

Do Current Account Deficits Matter?

by

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In the face of persistently high current account deficits of the United States, the debate has heated up whether current account deficits do matter at all. The opinion of former U.S. Treasury Secretary Paul O'Neill that current account deficits are rather a sign of strength of an economy than a problem recently received some prominent support from William Poole, who is the President of the St. Louis Federal Reserve Bank. For him, current account deficits do not matter when seen in terms of the balance of payments accounting framework.¹ Following his view, the current account deficit of the United States is largely the reflection of the on-going attractiveness of the U.S. as a harbor for international capital.

But can we really accept these tranquilizers? What is the substance of these arguments and what do balance of payments numbers actually reveal and what do they conceal? In fact, as widely as balance of payments figures are used in the public political discourse, they represent also one of the least understood economic statistics. Conventional economic analysis, too, rarely goes to the

¹William Poole: A Perspective on U.S. International Trade. Speech at Louisville Society of Financial Analysts Meeting, Louisville, KY, Nov. 19, 2003 (www.stls.frb.org)

heart of the matter due to the lack of a long-term perspective. In addition, most analyses apart from Austrian economics fail to take into account how international capital flows and foreign exchange manipulation impact the capital structures of the economies involved. In order to reveal the full economic meaning of the balance of payments a dose of Austrian economics will be warranted. But first a look at the basics of the balance of payments accounting framework will be required.

Balance of Payments Accounting

Balance of payments accounting is based on the double entry principle with every item booked as a credit and a debit. Therefore, the overall result will be in balance and the equation for the balance of payments will be zero. Deficits and surpluses can only show up in the sub balances such as in the balances of goods, services, investment income, current transfers and the capital and financial account.²

² This paper follows the U.S.-system of balance of payments accounting and terminology as it was introduced in 1999.

The registration of a current account deficit essentially means that a country spends more than it produces in a given period. The difference between absorption at home and domestic production constitutes the accumulation of debt or the sale of domestic assets to non-residents. While it is obvious that in accounting terms the balance of payments must be in equilibrium, excess spending implies debt accumulation or loss of ownership. These, however, are not directly registered in the balance of payments statistics. They show up merely indirectly and in a significant way only later on in the account called investment income where the payments for interest, dividends and rents to foreigners will be booked as a debit.

A negative current account balance requires a positive capital and financial account and this implies that the holding of domestic assets by foreigners must increase. The simple rule states: when the residents of a country (individuals, businesses, and government) sell more assets to foreigners than they buy from foreigners, the capital and financial account will be positive. It is this surplus in the capital and financial account that is being used to buy additional goods and services from abroad, which are registered as debit in the current account.

Leaving aside statistical problems (which are entered as a balancing item in the section for “statistical discrepancies”), the basics of the balance of payments accounting framework can be simplified as a set of equations.

A typical balance of payments (BP) contains three major sub balances: the current account (CA), the capital and financial account (CF) and the change of reserves account (ΔR). All items are registered as flows or as a change of stocks. The reserves account is seen as a form of compensatory financing and as such a net increase of the foreign exchange reserves receives a minus sign because it implicitly represents capital exports.³

The basic structure of a balance of payments equation is given by

$$(I) \quad BP = CA + CF - \Delta R = 0$$

Bringing the change of reserves (ΔR) to the right side, one gets

³ Foreign exchange reserves are held by a country's central bank. Their function is to serve as an ammunition chest for intervention in the currency markets. As a result of buying foreign currencies in order to keep the exchange rate competitive, a country will augment its foreign exchange reserves. On the other hand, a central bank will sell foreign exchange and buy its own currency if the government wants to avert a devaluation of its currency. A currency crisis happens when expectations take hold in the foreign exchange market that the central bank will run out of its foreign exchange reserves.

$$(II) \quad BP = CA + CF = \Delta R$$

In this form the equation demonstrates that when a country's current account (CA) and its capital and financial account (CF) should not balance, the discrepancy will show up as a change in the country's foreign exchange reserve position (ΔR). If a country's reserves are depleted ($R = 0$) or if a certain level of foreign exchange reserves must be maintained ($\Delta R = 0$) a current account deficit must fully be compensated by a net inflow of foreign capital. If the country can no longer obtain foreign financing, the burden of adaptation will fully fall on foreign trade. On the other hand, a country will accumulate foreign exchange reserves when the sum of the current account (CA) and the capital and financial account (CF) are positive.

In order to gain an understanding of the basic mechanisms and their economic implications, a closer look at the major sub balances will be required. All three major accounts of the balance of payments -- the current account, the financial and capital account and the reserves account -- are not only connected in terms of accounting procedures but also as to their economic content.

The current account balance (CA) contains three major items: the net result of the foreign trade in goods (NXG), net exports of

services (NXS), net foreign investment income (NFI), and net unilateral transfers (NTR). Any of these sub-accounts can have a surplus or a deficit just like the current account as a whole.

$$(III) \quad CA = NXG + NXS + NFI + NTR$$

The capital and financial account (CF) registers capital flows with an inflow as credit (+) and an outflow as debit (-). Thus, an increase of the assets abroad held by the residents will be booked as a debit, while the increase of liabilities towards foreigners represents a credit. The increase of liabilities to foreigners constitutes capital imports (CIM) and the increase of net assets against foreigners is counted as capital exports (CEX). The balance equation for the capital and financial account (CF) then is:

$$(IV) \quad CF = CIM - CEX$$

When the current account is in balance ($CA = 0$), the capital account automatically is in balance, too. Outflows equal inflows. However, when the current account is in deficit ($CA < 0$), a positive capital and financial account is required ($CF > 0$). In order to pay for the excess of domestic absorption as registered by a negative current account, there must occur a net sale of assets or, in other words,

foreign ownership of domestic assets must increase, i.e. non-residents must show up who lend money or buy financial or real assets. Therefore, a positive capital and financial account as the counterpart to a negative current account implies that this country is accumulating debt or that it is losing out on its stock of assets.

One can simplify the current account by leaving out the unilateral transfers (assuming they are zero). As all export items in this account are registered as credit (+) and the import items are registered as debit (-), the current account can be reduced to an account called net exports (NX).

$$(V) \quad NX = EX - IM$$

The balance of payments equation then becomes

$$(VI) \quad BP = (EX - IM) + (CIM - CEX)$$

and the basic balance of payments equation⁴ can be reduced to

$$(VII) \quad BP = NX + CF$$

⁴ Statistically the so-called “Basic Balance” is calculated as the sum of the current account and the financial account.

Under the constraint that a certain level of foreign exchange reserves must be maintained ($\Delta R = 0$) the balance becomes

$$(VIII) \quad NX + CF = 0$$

Thus, negative net exports ($NX < 0$) require a positive capital flow ($CF > 0$) and vice versa.

$$(IX) \quad -NX = CF$$

$$(X) \quad NX = -CF$$

When one country has a deficit in the current account, some other country or group of countries must have a surplus. If the countries that have a current account surplus finance the deficit country by exporting capital, there will be no balance of payment problem in the short run. It may seem as if a country could go on forever importing more goods and services than it exports. There seems to be no reason for concern, and usually this is where a conventional analysis would stop probably only adding that flexible exchange rates will do the balancing act. But while in fact the game can go on for a long time, limits will show up sooner or later. These limits will appear in the net investment position.

An "Austrian" Balance of Payments Analysis

The perspective of Austrian economics directs attention to three problem areas, which are often neglected in conventional balance of payments analyses. Firstly, we will ask what the long-term effects of persistent current accounts deficits will be; secondly, attention will be drawn to the question how international credit expansion affects the global money supply; and, thirdly, we must ask: what does all of this imply for the capital structure of the economies involved?

The payment of interest to foreigners gets a negative sign in the current account. If this is not matched by exports of some other item in the current account, the net result with other things being equal will be that the current account becomes negative and the way to pay for that will be by asset sales including debt instruments.

One of the long-term consequences of current account deficits will be that more domestic assets will go into foreign ownership. Each sale of assets implies the loss of domestic ownership and in the long run the consequence will be that the country is losing its autonomy. But while the popular concern is drawn to criticize the sale of visible assets -- such as some national landmark or a company with a

prominent national pedigree -- it is debt, which really matters and in particular when this debt is accrued by the government.

The visible capital imports such as foreign direct investment are usually meant to stay.⁵ In the long run it makes a decisive difference if the capital account will be financed mainly by foreign direct investment or through debt accumulation and even more so if it is government bonds that account for the overwhelming share of the transactions. The foreign sale of bonds by the government is not just a change in private ownership: it implies that additional liquidity is being created and that the stock of outstanding public debt is rising. While a sale of bonds to residents taps into private domestic savings and the money moves from private into public hands, foreign public debt is funded by foreign savings which will be spent at home by the government.

The current account includes the interest payments on debt, and the dividends and rents that are to be paid to foreign holders, all of which gets booked in the sub account called investment income. A persistently positive capital account will automatically drive the current account into a deficit beyond the trade of goods. While the

⁵Among industrial countries with close economic ties, foreign direct investment usually balance out over the long run, and in the case of developing countries, a positive inflow of direct investment is a major source of technology transfer and a boost for economic growth and development.

current account deficit may grow slowly at the beginning of a prolonged debt cycle and mainly at first rise due to the import of foreign goods, it will virtually explode later on due to the payment of investment income. Then, the current account deficit will widen not because of the import of merchandise -- which so far has had a stimulative effect on both the debtor and the creditor's economies -- but because the deficit in the current account will widen due to financial obligations. The end result would be the crowding out of physical imports and other services beyond investment income.

Before this would happen on a grand scale, the creditors most likely will perceive what is going on. But different from a small economy, which would be forced into default or be kept under IMF rule, prolonged and substantial foreign indebtedness by the country which holds the privilege of creating international reserves may be welcomed because its debt expansion provides the basis for a global boom. The expansion of debt by the issuer of the international reserve medium augments the stock of international reserves and the increase of the reserves works like a growth of the global money supply. Central bank balance sheets show that the circulating domestic money forms a debit item, while foreign reserves are part of the credit side. All other things being equal, an increase in foreign reserves implies money creation. This way, foreign debt

accumulation by the issuer of a global reserve currency impacts the global money supply through two channels: at home by the domestic spending of foreign savings, and abroad by the accumulation of foreign exchange reserves.

The country, which emits the international reserve currency, does not face a foreign exchange constraint; thus there will be no immediate limit for this process to go to its extremes. Additionally, an expansion of this kind must not be accompanied by price inflation right away. The prices for tradable goods may stay low for a considerable period of time⁶ and instead of a price inflation the bubble emerges in the asset markets. After all it is the transaction in the capital account of the balance of payments -- the buying and selling of debt instruments -- which lies at the heart of the process and it is here where the music plays in terms of the bubble. Bubbles, however, have the nasty habit of imploding because they are build on some unsustainable element. This factor within an international debt cycle concerns debt service payments, and this has consequences for international trade and economic growth.

⁶ When creditor countries accumulate foreign exchange reserves as a consequence of intervention in currency markets in order to achieve a competitive advantage, they gain the ability to flood world markets and the market of the debtor country in particular with cheap goods and this will exert a deflationary effect.

In its general form a debt cycle will be different for the issuer of the international reserve medium mainly only in so far as the potential extent and duration of the process may be much larger and longer. The stock of dollar reserves for the United States is unlimited. What is ultimately at stake for the U.S. is not its dollar reserve position but its role as the issuer of the dollar as a global reserve currency.

Once the expectation takes hold that the United States will use additional bond and other asset sales mainly for debt service purposes and less so in order to finance the import of goods, the creditor countries are faced with the loss of the advantage they want to enjoy. The strategy of the creditor countries of maintaining undervalued currencies by buying U.S. assets in order to gain advantages for their export industry no longer makes sense when most of the newly created U.S. debt simply goes into debt service. Faced with the imminent collapse of their U.S. dollar asset positions, the creditors will scramble for the remains. The inexorable result will be the collapse of the financial asset markets together with a dollar crash.

The worst part of such a process would come when the financial crisis becomes an economic crisis and the economic crisis turns into a social and political crisis. The longer the debt cycle has continued

and the more pronounced it was, the more deeply the capital structures in both the debtor and the creditor country have been transformed in this process. Then it will be as hard for the creditor countries to re-adapt their industries to the new constellation, as it will be for the United States. While the creditor countries will be faced with the breakdown of their major export market, the U.S. will be faced with the situation that there is no longer a sufficient capacity of domestic supplies to substitute for the contraction of imports. It will be at this point when the price inflation sets in. The liquidation of the debt overhang happens at a time when the supply structure is inadequate to meet demand. It is this mismatch, which lies at the heart of stagflation.

International Capital Flows and the Transformation of Capital Structures

Under capitalist conditions when market prices and private enterprises guide the allocation of resources in response to final demand, the capital structure will be constantly tuned. But what if the major prices are not market prices but intervention prices? While

there is little disagreement concerning the microeconomic effects of price intervention in particular markets in terms of misallocation, it is often ignored outside of Austrian economics that there are distortions at work in the modern mixed economy at the macroeconomic level. The State does not only absorb a large part of production, governments also manipulate two of the most important macro-prices: the price for money, which is determined by central banks, and the price for foreign exchange, when governments manipulate the exchange rate.⁷ Due to the macro-character of these prices, interventions at this level produce economic distortions that impact the whole economy and undermine well-established laws of economics, such as the beneficial effects of division of labor between nations and the efficiency rules of allocation.

Governmental intervention can fight against market forces for a long time and massively; but in the end, government, too, must give in. However, due its political agenda and because it must not consider profit and loss, government intervention can go on for such a long time and to such an extent that it will thoroughly transform an economy's capital structure. External debt accumulation fits well into this pattern. Debt cycles typically start slowly and during the phase of debt expansion the adaptation of the capital structure can be

⁷ One could also include the crude oil price as the third major price with relevance for the whole economy that is an intervention price.

managed gradually. It is when expansion turns into contraction that the trouble sets in. When a country has reached the end of its creditworthiness and credit suddenly breaks down, the capital structure proves being inadequate almost overnight. Capital structures cannot be smoothly re-switched in a short period of time. The adaptation to the new setting requires time and that sufficient savings will be generated.

Capital structures are composed of specific goods and their interrelationship is guided by relative prices. Any existent capital structure is specific in the sense that it reflects individual historical circumstances, the particularities of time and place. Therefore, each capital structure contains parts, which are “inconvertible”.⁸ This inconvertibility of capital in the face of changing market conditions represents the sources of losses and gains depending on the foresight of the entrepreneur. In an unhampered market this process will go on continuously and the capital structure is constantly updated. In fact, one can hardly see a reason why catastrophic changes of market conditions should happen aside than those coming from government.

Governmental debt accumulation and monetary expansions not funded by savings tend to go the extremes until they will collapse.

⁸ Ludwig von Mises: Epistemological Problems of Economics. Chapter 8: Inconvertible Capital. Auburn: The Ludwig von Mises Institute 2003

While it has taken many years for the capital structures of the economies involved to adapt to these conditions, the catastrophic event of the debt collapse will abruptly confront the capital structure with a new and very different setting. International capital flows driven by government possess the same general features like a debt cycle caused by monetary expansion that is not funded by savings.

In this perspective, one of the frequently noted riddles of a depression that there is a host of seemingly intact productive units, which stand idle is explained by the inadequacy of the capital structure. In terms of Austrian business cycle theory⁹ it is not aggregate demand, which is lacking in a depression but its cause is that a chain or several chains within the capital structures have broken down. The present capital structure no longer fits. It is the same with an individual production process, which will come to a standstill when specific items are unavailable or when a production unit has been set up whose output fails to meet demand. While this happens constantly at a small scale in a market economy, it is the massiveness of government intervention that has pushed large parts of the economy towards an unsustainable transformation. It is government intervention that has laid the groundwork for the depression to happen and to become deep and last for a long time.

⁹ For a modern exposition see Garrison

When economies are forced by government to adapt to unsustainable conditions, it will be more than one or a few production plants, which will stand idle after the collapse. Due to the duration and extent at which only government can pursue unsustainable debt accumulation and periods of monetary easing, the whole subtle edifice of the complex interrelationships among capital goods may be thrown out of balance. The creation of the new capital structure requires time and savings. Given that the collapse has brought a contraction of national income, it will be mainly through the reduction of consumption that a process of re-adaptation can be initiated.

The need to cut consumption in order to provide the funds for the economy to re-calibrate also explains why governments tend to refrain from aborting this path in time and instead bank on spending in the face of an imminent recession. Theoretically, a strong central bank could abort the process of credit expansion in time. However, the political process is inherently biased towards monetary expansion and central banks are rarely exempt from political pressures even if they are formally independent.

The United States as a Debtor Nation

Typically, all three cycles -- government deficits, monetary expansion, and external debt accumulation -- tend to go hand in hand as it is also currently the case in the United States (see table 1).

Table 1

United States. Government Budget, Money Supply and External Treasury Position. Selected Years 1991-2002 (in billions of US-dollars)

	1991	1995	2001	2002
Government Budget	-266	-146	92	-231
Money Supply M3	4,204	4,626	8,004	9,518
Treasury Securities held by non-residents	476	633	1,040	1,136

Source: International Monetary Fund, International Financial Statistics Yearbook. Washington: IMF 2003

It is not so much a problem when a country has a high current account deficit in one or even for a few years. Seen from the perspective of its impact on the capital structure, the problems come with the persistency of current account deficits and their necessary equivalent of a long period of debt accumulation. When small open

economies experience debt cycles, the major consequence of the collapse will be isolated to this economy. It is different with the U.S. where the debt cycle affects large part of the world economy. While being highly simulative in the phase of expansion debt, a sudden contraction of debt would bring down a major part of the world economy.

As is shown by the figures (Table 2), the United States has been a net foreign debtor since 1992 with the speed of its debt accumulation accelerating since the mid 1990s.

Table 2
Balance of Payments Components and Net Investment Position for the United States. Selected Years 1992-2001 (in billions of US-dollars)

	1992	1995	2000	2002
Current Account Deficit	48	105	411	481
Financial Account Surplus	93	96	457	532
Net Investment Liabilities	452	343	1,583	2,387

Source: International Monetary Fund, International Financial Statistics Yearbook, Washington: IMF 2003; U.S. Department of Commerce. Bureau of Economic Analysis

With a current account deficit of And a budget deficit of ... in 2003, an unsustainable trend is on its way that sooner or later will turn into reversal. Foreign direct investment in the United States has begun to peter out and in 2002 the flow became negative. It is now mainly foreign debt accumulation that accounts for the financial inflows (see Table 3).

Table 3
United States. Composition of Capital Account and Basic Balance
2000-2001 (in billions of US dollars)

	2000	2001	2002
Direct Investment	129	3	-93
Equities	90	15	35
Bonds (a)	203	317	343
Basic Balance (b)	12	-58	-218

(a) net long-term capital

(b) Current account plus net long-term capital

Source: Bank for International Settlements, 73rd Annual Report, Basel 2003, table II.4

As the figures for the basic balance show (Table 3), capital inflows no longer compensate fully the current account deficit. If the United States were a country like the rest and did not have the privilege of issuing the dominant world reserve currency, its rapidly deteriorating external position would have signaled imminent international payment disability. However, due to the role of the

U.S.-dollar within the international monetary system, the U.S. enjoys a considerable margin. But this margin will disappear once alternative reserve media become available. If the European currency, the euro, does not qualify for that, market dynamics may even give rise to quite a different kind of international exchange media beyond any fiat monetary system.

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