

The U.S. current account deficit and public policy

R. Glenn Hubbard*

Columbia University Business School, Uris Hall 101, New York, NY 10027, USA

Abstract

The late Herb Stein, Chairman of President Richard Nixon's Council of Economic Advisers, once famously quipped that "something that's growing too fast forever will stop". And so it is with the high and rising U.S. current account deficit relative to GDP. That ratio cannot rise forever, but many possibilities exist for adjustment. Where economists in the academic and policymaking communities can be particularly useful is in defining what our concerns should be about the U.S. current account deficit. This essay focuses on three principal questions. First, from an economic perspective, how should we frame worries about the size of the U.S. current account deficit? Second, understanding economic forces behind the current account deficit, how large is the deficit likely to be before adjustments take place to reduce its size? Third, what guidance does economic analysis offer for U.S. policy? This third question is of particular interest, as present policy discussion contains as much mischief as useful guidance. After reviewing the steps policymakers should not take, I focus on two questions, which should be of particular relevance. To wit: Is there a role for fiscal policy toward U.S. household saving? And, what role might fundamental tax reform play? I conclude with some questions for economic analysis.

© 2006 Society for Policy Modeling. Published by Elsevier Inc. All rights reserved.

JEL classification: F20; F30

Keywords: U.S. current account deficit; U.S. growth; Fiscal policy; Household saving; Global imbalances

1. Introduction

The late Herb Stein, Chairman of President Richard Nixon's Council of Economic Advisers, once famously quipped that "something that's growing too fast forever will stop". And so it is with

* Dean and Russell L. Carson Professor of Finance and Economics, Graduate School of Business, and Professor of Economics, Faculty of Arts and Sciences, Columbia University, and Research Associate, National Bureau of Economic Research. This essay was presented at the American Economic Association's Annual Meeting in Boston on 8 January, 2006. I am grateful to Dominick Salvatore for helpful comments and suggestions. Tel.: +1 212 854 2888; fax: +1 212 932 0545.

E-mail address: rgh1@columbia.edu.

the high and rising U.S. current account deficit relative to GDP. That ratio cannot rise forever, but many possibilities exist for adjustment. In my own tenure as Chairman of the Council of Economic Advisers under President George W. Bush, I observed with a hint of irony at OECD Economic Policy Committee Meetings, which I chaired, that the United States could be criticized on one day for its large current account deficit and the next day for not growing faster as the engine of the world's growth train (positions which are difficult to reconcile). Such ambivalence lies more than a bit at the heart of discussion of the 'problem' of the current account deficit or 'global imbalances'.

2. How should we think about 'the problem?'

Where economists in the academic and policymaking communities can be particularly useful is in defining what our concerns should be about the U.S. current account deficit. In this essay, I will focus on three principal questions. First, from an economic perspective, how should we frame worries about the size of the U.S. current account deficit? Second, understanding economic forces behind the current account deficit, how large is the deficit likely to be before adjustments take place to reduce its size? Third, what guidance does economic analysis offer for U.S. policy?

This third question is of particular interest, as present policy discussion contains as much mischief as useful guidance. After reviewing the steps policymakers should *not* take, I focus on two questions, which should be of particular relevance. To wit: Is there a role for fiscal policy toward U.S. household saving? And, what role might fundamental tax reform play? I conclude with some questions for economic analysis.

3. What's the problem?

Discussions of the U.S. current account deficit begin with the notion that 'size matters'. An annual current account deficit of about \$800 billion (with no apparent sign of imminent retreat) is virtually unprecedented. No other nation has been able to sustain a deficit of the size (though some nations, including some OECD countries, have run larger current account deficits as a percentage of GDP for a period of time). Even during its own period of economic development, the United States did not run a current account deficit of more than 4% of GDP (relative to about 6.5% of GDP today), and up to a generation ago, the country recorded almost 100 years of current account balance or even modest surplus. As [Obstfeld and Rogoff \(2004, 2005\)](#) have observed, the United States is presently drawing in about 10% of global saving and almost three-fourths of the world's current account surpluses.

What's going on? While the current account is a trade-related measure, economists generally assign the explanation for the worsening balance to prospects for productivity gains and rates of return that jointly determine domestic and foreign incomes, asset prices, interest and exchange rates, and current and capital transactions ('saving-investment imbalance')¹. Since 1980, the share of U.S. liabilities in the rest of the world's portfolio has risen, and this greater demand has come from both private investors and foreign central banks.

The large and growing excess of U.S. investment over saving in recent years has not been caused by an investment boom (apart from residential investment; see [OECD, 2005](#)); indeed,

¹ Economists typically view the current account through the lens of offsetting financial transactions when domestic saving and domestic investment are not equal. For further discussion, see [Hubbard and O'Brien \(2006, Chapter 30\)](#) and [Hubbard \(2003, Chapter 22\)](#).

U.S. gross domestic investment relative to GDP is approximately equal to the median of OECD countries. The U.S. domestic saving rate has fallen, leading to the requirement that foreign capital fund a portion of investment opportunities. The decline on saving has reflected a number of factors from the U.S. productivity boom (and asset price effects on consumption) to a reduced inflation risk premium on dollar assets to the substantial housing equity extraction accompanying low U.S. interest rates in recent years.

Looking more finely at the United States, the decline in U.S. saving has come not from the corporate sector, but from a decline on government saving and household saving. The link between the fall in government saving (the rise in the U.S. budget deficit) and net exports is not clear, as some economists have argued that the increase in the budget deficit has crowded out private domestic spending, with only a modest effect on the current account deficit (see, for example, [Barth & Pollard, 2006](#), [Erceg et al., 2005](#) and [Ferguson, 2005](#)). By contrast, the decline in household saving – particularly through consumption of housing equity – bears a close relation to the deterioration of the current account.

As [Bernanke \(2005\)](#), [Hubbard \(2005\)](#), and [Council of Economic Advisers \(2006\)](#) have observed, no assessment of global imbalances is complete with a focus on the United States in isolation. Bernanke emphasizes an increase in global saving in recent years, putting downward pressure on the world real interest rate and leading to U.S. absorption of excessive saving. The story is perhaps a bit more complicated. Global savings as a share of world GDP have increased modestly, reflecting in part demographic consideration and increased economic uncertainty. But a closer examination of the distribution of increased saving reveals another consideration. The rise in the global saving rate is more than accounted for by a higher saving rate in emerging economies, particularly in Asia. (I say “more than accounted for” because, again, the United States, the world’s largest economy, reduced its domestic saving over the same period.) This pattern suggests more than a global savings surplus—in particular, it is weaknesses in domestic financial systems in emerging economies that have led to excess savings. No description of U.S. current account ‘adjustment’ is complete without an analysis of adjustments in these economies.

4. How large can the problem get?

Many, if not most, serious students of the U.S. current account deficit argue that the current account deficit relative to GDP is likely to remain high for a period of time (or even rise further) before adjustment begins. On the trade side, the income elasticity of demand for U.S. imports appears to exceed the rest-of-the-world’s income elasticity of demand for U.S. exports. With this so-called Houthakker-Magee effect, global growth (accentuated by strong U.S. growth) has coincided with a deterioration of the U.S. current account. And the foreign-exchange value of the dollar has not fallen sufficiently to push U.S. import demand down. This persistent current account deficit has led to a buildup in foreigners’ claims on the United States,² but forecasts for U.S. economic growth or the foreign exchange value of the dollar do not suggest an imminent turnaround in patterns of U.S. exports and imports.

Looking from the perspective of the financial account, trends in global saving and investment point to the likelihood of a continuing high level of the U.S. current account deficit relative to GDP in the near-term. Eventual adjustment is likely to be gradual (for a contrary view, see [Mann,](#)

² There is some controversy over the extent to which the net financial position of the United States is measured correctly. In particular, [Hausmann and Sturzenegger \(2005\)](#) suggest that the true economic value of U.S. net debt to foreigners is much lower owing to unmeasured assets (intangibles, for example).

2004, and Obstfeld & Rogoff, 2004).³ Three such scenarios suggest themselves (and they are not mutually exclusive): (1) the salutary effects of dollar depreciation on the U.S. external financial position; (2) effects of continued improvements in global financial integration; (3) a gradual reversal of the so-called global savings glut.

That U.S. external liabilities are denominated in dollars gives the United States an advantage to the extent that dollar depreciation plays a significant role in shrinking the U.S. current account deficit (or, famously, an “exorbitant privilege”). A decline on the foreign-exchange value of the dollar precipitates asset revaluations—U.S. assets abroad denominated in foreign currencies increase in value, and the value of net foreign indebtedness declines. These effective capital gains reinforce the trade effects of currency changes. Indeed [Gourinchas and Rey \(2005a,b\)](#) estimate that each percentage-point depreciation on the dollar implies a wealth transfer to the United States of about one-half percentage point of GDP, offsetting a substantial portion of the current account deficit as representing an addition to U.S. net debt.

Greater global financial integration has been accompanied by a reduction in investors’ preference for domestic over foreign investments, or “home bias” (see, for example, [Ferguson, 2005](#)). In addition, the U.S. has become very attractive for foreign investments because of favorable U.S. economic institutions and opportunities for risk management (see, for example, [Greenspan, 2004](#)).

The ‘savings glut’ or ‘saving imbalances’ hypothesis is also not inconsistent with smooth adjustment of global imbalances. In the near term, continued high saving in economies with poorly functioning domestic systems of financial intermediation (particularly in Asia and the oil-exporting countries of the Middle East) is likely to flow in large part to dollar-denominated assets. Over time, reform of financial systems in high-saving emerging-market countries can facilitate financial flows to support domestic investment and particularly domestic consumption. At the same time as this process of financial reform occurs abroad, gradual increases in U.S. saving can reduce the current account deficit relative to GDP over a reasonable period of time. Both adjustments can be gradual. It is to the question of policy responses from the United States to make easier this gradual adjustment that I now turn.

5. What should U.S. policy do?

In the case of the United States, with an economy and capital markets highly open and efficient and with the dollar’s value determined by markets, not by fiat, it is important to begin with an injunction: No specific U.S. policy action should be undertaken just to bring down the current account deficit. Policy recommendations to the contrary fall into ‘protectionist’ and ‘reduce growth’ camps. That U.S. protectionism would be self-defeating requires little discussion (though the China tariff bills of Senators Charles Schumer and Lindsay Graham display a contempt for economic reasoning⁴). And contractionary policy actions that would reduce U.S. growth in order to reduce the U.S. current account deficit would only damage economic outcomes in the United States and its trading partners.

³ Dollar depreciation is almost sure to play a role for any path of adjustment. The channel through which dollar depreciation influences the current account deficit is not limited to changing the terms of trade between U.S. and non-U.S. goods and services. In addition, tradeables must be substituted for nontradeables in U.S. production (with the mirror image in the rest of the world), which will require differential shifts in saving.

⁴ Or, as my Columbia colleague Jagdish Bhagwati once observed in a debate over trade policy: “Familiarity with economics may breed contempt, but contempt for economics does not breed familiarity”.

A second U.S. policy option would be to narrow the “growth gap” between the United States and its industrial trading partners in Europe and Japan that has emerged in recent years. Encouraging global growth is, of course, a good thing, and U.S. economic policy officials in recent years have urged more rapid growth abroad to increase the demand for U.S. goods and reduce the U.S. current account deficit. But evidence to support this linkage is not strong. For example, [Blanchard et al. \(2005\)](#) argue that if European and Japanese growth rates since 1990 matched the American growth rate, the U.S. current account deficit would be lower by only about 0.5% points of GDP.

As I observed earlier, the most salient U.S. channel for adjustment is a gradual increase in U.S. saving. Much of the ‘saving’ discussion has centered on the need to reduce U.S. budget deficits. That changes in the budget deficit have no certain near-term link to the current account deficit can be seen from U.S. data in the early 1990s (at which time a deteriorating budget position was associated with an improving current account position) and in the late 1990s (at which time an improving budget position was associated with a deteriorating current account position).⁵ And, again, [Erceg et al.](#) estimate only a modest link between a change in the budget deficit and the current account (see also [Chinn & Prasad, 2003](#) and [Gruber & Kamin, 2005](#)).

6. What about fiscal policy toward household saving?

The foregoing discussion does not imply that public policy to raise saving is a bad idea or even that public policy attempts to raise household saving will not meaningfully affect the current account. The need to raise U.S. saving can be seen by the enormous challenges posed by U.S. entitlements programs. The unfunded liabilities of Social Security and Medicare, according to some estimates, total more than \$72 trillion. Pre-funding entitlement promises would raise national saving. And recent U.S. tax policy changes have reduced the tax bias against saving, including reductions in marginal income tax rates, cuts in tax rates on corporate equity dividends and capital gains, expansions of tax-advantaged saving vehicles, and the gradual elimination of the estate tax.

7. What about fundamental tax reform?

While incremental tax changes may raise household saving, the more promising current policy discussion is that over ‘fundamental tax reform’—that is, moving the U.S. tax systems to a broad-based income tax or consumption tax. Economic analyses of fundamental tax reform generally estimate significant gains in annual output per worker. These gains (of as much as 9% per year for a switch to a broad-based consumption tax in the estimates of [Altig, Auerbach, Kotlikoff, Smetters, & Walliser, 2001](#)) arise from effects of higher after-tax returns on saving, capital accumulation, and economic activity.

But fundamental tax reform is also likely to mitigate U.S. external imbalances. Eliminating capital income taxation (by removing anti-saving biases in the tax code) can raise household saving and reduce the current account deficit. Fundamental tax reform prototypes also permit broadening of the tax base by removing tax preferences for particular investments, particularly owner-occupied housing. Deductibility of home mortgage interest for tax purposes encourages borrowing. Indeed, [Greenspan \(2005\)](#) estimates that half of the funds borrowed as a consequence finance consumption

⁵ This U.S. example is not unique. An increase in Australian government saving of nine percentage points of GDP from 1993 to 2000 was associated with a widening of the country’s current account deficit. And Japan’s 11-percentage-point of GDP deterioration in the fiscal position from mid-1991 to mid-2003 was associated with a higher current account surplus of one percentage point of GDP (see [Barth & Pollard, 2006](#)).

and increase the current account deficit. Tax reform's elimination of mortgage interest deductibility would not only help lower marginal tax rates on a range of productive activities, but it would also facilitate a shift toward net exports.

Finally, fundamental tax reform would remove tax biases against business fixed investment in the United States. This effect will encourage another channel required for current account adjustment—and an increase in the share of tradeable goods and services in production. Tax reform can help this shift by a movement toward expensing of capital goods (under a consumption tax) and removing differential taxation of corporate equity capital (under corporate tax integration under a broad-based income tax or consumption tax (see Hubbard, 1993)). In addition to the extent that fundamental tax reform reduced the tax bias in favor of employer-provided health insurance, reduced health spending could make U.S. domestic production more competitive.⁶

8. Conclusion and some questions for economic analysis

Returning to Herb Stein's maxim, the unsustainability of the current trajectory of the U.S. current account deficit raises a concern, but need not and likely does not portend a crisis. Gradual adjustment is possible—in the United States and in high-saving emerging economies. In the United States, policy responses should focus on gradually increasing U.S. saving; particularly promising directions include entitlement reform and fundamental tax reform. High-saving emerging market economies need to undertake steady reform of their financial systems, making capital markets and financial intermediation more efficient to permit more rapid growth of domestic demand for investment and consumption. Slow-growing industrial economies need to emphasize structural reform of labor and capital markets to raise the rate of economic growth. While these gradual reforms will reduce global imbalances, they do not require formal policy coordination. Each action is in the country's or region's own interest.

Economists could usefully contribute three additional analyses to help policymakers' assess both the significance of the U.S. current account position and appropriate policy responses. First, what measurement issues surround our estimates of the value of U.S. assets abroad? And, relatedly, what are the sources of the apparent higher returns U.S. investors earn on overseas assets relative to what foreign investors earn on assets in the United States? Second, from the perspective of the United States, as policymakers think about links between the budget deficit and the current account deficit, what are the estimated effects of changes on taxes versus changes in government spending on the current account? Third, from the perspective of adjustment in the rest of the world, what is the effect of more efficient financial intermediation on domestic consumption and the current account?

References

- Altig, D., Auerbach, A. J., Kotlikoff, L. J., Smetters, K. A., & Walliser, J. (2001). Simulating fundamental tax reform in the United States. *American Economic Review*, 91, 574–595.
- Barth, M., & Pollard, P. (2006). *The limits of fiscal policy in current account adjustment. Occasional paper No. 2.* Washington, DC: U.S. Department of the Treasury, Office of International Affairs.
- Bernanke, B. S. (2005). *The global saving glut and the U.S. Current account deficit. Sandridge lecture.* Richmond: Virginia Association of Economists.

⁶ Such reforms would complement changes in the share of tradeable goods and services in production accompanying exchange-rate changes.

- Blanchard, O. J., et al. (2005). *The U.S. current account and the dollar*. Working paper No. 11137. Cambridge: National Bureau of Economic Research.
- Chinn, M. D., & Prasad, E. S. (2003). Medium-term determinants of current accounts in industrial and developing countries: An empirical exploration. *Journal of International Economics*, 59, 47–76.
- Council of Economic Advisers. (2006). *Economic report of the President*. Washington, DC: U.S. Government Printing Office.
- Ereceg, C. J., et al. (2005). *Expansionary fiscal shocks and the trade deficit*. International finance discussion paper No. 825. Washington, DC: Board of Governors of the Federal Reserve System.
- Ferguson, R. W. (2005). *U.S. current account deficit: Causes and consequences*. Remarks to the economics club of the University of North Carolina.
- Gourinchas, P.-O., & Rey, H. (2005a). *International financial adjustment*. Discussion paper No. 4923. London: Centre for Economic Policy Research.
- Gourinchas, P.-O., & Rey, H. (2005b). *From world banker to world venture capitalist: U.S. external investment and the exorbitant privilege* working paper No. 11563. Cambridge: National Bureau of Economic Research.
- Greenspan, A. S. (2004). The evolving US payments imbalance and its impact on Europe and the rest of the world. *Cato Journal*, 4.
- Greenspan, A. S. (2005). Current account. In *Proceedings of Remarks at the Advancing Enterprise 2005 Conference*.
- Gruber, J. W., & Kamin, S. B. (2005). *Explaining the global pattern of current account imbalances*. International finance discussion paper No. 846. Washington, DC: Board of Governors of the Federal Reserve System.
- Hausmann, R., & Sturzenegger, F. (2005). *U.S. and global imbalances: Can dark matter prevent a big bang?* Working paper. Cambridge: Harvard Center for International Development.
- Hubbard, R. G. (1993). Corporate tax integration: A view from the treasury department. *Journal of Economic Perspectives*, 115–132.
- Hubbard, R. G. (2003). *Money, the financial system and the economy* (4th ed.). Reading: Addison Wesley.
- Hubbard, R. G. (2005). A paradox of interest. *The Wall Street Journal*, 23.
- Hubbard, R. G., & O'Brien, A. P. (2006). *Economics*. Englewood Cliffs: Prentice Hall.
- Mann, C. L. (2004). Managing exchange rates: Achievement of global rebalancing or evidence of global codependency? *Business Economics*.
- Obstfeld, M., & Rogoff, K. (2005). *Global current account imbalances and exchange rate adjustments*. Working paper. Berkeley: University of California.
- Obstfeld, M., & Rogoff, K. (2004). *The unsustainable U.S. current account position revisited*. Working paper No. 10869. Cambridge: National Bureau of Economic Research.
- Organization for Economic Cooperation and Development. 2005. *Economic Surveys*. Paris: October.