ASK AN ECONOMIST

In Wu Zhen, China, a city likened to Venice, Italy.

YiLi Chien joined the Federal Reserve Bank of St. Louis as an economist earlier this year. His areas of interest are macroeconomics, household finance and asset pricing, asymmetric information, and dynamic contracting. In his spare time, he and his wife travel internationally; he also enjoys surfing the Internet, watching movies and reading. His Ph.D. in economics is from UCLA; his bachelor's and master's in economics are from National Tsing Hua University and National Taiwan University, respectively. Both are in Taiwan. See http://research.stlouisfed.org/econ/chien/ for more on his work.

Q. Is the large and persistent U.S. trade deficit a concern?

A. The answer to this question depends on several factors. Under certain favorable conditions, it is possible that the trade deficit is not a major concern.

The fact that the U.S. has a trade deficit means that the U.S. consumes more than it produces net of investment. This deficit must be financed either by reducing U.S. external assets or by increasing U.S. external liabilities. On balance, it seems possible that a persistent trade deficit would deplete U.S. overseas assets and perhaps, in the longer run, lead to insolvency.

However, this may not be the case because assets pay dividends and are associated with capital gains. Although the current difference between U.S. external assets and liabilities is negative, the U.S. is able to generate a net inflow because of the return difference between U.S. external assets and external liabilities. Economists Pierre-Olivier Gourinchas and Hélène Rey have documented that the U.S. earns a higher rate of return on its overseas assets than it pays on its liabilities to foreigners. The return difference is actually quite large: The U.S. external assets pay on average 3.3-percent-higher annual returns than do external liabilities. This return differential stems from a difference in the composition of U.S. external assets and liabilities. Assets with a higher return and risk, like foreign direct investment (FDI) and private equity, have a larger portfolio share in the U.S. external assets. The large return differential implies that the U.S. can have net inflows in spite of being a debtor country.

In sum, as long as the net investment income from the U.S. external account is sufficiently large, the trade deficit can be paid for and is not a major concern.

REFERENCE

Gourinchas, Pierre-Olivier; Rey, Hélène. "From World Banker to World Venture Capitalist: U.S. External Adjustment and the Exorbitant Privilege," in G7 Current Account Imbalances: Sustainability and Adjustment, NBER Chapters, pp. 11-66. National Bureau of Economic Research, 2007.

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LEARN WHAT'S BEHIND THE SOVEREIGN DEBT CRISIS, ALONG WITH ITS IMPLICATIONS FOR THE U.S.

An easy-to-understand explanation of the debt crisis in Greece and other parts of Europe can be found in the new annual report of the Federal Reserve Bank of St. Louis. Research Director Christopher J. Waller and Senior Economist Fernando M. Martin wrote **"Sovereign Debt: A Modern Greek Tragedy,"** an essay that is the core of the annual report. Besides explaining today's crisis in Europe, the authors provide a short history of government debt and briefly discuss the deficit and debt challenges facing the U.S. In a related message, St. Louis Fed President James Bullard calls the debt crisis **a wake-up call for the U.S.** Rounding out the report are a letter from Chairman of the Board Ward M. Klein, financial statements for the St. Louis Fed, and a snapshot of our work and employees.

The entire report can be read online at www.stlouisfed.org/ar. There, you will also find a **10-minute video** that captures the highlights of the essay. In addition, **a Spanish version** of the essay is available.

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IN THE NEW *REVIEW*: CENTRAL BANKS' ACTIVISM, SMOKING BANS, OUTSOURCING AND MORE

The July/August issue of *Review*, our research journal, features the Homer Jones Memorial Lecture given at the St. Louis Fed earlier this year by **Mohamed A. El-Erian**, CEO and co-chief investment officer of the investment firm PIMCO. He advocates for public and private agencies to work with central banks to deal with the economic and financial challenges that resulted from the Great Recession and financial crisis. He warns that central banks may find themselves facing one of two extremes: complementing policies by other agencies that put the global economy back on the path of high sustained growth and ample job creation, or cleaning up in the midst of a global recession, forced deleveraging and disorderly debt deflation.

Other articles examine:

- The extent and impact of **outsourcing**, with Germany as the case study.
- Whether the boom in **smoking bans** at workplaces, bars and restaurants is discouraging people from smoking.
- The relationship among **bank runs**, withdrawal history and depositors' private information.

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