Box 1

The US current account deficit

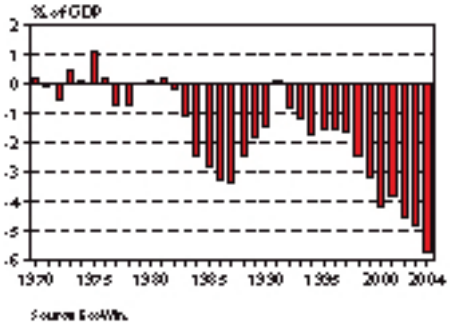
The US current account deficit is widening, especially with China ...

The US current account deficit has continued to widen this year. As discussed in Monetary Bulletin 2005/1 there are various explanations for the widening deficit, including lower private sector saving and the growing fiscal deficit. The deficit on the US merchandise account, which accounts for the bulk of the current account deficit, has widened with all major trading partner countries, and most of all with China. Since the mid-1990s the current account deficit with China has spread from virtually nothing to the annual equivalent of almost 200 b. US dollars in Q4/2004, which accounts for close to 30% of the total merchandise account deficit. It widened particularly rapidly after the dismantling of trade barriers with China's membership of WTO in 2002. US imports of oil and other commodities and manufactured goods have also grown substantially.

... but has been easily financed so far

Unlike the situation at the turn of the millennium, when much of the growing current account deficit was financed with foreign direct and portfolio investment in US companies, the recent US current account deficit has largely been financed with purchases of US bonds by non-residents, including central banks. Foreign investors have significantly increased their exposures in US assets and now own some 45% of outstanding US Treasury bonds and over 10% of equity in US companies. This is more than double the ratio a decade ago. Until now, the current account deficit has been easily financed. Asian central banks have been major buyers of US Treasury bonds. To a certain extent, these investments by Asian countries can be seen as an effort to build up reserves after the shocks they incurred over the period 1996-1998. However, Asian central banks have also intervened in FX markets in order to hold the exchange rates of their home currencies stable against the dollar. Although such funding is clearly unsustainable, it is difficult to predict when the turnaround will happen, or how quickly the adjustment will take place and what form it will take. Conceivably it will be effected through a further slide in the value of the dollar, but faster GDP growth in Europe and slower growth in the US could also contribute to a better balance.

Chart 1
US current account balance 1970-2004



Source: EcoWin.

The depreciation of the dollar has hitherto had little impact on the current account deficit

The depreciation of the dollar has hitherto had virtually no impact on the current account deficit. This is not to say that it will not contribute to closing the deficit in the long run. International trade is known to respond to changes in exchange rates with a considerable lag.1 Over time, however, imports should decrease and exports increase as a result of the weakening that the dollar has already undergone. Because exports are now equivalent to only 2/3 of imports, the current account deficit will take a long time to show

Chart 2
Exchange rate of the US dollar 1980-2005
Quarterly data

Source: EcoWin, OECD.

1. The OECD has calculated the relative price elasticity of US exports as 0.1 between quarters, 0.4 over one year and 0.6 over a longer horizon. Under the J curve effect, a current account deficit may widen immediately after a depreciation. Export prices fall and import prices rise at once, but the time required to finalise new orders and business agreements creates a considerable lag in export volume growth and contracting imports. Thus a deficit on a merchandise account can worsen before it begins to improve. In the US, however, import prices have been highly inelastic, since manufacturers have tended to keep their dollar prices unchanged in order to defend their market share.

a significant narrowing. The OECD expects the US current account deficit to peak in 2006.

If growth in the US continues to outpace that among most of its trading partner countries, the dollar will be more likely to need to slide even further in order to establish a sustainable external balance. There are no prospects that faster GDP growth in continental Europe will reduce the US current account deficit in the near future, since growth forecasts for the euro area have been revised downwards. The dollar may be more likely to depreciate against Asian than European currencies, since it is Asian central banks that are financing much of the deficit and the main depreciation of the dollar until now has been recorded against the euro. A counteracting trend is that interest-rate differentials between the dollar and the euro have widened, which strengthens the dollar.