



# Economic Hypochondria

YOU KNOW THE FRIEND WHO'S ALWAYS CLAIMING HE'S sick—the freckle that's cancerous, the uncertain heartbeat—that's how the many pessimists about the U.S. economy, from the International Monetary Fund to the financial press, sound right now. The recession that some of them feared would be so severe and lengthy is over, and it wasn't so bad. The other maladies they warned of last year turned out to be psychosomatic. Remember the "liquidity trap"—a situation in which interest rates are so low that the Federal Reserve might be unable to stimulate the economy? Or deflation, which would mire the nation in a Japan-like cycle of falling prices and economic stagnation? Both were false alarms.

Now that the economy is growing nicely again, pessimists have found something else to worry about: America's "unsustainable" current account deficit. (The current account is the broadest measure of the net flow of trade and investment income. For decades the U.S. has been taking in more of both than it sends abroad.) Eventually the argument goes—maybe soon!—the foreigners who are investing hundreds of billions of dollars in America per year will find more attractive places to put their money. Then there'll be hell to pay: The dollar's foreign-exchange value will collapse, import prices will rise, and GDP growth will slow or stop altogether.

Although the current account deficit will shrink someday, there's no reason to worry that it will vanish anytime soon.

What would it take for foreign investors to suddenly stop investing in the U.S.? You have only to look at the past three years for a hint. Foreign investment continued to flow into the U.S. during 2000 and 2001 despite the carnage in the stock market, despite the collapse of corporate profits, and despite the fact that interest rates have been unusually low. Most of that money comes to the U.S. because overseas investors are bullish on American assets. What else will they decide to buy? The euro? Japanese treasuries? French growth stocks?

Eventually the U.S. will lose some of its luster, and investment will flow elsewhere. Whether that will be in months, years, or decades is a question to which no one knows the answer. And that

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brings us to the second reason that the fears about the current account deficit are overblown.

Once foreign investment does slow and the current account deficit decreases, it's far from certain that it will happen suddenly or that it will cause economic harm. For evidence look at the last swing in the current account. Back before the 1987 stock market crash, we heard the very same warnings about the dangers of the unsustainable current account deficit. But no economic catastrophe ensued as the deficit unwound. From the mid-1980s to the early 1990s the current account deficit dwindled to almost nothing before it started to grow again. Except for the recession of 1990 (and nobody blamed the current account deficit for that recession), those were pretty decent years for the U.S. economy.

The final reason that it's silly to fret about the current account deficit is that the steps the U.S. could take to reduce it are impractical and potentially harmful. One way would be to devalue the dollar. But the only surefire way to do that is for the Federal Reserve to drive down interest rates. In the current economic climate, that would probably overheat the economy and produce the kind of inflation we haven't seen in a decade.

Another way to reduce the current account deficit, in theory, would be to balance the federal budget deficit or run a surplus (thereby boosting domestic saving and lessening the need for foreign investment). But given the costs

of the war on terror, the Bush Administration's aversion to tax increases, and Congress' innate propensity to spend, that's not likely anytime soon. And with the economy just beginning its recovery, this would be exactly the wrong time to shift to a tight fiscal policy. It's also worth noting that the recent ballooning of the current account deficit coincided with the buildup of the federal budget surplus in the late 1990s, so theory in this case is more than a little suspect.

As long as the U.S. economy remains robust and its future looks attractive relative to the economies of other regions, foreign investment will continue to flow into America, and the current account deficit will be with us. As for the pessimists, tell them what you might be tempted to tell your hypochondriacal friend: "Get a life!" ■

What else will foreign investors buy besides U.S. assets? The euro? Japanese treasuries? French growth stocks?