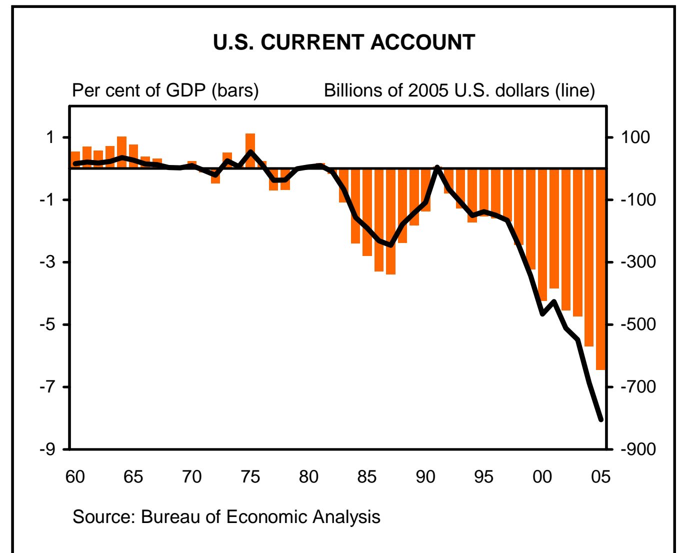
THE U.S. CURRENT ACCOUNT DEFICIT: NOTHING TO FEAR BUT FEAR ITSELF

Executive Summary

Just as a fast-growing business can finance its expansion through debt, so too can a fast-growing economy. The massive U.S. current account deficit (CAD) embodies this notion, as Americans have been borrowing from abroad to finance consumer and government spending. However, have American borrowing habits gone too far in mortgaging the future not to increase potential growth, but rather for one last hurrah today? The U.S. CAD now stands at a staggering 7 per cent of GDP. As a share of the economy, it has grown larger nearly every year for the last 15 years, implying a growing American dependence on foreign lending. Moreover, after running a CAD for nearly a quarter century, the U.S. has accumulated a stockpile of debt and increasingly larger debt service burden. Sustainability of the status quo, therefore, centers on whether foreign financing will dry up and whether the U.S. economy will ultimately buckle beneath its mounting debt. Both are unlikely.

Rather than the doom and gloom scenarios that have been floated, there are good reasons to expect the CAD will not prove cataclysmic. TD Economics' forecast is for the U.S. CAD to level off this year and only edge down below seven per cent of GDP by 2007. In the near-term, sources of international financing appear stable and the impact of the weaker U.S. dollar on trade will only take effect with a lag. As international investor sentiment remains measured, further U.S. dollar depreciation and a slowdown in the U.S. economy will drive higher U.S. savings, more competitive U.S. exports, and more expensive imports into the U.S. This will allow the CAD to mellow out gradually over time and return to a sustainable level of one to two per cent of GDP. In that range, the growth of the U.S. economy will be sufficient to prevent any new net accumulation of external debt.

This gradual deflation of the CAD will also allow time for other factors attracting foreign financing to the U.S. to adjust. The stratospheric ascent of property values in recent years has led U.S. consumers to borrow cheaply against the value of their homes. By financing debt con-



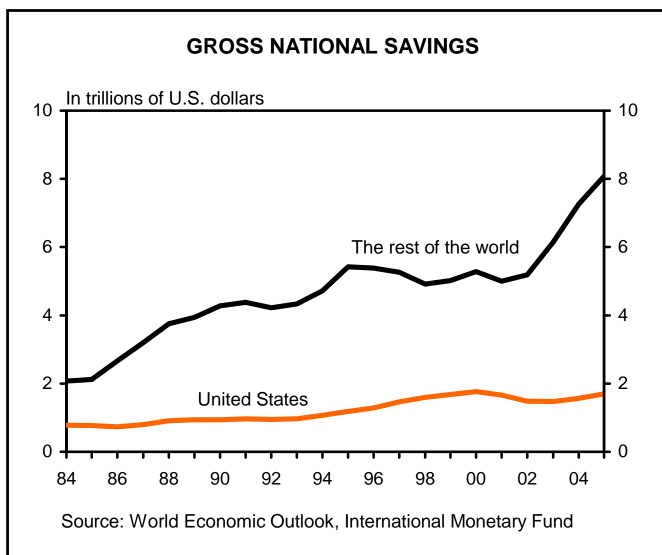
solidation, home improvement, and other spending in this way, U.S. consumers have reduced their savings and left foreigners to fill investment opportunities in the U.S. Also, while its impact is debated, the Bush administration's desire to cut taxes in the midst of rising government spending has worsened the U.S. government's fiscal position and raised its dependence on foreign investors. Internationally, aging populations and robust growth have increased the amount of savings available. In many emerging markets, slow growth in domestic investment opportunities and fledgling financial systems incapable of handling this savings glut has driven these funds overseas.

In general, there have been two key types of foreign investors willing to finance the U.S. deficit. The first are foreign central banks in export-dependent economies, especially those in Asia. By purchasing large amounts of Treasury bills, central banks in these countries have been able to keep their export prices low by minimizing pressure on their currencies to rise in value. The second are oil exporters. While high oil prices imply even more U.S. imports and therefore a larger CAD, they also mean more profits in oil exporting nations that need to be invested. These symbiotic relationships imply the risks of foreign

flight may be more benign than otherwise suspected. If exporters divert their financing, their currencies will appreciate relative to the U.S. dollar, their exports will become more expensive, and U.S. consumers will chose cheaper products causing the U.S. CAD to contract. Similarly, to the extent oil prices vary, changes in the U.S. import bill will be mirrored by changes in the amount of financing looking for a home. These relationships, therefore, imply financing of the U.S. CAD is sustainable for the near future.

Further supporting the CAD's sustainability, the U.S. has continued to earn more on its foreign investments than it pays to foreigners for their U.S. holdings. Some have falsely taken this as evidence the U.S. is not a net debtor and that the CAD is nothing to fear. Rather, this is evidence that while a falling U.S. dollar may be less likely to spark an emerging market-style financial crisis – with a cheaper dollar reducing the cost to the U.S. of servicing its debt rather than increasing it – the U.S. is nonetheless still beholden to foreign creditors. Nor can globalized production and the trade within multinational corporations mitigate the fact that a CAD requires willing foreign investors.

What is more, just because the relationships currently supporting the U.S. CAD are self-reinforcing does not imply they are fool-proof. There is no guarantee political considerations will not trump economic well-being and increase protectionist sentiments or foreign reluctance going forward. This was most recently demonstrated by security concerns raised by the U.S. Congress over foreign control of domestic ports. These restrictions may limit the rate of return foreign investors can realize in the U.S. and drive them to more lucrative markets abroad.



Inflows of financing to the U.S. have also been partly responsible for the rise in U.S. asset prices in recent years. To the extent investors may wake up one morning and decide these increases are not fundamentally sound, sharp corrections are possible. A fall in housing prices – or even a substantially slower rate of growth than the double-digits experienced in the last few years – risks not only reducing the portfolio wealth of a large slice of America, but spilling over into rising personal bankruptcies and slowing consumer spending. Moreover, a significant sell-off of government Treasury Bills would run the risk of suddenly driving U.S. interest rates higher and putting the emergency brake on the U.S. economy. While these unlikely scenarios may serve to reduce the U.S. CAD, they would come at significant costs to the economy at large.

In the end, foreign indebtedness always comes with some risk. To the extent the U.S. remains copasetic with increasing foreign ownership of its assets, the U.S. CAD can be sustained. To the extent foreign investors continue to be happy with their investments' returns, the U.S. CAD can be sustained. To the extent everyone is happy with circular logic, the U.S. CAD will be sustainable for as long as it can be sustained. Unfortunately, economic fundamentals suggesting the U.S. CAD is not a present danger can sometimes take a back seat to panic and fear of being the last man at the table left holding the bill. The sheer magnitude of the financing needed represents a substantial share of global savings and therefore heightens this concern. Just as consumers were shown during the Great Depression – and have been reminded in countless emerging markets over the last decade – once fear takes hold of an economy, it can exacerbate an otherwise innocuous blemish and prove protracted and costly to overcome.

Richard Kelly, Economist
416-982-2559