US balance of payments gap widens again

Nick Beams
22 June 2004

The US balance of payments deficit expanded to $144.9 billion in the first quarter of this year—a record in dollar terms—and a big jump from the deficit of $127 billion in the last quarter of 2003. As a percentage of gross domestic product, the deficit rose sharply from 4.6 percent to 5.1 percent. At this level, the US needs to attract more than $1.5 billion per day in foreign investment to cover the payments shortfall.

More than half of the increase, which was well above market forecasts of around $140 billion, came from the increase in the deficit on goods and services. That rose to $136.9 billion for the quarter compared to a deficit of $125.5 billion in the last quarter of 2003. With energy prices still at high levels, there seems little prospect of the trade gap narrowing in the immediate future, with the deficit for April coming in at a record $48.3 billion.

The release of the balance of payments data saw the dollar take a sharp fall on international currency markets when, as the *Financial Times* put it, the "spectre of the long-run structural US current account deficit", which had been lurking in the shadows, came out to centre stage.

The US is still able to attract funds from the rest of the world to finance its payments gap—there was a net inflow of $76.2 billion in April. But the make-up of this inflow is changing. At the height of the IT and dot.com bubble in 2000-2001, the inflow was mainly in the form of share purchases or foreign direct investment. Today, both these items are negative. Now the main source of foreign capital is purchases of US financial assets by foreign central banks, principally from Asia, anxious to prop up the value of the US dollar and ensure that their exports remain competitive. The latest figures show that foreign central banks spent $125.2 billion on US financial assets in the first quarter, compared to $83.7 billion in the fourth quarter of 2003.

The escalating US balance of payments deficit has again focused attention on the financial imbalances within the world economy. While world economic growth is back over 4 percent per year, it has become ever-more dependent on debt-financed consumption in the US and record low interest rates. There are growing concerns about what could happen once interest rates begin to rise under conditions where debt has been increasing sharply.

Last week, Bill Goss, the chief investment officer of Pimco, the world's biggest bond fund manager, told the *Financial Times* that the outlook for the global economy was the most uncertain for two to three decades.

"Too much debt, geopolitical risk and several bubbles have created a very unstable environment which can turn any minute," he warned. "More than any point in the past 20 or 30 years, there's potential for reversal. We have become a levered global economy, specifically in Japan and the US. With all this consumer debt, business debt, government debt, smaller movements in interest rates have a magnified effect ... a small movement can tip the boat."

According to Goss, the threat of financial instability arose, at least in part, from what he terms "the advent of financial alchemy" stemming from the growing use of hedge funds. "Even banks are employing the 'carry' trade—borrowing short and lending long. They're doing things they haven't done before. There's lots of risks in the economy now compared with even five years ago."

Some of those risks could begin to emerge when interest rates start to rise. This is the reason for the nervousness surrounding next week's meeting of the US Federal Reserve Board which is expected to announce an increase in the federal funds rate. After 13 successive cuts in the rate, Fed chief Alan Greenspan has been reassuring financial markets that when the inevitable increases do begin they will be "measured".

But as the *Economist* recently reminded its readers,

the extraordinary has become the norm and it is easy to forget "quite how breathtakingly low interest rates are around the world." Only four years ago the federal funds rate was 6.5 percent—by no means an abnormally high figure. Now it is just 1 percent, a negative figure in real terms.

This has led to a rapid growth in consumer debt and in the "carry" trade as banks and other financial institutions borrow at record low short-term rates to lend at longer-term higher rates.

An analysis of US indebtedness, published by the Financial Markets Center (FMC) last week, points to the potential impact of even relatively small interest rate increases. According to the FMC, while it was unclear whether the long period of easy money that had financed recent growth would "end with a bang or a whimper" there was no doubt that the "Fed-induced credit expansion of this era has been quite intensive relative to economic activity."

From the beginning of 2001 to the end of March 2004, domestic borrowers' outstanding credit-market debt as a percentage of GDP rose by 17 percentage points from 181.8 to 198.8 percent. Even more significant, according to the FMC analysis, was the rapid rise in the ratio of household debt to GDP over the same period—up from 70.5 to 83.2 percent, primarily as a result of a surge in home mortgage debt.

That debt is becoming increasingly sensitive to movements in interest rates. As the *Economist* noted, traditional American home-buyers have taken out fixed-rate mortgages which can be swapped for cheaper ones when rates fall. This has meant that only about one-fifth of new mortgages have been variable rate. But this pattern has been changing in the recent period because variable home loan rates have been lower than the fixed rates. In April at least half new mortgages were variable rate—the highest level on record. These rates will start to climb once the Fed starts to increase short-term rates.

While next week's expected rise of 0.25 percent in the federal funds rate is not expected to cause a great deal of disturbance, having already been "factored in", there could be some financial shocks in the longer term. Never has the US and world economy entered a period of interest rate tightening with such a level of indebtedness in both the household and corporate sectors as well as on financial markets.