ECONOMIC AND BUDGET ISSUE BRIEF

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The Decline in the U.S. Current-Account Balance Since 1991

Summary

The current-account balance summarizes a country's current transactions with the rest of the world, which include trade, income from international investments, and transfers. After rising briefly to be roughly in balance in 1991, the U.S. current account returned to a deficit soon afterwards. After 1997, the balance began to fall markedly, reaching a record deficit of 4.8 percent of gross domestic product (GDP) in 2003, considerably larger than the pre-1990s record deficit of 3.4 percent of GDP in 1987.

A diverse set of interrelated factors in the United States and abroad influences the current-account balance. Among the many that have contributed to its worsening since 1991, the primary ones have been the strong performance of the U.S. economy as compared with those of the country's trading partners, a surge in the demand for dollar assets in the late 1990s, and a renewed decline in the rate of national saving after 2000.

The Current-Account Balance and the Exchange Rate

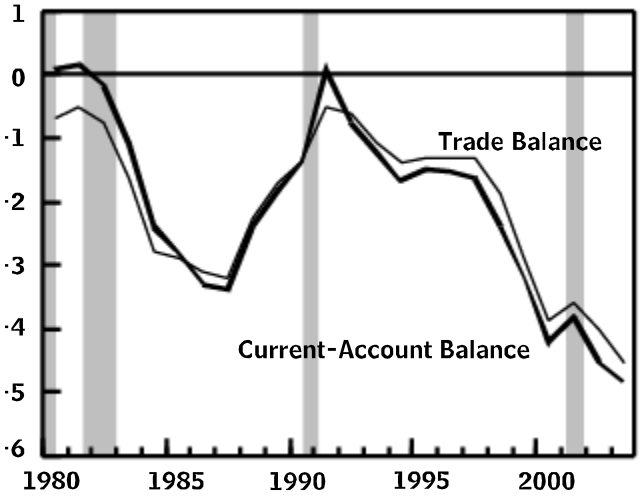
The current account has three main components. Trade in goods and services is by far the largest. The other two components—net investment income and net unilateral transfers—have had a much smaller effect on the overall balance in the account.[1] The balance of trade (exports minus imports) accounts for virtually all of the current-account balance (see Figure 1).

The current-account balance measures the difference between what residents of the United States earn and what they spend. When income is greater than spending, the nation has produced more goods, services, and construction than its residents have purchased; the difference was purchased by foreigners, and the current-account balance is in surplus. When spending exceeds income, the nation has purchased more than its residents have produced; the difference was purchased from foreigners, and the current-account balance is in deficit. Consequently, the fall

Figure 1.

The U.S. Current-Account Balance and Its Main Component, the Trade Balance

(Percentage of gross domestic product)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: The vertical bars indicate periods of recession as defined by the National Bureau of Economic Research.

1. Net investment income is the difference between income generated by domestic ownership of assets abroad and that generated by foreign ownership of assets in the United States. Net unilateral transfers are the difference between transfers (such as gifts, pension payments, and foreign aid) from foreigners and those made to foreigners.

Table 1.

How the Current-Account Balance Relates to the Rest of the Economy

(Percentage of income)

	1980	1985	1990	1995	2000	2003
Saving	19.5	18.1	16.1	15.9	18.0	13.5
minus						
Investment	19.1	20.7	17.3	17.2	22.0	18.1
equals						
Current-Account Balance	**0.4**	**-2.6**	**-1.2**	**-1.3**	**-4.0**	**-4.6**
equals						
Income	100.0	100.0	100.0	100.0	100.0	100.0
minus						
Spending	99.5	102.6	101.2	101.2	104.0	104.6

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: Numbers may not add up to totals because of rounding.

For the purpose of this table, the current-account balances are drawn from the Bureau of Economic Analysis's national income and product accounts, which relate the balances to the rest of the economy. The balances differ slightly from those referred to in the text, which come from the bureau's international transactions accounts. For the latest report on the relationship between those two sources of data, see Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (July 2004), Appendix A, Table 2.

Saving is gross national saving. Investment is gross domestic investment minus a statistical discrepancy reported in the national income and product accounts. Income is gross domestic product plus net international investment income. Spending is gross domestic purchases minus net unilateral transfers.

in the current-account balance since 1991 reflects the fact that U.S. residents collectively spent increasingly more than their income.

Because income is either consumed or saved, and spending is either consumption or investment, the current-account balance equivalently measures the extent to which the United States saves more than it invests (see Table 1). Hence, another way of viewing the fall in the current-account balance since 1991 is to observe that saving in the United States fell increasingly short of the amount necessary to finance domestic investment.

Current-account imbalances require financing. To pay for the extra spending, the nation must borrow from foreigners or sell them some assets. In other words, a current-account deficit requires a net inflow of capital from abroad; a surplus requires an outflow of capital to foreigners. Between 1991 and 2003, cumulative net borrowing from abroad raised the nation's net obligations to the rest of the world by $2.1 trillion, to a record $2.4 trillion, or 22 percent of gross domestic product (GDP).

The exchange rate of the dollar—the price of the dollar in terms of other currencies—both reflects and influences trade flows and capital flows. The dollar exchange rate directly affects trade flows by affecting the dollar price of foreign goods and services and the foreign price of U.S. goods and services. When the dollar exchange rate appreciates, the dollar buys more units of foreign currency, which lowers the prices of foreign goods and services in dollar terms and encourages imports. At the same time, a higher dollar exchange rate raises the prices of U.S. goods and services in terms of foreign currencies and discourages exports.[2]

The dollar exchange rate influences capital flows by affecting foreigners' expected rate of return on dollar assets. When the dollar exchange rate has appreciated to a high level, it becomes more likely to fall than to continue rising, and the value of dollar assets in terms of foreign currencies becomes more likely to fall than to rise. Consequently, once the dollar has appreciated for a sustained period, dollar assets could be less attractive to foreign in-

2. The exchange rate also can affect the prices and sales of domestic and foreign substitutes for traded goods and services.

vestors, which would reduce capital inflows to the United States. Of course, the opposite happens when the dollar exchange rate has fallen for a sustained period.

The dollar exchange rate adjusts in response to changes in foreign investors' demand for dollar assets and in trade flows, helping to keep the two consistent. For example, when the demand for goods and services in the United States rises above national income—that is, when the nation is running a current-account deficit and requires foreign financing—the dollar generally has to fall to persuade foreign investors to hold more dollar assets. On the other hand, when foreign demand for dollar assets falls, the dollar exchange rate generally falls, discouraging U.S. demand for imports and stimulating foreign demand for exports.

Primary Causes of the Decline in the Current-Account Balance

A large number of factors interact in complex ways to determine the current-account balance. However, three interrelated factors are primarily responsible for most of the decline in the current-account balance since 1991. One was the relatively rapid growth of income in the United States compared with that in other major industrialized countries over most of the period. Another important factor was a surge in foreign demand for dollar assets in the late 1990s, which contributed to a higher dollar exchange rate and lower U.S. interest rates. Finally, a drop in the national saving rate owing to a rising federal deficit has helped push the current-account balance lower since 2001.

Relatively Faster Income Growth in the United States

When income in the U.S. economy increases, consumers and firms generally demand more imports, and the increase in their purchases of domestically produced goods and services also creates a greater demand for imported materials and components. As a consequence, when income in the United States grows faster than that abroad, the U.S. current-account balance tends to fall. Conversely, faster foreign growth typically spurs the demand for U.S. exports and raises the current-account balance.

For nearly a decade after the recession in 1991, the United States enjoyed its longest postwar expansion while many other major industrial economies stagnated. From 1992 through 2000, for example, the average annual growth rate of real (inflation-adjusted) GDP in the United States was 3.7 percent. For much of that period, the United States experienced an investment boom, particularly in high-technology capital goods. Over the same period, the annual growth rate in the European Union (EU) averaged a slower 2.2 percent, and that of the world's second and third largest economies, Japan's and Germany's, averaged only 1.2 percent and 1.5 percent, respectively.[3] Consequently, the U.S. demand for imports, both capital goods and consumption goods, rose much more strongly than foreign demand for U.S. exports did during the period.

The U.S. economy entered a recession in 2001, earlier than most foreign economies, prompting the current-account deficit to shrink from 4.4 percent of GDP, where it stood at the end of 2000, to 3.5 percent at the end of 2001. The current-account deficit did not disappear, as it had in the 1990-1991 recession, however. In explanation, at least four differences between the two recessions deserve to be pointed out. First, the dollar exchange rate was much lower from 1987 to 1991 than it was from 1997 to 2001. Second, U.S. economic growth relative to foreign growth was weaker in 1990 and 1991 than in 2001. Third, while the rate of investment declined sharply in both recessions, the national saving rate behaved quite differently: in the earlier one, it hardly changed, but in the later one, it fell sharply because of the drop in government saving. Finally, foreign governments' reparation for U.S. military expenditures in the first Gulf War significantly boosted the current-account balance in 1991—a one-time event without a corollary in 2001.[4]

A stronger economic recovery in the United States than in other industrial economies after 2001 contributed to a renewed decline in the current-account balance. Over the 2002-2003 period, the growth rate of real GDP was 2.7 percent annually in the United States, compared with a mere 1.0 percent in the EU and 1.1 percent in Japan. The current-account deficit grew from 3.8 percent of GDP in 2001 to 4.8 percent in 2003.

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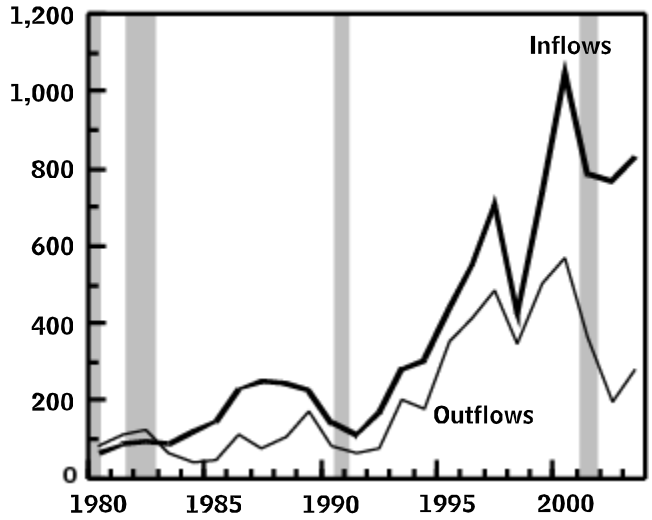
3. The EU consisted of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Denmark, Sweden, and the United Kingdom. On May 1, 2004, additional countries joined the EU.

4. Foreign reparation helped turn net unilateral transfers from a deficit of $33 billion in 1990 to a surplus of $8 billion in 1991.

Figure 2.

Gross Capital Flows to and from the United States

(Billions of dollars)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Strong Demand for Dollar Assets in the Late 1990s

Just as trade flows can affect capital flows, the reverse is also possible: capital flows can affect trade flows. If foreigners (either private investors or governments) want to hold more dollar assets for reasons besides expected changes in the dollar exchange rate, the increased demand for assets generally boosts equity prices and lowers interest rates in the United States.[5] The resulting increase in wealth and decrease in the cost of borrowing then help to widen the current-account deficit by stimulating consumption and investment. Moreover, the rise in demand for dollars pushes up the exchange value of the dollar, making U.S. goods more expensive to foreigners and foreign products cheaper for Americans to buy. So Americans generally will buy more imports while foreigners generally will buy fewer U.S. exports, thereby increasing the U.S. current-account deficit.

A decline in U.S. real long-term interest rates and an appreciation of the dollar exchange rate in the late 1990s indicate that the demand for dollar assets surged, boosting capital inflows to the United States (see Figure 2). The real interest rate on the 10-year Treasury note, for example, fell about a percentage point in 1998 and by almost another percentage point in 1999 and stayed low in 2000. The real dollar exchange rate appreciated 19 percent from January 1997 through December 2000 (see Figure 3).[6] Had foreign demand for dollar assets not been rising during that time, the persistent current-account deficit generally would have lowered the exchange value of the dollar and raised interest rates.

What caused the surge in the demand for dollar assets? The United States has always been an attractive destination for international investment because of its stable political environment, developed legal institutions, deep and liquid capital market, and strong banking and financial system. Moreover, because the U.S. dollar is a major medium of international transactions, it is less susceptible to extreme and sudden depreciation.

In the late 1990s, four major developments enhanced the appeal of the United States to foreign investors:

- Higher productivity growth in the United States than in other major industrial countries raised the expected rate of return (adjusted for risk) on investment in the United States relative to that in other economies.

- The rapid pace of financial globalization—spurred by technological advances, financial deregulation, and further liberalization of capital controls worldwide—allowed investors to take advantage of the U.S. capital market more fully.[7]

5. For example, foreign private investors may want to hold more dollar assets because they feel investment outside of the United States is becoming more risky; or some foreign governments may decide to boost their holdings of dollar assets because they want to enhance investors' confidence in their currencies.

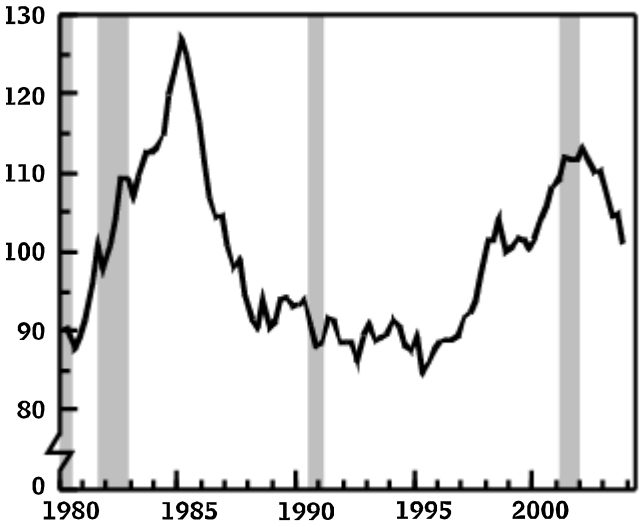
6. The real dollar exchange rate measures the dollar's exchange value in terms of its purchasing power at home relative to that abroad. A broad index of the real exchange rate, reported by the Board of Governors of the Federal Reserve System, rose from 90.5 in January 1997 to 107.7 in December 2000. (The index was set to equal 100 in March 1973,)

7. For example, Japan—the country with the largest current-account surplus in the world—did not fully liberalize cross-border transactions until April 1998. For more information on the chronology of such liberalization, see International Monetary Fund, *Advanced Country Experiences with Capital Account Liberalization,* Occasional Paper No. 214 (Washington D.C.: International Monetary Fund, 2002); and *Capital Account Liberalization and Financial Sector Stability,* Occasional Paper No. 211 (Washington D.C.: International Monetary Fund, 2002).

Figure 3.

The Real Exchange Rate of the U.S. Dollar

(Index, March 1973 = 100)



Sources: Congressional Budget Office; Federal Reserve Board.

- The spate of financial crises in emerging markets—the 1997-1998 Asian currency crisis, the Russian default of 1998, the Brazilian peso crisis in 1998 and 1999, and Argentina's financial crisis of 2001—probably encouraged capital inflows to the United States in search of a "safe haven."

- Emerging Asian countries, especially China, rapidly boosted their foreign exchange reserves and thereby raised the demand for dollars. Following the 1997-1998 Asian currency crisis, many of those countries may have realized the importance of maintaining a high level of foreign exchange reserves. China's level of such reserves rose at an even faster rate than those of other Asian economies because foreign capital flocked to China's attractive investment opportunities. Because most foreign governments tend to keep a high share of their foreign exchange reserves in dollar assets, official foreign demand for dollar assets increased rapidly along with official reserves.[8]

The general decline in gross capital inflows since 2000 and the overall depreciation of the dollar since early 2002 suggest that foreign demand for dollar assets has receded. It fell in part because expected rates of return in the United States fell as the U.S. stock market dropped in 2000 and as the Federal Reserve eased interest rates in the face of the recession in 2001 and the weak recovery thereafter. Improving prospects for investment in foreign economies also may have reduced the relative attractiveness of U.S. investments. Although there is no firm evidence, some foreign investors also may have been concerned about the increase in the risk of a sizable depreciation of the dollar as the large current-account deficit persisted and net foreign claims on U.S. assets rose.

Lower Rate of National Saving After 2000

Because the current account tallies the difference between saving and investment, shifts in consumers', firms', and the government's propensity to save can affect the balance. Indeed, the downward trend in the rate of national saving, the result of a steady decline in the personal saving rate, provided the underpinnings for the trend decline in the U.S. current-account balance since the early 1980s (see Table 1).[9] Between 1993 and 1999, even though the rate of national saving was rising—largely because the improvement in the federal budget balance outpaced the continued decline in personal saving—the investment boom in the United States created a growing shortfall of national saving relative to investment demand. The national saving rate began to fall again after 2000 and was below its 1993 value by early 2003. Because the drop in the saving rate was greater than the drop in the investment rate, particularly after 2001, the current-account

8. From 1991 to 1996, China's foreign exchange reserves rose by $62.3 billion. From 1997 to 2002, they increased by $146.5 billion (from $139.9 billion to $286.4 billion); in comparison, reserves of all developing countries that report to the International Monetary Fund rose by $315.6 billion (from $501.1 billion to $816.7 billion), and those of all industrial countries rose by $94.2 billion (from $386.1 billion to $480.3 billion). See International Monetary Fund, *International Financial Statistics Yearbook, 2003* (Washington, D.C.: International Monetary Fund, 2003). Dollar assets as a share of total world holdings of foreign exchange reserves rose from 60 percent in 1996 to 68 percent between 1999 and 2001 and fell to 65 percent in 2002. See International Monetary Fund, *Annual Report, 2003* (Washington, D.C.: International Monetary Fund, 2003), Appendix I.

9. Economists do not fully understand the causes of the trend decline in the personal saving rate. See M. Browning and A. Lusardi, "Household Saving: Micro Theories and Micro Facts," *Journal of Economic Literature,* vol. 34, no. 4 (December 1996), pp. 1797-1855; and Maria G. Perozek and Marshall B. Rensdorf, "Alternative Measures of Personal Saving," *Survey of Current Business,* Department of Commerce, Bureau of Economic Analysis, April 2002.

deficit rose again despite the receding foreign demand for dollar assets.[10]

The drop in the national saving rate after 2000 was largely due to the worsening federal budget balance, which fell as a percentage of potential GDP from a surplus of 1.3 percent in fiscal year 2001 to a deficit of 3.4 percent in fiscal year 2003.[11] Some of the reduced federal saving was related to the recession in 2001 and the weak recovery thereafter, when tax revenues fell and spending on social programs rose. However, less than half of that sharp fall in the federal budget balance was attributable to the effect of the business cycle.[12] Had federal saving not-fallen, national saving would not have fallen as much, and the current-account deficit would not be as large.

Related Publications: Congressional Budget Office, *Causes and Consequences of the Trade Deficit: An Overview (*March 2000); and Juann H. Hung and Charles Bronowski, *Modeling the U.S. Current Account as the Savings-Investment Balance,* Technical Paper 2002-5 (December 2002), available at www.cbo.gov.tech.cfm.

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10. It should be noted that part of the initial surge in the current-account deficit after 2001 was a typical response to the depreciation of the dollar. Because many imports are purchased by contract in advance and are invoiced in foreign currencies, a lower dollar raises import prices faster than it lowers import volumes. Consequently, a lower dollar initially raises the nominal value of imports before it begins to boost exports and lower real imports, thereby lowering the nominal current-account balance before raising it.

11. Potential GDP is the highest level of real GDP that could exist for a substantial period without raising inflation.

12. See Congressional Budget Office, *The Cyclically Adjusted and Standardized-Budget Measures* (May 2004).