

INTERPRETING THE U.S. CURRENT ACCOUNT DEFICIT

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Some Facts About the Current Account

The U.S. current account balance is a summary of international transactions by firms, households, and local, state and federal governments involving currently produced goods and services. Table 1 lists the current account balance and its main components (cols. 1-4) at five-year intervals from 1960 to 1990 and annually from 1991 to 2003 (covering the first two quarters at an annual rate). The single main component of the current account balance is the balance of merchandise trade (col.2), which has been negative and on a rising trend in each year since 1991. Merchandise imports have exceeded merchandise exports by growing amounts. In contrast, sales of services have regularly exceeded imports of services over the decade (col.3), but constituted only a fraction of merchandise trade.

Another component is the balance on investment income the U.S. obtains from the assets it owns abroad less the amounts it transfers abroad to foreigners as a return on assets they hold in the US (col.4). With the exception of 2002 the balance on investment income was a surplus. The balance has been a deficit only in 2002. This means that, with that exception, US investment in foreign countries has been more profitable than in the case of foreign investment in the US, apparently more so for direct investment than for portfolio investment.

For years the flow of U.S. capital abroad (col.5) has been lower than the flow of foreign capital to the U.S. The flow from foreign countries in part comes from official agencies,

generally central banks (col. 6) and, since 1991, to a major extent, from the private sector (col. 7).

In each year since 1992, U.S. has had a current account deficit, peaking at \$5.5 billion in 2003 or about 5% of GDP. A deficit as in every year since 1992 indicates that U.S. is importing capital, that is, its net claims on foreigners are declining. If there were a surplus, however, it would indicate that the U.S. was exporting capital. That is, the U.S. was increasing its claims on foreigners.

Although for any one country, there may be an imbalance in the sum of its current and capital accounts, but for the world as a whole, the sum should be in balance in each period. Because of accounting errors or unrecorded transactions, however, a statistical discrepancy exists for the U.S. and world economy. In 2002, the U.S. discrepancy was a negative \$4.6 million, or – 0.4% of GDP, not nearly enough to eliminate the current account deficit

The Trade Deficit

What drives foreigners' demand for US goods and services? Important influences include differences in growth rates of domestic and foreign income. Faster growth of domestic income stimulates imports; faster growth of foreign income stimulates exports. Similarly, a fall in relative prices of exports compared to those of competing goods and services in the foreign market, as when the dollar exchange rate depreciates, stimulates exports, and a fall in relative prices of imports compared to those of domestic goods and services in the home market, as when the dollar exchange rate appreciates, stimulates imports. The dollar exchange rate responds to changes in the foreign demand for dollar-denominated assets. If foreigners reduce their demand for U.S. assets, the dollar will depreciate. However, with steady growth in productivity and low inflation, and a shift by foreigners from dollar-denominated assets to assets located in other

countries, resulting in a decline in the real value of the dollar, there may be no effect on the nominal exchange rate provided U.S. inflation is lower than inflation abroad.

Figure 1 shows the current account balance and the goods and services balance as a share of US GDP since 1973. The US trade balance has been in deficit since the end of the 1970s. It grew in the 1980s and the second half of the 1990s when the US growth rate was higher than that of its trading partners and it declined in the first half of the 1990s when the growth rate of its trading partners was higher than that of the US. Figure 1 also shows the real exchange rate of the dollar, which fluctuated dramatically during the 1980s, peaking in 1985 and reaching a trough in the mid-1990s. It then rose moderately and reversed course after 2000.

The US Net International Investment Position

Table 2 lists categories of US -owned assets abroad and foreign-owned assets in the US. The difference between the two totals constitutes the US net international investment position. There are two ways of measuring assets. One way is a current-cost basis that uses the current cost of capital equipment to measure equity shares. The other way is a market-value basis that measures equity shares using stock market indexes. Both ways use general price indexes to measure land; and replacement cost to measure inventories. The information on a current-cost basis is available for years as far back as 1979 and on a market-value basis back to 1982. Table 2 shows the market-value estimates.

Both measurement ways show the US net international asset position turning negative in 1989. According to the *Economic Report of the President for 2003*, however, 1986 marks the year that the US net international investment position turned negative. The U.S. since then has been a debtor to the rest of the world, measured by the decline in the ratio to GDP of the market value of its asset holdings abroad less that of foreign holdings in the U.S. In 2002 the ratio was a

negative 25% of GDP. By contrast, in 1979, following decades of current account surpluses, the US, on a current-cost basis, was a creditor country, its net holdings of foreign assets amounting to 10% of GDP.

The main component of US-owned assets abroad at each date in Table 2 was foreign direct investment. Foreign direct investment in the US also tended to be the category of most importance among private sector foreign-owned assets in the US. Assets held by official foreign agencies in the U.S. were principally U.S. government securities.

Financing the Current Account Deficit

A surplus or deficit in the current account must be offset by capital account transactions. If the U.S. purchases imported goods and services in excess of its exports of goods and services, the definition of the current account indicates that there must be an excess of purchases by foreigners of real and financial U.S. assets over U.S. purchases of foreign real and financial assets. The capital account flows offset the change in the trade account.

Saving, Investment and the Current Account Balance

As a matter of national accounting the current account balance equals the difference between net national saving and net national investment. Figure 2 shows the gap between US national saving and domestic investment and the current account balance as a ratio to GDP since 1980. If US saving in a given period falls short of US investment, foreigners must be an external source of finance for the investment that domestic saving does not provide. Foreigners must acquire assets in the US in the form of financial instruments issued by the private sector or government as well as ownership of US firms and property. The return on these assets in the form of dividends, interest payments, and profits is transferred to investors abroad. The US capital stock grew rapidly in the 1990s but part of the income earned on it had to be remitted abroad.

The Twin Deficits Notion

From 1983 to 1989 domestic private savings and domestic investment were about equal, as were the trade deficit and the federal budget deficit, fostering the notion of a relation between the twin deficits. The idea was that domestic private saving and the trade deficit were sources of supply of capital and private sector investment and the federal budget deficit were sources of demand for capital. Expansionary fiscal policy created budget deficits that increased domestic spending for capital and imports. Tight monetary policy raised interest rates, which induced foreign investment and appreciated the dollar exchange rate. The strong dollar made American goods expensive for foreigners and imports cheaper for Americans. Thus the current account deficit was related to the effects of the twin deficits. The validity of this framework was shattered by developments in the 1990s when the budget deficit declined and became a surplus while the current account deficit surged.

What happened instead was that business investment boomed in the 1990s along with productivity increases while private savings declined as low inflation, low unemployment, and soaring stock market values increased household wealth. The contribution of the budget surplus to national saving was insufficient to close the gap with domestic investment. Foreign capital inflows in response to the US boom closed the gap.

Different Perspectives on the US Current Account Deficit

The question commonly addressed to the US current account deficit is “Is it sustainable?” Can the US continue to increase its foreign debts and service its accumulated debts? Different commentators offer scenarios emphasizing different aspects of the deficit. *The Economist* in a recent issue headlined its view of “America’s borrowing binge” as “profligacy.” In this

perspective, Americans selfishly absorb capital that the capital-poor rest of the world could use to better advantage.

Foreigners Seek US Assets

An alternative key to understanding why the U.S. current account is in deficit is to focus on what motivates non-Americans to acquire ever larger holdings (with few reversals) of US firms, property, stocks and bonds, bank loans, Treasury securities and US currency. The obvious answer is the US reputation as a safe haven even after 9-11, in the past decade a record of low inflation, lower transaction costs in its capital markets than elsewhere, productivity and rates of return on investments greater than in the foreign economies. The outlook for the future by some observers is pessimistic. At some point global investors will find their portfolios unbalanced with dollar-denominated assets and will decide to limit their holdings of such assets. These observers expect the share of euro-denominated assets will in time replace dollar-denominated assets with the ultimate consequence of narrowing the US current account deficit. The main concern of those who are partial to this approach is that the shift from dollar-denominated assets by foreign holders will be abrupt and sizeable and a flight from the dollar will accompany the fall in the dollar exchange rate.

Countering this projection is the view that as long as the US maintains price stability, it will not encounter constraints on borrowing from the rest of the world. If there should be a run on the dollar, it would alarm foreign central banks and foreign exporters. Foreign central banks would intervene by accumulating dollar reserves in order to prevent appreciation of their national currencies and a loss of exports. This pattern explains the huge accumulation of foreign reserves, held mostly in dollars, during the past two decades, despite generally floating exchange rates.

Another View on Sustainability

This view (presented in an NBER Working Paper) describes recent developments in the global economy as attributable to the behavior patterns of countries in three geographical areas. The US is one of the geographical areas and is the center country of the global economy. It is the system's financial intermediary. It does not manage its exchange rate and does not accumulate foreign reserves. It is both a trade account and a capital account country. It seeks growth through its trade account and finance for its growth. It seeks investment through its capital account and foreign savings to finance domestic capital formation. The US does not worry about its deteriorating international investment position.

A second geographical area is Asia, comprising China, Taiwan, Japan, Hong Kong, Singapore, Korea, and Malaysia. Asia is a trade account region. Exporting to America is Asia's main concern. Exports mean growth. Asian countries' growth-oriented trade surpluses are a source of finance for the US, channeled through their central banks as official providers of capital to the US. The countries manage their dollar exchange rates, and their central banks consistently intervene to limit appreciation of their currencies. Exchange controls and administrative pricing are often resorted to. Some currencies are explicitly fixed, like the Chinese yuan, the Hong Kong dollar, and the Malaysian ringit. The Japanese yen and the Korean won float but Japan and Korea accumulate vast official reserves in US dollars. The Asian country currencies float against the currencies of the third geographical area.

The third geographical area comprises Europe, Canada, Australia, and Latin America. This is a capital account region. Private investors in the capital account region care about the risk/return of their international investment position, and have recently become worried about

their U.S. exposure. Countries in the capital account region have floating exchange rates. Their governments do not intervene, and their official reserves have not increased.

The trade-weighted exchange rate of the DM and then the euro and other currencies of the capital account region depreciated substantially relative to the dollar from 1992 through 2002. The real exchange rate depreciation was consistent with private investors in the region helping to finance the US current account deficit.

Over the last five years, however, the US current account deficit has been financed by official inflows from the trade account region as well as private inflows from the capital account region. The surge in the US current account deficit has been the engine for growth in the rest of the world.

Until early 2003, the tripartite global economy was stable and sustainable in view of the trade account region's preference for official investments in the US and the capital account region's preference for private financial investments in the US. Lately, however, the countries in the capital account region have become concerned about the rise in US international debts. The depreciation of the euro and other capital account currencies was partially reversed in the first half of 2003. Normally, the solution would be for US yields to rise and the dollar to depreciate sharply. But that may not happen.

Instead, Asia may displace Europe in sending exports to the US and may be ready to accept even larger inflows of US securities. If so, US yields would not have to rise.

The nub of this view of the global economy is that, if European investors decide to limit further purchases of US assets unless US yields rise, the euro will appreciate dramatically. European domestic savings will remain at home and yields there will fall. Asia's exports to the

US will displace Europe's, and growth in Europe will slacken. US yields will not rise even as its current account deficit rises.

According to this view of the global economy, emerging market economies must choose between two models. One is the Asian model of free trade and exports as the engine of growth. The other model is the European one of capital mobility and an appreciating euro.

Protectionism in the US in Response

One consequence of the inflow of funds from abroad is that the dollar has been a strong currency in foreign exchange markets, with the effect of bolstering imports of goods and services. Complaints about unfair trade practices of foreign exporters are not unique to the present. Subsidies to agriculture to promote US crop exports have been a perennial feature of protectionist trade policy.

In the 1980s, demands for protection centered on textiles (the Multi-Fiber arrangement) and automobile exports from Japan. The innovation in managed trade then was VERs – Voluntary Export Restraints. Japan agreed to issue licenses to automobile manufacturers (with associated rents) that limited the quantity of Japanese-made cars that were exported to the US. Japan observed the quantity restriction but circumvented its intent by exporting high-priced luxury cars for which US manufacturers had no competing models. In addition, Japan has established plants in various locales to produce cars here.

Currently, US protectionist intervention is directed at two targets. One has been the domestic steel industry. The other target is undervalued Asian currencies, especially the Chinese yuan and the yen.

Since the recession of 2001 and the following economic slowdown steel imports have been the target of the Bush Administration's political concerns. Steel is a labor-intensive

declining industry located in concentrated areas with significant voting power. Section 301 of the 1974 Trade Act authorizes the President to enforce unilaterally perceived US rights under international trade agreements to respond to “unfair” foreign practices. The President invoked Section 301 on the basis that European steel exporters were exporting at a price below the home market selling price or the cost of production. He imposed countervailing duties on imported steel to expire in five years. He could have lifted the duties at a half-way mark in September 2003, but did not. Angry complaints from domestic steel users that they have had to absorb an increase in the price of the product were of no avail. Retaliation by European exporters is still to come. The WTO must decide what redress they are entitled to demand from the US.

On the other front, the Bush Administration pressured China and Japan before the recent APEC summit to revalue their currencies but neither country agreed before the meeting to quick concessions. The subject of Asian revaluation apparently was not pursued at APEC. The expectation is that opposition to Asian foreign exchange market manipulation will not die. US manufacturers have filed a petition with the US Trade Representative’s Office to get the WTO to apply trade sanctions against China because of its widening bilateral trade surplus with the US. The Bush Administration apparently would be content if China widened the band around its fixed yuan rate to the dollar to appease the manufacturing heartlands, rather than a big one-time revaluation or a free float.

In recent weeks the US\$ has weakened against the yen, but the yen has strengthened against all the Asian currencies. Japan will likely resist any further appreciation of the yen without appreciation in the rest of Asia. Japan meanwhile continues to intervene to limit appreciation of the yen. This year it is estimated to have bought 120 billion dollars, more than its

current account global surplus. Japan continues to be addicted to holding dollars rather than spending them on imports to improve the standard of living of the Japanese people.

Protectionism has not served to narrow the current account deficit. It is a blemish on the US record as a promoter of free trade since World War II.

Conclusion

The US on its own could narrow its current account deficit by actions -- such as conducting inflationary monetary policy -- that would induce foreigners to shun dollar assets in their portfolios. Such a course seems improbable. Otherwise, so long as foreigners choose to export their goods and services to the US and accept in payment dollar assets, the current account deficit can continue at its present or a higher level. The scenario that projects withdrawal of European exporters from the US market and their shift from dollar to euro assets envisages Asian exporters as inheriting the European share of exports to the US and acquiring the European share of dollar assets. The US current account deficit would remain undisturbed despite the displacement of European by Asian investors.

The euro and the yen have recently strengthened against the dollar. In part this development is the result of the reordering of the composition of some portfolios. In part, dollar weakening may reflect currency traders' belief that US monetary policy is too accommodative for the present stage of the economic recovery. The weakened dollar has been welcomed by US manufacturers. Dollar weakness, however, may not last if the US growth rate accelerates in coming quarters outstripping the growth rate of European countries. How the US current account will fare is imponderable.

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Note: Tables 1 and 2 update tables in Cooper, pp. 220-1.

Figure 1 updates figure in Mann, p. 132.

Figure 2 updates Chart 1-10 in *Economic Report of the President*, p. 60.

Table 1. U.S. INTERNATIONAL TRANSACTIONS, 1960 - 2003

[Billions of dollars]

	BALANCE ON:				U.S. INVESTMENT	FOREIGN INVESTMENT IN USA:	
	Current account	Goods	Services	Investment income ^a	ABROAD	Official	Other
1960	2.8	4.9	-1.4	3.4	-4.1	1.5	0.8
1965	5.4	5.0	-0.3	5.4	-5.7	0.1	0.6
1970	2.3	2.6	-0.3	6.2	-8.5	6.9	-0.6
1975	18.1	8.9	3.5	12.8	-39.7	7.0	10.1
1980	2.3	-25.5	6.1	30.1	-85.8	15.5	47.1
1985	-118.2	-122.2	0.3	25.7	-44.8	-1.1	147.2
1990	-79.0	-111.0	30.2	28.6	-81.2	33.9	107.7
1991	3.7	-76.9	45.8	24.1	-64.4	17.4	93.4
1992	-48.0	-96.9	58.7	23.3	-74.4	40.5	130.2
1993	-82.0	-132.5	63.3	24.3	-200.6	71.8	210.3
1994	-117.7	-165.8	68.6	17.1	-176.1	39.6	266.4
1995	-105.2	-174.2	79.1	25.0	-352.4	109.9	328.7
1996	-117.2	-191.0	88.1	24.5	-413.9	126.7	424.4
1997	-127.7	-198.1	91.1	20.7	-487.6	19.0	687.8
1998	-204.7	-246.7	83.5	6.9	-347.8	-19.9	443.5
1999	-290.8	-346.0	84.8	17.1	-503.6	43.5	696.7
2000	-411.5	-452.4	77.0	19.6	-569.8	37.7	988.4
2001	-393.7	-427.2	69.4	10.7	-349.9	5.1	760.4
2002	-480.9	-482.9	64.8	-4.0	-179.0	94.9	612.1
2003 ^b	-554.8	-548.0	57.9	3.7	-416.0	197.1	797.4

Note:

a. Net income received on U.S.-owned assets abroad minus payments on foreign-owned assets in the U.S.

b. First two quarters of 2003 at an annual rate.

Source: Department of Commerce, Bureau of Economic Analysis

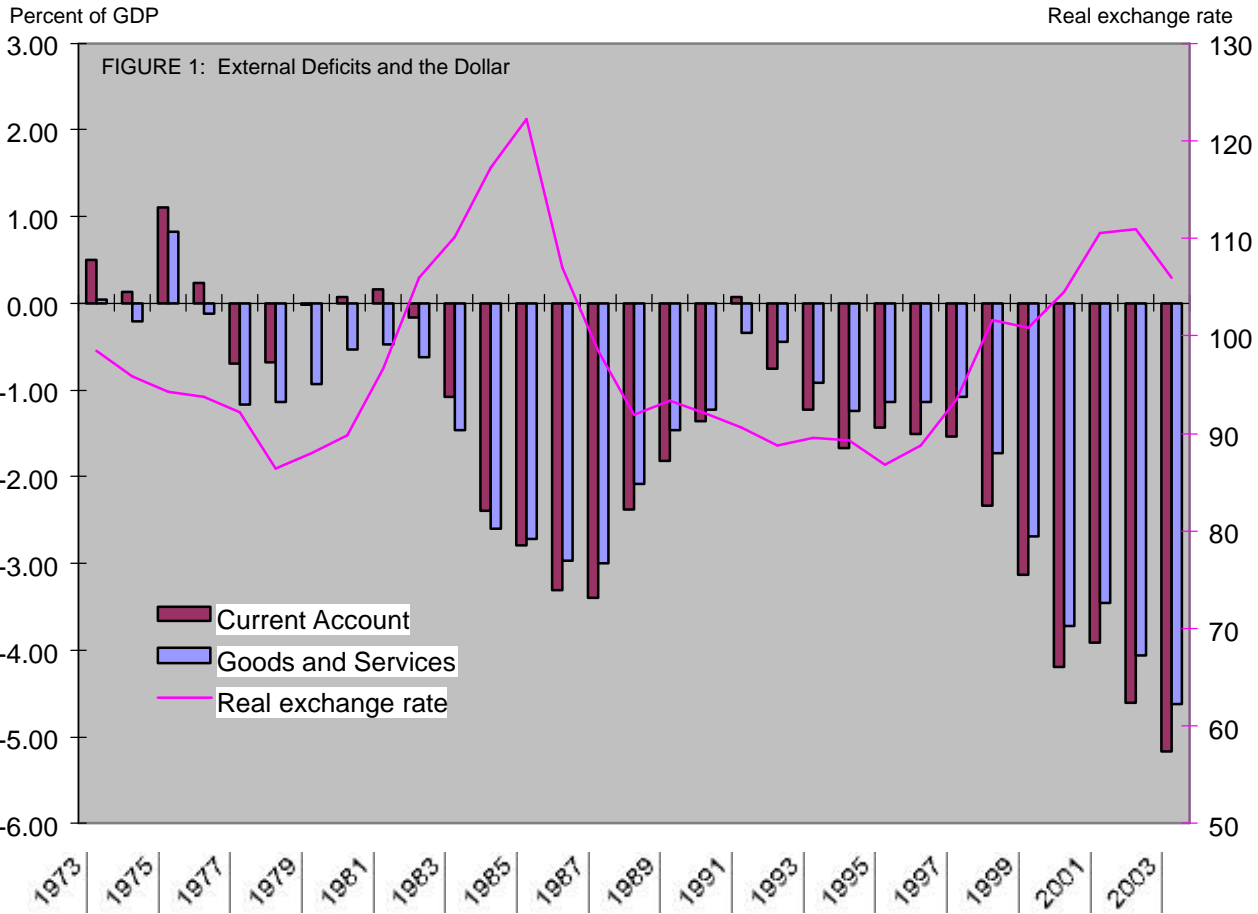
Table 2. International Investment Position of the United States

[Billions of dollars; Market-value basis]

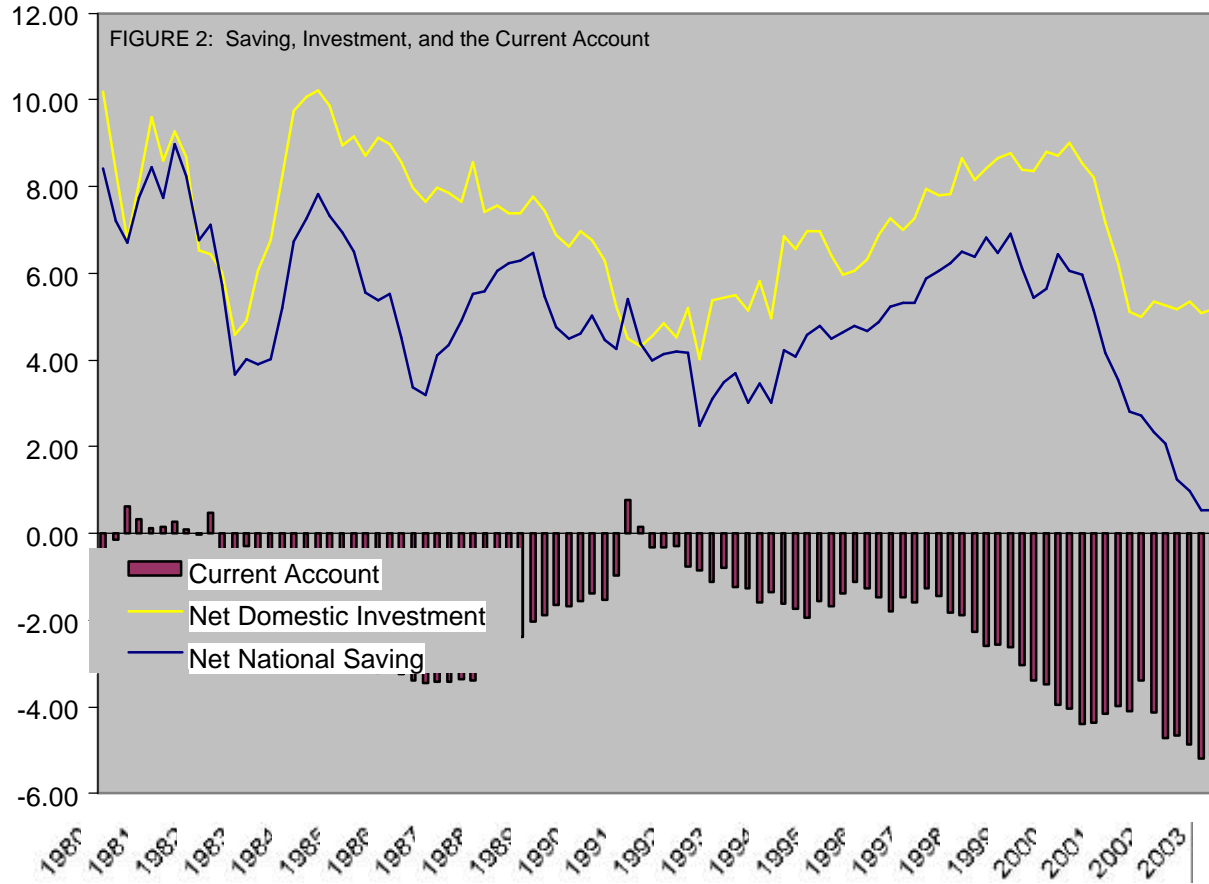
	1982	1989	1992	1999	2002
Net international investment position:	235.9	-47.0	-452.3	-1068.8	-2605.2
<i>U.S.-owned assets abroad:</i>	961.0	2350.2	2466.5	7390.4	6473.6
U.S. official reserves	143.4	168.7	147.4	136.4	158.6
Other government	76.9	86.6	83.0	84.2	85.7
U.S. private assets:	740.7	2094.9	2236.0	7169.8	6229.3
Direct investment abroad	226.6	832.5	798.6	2839.6	2036.2
Bonds	56.6	116.9	200.8	521.6	501.8
Corporate stocks	17.4	197.3	314.3	2003.7	1345.2
Other	440.0	948.1	922.3	1804.8	2346.1
<i>Foreign-owned assets in the United States:</i>	725.1	2397.2	2918.8	8459.2	9078.7
Foreign official	189.1	341.7	437.3	951.1	1132.5
U.S. Government securities	132.6	263.6	329.3	693.8	898.0
Other U.S. Government liabilities	13.6	15.4	20.8	21.1	17.1
Other official assets	42.9	62.8	87.1	236.2	217.4
Other foreign assets:	536.0	2055.5	2481.5	7508.1	7946.2
Direct investment	130.4	534.7	696.2	2798.2	2006.7
U.S. Treasury securities	25.8	166.5	197.7	462.8	503.6
Corporate and other bonds	16.7	231.7	299.3	825.2	1690.3
Corporate stocks	76.3	251.2	300.2	1526.1	1170.8
U.S. currency	31.3	67.1	114.8	250.7	297.1
Other	255.5	804.2	873.4	1645.2	2277.6
GDP (nominal)	3259.2	5489.1	6319.0	9274.3	10446.3

Note: Market-value basis measures equity shares using stock market indexes; land using general price indexes, and inventories using replacement cost.

Source: Department of Commerce, Bureau of Economic Analysis.



Percent of GDP



Source: Department of Commerce (Bureau of Economic Analysis)