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The U.S. current account deficit and public policy

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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 25 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.

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

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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).