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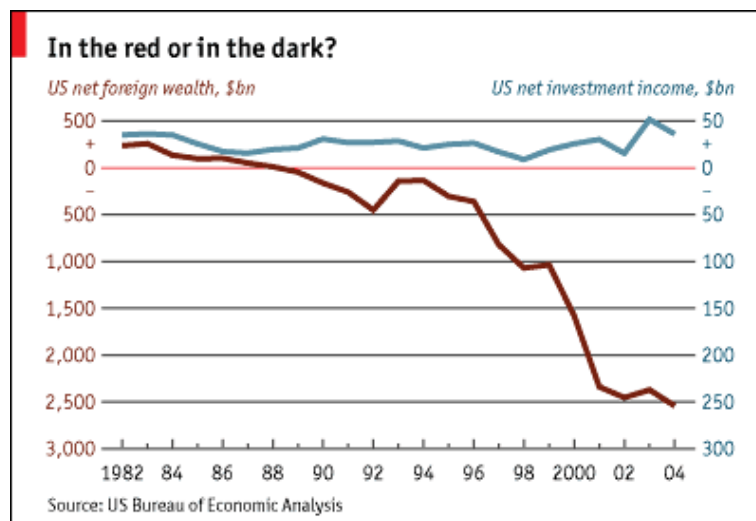
Economics focus

America's dark materials

Jan 19th 2006

From The Economist print edition

The United States' current-account deficit is a figment of bad accounting. If only



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STARE at something long and hard enough, and it will begin to swim before your eyes. Economists have been scrutinising America's current-account deficit for years now, and they are no closer to agreeing on what they are looking at. Now two economists at Harvard doubt whether the deficit even exists. Ricardo Hausmann and Frederico Sturzenegger first put this claim in a working paper* released last November. Your correspondent has blinked twice since then, but the claim has not gone away. On the contrary, it is gathering moss†.

At the heart of the argument is a well-known paradox. In the mainstream view, America is now the world's biggest debtor. Thanks to its chronic trade deficits, it stood \$2.5 trillion in the red at the end of 2004. And yet it still somehow manages to earn more on its foreign assets than it pays out to service its much bigger stock of debts: \$36.2 billion more in 2004.

Most economists conclude that America earns a higher return on its overseas assets (eg, EuroDisney)

than foreigners earn on investments in America (eg, Rockefeller Centre). They don their anoraks, immerse themselves in the data and try to work out why this might be so. Messrs Hausmann and Sturzenegger turn the question on its head. It is not the \$36.2 billion of income that is the mystery, they say. The anomaly lies in the \$2.5 trillion of debt. If America is still coming out ahead of foreigners, then, contrary to popular belief, it must still be a net creditor. America must have more foreign wealth than we can see.

The two authors have borrowed a name for this invisible wealth: dark matter. In theoretical physics, dark matter is the stuff in the universe that we can identify only by its gravitational pull. For the Harvard economists, dark matter is foreign wealth, the existence of which we can infer from the income it provides.

How much of it is out there? You can calculate a price for an asset from the earnings it provides. Messrs Hausmann and Sturzenegger elect to value America's net foreign assets at 20 times their annual earnings, which corresponds to a 5% rate of return. Valued at this ratio, America's national "portfolio" of foreign assets and liabilities is really worth \$724 billion, not minus \$2.5 trillion. What is more, if its foreign assets are as stable as the authors say, it follows that "the country has not been running a deficit."

Messrs Hausmann and Sturzenegger were the first to name dark matter, but not the first to discover it. In his book, "The United States as a Debtor Nation", published last year, William Cline, of the Institute for International Economics, performed the same calculation, backing out the value of America's net foreign assets from the income they generate. (Instead of calling it dark matter, Mr Cline, evidently not a born marketing man, called it "capitalised net capital income".)

Mr Cline agrees with the dark materialists when they say there is "something misleading about calling a country that makes money on its financial position the world's largest debtor". But sadly he does not think Americans can stop worrying. After making \$36.2 billion in 2004, America made just \$4 billion on its net foreign assets in the first three quarters of 2005. If it continues on its present trajectory, it will shell out about \$190 billion in 2010, Mr Cline calculates. Using Messrs Hausmann and Sturzenegger's methodology, America's net foreign assets would then amount to minus \$3.8 trillion. A dark matter indeed.

Ptaking on Ptolemy

Apart from its name, the dark matter thesis appeals because of its simplicity. Philip Lane, of Trinity College, Dublin, thinks it too simple. It matters, he says, what a nation's foreign wealth is composed of. Foreigners hold a lot of American debt (bonds and bank loans), whereas America holds a lot of foreign equity, especially foreign direct investment (FDI). This has two implications. First, what America pays to foreign creditors depends a lot on interest rates, which have been unusually low in recent years. Second, the value of America's assets depends on the risks they carry. Yet Messrs Hausmann and Sturzenegger apply the same valuation ratio indiscriminately to bonds, equities, trade credits and bank loans on both sides of the balance sheet.

That said, there remains a big gap in reported profitability between American FDI and FDI in America that risk alone cannot explain. Perhaps taxes can. To dodge the revenue men, a multinational company might report artificially high profits in a low-tax jurisdiction abroad. This tax arbitrage, Mr Lane points out, can shift money from one line of the current account to another. But it does not change the size of the deficit one jot.

To Messrs Hausmann and Sturzenegger, mainstream attempts to explain away dark matter look a bit desperate. Fond of their cosmological analogies, they liken them to the labours of medieval astronomers, trying to fit anomalous movements of the planets into their Ptolemaic model of the universe.

But the authors' thesis raises anomalies of its own. By their own account, dark matter should be stable. It stems from abiding features of the American economy, such as managerial know-how, a prized but uncounted commodity that Americans export to their subsidiaries abroad. But as Ed McKelvey, of

Goldman Sachs, points out, America's exports of dark matter seem to jump up and down wildly from year to year: \$351 billion in 2004, \$1.2 trillion in 2003, just \$172 billion in 2002. Dark matter seems to fluctuate at frequencies that are not structural, nor even cyclical. Perhaps they are best described as epicyclical.

Not all physicists regard dark matter as an elegant theoretical solution to the mysteries of the universe. Many think it is a bit of a fudge. Just a few months before the concept was introduced into economics, two theorists were hoping to dispel it from physics. Physicists, you see, expect beauty as well as truth from their theories. Economists, alas, must settle for one or the other.

* "US and Global Imbalances: Can Dark Matter Prevent a Big Bang?" Short and long versions of the argument are available at

www.utdt.edu/~fsturzen/Publications.htm

†For critical commentary see www.rgemonitor.com/blog/setser/113810

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