News

1750 MASSACHUSETTS AVENUE, NW
WASHINGTON, DC 20036-1903
TEL: (202) 328-9000 FAX: (202) 659-3225
WWW.IIE.COM

INSTITUTE FOR INTERNATIONAL ECONOMICS

September 19, 2005

Contact: William R. Cline (202)-416-0726

US FISCAL ADJUSTMENT AND FURTHER DOLLAR DECLINE REQUIRED TO CURB RISING US EXTERNAL DEBT

Washington, DC—In the absence of US fiscal adjustment and a further correction of the dollar, the current account deficit is headed to $1.2 trillion by 2010 (7½ percent of GDP) and net US foreign liabilities to about $8 trillion (50 percent of GDP). Although the rising trade deficit and associated borrowing from abroad were benign in the late 1990s when the additional foreign resources were going toward more investment, they are now financing a decline in personal saving and rise in the government deficit. The rising imbalance will increasingly put the US economy—and hence the world economy and especially developing countries—at risk.

The dollar needs to decline by as much as another 20 percent, and the fiscal deficit needs to be eliminated, to bring the current account deficit down to a sustainable 3 percent of GDP—which would keep net foreign debt from rising beyond 50 percent of GDP. Asian currencies that have not yet appreciated significantly against the dollar, especially the Chinese renminbi, will need to rise sharply, and central banks should stop intervening to prevent this rise. An "Asian Plaza Agreement" may be needed to coordinate these currency adjustments.

If continued for two decades, the present trajectory would place the US current account deficit at 14 percent of GDP and net foreign debt at 135 percent of GDP by 2024. Some form of major crisis would occur well before then, as foreign investors lose confidence and US protectionist pressures increasingly get out of control. The longer the adjustment is delayed, the greater will be the future cutback

imposed on US households' living standards, and the more damage could be done to the global economy from a wrenching adjustment involving high interest rates and US recession, and perhaps a major outbreak of trade protectionism. For the poorest among the developing countries, especially in Africa, a wrenching global adjustment could more than offset the gains from recent debt relief and pledges for more aid.

These are the central conclusions of *The United States as a Debtor Nation* by William R. Cline, a new study published today by the Institute for International Economics and the Center for Global Development.

The United States has already swung from the world's largest creditor to debtor nation, from net foreign assets of +11 percent of GDP in 1970–75 to –22 percent by 2004 (chapter 1). A surprising number of other industrial countries have also followed such a trajectory, including the United Kingdom and the Netherlands, and industrial countries with falling net assets have tended to have higher growth. So to some extent the rising net debt can be associated with higher US growth.

Moreover, special features of US foreign assets and liabilities have provided favorable offsets to the growing indebtedness (chapter 2). The United States owes external debt denominated in dollars but holds foreign direct investment and portfolio assets in foreign currencies, so when the dollar depreciates there is a windfall gain as assets rise in dollar value but debt remains unchanged. Without this valuation benefit as the dollar fell in 2002–04, US net foreign liabilities would have already reached 30 percent of GDP.

More importantly, rates of return on US direct investment abroad are persistently about 4½ percentage points higher than on foreign direct investment in the United States. This differential has generated a large capital income surplus even though the stock of direct investment is about the same on both sides (at about $3 trillion). As a result, overall capital income has remained in surplus despite large net external liabilities. Cline proposes "capitalized net capital income" (CNCI) as a better measure of the burden of net foreign liabilities, and by this measure the United States was still a small net creditor (+7 percent of GDP) in 2004.

Unfortunately, the special valuation and rate of return advantages are not enough to stem the tide of rising net economic liabilities in the face of a large and rising current account deficit. The United States is on the verge of becoming a net debtor nation even in terms of capitalized net capital income,

and the future path is just as adverse on this measure as on the traditional (accounting) net international investment position (NIIP).

Cline develops two alternative models to project the US current account deficit and net foreign assets (chapter 3). He finds that, after a lag, a decline of the dollar by 10 percent generates an improvement in the current account balance by 1.4 percent of GDP. An extra percentage point of foreign growth for one year, or 1 percentage point lower US foreign growth for one year, or a sustained 1 percentage point lower interest rate, each have a favorable impact of about 0.4 percent of GDP on the current account by the third year. The ideal adjustment would involve a further rise of foreign currencies against the dollar by about 20 percent and modest acceleration of foreign growth, which would cut the 2010 baseline current account deficit by about half.

Cline carefully analyzes the relationship between the fiscal deficit and the current account deficit (chapter 4). Although the two have by no means been "twins," he shows that much of the potential corrective effect of dollar depreciation will be frustrated without a reduction in the fiscal deficit. The current account deficit is the excess of resource use over domestic resource availability, and government "dissaving" acts as a siphon, drawing on foreign resources. Dollar depreciation without fiscal correction will mainly boost interest rates and thereby bid the dollar up again.

Cline challenges recent Federal Reserve analyses that have downplayed the importance of fiscal adjustment to achieving external adjustment. He suggests that, instead of a 20-cent or smaller reduction in the external deficit for each dollar of fiscal adjustment, the proper estimate is probably about 50 cents. If there is an accompanying exogenous decline in the dollar, the relationship can reach 100 cents on the dollar.

Cline recognizes the role of falling private saving in prompting the US external deficit but argues that there is no reliable policy instrument for boosting private saving. He also takes issue with the recent argument that a "global saving glut" resulting from a decline in investment in East Asia and Latin America is the root cause of the US external deficit. He shows that this influence would have been expected to erode the US external balance by only 0.7 percent of GDP instead of by about 4 percent of GDP since 1997. He points to a much simpler explanation: The "smoking gun" of a collapse in the US fiscal balance from a surplus of 2.4 percent of GDP in 2000 to a deficit of 3.6 percent of GDP in 2004. The tax cuts alone caused a structural fiscal erosion of 2.6 percent of GDP.

He examines the evolution of the debate on whether the US current account imbalance is a serious problem, both among policymakers and in the academic literature (chapter 5). After reviewing past near-crises in 1979 and 1987, he suggests that a "hard landing" from a surge in interest rates and resulting recession still remains less than likely but will become more probable as the current account deficit continues to rise.

Cline emphasizes the importance of a smooth adjustment for the rest of the world. He notes that in recent years the rising US external deficit has been a major source of demand for developing countries and emphasizes that they will need to reorient their growth toward domestic sources as the US deficit is adjusted. He cites the weak global performance during the largest previous episode of US external adjustment as underscoring the importance of this point. Growth of non-G7 countries fell from 5.2 percent in 1987 to 2.5 percent in 1991–92 as the United States eliminated a current account deficit of 3.4 percent of GDP. If the United States delays external adjustment until it is forced, the result is likely to be recession and high interest rates, which would damage developing-country exports and boost interest payments on their external debt.

Cline concludes with recommendations to achieve external adjustment with growth (chapter 7). He examines the country profile of currency realignments needed to accomplish an overall foreign real appreciation against the dollar by about 40 percent from the 2002 average, or a further 20 percent from January–May 2005 average, taking account of the current account position of each country. He finds that, whereas the euro has completed most of the "optimal" appreciation above the 2002 base, Japan has carried out far less, and several key Asian economies have completed almost none of the desired exchange rate realignment (including especially China but also Hong Kong, Taiwan, Malaysia, Singapore, and others). He emphasizes that the size of the trade-weighted overall appreciations of foreign currencies would typically be substantially less than their real appreciations against the dollar because these nations' other trading partners would also be appreciating their currencies against the dollar. Even so, the real trade-weighted appreciations would be on the order of 15 to 20 percent or more for a number of key countries.

Cline calls for Asian and other central banks to cease intervening in the exchange markets and accumulating massive amounts of dollar reserves to permit the market to begin to make the needed exchange rate corrections. He also suggests, however, that an Asian Plaza Agreement to coordinate

exchange rate realignments in that region may be necessary given the reluctance of any country in isolation to appreciate sharply and lose competitiveness. Such a coordinated realignment could appropriately accompany a large one-step revaluation of the Chinese renminbi. For the United States to have its own house in order as its contribution in such an international adjustment package, US authorities would need to have in hand a credible program to eliminate the fiscal deficit by 2010. At present, in contrast, the realistic baseline for the fiscal deficit is continuation of the deficit at about 3½ percent of GDP through 2010 and beyond, even without including reconstruction costs from Hurricane Katrina.

Finally, Cline suggests that if market-based and voluntary policy adjustments fail to achieve the needed exchange rate realignments, the United States may find it necessary to pursue countervailing duties against countries refusing to permit their currencies to appreciate, within the framework of WTO provisions that exchange rate practices should not "frustrate" GATT commitments and supported by IMF principles that countries not "manipulate" exchange rates.

About the Author

William R. Cline holds a joint appointment as a senior fellow at the Center for Global Development and the Institute for International Economics. He has been a senior fellow at the Institute since its inception in 1981. During 1996–2001, while on leave from the Institute, he was deputy managing director and chief economist at the Institute of International Finance. He was a senior fellow at the Brookings Institution (1973–81); deputy director of development and trade research, Office of the Assistant Secretary for International Affairs, US Treasury Department (1971–73); Ford Foundation visiting professor in Brazil (1970–71); and lecturer and assistant professor of economics at Princeton University (1967–70). Among his publications are *Trade Policy and Global Poverty (2004), Trade and Income Distribution (1997), International Debt Reexamined (1995), The Economics of Global Warming* (1992), *United States External Adjustment and the World Economy* (1989), and *International Debt: Systemic Risk and Policy Response* (1984).

About the Institute

The Institute for International Economics, whose director is C. Fred Bergsten, is the only major research center in the United States that is devoted to global economic policy issues. Its staff of about 50 focus on macroeconomic topics, international money and finance, trade and related social issues, and internation-

al investment, and cover all key regions—especially Europe, Asia, and Latin America. The Institute averages one or more publications per month; holds one or more meetings, seminars, or conferences almost every week; and is widely tapped over its popular Web site.

About the Center

The Center for Global Development is a nonprofit, nonpartisan institution dedicated to reducing global poverty and inequality through policy-oriented research and active engagement on development issues with the policy community and the public. The Center's Board of Directors includes distinguished leaders of nongovernmental organizations, former officials, business executives, and some of the world's leading scholars of development. The Center's President, Nancy Birdsall, works with the Board, the Advisory Committee, and its own senior staff in setting research and program priorities, and approves all formal publications. The Center is supported by an initial significant financial contribution from Edward W. Scott, Jr., and by funding from philanthropic foundations and other organizations.

The United States as a Debtor Nation
William R. Cline
September 2005 · 336 pp. · $29.95
ISBN paper 0-88132-399-3

Table 2.1 US balance of payments and net international investment position (NIIP), 1991–2004 (billions of dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Sum 1991–2004
Current account	2.9	−50.1	−84.8	−121.6	−113.7	−124.9	−140.9	−214.1	−300.1	−416.0	−389.5	−475.2	−519.7	−668.1	−3,615.6
Percent GDP	0.0	−0.8	−1.3	−1.7	−1.5	−1.6	−1.7	−2.4	−3.2	−4.2	−3.8	−4.5	−4.7	−5.7	
Statistical discrepancy	−44.8	−45.6	4.6	−3.7	28.3	−12.2	−79.4	145.0	68.8	−69.4	−9.6	−23.7	−37.8	85.1	5.6
Subtotal	−41.9	−95.7	−80.2	−125.3	−85.4	−137.1	−220.3	−69.0	−231.3	−485.4	−399.0	−499.0	−557.4	−582.9	−3,610.0
Capital account	−4.5	−0.6	−1.3	−1.7	−0.9	−0.6	−1.0	−0.7	−4.9	−0.9	−1.2	−1.4	−3.2	−1.6	−24.6
Financial account (FA)	46.4	96.3	81.5	127.1	86.3	137.7	221.3	69.7	236.1	486.4	400.2	500.3	560.6	584.6	3,634.6
Outflows	−64.4	−74.4	−200.6	−178.9	−352.3	−413.4	−485.5	−353.8	−504.1	−560.5	−382.6	−294.0	−328.4	−855.5	−5,048.4
Inflows	110.8	170.7	282.0	306.0	438.6	551.1	706.8	423.6	740.2	1,046.9	782.9	794.3	889.0	1,440.1	8,683.0
Subtotal	41.9	95.7	80.2	125.3	85.4	137.1	220.3	69.0	231.3	485.4	399.0	499.0	557.4	582.9	3,610.0
NIIP															
Begin year	−164.5	−260.8	−452.3	−144.3	−135.3	−305.8	−360.0	−822.7	−1,070.8	−1,037.4	−1,581.0	−2,339.4	−2,455.1	−2,372.4	
−FA	−46.4	−96.3	−81.5	−127.1	−86.3	−137.7	−221.3	−69.7	−236.1	−486.4	−400.2	−500.3	−560.6	−584.6	−3,634.6
+Valuation change (VC)	−49.9	−95.2	389.5	136.1	−84.3	83.5	−241.4	−178.3	269.5	−57.2	−358.2	384.7	643.4	414.7	1,256.9
Price	−95.8	−75.6	292.7	23.2	−152.5	84.2	−92.1	−287.9	329.7	133.7	−224.2	−59.6	−1.7	146.5	20.8
Exchange rate	4.6	−75.0	−22.0	73.1	39.0	−66.1	−207.6	68.1	−126.0	−270.6	−151.7	231.3	415.5	272.3	185.0
Other	41.2	55.3	118.8	39.8	29.2	65.4	58.3	41.5	65.8	79.7	17.7	213.0	229.6	−4.1	1,051.1
End year	−260.8	−452.3	−144.3	−135.3	−305.8	−360.0	−822.7	−1,070.8	−1,037.4	−1,581.0	−2,339.4	−2,455.1	−2,372.4	−2,542.2	
Percent GDP	−4.3	−7.1	−2.2	−1.9	−4.1	−4.6	−9.9	−12.2	−11.2	−16.1	−23.1	−23.4	−21.6	−21.7	

Source: BEA (2005b, c, e).

Table 3.2 Baseline projections, KGS model, 2004–10 (in billions of dollars, in percent, and in ratios)

	2004	2005	2006	2007	2008	2009	2010
Exports, GS	1,151.5	1,296.9	1,434.6	1,554.3	1,669.3	1,792.8	1,925.4
Imports, GS	1,769.0	1,938.4	2,052.7	2,200.2	2,376.5	2,567.0	2,772.6
Trade balance	−617.6	−676.5	−653.0	−680.9	−742.2	−809.2	−882.3
Transfers	−80.9	−80.4	−84.7	−89.2	−94.0	−99.0	−104.4
Capital services	36.2	12.6	−58.9	−87.1	−117.7	−152.3	−191.5
Current account	−668.1	−744.3	−796.6	−857.3	−953.9	−1,060.6	−1,178.1
CA/Y	−5.7	−6.0	−6.1	−6.2	−6.6	−7.0	−7.3
Net foreign assets							
Accounting: NIIP	−2,542.3	−3,346.4	−4,122.1	−4,957.5	−5,888.7	−6,925.4	−8,078.7
NIIP/Y (percent)	−21.7	−27.1	−31.6	−36.1	−40.7	−45.4	−50.3
Economic: CNCI	848.6	286.1	−1,070.8	−1,583.9	−2,139.7	−2,769.3	−3,481.0
CNCI/Y (percent)	7.2	2.3	−8.2	−11.5	−14.8	−18.2	−21.7
ERvaladj	272.3	−81.3	0.0	0.0	0.0	0.0	0.0
Real dollars/FC	0.968	1.0	1.0	1.0	1.0	1.0	1.0
Real dollars/FC (-2)	0.869	0.925	0.968	1.0	1.0	1.0	1.0
Bond rate (ppa)	4.3	4.4	5.5	5.5	5.5	5.5	5.5
FDI return difference (ppa)	4.3	4.6	4.6	4.6	4.6	4.6	4.6

CA/Y = current account balance as percent of GDP
CNCI = capitalized net capital income
ERvaladj = exchange rate valuation change
FC = foreign currency
FDI = foreign direct investment
GS = goods and services
KGS = Krugman-Gagnon symmetrical elasticities structure model
NIIP = net international investment position
ppa = percent per annum

Table 6.2 Optimal exchange rate realignments for US external adjustment[a] (percent)

Country	Real appreciation from 2002 average				Remaining real appreciation to reach optimal amount	
	Optimal		Actual to March 2005			
	Versus dollar	Overall[b]	Versus dollar	Overall[b]	Versus dollar	Overall[b]
Argentina	40.7	5.2	23.1	3.2	14.3	1.9
Australia	44.2	2.6	44.6	25.5	−0.3	−18.3
Brazil	39.0	7.2	29.3	11.2	7.5	−3.7
Canada	16.9	4.6	27.5	21.8	−8.4	−14.1
Chile	38.3	3.4	15.3	−1.0	19.9	4.5
China	45.9	8.1	0.7	−10.4	44.8	20.6
Colombia	25.7	3.4	16.8	5.3	7.6	−1.8
Euro area	44.4	7.3	37.5	15.4	5.0	−7.0
Hong Kong	55.9	11.1	−8.8	−16.4	70.9	33.0
India	44.5	4.9	15.6	−1.6	24.9	6.6
Indonesia	49.8	5.8	10.7	−2.6	35.4	8.6
Israel	32.9	2.5	2.7	−12.9	29.5	17.7
Japan	53.3	16.7	10.7	−1.0	38.5	17.9
Korea	45.6	6.4	27.3	15.4	14.4	−7.8
Malaysia	55.7	13.3	−2.3	−12.0	59.4	28.8
Mexico	13.6	2.1	−8.3	−13.0	23.9	17.3
Philippines	47.3	6.3	2.3	−6.8	44.0	14.1
Russia	55.6	14.5	46.1	15.7	6.5	−1.0
Saudi Arabia	60.7	22.2	−5.1	−18.9	69.4	50.6
Singapore	87.5	46.2	4.9	−5.2	78.7	54.2
Sweden	49.9	10.2	35.4	5.8	10.7	4.1
Switzerland	55.7	14.9	27.4	−0.3	22.2	15.2
Taiwan	47.7	7.1	7.3	−2.3	37.7	9.6
Thailand	47.2	5.2	10.8	−0.9	32.8	6.2
United Kingdom	42.2	3.1	28.5	2.0	10.7	1.1
Venezuela	31.0	17.7	−0.6	−7.3	31.7	27.0

a. For weighted average real appreciation against dollar by 39 percent.
b. Trade weighted.