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Federal Reserve Bank of Cleveland

A Hitchhiker's Guide to the U.S. Current Account Problem

by Owen F. Humpage

The U.S. current account deficit reached a record \$664.8 billion in the second quarter, renewing fears of a flight from the dollar with wrenching consequences for U.S. economic prosperity. There is, of course, nothing intrinsically wrong with a country running a current account deficit, and as the global economy becomes more closely integrated, we should see countries sustaining large, persistent current account deficits and surpluses. But the United States has run a nearly unbroken string of current account deficits for 20 years, and, as a by-product, the world now holds an unprecedented amount of financial claims against the United States. Many fear that foreigners are becoming saturated with these claims and worry that with U.S. current account deficits likely to continue, a correction is surely in the offing.

This *Economic Commentary* offers a hitchhiker's guide to the U.S. current account problem for those who want to follow along, but are not inclined to take the wheel. I show how foreigners finance our propensity to import, stopping long enough to make the connection between our budget and current account deficits. I explain why growing current account deficits and expanding inflows of foreign savings are not indefinitely sustainable, and why big deficits imply big corrections. Throughout the trip, however, I emphasize that we simply have no basis for determining when, how fast, or how jarring any adjustment might be. Those who claim a definitive word on that topic may just be spinning their wheels.

■ Basic Relationships

In running a current account deficit, the United States uses more of the world's output than it produces, and we import more goods than we export (figure 1). In exchange for the extra imports, we offer the rest of the world financial claims against our future output. We will gladly pay tomorrow for output today.

These financial claims consist of stocks, bonds, Treasury issues, bank accounts, and other types of securities. Private individuals and organizations hold most of these claims, but foreign governments, their central banks, and international organizations often take up a good portion.

The issuance of financial claims creates a net flow of foreign savings into the United States that, absent measurement error, exactly equals our current account deficit. Even though millions of people make independent decisions about trade and unconnected choices about which financial instruments to buy, if their actions do not match up, a whole host of economic parameters—exchange rates, interest rates, prices, etc.—will adjust to pull them into alignment. This balancing act occurs, as Adam Smith observed, as if directed by an invisible hand.

I have discussed the basic correspondence between current account balances and net financial flows as if the latter responds to the former, but this need not be the case. Changes emanating from either set of transactions will produce responses in the other. In the late 1990s, for example, net financial inflows grew in response to attractive financial opportunities in the United States, causing a

The United States has run a current account deficit for the past 20 years, and, as a consequence, foreigners now hold unprecedented financial claims on the United States. At some point, foreigners will become reluctant to hold these claims and will set into motion a series of corrective economic adjustments. This *Economic Commentary* describes the interaction between our current account deficits and the broader economy and explains the problem that continued deficits pose.

dollar appreciation that then helped to widen the current account deficit. At that time, the current account deficit adjusted to the growing financial inflows.

We can often get a basic idea about which set of transactions dominates the adjustment process by observing the relationship between changes in the current account deficit and movements in the dollar. As noted above, when the impetus starts with a financial inflow, the dollar appreciates and the current account deficit widens. But, when a widening current account deficit—responding, for example, to domestic aggregate demand growth—leads the process, the dollar moves in the opposite direction. If we buy more goods and services from abroad than we sell, we add dollars to the foreign exchange market and cause the dollar to depreciate. This in turn makes our financial instruments more attractive to foreign savers.

FIGURE 1 CURRENT ACCOUNT BALANCE

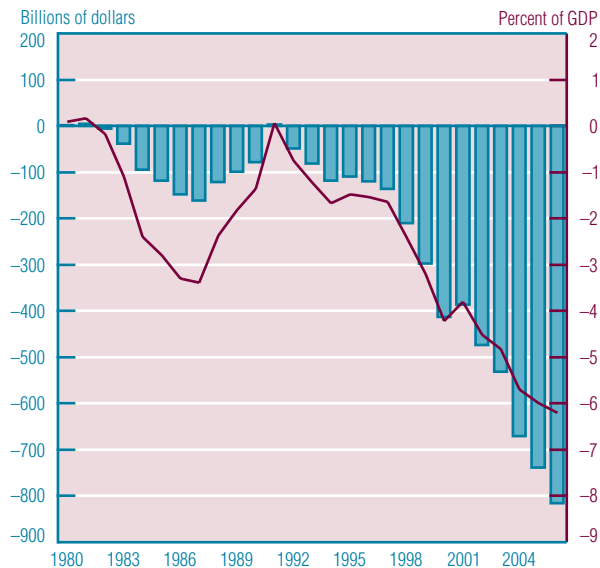
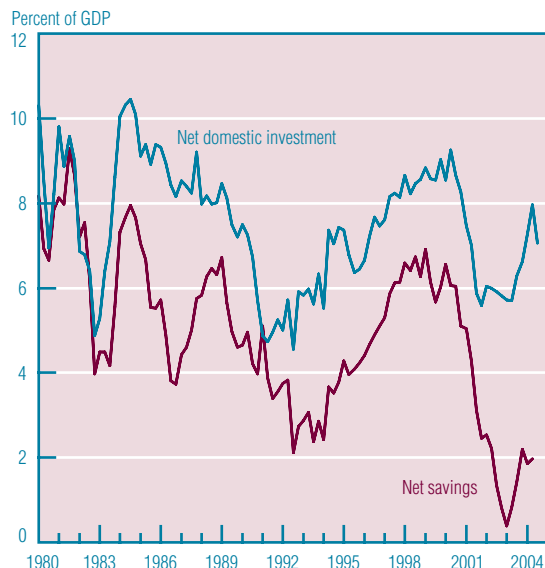


FIGURE 2 SAVINGS AND INVESTMENT



NOTE: Data plotted for 2005 and 2006 are based on the author's estimate.

■ The Twin Deficit Problem

Extending these fundamental international relationships just a bit more establishes a potentially important link between the U.S. current account and budget deficits. When the government budget deficit rises, as it recently has, it often raises alarm, even though budget deficits have usually remained a minor sidebar to the U.S. current account problem. The alarm is not wholly misplaced; under some circumstances a growing budget deficit could increase the current account deficit.

When foreigners hold net financial claims on the United States, their savings do not sit idle in U.S. bank accounts, corporate coffers, or the Treasury. Americans tap these funds to finance investments and consumption. Consequently, a country that runs a current account deficit and experiences an inflow of foreign savings will find that its domestic investment exceeds its domestic savings by exactly that amount, assuming no measurement error (figure 2). Net domestic investment in the United States currently amounts to approximately 8 percent of GDP, while net domestic savings equals roughly 2 percent of GDP. The 6 percent difference equals the ratio of the current account deficit (and net foreign financial inflows) to GDP.

Since federal, state, and local governments finance their budget shortfalls by issuing debt instruments to savers, budget deficits—all else constant—reduce

the amount of private savings available to finance private investment in the United States and put upward pressure on interest rates. Attracted by the prospect of higher yields, foreigners channel their savings into the United States and fill the growing wedge between domestic investment and savings. In the process, aggregate demand also expands, causing the current account deficit to widen. Many economists refer to this connection as the “twin deficit problem”—a wider government budget deficit leads to a wider current account deficit, all else constant.

But all else rarely stays constant, and there is the rub. While this connection is logically straightforward, economists have not mustered much empirical support for it, because widening U.S. budget deficits set off all sorts of economic reactions. If, for example, budget deficits result in higher interest rates, private investment might fall and private savings might rise with constant or even smaller current account deficits. Between 1992 and 2000, for example, the total federal, state, and local budget balance shifted from a deficit of \$297 billion to a surplus of \$239 billion, but the current account deficit widened by over \$365 billion, instead of falling as the twin-deficit story predicts.

One should not take comfort in the fact that the connection between the budget and current account deficits is empirically tenuous. Governmental spending, taxing, or borrowing policies that raise

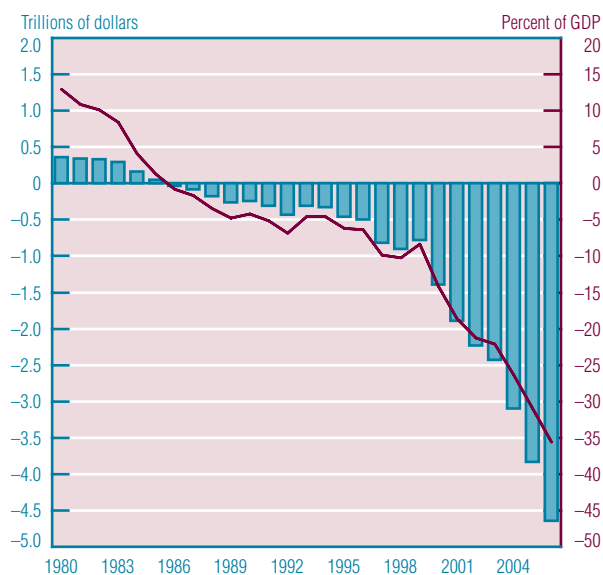
interest rates, lower domestic investment, and slow economic growth could impede our ability to sustain our current account deficits.

■ Sustainability

The U.S. current account deficit has grown over the past 20 years, irrespective of the government's budget position, and, in the process, foreign savers have accumulated a growing stock of financial claims on the United States. Since 1986 foreigners have held more financial claims on the United States than U.S. residents have held against them, and in 2003, the latest available data, foreigners held net claims against the United States exceeding \$2.4 trillion. Given current projections for the current account deficit, this number could easily top \$4.0 trillion by the end of 2006.

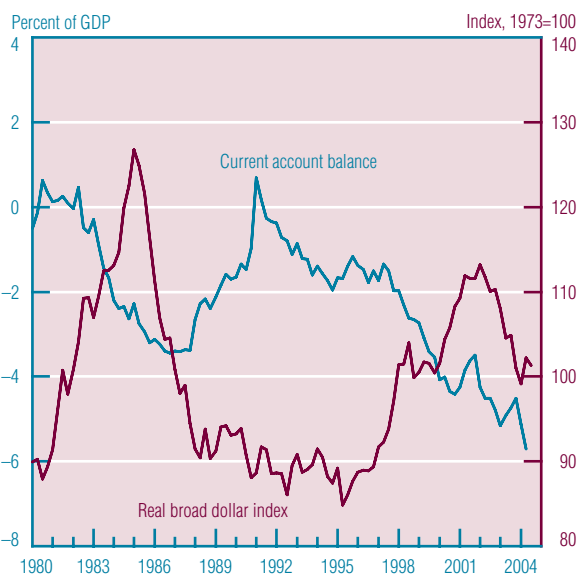
When foreigners hold more claims against the United States than we hold against them, our country's net international investment position turns negative (figure 3). Because these financial instruments ultimately represent claims to our future output, economists typically gauge our net international investment position as a percentage of our GDP. What matters is not the net dollar amount of outstanding financial claims on the United States, but their size relative to our ability to service them—their ratio to GDP. This ratio, which has expanded quite sharply since 2000, reached a record 22 percent of GDP in 2003 and will probably approach 35 percent of GDP by 2006.

FIGURE 3 NET INTERNATIONAL INVESTMENT POSITION



NOTE: Data plotted for 2004, 2005, and 2006 are based on the author's estimate.

FIGURE 4 CURRENT ACCOUNT BALANCE AND THE REAL EXCHANGE RATE



Whether this percentage is particularly big or small is unclear. More important than the ratio is the disconcerting direction and speed in which it is headed. Since our negative net international investment position represents a foreign claim to our future output, the ratio cannot fall (become a bigger negative number) indefinitely as a share of GDP. As foreign portfolios become heavy with dollar-denominated financial instruments, global investors will eventually grow uncertain about our ability to smoothly service these claims and increasingly reluctant to hold them in their portfolios without compensation for the growing risks of doing so. When this starts to unfold, the dollar will depreciate, and U.S. interest rates will rise. These adjustments—dollar depreciation and higher interest rates—will increase the prospective return on dollar-denominated claims, compensate for the risks, and discourage further foreign diversification out of them.

When observers ask if the current account deficit is sustainable, they are really questioning when and how fast these adjustments might take place, implying concern for their potential economic consequences. Higher interest rates will narrow the gap between domestic investment and savings by reducing the former and encouraging the latter. Domestic consumption then should slow. At the same time, the dollar's depreciation will narrow the U.S.

current account deficit by raising the dollar price of imports and lowering the foreign-currency price of exports. This adjustment should encourage foreigners to buy more of our goods. To completely stop net foreign claims against the United States from expanding relative to GDP, however, the current account deficit must pretty much disappear. So the bigger our current account deficit grows, the larger the potential interest and exchange rate adjustment could be. A large, very rapid dollar depreciation and interest rate rise might put the economy into a bit of a tail pin, with less investment, lower consumption, and rising import prices. A smooth, prolonged adjustment, on the other hand, might be barely perceptible.

Unfortunately, economists have no scientific basis with which to determine when and how fast this adjustment might be. While we are sure that our negative net international investment position cannot expand indefinitely relative to GDP, we simply do not know if the trigger point for rapid diversification out of dollar assets is 30 percent, 50 percent, or even 100 percent of GDP. Cases of large developed countries in similar circumstances are few and not necessarily comparable to the United States. Moreover, the U.S. dollar's fairly unique position as the world's key international currency limits the prospects of foreign diversification.

Although the dollar has depreciated substantially since it peaked in February 2002, portfolio diversification out of dollar-denominated assets has not been the main driving force (figure 4). As suggested above, portfolio diversification will prompt a narrowing of the current account deficit; instead, our deficit has widened. The present pattern—dollar depreciation and a widening current account deficit—suggests that the U.S. balance of payments is primarily adjusting to faster aggregate demand growth in the United States than abroad. Until foreign economic growth substantially exceeds U.S. economic growth, which seems doubtful in the next year or so, the current account deficit is destined to expand as Americans continue to buy more from abroad than the rest of the world buys here. Foreign savings will flow in, and U.S. investment will exceed domestic savings.

■ Are the Risks Rising?

Growing global interdependence, which ultimately allows us to consume more than we produce and to invest more than we save, also increases our vulnerability to world events. What matters to foreign investors is a credible promise to repay their claims. This promise implies that at some point in the future Americans must either increase their production, slow their consumption, or both to meet their growing obligations. Anything that reduces the long-term growth prospects

in the United States—inappropriate fiscal and monetary policies, prolonged war, adverse economic shocks—increases the difficulty of financing our outstanding claims. Events that do so raise the chances that foreigners will shy away from dollar assets at lower ratios of those outstanding claims to GDP, say, 35 percent of GDP, than at higher ratios, say, 50 percent or 100 percent. This prospect will become even more important as growth abroad strengthens.

During most of the 1990s, rapid growth in domestic savings and investment accompanied the expanding U.S. current account deficit (figure 2). The corresponding inflow of foreign savings helped to finance a U.S. investment boom that contributed to productivity and increased our country's long-term growth potential. In a sense then, the inflow in foreign savings fostered conditions that could eventually ease the future burden associated with servicing them, and foreigners were not sensitive to the sharp rise in the net international investment position relative to GDP. With a return to these circumstances,

which may now be tentatively taking hold, a continued rise in net foreign claims, even relative to GDP, might not rattle investors. A decline in investment and a further decline in savings, however, could have the opposite effect.

Uncertainty is not much of a palliative, but uncertainty pervades this issue. Economists are pretty sure about where we are heading, but we simply do not know when the journey might commence, how quickly we might get there, or how rough the road might be.

■ Recommended Reading

For more on current account sustainability and additional references:

Owen F. Humpage, 2001. "International Financial Flows and the Current Business Expansion." Federal Reserve Bank of Cleveland, *Policy Discussion Papers*, No. 2.

For an excellent related discussion of foreign official dollar portfolios: Matthew Higgins and Thomas Klitgaard, 2004. "Reserve Accumulation: Implications for Global Capital Flows and Financial Markets," Federal Reserve Bank of New York. *Current Issues in Economics and Finance*, 10(10).

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