The US trade deficit and global imbalances

As a proportion of GDP the US current account has been declining throughout the 1990s and the new millennium (see figure 1). In 2005 the deficit had risen to $805 billion or 6.4% of GDP. Despite such a large deficit there has not been strong downward pressure on the US dollar or the need to increase interest rates in order to market the debt. This is because the US has been able to fund the deficit by selling bonds which the rest of the world has continued to buy despite the low yields on offer.

One of the major purchasers of US bonds is China. By June 2005 China had overtaken Japan as the largest holder of US bonds, with the Peoples' Bank of China and the Hong Kong Monetary Authority amassing $833 billion in combined reserves.

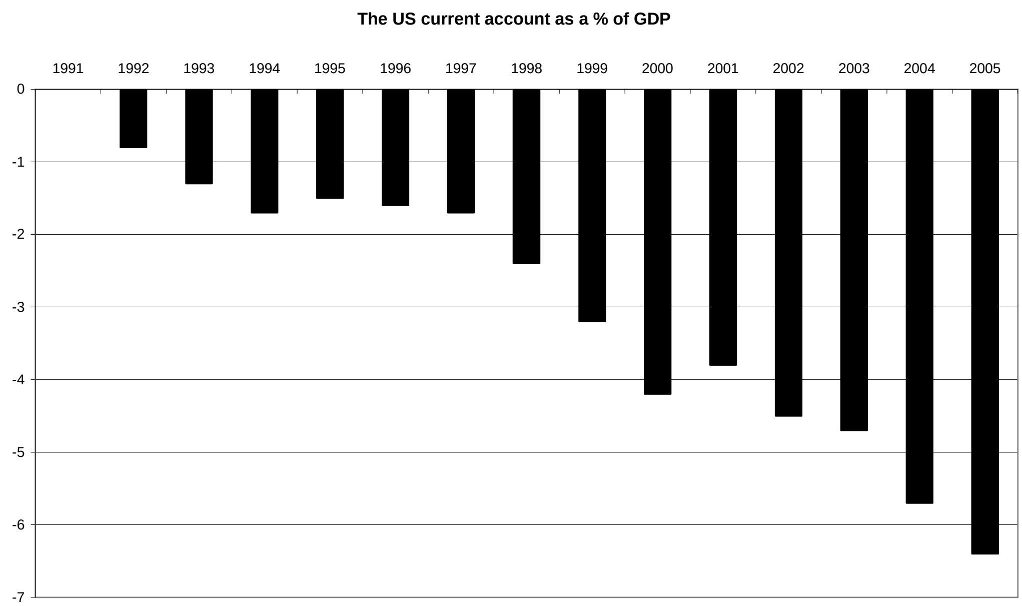

Figure 1: Source IMF World Economic Outlook database

These imbalances have raised a number of issues. The two most debated are whether the Chinese currency is undervalued, and whether the unwinding of these imbalances might result in a hard landing for the US economy.

There has been much suspicion in the US that the Chinese Yuan has been pegged at an artificially low level against the US dollar. For the best part of a decade the rate was maintained at the 8.28 Yuan per dollar. In 2005 there was a slight revaluation to 8.10 Yuan per US dollar, and the Chinese government moved to pegging against a basket of currencies rather than just the dollar. This has enabled a little more flexibility in the exchange rate against the dollar, and because the US dollar has depreciated against the other currencies in the basket the dollar had further depreciated to around 8.03 Yuan per dollar in April 2006.

Despite the modest revaluation the belief is that the Yuan remains undervalued. Figure 2 plots the top 10 trade deficits by country for the US in 2004. China is the greatest deficit nation, accounting for approximately $162 billion of the overall trade deficit of $665 billion.

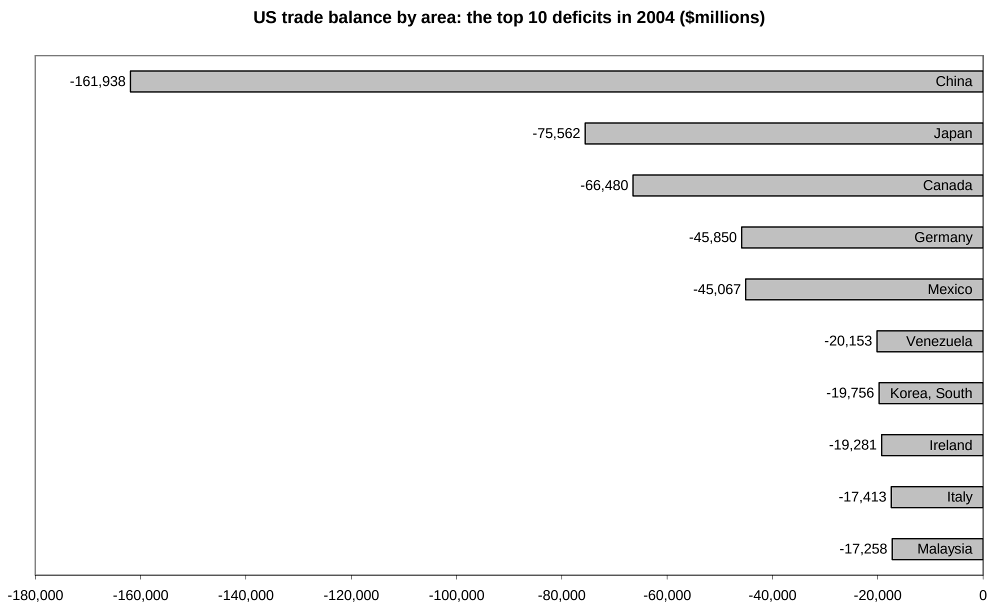

Figure 2: Source US Department of Commerce

Some quarters within the US have accused the Chinese authorities of deliberately intervening to keep their currency artificially low and promote export led growth. The US trade deficit would narrow if there was a greater revaluation. In fact the US congress has gone further and advocated the possible imposition of a tariff on Chinese imports unless action is taken to sufficiently revalue the Yuan.

Studies have been undertaken to assess the extent of the Yuan overvaluation. Purchasing power parity studies have indicated that the Yuan may be around 40% undervalued. The Fundamental Equilibrium Exchange Rate (FEER) is the exchange rate where the economy is in both internal and external equilibrium. These measures suggest an overvaluation of 15-40%, but all these figures are subject to debate. With over 400 million people underemployed in the Chinese rural economy it is argued that China is much further away from internal balance than some of the studies have argued.

Laying the entire blame on the exchange rate is perhaps narrow-minded. In figure 3 the US and Chinese trade deficits are plotted for the period 1980-2004 and gives the issue some wider-context. Although China ran a trade surplus with the US of $162 billion in 2004 its overall surplus was much lower at $68 billion. China ran relatively large deficits against other Asian countries from which it imports capital goods, and is also a large net-importer of raw materials, especially oil.

The extent to which the US current account deficit will be corrected by a Yuan revaluation is open to question.   It is likely that the US current account deficit reflects other imbalances in the US economy, particularly the low saving rate. Correcting the US current account deficit will therefore require a rebalancing of the US economy away from consumption to saving and investment.

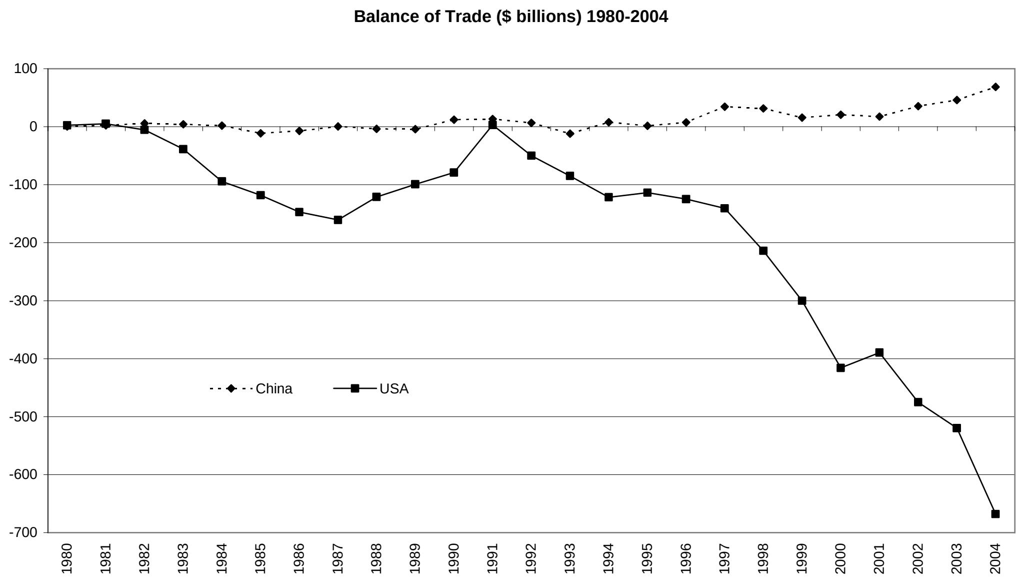

Figure 3: Source IMF World Economic Outlook database

The great worry is that the correction of the global imbalances will invoke a hard landing in the US economy. If the current account is no longer freely funded by Asian and middle-eastern surplus countries then the US Treasury would have to offer higher interest rates in order to encourage investors to purchase bonds. A rise in interest rates could then undermine asset prices and domestic demand, and lead to a global increase in interest rates.

The relationship between interest rates and current accounts has been an issue in explaining currency crises in developing and transition countries. Correcting a current account deficit often requires a sharp rise in interest rates in order to encourage investors to hold bonds. This is because many developing countries issue debt in foreign currency (to make it more attractive to investors), so a sharp depreciation in the domestic currency will substantially raise the real value of debt and the risk of default.

In developed countries current accounts have a more benign effect on interest rates. Because debt is issued in own currency, the real value of the debt will not worsen following a depreciation. The credibility of monetary policy institutions also lessens the likely impact of a depreciation on inflation. So there are strong reasons to believe that the required hikes in US interest rates will be fairly modest compared to the experiences of Mexico and Argentina. A softer landing would consist of a gradual depreciation in the US dollar and a fall in US consumption.