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Current Account Deficit of the U.S. – Do We Need to Fret About It?

The financial press is inundated with discussions about the current account deficit of late. The questions and answers that follow are written to help understand this issue.

Q: What is the current account?

A: The current account is part of a country's balance of payments statement. The balance of payments is a summary of international transactions. International transactions are recorded in the balance of payments on a basis of the double-entry method used in accounting. Therefore the balance of payments must always balance. References to surpluses and deficits imply that the focus is on a part of the balance of payments. The U.S. balance of payments has two main categories – current account balance and financial account balance. (There is a third category called capital account which is small). Transactions pertaining to goods, services, and unilateral transfers make up the current account. Transactions in financial assets and liabilities make up the financial account. For the balance of payments to balance, a current account imbalance (i.e. not equal to zero) must be matched by an equal and opposite imbalance in the financial account. In other words, a current account deficit implies a financial account surplus and vice versa.

The current account balance is the sum of the trade balance (exports of goods and services less imports of goods and services), the balance on investment income (investment income from U.S. assets abroad less investment income from foreign assets in the U.S.), and unilateral transfers (foreign aid).

A basic macroeconomic identity links the current account balance/trade balance to the difference between national (private and public) savings and national investment. If national savings is less than national investment, the country is importing capital (that is borrowing) and is running a current account deficit. Based on this relationship, the question that follows is whether the deterioration of the current account deficit reflects increased investment or a reduction in saving. The saving-investment issue is examined in detail later in this discussion

Q: Who publishes this information?

A: The Bureau of Economic Analysis of the Department of Commerce publishes this information for every quarter in the report titled "U.S. International Transactions." It is published about 10 weeks after the end of each quarter. (<http://www.bea.gov/bea/di/home/bop.htm>)

Q: What is the recent current account position of the United States?

A: Data for the third quarter of 2004 show a current account deficit of \$164.7 billion, taking the three quarter total to \$476.3 billion. A conservative estimate for the fourth quarter yields a current account deficit of \$630 billion in 2004 vs. a \$530.7 billion deficit in 2003. The current account as a percent of GDP was 5.6% in the third quarter, the highest on record. The recent size of the current account deficit has no precedent.

Chart 1

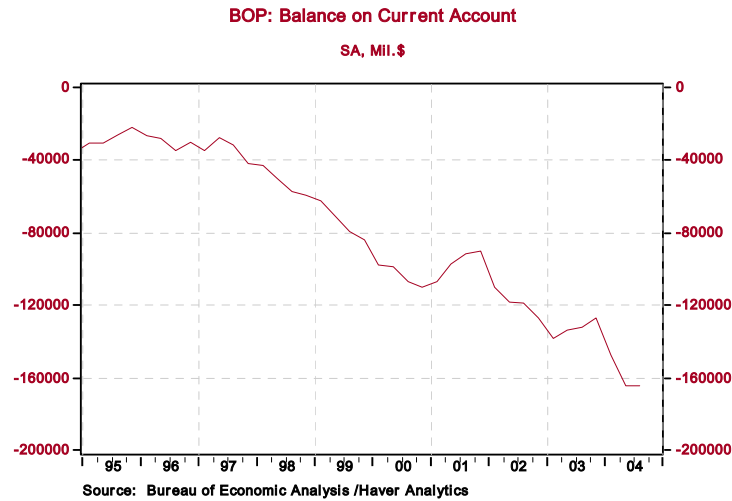
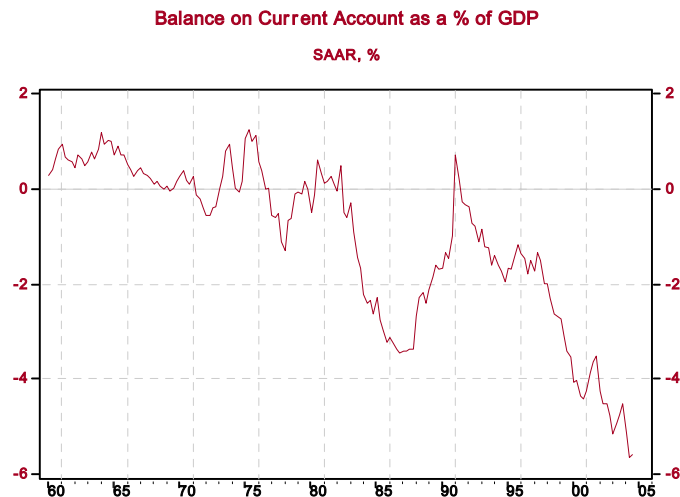


Chart 2



Q: What is the composition of the current account deficit of the U.S. economy?

A: Currently, the U.S. current account deficit is roughly equal to the trade balance (exports of goods and services less imports of goods and services). The balance on investment income is a small surplus. Over time this surplus is likely to change as debt service costs of foreign owned assets (for example, foreign holdings of U.S. stocks, bonds) in the U.S. rise from the current low cost situation. Unilateral transfers add up to less than 1.0% of GDP. The current account deficit, at the present time, in the U.S. amounts to imports of goods and services exceeding export of goods and services. Essentially, the U.S. economy is spending more than it is earning. Foreigners are financing this shortfall. Foreigners lending in the form of their purchases of stocks, bonds and direct foreign investment is the surplus recorded in the financial account of the balance of payments. Based on the estimate of the current account deficit for 2004, the U.S. is borrowing \$1.7 billion dollars a day!

Q: What is the immediate consequence of large persistent current account deficits?

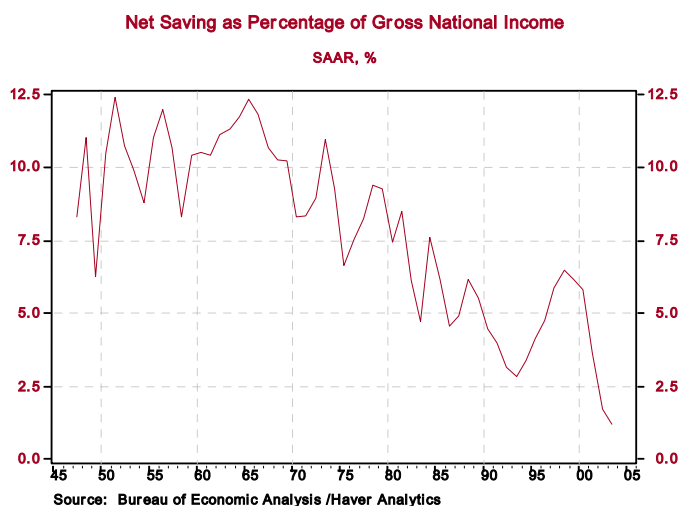
A: Irrespective of the cause of current account deficit, ongoing current account deficits are equal to what the nation is borrowing or they make up net foreign claims on the U.S.. This measure of what

the U.S. owes to the rest of the world is called the net international investment position (NIIP). It is the total stock of accumulated foreign claims on the U.S. less the stock of U.S. claims on the rest of the world. The NIIP of the U.S. was negative \$2.65 trillion in 2003 compared with negative \$360 billion in 1996. This number is expected to jump to over negative \$3.0 trillion in 2004. Relative to GDP, net foreign liabilities amounted to 24.0% of GDP in 2003, a significant increase from 4.6% in 1996.

Q: What is the record of savings in the United States?

A: National savings is the sum of personal savings, business savings, and government savings (dissavings when the government is running a budget deficit). The national saving rate is this sum divided by national income. The average national savings rate was 1.6% in the first three quarters of 2004, which is close to the 1.2% record low reading registered in 2003. From Chart 3 it is clear that the saving rate of the U.S. economy shows a marked downward trend since 1996.

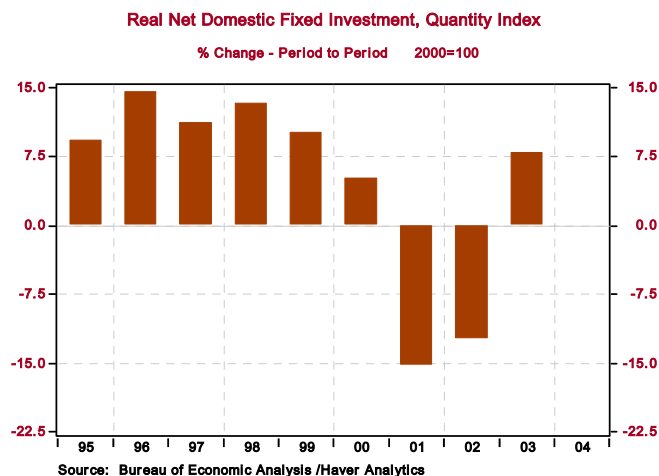
Chart 3



Q: What is the recent record on investment ?

A: As Chart 4 indicates, net domestic investment posted a deceleration or a decline between 1999 and 2002.

Chart 4



The information herein is based on sources which The Northern Trust Company believes to be reliable, but we cannot warrant its accuracy or completeness. Such information is subject to change and is not intended to influence your investment decisions.

Q: Alternatively, what are the relative shares of investment and consumption in GDP during the recent years?

A: We can look at shares of consumption and investment of real GDP in recent years to establish if foreign borrowing financed consumption or investment expenditures. The table below and Charts 3 and 4 make a case that the bulk of foreign funds has financed consumption expenditures. (Recent data suggest that foreign central banks not private investors are the source of foreign funds. This detail has economic and political implications – subject of another related discussion.)

Table 1 Shares of C and I in U.S. Real GDP

Year	Consumption [C]	Investment [I]
1998	67.2	16.4
2003	70.5	15.1
Change	3.3	-1.3

Q: Why should we examine the recent trend of saving, consumption, and investment?

A: The current account deficit implies that the U.S. is borrowing large sums of money to finance its expenditures. The acceleration in the current account deficit began after the 1997 Asian crisis and has persisted even after the Asian economies recovered. The saving and investment data indicate that the current account deficit reflects reduction in investment and saving. The consumption numbers tell us that the nation has borrowed to finance a consumption binge not an investment boom. The U.S. is borrowing to support consumption expenditures not to build factories and enlarge the capital base of the economy.

Q: Given this information, is the current account deficit something to fret about?

A: Yes, it is a problem and not a reflection of America’s strength.

Q: Is the current account deficit sustainable?

A: No, it is not sustainable. If history is a guide, the current account deficit will narrow in time but the adjustment process is the important question at hand. With the NIIP at 24.0% of GDP, further growth in the current account deficit translates into a larger debt and debt service costs. If this is one of the likely scenarios, the process of adjustment will be long-drawn. Alternatively, reducing the current account deficit requires substantial slowing of growth in the U.S. economy. This would also have severe consequences not only in the U.S. but across the entire global economy.

It appears that the process of adjustment will include a combination of (1) a significant change in the exchange rate, (2) slower growth of the U.S. economy, and (3) probably faster growth in the rest of the world. In this entire adjustment phase, it will be necessary for savings in the U.S. economy to show a substantial improvement.

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