

THE BERNARD AND IRENE SCHWARTZ SERIES  
ON THE FUTURE OF AMERICAN COMPETITIVENESS

# Getting Serious about the Twin Deficits

Menzie D. Chinn

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COUNCIL ON FOREIGN RELATIONS

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## FOREWORD

Menzie D. Chinn has performed an invaluable service. He examines the fiscal and current account deficits, explains how we arrived at them, challenges the notion that they are sustainable, and puts forward an agenda for remedying the situation. He explains how and why the twin deficits constitute an important foreign policy issue—and how and why the United States must act lest the dollar, a primary element of U.S. economic strength and political influence in the world, be undermined. The result is an educational and practical study that deserves to be read widely and carefully.

This Council Special Report by Professor Chinn is the first in the Bernard and Irene Schwartz Series on the Future of American Competitiveness, and it was produced by the Council's Maurice R. Greenberg Center for Geoeconomic Studies. The Council and the center are grateful to the Bernard and Irene Schwartz Foundation for its support of this important project.

*Richard N. Haass*  
President  
Council on Foreign Relations  
September 2005



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*Menzie D. Chinn*



## INTRODUCTION

*“If something cannot go on forever, it will stop.”*

—Herb Stein, Chair, Council of Economic Advisers, 1972–74

Twenty years ago, the United States was the world’s largest creditor nation, unsurpassed in its ownership of assets outside of its borders, even after deducting what foreigners owned inside its borders. Yet over the past two decades, America has been transformed into the world’s largest debtor nation. At the end of 2004, its debts to the rest of the world exceeded its assets by about \$2.5 trillion—21 percent of its gross domestic product (GDP). This proportion is unmatched by any other major developed economy.<sup>1</sup>

It would be nice to say that the situation has started to improve, but in fact the opposite has happened, and another record has been broken. Since 2000, the value of the net foreign debt accumulated has been unparalleled. The main culprits in this recent surge are the enormous increases in the current account deficit that largely resulted from the return of the government’s budget deficit. The current account balance—the sum of the trade balance and what the United States earns from its assets abroad—was about negative 5.7 percentage points of GDP in 2004. The budget balance—the gap between government tax revenues and total spending—was also negative last year, amounting to 4.7 percentage points of GDP.<sup>2</sup> The simultaneous emergence of the two deficits during the mid-1980s led to the characterization of this phenomenon as the “twin deficits” issue, because both economic theory and empirical observation suggested a link between the two gaps.<sup>3</sup> After becoming estranged during the late 1990s, they have recently reconciled.

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<sup>1</sup> The end-2004 data for the United States are reported by the Bureau of Economic Analysis (BEA), *U.S. Net International Investment Position at Yearend 2004* (June 30, 2005). The ranking of largest creditor nations is based upon the March 2001 version of the Lane and Milesi-Ferretti data set; estimates reported for 2004 for the G7 countries are in Philip Lane and Gian Maria Milesi-Ferretti, “A Global Perspective on External Positions,” paper presented at the National Bureau of Economic Research (NBER) conference, “G-7 Current Account Imbalances: Sustainability and Adjustment” (Newport, RI: June 1–2, 2005).

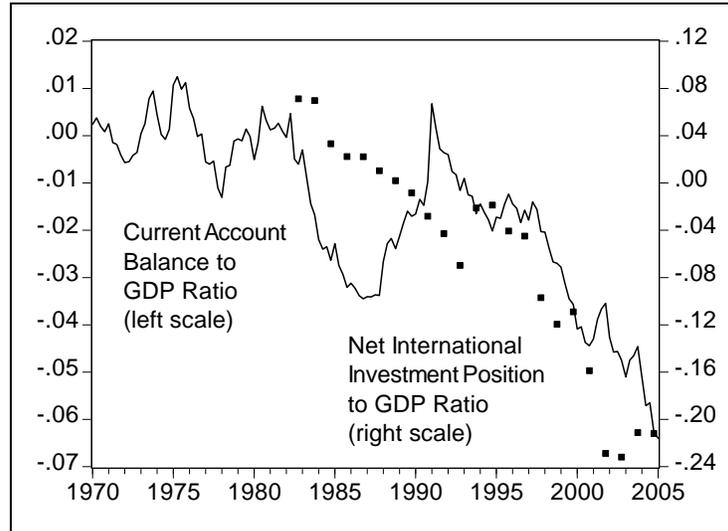
<sup>2</sup> Net borrowing by all levels of government for calendar year 2004, on a National Income and Products Accounts basis.

<sup>3</sup> In describing the deficits as twins, most observers do not assert that they need to move in lockstep; rather, they are related by virtue of causal links that may at times be obscured by other factors.

This essay addresses the challenges posed by the reemergence of this phenomenon and what must be done to address its threat to the American economy.

The first half of the twins, the current account deficit, has soared from just under \$389.5 billion in 2001 to \$665.9 billion in 2004. Historically, other countries have experienced deficits this large (relative to the size of their economy), but the absolute magnitude of the deficit is unprecedented because the United States looms so large in the international economy. Moreover, the first-quarter deficit of 6.4 percent of GDP provides no evidence that the trend in the current account, displayed in Figure 1, is being reversed.

**Figure 1.** The Current Account Balance and the Net International Investment Position (at market prices), Expressed as a Proportion of GDP.



Source: Bureau of Economic Analysis; see <http://www.bea.gov/bea/di/home/bop.htm>; <http://www.bea.gov/bea/di/home/iip.htm>.

How are these trends in the current account deficit and foreign debt linked? A trade deficit results whenever consumption exceeds production. Add to the trade deficit the difference between the income the United States earns on its assets abroad and what it pays on foreign-owned liabilities in the United States and the resulting number is the current account deficit (which is currently about the same size as the trade deficit). The United States must borrow to pay for the current account deficit, and the amount shows up as capital flowing in (see the box on page 4). This borrowing results in the

accumulation of debt or the selling off of assets held in the form of U.S.-owned factories and securities abroad.<sup>4</sup>

Since the United States cannot continue increasing its indebtedness to the rest of the world at this pace—at some point, global investors will tire of holding ever-larger amounts of American debt—the size of the current account deficit is not sustainable and must shrink over time. U.S. policymakers should be concerned about how the current account deficit, and its associated borrowing, is reduced, since theory suggests that the more prolonged the borrowing, the sharper the adjustment of the dollar and the current account.<sup>5</sup> Taking the initiative now to reduce borrowing will give the United States greater control over its economic destiny. Failure to do so will cede to foreign governments increasing influence over the nation’s fate. Perhaps equally alarming, it will lead to slower growth, escalating trade friction, and reduced American influence in political and economic spheres.

Some view the current account deficit as a problem that can be remedied solely by movements downward in the dollar’s value relative to other currencies, which would improve the competitiveness of American goods in world markets. That is why the Chinese government’s announcement on July 21, 2005, of a modest revaluation of its currency, the renminbi, and an end to its rigid link to the dollar attracted such attention. However, this action has proved more symbolic than real, with the change so far amounting to a mere 2 percent or so—far too little to affect the competitiveness of Chinese goods.<sup>6</sup> Even if the Chinese authorities finally allow greater appreciation of their currency, this development will not have sufficient impact on its own to alter the current pattern of external deficits. Hence, the appreciation of the Chinese currency should be considered an adjunct to—not a substitute for—action on the part of U.S. policymakers.

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<sup>4</sup> Technically, capital gains on our assets abroad can weaken the relationship. This effect can be important in periods of large currency fluctuations.

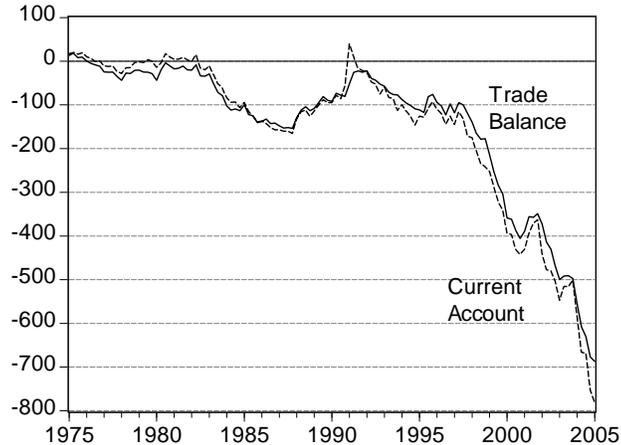
<sup>5</sup> See Olivier Blanchard et al., “The U.S. Current Account and the Dollar,” NBER Working Paper, No. 11137 (February 2005).

<sup>6</sup> Barry Eichengreen, “China’s Exchange Rate Regime: The Long and Short of It,” mimeograph (July 29, 2005).

## Accounts, Flows, and Stocks

The **trade balance** is the difference between exports and imports of goods and services. The **current account** is the trade balance, adding in net factor income and transfers (which includes remittances). These two series are displayed below.

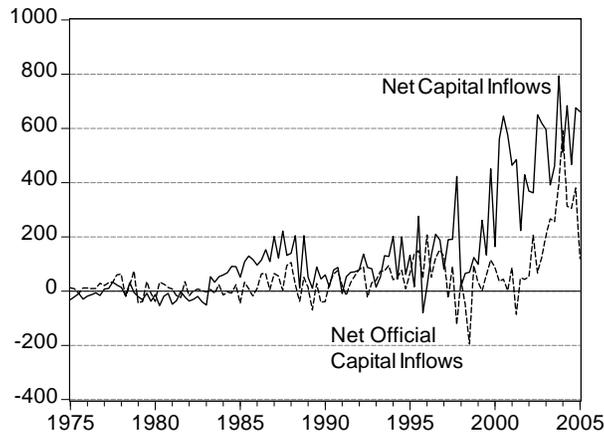
**Figure 2:** Trade and Current Account Balances, in Billions of Dollars, Seasonally Adjusted Annual Rates (SAAR).



Source: Bureau of Economic Analysis; see <http://www.bea.gov/bea/di/home/bop.htm>.

**Net capital inflows** is the difference between capital inflows (borrowing) and capital outflows (lending). Capital flows are composed of private and official flows. Official inflows, for instance, include foreign central bank accumulation of U.S. assets (usually either dollars or U.S. Treasury securities). The current account deficit must equal net capital inflows, up to a (sizable) statistical error, and a difference due to the basis for accounting.

**Figure 3:** Total Net Capital Inflows (private and official) and Net Official Capital Inflows, in Billions of Dollars, Seasonally Adjusted Annual Rates (SAAR).



Source: Bureau of Economic Analysis; see [Hhttp://wwwH.bea.gov/bea/di/home/bop.htm](http://wwwH.bea.gov/bea/di/home/bop.htm).

**Current account balances and capital inflows.** As long as a country runs a current account deficit, it must borrow to cover that deficit, or run down its foreign exchange reserves. Usually this process means that a country becomes ever more indebted to the rest of the world. Large revaluations in assets and liabilities due to exchange rate changes or price changes can affect this relationship.

The actions I propose attack the current account deficit along a number of fronts. Of primary importance, though, is tackling the second half of the twins, namely the government's budget deficit. Specifically, the United States needs to acknowledge the role of fiscal policy in driving the current account deficit wider and return to a policy of fiscal restraint. Reducing the growth rate of government spending and raising tax revenues should be at the top of the country's economic agenda.<sup>7</sup> Successful reduction of the budget deficit will curtail overall spending in the economy and thereby reduce the U.S. role as the world's consumer of first resort. Moreover, since foreigners are currently financing the federal government budget deficit, reducing the government's borrowing needs will lower the country's exposure to the whims of East Asian governments.

Second, the United States needs to reduce its imports of foreign oil. Currently, the value of imported petroleum and oil products equals about one-third of the trade deficit. In the short term, reducing oil imports will reduce the rate at which the United States accumulates external debt. Over the longer term, it will make imports more responsive to changes in the dollar's value and thereby minimize the vulnerability of the economy to changes in the willingness of foreigners to lend to us, as we will see later in this report.

Third, U.S. leaders must remain engaged in East Asia's process of policy formulation. The Chinese revaluation is but the first step in a long process of implementing greater currency flexibility, and it may be the case that the Chinese do not intend to allow further substantial appreciation for at least several months.<sup>8</sup> Indeed, with the Chinese economy slowing, it may prove all too convenient to backtrack on renminbi appreciation.

The American role is central. Currently, no country in the East Asian region has the incentive to move quickly. Each country fears a loss of competitiveness if it allows its currency to appreciate out of line with other regional currencies. In order to maintain the

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<sup>7</sup> The recent surge in tax revenues has led to some premature assertions that the budget deficit is under control. However, a close analysis indicates that about \$50 billion of the improvement was due to the expiration of the tax cut on investment expenditures, as noted in Richard Kogan and Isaac Shapiro, *Revenue Collections in 2005: What Does the Recent Increase in Revenues Signify?* (Washington, DC: Center for Budget and Policy Priorities, July 15, 2005), while another portion was attributable to a one-time tax reduction on repatriated overseas profits.

<sup>8</sup> Mure Dickie, "China Cools Hopes of Rising Renminbi," *Financial Times*, July 23, 2005, p. 8. The day after the revaluation, Xia Bin, the director general of the Financial Research Council of the State Council, indicated no appreciation should necessarily be expected for the remainder of the year.

momentum of adjustment, the United States should encourage a gradual, and synchronized, appreciation of *all* the East Asian currencies. An agreement along the lines of the mid-1980s Plaza Accord might serve as a template. That accord steadied markets as the dollar's decline proceeded. A similar arrangement now could perform that role while at the same time letting Chinese leaders tolerate further appreciation without losing face. In fact, participation in such an accord would allow Chinese leaders to bill their actions as those of a newly responsible global citizen.

Once East Asian currencies have strengthened noticeably, central bank purchases of U.S. Treasury securities will decline, along with the flow of savings to the United States. U.S. interest rates, savings, and investment will move toward long-run rates, reducing pressure on the trade deficit.

The next section describes the path by which the United States arrived at this confluence of a widening current account deficit and increasing indebtedness to the rest of the world. It also explains why, absent some decisive actions, these trends will not self-correct painlessly.

## HOW DID WE GET HERE?

A large portion of the current account deficit is of our own making. First and foremost among domestic factors is the expansionary fiscal policy undertaken over the past four years. In 2000, the federal budget surplus, adjusted to remove business-cycle effects, was nearly 1 percent of GDP. By 2004, it had swung to a *negative* 5 percent; this is a dramatic shift in the fiscal stance of six percentage points.<sup>9</sup> Moreover, while the first term of the Bush administration had inherited projected budget surpluses as far as the eye could see, two rounds of tax cuts, two wars, and an inability to “just say no” to spending (as in the recently passed energy and transportation bills)<sup>10</sup> have replaced those expected surpluses with an endless vista of projected deficits. The recent improvement in tax receipts should not deceive people into thinking that the situation has changed substantially. The Congressional Budget Office (CBO) confirms that in the out years, the deficit will still be expanding as a share of GDP. And even in the short term, the costs associated with the federal government’s recovery effort in the wake of Hurricane Katrina are likely to more than negate this factor.<sup>11</sup>

The resulting deficits affected the current account deficit in an obvious way: Tax cuts and government spending increased private consumption, sucking in additional

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<sup>9</sup> *Economic Outlook*, statistical tables (Paris: Organization for Economic Cooperation and Development [OECD], December 2004). Clearly, the recession of 2001 reduced the revenue outlook for 2001–2003, but it does not enter into the calculation of the current deficit. Some of the deficit is accounted for by the expenditures arising from the events of September 11, 2001, for homeland security, and operations in Afghanistan. On the other hand, one could argue that the expenditures associated with the occupation of Iraq are of a discretionary nature.

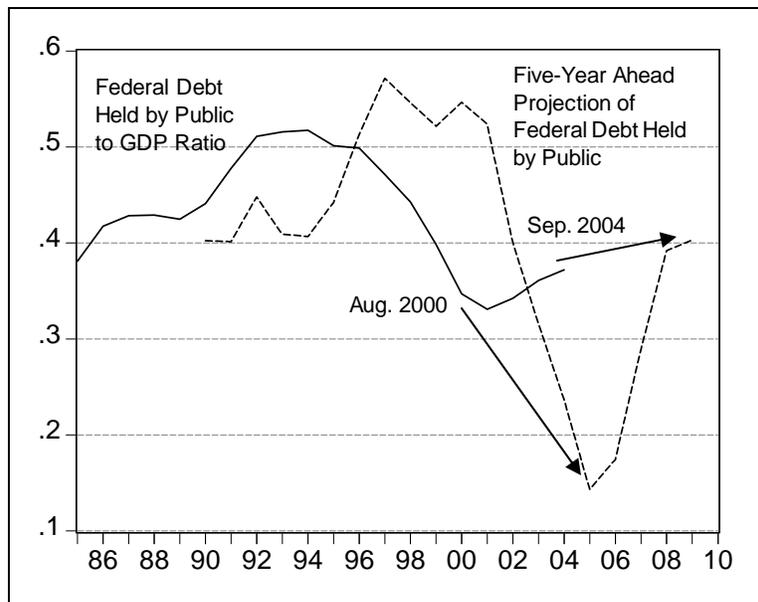
<sup>10</sup> These figures are for fiscal years. While the recession affected the short-term deficit projections in 2001–2003, this factor is no longer relevant to the deficit outlook. Congressional Budget Office graphically depicts the breakdown of the increase in projected deficits from the previous January (*The Budget and Economic Outlook* [Washington, DC: Congressional Budget Office, January 2002]). Only about one-third of the projected deficit in fiscal year 2010 was attributed to technical and economic factors. Fully one-third was accounted for by revenue decreases associated with just the first round of tax cuts. The second round of tax cuts added to that shortfall. For a discussion of the longer-term challenges posed by looming deficits, see Peter G. Peterson, *Running on Empty: How the Democratic and Republican Parties Are Bankrupting Our Future and What Americans Can Do About It* (New York: Farrar, Straus and Giroux, 2004).

<sup>11</sup> In fact, the projected FY2010 total budget deficit *increased* going from the March to August reports. See *The Budget and Economic Outlook: An Update* (Washington, DC: Congressional Budget Office, August 2005), p. xi. Early cost estimates for the recovery efforts range as high as \$200 billion. See John D. McKinnon, David Rogers, and Dionne Searcey, “First Estimates on Katrina Costs for Washington Hit \$200 Billion,” *Wall Street Journal*, September 7, 2005, p. A1.

imports. Government borrowing increased the demand for credit, bidding up interest rates and hence the value of the dollar. This process made U.S. exports relatively less competitive on world markets and made more difficult the position of U.S. industries competing with imported goods.

There is a second way in which fiscal profligacy has affected the current account deficit that has received little discussion, particularly by the administration.<sup>12</sup> When the U.S. government runs a budget deficit, it increases the stock of government debt outstanding. The nonpartisan CBO's five-year-ahead projection of the amount of federal government debt outstanding swung from 15 percent of GDP in 2000 to a September 2004 projection of 40 percent (Figure 4).

**Figure 4:** The Federal Debt Held by the Public, as a Proportion of GDP, Actual and Five-Year-Ahead Projections.



Sources: Thomas Laubach, "New evidence on the interest rate effects of budget deficits and debt," *Finance and Economics Discussion Paper*, No. 2003-12 (Washington, DC: Board of Governors of the Federal Reserve System, March 2003); Congressional Budget Office, *The Budget and Economic Outlook*, various issues.

Someone has to buy this additional debt. In 2004, on net, it was foreigners that took up the slack. In fact, almost the entire 2004 federal deficit of \$369.4 billion was

<sup>12</sup> For one rare—and late in the game—acknowledgment of the deficit's role, see John Snow, "Testimony of the Treasury Secretary John W. Snow before the Senate Committee on Finance" (June 23, 2005).

financed by foreign *central banks*' accumulation of \$355.3 billion of U.S. currency and Treasury securities. In essence, the federal government has been borrowing at very low rates—lower than any other private or government entity—and then providing those resources in the form of a tax cut to households to consume at the government's expense. This is not prudent long-term policy when the government itself faces a set of daunting contingent liabilities on the horizon, from guarantees on pension benefits to Medicare and Social Security.

The conduct of monetary policy over the past four years has contributed to the widening of the trade deficit.<sup>13</sup> While the aggressive easing of interest rates by the Federal Reserve in the wake of the stock market collapse successfully staved off a consumption decline, it also led to a housing market boom that continues to this day. In response to the rise in perceived wealth associated with rising house prices, consumers have kept spending without pause even during the last recession. Since the end of the recession, imports of consumer goods have been rising at over 10 percent per annum, far faster than the 7 percent rate for total non-oil imports and much higher than the approximate 8 percent rate recorded over the previous quarter century.

The Federal Reserve has embarked on a path of raising short-term interest rates since mid-2004. Eventually higher interest rates will cool consumer spending and hence put downward pressure on imports. But until growth of consumption spending slows down, imports will tend to remain high.

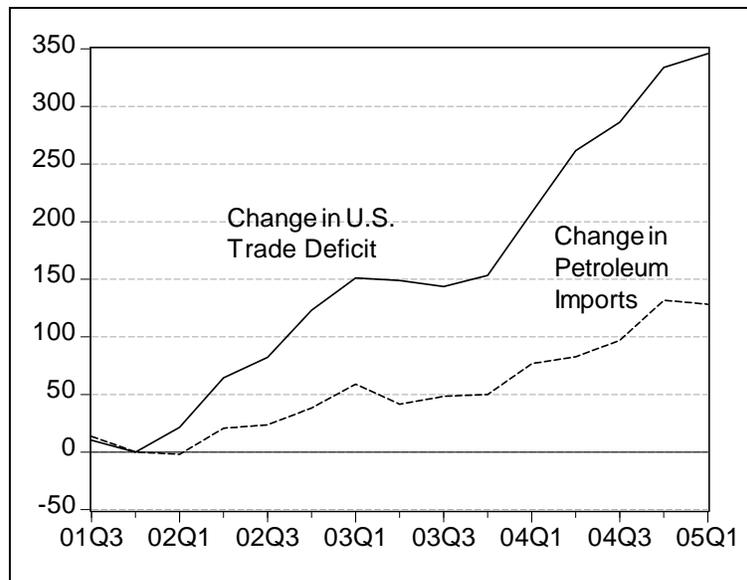
The United States has also become increasingly dependent upon oil imports. When oil prices were low, the United States made little attempt to spur energy conservation. Firms invested in energy-intensive equipment and consumers in gasoline-intensive vehicles. Even now, the tax rate on gasoline is substantially lower in inflation-adjusted terms than it was before the first oil crisis in 1973–74. Now that oil prices have surged to over \$60 a barrel, the hazards of being so energy-dependent are becoming clear.

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<sup>13</sup> In textbook treatments, monetary policy has ambiguous effects on the trade balance. The expansionary effect on income increases imports, while the resulting lower interest rate and hence value of the currency tends to improve the trade balance. In most macroeconomic models, the former effect dominates in the first two years after the interest rate decline. In Edwin M. Truman, "Postponing Global Adjustment: An Analysis of the Pending Adjustment of Global Imbalances," *Working Papers*, No. 5–6 (Washington, DC: Institute for International Economics, July 2005), Truman asserts the latter effect is essentially zero.

Not only is the health of the economy vulnerable to oil price movements,<sup>14</sup> but the current account is becoming increasingly sensitive to such movements as well. Forty percent of the \$350 billion increase in the trade deficit from the end of 2001 until the first quarter of 2005 is accounted for by increases in oil imports, as shown in Figure 5. Currently, the trade balance excluding oil imports is 4.7 percentage points of GDP, compared to the total trade balance figure of 6.4 percentage points. Since predictors of oil prices, such as contracts for petroleum futures, do not indicate a substantial reduction in prices in the near term, and the recently approved energy bill is widely acknowledged to do little to decrease oil dependence, policymakers can expect the energy component of the trade deficit to remain large indefinitely.

**Figure 5:** The Change in the U.S. Trade Deficit and the Change in Petroleum Imports, in Billions of U.S. Dollars, at Seasonally Adjusted Annual Rates (SAAR).



Source: Bureau of Economic Analysis; see <http://www.bea.gov/bea/dn/home/gdp.htm>.

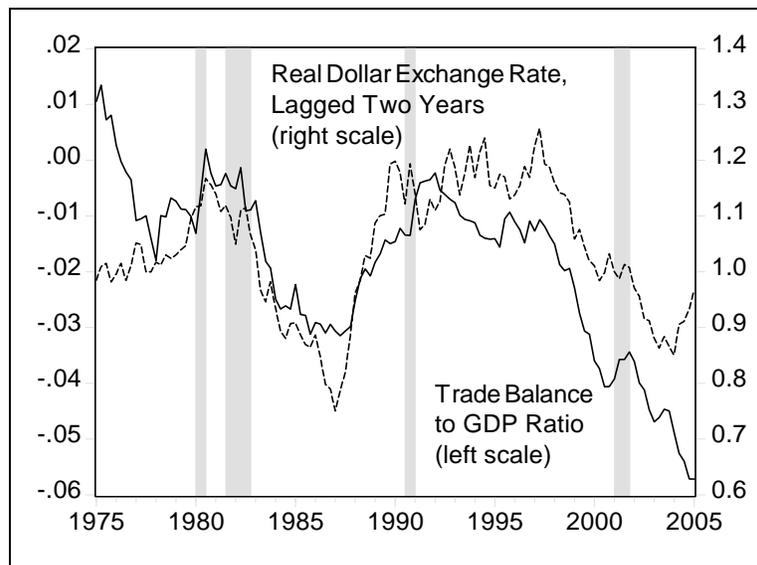
A large oil component of imports has an additional implication: Since oil is priced in dollars, the weakening of the dollar has almost no effect on the dollar value of oil imports. This means a larger exchange rate change is necessary to get a given reduction

<sup>14</sup> See Benjamin Hunt, Peter Isard, and Douglas Laxton, “The Macroeconomic Effects of Higher Oil Prices,” *IMF Working Papers*, WP/01/04 (2001). According to Hunt et al., a persistent 50 percent increase in oil prices reduces U.S. GDP 0.2 and 0.4 percentage points below baseline in the first and second years after the price increase. Core inflation is 0.2 and 0.7 percentage points above baseline in these years.

in imports than would be the case if energy accounted for only a small portion of total imports.

In response to the ballooning current account deficit, the administration has emphasized almost entirely dollar depreciation as a policy approach. Its public pressure on the Chinese government to revalue the renminbi is only the most recent example. The administration has also exhorted governments in Europe and Japan to continue with structural reforms of labor, financial, and product markets, in the hopes that success along these dimensions will lead to an acceleration of growth and hence additional American exports.

**Figure 6:** The Trade Balance to GDP Ratio and the Real Dollar Exchange Rate, Lagged Two Years.



Source: Bureau of Economic Analysis and Federal Reserve Board; see <http://www.bea.gov/bea/dn/home/gdp.htm> and [http://www.federalreserve.gov/releases/H10/Summary/indexbc\\_m.txt](http://www.federalreserve.gov/releases/H10/Summary/indexbc_m.txt).

These policies have not worked to reduce the deficit so far, and they are unlikely to work in the future.<sup>15</sup> The dollar's depreciation since February 2002 will only marginally reduce the trade deficit. Figure 6 illustrates the correlation between the trade deficit

<sup>15</sup> Federal Reserve Board Chairman Alan Greenspan provided his views regarding the current account deficit in a February 4, 2005, speech. He argued that the deficit was set to stabilize as a proportion of GDP, although the prediction was contingent upon fiscal restraint. In any event, stabilization of the current account deficit at over 6 percent of GDP does not mean that the deficit will shrink as a proportion of GDP, or that a sustainable deficit level has been achieved. See Alan Greenspan, "Current Account," Presentation at Advancing Enterprise 2005 Conference (London, England: February 4, 2005).

and the dollar's real exchange rate (the inverse of the dollar's value), lagged two years. While the trade balance does track the dollar's value lagged a couple of years, over the past decade a gap has opened up between the two series.

The gap reflects the fact that economic growth abroad has been fairly lackluster. Even in East Asia, growth rates outside of China have not regained their pre-1997 levels. As a result, American exports have grown commensurately slowly, despite the dollar's decline in value.

The fiscal deficits that the federal government has run since 2001, and the associated current account deficits, have resulted in collateral damage to the economy, and even to administration initiatives. With regard to the economy, the expansionary fiscal policy associated with the tax cuts kept the value of the dollar higher than it otherwise would have been. A stronger dollar means the labor costs of American firms are higher than those of their foreign competitors. Partly as a result, three and a half years after the end of the last recession, U.S. manufacturing employment remains 16 percent below its January 2001 levels. If the dollar's overvaluation had not been so sustained, some of those jobs would not have migrated abroad.<sup>16</sup> Now that the plants have been shuttered, the dollar depreciation that would spur a return of those jobs will have to be commensurately larger than would have been the case had the episode of overvaluation been briefer.

In regard to the implications for the administration's other policy goals, the large trade deficits have sparked bouts of trade protectionism that threaten the completion of the Doha Development Round of trade barrier reductions, something the administration has enthusiastically supported. The Bush administration began succumbing to protectionist pressures in 2001 when it introduced its steel tariffs, but expanding trade deficits, both bilateral (with China) and multilateral, are making it ever harder to resist calls for protection—witness the razor-thin vote on the passage of the Central America Free Trade Agreement (CAFTA). So tax cuts, which expanded the budget deficit, drove up the dollar, and widened the trade deficit, have incited resistance to further trade

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<sup>16</sup> U.S. manufacturing employment has been trending lower for decades. Nonetheless, the 2001 decline is quite sharp and discrete. Note that rapidly increasing manufacturing productivity is partly a consequence of dollar overvaluation, arising partly from exchange rate-induced outsourcing.

liberalization. In other words, two of the administration's major economic initiatives have proven mutually incompatible with each other.

Over the past decade, the U.S. economy has averaged faster growth than most other economies. Its imports have thus grown faster than the rest of the world's imports from the United States. This pattern is unlikely to change soon. The Organization for Economic Cooperation and Development (OECD) forecasts this year's growth in the euro area and Japan at 1.2 percent and 1.5 percent, respectively, compared with 3.6 percent in the United States. While growth is forecast to accelerate in those countries in 2006, the United States is predicted to grow still faster.<sup>17</sup> Over the longer term, America may have a pleasant surprise if global growth booms, and Europe and Japan finally run current account deficits. It doesn't make sense to gamble on this happening, however; such hopes have been dashed before.<sup>18</sup>

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<sup>17</sup> *Economic Outlook* (Paris: OECD, June 2005). This estimate predates the news that growth rates in the euro area and the United States were falling due in part to high oil prices. Since both the euro area and Japan are more dependent upon oil, the negative effect on these economies' growth rates is likely to be larger than the corresponding effect on the United States.

<sup>18</sup> An additional complication is that for each 1 percent increase in U.S. income, total imports rise by 2.2 percent. In contrast, each 1 percent increase in out trading partners' income increases our exports by only about 2 percent. This Houthakker-Magee result, which incorporates the latest data, is fairly robust for total trade flows and means that closing the gap by faster growth abroad will be that much more difficult. See Menzie Chinn, "Incomes, Exchange Rates, and the U.S. Trade Deficit, Once Again," *International Finance* 7 (2004), pp. 451–69, and Hendrik Houthakker and Stephen Magee, "Income and Price Elasticities in World Trade," *Review of Economics and Statistics* 51 (1969), pp. 111–25.

## SO FAR, SO GOOD?

Perhaps surprisingly, some experts say the widening current account deficit is not a reason to worry, or that even if it is, there is not much that U.S. policy can do. The first of these perspectives is rationalized by two arguments—termed here the “Deficits are Good” argument and the “Perpetual Free Lunch” argument—while the second is underpinned by what we will term the “Made-in-China” argument. Unfortunately for their defenders, none of these arguments holds up to critique.

### THE “DEFICITS ARE GOOD” ARGUMENT

There has long been a strand of thinking that considers a trade deficit an unambiguously good thing. The refrain goes as follows: Since the United States is growing more rapidly than its trading partners, the trade deficit widens. That is because faster growth results in bigger increases in consumption, some of which takes the form of imported cars, furniture, and such. According to this view, the current account surpluses in Europe and Japan are the result of lackluster economic growth and consumption.

Proponents of this view dismiss the idea that the United States should take active steps to shrink the current account deficit. In fact, they accuse proponents of that action of wishing to drive the United States into a recession, so that growth rates here will be as slow as those in Germany or Japan. Often, they argue that the deficit will be remedied if the rest of the world follows the U.S. lead in implementing pro-market reforms.<sup>19</sup> The eventual growth bonus arising from such policies will turn current account surplus economies—the euro area, Japan—into deficit economies. Unfortunately for this cheery worldview, the empirical evidence is not supportive; the most recent systematic analysis

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<sup>19</sup> Representative statements include Treasury Secretary Snow’s 2004 speech at the Center for Strategic and International Studies: “This is why I felt it was so important to move ahead with what we are calling the Agenda for Growth initiative, which was launched by the G7 last September. This initiative focuses on supply-side reforms to boost productivity, raise growth and employment, and thereby increase living standards.” See John Snow, “Speech at the Center for Strategic and International Studies” (Washington, DC: February 27, 2004), available at <http://www.treas.gov/press/releases/js1202.htm>.

has found that structural reform, while desirable on many grounds, has little effect on current account balances.<sup>20</sup>

Many deficit fans will state their argument another way: Deficits signal future economic strength; they show that the United States is an attractive place to invest, since the returns are highest here. This argument would be more convincing if GDP growth were being maintained by investment rather than consumption and, more importantly, if lending to the United States took the form of purchases of stock and direct investment. Instead, a large proportion of capital flowing to the United States takes place in the form of purchases of U.S. government securities—not purchases of American stocks or direct investment in its factories, as it did in the years leading up to 2000.<sup>21</sup> The fact that foreign central banks are doing so much of the lending suggests that the profit motive is not behind the ongoing flows to the United States.

#### THE “PERPETUAL FREE LUNCH” ARGUMENT

Other observers<sup>22</sup> have taken comfort from recent research demonstrating that the United States can finance up to 5 percent of U.S. GDP by dollar depreciation. This seemingly strange phenomenon occurs because most U.S. overseas assets are denominated in foreign currencies, and when the dollar loses value, most of America’s assets gain value. This means that the dollar depreciation over the past two years has yielded a large gain to the United States, equal to several hundred billion dollars each year.<sup>23</sup> However,

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<sup>20</sup> See Mike Kennedy and Torsten Sløk, “Structural Policy Reforms and External Imbalances,” *Economics Development Working Papers*, No. 415 (January 2005), for an exhaustive study of the macroeconomic effects of deregulatory experiences.

<sup>21</sup> See Michael R. Pakko, “The U.S. Trade Deficit and the ‘New Economy,’” *Federal Reserve Bank of St. Louis Review* 81, No. 5 (1999), pp. 11–20. Note that the empirical evidence for the theoretical model underpinning this argument is weak. See James M. Nason and John H. Rogers, “The Present-Value Model of the Current Account has Been Rejected: Round up the Usual Suspects,” forthcoming in *Journal of International Economics*.

<sup>22</sup> See, for instance, Richard Cooper, “America’s current account deficit is not only sustainable, it is perfectly logical given the world’s hunger for investment returns and dollar reserves,” *Financial Times*, November 1, 2004, p. 19.

<sup>23</sup> See Cedric Tille, “Financial Integration and the Wealth Effect of Exchange Rate Fluctuations,” mimeograph (New York: Federal Reserve Bank of New York, August 2004), and Pierre-Olivier Gourinchas and H el ene Rey, “From World Banker to World Venture Capitalist: The U.S. External

adherents of this view can gain succor from this finding only as long as either of two conditions hold: (1) unanticipated dollar depreciation continues, or (2) foreign investors remain happy with their present holdings of American assets at current interest rates. Neither is likely to hold true indefinitely.<sup>24</sup>

Under what conditions could our level of debt stabilize? First, we must consider that the change in net foreign debt (expressed as a percent of GDP) is determined by four factors: the trade deficit, the relative rate of interest the United States pays on its liabilities and earns on its assets, the rate of growth of the economy, and the amount of foreign debt (once again, expressed as a percent of GDP). If the United States pays a higher rate of return on foreign-owned assets (say, Treasury bonds) than it earns on its assets overseas (like factories), its liabilities will accumulate more quickly; if real GDP grows rapidly, its liabilities will accumulate more slowly. If the future is roughly like the past in the sense that American-owned foreign assets earn a higher return than foreigners earn on American assets, then a trade deficit of 1.4 percent of GDP is consistent with stabilization of the level of indebtedness.<sup>25</sup>

Compare the numbers: 1.4 percent is considerably smaller than the 5.2 percent recorded for 2004. In addition, there is no guarantee that the historical pattern of low returns on dollar denominated securities will persist. In a 2005 paper, Nouriel Roubini and Brad Setser calculated what would happen to the debt-to-GDP ratio if the trade deficit to GDP ratio were to stabilize at approximately 5 percent—a pretty optimistic case considering the trade deficit has already grown to 6.4 percent in the first quarter of this year. Making a couple of additional assumptions, Roubini and Setser determined that the ratio of debt to GDP would rise to nearly 90 percent by 2015. This means that the United States would need to devote up to nearly 90 percent of its income in that year to pay off its debt to the rest of the world. If, instead, the trade deficit were to continue to rise—

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Adjustment and the Exorbitant Privilege,” paper presented at the NBER conference, “G-7 Current Account Imbalances: Sustainability and Adjustment” (Newport, RI: June 1–2, 2005).

<sup>24</sup> The recent appreciation in the dollar in the first half of 2005, if durable, means that the United States will not benefit from the revaluation effect this year.

<sup>25</sup> Michael Kouparitsas, “Is the U.S. Current Account Sustainable?” *Chicago Fed Letter*, No. 215 (June 2005).

albeit at a slower pace than it has—to around 8.5 percent of GDP, the debt ratio would rise to over 100 percent.<sup>26</sup>

Although the results will vary with the assumptions, most of the trends are driven by the arithmetic of consistently large trade deficits. Assumptions of faster growth at home, or lower real interest rates—perhaps even lower than currently record low rates—would modify the results in the expected direction, but not change the general trend. If the objective were to stabilize the debt-to-GDP ratio at about 55 percent, this would require a reduction of the trade deficit from current levels by about two percentage points of GDP by 2010—a big shift considering where the deficit seems to be heading right now.

#### THE “MADE IN CHINA” ARGUMENT

Another view—rapidly gaining adherents—holds that there is a global “savings glut.” *The Financial Times*’ Martin Wolf, as well as the president’s newly appointed chair of the Council of Economic Advisers, Ben Bernanke, have argued that the large current account surpluses in the rest of the world, particularly in China, but more generally in East Asia and continental Europe, are at the heart of the pattern of global imbalances.<sup>27</sup> These current account surpluses have to be offset somewhere, and that somewhere is in the United States, largely because of the greater attractiveness of American assets. It is a line of reasoning that leads to the inexorable conclusion that the current account deficit

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<sup>26</sup> Nouriel Roubini and Brad Setser, “The Sustainability of the U.S. External Imbalances,” *CEsifo Forum*, 2005/1, pp. 8–15. Roubini and Setser assume the rate of return on assets and liabilities equals the real rate of growth. In fact, most of the plausible variations would make matters worse. Real interest rates are very low relative to historical standards (this is the “interest rate conundrum”). Ten-year inflation indexed bonds are yielding an extraordinarily low 1.6 percent at the end of May. A careful analysis by Warnock and Warnock confirms that rates are low relative to a standard bond yield model, and that the deviation of about 150 basis points in 2004 is associated with record foreign net purchases of U.S. government bonds; see Francis E. Warnock and Veronica Cacdac Warnock, “International Capital Flows and U.S. Interest Rates,” mimeograph (2005). Similarly, Chinn and Frankel conclude that rates are likely to rise in the future, although cyclical developments may delay that event; see Menzie Chinn and Jeffrey Frankel, “The Euro Area and World Interest Rates,” paper presented at Federal Reserve Bank of New York conference, “Financial Globalization” (December 2–3, 2004). A small change in interest rates could result in a reversal of the historical pattern of returns, given the large amount of U.S. Treasuries being held by foreigners.

<sup>27</sup> Martin Wolf, “Global Imbalances Will Require Global Solutions,” *Financial Times*, April 27, 2005, p. 17; Ben Bernanke, “Remarks at the Homer Jones Lecture” (St. Louis, MO: April 14, 2005).

will continue as long as the phenomenon of excess savings in the rest of the world persists.<sup>28</sup> And, in one view, the end could be years away. Michael Dooley, David Folkerts-Landau, and Peter Garber view the U.S. current account deficit as the outcome of concerted mercantilist efforts by East Asian state actors.<sup>29</sup> In this context, the financing of America's trade (and budget) deficit is an explicit quid pro quo for continued access to American markets.

While the savings glut view has some intellectual merit, particularly for the last year or two, there is reason to suspect that much of its newfound popularity stems from how it conveniently absolves U.S. elected officials from taking action. After all, in this worldview, fiscal policy cannot really have an impact on the current account deficit. In support of this proposition, Federal Reserve Board Chairman Alan Greenspan has cited Fed research indicating that one dollar's worth of budget-deficit reduction will only induce a twenty-cent decrease in the trade deficit.<sup>30</sup> Taking this point estimate literally, a reduction in the budget deficit of 5 percentage points of GDP would only result in a 1 percentage point reduction in the trade deficit. However, it is important to realize that there is some disagreement on the true size of the effect. The OECD's macroeconomic model implies something around a forty-cent impact on the current account for each dollar's worth of fiscal consolidation; this larger point estimate is not atypical.<sup>31</sup>

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<sup>28</sup> See also Richard Clarida, "Some Thoughts on Exchange Rate Protectionism," *CATO Journal* 25, No. 1 (Winter 2005) and R. Glenn Hubbard, "A Paradox of Interest," *Wall Street Journal*, June 23, 2005, p. A12.

<sup>29</sup> Michael Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," *NBER Working Paper*, No. 9971 (September 2003). See also Dooley et al., "Direct Investment, Rising Real Wages, and the Absorption of Excess Labor in the Periphery," paper presented at the NBER conference, "G-7 Current Account Imbalances: Sustainability and Adjustment" (Newport, RI: June 1–2, 2005). There are problems with this view. Most notable is the mysterious aspect of timing: East Asian savings began flowing to the United States in 2003. Why not earlier, if the mercantilist impetus had been there all along (and why not devalue the renminbi in 1997)? For a thorough critique, see Eswar Prasad and Shang-Jin Wei, "The Chinese Approach to Capital Inflows: Patterns and Possible Explanations," *IMF Working Paper*, No. 05/79 (April 2005), and for an alternative view of reserve accumulation, see Joshua Aizenman and Jaewoo Lee, "International Reserves: Precautionary versus Mercantilist Views, Theory, and Evidence," *NBER Working Paper*, No. 11366 (May 2005).

<sup>30</sup> See Alan Greenspan, "Current Account," presentation at Advancing Enterprise 2005 Conference (London, England: February 4, 2005). The cited Fed estimate is partly based upon the Federal Reserve Board's microfounded open economy model, Sigma, discussed in Christopher Erceg, Luca Guarrieri, and Christopher Gust, "Explanatory Fiscal Shocks and the Trade Deficit," *International Finance Discussion Paper*, No. 825 (Washington, DC: Board of Governors of the Federal Reserve System, January 2005). The effect of tax reductions arises from the rule-of-thumb consumers imbedded in a model otherwise characterized by Ricardian equivalence.

<sup>31</sup> *Economic Outlook* (Paris: OECD, June 2004). See also Hamid Faruqee, Douglas Laxton, Dirk Muir, and Paolo Pesenti, "Current Accounts and Global Rebalancing in a Multi-Country Simulation Model," paper

Sidestepping the arcane debate over the precise size of this fiscal effect, the argument is strange and, additionally, beside the point. First, over half of the financing of the U.S. current account in 2004 was accounted for by accumulation of dollars and U.S. Treasury securities by foreign central banks. This is not a “savings glut” in the sense of excess *private* savings flowing to the United States.

Second, it does not make sense to think of the East Asians essentially *forcing* the United States to consume beyond its means and borrow from them. The idea that developments in the United States are driven by those in East Asia appears at variance with common sense when the U.S. economy is three times the size of developing and industrializing East Asia and 30 percent larger even after Japan is combined with this grouping.<sup>32</sup> The conventional wisdom is more plausible: there is a savings *scarcity* in the United States, driven largely by the federal budget deficit, and it is this savings drought *in the United States* that has been sucking in excess savings from the rest of the world for most of the past five years.<sup>33</sup>

It is important to note that the lion’s share of this American-made savings drought is on the public sector side, and not the private sector side. In fact, household savings are very low, but corporate sector saving has been extremely high. The private saving rate in 2004 was slightly higher than it was five years before that.<sup>34</sup> This is not to say that it would not be a positive development if the personal saving rate were to rise. However,

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presented at the NBER conference, “G-7 Current Account Imbalances: Sustainability and Adjustment” (Newport, RI: June 1–2, 2005). They find an effect of fifty cents on the dollar.

<sup>32</sup> Calculations based upon data drawn from the International Monetary Fund (IMF) *World Economic Outlook* April 2005 database. The European Union’s current account balance is minus \$6.0 billion, while Developing East Asia’s balance is \$103.3 billion, the Newly Industrializing Countries’ is \$89.6, and Japan’s is \$171.8.

<sup>33</sup> For the 2001–2003 period, ongoing research by myself and Hiro Ito indicates that a standard model underpredicts the U.S. current account deficit by only 0.9 percentage points. The model is based upon conventional determinants, including demographics and the budget deficit, as described in Menzie Chinn and Eswar Prasad, “Medium-Term Determinants of Current Accounts in Industrial and Developing Countries: An Empirical Explanation,” *Journal of International Economics* 59, No. 1 (Winter 2005). Hence, the “savings glut” story might better apply to the period running from 2004 to the present, insofar as capital from the rest of the world has driven down long-term interest rates, thus exacerbating the boom in housing. Elevated wealth in the form of housing has been a large part of the story behind the strong growth in private consumption.

<sup>34</sup> Jan Loeys et al. locate the source of the savings glut in U.S. corporates; see Jan Loeys, David Mackie, Paul Meggyesi, and Nikolaos Panigirtzoglou, *Corporates Are Driving the Global Savings Glut* (London: J.P. Morgan Research, June 24, 2005). The net savings to GDP ratios are obtained from BEA.

since we have not had much luck implementing effective savings enhancing policies, it does not pay to rely upon this channel.<sup>35</sup>

To the extent that savings abroad are to blame for some portion of the U.S. current account deficit, there are many reasons to doubt the durability of continued East Asian lending to the United States. First and foremost, Chinese lending to the United States in the form of purchases of U.S. Treasury securities can continue only as long as the People's Bank of China can prevent the expanding reserve accumulations from spilling over into money creation. Otherwise, inflation will accelerate, eroding Chinese competitiveness or spurring capital flight.

There is also a more pernicious, less intellectually respectable, variant of the "Made-in-China" argument. This argument starts with the rhetorical question of whether it matters why the rest of the world is willing to lend to the United States at such favorable rates. Shouldn't the United States just accept reality and borrow as much as it can at these incredibly low rates?

Such arguments prompt thoughts of offers for credit cards with low—or even no—interest for the first  $n$  months, with an annual percentage rate (APR) in the out months tied to the prime interest rate. Using the logic laid out in the previous paragraph, consumers should sign up for as many credit cards as possible and max out each and every one of them. If they have invested the funds wisely, they will be able to close out the credit cards with ease when the introductory rate has ended. However, if they have used their borrowed dollars to consume more, they will end up in trouble. Similarly, a United States that is borrowing to finance consumption may also end up in trouble.

To the extent that the savings glut argument has held some elements of truth in the past few quarters, we have much to fear from an end to that glut. If East Asian investment, which has been unnaturally low since 1997,<sup>36</sup> rebounds, interest rates will rise at exactly the same time as U.S. national savings is declining (remember the projected widening of federal budget deficits). The collision of expanding demand for credit here and abroad will lead to much higher interest rates in the future.

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<sup>35</sup> See Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives* 10, No. 4 (1996), pp. 113–38.

<sup>36</sup> See IMF, *World Economic Outlook* (Washington, DC: International Monetary Fund, April 2005), pp. 33–36.

## WHY WE SHOULD WORRY

The three arguments for a benign view of the deficit discussed in the preceding section do not stand up to scrutiny. U.S. citizens and foreign governments *do* need to worry about the current account deficit.

The United States faces a wide variety of possible outcomes, with the most dire having a significant likelihood. One real possibility entails the satiation of global investors' appetite for U.S. Treasury securities, combined with an endless vista of government budget deficits. After several years of large losses on dollar assets due to depreciation, they then demand a substantial premium for holding dollar-denominated assets; either the dollar must weaken so as to make Treasury securities cheap, or yields must rise relative to those on other assets.<sup>37</sup>

Let us make this scenario a bit more concrete. The federal debt-to-GDP ratio projected by the CBO in August 2000 for the end of 2005 was 14.3 percent of GDP. In September 2004, the CBO projection for 2009 was about 40.3 percent. Moreover, this projected debt-to-GDP ratio of 40.3 percent by 2009 is still far too optimistic because it assumes implausibly low growth rates of discretionary spending. Figure 7 illustrates various paths for U.S. government debt held by the public, expressed as a proportion of projected GDP.<sup>38</sup> The baseline path, which exhibits a downward trend, is not taken seriously by the market; this projection assumes that no new spending programs are implemented<sup>39</sup> and includes unrealistically slow discretionary expenditure growth. The baseline also assumes the expiration of the 2001 and 2003 tax cuts. A more realistic debt trajectory, notwithstanding the recent temporary surge in tax revenues and a likely

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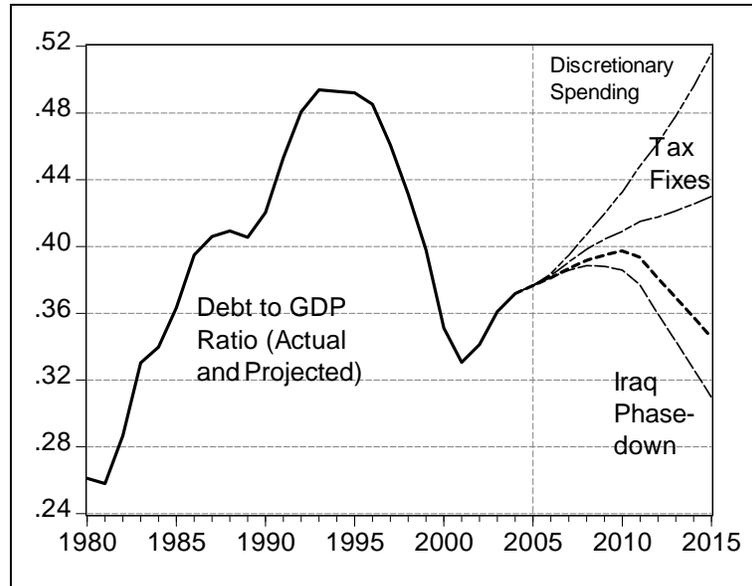
<sup>37</sup> It is not necessary to appeal to thoughts of "flight to quality" or "disruptive adjustments" to conceive of a very negative outcome. "Flight to quality" can characterize the behavior for individual funds, but in the aggregate, *somebody* must hold dollar assets. The *terms* at which these assets will be held are worrying.

<sup>38</sup> These projections are not forecasts. In particular, the GDP numbers do not take into account the repercussions of having differing government debt-to-GDP levels. Consequently, one should think of the division by GDP as a convenient normalization.

<sup>39</sup> Making projections assuming that only existing laws are implemented, even if it is obvious that such laws will be amended, or new programs will be passed, means that the projections incorporate "current law." Expenditures in Iraq and Afghanistan are assumed to grow at the rate of inflation.

reduction in operations Iraq, is one that leads to a government debt-to-GDP ratio of over 50 percent by 2015.<sup>40</sup>

**Figure 7:** Projections of Federal Debt Held by the Public.



Source: Congressional Budget Office and the author's calculations based on CBO data. Dates are fiscal years; see <http://www.cbo.gov/ftpdocs/66xx/doc6609/08-15-OutlookUpdate.pdf>.

None of these projections include the fiscal outlays associated with responding to Hurricane Katrina.

Right now, nonresidents (foreign firms, individuals, and governments) are funding America's budget deficits. In the absence of action, the government's financing needs will increase over time, meaning that more debt will be issued at a faster and faster

<sup>40</sup> The graph contains projections, not forecasts; in particular, figures are normalized by GDP projections that do not incorporate the effects of each of these budget options. In the figure, "CBO projection" is the CBO August 2005 baseline; "Iraq phase-down" is the reduction of operations in Iraq, Afghanistan, and homeland security; "Tax fixes" include reform of Alternative Minimum Tax and extension of the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and the 2003 Job and Growth Tax Relief Reconciliation Act (JGTRRA); and "Discretionary spending" assumes discretionary spending grows at a rate of nominal GDP instead of with the consumer price index. All data and projections from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Washington, DC: Congressional Budget Office, August 2005), Tables 1-2 and 1-6. Including the CBO's interpretation of the president's Social Security proposal would add about 5.5 percentage points of debt to the 2015 debt-to-GDP ratio, according to calculations based on projections from Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2006* (Washington, DC: Congressional Budget Office, March 2005), Appendix B, assuming full participation and debt service estimates incorporating a 4.6 percent interest rate, as assumed in Table 1-8.

pace. Foreigners do not have an infinite appetite for Treasuries, so yields will have to rise.<sup>41</sup>

As more U.S. government debt is dumped into financial markets, either U.S. interest rates will rise relative to foreign interest rates after accounting for expected depreciation, or the dollar will plummet. In their survey, Caroline Freund and Frank Warnock document that the higher the share of bond financing of deficits, the higher interest rates tend to rise in the wake of a current account reduction.<sup>42</sup> Foreign purchases of U.S. bonds now account for the majority of the financing of America's current account deficit.

A dollar depreciation eventually improves the trade deficit, but the short-term effect is an increase in the dollar value of imports and exports. With the volume of imports so very much larger than that of exports, the immediate consequence is to enlarge the dollar value of the trade deficit. Therefore, the United States will need even more financing from abroad at the exact time that financing is expensive.

How will this play out in the broader economy? With interest rates spiking, the housing sector will experience a sharp correction. Since much of the typical American household's wealth is in the form of housing, less wealthy consumers in particular will suddenly be forced to cut back on their spending. The weakening dollar will put upward pressure on import prices, which will then confront the Fed with a choice between accommodating the shock and stifling inflationary pressures. To the extent that the Fed opts for greater price stability, interest rates will have to rise by even more.<sup>43</sup> All of these events will result in a deep recession.

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<sup>41</sup> This factor, called the exchange risk premium, is often not incorporated in recent models (like the one cited by Greenspan), mostly because it is hard to pin down (although Lane and Milesi-Ferretti provide some evidence of such an effect in "A Global Perspective on External Positions"). As we enter a new world of rapidly changing debt shares, assuming away a risk premium is unwise. Thus far, the increase in U.S. government debt has not shown up as an increase in the share of the global long-term debt portfolio. The 2002 share was only 44 percent; see Roger W. Ferguson, "Global Imbalances," presentation at European Institute Roundtable on Financial and Monetary Affairs (Washington, DC: April 23, 2004).

<sup>42</sup> Caroline Freund and Frank Warnock, "Current Account Deficits in Industrial Countries: The Bigger They Are, The Harder They Fall?" Paper presented at the NBER conference, "G-7 Current Account Imbalances: Sustainability and Adjustment" (Newport, RI: June 1-2, 2005).

<sup>43</sup> Pass through of exchange rate changes into import prices has been much lower in the wake of the East Asian crises. However, there is no guarantee that such low pass through will persist: The larger and more persistent the perceived drop in the dollar's value, the larger the likely impact on import prices and the CPI.

Although the likelihood of a “disorderly adjustment” is small,<sup>44</sup> the potential consequences are so troubling that the possibility of economic disruption cannot be ignored. In addition to the threat of rising unemployment and declining income, sharp movements in asset prices and interest rates could also threaten the stability of the financial system. In the past, policymakers have been able to contain the threats of systemic crises, such as the crisis of Long-Term Capital Management in 1998. That event was at least partly attributable to bets on interest rates movements that did not meet expectations. Markets for making bets are much larger and more diverse than they were seven years ago. Some are very new and remain untested. The question is whether they are up to the task of distributing risks when low-probability events occur.<sup>45</sup> This open question should in itself give some additional weight to the case for action now, to avoid putting the world economy in the position of finding out the answer.

Do more benign outcomes support the rationale for continued inaction? Suppose we consider a more likely outcome in which investors merely slow their acquisition of U.S. Treasuries, or state actors such as the People’s Bank of China choose to diversify their reserve currency holdings, away from dollars and toward other currencies. That is, they do not actually “dump” the dollar holdings, but acquire them at a slower pace.

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<sup>44</sup> See one scenario described in Peter Orszag, Robert E. Rubin, and Allen Sinai, “Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial Disarray,” paper presented at the American Economic Association-North American Economics and Finance Association (AEA-NAEFA) Joint Session at Allied Social Science Associations (ASSA) (San Diego, CA: January 5, 2004). One recent analysis concluded that, in contrast to earlier times, since 1985 bond yields have not risen in the wake of currency depreciations. This difference is attributed to enhanced central bank credibility in recent years; see Joseph Gagnon, “Currency Crashes and Bond Yields in Industrial Countries,” *International Finance and Discussion Papers*, No. 837 (August 2005). One difference between the episodes analyzed and the present one is that oil prices are now exerting inflationary pressures. For an examination of economic activity around episodes of current account adjustment, see Guy Debelle and Gabriele Galati, “Current Account Adjustment and Capital Flows,” *Bank for International Settlements (BIS) Working Papers*, No. 169 (Basel: Bank for International Settlements, September 2005), and Hilary Croke, Steven B. Kamin, and Sylvain Leduc, “Financial Market Developments and Economic Activity during Current Account Adjustments in Industrial Economies,” *International Finance Discussion Papers*, No. 827 (Washington, DC: Federal Reserve Board, February 2005).

<sup>45</sup> See Timothy Geithner, “Keynote Address on the Hedge Funds and their Implications for the Financial System,” November 17, 2004, for a discussion of hedge funds. Credit default swaps, a means of transferring the risk of sovereign default, have become increasingly prominent. See Basel Committee on Banking Supervision, *Joint Forum: Credit Risk Transfer*. (Basel: Bank for International Settlements, March 2005). Alan Greenspan presents a more sanguine view of derivatives in “Risk Transfer and Financial Stability,” Presentation at the Federal Reserve Bank of Chicago Forty-First Annual Conference on Bank Structure (May 5, 2005).

In this scenario, the premium necessary to induce investors to hold U.S. Treasuries will rise gradually but inexorably, slowing the economy. Because of the large and increasing budget deficits set in place, expansionary fiscal policy will be off the table. The role of monetary policy will also be circumscribed. Lowering interest rates further would alarm holders of U.S. Treasuries, an alarm that would be well founded given the tremendous incentives the Fed would have to inflate away the government's debt held by foreign residents. So America will be trapped in slow growth, with no viable policy options. In such a state, policymakers may be even more tempted than they are now to impose tariffs and sanctions, increasing further the possibility of trade wars.

Even if there is no sharp, discrete adjustment, the "comfortable path to ruin," as Martin Wolf has characterized America's continued descent into greater and greater debt, threatens an important source of America's influence: the dollar's role as the key global currency. The dollar overtook the British pound as the most important currency after Britain slipped into debtor status. Analyses of more recent experiences indicate that sustained periods of decline in a currency's value lead to an erosion of that currency's status. The greater the decline, the less other central banks tend to hold that currency in their foreign exchange reserves.<sup>46</sup> This threat to the dollar as the world's key reserve currency is one hazard that must be confronted by those who are comfortable with a long-term decline in the dollar's value.

The discussion so far has focused on the direct effects on the U.S. economy. By virtue of its flexible markets and well-developed legal institutions, the United States is well situated to avoid the worst effects of an economic disruption. However, the emerging-market economies are *not* so fortunate. As U.S. interest rates rise or growth slows dramatically, the rest of the world—the Chinas and the Argentinas—will experience the effects. The precedents are not good; the debt crises of 1982 and the financial crises of 1997 were both preceded by run-ups in real interest rates in the United States.<sup>47</sup> To the extent that the United States is now more exposed to events in the rest of

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<sup>46</sup> For a statistical analysis, as well as a discussion of the historical experiences, see Menzie Chinn and Jeffrey Frankel, "Will the Euro Eventually Suppress the Dollar as Leading International Reserve Currency?" Paper presented at the NBER conference, "G-7 Current Account Imbalances: Sustainability and Adjustment" (Newport, RI: June 1–2, 2005).

<sup>47</sup> Emerging markets are very sensitive to interest rate changes in the United States, for instance. See Menzie Chinn, "Macroeconomic Management and Financial Stability: The Implications for East Asia," in

the world—that is, after all, the definition of globalization—we can be sure that America will share in some of the world’s economic distress.

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K. Fukasaku, M. Kawai, and M. Plummer (eds.) *Policy Coherence towards East Asia: Development Challenges for OECD Countries* (Paris: OECD, forthcoming).

## AN AGENDA FOR SUSTAINABLE CURRENT ACCOUNT BALANCES

There is a looming crisis. American leaders of both political parties can and should act to avert that crisis. How much adjustment to American policies is required, and how much is feasible? No informed observer believes that the United States needs to reduce the current account deficit to zero in short course. Rather, it needs a combination of policies to reduce the deficit substantially so that its indebtedness to the rest of the world stops rising at some point. These policies include:

- A concerted effort to reduce the federal budget deficit
- Reducing the quantity of oil imports
- Coordinating a revaluation of East Asian currencies

On the first point, the United States must aggressively attack its budget deficit. In the short term, budget deficits spur spending by consumers, sucking in imports and thereby exacerbating the trade deficit. Over the longer term, persistent budget deficits imply a higher trajectory for the amount of outstanding U.S. government debt. The larger the amount of government debt that is going to be accumulated, the weaker the dollar and the higher interest rates will eventually have to be when the rest of the world finally tires of financing our spendthrift ways.

Stemming the rapid rise of government debt can only be accomplished by two means: reducing expenditures or increasing revenues. On this first count, the Bush administration is to be lauded for its attempts to curtail spending on programs that are widely agreed to be distorting America's economy, including, most prominently, agriculture subsidies. Whether the administration will be successful in these endeavors remains to be seen. The administration's budget proposal assumes slow growth in discretionary expenditures (equal to the rate of inflation). This could happen, but it seems unlikely. In addition, the omission of likely expenditures on military operations in Iraq and Afghanistan from the president's budget means that defense expenditures will substantially exceed budgeted amounts.

Even if the administration and Congress succeed in curtailing spending, the vast size of the budget deficit, and the looming surge in entitlements spending as the baby-

boomers enter their retirement years, makes it incumbent upon policymakers to raise tax revenues. From a purely macroeconomic perspective, it does not matter too much how the taxes are raised. One way this can be accomplished is by allowing the tax reduction bills enacted in 2001 and 2003 to lapse. Contrary to some critics of this proposal, the resulting contractionary impact on economic growth will be minimal. First, the high-income households affected by these taxes tend to change consumption only slightly as their tax rates rise. Second, as demonstrated in a number of experiences with fiscal consolidation, the decrease in government debt resulting from higher tax receipts has a countervailing positive impact on GDP.<sup>48</sup>

To make concrete how much current account adjustment could be accomplished with sufficient fiscal consolidation, consider the experience of the 1990s, when the U.S. budget balance shifted 6 percentage points toward surplus. Such a shift would reduce the trade deficit-to-GDP ratio by just over two percentage points.<sup>49</sup>

The second step is to alter the upward trend in oil imports. According to the Energy Information Administration, imports will rise from 56 percent of total oil consumption to 62.4 percent over the next decade.<sup>50</sup>

Reducing oil imports has two effects on the behavior of the current account. First, it directly decreases the overall size of the current account deficit. Second, over time it increases the effectiveness of exchange rate changes on the value of total imports. While the direct effect is important, the second aspect is perhaps more important. Right now, only a part of total imports of goods and services responds significantly to changes in the exchange rate. This makes reducing imports via dollar depreciation harder. Each 10 percent change in the dollar's value decreases *non-oil* imports about 5 percent, while the

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<sup>48</sup> See Roberto Perotti, "Fiscal Policy When Things are Going Badly," *Quarterly Journal of Economics* 114 (1999), pp. 1399–1436.

<sup>49</sup> *Economic Outlook* (Paris: OECD, June 2004). Faruqee et al., "Current Accounts and Global Rebalancing," report a simulation where the current account improves a half of a percentage point of GDP for each percentage point improvement in the fiscal balance, where government debt is linked to the net foreign debt of a country. In this case, the current account would improve by three percentage points of GDP. Some econometric estimates suggest that the current account would increase by at least this amount, and up to 4.8 percentage points (based on estimates reported in William G. Gale and Peter R. Orszag, "Budget Deficits, National Savings, and Interest Rates," *Brookings Papers on Economic Activity* [2004], pp. 103–87).

<sup>50</sup> These figures are based on the Energy Information Administration's reference case in *Annual Energy Outlook 2005 with Projections to 2025* (Washington, DC: Department of Energy, January 2005). Estimated imports for 2005 are 11.7 million barrels daily (mbd), while projected 2015 imports are 15.4 mbd.

oil component—about a sixth of total import value—does not respond at all since oil is priced in dollars. Shifting the composition of imports toward those goods that respond to exchange rates makes adjustment easier.

Either production-side or demand-side measures can achieve the goal of reducing oil imports. For a variety of technical reasons, the consumption side is more likely to yield larger and quicker results.<sup>51</sup> Unfortunately, past proposals to manage oil demand have foundered upon public and government indifference. Conditions may be more favorable now. For a variety of reasons, groups across the ideological spectrum, ranging from the Committee on the Present Danger and the more centrist Energy Future Coalition to the Sierra Club, have weighed in on the agenda to reduce oil imports.<sup>52</sup>

The final step is to negotiate a *coordinated* process of East Asian currency appreciation. The sooner this is accomplished, the smaller the eventual costs to both the United States and to the economies of the region. Although this point is well recognized, no single country in the region has an incentive to move first. Any country that allows its currency to appreciate substantially will be exposed to the possibility of losing market share. Even the largest economy in the region, China, will be wary of losing export market share just as its economy is cooling off. This concern is surely weighing on the Chinese government's calculation of the rate of renminbi appreciation. And the more the Chinese temporize, the more slowly the other regional monetary authorities will allow their currencies to adjust. So, China's modification of their currency regime

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<sup>51</sup> On the supply side, production is unlikely to rise strongly given the depletion of onshore reserves. In addition, production takes years to put into operation. On efficiency grounds, a gasoline tax would be preferable to higher fuel economy standards; see *The Economic Costs of Fuel Economy: Standards versus a Gasoline Tax* (Washington, DC: Congressional Budget Office, December 2003). In addition, a tax acts immediately, while standards would take longer to have an impact on consumption. A back-of-the-envelope calculation can be useful in defining the potential impact of a gasoline tax. In 2004, the United States imported about \$180 billion worth of petroleum and petroleum-related products, equal to about one-third of the trade deficit. Ignoring interaction effects, a \$1 per gallon tax on gasoline would reduce annual petroleum imports by \$10 to \$25 billion, or about 1.6 percent to 4 percent of the trade deficit. The calculation relies upon estimates of the gasoline demand elasticity of 0.3 percent to 1.0 percent. Specifically, each barrel of oil yields approximately 19.5 gallons, and U.S. consumption was 19.4 billion gallons. Using CBO's preferred elasticity, a twenty-cent tax would save 40.5 million barrels of oil, reducing oil consumption by \$2.03 billion (at 2004 prices). There is also an increment to tax receipts, but it is very small—less than \$20 billion per annum initially.

<sup>52</sup> See George P. Schultz and R. James Woolsey, "Oil and Security," *A Committee on the Present Danger Policy Paper* (2005); *Challenge and Opportunity: Charting a New Energy Future* (Washington, DC: Energy Future Coalition, 2003); and J. Andrew Hoerner and James Barrett, "Smarter, Cleaner, Stronger: Secure Jobs, a Clean Environment, and Less Foreign Oil," *A Special Report for the Blue-Green Alliance* (October 2004), respectively.

notwithstanding, the undervaluation issues that were of importance before remain important now.

An agreement—either explicit or implicit—to increase the values of all the East Asian currencies simultaneously can overcome this problem of coordination. None of the countries would then have as much to fear from revaluing their currencies; in addition, they would relieve the pressure of capital inflows into their economies, which have stressed their monetary and financial systems.

Packaging the revaluation as a regional agreement has the added benefit of transforming this from a U.S.-China conflict to a regional bargain. The United States and the rest of the world benefit from a smooth change in the monetary arrangements in the Pacific Basin region. China is allowed a graceful means of revaluing its currency without being seen as bowing to American pressure.

The focus of this essay has been on the economic consequences of inaction. The longer we wait, the greater the likelihood of a global financial and economic disruption. Even absent a discrete crisis, hewing to the current course raises the chances of stagnant economic growth, if not recession, in the future. But there may well be other ramifications.

A cautionary note regarding America's current path is provided by Britain's loss of military and political primacy in the twentieth century; that development followed a shift from creditor to debtor status.<sup>53</sup> Similarly, a prolonged decline in the dollar's value and increasing indebtedness will erode America's dominance in political and security spheres. These trends threaten the dollar's role as *the* global currency that facilitates international trade and finance, something the United States has gained immeasurably from over the years. A weaker dollar also reduces American leverage in international financial institutions such as the World Bank and International Monetary Fund (IMF). Finally, a diminished U.S. currency means that each dollar's worth of military and development assistance has less impact at precisely the time when the nation faces the greatest challenges. Those threats we ignore at our own peril.

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<sup>53</sup> See Menzie Chinn and Jeffrey Frankel, "Will the Euro Eventually Suppress the Dollar as Leading International Reserve Currency?" Paper presented at the NBER conference, "G-7 Current Account Imbalances: Sustainability and Adjustment" (Newport, RI: June 1–2, 2005).

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## ABOUT THE AUTHOR

**Menzie D. Chinn** is professor of economics and public affairs at the University of Wisconsin's Robert M. La Follette School of Public Affairs and the Department of Economics. In 2000–2001, Professor Chinn served as a senior staff economist for international financial issues on the president's Council of Economic Advisers. He is currently a research fellow of the National Bureau of Economic Research, and has been a visiting scholar at the International Monetary Fund, the Federal Reserve Board, and the Congressional Budget Office.

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