Dangers of Current Account Deficit: The Case of the United States

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ABSTRACT

A current account is said to be in deficit if the overall value of imports of goods, services and investment income of a country outweighs the value of their expenditure. Another terms associated with current account deficit is balance of trade deficit but technically, trade deficit includes only exchange of goods hence just a component of current accounts. A current account balance implies there is surplus on the financial and capital accounts for the country to offset. There are often disagreements as to whether having a current accounts deficit is good or bad and under what circumstance a country should consider it as a threat. Understanding the challenges posed by current account deficit and the potential benefits can help to explain these intricate issue more clearly and this is done in subsequent sections.

Keywords: Current Account, financial, capital, benefit, challenges

INTRODUCTION

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Harmful Effect of Current Account Deficit

According to Ferrero (2015) in instances where the current account deficit of the country is financed through borrowing, it is likely to be unsustainable since borrowing itself is an unsustainable venture in the long term. This is because perpetual borrowing will lead to high interest rates payments, inability to meet debt obligation when they fall due and little or no funds for capital investment. This trend occurred in Russia in 1998 when the country was unable to pay back due debts. Similarly, Brazil and many African countries have little to spend on investments due to excessive debt financing (Sinn & Wollmershäuser, 2012). It is the contention of McCombie & Thirlwall (2016) that one of the precursors of the 1997 Asian Crisis was the fact that a number of the countries had run up large current account deficits by attracting capital flows (hot money) to finance their deficits. However, hot money dried up instantly as a result of investor loss of confidence in these countries leading to a rapid devaluation and crisis of confidence (McCombie & Thirlwall, 2016).

Running a current account deficit implies running a surplus on the financial /capital account. It connotes a financial system in which foreigners exert a significant influence or claim on the country’s asset which they can claim or desire return within short notice. A typical example is the case when the current account deficit is financed by multinational companies investing in the country or have purchased of assets. There is a risk that a country’s best asset could be brought by the foreigners, reducing long term income (Tang, 2014)

In the opinion of Mann (2009) a current account may equally imply that the country is reliant on consumer
spending and are becoming uncompetitive leading to a slow growth rate of the export sector. This is particularly seen in the case of countries in the eurozone where there is limited opportunity to devalue currency and move importers from their respective countries to restore competitiveness. Indeed it is the contention of Eichengreen & Gupta (2015) that this challenge was a major cause of the very large current account deficit experienced by countries such as Greece, Italy Ireland, Cyprus and Spain and Portugal leading up the EU recession from 2008 to 2013. Moreover a current account deficit has the potential to reduce investor confidence by foreign investors. There is always the risk that investors will take away their investments to safer havens and that can cause a big fall in the value of the country’s currency (Eichengreen & Gupta, 2015). Eventually this can lead to sharp decline in the living standards of people and further reduce investment confidence

Positive Benefits of the UK Current Account Deficits

Eventhough there are substantial evidence to support the notion that current account deficit may be harmful to the economy, there are other positive indicators or implications that must guide concerns. Firstly, there is a higher likelihood that a current account deficit will occur when there is inward investment surplus on financial account (Hugenberg, et al, 2010). The inward investment can create jobs and investment in the economy as in the case of the US. In 2009 the United States run into current account deficit for a long time after borrowing to invest in its economy. This led to higher growth helping the country to quickly payback its debt. This further restored the confidence in lending to the country. On the other hand, the Japanese investment had been good for the UK economy- not only did the economy benefit from the increases investment but the Japanese firms also helped to bring the new working practices in to increase labour productivity (Holmes, 2011).

Secondly with a floating exchange rate a large current account deficit can cause devaluation to automatically reduce the level of the deficit. A current account deficit may be an indication of a strong economy that is growing rapidly. For example the rise in deficit of the UK primary incomes may show that investments in the UK were giving a good return to foreign investors. Another view about the positive effect of the current account deficit is that it provides an outlet for domestic demand while preventing inflation (Faraone & Biederman, 2016)

Evaluating a Deficit

In the light of the above explanation, the question as to whether a current account deficit must be of concern to a country is dependent on a number of factors as explained below. It depends on how large the current account is as a percentage of the GDP. Where the deficit is over 5% it may give a cause for concern. Greece, Italy etc all exceeded the Maastricht Treaty Debt-GDP threshold and paid a severe penalty for it. This eventually affected the whole of the Eurozone since they have a fixed foreign exchange regime and no country can devalue its currency (Murat, et al, 2014). However having high current account deficit (in excess of 5% does not also mean that one will suffer crisis. The case of Australia and US are typical examples. It also largely depends on the way the current account deficit is being financed (De Grauwe & Ji, 2013). Where the country is borrowing from abroad to finance only consumption and not capital expenditure, there is a damaging consequence in the long run as these do not generate any returns to repay the deficit. Moreover the concern of a current account deficit depends on the specific country in question. Without doubt the US has very limited reason to be concerned about its current account deficit

Evaluation of the US Deficit

Thus putting the case of the United States into context, the response to the questions as to whether persistent current account deficit should be of concern to the US or how dangerous it is likely to be for the country is simply a no answer. In other words the history of the long term consequences of excessive or persistent current account deficits in the United States is not the same as those of other countries such as the EU, Brazil, Russia and other Asian countries (Eaton, et al, 2016). A number of factors accounts for this uniqueness. Generally, the US financial market and its currency (the US dollar) play a central role in the global economy. Most of the current account deficits and capital account surpluses driven primarily by excessive foreign demand for U.S. assets and not as a results of any structural imbalance in the American economy itself.

As observed by Minsky (2015) most of the economic forces that drive inflows occur in the long term rather than the short term. For example, portfolio allocation occurs as home bias declines and this takes time. Eventhough it is often said that investors will likely withdraw in the face of a declining economic
condition with high current account deficit precipitates; this is not true in the face of it. The reason is that firms establish their operations in other countries based on plans that extend for many years into the future (Minsky, 2015). These decisions are done by considering different economic scenarios hence do not simply withdraw from an economy by the advent of any bad economic news. Similarly demographic changes or developments also unfold over decades hence what may appear to be an imbalance from the short run perspective may make a perfect sense in the long run. This means that any major adjustment in the current accounts will need major changes in the foreign exchange value of the dollar and this is quite unlikely to take place over time in an orderly market (Patterson, 2015). This there is no inherent reason that such changes would automatically lead to a financial market crisis, because a stable, diversified and growing economy like that of the United States is not likely to suffer a sudden lack of confidence by investors in as much as it maintains sound economic policies.

Another argument regarding the United States current account deficits is that being a net debtor to nations can stimulate currency depreciation risk and the depreciation of the dollar can trigger widespread economic crisis due to its value in global economic system (Patterson, 2015). This makes sense to the extent that the US’s current account deficit of nearly 6 percent and a negative net international investment position in excess of 20 percent of GDP is similar to what pertained in countries such as Argentina, Brazil, Mexico, Russia etc and eventually experienced severe balance-of-payments crises (Laibson & Mollerstrom, 2010). However a critical analysis of the case of the US shows that the use of the word “debtor” can be misleading. This is because most of the US assets that is owned by foreigners include equities, physical capital invested in the United States in addition to bonds issued by US entities (Laibson & Mollerstrom, 2010).

Additionally, the debt component of America’s international financial position such as bonds and other fixed claims, including bank loan are mostly denominated in dollar terms (Gudmundsson & Zoega, 2014) report that nearly 95% of all the foreign claims on America are dollar denominated and a country with most of its debt denominated in its own currency is unlikely to experience the same negative consequences as Argentina, Brazil, Mexico, Russia etc whose large debt levels denominated in other currency led to huge crisis. In other words it is out of place to compare the case of US high current account deficit with those of the Asian countries, Mexico, Argentina and others that eventually suffered for it because all of them had their debt obligation denominated in a foreign currency especially the US dollar. It is observed that in the previous crisis (Asian, Argentina, Brazil, and Russia). These foreign denominated domestic debts played a major role in the destabilization of the economies.

As noted earlier, when a country has balance of payment crisis, its foreign currency depreciates conterminously with the value of its foreign liabilities i.e. the domestic purchasing power increases as the burden of debt servicing also increases. With this in mind the international investor will respond through the medium of reducing their position further (parrying back) and that can engender greater currency depreciation (Ferrero, 2015). The combined effect of foreign denominated debt instrument and depreciating currency has proven to be a vicious cycle that can compound or accelerate a financial crisis but this is not the case with the US due to differences in conditions.

A decline in foreign exchange value of the dollar does affect the values of U.S. and foreign asset holdings to accelerate crisis but rather act as a self correcting or an automatic stabilizer in the US economy (Sinn & Wollmershauker, 2012). This is because the domestic value of the dollar denominated liabilities of the US does not change implying that the amount of debt to be serviced remains unchanged and this eventually influences the U.S. economy. Further, the holdings of US investors abroad (nearly two-thirds of that are denominated in foreign currencies) appreciate in dollar terms. The composition of the U.S. international investment account, therefore, contributes to stability rather than to instability. There are classic case in points to make reference when it comes to the quantitative importance of exchange rate changes and the net US investment position. For example between the year 2002 and 2004, the Fed’s trade-weighted exchange rate index of major currencies depreciated by nearly 27 percent.

In this period the US had a significant current account deficit and there were financial flow into the US of 1.6 trillion dollars. Despite this set back since the foreign claims on the US assets were denominated in dollars while two third of the US foreign assets were in foreign currency, the
depreciation rather led to an increase in the value of the US assets abroad relative to foreign assets in the US.

**Conclusion**

In conclusions, it has been established that current account deficit has negative consequences in theory but there are other positive effects of this trend. Any negative effect of current account deficit is not universal but is context specific. It depends on the source of deficit, the type of country and other factors that can work to automatically adjust any potential threat posed by current account deficits.

**List of References**


