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America's current account: a deficit of judgment

Despite arguments to the contrary, America's current account deficit is a huge problem, says Kenneth Rogoff. But a decline in the dollar won't solve it: a more sophisticated, multi-lateral, response is required

Will America's latest public and private borrowing rampage, already more than a decade old, end in tears? Should we expect the gaping current account deficit, (the excess of what the country invests less what domestic savings provide) to continue indefinitely, with countries like China, Brazil, Japan and Germany running huge offsetting surpluses? Or, as some of us have been arguing for years, should we expect the gap, (estimated at $600 billion in 2004), eventually to close, followed by a broad-based, and potentially disruptive, decline in the dollar? There is a raging policy debate, and whether or not decision-makers engage in a more intensive and balanced response will determine the future of international macroeconomic policy co-ordination.

Crisis? What crisis?

Basically, there are three schools of thought**.** The first is that there is no problem, as former United States Treasury secretary Paul O'Neill famously opined. If foreign investors want to keep pouring their money into the country this is a sign of strength, not of weakness. America, with its vast liquid markets, counts for a disproportionate share of the world's tradable bonds and stocks, even beyond its 22% share of global income. As people expand their global portfolios, this inevitably involves buying more and more American assets. Emerging Asian economies, especially China, the argument runs, also need to keep accumulating dollar assets to prepare for the day when their economic boom turns into bust. According to this world-view, foreigners can keep piling up dollars for decades, perhaps even another fifty years. So don't bother America about its pathetic savings rate. Don't bother China about its inflexible exchange rate: everything's fine.

A nice bedtime story, perhaps, but, like all good bedtime stories, there's an element of fantasy about it. One delusion is that the American current account deficit still supports high real investment, as it did in the 1990s: it doesn't. Rather, it increasingly mirrors open-ended government borrowing. Investment in the real economy leads to growth, helping to repay higher debt. Government deficits, on the other hand, just lead to higher taxes and lower growth. (Unless, perhaps, the funds are used to invest in high social return public infrastructure projects like roads, bridges and education. Unfortunately, this is patently not the case today.) Usually, when a big current account deficit reflects a big government deficit, it is the beginning of the end. A second fantasy is the notion that foreigners will continue to be satisfied with the miserable returns they have been getting on their dollar investments. For a complex variety of reasons, foreigners have consistently earned stunningly low, often negative, returns in America. Japanese blunders are the stuff of legend (the purchase of New York's Rockefeller Center

at the peak comes to mind.) But Europeans have not done much better. They invested heavily in bonds during the second half of the 1990s, until they switched into equities just ahead of the technology crash. Partly as a consequence of this asset depreciation, and also because of 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.

But this cannot continue. If foreigners don't start earning normal returns, they will retrench. And if they do start earning reasonable returns, America's net debt (currently around 25% of national income, a record) will start rising even faster. Then there is the much-ballyhooed accumulation of dollar reserves in China, Japan and rest of Asia, now approaching $2 trillion. Given the dollar's vulnerability, and the low yields on Treasury bills, we are likely to see Asian central banks diversifying into the euro and other currencies. Lastly, most projections suggest that Japan's savings rate will continue to sink as its population—with the fastest ageing in the developed world—retires.

"It'll sort itself out…"

So much for the "what me, worry?" school of thought. A second argument goes that, sure, the current account is going to have to rebalance at some point, but it is no big deal and deep global capital markets can handle the adjustment easily. There is some history to support this perspective. During the 1980s, after Ronald Reagan's aggressive tax cuts, America was also running large simultaneous current account and budget deficits (although the current account deficit then was much smaller as a share of national income than it is today.) Sure, when the correction hit, the dollar crashed by 40% on a trade-weighted basis (and by even more against the deutschmark and the yen). But, according to this Pollyanna-ish argument, the fallout wasn't so bad, except, perhaps, for helping set off the events that led to Japan's recent decade-long recession. Unfortunately, there are some growing holes in this logic, which perhaps explains why some early adherents, including US Federal Chairman Alan Greenspan, are now expressing growing concern.

"…no it won't"

First, a huge fall in the dollar is always going to have unpredictable global ramifications, possibly triggering financial crises and probably suffocating global growth. Just because the world dodged a bullet once doesn't mean we'll be so lucky again. The other problem is that the current decade looks less like the 1980s than the 1970s, when the collapse of the Bretton Woods fixed exchange rate system also led to a fall in the dollar. Today, like the 1970s, America is engaged in an aggressive monetary and fiscal expansion (then, particularly in advance of President Richard Nixon's re-election in 1972.) Today, like then, America was facing unlimited security costs. Back in the 1970s, it was Vietnam. Today it is "homeland security" and Iraqistan. Last, but not least, in 1972 Congress passed a huge open-ended increase in social security pensions (again, conveniently timed to go into effect just before the election.) Today, newly-passed higher prescription drug benefits will have the same effect on the budget. Oh, and did I forget to mention oil prices, which exploded in the 1970s and are under pressure again today?

The 1980s may have led up to the boom of the 1990s, but the 1970s were a growth disaster for the industrialized countries. So, whereas a sudden rebalancing of the American current account might be benign, it will not be if it occurs against the backdrop of other serious problems.

Having a bit of perspective on the numbers helps illustrate the potential gravity of the situation, and why some of us are so concerned. Let's compare the $600 billion current account deficit—let's call it a borrowing tab—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 $166 billion in 2004 and are projected to be about the same in 2005. Incredibly, if one adds up the surpluses of all the countries in the world who are 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%** of the total. When the United States wades into the global capital market, it pretty much empties all the water out the pool. The $600 billion borrowing tab represents more than 5.4% of US income. Never, even as a developing nation in the 19th century, or during wars, has America ever depended so much on the "kindness of strangers". There are few enough examples of small countries borrowing such large fractions of income year in, year out, much less a large country like America.

A cheap dollar won't be enough…

So policymakers are right to be worried. But what, if any, action can be taken? The clearest advice is on what not to do. Policymakers should not try to engineer an unprovoked, broad co-ordinated decline in the dollar. Many people think that a dollar decline is going to solve the problem. They are wrong. A dollar decline, even if one could be engineered, is only going to take care of a part of the deficit. Indeed, according to my analysis with Professor Maurice Obstfeld of Berkeley, even a broad-based fall in the dollar of 20% would only knock 2 percent off the US's 6 percent deficit. Other steps are still needed to close the gap.

... but dearer money will help

A restoration of normal interest rate levels will help, of course, by encouraging savings and, more directly, by capping house price increases that have fueled a mortgage refinancing and borrowing cycle. It would also help if the government closes up its own deficit—good advice in any event. Another positive shock would be for foreign countries to start catching up with American productivity gains in the non-traded sectors of their economies. Retailing, for example, is an area where America has enjoyed a productivity explosion in recent decades. A similar productivity gain abroad would drive foreign demand for American goods. Of course, if the productivity gains were concentrated in foreign export industries, that would simply exacerbate the problem. Finally, while having more flexible exchange rates in Asia won't turn around America's deficit overnight, they will provide a more flexible global environment for imbalances to unwind.

Global imbalances have been cumulating for some time, and now represent a substantial risk to the world economy, especially if they unwind in an otherwise adverse

scenario. Whereas there are limits to what policymakers can do to anticipate the correction, this does not mean they are helpless. Far better to try to move the global economy towards 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 multi-lateral policy consultations. If we don't see any coordinated response on this one, it won't auger well for global financial governance over the next decade.