Chapter 4

Are large trade and current account deficits sustainable?

Two Differing Views on the Sustainability of the Trade Deficits

Democratic and Republican Commissioners hold differing views on whether the trade and current account deficits can be sustained over time.

In the view of the Republican Commissioners, (page 137) the trade deficit, relative to GDP, cannot continue to increase without end. At some point the situation will reverse itself. No one can know with certainty when or how this will happen. However, the fundamental strength and flexibility of the U.S. economy, the attractiveness of the United States as a destination for foreign investment, along with the ability of the U.S. economy and financial markets to adjust to changing circumstances, leads us to conclude that at some point in the future the trade deficits will most likely come down in an orderly way without significant disruption to the U.S. economy. This is what happened in the 1980s, the last time that the United States ran such large trade and current account deficits. A disruptive end, with adverse effects throughout the economy, cannot be totally dismissed but is highly unlikely. What risks are caused by the trade and current account deficits are associated with potentially diminished ability to use monetary policy to respond to a future domestic economic downturn—and these risks can best be addressed by increasing national saving. Increased national saving would better enable the U.S. economy to sustain growing incomes and productive investment.

In the view of the Democratic Commissioners, (page 145) the United States cannot escape the economic reality that our economy has become critically dependent on the influx of foreign borrowing. If present trends continue, this is likely to lead to lower growth rates and possibly to a significant depreciation of the dollar. In addition, the repayment of the various obligations representing this influx will steadily consume ever-greater portions of our national economic output. It is no more fiscally prudent now to run ever-increasing trade deficits than it was in the past to run ever-increasing budget deficits.

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The trade and current account deficits have turned the United States from the world's largest creditor into the world's largest debtor nation, with a foreign debt of about $1.5 trillion, about 16 percent of GDP. The trade deficit reached 3.6 percent of GDP in the second quarter of 2000. The deficit in manufacturing was an even larger 3.9 percent of GDP (since the United States has a services surplus). The overall current account deficit was 4.3 percent in the most recent period, the highest level in the post war era. Most projections of U.S. and international activity foresee U.S. current account deficits and the net international indebtedness will grow rapidly over the next five to ten years.

If the current account deficit continues to grow, at some point in the near future we are likely to reach the limit of our ability to borrow abroad in order to finance trade deficits. This could force the United States to reduce the deficit quickly and risk a "hard landing," or abrupt correction, with the clear possibility of triggering a recession. This would have enormous repercussions not only for the United States, but also for the world economy.

Some of the key findings in this chapter include the following:

- Projections indicate that the current account deficit could reach 7.5 percent of GDP by 2010, from 4.3 percent today, even if the trade deficit does not deteriorate further. Net U.S. foreign debt (now 16 percent of GDP) could grow to nearly 60 percent of GDP by 2010.

- This large and growing U.S. foreign debt has an influence on the status and authority of the United States around the world, with uncertain consequences. Investors may develop doubts about the continued strength of the dollar and quickly shift investments to other markets.

- Impacts on the U.S. stock market, the strength of the dollar, interest rates, and inflation, if not controlled, could be adverse to our continued high level of prosperity.

- There are no guarantees that this process will unfold in an orderly way, without careful contingency planning, and the history of market psychology gives little comfort that a "soft landing" is the probable outcome.

- There is an additional danger that should be addressed in the increase in the net flow of interest and other property income paid to foreigners on U.S. investments.
  In 1999, the United States paid foreigners a net –0.2 percent of its GDP for interest and other property income foreigners held in the United States. Even if the trade deficit begins to improve, our net foreign debt will likely continue to grow and therefore the net flow of interest and property payments abroad will continue.

For these reasons, we strongly advise policymakers to develop contingency plans that can be implemented if a crisis develops to ensure stable financial markets and continued economic prosperity.