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Introduction

The Global Crisis and the International Economic Position of the United States

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The global financial and economic crisis is likely to change the outlook for the international economic position of the United States in several, perhaps fundamental, ways.

First, it will sharply *reduce* the current account deficit in the short run. Lower foreign growth will only partly offset the combination of US recession and much lower oil prices. In chapter 2 William R. Cline calculates that the US external imbalance could drop as low as 3.1 percent of GDP ($430 billion) in 2009. This would be its lowest level since 1998. The gains are likely to be short-lived, however, as noted below.

Second, the crisis will sharply *increase* the budget deficit. Lower tax revenues and increased spending, including for fiscal stimulus and financial rescue operations, will probably raise the US internal imbalance to at least 10 percent of GDP (about $1.4 trillion) for the next couple of years.

Third, the crisis has created an unprecedented demand for safe dollar assets and particularly US Treasury securities. The dollar has strengthened, by about 13 percent on average and about 20 percent against the euro, since the crisis entered its acute phase in early 2008 despite the central role of the United States in the turmoil. Yields on Treasuries dropped sharply, almost to zero on short-term maturities during some periods.

How do these developments affect the prospects for long-term US sustainability? We suggest answers to that question by assessing the outlook for the external and budget deficits to 2030, on sharply different assumptions regarding the latter, and then analyzing both the role of the foreign

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imbalances in triggering the crisis and how the crisis itself might affect the (un)sustainability of future deficits.

Recent developments further demolish the simplistic version of the "twin deficits" thesis—i.e., a rise (decline) in the budget deficit necessarily produces a rise (decline) in the external deficit. Moreover, we do not know how private saving will respond to the unfolding of the crisis and recovery from it; the rapid rise in housing and equity wealth presumably had a great deal to do with the precipitous fall in private saving in recent years, so that variable could rebound substantially with the sharply negative wealth impact of the crisis. In light of the huge uncertainties surrounding the amount (and even the sign) of any changes in private saving, however, and the inability to date of the United States to devise policy tools that would reliably alter it, we stress the fiscal position as a key driver of the external accounts and the primary policy instrument for affecting them.[1]

The Long-Run Prospects

In chapter 2 Cline first calculates a "benign baseline" scenario premised on an early return to a fiscal deficit of only 2 percent of GDP, maintained through 2030. Even on that highly optimistic budget prospect, the net international investment position of the United States (its "net foreign debt") would climb steadily from its present 30 percent of GDP to about 70 percent by 2030. This substantially exceeds the generally accepted prudential threshold of 40 to 50 percent, and there is evidence that net foreign debt at such a level could push up US interest rates as the appeal of dollar assets to foreigners is reduced. The current account deficit remains at 4 to 5 percent of GDP, which many analysts would see as beginning to test the limits of sustainability for external financing. Nonetheless, US "debt service" remains positive until 2020 and is minimally negative thereafter despite the growing "net debtor" position because the return on foreign assets held by Americans is so much higher than the return on US assets held by foreigners.

Cline's benign baseline is only slightly more pessimistic than the "current law" baseline calculated by the Congressional Budget Office (CBO). By statute, that calculation assumes no change in tax law, even though partial replacement of the 2001 and 2003 tax cuts when they expire in 2010 is likely, as is some relief from the alternative minimum tax. The current law baseline also assumes no increase in real discretionary spending (and hence a persistent decline of this spending as a percent of GDP).

It has accordingly become CBO practice to include an "alternative sce-

1. The external imbalance, of course, equals the difference between national (public and private) saving and total investment in the economy. An external deficit can be reduced only through some combination of lower investment, higher private saving, and/or higher public saving (a stronger budget position).

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nario" meant to reflect current policy trends. Under that scenario, which was more realistic even before the crisis and is now much more so, the fiscal deficit rises to 10 percent of GDP by 2030. The current account imbalance would then climb to 15 to 25 percent of GDP (figure 2.3 in chapter 2) and net US foreign debt would hit 140 to 175 percent of GDP—far above any levels that could be considered "sustainable." The key transmission mechanism would be a renewed rise of about 20 percent in the trade-weighted value of the dollar, promoted by interest rates about 240 basis points higher (7.4 percent instead of 5 percent) than in the baseline. The recent sharp rise in the budget deficit and strengthening of the dollar due to the crisis, which will increase the external deficit after its present temporary improvement, may have already begun this process. Cline concludes that there would likely be a run on the dollar and "some form of crisis" long before these extreme numbers could eventuate.

On this "fiscal erosion" scenario, Cline shows that the United States would be transferring almost 7 percent of its GDP abroad annually by 2030 to service its huge net international debt position (despite continuing higher returns to US investors). In addition, the inevitable adjustment in the current account position would force Americans at some point to curb domestic demand by at least 13 percent of GDP annually—a huge number perhaps double the maximum hit that is likely from the current crisis, severe as that is likely to be. Although the recent rebound in household saving from zero to about 5 percent of disposable income (or 3.5 percent of GDP) could partially offset the adverse effect of fiscal erosion, a considerable portion of increased personal saving could in turn be offset by a reduction in corporate profits and corporate saving from their unusually high levels in recent years (see chapter 2, figure 2.2).

In chapter 3, Catherine L. Mann analyzes the prospects for external financing of the US current account deficit. She assesses both the ability of the United States to finance its accumulating foreign debt and, more importantly, the willingness of foreigners to buy US assets. She includes both the stock and flow dimensions of the US and foreign positions, for the latter comparing the share of dollar holdings in foreigners' portfolios from both the stock and flow perspectives.

Her analysis, drawing importantly on research at the Federal Reserve Board as well as her own, suggests that a key reason for the dollar's decline of about 25 percent during 2002–08 was that foreign investors would have had to allocate more than 100 percent of the total increase in their international portfolios to US assets to finance the US external deficits of that period without any change in exchange rates and interest rates. It is also true, however, that those same foreign investors remain substantially underweighted in US assets compared with global market capitalization and other indicators of a "normal" international distribution of their holdings.

Mann applies this framework to Cline's alternative projections of future US external financial needs. Working with an earlier version of the

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projections, she concludes that funding for the baseline scenario of modest current account deficits (3 to 4 percent of GDP) should be readily available while the "fiscal erosion" scenario would require foreigners to continually invest 65 to 85 percent of their additional international investments in dollar assets. This would amount to a huge shift from "home bias" to "US asset bias" and starts to "look unreasonable!" Mann emphasizes that it is not so much the average investment required of foreigners but rather the marginal demand on their investable wealth that drives the unsustainability of the US external deficit from the financial standpoint. Moreover, the updated projections in chapter 2, taking account of the now stronger dollar, indicate even more pessimistic trajectories for both scenarios.[2]

Even before the current crisis, the likely evolution of the US external economic position thus appeared highly vulnerable unless the budget deficit could be corrected to much lower levels or private saving could increase by similarly large amounts. The crisis has sharply raised the starting point for the fiscal imbalance and thus, despite the temporary improvement it will generate in the current account deficit, increases the future risks via the international sector. This element of the equation clearly increases the urgency of launching remedial fiscal action as soon as the short-term outlook improves enough to do so.

Implications of the Current Crisis

The current global financial and economic crisis has other important implications for the US external position as well. Many observers believe that the crisis was at least partly caused by the large and persistent international imbalances. The sizable US current account deficits, which exceeded 6 percent of GDP at their peak in 2006, required net capital inflows of identical magnitudes from the rest of the world. These inflows lowered US interest rates, by 50 basis points or more according to various estimates, and permitted monetary policy to remain much easier than otherwise. This in turn facilitated the credit bubble and the excessive leveraging of the financial system, centered on housing but radiating much more widely, that burst in 2007–08 and brought on the crisis.

The external imbalances and related capital inflows did not, of course, *force* the United States to adopt an excessively easy monetary policy and inadequate regulation of its financial markets, and thus to experience a credit bubble. It could have chosen alternative policy courses that would have prevented at least the worst of the financial excesses and thus the

2. In chapter 2, current account deficits through 2030 are in a range of 4 to 5 percent of GDP instead of 3 to 4 percent in the benign baseline. In the fiscal erosion scenario, the current account deficit reaches 7.5 percent of GDP in 2020 and 15.9 percent in 2030, instead of the 6.9 and 14.7 percent levels reached respectively in the earlier projections used in chapter 3.

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severity of the current turmoil. But the ready availability of huge amounts of foreign financing facilitated lending into new (and clearly dangerous) territory and ready opportunities for the increased leveraging that magnified both the buildup of all kinds of debt and the repercussions that are now being felt so widely and so deeply.

There are at least two major paradoxes, however, in the relationship between the international financial position of the United States and the current crisis. One is that the crisis occurred at least partly because the rest of the world was *too* willing to finance US current account deficits rather than becoming unwilling to do so. The classic "hard landing" scenario (Marris 1985) envisaged a "capital strike" (now often called a "sudden stop") through which foreigners stopped lending to the United States and forced a draconian contraction of the US economy. The United States has experienced instead an opposite scenario under which the external investors gave us more than enough rope to hang ourselves.[3]

The second paradox is that, at least as of this writing, the dollar strengthened rather than weakened as the crisis intensified. After declining by a trade-weighted average of about 25 percent from early 2002 through early 2008, the dollar has rebounded by about 13 percent since the spring of 2008. The move against individual key currencies has been even greater—e.g., down over 50 percent against the euro from its trough in late 2000 and then back up by about 20 percent. An increased demand for dollar liquidity and the equally weak (or even weaker) outlook for other major countries pushed up the dollar despite the continuation of large, if reduced, US external deficits and net foreign debt.

Despite these paradoxes, which run counter to most prior analyses of these problems, the unfolding impact of the crisis on the US economy looks similar to the warnings of most international economists concerning the ultimate adjustments that would be forced on the United States if it continued to run large external imbalances (see a series of Institute publications from Mann 1999 through Bergsten 2005 and Cline 2005). Those forecasts envisaged a period, probably lengthy, during which US domestic demand would have to grow more slowly than total output in order to permit the current account deficit to decline to a sustainable level (perhaps 3 percent of GDP) without generating excessive inflationary pressures (e.g., Mussa 2005).

Just such an adjustment began around mid-2006. Since then, real net exports of goods and services (as recorded in the GDP accounts) have strengthened by over $200 billion, and most forecasters believe that at least

3. The impact of such international imbalances is not confined to the United States and its foreign creditors. The equally large imbalances within Euroland suggest that surplus Germany gave deficit Spain enough rope to hang itself via a very similar housing collapse despite a much more solid banking system.

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another $50 billion to $100 billion is in the pipeline.[4] Over the four quarters through the fall of 2008, these gains in fact wholly offset the declines in domestic demand that began in late 2007.

This reverses the pattern of the previous decade, when domestic demand grew considerably faster than output with the result that the current account deficit grew from near zero in the early 1990s to over 6 percent of GDP in 2006. One important cause of the recent reduction of the trade imbalance was of course the substantial (though gradual and orderly) decline of the dollar over the previous six years. But the real adjustment, via the trade balance and the domestic slowdown, turned out to start too late and take too long to prevent the financial effects of the imbalances from helping burst the bubbles and bring on the crash.

The relationships between the crisis and the buildup of US external deficits and debt remain controversial. Some of the traditional linkages that were thought to be among the most risky have not eventuated. On the other hand, a "hard landing" is clearly occurring and the real adjustment costs now being experienced by the US economy are precisely those suggested by most long-standing fears over the unsustainability of the US external accounts.

The foreign dimension of the crisis also needs to be taken into account. Many economies large and small, including such global powers as China and Germany, found it much easier during the 2003–06 upswing to rely on booming exports to the United States and growing trade surpluses than on expanding domestic demand. Just as the United States would inevitably have to curb the growth of domestic demand to reduce its deficits, these countries would inevitably have to expand domestic demand to offset their falling external surpluses. But it remains unclear whether they will be able to do so, and the global slowdown/recession may also turn out to be much greater as a result of this additional legacy of the persistent imbalances.

A central question is thus whether the "dollar crisis" that has been predicted for the US economy for over 20 years has already arrived, albeit under a different label and following different dynamics from the traditional model. Do we believe that the US international position has played a sufficiently important causal role in bringing on the current crisis that we must resolve to avoid such a level of external imbalances in the future? If we do, could the links to the crisis provide sufficient evidence to convince the public that, as part of the wide-ranging postcrisis effort (including new financial regulation) that will undoubtedly ensue to attempt to prevent similar shocks in the future, the United States (and the rest of the world) must adopt policies to that end?

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4. The more familiar current account deficit in nominal dollars, as opposed to real volumes, declined much less in the early part of the period because of the soaring price of oil imports but is now improving much faster as the oil price plummets (as already seen in the monthly trade numbers in late 2008 and early 2009).

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In particular, could such reasoning make a major contribution to the adoption of future strategies to avoid large budget deficits, even perhaps to run modest budget surpluses during boom periods for the economy (as the United States should have continued doing in the early years of this decade), since fiscal policy is one of the few instruments available to government to increase national saving and thus curtail excessive dependence of the United States on foreign capital? Alternatively, or in addition, could these concerns spark a serious effort to discern and implement measures that could significantly increase private saving (once the economy is growing again at a sufficient pace to absorb the corresponding cutback in consumption)? The answers to all these questions will of course turn in part on how the current crisis plays out, particularly in terms of its depth and duration, and on the further understanding of its causes that will undoubtedly emerge over the coming months and years.

Several other important lessons for future policy toward the US external economic position may be derived from the current crisis.[5]

One is whether the US authorities could employ the same crisis response policies as on this occasion if the country entered the next crisis with much larger fiscal and external deficits. The extension of massive federal loans and guarantees for financial (and some nonfinancial) firms, large cuts in interest rates, and substantial fiscal stimulus measures have been possible (at least so far) because the world retains confidence in US government debt and in the financial commitments of the US government and the Federal Reserve. Such actions might not be possible if the United States enters a future crisis with much greater internal and external imbalances, at least without driving up interest rates and risking a disorderly run on the dollar. The room for maneuver in managing the next crisis might be considerably smaller.

This would be particularly true if the Europeans (or anybody else) were to offer a more credible alternative by the time the next big crisis hits. If the euro and European financial paper were widely viewed as more attractive than the dollar or Treasury securities, it would clearly be harder for the US authorities to rescue their own economy and the world's. Europe has not distinguished itself in this crisis, enabling the United States to deploy its policy instruments without serious competition, but that may not remain the case.[6]

Second, the crisis demonstrates that unexpected financial-sector losses can be quite large and hence add to potential long-run demands on the

5. Peterson Institute Senior Fellows Morris Goldstein and Michael Mussa contributed substantially to this section of the chapter.

6. The crisis in fact represents a major stress test for Euroland, to see whether a currency union can survive without a common fiscal policy or regulatory apparatus, but has also greatly enhanced its appeal to nonmembers who want to get inside its perimeter of stability.

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budget. This adds further to the imperative of controlling fiscal policy in the period ahead.

Third, the crisis has stained the reputations of US financial firms and US regulators and indeed of the "American model of capitalism" and of the United States as a whole. Many foreign as well as domestic investors no longer believe that US financial markets are the "gold standard" they previously thought, and broader foreign policy and even national security questions have been raised as well. In chapter 4, Adam S. Posen particularly draws implications for the international role of the dollar and how that in turn may affect America's broader reputation, credibility, and power positions in world affairs, concluding that continued significant deterioration in its external economic position would considerably undermine the global "soft power" of the United States.

However, it is far too early to assess the seriousness of this risk and, as noted above and by Posen, there is little evidence to substantiate it to date. But any movement in that direction would highlight the risks for the United States of trying to finance future external imbalances and could bring even more serious if intangible costs for the United States.

Fourth, other countries will also be drawing lessons from the crisis to guide their future policies. In particular, emerging-market economies (and others that manage their exchange rates) will almost certainly aim to self-insure through even larger accumulations of reserves than we have witnessed in recent years. China's hoard of $2 trillion will now look especially attractive to others who have seen sudden large declines in their reserves as they defended their currencies against sharp falls. For example, some India experts (Subramanian 2009) have suggested that India alone might target a level of $1 trillion (compared with its recent peak of $315 billion, previously regarded by most Indians as far too high) to protect itself in the future. Such a new mercantilist competition would of course include deliberate currency undervaluations, perhaps of substantial magnitudes à la China in recent years, which would (again) promote dollar overvaluation and increase the likelihood that the United States would (again) run large current account deficits with all the corresponding perils discussed here unless it takes strong and explicit countervailing actions.

Conclusion

Whether we view the current crisis as largely or only partially caused by the US external imbalances and their foreign counterparts, and whether we view the "benign baseline" or at least some measure of the "fiscal erosion" scenario as a more accurate projection of the future budget position and thus the current account deficit, it is clear that those imbalances pose serious risks for the United States and indeed for the world economy as a whole. The risks range from moderate to catastrophic but they clearly exist

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under any reasonable expectations and tend toward the more worrisome end of the spectrum on a sober judgment concerning the fiscal outlook.

There is thus a very strong case for initiating, and maintaining, preventive policies that will limit the external imbalances of the United States to a modest (perhaps 3 percent) share of GDP. This could be achieved by running the economy at subpar growth rates on a continuing basis but that is obviously undesirable. Partial relief could come from higher private saving (and a correspondingly weaker exchange rate for the dollar), but there is no firm basis for anticipating either an autonomous and lasting rise of significant magnitude or policy steps that could reliably promote such an outcome. The only prudent alternative is to run a responsible fiscal policy, including at least modest surpluses during periods of above-normal growth. In addition, more effective international rules and multilateral arrangements are needed to prevent prolonged and substantial currency undervaluations by other major trading countries. The United States and the rest of the world clearly need to broaden their responses to the current crisis, and especially their long-term strategic planning, to reduce the probability of the recurrence of even more severe crises in the foreseeable future.

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