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What Are the Risks to the United States of a Current Account Reversal?

The U.S. current account has been in deficit since the beginning of the 1980s, except for a brief period in 1991, and has grown to 6.6% of gross domestic product (GDP) in the second quarter of 2006. The growing deficit has clearly caught the attention of policymakers and analysts. As Fed Chairman Bernanke put it in a speech he gave while a Governor of the Federal Reserve Board, “the current pattern of international capital flows—should it persist—could prove counterproductive” (Bernanke 2005).

The current account measures the difference between domestic income and expenditures, and it is the mirror image of the funding needed to finance this difference. With the deficit in the current account at historic highs, there is a perceived risk that it could quickly reverse (become less negative) if, for any reason, the United States should lose access to the financing that covers the income–expenditures gap. For example, this could happen as a result of a reduction in the demand for U.S. assets if foreign central governments diversified their reserves.

Economic theory does not offer a robust prediction as to how a current account reversal impacts economic growth, asset prices, or the exchange rate. Indeed, in the simplest models of open economies, countries can run very large current account deficits without much impact at all, as long as they reduce those deficits eventually by repaying old loans. However, other models predict that current account reversals can have a negative impact on economic output, asset prices, and the exchange rate (Mendoza 2006, Obstfeld and Rogoff 2005). Still other models predict that adjustments leading to strong exports and current account surpluses can boost income. Given the lack of a theoretical consensus, this *Letter* turns to the recent empirical literature to learn more about the potential risks to the U.S. economy of a possible current account reversal and about the factors that are associated with more disruptive corrections.

What can we learn from past adjustments in developing countries?

When policymakers and economists refer to the possibility of a disruptive current account correction in the United States, many are thinking about the experiences of developing countries during “sudden stops,” which are especially disorderly reversals (Calvo and Reinhart 1999). In the buildup to a sudden stop, investment and consumption booms typically lead to a rapid widening of the current account deficit. The sudden stop occurs when, in a short period of time and usually in response to a sudden change in economic conditions, a country loses access to external financing; then imports fall, and the current account reverses. Some of the most dramatic sudden stop episodes are the Mexican crises of 1981 and 1994 and the East Asian crisis of 1997. Calvo and Reinhart find that net private capital flows to Mexico fell by 12% of GDP between 1981 and 1993 and by 6% between 1993 and 1994; for South Korea flows fell by 11% of GDP (1996–1997), and for Thailand by 26% of GDP (1996–1997).

During sudden stop episodes, as foreign financing quickly dries up, consumption and investment contract, and output quickly slumps. Calvo, Izquierdo, and Talvi (2006) find that output in Mexico declined by 4.8% between 1981 and 1983 and by 6.2% between 1994 and 1995, while in South Korea it declined by 6.9% between 1997 and 1998, and in Thailand by 11.7% between 1996 and 1998. During these reversals, asset prices, such as the value of the exchange rate and equity prices, also tend to experience large falls, wiping out wealth. The real exchange depreciation puts great strain on the domestic banking system. Historically, many countries going through sudden stops also experience banking crises.

However, not all reversals in developing countries are associated with output contractions. Milesi-Ferretti and Razin (2000) study reversals in a sample of 105 low- and middle-income countries between

1970 and 1996. They find that, for the median country, the current account deficit shrank dramatically—by 7.4% of GDP (going from 10.3% to 2.9%). They also find varying consequences in terms of economic growth after the reversals. For example, in Uruguay, economic growth fell from 4% between 1979 and 1981 to -7% between 1982 and 1984, while in Malaysia, it increased from 2.4% (1984–1986) to 8% (1987–1990). Indeed, for over half the countries that experienced current account adjustments, economic growth increased rather than decreased.

These authors also study some of the factors associated with slower output growth after a reversal. One factor is less openness to trade; in particular, it appears that the more closed the country, the greater the relative need to reduce investment and expenditures to close the gap. Another factor is the degree to which the exchange rate has appreciated; specifically, the greater the appreciation, the greater the needed depreciation to induce the transfer of resources into the export sector to boost exports and reduce the current account deficit.

What can we learn from past adjustments in industrialized countries?

Some may argue that empirical studies looking at previous current account adjustments in developing countries may not be directly relevant in evaluating the risks of a U.S. current account reversal. Rather, it may be more to the point to consider the evidence of current account adjustment in developed economies. Croke, Kamin, and Leduc (2005) study 23 episodes of current account adjustments in industrialized countries. They find that current account adjustments were associated with modest decreases in economic activity about two-thirds of the time. They then split the sample to study the differences between the seven episodes where output growth increased the most (they call these “expansion episodes”) and the seven episodes where output growth decreased the most (“contraction episodes”). For contraction episodes, they find that output growth turns slightly negative about one year after the current account reversal. However, they do not find that the slowdown was associated with large currency depreciations, rapid increases in interest rates, or asset price collapses. In the expansion episodes, typically large currency depreciations occurred without an asset price collapse. This latter finding is significantly different from the sudden stop episodes in developing countries, where large currency depreciations are asso-

ciated with economic slowdowns and asset price collapses.

It is natural to ask whether a larger initial current account deficit leads to more economic disruption after a reversal occurs. If it does, then the growing U.S. current account deficit increases the risk a reversal will be disruptive. Freund and Warnock (2005), using a data set similar to that of Croke, Kamin, and Leduc, find that larger initial current account deficits lead to larger output declines when the deficit reverses. However, they also find that a 1 percentage point increase in the deficit is associated with only a 0.15 percentage point decrease in annual growth for three years. If the United States were forced to halve its current account deficit, which stood at 6.6% of GDP in the second quarter of 2006, the results of the study would suggest that the current account adjustment may be associated with a modest reduction in GDP growth—0.5 percentage points over the next three years.

Possible global effects of a U.S. current account reversal

U.S. GDP alone represents about one-third of world output and takes the lion’s share—more than half—of worldwide capital flows. Thus, when one considers the potential risks to the United States from a current account reversal, one must also consider any second round effects arising from its impact on other countries.

For instance, if the U.S. economy were to slow down significantly, reducing its demand for imports, it would negatively affect many of its trading partners. If these economies were to slow down as a result, then demand for U.S. products may also drop, making the current account adjustment harder to achieve.

If the dollar significantly depreciated at the same time as the current account reversed, it also would have worldwide financial implications. Many foreign banks, particularly in developing countries, are vulnerable to rapid currency changes because of currency mismatches in their balance sheets: a big depreciation would result in significant capital losses for foreign banks that hold a large fraction of their reserves in dollars. For developing countries, this would be particularly problematic because they use these reserves as a buffer to protect against and prevent financial crises. These countries would observe a drop in U.S. demand for their

goods and a fall in the value of their reserves concurrently, making them more vulnerable to financial and currency crises.

Conclusions

There have been many instances of disruptive current account adjustments, particularly in developing countries. However, there is little evidence that current account adjustments, in general, lead to lower GDP growth. Some of the most disruptive current account adjustments have occurred in developing countries that experience sudden stops. However, on average, adjustments have coincided with either small increases in output growth (in developing countries) or very moderate reductions in growth (in industrialized countries). From the experience of industrialized countries we learn that the larger the deficit, the faster and the greater the associated fall in output.

Based on the historical evidence, the likelihood of a rapid and disruptive current account adjustment in the United States remains low. However, the downside risk cannot be ruled out. In particular, the large size of the U.S. economy makes these risks more substantial if a slowdown in the United States were to lead to a worldwide economic downturn or to an international financial disruption.

Diego Valderrama
Economist

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