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# Current Issues

## The U.S. balance of payments: wide-spread misconceptions and exaggerated worries

- The U.S. balance of payments is by far the most confusing and least understood area of the U.S. economy. The confusion is centered around the large and rapidly growing deficits. Indeed, the deficit on the current account of the balance of payments rose to new records, both in absolute and relative terms.
- These developments created worries and fears regarding the sustainability of the external deficits. However, closer examination of the issue shows that the worries and fears are exaggerated and, most importantly, there are no short- and medium-term solutions because of a number of structural reasons.

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The U.S. balance of payments is by far the most confusing and least understood area of the U.S. economy. The confusion is centered around the large and rapidly growing deficits. Indeed, the deficit on the current account of the balance of payments rose from USD 474 billion in 2002 to USD 531 billion in 2003 and is estimated to reach over USD 600 billion in 2004 (see table 1). In relative terms, the deficits amount to 4.5%, 4.9% and 5.3% of GDP, respectively, in those years. Both in absolute and relative terms, these are all-time records.

### The sustainability of external deficits

Persistent and rising external deficits have attracted increasing attention of politicians, economists and the media. Needless to say, the deficits are generally viewed as highly negative for the U.S. economy and U.S. financial conditions. The main points of concern are:

- Rising foreign indebtedness that might create financial difficulties over time.
- A potential massive dollar depreciation needed to rectify the situation.
- In an extreme case, a financial crisis as foreigners refuse to finance U.S. deficits and switch their capital to other places.

The media, regardless of their political outlook, have been commenting on the U.S. external deficits for quite some time, spreading fear and predicting all sorts of calamities, which apparently sells newspapers well. About five years ago, in the fall of 1999, The New York Times ran an article with a pointed headline: "The United States sets a record for living beyond its means;" and a Barron's article talked about a current account crisis and a ticking time bomb.

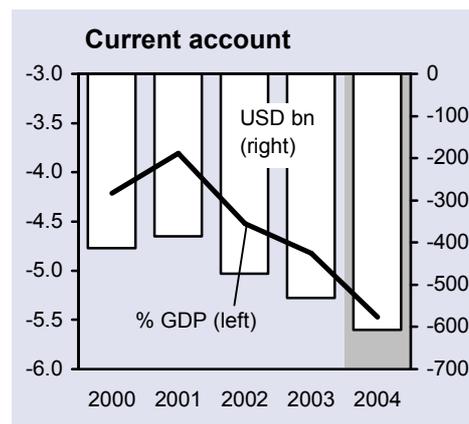
Had these scary predictions materialized, the U.S would have been bankrupt by now. But never mind, the fascination with the rising deficits continues. A Financial Times article a few weeks ago was headlined: "America is now on the comfortable path to ruin."

The persistence of external deficits and their presumable negative effects have focused the economic debate on the key question. Are the deficits sustainable? A generally uniform answer is that not, that they are not sustainable. The Federal Reserve chairman Alan Greenspan has repeatedly emphasized that he does not believe the deficits can go on indefinitely. But he confessed that he does not know when will they stop. And he admitted that so far the financial markets have coped very well with the global payments imbalances.

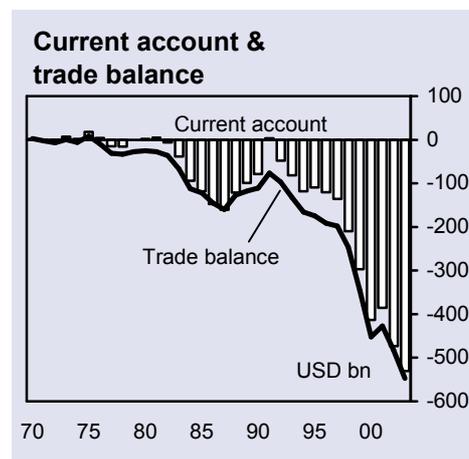
The late Herbert Stein, a great economist with a great sense of humor, had famously said that if something cannot go on forever, it will stop. The logic of this reasoning is unassailable. However, 2004 will be the 29<sup>th</sup> consecutive year of trade deficits and (disregarding the statistical aberration in 1991 when foreign contributions to finance the Gulf war produced a small surplus) the 23<sup>rd</sup> consecutive year of current-account deficits. But during this period, the U.S. enjoyed a generally prosperous economy, especially during the decade of the 1990s when the economy went through an unprecedented boom.

So maybe Stein's saying should be reversed – if a trend goes on for a long time, and it not only does not have any harmful effects but, on the contrary, coincides with a period of prosperity, it may well be sustainable.

One-liners aside, there is an apparent conflict between theory and empirical evidence. To address the contradiction between theoretical and empirical considerations, it is necessary to examine the



### Scary media predictions have so far not materialised



following key aspects of the U.S. balance of payments: a) the nature and underlying causes of the deficits, b) the financing of the deficits, c) main characteristics of U.S. foreign debt, and d) the role of the dollar in dealing with the external deficits.

## Main characteristics of U.S. external deficits

When analyzing the external deficits, it is essential to distinguish between cyclical and structural deficits. **The cyclical deficits** are non-controversial and easy to understand. They result from the disparity in economic growth between the U.S. and its main trading partners, with the U.S. showing stronger growth. This generates increased demand for imports while U.S. exports are hampered by slower growth abroad.

Over the past 20 years, the U.S. has shown generally strong economic performance (except for two brief and shallow recessions in 1991 and 2001), superior to most other industrial countries. It is, therefore, not surprising that this coincided with rising trade and current-account deficits. Indeed, while in 1983 the current-account deficit amounted to 1.1% of GDP, it has risen to about 5% in the last two years.

How long this strongly rising deficit trend would last? It is difficult to predict with any certainty. Yet, although the trend has been cyclically driven, it has certain permanent characteristics rooted in demographic and productivity aspects.

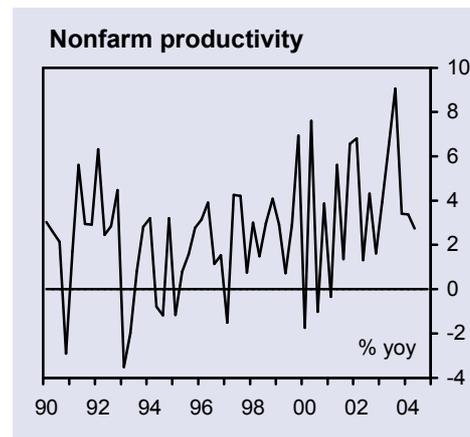
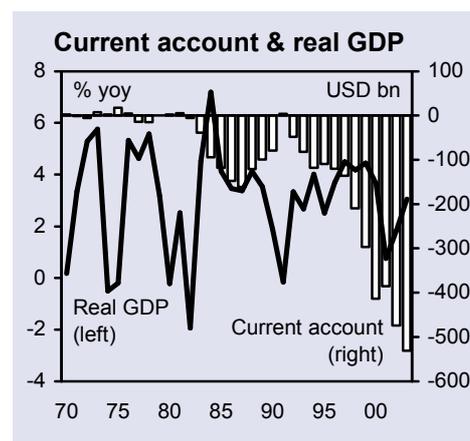
First, the U.S. is the only major industrial country with growing population. The latest census in 2000 has shown that during the decade of the 1990s U.S. population grew by 13.2%, in contrast with stagnating or shrinking populations elsewhere in the industrial world. Moreover, although the U.S. population is aging, it is aging less than in other main industrial countries – the census revealed, e.g., that 72.7% of U.S. population was below the age of 50, while the number of people in the 35-54 age range, the most productive and highest spending segment, increased by 32% in the previous decade.

Second, the technological revolution of the 1990s was most pronounced in the U.S. as it was in America where the Schumpeterian “creative destruction” took mostly place. This led to strong productivity gains, superior to those in most other nations. The combination of population and productivity growth resulted in a rising growth potential of the economy. Even allowing for the most recent slowdown in productivity growth, potential annual growth of the U.S. economy is still estimated at about 3.5%, i.e. about 1% higher than in Europe.

To be sure, there has been an acceleration of the economic expansion in Japan (even allowing for the most recent slowdown) and continuing strong growth in China and the Asian newly industrialized countries (NIC). This should boost U.S. exports and possibly arrest the inexorable widening of U.S. deficits. But eliminating them, let alone turning them around into surpluses, is out of the question in the foreseeable future. The reasons lie in the structural deficits.

**The structural deficits** draw much less attention than the cyclical ones, even though they are at least equally important. Even if the disparity in economic growth rates between the U.S. and the rest of the world were eliminated, the U.S. would still have trade and current-account deficits for the following main reasons.

First, U.S. income elasticity of imports is higher than foreign income elasticity for U.S. exports. This phenomenon is rooted in the general openness of the U.S. market, which makes imported goods readily available and it makes them available at increasingly competitive



## U.S. has exceptionally high income elasticity of imports



prices. Moreover, the development of industrial cooperation and outsourcing has increased sharply income elasticity of imports, as some products or groups of products are no longer produced in the U.S. While traditionally the ratio of import growth to GDP growth was about 1.7, it is now closer to 2.5–3.0.

Second, the proliferation of outsourcing, beginning with the North American Free Trade Agreement (NAFTA) 10 years ago, and now extended to India, China and other Asian countries, has almost by definition widened the U.S. trade deficit as US products shipped abroad return to the US with value added; hence, the value of imports exceeds that of exports.

Third, the U.S. dollar's function as the main reserve currency makes the current-account deficit inevitable because of (a) inflow to the U.S. of monetary reserves of foreign central banks due to the normal accumulation of these reserves, especially in countries with current-account surpluses, and (b) occasional interventions in foreign exchange markets by countries trying to resist the appreciation of their currencies vis-à-vis the U.S. dollar.

Of course, this source of financing the U.S. current-account deficits is not guaranteed forever. It is hoped that eventually the euro will also become a main reserve currency, which would in fact fulfill de Gaulle's idea of breaking the dollar's hegemony that was at the foundation of the concept of a single European currency. But this is not likely to happen in the near future. The dollar is still the dominant reserve currency as about 65% of global monetary reserves are held in dollars.

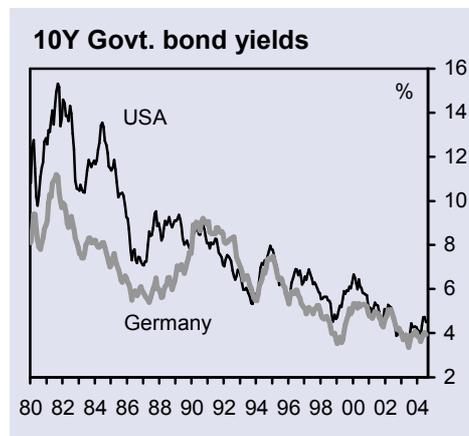
### The financing of U.S. external deficits

It is an axiom of the foreign trade theory that a country can run a balance of payments deficit only to the extent it can finance it, either through borrowing or through depleting its foreign exchange reserves.

In this respect, the U.S. is in an exceptionally advantageous situation because it does not need to borrow in a conventional sense. The financing comes voluntarily because of the attractiveness of the U.S. as an investment destination providing generally higher rates of return than obtainable elsewhere; because of the size, scope, openness and liquidity of the U.S. capital markets; and because of the dollar's role as the world's prime investment, transaction and reserve currency. Interest rates are determined by the conditions in the U.S. money and capital market rather than dictated by the lenders. And, unlike most other countries, the U.S. has the ability to finance its external deficits in its own currency.

There is no doubt that this relative easiness in financing is an important factor in sustaining the US trade and current-account deficits. Some economists go even further. They contend that it is the financing side of the equation, or net capital inflow, that determines the current-account deficits. For example, Milton Friedman – in an interview earlier this year – when asked about the reason for the U.S. current-account deficit, responded that it is because foreigners want to invest in the U.S. This view was postulated by the Austrian economist Böhm-Bawerk a good 100 years ago, stating that it is the capital account of the balance of payments which leads the current account.

This view is also represented by William Poole, president of the Federal Reserve Bank of St. Louis. In a paper published in the January/February 2004 issue of the Federal Reserve Bank of St. Louis Review, Poole – drawing on research of Catherine Mann from the Institute for International Economics in Washington – examines



three different views of the U.S. international imbalance: (a) the trade view, in which trade flows are the primary factors and the offsetting capital inflows are secondary, (b) the GDP view, in which the current-account deficit is perceived as a shortfall between domestic investments and domestic savings, and (c) the capital flows view, in which the trade and current-account deficits are a residual, the result of the capital-account surplus.

This surplus, in turn, is driven by foreign demand for U.S. assets rather than by any structural imbalance in the U.S. economy. Needless to say, the capital flow view is the most amenable to the sustainability of the U.S. external deficits. There is a legitimate concern voiced by some economists that – due to persistent foreign demand for U.S. assets – the U.S. has absorbed some 80% of international savings in recent years. This may cause a U.S. dollar overweight in global portfolios. However, there is no solution in sight for this apparent asymmetry in portfolio allocations.

The financing of U.S. external deficits is an area of the greatest misconceptions. A popular view held by some economists and the media is that foreign investors might refuse to finance the U.S. deficits and switch their capital to other places or invest in their own countries, which could have dire consequences for the U.S.

This may indeed happen. But one should keep in mind that foreigners invest in the U.S. because they view this as advantageous for them, not to do America a favor. Granted, they may decide to increase their domestic investments. But as long as the U.S. has a large current-account deficit and Japan, China and other countries have large surpluses, continuing capital inflow to the U.S. is assured.

It is also true that foreign countries may shift some of their monetary reserves to other places. But as long as the U.S. dollar remains the pre-eminent reserve currency, this is unlikely because of the limited size and scope of other monetary areas. The situation illustrates the “exorbitant privilege” – in de Gaulle’s words some 45 years ago – the U.S. derives from the dollar’s global role. This enables the U.S. to run “deficits without tears” as described by Jacques Rueff, de Gaulle’s adviser.

In short, if someone argues that at some point foreigners might refuse to continue financing U.S. external deficits, a question must be answered – where would they go with their money. The alternatives to investing in the U.S. are very limited, indeed.

## The U.S. international indebtedness

A very important issue in assessing the sustainability of the U.S. external deficits is the magnitude and structure of U.S. foreign indebtedness, as reflected in annual Commerce Department reports on U.S. international investment position (see table 2).<sup>1</sup>

As can be seen, net indebtedness reached at the end of 2003 USD 2.4 trillion or USD 2.6 trillion (depending on the valuation method of U.S. and foreign direct investments), i.e. close to 25% of GDP, up from a rough equilibrium in 1989. This has caused widespread lamentations that the U.S., the richest country in the world, has become within 15 years the biggest debtor in the world.

**Current-account deficit can be financed by a “structural surplus” in the capital account**

**Lack of alternative locations for investment**

<sup>1</sup> U.S. international investment position does not exactly represent U.S. foreign debt, since it also includes equities and physical capital, but it is a good proxy of the U.S. international indebtedness.



Such a sharp rise in foreign debt should not be surprising, considering the piling up of current-account deficits in recent years. What is surprising, though, is that the investment income/payments balance has been in surplus (see table 1) despite the large and rising debt. How to explain this apparent incongruity?

The main reason for the surplus in investment income despite the rising U.S. indebtedness is that U.S. investments abroad are, in aggregate, more profitable than foreign investments in the United States.

This fact is primarily caused by a very large share of foreign official assets in the U.S. due to the dollar's function as the main reserve currency. (Private capital flows, as mentioned before, have an opposite characteristic as foreigners generally enjoy a higher return on their investments in the U.S.)

As can be seen from table 2 (item 18), foreign official assets in the U.S. reached USD 1.5 trillion at the end of last year, i.e. 60% or 55% of U.S. net indebtedness (depending on the valuation method of direct investments). In allocating their monetary reserves, foreign central banks are primarily motivated by safety and liquidity rather than by the rate of return. They invest these reserves mostly in U.S. Treasury bills, which bring them relatively low returns.

In addition, U.S. currency owned by foreigners, which is practically costless, reached USD 318 billion last year (item 27), bringing the total of low- or no-cost U.S. liabilities to about 70% of net U.S. debt.

Moreover, foreign official assets and currency have, by a large, a permanent character, similar to demand deposits at commercial banks, further easing the burden of U.S. foreign indebtedness.

### The balance of payments and the dollar

One of the most controversial issues of the U.S. international economy is the relationship between the balance of payments and the dollar exchange rate. Many economists believe that it is the widening of the U.S. current-account deficit that is responsible for the dollar decline during the past 2-3 years. Some even go further by saying that it would be impossible to eliminate the deficit without a massive, prolonged devaluation of the dollar.

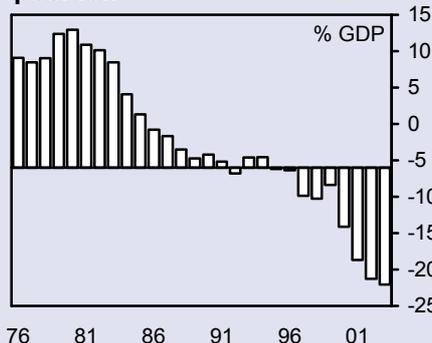
These views are highly questionable. They ignore historic experience and they are based on an obsolete theory. If the weakening dollar is mainly the result of rising external deficits, how to explain the fact that between 1995 and 2001, when the U.S. current-account deficit nearly quadrupled, the dollar was on a strongly rising trend.

Going back another 10 years to 1985, the Plaza Hotel Agreement was a major international event aimed at pushing the dollar down, with the main underlying objective of shrinking and eventually eliminating the U.S. current-account deficit. This did not happen, however, and the deficit rose to new highs.

The main underlying reason for the weak response of trade flows to the dollar devaluation is the relative low price elasticity of both sides of the U.S. trade balance. On the import side, for the dollar devaluation to have a full effect on trade flows, two conditions must be fulfilled: a) foreign exporters have to raise their prices to offset the currency loss, and b) domestic producers competing with imports have to keep their prices constant in order to increase their market share and shift demand away from imports to domestic production.

None of these conditions is fulfilled to the full extent. Foreign exporters are reluctant to raise their dollar prices in order not to jeopardize their competitive position in the huge and lucrative American market. They often cut their profit margins and sometimes

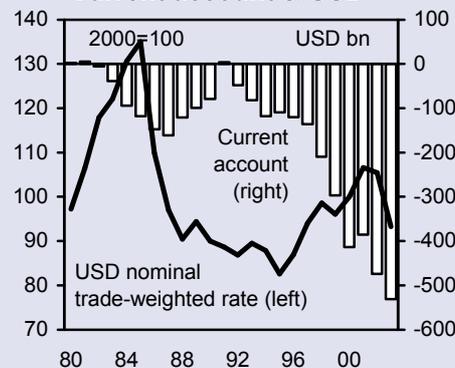
**Net international investment position**



**Balance of investment income**



**Current account & USD**



even run temporary losses, all in order to keep their market shares. Labor Department data on import prices clearly show this phenomenon. For the past two years non-oil import prices have risen only marginally.

Moreover, even when foreign exporters raise their prices, domestic producers competing with imports often raise prices, too, under the umbrella of higher import prices, thus defeating the macro-economic purpose of devaluation. This had happened on a massive scale in the 1985-1995 period when U.S. auto makers did not bother to go for higher market shares; they raised their prices, knowing that Americans will buy Japanese cars anyway because of their superior quality.

Interestingly, these are not new phenomena, they have been known for decades. Weak macro-economic effects of currency devaluation were particularly visible during the devaluation of the British pound in 1967. Since that time, if anything, devaluation effects have become weaker still as trade flows shifted further away from commodity-type trade toward capital equipment.

Similarly, on the export side, currency changes and the associated changes in relative prices have had diminishing results on the trade balance. This was especially clear during periods of the dollar appreciation in the 1980s and 1990s. It did not hamper U.S. exports, as theoretically expected. On the contrary, exports were running strong since U.S. trade partners were willing to pay higher prices for the U.S. technology, know-how and sophisticated capital goods.

A separate case is the possible revaluation of the Chinese yuan by eliminating its fixed exchange rate to the dollar. This is strongly advocated by some economists and policymakers in view of the rapidly rising U.S. trade deficits with China. But it is dubious that this would really happen. The exchange rate of the yuan is a political issue rather than an economic one; it is determined by the Chinese Politbureau, not by market forces.

The dollar decline during the 2001-2004 period cannot be attributed to any large extent to the widening U.S. trade and current-account deficits. The main contributing factors were a) exceptionally wide interest rate differentials between the U.S. and other industrial nations as U.S. rates fell to their lowest levels in over 40 years, b) the September 11 events and constant fears of further terrorist attacks, and c) a change in the attitude of the U.S. toward the dollar as clear signs emerged that the Bush administration is not unhappy with the weaker dollar, in contrast with the strong-dollar policy of the second Clinton administration.

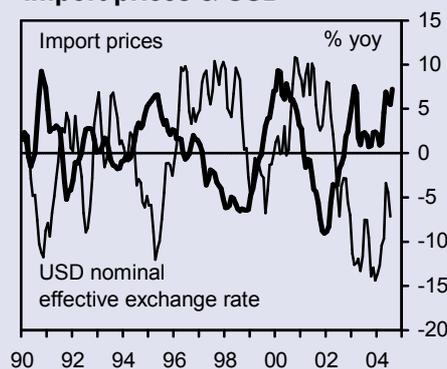
All together, a dollar devaluation is not likely to solve the deficit problem (if there is one), and may disappoint those who advocate it. On the contrary, from the policy standpoint, it may have a negative impact on the U.S. economy. Considering that it is capital flows rather than trade flows that determine the dollar exchange rate, devaluation might hamper the financing of the deficit without reducing it to any large extent.

## Concluding remarks

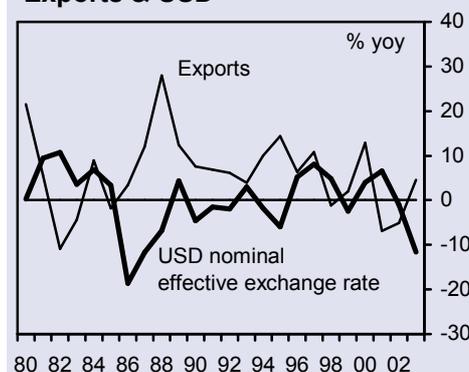
The persistence of U.S. external deficits and the associated rise of U.S. international debt have led to widespread worries and fears as to how long this condition may last and how could it be rectified.

Closer examination of this issue shows, however, that the worries are far from justified and the fears greatly exaggerated, for the following main reasons:

### Import prices & USD



### Exports & USD



- The primary cause of U.S. trade deficits is disparity of economic growth, with the U.S. growing faster than most other industrial nations due to demographic and productivity factors. Sure, a deep and protracted recession in America could possibly reverse the rising deficit trend. But, obviously, the cure would be worse than the disease. The U.S. is thus a victim of its own success. The deficit is a reflection of U.S. strength not weakness.
- Even when disregarding the growth disparity, the U.S. would still run external deficits for a number of structural reasons, the most important of which are: a) high income elasticity of imports, b) spreading industrial cooperation and outsourcing, c) the dollar's function as the key global reserve currency.
- Although the accumulation of current-account deficits raised U.S. international debt to about one-quarter of its GDP, the structure of the debt is highly advantageous as about 70% of it constitutes liabilities to foreign central banks and U.S. currency owned by foreigners. Both sources have pretty permanent characteristics and, above all, very low cost of financing or are outright costless.
- The depreciation of the dollar is not likely to change much the balance of payments deficit but it may jeopardize its financing.

So, all together, does the U.S. have a problem with its external deficits? If it does, the problem certainly pales in comparison with major long-term problems, such as the unfunded liabilities of the Social Security system in view of the forthcoming retirement of the baby-boom generation, the explosive rise in health-care costs, and the growing dependence on oil imports from volatile areas of the world.

Most important, as the paper was trying to demonstrate, if it is a problem, there are no immediate solutions of the problem. And to quote another Herb Stein's one-liner, "if there is no solution to a problem, there is no problem."

Finally, an important mitigating circumstance is that it is mostly economists and politicians who worry about the external deficits. The general public does not lose sleep over the issue, which only attests to the common sense of the American people.

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**Table 1: U.S. Balance of Payments**  
(in billions of dollars)

<b><u>I. Current Account</u></b>	<b><u>2002</u></b>	<b><u>2003</u></b>	<b><u>2004*</u></b>
Exports of goods	681.8	713.1	791.5
Imports of goods	-1164.7	-1260.7	-1400.2
<u>Merchandise Trade Balance</u>	<u>-482.9</u>	<u>-547.6</u>	<u>-608.7</u>
Income from services	294.1	307.3	334.3
Payments for services	-232.9	-256.3	-283.4
<u>Services Balance</u>	<u>61.2</u>	<u>51.0</u>	<u>50.9</u>
Income from U.S. assets abroad	266.8	294.4	340.8
Payments on foreign assets in the U.S.	-259.6	-261.1	-311.2
<u>Investment Income/Payments Balance</u>	<u>7.2</u>	<u>33.3</u>	<u>29.6</u>
<u>Unilateral Transfers</u>	<u>-59.4</u>	<u>-67.4</u>	<u>-78.8</u>
<u>Current-Account Balance</u>	<u>-473.9</u>	<u>-530.7</u>	<u>-607.0</u>
<b><u>II. Capital (Financial) Account (private)</u></b>			
Foreign direct investment	72.4	39.9	85.8
Foreign portfolio investment	385.9	365.4	503.4
Bank borrowing	96.4	75.6	343.5
Other	99.5	100.7	85.0
<u>Capital inflow</u>	<u>654.2</u>	<u>581.6</u>	<u>1017.7</u>
U.S. direct investment abroad	-134.8	-173.8	-216.7
U.S. portfolio investment abroad	15.9	-72.3	-93.7
Bank lending	-30.3	-10.4	-436.0
Other	-46.4	-32.5	-108.8
Statistical discrepancy	-95.0	-12.0	57.3
<u>Capital outflow</u>	<u>-290.6</u>	<u>-301.0</u>	<u>-797.9</u>
<u>Capital-Account Balance</u>	<u>363.6</u>	<u>280.6</u>	<u>219.8</u>
<b><u>III. Balance of Payments</u></b>	<b><u>-110.3</u></b>	<b><u>-250.1</u></b>	<b><u>-387.2</u></b>
<b><u>IV. Official Reserve Transactions</u></b>			
Decline (+) /Increase (-) in U.S. official reserve assets	-3.7	1.5	3.4
Increase in foreign official assets in the U.S.	114.0	248.6	383.8

\*) Forecast

Source: US Department of Commerce, own calculation and regroupings



**Table 2: International Investment Position of the United States at Yearend, 2002 and 2003**  
[Millions of dollars]

Line	Type of investment	Position, 2002 <sup>r</sup>	Position 2003 <sup>p</sup>
	<b>Net international investment position of the United States:</b>		
1	<b>With direct investment positions at current cost (line 3 less line 16).....</b>	<b>-2,233,018</b>	<b>-2,430,682</b>
2	<b>With direct investment positions at market value (line 4 less line 17).....</b>	<b>-2,553,407</b>	<b>-2,650,990</b>
	<b>U.S.-owned assets abroad:</b>		
3	<b>With direct investment at current cost (lines 5+6+7).....</b>	<b>6,413,535</b>	<b>7,202,692</b>
4	<b>With direct investment at market value (lines 5+6+8).....</b>	<b>6,613,320</b>	<b>7,863,968</b>
5	U.S. official reserve assets.....	158,602	183,577
6	U.S. Government assets, other than official reserve assets.....	85,309	84,772
	U.S. private assets:		
7	With direct investment at current cost (lines 9+11+14+15).....	6,169,624	6,934,343
8	With direct investment at market value (lines 10+11+14+15).....	6,369,409	7,595,619
	Direct investment abroad:		
9	At current cost.....	1,839,995	2,069,013
10	At market value.....	2,039,780	2,730,289
11	Foreign securities.....	1,846,879	2,474,374
12	Bonds.....	501,762	502,130
13	Corporate stocks.....	1,345,117	1,972,244
14	U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns.....	908,024	614,672
15	U.S. claims reported by U.S. banks, not included elsewhere.....	1,574,726	1,776,284
	<b>Foreign-owned assets in the United States:</b>		
16	<b>With direct investment at current cost (lines 18+19).....</b>	<b>8,646,553</b>	<b>9,633,374</b>
17	<b>With direct investment at market value (lines 18+20).....</b>	<b>9,166,727</b>	<b>10,514,958</b>
18	Foreign official assets in the United States.....	1,212,723	1,474,161
	Other foreign assets:		
19	With direct investment at current cost (lines 21+23+24+27+28+29).....	7,433,830	8,159,213
20	With direct investment at market value (lines 22+23+24+27+28+29).....	7,954,004	9,040,797
	Direct investment in the United States:		
21	At current cost.....	1,505,171	1,553,955
22	At market value.....	2,025,345	2,435,539
23	U.S. Treasury securities.....	457,670	542,542
24	U.S. securities other than U.S. Treasury securities.....	2,786,647	3,391,050
25	Corporate and other bonds.....	1,600,414	1,852,971
26	Corporate stocks.....	1,186,233	1,538,079
27	U.S. currency.....	301,268	317,908
28	U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns.....	864,632	466,543
29	U.S. liabilities reported by U.S. banks, not included elsewhere.....	1,518,442	1,887,215

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Source: US Department of Commerce, Bureau of Economic Analysis

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