our negative international investment position was $7.9 trillion, 41 percent of GDP, as of the end of the second quarter this year, composed of gross assets of $25.9 trillion, 135 percent of GDP, and gross liabilities of $33.9 trillion, 176 percent of GDP. If there were a run on assets held in the United States, a lot that could run. The run would have profound effects on the US economy. The dollar would weaken precipitously, asset prices in US dollars would decline steeply as market interest rates rose, the US economy would go into a deep recession.

**Question 3: What role do the exchange rate policies of other countries have in perpetuating out external deficit?**

**Answer**: The exchange rate policies of other countries have had a marginal impact on our external accounts.

A few countries have successfully manipulated their currencies to obtain a competitive advantage, but the overall impact of this behavior on the US economy has been small and relatively recent. (I am aware that my colleagues Joe Gagnon and Fred Bergsten do not entirely agree that this effect on the US economy has been minimal.) The rapid accumulation of foreign currency reserves mostly in US dollars, has been a phenomenon of the 21st century. For much of this century the United States has been at or near full employment. At full employment, a stronger dollar associated with currency manipulation by another country that depresses its currency relative to the dollar and other currencies cannot have a significant impact on the US economy as long as US policy acts to preserve full employment; a weaker currency of one country relative to the currencies of other US trading partners tends to redistribute the US current account deficit toward the manipulator and away from other countries.

High desired rates of saving in the rest of world relative to investment and desired savings in the United States tend to depress their currencies relative to the dollar as capital flows into US assets. Quite frankly, I do not understand the view, expressed in Bob Aliber’s overview notes, that this phenomenon depresses the outflow of US saving to the rest of the world, i.e., “crowding out” foreign borrowers.

I also do not understand why he refers to “shocks” in the US or foreign economies as somehow relevant to trends in current account transactions. Shocks, by definition, dissipate and it requires special mechanisms/assumptions for them to have lasting effects.

**Question 4: To what do we attribute the persistent US current account deficit since the early 1970s?**

**Answer:** The deficits are attributable primarily to the low and declining level of US saving relative to the US investment.

I reject the view that the deficits are attributable to floating exchange rates per se.

I also reject the view that the adoption of floating exchange rates was motivated by a desire “to facilitate an improvement in the US competitive position in trade in goods” or more properly trade in goods and services. Some naïve models of the economy close the economy by assuming that the exchange rate will balance trade. Other equally naïve models close the economy by assuming uncovered interest parity. But in either case there is nothing in those assumptions that guaranty either balanced current account positions or either surplus or deficit positions.

The adoption of floating exchange rates among the major economies had nothing to do with these models or the naïve assumption, on the part of US policymakers, that floating exchange rates would yield a lower US current account deficit or larger surplus. Floating exchange rates were forced on largely unwilling policymakers by the explosion in capital flows starting in the late 1960s and continuing into the 1970s. That explosion was nothing like the scale of gross capital flows we observe today.

The principal determinant of the US current account balance is the low level of US savings relative to investment and relative to the surplus in savings in the rest of the world. The level of and changes in exchange rates can affect the current account, but in the end the current account and its components must help to satisfy the identity that savings equals investment. Simple econometrics reinforces this point.

1. A simple regression over the period Q1 1973 through Q2 2017 of the US current account as a percent of GDP on the Federal Reserve Board staff’s real broad index of the foreign exchange value of the dollar does yield a statistically significant small negative coefficient of 0.04, but the relationship explains only 4 percent of the total variation in the current account.
2. On the other hand, a simple regression over the same period of the current account on US gross national saving as a percent of GDP yields a much more significant coefficient of 0.44 and the relationship explains 33 percent of the total variation.
3. A simple regression of the current account on government staving by itself is not significant. The obvious explanation is that government saving is a cyclical variable and the cycle affects both it and the current account directly.
4. A multiple regression of the US current account on the dollar and gross national saving yields significant coefficients that are essentially identical (minus 0.04 and plus 0.49) to the univariable regressions and explains 37 percent of the overall variation.
5. The US current account deficit averaged 2.1percent of GDP over this period, the dollar index (on a March 1973 base) was 95.8 and gross national saving averaged 19.42 percent of GDP. Thus, to close the gap in the current account on average over this period US national savings would have had to have been about 4-1/2 percent higher, which is conceivably doable, in particular because increased national saving would be expected to be associated with lower interest rates and a weaker dollar, serving to reinforce the influence of the higher savings. In 1973, US gross national saving was 23.5 percent of GDP and between mid-2016 and mid-2017 it has been 17.7 percent.
6. On the other hand, these results imply that to close the gap with a lower dollar, the currency would have had to have been about 50 percent lower, which is neither conceivable nor doable. The normal rule of thumb is that a 10 percent lower dollar is required to produce a 1 percentage point of GDP improvement in the current account as a share of GDP, but this relationship assumes that the level of economic activity is unchanged.
7. Note, however, that a dollar 20 percent lower on average over the past 40+ years also would have been implausible. This observation reinforces the point that a substantially weaker dollar associated with a smaller current account deficit leaves open what would be going on in the rest of the economy. Consumption would be lower and investment would be lower. The former has a current negative impact on US wellbeing and the latter has a future negative impact through a reduced growth rate. This may remind some of us why for 20+ years the view that a strong US dollar is in the national interest was an analytically attractive mantra.

1. \* I have thrown these notes together. Please excuse typos and incomplete thoughts. [↑](#footnote-ref-1)