

Federal Reserve Bank of Cleveland

Is the Current-Account Deficit Sustainable?

by Owen F. Humpage

In 1987, after six straight years of large current-account deficits, the United States became a net debtor country. Our deficits have since persisted and our debts have grown—today we owe more than any other country—but the dire consequences predicted by some analysts have not materialized. Old concerns are now reemerging as Asian and Russian financial crises push the U.S. current-account deficit to new record levels. It reached \$220 billion (annual rate) over the first three quarters of 1998, raising our debts to more than 17 percent of GDP. How long can we continue to service our growing international indebtedness without a sharp hike in U.S. interest rates, a rapid depreciation of the dollar, or some other economic disruption?

No economist can answer precisely. Instead, this *Economic Commentary* provides a basic explanation of the current-account adjustment process. It offers some fundamentals that will enable the reader to form opinions about the state of affairs and to estimate, albeit subjectively, the probabilities of possible outcomes.

■ Current Accounts and Capital Flows

The U.S. *current account* records exports and imports of goods and services, unilateral transfers (that is, gifts), U.S. earnings on investments abroad, and income payments to foreigners from their U.S. assets.¹ All of these items represent claims on current economic resources, in contrast to the components of the *capital account* (discussed below), which represent claims on future output.

Analysts often refer to the current account as a measure of international trade, although it includes other components. Trade items are by far the largest category within the current account, and changes in our trade position seem to dominate its movements (see figure 1). The U.S. trade balance has been in deficit almost continuously since the early 1970s, despite a surplus in services. This deficit narrowed somewhat in the late 1980s, but has expanded again since 1991 because of relatively strong U.S. economic growth and the dollar's real (inflation-adjusted) appreciation. In addition to the trade deficit, a growing negative balance on investment income since late 1996 has contributed to the widening of the current-account deficit.

The deficit's persistence indicates that the United States has not exported goods and services of sufficient value to pay for its imports. To settle our balance, we have given foreigners financial claims against our future production and have reduced our claims against their future output. This process, through which foreigners acquire such things as stocks, bonds, and bank accounts that U.S. residents previously held, creates an inflow of foreign capital, or, more precisely, of foreign savings. Demonstrating the most basic fact of economic life—that one never gets something for nothing—an equivalence always exists between any current-account deficit or surplus and a capital inflow or outflow (see table 1).²

In the previous paragraph, I described our capital flows as responsive to developments in the current account. The U.S. imported a surfeit of foreign goods, and this caused an inflow of foreign capital. The process can—and often does—work the other way around, with capital

The U.S. current-account deficit for 1998 will break all records, adding still more to our international indebtedness. Our persistent shortfalls imply neither profligacy nor an unstable economic situation. On the contrary, foreign borrowing has enhanced our economic well-being. As our debt burdens mount, however, so does the potential for an abrupt market correction.

flows initiating changes in the current account. For example, if foreigners want to purchase U.S. financial instruments exceeding the amount of foreign financial obligations that Americans want to hold, they must pay for the excess with shipments of foreign goods and services. As in the earlier example, an inflow of foreign capital to the United States is associated with a U.S. trade deficit.

Billions of individuals make these independent decisions about exporting, importing, and investing in foreign financial instruments. As *conceived*, their various transactions rarely, if ever, balance; but as *executed* and *recorded* in our international accounts, they will always exactly net out. Exchange- and interest-rate changes ensure their equivalence. The current financial situation is a case in point. Since 1996, international investors have moved substantial funds into U.S. financial securities. To do so, they first acquired dollars, thereby encouraging the dollar's 15-percent appreciation in foreign exchange markets.³ This appreciation, however, fostered a deterioration in our current-account deficit from \$129 billion in 1995 to \$220 billion in the first three quarters of 1998. It also may have blunted the desire for U.S. financial assets by raising their foreign currency prices. In addition, foreign acquisitions of U.S. financial assets tend to lower their yields compared to what they otherwise would have been. Declining yields trim desired capital inflows and discourage domestic saving. These exchange- and interest-rate adjustments continue until the actual trade deficit and foreign capital inflows exactly match. In my example (and in all other cases) exchange- and interest-rate changes do not eliminate a trade imbalance. These adjustments continue only until the trade deficit (or surplus) and capital-account inflow (or outflow) equilibrate.⁴

■ Perpetual Debt

As recent U.S. experience illustrates, countries with persistent current-account deficits eventually become debtors (see figure 2).⁵ The mere existence of these debts indicates neither profligacy nor an unstable economic situation. As long as creditors judge us capable of servicing our debts—paying interest and retiring principle—on a timely basis, they will continue to lend. Under such circumstances, the United States could maintain its debtor status forever.

Since our capacity to service our obligations depends on our ability to produce, analysts often gauge our creditworthiness by the ratio of international indebtedness to GDP. The higher that ratio, the greater the likelihood of debt-servicing problems; at some upper bound, international investors will refuse to lend to the United States.

Although our international debts have mounted rapidly since 1986, they equaled only about 16 percent of GDP in 1997 and are unlikely to top 19 percent in 1998. Economists simply do not know how high the ratio can rise before foreign investors associate significant default risk with it; however, Canada and Australia have carried debt burdens roughly three and five times larger than ours for many years, apparently without dire economic consequences. In 1996, for example, Australia's international indebtedness amounted to nearly 60 percent of its GDP, and Canada's approached 45 percent. There is no economic argument to preclude ours from exceeding 100 percent.

If U.S. indebtedness keeps rising relative to GDP, however, international investors will eventually become skittish about holding additional U.S. debts. Then, to entice them into purchasing additional financial claims, the return on those securities must rise enough to provide a premium against a growing risk of default. This would involve a depreciation of the dollar relative to its long-term equilibrium, a rise in U.S. interest rates relative to foreign ones, or some combination of both. The greater the debt-to-GDP ratio, the larger the risk premium is likely to become. Besides compensating foreign investors for a higher probability of default, these exchange- and interest-rate adjustments would tend to discourage further expansion of the current-account deficit. Whether the adjustments are orderly or abrupt depends on how quickly foreign attitudes about holding our debt might change.

During 1996 and 1997, appreciation in the effective dollar exchange rate accompanied a sharp expansion of the U.S. current-account deficit. As noted before, this situation suggests that capital inflows were driving the trade deficit and seems inconsistent with the view that international investors are uneasy about holding dollar assets. The chances of an abrupt financial adjustment to our widening deficits and debt are currently small, but they are growing.

TABLE 1
U.S. BALANCE
OF PAYMENTS
(Billions of dollars)

	1991	1998	Change
Current account	-4	-220	-216
Capital flows	52	226	174
Official reserves	23	-66	-89
Other U.S.			
government	3	-1	-4
Direct investment	-9	-32	-23
Securities	24	251	227
Other nonbank	8	48	40
Other bank	3	27	24
(Discrepancy)	-47	-7	40

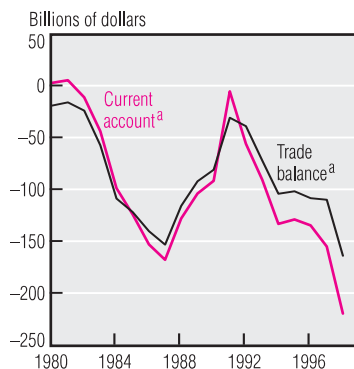
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

■ Debt Dynamics

Even if our trade account were to balance permanently, our overall debt-to-GDP ratio could keep growing if the interest costs of servicing our existing liabilities to foreigners (which affects the ratio's numerator) exceeded our rate of economic growth (which determines its denominator). Our liabilities to foreigners, of course, equal their assets in the United States. One would expect the rate of return on these assets to approximate our growth rate over the long term, making this concern seem rather inconsequential for the debt-to-GDP ratio.

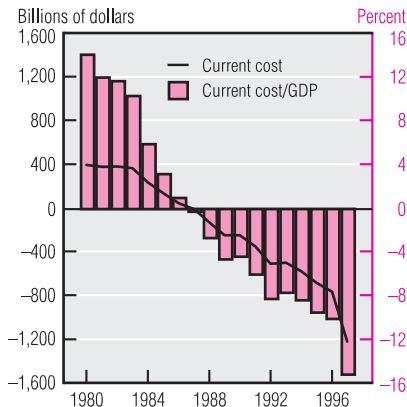
The prospect, however, illustrates an important problem of persistent trade deficits and a rising debt burden. If, at some point, foreign investors demand a risk premium that pushes the interest cost of our foreign liabilities above the economy's growth rate, maintaining solvency could require us to run a trade surplus. Events in many emerging-market economies have shown that shifting rapidly from a large trade deficit to a trade surplus can force some rather unpleasant outcomes: reduction in domestic consumption, investment, and government spending, along with a rapid real depreciation of the dollar to spur exports. As the next section suggests, these adjustments must alter the relationship between gross domestic savings and gross domestic investment to shift the trade balance.

FIGURE 1 CURRENT-ACCOUNT BALANCE AND TRADE BALANCE



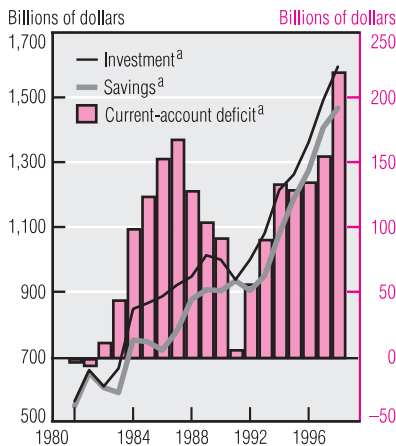
a. Through 1998:IIIQ.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

FIGURE 2 INTERNATIONAL INVESTMENT POSITION



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

FIGURE 3 DOMESTIC INVESTMENT AND SAVINGS AND CURRENT-ACCOUNT DEFICIT



a. Through 1998:IIIQ.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

■ Savings, Investment, and the Current Account

As our GDP accounts indicate, the value of a nation's output must exactly equal that of its income and must exactly equal the combined value of its consumption, investment, government spending, and net exports. A country that incurs a current-account deficit is absorbing (through private consumption, investment and government spending) more of the world's output than it is producing. Such a country's spending necessarily exceeds its income. Imports of goods and services make up the difference between that country's absorption of goods and services and its production of them, while inflows of foreign capital (savings) fill the gap between its domestic spending and its income. As noted earlier, changes in interest rates and exchange rates ensure that these items always equate.

While these relationships are tautological, the manner in which the components add together can sometimes provide an important clue about the sustainability of the current-account deficit. If, for example, an increase in net domestic investment accompanies the current-account deficit, then foreign savings are financing an expansion of the domestic capital stock and will promote a higher level of output per capita. In this case, servicing and eventually retiring foreign debt need not require a reduction in future standards of living. Higher output supports higher levels of consumption and savings, the second of which can go towards servicing international debts. It matters little that the debt-to-GDP ratio may initially be very high, since an automatic process exists for its reduction. This scenario, which many development economists see as ideal for emerging markets, makes default unlikely.⁶

If, on the other hand, a decline in national savings accompanies an increase in the current-account deficit, then the inflow of foreign savings is financing higher levels of domestic consumption and government spending than would be reached in the absence of trade. To service international debt, citizens of the deficit country must eventually reduce their consumption below predeficit levels. In such a case, the ratio of debt to GDP becomes a better barometer of the possibility of default. This unfortunate scenario, which is often the outcome in developing economies, encourages default.

Since 1993, capital inflows associated with expanding U.S. current-account deficits have been accompanied by an even bigger increase in domestic savings, both public and private (see figure 3). Together they have financed an enormous expansion of domestic investment. This situation reduces the risk that servicing our widening debts will impose an exorbitant burden on future U.S. standards of living; it thereby decreases the likelihood that foreign creditors will impose a risk premium on our future borrowing.

■ Big Country, Small Country

My analysis so far has considered the sustainability of mounting U.S. international indebtedness from the perspective of our ability to service our obligations in a timely way. It has, therefore, focused on our debt-to-GDP ratio. For a small country, that perspective would suffice to explore the economic and financial aspects of debt; for a large country, like the United States, it provides an incomplete picture. U.S. liabilities equal slightly more than one-third of the assets of the major developed countries.⁷ Since 1989, this ratio has fluctuated but has not changed much on balance. If our international indebtedness should rise relative to the world's total financial assets—increasing the worldwide demand for credit faster than the supply—global interest rates would undoubtedly rise.

In that case, the higher interest costs associated with our outstanding obligations might push our debt-to-GDP ratio upward, even if the noninterest part of the debt remained stable as a fraction of GDP. The debt dynamics could again become precarious, eventually increasing the chances of a substantial risk premium. For a country the size of the United States, the sustainability of a current-account deficit depends on the debtor's capacity to service its debts and on the world's ability to finance them.

■ Debt and Welfare

The U.S. current-account deficit and international indebtedness are likely to rise sharply over the next year or so. This will undoubtedly alarm many observers, some of whom may clamor for a policy response. Pundits and policymakers should remember, however, that our international indebtedness is a market outcome, reflecting in the aggregate the choices made by millions of

individuals throughout the world. It involves a sequence of transactions whereby debtors receive additional resources today and creditors increase their opportunities for future consumption. The interest rates and exchange rates underlying these transactions were not established by fiat; they were determined by the market. This is not to say that the potential for an abrupt market correction—a sharp depreciation of the dollar or a rapid rise in U.S. interest rates—will not increase with our indebtedness. Instead, it emphasizes that our indebtedness has enhanced our welfare.

■ Footnotes

1. The \$220 billion (annual rate) current-account deficit in the first three quarters of 1998 resulted from a \$166 billion deficit in goods and services trade, a \$39 billion debit associated with unilateral transfers to foreigners, and a \$15 billion debit from net interest and dividend payments to foreigners.

2. As table 1 indicates, measurement errors create an unfortunate discrepancy between these accounts.

3. The dollar's appreciation is based on a trade-weighted average of the exchange rates of our top 15 trading partners. See Federal Reserve Bank of Cleveland, *Economic Trends* (August 1998), p. 19. *Economic Trends* also provides frequent updates.

4. When the current account expands, the dollar can move in either direction. As shown in the example used here, when an inflow of foreign capital initiates the adjustment to a higher current-account deficit, the dollar appreciates. When an increase in imports produces a higher current-account deficit, the dollar depreciates. See Owen F. Humpage, "A Hitchhiker's Guide to Understanding Exchange Rates," Federal Reserve Bank of Cleveland, *Economic Commentary* (January 1, 1998).

5. Figure 2 shows the difference between the stock of U.S. holdings of foreign assets and the stock of U.S. liabilities to foreigners, a capital balance. The title of figure 2 follows the official designation for this series, which erroneously suggests flow (or change in) investments each year. See U.S. Department of Commerce, *Survey of Current Business*, vol. 78, no. 10 (October 1998), p. D57.

6. Often, however, capital inflows to developing countries augment domestic savings but are channeled into unproductive investment projects.

7. These figures are based on a comparison of U.S. international liabilities with the total international assets of Australia, Austria, Canada, Finland, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, and the United Kingdom. The data are from the International Monetary Fund, *International Financial Statistics*.

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