

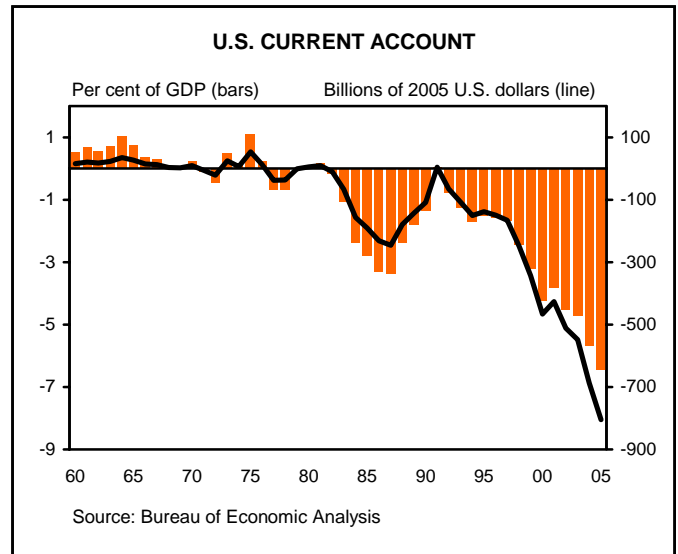
# THE U.S. CURRENT ACCOUNT DEFICIT: NOTHING TO FEAR BUT FEAR ITSELF

## 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 choose 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.

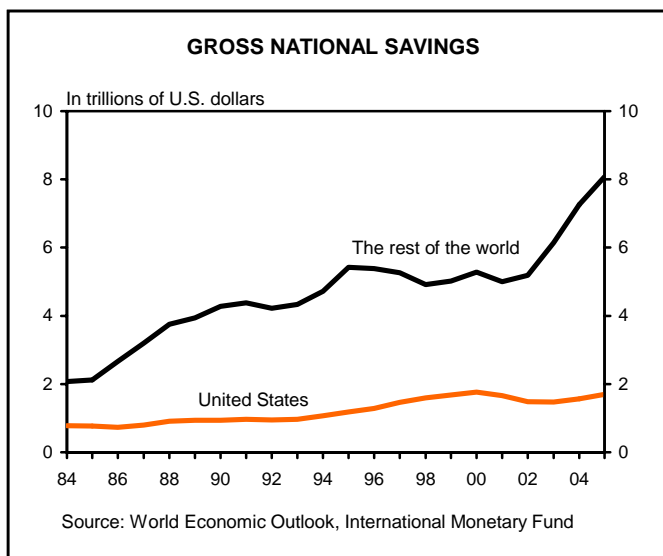
What is more, just because the relationships currently supporting the U.S. CAD are self-reinforcing does not imply they are fool-proof. There is no guarantee political considerations will not trump economic well-being and increase protectionist sentiments or foreign reluctance going forward. This was 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.

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# TD Economics

## Special Report

May 18, 2006

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

Even though the U.S. economy has experienced robust growth, concerns are mounting surrounding three factors: high oil prices, a potential housing bubble, and mounting US foreign indebtedness. In fact, the swelling U.S. current account deficit (CAD) encapsulates all three. The traditional argument contends the United States has mortgaged its future in a naïve attempt to spend now and save never. Alternatively, new age arguments have falsely claimed these concerns are nothing more than scaremongering based on faulty accounting.

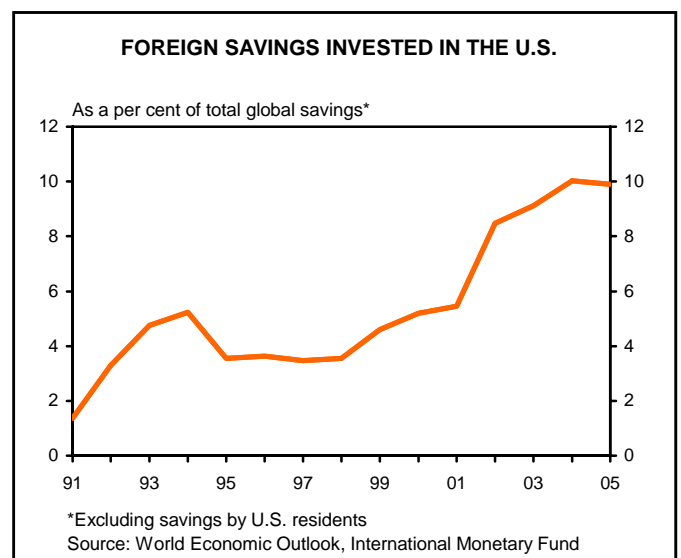
Actually, the U.S. is one of many parties responsible for the towering current account deficit and not the only one who may ultimately suffer should it come unhinged. U.S. consumer spending has fueled uninterrupted growth in numerous nations, who in turn have lent these profits back to America in support of further spending. While this symbiotic relationship has shown no signs of waning, a fall in U.S. spending or foreign willingness to provide financing could prove damaging for all. Nevertheless, we anticipate these risks will continue to be tempered by the mutual benefits and expect the U.S. current account deficit will level off near seven per cent of GDP in 2006 and 2007 before slowly receding.

#### U.S. Current Account Deficits Are Nothing New

One reason for the range of views is the alternative – albeit entirely correct – means of defining a current account (CA). Each individual may either spend or save their income. By the same token, a country which is saving less than is needed for investment is necessarily consuming more than it produces. This implies it imports more than it exports, giving birth to a CAD. Now that

may sound bad, but the flip side of the coin is that growth prospects are so large, local savings are insufficient to finance every profitable venture. Therefore, a more pleasant story is that foreign investors enter, supply financing, and permit the economy to grow faster. Conversely, a CA surplus – rather than a sign of strength – may signal a lack of viable investment opportunities.

As a result, there is nothing intrinsically wrong with the existence of a CAD. Indeed, the U.S. deficit has persisted for nearly a quarter-century. To the extent spending lifts investment and fuels productivity, this allows you to get from rich to richer much quicker. For this reason, fast-growing economies frequently run a CAD. On the other hand, growing indebtedness implies increased debt service costs, which may limit current investment, strain budgets, or burden future generations. A large or increasing



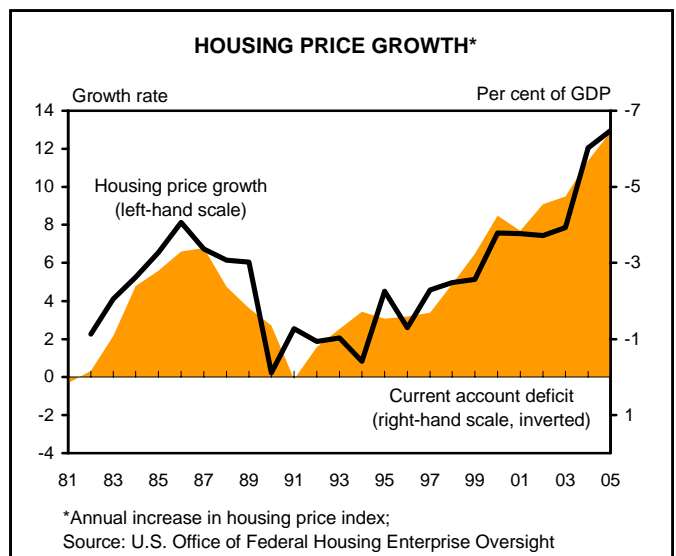
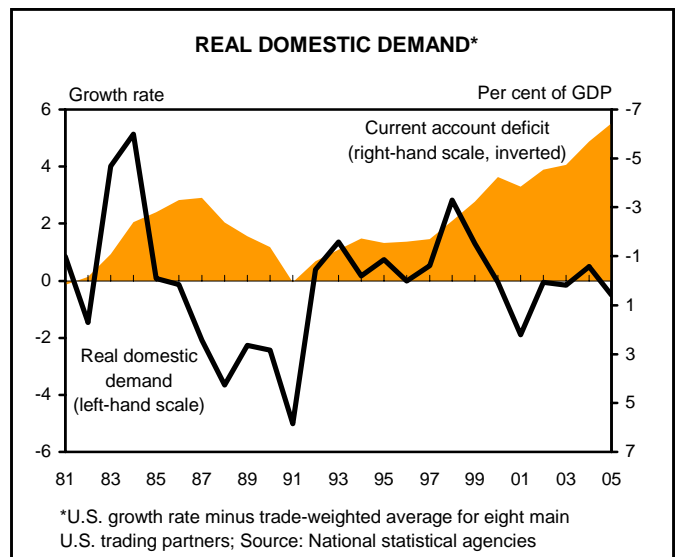
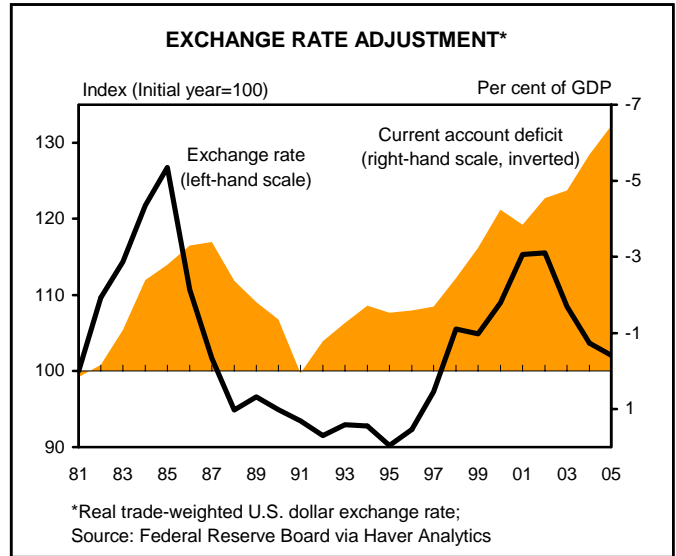
CAD also carries the risk of an abrupt shift in investor sentiment. When animal spirits take over, there is a risk of over-adjustment and unneeded disruption to foreign exchange, interest rates, and output that could destabilize the broader economy. However, given sufficient time, this process can be smooth and gentle.

**The U.S. Then and Now: A Tale of Two Deficits**

The U.S. CA was last in surplus in 1991, creating two distinct episodes of a protracted CAD: 1981-1991 (1980s) and 1991-present (today). The 1980s deficit actually has its origin in the 1970s, when high oil prices left oil exporters flush with cash. Deposited in commercial banks, these funds facilitated an enormous amount of borrowing by developing countries. As their debt burdens rose, their ability to service this debt declined until, in August 1982, Mexico announced it could no longer service its debts. This cascaded throughout the developing world and the Latin American debt crisis was born. As the crisis unfolded, investors sought the relative safety of American assets. The increase in global demand led the U.S. dollar to appreciate, which in turn made imports cheaper and fueled a growing CAD.

On the heel of these inflows, U.S. domestic demand grew rapidly while the fiscal position deteriorated, driving a further wedge between savings and investment for several years. By late-1985, the dollar's value began a precipitous fall as the relative attractiveness of U.S. assets started to wane. This impact would only start to take effect with a lag of several years as U.S. imports continued to outstrip exports, and consumer spending was fueled by a steady increase in housing wealth. But in 1987, housing wealth started to unwind as prices flattened. Around the same time, households began to experience a deterioration in their portfolio wealth as the Dow Jones Industrial Average lost 22 per cent of its value on Black Monday (October 19, 1987). U.S. demand started to noticeably lag that of its trading partners and within four years, the U.S. eliminated its CAD from a peak of 3.5 per cent of GDP.

Contrary to the gradual unwinding of the 1980s, today's deficit has grown larger 12 of the last 14 years, topping 7 per cent by the end of 2005. Rather than a Latin American debt crisis, this time emerging market (EM) financial crises in Asia in 1997 – later joined by Brazil, Russia, Argentina, and Turkey, among others – led investors to seek out safe returns in the U.S. market. A stronger



dollar once again hampered exports and the deficit began to grow by half a per cent of GDP each year. And just as before, refinancing derived from housing wealth drove consumer spending in spite of a falling dollar in 2002 which should have served to limit the relative attractiveness of imports for U.S. consumers. This housing wealth effect also explains why, with the exception of the brief U.S. slowdown in 2001, the economy's growth has yet to slow relative to its partners.

Pronounced growth in real estate assets often arises in tandem with a CAD. An analysis of Eurozone countries, where a common currency eliminates confounding signals, reveals a correlation of nearly 80 per cent between changes in real housing prices and changes in the CA.<sup>1</sup> In the first round effect of a CAD on increasing housing prices, foreign capital competes with domestic capital to bid up asset prices. This is joined by a second round effect where the inflow of foreign capital helps to depress interest rates and make subsequent new borrowing even more attractive. This secondary effect has been especially pronounced recently with strong purchases of U.S. Treasury Bills – used as a benchmark to set commercial bank lending rates – by central banks and pension funds (*See TD Economics Special Report: "Will U.S. Treasuries Pay a Price for Record Foreign Indebtedness?"*).

In light of these facts, it is no surprise that the deficit has not yet leveled off. However, the sheer size of the CAD presents real risks that the U.S. has taken on an onerous debt burden and is now extremely susceptible to panicked investors and capital flight. A new paradigm of

MNCs IN THE U.S. CURRENT ACCOUNT			
	Billions of U.S. dollars		Annualized Increase 1982-2003
	1982	2003	
<b>TOTAL TRADE</b>			
Imports and Exports	575	2,540	7.3
Unaffiliated foreigners	397	1,686	7.1
Affiliated foreigners	177	854	7.8
Foreign affiliates of U.S. parents	97	430	7.3
Foreign parents of U.S. affiliates	80	424	8.3
<b>MNC PROFITS</b>			
U.S. MNCs abroad	29	193	9.4
Foreign MNCs in U.S.	2	71	18.3
<b>OTHER INCOME</b>			
Received by U.S.	62	117	3.0
Payments abroad	54	192	6.2

Source: Bureau of Economic Analysis

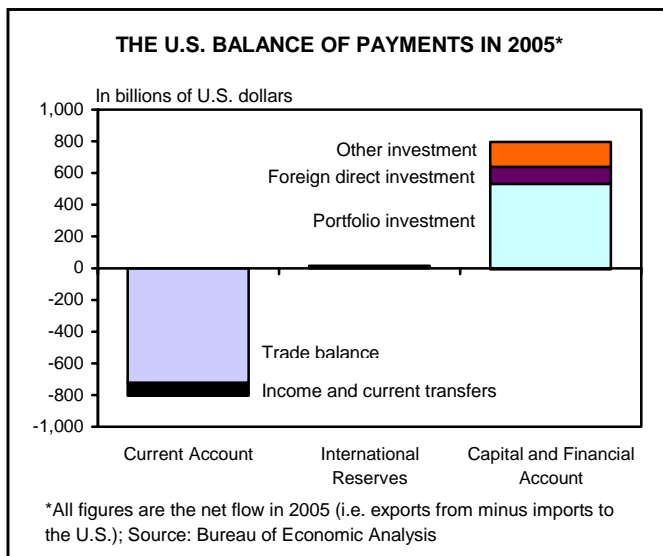
thought, however, argues that the focus on the risks of the U.S. CAD is misplaced. The deficit, they argue, is not an untamable beast but just misunderstood and mismeasured.

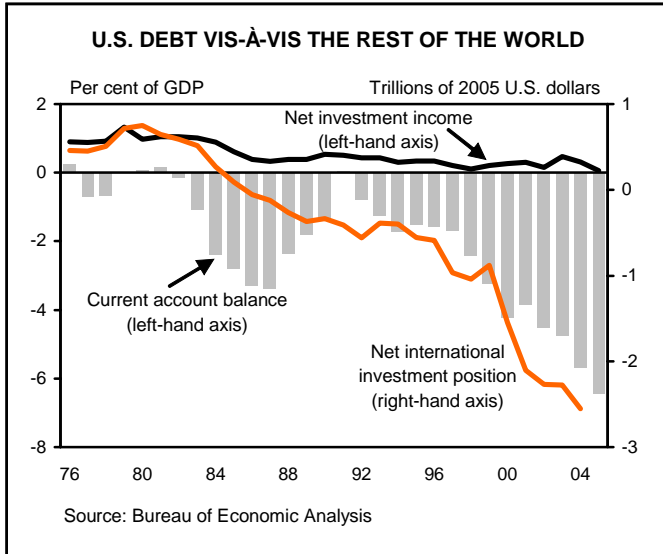
### The Devil is in the Details – Multinational Trade

The first justification offered to support a banal interpretation of the CAD is the increasing propensity of firms to stage production in different countries.<sup>2</sup> For example, Ford Motor Company may have parts machined in China, assembled in Mexico, and ultimately inspected and sold in the U.S. As the profits from these operations are ultimately repatriated to the U.S. in one form or another – whether through direct transfers or Ford's higher rate of return – surely Ford's decision to increase profits has improved the prospects for U.S. growth. To support their argument, McKinsey and Co. cite \$2.7 billion in U.S. stock market capitalization that results from overseas profits.

Contrary to their argument, however, moving production abroad to cut costs results in a wider CAD and lower national income. For example, suppose Ford produces a line of cars in the U.S. which requires \$5,000 in imported Chinese parts, \$5,000 in U.S. labour, and is ultimately sold in the U.S. for \$20,000. The Chinese imports result in a CAD of \$5,000, and Ford Motor Company reports a profit of \$10,000. Now suppose Ford is offered the opportunity to move production to China with a promise of free labour. Production costs are cut in half and profitability is up while each sale results in a \$20,000 import.

While the main element of the CA is the trade balance – the difference between imports and exports – the flow of income and profits is also included. Although the trade deficit has widened by \$20,000, the CA now records Ford's





profits as an income receipt of \$15,000 irregardless of whether these profits are physically repatriated that year. This means Ford's decision has had no material impact on the CAD. This is only true, however, to the extent Chinese labour is free. For every dollar spent on labour, the CAD widens by one dollar – the direct result of lower reported profits. Past experience suggests a 10 per cent increase in U.S. direct investment in China is associated with a 7 per cent increase in the volume of imports from China and a 2 per cent decline in exports to China in that industry.

The firm's profits have certainly improved, but this does not imply the country's CAD is smaller. It is not even true that accounting for the increased volume of intra-firm trade would affect the accounting of the U.S. deficit more than others. While U.S. total trade has more than quadrupled between 1982 and 2003, the share of this trade between subsidiaries of the same multinational corporation (MNC) has remained a fairly constant one-third of total trade. Not only that, but growth in trade between MNCs with foreign parents has been faster than among those with U.S. parents – on the order of one percentage point per year. And just to drive the point home, reported profits of foreign parents from their U.S. affiliates have grown nearly twice as fast as their U.S. counterparts.

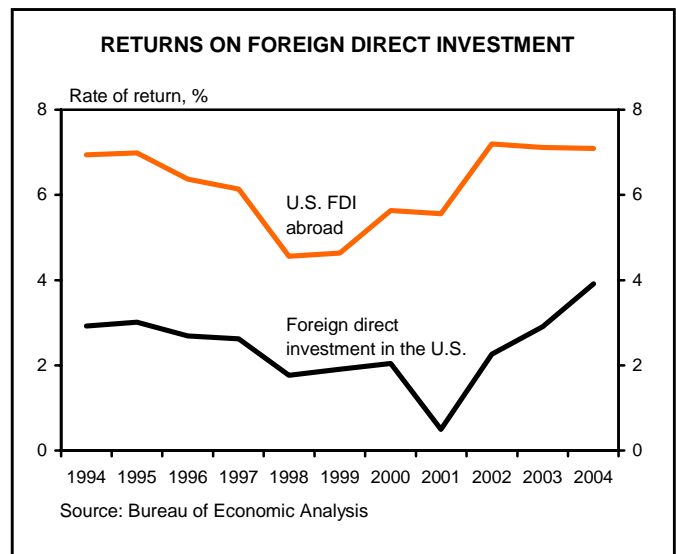
At the end of the day, the impact of a CAD is the same. Foreign claims on future output are higher, exchange rate fluctuations impact firms' decisions, and the sudden flight of foreign capital can spoil economic well-being. Foreign investment in the U.S. need not persist for the foreseeable future. For example, Chinese productivity growth outpaces that in the U.S. – implying possibly greater re-

turns abroad. MNCs therefore offer no panacea to mitigating the risks of a large deficit.

### The Devil is in the Details – Dark Matter

Rather than a benign interpretation of the CAD, what if there was evidence that the deficit is measured wrong? Two Harvard economists, Hausmann and Sturzenegger (H&S) have proposed just this.<sup>3</sup> If the CAD measures annual U.S. foreign borrowing and the level of external debt is rising, then this should imply that net investment income (NII) – interest earned abroad minus interest paid to foreigners – should be declining. But to the contrary, U.S. NII has been consistently positive and relatively flat as a per cent of GDP every year since the Second World War suggesting a net creditor position. In 2004, foreign investors' holdings in the U.S. were worth \$2.5 trillion more than U.S. holdings abroad – 21 per cent of GDP – yet U.S. holdings abroad netted \$30 billion more than foreign holdings in the U.S.

H&S argue the U.S. must be a net creditor; One need only value holdings properly. First, NII was approximately \$30 billion in both 1980 and 2004. Therefore, net debt in both years should likewise be similar. Assuming a constant rate of return on investments of 5 per cent (P/E ratio of 20), H&S find the U.S. is actually a net creditor to the world to the tune of \$600 billion dollars. They dub the \$3.1 trillion dollar difference between this and the official debt statistics “dark matter.” Like physicists who theorize the existence of an undetectable substance to balance equations of gravitational pull in the universe, H&S argue

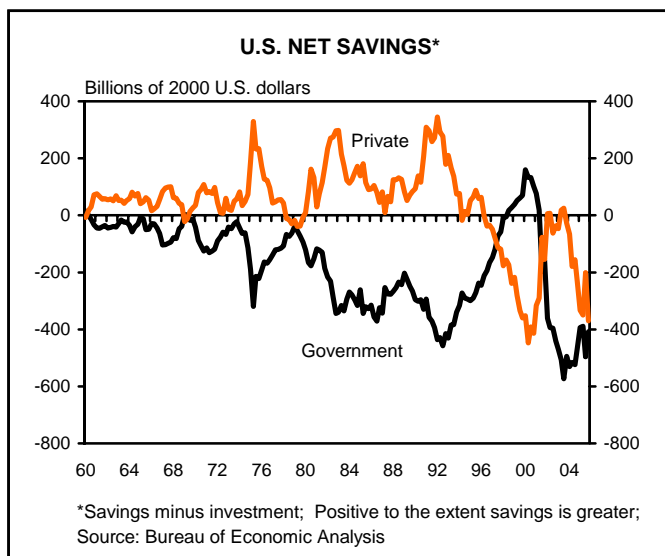


economic dark matter “corresponds to assets we know exist, since they generate revenue but cannot be seen (or, better said, cannot be properly measured).”

The authors highlight three sources – the U.S. as a net provider of knowledge, liquidity, and insurance. If a U.S. firm borrows \$1 million abroad to open a business, there is no net change in external debt. H&S argue that if the loan charges 5 per cent while the business returns 20 per cent, FDI is in fact undervalued. Second, H&S argue that the U.S. earns seignorage revenue. This means that when individuals hold a non-interest bearing asset like cash, the purchasing power lost from inflation accrues to the government that printed the money. Lastly, the U.S. acts as a quasi-hedge fund, borrowing abroad with low-cost debt and investing this in high-return EM equity and debt.

Each of these is factually true, but insufficient to dismiss the importance of the CAD. H&S argue FDI is the most important factor, especially since NII from FDI has risen faster than the interest payments on government debt. But we’ve already seen this gap narrow rapidly. In fact, at current rates, net FDI will be zero in only 10 years. Even more damaging, in 2004, U.S. assets abroad returned 7.1 per cent while FDI in the U.S. returned just 3.9 per cent. This is hardly a sign of the exceptionality of U.S. investors. Rather, FDI in the U.S. is almost as profitable as a savings account. Once you realize that much of these reported profits are actually derived from tax filings, rather than savvy American investors, they appear to suggest savvy tax accountants (see Box).

This is not dark matter’s only fault. A constant P/E



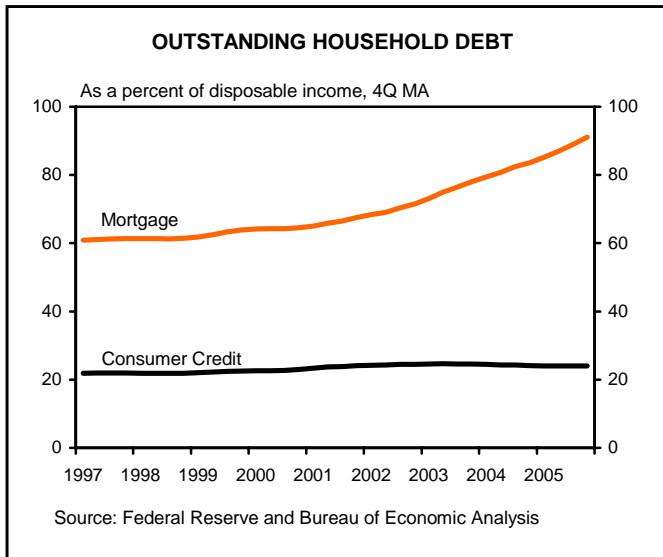
#### Border-Crossing Bean Counting Difficulties

Between 1994 and 2003, the six largest pharmaceutical companies in the U.S. reported overseas sales increased from 40 to 43 percent while reported foreign profits (as a share of total income) increased from 38 to 65 per cent.<sup>4</sup> Similarly suspicious, from 1982 to 2004, U.S. firms reported \$1,100 billion in retained earnings overseas while foreign subsidiaries in the U.S. reported a grand total of \$20 billion.<sup>5</sup> While retained earnings have offsetting entries in the current and capital accounts – all overseas profits are reported as repatriated while the amount retained abroad is recorded as new FDI – U.S. MNCs need not pay taxes on foreign earnings not repatriated to the U.S.

The first implication is the incentive to report as many earnings reinvested abroad as possible for U.S. and foreign-owned MNCs. Second, on net the measurement of retained earnings should record the flow of profits which were ultimately repatriated and removing them altogether from the CA should have no material impact. In fact, if you net out retained earnings, the implications for NII and dark matter are dramatic. NII has remained positive for 50 years as a result of strong reported net earnings of U.S. FDI, but 80 per cent of net income from FDI is due to this difference in reported retained earnings. Rather than having no material impact, netting out retained earnings implies NII is negative, the U.S. current account deficit is one per cent of GDP larger than reported, and over half of the enigmatic dark matter is accounted for.

ratio over 20 years is a rather bold assumption. The S&P 500 P/E ratio has doubled over the last twenty years with fluctuations twice that. Moreover, the existence of dark matter implies the U.S. CA – measured appropriately – has fluctuated by five to ten per cent of GDP annually.

The persistence of positive NII can also be explained. The current account deficit must be financed by new borrowing each year; this implies growing interest payments on this new debt. A deficit of 6 per cent in 2005 financed by Treasury Bills paying 5 per cent, would lead to a deterioration of the U.S. CAD by 0.3 per cent of GDP in 2006. In the case of the U.S., this deterioration has been counterbalanced by two factors. Existing debt must be rolled over as it reaches maturity implying as interest rates fell over the last 20 years these debts were refinanced at lower rates. Second, since U.S. liabilities are denominated in



dollars while its assets are largely foreign-denominated, a depreciating dollar improves U.S. NII by reducing the value of foreigners' claims while increasing the value of U.S. assets held abroad. Ultimately, the fact U.S. NII has remained positive is evidence these factors have been sufficient to offset increasing U.S. external debt and do not portend the existence of dark matter.

### Why the U.S. Can Not Do It Alone

But if the deficit is not a figment of bad accounting, why hasn't the U.S. acted to offset the potential risks? While domestic factors in the U.S. could – and in all likelihood will – adjust to mitigate further deterioration, there is strong evidence that this adjustment would prove largely ineffective in the face of current incentives driven by international factors. Specifically, low interest rates supporting borrowing and structurally larger decreases in the price of imported goods relative to domestic products provide incentives to spend.

Moreover, the idea that American spending is irresponsible is largely false. Since 1997, outstanding U.S. consumer credit as a share of disposable income has been almost flat, rising only from 22 to 24 per cent. Outstanding mortgage debt, on the other hand, has increased as a share of disposable income from 60 to 90 per cent since 1997. Part of this growth is from home equity lines of credit, which have grown at an average annual rate of 30 per cent since 2000. While some of this is fueling discretionary spending, these tax-deductible, low-interest loans have also driven debt consolidation and real estate investment. Consumers are not borrowing to buy Lamborghinis. They are

borrowing to buy bedrooms. While any U.S. adjustment process will entail some forgone consumption, it would be unwise to blindly save for marginal benefits, especially in light of this arguably more benign source of dissavings.

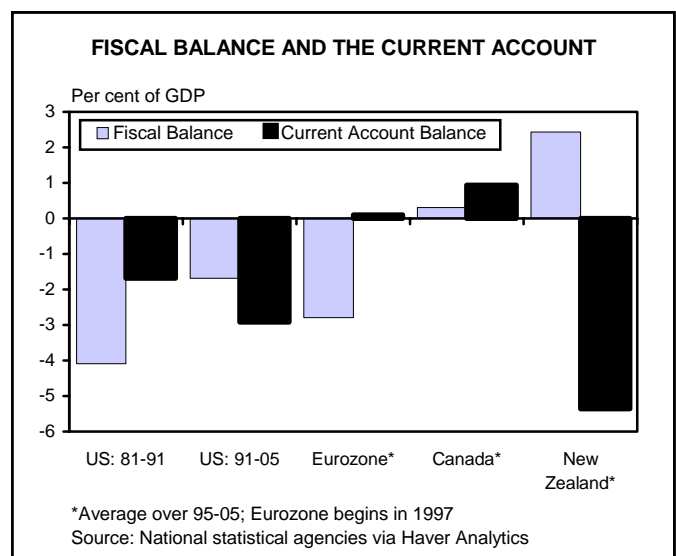
### Why Federal Budget Tightening Will Be Unproductive

One frequent refrain is that a lower federal budget deficit would taper the CAD by allowing more domestic savings to finance investment rather than the government. But to the extent federal budget changes alter the level of desired private investment, desired domestic savings, or desired foreign savings willing to be lent to the U.S., the impact can be ambiguous. The U.S. budget deficit of the 1980s was actually twice as large as it is now while the CAD was only half its present size. The U.S. Federal Reserve, International Monetary Fund, and OECD estimate that narrowing the fiscal deficit by 1 per cent of GDP would reduce the CAD by only 0.2 to 0.4 per cent of GDP. Given that the U.S. budget deficit was 2.6 per cent of GDP in 2005, eliminating this entirely would only reduce the CAD by 0.5 to 1.0 per cent of GDP.

Historically, movements of net private and government savings have been in opposite directions. It was not until the early 2000s that the link became extremely tenuous. Increasing housing wealth is one important factor in this development, but regardless of its origins, it implies an increased propensity of foreigners to invest their savings in the U.S.

### Why the World Saves Too Much

Before he became Chairman of the Federal Reserve,



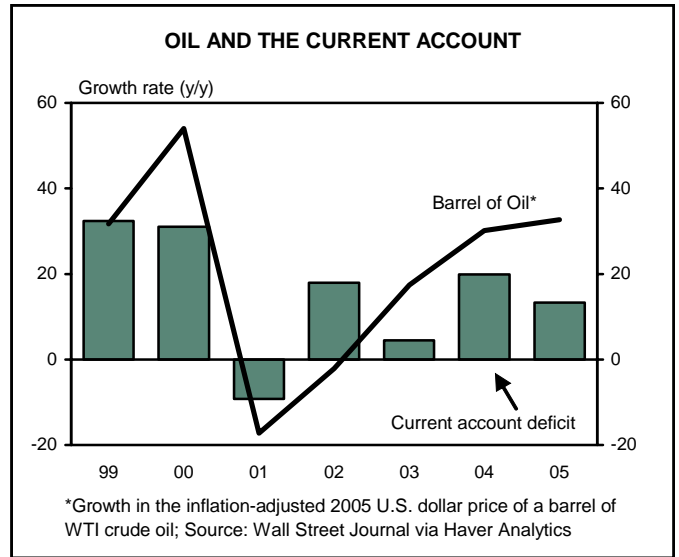


Ben Bernanke suggested many non-U.S. economies were saving too much. The scarcity of savings relative to investment in a rapidly-growing economy – as well as the potential returns – should attract financing from capital-rich industrial economies and lead to CA surpluses there and deficits for EMs. With this status quo turned on its head, however, the U.S. CAD has been driven higher and U.S. savings lower.

There are several reasons for the international savings glut. Aging populations throughout the world – especially former communist countries where state dependence was absolute – are saving much more. Also, in spite of rapid income growth in many economies, the transition to higher levels of consumer and investment spending has proven sluggish. Moreover, the domestic banking system in many emerging economies has been incapable of either absorbing this increase in savings or financing further investment. In China, for example, over half of national savings appears to be accounted for by businesses, suggesting the lack of a developed financial system. With foreign opportunities slow to respond, these savings come to the U.S.

**Why Exchange Rates Aren't Helping**

With this influx of savings, the dollar's depreciation has been neither as substantial nor as effective as in the 1980s. To help balance trade, the U.S. dollar should depreciate vis-à-vis currencies with which the U.S. is running the largest deficits. For the most part, however, this has not been the case. Rather, much of the dollar's depreciation has come against currencies where the U.S. is running a minimal deficit. Much of this has been the result of



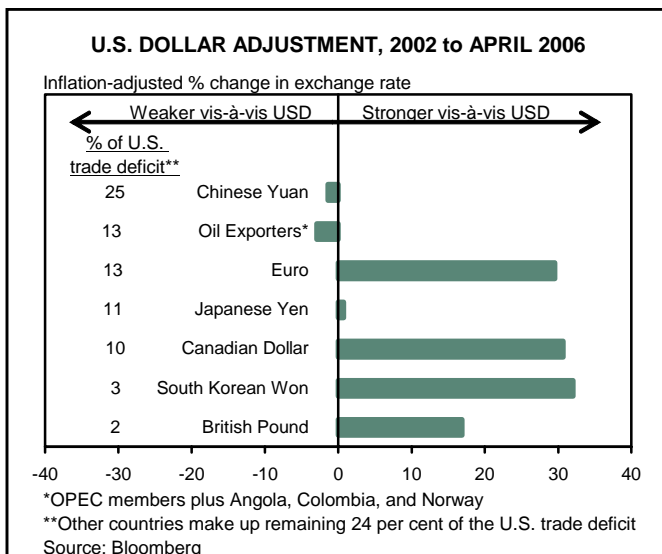
emerging Asian economies' strategies of export-led growth.

By intervening in the currency market, central banks can reduce upward pressure on the currency – with lower prices and increased export market share than might otherwise exist. In turn, these countries have lent their profits back to the U.S., supporting further U.S. purchases and continued EM exports. This symbiotic relationship has been dubbed Bretton Woods II – harkening back to the fixed exchange rates which governed flows between all countries following World War II. Currency intervention by EMs also has allowed them to prepay debt and accumulate sizeable reserves as insurance against possible speculative attacks.

Since China now accounts for a quarter of the U.S. trade deficit, there has been considerable U.S. pressure on China to allow the yuan to appreciate. It is unclear, though, how effective more Chinese flexibility might be. For one, the majority of goods the U.S. imports from China have no immediate domestic replacement, implying the U.S. would import the same goods – at higher prices – from a new country. Second, the Chinese continue to benefit from the de facto peg of the yuan – accumulating reserves, slowing hot money, and recapitalizing fragile banks in which almost a quarter of all loans are nonperforming. Moreover, in lieu of domestic consumers, over 80 per cent of Chinese per capita GDP is supported by exports.

**Why Oil Wealth is Keeping the Deficit Afloat**

But China is not solely to blame. In the last few years an old boogeyman has returned to fuel the deficit – high oil prices. IMF estimates suggest half of the deterioration



of the U.S. CAD in the last two years has been a direct result of oil prices. Also a concern, oil-exporters' spending has increased slower than during past episodes of high prices and has largely been directed at Asian and European markets. This provides little opportunity for American exports to offset the rising trade deficit and explains why many other oil importers' CAs have been less affected.

The evidence is less clear as to whether these higher prices imply anything about the sustainability of the U.S. CAD. High oil prices have caused the trade balance to worsen, but just as with Asian exporters, oil exporters have for the most part channeled these increased revenues into financial opportunities in the United States. Since oil sales are denominated in U.S. dollars, depositing these revenues directly into U.S. accounts avoids pressure on their predominantly pegged exchange rates. Should oil prices begin to recede, an improvement in the trade balance would be matched with diminished demand for American assets.

### Why Real Risks Remain

While the U.S. can not sustain an increasing deficit, in principle, the current symbiotic relationships could be sustained into the indefinite future. If present conditions persist – a CAD of 7 per cent of GDP, real GDP growth of 3 per cent, and annual inflation of 2 per cent – foreign holdings of U.S. assets would ultimately stabilize in about 20 years near 125 per cent of GDP. To the extent foreigners want to hold this many U.S. assets and Americans are willing to cede control of them, there is no problem per se with this outcome. In order to maintain external debt at current levels of 25 per cent of GDP, the U.S. would need to run an annual deficit of about 1 ½ per cent of GDP.

Since 1981, one in four countries has run a CAD for as many years as the U.S. Among them, the average level of the U.S. deficit as a share of GDP has been one of the lowest. While the U.S. may not like to compare itself with countries such as Sudan and Rwanda, the list also includes OECD nations like Greece, Australia, and New Zealand whose deficits as a share of their economies have averaged twice that of the U.S. There is no magic number beyond which a CAD ultimately proves fatal. Any debt service costs limit the responses available to shocks and increase the economy's vulnerability to the potential risks below.

RECENT CURRENT ACCOUNT HISTORY, 1981-2005				
Countries	Balance (%GDP)			# of years in deficit
	Median	Min	Max	
<b>52 with a deficit lasting as long as the U.S., median</b>	<b>-7</b>	<b>-16</b>	<b>0</b>	<b>24</b>
Guyana	-28	-76	-8	25
Equatorial Guinea	-23	-126	2	24
Nicaragua	-22	-36	-12	25
Guinea-Bissau	-19	-39	1	24
Lebanon	-18	-57	37	24
Lesotho	-18	-46	-3	25
Mozambique	-18	-24	-7	25
Sudan	-15	-44	-6	25
Small Island Nations (10)	-14	-63	6	25
Mauritania	-11	-37	10	23
Chad	-10	-101	2	23
Cape Verde	-9	-17	6	23
Lao, P.D.R.	-8	-16	-2	25
Togo	-8	-13	3	24
Sierra Leone	-8	-16	0	25
Malawi	-8	-24	0	24
Burundi	-7	-16	-1	25
Madagascar	-7	-13	-1	25
Senegal	-7	-18	-4	25
Rwanda	-7	-11	-3	25
Benin	-6	-30	-2	25
Guinea	-6	-13	0	25
Sri Lanka	-6	-17	0	25
Niger	-6	-12	2	24
Tanzania	-5	-14	-2	25
Burkina Faso	-5	-12	1	24
New Zealand	-5	-9	-1	25
Peru	-5	-9	1	23
Australia	-5	-6	-2	25
Guatemala	-5	-8	-1	25
Congo, D.R.	-5	-14	1	23
Honduras	-5	-11	-1	25
Costa Rica	-4	-16	-2	25
Tunisia	-4	-13	1	24
Central African Republic	-4	-13	2	24
Greece	-3	-9	3	23
Gambia, The	-3	-13	4	23
Ghana	-3	-14	2	23
Uganda	-3	-9	1	24
Chile	-2	-15	2	23
United States	-2	-6	0	23
Kenya	-2	-8	2	23
Bangladesh	-2	-5	0	23
<b>82 others in deficit, median</b>	<b>-3</b>	<b>-12</b>	<b>5</b>	<b>18</b>
<b>46 others in surplus, median</b>	<b>2</b>	<b>-6</b>	<b>14</b>	<b>7</b>

Source: World Economic Outlook, International Monetary Fund

### Risk #1: Central Banks find a new reserve currency

One concern is that central banks may hold fewer U.S. dollars. While some have already started, its impact is likely overstated. For one, exposure to the U.S. as the world's dominant economy will only change gradually, therefore large U.S. dollar reserves will be needed for some time. Moreover, any divestment of dollars by industrial nations would likely pale in comparison with the rapid recent accumulation by EMs, who now control almost

three-quarters of all global reserves. While these reserves stave off speculative currency attacks and ensure coverage of short-term debt, they earn little interest and therefore prove exceedingly costly. Yet it would be difficult for EM central banks to simultaneously limit their accumulation of dollars and maintain fixed exchange rates at current levels. Therefore a decline in EM dollar demand would likely be coupled with stronger U.S. exports to these same countries.

### **Risk #2: Foreign appetite wanes**

A growing concern is a sudden sell-off, with more than a third of foreign-owned Federal debt held by private parties who are more concerned with the value of their investments. Previous episodes of capital flight centered on mismatches, with assets denominated in local currency and foreign debt borrowed in U.S. dollars. Fear that the local currency will depreciate causes foreign investors to leave, the currency depreciates, and debt repayments now cost more. For the U.S., most of its portfolio is denominated in U.S. dollars, but there may still be a risk of a run. Fearing depreciation, foreign investors may try to liquidate assets in order to retain as much value as possible. To the extent the interests of currency-peggers, oil-exporters, and pension funds do not align, however, there may be ready buyers for these assets in a liquid U.S. market to limit the possibility of a perfect storm.

### **Risk #3: The U.S. chains the doors**

U.S. protectionism, however, runs the risk of artificially cutting foreign appetite and exacerbating the situation. Financing the U.S. CAD requires that foreigners purchase U.S. assets. As their holdings grow, foreign investors will naturally require higher returns. This runs the risk of increasing Congressional intervention to restrict purchases in sensitive areas, such as a bid by a Dubai firm to take control of operations at six U.S. ports. While any nation has the right to monitor sensitive areas, legislation is a blunt tool and risks alienating foreign investors and instigating sudden, dramatic shifts in investor sentiment.

### **Risk #4: A sharp domestic slowdown in the U.S.**

Outside of these external factors, it is possible that a sharp adjustment in the CA could be triggered by a secular slowdown in the U.S. economy. Rather than a soft landing, perhaps the U.S. experiences a sudden correction

in the housing market and sagging consumer spending. In this case, the narrowing CAD would be largely a symptom, rather than a contributing factor, and this economic slowdown would likely spill over into the global economy. Just as the sharp recession in the U.S. in the 1980s was matched with similarly slow growth in many major economies, it was the slow recovery in the U.S. relative to the world that caused the erasure of the CAD. This is not to say the slowdown would be cost-free for the U.S. But to the extent this slowdown is shared in some small part with the global economy and the U.S. dollar is able to depreciate, the costs to the economy should not be exacerbated by the unwinding of the CAD.

### **Risk #5: The U.S. becomes insolvent**

Irregardless of its origin or currency denomination, capital flight risks increasing the burden of debt service. For the U.S., a depreciating dollar reduces some of these costs as interest payments become cheaper and implies the U.S. may be able to sustain a larger CAD than countries which borrow in foreign currency. But U.S. debt service is not yet approaching the threshold of insolvency as the cost of servicing new external debt has been increasing by only a quarter per cent of GDP each year. In fact, during the Latin American debt crisis, annual repayments reached 10 per cent of regional GDP, slightly less than half of the entire level of current U.S. external debt.

### **Conclusion**

In the end, the risks to U.S. economic performance from a dramatic unwinding of the CAD remain relatively balanced at this time. This is largely because the imbalances fueling the deficit remain in the best interests of those involved. But any debtor faces the risk that the cost of repaying debt may exceed available resources, as well as the danger that new financing will become unavailable and prevent further rollover. Ultimately dependence on foreign actors comes with some risk. Just as herd mentality can inexplicably drive markets, an investor's assessment of why a run has begun sometimes takes a back seat to ensuring they are not left holding the proverbial bag.

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## Endnotes

- 1 Gros, Daniel. February 2006. "Bubbles in real estate? A Longer-Term Comparative Analysis of Housing Prices in Europe and the US." Centre for European Policy Studies, Brussels.
- 2 McKinsey Global Institute. December 2004. "A New Look at the U.S. Current Account Deficit: The Role of Multinational Companies."
- 3 Hausman, Ricardo and Federico Sturzenegger. January 2006. "Global Imbalances or Bad Accounting? The Missing Dark Matter in the Wealth of Nations." CID Working Paper No. 124, Harvard University.
- 4 Aldan, Edward. 16 October 2004. "Rules on overseas profits become less taxing." Financial Times.
- 5 For more on this topic, see: Gros, Daniel. April 2006. "Foreign Investment in the U.S. (II): Being taken to the cleaners?" Centre for European Policy Studies, Brussels.

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