BY CATHERINE L. MANN

In a world grown blasé by big numbers, here's one still big enough to stand out: The United States' current account balance deficit – the broadest measure of our annual trade and investment relations with the rest of the world – is roughly one-half trillion dollars in the red per year. Can America continue to suck in the torrent of cash needed to cover deficits of this magnitude?

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Can the current account be narrowed sufficiently to generate a soft landing, or will the exchange value of the dollar crash, even as trade and investment flows become hostage to rapidly changing market sentiments and government responses?

America's current account, which largely mimics the difference between exports and imports of good and services, has been in deficit for almost a quarter-century. Now, by definition, an economy running a current account deficit will, one way or another, experience a net capital inflow that mirrors the deficit as foreigners accepts a country's financial assets in exchange for its purchases. But analyzing the consequences of the current account deficit and the corresponding net capital inflow is not so easy, because how we got to where we are is all about composition – about the types of products we buy and the types of financial assets we give in exchange.

Running a current account deficit can mean a country is living beyond its means – that imports exceed exports because overall consumption and investment exceed national savings. Or robust capital inflows can mean that a country is viewed as an oasis of prosperity and stability, attracting investment from around the globe because its economy delivers higher returns at lower risk than other venues do. There's a third possibility: a country's large current account deficit and capital account inflow can be caused (or at

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least exacerbated) by trade and investment partners' economic policies that stymie efforts to balance international accounts. How one sees the prospects for the United States current account (and the exchange value of the dollar) is linked to how much weight one puts on each of these not-mutually-exclusive interpretations of cause and effect.

HOW DID THE CURRENT ACCOUNT DEFICIT GET SO BIG?

The current account is driven predominantly by trade in goods and services, which in turn is largely determined by U.S. and foreign income growth, along with the exchange value of their currencies. Underlying the $540 billion current account deficit in 2003 is a deficit on trade in goods and services of about $490 billion.

United States exports grow faster when foreign income grows faster and when the dollar depreciates. Conversely, U.S. imports grow faster when U.S. income grows faster and when the dollar appreciates. So movements in the U.S. trade balance are greatly influenced by the degree to which the U.S. and foreign economic cycles are out of synch.

In the early 1980s and again in the early 1990s, the American economy slipped into recession and imports slowed. World growth remained robust, so U.S. exports rose. For both reasons, the trade deficit narrowed. In the late 1990s and early years of the new century, though, anemic growth in Japan and Europe dampened demand for United States exports, while appreciation of the dollar relative to the euro and yen made imports more attractive to Americans. Hence, until quite recently, both income and price factors tended to widen the U.S. trade deficit.

Structural factors have also worked to widen the trade deficit. One such factor is Americans' lusty appetite for foreign products: U.S. imports expand more rapidly when we grow than U.S. exports grow when foreign economies are on the upswing. Moreover, simply as a matter of arithmetic, once America has a big trade deficit, proportional growth of imports and exports increases the absolute dollar value of the deficit. Since imports are now about 50 percent greater than exports, that is a deep hole to climb out of.

Here is where the composition of trade starts to matter. The biggest trade deficit hole is in consumer goods and autos, where there is a persistent, long-term trend toward deficit that was exacerbated both by robust personal consumption growth in the United States during the go-go 1990s that endured even as the economy slipped into recession, and by the recent tax-reduction-led recovery in consumer spending. In addition, services such as ocean transport, which is tied to the U.S. import boom, and, more recently, outlays related to anti-terrorism and the war in Iraq, have added sharply to the trade and current account deficits.

On the other hand, America's competitiveness in services shines through. The balance on trade in what the bean counters call "other private services" – education, finance, and business and professional services – is persistently positive, and the surplus has continued to rise despite slow economic growth abroad.

Finally, one of the bigger puzzles in recent years is the balance of trade in capital goods, and industrial supplies and materials. Until 1997, this balance cycled through larger and smaller surpluses, depending on global business conditions. Since that year, however, the trade balance in this category has deteriorated from a surplus of about $50 billion to about zero.

In sum, the current account deficit has ballooned for a host of reasons. Any signifi-

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cant change in the trajectory of the United States current account depends, at a minimum, on changes to policies underpinning both growth prospects and exchange rates. But, given the composition of trade, only draconian changes would be likely to make a big dent in the deficit.

HOW BIG A CURRENT ACCOUNT DEFICIT IS TOO BIG?

By the mid-1980s, the accumulation of the current account deficits financed by foreign capital inflows transformed the net international investment position of the United States from positive to negative. That is, foreign investors now hold more in U.S. assets than United States investors hold in foreign assets. By the end of 2002, the net international investment position of the United States economy was $2.7 trillion in the red.

The net international investment position bears on the question of the sustainability of the current account deficit and the associated inflow of capital. Big liabilities today increase the rate of growth of liabilities tomorrow; the large stock of financial obligations implies outflows of interest, dividends and the like that must be paid out of the economy's current production.

Note, too, that the awesome net investment position of foreigners means that even a dominant economy like that of the United States must consider the consequences of a change in foreign investor sentiments about the desirability of holding dollar assets in their portfolios and continuing to provide

the net inflow of financial capital needed to offset the U.S. trade deficit. But, here again, composition matters.

Taking a United States-centric view of "bigness," the current account deficit and its accumulated negative net international investment position are not daunting because foreigners (a) seem inclined to hold onto dollar-denominated financial assets, (b) seem to like buying assets that do not demand an immediate return (stocks), and (c) have an appetite for low-yield U.S. Treasury securities. With nobody beating on the door for repayment – indeed, with foreigners throwing more money at us than we need to cover our foreign spending – there is little incentive to alter our inclination to consume and import, and thereby to change the trajectory of the current account.

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Taking a more global view of bigness, the $540 billion net inflow of capital, along with the trajectory of net capital flows that will be needed to cover the external deficit, looms larger. Domestic economic conditions aren't the only factors affecting the current account and the value of the dollar. Factors outside Washington control – growth in the global economy, financial leverage and how foreigners allocate their wealth according to preferences for risk, return and diversification – also have an effect.

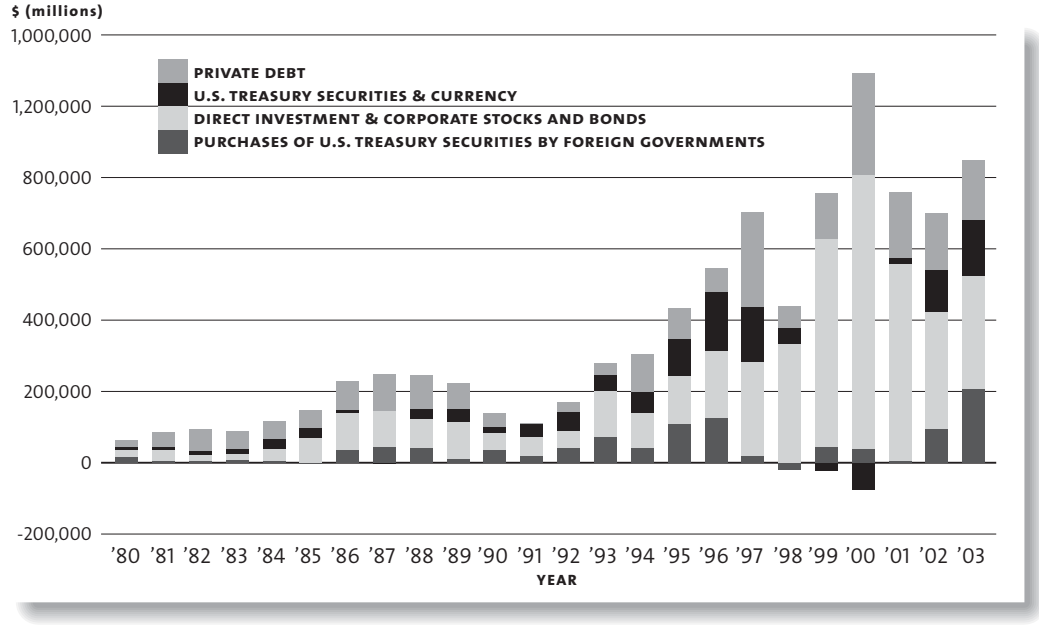
In theory, a large and persistent current account deficit leads to an ever-growing negative net international investment position. And eventually, the imbalance is self-correcting. Financial payments (like interest and dividends) to foreigners become large enough to cut into domestic consumption and business investment. The current account deficit itself (and its accumulation) reduces domestic spending, which reduces import growth, which changes the trajectory of the current account toward a sustainable path. For industrial countries, a current account that reaches 4 to 5 percent of GDP is typically associated with economic forces – rising interest rates, slowing consumption and domestic investment – that begin to narrow the current account deficit.

America's current account deficit was about 4 percent of GDP in 2000 and 2001, then jumped to 4.6 percent of GDP in 2002 and 4.9 percent of GDP in 2003 – a new record. But these external imbalances have not yet caused a financial pinch. In fact, even though the net international investment position turned negative in the 1990s, the United States still earned $16 billion more in interest and dividend payments than it paid out in 2003. Moreover, interest rates remained low and consumption strong through 2003.

How can the United States have a negative net investment position, yet not pay more to service financial obligations than it collects? More broadly, why is the 5 percent current account deficit apparently not generating economic forces that narrow the deficit?

A key factor here is the composition of foreign purchases of U.S. assets. Most of the private capital flowing into the United States consists of foreign direct investment and portfolio investment, neither of which require

FOREIGN PURCHASES OF U.S. ASSETS BY MAJOR ASSET TYPE



regular fixed payments to maintain, as is the case for bank loans. Moreover, the market-oriented nature of stock and bond investment means that if some foreign investors sold their holdings, asset prices likely would decline, motivating other investors to buy. Finally, U.S. entities borrow almost exclusively in domestic currency; more than 90 percent of their external debt to banks is in dollars, and most securities liabilities are denominated in dollars. Consequently, America can afford to carry a larger current account deficit than a country whose obligations consist primarily of short-term bank loans denominated in foreign currencies.

Even if the composition of U.S. obligations reduces the need for timely maintenance payments, the pressure to sell huge quantities of dollar-denominated assets to cover the current account deficit could drive down their price – that is, the exchange value of the dollar could fall. How much the global investor is willing to invest in dollar assets is determined by several factors, among them the costs of buying and selling, market regulation, and, of course, the American economy's prospects compared to those of other economies. Hence, estimating just how much global investors wish to hold in dollar assets is difficult. Moreover, it is not just the stock of global wealth that matters, but how fast global wealth is growing compared to how fast the supply of dollar-denominated assets offered into the international marketplace is growing.

Survey evidence from *The Economist* suggests that global investors increased the share of U.S. stocks and bonds in their portfolios from about 40 percent in 1992 to about 55 percent at the end of 2003. Increased holdings of dollar assets come from disproportionately large purchases of stocks and bonds as wealth grows. A calculation of the marginal investment allocation for recent years suggests that

investment of new foreign wealth in dollar assets was quite modest in the early 1990s, doubled in the mid-1990s, and was just about the average share of equity portfolio holdings from 1998 to 2001.

This pattern is consistent with the changes in the average holdings of dollar assets observed in *The Economist* survey, as well as with factors generally believed to determine investor choices. First, it is consistent with the relative performance of the American economy in the late 1990s to the end of 2000. Second, it is consistent with the data on net foreign purchases of dollar assets, particularly during the bubble period in United States and global stock markets. Finally, in 2001 when collapse of equity valuations worldwide hit global financial wealth hard, the U.S. current account deficit conveniently narrowed, reducing the supply of dollar assets being fed into the financial markets.

Beginning in 2002, however, even though the share of dollar-denominated assets in global portfolios stayed high, the value of the dollar started to depreciate – particularly against the euro. The U.S. current account deficit began to widen again, but sluggish global growth translated into smaller increases in global wealth. Moreover, at least in the early months of 2002, differences between major stock market indexes in Europe and the United States narrowed as the prospective returns on United States assets seemed to be less attractive, and widening corporate scandals – think Enron, WorldCom and Tyco – increased the perception of risk associated with owning dollar assets.

All told, concerns over portfolio diversification, slow growth in global wealth, and a too-generous offering of U.S. assets to the marketplace, along with less attractive returns and higher perceived risk in U.S. investments, all help to explain why the dollar depreciated in 2002 and into 2003. But these factors don't help much to explain why the dollar depreciated against some – but not other – major currencies.

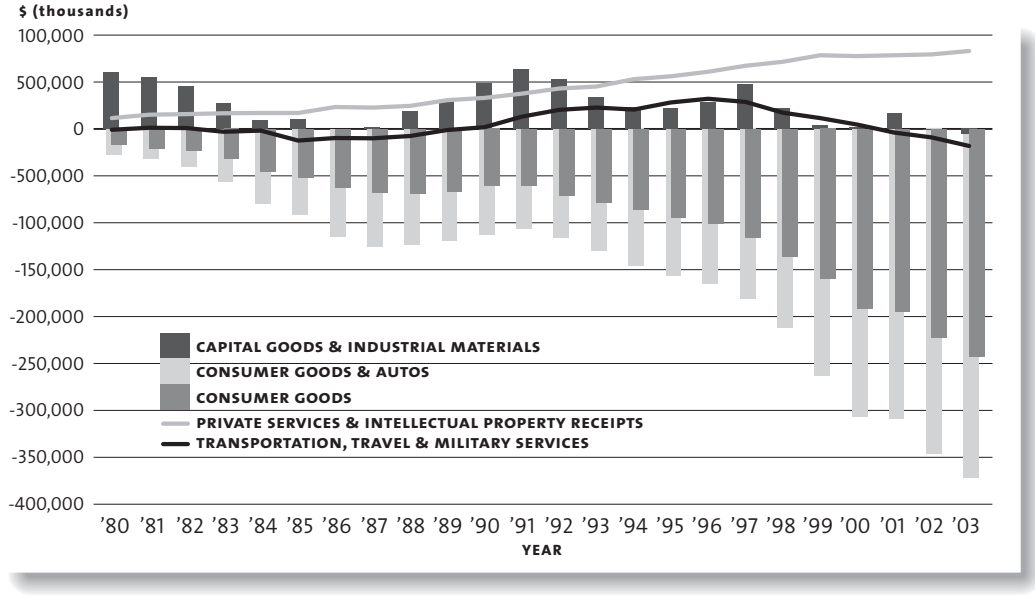
GLOBAL CO-DEPENDENCY

Several factors point to the reality that countries other than the United States have a vested interest in large and chronic U.S. trade deficits – that deficit persistence is linked to global co-dependency. First, some foreign governments chose to create fresh demand for dollars by doubling their purchases of United States assets in 2003, to a remarkable $208 billion. Second, the rate of dollar depreciation was much greater against some currencies than others – 20 to 30 percent against the pound, Swiss franc, Australian dollar, yen and euro, compared to 10 percent or less against most Asian currencies.

Why the intervention to curb dollar depreciation? Some governments are buying dollar assets in order to maintain export market shares in the United States. Their purchases reduce pressure on the dollar to depreciate against their own currencies, thereby making their goods more attractive to Wal-Mart and the like. This constitutes a bargain with the devil in the sense that when their own currencies eventually do appreciate, not only will their exports fall, but the value of the dollar-denominated assets they own will, too.

For various reasons, though, this bargain is viewed as worth the cost right now. Not the least of the reasons is that many countries are desperate to remain competitive with Chinese exports to the United States, and China has locked its exchange rate to the dollar. But it also follows from Asia's born-again commitment to export-led growth in the wake of the 1997 financial crisis. To these countries, the financial crises proved the folly

U.S. TRADE BALANCE: MAJOR COMPONENTS



of a domestic-led growth strategy and turned them back to time-tested export-oriented growth strategies.

This has tended to dampen American exports at a moment in which global growth is increasingly important for U.S. producers of capital goods. At the same time, low interest rates and the expansion of buying power associated with the big tax cuts in the United States is keeping U.S. import growth strong – particularly in consumer goods and autos, which remain relatively cheap because the dollar's depreciation has been slowed by Asian government intervention.

This, too, is a devil's bargain for the United States, in that the accumulation of both internal and external debt will lead to a day of reckoning. But Americans have so little experience with the consequences of excessive borrowing, particularly on international markets, that consumption today is enjoyed with little regard for the future.

How long can this global co-dependency go on, and what are the broader global ramifications of the current account imbalances? Severe global co-dependency creates significant currency-management issues. Third parties, notably the European Union, that have not sought to hang tough with the dollar will bear the brunt of dollar depreciation. The pressures on firms and workers dependent on exports will be intense, and aggressive macroeconomic stimulus will be required to offset falling demand for their exports. But global co-dependency could have a very long duration, and the imbalances created along the way will be difficult to unwind without precipitating a crisis of exchange rates, domestic growth, and international exchange of goods and financial assets.

Muddling through may seem a less-than-optimal approach to international public finance. In view of the political and economic constraints on policy in the America and abroad, however, it may well be the only practical approach. M