One way nations spend beyond their means is by incurring debts to the rest of the world. The U.S. current-account deficit indicates that Americans have been consuming in excess of their income by amassing foreign liabilities for more than 15 years. With the situation in Southeast Asia threatening a further deterioration in U.S. international accounts, some might wonder how long we can continue to service rising debts without a sharp hike in interest rates, a rapid depreciation of the dollar, or some other financial market disruption.

Foreigners will lend to the U.S. as long as they believe the nation can make interest payments on time and repay any maturing principle. Because our capacity to do so is ultimately linked with our ability to produce, foreigners will consider the ratio of U.S. international indebtedness to GDP in gauging our creditworthiness. The U.S. shifted to debtor status in the late 1980s, and although the debt has since mounted rapidly, it equaled only about 15% of GDP in 1997. Economists do not know how high the ratio can rise before foreign investors attach a significant default risk to it, but Canada and Australia have carried substantially larger debt burdens for many years without any obvious financial-market meltdowns.

Stabilizing our debt-to-GDP ratio depends primarily on our ability to fix our trade deficit (and unilateral transfers) relative to GDP. To do so — holding other things equal — foreign economic growth must exceed U.S. economic growth by approximately two percentage points, which seems unlikely to occur over the next two years. Moreover, the (continued on next page)
dollar’s steady real appreciation since 1991 does not favor a narrower trade deficit.

Even if the trade deficit stabilizes relative to GDP, holding the overall foreign-debt-to-GDP ratio constant requires that the rate of return on our foreign liabilities, which affects the proportion’s numerator, be less than our economic growth, which affects its denominator. Over the long term, one would expect the rate of return to approximate our nominal growth rate, making this second criterion rather inconsequential. If, however, foreign investors attach a risk premium to their expected return (possibly because our trade-deficit-to-GDP ratio reached a very high level), maintaining creditworthiness might necessitate a declining trade deficit or a trade surplus, instead of just a stable ratio. This situation could force some rather unpleasant outcomes: relatively slower real U.S. economic growth or a rapid real depreciation of the dollar.

Creditworthiness aside, persistent current-account deficits could still affect real interest rates if U.S. foreign borrowing increased faster than the rest of the world’s savings. The U.S. is a large borrower; its liabilities equal about one-third of the rest of the world’s assets. Over the past 10 years, however, U.S. liabilities and foreign assets have grown in sync.