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ECONOMIC VIEWPOINT

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Mysteries Of The Gaping Current-Account Gap

The budget deficit isn't to blame, but spending discipline won't hurt

Fed Chairman Alan Greenspan recently expressed concern about the stubbornly high U.S. current-account deficit. I share his concern, but I find that understanding it is like unraveling a Sherlock Holmes mystery. There are lots of clues, but I am not enough of a sleuth to put them all together. The current-account deficit is amazingly large, averaging 4.4% of gross domestic product since 2000. In comparison, during the twin-deficits era of 1984-88, the current-account gap averaged just 2.7% of GDP. The only prior year with a deficit greater than 4% of GDP was 1816, when imports surged following the end of the War of 1812.

The accumulation of current-account deficits has pushed the U.S. to substantial net indebtedness with the rest of the world. Back in 1996 the net international investment position was -4.6% of GDP. At the end of 2003 it reached -24.1%.

A COMMON VIEW IS THAT this debt is piling up as U.S. Treasury bonds held by central banks in Japan, China, and elsewhere. In fact, at the end of 2003 foreign official holdings were still only \$1.5 trillion, or 14% of foreign-owned U.S. assets. Of the \$2.1 trillion increase in such assets from the end of 1999 to the end of 2003, only \$500 billion went into official holdings. But the share of official holdings in total foreign claims has trended upward since 2002.

The rise in U.S. indebtedness should have generated large net payments on assets from the U.S. to the rest of the world. Surprisingly, that hasn't happened. The returns on U.S.-owned foreign assets increased so much relative to those on foreign-owned U.S. assets that the net U.S. income on assets in 2004 is still positive. The puzzle is why foreign investors - not just central banks -- are willing to hold so much in low-yielding U.S. assets. America's ability to incur foreign debts, essentially without paying for them, is eroding the normal market forces that correct a current-account imbalance.

The current-account balance is the difference between a country's total income and its spending on consumption and investment (and net transfers abroad). The current account is the difference between national saving -- income not spent on consumption -- and domestic investment. To think about why the ratio of the current-account deficit to GDP is large, ask why the ratio of investment to GDP is high or why the national saving rate is low.

In the mid-1980s the standard story was that U.S. budget deficits reduced the national saving rate and caused current-account deficits. But the current-account gap vanished by 1991, when the budget deficit was still large. As the budget deficit was being replaced by surplus, the current-account gap returned, rising to 4% of GDP in 2000. Clearly, budget deficits were not the main determinant of current-account deficits. One does better by considering investment. The ratio of investment to GDP rose from 13.1% during the 1991 recession to 18.1% in mid-2000. This increase in the investment ratio by five percentage points helps explain why the current account went from near zero in 1991 to a deficit of 4% of GDP in 2000. The national saving rate changed little. Added investment was financed by borrowing from foreigners.

The 2001 recession lowered the investment ratio by three percentage points. The current-account deficit fell by a percentage point. The growth in government spending after September 11 raised the current-account deficit in 2002. In 2003-04, the current-account deficit was boosted by an investment rebound and oil-price hikes.

Many economists think that current-account deficits explain why a broad index fell 17% since 2002. Some predict that the dollar will fall further. But the relationship between exchange rates and current-account deficits is slippery. The broad dollar index appreciated by 14% from December, 1998, to July, 2001, despite large U.S. current-account deficits. Futures contracts forecast a depreciation of the dollar against the euro by only 0.5% over the next year. If current-account deficits predict a falling dollar, the financial markets have yet to figure this out.

The greatest threat from the yawning current-account deficit is that the government will follow bad policies to fix things. Washington could lower the current-account deficit with spending discipline. It would be bad to respond to the falling dollar by limiting free trade or diverting monetary policy from maintaining low and stable inflation.