

The Dollar and the Current Account Deficit:
How Much Should We Worry?

By Michael Mussa
Senior Fellow, the Peterson Institute for International Economics

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Twenty-four years ago here in Chicago, I opined for the first time before a large public gathering—the GSB Business Forecast Luncheon—that the exchange rate of the U.S. dollar had become too strong and the dollar would need to depreciate. A year later, with the dollar 15 percent stronger, I repeated that assessment; and I did the same in December 1984 when the dollar was up another 20 percent. Finally, the market got it right and from its peak in February 1985, the dollar depreciated over the next three years, reversing all of the enormous appreciation that had occurred since 1980.

From this experience derives one key conclusion: In assessing the exchange rate of the dollar and the sustainability of the U.S. external payments position, the cardinal virtue is—modesty. Like every other virtue, however, modesty can be overdone.

At its latest quarterly reading, the U.S. current account deficit was running at \$900 billion per year. This is equivalent to almost 7 percent of U.S. GDP is roughly double the peak deficit as a share of GDP that was reached in the 1980s. Like most, but by no means all, international economists, I have said for some time that the U.S. current account deficit cannot continue to expand as it has for the past fifteen years and that at some time, probably before much longer, it will need to start to shrink as a share of U.S. GDP.

Modesty is maintained by being somewhat vague about when and how fast the U.S. external deficit will need to shrink and by emphasizing that deficits on the order of half of their present size (as a share of U.S. GDP) may well be sustainable for the foreseeable future. Nevertheless, the implication is clear that three things will need to happen over the next decade or so in order to bring a substantial reduction in the U.S. external deficit. (1) The U.S. dollar will need to depreciate substantially in real effective terms, probably by at least another 20 percent to cut the current account deficit by half. (2) U.S. domestic demand will need to grow more slowly than U.S. actual (and potential) output, reversing the trend of the past fifteen years. And (3) domestic demand in the rest of the world will need to grow more rapidly than actual (and hopefully potential) output. I emphasize that these three basic requirements are **not** alternative means for reducing the U.S. external deficit and the corresponding surplus of the rest of the world; they are jointly necessary.

Alfred E. Newman versus Chicken Little

In view of the experience of the past fifteen years, one might reasonably ask why the U.S. external deficit needs to start shrinking or, indeed, cannot keep on growing?

Despite the substantial deterioration of the U.S. net foreign asset position from significant surplus to a deficit of about 25 percent of U.S. GDP, the U.S. reportedly continues to earn as much on its foreign assets as foreigners earn on their U.S. assets. And, at least some prominent economists have argued that the growing U.S. external deficit is primarily a reflection of a savings glut in the rest of the world which leads foreigners to want to dump large, and perhaps ever increasing, amounts of their net saving onto U.S. based assets. Indeed, there is a school of thought among some prominent economists—which I call the Alfred E. Newman What Me Worry School—that maintains there is virtually not practical limit the scale and longevity of the U.S. external payments deficit and to the associated buildup of U.S. net external liabilities.

Other prominent economists and pundits adhere to what may be termed the Chicken Little The Sky is Falling view of the U.S. external deficit. A day of reckoning is fast approaching when foreigners will no longer be willing to add rapidly to their already large net accumulations of U.S. based assets. When this happens, the value of the dollar in foreign

exchange markets will crash and cost of capital to finance investment in the United States will shoot up, restricting demand within a much reduced supply of domestic and foreign saving. The U.S. economy will fall into steep recession as investment and consumption spending are curtailed and the Federal Reserve is constrained by worries about the possible inflationary effects of a much weaker dollar. Meanwhile, a sharp fall-off in exports to the U.S. will undermine growth in the rest of the world and threaten a serious global recession.

The truth presumably lies somewhere between these two extreme schools of thought. In my view, it is a little closer to Alfred E. Newman than Chicken Little. Substantial U.S. external deficits probably can and will go on for some time, but the an ever growing deficit (as a share of U.S. GDP) is not feasible in the long run, and even the present level of the deficit is not likely to be sustained for another five years. The foreign exchange value of the U.S. dollar will need to depreciate substantially, particularly against Asian currencies, as part of the process of adjustment to significantly lower U.S. deficits. This adjustment process will not be completely smooth, but risk of a highly disruptive “dollar crash” is not particularly great. Policy measures, including more aggressive efforts to improve the U.S. fiscal balance and more rapid appreciation of the Chinese exchange rate, could and should usefully reduce these risks, but the likely benefits of such actions should not be exaggerated.

The Need to Reduce the U.S. External Deficit

Reflecting a variety of factors, including the higher return on foreign assets held by U.S. residents than on U.S. assets held by foreign residents, the deterioration of the U.S. net asset position over the past decade has been significantly less than the reported cumulative U.S. current account deficit over this period. Nevertheless, a persistent U.S. current account deficit of about 7 percent of GDP implies that U.S. net foreign liabilities, which are presently about 25 percent of U.S. GDP, will eventually rise to over 100 percent of U.S. GDP. This implied long-run ratio will be even higher if the U.S. current account deficit continues to expand (as a share of GDP).

There is no clear upper bound to U.S. net foreign liabilities. However, experience provides no examples of large countries that have run their ratios above 100 percent of GDP. Moreover, the likely bound on net foreign liabilities needs to be judged relative to the stock of marketable assets that

may be relatively easily traded among U.S. residents and potentially held by foreigners—not relative to the total U.S. wealth measured as the expected present value of U.S. net national product (which includes the value of a great deal of human capital and other assets that are not marketable). The value of marketable U.S. based assets (equities, bonds, mortgages and some direct claims to real assets) is roughly 400 percent of U.S. GDP. For foreigners to hold a net position equal to 100 percent of U.S. GDP, their gross position in U.S. based assets would probably have to be at least 200 percent of U.S. GDP. It is questionable whether either foreigners or U.S. residents would be very comfortable if foreigners owned one-half of all U.S. based marketable assets.

More immediately, it is noteworthy that the willingness of many foreigner investors to accumulate additional U.S. based assets seems to be diminishing. In the late 1990s, when the U.S. current account deficit rose to 4 percent of U.S. GDP, most of the flow of foreign financing came from foreign private investment flows into U.S. assets. In recent years, these private flows have diminished and have been more than replaced by rapidly expanding official flows associated with massive reserve accumulation by several Asian countries (especially China) and, more recently, by a number of oil exporters. Over time, these official flows are also likely to diminish, as is already suggested by decisions of some authorities to diversify their reserve holdings to some degree out of U.S. dollars.

Indeed, we already see evidence that the process of downward adjustment of the U.S. external deficit is underway. The substantial depreciation of the U.S. dollar against the currencies of most industrial countries (except Japan) since early 2002 is presumably a manifestation of diminishing relative enthusiasm for U.S. dollar investments, at least where market forces operate without significant official involvement. This depreciation of the dollar against most industrial country currencies has reduced the real effective foreign exchange value of the dollar by about 10 percent since the peak in early 2002. With the usual lag of about two years, effective dollar depreciation, together with the relative strengthening of growth in other countries, has stabilized the U.S. external deficit when measured in real volume terms since late 2004; and the fourth quarter of 2006 will probably see a significant decline in this measure of the real payments deficit. The current account deficit as a share of GDP may also show a modest decline next year, especially if world oil prices remain below their average 2006 level.

The Market Based Process of Adjustment

The build-up of the deficit took many years and primarily involved the operation of market forces responding to evolving global economic conditions in ways that mainly helped to preserve global prosperity. So too should we expect that the gradual (and partial) unwinding of the now huge U.S. external deficit to take a number of years and will involve primarily the operation of market forces.

More specifically, as foreign investors become less willing to add to their hoards of U.S. assets, it is reasonable to anticipate that the foreign exchange value of the U.S. dollar will continue the decline that has been underway since early 2002 and that the cost of foreign capital to finance the excess of U.S. investment over U.S. saving will increase somewhat. The weaker dollar will tend to encourage U.S. exports (which are already growing quite rapidly) and discourage U.S. imports. If slower growth of U.S. domestic demand (responding partly to higher costs of foreign capital) does not make adequate room for improving U.S. real net exports within the confines potential output growth, then U.S. macroeconomic policy will need to step in. A somewhat more aggressive tightening of U.S. fiscal policy, which is desirable in its own right as the means to address longer-run fiscal challenges, would be helpful in this regard. If this is not forthcoming, then U.S. monetary policy will play the needed role—as it has during the recent cycle of Federal Reserve tightening.

For the rest of the world, maintaining adequate output growth in the face of appreciating currencies relative to the U.S. dollar and declining net exports to the United States may pose a challenge for some countries. The scope of this challenge, however, should not be exaggerated. The rest of the world economy is about three times as large as the U.S. economy (valued, appropriately for these purposes, at market exchange rates). Most developing countries are growing vigorously and can continue to do so. Moderate adjustments in macroeconomic policies, in accord with standard operating procedures (such as flexible inflation targeting) will naturally tend to offset weaknesses in output growth emanating from interactions with the U.S. economy. We have seen some of this already. The current cycle of monetary tightening by the European Central Bank has usefully lagged well behind the pace set by the Federal Reserve. The Bank of Japan has moved very cautiously in adjusting to a more normal stance for short-term interest

rates as the Japanese economy has gathered strength over the past three years.

Risks of a Dollar Crash

Of course, the gradual process of reducing the U.S. external deficit will not be completely smooth, especially as regards the exchange rate of the U.S. dollar. During more than three decades of floating exchange rates among the major industrial country currencies, the annual change (on a yearend basis) for the exchange rates between the dollar and either key European currencies or the Japanese yen have averaged 10 percent and annual changes of 15 percent or more have not been particularly unusual. Movements of the dollar against the euro since that currency was instituted in 1999 have continued that pattern. Movements of exchange rates of the dollar against developing country currencies are more difficult to characterize, but large changes over relatively brief periods have not been unusual.

Looking ahead, we may be reasonably confident that a significant downward adjustment of the U.S. external payments deficit will be associated with substantial downward adjustment in the real effective foreign exchange value of the U.S. dollar. The course of the dollar against individual currencies will be erratic, with a general bias toward depreciation especially for those currencies (particularly in Asia) where little or no downward correction against the dollar has occurred since early 2002. Sudden sharp appreciations of some currencies against the dollar may well be part of this general picture. Experience suggests that the Japanese yen is particularly vulnerable in this regard, especially in view of the present substantial undervaluation of the yen relative to a reasonable assessment of its medium term fundamentals. If this were to happen, the Japanese economy would likely feel a significant negative short-run shock, as it did from the sudden yen appreciations in 1985-87 and 1993-95. Other countries could also be vulnerable to such shocks.

However, both experience and analysis suggest that we are unlikely to see a sudden massive depreciation of the U.S. dollar on a real effective basis that threatens significant damage to both the U.S. and the rest of the world economies. Between early 1985 and late 1987, the U.S. dollar lost about one-third of its value against foreign currencies. Despite a spectacular stock market crash in October 1987, however, the U.S. economy prospered

throughout this period and thereafter. Aside from a temporary slowdown in Japan, the rest of the world economy absorbed the massive depreciation of the U.S. dollar without much apparent difficulty. The fears of the alarmists who worried about a “hard landing of the dollar” never really materialized.

This time, of course, things could be different. Growth in the other industrial countries is generally less robust than it was in the mid and late 1980s. But, for most of these countries exchange rates have already adjusted quite considerably, leaving primarily Japan in an exposed position. Developing countries now have a much larger share of world GDP and world trade than 20 years ago. Here, as previously noted, growth has been strong and there is little reason for pessimism about the ability to accommodate a reasonable share of the moderate and gradual improvement that is needed in U.S. real net exports.

Moreover, there is strong reason to believe that the United States is not very vulnerable to the type of exchange rate crisis that afflicted a number of emerging market countries from the mid 1990s through 2003. Unlike emerging market countries caught up in recent crises, U.S. external debt is primarily denominated in U.S. dollars not in foreign currencies. This means that foreign owners of U.S. debts have no reason to panic that dollar depreciation will leave U.S. debtors unable to service their foreign obligations. Also, on balance U.S. residents have net positive holdings of foreign assets that are likely to rise in value with dollar depreciation. This means that sudden depreciation of the dollar is likely to have a positive effect on U.S. wealth that will tend to augment the positive net trade effect of dollar depreciation on demand for U.S. output—in contrast to the large negative wealth effects that adversely impacted many emerging market countries caught up in exchange rate crises. In addition, large sudden depreciation of the U.S. dollar is likely to be actively resisted by official intervention as national authorities (other than the U.S.) seek to protect their economies from too much currency appreciation.

A Role for Policy

Although the risk of a cataclysmic collapse of the U.S. dollar is low, it is still reasonable to ask what policy might do to diminish further this risk and to facilitate the gradual reduction in the U.S. external payments deficit? In this regard, two points deserve particular emphasis.

First, it has already been argued that more aggressive efforts at U.S. fiscal consolidation are both needed for their own sake and would likely contribute to reduction of the U.S. external payments deficit in a globally constructive manner. Without negating this point, it is also important to emphasize that U.S. fiscal consolidation is not the be-all and end-all of policies to address the U.S. external deficit. In particular, the “twin deficits theory” that asserts that the U.S. external deficit is primarily the consequence of the U.S. fiscal deficit as largely nonsense. The fact is that the U.S. current account deficit disappeared between 1987 and 1991 as the fiscal deficit expanded to a postwar peak (as a share of U.S. GDP). Then the current account deficit widened to a new record of over 4 percent of U.S. GDP in 2000 as the fiscal deficit moved from large deficit to significant surplus. Most recently, over the past three years, the U.S. external deficit has continued to expand while the fiscal deficit has fallen by about half.

Second, China’s exchange rate policy is not the principal cause of the U.S. external deficit or a cause of substantial harm to the U.S. economy (despite its negative impact on some sectors). However, China’s exchange rate policy is misguided from the perspective of Chinese and global economic welfare and is a meaningful impediment to orderly reduction of international payments imbalances. This conclusion is now broadly accepted by most international economists, including those at the IMF. But some, including members of this panel, maintain the misbegotten view that holding the exchange rate of the Chinese yuan virtually pegged to the U.S. dollar at close to 8 to 1 is a sustainable and desirable policy.

Let us recall that over the past fifteen years there are literally dozens of countries—in Europe (remember the ERM crises of 1992-93), in Africa (remember the 50 percent devaluation by the CFA countries in 1994), in Latin America, and in Asia—that have sought to maintain substantially overvalued exchange rates and have been forced to devalue in the midst of foreign exchange crises. Is it believable that all of this was a vast mistake and that these countries should have and could have fought through to maintain their pegged or quasi-pegged exchange rates? Is it believable that countries with pegged or quasi-pegged exchange rates only get into situations where their exchange rates are substantially overvalued and never substantially undervalued? Is it believable that the salient facts of the present Chinese case—substantial real effective depreciation of the currency over the past five years, a rapidly growing current account surplus now likely reaching 9 percent of China’s GDP (despite rising energy import

costs), and massive persistent accumulation of official foreign exchange reserves to set a new world's record—can somehow be explained away as not persuasive indicators of substantial exchange rate overvaluation?

My answer to these questions is drawn from the plot of the typical Doris Day movie: No! No! No! A thousand times, No!

The argument that the Chinese authorities should not immediately move the exchange rate to a plausible estimate of its medium-term equilibrium value (probably around 5 yuan to the dollar assuming substantial exchange rate adjustments by other Asian countries including Japan) is reasonable. Stimulating a crash of the dollar by official Chinese action would be unwise for everyone. But the need for substantial appreciation of the yuan against the dollar over the medium term is unmistakable—and it needs to proceed far more rapidly than it has over the past 18 months.