

Does the United States Have a Current Account Deficit Disorder?

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Since the beginning of 1998, the U.S. current account balance has declined sharply. In 2000, the current account deficit reached 4.4 percent of U.S. gross domestic product (GDP), which has caused much concern about the sustainability of this large deficit. Clearly, if this deficit is not sustainable, questions arise as to how the United States' current account balance would return to levels that could be maintained. One specific question concerns the implications of a sudden reversal of investor sentiment about the desirability of holding U.S. assets. Some commentators have raised the specter of a financial crisis with predictions of capital flight, sharp declines in the foreign exchange value of the dollar, higher interest rates, and numerous bankruptcies and defaults. Such a scenario could produce consequences for the U.S. economy similar to those experienced by a number of countries in East Asia during the late 1990s.

My remarks focus on how to interpret recent developments in the U.S. current account. I plan to examine four related topics. First, I think some of the analysis and commentary discussing the U.S. current account is misinformed. Using some terminology from balance of payments accounting, which I will discuss later, many commentators have expressed the mistaken view that the capital and financial account “finances” the current account. In fact, for the United States, changes in the capital and financial account have been driving changes in the current account for many years. That is, the current account “finances” the capital

and financial account. Second, and consequently, an understanding of changes in the capital and financial account requires an understanding of the reasons for the large financial flows to the United States in recent years. Third, I will explore what might cause a reversal of financial inflows into the United States. Fourth, I will examine evidence from other countries that have run large current account deficits to see how such evidence might add to our understanding of the U.S. situation today.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. This speech is a joint product with Cletus C. Coughlin, vice president in the Research Division of the Federal Reserve Bank of St. Louis; I greatly appreciate his assistance. However, I retain full responsibility for errors.

SOME BALANCE OF PAYMENTS ACCOUNTING

Prior to developing my key points, I'll discuss a few concepts from balance of payments accounting to be sure we are all on the same wavelength. A country's balance of payments is a systematic account of all the exchanges of value between residents of that country and the rest of the world during a given period of time. For my discussion I will focus on two particular accounts within the balance of payments—the current account and the capital and financial account.

The U.S. current account summarizes all transactions involving flows of goods, services, income, and unilateral transfers that take place between U.S. and foreign entities, which include private individuals, businesses, and governments. The current account balance is simply the difference between U.S. receipts from the rest of the world and U.S. payments to the rest of the world as a result of these transactions. If U.S. payments exceed receipts, then the U.S. is said to be running a current account deficit. During 2000, U.S. payments exceeded receipts by \$435 billion.

U.S. receipts arise from exports of goods and services, interest and dividends received by U.S. owners of foreign stocks and bonds, the reinvested earnings of the foreign affiliates of U.S. corporations, and gifts to the United States from foreign residents and governments. Conversely, U.S. payments result from imports of goods and services, interest and dividends received by foreign owners of U.S. stocks and bonds, the reinvested earnings of U.S. affiliates of foreign corporations, and gifts from the United States to foreign residents and governments.

This definition highlights a number of important facts. First, the receipts and payments encompass much more than the movement of merchandise across national borders. Second, the current account reflects the interaction of numerous decisions by individuals, firms, and governments both in the United States and abroad. Third, when receipts exceed payments, the United States, on net, is acquiring assets abroad. When U.S. payments exceed receipts, foreigners, on net, are acquiring assets in the United States.

When either U.S. residents acquire assets abroad or foreign residents acquire assets in the United States, the transactions are recorded in the capital and financial account of the balance of payments. A key accounting identity is that the capital and financial account balance must be exactly the opposite of the current account balance for any given period of time. In other words, a current account deficit must be matched by a capital and financial account surplus and vice versa. The balance of payments must balance!

There is, however, a more subtle point that is

crucial to my analysis. The accounting balance measures, or accounts for, an economic equilibrium. The sum total of all purchases of U.S. dollars equals the sum total of all sales of U.S. dollars. Purchases and sales are simply the opposite sides of the transactions in which dollars are traded for goods, services, and assets. Markets reach equilibrium through changes in prices of goods, exchange rates, interest rates, and other variables that determine the supplies and demands for goods, services, and assets. The issue of the sustainability of the U.S. current account deficit—or its counterpart, the capital and financial account surplus—is, then, the issue of the sustainability of the combination of prices, interest rates, exchange rates, and so forth that give rise to the current account deficit.

INTERPRETING THE CURRENT ACCOUNT

A common interpretation of the current account is that an increasing current account deficit is bad. One reason for such an interpretation is psychological—we tend to view deficits as bad and surpluses as good. Thus, it is understandable that our initial instinct is to view an increasing deficit as bad. The possible error of this view is obvious: If the current account deficit is bad, so also is the capital and financial account surplus.

Concerns about current account deficits, however, are not strictly psychological. Several economic arguments suggest that an increasing current account deficit can be bad. A common argument begins by noting that to finance a current account deficit, the United States must borrow from abroad. Many perceive the accumulation of indebtedness to foreigners as a problem. In fact, the cumulative effect of U.S. current account deficits has made the net international asset position of the United States the largest such negative position in the world.

Some worry that if foreign nations suddenly attempted to liquidate their assets in the United States, they might precipitate a financial crisis

here. Such actions, however, are unlikely because foreign investors would be driving down their own wealth. Others are concerned about the sustainability of substantial levels of borrowing from abroad. Markets, however, will provide clear signals about sustainability by means of higher interest rates, lower exchange rates, and reduced credit availability. At this point, there are no signals indicating such a problem.

Related to the issue of sustainability is the fact that the debt must be repaid. If most of the foreign financing is for capital goods, such as factories and equipment, that will allow for increased U.S. production in the future, then foreign debt is not necessarily a problem. If the foreign financing is for consumption goods, however, it may be undesirable because future generations will bear the burden of the debt. Accordingly, there are some reasonable arguments to support the view that an increasing current account deficit can be bad.

AN ALTERNATIVE VIEW

There is another view, based on analyzing current account changes from a different perspective, that suggests in the present circumstances that the U.S. current account deficit is far from bad. This view starts from the position that capital and financial account transactions induce changes in the current account. To emphasize this alternative perspective, I'll now focus on the capital and financial account surplus. However, keep in mind that whenever I refer to the "capital and financial account surplus" you can substitute "current account deficit" because their dollar values are identical by the rules of accounting.

To illustrate: Assume that a foreign firm decides to build or expand a production facility in the United States. Two recent examples related to Dyersburg are Quebecor World's purchase and installation of a specialized printing press for high-quality magazines and catalogs and Northdown Industries' purchase of a building that will be converted to manufacture cat litter. In each of these cases, foreign residents are increasing their

claims on assets in the United States. In terms of balance of payments accounting, these transactions would tend to increase the U.S. capital and financial account surplus, which, in turn, means that the U.S. current account deficit would increase.

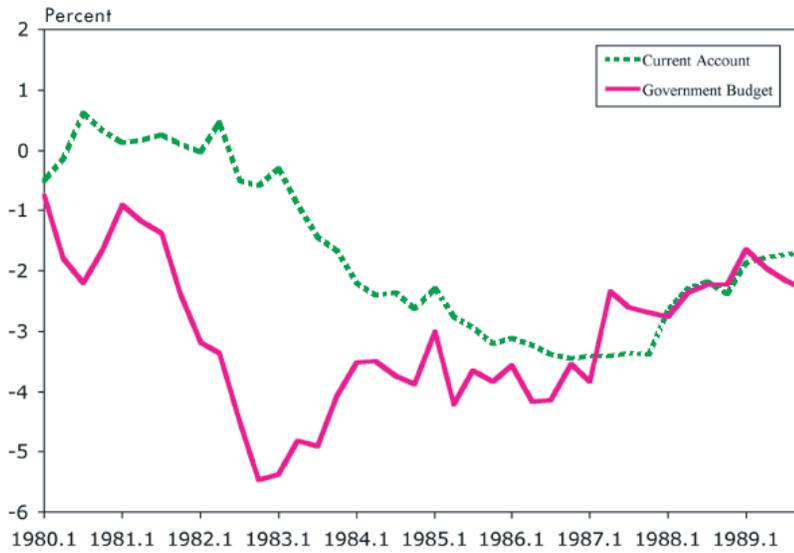
An important question is what would induce foreign residents to increase their ownership of assets in the United States. It is reasonable to think that these investors would be looking at a rate of return, adjusted for risk, that is high enough relative to investing in other locations that makes the United States attractive. It is clear that in recent years the United States has been an attractive investment location. Low and stable inflation rates, rapid productivity growth, and flexible labor markets are a few of the characteristics that have made the United States a rapidly growing economy and, therefore, an appealing investment location.

The preceding discussion suggests that we can gain a deeper insight into changes in the U.S. current account by examining saving and investment behavior both here and abroad. Our total investment spending as a country must be financed by a combination of domestic and foreign saving. Domestic saving consists of private saving and government saving. Until recently, government "saving" was actually dissaving because government spending exceeded tax revenue. Meanwhile, foreign saving directed to the United States is reflected in the magnitude of our current account deficit.

During the 1980s, the United States experienced rising deficits in both its current account and government budget balances. Figure 1 shows both of these balances relative to GDP. It shows that these twin deficits moved in tandem in some years. Some economic analysts argued that the federal budget deficit was driving the current account. But that argument clearly breaks down during the 1990s. Figure 2 shows that these balances have tended to move in opposite directions since 1993. Moreover, based on research by Patricia Pollard, an economist at the Federal Reserve Bank of St. Louis, it is clear that the twin deficit phenomenon is not a historical regularity

Figure 1

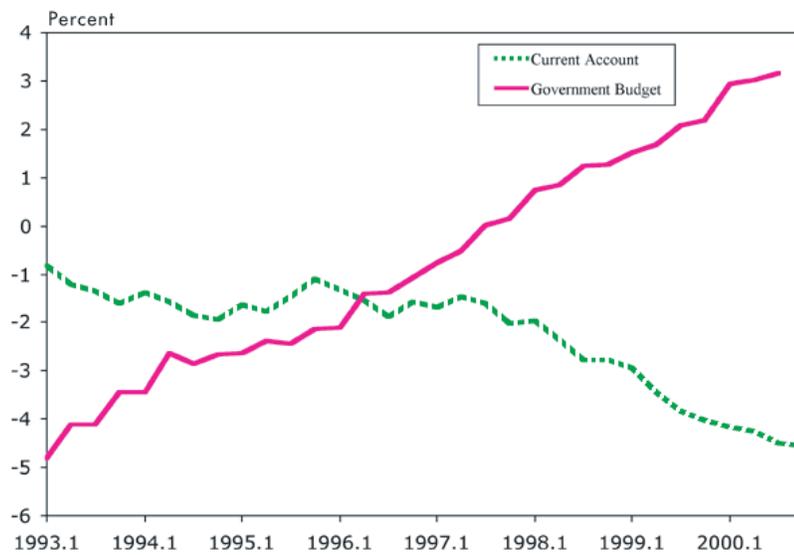
U.S. Current Account and Government Budget Balances: 1980s (percent of GDP)



NOTE: Quarterly data. Labels indicate first quarter of each year.

Figure 2

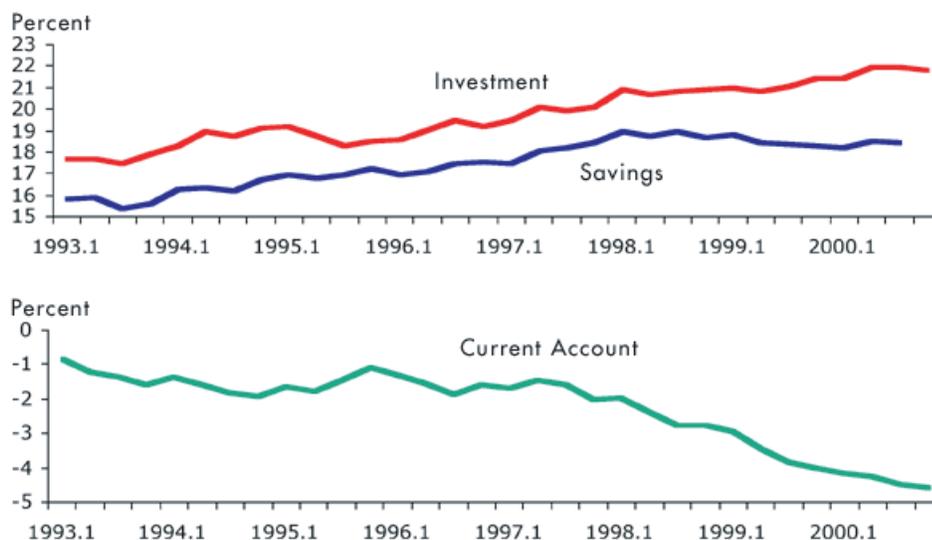
Recent U.S. Current Account and Government Budget Balances (percent of GDP)



NOTE: Quarterly data. Labels indicate first quarter of each year.

Figure 3

U.S. Current Account Balance, Saving and Investment (percent of GDP)



NOTE: Quarterly data. Labels indicate first quarter of each year.

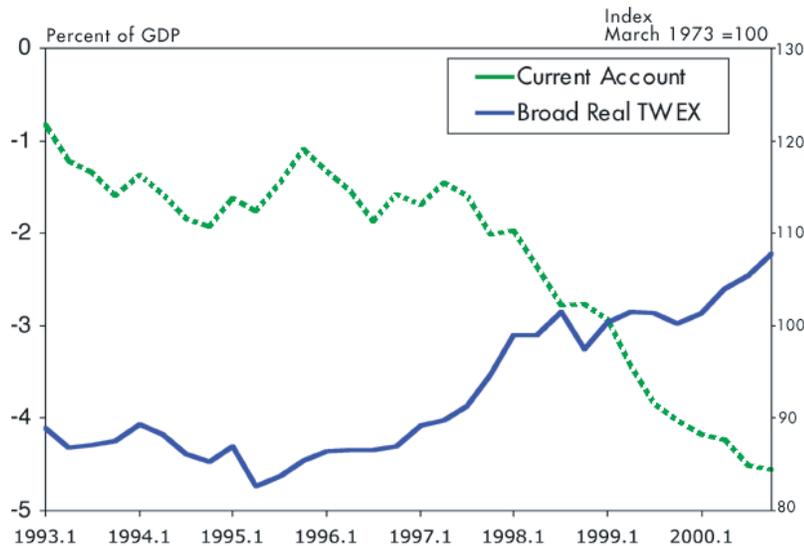
in many advanced countries. She found that the changes in these two accounts are as likely to be moving in opposite directions as the same direction.

Now let's turn our attention to saving, both private and government, and investment. The current account deficit increases if either saving increases less than investment increases or if saving decreases more than investment decreases. Generally speaking, saving and investment are both desirable. Saving frees up resources that can be used for investment either here or abroad. Gross private domestic investment, which includes the purchases of durable goods, such as business equipment, is essential for expanding both productive capacity and productivity. Such expansion permits more output to be produced in the future.

Figure 3 shows that the rising current account deficit in recent years has been accompanied by a rising rate of U.S. domestic investment. Between 1993 and 1997, the current account generally

stayed in the range of 1.0 to 1.5 percent of GDP, as a rising national saving rate, caused primarily by declining federal budget deficits, kept pace with rising domestic investment. In 1998, this pattern changed: Investment continued to rise, but saving stagnated and then fell slightly.

Figure 4 illustrates another fact that bolsters the contention that an increasing current account deficit is evidence of a strong and healthy economy. Since 1995, the foreign exchange value of the dollar has trended upward, as shown by the solid line in the chart. If the current account were driving the capital account, then a weakening dollar would likely result. This reasoning is straightforward. A current account deficit means that the quantity of dollars demanded by foreign citizens to buy U.S. goods is less than the quantity of dollars supplied by U.S. citizens to buy foreign goods. We might expect that this excess supply of dollars would put downward pressure on the foreign exchange value of the dollar. Alternatively, if the capital and financial account is driving the

Figure 4**U.S. Current Account Balance and Real Trade Weighted Exchange Rate (percent of GDP)**

NOTE: Quarterly data. Labels indicate first quarter of each year.

current account, then a strengthening dollar is possible. The reason is that the quantity of dollars demanded to make investments in the United States relative to the quantity of dollars supplied to make investments abroad can more than offset the excess supply of dollars for current account transactions. Given the attractiveness of U.S. assets, the dollar strengthens as international investors buy U.S. assets.

In fact, the relationship between investment and the current account for the United States appears to be a broad empirical regularity. Across developed countries that have experienced large current deficits, Pollard finds that the current account deficit systematically tends to increase as investment rises and tends to shrink as investment declines.

A return to smaller current account deficits requires a rise in saving and/or a fall in investment as a share of GDP. Both of these changes took place during the late 1980s in the United States. Exactly when and how, or even whether,

the present U.S. current account will shrink remains to be seen.

My investment discussion makes clear another critically important point. It is misleading to refer to the United States as a “debtor” nation. A significant share of international investment in the United States is equity investment. International investors who purchased shares of “dot-com” companies do not have to be repaid. Obviously, both domestic and international investors buy assets with the expectation of adequate returns, but may be disappointed after the fact. The important question is not whether investments made in 1999 will have to be repaid, but whether the U.S. investment climate this year and in the future will remain attractive to all investors, both domestic and international.

To date, my conclusion continues to be that the U.S. investment climate remains robust, perhaps surprisingly so given the extent of the stock market decline. Weaker near-term prospects seem not to have dimmed the long-run outlook of

robust growth. Moreover, the dollar remains strong on the foreign exchange markets. It does not appear to me that the U.S. capital and financial account surplus is about to decline sharply. And that is good news rather than bad news.

CONCLUDING COMMENTS

What is clear from my discussion is that the capital and financial account drives the current account. The large U.S. current account deficit in recent years is the result of a large capital and financial account surplus. These annual surpluses reflect a healthy and growing U.S. economy that has provided an excellent environment for investment. A similar comment applies more generally to developed economies that have experienced large current account deficits. An examination of the evidence shows that increased gross private domestic investment is systematically associated with increasing current account deficits. If longer-run U.S. economic growth declines, then it is reasonable to expect the U.S. current account deficit to shrink. However, as long as the fundamentals of the U.S. economy do not deteriorate rapidly, the prospects of a financial crisis are very slim. Thus, my answer to the question posed in the title of this presentation is that the United States certainly does not have a current account deficit disorder.

With respect to my own responsibilities, one fundamental that I see as crucial for a healthy U.S. economy is the control of inflation. An increasing inflation rate complicates the decisions of all economic actors and raises doubts about the real returns on U.S. assets—one of the consequences being that the attractiveness of acquiring and holding U.S. assets relative to foreign assets is reduced. Such a development would cause the capital and financial account surplus to decrease and, thus, the current account deficit would also decrease. Even though some might view such a change in the current account as desirable, the key to assessing the desirability of such a change hinges on the reason for the change. Rising inflation is not a desirable event condition for the U.S. economy.

I hope the perspective I've offered on the U.S. current account deficit is useful to you. If nothing else, remember that it makes no sense to be concerned about that deficit unless you are also concerned about the capital account surplus, because one is a necessary implication of the other. A little accounting can take us far in the direction of focusing on the real issues and not just on that scary word "deficit"!