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...
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

Current account balance

Balance on goods and services (non-oil)
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

<table>
<thead>
<tr>
<th>Change in current account balance (percent of GDP)</th>
<th>1980-87</th>
<th>1997-2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>of which</td>
<td></td>
<td></td>
</tr>
<tr>
<td>change in non-oil balance on goods and services</td>
<td>-4.3</td>
<td>-3.3</td>
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<tr>
<td>change in oil balance</td>
<td>1.8</td>
<td>-0.7</td>
</tr>
<tr>
<td>change in income balance</td>
<td>-0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>change in transfers</td>
<td>-0.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>change in real effective exchange rate (t-2)</td>
<td>34.1</td>
<td>24.6</td>
</tr>
<tr>
<td>change in U.S. output gap</td>
<td>1.9</td>
<td>-0.3</td>
</tr>
<tr>
<td>change in output gap in trading partners</td>
<td>-2.0</td>
<td>-0.5</td>
</tr>
</tbody>
</table>
### 1980s vs today: adjustment

<table>
<thead>
<tr>
<th>Change Description</th>
<th>1987-91</th>
<th>2004-08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in current account balance (percent of GDP)</td>
<td>3.4</td>
<td>1.1</td>
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<tr>
<td>of which</td>
<td></td>
<td></td>
</tr>
<tr>
<td>change in non-oil balance on goods and services</td>
<td>2.6</td>
<td>2.1</td>
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<tr>
<td>change in oil balance</td>
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<td>0.0</td>
</tr>
<tr>
<td>Change in real effective exchange rate (t-2) 1/</td>
<td>-26.9</td>
<td>-13.6</td>
</tr>
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<td>Change in U.S. output gap</td>
<td>-2.2</td>
<td>-2.0</td>
</tr>
<tr>
<td>Change in output gap in trading partners 2/</td>
<td>1.9</td>
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</table>
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 level between trading partners
Two measures of international relative prices

Real effective exchange rate (FRB index)
WARP and non-oil trade balance

Correlation: -0.83

Non-oil balance on goods and services (ratio of GDP) (right axis)

log "WARP", 2-year lag (left axis)
Historically, U.S. net foreign assets have declined by much less than the CA deficit.

- Valuation effects
- Dark matter
- Other measurement issues
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

![Graph showing cross-correlations of trade balance and REER.](image-url)
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
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