Our Money, Our Debt, Our Problem

Brad **Setser** and Nouriel **Roubini**

The U.S. current account deficit -- the gap between what the United States earns abroad and what it spends abroad in a year -- is on track to reach seven percent of GDP in 2005. That figure is unprecedented for a major economy. Yet modern-day Panglosses tell us not to worry: the world's greatest power, they say, can also be the world's greatest debtor. According to David Levey and Stuart Brown ("The Overstretch Myth," March/April 2005), "the risk to U.S. financial stability posed by large foreign liabilities has been exaggerated." Indeed, they write, "the world's appetite for U.S. assets bolsters U.S. predominance rather than undermines it."

But in fact, the economic and financial risks that arise from the U.S. current account deficit (and the resulting dependence on foreign financing) have not been exaggerated. If anything, they have received too little attention -- and are set to grow in the coming years.

Levey and Brown make three basic arguments. **First, they claim that foreign central banks will probably continue to finance U.S. deficits. Second, they predict that even if foreign central banks do pull back at some point, private investors will step in. And finally, they assume that even if this financing does not materialize, a dollar crash would hurt Europe and Japan more than it would hurt the United States**. Unfortunately, there is a good chance that all of these assumptions will prove false. Foreign central banks may well stop financing growing U.S. deficits, private equity investors might not take their place, and the resulting adjustment process would prove quite painful for the United States.

DEBT DYNAMICS

U.S. external debt is now equal to more than 25 percent of GDP, a high level given that exports are a small fraction of U.S. GDP. More important, the United States is adding to its debt at an extraordinary pace. **The U.S. current account deficit is now comparable to those of Thailand and Mexico in the years leading up to their financial crises.**

In the late 1990s, the United States borrowed abroad to finance private investment. Today, however, the country does most of its foreign borrowing to **finance the federal budget deficit, which is projected to be close to 3.5 percent of GDP in 2005. (**In 2000, the United States had a surplus equal to 2.5 percent of GDP.) Recent economic growth has not reduced the budget deficit, but it has increased private demand for scarce savings; the net result has been even more borrowing from abroad. In 2004, foreigners bought an amazing $900 billion in U.S. long-term bonds; the United States exported a dollar of debt for every dollar of goods it sold abroad. Looking ahead, the U.S. debt position will only get worse. As external debt grows, interest payments on the debt will rise. The current account deficit will continue to grow on the back of higher and higher payments on U.S.

foreign debt even if the trade deficit stabilizes. That is why sustained trade deficits will set off the kind of explosive debt dynamics that lead to financial crises.

Nothing to worry about, argue Levey and Brown: foreigners may own a majority of U.S. Treasury bonds, but their holdings of other types of U.S. debt and equities remain limited; **the United States, unlike other debtors, borrows in its own currency, displacing the negative consequences of a falling dollar onto its creditors; and the United States has substantial assets abroad, the value of which rise as the dollar falls.**

In recent years, the rising value of existing U.S. assets abroad has in fact offset much of the new borrowing the United States has taken out to finance its trade deficit, and Levey and Brown bank on similar gains in the coming years. But this bet is unwise. Most U.S. assets abroad are in Europe. **Since the dollar already has fallen by around 40 percent against the euro, further falls in the dollar are likely to be against Asian currencies, and the United States holds relatively few Asian assets.**

THE KINDNESS OF STRANGERS

The falling dollar also reduces the value of foreign investments in the United States. **Eventually, foreign creditors are likely to demand higher interest rates to offset the risk of further decreases**. Over the past few years, the United States has found a novel way out of this dilemma: rather than selling its debt to private investors who care about the risk of financial losses, it has sold dollar debt at low rates to foreign central banks. The extent of U.S. dependence on only ten or so central banks, most of them in Asia, is stunning: in 2004, foreign central banks probably increased their dollar reserves by almost $500 billion, providing much of the financing the United States needed to run a $665 billion current account deficit. **These banks are not buying dollar-denominated bonds because they are attracted to U.S. economic strength, the high returns offered in the United States, or the liquidity of U.S. markets; they are buying them because they fear U.S. weakness. If foreign central banks stopped buying dollar-denominated bonds, the dollar would fall dramatically against their currencies, U.S. interest rates would rapidly rise, and the U.S. economy would slow.**

Foreign central banks have financed the United States to keep their export sectors -- heavily dependent on U.S. consumer spending -- humming. But they now must weigh the benefits of providing the United States with such "vendor financing" against the rising costs of keeping the current system going.

Now, foreign central banks with large dollar holdings are facing the prospect of huge losses as a result of the dollar's decline. **A 20 percent increase in the value of the yuan against the dollar would reduce the value of China's roughly $450 billion in dollar reserves by about $100 billion -- 6 percent of China's GDP**. In four years, if nothing changes, Chinese dollar reserves could reach $1.4 trillion, raising the costs of a falling dollar to $300 billion -- some 12 percent of China's GDP. **In short, the longer China continues to finance U.S. deficits, the larger its ultimate losses.**

More important, the current arrangement increasingly risks creating domestic financial trouble. Growing reserves naturally lead to growth in the money supply, raising the risk of inflation. In order to avert this risk, central banks must resort to a process called "sterilization": selling local-currency bonds to reduce the amount of cash in circulation. But this process is expensive, especially if local interest rates are higher than dollar interest rates. Chinese domestic interest rates are low, so China does not face this problem. But it does face another: rapid monetary growth has contributed to a boom in bank credit, excessive investment growth, and a real estate bubble. Thus far, China has used price controls to keep prices from rising, but such controls, which cause deep distortions in the economy, cannot keep the lid on inflation forever. Eventually, rising domestic prices will erode China's competitiveness even if it keeps its currency pegged at its current level. **China is likely to let its currency appreciate rather than accept socially and politically destabilizing inflation.**

Let's face it: most Asian central banks view financing the U.S. deficit as a burden, one that they would rather not shoulder. A recent survey of central banks (which did not include the People's Bank of China or the Bank of Japan) indicated that most want to scale back their dollar purchases, and some smaller central banks are already adding more euros and yen to their portfolios. In March, a former manager of China's currency reserves questioned China's current development strategy, **asking why it should seek out foreign investors looking for a 15 percent return on their investment only to have the central bank lend these funds back to the United States at 4 percent**. China will conclude that rapid accumulation of dollar reserves no longer serves its interests sooner than optimists think.

Many claim that Asian central banks have to hold on to their dollars -- and the U.S. bonds that they have bought with their dollars -- because a selloff would drive the market for dollars lower and thus be self-defeating. This argument, however, misses a key point: foreign central banks do not need to dump their existing stocks of U.S. dollars to cause financial distress in the United States; **they only need to slow their new purchases of dollar debt.** If central banks decide that $2.5 trillion in dollar reserves is enough, the **result will be a sharp fall in the dollar and a sharp rise in U.S. interest rates.**

Levey and Brown further argue that even if foreign central banks scale back their financing, there is little to worry about, since the United States **is on the verge of a new information technology (IT) revolution that will attract a new wave of investment from abroad. Alas, there is little evidence to suggest this pleasant scenario will come to pass.** In both 2003 and 2004, equity investors took more than $150 billion out of the United States: U.S. direct investment abroad exceeded foreign direct investment in the United States, and U.S. purchases of foreign stocks exceeded foreign purchases of U.S. stocks. High equity inflows are more likely to come because a further fall in the dollar makes U.S. assets fire-sale cheap than because of a scramble to get in on another IT boom.

Other countries do of course depend on U.S. spending to make up for a lack of demand inside their own economies. But the United States cannot take comfort in the fact that the necessary "adjustment" will be painful abroad. **If a falling dollar slows German, Japanese, or even Chinese growth, it will become even harder for the United States to reduce its trade deficit by exporting more -- a key part of any "soft landing" scenario.**

And even if the United States has relatively little to fear from a falling dollar, it has much to fear from an increase in interest rates. If central banks ever cut back on their dollar purchases, private investors abroad would likely demand much higher interest rates. They would have to be compensated for the risk of buying a dollar that may fall even more. **Given how leveraged the U.S. economy has become, with large domestic and external debts, any large rise in interest rates would do significant damage.**

POWER DRAIN

There is little doubt that U.S. external debt and the current account deficit are eroding the appeal of the U.S. approach to economic policy, an important element of U.S. "soft power." Asian policymakers, in particular, view U.S. economic policy not as a model but as a problem: the United States' "exorbitant privilege" -- Charles de Gaulle's term for Washington's ability to finance deficits by printing dollars -- comes at their expense.

The United States has a particularly delicate relationship with **China, which is currently the single biggest buyer of U.S. debt.** To date, disagreements on other issues have not prompted China to slow its accumulation of dollar reserves, but that is not to say that it could not happen in the future. The ability to send a "sell" order that roils markets may not give China a veto over U.S. foreign policy, but it surely does increase the cost of any U.S. policy that China opposes. Even if China never plays its financial card, the unbalanced economic relationship between the United States and China could add to the political tensions likely to accompany China's rise.

Economic power usually flows to creditors, not debtors. While the United States roams the world looking to sweep up any spare savings to finance its huge deficits, China roams the world looking for new places to invest its surplus savings -- including in oil and gas resources and in states that Washington has judged pariahs. **This is a far cry from the early days of the Cold War, when the United States used its surplus savings to finance the reconstruction of its allies, cementing political alliances with strong economic ties.**

Levey and Brown are right that so far, the world's appetite for U.S. credit has bolstered the U.S. ability to be a global hegemon "on the cheap." The United States exports enough to pay for only two-thirds of its imports; after recent tax cuts, the U.S. government collects enough non-Social Security revenue to cover only two-thirds of its non-Social Security spending. Foreigners made up the difference last year, buying enough U.S.

Treasuries to fund the entire budget deficit. But without access to this easy financing from foreign central banks, the U.S. government and the U.S. electorate will have to make the kinds of unpleasant choices they have thus far avoided: among guns, butter, pork, tax cuts, and low interest rates.

It is far better for Washington to act now, when it can act on its own terms, than to wait until sharp falls in foreign demand for dollar debt forces it to act. **The most important step, of course, is to start cutting the budget deficit rather than just talking about cutting the budget deficit. This will require reversing some recent tax cuts, not just controlling spending. Otherwise, the only way to reduce U.S. demand for foreign savings would be through a sharp decrease in private investment and consumption -- with disastrous consequences for the U.S. economy**. The Bush administration has been lucky over the past few years -- the growing value of U.S.-held European assets has kept U.S. external debt from rising, and foreign central banks' willingness to buy U.S. debt has helped keep U.S. interest rates low in the face of large deficits -- but its luck could easily turn.

Arguing that deficits -- external as well as domestic -- do not matter does not make them go away. Celebrating the United States' real economic strengths while ignoring the real -- and growing -- economic vulnerabilities associated with unprecedented current account deficits is dangerous.

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LEVEY AND BROWN REPLY

Brad Setser and Nouriel Roubini portray us as modern-day Panglosses for expecting an orderly adjustment of global economic imbalances and sustained U.S. hegemony. But to us, they are would-be Cassandras who gravely warn of U.S. decline just like the armies of "imperial overstretch" aficionados before them. Because Setser and Roubini misconstrue the causes of current imbalances, they lay the principal blame for these imbalances on U.S. macroeconomic policy, while ignoring European and Japanese stagnation and Asia's problematic economic policies. The United States, in their view, stands alone at the precipice, facing a stark choice: restore fiscal sanity to eliminate external imbalances or confront the prospect of nervous central banks severing the country's tenuous financial lifeline and setting it on the path to decay.

Fortunately, their rigid "twin deficit" view is not supported by the facts. Although there are good reasons to reduce medium-term budget deficits, there is only a tenuous link between the budget deficit and the current account deficit. The current account deficit, contrary to their depiction, is mostly the result of a post-bubble global savings glut, especially relative to good investment opportunities. The excess saving of the Europeans

and the Japanese has depressed global interest rates and required a large external deficit somewhere in the global economy. Thanks to its unequaled openness to imports and capital, the United States has provided that deficit.

Deep unilateral budget cuts, then, would do little to correct the current account deficit and -- in the absence of perpetually postponed growth-enhancing reforms in Europe and Japan -- are a recipe for global recession. Correcting global imbalances will instead require a cooperative approach: faster growth of domestic demand in Europe and Asia, higher U.S. saving, and a further gradual depreciation of the dollar. Although the current account deficit is not likely to stabilize anytime soon, all the major global economic players ultimately have good reason to favor an orderly adjustment process based on such complementary, mutually reinforcing policies. In the United States, tighter U.S. monetary policy and growing bipartisan attention to the fiscal trajectory will eventually raise the savings rate; in Asia, moderate reserve-currency diversification combined with a slowed pace of export growth can be achieved with gradual macroeconomic adjustment.

According to Setser and Roubini, the current situation is especially dangerous because foreign central banks are financing three-quarters of the $665 billion current account deficit. This accounting is incomplete, because it ignores most of the funds flowing into and out of the United States -- especially private foreign investment, which totaled over $800 billion in 2004. The $500 billion provided by central banks, therefore, represents only one-third, not three-fourths, of total capital inflows. Ongoing sizable additions to foreign private holdings reflect the unmatched safety and liquidity of U.S. financial markets and the dollar's as-yet-unchallenged key-currency role. Portraying the United States as desperately scrounging for surplus savings distorts the voluntary nature of these U.S.-bound capital flows.

By arguing that foreign investors currently fund only the budget deficit, rather than private investment as they did in the late 1990s, Setser and Roubini mislead again. True, central banks fund government borrowing, but only because they must hold risk-free, highly liquid reserve assets. Most of the remaining $1 trillion of foreign money that flowed into the United States in 2004 funded private economic activity, as large an amount as in any previous year. Meanwhile, U.S. private investors and corporations are vigorously amassing foreign assets. They added $821 billion in 2004, almost double the annual average during the late 1990s.

Setser and Roubini further warn that Asian central banks' fears of capital losses on dollar-denominated reserves could lead to a dollar selloff and a disorderly downward spiral for the greenback, forcing a painful spike in U.S. interest rates. Such arguments conflate the incentives governing private behavior -- with its fixation on exchange-rate-adjusted real returns -- with the very different constraints facing central banks. The latter use reserves to manage their exchange rates and protect against capital-flow reversals. They care far less about the value of their reserves in terms of their own domestic currencies, as reserves do not represent claims against domestically produced goods and services. Therefore, capital losses measured as a share of GDP -- as Setser and Roubini estimate with China's reserves -- hold little economic meaning. The relatively small cost of

currency appreciation pales in comparison to the enormous benefits Asia derives from maintaining competitiveness in U.S. markets.

Finally, U.S. debt has eroded neither the appeal of the U.S. economic model nor its soft power. The "Lisbon agenda" of market reform in Europe, the ongoing liberalization of Asian capital markets, and structural change in Japan all suggest that growth-enhancing elements of the U.S. model represent vital complements to existing national varieties of capitalism. China also faces serious difficulties -- unreformed state enterprises, bankrupt banks, and the need for massive job creation, to name only a few -- which Setser and Roubini's view of global economic imbalances vastly underestimates. The Chinese government remains heavily dependent on U.S. market access and technology to manage its potentially unstable transformation.

It is a mistake to equate borrowing with a loss of power just because the United States was once a net creditor and also powerful. If power presupposes creditor status, is the ticket to sustained hegemony the investment stagnation, structural unemployment, and aging populations characteristic of Europe and Japan? Its net debtor status notwithstanding, the United States enjoys overwhelming dynamism and influence rooted in rapid productivity growth based on innovation at the technology frontier. **Meanwhile, it serves as the "buyer of last resort," the primary source of technology transfer, and the global monetary anchor -- the classic hegemon providing critical "public goods."**

Setser and Roubini see the United States as a floundering Leviathan; we see it as a firmly grounded giant. Over the last decade, business investment in equipment and software (even excluding vital "intangible investment") has increased 66 percent in real terms, compared to a 44 percent increase in personal consumption. The result is an economy leagues ahead in the production and utilization of information technology. Meanwhile, net household wealth is at an all-time high, government debt remains moderate by international standards, and corporations -- having paid down their debts -- are unusually liquid. The tired caricature of an overconsuming and underinvesting wastrel is difficult to square with a country that has combined strong growth -- interrupted only by two brief and mild recessions -- with monetary stability over the last 20 years.

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