Current Account Sustainability

1. Consider a two-period economy that has at the beginning of period 1 a net foreign asset position of -100. In period 1, the country runs a current account deficit of 5 percent of GDP, and GDP in both periods is 120. Assume the interest rate in periods 1 and 2 is 10 percent.

   (a) Find the trade balance in period 1 ($TB_1$), the current account balance in period 1 ($CA_1$), and the country’s net foreign asset position at the beginning of period 2 ($B^*_1$).

   (b) Is the country living beyond its means? To answer this question find the country’s current account balance in period 2 and the associated trade balance in period 2. Is this value for the trade balance feasible? [Hint: Keep in mind that the trade balance cannot exceed GDP.]

   (c) Now assume that in period 1, the country runs instead a much larger current account deficit of 10 percent of GDP. Find the country’s net foreign asset position at the end of period 1, $B^*_1$. Is the country living beyond its means? If so, show why.

2. Ever since the 1980s, when a long sequence of external deficits began, many economists and observers have shown concern about the sustainability of the U.S. current account. Use question 1 and the concepts developed in chapter 2 of the book as a theoretical basis to provide a critical analysis of the attached article from the November 27, 2003 edition of the The Economist magazine entitled “Stop worrying and love the deficit.”

3. Suppose that, at the time of the writing of this article, its author had known the path of the U.S. economy to the present. How do you think his predictions would have changed?
Stop worrying and love the deficit
Nov 27th 2003
From The Economist print edition

America’s current-account deficit poses few dangers, says Alan Greenspan. Except to Europeans

In the past year the United States has run up a current-account deficit of more than $500 billion. Some think that the line of credit extended by the rest of the world to America is dangerously long. As Kenneth Rogoff, formerly chief economist of the International Monetary Fund, puts it, foreign creditors give poor countries just enough rope to hang themselves, but they are giving the Americans enough rope to tie the noose around their neck several times. Most countries with a deficit of such size would find the downward pressure on their currencies and the upward pressure on bond yields irresistible. They would be forced to cut their expenditure and switch their spending from imports to domestic production. But for America the gallows do not beckon yet, according to a recent speech by Alan Greenspan, the chairman of the Federal Reserve, at a conference sponsored by The Economist and the Cato Institute. Admittedly, Americans’ demands on the world’s savings are greater than ever. But Mr Greenspan argues that, thanks to spreading globalisation, the pool of savings on offer in today’s global capital markets is deeper and more liquid than ever. The markets continue to furnish America with the money it needs without demanding higher yields in return. In a recent paper Michael Dooley, of the University of California at Santa Cruz, and David Folkerts-Landau and Peter Garber, of Deutsche Bank, come to the same sanguine conclusion from opposite premises: the deficit is manageable not because today’s world is unique but because it replicates the post-war Bretton Woods era. America is once again at the centre of an international monetary system. On the periphery, where post-war Europe once stood, now stands East Asia, with its cosseted capital markets and fear of floating against the dollar. The players have changed, but the rules of the game are much the same. Under Bretton Woods, the Europeans, as they regained their exporting strength, amassed ever greater dollar claims on America. Similarly, under today’s revived Bretton Woods system, the East Asians hoard their export earnings in low-yielding dollar assets, such as Treasury bills. What East Asia hoards, America happily spends: the inflow of Asian capital keeps American interest rates low and demand high. Moreover, America tends to spend its cheap East Asian loans on cheap East Asian goods. America and Europe used to enjoy a similar relationship. As Jacques Rueff, a French economist, put it in 1965: If I had an agreement with my tailor that whatever money I pay him returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him. America gets more suits, but what do the East Asian tailors get out of it? Yields on safe, dollar assets are low and the opportunity cost is high, given better returns at home or elsewhere. Messrs Dooley, Folkerts-Landau and Garber argue that East Asia’s governments are accumulating dollar assets as a by-product of a strategy of export-led growth. East Asia is prepared to forgo better returns in order to keep its exchange rates down and export demand up. This allows the region’s industries to compete on world markets and attract foreign investment. To stretch Mr Rogoff’s metaphor, the rope East Asia extends to America is not a noose but a tow-line, which will gradually pull Asian economies towards greater prosperity. Others, such as Ronald McKinnon of Stanford University, think that American profligacy has trapped East Asia into running current-account surpluses. The region is forced to acquire dollar assets in order to avoid exchange-rate appreciation and deflation. Under the original Bretton Woods system, Mr McKinnon points out, America borrowed on a short-term basis from Europe, but lent long, making enormous direct investments in the rebuilding of Europe’s war-blasted capital stock. These days America (direct investments in China notwithstanding) borrows short in order to spend.

Slow change, or slower The $500 billion question, however, is whether America’s deficit is sustainable. The authors believe that the current system can endure, but that it will change. East Asia will continue to lend to America until the surplus labour in its hinterlands is absorbed into its export industries, its financial system has matured and its currencies are ready to float. And after East Asia has graduated from the economic periphery, as Europe did before it, South Asia may take its place. Mr Greenspan, by contrast, thinks America’s build-up of foreign debt must slow and eventually be reversed. But he is confident of a soft landing: market forces will incrementally defuse the deficit. The dollar may fall and bond yields rise, but America is flexible enough to adjust painlessly. Messrs Dooley, Folkerts-Landau and Garber put their faith in the rigged exchange rates and regulated capital markets of Asia. Mr Greenspan puts his faith in market

forces and the flexibility of America. None of them thinks America should lose any sleep over its current-account deficit. All of them caution against protectionism, of which there have recently been unnerving signs. Most of the discomfort caused by America’s deficit will be felt neither in Asia nor in America but in Europe. European investors may be growing less willing to underwrite American borrowing for miserable returns: according to Morgan Stanley, they sold $403m-worth of American stocks, bonds and notes in September after purchasing $28 billion-worth a month between January and August. Meanwhile, European exporters are losing markets, squeezed out by an appreciating euro. However much rope East Asia provides, European necks are in the noose.

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