

Democratic Commissioners' Views

Is America's trade deficit sustainable? The consequences of growing international debt

I. Introduction

The borrowing required to cover chronic current account deficits since the 1980s has turned the United States from the world's largest creditor nation to the world's largest debtor (with negative net assets). America's trade deficits are financed either by borrowing from foreigners or by reducing the stock of U.S. assets abroad – in either case, increasing our net international indebtedness. Figure 4.1 presents the U.S. net international investment position from 1982 through to 1999, as a share of GDP. As it shows, the United States was a net creditor nation as recently as 1988 but has since seen its accumulated net international debt soar to 16 percent of GDP, or about \$1.5 trillion in 1999, making the United States the world's largest debtor nation.¹ In addition, as discussed below, most projections of U.S. and international economic activity see U.S. current account deficits and net international indebtedness continuing to grow rapidly over the next five to ten years.²

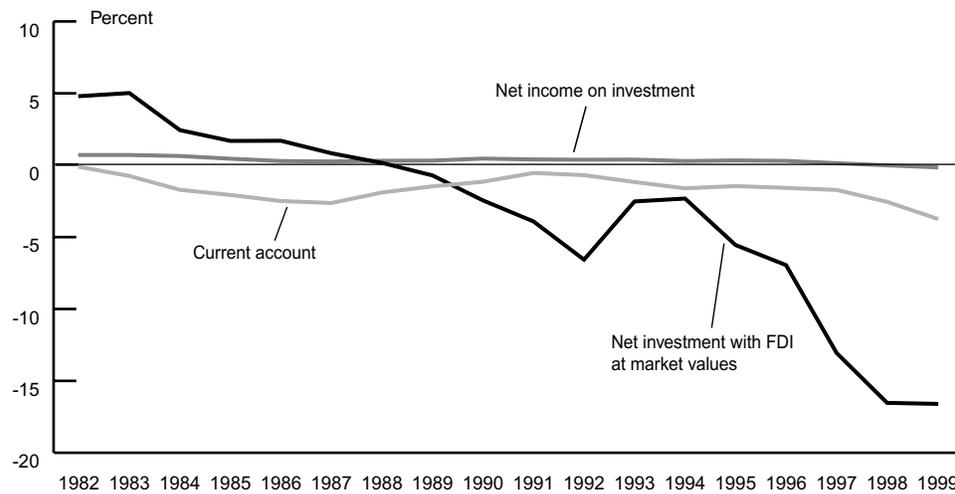
Figure 4.1 also shows two important international flows. The U.S. current account deficit has ranged between 2 percent and 4 percent of GDP since the early 1980s, and it has increased sharply in the past five years, relative to output. While the current account's share of GDP appears small on the graphs, it is the accumulation of the annual deficits that has resulted in our current net indebtedness. While U.S. net investment income has been a tiny share of GDP, it has recently crossed over from a surplus to a deficit, as the net U.S. foreign debt has expanded. The U.S.' negative net investment income is likely to grow in importance in the future, as shown below.

The financial disasters of the 1980s and 1990s in both developing and industrialized countries have clearly shown that too much external borrowing and accumulated international liabilities can precipitate financial crises and economic collapses (see section 1, Chapter 2). Whenever a country's current account deficit becomes large and persistent, questions arise as to how large the country's net debt can become.

¹ This measure of net U.S. debt includes foreign direct investment valued at current market prices.

² See, for instance, Wynne Godley, *A Critical Imbalance in U.S. Trade*, Public Policy Brief No. 23, (Annandale-on-Hudson, New York: The Jerome Levy Institute, 1995), and the analysis presented in Table 10.3 of Catherine Mann, *Is the U.S. Trade Deficit Sustainable?* (Washington, D.C.: Institute for International Economics, 1999), or Robert A. Blecker, "The Ticking Time Bomb: Why the U.S. International Financial Position is Not Sustainable," Briefing paper (Washington, D.C.: Economic Policy Institute, June 1999).

Figure 4.1
The Stock and Flow of U.S. International Trade and Investment
as Shares of GDP, 1982-99



Source: U.S. Department of Commerce, International Transactions Tables, web page: <http://www.bea.doc.gov/>

Moreover, when current account deficits become large and unsustainable, policymakers must ask whether a financial or economic crisis is inevitable or if more gradual and less harmful outcomes are possible. A sudden drop in the value of the currency or a sharp rise in interest rates can throw a country into financial crisis, followed by a potentially severe economic downturn. We have observed this phenomenon in a number of countries in the past decade – including the European Monetary System crisis in the early 1990s, the Mexican peso crisis of 1994-95, the economic collapse of Southeast Asian countries in 1997-98, and the crises in Brazil and Russia in 1998-99.

Many of those who gave evidence to the Commission took the view that the U.S.' trade and payments deficits do not matter very much and that they may even be beneficial to the United States. While the deficits could correct themselves spontaneously, there is a growing body of research that is reviewed in this chapter, which shows that the deficit is unlikely to adjust smoothly or easily. Despite these risks, witnesses who took the view that "deficits are no problem" called for no major change in policy now or in the future. They argued that the international role of the dollar and the strength and size of the American economy make the United States a special case among nations and that the unique position of the United States may allow it to maintain sustainable trade deficits at somewhat higher levels than other countries. Nonetheless, it now seems clear that the U.S. trade deficit may be reaching levels that are close to unsustainable.

We do not believe that any spontaneous improvement in the U.S. external deficits will occur unless there is a recession. The postwar period is filled with instances of countries running

deficits that resulted in huge accumulations of debt and that were not corrected spontaneously or in any orderly way but that did indeed eventually result in a crisis. Several examples are discussed in the next section, below. The adverse trends in U.S. trade, particularly trade in manufactured goods, seem to be deeply entrenched, and it seems likely to us that these trends will continue in the future. The current account deficit has so far caused no weakness in the dollar such as might inaugurate an orderly turnaround. On the contrary, the dollar has so far been exceptionally strong.

It is one of the central contentions of this report that a continuation of the present current account deficit - let alone a larger one - will have consequences that absolutely require corrective action at some point. Moreover, the deeper the United States gets into debt, the larger and more draconian the remedial policies will ultimately have to be. While a spontaneous recovery cannot be ruled out, policymakers are strongly advised to actively develop appropriate policies that can be put in place if a financial crisis develops in this country. The risk of a "hard landing" that quickly reduced U.S. current account deficits, but at huge costs to the economy, must be acknowledged and addressed by policymakers to safeguard the continued prosperity of the American economy and to avoid a global financial crisis.

How much longer can the U.S. current account deficit be sustained?

In the context of the economics of a country's external balance, "sustainable" refers to a stable state or a stable path where the external balance generates no economic forces of its own to change its trajectory.³ In other words, a sustainable current account deficit is one that does not result in a traumatic change in the exchange rate, interest rates, or market values. To illustrate, a large current account deficit leading to growing net foreign debt may lead foreign investors to worry that the dollar is about to fall or that financial markets are about to crash, as they did in Japan in 1990. This may lead such investors to sell some of their excess dollars or other assets, which would generate upward pressure on U.S. interest rates or depreciate the dollar. Either of these changes would set in motion economic forces to narrow the current account deficit. Thus, in this case, the current account deficit would not be sustainable. A large current account deficit is not necessarily unsustainable, however; if investors want to hold more assets in the country in question, interest rates will not rise and the currency will not depreciate. However, such a situation is not likely to persist indefinitely – even the United States must ultimately obey the financial laws of gravity, as shown below. Finally, even if the current account is not sustainable, crisis is not inevitable; a smooth and economically benign transition back to a sustainable trajectory is possible. However, this is not how financial markets have worked in the past thirty years, the period of open capital markets and flexible exchange rates. Thus, achieving a soft landing would require a combination of important policy reforms and extremely good luck on the part of the United States.

³ This definition of sustainability in this section is based, in part, on Catherine Mann, *Is the U.S. Trade Deficit Sustainable?* (Washington, D.C.: Institute for International Economics, 1999).

The size of the net foreign debt of a country and its relation to GDP are key factors in assessing the sustainability of its current account deficit. Current account deficits measure the yearly changes in the net foreign debt position of the country as foreign borrowing finances the gap between a country's export revenues and the costs of its imports. The size of a country's net foreign debt cannot increase indefinitely, since ultimately net payments on the debt would take the full resources of the country, leaving nothing for consumption. Of course, investors will have serious concerns about the stability of the dollar and of U.S. asset markets well before it reaches the point where net payments on the debt take up all the country's resources. Tracking the size of a country's net foreign debt and judging whether it is near the point of making the present trajectory in the current account unsustainable is best done by looking at the net foreign debt/GDP ratio.

A number of factors determine the relationship between the size of current account deficits and the growth in the net foreign debt/GDP ratio. These include the growth rate of the economy and the (real or nominal) interest rate on debt obligations. Faster economic growth allows a country to maintain high levels of current account deficits longer, because higher levels of net foreign debt can be accumulated without the debt-to-GDP ratio rising. The service on the debt is lower if the interest rate on debt obligations is lower or if a higher share of the debt is in the form of equity obligations (which have contractual service requirements that are less strict than bank debt). This allows higher levels of current account deficits to be maintained with lower total growth in the net foreign debt/GDP ratio. In addition, the more a country can borrow in its own currency, the less vulnerable the country is to exchange rate volatility and the possibility of a climbing debt-to-GDP ratio as a result of a depreciation of its currency.

Once a country's current account deficits and/or net foreign debt reach a certain size relative to output, investors will have serious concerns that the country's currency or asset markets will crash. At this point, both domestic and foreign investors may move investments out of the country, and the shift usually happens quickly. Once these processes begin to operate, separately or in combination, the current account deficit and the net international investment position are no longer sustainable.

Current Account Projections. To bring focus to these questions, a projection ten years into the future has been constructed. Its results are portrayed in the following figures. Figure 4.2 shows the U.S. current account and the "primary" balance of payments⁴ from 1970 until the second quarter of 2000, expressed as percentages of GDP.⁵ For the following ten years, 2000-2010, it has been assumed, in line with the projections made by the Congressional Budget Office in July, that the growth of GDP slows down to about 2.7 percent per year, while world trade continues to recover. As a consequence, the deterioration in the primary balance almost ceases after the third quarter of 2000.⁶

⁴ The primary balance is defined as the current account balance - less net interest and other property income.

⁵ It would be more accurate to present the analysis in Figures 4.2 and 4.3 as a range of projections based on alternative sets of assumption. These figures present simplified forecasts that reflect moderate, generally acceptable assumptions for key parameters, such as interest and growth rates for the economy.

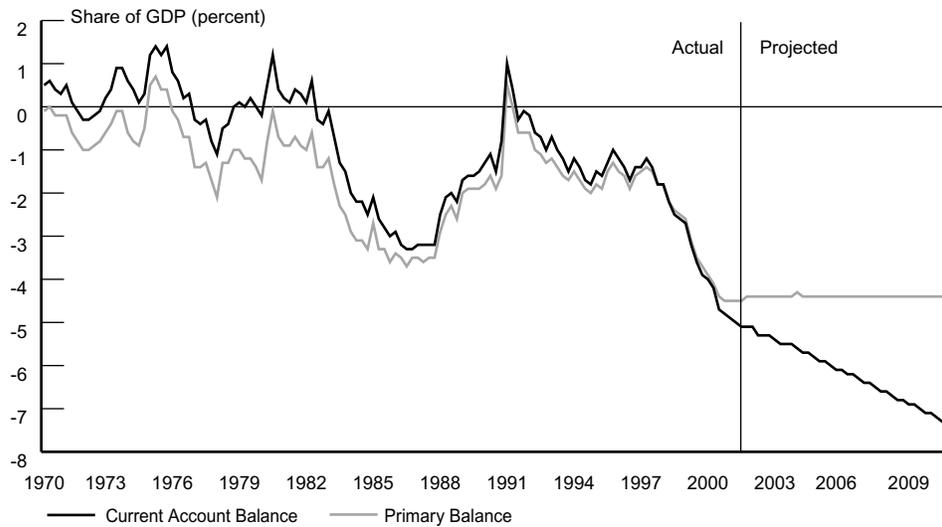
⁶ The charts, projections, and analysis in this section of the report were prepared by Wynne Godley of the Levy Institute, and are based on models developed in Wynne Godley and William Milberg, "U.S. Trade Deficits: The Recovery's Dark Side," *Challenge* (November-December 1994), pp. 40 - 47, and Godley, *A Critical Imbalance*.

Yet even if the deterioration in the primary deficit were to quickly slow in this way, the current account as a whole would continue to deteriorate, perhaps quite rapidly. The reason is that there will be a rapid increase in net payments for interest and other property income from the United States to foreigners (as reflected in the growing gap between the current account and the primary balance in Figure 4.2). This is the ticking time bomb in the current account. U.S. officials may have a false sense of security because, although the net asset position of the U.S. turned negative in 1982, the net flow of property income remained positive until 1998, and since then the outflow has been extremely small; in the first half of 2000, the net outflow was 0.1 percent to 0.2 percent of GDP, although the net asset position was negative in the amount of almost 16 percent.

Figure 4.2

U.S. Current Account and Primary Balance, 1970 Projected to 2009

(current account less net interest and other income payments to foreigners)



Source: These projections were prepared by Wynne Godley of the Levy Institute and are based on models developed in Godley, *A Critical Imbalance*

There are two major reasons why the outflow has been held in check so far. First, the measured return on foreign direct investment in the United States has been far lower than the return on U.S. direct investment abroad - although this gap has recently been narrowing (see Chapter 2).⁷ It is this gap that explains why overall the net income flow remained positive for years after the net asset position turned negative. A second reason why the net outflow has risen so little is that nominal interest rates, which have a large effect on the income that is earned and paid on "financial assets" - that is, all assets and liabilities other than direct investments - have fallen since 1988, when the United States first became a "debtor."

But there are grounds for supposing that the U.S. net indebtedness, if it continues to grow by an amount at least equal to 4.5 percent of GDP a year (that is, by an amount equal to the deficit in

⁷ This gap may be partially explained by the use of transfer pricing schemes by firms trading with their overseas affiliates. By charging a high price for their imports to the United States, and a low price for their exports from the United States, the exporting firm is able to minimize accounting profits in the United States, which allows them to limit or completely avoid U.S. liability for corporate income taxes.

the current account), will generate a significant and growing net outflow of property income and interest from now on.⁸

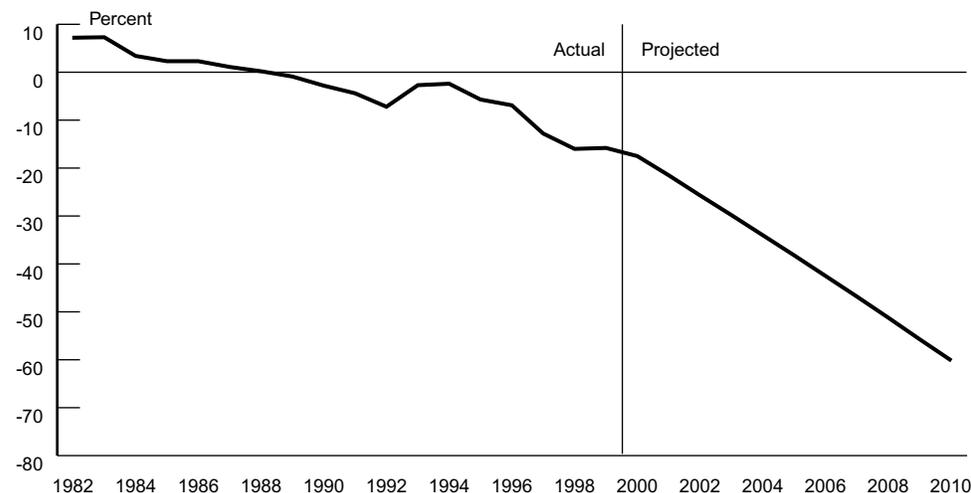
The projections illustrated in Figure 4.2 assume that the bulk of the addition to net indebtedness, in the future as in the past, takes the form of net foreign acquisition of U.S. financial instruments. As a consequence, the net rate of return on the U.S. debt converges slowly toward the rate payable on financial liabilities - here assumed to be 5.5 percent.⁹

These assumptions imply, as Figures 4.2 and 4.3 show, a current account deficit rising to about 7.5 percent of GDP in 2010, with a total "debt" rising to about 60 percent of GDP. Moreover, there is nothing in sight to stop these adverse trends from continuing relentlessly into the more distant future. If higher interest rates had been assumed, the current account and net financial income deficits would obviously grow much more rapidly.¹⁰

These projections are not forecasts. On the contrary, these projections illustrate a situation that, while only remotely likely to begin with, should not be allowed to happen. There are three major grounds for this assertion.

Figure 4.3

U.S. Net Foreign Asset Position, Actual and Projected, 1982-2010
(as a share of GDP)



Source: These projections were prepared by Wynne Godley of the Levy Institute and are based on models developed in Godley, *A Critical Imbalance*

⁸ We are taking existing measurement conventions at face value, as they are probably sufficiently meaningful to support our main conclusions. However, it should be noted that grave difficulties could arise concerning the measurement of international income flows. For instance, capital gains are not considered part of income in the official accounts, although investors in equities obviously expect a large proportion of their receipts to take this form. This is one reason why the official measure of the net income outflow will, in normal times, be an underestimate for a "debtor" country. The practice of transfer pricing, though not proved to take place, could also affect the measured net flow of property income.

⁹ These projections use similar assumptions and reach similar results as Catherine Mann, *Is the U.S. Trade Deficit Sustainable*, but the baseline data have been updated to reflect the most recent data and statistical revisions available in late summer 2000.

¹⁰ In their paper, Obstfeld and Rogoff, "Perspectives on OECD Economic Integration," observe correctly that if the current account were to remain a constant 4.5 percent of GDP, the "debt" would stabilize at about 80 percent of GDP. However, their assumption that the current account stabilizes at this level implies that the primary balance improves by an amount equal to 8 percent of GDP or more, moving from its present deficit of 4 percent to a surplus of roughly equivalent size, this being the only way the United States could pay interest on its debt at the rates of interest that they assume. As we argue below, such an improvement in the primary balance is a mountain which, by hook or by crook, would have to be painfully climbed if net U.S. debt is going to be stabilized at 80 percent of GDP; the adjustments required will certainly not happen automatically.

First, a current account deficit of 7 percent to 8 percent of GDP and rising fast would have to be financed by an inflow of foreign capital of equal size. The problems of financing an external deficit are much less immediate than they were in the days of fixed exchange rates, when deficits had to be mainly paid for from finite reserves of gold and foreign exchange. But that is not to say that capital will nowadays flow on any scale whatever, and at low cost, to wherever it is needed. As pointed out by Obstfeld and Rogoff, international capital markets remain more segmented than is commonly supposed, the residents of most countries retaining a considerable preference for investing in their own markets. The fact that the U.S. deficit is now being easily financed when it is "only" 4.5 percent of GDP, at a time when the United States is seen as an exceptionally favorable place to invest, cannot be taken to imply that financial inflows will be forthcoming on any scale whatever and for any length of time. And if it turned out that a 7 percent or 8 percent deficit could be financed, what about a 15 percent or 50 percent deficit? There must be a limit at some point.

It cannot be foreseen when the crunch would come or how it would happen or what its manifestations would be in the domestic economy. The danger is that the dollar would at some stage suffer a large and disorderly decline, that inflationary pressures would develop as a consequence, and that restrictive monetary policy would then bring about an economic downturn. Alternatively, a period of renewed "stagflation" could ensue, with grave consequences for the rest of the world. To get some idea of the size of the required adjustment, recall that the improvement in the deficit in the late 1980s was equal to "only" about 3 percent of GDP, and this followed a depreciation of some 30 percent in the dollar and was accompanied by a stagnation in the economy severe enough to add 2.5 percentage points to the unemployment rate. We do not dissent from the estimate made by Obstfeld and Rogoff that a dollar devaluation as large as 40 percent might be needed to substantially reduce or eliminate a current account deficit that is equal to 4.5 percent of GDP. In addition, any way of eliminating a 4.5 percent current account deficit would require the United States either to increase exports or to reduce the share of GDP taken by imports.

Second, there is a limit to the extent to which a country can become indebted to the rest of the world. Regardless of whether or not it can be financed, a large, persistent, and growing deficit will generate a continuously rising foreign debt, giving rise to growing costs for U.S. residents as a whole in the form of higher interest payments to foreign lenders and investors; as a result, national income (gross national product) must fall relative to what the country is producing (gross domestic product). At the moment, U.S. net foreign debt is causing an insignificant loss of income. If the debt rose to 60 percent of GDP, the loss would probably approach 2.5 percent to 3.0 percent of GDP, as shown in Figure 4.3—quite enough to hurt.

Once again, there has to be a limit to this process. For instance, the debt could not be allowed to rise to 500 percent of GDP, for then the United States would have to pay 25 percent or more of its national income every year in tribute to foreigners. The question is when, not whether, the constraint of indebtedness becomes binding.

Third, the large and growing external debts and deficits depicted in the charts must be considered interdependently with other, domestically generated, stocks and flows of public and private savings and investment. A current account deficit of 7 percent to 8 percent of GDP implies, by the rules of accounting logic, an equivalent deficit in the combined public and private financial balances.¹¹ But the private sector cannot continue to expand its spending relative to income indefinitely in the long term, and, if it did so, the U.S. private sector would be accumulating debt on an inconceivably large scale. So the current account deficits depicted in the chart could not, in practice, occur unless the government's finances were to move into substantial deficit again—and on an increasing scale. With the balance of payments extracting such large and growing sums from the circular flow of income, real growth could only be maintained at the rates assumed in the charts if the government were to resort, once again, to deficit finance.

Further evidence on sources of instability in the United States

Empirical analysis can be used to yield sustainability benchmarks for the ratios of net foreign debt or current account deficits to GDP – that is, to determine the values of these ratios at which investor sentiment changes and the trajectory for the current account becomes unsustainable. Because countries differ in their prospects for growth and the composition of their debt and because global economic conditions are relevant to the sustainability of current account deficits, these factors must be considered in using sustainability benchmarks derived from empirical research.

In a careful analysis by Catherine Mann of the Institute of International Economics, data from the 1980s and 1990s for ten industrial countries was used to find a sustainability benchmark for the current account deficit.¹² Examining seventeen episodes of current account reversals for these countries, an average current account/GDP ratio of –4.2 percent was found at which the current account began to narrow. To assess the sustainability of the U.S. current account now and in the future, Mann then used several scenarios to project the size of the current account and the net foreign debt for the United States in three different future points in time.¹³ Table 4.1 shows the estimates arrived at in this analysis; in the two later time periods, two scenarios forecast by the OECD for U.S. and world economic growth are presented. The "high performance" scenario sees higher growth in the United States (2.7 percent) and worldwide (5 percent), while the "business as usual" scenario assumes relatively low growth in the United States (2.1 percent) and worldwide (3.2 percent). The results shown in Table 4.1 assume no change in the value of the dollar or in U.S. export or import elasticities over the period.

¹¹ See Chapter 2, Box 2.2.

¹² From Mann, *Is the U.S. Trade Deficit Sustainable?* Chapter 10. The countries used in the analysis are Australia, Canada, Finland, Italy, Norway, New Zealand, Spain, Sweden, the United Kingdom, and the United States.

¹³ The equations that make up the analytical framework and the assumptions for key parameters such as trade elasticities and economic growth rates can be found in Chapter 10 of Mann's book.

Table 4.1
U.S. Net International Investment Positions, 1960-99

	Medium horizon: 2005			Long horizon: 2010	
	Near Horizon 2000	High Performance	Business as usual	High Performance	Business as usual
Trade balance, \$billions	-248.5	-432.7	-463	-730.7	-796.7
Current account, \$billions	-316.6	-583.3	-616	-1,030.0	-1,108.5
Current account/GDP, percentage	-3.4%	-5.0%	-5.4%	-7.0%	-8.0%
Net foreign debt, \$billions	-2,020.4	-43,440.3	-4,440.3	-8,514.3	-8,903.0
Net foreign debt/GDP, percentage "	-21.8%	-37.3%	-39.2%	-58.0%	-64.2%

*From Catherine Mann, Is the U.S. Trade Deficit Sustainable?
(Washington, D.C.: Institute for International Economics, 1999), Chapter 10*

Mann forecasts that the U.S. current account deficit will pass the average sustainability benchmark of -4.2 percent for other industrial countries within the next two years, as shown in Table 4.1. In fact, the United States exceeded this benchmark in the second quarter of 2000; the current account deficit reached 4.3 percent of GDP.¹⁴ Given the special role of the United States in the world economy and the composition of the U.S. debt, Mann claims that it is likely that the sustainability benchmark for the United States is higher than the -4.2 percent average turning point for other countries. If her analysis is correct, this suggests that the U.S. current account trajectory can be sustained until only perhaps 2005. However, Mann's forecast for the 2000 current account (-3.4 percent of GDP) is now well below actual levels in the second quarter of this year (-4.3 percent of GDP). It seems, therefore, that the U.S. current account is sustainable for only another year or two, according to her analysis.

Escalating foreign debt-to-GDP must eventually lead to a correction (this is obvious because, in the extreme case, the foreign debt could not be allowed to grow to the point at which the entire GDP is taken up by payments abroad to service the debt). Under the conditions of a debt trap, when real interest rates exceed the economy's growth rate, a country needs to achieve a surplus in its trade account balance if the debt is not to explode, as projections developed in the previous section show for the United States. When the level of net foreign debt is high, this movement from deficit to surplus may need to take place rapidly to keep the debt-to-GDP ratio from soaring to heights that would cause sharp and chaotic contractions in economic activity.

¹⁴ Bureau of Economic Analysis, U.S. International Transactions Press Release, September 13, 2000. Estimate for 2000 reflects the effects of continuing growth in the U.S. trade deficit through July, according to the U.S. Census Bureau, FT 900 – U.S. International Trade In Goods and Services (Washington, D.C.: U.S. Bureau of the Census, September 20, 2000).

It is possible that the real interest rate on U.S. foreign debt may soon come to exceed the economy's growth rate, placing the United States in a debt trap situation.¹⁵ Given the large size of the U.S. net foreign debt, if the United States finds itself in this position, the current account deficit would eventually become unsustainable. The necessary corrective actions would likely need to be drastic and relatively rapid to avoid an exploding debt-to-GDP ratio. Escaping the debt trap and the exploding size of foreign debt and income payments to foreigners would require the United States to achieve a surplus in its current account balance. While it may be possible for the United States to narrow its current account deficit in a relatively orderly way, moving from today's high levels of deficit to a current account surplus would require a very painful period of retrenchment. To avoid the painful correction needed to overcome a possible debt trap, it is essential to address the challenge of bringing down the levels of America's consistent current account deficits. Policy proposals for reducing the U.S. trade deficit are discussed in Chapter 6.

How hard a landing for the dollar and for the U.S. economy?

If U.S. current account deficits do become unsustainable, and there is a loss of confidence in the U.S. economy by foreign investors in the near or medium term, the question remains whether the result will be a "hard landing" or a "soft landing" for the dollar.¹⁶ One factor that militates against a hard landing for the dollar, if the current account reaches into unsustainable territory, is that, unlike in Mexico in 1994 and various Asian countries in 1997-98, the U.S. dollar has a floating exchange rate. The countries that underwent currency crises over the past several years all had some form of pegged or fixed exchange rate. Especially in the original crisis countries (Mexico and Thailand), the governments spent billions of dollars of hard currency reserves in failed efforts to defend their pegs and then had to devalue sharply when they were virtually out of reserves. The EU countries that experienced financial crises in the 1990s were also attempting to maintain their currencies within bounds established by the European Exchange Rate Mechanism that was in use during this period.

Since the dollar has no official target value that the U.S. monetary authorities (the Treasury Department and the Federal Reserve) are obligated to uphold, it is possible that the dollar could decline gradually. In an optimistic scenario, this could engender a soft landing for the economy by restoring the competitiveness of U.S.-traded goods. This increased competitiveness would help lower the trade deficit and reduce the rate of increase in net foreign debt.

A soft landing scenario, following a loss of investor confidence in the U.S. dollar, is not likely to occur unless serious steps are taken to reduce the trade deficit. The possibility of a dramatic reversal in confidence in the U.S. economy cannot be ruled out, especially in the case of a sudden fall in prices in the stock market (which many analysts consider to be an asset bubble that

¹⁵ See Wynne Godley, "Interim Report: Notes on the U.S. Trade and Balance of Payments Deficits" (Annandale-on-Hudson, New York: The Jerome Levy Institute, 1999).

¹⁶ This section draws heavily upon Robert A. Blecker, *The Ticking Debt Bomb: Why the U.S. International Financial Position Is Not Sustainable*, Briefing Paper (Washington, D.C.: Economic Policy Institute, June 1999).]

will eventually burst). Moreover, floating exchange rates do not always depreciate gradually but instead often collapse abruptly – as the dollar did in 1985-87 and numerous other currencies have since. If expectations of dollar depreciation do arise, investors could panic and try to sell off massive amounts of U.S. assets in a hurry, precipitating a sharp decline in the dollar's value.

Another factor often cited as precluding an Asian or Latin American-style crisis for the United States is the fact that this country can do so much of its borrowing in its own currency. The United States does not have to worry about having adequate international currency or export revenues to service its debts. If necessary, the Federal Reserve could even print more dollars to ensure adequate liquidity for debt service. Furthermore, the fact that the United States can service its debt in dollars means that dollar depreciation would not force the United States to devote an increasing proportion of its national income toward servicing its debts.

It is true that being able to borrow in its own currency can make it easier for the United States to service its foreign debt than other countries. But being able to borrow in dollars does not completely insulate the U.S. economy from the possibility of currency collapse or other adverse consequences stemming from loss of investor confidence in response to mounting current account deficits. The world's willingness to lend to the United States in dollars is predicated on the expectation that the dollar will maintain its value. If there is a loss of confidence in either the United States as an investment location or in the value of the dollar, foreigners may be unwilling to continue to lend to the United States in dollars. In addition, the Federal Reserve is likely to be very reluctant to print dollars to satisfy external obligations. Increasing the dollar money supply to facilitate external debt service would be viewed as inflationary and so to be avoided. Moreover, inflating away external debts would be likely to engender a loss of confidence in the value of the dollar that the Fed would be trying to avoid. In the long run, taking advantage of this kind of strategy would be likely to lead to the loss of the dollar's preeminent role in the international monetary system. In short, unlike other countries that are freer to let their currencies depreciate to improve their balance of payments and competitiveness, the United States cannot allow the dollar to depreciate too much if it wants to preserve the role of the dollar as the world's dominant currency.

Even if the United States succeeds in avoiding a hard landing for the dollar, it may not be able to avoid one for the real economy. If the dollar begins to fall and the government wants to prevent a rapid collapse in its value, the most likely response would be an increase in interest rates by the Federal Reserve. However, in a crisis, the Fed should not raise interest rates significantly, since the deficit is a very small international tail wagging a very big economic dog. High interest rates would be likely to slow or contract the economy. Increased interest rates would also make indebted firms, banks, and households more vulnerable to bankruptcy as well as raise the net outflows of interest payments to foreign creditors, worsening the current account deficit.

If the willingness of foreign investors to continue lending to the United States drops off sharply, the prospects for ongoing prosperity in the United States may be seriously threatened. If the United States were forced by the withdrawal of net foreign lending to balance its current account very quickly, a very large fall in national income would be needed to reduce the volume of imports to narrow the deficit, even if the dollar was allowed to fall substantially. The decline in the dollar could result in an inflationary shock (due to the dollar's depreciation) and a serious economic recession (due to the income adjustment to reduce import demand). However, if foreign suppliers price to the market, as they have in recent years, even a big fall in the value of the dollar might lead to only small amounts of inflation. Note, for example, that the prices of imported cars have not fallen much in the past four years, despite the 23 percent appreciation in the dollar.

In addition, an economic downturn in the United States would be likely to trigger an economic depression in the rest of the world. A run on the dollar could cause more damage in the rest of the world than in the United States. The rest of the world would lose millions of jobs, more than in the United States, because their average labor productivity levels are lower. If we could not afford imported cars, U.S. automakers could expand their production here very quickly (by adding third shifts to plants, for example). For example, it takes between \$85 billion and \$90 billion dollars in exports or import-competing goods to create one million jobs in the United States. In most poor developing countries, this same amount of exports could create at least eight million to ten million jobs, and probably many more. Thus, the employment impacts of a sharp decline in U.S. imports would be much larger in the rest of the world than in the United States.

Many other countries around the world are particularly vulnerable to a recession or decline in the demand for imports from the United States. For example, Europe and Japan have been mired in recessions or persistently low growth rates for most of the 1990s. A sharp decline in exports to the United States could easily tip these countries into another downturn. A global recession is not out of the question if a financial crisis hits the United States.

As suggested in the last section, the keys to avoiding the movement of America's current account balance into unsustainable territory and making a soft landing more likely are a gradual drop in the value of the dollar, improvements in the access of U.S. goods and services to foreign markets, and higher economic growth rates among our trading partners.

IV. Rising Payments on the U.S. debt

As America's debtor position grows, the interest, profits, and dividend payments to creditors and stockholders abroad grow as well. In spite of the U.S. turn to an overall net debtor position in the late 1980s, total net investment income remained positive in the early 1990s, because the rate of return on direct investment (in which the United States has a net creditor position) exceeded the rate of return on financial investments (in which the United States is a net debtor).¹⁷

¹⁷ Data on international income payments from Bureau of Economic Analysis, U.S. Department of Commerce.

By 1998, however, the huge growth in net financial debt had come to overwhelm the differences in rates of return so that the net investment income position had become negative.

From a net investment income deficit of \$13.1 billion in 1999, net payments to foreign creditors are expected to rise to several hundred billion dollars by 2005, even assuming relatively modest increases in interest rates and the size of the current account deficit.¹⁸ The deficit in investment income will significantly worsen the overall current account balance, on top of the deficit in trade in goods and services and net transfers.¹⁹ The component of the current account imbalance made up by these payments on the U.S. foreign debt is likely to approach the size of the goods and services deficit in the next few years unless deficits are significantly narrowed.

Financing the large net investment income payments being forecast for the next few years would put a serious squeeze on U.S. incomes just as large debt burdens have done to incomes in many nations in the developing world. As U.S. international debt rises, an increasing fraction of our gross income is paid to foreign owners of U.S. assets. Within a few years, net investment income payments may require sending as much as 2 percent to 4 percent of U.S. GDP abroad to foreign creditors each year to service growing debt levels.

V. Foreign debt and U.S. influence abroad

As the level of U.S. debt has grown, U.S. strategic and policy influence around the world becomes increasingly vulnerable to foreign threats to withhold credit or launch speculative attacks on the dollar. According to Dr. Ernest Preeg's testimony to the Commission, as U.S. current account deficits have grown over the past decade, foreign central banks have come to hold well over a trillion dollars in their official reserves.²⁰ (As discussed in Chapter 2 of this report, some of this buildup in dollar reserves by foreign central banks is the result of mercantilist-oriented exchange rate policies by these governments aimed at keeping the value of the dollar high to boost the competitiveness of their exports.) One result of these large official dollar purchases, as Dr. Preeg emphasized, is that other governments now have greater potential political leverage against the United States in terms of how they use, or threaten to use, their enlarged dollar holdings. Others argue that other governments holding U.S. assets does not give them leverage, because they would lose more than we would if they tried to use that leverage. But those countries may believe that holding U.S. assets gives them leverage, and do something ill conceived. Some experts believe that China thinks that it has such leverage now because of its large dollar holdings.

A new development that facilitates the use of official reserves for political or economic leverage is the introduction of the euro as a currency. The euro immediately joined the dollar as a key currency in the international economy along with the yen. The option of switching their reserves

¹⁸ This figure is the sum of net payments on financial investments and on FDI for the United States. Source: Bureau of Economic Analysis, Current period data for Tables 1 through 10 of the International Transactions Accounts (as of September 13, 2000), web page: <http://www.bea.doc.gov/bea/di1.htm>. For forecasts of future net financial payments see, for instance, the forecasts for the investment income deficit presented to the Commission in the statements by Professor Robert Blecker of American University on August 19, 1999; Dr. Ernest Preeg of the Hudson Institute on September 9, 1999; and Dr. Wynne Godley at the Levy Institute at the December 10, 1999, hearing.

¹⁹ Net transfers are flows of funds that are unrequited, such as foreign aid and private remittances (e.g., funds sent to relatives overseas by immigrants).

²⁰ See testimony of Dr. Ernest Preeg of the Hudson Institute at the September 19, 1999 hearing.

from dollars into euros²¹ gives governments that hold large amounts of dollars (for example, Japan or China) a more credible threat to undermine the value of the U.S. currency and cause economic disruption.²² The threat of selling off dollars to gain leverage over U.S. actions would become even more powerful if the United States comes to face a "hard landing" -- a falling dollar, rising interest rates, and increased unemployment. In this situation, one government's threat to switch its sizeable reserves of dollars and into euros or yen could set off a flight from dollar reserves among other central banks and private investors, exacerbating the economic crisis in the United States.

Foreign governments may be wary of dumping dollars, because the resulting appreciation of their currencies would hurt their current account positions. The risks are greater with private sector holdings of liquid U.S. assets. Private parties can dump them and pick up foreign stocks and protect their investments from exchange risk if they get out early, hence the incentive for herd-type movements. Private investment in the stock market has grown rapidly in recent years, and government purchases of U.S. financial instruments have declined. Hence, the threat of a "private race for the exits" has increased in U.S. markets.

Conclusion

Large and growing current account deficits have turned the United States from the world's largest creditor as recently as the early 1980s into the world's largest debtor nation, with an accumulated net foreign debt of more than \$1.5 trillion this year. Most projections see U.S. current account deficits and net international debt continuing to grow rapidly over the next five to ten years.

We believe that a continuation of the present current account deficit – let alone a larger one – will have consequences that will require that the deficit absolutely must be reduced at some point. Moreover, the longer we avoid implementing such measures, and the deeper the United States gets into debt, the larger and more costly those policies will ultimately have to be. While a spontaneous recovery cannot be ruled out, policymakers are strongly advised to develop contingency plans and procedures that can be put in place if a financial crisis develops in this country. Policymakers must address the risk of a "hard landing" that quickly reduces U.S. current account deficits, but at huge costs to the economy, in order to ensure the continued prosperity of the United States and to reduce the risk of a global financial crisis

Projections of the current account deficit were developed that showed that it could rise to 7.5 percent of GDP by 2010, from 4.3 percent today, even if the balance of trade on goods and services stabilizes in the near future. The net U.S. investment deficit could rise to nearly 60 percent of GDP under these same assumptions. As a result, the U.S. deficit on net investment income, which is a trivial share of GDP today, could rise rapidly in the future, adding substantial-

²¹ Some have pointed out that given the recent weakness of the euro, it may not be an attractive option for countries or investors looking for a safe haven. However, despite its recent problems, the euro could recover quickly. Note, for example, the recent swings in the value of the Japanese yen, which appreciated from 146 in August 1998 to 107 in September 2000, a 36 percent gain.

²² As an example of the potential influence of foreign governments holding large dollar reserves, in June 1997, Japanese Prime Minister Ryutaro Hashimoto commented about "the temptation to sell off U.S. Treasury bills," and the Dow plunged 192 points. Mr. Hashimoto backed off from carrying out this action, and the market recovered.

ly to our current account problems, and would require us to export even more or import even less in order to balance the current account. At some point in the next ten years, we are increasingly likely to encounter limits on our ability to borrow abroad in order to finance the U.S. trade deficit. These projections are confirmed in a number of other studies reviewed in this chapter.

We also explored in this chapter the potential threat to the United States from a hard landing, should one occur. If foreign investors cut back sharply on their lending to the United States, then our prosperity could be seriously threatened. A sharp decline in U.S. income would be required to reduce our demand for imports over a brief period of time. Furthermore, if the United States did experience an economic crisis of this type, it would probably have a large impact on many other countries around the world, especially those that are heavily dependent on exports to the United States.

Finally, we explored the influence of our growing foreign debts on our status and influence around the world. While these debts are not likely to give foreign investors much power over the U.S. economy (where else could they go?) it could change perceptions of the United States around the world, which could cause unpredictable changes in our relations with other countries.

