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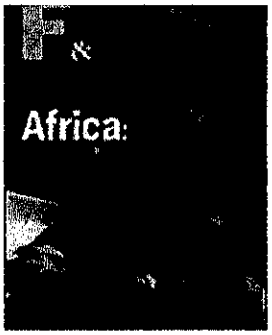

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Back to Basics

Do Current Account Deficits Matter?

Atish Ghosh and Uma Ramakrishnan

THE CURRENT account balance may seem to be an abstruse economic concept. But in countries that are spending a lot more abroad than they are taking in, the current account is the point at which international economics collides with political reality. When countries run large deficits, businesses, trade unions, and parliamentarians are often quick to point accusing fingers at trading partners and make charges about unfair practices. Tension between the United States and China about which country is primarily responsible for the trade imbalance between the two has thrown the spotlight on the broader consequences for the international financial system when some countries run large and persistent current account deficits and others accumulate big surpluses.

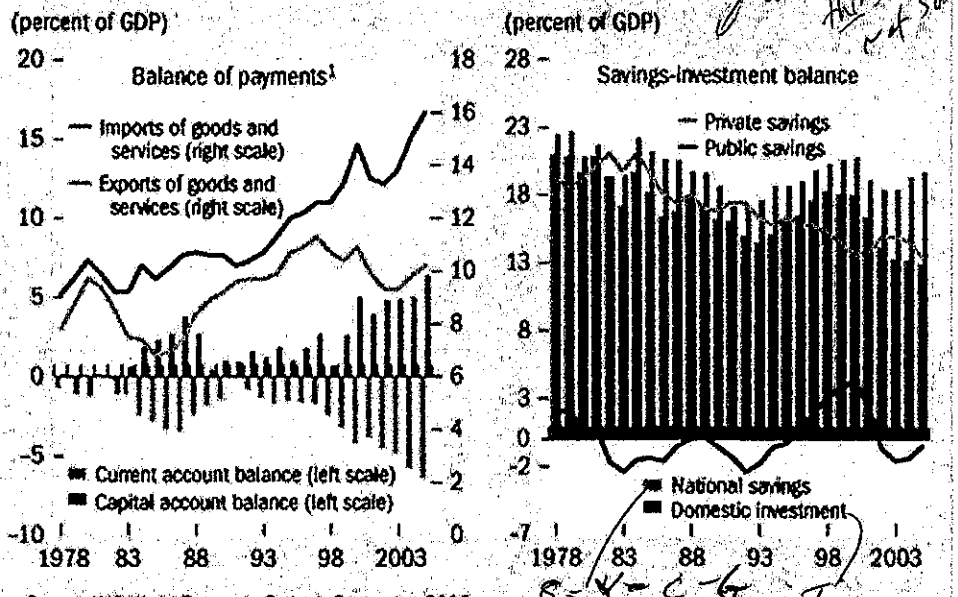
The IMF, whose mandate includes promoting and maintaining an open international trade and payments system, has recently started multilateral consultations on global imbalances with the major players: China, the euro area, Japan, Saudi Arabia, and the United States. Back to Basics tries to remove the emotion from the issue and examine whether current account surpluses and deficits even matter.

Measuring the current account

A good starting point is to ask what a current account deficit or surplus really means and to draw insights from the many ways that a current account balance is measured. First, it can be expressed as ***the***

Net foreign borrower

The United States runs a persistent balance of trade and a current account deficit and uses foreign capital to finance the difference between domestic investment and domestic savings.



Source: IMF, *World Economic Outlook*, September 2006.
[1]Balance of payments=current account plus capital account (now also called the financial account).

One point that the savings-investment balance approach underscores is that protectionist policies are unlikely to be of much use in improving the current account balance because there is no obvious connection between protectionism and savings or investment.

Third, the current account can be viewed in terms of ***the timing of trade***. We are used to intratemporal trade—exchanging cloth for wine today. But we can also think of intertemporal trade—importing goods today (running a current account deficit) and, in return, exporting goods in the future (running a current account surplus then). Just as a country may import one good and export another under intratemporal trade, there is no reason why a country should not import goods of today and export goods of tomorrow.

Intertemporal theories of the current account also stress the consumption-smoothing role that current account deficits and surpluses can play. For instance, if a country is struck by a shock—perhaps a natural disaster—that temporarily depresses its ability to access productive capacity, then rather than take the full brunt of the shock immediately, it can spread out the pain over time by running a current account deficit. Conversely, research also suggests that countries that are subject to large shocks should, on average, run current account surpluses as a form of precautionary savings.

When persistent is too persistent

Does it matter how long a country runs a current account deficit? When a country runs a current account deficit, it is building up

liabilities to the rest of the world that are financed by flows in the financial account. Eventually, these need to be paid back. Common sense suggests that if a country fritters away its borrowed foreign funds in spending that yields no long-term productive gains, then its ability to repay—its basic solvency—might come into question. This is because solvency requires that the country be willing and able to (eventually) generate sufficient current account surpluses to repay what it has borrowed. Therefore, whether a country should run a current account deficit (borrow more) depends on the extent of its foreign liabilities (its external debt) and on whether the borrowing will be financing investment that has a higher marginal product than the interest rate (or rate of return) the country has to pay on its foreign liabilities.

But even if the country is intertemporally solvent—meaning that current liabilities will be covered by future revenues—its current account deficit may become unsustainable if it is unable to secure the necessary financing. While some countries (such as Australia and New Zealand) have been able to maintain current account deficits averaging about 4½ to 5 percent of GDP for several decades, others (such as Mexico in 1995 and Thailand in 1997) experienced sharp reversals of their current account deficits after private financing withdrew in the midst of financial crises. Such reversals can be highly disruptive because private consumption, investment, and government expenditure must be curtailed abruptly when foreign financing is no longer available and, indeed, a country is forced to run large surpluses to repay in short order its past borrowings. This suggests that—regardless of why the country has a current account deficit (and even if the deficit reflects desirable underlying trends)—caution is required in running large and persistent deficits, lest the country experience an abrupt and painful reversal of financing.

What determines whether a country experiences such a reversal? Empirical research suggests that an overvalued real exchange rate, inadequate foreign exchange reserves, excessively fast domestic credit growth, unfavorable terms of trade shocks, low growth in partner countries, and higher interest rates in industrial countries influence the occurrence of reversals. More recent literature has also focused on the importance of balance sheet vulnerabilities in the run-up to a crisis, such as the extent of liability dollarization and maturity mismatches. It has also underscored the importance of the composition of capital inflows—for example, the relative stability of foreign direct investment versus portfolio and other types of short-term investment flows. Moreover, weak financial sectors often lead to higher vulnerability to a reversal as banks borrow money from abroad and make risky domestic loans. Conversely, a flexible exchange rate regime, higher degree of openness, export diversification, financial sector development, and coherent fiscal and monetary policies are some factors that make a country with persistent deficits less vulnerable to a reversal.

So, are deficits bad?

A common complaint about economics is that the answer to any question is, "It all depends." It is true that economic theory tells us that whether a deficit is good or bad depends on the factors giving rise to that deficit, but economic theory also tells us what to look for in assessing the desirability of a deficit.

If the deficit reflects an excess of imports over exports, it may be indicative of competitiveness problems, but because the current account deficit also implies an excess of investment over savings, it could equally be pointing to a highly productive, growing economy. If the deficit reflects low savings rather than high investment, it could be caused by reckless fiscal policy or a consumption binge. Or it could reflect perfectly sensible intertemporal trade, perhaps because of a temporary shock or shifting demographics. Without knowing which of these is at play, it makes little sense to talk of a deficit being "good" or "bad": deficits reflect underlying economic trends, which may be desirable or undesirable for a country at a particular point in time.

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