

THE US CURRENT ACCOUNT DEFICIT

THE DOLLAR AND THE GLOBAL IMBALANCES

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From 1995 to early 2002, the dollar rose by a trade-weighted average of about 40 percent. Largely as a result, the US current account deficit grew by an average of about \$75 billion annually for ten years. It exceeded \$800 billion and 6 percent of GDP in 2006. There were two major consequences for the world economy.

The first is the risk of *international financial instability and economic turndown*. To finance both its current account deficit and its own large foreign investments, the United States must attract about \$7 billion of foreign capital every working day. Any significant shortfall from that level of foreign demand for dollars would drive the exchange rate down and US inflation and interest rates up. A drying up of that demand, and especially any net disinvestment from the \$20 trillion or so of existing dollar assets held around the world, would trigger even larger changes in these critical prices (and thus in the equity and housing markets as well). With the US economy near full employment, but also having slowed, and with housing already under intense pressure, the result would be stagflation at best and perhaps a nasty recession. Other countries would be affected severely as well, as their currencies rose and they experienced significant reductions in the trade surpluses on which their growth now depends.

Second is the domestic political risk of trade restrictions in the United States and thus *disruption of the global trading system*. Dollar overvaluation and the resulting external deficits are historically the most accurate leading indicators of US protectionism because they drastically alter the domestic politics of the issue, adding to the pressures for new distortions and weakening pro-trade forces. These traditional factors are particularly toxic in the current context of strong anti-globalization sentiments. The spate of administrative actions against China over the past

several years, and the numerous anti-China bills now under active consideration by the Congress, demonstrate the point graphically since China is by far the largest surplus country and its currency is so dramatically undervalued.

The US current account deficit does not have to be eliminated. It needs to be cut roughly in half, however, to stabilize the ratio of US foreign debt to GDP. When the deficit peaked in 2006, the ratio was on an explosive path that would exceed 50 percent within the next few years and an unprecedented 80 percent or so in ten years. Avoiding such outcomes requires improvement of about \$400 billion from those levels.

I and colleagues at our Peterson Institute for International Economics have been pointing to these dangers, and calling for corrective action since the end of the 1990s. The adjustment process began in early 2002. The dollar has declined, in a gradual and orderly manner, by 20 to 25 percent since that time as the needed capital inflows have been obtained only through additional price inducements from a cheaper exchange rate and higher interest rates (and, until recently, higher equity and housing prices due to strong US growth). The budget deficit has also fallen over the past three years, limiting the saving shortfall that forces the United States to borrow so heavily abroad. US growth has slowed while expansions have accelerated in Europe, Japan and (even further) in China and most of the oil producers.

The adjustment to date, however, has been inadequate and unbalanced. It has halted the deterioration of the US deficit, which is no mean feat since imports came to exceed exports by more than 50 percent, but has not yet convincingly reversed the trend. The surpluses of the largest creditor countries, Japan and especially China, continue to soar to record levels.

An important reason for the inadequate size of the adjustment is its skewed geographical compo-



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sition. The floating currencies of Europe (euro, sterling, Swiss franc), Canada, Australia, Korea and a couple of other Asians have risen by 30 to 50 percent against the dollar. However, the heavily managed currencies in much of emerging Asia and the yen, due mainly to Japan's extremely low interest rates, have appreciated by modest amounts if at all. The same is true for most of the large oil exporters. Hence the improvement of the US imbalance against Europe has been offset by continued deterioration against the Asians, much of which shows up as occurring with China due to its central role as the final assembly point for Asia-wide production networks, and the energy producers.

Unless all economic history is repealed, further adjustment of these global imbalances is inevitable. The key question is whether it will occur wholly through market forces, including the "political market" for trade protection, or at least partly through preemptive policy actions by the major countries. The impact on global growth, international financial stability and the world trading system could turn importantly on which path is followed.

Either path will have to include a further decline of ten percent or so in the trade-weighted average of the dollar. There are two main risks in relying solely on the market for this outcome. One is the possibility of a hard landing if the dollar falls abruptly rather than in an orderly manner, especially as it can easily overshoot its needed correction (perhaps by a substantial amount). This risk is considerably greater than five years ago: the US external financing requirement is much larger, US net foreign debt is headed into uncharted territory, US full employment means that a dollar plunge would now lead to much more inflation and much higher interest rates, and the maturation of the euro offers a real alternative to the dollar so there is now "some place else to put the money". There are any number of potential triggers for a precipitous decline in the dollar including a sharp fall in US interest rates in response to the present liquidity difficulties, a US recession while the rest of the world keeps growing, diversification out of the dollar by one or more large sovereign wealth funds (or even rumors thereof), a drop in the rapid US productivity growth of the past decade, protectionist legislation and the 2008 elections as well as a generalized collapse of confidence due to the spillover from the subprime lending crisis.

The other risk of relying solely on the market is that the floating currencies (once more excluding the yen?), which have already largely adjusted, will once again experience most of the counterpart appreciations against the dollar decline because the countries that aggressively manage their exchange rates continue to block their essential contribution to the adjustment. This especially means China, because its surplus is so large and its exchange rate is so key to others in its region, but also a number of other East Asians and oil producers including Hong Kong, Malaysia, Norway, Russia, Singapore, Taiwan and several Gulf exporters.

The next big currency move, which could exacerbate rather than correct the global imbalances, could in fact be an even more dramatic rise in the euro. European growth has accelerated relative to US growth. Euroland interest rates have been rising while US rates are falling. The euro is moving up alongside the dollar as a global currency and portfolios around the world, both private and official, are likely to adjust considerably as a result. Diversification from dollars into euros by a number of emerging economies that have accumulated large reserves, including via their sovereign wealth funds, intensifies this prospect. The euro (and the Canadian dollar and a few other floating currencies) could become substantially overvalued, especially against the Asians, weakening their economies and creating protectionist spillovers that add to the threat to the global trading system.

An alternative strategy for completing the global adjustment through constructive policy actions by the key countries was recently developed at a conference of thirty top international economists hosted by our Peterson Institute for International Economics and co-sponsored by leading think tanks from Asia and Europe, the Korea Institute for International Economic Policy and BRUEGEL. It would have four key components:

- attainment of modest budget surpluses in the United States, as needed for purely domestic reasons and as actually achieved during 1998-2001, to make room for the needed improvement in the external balance without generating higher inflation and interest rates;
- aggressive expansion of domestic demand in East Asia, especially in China and Japan, to offset the essential large cutbacks in their trade surpluses;

- continued rapid growth of domestic demand in key oil exporting countries; and
- a series of substantial exchange rate changes, especially by countries that have not yet participated in the adjustment package.

The Chinese renminbi needs to rise by about 30 percent against the dollar, over a period of three to four years, with a “down payment” of at least 10 percent each in the near term. This will require China to sharply scale back its intervention to block the renminbi appreciation. The yen needs to rise by 10 to 20 percent against the dollar, which may require Japan to signal (perhaps through intervention) a desire to strengthen its currency. The other surplus countries cited above must also limit their market intervention and allow their currencies to appreciate substantially. It will be much easier for the other Asians to do so once China and Japan take the lead, and all these currencies will rise much less on a trade-weighted average than against the dollar if they move together. Euroland, Korea and a few other floaters must accept further rises in their exchange rates against the dollar but, because of the much larger increases in the surplus country currencies, without appreciation of their trade-weighted averages.

In the 1980s, the US Government and the G-5 abandoned their benign neglect of problems very similar to those we now face in the nick of time to head off major disruption of the international monetary system, world trade and the global economy. Similar statesmanship is sorely needed again today to enhance the odds that the inevitable correction will take place constructively and to avoid the enormous risks to all involved from letting nature take its course.