



## THE SUSTAINABILITY OF THE US EXTERNAL IMBALANCES

NOURIEL ROUBINI\* AND  
BRAD SETSER\*\*

The US trade deficit looks set to top \$700 billion in 2005. It has risen by about \$100 billion a year since 2002. This deficit is large absolutely, large relative to US GDP, large relative to the United States' small export base and large relative to the world's current account surplus. Trade deficits of this scale imply an even larger deficit in the broader measure of the United States' external balance, the current account<sup>1</sup> and a rapid increase in the United States' net external liabilities.

Large US trade and current account deficits reflect strong consumption and low savings in the United States. In the mid to late 1990s, a dramatic improvement in the government's fiscal position prevented a fall in the private savings rate from reducing overall national savings. The current account deficit in the late 1990s rose largely on the back of a surge in private investment. That changed radically in 2001. From 2001 to 2003, investment fell sharply. However, the deterioration in the US budget deficit over the same period reduced national savings. Mechanically, rising fiscal deficits and continued falls in personal savings overwhelmed the fall in investment, keeping the US current account deficit high. The permanent gap between government revenue and government spending created by the Bush Administration's tax cuts set the stage for the current account deficit to expand dramatically as investment recovered along with the US economy. The growing gap between stagnant or even falling US savings and rising US investment required that

the US borrow more and more of the rest of the world's savings.

Recent forecasts confirm that the fiscal deficit will not fall in 2005 or 2006. Private consumption growth has outpaced income growth for the past few years: US consumers increasingly borrow against rising asset values – recently housing – to support their current consumption. All evidence suggests that household savings will remain low, if not fall further. Consequently, barring a major change in policy, a slump in US growth or a sharp fall in the dollar, there is little prospect for the current account deficit to improve markedly in the near term. The US current account deficit is on track to exceed \$800 billion (6.5 percent of GDP) in 2005 and, absent some shift in the markets or policy, could easily reach 7 percent of GDP in 2006 and 8 percent of GDP in 2008.

The United States now imports significantly more than it exports (imports are a bit above 15 percent of GDP, exports are only 10 percent of GDP), so US exports have to grow about 50 percent faster than US imports just to keep the trade deficit constant. The math works against any quick reduction in the trade deficit. Moreover, the combination of a rising stock of external debt and rising US interest rates will soon force the United States to start making net interest payments to the rest of the world, and start to add in small, but still noticeable ways, to the overall US current account deficit. Looking ahead, the United States increasingly will need to borrow from the rest of the world to pay interest on its external debt, not just to import more than it exports.

Large ongoing deficits have to be financed by foreign direct investment, by net foreign purchases of US stocks, or by borrowing from abroad in the form of debt. The broadest measure of the amount the United States owes the rest of the world – the net international investment position or NIIP – has increased from 5 percent of GDP in 1997 (\$360 billion) to an expected 28 percent of GDP (\$3.3 trillion) by the end of 2004. At an estimated 280 percent

The large current account deficit reflects a savings shortage in the U.S.

\* Nouriel Roubini is Associate Professor of Economics and International Business at the Stern School of Business, New York University.

\*\* Brad Setser is Research Associate in the Global Economic Governance Programme at University College, Oxford.

<sup>1</sup> The current account is the sum of the trade balance, the balance on labor income, the balance on international investment income and unilateral transfers (foreign aid and remittances).

of exports at the end of 2004, the US debt<sup>2</sup> to export ratio is in shooting range of troubled Latin economies like Brazil and Argentina.<sup>3</sup> Barring major adjustments, net US external debt is on track to increase to about 50 percent of GDP and almost 500 percent of export revenues by 2008.

Rising US external debt implies, as Fed Chairman Greenspan emphasized in November, a rising concentration of US assets in foreign portfolios – something that cannot go on forever. Moreover, foreign investors are financing the U.S. on terms – in dollars, and at low interest rates – that offer little protection against the risk of further falls in the dollar. Yet it is hard to see how the US trade deficit can be brought down to levels consistent with long-run sustainability without further falls in the dollar. No country, not even the United States, can finance large external deficits on terms that imply that its creditors are running very substantial risks of large capital losses for an extended period of time.

Something will give. It is possible that the US consumer's propensity to spend gives way without any financial market shock, or the United States may decide to take preemptive steps to cut its fiscal deficit even in the absence of bond market pressure. But it is more likely that neither the US government nor the US consumer will cut back until market pressures force them to. If the Asian central banks now financing the US current account (and fiscal) deficit cut back the pace of their reserve accumulation,<sup>4</sup> the dollar would slump and US interest rates would have to rise sharply to attract the external financing the

United States would still need from private investors. US investment would fall, US consumer spending would slump, freeing up more domestic savings to finance the US budget deficit. The US current account would improve, but the adjustment would occur in the worst way for the United States, via a sharp recession. Even if foreign central banks do not cut back on the pace of reserve accumulation, as the US current account deficit continues to grow, a higher share of the deficit will need to be financed by private investors. Eventually, private investors will demand higher rates to compensate for the risks intrinsic in lending to a country that already has substantial external debt and has a large, and expanding, current account deficit.

### Three core points

To put it simply, even if the United States continues to be able to borrow on terms that other debtors could not imagine, the United States is on an unsustainable and dangerous path. We will make three core points.

- The amount of adjustment required over time to prevent the US debt to GDP ratio from rising indefinitely is significant. To keep the US external debt to GDP ratio from continuing to rise, the US trade and transfers deficit will need to be brought down from around 6 percent of US GDP (2005 estimate) to no more than 1 percent of GDP. Indeed, if the US adjusts gradually, US external debt would still rise to over 50 percent of GDP and the current account deficit would remain over 3 percent of GDP as a result of the net interest rate payments (and continued transfers) even after the trade deficit has been brought down to close to zero.
- The United States is not attracting significant amounts of equity financing, so its need to place debt abroad to finance its current account deficit is exceptionally large. In 2003 the United States “exported” \$700 billion of low yielding, dollar denominated debt to the rest of the world to finance both its current account deficit and US investment abroad. That rose to an astonishing \$900 billion in 2004. In both 2003 and 2004, however, the need for private investors outside of the U.S. to add to their portfolio of US debt was limited by the extraordinary scale of the build-up of central bank dollar reserves. In 2003, central banks added \$485 billion to their dollar reserves;

The U.S.' creditors are running substantial risks of large capital losses

<sup>2</sup> Formally, the net foreign liabilities of a country are the sum of the country's net debt and net equity liabilities. In this article, we use the term “US foreign debt” loosely to mean net US foreign liabilities. US holdings of foreign equities (including US direct investment) are only a bit larger than foreign holdings of US equities (and foreign direct investment in the U.S.), so the large negative net debt position of the U.S. accounts for the majority of overall US foreign liabilities.

<sup>3</sup> Before its crisis, Argentina's debt to export ratio varied between 375 percent and 425 percent, depending on world commodity prices. Brazil's debt to export ratio reached 400 percent before the 2002 real depreciation, but it is now below 300 percent on the back of strong recent export growth.

<sup>4</sup> In 2004, foreigners – mostly foreign central banks – bought the entire net increase in the Treasury stock associated with the US budget deficit. However, the precise impact of the loss of demand from Asian central banks on US long rates is a matter of dispute. It depends on how readily private foreign investors abroad would step in and make up the gap created by the end of official demand for US Treasuries, as well as the impact central bank intervention is having on a host of other macroeconomic variables – like inflation – that influence Treasury yields. If private and public demand were perfectly substitutable, the effect on US rates would be small. But if Asian central banks are purchasing large amounts of US assets exactly because their private sector is not willing to, US rates will have to go up by a significant amount. Some estimates of the narrow impact of central bank demand on the Treasury market are at only 50 basis points; Bill Gross and Stephen Roach have suggested an impact of over 100bps. In our view, it is not unrealistic to think that the overall impact on US interest rates might be closer to 200 bps.

in 2004, we estimate that central banks added at least \$465 billion to their dollar reserves. However, the rapid pace of dollar reserve accumulation of the past two years is unlikely to be sustained for the next two years, let alone longer.

- The prospects for orderly adjustment – one that does not require a sharp slowdown of US and global growth – increase if the adjustment starts soon, and if the adjustment process is supported by appropriate policies. For the past ten years, the world has grown on the back of strong US domestic demand, as falling US savings has allowed US spending to grow faster than US income, and US imports to grow much faster than US exports. That will have to change. The US needs gradually to shift the basis of its growth toward external demand, and the rest of the world needs gradually to shift the basis of its growth toward domestic demand. Reversing current patterns will not be easy. There is a strong case for global coordination during the adjustment process, despite its difficulties.

If foreign central banks fail to keep up the recent pace of dollar reserve accumulation, adjustment may be sudden and unstable

No doubt the dollar's position as the world's reserve currency and the depth of US financial markets creates an intrinsic source of demand for both dollars and dollar denominated assets. However, this could prove to be a mixed blessing. The dollar's privileged position could increase the risk that the world will finance large US trade deficits for too long, delaying the needed adjustment and making the eventual adjustment all the more difficult and unstable.

#### *The scale of the needed adjustment*

In recent years, the deterioration in the current account has largely been driven by the growing trade deficit. Looking forward, the trade deficit is set to continue to widen, barring a major shift in the composition of US growth, a sharp fall in oil prices<sup>5</sup> or a significant further fall in the dollar. The dollar's depreciation against the euro since 2002 has not been matched by a comparable depreciation against many other US trade partners. Consequently, on a broad trade-weighted basis, the dollar is not that

weak: the real value of the dollar, now around 90 on the Federal Reserve's index, remains only just a bit below its 1990 to 2004 average (93.5). Since imports grew at an average rate of over 7 percent between 1990 and 2003, and exports at an average rate of 5.5 percent over the same period, we suspect that the dollar's current value is consistent with a continued, albeit more modest, increase in the US trade deficit.

However, even if the trade deficit stabilizes at some share of GDP, the deteriorating balance of investment income will lead the US current account deficit to expand. The impact of the deterioration in the United States overall external debt position has been masked recently by unusually low US interest rates: the fall in US interest rates reduced interest payments on existing US external debt by roughly \$130 billion between 2000 and 2004.<sup>6</sup> As US "policy" interest rates head up and the US net external debt continues to grow, net income payments will soon turn negative.

Modest current account deficits can be sustained indefinitely. However, analysts who argue that a US current account deficit of 3 percent of GDP (Cooper 2004) is sustainable indefinitely miss two important points. First, the US current account deficit is nowhere near 3 percent of GDP right now, and is likely to get larger, not smaller, without significant adjustments. Second, as interest payments on the growing net external debt of the United States rise, a current account deficit of 3 percent of GDP will likely imply reducing the trade deficit to no more than 1 percent of GDP – a far cry from today's trade deficit of over 5 percent of GDP. Ongoing current account deficits are consistent with a stable external debt to GDP ratio; but large ongoing trade deficits are not.

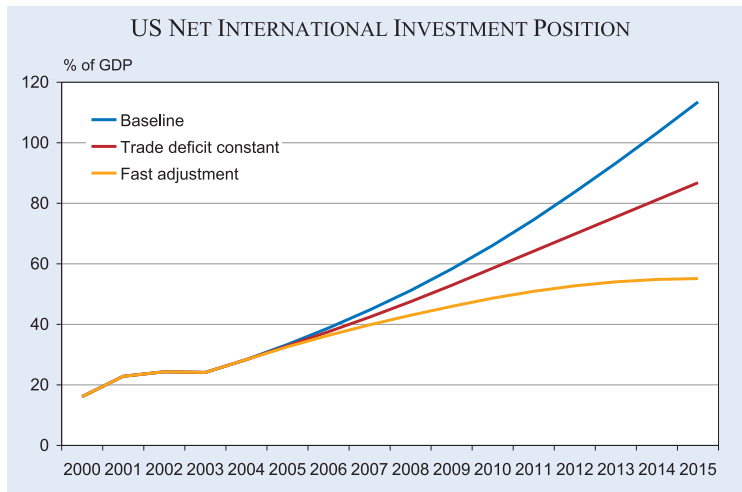
The United States does not need to stabilize its debt to GDP ratio at current levels. But it does need to reduce the rate at which its external debt to GDP ratio is growing, and eventually, stabilize its external debt to GDP ratio. Valuation gains on US investments in Europe as a result of the euro's rise in 2002 and 2003 kept the US external debt to GDP ratio from rising recently, but the scope for similar gains in

<sup>5</sup> In 2004, the average price of sweet light crude was around \$41 a barrel. A \$5 increase in the average price of oil to \$46 a barrel would add roughly \$25 billion, or 0.2 percent of GDP, to the 2005 current account deficit. Conversely, if oil falls back to say \$36 a barrel, that will subtract 0.2 percent of GDP from the current account deficit. Every \$1 per barrel change in the price of oil directly adds/subtracts \$5 billion from the US trade deficit. The "general equilibrium" impact is harder to estimate: higher oil prices should increase US exports to oil exporting countries, but reduce US exports to oil importing countries. On balance, the overall impact on exports is probably modest.

<sup>6</sup> The \$130 billion estimate comes from taking the estimated stock of US liabilities at the end of 2003 (\$10.52 trillion) and multiplying that stock by the difference between the 2000 rate of 3.61 percent and the 2003 rate of 2.40 percent. Returns on the United States' \$7.9 trillion in external assets also fell between 2000 and 2003, but not by as much. If returns on US assets and payments on US liabilities both went back to their 2000 levels, the net US interest bill would rise by about \$45 billion (0.4 percent of GDP).

the future is limited: most US external assets are in Europe – not Asia – so the prospective valuation gains from adjusting vis-à-vis Asian currencies are relatively limited. Valuation gains alone won't allow the US to sustain large ongoing trade deficits for long – particularly since the same process that gives rise to valuation gains for Americans with assets abroad also creates large losses for any foreign creditor who has lent to the United States in dollars.

Figure 2



Over time, the key variable that determines how quickly a country's external debt is rising is the trade and transfers balance. Both the real growth rate and the real interest rate also matter; strong real growth and low real interest rates have kept the US external debt to GDP ratio from increasing as fast as one would expect, given the size of the US trade and transfers deficit. This may not last forever: a large external debt stock typically leads to both higher interest rates and lower growth. But even if real interest rates on US debt remain low and US growth remains strong, the trade and transfers balance needs to fall from its current level of close to 6 percent of GDP to close to 1 percent of GDP to stabilize the US external debt to GDP ratio (a trade and transfers deficit of 1 percent of GDP implies that the trade deficit would need to be well below 0.5 percent of GDP).<sup>7</sup>

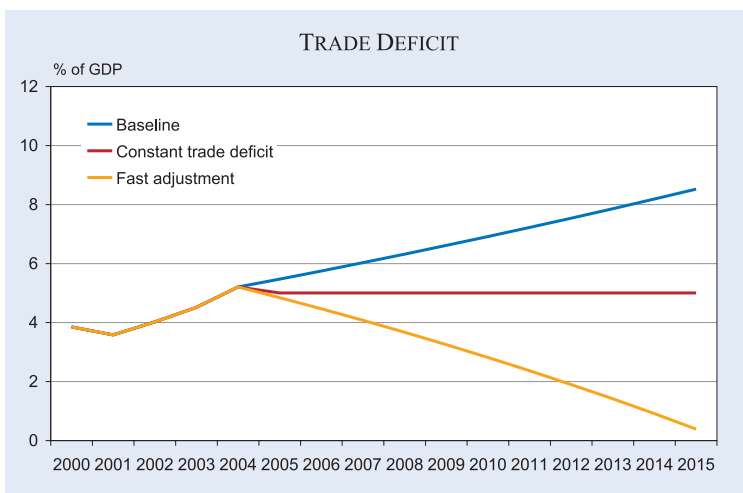
Consequently, the amount of adjustment required over time to limit the increase in the US net external

debt to GDP ratio is quite large. Over time, US imports either have to fall back to the level of US exports, or US exports have to rise to the level of US imports. The last thing the United States, or the world, should want is for the United States to be forced to make an adjustment of that magnitude suddenly. Sudden adjustment typically comes from a fall in imports, not an increase in exports – and likely implies a sharp global and US recession. Most policy makers should be able to agree that it is far better for the United States (and the rest of the world) if the adjustment needed to reduce the US trade deficit comes from rising US exports, not falling US imports.

The sustained adjustment that is needed will not happen on its own. The dollar needs to fall well below its long-term average to encourage a sustained expansion of US exports, and to make imports more expensive and thus encourage the substitution of US made products. The expenditure-switching induced by a change in the exchange rate, however, is unlikely to be enough to bring about the need-

The amount of adjustment needed to limit the increase in the external debt to GDP ratio is large

Figure 1



<sup>7</sup> If the real interest rate is equal to the real growth rate, the trade and transfers deficit would need to be entirely eliminated. A 1 percent trade and transfers deficit (mostly from transfers) would be consistent with a stable debt to GDP ratio, assuming the US net external debt rises to around 50 percent of GDP, if the real growth rate exceeds the real interest rate on US external debt by 2 percent. The real interest rate here is defined at the net investment income payments the U.S. makes to the world, after being adjusted for inflation. Higher returns on US assets than those the U.S. pays on its liabilities effectively reduce the effective interest rate the U.S. pays on its net debt.

ed fall in the trade deficit on its own. The large gap between US imports and US exports suggests that some expenditure-reduction will be needed as well: no one should want US imports to fall absolutely, but the pace of US import growth does need to slow significantly for export growth to be able to generate a reduction in the trade deficit. The best way to bring about the needed expenditure reduction would be a sustained improvement in the US fiscal deficit. Otherwise, the needed improvement in the current account will all have to come from a rise in private savings (a fall in consumption) and a fall in private investment. US interest rates almost certainly need to rise as part of the adjustment process, but if the United States does not take steps to reduce its fiscal deficit, the needed increase in interest rates could be particularly brutal.

#### *The scale of central bank financing*

Rising US debt implies that foreigners are increasing their holdings of financial claims on the United States. Europe (as a region), East Asia (as a region) and the major oil exporters all run substantial current account surpluses. Since the US current account deficit is now about equal to the rest of the world's current account surplus (netting out intra-European deficits), all regions of the world have to lend, one way or another, their surpluses back to the United States for the global current account to balance.

The process of financing the United States, however, differs significantly from region to region. The major European currencies float freely against the dollar. The flow of financing from Europe to the United States comes overwhelmingly from private European investors. However, most Asian currencies do not float freely against the dollar: China, Malaysia, Hong Kong explicitly peg their currencies to the dollar, and other countries often intervene heavily to prevent their currencies from appreciating against the dollar (and the Chinese renminbi). The result: Asian central banks, not private investors, are financing much of the US current account deficit.

Official US data significantly understates US dependence on foreign central bank financing, as work by Higgins and Klitgaard (2004) of the New York Federal Reserve Bank has

demonstrated. The increase in dollar reserves reported by the Bank of International Settlements provides a better measure of total central bank financing than the official inflows reported in the US data. The BIS data show that growing dollar reserves provided around \$485 billion in reserve financing for the United States in 2003,<sup>8</sup> and probably provided almost as much – \$465 billion – in 2004. This allowed the United States to finance enormous deficits without having to convince private investors abroad to dramatically increase their net claims on the United States. It also left the world's central banks with enormous exposure to the United States.

Not all reserves are invested in dollars, so global reserve accumulation exceeds the buildup of dollar reserves. The lion's share of reserve accumulation is taking place in Asia. In 2004 Asian central bank's added roughly \$535 billion to their reserves, other central banks are estimated to have added around \$165 billion to their reserves, a comparatively modest sum. Since Asian reserve accumulation far exceeded Asia's current account surplus,<sup>9</sup> Asian central banks are doing much more than just lending their own current account surplus back to the United States. This is most obvious in China, since China's reserve accumulation of \$200 billion in 2004 far exceeds its estimated \$70 billion current account surplus. By using large-scale capital inflows to fuel the rapid buildup of its reserves, the People's Bank of China effectively intermediates global savings, not

The financing of the US deficit differs significantly between Europe (private investment) and Asia (central banks)

<sup>8</sup> The BIS (2004) reported an increase of \$442 billion. This figure, however, needs to be adjusted to reflect the \$45 billion that the Chinese transferred from the People's Bank of China to two state owned banks.

<sup>9</sup> East Asia runs a current account surplus with the rest of the world, as its large bilateral surplus with the US more than offsets deficits from commodity-exporters. Intra-regional trade in East Asia has been growing, but some of that growth stems indirectly from growing trade with the US, as many Asian economies are supplying components or capital goods to China.

**The financing of the US current account deficit**  
\$ billion

	2000	2001	2002	2003	2004
Central bank financing – US data	43	28	114	249	355
Change in dollar reserves <sup>a)</sup>					
Reported by the BIS	51	83	185	486	465
Current account deficit	-413	-385	-474	-531	-666
Portfolio equity (net)	93	13	38	-63	-28
FDI (net)	162	25	-62	-134	-133
Total debt financing need	158	347	498	728	827

<sup>a)</sup> \$45 billion in reserves transferred from the People's Bank of China to two state-owned Chinese banks have been added to the BIS estimates of 2003 dollar reserve accumulation.

Source: BIS (2004), BEA and author's own estimates.

just Chinese savings: it transforms the world's demand for Chinese assets into demand for US Treasuries, US agency bonds, and other US debt.

Dooley, Folkerts-Landau and Garber (2003, 2004 a,b) have labeled this system of reserve financing the "Revived Bretton Woods System" (also referred to as Bretton Woods 2). The system is stable only so long as the world's central banks continue to add to their dollar reserves at an extremely rapid pace, financing the United States in the process. However, the tensions created by this system are large: There is a real high risk that the system will crack in the next two years and near certainty that the system will crack over the next four years. The implied reserve accumulation required to sustain the system for four more years is simply too large.

- Unless recent patterns reverse, the annual US borrowing need will continue to substantially exceed the current account deficit. Foreign direct investment by US firms abroad recently has exceeded foreign direct investment in the United States and Americans bought more foreign stocks than foreigners bought American stocks in both 2003 and 2004. Consequently, the annual borrowing need of the United States was close to \$830 billion in 2004, as it needed to finance a net equity outflow of bit more than \$160 billion along with a roughly \$666 billion current account deficit. In 2005, the United States may need to raise that much abroad just to finance its current account deficit; if net equity flows into the United States do not resume, it will have to borrow even more. Ongoing current account deficits imply that US net external liabilities will more than double over the next four years, rising from \$3.3 trillion now to \$7.4 trillion at the end of 2008.
- Private investors are unlikely to be willing to finance a large fraction of the trend \$800 billion a year current account deficit at current low US interest rate. The United States' ability to finance deficits of such a scale therefore hinges on continued large-scale financing of the United States by Asian – and other – central banks. Yet the longer this financing continues, the bigger the risks to the balance sheets of the world's central banks. If current trends continue, Asian central bank reserves would have to rise from an estimated \$2.4 trillion now to \$5.2 trillion at the end of 2008 – an annual increase of more than \$500 billion a year. Chinese and Japanese reserves would need to double. Foreign holdings of

Treasuries would rise from roughly \$2 trillion to around \$4 trillion. This enormous increase in exposure would come even as the United States' external credit fundamentals were deteriorating, implying enormous financial risks to any creditors extending financing to the United States in dollars at low nominal (let alone real) interest rates.

- Those countries now providing the most financing to the United States are also most exposed to the risk of future capital losses, since in general, their currencies have fallen less against the dollar than the major European currencies since 2002. Consider the case of China. If nothing changes, its reserves are likely to increase by \$240 billion a year – as investors will continue to bet on the renminbi's future appreciation. Assuming that China adds \$200 billion a year to its dollar reserves, China's dollar reserves would rise from an estimated \$465 billion today to \$865 billion in 2006, and \$1265 billion in 2008. These are enormous sums for an economy with a dollar GDP of only \$1.6 trillion. Such reserve accumulation implies absolutely enormous losses on the central banks' balance sheet should the renminbi eventually rise as much against the dollar.
- The rapid pace of reserve accumulation also poses real domestic financial challenges for many Asian economies. Preventing such large increases in reserves from bringing about an increase in the money supply (sterilization) is difficult, particularly if a country's financial system is not highly developed. In China in particular, rapid reserve growth is fueling rapid monetary growth, contributing to inflationary pressures and helping to fuel an investment and real estate bubble. The administrative steps taken to limit inflationary pressures only add to the economy's existing distortions.

#### *The case for starting to adjust now*

Pulling off the adjustment needed to unwind the current US external deficit smoothly will be a major policy challenge, both for the United States and the world. It is far easier for the needed adjustment to happen smoothly if it starts sooner rather than later: the US external debt to GDP ratio will almost double over the medium term – peaking at over 50 percent of GDP – *even if* the US trade deficit started to shrink by about 0.5 percent of GDP annually.<sup>10</sup> The United States will still need to attract substantial amounts of external financing even after it starts to adjust. If the

<sup>10</sup> Since 2001, the US trade deficit has deteriorated at a similar pace. Such adjustment requires US exports to grow roughly twice as fast as US imports.

The Chinese central bank transforms world demand for Chinese assets into demand for US debt instruments

US current account keeps on rising until the external debt to GDP ratio reaches 40 or even 50 percent of GDP, the needed adjustment is likely to have to occur more rapidly, and cause greater disruption, than if the adjustment process started now.

Make no mistake: the large US current account deficit reflects macroeconomic policy choices, notably the large US fiscal deficit and East Asian governments' policies of reserve accumulation to support export-led growth, not just market forces. On their own, private capital flows would have financed a \$200 billion current account deficit in the United States in 2004 – not a \$650 billion US current account deficit. The needed adjustment in the US current account deficit will happen smoothly only if backed by supportive macroeconomic policies, and a degree of tacit coordination between the United States, Europe and the major Asian economies, especially China and Japan.

The broad outlines of the needed policy changes are by now well known.

- *Fiscal adjustment in the United States.* A low savings economy like the United States can only run large budget deficits without crowding out domestic investment by drawing on the world's savings. Recently, the United States has sacrificed exports (and jobs in export sectors of the economy) for cheap financing from East Asia (and jobs in interest sensitive sectors of the economy). If Asia reduced the pace of its reserve accumulation and the United States continued to run a large fiscal deficit, US interest rates would have to rise sharply, crowding out productive investment.
- *Exchange rate adjustment and policies that support demand growth in East Asia.* A US current account deficit of nearly 6 percent of GDP cannot be reduced if the fastest growing, most dynamic parts of the world economy continue to maintain exchange rates that suppress domestic consumption by keeping the domestic price of imports high. China in particular is now too big not to play a more constructive role in global economic management. Given its large stock of reserves, its rapidly expanding economy and its ability to attract over \$50 billion a year in foreign direct investment, there is no reason why China should not run a modest current account deficit.
- Europe – and in particular the ECB— needs to do more to stimulate European demand. However, Europe cannot bring about the needed global rebalancing alone: it simply is not poised for a

dramatic boom in consumption that would let Asia continue its export-led growth while the United States started its own process of export-led growth. Europe needs to do more, but even with policies directed at supporting domestic demand growth, the aging, already developed economies of Europe are unlikely to be able to contribute as much to global demand growth as younger, more dynamic economies elsewhere.

East Asian economies cannot painlessly extricate themselves from their enormous – and growing — financial bet on the US dollar. This should not give the United States much comfort, however. The United States cannot quickly extricate itself from its dependence on the cheap financing provided by Asian reserve accumulation any more easily. Those who argue that the system of Asian reserve financing is stable because Asian central banks cannot sell their existing stock of Treasuries without causing the market to move against them miss an important point. The Bretton Woods 2 regime would come to a rapid end if Asian central banks, in aggregate, just decided to stop adding to their dollar reserves at their current pace. The stability of the world economy hinges on the willingness of all parties to maintain what Larry Summers accurately called “the balance of financial terror” and double down their existing bets.<sup>11</sup>

The United States and Asia face a troubling dilemma. Immediate adjustment to end US external deficits would be extremely costly. The boom in housing created by low interest rates and, for that matter, the surge in value of all financial assets linked to low interest rates, would come to an abrupt end without access to Asian financing. Yet, the longer adjustment is delayed, the more costly it will be. The continued transfer of resources out of the production of tradables that cheap financing from abroad implies bodes ill for the long-run health of the US economy. The United States is left trying to support an ever-increasing external debt load on the back of a shrinking tradables sector.<sup>12</sup> Asian central banks are left with an ever-increasing stash of low yielding Treasuries whose

<sup>11</sup> Summers (2004).

<sup>12</sup> Rogoff (2003) has emphasized that the external adjustment process is more difficult if a country “does not export.” Bringing about the adjustment required to close a 5 percent of GDP (or larger) trade deficit off a 10 percent of GDP export base could well require large moves in the exchange rate and other key economic variables. The currency appreciation associated with the end of Asian central bank intervention would lead, over time, to higher production and employment in the US export and tradables sectors. But since these sectors are small relative to the sectors that would be hurt by higher interest rates, the short-run impact on overall employment and output could well be negative.

Adjustment should start now and should be coordinated

value will drop the moment Asian central banks stop adding to their holdings of dollars.

The good news of our analysis is that it is possible to conceive of a scenario where the United States begins to adjust before its creditors force it to adjust, and Asian economies gradually reduce their dependence on export-led growth. Even in this scenario, the United States will still see its external debt to GDP and debt to exports ratios rise to levels that would be alarming for any country that is not a reserve currency country and is not able to borrow from abroad in its own currency. That is why the adjustment process needs to start now: it is far better for the US debt to GDP ratio to rise gradually to 50 percent of GDP and stabilize than for the US debt to GDP ratio to surge to 50 percent before triggering a crisis.

## Conclusion

The policy mess created by large US fiscal deficits, meager private savings and resulting dependence on cheap external financing, Asia's equally ingrained dependence on the United States to help drive its own growth, and persistent weakness in European demand cannot be solved overnight. But policymakers in the United States, Europe and Asia need to recognize that letting the current disequilibrium continue poses unacceptable political and economic strains. No system that requires that key actors knowingly add to their future financial losses can be all that stable. In the short run, the needed adjustments will pose difficulties for all major parts of the current international monetary system. However, in the long term, the needed adjustments are in the interest of both the United States and its major creditors – including China. Producing only to export, and building up external assets that are never spent makes little sense. Greater reliance inside Asia on domestic demand and less reliance on foreign demand is consistent with an increase in Asians' real incomes and welfare, just as a rebalancing of US growth so that it is based more on net exports and less on consumption is necessary for the long-run health of the US economy.

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