

The United States as a Debtor Nation

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The United States has swung from being the world's largest creditor to the largest debtor nation. At the end of 2004, it had net external liabilities of \$2.5 trillion, or 22 percent of GDP. The current account (goods and services, transfers, and capital income) is massively in deficit—about \$670 billion in 2004, or about 6 percent of GDP. If corrective measures (US fiscal adjustment and a further decline of the dollar) are not taken, the current account deficit will reach about 7½ to 8 percent of GDP by 2010, and net international liabilities will reach about 50 percent of GDP.

The rising imbalance will increasingly put the US economy—and hence the world economy and especially developing countries—at risk of a major crisis, as foreign investors lose confidence and US protectionist pressures mount. The longer the needed adjustment is delayed, the more wrenching it will be, triggering high interest rates, US recession, a greater decline in US households' living standards, and more damage to the global economy.

In the late 1990s, the rising trade deficit and associated borrowing from abroad were benign, and the additional foreign resources were directed toward more investment. But now such resources largely finance US private and government consumption rather than productive investment. A favorable consideration is that the United States has a higher rate of return on direct investment abroad than the rate on foreigners' direct investment in the United States. This has kept net capital income positive, so the United States is not yet a net debtor nation when measured by economic burden of payments. Moreover, when the dollar depreciates, there is a windfall gain on equity assets abroad, which are denominated in foreign currency. But despite these two advantages, the author's projections show a sharp deterioration in the net foreign asset position going forward, as even net capital income swings into large deficit.

Several major policy implications arise from the climbing US debt. First, there must be a major correction in the US fiscal deficit. Reasonable baseline estimates show the budget deficit continuing in the range of 3 to 3.5 percent of GDP, taking into account the Bush administration's goal of making the tax cuts permanent and without considering Katrina recovery spending. The budget deficit should be completely eliminated rather than merely cut in half (as the Bush administration seeks) if the current account deficit is to be cut to the range of 3 percent of GDP. A reasonable target would be to reach a zero federal deficit by 2010. This goal would require

reducing the deficit by an average of 0.6 percent of GDP each year between now and then.

At least a partial reversal of the decline in personal saving over the past decade should accompany fiscal adjustment. The greater the rebound in personal saving, the smaller the needed fiscal correction. If fiscal correction is not achieved or is only minor (for example, if the fiscal deficit continues at 3 percent of GDP), then the external account adjustment from further real depreciation of the dollar is likely to be much smaller than would be achieved through joint depreciation and fiscal adjustment. Dollar depreciation without fiscal correction will tend to boost interest rates, bid the dollar back up, and frustrate much of the potential trade adjustment.

Another broad implication is the need for a widespread appreciation of currencies against the dollar. The dollar needs to decline by as much as 20 percent more, which with the elimination of the fiscal deficit could bring the current account deficit down to a sustainable 3 percent of GDP and thereby keep net foreign debt from rising beyond 50 percent of GDP. Asian currencies that have not yet appreciated significantly against the dollar, especially the Chinese renminbi, will need to rise sharply, and central banks should stop intervening to prevent this rise. An Asian Plaza Agreement may be needed to coordinate these currency adjustments.

Second-best alternatives, if numerous countries with surpluses resist appreciation, primarily focus on China but apply more broadly. The United States might legitimately impose countervailing duties on imports from countries judged to be subsidizing exports by keeping their currencies artificially undervalued. The possibility of such penalties might prompt countries to let their exchange rates rise against the dollar. However, it would be appropriate to consider such an approach only in conjunction with a US commitment to place its own house in order by adopting a credible plan to eliminate the fiscal deficit over a reasonable period. The author also suggests that if large capital inflows into the United States continue to keep the dollar overvalued and provoke continued widening in the current account deficit, eventually it may become desirable to impose a withholding tax on foreign earnings on assets held in the United States as a disincentive to these inflows.

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