

The US deficit problem is not only a domestic issue, but a global concern and neither candidate has the answer, say Maurice Obstfeld and Kenneth Rogoff.

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Should the next US administration worry that high oil prices are pushing America's current account deficit towards 6 per cent of national income, the country's all-time record high? Should it worry that the US is single-handedly eating up more than 70 per cent of the combined current account surpluses of China, Japan, Germany and all the other surplus countries in the world? Should it worry that foreigners might start balking at the sub-par returns they have been averaging in the US market for more than a decade? Will it matter for this foreign borrowing binge whether George W. Bush or John Kerry wins tomorrow?

Our answer to the first question is a resounding "yes". We first began publishing papers on the risks of a US current account collapse more than four years ago.* Back then it was an important medium-term problem. Today it should be problem number one on the new president's international financial agenda. Sadly, we fear it will not be. The winning candidate will probably find it convenient to hide behind one of the proliferating versions of the revisionist theory that there simply is no problem.

According to this seductive view, foreign investors, especially official ones, will never tire of accumulating crisp green dollars. In fact, it would be unneighbourly of the US to stop pumping nearly Dollars 600bn (Pounds 325bn) a year (and growing) of its liabilities out into the world market. Besides, even if the current account did close up and the dollar collapsed (by 20-40 per cent, according to our latest analysis**), there would be no need to worry. Global capital markets are deep, and a dollar meltdown would be relatively benign, as in the 1980s.

We are very sceptical. 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 towards 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.

No, a sober US president-elect ought to worry a lot about his country's foreign borrowing addiction. But what to do? Given that the federal government's own impecuniousness is a big part of the problem, raising taxes would seem like a good place to start. Taxes would have to rise more broadly than in Mr Kerry's proposals to tax high wage earners, even ignoring his spending promises. George W. Bush, if he wins, ought to look at how Ronald Reagan did it. His decision to raise taxes in his second term almost certainly helped facilitate the steep but smooth adjustment in the dollar's exchange rate that took place on his watch.

Perhaps as the Federal Reserve continues to normalise interest rates, that, too, will help by tempering the dollar's fall and stimulating US private saving. Countries such as Germany and Japan could help by encouraging productivity growth in the nontraded goods sectors that constitute the bulk of their outputs. Productivity gains would be welcome in traded goods, but if that is the main locus of growth, current account imbalances will get worse before they get better. Of course, a move to more flexible exchange rates in Asia is also needed, although this step alone is not enough.

Four years ago the US current account deficit stood at 4.4 per cent of gross domestic product, below today's level. We then speculated that an unwinding of the imbalances would probably take place over a three to five years, accompanied by a large depreciation of the dollar. That was before the Bush tax cuts, September 11 2001 and the Iraq war. Four years ago the US current account deficit was arguably financing high investment, although a collapse in private savings also weighed heavily. Today's 6 per cent deficit is larger and is mainly financing government borrowing, a far riskier situation. With the government's fiscal deficit now accounting for most of the country's overall borrowing, events are likely to unfold within the next presidential term.

Neither candidate has yet proposed a convincing solution. Both seem to think, in denial of spending realities, that at least half the budget deficit is going to evaporate painlessly. Whoever wins tomorrow can look forward to a cold blast of water from the ocean of international capital markets. The problem for the world economy is that many other countries will get flooded at the same time.

* "Perspectives on OECD Capital Market Integration", in *Global Economic Integration* (Federal Reserve Bank of Kansas City, 2000); ** "The Unsustainable US Current Account Position Revisited," *NBER working paper* 10869, October 2004.

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