The Current Account Deficit

Christopher J. Neely

Little Rock Board of Directors Meeting

March 25, 2005

Disclaimer: The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve Bank of St. Louis, or the Federal Reserve System.

BOTTOM LINERS

"The views and opinions I've expressed in this meeting are not necessarily my views and opinions."

How is the economy doing?

- Real GDP growth has been fairly strong: 3.81 percent in 2004Q4.
- Unemployment is fairly low, at 5.4 percent, and labor force participation is fairly high.
- CPI inflation is a bit higher than we'd like, at 2.7 percent, but it is driven mainly by food and energy.
- Productivity growth has been fairly high.
- But the current account deficit is at record levels.

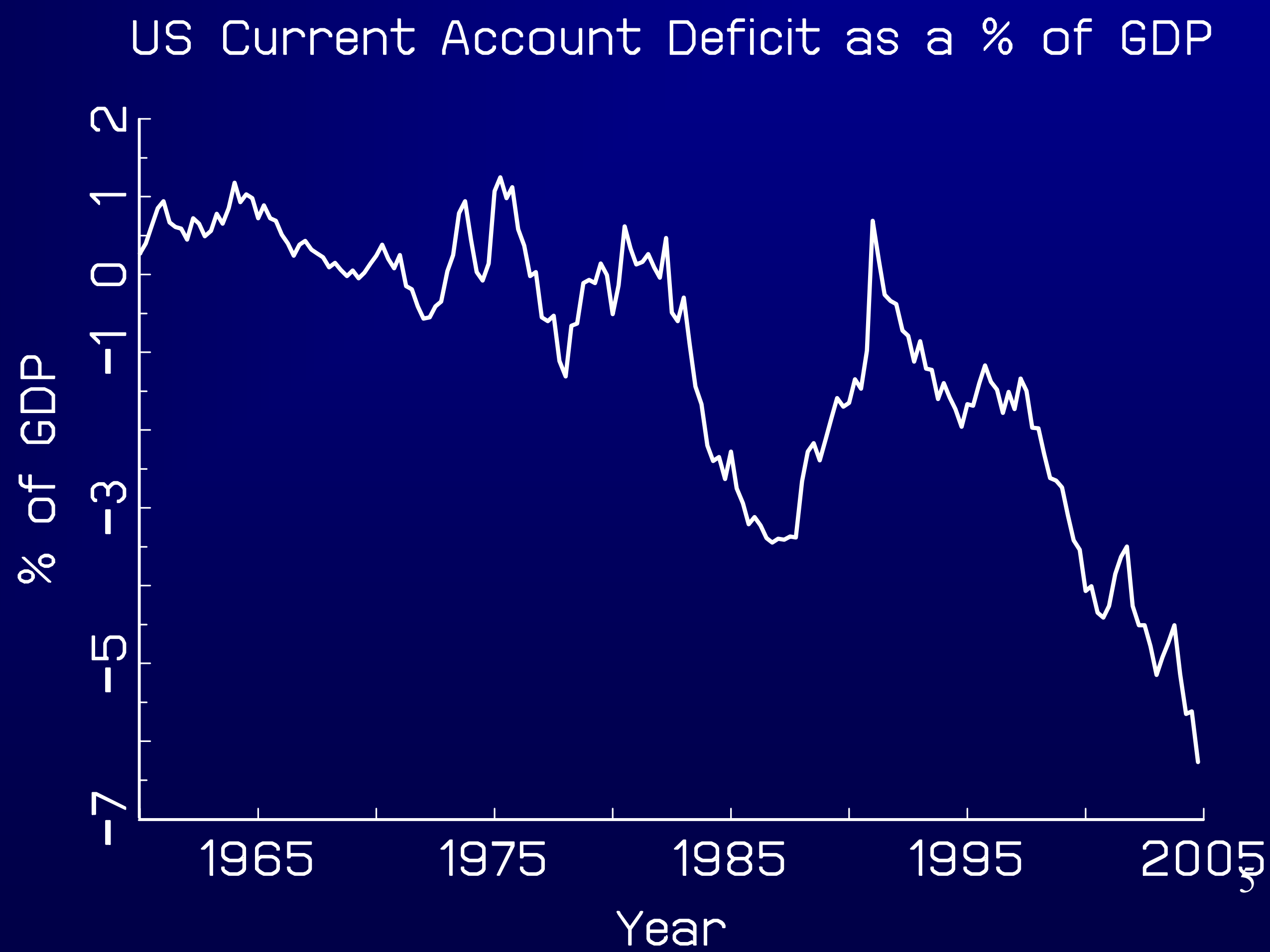
What is the Current Account?

- **The *current account* (*CA*) measures trade in goods and services, net receipts on foreign investment, and unilateral transfers.**
  - **The CA is dominated by the *merchandise trade balance*.**
- **A *CA deficit* means that a country imports more goods and services than it exports.**

What is the U.S. CA situation?

The U.S. is running very large CA deficits. That is, we are importing more goods and services than we are exporting.

The CA deficit has increased very substantially in recent years.



What drives CA deficits?

- Competitiveness?
  - Does a CA deficit reflect poor goods/services?
- Trade barriers?
  - Does a CA deficit reflect trade barriers or currency manipulation?
- Oil imports?
- Savings/investment decisions

Savings/Investment and the CA

Recall that a *current account deficit* occurs when we import more goods & services than we export.

Why does the rest of the world give us more goods & services than we give them? (What's in it for them?)

A CA deficit is always accompanied by a *capital account surplus*. A capital account surplus means that we sell more assets abroad than we buy from abroad.

A CA deficit always means that a country sells claims on future income. This is neither intrinsically good nor bad.

Savings/Investment and the CA

Another way to look at CA deficits.

Output = Consumption + Investment + Net exports

Output = Income

Income = Consumption + Investment + Net exports

Income − Consumption = Investment + Net exports

Savings = Income − Consumption

Savings − Investment = Net exports (the CA deficit)

Savings/Investment and the CA

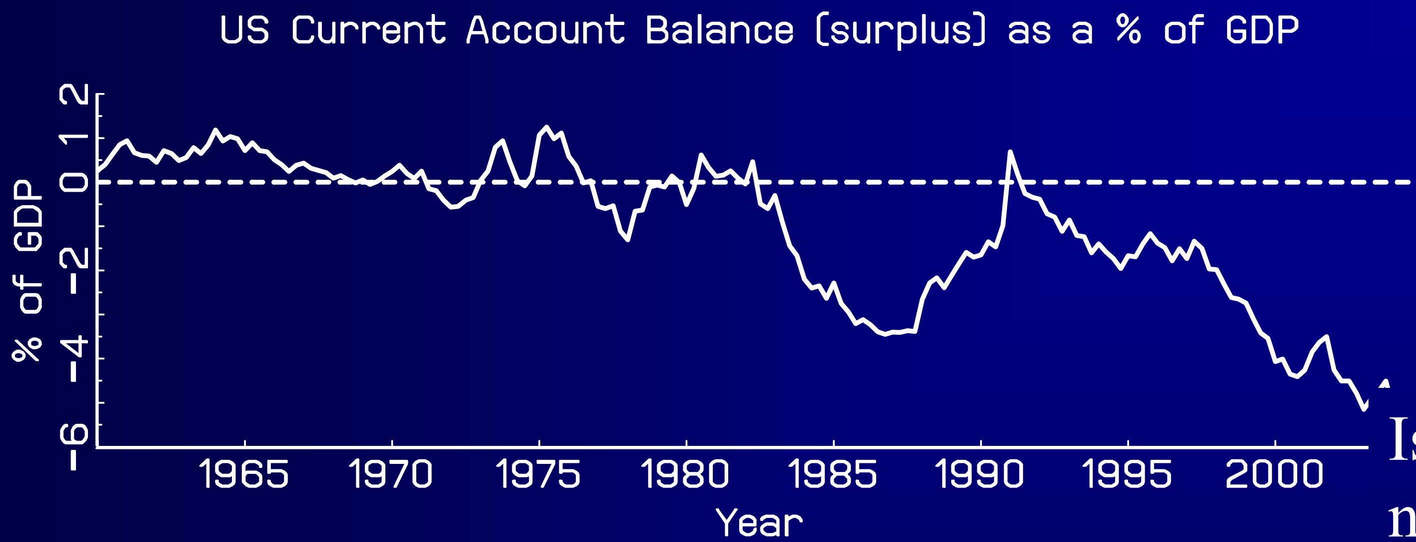
Anything that reduces savings and/or increases investment in the U.S. will raise the CA deficit.

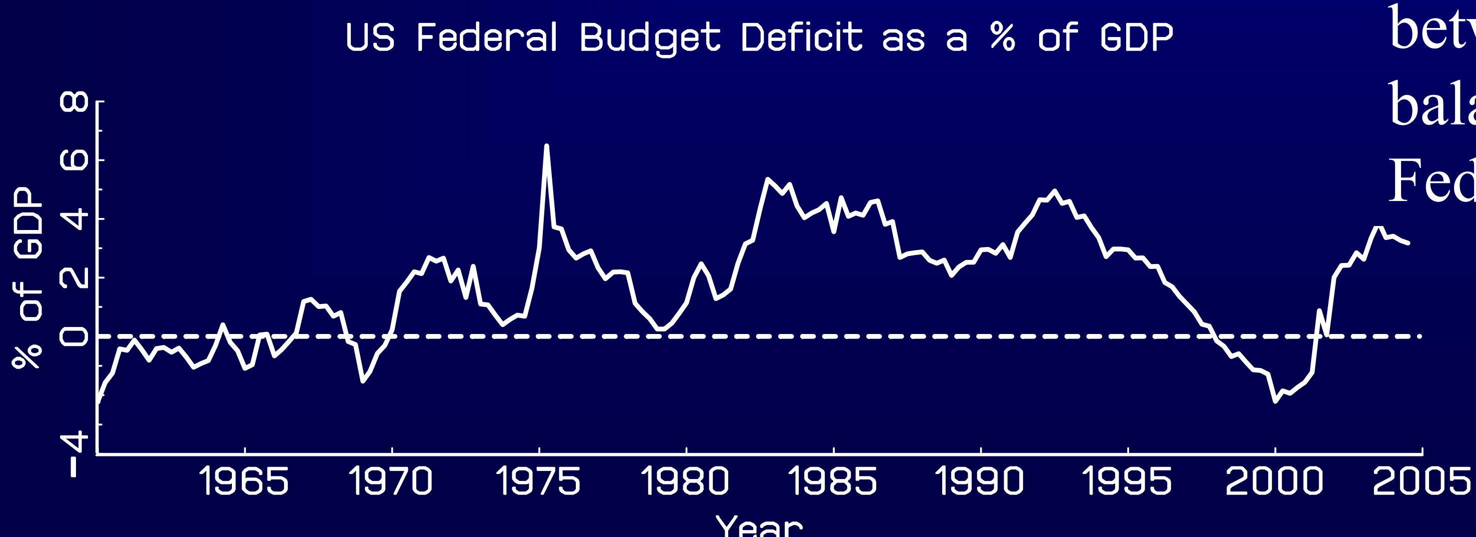
What might change savings/investment? (ceteris paribus)

- Changes in desired savings rates.
  - Demographics, perception of risk
- Government deficits (negative saving)
- Cyclical demand for investment goods.

Savings/Investment and the CA

- **Government deficits: The "Twin Deficits"**





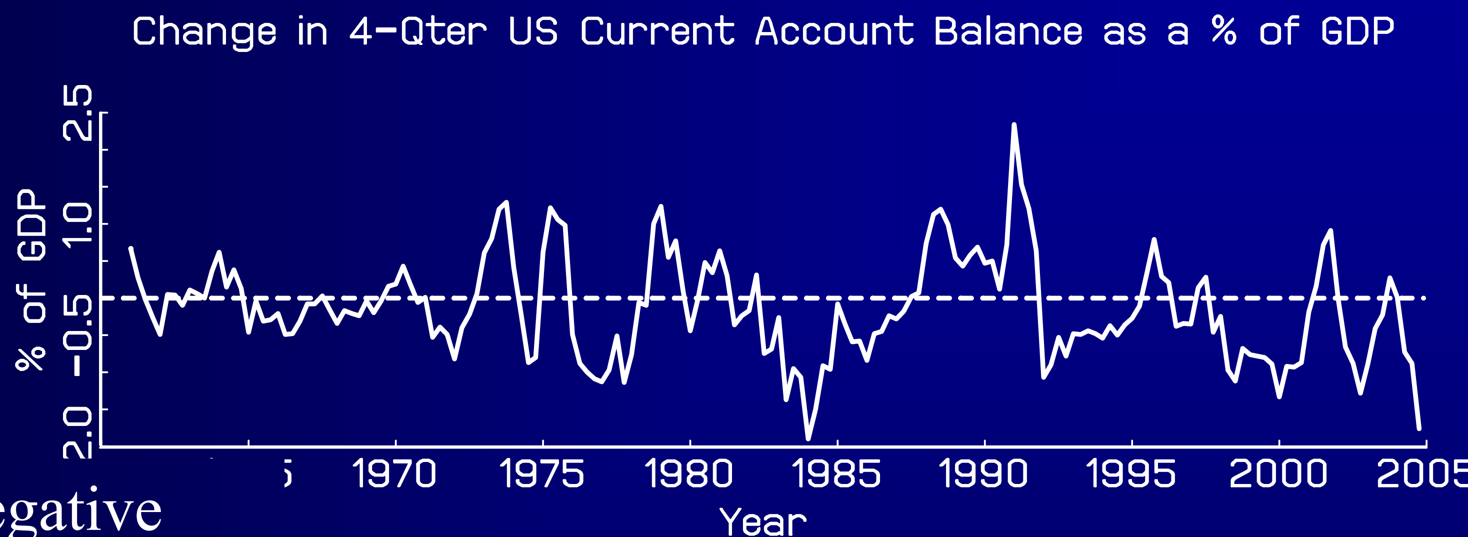
Is there a negative relation between the CA balance and the Federal deficit?

Savings/Investment and the CA

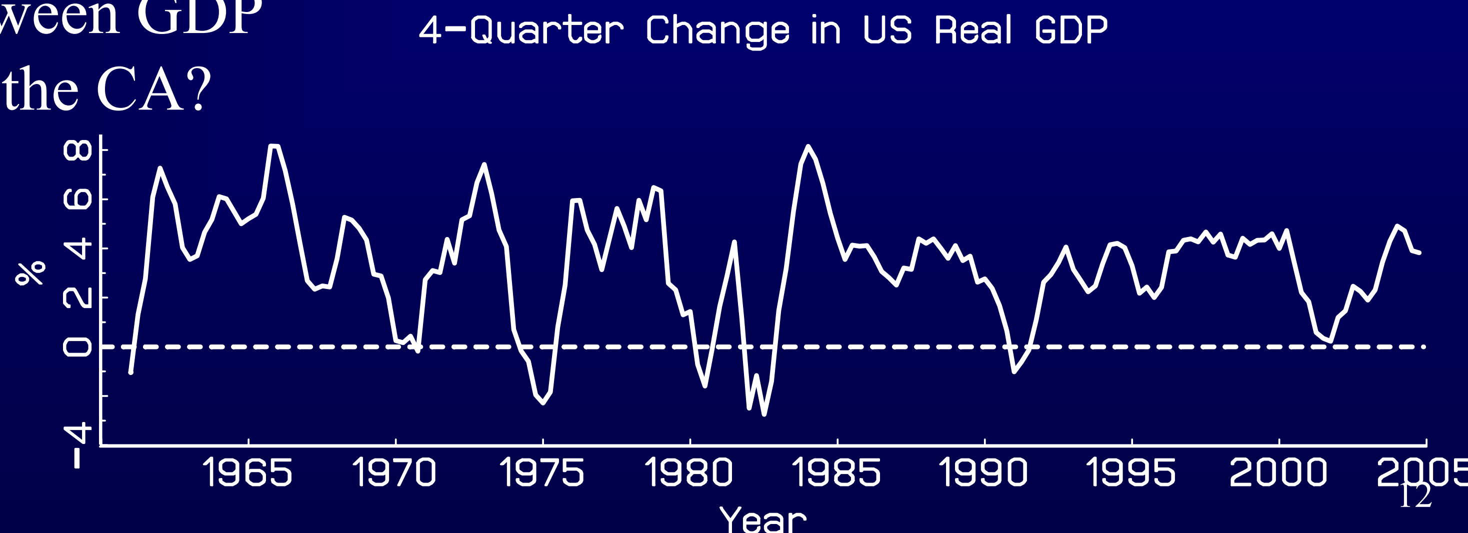
- **Government deficits: The "Twin Deficits"**
  - **The negative relation between the CA balance and the Federal deficit is a "ceteris paribus" relation.**
  - **We shouldn't expect it to hold unconditionally.**
  - **For example, a rising stock market might decrease the budget deficit while increasing the current account deficit through investment demand.**

Savings/Investment and the CA

- **Cyclical demand for investment goods.**



Is there a negative relation between GDP growth and the CA?

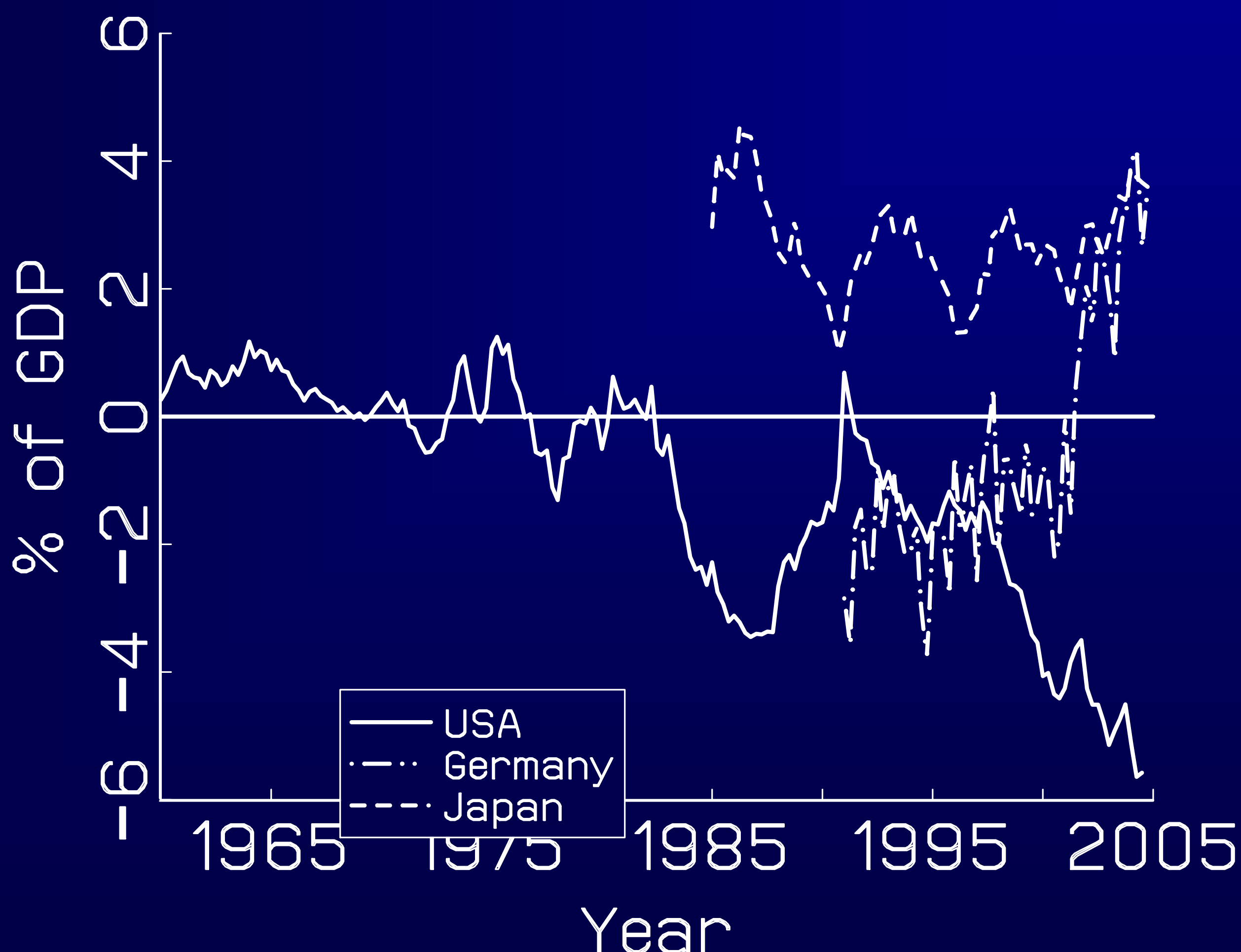


What doesn’t change S/I decisions?

- Changes in exchange rates.
  - Changes in prices are *endogenous*, they don’t change quantities. Both P and Q react to fundamental shocks through supply and demand.
- Changes in preferences, trade barriers, etc have very small effects on S/I decisions.
  - Changes in trade barriers/preferences will be offset through changes in exchange rates.

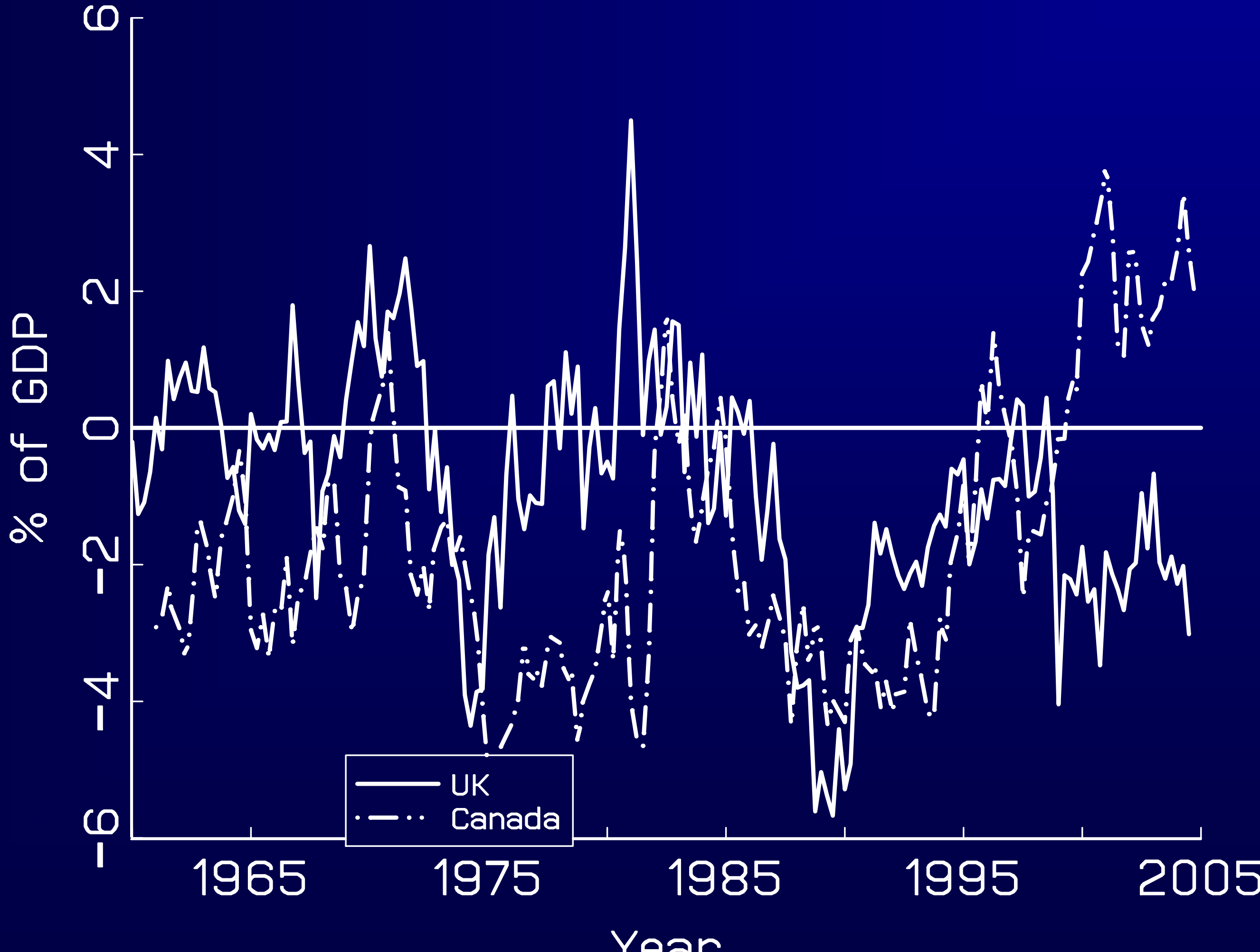
International Comparison

- How big is the U.S. CA deficit compared to those of other major countries?



International Comparison

- How big is the U.S. CA deficit compared to those of other major countries?



Why is the U.S. CA deficit so big?

- **Business Cycle effects**
  - **The U.S. is growing relatively rapidly compared to our trading partners.**
- **The Federal Deficit:**
  - **A rise in U.S. government dissavings (the deficit) leads to a fall in the national savings rate.**
- **Flight to safety**
  - **The international security situation might have increased demand for relatively safe U.S. assets.**

Can a CA deficit persist forever?

- Theoretically, there is no reason why a nation cannot run a CA deficit forever.
- The size of deficits is limited by expectations of claims on future income. (Can you pay it back?)
- In practice, countries have run persistent deficits, as long as they attracted foreign investment.
- The U.S. deficit is likely to decline at some point.

How will the CA resolve?

- Will the U.S. experience an exchange rate crash like those in Mexico (1994) and Asia (1997)?

  - Probably not. The U.S. has a flexible exchange rate system and a fall in demand for U.S. assets will gradually reduce the value of the dollar.

  - A reduction in the CA deficit must be accompanied by a rise in S/I.

Conclusions

- The U.S. is running a very large CA deficit.
  - That is, the U.S. is selling claims on future income. This might be good or bad.
- The CA deficit results from the fact that U.S. saving is less than U.S. investment.
- A “crash” is unlikely, but the level of the CA deficit will not persist.
- Current account deficits do not destroy net jobs.

Thanks for your attention.

The End

Is a CA deficit disastrous? Are we exporting jobs?

- If you buy a foreign-made car, do you put some Detroit autoworker out of a job?

- When Dell outsources a call center to India, does that put Americans out of work?

- If we could eliminate the CA deficit, how many Americans could be put to work?

Does a CA deficit export jobs?

- When foreigners sell us goods, they must do one of two things with the money: 1) Buy U.S. goods; or 2) Buy U.S. real or financial assets.
- Either course of action creates about as many jobs as are "lost" by the imports.
- Trade can help or harm individuals, but—on net—it neither creates nor destroys jobs.

Does a CA deficit export jobs?

- **The U.S. unemployment rate 1948-2004.**

A huge rise in trade in the last 60 years has not increased the average unemployment rate.