Unwinding the Current Account Deficit

The U.S. trade deficit—the excess of imports over exports—climbed to an all-time high of $61.64 billion in February 2005. This merchandise trade deficit is, by far, the largest component of the current account deficit, which also records trade in services, payments on factors of production, and unilateral transfers. The U.S. current account deficit was a whopping 6 percent of GDP in 2004Q4, the largest in U.S. history.

A capital account surplus is the necessary counterpart of a current account deficit. The capital account records transactions in real and financial assets, such as factories, stocks, and bonds. A country with a current account deficit and a capital account surplus—e.g., the United States—is selling claims on its future income in exchange for goods and services that it can consume or invest today.

A current account deficit can benefit a country by enabling it to consume or invest more than it otherwise could. Higher investment can generate faster growth. The drawback is that the deficit country must devote part of its future income to pay off the claims—bonds, dividends.

The upper panel of the chart shows the components of the U.S. capital account surplus. Private purchases of U.S. assets have been important for many years but official (government) purchases have recently become much more important. The lower panel shows official purchases of U.S. assets by region. Asian central banks—China, Japan, South Korea, Taiwan, and India—have significantly increased their holdings of U.S. assets since 2001. Governments choose to hold highly liquid U.S. assets, such as Treasury securities, to defend their currencies’ value and to insulate against adverse economic conditions. The uncertainty associated with the war on terror might contribute to precautionary demand for safe U.S. assets. While there are several issues associated with these official purchases and the current account deficit, this cover page focuses on how the deficit will resolve.

Demand for U.S. dollar assets is not infinite; there are signs that foreign governments might already be diversifying their portfolios by reducing their purchases of U.S. assets. Some analysts claim that falling foreign demand for U.S. assets will devastate the U.S. economy through rapidly rising interest rates and a falling dollar, presumably coupled with severe recession.

A disaster scenario might be alarmist, however. While lower foreign demand for U.S. assets would very probably raise U.S. interest rates, weaken the dollar, and lower consumption and investment, such changes would not necessarily be accompanied by rising unemployment or falling output. A weaker dollar and higher interest rates would reduce U.S. consumption by making goods more expensive, but the dollar’s depreciation would also make U.S. goods more competitive on world markets, which might increase U.S. exports, output, and employment. Adjustment will be necessary, but will not necessarily be disruptive.

In the long-term, domestic productivity will mainly determine the U.S. standard of living. And Americans’ education, training, and willingness to save will determine domestic productivity. Our fate is in our own hands; not in those of foreign central bankers.

—Christopher J. Neely
Beginning with this issue, the OECD is now the source for all Retail Sales data for France.

Dear Reader,

Thank you for reading International Economic Trends. Please assist us in providing you with the most useful international economic data by offering your comments and suggestions for how the publication could be improved. Such feedback can be sent to one of the following addresses:

stlsEIT@stls.frb.org
or
Editor, International Economic Trends
Research Department
Federal Reserve Bank of St. Louis
411 Locust St.
St. Louis, MO 63102

Please keep in mind that we must make some difficult choices with respect to the material we include.

Thank you in advance for your help in making International Economic Trends a great publication.

Sincerely,
Christopher J. Neely
Editor, International Economic Trends

Notes and Sources

International Economic Trends

MFM
United States: currency in circulation, travellers’ checks, total publicly held checkable deposits minus cash retained in the process of collection and Federal Reserve floor, savings deposits, shares in retail money market mutual funds (with initial investments of less than $50,000), net of retirement accounts, and institutional money market mutual funds.

M2
Canada: M1 plus all checkable deposits and personal term deposits.

M2+
Japan: M1 plus private deposits, public deposits less demand deposits, and certificates of deposit.

M3
Two area: M1 plus deposits with a maturity up to 2 years, deposits redeemable at notice up to 5 months, repurchase agreements, money market funds, and debt securities up to 2 years.

M4
United Kingdom: M2 plus wholesale deposits with the U.K. banks and building societies.

Output Per Worker is the ratio of real GDP to employment.

Producer Price Index covers manufacturing for Canada and the United Kingdom; and total industry for Japan and the United States. Data for the euro area, France, Germany, and Italy are based on the harmonized index of total industry excluding construction.

Retail Sales are based on a volume index. The percent change in retail sales for the United States is based on the Standard Industrial Classification system through 1992 and the North American Industrial Classification System from 1993 on.

Stock Exchange Indices refers to all share prices except for the United Kingdom, which excludes financial firms.

Unemployment Rate is the standardized unemployment rate. It is the percent of the civilian labor force that is unemployed. The unemployed are all persons of working age who are without work, usually available for work, and actively seeking work. The standardized rate may differ from the national unemployment rate calculations.

Sources
Abbreviations
Board of Governors of the Federal Reserve System (BOP)
Bureau of Economic Analysis, U.S. Department of Commerce (BEA)
International Monetary Fund, International Financial Statistics (IFS)
Organization for Economic Cooperation and Development, Economic Outlook (OECD)
Main Economic Indicators (OECD)
National Accounts Quarterly (OECD)

Canada
Bank of Canada: M1 and M2.
BOP: exchange rate.

IMF: foreign exchange reserves, merchandise and service trade, real effective exchange rate, and reserve money.

OECD: government debt and budget balance.

OECD: capacity utilization, consumer price index, current account balance, GDP, hourly earnings, industrial production, interest rates, producer price index, retail sales, stock exchange index, and unemployment rate.

Statistics Canada: employment.

Euro Area
European Central Bank: current account balance and employment.

Eurostat: capacity utilization, consumer price index, GDP, interest rates, merchandise trade, producer price index, and retail sales.

France
BOP: exchange rate.

Eurostat: capacity utilization, consumer price index, and producer price index.

IMF: foreign exchange reserves, merchandise and service trade, and real effective exchange rate.

Institut National de la Statistique et des Etudes Economiques: employment.

OECD: government debt and budget balance.

OECD: government debt and budget balance.

OECD: current account balance, GDP, hourly earnings, industrial production, retail sales, interest rates, stock exchange index, and unemployment.

Germany
BOP: exchange rate.

Bundesanstalt Für Arbeits: employment.

Eurostat: capacity utilization, consumer price index, and producer price index.

IMF: foreign exchange reserves, merchandise and service trade, and real effective exchange rate.

OECD: government debt and budget balance.

OECD: current account balance, GDP, hourly earnings, industrial production, retail sales, interest rates, stock exchange index, and unemployment.

Italy
BOP: exchange rate.

Eurostat: capacity utilization, consumer price index, and producer price index.

IMF: foreign exchange reserves, merchandise and service trade, and real effective exchange rate.

Istituto Nazionale di Statistica: employment.

OECD: government debt and budget balance.

OECD: current account balance, GDP, hourly earnings, industrial production, long-term interest rates, retail sales, stock exchange index, and unemployment.

Japan
Bank of Japan: adjusted money basis and long-term interest rate.

BOP: exchange rate.

IMF: foreign exchange reserves, merchandise and service trade, and real effective exchange rate.

OECD: government debt and budget balance.

OECD: capacity utilization, consumer price index, current account balance, employment, GDP, hourly earnings, industrial production, retail sales, producer price index, retail sales, short-term interest rate, stock exchange index, and unemployment.

United Kingdom
Bank of England: M1, M2.

BOP: exchange rate.

IMF: foreign exchange reserves, merchandise and service trade, and real effective exchange rate.

OECD: government debt and budget balance.

OECD: capacity utilization, consumer price index, current account balance, GDP, industrial production, interest rates, M4, producer price index, retail sales, stock exchange index, unemployment, and weekly earnings.

U.K. Office for National Statistics: employment M0.

United States
BOP: capacity utilization, exchange rate, industrial production index, M2, and interest rates.

BLS: employment, consumer price index, and producer price index.

Federal Reserve Bank of St. Louis: adjusted money basis and M2M.

IMF: foreign exchange reserves and real effective exchange rate.

OECD: government debt and budget balance.

OECD: hourly earnings, stock exchange index, and unemployment.
Notes

Euro Area Data: On January 1, 2001, the euro area was enlarged to include Greece as its 12th member country. Historical euro area rates for capacity utilization, the consumer price index, current account balances, earnings, employment, government deficits and budget balances, industrial production, merchandise trade, the producer price index, and unemployment include Greece as of January 1, 2001. The series for the euro area are calculated on the basis of national government bond yields weighted by the nominal outstanding amounts of government bonds in each maturity band. The euro-bond rate used in the chart on page 12 is a synthetic rate prior to January 1999. This is constructed by calculating a weighted average of the exchange rates of the euro-area countries, excluding Greece and Luxembourg, against the dollar. The weights are based on 1997 GDP shares.

German Data: As a result of reunification, data for all of Germany are now incorporated in the statistical series. The starting points for unified German data are those of the former GDR; data for the separate GDR should be compared with data for the GDR before reunification.

Second quarter 1999: current account balance, international trade, and employment

First quarter 1999: consumer price index, GDP, industrial production, output per worker

Third quarter 1999: consumer price index, first quarter 1998: utilization

Capacity Utilization covers the manufacturing sector for Canada, France, Japan, the United Kingdom, the United States, and the euro area; manufacturing excluding food, beverages, and tobacco for Germany and mining and manufacturing for Italy.

Consumer Price Index is for all items. The current index is based on goods and services consumed by all individuals for Canada, all households for France, and all households except persons dependent on government and high income households for the United Kingdom; and all urban households for the euro area. Data for the euro area, France, Germany, and Italy are based on the harmonized index of consumer prices.

Current Account Balance is the sum of merchant and service exports and import receipts on domestic asset abroad minus the sum of merchandise and service imports and income transfers from foreign assets in the domestic economy plus unilateral transfers.

Earnings are based on hourly earnings in manufacturing for Canada, Germany, Italy, and the United Kingdom; and the hourly earnings in manufacturing excluding construction for France; hourly earnings in industry for Italy; monthly earnings in manufacturing for Japan; and weekly earnings in manufacturing for the United Kingdom.

The Exchange Rate for all countries except the United States is expressed as units of local currency per U.S. dollar. For the United States the trade-weighted exchange rate, TWIX, is used. This is a weighted average of the exchange value of the U.S. dollar relative to the major international currency—the euro, Canadian dollar, Japanese yen, Swiss franc, Australian dollar, and Sterling pound. Prior to 1995, the currencies of the euro-area countries (with the exception of Greece) are used instead of the euro.

Real Effective Exchange Rate uses nominal unit labor costs in manufacturing and the weighting schemes used to construct the rates, for all except the euro area, is based on disaggregated data for trade among 21 industrial countries (Canada, France, Germany, Italy, Japan, Mexico, the United Kingdom) in the United States.
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International Economic Trends
United States

GDP
Percent change from year ago

Industrial Production
Percent change from year ago

Retail Sales
Percent change from year ago

Capacity Utilization
Percent

Data prior to 1990 may not be strictly comparable with later figures (see Notes).

Canada

International Economic Trends

GDP
Percent change from year ago

Industrial Production
Percent change from year ago

Retail Sales
Percent change from year ago

Capacity Utilization
Percent

Research Division
Federal Reserve Bank of St. Louis