The balance-of-payments current account has become a popular indicator of a country’s economic health. It is a difficult one to interpret.

IT IS hard to open a newspaper without reading about some country’s problem with its current account. The Japanese are lambasted for the size of their surplus. Americans fret over their current-account deficit. Excessive current-account deficits have taken the blame for many currency crises, from Mexico’s in 1994 to Thailand’s last year. Exactly what this means, however, is often hard to figure out: even the concept of the current account is ill-understood.

And not just among laymen. A new paper* by Malcolm Knight and Fabio Scacciavillani, both of the International Monetary Fund, shows that economists’ thinking about what the current account means and whether it matters has changed greatly in recent years. The two economists report, however, that very little of this new thinking has found its way into the making of economic policy.

The current account is confusing partly because it can be defined in different ways. The most familiar is the sum of a country’s trade surplus (or deficit), the investment income paid to (or received from) foreigners, and net transfers (such as remittances sent home by migrant workers). For most countries the trade balance is the biggest of these factors, so changes in the current account often reflect changes in trade flows. The importance of the trade balance often misleads people into believing that trade barriers, such as tariffs, will determine the current account.

That is nonsense, as can be seen by looking at the current account from the other end: as the difference between a country’s saving and its investment. A country that invests more than it saves must obtain resources from abroad, meaning that it has to run a current-account deficit. A country that saves more than it invests will export resources—and so run a current-account surplus.

A third way of describing the current-account balance is as the addition to (or reduction of) a country’s claims on the rest of the world. A country that runs a current-account surplus must be acquiring foreign assets of equal value. Thus the current account gives information about people’s decisions as to what kind of assets to hold. The keener investors are to hold a country’s assets, the bigger its current-account deficit will tend to be.

The best-known theory for understanding why a country’s current-account balance might rise or fall was developed by Robert Mundell, a Canadian economist, and Marcus Fleming, a Briton, in the early 1960s. The “Mundell-Fleming” framework shows how various government policies, such as higher spending, will affect interest rates, economic output and thus, indirectly, the current...
account. These effects, Messrs Mundell and Fleming showed, will depend on whether capital can move freely across borders and how a country manages its exchange rate. Mundell-Fleming is still the workhorse of international economic policymakers. Many of today’s prescriptions—for instance, that Japan should cut taxes to boost consumer demand and thereby reduce its current-account surplus—are based on it.

The Mundell-Fleming approach is clear, but it is also static. It does not help in understanding the dynamics of the current account over time, especially in countries that run persistent current-account deficits or surpluses. This matters, because a country that continually runs a current-account deficit will become ever more indebted to foreigners. So long as these borrowings are invested wisely this need not be a problem, since future economic growth should allow the debt to be serviced. But if the foreign resources are badly employed, or if the current-account deficit grows too fast, a country may not be able to meet its obligations to foreign creditors. Hence, a large current-account deficit that fuels consumption (as in Mexico in the early 1990s) or a property-price bubble (as in Thailand until last year) may be a problem.

Unfortunately, as Messrs Knight and Scacciavillani point out, neither of these two frameworks explains sudden, dramatic shifts in capital flows, such as those that have turned current-account deficits in a number of Asian countries into surpluses. To understand this phenomenon, it is useful to consider foreign investing as a way for an individual in any country to hedge against the risk of economic shocks at home. The continual process of portfolio shifting inevitably leads to greater international capital flows and larger current-account deficits or surpluses.

**Objects of desire**

Looked at in this way, America’s increasing current-account deficit reflects rising global demand for its assets; Japan’s growing surplus indicates investors’ lack of interest in holding assets in Japan. If there is a shift in investors’ desires for a particular country’s assets—caused, perhaps, by changed perceptions of risk—then current-account balances can change quickly.

Messrs Knight and Scacciavillani observe that these sophisticated economic frameworks are rarely put to use. Instead, many economic policymakers use rules of thumb, such as not worrying about a current-account deficit that is less than 5% of GDP. Some analysts, including experts at the IMF, try to calculate whether a country’s current-account deficit or surplus is sustainable by looking at likely long-term capital flows and exchange-rate movements. But these measurements are extremely crude.

The problem policy-makers face is that no single theoretical framework explains all changes in the current account. America’s current-account deficit today may be driven mainly by shifts in international portfolio allocation. But at some point other factors, such as a low saving rate, may become more significant. Many fast-growing emerging markets run current-account deficits that do not seem excessive when looked at in the saving-investment framework, yet alarm investors who are motivated by asset diversification. And none of the theoretical models can predict when a country’s current-account deficit will suddenly seem dangerously large, triggering a flight of capital—a shortcoming for which many Asian countries are now paying a painful price.