
Overview

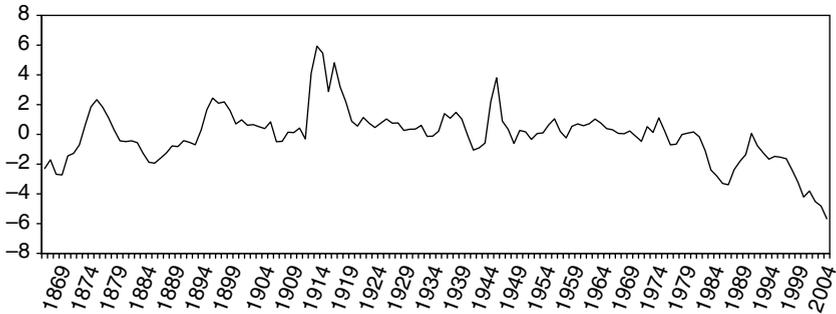
The United States has once again entered into a period of large external imbalances. This time, the current account deficit, at nearly 6 percent of GDP in 2004, is much larger than during the last episode, when the deficit peaked at about 3.4 percent of GDP in 1987.¹ Indeed, the deficit is larger than at any other time in the 135 years for which data are available (figure 0.1). Moreover, the deficit is on track to become substantially larger over the next several years.

Policymakers and economists have been divided as to whether the large external deficit is a problem, and if so, what should be done about it. This study argues that the external imbalance is a serious problem, and that its correction requires both forceful US fiscal adjustment and further depreciation of the dollar. Resolving the problem will also require adjustment measures abroad, most notably exchange rate appreciation in China, East Asia, and to a lesser degree in other regions, as well as increased domestic demand abroad to sustain growth as the stimulus from trade surpluses with the United States grows smaller.

This study seeks to advance the debate by integrating analysis of the growing “stock” of external debt with the “flow” of current account deficits. In the long term, the stock issue determines whether there is a

1. The “current account” is the sum of the balance between exports and imports of goods and services (“trade balance”), net transfer payments, and net capital income. In 2004, the trade balance was -5.3 percent of GDP, the balance on transfers was -0.6 percent of GDP, and the balance on capital income was $+0.25$ percent of GDP (Bureau of Economic Analysis 2005c).

Figure 0.1 US current account balance as percent of GDP, 1869–2004



Sources: Jones and Obstfeld (2001); Bureau of Economic Analysis (2005c).

problem. If the rest of the world were willing to finance the US current account deficit with outright grants-in-aid, then there would be no burden of future repayment, and no economic grounds for concern about the current account deficit (although there might still be political grounds, given potential protectionist pressures from large trade deficits). Instead, the United States incurs real debt obligations when it borrows abroad to finance the current account deficit, and building up this debt imposes a burden on future generations already beset by prospective increases in Social Security and Medicare and Medicaid obligations. Even though the true burden of the debt to date is much less than that implied by the accounting definition of US net foreign liabilities (see chapter 2), the trend implied by the growing current account deficit would mean a large future burden. This is especially the case because the resources coming from abroad are currently financing high levels of consumption and large fiscal deficits rather than high levels of investment.

In the near term, there is also a problem associated with potential crises of confidence. If foreign investors and central banks were to sharply curb their financing of the US current account deficit, there could be a wrenching impact on financial markets and the real economy. Although many (including in the official sector) have downplayed the likelihood of such a “disorderly adjustment” or “hard landing,” the risk of such an outcome is high enough that it cannot be dismissed and should be taken into account in prudent policy formation.

Several factors have contributed to the widening of the current account deficit from a zero balance in 1991. The investment boom associated with the “new economy” in the late 1990s induced large capital inflows, whose counterpart was a large trade deficit. After the stock market bubble burst in 2000 and investment decelerated, the demand for outside resources was replaced by a decline in private saving and a large swing in the fiscal

accounts from surplus to deficit (government dissaving). Higher prices for oil also contributed by 2004 and early 2005, and a slowdown in domestic investment and rising trade surpluses in East Asia and Latin America after the financial crises in 1997–98 also played a role. For US policy purposes, however, this study argues that it would be seriously mistaken to adopt the passive position that the deficit has largely been imposed by circumstances beyond US control, and on this basis rationalize inaction on fiscal adjustment and indifference to needed exchange rate appreciation by important foreign economies not allowing their currencies to adjust.

This study begins by considering a potentially important dimension of US external imbalances: the transformation of the United States' net international investment position (NIIP) from large net-creditor to large net-debtor status. US external assets exceeded liabilities by about 11 percent of GDP in the early 1970s. By the late 1980s, the position was down to about zero. By 2004, the NIIP had reached net liabilities of about 22 percent of GDP.

The United States has had three major episodes of external imbalances and downward pressures on the dollar during recent decades. The first, in the early 1970s, led to the breakdown of the Bretton Woods regime of fixed exchange rates, which proved unsustainable because the rigidity of global pegging of exchange rates to the dollar imposed a straitjacket that prevented the United States from correcting balance of payments problems. The second episode was dollar overvaluation in the early 1980s followed by large deficits and the need for coordinated action to correct the dollar through the Plaza Accord of 1985. The United States is now squarely in a third episode, which so far has been marked by a large rise and then major decline of the dollar against the euro and several other industrial-country currencies, and by the large external deficit. The cumulative effect of these rounds of imbalances has been to reduce the NIIP by about 33 percent of GDP, converting the United States from a creditor to debtor nation by this measure.

This loss of net foreign assets, and the much larger current account deficit during the present episode compared with that of the 1980s, are two major reasons for concern that adjustment of the US external imbalance could prove more difficult this time around. In particular, even though the United States successfully avoided such "hard landings" as severe recession and a sharp decline in the dollar in the last episode of external adjustment, there is no assurance it will be able to do so this time in view of a deficit nearly twice as large and a weaker international asset position.

Chapter 1 approaches the problem from the standpoint of the international debt cycle, and asks whether the large US net debtor position can be understood in terms of theories about natural "stages" of creditor or

debtor status as economies grow. The classical debt cycle theory holds that capital flows from creditor rich countries where credit is abundant to debtor developing countries where it is scarce and its rate of return is higher. The US position is an aberration in this framework, but chapter 1 finds that the United States is not unique. Several other industrial countries, notably Australia and Canada, have been net debtors and have run persistent current account deficits. The analysis finds that these countries have tended to have more rapid growth than the industrial countries fitting the traditional pattern of net creditor with current account surplus. This suggests that for debt cycle purposes, there has been a certain logic to departures from the expected pattern on grounds that some of the industrial countries are more aptly characterized as “developing” for purposes of relative return and directions of capital flows. This justification for US external deficits loses force, however, when large capital inflows are going primarily to finance fiscal deficits and to compensate for low levels of private saving, rather than to finance high investment. That is the case today, in contrast to the late 1990s, when there were large fiscal surpluses, but the private saving rate had not fallen as far as it has by now, and investment was high.

Chapter 2 examines the US NIIP more closely and finds a strong and persistent favorable difference between the rate of return on US direct investment abroad and foreign direct investment in the United States. This difference has meant that net capital earnings have remained positive even as the United States has become a large “net debtor nation” whose liabilities (including direct and portfolio equity capital) substantially exceed assets as measured by the accounting of the NIIP. Another advantageous feature of US external liabilities is that, unlike those of most other nations, they are denominated in the US home currency. This means that when the dollar depreciates, there is a windfall gain instead of a shock to the burden of external debt—the opposite of what happened in East Asia in 1997–98 and Argentina in 2002. The dollar value of liabilities remains unchanged but the dollar values rise for equity assets owned abroad, which are typically denominated in foreign currency. These two features of US external assets and liabilities have helped curb the erosion of the NIIP to a slower pace than would otherwise have been expected from the cumulation of annual current account deficits.

Chapter 2 closes with an examination of the underlying concept of net external liabilities, in terms of long-term debt burden and short-term vulnerability. It suggests a measure of economically meaningful net foreign assets, based on the capitalized value of annual net capital income (CNCI). The discussion argues that the CNCI is a better gauge of long-term debt burden than the conventional accounting measure (NIIP). By the CNCI measure, US net external assets were still positive at the end of 2004 (at about 7 percent of GDP). The expected future trend of CNCI, however, is also strongly adverse.

Chapter 3 develops a simple model for forecasting the US current account deficit and net foreign assets (both economic CNCI and accounting NIIP). The baseline projections through 2010 indicate that the current account deficit would reach approximately 7½ percent of GDP by then in the absence of further exchange rate correction. Net external liabilities would reach about 52 percent of GDP as measured by the conventional NIIP, and about 22 percent even using the CNCI concept. The chapter also reviews other widely reported projections that show even more severe widening of the deficits. Those projections are less favorable because they tend not to incorporate either the dose of adjustment already in the pipeline from the decline of the dollar in 2003–04 or the favorable differential in the rate of return on foreign assets versus liabilities. Their qualitative implications are nonetheless the same as those in this study: the US external deficit is headed toward even larger magnitudes, strongly suggesting it eventually will be unsustainable.

Chapter 3 quantifies impact parameters indicating the extent of current account adjustment that can be expected from given amounts of dollar depreciation, accelerated foreign growth, or diminished domestic growth. Alternative simulations indicate that to reduce the US current account deficit to a more sustainable level of 3 to 3.5 percent of GDP by 2008–10, it will be necessary for foreign currencies to appreciate in real terms by about another 20 percent against the dollar from the level already attained in the January–May 2005 average, even with favorable assumptions about foreign growth. Foreign currencies had already risen in real terms by about 15 percent from the 2002 average to the average for the first five months of 2005 (using the Federal Reserve’s broad real exchange rate index). This key finding indicates that the dollar has a considerable distance to fall further in order to restore a more sustainable current account balance, as also emphasized by Bergsten and Williamson (2004) and Mussa (2005).

Chapter 4 examines the fiscal imbalance that is part of the underlying problem of the US external imbalance. The US federal budget swung from a surplus of 1.5 percent of GDP in 2000 to a deficit of 3.6 percent of GDP in 2004. A decline in fiscal revenue by 4.7 percent of GDP was the driving force in the erosion, and by 2004 the bulk of this decline was attributable to the tax cuts of the first administration of President George W. Bush. The discussion considers the long-term fiscal problems posed by Social Security and, far worse, Medicare and Medicaid. The chapter’s appendix develops a simple general equilibrium model designed to integrate the effects of fiscal adjustment and exchange rate adjustment in correcting the US external imbalance. The central message of the simulations of the model is that further depreciation of the dollar will have to be accompanied by a large fiscal correction if major external adjustment is to be achieved. Otherwise the potential trade effects of a more competitive

dollar will be dissipated by higher inflation and higher interest rates that partially bid the dollar back up, and real resources will not be sufficiently allocated away from government and private consumption toward use for increased exports.

Chapter 5 then examines the risks posed by the external deficit. The analysis first looks at whether foreign holdings of US assets have risen so fast that there is a risk of portfolio satiation, and hence reduced willingness of foreigners to accumulate even more assets by financing ongoing (and widening) deficits. US gross external liabilities rose from about 6 percent of the gross financial assets of the rest of the world (including domestic assets) in the early 1990s to about 14½ percent by 2004, and the baseline projections show this share rising to about 16 percent by 2010. This rapid increase suggests possible limits to future buildups, even allowing for some reduction in “home bias” in portfolios from traditional levels. The chapter gives special attention to the explosion of official foreign reserve holdings of US dollar assets, particularly by the central banks of Japan, China, and several other East Asian economies. Also noted are the signs that central banks want to diversify away from the dollar. In addition, the chapter examines the possibility of a surge in interest rates in the event that further accumulation of dollar reserves by foreign central banks comes to an end.

Chapter 5 also looks at the classic “hard landing” scenario of recession caused by higher interest rates provoked by a cutoff in foreign capital inflows. Although not the most likely outcome in the near term—in part because the Federal Reserve would likely only raise the policy interest rate if the economy were overheating—a hard landing for the economy becomes a more likely possibility as the current account deficit widens.

Traditional benchmarks for “dangerous” levels of the stock of external debt are then considered. Because these levels typically have been identified for developing countries, however, they are found to be inapplicable to the United States. Other statistical studies have shown that the debt difficulties of industrial countries do not show the same relationship to debt-to-GDP ratios as those of developing countries. The denomination of the United States’ external liabilities in its own currency further reduces the relevance of developing-country debt benchmarks to the US economy. Nonetheless, chapter 5 suggests that flow problems—that is, a larger deficit than capital markets are willing to finance—can arise even if the debt stock problem is not acute. The chapter cites the international disagreement on the dollar and interest rates in 1987 that contributed to a run-up in US interest rates and a severe correction in the US stock market.

Chapter 5 closes with a review of the debate among economists over the sustainability of the current account deficit, and of the evolving perceptions of US policymakers toward greater concern about this issue, especially as the fiscal accounts have swung from surplus to deficit.

Chapter 6 examines the implications of US external adjustment for the rest of the world. It reviews what happened in the previous adjustment episode in the late 1980s, and finds that even though the United States avoided the feared hard landing, there were considerable signs of deceleration in foreign growth, especially for developing countries, as the United States curbed its external deficit. So far during the present episode, the dominant influence of the widening US deficit has been to provide a strong source of demand stimulating growth in the rest of the world beyond levels that otherwise would have been attained. The potential negative spillover of higher interest rates spurred by the rising US demand on global capital has not proven to be significant, in part because of the sharp drop in US interest rates reflecting the phasing of the business cycle.

The discussion rejects the argument made by some that developing countries have been forced against their will by an inadequate international financial system to build up excessive and costly reserves. On the contrary, the large accumulations of reserves by such countries and regions as China, Hong Kong, Taiwan, Malaysia, and even India have on balance been a part of the problem of international imbalances rather than a manifestation of damage inflicted by the financial system. Instead of building up excessive reserves, these economies should have been allowing their currencies to appreciate against the dollar, thereby participating in the global adjustment process that is needed to curb US external deficits. The chapter develops a simple model to identify the extent of exchange rate appreciation needed by individual major economies to be consistent with reduction of the US external deficit to a more sustainable level of about 3 percent of GDP. These currency adjustments are related to the size of current account surpluses. It is found that whereas the euro and some other industrial-country currencies had already accomplished most of the needed appreciation by end-2004 (some of which was eroded by the dollar's subsequent rally through mid-2005), the Japanese yen had not done so, and the Chinese renminbi and several other Asian currencies in particular had carried out almost none of the needed real appreciation.

At the same time, the analysis indicates that whereas the real appreciations needed against the dollar remain large, in trade-weighted terms they are much smaller, because a wide array of competing economies would be appreciating against the dollar at the same time and hence not losing competitiveness against each other. The chapter suggests that there is a "prisoners' dilemma" problem that discourages each country individually from being the first to allow its exchange rate to rise against the dollar, so that some form of international coordination may be required to facilitate the adjustments.

Chapter 7 concludes with an enumeration of the principal findings of this study in greater qualitative and quantitative detail than presented in this overview. The chapter then turns to policy implications, paramount

among them the need for a large US fiscal adjustment. The other broad implication is the need for some means to obtain a widespread appreciation of currencies against the dollar, along the lines modeled in chapter 6. The discussion suggests some sort of agreement along the lines of the Plaza Accord or, more aptly, the Smithsonian Agreement of 1971, to coordinate such a realignment of exchange rates. Part of the problem is that today's monetary regime has in meaningful ways regressed to the fixed-rate regime of Bretton Woods. Not only are there the outright pegs of the Chinese renminbi, Hong Kong dollar, and Malaysian ringgit to the US dollar, but, in addition, the "fear of floating" in effect pegs numerous other developing- country currencies to the dollar. The overall effect is partially to recreate a straitjacket for the dollar (albeit this time through numerous bindings by smaller economies) similar to that at the end of the Bretton Woods system.

Although the optimal policy would likely be some form of coordinated appreciation against the dollar, chapter 7 also considers second-best alternatives if numerous countries with surpluses resist appreciation, an issue that so far has primarily been focused on China but applies more broadly. The United States might have a legitimate basis for imposing countervailing duties on imports from countries judged to be subsidizing exports by keeping their currencies artificially undervalued. A determination by the International Monetary Fund that certain countries were "manipulating" their exchange rates by heavy intervention could strengthen such a case. The possibility of such penalties might help prompt countries to allow their exchange rates to rise against the dollar. However, it would only be appropriate to consider such an approach after the United States had first placed its own house in order by adopting a credible plan to eliminate the fiscal deficit over a reasonable period of time. Finally, the chapter suggests that if large capital inflows into the United States continue to keep the dollar overvalued and provoke continued widening in the current account deficit, it could become desirable to impose a withholding tax on foreign earnings on assets held in the United States as a disincentive to these inflows.