

The U.S. and the World Economy

The trade deficit is commonly viewed as a bad thing, but this view is often based on a misunderstanding of international trade data. For one thing, the counterpart to this deficit is a capital account surplus that indicates that foreigners find the U.S. a more attractive place to invest than the rest of the world.

Recent developments in the rest of the world have focussed attention on the role of international trade and investment in the U.S. economy. Some analysts are warning that ripple effects from the economic and financial problems in Asia will slow the U.S. economy and perhaps precipitate a recession. Others suggest that the impact of the "Asian contagion" will not be entirely negative. The exchange rate of the dollar has increased relative to Asian currencies as a result of that region's problems, and this has made Asian imports cheaper for U.S. consumers. In addition, to the extent the United States is perceived as a "safe haven" against the economic and political risks in Asia, investors may invest more here and less abroad, which could help keep U.S. interest rates relatively low.

No one can say with certainty how the troubles in Asia will play out. But to put some perspective on how developments in the rest of the world may influence the U.S. economy, it is helpful to review the data on U.S. international trade and investment.

Most news reports on U.S. international transactions focus on only one component, such as the trade deficit, or, even more narrowly, on trade between the

United States and an individual country, such as Japan. Such a simplistic view can be misleading. International transactions comprise many more resources besides goods. In addition, trade patterns with one country do not give an accurate picture of the overall movement of resources between the United States and the rest of the world. A more useful approach is to look at the overall statistics of U.S. international trade and payments.

International trade and payments data include many types of transactions. By convention, the two major categories are the so-called current account and capital account. Transactions included in the current account are those that, once made, do not result in any claims for future payment. These include payments for exports and imports of merchandise (goods and commodities) as well as for services, which includes tourism, travel, shipping, insurance, and financial and legal services. The current account also includes interest and dividends from international investments. For example, when a foreign investor receives interest on a U.S. investment, the interest is reported as a U.S. import payment (the import being the use of another country's capital). A fourth category of current payments is transfer pay-

ments, which are payments for which nothing measurable is received in return, such as private remittances and official foreign aid.

Everything else in the international statistics, including errors and omissions, is usually deemed to reflect capital transactions. Capital transactions generate continuing obligations for future payment, as in the purchase of U.S. Treasury bonds. Foreign investors can sell their bonds to a U.S. investor or claim the principal when their bonds mature. The capital account also can be divided into various categories. These include direct investment (i.e., where a business is controlled by a foreign investor), bonds, stocks, and bank lending. Changes in the amount of U.S. currency held abroad are also reported on the capital account. Currency accounts for a small portion of the outflow of U.S. capital, but in recent years this outflow has increased rapidly. As a result, as much as two-thirds of U.S. currency is now held by foreigners, according to Federal Reserve estimates.

It may be noted that the capital account measures the flow of investment capital between the U.S. and the rest of the world over a period of time, not the outstanding value of U.S. assets abroad or foreign assets in the United States. In addition, not all investment flows are reported in the capital account. Many real estate transactions (and all land sales) are excluded, as are most capital gains. Transactions that are omitted or mismeasured presumably account for a large portion of "unidentified" capital flows. International data are compiled from a wide variety of

Table 1
U.S. Balance of Payments, Current Account Components
 (as a percent of GDP)

	<u>1987</u>	<u>1989</u>	<u>1991</u>	<u>1993</u>	<u>1995</u>	<u>1997</u>
Merchandise Exports	+5.3	+6.3	+7.0	+6.9	+7.9	+8.4
Less: Merchandise Imports	<u>-8.7</u>	<u>-8.3</u>	<u>-8.3</u>	<u>-8.9</u>	<u>-10.3</u>	<u>-10.9</u>
<i>Balance of Merchandise Trade</i>	-3.4	-2.0	-1.3	-2.0	-2.4	-2.5
Plus: Service Exports	+2.1	+2.2	+2.8	+2.8	+3.0	+3.1
Less: Service Imports	<u>-2.0</u>	<u>-1.8</u>	<u>-2.0</u>	<u>-1.9</u>	<u>-2.0</u>	<u>-2.1</u>
<i>Balance of Trade (Goods and Services)</i>	-3.3	-1.6	-0.5	-1.1	-1.4	-1.4
Plus: Income on U.S. Investments Abroad	+2.1	+2.7	+2.4	+2.0	+2.7	+2.9
Less: Income payments on foreign investments in U.S.	-1.9	-2.4	-2.0	-1.7	-2.6	-3.1
Transfer Payments (net)	<u>-0.5</u>	<u>-0.5</u>	<u>+0.1</u>	<u>-0.6</u>	<u>-0.5</u>	<u>-0.5</u>
<i>Balance on Current Account</i>	-3.6	-1.8	-0.1	-1.4	-1.8	-2.1

sources whose information is often incomplete, mismeasured, and inconsistent. The numbers seldom “add up,” and unidentified flows are the statistical discrepancy between the total reported balances on the current and capital accounts. By convention, unidentified flows are classified as capital flows, but they probably include other, possibly large, flows that would be included in the current account if they were reported (e.g., imports of illicit drugs).

Table 1 shows statistics for the current account and its major components for the period 1987-97. Table 2 shows similar data for the capital account. Along with the gross flows for each type of transaction, a net balance is shown. The net balance of merchandise trade, for example, is the value of goods exported less the amount imported. When news accounts talk about the “trade deficit,” they usually are referring to this balance. The balance on the current account adds international payments for services, investment income, and transfer payments to the merchandise trade balance. Because it takes more transactions into account, this balance is a better indicator of the flow of resources in and out of the United States.

All of the flows in Tables 1 and 2 are expressed as a percentage of current-dollar U.S. Gross Domestic Product (GDP). This provides a simple means of obtaining a common denominator among flows and across years. Because of price inflation and the overall expansion of the U.S. economy, comparisons of dollar flows may be misleading. For example, in 1997, the merchandise trade balance showed a deficit of \$199 billion, or about 25 percent more than the corresponding amount (\$160 billion) in 1987. News reports usually present this kind of change as a worsening of the deficit. However, because U.S. GDP increased from \$4.7 trillion in 1987 to \$8.1 trillion last year, the mer-

chandise trade deficit actually decreased in terms of its significance to the U.S. economy, from 3.4 percent of GDP in 1987 to 2.5 percent in 1997 (see the last line in Table 1).

It may be noted that positive flows in the tables are those which lead to net sales of foreign currencies for dollars (e.g., exports), while negative flows presumably lead to net sales of dollars for other currencies (e.g., imports). Except for rounding errors, the total of the positive and negative flows in the various accounts is always zero. In other words, a deficit in the current account is matched by a surplus in the capital account, and the overall international account balances to zero.

This accounting identity simply reflects the fact that, with currencies that are not officially redeemable for gold, every purchase of a foreign currency with dollars is also a purchase of dollars with the currency. There must be a buyer for every seller of one currency for another, and any “imbalance” in supply and demand is resolved by changes in exchange rates. Nonetheless, it seems to be widely believed that the United States is running a “deficit” with the rest of the world.

The Trade Deficit

Most discussions ignore the capital account and focus on the current account or its largest component, merchandise trade. The tendency to focus on the trade of goods and ignore services is a throwback to the days when goods accounted for the largest part of the economy. However, the notion that services do not matter is akin to the argument that it is better for people to work at manufacturing jobs than in banking or engineering.

Since the early 1980s, merchandise imports have consistently exceeded U.S. exports. The resulting merchandise trade deficits have more than offset surpluses

in the rest of the current account. Thus the overall current account has been in deficit for roughly the past 15 years. This deficit narrowed in the early 1990s, when the recession dampened U.S. imports. In addition, the flow of transfer payments turned positive in 1991 for the first time in decades, due to a one-time inflow of funds from other nations helping to pay for the Gulf War. As a result, the current account deficit almost disappeared in 1991, shrinking to 0.1 percent of GDP. Since then, however, it has widened again. In 1997 it increased to 2.1 percent of GDP.

Bigger deficits are widely viewed as bad, but the deficits of the 1990s largely reflect the fact that the U.S. economy has outperformed its major trading partners. Strong domestic growth has spurred imports, and the booming U.S. financial markets have provided larger investment income to foreigners. In contrast, the rest of the world has struggled to emerge from a prolonged period of slow growth and outright recession. Western Europe, Japan, and Mexico have been in the doldrums for most of the 1990s, and this has dampened the growth in foreign demand for U.S. exports.

The focus on deficits tends to obscure important trends in the gross flows of resources in and out of the U.S. economy. During the past decade, the current account deficit never exceeded 3 percent of GDP, which might suggest that trade is a relatively small and unchanging factor in the U.S. economy. However, the gross flows of export and imports of goods, services, and investment income grew substantially during this period, increasing from 22.5 percent of GDP in 1987 to 31 percent in 1997. As indicators of the growing importance of international trade and investment to the U.S. economy, these gross figures are a better measure than the net flows that attract so much comment.

Table 2
U.S. Balance of Payments, Capital Account Components
(as a percent of GDP)

	<u>1987</u>	<u>1989</u>	<u>1991</u>	<u>1993</u>	<u>1995</u>	<u>1997</u>
Foreign direct investment in U.S.	+1.2	+1.2	+0.4	+0.7	+0.9	+1.3
Foreign holdings of U.S. stocks and bonds (excl. Treasury debt)	+0.9	+0.7	+0.6	+1.2	+1.3	+2.3
Private foreign holdings of Treasury securities and U.S. currency	-0.0	+0.6	+0.6	+0.7	+1.5	+2.3
Other private foreign holdings of U.S. assets	+2.2	+1.3	+0.0	+0.5	+0.9	+2.3
Foreign official holdings of U.S. assets (incl. Treasury debt)	<u>+1.0</u>	<u>+0.1</u>	<u>+0.3</u>	<u>+1.1</u>	<u>+1.5</u>	<u>+0.2</u>
<i>Capital Inflows (A)</i>	+5.3	+3.9	+1.9	+4.2	+6.2	+8.5
U.S. direct investment abroad	-0.6	-0.6	-0.5	-1.2	-1.2	-1.5
U.S. holdings of foreign stocks and bonds	-0.1	-0.4	-0.8	-2.2	-1.4	-1.0
Other private U.S. holdings of foreign assets	-1.0	-1.5	+0.2	+0.5	-1.5	-2.8
U.S. official holdings of foreign assets	<u>+0.2</u>	<u>-0.4</u>	<u>+0.1</u>	<u>-0.0</u>	<u>-0.1</u>	<u>-0.0</u>
<i>Capital Outflows (B)</i>	-1.5	-2.9	-1.0	-3.0	-4.2	-5.3
<i>Net Identified Capital Inflows (A - B)</i>	+3.7	+1.0	+0.9	+1.3	+2.0	+3.3
Less: Unidentified Capital Outflows	<u>-0.2</u>	<u>+0.8</u>	<u>-0.8</u>	<u>+0.1</u>	<u>-0.2</u>	<u>-1.2</u>
<i>Equals: Surplus on Capital Account (also equals Deficit on Current Account)</i>	+3.6	+1.8	+0.1	+1.4	+1.8	+2.1

The Capital Account Surplus

As noted, our trade balance is matched by a net flow of investment capital. Consequently, we cannot win a “trade war” without also simultaneously losing an “investment war” and *vice versa*. What the capital account surpluses of the past 15 years indicate above all is that U.S. assets have been perceived as a better bargain in world markets than have U.S. goods and services.

During the 1990s the inflow of foreign capital to the United States has increased substantially, particularly since 1993 (see Table 2). Foreigners’ direct investment and purchases of U.S. stocks and corporate bonds have increased. In addition, foreign private investors and central banks have purchased record amounts of U.S. Treasury securities. As a result, foreigners now hold more than one quarter of total U.S. Treasury debt, the largest share in the postwar era. Purchases by Japan have been especially strong. Presumably, Japanese investors have taken advantage of the fact that interest rates are higher in the United States than in Japan. In addition, the yen was relatively strong against the dollar, until recently, making U.S. investments even more attractive.

Outflows of U.S. capital also increased in the 1990s, led by increased direct investment abroad, purchases of foreign stocks and bonds, and lending by U.S. banks to the rest of the world. However, the outflow of capital increased less strongly than the inflow of foreign capital, thus the net capital surplus widened to 2.7 percent of GDP in 1997 (see last line of Table 2).

The fact that we run a capital account surplus and a current account deficit is often taken as evidence that we are borrowing from foreigners in order to finance purchases of imports. However, another way of looking at it is that our capital account surplus indicates that investors around the world find the investment opportunities in this country more attractive than those elsewhere. The resulting inflow of resources enables us to buy more goods from the rest of the world.

In a more perfect world, the situation would be the opposite. There would be a net outflow of capital from economically advanced countries like the United States to underdeveloped parts of the world, where, by definition, resources are underutilized and the potential returns from more intensive and efficient use of resources is higher than in developed countries. That this is not the case suggests how unattractive the rest of the world is to investors.

Free market ideas are increasingly being accepted around the world, which may

be one factor behind the larger outflow of U.S. capital to the rest of the world in recent years. However, many barriers to genuinely free markets remain. These include excessive regulation and bureaucracy, high taxes, and the absence of adequate private property rights and bankruptcy laws. Prospective investors face additional risks arising from political instability, cronyism, corruption, and foreign accounting systems that may conceal as much as they reveal.

The barriers to foreign investment in foreign countries reflect the foreigners’ problems, not ours. In particular, making the United States a less attractive place to invest (which would seem to be the perverse agenda of many critics who would “cure” our trade deficits via higher taxes, more regulation, etc.) would amount to “cutting off our nose to spite our face.”

Recent Developments

The annual data in the tables mask substantial shifts in international transactions in 1997, in response to the deteriorating economic and financial conditions in Asia. The current account deficit widened at the end of last year and has increased further in 1998. Both exports to Asia and income from Asian investments have decreased. Most analysts expect the problems in Asia to lead to even larger current account deficits later this year.

The capital account surplus has also

increased. The outflow of U.S. capital slowed sharply in the first quarter, as U.S. purchases of foreign stocks and bonds, particularly Asian securities, plummeted. Net U.S. purchases of foreign securities decreased to \$5 billion in the first quarter, compared to \$41 billion in the third quarter of 1997. The inflow of foreign capital to the United States also has slowed, although to a lesser extent. Foreigners, particularly the Japanese, were net sellers of Treasury securities in the first quarter, in sharp contrast to their record purchases in recent years. However, net foreign purchases of U.S. stocks soared to a record \$29 billion in the first quarter. Asian investors were net sellers of U.S. stocks, but purchases from Western Europe surged. Investors apparently switched funds to the United States in response to uncertainty over Asia, coupled with the strong growth of the U.S. economy.

In May, the deficit in the trade of goods and services increased to a 6-year high. Any trade deficit has a negative effect on GDP, and some economists are now warning that GDP may actually have declined in the second quarter. If so, this would be the first quarterly decrease since the 1990-91 recession. This does not mean the economy is in recession or that a recession is imminent. But it does indicate that the problems in Asia are having a substantial impact on the U.S. economy, which will intensify if these problems worsen. □

BUSINESS-CYCLE TREMORS

The leading indicators deteriorated markedly this month. Our conventional statistical analysis suggests that continued expansion remains a likely outcome, but that outlook could change quickly. Of particular note, the leaders contain no information about the possible effects of the net trade adjustment to gross domestic purchases used in the calculation of GDP.

Only two primary leading indicators reached new highs this month, *M2 money supply* and the *ratio of manufacturing and trade sales to inventories* (M2 and all other dollar-denominated series are reported in constant dollars). Moreover, only two other leaders, the *index of common stock prices* and *initial claims for state unemployment insurance* (inverted), now remain clearly expanding — and the most recent base data for both of those series are negative.

The cyclical statuses of the rest of the leading indicators are to some extent in question: *new housing permits* is probably expanding; the *3-month percent change in sensitive materials prices* and the *3-month change in consumer debt* are probably contracting; and the cyclical status of the five remaining leaders is inde-

terminate. The percentage of leaders with apparent cyclical trends expanding thus dropped to 71 percent (five out of seven) from last month’s 80 percent. At this level, continued expansion remains a statistical probability. AIER’s cyclical score, our mathematically derived diffusion index of the leading indicators, was unchanged this month at 77, a level that would tend to confirm a favorable outlook for the next several months.

Confidence in these indexes must, however, be tempered by the widespread uncertainty that now prevails among the leaders. Given such uncertainty, the outlook could change very quickly: if just three of the five indeterminate series turned negative a contraction would become statistically likely. Moreover, as discussed below, other information not captured by the lead-

ers raises further doubt about even the current status of the economy.

Only one of the six primary roughly coincident indicators, the *civilian employment to population ratio*, was downgraded this month (from clearly expanding to probably expanding). Although the most recently reported base data for four series decreased, the cyclical statuses of the remaining five coinciders were unchanged. As last month (and for many months previously), 100 percent (six out of six) of the primary roughly coincident indicators with apparent cyclical trends are expanding.

Three of the six primary lagging indicators attained new highs this month: *the average duration of unemployment* (inverted), *manufacturing and trade inventories*, and *commercial and industrial loans*. All are appraised as clearly expanding. Of the remaining three laggings, the *percent change from a year earlier in manufacturing labor cost per unit of output*, remains appraised as probably expanding; the ratio of consumer debt to personal income is clearly contracting; and, as it has for many months, the cyclical status of the *composite of short-term interest rates* remains indeterminate. Overall, 80 percent (four out of five) of the primary lagging indicators with apparent cyclical trends are expanding — unchanged from last month.

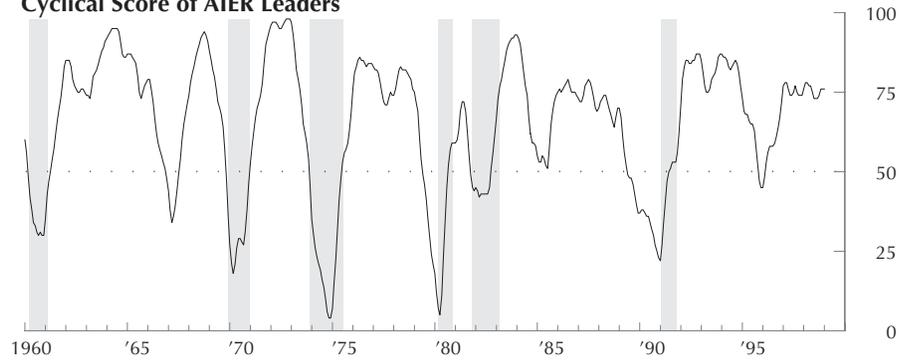
A Stealth Contraction?

As noted in the previous article, some analysts now report that huge trade deficits stemming from the Asian meltdown may already have resulted in negative GDP growth for the second quarter. Even though the conventional statistical series on which we and others usually rely have as yet provided little, if any, indications that a business contraction may be imminent or already underway (see chart above), this possibility cannot be dismissed.

The reason is that our indicators provide virtually no information about the possible effects that recent trade flows may have had on Gross Domestic Product. In brief, in the computation of real GDP, exports are added and imports are subtracted from the total of gross domestic purchases. At times when GDP growth rates are narrowly positive (or negative), large trade deficits or surpluses may be a statistically determining factor in ascertaining the direction of economic activity. In short, if the U.S. trade deficit was of sufficient magnitude, it is possible that the second quarter economy may technically have been contracting even though our statistical series provided no indication.

What such a “stealth contraction” might imply is far from clear, however.

Cyclical Score of AIER Leaders



For example, how firms book their unsold products resulting from cancelled Asian orders — as inventory (which is counted in GDP), or as write-offs (which are not) — could have various effects on the direction of GDP. But such accounting decisions made on the basis of tax or

other financial considerations say little about real business activity.

In any event, at some point we would expect to see any related reverses in business activity to be reflected in the leaders before such a technical contraction evolved into a full-blown recession. □

Statistical Indicators of Business-Cycle Changes

Change in Base Data				Primary Leading Indicators	Cyclical Status		
Mar.	Apr.	May	Jun.		May	Jun.	Jul.
+	-	-		M1 money supply	+?	+?	?
+	+	+		M2 money supply	+	+	+
+	+	+		Change in sensitive materials prices	-	-	-?
+	+	-		New orders for consumer goods	+?	+?	?
+	+	-		Contracts and orders for plant and equipment	+?	+?	?
-	-	+		Index of new housing permits	+	+	+?
+	-	-		Ratio of manufacturing and trade sales to inventories	+?	+	+
+	-	-	+	Vendor performance	?	?	?
+	+	-	-	Index of common stock prices (constant purchasing power)	+	+	+
-	-	+	nc	Average workweek in manufacturing	?	?	?
+	-	-		Initial claims for unemployment insurance (inverted)	+	+	+
-	+	-		Change in consumer debt	-	-?	-?
<i>Percentage expanding cyclically</i>					80	80	71
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+	+	-	Index of industrial production	+	+	+
nc ^r	-	-		Personal income in manufacturing	+	+?	+?
+	-			Manufacturing and trade sales	+	+	+
-	+	-	-	Civilian employment to population ratio	+	+	+?
+				Gross domestic product (quarterly)	+	+	+
<i>Percentage expanding cyclically</i>					100	100	100
				Primary Lagging Indicators			
+	nc	-	+	Average duration of unemployment (inverted)	+	+	+
+	+			Manufacturing and trade inventories	+	+	+
+	-	+		Commercial and industrial loans	+	+	+
-	+ ^r	-		Ratio of consumer debt to personal income	-	-	-
-	-	-		Change in labor cost per unit of output, manufacturing	+?	+?	+?
+	-	nc	+	Composite of short-term interest rates	?	?	?
<i>Percentage expanding cyclically</i>					80	80	80

Under “Change in Base Data,” plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under “Cyclical Status,” plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

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