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Risks of U.S. Macroeconomic Policy

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The U.S. current account deficit is projected to reach 5.7 percent of gross domestic product this year. This means that the United States is laying out about $700 billion more on foreign goods, services, and net interest payments than it is currently earning from its transactions with the rest of the world. The deficit must be financed, and U.S. national savings are woefully inadequate to cover the financing.

If the United States were like other countries, a crash would have come long ago, forcing an adjustment involving depreciation of the dollar, capital flight, and a decline in GDP. The adjustment, in my view, will come, but the impact will be greater because of the delay in acting. The dollar, in fact, has depreciated with respect to most currencies over the past several years, but the U.S economy has been growing—by 4.4 percent in 2004 and an expected 3.8 percent this year. Rather than fleeing, investors and central banks of other countries are sending capital to finance the U.S. deficit. Paul Volcker (in an op-ed piece in the *Washington Post* on April 10) noted that 80 percent of the net flow of all international capital is being absorbed by the United States. This is topsy-turvy; a well-functioning world economy would have a rich country like the United States sending capital to poor countries, not the reverse.

If the U.S. economy is on thin ice (Volcker's phrase), why are foreigners investing so heavily here? There are several explanations: the depth of the U.S. capital market; habits of the past; the large role of the dollar in world trade; and the relatively high economic growth of the United States makes it an attractive market for investment. Another consideration is that many countries are already so heavily invested in U.S. government instruments that a shift, likely followed by devaluation of the dollar, would subject them, and their central banks, to heavy losses. The expectation under these circumstances is that foreign central banks will largely keep their current assets in place but diversify additional reserve accumulations into other currencies—such as the euro—in order to hedge a bit. There is some evidence that this already is taking place in modest amounts—but floods can start with trickles. It is not clear whether the relatively high U.S. GDP growth rate can continue under current circumstances. We are now witnessing increases of both national debt to foreigners and consumer debt at home; the first casts doubt on the durability of large current account deficits and the latter on the solidity of future U.S. economic growth. Can the adjustment of the U.S. economy take place gradually? Yes, but the necessary action is not being taken. Will the U.S. economy crash at some point? It probably will, unless there is a change of policy to put the correctives in place to prevent this. The odds are high that correctives will follow rather than avert a crash.

Many nations benefit from this situation. China clearly does. The relatively large U.S. GDP growth sucks in imports; the U.S. merchandise trade deficit with China last year was $163 billion, an increase of 31 percent over 2003. In addition, China intervenes heavily in currency markets, selling renminbi and accumulating foreign reserves, mostly dollars, and the consequent weakness of the Chinese currency further stimulates the country's exports. At the end of 2004, China's foreign reserves were $610 billion, an obscenely high level for China's real needs. The sentiment in the U.S. Congress is for legislating punitive tariffs against imports from China unless there is a change in the country's foreign-exchange policy. U.S. Treasury statements on China's exchange rate have hardened considerably in the past few weeks, though with no precise indication of what action the executive branch will take if there is no revaluation of the Chinese currency. The choice of action is not an easy one. As former president Clinton has observed, it is hard to get tough with your banker.

Other countries are also benefiting from the U.S. tendency to be the importer of first resort. These include many countries in Asia, including Japan, Korea, Taiwan, and Malaysia, and our North American neighbors, Canada and Mexico. The East Asian countries mentioned would be unlikely to revalue their currencies unless this could be done simultaneously with a Chinese currency revaluation or floating so as not to prejudice inter-Asian trade.

If the U.S. economy goes through a major currency adjustment and a decline in GDP, the impact would be felt

around the world, especially in those countries that rely heavily on the U.S. market for their exports of goods and services. The risk to emerging countries is discussed in the World Bank's 2005 *Global Development Finance* report (and reported in the *Financial Times* of April 7, 2005). According to the World Bank report, an abrupt dollar collapse would create considerable volatility in world financial markets, probably push interest rates higher, and lead to industrial restructuring that would last until the dollar returned to an equilibrium level.

The Bank also reported that developing countries held $1.6 trillion in international reserves at the end of 2004, and about 70 percent of these reserves were held in U.S. dollars. These increased by $292 billion in 2003 and $378 billion in 2004. The largest increases were in China and other Asian countries, but the Bank noted that 101 of 132 developing countries increased their reserves last year. There are a number of reasons for this: countries are protecting themselves against swings in financial markets; there may be some emulation of successful Asian countries of market intervention (and reserve accumulation) to lower the value of their currencies in order to stimulate exports; and, linked to this, the realization that old habits of currency overvaluation can lead to disaster, as in Argentina in 2001. As between overvaluation and undervaluation, the current preference is toward undervaluation.

It is impossible to travel the world today without being asked by educated people what will happen to the U.S. dollar and whether the large and persistent current account deficits, and the foreign debt buildup that goes with this, can continue. The questioning one gets notes the unparalleled economic and political power of the United States, but also probes whether the large current account and fiscal deficits and the growing debt will bring down what many see as a house of cards. The questions are asked not just out of curiosity about what is happening in the United States, but also out of fear of what will happen to their countries if this unfortunate outcome comes to pass. There undoubtedly is also some schadenfreude at play, some glee that an imperious United States may turn out to have economic feet of clay.

My impression, also, is that economic and financial policymakers in more advanced developing countries, such as Mexico, are trying to do what they can to protect their countries should there be a dollar collapse. They can do small things, such as building up reserves despite floating currencies, so that they are marginally less at the mercy of the market or international institutions if confronted by a foreign financial shock. Mexico, to stick with this example, cannot fully protect itself from a U.S. crash because 80 percent of its export goes to the United States—and some 30 percent of its GDP is tied to exports to the United States—but reserve accumulation is probably seen as a small shield.

A U.S. visitor abroad now is subjected to a number of simultaneous realities about the U.S. position in the world. The first is the loss of U.S. popularity in most countries because of the way the Iraq invasion was handled. This sentiment could improve if the situation in Iraq improves, if the new government has some success in running the country, and if the insurgency declines. The need to improve the U.S. image is recognized by the proposed addition of Karen P. Hughes and Dina Powell to the team in the State Department. But beyond public affairs this political effort to counter U.S. unpopularity, there is a simultaneous need to assure the rest of the world that the United States knows what it is doing in its economic policy and that it's growing current account and budget deficits will be addressed and reversed. My recent experiences as a visitor in foreign countries lead me to believe that the rest of the world doubts that we will act to correct the situation. This probably is just as important to the rest of the world as the political unpopularity because if the United States must confront a financial crisis, so too will they.

Many years ago, General de Gaulle complained that the United States enjoyed a privileged position because, unlike other countries, it did not have to adjust to balance-of-payments problems. We are witnessing the validity of his comments. It is not clear whether this freedom to delay painful adjustments is a blessing or a punishment. If delay increases the eventual cost of adjustment, it may not be a blessing. It is true that many analysts do not believe as I do that the failure to reduce the current account and budget deficits is a serious shortcoming of U.S. macroeconomic policy. There has been little cost up to now, other than the growing foreign debt. But if those of us who believe the U.S. economy is tramping on thin ice are correct, then the price of this "I'm all right, Jack" policy could be highly costly to Americans and to the rest of the world.

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