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The Economy in Perspective

With a little help from our friends ... The United States continues to import more goods and services than it sends abroad, and by a wide margin. According to preliminary estimates, the real trade deficit amounted to approximately $30 billion in the first quarter. During the past several years, our real net export deficit has been running about $100 billion annually, up sharply from the pace established earlier in the decade, but still below rates recorded in the mid-1980s. While some people regard this persistent trade imbalance as a threat to national welfare, others view it as a boon to consumers. Few people, however, think about the connection between trade flows and capital formation.

When Americans consume and invest more than they produce, the extra resources are obtained from abroad. U.S. businesses pay for imports by either purchasing foreign exchange with dollars or directly remitting dollars to the seller. In either case, Americans receive goods and services, and foreign parties acquire dollars, which they invest in various ways. These dollar-denominated investments are essentially IOUs given to our trading partners for future redemption. Their ultimate value stems from foreigners' claims on goods and services produced in the United States.

For their part, foreign citizens collectively are producing more goods and services than they are using at home, and are sending the extra production to us. They are sacrificing the current use of these resources for greater consumption in the future, when they redeem their IOUs. Foreign citizens are saving and exporting capital, while U.S. residents are dissaving and importing capital.

The U.S. current account balance represents the trade balance plus net income from foreign investments plus unilateral transfers; a positive value means that we are generating net claims against the rest of the world, and a negative value means that we are generating net claims against ourselves. The U.S. capital account records the net flow of investment funds between the United States and our trading partners. The current account and capital account must mirror each other at all times: When the current account indicates that we are importing on net, the capital account must show an equal net generation of dollar claims against us.

According to popular opinion, international transactions are driven by international trade flows, that is, foreign saving positions adjust passively to accommodate the movement of goods and services. But this need not be so. If foreigners view the United States as a safe haven for their investment funds and have confidence in the purchasing power of the dollar, they may be willing to slow their consumption and place some of their savings in the debt and equity offerings of U.S. businesses, and in U.S. Treasury instruments. A strong demand for these investment vehicles will strengthen the dollar's value in foreign exchange markets, which in turn will lower the import price of foreign goods and services in dollar terms. Through this channel, the capital account can actually drive the current account.

The U.S. international investment position, which indicates our net creditor/debtor status, represents the sum of all past current account balances (plus adjustments for changing asset values). In 1982, the U.S. current account began a shift into the deficit position that has continued to the present day. Consequently, our international investment position, which had been registering around 10 to 15 percent of GDP between 1978 and 1983, began to reverse. In 1995, our net foreign indebtedness reached nearly $1 trillion, or 11 percent of GDP.

This means that foreign residents are enabling Americans to invest and to consume at a greater pace than otherwise would have been possible. Without the net savings inflow, U.S. interest rates certainly would have been higher during this extended period, as the demands for consumption and investment competed for the more limited pool of domestic savings. Had we saved more in response to higher interest rates, consumption would have been curtailed. During the past few years, net foreign investment coming into the United States has accounted for more than half of all domestically generated personal saving and for about 13 percent of gross domestic investment.

So the next time you purchase an imported car from Japan, coffee from Brazil, or toys from China, silently thank the people of those countries for their willingness to delay their gratification. They are partners in America's future, and they have $1 trillion worth of reasons to hope that our good fortune continues.