These challenges and the policy responses of the Administration are discussed below.

The U.S. Trade Balance and Current Account

The recent rapid growth in investment and the resulting strong performance of the U.S. economy have contributed to an increase in the Nation's trade deficit. Robust income growth and increased wealth from rising asset prices have contributed to higher domestic consumption, and thus to rapid growth in imports. Growth was slower in major U.S. trading partners in Europe and Asia than in the United States in 1998 and the first part of 1999 (Chart 4-3). This contributed to weaker import demand in those regions and slower growth of U.S. exports. A strong dollar, reflecting in part capital inflows from foreigners eager to participate in attractive investment opportunities in the United States, has also contributed to the growing trade deficit by lowering prices of foreign-made goods relative to those of U.S. products. Through the first three quarters of 2000, the trade balance in goods and services was about $270 billion in deficit. That would correspond to roughly $360 billion for the whole year, or about 3.6 percent of GDP (Chart 4-4). Meanwhile the current account (a comprehensive measure that comprises not only the trade balance in goods and services but also net income and transfers) recorded a deficit of roughly 4.3 percent of GDP (Chart 4-5).

In recent years, the U.S. economy has grown faster than those of many of its major trading partners.

Chart 4-3  Growth in Real GDP by Region

<table>
<thead>
<tr>
<th>Region</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>0</td>
<td>0</td>
<td>-3</td>
</tr>
<tr>
<td>East Asia</td>
<td>1.5</td>
<td>2.5</td>
<td>3.5</td>
</tr>
<tr>
<td>European Union</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>World</td>
<td>3.0</td>
<td>3.5</td>
<td>4.0</td>
</tr>
<tr>
<td>United States</td>
<td>6.0</td>
<td>7.0</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Note: Data for 2000 are estimates. Source: International Monetary Fund.
The trade deficit increased as the dollar appreciated in the late 1990s.

Chart 4-4  The Trade Deficit and the Real Effective Exchange Rate of the Dollar

Note: The real effective exchange rate is the Federal Reserve’s price-adjusted broad index of the foreign exchange value of the dollar. A rise in this index indicates a real appreciation of the dollar.
Sources: Department of Commerce (Bureau of Economic Analysis) and Board of Governors of the Federal Reserve System.

The increase in the current account deficit after 1995 has supported higher investment.

Chart 4-5  Saving, Investment, and the Current Account Balance

Note: The current account balance equals net national saving minus net domestic investment plus the statistical discrepancy.
Source: Department of Commerce (Bureau of Economic Analysis).
The current account balance equals by definition the difference between national saving and national investment. A current account deficit reflects an excess of investment over domestic saving, and thus an inflow of foreign capital that makes up for the shortfall. The widened current account deficit reflects the fact that although net saving has risen, net domestic investment has risen even more. The share of net domestic investment in GDP (Chart 4-5) grew by 4.6 percentage points from 1992 through the first three quarters of 2000 (from 4.8 percent to 9.4 percent), while the share of net national saving rose by only 2.3 percentage points (from 3.5 percent to 5.8 percent).

What explains the willingness of the rest of the world to provide the United States with the capital inflows needed to finance its current account deficit? The answer is simply that the attractive opportunities for investment in the United States today exceed those in other countries. This can be seen by comparing the deficits of today with the comparably large (as a percentage of GDP) deficits of the 1980s. In the earlier decade, most of the inflows went to the purchase of U.S. government debt securities. The more recent inflows, in contrast, have mainly been invested in privately issued assets. Indeed, much of the inflow has come in the form of foreign direct investment (equity investment for purposes of control of the enterprise) rather than purchases of bonds or portfolio equity participation: the value of inward direct investment into the United States rose from $51 billion in 1993 to $271 billion in 1999.

With saving from the rest of the world continuing to flow to the United States, the U.S. net international investment position—the value of U.S. assets abroad less the value of foreign assets in the United States—will continue to turn more negative. At the end of 1999 the net international investment position was approaching a negative $1.5 trillion, or almost 16 percent of GDP that year; foreigners held more than $8.6 trillion of U.S. assets, while Americans held foreign assets valued at more than $7.1 trillion.

Part of the income from these international investment holdings consists of retained earnings and reinvested dividends and interest payments, which are recorded as an outflow in the current account and an offsetting inflow in the capital account. This would tend to raise the apparent magnitude of capital flows. On net, however, income on investment now flows out of the United States, as foreigners repatriate earnings on their U.S. investments by a greater amount than Americans are bringing their earnings on foreign investments back to the United States.

The availability of foreign saving has permitted the United States to maintain the high rate of investment that has expanded productive capacity and raised economic performance. This shows that foreign capital inflows are not in themselves a bad thing: it is better to finance attractive investment opportunities using foreign capital than not to undertake them at all. But our income would be even higher if that investment were financed instead by domestic
saving. Saving trends in the United States over the last several years present a mixed picture. From 1992 through the third quarter of 2000, the share of net saving by the public sector (Federal, State, and local governments) in GDP has risen by 7.8 percentage points. But this rise has been largely offset by a decline in the share of net private saving of 5.5 percentage points. Higher private saving would help to ensure the continued ability of the United States to finance domestic investment. The saving rate can be raised without threatening continued strong growth in income if the composition of demand for U.S. goods shifts, with external demand replacing some domestic consumption. In the meantime, it is important to maintain public saving, through continued fiscal discipline at all levels of government, in order to support national saving.

It is difficult to say what level of the current account balance would be most appropriate. But if some adjustment in the current account is deemed necessary, the way it is accomplished matters. It would be better to reduce the current account deficit through higher domestic saving than through lower investment, because reducing investment would mean a smaller capital stock and thus lower national income than would otherwise be the case. In the best of all possible world economies, increased growth in the rest of the world would lead to increased U.S. exports, which would compensate for the reduced domestic demand that higher domestic saving would entail, and thus maintain strong income growth in the United States. More rapid growth abroad would cause saving by foreigners to shift from the accumulation of U.S. assets to investment in their own domestic economies, made newly attractive by their increased domestic growth. The rebound in investment abroad would further spur U.S. exports, which, as we have seen, consist largely of capital goods.

Opening foreign markets can play a role in adjustment by encouraging U.S. exports. In contrast, efforts to narrow the trade deficit or the current account by raising barriers to imports into the United States would likely make the economy less efficient and thus lower national income, without necessarily increasing national saving.

Raising Performance in Other Countries

At present, the U.S. current account deficit is supporting too large a share of the global economic expansion. It would be desirable for other countries to take steps to accelerate their growth and promote a smooth return to a more balanced global distribution of growth. As this adjustment occurs, the U.S. current account deficit should return to levels in line with the historical U.S. saving and investment relationship. To ensure sustained, balanced global growth, the major industrial economies need to maintain supportive fiscal and monetary policies and push ahead with structural reforms to remove barriers to investment opportunities (including opportunities for new technologies).