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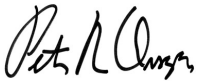
Will the U.S. Current Account Have a Hard or Soft Landing?

Introduction and Summary

The current-account deficit measures the excess of a country's spending over its income or, equivalently, of its investment over its saving. Such a deficit is possible only if foreign investors (either public or private entities) finance it by buying domestic assets (such as government securities, bonds, stocks, and real estate) or by providing loans to domestic entities.

Foreign investors have been steadily adding to their holdings of U.S. assets since 1991, when the U.S. current-account deficit began to climb. The persistence of the large U.S. current-account deficit—which reached 6.5 percent of gross domestic product (GDP) last year—and the resulting accumulation of net U.S. liabilities have led to concerns that foreign investors might at some time be less willing to keep financing that deficit. Some analysts are worried that a "sudden stop" of foreign financing could trigger a hard landing—an abrupt and steep decline in the dollar associated with a sharp contraction in the U.S. bond and stock markets, leading to a severe slowdown or even a recession in the United States.[1] By contrast, other analysts believe that the risk of a hard landing in the near future is small, even though they agree that the U.S. current-account deficit cannot indefinitely stay high (or grow higher) relative to GDP.[2]

This brief was prepared by Juann H. Hung. For more information about the current-account deficit, see Congressional Budget Office, *Why Does U.S. Investment Abroad Earn Higher Returns Than Foreign Investment in the United States?* (November 30, 2005), *Recent Shifts in Financing the U.S. Current-Account Deficit* (July 12, 2005), and *The Decline in the U.S. Current-Account Balance Since 1991* (August 6, 2004)—all available at www.cbo.gov.



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This brief discusses the reasons why the U.S. current-account deficit is not sustainable at its current level relative to GDP and explores how it might be resolved. According to the Congressional Budget Office's analysis, the more likely scenario is a soft landing—in which the dollar's exchange value and the current-account deficit decline slowly. In the less likely event of a sudden stop of foreign financing, the adjustment would not necessarily turn into a hard landing, even though that risk cannot be ruled out.

In assessing the adjustment of the current-account deficit, two caveats are important. First, the present situation is uncharted territory: Never before has the world's largest

1. See, for example, Nouriel Roubini and Brad Setser, "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005–2006" (working paper, February 2005), available at http://pages.stern.nyu.edu/~nroubini/papers/BW2-Unraveling-Roubini-Setser.pdf, and articles cited in Hilary Croke, Steven B. Kamin, and Sylvain Leduc, *Financial Market Developments and Economic Activity During Current Account Adjustments in Industrial Economies,* International Finance Discussion Paper No. 827 (Washington, D.C.: Board of Governors of the Federal Reserve System, 2005), available at www.federalreserve.gov/pubs/ifdp/2005/827/ifdp827.pdf.

2. See, for example, Michael Dooley, David Folkerts-Landau, and Peter Garber, *International Financial Stability: Asia, Interest Rates, and the Dollar* (New York: Deutsche Bank Securities, Inc., October 27, 2005), and Croke, Kamin, and Leduc, *Financial Market Developments and Economic Activity During Current Account Adjustments*.

economy become the world's largest debtor. In that context, if a hard landing were to occur, it could exact a heavy toll not just on the U.S. economy but also on those of other countries. Second, a soft landing may not be without costs. A slower decline of the current-account deficit may avert a short-term crisis, but ultimately it may more substantially erode the advantages that accrue to the United States from the dollar's special role as the main international reserve currency—the one commonly relied on for international transactions and accumulations of assets.

The Large U.S. Current-Account Deficit Is Not Sustainable

Analysts generally agree that the large U.S. current-account deficit cannot be sustained indefinitely at its present high level relative to GDP. The United States—like any other country—cannot continue accumulating debt at a rate faster than its ability to repay it. If policy actions or other economic developments do not rein in the current-account deficit, at some point foreign investors will become less willing to keep adding to their holdings of U.S. assets.

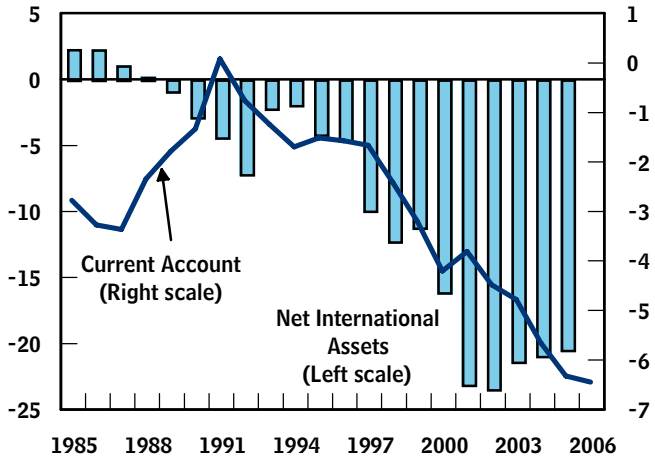
Even though net U.S. liabilities (as shown in Figure 1 as negative net assets) have hardly risen relative to GDP over the past several years despite the large current account deficit, that situation is unlikely to continue over the long run. Movements in asset prices and in the exchange rate have raised the dollar value of U.S.-owned foreign securities and direct investments overseas by more than that of U.S. securities and investments held by foreign investors, offsetting the consequence of the current-account deficit. However, such favorable effects of valuation cannot be relied on in the long term, and sooner or later net U.S. international liabilities will begin to rise rapidly relative to GDP if the large U.S. current-account deficit persists.[3]

Because the U.S. current-account balance is the difference between the nation's saving and investment, policy actions that enhance saving relative to investment in the United States—such as cutting the U.S. government's budget deficit or encouraging private saving—can reduce the current-account deficit. By the same token, because the U.S. current-account deficit reflects a current-account surplus in the rest of the world, actions by foreign governments or private investors that boost investment relative to saving in other countries can also narrow the U.S. current-account deficit. Other developments that increase foreign spending by more than domestic spending—such as economic expansion abroad accompanied by slower growth in this country—can similarly reduce that deficit.

Figure 1.

The U.S. Current Account and Market Value of Net International Assets

(Percentage of gross domestic product)



Sources: Congressional Budget Office and Department of Commerce, Bureau of Economic Analysis.

In the absence of such developments or policy actions, a persistent current-account deficit will, over time, make foreign investors less willing to provide low-cost financing for it. To date, foreign demand for dollar assets has not yet weakened significantly, in part because the dollar is still the major international reserve currency.[4] How-

3. If net U.S. liabilities were to grow 30 percent per year (roughly the ratio of the current-account deficit to those liabilities in 2005, the last year for which data are available) and nominal GDP grew at 5 percent per year, it would take no more than six years before they reached 60 percent of nominal GDP.

4. The dollar's status as the major reserve currency has meant that foreign demand for dollar assets has increased as other economies and international transactions have grown. Moreover, central banks intent on managing their exchange rates have tended to increase their accumulation of dollar assets following tumultuous times, in an attempt to avoid currency crises in their countries. Indeed, many Asian governments accelerated their accumulation of foreign reserves, most of which are dollar-denominated assets, after the Asian crisis of 1997 and 1998.

ever, once investors accumulate enough dollar assets to facilitate international transactions and to meet their needs for holding reserves, they are likely to slow down their purchases of dollar assets for those purposes and increasingly will buy or sell dollar assets on the basis of their expected returns. For example, the Chinese government announced in March this year that it would establish an investment agency to more "profitably" and "efficiently" manage a portion of its foreign reserves, which exceeded $1.2 trillion in the first quarter of this year.[5] Thus, to the extent that investors and governments believe that the U.S. current-account deficit will cause the dollar to depreciate, which reduces the expected return on dollar assets, the demand for dollar assets will fall.

What Market-Driven Adjustments Are Possible?

Once foreign demand for U.S. assets begins to grow more slowly than the supply, there will be growing downward pressure on the dollar and U.S. asset prices. A lower dollar raises the prices of imports and reduces U.S. residents' purchasing power at home and abroad, and lower asset prices make U.S. residents poorer. As a result, U.S. residents will be less able and willing to borrow and spend, thereby lowering the current-account deficit. As long as foreign demand for dollar assets does not drop too suddenly, the adjustment will be a gradual one—a soft landing. In that case, growth of the U.S. economy is likely to remain on track. The gradual rise in exports and decline in imports would entail more production and employment in sectors that export and sectors that compete with imports, helping to offset the negative effects of the gradual adjustment in asset prices, interest rates, and the prices of imports.

If the U.S. current-account deficit persisted and foreign holdings of U.S. assets continued to rise, however, at some point many foreign investors could stop buying U.S. assets—if, for instance, adverse events or opinions reduced investors' expectations about the strength of the dollar or the U.S. economy. In that sudden-stop scenario, a sharp decline in the dollar and U.S. asset prices would cause the current-account deficit to shrink much faster than in a soft landing. Initially, the economy could be dragged down by lower domestic spending, but the rise in net exports would help to limit the duration and extent of the slowdown.

If a sudden stop were to induce a collapse of confidence and trigger sell-offs of dollar assets by both U.S. and foreign investors, it could turn into a hard landing—the collapse of the dollar and of the prices of financial assets, leading to a severe slowdown or even a recession in the United States. Import prices could rise significantly, leading to a jump in the prices consumers faced or even a rise in inflation. As people bought less and firms became less profitable, the severity of the economic downturn would increase. The U.S. current-account deficit would fall rapidly, but at the cost of lower national income, households' reduced purchasing power and wealth, and higher unemployment.

How bumpy the adjustment of the U.S. current account will be thus largely depends on what happens to foreign demand for U.S. assets. If demand for U.S. assets continues to grow faster than the supply, the U.S. current-account deficit may temporarily widen further.[6] Indeed, the longevity of the large U.S. current-account deficit can be viewed as reflecting a sequence of events that caused demand for U.S. assets to grow even faster than the supply. Between 1997 and 2000, a host of developments—financial globalization, a succession of financial crises (the 1997–1998 Asian crisis, Russia's default of 1998, and the Brazilian *real* crisis of 1999), and weaker economic growth in other industrial countries than in the United States—all added to the demand for U.S. assets.[7] By propelling the dollar and U.S. asset prices higher, those developments contributed to widening the current-account deficit. The long-term downward adjustment of

5. The announcement did not specify how much of the reserves would be managed by the new agency, but Chinese officials and the press have suggested an amount of up to $300 billion.

6. Given the supply of U.S. assets (which reflects U.S. demand for foreign goods and services at current levels of the exchange rate, interest rates, and asset prices), an increase in foreign demand pushes up the dollar and the prices of those assets, lowering interest rates in the United States. As a result, U.S. residents are more able and willing to borrow and spend, which works to widen the current-account deficit.

7. Financial globalization has allowed private foreign investors to participate in the U.S. capital market more fully. See Congressional Budget Office, *The Decline in the U.S. Current-Account Balance Since 1991* (August 6, 2004).

Box 1.

Which Countries Are Prone to Currency Crises?

Currency crises have occurred mostly in emerging economies, especially in those that have a managed exchange rate. Between 1970 and 2004, 86 currency crises occurred among 25 emerging economies studied, compared with 47 in 24 industrial economies studied (see the table).[1] Even more striking, about 76 percent of all 133 crises occurred in countries that managed their exchange rate rather than letting it float freely.

An emerging country is more vulnerable to a currency crisis largely because international investors are much less willing, when it is in trouble, to provide new loans or to roll over existing debt than they are for an advanced country. In part, that reluctance stems from the fact that an emerging country's international debt is mostly denominated in foreign currencies, making it more difficult for the country to pay off or service that debt through a depreciation of its currency. (Even though its currency's depreciation will help improve its trade balance, that depreciation will also raise the domestic-currency value of that debt and interest payments on that debt.)

A country with a managed exchange rate system is also more prone to a currency crisis. First, it is easier for speculators to place "one-way bets" against a currency with a managed exchange rate. For example, suppose that a country runs a persistent current-account deficit and its currency is under increasing pressure to depreciate. To keep its exchange rate from falling below the fixed rate, the government has to continually buy its own currency with its foreign exchange reserves. As long as the government keeps its exchange rate fixed while the country runs a current-account deficit, its foreign exchange reserves will continue to dwindle. Once those reserves fall far enough, speculators can be much more confident that its currency will soon be forced to be devalued than they would be if that currency had been adjusting to market forces along the way.[2] Confident of their one-way bets, speculators will try to shift their money out of the country before other investors force the devaluation to occur, causing the currency to crash sooner and fall farther than it would in a flexible exchange rate regime.

In addition, economic imbalances tend to grow until the country can no longer maintain its exchange rate policy. Unless the government is able to prevent private capital from flowing in and out of its country, its fixed exchange rate policy means that it cannot use monetary policy to fight inflation or a recession.[3] Take Thailand as an example. Large capital inflows poured into Thailand for years prior to the 1997–1998 crisis because its

1. See Juann Hung and Young-Jin Kim, *Implication of Past Currency Crises for the U.S. Current Account Adjustment*, CBO Working Paper 2006-7 (June 2006).

2. If the currency had been free to float, the country would not have been running down its foreign exchange reserves to maintain a fixed exchange rate. Moreover, predicting which way market forces could be moving its exchange rate in the near future would be harder.

3. If a country has a fixed exchange rate and investors are free to move their investments into and out of the country, then its domestic interest rates will be determined by the world market. Suppose its central bank increases the money supply to lower domestic interest rates. Because the exchange rate is fixed, the initial decline in the domestic interest rates will immediately lower the expected rate of return on investment in that country, causing investors to move their money out of that country until domestic interest rates return to their prior levels. Likewise, any tightening of the money supply cannot succeed in raising domestic interest rates because its initial effects will be undone by international investors' moving money into the country.

Box 1.

Continued

Currency Crises in Industrial and Emerging Economics, 1970 to 2004

	Number of Crises	Total Change in Output Growth (Percent)[a]
Industrial Economies		
Pegged exchange rate	8	-2.1
Intermediate exchange rate	23	-1.2
Floating exchange rate	16	0.6
Total/Average	**47**	**-0.7**
Emerging Economies		
Pegged exchange rate	30	-2.7
Intermediate exchange rate	40	-1.6
Floating exchange rate	16	1.3
Total/Average	**86**	**-1.5**

Source: Congressional Budget Office.

Notes: A currency crisis is defined as an occasion when a currency's nominal depreciation from its level 12 months ago exceeds 25 percent and the rate of that depreciation is 10 percentage points higher than a year ago.

In a pegged exchange rate regime, the government keeps the currency pegged to a major currency (such as the dollar) at a predetermined exchange rate. An intermediate regime is one that allows restricted and infrequent adjustments of the exchange rate. A floating rate is determined by market forces.

Classifications of exchange rate regimes are taken from the International Monetary Fund's *Annual Report on Exchange Arrangements and Exchange Restrictions.*

a. Changes in output growth are simple averages of the difference of annualized growth rates between the precrisis period and the crisis period, with each period considered to last three years. For emerging economies, those averages are based on 76 crises, rather than 86, because of a lack of data.

interest rates were much higher than those in industrial countries.[4] The massive capital inflows in turn resulted in a rising inflation rate and a current-account deficit.

However, Thailand's central bank could not contain its country's inflation. Because its currency-peg system meant that investors did not need to worry about daily fluctuation of the exchange rate (at least until the run-up in the current-account deficit became worrisome), an increase in its interest rates would only have attracted even more capital inflows and fueled a further rise in inflation and its current-account deficit.

4. For example, the average interest rate on three-month deposits in Thailand's commercial bank was about 10 percent from 1995 to 1996; the corresponding interest rate was 5.7 percent in the United States, 6.1 percent in the United Kingdom, and 0.9 percent in Japan.

the current-account deficit was again delayed in 2005, as demand for dollar assets was boosted by the rise in the U.S. short-term interest rate relative to those rates in Japan and the euro countries, a temporary increase in the repatriation of overseas profits to the United States (due to the one-year tax holiday for such profits granted by the American Jobs Creation Act of 2004), and a rise in oil-exporting countries' demand for dollar assets because of the hike in oil prices.

However, it seems implausible that foreign demand for U.S. assets will be boosted indefinitely by such short-term factors. Once long-term downward pressures on demand begin to outweigh short-term supports for dollar assets, they will push down the dollar and those asset prices, facilitating the decline of the current-account deficit.[8]

The More Likely Scenario Is a Soft Landing

Studies of past currency crises suggest that the more likely scenario for the U.S. current account is a soft landing. Currency crises tend to occur in emerging countries rather than in industrial ones, and in countries with a managed exchange rate system, in which the government fixes its exchange rate or allows it to fluctuate only within a narrow band (see Box 1). Neither of those factors applies to the United States.

The unique role of the U.S. dollar as the world's main reserve currency also helps to reduce the probability of a sudden stop of foreign financing. Nearly all U.S. international liabilities are denominated in dollars, but at the same time, about two-thirds of U.S. holdings of assets abroad are equity assets, denominated in host countries' currencies. Therefore, a large depreciation of the dollar would lower net U.S. liabilities to foreign investors not only by lowering net imports but also by boosting the dollar value of U.S. assets abroad. Consequently, the depreciation would not necessarily feed on itself and become a full-blown dollar crisis, unlike the effects of a sharp drop in the currency of a country with a large amount of debt denominated in foreign currencies.[9] Moreover, the dollar's role as the major reserve currency and medium of international transactions also results in a basic level of demand for the dollar, a stabilizing cushion to the dollar's exchange value.

Even if a sudden stop were to occur, a resulting slowdown in economic activity may be limited. (That is, the probability of a hard landing is likely to be smaller than the probability of a sudden stop.) The strength of U.S. financial markets and the ability of U.S. entities to borrow in their own currency should help mitigate the risk of a sudden stop turning into a severe financial crisis and economic recession. (A sudden stop of foreign financing in a country with an emerging economy tends to spread into a full-blown financial crisis and lead to severe losses of output and jobs, largely because such a country has weak financial institutions and is unable to borrow in its own currency.) Because most U.S. international debts are denominated in dollars, a currency crash would be less likely to inflate U.S. borrowers' debt burden and cause widespread bankruptcy than it would be in an emerging economy. At the same time, that crash would enhance the dollar value of most foreign assets owned by U.S. residents, mitigating their possible financial losses. Moreover, the Federal Reserve System could attempt to limit the spread of a dollar crisis by lowering short-term interest rates, an option not available to a country whose debts are denominated in foreign currencies.[10]

Over time, a sharply lower dollar would help improve investment and employment by boosting the price competitiveness of U.S. products in sectors that export and those that compete with imports. Unless the sudden stop triggered a domestic financial crisis, those effects could—within one to two years—begin to outweigh the initial drag on the economy from the loss of foreign financing. Indeed, on average, from 1971 to 2004, currency collapses in countries using a floating exchange rate regime were followed by economic recovery, not contraction. The average growth rate of real (inflation-adjusted) GDP

8. The trade-weighted dollar exchange rate relative to major industrial currencies, computed by the Federal Reserve Board, declined about 9 percent between November 2005 and May 2007.

9. For such an indebted country, its currency's depreciation necessarily raises the domestic-currency values of its international debt and interest payments on that debt but may not go very far in raising the value of its trade surplus (especially if its exports rely significantly on imported materials). Thus, its net debt could become higher even as its currency depreciates, putting greater downward pressure on its currency.

10. That is not to say that the Federal Reserve System would necessarily have an easy choice. If the rise in prices from the sudden stop increased expected inflation, the U.S. central bank might be concerned about the potential effect of fueling those expectations by increasing liquidity.

increased 0.6 percentage points in industrial countries and 1.3 percentage points in emerging economies (see the table in Box 1). During that same period, the dollar fell sharply four times. All were mild declines compared with the steep falls in "crisis" currencies. Moreover, none of those four episodes caused widespread economic hardship for U.S. residents. The unemployment rate fell in all four episodes, and real GDP growth increased in three out of the four.[11] The only episode during which real growth decreased was the one from 1971 to 1973, when the dollar's fixed exchange rate collapsed relative to gold.[12] Even in that episode, real GDP grew 4.7 percent a year on average (from the second quarter of 1971 to the third quarter of 1973).[13]

However, past experiences may offer only limited guidance in this uncharted territory. It is unprecedented that the world's largest economy has become the world's largest debtor, and the world is also more connected than ever—through the Internet and globalization in trade and finance. In the unlikely event of a hard landing in the United States, its negative repercussions could be much larger than implied by the experiences of past currency crises. With most U.S. liabilities denominated in dollars, foreign holders of U.S. assets would find the dollar value of their assets collapsed at the same time their ability to export to the United States was sharply curtailed. As a result, the growth of the world economy could be significantly restrained.

Even a soft landing is not without potential costs—indeed, they could be higher. U.S. residents' future living standards could grow more slowly following a soft landing than after a sudden stop. The dollar could decline for a longer period and eventually by a greater extent—spelling a greater reduction in the dollar's purchasing power for foreign goods and services (see Box 2). Moreover, the expectation that the dollar would keep falling for a long time would make dollar assets less useful as a medium of exchange and less attractive as an investment instrument. That expectation could then undermine the dollar's status as the major international reserve currency, perhaps by more than a one-time sharp fall of the dollar would.[14] That special status of the dollar has allowed the United States to borrow in its own currency and helped keep the cost and risk of borrowing from abroad lower than otherwise. The more the dollar's reserve-currency status deteriorated, the more those advantages would erode.

11. See Juann Hung and Young-Jin Kim, *Implication of Past Currency Crises for the U.S. Current Account Adjustment,* CBO Working Paper 2006-7 (June 2006), Table 8.

12. Under the international payment system established after World War II, each member country had an obligation to adopt a monetary policy that maintained the fixed exchange rate of its currency in terms of gold. In the late 1960s, the dollar was becoming increasingly overvalued relative to gold. As the balance of payments deficit surged in 1970 and 1971 (mainly due to large capital outflows), the United States suspended converting dollars to gold in 1971, beginning the process of ending the dollar's unsustainable peg to gold. The dollar (and other major currencies) began to float in 1973.

13. The average growth rate fell to 0.8 percent during the two years after the third quarter of 1973. But that sharp slowdown was mostly attributable to the 1973–1974 oil crisis.

14. See also, Barry Eichengreen, *Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition*, Working Paper No. 11336 (Cambridge, Mass.: National Bureau of Economic Analysis, May 2005). Eichengreen predicts that, if that the current-account deficit could be gradually brought under control, the dollar could remain a reserve currency, though not the dominant one, as it has been in the past. However, if the U.S. current-account deficit is allowed to persist, the prospect of disorderly adjustments (possibly involving repeated sharp falls of the dollar and high inflation or interest rates) could more seriously undermine the dollar's reserve-currency status.

Box 2.

The Long-Term Risk of a Soft Landing

While a soft landing avoids large disruptions to the economy in the short run, it presents the risk that the dollar could decline for a longer period and eventually by a greater extent than it would following a faster decline in the current-account deficit. A slower decline in that deficit means a faster accumulation of net international liabilities, which could tend to stay larger than they would following a faster decline.

Compare two scenarios: a sudden stop and a soft landing. In the sudden stop, the dollar falls 30 percent in 2007 and stays unchanged thereafter and real (inflation-adjusted) gross domestic product (GDP) stops growing for a year before rebounding to its potential level. In the soft landing, the dollar falls 3 percent a year for the 10 years from 2007 to 2016, and real GDP grows at its potential rate.

In the first scenario, the current-account deficit falls more sharply in 2007 and 2008 because of the steeper drop of the dollar (which will dampen imports while boosting exports) and a sharper slowdown in domestic spending (which will greatly curtail imports). The current-account deficit will then tend to decline faster in the years after 2008 for two reasons. First, once imports are reduced and exports boosted in 2007 and 2008, imports would tend to be smaller and exports larger in the ensuing years. Second, the lower level of net international liabilities after 2008 reduces future net interest payments, a component of the current-account deficit.

In the second scenario—a soft landing—the size of net U.S. international liabilities will grow larger and will tend to stay larger indefinitely if the dollar does not keep declining after 2016. Thus, the dollar could eventually fall by a greater extent than it would after a sudden stop.