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The U.S. Current Account Deficit and Its Implications for Fed Policy and the Dollar

By Maria Vassalou, Ph.D. and John Donaldson, Ph.D.

Current account deficits have persisted in the U.S. since at least 1992. Some critics view them as a sign of an erosion in the country's competitiveness, whereas others justify them as a natural and not particularly worrisome consequence of free trade. President Trump has blamed "unfair trade" terms for costing the U.S. millions of manufacturing jobs and leading to current account deficits. To counter these effects, he has embarked on a spat with many allies and trade partners in an effort to renegotiate parts of trade agreements (e.g., NAFTA) that he views as disadvantageous to the U.S. To that end, he has imposed or threatened to impose tariffs on a wide range of goods originating from several countries.

In this paper, we provide some perspective on the nature, sources and effects of the U.S. current account deficits and draw implications for Fed policy going forward and the value of the U.S. dollar.

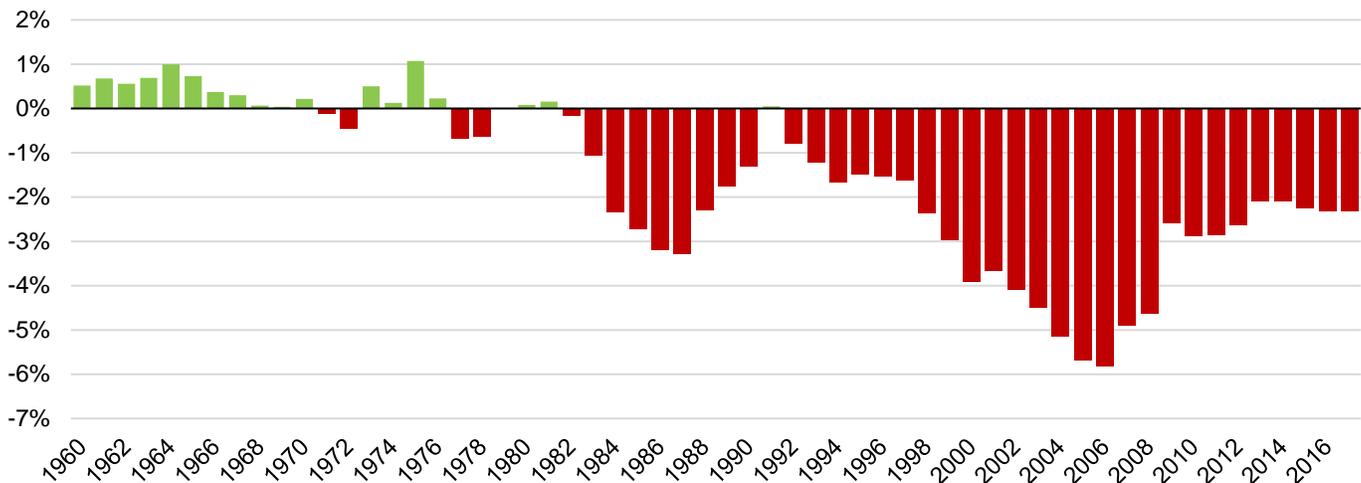
How Serious of a Problem are the U.S. Current Account Deficits?

In 2017, the aggregate U.S. current account balance in goods and services was negative \$566 billion, or 2.9% of U.S. GDP. To a good approximation, the current account balance represents the difference in the value of exports and imports of goods and services between the U.S. and the rest of the world. A negative balance denotes a deficit, meaning that imports outweigh exports in value. While the 2017 deficit is less than the record of \$762 billion set in 2006, which at the time was equivalent to 6.2% of GDP, it is nevertheless quite sizeable. For comparison purposes, the size of the U.S. current account deficit is approximately equal to the GDP of Switzerland at Purchasing Power Parity (PPP) terms.

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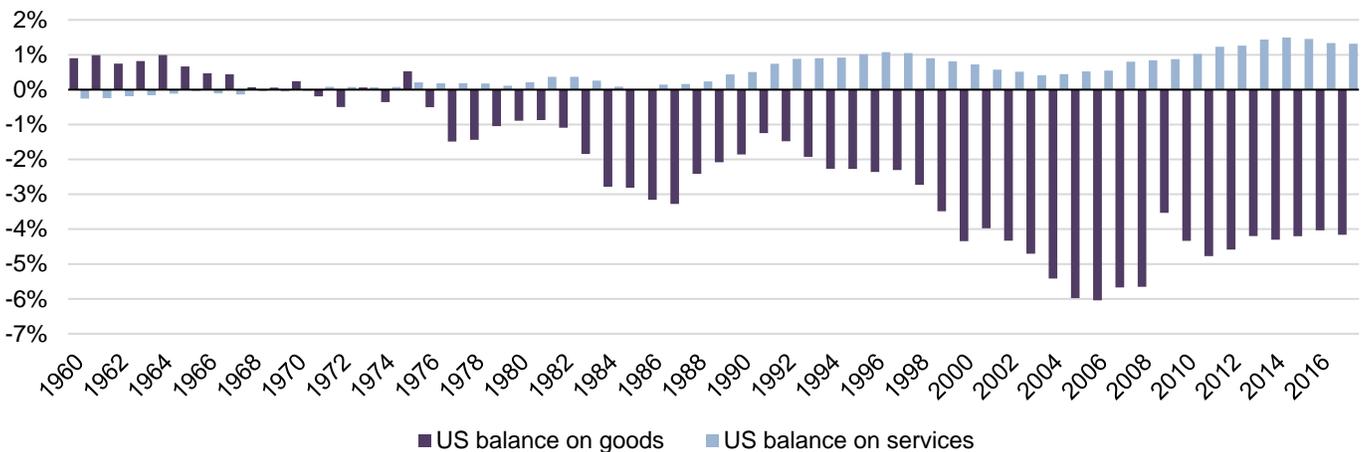
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Client Services
212.287.3111
perellaweinbergir@pwpartners.com

FIGURE 1: U.S. CURRENT ACCOUNT SURPLUS / DEFICIT (-) AS % OF GDP

Source: BEA

Figure 1 shows the evolution of the U.S. current account balances since 1960. With a brief interruption in 1992, the U.S. has been running deficits essentially since 1982. However, from 1992 onwards, these deficits have become persistent, and after peaking at almost 6% of GDP prior to the financial crisis, they have stabilized at around 2-2.5% of GDP in the post-crisis era.

FIGURE 2: U.S. BALANCE ON GOODS AND SERVICES SURPLUS / DEFICIT (-) AS % OF GDP

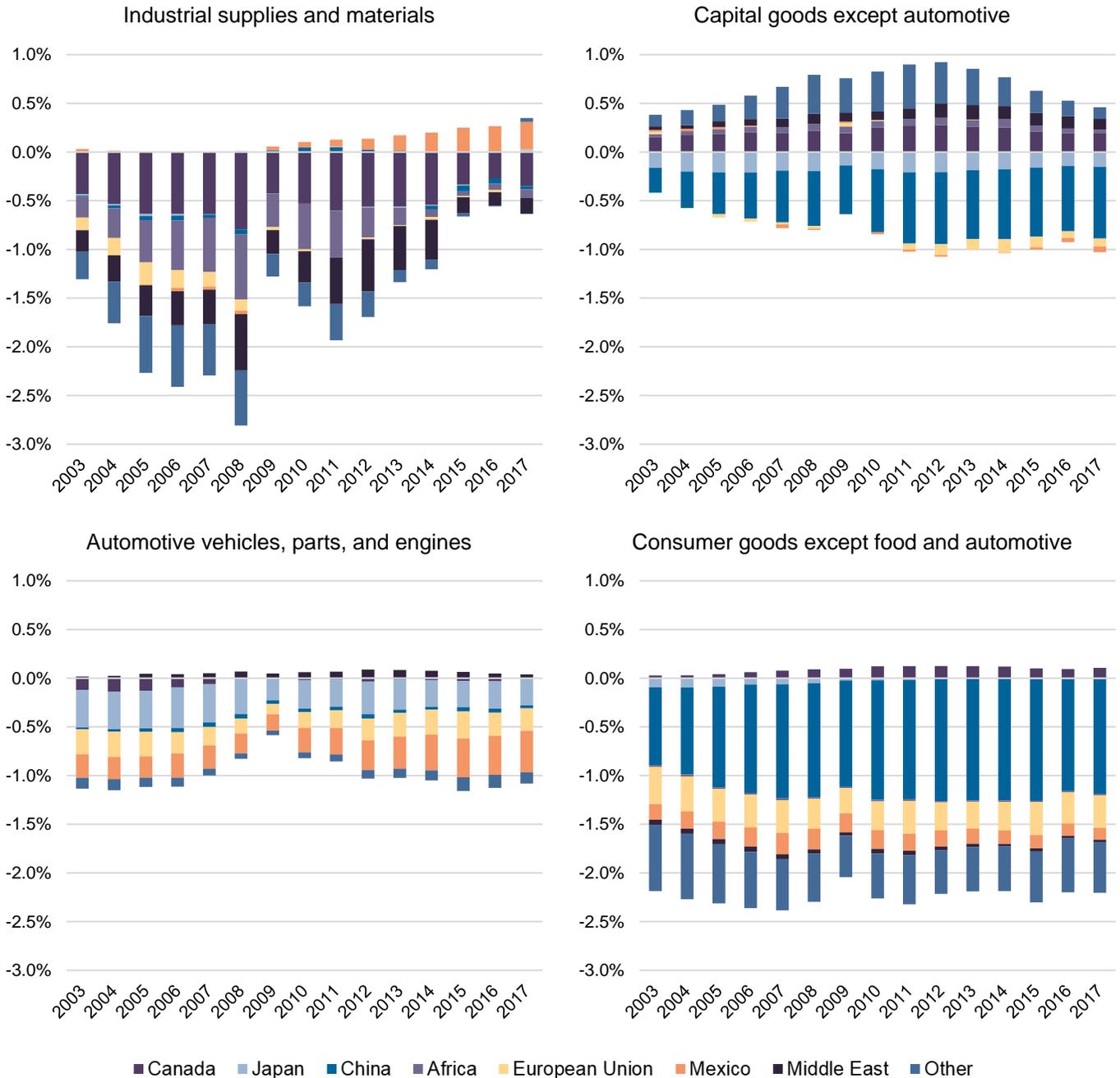
Source: BEA

To gain further understanding into these deficits, it is useful to look into their composition. As a first pass, Figure 2 shows the balances of goods and services for the U.S. as a percentage of GDP. It can be seen that the U.S. started running modest surpluses in the services sector in the early 1970s that have recently increased to account for over 1% of GDP. In the goods sector, the U.S. has been running increasingly larger deficits over the years that peaked at over 6% of GDP in the pre-crisis period, and have by now been reduced to slightly over 4% of GDP. This reduction in the goods deficits achieved over the past decade is significant and largely due to the development of the shale industry that reduced the U.S.'s energy dependence and the

need for fossil fuel imports. However, going forward, it is unclear whether the trend of shrinking goods deficits can continue, or whether the surpluses generated from the services sector will persist and expand further into the future. For instance, in recent years, the services surplus as a percentage of GDP has been shrinking.

What Drives the Goods Deficits and Services Surpluses in the Current Account?

FIGURE 3: U.S. GOODS TRANSACTIONS AS % OF U.S. GDP



Source: BEA

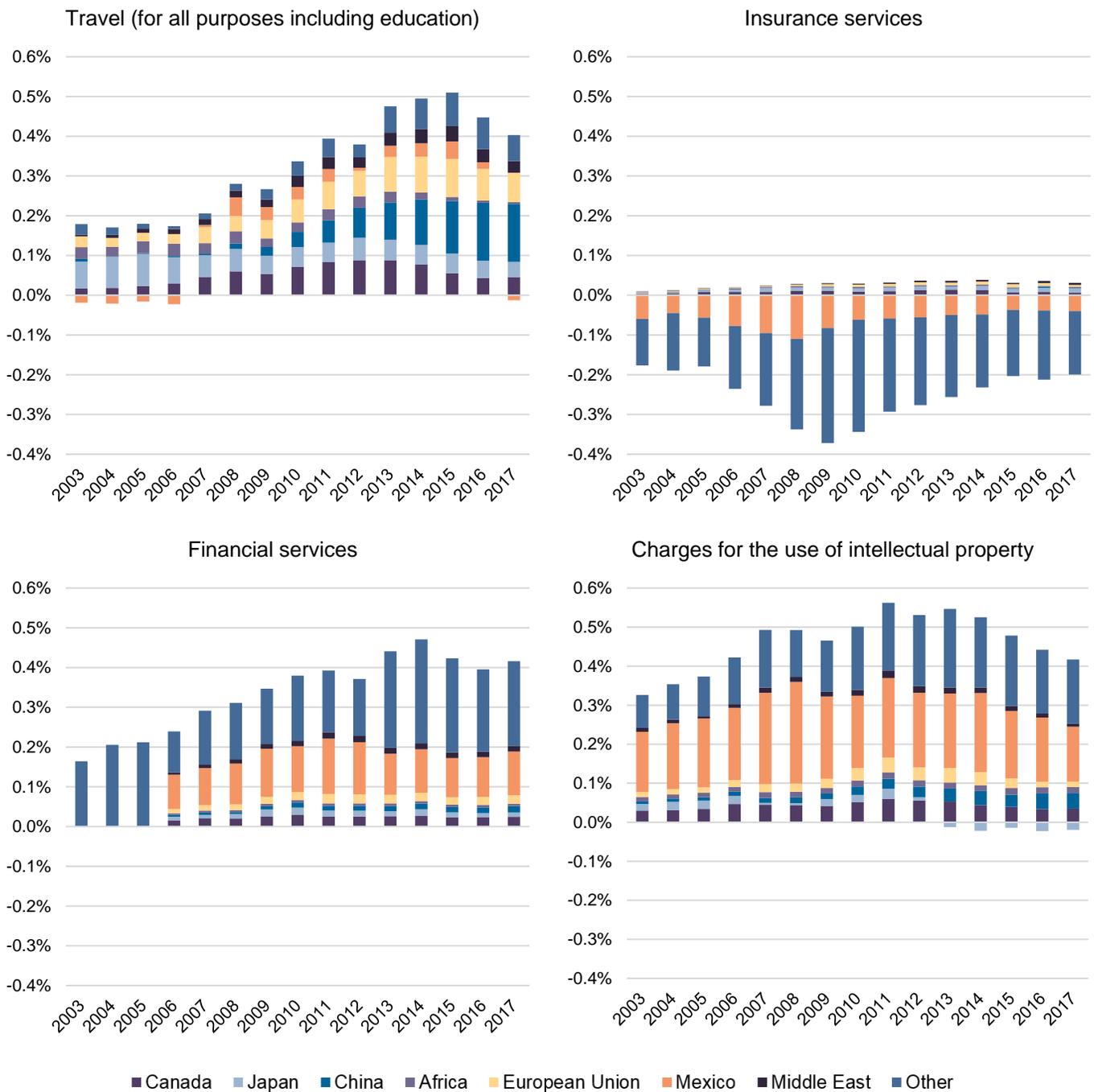
Figure 3 provides an overview of some of the larger goods deficits in the U.S. since 2003 that have exhibited change over time, broken out by industry and the main trade partners/regions.

The composition of the goods deficit has evolved over time as the structures of the U.S. economy and those of other countries have changed. In the early 2000s, deficits were driven primarily by imports in industrial supplies and materials, as well as autos and consumer goods. More recently, the need for energy imports has significantly decreased, reducing the imports in the industrial supplies and materials category. At the same time, imports of capital goods other than automotive have increased and the U.S. exports in this category have shrunk. In terms of origin, more of the imports are now sourced from China than other countries whereas imports from Japan have diminished.

In the services sector, the U.S. maintains a surplus as shown in Figure 2 and detailed in Figure 4.

Whereas in the earlier years charges for the use of intellectual property (IP) dominated the services surplus, recently, the contribution of IP in the surplus has decreased and other categories such as travel (including education) and financial services have increased in importance to match the level of contribution of IP services. However, caution is in order in interpreting the evolution of the revenues from IP. While it is possible that the U.S. is losing ground in IP producing matters and its comparative advantage may be getting eroded, the extensive use of inversions and tax loopholes by U.S. multinationals, in an effort to shift profits to tax havens, are likely to be biasing the reported current account surplus from IP sources downwards. Still, the fact that the dominant part of the services surplus is now driven by sources such as travel and financial services is concerning. At the very least, it implies that the size of the services surplus may be less stable and more vulnerable to competition from abroad going forward.

FIGURE 4: U.S. SERVICES TRANSACTIONS AS % OF U.S. GDP



Source: BEA

Is the U.S. Current Account Deficit Sustainable Over Time?

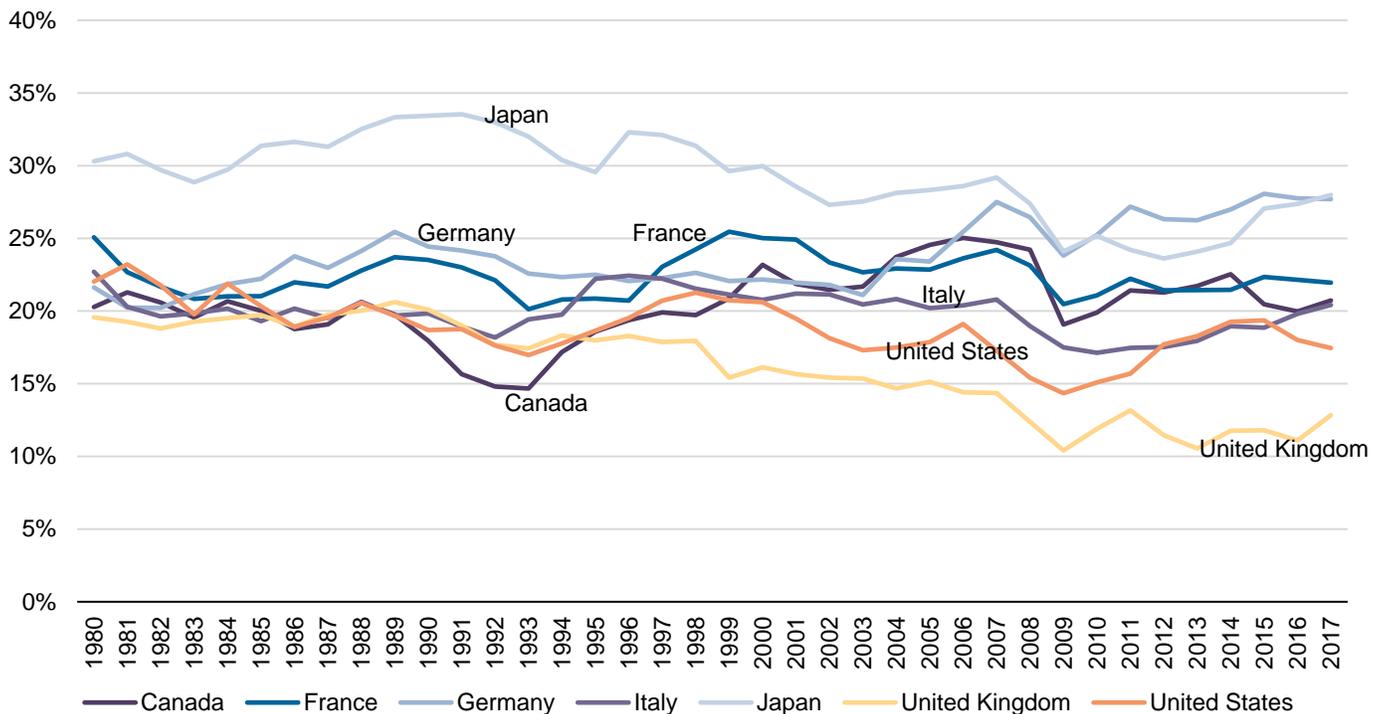
Whether a current account deficit is sustainable or not, depends on its sources. In particular, the following drivers matter:

- Is the deficit the result of excess consumption or increased investment?
- Is the savings ratio of the country increasing or decreasing?

- What is the Net Foreign Assets position of the country? Does the country own enough foreign assets to cover its liabilities?
- How will the monetary and fiscal policies of the country affect its exchange rate?

In the case of the U.S., it is clear that the current account deficit is the result of excess consumption as the majority of the deficit is driven by imports of consumer goods. This excess consumption has also led to reduced savings over time as wage increases have been muted. Figure 5 shows the gross national savings of the G7 countries as a percentage of their GDP. U.S. gross national savings have declined over time and they are the second lowest among the G7 economies after the UK.

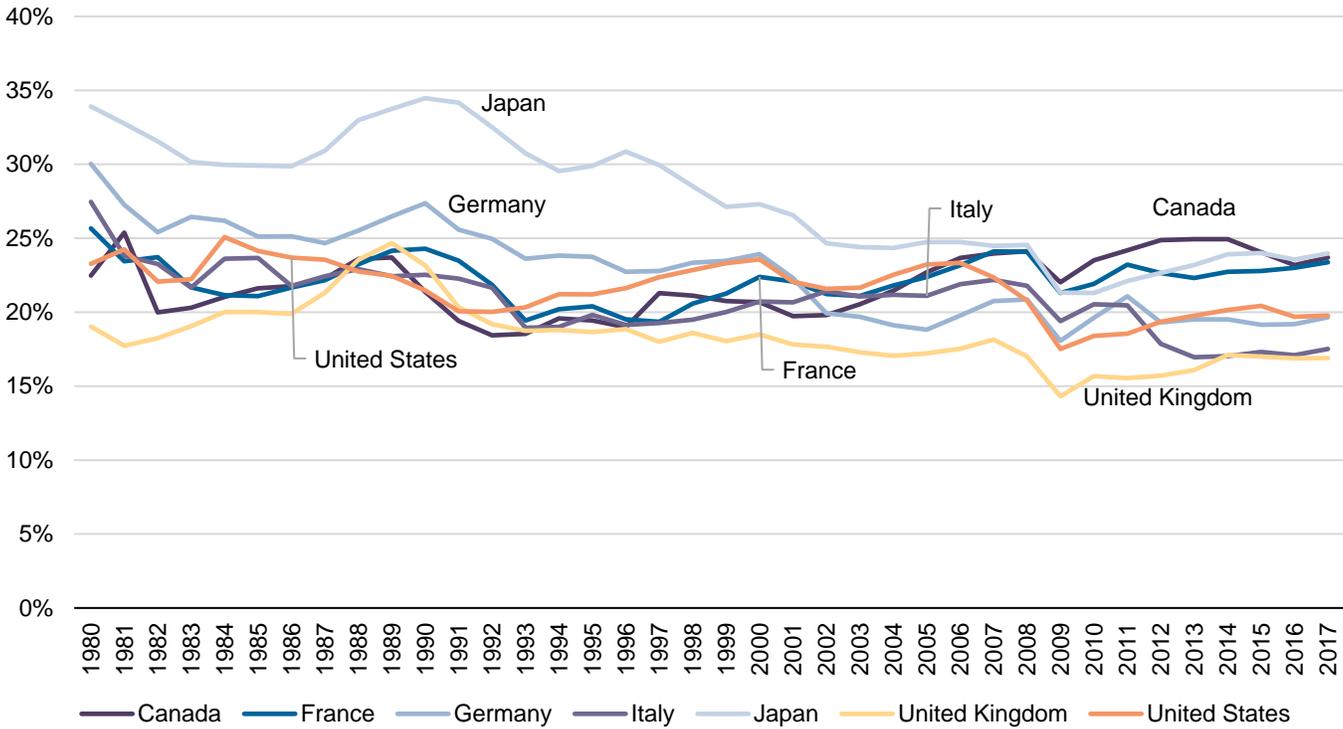
FIGURE 5: GROSS NATIONAL SAVINGS AS % OF GDP



Source: IMF

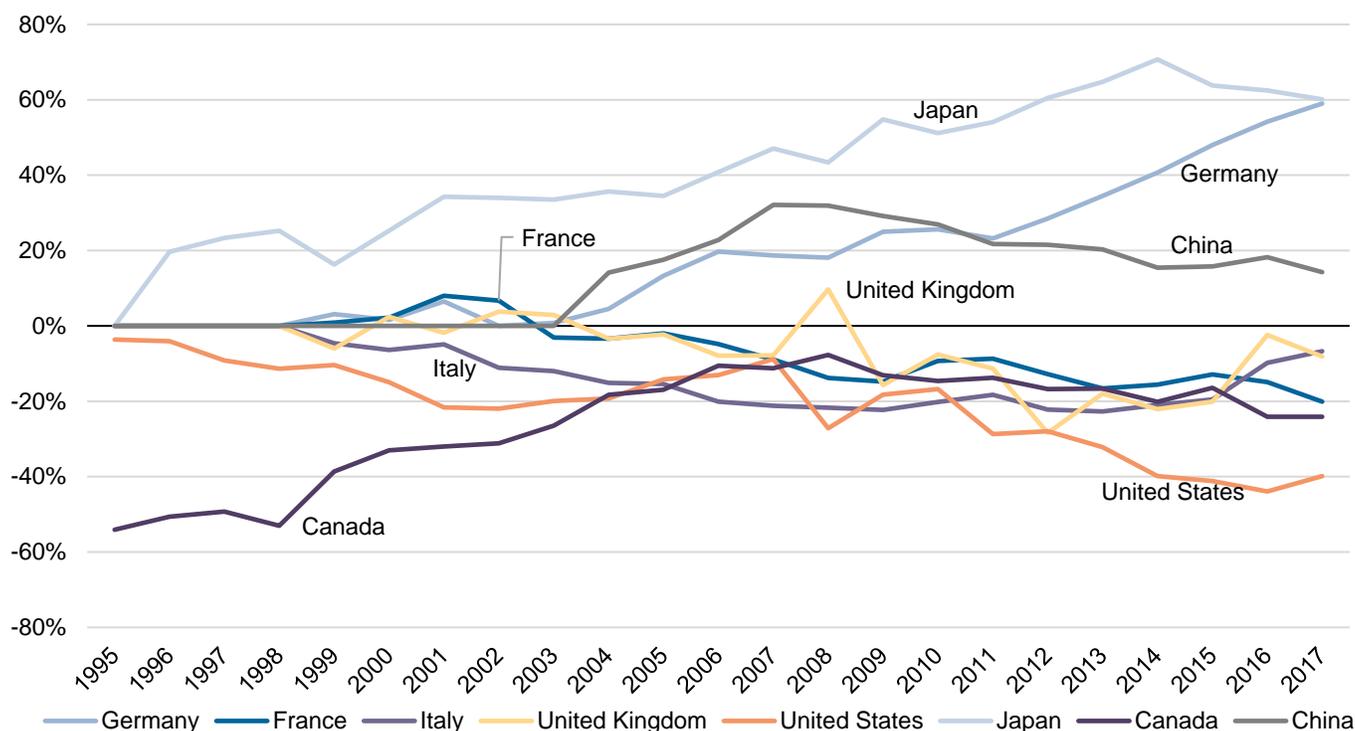
The worrisome part of the above chart is that the decrease in savings was not used to increase investments. Indeed, Figure 6 shows that total U.S. investments as a percentage of GDP have been declining after initially stabilizing at levels significantly lower than what was prevalent in the pre-GFC period.

FIGURE 6: TOTAL INVESTMENT AS % OF GDP



Source: IMF

Furthermore, the Net Foreign Asset value for the U.S. has been declining since the financial crisis and it currently stands at negative \$8 trillion which roughly corresponds to 40% of U.S. GDP. While some of the recent declines can be attributed to the strengthening of the U.S. dollar that reduces the value of U.S. foreign investments when expressed in U.S. dollar terms, the trend appears to be somewhat negative.

FIGURE 7: NET INTERNATIONAL INVESTMENT POSITION AS % OF GDP

Sources: Eurostat, Federal Reserve Economic Data, Ministry of Finance (Japan), Statistics Canada, State Administration of Foreign Exchange (China)

Does Monetary Policy Matter for the Sustainability of the Current Account Deficits?

By ensuring price stability through prudent monetary policy, the Fed effectively reduces the need for investors to require a sizeable inflation premium when they lend in U.S. dollars. Therefore, long-end U.S. Treasury rates can stay relatively low, supporting the increased borrowing necessary to fund the current account deficits. Note that most capital inflows that finance the U.S. current account deficit take the form of debt financing. However, too stringent monetary policy can have an adverse effect on the current account, as it would boost the value of the U.S. dollar and reduce the competitiveness of U.S. goods in foreign markets. A deteriorating current account is itself contractionary, and could contribute significantly to ending the current economic expansion. Given the size and nature of the U.S. current account deficits, it is our view that a monetary policy that ensures dollar exchange rate stability at its present or somewhat diminished level, would be the most appropriate. If the current expansion is to continue, the Fed is effectively constrained from raising interest rates to pre-crisis levels or indeed much beyond the current ones. To do otherwise risks triggering a rapid and potentially dramatic deterioration in the U.S. current account—an event that is likely to be contractionary.

Can Trade Policy Changes And Tariffs Help Shrink The Deficit?

To the extent that any agreement between the U.S. and its trade partners is no longer advantageous to both sides, it makes sense that it be reset. However, when we consider whether an agreement is advantageous or not, it is important to specify for whom. While an agreement may be disadvantageous for U.S. manufacturers and may even be considered to discourage innovation creation in the specific field, it may be currently advantageous to consumers by keeping prices artificially low via predatory trade practices. In either

case, tariffs per se are a blunt policy tool and their use can often be more disruptive than helpful to producers and companies, especially in the short-run. In particular, tariffs that are imposed on short notice do not allow for the necessary time lag needed for supply chains and production processes to adjust to the price distortions they create.

There is a case where tariffs can be helpful. If the U.S. dollar becomes overvalued relative to specific currencies or if certain countries explicitly devalue or allow their currencies to depreciate to gain a predatory competitive advantage, tariffs can rectify the situation. While fiscal authorities do not have the ability to affect the exchange rate directly, by imposing tariffs in certain cases, they can redress any disequilibrium that currency moves unjustified by economic fundamentals create.

Lastly, tariffs can at times be used as a negotiating chip to bring trading partners to the negotiating table and induce them to make concessions. While the effectiveness of this tool can vary, it appears at the moment to be the dominant strategy of the Trump Administration in its dealings with China.

Implications for the U.S. Yield Curve and the Dollar

The state of the U.S. current account deficit imposes an implicit constraint on the ability of the Fed to raise interest rates. In effect, the size of the current account deficit reduces the neutral rate—the Fed Fund rate that neither stimulates nor slows down the economy. Given recent increases, our view is that the Fed is very close to its neutral rate and has little room left to raise interest rates further before it induces a deterioration in the current account. Therefore, for the short- to medium-term, we expect the yield curve to remain relatively flat and perhaps flatten further whereas we view the movements in the U.S. dollar to be range-bound.

Concluding Thoughts

Prolonged U.S. current account deficits are certainly worrisome, especially if they signal deteriorating U.S. economic competitiveness. While they can in principle remain sustainable indefinitely, their sustainability hinges on three main factors. In the short- to medium-term, Fed policy is key, as discussed above. For longer horizons, two other factors enter into play. First, the ability of the U.S. dollar to remain the world's reserve currency. As a currency of choice for most commodity-related transactions, a natural expansion of the world economy will generate the need for additional dollars which only current account deficits can on net provide. Second, the willingness of the world to hold U.S. dollars ultimately depends on the desirability of U.S. exports of goods and services, and the attractiveness of U.S. firms that become available for purchase by foreigners. For these conditions to remain in place, the emphasis, both corporate and governmental, must be on basic and applied research, industrial investment in new processes and products, maintenance of R&D clusters and the continuous enhancement of the education provided to the U.S. work force so that it can meet the evolving challenges of the future. Should any of these circumstances substantially degrade, compared to those in place for other economies, the supremacy of the U.S. dollar will inevitably come into question. The implications of such a development for the U.S. current account could be dramatic. In the short-term, so could be a substantial Fed policy error.

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Maria Vassalou, Ph.D.

Partner & Portfolio Manager, PWP Global Macro

Maria Vassalou is Partner and Portfolio Manager for the PWP Global Macro strategy. Dr. Vassalou joined Perella Weinberg Partners from MIO Partners, a subsidiary of McKinsey & Company, where as a Portfolio Manager she managed a similar global macro investment strategy in a dedicated legal entity, and as Head of Asset Allocation she provided counsel on allocation for liquid assets within MIO's portfolio. Prior to joining MIO, Dr. Vassalou was a Global Macro Portfolio Manager at SAC Capital Advisors, LP. She joined SAC from Soros Fund Management where she was responsible for global quantitative research, as well as the development and management of global quantitative trading strategies. Prior to her career in asset management, Dr. Vassalou was an Associate Professor of Finance at Columbia Business School which she joined in 1995 and where she established many of the investment principles she employs today. Dr. Vassalou is a Past President of the European Finance Association and was the Chair of the 2008 European Finance Association Meetings. She has also served as a Research Affiliate of the Centre for Economic Policy Research (CEPR) in London for many years and is a past member of the Academic Advisory Board of the Vienna-based Guttmann Center of Competence in Portfolio Management. Her research focus has been on the interrelation of the macro-economy and financial markets with applications in hedge fund strategies. A frequent speaker to both academic and practitioner-oriented seminars and conferences, Dr. Vassalou has published in leading academic journals, such as the Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Journal of Business, Journal of International Money and Finance, and the Journal of Economic Dynamics and Control. While she was on the faculty of Columbia University, she also served as a consultant to many premier hedge funds and asset management institutions in the U.S. and Europe. Dr. Vassalou received a Bachelor of Arts in Economics from the University of Athens and she holds a Ph.D. in Financial Economics from London Business School.

John Donaldson, Ph.D.

Mario Gabelli Professor of Finance and Economics, Columbia Business School

John Donaldson is the Mario Gabelli Professor of Finance and Economics at the Columbia Business School where he has been on the faculty for nearly 38 years. He has served as the Chair of the Finance and Economics Division of Columbia Business School, as well as the Director of the MBA Program. Professor Donaldson is an expert on dynamic equilibrium macroeconomic models and business cycle theory. A widely published author, his research contributions have appeared in leading academic journals such as the Journal of Economic Theory, Econometrica, and Review of Economic Studies, among others. Together with Jean-Pierre Danthine, he is the co-author of the Masters' level textbook "Intermediate Financial Theory". The recipient of various awards, Professor Donaldson has also received the Columbia University teaching excellence award which recognizes outstanding teaching performance at the pan-University level. Donaldson received his Ph.D. in Economics from the Graduate School of Industrial Administration at Carnegie Mellon University. Prior to entering the field of economics, Professor Donaldson academic training was on mathematics and probability theory in particular. He has also been involved in Silicon Valley startups and other entrepreneurial activities.

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