

DAILY GLOBAL  
COMMENTARY

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## U.S. Current Account Deficit – Foreign Investors Making It Up On Volume?

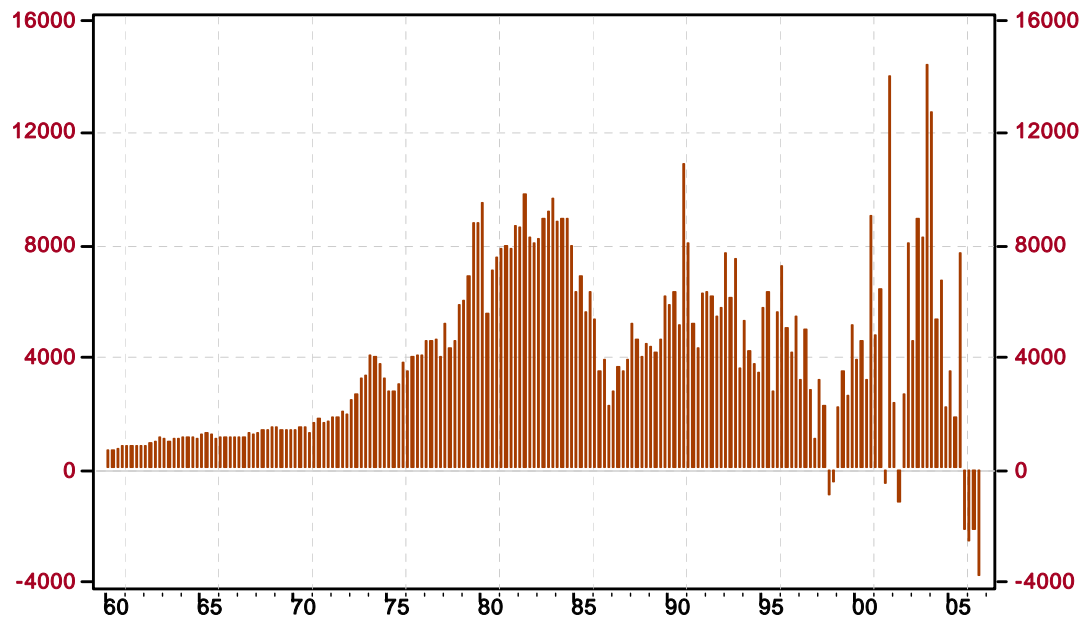
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What I found most interesting about the third quarter current account data was not that the U.S. deficit ran at a record annualized rate of \$902.2 billion, nor that this represented 6.8% of nominal GDP, the second highest percentage since Q4:2005's 7.0%. No, what I found most interesting was, as shown in Chart 1, that for the fourth consecutive quarter, the U.S. ran a deficit in the income account. That is, for the fourth consecutive quarter, the income earned on foreign assets owned by U.S. entities was less than the income earned on U.S. assets owned by foreign entities. As Chart 1 shows, in the past 45 years it was a rare occurrence for the U.S. income account to be in deficit. Prior to the most recent four quarters, a deficit in the income account has occurred only four other times since 1960.

Chart 1

### BOP: Balance on Income

SA, Mil.\$



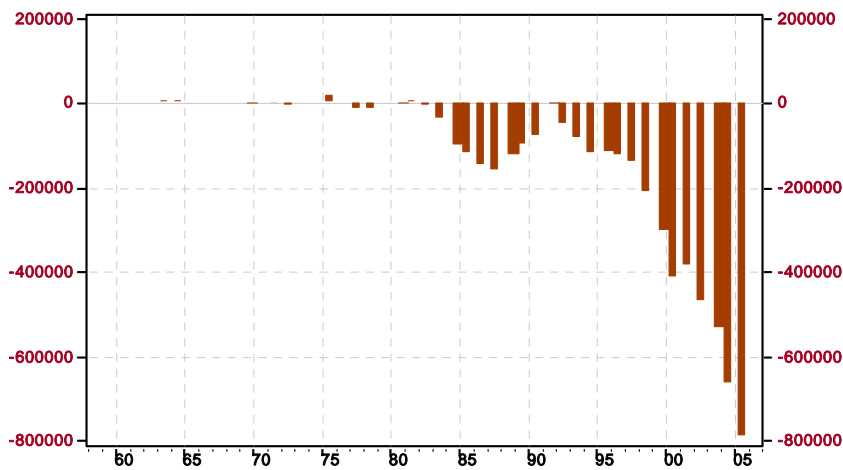
Source: Bureau of Economic Analysis /Haver Analytics

But a deficit in the income account probably is something we need to get used to. Why? When an entity – person, business or entire economy – runs a deficit, it means that it is borrowing from and/or selling assets to another entity. If a deficit is run persistently and at ever larger magnitudes, the lending entity starts to amass claims against the deficit entity in excess of its liabilities to the deficit entity. As Chart 2 shows, the U.S. has run a current account deficit in every year starting in 1982 except for a small surplus in 1992.

Chart 2

BOP: Balance on Current Account

Mil. \$



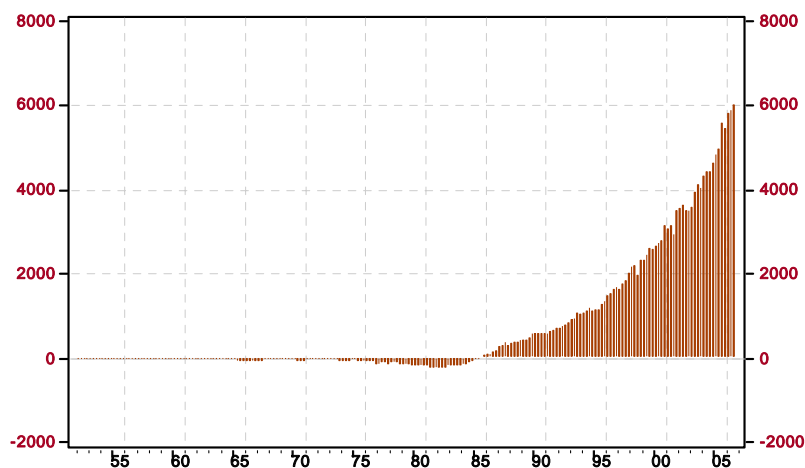
Source: Bureau of Economic Analysis /Haver Analytics

So, by running persistent current account deficits, the financial claims that the rest of the world has on the U.S. have been building up faster than the liabilities owed by the rest of the world to the U.S. As shown in Chart 3, this excess of foreign claims over liabilities reached \$6 trillion in round numbers in the third quarter.

Chart 3

Rest of the World: Financial Claims Against U.S. vs. Liabilities to U.S.

\$ billions



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Even if the return on U.S. assets owned by foreign entities is less than the return on foreign assets owned by U.S. liabilities, the sheer magnitude of the net financial asset surplus position of the rest of the world at some point would turn the U.S. income account surplus into a negative. In other words, the rest of the world is “making it up on volume.” What this deficit in the income account means is that the U.S. deficit in the goods/services account will have to narrow at a faster rate than otherwise if the overall current account deficit is to narrow. The arithmetic wind is now even more in our face if the current account deficit is to be narrowed.

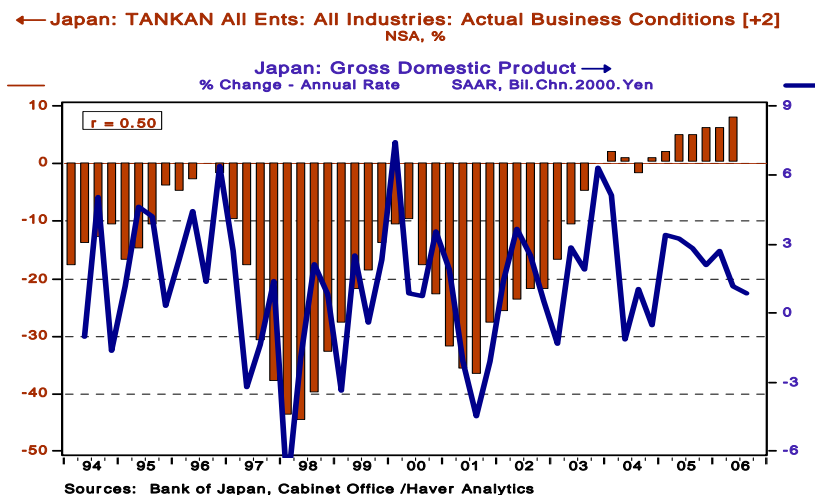
By the way, it is not clear that Treasury Secretary Paulson’s trip to China last week did much but to temporarily widen our current account deficit. After all, “tourism” is counted as an export to the country being visited. I would suggest that Secretary Paulson travel with a much smaller entourage in his next visit to China. Better yet, invite a large delegation of Chinese officials to the U.S. next time. At least this will work at the margin to narrow our current account deficit.

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### Japan: Tankan Rallies Markets But We Remain Cautious

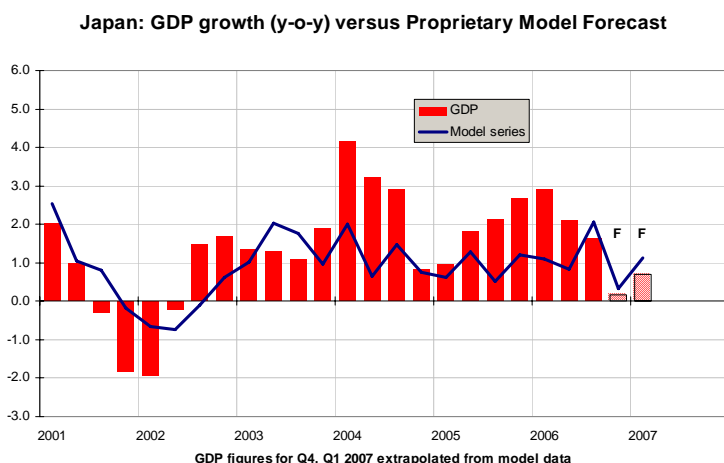
Tokyo markets closed last week on an optimistic note after data in the quarterly Tankan survey of business conditions suggested increased economic activity in coming months. The near-term outlook for large companies was up a few ticks, and the situation for small manufacturers improved to a 15-year high. With the economy showing signs of a slowdown, such reassurance was welcomed by Japanese investors. We, however, cannot help but focus on other, more striking figures that suggest the country’s near-term outlook may not be as positive as the Tankan survey suggests.

First and foremost, we question the Tankan’s ability to reflect the economy at large. Any series meant to represent economic growth should have a good track record in past years, and the relation between the Tankan’s broad index for current business conditions and actual GDP growth does not exhibit a statistical “goodness of fit”. If anything, the best correlation between the Tankan and GDP suggests that the broad index is a fair indicator of economic performance about six months *earlier* – implying that GDP is a fair predictor of the Tankan. And during the past couple of years, the relation between GDP and the Tankan’s All Industries index has been non-existent.



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The part of the Tankan release that we pay attention to is the section on capital spending plans. This section is often overshadowed by the headline index figures, but usually aligns more closely with the economy's performance in months to come. According to the Tankan report, capital spending for the current fiscal year ending on March 31<sup>st</sup>, 2007, is forecast to increase by 10.5% versus a rise of 8.9% for the previous fiscal year, with large companies planning to increase capital spending by 12.4% versus only 7.2% during the previous period. This is a nice improvement, but corroborating indicators suggest that most of this spending was done earlier this year, and the last half of fiscal 2006 will show less-than-impressive growth in capital spending. Once these presumptions are folded into our model for the Japanese economy, the near-term results are not exactly positive.



The implications of our model's output are that quarter-on-quarter growth will be very weak for Q4, leaving the year-on-year change at its lowest point for 2006. Growth will accelerate somewhat in the following quarter, but not at the rates exhibited earlier this year when optimism ran particularly high. This mild slowdown should also be enough to hold off the Bank of Japan's next rate hike for a few more months, and we are now calling for the next rate increase to be postponed until Q2 2007. We also recognize that there are significant downside risks to our base scenario for economic growth, any of which could further hold off central bank tightening.

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