

THE SHRINKING CURRENT ACCOUNT DEFICIT: A CLOSER LOOK

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St. Louis, Missouri
May 28, 1992

During the 1980s, the U.S. current account balance--a broad measure of our net transactions with foreigners--underwent major changes. From virtually zero in 1980, this account decreased sharply until 1987, when U.S. payments to foreigners exceeded receipts from foreigners by \$160 billion. From then until 1991, the U.S. current account deficit shrank to \$8.6 billion; of course, most analysts view the 1991 deficit as \$51 billion because more than \$40 billion was received by the United States in the form of unilateral transfers from Desert Storm allies. Nonetheless, no matter which number one uses for 1991, the fact is that the current account deficit has diminished significantly in recent years.

What I would like to explore in my brief remarks this afternoon is how we should interpret this change. Is a shrinking current account deficit good or bad?

The standard interpretation is that a shrinking current account deficit is good. Part of this interpretation is strictly psychological, as we tend to view deficits as bad and surpluses as good. As a result, we view the shrinking current account deficit as beneficial because something that is "bad" is being reduced.

Several economic arguments, however, suggest that such a development is good. One revolves around the fact that a U.S. current account deficit reflects purchases by U.S. consumers, business firms, and government that exceed the value of U.S. production. To finance these purchases, the United States must borrow from abroad. Many, of course, view the accumulation of indebtedness to foreigners, which has transformed the United States from a creditor to a debtor nation, as a problem. Some observers have worried, for example, 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 highly unlikely because foreign investors would be driving down their own wealth. Others have worried that increased borrowing by the United States tends to limit borrowing by other, possibly more needy, nations. Still others are concerned about the sustainability of large borrowing from abroad. The market, however, will provide clear signals about sustainability by way of higher interest rates, lower exchange rates and reduced credit availability, none of which we are presently observing.

Related to the issue of sustainability is the fact that the debt must be repaid. If most of the foreign financing is for goods 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 reasonable arguments to support the view that reducing our current account deficit is good.

There is another view, however, one that is based on analyzing current account changes from a slightly different perspective, which leads to the opposite conclusion. To pursue this requires some background information on the current account, as well as its counterpart, the capital account.

The current account is designed to summarize all transactions involving goods or services that take place among U.S. private individuals, businesses and governments and the rest of the world. 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 that stem from these transactions. If U.S. payments to foreigners exceed receipts, then the U.S. is running a current account deficit.

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. 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, which has not occurred since the early 1980s, the United States, on net, is acquiring assets abroad. This difference is termed net foreign investment. On the other hand, when our payments exceed receipts, foreigners, on net, are acquiring assets in the United States. This is termed net foreign saving.

When U.S. residents acquire assets abroad and foreign residents acquire assets in the United States, the transactions are recorded in the capital account of the balance of payments. As a result, our capital account balance must mirror the current account balance for any given time period. But because capital account transactions involve both real and financial assets and reflect foreign direct, as well as portfolio, investment decisions, it suggests that the current account is not driven solely by changes in international trade of goods and services.

In fact, capital account transactions can induce adjustments involving the current account. To illustrate, assume that a foreign firm decides to build a production

facility in the United States. In this case, foreign residents would be increasing their claims on assets in the United States. This net foreign saving would increase our current account deficit, all other things the same, implying a comparable adjustment in underlying components of the current account.

This discussion suggests that insights into changes in the U.S. current account can be made by examining saving and investment behavior both here and abroad. Our total investment needs as a country must be met by a combination of domestic and foreign saving. Domestic saving is made up of private saving less, at least in our case, government dissaving, which is the difference between taxes and spending. Foreign saving is reflected in our current account balance, which would necessarily be in deficit. Accordingly, our current account deficit is equal to the gap between private saving and investment plus the government budget deficit.

Given the preceding identity, what must be happening for the current account deficit to shrink? Focusing first on saving and investment, the current account deficit shrinks if either private saving increases more than investment or private saving decreases less than investment. Generally speaking, private saving and investment are both desirable. Private saving frees up resources that can be used for investment either here or abroad. And gross private domestic investment, which includes the purchases of

durable goods such as business plant, equipment and inventories, is essential for expanding both productive capacity and productivity. Such expansion permits more output to be produced in the future.

Focusing on taxes and government purchases, the current account deficit shrinks when the budget deficit shrinks. In other words, the current account shrinks if either taxes increase more than government purchases or taxes decrease less than government purchases.

Let's examine how investment and saving, including government dissaving, have changed in recent years. Because these variables are related to the level of economic activity, it is helpful to examine recent changes in economic growth in the United States.

A standard finding is that U.S. current account deficits shrink (and surpluses increase) when the U.S. economy is growing more slowly than foreign economies. In recent years, U.S. growth has been slower than that of other developed countries, as well as slower than usual. For example, our annual growth rate was 3.2 percent between 1982 and 1987, but only 0.9 percent between 1988 and 1991. An economy growing below its capacity is certainly disappointing. Moreover, this slower growth, by restraining the growth of imports, has caused the current account deficit to shrink.

Saving and investment have also changed substantially in recent years. Both private saving and gross private

domestic investment as a percentage of gross domestic product have fallen, with investment falling much more than saving. These drops are substantial, especially that of investment which has fallen from 16.5 percent of GDP in 1987 to 12.8 percent in 1991.

Even though I do not claim to know the "best" levels of saving and investment, it is hard to view such changes as desirable. The drop in investment, which is related to many developments including the weak national economy and tax law changes, does not bode well for future U.S. growth. But because investment has fallen relatively more than saving, the current account deficit has decreased.

To complete my analysis, let's look at changes in government dissaving. Generally speaking, when the economy contracts, the government's deficit increases, even if there is no change in the tax rates or spending programs. As incomes fall during an economic contraction, tax revenues fall and government expenditures for unemployment and welfare benefits increase. Likewise, when the economy expands, the government's deficit decreases because tax revenues rise and expenditures for unemployment and welfare benefits decline.

The government deficit as a percentage of GDP shrank between 1986 and 1989. Thus, shrinking budget deficits coincided with shrinking current account deficits in 1988 and 1989. More recently, budget deficits have risen, from 1.6 percent of GDP in 1989 to 3 percent in 1991. This sharp

increase has alarmed many observers and led to proposals to legislate a balanced budget. Overall, the increase in government dissaving in recent years, which tends to increase the current account deficit, has been more than offset by the undesirable changes in saving and investment, thus producing a shrinking current account deficit.

To summarize, one should be cautious in viewing a shrinking current account deficit as an indicator of a healthy economy. It certainly could be if private saving were increasing, government dissaving were dwindling and investment were strong. In fact, however, our alleged "improvement" in the current account deficit has occurred simultaneously with sharp declines in economic growth and investment and a growing government budget deficit. Although these developments, to some extent, reflect the temporary effects of the recession, it is difficult to view them constructively. The moral of the story is that current account deficits are not necessarily good or bad. The important issue is understanding why they exist.