

WHY THE U.S. EXTERNAL IMBALANCE MATTERS

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Last year the U.S. current account deficit (mainly on trade but including capital income and transfers) reached almost 7 percent of GDP, or about twice as large a share as in 1987, the peak of the previous episode of large external imbalances and dollar overvaluation. A major reason is that from 1995 to 2002 the dollar rose by 28 percent against other currencies, after taking account of inflation and weighting by trade. A strong dollar made U.S. exports expensive and imports cheap, driving up the trade deficit after about a two-year reaction time. With large and persistent external deficits, the United States has swung from being the world's largest creditor nation to its largest debtor, with net foreign liabilities now at about one-fourth of GDP.

The dollar has corrected somewhat and is now about 13 percent lower on a trade-weighted basis than its average in 2002, based on the Federal Reserve's broad real exchange rate index. Without that partial correction the trade deficit would now be even larger. It will likely require a decline of an additional 15 to 20 percent in the dollar to cut the current account deficit back to about 3 percent of GDP. That rate would be consistent with limiting net foreign liabilities to 50 percent of GDP in the long term. Exceeding that ceiling would seem imprudent for both the U.S. and global economies. It will be crucial that China, Japan, and much of the rest of Asia participate in realignment of their currencies against the dollar, because the decline of the dollar so far has been heavily concentrated against the euro and other industrial country currencies except for the Japanese yen. Dollar correction will also need to be accompanied by fiscal adjustment.

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Otherwise much of the competitive effect of the dollar adjustment would be offset by higher inflation and a dollar rebound from higher interest rates. Fundamentally the external deficit is the excess of resources used over resources produced, and with U.S. household saving near zero, the government cannot be a large net borrower without keeping the nation in large external deficit.

Why is the large external deficit a problem? After all, if the rest of the world wishes to finance overconsumption by the United States, why should we complain? There are three reasons. First, there is significant risk of a “hard landing” in which a shift in market confidence causes a plunge in the dollar, a surge in interest rates, and a recession for the U.S. and possibly global economies. Second, even with no such disruption the delay of adjustment until the current account deficit is even larger will impose a more severe burden on households a decade or more from now. Third, the trade deficit is especially punishing for the manufacturing sector, and can be expected to exert rising pressure for protection against imports, yet protection would be a highly inefficient way to narrow the trade gap.

Risk of a Hard Landing

Those who have warned about the dangers of a large external deficit may seem like the boy crying wolf, but as in the fable, the wolf may eventually come. The “hard-landing scenario” is the classic concern. It worried policymakers more in the 1980s than it does now, despite the higher relative deficit today. In this scenario, an adverse shift in confidence of foreign investors causes a rapid decline in the dollar and in capital inflows. With less capital from abroad, U.S. interest rates rise sharply. Higher interest rates provoke a decline in the stock market, the housing market, and investment, prompting a recession. The U.S. recession and higher dollar interest rates in turn prompt a global slowdown or recession.

Quite apart from the failure of such a crisis to materialize so far despite ever larger U.S. deficits, there seem to be basically two reasons the hard-landing scenario has not generated much consternation in the present historic cycle. The first is that there seems to be a persistent strong desire by foreigners to place assets in the U.S. market, perhaps in part because of the legacy of the financial crises of the late 1990s and the associated decline of investment relative to saving in Asian and Latin American economies, and in part because of advantages of legal rights and market liquidity in the United States. The problem so far has been too much foreign capital, not too little, and Federal Reserve Chairman Ben Bernanke has coined the “global

savings glut” to explain the U.S. external deficit, arguably distracting attention from the home-made problem of the swing from fiscal surplus to fiscal deficit (see Cline 2005a: 202–7).

The second reason the hard landing may have seemed remote reflects growing faith in the Federal Reserve after the successful outcomes under the long Greenspan regime. The scenario of a surge in interest rates as a consequence of a collapse of the dollar confronts this Fed-confidence, because the Federal Reserve would supposedly not raise interest rates unless inflation were to rise, and would be especially loath to raise interest rates in the face of a recession. Recent evidence seems to suggest that the pass-through of exchange rates to import prices is relatively low as foreign firms price to market, so there might not be much direct inflationary risk from a lower dollar. However, comfort from such considerations fails to recognize that the Federal Reserve controls the short-term interest rate (the federal funds rate, which in turn closely governs the treasury bill rate) but not the long-term interest rate, which is more important in influencing economic activity. A collapse in capital inflows could create a squeeze in capital supply that would boost the rate on the 10-year treasury bond even if the Federal Reserve did not raise the short-term rate.

A good reason to worry that the hard-landing scenario has teeth is that it came close to happening twice in the past: in 1979 and again in 1987. The late 1970s was a period of high inflation and a falling dollar. The dollar declined almost 20 percent against the German Deutsche Mark from the end of 1977 to the end of 1979, despite an emergency line of credit amounting to \$150 billion at today’s scale from foreign governments to help support the dollar in late 1978. Under Chairman Paul Volcker, the Federal Reserve embarked on steep increases in interest rates within a new framework targeting the money supply, although the motive was primarily to halt inflation rather than stem the decline of the dollar. The aftermath of the worst postwar recession in 1982 is well known.

In 1987, the dollar was again under pressure after the overly successful 1985 Plaza Accord to curb the dollar’s strength. The Louvre Agreement in early 1987 achieved success in stabilizing the currency for several months, but then broke down over seeming disagreement between German and U.S. monetary authorities. The dollar fell 15 percent against the Deutsche Mark from the end of July to the end of December despite a rise in the 10-year Treasury bond rate from 7.25 percent in February to 9.5 percent in October. The U.S. stock market fell by 23 percent in a single day (October 19). Although the economy

escaped recession, the potential for financial market fallout from falling confidence in the dollar was amply demonstrated.

In sum, even though the probability of a hard landing for the dollar and the U.S. and world economies may be significantly less than 50 percent at present, prudent economic management would suggest the desirability of further reducing this risk through a process of measured external adjustment.

Postponing and Increasing the Adjustment Burden

Instead of triggering a hard landing, investors abroad may give the United States enough rope to hang itself by building up such large current account deficits and net foreign liabilities that the ultimate adjustment is much more painful than if the correction came earlier. In the baseline projections of my current account model, and in the absence of further correction of the dollar, over the next two decades the external deficit would widen to 14 percent of GDP and the net foreign liabilities would rise to 135 percent of GDP, even though my model takes account of the special advantages built into the U.S. capital income accounts.¹ Some forcing event would almost certainly halt this process before the deficit and net liabilities reached these magnitudes. The real question is whether the adjustment comes earlier or later.

In two runs of the model both imposing a ceiling of 50 percent of GDP for net foreign liabilities by the end of two decades, the early adjustment scenario involves a decline of the dollar by about 24 percent over the next three years, whereas the late adjustment scenario calls for no adjustment for a decade but then a decline of 35 percent over three years. In the early adjustment scenario, households cut consumption from the no-adjustment baseline by 4.6 percent of GDP in the first decade and 8.8 percent in the second, whereas in the late-adjustment scenario there is no cut at all in the first decade but a 12.5 percent of GDP cut required in the second decade. So delaying correction of the external deficit imposes a sharp inequity between consumption potential in the first and second decades. Economists cite “consumption smoothing” as a fundamental reason for global capital flows. Today these flows are instead

¹The rate of return on U.S. direct investment abroad is much higher than on foreign direct investment in the United States; and there is some valuation gain whenever the dollar depreciates, because the dollar value of holdings of foreign assets correspondingly rises whereas the dollar value of U.S. obligations abroad (mainly denominated in dollars) remains unchanged.

facilitating “consumption roughening” for the United States, in light of the future corrections that will have to be made when the bill comes due for consuming well beyond national means.

Courting Protection

The final reason not to ignore the external deficit is that it could eventually lead to trade protection, with its well-known inefficiencies and costs (especially for low-income households who tend to benefit disproportionately from consumption of cheap imported goods). Increased protection in textiles and steel in the 1970s reflected, in part, pressures from large trade deficits in the late 1960s and early 1970s. Meanwhile, the overvalued dollar and widening trade deficits of the mid-1980s contributed to protectionist pressures and resulting facilitation of antidumping measures and introduction of “reciprocity”-based retaliatory authority in the late 1980s.

The global trade regime could face serious tests if the Doha Round of multilateral negotiations remains stalled. It is inadvisable to further increase pressures for backsliding on open trade by sanctioning ever wider trade deficits. These deficits tend to hit the manufacturing sector disproportionately. Overall employment may be maintained, but employment shifts toward such nontraded sectors as housing and many services. The squeeze of an overvalued currency on key traded goods contributes some part of the distress in such sectors as automobiles (although most of Detroit’s problems are homegrown). As pressures in these sectors mount, it becomes easier for politicians to argue that the old theories of free trade are no longer valid. It is then a short step to protection.

Ironically, one lever that may have to be used to achieve external adjustment may indeed be a trade threat involving a countervailing duty against imports from China and other countries that are keeping their currencies artificially cheap by intervening in currency markets and piling up massive foreign exchange reserves. This practice amounts to a subsidy of their exports, and there is precedent in global trade rules for offsetting the distorting effects of subsidies.² Ideally any such measures would be implemented within the framework of existing international commitments, for example by obtaining a determination by the International Monetary Fund that the country in

²The GATT provides that members shall not use “exchange action” to “frustrate the intent” of the agreement (see Cline 2005a: 279). Significantly, Federal Reserve Chairman Ben Bernanke has explicitly called the Chinese exchange rate policy a subsidy to exports (Bernanke 2006).

question was indeed artificially keeping its currency undervalued and then taking a trade complaint to the World Trade Organization on the strength of that determination.

Conclusion

It would be a mistake for policymakers to treat the large U.S. external deficit as a benign phenomenon that should be allowed to widen (or even persist at its current rate) indefinitely. I have suggested that it would be desirable to hold a Plaza II meeting for realignment of exchange rates by a number of key economies, with the principle incorporated that nations in current account surplus would allow their currencies to appreciate rather than intervene in currency markets and further build up reserves (Cline 2005b). I have also argued that the U.S. fiscal deficit should be eliminated as the complement to exchange rate adjustment. Others may have alternative policy solutions. However, the strategy of doing nothing and countenancing the further widening of historically high external deficits should not be among the acceptable approaches.

References

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