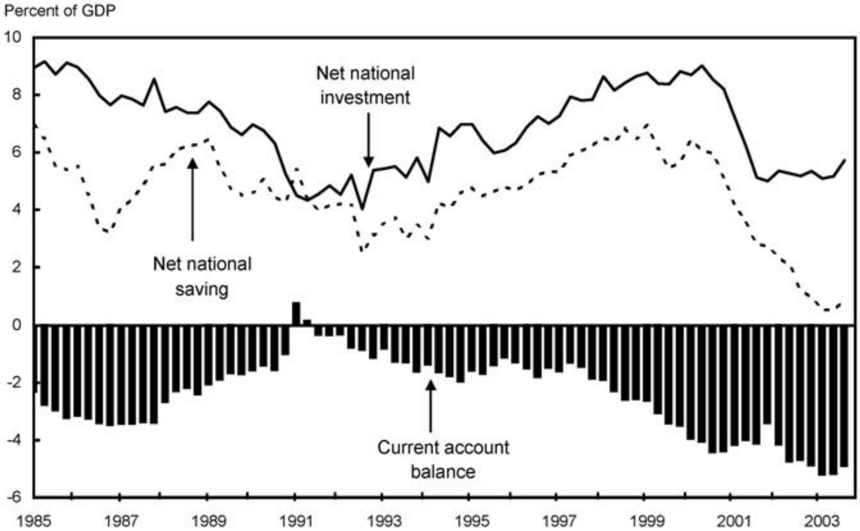
U.S. net capital flows grew from about 1 percent of GDP in 1990 to over 4½ percent of GDP in 2000. This resulted from roughly equal increases in foreign purchases of debt securities, equity securities, and direct investment. This increase in net capital flows into the United States largely reflected the desire of foreigners to participate in higher-return investment opportunities in the United States. The global economic downturn and the collapse of high-tech stock prices and broader equity indices that began in 2000 contributed to a shift in the composition of capital flows in the United States. Foreign investors moved away from foreign direct investment and private equity assets and toward government and corporate bonds. In addition, foreign governments increased their share of these capital flows, although the foreign private sector still accounts for a far greater proportion.

Over the latter half of the 1990s and the early 2000s, the counterpart to the rising U.S. current account deficit has been a growing wedge between U.S. investment rates and U.S. national saving rates (Chart 14-4). The national saving rate in the United States began to decline in 1999, but increased capital inflows allowed U.S. investment rates to remain at a high level through 2000. As discussed in Chapter 1, *Lessons from the Recent Business Cycle*, investment fell substantially after the collapse of the stock market bubble of the late 1990s. In 2001, the decline in investment outpaced a contemporaneous decline in U.S. saving, so that the current account deficit narrowed. U.S. investment has since leveled off while saving remains low, causing a wider U.S. current account deficit. Over the entire period, the availability of foreign investment permitted the United States to maintain higher investment rates than it could have funded relying solely on domestic financing. These capital inflows have helped finance U.S. investments, expand U.S. productive capacity, and strengthen U.S. economic performance.

Factors that Influence the Balance of Payments

A number of underlying economic factors influence the level of and changes in the balance of payments. One of the most important factors is the differential rate of GDP growth across countries. During the late 1990s, the United States grew faster than many of its major trading partners, such as Japan and a number of major European countries. As a result, capital flowed into the United States, leading to a corresponding trade deficit. Even during the recent business-cycle downturn and recovery, U.S. growth rates have exceeded those of many of our major trading partners. This has contributed to the slow recovery in U.S. exports and has helped to maintain continued capital inflows into the United States.

Chart 14-4 **Saving, Investment, and the Current Account Balance**
In the late 1980s, a decline in the investment rate led to a reduction in the current account deficit, while a sharp decline in the national saving rate accounted for the most recent expansion of the deficit.



Source: Department of Commerce (Bureau of Economic Analysis).

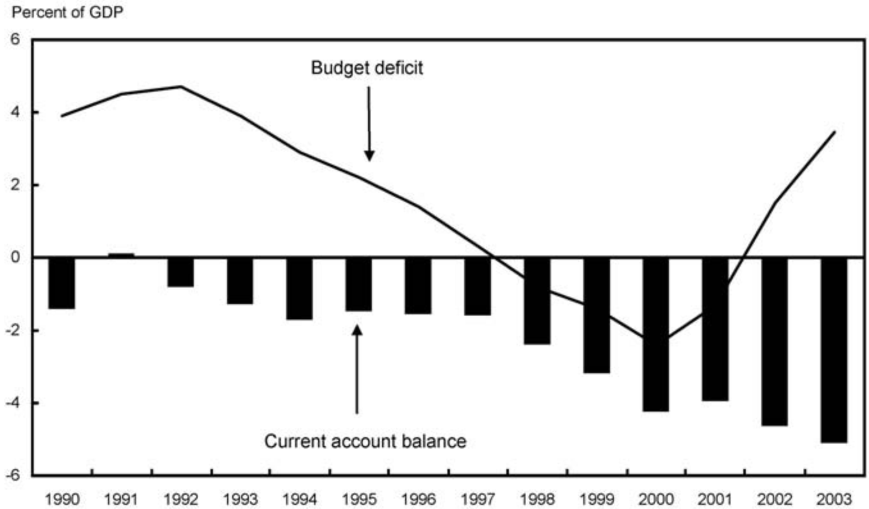
A second determinant of trade and capital flows is the price of domestic goods relative to foreign goods. Relative prices are influenced by a number of factors, including labor and production costs, labor productivity, and exchange rates. For many manufactured products, for example, labor and production costs in developing countries are often below such costs in the United States. As a result, the prices of these goods produced in developing countries may be substantially lower than the price of similar goods produced in the United States. For other products and projects, such as airplanes and the development of new drugs, the availability of factors of production such as skilled engineers may be more important than the availability of low-skilled workers. Exchange rates can also influence relative prices. A depreciation of a country's currency can make its products cheaper and thus more competitive abroad, even if domestic prices do not change. When a country's currency appreciates, domestically produced goods become relatively more expensive in foreign markets.

A third determinant of the direction and size of capital flows is the relative return that investors expect to make in one country compared with another. This return differential can reflect factors discussed earlier, such as relative output growth, labor costs, or exchange rates. This differential can also depend on a country's legal framework, accounting and tax systems, infrastructure, culture, and institutions. The flow of capital into the United States likely reflects a view that the expected risk-adjusted, after-tax return on U.S. assets is higher than the return on similar foreign investments.

These factors—growth rates, relative prices, and rates of return—all drive national saving and investment decisions. Those decisions most directly determine the balance of payments. *National saving* is the sum of *private saving* (saving of households and corporations) and *public saving* (the total saving of Federal, State, and local governments, as reflected in their budget balances). When national saving is less than domestic investment, a country must be borrowing from abroad. This borrowing will be reflected in positive net capital flows and a current account deficit.

Although this suggests that the recent increase in the U.S. budget deficit may be related to the recent increase in the U.S. current account deficit, the historical evidence for a relationship between government deficits and trade deficits is mixed. A number of academic studies suggest that other domestic and international factors are more important influences on current account balances than government deficits. The recent U.S. experience supports this. In the 1990s, the large increase in the U.S. current account deficit occurred while the Federal budget surplus was growing (Chart 14-5). From 1997 to 2000, the U.S. current account deficit increased by almost 3 percentage points. Over the same period, the U.S. budget balance went from a slight deficit to a surplus of 2½ percent of GDP. Since 2000, the U.S. budget has moved into deficit by several percentage points of GDP, but the current account deficit has widened by only about 1 percentage point of GDP. These figures show that the current account and Federal budget do not move in lockstep, and that the government deficit is only one of several factors behind the widening of the current account deficit since the mid-1990s.

Chart 14-5 **Budget Deficit and the Current Account Balance**
The relatively steady decline in the current account balance contrasts with the initial reduction and subsequent expansion of the budget deficit.



Note: Budget deficit data are for fiscal years ending September 30; current account data are for calendar years. Current account balance for 2003 includes data through the third quarter.
Source: Department of Commerce (Bureau of Economic Analysis).

Possible Paths of Balance of Payments Adjustment

The U.S. current account deficit reached about 5 percent of GDP in the first three quarters of 2003. Historically, many countries with sizable current account deficits have experienced reductions in capital flows and corresponding reductions in their current account deficits. Because the U.S. current account deficit and U.S. capital inflows are balanced by trade and capital flows in other countries, any change in the U.S. balance of payments would involve corresponding changes in other countries' flows of trade and capital. The economic implications of any adjustments depend on how it occurs.

An adjustment in the U.S. trade balance could involve a number of domestic and global factors. For example, faster growth in other countries would be expected to increase demand for U.S. exports and narrow the U.S. current account deficit. Slower growth in the United States relative to its major trading partners would dampen U.S. demand for imports and reduce the U.S. trade deficit. Trade flows could also adjust through changes in the relative prices of U.S. goods and services compared to the prices of foreign goods and services. This relative-price adjustment could occur through changes in nominal exchange rates or through different inflation rates in different countries.