Fundamentals at Odds? The U.S. Current Account Deficit and the Dollar

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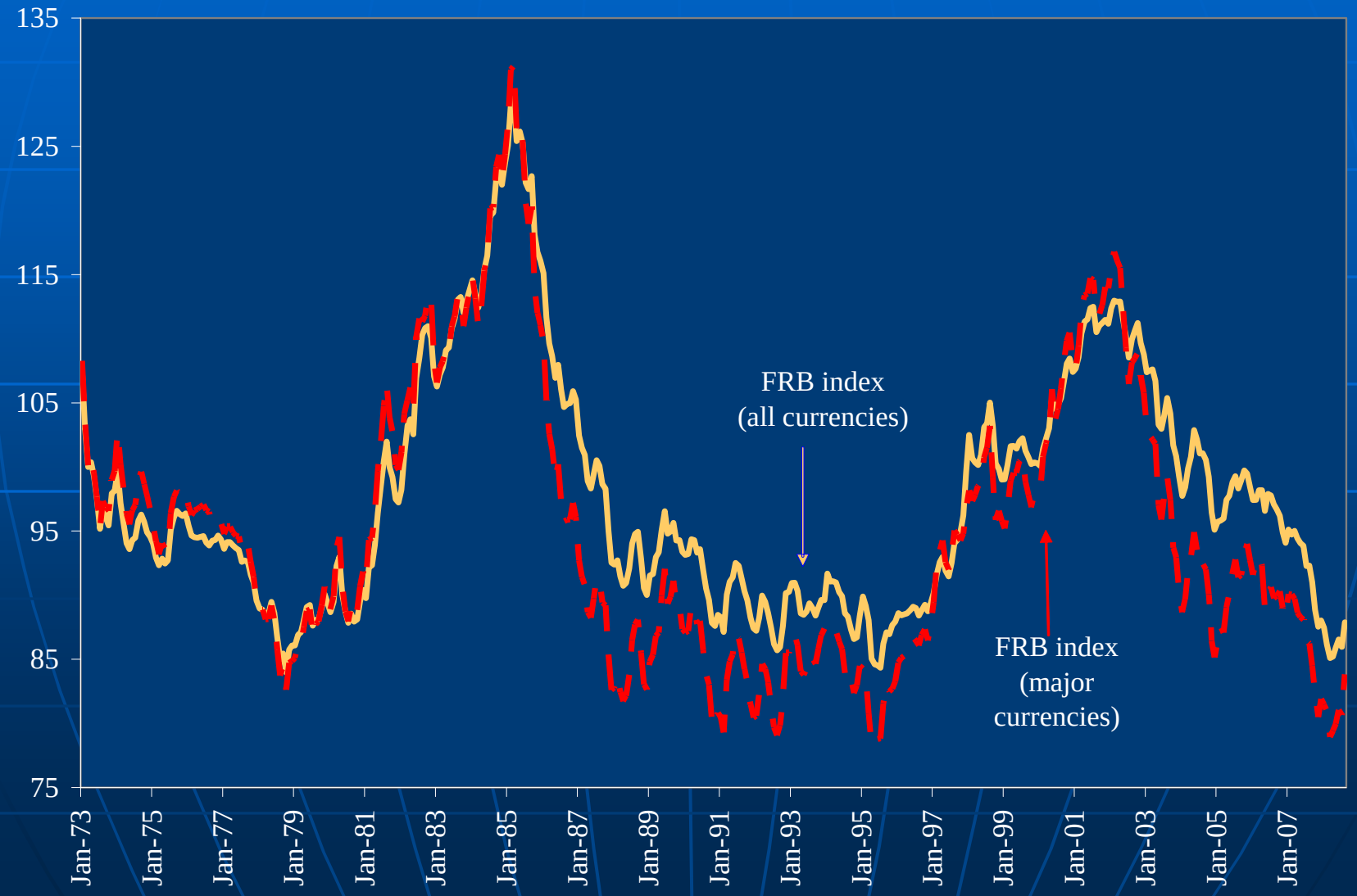
A Disclaimer

- Paper focuses on medium-term issues
- Global financial crisis
  - High exchange rate volatility
  - Over 6 percent USD appreciation in October (largest in the past 35 years)

Key Issue

- Why is the U.S. dollar “weak” but the current account deficit “large”?
  - Real effective value of the US$ is close to its minimum for the past 35 years…

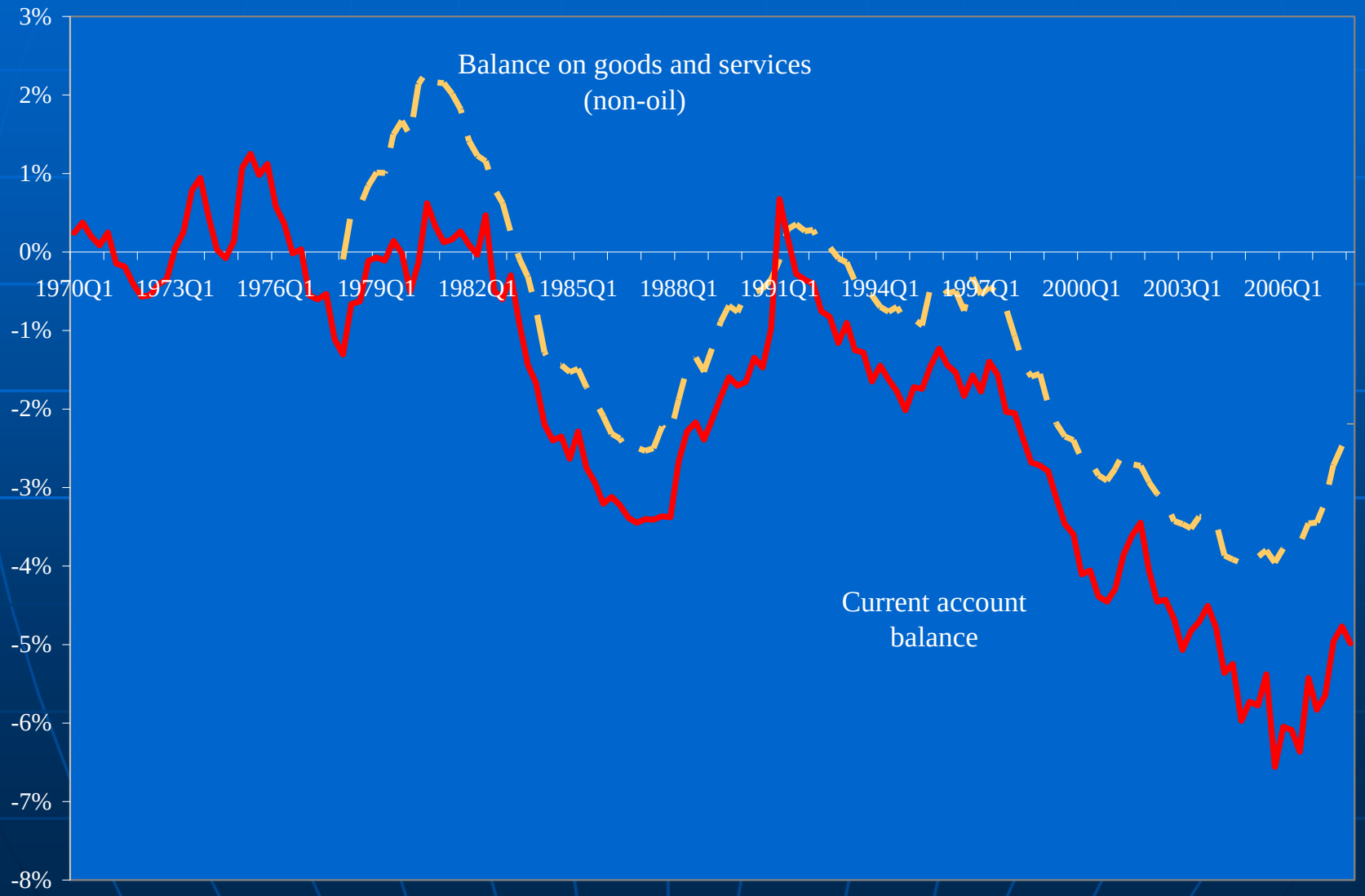
The dollar, Jan. 1973-Sept. 2008



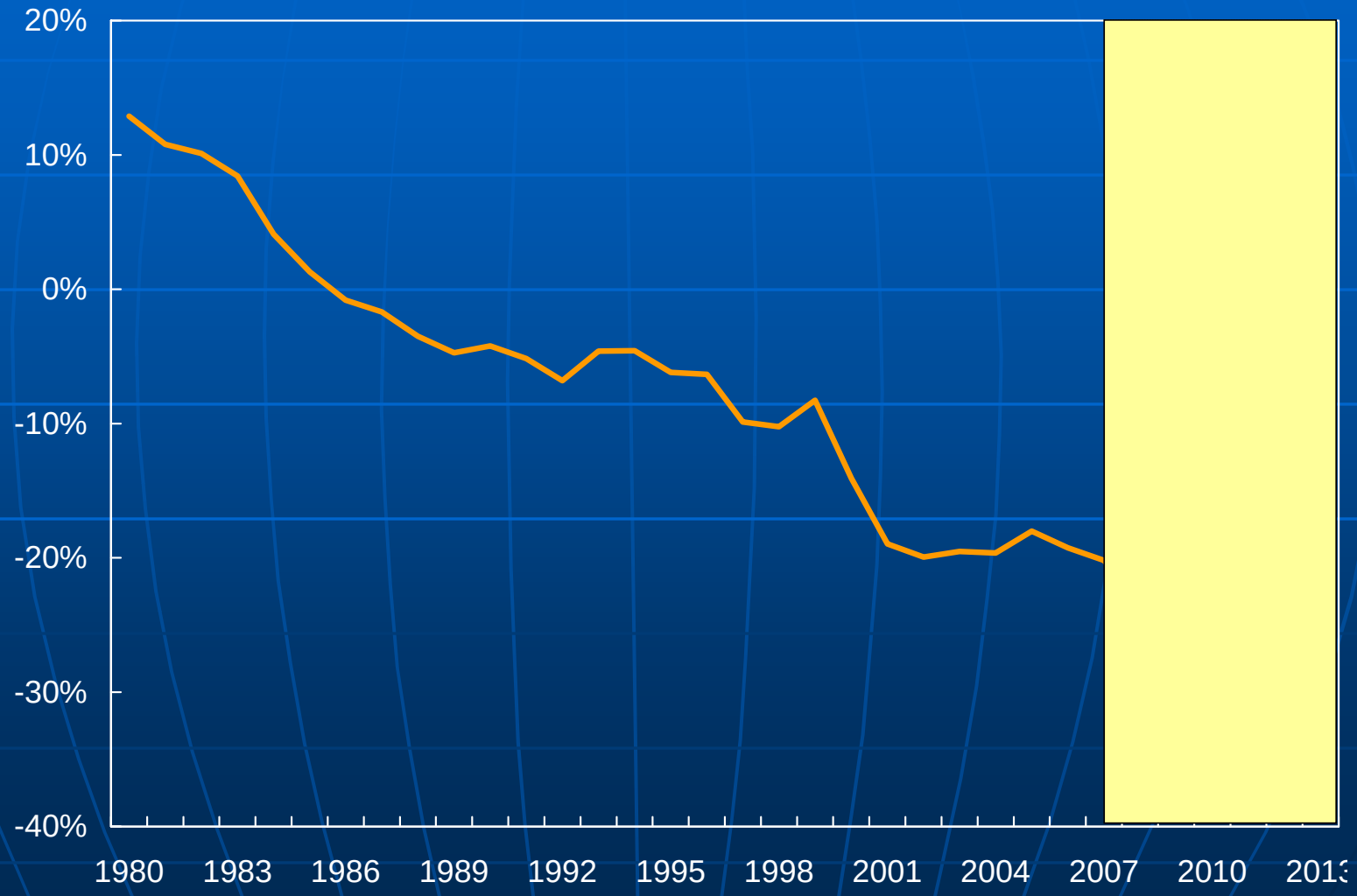
Key Issue (continued)

- …but, despite recent improvements, the U.S. current account deficit remains large and is projected to lead to a significant accumulation of external liabilities

U.S. current account balance



United States: Net Foreign Assets (ratio of GDP)



Structure of Presentation

- Literature Review
- Stylized Facts from 2 Adjustment Episodes
  - 1985-1991
  - 2002-2008
- How Can We Explain The Disconnect Between Current Account and Real Exchange Rate?

Ample literature on global imbalances

- Dollar needs to adjust
  - Obstfeld-Rogoff
  - Blanchard-Giavazzi-Sa
  - IMF GEM simulations
- No need for dollar adjustment
  - Dooley et al.
  - Engel and Rogers
  - Cooper
- Dollar has fallen...but CA has not adjusted much

1980s vs today: Widening deficits….

	1980-87	1997-2004
Change in current account balance (percent of GDP)	-3.5	-3.8
of which		
change in non-oil balance on goods and services	-4.3	-3.3
change in oil balance	1.8	-0.7
change in income balance	-0.8	0.3
change in transfers	-0.2	-0.2
change in real effective exchange rate (t-2) 1/	34.1	24.6
change in U.S. output gap	1.9	-0.3
change in output gap in trading partners 2/	-2.0	-0.5

1980s vs today: adjustment

	1987-91	2004-08
Change in current account balance (percent of GDP)	3.4	1.1
of which		
change in non-oil balance on goods and services	2.6	2.1
change in oil balance	0.1	-1.3
change in income balance	0.1	0.3
change in transfers	0.7	0.0
Change in real effective exchange rate (t-2) 1/	-26.9	-13.6
Change in U.S. output gap	-2.2	-2.0
Change in output gap in trading partners 2/	1.9	0.5

Comparing episodes

- Adjustment in the 1980s
  - Helped by oil prices
  - Large transfers in 1991 associated with first Gulf war
- Current Adjustment Episode
  - Oil prices hindered adjustment
  - Modest depreciation between 2002 and 2006

Explaining Fundamentals at Odds: Five Stories

i. The real exchange rate is mismeasured

ii. The current account is mismeasured
- Dark matter
- Valuation gains
- Other measurement problems

iii. Terms of trade and real exchange rate

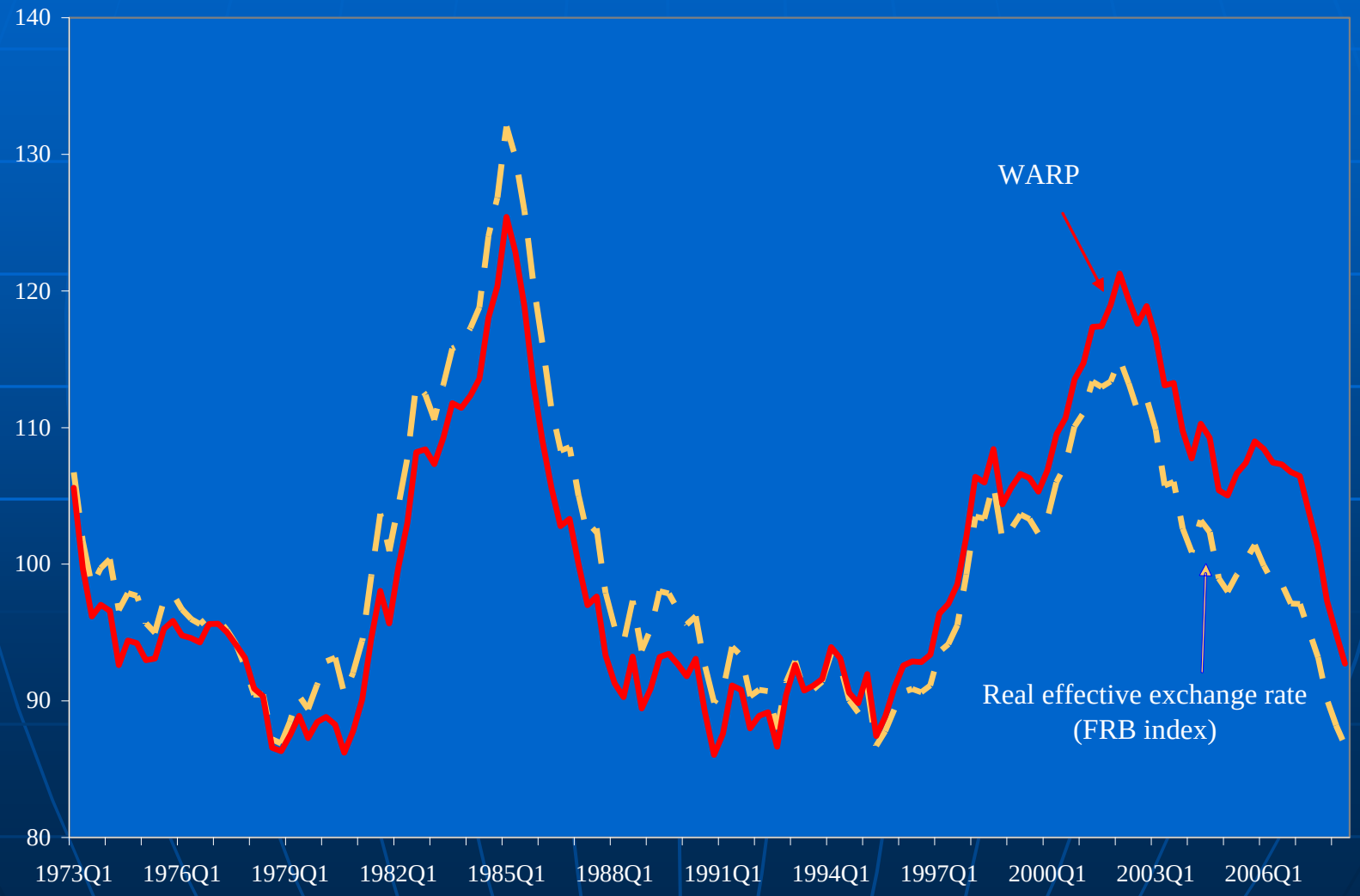
iv. Lags

v. REER Changes and External Adjustment

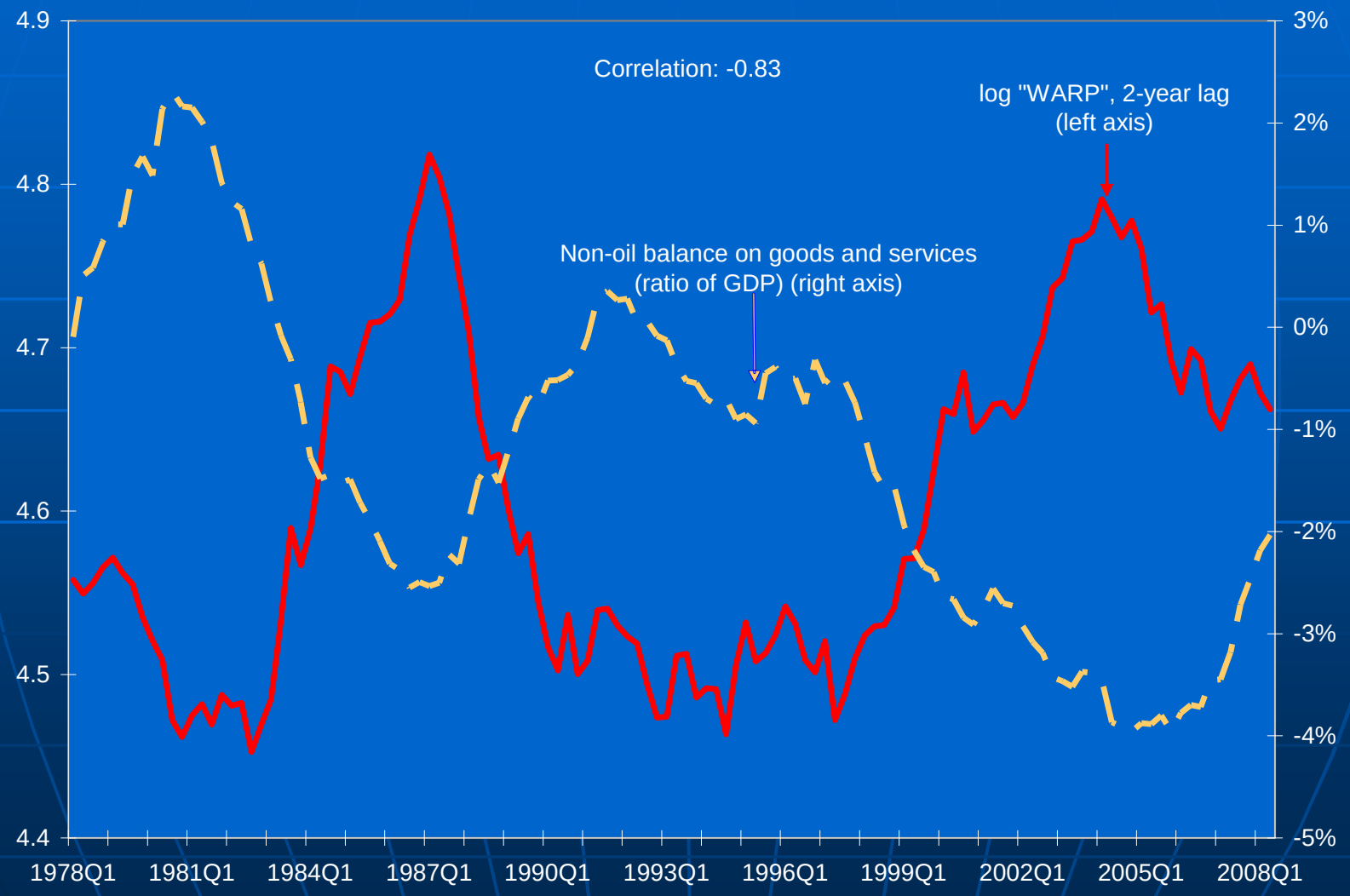
Mismeasurement of the REER

- Key point (Thomas, Marquez, and Fahle):
  - Shift in U.S. trading partners from advanced economies (high-price producers) to emerging economies (low-price producers)
  - Real exchange rate index does not capture the difference in price <u>level</u> between trading partners

Two measures of international relative prices



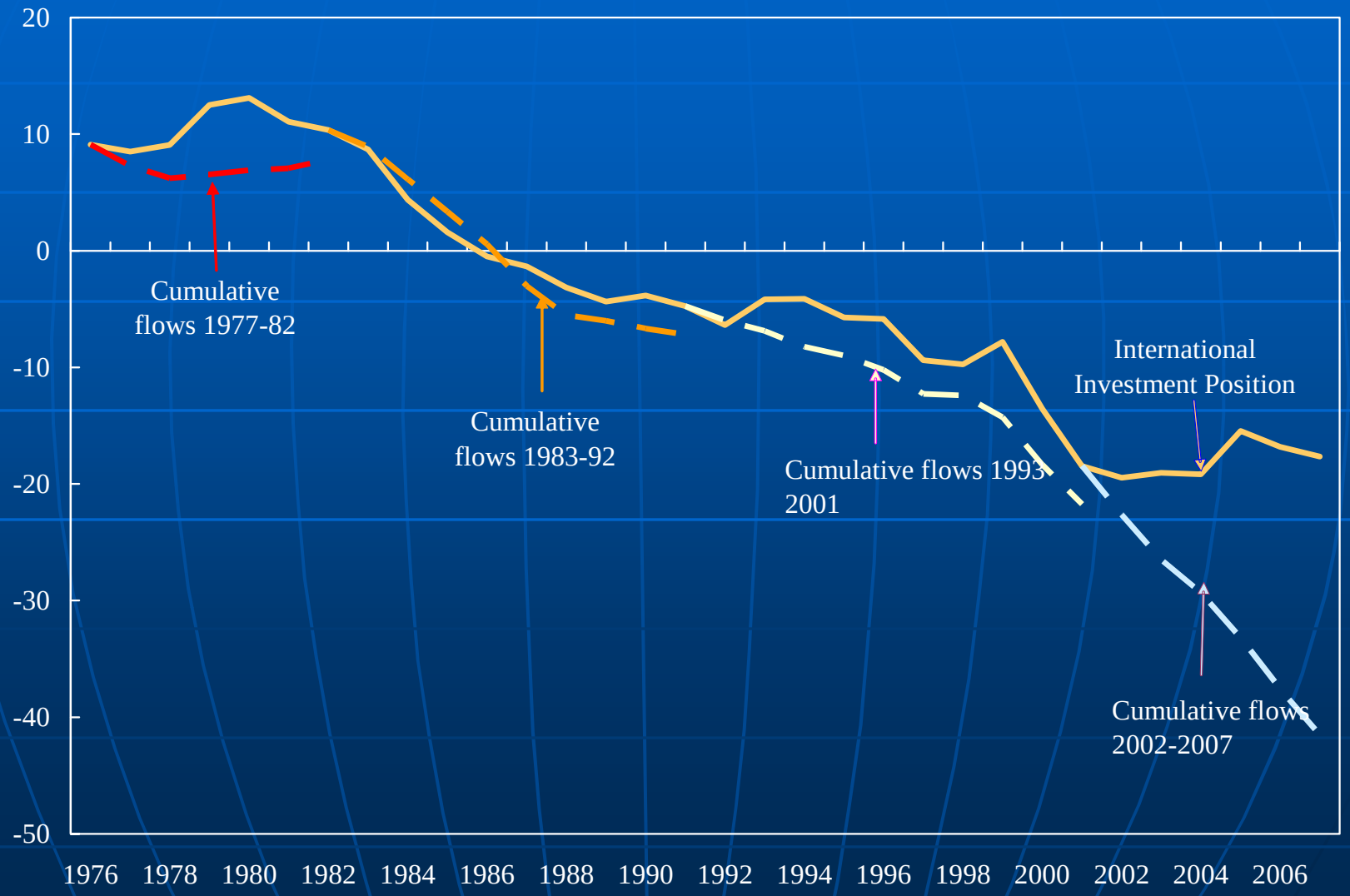
WARP and non-oil trade balance



Current Account Deficit and Accumulation of External Liabilities

- Historically, U.S. net foreign assets have declined by much less than the CA deficit
  - Valuation effects
  - Dark matter
  - Other measurement issues

Mismeasurement of the US CA



Exorbitant privilege?

- In recent years US returns on foreign assets very high
  - Better stock market performance outside US
  - Dollar depreciation
- This is not likely to persist...
- ..but some return differential can remain
  - FDI
  - Portfolio composition effect (US is “long” equity and “short” debt)

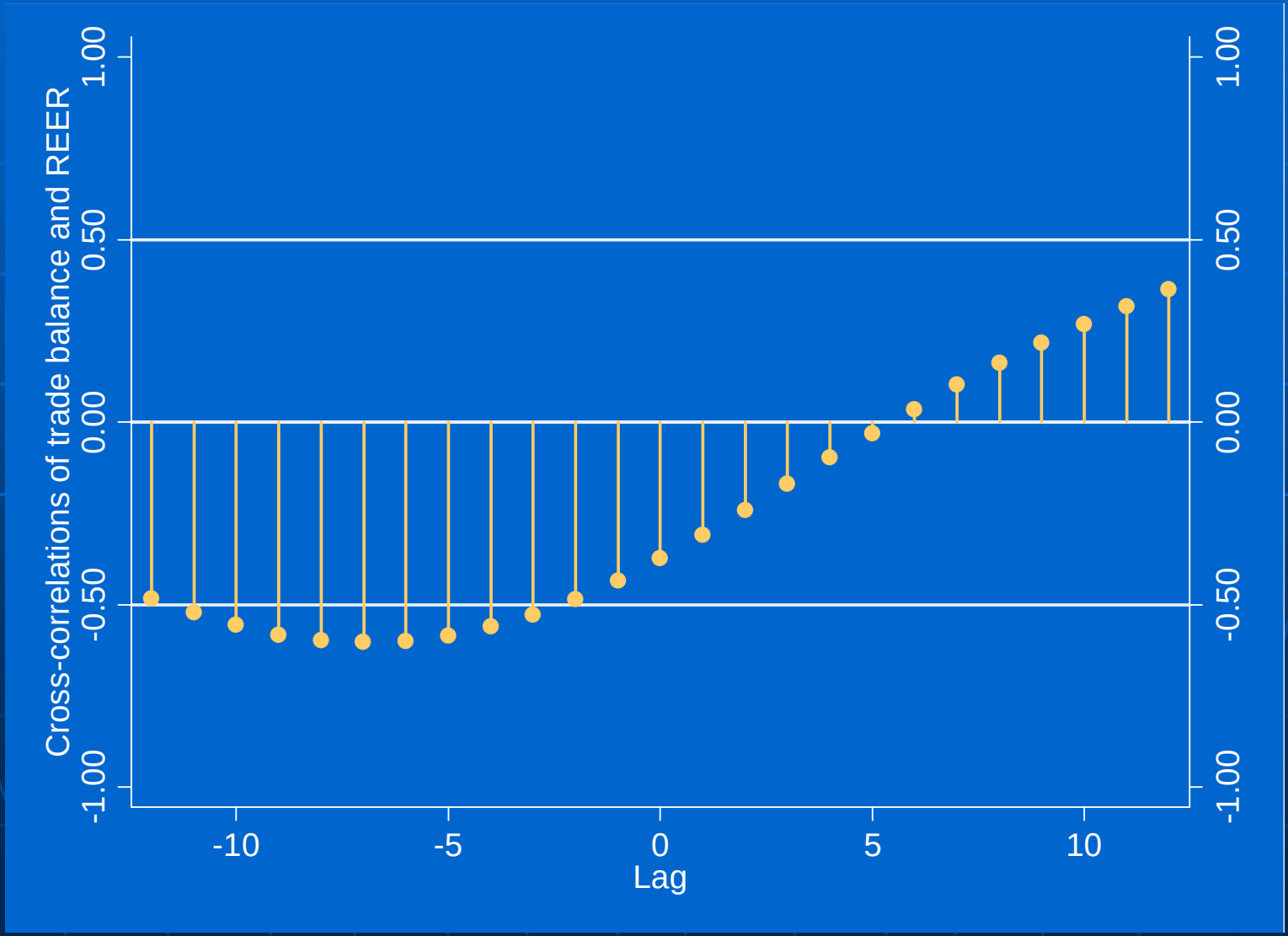
Is the US CA mismeasured?

- Bottom line:
  - CA deficit may be somewhat overstated, but not by much (Lane-MF, 2008; Curcuru, Thomas, Warnock, 2008)
  - Valuation effects may help, but trade deficit needs to fall

Adjustment lags

- J-curve: exports and imports respond to exchange rate changes with a lag
- About half of the U.S. depreciation since 2002 has taken place in the last two years

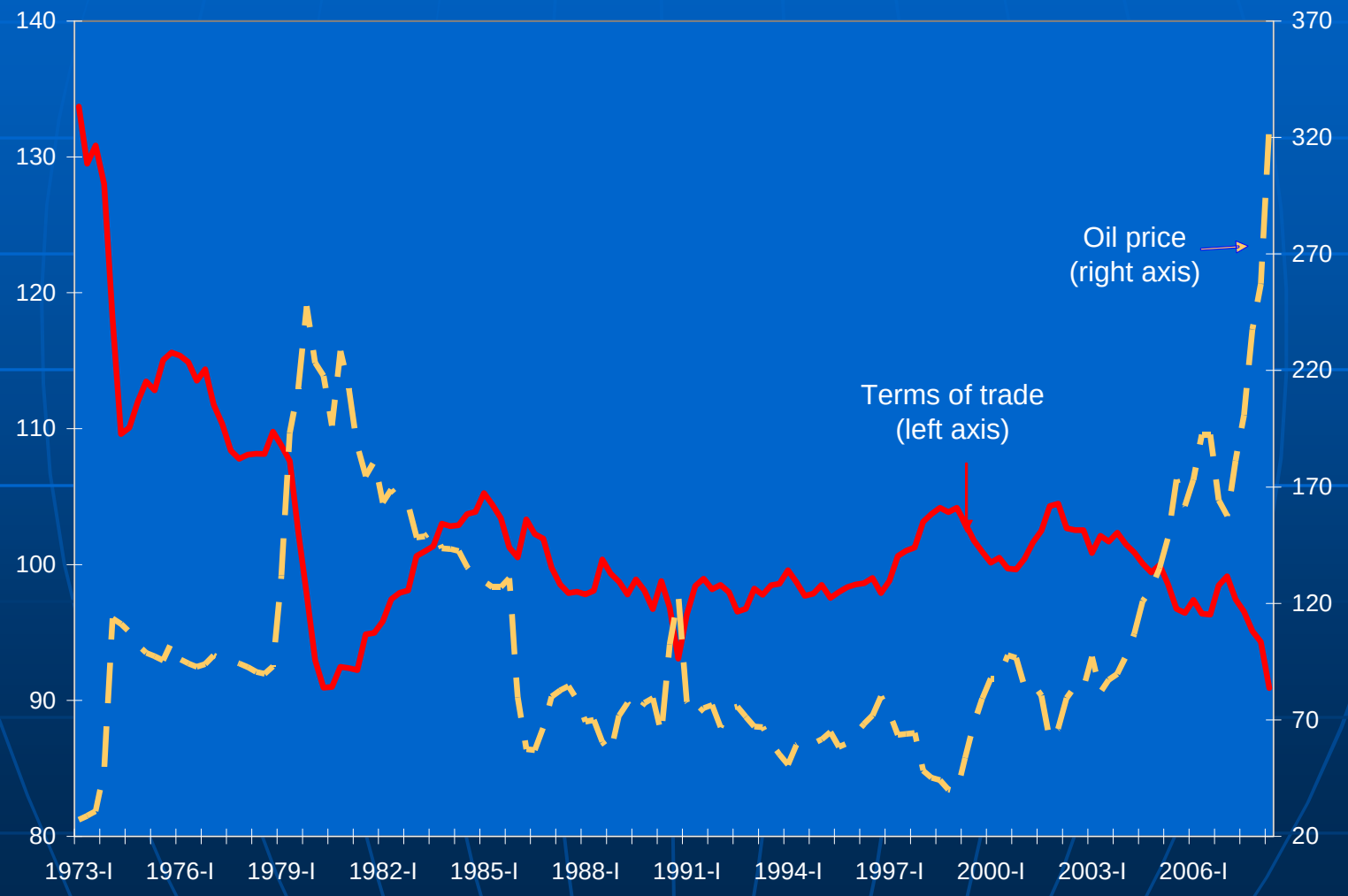
Cross-correlation trade balance-REER



REER and The Terms of Trade

- Very significant role of oil price increases in explaining US CA
  - More depreciated equilibrium REER
  - Uncertainty on longer-term projections for oil imports (energy saving etc)

Oil prices and terms of trade



REER and External Adjustment

- Over the medium term, CA can change significantly even with relatively modest shifts in relative prices, because of the introduction of new goods (Corsetti et al)
- Some evidence from Galstyan and Lane (2008)

Conclusions

- Fundamentals at odds (REER and CA)
- Several possible explanations
  - REER weakness overstated
  - CA adjustment may need to be smaller
  - Role of lags
  - Role of oil prices
  - Adjustment can occur with small shifts in relative prices