

The U.S. as a Debtor Country: Causes, Prospects, and Policy Implications

*Stephen A. Meyer**

One and a quarter trillion dollars—that is roughly the value of claims on the United States accumulated by foreigners from 1982 through 1988. Their purchases of U.S. assets far exceeded U.S. residents' purchases of foreign assets, turning the United States into a net foreign debtor in 1985. By the end of 1988, foreign ownership of assets in the U.S. exceeded our ownership of foreign assets by about \$530 billion.

Our growing status as a net debtor has raised various concerns. A major one is that future generations of Americans may face lowered living standards because they will be forced to service the foreign debt we have accumulated. A second concern is that our large foreign debt might bring the U.S. very high inflation rates in the future, like those experienced recently by some of the world's debtor nations.

To assess the validity of these concerns, we first need to understand the economic factors that generated large net capital inflows into the United States. That understanding will enable us to analyze the implications for future living

*Stephen A. Meyer is Vice President and Associate Director of Research at the Federal Reserve Bank of Philadelphia.

standards and inflation. We also will be able to evaluate the prospects for reversing our position as a net debtor and weigh the role economic policies can play in that process. (See *Glossary*, pp. 30-31, for definitions of terms that appear above and elsewhere in this article.)

LARGE CURRENT ACCOUNT DEFICITS MADE THE U.S. A NET DEBTOR

A direct link exists between the current account balance and international capital flows. Understanding that link is critical to understanding how the U.S. became a net debtor.

What Does It Mean to Be a Net-Debtor Country?

There is widespread confusion about what the Commerce Department's figures mean when they show that the U.S. is a net foreign debtor. Technically, those figures show that foreigners' ownership of claims on the U.S. (including land, buildings, firms, stocks, bonds, and other financial instruments) exceeds U.S. residents' ownership of claims on foreign countries. The important point here is that *all* foreign assets and liabilities are included in this calculation, not just debt instruments.

About 30 percent of U.S. foreign "debt" is accounted for by foreign ownership of stock issued by U.S. corporations and by foreign direct investments in the United States (such as foreign-owned land, office buildings, and manufacturing and distribution facilities in the United States). For example, automobile factories built in the U.S. by Japanese auto companies show up in the official figures as foreign claims on the United States. Corporate stocks and direct investments account for nearly the same percentage of U.S. claims on foreigners.

That some of our foreign assets and "debts" are actually real investments matters for three reasons. First, direct investments produce goods and services in the U.S. and thereby generate the stream of dividends or profits that are paid to foreigners. In the process, direct investments generate output and employment in the U.S., benefiting residents as well as nonresidents. Second, while direct investments generate a stream of profits or dividends that flow to their owners, direct investments do not normally require a contractually fixed stream of payments to foreigners (such as are required by interest payments on a bond). Instead, foreign direct investments in the U.S. pay high returns when profits are strong in the U.S. and lower returns when profits are weak. In effect, we pay more to foreigners when we can best afford to. Third, direct investments are valued at their "book value" (historical acquisition cost) in the official figures, unlike financial instruments, which usually are valued at their current market value. Using book value results in a large understatement of the true value of foreign direct investments owned by U.S. residents, but a much smaller understatement of the true value of foreign-owned direct investments in the United States. Thus, valuing foreign direct investments at their book value results in a large overstatement of the true size of the U.S. net-debtor position. These three points argue that the true burden that will arise from the need to service our foreign "debts" is likely to be smaller than estimates based on official Commerce Department figures seem to suggest.

Making these and other technical adjustments to the official figures suggests that the U.S. net-foreign-liability position was at least \$350 billion *smaller* at the end of 1987 than the official figures show.* Despite the ambiguities in the official figures, however, it is clear that the balance between U.S. claims on foreigners and U.S. liabilities to foreigners has changed dramatically during the 1980s. From a large net-foreign-asset position in 1982, the U.S. almost certainly shifted to a net-foreign-liability position at the end of 1988.

*For a discussion of these issues and other measurement problems in the official statistics, and also for corrected estimates of U.S. foreign assets and liabilities, see Michael Ulan and William G. Dewald, "Deflating U.S. Twin Deficits and the Net International Investment Position," Planning and Economic Analysis Staff Working Paper 12 (Bureau of Economic and Business Affairs, U.S. Department of State, 1989).

When the U.S. imports more than it exports and runs a current account deficit, as it has each year since 1982, our receipts from abroad fall short of our payments to foreigners. To finance the excess of foreign payments over receipts, the U.S. must borrow from foreigners or sell assets to them. In each case, financial capital flows into the United States. At the same time, either our liabilities to foreigners rise or our holdings of foreign assets decline, so our *net* foreign asset position declines.¹

Current Account Deficits and Matching Capital Inflows Reflected Macroeconomic Imbalances. Fundamentally, the large capital inflows into the U.S. during the 1980s resulted from a shortfall of national saving relative to the demand for funds to finance real invest-

ment in buildings, equipment, structures, and inventories. The excess of investment spending over national saving was financed by an inflow of capital from abroad.

National saving (the sum of personal saving, business saving, and government saving) declined as a share of GNP during the 1980s. National saving declined from 16.2 percent of GNP in 1980 and 17 percent in 1981 to a little more than 12 percent in 1987 before rising somewhat in 1988. Business saving did not decline relative to GNP; it was just about the same share of GNP in 1987 and 1988 as in 1980 and was higher between 1981 and 1986. But personal saving fell from about 5 percent of GNP at the beginning of the 1980s to less than 2.5 percent in 1987. And government *dissaving* in the form of budget deficits (for all levels of government combined) grew from a little more than 1 percent of GNP to an average of almost 3.5 percent in 1982 through 1986, then declined in 1987 and 1988. Thus, about half of the decline in national saving relative to GNP was caused by falling personal saving rates and about half by rising government budget deficits.

¹A standard source for information on the U.S. trade and current account balances, and on the foreign assets and liabilities of the U.S., is the *Survey of Current Business*, published monthly by the Bureau of Economic Analysis, U.S. Department of Commerce. The March, June, September, and December issues contain detailed information on the U.S. current account balance and its components. The June issue also includes details on foreign assets and liabilities of the United States.

TABLE 1
Personal and Government Saving Fell Relative to GNP
While Investment Rose

	Investment Spending (% of GNP)	National Saving (% of GNP)	National Saving (% of GNP)		
			Business	Personal	Government
1980	16.0	16.2	12.5	5.0	-1.3
1981	16.9	17.0	12.8	5.2	-1.0
1982	14.1	14.1	12.7	4.9	-3.5
1983	14.8	13.6	13.6	3.8	-3.8
1984	17.6	13.5	13.5	4.4	-2.8
1985	16.0	13.3	13.4	3.1	-3.3
1986	15.6	12.4	12.9	3.0	-3.4
1987	15.5	12.2	12.4	2.3	-2.4
1988	15.4	13.2	12.2	3.0	-2.0

While the national saving rate fell, investment spending rebounded from its 1982 low as the economy recovered from recession. Investment spending grew especially strongly in 1983 and 1984, rising to 17.6 percent of GNP, then fell back to about 15.8 percent of GNP from 1985 through 1988. The resulting imbalance between investment spending and national saving has exceeded \$100 billion each year since 1984, generating the need for a capital inflow from abroad.²

The large current account deficits and matching deterioration in the U.S. net-foreign-debt position also reflected a decline in the international competitiveness of U.S. firms from 1980 to 1985, most of which was caused by the more than 50 percent increase in the value of the dollar during that period. That rise in the dollar's value, which has since been reversed, meant that firms in the U.S. could buy various goods abroad and import them into the U.S. at a lower cost than they would incur by producing the goods here. The resulting increase in U.S. imports, and the accompanying decline in exports, accounts for most of the growth in our current account deficit.

The imbalance between national saving and investment was an important cause of the dollar's appreciation. The shortfall of national saving relative to investment spending helped drive up real (inflation-adjusted) interest rates in the United States. The rise in real interest rates, in turn, contributed to the rise in the dollar's value that reduced U.S. international competitiveness. The interplay between these

²Data on U.S. national income and product, including saving and investment spending, are available monthly in the *Survey of Current Business*. Those data show that personal saving has been declining as a share of GNP since the mid-1970s, when it peaked at 6.5 percent. For more detail on the behavior of private and government saving in the U.S., see Behzad Diba, "Private-Sector Decisions and the U.S. Trade Deficit," this *Business Review* (September/October 1988).

factors produced the large current account deficits and matching capital inflows of the 1980s. Those capital inflows cumulated to produce our net-foreign-liability position of \$530 billion—almost 11 percent of GNP—at the end of 1988.³

WILL OUR NET-DEBTOR STATUS REDUCE OUR FUTURE STANDARD OF LIVING?

Our growing net-debtor status has raised worries that we will have to transfer to foreigners so much of our future income—in the form of interest and dividend payments to foreign owners of claims on the U.S.—that we will end up with a falling standard of living. Whether the U.S. faces reduced living standards depends upon how the capital inflows of the 1980s were used—in particular, whether they financed investment or consumption. And the answer also depends upon our future savings behavior.

If Capital Inflows Financed Additional Investment, Our Future Standard of Living Is Likely to Rise. Additional spending on new investment in plant and equipment generates higher output and incomes by making workers more productive and by creating new jobs. Only part of the increased output and income accrues to foreign investors in the form of interest and dividend payments. The remainder of the higher incomes flows to workers in the U.S. in the form of wages and salaries and to governments in the U.S. in the form of tax revenues.

Foreign capital inflows can finance additional investment either directly or indirectly. They can finance additional investment directly if they are used to build new factories,

³A shortfall of national saving relative to desired investment spending in one country can generate foreign capital inflows into that country only if other countries' saving exceeds their investment spending. That has been true for Germany, Japan, and other countries during the 1980s.

office buildings, and other structures, or if they are used to purchase new equipment. Foreign capital inflows can finance new investment indirectly if they are used to buy financial instruments (such as stocks and bonds) from Americans, who will then be able to use the funds to finance investment.

But if Capital Inflows Financed Consumption, Our Future Living Standards May Be Reduced. If the inflow of foreign capital financed only current consumption spending, including consumption by the government, then we incur future payments to service the accumulated foreign debt but gain no offsetting increase in future incomes. In this case, our future standard of living will be lower *than it otherwise would have been*, but it still may be higher than today's. Continuing technological progress and real investment financed by domestic savings will raise our future standard of living, unless interest and dividend payments to foreigners rise more than our GNP. Thus there is a possibility that foreign capital inflows could produce a burden on future generations in the form of a lowered standard of living, if those capital inflows are used to finance consumption spending rather than new investment.

More Than Half of the Capital Inflow Was Used to Finance Increased Net Investment. By comparing the net capital inflows during the 1980s with the increase in the amount of *net* investment spending undertaken in the United States, we can determine how much of the capital inflows were used, directly or indirectly, to finance additions to the capital stock. During 1980 and 1981, when there was virtually no net capital flow, net investment spending by U.S. businesses averaged about \$150 billion per year. From 1984 to 1988 there were sizable net foreign capital inflows averaging a little more than \$126 billion per year. Net investment increased to an average of about \$221 billion per year over this period, better than \$70 billion per year higher than in 1980-

81.⁴ On average, then, about 55 percent of the net foreign capital inflow from 1984 to 1988 was used, directly or indirectly, to finance additional net investment.

There is another way to look at this issue: although national saving declined from 16.6 percent of GNP in 1980-81 to about 13.2 percent in 1984-88, net investment was unchanged as a share of GNP; net investment averaged 5.2 percent of GNP during the earlier period and also during the latter years. The implication is that foreign capital inflows allowed the U.S. capital stock to grow at the same rate from 1984 through 1988 as during 1980 and 1981, despite the drop in national saving relative to GNP. In

⁴We omit data for 1982 and 1983 from this comparison because investment spending was depressed during those years as a result of the 1981-82 recession. It would be misleading to attribute either the drop in investment spending from 1981 to 1982, or the increase from 1983 to 1984, to changing foreign capital inflows. If we were to include data for 1982 and 1983, it would appear that nearly 80 percent of the foreign capital inflow financed additional net investment.

TABLE 2
More Than Half
of Net Capital Inflows
Were Used to Finance
Added Investment

	Net Capital Inflow Per Year (\$ billion)	Net Investment Spending Per Year (\$ billion)
1980-81	-4.4	150.5
1984-88	126.3	220.9
	Increase = 70.4	

the absence of foreign capital inflows, a drop in national saving relative to GNP would have to be accompanied by a drop in investment relative to GNP. The inflow of capital from abroad allowed continuing growth in the capital stock, which is likely to mean rising living standards in the future. Nevertheless, more of the returns to that new capital will accrue to foreigners, so our standard of living will grow less rapidly than if net investment had been financed by domestic saving rather than foreign saving.

A simple back-of-the-envelope calculation will give a feeling for the potential size of this effect. The ratio of net foreign debt to GNP for the U.S. was almost 11 percent at the end of 1988. Whether that ratio rises or falls in the future, and by how much, will be critical in determining the size of the burden. If that ratio rises, indicating that our net foreign debt is growing faster than our GNP, then a rising share of our total incomes will accrue to foreigners.

Projections by various economic forecasting services of the likely future paths of GNP and the current account deficit suggest that the ratio of our net foreign debt to GNP might gradually rise to 15 percent of GNP, or perhaps to as much as 20 percent, before it begins to decline sometime late in the 1990s.⁵ As a result, we would need to transfer a rising share of each year's GNP to foreigners to make the interest and dividend payments that go with our net-debtor status. The projections indicate that net interest and dividend payments to foreigners might peak at as much as 1 percent of GNP. That is the potential burden of our position as a net foreign debtor.

We can gain some perspective on the size of this potential burden by noting that net interest

and dividend payments to foreigners are projected to rise from about \$4 billion in 1988 to as much as \$90 billion in 10 years' time. But over the same 10 years our GNP is projected to roughly double, rising by nearly \$5 trillion. Some of that growth in measured GNP reflects price increases rather than production of more goods and services, and some of that growth is needed to maintain our existing standard of living as the U.S. population grows. But even after adjusting for inflation and population growth, the projections suggest that per capita real GNP less net interest and dividend payments to foreigners is likely to grow about 16 percent by 1998.

That is not to say that our growing net-foreign-debtor position will have no effect upon Americans' future living standards, however. According to these projections, growing net interest and dividend payments to foreigners will leave our per capita real income roughly 1 percent lower at the turn of the century than it would be in the absence of those payments. Such an effect is small, but noticeable.

While the projections upon which these calculations are based are necessarily subject to great uncertainty, they do give a feeling for the size of the future burden of our net-debtor position. Americans are not likely to face a lower standard of living than we enjoy today. Still, our standard of living will grow a little less quickly as a result of our growing net-debtor position.

WILL OUR FOREIGN DEBT CAUSE HIGH INFLATION?

While it is unlikely that our growing net foreign debt will mean a lower standard of living than we have today, the concern remains that our net-debtor status might generate strong inflationary pressures like those in some other debtor countries. This concern raises two related questions. First, does the U.S. face the temptation to generate higher inflation because doing so could reduce the real value of its

⁵These figures, and other numbers cited below, are based upon long-term economic projections published during the winter of 1988-89 by DRI/McGraw-Hill and The WEFA Group.

foreign debts? And second, if foreigners were to become unwilling to continue accumulating claims on the U.S., as has happened with some other debtor countries, would the result be a debt crisis that generates high inflation in the United States?

Can We Inflate Away Our Foreign Debt?

One important difference between the U.S. and other debtor countries is that much of our foreign debt is denominated in our own domestic currency while theirs is not. That fact raises the possibility that the U.S. could inflate away the real value of its foreign debt by generating higher domestic inflation so that each dollar owed to foreigners would buy fewer U.S. goods.

In assessing this possibility, it is important to note that it is only fixed-rate, long-term nominal debt whose real value can be reduced by higher inflation. That is, the real value of fixed-income securities with fixed value at maturity, such as long-term bonds, can be reduced by higher inflation. But the real value of shares of stock in U.S. firms and of real assets such as buildings, factories, or land cannot reliably be reduced by inflation; their dollar values tend to rise along with prices of goods and services. And the real value of short-term or floating-rate debt cannot be reduced by higher inflation, because interest rates on such debt would rise along with the inflation rate, thereby compensating the holder of such debt for the higher inflation. Indeed, higher inflation would actually increase the burden of servicing short-term or floating-rate claims held by foreigners, because it would quickly raise the required interest payments on such debt.

Fixed-rate, long-term debt, whose value can be reduced by higher inflation, accounts for at most 20 percent of foreign claims on the United States.⁶ The bulk of U.S. liabilities to foreigners

consists of short-term debt, equity, and investments in real property. Thus, the U.S. cannot effectively inflate away the real value of its foreign debt, even though most of that debt is denominated in U.S. dollars.

That the U.S. cannot inflate away its foreign debt may not be enough to prevent inflationary pressures. Some of the world's debtor countries have suffered very high inflation, even though their foreign debts are largely floating-rate debt denominated in currencies other than their own so that their domestic inflation does not reduce the real value of their foreign debt. Those episodes of very high inflation seem to follow or accompany debt crises, in which foreign lenders become unwilling to continue accumulating claims on a particular country.

Would the U.S. Face Very High Inflation if It Could No Longer Borrow From Foreigners?

Although very high inflation seems to be connected with debt crises, episodes of very high inflation actually have little to do with the presence of foreign debt, or with debt crises, per se. Rather, very high inflation reflects a lack of well-developed internal capital markets, governments' inability to collect taxes effectively, and governments' responses to debt crises.

Many of the world's debtor countries had large government budget deficits that they financed mostly by borrowing from foreigners,

derived by treating all U.S. government notes and bonds plus all U.S. corporate and other bonds held by foreign official and foreign private investors as long-term, fixed-rate claims, and dividing that sum by total foreign claims on the United States. (Data on foreign holdings of U.S. government debt are available in the *Treasury Bulletin*; data on foreign ownership of U.S. corporate bonds are given in the June issue of the *Survey of Current Business*.) This method for estimating how much of foreign claims on the U.S. is fixed-rate, long-term debt almost certainly produces an overestimate because much of the stock of U.S. government notes outstanding at any point in time actually has a fairly short time remaining to maturity. The rest of foreign claims on the United States, other than those cited above, are either short-term or are real assets.

⁶Twenty percent is almost certainly an overestimate. Very little data on the maturity structure of foreign claims on the U.S. are available. The 20 percent figure is an estimate

especially from international banks and multi-lateral organizations. After issuing so much foreign debt that lenders became unwilling to provide additional funds, or became unwilling to provide as large a flow of new lending as in earlier years, many of those countries found that their domestic capital markets could not absorb enough new debt to finance ongoing government budget deficits as large as those previously financed by borrowing from foreigners. Policymakers in those countries then faced a choice between reducing government spending, raising taxes to finance that spending, or simply printing new money to finance the excess of government spending over revenues. Those governments that printed money to finance continuing budget deficits generated high inflation.⁷ On the other hand, those

debtor countries that responded to the reduced availability of foreign funds by reducing their budget deficits, thereby avoiding rapid growth of their money supplies, did not experience rapid inflation.

Thus, it is not foreign debt per se, or even the inability to issue new foreign debt, that causes high inflation in debtor countries. Rather, it is continuing rapid expansion of the money supply, usually to finance large government budget deficits, that causes high inflation.

Should we expect our government budget deficits to generate high inflation in the United States? In applying the lesson from those debtor countries that have experienced very high inflation, there are three points to bear in mind. First, the U.S. has well-developed domestic

⁷For a more thorough discussion of these problems, with details of particular countries' experiences, see Thomas J. Sargent, "The Ends of Four Big Inflations," in Robert Hall

(ed.), *Inflation*, NBER and University of Chicago Press (1982), and also Rudiger Dornbusch and Stanley Fischer, "Stopping Hyperinflations Past and Present," NBER Working Paper #1810 (1986).

Comparing the U.S. to High-Inflation Debtor Countries

While foreign claims on the U.S. are large, they are much smaller relative to the size of our economy than is true for those debtor countries that have suffered very high inflation. More importantly, the growth rate of the money supply in the United States is much, much lower than in high-inflation debtor countries.

In most of the debtor countries that have experienced very high inflation, large and continuing government budget deficits caused a large shortfall of domestic saving relative to investment spending. That shortfall was financed primarily by borrowing abroad. Accordingly, those countries accumulated very large foreign debts relative to their GNP and foreigners eventually became unwilling to continue lending at the same pace.

The size of the foreign debt was not itself the cause of high inflation, however. Nor was foreigners' reluctance to continue lending the cause of high inflation. Rather it was governments' response to the reduced availability of foreign funds that was critical. When foreigners became unwilling to continue lending to the same extent, some governments responded by creating large amounts of new money to finance continuing large budget deficits. Those governments that did so generated high inflation. Comparing the U.S. to Argentina, Bolivia, Brazil, Peru, and South Korea makes the point clear. In contrast to the United States, the first four of these debtor countries have experienced very high inflation because their governments generated very rapid growth of their money supplies.

South Korea, too, has a large foreign debt relative to the size of its economy; its government, however, did not allow very rapid money growth. Thus South Korea, like the United States, did not experience high inflation. The difference in monetary policy, not in the level of foreign debt, is what separates debtor countries that experienced high inflation from those that did not.

financial markets. The U.S. government has had no difficulty financing its deficits by issuing debt in these markets, although some of that debt has been purchased by foreigners. And no such difficulty is likely to arise as long as investors perceive that the U.S. budget deficit will shrink further relative to GNP.

Second, the shortfall of national saving relative to investment has been much smaller over the past 15 years for the U.S. than for the major debtor countries that have experienced very high inflation. As a result, the foreign debt of the U.S. is much smaller relative to our GNP than is the case for those countries. And the money supply has grown much less rapidly in the United States than in those countries.

Third, the U.S. Treasury cannot finance its deficit by printing new money. The power to issue new money in the U.S. is vested in the Federal Reserve System, which is prohibited by law from issuing new money to purchase

newly issued debt directly from the U.S. Treasury.⁸ Thus we should not expect budget deficits to generate very high growth rates of the money supply or very high inflation in the United States. Still, the inflationary experience of many debtor countries makes clear the importance of conducting monetary policy so as to avoid very rapid growth of the money supply, even when government deficits put pressure on financial markets.

⁸There is a minor exception (contained in 31 United States Code, section 5301; act of September 13, 1982) that allows the Federal Reserve to buy up to \$3 billion of securities directly from the U.S. Treasury when the President of the United States declares an economic emergency. This amount is tiny relative to the roughly \$230 billion of government securities that the Federal Reserve System held during the summer of 1989 — securities that were acquired in the open market during the normal course of monetary policy operations.

Large Foreign Debts Need Not Mean High Inflation

	Argentina	Bolivia	Brazil	Peru	S. Korea	U.S.
Total external debt (public and private) as % of GNP (1986)	59	103	43	62	47	22
Avg. saving shortfall (I - S) as % of GNP (1973-80)	0.6	6.8	4.6	4.3	6.0	0.0
(1980-86)	4.7	8.7	3.3	4.4	3.0	1.5
Average money growth (broad money: M2) (% per year, 1980-86)	302	643	176	101	18	9
Average inflation (% per year, 1980-86)	326	684	157	100	5	4

Sources: *World Development Report 1988* (World Bank, Washington, D.C., 1988);
Survey of Current Business, June 1988 (U.S. Department of Commerce, Washington, D.C.)

Continued Increases in Net Foreign Debt Might Lead to Slightly Higher Inflation. Although the buildup of foreign claims on the U.S. is unlikely to generate high inflation, future debt increases might contribute to modestly higher inflation for several years. Theoretical models of exchange-rate behavior suggest that if U.S. current account deficits do not shrink and our net-foreign-debtor position continues to grow rapidly as a result, then the dollar would tend to depreciate gradually over time. Such gradual but continuing depreciation would be expected to make inflation as measured by the Consumer Price Index a little higher than it would be otherwise. The reason is that the dollar's depreciation would contribute to rising prices for imports and for import substitutes produced domestically.

WHAT ARE THE PROSPECTS FOR REVERSING OUR NET-DEBTOR STATUS?

We have seen that the costs of our net-debtor status, whether it affects our future living standards or inflation, are likely to be small. Still, a long-run economic perspective suggests that it may be desirable for the U.S. to eventually reverse its net-debtor position and return to being a net foreign creditor.

When large numbers of those in the "baby boom" generation begin to retire, roughly 25 to 30 years from now, they will need a large stock of assets—domestic or foreign—upon which to draw in order to finance their consumption during retirement. Americans can accumulate such a stock of assets by saving more to finance more domestic investment, or by saving more and using the funds to lend to foreigners or buy assets from foreigners. Those foreign assets can later be sold back, in exchange for the goods that members of the baby-boom generation will want to consume during their retirement. Such behavior by individuals would imply that the U.S. would need to accumulate a positive net-foreign-asset position—a position that would eventually be drawn down to

finance imports of consumer goods after the baby-boom generation retires.

Reducing Our Net-Debtor Position Will Require National Saving to Exceed Investment Spending. We saw earlier that the foreign capital inflows that produced our net-debtor status reflected a shortfall of national saving relative to investment. To reduce our net-foreign-debt position, we must generate capital outflows either to repay foreign debt or to acquire foreign assets. To generate capital outflows, national saving must exceed investment in the United States. Are there forces at work in the U.S. economy that will raise national saving relative to investment spending?

Recall that national saving is composed of personal saving, business saving, and government saving in the form of budget surpluses. Both personal saving and government saving seem likely to rise in the future.

The U.S. Personal Saving Rate Should Rise Over the Next 20 Years. Historical evidence clearly indicates that the bulk of personal saving in the U.S. is done by people 45 to 64 years old. During the past 20 years, the share of the U.S. population in that age group has fallen to a low of about 18.5 percent, and personal saving as a share of GNP has fallen too. The U.S. Census Bureau projects that as the baby-boom generation grows older, the share of those aged 45 to 64 is likely to grow to about 23 percent of the population by the year 2000 and then rise still further. Thus, the U.S. personal saving rate is likely to rise over time, contributing to a rise in national saving relative to GNP. How much personal saving will rise is not known, however.

Government Saving Is Likely to Increase Too. Large government budget deficits, especially at the federal level, as well as a declining personal saving rate, contributed to the decline in national saving relative to GNP during the 1980s. While large federal budget deficits were to be expected when the U.S. economy was in **recession from 1980 to 1982** (because reces-

TABLE 3
Demographic Trends
Suggest Personal Saving
Will Rise

	Share of U.S. Population Ages 45 to 64 (%)	Personal Saving as Share of GNP (%)
1970	21.5	5.7
1975	20.3	6.0
1980	19.1	5.0
1985	18.8	3.1
1987	18.6	2.3
1988	18.7	3.0
1990	18.7	—
1995	20.2	—
2000	23.0	—

sions produce lower incomes and profits and thus lower federal revenues), large budget deficits now that the economy is at or close to full employment suggest a need for corrective policies. Those corrective policies are embodied in the Gramm-Rudman-Hollings deficit reduction legislation, which commits the U.S. government to eliminate its budget deficit by 1993. Even if that target is not met fully, the government budget deficit seems quite likely to shrink relative to GNP over the next few years, as it has since 1986.⁹

Continuing to reduce the budget deficit, or even running a budget surplus, would raise national saving relative to investment spending and thereby help transform current account deficits and net capital inflows into current account surpluses and net capital outflows. Such capital outflows will be required if

⁹Part of the reduction in the federal budget deficit reflects the growing surplus of the Social Security trust fund. That surplus is projected to continue growing at least through the end of the century, contributing to higher government saving.

we are to reduce our net foreign liabilities and eventually return to being a net foreign creditor.

One way to reduce the shortfall of national saving relative to investment spending would be to reduce investment. Few people would argue that the U.S. should cut investment spending, because doing so would reduce our future standard of living. In addition, the U.S. already uses a smaller share of its GNP for investment purposes than do other major industrial countries. If we do not wish to reduce investment spending relative to GNP, our focus in eliminating the shortfall of national saving relative to investment must be on generating higher savings. Whether national saving will eventually rise enough to exceed investment spending, and thereby generate capital outflows from the U.S., remains an open question. Private saving is expected to rise relative to GNP in coming years, as is government saving. To close the shortfall of saving relative to investment without reducing investment as a share of GNP, national saving's share of GNP must rise by about 2.2 percentage points from its level in 1988 (or 2.8 points from its average level for the years from 1983 through 1988). Such an increase is possible, but not certain.

THE ROLE OF MONETARY POLICY

While it is clear that fiscal policy can help reduce or reverse our net-foreign-liability position by continuing to reduce the budget deficit, nothing in the preceding discussion seems to suggest much of a role for monetary policy. In fact, monetary policy can play an important role by promoting sustainable economic growth and low inflation. Too-rapid growth in the demand for goods and services in the U.S., and the attendant rise in inflationary pressures, would tend to increase our trade and current account deficits and thus contribute to higher foreign debt. But a recession, while it would reduce imports, would tend to increase the burden of our existing foreign debt because

interest and dividend payments to foreigners would become a greater share of our diminished GNP.

Another way of stating the role of monetary policy—and of fiscal policy as well—is that policymakers can promote an eventual reduction in our net foreign debt by adopting policies to ensure that the domestic components of demand for U.S. goods and services (especially consumer spending and government purchases) grow less rapidly than the

economy's capacity to produce goods and services. By doing so, policymakers would allow U.S. firms to meet growing export orders without generating stronger inflationary pressures. If government deficits continue to shrink as a share of GNP, and if personal saving rates increase appreciably as demographic trends suggest, then the domestic components of demand will grow more slowly; so, in the future it may not be necessary to use monetary policy to restrain growth in demand so as to reduce our net foreign debt.

GLOSSARY

Current account balance - a broad measure of the difference between the international receipts and payments that result from transactions with foreigners. It includes the difference between our exports and imports (the trade balance), and it also includes "factor payments" such as interest and dividends, and outright gifts such as charitable donations and foreign aid. The U.S. current account balance is the difference between our receipts from foreigners and our payments to foreigners that result from all transactions *except* purchases or sales of assets (whether stocks and bonds and other financial assets, or real assets such as land and buildings and factories).

Capital inflow into the U.S. - financial capital flows into the United States when residents of the U.S. borrow abroad or when they sell existing assets to foreigners.

Capital outflow from the U.S. - financial capital flows out of the United States when residents of the U.S. lend to foreigners or when they buy existing assets from foreigners.

Net capital inflow into the U.S. - the capital inflow from abroad minus the capital outflow.

Foreign claims on the U.S. - the total value of foreign-owned assets in the U.S., including the value of loans to U.S. residents.

U.S. claims on foreigners - the total value of assets outside of the U.S. that are owned by U.S. residents, including loans to foreigners.

U.S. net-foreign-asset position - U.S. claims on foreigners minus foreign claims on the United States. A country with a positive net-foreign-asset position is a "net foreign creditor."

U.S. net-foreign-liability position - foreign claims on the U.S. minus U.S. claims on foreigners. A country with a positive net-foreign-liability position (and thus a negative net-foreign-asset position) is a "net foreign debtor." The United States is now a net foreign debtor.

SUMMARY

A look at the causes and implications of the U.S. becoming a net-debtor country yields four conclusions. First, our standard of living is unlikely to decline, although it may grow less rapidly because of the need to service our liabilities to foreigners. Second, our net-debtor status is unlikely to cause very high inflation rates like those experienced by some of the world's debtor countries. Third, we can reduce, and eventually reverse, our net-debtor

position if we save a greater proportion of our incomes in the future—especially if the baby-boom generation saves more as it enters middle age. And fourth, the government can help if it continues to reverse the budget deficit as a share of GNP, and if it chooses monetary and fiscal policies that promote sustainable, noninflationary economic growth.

Personal saving - that part of households' current after-tax income that is not spent to buy goods and services. This is the part of current income that is deposited in financial institutions, used to buy additional financial assets, or otherwise lent out. When we aggregate personal saving for the economy as a whole, we net out new consumer borrowing from the flow of new saving done by households.

Business saving - that part of businesses' revenues that is not paid out to workers, lenders, suppliers, or owners. Alternatively, the funds that are retained as cash on hand, deposited in financial institutions, or lent out. Business saving is comprised largely of retained earnings and depreciation or amortization allowances.

Government saving - the consolidated government budget surplus for all levels of government. When governments run a budget surplus they use the excess of revenue over outlays either to retire debt they had issued previously, or they buy financial assets. When governments run budget deficits, they dissave and issue new debt or money.

National saving - the sum of personal, business, and government saving. Conceptually, national saving represents the quantity of funds that can be used to finance domestic investment or that can be lent to foreigners.

Real investment - the purchase and installation of new machinery and equipment, the construction or expansion of buildings and structures, and the accumulation of additional inventory.

Net investment - gross (total) investment spending by businesses less an estimate of economic depreciation. Economic depreciation is the amount of the capital stock that wears out or becomes useless. Thus net investment is a measure of the amount by which investment spending increases the stock of capital in the economy.