

United States Current Account Deficit and Capital Flows

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Abstract

Before the financial crisis the US current account deficit was hovering around 6 per cent of the US GDP. Questions about the sustainability of the current account deficit of this magnitude or its causes were raised but now mostly these worries are pushed back both as a result of slower growth of the US economy and as a result of more urgent issues. Yet, the special position of the dollar and free capital flows among the countries bound to bring back the issues that come with the current account deficit.

Keywords: Current account, capital flows, reserve currency

1. Introduction

Before the financial crisis of 2007-2009, strong economic growth in the United States led to deep current account deficits, flip side of which showed as strong capital inflows that might have helped the asset bubbles and the mortgage crisis. Now the US economy is slowly recovering from its worst recession since World War II, the issues about current account deficit are mute taking the backstage compared to the issues of unemployment, government budget deficit, and slower growth. But the structural factors that led to chronic current account deficit since the early 1980s are still there and will come to foreplay as soon as the US economy returns to its balanced growth path and to its full-employment level of output or when the Federal Reserve ends its quantitative easing policy which will naturally lead to higher interest rates and stronger dollar. Meanwhile ever restive capital flows are looking for signs that might be coming from the uneasiness about the loose monetary policy in the United States. In this paper I will try to show that causes of the US current account deficit are structural and deeply embedded in the prevailing world economic order and international monetary system.

The current international monetary system, which is a product of the post World War II world order, is inadequate to meet the challenges of the current world order which was brought about by the fall of communism, internet revolution, privatization, multinational companies, in short by globalization. In a world like this, the dollar has various roles to play such as international reserve currency, invoice currency, transactions currency, etc (see Tavlas, 1998). These roles are similar to what any money in its capacity as a medium of exchange, store of value, and as unit of account must play. As it was prescribed in the Bretton Woods monetary system, naturally the dollar assumed these roles in the international transactions. The Bretton Woods system was basically a fixed exchange rate system in which major world currencies fixed their exchange rate against the dollar and the American government or the Fed promised to be a responsible steward of the dollar. The system worked quite well when the war ruined economies needed the American exports, mainly capital goods, to repair their economies, to rebuild their manufacturing base: America lent them money and in turn sold them goods necessary to get their economies functioning again. In this sense, the world economic system was a planned economic system and fixed exchange rates performed efficiently in this planned world (Eichengreen, 2011).

This world worked fine for a while because capital flows were restricted. All the major countries in Europe as well as the the United States were applying capital controls in order to be able to use independent monetary policy as well as to pursue the fixed exchange rate system, which they deemed to be necessary to rebuild the war-torn economies (Eichengreen, 2008). Yet, as the Western economies as well as the Japanese economy were becoming independent engines of growth or becoming mature economies on their own, restrictive capital controls were posing serious constraints on the world trade and allocation of resources. In the early 1960s Germany removed capital controls, and then Britain, France, and Japan followed the suit. Now the capital was free to flow, which led to inevitable strains and stresses on the existing edifice of the fixed exchange rate in the countries that were participating in the world trade. It is a celebrated result that goes by the name of Impossible Trinity, you cannot have three things at once: fixed exchange rate, independent monetary policy, and free capital account. It was only a matter of time that the Bretton Woods artifact of fixed exchange rates would have to be abandoned.

In August, 1971, the United States closed the gold window and at the end of 1973 world major currencies were on a so called floating exchange rate system despite many efforts to save the existing arrangements. Even though after 1973, the world has been technically on a floating exchange rate system, this does not eliminate the need for a currency to be designated as invoice currency because such an arrangement would dramatically reduce the number of exchange rates one needs to remember. In an n currency world with one invoice currency there will only be $n - 1$ exchange rates versus $n(n - 1)/2$ when there is no designated invoice currency (McKinnon, 2010). Special economic position of the United States, pre-existing institutional arrangements inherited from the Bretton Woods system, inertia all indicated the dollar as the natural candidate for this position. So, the dollar kept its privileged position as the international reserve currency in the floating exchange rate regimes after the official fixed exchange rate regimes came to an end.

The designation of a nation's currency as the international currency confers both a privilege and a burden on the nation. Indisputably, the dollar and hence the United States as the country issuing the currency has been enjoying this privilege and carrying the burden since the World War II. Of course, one might wonder, whether if it is really worth it. Yet, the answer to this question is not whether this double edged sword is worth carrying considering the net benefits but the important question is the distribution of benefits and burden. We should talk about it in sequence first the benefits and then burden.

International reserve currency status of the dollar bestows upon the United States quite a few privileges, the most important one among many is the ability of the country to be able to borrow internationally in its own currency. When one considers the fact that the currency does not have to be backed up by any precious metal but it is a pure fiat money, this is indeed quite a privilege; it is all a matter of how prudent the monetary authorities are or want to be. So far the United States has very well been aware of this fact and acted responsibly except the inflationary period of the late sixties and seventies. Second privilege that comes with the international currency is the low interest rates a country can borrow and hence not exposed to currency risks giving the country a free hand to follow an independent monetary policy, of course as long as it is effective given that the currency is an international currency.

On the other hand, burden of an international currency on the issuing country may not be so clear at first glance but it is similar to what is known as the Dutch Disease(Tavlas, 1998). As international money countries around the world would like to accumulate the dollar for transactional purposes, which would increase the demand for the dollar and make it more valuable in terms of other currencies than otherwise. Yet, a stronger dollar makes the American exports less competitive. There is also another implicit cost of issuing the international currency, inevitably international transactions will tend to make the financial industry stronger at the cost of the other sectors of the economy first as a result of currency exchanges and then many other paraphernalia that comes with it: London is a case in point. This is the function of international currency being used as invoicing currency. Yet, there is another dimension to it, which is the international reserve function.

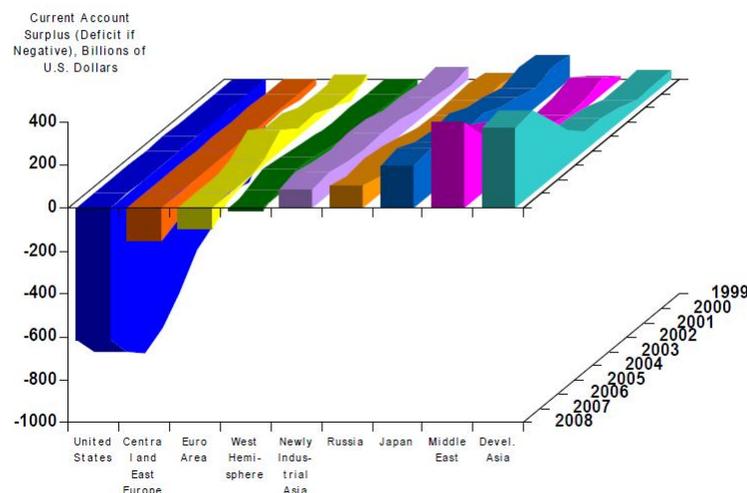


Figure 1: Global imbalances

Source: based on Lane-Milesi-Ferretti Data,(Lane & Milesi-Ferretti, 2007).

Accumulation of reserve currencies were not a big issue before the capital account, or financial account as they are called nowadays, liberalization. However, this has proved very important after the financial crises of the 1990s and early 2000s. Late 1990s financial crises led many East Asian economies hoard dollars as international reserves simply as a precaution against the sudden outflow of international capital. Yet, in order to accumulate dollar they needed to export merchandise to the United States, which could accommodate these exports because of its strong growing economy. Figure 1 very vividly depicts the imbalances born out of asymmetry created by the dollar being the reserve currency.

Another imbalance is also born out of the nature of floating or flexible exchange rates regime, which looks like an ideal solution in finding out a currency's value determined by the market. It does not require any intervention from the monetary authorities, does not invite speculator attacks, does not cause exchange rate crises which wreak havoc in the economy in their aftermath. This comes, however, at the cost of exchange rate volatility and uncertainty, which introduce exchange rate risk to investors and investments be it portfolio or direct. As a result, the countries that wanted to accumulate international reserves, i.e., dollars, wanted to export to the United States, which accepted them willingly because of its growing economy, early stages of housing bubble, and increasing inequality. Yet, exports required two things: competitive and stable exchange rates. This is the other issue, after the collapse of Bretton Woods fixed exchange rates, the world was de facto on a floating exchange rate regime. But, in reality many countries tried and still trying to manage their currencies within a narrow band, that again requires accumulation of dollars as international reserves. Therefore, the dollar as the world currency is a coveted currency which countries around the world is trying to hoard by selling stuff to the United States. Before the 2007-8 financial crisis someone might have asked if anything was wrong with that but the world financial crisis made the answer clear.

In this paper I will argue that the current account deficit of the United States is more of a structural kind rather than intertemporal decisions based on utility maximization. See Obstfeld(2012)on the elaboration of the current account deficit as the intertemporal trade. In this introduction so far we have been stating some facts and trying to explain why indeed ever worsening of the US current account balance really kept growing and did not cause any serious concerns. The deficit is part of a wider process caused by globalization, the existing international monetary system inherited from the post World War II arrangements, and changes in these structures brought about by capital flows. Therefore, understanding the nature of the capital flows is an important step to explain the causes and consequences of current account deficits. We will look at the capital flows in the next section. In section 3, we look at the current account deficit from a historical perspective to understand the evolution of current account deficit and various other issues. Next section examines some other explanations of the current account deficit, and the last section concludes.

2. The Open Economy and Current Account

To put things in perspective let's define (all in real terms), $Y = GDP$, $C = Consumption$, $I = Investment$, $G = GovernmentPurchases$, $NX = X - M = NetExports$, $F = NetForeignIncomeEarnings + (Transfers)$. Then the national income identity states that

$$Y = C + I + G + NX$$

Then the *current account balance* defined as

$$CA = NX + F.$$

National *saving* is defined as

$$S = Y + F - C - G.$$

Then we see that

$$CA = Y + F - (C + I + G) = S - I.$$

The balance of payments accounts has three main categories, current account, capital account, and financial account: the sum of which needs to add up to zero as follows:

$$CA + KA + FA = 0$$

3. Capital Flows, the Other Side of the Medallion

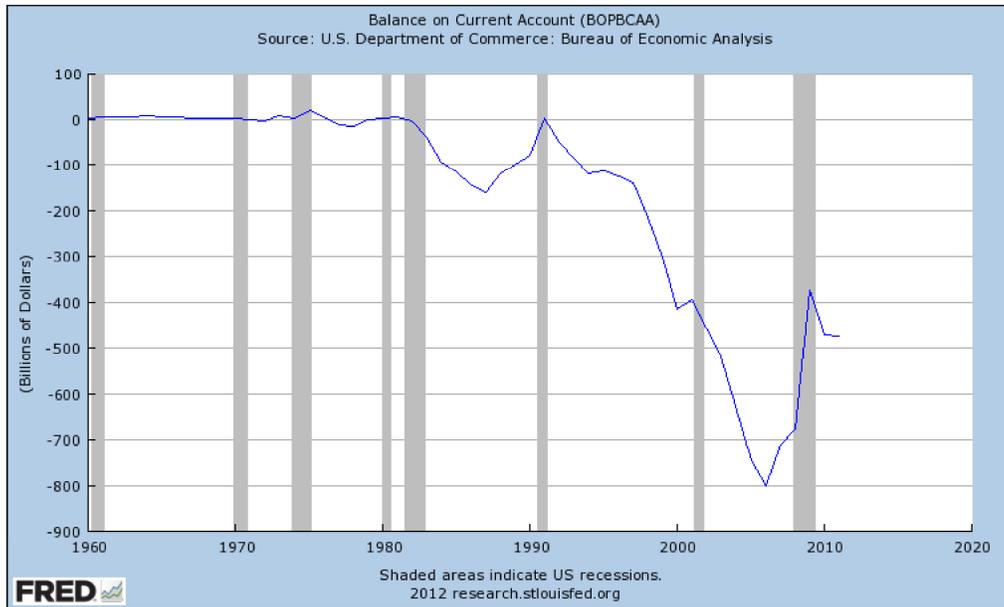


Figure 2: Balance on US Current Account. Source: Federal Reserve Bank of St. Louis.

As the Figure 2 shows until the 1980s the US current account was balanced and so did most of the world economies had balanced their trade with the rest of the world. This was not a prudent choice of world economies but rather a constraint imposed by the World monetary system. As the simple balance of payments account shows that the flip side of the current account deficit is capital account surplus, meaning that if a country is having a current account deficit then it must be receiving capital flows in some way or another to pay for the imports of goods and services in excess of that of its exports to the rest of the world. Capital flows, on the other hand, should incur the sale of domestic assets to foreigners. Overall in net, current account deficit should reduce the net foreign assets. Balance on current account is a flow variable, hence the accumulated current account is a stock variable and this is depicted in Figure 3. As far as the consequences of the current account deficit is concerned, the net international investment position, *NNIP*, is what really matters.

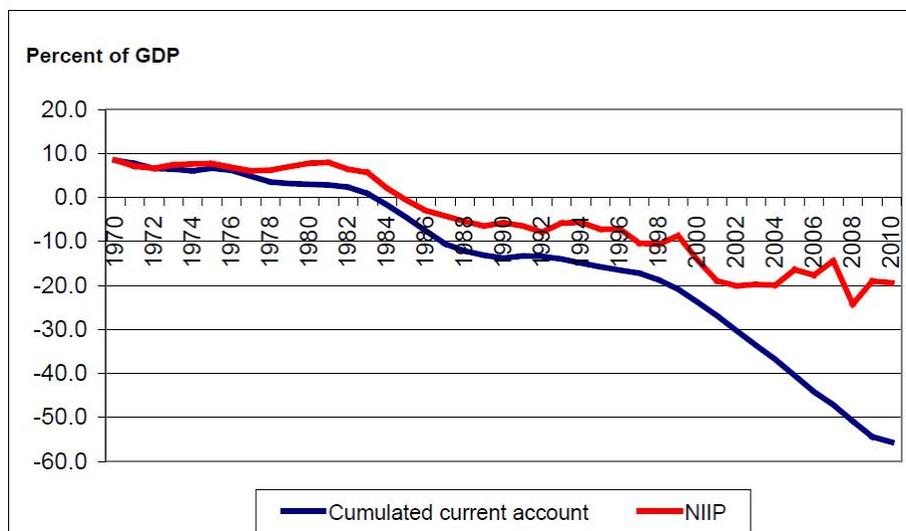


Figure 3: Cumulated Current Account and Net International Investment Position, United States. Source:(Obstfeld, 2012), based on Lane-Milesi-Ferretti Data.

As the Figure 3 shows there is a big discrepancy between these two measures. In some sense, it looks as if the United States is enjoying a free ride as far as its deficit in current account balance is concerned.

One would expect that cumulated current account deficit should show up as the net international investment position simply because cumulated capital flows is the flip side of the balance on current account account. But, the discrepancy arises from the fact that NIIP simply reflects the value of assets evaluated at the current exchange rates. So the composition of assets matter a lot in determining the net value of international assets as well as the exchange rates. In this sense the United States had a lucky streak since the 2000s. Most of American liabilities are in dollars and most of American international assets are in foreign currencies. Hence, a weaker dollar will enhance the value of American assets, on the other hand, will reduce the value of the American liabilities. As Figure 4 shows, the real exchange rate of the American dollar has been steadily decreasing compared to a basket of foreign currencies.



Figure 4: Real Exchange Rate of the U.S. Dollar. Sources: IMF and FRB.

Real exchange rate of the dollar is important because it determines the dollar value of balance on the US current account as well as value of its NIIP. As Figure 5 shows that about half of the US assets are invested in debt instruments, about 0.5 per cent of its GDP. The rest are equally divided between foreign direct investment and portfolio equity assets. This is important because usually return on these assets are higher, even though these are riskier assets. Also, increase in stock market values tend to improve net American position in these assets.

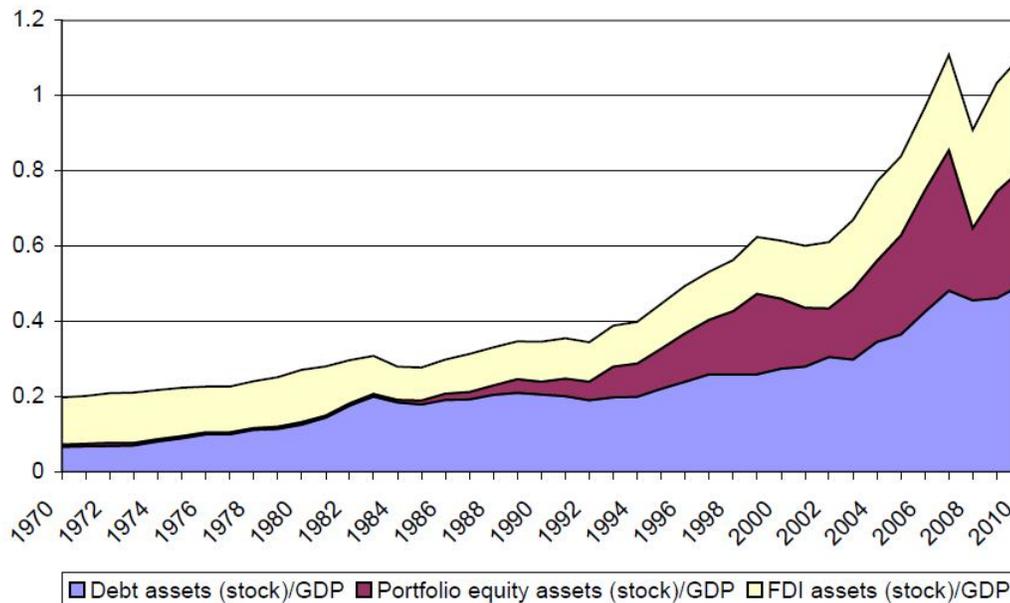


Figure 5: Composition of United States External Assets. Source: Obstfeld2012(Obstfeld, 2012), based on Lane-Milesi-Ferretti Data.

On the other hand, considering American liabilities Figure 6 shows that most of the US liabilities are in its government debt instruments and much smaller amount of its liabilities are in portfolio equity investments or in direct investment instruments. Putting weaker dollar and strong growth in stock markets, and higher asset prices in non-governmental instruments helped the international assets position of the United States while its current account deficit grew and sometimes beyond the critical five percent of its GDP.

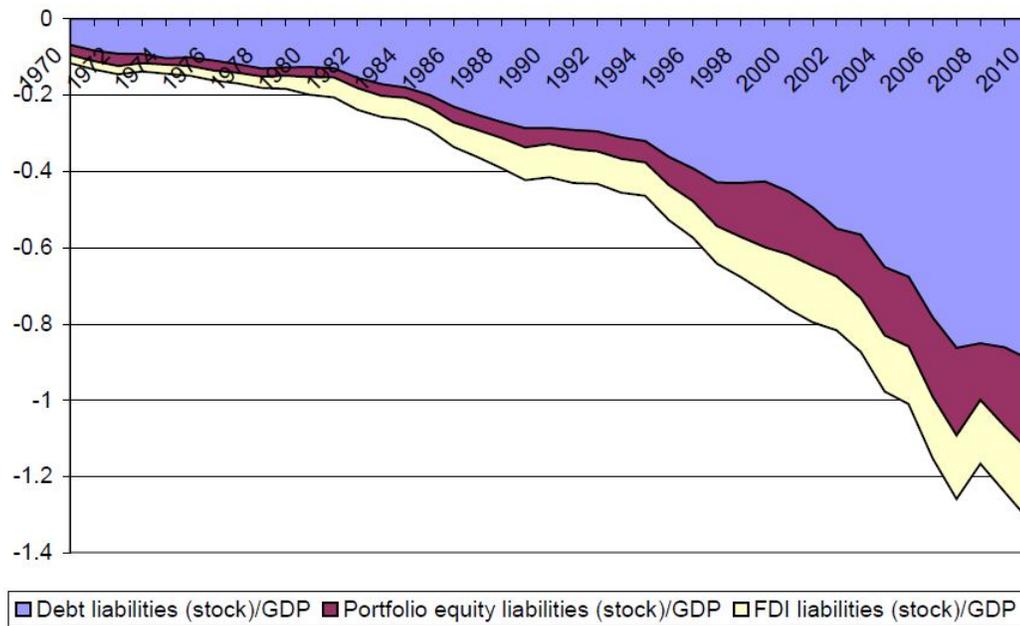


Figure 6: Composition of United States External Liabilities. Source:(Obstfeld, 2012), based on Lane-Milesi-Ferretti Data

Net Flows or Gross Flows

Current account or financial account show the net the balance on international transactions. In some sense this may be misleading even though the net effect might be small the components that go into the net might be quite large. One cannot get a feeling for the magnitudes, which might be what really matters after all in case of emergencies or financial crises. U.S. gross balance of payments are shown in the following figure. Up to the early 1990s, inflows and outflows did not exceed five per cent of GDP and they were more or less in balance as a result most of the countries in the world in one way or another uses some capital controls. Yet, after the early 1990s, capital (i.e., financial) account liberalization has become norm rather than exception. Since then capital inflows and outflows have been steadily increasing. On the eve of the financial crisis of 2007, Americans bought foreign securities worth about 10 per cent of their GDP and foreigners bought US securities worth 15 percent of American GDP as shown in Figure 7.

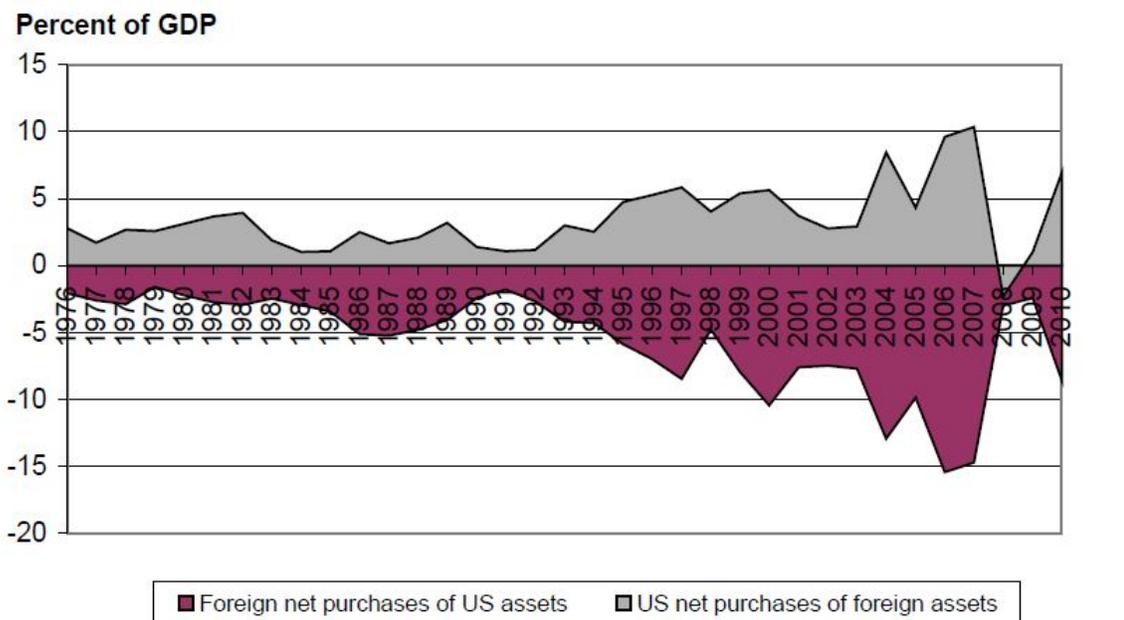


Figure 7: United States gross financial flows. Source(Obstfeld, 2012), based on Lane-Milesi Ferretti Data.

4. Historical Perspective

Evolution of views on the current account follows path similar to views on international economics and trade. How current account is viewed also depends on the epoch in which it is viewed. Until the mid-1970s, discussion on current account was based on its flow behavior and the method of analysis was relative prices – actually it was quite well understood that current account was the difference between national saving and investment. Yet, even so there was a doubt about the ability of the relative prices to influence the balance of trade, which reflected so called “elasticities pessimism” meaning that demand elasticities of imports is very low and depreciation or appreciation of exchange rates would not decrease or increase demand for imports. This view had important policy implications that led to exchange controls in the developing countries. Yet these policies did not cause any controversies especially if the whole world was on a fixed exchange rate regime. Another implication of the elasticities pessimism was the so called structuralist approach of the 1960s and early 1970s. Low demand elasticities of imports meant that developing countries did not have much to offer in terms of exports or their domestic manufactures could not compete with the developed countries exports. In other words, their economies were structurally backward and needed time to catch up to the Western standards, therefore it was a requirement that the developing economies needed to go through a structural change. From this perspective, the current account deficits were viewed as structural and hence the dominance of import substitution policies of the 1960s and 1970s. Considering that the prevailing economic view in these years were mostly Keynesian emphasizing the role of state in the economy as a stabilizing force, this is not a very surprising result.

However, the Keynesian ideology did not last but ended with the world oil crisis and run away inflation. In the United States and Britain economic liberalism was starting to change the course of theoretical discussions as well as policy choices, that opted more for reducing the role of the state in the economy. Consequently, this impacted the views on the international trade and particularly how the current account deficit was viewed. This is succinctly summarized in so called “Lawson Doctrine”, which basically builds upon the neoclassical model of sum of intertemporally optimizing individuals¹. The Lawson Doctrine claims that as long as the current account deficit is built upon the decisions of self-optimizing individuals there is nothing wrong with that especially if this is a result of consumption smoothing over time. According to this view, deficit created by the public sector is bad but deficit as a result of individual choices cannot be bad. The basis of this argument follows the fact that current account deficit is simply the difference between saving and investment, both of which are decided by intertemporally utility maximizing individuals or firms. Therefore, a country running large current account deficit is necessarily investing more than it is saving but this should not cause any concern because consumers are smoothing their consumption over time since investment will increase production and productivity in the future so that the country by increasing its output will be able to pay back its lenders and will not have to reduce its consumption presently or increase it in the future.

The Lawson Doctrine, however, was demonstrably, challenged in the early 1980s by the successive defaults in Latin America and elsewhere, where the defaulting countries had large current account deficits even though their public expenses were under control. For example Chile had 14 percent current account deficit most of which was created by the private sector (S. Edwards & Edwards, 1991). By now the emphasis had been shifted to sustainability of the current account rather than where it originated from as (Fischer, 1988) emphasized – referenced in Edwards. Clearly, the United States current account deficit is quite a different phenomenon than the developing countries. In case of developing countries reversal of capital flows and currency crises is a matter of fact issue. Sustainability questions come to mind as soon as the current account deficit exceeds 5 percent of GDP regardless whether it originated from the private sector or government spending (S. Edwards, 2002). Again in 1994 right before the Mexican crisis concerns about the sustainability of the Mexican current account deficit were played down because most of the deficit originated from the private sector yet Mexico had a serious financial and currency crisis anyway. Another example of big current account deficit is Turkey, (Dalgin & Gupta, 2012), that could sustain a current account deficit of more than 5 percent and that got into frequent crises. Yet, for the United States, even though capital flow reversals is a big issue it does not have to deal with currency crisis variety of a crisis because most of its debt is in its own currency. But also, as we have argued above the dollar is the world currency functioning as a medium of exchange for the international trade. Hence, it is unthinkable, in most cases, for the dollar to depreciate drastically. From this point of view the United States has quite a comfortable leeway when it comes to sustaining large current account deficits.

¹ The doctrine is named after Nigel Lawson, former British chancellor of exchequer

5. Causal Explanations

There are various explanations offered for the current account deficit such as the deficient savings view, the new economy view, the global savings glut view, and the role of dollar as the international currency. Yet, in general there are two approaches to explore the causes; one looks at the relationship between GDP growth at home and abroad and the two components of trade deficit as well as the exchange rates. The other approach is to examine relationship between internal imbalance between saving and investment and external imbalance, i.e., current account deficit (Mann, 2002). I would like to briefly review and critically examine each of these approaches and relate them to international currency status of the dollar. In both cases, in determining the balance on current account deficit capital markets play a crucial role through their effect on the interest rates hence on the exchange rates and relative prices of imports in terms of exports. In these discussions it is important to realize that current account records the transactions with the rest of the world therefore external or internal developments or imbalances will affect the current account.

According to the first approach fast *GDP* growth at home will increase aggregate demand part of which will be for foreign goods. Relative to the world if growth is faster at home than abroad that will increase the trade deficit and largely will result in current account deficit. This is what we observe in the second half of 1980s and 1990s. Growth related trade deficit introduces a cyclical component into the trade deficit. Yet, this is not all of it because structurally there is a trend widening of the trade deficit as a result of higher American consumer and business appetite for foreign goods and services. Even when the rest of the world grows faster than the US, the American trade deficits continues to widen, which is known as Houthakker-Magee effect. This effect has been observed in the postwar period but more strikingly since the breakdown of the Bretton Woods system. Yet, this is clearly not a long run equilibrium, which otherwise has the implication that the U.S. will absorb the whole world exports. Therefore, at some point this trend needs to stop. Capital markets and exchange rates will play a critical role in buckling the trend. So far the international currency status of the dollar has been resisting the change and letting this trend continue, yet at some point it will not be enough.

According to the second approach, the current account deficit is related to the balance or rather imbalance between investment and domestic saving. To observe this more clearly, we should break down domestic saving into its public and private components. As we argued above the national income identity states that current account balance shows the excess investment over national saving. It is also possible to breakdown national saving into two components as private saving and public saving, i.e., government saving, which is given by the difference between taxes government collects and government spending. It can be written as

$$I - S_{private} = T - G - M - X$$

In the equation above as long as private saving is about the same as investment, then the government budget deficit will imitate trade deficit. This is actually what happened in the early 1980s, during which time private saving was roughly equal to investment and the huge government budget deficit was matched by the trade deficit. This led to the phenomenon which was known as the twin deficits. After 1983, even private saving and investment followed similar paths, trade deficit moved along with the budget deficit and created the so called twin deficits. However, after 1990s, this behavior changed and the budget deficit and trade deficit were decoupled. Even though the budget deficit was put under control, private saving dropped as a result of higher stock market valuation and higher housing values leading to an increase in consumer wealth. Then in its turn higher consumer wealth increased consumption and consequently decreasing saving. The Composition of savings matter because import intensity of government output is much lower than than import intensity of household spending. Hence, a decrease in household saving matched by an equal increase in government saving will not offset each other in terms of their effect on imports: lower private saving matched by higher government saving still increases imports causing a higher trade deficit.

Also, as private saving was decreasing in the United States, in the aftermath of the East Asian financial crisis, these countries were increasing their savings and increasing their holdings of international reserves, mostly held in the dollar. This phenomenon has come to be known as the global savings glut in the view of Ben Bernanke, then vice chair of the Federal Reserve (Bernanke, 2005). The impact of this global savings glut on the trade deficit was mostly through the capital markets and higher exchange rates. Even though the U.S. fiscal deficit was decreasing, strong economic growth and the idea of new economy and hence profitable investment opportunities attracted foreign capital. This led to the appreciation of the dollar and comparatively more expensive American exports, which did not help with the trade deficit at all but on the other hand made it even worse (Figure 2).

When one considers the relevant forces such as stronger dollar as a result of higher demand for the dollar, strong economic growth at home leading to higher demand for imports, and stock market boom as well as boom in the housing market, all leading to higher demand for imports the current account account reaching to five percent of GDP does not look like very surprising.²

6. U.S. Dollar As International Currency

It is no accident that the dollar plays the role of international currency and at the same time the United States has a big current account deficit, on an almost permanent basis since the early 1980s. In this section we would like to explore the relationship between these two facts. As an international currency the dollar plays various roles such as vehicle currency, invoicing currency, reserve currency, and as an intermediary currency. But, in playing these roles it serves two broad categories: one at the micro level, it facilitates international transactions; and the other one, at the macro level it plays the role of a monetary anchor. The international reserve currency role, however, has a strong bearing on the current account deficit coupled with globalization of trade, which also requires globalization of finance, otherwise it cannot go beyond global barter trading.

The dollar as an international reserve currency has gained much importance especially after the East Asian Crisis as the crisis countries started accumulating reserves in order to be ready for the next capital flight that might happen some day. One way to accumulate capital was to have current account surplus with the United States from where originated this currency. Another version of this view has been propagated by Ben Bernanke in a famous speech that came to be known as the Global Savings Glut theory –(Bernanke, 2005). All the views propagated above puts the U.S. and the Federal Reserve Bank in sharp focus as the World Central Banker that is somewhat responsible for the international “monetary policy”. This brings two responsibilities on the American monetary authorities: first of all they have to keep the current account and financial account convertible in order to provide liquidity in the treasury bills to foreign governments. Secondly, it should not try to fix the exchange rate of the dollar but let the markets decide that. Although the second rule gives the Fed freedom to follow whatever monetary policy it chooses, which is a kind of freedom the rest of the world does not have. It looks as if in the U.S. monetary authorities can follow whatever domestic objective they want to achieve. Yet, this is illusory because sometimes or more domestic objectives might be in straight conflict with the international responsibilities of the dollar. The strains might build up over time and at some point might become quite irresistible. However, the first requirement of the dollar is a stable price level which will provide a stable basis for the price levels and exchange rates of other countries.

Since the early 1980s, the inflation rate has been subdued and many countries around the world were glad to hold the dollar as international reserve currency and stabilize their price level accordingly. This situation has provided the United States with a soft borrowing constraint for both private consumption, investment, and for public debts. Under the present circumstances, as long as the outside world needs the dollar to serve various functions of money, the United States can sustain its current account deficit forever unless a catastrophic inflation rate completely wrecks the current exchange rate arrangements.

However, this architecture of international monetary system has certain flaws or side effects such as credit booms and bubbles. Moreover a stronger dollar as a result of high demand makes American tradables less competitive, which creates a certain comparative advantage for the finance industry thriving at the expense of manufacturing as it was in the case London becoming the financial center of the world.

7. Conclusions

In the paper I was arguing that the current account deficit of the United States is not simply a matter of extensive investment that is not met by national saving as in the case of a developing country. The issue is also much more involved than just simply a matter of too much consumption and an appropriate rate of investment. It is true that as a result of large current account deficit, the United States is the largest net debtor country yet this is not only just because of accumulated current account deficits but rather there are rather more complex forces of international economics at play making possible ever larger current account deficits even proportionally.

The much used ubiquitous term globalization is certainly one of the culprits. However, it needs to be understood that the force behind globalization that makes it tick is the capital flows which makes possible trading goods and services not only across the globe but also trading assets over time.

² For the resulting imbalances see (Dalgin, 2013)

This kind of trading is more involved and requires a more integrated world because trading assets bring about a longer term relationship, couples economies, imposes more uniform rules and standards. This is the phenomenon that we call globalization. It is very natural that the country and its currency in the center will play a central role in developing this process especially when the already existing international monetary system was designed to function this way.

It looks as if one of the side effects of globalization is the large current account deficits ran by the United States year after year simply because globalization softened the borrowing constraints through large capital inflows to the United States. This was much easier thanks to the inter-temporal trading of assets and the appetite of foreigners for them as a result of their need for the international currency. This, in its turn made possible for the United States to run large current account deficits for a long time, unlike another country. However, not enough investment opportunities and a sluggish economy in the 2000s created harmful side effects such as real estate bubbles on the economy which led to the worst economic crisis since Second World War. These imbalances and their consequences were caused by the existing international monetary system, which is antiquated and designed according to post World War Two. Since then political and technological developments led to a quite different world. The world in the twenty-first century needs a new international monetary and financial system.

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