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Economic Analysis for the Institutional Investor

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Occasional Research Paper No. 2 - October 1989

Do Economists Know How to Recognise a "Balance-of-Payments Problem"?

The question posed in the title may seem rather cheeky. Surely, economists - with their sophisticated theories and computer models - know what a balance-of-payments problem looks like. The argument of this paper is that, in fact, economists do not know how to define a balance-of-payments problem. Because of this fundamental uncertainty, they should be careful about recommending far-reaching policy changes in order to eliminate allegedly "bad" deficits or surpluses. Three conceptual issues are discussed in a short introductory section.

1. Uncertainties over measurement. The first is how a payments deficit or surplus is to be measured. The convention is that revaluations of overseas-held assets are not included in the balance of payments. But it is obvious that a nation can incur a massive deficit and still have the same net international credit position if the assets it held at the outset have risen sharply in value.

2. Uncertainties over the definition of sustainability. The second is that a deficit is a "problem" requiring correction only if it is unsustainable. But, if a country is prepared to have substantial foreign ownership of its capital stock, it can run a deficit indefinitely and yet still have a stable ratio of foreign-held assets to national income.

3. Uncertainties about the location of responsibility. If a country has both a budget surplus and a current account deficit, the deficit is clearly the result of private-sector actions. It can be argued that this is not a policy problem and does not require a government response.

In a paper I recently submitted as evidence to the Treasury and Civil Service Committee of the House of Commons, I applied these ideas to the US payments position. The main point is that economists are not justified in recommending heavy dollar depreciation as an antidote to the American payments deficit. Because they do not know whether the deficit is a problem, they cannot be confident that a large dollar depreciation is superior in its policy implications to continued dollar strength. (This paper is for private circulation and is not to be quoted without the author's permission.)

Tim Congdon

12th October 1989

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Occasional Research Paper

No. 2, October 1989

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Can we define a balance-of-payments problem? How serious are the American and British payments deficits?

Illusion and reality in balance-of-payments statistics

At one time economists thought they knew what a balance-of-payments "problem" was. In the first 20 years after the Second World War, while the international monetary system designed at the 1944 Bretton Woods conference prevailed, exchange rates between the currencies of the major industrial countries were fixed and most governments imposed exchange controls on their citizens. If foreign exchange reserves were being steadily depleted as a result of intervention to protect the exchange rate, there was an obvious danger that the reserves would run out. One way for the government to rebuild its foreign exchange reserves was for the nation as a whole - including the private sector - to run a reduced current account deficit or an increased surplus. (The exchange controls obliged the private sector to hand over the extra foreign exchange to the central bank. Indeed, in many countries private sector agents had to seek official approval not just for holdings of foreign currency, but for *any* foreign investments.) In these circumstances the phrase, "a payments problem", had a clear meaning. It described a situation where a country's current account position was not strong enough to generate the reserves required to maintain a fixed exchange rate.

Nowadays matters are very different. Most industrial governments have ample foreign exchange reserves and, in any case, there is no binding commitment to any exchange rate. More fundamentally, exchange controls have been widely relaxed or abolished. Since the private sector does not have to exchange its foreign currency for domestic currency, there is no necessary connection between its current account position and the level of the foreign exchange reserves. The whole idea of a "payments problem" has become ambiguous and difficult to pin down. There are at least three aspects of this new ambiguity - uncertainties over measurement, uncertainties over defining the maximum sustainable deficit and uncertainties over identifying who (the private sector?, the public sector?) is responsible for correcting a deficit.

1. Difficulties of measurement

It is well-known that official statisticians have much more difficulty measuring the payments position today than they had 20 or even 10 years ago. These difficulties are the result of the larger scale of transactions, the greater variety of financial instruments in international investment, and the problems in categorizing all the people and companies involved in international trade and finance. The explosion in the offshore financial markets must take much of the blame. Nowadays it is not unusual for a syndicate of banks in several financial centres to arrange a loan for the offshore finance subsidiary of a multinational company with operations in many countries. Committees of official statisticians

can squabble endlessly about where the investment came from, who received the money, where it went and so on. Perhaps it is hardly surprising that the balancing item on the balance of payments has exceeded £11b. (over 2½% of GDP) in every one of the last three years. (It is generally accepted that the balancing item is more likely to reflect unrecorded capital inflows than unrecorded current account credits.)

But there is a further and perhaps more fundamental problem. When holdings of foreign assets were constrained by exchange controls, foreign assets were usually quite small as a share of GDP. Moreover, for most countries the foreign exchange reserves, short-term trade credit and claims on banking systems were the dominant items in the international balance sheet. The current account position was therefore a reasonably good guide to changes in a country's net overseas creditor/debtor position. But that is not true anymore. With the private sector nowadays usually holding both substantial foreign assets and incurring significant liabilities abroad, changes in the valuation of assets can be larger as an influence on the creditor/debtor position than the current account position.

Should capital gains/losses be part of a nation's payments statistics?

This point has particular force in the UK case, since the UK's foreign assets and liabilities are unusually high as a share of GDP. The structure of the UK's international balance sheet is also very interesting. It has incurred significant net debts to the international banking system, which amounted to about £60b. at the end of last year. But overall it is a substantial net creditor, with its holdings of direct and portfolio investments abroad much larger (about £125b. at end-1988) than foreign holdings of similar investments in this country.

Now the total return on direct and portfolio investments is the annual income (profits, dividends) *plus the capital gain on the assets*, whereas the total return on banking system assets and claims is simply the annual interest income. The convention in balance-of-payment accounting is that profits, dividends and interest appear in the *flow* statistics that determine the current account, but changes in capital value do not. In other words, they are omitted from the estimate of the current account, even though they obviously affect the value of the *stock* of net assets.

It follows that the UK's mismatch between bank debts and equity assets causes the current account statistics to understate systematically the strength of its external payments position. The table below indicates just how important this consideration has been in recent years. The estimates of 'revaluations' are crude, since they are taken to be the difference between the measured current account position and the measured change in net assets, and official statisticians warn that both sets of numbers have problems. Even so they are probably not that misleading as an indication of broad orders of magnitude. It turns out that on average the revaluation of the UK's net foreign assets has been

2¾% of GDP since 1981. An implication is that the large current account deficits of late 1988 and 1989 exaggerate the erosion of the UK's net credit position.

A similar argument is undoubtedly also valid for the USA, since the value of its direct investments overseas continues to exceed that of the direct investments held by foreigners in the USA, whereas its foreign liabilities include a large element of US government debt.

2. Difficulties about defining sustainability

There is a stubborn habit of thought that a balanced external payments position (with a zero current account) represents 'equilibrium' and is therefore wholesome and proper. There is also a related view that, if a country incurs a deficit in one period, it has to repay the money at a later period to keep its books tidy.

In fact, countries can run payments deficits indefinitely and still maintain their credit-worthiness. A possible criterion for defining a sustainable payments position is that the ratio of debt (or foreign-owned assets) to GDP be stable over time. If so, a country can run a current account deficit for ever, as long as the associated debts and foreign investment grow at a rate no faster than that of nominal GDP. In the following paper, this point is expressed in a simple formula. (See p. 9.)

Indeed, if a country does not mind foreigners owning a substantial chunk of its capital stock, a current account deficit can be enormous as a share of GDP and still be wholly sustainable. (In an appendix to the paper, we illustrate the point in an extreme way, with a hypothetical case where a country has a current account

Revaluations of the UK's overseas assets: how they compare with the current account "surplus" and "deficit"

Revaluations (measured as the change in the UK's net foreign assets minus the current account position) have frequently been larger than the current account position in recent years. On average there has been a capital gain of about 2¾% of GDP a year since 1981.

£b.	1 UK's net foreign assets at year-end	2 Change in net foreign assets	3 Current account position	4 Revaluations of foreign assets (i.e., 2 minus 3)
1977	6.4	0.1	-0.1	0.2
1978	13.4	7.0	1.0	6.0
1979	12.4	-1.0	-0.5	-0.5
1980	17.8	5.4	3.1	2.3
1981	32.2	14.4	6.9	7.5
1982	42.6	10.4	4.7	5.7
1983	55.0	12.4	3.9	8.5
1984	81.3	26.3	2.1	24.2
1985	82.9	1.6	3.4	-1.8
1986	112.8	29.9	0.2	29.7
1987	90.1	-22.7	-2.9	-19.8
1988	94.0	3.9	-14.9	18.8

Sources: Central Statistical Office *UK Balance of Payments*, 1989 edition

deficit equal to 20% of GDP, and yet both the citizens and the foreign creditors are perfectly happy with the situation.)

3. Difficulties about locating responsibility

Discussions about the balance of payments are often rather careless in their use of terms. It is commonplace to talk of 'the UK' having a deficit or surplus, and to say that 'we' (i.e., the citizens) must 'tighten our belts'. But 'the UK', and any other country, consists of a government and a private sector. It is not usually regarded as a matter of public policy if private individuals and companies incur debts that they cannot repay or service. So, why should it trouble the government if the large number of private sector agents who belong to one country incur debts to the large number of private sector agents who belong to another country?

This question was posed in an article I wrote for the October 1982 issue of the *Lloyds Bank Review*. Its point was to deny that the government has a responsibility to correct a payments deficit incurred by the private sector. Indeed, it challenged the whole idea that a current account deficit incurred by the private sector is a policy problem. Taken to its logical extreme, the conclusion was that, as long as the government's own finances are under good control, any current account position is acceptable.

Since the UK at present has a large budget surplus, this approach has obvious polemical attractions for the UK Government. It has been adopted by the Treasury, where it is known as the 'Lawson/Burns doctrine'. But it is again relevant to the USA, since the American budget deficit (on the general government definition, which includes states and local authorities) is not particularly large compared to the average budget deficit of the OECD countries. Arguably, the USA's payments deficit must largely reflect private-sector behaviour and is, to that extent, not a reason for particular concern.

Does anything remain of the balance of payments as a policy problem?

The arguments presented so far virtually destroy the simple notion of a 'balance-of-payments problem'. It is no longer possible - as it may have been for a few years after the Second World War - to see 'a payments problem' as a readily-defined situation in which, unless the government took corrective action, a country would 'go bankrupt'. Indeed, they question whether there is a unique number for 'the' payments surplus or deficit and undermine the idea of 'balance-of-payments policy' as a clearly identifiable government responsibility.

Economists should be more humble. They do not know that the payments deficits of either the UK or the USA have to be corrected. In particular, as argued in the following paper, their concern about the American deficit - and their warnings of global financial disarray unless it is reduced - are arbitrary and unjustified. It may be more sensible to see the heavy foreign exchange interventions now being undertaken by central banks around the world as themselves an aspect of the disarray.

What is a "sustainable" US payments deficit?

A sceptical view on fashionable forecasts of a dollar collapse

**The issue defined:
does the US
payments deficit
point to a large
dollar decline?**

International policy-makers have expressed much concern in recent years about the scale of the USA's payments deficit. There have been many dire warnings that, if the deficit is not corrected, various unwelcome outcomes will be inevitable. Substantial policy changes have therefore been recommended by a number of analysts, with the emphasis usually on a reduction in the US budget deficit, central bank intervention to lower the international value of the dollar, and stimulatory measures in West Germany and Japan. Implicit in the diagnosis is the belief that the present US current account deficit, which was \$126b. in 1988 and now amounts to about 2% of gross national product, is 'unsustainable'.

A leading example of this type of analysis has been provided by William Cline in a recent study on *American Trade Adjustment: the Global Impact* published by the Institute for International Economics. The study claims that, making reasonable projections with well-known econometric models and assuming no change in policy, 'the US trade and current account deficit will not fall below \$100b. and will begin to increase again after 1989'. It then asserts that 'far more needs to be done to reduce the US external deficits to sustainable levels' and proceeds to quantify a sustainable deficit as 'being in the range of \$50b.' by 1992. With that figure, the ratio of external debt to GNP would stabilize at about 14%. This 14% ratio is crucial to the analysis, since it sets the benchmark for an acceptable degree of indebtedness. It will be discussed in more detail and very sceptically later in this paper. The study suggests a 'feasible adjustment package' needed for the correction to the \$50b. figure, with the dollar undergoing substantial and early real exchange rate depreciation. The implied nominal exchange rate moves are dramatic. The package sets the end-1989 value of the German mark at 1.33 to the dollar and of the yen at 102 to the dollar.

The main purpose of this paper is to cast some doubts on policy-makers' ability to assess the 'sustainable' levels of external payments deficits and surpluses, and so to question the prevailing wisdom that the American payments deficit requires a radical policy response. Cline's work, which deserves admiration for presenting a widely-held view with clarity and force, will come under particularly critical scrutiny. Other distinguished economists who view the US payments position with alarm include Martin Feldstein, formerly chief economic adviser to President Reagan, and Rudiger Dornbusch, well-known for his work on exchange rate theory. (It should also be noted that Cline's study is similar to other work from the Institute for International Economics, notably C. Fred Bergsten's *America in the Work Economy: A Strategy for the 1990s*, published in late 1988.)

Persistent current account deficits are acceptable

There is a common tendency to think that the 'right' figure for the current account of the balance of payments is zero. The underlying idea here seems to be that, when a country is neither incurring debts abroad nor adding to its foreign assets, it has nothing further to settle - in a financial sense - with other countries. Since there is no implied requirement to adjust trade patterns in future (e.g., to change the relative size of imports and exports in order to repay debt), the position seems wholesome and sustainable.

This line of thought is too narrow-minded. Within countries, lending and borrowing are commonplace, and new debts are being registered continuously. It is widely agreed that the transfer of command over resources from passive personal savers to profit-motivated companies and entrepreneurs increases the economy's productivity. Similarly, there must be scope for profitable borrowing and lending between countries. The consequent international resource transfers should improve the efficiency of the global economy, just as those within a country improve the efficiency of the national economy. If the sum of debts incurred by one country exceeds the sum of the assets it acquires abroad, it has a current account deficit. But, if individual debts are regarded as normal and benign, the sum of many individual debts should also be looked upon as an acceptable outcome of free-market economic activity.

Must "debts" always be repaid?

The objection could be raised that the debts incurred now must be repaid at some future date. A country with a deficit in one year should intend to have a surplus in a later year or years. The ultimate aim must still be to achieve a zero balance over a suitably extended period.

But this is not so. When savers build up a capital sum, they expect to receive an income from it in the form of interest, profits and dividends. They do not usually plan to recall all their capital and spend it. To make the same point in a different way, it is apparent from long stretches of economic history that nations almost never indulge in sudden, wild bursts of spending in which they consume all their buildings and capital equipment. (War is the obvious exception.) By extension, if savers in one set of countries (creditor countries) steadily accumulate assets in another set of countries (debtor countries), it is certainly not inevitable that they will at some point want to run those assets down. On the contrary, if the return on capital in the debt countries is attractive relative to the return in their own countries, the creditor countries may want to accumulate assets indefinitely. They have permanent surpluses and the debtor countries have permanent deficits.

A startling example: 100% foreign ownership of the capital stock

Of course, the consequence of permanent deficits is that a proportion of the capital stock of the debt countries is owned by foreigners. *Indeed, it is possible to imagine a situation in which a debt nation's entire capital stock is owned by foreigners.* While its capital stock is being built up, it may import more goods and

services than it exports, and not remit much in the way of interest, profits and dividends. In the long run it has to export enough to pay a good rate of return on the capital and may have to run a substantial surplus on its goods and services account. Even so the deficit on interest, profits and dividends may exceed the surplus on goods and services by a wide margin and overall current account deficit may be very high as a share of GNP. But there is no difficulty working out cases where seemingly enormous deficits (as a share of GNP) are fully sustainable. *The current account deficit may represent all of the nation's investment, and yet neither the foreign creditor nor the debtor country and its people want to change their behaviour.*

An example to demonstrate this possibility is given in an appendix. It is a startling example, because it shows that a country could have a current account deficit equal to 20% of GDP year after year and still be in a wholly sustainable situation. The foreign investors own all the capital stock, which is equal to twice GDP and over three times exports. They are earning a 20% rate of return on their investment, of which they are re-investing half and remitting half. Since profits are equal to 40% of GDP, the half of profits retained within the country finances a steady build-up of the capital stock. GDP, exports and investment all grow at an impressive 10% a year, with no tendency for the ratio of foreign-held assets to GDP to rise over time.

Back to the real world: the US payments deficit in the 1990s and Cline's analysis

In the context of our discussion so far, Cline's view that the USA's ratio of foreign debt to GNP needs to be stabilized at 14% seems rather prim. Of course, we must not leap from our hypothetical example to the real-world problems of the American economy. It is one thing to say that in a particular abstract case the current account deficit can indefinitely run at 20% of GDP (with the foreign debt/GDP ratio at 200%) and something quite different to claim that the USA could have a payments imbalance of that size throughout the 1990s. Much depends on the productivity and profitability of foreign investment. But our discussion suggests that we should be suspicious of the Institute for International Economic's analysis. Cline must put up a strong case for selecting - indeed, virtually arbitrating on - 14% as the correct, sustainable debt/GNP ratio. (An appendix to this paper gives the data for one country, Singapore, where the current account deficit averaged over 20% of GNP in the early 1970s.)

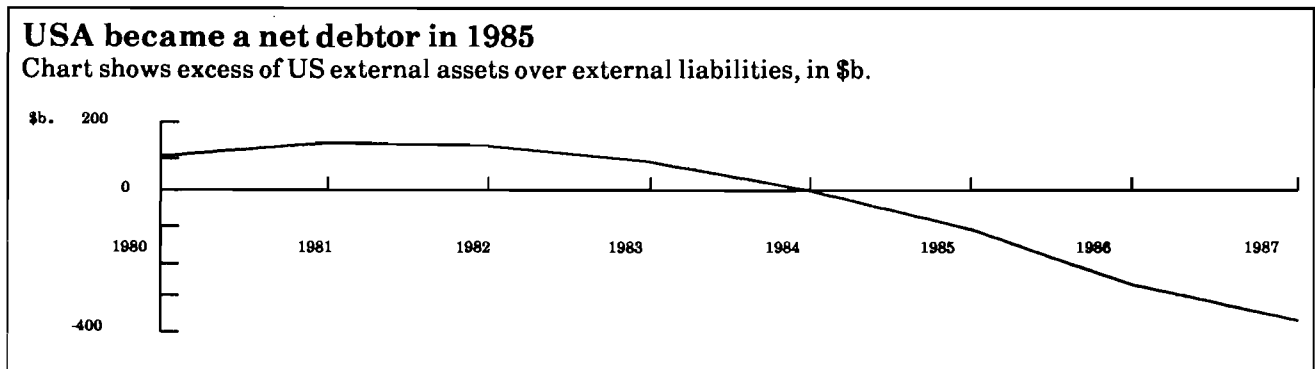
In fact, his study contains two arguments for this 14% figure. The first is simply that, with nominal GNP growing at 7% a year and the current account deficit at the 1% level specified as the objective of the feasible adjustment package, the debt/GNP ratio stabilizes at 14%. In other words, because the debt/GNP ratio stabilizes at a particular level with the particular numbers for nominal GNP growth and the payments deficit he favours, that particular level of the debt/GNP ratio is good and right. This is circular. No independent criterion is given for saying that the debt/GNP ratio should stabilize at 14% rather than some other number.

The second argument does not relate to the desirability of a particular debt/GNP ratio from the USA's viewpoint, but rather to the portfolio preferences of foreign creditors. According to some guesstimates made by Cline, the USA will have in 1992 a gross capital outflow of \$85b. as well as a current account deficit of \$50b. Its 'total financing requirements' will therefore amount to \$135b. This figure is very similar to the guesstimate of foreign earnings on assets held in the USA at that date, which is \$146b. So, 'passive reinvestment by foreigners of their annual earnings on assets held in the United States would be sufficient to cover US financing requirements'. Further, 'under the assumption that the overall portfolios of foreign investors would be growing at a rate at least as high as reinvestment of earnings, the share of US assets in their portfolios would hold steady or decline, avoiding the risk of satiation'.

No independent criterion of credit-worthiness?

This second argument does provide an independent test of the appropriateness of a particular level of external debt. However, it is unsatisfactory. According to Cline's criterion, any investment not financed from previous profits would 'carry the risk of satiation'. But profits cannot be earned unless there has been earlier investment. It follows from Cline's criterion that any initial build-up of foreign capital in a country, before the earning of profits, would 'carry the risk of satiation'. How, then, would international investment start up in the first place? Of course, there is one level of international investment which would clearly 'avoid the risk of satiation' and that level is nil.

Detailed inspection of Cline's arithmetic throws further doubt on his claims. His guesstimates of the composition of the USA's balance of payments in 1992 suggest foreign earnings on assets held in the USA of \$146b. and US earnings on assets held abroad of over \$159b. (This figure appears in Table B-2 on p.74 under the heading 'Factor services exports'. The \$146b. figure - actually \$145.55b., to be precise - appears under 'Factor services imports'.) In other words, the USA is still by the early 1990s receiving more profits, dividends and interest on its foreign assets than it is paying out on the assets foreigners hold in the USA. In these circumstances, it seems rather strange to believe that American policy would be seriously constrained by its net debtor status or that foreign investors would be approaching 'satiation'.



Cline's analysis - and other work in a similar vein from the Institute of International Economics - does not stand up. Its dramatic conclusions for policy depend upon statements about sustainability which are arbitrary and unjustified. The USA would not necessarily be in an unsustainable situation in the early 1990s if it had a much larger payments deficit than \$50b. a year and a foreign debt/GNP ratio substantially higher than 14%.

A simple formula defining sustainability

We have seen that the analysis from the Institute of International Economics does not give a satisfactory criterion for assessing credit-worthiness. But is there any such criterion?

Suppose it is agreed that, when the ratio of foreign-held assets to GNP is stable, the external payments' situation is sustainable. There is a simple formula which describes an economy of this kind:

$$B/Y = g \cdot D/Y$$

where B is the current account deficit, Y is GNP, D represents foreign-held assets and g is the growth rate of nominal GNP. In words, if the current account deficit as a share of GNP is equal to the growth rate multiplied the ratio of foreign-held assets to GNP, that current account deficit is sustainable. This idea is straightforward and was, indeed, the basis for the Institute of International Economics' first criterion of sustainability, with a 14% debt/GNP ratio, a current account deficit of 1% of GDP and 7%-a-year growth rate of nominal GNP.

The trouble - as we saw - was that, although it defined a sustainable current account deficit, it did not define the maximum sustainable current account deficit. Why is 14% the highest acceptable ratio of debt or foreign-held assets to GNP for the USA today? Since it is easy to propose hypothetical examples of sustainable debt/GNP ratios much higher than this, why should 14% be the ceiling?

The USA's external debts as a share of GNP

The USA was a net creditor before 1985. At the end of 1987 the debt/GNP ratio was still under 10%

	USA's,net external debt \$b.	US GNP in Q4 \$b.	Ratio of net debt to GNP
1982	-136.9	3,212.50	-4.3
1983	-89.4	3,545.80	-2.5
1984	-3.5	3,851.80	-0.1
1985	110.7	4,107.90	2.7
1986	269.2	4,304.60	6.3
1987	368.2	4,662.80	7.9

Source: *Economic Report of the President 1989*

Three approaches to sustainability

1. The private/public distinction

No final answer to the question of sustainability will be attempted here, but three approaches will be suggested. The first rests on a distinction between private sector and government decisions. When companies and individuals borrow and lend between each other within national frontiers, it is taken for granted that repayment is a matter for the private sector parties involved, not the government. If the same grown-up attitude is adopted for private sector debits and credits across frontiers, why should governments worry when the sum of the many thousands of financial transactions by a particular country's citizens is a large current account deficit? Surely, those citizens have a better understanding of the level of debts they can service and repay than the government has. (This view was first developed by Tim Congdon in an article 'A new approach to the balance of payments' in the October 1982 *Lloyds Bank Review*. The idea was originally expressed by the Australian economist, Professor Max Corden, in some brief remarks in lectures at the University of Chicago in 1976.)

Taken to its logical extremes, this argument implies that - if a country's public sector finances are under good control - any current account deficit is not a policy problem.

2. Possible resentment of foreign ownership

Secondly, it is clear that substantial foreign ownership of the capital stock may cause resentment and hostility. Let us suppose that when foreigners own more than a certain proportion of a nation's capital stock, the resentment becomes so deep that there are fears of punitive taxation, discriminatory regulation, expropriation or whatever. There is a maximum foreign ownership ratio, which is determined by political considerations. Then a limit is set to the amount of new foreign investment in any period and so to the current account deficit as a share of GNP. (Formally, suppose that a is the maximum foreign ownership ratio, which is D/K , where K represents the entire capital stock. Now $D/K = D/Y \cdot Y/K$, where Y/K is the inverse of the capital-output ratio, v . So the foreign ownership ratio is at its maximum when $D/Y = a \cdot v$. In this situation, the current account deficit is equal to $g \cdot a \cdot v$, which is the growth rate multiplied by the foreign ownership ratio multiplied by the capital-output ratio.)

Finally, some ideas more familiar in the analysis of fiscal policy can be applied to the analysis of the balance of payments. It is well-known that, when the real rate of interest on public debt is higher than the economy's rate of output growth, the government must run a primary budget surplus in order to prevent the ratio of public debt to GNP rising indefinitely. (The primary budget position is the balance between tax revenue and government expenditure, excluding debt interest.) On the other hand, when the real interest rate is less than the growth rate, it can have a primary budget deficit and still keep its debts under control. These concepts, appropriately re-labelled, can be used in assessing the sustainability of an external payments deficit.

3. Rate of return on foreign investment vs. growth rate of GDP

We can think of a country's payments position as having two parts, first, the balance between interest, profits and dividends paid on home-owned investments abroad and foreign-owned investments in the country concerned, and, second, the balance on all other transactions. The balance on all other transactions can be termed the primary payments balance and is analogous to the primary budget balance in fiscal policy discussions. Then, if the rate of return on foreign investments is above the growth rate of GDP and a country is a net debtor, it has to run a primary payments surplus to keep the ratio of foreign-owned assets to GDP stable. Alternatively, if the rate of return is beneath the growth rate, it can have a primary payments deficit and still not need to worry about the threat of constantly increasing foreign ownership in the economy.

No unique rule

It is clear from our discussion that there is no unique rule for judging sustainability. Our simple formula describes a sustainable situation, but it does not say what value of the foreign ownership ratio or ratio of foreign debt to GDP (i.e., D/Y in the formula) is the maximum. Strong emphasis needs to be placed on the further point that, even if it were possible to identify a particular number as the maximum foreign ownership ratio or the maximum ratio of foreign debt to GDP, the formula would not give a definitive answer valid in every period. If the current value of the foreign ownership ratio were beneath the maximum ratio, very large deficits could be recorded for a period as foreign-owned assets moved up to the maximum level. Only afterwards would the formula impose a constraint on the size of the deficits.

Enough has been said to indicate that no one really knows the size of the USA's maximum sustainable payments deficit. Is it reasonable to suggest that Americans would tolerate foreigners owning a sixth or a fifth of their capital stock? With a capital/output ratio of 4 and a trend growth rate of nominal GNP of 7% a year, our formula would give the maximum sustainable current account deficit in the very long run as between 4.7% and 5.6% of GNP. But deficits could be much higher than this for many years as the USA shifted from its present status as only a marginal net debtor to having significant foreign ownership of its capital stock.

Conclusion: the American payments deficit can be reconciled with a stable or strong dollar

This paper has a controversial message. It is that the existence of a large American payments deficit does not mean that the dollar has to depreciate heavily against other currencies. The US government does not need to undertake drastic corrective action to its economy's external payments. Indeed, the paper denies that economists have a clear understanding of what is meant by those much-repeated phrases, a 'sustainable payments deficit' and an 'unsustainable payments deficit'. Because this basic issue is so badly defined, warnings of a dollar collapse and other calamities are not anchored in a persuasive theory.

The mechanical assumption of many currency forecasters - that countries with current account deficits have weak currencies and those with surpluses have strong currencies - is unreliable. It follows that the policy conclusions reached by Cline and his colleagues at the Institute of International Economics, and by such influential economists as Feldstein and Dornbusch, are unconvincing. It is not the case that appalling things will happen to the world economy unless the dollar is driven down by concerted central bank action. Indeed, for central banks to oppose market forces too deliberately is to risk heavy and unnecessary foreign exchange losses which are ultimately borne by taxpayers. Also misguided is official US pressure on the Japanese and West German governments to stimulate their economies in order to reduce the American payments deficit. If the present pattern of international payments balances reflects private sector decisions to achieve the best global allocation of capital, it will not be changed permanently by government fiscal and monetary policy. Instead unjustified Japanese and West German reflation will merely add to world inflationary forces.

**Lurid
comparisons with
Latin America
inappropriate**

One of the reasons for misplaced alarmism about payments deficits is carelessness in the use of words. There is a tendency to believe that all current account deficits result in extra "debt" and to see "debt" as likely to cause the kind of problems experienced by Latin America in the 1980s. The Institute of International Economics slips into this vocabulary rather easily since it adds a certain luridness to their forecasts when they say that "the USA is a larger debtor than Brazil or Mexico". The trouble with using "debt" in this way is that current account deficits can be financed by a wide variety of financial instruments. The Latin American deficits of the late 1970s were covered by the incurrence of floating-rate bank debt, which left the countries concerned vulnerable to sharp increases in interest rates. But the USA's deficit nowadays is being financed mostly by foreign acquisition of equities and property (where the return depends on the success of the investment) and by purchases of US government bonds (where the return is fixed in money terms). Capital flows to the USA are predominantly in the form of direct investment and portfolio capital, instead of being via the international banking system. Because the USA's payments of interest, profits and dividends to foreign investors will not change sharply unless justified by the performance of the investments, there is little danger of the cataclysmic macroeconomic upheaval inflicted on Latin America by the jump in real interest rates in the early 1980s.

It would be better if economists confined the term "debt" to financial instruments of a particular kind, notably where there is an understood obligation to repay the principal by a certain date. Direct and portfolio investments are not debt in this sense, and should not be interpreted as such.

The argument of this paper is open to misunderstanding. Some economists might consider it to be advocating not so much a liberal attitude towards international capital flows, as a libertine approach towards financial policy. But it is important to emphasize that only private sector capital movements, and the associated debits and credits, are not a worry for policy-makers. An excessive government budget deficit, causing an unsustainable build-up of domestic public debt and spilling over into a deterioration in the external balance, is certainly a legitimate cause of anxiety. (The author strongly believes that a return to a balanced budget in the USA would be of great benefit to both the American and the world economies.) The aim of the paper has been to warn against unjustified alarmism about payments imbalances, not to endorse an irresponsible permissiveness about budget deficits and monetary policy. Indeed, the view that exchange rates are determined by relative rates of monetary expansion, rather than by contrasts in payments positions, fits in neatly with the general argument.

Appendices

1. An example of a country with 100% foreign ownership of the capital stock and a continuing current account deficit equal to 20% of GDP

Following Harrod (1939), economists have a simple formula to express the relationship between a country's growth rate, its savings behaviour and its technology. This relationship is

$$g = s/v$$

where g is the growth rate of output,
 s is the savings ratio (i.e. the ratio of saving, S , to national income, Y with $S = I$, where I is investment) and
 v is the capital/output ratio (i.e. K/Y , where K is the capital stock. Y is used interchangeably for national income or output, which are identical in value.)

Suppose that in our hypothetical country the entire capital stock is owned by foreigners. Then all investment is done by foreigners and is equal to the current account deficit on the balance of payments. Let us also suppose that the investment ratio - and so the ratio of the current account deficit to GDP - is 0.2. The current account deficit may be denoted by B .

Then, $I/Y = B/Y = 0.2$.

Let the rate of return on capital be r , which is of course equal to profits (P) divided by the capital stock (K).

Suppose that we are considering a young country with an abundance of raw materials and highly productive capital. The capital/output ratio (K/Y) takes a low value of 2, compared to a typical value in the mature industrial countries of 4 - 5. Suppose also that capital earns a return of 20%.

Then the share of profits in GDP is

$$P/Y = P/K \cdot K/Y = 0.2 \times 2 = 0.4$$

All of the profits accrue to foreigners and profit payments to foreigners therefore represent a debit item on the balance of payments equal to 40% of GDP.

The current account is equal to the excess of exports (X) over imports (M) minus the deficit on profits accruing to foreigners and we have already said that the ratio of the current account deficit to GDP is 20%. Then,

$$\frac{X - M - P}{Y} = \frac{B}{Y} = \frac{I}{Y} = 0.2$$

With profits equal to 40% of GDP, the above equation implies that exports must exceed imports by 20% of GDP.

The economy would be in a wholly sustainable situation if exports were, say, 60% of GDP and imports 40% of GDP. Foreigners would be earning a satisfactory rate of return on their capital, re-investing half of profits and remitting the other half. The local population would be saving nothing and consuming 60% of what they produce. Profits, consumption, investment, exports and imports would all be growing at 10%, according to the Harrod growth equation. This situation could continue indefinitely. Despite the apparently enormous payments deficit, there is no problem of unsustainability.

(Many other arithmetical examples could be given. The numbers here have been chosen for their rather dramatic quality, in order to bring out the point. The trick - to re-label domestic savings as foreign investment in a steady-state Harrod growth equation - is obvious, once the point has been grasped. In the example given the country has to run a trade surplus in order to cover the profit remittances. In some extreme cases, with the growth rate higher than the rate of return on capital, it would be possible for a country to run a continuous trade deficit as well as a large current account deficit.)

2. Singapore as an example of large, persisting current account deficits

Singapore had a current account deficit averaging 11.4% of GNP over the 23 years from 1960 to 1982. The figures are given in the table on the opposite page.

Over this period Singapore built up substantial foreign exchange reserves and had an enviable record of financial stability. The value of its currency rose from 3.06 to the US\$ at the end of 1960 to 2.1085 to the US\$ at the end of 1982, while its inflation rate was below the average of industrial countries. As the table shows, after the mid-1980s it began to achieve large current account surpluses.

The scale of the current account deficit may be partly due to statistical problems. (Some of it may be attributable to smuggling into neighbouring economies, particularly Indonesia, with high tariff barriers and quota restrictions on imports.) "Errors and omissions" were very high in the published figures in the 1960s. But measured private-sector capital inflows became much larger than "errors and omissions" in the 1970s and over the whole period "errors and omissions" are likely to have included significant unidentified private-sector capital inflows. The peak in the current account deficit coincides with particularly high direct foreign investment in, for example, the Jurong industrial estate. Between 1970 and 1974 the current account deficit averaged 22.4% of GNP.

Singapore' payments deficit as share of GNP

	Current account deficit, in m. of Singapore \$s	GNP, in m. of Singapore \$s	Ratio of current account deficit to GNP - in %
1960	244.7	2189.0	11.2
1961	278.6	2373.7	11.7
1962	199.0	2562.8	7.8
1963	332.0	2857.4	11.6
1964	166.2	2801.2	5.9
1965	150.1	3052.3	4.9
1966	-3.3	3428.9	-0.1
1967	209.4	3846.3	5.4
1968	408.2	4402.2	9.3
1969	585.3	5104.6	11.5
1970	1750.8	5861.1	29.9
1971	2205.4	6830.5	32.3
1972	1392.4	8174.4	17.0
1973	1275.0	10033.0	12.7
1974	2489.6	12259.5	20.3
1975	1385.2	13566.5	10.2
1976	1401.8	14569.6	9.6
1977	719.8	15851.7	4.5
1978	1029.3	17787.4	5.8
1979	1600.2	20444.1	7.8
1980	3345.6	24188.5	13.8
1981	3104.5	28191.2	11.0
1982	2773.6	31775.7	8.7
1983	1289.7	36561.1	3.5
1984	820.9	40815.1	2.0
1985	7.8	40330.4	0.0
1986	-1180.5	39612.8	-0.3
1987	-1163.7	43682.5	-2.7
1988	-3340.4	49864.5	-6.7

Source: Data supplied by the Monetary Authority of Singapore.