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The US Current Account Deficit and Economic Development: Collateral for a Total Return Swap

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We argue that a chronic US current account deficit is an integral and sustainable feature of a successful international monetary system. The US deficit supplies international collateral to the periphery. International collateral in turn supports two-way trade in financial assets that liberates capital formation in poor countries from inefficient domestic financial markets. The implicit international contract is analogous to a total return swap in domestic financial markets. Using market-determined collateral arrangements from these transactions we compute the collateral requirements consistent with recent foreign direct investment in China. The data are remarkably consistent with such calculations. The analysis helps explain why net capital flows from poor to rich countries and recent evidence that net outflows of capital are associated with relatively high growth rates in emerging markets. It also clarifies the role of the reserve currency in the system.

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