Threat of 'currency bullying'

US current account deficit rises as global imbalances worsen

by Otaviano Canuto in Washington

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On 24 July the International Monetary Fund released its 2018 External Sector Report, its latest assessment of the current account balances of the world's 30 largest economies. There was no major change relative to previous years, and the configuration of global surpluses and deficits that has prevailed since 2013 endures. However, there are reasons to expect more abrupt alterations ahead, particularly in the light of US fiscal easing at a time of high employment in the country. In the context of US-led trade wars, as well as recent bouts of Chinese exchange rate depreciation, it is possible that currencies will be subjected to their own war or 'currency bullying'.

After the substantial escalation prior to – and the unwinding in the aftermath of – the 2008 financial crisis, the absolute sum of surpluses and deficits has remained close to 3.3% of global GDP over the last few years. The generally stable landscape has featured some changes in composition. China's current account surpluses have gradually diminished, while Japan, euro area debtor countries and oil exporting countries have moved in the opposite direction. For deficit countries, while the US remains the major case, emerging market economies have displayed divergent trajectories: Brazil, India, Indonesia, Mexico and South Africa have repaired their fragility at the time of the 2013 'taper tantrum', while Argentina and Turkey have weakened.

Asymmetric macroeconomic policy among advanced economies since 2013 has impacted the balances. While some economies, such as Germany, Japan, the Netherlands, have combined large surpluses with weak domestic demand, the UK and US have seen stronger recoveries in domestic demand.

In the US, the expansionary effects of last year's tax cuts boosted second quarter GDP growth to 4.1%, the fastest in almost four years. Although exports are rising fast, the US current account deficit is poised to rise.

For six years now the authors of the External Sector Report have compared actual current account balances and real effective exchange rates with those that would reflect medium-term fundamentals and desired policies. A country is classified as being 'stronger' when its current account balance is larger than that 'consistent with fundamentals and desirable policies'.

Last year, Germany, the Netherlands, Singapore and Thailand were said to be 'substantially stronger', showing current account gaps above four percentage points of GDP. Malaysia was 'stronger', with a gap of 2-4 percentage points. China, Korea and Sweden were 'moderately stronger', at 1-2 percentage points.

Conversely, Argentina, Belgium, Saudi Arabia, Turkey and the UK were 'weaker', with negative current account gaps in the 2-4 percentage points range. Canada, France, Russia, South Africa, Spain and the US were 'moderately weaker', with gaps of between 1-2 percentage points of GDP. Within the euro area, large positive gaps (Germany, the Netherlands) have cohabited asymmetrically with negative gaps (Belgium, France, Spain).

In October, the US Treasury will report to Congress on 'macroeconomic and foreign exchange policies of major trading partners'. A country may be named a 'currency manipulator' if it meets three criteria: certain levels of bilateral trade surplus with the US, the country's overall current account surplus, and one-sided foreign exchange interventions aimed at maintaining depreciation. Japan, Taiwan and China were all labelled as currency manipulators at different times in the late 1980s and the early 1990s.

No countries are currently labelled as currency manipulators by the US, though China, Japan, Korea, Germany, India and Switzerland are on a 'monitoring list' because they are classified as fulfilling one or two of the three criteria. There are suggestions that this list will be increased, although no country is expected to meet all three criteria and be named a currency manipulator in the next report.

The renminbi depreciated sharply in July and August, partially reversing the course of appreciation that started in mid-2017.

The Institute of International Finance has suggested that Chinese authorities might be adopting a 'neglect' stance as a signal amid the trade battles with the Trump government. It also highlights risks of substantial capital outflows, with corresponding shocks to China's and other economies' financial markets.

The possibility of mutually damaging financial volatility in the US and China may limit the extent of 'currency bullying' being used as a proxy in the countries' trade war. Nonetheless, rhetoric from Washington is likely to remain clamorous as the US trade and current account deficits rise and global imbalances worsen.

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