

Should We Worry about the Current Account Deficit?

BY AARON STEELMAN

By most standards, the American economy looks pretty strong. Gross domestic product (GDP) increased roughly 3.5 percent in 2005, the unemployment rate fell to about 5 percent, and inflation remained relatively tame.

Still, some worry that those good data mask a more important truth — that the United States is becoming a heavily indebted nation. These skeptics point to the growing current account deficit, which measures the gap between what Americans earn and spend abroad. For 2005, the current account deficit was roughly 6 percent of GDP. Total net foreign liabilities now amount to roughly 25 percent of GDP. These figures are large by historical standards. But are they necessarily bad? Should we worry about America's growing current account deficit?

In a recent paper in *Foreign Affairs*, David Levey, formerly the managing director of Moody's Sovereign Ratings Service, and Stuart Brown, an economist at Syracuse University, argue that America's foreign debt poses little threat to the United States. Indeed, they claim that the current account deficit is increasing largely because of the strength of the U.S. economy.

Let's consider why we might be concerned about America's foreign debt. By definition, a large current account deficit means that foreign investors and governments are holding substantial dollar-denominated assets. Should a few big holders of these assets decide that they are no longer desirable and sell them, it's possible that this could set off a panic, resulting in a plummeting dollar, rising interest rates, and a shrinking U.S. economy. The net effect could be a global recession. This scenario is similar to what happened in Mexico and Thailand in the 1990s. But if it were to occur in the United States, the effects would be much more significant because the American economy is so much larger.

Levey and Brown argue that the current account deficit can be explained in terms of three different factors: trade, domestic savings and investment, or the composition of global wealth. "In each case, though, the risks are far less dire than they are made out to be," they argue. "And in many ways, chronic current account deficits reflect strong economic fundamentals rather than fatal structural flaws."

Consider a trade-based account, the central part of which is the relative strength of the U.S. economy. "In this view, the United States has a stubborn current account deficit because it grows faster than its trading partners and spends a dispro-

portionate share of its growing income on imported goods and services," Levey and Brown write.

Under the second scenario, the current account deficit results from the difference between total investment in the United States and domestic savings. But Levey and Brown argue that neither savings nor investment is well measured. "Capital gains on equities, 401(k) plans, and home values are excluded from measurements of personal savings; when they are added, total U.S. domestic savings is around 20 percent of GDP — about the same rate as in other developed countries," they write. (Of course, if home prices decline, as many analysts predict, this would weaken the case made by Levey and Brown.) On the investment side, "intangible" invest-

ments, such as on-the-job training and new-product development, are not included in the national account, even though they are large and growing.

The third approach focuses on international capital movements. Levey and Brown predict that, as the U.S. economy continues to grow, it will

become an increasingly attractive place for foreign investment from China, India, and other developing countries. This could generate high current account deficits, but the reasons would hardly be cause for concern.

In a response to Levey and Brown that appeared in a subsequent issue of *Foreign Affairs*, economists Brad Setser of Oxford University and Nouriel Roubini of New York University take a much less sanguine view. They argue that foreign central banks — mostly in Asia — are not buying dollar-denominated assets because of strong conditions in the United States. Rather, they are doing so to keep the U.S. economy afloat — but that will eventually prove too costly and come to an end. "Celebrating the United States' real economic strengths while ignoring the real — and growing — economic vulnerabilities associated with unprecedented current account deficits is dangerous," write Setser and Roubini.

Ultimately, it's not clear how big of a risk the current account deficit poses to the U.S. economy. On this issue, there is no consensus among economists. So what should the U.S. central bank — the Fed — do in the meantime? Continue to focus on its core mission: maintaining price stability. If there's a relatively sure way to induce foreign investors to shed dollars and dollar-denominated assets, it's to engage in inflation. **RF**

"The Overstretch Myth"

by David H. Levey and Stuart S. Brown.

Foreign Affairs, March/April 2005,

vol. 84, no. 2, pp. 2-7.