

# 'Dark matter' makes the US deficit disappear

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In 2005 the US current account deficit is expected to top \$700bn. It comes after 27 years of unbroken deficits that have totalled more than \$5,000bn, leading to concerns of an impending global crisis. Once the massive financing required to keep on paying for such a widening gap dries up, there will be an ugly adjustment in the world economy. The dollar will collapse, triggering a stampede away from US debt, interest rates will shoot up and a sharp global recession will ensue.

But wait a minute. If this is such an open and shut case, why have markets not precipitated the crisis already?

Maybe it is because there is something wrong with the diagnosis. Let us look at some facts. The Bureau of Economic Analysis indicates that in 1980 the US had about \$365bn of net foreign assets that rendered a net return of about \$30bn. Between 1980 and 2004, the US accumulated a current account deficit of \$4,500bn. You would expect the net foreign assets of the US to have fallen by that amount to, say, minus \$4,100bn. If it paid 5 per cent on that debt, the net return on its financial position should have moved from an income of \$30bn in 1982 to an expenditure of \$210bn a year in 2004. Right? After all, debtors need to service their debt. But the number for 2004 was, still, an income of \$30bn, just like in 1980. The US has spent \$4,500bn more than it has earned (which is what the cumulative current account deficit implies) for free.

How could this be? Here the official story becomes murky. Part of the answer is that the US benefited from about \$1,600bn of net capital gains (which, at best, cuts the puzzle in half). The other part of the official answer is that the US earns a higher return on its holdings of foreign assets than it pays to foreigners on its liabilities. But where did those large capital gains come from? Or, why are US investors abroad so much smarter than foreign investors in the US?

We propose a different way of describing the facts.\* We measure the assets according to how much they earn and the current account by how much these assets change over time. This is just like valuing a company by calculating its earnings and multiplying by a price-earnings ratio. Of course this opens up methodological questions, but the discrepancies with official numbers are so big that the details do not matter. To keep things simple in what follows we just take an arbitrary 5 per cent rate of return, which implies a price-earnings ratio of 20.

Let's get to work. We know that the US net income on its financial portfolio is \$30bn. This is a 5 per cent return on an asset of \$600bn. So the US is a \$600bn net creditor, not a \$4,100bn net debtor. Since the assets have remained stable then on average the US has

not had a current account deficit at all over the past 25 years. That is why it is still a net creditor.

We call the \$4,700bn difference between our measure of US net assets and the standard numbers “dark matter”, because it corresponds to assets that generate revenue but cannot be seen. The name is taken from a term used in physics to account for the fact that the world is more stable than you would think if it were held together only by gravity emanating from visible matter.

There are several reasons why dark matter exists. The most obvious is superior returns on US foreign direct investment. Why do US assets earn such returns? Because that investment comes with a substantial amount of know-how that increases its earning potential. It explains why the US can earn more on its assets than it pays on its liabilities and why foreigners cannot do the same. In measuring FDI, the value of the know-how is poorly accounted for. There are other sources of dark matter, but FDI is where the big bucks are. Once dark matter is considered, the world is surprisingly balanced. The US and European Union essentially cover their apparent imbalance with the export of dark matter, emerging markets use their surplus to import dark matter and Japan finances the rest of the world. Net asset positions of all big regions are fairly small.

Is US dark matter a stable asset? We find that it is. It now stands at more than 40 per cent of gross domestic product and has fallen in only six of the last 25 years, never by more than 1.9 per cent of GDP.

In a nutshell our story is simple. Once assets are valued according to the income they generate, there has not been a big US external imbalance and there are no serious global imbalances.

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