Flash Economics

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What logic lies behind current account imbalances?

Current account surpluses or deficits may depend on:

- Demographic situation: Younger countries normally accumulate foreign assets and therefore have current account surpluses; older countries use their foreign assets for consumption and therefore run current account deficits;
- Income level: Capital is generally expected to move from high-income countries to low-income countries, where the marginal productivity of capital is usually assumed to be higher. Thus, richer countries would have current account surpluses, and poorer countries deficits;
- Technical progress and innovation efforts, and therefore capital profitability: In reality, it is possible that rich countries have higher capital profitability than poorer countries due to strong innovation and thus run current account deficits (importing capital). The case of China is interesting: despite a very strong innovation effort, corporate capital profitability there is relatively low.

We compare the situations of the United States (which has an external deficit), the eurozone (which has an external surplus), Japan, and China (which also have external surpluses).

Demographics cannot explain this configuration of current accounts, since population ageing is more pronounced in Japan and China than in the eurozone or the United States. Therefore, Japan and China should have current account deficits if demographics were the explanatory factor.

Income level is also not a relevant explanatory variable, since Japan and China have lower per capita incomes than the eurozone and the United States. Therefore, if per capita income were the correct explanatory factor, Japan and China should have external deficits.

The only explanation that seems relevant for the situation of current accounts (and international capital flows) is capital profitability, which is markedly higher in the United States than in other countries. Any challenge to this US advantage would lead to a major crisis, as the United States would no longer be able to finance its current account deficit or its net external debt.

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Where can current account surpluses or deficits come from?

Let us recall that the current account is the sum of the balance of goods and services and the balance of income exchanges with the rest of the world. The current account balance is identical to the difference between saving and investment (a country with a current account surplus has excess saving over investment equal to the current account surplus).
In theory, the situation of the current account depends on:

1. **Demographic situation**. Younger countries normally accumulate foreign assets to prepare for the time when their population will age, and therefore, in principle, have current account surpluses. Conversely, countries where population ageing is already significant use their foreign assets to support consumption and thus normally have current account deficits.
2. **Per capita income level**. Capital is normally expected to move from high-income countries to lower-income countries, under the assumption that the marginal productivity of capital decreases with income level. This implies that the richest countries normally have current account surpluses, while the poorest countries have current account deficits.
3. **Technical progress and innovation efforts, and therefore capital profitability**. It is possible that rich countries have higher capital profitability than poor countries, which is the opposite of what the decreasing marginal productivity of capital with income would imply, because rich countries innovate heavily and attract researchers from around the world. This implies that rich countries attract capital from poorer countries and therefore have current account deficits, while poorer countries export capital and have current account surpluses.

The table hereafter **summarises these three possible explanatory theories for the situation of current accounts**.

Possible explanations for current account deficits or surpluses

Theory 1: Demographics
Young country: accumulation of foreign assets; current account surplus
Old country: use of accumulated foreign assets; current account deficit
Theory 2: Per capita income
Rich country: low marginal productivity of capital; capital outflows; current account surplus
Poor country: high marginal productivity of capital; capital inflows; current account deficit
Theory 3: Technical progress, capital profitability
Innovative country: high capital profitability; capital inflows and current account deficit
Less innovative country: low capital profitability; capital outflows and current account surplus

Which theory applies best to the cases of the United States, the eurozone, Japan, and China?

1. Explanation linked to demographics

The United States has a chronic current account deficit, while the eurozone, Japan, and China have chronic current account surpluses (**Charts 1a/b**).

Chart 1A
Current account balance (as % of nominal GDP)

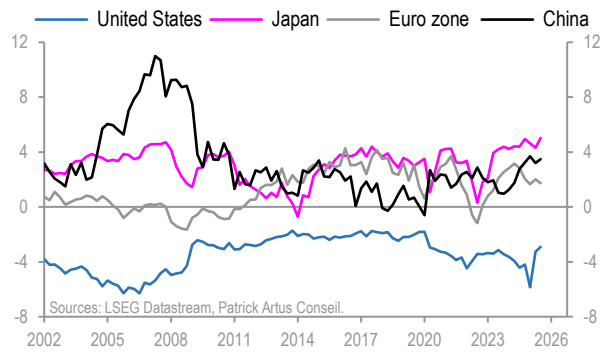
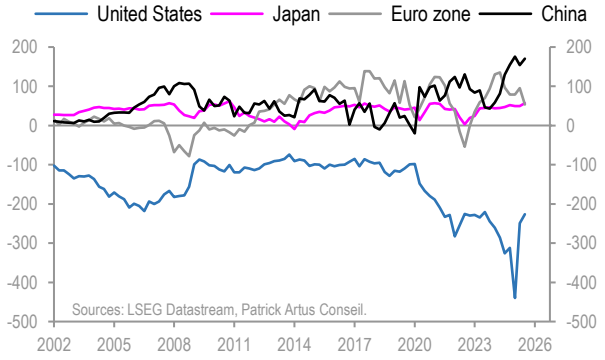


Chart 1B
Current account balance (Quarterly data, USD bn)



Population ageing is significantly more advanced in Japan and China than in the United States or the eurozone (**Charts 2a/b**).

Chart 2A
Total population (annual growth rate, in %)

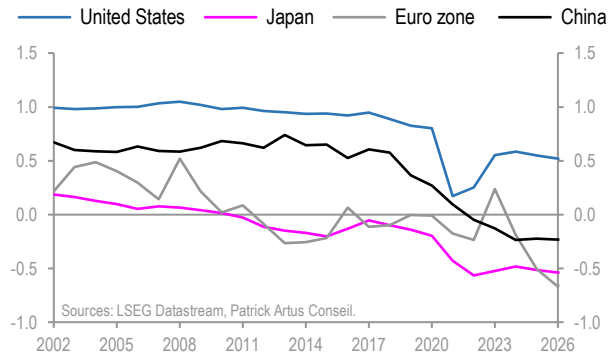
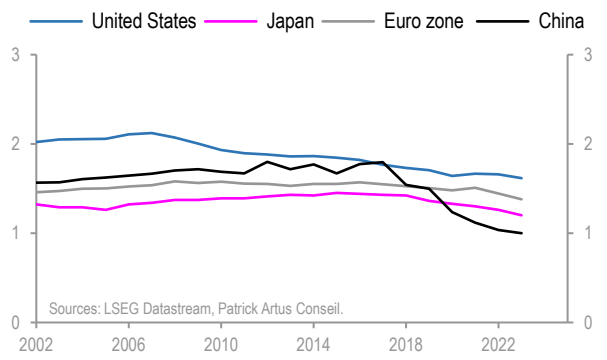


Chart 2B
Fertility rate (births per woman)



If demographics were the determining factor in explaining current account balances, we would expect an external surplus in the United States and the euro zone, and an external deficit in China and Japan, which is clearly not what we observe.

2. Explanation linked to per capita income

Chart 3a shows **GDP in dollars per capita** in the four countries (United States, euro zone, Japan, China), and **Chart 3b shows GDP in purchasing power parity dollars per capita** in these four countries.

Chart 3A
GDP per capita (USD)

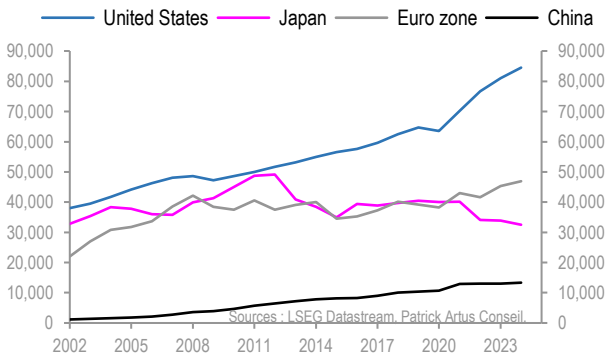
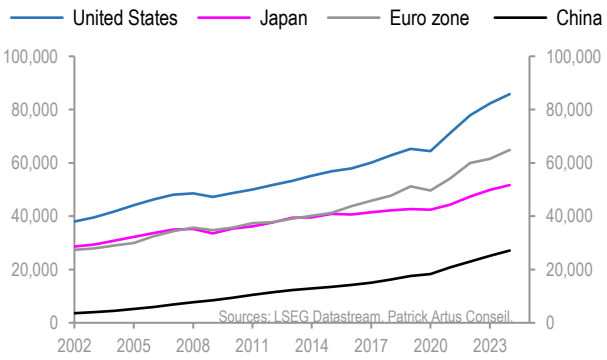


Chart 3B
GDP per capita (PPP USD)



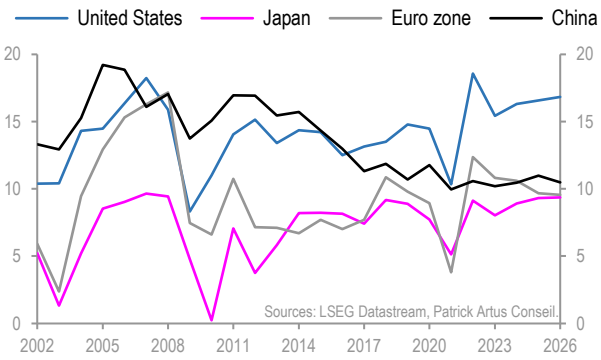
If the marginal productivity of capital declined with per capita income, given the hierarchy of countries (very high per capita income in the United States, high in the euro zone, fairly high in Japan, low in China), capital would flow from the United States and the euro zone towards Japan and especially China. **Thus, the United States would have a current account surplus and China a current account deficit, which is clearly not what we observe**.

3. Explanation by technical progress and capital profitability

The final possible explanation for the configuration of current accounts **is capital profitability**: a country where capital profitability is high attracts international capital and therefore has a current account deficit.

Chart 4 shows the **ROE** (return on equity) of the four countries (United States, euro zone, Japan, and China).

Chart 4
RoE



We can see that **ROE is higher in the United States than in the other countries: it is therefore natural that the United States attracts capital from other countries and has a current account deficit**.

It is known that R&D spending and innovation efforts are very high in China, but these do not translate into high corporate profitability.

Summary: only one theory aligns with the facts – capital profitability, resulting in particular in the United States from innovation efforts

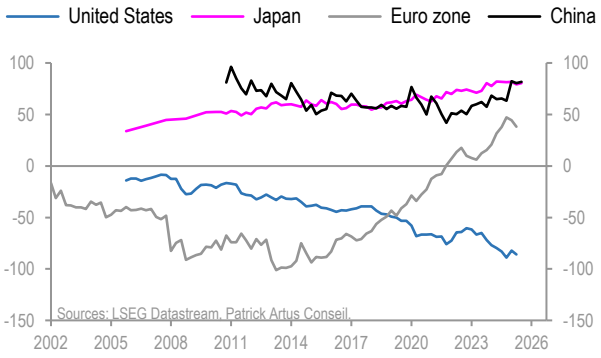
Demographics or per capita income cannot explain the configuration of current accounts (deficit in the United States, surplus in the euro zone, Japan, and China).

The only explanation consistent with this configuration is the one highlighting capital profitability. It is markedly higher in the United States than in the three other countries, which explains why the United States attracts capital and has a current account deficit, while the euro zone, Japan, and China experience capital outflows and current account surpluses.

Despite China's enormous innovation efforts, capital profitability is low due to deflation and overcapacity.

A major crisis would obviously result from a decline in capital profitability in the United States, for example due to anti-science policies implemented by the Trump administration. If the United States experiences a fall in corporate capital profitability, it would no longer be able to finance its current account deficit (Charts 1a/b above) or, equivalently, its net external debt (**Chart 5**).

Chart 5
Net foreign assets or liabilities (as % of nominal GDP)



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