The silver lining in America's subprime cloud

George Shultz and John Taylor

Turmoil in the US's financial markets got the top billing in news reports about the recent meetings of the world's leading international policymakers in Washington. Virtually everyone expressed concern that the housing slump and the financial crisis triggered by the subprime mortgage market would significantly slow down the US economy, and perhaps the world economy. But there is a surprising silver lining. Signs of it were revealed by the absence of reporting on the big bugaboo of the past few years: the US current account deficit.

The good news is the recent reversal of the steady upward climb in the current account deficit. During the past three quarters for which we have data the deficit has been cut by $119bn, falling from about 6 per cent of gross domestic product to 5 per cent, and the adjustment appears to be continuing.

Why the reversal? One explanation is the implementation of policies that these same international policymakers agreed to at recent past meetings. The basic economic principle that led to these policies is that the US current account deficit is caused by the gap between saving and investment. Accordingly, a three-pronged strategy was called for – reducing the US budget deficit to decrease government dissaving, raising economic growth abroad relative to the US in order to stimulate US exports and increasing the flexibility of exchange rates, especially in China, to facilitate the adjustment.

You can see the strategy being implemented now. The budget deficit has come down sharply to 1.2 per cent of GDP, well below historical averages and less in than most other countries. World economic growth – especially in emerging markets – has been strong, even as US growth has slowed. And China's exchange rate has become more flexible – appreciating by 10 per cent since the peg was abandoned. Forward markets project further appreciation. All these policies are expected to reduce the current account deficit, but they take time – too much time to explain the sharp reduction in the current account in the past year.

So there must be other forces at work too. Because the current account deficit equals saving minus investment, these are logical places to look. Herein lies the silver lining. The housing turmoil has indeed cut a chunk out of investment – residential investment has fallen by $81bn in the three quarters during which the current account deficit declined, and even more compared with the peak of the housing boom earlier last year. Hence a good part of the current account reduction can be directly attributed to the decline in residential investment. Moreover, the decline in housing prices is starting to increase the personal saving rate, as home equity loans are drying up and people are recognising that their housing wealth is not as large as they had expected. When asset prices were rising, households could spend what they earned and still see an increase in their net worth. Sometimes spending even exceeded income. Now, consumption is falling relative to income, so there is more household saving.

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Including both the direct investment effect and the personal saving effect, about three-quarters of the reduction in the current account deficit can be attributed to the housing market turmoil. So while the agreed economic policies have begun to improve the current account, and will continue to do so, they have had important assistance. The housing market correction has been an important factor in the current account correction; as a result we are seeing a dramatic beginning of a welcome rebalancing of the world's investment and saving flows.

The nature of this adjustment has implications for future policy. First, since we cannot rely on the housing slump to reduce the current account without limit, it is important to continue with the three-pronged strategy, which would be good economics even if there were no current account deficits. Second, the decrease in the current account deficit in the US means that other countries will be exporting less and importing more from the US. Unless other components of demand in these countries increase, there will be negative spillovers on the world economy. Given the continued importance of productivity-raising investment, it is important for the US's trading partners to encourage more investment in their own countries. Improving the investment climate – especially in emerging market countries where investment is low – is more important than ever. Countries with extraordinary rates of saving would do well to look more favourably on consumption.

Throughout the recent world economic expansion, many have warned that the current account deficit would cause a sharp collapse of the dollar and a global currency crisis. That has not happened. The dollar depreciation has been gradual, with low volatility serving as a stabilising force during the six-year expansion. A US exchange rate policy that has stressed market forces, avoided exchange market intervention and not tried to talk the dollar down has worked well. It should be continued. To the degree that the improvement in the current account is caused by the housing turmoil, further depreciation of the dollar is less likely. But it is best to let the market decide that.

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