



WHY A LARGE US DEFICIT IS LIKELY TO PERSIST

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It has been three years since I last wrote on the US current account deficit for CESifo Forum, based on data through 2003, when the US current account deficit (balance of payments basis) was \$522 billion. I argued then that, contrary to frequent claims of unsustainability, the US deficit was likely to endure for many years. After 2003, the deficit grew annually, reaching \$811 billion in 2006 before dropping below \$800 billion in 2007, a response both to slower growth in the United States and to some cumulative depreciation of the dollar against other major currencies – although prices of US oil imports were significantly higher in 2007 than in 2003. The dollar depreciated in 2003 and 2004, but actually appreciated in 2005 before resuming depreciation in 2006/07. In the meantime there have been numerous articles and at least one book (Cline 2005) on the precarious state of the US deficit and the risk of major financial turmoil, although claims of literal unsustainability seem to have receded somewhat in face of growing deficits.

This article will review some arguments why the US deficit, far from being unsustainable, is likely to last for a decade or longer. They rest on globalization of world financial markets combined with significant demographic change in Europe and East Asia, the locus (along with oil-exporting countries) of the large current account surpluses of the world.¹ In brief, demographic change results in excess savings in parts of Europe and Asia, this excess saving properly seeks investment abroad, the United States has been and is likely to continue to be a major destination of such investment, and growth in the net foreign indebtedness of the United States falls well short of US current account deficits because of valu-

ation changes in US investments abroad relative to foreign investments in the United States.

A thought experiment

Savings as conventionally defined in the national accounts, relative to output, have been significantly higher in the rest of the world in recent decades than they have been in the United States, and that relationship is likely to continue, at least for some years.² If we take full globalization of financial markets to mean the absence of home bias in the allocation of savings, one interpretation is that each country invests its savings (including depreciation allowances) around the world in proportion to GDP (another interpretation would focus instead on available financial assets). If such a condition had existed in 2006, Americans would have invested \$1.3 trillion of their savings abroad, and non-Americans around the world would have invested \$2.5 trillion of their savings in the United States, which accounted for 27.5 percent of gross world product in that year. The US current account deficit (conceptually equal to net foreign investment) in 2006 would have been \$1.2 trillion, significantly higher than \$0.8 trillion. It would have risen from \$0.5 trillion in 2001, and would continue to rise in subsequent years until some combination of a declining share of the United States in the world economy, a decline in non-US saving rates, and a rise in US saving rates would bring the continuing increases to a halt. A focus on marketable financial assets rather than GDP would have resulted in an even greater US current account deficit, because roughly half of all available marketable financial assets are in the United States.

Of course, world financial markets are not fully globalized in this sense, and perhaps never will be. Moreover, this thought experiment, like gravity models of international trade, ignores the incentives for trade in financial assets, such as yield, liquidity, risk diversification, and so on. But it makes

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¹ This article draws on my contribution to the final meeting of the Brooking Panel on Economic Activity, to be published in *Brookings Papers on Economic Activity (BPEA)*, 2007, No. 2.

² For doubts about the adequacy of conventional measurements of saving for today's knowledge economies, see BPEA, *op. cit.*

the point that by this standard the United States has not been drawing an unsustainable amount of world savings, and indeed that by this standard the flow of savings into the United States is likely to continue to grow for some years, as further globalization proceeds.

The US deficit has its exact counterpart (apart from measurement errors) in surpluses elsewhere. In 2006 these surpluses were concentrated in oil-exporting countries (including Norway and Russia as well as members of OPEC); China, Japan, and most other East Asian economies; and Germany and its neighbors whose economies are closely integrated with Germany: Switzerland, Netherlands, Sweden, and Austria. The surplus of China, which has received much attention, came to \$250 billion; that of Japan and other East Asian countries came to \$261 billion. The surpluses of Germany and its close economic neighbors, which have received much less attention, came to \$306 billion. The surpluses of oil-exporting countries were \$423 billion.

The oil country surpluses will prove transitory, at least in part. Oil revenues in most such countries accrue in the first instance to governments, and take a while to get into the revenue stream, and hence into higher imports. Also, oil prices are likely to decline from the high levels of 2006/07. On both counts, the surpluses of the oil-exporting countries should decline, although that may take several years. Moreover, more countries are emulating Norway and Kuwait in saving a portion of their high oil revenues for future generations, so some part of their surpluses, and of their investments abroad, may persist.

Demography

The surpluses of Germany, Japan, and other East Asian countries are also likely to persist, although for quite a different reason. These countries are aging rapidly, due both to increasing longevity (as in most countries) and to low natality. The aging of rich countries has received much attention, focused on future fiscal strains arising from pension and health care commitments. Such concerns may lead to higher private saving rates during working years, and even into early retirement, not least because with medical advances the timing of death is both postponed and is increasingly uncertain. Eventually, of course, saving rates in aging

societies may be expected to decline, as more people move into late retirement and draw on their accumulated assets. But that may take many years.

Much less attention has been focused on the implications of low natality for the savings-investment balance in aging societies. The number of young adults in Germany, Japan, China, and other East Asian and European countries is expected to decline in the coming decades, at roughly one percent a year 2005 to 2025. Young adults are the most highly educated and the most flexible members of the labor force, and they are the people who form new families. A decline in their numbers in rich countries means lower demand for housing and for schools. It also means lower demand for capital to equip new members of the labor force with the average capital stock. Some capital-deepening will occur, but that will drive down the domestic return to capital and make investment abroad correspondingly more attractive.

Among rich countries, the United States stands out as a marked exception. Birth rates have also fallen in the United States, but remain at replacement rates (2.1 children per woman of child-bearing age), much higher than birth rates in other rich countries and East Asian countries. Moreover, the United States (like Australia and Canada) remains a country of significant immigration, overwhelmingly young adults, and second-generation and later immigrants are well integrated into the American labor force. As a result of both sources, the number of young adults in the United States is expected to rise in the coming decades, in sharp contrast to most non-oil countries with large surpluses.

The implications of low natality for the savings-investment balance are rather different for China. While the number of young adults is expected to decline significantly, large numbers of poor people continue to live in rural areas. Rural to urban migration can be expected to continue, and as incomes rise families will upgrade the quantity and quality of their housing. Thus residential investment will continue apace in China for another decade or more, and new members of the urban labor force must be provided with space and equipment. But saving rates have risen with rapidly rising income (as they did in Japan at a corresponding stage of development), even as consumption and investment have risen rapidly.

Low natality, then, leads many countries to have excess savings. In a globalized world, these excess savings will be placed abroad. The United States is a relatively attractive place to invest. Expected returns may not be so high as they are in emerging markets, but they will be higher than in stagnant markets. Moreover, investors, especially prospective pensioners, are concerned about the security of their investments even more than yield. As Argentina, Bolivia, Russia, and Venezuela have reminded everyone in recent years, private investment, especially foreign investment, is not always secure in supposedly developing countries.

Investments in the United States are relatively secure, dispute settlement is impartial and reasonably speedy, financial assets are relatively liquid by virtue of the size of the markets, and, as noted above, US markets account for nearly forty percent of the world's financial assets, and probably over half of the available marketable assets (stocks and bonds) once allowance is made for claims held by governments and other firm owners. Yields in recent years have been higher than in Japan and continental Europe, though not so high as in Australia and Britain, countries with some of the attributes of the United States that have also run substantial current account deficits.

Much has been made of investment in the United States by foreign central banks, whose reserves collectively have grown enormously in the past five years. The United States, it is said, is taking advantage of the international role of the dollar, and foreign central banks are financing both the US Federal budget deficit and the US current account deficit by buying US Treasury securities. It is true that foreign central banks, and particularly central banks of East Asia, have added extensively to their reserves, and that much of this addition has been in US government securities. But the role of official investment in US markets needs to be kept in perspective. During 2005 more than \$1.2 trillion in foreign funds flowed into the United States, and in 2006 nearly \$1.9 trillion. During the first half of 2007 the inflows exceeded \$2.5 trillion at an annual rate. Under one quarter of the total inflows were from foreign central banks in 2005 and 2006, and under one-fifth in 2007, on preliminary figures. It is true that some portion of "private" inflows are beneficially owned by official bodies, and that official inflows into London and other international financial centers get recycled to the United States as private flows. But this is not man-

dated. The fact that the funds are privately invested in the United States reflects decisions by fund managers where to put their clients' money, and they have chosen massively to put these funds into the United States, *inter alia* for the reasons indicated above.

Moreover, in some cases foreign central bank intervention can be interpreted as intermediating on behalf of private citizens. Japanese households historically invested heavily in low-interest postal savings deposits, proceeds of which were used to finance politically motivated construction projects with a low social return. Japanese official investment overseas at least acquired assets that would yield positive returns to the nation as society aged, in command over tradable goods and services. Japanese households became more venturesome in the mid-2000s, the Bank of Japan did not intervene extensively in the foreign exchange market after the spring of 2004, but Japan's current account surplus did not decline. Similarly, official Chinese acquisition of foreign assets anticipates in part the day at which Chinese residents are permitted to invest abroad; their demand for foreign assets may be large, given their high saving rates and the limited domestic investments available to households.

Debt Dynamics

But do not the large US current account deficits jeopardize future American incomes, by mortgaging future output to foreigners? Some simple debt dynamics help to make the point. Suppose D equals the net international investment position of the United States (NIIP: total US claims on the rest of the world minus total foreign claims on the United States), and commands a net yield r . D can of course grow indefinitely in a growing world in which US GDP is growing, say at the rate of five percent annually in nominal terms. D/GDP will then stabilize when D is also growing at five percent.

$dD = B + rD$, where B is the balance on goods, services, and unilateral transfers, and $B + rD$ is the current account. Thus stabilizing D/GDP would require $B/D + r$ to equal 0.05. At the end of 2006 D/GDP for the United States was 16 percent and B/D was about 35 percent.³ These numbers suggest

³ The NIIP here and below values inward and outward direct investment at market values, as estimated by the US Bureau of Economic Analysis.

little prospect of stabilizing D/GDP anytime soon, if ever, even if interest payments to foreigners are low. It looks as though the US deficit may not be sustainable, or that it can be sustained only if r is significantly negative.

In fact, to date r has been negative, since recorded earnings on US investments abroad have continued to exceed foreign earnings on investments in the United States despite a negative NIIP since the late 1980s. Moreover, total returns on foreign investments substantially exceed recorded earnings, and the gap favoring the United States has been even larger, thanks mainly to increased market values and, to a much lesser extent, depreciation of the dollar. Thus, although the cumulative US current account deficit over 1990 to 2006 was \$5.2 trillion, the increase in the net debtor position of the United States, at \$2.0 trillion, was less than half that. The average annual total return on US investments abroad since 1990 (including exchange rate effects, on which more below) was 10.0 percent, compared with a total return (in dollars) of 6.2 percent on foreign investments in the United States. The main reason is that equity investments, both direct investment and portfolio equity, make up a substantially larger share of US claims on the rest of the world (61 percent) than of foreign investments in the United States (35 percent). Americans act in effect as risk-taking intermediaries in the world economy, selling fixed-interest claims and investing in equity; they thus earn an equity premium in the world economy.

In addition, changes in exchange rates affect valuations when US claims on foreign assets are converted into dollars, in which the US NIIP is reckoned. Most US assets abroad are denominated in other currencies, whereas most foreign claims in the United States are denominated in dollars. When the dollar depreciates against other currencies, US claims rise in value relative to foreign claims, and vice versa when the dollar appreciates.

The combined valuation effects can be substantial. In 2005 the US current account deficit was \$755 billion, but the NIIP actually increased by \$200 billion, despite an appreciation of the dollar in that year (reversals of sign also occurred in 1999 and 2003). The deficit of \$811 billion in 2006 produced no change in the NIIP, on preliminary figures. Remarkably, the ratio of the NIIP to GDP declined from over 23 percent in 2001 to under 17 percent in

2006, despite large and growing current account deficits during that period. Indeed, D/GDP was only four percentage points of GDP higher in 2006 than eight years earlier, despite a cumulative current account deficit of 38 percentage points of GDP. The dollar depreciated on balance over his period, and the NIIP would have equaled 19 percent of GDP at the end of 2006, or 2.6 percentage points higher than it was, if the dollar had not depreciated. Most of the valuation changes, in other words, were not due to exchange rate changes. Of course, US total return may not remain so high in the future, and foreign returns may rise as foreign official funds are moved into longer-term and riskier assets.

The ratio of NIIP to GDP is far below where it would be in a world without home bias, as described above, where foreigners would hold nearly 30 percent of their financial assets in the United States (over twice the ratio they currently hold). On these grounds, then, the NIIP could still rise significantly.

How much of US financial assets do foreigners own? Here it is necessary to look at gross foreign investment in the United States, before netting it against US investment abroad. Total foreign claims on the United States were \$13.6 trillion at end 2006 (including only the net position of US banks), roughly equal to US GDP and to the private nonresidential fixed capital stock. The share of foreign ownership has increased steadily for the past two decades. But foreigners do not generally invest in the domestic capital stock, and their share of US assets is not rising so rapidly as one might suppose by looking at dollar magnitudes. A remarkable feature of the US economy is that the total value of financial assets has been rising significantly more rapidly than the underlying economy. The Federal Reserve estimates total financial assets at the end of 2006 to have been \$129 trillion (this figure of course is sensitive to the system of classification used in the flow of funds accounts, and does not include derivatives), or 9.7 times GDP. Forty years earlier, in 1965, total financial assets were 4.8 times GDP. Put another way, while nominal GDP grew by 7.4 percent a year over 1965 to 2006, total financial assets grew by 9.2 percent a year.

This phenomenon reflects, among other things, innovation by the financial sector, which has devised a host of new financial instruments to appeal to a wider variety of circumstances and tastes. This articulation of financial assets appeals to

many foreigners as well as to Americans, and foreigners invest in a wide array of these instruments. So, although the stock of gross foreign investment in the United States slightly exceeded GDP in 2006, it amounted to only 12 percent of total financial assets, up from three percent in the mid-1980s, but the rise has been slow.

Evaluation

Viewed in the context of globalization and demographic change in other rich countries, the large US current account deficit is both comprehensible and welfare-enhancing from a global point of view, reflecting inter-temporal trade, so long as Americans invest the funds productively. Prospective retirees around the world are making investments that are profitable and secure. If this is so, strong governmental efforts to reduce the deficit significantly may be deeply misguided at best, and run a serious risk of precipitating the financial crisis and/or economic recession that its proponents hope to forestall.

Not so long ago it was argued that as a rich country the United States should be running a current account surplus, not a deficit. More recently it has been suggested that for sustainability the deficit needs to be reduced to no more than around three percent of GDP. Reduction of the deficit by three percentage points of GDP would require that US expenditure drop, relative to output, by three percentage points of US GDP, roughly one percent of GDP in the rest of the world. Foreign surpluses, taken together, would have to decline by three percent of US GDP, implying a rise in demand relative to output by that amount elsewhere in the world.

It is also usually said that to bring about the required substitutions in product demand, the US dollar must depreciate, probably significantly, perhaps by 30 percent on a trade-weighted basis. So the additional demand in the rest of the world must be domestic demand. For export-oriented economies such as Japan, Germany, and China, currency appreciation is likely to discourage, not encourage, productive investment. So the additional demand must come from domestic consumers or governments. Many governments have been concerned about excessive government deficits in recent years, and are engaged in "fiscal consolidation", i.e. reducing their deficits. This is especially true for Japan and Germany, two coun-

tries with large current account surpluses. What will induce aging consumers to spend more? Easier monetary policy, which in Euroland is outside the control of national governments, would in a world of high capital mobility tend to weaken currencies, not strengthen them. The prescription must include more stimulative fiscal policy combined with tighter monetary policy, and currency appreciation. Europe's mid-term policy focus, reflected in the Lisbon agenda of 2000, has on the contrary been on fiscal consolidation plus measures to improve productivity and output, resulting (as explicitly desired) in greater international competitiveness, not greater domestic demand.

China, which controls its exchange rate, could decide to revalue its currency, as many have urged. But even if China were to eliminate its current account surplus entirely, only a fraction would accrue to the United States as US imports from China switched to other low-income countries. That would still leave a current account deficit in excess of the targeted level. Moreover, what would an appreciation large enough to eliminate China's surplus do to China's economy, where processing exports has led China's growth? Exports have not been China's only source of growth in demand. Public and private construction has boomed, and Chinese consumption has grown in excess of eight percent a year 1989 to 2005, the highest growth in the world. But exports have been the driving sector.

The argument developed here suggests that the US deficit can continue for some years, and even rise above its current level. Of course, a significant depreciation of the dollar might nevertheless occur. Financial markets are driven by psychological as well as by economic factors. If enough people decide to sell dollars, the dollar will depreciate. If foreigners collectively decide to invest less in the United States than the current account deficit (plus American capital outflow), the dollar will depreciate. Adverse developments in the subprime mortgage market, on which many collateralized debt obligations (CDOs) were based, has increased greatly the risks associated with one newly important class of interest-bearing assets. It remains to be seen whether these developments will dampen foreign enthusiasm for investing in the US financial market as a whole.

A large drop in the dollar would have grave economic consequences, reducing exports and depressing investment in other rich countries. For this rea-

son, their monetary authorities are likely at some point to intervene in foreign exchange markets to limit the resulting economic downturn, in effect substituting official for private capital investment in the United States, and thereby putting effective limits to any depreciation of the dollar. But, of course, the current account deficit cannot rise indefinitely relative to GDP, nor can foreign-owned assets rise indefinitely as a share of total US assets. Sooner or later the process of financial globalization will slow, and eventually stop, probably well before the hypothetical state of “no home bias” is reached. Moreover, aging societies will eventually reach the point at which they cease acquiring new foreign assets and begin to liquidate their outstanding claims. Then the US deficit must decline, perhaps significantly. The trade deficit will need to decline even earlier, as foreigners begin to consume the earnings on their US investments. But that point may not be reached for a decade or longer, especially if people work longer and continue to save past conventional retirement age, as many do.

As Asians and Europeans begin to consume their overseas earnings, and their assets, total expenditure in their countries will rise relative to output, and their surpluses will decline and eventually disappear. This process alone will help reduce the US deficit, without any depreciation of the dollar against their currencies. To what extent the dollar needs to depreciate will depend on the emerging consumption patterns in the ageing societies, in particular on the mix between tradable and non-tradable goods and services, keeping in mind that these categories are themselves constantly changing, as more non-tradables join the category of tradables with increased possibilities for offshoring. Even non-tradables can enter the international accounts insofar as they are provided by temporary migrant workers who remit earnings to their home countries. Elder care is likely to involve both processes – diagnoses of measured symptoms in remote locations, and in situ help by migrant workers, as the children and grandchildren and great-grandchildren of the aged choose to stay in the labor force. Another possibility involves retirement of Asians and Europeans in the United States, just as some Canadians do now. Their assets would then cease to be foreign claims on the United States. The adjustment process involves the classic transfer problem in a more complex setting. How much, if at all, the dollar needs eventually to depreciate will depend on all of these factors, and certain-

ly cannot be foretold years in advance of the required adjustment.

The United States has a vibrant, innovative economy. Its demographics differ markedly from those of other rich countries in that birth rates have not fallen nearly so far and immigration, concentrated in young adults, can be expected to continue on a significant scale. In these respects the United States, although rich and politically mature, can be said to be a young and even a developing country. It has an especially innovative financial sector that continually produces new products to cater to diverse portfolio tastes. The United States has a comparative advantage, in a globalized market, in producing marketable securities; and in exchanging low-risk debt for higher risk equity. It is not surprising that savers around the world want to put a growing portion of their savings into the US economy. The US current account deficit and the corresponding surpluses elsewhere, described as imbalances, do not necessarily signal economic disequilibria in a globalized world economy, and may well remain large for years to come.

Reference

Cline, W. (2005), *The United States as a Debtor Nation*, Washington DC: Institute for International Economics.