

THE UNSUSTAINABILITY OF THE U.S. TWIN DEFICITS

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Global current account imbalances are increasing rather than decreasing. The U.S. current account deficit was about \$665 billion in 2004 and rose to \$791 billion (around 6.5 percent of GDP) in 2005, and it is likely to grow to more than \$950 billion in 2006 and well above \$1 trillion in 2007. Most other regions of the world—with the exception of Central Europe—are now running a current account surplus. Thus, with the exception of a few countries—Turkey, Australia, New Zealand, Iceland, Spain, Britain, and some Central European countries—most of the world is running a current account surplus and financing the U.S. current account deficits. Moreover, unlike some of these other countries running current account deficits, the United States is also running a large budget deficit that is growing—after a drop in 2005—at rates that are worrisome. Thus, the United States appears to be experiencing a twin fiscal and current account deficit whose medium- to long-term sustainability is doubtful.

The stability of this global current account disequilibrium is widely debated. According to some (Dooley, Folkerts-Landau, and Garber 2004, 2005), we are in a new Bretton Woods 2 (BW2) regime where Asia and most of the emerging world is now actively pegging its currencies to the U.S. dollar and thus following a mercantilist policy of undervalued currencies that lead to export-led growth. The resulting current account surpluses lead to an accumulation of official foreign exchange reserves that imply a cheap financing of the U.S. current account deficit. According to the supporters of the BW2 view, this is a stable disequilibrium that could last for a decade or two. In fact, this BW2 regime and the growing global imbalances are unsustainable and bound to unravel in the next couple of years. The U.S.

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current account deficits—bound to rise above 7–8 percent of GDP in 2006–07—imply an accumulation of foreign liabilities that will lead the U.S. net foreign debt to grow from the 25 percent of GDP level of 2004 to over 50 percent by 2010. Thus, the issue is whether foreign investors—both private and public—will be willing to accumulate U.S. assets at the net rate of \$800 billion to \$1,000 billion a year for the foreseeable future.

Those who believe in the sustainability of such trends point to the strength of the U.S. dollar in 2005 and to the low levels of U.S. long-term interest rates—the so-called bond market conundrum. They also argue that global imbalances are not due to the U.S. fiscal deficits but, rather, to other phenomena such as a global savings glut or foreigners' desire to accumulate U.S. assets (the “capital account surplus” interpretation of the current account deficit in the Council of Economic Advisers 2006 *Economic Report of the President*). However, a careful analysis of the data refutes the complacency of financial markets and the revisionist interpretations of the U.S. external deficit.

Why the Dollar Must Fall

The U.S. dollar did indeed appreciate in 2005 after falling relative to floating currencies in 2002–04, but the factors leading to such a dollar appreciation—in spite of a large and growing current account deficit—were all cyclical. In 2006, the laws of gravity—a growing current account deficit—will dominate the cyclical forces that lifted the dollar in 2005.

Such cyclical forces were several: (1) the increasing differential between short-term interest rates in the United States relative to Europe and Japan as the Fed kept on tightening while the European Central Bank (ECB) and the Bank of Japan (BOJ) remained on hold;¹ (2) the increase in the relative growth differential between the United States, Japan, and the European Union (EU) as the United States kept on growing around potential while Japanese and eurozone growth was sub par; and (3) the effects of the Homeland Investment Act (HIA) that led to the return to the United States of almost \$200 billion of U.S. corporate profits that were kept abroad for tax reasons.

¹According to the uncovered interest parity condition, a U.S. tightening initially strengthens the dollar but over time leads to an expected and actual depreciation of the dollar, because the interest rate differential is a return to compensate for the expected fall of the U.S. dollar. So, unless the United States keeps on tightening, a stable interest rate differential would be bearish for the dollar.

In 2006, instead, the issue will not be whether the dollar will be falling but rather when and how much as the gravitational forces that would weaken the dollar—a large current account deficit—will weigh with even greater force while the antigravitational forces that have lifted the dollar in 2005 will fizzle out over time. Specifically, one can expect the following factors to weaken the dollar in 2006.

First, the short-term interest rate differential will reverse against the U.S. dollar as the Fed will eventually stop its tightening cycle (and possibly reverse it if U.S. growth sharply slows) while the ECB will start its tightening phase and the BOJ will drop its zero interest rate policy.

Second, the growth differential factor will also turn against the U.S. dollar if the U.S. growth rate slows toward 2–2.5 percent (driven down by a shopped-out consumer with negative savings, high oil prices, high debt and debt servicing ratios, and a fizzling housing bubble) while Japanese growth may recover toward potential (2 percent) and even the anemic eurozone growth rate may recover toward a 2 percent potential level.

Third, the dollar boosting effects of the HIA will disappear as this profit-capital returning factor will be phased out by the expiration of this tax incentive.

Fourth, the relative returns in equity markets—that already in 2005 saw the outperformance of European and Japanese equities relative to U.S. equities—may get reinforced if U.S. growth slows while Japanese and eurozone growth recovers.

Fifth, the relative yields on long-term bonds may also become bearish for the dollar as capital losses on U.S. dollar long-term fixed income assets coming from rising U.S. long rates may be—for a while—larger than similar losses on eurozone and Japanese bonds.

Sixth, the attractiveness of U.S. dollar assets may be reduced by a bursting—or even flattening—of the U.S. housing bubble compared with Japan and the eurozone where such an asset bubble did not materialize (apart from specific exceptions such as Spain). The capital gains from such a bubble have sustained, so far, the demand for U.S. dollar assets.

Seventh, the political factors that weakened the euro in 2005—the EU constitutional referenda failures, the EU fight over the budget, the mixed results of the German election, and the French riots—may not be as serious as in 2005, because some of those issues will be tackled by Europe and resolved. Conversely, the U.S. political factors may weaken the dollar because the Bush administration looks like a lame duck even this early in its second term; Iraq is becoming an increasing quagmire; and other serious domestic (Katrina and its

fiscal effects) and international challenges (geostrategic stress points related to terrorism, Iran, Iraq, and North Korea) may fester and worsen.

Finally, China may decide to move its currency by about 5–10 percent in 2006, thus leading not only to a weakening of the dollar relative to the renminbi (RMB) but also to an appreciation of a wide range of Asian currencies (including the Yen) relative to the U.S. dollar. China would move for two reasons: (1) threats of U.S. protectionism as the Chinese trade surplus increases, and (2) the domestic need to cool down the overheated economy. The reduction in the relative demand for U.S. dollar assets deriving from a lower foreign exchange intervention by central banks and stronger Asian currencies will then affect the dollar directly but also indirectly, because the private carry trade Asian demand for U.S. dollar assets is not independent from the currency risk that appreciating Asian currencies will imply.

The Bond Market Conundrum

As for the bond market conundrum, it is also likely that 2006 will be the year when such a conundrum will disappear. According to some, the conundrum is mostly explained by the same factor alleged to be explaining the global imbalances—that is, a global savings glut. But, while there is some evidence of such excess savings in China, among oil exporters, and in parts of the corporate sectors, there is little evidence of a global glut of savings. Thus, the conundrum is more related to other factors that are likely to be cyclical and temporary rather than structural and permanent: the forex intervention policies of foreign central banks; the easy monetary policies of the United States, Europe, and Japan; the global investment drought that has kept global investment rates low relative to GDP; and expectations of a U.S. and global economic slowdown. Indeed, as such cyclical factors appeared to be fading out in the first quarter of 2006, U.S. and global long-term interest rates started to sharply increase, with 10-year U.S. Treasury yields rising for the first time since 2002 above the 5 percent level.

The Real Causes of Global Imbalances

With regard to the causes of global imbalances, the evidence is not consistent with views that argue that such imbalances have to do more with factors external to the United States than internal. The growing U.S. current account imbalances in the 1990s were certainly driven by

an investment boom that outpaced the increase in national savings. The emergence of new information technologies and the Internet led to a productivity boom that was associated with a sharp increase in the national investment rate. National savings increased less than investment as the sharp turnaround in fiscal balances and public savings—from a large deficit in 1992 to a large surplus by 2000—was counterbalanced by a fall in private savings driven by the wealth effects of the 1990s stock market bubble. Thus, one can certainly argue that the growing current account deficits of the 1990s were driven by a productive investment boom.

The bursting of the tech bubble in 2000, however, led to a sharp contraction of investment: between 2000 and 2004 U.S. investment as a share of GDP fell by about 4 percent. That decline would have led, at unchanged national savings, to an improvement of 4 percent of GDP in the U.S. current account. Instead, between 2000 and 2004, the U.S. current account worsened by another 2 percent of GDP. What accounts for such a worsening?

U.S. public savings, that had been as high as 2.5 percent of GDP in 2000, turned into a 3.5 percent of GDP deficit by 2004, a 6 percent of GDP turnaround that explains why the current account worsened in spite of the fall in investment. Thus, while the 1990s deficit was driven by a private investment boom, the growing deficits since 2004 were instead driven by the widening fiscal deficit, the twin deficit phenomenon. It is true that in 2005 the U.S. current account deficit worsened further at a time when the fiscal balance was improving. Indeed, excess savings by China and oil exporters in 2005 and on may have contributed to keep U.S. long-term interest rates lower than otherwise. And that reduction in long rates is the reason why the current account widened further. Such low rates stimulated investment in real estate, induced a continuation of the housing bubble and, via the wealth effects of such a bubble, led to a further increase in private consumption and a reduction in private household savings. Thus, the idea that the overall worsening of the U.S. current account deficit since the early 2000s is due to a global savings glut is not supported by the data.

Similarly, the idea that U.S. current account imbalances are driven by the desire of foreign private investors to accumulate U.S. dollar assets (the capital account surplus hypothesis) is not supported by the data. In the 1990s, foreign direct investment (FDI) and foreign portfolio equity investments in the United States were about \$200 billion a year. So a large fraction of the U.S. current account deficit was being financed with equity rather than debt. However, beginning in 2003, net FDI and portfolio equity investments have turned negative,

to about \$200 billion a year by 2003, and debt flows that finance the U.S. current account are actually larger than the current account deficit. This switch in current account financing from equity to debt is not surprising. In the 1990s, the United States was borrowing from abroad in the form of equity to finance real capital accumulation and investment. In the 2000s, the United States has been increasingly borrowing from abroad in the form of debt to finance the growing U.S. fiscal deficit.

More important, the idea that private investors are fully willing to finance the U.S. current account deficit is also rejected by the data. Since 2003, a large fraction of the U.S. current account deficit has been financed by official—rather than private—investors. About two thirds of the 2004 U.S. current account deficit was financed by foreign central banks, and about half of the \$791 billion current account deficit in 2005 was financed by central banks—even though 2005 was a year when the U.S. economy was growing fast, the Fed was increasing the Fed Funds rate, and the dollar was sharply appreciating. If the U.S. economy were to slow, the Fed stops tightening (while ECB and BoJ increase policy rates), and the dollar weakens, what amount of official intervention would it take to finance a U.S. current account deficit that may be above \$900 billion in 2006? Moreover, if foreign central banks are not willing under such conditions to sharply increase their financing of the U.S. deficit, what will be the effect of such portfolio choices on the value of the U.S. dollar and the level of U.S. long-term interest rates?

Financing the U.S. Fiscal Deficit

The unsustainability of the financing needs of the United States is also clear by considering the U.S. fiscal deficits and their financing. Of the 6 percent deterioration of the U.S. budget balance between 2000 and 2004, 75 percent was due to a fall in government revenues relative to GDP, while only 25 percent was due to an increase in government spending (mostly on defense and homeland security). In 2006, government revenues as a percent of GDP were at their lowest level since 1950. Thus, the structural 3.5 percent of GDP gap between spending and revenues was mostly due to an unsustainable fall in tax revenues. And if the Bush administration's goal of making permanent its 2001 and 2003 tax cuts—income taxes, capital gains taxes, dividend taxes, and estate taxes—was achieved (while repealing the increasingly distortionary alternative minimum tax), the U.S. fiscal deficit would sharply increase for the rest of the decade.

Since 2003, almost 100 percent of the U.S. fiscal deficit has been

financed by nonresidents as U.S. residents have not increased their net holdings of U.S. Treasuries. Official Treasury data show that 53 percent of all outstanding Treasury notes and bonds are held by nonresidents—an all-time high—and a large fraction are also held by foreign monetary authorities. Moreover, there has been a dramatic shortening of the average and marginal maturity of U.S. debt as—in the years when U.S. short rates were low and falling—the U.S. debt management strategy switched to a shortening of the maturity of the public debt. Because of that debt strategy, the gross financing needs of the U.S. Treasury are rapidly approaching \$1 trillion, with a net increase in debt of more than \$400 billion to finance the fiscal deficit and another \$600 billion to roll over the maturing debt whose maturity has sharply shortened.

A Balance of Financial Terror

If the United States had been an emerging market economy running such large current account and fiscal deficits, having an overvalued currency, and financing those deficits with short-term debt, it would have already experienced a currency crisis and a liquidity run against its government debt. However, the United States is not an emerging market economy: it is a solid economy, its currency is the reserve currency of the world, it borrows in its own currency rather than in foreign currencies, and it has no history of defaults. Even so, the experience of advanced economies suggests that disorderly adjustments of excessive current account deficits can occur (2005). Thus, the United States cannot expect to be able to run unsustainable twin deficits forever and hope that the kindness of strangers or a “balance of financial terror” (following the expression used by Larry Summers [2004]) will ensure the smooth financing of such imbalances.

Also, unfortunately, the countries that are now financing the U.S. current account deficit are not the U.S. friends and allies but, potentially, our geopolitical rivals or unfriendly states. In the 1980s, the biggest financer of U.S. twin deficits were the U.S. geostrategic allies: Japan and Europe. Today, in contrast, the biggest financers are China, Russia, and Saudi Arabia. China is potentially the most significant strategic rival of the United States or, at least, a strategic competitor; Russia is a relatively unstable country that is not a U.S. ally and is becoming increasingly authoritarian; while Saudi Arabia is an authoritarian and unstable regime that has been using a small part of its accumulation of petrodollars to finance Islamic fundamentalism around the world. So, for its own financing the United States is

effectively captive to the political decisions of potentially unfriendly states, an indeed worrisome “balance of financial terror.”

The war on terror and the war in Iraq are being financed by China, Russia, Saudi Arabia, and a host of other unfriendly or unstable countries (Nigeria, Venezuela, and Iraq). All those countries and their private and public investors, whether friendly or unfriendly, now increasingly want to buy U.S. equities rather than low-yielding U.S. Treasury bonds. Whether the United States likes it or not, the United States increasingly will have to sell a large fraction of its assets and capital stock to foreigners, whether those foreigners are friendly or unfriendly. And since one can expect, at current trends, U.S. current account deficits of at least \$1 trillion a year from 2007 on, one can forecast that, if an increasing fraction of the new desired inflow of capital into the United States will go into equities rather than debt, an increasing fraction of the entire U.S. capital stock will, in a matter of a decade, be owned by nonresidents. There is nothing wrong with that from the foreigners’ point of view: They will sell their goods and services to the United States and require to be paid not in IOUs but, rather, in real assets—including the gems of the U.S. capital stock. In that respect, the recent backlash against foreign purchases of U.S. assets—as shown in the CNOOC-Unocal case and the Dubai Ports case—is another dangerous development that may jeopardize the badly needed future foreign financing of the U.S. current account deficit.

Risks of a U.S. and Global Economic Slowdown

The growing U.S. twin deficits are occurring in a very delicate moment for the U.S. and the global economy. There are now increasing risks that the United States may experience a significant economic slowdown in the second half of 2006 and in 2007, and that this slowdown will lead to a global economic slowdown. While the consensus view—on Wall Street and at the Fed—still expects that the United States will grow this year at a rate close to its potential growth of 3.5 percent, there are many reasons to expect that such a slowdown will occur. These vulnerabilities include rising oil prices, a bursting of the housing bubble, an increase in inflation, and a tightening in monetary policy beyond what is currently expected in financial markets.

In the spring of 2006, oil prices were surging again and reached a level of more than \$70 a barrel. After reaching a level above \$70 a barrel following the Katrina hurricanes of the summer of 2005, oil prices fell to the low \$60s in the fall and winter of 2005 as the summer peak season of high oil demand passed and as the oil released from

the petroleum strategic reserves of the United States and Europe helped to calm energy markets. But in the spring of 2006 oil and gasoline prices were sharply up again driven by several factors: the political tensions in Nigeria where supplies, production, and exports are impeded by a growing civil war; the rising tension between the United States and Iran on the issue of nuclear proliferation; the very tight supply conditions in the oil market with very limited spare capacity; and the incoming high-energy demand season of spring and summer. Moreover, structural conditions in the oil market remain tight as further supply and capacity increases are constrained by limited investment in unstable oil-producing countries such as Iran, Iraq, Saudi Arabia, Russia, Venezuela, and Nigeria while demand is still growing at a good pace given sustained global economic growth. Thus, even leaving aside the fact that meteorologists now predict another banner hurricane season in the United States this summer, oil prices are likely to stay above \$70 for the rest of the year. With tensions in Iran and Nigeria rising and no near-term resolution of these geopolitical tensions (and some meaningful probability of worsening of such tensions), oil prices can only be headed higher.

The Consequences of High Oil Prices

A crucial economic and policy issue is: if oil prices drift toward \$70 a barrel and stay close to that level for the rest of 2006 (let alone drifting higher), what will be the consequences of such high oil prices for the U.S. and global economy, both in terms of growth and inflation?

Many observers, including myself (Roubini and Setser 2004), predicted in 2004 and later that high oil prices would lead to a U.S. and global economic slowdown. Such a slowdown, however, did not occur for several reasons: the oil and commodity price shock was driven more by higher global demand than by a supply shock; the United States and other advanced economies are less dependent on oil than in the 1970s and 1980s; the recycling of petrodollars—via high oil exporters' current account surpluses and excess savings—kept global long rates lower than otherwise and thereby stimulated consumption and investment demand in oil-importing countries; monetary policy remained very easy in the G7 (in the United States until late 2004; in the eurozone and Japan until very recently) thus helping growth; asset and housing bubbles driven by low short- and long-term interest rates sustained demand and investment in many advanced economies; in China and other countries high oil prices did not lead to higher oil/energy retail prices because of price controls; many oil importing

countries, especially the United States, reacted to the oil shock as if it was only temporary, thus not adjusting consumption and savings to the higher oil price level; and, finally, in the United States in 2002–04 a very loose policy stance with easy money, easier fiscal policy and a weaker dollar stimulated economic activity. On the inflation side, the spike in oil, energy, and commodity prices did not lead to an increase in U.S. and global core inflation rates. Again, the reasons are several: less structural dependence on oil and energy; globalization keeping non-oil import prices low; stable and credible low inflation monetary policies; and sluggish growth of labor costs, in part due to globalization, that kept a lid on overall production costs.

One may also note that the peak in oil prices, above \$70, in the summer of 2005 was very temporary with oil prices falling toward the low \$60s in the fall-winter of 2005. Thus, the potential stagflationary shock of oil at \$70 was dampened by its transitory nature. The relevant issue in 2006 is whether a renewed increase in oil prices to a level close to or above \$70 that is sustained for the rest of 2006 would have a larger effect on global economic growth and global inflation. I believe they would for the following reasons.

First, oil close to \$70 for most of 2006 would imply another 30 percent increase in oil prices relative to the already high 2005 average levels. The stagflationary effects of oil at \$70, and possibly higher if the tensions with Iran rise further, in terms of lower real incomes and higher production costs would be more significant than with oil at \$45 in 2004 or even \$56 average as in 2005.

Second, the factors that sustained U.S. economic growth in 2004–05, in spite of high and rising energy prices, are fizzling away. The Federal Reserve increased the Fed Funds rate from 1 percent to 5 percent and is likely to bring it to above 5 percent; the bond conundrum is also shrinking as long rates are now starting to increase toward the 5 percent level; most signals from the housing market are showing a cooling of the housing bubble as shopped-out and saving-less consumers are now being hammered by higher interest rates on both their adjustable-rate and fixed-rate mortgages; real wages for median and mean households are falling while consumer confidence is depressed for low-income workers, as increasing income inequality is rightly making workers worried about their future prospects in an economy where globalization is increasing and the social safety net is shrinking. Thus, the last thing that a shopped-out consumer with negative savings and increasing debt and debt service ratios needs now is higher oil and energy prices at a time when both the housing bubble and the purchasing power support provided by mortgage equity withdrawals are fizzling out. The U.S. consumer will not survive

unscathed the triple whammy of a housing bubble flattening, oil prices surging, and short- and long-term interest rates rising. One should also notice that, in addition to the direct stagflationary effects of an oil shock and the induced policy response, higher oil prices driven by geopolitical tensions—such as an increased probability of a military confrontation with Iran—could have an independent effect on consumption and investment demand via their likely effects on consumer and business confidence.

Third, one does not need to predict a collapse of consumption to forecast a sharp U.S. growth slowdown: with consumption representing 70 percent of GDP, even a slowdown of consumption from a 4 percent growth to a moderate 2 percent growth would be enough to slow down U.S. economic growth from its potential and actual 3.5 percent growth rate to a rate closer to 2 percent by the end of 2006 and into 2007. Of course, other components of aggregate demand could pick up if private consumption were to slow down, but that result is highly unlikely. Net exports are still deteriorating in the United States and government consumption growth is modest. In the housing slump scenario, housing investment would be falling so only nonresidential investment could help. But in a scenario in which consumption growth is falling, it is unlikely that firms would want to expand their production capacity.

Fourth, Asia and Europe are unlikely to “decouple” from a U.S. economic slowdown. There are three main reasons why such decoupling would be unlikely: (1) a U.S. slowdown would be sharper if it is triggered by both a housing and an oil shock, thus leading to greater trade transmission effects to the rest of the world; (2) an oil shock will negatively hit oil-importing countries regardless of its effects on the United States— and regions such as the eurozone, China, and Japan depend on imported oil much more than does the United States and are thus more vulnerable to an oil shock; and (3) a sustained oil shock would have some inflationary consequences that would force central banks in the United States, Europe, and Japan to tighten monetary policy more than they currently plan to and more than financial markets are currently pricing. Thus, it is hard to believe in a decoupling if the rest of the world is hit by a triple whammy of a U.S. slowdown, stagflationary high oil prices, and tighter monetary policy.

Fifth, the oil shock would have inflationary consequences that would force central banks to tighten monetary policy more than currently priced by the financial markets. And this additional monetary tightening will slow global growth further than otherwise. So far, the oil, energy, and commodity shock of 2004–05 has had effects on headline inflation but not on core inflation. But oil at \$70 for a

protracted period of time would have more meaningful effects on core inflation than in the recent past. This oil shock would have more aspects of a supply shock—as being driven by geopolitical tensions—than the demand increase of the last two years. Growth is recovering in Japan and the eurozone, as it did since 2004 in the United States; thus, the oil shock would hit the advanced economies at a time when labor markets are tighter than in 2004 and output gaps smaller. There is evidence of labor market tightness, wage pressures, and inflation concerns even in China. Until now firms could absorb the previous oil shocks via reductions in their high profit margins and via slack labor markets, but from now on it will be harder for firms to squeeze further profit margins. More likely some pass-through from costs to prices would occur. Finally, the pass-through from headline to core inflation would be greater if oil prices rise above \$70 and persist.

We do not need to assume a sharp and unrealistic increase in headline and core inflation. It is, for example, enough for core inflation to increase from around 2 percent to 2.5 percent for the Fed to be forced to tighten by an extra 50 to 100 basis points, more than currently expected by the markets at unchanged core inflation.² The same holds true for the ECB and the BoJ. While the Fed could react to a U.S. slowdown that is only driven by housing with a halt to its tightening (say stopping at a 5 percent Fed Funds rate), the Fed would be forced—based on a standard Taylor Rule—to hike the Fed Funds rate at least to 5.5 percent and possibly as high as 6 percent if core inflation were to increase toward 2.5 percent. The last thing that the new Fed Chairman Ben Bernanke could afford, in the face of rising core inflation, would be to be labeled as an inflation dove. Similarly, any increase in core inflation in the eurozone and Japan would be met by an increase in the policy rates more than otherwise priced in, as the concerns about increased inflation triggered by such persistent stagflationary shock would dominate any concern about a growth slowdown that such a shock entails.

Given the preceding arguments, one can conclude that a persistent spike in the price of oil above \$70 in 2006 would have stronger effects on growth and inflation—in the United States, other advanced economies, and oil-importing emerging markets—than the oil shocks of 2004–05. What could derail my forecast that an oil shock will meaningfully affect the global economy in 2006? First of all, of course, if oil prices do not surge to a level around \$70 and do not stay around such

²Indeed, the March 2006 data for CPI inflation already showed a worrisome increase in core inflation, growing at the high 0.3 percent rate that month.

a level for the rest of 2006, any U.S. slowdown would depend more on developments in the housing market than developments in the oil market. In that scenario, the rest of the world could partially decouple from a housing-driven U.S. slowdown. Second, a \$70 oil shock that leads oil exporters to further increase their savings and current account surpluses could lead to a further reduction in long-term interest rates that—everything else equal—would benefit aggregate demand in oil-importing countries. But any such effects on long rates are likely to be swamped by the direct inflationary effects of the shock and the monetary tightening by the policy authorities in the G7. Third, a really robust and synchronized global reflation in the G7 countries and emerging market economies—driven by investment demand, trade, and consumption—could sustain global growth in spite of rising oil prices. But, again, it is highly unlikely that the United States and the rest of the world could withstand, with little effect on global growth, the triple whammy of a housing-driven U.S. slowdown, high oil prices, and tighter monetary policy.

In sum, if oil prices rise above \$70 and stay there for the rest of 2006, it is highly likely that the U.S. and global economy could experience a serious growth slowdown and a meaningful increase in core inflation that will have effects on monetary policy. Of course, if the tensions with Iran were to seriously escalate and a military confrontation becomes highly likely, oil could easily spike above \$100 and we would experience a global recession rather than just a global slowdown.

Conclusion

The U.S. twin fiscal and current account deficits are growing at a time when increasing clouds are looming over the U.S. and global economic horizon. Meanwhile, the political willingness to tackle the causes of those imbalances is missing in the United States and the rest of the world. Global imbalances will widen and the risk of a disorderly rebalancing of the U.S. and global economy will increase unless the following steps are taken: (1) the United States must increase its savings by seriously reducing its fiscal deficit; (2) China and the rest of Asia must allow their currencies to appreciate; and (3) Europe and Japan must implement economic reforms that will restore high potential growth.

Because the United States is the main culprit of the upcoming twin fiscal and current account train wrecks, it is up to the United States to start addressing its own fiscal and saving imbalances before it can

legitimately call on other countries to change their policies to share the burden of an orderly rebalancing of the global economy.

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