OECD Economics Department Working Papers No. 467

Coping with the Inevitable Adjustment in the US Current Account

Peter Jarrett

https://dx.doi.org/10.1787/572327145660

OECD

Unclassified **ECO/WKP(2005)54**

Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

13-Dec-2005

English - Or. English

ECONOMICS DEPARTMENT

ECO/WKP(2005)54
Unclassified

COPING WITH THE INEVITABLE ADJUSTMENT IN THE US CURRENT ACCOUNT

ECONOMICS DEPARTMENT WORKING PAPER No. 467

By
Peter Jarrett

JT00195952

English - Or. English

ABSTRACT/RÉSUMÉ

Coping with the inevitable adjustment in the US current account

In recent years the US current account deficit has grown to the point that most observers consider its level to be already unsustainable. Yet it seems set to continue to increase in the foreseeable future, with net foreign debt likely to surge. This paper describes the present deficit from three points of view: imbalances of imports over exports of goods, services and income; of inflows over outflows of capital; and of investment and spending over savings and income in the domestic economy. It then examines the possible causal factors for these disequilibria and goes on to describe the arguments for both optimistic and pessimistic views as to their unwinding over time. Last, it suggests a number of policy conclusions as to how the US authorities should factor the presence of the deficit into their decision-making, even though they rightly do not view it as a target outcome. The bottom line is that the importance of avoiding disincentives to save and of maintaining as much flexibility as possible in the economy is reinforced by the risks posed by the deficit.

This Working Paper relates to the 2005 OECD Economic Survey of the United States (www.oecd.org/eco/surveys/us).

JEL classifications: F1, F3, F4
Key words: adjustment, current account, external deficit, national saving

* * * * *

Faire face à l'inévitable ajustement de la balance courante aux États-Unis

Ces dernières années, le déficit de la balance courante des États-Unis s'est creusé à un point tel que la plupart des observateurs jugent son niveau déjà insoutenable. Pourtant, il semble devoir continuer de croître dans l'avenir prévisible, tandis que la dette extérieure nette devrait augmenter fortement. Ce papier décrit le déficit actuel sous trois angles : le déséquilibre entre les importations et les exportations de marchandises, de services et de revenus ; le déséquilibre entre les entrées et les sorties de capitaux ; enfin, dans l'économie intérieure, le déséquilibre entre l'investissement et la dépense, d'une part, et l'épargne et le revenu, d'autre part. Il examine ensuite les causes possibles de ces déséquilibres puis expose les arguments sur lesquels se fondent les évaluations optimistes ou pessimistes concernant leur résorption à terme. Enfin, ce chapitre présente un certain nombre de conclusions sur la façon dont les autorités des États-Unis devraient intégrer le déficit dans leur processus de prise de décision, même si, à juste titre, elles n'en font pas un objectif de résultat. En fin de compte, les risques posés par le déficit soulignent la nécessité d'éviter les désincitations à épargner et de maintenir un maximum de flexibilité dans l'économie

Ce document de travail se rapporte à l'Étude économique de l'OCDE des États-Unis 2005 (www.oecd.org/eco/etudes/us).

JEL classifications : F1, F3, F4
Mots clés :ajustement, balance courante, déficit extérieur, épargne nationale

Table of contents

Boxes

Tables

Figures

Coping with the inevitable adjustment in the US current account[1]

By

Peter Jarrett

Introduction

Despite the fact that the United States is by no means a youthful nation, which might call for substantial investment in infrastructure and other capital that typically enables the development process to get underway and thereby justifies large external deficits,[2] its balance of payments on current account has shown a strong negative trend over the past quarter century and is widely believed to be on an unsustainable trajectory. If it were not the world's largest economy and did not enjoy the privilege of being able to borrow in its own currency,[3] since the US dollar is the world's primary reserve currency (accounting for nearly two-thirds of global reserves), it is likely that this trend would not have been sustained and that market forces would have acted so as to restrain the shortfall before it got as large as it is. It is therefore difficult to know how and to what extent this peculiarity will continue to allow it to escape the disruptive adjustment that may well have befallen another country in a similar situation of rising foreign indebtedness.[4] History provides little guidance as to how such a dominant-currency nation might

1. The author is Head of Country Studies 1 Division in the Economics Department. This paper is a slightly modified version of Chapter 4 of the 2005 *OECD Economic Survey of the United States* published in October 2005 on the responsibility of the Economic and Development Review Committee of the OECD. The author is grateful to colleagues in the OECD, especially Ann-Marie Brooke, Andrew Dean, Val Koromzay, Thomas Laubach and Hannes Suppanz for their helpful comments. Special thanks go to Françoise Correia and Mee-Lan Frank for technical assistance. The author can be contacted at peter.jarrett@oecd.org.

2. In effect, the less developed the economy and thus the lower is its income per capita, the greater should be its lack capital and the higher its rate of return and thus the more capital it should attract and the more likely its current account balance would be in deficit and the more net foreign liabilities one would expect it to have. This is borne out in a recent paper by Lane and Milesi-Ferretti (2005a), who show that such a simple cross-country relationship explains 39% of the variance in the ratio of such assets to GDP. The United States is notably very far (about 35 percentage points) below the regression line, a distance exceeded only by Iceland in that direction.

3. This is a significant advantage (often called an "exorbitant privilege"), since it avoids the risks emanating from currency mismatches on the national balance sheet (McKinnon, 2001). A closely related advantage is that dollars are used in a number of foreign countries as common currency, providing seignior age revenue. Indeed, at end-2003 fully 45% of the outstanding stock of dollar notes was held abroad.

4. Examining the period of floating exchange rates that began in the early 1970s, Edwards (2005) opines that the US external accounts look more like those of a Latin American or Asian nation than an industrialised

emerge from this problem, either, in the limit, unscathed or, alternatively, having lost that status[5]: none of the dollar's predecessors lost their positions because of chronic peacetime deficits. Moreover, with a floating exchange rate and an unrestricted capital account, there is a valid *prima facie* case that US policymakers should not take any action solely to try to rein in the US deficit. The temptation is therefore strong to neglect it entirely and just leave it to the workings of the market to get the job done, especially as many of the possible scenarios that would lead to its correction would entail political, economic and financial pain not only at home, but just as seriously in the rest of the world (as US demand is curbed): see the Appendix to the General Assessment of the Economic Situation in OECD *Economic Outlook* of May 2005 (Number 77).

But neglect would be inappropriate. Even though no policy actions are called for solely to reduce the size of the deficit, the onus is on the US authorities to avoid any compounding of the problem by their own budgetary decisions and to ensure that none of their domestic economic policies distort private decision-makers' choices between investing at home or abroad and, more importantly, between saving and spending. To the extent that there is a deep-seated problem of deficient saving, whose short-term cost is being masked by the availability of foreign savings on reasonable terms, that does not imply there will be no burden at any horizon: financial inflows allow capital to be put in place in any case, but the claims on it will be held abroad and the resulting income flows will accrue to foreign residents. Fortunately, the United States has arguably the OECD's most flexible economy, for when the external adjustment – however uncertain the timing and whatever the effect on the dollar – finally takes place, the impact on the production side of the economy will be a shift of capital and labour resources from the non-tradable to the tradable sector.[6] The ease with which such an adjustment can be made will to a large extent determine the transition costs of the adjustment. The inescapable conclusion is that the importance of maintaining that flexibility will be especially acute at that point in time.

This paper first reviews the historical development of the current account balance and its stock counterpart, the net international investment position. Trade, capital flow and saving/investment perspectives will successively be taken. It will then enumerate the various arguments that have been advanced in the burgeoning literature on this issue for optimistic and pessimistic assessments of the likely unwinding of the deficit. Various scenarios will be briefly described. Thereafter the paper will turn to the implications for policies, first for the budget and monetary settings and later for microeconomic policies, and then draw some conclusions.

How did the US trade deficit get so big?

The fact that the United States is running a current account deficit that the OECD projected in its most recent *Economic Outlook 77* to be $800 billion this year is unprecedented in a number of dimensions (Summers, 2004). *First*, no other country has ever been able to finance/sustain a deficit on anywhere near

---

country. Among the latter, only small nations have had deficits in excess of 5% of GDP and there have been only two cases where a deficit of this magnitude has persisted for any length of time: Ireland from 1978 to 1984 and New Zealand from 1984 to 1988. Indeed, in May Lehman Brothers wrote that: "were the US an emerging market economy – which it decidedly is not – … [its risk indicators] would imply a near one-in-two chance of a financial crisis" (Llewellyn and Subbaraman, 2005, p. 5).

5. Bordo (2005) has recently looked at four historical episodes of breakdown in the international monetary regime thanks to global imbalances and ultimately believes that a benign outcome is still the most likely, with gradual adjustment somewhat like the late-1980s. In his view, there is no case for international co-operation to resolve the systemic imbalances. Eichengreen (2005) points out that the outcome of reserve currency competition is not necessarily winner-takes-all: multiple reserve currencies already co-exist.

6. To a close approximation this is from services to goods, though that is far less true than it was a decade ago.

such a scale; it represents over $2 billion a day. Even allowing for the fact that the US economy is enormous, the US deficit nonetheless represents more than 1½ per cent of global GDP and nearly 6½ per cent of US GDP, a figure which itself is larger than any other in the OECD except Iceland, Portugal and Hungary. The result is that the United States is attracting some 10 per cent of the entire world's saving and 75% of that not invested at home (equivalently, three-quarters of the total of all the world's current account surpluses) (Roubini and Setser, 2005; Obstfeld and Rogoff, 2005).[7] *Second*, even in its infancy when it was absorbing mass immigration and installing plenty of infrastructure, the United States never recorded a deficit of more than 4% of GDP, and, prior to the early 1980s, its history was one of at least a century of outcomes close to balance or moderate surplus (Figure 1). The result was that at that point the nation had substantial net foreign assets, officially estimated at around 10% of US GDP. Even at the trough in 1987 the deficit never exceeded 3½ per cent of GDP.

A trade perspective

However, already in the early 1980s various signs pointed to potential problems on the horizon; in particular, it seemed as though there was a strong tendency for the United States to demand more imports (at least of goods) at the margin, as its economy expanded, than its trading partners were interested in purchasing in the way of additional US exports (the so-called Houthakker-Magee effect described in Hooper *et al*., 2000).[8] Once US output growth began to match those rates recorded by its trading partners in the 1980s (with the first LDC debt crisis and the end of the post-war recovery in Europe), US domestic spending increases began chronically to outpace GDP growth (Figure 2),[9] drawing in imports. Nonetheless, the dollar surged, and the US current account quickly deteriorated, reaching a peak deficit of 3.4% of GDP in 1987. That process was reversed by a sharp fall in the dollar in the second half of the decade, which served to enhance the price competitiveness of US exports and import-competing production.[10] Combined with the payments resulting from the Gulf War in 1991, the current account balance even managed to return to a tiny surplus that year.

Since then, however, the story has been one of uninterrupted decline in the balance. With the end of the brief phase of depreciation in the effective rate of the dollar in 1988, along with faster growth than in the OECD at least, if not than in the rest of the world, beginning in 1992, the Houthakker-Magee effect took over again, even if the underlying asymmetry in income elasticities seems to have shrunk beginning in the 1990s (Taylor, 2004; Chinn, 2005). The US share of world imports of goods and services rose from 14.3% in 1991 to 18.8% at the business-cycle peak in 2000, while its export share was roughly flat; when weighted by export markets and taken in volume terms, US exporters gained market shares until around 1997-98 and have lost them steadily since then. The balance on current account blew out (despite a trend improvement in the services balance until around 1996, and a sustained albeit shrinking surplus on the income account), reaching $416 billion or 4.2% of GDP by 2000 (Table 1). At the same time there was an unprecedented rise in private expenditure relative to disposable income and a corresponding deterioration

7. Cooper (2004) argues that this 10% share is by no means unreasonable, since the US share of global GDP is around one quarter and of marketable financial assets around a half.

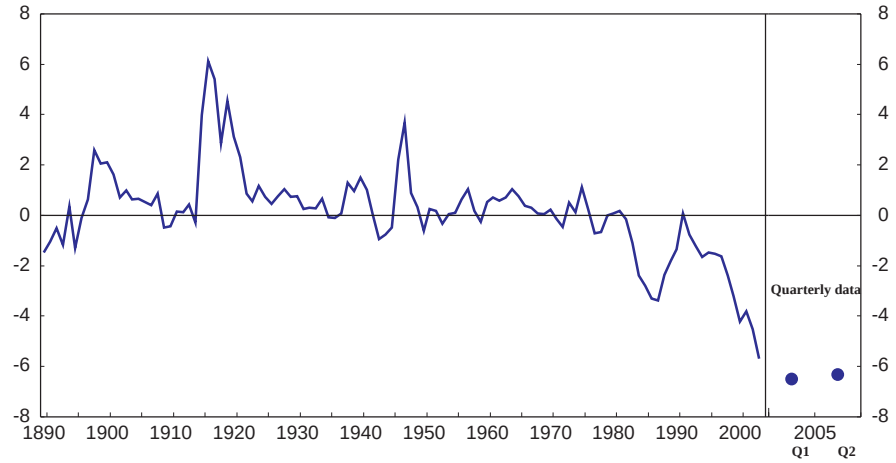
8. See Brook *et al*. (2004, Box 1) for a discussion of the possible reasons for the asymmetry. Note that the asymmetry exists only for goods: indeed, for services there is an opposite gap in income elasticities. In any case, import penetration has risen steadily with only brief cyclical interruptions from around 5% in 1970 to over 13% most recently.

9. The only precedent for this came in the late 1960s during the Vietnam war, often cited as an example of a failure to choose between guns and butter.

10. Edwards (2005) notes that the simple correlation between the current account deficit and a broad measure of the real exchange rate of the dollar is greatest (0.6) when the exchange rate is lagged three quarters of a year.

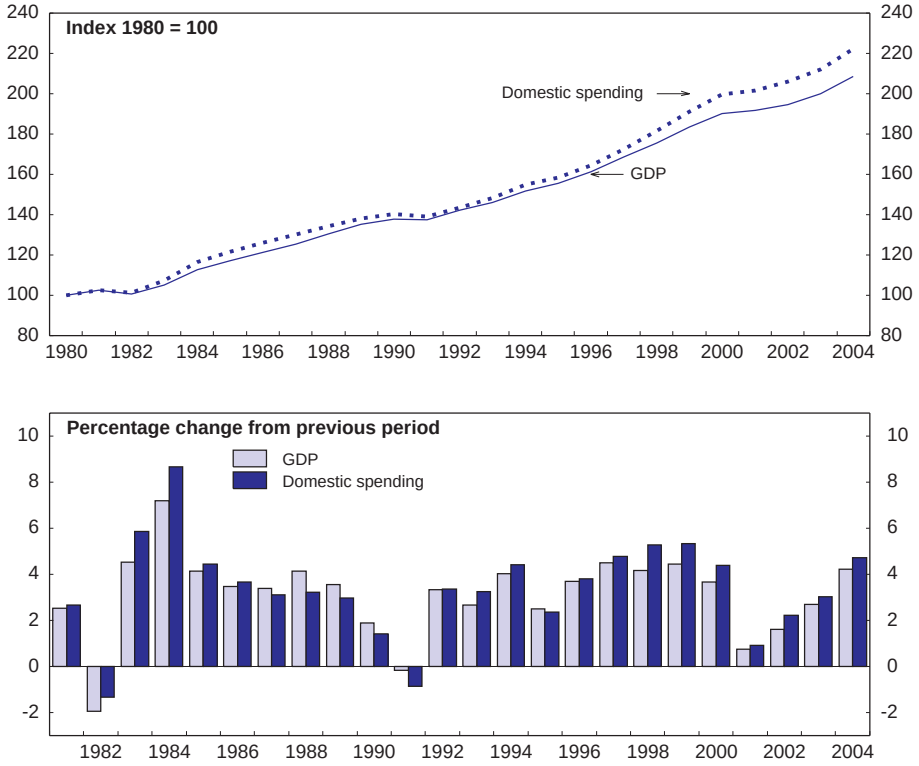
in the private-sector balance (Godley and Izurieta, 2004), associated in part with the wealth effects resulting from the stock market boom.

Figure 1. **The current balance is still declining**
Per cent of GDP



Source: Bureau of Economic Analysis.

Figure 2. **Real growth of domestic spending and GDP**



Source: OECD Analytical database.

Table 1. **The balance of payments: a historical perspective**
$ billions

	1960	1970	1980	1990	2000	2001	2002	2003	2004	2005 H1
A. Current account										
Exports										
Goods	19.7	42.5	224.3	387.4	772.0	718.7	682.4	713.4	807.5	874.8
Services	6.3	14.2	47.6	147.8	299.5	288.4	294.9	309.1	343.9	372.7
Income receipts	4.6	11.7	72.6	171.7	350.9	288.3	270.8	309.8	379.5	440.6
Imports										
Goods	14.8	39.9	249.8	498.4	1 224.4	1 145.9	1 164.7	1 260.7	1 472.9	1 621.3
Services	7.7	14.5	41.5	117.7	225.3	224.0	233.7	256.7	296.1	318.9
Income payments	1.2	5.5	42.5	143.2	329.9	263.1	260.8	263.5	349.1	440.2
Unilateral current transfers, net	-4.1	-6.2	-8.3	-26.7	-58.8	-51.9	-64.0	-71.2	-80.9	-96.3
Balance on:										
Goods	4.9	2.6	-25.5	-111.0	-452.4	-427.2	-482.3	-547.3	-665.4	-746.5
Services	-1.4	-0.3	6.1	30.0	74.1	64.5	61.1	52.5	47.8	53.8
Goods and services	3.5	2.3	-19.4	-80.9	-378.3	-362.7	-421.2	-494.8	-617.6	-692.8
Income	3.4	6.2	30.1	28.6	21.1	25.2	10.0	46.3	30.4	0.4
Current account	2.8	2.3	2.3	-79.0	-416.0	-389.5	-475.2	-519.7	-668.1	-788.6
Share of GDP (%)	0.5	0.2	0.1	-1.4	-4.2	-3.8	-4.5	-4.7	-5.7	-6.4
B. Financial account[1]										
US-owned assets abroad, net	-4.1	-8.5	-85.8	-81.2	-560.5	-382.6	-294.0	-328.4	-855.5	-664.6
Official reserve assets, net	2.1	3.3	-7.0	-2.2	-0.3	-4.9	-3.7	1.5	2.8	9.1
Other government assets, net	-1.1	-1.6	-5.2	2.3	-0.9	-0.5	0.3	0.5	1.2	9.5
Private assets, net	-5.1	-10.2	-73.7	-81.4	-559.3	-377.2	-290.7	-330.5	-859.5	-683.2
Direct investment	-2.9	-7.6	-19.2	-37.2	-159.2	-142.3	-154.5	-140.6	-252.0	-121.2
Foreign securities	-0.7	-1.1	-3.6	-28.8	-127.9	-90.6	-48.6	-156.1	-102.4	-149.4
Foreign-owned assets in the United States, net	2.3	6.4	62.6	141.6	1 046.9	782.9	794.3	889.0	1 440.1	1 273.0
Official assets, net	1.5	6.9	15.5	33.9	42.8	28.1	115.9	278.3	394.7	215.2
US Treasury securities	0.7	9.4	11.9	30.2	-5.2	33.7	60.5	184.9	272.6	74.1
Other foreign assets, net	0.8	-0.6	47.1	107.7	1 004.1	754.8	678.4	610.8	1 045.4	1 057.8
Direct investment	0.3	1.5	16.9	48.5	321.3	167.0	80.8	67.1	106.8	105.3
US Treasury securities	-0.4	0.1	2.6	-2.5	-70.0	-14.4	100.4	104.4	107.0	161.6
Other US securities	0.3	2.2	5.5	1.6	459.9	393.9	283.3	226.3	369.8	390.6

1. Positive figures imply inflows.
Source: Bureau of Economic Analysis.

It was widely expected that once the long-awaited recession hit, the dollar would depreciate, and, along with the income effect on demand for imports, the balance would adjust sufficiently to regain a sustainable position. However, the US recession of 2001 was mild and, in particular, shallower than in many other OECD countries, and the dollar continued to appreciate in effective terms until early in 2002. Even the following depreciation was not large enough to offset the combination of the income effect from the real growth advantage of the United States,[11] the effects of the series of substantial tax cuts, a surge in the energy import bill in line with the run-up in global oil and natural gas prices and an increasing trend for foreign producers and US wholesalers to engage in "pricing to market" whereby the effects of depreciation are mitigated by the absorption of cost increases in their margins.[12] Thus, the US consumer has to a

11. Blanchard *et al*. (2005) argue that even if Europe and Japan had grown as fast as the United States since 1990, the likely partial-equilibrium increase in US exports would have been enough to lower the present current account deficit by only around ½ percentage point of GDP.

12. Pass-through rates from changes in exchange rates seem to have declined in most countries (except the United States), in large part as the structure of trade has shifted from primary commodities, especially energy, to differentiated manufactured goods. But such rates remain lower for the United States (at 0.26 in

considerable extent been shielded from the usual trade adjustment following the recent depreciation (with the implication that sufficient expenditure-switching to bring about a sustainable current account deficit is going to require a larger depreciation, all else equal). The result was only the briefest of respites in the march towards higher US deficits in 2001. Since then, the merchandise deficit has continued to grow almost inexorably; the non-factor services surplus has been edging down; the income balance has been fairly flat, though positive until this year's second quarter, despite the large and growing net foreign indebtedness;[13][14] and the final component, the current transfers deficit, has been inching higher. The result is that the overall current account has been moving very much in line with the merchandise balance (and the balance on goods and services). In the first half of 2005, before the effects of the hurricanes, it already reached $789 billion at an annual rate (6.4% of GDP). Meanwhile, the need to finance those chronic trade deficits has pushed net foreign debt to around $2½ trillion or 22% of GDP in 2004 (Table 2) (and more than 200% of export revenue from goods and services), nearing the previous all-time high of 26% set in 1894 (Obstfeld and Rogoff, 2005). This has been limited in recent years by favourable valuation changes (averaging $480 billion per year in 2002-2004), attributable not only to exchange rate changes – a 10% depreciation of the dollar represents a transfer of nearly 6% of US GDP from the rest of the world, nearly a year's worth of the recent shortfall on current account (Gourinchas and Rey, 2005b) – but also to capital gains and losses on the underlying assets. With the strengthening of the dollar in 2005, net indebtedness will suffer from revaluation effects that could in and of themselves, all else equal, worsen the net international investment position by around $200 billion (Shin, 2005). Although the United States is not yet even close to being the largest debtor relative to GDP among OECD countries (Table 3), it may soon be on a path to catch up with the leaders. The implication is that a higher share of GDP will have to be paid to foreigners in the form of investment income, shaving the real incomes of US residents.

---

the short run and 0.41 in the long run) than for almost any other developed country (Campa and Goldberg, 2004).

13. The surplus on this account is only partly attributable to the different form the asset stocks have taken, with foreigners mainly buying low-risk and therefore low-yielding US debt, especially government debt, whereas US investors have focussed their acquisitions on equity-based assets (which represent about 60% of the their foreign asset portfolios, compared with less than 20% for Japanese investors); direct investment represented 33% of total foreign assets at end-2004, compared with only 21.5% of foreign owned assets in the United States. The United States has been recently described as having evolved from the world's banker to its venture capitalist (Gourinchas and Rey, 2005). The more important explanation, however, is due to within-class differences that have been present for decades: while average annual portfolio investment returns have been comparable across inflows and outflows, US direct investors have earned an order of magnitude more than their foreign counterparts investing directly in the United States: 7.6% per year versus 2.2% (Hung and Mascaro, 2005). This could be due to a greater risk of political or economic disruption abroad than in the United States: bond ratings for destination countries for US direct investment are much lower than for the United States itself. In addition, US assets were on average acquired earlier and, being therefore more mature, are hence more profitable. They may also appear more profitable because such profits are overstated through "transfer pricing" so as to reduce their tax liabilities domestically. In any case, Godley and Izurieta (2004) argue that undistributed profits from foreign direct investment are not available to finance transactions deficits and therefore should be excluded; this would lower this balance by around a percentage point of GDP.

14 . In fact, the "puzzle" of having a sustained surplus on this income account despite the persistent increase in net foreign indebtedness has led Hausmann and Sturzenegger (2005) to propose that the true economic value of the debt is radically less than the accounting value and possibly even that the United States is in a net asset position. They label the difference "dark matter": assets that exist but cannot be observed. Much of this may be intangibles associated with direct investment. The rest, they argue, comprises assets providing liquidity services (seigneurage) and insurance (as exemplified by the risk premia, referred to in the previous footnote). With their assumptions, the US stock of dark matter reached some $5 trillion in 2004.

Table 2. **Net international investment position of the United States**
$ billions, year-end values

	1976	1982	1990	1995	2000	2001	2002	2003	2004
US-owned assets abroad									
With direct investment at:									
Current cost	457.0	1 108.4	2 179.0	3 486.3	6 238.8	6 308.7	6 645.7	7 641.0	9 052.8
Market values	n.a.	961.0	2 294.1	3 964.6	7 401.2	6 930.5	6 807.8	8 296.6	9 972.8
US official reserve assets	44.1	143.4	174.7	176.1	128.4	130.0	158.6	183.6	189.6
Other US government assets	45.0	76.9	84.3	85.1	85.2	85.7	85.3	84.8	83.6
Direct investment abroad									
Current cost	222.3	374.1	616.7	885.5	1 531.6	1 693.1	1 860.4	2 062.6	2 367.4
Market values	n.a.	226.6	731.8	1 363.8	2 694.0	2 314.9	2 022.6	2 718.2	3 287.4
Bonds	34.7	56.6	144.7	413.3	572.7	557.1	705.2	874.4	916.7
Stocks	9.5	17.4	197.6	790.6	1 852.8	1 612.7	1 374.7	2 079.4	2 520.1
Foreign-owned assets in the United States									
With direct investment at:									
Current cost	292.1	779.5	2 424.3	3 944.7	7 620.0	8 228.1	8 752.9	9 797.7	11 537.0
Market values	n.a.	725.1	2 458.6	4 270.4	8 982.2	9 269.9	9 263.0	10 669.0	12 515.0
Foreign official assets in the									
United States	104.4	189.1	373.3	682.9	1 030.7	1 109.1	1 251.0	1 567.1	1 982.0
US government securities	72.6	132.6	291.2	507.5	756.2	847.0	970.4	1 192.2	1 499.6
US Treasury securities	70.6	124.9	285.9	490.0	639.8	720.1	812.0	990.4	1 260.5
Direct investment in the United States									
Current cost	47.5	184.8	505.3	680.1	1 421.0	1 518.5	1 517.4	1 585.9	1 708.9
Market values	n.a.	103.4	539.6	1005.7	2 783.2	2 560.3	2 027.4	2 457.2	2 686.9
Other US Treasury securities	7.0	25.8	152.5	327.0	381.6	375.1	473.5	543.2	639.7
Bonds	12.0	16.7	238.9	459.1	1 068.6	1 343.1	1 531.0	1 707.9	2 059.3
Stocks	42.9	76.3	221.7	510.8	1 554.4	1 478.3	1 248.1	1 700.9	1 928.5
Currency	11.8	31.3	85.9	169.5	256.0	279.8	301.3	317.9	332.7
Net international investment position									
With direct investment at:									
Current cost	164.8	329.0	-245.3	-458.5	-1 381.2	-1 919.4	-2 107.3	-2 156.7	-2 484.2
Share of GDP (%)	9.0	10.1	-4.2	-6.2	-14.1	-19.0	-20.1	-19.6	-21.2
Market values	n.a.	235.9	-164.5	-305.8	-1 581.0	-2 339.4	-2 455.1	-2 372.4	-2 542.2
Share of GDP (%)	n.a.	7.2	-2.8	-4.1	-16.1	-23.1	-23.4	-21.6	-21.7

Source: Bureau of Economic Analysis.

A capital flow point of view

While the current account is a trade-related measure, in the view of most observers it is not trade-related factors[15] that explain either the level of or the worsening in the balance; instead, it is the fundamental forces of perceived prospects for productivity gains[16] and rates of return that jointly determine domestic and foreign incomes, asset prices, interest and exchange rates and thereby simultaneously the balances on current and capital transactions as well (Bernanke, 2005). Currently, foreigners wish to buy more US assets than US residents want to invest abroad, raising the value of the dollar to a point where the balance of trade is in sizeable deficit. On the other side of the balance of payments (what is now called the

15. Examples of such factors that have often been advanced include: trade policy and unfair foreign competition and the quality, composition or internalisation of US and foreign production.

16. Differential productivity developments explain 2/3 to ¾ of the $/euro and $/yen exchange rate changes in the late 1990s (Tille *et al.*, 2001).

"financial account"), both capital inflows and outflows have grown enormously over time,[17] with the exception of the recessionary period earlier in the current decade, as have the corresponding stocks. US gross foreign assets of around 85% of GDP are surpassed by gross foreign liabilities of 107% of GDP. It was only in 2003 that US residents once again began to increase the amount of their investments abroad, with most of the gain in the form of liquid, presumably low-risk funds passing through banks. On the other hand, just as US residents' demand for foreign goods and services has surged, foreigners' demand for US assets has skyrocketed since 1990.[18] Some argue that the enormous growth in global portfolios has been far more important than their rebalancing towards US assets (Ventura, 2001). In fact, the share of US liabilities in the portfolio of the rest of the world has trended up since 1980, and especially in the second half of the 1990s (when it reached one-third), but it has since fallen back quite sharply (Lane and Milesi-Ferretti, 2005b). The increased demand for US assets has come from foreign central banks (see below) as well as private investors. A great deal of it took the form of direct investment and portfolio

Table 3. **Net foreign asset positions of OECD countries**
Per cent of GDP

	1990[1]	2000[1]	2003[1]	2003[2]
Australia	-47.4	-65.2	-59.1	-74
Austria				-22
Belgium				34
Canada	-38.0	-30.6	-20.6	-21
Denmark		-21.5	-13.0	-20
Finland	-29.2	-58.2	-35.9	-28
France				4
Germany				8
Greece				-60
Iceland	-48.2	-55.5	-66.0	-82
Italy				-10
Japan				37
Netherlands				-15
New Zealand	-88.7	-120.8	-131.0	-90
Norway				45
Portugal				-64
Spain				-45
Sweden	-26.6	-36.7	-26.5	0
Switzerland				145
United Kingdom				-6
United States				
Direct investment at current cost	-4.2	-14.1	-19.6	-19.6
Direct investment at market prices	-2.8	-16.1	-21.6	-21.6

1. All figures from Edwards (2005a).
2. All figures estimated from Lane and Milesi-Ferretti (2005a).

Source: S. Edwards (2005), "Is the U.S. Current Account Deficit Sustainable? And If Not, How Costly is Adjustment Likely To Be?", draft paper prepared for the Spring 2005 meeting of the Brookings Panel on Economic Activity, 16 March, Table 5 and OECD estimates based on P.R. Lane and G.M. Milesi-Ferretti (2005), "Financial Globalization and Exchange Rates", IMF Working Paper WP/05/3, January, Figure 1.

17. Private capital inflows rose from 1.6% of GDP in 1991 to 8.9% in 2004, while private capital outflows increased from 1.6% to 7.3% of GDP over the same period (Hung, 2005).

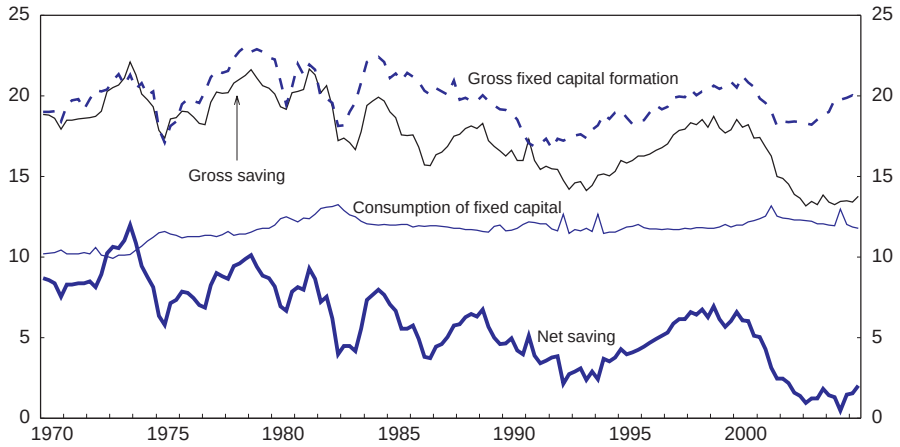
18. Blanchard *et al*. (2005) point out that these changes have initially offsetting effects on the exchange rate but that both lead to anticipated depreciation. Over the past 20 years, nominal growth in US GDP has averaged 5.6% per year, while trade has grown at an average rate of 7.4% and gross foreign assets and liabilities at an average 11.7% rate (Hatzius, 2005a).

investment in equities prior to the bursting of the stock market bubble; more recently it has been attracted more by the United States as a safe haven: inflows have been concentrated on debt securities, especially those issued by the US Treasury – nearly $380 billion worth in 2004, enough to fund over 90% of last year's federal government deficit (on a national accounts basis). The result is that the share of US federal government debt held by foreigners has doubled in less than a decade to 48%, and even higher figures apply if the base is restricted to marketable Treasury debt (Higgins and Klitgaard, 2004; Wu, 2005).[19]Nonetheless, US government securities represented only 17% of total US assets held by foreigners (by market value) in 2004, up from 13% in 2000, but down from 19% in 1992 and even 24% in 1982 (Hung, 2005).

The deficit as a deficiency of national saving

As mentioned before, the current account balance is also by definition the counterpart of the difference between saving and investment, which itself can be distinguished by the various agents involved. In the US case the excess of investment over saving has not been caused by an unusually large amount of investment (except in recent years by the household sector in the form of residential housing – see below and Chapters 1 and 2 of OECD (2005c)). Gross domestic investment has been struggling to reach 18-20% of GDP ever since 1990, broadly similar to the OECD median of 20.5% in recent years, and there has been little sign of any long-term trend (Figure 3). Rather it is the lack of domestic saving that is the source of the need to borrow from abroad to finance profitable investment opportunities. Indeed, gross saving as a share of GDP has on balance declined since the early 1980s, in part because of the reduction in inflation; the decline picked up pace in the late 1990s and has become an increasing concern (Cotis *et al.*, 2004). From 1998 to 2003 the nation's overall saving rate fell by 5 percentage points, 55% of which represented additional capital inflows and a wider current account deficit and the rest a fall in net domestic investment. This was probably initially because of the combination of the favourable asymmetric technology shock and a reduced risk premium on dollar assets. Together, they raised expectations of future rates of return on investment and income growth, which attracted capital inflows – boosting the dollar and depressing the current account (Hunt and Rebucci, 2003) as well as cutting longer-term bond yields (see below) – and were capitalised in wealth gains on the stock market. More recently the dearth of saving has

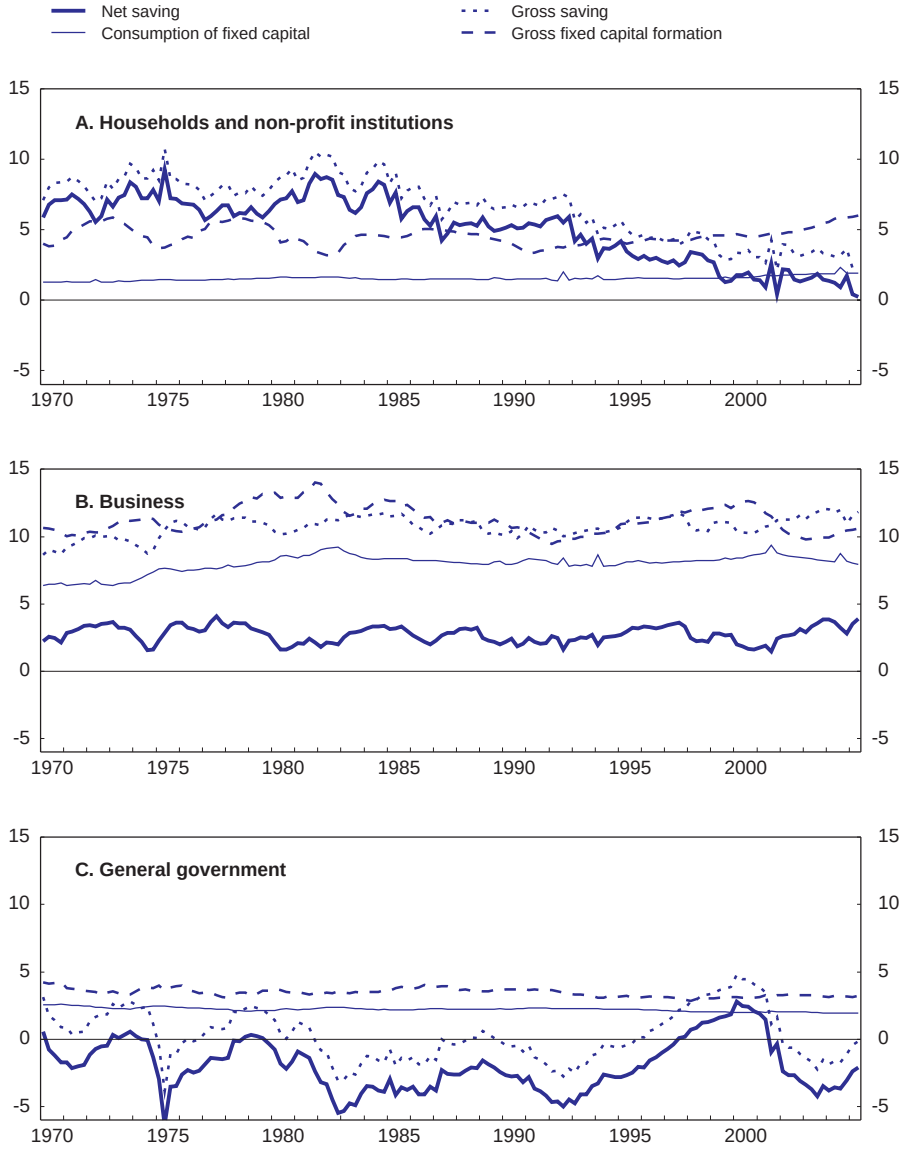
Figure 3. **Domestic saving and investment**
Per cent of GDP



Source: Bureau of Economic Analysis.

19. They also own more than 30% of the debt issued by the two large government-sponsored housing finance enterprises, Fannie Mae and Freddy Mac (Obstfeld and Rogoff, 2004; 2005 update).

Figure 4. **Saving and investment by sector**
Per cent of GDP



Source: Bureau of Economic Analysis.

been the result of low interest rates and their effect on housing wealth.[20] In net terms, saving almost fell to zero briefly in early 2003 and remains extremely small by international standards: net saving in the median OECD country was 7.4% of GDP in 2003.

Looked at sectorally (Figure 4), it does not appear to be the enterprise sector that is responsible for this shortage, other than occasionally during cyclical downturns: a slight uptrend in business gross

20. Note that the cross-country pattern of current account balances is well explained by the relative behaviour of housing prices and housing wealth (Bernanke, 2005). Al-Eyd *et al*. (2005) estimate that each 10% rise in real US house prices brings about a short-term widening of the current account deficit of ¼ percentage point of GDP through the stimulative effect on real private consumption.

saving has been offset by a steady rise in depreciation. Indeed, in recent years US firms have contributed to the global glut of savings. On the other hand, government saving – which largely coincides with the balance on the federal budget as usually measured (see Chapter 2 of OECD (2005c)) – seems to be in a chronic but heavily pro-cyclical position, particularly in the late 1990s, when the federal finances were in extraordinarily robust form. Thus, it was during the 1980s (when private savings and investment were moving together) that it became popular to refer to the "twin deficits" as though a budget imbalance brings about an external deficit at all points in time.[21] However, the latter persisted right through the period of budget surplus, as the "new economy" shock drove investment higher and saving lower. It is now widely understood that, while the two phenomena are intrinsically related (according to the Ricardian equivalence proposition, private agents recognise to a large extent the existence of the government's budget constraint and thus vary their saving rates according to their perceptions of the need to raise taxes to sustain the likely future level of government outlays[22]), their inter-relationship is by no means one for one. Some experts have argued that the rise in the federal deficit has crowded out mainly private domestic spending, rather than net exports (Ferguson, 2005). They would attribute no more than one percentage point of GDP of the increase in the current account deficit to the deterioration in the structural budget deficit.

Hence the most fundamental source of low and falling domestic saving is the household sector whose saving rate has been dropping in both net and gross terms since the early 1980s. While the rate of decline in its saving has diminished since the turn of the millennium (and there is a systematic tendency for the rate to be revised up – see Gramlich, 2005), that limited form of improvement has been more than offset at the aggregate level by the turnaround in government finances. The persistence of large current account deficits raises sustainability questions: the risk that foreign investors could eventually require some combination of higher US expected returns (requiring lower US asset prices), higher US interest rates and a weaker dollar for them to be willing to continue to acquire the flow of claims on US assets, much less hold the outstanding stock. Some observers have suggested that there exists a "credibility range" within which a country may be able to violate its stability conditions for either the budget and/or the current account deficit without large effects on asset prices (Gramlich, 2004; Truman, 2005), but that when the deficits are expanding the range may narrow and raise the risk of a crisis. Indeed, in a recent paper Clarida *et al.* (2005) have demonstrated that there exist estimatable thresholds for most G7 countries beyond which current account adjustment occurs; their estimate for the United States is -4.2% of net output (which corresponds to -2.75% of GDP), but the US speed of adjustment is much slower than for the others.

The risks of what might be needed to restore sustainability

Baseline projections of what would happen to the external accounts in the coming years absent any change in the dollar vary significantly, but most show a rapid widening of the deficit.[23] Among the most extreme prognostications are Mann (2004), who projects that the current account deficit on present trends would hit 13% of GDP in 2010, and Roubini and Setser (2004), who have it reaching 14% of GDP (including a deficit on investment income account of around 5% of GDP) and the net international investment position (NIIP) hitting 107% of GDP in 2015. There are five main reasons for thinking that the US deficit will worsen steadily – and that therefore the current configuration of exchange rates and other

21. The evidence is nonetheless fairly persuasive that fiscal policy does influence national saving – even if the effects may be small and less compelling for the United States than other G7 countries (Cotis *et al.* (2004) – mainly through the government purchases channel: see, for example, Hayford (2005).

22. A significant correlation between the structural budget balance and changes in private saving in the United States was most recently demonstrated by de Mello *et al.* (2004).

23. Only Brown (2004) seems to think that the US current account deficit has already peaked, and his detailed estimates point to capital inflows easily covering the present trade shortfall.

features of the economy are not sustainable[24] (see Box 1) – unless the dollar weakens. *First*, with imports nearly half again as large as exports, the dollar value of the balance will grow unless export growth exceeds import growth by the same fraction. *Second*, even though the significance of the Houthakker-Magee asymmetry may be waning because of shifting country and commodity composition of trade (Mann and Pluck, 2005), it is still present nonetheless: at similar growth rates to its trading partners US exports just do not rise as quickly as US imports. In addition, US growth rates have often exceeded those recorded by the rest of the world, at least on a trade-weighted basis. *Third*, the investment income balance is most likely going to deteriorate significantly over time, in view of the spread of returns between those earned by US residents on their investments and the average yield on foreign investments in the United States. This was still 1.0 percentage point in 2004, pegging the possible shortfall in that category at current levels of indebtedness at more than a percentage point of GDP. *Fourth*, there is some evidence that demographic factors are at work in explaining some of the pattern of current account balances both over time and across countries (Lührmann, 2003; Domeij and Flodén, 2004), and for the United States the comparatively slow speed of ageing is expected by some authors to have a fairly sharp negative effect on the current account over the next couple of decades.[25] *Finally*, macro-econometric model simulations show that most scenarios designed to achieve a substantial improvement in the balance entail second-round effects that tend to offset the initial, helpful shock (Brook *et al.*, 2004): for example, dollar depreciation raises costs and prices, cutting competitiveness, eating away at the improvement in the trade balance. The more debatable proposition is that the situation cannot be defused without some sort of abrupt

Box 1. **The sustainable level of the current account deficit**

The stability condition for the external deficit is identical to that for the budget deficit: the equilibrium ratio of foreign debt to GDP is equal to the primary (or goods, services and transfers) deficit-to-GDP ratio multiplied by the ratio of one plus the nominal growth rate of GDP to the difference between the nominal growth rate of GDP and the nominal interest rate). In the US case, since the GDP growth rate exceeds the interest rate, the condition is satisfied with a primary deficit of moderate proportions. However, the latest primary deficit of some 6½ per cent of GDP would entail a plateauing of the debt/GDP ratio at well beyond 100% of GDP.

Assuming that nominal GDP is likely to rise about 5% per year, a number of scenarios that would satisfy the sustainability criterion are possible. *First*, the deficit would have to fall to below 1¼ per cent of GDP for the peak level of indebtedness to stay at the recent level of 22% of GDP. *Second*, if the current account deficit were not to adjust at all in relation to GDP from its latest (first-quarter 2005) outcome of 6.4%, then the NIIP would eventually reach 128% of GDP, a level that has virtually never been seen before for any developed country. With so much foreign debt and thus a large negative income balance the goods and services balance would have to shrink to around 1¼ per cent of GDP. Thus, substantial trade balance adjustment would eventually be required even if the current account remains where it is now. *Third*, there are various intermediate possibilities. For example, the current deficit could stabilise at some recent value, say $500 billion (Cooper, 2004), in which case it would shrink as a share of GDP to around 2¼ per cent and the NIIP would rise to 46% of GDP. Alternatively, following Mann's portfolio balance approach that assumes that net claims on the United States as a share of global wealth must stabilise, Truman (2005) argues that the current deficit would need to come down to some 3% of GDP and NIIP around 60% of GDP. Finally, if the goods and services balance were to be zero, then NIIP would be indeterminate; an assumption of 50% of GDP would yield something on the order of a current deficit of 2¾ per cent of GDP. To get there in a decade would require export growth to exceed import growth by 4 to 4½ percentage points per year.

24. There is a certain literature that tries to examine the US external sustainability question directly through either unit root tests for the ratio of the current account balance to GDP or changes in private saving and investment or the co-integrating relationship between exports and imports. The results have varied, but the latest contribution (Matsubayashi, 2005) still concluded that sustainability cannot be rejected.

25. However, Feroli (2003) predicts a period of US current surpluses before renewed deficits in a few decades. This might be explained by the heavy saving that typically occurs right before retirement.

reversal/crisis; a number of observers refuse to dismiss this possibility (see, for example, Roubini and Setser, 2005; Mann, 2004; and Wolf, 2004), given that it is widely accepted that the risk of such a *dénouement* increases the greater is foreign indebtedness (see, for example, Edwards, 2005b).[26]

The lessons from the growing literature on crises are that they tend to occur after the external adjustment process gets underway, rather than as a trigger (which could be a housing market decline, for example) and that the largest real depreciations in developed economies have occurred when growth is rising (Croke *et al*., 2005). Many authors conclude nonetheless that the eventual external adjustment will be accompanied by a significant reduction in growth, at least temporarily, (*e.g*. Edwards, 2005a and b; Adalet and Eichengreen, 2005), led by a reduced rate of increase in domestic demand.[27] Models have been developed based on continuing falls in home bias abroad that show that the increased demand for US assets leads to an overshooting of the sustainable level of the deficit with quite an abrupt reversal.[28]

Whatever the adjustment path – smooth or disorderly – it is widely agreed that adjustment will entail some degree of dollar depreciation. Most observers have tried one approach or another to estimate how big a depreciation might be required (Table 4). Outcomes range from a modest decline to as much as 90%. The range of estimates, even by the same authors, points to the substantial uncertainties related to, for example, the sustainable current account deficit and NIIP, the appropriate model and its parameterisation. But Obstfeld and Rogoff (2004) argue that the magnitude of currency depreciation is not the right question. Dollar depreciation will equilibrate the external imbalance through changing the terms of trade between US and non-US goods and services. They find that this is only half as important as adjustment by substituting tradables for non-tradables in the United States (and conversely abroad), which has to result from differential saving and productivity shocks, which themselves will bring about a dollar depreciation as a by-product. Depreciation alone is not enough to both deal with the current account problem and keep

26. Debelle and Galati (2005) find that reversals tend to occur when the current account deficit reaches 4 to 5% of GDP and net foreign indebtedness around 20% of GDP; they are also more likely when world output growth is slower and world interest rates higher. In a recent study covering more than a century, Adalet and Eichengreen (2005) also find the size of the trade balance to play a clear role, as does lagged growth in the home country of the world's reserve currency, with openness, *per capita* income and the fiscal balance having less robust outcomes.

27. Based on historical evidence since 1970, Edwards (2005b) estimates that growth could be cut from trend rates by 4 to 5 percentage points for a large, front-loaded reversal and even by 2½ to 4 points for a smaller, more gradual adjustment. Similarly, Debelle and Galati (2005) find that the average episode of current account adjustment involved a slowing of real output growth of 2 percentage points for one to three years. For his part Truman (2005) estimates that domestic demand growth will have to slow by at least one percentage point compared to the recent past. Assuming that the current account shrinks by 3 percentage points of GDP, but that real GDP growth is maintained, this amounts to $1 350 per person per year in addition to the terms-of-trade effect, which he pegs at $1 000 per person using a 30% depreciation and a 50% pass-through. The 1980s episode in fact had an annual growth slowdown of 2¼ percentage points and an annual domestic demand slowdown of 3¼ percentage points. Freund and Warnock (2005) are rather more sanguine: their look at post-1980 reversals in industrial countries generates an average growth shortfall relative to trend of only 0.15 percentage points for each percentage point of GDP adjustment in the deficit.

28. There is a growing literature – primarily with respect to developing countries – on what has become known as "sudden stops" (of capital flows), which tend to accompany current account reversals. See, for example, Calvo *et al*. (2004) and Edwards (2004). However, the observed coincidence of current account reversals and currency crises is attributable only to developing countries; industrial countries with reversals on average experienced an appreciation (Edwards, 2005a). Reversals have a significant negative effect on long-run real *per capita* growth in a large sample of countries. For larger countries this depressive effect is greater the more open the country is to international trade in goods and services, but smaller the more open it is to capital flows.

the economy at full employment: the extra net exports must be crowded in by expenditure-reducing/savings-increasing policies as well. This is where the need for budget deficit reduction comes in (see below).[29]

Table 4. **Dollar depreciation and the US current account deficit**

Study/Authors	Deficit/debt outcome[1]	Dollar outcome
Obstfeld and Rogoff (2000)	NIIP: -20% CA: zero	Real: -16% Nominal: -12%
O'Neill and Hatzius (2002)	CA: -2%	Real: -43%
Wren-Lewis (2004)	CA: -2%	Yen/dollar: 88 Dollar/euro: 1.18
Brook *et al.* (2004)	CA: improves by 1.3-1.4% of GDP	Nominal: -22.5%
	CA: improves by 2.5%of GDP	Nominal: -15% (plus 300 basis point rise in short rates and fiscal tightening of 4.2%of GDP)
Bénassy-Quéré *et al*. (2004)	None	Yen undervalued: 14.3-22.1% Euro undervalued: 1.2-7.6%
Mussa (2004)	NIIP: -40 to -50% CA: -2%	Real: -20%
O'Neill and Hatzius (2004)	CA: -3% CA: -2% CA: zero	Real: -21.6 to -23.6% Real: -32 to -34.1% Real: -53 to -55%
Obstfeld and Rogoff (2004)	CA: zero	Real: -14.7 to -33.6%
Mann (2004)	CA: -10%	Real: -20% plus -10% yearly
Roubini and Setser (2004)	NIIP: -55% CA: -43%	Nominal: -50% (fiscal deficit also gradually eliminated)
Blanchard *et al*. (2005)	CA: zero	Real: -40 to -90%
Truman (2005)	CA: -3.2%	Real: -28%
Obstfeld and Rogoff (2005)	n.a.	Real: -33.3%
Gourichas and Rey (2005b)	CA: zero	Nominal: -13 to -18% yearly for 5 years

1. In per cent of GDP. CA = current account balance; NIIP = net international investment position (net debt).
Source: S. Edwards (2005), "Is the U.S. Current Account Deficit Sustainable? And If Not, How Costly is Adjustment Likely To Be?", draft paper prepared for the Spring 2005 meeting of the Brookings Panel on Economic Activity, 16 March, Table 6 and OECD.

29. It would be up to monetary policy to ensure that full employment is maintained during the adjustment period

No matter what the sustainable level of the current account is, the deficit on goods and services will have to go well below that share of GDP because of the likely deficits on transfers and income accounts. As described above, the latter has thus far remained in rough balance. The financial costs of the deteriorating net international investment position have been successively delayed by the gap in returns between US assets and liabilities and the revaluation effects of depreciation in 2002-03 as well as differences in underlying capital gains.[30] However, with the dollar's renewed strength thus far in 2005 and, the widening interest spread in favour of the United States, the presumption must be strong that the investment income balance will move rapidly into deficit by next year (Hatzius, 2005a), despite the recent performance differential favouring foreign over US equity returns. Furthermore, there is a case for believing that the worsening net foreign debt position will eventually raise the risk premium on the dollar (Al-Eyd *et al*., 2005); yet thus far there is no evidence of any such premium. In any case it is a depressive factor for the steady-state equilibrium exchange rate because of the need to earn more on exports of goods and non-factor services so as to make the interest payments on the debt (Blanchard *et al*., 2005).

Another aspect of the recent situation that is disturbing to many observers is the structure of capital flows to and from the United States in recent years. *First*, the fact that there have once again been net outflows on direct investment (since 2002) and portfolio equity (since 2003) accounts has added to the financing need on the other accounts (*i.e*. borrowing) – together these summed to $1 192 billion in 2004. It also sits somewhat uneasily with the claim that expected risk-adjusted returns are greater than those available abroad. *Second*, foreign central banks are responsible for such a large share of recent capital inflows.[31] While there is some uncertainty because of differences between data sources (see the Appendix to Higgins and Klitgaard, 2004), it seems that central banks financed around half of the US current account deficit in 2003 and 2004 (though substantially less thus far in 2005). These purchases have overwhelmingly taken the form of Treasury securities: effectively, such official purchases have covered nearly the entire non-cyclical component of US federal borrowing in recent years. The impact of such accumulations on US longer-term interest rates has been much debated, with estimates ranging from a few basis points to close to two percentage points (Roubini and Setser, 2005).[32] The greater the importance of this channel, the more serious are a number of concerns: for example, that the current housing market boom may already be a bubble (see Box 1.1 in OECD (2005c)). In any case, there are legitimate reasons to doubt that foreign central banks' willingness to increase reserves will continue at this pace for much longer (Summers, 2004). The dollar already represented 64% of global foreign exchange reserves at the end of 2003, 15 percentage points higher than at end-1992 (Chinn and Frankel, 2005).

The case for a smooth resolution of the situation

Other than the hypotheses that the apparent imbalances are the result of a failure to recognise and measure persistent US capital outflows mainly on direct investment account that exploit superior know-

30. The long-term average gap in rates of return between US foreign assets and liabilities has averaged 1.2 percentage points before capital gains are taken into account but 3.1 percentage points in total. One important reason for the persistence of this gap is that 60% of US foreign assets are equity related, whereas the corresponding figure for its liabilities is only 38% (mainly because of the large share of foreign official assets).

31. However, foreign governments held only 16% of all US assets held by foreigners at end-2004, up from 12% in 2000 and 15% in 1992, but well below the 26% share recorded in 1982 (Hung, 2005).

32. Truman (2005) argues that the interest-rate effect of a reduction in capital inflows should be comparable to those of budget deficit cutting. Citing Laubach (2003), he says that the total effect of a fall equivalent to three percentage points of GDP should therefore be something of the order of ¾ percentage point. Most recently, Warnock and Warnock (2005) estimate that foreign capital inflows have lowered the yield on the ten-year Treasury note by some 150 basis points, with official flows responsible for about 60 basis points of that.

how (Hausmann and Sturzenegger, 2005) (see footnote 14 above) or that foreign capital inflows will continue to meet the requirements of a growing US current account deficit because the United States is such a good investment location (an idea heard less often since the stock market plunge of 2000-01, but which has just resurfaced, possibly because of the dollar's renewed strength)[33], the most extreme case for the durability of the current equilibrium, however tenuous, has been made by Dooley *et al.* (2003). They argue that the current situation is not unlike the Bretton Woods system – since foreign, mainly Asian, central banks have used an export-led development strategy supported by heavy intervention to prevent their currencies from appreciating against the dollar – and accordingly dub it "Bretton Woods 2". They see the system as being intact "for the foreseeable future". Similarly, others have argued that the US line of credit with the rest of the world has no clear time frame for repayment: it is like a central bank that issues fiat money that "never" has to be repaid (McKinnon, 2001). Foreign official institutions are said to be guided by different objectives than the profit motive that drive private investors (Hung, 2005). Others have disputed this and point out that the dollar could lose its place as the leading international reserve currency if inflation and/or depreciation undermine confidence in its value or if the attractions of the euro increase (Chinn and Frankel, 2005). Others go so far as to say the current uneasy outcome will have difficulty lasting through the end of 2006 (Roubini and Setser, 2004 and 2005).[34] In effect, the official flows involved are akin to international vendor financing in the commercial market (Summers, 2004). The situation has also been called "global co-dependency" (Mann, 2004), since the United States is dependent on foreign central banks for their purchases of its liabilities (a cumulative $789 billion in the last three years), and they are dependent on the United States as the borrower and consumer of last resort (Cooper, 2001).

In any case, having its liabilities denominated in dollars gives the United States a unique advantage. Whenever it suffers a depreciation, foreign investors may well be induced to increase their acquisition of dollar assets so as to restore their portfolio share (known as the "portfolio rebalancing effect"). Furthermore, depreciation leads to asset revaluation effects: the income account improves because of earnings on US assets abroad denominated in foreign currencies and net foreign indebtedness diminishes as well.[35] Such capital gains relax the external budget constraint and have been shown to be helpful in reinforcing the trade effects of currency changes in the US case, especially at horizons out to two years (Gourinchas and Rey, 2005a).[36] But their impact is only modest: they relieve only about 13% of the exchange rate adjustment, according to one recent estimate (Obstfeld and Rogoff, 2005).

Most recently the optimistic position has been defended by the argument that the US deficit is the result of a global savings glut (Bernanke, 2005), which also helps explain low long-term bond yields world

33 . Caballero *et al*. (2005) argue that one needs a non-conventional view to account for both the US external imbalance, the rise in the share of U.S. assets in global portfolios and the persistent decline in global real interest rates. They propose a model where the US ability to avoid both the growth slowdown that has befallen much of the rest of the world and the periodic collapse of emerging market economies' ability to generate "enough" reliable savings instruments lies at the heart of recent outcomes.

34. Skepticism that this "system" can last has been led by Eichengreen (2004). There are a variety of forces that will make it difficult for it to endure: a near-certainty of capital losses for dollar holders and thus a strong temptation to quit the cartel; internal dislocations in the United States (including structural resource misallocation); and risks of inflation in the undervalued-currency areas in Asia (because of imperfect sterilisation) and to their financial systems more generally.

35. As shown by Gourinchas and Rey (2005a), the wealth transfer to the United States is about ½ percentage point of GDP for every percentage point depreciation in the dollar (since about 70% of foreign assets are denominated in foreign currencies and such assets represent 71% of GDP). That means that the 16.3% fall in the dollar in 2002-04 offset roughly 55% of the impact of the current account deficits in those years.

36. They showed that a unit standard deviation shortfall of the ratio of net exports to net foreign assets yields a predicted 4% (annualised) increase in the rate of trade-weighted depreciation in the subsequent quarter.

wide. Unfortunately, this rise in savings has not been seen in the United States.[37] One of the key reasons for this glut is the imminent retirement of the baby-boom generation and the consequent increase in the ratio of retirees to workers. But this does not explain fully the differential pattern of savings rate changes, since much of the additional savings has come from developing and emerging-market countries that have no such imminent demographic concerns (such as dynamic Asia).[38] Non-OECD countries' current accounts have strengthened by around $420 billion since 1997, following the series of financial crises that began in Mexico in 1994, spread to Asia in 1997-98 and most recently befell Argentina in 2001. Their governments were initially forced to adopt macroeconomic policies to adjust their trade balances and to refrain from borrowing, and eventually many, especially in Asia, chose to reduce national net leverage by building up foreign exchange reserves (even if that strategy is an expensive and incomplete way of protecting against sudden stops – see Caballero and Panageas, 2005) so as to safeguard against the repetition of such events. As mentioned above, how long that willingness to accumulate reserves will last is unclear, as is why a disproportionate share of the resulting surpluses have been channelled into US assets, even accounting for the strong growth and more favourable regulatory and other institutional features there (Gruber and Kamin, 2005). A third contribution has come from the recent sharp rise in oil prices: producer revenues are only gradually being recycled back to consumers in the form of increased imports. In the meantime the majority of these revenues are being saved, probably in highly liquid form, largely in dollars. Financial market expectations are that high oil prices are likely to be long-lasting, so while the demand for dollar assets might not be reversed, it will gradually fade as the savings are drawn down to finance producing-nation consumption and investment. To the extent that involves purchases of US goods and services the need for any financing disappears. However, the US share of this expanding market would probably be smaller than its share of accretions to producing nations' financial portfolios. Overall, it is arguable whether the hypothesised savings glut will persist into the medium term (Hatzius, 2005b).

Another hypothesis that would support an optimistic interpretation of the sustainability and eventual resolution of the imbalance is that improved global financial integration[39] has helped bring about a reduction in "home bias" (the tendency for investors to favour domestic over foreign investments, thereby foregoing efficient portfolio diversification) (Ferguson, 2005) other than in Japan. This is said to have facilitated the financing of current account deficits in general and the US deficit in particular[40] (as

37. A number of possible explanations for this asymmetry present themselves (Ferguson, 2005). As mentioned above, a rise in expected future income, possibly caused by the productivity acceleration of the past decade and the associated increase in stock-market wealth, would be expected to reduce desired saving, as would the lower interest rates and greater housing wealth seen in recent years. While stock markets have risen largely in tandem around the world over the past decade, the US market is far larger in relation to its economy, and equities represent a greater share of US wealth than elsewhere. Structural factors, especially ongoing financial liberalisation, could be encouraging private agents to re-optimise their spending patterns, as previous constraints on the ability to borrow are overcome. However, there is little evidence that this process has been unique to the United States.

38. Hatzius (2005b) posits that the glut has been due to a shift in the global distribution of income from low- and middle-income workers in OECD countries to emerging markets, oil producers, high income workers and multinational corporations. The latter group have higher savings propensities, at least in the short run. He shows that there has been a tight correlation between the global saving rate and a rough and ready calculation of the share of global GDP accruing to production and non-supervisory workers in OECD countries. The latter share has fallen by more than 3 percentage points since 1999 at the same time as the global saving rate has risen by more than 2 percentage points.

39. IMF (2005) extend the hypothesis to include higher trade openness, greater global competition and the rapid expansion of international capital flows as capital controls were dismantled.

40. This additional willingness to invest abroad is more likely to be exploited for investments in the United States because of its culture of innovation, favourable investment climate, security, transparency, protection of investor and property rights, and high perceived rates of return (Greenspan, 2004 and

foreign investors move toward a full risk-adjusted weighting of US investments in their portfolios). Proponents claim that it will also cushion the process of their unwinding (Greenspan, 2004), something sceptics term "deceptively reassuring" (Obstfeld and Rogoff, 2005, p. 19)[41]. Other evidence in favour of a decline in home bias besides the persistence of current account deficits is provided by the apparent fall in the cross-country correlation of national savings and investment rates (Blanchard and Giavazzi, 2002; Helliwell, 2004) (Figure 5). To the extent that this and other fundamental and permanent changes in the world economy lie behind the widening of the deficit, then its correction would be less likely to be disorderly and the implications for US growth and inflation more likely benign (Ferguson, 2005). But eroding home bias, along with other explanations for the size and durability of the US deficit such as global co-dependency and differential ageing, all have natural stopping points (Gramlich, 2005). There remains a long-run national solvency constraint that is binding for all countries, not least the United States (Pelgrin and Schich, 2004).

The implications of the current account deficit for US policies

The appropriate lessons for macroeconomic policies

In a context of open and efficient capital markets and a freely floating exchange rate of the dollar there is no reason to take any specific policy action solely to try to bring down the external deficit. Indeed, policy action that would curb US growth in order to reduce the US deficit would damage both US outcomes and those of its trading partners. Rather, the question that needs to be posed is whether the deficit is at least in part the result of other US policy settings that themselves may be inappropriate. The key implication of the earlier discussion is that attention should focus on the dearth of saving, rather than on trying to deal directly with trade or capital flows themselves (such as, for example, through a 1970s-style import surcharge, as proposed by Godley *et al*. (2004) or passage of the proposed Foreign Debt Ceiling Act of 2005[42]). For increases in saving raise future living standards, either by financing productivity-boosting domestic investment or reducing international borrowing, thereby cutting future interest payments (Gramlich, 2005). The first place to look for higher saving is the government budget.

The role of budgetary policy in contributing to current account outcomes has long been recognised. Ever since the "twin deficits" of the 1980s observers have to varying degrees linked the two phenomena. A variant of that view sees the effect emanating more from government consumption than from the tax side (see, *e.g*. Faruquee *et al*., 2005); in addition, it has been shown that public consumption spending on final goods and services has a far larger effect on the external balance than its outlays in the form of wages and salaries, allegedly because the former stimulates output and private investment whereas the latter has a depressive impact (Cavallo, 2005).[43] A reduction in the US federal deficit will shrink the external deficit so long as it is not completely offset by other changes in private savings and investment

---

Ferguson, 2005). However, IMF (2005) suggests that the United States could have become a less attractive destination for foreign investors: securities markets abroad, especially in the euro area, have developed rapidly, increasing the scope for broader-based currency diversification.

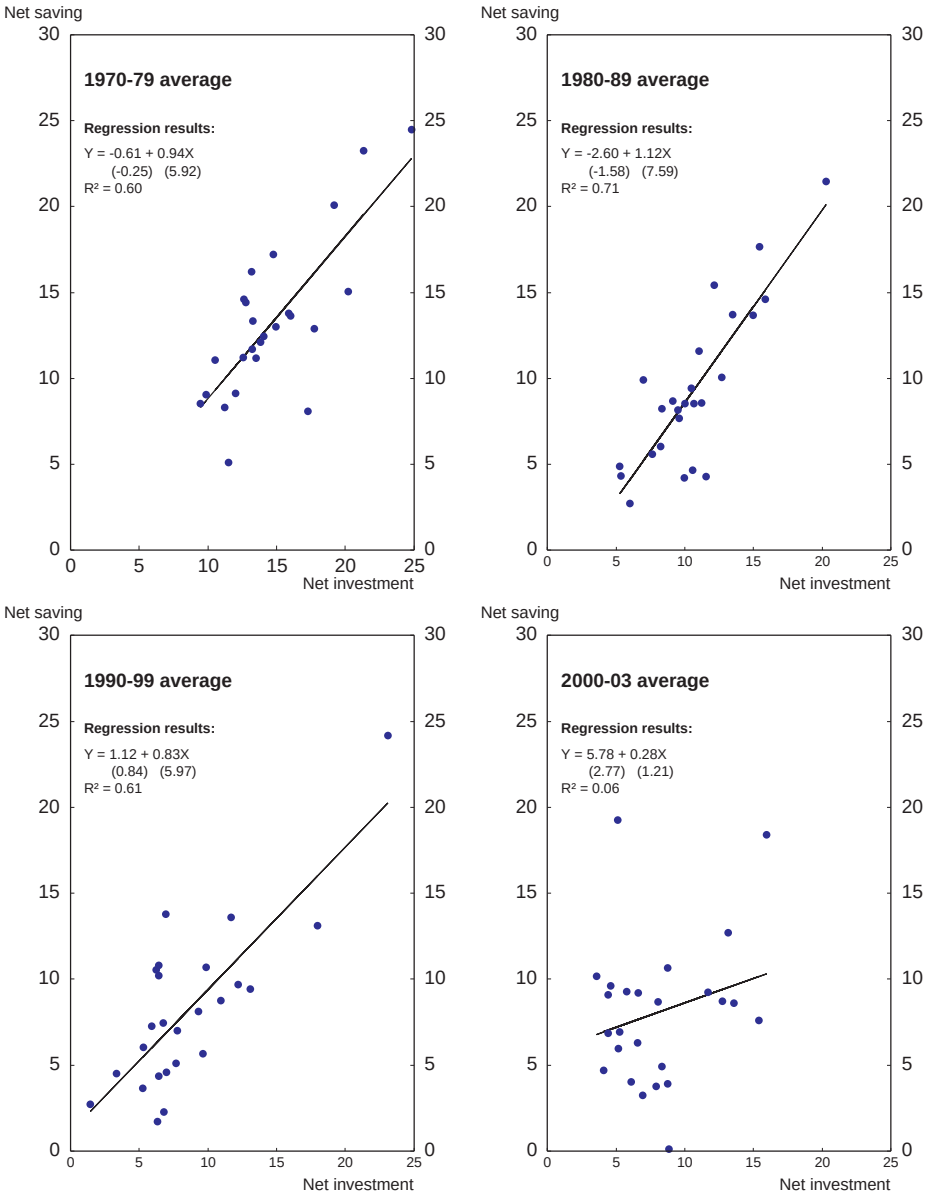
41. Their view is based on the argument that such integration raises counterparty risk and on the observation that ultimately it is goods markets that have to bear the adjustment burden and their integration has not kept pace.

42. In the event that either NIIP exceeds 25% of GDP or the deficit on goods and services was greater than 5% of GDP (both of which are now true), this legislation (US Congress, 2005) would require the US Trade Representative to convene an emergency meeting of the Trade Policy Review Group so as to develop a plan of action to reduce the trade deficit and then to report back to Congress on that plan.

43. However, an earlier article by Lane and Perotti (1998) had shown that the depressive effect on net and gross export volumes is larger for wages than non-wage consumption.

behaviour. However, the evidence is that most of the impact of budget deficit reduction will come through lower interest rates and expanded interest-sensitive domestic demand (and thus lower private saving): only 20-50% is the latest estimate for the effect of a rise in government consumption on the trade account over a two-to-three year horizon.[44] Yet budget consolidation does not substitute for dollar depreciation: the resulting lower interest rates will in fact help to bring about the decline in the dollar that will stimulate the extra net exports that are sought.

Figure 5. **The disappearance of the Feldstein-Horioka puzzle**
Percentage of GDP



Source: OECD Annual National Accounts database.

44. See Erceg *et al.* (2005) for the lower-bound estimate and Gale and Orszag (2004) for the upper limit. Others have found elasticities both greater and smaller than this range (and even of the opposite sign). Recent OECD work found an effect of about 40% (Brook *et al.*, 2004).

As to the appropriate role of the monetary authorities, Blanchard *et al.* (2005) conclude that tighter policy would be self-defeating, since by limiting depreciation in the short run it would increase it in the long run. They contend that it is a change in mix that is called for: tighter fiscal policy and looser monetary policy would assist in adjusting the current account by lowering the dollar while keeping the economy at full employment. Yet it is unclear if the need to crowd in net exports can be satisfied without overheating unless higher rates can be used to crowd out household spending. Truman (2005) controversially advocates the use of higher interest rates to slow the growth of aggregate demand relative to aggregate supply.

The Administration is aiming to cut the federal deficit in half by 2009 and also to raise private saving through educational and health savings accounts and to encourage retirement savings through private accounts as an optional partial carve-out from Social Security (see Chapter 2 of OECD (2005c)).[45] It is also attempting to make tax and social security reforms that would be pro-saving. In addition, it favours elimination of the estate tax, which might help reduce the incentive to consume all one's wealth before death. Finally, it is trying to boost growth at home and abroad (through, for example, the US-Japan Economic Partnership for Growth, the US-Brazil Group for Growth, the completion of the Doha Round and the Millennium Challenge Account).

Besides cutting the federal budget deficit, the most efficient way to raise national saving and shrink the external deficit is to remove the saving biases in the tax code. The most egregious case is the deductibility of mortgage interest, which provides a strong incentive to borrow, with experience showing that half the proceeds are spent on consumption, thereby boosting the trade deficit.[46] Eliminating this deductibility would not only broaden the tax base, allowing lower tax rates with all their attendant gains in efficiency (see Chapter 2 of OECD (2005c)), but it would also ease the shift towards net exports in spending and towards tradable goods and services in production that will ultimately be required.

The need for adjustments in the industrial structure

One of the most confident predictions resulting from economists' knowledge of adjustment patterns to external imbalances is that the share of tradable goods and services in production has to rise for the current account to improve.[47] It is the decline in the exchange rate of the dollar that would bring about this change in industrial structure. Historically, there is some evidence that the share of such tradables in US production[48] has responded to changes in relative prices brought about by the strength of the dollar[49],

45. However, the evidence on how much retirement savings through pension funds represents new savings is inconclusive (Bernheim, 2002).

46. In fact, a regression of the current account deficit just on the change in home mortgage debt using quarterly data from 1952 has a coefficient of determination of 0.5 (Greenspan, 2005).

47. However, relatively little empirical work has looked at this. Tilton (2005) showed that the likely biggest gainers would be a variety of machinery and equipment sectors, especially semiconductors and electronic components. Gourinchas (1999) found that a 1% appreciation of the real exchange rate in France destroyed 0.95% of tradable-sector jobs over a two-year horizon. Job creation was seen to be more responsive than destruction, especially in import-competing tradables. Depreciation episodes tend to lead to "chill", that is a simultaneous reduction in both creation and destruction, whose downside is an increase in the average age of physical capital.

48. One note of caution is that tradability is increasing over time: some services have become tradable thanks to the plunging price of telecommunications. See Chapter 5 for a discussion of such "offshoring". Perhaps in part for this reason the IMF (2005) estimates that the share of tradables in the US economy is 32%, as it was in the 1980s, though the OECD's STAN database used in Figure 4.6, with a fixed sectoral allocation, shows much lower numbers and a sharp fall. In level terms the order of magnitude used here is confirmed by Gourinchas' (1998) more careful analysis.

perhaps even more so than in other OECD countries, especially given its more limited openness to trade. This points out to the flexibility of its economy. However, the historical experience has been largely limited to dollar appreciation on a trade-weighted basis, and the question remains whether resources will flow as flexibly and smoothly toward tradables when the dollar falls as they have tended to flow away from that sector since the early 1980s. US manufacturing companies in particular have in recent decades suffered not only from the rising exchange rate but also from onerous retiree health and pension costs (so-called "legacy costs"), a chronic lack of skilled labour, in part due to the shortcomings of the compulsory education system, and a dysfunctional corporate tax system (Bivens *et al.*, 2003).

Complementary policy changes could support a tradables renaissance, although expanded specific support for manufacturing would be wrong-headed.[50] The imminent implementation of the Medicare prescription drug benefit will ease the burden of retiree health costs. But proposed changes in pension funding rules before Congress would tighten the requirements on employers so as to avoid underfunded defined-benefit plans being transferred to the public corporation that insures such benefits (see Chapter 2 of OECD (2005c)). Public initiatives to upgrade production worker skills would be appropriate, because they are under-provided by employers who cannot capture the resulting economic returns (see below). The corporate tax has become even less efficient over time and is in need of overhaul, if not outright replacement (see Chapter 2 of OECD (2005c)). Finally, more market opening by foreign governments in response to a successful completion of the Doha round would enhance the potential for more competitive US firms to break into or expand their presence in new markets abroad. In any case any further widening in the deficit will no doubt augment the risk of pressures to implement protectionist policies bearing fruit, which itself would make unwinding the deficit without negative side-effects on the welfare of US residents more difficult. A prime example would be the draft legislation to impose an across-the-board tariff on all Chinese imports if China refuses to increase the flexibility of its exchange rate.

The possible role of various other structural reforms in reducing external imbalances in a broad sample of OECD countries has recently been examined in Kennedy and Sløk (2005). While some research has found that some reforms in the labour market (lower tax wedges on earned income and weaker employment protection) seem to have a favourable impact on the current account when looked at in a foreign trade perspective (but not through either the capital flow or saving/investment lenses), their empirical work on 13 OECD countries over more than two decades yielded unsatisfactory results for various labour market variables. However, reforms in product market (a reduction in FDI restrictiveness and an index of product market regulations) and in financial markets (proxied by a higher ratio of stock market valuation to GDP) both have a negative impact on the current account. Overall, there is no basis for seeking favourable side-effects on the current account from these growth-enhancing structural reforms (OECD, 2005a, Box I.4): the obvious conclusion is that the fact that the United States has already adopted most of them long ago (see below) is one of the reasons for its present external imbalance. Yet the continued implementation of such reforms elsewhere may bolster economic performance in the rest of the world and contribute to unwinding the global pattern of external imbalances.

---

49. Gourinchas (1998) finds that a 10% real appreciation of the dollar leads after a three-quarter lag to a 0.44% increase in job destruction in the tradables sector and a 0.17% increase in job creation (resulting in increased "churn", as opposed to greater "chill" in the event of depreciation) for a net loss of 0.27% (mostly concentrated in import-competing sectors). The US industrial base has shrunk in response to what McKinnon (2001) calls the international monetary version of the Dutch disease.

50. The US government already spends around $0.7 billion per year for programmes related to manufacturing technology administered by the National Science Foundation and the National Institute of Standards and Technology, for example. Its large defence spending also contributes to manufacturing competitiveness.

Probably the sector that is the least tradable and the most likely to suffer from external adjustment brought about by dollar depreciation, whether accompanied by tighter monetary or budgetary policy, is housing investment (Tilton, 2005). Residential construction has been the greatest beneficiary of the overvaluation of the dollar, the low interest rate environment and the extremely generous terms on such investments offered by the personal tax code. The confluence of these supportive factors has resulted in a housing boom unmatched since the 1970s (see Chapter 1 of OECD (2005c)). Fortunately, *non-residential* construction would probably be stimulated by any dollar-induced adjustment, once cyclical effects wash out, since substantial capacity growth will be needed to lower the merchandise trade deficit beyond what can be achieved by shifting domestic to foreign demand for the same items and raising the utilisation of existing capacity (Tilton, 2005). This will be especially important for several types of infrastructure, most notably ports, where capacity constraints are fast becoming a problem: according to the US Chamber of Commerce, in 12 of 16 ports it recently studied capacity constraints will become a significant problem by 2010 (US Chamber of Commerce, 2003).

A wide range of other more micro evidence supports the conclusion that a high degree of flexibility has helped the US economy shift its industrial structure more smoothly than other OECD countries (Kongsrud and Wanner, 2005).[51] Most importantly, the labour market has a number of features that indicate rapid adjustment:

- long-term unemployment rates are low;
- outflow rates out of unemployment are high;
- job tenure is low;
- internal migration is high;
- employment protection is low;
- re-employment incentives are strong (replacement rates are low and sanctions are prevalent); and
- wage setting is flexible (union density and coverage are weak).

The result is that, according to Kongsrud and Wanner (2005), the United States has the best labour-market adjustment capacity in the OECD, though the cost of that flexibility is considerable insecurity for individual workers.[52] Furthermore, the ability of US labour markets to adjust to local or regional shocks seems to have increased noticeably over time, hinting that adjusting to sectoral shifts might not be as burdensome as in the past. The standard deviation of the 50 state unemployment rates has been on a clear downtrend over the past three decades. Even correcting for the fall in the aggregate unemployment rate by comparing two years with similar rates (1979 and 2002) shows a 25% decline in the standard deviation. Alternatively, using the coefficient of variation (that is, normalising by the national unemployment rate) also shows a similar-sized reduction, especially since the mid-1980s (Figure 6). In

51. Of course thus far that adjustment has been towards services, which are mainly non-tradable. The United States has the OECD's largest service sector measured by employment and third-largest by value added. Some but by no means all of that is explained by its higher real income *per capita*.

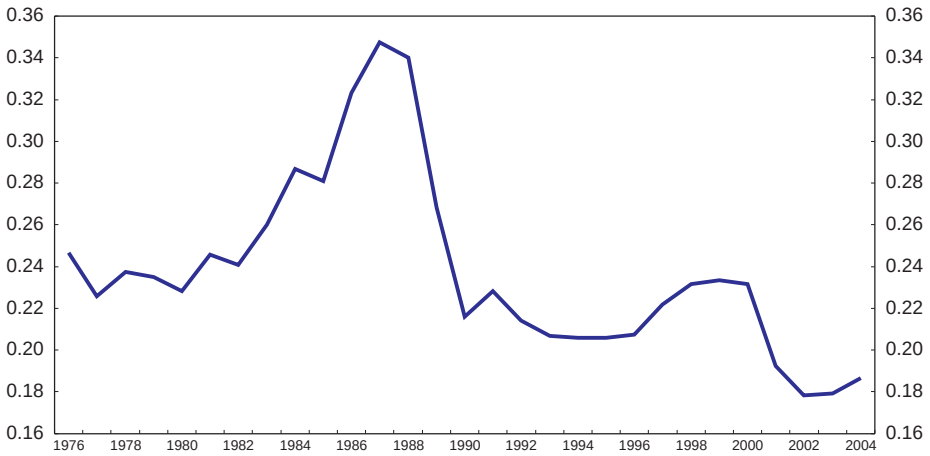
52. This contrast is illustrated by the fact that displaced workers find new jobs much faster than their European counterparts but are much more likely to experience pay cuts of 30% or more – see Chapter 1 of OECD (2005b). This might have deeper negative implications if it were to lead to increased support for protectionist policies.

addition, this flexible labour market adjustment mechanism enhances the efficacy of other macroeconomic channels of adjustment (Lane and Perotti, 1998).[53]

The United States also ranks very highly in terms of a number of product market indicators, which suggests easier adjustment. For example, its use of product market regulations with a view to retaining the benefits of market competition is amongst the best in the OECD (Conway *et al*., 2005), though it has important barriers to inward investment in some transport sectors.

However, there are a small number of areas that have important flexibility aspects where the United States does not rank highly and could definitely do better. The most important is in the sphere of education and training: the more the work force is equipped with human capital, especially in the form of general skills, the less difficult it will be for labour to shift between sectors.[54] Whereas for people in the 45-54 age cohort the nation is ranked number one for the share that have completed at least upper secondary education, turning to the following group of 25 to 34 year-olds, it is only slightly above average, implying a dwindling advantage compared to other OECD Members. While the volume of employer-sponsored education and training is also above average, it is far below the Nordic leaders. Little public support for training for the unemployed is also made available, despite the fact that wage losses resulting from displacement are greater than for other countries. And comparative international results on standardised tests for 15 year-olds do not show the United States in a particularly favourable light (OECD, 2004). Indeed, further ground appears to have been lost in recent years (Table 5). Increasing expenditure on active labour market policies, especially those designed to assist those displaced by increasing globalisation could be helpful in raising perceptions of job security, thereby heading off political pressures for protectionism (OECD, 2005b, Chapter 1).

Figure 6. **The dispersion of unemployment rates across the 50 states has fallen**
Coefficient of variation, annual average



Source: Bureau of Labor Statistics and OECD calculations.

53. They write: "The labour market adjustment mechanism relies on inter-sectoral mobility of labour, so labour market policies that promote the reallocation of workers across sectors maximise the trade balance improvement that can be achieved from a fiscal reform of a given magnitude".

54. The only other recommendation made to the United States in Kongsrud and Wanner (2005) is that it should ensure the portability of pension rights.

Table 5. **Results from PISA 2000 and 2003 for 15 year-olds**

	United States	Best performing country	OECD average
Mathematics/space and shape	472	553	496
PISA 2000	461	565	494
Mathematics/change and relationships	486	548	499
PISA 2000	486	536	488
Mathematics/quality	476	549	501
Mathematics/uncertainty	491	545	502
Mathematics/overall	483	544	500
PISA 2000	493	557	500
Reading	495	543	494
PISA 2000	504	534	500
Science	491	548	500
PISA 2000	499	552	500

Source: OECD (2004), Learning for Tomorrow's World: First Results from PISA 2003, Paris.

Another feature of US settings that might well hinder industrial restructuring is bankruptcy law. While the federal legislation has just gone through a reform this year, the changes made dealt largely with chapters relevant for personal bankruptcies. The motivation was to make it more difficult for individuals to write off all their debts. However, as many as 10 to 20% of such bankruptcies might actually involve small businesses, implying an enormous undercount of business failures (Lawless and Warren, 2005). This has led some observers to express concern that less credit will be available for start-ups, since so many entrepreneurs use credit card debt to finance their ventures at the outset. But the issue here is with Chapter 11 of the bankruptcy law, which provides firms with protection from creditors while they reorganise. Though it is obviously a good thing that companies in difficulty are not forced immediately into liquidation (under Chapter 7 of the law), there is a legitimate question whether the US system is too slow, costly and generous to debtors, especially their managers, mainly as opposed to employees and suppliers. It may be biased in favour of allowing petitioners to continue to operate beyond the point when the most efficient outcome would be liquidation so that the resources they have tied up would usefully be released for other uses and industry capacity would shift (White, 1994). This conclusion is supported by the observation that few companies that file for Chapter 11 ever emerge and, of those that do, a high proportion go through another financial restructuring within a few years (Hotchkiss, 1995). Overall, only about 7% of filers ever emerge and go on to become thriving concerns (Murray, 2004). Performance is especially sub-standard in the very courts where the largest firms tend to file: New York and Delaware (LoPucki and Doherty, 2002). The most obvious example of a sector that has used Chapter 11 to avoid downsizing is airlines.

Several alternatives to the bargaining-based approach involved in Chapter 11 have been proposed. One is based on an auction of the company so as to separate what should be done with the assets from how to divide the firm's value (one of the inherent weaknesses of Chapter 11); another is based on options (Bebchuk, 1998). The (unsecured) debt could be converted to equity, and then the new owners could decide whether to liquidate or not (Hart, 1999). Or changes could be made to move toward the Canadian reorganisation system, since firms exiting from it are much more likely to survive than their US counterparts (Fisher and Martel, 1996). Other less-radical but beneficial reforms would include limiting

the maximum time spent in Chapter 11: at least the 2005 reform limits the time during which managers have the sole right to propose a restructuring plan.

Finally, while it remains a lesser offender than many other Member countries, the United States does engage in substantial government support to agriculture. By holding resources within the sector it prevents them shifting to other areas where their export prospects are more promising, even without a hypothetical free trade environment. The most obvious examples are sugar and cotton.

The burden of adjusting the industrial structure is therefore likely to be less onerous than had US markets and institutions been less flexible. The more mobile are its production factors (and the longer the time they have to relocate), the smaller will be the required change in the real exchange rate (Obstfeld and Rogoff, 2005).[55] Adjustment may also be facilitated if the range of goods exported broadens (Gagnon, 2004). It is therefore incumbent on US policymakers to examine all aspects of their economic policies so as to ensure they do not encumber the process of adjustment, whenever it gets under way in earnest.

Some concluding comments

It has been argued that the US current account has almost certainly reached an unsustainable level, even though it looks set to continue to grow in the next few years. Merely arresting its upward trend will require several changes in the behaviour of both market participants and policymakers. However, no specific policies aimed solely at reining in the deficit are recommended. Rather, the government's focus should be on looking at all its policy settings with a view to ensuring there are no anti-saving biases and that nothing is limiting smooth inter-sectoral resource shifts. More detailed recommendations are given in Box 2.

Box 2. **Summary of recommendations emanating from considering the current account deficit**

- There is no reason to seek out policies that would be aimed solely at bringing down the external deficit.
- The proper way to approach the imbalance from a macroeconomic policy point of view is to focus on ensuring that nothing is being done to discourage saving. That implies that the federal government should take whatever steps are necessary to *curb the budget deficit*, even if the benefits in terms of national saving and the current account may be modest. Such a policy is prudent in its own right (see Chapter 2 of OECD (2005c)).
- The well-known *anti-savings biases in the tax code should be removed*. Shifting the personal income tax further to a consumption base can also be justified by the predicted efficiency gains that would ensue. But to ensure an improvement in the government balance this should be done preferably by implementing a VAT, rather than by increasing the proliferation of savings incentives. Similarly, the tax base should be broadened to include mortgage interest payments and fringe benefits, especially health insurance premiums (see Chapter 2 of OECD (2005c)). The perceived government guarantee of the mortgage-backed securities issued by the large government-sponsored enterprises has also contributed to excessively low mortgage rates and undue amounts of residential investment. Making such investments less attractive should allow the nation to use its scarce capital more efficiently and facilitate the downsizing of this pre-eminent non-tradable sector.
- *The dollar should continue to be allowed to respond flexibly to market forces.* In the current context of open financial markets it will always move to accommodate differences in desired trade and capital flows and savings/investment imbalances. Ultimately, it looks likely to have to decline, but the timing of that move is not easily predictable.

55. Obstfeld and Rogoff (2005) show that in a three-country model if substitution elasticities are raised to the point that the adjustment horizon is 10 to 12 years, rather than one to two, the dollar's equilibrium decline against the euro, for example, is reduced by 77%.

- At the microeconomic level the most important consideration is to *retain the economy's outstanding degree of flexibility* so as not to encumber the inevitable shift in the industrial structure towards tradable goods and services. Increased protectionism is the number one risk to that smooth restructuring.

- Labour resources would be better equipped to handle the geographic and industrial moves if *workers were better supplied with human capital*. The United States used to be a leader in average educational attainment levels, but several other countries have passed it by in recent years, and the compulsory education system has been underperforming for some time and may be falling further behind. At a minimum the federal government needs to remove any doubts that its No Child Left Behind initiative is fully funded (see Chapter 3 of OECD (2005c)). But the availability of high-quality training programmes to the unemployed and especially those displaced by expanded trade should also be improved (see Chapter 5 of OECD (2005c)).

- Resources are probably being held for too long in existing uses by the *excessive support provided to the agriculture sector* and by *the inefficiencies of the bankruptcy law*. Chapter 11 of the bankruptcy code is slow, costly and biased against liquidation. Too few filers ultimately return to the path of success. The recent overhaul focused only on aspects thought to influence personal bankruptcies, but a large number of entrepreneurs may have been caught inadvertently and find their access to credit curtailed in the future.

- The tradable sector would benefit from a number of other measures. Obviously, exporters need to be assured that the basic infrastructure for trade will be available: *port capacity needs upgrading*, as it looks already insufficient in a number of places, and the situation is predicted to worsen. Firms also need to be able to count on expanding markets abroad; hence, *a successful completion to the Doha Round is crucial.*

Bibliography

Adalet, M. and B. Eichengreen (2005), "Current Account Reversals: Always a Problem?", xerox, June.

Al-Eyd, A. (2005), "Correcting US Imbalances", *National Institute Economic Review*, No. 192, April.

Bebchuck, L.A. (1998), "Chapter 11", *NBER Working Paper No. 6473*, March, published in *The New Palgrave Dictionary of Economics and the Law*, Macmillan, 1998.

Bernanke, B.S. (2005), "The Global Saving Glut and the U.S. Current Account Deficit", Sandridge Lecture, Virginia Association of Economics, Richmond, 10 March.

Bernheim, D. (2002), "Taxation and Saving", in A. Auerbach and M. Feldstein (eds.), *Handbook of Public Economics*, Vol. 3, Elsevier Science, Amsterdam.

Bivens, J. *et al*. (2003), "Mending Manufacturing", *Economic Policy Institute Briefing Paper*.

Blanchard, O. and F. Giavazzi (2002), "Current Account Deficits in the Euro Area: The End of the Feldstein-Horioka Puzzle", *MIT Economics Department Working Paper No. 03-05*, September.

Blanchard, O. *et al*. (2005), "The U.S. Current Account and the Dollar", *NBER Working Paper No. 11137*, February.

Bordo, M.D. (2005), "Historical Perspective on Global Imbalances", *NBER Working Paper No. 11383*, May.

Brook, A.-M. *et al*. (2004), "Channels for Narrowing the US Current Account Deficit and Implications for Other Economies", *OECD Economics Department Working Paper No. 390*, May.

Brown, B. (2005), "Dollar Focus", Mitsubishi Securities International, 14 February.

Caballero, R.J. and S. Panageas (2005), "A Quantitative Model of Sudden Stops and External Liquidity management", *NBER Working Paper No. 11293*, May.

Caballero, R.J. *et al.* (2005), "An Equilibrium Model of 'Global Imbalances' and Low Interest Rates", unpublished paper, 12 October.

Calvo, G.A. *et al*. (2004) "On the Empirics of Sudden Stops: The Relevance of Balance Sheet Effects", *NBER Working Paper No. 10520*, May.

Campa, J.M. and L.S. Goldberg (2004), "Exchange Rate Pass-Through Into Import Prices", *CEPR Discussion Paper 4391*, May.

Cavallo, M. (2005), "Government Consumption Expenditures and the Current Account, *Federal Reserve Bank of San Francisco Working Paper 2005-03*, February.

Chinn, M. (2005), "Doomed to Deficits? Aggregate U.S. Trade Flows Re-examined", *Review of World Economics*, forthcoming.

Chinn, M. and J. Frankel (2005), "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currrency?", xerox, 6 June.

Clarida, R.H. *et al.* (2005), "Are There Thresholds of Current Account Adjustment in the G7?", xerox, 9 May.

Conway, P. *et al*. (2005), "Product Market Regulation in OECD Countries: 1998 to 2003", *OECD Economics Department Working Paper No. 419*, February.

Cooper, R.N. (2001), "Is the U.S. Current Account Deficit Sustainable? Will it be Sustained?", *Brookings Papers in Economic Activity*, 2001:1.

Cooper, R.N. (2004), "How Big is the Hole in the Economy?", *Financial Times*, 1 November.

Cotis, J-P. *et al.* (2004), "Is the US Prone to 'Over-Consumption'?", unpublished paper presented to the Federal Reserve Bank of Boston Economic Conference on "The Macroeconomics of Fiscal Policy", Chatham, Massachusetts, 14-16 June.

Croke, H. *et al*. (2005), "Financial Market Developments and Economic Activity During Current Account Adjustments in Industrial Economies", Board of Governors of the Federal Reserve System, *International Finance Discussion Paper No. 827*, February.

Debelle, G. and G. Galati (2005), "Current Account Adjustment and Capital Flows", *Bank for International Settlements Working Paper No. 169*, February.

De Mello, L. (2004), "Saving Behaviour and the Effectiveness of Fiscal Policy", *OECD Economics Department Working Paper No. 397*, July.

Domeij, D. and M. Flodén (2004), "Population Ageing and International Capital Flows", *CEPR Discussion Paper No. 4644*, September.

Dooley, M.P. *et al*. (2003), "An Essay on the Revived Bretton Woods System", *NBER Working Paper No. 9971*, September.

Edwards, S. (2004), "Thirty Years of Current Account Imbalances, Current Account Reversals, and Sudden Stops", *IMF Staff Papers*, Vol. 51, Special Issue, June.

Edwards, S. (2005a), "Is the U.S. Current Account Deficit Sustainable? And If Not, How Costly is Adjustment Likely To Be?", draft paper prepared for the Spring 2005 meeting of the Brookings Panel on Economic Activity, 16 March.Edwards, S. (2005b), "The End of Large Current Account Deficits", xerox, 27 July.

Eichengreen, B. (2004), "Global Imbalances and the Lessons of Bretton Woods", *NBER Working Paper No. 10497*, May.

Erceg, C.J. *et al*. (2005), "Expansionary Fiscal Shocks and the Trade Deficit", Board of Governors of the Federal Reserve System, *International Finance Discussion Paper No. 825*, January.

Faruquee, H. *et al.* (2005), "Current Accounts and Global Rebalancing in a Multi-Country Simulation Model", xerox, May.

Ferguson, R.W., Junior (2005), "U.S. Current Account Deficit: Causes and Consequences", Remarks to the Economics Club of the University of North Carolina at Chapel Hill, 20 April.

Feroli, M. (2003), "Capital Flows Among the G7 Nations: A Demographic Perspective", Board of Governors of the Federal Reserve System, *Finance and Economics Discussion Paper No. 2003-54*, October.

Fisher, T.C.G. and J. Martel (1996), "Should We Abolish Chapter 11? Evidence From Canada", *CIRANO Working Paper 96s-22*, Montreal, August.

Freund, C. and F. Warnock (2005), "Current Account Deficits in Industrial Countries: The Bigger They Are, The Harder They Fall?", xerox, 2 May.

Gagnon, J.E. (2004), "Growth-Led Exports: Is Variety the Spice of Trade?", Board of Governors of the Federal Reserve System, *International Finance Discussion Paper No. 822*, November.

Gale, W.G. and P.R. Orszag (2004), "Budget Deficits, National Saving, and Interest rates", *Brookings Papers on Economic Activity*, 2004:2.

Godley, W. and A. Izurieta (2004), "The US Economy: Weaknesses of the Strong Recovery", *BNL Quarterly Review*, No. 229, June.

Godley, W. *et al*. (2005), "Prospects and Policies for the U.S. Economy: Why Net Exports Must Now Be the Motor for U.S. Growth", Levy Economics Institute of Bard College and Cambridge Endowment for Research in Finance, August.

Gourinchas, P.-O. (1998), "Exchange Rates and Jobs: What Do We Learn From Job Flows?", in B.S. Bernanke and J.J. Rotemberg (eds.), *NBER Macroeconomics Annual 1998*, MIT Press, Cambridge and London.

Gourinchas, P.-O. (1999), "Exchange Rates Do Matter: French Job Reallocation and Exchange Rate Turbulence, 1984-1992", *European Economic Review*, Vol. 43.

Gourinchas, P.-O. and H. Rey (2005a), "International Financial Adjustment", *CEPR Discussion Paper No. 4923*, February.

Gourinchas, P.-O. and H. Rey (2005b), "From World Banker to World Venture Capitalist: US External Adjustment and the Exorbitant Privilege", *NBER Working Paper No. 11563*, August

Gramlich, E.M. (2004), "Budget and Trade Deficits: Linked, Both Worrisome in the Long Run, But Not Twins", Isenberg School of Management Seminar Series, Amherst, Massachusetts, 14 May.

Gramlich, E.M. (2005), "The Importance of Raising National Saving", Benjamin Rush Lecture, Dickinson College, 2 March.

Greenspan, A. (2004), "The Evolving U.S. Payments Imbalance and its Impact on Europe and the Rest of the World", *Cato Journal*, Vol. 24, No. 1-2, Spring/Summer.

Greenspan, A. (2005), "Current Account", Remarks at Advancing Enterprise 2005 Conference, London, 4 February.

Gruber, J.W. and S.B. Kamin (2005), "Explaining the Global Pattern of Current Account Imbalances", Board of Governors of the Federal Reserve System, *International Finance Discussion Paper No. 846*, November.

Hart, O. (1999), "Different Approaches to Bankruptcy", xerox, International Insolvency Institute, November.

Hatzius, J. (2005a), "America's Short Dollar Position", *US Economics Analyst*, Goldman Sachs Economic Research, 05/18, 6 May.

Hatzius, J. (2005b), "Income Redistribution Depresses Real Rates", *US Economics Analyst*, Goldman Sachs Economic Research, 05/24, 17 June.

Hausmann, R. and F. Sturzenegger (2005), "U.S. and Global Imbalances: Can Dark Matter Prevent a Big Bang?", unpublished working paper, Harvard Center for International Development, 13 November.

Hayford, M. (2005), "Fiscal Policy and National Saving", *Applied Economics*, Vol. 37.

Helliwell, J.F. (2004), "Demographic Changes and International Factor Mobility", *NBER Working Paper No. 10945*, December.

Higgins, M. and T. Klitgaard (2004), "Reserve Accumulation: Implications for Global Capital Flows and Financial Markets", *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, Vol. 10, No. 10, September/October.

Hooper, P. *et al*. (2000), *Trade Elasticities for G-7 Countries*, Princeton Studies in International Economics No. 87, August.

Hotchkiss, E.S. (1995), "Post-bankruptcy Performance and Management Turnover", *Journal of Finance*, Vol. 50, No. 1, March.

Hung, J.H. (2005), "Recent Shifts in Financing the U.S. Current-Account Deficit", *Economic and Budget Issue Brief*, Congressional Budget Office, 12 July.

Hung, J.H. and A. Mascaro (2005), "Why Does U.S. Investment Abroad Earn Higher Returns Than Foreign Investment in the United States?", *Economic and Budget Issue Brief*,Congressional Budget Office, 30 November.

Hunt, B. and A. Rebucci (2003), "The U.S. Dollar and the Trade Deficit: What Accounts for the Late 1990s?", *IMF Working Paper No. WP/03/194*, October.

IMF (2005), "Globalization and External Imbalances", *World Economic Outlook*, Chapter 3, April.

Kennedy, M. and T. Sløk (2005), "Structural Policy Reforms and External Imbalances", *OECD Economics Department Working Paper No. 415*, January.

Kongsrud, P.-M. and I. Wanner (2005), "" The Impact of Structural Policies on Trade-Related Adjustment and the Shift to Services", *OECD Economics Department Working Paper No. 427*, April.

Lane, P.R. and R. Perotti (1998), "The Trade Balance and Fiscal Policy in the OECD", *European Economic Review*, Vol. 42.

Lane, P.R. and G.M. Milesi-Ferretti (2005a), "Financial Globalization and Exchange Rates", *IMF Working Paper No. WP/05/3*, January.

Lane, P.R. and G.M. Milesi-Ferretti (2005b), "A Global Perspective on External Positions", xerox, 20 May.

Laubach, T. (2003), "New Evidence on the Interest Rate Effects of Budget Deficits and Debt", Board of Governors of the Federal Reserve System, *Finance and Economics Discussion Paper No. 2003-12*, April.

Lawless, R.M. and E. Warren (2005), "The Myth of the Disappearing Business Bankruptcy", *California Law Review*, Vol. 93, forthcoming.

Llewellyn, J. and R. Subbaraman (2005), "Low Risk Continues", Global Letter, *Global Weekly Economic Monitor*, Lehman Brothers, 20 May.

LoPucki, L.M. and J.W. Doherty (2002), "Why are Delaware and New York Reorganizations Failing?", *Vanderbilt Law Review*, Vol. 55, No. 6, November.

Lührmann, M. (2003), "Demographic Change, Foresight and International Capital Flows", MEA (University of Mannheim Economic Research Institute), November.

Mann, C.L. (2002), "Perspectives on the U.S. Current Account Deficit", *Journal of Economic Perspectives*, Vol. 16, No. 3, Summer.

Mann, C.L. (2004), "Managing Exchange Rates; Achievement of Global Re-balancing or Evidence of Global Co-dependency", *Business Economics*, July.

Mann, C.L. and K. Pluck (2005), "The US Trade Deficit: A Disaggregated Perspective", *Institute for International Economics Working Paper 05-11*, September.

Matsubayashi, Y. (2005), "Are US Current Accounts Unsustainable? Testing for the Private and Government Budget Constraints", *Japan and the World Economy*, Vol. 17.

McKinnon, R.I. (2001), "The International Dollar Standard and the Sustainability of the US Current Account Deficit", *Brookings Papers in Economic Activity*, 2001:1.

Murray, J.C. (2004), "Bankruptcy Facts: 2004", *John C Murray Reference Library*, The First American Corporation.

Obstfeld, M. and K. Rogoff (2004), "The Unsustainable US Current Account Position Revisited", *NBER Working Paper No. 10869*, October, revised 28 April 2005.

Obstfeld, M. and K. Rogoff (2005), "Global Current Account Imbalances and Exchange Rate Adjustments", xerox, 16 May.

OECD (2004), *Learning for Tomorrow's World: First Results from PISA 2003*, Paris.

OECD (2005a), *Economic Outlook No. 77*, Paris, June.

OECD (2005b), *Employment Outlook*, Paris, June.

OECD (2005c), *Economic Surveys: United States*, Paris, October.

Pelgrin, F. and S. Schich (2004), "National Saving-Investment Dynamics and International Capital Mobility", *Working Paper 2004-14*, Bank of Canada, Ottawa, April.

Roubini, N. and B. Setser (2004), "The US as a Net Debtor: The Sustainability of the US External Imbalances", xerox, November.

Roubini, N. and B. Setser (2005), "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006", xerox, February.

Shin, J. (2005), "Current account debt", *Global Weekly Economic Monitor*, Lehman Brothers, 15 July.Summers, L.H. (2004), "The U.S. Current Account Deficit and the Global Economy", 2004 Per Jacobsson Lecture, 3 October.

Taylor, J.B. (2004), "The U.S. Current Account: Recent Trends and Policies", Keynote Address to the AEI Conference on Policy Challenges of Global Payment Imbalances, 4 November.

Tille, C. *et al.* (2001), "To What Extent Does Productivity Drive the Dollar?", *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, Vol. 7, No. 8, August.

Tilton, A. (2005), "Who Will Benefit From Trade Improvement?", *US Economics Analyst*, Goldman Sachs Economic Research, 05/03, 21 January.

Truman, E.M. (2005), "Postponing Global Adjustment: An Analysis of the Pending Adjustment of Global Imbalances", *Institute for International Economics Working Paper 05-6*, July.

US Chamber of Commerce (2003), "Trade and Transportation: A Study of North American Port and Intermodal Systems", March.

US Congress (2005), "A Bill to Require Congress to Impose Limits on United States Foreign Debt", S. 355, 10 February.

Ventura, J. (2001), "A Portfolio View of the U.S. Current Account Deficit", *Brookings Papers in Economic Activity*, 2001:1.

Warnock, F.E. and V.C. Warnock (2005), "International Capital Flows and U.S. Interest Rates", Board of Governors of the Federal Reserve System, *International Finance Discussion Paper Number 840*, September.

White, M.J. (1994), "Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-of-court Debt Restructurings", *Journal of Law, Economics and Organization*, Vol. 10, No. 2, October.

Wolf, M. (2004), "Why America is Switching to a Weak Dollar Policy", *Financial Times*, 1 December.

Wu, T. (2005), "The Long-term Interest Rate Conundrum: Not Unravelled Yet?", *Economic Letter*, Federal Reserve Bank of San Francisco, 2005-08, 29 April.

WORKING PAPERS

The full series of Economics Department Working Papers can be consulted at www.oecd.org/eco/Working_Papers/

466. Is there a case for sophisticated balanced-budget rules?
(December 2005) Antonio Fatás

465. *Fiscal rules for sub-central governments design and impact*
(December 2005) Douglas Sutherland, Robert Price and Isabelle Joumard

464. *Assessing the robustness of demographic projections in OECD countries*
(December 2005) Frédéric Gonand

463. *The Benefits of Liberalising Product Markets and Reducing Barriers to International Trade and Investment in the OECD*
(December 2005)

462. *Fiscal relations across levels of government in the United States*
(November 2005) Thomas Laubach

461. *Assessing the value of indicators of underlying inflation for monetary policy*
(November 2005) Pietro Catte and Torsten Sløk.

460. *Regulation and economic performance: product market reforms and productivity in the OECD*
(November 2005) Giuseppe Nicoletti and Stefano Scarpetta.

459. *Innovation in the Business Sector*
(November 2005) Florence Jaumotte and Nigel Pain

458. *From Innovation Development to Implementation: Evidence from the Community Innovation Survey*
(November 2005) Florence Jaumotte and Nigel Pain

457. *From Ideas to Development: the Determination of R&D and Patenting*
(November 2005) Florence Jaumotte and Nigel Pain

456. *An Overview of Public Policies to Support Innovation*
(November 2005) Florence Jaumotte and Nigel Pain

455. *Strengthening Regulation in Chile: The Case of Network Industries*
(November 2005) Alexander Galetovic and Luiz de Mello

454. *Fostering Innovation in Chile*
(November 2005) José-Miguel Benavente, Luiz de Mello and Nanno Mulder

453. *Getting the most out of public sector decentralisation in Mexico*
(October 2005) Isabelle Joumard

452. *Raising Greece's Potential Output Growth*
(October 2005) Vassiliki Koutsogeorgopoulou and Helmut Ziegelschmidt

451. *Product Market Competition and Economic Performance in Australia*
(October 2005) Helmut Ziegelschmidt, Vassiliki Koutsogeorgopoulou, Simen Bjornerud and Michael Wise

450. *House Prices and Inflation in the Euro Area*
(October 2005) Boris Cournède

449. *The EU's Single Market: At Your Service?*
(October 2005) Line Vogt

448. *Slovakia's introduction of a flat tax as part of wider economic reforms*
(October 2005) Anne-Marie Brook and Willi Leibfritz

447. *The Education Challenge in Mexico: Delivering Good Quality Education to All*
(October 2005) Stéphanie Guichard

446. *In Search of Efficiency: Improving Health Care in Hungary*
(October 2005) Alessandro Goglio

445. *Hungarian Innovation Policy: What's the Best Way Forward?*
(October 2005) Philip Hemmings

444. *The Challenges of EMU Accession Faced by Catch-Up Countries: A Slovak Republic Case Study*
(September 2005) Anne-Marie Brook

443. *Getting better value for money from Sweden's healthcare system*
(September 2005) David Rae

442. *How to reduce sickness absences in Sweden: lessons from international experience*
(September 2005) David Rae

441. *The Labour Market Impact of Rapid Ageing of Government Employees: Some Illustrative Scenarios*
(September 2005) Jens Høj and Sylvie Toly

440. *The New OECD International Trade Model*
(August 2005) Nigel Pain, Annabelle Mourougane, Franck Sédillot and Laurence Le Fouler

439. *The French Tax system: Main characteristics, recent developments and some considerations for reform*
(July 2005) Willi Leibfritz and Paul O'Brien

438. *The Effects of EMU on Structural Reforms in Labour and Product Markets*
(July 2005) Romain Duval and Jørgen Elmeskov

437. *Product Market Competition andEconomic Performance in New Zealand*
(July 2005) Annabelle Mourougane and Michael Wise

436. *Getting the Most out of Public Sector Decentralisation in Spain*
(July 2005) Isabelle Joumard and Claude Giorno

435. *Sources of Inflation Persistence in the Euro Area*
(July 2005) Boris Cournède, Alexandra Janovskaia, Paul van den Noord

434. *Measuring Cyclically-Adjusted Budget Balances for OECD Countries*
(July 2005) Nathalie Girouard and Christophe André

433. *Product Market Competition and Economic Performance in the United Kingdom*
(June 2005) Maria Maher and Michael Wise

432. *The Benefits of Liberalising Product Markets and Reducing Barriers to International Trade and Investment: the Case of the United States and the European Union*
(June 2005)