

**Learning the Right Lessons  
from the Current Account Deficit and Dollar Appreciation**

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United States trade and current-account deficits have risen sharply in recent years. The current account deficit reached 4.27 percent of GDP in the second quarter of 2000, and will probably exceed that slightly in the third quarter. The U.S. trade deficit reached 4.06 percent of GDP in the second quarter of 2000 and grew slightly to 4.08 percent of GDP in the third quarter. Despite rapid growth in GDP, trade and current account deficits have risen even faster. Meanwhile, the dollar has appreciated against most major currencies in the past two years, rising about 30% against the Euro, and rising by 10% to 20% against many other currencies (including the British pound, the Australian dollar, the New Zealand dollar, and the Swiss franc). In contrast to the prognosticators' claims, repeated for more than a decade, that U.S. current-account deficits would lead to dollar depreciation, the evidence refuses to cooperate with their predictions. It is time for a new look at the lessons to be learned from the current account and the exchange rate, and their implications for U.S. economic policy.

Under some circumstances, current-account deficits can signal economic problems that call for changes in economic policies. However, current account deficits *at best* provide mixed and ambiguous evidence about appropriate economic policy changes because the current account agglomerates a large array of underlying economic factors. Current-account deficits sometimes result from new investment opportunities created by technical change, leading countries to engage in net borrowing on world markets to finance those investments. At other times, current-account deficits result from reductions in net national savings rates, due to changes in consumer confidence that lead to changes in consumer expenditures, or due to changes in tax rates that affect after-tax savings rates, or due to changes in government fiscal positions that affect national savings.

U.S. current-account deficits today, as for the past two decades, reflect three main factors. Two of these factors have important implications for economic policies; though neither involves monetary policy directly. These factors are (1) increases in investment opportunities in the United States; (2) low rates of (conventionally-measured) saving in the United States; and

(3) economic disruptions and distortions in other countries, ranging from the Asian financial crises to the deep structural problems that continue to haunt the European economies.

Analysts have repeatedly misinterpreted current-account deficits and misread their lessons for economic policy. Beginning in the 1980s, it became popular to claim that the U.S. current-account deficit was the direct result of the rising U.S. government budget deficit. This “twin-deficits” view became dominant in academic papers, conferences, policy analyses, and media reports. However, the “twin-deficits” claim was incorrect. The claim started to become less common in public pronouncements after U.S. government budget deficits began to decline in 1984 without a corresponding decline in the current account deficit, but it remained the dominant view nonetheless. The twin-deficits view became obviously untenable only as rapid economic growth, reductions in government purchases (mainly on defense), and tax increases have eliminated budget deficits and created budget surpluses, without any major impact on the current-account deficit.

What *is*, then, responsible for the current-account deficits, reaching \$331 billion in 1999, that the United States has experienced since 1982 (with the sole exception of a \$4 billion surplus in 1991)? What lessons for economic policy did the United States miss, and fail to learn, by clinging incorrectly to the twin-deficits view?

The main factor behind U.S. current account deficits lies in the robust economic growth that the United States has experienced for nearly two decades, beginning with recovery from the 1982 recession, and with the sole exception of the 1990-91 recession. Indeed, 1990-1991 marks the only time since 1981 that the U.S. has experienced a current-account surplus. (All the while, large federal budget deficits continued, increasing in 1990 and 1991 as the current-account deficit fell.) Note that the current-account deficit *results* from rapid U.S. economic growth; it does not hinder that growth. Quite the contrary: the ability of the United States to borrow on international markets (that is, to run current account deficits) *enhances* U.S. economic growth by allocating resources efficiently and providing lower-cost financing for investment.

Current accounts involve intertemporal trade -- a U.S. current-account deficit means that the U.S. trades claims on its future production for current goods and services. Commentators often suggest that a current-account deficit threatens future economic problems if current spending falls on consumption rather than investment. That is *not* the case in the United States today, where current-account deficits have financed an investment boom. Even if those deficits were to finance consumption spending, however, there would be little reason to regard them as problems. After all, the current-account would be merely the *symptom* of some underlying problem, not its cause. The root problem, if there were one, would lie in the choices that people and business firms made on consumption vs. savings, and on investment in new capital. Of course, there is no *a priori* reason to regard consumption spending as bad and investment spending as good. After all, the main *point* of the economy is to provide consumption. Investment is merely a means toward the goal of even more consumption, at the cost of its postponement. Economic efficiency requires, that the intertemporal tradeoffs that consumers (and business firms) face when they make their consumption and investment decisions reflect the available intertemporal opportunities. However, economic policies affect the extent to which these tradeoffs and opportunities diverge, and thereby the efficiency with which the economy operates and the rate at which it grows.

As a matter of pure accounting, we can divide factors affect the U.S. current-account deficit into those affecting investment in the United States and those reflecting national savings. The major factor responsible for the deficit is the high rate of investment in the United States. A secondary factor is the low (measured) U.S. savings rate. Evidence over many countries and time periods shows that growth rates of exports and imports are procyclical, rising and falling with the growth rate of real GDP. However, exports typically vary less than imports; consequently, the trade deficit is distinctly procyclical. Trade and current account deficits, as shares of GDP, rise and fall with the growth rate of GDP. Given the strong investment-led growth of the U.S. economy, resulting from rapid technical change that has increased productivity and opened a vast spectrum of new investment opportunities, it would be very

surprising if the United States did *not* have large trade deficits.

Although investment has been the main factor behind U.S. current-account deficits, it is not the sole factor. The personal savings rates in the United States, which has been low for many years, fell from 2.2 percent of disposable income in 1999 to an average of 0.1 percent over the first three quarters of 2000. Two factors affect the inferences that should be drawn from these savings data. First, government budget surpluses have helped to offset the effects on national savings of the fall in personal savings. Second, the measured personal savings significantly misstates relevant personal savings by ignoring changes in the market value of existing capital (mainly through stock-market swings). Those valuation changes also imply that standard measures of investment misstate economically-relevant investment. Nevertheless, the low personal savings rate in the United States serves as one indicator of the (potentially large) economic inefficiencies created by the current U.S. tax system and social-security system. Economists widely agree that taxation of savings and investment income creates economic inefficiency and should be replaced by taxes that fall more on consumption; they also widely agree that the social security system has, as a pay-as-you-go system, reduces personal and national savings. Changes in these policies would raise national savings, reducing the current account deficit while adding to U.S. investment, reduce economic distortions and inefficiencies, and raise the long-run U.S. capital stock and U.S. GDP.

While U.S. current-account deficits result partly from U.S. conditions and policies, they also reflect conditions and policies in other countries. Structural economic problems in Europe and, more recently, slow economic growth in Japan, have contributed to the U.S. current account deficit. Those factors have also contributed to appreciation of the U.S. dollar on foreign exchange markets. That result has surprised many analysts. After all, the European central bank has apparently succeeded in establishing its ability to pursue its mandate and to establish goals of low inflation and a stable monetary environment. Nevertheless, the Euro has fallen from a high of \$1.20 in January 1999 to recent lows below \$0.85. Moreover, the exchange rate has resisted any long-lived response to concerted central bank intervention (as

expected from evidence on previous interventions in foreign exchange markets around the world).

The appreciation of the U.S. dollar in terms of the Euro, and many other currencies, has not reflected inflation differentials between United States and those countries. Nor does it reflect expected future inflation differentials.

The rise of the dollar in terms of the Euro reflects four main factors. First, the United States has experienced faster economic growth in Europe, and markets expect this difference in the rate of economic growth to continue in the future. Evidence indicates that international differences in rates of economic growth, by themselves, are not strongly associated with changes in exchange rates. However, a second factor involves the source of this growth differential -- more rapid technical progress and productivity growth in the United States. The difference in rates of economic growth between the United States and Europe has been associated with differences in productivity and aggregate supply, rather than differences in aggregate demand. The relatively greater degree of economic freedom in United States, as compared to Europe, and the associated difference in economic flexibility and opportunity for pursuing innovation, has made the United States a relatively more attractive location for real investment. This has been the major factor behind U.S. current-account deficits. It has also helped to prevent the U.S. dollar from *depreciating* in response to faster U.S. growth (and the associated increase in the relative supply of American goods and services).

The third major factor involves the stagnation of European policy reforms and continuation of a European legal and regulatory infrastructure that raises costs of production, reduces economic flexibility, inhibits risk-taking and entrepreneurship, and discourages innovation and growth. High unemployment rates in Europe are one visible symptom of these problems.

The fourth and most important factor involves the greater risks that investors must take to invest in Europe rather than the United States. These risks are associated less with normal ECB policies than with fiscal and regulatory policies, and the ultimate responses of the ECB to

the possibility of a European recession. Increases in the relative risk of European investments, as compared to U.S. investments, have led financial markets to reduce the value of the Euro to a level at which investors holding Euro-denominated assets take less risk of additional depreciation and are compensated by a greater possibility of appreciation. This development implies that the Euro is not likely to rise until markets perceive a fall in the risks they would take on European investments, or until changes in U.S. economic conditions lead to an increase in the risks of investments in the United States.

This lesson has important implications for U.S. economic policy. Some analysts have argued that the combination of more rapid U.S. economic growth, a current-account deficit, and an appreciating U.S. dollar shows that U.S. economic growth has been fueled by aggregate demand rather than by aggregate supply. Productivity increases alone, they argue, would lead to greater U.S. output, a U.S. trade surplus, and a fall in the relative price of American products through real dollar depreciation. If that scenario were true, then the Federal Reserve might rightly concern itself with the implications for inflation of those increases in aggregate demand. However, productivity increases in the United States have not taken the simple form of a greater supply of American-made products. Instead, technical change and entrepreneurship in United States have increased investment opportunities in United States, raising real U.S. investment by more than the increases in supplies of American-made products. This has resulted in a sustained U.S. current-account deficit without dollar depreciation, and with the recent appreciation. Consequently, the strength of the dollar and the persistence of current-account deficits are *not* reasons to alter U.S. monetary policy. Instead, they signal strong U.S. economic performance and a monetary policy that has not hindered it.

If robust U.S. economic growth continues over the long term, the future production that will be required to finance the U.S. international debt position, that will have resulted from its current-account deficits, will not prevent rapid growth in U.S. consumption. Markets currently expect those increases, as indicated by the performance of the stock market, rapid consumption growth, and a low savings rate. Monetary policy can best contribute to continued long-run

economic growth by creating an environment with a stable price level or a low, and predictable, rate of inflation, and by using all means at its disposal to ensure that it will continue to provide that environment in the future.

It is easy to draw incorrect inferences from international trade deficits and changes in exchange rates, because a large set of factors influence them and isolating those individual factors can be difficult. Nevertheless, evidence clearly indicates the fallacies contained in some common interpretations of the current account deficit. And evidence supports the view that U.S. trade deficits are the result of two decades of (mostly) rapid U.S. economic growth and that, with certain caveats, they reflect economically-efficient responses of the U.S. economy.

Consequently, the behavior of the current account and exchange rates should not lead U.S. economic policy to stray from the goal of promoting long-run economic growth. The United States should seize the opportunity afforded by this period of strong economic performance to remedy the main inefficiencies and distortions that hold back even stronger economic performance and that loom on the future horizon. Those policy changes should include reducing the strong disincentives to save created by the U.S. tax system and the social security system; reducing the disincentives to invest created by government regulations and the wide absence of cost-benefit analysis in their formulation and administration; and beginning institutional changes that would facilitate a credible long-run commitment to maintaining stable monetary environment, with a low and predictable rate of inflation, that has been achieved by the Federal Reserve under the leadership of Alan Greenspan but that cannot be credibly promised for the long-run under current institutional arrangements.