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The U.S. Current Account Deficit

Remarks by

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As a representative of the country that issues the "Old Choice" in reserve currencies, I thought that I might use my time to address the source of the growing amount of assets denominated in that currency and held outside the United States--that is, the U.S. current account deficit. As a basis for discussion, I will put some hypotheses on the table about the origin of the deficit, its course over time, and its implications for macroeconomic policy. Before I get started, I should remind you that the views expressed here are my own and do not necessarily represent the views of other members of the Board or its staff.\*

For the most part, the existing distribution of current account surpluses and deficits among the countries of the world reflects market decisions regarding the global allocation of capital. Evidently, savers around the world have anticipated greater risk-adjusted returns on their investments in the United States than in surplus countries. The upward trend in the foreign exchange value of the dollar since the mid-1990s as the deficit was climbing indicates that the rising demand for dollars from capital inflows, and not the rising supply of dollars from the trade deficit, was the dominating force in international transactions between the United States and the rest of the world.

To be sure, developments of the past few years suggest that expectations for returns on investment were not fully realized. Still, the remarkably similar asset price movements around the globe in the past two years and the relatively modest correction of the dollar imply that investors are not having major second thoughts about the relative distribution of their savings. Moreover, judging from the fact that productivity in the United States did accelerate in the latter half of the 1990s and continues to grow rapidly, the spending financed through the deficit apparently did add to real GDP growth, even though the financial returns to capital proved

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\*Michael Leahy, of the Board's staff, contributed to the preparation of these remarks.

disappointing.

In addition, the developing configuration of current account balances has played an important role in stabilizing economies over recent years. The U.S. deficit has boosted aggregate demand outside the United States, which was especially beneficial in the mid- to late-1990s, when disruptions to capital flows and financial markets in many other countries were damping economic activity. In the United States, the availability of foreign savings and foreign goods and services served as safety valves, diverting U.S. aggregate demand during the late 1990s, when it might have otherwise created inflationary pressures.

It is crucial in thinking about this deficit to keep in mind that, to the extent that it reflects an imbalance, the imbalance is shared around the world. The U.S. current account deficit is two-sided: Low saving relative to investment demand in the United States necessarily implies the reverse--a shortfall of domestic demand relative to production in the rest of the world. Therefore, any adjustment that proves necessary will also be shared around the world and will not fall solely on the United States.

It is hard to imagine that present trends in this global imbalance can continue indefinitely. U.S. assets are occupying a growing share of global portfolios. At some point, reflecting both the decline of marginal returns as resources shift toward stocks of U.S. capital and other durable assets and the inevitable flagging in the willingness of investors to place an ever-increasing share of their portfolios in dollar-denominated assets, the net flow of saving to the United States will taper off. As that happens, the level of U.S. spending on foreign goods and services will have to begin to match more closely the level of foreign spending on U.S. goods and services. U.S. and foreign asset prices, including the real exchange rate, will have to adjust to close the trade gap or,

from another perspective, to bring domestic demand in the United States and elsewhere into closer alignment with domestic production.

We all need to be humble about our ability to predict when this adjustment might begin or what economic conditions might accompany it. I am sure you need no reminding of the many events in the U.S. economy and financial markets that people thought would trigger a dollar decline and current account correction, but did not. Obviously, expected returns from investments in the United States have been marked down substantially--but so, apparently, have expected returns abroad, and on a relative basis, savers seem reasonably content to continue to shift their portfolios toward U.S. investments. The rising level of foreign net investment in the United States has elevated the concern that a sudden shift in preferences away from dollar assets could be disruptive. Such a shift could be associated with large, sharp movements in exchange rates and other asset prices that might expose weaknesses in the balance sheets of some entities. Even abstracting from financial vulnerabilities, such developments in financial markets might prompt dislocations in resource usage and temporary reductions in incomes because resources are slower to adjust than asset prices.

To be sure, a disruptive correction in current accounts is a distinct risk. However, that the recent recession in the United States and the accompanying sharp drops in profits and equity valuations have not caused such a re-evaluation of relative returns is encouraging. Moreover, although resource reallocations are never frictionless, major dislocations need not result from rapid movements in asset prices. In 1985-86 the foreign exchange value of the dollar declined substantially, but the decline was not disorderly, and severe dislocations did not occur in the United States, importantly because of the mobility of labor and capital. Indeed, the currently low

level of capacity utilization in our manufacturing sector means that considerable resources are available to meet increased foreign demand without putting pressure on prices.

However, even relatively smooth adjustments will present challenges to macroeconomic policies, as they did in the late 1980s. The shifting balance of domestic demand and potential supply in each country means that policies affecting domestic demand will need to be recalibrated to preserve price stability and keep economies operating at high levels of reserve utilization. The deficit country--the United States--will need to generate more net domestic savings, perhaps through tighter government budgets, as it absorbs a greater share of global demand if it is to avoid inflation pressures and much higher real interest rates that damp investment and growth. And, as demand is trimmed in the United States, surplus countries will have to boost domestic demand to forestall a slowing in global economic growth. If the asset- and product-market adjustments are smooth or incremental, the required modifications to policy can be made gradually once adjustment seems to be under way and potential macroeconomic effects begin to be identified.

Are there steps policymakers can take even earlier--to reduce the possibility, however remote, that the adjustment will involve dislocations? Over the long-run, using fiscal policy to boost domestic saving in the deficit country might help, but such an adjustment would be counterproductive now, when the U.S. economy is operating well below its potential. Conversely, fiscal policy expansion in the surplus countries could be used to augment domestic demand, but any such adjustments would need to take account of medium-term goals for fiscal consolidation. Furthermore, fiscal policy adjustment cannot guarantee current account adjustment. For example, in the late 1990s, the fiscal stance of the United States switched from

deficits to surplus, and the switch was only partly offset by declines in private savings, leaving national savings higher. Nonetheless, the current account deficit continued to grow as a result of the surge in U.S. investment and productivity and the associated capital inflows seeking the higher U.S. rates of return.

Monetary policy has an ambiguous effect on trade imbalances. Although exchange rates are notoriously difficult to predict, over time easier monetary policy relative to that abroad should prompt currency depreciation, which in turn would tend to reduce the current account deficit. However, easier monetary policy also stimulates domestic incomes, which would tend to increase the current account deficit. Simply put, monetary policy is not the appropriate tool for improving the current account. Rather, central banks have learned over the years that their policies should be devoted to fostering macroeconomic balance and price stability.

In addition, as with equity market bubbles, one is hard put to know beforehand whether large current account deficits are out of line with fundamentals, especially when those outcomes could be a result of strong productivity and high rates of return rather than of excessive spending. All told, actions to preempt a possible disruptive adjustment in asset markets and the economy are problematic in many respects.

As I have emphasized, the major reason for the growing deficit has been that the United States has been an attractive place to invest, and such investment has helped foster higher productivity and economic potential at home and a more efficient use of foreign savings. No policymaker would deliberately try to make his or her economy less attractive to reduce the discrepancies in relative returns. Monetary and fiscal policy in the United States will continue to be aimed at fostering high employment and price stability and a favorable environment for

growth in productivity and incomes. Surely the best way to make perceived returns more equal around the globe would be for authorities in other countries to take whatever steps might boost expected rates of return in their domestic economies. Required actions might involve policies to improve expected cyclical performance over the next few years as well as structural reforms--to increase the flexibility, transparency, and receptiveness to risk-taking and innovation that enhance productivity and growth.