

The US Current Account Deficit and its Global Ramifications

The World Economic Forum's Chief Economist

AUGUSTO LOPEZ-CLAROS talks with
RICHARD COOPER and **KENNETH ROGOFF**,
both Harvard University

ALC: One of the reasons I want to discuss this issue with both of you is because—as you have seen in the program in Davos this year—there is keen interest in global imbalances. Larry Summers highlighted these as one of the most important threats to global prosperity. Richard, you made the point in Paris last July that a large US current account deficit could continue for quite a while, as long as the US economy is continuing to offer attractive financial assets.

Cooper: The startlingly large US current account deficit is not only sustainable but a natural feature of today's highly globalized economy. This does not mean that there are no problems with the current state of affairs. Rather, events need to be interpreted in light of the evolution of the US and world economies in recent years, putting the global imbalances in a different perspective.

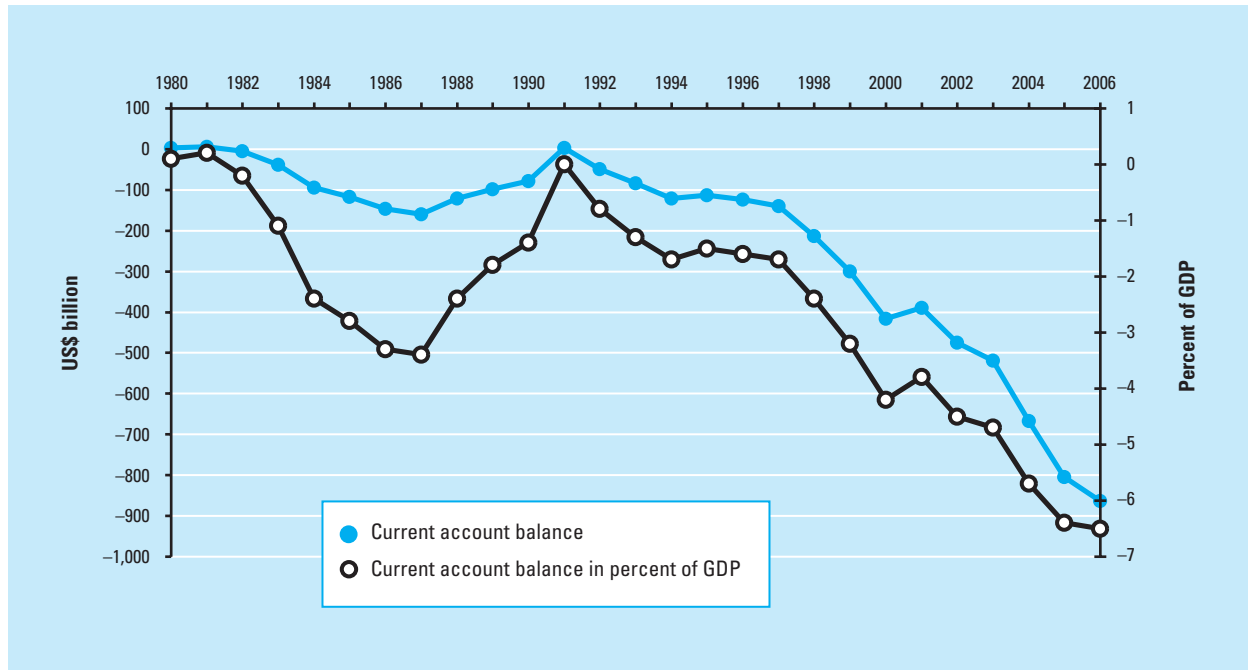
The US current account deficit reached an extraordinary US\$660 billion in 2004, up from US\$520 billion in 2003 and US\$475 billion in 2002. This is not only very large because the United States is a large economy but, at 6.4 percent of GDP in 2005, it is even large relative to the size of the economy, so it has become a dominant feature of the world economy that naturally, and understandably, attracts attention. But just because something is new and big and unprecedented does not mean it is unsustainable. Many contend that it must come down, and that if it is not brought down carefully and deliberately, it will precipitate a financial collapse of the dollar and probably a world recession. Most analysts focus on the linkages of the deficit to the US economy, and on the need to raise national savings, or alternatively (but not equivalently) on the need for a substantial depreciation of the dollar against other leading currencies.

ALC: Is low private savings in the United States the real culprit and, more generally, what can be done about this? Is there a role for fiscal policy?

Rogoff: Gross investment—including investment in housing, which accounted for about one-third of the total, and modest investment by governments—accounted for nearly 20 percent of GDP, significantly up from the recession lows of 2001–2002 but low by international standards.

Private saving in the United States of 15 percent in 2004 includes not just the often-cited household saving, below 2 percent of personal income, but also corporate saving. However, this measurement of saving takes the national accounts as they come. In an information-, knowledge-based economy, one needs to take a broader view of saving.

In the United States, expenditures for consumer durables, education, and R&D taken together have amounted to about 19 percent of GDP in recent years.

Figure 1: The United States: Current account balance (US\$ billion and percent of GDP)

Source: International Monetary Fund, 2006.

When added to the 15 percent from the national accounts, Americans save a third of GDP, properly measured. Furthermore, Americans in general have confidence in their future. In particular, they are confident, thanks to continuing technological change, that their grandchildren will be materially much better off than they are, just as they are materially much better off than their grandparents were. It is not surprising, then, that diverse government measures to increase private savings over the years have shown meager success: Americans are aware that they save quite enough. Moreover, a given amount of saving has resulted in greater real investment in recent years as the price of capital goods has fallen. From an individual's point of view, although not from a social perspective, increases in the relative prices of houses represent effective saving, particularly with a capital market that permits mobilization of home values in retirement. Finally, the market sensibly values the intangible assets of firms more

“The growth dynamic in a knowledge-based economy comes from teams of people creating new goods and services, not from the accumulation of physical capital.”

highly than the tangible assets. The growth dynamic in a knowledge-based economy comes from teams of people creating new goods and services, not from the accumulation of physical capital. Of course, the corrections to saving suggested above apply to all countries, not just to the United States, but their contribution to total savings is higher in the United States than in most other countries.

If private saving cannot be increased, what about public saving? The United States ran substantial budget surpluses in the late 1990s. At the federal level, these became deficits with the recession of 2001–02, the stock market collapse, and the tax reductions of 2001 and 2003. State and local governments normally run surpluses. The federal deficit came to 4.1 percent of GDP during 2005. It is projected to decline slowly in the coming years, provided government expenditure is not allowed to expand unduly and the temporary tax cuts of 2001 and 2003 are not made permanent. So there is at least a prospect for some decline in public dissaving, and this could be accelerated through deliberate fiscal action.

Rogoff: A restoration of normal interest rate levels will help, of course, by encouraging savings and, more directly, by capping house price increases that have fuelled a mortgage refinancing and borrowing cycle. It would also help if the government were to reduce its own deficit. Ultimately, the United States should save more, but how

are we going to deal with the short-term adjustment problems? More flexibility would help, but I doubt that we are going to see more flexibility in the very near future.

ALC: What are some of the factors which have turned the “global imbalances” issue into a world problem, with international ramifications?

Cooper: Simple arithmetic tells us that the US deficit must have exactly matching surpluses in the rest of the world. It will not be possible to reduce the US deficit without other countries reducing their surpluses, or increasing their deficits, through some combination of increased investment and/or a reduction in savings. Rich countries with the largest surpluses are Japan, Germany, Switzerland, Netherlands, Sweden, and Singapore, and now Russia, China, and the members of the Organization of Petroleum-Exporting Countries (OPEC), thanks to high oil prices during 2004 and thereafter. The surpluses of Japan and Germany alone equaled nearly half the US deficit and even exceeded half, if those of Switzerland and the Netherlands, two economies closely linked to Germany, are included.

What explains these large surpluses and how will this affect investment? The answer I give—by no means the whole story, but one that probably hasn’t received the attention it deserves— is rapidly aging, high-saving populations, as people live longer and birth rates have collapsed. This applies especially to Korea, Japan, Italy and Germany. The result is that new entry into the labor force is declining from year to year. This group aged 18 to 26 is also the most educated and most mobile part of the labor force, both geographically and occupationally. This trend already hit Japan some years ago, is now visible in Germany, and, believe it or not, in China. So those countries will lose flexibility in the labor force, and, sooner or later, suffer a diminishing investment demand over time as the need for capital to equip the labor force drops. Low birth rates and low new-household formation will also lead to lower demand for housing, which, as many people are unaware, is a very important component of investment. It makes up about one quarter of investment in most economies, and as much as a third in the United States because of its exceptional mobility. Meanwhile, rates of return on industrial investment are low and, of course, sensitive to what is happening in the export and import competing sectors. To sum up, this means a declining demand for housing, a declining demand for new equipment, and a loss of flexibility in the cutting edge of the labor force. I think this is the underlying reason for the very low returns to capital and a sharp decline in investment that we have been

seeing over the last decade or more in these countries. And this will do little to boost investment in these surplus countries. No doubt, in the long term, savings will fall as aging trends continue in Germany and Japan. But today they remain remarkably high, given their demographic structures. And, finally, aggressive public spending also seems more or less precluded, given the large budget deficits in both Germany and Japan. In other words, there are serious obstacles to significant adjustment in current account imbalances in both Europe and Japan, at least in the short to medium run.

German and Japanese saving is sensitive to perceived economic performance, which in turn is sensitive to export performance. This is important when it comes to correcting the US current account deficit. If the dollar declines significantly, as many analysts suggest it must— leading to significant declines in the export competitiveness of key surplus countries—then we are likely to see an increase, not a reduction, in the propensity to save in those countries, as well as a decline in investment. Whether an increase in the propensity to save gets translated into actual additional savings depends, of course, on what happens to output and income. The conditions just described are those under which a recession in economic activity could occur. An increase in the propensity to save with no obvious vehicle for that savings leads to a fall in output and income. US exports to those countries may fall instead of rising.

I do not see interest rates being an effective adjuster here. With a large appreciation of the currencies of these countries with balance of payments surpluses, the adjuster is more likely to be economic activity. It will decline, except insofar as the authorities become so concerned that they pursue an aggressive stimulative policy.

Excess saving in these big rich countries manifests itself in budget deficits and current account surpluses. Europe and Japan both already have large budget deficits. Further reductions in the long-term interest rate are not likely to produce enough domestic investment to substitute for those two channels, particularly in the face of a decline in competitiveness brought about through large appreciations of their currencies. It is entirely unclear how currency appreciations will produce the large changes in saving and investment required to eliminate, or even greatly reduce, the current account surpluses of rich Asia and Europe. They may even produce the opposite effect.

ALC: To what extent is part of the problem the lack of a sufficiently attractive outlet for excess savings elsewhere in the world, i.e. outside the United States? And is it unreasonable to assume that some savings would, in any event, find their way to the U.S., the global center of technological innovation?

Cooper: Well, that's part two of my argument. It seems to me that whether you are sitting in Sydney, Singapore, Tokyo, Zurich, or Buenos Aires—anywhere really—and looking for places to put your savings, the US economy certainly looks very attractive. As a result, much of the excess saving in the rest of the world comes to the United States. It exceeds investment abroad by Americans and accounts for the large current account deficit of the United States. Why does this saving come to the United States rather than going to emerging markets, where returns should be expected to be higher? Emerging markets also have excess saving, and are not only volatile but may be insecure from political or legal action. The United States, in contrast, has investment opportunities that produce higher yields than Japan and Europe, and are both less volatile and more secure than investments in many emerging markets. Moreover, the US economy is large, accounting for a quarter to a third of the world economy. It has especially well-developed financial markets, accounting for half of the world's marketable securities. So, it is not surprising that funds from all around the world are invested in the United States.

“Whether you are sitting in Sydney, Singapore, Tokyo, Zurich, or Buenos Aires and looking for places to put your savings, the US economy certainly looks very attractive.”

Gross world savings outside the United States runs around US\$8 trillion, rising from year to year. In a world with increasingly globalized financial markets, it would not be surprising for savers desire to place 10 or even 15 percent of their savings into the United States, given the characteristics noted above. Yet 10 percent of this saving would amount to US\$800 billion, exceeding the US current account deficit in 2004. Indeed, in that year, an estimated US\$1.1 trillion of foreign private capital came into the United States. Of course, Americans also invest abroad, and any inflows must cover those outflows as well. Still, these numbers suggest that a large US current account deficit could continue for a long time, so long as the American economy is producing attractive financial assets.

“A large US current account deficit could continue for a long time, so long as the American economy is producing attractive financial assets.”

Rogoff: There are other explanations besides Professor Cooper's, although I think that this is probably the best. But there is a really important additional point: US investors hold a much riskier portfolio abroad, with much higher ratio equity, high-yield debt and junk bonds, than partners of the United States which have 60 percent in low-interest yield assets. Professor Cooper's very valid point is that the United States is an exciting opportunity, despite the fact that emerging markets offer clearly better returns than the US stock market over the long run—though of course not by as much as they outperformed in 2005. Indeed, it is more accurate to describe the United States as the world's venture capitalist than as the world's premier investment location. If we look at some numbers, one could argue that maybe because of the US role as a venture capitalist it can expect an average profit of perhaps 150 or 200 billion a year. However, that doesn't explain US\$700 billion dollar trade deficits. The US can run a 2 percent of GDP trade deficit without having to worry, but that doesn't really get us to a 7 percent of GDP trade deficit. I guess Professor Cooper comes to this conclusion by saying that there is a stock adjustment as world portfolios go up. But I think that it is very hard quantitatively to get to this number simply out of portfolio rebalancing.

ALC: So, the US current account deficit will continue to be financed by capital inflows?

Cooper: Only in the accounting sense. When one talks about the need to finance the US deficit, that language seems to me to get the fundamental framework wrong. The motivating force is a desire to invest in the US economy and the dollar. That keeps the dollar strong and that, of course, produces an import surplus in the US. So the dynamic, I think, is from savings to capital movements to the exchange rate and growth to the current account, rather than the other way around.

ALC: Now, what about the role of official capital flows into the US? So much has been said about all those billions of U.S. Treasury Bills piling up in the vaults of emerging market central banks.

Cooper: When private foreign investment slackens, as it did after 2001, foreign official investment often takes up the slack. There has been a huge build-up of foreign exchange reserves in 2003–05, especially in East Asia but also in India and Russia. Budget deficits have reached practical limits in Japan and, at least in principle, are constrained in Germany, France, and Italy. China has been overheating and requires some fiscal tightening, despite large infrastructure needs. That would tend to increase China’s already high saving rate, not reduce it.

Japanese savers have (a) a high savings rate, (b) they’re extraordinarily conservative and (c) many Japanese household savings go to the low-yield, postal savings system. And where do all the savings in Japan’s postal institutions go? They are placed in what the Japanese call the “second budget,” essentially government securities. Japan has been running a big deficit and is basically channeling these savings to buoy up Japan’s large construction industry—what the critics call “building bridges from nowhere to nowhere.” The social return to these “investments” is negligible, so in a social sense the Japanese savers are being cheated, as their savings are being misused. By investing overseas, the Bank of Japan—as agent for the Ministry of Finance—is running the exchange rate risk that risk-averse Japanese households are not willing to run, but which the country needs to run to ensure a higher real rate of return for an aging population. My main complaint about Japan is that its reserves are now so large that it should already have done what Norway, Kuwait, and Singapore did years ago, that is, to divide their reserves into a liquid component for monetary management and an investment account where they could invest abroad in less liquid but higher yield securities. Japan’s overseas investments could produce a real return to the Japanese in the future, which increased Japanese budget deficits will not.

Now Germany is a somewhat different case: private Germans are investing a lot in Central Europe and in Spain. Spain has a construction boom going on. In spite of Spanish demographics, North Europeans are financing Spanish construction for purposes of retirement or second homes. We don’t complain about the large German surplus, and, I dare say, the public debate would be different if Japanese households were also investing abroad on the same scale as their surplus.

That brings me to China, whose surplus is smaller than the other two. The Chinese are very high savers and from a household point of view, they have a very limited menu from which to choose: basically bank accounts and the incipient government bond market. Residents cannot

legally invest abroad without specific authorization. Again, official investment abroad by the People’s Bank of China—some US\$200 billion last year and US\$200 billion the year before—occurs when private investment cannot take place. But latent demand by the Chinese private sector for overseas investment is undoubtedly high.

These are consequences of financial globalization. Capital inflows into the US economy are said to be “financing” the US current account deficit. That is true only in an accounting sense. The motivation for private flows—more controversially for official flows—is investment in the United States. Americans have accommodated this excess saving abroad by importing much more than they export, that is, by “living beyond their means.” Although, as those societies increasingly age, the savings of Japan and Europe will eventually fall, but the current configuration could last for many years.

“If the United States wants to reduce these claims, increase national saving, and encourage greater private investment, it needs to take serious steps to reduce the federal budget deficit.”

These flows are mutually beneficial, as long as the United States generates productive assets for sale to foreigners, and in financial forms that yield less than the underlying investment yields. The problem at present is that the United States is producing high-quality US Treasury securities in abundance. These are attractive to foreign institutions, but they do not support an increase in the productive assets of the United States. Thus, they represent a claim on the future income of Americans. If the United States wants to reduce these claims, increase national saving, and encourage greater private investment, it needs to take serious steps to reduce the federal budget deficit. And these steps must be more serious than simply proposing cuts in expenditure programs with strong congressional and public support.

Rogoff: The situation described by Professor Cooper raises two serious problems. One is that the US deficit still supports high real investment. It doesn’t. To some extent, it also mirrors open-ended government borrowing. Investment in the real economy leads to growth, helping to repay higher debt. Government deficits just lead to higher taxes and lower growth. (Unless, perhaps, the funds are used to invest in high social return public infrastructure projects, unfortunately not the case for the United States today.) Usually, when a big current account deficit

“Usually, when a big current account deficit reflects a big government deficit and low private savings, it is the beginning of the end.”

reflects a big government deficit and low private savings, it is the beginning of the end.

The second problem is the notion that foreigners will continue to be satisfied with the miserable returns they have been getting on dollar investments. For complex reasons, foreigners have consistently earned stunningly low, often negative, returns in America. But this cannot continue. If foreigners don't start earning normal returns, they will retrench. And if returns do rise, US net debt—currently around 25 percent of national income, a record—will start rising even faster.

ALC: So, Richard, will foreigners eventually end up owning all the assets in the United States?

Cooper: The current account deficit represents net foreign purchases of assets in the United States. If the current account deficit continues at US\$600 billion, the ratio of net foreign claims to US GDP—a ratio many economists look at in assessing sustainability—will rise for some years to come, but it reaches a peak of 50 percent (up from 22 percent in 2003). Foreigners will then own more of the US capital stock. But the United States has several layers of financial assets above and beyond the capital stock, i.e., the financial assets that foreigners typically buy, which by now constitute more than three times the capital stock and are still growing. So foreigners would own under 10 percent of US financial assets. The yield on these net claims represent claims on US output, thus reducing the income of Americans relative to what it would be if Americans owned all the assets, but almost certainly leaving American incomes higher than they would have been had the rest of the world made fewer investments in the US economy. Foreign earnings on their US investments will grow over time, so the trade balance must improve in order to maintain a constant current account deficit.

However, the deficit cannot continue to grow indefinitely as a share of GDP. Careful analysts correctly point to the unsustainability of the trajectory of the deficit that they have observed in the recent past and that they project into the future. While the deficit can continue to rise as a percentage of GDP for a while, sooner or later that rise must come to a halt. That valid proposition is an altogether different claim from one that the deficit, even a large deficit, is unsustainable.

A constant share deficit may require some depreciation of the dollar. Foreign earnings on their growing US claims will also grow, and the trade deficit may have to decline to accommodate this. The depreciation of the dollar, in turn, will slow the growth of net foreign claims on the United States, not only by reducing the trade deficit, but also from the fact that most US claims on foreigners are denominated in foreign currency, whereas most foreign claims on the United States are denominated in US dollars. For this reason and others, the change in the net international investment position of the United States is typically much less than the current account deficit.

“A large current account deficit for the United States is likely to continue for some years, a natural consequence of excess saving in the rest of the world, an attractive menu of financial assets from which to choose in the United States, and increased globalization of financial markets.”

In summary, a large current account deficit for the United States is likely to continue for some years, a natural consequence of excess saving in the rest of the world, an attractive menu of financial assets from which to choose in the United States, and increasing globalization of financial markets. The United States has a revealed comparative advantage in producing highly attractive financial claims, to the mutual benefit of foreigners and American alike, as long as Americans invest the proceeds productively. This is not to argue that there will be no financial crisis focused on sharp depreciation of the dollar, as some analysts fear, but such a crisis is far from inevitable and indeed will not arise from a large deficit per se. In particular, it would be a mistake to try to eliminate the current account deficit in the near future or even to try to reduce it to US\$200 to US\$300 billion, as some analysts have proposed.

ALC: Given increased globalization and the impact this is having on the integration of financial markets, the concept of the “current account” may have become fuzzier. Ten years ago, Spanish policymakers worried a great deal about the current account deficit; today, with the country firmly anchored within the EU, it no longer appears on policymakers’ radar. Could this signal a broader trend?

Cooper: I think the answer to that is no, but that's because I think it has always been fuzzy! I have been in this

business now for nearly half a century and the U.S. has allegedly had a balance of payments “problem” every year since 1958, with no exceptions. Now, during much of the early part of that period, the U.S. ran a current account surplus. We didn’t pay much attention to current account surpluses in those days. It is only in the last two decades that we’ve shifted our attention to the current account deficit, now that we’re in that position. So, in the American academic community—and in part of the official and the US financial journalist community—there is a heavy bias in favor of a US balance of payments problem. I have no doubt that if the U.S. were to move into a balance of payment and current account surplus—which I do not expect any time soon—they would find some other formulation to complain about.

ALC: Actually, my question was meant in the sense that if General Motors opens up a plant in Brazil, at one level this reflects a sign of U.S. strength. But, at the same time, it also contributes to a widening of the current account deficit, since the output of these factories is eventually imported back into the U.S. More importantly, there is the bigger issue of the increasing difficulty in distinguishing between current account and capital account transactions.

Cooper: Yes, but let’s not forget that this accumulates over time. The earnings of General Motors on that Brazilian plant also count as a credit in the current account. So you have the debit from the import of the automobiles and the credit from the net earnings. There is another peculiar feature of the US situation, namely, that the US earns much more on its foreign investments than it pays on its foreign liabilities. And that has to do mainly with the nature of the liabilities, which are mostly fixed interest. It’s noteworthy that many of the private claims on the U.S. are also fixed interest claims for their own reasons: foreign insurance companies and foreign savings behavior, and so forth. Europeans are historically a bit more conservative in their savings behavior, whereas a higher fraction of the American investment overseas—and indeed of US household saving—is equity, and the Americans are taking the risk. So, once again, the United States is earning the rewards for risk-taking. Speaking in terms of general averages, while the U.S. has, in the accounting sense, much bigger liabilities to the rest of the world than it has claims on the rest of the world, the earnings are roughly equal.

ALC: Now to you, Ken. Most forecasts of the US current account deficit suggest that this is actually going to rise steadily over the next several years, in the absence of some kind of discontinuity. On the other hand, Richard Cooper argues persuasively that the US current account deficit may be large but not necessarily unsustainable. What is your view?

Rogoff: Admittedly, we don’t completely understand why it is that current accounts tend to collapse at relatively low levels. Yet historically, for a couple of hundred years, this is what we have observed. What we see in the case of the U.S. is a current account deficit outside of historical norms, certainly for a large country. I think the single fact that seizes my attention the most about the US current account deficit is the percent of net global savings that it represents. The US deficit absorbs much of the world’s net savings through the current account surpluses of Japan, Germany, and China, and all the surplus countries in the world, which are actually led by the oil countries now. One can rationalize this particular equilibrium, but it certainly strayed rather far relative to any norm.

Now, this doesn’t mean that the United States can’t repay its debt, or that there is an urgent fiscal crisis coming on. But, on the other hand, I think that to presume that this is a normal pattern that can continue for a long time is only a possibility. I don’t think it’s something that policymakers should be blasé about by saying “oh well, it’s because we’re in this new era of globalization.” I think there is a greater likelihood that there will be a reversion back to the norm.

It’s hard to imagine there won’t be a housing slump in the United States. If we see a stalling of the housing market, there is little doubt that the US economy will slow down markedly in the second half of the year. At the same time, the countries in the rest of the world are on a very different cycle. Japan is growing sharply, with enormous potential to grow much faster. Germany is having a surprisingly good year and Latin America seems to be having a good year too.

That alone is going to bring down the deficit by 2 percent, and this will have quite a dramatic effect on the dollar. Not that I expect the present US current account deficit of 6–6.25 percent of GDP to suddenly go to zero overnight, much less to reverse itself by 180°, as happened in Thailand during the Asian crisis. Thailand went from minus 7 percent current account to plus 5 percent current account overnight, and that’s not going to happen in the U.S.

But if the current account deficit were to be suddenly cut in half—and I’ve just laid out a scenario which would take us one-third of the way there—that will give rise to a 15–20 percent drop in the trade-weighted dollar. I emphasize the *trade-weighted* dollar because people look at the nominal US\$/EUR exchange rate and think that the

dollar is going up. However, the dollar is not really going up on a trade-weighted basis. The current account is about the trade-weighted basis, while bilateral nominal rates are secondary.

On the other hand, it is also certainly possible, theoretically, that the United States current account deficit will continue to grow, because, as fast as it's growing, the U.S. is not growing faster than other parts of the rest of the world. Right now it is only absorbing 70 percent of the global savings, and there really are limits to this process. What happens when it climbs to 90 or 95 percent? In some ways, it can't continue to go up unless others refuse to save.

The quantitative paper I wrote about 5 years ago was considered radical and crazy at the time, when the US current account deficit was only 4.5 percent of GDP. We said in our paper that this was a medium term problem taking three to five years to readjust. But five years have passed, and it has already gone from 4.5 to 6.5 percent. I mean there are enough red lights blinking!

ALC: How can the world prepare for the necessary adjustments?

Rogoff: In the United States, financial deepening has allowed money to suddenly shift from one part of the economy to another, although often to the dismay of managers, who are seeing their companies being taken over. But the system works because labor markets are reasonably flexible. Without the ability to displace workers, industry consolidation will be difficult, and the benefits of financial integration fewer.

As the global economy becomes more flexible, the adjustment process becomes less burdensome. But how flexible is the global economy? Europe certainly isn't. Japan isn't. Latin America isn't. Moreover, it is quite wrong to think that just because capital markets are deep, commodity markets can seamlessly adjust to a giant shift in global demand toward the United States and away from the rest of the world—which is exactly what a closing-up of the US current account deficit would imply. Hence, I believe that it is very likely that when the US current account reverses, there will be a sharp drop in the dollar and an adverse effect on global output.

"I believe that it is very likely that when the US current account reverses, there will be a sharp drop in the dollar and an adverse effect on global output."

I am convinced that one wrong lesson some have taken from the Asian crisis is that somehow countries should deal with volatile financial markets by putting in more capital controls or trade restrictions. Such restrictions will make the adjustment process to current account reversals more traumatic, not less. Indeed, if you try to bottle-up the adjustment process with capital controls and trade restrictions, you are simply buying time to stave off a bigger crisis later on. Ultimately, countries need more flexibility, and to the extent policy can do something about it, that is where the focus should be.

ALC: What are the concrete implications for the dollar?

Rogoff: The dollar is clearly overvalued, on the basis of purchasing power parity against the Asian currencies, though not against Europe. Still, because a rebalancing of the US current account deficit is likely to affect the entire world, we could see a euro at US\$1.50 with no problem, if the US current account closed up even by a few percentage points. That outcome would not be catastrophic, but it would certainly be awfully painful in Europe. Of course, it would be less painful if the Asian central banks permitted their currencies to appreciate, but it is not obvious how that is going to play out. Indeed, that is the big question in the global monetary order.

"If we look ahead all the way to 2040, the odds that the dollar will still reign supreme are only 50:50."

The risk of a US current account collapse should be problem number one on the international financial agenda of the US administration. Sadly, it is more convenient to hide behind one of the proliferating versions of the revisionist theory that there simply is no problem. Yet the US position is simply unsustainable. When the US current account deficit eventually crashes and burns, the world will not stand by and let East Asia's currencies plummet in value along with the dollar. Both theory and experience tell us that the position of global reserve currency can be a fragile one. If we look ahead all the way to 2040, the odds that the dollar will still reign supreme are only 50:50.

But suppose the US current account suddenly reverts from its current deficit to a balance—let's say, due to a precipitous collapse in US housing prices that leads to a sharp rise in the private savings rate. Then the dollar

would fall by more than 40 percent in the short term, with the long-run depreciation more of the order of 12 to 14 percent.

A dramatic fall in the dollar could precipitate an international financial market crisis. We have very little idea of how—or whether—financial institutions have hedged against this kind of risk, if they have at all. Then people will say: why didn't the IMF see this coming? Or, it could lead to a sharp spike in global interest rates; Asian central banks have been serving as the world's lender of first resort. Finally, one has to worry about how well the inflexible economies of Europe and Japan would handle a sudden drop in the dollar. Very poorly, I would venture.

The main costs would fall outside the United States, because the US economy is so flexible it could absorb even a major shock—such as the collapse of some major financial institutions as a result, for example, of soaring interest rates—much better than Europe or Japan. The impact on economies in these other big economic areas would be deeply problematic.

ALC: As former Chief Economist of the International Monetary Fund, how do you see the role of the international financial institutions?

Rogoff: I have long believed that in an ideal world both the IMF and World Bank funds would all come in the form of outright grants not loans. The Bank is a development agency. Its financial architecture is built on the assumption that developing countries develop quickly and that emerging markets emerge quickly: thus, the idea is to make loans, which will presumably earn high real returns, enabling the borrower to easily pay the money back. But the reality is very different, and the world community is constantly having to come up with accounting gymnastics—e.g., aid funds to repay Bank loans to keep going. One consequence is that the World Bank has great difficulty imposing any meaningful conditionality on its aid—despite its rhetoric. And this hinders the Bank's effectiveness. The issues for the International Monetary Fund are different as its goal is to maintain global financial stability. I believe that the Fund's ability to act as a lender of last resort helps in some cases, but in many others it exacerbates the build-up of loans in the first place. On net, it would be preferable for it mainly to help transmit information and advice, and to serve as a secretariat for global financial leaders.

ALC: What about the problem of budget deficits? Is there a tension between fiscal and monetary policy? I increasingly find myself among those who think that we do not give enough importance to sound fiscal management.

Rogoff: Over the next couple of decades, budget deficits in many countries are likely to balloon under the pressure of rising expenditures for the elderly—and then there are the direct and indirect costs of dealing with terrorism. The United States is facing open-ended security costs, and Europe may some day be facing the same scenario. Extreme stresses in budgets are always going to be a problem for monetary policy. At the same time, I worry that anti-terrorism measures may slow the pace of globalization, forcing us to sacrifice some of the productivity gains that have made disinflation so much easier over the past 15 years.

People grossly underestimate the threat to price stability posed by the steady deterioration in budget positions that is forecast across the OECD over the next 30 years, due mainly to the aging of populations. When an immovable anti-inflation monetary authority meets an irresistible spendthrift fiscal authority, what will happen? To prepare for this day, it is terribly important to continue to strengthen monetary independence over the coming decades.

Many emerging markets have experienced sharp increases in debt-to-GDP ratios in recent years, especially the ratio of government debt to GDP. Unfortunately, as global interest rates rise, it will put tremendous pressure on some emerging markets, and we will almost certainly see another rash of emerging-market debt crises within the next two to three years. Floating rates will help some countries weather the storm, as will loans from the International Monetary Fund. But some countries may be backed into a corner and forced to restructure as Argentina is now doing.

“Unfortunately, as global interest rates rise . . . we will most certainly see another rash of emerging market debt crises within the next two to three years.”

The risk is particularly great for debt-intolerant countries that have serially defaulted on their external debt, such as Venezuela, Brazil, and Argentina, not to mention repeatedly turning to high inflation to renege on domestic debt. Countries that are debt intolerant have to maintain much lower debt-to-GDP (or debt-to-exports) ratios than

countries that have pristine records, such as Korea or Malaysia. We find that to graduate from debt intolerance—as Chile, Portugal, and Greece have done—a country must maintain an extremely low debt-to-GDP ratio for a very long time. There does not seem to be any other way to do it. Latin countries, especially, have had a long history of seeking solutions to their recurring debt problems in financial engineering. I believe the main path to salvation lies in sustained fiscal rectitude—though I am certainly not advising countries that they should always pay all their debts and under no circumstances restructure. On the contrary, I believe that at least a couple of large emerging-market countries may have to restructure their debts when the next wave of crises hit, and the official community should not stand in the way. However, once the debts are written down, it is important that countries do not turn around and borrow to the hilt again, as happened widely after the restructurings of the late 1980s and early 1990s.

Financial crises will always be with us. The flaw is not in the markets—and certainly not just with the lenders—but rather mainly with policy makers who consistently underestimate the risks of over-borrowing. The big losses in welfare fall on the poorest citizens of the (over-) borrowing countries. Unfortunately, many middle-income countries are doing it again now. As the IMF recently demonstrated, the average developing country already has more debt than it can service.

ALC: Can past experience tell us anything about the present situation?

Rogoff: When one looks closely at the US twin deficits (current account and fiscal) in the context of open-ended security costs, geopolitical tensions, rising old age pensions, higher energy costs and extraordinarily stimulative macroeconomic policies, we see stronger parallels to the early 1970s than to the late 1980s. The years following Richard Nixon’s 1972 re-election were not pretty for the dollar or for the world economy. If current accounts are forced toward balance in the context of a difficult global economy, the effects could include financial crises, higher interest rates and a big drop in global output.

During the 1980s, after US president Ronald Reagan’s aggressive tax cuts, America was also running large simultaneous current account and budget deficits, although the current account deficit was then much smaller as a share of national income than it is today. To be sure, when the correction hit, the dollar crashed by 40 percent on a trade-weighted basis. Some claim the fallout wasn’t so bad, except, perhaps, for the fact that it set off events that led to Japan’s decade-long recession. Because of the fall in the dollar, America’s net indebtedness to the rest

of the world has been more stable than one would expect, given its heavy borrowing trajectory.

A bit of perspective on the numbers helps illustrate the gravity of the situation. Let’s compare the US\$670 billion current account deficit that the United States ran up in 2004 with a few benchmarks. Gross direct foreign investment flows to all developing countries in 2004, including popular destinations like China and India, were

“When the United States wades into the global capital market, it pretty well empties all the water out of the pool.”

US\$166 billion in 2004 and roughly similar in 2005. Incredibly, if one adds up the surpluses of all the countries running current account surpluses—that is, generating savings that can be used by the rest of the world—America is eating up well over 70 percent of the total. When the United States wades into the global capital market, it pretty well empties all the water out of the pool.

ALC: What recommendations do you have for today’s policymakers?

Rogoff: Global imbalances have been accumulating for some time and are now a substantial risk to the world economy, especially if they unwind in an otherwise adverse scenario. While there are limits to what policymakers can do to anticipate the correction, they are not necessarily helpless. Far better to try to move the global economy toward balance in a stable period than to wait for the current account imbalances to implode against a backdrop of 1970s-style problems. The global current account imbalances, and their potential consequences for exchange rates, offer the quintessential case for multilateral policy consultations. If we don’t see any coordinated response on this one, it won’t bode well for global financial governance over the next decade.

Over the longer term, I think some adjustment has to take place. There has to be a massive appreciation in emerging Asia. People talk about numbers like 30 percent or even more, in order for the current account to go to zero. But, of course, if we are looking over 30 or 40 years, I would see the real yuan exchange rate appreciate by a couple of hundred percent against the dollar. That process has to take place at some point, but it’s not going to happen all at once.

ALC: Would you make the point you just made about the yuan also about the ruble and the rupee?

Rogoff: Absolutely. The same would be true of India's currency. Russia doesn't have the broad diversified growth that India and China have, so I am less sure about where that country is going. We are basically looking at an economy that is overly dependent on high oil prices. Another factor, which I think will lead to rebalancing current accounts is that whenever we have an oil shock, the oil exporting countries always save a big share of it initially. Everyone's praising the oil exporting countries for saving so much this time, but it is too soon to say if they are

“But, of course, if we are looking over 30 or 40 years, I would see the real yuan exchange rate appreciate by a couple of hundred percent against the dollar.”

behaving much differently from last time. We will know better in a few years. A country like Saudi Arabia, has a lot of oil money, but its per capita income still qualifies it as a developing country. Saudi leaders face enormous social pressures, including huge unemployment among its large and growing youth population. They cannot afford to just sit back and put the money in US Treasury bills.

But in the end, it will fall on the US to do some of the adjusting. The United States is booming. The country is in an expansion phase. If you are not running a balanced budget when the economy is booming, when are you going to? And when we look forward to social security for an aging population, as we are now, it's most unwise to be running a deficit. If I were President Bush I would go to people and say look I know I said that there wouldn't be any tax hikes but please understand that the economy is doing better than I dreamed. And in light of that we have to reassess and perhaps try to balance the budget now and not in 5 or 6 years. I certainly think that would play a role in rebalancing the current account, though maybe it wouldn't be as dramatic as people say. A carbon tax would also not be a bad place to start.

References

International Monetary Fund. 2006. *World Economic Outlook* database.