

## Revisiting the Outlook for US External Deficits and Net International Liabilities

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Two years ago the prospects for US external adjustment looked bleak. A “Massachusetts Avenue” current account model projected that the current account deficit would rise from 6 percent of GDP in 2005 to the range of 7–8 percent of GDP by 2010 and that there would be a corresponding rise in net international liabilities from 22 percent of GDP at the end of 2004 to a range of 50–53 percent of GDP by 2010 (Cline 2005, 94–86). The baseline projections assumed that the real value of the dollar would remain unchanged at the level of January–August 2005, and that US growth would average 3.5 percent and foreign growth weighted by US exports would average 3.1 percent. The projections incorporated the effect of rising net international liabilities on capital services, predicting a swing from net capital income from about \$40 billion in 2004 to –\$200 billion by 2010, despite an ongoing favorable differential of 4.6 percentage points between the rate of return on US direct investment abroad and foreign direct investment in the United States. What is the early evidence on the accuracy of these projections, and how has the medium-term US external sector outlook changed in the meantime?

### **Evidence to Date**

#### *Current Account*

The projections for the current account turned out to be close to the actual outcome for 2005 and 2006, but modestly overstated the prospective deficit for 2007. The preferred model variant (Krugman-Gagnon Symmetric [KSG]) placed the current account deficit at 6.0 percent of GDP in 2005, 6.1 percent in 2006, and 6.2 percent in 2007. The actual outcome was 6.1 percent in both 2005 and 2006. For 2007, however, in the first half, the current account deficit was an average of only 5.7 percent of GDP. The new estimates developed below place the full-year deficit at 5.4 percent of GDP. The key reason for the divergence is that the 2005 model predicted that by 2007 net capital services would show a deficit of \$87 billion for the year, whereas in the first half of 2007 there was a capital services surplus at an annual rate of \$34 billion, a difference amounting to an increase of 0.9 percent of GDP.

In contrast, the prospective results for 2007 on trade in goods and services are considerably closer to, and actually somewhat less favorable than, the original projections. The trade balance on goods and services for the first half of 2007 stood at –\$355 billion, an annual rate of –\$710 billion or –5.2 percent of GDP. In comparison, the

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earlier projections placed the 2007 trade outcome at a deficit of  $-\$680$  billion or  $-5.0$  percent of GDP. The 2005 projection had anticipated that the price of oil would remain at  $\$50$  per barrel; instead, it rose to an average of  $\$58$  per barrel in 2006 and  $\$57$  per barrel in the first seven months of 2007. Each dollar per barrel of oil boosts the import bill by  $\$3.7$  billion. So for 2007 the higher cost of oil than in the original projections should add  $\$26$  billion to imports (before considering the implications of the September surge to over  $\$80$  per barrel).

The 2005 projections anticipated a rise of imports of goods and services by 13.5 percent from 2005–07. Instead, they rose by 14.9 percent. The difference is almost exactly the  $\$26$  billion in extra oil imports. However, economic growth was lower than projected, at 3.1 percent in 2005, 2.9 percent in 2006, and an annual rate of 2.3 percent in the first half of 2007, rather than a steady 3.5 percent. The average annual shortfall of 0.7 percentage point, sustained for three years, should have curbed imports enough to bring about a reduction in the current account deficit by about 0.9 percent of GDP by 2007 from levels otherwise reached.<sup>1</sup> So actual imports have been somewhat above what the model would have predicted even using actual import prices, because there has not been as much slowdown in import growth as would have been expected given below-projection growth.

On the other side, exports have grown faster than projected. The 2005 projection called for a rise of 19.8 percent in the dollar value of exports of goods and services from 2005–07. Instead, based on the rate of the second quarter of 2007, the actual rise will turn out to be 23.4 percent. In part this difference likely reflects higher foreign growth than in the baseline.<sup>2</sup>

In short, higher oil prices and lesser import reduction from slower US growth were approximately offset by higher than anticipated export growth to leave the prospective actual trade surplus on goods and services for 2007 at about the same amount as projected in 2005. Again, this means that the main reason the current account deficit in 2007 will be lower than originally projected is that the capital services account will likely still be in surplus rather than in significant deficit.

### *Net International Assets*

Whereas the 2005 baseline projections have been close to the outcome for trade, they have been far off the mark for the net international investment position (NIIP), and the divergence in turn helps explain much of the divergence in the actual outcome on capital income. Once again it has been price and exchange rate valuation influences, as well as outright unexplained statistical discrepancies, that have bedeviled the attempt to project NIIP based on cumulative current account flows.

The mid-2005 book projected end-2005 US external assets at  $\$8.8$  trillion and liabilities at  $\$12.6$  trillion, for an NIIP of  $-\$3.8$  trillion. It placed the corresponding

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<sup>1</sup> In the KSG model, 1 percent slower US growth for one year reduces the current account deficit by 0.43 percent of GDP by year three, mainly from lower imports but also from interest payments on lower international liabilities.

<sup>2</sup> The 11 largest export markets for the United States (Canada, European Union, Mexico, Japan, China, Korea, Singapore, Hong Kong, Australia, Brazil, and Switzerland) grew at an annual average of 3.5 percent in 2005–07, weighting by US exports and using the 2007 IMF forecast. The baseline projection had called for 3.1 percent growth.

estimates for end 2006 at \$9.2 trillion assets, \$13.8 trillion liabilities, and –\$4.7 trillion NIIP. Instead, actual results for end-2005 were as follows: assets: \$12.6 trillion; liabilities: \$14.8 trillion; and NIIP: –\$2.1 trillion. For end-2006 the outcome was as follows: assets: \$15.3 trillion; liabilities: \$17.4 trillion; and NIIP: –\$2.1 trillion.<sup>3</sup>

**Table 1 Change in NIIP by source, 2005 and 2006** (billions of dollars)

	Financial flows	Valuation adjustments			Total	Memo
		Price	Exchange rate	Other		
<i>Total</i>						
2005	–777.4	1097.9	–390.3	325.4	255.6	–754.8
2006	–833.2	501.3	365.1	–32.6	0.6	–811.5
<i>Assets</i>						
2005	426.9	1030.6	–440.3	1464.3	2481.5	
2006	1055.2	1023.6	409.1	130.3	2618.3	
<i>Liabilities</i>						
2005	1204.2	–67.3	–50.0	1138.9	2225.9	
2006	1859.6	522.3	44.0	192.7	2618.7	

Note: With direct investment at market value.

Source: Bureau of Economic Analysis.

Table 1 reports the Commerce Department estimates decomposing the change in the NIIP in 2005 and again in 2006. For the net of assets and liabilities, the first column shows almost the same figures as the final column. The change in the NIIP from net financial flows is almost identical to the current account balance. Essentially, this must be true because the United States does not intervene in the exchange market to accumulate or draw down international reserves.

The table shows the dramatic effects of valuation changes on the NIIP. In 2005, price changes added \$1 trillion to the NIIP. The rise of the dollar in 2005 did mean that there was an offsetting reduction in the NIIP from exchange rate valuation (because foreign holdings no longer translated into as many dollars). However, the pure statistical manna from heaven, “other,” boosted the NIIP by \$325 billion. Overall the NIIP *rose* by \$255 billion in 2005 despite a current account deficit of about \$750 billion. In 2006 there was a smaller price gain, but a positive rather than negative exchange rate valuation effect as the dollar fell again, and for a change a slight reduction instead of gain from “other” manna.<sup>4</sup>

The table shows that price gains in 2005 and 2006 were much larger on assets owned abroad than on liabilities owed to foreigners. This phenomenon reflects what turned out to be a much larger stock market surge abroad than in the United States. Thus, the Dow Jones World Index excluding the United States rose by 42.4 percent from end-2004 to end-2006, whereas the US Standard & Poor’s 500 index rose only 17.0 percent.

<sup>3</sup> Market value rather than cost is used for direct investment.

<sup>4</sup> For 2000–2004, the annual average “other” valuation change was +\$125 billion annually.

In addition, there is a relatively larger share of direct investment and portfolio equity in US assets abroad than in foreign holdings in the United States (which tend more to be in bonds and other credits).

In summary, we can say for the evidence to date that the model projections were broadly on track for trade, but seriously understated price gains on US equity held abroad. The understatement of valuation gains on assets abroad then contributed to a substantial overstatement of the downswing in capital income. The overall result was to overestimate the current account deficit for 2007 (at 6.2 percent of GDP instead of 5.4 percent), and far more dramatically to overestimate the move toward greater net international liabilities. Thus, the model projections had called for the NIIP to be -31.6 percent of GDP at the end of 2006. Instead, net liabilities turned out to be only half as large, at 16.2 percent of GDP. Indeed, this was the lowest level for net international liabilities since 2000 (also 16 percent), and represented a sizable decline from the largest net international liability position reached: 23.4 percent of GDP at the end of 2002.

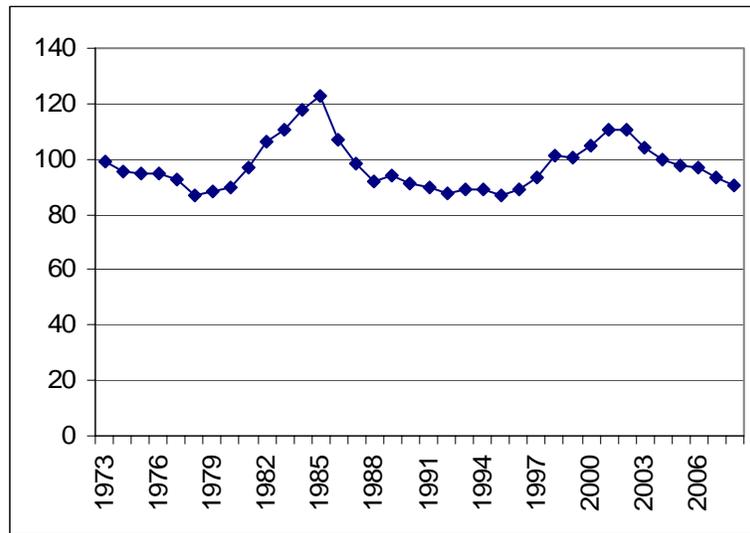
### **Revising the Outlook**

In the 2005 model projections with the real value of the dollar held constant at the level of the first five months of 2005, and with projected steady US growth at 3.5 percent annually, the baseline outlook called for the current account deficit to widen to 7.3 percent of GDP in 2010 (and 8.1 percent using an alternative model). As of September 2007, however, several factors have changed. The starting point on the NIIP is much more favorable than had been anticipated, as just discussed. US growth has slowed below the 3.5 percent expected, and over the medium term it seems likely that US growth will continue to be lower than that mark as well. The real exchange rate now is 6 percent lower than the base used in the earlier calculations.<sup>5</sup>

Figure 1 provides historical perspective on the level of the real value of the dollar. Using the broad real exchange rate index of the Federal Reserve, with March 1973 equal to 100, the average for 1973–2007 was 97.8. So the September 2007 value at 90.6 is 7.3 percent below the quarter-century average. However, it is still 2.3 percent above the average for 1991–96 (88.6), the most recent period of relatively modest current account deficits. Even so, against the full-year 2002 recent high of the dollar at 110.8, the dollar has now declined by 18.2 percent, a major correction.

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<sup>5</sup> The Federal Reserve's broad real index stood at 96.4 in January–May 2005 and is now at 90.62 for September 2007.

**Figure 1 Real broad index of the dollar (March 1973 = 100)**

*Source:* Federal Reserve.

Table 2 reports projections through 2012 using the KGS model with updated information on NIIP (including the large valuation effects), growth trends, and the lower recent level of the dollar. The projections assume that US growth reverts to 3 percent rather than 3.5 percent. The baseline applies the real level of the dollar as of September (and the table expresses the exchange rate in terms of real dollars per unit of foreign currencies, with 2006 = 1.0).

The new outlook for the external accounts is considerably more favorable than in the 2005 projections, although the long-term current account deficit still remains well above a target range of about 3 percent of GDP needed to stabilize net international liabilities eventually at no more than 50 percent of GDP. By 2010, the current account deficit is only 5.1 percent of GDP rather than 7.3 percent. By 2012 the deficit edges back up to 5.4 percent of GDP. The deficit falls to 5.4 percent in 2007, thanks to a strong 11.4 percent rise in exports and modest 4.6 percent rise in imports (imposed on the model based on the actual outcome for the first seven months compared to the same period last year). There is a significant drop from 2008 (5.5 percent deficit) to 2009 (5.1 percent) as a consequence of the recent further depreciation of the dollar after a two-year lag. The capital services account is in surplus at about \$40 billion again this year, but then swings to -\$40 billion next year and falls to -\$133 billion by 2012.

**Table 2 Baseline current account and NIIP (billions of dollars)**

	2006	2007	2008	2009	2010	2011	2012
Exports, GS	1445.7	1610.5	1813.6	2023.3	2218.7	2417.4	2633.9
Imports, GS	2204.2	2305.0	2488.2	2649.8	2852.3	3087.4	3341.9
Trade balance	-758.5	-694.4	-674.6	-626.5	-633.6	-670.0	-708.0
Transfers	-89.6	-90.3	-95.0	-99.9	-104.9	-110.2	-115.8
Capital services	43.2	39.9	-39.9	-55.4	-79.8	-105.4	-133.4
Current account	-811.5	-744.8	-809.6	-781.7	-818.3	-885.6	-957.2
CA/Y	-6.1	-5.4	-5.5	-5.1	-5.1	-5.2	-5.4
Net foreign assets:							
Accounting: NIIP	-2140.5	-2690.6	-3206.8	-3919.1	-4665.1	-5475.4	-6354.0
NIIP/Y %	-16.2	-19.4	-21.9	-25.5	-28.9	-32.3	-35.7
Economic: CNCI	900.3	868.0	-726.1	-1006.8	-1451.6	-1915.7	-2425.6
CNCI/Y %	6.8	6.2	-5.0	-6.6	-9.0	-11.3	-13.6
ERvaladj	363.0	117.3	221.9	0	0	0	0
Price valadj	472.2	77.4	71.5	69.4	72.3	75.4	78.5
Real \$/FC	1	1.042	1.067	1.067	1.067	1.067	1.067
Real \$/FC (-2)	0.972	0.988	1	1.042	1.067	1.067	1.067
Bond rate	4.8	4.6	5.5	5.5	5.5	5.5	5.5
FDI return difference	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Growth: US	3.3	2.1	2.9	3	3	3	3
Foreign	3.5	3.4	3.6	3.6	3.6	3.6	3.6

The net international investment position erodes from –16 percent of GDP at the end of 2006 to –36 percent of GDP at the end of 2012. The economic capitalized net capital income (CNCI) concept still shows the United States as a net creditor this year (with positive net capital income), but this measure shows the United States as a moderate debtor (–14 percent of GDP) by 2012.

Overall these updated estimates suggest a less daunting medium-term external imbalance for the United States than those in Cline (2005). Even so, net international liabilities at about 30 percent of GDP instead of 50 percent by 2010, and a current account deficit at about 5 percent of GDP instead of 7 percent, represent modest progress but not yet a path of fully successful adjustment. For that purpose, another 2 percent of GDP would need to be pared off the current account deficit. Using the parameter that 10 percent real foreign appreciation against the dollar boosts the current account by 1.4 percent of GDP after 3 years (Cline 2005, 96), it would require an additional 15 percent foreign appreciation (13 percent decline in the dollar) to complete the adjustment process. Essentially, the large windfall gain from price and exchange rate valuation effects on US direct and portfolio assets abroad, especially the boom in global equity prices, a real depreciation of about 6 percent from the original 2005 base, and weaker growth than the 3.5 percent steady performance previously assumed, have cut the size of the US external adjustment problem in half. But the other half remains to be accomplished.

## Reference

Cline, William R. 2005. *The United States as a Debtor Nation*. Washington: Institute for International Economics.