Box 1

US CURRENT ACCOUNT: INTERACTION WITH THE INTERNATIONAL INVESTMENT POSITION AND ADJUSTMENT CHANNELS

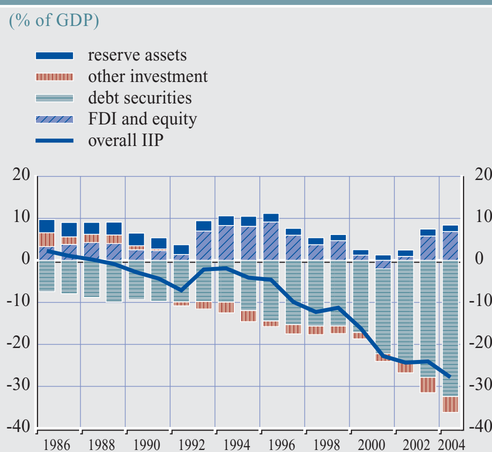
Large and growing global current account imbalances may be an increasing source of tension in the world financial system as they pose risks for financial and exchange rate market volatility, ultimately affecting the optimal allocation of world savings. These risks are well recognised in both academic and policy quarters, and there is a broadening consensus that the current composition of global current accounts could prove unsustainable from a long-term perspective, with the evolution of the US current account being seen as a key factor. This Box highlights specific trends that could undermine the sustainability of the US current account relative to its international investment position (IIP). It also discusses the possible channels through which an adjustment of global imbalances may take place.

As far as the US is concerned, the accumulation of large current account deficits brought its IIP – measuring the stock of US claims on foreign assets net of foreign claims on US assets – to a historical low of -28% by end-2004 (see Chart B1.1).[1] The sustainability of this net debtor position largely hinges on the interaction between the US current account and its net external liabilities. In this context, two aspects should be highlighted:

First, the relevance of valuation effects on the stock of foreign assets and liabilities is large, in an interaction running from the current account to the net external position. Despite cumulative net capital inflows to finance the current account deficit in the US to the order of 5% of GDP per year, the US IIP deteriorated by only 1.5 percentage points between 2002 and 2003 (see Chart B1.2). The difference is accounted for by GDP growth and, more importantly, by changes in the valuation of assets and liabilities that have been mainly produced by exchange rate

Chart B1.1 US international investment position

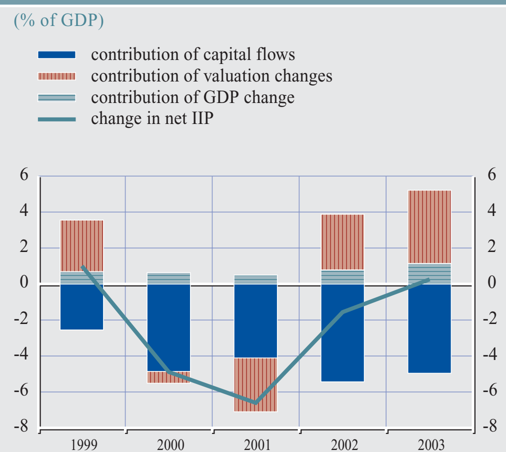
(% of GDP)



Sources: IMF and ECB calculations.

Chart B1.2 Changes in the US net IIP/GDP ratio

(% of GDP)



Sources: IMF and ECB calculations.

1 The data exclude valuation changes.

fluctuations. In particular, the depreciation of the US dollar after February 2002 led to a revaluation of US external assets, which are largely denominated in foreign currency, whereas the bulk of US foreign liabilities are denominated in US dollars. This valuation effect, a by-product of the international role of the dollar, brought about a cumulative capital gain for the US of almost USD 700 billion, or around 7% of GDP, between 2002 and 2003. The importance of these valuation changes tends to increase with the sheer size of US net foreign liabilities, even though, barring a persistent depreciation (or appreciation) of the dollar, their impact over the medium term should eventually be overshadowed by the flow variable, i.e. the current account and its counterpart in terms of financial flows.[2]

Second, it is also important to highlight the impact of an increasingly negative foreign debt position on the balance on income. Since 2001 the US current account deficit has been largely financed by foreign purchases of debt securities, different to the pattern of the late 1990s, when foreign direct investment (FDI) and equity inflows made a positive contribution. The increasingly negative US external position can be attributed to the accumulation of foreign debt, which is expected to generate growing debt servicing obligations, and will have a negative impact on the US current account through the balance on income (see Chart B1.1). In recent years, and despite a deteriorating net foreign position, the US balance on income consistently posted surpluses thanks to relatively low income outflows related to FDI in the US compared with income inflows of US direct investment abroad and, more recently, very low yields on US debt securities. However, according to several projections,[3] the possibility of a sizeable rise in US interest rates together with the building up of stocks of foreign-owned US debt in recent years would most likely bring the balance on income into negative territory in the coming years, thereby complicating the unwinding of the US current account deficit.

Looking forward, three main adjustment channels have been identified by international institutions, policy authorities and academics as possible ways of closing global imbalances.[4] First, considering exchange rate adjustment in simulations, a 10% depreciation of the US dollar vis-à-vis all currencies would, beyond some short-term positive impacts related to improved competitiveness, most likely have a negative effect on US real output through a deterioration in financing conditions. Effects for the rest of the world (and the euro area in particular) would most likely prove negative, owing to declining competitiveness and decreasing foreign demand. Under the same assumptions, all models indicate a reduction in the US current account deficit of between 0.4% and 1.1% of GDP over three to six years.

Second, looking at current account deficits as a saving-investment imbalance, an increase in US savings by both the public and the private sectors would appear to be a natural channel enabling the correction of the US current account deficit. Fiscal consolidation in the US appears to be the main policy for achieving such an adjustment, apart from targeted measures to

2 For a general discussion of these valuation effects, see P. R. Lane and G. M. Milesi-Ferretti (2005), "Financial globalization and exchange rates", IMF Working Paper, No 05/03. For an analysis of the US case, see C. Tille (2003), "The Impact of Exchange Rate Movements on U.S. Foreign Debt", Current Issues in Economics and Finance, Vol. 9, No 1, Federal Reserve Bank of New York.

3 See, for instance, N. Roubini and B. Setser (2004), "The US as a Net Debtor: The Sustainability of the US External Imbalances", New York University, November; and R. Berner (2004), "Upside Risks for U.S. Current Account", Morgan Stanley Global Economic Forum, October.

4 See among others M. Obstfeld and K. S. Rogoff (2004), "The Unsustainable US Current Account Position Revisited", NBER Conference paper; and J. W. Lee, J. McKibbin and Y. C. Park (2004), "Transpacific Trade Imbalances: Causes and Cures", Brookings Discussion Papers No 162.