
Is the US External Deficit Sustainable?

Over the longer run . . . the persistence of large trade deficits could cause foreign investors to shift out of dollar assets—perhaps precipitously.

—Gene Koretz, *Business Week* (23 February 1998)

[T]his deficit has a very different character from the imbalances of the mid-1980s. . . . [T]he U.S. trade gap is “self-financing” to a greater extent than were the deficits of the 1980s.

—Chase Currency Research, *Special Report* (6 April 1998)

[T]he international system cannot sustain indefinitely the large current account imbalances created by the disparities in growth and openness between the U.S. and its major trading partners.

—Treasury Secretary Robert Rubin, press conference before G-7 meeting
(17 February 1999)

Whenever a country's current account deficit grows large, questions arise as to how large it can get, how long it can persist, and what forces might either stabilize it or cause it to shrink. The history of financial crises from Latin America in the 1890s to Asia in the 1990s, and plenty of industrialized countries in between, clearly shows that too much external borrowing and/or accumulated international obligations can precipitate financial and, subsequently, economic disasters. But what is it that precipitates the crisis? Is it the size of the deficit or accumulated obligations? Do their particular characteristics (such as maturity or currency) or their use (such as for consumption or real estate ventures) contribute to the economic

forces that precipitate a crisis? Moreover, when the current account deficit gets large, is crisis inevitable, or are more benign outcomes possible?

Answering the question of whether the US current account deficit and net international investment position are sustainable requires some preliminary analytical and empirical groundwork. We must define “sustainable,” and we must do so from two related perspectives: that of the net borrower—the United States—and that of the net investor—the rest of the world. (A third dimension, political sustainability, will be discussed as well.) On the borrower’s side, analyses of different countries’ experiences with large current account deficits and net international obligations can help to uncover empirical evidence of what constitutes sustainability. But will these be applicable to the United States, or do different rules apply to the United States because of the international role of the dollar or the size and strength of the US economy?

On the investor side, we must look at the size and composition of global wealth portfolios. How important are US dollar obligations in the portfolios of potential investors? Can the US dollar share in world portfolio holdings grow larger than might be the case for some other countries’ assets because the United States is so important in global trade and finance? What we find is that it is not only how much the United States can and does borrow that matters for the deficits’ sustainability but also how much investors in other countries are willing to buy and hold US assets in their portfolios of financial assets. The United States is special in both regards.

This chapter begins with a framework for assessing sustainability and then applies it to data from the United States and from other industrial countries. I then construct trajectories for the trade account, the current account, and the net international investment position under three different scenarios. The first scenario assumes that the exchange value of the dollar remains at the high levels of 1998 and early 1999 and that US and world growth rates return to long-term rates of growth of potential. I compare the values for the external accounts to sustainability benchmarks taken from US experience as well as from the experience of other industrialized countries. Whether the United States is special—and if so, in what way—is an important part of assessing whether the constellation of growth and exchange value of the dollar assumed in this scenario yields sustainable trajectories of external balance and position.

In the second scenario, I review what would happen to the trajectory of external accounts and their relationship to sustainability benchmarks if the dollar were to depreciate substantially. The amount of depreciation is chosen by how much it would take to return the dollar to an estimate of the fundamental equilibrium exchange rate (Wren-Lewis and Driver 1998).

The third scenario focuses on structural change in the international environment. Specifically, the third trajectory shows the implications for US external accounts if the exchange value of the dollar remained unchanged, if economic reforms increased US and world rates of growth of

potential, and if liberalization and deregulation of service sectors worldwide increased US services exports as a share of total exports.

The Concept of Sustainability

“Sustainable” in the context of the economics of external balance refers to “stasis,” that is, a stable state or a stable path where the external balance generates no economic forces of its own to change its trajectory. A sustainable external balance is one in which the feedback relationships between the external balance and exchange rates and interest rates are relatively weak in comparison to other macroeconomic forces that affect these asset prices. For example, a large current account deficit may make investors worry that they might not be repaid. They might then decide to sell some assets, which would generate upward pressure on interest rates or depreciation pressure on the exchange rate. In this case, the current account deficit would not be sustainable by this definition. A large current account deficit alone need not engender these feedback relationships, however. If investors want to hold more assets of the country in question because growth there is strong, interest rates will not rise and the currency could appreciate. Finally, even if the trajectory is unsustainable, crisis is not inevitable. Feedback relationships can yield a smooth transition to a sustainable trajectory.

There are two points of view to any analysis of whether an external imbalance is sustainable: that of the borrower (the country in question) and that of the lender (the investor). The borrower cares about the implications for the domestic economy of both a trade deficit (which is a *flow* concept) and the net international investment position (which is a *stock* concept), because both represent future claims on the resources of the country that cannot be used for domestic consumption or investment. A trade deficit represents the value over a period of time of a country’s borrowing on international markets, as a sovereign nation and/or as a collection of private market participants, to finance the excess of domestic spending over domestic production.¹ The net international investment position (NIIP) is the accumulation over time of trade deficits plus any additional borrowing needed to service (e.g., pay interest and dividends on)

1. The trade deficit can be expressed as the excess of total investment over total savings (public and private) or, alternatively, as the difference between production and expenditure. (For more on these approaches to analyzing the deficit, see chapters 3 and 8.) The point to remember is that if there is an external imbalance (a trade deficit), there is an internal imbalance (domestic demand exceeds production). In addition, whereas a trade deficit today means that resources are being transferred to the country from the rest of the world, in the future today’s trade deficit and accumulated borrowing will have to be paid back—representing the future transfer of resources *back* to the rest of the world.

the NIIP. The sum of the trade deficit and net investment payments is the current account deficit.²

For the United States, the NIIP has been increasingly negative since the late 1980s (figure 10.1). This is a result not only of borrowing since 1980 to finance the persistent trade deficit but also of additional borrowing since 1997 to finance net investment payments on the negative NIIP.³ From the standpoint of global investors, the US trade deficit represents the additional flow of US assets into their portfolio of wealth, and the negative NIIP represents the stock of US assets in their portfolio of wealth.

Borrower's Constraint

For a net borrower, a key sustainability relationship involves the accumulated stock of net international investments and the flow of trade deficits that accumulate to this stock.⁴ A negative net international investment position cannot increase without bounds, since ultimately net investment payments on the negative position would use all the resources of the economy, leaving nothing for domestic consumption. From the standpoint of the domestic economy, the importance of the stock of foreign claims is best measured not by the NIIP itself but by the ratio of NIIP to GDP.

Even when the NIIP/GDP ratio reaches a constant value, net capital inflows (that is, net investment by foreigners) will continue, since GDP, which constitutes the wherewithal to service the obligations, increases as well. These net capital inflows represent the financing of the ongoing current account deficit. Thus, as GDP grows, capital inflows can continue, and the current account can remain in deficit and accumulate to a rising NIIP but a constant NIIP/GDP ratio.

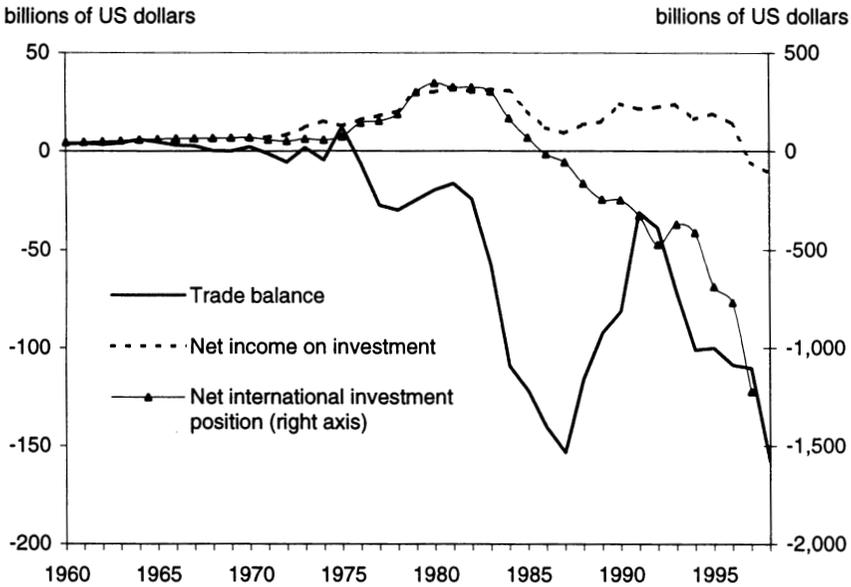
The relationship between the current account and the NIIP/GDP ratio is affected primarily by two factors: the growth rate of GDP and the characteristics of the obligations. With a higher growth rate of the economy in the long run, servicing interest and principal on the NIIP accounts for a smaller share of future output, so it reduces domestic consumption and investment by less. Hence higher long-run growth allows a country to continue along its current trajectory of spending and saving (as measured by the current account deficit) longer than could a country with slower long-run growth.

2. For analytical purposes, I have left out unilateral transfers. As shown in figure 8.1, unilateral transfers have been increasing a bit over the years and hence they do affect the level of the deficit, but they are less important for understanding the dynamics of the current account deficit or the net international investment position.

3. For some time after the NIIP turned negative, the net investment payments were positive, because the rate of return on US investment abroad was greater than that on foreign investment in the United States. For more on this issue, see Stevens (1997).

4. This section and the next draw on Milesi-Ferretti and Razin (1996) and Sekiguchi (1997).

Figure 10.1 The stock and flow of US international investment, 1960-98



Source: US Department of Commerce, *International Transactions Tables*.

As for the second factor, the lower the interest rate on debt obligations in the NIIP and the higher the share of equity obligations (which have contractual service requirements less strict than bank debt), the longer a country can run current account deficits, since the investment service likely is lower. In addition, the higher the share of obligations in the country's own currency, the less vulnerable the country is to exchange rate volatility. Hence a country that issues assets (that is, borrows) mostly in its own currency, at low interest rates, and with a high share of equity can continue along its trajectory of spending and saving for longer than could a country that borrows in currencies other than its own, at high interest rates, and using fixed-maturity debt.

At some point, investors will want to be repaid their principal, not just have their debt serviced. In theoretical terms, if all investors someday want to be repaid and there are no new investors, this means that a country that currently borrows will ultimately have to be a net lender—that is, run a trade surplus.⁵ The present discounted value of the future years of

5. This simple presentation in the static world abstracts from many key features of the real world, including—most importantly—growth in wealth and the changing pattern of savers and investors around the world. The static presentation highlights the essential point, which is the link between investors' expectations for the future and the observable situation in the present.

trade surpluses must equal the outstanding net investment position. If the accumulation of *future* trade surpluses is too small, the principal plus interest will not be repaid—that is, the outstanding NIIP now is too large, which means that the current account deficits *now* also are too large.

When investors recognize that this situation might occur sometime in the future, they will not lend at current terms even today. Given this change in willingness to lend (that is, to invest in the borrowing country's assets), the borrower's interest rate rises as it tries to attract lenders, or its currency depreciates as existing lenders try to sell their investments, or investors simply are unwilling to lend at all (capital inflows cease)—or these tendencies occur in some combination. Once these forces are in motion, the current account deficit and the net international investment position have become unsustainable.

Empirical analysis can be used to determine the values for the ratio of NIIP to GDP and the ratio of current account to GDP (CA/GDP) at which investor sentiment can change and make the trajectory for the external accounts unsustainable. However, countries differ in their prospects for growth as well as in the maturity characteristics and currency composition of their debt. Other factors, such as global economic conditions, also will affect whether a country's external accounts are sustainable. Consequently, sustainability benchmarks derived from empirical analysis must be judged with caution and with an eye toward a country's particular situation as well as the prospects for the global economy.

Investor's Constraint

A country's obligations constitute assets in the wealth portfolios of global investors. Investors have their own portfolio constraints, which are similar to and related to the constraint on the NIIP/GDP ratio for the borrowing country. The highest possible share of a given global investor's portfolio allocated to the obligations of a given net borrowing country is 100 percent—though, of course, the share would likely settle at some lower level. Even if the portfolio share of one country's assets reaches some constant level, however, the value of those obligations could continue to rise as the value of global investors' portfolios increases.

How much lenders are willing to lend to residents of a country is a function of the risk-return profile of that borrower's assets relative to other assets as well as the investor's attitude toward risk and desire to diversify investments. Risk and return are codetermined by interest rates and currency valuations. The growth of the investor's home economy, the size of his or her global portfolio, and the available supply of alternative foreign investments also are important in determining how much of a country's assets the foreign investor wants. If the variability of the rate of return on a foreign investment increases—because of variability either in interest rates or in exchange rates—investment in that foreign asset gen-

erally declines. On the other hand, as the investor's country grows, the wealth portfolio grows, and lending to foreign countries increases.

The value of foreign financial assets added to the investor's portfolio must equal the value of financial assets offered by the borrowing country, which is its current account deficit. If the demand for these assets is too low (or if the current account deficits are too large), this means that the borrower's and the investors' desires do not match; there is a wedge between what the investors are willing to buy and what the borrower needs to sell. The investors may demand a higher return (interest rate), or may sell investments, causing the borrower's currency to depreciate. A higher interest rate will tend to slow the rate of growth of income and imports, and a depreciated currency will tend to shift relative prices in favor of domestic products and thus narrow the borrower's current account gap to bring it into line with what the investor is willing to finance. When these economic forces are set in motion, a current account deficit is revealed to be unsustainable.

Political Sustainability

There is a third dimension—political sustainability. It is clear that as a country's trade deficit grows large and differentially affects certain sectors, political activity on the trade agenda (on the part of both Congress and the administration) increases, often with the intent of protecting certain domestic markets.⁶ The evidence suggests that political sustainability might break down far earlier than economic sustainability as measured from either the borrower's or the investor's perspective. In 1985, when the trade agenda was rife with protectionist legislation, the current account deficit was 3 percent of GDP; it would rise to 3.6 percent of GDP before the change in the value of the dollar worked through to change relative prices and trade flows. In 1998, although the current account deficit was a relatively smaller 2.6 percent of GDP and the US economy was growing rapidly with historically low unemployment and inflation rates, negotiations to liberalize trade remained at a standstill because the administration did not have "fast-track" negotiating authority. And in 1999, as several protectionist steel bills worked their way through Congress, steel imports were slapped with antidumping duties. What this political unsustainability might mean for the evolution of policy, particularly with regard to exchange rates, is discussed later in this chapter.

Sustainability and the Business Cycle

Finally, sustainability benchmarks can be applied over short-term or long-term time horizons. In most theoretical exercises that explore sustainability, it is usually the case that the key ratios of CA/GDP and NIIP/GDP are

6. See chapter 4 on how trade affects workers and chapter 6 on how trade policy affects trade and the trade balance, and the references cited there on the politics of trade policy.

always rising—that is, the trade deficit increases, the negative net investment position increases, and investment service payments increase until some critical value of the CA/GDP or NIIP/GDP ratio is reached. This is because rates of growth usually are assumed to be constant for the period of the exercise. As discussed in chapter 8, however, the US external balance has exhibited cyclical variation caused by changes in GDP growth on top of the trend widening of the deficit, negative NIIP, and net service payments; so the deficits and the CA/GDP ratio have not always been rising in the United States. Hence the trajectories of external balance that result from these modeling exercises and the application of sustainability benchmarks to those trajectories must be interpreted cautiously, since countries will experience business-cycle swings that generally are not reflected in the assumptions underlying the trajectories. In this regard, benchmarks for the CA/GDP or NIIP/GDP ratios have less value as point estimates than as indicators of when economic forces might start to build, which ultimately will drive the country back toward a sustainable path.

Empirical Criteria and Evidence of Sustainability for Industrial Countries

Given that real economic systems are in a state of constant change, evaluating sustainability implies comparing today's external flows and net international investment position to empirical observations for the sustainability benchmarks. There is a rich sample of sustainability crises that offer empirical observations (Goldstein, Kaminsky, and Reinhart, forthcoming). While most of these events pertain to low- and middle-income countries, there have been episodes of financial-market instability and questions of current account sustainability for some high-income countries as well. From these episodes, empirical regularities might point to sustainability benchmarks for industrial countries that can be applied to US data.

In data from the 1980s and 1990s for 10 industrial countries, we can pick out 17 episodes in which a trend widening of a current account deficit was reversed.⁷ The reasons for these reversals are not addressed, however, so they are not necessarily all sustainability episodes. With the outliers excluded, the average CA/GDP ratio was -4.2 percent when the current ac-

7. The countries and years of the episodes are: Australia, 1986 and 1995; Canada, 1981 and 1991; Finland, 1983 and 1991; Italy, 1981 and 1992; Norway, 1986; New Zealand, 1984 and 1996; Spain, 1981 and 1991; Sweden, 1982 and 1992; United Kingdom, 1989; and United States, 1987. I have selected the 1980s and 1990s observation time frame because financial markets play the key role in sustainability (see chapter 9), and these markets have changed dramatically in the past 20 years. For reference, however, in 1971, when the dollar was devalued 10 percent in the Smithsonian Agreement realignments, the current account was headed for -\$5.8 billion or 0.5 percent of GDP in 1972. In 1978, when the dollar began a bout of depreciation, the current account deficit was \$15.1 billion or about 0.7 percent of GDP. (The merchandise trade deficit and its share of GDP were twice these magnitudes—thus pointing again to the potential impact of political sustainability.)

Table 10.1 Selected industrial countries: Institutional investors' holdings of securities issued by nonresidents (percentage of total assets)

	1980	1988	1990	1991	1992	1993	1994	1995
Pension funds								
United States	0.7	2.7	4.2	4.1	4.6	5.7	n.a.	n.a.
Japan	0.5	6.3	7.2	8.4	8.4	9.0	n.a.	n.a.
Germany	n.a.	3.8	4.5	4.5	4.3	4.5	5.0	n.a.
United Kingdom	7.9	16.3	17.8	20.6	19.5	20.0	19.8	19.8
Canada	4.9	5.9	6.4	8.6	10.2	11.6	12.9	14.2
Mutual funds								
United States	n.a.	n.a.	6.6	n.a.	10.1	n.a.	n.a.	n.a.
Japan	n.a.	9.1	7.9	13.0	9.9	n.a.	n.a.	n.a.
Germany	n.a.	n.a.	n.a.	n.a.	n.a.	24.8	20.3	20.2
United Kingdom	17.9	33.0	31.0	34.3	35.2	35.8	36.4	34.5
Canada	19.9	19.4	17.5	16.1	17.0	20.0	24.0	24.6

n.a. = not available

Source: IMF, *International Capital Markets* (September 1998).

count started to narrow. Throughout these episodes, the NIIP/GDP ratio continued to climb, so this criterion does not appear to be the one that triggers the economic forces leading to the change in the current account trajectory.

For a sustainability benchmark based on the share of foreign assets in a global portfolio—the investor's constraint—there are fewer empirical examples. In general, market participants put the majority of their wealth into financial assets from their own country,⁸ although for the international financial markets as a whole, there is a clear preference for dollar-denominated assets (though not all of these are claims on US resources) (see table 2.1). In individual portfolios, the share of wealth invested in securities issued by nonresidents has risen over time, particularly with the increasing globalization of finance and financial institutions. In some countries mutual funds invest about one-third of their portfolio of assets in nonresident securities, but in other countries and in other investment funds the share is much lower (table 10.1).

Applying the Analytical Framework and Empirical Benchmarks to US Data

We now have an analytical foundation for assessing sustainability and some empirical benchmarks from previous US experience as well as from

8. See Lewis (1999) for a review of the literature on home bias.

Table 10.2 Exogenous variables and sustainability framework

	2001-10			
	1999	2000	High performance	Business as usual
US real GDP (percentage)*	3.3	2.2	2.7	2.1
World real GDP (percentage)*	2.3	3.4	5.0	3.2
Export income elasticity	1.0	1.0	1.0	1.0
Import income elasticity	1.7	1.7	1.7	1.7
Interest rate (percentage)	4.0	4.0	4.0	4.0
Inflation rate (percentage)	2.0	2.0	2.0	2.0

a. Forecast for 1999 and 2000 from IMF, *World Economic Outlook* (May 1999). Estimates for 2001-10 from OECD (1997). Other data are author's estimates.

Sustainability framework

$$EX = EX(t-1) * (1 + Y_w * E_{ex}/100 + (NEU - NEU(t-1)) / NEU(t-1))$$

$$IM = IM(t-1) * (1 + Y_{us} * E_{im}/100 - (NEU - NEU(t-1)) / NEU(t-1))$$

$$TB = EX - IM$$

$$CA = TB + NIIP(t-1) * r$$

$$NIIP = NIIP(t-1) + CA = NIIP(t-1) + NIIP(t-1) * r + TB$$

Where:

EX = exports

IM = imports

TB = trade balance

CA = current account

NIIP = net international investment position

E_{ex} = export income elasticity

E_{im} = import income elasticity

NEU = nominal effective exchange rate index

Y_w = world growth (nominal)

Y_{us} = US growth (nominal)

r = nominal interest rate

Note: (t - 1) indicates a lag.

other industrial countries. The benchmarks can be applied to US data to assess the sustainability of US external dynamics, now and in the future. The sustainability exercise has the following inputs: the analytical framework; data on exports, imports, current account, and NIIP; empirical values for critical parameters, such as the marginal propensity to import and export, which are key drivers of the trade balance; and trajectories for key variables such as forecasts for near-term GDP growth and estimates of long-term potential growth of GDP and the world interest rate and inflation rate (table 10.2).

The sustainability framework is a set of simple equations. Assumptions about the growth rate of US and foreign income and the exchange rate along with the export and import income elasticities generate trajectories

for exports, imports, and the trade balance.⁹ The current account equation adds up the trade balance and service payments on the NIIP, using an assumption for the nominal interest rate. The NIIP equation accumulates the current account deficits.

The near-term growth rates are taken from the IMF's May 1999 *World Economic Outlook*. Changes in the near-term outlook have been significant (as discussed in chapter 8) and have an important impact on the near-term assessment of sustainability. Estimating the long-term rate of growth of potential is substantially more complex. The OECD has undertaken an extensive exercise to examine two alternative scenarios for the world to 2010 and on to 2020: a "business-as-usual" scenario, leading to relatively low growth in the United States (2.1 percent) and worldwide (3.2 percent), and a "high-performance" scenario, leading to more rapid growth in the United States (2.7 percent) and worldwide (5 percent). As described by the OECD:

The "business as usual" case assumes a continuation in current productivity trends with limited progress in trade and investment liberalization, structural reforms, and budgetary control.

The "high-performance" case assumes more favourable trends in international liberalization of trade and investment policies, accompanied by a stepping up of the pace of structural reforms, including regulatory and budgetary reforms, and a stable macroeconomic environment.¹⁰

Three snapshots in time on the trajectories are presented in table 10.3: the near horizon to 2000, a medium-term horizon to 2005, and the long-term horizon to 2010. The near-term snapshot focuses on whether the consequences for global growth of the 1997-98 financial turmoil could precipitate a sustainability episode as the US economy continues to grow rapidly and the rest of the world grows slowly. The medium-term snapshot asks whether the rebound in global economic activity as the financial turmoil subsides and growth resumes, along with the projected slowing in the growth rate of the US economy, keeps the United States on a sustainable track. Finally, the question for 2010 is, once the US and global economies reach their estimated rates of growth of potential output, will the US external balance be sustainable given estimated parameters of export and import income elasticity? The structural changes underpin-

9. This is a simplified version of the income and relative price model discussed in chapter 8. However, in no way should the trajectories be viewed as forecasts, since I make two key simplifications. The first is to assume that all prices are rising at the same rate—2 percent. In fact, as discussed in chapters 5 and 7, import and export prices have been rising more slowly (or even falling) compared to broader measures of inflation, such as the GDP deflator. The second is to assume full pass-through of an exchange rate change into relative prices and an immediate response on the part of trade flows—i.e., no J-curve. (See chapter 7 for more discussion of exchange rate pass-through, and chapter 9 for a discussion of the J-curve.)

10. *OECD Economic Outlook* (December 1997, 42). For more substantive discussion, see also OECD (1997). See chapter 5 for a discussion of how globalization raises US productivity growth, which supports the OECD's linking of trade liberalization and productivity growth.

Table 10.3 Alternative scenarios

	Near horizon: 2000	Medium horizon: 2005		Long horizon: 2010	
		High performance	Business as usual	High performance	Business as usual
Base case scenario, import elasticity 1.7, export elasticity 1.0					
Trade balance	-248.5	-432.7	-463.0	-730.7	-796.7
Current account (billions of US dollars)	-316.6	-583.3	-616.0	-1,030.0	-1,108.5
Current account (share of GDP, percentage)	-3.4	-5.0	-5.4	-7.0	-8.0
NIIP (billions of US dollars)	-2,020.4	-4,347.6	-4,440.3	-8,514.3	-8,903.0
NIIP (share of GDP, percentage)	-21.8	-37.3	-39.2	-58.0	-64.2
FEER scenario, US dollar weakens by about 25 percentage points					
Trade balance (billions of US dollars)	-96.9	-220.2	-267.8	-432.6	-545.2
Current account (billions of US dollars)	-166.6	-335.1	-386.3	-635.8	-768.3
Current account (share of GDP, percentage)	-1.8	-2.9	-3.4	-4.3	-5.5
NIIP (billions of US dollars)	-1,908.5	-3,206.9	-3,350.1	-5,717.2	-6,347.0
NIIP (share of GDP, percentage)	-20.6	-27.5	-29.5	-38.9	-45.8
Service export scenario, import elasticity 1.7, export elasticity 1.3					
Trade balance (billions of US dollars)	-219.8	-241.6	-322.3	-229.2	-471.5
Current account (billions of US dollars)	-287.5	-373.7	-460.2	-442.1	-720.5
Current account (share of GDP, percentage)	-3.1	-3.2	-4.1	-3.0	-5.2
NIIP (billions of US dollars)	-1,979.2	-3,676.7	-3,906.1	-5,764.5	-6,945.6
NIIP (share of GDP, percentage)	-21.3	-31.5	-34.4	-39.3	-50.1

NIIP = net international investment position

FEER = fundamental equilibrium exchange rate

Sources: Forecast for 2000 from IMF, *World Economic Outlook* (May 1999). Estimates for 2002-10 from OECD (1997). Other data are author's estimates.

ning the high-performance scenario, for the world and for the United States, will have a critical impact on whether the US external accounts are sustainable in the long run.

Base Case

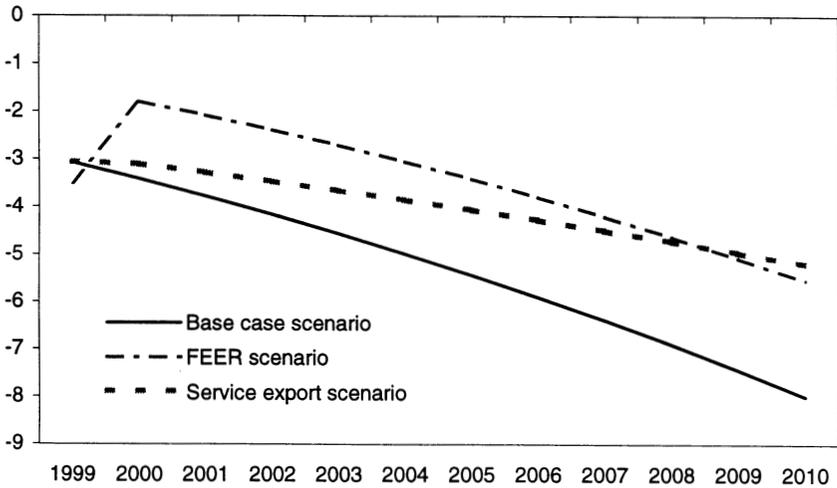
In the base case, GDP growth for the United States remains robust through 1999 at 3.3 percent, whereas world growth, at 2.3 percent, remains severely affected by the financial crises of 1997-98. As we move into 2000, world growth picks up some (3.4 percent), whereas US growth is projected to slow a bit (2.2 percent). Out to 2010, growth rates for the United States and the world are the same as in the two OECD scenarios (discussed above). In the base case, the exchange value of the dollar remains at its trade-weighted value in late 1998 and early 1999 (about 120 on the IMF's nominal effective exchange-rate index; 1995 = 100).

The base case suggests that the US current account is on a trajectory that is sustainable for about three years, with a CA/GDP ratio of about 3 per-

Figure 10.2 Growth rates and current account: Scenarios to 2010

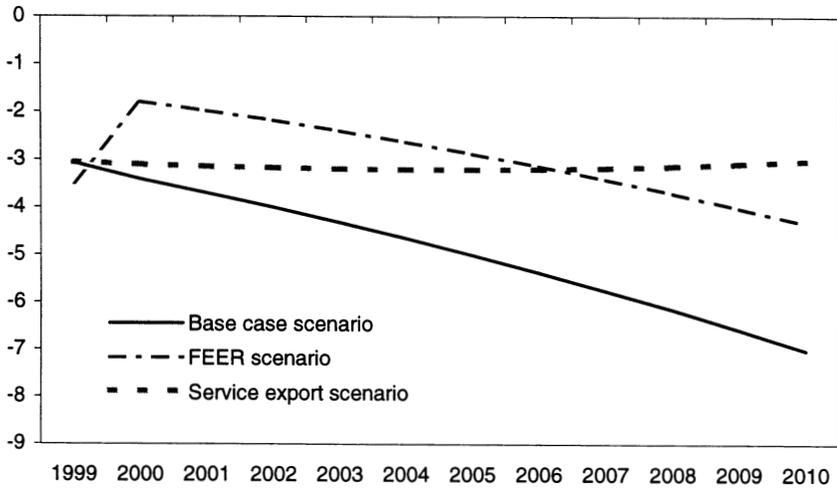
A. Low-growth scenario

percentage of GDP



B. High-growth scenario

percentage of GDP



cent through 2000, increasing to about 3.8 percent by the end of 2001 (table 10.3 and figure 10.2). In 2000, as growth resumes abroad and slows to a sustainable pace in the United States, the pace of deterioration in the CA/GDP ratio briefly slows. Thus, if the CA/GDP ratio is sustained through 1999, it can be sustained for another year after that. Moreover, even at 4.2 percent

(at the end of 2002 in the business-as-usual case) the CA/GDP ratio is at the average turning point for other industrial countries. Given the characteristics of US net international obligations (as I argue below), the sustainability benchmark for the US CA/GDP ratio is likely to be a larger figure than that for other industrial countries. All of this suggests that the trajectory could be sustained for two or three more years.

On the other hand, the CA/GDP ratio was only 3.0 percent in 1985 (headed toward 3.6 percent two years later), when trade policy activity was at a peak and when government intervention and market sentiment caused the dollar to reverse its appreciation. And, as indicated in one of the quotations at the beginning of the chapter, some market participants are already wondering about sustainability when the CA/GDP is less than 3 percent. Thus, the next few years may highlight a tension between economic sustainability, as measured by the borrower's constraint, and political sustainability, in which market sentiment can be a key factor.¹¹

By 2005, the effect of the asymmetry in the income elasticity of imports and exports starts to widen the trade deficit, regardless of the estimate for GDP growth. In 2005, the CA/GDP ratios of -5.0 percent in the high-performance scenario and -5.4 percent in the business-as-usual scenario are beyond any in US experience, and exceed the average of the other industrial countries' episodes, although they are still within the bounds of industrial-country experience. The value of the current account deficit, though, is about \$600 billion, well outside any country's experience. While the negative NIIP grows to more than \$4 trillion in this scenario, this is less than the *national* debt in 1998 and only about 40 percent of GDP, and the net investment payments account for a quite small 1 percent transfer of resources abroad.

Nevertheless, the trajectory for the external accounts is set by 2005 and plays out to 2010 and beyond. At this horizon, the buildup of the negative NIIP (the consequence of persistent trade and current account deficits) and the income asymmetry drive the dynamics of the current account and of sustainability. By 2010 the CA/GDP ratio is beyond any empirical trigger suggested by the experiences of the industrial countries. The current account deficit exceeds \$1 trillion. The NIIP/GDP ratio grows, although it is still not all that large, and the net investment payments on the NIIP amount to approximately 2 percent of GDP.

Thus far the discussion has focused on the borrower's constraints. What about the investor's constraints? By 2005, foreign investors would be asked to incorporate about \$2.4 trillion more of US assets into their port-

11. The role of market sentiment and current account data in precipitating crises through self-fulfilling prophecy is a large field with much ongoing research. A quick overview of the complex relationship between current account news and movements of the exchange rate can be found in Levich (1998, 172-75); see also Krugman (1985).

folios, and by 2010, about \$4 trillion more.¹² Will foreign investors be willing to add this much to their global portfolios? To put this figure into perspective, consider that the value in 1997 of net financial wealth in six of the largest industrial countries (not including the United States) was about \$25 trillion.¹³ Given the growth this collective portfolio itself would undergo from 1997 to 2005, the amount to be added by 2005 would represent less than 10 percent of the total.

For the period from 2005 to 2010, the value of US assets to be added to the global financial marketplace through the US current account deficit would be some \$4.5 trillion. The value of wealth in these six industrial countries would grow by about \$10 trillion. The global portfolios of the largest industrial countries would thus have to acquire significantly more US assets by 2010. However, by then net wealth accumulation in other countries around the world probably would be significant, and investors in those countries would probably want to invest in US assets.

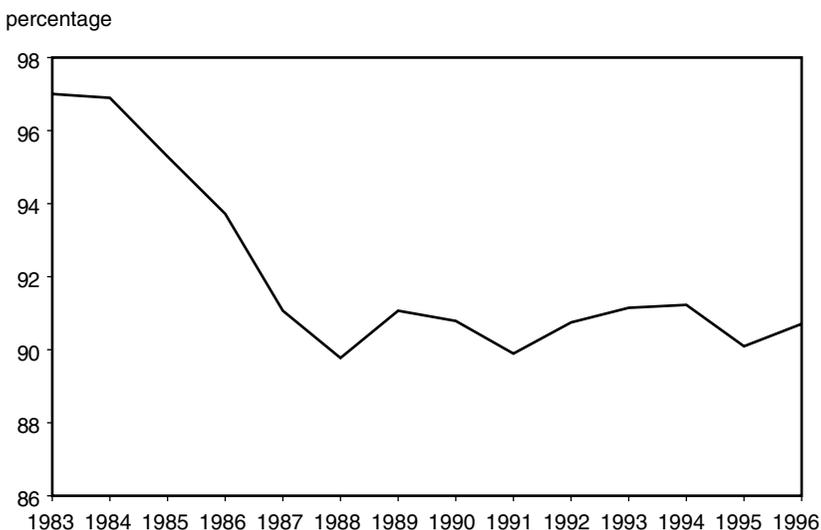
Indeed, the six countries accounted for about half of global GDP (excluding the United States) in 1997, and growth and wealth accumulation in many countries other than the six presumably will increasingly dominate the financial landscape. Moreover, as noted in the discussion of home bias, there is substantial room for all investors to increase their share of nondomestic assets. But it is impossible to know whether investors' preferences for US assets over their own countries' assets will coincide with increased availability of US assets. All told, this calculation for the investor constraint alongside the borrower constraint supports the notion that the US current account is sustainable for at least two or three more years, or even longer as judged by the investors' constraint. These somewhat different horizons set up a possible tension between the two criteria—borrower and investor—of economic sustainability.¹⁴

12. The dollar value is the additional assets sold abroad represented by the accumulated current account deficits; it is the net capital flow. Of course, US investors will purchase foreign assets during the time period, and that capital flow will also need to be financed.

13. The six countries for which detailed data are available are Canada, Germany, France, Italy, Japan, and the United Kingdom. This calculation assumes an average share of net financial wealth to nominal household income of 250 percent (OECD 1998b, annex table 58, p. 249); assumes that personal income is 75 percent of GDP (personal income is 84 percent of GDP in the United States, so this figure is conservative); and calculates nominal GDP in dollar terms using period average nominal exchange rates. Growth in the portfolio uses this same method and the rate of growth of nominal GDP in table 10.2, averaging between the high-growth and low-growth scenarios where appropriate.

14. These trajectories assume that the import and export elasticities are estimated with certainty and that the simple framework is a correct model of economic relationships. In fact, model and parameter uncertainty are important issues that can completely change the outlook for US external balances over long-term trajectories. See Mann (1991) for further discussion.

Figure 10.3 Share of liabilities to foreigners payable in dollars, reported by banks, 1983-96



Source: US Treasury Department, *Treasury Bulletin*.

Is the United States Special?

The results for the base case suggest that the CA/GDP ratio for the United States could test the limits of sustainability in two or three years, at least from the viewpoint of the borrower's constraint. However, in some key respects the United States is special in international financial markets, and the sustainability benchmarks for the borrower's constraint determined both from our 1985 (and earlier) experience and from the experiences of other industrial countries may not be applicable.

First, much of US international borrowing is in dollars, although the share has fallen somewhat in recent years (figure 10.3). Hence the most explosive difficulty that some countries have faced in sustainability crises—the inability to exchange the domestic currency for the currency in which it needs to make payments—will not be an issue for the United States. However, if investors have reached the desired share of dollars in their portfolios, then the United States could find itself having to offer higher interest rates to attract investors. This would imply that the current account has become unsustainable, but not that a crisis is imminent.

Second, US assets sold to finance the external deficit have contractual characteristics that make them relatively more stable in the case of a sudden change in investor confidence. For example, bank credit lines and short-term bills are relatively unstable; if investors lose confidence, they let the short-term credits mature and then refuse to roll them over into new

debt. For the United States, about 75 percent of foreign private investment is in longer-term, more stable investments: direct investment, bonds with maturities greater than one year, and stocks.¹⁵ Should investors lose confidence in the US economy, the value of these assets would decline (in particular, the stock market value and bond prices would fall as foreign investors sold some of the assets), but the consequences of price movements would be less serious, particularly in the short term, than if investors simply will not roll over credits.¹⁶ To be sure, a fall in the stock market and bond prices would hurt the United States; consumer confidence would be shaken, consumption would decline, and higher interest rates and financial market volatility would have a negative effect on business investment. However, these are manifestations of the economy's adjusting to a situation of external unsustainability and do not necessarily imply a crisis.¹⁷

On the other hand, an important component of the financing of the US external balance in recent years has been foreign purchases of US Treasury securities, apparently predominantly by a relatively small set of countries (figure 10.4). Is the US external position more likely to become unsustainable because of this concentrated lending and holding of US Treasury securities? In 1998, 36 percent of US government securities were held abroad, up from 25 percent just three years before. Limited data suggest that Japan is a large shareholder, holding perhaps one-fifth of the US government securities held abroad. These figures should be interpreted with care, however. Foreign investors are a diverse group, and there is no reason to suppose that all Japanese investors have the same risk-return profile. Moreover, the data are collected according to the location of the investor's agent; an investor from Singapore could well purchase US Treasury securities through a Japanese agent.

But suppose all the "Japanese" net purchasers did have the same risk and return preferences. And suppose they all decided to sell their US government securities at once because of a systematic "Japan-US" shock that raised the riskiness of holding US government securities or raised the returns on Japanese securities.¹⁸ There could be an upward pressure on

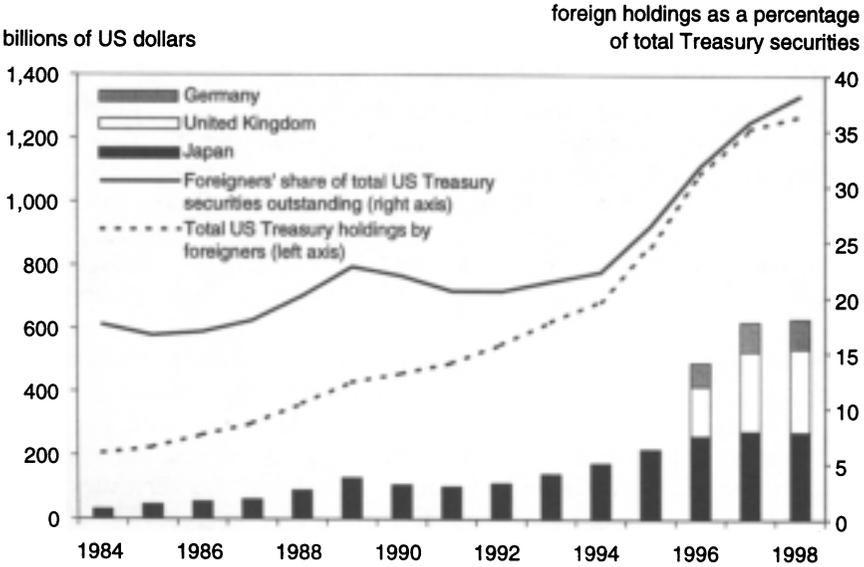
15. See chapter 3 for more detail on the composition of the capital account. For additional discussion of the implication of the composition of external credit for the stability of external finance, see Claessens and Gooptu (1993).

16. It is one thing to have to pay more for credit, and another to be unable to get credit at any price.

17. Proper monetary policy can smooth the adjustment path if unstable reactions set in. Examples include the injection of central bank credit in September 1987 when stock markets around the world were collapsing and the quick three-step reduction in the US federal funds rate in the fall of 1998 after the Russian default on debt caused liquidity in US financial markets to dry up.

18. Concern over this possibility was voiced in early 1999 (and numerous other occasions) as interest rates on Japanese securities were rising on account of the expected need to finance the fiscal programs in Japan.

Figure 10.4 Foreign holdings of US Treasury securities, 1984-98



Note: Data for countries other than Japan before 1995 are not available.

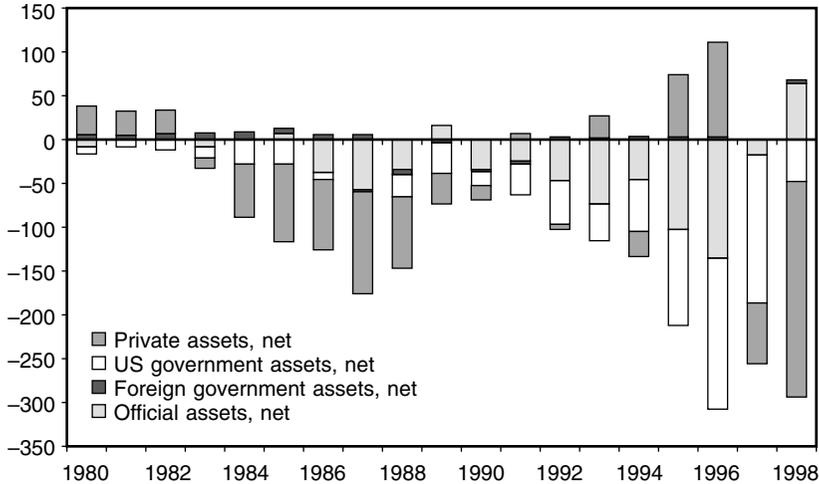
Source: US Treasury Department, *Treasury Bulletin*.

interest rates on US government securities or a downward pressure on the exchange value of the dollar. But would these pressures lead to a sustained change in the value of US securities or to an external sustainability crisis? These outcomes are unlikely, because the domestic and global markets for these securities are the most mature in the world, and the rest of the domestic and international investor body remains available to buy the securities, which likely would be bargain priced under such circumstances. The diversity of investors around the world and the importance of the United States to the global trade and financial markets are stabilizing features that make the United States special.

Looked at from yet a third perspective, net purchases of US government securities have, at times, been inordinately important as a balancing investment to the trade deficit, particularly in the 1995-97 period (figure 10.5). Some view foreign investment in US government securities as a mercantilist way of keeping the dollar exchange rate from depreciating and facilitating the adjustment in the US external balance (e.g., Preeg 1998). In this vein, some argue that while foreigners are willing to buy US assets, they are not willing to buy US goods and services for fear of creating an environment of greater competition and choice in their domestic economies that is disruptive to sheltered firms and sectors. While these arguments have merit, the evidence from 1998 shows that, on balance, foreign official investors sold US government assets from their portfolios.

Figure 10.5 Net US assets: Capital flows, 1980-98

billions of US dollars



Note: Positive numbers represent net outflow, and negative numbers represent net inflow.
Sources: Bureau of Economic Analysis, *International Transactions Tables*, Historical Data; US Department of Commerce, *Survey of Current Business*.

Not only has no US sustainability crisis ensued, but in fact the dollar continued to appreciate.

On the whole, investors around the world realize that relatively safe and high-yielding US investments are the best place to park their wealth right now given the financial turbulence in Asia and the uncertain currency marriage in Europe. However, there will come a time when US assets are no longer as attractive, either because returns in the United States are falling and/or because returns abroad are rising. At that point investors will choose other assets, the cost of financing the US external deficit will rise, the dollar may depreciate and/or US income growth will slow, and/or policies to change the structure of US and global trade flows will work to close the external deficit and put it on a sustainable path. Such changes will mean that the external balance has become unsustainable; they would not have to engender a crisis. Yet, to the extent that investors continue to augment—and perhaps to overweight—their portfolios with US assets rather than to buy foreign assets, an abrupt change could occur in the value of the dollar when their sentiment does change.

Ways to Achieve Sustainability

In the base case scenario, the constellation of economic growth, relative prices, and trade structure yields trajectories for the external accounts that

will be unsustainable in two or three years and certainly are unsustainable in the long term. What alternative constellations would make the external trajectories sustainable? The economic forces outlined in the analytical framework point to how an economy might respond. Recall that a sustainability episode can occur when investors are no longer willing to invest in a country by purchasing its assets. In the context of the framework, this is because the investors fear that they will not receive the expected rate of return—or, more radically, they fear for their principal.

Under such a scenario, the dearth of investors for a given flow of obligations entering the international marketplace leads to economic reactions that can move the economy back toward a sustainable path. First, the interest rate on the obligations would increase, simply from the forces of supply and demand. The increase should help to slow the economy and narrow the trade gap, and thus tend to reduce the need for investor credit. So long as the increase in interest rates does not raise the net investment payments faster than the trade account narrows, this response would constitute an equilibrating mechanism that gets the economy back on a sustainable track.

Second, with fewer investors, the exchange value of the currency should tend to depreciate, which would change relative prices of exports and imports to domestic goods and services, which in turn would tend to narrow the trade gap and slow the flow of US assets into the international marketplace. So long as the exchange rate change does not raise the domestic currency value of investment payments and of the external stock of obligations faster than the trade account narrows, this too would constitute an equilibrating response. Because the bulk of US obligations are denominated in dollars, a depreciation of the dollar almost surely would be an equilibrating force that would put the external accounts onto a sustainable path. Or would it?

Dollar Depreciation: Medium-Term But Not Long-Term Sustainability

Calculating what value of the dollar might yield a sustainable trajectory for the current account is a difficult task, since the two are endogenous; that is, the sustainable value of the dollar depends on the sustainable value of the current account deficit. Moreover, both of these have important effects on growth and trade in the rest of the world. Wren-Lewis and Driver (1998) offer one set of calculations for the dollar that depend in turn on calculations for the current account from a detailed global model.

Wren-Lewis and Driver calculate a fundamental equilibrium exchange rate (FEER) value of the dollar for 2000 of about 95 yen/dollar and about 1.3 dollars/euro. Compared with the exchange rates that prevailed at the beginning of 1999, this suggests that the dollar would need to depreciate some 25 percent against the yen and 10 percent against the euro. On the basis of broader trade weights, 25 percent is a good ballpark figure for how much the dollar would have to depreciate to reach its fundamental

equilibrium exchange rate. Suppose this depreciation took place immediately (1999), and the dollar stayed at this lower level for the duration of the scenario. The effects of this depreciation over the next few years would be dramatic; indeed, the simple framework overemphasizes the speed with which the current account would respond.¹⁹ The key point, however, is that over the longer term, dollar depreciation would only postpone the sustainability problem, not eliminate it (see table 10.3 and figure 10.2).

Suppose, then, that the dollar did depreciate some 25 percent. The current account deficit would be cut in half, with the effect on the trade deficit even larger. The CA/GDP ratio would narrow to less than -2.0 percent in the next two or three years. But after about five years, the dramatic effect begins to diminish as the trade account and current account widen again because of the income asymmetry—even though US growth is slowing and world growth is rebounding. Nevertheless, because the effect of the depreciation is so great, even five years out its effect remains on the *level* of the current account as well as the CA/GDP ratio. The depreciation puts this indicator comfortably within the range of previous US experience at -2.9 percent in the high-performance scenario and -3.4 percent in the business-as-usual scenario.

Over the long term, the dynamics of the income asymmetry take over and are augmented by the net investment-service payments, and the CA/GDP ratio rises to the range of -4.3 to -5.5 percent. The worsening of the current account deficit kicks in sooner than might be expected on the basis of the historical relationship between exchange rate changes and the trade balance. A change in the value of the dollar affects only the trajectory of exports and imports; it does not directly affect net investment-service payments, which are a rising fraction of the current account deficit. Consequently, the salutary effects on the current account of a depreciation of the dollar are smaller and shorter lived than they have been in the past, because the negative NIIP of the United States is so large. If everything else remained unchanged, the 25 percent depreciation of the dollar would buy about five more years of sustainability for the CA/GDP ratio in comparison to the base case.

However, the FEER scenario raises another issue that is particularly relevant in the current environment of a robust US economy. With a 25 percent depreciation, the shrinking of the US trade deficit would add back about \$150 billion dollars of spending to US goods and services within a year or two. The US economy would be hard pressed to generate approximately 1.7 percent more of GDP without running into even greater constraints on resource usage, particularly in the labor markets.²⁰

19. In the simple framework, with full pass-through and no J-curve, the effects of a depreciation are observed immediately, instead of taking one or two years to play out.

20. See chapter 5 for a discussion of the inflation-output relationship and how it has been affected by exchange rate movements and global forces.

In addition to the potential for wage inflation, the depreciation of the dollar would tend to raise import prices, with domestic prices likely to follow, and then monetary tightening as the likely policy response. As discussed in chapter 5, the appreciation of the dollar has played an important role in keeping US inflation low. Since 1996 the declines in import prices associated with the appreciating dollar have cut about 1.8 percentage points off CPI inflation. A depreciation of the dollar of some 25 percent could ultimately pass through to raise the inflation rate, both directly by raising input costs and prices of imported products and indirectly by allowing US producers to gain pricing power and raise prices. Moreover, a rise in domestic inflation would tend to push up wages beyond productivity growth, as workers in this unprecedentedly tight labor market have greater ability to bargain. Rising inflation (or the threat of rising inflation) is a key signal for monetary policymakers to respond by raising interest rates, which tends to slow domestic economic activity as borrowing costs rise. Although monetary authorities in this case would not intend to initiate a recession, monetary policy is not a precise instrument. On some previous occasions (see figure 5.1) rising inflation has presaged slower GDP growth, and indeed, sometimes recessions. A significant depreciation of the dollar thus could set in motion *internal* forces that unhappily could lead to the slowing of US growth while at the same time yielding the positive outcome of enabling the economy to skirt the *external* sustainability criteria.

Structural Change to Achieve a Sustainable Trajectory

Underlying both the base case and the FEER scenario are the asymmetric income elasticities of trade (see chapter 8) and the estimates of the rate of growth of potential output in the United States and the world (for the United States, see further discussion in chapter 5). Changes in these parameters and estimates could yield a sustainable current account position both in the medium term and the long term without any change in the value of the dollar from its current level.

What if the income elasticity of exports were to increase from 1.0 to 1.3 on account of economic development abroad, liberalization of international markets, and a rising share of service-sector trade in US exports?²¹ If the rest of the world proceeded along the “business-as-usual” path, this

21. The increasing share of services in US exports is discussed in chapter 3, the implications of service-sector liberalization for export growth in chapter 6, and how trade flows change when income changes in chapter 8. The export-income elasticity estimate of 1.3 is a weighted average (goods and services weights at 0.7 and 0.3, respectively—see table 3.3) of 1.0 for goods (taken from long-period regressions shown in table 8.2) and 1.9 for services (see table 8.1 and Wren-Lewis and Driver 1998, appendix C).

change in the value of the export elasticity would slow the widening of the current account deficit, but not otherwise substantially change its trajectory from the base case scenario (figure 10.2).

However, if the world embarked upon a path of trade liberalization, particularly in the services sector, this would likely be accompanied by the high-performance scenario for US and world growth. Indeed, service-sector deregulation and liberalization specifically (in both home and global markets) are among the types of reforms that underpin the higher productivity growth embodied in the high-performance estimates by the OECD. (Labor market reforms are another key element, particularly abroad.) The US experience in the relationship between globalization and productivity growth (discussed in chapter 5) bolsters the underpinnings of the OECD high-performance scenario.

Structural change in the export elasticity along with high-performance growth in the United States and the rest of the world makes the US external accounts sustainable and keeps them on a sustainable trajectory. The CA/GDP ratio remains around 3 percent throughout the trajectory, and indeed, the ratio starts to narrow toward 2010. In sum, structural change in both the United States and the rest of the world would put the US external balances on a sustainable trajectory. What is clear from the low- vs. high-growth scenarios, however, is that the United States cannot be alone in making the reforms. Because liberalization of trade and of domestic markets go hand-in-hand, particularly for the services sector, the United States should move quickly to launch and encourage wide participation in a new trade round.

Political Sustainability and Changes in the Value of the Dollar

The scenarios discussed above address questions of economic sustainability. From the standpoint of political sustainability, however, we might already have reached the limit of the trade deficit, given the four or five bills proposed recently in Congress to address specific sectors (although, as noted in chapter 6, this is a small number of trade bills compared to 1985). Trade surges also might generate a revival of Section 201 or Section 301 trade remedies. US policymakers might respond to trade pressures and either “talk the dollar down” or, as in 1985, the G-7 group of industrial nations could use concerted intervention to help the dollar depreciate (Funabashi, 1989).²²

22. It should be noted, however, that in contrast to 1985, as of June 1999, policymakers in Euroland were talking the euro down and Japanese policymakers were engaging in foreign exchange market intervention to keep the yen from appreciating—in effect the opposite of the 1985 activity.

The FEER scenario shows that a change in the exchange value of the dollar is a potent weapon for changing the trajectory of the trade and current account deficits in the next five years or so. Although this could tempt policymakers under political pressure to use dollar rhetoric and perhaps market intervention to change the value of the dollar, the trajectories also make clear that changes in structural parameters associated with economic reforms at home and abroad will lead to a long-term sustainable external balance for the United States, given the expectation for future growth. A once-and-for-all change in the value of the dollar alone does not yield long-term sustainability.²³

Policymakers can consider the quick fix of dollar depreciation, which narrows the deficits now but does not change the economic fundamentals. But they must be wary of the potential inflationary consequences of their action and the likely monetary policy response. Moreover, they should address the structural changes—both abroad in efforts to liberalize trade and internally in efforts to increase household savings and prepare the workforce—to put the sustainability of the US external balance on a more solid footing for the long term.

Implications of the Euro for Sustainability

The introduction of the euro constitutes a major change in the currency landscape and could conceivably press the US external deficit more rapidly toward unsustainable benchmarks. The new currency influences the sustainability benchmarks primarily on the investors' side. The availability of this new foreign asset should reduce the demand for investments in US assets once the market for euro-denominated assets is larger and more liquid than the markets for assets denominated in the national European currencies that it replaces. Although all the existing debt issued in the Euro-land currencies has been translated into euro obligations, the share of euro-denominated instruments accounts for only a bit more than one-fourth of the global bond market against nearly one-half accounted for by dollar-denominated assets and one-fifth by yen-denominated assets (see table 2.1). Therefore, much more issuance of new instruments in euro is necessary.

At what point will the euro challenge the dollar as a financial asset? It depends on the risk-return profile of the euro instruments that represent claims on Euro-land assets relative to that of dollar instruments that rep-

23. A slow but steady depreciation of the dollar might close the trade gap over a very long term, although there is some question about whether it could close the current account gap because of rising net investment payments. There is no evidence that financial markets would enable this path, nor that policymakers would (or could) enforce this regime. See the analyses and caveats presented in Marris (1985, 114-117) and Krugman (1985) regarding this issue in 1985, the last time the current account gap was so large.

resent claims on US assets. Risk and return depend on liquidity (itself important) as well as on the rate of growth in the market generating the claims. Suppose the euro financial market develops rapidly, so that it is a deeper and more liquid market than any of its predecessor markets (Bergsten 1997). Suppose, too, that Euroland begins a rebound in growth over the next two years. During this same period, the US external deficits could be widening, absorbing the tail end of the cyclical effect of continued robust US growth, the slowdowns in Asia and Latin America, and the appreciation of the dollar. Moreover, the longer-term sustainability benchmarks would be just around the corner and clear for all to see. Thus the shift in international investors' preferences toward holding a greater share of euro in their portfolios could occur about the same time that the sustainability criteria from the borrower's side began to put the bite on the United States. The dollar would get a push toward depreciation from both sides of the sustainability criteria (borrower and investor), and a push could become a rout unless the structural changes discussed in this volume are in train and help to limit the fall.

Conclusion

- The global financial crises and the robust US economy together have moved the US external accounts toward unsustainable territory. Yet because the United States is both special and a critical participant in the international markets, our robust domestic demand can continue to support the resumption of global growth for two or three more years. Given the structural asymmetries in the components of the US external balance and political and market sensitivities toward ever-increasing trade deficits, however, the economic forces leading to a narrowing of the trade imbalance are likely to build within and certainly beyond that time frame.
- Structural changes that are in train and that could be furthered by policy initiatives could make a significant difference to this picture and have a lasting impact on the trajectories for US trade and external accounts. On the domestic side, the United States must pursue a number of structural changes, including an increase in the household savings rate and an improvement in worker preparedness for current and future jobs. On the export side, economic development abroad and liberalization of the service sector through active trade negotiations would yield an increasing share of services in total exports that would significantly change the prospects for US external balances. But the United States cannot act alone; liberalization and productivity-enhancing policies must be implemented abroad as well. High perfor-

mance at home and abroad enhances not only the long-term economic prospects of both the United States and the world but also the sustainability of the US external accounts.

- A significant depreciation of the dollar would put the external accounts back into sustainable territory for the near and medium terms, but not on a sustainable trajectory for the long term. While the impact of a significant depreciation is dramatic, without structural changes and more robust productivity growth a depreciation of the dollar continues the cycle whereby a depreciation narrows the external balances but is followed by renewed widening of the imbalances as structural instabilities and net investment payments take hold. This precipitates another dollar depreciation, and so on. The dollar has been on this roller coaster since the breakdown of the Bretton Woods system, but since the NIIP is now negative, the ride could get wilder.
- From a political standpoint, congressional and administration activity on the trade front suggests that sustainability benchmarks have already been breached. This poses an unhappy dilemma for policymakers: capitulate with specific, ineffective protections (see chapter 6) or try to narrow the deficit quickly with a change in the value of the dollar. Orchestrating a dollar depreciation would reduce political pressures but would not improve the structural determinants of the external accounts. Moreover, it would likely generate inflationary pressure and a monetary policy response that would slow US economic growth.
- For a whole host of reasons, the economies of the rest of the world need to grow more rapidly. But simply from the narrow objective of the sustainability of the current constellation of US growth and the value of the dollar, if other countries were to grow, the rate of return on their investments would rise and the US dollar would gradually depreciate as investors sought a broader mix in their portfolios of international assets instead of overweighting toward US dollar-denominated securities. Faster growth abroad and a drifting down of the dollar would naturally help to close the US current account gap. The longer growth in the rest of the world stagnates or remains slow, the longer foreign investors will choose US dollar-denominated assets and keep the dollar high, and the greater the potential for an unpleasant change in investor sentiment to affect the dollar, the United States, and the world.