

THE FISCAL DEFICIT AND THE U.S. EXTERNAL DEFICIT

Statement by
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before the Hearing on

The Current Account Deficit and U.S. Foreign Debt

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It is an honor and a pleasure to be invited to testify before this Committee. In my view, it is crucial for the United States to eliminate its fiscal deficit and to substantially reduce its external current account deficit. Because the fiscal deficit affects the current account deficit, I believe that the Committee is well advised to consider the external sector dimensions in its deliberations on U.S. fiscal policy. Let me begin with a brief review of how the current account and external debt have arrived at where they now stand. I will then examine the long-term burden of the growing U.S. foreign debt, and conclude with an analysis of how fiscal adjustment could contribute to external sector adjustment. I will base most of my comments on my recent book, *The United States as a Debtor Nation*.²

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² Institute for International Economics and Center for Global Development, 2005a.

From Creditor to Debtor Nation Status

In the early 1970s, U.S. citizens, corporations, and the government owned much more in assets abroad than they owed in foreign liabilities. In 1971-75 net foreign assets averaged about 11 percent of GDP. Beginning in the 1980s, however, the United States persistently ran trade deficits as well as deficits in the overall current account -- which includes capital income and transfers. There have been two large deficit cycles, the first peaking in 1987 and the second one beginning in the mid-1990s and still showing no signs of reversal. As a consequence, the United States had dissipated its international creditor position by 1988; and by the end of 2005, U.S. external liabilities exceeded foreign assets by about 20 percent of GDP.

In the more recent cycle, the current account deficit has risen from 1.7 percent of GDP in 1997 to about 7 percent in 2006, or about twice the 3.4 percent of GDP peak in the 1980s cycle. In addition to rapid U.S. growth, the main factor driving the widening deficit has been the real appreciation of the trade-weighted value of the dollar by 28 percent from 1995 to 2002.³ The dollar fell in real trade-weighted terms by 13 percent from 2002 to 2006, but it still has a considerable distance to decline before the exchange rate incentive will be in place to begin narrowing the deficit to more sustainable levels.

The swing from large creditor to large debtor has happened despite two unusual U.S. strengths: a high return on direct investment abroad (which is about 4.5 percent higher than the return on foreign direct investment in the United States); and the fact that U.S. debt obligations abroad are almost fully in dollars whereas U.S. equity and direct investment claims abroad are in foreign currency, so that there is a windfall valuation

³ Using the Federal Reserve's broad real exchange rate index.

gain whenever the dollar declines. Without these two unusual features the swing into net debtor status would have been even greater.

Why the Current Account Deficit Matters: A Long-term View

In his testimony for this hearing, my colleague C. Fred Bergsten has stressed the near-term hazards associated with our present large external deficit. There could be a “hard landing” for the U.S. economy and perhaps the world economy if there were an unfavorable shift in confidence and a decline in the massive capital inflow needed to finance the U.S. current account deficit (and U.S. capital outflows). Higher interest rates and a severe decline in the stock market and consumption, along with a recession, could be the result. There could also be an outbreak in protectionism associated with an ever-widening trade deficit.

Let me complete the picture by focusing on the longer-term risks associated with continuing along our present path, in the event that foreign capital markets essentially give us enough rope to hang ourselves rather than cutting off capital supplies in the near future. It is important to recognize what last year’s rate of 7 percent of GDP for the current account deficit would imply if it were maintained indefinitely. The long-term nominal growth rate of the economy is only about 6 percent (say, 3.5 percent real growth plus 2.5 percent inflation). So if the current account deficit stayed at 7 percent of GDP, net foreign liabilities would keep rising until they eventually exceeded one hundred percent of GDP. That is, the long-term ratio of net foreign debt to GDP stabilizes at the ratio of the current account deficit as a percent of GDP to the nominal growth rate of GDP, in this case about 1 to 1 at 6 percent for both.

A foreign debt ratio of 100 percent would be extremely risky. In Latin America and other developing regions, debt crises have tended to occur once external debt exceeds about 40 percent of GDP. Even though the US economy is much stronger than most developing economies, surely there is some limit to a safe foreign debt level for the United States. Given the global responsibilities of our economy, I would place that prudential limit at about 50 percent of GDP, even after taking account of higher return on foreign assets than on liabilities to foreigners. To keep below this ceiling, it will be necessary to reduce the current account deficit to about 3 percent of GDP (that is, half the nominal GDP growth rate).

Instead, what we are doing at present is building up an imbalance that will be increasingly costly for us and our children to correct in the future. My baseline projection shows the U.S. current account deficit pausing at a plateau of 7 percent of GDP but then rising steadily to about 14 percent of GDP after two decades. This ongoing deterioration occurs despite the unique advantages on rate of return and currency valuation of assets. It is driven by a large swing from surplus into deficit in capital income as net liabilities rise; and also by the simple fact that because imports exceed exports by about 50 percent, growth in the same proportion on both sides causes a widening gap. Over the two-decade horizon, net external liabilities would rise to 140 percent of GDP in this baseline, a wholly unsustainable level. The basic choice, then, is between an earlier, smoother adjustment and a later, more painful one.

In my model simulations of alternative paths to limit net foreign liabilities to 50 percent of GDP, an early reduction in the deficit to 3 percent of GDP over the next three years would spread the inevitable belt-tightening much more smoothly over time than

would an adjustment delayed for a decade. Late adjustment would mean no cuts from baseline consumption and investment in the first decade but a cutback by about 13 percent from baseline in the second decade. In early adjustment, the cuts from baseline would be much more evenly phased, at about 4-1/2 percent in the first decade and 9 percent in the second. Essentially, in our external accounts we face the same issue of imposing an undue burden on the future that we face in our domestic fiscal accounts.

Correcting Dollar Overvaluation

In order to cut the U.S. external deficit in half, my model estimates suggest that the dollar will need to fall in real terms by an additional 15 to 20 percent on a trade-weighted basis, supplementing the partial correction that has already occurred from the dollar's high point in 2002. This further correction will need to be mainly against the currencies of China, Japan, and other major Asian economies (including Malaysia, Hong Kong, and Singapore). In contrast to the euro and most other industrial country currencies, the Asian currencies have not risen much at all against the dollar. I have suggested an "Asian Plaza Agreement" or a broader "Plaza II" to help bring about this correction.⁴ Whatever the mechanism, for sufficient currency adjustment to occur it will be essential that China and other Asian nations stop intervening in the foreign exchange market and increasing their already massive reserves in an effort to prevent appreciation of their currencies. It also appears increasingly likely that there will be a need for coordinated intervention to reverse the decline of the yen, just as there was coordinated intervention to reverse the decline of the euro earlier this decade.

⁴ See Cline, 2005a, chapter 6; and my essay "The Case for a New Plaza Agreement," *Policy Briefs in International Economics* No. PB05-4, Institute for International Economics, December 2005b.

Why Fiscal Adjustment is Important to External Adjustment

For the purposes of this hearing, however, I would like to focus on the other instrument of external adjustment: fiscal policy. Most international economists have long recognized that adjusting a current account deficit requires both a relative price effect from exchange rate realignment (sometimes called “expenditure switching”) and a consumption-curbing effect from increased domestic saving (sometimes called “expenditure reduction”). A decline in the dollar makes imports more expensive and U.S. exports more competitive, but if there is no accompanying rise in the nation’s aggregate saving, the result may be a strain on capacity and a rise in interest rates, resulting in a subsequent rebound in the dollar that frustrates the potential trade adjustment.

Fiscal policy is directly relevant because government saving is part of national saving. The national income accounts necessarily impose the following relationship: the trade deficit equals the excess of domestic resource use over domestic resource production. This turns out, again by an accounting identity, to show that the trade deficit equals the excess of domestic investment over domestic saving. Domestic saving in turn equals saving by corporations, households, and the government. When the government is dissaving, it is inherently placing pressure on domestic use of resources and hence exerting pressure tending to widen the trade deficit.

From 1997 to 2004, total U.S. saving fell by 4 percent of GDP (from 17.6 percent to 13.6 percent). This was the main force driving the widening of the current account deficit by a similar amount (from 1.6 percent of GDP to 5.7 percent). In turn, a driving force in the decline of national saving was the downswing in the U.S. fiscal balance by

about 5 percent of GDP from 2000 to 2004, even after taking out cyclical influences. The U.S. fiscal erosion mainly reflected a decline in federal tax revenue, which fell from 20.9 percent of GDP in 2000 to 16.3 percent in 2004. The tax cuts of 2001 and 2003 were a key source of this decline, accounting for a reduction of tax revenue by 2.6 percent of GDP in 2004 from levels that otherwise would have been reached.⁵

Of course, private saving was also falling. From 1990 to 2005, personal saving fell from about 7-1/2 percent of disposable income to about 1-1/2 percent. The most likely explanation is that households felt richer because of, first, the stock market boom, and then (even more importantly for most households) the housing market boom. With windfall gains more than covering their target wealth accumulation, households saved less and less out of current income. Maybe that process will begin to reverse with the now stagnant housing market and more normal stock market conditions. But if there is anything we have learned about macro-economic policy, it is that we have no reliable policy tool to increase private saving. So if public policy is to have an effect on national saving and hence the external deficit, it must be through use of the instrument of fiscal policy to shrink the government's dissaving (i.e. the fiscal deficit).

That is why the second major component of a package for U.S. external adjustment, in addition to further correction in the dollar, is the elimination of the federal budget deficit, and ideally a move into small surplus. Despite the recent mainly cyclical gains in the fiscal outcome, the prospective deficit seems likely to remain in the range of 2 percent of GDP over the next 5-7 years if the tax cuts are extended, the alternative

⁵ Cline, 2005a, pp. 111-112; 204-205. This U.S. fiscal "smoking gun" is why I am skeptical of the argument made by U.S. Federal Reserve Chairman Ben Bernanke that the current account deficit is simply a manifestation of a global saving glut caused by falling investment in Asia and Latin America after regional crises. My analysis shows that the appropriate contribution from that source was only 0.7 percent of GDP, a modest fraction of the deterioration in the current account.

minimum tax is reformed, and plausible assumptions are made about discretionary spending.⁶ The fiscal outlook is of course even more challenging over a longer horizon because of rising social security and (especially) medicare-medicare costs. A longer perspective would simply reinforce the need for early action.

It should be recognized that a 3 percent of GDP upswing in the fiscal outcome (e.g. from -2 percent of GDP to +1 percent) would not necessarily narrow the current account deficit by 3 percent of GDP, despite the national account identities. Those accounting relationships hold *after* taking account of induced effects. A smaller fiscal deficit would tend to reduce the interest rate, which in turn would tend to boost investment and consumption. As a consequence, the reduction in the excess of resources used domestically over resources available domestically would be less, after the induced effects, than the amount of the initial budget correction. Nevertheless, a reasonable relationship would be a reduction of about 50 cents in the current account deficit for each dollar reduction in the fiscal deficit, and if coupled with a strong independent correction of the exchange rate the relationship could be higher.

In sum, it is widely recognized that there are major domestic reasons for moving aggressively to eliminate the fiscal deficit. The case for doing so is even stronger after considering that fiscal adjustment will almost surely be a necessary part of external sector adjustment. In the absence of correction, the external imbalance is on a track that sooner or later will lead at best to an unpleasant second half of the journey, and at worst to a train wreck.

⁶ Projections by the Congressional Budget Office indicate that these three influences would respectively boost the deficit in 2012 by \$296 billion, \$35 billion, and \$110 billion, placing the budget in deficit at 1.6 percent of GDP instead of a potential surplus of 1 percent of GDP. CBO, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*, January 2007.

