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SUPER DEBT: MANAGING AMERICA'S BALANCE OF PAYMENTS

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The second Bush Administration will face many demanding challenges in foreign economic policy – the Doha Round of multilateral trade talks, regional and bilateral trade negotiations, poor-country debt problems, rising energy prices, the competitive threat of China, and more. But most demanding of all will be the critical issue of America's balance of payments. Persistent external deficits have led to an unprecedented growth of foreign debt for the United States, now in excess of \$3 trillion (\$3,000,000,000) on a net basis. For the first time in history, the world's greatest superpower is also the world's greatest debtor. If not managed effectively, America's Super Debt could become a grave source of strain on financial markets and possibly even trigger a global economic crisis. It is hardly an exaggeration to say that the fate of the world economy hangs in the balance. Is the Bush Administration up to the challenge?

THE PROBLEM

The question is by no means academic. In fact, we have been here before. Conditions were much the same back in the 1960s when, as now, the United States was plagued by growing payments deficits, generating a rapid accumulation of foreign liabilities. Then too, Federal budget deficits were on the rise, monetary conditions were relatively easy, oil prices were pushing upwards, and Washington was bogged down in a costly foreign war. For years, under three successive Presidents, policymakers fought to keep the payments problem under control, resorting to increasingly inventive financing arrangements and ultimately even to mandatory capital controls. Yet in the end crisis could not be averted, as confidence in America's ability to manage its balance of payments steadily eroded. In August 1971, Richard Nixon was forced to suspend the dollar's convertibility into gold, effectively terminating the Bretton Woods system of pegged exchange rates. What followed was a decade of financial instability, inflation, and diminished economic growth across the globe. The historical parallels are disturbing. It all could happen again.

The magnitude of today's challenge is undeniable. As measured by the current account of the balance of payments (the balance of trade in goods and services), America's external deficit exceeded \$600 billion in 2004, equivalent roughly to some six percent of gross domestic product (GDP), and in January 2005 reached almost \$60 billion, the second highest monthly figure on record. On present trend, the shortfall is projected to soar above \$800 billion at an annual rate by the end of 2006. These growing deficits, in turn, keep adding to the superpower's Super Debt, absorbing as much as three-quarters of the world's surplus savings. On a gross basis, foreign liabilities now exceed \$11 trillion. Net of America's own assets abroad, the Super Debt reached \$3.3 trillion at end-2004, equal to some 30 percent of GDP. In effect, the United States is now outsourcing its saving to the rest of the world.

The risk is clear. If these trends continue, another crisis could erupt comparable to what happened in 1971. A plausible scenario would start once again with the dollar. What enables the United States to sustain payments deficits year after year is the role of America's greenback as the world's pre-eminent international currency. America, in effect, has been able to finance its imbalances simply by printing its own money – a privilege available to no other country – and it has been able to do so because of widespread faith in the currency's underlying value and usefulness. Foreigners have willingly accepted the dollars that Americans pay for their foreign

expenditures, either holding onto the greenback itself or else converting into dollar-denominated assets. At some point, however, sentiment could shift, particularly if the greenback's recent weakness in exchange markets begins to seriously threaten the currency's role as a store of value. Dollar accumulations could turn into dollar sales, and modest depreciation could turn into a calamitous rout.

In turn, a run on the dollar would force the Federal Reserve, America's central bank, to hike interest rates sharply, which might destabilize financial markets around the world. Bond prices could collapse, exposing hidden weaknesses among financial institutions and hedge funds. Worse, real economic growth could be stalled as monetary conditions tighten. To compensate for the depreciation of their dollar revenues, OPEC countries would be tempted to engineer even higher oil prices, further aggravating recessionary tendencies in energy-importing nations. Other governments, faced with widening deficits of their own, might feel obliged to resort to protectionist import barriers, capital controls, or even debt default. At a minimum, we might find ourselves repeating the dismal experience of the stagflationary 1970s. At worst, events could make the Great Depression of the 1930s look like a genteel garden party.

The challenge for the Bush Administration, therefore, is acute. Three questions suggest themselves. First, how serious is the risk? Scenarios that are plausible are not necessarily probable. Is a run on the dollar likely, or is the risk exaggerated? Second, insofar as the risk is serious, what is the Bush Administration doing about it? Does it have a workable strategy to stave off a currency collapse? And third, what more could be done? Are there additional or alternative strategies available to manage America's Super Debt effectively? Regrettably, none of the answers to these questions are greatly reassuring.

HOW SERIOUS IS THE RISK?

Not everyone agrees that the risk of a dollar crisis is serious. Indeed, according to some authoritative specialists, there is not really much to worry about at all. The present situation is sustainable, perhaps even indefinitely; or in any event will resolve itself reasonably smoothly without undue hardship. Leading the way is Federal Reserve chairman Alan Greenspan, who has consistently championed an optimistic outlook. "The resolution of our current-account deficit... does not strike me as overly worrisome," he commented in a major speech in March.¹ Global financial developments, he argues, have "raised the probability of a benign resolution to the US current account imbalance.... History suggests that current imbalances will be defused with little disruption."² Clearly, the history that Greenspan has in mind is some period other than the unfortunate 1970s.

Optimists like Greenspan rest their case on three key arguments. Two arguments stress the attractiveness of the U.S. economy, either as a haven for investments or as a market for exports. The third argument stresses the reverse – the lack of attractiveness of any departure from the status quo. None of the three arguments, however, is without flaw, suggesting that optimism cannot in fact be justified in this instance.

A haven for investments?

The first argument proceeds from the assumption that America's current-account deficits

are a sign of strength, not weakness, in the U.S. economy. Current-account deficits, according to this view, are simply the accounting counterpart of capital inflows, which are said to be the real force driving the balance of payments. Investments in America are attractive because of their relative safety and historically high rates of return. If three-quarters of the world's surplus savings come to the United States, this view insists, it is because that is where asset values are most promising. In the words of John Taylor, Deputy U.S. Treasury Secretary, "Foreigners want to invest in the United States. That's what that gap illustrates."³

America's Super Debt, therefore, allegedly reflects nothing more than a huge pool of savings around the world – a "global savings glut," according to Ben Bernanke, vice-chair of the Federal Reserve – with nowhere else to go.⁴ When compared with U.S. GDP, the accumulation of liabilities looks large, even dangerous. But aggregate world wealth is growing rapidly and must be placed somewhere. When viewed in the context of global portfolio allocations, America's debt does not look so super after all.

Is the argument persuasive? Certainly there is no question that the United States has long functioned as a magnet for world savings. This was especially true during the stock market boom of the late 1990s, when returns were at all-time highs. Investors flocked to America in pursuit of easy profits. But all that began to change after the bubble burst in early 2000. Over the last four years interest in U.S. equities and bonds has steadily waned, compounded by growing fears about the dollar's exchange rate. In fact, the once enormous inflow of private capital is fast becoming a net outflow. In January 2004, net investments coming in the United States were still twice the current-account deficit. Before the end of the year, private inflows were actually smaller than the trade deficit. Today America's deficit is being financed almost exclusively by foreign central banks, particularly in Asia, rather than by private investors. So much for the attractiveness of the U.S. economy as a haven for investments.

A market for exports?

But what explains the willingness of foreign central banks to take on that financing role? That brings us to the optimists' second argument – an argument stressing the attractiveness of the U.S. economy as a market for exports. Many governments, it is noted, continue to cultivate essentially mercantilist development strategies, relying on the stimulus provided by exports abroad to promote vigorous growth at home. Nowhere is this more true than in China and the other emerging-market economies of East Asia, together with Japan; and no foreign market is more appealing to these countries than the United States, the world's wealthiest economy. To sustain exports to America, however, the Asians must remain competitive in price terms. To remain competitive, they must keep their exchange rates from appreciating. And to keep their currencies from appreciating, they must intervene to buy up surplus dollars in the exchange market. Hence, the argument goes, Asian central banks can be counted upon to continue financing the U.S. deficit, even if private investors cannot.

The numbers certainly seem to confirm the argument. Dollars have piled up at a prodigious rate in all East Asian central banks – for example, to nearly \$850 billion in Japan, more than \$600 billion in China, some \$250 billion in Taiwan, and \$200 billion in South Korea. It is hard to imagine any other reason for reserve hoards on such a remarkable scale.

Moreover, there would appear to be a historical precedent for such a pattern of behavior,

as has been pointed out by a trio of prominent economists – Michael Dooley, David Folkerts-Landau, and Peter Garber (hereafter referred to as DFG).⁵ Years ago, during the first decades of the Bretton Woods system, Europe and Japan adopted very much the same kind of mercantilist development strategies. Relying on exports to the United States to promote growth at home, they too sought to sustain competitive exchange rates by means of massive exchange interventions and reserve accumulations. The result was a more or less stable equilibrium that lasted for more than twenty years, with U.S. deficits being willingly financed by foreign central banks. Today, according to DFG, the Bretton Woods system has effectively been revived, with the European role now being played by the East Asians. In the optimistic view of DFG, there is no reason to doubt that this equilibrium too can be sustained for a long period of time. Asians, they argue, will go on financing US deficits indefinitely so long as their development strategies remain unchanged. As the three economists put it, “The US is being underwritten by Asia for the foreseeable future.”⁶

But is such optimism justified? The parallel with the original Bretton Woods system is hardly reassuring, given that system’s disastrous denouement in 1971 and all that followed in subsequent years. Worse, there are already signs that the fragile equilibrium of today’s revived Bretton Woods system could be breaking down. Since the middle of last year dollar purchases by Asian central banks have in fact slowed considerably, in some cases (e.g., Singapore, South Korea, Taiwan) allowing modest currency appreciations against the dollar despite continued reliance on the U.S. market. Moreover, rumors keep popping up suggesting that one central bank or another may be about to shift a portion of reserves from the greenback to its European rival, the euro. In February, the dollar plunged for a time on reports that South Korea might step up purchases of other currencies. A month later the scenario was repeated when Japan’s prime minister hinted that some reserve diversification might be in the offing. Asian policymakers may be eager to keep up their exports to the United States, but it is not at all clear that their appetite for dollars is as unlimited as DFG or others⁷ have argued.

A balance of financial terror?

On the other hand, what alternative do they have? Even if the flaws of the first two arguments are conceded, optimists have a third argument to fall back on – the lack of attractiveness of any other option. Suppose Asian central banks actually did try to switch out of the dollar. Even a limited amount of diversification, policymakers understand, could lead to a sharp depreciation of the greenback, causing massive losses on their remaining dollar holdings and a major erosion in the competitiveness of their exports. Would they really risk such self-inflicted wounds? To avert a doomsday scenario, it makes more sense to support the greenback whether they like it or not. Optimists see this as nothing more than enlightened self-interest. As Wall Street economist Henry Kaufman has said, “I believe that the Chinese and Japanese, down deep, realize that if they shifted from the American dollar to the euro, it would endanger their export drive to the United States.”⁸ Others see it as more like the notorious balance of terror that existed between the nuclear powers during the Cold War – a “balance of financial terror,” as former Treasury Secretary Larry Summers has described today’s equilibrium.

The optimists are right, of course – but only when we consider foreign central banks as a group. In reality, there is a collective action problem here. Together, countries clearly do have a

common interest in avoiding self-inflicted wounds. Individually, however, each country has a rational incentive to get out of the dollar as quickly as possible, leaving others to suffer losses. How long, therefore, can the balance of financial terror be expected to hold? As a practical matter, the equilibrium is unstable and could break down at any time. As economist Barry Eichengreen has argued, “the countries of Asia ... are unlikely to be able to subordinate their individual interest to the collective interest.... [Hence] even if there exists today something vaguely resembling the Bretton Woods system, it is not long for this world.”⁹

WHAT IS BEING DONE?

On balance, therefore, it appears that the risk of a crisis is indeed serious. There really is much to worry about. The present situation is less sustainable than optimists would have us believe.

In fact, the dangers of America’s growing Super Debt are widely recognized. President Bush likes to talk about making America an “Ownership Society.” But Warren Buffett, one of the country’s leading investors, has warned that if nothing is done to bring the external deficit under control, Americans will soon find themselves in not an Ownership Society but a Sharecropper’s Society, “perpetually paying tribute to their creditors and owners abroad.”¹⁰ Paul Volcker, Alan Greenspan’s immediate predecessor at the Federal Reserve, estimates that on present course there is a 75% chance of a currency collapse within five years.¹¹ The Bush Administration would be foolish – not to say, irresponsible – to ignore the challenge.

So what is the Administration doing about it? Regrettably, very little. President Bush has never placed any priority on the balance of payments, and his team of advisors on international economic policy remains notoriously weak. His strategy, mainly, has been to draw as little attention to the challenge as possible. The country’s growing Super Debt was barely remarked upon in the president’s latest annual economic report and received no mention at all in his State of the Union address. In this respect too, the parallels with the 1960s are disturbing. Then too a president, Richard Nixon, sought to downplay the gravity of America’s balance-of-payments problem, instead adopting a policy of “benign neglect” as it was then known. Benign neglect proved insufficient in 1971. It most likely will prove insufficient again.

For the Bush Administration, the solution lies in the exchange rate of the dollar – specifically, in depreciation. Publicly the president and other Administration officials, such as Treasury Secretary John Snow, continue to call for a “strong dollar,” just as did their predecessors in the Clinton Administration. But departing significantly from previous practice, formal statements also pointedly add references to the need for “flexibility” and reliance on “market forces.” Markets, we are told, should be the ultimate arbiters of currency values, not governments. Translated into plain words, the Administration’s rhetoric signals a preference for depreciation – the reverse of a strong dollar. That is what benign neglect means today: talking down the dollar. In financial circles, the Administration’s desire for greenback depreciation is an open secret.

Depreciation would have two advantages from the U.S. point of view. First, it would improve the competitiveness of American products, hopefully in time leading to increased exports and lower imports. A decline of the dollar is seen as a relatively painless remedy for the balance-of-payments problem – a way to shrink the current-account deficit without any

significant negative impact on the domestic economy. And second, depreciation would reduce the burden of the Super Debt, most of which is denominated in dollars – effectively a default by stealth, wiping trillions off the value of foreign-held dollar assets. For the United States, a critical advantage of its extraordinary ability to borrow in its own currency is that others are compelled to bear the exchange risk involved.

Is benign neglect working? It certainly has been effective in draining value from the dollar: Against a basket of 27 foreign currencies, the greenback fell by 16 % between early 2002 and the end of 2004. Against seven major currencies, the depreciation was more like one-third. Against Japan's yen, it was 24 percent; against the euro, 37 percent.

The disproportionate change of the dollar-euro exchange rate is noteworthy. Until now, Europe has been the main victim of the Administration's benign-neglect policy. Since Asian countries have resisted appreciation of their currencies by buying up dollars, the bulk of exchange-rate adjustment, inevitably, has fallen on the euro, which floats freely. The euro's rise has seriously damaged the competitiveness of European goods in world markets. The Europeans, not surprisingly, feel resentful. As they see it, Washington is forcing Europe's industry, rather than U.S. producers, to bear the brunt of adjustment. Ironically, a weak dollar is seen as an exercise of U.S. power – a neglect that is malign, not benign. Europeans are reminded of John Connally, Richard Nixon's Treasury Secretary, whose hard-nosed attitude was summarized by his famous dictum: "The dollar is our currency, but your problem." The Bush Administration's dollar strategy is not doing trans-Atlantic relations any good.

But has the greenback's depreciation been effective in reducing the payments deficit? The most charitable answer is: Not yet. In fact, the payments deficit continues to grow. Partly this is natural, due to inevitable lags in the adjustment process – the notorious J-curve of economic theory, which suggests that following depreciation imbalances tend to get worse before they get better. But partly it is because the current account will never get better by relying on the exchange rate alone. A cheaper dollar may be necessary to reduce the growth of America's Super Debt. But it is not sufficient.

As a factor explaining external deficits, the exchange rate is more symptom than cause. What really drives a current-account deficit is the balance between national savings and investment – put differently, the balance between domestic spending and income. The United States has a payments deficit because, collectively, Americans spend more than they earn. In effect, Americans live beyond their means. America's personal savings rate, at one half of one percent of disposable income, is among the lowest in the world. The Federal government, meanwhile, has a negative savings rate as a result of the massive shift from the budget surpluses of the Clinton years to the Bush Administration's deficits, presently running in excess of \$400 billion a year (equivalent to some 4.5 % of GDP after adjusting for the economic cycle). Overall, the economy's savings are simply too low – certainly too low to attain balance in the external accounts, even with significant depreciation of the dollar.

To achieve a lasting improvement in the balance of payments, national savings must be raised substantially. Above all, that means that Washington's fiscal deficits must be reduced. Is there any chance that they will be reduced? Again, the most charitable answer is: Not yet. An examination of the Bush Administration's budgetary priorities suggests that despite planned spending cuts in discretionary programs that mainly benefit the poor, fiscal deficits are more likely to grow, not shrink, in the years immediately ahead. Social Security reform, number one

on the president's domestic agenda, could require as much as a trillion dollars in new borrowing over the next decade; making the Administration's first-term tax cuts permanent (they are currently set to expire after seven years) would add another trillion. Also add proposed new tax cuts and escalating military spending, and there seems little doubt that Washington's negative savings rate will remain high, as even the optimistic Alan Greenspan has been forced to acknowledge. In testimony before Congress in March, Chairman Greenspan warned against the dangers of yet more public borrowing. "Addressing the government's own imbalances will require scrutiny of both spending and taxes," he insisted. "You cannot continuously introduce legislation which tends to expand the budget deficit."¹²

The outlook, therefore, is by no means promising. Even with substantial depreciation of the dollar, America's Super Debt looks set to keep growing – and as it grows, so too does the risk of a serious crisis. No one has articulated the dilemma better than Jacob Frenkel, former head of the Bank of Israel. Speaking in January at the World Economic Forum in Davos, Switzerland, Frenkel despaired of Washington's approach to the problem. "I am concerned with the U.S. current-account deficit, not because it cannot be dealt with but because of the way it is not being dealt with."¹³ Benign neglect, by itself, simply will not do the job. More must be done.

WHAT MORE CAN BE DONE?

What more can be done? It does not take a Nobel Prize economist to think of suitable remedies. A workable strategy for America's balance of payments would combine three critical elements: (1) harmonized currency interventions by the Federal Reserve and other major central banks to manage the exchange rate of the dollar; (2) fiscal reforms in the United States to contain Washington's burgeoning deficits; and (3) market reforms in Europe and Japan to promote faster growth in their domestic economies. The aim of harmonized interventions would be to ensure that any further depreciation of the dollar will not turn into a destabilizing run. The aim of fiscal reforms in the United States would be to increase the national savings rate, reducing dependence on foreign borrowing. And the aim of faster growth in Europe and Japan, America's most important trading partners, would be to create greater demand for U.S. exports. Together, these three elements would go a long way to eliminating the risk of serious crisis.

Unfortunately, the probability of these remedies being adopted is virtually nil. Why? The reason is familiar: politics. Economic analysis may point us in the right direction. But to get from Here to There, political barriers must be overcome. In the case of America's Super Debt, the barriers are particularly complex and stubborn.

Any attempt to harmonize currency interventions, for instance, will immediately run up against the conflicting policy preferences of participating governments. Would Europe, whose euro has borne the brunt of adjustment to the dollar's recent depreciation, be prepared to tolerate yet more loss of competitiveness in world markets? Would Asian governments be willing to sacrifice the mercantilist development strategies on which they have relied so heavily in the past? Most importantly, would the Bush Administration, with its firm ideological convictions, be disposed to forsake a reliance on market forces? Treasury Secretary Snow has repeatedly spoken out against the intervention option, even at the risk of an eventual collapse of confidence in the greenback.¹⁴ Admittedly, from time to time, governments have proved capable of

coordinated exchange-rate initiatives, suppressing their policy differences. But this happens only at moments of severe crisis and does not tend to last for very long. More than a decade ago, I wrote that monetary cooperation is like passionate love – a good thing but difficult to sustain.¹⁵ Regrettably, that dictum remains true even today.

Likewise, any attempt to promote fiscal reforms in the United States will run up against the Bush Administration's budgetary priorities. Can the president really be expected to abandon Social Security reform or future tax cuts – centerpiece goals for his second term -- for the sake of the balance of payments? Fiscal sacrifice appears to be an alien concept to an Administration whose vice president, reportedly, has said that "Ronald Reagan taught us that deficits don't matter." Many outsiders, including the International Monetary Fund and foreign government officials, have tried to make the case for budget restraint to the Bush team -- but to no avail. As the Prime Minister of Luxembourg has remarked: "I think there is an underdeveloped sense of hearing in the United States."¹⁶

And, of course, there are political barriers as well to market reforms in Europe and Japan. Across much of Western Europe (with the notable exceptions of Ireland and the United Kingdom), growth has long been anemic and unemployment rates remain stubbornly high. In Japan, overall conditions have been basically stagnant since the bursting of the "bubble economy" at the end of the 1980s. In both regions, the policy measures needed to promote faster growth are well known. These would include reforms of labor markets and pension systems, reductions of subsidies for inefficient producers, and deregulation and liberalization to foster greater competition. But it is also well known that any initiatives along these lines would inflict considerable pain and hardship on key local constituencies. Hence it is not at all difficult to understand why so little progress has been made to date. Like politicians anywhere, European and Japanese policymakers are naturally reluctant to do anything that might jeopardize their hold on office.

CONCLUSION

What conclusions may we draw? America's Super Debt clearly poses a serious challenge. Unless reformed, the Bush Administration's approach to the problem is apt to prove inadequate. And the ideal combination of policy elements that might forestall a serious crisis seems, for political reasons, to be out of reach. This does not mean, necessarily, that the revived Bretton Woods system is destined to go the way of its predecessor. It is indeed possible that the Administration's benign-neglect strategy could enable us to muddle through without a repetition of the 1970s. But the ice is thin, cracks are appearing, and the burden is heavy. We must all be prepared for the possibility of a crash.

NOTES

1. *New York Times*, 11 March 2005, p. C6.
2. Alan Greenspan, "The Evolving U.S. Payments Imbalance and Its Impact on Europe and the Rest of the World," *CATO Journal*, Spring/Summer 2004, pp. 1, 10.
3. *New York Times*, 16 November 2004, p. C1.
4. *New York Times*, 11 March 2005, p. C6.
5. Michael Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," Working Paper 9971 (Cambridge, MA: National Bureau of Economic Research, 2003).
6. Dooley, Folkerts-Landau, and Garber, "Essay," p. 7.
7. See e.g., David H. Levey and Stuart S. Brown, "The Overstretch Myth," *Foreign Affairs*, March/April 2005, pp. 2-7.
8. *New York Times*, 27 February 2005, p. 10BU.
9. Barry Eichengreen, "Global Imbalances and the Lessons of Bretton Woods," Working Paper 10497 (Cambridge, MA: National Bureau of Economic Research, 2004), pp. 5, 7. See also Nouriel Roubini and Brad Setser, "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006," paper prepared for a symposium on the "Revived Bretton Woods System: A New Paradigm for Asian Development?," Federal Reserve Bank of San Francisco, 4 February 2005.
10. *New York Times*, 7 March 2005, p. C2.
11. *The Economist*, 13 November 2004, p. 88.
12. *New York Times*, 3 March 2005, p. A1.
13. *New York Times*, 28 January 2005, p. C1.
14. See e.g., *New York Times*, 20 November 2004, p. A1.
15. Benjamin J. Cohen, "The Triad and the Unholy Trinity: Lessons for the Pacific Region," in Richard Higgott, Richard Leaver, and John Ravenhill, eds., *Pacific Economic Relations in the 1990s: Cooperation and Conflict?* (London: Allen and Unwin, 1993), p. 134.
16. *The Economist*, 20 November 2004, p. 52.