May 2001

International*Economic*Trends

THE FEDERAL RESERVE BANK of ST. LOUIS

What Drives Large Current Account Deficits?

In recent years, the U.S. current account balance has declined sharply, falling from –1.7 percent of gross domestic product (GDP) in 1997 to –4.4 percent in 2000. Similarly, the current account balance declined from a surplus of 0.2 percent of GDP in 1981 to –3.3 percent in 1986. These two episodes, as well as episodes involving other developed countries, suggest that investment spending plays a key role in determining the path of a country's current account balance.

During the 1980s, the United States experienced rising deficits in both its current account and government budget balances. This "twin deficit" relationship led many analysts to conclude that government budget deficits were driving current account deficits. As shown in the table, many developed countries experiencing current account deficits of 3 percent of GDP or higher in the 1970s and early 1980s fit the twin deficit pattern, as indicated by a positive correlation between these balances (both as percentages of GDP). Since the mid-1980s, however, the two balances generally have been negatively correlated.

How can government deficits be linked with current account deficits? The current account balance equals the difference between domestic saving and investment. A country's total investment spending must be financed by a combination of domestic and foreign saving. Domestic saving consists of saving by households, businesses and the government. If government deficits reduce domestic saving, then the only way for a country to maintain investment spending is by borrowing from abroad (foreign saving). This is what occurred in the U.S. in the 1980s.

The last column in the table illustrates the incompleteness of the twin deficit explanation. In nearly every episode, the current account balance as a percent of GDP was negatively correlated with investment spending as a percent of GDP. Rising current account deficits were associated with rising domestic investment.

The most recent U.S. example of a falling current account balance shows the importance of investment. Between 1993 and 1997, the current account balance generally stayed in the range of –1.0 to –1.5 percent of gross domestic product, as a rising saving rate, caused primarily by declining federal budget deficits, kept pace with rising domestic investment. In 1998, this pattern changed: investment continued to rise, but a drop in the household saving rate resulted in a slight fall in domestic saving, producing a rise in the current account deficit.

Changes in domestic saving behavior provide, at most, a partial explanation of changes in current account balances. More importantly, large current account deficits in the developed economies are associated with increases in investment, not merely a shift in the funding of the investment from domestic to foreign savers.

—Cletus C. Coughlin and Patricia S. Pollard

Correlation with the Current Account

Country	Period	Government Budget	Investment
Austria	1975-82	-0.54	-0.87
Belgium	1976-85	0.37	-0.05
Canada	1973-80	0.49	-0.20
	1984-95	0.19	0.15
Finland	1972-77	-0.07	-0.83
	1984-94	-0.28	-0.37
Ireland	1967-90	0.79	-0.81
Italy	1972-77	-0.34	-0.94
Norway	1972-80	0.62	-0.88
	1985-90	0.27	-0.87
Portugal	1972-85	0.44	-0.35
Spain	1972-78	0.36	-0.62
	1986-95	-0.51	-0.77
Sweden	1978-84	0.40	-0.54
	1987-94	-0.32	-0.49
United Kingdom	1971-77	0.55	-0.69
	1985-94	-0.55	-0.68
United States	1980-89	0.31	-0.12
	1993-00	-0.91	-0.91

Note: The periods chosen begin prior to the start of the rising current account deficit and end (except the recent U.S. case) following the shrinkage of this deficit.
Sources: OECD, IMF and U.S. Bureau of Economic Analysis

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