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Recent Shifts in Financing the U.S. Current-Account Deficit

When the United States runs a current-account deficit, its spending exceeds its income. Such excess spending is possible only as long as foreigners finance the deficit. That financing is provided by net capital inflows—the total net purchases of U.S. assets by foreign entities, both private and governmental (or "official"). An increase in the supply of such financing helps widen the current-account deficit by boosting the value of the dollar and the prices of U.S. assets (such as real estate, stocks, and bonds), thus enhancing the ability of U.S. residents to make purchases.[1] A decline in the supply of such financing has the reverse effect on the dollar, on U.S. asset prices, and on the current account.

For most of the past decade, foreign investors increased their holdings of U.S. assets substantially, which contributed to the rise of the U.S. current-account deficit. In 2001, however, private foreign demand for U.S. assets began to weaken. In 2002, central banks in several Asian countries stepped up their purchases of U.S. government securities to restrain the downward pressure on the value of the dollar relative to their currencies. Thus, the total supply of foreign financing continued apace. By 2004, the current-account deficit had reached a record level of $668 billion, or 5.7 percent of gross domestic product (GDP).

If official inflows should start to wane while private demand for dollar assets remained weak, there would be downward pressure on the value of the dollar and on the price of U.S. assets. Such a development would help reduce the current-account deficit. However, because private investors still hold the vast majority of foreign claims on U.S. assets, how the dollar and U.S. asset prices evolved would ultimately depend on the decisions made by private investors.

1. A rise in the dollar's value makes imports cheaper (and exports more expensive), while an increase in asset prices boosts U.S. residents' net wealth and their ability to borrow. For a more detailed discussion, see Congressional Budget Office, *The Decline in the U.S. Current-Account Balance Since 1991* (August 2004).

The Rise and Decline of Private Financing

Private capital inflows include direct investments (investments that foreign multinational companies make in their subsidiaries in the United States) and portfolio investments (primarily purchases of U.S. stocks and bonds by foreign individuals and companies, as well as loans extended to U.S. businesses and deposits in U.S. banks). Similarly, private outflows include direct investments that U.S. firms make in their foreign subsidiaries and portfolio investments that private entities in the United States make abroad.

For more than a decade in the United States, private capital inflows have risen more than outflows, and both have grown much faster than the economy. For example, as a percentage of GDP, private capital inflows grew from 1.6 percent to 8.9 percent between 1991 and 2004, while private capital outflows rose from 1.2 percent to 7.3 percent during the same period.

Flows of private capital change in response to expected returns and risks. Capital flows to the United States when investors believe that investments here offer returns that, after adjusting for risk, are larger than those available elsewhere. Foreign investors' demand for U.S. assets is also motivated by the desire to diversify away from their home currencies (and thereby minimize any currency risk inherent in their portfolios) and by the attractiveness of dollar-denominated assets (attributable primarily to the depth and liquidity of U.S. markets, the dollar's role as the main currency for international transactions and transfers, and the U.S. political and legal systems).

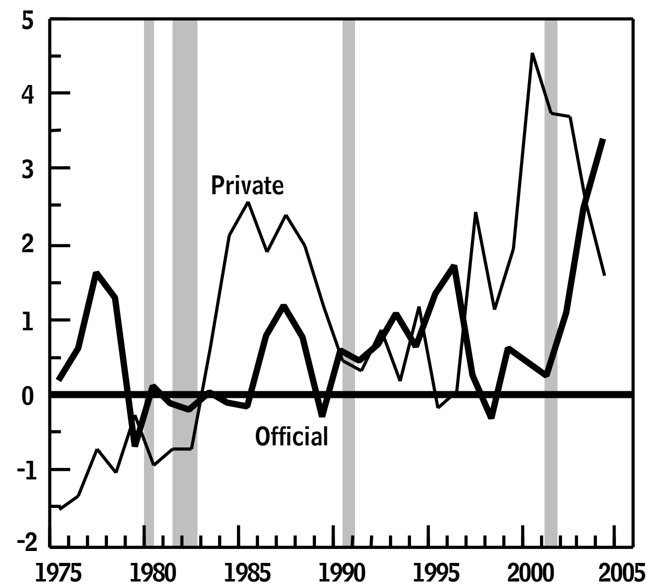
From 1997 to 2000, net private inflows to the United States surged (see Figure 1). That surge reflected a sharp rise in demand for U.S. assets by foreign investors,

prompted primarily by three developments. Financial globalization in recent years—spurred both by progress in information technology and by lowered regulatory barriers on the movement of capital across national borders—has allowed private foreign investors to participate in the U.S. capital market more fully. In addition, a succession of financial crises—the 1997-1998 Asian crisis, Russia's default of 1998, and the Brazilian peso crisis of 1999—undermined confidence in the safety of investments in emerging economies, boosting investors' demand for safer investments in the United States. Finally, the United States sustained a greater rate of productivity growth than other industrial countries did, making it an especially good place to invest. That strong demand from private

Figure 1.

Private Versus Official Net Capital Inflows, 1975 to 2004

(Percentage of gross domestic product)



Source: Congressional Budget Office based on data from the Department of Commerce, Bureau of Economic Analysis.

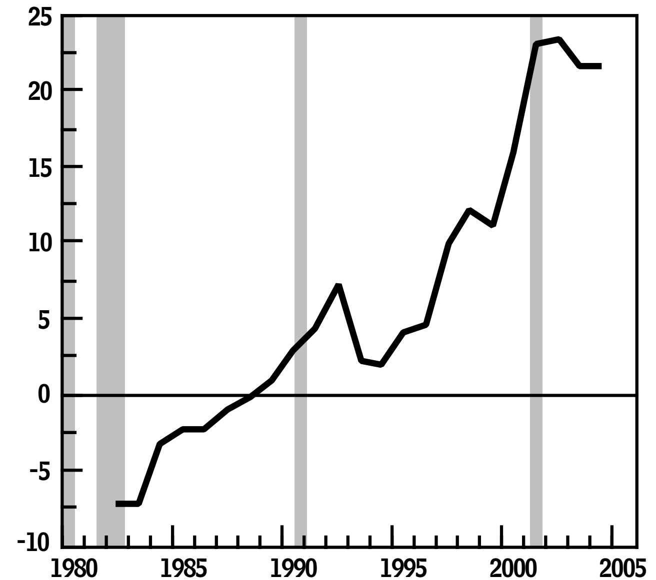
Notes: Net private inflows are the difference between purchases of U.S. (direct-investment and portfolio) assets by foreign individuals and companies and purchases of foreign assets by U.S. individuals and companies. Net official inflows are the difference between purchases of U.S. assets by foreign governments and purchases of foreign assets by the U.S. government.

The figures in this brief use shaded vertical bars to indicate periods of recession. A recession extends from the peak of a business cycle to its trough.

Figure 2.

Net U.S. Assets Held by Foreigners, 1982 to 2004

(Percentage of gross domestic product)



Source: Congressional Budget Office based on data from the Department of Commerce, Bureau of Economic Analysis.

Note: Net U.S. assets held by foreigners are the difference between foreign-owned U.S. assets and U.S.-owned foreign assets. Both are measured using a market-value method.

foreign investors helped enlarge the current-account deficit.

In 2001, however, private foreign demand for U.S. assets began to moderate. By 2004, net private capital inflows had fallen to just $186 billion from a high of $445 billion in 2000 (see Table 1). The slowdown may have resulted from three factors. First, the appeal of the United States as a safe haven may have subsided, as the economies of those countries that had suffered financial crises beginning in 1997 rebounded. Second, after years of acquiring U.S. assets on a steady basis, investors may no longer have needed to add to their holdings as rapidly as they did before to diversify their assets. Finally, investors' concern about the mounting level of net U.S. assets held by foreigners—and the attendant prospects for the further depreciation of the dollar to reverse the current-account deficit—may have reduced the attractiveness of U.S. assets (see Figure 2).

The decline in net private inflows occurred in direct investments. Inflows of those investments fell from

Table 1.

Private and Official Financing of the U.S. Current-Account Deficit, 1990 to 2004

(Billions of dollars)

	Annual Average						
	1990-1996	1997-1999	2000	2001	2002	2003	2004
Current-Account Deficit	**82**	**218**	**416**	**389**	**475**	**520**	**668**
plus							
Statistical discrepancy and other net inflows[a]	9	-43	70	11	25	41	-83
equals							
Total Net Capital Inflows	**91**	**176**	**486**	**400**	**500**	**561**	**585**
Net private inflows	**27**	**160**	**445**	**378**	**388**	**280**	**186**
Direct investment[b]	-21	34	162	25	-74	-73	-145
Portfolio investment[c]	47	126	283	353	461	354	331
Net official inflows[d]	**64**	**15**	**42**	**23**	**113**	**280**	**399**

Source: Congressional Budget Office based on data from the Department of Commerce, Bureau of Economic Analysis.

Notes: Negative numbers denote capital outflows.

Numbers in the tables of this brief may not add up to totals because of rounding.

a. Other net inflows consist mainly of debt forgiveness and transfers by migrants to their home countries. Such inflows are small relative to the statistical discrepancy. A statistical discrepancy could stem from many factors, such as timing differences between the recording of trade flows (exports and imports) and the recording of capital flows corresponding to those trade flows, inaccurate valuation, incomplete reporting, and errors from estimating procedures.

b. Direct-investment inflows are increases in foreign direct-investment assets in the United States, which are a foreign entity's ownership or control of 10 percent or more of the voting shares of a U.S. corporation. Direct-investment outflows are defined analogously.

c. Portfolio-investment inflows are increases in foreign holdings of U.S. stocks, bonds (including Treasury securities), U.S. currency, and other claims on U.S. banks, corporations, and individuals. Portfolio-investment outflows are increases in U.S. holdings of foreign stocks, bonds, and other claims of U.S. entities on foreigners.

d. Official inflows are increases in foreign governments' holdings of assets in the United States. Official outflows are increases in the U.S. government's holdings of assets abroad.

$314 billion in 2000 to $95.9 billion in 2004, while direct-investment outflows rose from $142.6 billion to $229.3 billion during the same period (see Table 2). Virtually all of the decline in inflows was in those from Europe. Most of the increase in outflows went to Asian and Pacific countries, but a significant share went to Europe.

According to preliminary data for the first quarter of this year, net private inflows increased, but it is too early to know whether that reversal will hold.

The Rise of Official Financing

Despite the reduced pace of net private capital inflows, the current-account deficit continued to widen, reaching an unprecedented $668 billion in 2004. Such a development would not have been possible if foreign governments had not substantially increased their official purchases of U.S. assets in 2002, thereby reducing the downward pressure on the dollar and asset prices that the decline in private demand for U.S. assets would otherwise have effected. From 2001 to 2004, net official inflows jumped from $23 billion to $399 billion (see Table 1).

Almost all official purchases of U.S. assets were made by a handful of Asian governments. The increase in those governments' foreign exchange reserves, which mainly consist of U.S. dollar assets, accounted for 77 percent of the increase in the world's reserves from 2002 to 2004 (see Table 3). The increase in Japan's reserves alone accounted for 26 percent of the increase in the world's foreign exchange reserves, while the increase in China's accounted for another 23 percent. Those governments' purchases

Table 2.

Direct Investment Flows into and out of the United States, by Selected Region or Country, 2000 to 2004

(Billions of dollars)

	Flows into the United States					Flows out of the United States				
Region or Country	**2000**	**2001**	**2002**	**2003**	**2004**	**2000**	**2001**	**2002**	**2003**	**2004**
Total[a]	**314.0**	**159.5**	**71.3**	**56.8**	**95.9**	**142.6**	**124.9**	**134.9**	**119.4**	**229.3**
Canada	27.3	9.2	1.9	12.2	31.8	16.9	16.8	15.0	15.0	22.4
Europe	251.0	140.7	46.5	22.7	41.4	78.0	65.6	79.5	81.7	96.8
United Kingdom	82.7	2.8	26.5	-5.6	19.4	28.3	7.9	15.3	24.0	22.9
Latin America and Other Countries in the Western Hemisphere[b]	12.7	8.2	9.4	9.1	0.4	23.2	25.7	15.2	5.5	21.0
Mexico	5.1	-0.7	2.3	2.0	-0.5	4.2	14.2	7.7	4.7	7.4
Asia and Pacific	19.9	2.1	12.3	12.5	22.3	22.4	12.9	23.3	14.1	85.0
China	c	c	c	c	c	1.8	1.9	0.9	1.4	4.2
Japan	7.8	-3.1	6.0	7.8	16.1	4.3	-4.7	8.7	3.1	10.7

Source: Congressional Budget Office based on data from the Department of Commerce, Bureau of Economic Analysis.

a. Direct-investment flows between regions and countries are not available using the same measure as that used in Table 1. However, differences between the two measures of total direct-investment flows are minor.

b. The United Kingdom's territories (primarily Bermuda and islands in the Caribbean) account for most of the direct-investment flows between the United States and other countries in the Western hemisphere.

c. The Bureau of Economic Analysis does not report direct-investment inflows from the People's Republic of China.

were motivated by their attempts to curb upward pressure on their respective currencies relative to the dollar, in hope of preventing a substantial appreciation in their currencies from hurting their economic growth.[2] Other Asian governments, most notably those of South Korea, Taiwan, and Hong Kong, also added to their reserves significantly. Consequently, the dollar dropped less against Asian currencies than it fell against the currencies of other industrialized nations. From February 2002 to December 2004, the dollar fell only about 16 percent against the currencies of a broad set of U.S. trading partners (including those in Asia and Europe), while it fell more than 35 percent against the euro alone.[3]

The Continued Dominance of Private Claims

Despite the substantial net official purchases of U.S. assets in the last several years, the large majority of foreign financial claims on the United States still belong to private investors. Private foreigners' ownership of U.S. assets

2. More than 99 percent of Japan's official foreign exchange transactions from 2002 to 2004 were net purchases of dollar-denominated assets (see data from Japan's Ministry of Finance, available at www.mof.go.jp/english/e1c021.htm). The rise in China's reserves stemmed almost exclusively from its purchases of dollar assets to counter upward pressure on the Chinese yuan and to keep its exchange rate fixed to the dollar. That pressure arose from China's current-account surplus and net private capital inflows. (From 2001 to 2003, China's current-account surplus averaged $33 billion a year, while net private capital inflows averaged $40 billion a year.) See International Monetary Fund, *International Financial Statistics* (Washington, D.C.: International Monetary Fund, May 2005).

3. The change in the trade-weighted dollar is based on the Federal Reserve Board's broad index of the foreign exchange value of the dollar. Asian countries carry a large weight in the calculation of that trade-weighted dollar. In 2005, 12 Asian economies (including Japan's) account for a 41.2 percent weight. For a complete list of countries and their weights, see www.federalreserve.gov/releases/H10/Weights/.

Table 3.

Foreign Exchange Reserves in Asia, 2000 to 2004

	2000	2002	2004	Change, 2002-2004
	Billions of Dollars			
Japan	347	451	824	373
China	166	286	610	324
Hong Kong	108	112	124	12
Taiwan	107	162	242	80
South Korea	96	121	198	77
Other	340	449	663	215
Total	**1,163**	**1,581**	**2,661**	**1,080**
	Percentage of World Total			
Japan	17	18	21	26
China	8	11	15	23
Hong Kong	5	4	3	1
Taiwan	5	6	6	6
South Korea	5	5	5	5
Other	17	17	17	15
Total	**57**	**62**	**67**	**77**
Memorandum:				
World Total (Billions of dollars)	2,048	2,569	3,978	1,409

Source: Congressional Budget Office based on data from the International Monetary Fund and the government of Taiwan.

has risen in importance relative to official foreign ownership since 1982 (when consistent data first became available). For example, in 1982, foreign governments owned 26.1 percent of all foreign claims on U.S. assets, while private foreign entities owned 73.9 percent. By 2000, foreign governments' ownership share had fallen to 11.5 percent, while private entities' share had increased to 88.5 percent (see Table 4). The share of foreign-owned U.S. assets belonging to foreign governments began to rise afterward, but it was only 15.8 percent by the end of 2004.

Although a number of Asian governments have made hefty purchases of dollar assets in the past few years, such official purchases may not continue at those levels in the future. For those governments, increasing the already high share of dollar assets in their reserves would mean heightened exposure to capital losses if their currencies appreciated against the dollar. However, if they tried to sell a portion of their dollar reserves or simply add to them at a much-reduced rate, they might precipitate a larger decline in the dollar—adding to their potential capital losses. How official demand might adjust is not clear because governments in general are guided by multiple policy objectives and typically are not driven by profit motives in the same way that private investors are. Therefore, foreign governments might respond differently to the rising share of dollar assets in their holdings than would private investors.

In the event that official inflows to the United States began to subside, how the dollar and U.S. asset prices adjusted would depend on the behavior of private investors, who hold most of the foreign claims on U.S. assets. If private demand for U.S. assets did not rebound, the decline in overall demand for U.S. assets would most likely exert downward pressure on the value of the dollar and on U.S. asset prices. That development would contribute to a reduction in the U.S. current-account deficit. If private demand for U.S. assets rose again, the dollar and U.S. asset prices could strengthen. That scenario appears to be what has happened over the first six months of this year. As the deteriorating outlook for the growth of major foreign economies helped revive private demand for U.S. assets, prices of those assets have stayed high, and the dollar has appreciated significantly against the euro, even though official inflows have waned.

Table 4.

Distribution of U.S. Assets Held by Foreigners, Selected Years, 1982 to 2004

(Percentage of total, measured by market value)

	1982	1992	2000	2001	2002	2003	2004
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Owned by foreign governments	26.1	15.0	11.5	12.0	13.5	14.7	15.8
Owned by foreign private sector	73.9	85.0	88.5	88.0	86.5	85.3	84.2
U.S. Government	**23.7**	**18.8**	**12.9**	**13.4**	**15.8**	**16.4**	**17.2**
Owned by foreign governments	20.2	12.0	8.6	9.3	10.7	11.3	12.1
Owned by foreign private sector	3.6	6.8	4.2	4.0	5.1	5.1	5.1
U.S. Private Sector	**76.3**	**81.2**	**87.1**	**86.6**	**84.2**	**83.6**	**82.8**
Direct investment	18.0	23.9	31.0	27.6	21.9	23.0	21.5
Stocks (By private foreigners)	10.5	10.3	17.3	15.9	13.5	15.9	15.4
Bonds (By private foreigners)	2.3	10.3	11.9	14.5	16.5	16.0	16.5
Stocks and bonds (By foreign governments)	2.5	1.1	1.1	1.2	1.2	1.5	1.5
Banks	34.9	24.2	14.7	15.8	18.3	19.9	20.6
Other	8.1	11.5	11.1	11.6	12.9	7.2	7.3
U.S. currency	4.3	3.9	2.8	3.0	3.3	3.0	2.7
Memorandum:							
Total							
In billions of dollars	725	2,919	8,982	9,270	9,263	10,669	12,515
As a percentage of U.S. GDP	22.3	46.1	91.5	91.5	88.3	97.0	106.6

Source: Congressional Budget Office based on data from the Department of Commerce, Bureau of Economic Analysis.

Note: GDP = gross domestic product.

This issue brief was prepared by Juann H. Hung. It and other CBO publications are available at www.cbo.gov.