THE CURRENT ACCOUNT DEFICIT
And
THE US ECONOMY

A Hearing Before the
Budget Committee of the
United States Senate

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The Problem

The huge and growing international trade and current account imbalances, centered on the US external deficits and net debtor position, represent the single greatest threat to the continued prosperity and stability of the United States and world economies. They could at any time trigger a large and rapid decline in the exchange rate of the dollar that would initiate sharp increases in US inflation and interest rates, bringing on stagflation at a minimum and quite possibly a deep recession.

Even in the absence of such a crisis, continued failure to address the imbalances constructively will inevitably lead to a costly and perhaps wrenching adjustment of the US and world

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economies. They could also lead to a disruption of US trade policy, threatening the openness of the global trading system.

The only effective US policy response to the problem, as its critical contribution to the needed global solution[1], is a conversion of our present (and especially prospective) budget deficits into modest surpluses à la 1998-2001. The possibility of a sharp dollar fall is in fact the greatest short-term risk now emanating from our budget deficits and provides the most compelling reason for urgent action on them. I am very pleased that the Senate Budget Committee today, and the House Budget Committee last week, are addressing these international dimensions of our fiscal position and urge you to take forceful action to correct both our internal and external deficits before it is too late.

The Current Situation

The US current account deficit reached $850-875 billion in 2006. It has exceeded annual rates of $900 billion in a couple of recent quarters, including the latest for which full data are available (the third quarter of 2006). It now accounts for about 7 percent of GDP, more than double the previous modern record of 3.4 percent in the middle 1980s (as a result of which the dollar dropped by 50 percent against the other major currencies over the three-year period 1985-87).

[1] China is the largest surplus country and also has a crucial role to play in the adjustment process. See my testimony on that topic of January 31, 2007 to the Senate Committee on Banking, Housing, and Urban Affairs.

Our external deficit has risen by an average of $100 billion annually over the past four years. It has climbed by an annual average of $80 billion for the past nine years. The trajectory as well as the level of the imbalances is clearly unsustainable.

There are a few signs that the sharp and steady rise of the US current account deficit may be leveling off. Excluding the impact of much higher prices for oil imports over the past year, the aggregate deficit is largely unchanged. Our trade imbalance with Europe has declined modestly, due to a pickup in European growth and the lagged effects of the substantial decline of the dollar against the euro in 2002-04. Our exports have risen about twice as fast as our imports over the past couple of months for the first time since the late 1980s, after the sharp dollar fall of the previous three years. (That currency adjustment, combined with the recession of 1990-91, virtually eliminated our external deficits in the early 1990s.)

The Risks to the US Economy

Even at their present levels, however, our current account deficits and external debt pose unacceptable risks to the US economy and to US foreign policy. A country that spends more than it earns has to finance its deficit just like an individual who spends more than she or he earns. Hence the United States must attract capital inflows of almost $4 billion from the rest of the world every working day to finance our current account imbalance. In addition, the United States makes large investments around the world that average between $500 billion and $1 trillion per year. These too must be offset by capital inflows so our total international funding requirement is on the order of $8 billion every working day.

As a result of these pervasive deficits, the United States has compiled a net foreign debt that reached $2.7 trillion at the end of 2005 (the latest date for which full data are available). An even more important number is our gross foreign debt of almost $14 billion because this measures the huge stock of dollar assets held around the world, most of which could be converted into other currencies or assets at almost any time.

Our payments to foreigners on our net foreign debt are surprisingly small and have in fact just recently turned negative. This is because US investors, especially direct investors, earn much more on their holdings abroad than foreigners earn on their holdings in the United States. This "net investment income" item will continue to deteriorate steadily in the future, however, adding further to the annual current account deficits and generating a lasting reduction in American incomes as we transfer a rising share of them to the rest of the world.

The major risk that the external deficits and debt pose for the United States, however, stems from the potential sharp reduction, or even elimination or reversal, of the very large net capital inflows that are required to finance them. Such a cutback would immediately lead to a decline, perhaps very large and very rapid, of the exchange rate of the dollar. This would in turn push up the prices of imported goods and services, and of the domestic products that compete with them. Interest rates would rise by at least as much as inflation, and probably by much more as the Federal Reserve tried to check the further inflationary pressures that would result from additional depreciation of the dollar. The equity and housing markets would inevitably fall, perhaps sharply, in response. The economy would slow and perhaps drop into recession.

It is impossible to quantify, with any precision, either the magnitude or timing of these events. We do know, however, that a very substantial correction of the US external deficit, including via a very large decline of the exchange rate of the dollar, is inevitable unless all economic history is repealed. Several reasonably reliable relationships can be invoked to suggest the possible course of events:

- every decline of 10 percent in the trade-weighted average of the dollar tends to increase US inflation by about 1 percentage point, especially if it occurs when the economy is operating near full employment as at present;
- the dollar is currently overvalued by at least 20 percent, and perhaps considerably more, even if the adjustment goal were "simply" to cut the current account deficit in half from its present levels (on the view that a deficit of 3-3½ per cent would eventually level off the rate of net foreign debt to GDP and thus be sustainable);
- hence the inevitable dollar decline, especially if it were to occur precipitously, could double the present inflation rate of 2-3 percent to at least 4-6 percent;
- this would in turn push interest rates up from their current level of about 5 percent to 7-8 percent, and plausibly under some scenarios even into double digits for a period of time, tilting an economy that is already softening considerably in the direction of outright recession.[2]

My own judgment is that the US economy is more likely to experience a soft landing rather than a hard landing from the present imbalances. The fundamentals of the US economy remain strong

[2] Martin Neil Baily, "Persistent Dollar Swings and the US Economy," in C. Fred Bergsten and John Williamson, eds., *Dollar Overvaluation and the World Economy,* Washington, Institute for International Economics, February 2003.

and there is no incentive for capital flight out of the dollar. The economies of Europe and Japan, while recovering to some extent from their recent prolonged stagnations, do not offer sufficiently attractive investment opportunities to prompt huge shifts from the United States. There is very little, if any, risk that foreign central banks or other official entities would sell dollars abruptly for political reasons; doing so would sharply reduce the volume of their (large) remaining dollar holdings and, even more importantly, any such actions would run directly counter to their overriding missions of fostering economic and financial stability in both their own countries and internationally. If the dollar were to start plunging, the G-7 and other relevant countries (e.g., China and some other Asians) would in fact surely agree to joint intervention in the currency markets to buy dollars and hence limit the damage to all their economies.

On the other hand, <u>a number of factors point</u> in the opposite direction and <u>toward the risk of a more brutal correction</u>. As noted, the US deficit is twice as large as its previous record – after which the dollar declined, over three years, by more than 30 percent on average and by more than 50 percent against the other major currencies (DM and yen). The present imbalance has been building up for more than a decade, compared with the five-year runup to the previous peak. The US economy is now at, or very near, full employment so a fall in the dollar would pass through more fully and more quickly into inflation and interest rates. (The substantial dollar decline in 2002-03 did not have such effects because we were just recovering from the recession of 2001 and there was still considerable slack in the economy.) The economy is now softening, probably to growth of less than 3 percent for 2007, so a severe external shock could push it into recession.

Potentially even more important are two key structural factors. First, the United States is piling its present external deficits onto the world's largest debtor position. Our imbalances of the 1980s began when the United States was still the world's largest creditor country and, in some sense, "used up" the net asset position accumulated over the previous half century or more. We have no such cushion today.

Second, the creation of the euro provides a true international financial alternative to the dollar for the first time in a century. The dollar has dominated global finance since the decline of sterling in the early twentieth century largely because it had no real competition. No other currency was based on an economy or capital markets anywhere near the size of those of the United States. The creation of the euro eliminates the dollar's currency monopoly, however, because the economy of Euroland is almost as large as that of the United States while its international trade and monetary reserves are even larger. Indeed, euro bonds have attracted more international investment than dollar bonds for the past two years and global holdings of euro currency now exceed those of the dollar. Hence the euro presents, for the first time in modern history, a true alternative to the dollar for footloose international investment that might previously have moved into dollar assets or that might already be invested in dollars.[3]

It is essential to recognize that the US economy will experience significant adjustment effects when the imbalances correct whether the "landing" is hard or soft. As our current account deficit declines, hopefully by at least 3-4 percent of GDP, a similarly increased proportion of domestic output will be sold to foreigners rather than consumed by Americans. Thus domestic US

[3] See C. Fred Bergsten, "The Euro and the Dollar: Toward a 'Finance G-2'?" in Adam S. Posen, editor, *The Euro at Five: Ready for a Global Role?* Washington, Institute for International Economics, April 2005, especially pp. 30-35.

demand will have to rise more slowly, eventually declining as a share of GDP by 3-4 percent. It would be undesirable to limit private investment as a part of this process since doing so would undermine the long-term growth potential of the economy. Cutbacks in private consumption, which would permit an increase in private saving, would help but cannot be counted on since there are no policy tools that are reliably effective in promoting such a shift.

The Policy Implications

Hence the central policy response to the unsustainable international economic position of the United States must be conversion of the budget position of the Federal government, over the next few years, from today's deficits of 2-3 percent of GDP to modest surpluses à la 1998-2001. Such a shift would both reduce domestic demand by the needed 3-4 percent of GDP and cut our requirement for foreign financing by a like amount.

Renewed growth of the budget deficit, by contrast, could trigger a hard landing. Under present circumstances, larger budget deficits would almost certainly lead to larger external deficits (as they did in the 1980s). Even more importantly, the implied lack of financial discipline in the United States might be the proverbial "straw that broke the camel's back" of confidence in the dollar and prompted foreign investors (and perhaps many Americans too) to move into other currencies.

Fiscal consolidation has been forced on the United States by external events on at least three occasions in the postwar period. In the late 1960s, the escalating gold and sterling crises finally

convinced Congress to pass President Lyndon Johnson's import tax surcharge to help finance the Vietnam War. In the late 1970s, the Carter Administration and the Congress had to tighten budget policy sharply when we experienced the hardest landing to date of the dollar and the US economy – to double digit inflation for three years, interest rates that rose about 20 percent and the deepest recession of the second half of the 20th century. In the late 1980s, the G-7 countries would agree to stabilize the dollar after its sharp three-year fall only when the United States agreed to start reining in the large budget imbalances of that decade. It would be far superior on this occasion to take preemptive action that, in light of the magnitude and duration of our external deficits and debts, could be far more damaging than any of these previous episodes.

It must be noted that there is no automatic link between the US budget and current account deficits. The external imbalance in fact soared anew during the late 1990s while the budget was moving into surplus (because domestic investment was running at postwar highs and continuing declines in private saving offset much of the reduction in public dissaving). In theory, there could be some offset to increases in public saving achieved by budget improvement via reduced private saving (though the two have tended to move in similar rather than opposite directions in the United States in recent decades).

The deficits were much more closely related throughout most of the 1980s, however, when both reached their previous record highs and required substantial adjustment. The external deficits would probably be much larger today had the budget not improved so dramatically during the 1990s. The tax cuts and large spending increases of the early years of this decade clearly worsened our external position, by further reducing national saving, and played central roles in

pushing it to today's precarious levels. Indeed, less expansionary fiscal policy in recent years would have reduced the need for tightening of monetary policy by the Federal Reserve and produced a weaker dollar that would have strengthened our current account. Budget correction would almost surely promote external adjustment under current circumstances, perhaps by around one half of the improvement in the budget itself.[4]

Trade policy is not the topic of this hearing but I would note, before closing, that the creation of new US barriers to imports of goods or capital would be a wholly inappropriate response to our trade and current account deficits. It is historically true that large US external deficits and the dollar overvaluations that help spawn them have been the best predictors of resistance to open trade policies, because they shift the politics of US trade policy in a restrictive direction. As indicated throughout my statement, however, these large imbalances are a macroeconomic problem that require macroeconomic (including exchange rate) remedies and for which new trade barriers would be ineffectual. It would be particularly counterproductive to discourage inflows of direct investment or any other forms of foreign capital, which we must continue to attract as long as we run (even a reduced level of) current account deficits, as might well be the result of some of the current proposals for "reforming" the Committee on Foreign Investment in the United States (CFIUS) and US policy in that area more broadly.[5]

There are strong reasons to convert the current, and especially prospective, US budget deficits into modest surpluses without appealing to these international aspects of the issue. But the

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[4] There is a wide range of estimates of this relationship but they tend to cluster around 50 percent. The main outlier is the Federal Reserve, whose much lower estimates are explained and criticized in William R. Cline, *The United States as a Debtor Nation*, Washington; Institute for International Economics, September 2005.

[5] Edward M. Graham and David M. Marchick, *US National Security and Foreign Direct Investment,* Washington, Institute for International Economics, May 2006.

vulnerability of the US economy to large and prolonged reductions in foreign capital inflows, especially if such shifts were to occur abruptly, surely counsel that we "put our house in order" as promptly as possible. I am delighted that the Committee is assessing these issues as part of its deliberations on the fiscal situation and hope my analysis will help persuade you to adopt an aggressive stance to sharply improve its prospects over the coming budget cycle.