

5-2005

US Current Account Imbalance

Milena Gueorguieva

Follow this and additional works at: https://digitalcommons.lsu.edu/honors_etd



Part of the [Economics Commons](#)

US Current Account Imbalance



Assosiated Press Picture (CBS/AP 2004)

by

Milena Gueorguieva

Undergraduate honors thesis under the direction of

Dr. Marios Zachariadis

Department of Economics

Submitted to the LSU Honors College in partial fulfillment of
the Upper Division Honors Program.

May 2005

Louisiana State University
& Agricultural and Mechanical College
Baton Rouge, Louisiana

Abstract

World economic growth has been strong in the last few years. In 2004, the world experienced possibly the highest rate of expansion in nearly 30 years. This expansion was also accompanied by tremendous increase in income per capita not only for the industrialized world but also for the developing world. This paper will focus on examining some of the threats and challenges that lie within these positive signs. A very current topic of concern for many of us has been the large US current account deficit, which, on the other side, is financed by the large current account surpluses in Japan, emerging Asia and some of the major oil-exporting countries. In other words, we have been worried about the present large global imbalances. If we look closer into those imbalances we can see that the world economic growth has been mainly due to the US and China. For example non-oil exports to the States accounted for 18% of global trade. (Rato 2005) The US economic growth by itself has contributed to the emergence of two forces. One of them is the increase in US demand for foreign goods and the other is the increase in the foreign demand for US assets. (Blanchard 2004) Those have been some of the major forces that contributed to the increase of the US current Account deficit. In this paper, I will study the effects of the large global imbalances and ways to keep them at a more sustainable level.

1. International Currency- definition, history and present

Historically, nations have always had a medium of exchange and most often this medium of exchange is called money. It includes the coins and

currency issued by the governments and the central banks throughout the world but also includes some other mediums of exchange. Money is defined to have the following functions: medium of exchange, a unit of account and a store of value. (Greenspan 2001) In the last few decades, the world has experienced an immense integration of trade, production and even labor force movement flexibility. This event is a very current issue, which makes many economists think and predict the final outcome of this integration. Transactions between two countries need a common medium of exchange, and the more transactions there are the more this medium of exchange will be used. Throughout the world development many countries have found that the easiest way to increase a transaction's smoothness is by having an international currency. From the Dutch guilder (17th-18th c.) to the British pound (19th-20th c.) to the US dollar (present) the world has used these currencies to fulfill the functions of money on a more global level. (European Parliament 2005)

The functions of an international currency are the same as the functions of currency but have to be fulfilled on an international level. It is means of payments, unit of account and store of value. (European Parliament 2005) As a **means of payments**, it is used by private non-resident users as an intermediate value in transactions between two smaller currencies, e.g. as a vehicle of exchange. For example, the exchange rate between the Bulgarian lev and the Indian rupih will depend on the lev/dollar and dollar/rupih transaction. The public authorities also use the international currency to intervene in the foreign exchange markets. As a **private unit of account**, the international

currency is used to set the price of goods and assets, but at the same time, while prices are set in one currency, the payments could be in another. Public authorities use currency as a unit of account when they peg a country's currency to some international currency. As a **store of value**, international currency is used to maintain the value of savings. (European Parliament 2005)

Countries that have had their currency perform the role of an international one have tried to maintain their favorable position. For example, international currency increases the volume of currency in the local area, since having an international currency might increase the willingness of some foreigners to hold money (since people will have the chance to hold a more secure currency). Furthermore, it facilitates access to local markets for foreign investors, increases employment opportunities and improves liquidity of the local area. All those are reasons that increase the desirability of possessing an international, vehicle currency. Other benefits include more price stability, low inflation and interest rates and other measures, which ensure the self-sufficiency of the home market.

Britain was the world's industrial power until throughout most of the 19th century and the sterling was the international currency at the end of the 19th century until the Bretton Woods conference in 1944, when it was officially decided to use the dollar as an international reserve currency.

The period between WWI and WWII Britain started losing its position of a great economic power. This is the time when most of the big economic powers retreated within their borders due to economic and political reasons. There

wasn't any generally accepted international system that regulated international relations. During the WWI the economic power of Germany surpassed that of Britain and France and it wasn't until the US entered the war in 1917, that the power shifted towards the allies. The end of the war in Europe was marked with economic hardships not only for the defeated but also for the "winners." The deaths amounted for over 8 million; much of the capital equipment in Europe was destroyed, while industry could not meet civilian needs for consumption and employments. International relations crushed, while assets distribution completely changed. This happened because many of the old international trade capital were lost and major amount of gold reserves (40%) were now in the US. (Rider 1995) The increase of gold reserves occurred because the US sold most of the necessary weapons and supplies to the allies in return for gold. Thus Britain lost its power of being the world's major economic creditor and the US took over the position. By 1931 the US received \$2.7 billion repayments, while at the same time Britain had received \$881 million but repaid to the US \$1.122 billion. Except Britain, all other countries had an unfavorable trade and payment position with the US. (Rider 1995)

After WWI, Britain returned to the gold standard, but the pound was overvalued thus hurting the UK's exports and causing a substantial increase in trade deficits. As a consequence, the sterling started to fade away as a store of value and the resumption of the sterling as an international currency was very unsteady.

The collapse of the gold standard created the need for a new international monetary system and by the end of the WWII the US agreed to accept the responsibility of a major economic power, since it was the world's largest market economy and was not affected largely by the wars. (Rider 1995) The next step taken was at the Bretton Woods conference of 1944. According to it, each country fixed the value of its currency in terms of gold (par value) and maintained the exchange rate within 1% of parity (by buying and selling dollars). (Bidian, 2005) Also the foreign reserves were kept as dollars and gold. The dominant position of the US economy after the WWII made this possible. The North American country created a stable currency whose supply could be expanded to correspond to an expanding volume of world trade.

2. US Economy

The United States has proven to be the world's strongest and most developed economy over the last decades. It has achieved this due to its technological advancements and free market-oriented economy. Its attractiveness to foreign investors has been due to the fact that US businesses enjoy considerably greater flexibility in labor markets, R&D funding and entrepreneurship. In the second half of the 1990s, the country has experienced steady growth of about 3 % for the years 1995-2000. (Penn World table 2005) Even after the September 11 recession in 2001, the US economy picked up again in 2002 with a GDP growth rate of 2.4%. This growth rate has been accompanied by one of the world's lowest unemployment and inflation rates- a

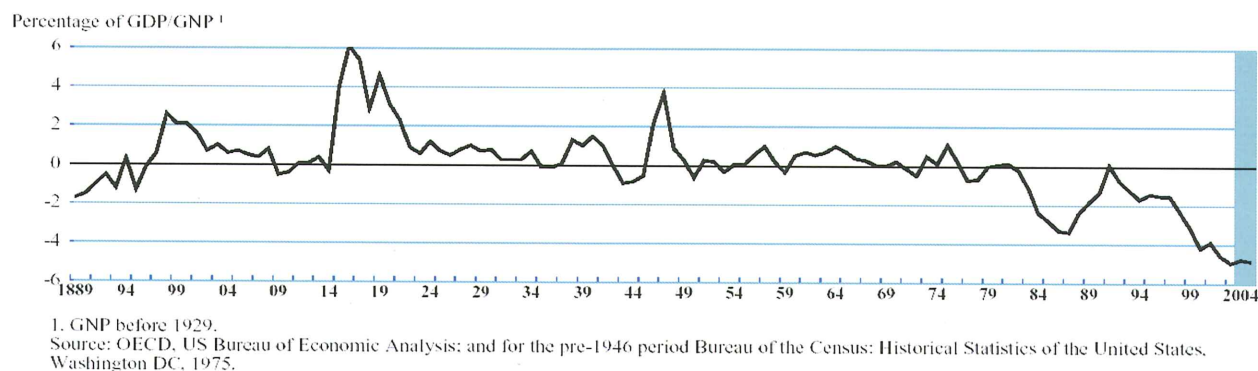
sign of a healthy economic system. (CIA World Factbook 2005) Nevertheless, this healthy economy has been somewhat worrisome lately.

The US current account deficit peaked recently to at 5.2 % of GDP. At the same time US debt has reached 25 % and is expected to increase tremendously over the next decade. The US, being the largest economy in the world, having a deficit of such magnitude implies significant investment flows from the rest of the world's savings and a significant increase of the US assets in the hands of foreigners. (Brook 2004) The US has proven to be an attractive investment to foreigners, but this attractiveness has started to fade and the ability of the US to finance its deficits has been questioned.

3. US Current Account Deficit

ECO/WKP(2004)13

Figure 1. The US current account in historical perspective



The problem of sustaining a CA deficit equal to 5 % has been debated for some time now. The biggest fear that many have is that if the CA deficit is sustained at the level of 5% of GDP, it will eventually lead to a currency crisis. Paul Krugman defines currency crisis as a time when *“investors [flee] a currency en masse out of fear that it might be devalued, in turn fueling the very devaluation they anticipated.”* (Krugman 2001) This is somewhat the case with the US current account deficit and the consistent dollar depreciation seen in the last few years. That is why many investors have been worried about keeping their assets in the US currency. However, the US economy is not facing the same economic situation as Britain was, when it lost its position of an international power. The US economy continues to grow at a steady rate, while investors are still attracted to hold US asset.

3.1 Is the deficit bad?

First, I will show some views on why the current account deficit of the US is viewed positively by some. Daniel Griswold (2005) points out that Americans have overall been better off, when current account deficits have been increasing. Furthermore, US citizens are better off when the CA deficit has been increasing rapidly. As seen he points out in the statistics the GDP growth rate when deficits were decreasing is on average 1.9%, while the GDP growth rate when deficits were increasing is 3.0% on average. Griswold also points out that rapid current account deteriorations are assimilated with the highest GDP growth rates- averages equal to 4.4%. (Griswold 2005) When we look at statistics of the US

compared to other the EU industrialized countries, we see that on average the EU has a trade surplus. However, this trade surplus has not been accompanied by a high economic growth. As the OECD table below shows, the US has experienced economic growth higher than the OECD average for the years 1994-2003, a time period when the US current account was worsening. On the contrary, EU countries are shown to have a lower economic growth than the average OECD countries for the same years (see chart below). Comparing this data to 1985-1993, a time period of improving CA deficits accompanied by growth rates below the OECD average, we see some relation between the current account and the performance of the US economy.

Structural indicators

	1990	1995	2000	2003
Trend GDP per capita (% growth rate)	1.7	2.0	2.1	1.8
Trend employment rate	71.6	73.7	74.2	71.5
Trend participation rate	76.1	77.9	78.1	75.1
Structural unemployment rate (NAIRU)	5.9	5.3	4.9	4.8

Source: Estimates based on OECD Economic Outlook, No. 76.

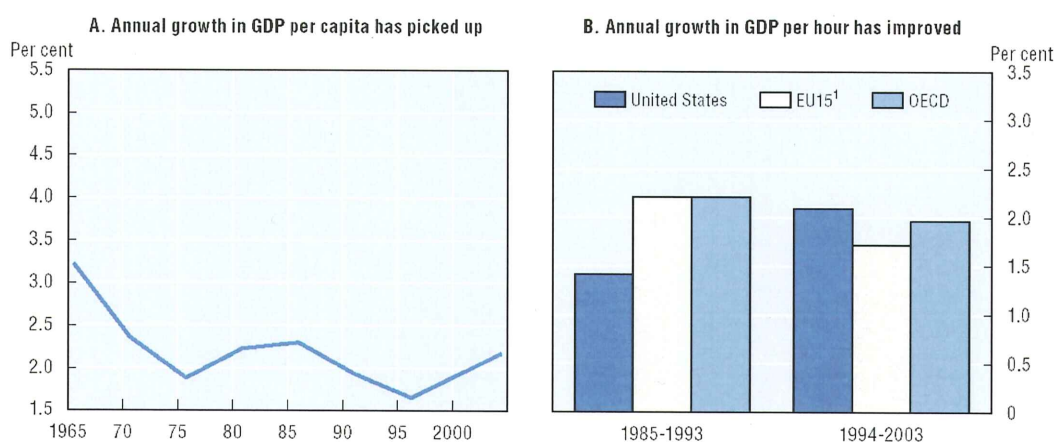


Chart 2- Source OECD

<http://www.wtcno.org/publications/impact/2005/03-05.pdf>

Another negative correlation that Griswold points out is with manufacturing, employment and the year 2004 (all of which were not hurt by the immense US deficits). Many believe that US manufacturing will be hurt when the country has high deficits, due to the tremendous foreign goods import, replacing domestic goods. Though, according to Griswold, the data does not agree with this and points out that on average the US manufacturing output declined, when the US deficits shrank. Another economic variable that seems to be hurt by the shrinking of the deficit was the unemployment rate. For example, today the US has one of the lowest unemployment rates in the world and the politicians are constantly predicting that the booming economy will bring about even more jobs. In a CBS news article the Treasury secretary John Snow says: "We're on very solid footing, our upward trend is strong" He mentioned some positive economic signs like GDP growth, rising exports and the creation of 300,000 payroll jobs in March 2004. He further continued "I anticipate that this economy will be creating a lot more jobs in the coming months." (CBS/AP 2004)

Overall, the above-mentioned facts do not seem to show causality between economic growth and large CA deficits. They are two variables that occurred at the same time. Though we may argue that when a country experiences an economic growth, then the income per capita increases (as is the case with the US). This increase in income per capita accompanied by the relatively high import elasticity for the US (discussed in the section of Channels decreasing the US current account imbalance) may be the reason why the US has high trade deficits. Those deficits are caused by the high US demand for

foreign goods. Another point that I want to propose is that usually there is time lag when one variable affects another rather than the two variables occurring simultaneously, like the case that Griswold proposes when the 2 variables are occurring together.

However deficits are not always bad. For example transition economies might be experiencing high deficits due to the high foreign investment flows in the country. The US though is not facing the same situation and its deficits are worrisome, especially if foreigners decide to invest their savings somewhere else. So, the long run question that must be answered and that makes the deficits worrisome is the question whether current account deficits could be sustained and for how long could they be sustained?.

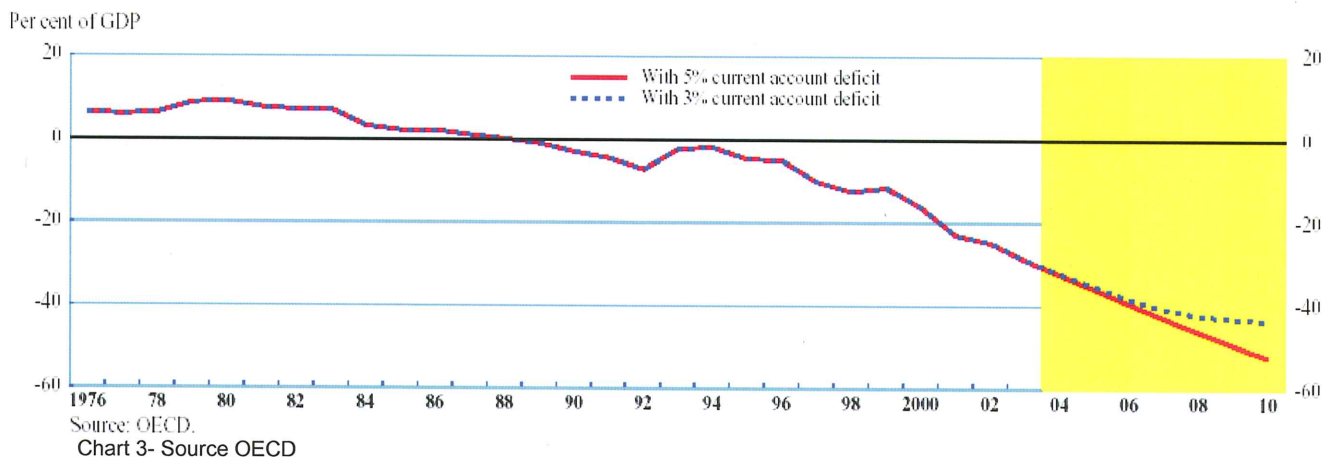
Another issue of concern, in addition to the large US deficit, is the value of the dollar. The high dollar value, during the time 1995 to 2002, is believed to have contributed to the worsening of the current account. Today, the current account is at it highest values. Since 2002 the dollar has been depreciating steadily but has not helped the improvement of the imbalances, contrary they have increased even more.

3.2. CA and the \$

Many economists have worked on predicting the long run consequences of the US current account deficit. One prediction is that at the current rate of economic growth and at the current exchange rates, the present net debt of 25% of GDP will increase to 50% in the next decade and to 100% within the next 25

years. (Mussa 2004) Since the probability of a crisis is bigger as the net debt position as a percentage of GDP increases, Mussa argues that the US CA deficit is at an unsustainable level. He believes that a further dollar depreciation is needed for the required readjustment when the current account will be able to sustain a steady net debt position. He argues that the US economy will be able to sustain a CA deficit of 2% of GDP and a net debt position of 40-50% in the long run, because with this deficit, the US net debt position will stabilize. As seen over the last three years, the dollar has experienced a continued real depreciation, but Mussa expects a further 30 % dollar depreciation will be needed for the 3% improvement of the deficit. (Mussa 2004) The chart below shows the 2 paths of the US net debt position as proposed by Mussa. One of them is with a sustained current account deficit of 5% of GDP. This position is represented by the red line, on which we see the worsening of the net debt position for the US. The dotted line represents a more sustainable net debt position, which will be achieved by an improved current account deficit equal to 2% of GDP.

Figure 2. Net US foreign assets



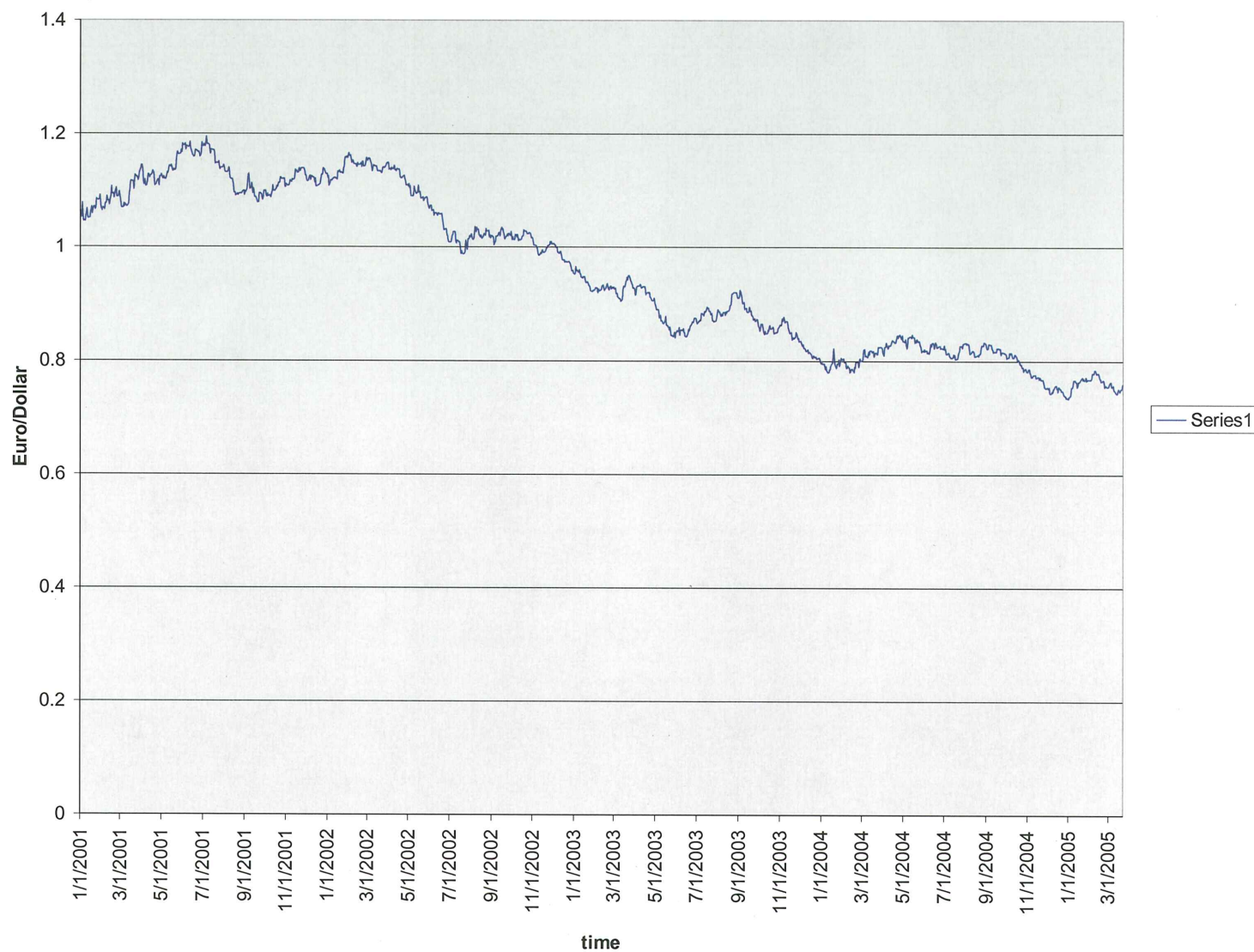
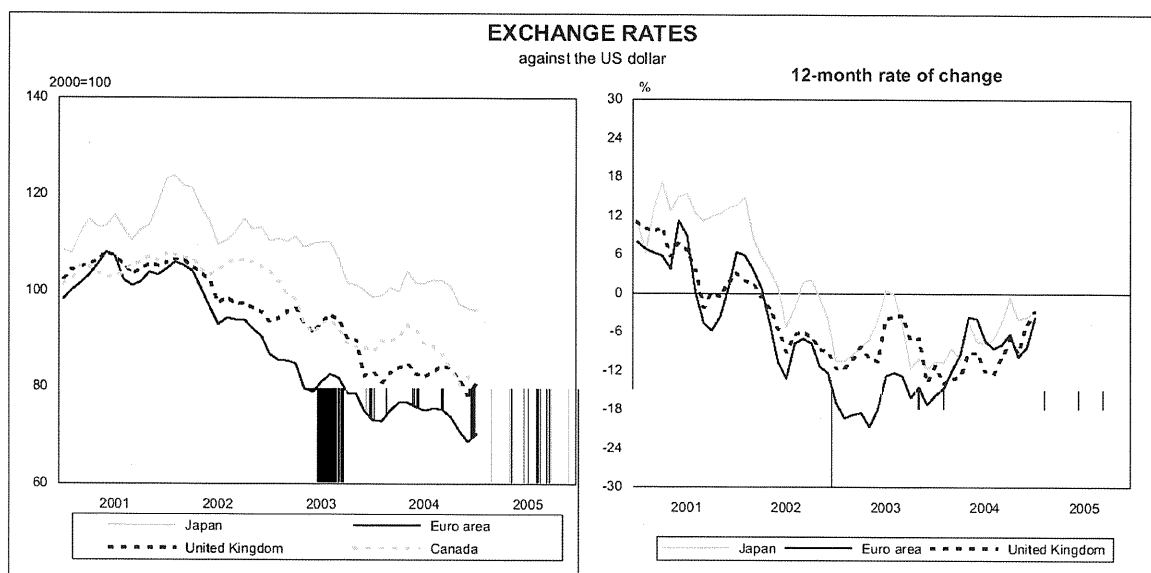


Chart 4- Source FX rates

The table above shows the decrease of the dollar value against the euro over the last 4 years. (FXConverter) Some might consider that the euro is a relatively new currency and that its value could be still adjusting, but as we can see the dollar has experienced depreciation against other major currencies, too. The table below shows the percentage fall and the real exchange rate fall of the dollar against the Yen, the Canadian Dollar, the British pound and the Euro.



Main Economic Indicators
© February 2005

27

Principaux Indicateurs Économiques
© février 2005



EXCHANGE RATES

TAUX DE CHANGE

	Monetary unit Unité monétaire	2004				2005											
		2002	2003	2004	2004				2005								
					Q1	Q2	Q3	Q4	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	
National currency units per US dollar — Unités de monnaie nationale par dollar E-U																	
Canada	CAD	1.570	1.400	1.301	1.318	1.359	1.308	1.220	1.358	1.322	1.313	1.288	1.248	1.196	1.218	1.225	
Mexico - Mexique	MXN	9.660	10.790	11.281	10.986	11.371	11.447	11.320	11.346	11.465	11.390	11.487	11.396	11.367	11.196	11.252	
Australia - Australie	AUD	1.841	1.542	1.359	1.305	1.400	1.410	1.322	1.438	1.396	1.407	1.426	1.364	1.299	1.303	1.306	
Japan - Japon	JPN	125.3	115.9	108.2	107.2	109.8	109.9	105.8	109.5	109.5	110.3	110.1	108.8	104.7	103.8	103.4	
Korea - Corée	KRW	1251	1191	1145	1171	1162	1154	1093	1158	1158	1158	1147	1142	1088	1051	1039	
New Zealand - Nouvelle-Zélande	NZD	2.163	1.724	1.509	1.482	1.591	1.533	1.431	1.590	1.549	1.530	1.520	1.464	1.429	1.400	1.418	
Czech Republic - République tchèque	CZK	32.73	28.13	25.70	26.24	26.61	25.86	24.08	26.04	25.76	25.96	25.87	25.21	24.14	22.88	23.07	
Denmark - Danemark	DKK	7.884	6.584	5.988	5.959	6.174	6.083	5.736	6.120	6.063	6.100	6.085	5.948	5.718	5.542	5.675	
Hungary - Hongrie	HUF	257.4	224.3	202.6	207.9	209.0	203.5	190.1	208.2	203.8	204.2	202.7	197.4	189.2	183.6	187.6	
Iceland - Islande ⁽¹⁾	ISK	91.59	76.69	70.20	69.70	72.85	71.59	66.66	72.16	71.52	71.52	71.73	70.16	67.10	62.71	62.65	
Norway - Norvège	NOK	7.986	7.078	6.740	6.902	6.859	6.866	6.332	6.817	6.912	6.841	6.845	6.591	6.270	6.136	6.254	
Poland - Pologne	PLN	4.082	3.888	3.651	3.813	3.893	3.620	3.279	3.778	3.644	3.633	3.584	3.460	3.286	3.091	3.102	
Slovak Republic - République slovaque	SKK	45.300	36.760	32.234	32.410	33.257	32.739	30.530	32.854	32.512	32.911	32.794	32.033	30.523	29.033	29.381	
Sweden - Suède	SEK	9.721	8.078	7.347	7.349	7.594	7.490	6.953	7.528	7.503	7.538	7.431	7.243	6.925	6.692	6.909	
Switzerland - Suisse	CHF	1.557	1.347	1.243	1.255	1.277	1.257	1.183	1.250	1.246	1.262	1.262	1.233	1.170	1.145	1.180	
Turkey - Turquie ⁽¹⁾	TRY	1.512	1.503	1.428	1.333	1.455	1.479	1.444	1.494	1.456	1.480	1.501	1.486	1.448	1.398	1.398	
United Kingdom - Royaume-Uni	GBP	0.667	0.610	0.546	0.544	0.554	0.550	0.536	0.547	0.542	0.550	0.558	0.553	0.538	0.518	0.532	
Euro area - Zone euro	EUR	1.061	0.885	0.805	0.800	0.830	0.818	0.772	0.823	0.815	0.820	0.818	0.801	0.769	0.745	0.763	
SDR - DTS ⁽²⁾	SDR	0.773	0.714	0.675	0.672	0.685	0.681	0.663	0.682	0.679	0.683	0.683	0.677	0.662	0.650	0.655	

Note: Daily averages of spot rates quoted for the US dollar on national markets expressed as national currency units per US dollar.

Note: Moyennes journalières des taux au comptant du dollar É-U cotés sur les places nationales, exprimées en unités de monnaie nationale par dollar É-U.

- (1) Some daily values may not yet be available for the latest month.
(2) The value of an SDR is the weighted average of market rates of a fixed group of currencies against the US dollar.

- (1) Certaines valeurs journalières peuvent ne pas être encore disponibles pour le dernier mois.
(2) La valeur du DTS est la moyenne pondérée des taux du marché d'un groupe de devises vis-à-vis du dollar É-U.

Chart 5-Source OECD

3.3 Japanese holdings of US treasuries

This decline of the dollar has begun to worry many foreign investors. The dollar decline has been partly due to the concerns about the deficit. A wider trade gap means more dollars need to be converted to other currencies to pay for

imports. Many foreign officials have been considering diversification of their foreign currency reserves due to the declining value of the US currency.

Koizumi, prime minister of Japan, thinks that Japan needs to do that too once the dollar reaches a certain line. Koizumi remarks affected the US 10-year Treasury yields leading to the highest level in more than seven months (Bloomberg 2005).

The finance minister Sadakazu Tanigaki and the top foreign exchange official Hiroshi Watanabe said that for the moment Japan will not shift its \$820.5 billion reserves, revealing their belief in the US currency. Japanese investors including the central bank are the largest holder of US Treasury Securities. That is why a Japanese shift of their reserves away from the dollar could have a very big impact on both the dollar and the treasury market. Meanwhile many central banks have increased their holding of euro. At the end of 2003, US dollars accounted for 63.8 % of the world's currency reserves versus 66.9% a year earlier. (Bloomberg 2005)

The concern of many economists is that the trade deficit may rise to a level where foreign investors are less willing to hold this currency or the deficit might get to a point where foreigners will become reluctant to hold dollar denominated assets e.g. stocks and bonds. If this happens, stock prices could decrease tremendously while US interest rates will be increasing fast. (Crustinger 2005) Except that the deficits could be detrimental to the US economy, the weak dollar could also hurt it. Having a weak dollar, tends to push interest rates upwards in order to attract investors, at the same time these higher interest rates increase the net debt even more, and the US has to repay an even bigger

debt.(Blanchard 2004) Olivier Blanchard(2004) talks about the negative relationship between net debt and the exchange rate in steady state. Having a higher net debt implies having larger interest payments. Thus in order to achieve a current account balance a country will need a larger trade surplus. (Blanchard 2004) Another peril to the US economy is the relatively higher foreign prices due to the appreciation of the foreign currency. These higher prices accompanied by high US demand for foreign goods also contribute to the increase of the net debt position of the dollar, because Americans continue to buy foreign goods. At the same time even though Griswold argues that manufacturing is not hurt by the deficit, the manufacturing that depends on imported intermediate inputs is hurt by deficits accompanied with a depreciating currency, due to the increased prices of foreign supplies and parts.

3.4 Other Perils from a declining dollar

Like other Asian countries, China has been recently absorbing US treasuries. (Garber 2003) According to Peter Garber's study, present international monetary arrangements are a revived Bretton Woods system, where the US is again central and issues the main reserve currency. They further propose that today many countries are pursuing an export-led growth with undervalued but competitive exchange rates and excessive labor supply. For example China is following the Japanese model of growth in the 1960s. It was giving priority to absorbing labor into the production of exports. The cost for exports is the large accumulation of low yield reserves like US treasuries.

However, the export lead growth and the financing of the US deficits is likely to continue as long as China has excess labor supply to absorb, or at least for another decade. (Bergsten 2004)

4. Channels for decreasing the US trade gap and growth prospects

Many economists have considered different channels to decrease the US trade deficit. Some of the channels for narrowing the US current account include dollar depreciation, fiscal policy consolidation and improvement of the non price-competitiveness of US producers.

4.1. Exchange Rate Adjustment Channel

Some economists argue that the depreciation of the dollar will not be the reason for the closure of the current account imbalance but will be the effect of the shocks in savings and production that will help equilibrate global net savings levels. Obstfeld and Rogoff (2004) discuss the fate of the US dollar and the necessary current account adjustments. In their new revised paper they compute a significantly larger dollar decline of 20% in the real trade-weighted terms, even when the current account is rebalanced gradually. The effect of a sharp current account adjustment could be much bigger- 40% decline of the dollar value. They also argue that the current level of the current account balance could worsen the fall of the dollar. Another concern that they seem to have is that the significantly large deficit could lead to a lack of confidence with respect to other countries. The US ability to issue debt in its own currency may

be to their advantage, as long as other nations finance these deficits with the purchase of US bonds and equity. In recent years Asia has somewhat offset the decline of the dollar by massive capital inflows from the Asian Central Banks, but there may be a time when the banks of Asia will divert their resources (as discussed in the section Japanese Holdings of US treasuries). Even though the Federal reserve is predicting a strong dollar supported by Asian inflows, Rogoff and Obstfeld predict a significant closing of the US current account balance will mean large exchange rate adjustments, which will be sharper the longer the process is delayed.

Olivier Blanchard (2005) also argues that large dollar depreciation is to come. He also proposes that this depreciation would not be a catastrophe for the US. A lower exchange rate leads to higher demand and higher output and offers ways to reduce budget deficits without leading to a recession. According to him, the threat is much bigger for Western Europe and Japan, where the monetary and fiscal policies are harder to maneuver in response to market forces. (Blanchard 2005)

The impact of dollar depreciation on other OECD economies would depend importantly on the flexibility of exchange rates in the Asian region. If the rembini and other currencies remain pegged to the dollar as it falls, the costs to Japan and other OECD economies would be greater than if the dollar is permitted to fall against all other currencies. (Brook 2004)

However, Obstfeld and Rogoff propose a model in which this is not necessarily the outcome. Dollar depreciation is likely to shift world demand

towards US exports, due to the lower prices. At the same time, demand for foreign good will decrease, somewhat mitigated by the home country bias effect. However, this will also affect the prices of the US and foreign goods. Foreign non-traded industries will experience a relative boost to US non-traded industries. (Obstfeld 2004)

Changes to the exchange rates have been defined as the main mechanism for achieving current account rebalances, especially for market economies where market participants determine the floating exchange rates. The graph below clearly shows that there is a somewhat negative link between the real exchange rate and the current account balance. Nonetheless, the causality is unclear and complex, due to the interaction of other economic factors.

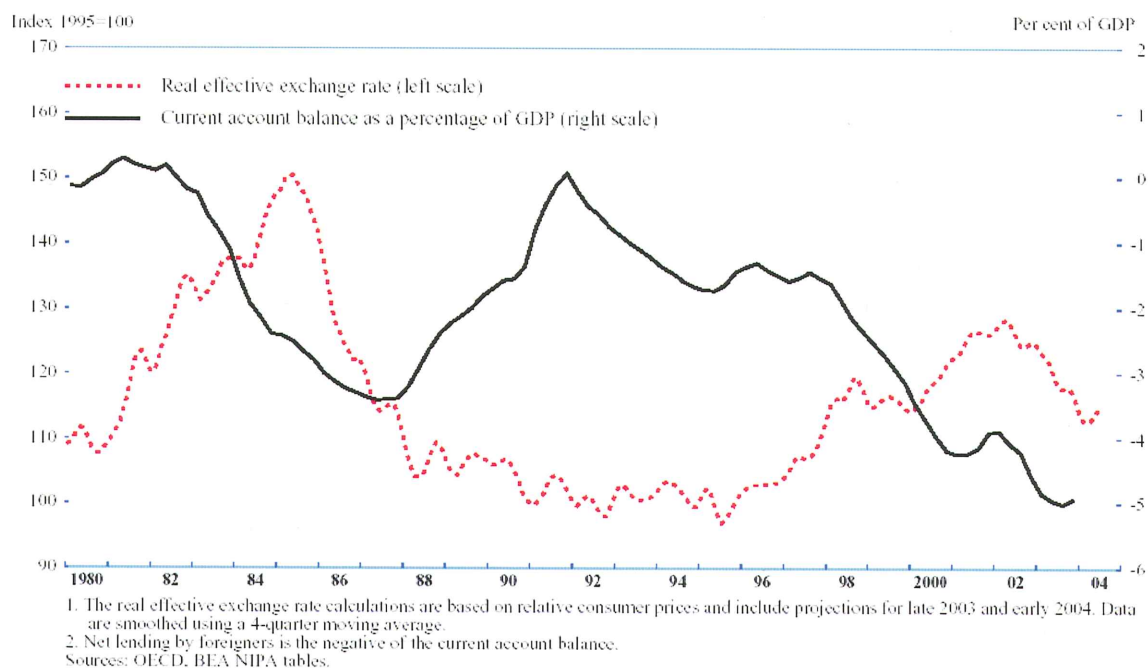


Chart 6-Source OECD

The following are some of the factors that limit the extent of current account improvement due to an exchange rate movement:

- the link between the two involves a delay
- pricing to market is significant- indeed, evidence suggests that exchange-rate pass-through into import prices is relatively low in the United States compared to other OECD countries
- monetary policy will have to respond, and interest rates would rise. Higher interest payments on foreign-held debt would then suggest that the improvement in the current account deficit would be less than that in the US trade balance. (Brook 2004)

4.2. Fiscal consolidation channel increasing US savings

The national accounting identity is $S_{\text{private}} + S_{\text{public}} = \text{Investment}$. So the current account deficit is equal to the shortfall of national savings minus national investment. In order to decrease the deficit, the US needs to increase national savings. If the government tightens its fiscal policy, the effects on the current account will depend on how much the increase in government savings will be offset by a decrease in private savings. As seen from the OECD chart below, there is a certain negative relationship between private and public savings. Also, the graph shows that the lower the US private and government savings are, the higher are the foreign savings, so that it could offset the shortfall.

Figure 6. The composition of savings in the United States

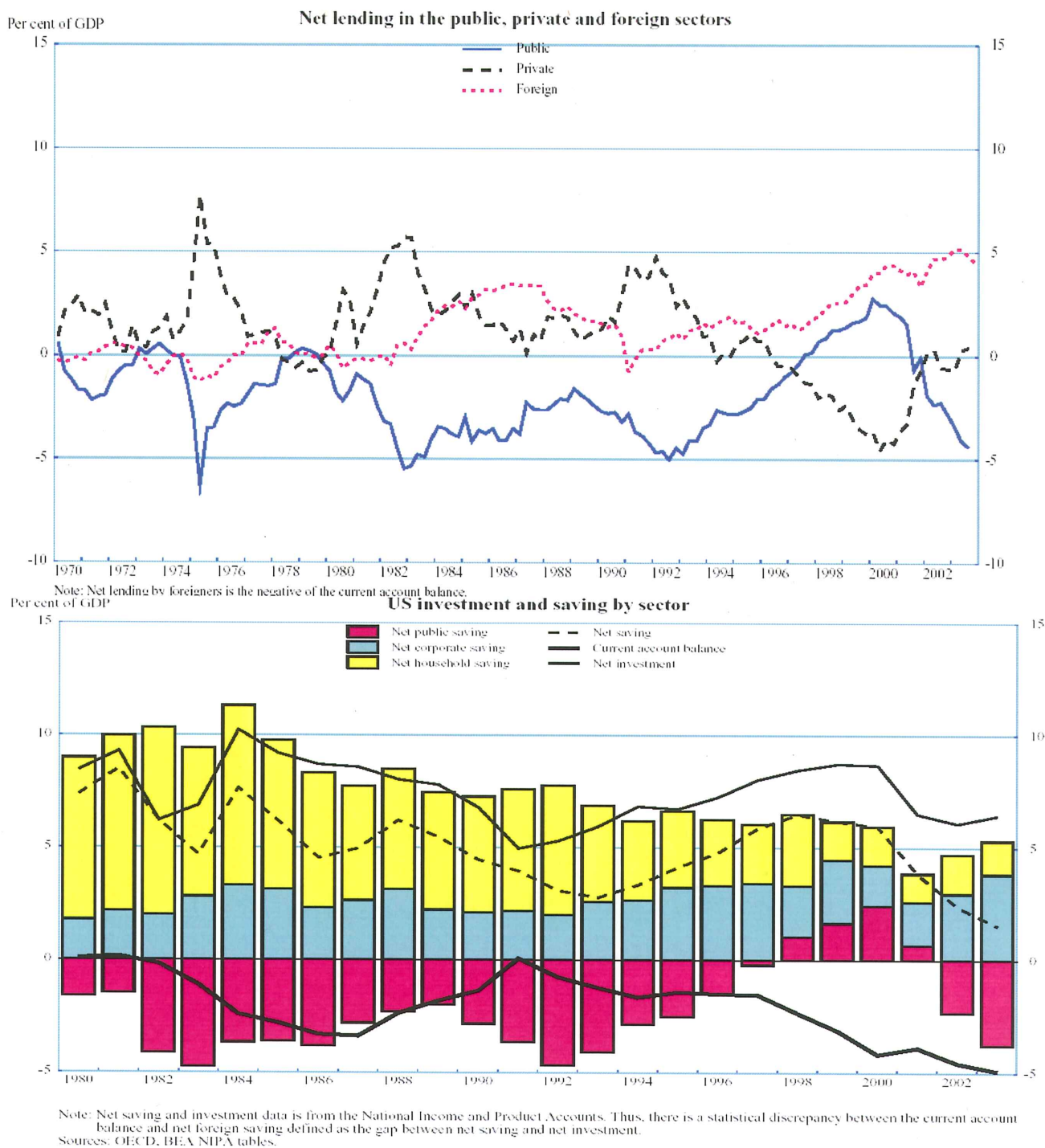


Chart 7- Source OECD

The fiscal consolidation though does not necessarily mean improvements in the US CA balance. The relationship between the two involves very complex macroeconomic interactions. At the moment, due to the real depreciation of the

dollar, a fiscal consolidation would improve US net exports and would decrease US demand for foreign goods. Mussa expects that a gradual fiscal consolidation will eventually improve the national savings/investment balance, without posing a threat to the US economic growth. (Mussa 2004) However, a relatively large improvement in the fiscal positions is required to have a noticeable effect on the current account.

Even though some economists argue that the US has a relatively low savings/investment rate there are some critics to this view. According to them the high consumer spending is not threatened by running out of savings. The US has the World's biggest accumulation of savings and investment, and the US household sector is favorably positioned with higher interest rates due to asset liquidity and fixed rate mortgage structure. This high saving is possible because the US is able to build up assets faster than to build debt. For example, on per capita basis the US's net financial assets total \$89,800, while Japan's are \$76,900. The argument is continued with a positive notion on the foreign financial inflows, stating that they are not showing the US "dependence" on foreigners but rather that the US is an effective user because it is increasing their value faster than the interest it has to repay increases. (Malpass 2005)

Even though investors might consider the US economy attractive due to its interest rates, it is important to notice that most of the investors here are Asian Banks that are trying to offset the capital outflow and a potential currency crisis.

4.3. Demand and Supply-side improvement channels (elasticity of imports and productivity improvement)

The US consumers have been willing to buy more foreign goods than foreigners were willing to buy American goods, which means that the income elasticity of the US for imported goods is greater than the foreign income elasticity for US exports. If this elasticity, also known as the Houthakker-Magee elasticity asymmetry, persists even if foreign trade partners have the same levels of economic growth as the US, the US current account will continue to deteriorate. This trend is one of the main reasons why other channels for current account improvements may not be working so efficiently. (Brook 2004) One way to improve this elasticity inequality is by focusing on increasing the sector of the economy in which a country has a comparative advantage. The US is found to have a comparative advantage in the service sector, so if the country further increases liberalization of its trade in services they could increase the fraction of the service sector in the economy. Many economists have noticed that the inequality of the elasticities for the US and its trading partners is for trade in goods. (Brook 2004)

The question of import elasticity is relatively important for the US long-term sustainability. Even though, the US is able to generate its growth through internal demand, due to the Houthakker-Magee asymmetry, the current account balance will not be sustainable in the long run given any exchange rate adjustments. Also, this asymmetry diminishes the effects of growth in the US trading partners. Even if they have higher economic growth, this will mean higher

export accompanied by a higher import demand for the US. So the impact of US trading partners growth, will have its effects only if this asymmetry is diminished or if the US experiences a demand side improvement.

Also, domestic demand growth in the US must be kept below the potential output growth, so there will be room for improvements. Those will include improvement in the US net export ratio and corresponding improvement in the US savings rates and foreign capital inflows. At the same time the world will have to experience the reverse. The domestic demand growth for the rest of the world must rise above the potential domestic output growth.

Another macroeconomic adjustment necessary to reduce the world capital outflows is real currency appreciation for the rest of the world. The currency adjustment would help to shift away from the foreign domestic demand to demand for US goods. In Europe, the currency adjustment retains a greater flexibility for maneuver to combat with the external imbalances than in Japan, but at the same time it is less than in Canada, UK and Australia. (Mussa 2004)

A supply side improvement that would help the US is an improvement in the productivity of the country. Suppose the US increases its R&D spending relative to other countries it is most likely to experience productivity improvements in both its trade and non trade industries, that will make the US more competitive, due to the lower prices on the global market.

Some economists further argue that the US current account rebalancing will be positively affected by a larger improvement in the foreign productivity rates relative to the US. This improvement, however, needs to be in the non-tradable

goods production. As observed when a country experiences productivity improvements, they first show up in the tradable industry sector. Thus, if the world relies on growth from Europe and Japan to correct global imbalances, this could initially worsen the US current account deficit. (Obstfeld 2004)

5. Conclusions

The emergence of the US as the major economic power in the world occurred between WWI and WWII. At that time Britain experienced an economic downturn due to the lost capital, equipment and huge debt during after the wars. Furthermore, the British economy was hurt by the overvalued pound, which worsened even more the international debt position of the country. During the Bretton Woods conference of 1944, the dollar officially became the international reserve currency because the US had experienced the least damage from the wars.

Today the US economy is still the strongest economy in the world, due to its relatively high growth rates, low unemployment, low inflation and attractiveness to foreign investors. However, in those positive signs lies the threat of the continuously increasing current account deficit. This deficit has brought the net debt of the country to 25 % of GDP, a position that will further worsen, unless the current account level is brought to a sustainable level. Therefore, major economic readjustments are the necessary channels that will improve the global imbalance.

One of those adjustments widely agreed on by most economists is that the dollar needs to further depreciate. The amount of depreciation varies and will be an effect of the necessary equilibration of world net savings.

Also, measures of fiscal consolidation must be taken to improve of the US national savings. The consolidation needs to tighten US demand and increase government savings overall. The weak dollar at the moment is further expected to improve the savings balance by increasing the demand for US produced goods. Another policy adjustment that will help to decrease the global imbalances is a demand and supply side improvements in the US.

I believe that today the US is not facing a currency crisis, due to its economic strength and attractiveness to foreigners. However, the threat of the deficits is tremendous and has to be addressed

I further believe that we live in an integrated world and a global economy that is why the global imbalance should be a problem for all countries and all countries should take the necessary measures for the global imbalance improvement.

Works Cited

1. Bergsten, Fred and Williamson John. 2004. Overview: Designing a Dollar Policy. Dollar Adjustment: How Far? Against What? (p.1-24) Institute of International economics
2. Bidian, Florin. 2005. (10-12). Past and present international Money Arrangements(sec3). University of Minnesota.
<http://www.econ.umn.edu/~florin/4432W/lect3.pdf>,
3. Blanchard, Olivier., Giavazzi, F., Sa, F., 2005. The US Current Account and The Dollar. NBER Working Papers. No 11137.
4. Bloomberg. 2004. Dollar Falls Versus Euro; Koizumi Says Japan May Shift Reserves.
5. Brook, Anne- Marie, Sedillot, F., Ollivaud, P., 2004. Channels for Narrowing the US Current Account deficit. Economic department Working Papers No 390. OECD's Internet Web Page.
6. CBS/Associated Press. 2004. US Deficit= World debate,
<http://www.cbsnews.com/stories/2004/06/20/national/main624971.shtml>
7. Crutsinger, Martin. 2005. Trade deficit- the 2nd highest ever. Associated Press. www.biz.yahoo.com/ap/050311/economy_12.html?printer=1
8. European Parliament. 1998. The Euro as an International Currency.
http://www.europarl.eu.int/workingpapers/econ/101/chap1_en.htm#a_role_of_the_Euro
9. FXConverter - 164 Currency Converter, Exchange Rates Values for Excel Table. <http://www.oanda.com/convert/classic>
10. Garber, P., Dooley Michael (2003). An essay on a revived Bretton Woods system. NBER Working Papers. No 9971.

11. Greenspan, Alan. 2001. *The euro as an international currency*.
<http://www.federalreserve.gov/boarddocs/speeches/2001/200111302/default.htm> , Remarks by Chairman Alan Greenspan
12. Griswold, Daniel. 2005. Are the U. S. Deficits Bad? World trade center Associations. <http://www.wtcno.org/publications/impact/2005/03-05.pdf>
13. Krugman, Paul. 2000. Currency Crises. National Bureau of Economic Research Conference Report.
14. Malpass, David. 2005. Running on empty? The Wall street Journal online. Dow Jones Copyrights
<http://online.wsj.com/article/0,,SB111196898194490525,00.html>
15. Mussa, Michael. 2004. Exchange rate adjustments needed to reduce global payments imbalances. Dollar Adjustment: How Far? Against What?(p.111- 138) Institute of International economics.
http://www.iie.com/publications/chapters_preview/382/5iie3780.pdf
16. New York University. The Euro as an international currency.
www.stern.nyu.edu/~vquadrin/GlobInt/Notes4.pdf
17. Obstfeld, M., Rogoff, K., 2004. The Unsustainable US Current Account position revisited. NBER Work Papers. No 10869.
18. Rider, Christine. 1995. An Introduction to Economic History. Southwestern College Publishing. Ch 21. WWI and the collapse of the International Order: II.
19. Rato, Rodrigo de. 2005. Correcting Global Imbalances—Avoiding the Blame Game. IMF EXTERNAL RELATIONS DEPARTMENT.
20. The World Fact Book. 2004. Central Intelligence Agency Publication.
www.cia.gov/cia/publications/factbook/