Focus

US Inflation and the current account

2 June 2021

- *It is widely assumed that 'excess' US demand will show up as accelerating inflation*
- *More likely is that much of it will turn up as a burgeoning current account deficit*
- *Meanwhile, rising US interest rates will likely take the dollar significantly higher*
- *This stands to cause serious problems for foreign-currency-indebted EM economies*

The Fed wants a pickup in inflation – just not too much

The Fed is getting the pick-up in inflation that it wanted

Ever since Larry Summers warned in early February[1] that the fiscal stimulus measures being proposed by the Biden Administration were much larger than needed to eliminate the shortfall between actual and 'potential' GDP – a warning that he repeated last week[2] – financial market participants and other pundits have been fretting about the risks of an acceleration in inflation, and of an earlier tightening of monetary policy than repeatedly indicated by the Federal Reserve's guidance.

Of course the Federal Reserve, like almost every other developed-economy central bank, wants to see some acceleration in inflation. Indeed, it has for some time now been explicitly seeking an inflation rate 'moderately above' its 2% target[3] in order to 'compensate' for the almost 12 years of being below target. And it has also indicated repeatedly that it will 'look through' any 'transitory' increases in inflation[4] arising from the supply-chain bottlenecks now being encountered in the US and around the world, or from higher oil prices.

And it has three reasons not to be unduly concerned

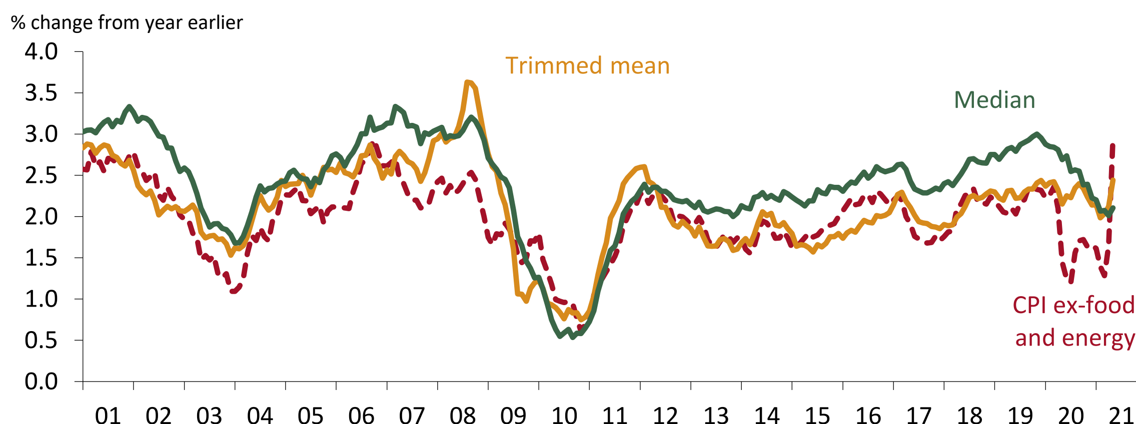
The most recent readings on US producer[5] and consumer prices[6] provide ample evidence both of widespread 'upstream' price pressures and of some instances of large price rises at the consumer level. But none of these amounts to persuasive evidence of a sustained increase in inflation of the sort that stands to ring alarm bells at the Fed.

Four reasons not to be alarmed

So far, the pick-up has been due largely to 'outliers' …

First, while clearly some significant increases in prices at the consumer level were evident in the most recent data, inspection shows that these were indeed 'outliers'. While the 0.9% increase in the 'core' CPI in April was the largest in almost 20 years, more than half

Figure 1: 'Statistical' measures of underlying US inflation



Sources: US Bureau of Labor Statistics; Federal Reserve Bank of Cleveland, Saul Eslake, and Llewellyn Consulting

of that was attributable to just four items – used-car and truck prices, car and truck rental charges, air fares, and prices for computers and peripheral equipment.

The statistical measures of 'underlying' inflation compiled by the Cleveland Fed[7] also indicate that, once 'outliers' (in both directions) are excluded, there has been very little discernible increase in inflation to date – and certainly not enough to warrant alarm at the Fed (see Figure 1).

… cost increases seem fairly hard to pass on in services …

Second, while it is undoubtedly possible for upward pressure on producer prices to be passed on to consumers, goods account for less than 38% of the US consumer price index, and only 25% of the CPI excluding food and energy (widely used as a gauge of 'core' inflation). The monthly business outlook surveys conducted by the Federal Reserve Bank of Philadelphia (whose territory is a reasonably good microcosm of the US as a whole) suggest that while services producers are facing similar pressures on the prices of inputs as manufacturing firms, they are having considerably more difficulty passing them on in the form of higher prices to their customers (see Figure 2).

Given that labour costs account for a much larger proportion of the costs of producing services than of goods, and that there is still substantial 'slack' in the US labour market, it is difficult to envisage a sustained acceleration in the growth rate of labour costs such as would be sufficient to push the overall inflation rate well above 2% any time soon.

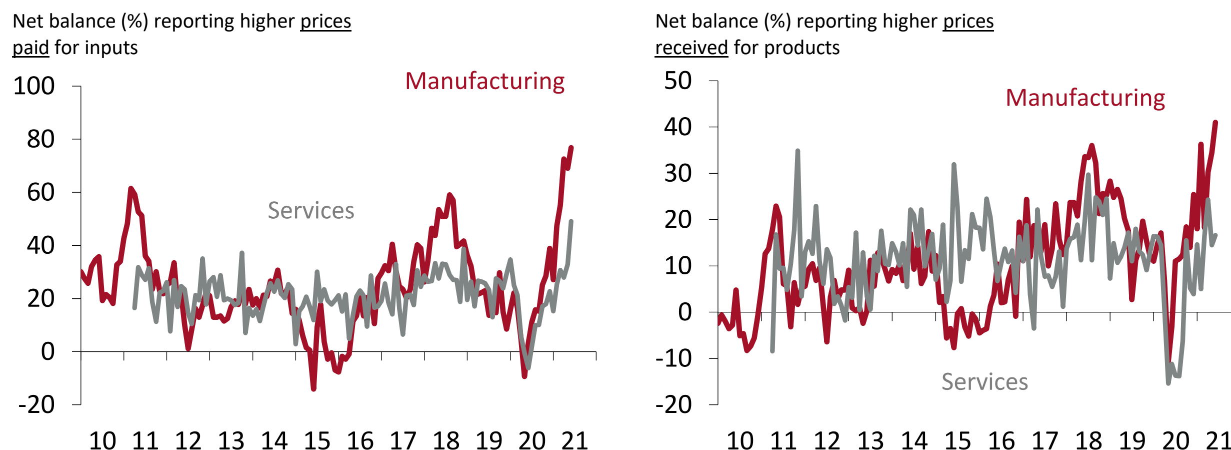
… global competitive pressures remain powerful; and …

Third, the sustained low inflation of the past two or three decades is the result of fundamental changes in both global and domestic product markets – stemming in particular from globalisation, rapid technological change, and changes in the social and regulatory frameworks within which wages and conditions of employment are determined. The world may have passed the 'high-water mark' with regard to globalisation, as governments place greater emphasis on the pursuit of 'national self-sufficiency' in the supply of what they deem to be 'strategic' products, but there is little evidence that this tide is ebbing rapidly.

… technological change continues apace

Nor is there any reason to believe that the pace of technological change is easing in a way that will make it easier for businesses to pass on cost increases in the form of higher prices; or that labour markets are on the cusp of being re-regulated to make it easier for employees to extract pay increases from recalcitrant employers.[8]

Figure 2: Philadelphia Fed survey measures of prices paid and received



Source: Federal Reserve Bank of Philadelphia, Saul Eslake, and Llewellyn Consulting

The current account safety valve

That still leaves open the question of where whatever 'excess demand' as may be generated by the massive Biden stimulus will show up, if *not* in higher inflation?

History suggests strongly the answer to that question: in the current account of the US balance of payments.

Demand pressure is likely to show up in the current account

In earlier epochs, 'excess demand' triggered by fiscal expansion was indeed, not surprisingly, reflected primarily in higher inflation – until the mid-1960s the US was a relatively 'closed' economy (exports and imports each accounted for only around 5% of GDP).

But in subsequent expansions the effects on the current account of the balance of payments have been substantial (Figure 3):

- Between 1964 and 1972 the US current account deteriorated from a surplus equivalent to 1.0% of GDP to a deficit of 0.5% of GDP.
- During the 1980s fiscal expansion the current account deficit widened from 0.2% of GDP in 1982 to 3.3% in 1987.
- In the early 2000s it widened from 3.0% of GDP in 1999 to 5.9% in 2006;
- And most recently from 1.9% of GDP in 2017 to 3.1% of GDP in 2020.[9]

Moreover, there is now already clear evidence that this history is repeating itself.

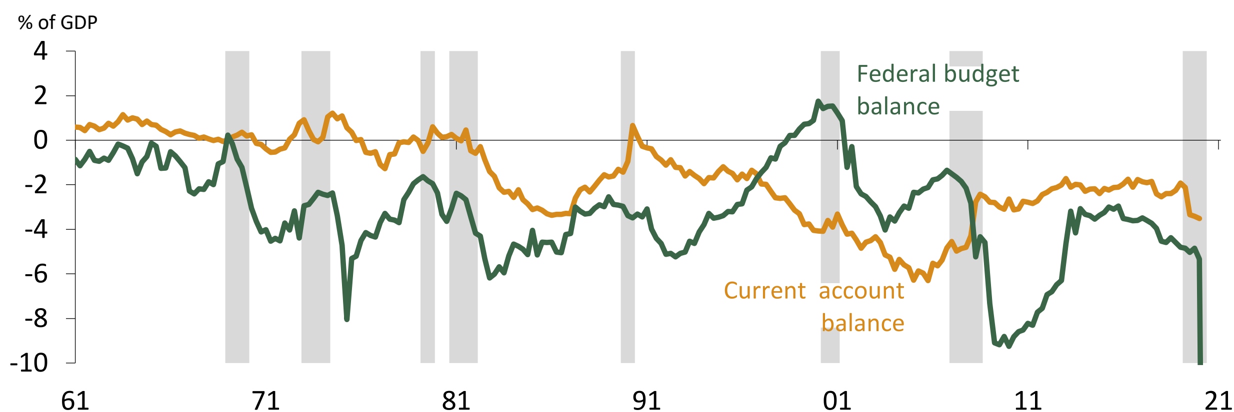
A special recession

This time the deficit has widened despite the recession

The recession of 2020-21 was the first in the past six decades during which the current account deficit has widened, rather than narrowed. That is essentially because the dramatic widening of the gap between public sector saving and investment (i.e. the blow-out in the federal budget deficit) more than offset the narrowing of the gap between private sector saving and investment that normally occurs during recession.

Moreover, as the US economy emerged from the depths of the recession during the second half of 2020,[10] the US external account has continued to deteriorate.

Figure 3: US budget and current account balances



Source: US Bureau of Economic Analysis, Saul Eslake, and Llewellyn Consulting

Note: The full extent of the US budget deficit in 2020 and 2021 is not shown in the Figure. Shaded areas denote recessions as designated by the National Bureau of Economic Research Business Cycle Dating Committee.

Four of the five largest ever US monthly trade deficits on goods and services have been recorded in the five months between November 2020 and March 2021 (including the two largest ever in February and March this year) (Figure 4). It seems highly likely that the US current account deficit will exceed 4% of GDP in 2021, for the first time since 2008.

This is in turn the principal channel through which the US fiscal stimulus 'spills over' to other economies, as outlined by the IMF and others.[11]

Upward pressure on the dollar

And the dollar is likely to come under upward pressure …

History also suggests strongly that a significant deterioration in the US current account balance is likely to be accompanied, at least in its initial stages, by an appreciation of the US dollar against other major currencies (Figure 5).

This may seem counter-intuitive, in the sense that it is widely believed that a deteriorating current account balance is a 'negative' for the currency of the country concerned, from a 'fundamental' perspective.

And for many economies, that is indeed so.

… mainly because of higher bond yields

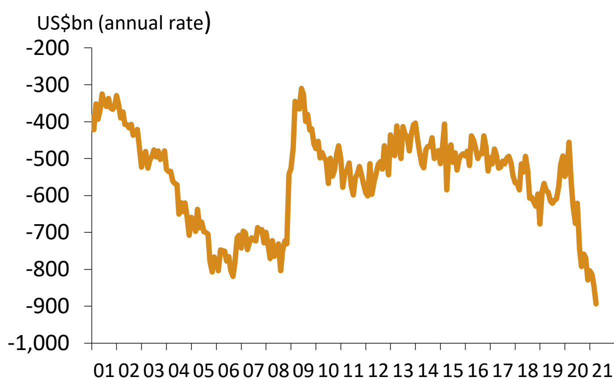
However the US, perhaps because of its position as the issuer of the world's principal reserve currency, is an exception to this generalisation. When the US current account deficit widens, US bond yields tend to rise relative to those in other countries (Figure 6), which in turn attracts the capital flows into the United States required to finance the widening current account deficit – which in turn drives the appreciation of the US dollar.

There would seem to be no compelling reason to think that "this time is different" with regard to the consequences of a widening in the US current account deficit, fuelled by a widening in the federal budget deficit, for bond yield spreads between the US and other countries, and for the US dollar.

Emerging markets in many parts of the world stand to be hit

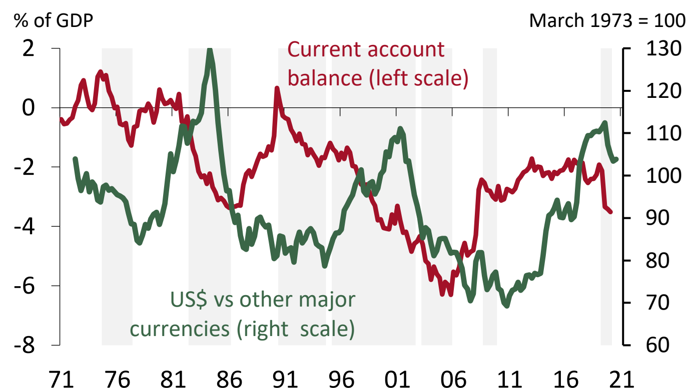
Finally, history also suggests that the combination of higher US bond yields and a stronger US dollar can be lethal for emerging markets – especially those which have been running large current account deficits, and which have been financing those deficits by borrowing (whether by their banking systems or their governments) in foreign currencies.[12]

Figure 4: US balance of trade in goods and services (monthly)



Source: Bureau of Economic Analysis, Saul Eslake, and Llewellyn Consulting

Figure 5: US current account balance and trade-weighted index of the US dollar



Source: US Bureau of Economic Analysis; Board of Governors of the US Federal Reserve System, Saul Eslake, and Llewellyn Consulting

Note: Shaded areas denote periods in which the US current account deficit (expressed as a proportion of GDP) was widening (in a trend sense). The 'other major currencies' are the euro, Japanese yen, Canadian and Australian dollars, British pound, Swiss franc, and Swedish krona.

Most Asian emerging markets (with the possible exception of the Philippines) appear, so far at least, to be less vulnerable to this combination of higher US bond yields and a stronger US dollar than during the 'taper tantrum' of 2013, or in 2018 when the Fed did tighten monetary policy. They have, for the most part, accumulated much larger foreign exchange reserves; reduced their foreign currency-denominated borrowings; and / or are running current account surpluses, or at least smaller deficits, than on those earlier occasions.

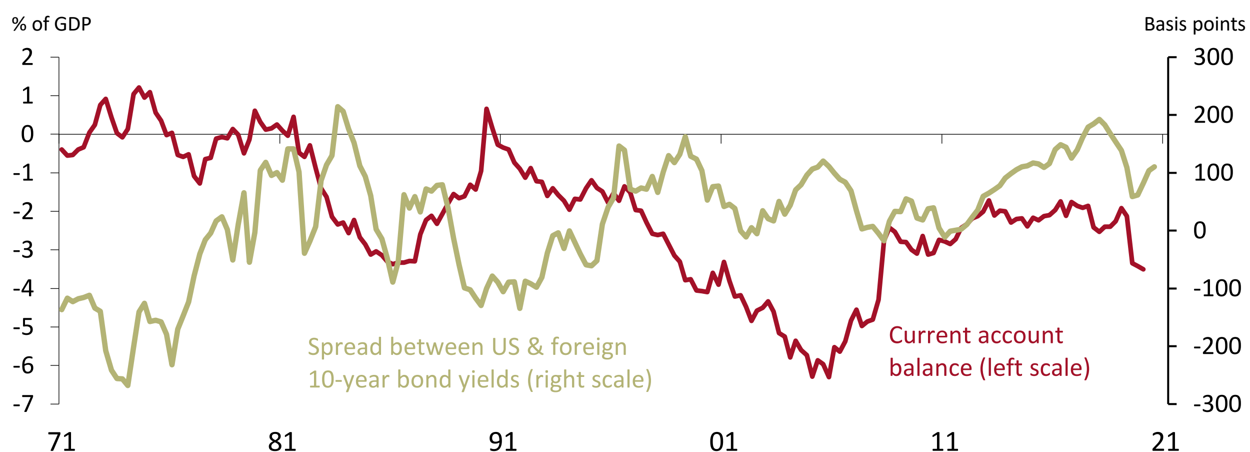
But emerging markets in other parts of the world – including in Latin America, the Middle East and Africa – would appear to be at least as vulnerable to these forces as they were three and ten years ago.

Watch fors

In order to assess whether our propositions are correct, watch for the following developments:

- An easing-off of aggregate measures of inflation as the pattern of demand becomes more normal and bottlenecks ease.
- A widening US current account deficit.
- An accompanying widening of current account surpluses in other economies.
- A strengthening US dollar.
- Signs of stress in foreign-currency-indebted Emerging market economies, particularly including in Latin America, the Middle East, and Africa.■

Figure 6: US current account balance and the spread between US and other bond yields



Source: US Bureau of Economic Analysis; Federal Reserve Bank of St Louis FRED; Refinitiv Datastream. Saul Eslake, and Llewellyn Consulting
Note: Foreign 10-year bond yields are those for Germany, France, Japan, Canada, Switzerland, Sweden and Australia, weighted in the same proportions as in the Federal Reserve's index of the US dollar against other major currencies (used in Figure 4), with an equally-weighted average of German and French yields used as a proxy for Euro-area yields.

[1] See Summers, L., 2021. *The Biden stimulus is admirably ambitious. But it brings some big risks, too.* The Washington Post, February 4. Available at https://www.washingtonpost.com/opinions/2021/02/04/larry-summers-biden-covid-stimulus/ [Accessed 1 June 2021]

[2] See Summers, L., 2021. *The risk is real.* Washington Post, 24 May. Available at https://www.washingtonpost.com/opinions/2021/05/24/inflation-risk-is-real/

[3] See Federal Reserve, 2020. *Guide to changes in the 2020 Statement on Longer-Run Goals and Monetary Policy Strategy.* Board of Governors of the Federal reserve System, 27 August. Available at Federal Reserve Board - Guide to changes in the 2020 Statement on Longer-Run Goals and Monetary Policy Strategy [Accessed 1 June 2021]

[4] See Federal Reserve, 2021. *FOMC statement.* Board of Governors of the Federal Reserve System, 28 April. Available at Federal Reserve Board - Federal Reserve issues FOMC statement [Accessed 1 June 2021]

[5] See US Bureau of Labor Statistics, 2021. *Producer Price Index News Release summary.* US Bureau of Labor Statistics, 13 May. Available at Producer Price Index News Release summary (bls.gov) [Accessed 1 June 2021]

[6] See US Bureau of Labor Statistics, 2021. *Consumer Price Index Summary.* US Bureau of Labor Statistics, 12 May. Available at Producer Price Index News Release summary (bls.gov) [Accessed 1 June 2021]

[7] Federal Reserve Bank of Cleveland, 2021. *Median CPI.* Federal Reserve Bank of Cleveland. Available at Median CPI: Latest Data (clevelandfed.org) [Accessed 1 June 2021]

[8] For a recent perspective on these topics see for example Leduc, S. and Liu, Z., 2021. *Robots or Workers? A Macro Analysis of Automation and Labor Markets*. Working Paper No. 2019-17, Federal Reserve Bank of San Francisco, April. Available at Robots or Workers? A Macro Analysis of Automation and Labor Markets (frbsf.org) [Accessed 31 May 2021]; and

Dewan, S. and Ernst, E., 2020. Rethinking the World of Work, *Finance & Development*, International Monetary Fund, December, pp.. 22-25. Available at https://www.imf.org/external/pubs/ft/fandd/2020/12/rethinking-the-world-of-work-dewan.htm [Accessed 31 May 2021]

[9] Note that the budget balance is not the only (or indeed necessarily the most important) influence on the current account balance. Arithmetically the current account balance is equal to the sum of the differences between public saving and investment (broadly equivalent to the budget balance) and between private saving and investment: during the 'tech bubble' of the late 1990s, the widening in the US current account deficit was driven by the rise in private (mainly business) investment and fall in private (mainly household) saving, which more than offset the impact of the swing in the federal budget from deficit to surplus.

[10] Although the NBER's Business Cycle Dating Committee has yet to make any formal pronouncement as to whether, and if so when, the recession which 'officially' began in February last year has ended.

[11] See for example the IMF, 2021. *Managing divergent recoveries*. International Monetary Fund, April., p. 11. Available at World Economic Outlook, April 2021: Managing Divergent Recoveries (imf.org) [Accessed 31 May 2021]

[12] See for example, Turner, P. and Llewellyn, J., 2021. *Seeds of the next financial crisis – EM dollar borrowing.* Llewellyn Consulting, 31 March. Available on request.

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